II. The year in retrospect

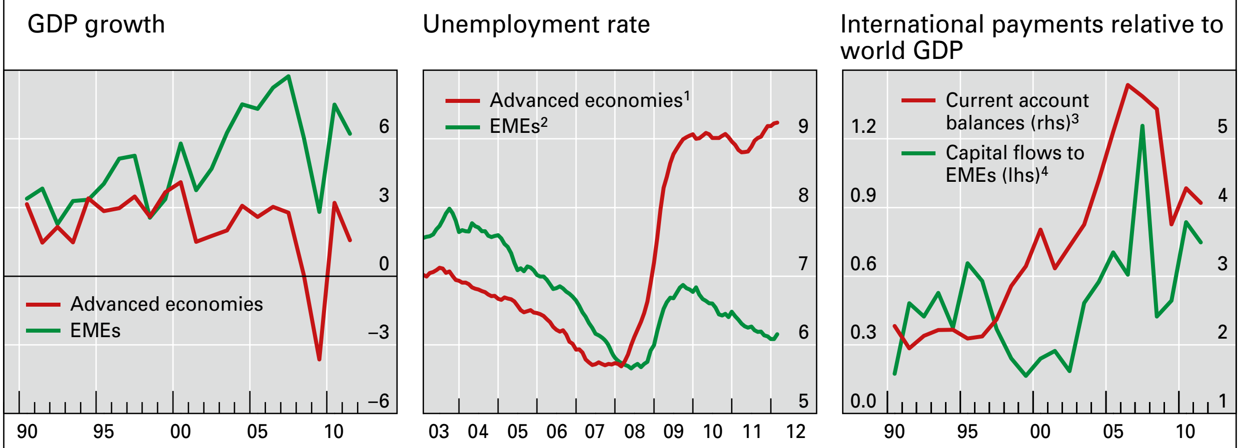
The global economic recovery faltered over the past year. Rising commodity prices and the intensification of the euro area sovereign debt crisis hit at the time when unresolved structural weaknesses were still weighing on the global economy. Increases in commodity prices had boosted inflation pressures in fast-growing emerging market economies (EMEs), which prompted tighter policies to moderate demand growth. In slow-growing advanced economies, which had more spare capacity, higher commodity prices did not generate as much inflationary pressure, but they undermined discretionary spending, which was already subdued because households were paying down debts. The intensification of the euro area crisis led to a global rise in risk aversion, growing concerns about exposures to sovereign risk and ultimately to banking sector stress. Following a new round of central bank interventions, there were signs of stronger global expansion in the first few months of 2012. But with sectoral and geographical imbalances still present in the world economy, sustained growth remained elusive.

The global recovery faltered in 2011

The global economic recovery slowed in 2011. For the year as a whole, world output grew by 3.9%, slightly slower than the average growth rate of the decade prior to the financial crisis, but down significantly from 5.3% in 2010. The pace of economic growth in advanced economies halved, to just 1.6%

Global economic activity and imbalances

In per cent



[1] Simple average of Australia, Canada, France, Germany, Ireland, Italy, Japan, Spain, Switzerland, the United Kingdom and the United States. [2] Simple average of Brazil, China, Chinese Taipei, the Czech Republic (since April 2004), Hong Kong SAR, Hungary, India, Indonesia, Korea, Malaysia, Mexico, the Philippines, Poland and Singapore. [3] Sum of all countries' absolute current account balances. [4] Net private flows.

Sources: IMF, *World Economic Outlook*; Bloomberg; Datastream; national data; BIS calculations. Graph II.1

(Graph II.1, left-hand panel). This reflected a significant weakening of the economy in the United States and the United Kingdom and a sharp drop in activity in Japan after the March 2011 earthquake, while growth in the euro area as a whole was broadly unchanged.

Overall, the economic momentum in advanced economies was too weak to generate a robust, self-sustaining recovery. The drag on private consumption persisted. Unemployment remained high, or even increased further (Graph II.1, centre panel). Falling property prices and high levels of debt continued to weigh on household balance sheets in the mature economies hit hardest by the financial crisis (see Chapter III). Household sector weakness also weighed on business spending. Very weak public sector finances generally left no room for further fiscal stimulus.

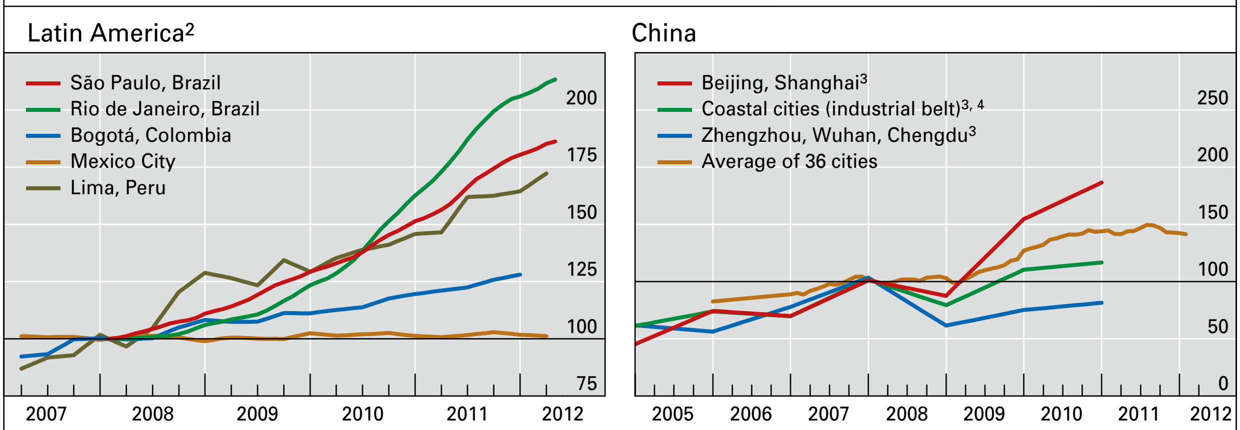
Emerging market economies grew by around 6% in 2011, with the pace of growth moderating only slightly from 2010 (Graph II.1, left-hand panel). Emerging Asia grew at 7.8%, led by China (9.2%) and India (7.2%); Latin America grew at 4.5%. Growth in central and eastern Europe was broadly unchanged at 5.3% for 2011 as a whole.

