HM Government

The road to the London Summit:

The plan for recovery

THE LONDON SUMMIT 2009

STABILITY | GROWTH | JOBS

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The London Summit

On 2 April 2009, world leaders from the G20 countries – representing 85% of the world's output – will meet in London. They will meet against the backdrop of the worst international banking crisis in generations. Confidence in the international banking system has fallen. Major institutions have failed. Countries around the world have entered recession, with falling trade and rising unemployment.

Governments have had to step in where markets failed. Like countries around the world, the UK Government has taken unprecedented action. Its plan for recovery has four pillars: to protect savings; to provide real help for families and businesses in the downturn; to ensure that banks maintain lending; and to invest in a resilient recovery and prepare the country to take the opportunities of globalisation and low-carbon growth.

At the Summit, countries need to come together to enhance global coordination in order to help restore global economic growth. World leaders must make three commitments:

- First, to take whatever action is necessary to stabilise financial markets and enable families and businesses to get through the recession.
- Second, to reform and strengthen the global financial and economic system to restore confidence and trust.
- Third, to put the global economy on track for sustainable growth.

The crisis unfolds

The financial crisis broke in summer 2007 against a backdrop of strong economic growth, low inflation and low unemployment.

Subprime risks trigger market freeze

There had been a rapid growth in the number of subprime mortgages in the US – mortgages that offered low initial interest rates to borrowers with poor credit histories. However, many borrowers were unable to afford their repayments.

Mortgage defaults rose and house prices started to fall. Holders of mortgage-backed securities – loans that banks had packaged up and subsequently sold – started to question their exposure to this increased risk of default. Investors found that they were unable to quantify the value and risk of these increasingly complex products.

The market for these assets effectively closed down. They could only be sold at fire-sale prices, far below their long-term economic value. Banks had assumed that liquidity would always be available – however, this was no longer the case.

Over summer 2007 a number of institutions failed. Banks that had become reliant on short-term funding from the money markets – such as Northern Rock – suddenly found that their business models were no longer viable.

As a result of this uncertainty, banks hoarded liquid assets and the cost of lending between banks rose sharply. At the same time, central banks were constrained in their ability to react by the inflationary pressures of the concurrent surge in oil and food prices.

Concerns about solvency

As the banks uncovered losses, concerns grew. These increased as banks started to bring off-balance-sheet lending back onto their books. What started as a liquidity crisis – difficulty with funding day-to-day operations – evolved into a wider issue over the solvency of the banking system.

The International Monetary Fund (IMF) estimated that the majority of the losses had still to be realised – and could reach over $2tn in the US alone. The growth in securitisation meant that it was difficult to identify who would ultimately bear these losses. As a result, banks remained unwilling to lend to each other and the inter-bank lending rate remained high.

Collapse in confidence

The failure of Lehman Brothers in September 2008 led to a collapse in confidence in the wider banking sector across the globe. Financial institutions were exposed through their greatly enhanced leverage and the complex network of bilateral contracts.

Investors shunned all forms of risk. Together with growing concerns over economic growth, this led to a fall in the price of many assets, in particular equities and corporate bonds. This brought the fragile global financial system to the brink of collapse.

Impact on the wider economy

The global economy was growing strongly when the subprime crisis hit. In the UK, the economy was close to trend, inflation was close to target, public sector debt was relatively low and unemployment remained low.

The US economy was the first to slow, but the crisis quickly spread to other advanced economies. By mid-2008 many advanced economies were in recession. Emerging markets, through a combination of buoyant trade and high commodity prices, appeared to be relatively resilient.

However, the events of September 2008 led to a wider collapse in confidence. This has fed through into sharp falls in trade, production and investment around the world. As economic activity has slowed, unemployment has risen and inflation fallen.

Over the last year – due to the complexity and uncertainties of the global crisis – international forecasts of economic growth have been continually revised downwards. Countries initially not affected by the problems in the financial markets have been hit through the impact of falling activity on international trade. The latest IMF *World Economic Outlook* for 2009 forecasts world economic growth will be at its lowest rate since the Second World War.

Banks continue to uncover further losses that need to be met by additional capital. However, the collapse in the market value of the banking sector makes it increasingly difficult to raise this capital from the private sector. As a result there is a risk that, unaided, banks will cut lending to businesses and families. The challenge is to limit the impact of these pressures on the wider economy.

Context of the global financial crisis

Globalisation has delivered significant benefits over recent decades. Consumers have a wider choice of goods and services, prices have fallen, productivity has increased and millions have been lifted out of poverty. However, globalisation also brings challenges such as climate change, unequal growth and widespread exposure to financial crises.

Increased global financial integration has enabled record financial flows. Firms are increasingly able to access capital from across the world. Investors are no longer limited to investing in domestic markets.

The US and some European countries responded to the significant increase in the world labour force (as large emerging markets became integrated into the global economy) with increased consumption and investment. As a result they ran large current account deficits, financed by external borrowing. At the same time, as many Asian economies expanded, these economies saved more than they invested domestically and, coupled with export-led growth strategies, generated surpluses that were invested abroad.

The search for yield

The entry of China, India and other emerging countries into the global trading system increased the global labour supply, increasing world trade and the supply of low-price goods. This change had a powerful disinflationary effect.

Low inflation coupled with record financial flows helped contribute to low interest rates across the world and pushed down returns in traditional assets. As yields across a range of assets fell, banks looked for new ways to increase their returns – the 'search for yield'. This search sparked a wave of financial innovation.

Rather than relying on traditional retail deposits, banks increasingly used the wholesale money markets to provide funding. There was a dramatic increase in the use of complex forms of securitisation – where loans are packaged up and sold to third parties.

These new ways of working loosened the traditional limits on banks' balance sheets. Banks had less incentive to apply as stringent credit checks on borrowers. As a result, banks were able to significantly increase lending volumes. Leverage – the ratio of lending to capital – dramatically increased.

In addition, banks – in a search for higher returns – started to trade and hold these structured products off-balance-sheet, thereby releasing capital to allow them to increase lending further.

Impact of financial innovation

Increased levels of lending and securitisation left banks exposed as the crisis unfolded. Complex securitisation reduced transparency. Banks were less worried about credit risk as the loans were subsequently sold on to third parties. Little or no account was taken of low-probability, high-impact events by the external credit rating agencies – on which investors increasingly relied.

Two-thirds of the growth in lending over the last decade was within the financial system, rather than the wider economy. In addition, it is apparent that the pay structure within banks encouraged short-term revenue generation, with little regard for the longer-term risks this could create. This combined with over-exuberance to perpetuate risks – at a cost to consumers and the resilience of the wider system. Coupled with strict conditions on those banks receiving Government support, the UK has set up a review of banks' corporate governance to learn the lessons from these events.

Regulators around the world had not fully taken account of financial innovation and the rise of off-balance-sheet vehicles. Insufficient focus was given to the liquidity risks faced from increased reliance on wholesale funding. Increased trading between banks left the system over-leveraged, more interdependent and therefore less resilient to shocks. These systemic risks have significant implications, and demonstrate the need for stronger international coordination.

Overall, the regulatory framework had arguably become 'pro-cyclical' – encouraging excessive lending in the 'good times'. The UK Government has asked Lord Turner to consider what reforms need to be made to financial regulation.

The UK response

The global financial crisis has required unprecedented action from governments, central banks and regulatory authorities across the world. Governments have stepped in where markets have failed.

The UK plan for recovery has four pillars:

1. Protecting people and their savings by preventing the collapse of the banking system.

2. Giving real help to families and businesses now to support the economy.

3. Supporting bank lending to families and businesses.

4. Investing for recovery and preparing the country for the new opportunities and challenges of globalisation.

Financial instability has the potential to affect families and businesses far beyond the banking sector. It is important to prevent an abrupt reduction in credit. It is needed to fund investment, the day-to-day costs of businesses and purchases by families. The best way to protect jobs and prosperity is to maintain the level of credit.

Protecting people and their savings by preventing the collapse of the banking system by:

- **Providing temporary liquidity:** Countries around the world have provided liquidity to their banking sectors. The Bank of England has made £185bn available to allow banks to swap illiquid financial assets with highly liquid Treasury bills. Up to £250bn is available to guarantee lending to banks to refinance funding from wholesale money markets.

- **Protecting depositors by supporting individual banks:** When confidence in Northern Rock was lost, the UK Government acted to guarantee deposits and take it into temporary public ownership. The level of depositor protection has now been increased. Other countries have also intervened to rescue or restructure individual banks.

- **Recapitalising the banks in return for shares:** The UK Government made £37bn of new capital available to banks in return for an equity share. This reduced their risk of insolvency and helped to restore confidence in the financial system. Globally, nearly $500bn has been announced for recapitalisation.

Giving real help to families and businesses now to support the economy

- **Stimulating demand through lower interest rates:** Monetary authorities across the world have significantly cut interest rates in order to support demand. Falling inflation will provide support for living standards for those in work or on fixed incomes. The monetary policy framework has enabled the Bank of England to reduce the base rate to a record low of 1.0%. The US Federal Reserve has cut interest rates by over five percentage points to effectively zero.

- **Providing a fiscal stimulus:** The UK Government has provided a £20bn stimulus to help mitigate the impact of the downturn. Measures include a cut in VAT and increased support for pensioners and children. It is targeted, timely and temporary – and so will not compromise medium-term sustainability. Most G20 countries have announced stimulus packages, most recently with the US $787bn stimulus, with injections estimated at over $2tn into the world economy.

- **Providing direct support for households and businesses:** The UK is also implementing a range of targeted measures to provide real help to those feeling the impact of the financial crisis. This includes help for homeowners and those facing redundancy, and maintaining access to funding for businesses and providing direct support for the car industry. Other countries are implementing similar packages, including support for car industries in the US, Canada and a number of European countries, unemployment support in Japan, increases in social security in Mexico and loan packages for Brazilian industry.

Supporting bank lending to families and businesses by:

- **Reducing uncertainty through asset protection:** Governments are considering how best to reduce the continuing uncertainty about the value of banks' past investments, so providing them with greater confidence to lend in the future to creditworthy businesses, homeowners and consumers. One aspect of the UK Government response is to protect banks against losses in return for a fee. Other countries have been dealing with impaired assets at individual banks, and are proposing similar options of asset and capital insurance and so-called 'good bank – bad banks' proposals.

- **Providing support for business lending:** The Bank of England has been authorised to purchase up to £50bn of high-quality private sector assets. This will help to increase the availability of corporate credit and improve liquidity within the market. We have supported £21bn of loans to small- and medium-sized businesses.

Investing for recovery and preparing the country to take advantage of the opportunities of globalisation:

The UK Government is also putting in place the foundations for a balanced recovery including taking advantage of new and expanding export markets. The economy cannot go back to 'business as usual'. Governments want to build a resilient recovery that offers stable, sustainable and low-carbon growth. As a result of these decisions, the UK's economy will emerge stronger and more competitive, with the following in place:

- A stronger, more responsible, more resilient financial sector with more effective governance. Tougher, smarter regulation will address the weaknesses identified over the last two years, but without undermining the sector's role in supporting investment.

- A new drive to cement Britain's place at the heart of the global trading system. This will build on the strong increase in competitiveness seen over the last year, the highly skilled international talent base and UK Trade & Investment's work to strengthen our export performance in emerging markets and our openness to inward investment.

- A commitment to ensuring that the UK workforce has the skills it will need to take advantage of the opportunities of an increasingly globalised world, through a high-quality education system and the provision of lifelong learning.

- A new focus – backed by investment in skills, research and national infrastructure – on vital knowledge-based sectors of the future such as the low-carbon, digital, bioscience and creative industries, and education. This will build on the world-class businesses that we already have in key sectors such as advanced manufacturing, defence and security, pharmaceuticals, insurance and energy.

- A continued commitment to medium term macroeconomic stability built on low inflation and sustainable public finances.

- Investment in low-carbon infrastructure, which will not only tackle climate change but will also create incentives for firms to invest and new opportunities to support the move to a low-carbon economy. The UK and other countries are advocating a low-carbon recovery including: major investments in energy efficiency; a shift to renewables; research and development including the commercialisation of low-carbon cars; and the skilled workforces that these sectors need.

The London Summit

At the London Summit, governments and International Financial Institutions will come together to agree the need for a comprehensive package of measures, coordinated globally, to address the causes and consequences of the crisis. By working together, and coordinating their actions, each country will maximise the impact for themselves and each other.

The macrofinancial response

Further steps are required to stimulate global demand. At the London Summit, world leaders will:

- review the following: the global impact of the financial crisis and whether further action may be warranted; how to ensure that the imperative to boost demand immediately is consistent with the need for long-term fiscal sustainability; and how to maintain levels of public investment, both in physical and human capital;
- reaffirm their commitment to price stability and to avoiding deflation, and support central banks to continue to take the necessary monetary policy measures; and
- reaffirm their determination to take whatever action is necessary to ensure the stability of the global financial system, including immediate action to support lending, and considering the case for cooperation on dealing with impaired assets.

The role of the International Financial Institutions

At the London Summit, world leaders will identify whether:

- the IMF's resources should urgently be increased so that it can increase its lending capacity to prevent crises, address damaged financial systems and help stimulate demand;
- to strengthen the IMF's early warning and surveillance function and reform its governance structures;
- the Multilateral Development Banks can increase their support for trade credit in the developing world;
- the Multilateral Development Banks can make better use of existing resources to support global demand and increase their focus on the poorest; and
- to speed up the strengthening of the IMF and World Bank's governance structures.

Reshaping the global financial system

At the London Summit, world leaders will consider how governments and regulators can:

- work together internationally to agree what further steps are needed to enhance corporate governance and risk management by financial institutions;
- agree steps to strengthen prudential regulation, including requiring banks to build buffers of resources in good times;
- manage the transition through the current downturn to a new equilibrium, with strengthened prudential standards so as to ensure that regulatory regimes do not act pro-cyclically, exacerbating the current downturn;

- ensure that financial activities are regulated according to their economic substance rather than their legal form and regulated consistently in all jurisdictions; and
- ensure that regulatory regimes are better prepared for failure within financial markets.

In addition, world leaders at the London Summit will review whether further steps are needed to marry better the objectives of financial and macroeconomic stability.

Putting the world economy on track for sustainable growth
At the London Summit, world leaders should:

- call for an early completion of the current global trade negotiations, the Doha Round, and strengthen the commitment made in Washington to refrain from measures that are protectionist, either in intention or in effect, and put in place transparent mechanisms to monitor such commitments;
- discuss how to ensure that everyone has the skills they need for the jobs of the future;
- call for a low-carbon recovery, and agree the need for international leadership on a strategic framework to stimulate investment; and
- reaffirm their commitment to the Millennium Development Goals and commit to making the necessary investments, including honouring their previous commitments to increase development assistance.

The Global Deal

The world's leading economies can come together to agree a package of internationally coordinated measures to restore stability and set a course for a sustainable recovery, including:

- review the global impact and effectiveness of measures taken so far to **stimulate global demand** both by national authorities and by the global financial institutions, and consider the implications for the future;

- immediate action to substantially **increase the IMF's resources** so that it can increase its lending capacity to support countries suffering from reductions in capital flows, supporting the objective of stimulating demand;

- immediate action consistent across countries and with clear exit strategies to support domestic and international **lending** by ensuring that banks are adequately capitalised and can raise the funds needed by dealing with banks' impaired assets and, where appropriate, through direct government or central bank lending;

- all countries to **renounce protectionism**, with a transparent mechanism to monitor commitments and measures to increase access to trade finance;

- **reform of financial regulation** – closing regulatory gaps, enhancing corporate governance and coordinating regulation of global financial markets in order to create a global financial sector that serves the needs of the wider economy;

- **an international early warning system**, with a strengthened role for the IMF in order to help promote balanced growth;

- **reform of the International Financial Institutions**, increasing their resources, encouraging greater access to IMF resources, and strengthening the voice and participation of emerging and developing countries; and

- **honour commitments to increase development assistance**, to protect the poorest from the impact of the crisis.

Chapter 1
The banking crisis unfolds

Over the past 18 months, the world has witnessed a series of events that culminated in the worst international banking crisis in generations.

It is possible to identify three phases of the crisis.

In the first phase, market participants realised that they had under-estimated the risks associated with a number of structured loans. Demand for these products fell sharply, driving down their prices. As no bank knew which other bank was more exposed to these assets, they became wary of lending to each other.

In the second phase of the crisis, banks started announcing losses made on structured loans and other impaired assets. These losses, combined with deteriorating macroeconomic conditions in the advanced economies, turned uncertainty about the value of impaired assets into concerns about the solvency of a number of banks.

In the third phase of the crisis, the failure of a US investment bank, Lehman Brothers, triggered a sharp intensification of the crisis. Banks stopped trusting each other and their customers stopped trusting their banks. Confidence in the international financial system was lost.

Starting with the UK's recapitalisation plan in October, a large number of governments adopted policies that were successful in restoring trust in the banking system. But despite these unprecedented interventions, the financial crisis has triggered a global economic downturn, which continues to threaten our economic prosperity and has necessitated further action.

The three phases of the financial crisis

Over the past 18 months, the world has witnessed a series of financial market events that culminated in the worst international banking crisis in generations. It is possible to identify three phases of the crisis.

In the first phase, investors realised that they might have undervalued risk in securities linked to US low-quality – subprime – mortgages. As a result, demand for these securities fell sharply and liquidity in the market for these products dried-out. Uncertainty about the true value of securities disrupted all asset-backed security markets – prime and subprime. Investors were not only uncertain about how to price these assets but also about which financial institutions held them. Banks also became aware that they might have to retain loans onto their balance sheets that they had planned to securitise. As a result, they bid up the price of funds in wholesale markets.

In the second phase of the crisis, financial institutions started announcing losses related to their holdings of impaired assets, and investors started worrying that more losses were in the pipeline. This uncertainty then combined with expectations of a slowdown in the major advanced economies to raise concerns about the solvency of a number of financial institutions.

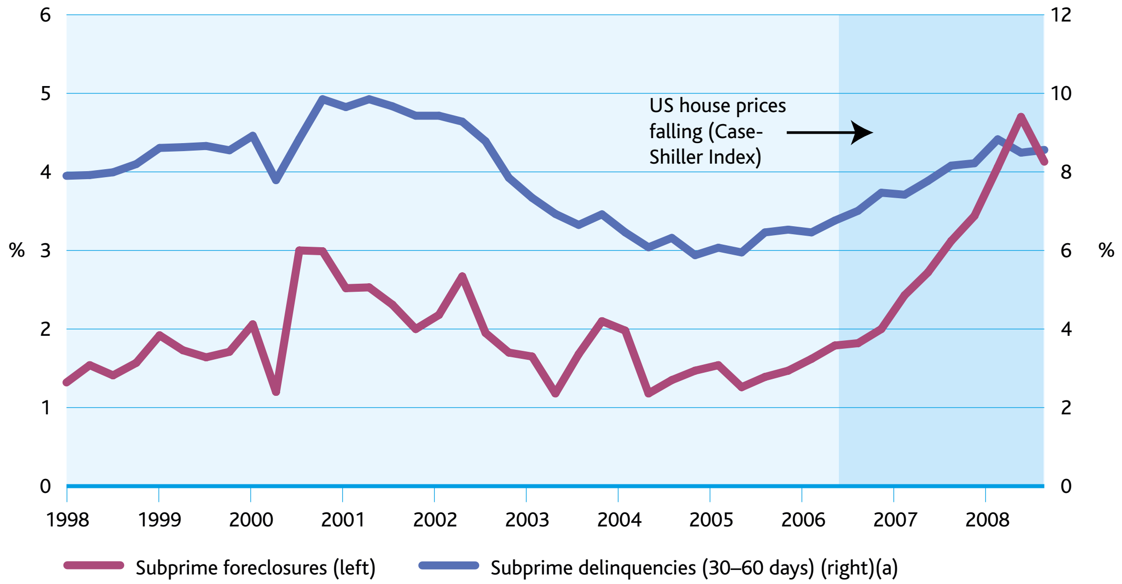
In the third phase of the crisis, the repercussions from the failure of a US investment bank, Lehman Brothers, undermined confidence in the banking system at large. Significant capital injections and credit guarantee plans adopted by governments all around the world were successful in restoring confidence. But by that time, the overhang of impaired assets on financial institutions' balance sheets was no longer the only source of potential losses. Deteriorating macroeconomic conditions in the world's largest economies – the US, the euro area, Japan and the UK – coupled with a slowdown in the economic growth of a number of emerging markets then led to further pressure on banks' balance sheets, as expected losses on traditional loans to households and companies increased.

The rest of this section describes the three phases of the financial crisis in more detail.

Phase 1 – Banks become wary of lending to each other

The trigger for the crisis can be traced back to when subprime borrowers in the US started falling behind on their mortgage payments and house prices started to drop (Figure 1.1). These developments increased the likelihood of losses in certain residential mortgage-backed securities, which were previously thought to be of high quality and low risk.

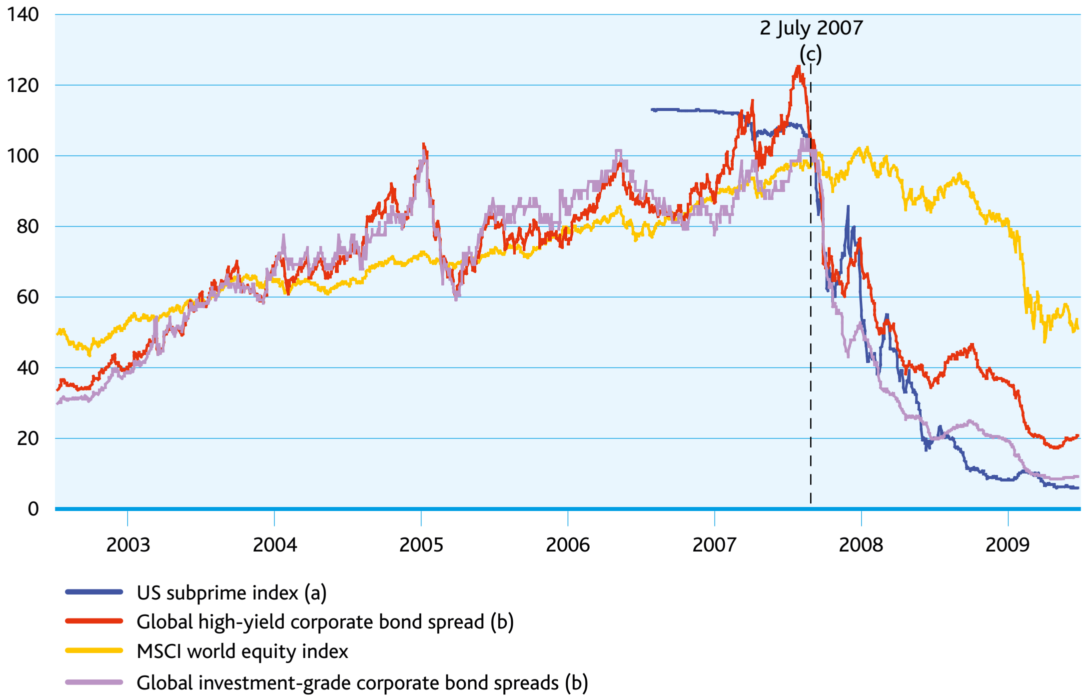
Figure 1.1: US subprime delinquencies, 1998 to 2008



Source: Thomson Datastream
Note: (a) Percentage of US subprime mortgage loans that have fallen behind by more than 30 days

As a result, investors who had relied heavily on the assessments of external ratings, and on their relationships with the sellers of subprime structured products, were alarmed. From July 2007, prices on all subprime securitised assets fell sharply, while markets for other securities, such as equities, held up (Figure 1.2). Rating downgrades and changes in the methodologies that rating agencies use to assess the quality of these assets increased uncertainty about their true value even further.

