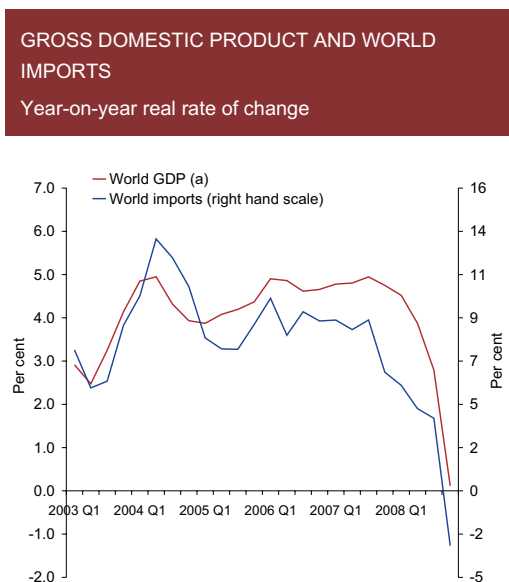


1. INTERNATIONAL ENVIRONMENT

The world economic activity showed a sharp deterioration in 2008 and is expected to record the most severe and synchronized economic recession of the past decades in 2009. This evolution reflects the growing interaction of a series of negative shocks, namely the intensification and globalization of the financial crisis started in mid-September of 2008, following the bankruptcy of Lehman Brothers investment bank, in an environment of economic activity deceleration in several advanced economies since mid-2007, steep rise in the prices of commodities in the first half of the year, significant correction in some housing markets and intensification of financial deleveraging in several countries. The convergence of all these factors brought on a crisis of global confidence, translated by a sharp fall in aggregate demand and world trade in the last quarter of 2008, causing a significant deceleration of external demand directed to the Portuguese economy (Chart 1.1). The strong deterioration in world economic activity exacerbated the expectations of losses in the financial system, causing a series of negative self-reinforcing effects between economic activity and the financial markets perspectives. To counteract this situation governments and central banks of several countries, including Portugal, adopted, in a framework of international cooperation, a large set of historically unprecedented measures, both in number and in terms of amounts, to support the financial system and stimulate economic activity. The risk transference from the private sector to the public sector caused by these measures raised concerns regarding the sustainability of public finances in several advanced economies creating upward pressures in sovereign debt yields. These measures contributed to decrease systemic risk and raise economic agents' confidence in the financial system, with some signs of decrease in uncertainty and risk aversion appearing in the financial markets since March 2009, remaining however in very high levels (Chart 1.2).

Chart 1.1

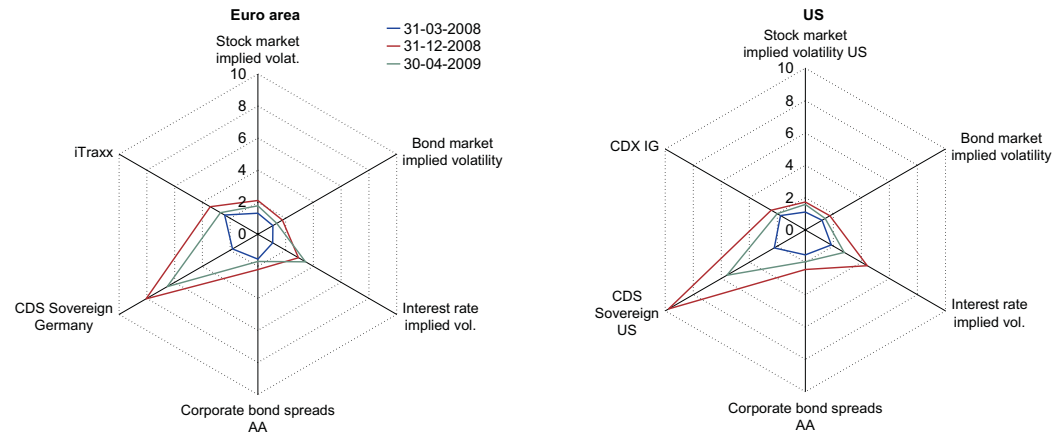


Sources: Netherlands Bureau for Economic Policy Analysis (CPB), Thomson Reuters and Banco de Portugal calculations.

Note: (a) The world GDP series was calculated on the basis of a sample of countries representing around 90 per cent of world GDP in 2004, expressed in purchasing power parities. The weighting assigned to each country corresponds to the weights of each country in world GDP in the previous year, expressed in purchasing power parities, as disclosed by the IMF.

Chart 1.2

RISK INDICATORS IN THE FINANCIAL MARKETS

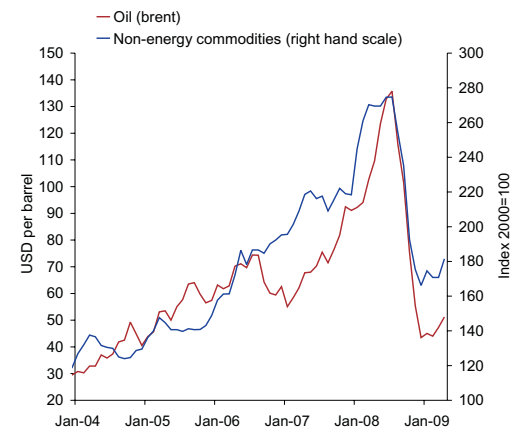


Sources: Bloomberg, Thomson Reuters and Banco de Portugal calculations.
 Note: Ratio between values for the indicator at the indicated date and values at 2 January 2008.

At the same time, global inflationary pressures subsided quickly since the middle of the year, after registering a significant increase during the first part of 2008, an increase specifically associated to the strong growth in international commodity prices. This decrease is mostly due to the impact of a weakening world demand on salaries and prices, namely on commodity prices. In effect, 2008 was also marked by a high volatility in the international prices of commodities that registered a strong increase in the first half of the year, followed by a sharp fall since the summer (Chart 1.3). Brent oil reached a maximum price of USD 146 per barrel in early July (USD 95 at the end of 2007) and prices of non-energy commodities increased by 26 per cent in the first half of the year. This evolution reflected both the continuation of strong world demand for commodities in an environment of continued dynamism in emerging markets and relative tight conditions on the supply side. This evolution was reversed in the

