

# **INTERNATIONAL ENVIRONMENT**

## I. INTERNATIONAL ENVIRONMENT

The world economy was affected in 2008 by record high commodity prices (especially for oil and foodstuffs) which then fell somewhat starting in the summer. The other major influence was fallout from the international financial crisis, which became more acute starting in mid September. This crisis, the most serious since the great economic depression of the 1930s, started with turbulence on the US financial market that began more than a year ago as high risk mortgage loans (subprime) failed, leading to bankruptcy at major financial institutions, especially those overly committed to financing the real estate loans with a high level of securitized claims.

Already in March 2008, the US Federal Reserve intervened to save the business bank Bear Stearns, while the governmental mortgage refinancing structures Freddie Mac and Fannie Mae (that guarantee almost half of all mortgages in the United States) had to be put under the supervision of the US Treasury.

After the fourth business bank (Lehman Brothers) went into bankruptcy in September 2008, the financial crisis took on unprecedented proportions, spreading to financial markets in other developed countries (especially European countries) as well as emerging and even developing countries, leading to a truly global financial crisis. The result was a sharp drop in the value of financial assets and loss of confidence in the solvency of financial institutions as liquidity dried up and interest rates rose markedly on interbank markets.

Faced with this situation, governments and monetary authorities (especially in developed countries, first and foremost the United States) had to intervene individually or in a concerted manner, injecting a significant level of liquidity, reducing key interest rates, selling off risky assets, and increasing guarantees on bank deposits and commitments, going so far as to use public funds to recapitalize banks in trouble.

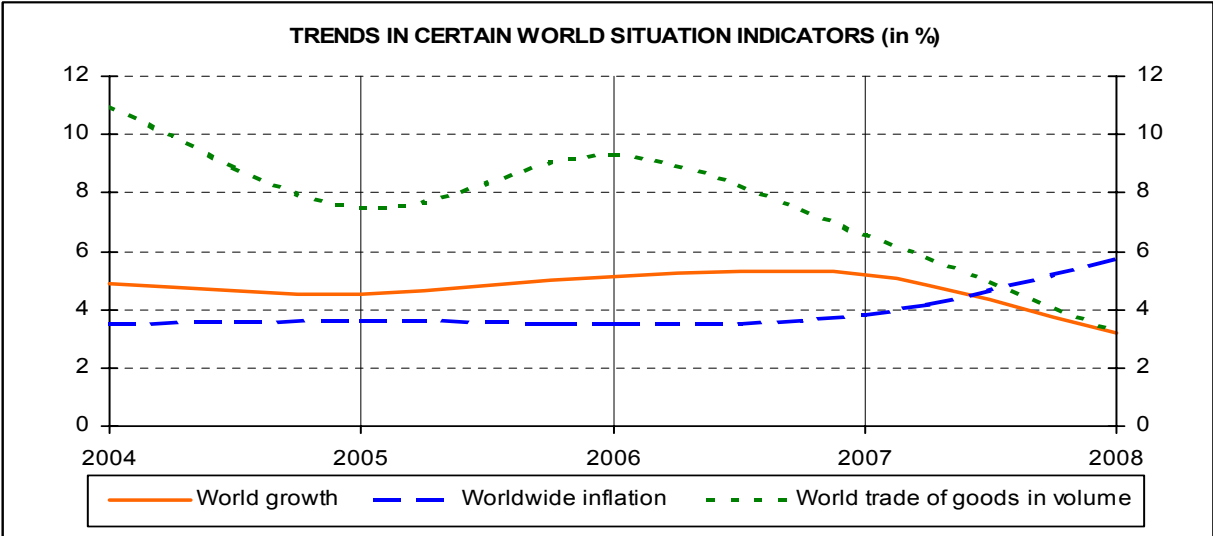
But these measures were not enough to stabilise financial markets and restore investor confidence. Thus the repercussions of the financial crisis spread throughout the real economy and to countries throughout the world, although to different extents. These included tougher loan conditions, a drop in world trade in goods and services, lower consumer and business confidence, and considerable loss of value on international stock markets. Industrialised countries experienced recession starting in the third quarter of 2008 and governmental authorities in these countries had to come up with extensive budgetary recovery plans capable of bringing about economic recovery and setting right financial systems.

Even if certain emerging and developing countries were not directly affected by the financial crisis thanks to fairly sound fundamentals, they could not avoid certain indirect effects, notably falling international demand, a dip in commodity prices after hitting record levels (especially crude oil prices that approached \$150 a barrel in mid July 2008), lower inflows of foreign capital, and a sharp increase in spreads on sovereign and corporate bonds. Thus countries with domestic and external imbalances had to count on the financial assistance of international institutions, notably the International Monetary Fund (IMF), while others had to launch measures to support and boost their economies. In this context, some 3,200 billion

dollars were mobilised around the world to bail out banks and boost the economy to avoid collapse of the international financial system and a recession on the scale of the 1929 crash.

Given these various developments, the world economy could not help but suffer a sizeable downturn in 2008, posting a growth rate of 3.2% vs. 5.2% in 2007. Falling international demand, along with drying up of bank loans and falling stock market prices were hard on major corporations and caused bankruptcy at small/medium sized businesses. This situation led to a wave of staff dismissals, especially in the sectors hardest hit by the crisis such as finance, construction, and automotive industries, with world unemployment rate up from 5.7% in 2007 to 6% in 2008. Furthermore, falling demand (especially in developed countries) in an environment of lower economic activity meant considerably slower growth in the volume of world trade of goods and services, down from 7.2% in 2007 to 3.3% in 2008.

