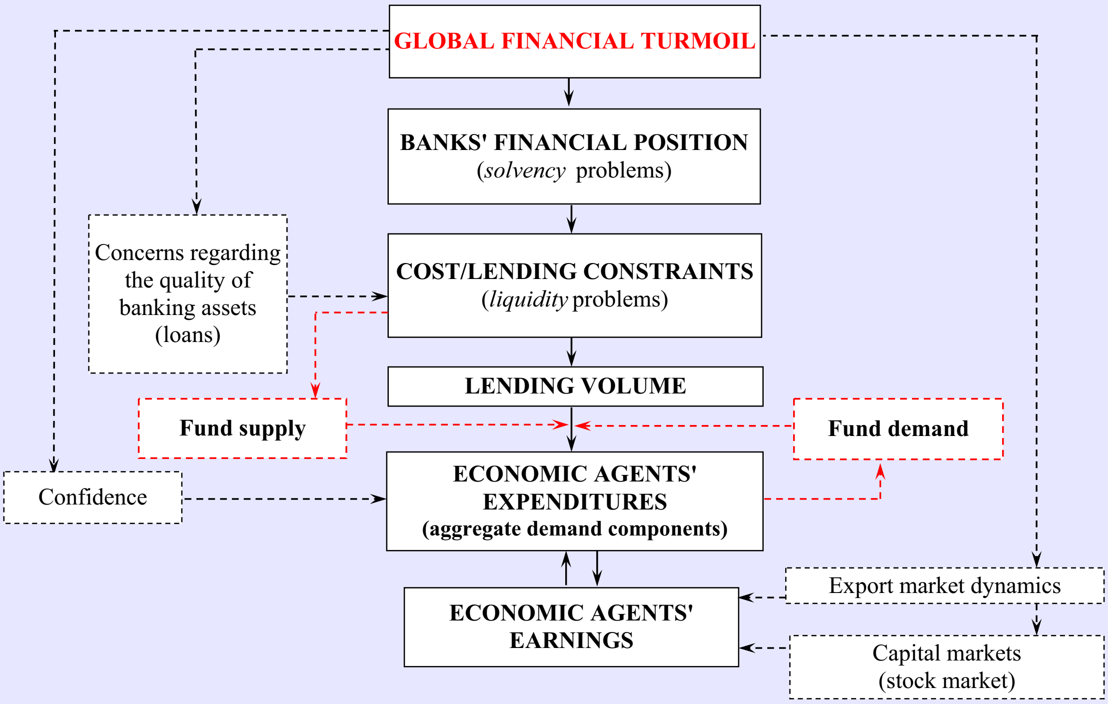
Box 2. The financial crisis and the real economy



The subprime mortgage crisis in the United States, which emerged in the summer of 2007, lies at the root of the financial turbulences that have revived lately. Massive exposures of a large number of banks worldwide to subprime mortgage-backed securities[77] triggered, along with the collapse of the U.S. housing market, huge losses associated with such mortgage loans. The outcome was a *solvency crisis* for the exposed financial institutions.

The increased difficulty – amid highly sophisticated financial products – in identifying the affected classes of assets led to a global diminishing of investors' appetite for risk. Rising concerns regarding the asset quality of banks exposed to such assets entailed a generalized confidence crisis, as a result of which banks were faced with a liquidity crunch. Thus, banks' access to financing sources (for recapitalisation and business continuity purposes) in competitive cost conditions was significantly limited, which forced them to apply restrictions to the loans extended to the real economy (loan supply).

The contraction of the real estate market in a large number of countries and the shrinkage of activity on world stock markets (against the backdrop of investors reassessing the risk associated with such placements) had a direct impact on economic agents' earnings, in the sense of an overall cutback. Associated with the shocks that considerably diminished the real disposable income of economic agents worldwide (on the back of the global rise in commodity and food prices), these developments led to a confidence crunch, apparent in economic agents' increased caution in incurring further expenses. Hence, this has also restrained the resort to bank loans (loan demand).

The economies with low exposures of the banking system to financial instruments that lay at the origin of the crisis, mainly emerging economies, were initially hit via a deceleration in foreign capital inflows on domestic markets and higher exchange rate volatility of their domestic currencies. Given the foreign investors' subsequent repatriation of funds placed on these markets, perceived as inherently exposed to a higher degree of risk, emerging economies were hit as collateral victims.

A reasonably plausible risk scenario across the projection horizon might imply that global risk aversion leave an imprint on the economies perceived as displaying a series of vulnerabilities (excessive budget deficits, wide current account deficits, large volumes of loans extended over short periods and denominated in foreign currency) and thus being likely to witness an even more sizeable contraction of the real economy.

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[77] Subprime mortgage-backed securities are mortgage lending products extended to debtors perceived as having a negative credit history (either as a result of their previous lack of exposure to the banking system or due to violations of previous financial commitments). Under the circumstances, the risk associated with these financial products was perceived as high.