During the period under review, rapid growth in EMEs was in many cases associated with signs of domestic overheating, including rising inflation, strong credit growth and rising asset prices. Real credit continued to expand rapidly in emerging Asia and Latin America, and real residential property prices rose close to or above previous historical highs in major cities in China and Latin America (Graph II.2). However, house price increases seem to have decelerated more recently, and in some cases prices have even declined.

Reflecting the two-speed global expansion, external imbalances remained wide. Although slightly lower than in 2010, global current account imbalances

Real property prices in selected emerging market cities[1]

1 January 2008 = 100

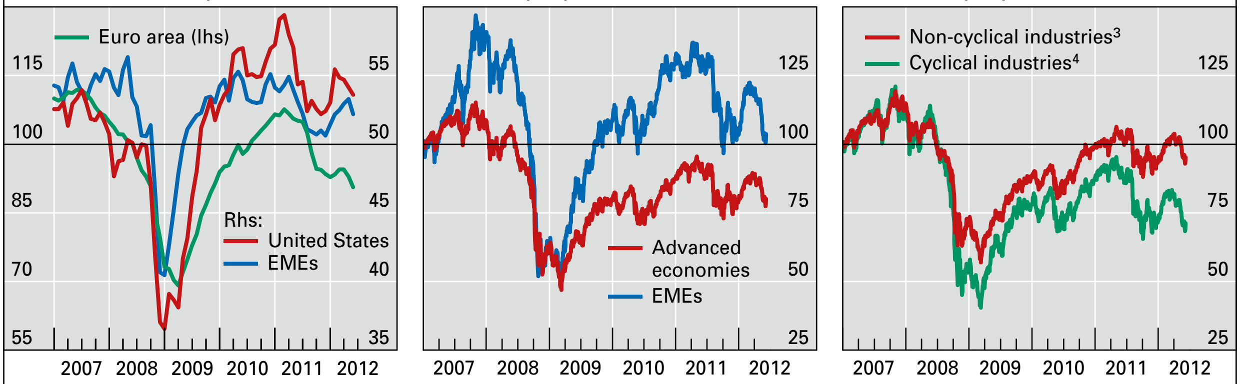


[1] Nominal prices deflated by national consumer price indices. [2] For Brazil, FipeZap index of residential property prices; for Colombia, price indices for new dwellings; for Mexico, SHF index of dwelling prices; for Peru, index of sale prices per square metre (apartments, selected Lima districts). [3] Average residential land prices. [4] Changchun, Dalian, Fuzhou, Guangzhou, Hangzhou, Nanning, Ningbo, Qingdao, Shenyang, Shenzhen and Xiamen.

Sources: J Wu, Y Deng and H Liu, "House price index construction in the nascent housing market: the case of China", *Institute of Real Estate Studies Working Paper Series*, National University of Singapore, June 2011; Bank of the Republic (Colombia); Central Reserve Bank of Peru; CEIC; National Administrative Department of Statistics (DANE, Colombia); National Development and Reform Commission (China); Sociedad Hipotecaria Federal (Mexico); national data; BIS calculations. Graph II.2

Business activity and equity prices

Business activity indices[1] | Global equity indices[2] | Sectoral equity indices[2]



[1] For the euro area, European Commission Economic Sentiment Indicator; for EMEs, weighted average of manufacturing purchasing managers' indices (PMIs) for China, Hungary, India, Mexico, Russia, Singapore, South Africa and Turkey, with weights based on 2005 GDP and PPP exchange rates; for the United States, simple average of Institute of Supply Management manufacturing and non-manufacturing PMIs. [2] 1 January 2007 = 100. [3] Consumer goods, consumer services, telecoms and utilities. [4] Basic materials, finance, industrials, and oil and gas.

Sources: Bloomberg; Datastream; national data; BIS calculations. Graph II.3

remained at about 4% of world GDP, which is high by historical standards (Graph II.1, right-hand panel, red line). Major advanced economies again recorded sizeable current account deficits, with the notable exceptions of Germany and Japan. Current account surpluses in emerging Asia, though shrinking, remained sizeable. Latin America and central and eastern Europe ran current account deficits. The net private capital flow into EMEs in 2011 was still one of the strongest on record (Graph II.1, right-hand panel, green line). Despite this, few emerging market currencies strengthened significantly against the major currencies, and many depreciated.