In line with the drop in commodity prices, there was easing of inflation over the second half of 2008, following record peaks in July. This development allowed for more flexibility for central banks to ease monetary policy in a significant manner.



International investment flows were affected by slowing world economic activity, tougher loan conditions, and lower profits, especially at major business groups. In effect, world flows of direct investment went down by 14.5% in 2008, amounting to 1,659 billion dollars vs. 1,941 billion the year before, with variations from one region to another.

In developed countries, external investment flows went down by a high 25%, mainly in the countries of the European Union and Japan, with share in world total down from 69% in 2007 to some 60% in 2008. But in emerging and developing countries, inflows of foreign direct investment went up by 9.6%, with significant increases in Africa (34.7%) and to a lesser degree Latin America (9.4%).

Stock markets were hard hit starting mid September 2008, affected by growing fears about the soundness of the international financial system and the risk of transmission of the financial crisis to the real economy, as major business groups started showing lower earnings and the risk of bankruptcy grew. After an eventful 2007 and steady growth since 2003, the major financial centres suffered in 2008 from the impact of the world economic

downturn, closing for the year with a sizeable drop in quoted shares of some 30,000 billion dollars. Stock market indexes between end 2007 and end 2008 fell by 65% in Shanghai, 52% in Amsterdam, 42% in Paris and Tokyo, 34% in New York, and 31% in London.

International foreign exchange markets in 2008 were marked by strong appreciation of the euro against the US dollar, reaching a record level of 1.6038 dollars to the euro in mid July. This was due mainly to the widening differential in key interest rates between the Euro Zone and the United States. Over the closing months of the year, the dollar appreciated against the euro, taking advantage of its status as an international reserve currency as well as the currency used for settlement of a large portion of trade and financial transactions worldwide. Furthermore, investors turned to US Treasury bonds as a safe investment in a climate of troubled financial markets. Thus after a long run of appreciation in 2008, the euro closed for the year on a downturn of some 5% against the dollar.

The Japanese yen gained considerable value in 2008, up by some 17% against the US dollar. This appreciation was due in particular to the outcome of carry trade transactions, which consist in financing investment in currencies with high interest rates from borrowings in currencies with low interest rates such as the yen. But it should be noted that these transactions were less attractive in an international context marked by high volatility on financial and foreign exchange markets and by deteriorating economic prospects.

## **A. WORLD ECONOMIC GROWTH**

Influenced by soaring commodity prices (notably for energy and foodstuffs) and the impact of the world economic and financial crisis, economic activity in developed countries grew at a considerably slower pace in 2008. Certain countries even went into recession, and the growth rate for this category of countries as a whole came to just 0.9%, down from 2.7% in 2007. Emerging and developing countries also posted a lower economic growth rate : 6.1% vs. 8.3% in 2007.

The US economy grew by just 1.1% in 2008, down from 2% the year before. This rate would have been even lower if it had not been for good performance over the second half of the year thanks to the 152 billion dollar economic recovery package introduced at the beginning of the year, before the economy entered into recession in the third quarter. Lower household consumption led to slower growth as prices went up, jobs were lost, credit dried up, and wealth turned negative due to the lower value of financial and real estate assets.

Moreover, corporate investment continued to drop, especially in the housing sector, marked by higher unsold properties and tougher conditions for mortgages. Companies also reduced their investment in other sectors (such as automotive industries) as international demand fell off and financing conditions deteriorated. Exports grew at a slower pace in 2008, capped by a sharp drop over the closing months of the year in the wake of a stronger dollar.

As the real estate crisis got worse and trouble spread to international financial markets, US authorities introduced a set of measures meant to reassure and stabilise markets and boost economic activity. The Federal Reserve proceeded to injection of massive amounts of liquidity and to a considerable reduction of its key interest rate, while also bailing out a number of major financial institutions. In October 2008 the government also adopted a 700 billion dollar plan to prop up the financial sector, mostly in the form of recapitalizing banks encountering difficulties and increasing guarantees on bank deposits.

Economic growth in the Euro Zone came in at just 0.9% for 2008, down from 2.7% the previous year, affected by lower domestic and external demand. Faster growing inflation, which affected available income and was accompanied by a deteriorating job market and tighter credit, kept household consumption down. Similarly, corporate investment (including in the real estate sector) was down in a context of rising raw material prices and wage costs, falling international demand and more stringent conditions for bank loans, along with falling prices on the stock market.

At the same time, growth in export of goods and services slowed considerably as external demand decreased, especially demand from the Maghreb and the Middle East, regions that suffered from the drop in commodity prices over the second half of 2008 as well as from appreciation of the euro.

All Euro Zone members were affected by slowing economic activity, although to different degrees. Spain and Ireland were the countries most impacted by trouble in the real estate sector. In Germany, the biggest economy in Europe, the economic growth rate fell from 2.5% in 2007 to 1.3% in 2008. Slower growth was due mainly to exports that increased more slowly as demand from major trading partners (notably the US and the UK) fell. Appreciation of the euro was another factor. Faster rising consumer prices from the beginning of the year until the autumn of 2008 meant a lower level of real available household income and consequently household expenditure was lower, despite higher wages. Corporate investment was also down, although there was some improvement in the housing sector, especially over the closing months of the year.

