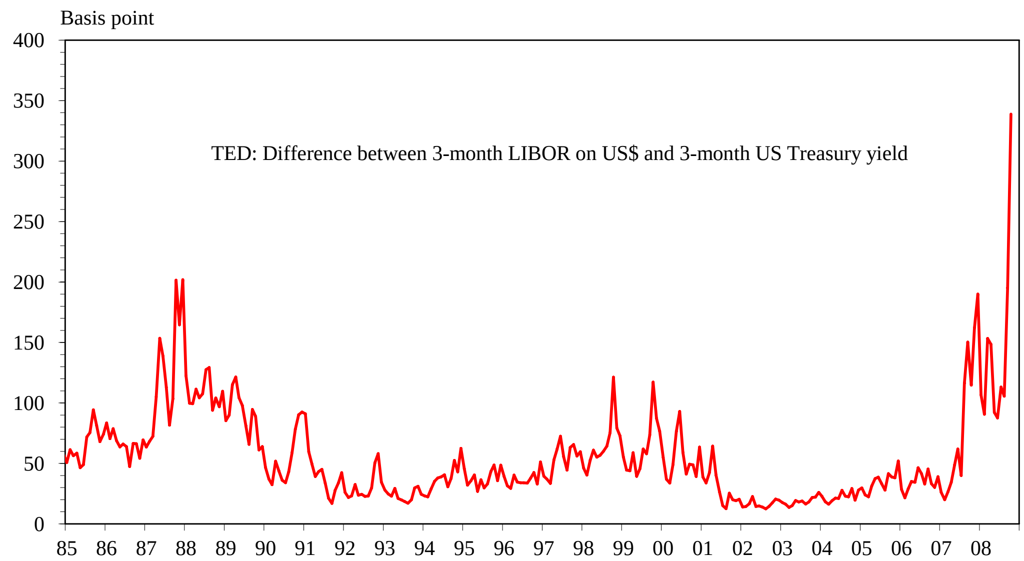
Box 1.1

Will the financial tsunami cause a steeper and longer global recession?

The global financial crisis, that has been lingering on since August last year, deepened abruptly in September, following the collapse of Lehman Brothers, the US's fourth largest investment bank. The serious concerns about insolvency of financial institutions clogged credit markets in the advanced economies, and increased markedly the systemic risks to the global financial systems. As an indication, the rate that banks charge each other, the London Interbank Offered Rate (LIBOR) on the US dollar, has been trading so high above three-month US Treasury-bill rates (on 10 October it was 4.82% vs. 0.25%, giving a TED spread of 457 basis points) that lending among banks have virtually come to a halt. This so-called TED spread signals the health of credit markets and has rarely been over 100 basis points (Chart 1). With governments of the major advanced economies taking various unprecedented measures, including direct equity injection into banks, credit markets have showed some signs of soothing after mid-October.

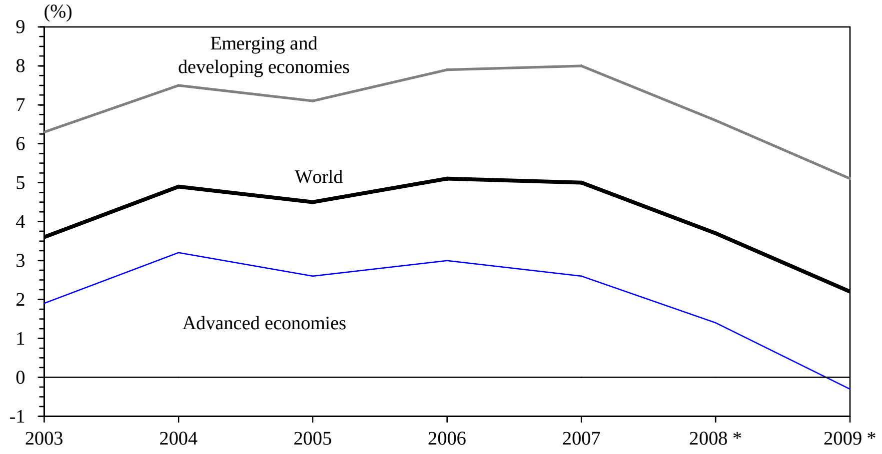
Chart 1: TED spread surged to the largest in decades in October (monthly average)



Recognising the crisis as the most dangerous financial shock in mature financial markets since the 1930s, the International Monetary Fund (IMF) noted in early November that global activity is slowing quickly, as financial sector deleveraging has continued and producer and consumer confidence have fallen. World economic growth is projected to moderate to 3.7% in 2008 and 2.2% in 2009 from the 5.0% in 2007 (Chart 2). The advanced economies would be in recession well into 2009, and the anticipated recovery will be exceptionally gradual by past standards. In advanced economies, output is forecast to contract on a full-year basis in 2009, the first such fall in the postwar period. Growth of emerging and developing economies, mostly export-dependent, will also slow notably.

