Global issues

**Weak demand in Europe dragging down growth prospects of trading partners**

The recessionary environment in Europe is directly affecting the growth prospects of many developing countries and economies in transition by reducing demand for their exports. According to new figures from the Netherlands Bureau of Economic Policy Analysis (CPB), the euro area’s second quarter import volume was down 4.2 per cent from a year ago. Eurostat data indicate that Asian exports have been hit hardest.

Exports from East and South Asia to the EU fell by 7.2 per cent year on year and from Western Asia (including the Islamic Republic of Iran) by 18 per cent. By contrast, exports of Latin America and North America to the EU have held up so far this year, owing partly to their diversified export profiles. The particularly strong effect on East and South Asia’s exports can be explained by the fact that the EU mostly imports machinery, transport equipment and manufactured goods from this part of the world—product categories in which EU demand has declined rapidly since the third quarter of 2011. The significant drop in Western Asia’s exports to the EU, which consist mainly of mineral fuels, is primarily a result of EU embargoes on oil imports from the Islamic Republic of Iran and the Syrian Arab Republic as well as the resumption of oil production in Libya and a related return to more imports from Northern Africa.

**ECB and Fed announce new bond-buying programmes**

The European Central Bank (ECB) announced the initiation of a programme of “outright monetary transactions”, (OMT) through which it would buy sovereign debt of eurozone countries with maturities of one to three years. This move is designed to deal with what the ECB calls “short-term distortions in financial markets”, referring to the sharply diverging borrowing costs among eurozone countries. Potentially, the ECB could buy up unlimited amounts of bonds, but only from countries that have signed on with a European Financial Stability Facility (EFSF) or European Stability Mechanism (ESM) programme, or have already received an EU-IMF bailout. The ECB did not set a ceiling on bond yields that it deemed excessive, which adds further concerns as to the length and breadth of the potential bond buying. Germany was the lone dissenter on the ECB governing council voicing opposition to the programme. Following the announcement, Italian and Spanish 10-year bond yields fell to the lowest levels in recent months.

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**Figure 1: Exports volume index of selected regions of the European Union (January 2011=100)**

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*Source: Eurostat*
The United States Federal Reserve Bank (Fed) announced that it would initiate a new programme to purchase $40 billion worth of agency mortgage-backed securities per month, as well as continuing its program to extend the average maturity of its holdings (previously referred to as “Operation Twist”). The Fed said that it would monitor economic and financial conditions and continue the programme until there was significant improvement in the employment situation. It also extended its forecast for interest rates to remain at “exceptionally low levels” from the end of 2014 to middle of 2015.

These two programmes are expected to help calm financial markets for the time being. By themselves, however, they should not be expected to provide much impetus to output and employment growth as they address only one element of the larger underlying problems.

**Developed economies**

**United States: no visible signs of economic rebound**

Economic growth in the United States decelerated in the second quarter of 2012. Economic data released since July do not signal any rebound. Consumer confidence declined in August and real consumer spending remained lacklustre. Automobile sales dropped to the lowest level in a year. Various business surveys also indicate weak growth in manufacturing output. Job growth in August was also disappointing and the unemployment rate remained up at 8.3 per cent. Higher gasoline prices and the anticipated increases in food prices related to drought in the Midwest are expected to curb real household incomes and limit consumer spending growth.

More positive news can be reported about the continued recovery in the housing market. Sales of both new and existing homes showed a solid increase in July, and new construction is on an upward trend, although from extremely low levels. House prices remain well below pre-crisis peak levels, however. Residential construction is also not expected to become a growth driver any time soon.

**Developed Asia and the Pacific: Japan addressing fiscal sustainability**

On 10 August, the Japanese Parliament finalized the ratification of a bill for the comprehensive reform of the social security and taxation systems. Targeted towards improving medium- and long-term fiscal sustainability, one key policy action of this reform will be raising the consumption tax rate from the current level of 5 per cent to 8 per cent in April 2014 and further up to 10 per cent in October 2015, barring a significant deterioration of the economy ahead of the hike. A study by one financial institution suggests that the increase in the consumption tax could lower GDP growth by 1 per cent and push up the rate of inflation to above 2 per cent; inflation would decline again once the tax increase has settled in.