Figure 1.2: Global asset prices around the July 2007 turbulence



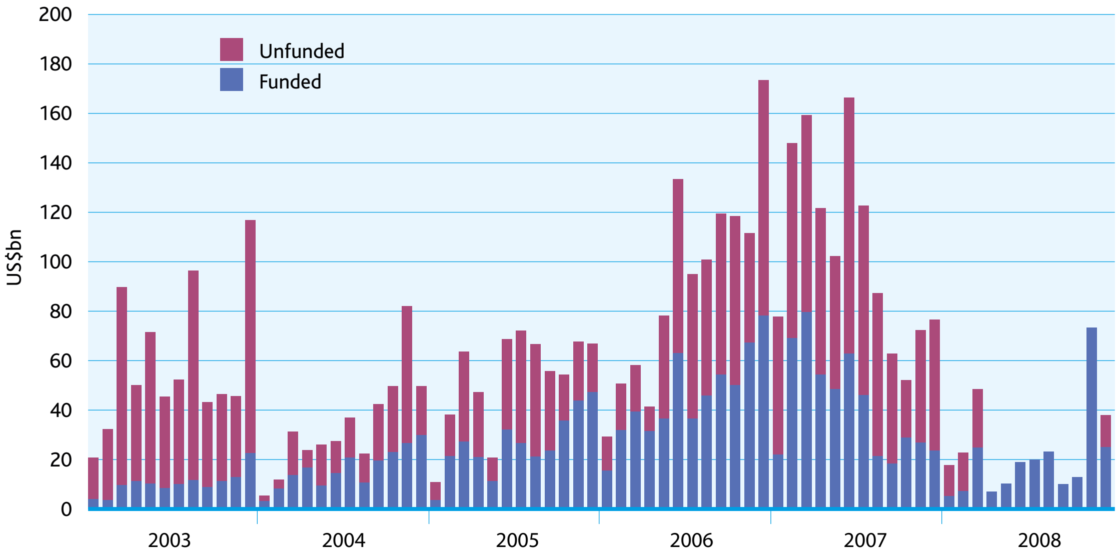
Sources: Thomson Datastream, Merrill Lynch, Halifax, IPD, JPMorgan Chase & Co. and Bank of England calculations
Notes: All series are indexed on 2 July 2007
(a) Subprime series is the A-rated 2006, H2 vintage ABX.HE index
(b) Series inverted
(c) Dotted line shows start of July 2007

Valuation uncertainty was most acute for more complex and opaque securities, such as collateralised debt obligations (CDOs) – a security backed by a pool of various types of debts (Figure 1.3).[1] As demand for CDOs fell, demand for leveraged corporate loans, which were often packaged into CDOs, also fell sharply. As a result, banks that had agreed to finance large leveraged buyouts over the previous months were not able to remove these loans from their balance sheets.[2]

[1] For a brief description of what these assets are, see Box 2.1 in Chapter 2.

[2] A 'leveraged buyout' occurs when a private investor or a syndicate of private investors acquires a controlling interest in a company's equity and where a significant percentage of the purchase price is financed through a 'leveraged loan' – that is, borrowing. The assets of the acquired company are used as collateral against the leveraged loan, supplemented sometimes with assets of the acquiring company. The arrangers of the loan, usually commercial or investment banks, would often package the loans into CDOs and sell them to investors in capital markets.

Figure 1.3: Global CDO issuance, 2003 to 2008



Source: JPMorgan Chase & Co
Note: Funded CDOs refer to instruments backed by corporate bonds; unfunded CDOs refer to instruments backed by credit default swaps

Over the summer of 2007, a number of events added impetus to these developments. In June, difficulties experienced by creditors of two hedge funds linked to Bear Stearns, a US investment bank, indicated that the drying-up of liquidity had spread from the markets where these securities are issued – primary markets – to the markets where they are traded – secondary markets.

These problems were highlighted further with the emergence in July and August of difficulties in two banks in Germany – IKB and Sachsen LB – with links to off-balance-sheet vehicles that had invested in these assets. The announcement by the French bank BNP Paribas on 9 August 2007, that it would have to temporarily suspend redemptions from three of its investment funds because it was unable to value them, provided additional confirmation of the emerging crisis.[3]

The effective closure of the market for asset-backed securities and leveraged loans meant that banks had to retain on their balance sheets exposures that they had intended to remove, under the so-called 'originate and distribute' model described in more detail in the next chapter. Separately, a number of banks had to extend loans to their own off-balance-sheet vehicles to avoid their disorderly liquidation.

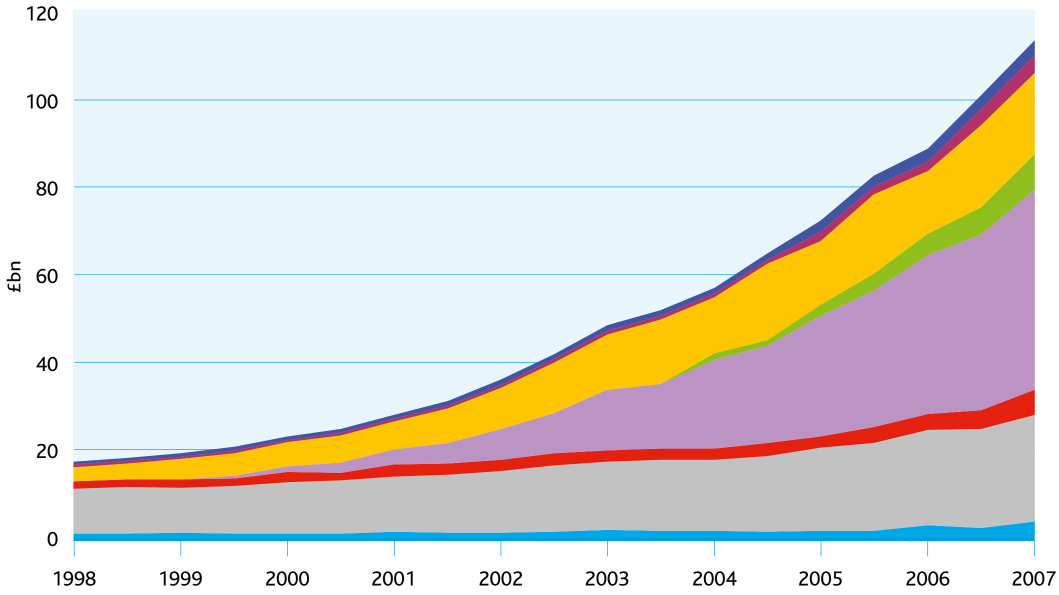
Both of these developments increased the funding needs of several financial institutions, driving up the price of longer-maturity loans in wholesale money markets (Figure 1.4). This development, in turn, forced a number of banks to substitute maturing longer-term loans with shorter-term loans. The result was a reduction in liquidity across the system, as funding maturities became shorter. Some banks that were relatively more reliant on wholesale markets for funding, including Northern Rock in the UK, were particularly badly hit (see Box 1.1).

[3] The BNP Paribas press release began: "The complete evaporation of liquidity in certain market segments of the US securitisation market has made it impossible to value certain assets fairly regardless of their quality or credit rating. The situation is such that it is no longer possible to value fairly the underlying US ABS assets in the three above-mentioned funds. We are therefore unable to calculate a reliable net asset value for the funds."

Box 1.1: The liquidity crisis in Northern Rock

Northern Rock, a UK bank, embarked on a growth strategy that enabled it to treble its share of the UK mortgage market in eight years.[4] This strategy was largely funded through increasing reliance on markets for mortgage-backed securities and other types of secured loans, such as covered bonds (see figure below). Until late July 2007, Northern Rock was largely unaffected by problems in the US subprime market, in part because of its low exposure to US subprime mortgages.

Northern Rock: balance sheet growth and liability structure, 1998 to 2007



Notes:

Equity Other liabilities Other securities Covered bonds Securitised notes

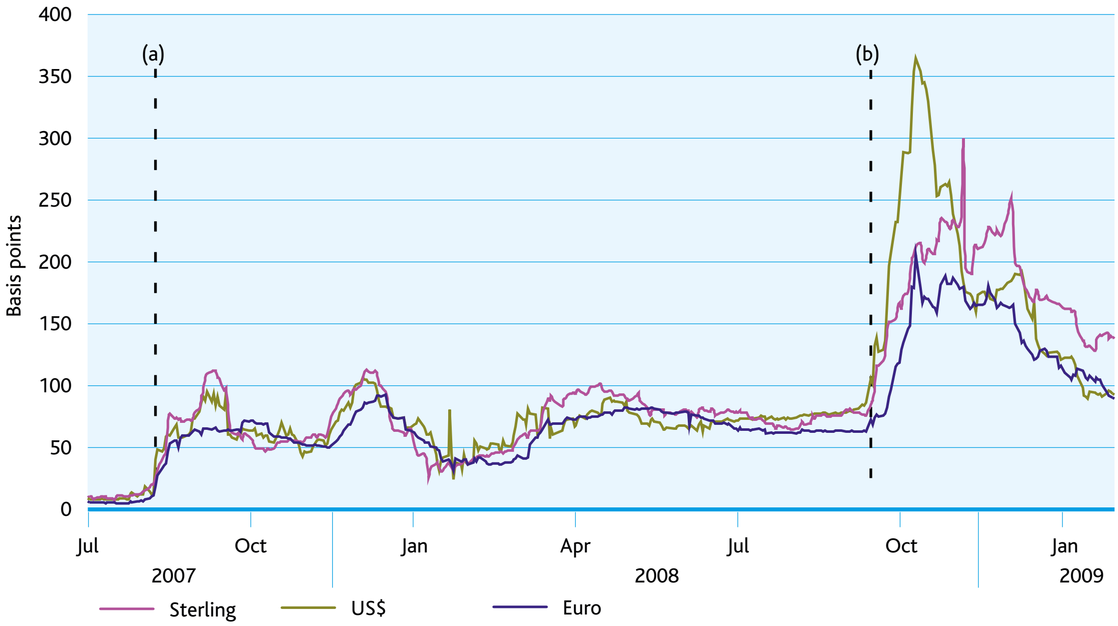
Other customer accounts Retail funds and deposits Deposits by banks

Source: Bank of England (October 2007) *Financial Stability Report*, London: Bank of England

But its strategy depended heavily on the assumption that it would be able to fund its growing loan book by accessing the market for asset-backed securities. By mid-September it became apparent to Northern Rock that longer-term funding markets were closed to it. In addition, unlike Countrywide Financial, a US bank that was facing similar problems at the same time, Northern Rock failed to secure a capital injection from the private sector and had no alternative funding strategy in place. As a result, it was forced to request liquidity support from the Bank of England. A chain of events, including a large withdrawal of deposits, that culminated in the temporary public ownership of the bank.

[4] In 2007H1 Northern Rock accounted for 9.7% (gross) and 18.9% (net) of UK mortgage lending. In 1999H1 these shares had been only 3.6% and 6% respectively (Bank of England (October 2007) *Financial Stability Report*, London: Bank of England).

Figure 1.4: LIBOR-OIS spreads in US$, euro and sterling



Source: Bloomberg

Notes: Three-month LIBOR-OIS spreads – a measure of the cost that banks have to pay to lend to each other in wholesale markets and expected central bank policy rates

(a) BNP Paribas 9 August announcement

Phase 2 – Concerns about banks' solvency increase

The second phase of the crisis saw a large number of major financial institutions announcing losses related to asset valuation in the autumn and early winter of 2007. This led to some high-profile resignations of chief executive officers towards the end of that year.

By April 2008, global writedowns linked to losses on US subprime assets had totalled $100bn.[5] Uncertainty about the scale and location of further losses was widespread, driven in part by the complexity and opacity of some of these assets.[6] Moreover, the accounting practice of assessing losses in banks' trading books – so-called 'mark-to-market' and 'fair-value accounting' – extended the ongoing link between falling asset prices and financial institutions' balance sheets, as set out in the next chapter.[7]

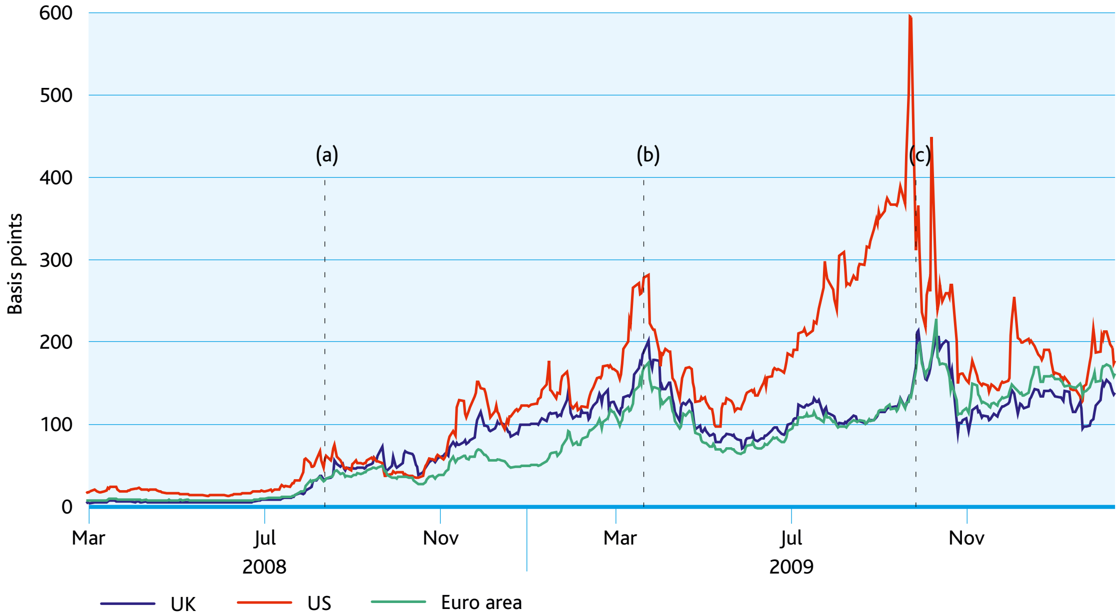
These mechanisms, combined with weakening housing markets in a number of countries and a deterioration in real incomes (due to high oil and food prices), heightened concerns about the capital adequacy of a number of financial institutions. The premium charged for insuring bond investors against the risk of a major bank defaulting increased sharply around the end of 2007 (Figure 1.5).

[5] See Box 1.1, Bank of England (April 2008) *Financial Stability Review*, London: Bank of England. These losses relate to losses linked to US subprime assets only and not to losses from other sources.

[6] See, for example, Gorton G (2008) 'The panic of 2007', *Yale School of Management working paper*, presented at the Jackson Hole Conference in August 2008 and updated on 4 October 2008.

[7] See, for example, Brunnermeier M, Crockett A, Goodhard C, Persaud A, Shin H (2009) 'The fundamental principles of financial regulation', *Geneva Report on the World Economy*, ICMB-CEPR, January 2009, and the discussion in Chapter 2.

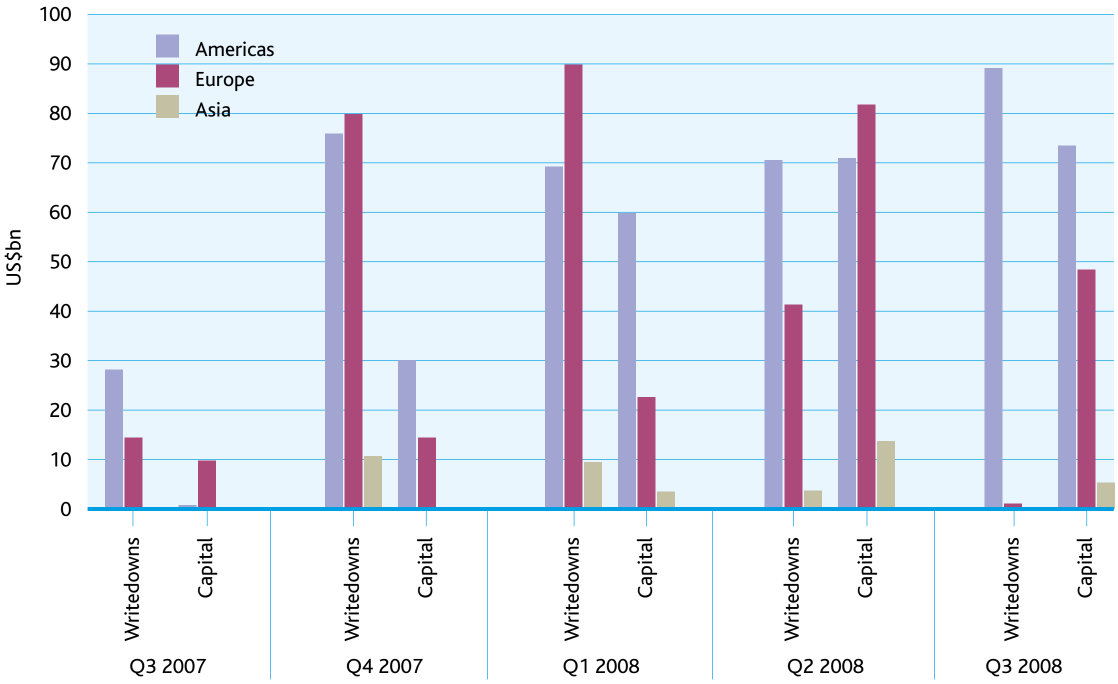
Figure 1.5: International credit default swap premia for banks since March 2007



Source: Thomson Datastream
Notes:
(a) BNP announcement
(b) Bear Stearns' rescue
(c) Lehman Brothers goes into administration

As a result, a number of banks needed to raise capital to replenish depletion by writedowns and to allay investor fears that banks may not have sufficient capital to absorb future losses. According to an IMF report, between the summer of 2007 and September 2008, banks around the world raised $430bn of capital (Figure 1.6). This compared against global writedowns over the same period of roughly $580bn. The IMF has recently updated this figure – global writedowns now stand at $792bn.

Figure 1.6: Global writedowns



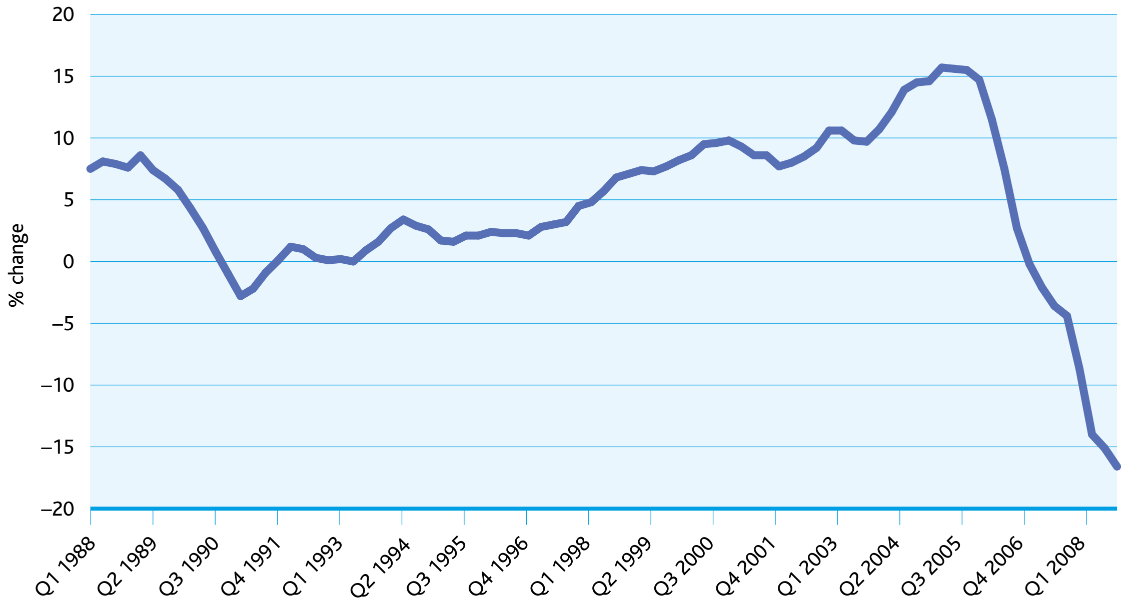
Source: IMF Global Financial Stability Report, October 2008

The combination of this cycle of losses, coupled with slowing global economic prospects, culminated in the failure of Bear Stearns, a US investment bank, in mid-March 2008. Concerns about the solvency of the firm had led its wholesale depositors to withdraw. Bear Stearns was forced to seek support from a major US commercial bank, JPMorgan Chase & Co, and from the Federal Reserve Bank of New York (FRBNY). In response to the crisis, the FRBNY widened its liquidity provision outside banks to US non-bank securities houses – primary dealers. This was a significant development because it recognised the potential impact on the whole financial system of non-banks – that is, the so-called 'shadow banking' system.[8]

In the summer of 2008, a number of other US financial institutions started facing difficulties. As the US housing market and the US economy continued to weaken, concerns about the credit quality of two US mortgage agencies – Fannie Mae and Freddie Mac – increased markedly, with a number of commentators suggesting that the firms were under-capitalised (Figure 1.7). Because of the central role that these two institutions play in the US mortgage market, concerns about their solvency led to expectations about a further weakening of prospects for the US housing market (see Box 1.2 on page 23). On 7 September, the two agencies were placed into conservatorship, that is, they were effectively nationalised.

[8] For an account of the growth in the importance of the shadow banking system, see the speech by Paul Tucker, Executive Director of the Bank of England, Markets, on 13 December 2007. For a more recent discussion, see the speech by Adair Turner, Chairman of the Financial Services Authority on 21 January 2009.

