



The Global Meltdown

A Background Brief

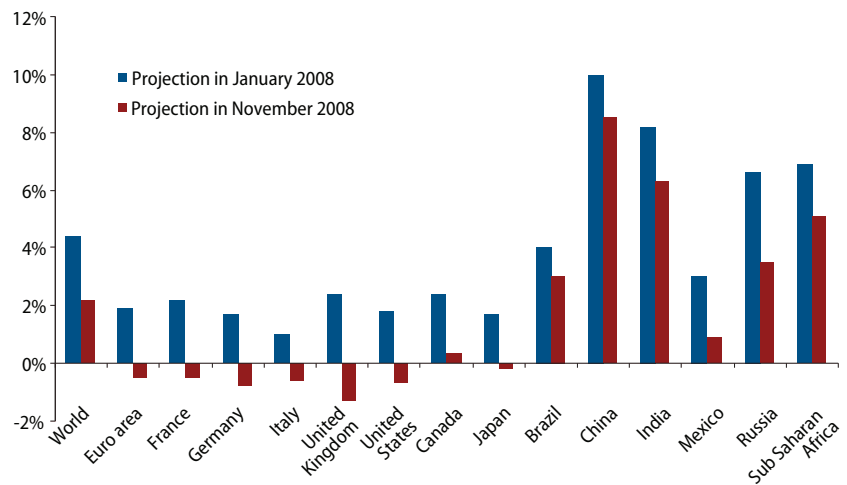
Will Straw December 2008

The global financial crisis has its origins in the U.S. subprime mortgage crisis of August 2007. It seemed initially that it would only affect developed countries, but the so-called “decoupling phenomenon,” which predicted that developing countries would remain unaffected, has not occurred. Instead the crisis has become a global phenomenon, as the following measures indicate.

Growth

Expectations of growth rates for 2008 have fallen in most countries. In October 2007, world growth was predicted to be 4.8 percent. The International Monetary Fund now predicts that it will be 3.7 percent. Expectations for 2008 growth for advanced economies now stand at 1.4 percent, down 0.8 percentage points from predictions made in October 2007. Expectations for emerging and developing country growth in 2008 now stand at 6.6 percent, also down 0.8 points from a year ago.

Chart 1: The drop in growth projections for 2009



Source: IMF

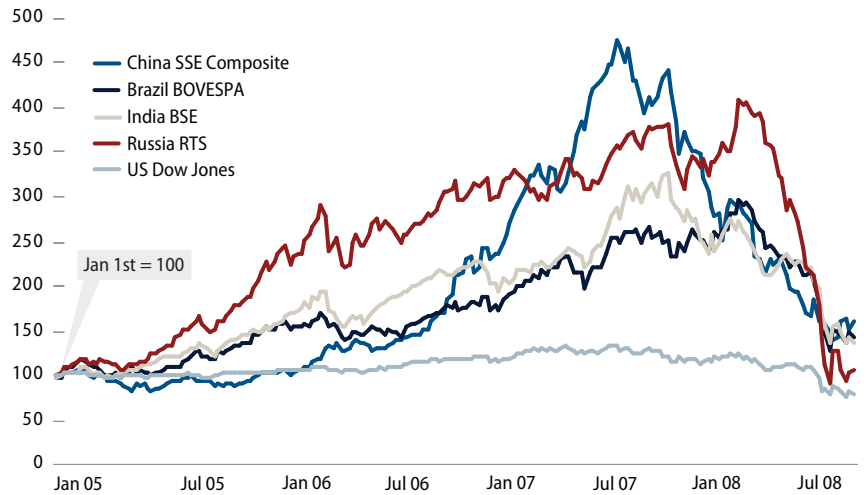
Chart 1 shows 2009 growth projections for several countries and regions. Expectations of 2009 growth fell everywhere between January and November. Projections of world growth for 2009 slumped from 4.4 percent in January to 2.2 percent today—effectively a global recession. Every G7 country aside from Canada is expected to contract next year

and the United States and United Kingdom are already in recession. Every BRIC country (Brazil, Russia, India, and China) has seen growth expectations fall by between 1 and 3 percentage points.

