Contents

Letter of transmittal ......................................................... 1

I. Introduction: the unsustainable has run its course ........... 3

What has been happening: a description .......................... 4
What has been happening: an explanation ......................... 7
What has been happening: the policy response to date ........ 9

II. The global economy ..................................................... 11

Highlights ................................................................. 11
Overview of developments ............................................. 12
Global demand developments .......................................... 14
  The cyclical downturn in major advanced industrial economies .. 14
  International linkages and economic prospects .................... 16
  Policies and other factors affecting future demand ............. 19
Inflation developments in advanced industrial economies .... 22
  Rising inflation risks .................................................. 22
  Factors driving core inflation ....................................... 23
Balance sheet vulnerabilities, credit tightening and headwinds ..... 26
  Vulnerability of households ......................................... 28
  Possible impact on non-financial firms ............................ 31

III. Emerging market economies ........................................ 33

Highlights ................................................................. 33
Macroeconomic developments ......................................... 33
Commodity price developments ....................................... 37
External balances and capital flows .................................. 39
Policy responses ........................................................ 43
Vulnerabilities of EMEs .................................................. 46
  So far so good: the experience to date ............................ 47
  Resilience of EME export growth ................................... 49
  Resilience of domestic demand ...................................... 50
  Vulnerability to capital flow reversals ............................. 52

IV. Monetary policy in the advanced industrial economies .... 56

Highlights ................................................................. 56
Developments in monetary policy ..................................... 56
  The situation in mid-2007 ............................................ 56
  Monetary policy during the turbulence ............................. 60
  Different economic conditions or different approaches to policy? .. 62
Developments in central bank communication ........................................ 65
Changes in monetary policy communication ....................................... 65
Communication in financial crises ....................................................... 66
Central bank operations in response to the financial turmoil ................. 67
Reserve management ........................................................................... 68
Replacing impaired sources of funding ............................................... 70
Issues raised by central banks’ response to the financial market turmoil . 73

V. Foreign exchange markets ................................................................. 75

Highlights ........................................................................................... 75
Developments in foreign exchange markets .......................................... 76
Conditions in foreign exchange markets .............................................. 77
Determinants of exchange rate movements ......................................... 80
Interest rate and growth differentials .................................................... 80
Current account positions .................................................................... 81
Exchange rate policy ............................................................................ 82
Trends in capital flows ......................................................................... 85
Commodity prices ............................................................................... 87
Resilience of the foreign exchange market – a longer-term perspective . 87
Higher turnover and greater diversity of participants ......................... 87
Improved risk management ................................................................. 90
Implications for market resilience ....................................................... 90

VI. Financial markets ............................................................................ 92

Highlights ........................................................................................... 92
Anatomy of the credit market turmoil of 2007–08 ............................... 92
Stage one: the initial subprime crisis (June–mid-July 2007) ................. 94
Stage two: spillovers into other credit markets (mid- to end-July 2007) . 97
Stage three: squeezed liquidity and involuntary reintermediation (August 2007) ................................................................. 99
Stage four: broad-based financial sector strains (September–November 2007) ................................................................. 100
Stage five: growth fears and dysfunctional markets (January–mid-March 2008) ................................................................. 101
Stage six: the crest of the credit crisis to date (mid-March–May 2008) ... 102
Money markets hit by liquidity squeeze .............................................. 103
Credit turmoil spilled over to equity markets ..................................... 105
Weakness concentrated in the financial sector and Japanese shares ...... 106
Elevated US recession risk weighed on earnings expectations ............ 107
Bond yields fell sharply as the financial turmoil deepened .................. 108
Flight to safety led to scramble for government securities ................. 109
Recession fears drove yields further down ........................................ 110
Break-even inflation rates rose despite a softening economic outlook ... 111
Emerging market assets showed signs of resilience ......................... 113