Box 1.1 (Cont'd)

Chart 2: The global economy entering a major downturn
(year-on-year GDP growth)



Source: IMF World Economic Outlook Update November 2008
(*) Forecast from the IMF

Given the deepening financial crisis, the economic situation is exceptionally uncertain and subject to considerable downside risks. The biggest risk for the advanced economies, in particular the US and some other European economies that are experiencing housing market downturn, is a negative feedback loop between financial market strains and housing market falloff, mutually reinforcing each other to a downward spiral of balance sheet adjustments, tighter credit conditions, lower asset prices and further financial market strains. Meanwhile, risk aversion and financial market contagion have led to severe strains on developing economies with high external debt, large current account deficits or problematic financial systems. All these suggest that the risk of the global economy experiencing a longer and steeper downturn is considerable.

Box 1.1 (Cont'd)

Financial Tsunami – Selected key events

Jul 2006	US housing prices peaked, more than doubled the level in Jan 2000.
Feb 2007	A major bank announced losses linked to US subprime mortgages, the first of a long series of similar announcements by key financial institutions.
Aug	French bank BNP Paribas stopped withdrawals in three investment funds.
Sep	UK bank Northern Rock admitted financial difficulties.
Feb 2008	UK bank Northern Rock nationalized.
Mar	An UK hedge fund and an US private equity fund failed. US investment bank Bear Sterns collapsed and taken over by JP Morgan.
Aug	German bank AG took over investment bank Dresdner Kleinwort.
7 Sep	US Treasury took over Fannie Mae and Freddie Mac.
14 Sep	Lehman Brothers filed for bankruptcy. Merrill Lynch sold to Bank of America.
16 Sep	AIG Corp, the US's biggest insurer, bailed out by the Fed.
17 Sep	Halifax Bank of Scotland (HBOS) merged with Lloyds TSB in an emergency rescue plan.
18 Sep	Central banks injected billions into global markets.
25 Sep	Washington Mutual sold to JP Morgan.
29 Sep	US Congress rejected the US$700 bn rescue plan. UK's Bradford and Bingley nationalized. German bank Hypo Real Estate bailed out by banks and government. Belgian bank Fortis bailed out by governments of Netherlands, Belgium and Luxembourg. Iceland part-nationalized one of its largest banks.
30 Sep	Belgium bank Dexia bailed out by governments of France, Belgium and Luxembourg. Irish government announced guarantees for debts and deposits and similar moves made by other governments in the ensuing weeks.
3 Oct	US Congress passed the US$700 bn plan into law.
7 Oct	Iceland nationalized another large bank.
8 Oct	UK Treasury announced £500 bn bank rescue package. Coordinated interest rate cuts by six central banks.
10 Oct	G7 issued a 5-point plan, endorsed by IMF and World Bank members. Iceland nationalized another large bank.
11-12 Oct	EU leaders agreed to guarantee loans between banks until end-2009. Germany, France and Italy announced bank rescue plans.
13 Oct	UK injected equity into three banks.
14 Oct	US announced US$250 bn plan of equity injection into banks.
16 Oct	Swiss government injected US$59.2 bn into UBS. Hungarian central bank obtained cash injection from ECB.
19-21 Oct	Korean government announced plans to inject US$130 bn into banks and guarantee external debt. Swedish government announced a 1.5 trillion kronor plan to guarantee loans and inject capital into financial companies. French government announced to inject 10.5 bn euros into the nation's six biggest banks, and the Fed to provide up to US$540 bn in loans to help relieve pressure on money-market mutual funds beset by redemptions.
23-31 Oct	Standard & Poor's cut the outlook on Russia to negative from stable. China, Japan, South Korea and 10 members of ASEAN agreed to set up a US$80 bn fund to help countries in crisis. IMF agreed to lend US$2.1, US$16.5 and US$15.7 bn respectively to Iceland, Ukraine and Hungary.