Chart 1.3

COMMODITY PRICES
 US dollars

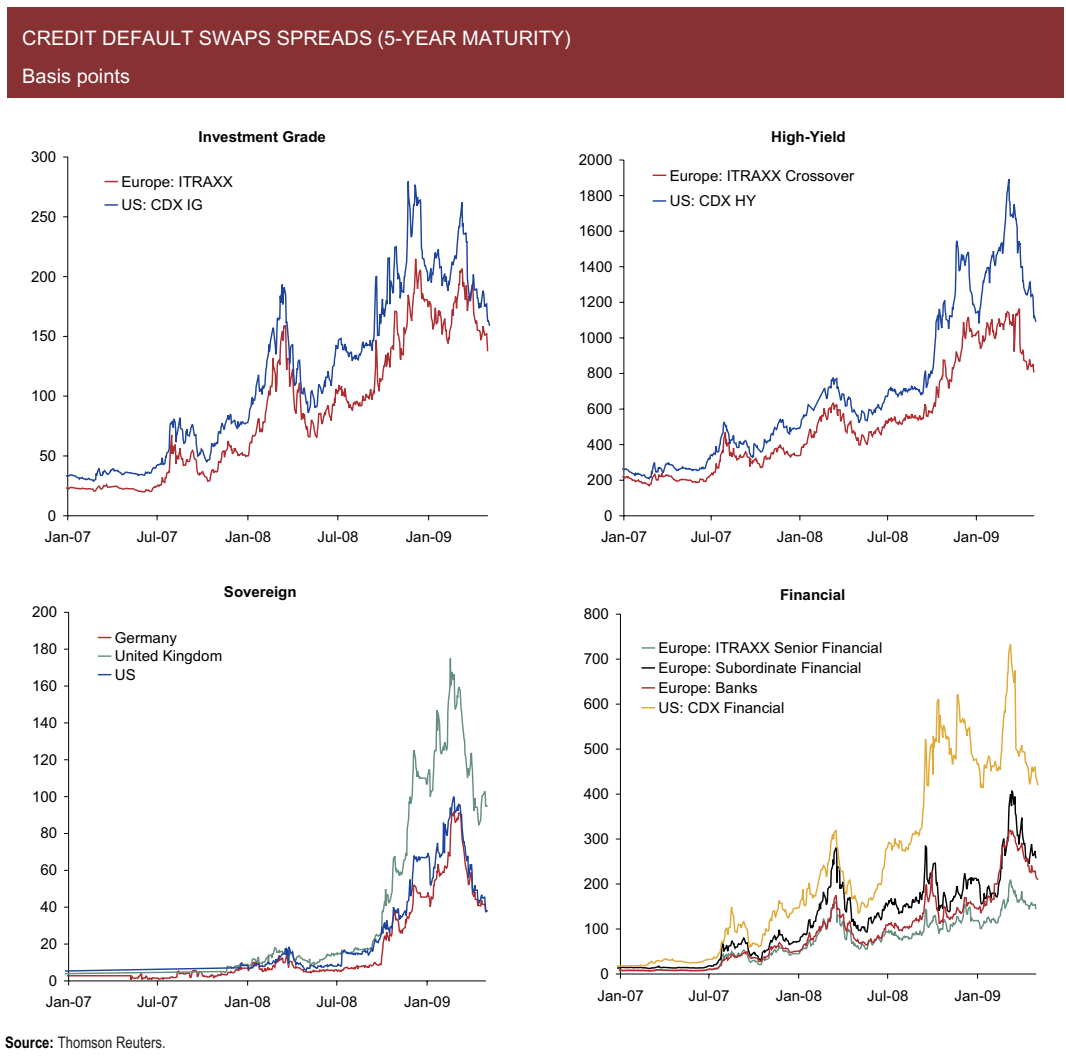


Sources: Bloomberg and HWWI.

second half of the year when commodity prices started a sharp fall, made worse from mid- September with the intensification of the financial crisis and its transmission to real economy. At the end of 2008 the price of Brent oil was 39.5 USD, which corresponds to a decrease of 58 per cent when compared to the level observed at the end of 2007 (a decrease of 56 per cent in euros). At the beginning of 2009, Brent oil stayed at around 45 USD/barrel, with a slight raise since March to 52 USD/barrel, associated to additional production cuts announced by the OPEC countries. The prices of non-energy commodities also registered a sharp fall since mid-2008, ending the year at about 24 per cent below the end of 2007, with a slight recovery from March of 2009.

The turmoil in financial markets intensified in 2008, more dramatically since mid-September. At the beginning of the year, financial markets were negatively affected by news regarding the deterioration of the balance sheets of financial institutions, especially the monoline insurance companies in the USA, and by heightened fears of a recession in the USA and its impact in world economy. The increase in uncertainty and risk aversion strengthened in the first weeks of March with rising concerns over systemic risks. The credit default risk of companies, assessed by Credit Default Swaps (CDS) spreads and corporate bonds yield spreads relatively to government bond yields widened considerably, more sharply in the United States and in the financial sector (Chart 1.4). In the interbank money markets for the dollar, euro and sterling, spreads between unsecured and secured operations increased, particularly over

Chart 1.4

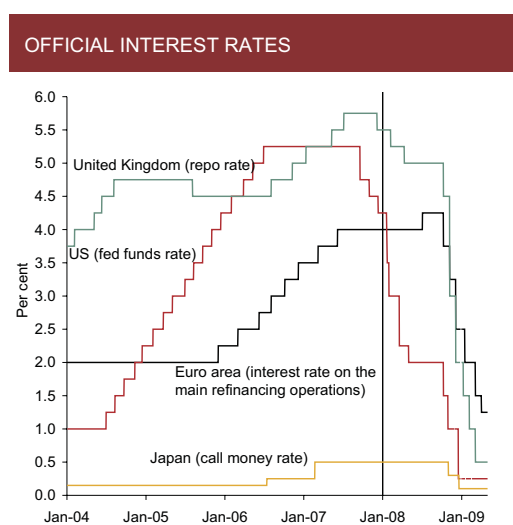


the longer maturities, indicating an increase in counterparty credit risk. In this context, central banks introduced additional exceptional liquidity management measures, in which particular reference should be made to the joint action agreed between the US Federal Reserve, the ECB and other central banks, to resume US-dollar liquidity-providing operations on March 11, 2008. The Federal Reserve also approved a financing plan for the acquisition of the distressed investment bank Bear Stearns on March 16. These measures, compounded by the sharp policy interest rate cut by the Federal Reserve (the fed funds rate was reduced by 2.0 p.p. in the first quarter of the year, to 2.25 per cent) and by news of banks' recapitalisation efforts, led to the perception of a reduction of systemic risks and the idea that the impact of the financial turmoil on the real economy could be less severe than expected. The following months, therefore, witnessed a certain level of moderation in financial market tensions.

The second quarter of 2008 witnessed growing concerns over the prospects of inflation, owing to short term upward pressures associated with the strong growth of international commodity prices, with inflation reaching high levels in most economies. Year-on-year inflation in the United States increased from 4.1 in December 2007 to 5.6 per cent in July 2008, from 3.1 to 4.0 per cent in the euro area, from 2.1 per cent to 4.4 per cent in the United Kingdom, and from 0.7 per cent to 2.3 per cent in Japan, in the same period. With the objective of countering the growing risks to medium term price stability and preventing broad-based second-round effects, the Governing Council of the ECB decided to raise key interest rates by 25 basis points (b.p.) on the 3rd of July, 2008. Concerns over upward risks on inflation were also a factor behind the decisions taken by the Federal Reserve and Bank of England to keep official interest rates unchanged in this period (Chart 1.5).

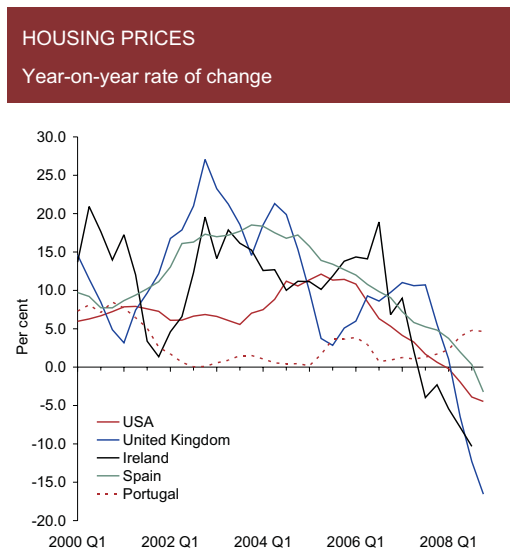
A renewed upsurge of risk aversion and uncertainty was observed from end-May, becoming severe from September onward. The change was initially associated with growing signs of a world economic deceleration which, simultaneously with the increase in inflationary pressures and tighter financing conditions, suggested that corporate earnings and credit quality were likely to be eroded. In this context, credit markets began to evidence expectations of gradually rising default rates, with CDS and corporate bond yield spreads widening once again, and stock prices falling in all sectors of activity. At the same time, the housing market in the United States and in several other European economies continued to deteriorate significantly (Chart 1.6). The intensity of the correction in the United States, in progress since the end of 2005, showed no signs of abating, with the negative changes in housing

Chart 1.5



Source: Bloomberg.

Chart 1.6



Sources: Newsletter *Confidencial Imobiliário* and Thomson Reuters.

Note: Prices in the United Kingdom, Spain and Portugal regard all houses (new and existing), while in Ireland and the United States they regard existing houses.

price indices having accentuated during the course of the year, suggesting that the adjustment process was likely to take longer than expected. In several European countries in which the housing market was also showing signs of downward correction, year-on-year changes in nominal house prices were very negative, such as in the United Kingdom and Ireland, or under a very pronounced deceleration, such as in Spain, which witnessed a nominal fall in house prices in the last quarter of 2008 (for further details see “Box 1 Housing markets in some advanced economies”, *Banco de Portugal, Economic Bulletin-Autumn 2008* of this Report). House prices in Portugal in 2008 maintained moderate nominal growth, after a long period of annual growth rates of close to zero. The deterioration in housing markets implied further valuation losses on mortgage-backed securities, raising fears over the viability of several major specialised US mortgage finance agencies, leading the US government to formally take control of the Fannie Mae and Freddie Mac on September 7. The deterioration of financing conditions in equity and credit markets added to pressures already faced by financial institutions more dependent on wholesale funding (such as the investment banks) and heavily involved in credit derivatives markets.