Figure 1.7: US house prices, 1988 to 2008

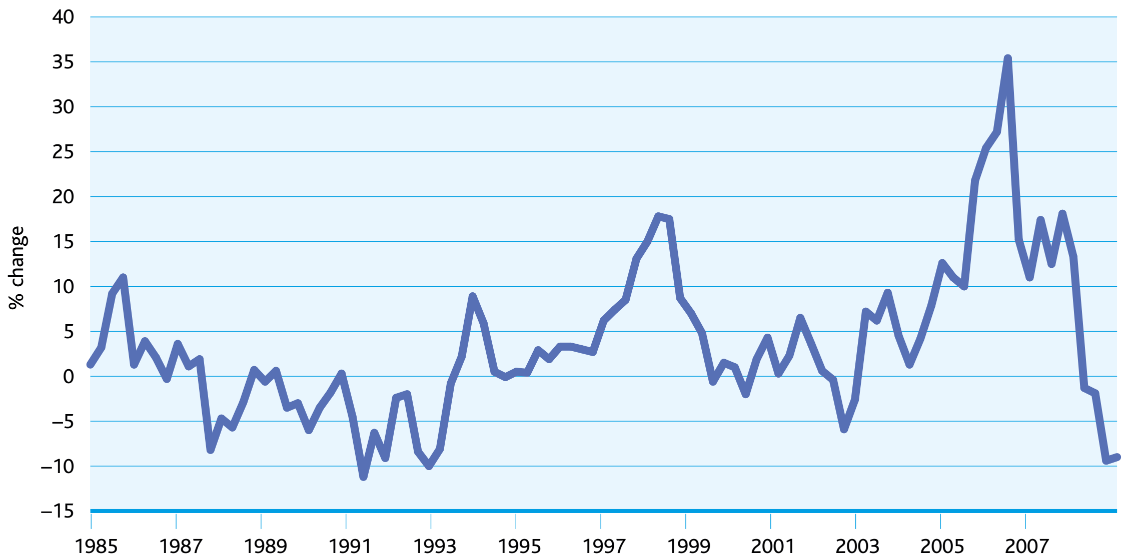


Source: Case-Shiller national index
Note: Quarter-on-quarter growth in Case-Shiller index

Phase 3 – Collapse in banking system confidence

The severe pressures on the two US mortgage agencies focused the market's attention on other financial institutions, especially on US investment banks (due to a combination of exposures to property-related assets and reliance on wholesale markets for funding). Lehman Brothers, a high-profile US investment bank, came under particular pressure. Some market participants believed that the firm was exposed to the commercial property market, which had weakened significantly over the past few months (Figure 1.8). On 15 September, Lehman Brothers went into administration.

Figure 1.8: US commercial property prices, 1985 to 2007



Source: MIT/NCREIF (National Council of Real Estate Investment Fiduciaries)

Following the failure of Lehman Brothers, market attention switched to a number of other financial institutions, starting with AIG – which was downgraded on the same day that Lehman Brothers entered administration. The firm – the largest insurance company in the US – offered credit insurance against mortgage-backed securities to investors all around the world. The failure of the company would have left these investors exposed, with significant consequences for the international banking system. On 16 September, the US Government agreed a loan of $85bn in return for a 79% capital stake in the firm.

During the same week, the remaining major US investment banks took action to avoid suffering the fate of Lehman Brothers. Bank of America, a key commercial bank, acquired Merrill Lynch, a US investment bank that was seen to have exposures and reliance to wholesale funding. Goldman Sachs and Morgan Stanley applied to become US commercial banks. This is because US investment banks are not allowed to accept retail deposits and do not have access to the discount window of the FRBNY. By becoming commercial banks, these securities firms would gain access to both and they would be subject to the stricter regulatory requirements that apply to commercial banks.

Money market funds in the US played a significant role in accentuating pressures on banks. Some funds that had held Lehman Brothers' assets made losses. Because money market funds had almost always produced positive returns, these losses triggered withdrawals from funds that invested in short-term bank debt and deposits into funds that invest in government debt. This put further pressure on the ability of banks to raise funds in the wholesale markets. This development demonstrated that the actions of another set of non-bank financial institutions, money market funds, could also have systemic consequences for the financial system.[9]

The result of these events was a sharp increase in the rate that banks use to lend funds to each other (Figure 1.4). These funding pressures, in turn, caused distress in a number of major banks around the world, including Wachovia and Washington Mutual in the US, and Dexia, Fortis and Hypo Real Estate in the euro area, forcing governments to take action to prevent their distress from spilling over.

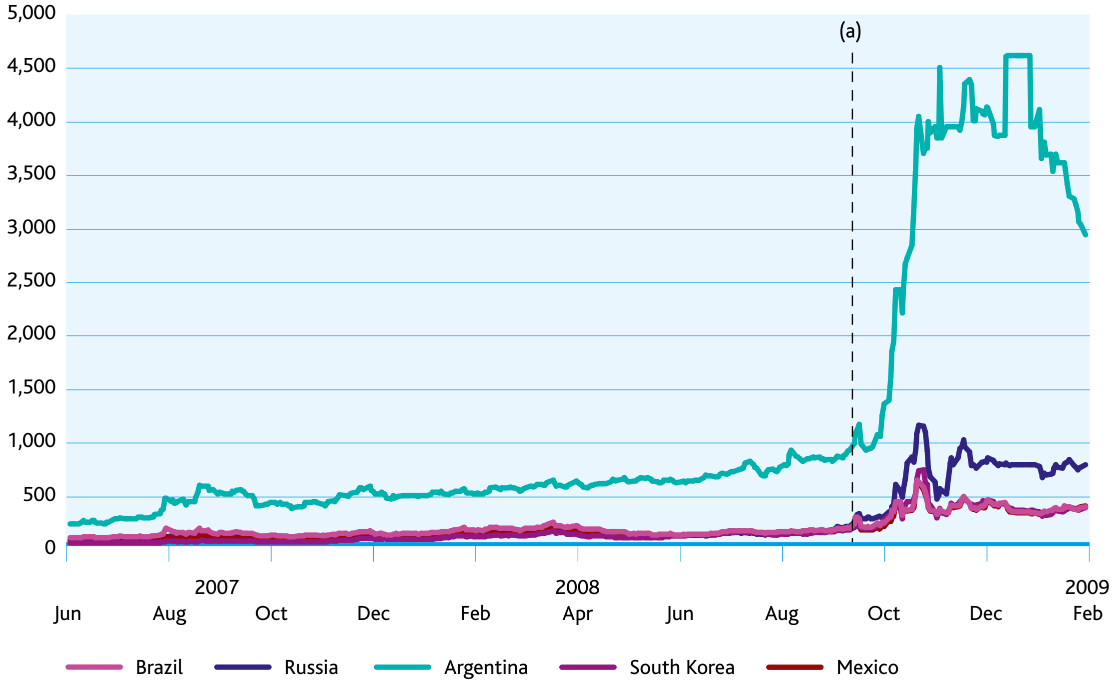
In the UK, the financial turmoil led to financial system consolidation. Earlier in the year, during the second phase of the crisis, Banco Santander, a Spanish bank, had acquired Alliance & Leicester. In mid-September 2008, Lloyds TSB and HBOS, two large UK banks, announced that they had reached agreement for the former to acquire the latter, subject to shareholder approval – this was given in January 2009. In September 2008, Abbey National, a wholly owned subsidiary of Banco Santander, acquired the retail deposit business and branch network of Bradford & Bingley, a mortgage lender, with the remaining assets and liabilities of the firm being transferred to the public sector.

These market events led to a step-change in global asset prices as investors shunned all forms of risk. Global equity prices fell more in the month following the failure of Lehman Brothers than at almost any other time over the past 300 years.[10] And as Chapter 3 sets out in more detail, capital exited a number of emerging markets, which up until then were thought to be largely immune to the financial turmoil in the developed world. As a result, the cost of insuring the debt of a number of emerging markets increased sharply (Figure 1.9).

[9] It has long been recognised that banks are 'special', that is, they are different from other non-bank companies. Banks perform an economically useful 'maturity transformation' function, by using short-term deposits to fund longer-term loans. But banks are also inherently fragile to a loss of confidence – a depositor run. This is why banks have traditionally enjoyed access to the discount window of central banks and have been subject to stricter prudential regulation (see, for example, Diamond D and Dybvig P (1983) 'Bank runs, deposit insurance and liquidity', *Journal of Political Economy*, 91, pages 401–19 and Freixas X and Rochet J C (1997) *The microeconomics of banking*, MIT Press). But developments over the last 18 months have demonstrated that certain non-bank financial institutions, such as securities houses and money market funds, had also become 'special', in the sense that they performed a maturity transformation function of a kind.

[10] See speech by Mervyn King, Governor of the Bank of England, 20 January 2009.

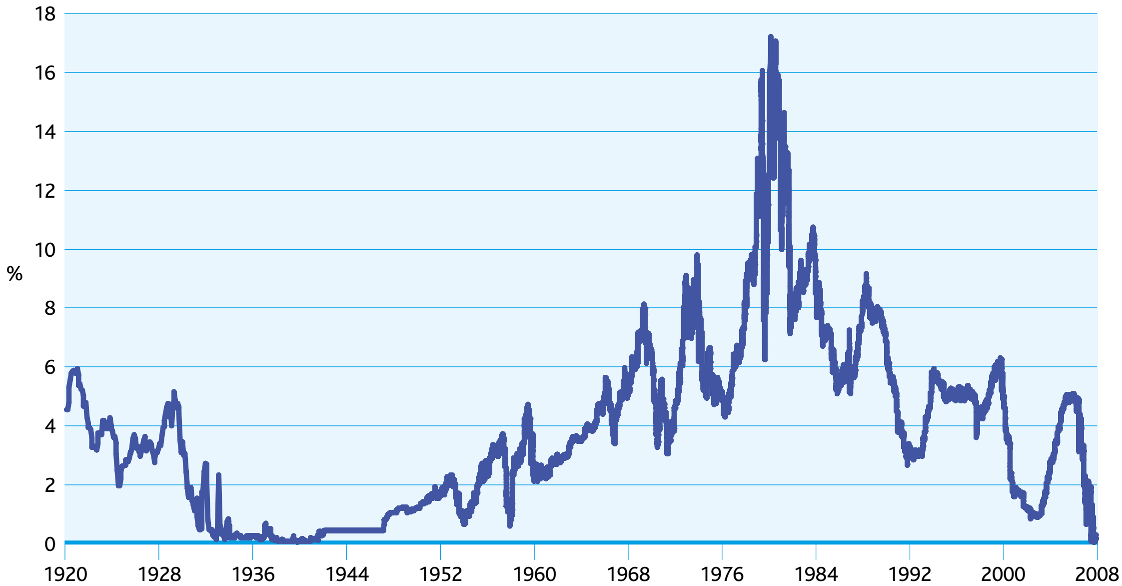
Figure 1.9: Credit default swap premia on selected emerging market sovereign debt, 2007 to 2009



Source: Thomson Datastream
Note: Five-year CDS premia
(a) Lehman Brothers goes into administration

Money withdrawn from these markets flew to the safety of short-term US government bonds. During the month following the failure of Lehman Brothers, yields on US Treasury bills fell close to, and briefly below, zero – levels not seen since the Great Depression (Figure 1.10).

Figure 1.10: 90-day US Treasury bill yields, 1920 to 2008



Source: Global Financial Data

A global policy response

Banks exist in order to intermediate between people who want to get a return on their savings and those who want to borrow to buy a house or make a long-term business investment. In other words, banks are the intermediaries that create the necessary trust that enables savings to fund investment through maturity transformation. But following the failure of Lehman Brothers, trust in the global banking intermediation system – the lifeblood of the globalised economy – had collapsed. A number of national authorities took action to address the loss of confidence in their financial systems. For example, a number of central banks introduced 'dollar swap' facilities with support from the US Federal Reserve. And the US Treasury intervened in specific markets to restore confidence, including by offering guarantees to money market funds. Notably on 3 October, the US Congress approved a Troubled Asset Relief Program to purchase $700bn of impaired securities.

But by that stage it had become clear that case by case, institution-specific bank resolutions were no longer sufficient. On 8 October 2008, the UK Government announced a comprehensive package of measures to restore confidence in the entire banking system based on the recapitalisation of the banks.

In the following weeks the European Union as a whole adopted a comprehensive framework, with many member states taking significant measures with the same underlying principles. The US followed. As Table 1.1 shows, these actions led to significant recapitalisation of the world's banking system. Coupled with banks' own capital-raising initiatives, a total of $964bn has been raised over the period of the crisis.

Table 1.1: Capital injections

	Private sector	Public sector	Public sector as percentage of total
	US$bn	US$bn	%
Total capital raised	963.8	467.0	48.5
America	572.2	317.5	55.5
Europe	335.5	146.4	43.6
Asia	56.1	3.1	5.6

Source: Bloomberg, as per 2 February 2009

These unprecedented actions restored basic trust in the global financial system. But by that time, the combination of tighter credit conditions and the sharp fall in business and consumer confidence that followed the failure of Lehman Brothers had triggered a cycle between a slowing global economy and a banking system that is still in the process of de-leveraging. Clearly, further action was necessary by governments and central banks around the world.

Box 1.2: US mortgage agencies – Fannie Mae and Freddie Mac

The Federal National Mortgage Association (FNMA), known as Fannie Mae, was founded by the Roosevelt administration during the Great Depression. Its role was to support mortgage lending, especially for low- and middle-income families, through the establishment of a government-sponsored organisation that would purchase and securitise mortgages. Fannie Mae became a stock-form company in 1968. The Federal Home Loan Mortgage Corporation (FHLMC), known as Freddie Mac, was set up in 1970 to provide competition.

Since then, the mortgage agencies have enjoyed an implicit government guarantee, allowing them to borrow at rates close to those achieved by the US government itself. Their debt is held widely in international private portfolios and as central bank reserves all over the world. The agencies use their ability to raise funds cheaply to guarantee residential mortgages originated by private banks and to finance their own portfolio of mortgage-related assets. By the end of the first quarter of 2008, Fannie Mae and Freddie Mac guaranteed or owned around 42% of the outstanding stock of US mortgages – $5,100bn in total.

As the US housing market weakened and other US financial institutions withdrew from originating and guaranteeing new mortgages, the share of new lending by the two agencies increased, also in part reflecting earlier relaxation of the types of mortgages that the agencies were allowed to hold.

Investors started to become concerned about the solvency of the two agencies in early July. Their concern was possibly triggered by remarks made by commentators, including a former Governor of the Federal Reserve Board, that Freddie Mac was insolvent on a fair value accounting basis by $5.2bn.

As liquidity in mortgage-backed markets dried up, the share prices of the two agencies had declined since the summer of 2008. But during the week beginning 7 July, the share prices of the agencies fell by 40% and their bond spreads rose significantly. The rise in bond spreads pointed to increased debt rollover risk. In other words, the agencies faced more expensive borrowing.

Given their central role in providing new mortgage lending to US households, an increase in the financing costs of the two agencies risked translating into an increase in US mortgage rates, weakening even further the US housing market, the stabilisation of which was seen as a necessary condition for the recovery of the US economy.

On 13 July 2008, the US Treasury announced that it would extend its existing $2.5bn credit line to the agencies and would be seeking approval from Congress to buy equity in them. On 7 September the US Government placed the agencies into conservatorship under the direction of the newly created Federal Housing Finance Agency. The US Treasury injected $1bn capital in each company and was given authority to inject a maximum of $100bn into each of them.

Chapter 2
The context of the global financial crisis

Globalisation has delivered significant benefits, but it also presents challenges to the G20. These include whether, in a world of global financial markets, we have the financial supervision equal to its risks.

The entry of China and India and other countries into the global trading system increased the global supply of labour, leading to an increase in world trade and, in particular, an increase in the supply of low price goods. This change had a powerful disinflationary effect, helping to keep interest rates lower than they would otherwise have been.

At the microeconomic level, falling returns on traditional assets prompted investors to engage in a 'search for yield', which was met by increasingly complex financial products and financial sector leverage.

The realisation that assets linked to subprime mortgages were riskier than the market had estimated triggered the drying-up of liquidity as investors lost confidence. As institutions failed, the system as a whole came under threat.

It is now generally recognised that financial innovation outpaced risk management, and that both domestic and international regulatory frameworks need to recognise fully the systemic consequences of liquidity and credit risk. This has led to an examination of:

- whether corporate governance arrangements in banking are sufficiently robust; and
- the reforms to financial regulation by national and international bodies that are needed in order to keep pace with financial innovation and market practices.

Benefits of globalisation

The last two decades have seen dramatic growth in global trade, global capital flows and global sourcing of goods. World trade has grown by more than 30% in just one decade, and 70% of the increase in world GDP since 2000 has come from emerging and developing countries. Growth has come from new sources and has been shared by an ever-increasing percentage of the world's population.

While global trade between individual nations has grown steadily over the last few hundred years, the last few decades have seen a much greater level of economic integration, as evidenced by the growth of genuinely global companies and, with some exceptions, global markets in capital as well as in goods and services.

Globalisation has been facilitated not only by technological developments reducing transport and communication costs, but also by successive rounds of increasingly multilateral trade negotiations, which have opened up markets. Evidence shows that economies that open their own markets benefit most, but in the long term, the full benefits can only be realised through the openness of all economies. Long-term trends demonstrate this: since 1945, average developed country industrial tariffs have fallen from nearly 40% to less than 5%; world exports have risen 27-fold; and world income eightfold.

The global age is marked by new opportunities for businesses and individuals in all countries, a better deal for consumers and the continued lifting of millions out of poverty. Growth accounts for approximately 80% of the poverty reduction that has, over the last 15 years, lifted 500 million people around the world above the poverty line. As well as unilateral liberalisation, appropriate sequencing and complementary action to improve the investment climate, build capability and meet adjustment costs will be key to the ability of low-income countries to unlock the benefits of globalisation.

So this globalisation of the economy has brought and will continue to bring substantial gains to the global economy as a whole. The increasing integration of global markets and diversification in the pattern of trade and foreign direct investment have increased competition among producers and service providers, leading to greater choice and lower prices. In addition, technological change has lowered transport and communications costs and acted as a powerful driver in facilitating global transactions and information flows.

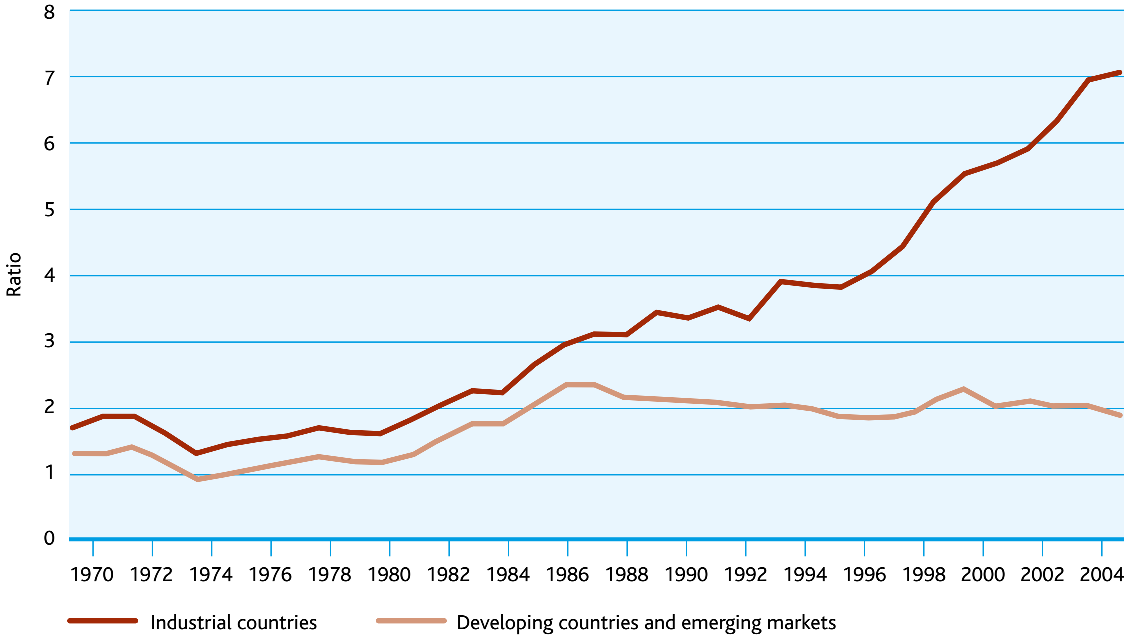
The issue, then, is not whether we have a global economy or not – because globalisation is a fact. The question is whether globalisation is managed well or badly. And whether, with global financial markets, we have the financial supervision equal to its risks.

Promoting a global trade framework that enables and supports increased openness will require securing commitment to economic openness and multilateralism among central players, as well as ensuring that international institutions are effective.

The rules-based multilateral system embodied by the World Trade Organization is the best route for securing open, fair and sustainable global markets. Multilateralism delivers wide-scale market opening and binds in unilateral liberalisation, including in key emerging economy markets – delivering benefits to UK and EU families and businesses, and to emerging economies and low-income countries. It is fair, with the principle of non-discrimination at its core. A more prosperous world, based on greater economic ties, will be a more stable, safe and secure world. Commitment to and support for multilateralism are central to ensuring a global trading framework that contributes to prosperity, security and opportunity for all.

Financial globalisation (the extent to which the world's economies are linked through cross-border financial trading flows) has also increased rapidly in the last 30 years – particularly for the advanced economies. In the 1970s, the ratio of the value of international trade in goods and services and international finance was almost 1:1 for the advanced economies. Now the level of international finance is seven times – 700% – that of international trade for this group (Figure 2.1).

Figure 2.1: Ratios of international finance to trade for emerging markets and developed countries group, 1970 to 2004



Note: Sum of external assets and liabilities in % of sum of exports and imports.
Source: Lane P and Milesi-Ferretti GM (2006) *The external wealth of nations Mark II*. IMF Working Paper. Washington DC: IMF

Financial globalisation, properly managed, can and should benefit all economies, most importantly with enhanced economic growth, through:

- improving the allocative efficiency of capital, reducing the cost of capital to firms and thereby boosting global growth;
- intensifying internal competition, increasing productivity, reducing prices for consumers and reinforcing incentives for innovation;
- spreading technological and managerial expertise, helping to raise aggregate productivity and growth and spreading best practice in corporate governance;
- spurring the development of secondary market liquidity by allowing access to a larger pool of capital and an increased investor base; and
- potentially enabling a more efficient allocation of risk across a number of end-investors.

But globalisation brings not just opportunities. It brings insecurities and new challenges, such as tackling climate change, inequality and poverty reduction, as well as those challenges that have been brought to the fore in the immediate economic crisis.

At an individual level, the transition to a more open global economy can result in insecurity and adjustment costs. There is a role for governments both in facilitating the transition process and helping to mitigate the adjustment costs that come with change.

While responding effectively to all of these challenges requires international cooperation and is a priority for the G20, this report focuses specifically on the global economic crisis that the world currently faces.

The context of the global financial crisis

The underlying factors that were the context for the crisis can be divided into those that came together to set the global macroeconomic context of low interest rates, and those that constituted the microeconomic response.

On the macroeconomic side, a combination of the disinflationary effect of the increase in the global labour force (as emerging markets become integrated into the world economy) and credible monetary policy frameworks directed at inflation contributed to low global interest rates and low levels of risk premia, and to record global capital flows.

At the microeconomic level, investors engaged in a 'search for yield' that was met by increasingly complex financial products; at the same time, firms and individuals in some developed countries increased their leverage, encouraged by low borrowing costs. As the previous chapter set out, the realisation that certain assets linked to subprime mortgages were riskier than previously predicted triggered the drying up of liquidity in those markets and led to investors losing confidence in their ability to value those assets. As markets froze and institutions failed, the system as a whole came under threat.