The global recovery started to falter in the second quarter of the year. At that time, indicators of business activity weakened significantly in the United States, followed by those for EMEs; and in the second half of 2011, they deteriorated relatively sharply in Europe (Graph II.3, left-hand panel). The prices of many growth-sensitive financial assets declined. Major equity indices around the world fell, with the prices of cyclical stocks declining relatively sharply (Graph II.3, centre and right-hand panels). Corporate bond spreads generally rose, notably for low and sub-investment grade ratings.

These developments reflected two major shocks which exposed underlying weakness in the global economy associated with domestic and external imbalances. First, commodity prices, which had already increased significantly, remained high against the backdrop of strong demand from EMEs. This eroded household income in the United States and other advanced economies at a time of high unemployment and ongoing balance sheet repair. In contrast, the main effect in a number of EMEs was higher inflation, which led to policy tightening. Second, financial market investors became increasingly wary about the credit quality of several euro area governments and the exposure of European banks to sovereign credit risk. In the second half of the year, a sharp increase in global risk aversion, fiscal restraint and growing deleveraging pressure on banks sapped demand.

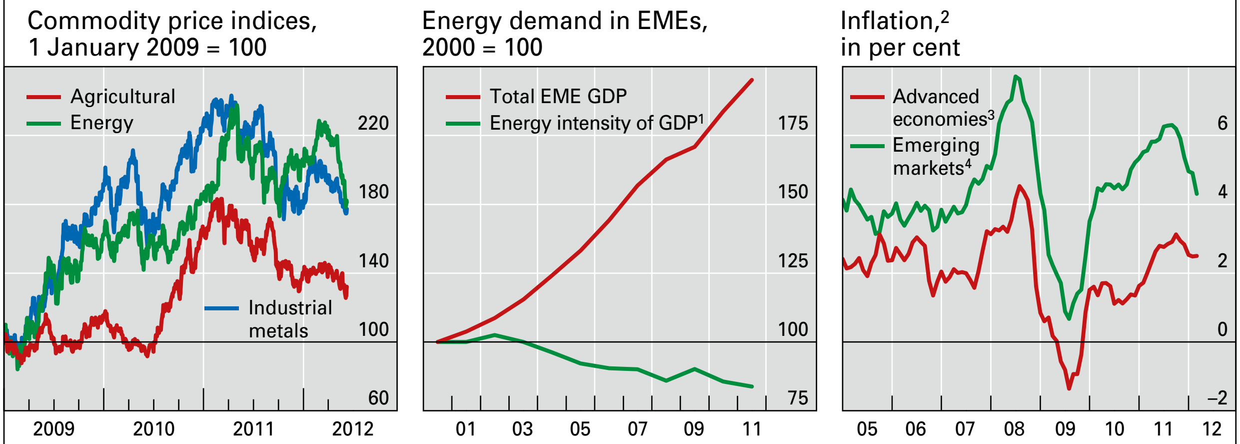
High commodity prices had differential effects around the world

Commodity prices increased sharply until the end of the first quarter of 2011 (Graph II.4, left-hand panel). From their cyclical trough in mid-2010, agricultural commodity prices doubled and energy and industrial metals prices rose by more than 50%. Commodity prices then fell by 20–30% over the following six months. From the end of the third quarter, however, energy prices rebounded by around 20%, while agricultural commodity and industrial metals prices were relatively stable. In 2011, all of these commodity prices remained significantly above 2009–10 average levels.

A series of negative supply shocks contributed to the strong price performance. Bad weather and poor harvests lifted agricultural commodity prices in the second half of 2010 and early 2011. Similarly, political unrest in the Middle East and North Africa in the early months of 2011 threatened to disrupt oil supplies and drove up oil prices at that time. Modest increases in output from the major oil-producing countries were not sufficient to stop this trend. Oil prices were again driven higher in late 2011 and early 2012 by geopolitical supply risks, this time related to Iran.

In addition to supply shocks, the pattern of global growth helped keep commodity prices high. The integration of EMEs into global production chains and their rapid economic development led to strong demand, especially for energy and industrial metals, but also for agricultural commodities. As Graph II.4 (centre panel) shows, GDP growth has outpaced gains in energy efficiency in major EMEs during the past decade. With limited spare capacity, the prices of oil and other commodities have been highly sensitive to changes

Commodity markets and inflation



[1] Proxied as oil consumption of Brazil, India, Korea and Mexico relative to their combined GDP. [2] Weighted averages of consumer price inflation in the listed economies based on 2005 GDP and PPP exchange rates. [3] The euro area, Japan, the United Kingdom and the United States. [4] Brazil, China, India (wholesale price index), Indonesia, Korea, Malaysia, Mexico, the Philippines, Poland, South Africa and Thailand.

Sources: IMF, *World Economic Outlook*; International Energy Agency; Datastream; national data; BIS calculations. Graph II.4

in growth expectations. In 2011, the associated commodity price movements tended to act as a brake on the global recovery.

Strong commodity price gains in early 2011 and tight spare capacity lifted headline inflation later in the year in EMEs. By mid-2011, average inflation in these economies exceeded 6%, one of the highest rates of the past decade (Graph II.4, right-hand panel). Inflation pressures were strong, as energy and food account for a much larger share of consumption than in advanced economies.