Stock markets

As expectations of growth have fallen and credit has remained frozen, stock markets have been adversely affected. Dramatic drops in developed countries have been well documented, but since reaching highs in 2007 or early 2008, stock markets have fallen in every G20 country—aside from South Africa—with an average fall of 45 percent. As Chart 2 shows, the BRIC countries have faced dramatic collapses in their stock markets during 2008 following rapid expansion in the preceding three to four years. Stock markets for these countries are now at or below their 2005 values. Indeed, the Russia Trading System has lost 76 percent of its value so far in 2008.

Chart 2: Stock market performance, January 2005 to December 2008

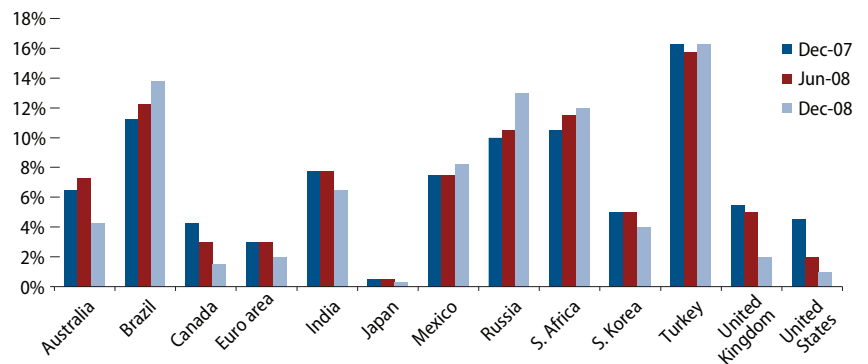


Source: Yahoo Financial; RTS.ru

Policy responses

The global credit crisis combined with collapsing share prices and the looming risk of recession have led to calls for dramatic policy interventions, including coordinated interest rate cuts, bailouts for the banking sector, and large fiscal stimulus packages. The communiqué from the world leaders' summit on November 15 said that G20 countries would, "Recognize the importance of monetary policy support,

Chart 3: Interest rates since December 2007 in selected countries



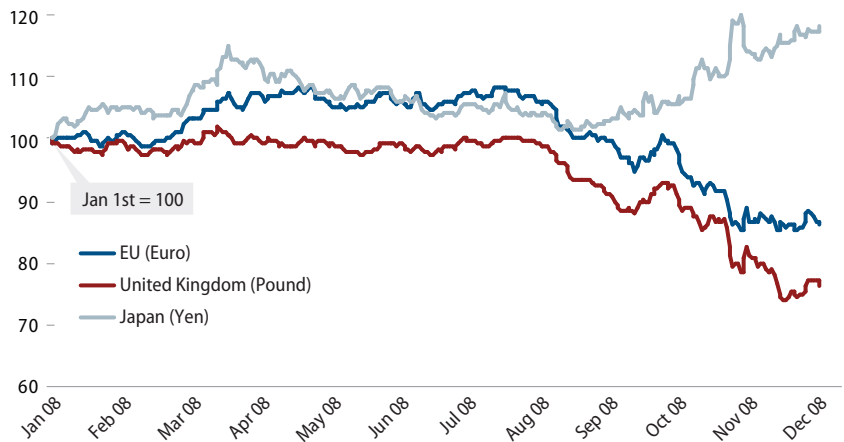
Source: Central Bank websites. Note: Interest rate figures vary by country. We used the interbank rate in Canada, Mexico, and Turkey; the policy rate in Australia, Brazil, Japan, South Korea, and the United Kingdom; the deposit facility rate for the eurozone; the refinancing rate in India, Russia, and South Africa; and the Fed Funds Rate in the United States. China is excluded because it targets the reserve requirement ratio.

as deemed appropriate to domestic conditions [and] use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.” These tools, however, have not been available to all countries. Stimulative monetary policy has only been possible in a handful of countries. Chart 3 shows interest rate changes across a range of G20 countries in December 2007, June 2008, and December 2008.