The financial turmoil worsened considerably following the failure of Lehman Brothers on September 15, giving rise to a crisis of confidence which quickly spread to the global financial system. The crisis of confidence led to a massive sell-off affecting all segments of the financial market and particularly several segments of the money and credit markets. Credit risk premiums reached their highest levels since the start of the turbulence. In the money markets of major economies, there was a sharp increase in interest rate spreads between unsecured and secured loans with major difficulties arising in terms of US dollar financing. The risk of corporate defaults, as measured by CDS spreads also rose sharply and corporate bonds yield spreads reached their highest levels since the start of the turbulence. Financial companies with the worst ratings were the most affected, both in the United States and in the euro area. Equity prices, in turn, fell sharply, including in emerging markets which, for a long period appeared to be relatively immune to the current crisis (Table 1.1). In 2008, stock markets declined by 46 per cent year in the euro area and by 38 per cent in the United States, with bank share prices in these economies falling by 64 and 50 per cent, respectively. The demand for more liquid and safer financial instruments favoured government debt markets, which registered gains. The surge in uncer-

Table 1.1

INTERNATIONAL FINANCIAL MARKETS						
Based on end of period values (daily data)						
	2006	2007	2008	2009 ^(a)	Compared to the beginning of the financial crisis (change in percentage or base points) ^(b)	
					2008	2009 ^(a)
Stock market indexes (percentage change)						
Dow Jones Euro Stoxx	20	5	-46	-1	-49	-49
Banks	22	-9	-64	10	-68	-65
S&P 500	13	4	-38	-3	-41	-43
Banks	12	-33	-50	-29	-64	-74
Nikkei 225	6	-11	-42	0	-51	-51
FTSE 100	11	4	-31	-4	-33	-36
MSCI - emerging market economies ^(c)	26	30	-47	16	-44	-35
10-year government bond yields (per cent)						
Euro area	4.1	4.4	3.8	4.0	-71	-56
United States	4.7	4.0	2.2	3.1	-274	-183
Japan	1.7	1.5	1.2	1.4	-69	-43
United Kingdom	4.7	4.5	3.0	3.5	-230	-182
Spreads between private and government debt yields (basis points)						
Euro area						
AA	26	88	196	151	156	111
Non-financial corporations	22	53	104	92	79	67
Financial corporations	27	96	217	166	175	124
BBB	73	145	573	524	501	451
Non-financial corporations	70	134	455	319	387	251
Financial corporations	98	240	1369	1947	1259	1836
Banks	35	105	399	362	354	318
United States						
AA	51	171	420	337	344	262
Non-financial corporations	54	139	299	229	230	160
Financial corporations	51	176	458	390	381	313
BBB	113	262	802	664	669	531
Non-financial corporations	113	238	735	554	605	424
Financial corporations	130	458	1450	1559	1273	1382
Banks	75	250	656	665	562	571
Emerging market debt spreads (base points)						
EMBI+	169	239	690	529	508	347
Nominal effective exchange rates (percentage change)						
Euro	4.7	6.3	2.7	-2.8	6.8	3.8
US dollar	-4.3	-7.5	8.6	1.8	5.0	7.0
Japanese yen	-6.1	0.8	30.7	-6.7	38.1	28.8
Pound sterling	5.7	-6.2	-23.4	5.2	-28.8	-25.1
Memo:						
EUR/USD exchange rate ^(d)	11.6	11.8	-5.5	-4.6	0.7	-4.0

Sources: Bank for International Settlements, Bloomberg, ECB, Federal Reserve Board and JPMorgan.

Notes: (a) Data up to 30 of April. (b) Changes compared to 23 July, 2007. (c) Morgan Stanley Capital International Index for emerging market economies: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey. (d) A positive change corresponds to an appreciation of the euro.

tainty is clearly evident in the spike of implicit volatilities of stock markets (Chart 1.7). In emerging markets equity prices fell by around 50 per cent in 2008, sovereign debt yield spreads relatively to US Treasury bonds yields widened significantly and there were strong pressures in the foreign-exchange markets for the respective currencies (Chart 1.8). In such a context, the banks' financial situations worsened dramatically: firstly because access to external sources of financing became very difficult and, secondly because accrued asset losses led to the erosion of their capital base.

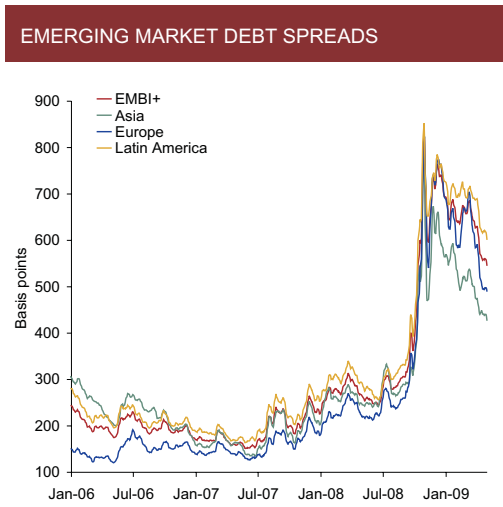
Chart 1.7



Source: Thomson Reuters.

Note: Market expectations for equity market volatility in the next 30 days, based on option prices.

Chart 1.8



Source: JP Morgan.

To contain systemic risks, the central banks and the governments of several countries have implemented a broad range of measures. On October 8, in a coordinated action, several central banks reduced their official interest rates, with the ECB having reduced key interest rates by 50 b.p. (to 3.75 per cent for the main refinancing operations' interest rate). Central banks have also endeavoured to boost market liquidity by providing substantial amounts of funds, including in coordinated actions and in several cases, by expanding the list of collateral and counterparts acceptable in monetary policy operations (see "Box 1.2 *Operational framework of the Eurosystem, Federal Reserve and Bank of England in the context of the financial crisis*", of this Report). Regarding the Eurosystem, we should mention the introduction of fixed rate tenders with full allotment both in euro and USD operations, starting on October 15th (in this latter case, jointly with the Federal Reserve to provide for the high demand for dollars), and reduction of the standing facilities' corridor from 200 to 100 b.p.. Governments, in turn, provided specific assistance to individual institutions experiencing more significant financial difficulties and also implemented more comprehensive intervention programmes. Owing to the global nature of the financial crisis, significant efforts were also made to coordinate international policy response. In early October of 2008, the G7 announced a joint plan of action to stabilise financial markets and promote credit. Following this action, euro area countries announced a concerted action plan, after the Heads of State and Government summit of October 12, of 2008. The measures adopted by several countries globally concentrated on the following aspects: (i) additional guarantees on bank deposits with the aim of restoring depositors' confidence and ensuring the banking system's adequate operation; (ii) public guarantees on financial institutions' issuances of new debt securities to regain the confidence of investors; (iii) voluntary recapitalisation programmes and public capital injections in distressed financial institutions; and (iv) several governments also provided loan programmes to banking institutions or an exchange of less liquid assets; (see "Box 1.3: *Government measures to support the financial sector and stabilize the financial markets*", of this Report).

The measures taken helped to increase economic agents' confidence in the financial system and eased tensions in several market segments, namely in the interbank money markets in which there was a progressive decrease in differentials between interest rates on unsecured and secured loans. Additionally, financial corporations CDS and bond spreads declined to pre-September levels, while sovereign CDS spreads widened in the context of the transfer of risk from financial institutions to the

governments pursuant to the support packages adopted (Chart 1.4). By the end of October, the accumulation of evidence suggesting a significant weakening of world economic activity, with a large number of advanced economies in recession and a significant slowdown in the emerging markets, led to a renewed increase in uncertainty and risk aversion, with a consequent sharp fall in asset prices. During the course of the last quarter of 2008, this situation translated into a very low level of confidence of economic agents and exacerbated financial system losses. The last two months of 2008 and the beginning of 2009 were characterised by a greater interaction of negative impacts between weakening economic activity and financial markets strains, substantially aggravating global economic and financial prospects. It should be noted that the earning prospects of non-financial corporations, which remained relatively unchanged since the beginning of the crisis, were revised significantly downward since October of 2008. In early 2009 CDS and corporate bond spreads increased further, more markedly in the financial sector. There were also fresh falls in equity markets, led by the financial sector, with volatilities remaining high. From the second half of March 2009, there was a certain reversal of these movements, following the announcement of better than expected profits by financial institutions, the disclosure of new economic support measures in the United States and the United Kingdom, and in April the presentation of the Global Plan for Recovery and Reform approved by the G20. At the end of April, 2009, share prices in the euro area and United States were back to pre end of 2008 levels, except for US banking sector shares that remained devalued in about 30 per cent. In the money markets, the interest rate differentials between unsecured and secured operations, in the first months of 2009, decreased in the euro area and the United Kingdom to 60 and 80 b.p., respectively and to a lesser extent in the USA to 70 b.p, which suggests a risk premium relatively lower in the euro area. In the United Kingdom this differential remained at levels higher than those prior to the intensification of the financial turbulence in September 2008.