In advanced economies, rising energy prices also lifted headline inflation, but spare capacity limited second-round effects. High energy prices undermined the purchasing power of a household sector already burdened by high unemployment and persistent balance sheet strains. In the United States, for instance, households spent an additional 2% of their income on fuel. With the unemployment rate above 9% and house and equity prices falling, US consumer confidence declined sharply over the summer of 2011.

Partly as a result of these differential effects of commodity prices, monetary policy responses in EMEs diverged from those in advanced economies during the second and third quarters of 2011. Many EMEs tightened monetary policy in response to rising inflation, while central banks in major advanced economies either reversed previous tightening or loosened further via extraordinary measures.

The euro area sovereign debt crisis intensified

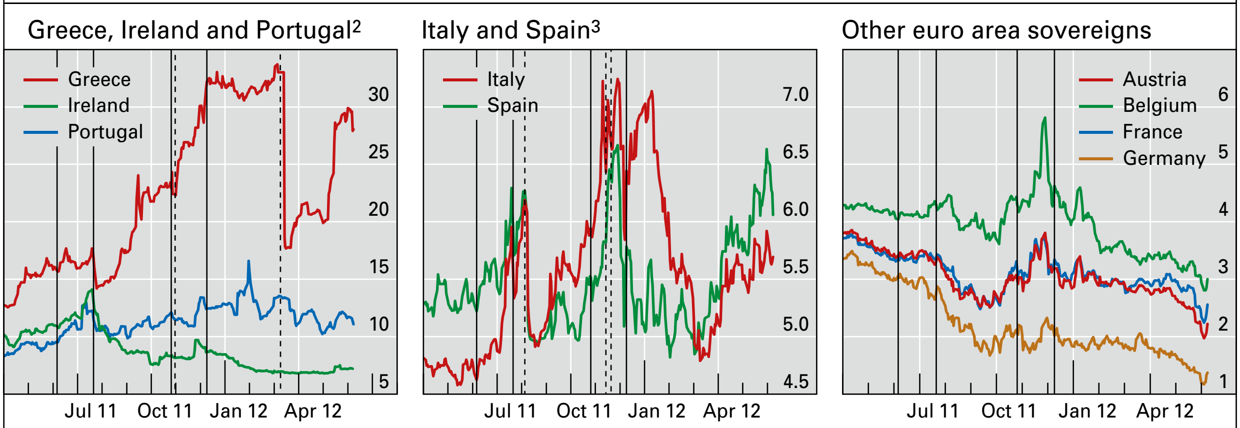
In mid-2011, the euro area sovereign debt crisis intensified. In the preceding months, government bond yields in countries on official support programmes – Greece, Ireland and Portugal – had increased substantially (Graph II.5, left-hand panel), while those elsewhere had been much more stable. But then yields for Italy and Spain, two much larger debtors, rose sharply and continued to drift up for much of the second half of the year (Graph II.5, centre panel). Furthermore, towards the end of 2011, yields on some of the highest-rated euro area government bonds, including those of Austria, Belgium and France, also increased, widening relative to those for Germany (Graph II.5, right-hand panel).

Several factors contributed to this intensification. First, official lenders, who were considering a second support package for Greece, demanded private sector involvement in reducing Greece's debt burden as a condition for additional loans. This raised uncertainty among bondholders regarding their treatment in any future euro area support programmes. Second, euro area growth was beginning to falter, making it harder for governments in the region to strengthen their financial positions in the near term. Third, the downgrade of the United States by one rating agency heightened investors' focus on fiscal sustainability.

A series of policy initiatives aimed at addressing the crisis followed in the second half of 2011. The ECB resumed purchasing euro area government bonds in August. Italian and Spanish sovereign yields initially declined sharply, but resumed their climb after just a few weeks, reflecting market concerns

Euro area sovereign bond yields[1]

Ten-year yields, in per cent



[1] The solid vertical lines in each panel mark the dates of: the first official call for private sector involvement in sovereign debt reduction (6 June 2011); the conclusion of the July 2011 EU summit (21 July 2011), which included a second official support package for Greece and expanded potential uses of stabilisation funds; the conclusion of the October 2011 EU summit (26 October 2011), which raised the lending capacity of the stabilisation facility; and the adoption of the EU fiscal compact (9 December 2011), aimed at limiting future structural budget deficits. [2] The dashed vertical lines mark the dates of: the announcement of a Greek referendum on Greece's second official support package (31 October 2011); and the agreement with private sector creditors on a Greek debt swap (8 March 2012). [3] The dashed vertical lines mark the dates of: the first reported purchases of Italian and Spanish government bonds by the ECB (5 August 2011); the instalment of a technocratic government in Italy (13 November 2011); and the election in Spain (20 November 2011).