To counter the impact of the world financial crisis, the German government introduced a plan to prop up the financial system at a cost of some 500 billion euros as well as a 30 billion euro budgetary recovery plan.

#### TRENDS IN THE MAIN ECONOMIC AND FINANCIAL INDICATORS OF THE DEVELOPED COUNTRIES

Description	Economic growth (volume & %)		Budget balance (% of GDP)		Inflation (Variation in consumer prices %) <sup>1</sup>		Interest rate (%) <sup>2</sup>		Unemployment (% of working population)	
	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008
<b>All developed countries</b>	<b>2.7</b>	<b>0.9</b>	<b>-1.2</b>	<b>-3.5</b>	<b>2.2</b>	<b>3.4</b>			<b>5.4</b>	<b>5.8</b>
Of which :										
United States	2.0	1.1	-2.9	-6.1	2.9	3.8	4.24	0.16	4.6	5.8
Japan	2.4	-0.6	-2.5	-5.6	0.0	1.4	0.50	0.30	3.8	4.0
Canada	2.7	0.5	1.4	0.4	2.1	2.4	4.26	1.50	6.0	6.2
European Union	3.1	1.1	-0.8	-2.3	2.3	3.7			7.1	7.0
of which :										
-Euro Zone	2.7	0.9	-0.7	-1.8	2.1	3.3	4.20	2.49	7.5	7.6
of which :										
*Germany	2.5	1.3	-0.5	-0.1	2.3	2.8	3.86	2.39	8.4	7.3
*France	2.1	0.7	-2.7	-3.4	1.6	3.2	3.00	..	8.3	7.8
*Italy	1.6	-1.0	-1.5	-2.7	2.0	3.5	4.86	3.38	6.1	6.8
-United Kingdom	3.0	0.7	-2.6	-5.4	2.3	3.6	5.80	2.00	5.4	5.5

Sources : World Economic Outlook and International Financial Statistics of the IMF and Eurostat

<sup>1</sup> Base 100 in 2000.

<sup>2</sup> Money market rate for December of each year, except for France (Deposits interest rate).

In France, economic growth fell from 2.1% in 2007 to 0.7% in 2008 in the wake of falling domestic demand due to the credit crunch. Household consumption expenditure was affected by rising inflation and diminishing wealth as housing and capital markets saw their value plummet. This was also the case for export of goods and services, suffering from slower growth in international demand. As in other developed countries, French officials adopted a bailout plan for the banking sector involving 360 billion euros as well as an economic recovery plan involving 26 billion euros.

Italy, already weakened by a long stretch of flat economic growth, entered into recession starting the second quarter of 2008. Insufficient credit was also a real problem for household expenditure as well as for businesses, while export of goods and services grew at a very slow pace, in line with adverse international conditions. Thus real GDP in Italy fell by 1% in 2008, compared to 1.6% growth the year before. Faced with this situation, the Italian government took a number of measures to boost household expenditure, notably a temporary freeze on electricity and gas prices and tax credits for poor families. A 12 billion euro fund was also set up to support banks and 16 billion euros were allocated to fund a major public works programme.

Economic growth in the United Kingdom came to just 0.7% in 2008, down from 3% a year earlier. The economy entered into recession in the second half of the year, following upheaval in the real estate market and the impact of the world financial crisis on financial services and related activities that account for 14% of GDP. Tougher loan conditions and lower domestic and external demand led to a drop in corporate investment. Household expenditure was constrained by limited access to bank loans and to diminishing wealth as assets lost value. But exports were on the rise, further helped by depreciation of the pound sterling. The British government announced measures to recapitalize banks and to provide State guarantees for part of their medium and long term debt. A 24.2 billion euro budgetary recovery plan was also introduced, focusing on help to households, mainly in the form of a reduction of VAT from 17.5% to 15% until the end of 2009. The Bank of England injected a massive level of liquidity, extended the list of securities eligible for uptake allowance operations, and considerably reduced its key interest rate on several occasions.

Although Japan was somewhat spared from the international financial and banking crisis thanks to high equity and prudent investment policy followed by banks since the 1990s, it was not able to avoid the impact of deteriorating conditions. Exports suffered from lower external demand, especially from the United States (the country's major trade partner) as well as the Euro Zone and the emerging countries of Asia, on top of appreciation of the yen. Domestic demand, still weak, was not enough to compensate for the drop in external demand to prop up economic growth. Higher consumer prices, wages that remained unchanged, and a slight deterioration of the job market weighed on household consumer expenditure. Companies cut back on investment as demand fell, while investment in housing continued to drop after new, tougher regulations went into effect in June 2007 with regard to obtaining building permits. Consequently, the Japanese economy went into recession in the second quarter of 2008, with GDP falling by 0.6% in real terms for the year as a whole, compared to 2.4% growth in 2007. To stimulate economic activity, the Japanese government introduced three budgetary recovery plans for a total amount of some 750 billion dollars. The

Bank of Japan lowered its key interest rate twice in order to ease conditions for loans to businesses and households.