In a context of growing economic weakness and a reduction in inflationary pressures, the national authorities of major world economies have been taking measures to boost economic activity, both in terms of monetary and fiscal policies. Official interest rates in the main advanced economies were reduced at an unprecedented pace and magnitude, in several cases to historical minimums at the end of 2008 (0.25 per cent in the United States, 2 per cent in the United Kingdom and 2.5 per cent in the euro area). In early 2009, several monetary authorities continued to reduce their official interest rates, to 0.5 per cent in the United Kingdom and 1.0 per cent in the euro area. Several central banks also adopted quantitative easing measures. In March of 2009, the Federal Reserve started a program to purchase significant amounts of agency mortgage-backed securities and debt, as well as longer term Treasury securities, and the Bank of England also set up a programme for the purchase of public and private debt securities on the secondary market (including commercial paper and corporate bonds). Following the announcement of such measures there was a significant reduction on long-term government bond yields in these economies. Lately these yields increased staying at the end of April of 2009 at levels above those at the end of 2008, +0.9 p.p. in the United States and +0.5 p.p. in the United Kingdom. In the same period the long-term government bond yields in the euro area increased 0.2 p.p.. On May 7, the Eurosystem decided in principle to purchase euro-denominated covered bonds issued in the euro area.

Regarding fiscal policy, at the end of 2008 and beginning of 2009 several governments announced programmes designed to stimulate economic activity and limit the impact of the current crisis on real economy. In the USA the “American Recovery and Reinvestment Act” was approved in February of 2009. In Europe, several countries had been adopting anti-crisis fiscal measures since the summer. The European Commission presented its “European Economic Recovery Plan” at the end of November 2008, in which it proposed a coordinated stimulus package (of around 1.5 per cent of European Union GDP, with 1.2 per cent of GDP being financed by national budgets), resulting in the adoption of

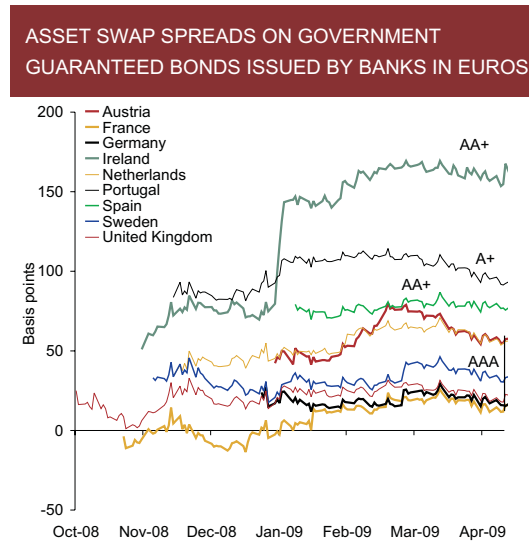
several national packages by the Member States. A large number of measures, involving both the revenue and the expenditure side, have been adopted by different countries worldwide. The composition of such measures, however, varies substantially from country to country, with particular reference being made to personal and corporate income tax reductions as well as VAT, increased public investment, subsidies for purchases of consumer durables (such as cars in the United States, Germany, France and Italy) and an increase in social spending (for low-income households) (see “Box 1.5 *Fiscal policy in the context of the economic and financial crisis*”, of this Report).

Following the above measures, financial market participants began to denote concerns over the sustainability of public finances in several countries, related in particular with the issuance of large amounts of public debt which could be difficult to absorb. In the case of euro area, the evolution of government bond yields was varied across countries, resulting in a substantial upward move of spreads *vis-à-vis* Germany to levels only observed in the period preceding the introduction of the single currency. This was probably a reflection of the greater relative liquidity of German debt securities in the context of “flight to liquidity” movements, in addition to a revaluation of credit risk in different countries, penalising those countries with the most pronounced macroeconomic imbalances and/or in which the fiscal positions could deteriorate the most, in particular through the transfer of risk from the financial sector. The evolution of credit risk premiums is also likely to have reflected the increase in the price of risk in global financial markets (see “Box 1.1 *Evolution of the sovereign bond yield spreads in the euro area in the context of the financial crisis*”, of this Report). At the end of 2008, the highest 10 year-government bond yield spread *vis-à-vis* Germany was that of Greece at around 230 b.p.. Spreads in Ireland, Italy, Portugal, Spain and Belgium also recorded very significant increases, and at the end of the year were between 83 b.p. in Belgium and 142 b.p. in Italy. In Portugal spreads increased by 81 b.p. to 102 b.p. in 2008. At the beginning of 2009, there was an additional increase accompanied by high volatility in the context of a further deterioration of economic growth prospects, a downward revision of ratings of several countries in the euro area (Greece, Spain, Portugal and Ireland), and greater fears of major disruptions in the Eastern European economies, and consequent contagion effects to banks and euro area economies more exposed to the region. These spreads were corrected downward from mid-March of 2009. The spread on Irish public debt, rose particularly sharply to around 190 b.p. at the end of April, a level similar to that of Greece. Increases in spreads in Portugal and Austria were also higher than those of the other economies under analysis, staying at around 110 b.p. and 80 b.p., respectively, at the end of April of 2009. The increase in the long-term government bond yield spreads is an additional penalty on the financing costs for these countries’ economic agents. In particular, this implies a differentiation in banks’ guarantee debt issuance costs among the various countries in the euro area, as well as long-term debt issuance costs by non-financial corporations (Chart 1.9).

Notwithstanding the significant increase in spreads, 10-year government bond yields in the euro area, with the exception of Ireland and Greece, remain at levels lower than the ones recorded prior to the summer of 2007, although, in the case of Portugal the difference is very small (about 0.3 p.p.) (Chart 1.10). By contrast, 10-year government bond yield in Germany declined significantly between the end of July of 2007 and end of April of 2009 (-1.2 p.p.), staying at 3.2 per cent at the latter date.

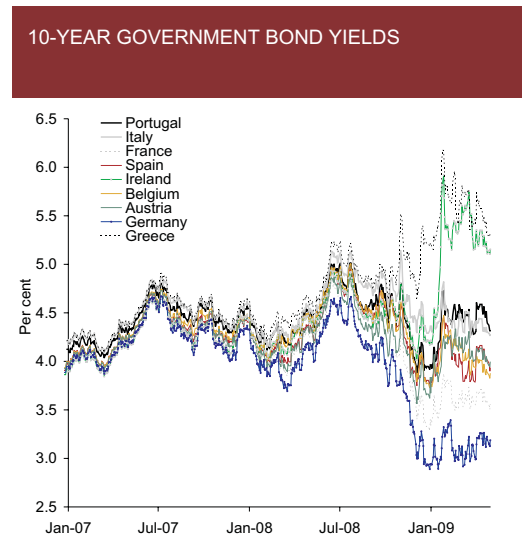
The foreign exchange market witnessed abrupt movements in terms of the evolution of the major currencies, starting in mid-October of 2008. The yen appreciated strongly in nominal effective terms, by around 31 per cent at the end of 2008 in comparison to the end of 2007, largely associated with the reversal of carry trade movements in an environment of increased risk aversion and deleveraging, while sterling depreciated significantly by about 23 per cent. The dollar, in turn, appreciated by 8.6 per cent, coming into line with the long term average, and the euro appreciated 2.7 per cent, remaining appreciated against the long term average (Chart 1.11). In bilateral terms, the euro depreciated by around 24 per cent against the yen, 6 per cent against the US dollar, 10 per cent against the Swiss franc and ap-

Chart 1.9



Sources: Bloomberg and Banco de Portugal calculations.