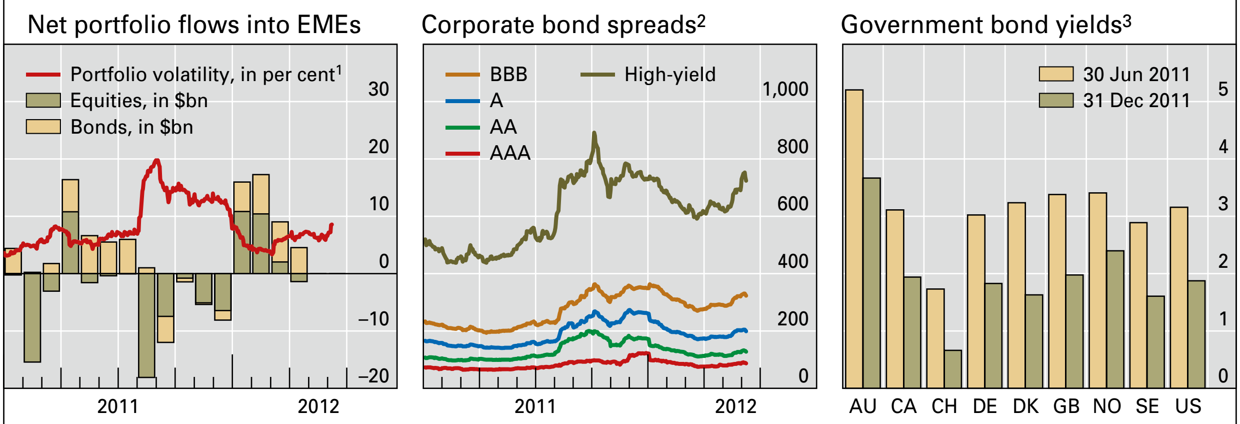
Sources: Bloomberg; national data. Graph II.5

about the governments' ability to implement the fiscal consolidation measures agreed with European partners. Expansion of the potential uses of the euro area stabilisation fund in July and of its lending capacity in October appeared to have even less durable effects on yields. Towards the end of 2011, however, the fiscal compact to limit structural budget deficits ushered in more significant and sustained reductions in yields (see Chapter V).

The sovereign debt crisis heightened risk aversion in global financial markets. Investors adjusted their portfolios in recognition of greater sovereign risks. For example, when the volatility of portfolios increased in August, international investors started selling emerging market bonds and equities – a shift that continued for much of the second half of 2011 (Graph II.6, left-hand panel). Demand for equities and corporate bonds in advanced economies also declined, leading to lower prices and higher spreads, especially for lower-rated bonds (Graph II.6, centre panel).

Some financial assets benefited from safe haven flows. These included Australian, Canadian, German, Nordic, Swiss, UK and US government bonds, whose yields dropped to extremely low levels by historical standards during the second half of 2011 (Graph II.6, right-hand panel). Such was this demand that yields on some shorter-dated bonds became negative for a time. The yen and the Swiss franc also appreciated markedly as a result of portfolio adjustments in favour of safe haven assets. To counter these trends, the Japanese authorities sold yen in the currency markets, with sales reportedly reaching a record volume on one day, while the Swiss National Bank capped the value of the franc against the euro.

Safe and risky assets



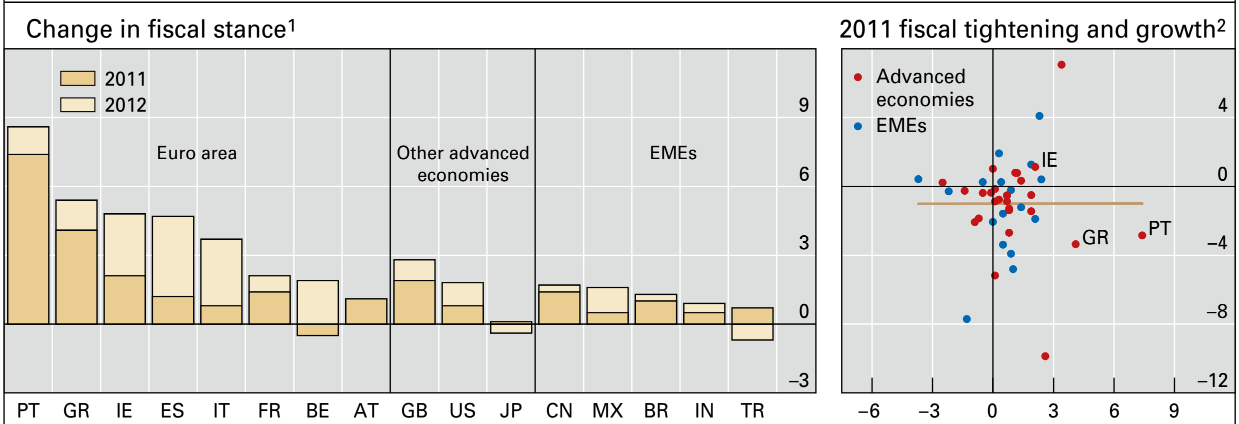
AU = Australia; CA = Canada; CH = Switzerland; DE = Germany; DK = Denmark; GB = United Kingdom; NO = Norway; SE = Sweden; US = United States.

[1] Annualised volatility of daily returns, computed over previous 22 business days, on a hypothetical portfolio comprising MSCI world equity index (60% weight), Merrill Lynch high-grade global bond index (35% weight) and Merrill Lynch high-yield corporate and emerging markets bond index (5% weight). [2] Option-adjusted spreads of yields on indices of global corporate bonds over government bonds, in basis points. [3] Ten-year, in per cent.