China posted a lower growth rate in 2008, down from 13% in 2007 to 9%. This reflects slower growth in investments, especially in housing, as monetary policy tightened over the first half and exports dropped over the closing months of the year in the wake of falling world demand. But household consumer expenditure went up, in line with higher wages, and this offset the impact of fast growing prices. To stimulate economic activity, the Chinese government decided to introduce a major plan to boost the economy, amounting to some 586 billion dollars over two years, targeting mainly infrastructure. The Bank of China eased monetary policy starting in September 2008, introducing successive reductions in the key interest rate and the reserve requirement rate.

Despite fairly solid economic fundamentals and a high level of foreign currency reserves, the emerging economies of South-East Asia suffered from the impact of the international financial crisis, given their high degree of integration in the world economy. Certain countries in the region were affected by the drop in commodity prices over the second half of 2008 as well as by the lower volume of exports shipped to major markets such as the United States, the Euro Zone and Japan. Lower external demand was the reason for the drop in corporate profits. Businesses had to reduce investment, especially in light of difficulties encountered in trying to raise funds on international markets. In the same way, the prevailing climate of aversion to risk brought about massive withdrawal of capital, leading to falling values on stock markets and depreciation of the region's currencies. It became necessary to draw up budgetary recovery plans to support their economies and avoid recession, while Central Banks lowered key interest rates. Economic growth rates in the five main countries of the Association of South East Asian Nations (ASEAN) - made up of Indonesia, Malaysia, the Philippines, Singapore and Thailand – came to an average of 4.9% in 2008, down from 6.3% the year before.

The economies of Latin America also experienced slower growth: just 4.2% on average compared to 5.7% in 2007. This slowdown was due to fallout from the international financial crisis, especially the drop in prices for exported commodities and lower external demand, especially from the United States and the Euro Zone. Moreover, the countries of this region were hit by a drop in remittances by workers abroad as well as by a sizeable drop in inflows of foreign capital and an increase in margins on both sovereign and corporate bonds. These adverse trends, combined with tighter monetary policy over the first half of 2008 in order to counter inflationary pressure, led not only to lower economic growth but also a drop in investment.

Mexico is the United States' primary economic partner and destination for 80% of its exports. The US provides half of Mexico's foreign direct investment flows and takes in virtually all of its emigrant workers. Thus growth in Mexico was particularly hard hit, falling from 3.3% in 2007 to 1.3% in 2008.

In Africa, the direct impact of the world financial crisis was in general limited, given the low level of integration of its economies in international financial markets. But falling external demand and the sharp drop in commodity prices over the second half of 2008 led to lower

earnings from exports, on top of the lower level of worker remittances and overseas development assistance. Thus economic growth in Africa fell from 6.2% in 2007 to 5.2% in 2008.

As for the Arab Maghreb Union (*UMA*), economic activity remained strong in 2008 in most countries, especially Algeria and Libya where growth was led by dynamic hydrocarbon sectors and stimulated by implementation of five-year public investment programmes in the respective amounts of 122 billion and 93 billion euros. Thus growth rates in these two countries remained at virtually the same level as in 2007: 3% for Algeria and 6.7% for Libya.

#### TRENDS IN SELECTED ECONOMIC AND FINANCIAL INDICATORS IN CERTAIN EMERGING AND DEVELOPING COUNTRIES AND THE EUROPEAN UNION COUNTRIES

Description	Economic growth (volume & %)		Inflation (Variation in consumer prices %) <sup>1</sup>		Budget balance (% of GDP)	
	2007	2008	2007	2008	2007	2008
<b>Countries of the EU</b>	<b>3.1</b>	<b>1.1</b>	<b>2.3</b>	<b>3.7</b>	<b>-0.8</b>	<b>-2.3</b>
of which :						
Spain	3.7	1.2	2.8	4.1	2.2	-3.8
Portugal	1.9	0.0	2.4	2.6	-2.6	-2.6
Greece	4.0	2.9	3.0	4.2	-3.5	-3.7
<b>Emerging &amp; developing countries</b>	<b>8.3</b>	<b>6.1</b>	<b>6.4</b>	<b>9.3</b>	<b>0.4</b>	<b>-0.2</b>
of which :						
<b>Tunisia</b>	<b>6.3</b>	<b>4.6</b>	<b>3.2</b>	<b>5.0</b>	<b>-2.9<sup>2</sup></b>	<b>-1.2<sup>2</sup></b>
Morocco	2.7	5.4	2.0	3.9	0.9	-1.6
Algeria	3.0	3.0	3.6	4.5	..	..
Egypt	7.1	7.2	11.0	11.7	..	..
South Africa	5.1	3.1	7.1	11.5	..	..
Turkey	4.7	1.1	8.8	10.4	..	..
Argentina	8.7	7.0	8.8	8.6	..	..
Chile	4.7	3.2	4.4	8.7	..	..
China	13.0	9.0	4.8	5.9	..	..

Sources : World Economic Outlook and International Financial Statistics of the IMF, Eurostat, Ministry of Development and International Cooperation and National Statistics Institute.