Chart 1.10

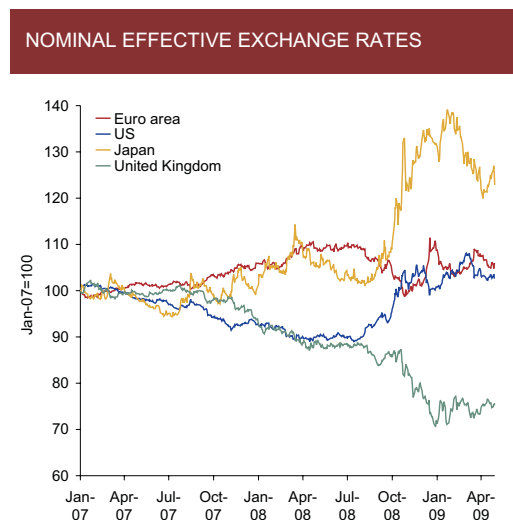


Source: Thomson Reuters.

preciated 30 per cent against the sterling. In the first four months of 2009, the dollar and the sterling appreciated in nominal effective terms by 1.8 per cent and 5.2 per cent, respectively, while the yen depreciated by 6.7 per cent. During the same period, the euro appreciated against most of the currencies of the new Member States of the European Union and against the yen, having depreciated 4.6 and 6.2 per cent, respectively, against the dollar and the sterling, resulting in a nominal effective depreciation of 2.8 per cent.

The worsening of the financial crisis in 2008 had a negative repercussion in global economic activity in several ways. Financial deleveraging and massive sell-off caused a substantial deterioration in private economic agents' financing conditions, including the ones with better rating. On the other hand, the strong fall in equity markets and the continued price correction in housing markets in several countries

Chart 1.11

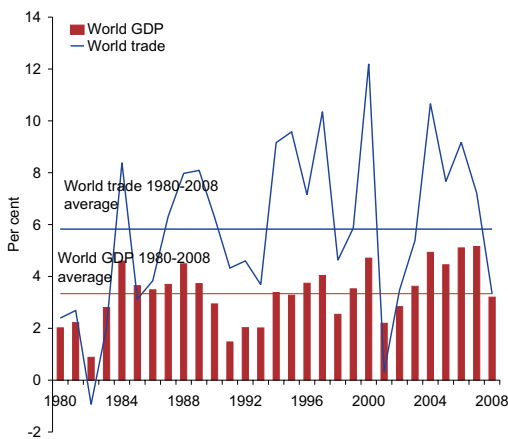
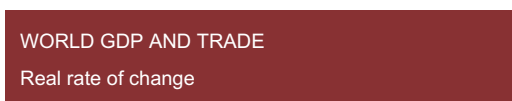


Sources: Bank for International Settlements, ECB and Federal Reserve Board.

caused significant losses in household wealth. Finally, the uncertainty regarding financial system situation and its impact on real economy led to a global confidence crisis. In this context, world economy decelerated significantly in 2008, with world GDP growing by 3.2 per cent, slightly below the average of the last 28 years, after five consecutive years with higher growths (Chart 1.12). The deceleration was particularly marked at the end of the year, with year-on-year growth of world GDP decreasing from 4.5 per cent in the first quarter of 2008, to no more than 0.2 per cent in the last quarter. World trade flows for goods and services grew 3.3 per cent in 2008, 3.9 p.p. less than the growth registered in 2007, and greatly below the average growth since 1980. Intra-annual data show world trade flows continued the tendency of deceleration started in mid-2007, registering a sharp fall in the last months of the year which continued in the beginning of 2009. The collapse in world trade at the end of 2008 was precipitated by the generalised loss of confidence and high levels of uncertainty, leading economic agents to reduce or postpone expenditure, and was exacerbated by increased difficulties in obtaining trade credit in the context of a worsening financial crisis. Additionally, the phenomenon of the vertical specialisation of worldwide production, in evidence over latter years (with the delocalisation of parts of production of industrial activities and services) was also a contributory factor to this major contraction of world trade. In fact, vertical specialisation of global production increases the sensitivity of trade to changes in demand in a specific economy, having contributed to the rapid expansion of world trade flows over the last years and, more recently, to its contraction.

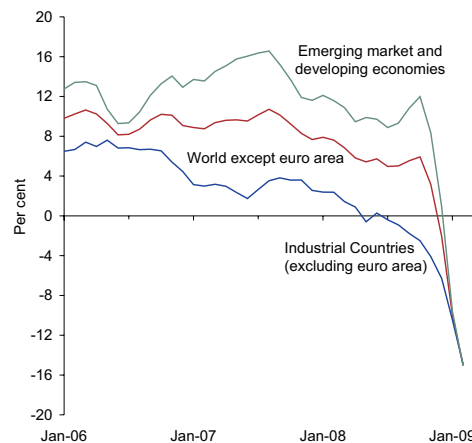
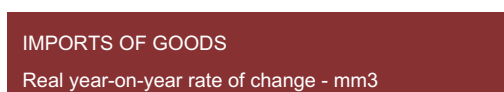
World trade imports, excluding the euro area, contracted by 2.1 per cent in year-on-year terms over the last quarter of 2008, and by 15 per cent in the three months ending in February of 2009 (Chart 1.13). The contraction of imports, at the end of 2008, was a common factor in industrialised countries (excluding the euro area) and developing countries, whose robust demand had, up to that date, sustained world trade, despite the ongoing financial turmoil. The contraction of world trade at the end of 2008 was accompanied by a global fall in industrial production. Regarding services we should note the marked decrease in tourism during 2008, especially in the second half of the year. In fact, after registering an year-on-year growth of 5 per cent in the first six months of 2008, world tourism contracted by about 1 per cent, year-on-year, over the next six months, with an expansion of only 1.8 per cent during the year as a whole (comparing to about 7.0 per cent in the previous year) (Table 1.2). The deceleration was general to all regions, more specifically in the Asia/Pacific and European regions. In the European

Chart 1.12



Source: IMF.

Chart 1.13



Source: Netherlands Bureau for Economic Policy Analysis (CPB).

countries there was a stagnation of international tourist arrivals in 2008, a reflex of tourism contraction in the Northern and Western European countries of 2.1 and 1.2 per cent, respectively, and reduced growth in tourism destined to Southern and Mediterranean Europe, and Central and Eastern Europe of 0.6 and 2.7 per cent, respectively. According to the World Tourism Organization, world tourism should stagnate in 2009 or even suffer a slight fall, and the most affected regions will be America and Europe.

Global foreign direct investment flows were around 21 per cent down in 2008 (after an increase of 30 and 47 per cent in 2007 and 2006, respectively), according to UNCTAD estimates. This decrease happened in the advanced economies where foreign direct investment flows fell 33 per cent in 2008, after several years registering very high growth rates (33 per cent in 2007 and over 50 per cent in 2005 and 2006) (Chart 1.14). In the advanced economies group, the main destination of the global foreign direct investment flows in 2008, note the strong fall in the flows destined to European Union countries (EU), while the USA saw only a slight decrease. This evolution was possibly a reflection of the significant increase in uncertainty over economic prospects, in addition to the deterioration of multinational companies' profits and a decrease in bank loans (notably syndicated loans), which made it difficult to finance such investments. Growth of foreign direct investment, in the case of developing economies, although much lower than that noted in 2007 (where it surpassed 20 per cent), maintained a positive value of around 4 per cent in 2008. The globalisation of the financial crisis and worsening world economic prospects suggest that foreign direct investment flows to these economies will also be significantly affected in 2009.

In 2008 global imbalance softened slightly (Chart 1.15). In the United States, the current account deficit presented a reduction from 5.3 to 4.7 per cent of the GDP in 2008, reflecting a strong contraction of goods and services imports, in a context of domestic demand deterioration. In the United Kingdom there was a decrease in the deficit from 2.8 to 2.1 per cent of the GDP in 2008, while Japan's surplus reduced to 3.2 per cent in 2008, compared to 4.8 per cent in 2007. The aggregate surplus of emerging and developing markets in Asia, excluding Japan and China was also reduced in 2008. However, China's surplus increased again, reflecting the maintenance of a relatively higher dynamism of exports *vis-à-vis* imports. Also in oil exporting countries the surplus in the current account increased, reflecting the impact of past increases in oil price. According to International Monetary Fund (IMF), global imbalances should present a significant decrease in 2009, reflecting an additional reduction in the United States' current account deficit and a surplus reduction in the current account of oil exporting countries

Table 1.2

DEVELOPMENTS IN INTERNATIONAL TOURISM					
International tourist arrivals					
	Millions		Rate of change (per cent)		
	2007	2008	2006	2007	2008
World	908	924	5.3	6.9	1.8
Americas	143	148	1.8	4.9	3.6
Asia and the Pacific	185	188	7.8	10.5	1.6
Africa and the Middle East	92	100	10.2	11.7	8.0
Europe	488	489	4.6	5.2	0.1
Northern Europe	58	57	7.0	2.7	-2.1
Western Europe	155	153	4.9	3.5	-1.2
Central and Eastern Europe	97	99	4.2	6.2	2.7
Southern and Mediterranean Europe	178	179	3.8	7.0	0.6

Source: World Tourism Organisation.