Sources: Bloomberg; Datastream; EPFR; Merrill Lynch; BIS calculations. Graph II.6

Many advanced and emerging economies tightened their fiscal policies (Graph II.7, left-hand panel). While advanced economies tightened policies in response to fiscal sustainability concerns, emerging economies did so rather to contain domestic demand. Euro area countries experienced the sharpest tightening. In Greece, Ireland and Portugal, official support programmes also prescribed substantial fiscal tightening that required deficit cuts of several percentage points of GDP. Large euro area economies such as

Public finances



AT = Austria; BE = Belgium; BR = Brazil; CN = China; ES = Spain; FR = France; GB = United Kingdom; GR = Greece; IE = Ireland; IN = India; IT = Italy; JP = Japan; MX = Mexico; PT = Portugal; TR = Turkey; US = United States.

[1] Fiscal stance measured as cyclically adjusted primary balance for general government, as a percentage of GDP. [2] On the horizontal axis, difference between 2011 and 2010 fiscal stance; on the vertical axis, difference between 2011 and 2010 GDP growth, in percentage points. The trend line is calculated over the entire sample of countries.

Sources: IMF, *Fiscal Monitor* and *World Economic Outlook*; BIS calculations. Graph II.7

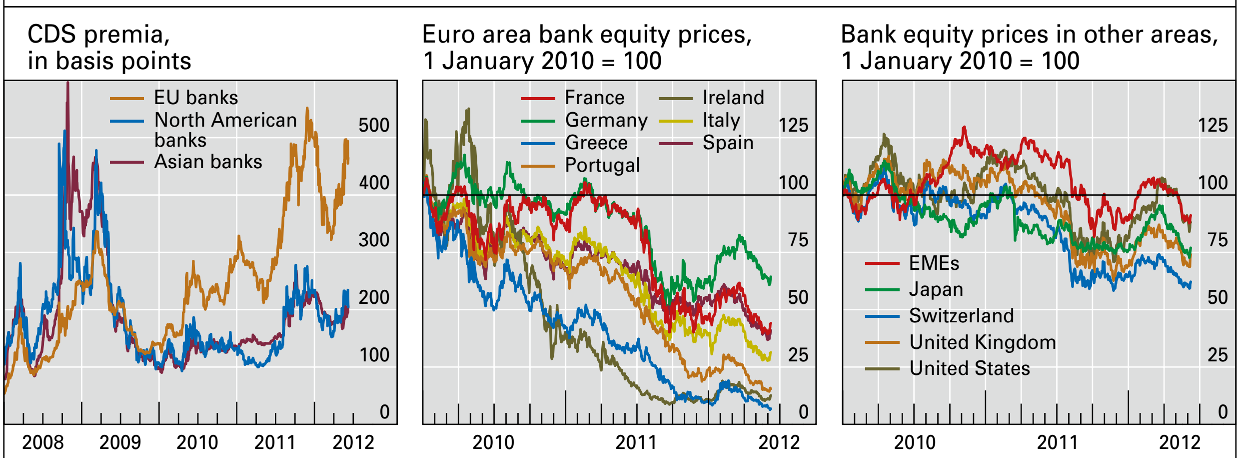
France, Italy and Spain also tightened their fiscal stance substantially. Outside the euro area, the United Kingdom continued to rein in its budget deficit, under a negative outlook from two of the major rating agencies. The United States also tightened its fiscal stance somewhat despite the extension of temporary payroll tax cuts and supplementary unemployment benefits during 2011 and 2012. Japan was the only major advanced economy to loosen its fiscal stance, in order to implement post-earthquake reconstruction expenditures. A number of EMEs also tightened fiscal policy moderately in order to contain domestic demand. However, this fiscal consolidation does not seem to have been systematically associated with weaker economic growth in 2011 (Graph II.7, right-hand panel).

European bank funding and credit supply declined

The euro area sovereign debt crisis put European banks under growing stress in the second half of 2011. This reflected uncertainty about banks' exposure to sovereign credit risk and questions about governments' ability to support weak banks. European banks' credit default swap (CDS) premia rose sharply, as their perceived creditworthiness deteriorated (Graph II.8, left-hand panel). Bank equity prices plummeted in countries where the value of sovereign debt had fallen most, and declined sharply elsewhere in the euro area (Graph II.8, centre panel). But the crisis also affected banks elsewhere, as shown by the behaviour of equity prices (Graph II.8, right-hand panel) as well as of CDS premia.

Euro area bank funding conditions quickly worsened in autumn 2011. Depositors began to withdraw funds from banks in Spain and, to a lesser extent, Italy, adding to continued deposit outflows from banks in Greece and Ireland. Markets for unsecured debt essentially closed for many euro area banks (Graph II.9, left-hand panel). And the cost of borrowing in the interbank market increased, significantly for euros, but also for dollars and sterling (Graph II.9, centre panel). Dollar funding for euro area banks was in short