VII. The financial sector in the advanced industrial economies ............ 117

Highlights ........................................................................................... 117
The financial sector under stress ........................................................ 118
Commercial banking .......................................................................... 119
Investment banking ............................................................................ 121
Insurance companies .......................................................................... 122
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>II.1</td>
<td>Global macroeconomic situation</td>
<td>11</td>
</tr>
<tr>
<td>II.2</td>
<td>Contribution to inflation</td>
<td>14</td>
</tr>
<tr>
<td>II.3</td>
<td>US housing and household sector</td>
<td>15</td>
</tr>
<tr>
<td>II.4</td>
<td>US business cycles</td>
<td>16</td>
</tr>
<tr>
<td>II.5</td>
<td>Global economic linkages</td>
<td>17</td>
</tr>
<tr>
<td>II.6</td>
<td>Housing and mortgage markets</td>
<td>18</td>
</tr>
<tr>
<td>II.7</td>
<td>Budget balance and output gap</td>
<td>20</td>
</tr>
<tr>
<td>II.8</td>
<td>Export competitiveness</td>
<td>21</td>
</tr>
<tr>
<td>II.9</td>
<td>Inflation in the G3 economies</td>
<td>22</td>
</tr>
<tr>
<td>II.10</td>
<td>Economic slack and import prices</td>
<td>24</td>
</tr>
<tr>
<td>II.11</td>
<td>Inflation expectations</td>
<td>26</td>
</tr>
<tr>
<td>II.12</td>
<td>Current lending conditions</td>
<td>27</td>
</tr>
<tr>
<td>II.13</td>
<td>Real bank credit to the private sector</td>
<td>28</td>
</tr>
<tr>
<td>II.14</td>
<td>Historical transmission of tighter credit</td>
<td>30</td>
</tr>
<tr>
<td>III.1</td>
<td>Contributions to real GDP growth</td>
<td>35</td>
</tr>
<tr>
<td>III.2</td>
<td>Consumer price inflation</td>
<td>35</td>
</tr>
<tr>
<td>III.3</td>
<td>Headline vs core inflation</td>
<td>36</td>
</tr>
<tr>
<td>III.4</td>
<td>Inflation and possible drivers, 2007</td>
<td>36</td>
</tr>
<tr>
<td>III.5</td>
<td>Commodity prices</td>
<td>37</td>
</tr>
<tr>
<td>III.6</td>
<td>Composition of gross private capital inflows</td>
<td>40</td>
</tr>
<tr>
<td>III.7</td>
<td>Gross private capital outflows and increase in official reserves</td>
<td>42</td>
</tr>
<tr>
<td>III.8</td>
<td>Monetary conditions</td>
<td>44</td>
</tr>
<tr>
<td>III.9</td>
<td>Reserves, debt and bank credit</td>
<td>45</td>
</tr>
<tr>
<td>III.10</td>
<td>Exchange rate developments</td>
<td>46</td>
</tr>
<tr>
<td>III.11</td>
<td>Growth forecasts and equity markets</td>
<td>47</td>
</tr>
<tr>
<td>III.12</td>
<td>Growth relative to trend</td>
<td>48</td>
</tr>
<tr>
<td>III.13</td>
<td>China's import developments</td>
<td>50</td>
</tr>
<tr>
<td>III.14</td>
<td>Indebtedness</td>
<td>51</td>
</tr>
<tr>
<td>III.15</td>
<td>Reliance on cross-border financing and cost of sovereign debt insurance</td>
<td>55</td>
</tr>
<tr>
<td>IV.1</td>
<td>Inflation rates</td>
<td>58</td>
</tr>
<tr>
<td>IV.2</td>
<td>Policy rates</td>
<td>59</td>
</tr>
<tr>
<td>IV.3</td>
<td>Central bank reaction functions</td>
<td>63</td>
</tr>
<tr>
<td>IV.4</td>
<td>Changes in policy rates and economic conditions</td>
<td>64</td>
</tr>
<tr>
<td>IV.5</td>
<td>Measures of stigma</td>
<td>70</td>
</tr>
<tr>
<td>IV.6</td>
<td>Share of longer-term reverse operations at selected central banks</td>
<td>71</td>
</tr>
<tr>
<td>V.1</td>
<td>Exchange rates and implied volatilities of the dollar, euro and yen</td>
<td>76</td>
</tr>
<tr>
<td>V.2</td>
<td>Nominal effective exchange rates</td>
<td>77</td>
</tr>
<tr>
<td>V.3</td>
<td>Real effective exchange rates in a long-term perspective</td>
<td>78</td>
</tr>
<tr>
<td>V.4</td>
<td>Implied volatilities and bid-ask spreads</td>
<td>79</td>
</tr>
<tr>
<td>V.5</td>
<td>Carry-to-risk ratios and FX futures positions</td>
<td>81</td>
</tr>
<tr>
<td>V.6</td>
<td>Exchange rates, interest rates and current account</td>
<td>82</td>
</tr>
<tr>
<td>V.7</td>
<td>Managed exchange rates and capital flows to the United States</td>
<td>84</td>
</tr>
<tr>
<td>V.8</td>
<td>Portfolio share of foreign equity and bond holdings</td>
<td>85</td>
</tr>
<tr>
<td>V.9</td>
<td>Foreign assets of mutual funds and uridashi bonds</td>
<td>86</td>
</tr>
<tr>
<td>VI.1</td>
<td>Major credit default swap indices</td>
<td>93</td>
</tr>
<tr>
<td>VI.2</td>
<td>Risk appetite in credit markets</td>
<td>93</td>
</tr>
<tr>
<td>VI.3</td>
<td>Corporate spread levels, default rates and default volumes</td>
<td>94</td>
</tr>
<tr>
<td>VI.4</td>
<td>US securitisation markets</td>
<td>97</td>
</tr>
<tr>
<td>VI.5</td>
<td>Subprime markets: loss projections and rating transitions</td>
<td>98</td>
</tr>
<tr>
<td>VI.6</td>
<td>Issuance volumes</td>
<td>98</td>
</tr>
<tr>
<td>VI.7</td>
<td>Asset-backed commercial paper (ABCP) markets</td>
<td>99</td>
</tr>
<tr>
<td>VI.8</td>
<td>Financial sector and municipal spreads</td>
<td>101</td>
</tr>
<tr>
<td>VI.9</td>
<td>Interest rate and bank credit spreads</td>
<td>104</td>
</tr>
</tbody>
</table>
VI.10 Funding in the US dollar interbank market and swap-implied rates
VI.11 Equity prices and earnings expectations
VI.12 Equity market volatility and valuations
VI.13 Interest rates
VI.14 Interest rates and spreads
VI.15 Policy rates and implied expectations
VI.16 Real bond yields and forward break-even inflation rates
VI.17 Emerging market financial indicators
VI.18 Sensitivity of emerging market equity indices to global factors
VI.19 Conditional correlation between emerging market and US credit spreads