In Morocco too, 5.4% growth was posted, up from 2.7% a year earlier, thanks in particular to a good agricultural year after 2007's drought. There were also measures taken by the government to keep inflation down. This involves in particular subsidised prices for foodstuffs and fuel and temporary suspension of customs duty on imported cereals, which helped household consumption.

Economic growth in Tunisia came to 4.6% in 2008, down from 6.3% the previous year. This rate would have been higher if it had not been for the modest agricultural season that was marked by a sharp drop in cereal production, and slower growth in hydrocarbons. Falling external demand over the closing months of the year had an adverse effect on exports by manufacturing industries.

The economies of Central and Eastern European countries (CEEC), already weakened by restrictive monetary and budgetary policies to counter inflationary pressure, suffered from falling international demand, foreign capital inflows, and worker remittances from abroad, due

<sup>1</sup> Base 100 in 2000.

<sup>2</sup> Excluding privatisation and grants.

in turn to recession in the countries of the Euro Zone that are their primary partners. Thus there was slower economic growth for these countries as a whole, coming to 2.9% in 2008 compared to 5.4% the year before.

Several countries in this region had already been under the constraint of various weak points, for example excessive current deficits, high external indebtedness, and banking sectors involved in financing of risky real estate investments. This situation, on top of the onset of the world financial crisis, increased worries among international investors, who proceeded to pull out their capital in massive volume. This resulted in falling value on the stock markets of the region and recourse by a number of countries such as Hungary, the Ukraine and Latvia to international assistance, especially from the IMF, in an effort to avoid collapse of financial systems and boost economic activity.

Despite Russia's sound economic fundamentals (budgetary surplus, low level public debt, stable currency and especially the high level of gold and foreign currency reserves), the country suffered from the downturn in world conditions that began the summer of 2008. The pace of economic growth, which fell from 8.1% in 2007 to 5.6% in 2008, was affected by the drop in oil prices and diminishing international demand (leading to slower pace of exports) as well as drying up of credit that weakened domestic demand. Pulling out of foreign capital from the country led to falling values on the stock market and depreciation of the rouble, which required massive intervention from the central bank to prop it up.

## **B. EMPLOYMENT**

Recession in industrialised countries and slowing economic activity in most emerging and developing countries pushed up the worldwide unemployment rate from 5.7% in 2007 to 6% in 2008.

The biggest increase in the unemployment rate was in developed countries, as many jobs were eliminated. Hardest hit was the building sector, especially in countries like the United States, Spain and Ireland, where the real estate crisis was the most acute. There was also a high level of lost jobs in the financial sector, following bankruptcy at a number of loan institutions and mergers/acquisitions at major banks, leading to waves of dismissals. The average unemployment rate for this group of countries increased from 5.4% in 2007 to 5.8% in 2008.

In the United States, 2.6 million jobs were lost in 2008, the highest figure since 1945. Hardest hit were the financial sector (as a number of financial institutions failed, while others issued dismissal plans) and the building sector. Thus the unemployment rate rose from 4.6% in 2007 to 5.8% in 2008.

In Japan, the number of jobless went up just slightly, from 3.8% in 2007 to 4% of the working population in 2008. This affected in particular temporary employees or those with fixed-duration contracts, who represent one third of all employees.

Unemployment rate in the Euro Zone was also up slightly (from 7.5% in 2007 to 7.6% in 2008), influenced mainly by flat activity in services (especially financial services) and difficulties in automotive industries. But there was actually a drop in unemployment rate in the biggest European economies : France (from 8.3% to 7.8%) and Germany (from 8.4% to 7.3%).

The better job market in Germany was due mainly to reforms carried out in the field of employment over the past few years. Spain on the other hand posted the highest unemployment rate in the Euro Zone, up from 8.3% to 11.3%, due to the relatively high proportion of jobs in housing construction, which was at a virtual standstill.

In emerging and developing countries there was greater unemployment in Asia, a region that in 2008 contributed some 60% of new jobs worldwide. Especially hard hit were the sub-region of Eastern Asia (where unemployment rose from 3.5% in 2007 to 3.8% in 2008) and that of South East Asia and the Pacific (up from 5.5% to 5.7%). In other regions, unemployment rates remained practically unchanged, with the highest average unemployment levels of 9.4% in the Middle East and 10.3% in the Maghreb.

### **C. WORLD TRADE**

World trade in goods and services suffered from the effects of the world economic and financial crisis in 2008, with demand for imports considerably down in developed countries (especially the United States), tighter credit, and thus deterioration in the conditions for financing of exports. There was also the problem of volatility in exchange rates for the main currencies. In this context, the volume of world trade in goods fell from growth of 6.6% in 2007 to 3.2% in 2008. In terms of value, growth in exports rose slightly, from 15.4% in 2007 to 15.6% in 2008, worth 15,875 billion dollars. This was due mainly to higher commodity prices (notably for crude oil) and depreciation of the dollar. The terms of trade worsened for developed countries (-2.4% vs. 0.4% the year before) but improved for emerging and developing countries (4% vs. 0.9%).

Unlike export of goods, the value of export of services, expressed in dollars, grew at a slower pace in 2008 (12% vs. 19% the year before), posting 3,819 billion dollars. This slower pace involved in particular international transport, tourism and financial services.