Indicators of banks' financial strength

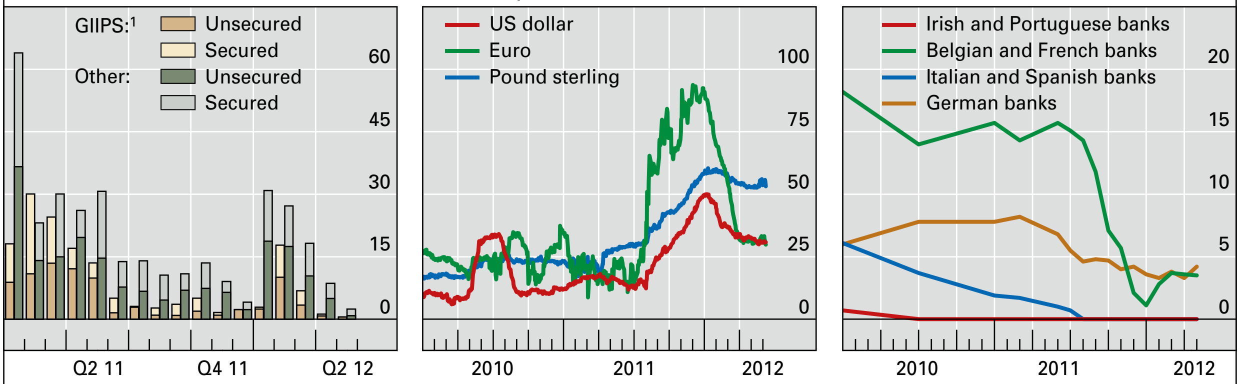


Sources: Datastream; BIS calculations.

Graph II.8

Bank funding conditions

Bank bond issuance in the euro area, in billions of euros | Three-month Libor-OIS spreads, in basis points | US money market fund claims on banks[2]



[1] Greece, Ireland, Italy, Portugal and Spain. [2] Claims on euro area banks of the 10 largest US prime money market funds, as a percentage of the funds' assets under management. As of 30 April 2012, these 10 funds held $642 billion in assets and all US prime money market funds held $1.42 trillion in assets.

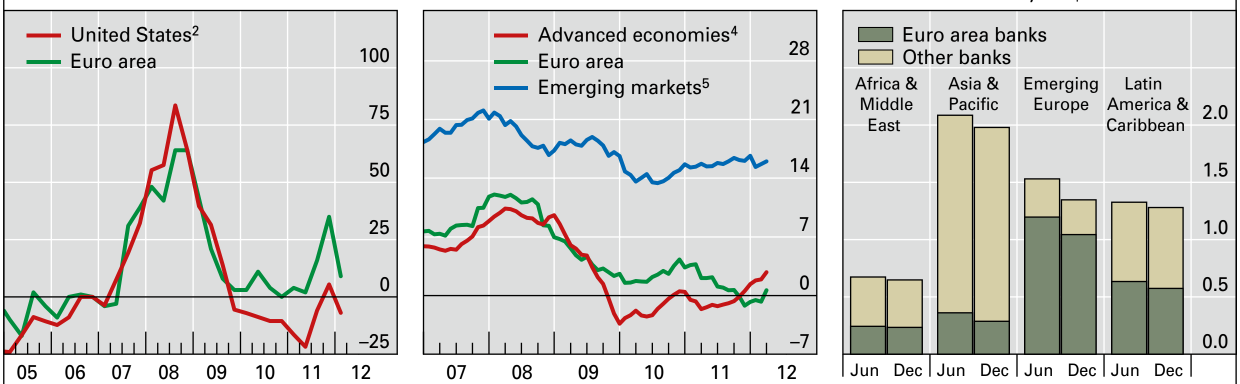
Sources: ECB; Bloomberg; Dealogic; Fitch Ratings. Graph II.9

supply partly because US money market funds cut their exposures (Graph II.9, right-hand panel).

Growing deleveraging pressure led to a rising home bias in euro area bank lending. On balance, euro area banks tightened lending standards for firms in the final quarter of 2011, more sharply than in the United States (Graph II.10, left-hand panel). While the growth rate of credit from euro area banks to domestic non-financial borrowers fell to zero (Graph II.10, centre

Bank credit

Lending standards for firms[1] | Domestic bank credit growth[3] | Foreign claims on emerging markets[6] in 2011, in $trn



[1] Net percentage of bank survey respondents tightening standards. [2] Lending to large and medium-sized firms. [3] Year-on-year changes in bank claims on the domestic non-financial sector, weighted by 2005 PPP exchange rates, in per cent. [4] The euro area, Japan, the United Kingdom and the United States. [5] Argentina, Brazil, Chile, China, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey. [6] Foreign claims by nationality of reporting bank on an immediate borrower basis.

Sources: ECB Bank Lending Survey; Federal Reserve Senior Loan Officer Survey; IMF, *International Financial Statistics*; Datastream; BIS consolidated banking statistics by nationality; national data; BIS calculations. Graph II.10

panel), their credit to other regions weakened more substantially. Between the middle and end of 2011, foreign claims of euro area banks on borrowers in EMEs fell by 12%: 4% in Africa and the Middle East, 20% in Asia and the Pacific, 13% in emerging Europe and 9% in Latin America and the Caribbean (Graph II.10, right-hand panel). Cuts were especially sharp for loans with high risk weights, such as leveraged loans or project finance, and for loans that often require dollar funding, such as aircraft and ship leases or trade financing.

That said, to a considerable extent, other forms of financing substituted for euro area bank lending. In some cases, this included loans from other large international lenders (Graph II.10, right-hand panel). Some Australian, Japanese and UK banks that already had a focus on emerging Asia increased lending in the region. Domestic lenders also boosted credit, notably in Latin America, although less so in emerging Europe, where western European banks had a large market share. In addition, some larger corporate borrowers turned to bond markets, where gross issuance increased by almost 30% in the final quarter of 2011.