The United States undertook the most dramatic interest rate cut from 4.5 percent to 1.0 percent. The United Kingdom and Canada also cut their rates throughout the year. China has adopted an alternative form of stimulative monetary policy and cut its reserve requirement ratios in recent months. But other countries, particularly in the developing world, have seen their interest rates rise as capital flight has taken hold and hot money has sought less-risky havens such as Treasury Bills. Brazil, South Africa, and Russia, for example, all have interest rates above 10 percent which continue to rise.

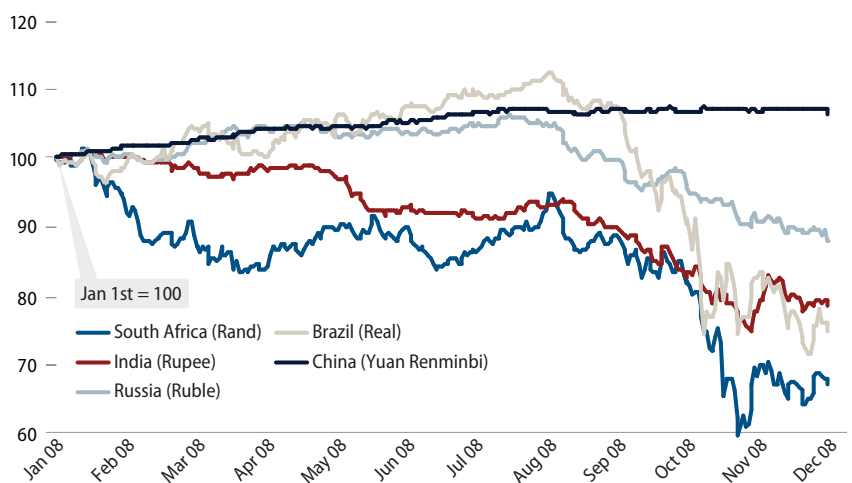
Capital flight has also had a profound impact on exchange rates. In every G20 country aside from China and Japan, exchange rates have depreciated, including falls since January of over 20 percent for Australia, Brazil, Canada, India, South Africa, South Korea, Turkey, and the United Kingdom. Many currencies have faced a particularly dramatic slide in recent weeks. For example, in the month of October alone, the South African rand lost 25 percent of its value. Chart 4 outlines the exchange rate performance

Chart 4: Developed country exchange rate performance vs. the dollar, since January 2008



Source: onada.com

Chart 5: Percentage depreciation in domestic currency per \$1, Sept.-Nov. 2008



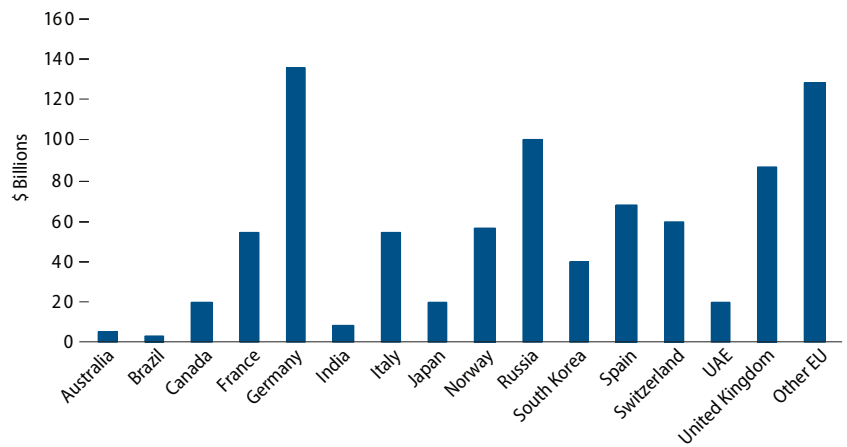
Source: onada.com

against the dollar of the other three major global currencies. Chart 5 depicts a similar story for the key middle-income countries: Brazil, China, India, Russia, and South Africa.