### **D. BUDGETARY AND MONETARY POLICIES**

In an international context marked by overall slowing of economic activity and adoption of budgetary recovery plans to counter the international financial crisis, there was a worsening of public finances in 2008, especially in developed countries. The average deficit in public accounts for this group of countries came to 3.5% of GDP, compared to 1.2% in 2007.

The budget deficit in the United States widened considerably, up from 2.9% of GDP in 2007 to 6.1% in 2008. This was due to both the tax incentives introduced in early 2008 to prop up household consumption and increased expenditure in the wake of measures taken to keep financial chaos at bay. Expenditure for social security and defense continued to rise, while the drop in the price of financial and real estate assets led to lower tax revenue, both from individuals and businesses.

In the Euro Zone, the average budget deficit was also on the rise in 2008, coming to 1.8% of GDP vs. 0.7% a year earlier. This was due not only to slowing economic growth (which brought about a drop in tax revenue) but also higher expenditure for unemployment benefits. Diminishing values on stock markets and deterioration of the housing sector (both of which are generally major sources of tax revenue) contributed to aggravation of public deficits.

In France the budget deficit (which rose from 2.7% in 2007 to 3.4% in 2008) exceeded the threshold of 3% of GDP set in the stability and growth pact. This was due to slowing economic activity, which in turn caused a drop in tax revenue (especially from businesses) as well as a higher level of social expenditure (notably outlays related to unemployment).

The State budget deficit also increased in Italy, up from 1.5% of GDP in 2007 to 2.7% in 2008. This was attributable to economic recession and expansionary budgetary measures, especially wage increases for civil servants, lower tax rates on overtime, and elimination of property taxes on housing when owners live in their own homes.

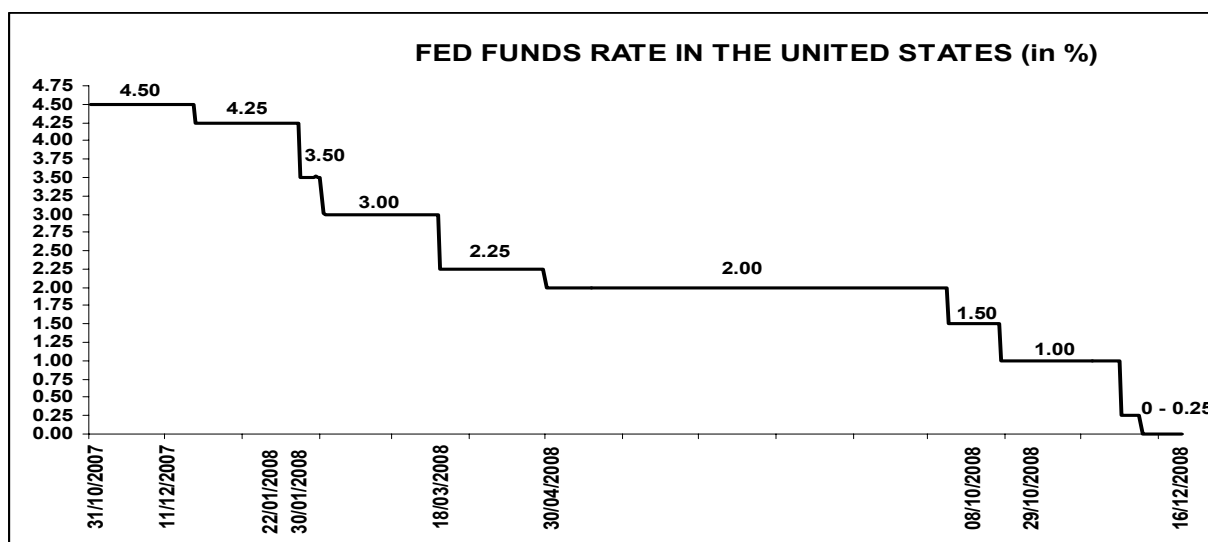
But in Germany the State budget remained more or less balanced in 2008, with a deficit of just 0.1% of GDP vs. 0.5% in 2007, thanks in particular to good performance on the job market. Thus tax revenue on wages rose and outlays for unemployment benefits went down. This situation helped counter the impact of the lower corporate tax rate, a reduction in the rate of contribution to unemployment insurance, an increase in retirement benefits, and higher salaries in the civil service.

In Ireland and Spain, two countries in the Euro Zone that were hard hit by the real estate crisis, public finance moved from a surplus balance in 2007 to a deficit in 2008. The Spanish government issued an economic recovery plan at the beginning of 2008 that yielded a budget deficit of 3.8% of GDP vs. a surplus of 2.2% in 2007.

In Japan the budget deficit widened from 2.5% of GDP in 2007 to 5.6% in 2008, following the country's slide into economic recession starting in the second quarter. The impact of the two latest economy recovery plans, adopted toward the end of the year, will not be felt before the end of 2009.

Monetary policy had to be tightened over the first half of 2008 in order to counter inflationary pressure brought about by soaring commodity prices, then eased over the second half so as to offset the effects of the international financial crisis and boost economic activity. It was in this framework that a common decision was taken on 8 October 2008 by six major central banks (the US Federal Reserve, the European Central Bank, the Bank of England, the Bank of Canada, the Central Bank of Sweden and the Swiss National Bank) to reduce their respective key rates by 50 base points.