Chart 1.14

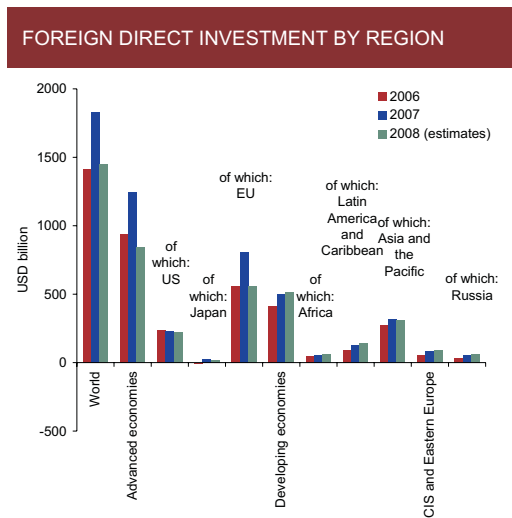
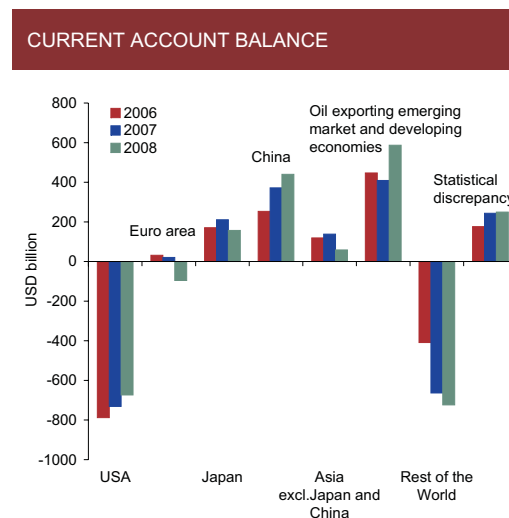


Chart 1.15



and, to a lesser degree, Japan. Despite the fall in global demand, the IMF forecasts a slight increase in the surplus of emerging market economies of Asia, namely China, Korea, Taiwan and Singapore, reflecting largely an improvement in the terms of trade associated to the drop in oil prices.

The reduction of the United States' current account deficit was accompanied by a change in its financing structure, related to the intensification of the financial crisis. In fact, since the beginning of the financial crisis in August of 2007 up to the third quarter of 2008 net inflow of external funds in the USA were dominated by the official non-resident sector, while the private sector registered a significant fall. However, in the second half of the year, net official flows decreased, resulting in large part from the drawings on temporary swap lines established between the Federal Reserve and foreign central banks, within the framework of response to tensions in the dollar money market. Private financing flows, in turn, increased in the second half of the year, largely reflecting capital repatriation from US residents. Note that, like in previous years, the importance of the official non-resident sector in the financing of the American external deficit is probably underestimated, since part of this sector's applications is included in the private flows through sovereign wealth funds.¹ The purchase of US Treasury securities by the non-resident private sector stayed strong in the second half of the year, while investment in other securities were substantially reduced, following a general flight to more liquid and less risky assets.

The slowdown of world economy registered during 2008 was initially concentrated in advanced economies, where the financial crisis started, having spread at the end of the year to the whole world, in an environment where the collapse in world trade amplified the adverse impact of a worsening financial crisis in the emerging markets. Over the last years, the emerging and developing economies registered a significant growth in the external trade flows of goods and services, having in 2008 surpassed world total by 1.9 p.p. in exports and 3.1 p.p. in imports (Chart 1.16). In the year as a whole economic activity in advanced economies registered a growth of only 0.9 per cent and is currently undergoing a strong recession. On the other hand, GDP in the emerging and developing economies registered a growth rate of 6.1 per cent in 2008 and continued to decelerate in the beginning of 2009 although maintaining a positive growth (Chart 1.17). The developing countries of Asia registered the strongest

(1) Sovereign Wealth Funds are investment vehicles created by the governments of economies with large current accounts' surplus to manage accumulated reserve assets, substituting their respective central banks.

growth in 2008, especially China and India where the economic activity expanded 9.0 and 7.3 per cent, respectively (Table 1.3). The emerging economies of Europe and the Commonwealth of Independent States, more dependant on short-term external financing (and in many cases with strong links to the banking system of European advanced economies), and on the exports of finished goods and commodities, were strongly affected, and will probably register in 2009 a significant contraction in economic activity.

In the United States GDP growth was down from 2.0 per cent to 1.1 per cent in 2008. There was a decelerating trajectory of GDP during the course of the first half of 2008, although growth remained positive, sustained by temporary fiscal stimulus measures implemented in February, a major reduction in official interest rates and by the depreciation of the dollar, together with continued robustness in external demand. During the second part of the year, however, the disappearance of the temporary effect of the fiscal stimulus, the continued downward correction in the housing market and the intensification of the financial crisis, with consequent tightened credit conditions and sharp fall in asset prices, had a sharply weakening effect on economic activity. In the last quarter of 2008, GDP contracted by 1.6 per cent quarter on quarter, compared with a contraction of 0.1 per cent in the third quarter. In contrast to developments in the first half of the year, the contribution of net external demand to GDP turned negative, particularly reflecting a sharp drop in exports. In terms of domestic demand, private consumption and non-residential investment, which in the first half of the year had, in conjunction with public consumption, offset the negative impact of the reduction in residential investment, recorded significant reductions in the second half of the year. In such a context, there was a particularly sharp fall in domestic demand in the last quarter of the year. According to IMF projections disclosed in April of 2009, GDP is likely to record a contraction of 2.8 per cent in 2009, and present zero growth in 2010.

The slowdown in economic activity was particularly sharp in the euro area, where real GDP growth fell from 2.6 per cent in 2007 to 0.7 per cent in 2008. After a strong quarter on quarter growth rate of 0.7 per cent in the first quarter of 2008, partly associated with temporary factors – particularly relatively mild weather in several countries which favoured construction activity - GDP fell successively in the following three quarters. The contraction of economic activity was particularly sharp in the last quarter of 2008 (-1.6 per cent compared to the previous quarter), reflecting the impact of the intensification and

Chart 1.16

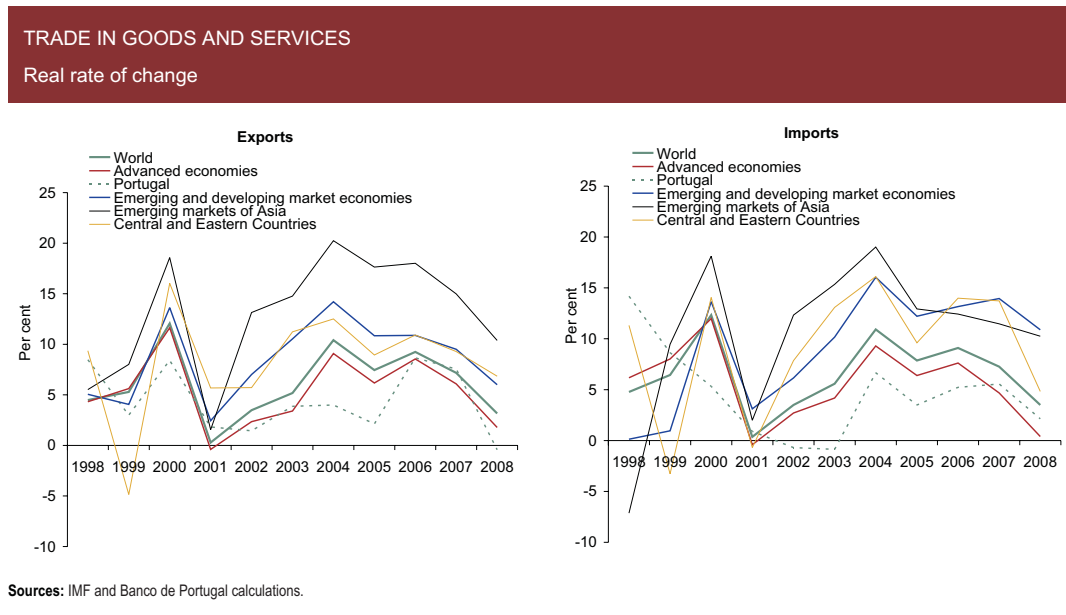
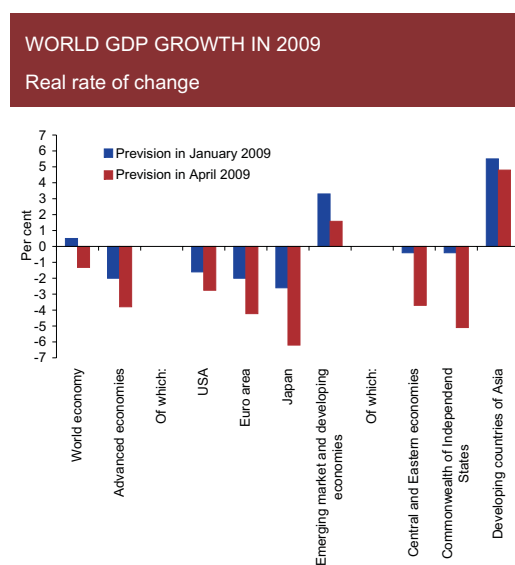


Chart 1.17



Source: IMF.