Macroeconomic factors

At the macroeconomic level, a number of inter-connected factors delivered the unparalleled period of output and inflation stability that proved conducive to rapid credit growth:

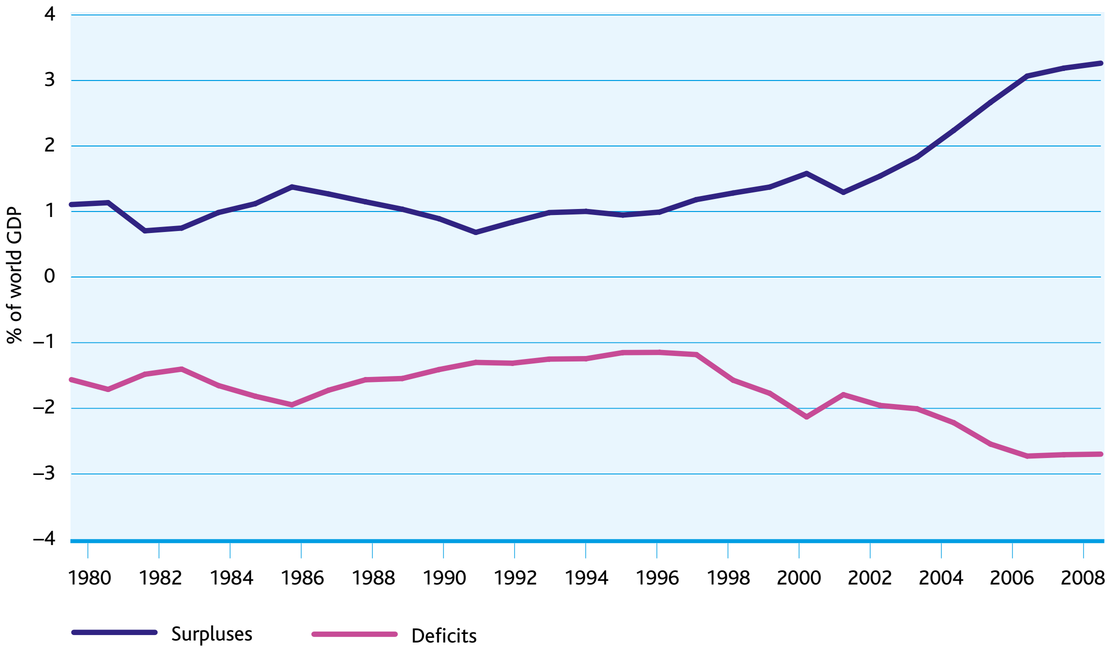
- **Imbalances in supply and demand** – increased consumption led to deficits in a number of countries, while other countries generated surpluses from export-led growth that were invested abroad.
- **Global production and trading patterns –** the entry of China, India and others into the global trading system led to a very large positive supply shock.
- **Low inflation and interest rates –** macroeconomic stability delivered low interest rates in both real and nominal terms.

Each of these factors are discussed in turn in the following sections.

Imbalances in supply and demand

The past decade saw the build-up of large imbalances of supply and demand across the world, reflecting a number of different factors. The US and some European countries responded to the increased labour supply from large emerging markets becoming integrated into the global economy with large current account deficits that were necessarily financed by external borrowing. At the same time, as many Asian economies expanded, they saved more than they invested domestically and, coupled with export-led growth strategies, generated surpluses that were invested abroad.

Figure 2.2: Global imbalances, 1980 to 2008



Source: IMF

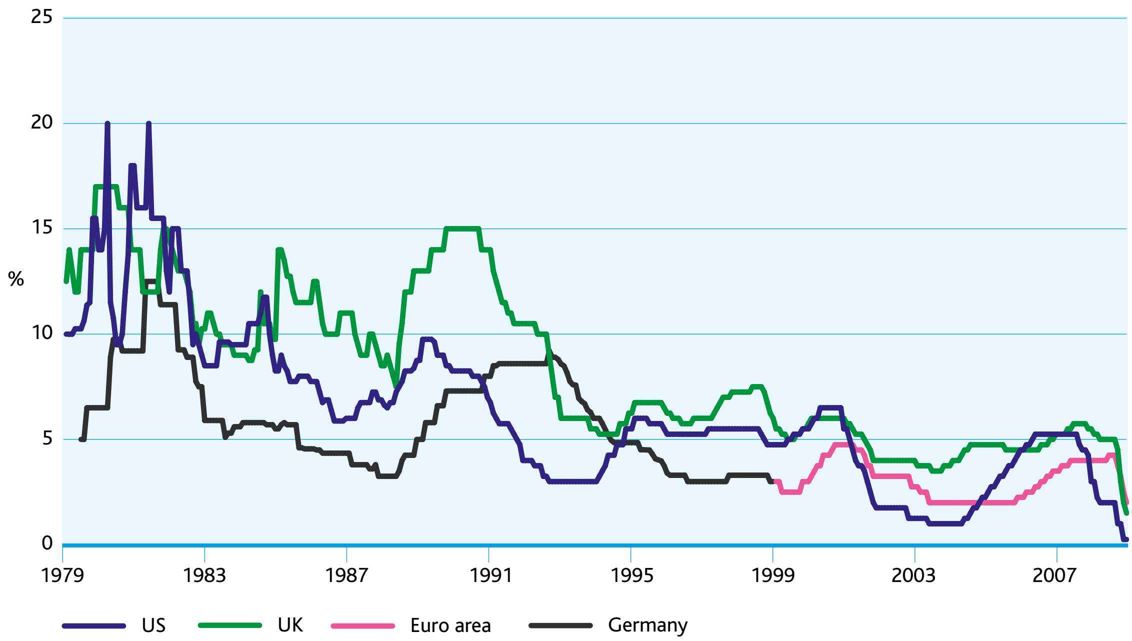
Note: 'Deficits' series is the sum of current account balances for all those countries in deficit in that year, expressed as a percentage of world GDP. Deficit countries in the 2007 data set include (but are not limited to) the US, UK, Spain, Australia, Italy, Greece, Turkey, France, Romania and Portugal. 'Surpluses' series is the sum of current account balances for all those countries in surplus in that year, expressed as a percentage of world GDP. Surplus countries in the 2007 data set include (but are not limited to) China, Russia, Germany, Japan, Saudi Arabia, Norway, the Netherlands, Kuwait, Singapore and Switzerland.

Since domestic investment opportunities for the surplus emerging market countries were limited, the vast majority of the accumulated foreign reserves were invested in the largest, safest, most liquid markets: developed countries' government bonds, particularly US treasuries. At a global level, strong demand for financial assets helped to push down on real global interest rates.

Global production and trading patterns

The entry of China, India and other countries into the global trading system increased the market participants in the global economy and the global labour supply leading to an increase in world trade and, in particular, an increase in the supply of low price goods. This change had a powerful disinflationary effect, helping to keep interest rates lower than they would otherwise have been. This disinflationary effect, combined with the adoption of credible monetary policy frameworks with a greater focus on inflation, helped to ensure that consumer price inflation (and inflation expectations) were kept at low and stable levels throughout the current decade. Central banks were able to keep nominal interest rates at historically low levels without compromising their objectives for inflation. The result was low government bond yields and low returns on fixed-income financial assets across all advanced economies.

Figure 2.3: Policy interest rates, 1979 to 2007



Source: Bloomberg

Low inflation and interest rates

Overall, credible macroeconomic policy and the effects of globalisation delivered an unparalleled period of global stability: economies operated close to trend growth, with low and stable inflation and interest rates and strong employment. This strong and stable performance engendered confidence that belied possible warning signs of significant risks building in the global financial system.

The traditional macroeconomic warning signs were not present. For example, in the UK the late-1970s oil price shock and the late-1980s overheating of the domestic economy generated high inflation, which reached 20% in 1980 and 10% in 1990. High inflation quickly fed through to higher wages. The subsequent high interest rates that followed, peaking at 17% in 1980 and 15% in 1990, accompanied by tightened fiscal policy, precipitated the recessions that followed. This did not happen in 2007 and 2008.

Much of the analysis of the impact of this global crisis has considered improving early warning and multilateral surveillance of the global economy and its markets. It is noted that, with sound macroeconomic outcomes prevailing across most countries, more focus could have been given to the combination of global markets and financial sectors than to national institutions or markets. A focus for future reform of the International Financial Institutions – notably the IMF and the Financial Stability Forum (FSF) – will be to strengthen both the early warning capacity and global rather than national surveillance functions. Encouraging a shift to crisis prevention, alongside the important wider functions, will require a consideration of the remit and funding of International Financial Institutions as well as the representation of emerging and poorer nations.

Microeconomic factors

While macroeconomic factors delivered low risk-free interest rates and record financial flows, these do not of themselves necessitate or cause a financial crisis. Microeconomic factors created the context. They included the following:

- **Demand for credit –** low interest rates encouraged households and firms to borrow in order to fund consumption and the purchase of assets such as housing.

- **The 'search for yield' –** a demand on the part of investors for assets that could offer a return in excess of the risk-free rate, which spurred financial innovation and led to a widespread under-valuation of risk.
- **Financial innovation outpacing risk management –** the crisis has led to an examination of certain aspects of the financial markets and the future role of banking governance and regulation with respect to those markets.

1. Demand for credit

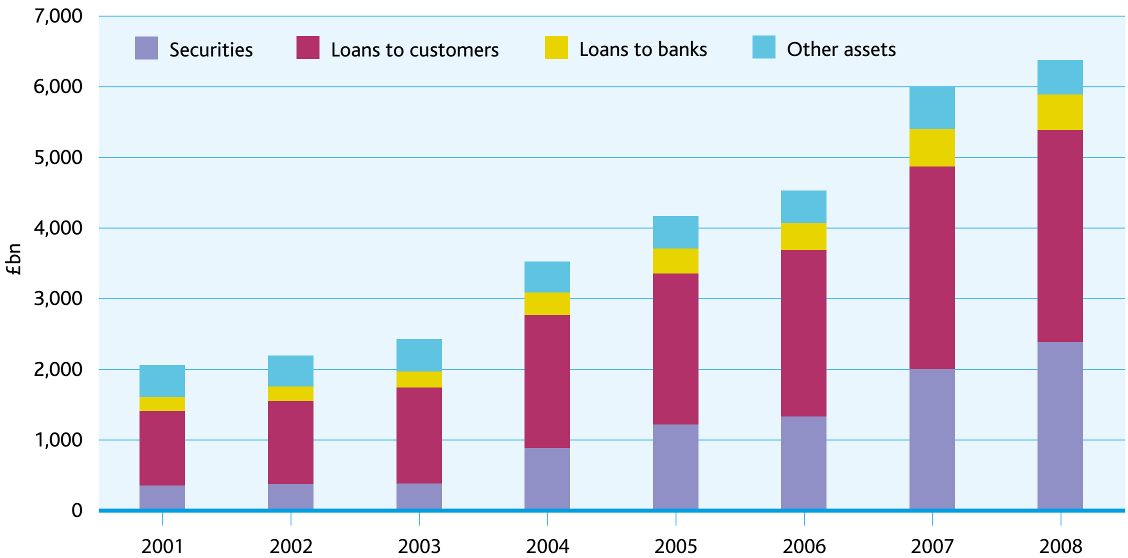
The context to the growth of the subprime mortgages that eventually triggered the current crisis was one of low long-term interest rates, which encouraged borrowing more broadly on the part of firms and individuals across the developed world.

Easier access to credit due to lower interest rates and innovative financial products provided prospective homeowners with access to greater sources of funding at attractive rates. Relatively low and stable interest rates, coupled with increasing wealth, saw home ownership become more affordable to many, and leverage among the household sector increased in the UK and many European countries as well as in the US.

In the US this has been linked to subprime mortgages, where the provision included low initial fixed rates for borrowers with weak credit histories, funding an increase in demand for housing from individuals previously unable to afford a house. As US interest rates rose and house prices fell, defaults on subprime loans increased markedly. This triggered the broad-based re-pricing of risk and evaporation of market liquidity that followed.

As demand for credit rose, so did leverage (the ratio of debt to equity). Much of the increase in leverage occurred within the financial sector itself, as assets that were repackaged to be distributed to end-investors were actually held on the balance sheets of financial institutions, particularly non-bank financial institutions. As Adair Turner has pointed out, while some banks were truly operating an 'originate and distribute' model, others were increasingly operating an 'acquire and arbitrage' model – a model that left risk on banks' balance sheets but in the form of more complex and less transparent securities. This increased leverage was to leave institutions more exposed as the crisis unfolded.

Figure 2.4: UK banks' assets



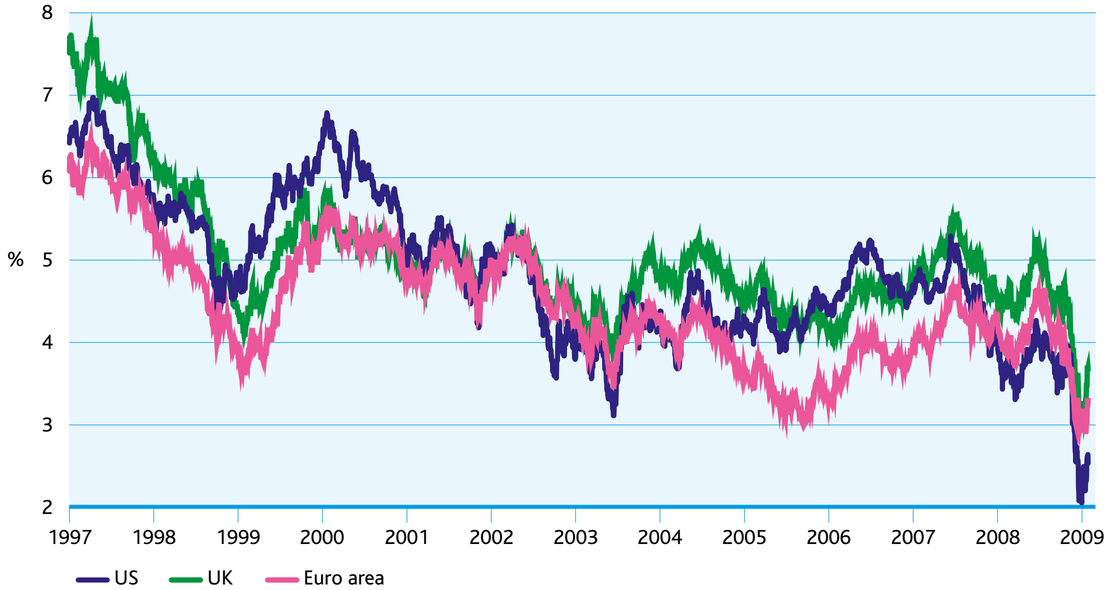
Source: Bank of England (October 2008) *Financial Stability Report*. London: Bank of England

2. The 'search for yield'

Falling returns offered by risk-free assets, coupled with a ready access to credit, fuelled demand for higher-yielding assets on the part of investors – the so-called 'search for yield'. Initially, demand was channelled into the purchase of conventional assets, such as corporate bonds, equities and emerging market government bonds, but the increased demand only served to push up prices and reduce yields, causing a compression of the spread that could be earned on such assets relative to the risk-free interest rate (Figures 2.5 to 2.7).

Figures 2.5 to 2.7 show falling bond spreads in the 'search for yield'.

Figure 2.5: Ten-year government bond yields, 1997 to 2009



Source: Bloomberg

Figure 2.6: US corporate bond spreads, 2000 to 2007

Source: Moody's Investors Service via Bloomberg

Figure 2.7: Emerging market bond spreads, 1999 to 2009

Source: JPMorgan Chase & Co

In order to meet the appetite for higher-yielding assets, new structured financial products were created, primarily by bundling together and repackaging traditional loans as securities or by creating synthetic exposures to underlying risks by the use of derivative products. Many of these products were traded 'over the counter' and tailored to investors' own appetites. Data from the Bank of International Settlements shows that the notional value of all outstanding over-the-counter derivatives products is almost $700tn, more than 10 times global GDP and around 20 times the current market value of all the world's stock markets. Box 2.1 describes the securitisation process in more detail.

Box 2.1: Securitisation and the 'originate and distribute' model of banking

Securitisation is the process of originating or purchasing loans and other assets associated with a cashflow, then pooling and packaging them into securities and selling them to investors and other banks, thereby distributing some or all of the associated credit risk. For example, a large proportion of the underlying mortgages in the US subprime mortgage market were securitised into residential mortgage-backed securities (RMBSs) and sold. In some cases, RMBSs were re-securitised as more complex and highly leveraged structured products called collateralised debt obligations (CDOs).[11]

The growth of this 'originate and distribute' model of banking was driven by three main motivations:

- It allowed banks to distribute off their balance sheets more of the credit they originated, thereby earning interest income without tying up significant amounts of regulatory capital.
- Banks were able to obtain a relatively cheap, plentiful supply of wholesale funding by packaging some of their mortgage and other lending into asset-backed securities (ABSs).
- Banks were able to better tailor securities to investors' risk appetites by re-securitising RMBSs and other ABSs into CDOs and other structured products that 'slice and dice' credit risk into tranches with different risk characteristics.

In many cases banks sponsored, and provided liquidity lines to, conduits and structured investment vehicles (SIVs), which purchased long-maturity ABSs and other assets from their sponsor bank or other banks and funded this by issuing short-maturity, asset-backed commercial paper (ABCP) or other securities. ABCP conduits issued only a single class of debt. They were fully backed by bank-provided liquidity lines, available to be drawn should the market for ABCP dry up (as happened in 2007). SIVs issued a range of short- and medium-term securities and invested the proceeds in assets with a somewhat longer average maturity. In contrast to ABCP conduits, the ABCP issued by SIVs was not fully supported by liquidity facilities.

Securitisation was prominent in the mortgage market where individual mortgages were packaged up and sold together. This was significant in the US, but in the UK only 17% of mortgages were securitised. As defaults increased in the subprime mortgage market, it became clear that the assets underpinning these securities were worth less than had been thought. Financial institutions around the world sought to revalue these securities accordingly and to reappraise risk. However, the complex nature of these assets made the recognition of the size and location of the losses, and thus risk, difficult. The uncertainty in valuation quickly translated into a severe impact on the markets for these products, endangering those institutions that were most exposed to them.

As liquidity dried up, banks became uncertain about their future funding needs and less confident about their ability to meet potential demands quickly. Investors became reluctant to place funds in unsecured money markets at anything other than the shortest horizon. In such troubled market conditions, even major institutions were vulnerable.

In the aftermath of the conservatorship of US mortgage finance agencies Fannie Mae and Freddie Mac and the failure of Lehman Brothers, the global financial system came under extreme stress as financial institutions and investors lost confidence in counterparties in general. Spreads on inter-bank lending reached unprecedented highs and stock markets fell 20% or more in less

[11] CDOs are securities backed by a portfolio of fixed-income assets that are issued in tranches of varying seniority. As default losses accrue to the underlying portfolio, they are applied to the securities in reverse order of seniority.

than a month. The extreme financial volatility, and the threat it posed to the functioning of the banking system, necessitated significant government interventions across the world.

3. Financial innovation outpaces risk management

The context of the global financial crisis and the description of how the banking crisis unfolded has shown how the financial innovation triggered by the search for greater yield outpaced the risk management both of the institutions themselves and of the regulatory bodies and international institutions around the world. The scale of innovation exceeded the scope to manage it. The following section examines the role of corporate governance in the banking system itself and the role of regulation.

Corporate governance

As discussed above, financial institutions around the world failed to properly understand the nature and extent of the risks they were exposed to – particularly risks of rare or unusual magnitude ('tail risks'), and the correlation of risks in different markets. The primary responsibility for managing risk lies with financial markets participants. It is generally agreed that the failures in the risk management practices of banks and other financial institutions in each country are central to an explanation of the global financial crisis.

This has raised questions as to whether in each country, banking corporate governance arrangements are sufficiently robust. In the UK, the Government has announced a review led by Sir David Walker to examine this question and make recommendations. Box 2.2 describes this review.

Box 2.2: Corporate governance of the UK banking industry

Sir David Walker will examine corporate governance in the UK banking industry and make recommendations, including in the following areas:

- The effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively.
- The balance of skills, experience and independence required on the boards of UK banking institutions.
- The effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees.
- The role of institutional shareholders in engaging effectively with companies and monitoring of boards.
- Whether the UK approach is consistent with international practice and how national and international best practice can be promulgated.

The review will report in the autumn to the Chancellor of the Exchequer, the Secretary of State for Business, Enterprise and Regulatory Reform and the Financial Services Secretary to the Treasury.

Regulation

It is generally recognised that, in all countries, regulation did not keep pace with financial innovation and market practices.

Much has been written about the role and effectiveness of regulation through this crisis. Significant recent reports dealing with these issues include those by the G30,[12] the FSF,[13] Lord Turner at the FSA,[14] Oliver Blanchard,[15] Markus Brunnermeier and others.[16]

Regulation in all countries had insufficient focus on the pace and nature of balance sheet expansion by many financial institutions, and on the systemic consequences of liquidity and credit risk. The combination of product and technological innovation made it possible to design and trade financial instruments in such a way that the nature of the risk they contained, and where that risk was located, was difficult to determine. When concerns over the size and location of exposures to certain risky assets escalated, the close integration of financial markets ensured that the withdrawal of liquidity in one area rapidly transmitted instability to other, seemingly unrelated, parts of the global financial system.

What people thought was that the mechanism to spread risk became the mechanism to spread contagion. As the former chairman of the US Federal Reserve Board Alan Greenspan, at the Committee on Oversight and Government Reform, put it in October 2008: "I made a mistake in presuming that the self-interests of organisations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms." He continued: "This modern risk-management paradigm held sway for decades..." but "the whole intellectual edifice, however, collapsed in the summer of last year."[17]

In the UK the formation of the Financial Services Authority in the 2000 Financial Services and Markets Act brought together a previously fragmented and self-regulating system with multiple regulators into a single authority on a statutory footing for the first time. The UK Government has asked Lord Turner to consider the necessary reforms to the UK's system of financial regulation. Box 2.3 describes this review.

"This modern risk-management paradigm held sway for decades..."
"The whole intellectual edifice, however, collapsed in the summer of last year."

Alan Greenspan

[12] Group of 30 (January 2009) *Financial Reform: A Framework for Financial Stability*. Washington DC: G30

[13] Financial Stability Forum (2008) *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*. Financial Stability Forum

[14] Lord Turner (January 2009) *The financial crisis and the future of financial regulation*. The Economist's Inaugural City Lecture. London

[15] Blanchard O (2008) *'Cracks in the System', Finance and Development* December 2008. Washington DC: IMF

[16] Brunnermeier M et al (2009) *The Fundamental Principles of Financial Regulation*. Geneva Reports on the World Economy 11. Geneva: ICMB/CEPR

[17] Former Federal Reserve Chairman Alan Greenspan's testimony to the House Committee of Government Oversight and Reform, 23 October 2008

Box 2.3: FSA review of financial services regulation led by Lord Turner

A strong and effective system of outcome-focused regulation has a leading role to play in restoring stability and creating a framework for change. On 6 October, the Chancellor asked Lord Turner, the Chairman of the FSA, to make recommendations for reforming UK and international approaches to regulation in order to ensure the future stability of the UK banking system.

The FSA's review will be published in March 2009 and will address the following issues:

- The causes of the global banking crisis.
- The capital adequacy framework, including how much and what kind of capital banks should hold and whether counter-cyclical mechanisms should be introduced.
- Liquidity risk-management regulations and practices, including the extent to which these could achieve counter-cyclical effects.
- Analysis and implications of macro trends in the financial system – what actions may be required to ensure that analysis of macro financial trends feeds into adjustments to regulatory policy or supervisory focus, both at national level and internationally, including consideration of policies aimed at mitigating pro-cyclicality.
- UK and international policies relating to how to treat systemically important firms; rating agencies and the originate and distribute model; market infrastructure in over-the-counter derivatives markets; valuation and accounting; and remuneration and incentive structures.
- The institutional coverage of prudential regulation – whether recent steps to extend the appropriate accounting and regulatory coverage of near-bank and shadow bank institutions go far enough.
- Cross-border cooperation and coordination – including international regulatory cooperation in non-crisis periods, and the scope for better international coordination during individual institutional crises.
- The FSA's supervisory approach, processes and resources – in particular whether the changes already being implemented through the FSA's Supervisory Enhancement Programme are sufficient, given the further global developments since it was initially designed.