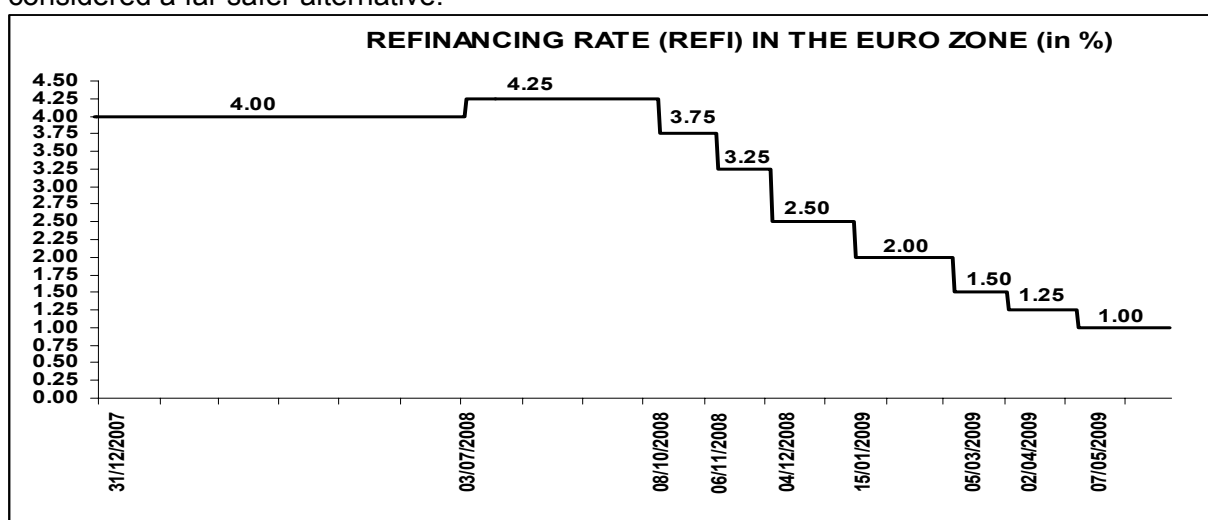
The US Federal Reserve reduced its key interest rate seven times in 2008, bringing it down from 4.25% at the end of 2007 to between 0% and 0.25% as of 16 December. It also took a number of measures to guarantee smooth operations on the money market and interbank activity while restoring investor confidence, injecting massive doses of liquidity to help financial institutions and to establish more flexible conditions in the area of guarantees. The Federal Reserve also intervened to take back up to 100 billion dollars in debt and up to 500 billion in securities tied to mortgage claims from the two governmental mortgage refinancing agencies (Fannie Mae and Freddie Mac) and to ensure the survival of a number of major financial institutions.



After increasing the refinancing rate (main key rate) by 25 base points on 3 July 2008 in order to counter inflationary pressure, the European Central Bank (ECB) had to lower it three times throughout the year, bringing it down to 2.5% on 4 December, seeking to boost domestic demand and get the Euro Zone out of recession. And to keep a lid on pressure on interbank markets characterised by lack of trust on the part of economic operators, the ECB provided massive amounts of liquidity under favourable conditions. It also decided, for the main weekly refinancing operations, to move to a system of sale by auction at a fixed rate (i.e. the main key rate), handling requests in such a way that all needs for liquidity are fully met. The ECB also enlarged the list of assets eligible to be used as guarantees.

Despite a narrow margin for manoeuvre, the Bank of Japan decided to reduce its key rate on two occasions (31 October and 19 December 2008) by 20 base points each time to bring it down to 0.10%. It also took other measures to supply adequate liquidity to the banking sector. The most important of these measures was to pay interest (on a temporary basis) on banks' reserve requirements.

Like short term interest rates, long term rates on bond markets fell in 2008 to record lows, as capital invested in risky financial assets was pulled out and placed in State securities, considered a far safer alternative.



## **E. INFLATION**

Inflation rates throughout the world in 2008 followed the same trend as commodity prices, reaching their highest levels in industrialised countries in July, particularly in the United States (5.6%), France (4%) and Germany (3.5%). Fears of runaway inflation, in line with record highs for most commodity prices, gave way to threats of deflation over the closing months of the year. Overall, inflation levels were higher than in 2007 everywhere in the world.

Inflation rose in all developed countries, at an average rate that went up from 2.2% in 2007 to 3.4% in 2008. In the United States, consumer prices rose by 3.8%, up from 2.9% in 2007, effected mainly by soaring world prices for energy and agricultural/food products as well as depreciation of the dollar. In the Euro Zone, the inflation rate rose to 3.3% in 2008, up from 2.1% a year earlier, in the wake of higher prices for imported commodities and higher wages. There was a similar situation in Japan, where the overall level of prices went up by 1.4% after remaining stable in 2007. This situation was due in particular to higher prices for food and oil products as well as for gas and electricity. In emerging and developing countries, inflation grew at a much faster pace in 2008, reaching 9.3% on average compared to 6.4% a year earlier. This increase was due to vigorous domestic demand in most countries as well as the impact of high commodity prices over the first half of the year.