More countries have been able to announce rescue packages for their domestic financial sectors. Policy measures have included deposit insurance, short-term loan guarantees, the purchase of shares in financial institutions, and the removal of bad assets from bank balance sheets. Chart 6 shows the authorized levels of expenditure on recapitalization and liquidity in a range of countries. The \$700 billion that Congress has made available to Treasury Secretary Henry Paulson to buy preferred stock in struggling banks has been well documented, but many other countries have provided bailouts. This includes a \$100 billion liquidity injection in Russia, \$19 billion for emergency bank use in the United Arab Emirates, and \$8 billion released into the banking sector in India by cutting the reserve requirement ratio.

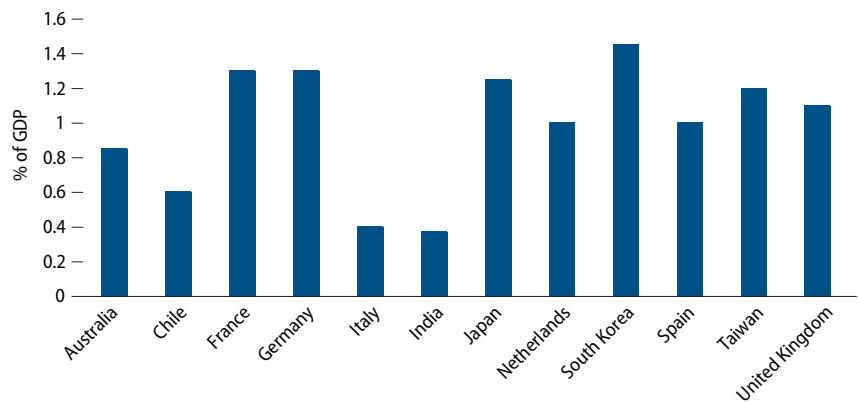
In addition to these bailouts, sovereign governments are being encouraged to use fiscal stimulus packages to kickstart their domestic economies. China announced a \$586 billion package worth 14 percent of gross domestic product on November 8 [although this number has been challenged]. Britain announced on November 24 a package of tax cuts and speeded up investment measures worth 1.1 percent of GDP. The United States is expected to follow suit with a stimulus package worth 2 to 4 percent of GDP by January at the latest. Australia, Chile, Germany, Italy, Japan, South Korea, and Taiwan are other countries that have been able to announce stimulus packages as shown in chart 7.

Chart 6: Recapitalization and liquidity injections



Source: Financial Times; Central Bank websites

Chart 7: Fiscal stimulus packages excluding China



Source: Government websites; Financial Times; Bloomberg.

Many other countries, without either reserves or the ability to increase borrowing by issuing government bonds, have their hands tied. Iceland, Hungary, Ukraine, and Pakistan have already been forced to rely on the IMF's lending facility.

Conclusion

The U.S. subprime mortgage crisis, which became a developed country banking crisis, is now a global economic meltdown. Global growth projections have fallen, stock markets have plummeted, and currencies have lost value against the dollar. Meanwhile, the call has increased for coordinated monetary policy interventions, bank bailouts, and fiscal stimulus packages.

As outlined in this briefing paper, these policy interventions are only available to the handful of countries which have the ability to defend themselves from capital flight or can fund their fiscal deficits. With the notable exception of China, most middle-income countries have struggled to make the necessary policy interventions. Least-developed countries look on with concern as necessary expansions in development assistance are threatened. Options for these countries are running out, but the costs of inaction could be even more catastrophic.

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