Listed below are the areas most often cited as factors that contributed to the unfolding of the financial crisis around the world.

Solvency versus liquidity

Regulation was primarily focused on the solvency risk of banks' assets – not the liquidity risk of the liabilities. When wholesale markets effectively froze, the problem was not whether individual banks had the correct capital requirements, solvency or governance, but that they simply could not raise the money they needed in order to sustain their business models.

Off-balance sheet exposures and the rise of shadow banking

There was rapid growth, especially in the US, in the size of the shadow banking sector – particularly structured SIVs – which was able to take riskier positions with less capital.

This was in part encouraged by regulatory arbitrage incentives created by Basel I regulatory capital requirements. Banks reacted by shifting risk off their balance sheets, as well as by securitising assets to be held in the trading book. However, the interdependence of the regulated and non-regulated sectors remained high. In the unfolding of the crisis in 2007 it became apparent that the banking sector had a high exposure to the financial risks contained in the shadow banking sector. As the SIVs' access to wholesale funding dried up, many had to be brought back onto the balance sheets of the institutions that had created them.

Due diligence and the role of credit-rating agencies

Investors appear in many cases to have relied excessively on rating agencies' assessments of structured products as a substitute for their own due diligence. Credit-rating agencies have been criticised for their ratings of structured products, and in particular for the perceived slowness with which they moved to downgrade US subprime products in 2007. Particular concerns have been expressed about credit-rating agencies' business models, in that they are typically paid by issuers rather than investors. It has been argued that this creates conflicts of interest for credit-rating agencies.

Remuneration and bonuses

There is a consensus that some compensation schemes appeared to have encouraged risk-taking in the run-up to the current crisis. Directors, shareholders and investors in financial institutions failed to recognise the inherent risks associated with remuneration policies that were based on bonuses rewarding short-term book profits irrespective of the longer-term risk inherent in those profits, or the implications when the financial cycle turned. Remuneration based on current period profits, with no mechanism for adjustment for future losses, favoured risk-taking and perpetuated the behaviour of searching for higher yields via increased financial innovation and balance sheet expansion.

Pro-cyclicality

Financial systems have a tendency to be pro-cyclical, fluctuating with the economy and potentially amplifying business cycles. Financial innovations in recent years, and in particular the development of securitisation markets and the consequent holding by banks of a greater proportion of assets on their trading books, may have made the financial system more prone to pro-cyclicality for a number of reasons, including the following:

- The ability to transfer credit risk has reduced some of the incentives for those originating the loans and constructing the financial instruments to assess and monitor ongoing credit quality. Banks were therefore incentivised to originate assets that were rising in value due to high demand, and investors were often poorly placed to assess and monitor the risk associated with these assets.
- The use by banks of best practice value-at-risk models, which use the volatility of the price of the asset over the recent past in order to quantify the risk entailed in marketable securities, appears to have exacerbated the tendency for financial markets to under-price risk in good times, and contributed to the herding tendencies of market participants.
- Market assets also often include tools for managing risk, such as margining, which are pro-cyclical and do not 'see through the cycle'.

It has also been argued that aspects of the current regulatory and financial reporting frameworks are pro-cyclical. While Basel II marks a significant improvement over Basel I in many respects, and fair value accounting is an important contributor to achieving the goals of full and transparent disclosures, concerns have been raised that the fair value accounting and risk-sensitive Basel II regulatory capital requirements may interact to increase financial system pro-cyclicality. Specifically, it has been argued that the practice under international accounting standards of marking trading book assets to market, which prices an asset according to its current market price, helped to swell profits as the market rose, encouraging a continuation in trading. The abrupt shift in market sentiment that precipitated the crisis, reflected in loss of liquidity and a sharp increase in risk premia, appears in turn to have caused prices in many markets to undershoot their long-term trend. There are concerns that mark-to-market accounting rules may be amplifying market stress, due to the requirement to value and disclose at prices that in effect may be distressed. The International Accounting Standards Board has taken steps to clarify the application of fair value accounting in distressed market conditions.

It has also been argued that the increased risk sensitivity of Basel II could lead to additional pro-cyclicality in the system. For example, an economic downturn could put downward pressure on regulatory capital ratios through losses and writedowns that banks may incur, and also because the perceived risk of banks' portfolios will tend to increase. ECOFIN ministers recently called for the international regulation of capital to be modified in future to ensure that the pro-cyclical consequences of the capital regime are mitigated, and they emphasised that capital is intended to provide a buffer to withstand challenging economic conditions and to maintain lending.

Macro- versus micro-prudential regulation

It is generally accepted that the regulation of financial markets in all countries over this period focused too much on micro-prudential regulation of individual firms and insufficiently on systemic risk arising from the collective behaviour of market participants. There was insufficient focus on the impact of the collective behaviour of market participants on risk in the financial system, including the channels through which contagion operates in a market-based financial system. Stress tests, for example, tended to focus on whether banks could survive the first-round effects of a particular event, such as a recession, but did not take into account the second-order feedback effects if a number of financial institutions are hit by the same shock and then all respond in the same way (for example by trying to sell the same assets).

Cross-border cooperation

The crisis has highlighted that in modern financial markets shocks can be transmitted rapidly across borders, and the regulatory and supervisory decisions of national authorities can have international consequences. Equally, while we have global finance and global banks, there remains national supervision. It has highlighted the need for greater surveillance of the financial system as a whole. It is essential that the cross-border cooperation between national authorities is enhanced and that the international regulatory architecture is strengthened.

Chapter 3 Transmission of the crisis to the wider economy

The global economy was experiencing a sustained period of growth and stability when the subprime crisis hit in the summer of 2007. The US was the first economy to slow, but the crisis quickly spread to other advanced economies. By mid-2008, most advanced economies were in recession. Policy-makers in advanced economies faced the conflicting challenges of inflationary pressures from high commodity prices and the effects of slowing growth caused by the banking crisis. Emerging markets, through a combination of buoyant trade and high commodity prices, appeared to be more resilient.

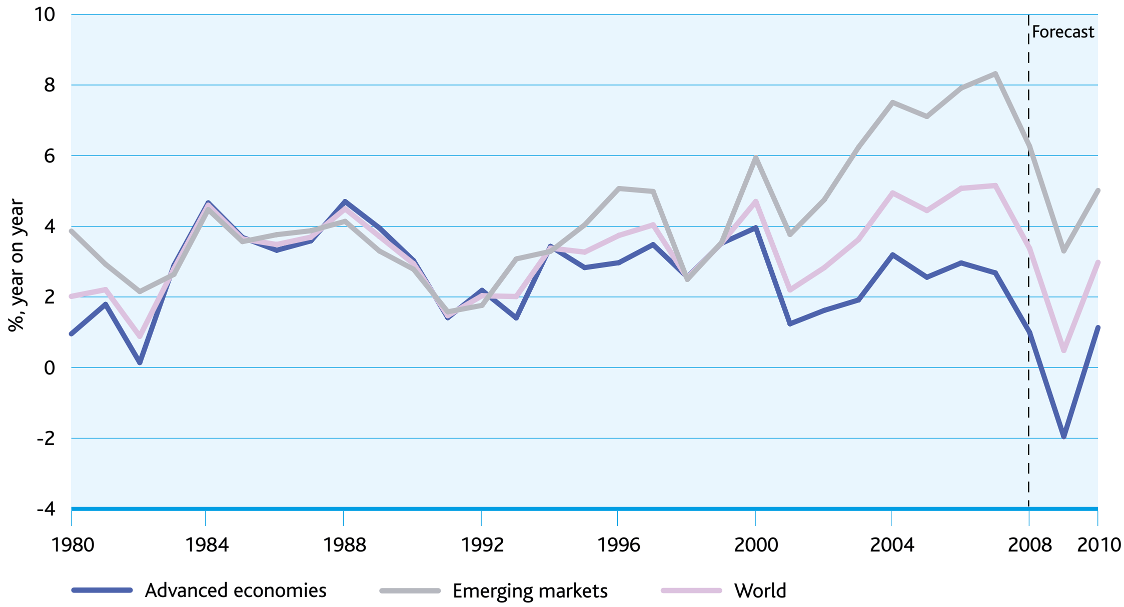
The collapse of Lehman Brothers sent a shock wave around the global financial system which was quickly felt in the wider economy as confidence collapsed and credit evaporated. Emerging markets and developing countries were hit by a concurrent decline in trade flows, as consumers and firms in advanced economies retrenched, and by capital flight as investors sought safety and to cover losses at home. A severe reduction in demand had taken hold in virtually all economies by the end of 2008.

The global economy remains in a very fragile position, with the damage to the financial system continuing to pose a risk to wider economic activity. The international community needs to break this downward cycle with decisive policies to get credit flowing again and to kick-start demand.

The global economic context

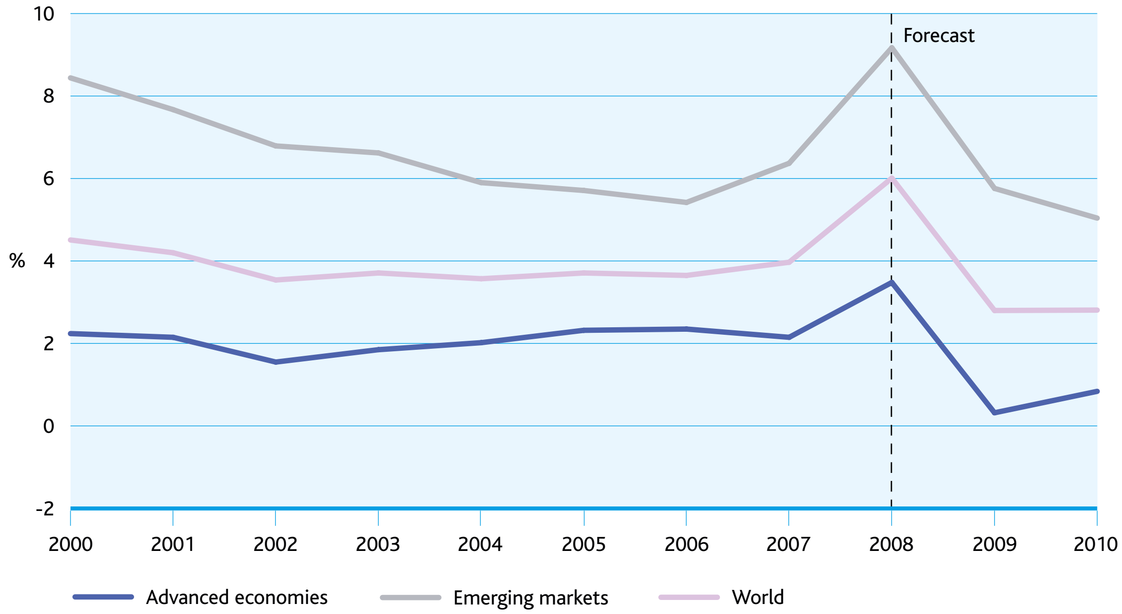
The global economy was experiencing an extended period of strength and stability in the run-up to the US subprime crisis (Figure 3.1). In the four years preceding the summer of 2007, the global economy boomed, averaging growth of 5% a year, and growing faster in 2006 than at any time since 1990. Advanced economies were growing at or above trends, and output in emerging markets was particularly strong. Only the US economy was moderating following a period of monetary tightening, where the interest rate was increased from a low of 1% in May 2004 to a peak of 5.25% in August 2007. Despite buoyant global growth, inflation remained low and stable, averaging just 2% in advanced economies between 2002 and 2006 (Figure 3.2).

Figure 3.1: World economic growth, 1980 to 2010



Source: IMF

Figure 3.2: Global inflation, 2000 to 2010



Source: IMF

US house prices peaked in mid-2006, coinciding with a moderation in the economy through the second half of 2006 and early 2007. Many commentators expected that this was the start of a slow readjustment, which would feed through to the wider economy and help reduce global imbalances.

“Tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally.”

Federal Open Market Committee

By mid-2007, declining house prices were becoming widespread across the US and default rates – particularly on subprime mortgages – were soaring, triggering distress in financial markets. The crisis prompted the Federal Reserve to start its rate-cutting cycle. US interest rates were cut by 50 basis points in September 2007, the Federal Open Market Committee noting that a “tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally”.[18]

The crisis quickly spread to financial sectors around the globe that were exposed to the US subprime assets, particularly in the UK, Europe and Australia. Authorities around the world took action to protect deposits and to guarantee savings to prevent the crisis spreading to the rest of the economy. Bank customers were protected from the initial fall-out, prompting commentators to suggest that the advanced economies could engineer a soft landing.

Economic conditions in non-US advanced economies remained strong through 2007. Japan’s direct exposure to subprime was limited and the economy grew, but became increasingly reliant on net exports. Euro-area growth remained above its trend rate, despite the 3 percentage point increase in German VAT in the first half of the year, and the appreciation of the euro in the second half. The UK grew by 3% in 2007, supported by private consumption and investment.

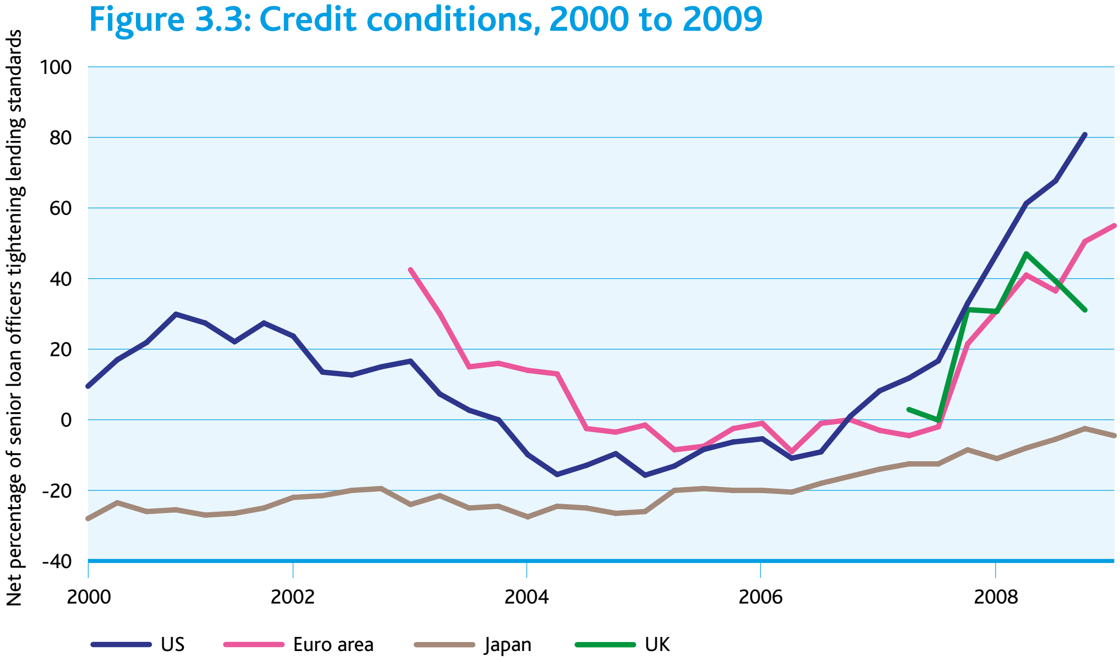
Trade flows continued to grow strongly through 2007 and commodity prices were high. Asia grew at its fastest pace in over a decade, with China’s 13% economic growth in 2007 reflecting both increasing domestic demand and the continuing success of its export sector. Growth among the former Soviet states averaged above 8%. The onset of the financial crisis took place against a backdrop of strong world growth across nearly every continent.

Transmission of the US subprime crisis to advanced economies

The tightening of credit conditions was the first sign of danger to the wider economy. As uncertainty reigned over the extent of subprime-related losses and their concentration, banks began to hoard cash. The resulting illiquidity and increase in perceived credit risk caused spreads on inter-bank rates to widen (shown in Figure 1.4) and exacerbated banks’ unwillingness to extend credit to customers (Figure 3.3). This started a direct transmission from the financial sector to the wider economy, and impaired the effectiveness of subsequent monetary policy easing.

[18] www.federalreserve.gov/newsevents/press/monetary/20070918a.htm

Figure 3.3: Credit conditions, 2000 to 2009



Source: Central banks

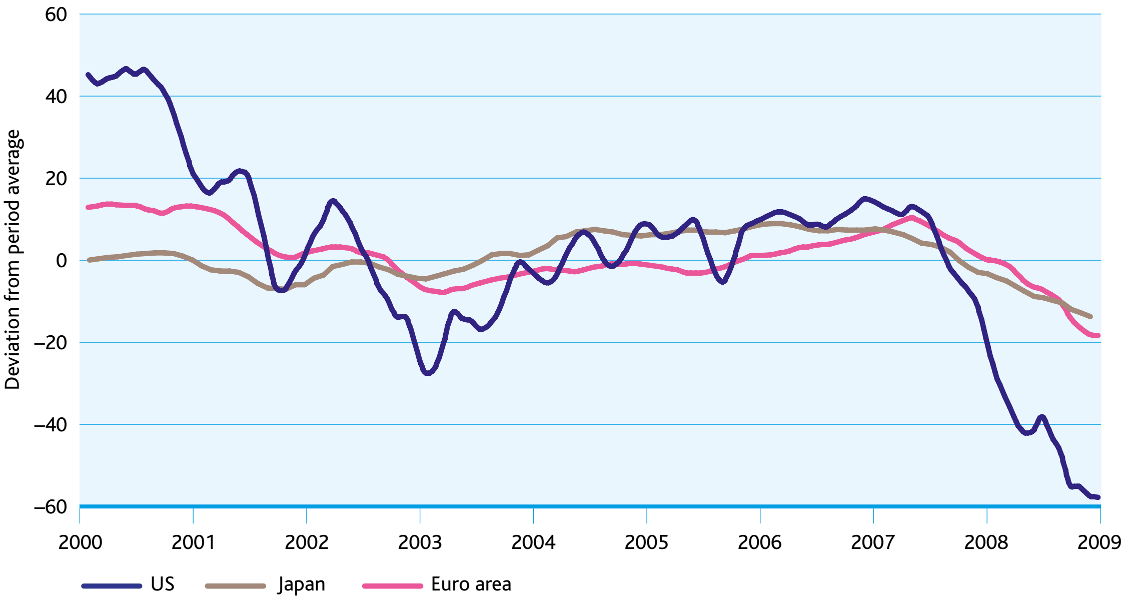
Box 3.1: Transmission from the financial crisis to the real economy

Financial services comprise only a small component of global output, but the stability of the sector is critical to the economy of every country. Banks channel savings in the form of lending to finance investment and consumption, and thereby support demand in the economy. A shock in financial markets that affects the price of assets can feed into the wider economy of every country through a number of channels:

- **confidence:** weak and volatile financial market conditions can contribute to reduced confidence in prospects for the economy, tending to reduce consumption and investment;
- **wealth effects:** falling house prices and other asset prices can erode the wealth of households, which can reduce current consumption;
- **collateral:** declining asset prices can directly reduce households' and businesses' ability to borrow by reducing the value of the collateral they can post to secure credit;
- **credit:** reduced credit availability and the higher cost of credit constrain the ability to consume and invest;
- **exchange rates:** asset price shocks can have a sharp impact on exchange rates, disrupting trade flows.

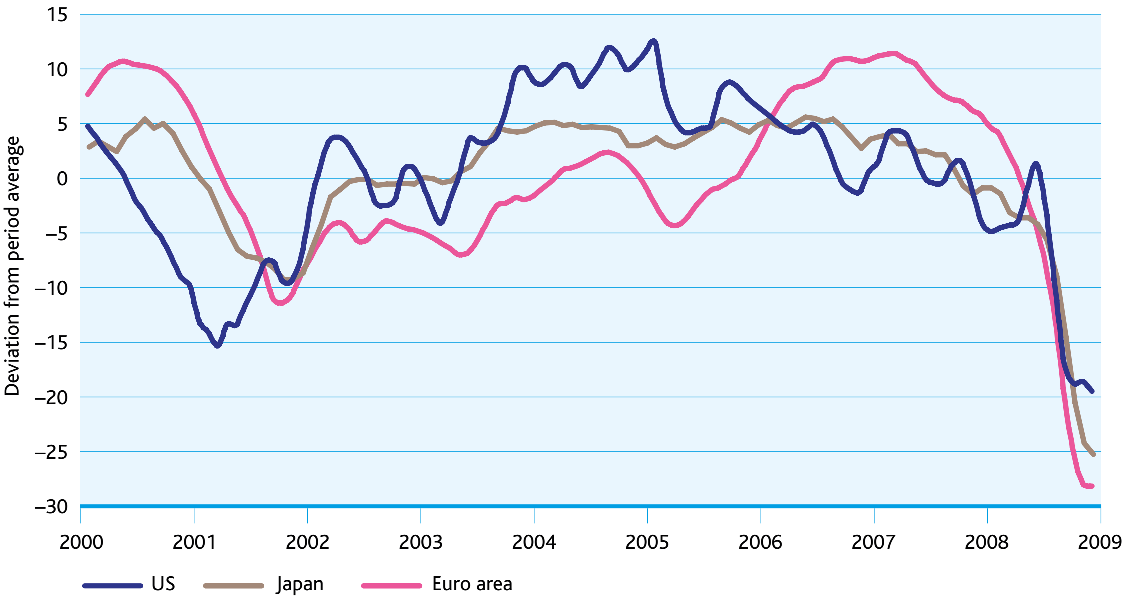
While economic growth in advanced economies was holding up, underlying weaknesses were emerging and leading indicators began to deteriorate in the second half of 2007. Falling house and stock prices, coupled with uncertainty over future growth prospects, led consumers and businesses alike to retrench. In the US, the labour market was in retreat and consumer confidence was deteriorating. The corporate sector remained profitable but scaled back or delayed investment plans. The benchmark Institute for Supply Management (ISM) manufacturing survey in the US moved close to levels consistent with past recessions. In the euro area and the UK, consumer and business confidence began to decline (Figures 3.4 and 3.5). High commodity prices squeezed real incomes, continuing a trend that had begun in 2002.

Figure 3.4: Consumer confidence index, 2000 to 2009



Sources: Conference Board, DG ECFIN, Japan Cabinet Office

Figure 3.5: Business confidence index, 2000 to 2009



Sources: DG ECFIN, Chicago PMI, Shoko Chukin Bank

Tight credit conditions, commodity price-related inflationary pressures and deteriorating confidence brought an end to the period of rapid house price growth in the UK, Ireland and Spain, among others. In many markets, house prices peaked in the third quarter of 2007, while equity and other asset prices registered marked falls over the year.