## **F. INTERNATIONAL COOPERATION**

The outstanding occurrence in international cooperation in 2008 was the massive, concerted action taken by developed countries and world financial institutions to coordinate action to counter fallout from the financial crisis. Aside from the coordinated intervention on the part of the major central banks in industrialised countries, the International Monetary Fund (IMF) came to the assistance of a number of emerging countries hard hit by the crisis, granting loans worth some 47 billion dollars: 16.5 billion to the Ukraine, 15.7 billion to Hungary, 7.6 billion to Pakistan, 2.5 billion to Belarus, 2.4 billion to Latvia and 2.1 billion to Iceland. IMF also set up a new facility to issue short-term liquidity to help countries with fundamentals that are basically sound but that need to correct insufficient liquidity. It also reactivated the procedure for emergency loans based on simpler conditions for countries suffering from the crisis. Japan committed to loaning 100 billion dollars to the Fund in support of efforts to help the above-mentioned countries. In this same framework, the World Bank introduced a mechanism for quick financing in the amount of 2 billion dollars in favour of 78 of the poorest countries faced with a drop in revenue, investment and trade. The Bank also set up a recapitalization fund to provide capital to banks in small emerging and developing countries in support of investment, especially investment by small/medium sized businesses. Japan in particular has put 2 billion dollars into this fund.

The Group of Seven (G7) at its October 2008 meeting adopted a set of measures focusing on bail out of financial institutions, a return to a better loan market, guarantee of savings deposits, contribution of capital for banks encountering difficulties, and assistance to real estate markets. The Group of Twenty (G20), made up of advanced and emerging countries, met in November 2008 to draw up a worldwide plan to counter the crisis, based on closer macroeconomic cooperation to support growth, to re-establish confidence, and to contain the

effects of the financial crisis, especially in emerging and developing countries. The G20 committed to ensuring transparency in the international financial system, to taking the measures needed to stabilise it, to strengthening international prudential norms, and to monitoring trans-national companies on the one hand, while also rejecting protectionism, re-launching multilateral trade negotiations, and respecting commitments in the area of development aid, especially to vulnerable countries that have been hard hit by the crisis. In this framework, the United States and China decided to release 20 billion dollars in loans to developing countries to ensure financing for trade and to support economic growth in these countries.

To deal with the food crisis created by the unprecedented increase in the price of foodstuffs (which added another 100 million to the 850 million people already facing famine and poverty), the World Bank created a quick financing mechanism with 1.2 billion dollars in funds to help countries affected by soaring prices. 200 million dollars of this amount are earmarked for grants of up to 10 million dollars per country. The World Bank also committed to increasing its worldwide support for food and agriculture from 4 billion dollars in 2008 to 6 billion in 2009 and to provide instruments to manage risk (harvest insurance schemes) to protect poor countries and small-scale farmers. IMF doubled its financial assistance to four countries and entered into negotiations for additional assistance with 11 other countries. The United States decided to provide 200 million dollars for emergency assistance, especially for African countries, while the European Union adopted a food aid programme worth one billion euros.

The food crisis obliged several countries, especially developing countries, to increase subsidies on food products and to reduce exports of agricultural products. These measures, combined with a greater number of bilateral and regional agreements and greater protectionism in a world context marked by slowing economic activity and growing unemployment, were an additional factor complicating the Doha round of multilateral trade negotiations launched in 2001. But several countries continued to call for quick resolution of these negotiations, which would help world trade to fully play its role as a factor for development and to help countries emerge from the economic and financial crisis.

As for regional cooperation, 43 Mediterranean countries on 13 July 2008 officially launched the Mediterranean Union at France's initiative. The Union will be co-chaired by one country on the northern rim of the Mediterranean and one on the southern rim. A summit will be held every two years. This union will seek to enhance cooperation, especially in the fields of de-pollution of the Mediterranean, «sea highways» that provide better-integrated maritime transport, development of solar energy, and support to small/medium sized businesses. The goal of creating a free trade zone among member states is set for 2010.

With the addition of Cyprus and Malta on 1 January 2008, the Euro Zone now counts 15 countries. It is expected that by adopting the euro it will be easier to attract foreign investors, stimulate growth, and increase monetary stability. With these same objectives in mind, the Slovak Republic signed an agreement with the Euro Zone on 19 June 2008 that will lead to membership on 1 January 2009. At that time, four of the 10 new members that joined the European Union in May 2004 will have joined the monetary zone.

The countries of the Cooperation Council of the Gulf (GCC) officially launched a common market on 1 January 2008 and on 17 September of the same year adopted a draft agreement to set up a monetary union as well as a monetary council, which will become the future Central Bank of the Gulf, seeking to move to a single currency in 2010.

Mergers and acquisitions of companies worldwide in 2008 were down by some 30%, putting an end to sustained growth for five straight years. These operations were worth just 2,936 billion dollars (the lowest level since 2005), compared to 4,169 billion in 2007, due to turbulence on stock markets, insufficient financing in the wake of the credit crunch, and lack of liquidity worldwide. The financial sector continued to monopolise a large portion of these operations (23%), in line with the banking sector's move to consolidate.

The drop in operations took place in all regions, varying from 8.7% for Asia and the Pacific to 39.6% for Africa and the Middle East. There were drops of 37.2% (to 986 billion dollars) in the United States and 27.3% (to 1,158 billion) in Europe, corresponding respectively to 33.6% and 39.4% shares in world total, compared to 37.7% et 38.2% a year earlier.