Table 1.3

GROSS DOMESTIC PRODUCT AND INFLATION
Per cent

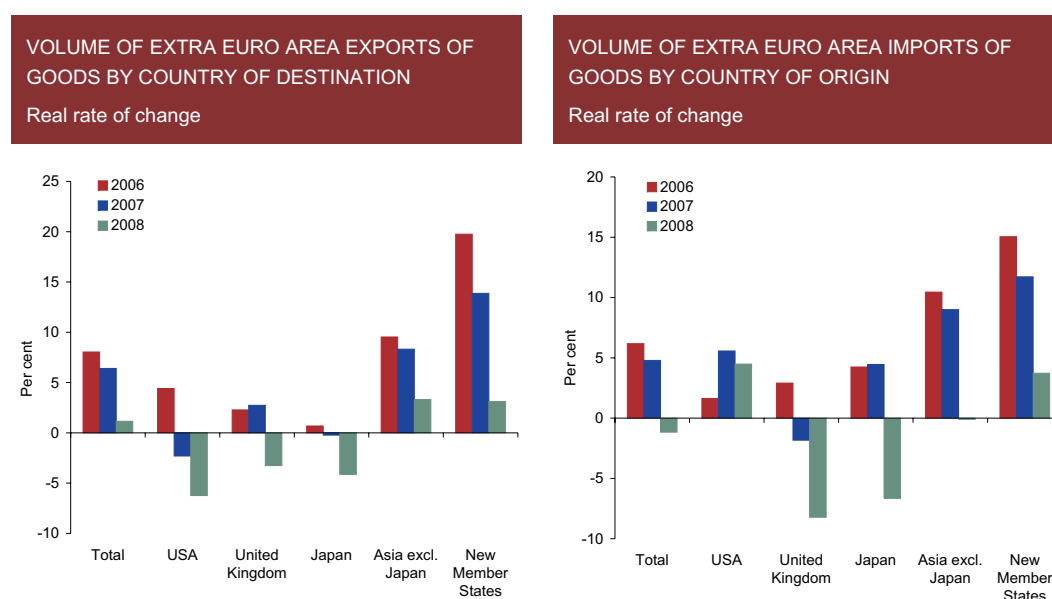
	Weight in world GDP 2008 ^(a)	GDP Rate of change			Consumer prices ^(b) Rate of change		
		2006	2007	2008	2006	2007	2008
World economy	100.0	5.1	5.2	3.2	3.6	4.0	6.0
Advanced economies	55.3	3.0	2.7	0.9	2.4	2.2	3.4
USA	20.7	2.8	2.0	1.1	3.2	2.9	3.8
Japan	6.4	2.0	2.3	-0.7	0.2	0.1	1.4
Euro area	15.7	3.0	2.6	0.7	2.2	2.1	3.3
Germany	4.2	3.2	2.6	1.0	1.8	2.3	2.8
France	3.1	2.4	2.3	0.3	1.9	1.6	3.2
Italy	2.6	2.1	1.5	-1.0	2.2	2.0	3.5
Spain	2.0	3.9	3.7	1.2	3.6	2.8	4.1
United Kingdom	3.2	2.8	3.0	0.7	2.3	2.3	3.6
New industrialised Asian economies ^(c)	3.7	5.6	5.7	1.6	1.6	2.2	4.5
Developing and emerging market economies	44.7	8.0	8.3	6.1	5.4	6.4	9.3
Central and Eastern Europe	3.5	6.6	5.4	2.9	5.7	6.1	8.0
Commonwealth of Independent States	4.6	8.4	8.6	5.5	9.4	9.7	15.6
Russia	3.3	7.4	8.1	5.6	9.7	9.0	14.1
Developing Asian countries	21.0	9.8	10.6	7.7	4.2	5.4	7.4
China	11.4	11.6	13.0	9.0	1.5	4.8	5.9
India	4.8	9.8	9.3	7.3	6.2	6.4	8.3
Middle East	3.9	5.7	6.3	5.9	6.8	10.5	15.6
Latin America	8.6	5.7	5.7	4.2	5.3	5.4	7.9
Africa	3.1	6.1	6.2	5.2	6.3	6.3	10.1

Sources: Eurostat, IMF and Thomson Reuters.

Notes: (a) Based on GDP measured in purchasing power parities. (b) Harmonised Index of Consumer Prices for the euro area, Germany, France, Italy, Spain and the United Kingdom. (c) Korea, Hong-Kong, Taiwan and Singapore.

globalisation of the economic and financial crisis on external demand and on consumption and investment decisions of economic agents in the euro area. Private consumption, for the year as a whole, grew by no more than 0.4 per cent (1.6 per cent in the preceding year). Private consumption remained weak in the first three quarters, particularly reflecting the impact on real disposable household income of higher consumer prices, namely energy and food. The large falls in stock markets and substantially higher uncertainty over prospects for economic activity and employment at the end of the year, also had a significant effect in terms of eroding the confidence of consumers and in the contraction of private consumption in the last quarter of 2008 (-0.3 per cent quarter on quarter). The total investment growth rate, in turn, was down to 0.1 per cent in 2008, after having recorded high values in the preceding years (4.4 and 5.9 per cent in 2007 and 2006, respectively). In intra-annual terms, there were significant falls in investment starting from and including the second quarter, with a contraction of 4.0 in the last quarter compared to the preceding quarter. Exports of goods and services were also markedly down in 2008, with an annual growth rate of 1.1 per cent against the preceding year's 5.9 per cent. The last quarter of 2008 witnessed an abrupt contraction of 6.7 per cent in exports compared to the previous quarter. The fall in exports was a factor common to all goods, but was particularly felt in the case of intermediate goods. An analysis by geographic markets shows that exports of goods to the United States, Japan and United Kingdom were markedly down but continued to expand to the new Member States of the European Union (EU) and to Asia excluding Japan, although at much lower rates than in the preceding two years (Chart 1.18). Imports in the euro area were also sharply down in 2008, to 1.2 per cent, against the preceding year's 5.3 per cent, reflecting weakening domestic demand. Goods imports suffered a contraction in 2008, with particular reference to the falls in purchases from the United Kingdom, Japan and, to a lesser extent, countries in Asia excluding Japan. Growth in imports from the United States and the new Member States were positive. Net external demand made a nil contribution to the expansion of economic activity, for the year as a whole, and was negative in the second half of the year. According to IMF most recent projections, economic activity in the euro area should contract 4.2 per cent in 2009 and 0.4 per cent in 2010, which qualifies this as the worst recession since World War II.