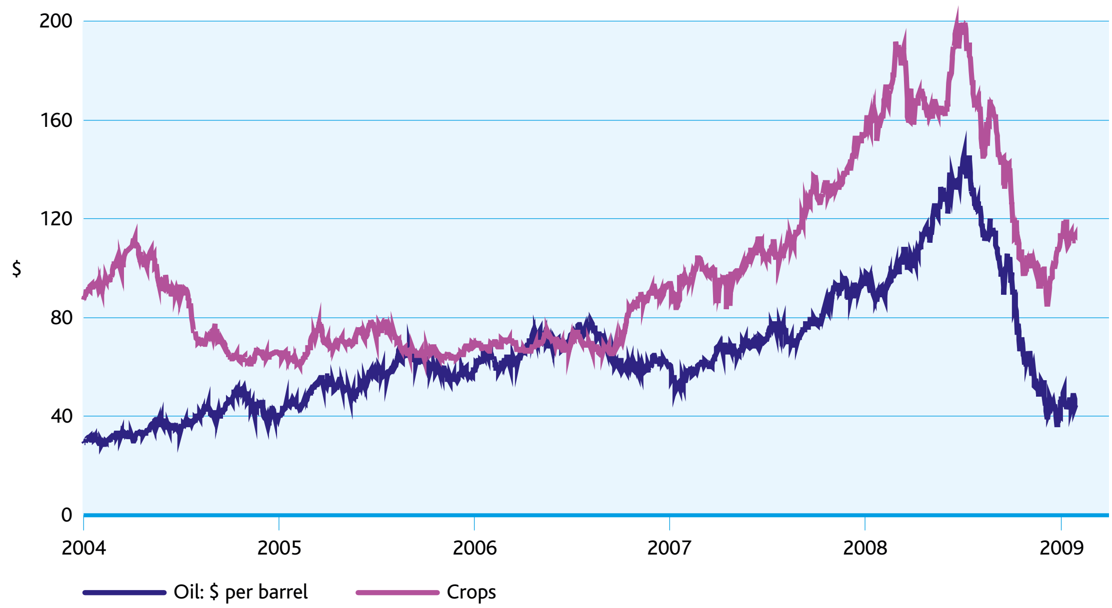
Rising commodity prices and inflation

The US was officially declared to have been in recession from December 2007.[19] In response to declining economic conditions, the US Congress passed plans for a fiscal stimulus in February 2008. This incorporated around $100bn tax cuts and $50bn relief for businesses; most of the support to households was distributed in May. The Federal Reserve continued to cut interest rates: by January 2008 the Fed Funds rate was 3.5%, and by August it was down to 2%. The US economy picked up temporarily in the second quarter of 2008, growing 0.7% on the previous quarter, supported by the fiscal stimulus and strong export growth.

The euro area entered recession in the second quarter of 2008, with the three largest economies – Germany, France and Italy – all contracting. Weaker consumption was mainly due to deteriorating purchasing power as inflation rose to a peak of 4.1% in July. Tighter lending conditions and concurrent drops in sentiment also played a part in weakening investment growth. There was a marked decline in economic conditions in Japan, driven by weaker global demand and an appreciating yen as the global carry trade unwound.[20]

Trade held up in the first half of 2008 while commodity prices continued to accelerate, oil breaking $100 per barrel in February. Shipping costs reached unprecedented heights, driven by high demand for commodities in the first half of 2008 (Figure 3.6).

Figure 3.6: Commodity prices, 2004 to 2009

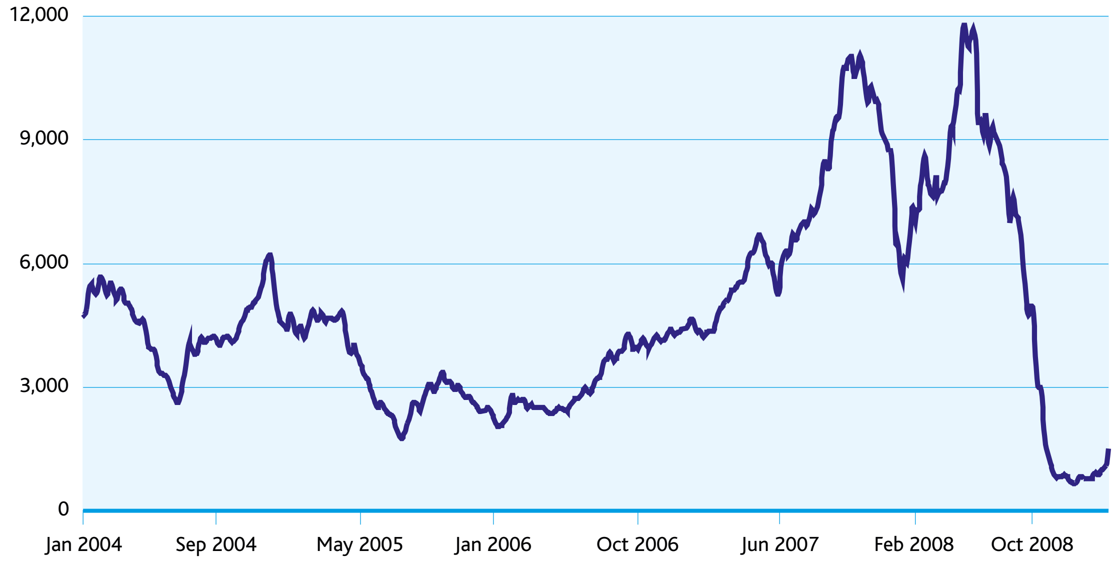


Source: Bloomberg

[19] www.nber.org/cycles/dec2008.html

[20] In its simplest form, the carry trade involves borrowing in a low-interest-rate currency like the yen and investing in a high-interest-rate currency like the Australian dollar. As such, it involves capital flowing from the low-interest-rate currency to the high-interest-rate currency, weakening the former and strengthening the latter. As investors became increasingly averse to all types of risk, including the currency risk involved in this transaction, the flow of capital reversed and the yen in particular appreciated significantly.

Figure 3.7: Shipping costs (Baltic Dry Index), 2004 to 2009



Source: Baltic Exchange and Bloomberg

While advanced economies were slowing, emerging markets appeared insulated from the crisis. This gave rise to the notion of 'decoupling' – that stronger emerging market economies would be less affected by a recession in the advanced economies than in previous business cycles.

Commodity-price-driven inflation began to pick up around the globe. Net commodity importers in emerging markets and developing countries were struggling with high food and oil prices, which many governments subsidised. Higher food prices meant that as many as 100 million more people were living in extreme poverty and up to 44 million more were undernourished. Meanwhile, commodity exporters continued to benefit from rising revenues, increasing foreign exchange reserves and funding the continued growth in sovereign wealth funds.

Policy-makers in advanced economies faced the conflicting challenges of commodity-price-driven inflationary pressures and the disinflationary effects of slowing growth caused by the banking crisis. Many central banks paused their interest-rate-cutting cycle in spite of deteriorating prospects for economic growth, while the European Central Bank raised interest rates by a quarter percentage point in July 2008.

The global recession

The failure of Lehman Brothers caused a dramatic collapse in confidence in the financial markets and in the wider economy. The crisis quickly spread around the world, pushing the global economy into a severe and synchronised recession. Inflation eased rapidly, reflecting the sharp fall in economic activity and the collapse of commodity prices from mid-2008, sparking fears of deflation.

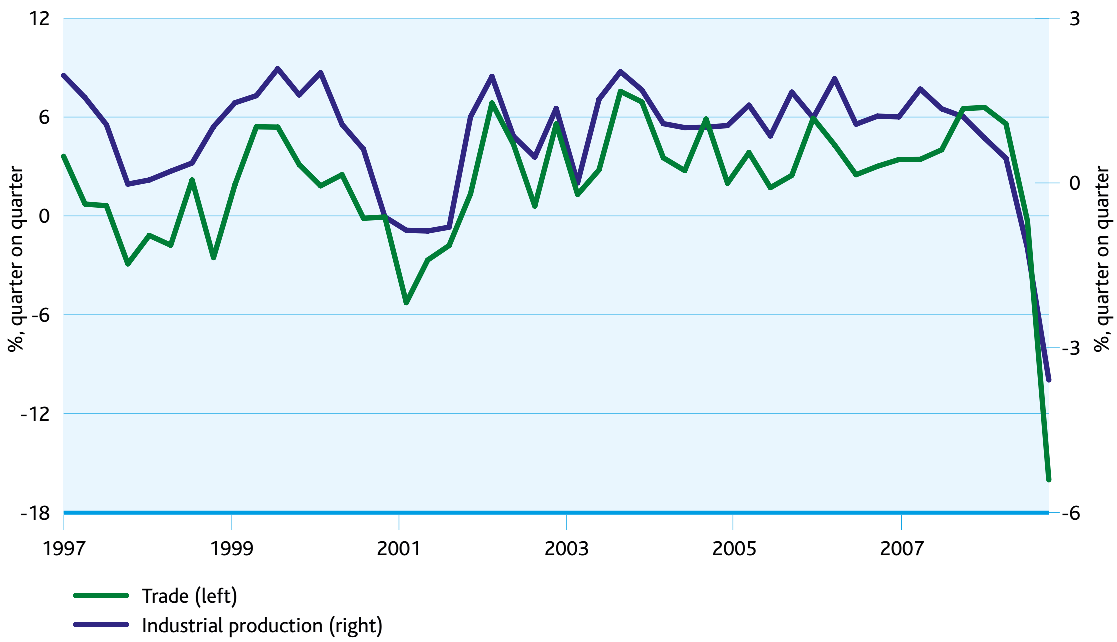
Even as policy-makers acted to bring the banks from the brink of collapse, consumer and business confidence declined. In advanced economies, households were suffering from mounting job losses – the US has lost 3.6 million jobs since the recession began – and steep falls in wealth – by the third quarter of 2008, US household net worth had fallen by $5.6tn over the year. Corporate growth across all sectors of the economy deteriorated rapidly in the face of weak and uncertain demand prospects.

Emerging markets and developing countries have experienced capital flight and the drying-up of the types of credit that keep the world economy functioning: working capital, commercial paper and letters of credit for international trade. The contraction of trade credit has made international trade more difficult and has put great strain on smaller firms in poorer countries that have few internal sources of working capital.

The result is a synchronised global collapse in trade and industrial production (Figure 3.8). The IMF estimates that global industrial production fell at an annualised rate of some 13% in the three months to November 2008. Merchandise exports also fell sharply. In the US, exports contracted 5.4% in the fourth quarter of 2008. Chinese import demand contracted by 21% year on year, with severe knock-on effects felt across Asia, for example in Japan and Taiwan, where December exports dropped by 35% and 42% respectively on the previous year. Korea registered a 32% decline in exports in January. The IMF forecasts world trade to contract by 2.8% in 2009.

The loss of demand also affected the very poorest countries. For example, India and China have each lost 10 million jobs and 14,000 jobs have gone in South African mining. Remittances are down by 40% in Kenya and tourism bookings by 40% in Cambodia and Kenya.[21] Mali, Togo, Niger and Ghana have all seen their exports to the US fall by over 75%.[22]

Figure 3.8: Global trade and industrial production, 1997 to 2007



Source: IMF

The collapse in trade flows exacerbated the problems emerging markets were already facing from the flight of capital to safety. The withdrawal from emerging markets' assets from mid-September was widespread, and financing costs for these countries remained much higher than in the recent past.

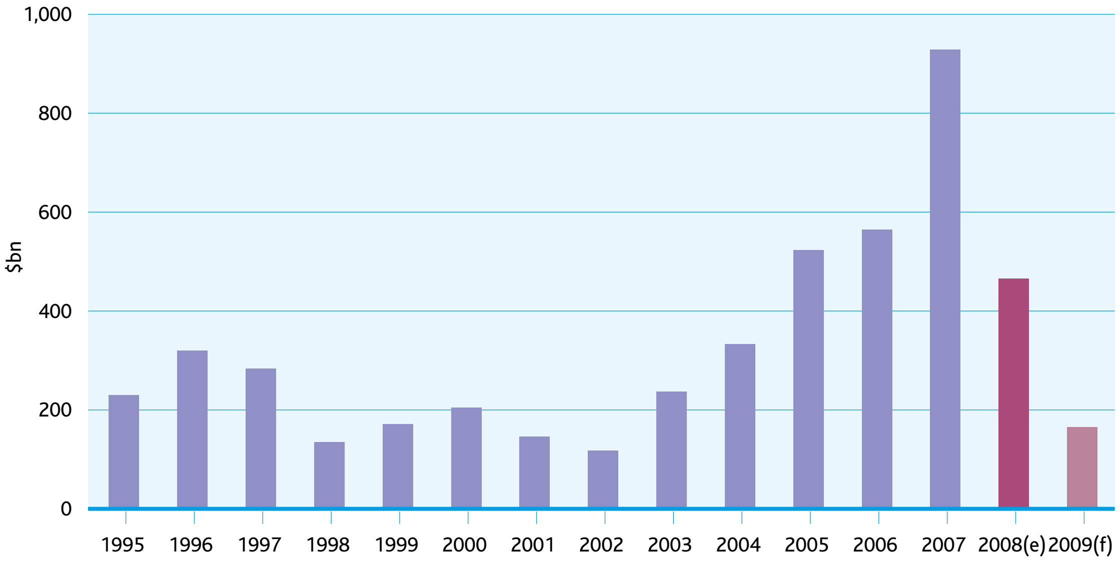
This poses a specific risk to corporate sectors and sovereigns in emerging markets that could be badly damaged if limited access to external financing persists.

[21] Overseas Development Institute (January 2009), *The global financial crisis and developing countries: What can the EU do?*

[22] World Bank

Projections of private capital flows to emerging and developing countries suggest large cuts. The Institute of International Finance (IIF) estimates that net flows will be just $165bn in 2009, down from $466bn in 2008 and a decline of 82% from the boom year of 2007 ($929bn). The IIF identifies bank lending as the worst affected area, and forecasts that there will be a shift from a net inflow of $167bn in 2008 to a net outflow of $61bn in 2009, equal to a $227bn negative swing. This would be a dramatic reversal from the peak year of banking sector net flows ($410bn in 2007).[23] This will curtail private investment and constrain government borrowing, even in countries that have the capacity to take on more debt. These in turn threaten sudden stops in investment and public expenditure at exactly the point at which a boost in global demand requires the opposite.

Figure 3.9: Net private capital flows to emerging markets, 1995 to 2009 (forecast)



Source: IIF
(e) = estimate
(f) = forecast

Furthermore, foreign direct investment was equivalent to 2.8% of low-income countries' GDP during 2005–07, and flows are already starting to fall. World Bank offices report 'serious concerns' in three-quarters of countries and in some countries specific investment projects have been cancelled or postponed. The World Bank's Public–Private Infrastructure Advisory Facility (PPIAF) reports that public–private infrastructure projects that reached financial closure between August and November 2008 involved investment commitments of $17.2bn – down 40% on levels a year earlier. It reports that numerous projects have been cancelled, delayed or potentially delayed due to financing difficulties and increased uncertainty.[24]

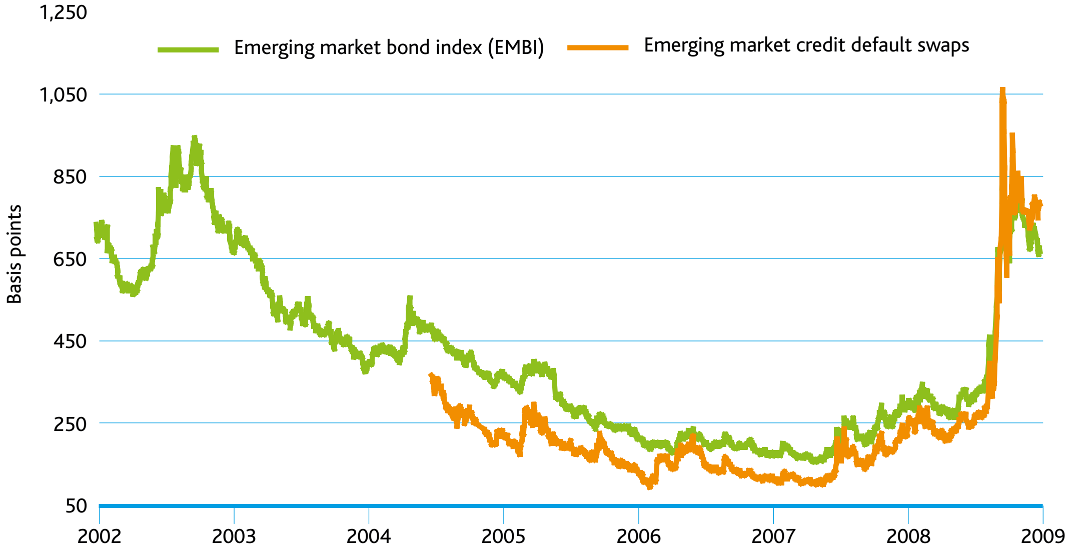
[23] Institute of International Finance (January 2009) *Capital flows to emerging market economies*

[24] World Bank (December 2008) 'New private infrastructure projects in developing countries have started being affected by the financial crisis' (www.ppiaf.org)

Box 3.2: Financial contagion to emerging markets

Although most emerging markets had minimal exposure to subprime or other toxic assets, the losses experienced by investors in advanced markets led to a general flight into dollar-denominated safe assets. In many instances, de-leveraging in advanced economies meant that emerging market investments were sold to raise funds to support domestic capital positions.

Emerging market spread, 2002 to 2009



Source: JPMorgan, Markit Group
Note: EMBI shows the spread between emerging market sovereign bonds and US Treasury bills.

The capital flight exposed serious weaknesses in financial systems of the emerging markets. The growth in both domestically and externally sourced credit in recent years meant that many emerging markets, especially in former Soviet countries, Central and Eastern Europe and the Baltic states, entered the current crisis with very highly leveraged banking sectors, much of which was financed by short-term external debt. Over the past five years, private sector credit growth has been particularly strong in some countries, leaving many with sizeable funding gaps and extremely vulnerable to capital flight and, in extreme cases, possible banking crises.

Commodity prices collapsed in the final months of 2008, reflecting the global downturn. Despite production cutbacks by OPEC, oil prices have declined by nearly 70%, and food prices have eased 35% from their peak in July 2008.

By late 2008, it was clear that the majority of the advanced world was already in recession, with economies across Europe suffering, regardless of whether they had seen large increases in credit in preceding years, and the trade-reliant economies of East Asia slowing very sharply. The US economy contracted by 1.0% in the fourth quarter of 2008, following a decline of 0.1% in the third quarter. The euro area contracted by 1.5% during the same period, while Japan's economy contracted by 3.3%. The Chinese economy grew by just 6.8% on a year-on-year basis in the fourth quarter.

Global prospects and risks

Forecasters have been rapidly revising down their expectations for the coming year as the extent of the downturn has been revealed. The latest IMF forecasts suggest that global growth will decline from 3.5% in 2008 to 0.5% in 2009 – the lowest since the Second World War – and recover gradually to around 3% in 2010. Growth in developing countries is expected to be 3.3%, five percentage points lower than in 2007, and an additional 90 million people risk falling into extreme poverty. The global economy faces many interrelated risks, which the international community needs to tackle. These are discussed in the remainder of this chapter.

Declining demand

Until recently, the crisis has fed through to the wider economy via the channels set out in Box 3.1. However, as the global recession takes hold, the risk now is that slowing economic activity further exacerbates weakness in the financial sector. Weak profits and job losses can lead to increased defaults on loans, generating further losses for banks and so reducing further the availability of credit. The IMF identifies this as a key risk, saying that a "pernicious feedback loop between real activity and financial markets" will intensify the negative effects on global growth.[25]

Credit availability

The banking sector is contracting as institutions fail, merge and retrench. Banks are under pressure from markets to raise capital and show that they have the strength to weather the crisis and cover uncertain exposure to future losses.

The key focus for policy-makers, and of the policies already made, is to ensure that the de-leveraging process is contained within the financial sector.

Financial isolationism

Recent capital flows suggest that there has been a retrenchment of banks towards the home markets they know best, and where taxpayers have supported them. This poses a risk to all economies as it may further amplify the scale of the writedowns on assets and the ultimate scale of the de-leveraging process. Furthermore, financial integration remains an important source of growth for all countries and an important way of tackling other global strategic issues such as development and climate change.

As the international community works towards better ways of managing the global financial system, it should ensure that it does not do so in a way that would unnecessarily impinge on the poor or limit the potential benefits of well-managed financial integration.

Trade protectionism

In times of economic difficulty, protectionist arguments resurface. The temptation for countries to resort to policies that put the interests of their own national producers and exporters first is understandable but futile. Restricting imports or subsidising national production increases costs for consumers and taxpayers, leaving them less to spend on other goods and services. It may force national resources to be diverted away from what a nation does best towards the domestic provision of goods and services, which others could provide at better value. Moreover, such action is likely to provoke retaliatory action, with trading partners restricting opportunities for exporters as well, leading to a vicious cycle of protectionism everywhere.

It is therefore encouraging that the leaders of the G20, the Asia-Pacific Economic Cooperation and, separately, China, Japan and the Republic of Korea pledged in December 2008 to refrain over the next 12 months from raising new barriers to trade and investment, from imposing new export restrictions, and from implementing measures to stimulate exports that are inconsistent with the World Trade Organization.

[25] IMF (January 2009) *World Economic Outlook Update* (www.imf.org)

Nevertheless, the political pressure remains, and signs of increased protectionism have already surfaced in political rhetoric and in the form of increased tariffs, badly designed subsidies to troubled industries, and exchange rate interventions. Maintaining global trade will be crucial to sustaining demand during the downturn and supporting growth during the recovery. The very sharp contractions seen in East Asian economies in recent months have illustrated clearly the economic cost of declining trade.

Deflation

Deflation risks are becoming an increasing concern, particularly in advanced economies where the room for further conventional monetary easing is limited. Under normal circumstances, a brief period of negative headline inflation would not be a major concern, especially if it were a temporary by-product of declining commodity prices. However, in the current environment of falling demand in advanced economies, the danger that this might lead to the setting in of deflationary expectations is a greater concern than usual.

Chapter 4
Planning for recovery

Governments and regulatory authorities around the world have taken unprecedented action in response to the global financial crisis and economic downturn. Governments have had to step in where financial institutions and markets have failed. Globally, nearly $500bn has been announced for recapitalisation to shore up the financial system. In addition, most G20 countries have announced stimulus packages – with injections estimated at over $2tn into the world economy.

The UK Government has responded to the economic crisis through a plan for recovery that comprises four pillars:

1. Protecting people and their savings by preventing the collapse of the banking system.
2. Giving real help to families and businesses now to support the economy.
3. Maintaining bank lending.
4. Investing for the recovery and preparing the country for the new opportunities and challenges globalisation will bring.

Pillar 1: Protecting people and their savings by preventing the collapse of the banking system

Financial markets and institutions influence the lives of individuals and businesses throughout the world. They are the core mechanism by which savings fund investment in an economy. Financial instability and disruption to the markets therefore has the potential to impact far beyond the banking sector.

Governments around the world have intervened to limit this impact. The UK Government has worked closely with the Bank of England and the FSA to ensure that interventions targeted at the financial system are aimed at maintaining opportunities for saving and investment for business and families across the country.

Providing temporary liquidity to support the financial system

The first external signs that financial institutions were in trouble came as the exposure to sub-prime lending caused uncertainty in asset prices, which led to the collapse of the asset-backed securities market in 2007.

The subsequent lack of liquidity reduced the availability of funding between banks. In response, governments and central banks around the world took specific measures to tackle liquidity shortages by providing temporary financial support to banks. This allowed those banks that were short of liquid funds to continue to lend.