VII.1 Price of insurance against systemic distress
VII.2 Indicators of investment banks' activity and risk
VII.3 Hedge fund size, performance and leverage
VII.4 LBO loan market: size, risk and pricing
VII.5 Mortgage delinquency rates
VII.6 Inflation-adjusted house prices
VII.7 US commercial real estate sector
VII.8 Bank equity prices and cost of capital
VII.9 Pricing of risk in syndicated loan and bond markets
VII.10 Sectoral composition of bank credit
VII.11 Financial markets and the real economy
VII.12 International lending and interbank exposures

Tables
II.1 Contributions to global demand, consumption and investment
II.2 Inflation forecast performance
II.3 Inflation pass-through
II.4 Non-financial sector funding, outlays and balance sheet ratios
III.1 Output growth, inflation and current account balance
III.2 Global oil demand
III.3 Cross-border and domestic credit in emerging markets
III.4 Selected external vulnerability indicators, 2007
IV.1 Policy rates, GDP growth and inflation projections
IV.2 Steps taken during the financial turmoil
V.1 Annual changes in official foreign exchange reserves
V.2 Global foreign exchange market turnover
V.3 Reported foreign exchange market turnover by counterparty
VI.1 Timeline of key events
VII.1 Profitability of major banks
VII.2 Capital and liquidity ratios of major banks
VII.3 Subprime-related writedowns and capital-raising
VII.4 Commercial property prices
Conventions used in this Report

lhs, rhs  left-hand scale, right-hand scale
billion   thousand million
...      not available
.        not applicable
$        US dollar unless specified otherwise

Differences in totals are due to rounding.
Ladies and Gentlemen,

It is my pleasure to submit to you the 78th Annual Report of the Bank for International Settlements for the financial year which ended on 31 March 2008.

The net profit for the year amounted to SDR 544.7 million, compared with SDR 619.2 million for the preceding year. The figure for the preceding year has been restated to reflect a change in accounting policy made in this year’s accounts. Details of the results for the financial year 2007/08 may be found on pages 180–5 of this Report under “Financial results and profit distribution”. The amended accounting policies are disclosed on pages 199–204, and their financial impact is disclosed in note 3 on pages 206–207.

The Board of Directors proposes, in application of Article 51 of the Bank’s Statutes, that the present General Meeting apply the sum of SDR 144.7 million in payment of a dividend of SDR 265 per share, payable in any constituent currency of the SDR, or in Swiss francs. This year’s proposed amount compares to the dividend of SDR 255 per share paid out last year.

The Board further recommends that SDR 40.0 million be transferred to the general reserve fund, SDR 6.0 million to the special dividend reserve fund and the remainder – amounting to SDR 354.0 million – to the free reserve fund. In addition, it is proposed to deduct SDR 71.3 million from the free reserve fund for the prior year effect of the change in accounting policy.

If these proposals are approved, the Bank’s dividend for the financial year 2007/08 will be payable to shareholders on 3 July 2008.

Basel, 10 June 2008

MALCOLM D KNIGHT
General Manager