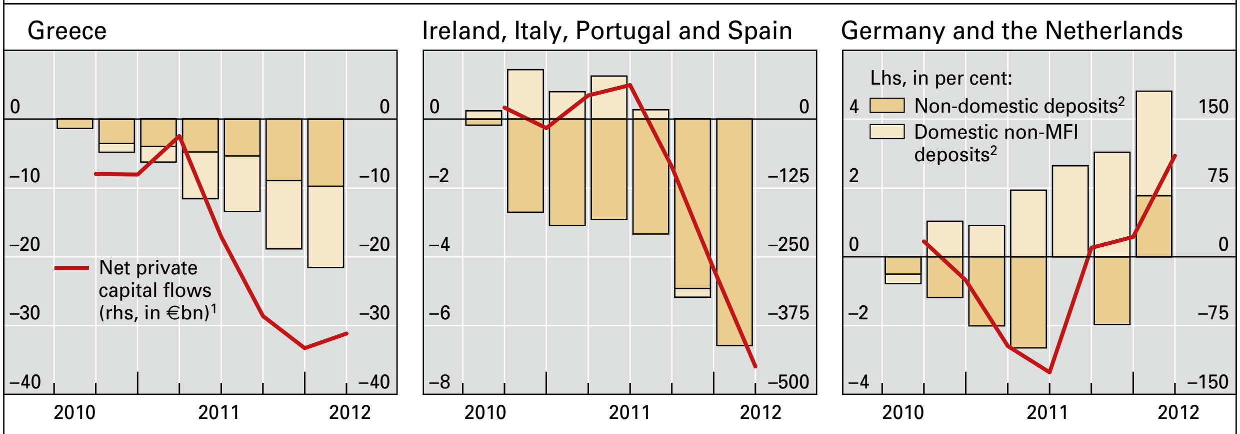
Global growth remained fragile in early 2012

Economic weakness and growing strains in global financial markets towards the end of 2011 triggered a new round of central bank support measures (see Chapter IV). The Federal Reserve committed to buy an additional $400 billion of long-dated US Treasury securities, funded by sales of shorter-term notes. It also announced that it planned to keep its short-term policy rate at exceptionally low levels until at least the end of 2014. The Bank of Japan and the Bank of England further increased the size of their asset-buying programmes. The central banks of Brazil, China, India, Indonesia, the Philippines and Turkey also loosened monetary policy. In December 2011, the ECB announced offerings of funding to euro area banks for three years, against an expanded set of collateral. Major central banks had already agreed to reduce the prices of currency swap lines between themselves, allowing them to exchange euros for dollars with banks more cheaply than previously.

These measures triggered significant improvements in bank funding markets (Graph II.9) and financial markets more broadly. The ECB's two auctions of three-year funding in December 2011 and February 2012 allowed euro area banks to prefund much of their unsecured debt redemptions due by 2014. In addition, banks used some of the cash to purchase assets, including euro area sovereign bonds. The yields on these securities declined significantly (Graph II.5). More generally, additional policy support helped to boost a wide range of asset prices during the first few months of 2012. The completion of an orderly restructuring of Greek debt in March also removed a downside risk to asset prices.

Global economic activity seemed to recover somewhat in the first quarter of 2012. In the United States, the unemployment rate declined, hand in hand with a significant increase in consumer confidence and spending. In Japan, machinery orders and corporate investment lifted business activity, as the economy continued to rebound from the effects of the March 2011 earthquake.

Euro area bank deposits and private cross-border capital flows



[1] Cumulative since end-June 2010, estimated as cumulative current account deficits minus changes in TARGET2 liabilities to the ECB minus cumulative disbursements from EU-IMF programmes where applicable. For further details, see H-W Sinn and T Wollmershäuser, "Target loans, current account balances and capital flows: the ECB's rescue facility", *NBER Working Papers*, no 17626, November 2011. Latest available observation used. [2] Cumulative change, including repos, as a percentage of total deposits at end-June 2010. MFI = monetary financial institution.

Sources: Central banks; Eurostat; IMF; BIS calculations. Graph II.11

Following a contraction in the last quarter of 2011, GDP in the euro area stabilised. And activity in several EMEs increased at a faster pace, notably in Latin America and Southeast Asia.

That said, sustainable economic growth remained elusive, and economic activity fell in the second quarter. In April and May, a number of economic indicators for the United States were weaker than expected and employment growth slowed again. Indicators of activity in China weakened significantly from the start of 2012, although this partly reflected a response to measures aimed at bringing growth down to more sustainable levels. Output growth also slowed markedly in Brazil and India, notably in the agricultural and manufacturing sectors. In the euro area, output appeared to be contracting again in the second quarter of 2012.

Financial risks in the euro area also intensified in the second quarter of 2012, driven primarily by concerns about the post-election policy orientation of Greece. Deposit and other capital outflows increased from countries perceived as vulnerable to a further deepening of the crisis. In particular, deposit withdrawals from banks in Greece reportedly accelerated in May. These banks had already lost around one third of their foreign deposits and one quarter of their domestic non-financial deposits (Graph II.11, left-hand panel). Foreign depositors had also withdrawn funds from banks in Ireland, Italy, Portugal and Spain, while domestic deposits had been more stable (Graph II.11, centre panel). In contrast, deposits at banks in Germany and the Netherlands increased significantly in the first quarter of 2012 (Graph II.11, right-hand panel). Similarly, estimates of overall capital flows show net private outflows from Greece, Ireland, Italy, Portugal and Spain and inflows into Germany and the Netherlands (Graph II.11, red lines).