The US Federal Reserve established a temporary 'term auction facility' to inject liquidity by lending with a broader range of collateral to a broader range of counterparties. In addition, a number of central banks have been working together to ensure liquidity in dollar markets around the world through currency swaps.

In the UK, the Bank of England, backed by the UK Government, introduced the Special Liquidity Scheme (SLS) in April 2008. This scheme provided banks and building societies with additional liquidity, allowing them to swap pre-existing illiquid financial assets with highly liquid Treasury bills for three years. As of 30 January 2009, when the window closed, the Bank of England held high-quality private sector assets with a market value of approximately £242bn against the £185bn nominal value of Treasury bills lent to the banks.

In October 2008 the Bank of England introduced a collateral swap facility – the discount window facility (DWF) – on a permanent basis. The DWF works in a similar fashion to the SLS by allowing banks to swap their assets for gilts for a period of 30 days. The terms of the DWF were enhanced following the closure of the SLS with swapping arrangements for 364 days for an additional fee.

In October 2008, the Government also established the Credit Guarantee Scheme (CGS). This scheme offers a government guarantee to eligible UK banks and building societies that need to refinance maturing debt. The scheme guarantees debt issued by the banks, with the Government paying out under the guarantee should the participating bank default. Eligible institutions pay a commercial fee for their use of the scheme. This Government guarantee is intended to support greater confidence across the financial system. By helping banks to gain access to funds, guarantees allow banks to continue to lend more widely. By February 2009, banks had drawn down some £100bn of guarantees.

Other countries have introduced similar guarantees. For example, Germany has pledged €400bn to guarantee debt securities and liabilities of financial institutions with maturities up to 36 months issued or incurred between October 2008 and December 2009.

Protecting savings

If a retail financial institution fails, customers can be denied access to their savings unless adequate protection is in place. Such failure can impact far wider than the failed bank, reducing confidence in the financial system and damaging everyday economic activity – so-called 'systemic risk'. So it was both to safeguard deposits and to shore up confidence in the financial system that governments around the world intervened in the banking sector.

The UK Government intervened to support Northern Rock in late 2007. It became clear that Northern Rock was particularly vulnerable due to its business model and the market conditions – meaning that it had difficulty accessing finance and faced increasing costs of financing. Box 3.1 outlines the liquidity crisis that Northern Rock faced. The Bank of England provided £4bn of extra support in order to provide increased liquidity to the wider market, but Northern Rock's position continued to deteriorate. It became clear that the bank was likely to need specific support in order to protect ordinary depositors.

As large-scale withdrawals of deposits continued, to provide additional assurance to individual savers, the UK Government announced guarantee arrangements for all existing retail savings in, and certain existing wholesale liabilities of, Northern Rock. This ensured that no individual's savings would be lost. But the bank's funding problems remained, and after exploring all options for a private sector solution (including options that included ongoing public support), the Government took Northern Rock into temporary public ownership. This action protected the savings of the bank's customers and helped to limit instability in the UK financial system.

The UK Government has also acted to establish a permanent statutory regime for dealing with failing banks (the Banking Act 2009), introduced, following emergency legislation, in February 2008. This creates a system for dealing with banks in financial difficulties, including taking them into temporary public sector ownership and transferring deposits to other banks. It also gives a statutory footing to increasing depositor protection, increasing the limit for protected funds to £50,000. The Act also creates a new insolvency procedure for banks, formalises the Bank of England's role in overseeing systemically important payment systems, and introduces a new statutory financial stability obligation for the Bank of England.

New legislation enabled the Government to take action in relation to Bradford & Bingley. The bank was seen as reliant on buy-to-let and self-certified mortgages, which were vulnerable to a sharp rise in the rate of arrears. It lost market confidence, causing its share price to fall sharply and making it increasingly difficult for it to access funding. On 27 September 2008, the FSA determined that Bradford & Bingley was no longer meeting its regulatory threshold conditions to operate as a deposit-taker. The Government, on the advice of the FSA and the Bank of England, to protect ordinary depositors, transferred the retail deposits and branches of Bradford & Bingley to Abbey National, following a competitive sale process. The remainder of Bradford & Bingley's business was taken into public ownership and will be wound down.

Countries around the world have seen their banking sectors consolidate. In the UK, Alliance & Leicester has been taken over by Santander, and in October 2008 the Government concluded that the merger of Lloyds TSB and HBOS was, on balance, in the public interest, helping to maintain the viability of the banking system and protect ordinary depositors.

Similar situations have been seen around the world. Many banks, reliant on short-term funding from the markets, have struggled to raise capital. A number of other countries have introduced or increased guarantees on retail deposits, including Ireland and Germany. Other governments have also intervened to rescue particular banks, including Anglo-Irish (Ireland), Sachsen and IKB (Germany), and Fortis (Belgium, Luxembourg and the Netherlands). Other situations have resulted in takeovers and mergers, including Bear Stearns-JPMorgan Chase (USA).

Recapitalising the banks
Despite the concerted action taken in late 2007 and 2008, the collapse of Lehman Brothers in October 2008 marked a new phase in the financial crisis, prompting complete decline in trust and confidence in banking. The uncertainty that followed risked not only institutional failures but potentially the collapse of the entire system. It became clear that, unaided, continued solvency for many banking institutions would require substantial contraction of their lending to customers. Governments around the world considered whether, and how, they could step in to restore confidence, protect depositors and sustain the credit system.

Recapitalisation – whereby a government takes a stake in a bank to increase the bank's equity relative to its debt – has been a key part of governments' response. This reduces the risk of insolvency and helps to restore confidence in the banks and wider financial system. In October 2008 the UK Government agreed with eight major UK banks that they would recapitalise. The Government made up to £50bn available to facilitate this, and in return the Government would take shares in any participating institutions.

Two UK banks have been recapitalised with government support. The government agreed to make a series of investments amounting to £37bn: £20bn in the Royal Bank of Scotland, and following the takeover of HBOS by Lloyds TSB, £17bn in the merged bank. The Government will not be a permanent investor. Over time it will dispose of these investments in an orderly way. In the meantime the shares will be held at arm's length, enabling the banks to respond to the market while protecting the taxpayer investment.

This recapitalisation was conditional on, firstly, bringing an end to rewards for failure. The boards of the banks that received injections of capital from the taxpayer will take no cash bonuses in 2008. This coincided with announcements by several banks that senior board members will be leaving their positions. Going forward, the rewards will be linked to long-term performance and value creation, not excessive risk-taking. Second, support was made conditional on commitments to restore and maintain the availability of loans for home buyers and small businesses at competitive rates. Third, there will be limits to dividend payments. As set out in Chapter 2, the FSA and Sir David Walker are reviewing incentives and remuneration as part of the corporate governance of banks.

Following this action, in October 2008 the G7 finance ministers agreed an action plan for coordinated interventions concerning the recapitalisation of financial institutions and the unfreezing of credit and money markets. This was then endorsed by the International Monetary and Financial Committee.

Following the UK's recapitalisation programme, the US Government announced its Capital Purchase Program, with committed funds of $250bn. France pledged €40bn for bank recapitalisation and Japan set aside ¥2tn. A series of countries followed, with recapitalisation announcements amounting to some $500bn. Countries have taken a broad range of measures to stabilise the financial system (see Box 4.1).

Box 4.1: Countries have undertaken a broad range of measures to stabilise the financial system

European governments have introduced measures to provide liquidity and to increase the minimum deposit guarantee, with permission given for member states to offer higher guarantees. Several European countries have announced bank debt guarantees and many have injected capital into financial institutions. Spain has created a fund to buy high-quality bank assets on a voluntary basis, at market prices. And most recently, the Netherlands has adopted a 'bad-bank' solution for one of its financial institutions.

The US has undertaken significant measures through liquidity injections, increased deposit insurance, guarantees for bank liabilities and assets, extending credit lines to troubled financial institutions, capital injections for financial institutions, and asset insurance. On 10 February 2009, Treasury Secretary Tim Geithner outlined the Financial Stability Plan, expanding the range of financial tools available for cleaning up lingering problems in the banking system, opening up credit and beginning the process of financial recovery. The plan includes a new Capital Assistance Program, a new Public-Private Investment Fund, expansion of the existing Term Asset-Backed Securities Lending Facility up to $1tn, an extension of the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program to 31 October 2009 and a new framework of governance and oversight to help ensure that banks receiving funds are held responsible for appropriate use of those funds through stronger conditions on lending, dividends and executive compensation along with enhanced reporting to the public.

Japan has acted to inject liquidity and has increased the size of funds set aside for capital injection. The government has expanded public credit guarantees on banks lending to small- and medium-sized enterprises while the Bank of Japan has announced plans to resume purchases of stocks held by financial institutions.

Canada has taken steps to provide liquidity and broaden the range of acceptable collateral. Moreover, the Canadian Government also authorised the Minister of Finance to inject capital into troubled financial institutions.

The increasing role of the public sector in financing the international financial system is illustrated in Table 1.1 and government capital investments to date are summarised in Table 4.1.

Table 4.1: Government capital investments in financial institutions

Country	Government capital investments (US$bn)
Belgium	15.6
Britain	52.2
China	2.1
France	10.5
Germany	40.7
Japan	0
Luxembourg	3.7
Netherlands	17.9
Singapore	0
Spain	0
Switzerland	5.2
US	317.5
Total	**465.4**

Source: Bloomberg, 2 February 2009

The danger that governments and the wider economy face is that, without this government intervention, banks will offer fewer new loans, contract the lines they have open to existing clients and increase the cost of lending. Recapitalisation was an unprecedented step needed to keep open the channels through which money flows, from savers to those who want to invest. It was taken on the basis that to let banks fail would have impacted on many more businesses, workers, savers and mortgage holders.

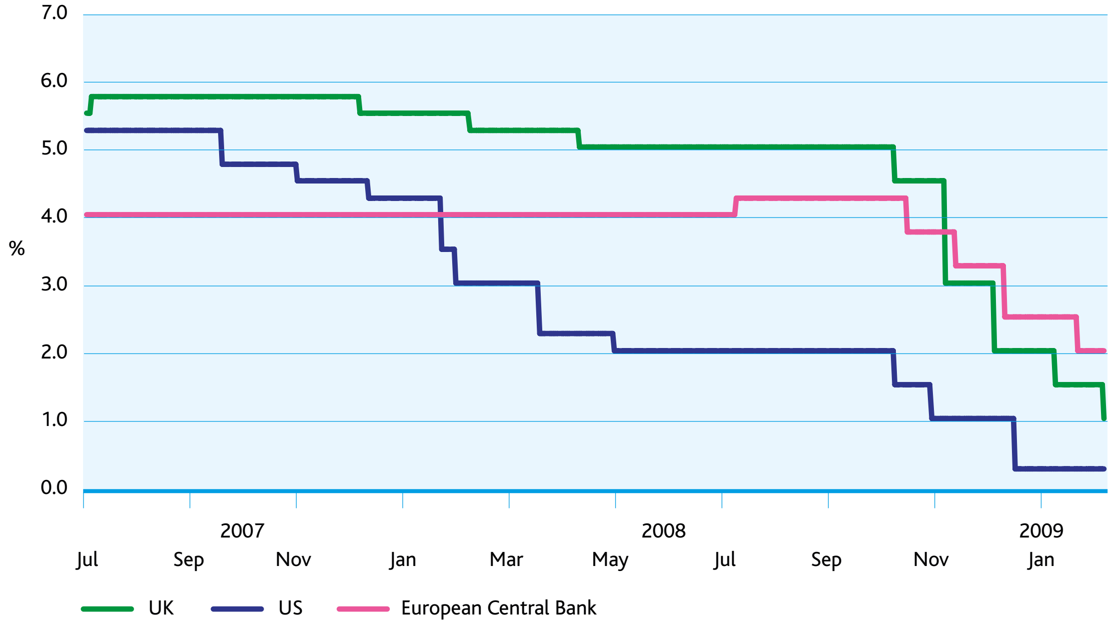
Pillar 2: Giving real help to families and businesses

The financial crisis imposed significant restrictions on access to credit for people and businesses across the world. At the same time there has been a severe contraction in global demand as countries around the world enter recession. In response, governments and central banks have taken further action to support monetary policy in order to help stimulate demand in the short-term and so reduce the length and severity of global and national recessions.

Stimulating demand – monetary policy

Faced with falling demand and falling inflation, monetary authorities across the world have cut interest rates extensively and often in coordination in an attempt to stimulate demand. The Bank of England has cut interest rates 4.75 percentage points to 1% between July 2007 and February 2009, as threats to the Government's inflation target have shifted to the downside. The US Federal Reserve cut interest rates by more than 5 percentage points to 0–0.25% over the same period. For both institutions, these represent the lowest interest rates in their history – more than 300 years in the case of the Bank of England. For the UK, the independence of the Bank of England has meant that these decisions were made independently of the Government.

Figure 4.1: Benchmark interest rates



Source: Reuters EcoWin

Normally, interest rate cuts on this scale would be expected to deliver a significant boost to the economy. But the financial system remains under such severe strain that it has generally been recognised that monetary policy alone will be insufficient to stimulate demand. As Dominique Strauss-Kahn of the IMF has noted, "If there has ever been a time in modern economic history when fiscal policy and a fiscal stimulus should be used, it's now."[26] So countries around the world have looked to fiscal policy to support monetary policy as a means of stimulating short-term demand.

> "If there has ever been a time in modern economic history when fiscal policy and a fiscal stimulus should be used, it's now."
>
> Dominique Strauss-Kahn of the IMF

[26] Press Briefing by Dominique Strauss-Kahn, IMF Managing Director, 15 November 2008.

Fiscal stimulus

Across the world, governments have looked to fiscal policy to provide a temporary stimulus to demand and speed the transition to a low-carbon economy. Typically, the role of fiscal policy has been to focus on allowing the automatic stabilisers to operate in full, in order to avoid fiscal policy tightening when the economy is weakening. However, the nature of the current crisis has led governments around the world to go further in using a fiscal stimulus – discretionary increases in spending or reductions in taxes, or both – to help increase consumption and demand and ensure that falls in economic growth are shallower and shorter than would otherwise be the case.

A concerted stimulus among major trading partners allows each country to benefit from stronger demand in both domestic and export markets. It will also provide a strong signal to the private sector of governments' willingness to act effectively together. This will in turn help to reduce the risk of a vicious circle of declining expectations, cautious spending and therefore lower growth. The approach was endorsed by the leaders of G20 countries in their summit of 15 November 2008. In recognition of the importance of concerted action, the European Council supported a coordinated fiscal boost of €200bn in December 2008.

Any fiscal response needs to be consistent with maintaining sustainable public finances over the medium term. It also needs to be sustainable in the long term by putting the global economy on a low-carbon path to recovery. For fiscal support to help stabilise the economy effectively it should be: timely – needing to have a swift impact; temporary – to maximise its immediate impact and to protect medium-term fiscal sustainability; and targeted – so that support maximises the impact on economic activity.

UK national debt is low by historical and international standards – currently the second-lowest in the G7 group of nations behind Canada, according to the IMF. Because of relatively low debt, borrowing is being allowed to rise for a temporary period to support the economy when it is needed, as is the case in many other countries. But to ensure that the UK has sustainable public finances over the medium term, the Pre-Budget Report (PBR) also set out a series of measures to ensure sustainable public finances in the medium term. This package is based on a fiscal consolidation from 2010–11 including an additional £5bn in public sector efficiency savings.

In the PBR the UK Government announced a package of measures that will provide a fiscal stimulus of around £20bn, or 1% of GDP, between November 2008 and April 2010. This is on top of the impact of the automatic stabilisers that see higher public spending and lower tax revenues than would otherwise be the case as the economy slows that account for 0.8% of GDP in 2009–10. The measures that the Government is implementing have been designed to support demand in the economy, and target specific problems that could either hold back the recovery or make the effects of the downturn longer lasting.

An important part of the UK stimulus is a reduction in the rate of VAT from 17.5% to 15%, effective from 1 December 2008 to 31 December 2009. The VAT cut has injected £12.4bn into the economy and is worth an extra £275 to the average household.

A temporary reduction in the rate of VAT is an effective mechanism for injecting money into the economy because it can be implemented rapidly, and so is timely; it will impact immediately by increasing the incomes of both consumers, giving more help to those with a higher propensity to consume, and businesses, and so is targeted; and it is reversible and thus temporary. A temporary reduction in the rate of VAT will lower prices for households and should provide help immediately and it will support firms and the people that they employ.

In addition to VAT, the UK response has focused on three issues:

- Bringing forward investment in jobs and infrastructure – £3bn of public investment has been brought forward from 2010/11 to 2008/09 and 2009/10, including investment in transport, schools, housing, environmental initiatives and regeneration projects, which provides an important additional source of stimulus. Coupled with this, total net investment in 2009/10 is planned to be £10bn more than in 2008/09.
- Providing greater security for home owners – through a mortgage rescue scheme and support for mortgage interest scheme for eligible homeowners in difficulty.
- Supporting those who are unemployed, or who are facing unemployment to prevent short-term unemployment translating into long-term unemployment – £83m to provide 75,000 people who are out of work with high-quality training places.

The PBR included support for pensioners, families with children, businesses and all taxpayers with modest and middle incomes.

Most G20 countries have now announced a fiscal stimulus package. In total this is estimated to inject over $2tn into the world economy. Most countries have drawn on a mix of reduced taxes and increased public expenditure in designing their stimulus packages. On the tax side, measures include income tax cuts in countries such as Germany and Brazil and corporate tax cuts in countries including Canada, Singapore and the Czech Republic. A number of countries have also altered their tax regimes to provide temporary rebates to households and businesses.

The US stimulus, recently passed, totalled $787bn, or 5.5% of GDP – the largest fiscal expansion in the post-war period. This is split between around $500bn of increased spending and around $280bn of tax measures. The details include: some $240bn in personal and business tax cuts; $160bn spending and investment on energy, health and education; $150bn in aid to local and state governments; $125bn in infrastructure and transportation spending; and $105bn in welfare transfers and other assistance for households. Policy areas seen as essential for the future receive significant investment. This includes spending towards building a lower-carbon economy, with a doubling of alternative energy within three years, and spending on infrastructure and transportation and health and education.

In terms of expenditure, many of the fiscal packages announced so far have included significant investments in public infrastructure, particularly with emphasis upon putting low-carbon infrastructure in place.

Additional help for businesses and families

Families and businesses face difficulties accessing credit for investment and mortgages, and concerns about employment. While those who remain in employment will see a rise in living standards as inflation and interest rates fall, those who face unemployment will require additional support. That is why, across the world, governments have acted to provide real help for families and businesses to see them through this financial crisis.

Since October 2008 the UK Government has announced a series of measures to support families, the unemployed or those at risk of redundancy, and support for housing and those at risk from repossession. A number of other countries have announced similar measures. The main measures are listed below.

Families
- A £145 tax cut for the 22 million basic-rate taxpayers from April
- A VAT cut worth £275 on average for each household
- A payment of £60 to all pensioners in January 2009
- Child benefit increase brought forward to January 2009, worth an additional £22 on average to families
- £1bn to reduce energy bills permanently through free insulation for 11 million pensioners and low-income households and half-price insulation for 14 million households
- Winter fuel payments increased by up to £100 in 2008/09.

Employment and skills
- A £500m package to ensure that anyone taken on after six months of unemployment will receive additional support to get back into employment. This support includes a £1,000 recruitment subsidy paid to an employer and access to £1,500 for training through the Government's Train to Gain programme
- £83m to provide 75,000 people who are out of work with high-quality training places to create an additional 35,000 apprenticeships.

Housing
A £1bn package both to improve access to housing and to support people to stay in their homes. This package includes:

- £200m to convert unsold stock into social housing;
- Stamp Duty holiday for all homes under £175,000; and
- bringing forward £550m for new social rented homes.

There are also three schemes to help those in fear of repossession:
- **Mortgage interest scheme** – interest payments for those made redundant after 13 weeks, rather than the previous 39 weeks, for mortgages up to £200,000;
- **Homeowner mortgage support scheme** – allows deferral of a portion of interest payments for up to two years; and
- **Mortgage rescue scheme** – shared equity for 6,000 vulnerable households.

This is supplemented by a commitment from major mortgage lenders not to initiate repossession action within at least three months of an owner-occupier going into arrears.

Car industry
The Government has also announced a package of measures worth more than £2bn to support the automotive industry. This package includes guarantees to unlock loans of up to £1.3bn of European Investment Bank (EIB) guarantees for investment in lower-carbon initiatives and loans or loan guarantees to support up to £1bn of lending for lower-carbon initiatives for non-EIB backed projects. The US Government has also extended support to the automotive industry; in December 2008 President Bush announced $13.4bn in government loans for General Motors and Chrysler. Announcements have been made in Germany and France and across Europe and Asia.

New green investment is vital to ensure that the industry emerges from the current downturn with the skills and technology base needed to be competitive in the global automotive market

Pillar 3: Maintaining bank lending to families and business
The global financial crisis has seen the reduced availability of credit across economies with the retrenchment of many banks back to their home markets and the withdrawal of non-banking financial institutions from funding. To put this into perspective, over half of new corporate loans in Britain and 40% of new mortgages over the last decade came from foreign banks and non-bank institutions.

The Government included lending commitments as a condition of participation in the recapitalisation scheme. Banks agreed to maintain, over the next three years, the availability and active marketing of competitively priced lending to homeowners and to small businesses at 2007 levels. In addition, banks have agreed to support schemes to help people struggling with mortgage payments to stay in their homes.

The UK Government has acted to support lending, both through interventions in banks and by direct support to business.

Supporting businesses to invest

On 14 January 2009 the UK Government announced a package of measures designed to address the cash flow, credit and investment needs of small- and medium-sized businesses, supporting lending up to £21bn. This package includes:

- a £10bn working capital scheme, securing up to £20bn of short-term bank lending to companies with a turnover of up to £500m;
- an enterprise finance guarantee scheme, securing up to £1.3bn of additional bank loans to small firms with a turnover of up to £25m; and
- a £75m capital for enterprise fund to invest in small businesses that need equity.

Businesses are also being allowed to defer tax payments, with 60,000 benefiting since its announcement in November.

To help the largest companies increase lending, the Bank of England is establishing a new fund of up to £50bn to buy up high-quality corporate bonds and other assets. This Asset Purchase Facility will encourage lending by businesses in the large corporate sector – who have found the cost of their borrowing has increased simply because the market that used to be working effectively is more strained. The programme also provides a framework for the Monetary Policy Committee (MPC) of the Bank of England to use asset purchases for monetary policy purposes, should the MPC conclude that this would be a useful additional tool for meeting the inflation target.

Reducing uncertainty to promote lending

The uncertainty that continues to surround the valuation of certain impaired assets on banks' balance sheets continues to hamper those banks' ability to lend into the wider economy while the value of potential losses remains unclear. To address the impact that this will have on lending, and therefore the ability of the wider economy to invest, governments are looking at interventions that will bring greater certainty and free-up lending.

In January 2009 the UK Government announced the introduction of the Asset Protection Scheme. This provides for banks to receive government protection for assets in return for a fee, in turn allowing them to be better able to raise capital to lend to business and families. All participating banks will have to enter agreements to support lending to creditworthy borrowers in a commercial manner.