Chart 1.18

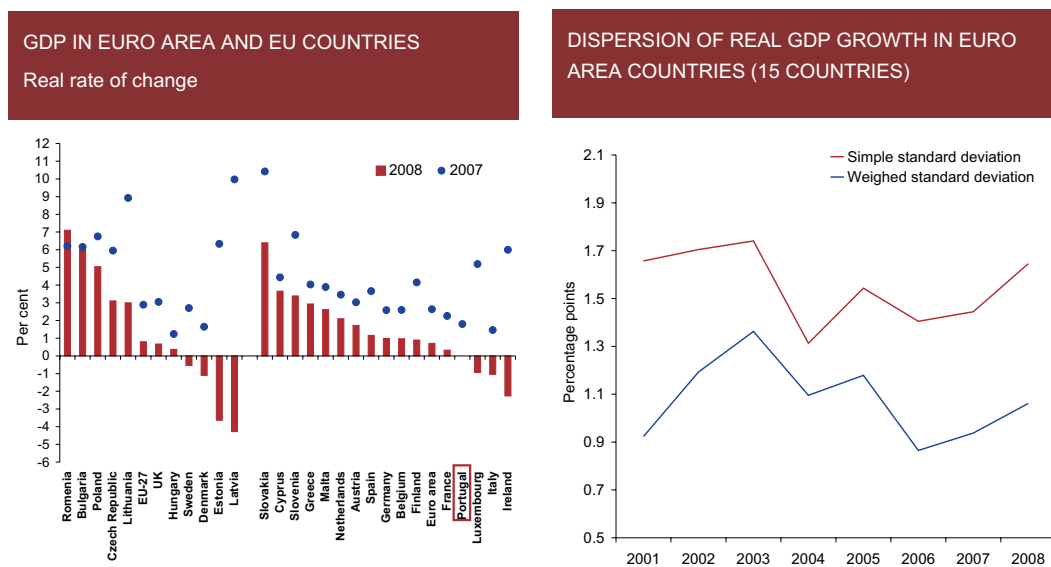


Sources: Eurostat, IMF and Banco de Portugal calculations.

The deceleration of economic activity was common to all economies in the euro area and was particularly pronounced in Ireland and Luxembourg and, to a lesser extent, in Slovenia, Finland, Spain and Italy. There was a contraction of activity in Ireland, Italy and Luxembourg over the year as a whole, of 2.3, 1.0 and 0.9 per cent, respectively. The rate of economic expansion in Germany and France fell to 1.0 and 0.3 per cent, respectively, against 2.6 and 2.3 per cent in 2007. Portugal's performance was one of the weakest among euro area and EU countries, with a stagnation of economic activity in 2008, in comparison to a growth of 1.8 per cent in 2007. In this context, the dispersion of growth among the euro area countries increased slightly when compared to 2007 (Chart 1.19). In terms of composition of GDP growth, in all major countries of the euro area, except Italy, the domestic demand had a positive contribution for GDP growth, even though below the previous year's. In Germany and France, net exports had a negative contribution. Net exports also contributed negatively to economic activity in Portugal (Chart 1.20). There was also a slowdown in economic activity in non-euro EU countries, with the exception of Romania, in 2008. Most of the new Member States, however, continued to record growth rates significantly higher than the EU average. The worsening economic situation in the Baltics (Estonia, Latvia and Lithuania) was particularly significant, with Estonia and Latvia having posted the highest GDP contractions in terms of EU countries in 2008 (-3.6 and -4.3 per cent, respectively). Of the remaining EU economies, reference should be made to the deceleration of GDP in the United Kingdom, from 3.0 to 0.7 per cent.

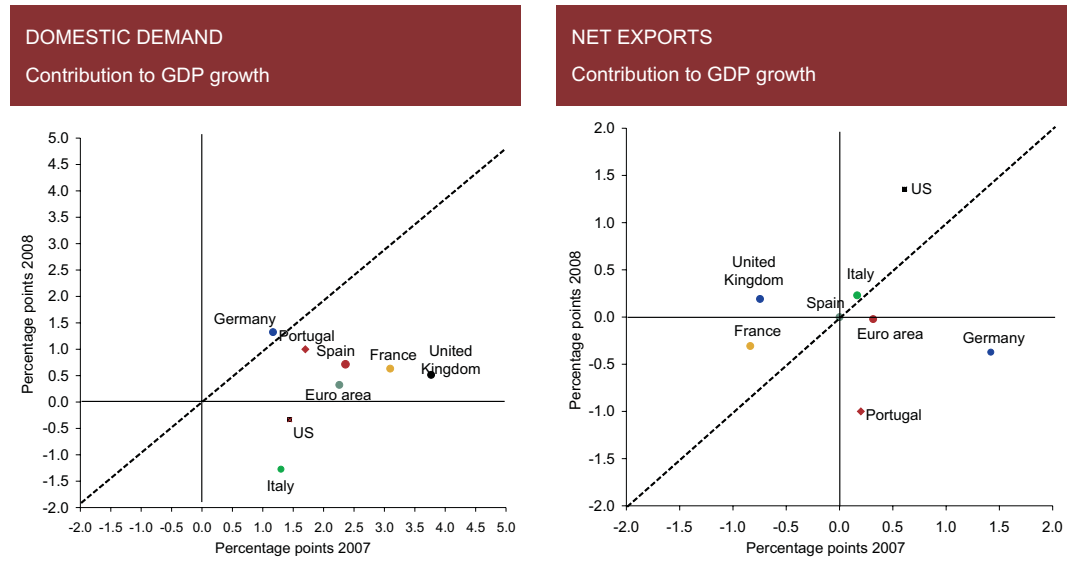
The evolution of the economic situation in the main export markets for Portuguese goods and services was characterised by a significant weakening of their imports of goods and services, which showed a sharp and generalised contraction in the last quarter of 2008. This was particularly marked in the case of the Spanish economy's imports, which is Portugal's major export market, with a year-on-year contraction of 13.2 per cent in the last quarter of 2008 and 2.5 per cent for the year as a whole (against the preceding year's growth of 6.2 per cent) (Table 1.4). Germany's imports were also significantly down in the last quarter of 2008, although growth rates remained positive, expanding by 3.6 per cent over the year as a whole. France, United Kingdom, United States and Italy's imports contracted by 2.4, 7.9, 7.5 and 8.8 per cent, respectively, in the last quarter of 2008 and also in the year as a whole (with the exception of France). In such a context, the indicator of external demand for Portugal's exports of goods and services decelerated significantly in 2008 to 1.5 per cent (in comparison to the preceding year's

Chart 1.19



Sources: AMECO, Eurostat and Banco de Portugal calculations.

Chart 1.20



Sources: Eurostat, Thomson Reuters and Banco de Portugal calculations.

5.6 per cent). The deceleration of Portuguese exports of goods and services was more sharp than the slowdown in external demand, translating into a market share loss of Portuguese exports in the year as a whole (see “Chapter 4. Demand and external accounts” in this Report). The indicator used to measure the evolution of external demand of goods directed to the Portuguese economy suggests an almost nil change in 2008, translating an increase of 0.3 per cent in the demand for goods from the euro area partners and a fall in the demand for goods from economies not belonging to the euro area, namely the USA and the United Kingdom (Table 1.5).

Table 1.4

IMPORTS OF GOODS AND SERVICES BY SOME OF THE MAIN DESTINATION COUNTRIES OF PORTUGUESE EXPORTS								
Rate of change, per cent								
	Weights 2007	2006	2007	2008	2008 ^(a)			
					I	II	III	IV
Spain	28.3	10.3	6.2	-2.5	3.6	1.8	-2.0	-13.2
Germany	13.0	12.2	5.2	3.6	4.5	3.5	4.9	1.5
France	12.6	5.9	5.4	0.6	4.0	1.1	-0.2	-2.4
United Kingdom ^(b)	6.0	6.8	3.7	-0.8	4.1	3.0	-2.2	-7.9
USA	4.8	6.0	2.2	-3.5	-1.0	-1.9	-3.5	-7.5
Italy	4.1	6.2	3.3	-4.5	-2.4	-2.7	-4.1	-8.8

Source: Thomson Reuters.

Notes: (a) Year-on-year rate of change. (b) Excludes the effects of VAT fraud, according to estimates of the UK Office for National Statistics.

Table 1.5

EXTERNAL DEMAND DIRECTED TO THE PORTUGUESE ECONOMY (GOODS)				
Real rate of change, per cent				
	Weights 2007	2006	2007	2008
External demand ^(a)	100.0	9.0	5.0	0.1
Intra-euro area external demand	78.6	9.3	5.0	0.3
of which:				
Spain	33.6	10.3	4.8	-2.7
France	15.0	6.7	5.8	3.3
Germany	15.4	13.5	5.1	4.9
Italy	4.9	5.4	2.4	-5.4
Extra-euro area external demand	21.4	8.2	4.7	-0.7
of which:				
United Kingdom	7.1	7.6	2.6	-2.1
USA	5.6	5.9	1.7	-4.1

Sources: European Commission, INE, UK Office for National Statistics and Banco de Portugal calculations.

Note: (a) Computed as a weighted average of real growth in good imports from 34 of the major trading partners. Each individual country was weighted according to its share in Portuguese exports in the previous year. The 34 selected countries account for about 84 per cent of total good exports in 2007. Due to statistic limitations the external demand indicator does not include imports of some markets, namely Angola.