Under the scheme, in return for a fee, the Government will provide protection to each participating institution against future credit losses on defined assets to the extent that credit losses exceed a 'first loss' amount to be borne by the institution. The Government protection will cover the major part but not all of the credit losses that exceed this 'first loss'. It is intended that the scheme will target those assets most affected by the current economic conditions. See Box 4.2 for further information on this package. In addition to this, the UK Government has also indicated that it would consider buying assets directly in certain circumstances.

Box 4.2: UK intervention to support lending into the real economy, 19 January 2009

On 19 January the Chancellor announced a package of measures to maintain lending capacity and remove some of the barriers and uncertainty preventing banks from lending further.

This was against a context where the collapse of Lehman Brothers had heralded a further deterioration in financial markets, with banks facing increasingly difficult conditions. Combined with this, the economic downturn had intensified around the world with the US, the euro area and increasingly Asia all seeing weaker production and loss of jobs. The package had the following elements.

First, a new scheme under which the Government will protect certain bank assets for a fee against losses on banks' existing loans. In return for this, Government will negotiate with each bank a lending agreement to support lending to creditworthy borrowers, consumers and businesses across the country. This will reduce the banks' exposure to risks stemming from uncertainty about the value of their assets and give them the room they need in order to lend more.

Second, an expansion of the funding capacity of financial markets. The Credit Guarantee Scheme was extended to run until the end of 2009 in order to guarantee new unsecured borrowing – so far over £100bn of these guarantees have been taken up and have been successful in helping bring down the inter-bank lending rate.

Third, the Chancellor also announced that the Government will provide guarantees, initially on new mortgage lending and eventually on other assets. Overall, the liabilities taken on will be backed by financial assets and fees will be charged.

Fourth, the FSA clarified its policy on capital requirements ensuring that the capital buffers already built in play a role in both withstanding losses and facilitating continued lending.

Other countries are also considering a number of measures to deal with these assets, including the creation of 'bad banks' to purchase the impaired assets – similar to the €21bn support provided by the Dutch government to ING, announced in January 2009.

Pillar 4: Investing for the recovery, preparing the country to take the opportunities of globalisation

Those countries that prepare for the recovery during the downturn will be well placed to take full advantage of the upturn. This is the UK ambition – taking the right decisions to enable the economy to emerge stronger from the recession, better able to compete in the global economy of the future.

Therefore in the UK, even as measures are taken to get through the recession now, so policies are also being put in place for the foundations for a strong recovery. The UK and other countries are advocating a low-carbon recovery. The focus for the coming months will be fivefold.

First, the Government will work to support a stronger, more responsible and more resilient financial sector. A financial sector that remains a world leader, doing business around the globe. A financial sector with more effective governance and smarter regulation, addressing the weaknesses identified, but without undermining the sector's role in supporting investment in the wider economy.

Second, a new drive to cement the UK's place at the heart of the global trading system, building on the UK's strong competitiveness and helped by UK Trade and Investment's work to strengthen both export performance in emerging markets and openness to inward investment and highly skilled international talent.

The UK will continue to champion open, global markets and guard against any resort to protectionism that will delay recovery, and reduce the risk of repeating the mistakes of the past. The UK will continue to call for early completion of the Doha Trade Round.

Third, ensuring that the UK workforce has the skills it will need to take advantage of the opportunities of an increasingly globalised world, through the education system and lifelong learning including support for part-time and flexible work for men and women.

Fourth, continued commitment to medium-term macroeconomic stability built on low inflation and sound public finances.

Finally, build on the world-class businesses growing in the UK already in multiple sectors like advanced manufacturing, security, pharmaceuticals, insurance, education and energy to name just a few. Together with a new focus, backed by investment in skills, research and national infrastructure, in vital knowledge-based sectors of the future such as:

- low carbon – as we move to a low-carbon future, taking the significant opportunities in markets for new low-carbon technologies;
- digital economy – a driving force in changes to the economy in the decades ahead, in terms of enhancing business links across the world and delivering a wide range of applications and services;
- science and bioscience – turning research into business innovation and tackling the barriers to the adoption of new ideas; and
- creative industries – making the most of the UK's talent in new and expanding industries.

Governments want to build a resilient recovery that offers stable and sustainable growth. The International Energy Agency has noted that the challenges facing the energy market still exist and, unless addressed, continue to be a threat to future growth and a sustainable economy. In order to ensure that recovery is resilient and sustainable, the UK and other countries are advocating a low-carbon recovery. This will put us in a good position to take full advantage of the opportunities for jobs and growth. The global market for low-carbon and environmental goods and services is already very large – currently around £3tn – and expected to continue to grow strongly over the next decade as the world addresses the increasing challenges of tackling climate change.

A low-carbon recovery could include major investments in energy efficiency; a shift to renewables, nuclear power and alternative energy; investment in smart infrastructure and research and development including accelerating the commercialisation of low-carbon cars and carbon capture and storage; and ensuring, through appropriate training programmes, that new sectors have the skilled workforces they need.

The Prime Minister has called for a Low-Carbon Prosperity Task Force to report in time for the G20 with further practical recommendations for a low-carbon recovery.

The need for a low-carbon recovery is being recognised internationally. In the US, President Obama has pledged to create five million new jobs by investing $150bn over the next 10 years to build a clean energy future. Japan has a goal of increasing green business to $1tn by 2015, with an increase of over 600,000 new jobs. France has a €400m aid package for clean cars and faster implementation of government public investment projects. Germany has €1.5bn of incentives for new car buyers.

International coordination of these measures will help drive innovation and investment in low-carbon, resource-efficient solutions by giving confidence and certainty to industry. Globally we must ensure that measures taken to stimulate demand over the short and medium term create economically viable jobs, diversify energy supplies and reduce greenhouse gas emissions.

Chapter 5
The London Summit – A plan for stability and recovery

Chapter 1 described how the financial crisis of the last 18 months unfolded. Chapter 2 examined its context, and Chapter 3 discussed its transmission to the real economy. Chapter 4 set out the policy responses taken to date in the UK that will lay the foundations for a sustainable recovery.

This chapter outlines the issues that world leaders and International Financial Institutions will come together to discuss and agree at the London Summit on 2 April; and sets out the need for a comprehensive set of measures, coordinated globally, to address the causes and consequences of the crisis. Taken together, these will be in the interests of all countries; by working together, and coordinating our actions, we will maximise the impact both in the short and long term.

We have seen that action is more successful and more effective when it is taken not just by one country but by many. That is why the leaders of the G20 countries – representing 85% of the global economy – came together at the Washington Summit to enhance global economic cooperation, resist protectionism and consider the reforms needed to help restore global growth and stabilise the world's financial systems.

Washington G20 Summit on financial markets and the world economy

Leaders of the G20 industrialised and emerging economies met in Washington on 15 November 2008, to discuss the serious challenges facing the world economy.

Their Summit Declaration points to the search for higher yields without an adequate appreciation of risks as one of the root causes of the crisis. The development of increasingly complex and opaque financial products and excessive leverage combined to create vulnerabilities in the system. They also point to a number of underlying factors, including inconsistent and insufficiently coordinated macroeconomic policies, and inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. Together, these developments ultimately resulted in severe market disruption.

The Summit Declaration sets out a broad policy response, based on closer macroeconomic cooperation, in order to restore growth, avoid negative spillovers and support emerging market economies and developing countries. G20 countries will:

- take whatever further actions are necessary to stabilise the financial system;
- recognise the importance of monetary policy support, as deemed appropriate to domestic conditions;
- use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability;
- re-affirm the importance of the development assistance commitments already made;
- help emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and programme support. Leaders stressed the International Monetary Fund's (IMF) important role in crisis response;
- encourage the World Bank and other Multilateral Development Banks to use their full capacity in support of their development agenda, and welcome the recent introduction of new facilities by the World Bank in the areas of infrastructure and trade finance; and
- ensure that the IMF, World Bank and other Multilateral Development Banks have sufficient resources to continue playing their role in overcoming the crisis.

In addition to these actions, leaders agreed to implement reforms to strengthen financial markets and regulatory regimes so as to avoid future crises.

The G20 will come together again at the London Summit to build on the commitments made in Washington and set a course for world economic stability and recovery. The London Summit must make three commitments:

- First, confirming the global economic community's determination to do whatever it takes to stabilise financial markets, to reduce the severity of the global recession and help families and business to get through it, and to hasten recovery.
- Second, to reform and strengthen the global financial and economic system to rebuild confidence and trust.
- Third, to put the global economy on track for economically, environmentally and socially sustainable growth and ensure that the benefits extend to the poorest.

In each case, the international economic community must continue to work together both where concerted action can make national measures more effective, and in bringing about a more rapid and more radical mobilisation of the International Financial Institutions.

Taking all necessary action

Action is required around the world to:

- avoid a severe and protracted recession;
- guard against deflation;
- strengthen the financial sector and mitigate the decline in investment and the risks of financial isolationism, as foreign-owned banks withdraw lending or return it to their home markets; and
- forestall the pressure for protectionist policies that will damage every country.

Policy measures to date have avoided the collapse of the financial system and are already playing a useful role in supporting demand, countries will want to monitor conditions in the real economy and consider what further action may be warranted. Therefore the London Summit could focus on the following issues.

The macrofinancial response

First, fiscal policy. So far, government fiscal commitments total approximately 2% of global output. However, in recent months the IMF and others have revised down global growth forecasts significantly. While the significant global action taken to date, through support to the banking sector and in monetary and fiscal stimuli, would be expected to feed through to the real economy over the coming months, countries will want to monitor very closely the global impact and consider whether further action may be warranted.

Although fiscal policy is more effective if concerted internationally, as has broadly been the case so far countries will need to continue to tailor their response to their individual situations, balancing the need to use fiscal policy to provide timely support for economic activity while maintaining a credible commitment to longer-term sustainability.

Second, monetary policy. Monetary policy remains an important policy tool to influence demand. However, as interest rates approach zero in some countries, conventional monetary policy may not be sufficient to provide the necessary economic stimulus. Monetary authorities may need to adopt additional policies, while retaining a credible commitment to maintaining price stability.

Third, financial system stability. The recent capital injections and related measures have stabilised the financial system, but countries are looking at further measures to encourage lending. The crisis has impacted on the real economy in both advanced economies and emerging markets. Rapid, decisive and concerted actions combining liquidity provisions, further capital injections, and disposal of impaired assets are now needed to restart lending to the real economy. Continued early action is essential to break the circle between declining asset values, credit contraction and weakened consumer demand. In addition, regulators need to make clear that capital requirements should not be interpreted in a way that exacerbates pro-cyclicality in the downturn as happened in the upturn.

The macrofinancial response: stimulating global demand

At the London Summit, world leaders will want to:

- review the global impact and effectiveness of measures taken so far and consider the implications for the future – how to ensure that the imperative to boost demand now is consistent with the need for long-term fiscal sustainability, and how to maintain levels of public investment, both in physical and human capital;
- reaffirm their commitment to price stability and to avoiding deflation, and in this context, their support for central banks to continue to take the necessary monetary policy measures to foster growth; and
- reaffirm their determination to take the necessary action to ensure the stability of the global financial system, including immediate action to support lending; and considering the case for cooperation on dealing with impaired assets.

The role of the International Financial Institutions

The Washington Summit emphasised the important role of the IMF, World Bank and other Multilateral Development Banks in responding to the crisis. The Summit called for reform of the International Financial Institutions as part of ensuring a strong, stable multilateral financial and economic system that serves the interests of all countries.

The International Monetary Fund

The IMF's primary responsibility must be to address financial and economic instability, and the unfolding global downturn. This ranges from the provision of international liquidity support to the assistance of specific countries adversely affected by the crisis, facilitating the coordination of members' macroeconomic policies.

The IMF has recognised the importance of stimulating global demand, including through fiscal stimuli. Important measures that need to be considered in order to support the overall objectives of preventing the crisis from spreading, helping countries address damaged finance systems and stimulating global demand include: a substantial increase in its lending capacity; liquidity support to those emerging markets facing a sudden stop or reversal in capital flows; and assisting poor countries affected by global recession. In order to achieve these objectives, substantial increases in the resources available to the IMF will be urgently required.

Going forward, a wider package of IMF reform is needed. We not only need to ensure the Fund has the right resources. It must have the right mandate and the right governance. The IMF's surveillance function needs to be strengthened to allow it to take better account of multilateral spillovers in order to help promote balanced global growth. And its governance structures need to be reformed – where increasing the participation and voice of key emerging markets and developing countries, and the effectiveness of its governance, should be the starting point.

The Multilateral Development Banks

The global crisis puts recent progress in helping the poorest, and the 2015 targets of the Millennium Development Goals, at risk. The World Bank and other Multilateral Development Banks have already increased lending and mobilised additional financing for trade credit, infrastructure financing, recapitalisation of banks and microfinance. But more needs to be done so that the Multilateral Development Banks also play their part in enabling countries to support global demand and cushioning the impact of the crisis on the poorest.

In particular, actions already undertaken to increase the supply of trade finance have not been sufficient. To mitigate further declines in world trade, substantially more credit needs to be made available to exporters in developing countries. The Multilateral Development Banks can help to fill this gap.

First, the Multilateral Development Banks must make better use of existing resources. Second, in the case of the Asian Development Bank, more resources are required. Third, there needs to be an increased focus on the poorest, particularly in low-income countries. Fourth, the process for strengthening the governance structure of the World Bank, so that it can better respond to future crises, must be speeded up.

The role of the International Financial Institutions

At the London Summit, world leaders will identify whether:

- the IMF's resources should urgently be increased, so that the IMF can increase its lending capacity to prevent the spread of the crisis, address damaged financial systems and help stimulate demand;
- to strengthen the IMF's early warning and surveillance function, increase its effectiveness and reform its governance structures;
- the Multilateral Development Banks can increase their support for trade credit in the developing world;
- the Multilateral Development Banks can make better use of existing resources to stimulate demand and support global demand and increase their focus on the poorest; and
- to speed up the strengthening of the IMF and World Bank's governance structures.

Reshaping the global financial and regulatory system

Responding to the immediate crisis can only be a first step. The London Summit's second commitment must be to the reshaping of the global financial and economic system in order to restore confidence and trust in the future.

Reform of the international financial architecture should be guided by the following objectives:

We must retain and build on the benefits that open financial markets bring to the world economy. While it is clear that financial markets regulation globally has failed to strike the right balance between financial stability and financial innovation and appropriately managed risk, it is essential that we retain and build on the benefits that open financial markets bring, in which all countries must be able to share.

Financial institutions' corporate governance arrangements need to be effective at delivering robust risk management. A key aspect of this will be to ensure that remuneration structures create incentives for appropriate risk management. Regulation should also in turn incentivise market participants to adopt remuneration schemes that are in line with sound risk management.

In future, prudential regulation needs to ensure that banks build sufficient buffers of resources in good times so that they are able to absorb losses as conditions worsen without amplifying the effects on the financial sector and the wider economy. And an international agreement on a common framework for identifying and assessing liquidity risks is urgently needed. It will be essential to manage the transition through the current downturn to a new equilibrium with strengthened prudential standards, so as to ensure that regulatory regimes do not act pro-cyclically.

Innovative financial markets must be transparent, appropriately regulated, and supported by robust market infrastructures. The financial services industry must enhance transparency in the securitisation markets, including the standardisation of information provided to investors; and, working with policy-makers and regulators, address how to better align incentives between market participants.

Financial activities should be regulated according to their economic substance rather than their legal form. This will involve addressing the emergence of the shadow banking sector; a shift in regulatory focus towards those institutions and markets that pose the greatest risk; and considering greater powers for regulators to oversee previously under-regulated sectors and how to ensure consistent regulation in all jurisdictions.

Regulation needs to focus on systemic as well as institution-specific risk. This will mean focusing on the most innovative and risky parts of the financial system, and on the impact of the collective behaviour of market participants on risk. As part of this, the London Summit will review progress towards creating a global early warning system led by the IMF and Financial Stability Forum (FSF), which would aim to identify both macroeconomic and financial market risks, including potential triggers and systemic vulnerabilities, and agree appropriate policy responses.

Regulatory regimes must be better prepared for failure within financial markets. Regulation cannot address every potential failure, nor is it appropriate for regulators to attempt to operate a zero-failure regime. Instead, there must be greater contingency planning, more effective ways of winding down financial companies and better arrangements for protecting and compensating depositors.

International financial markets need internationally coordinated regulation. Financial shocks can be transmitted rapidly across borders, and the regulatory and supervisory decisions of national authorities can have international consequences. Therefore policy-makers and regulators must agree principles that national regulatory regimes should follow; internationally consistent standards; a strengthening of the FSF and a broadening of its membership; stronger supervisory cooperation; and more effective cross-border crisis management.

Reshaping the global financial system

A reformed and internationally coordinated system of financial regulation that closes regulatory gaps is urgently needed. At the London Summit, world leaders should address how governments and regulators:

- work together internationally to agree what further steps are needed to enhance corporate governance and risk management by financial institutions;
- agree steps to strengthen prudential regulation, including requiring banks to build buffers of resources in good times;
- consider how to manage the transition through the current downturn to a new equilibrium with strengthened prudential standards, so as to ensure that regulatory regimes do not act pro-cyclically, exacerbating the current downturn;
- ensure that financial activities are regulated according to their economic substance rather than their legal form and regulated consistently in all jurisdictions; and
- ensure that regulatory regimes are better prepared for failure within financial markets.

In addition, world leaders at the London Summit could review whether further steps are needed to marry better the objectives of financial and macroeconomic stability.

Putting the world economy on track for sustainable growth

Chapter 4 set out how the UK Government is investing for the recovery by preparing the UK to take the opportunities that the global recovery will bring.

The Washington Summit emphasised the global economic community's commitment to laying the foundations for this recovery through economic reform.

The London Summit should assess the progress made towards our shared vision of sustainable economic growth, high levels of employment and poverty reduction, and identify those areas where our efforts must be redoubled. In particular:

Trade

Trade and globalisation have been the main engines of the sustained global growth we have seen over recent years, and are now threatened by protectionism and lack of trade finance. If this were to lead to a permanent shift away from an open global economy, this would damage the economic interests of advanced and, especially, emerging and low-income countries, and reduce our collective capacity to generate the jobs and growth that will lift us out of the downturn.

Families' and businesses' concerns about the impact of the global recession are widespread and understandable. But governments must demonstrate that the mistakes of the past – raising trade barriers in response to recession – won't be repeated. In fact, progress towards a global trade agreement – which could be worth over £100bn a year in additional global economic growth – has never been more important. The London Summit should also strengthen governments' commitments not to restrict or distort trade, and put in place transparent mechanisms to monitor those commitments.

90% of world merchandise trade involves some form of credit, insurance or guarantee. In the short term, governments, Multilateral Development Banks, export credit agencies and the private sector must work together to provide a substantial, quick and targeted increase in trade finance resources where it is most needed.

Jobs and skills

Governments must demonstrate their commitment to high and stable employment levels. The ultimate guarantee of the viability of jobs is the development of innovative goods, services and processes which can compete in global markets. Governments, in partnership with business, trade unions and the third sector, must encourage the investment, innovation, skills and enterprise that will generate sustainable jobs, and help individuals develop the skills they need in order to take advantage of these jobs of the future.

Low carbon recovery

There is a clear case for driving a global economic transition that is stable and sustainable. The need to develop a low-carbon economy and tackle climate change cuts across business in all sectors around the world. Taking the necessary action will have profound effects on industry and the global workforce. To provide energy for the future it is vital that, as we rebuild the global economy, we seek to diversify energy supplies to reduce our dependence on high-carbon sources. And to set the world on the path to a low-carbon future we must seize this opportunity to make the long-term investments – economic, scientific and technological – that are required and generate green jobs as a means towards green growth.

Such measures will include investment in energy efficiency and research and development in new technologies, a shift towards renewable energy, and the commercialisation of low-carbon vehicles. The more these low-carbon measures can be pursued by countries acting together, the more investment will be able to be brought forward, with environmental industries forecast to grow by around 50% over the next decade. The Prime Minister has called for a Low-Carbon Prosperity Task Force to report in time for the London Summit, with practical recommendations for a low-carbon recovery.

The automotive sector will be critical to meeting this environmental imperative and economic opportunity, including through the commercialisation of low-carbon vehicles.

Helping the poorest
The current crisis could result in an additional 90 million people a year living in extreme poverty. And a global recovery will not be sustainable unless it benefits the poorest and provides them with the opportunities they need to escape poverty. Governments must not only reaffirm their commitments to the Millennium Development Goals, but ensure that we honour our previous commitments to increase development assistance to improve health, education and the environment in the poorest countries.

So the international community must respond quickly to help the most vulnerable. First, by ensuring continued progress towards the Millennium Development Goals. Second, through increased support to middle- and low-income countries from the Multilateral Development Banks. Third, by both targeting support towards investment in employment and social protection and meeting our aid-for-trade commitments, helping the poorest countries – and their citizens – to take advantage of, and play their full role in supporting, the opportunities of global economic recovery.

Putting the world economy on track for sustainable growth

At the London Summit, world leaders should:

- call for an early completion of the current global trade negotiations, the Doha Round, and strengthen the commitment made in Washington to refrain from measures that are protectionist either in intention or in effect; and put in place transparent mechanisms to monitor such commitments;
- discuss how to ensure that everyone has the skills they need for the jobs of the future;
- call for a low carbon recovery, and agree the need for international leadership on a strategic framework to stimulate investment; and
- reaffirm their commitment to the Millennium Development Goals and commit to making the necessary investments, including honouring their previous commitments to increase development assistance.

Conclusion
The London Summit will take place against the backdrop of exceptionally challenging economic circumstances. But, just as after the Second World War visionary leaders laid the groundwork for 30 years of prosperity and growth, built on international economic cooperation, this crisis is also an opportunity. The world's leading economies can come together and lay the foundations not just for a sustainable economic recovery, but also for a genuinely new era of international economic partnership – a global deal, in which all countries have a part to play and all will see the benefits.

The following concluding box sets out the concrete commitments the leaders of the world's major economies could make at the London Summit – commitments which would go a long way to putting in place the building blocks for a global deal.

The Global Deal

The world's leading economies can come together to agree a package of internationally coordinated measures to restore stability and set a course for a sustainable recovery, including:

- review the global impact and effectiveness of measures taken so far to **stimulate global demand**, both by national authorities and by the global financial institutions, and consider the implications for the future;
- immediate action to substantially **increase the IMF's resources** so that it can increase its lending capacity to support countries suffering from reductions in capital flows, supporting the objective of stimulating demand;
- immediate action consistent across countries and with clear exit strategies to support domestic and international **lending** by ensuring that banks are adequately capitalised and can raise the funds needed, by dealing with banks' impaired assets and, where appropriate, through direct government or central bank lending;
- all countries to **renounce protectionism**, with a transparent mechanism to monitor commitments and measures to increase access to trade finance;
- **reform of financial regulation** – closing regulatory gaps, enhancing corporate governance and coordinating regulation of global financial markets in order to create a global financial sector that serves the needs of the wider economy;
- **an international early warning system**, with a strengthened role for the IMF in order to help promote balanced growth;
- **reform of the International Financial Institutions**, increasing their resources, encouraging greater access to IMF resources and strengthening the voice and participation of emerging and developing countries; and
- **honour commitments to increase development assistance**, to protect the poorest from the impact of the crisis.

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