Data released in August also show that Japan’s GDP expanded at an annualized rate of 0.7 per cent quarter over quarter during the second quarter of 2012, much weaker than the revised figure of 5.3 per cent for the first quarter. Private consumption demand grew by only 0.6 per cent (down from 5.0 per cent in the first quarter), explaining most of the overall economic slowdown. Use of inventories and slower export growth further contributed to the slowdown.

**Western Europe: activity likely to deteriorate significantly in the coming months**

Short-term indicators for industrial production and construction deteriorated in June after improving in May. Retail sales, however, improved for a second month in a row. Each of the three indices is very close to their respective levels registered at the beginning of the year but well below those of a year ago.

Indicators of confidence paint a gloomy picture for the rest of the year. The European Commission’s Economic Sentiment Indicator has now fallen for five consecutive months and is well below the level observed during the fourth quarter of 2011. Unlike earlier in the year, all economies in the region are now seeing dramatic drops in confidence.

A flash estimate for euro area inflation for August came in at 2.6 per cent, which is higher than expected. As this is also higher than the ECB’s target range, it was unsurprising that the ECB decided to maintain current interest rates at its most recent meeting.

**New EU members: still muddling through**

Growth of the Polish economy slowed in the second quarter to 2.4 per cent year on year (from 3.5 per cent in the first quarter), as domestic demand weakened amid depletion of inventories. Following the completion of the Euro-2012 Football Championship, investment spending is set to soften for the rest of the year, dragging GDP growth. The PMI for August reflects declining business confidence. Although Poland has some fiscal space to stimulate the economy, the Government is constrained by a constitutional limit on public debt.

Elsewhere, economic trends in the second quarter diverged. Growth remained resilient in Latvia at 5.1 per cent year on year, while slowing in Estonia and Lithuania. The Czech Republic remained in recession, its GDP contracting by 1.2 per cent year on year. The country’s borrowing costs, however, continued to fall in August. GDP also declined year on year in Slovenia and in Hungary, which
slipped into technical recession. By contrast, Slovakia’s economy expanded by 2.9 per cent thanks to more successful diversification of automobile exports, towards the Russian market, in particular. Inflation also showed divergent trends, accelerating in July to 5.8 per cent in Hungary on the back of external factors and additional taxes, while slowing to 1.7 per cent in Latvia. Notwithstanding inflationary pressures, Hungary’s central bank cut its policy rate by 25 basis points in August unexpectedly. Severe drought in Bulgaria and Romania is threatening agricultural output.

**Economies in Transition**

**CIS and Georgia: Russian Federation joins the WTO**

As anticipated, growth of the economy of the Russian Federation slowed to 4 per cent year on year in the second quarter, down from 4.9 per cent in the first quarter. Nevertheless, domestic demand remains strong, and business and consumer sentiment is positive, mostly because of the fiscal stimulus enacted at the start of the year. Industrial output recovered in July, increasing by 3.4 percent year on year, up from 1.9 percent in June. The increase in the prices of utilities spurred inflation to 5.6 per cent in July, and in August inflation accelerated to 5.9 per cent after three months of drought. Monetary tightening, however, looks unlikely. In August, the country became the 156th member of the WTO, following 19 years of negotiations. In the short term, the impact of their new membership will be limited as transition periods for introducing tariff changes, for instance, are still to be agreed upon.

In Ukraine, GDP increased by 3 per cent year on year in the second quarter, thanks to an early harvest. In Central Asia, the economy of Turkmenistan is reported to have expanded by 11 per cent year on year in the first half of 2012, bolstered by rising gas exports to China. Tajikistan also recorded strong GDP growth of 7.7 per cent.

**South-Eastern Europe: drought threatens food security**

In the second quarter, GDP declined by 2.1 per cent in Croatia and 0.6 per cent in Serbia year on year. The economy of Bosnia and Herzegovina also appears to have shrunk. Severe drought in the region has damaged agricultural output, especially in Bosnia and Herzegovina, Croatia, Montenegro and Serbia, as irrigation systems remain outdated and dysfunctional. In some areas, production of potatoes and maize may decline by 50 to 80 per cent year on year, which will necessitate increasing food imports.

The new legislation adopted by the central bank in Serbia prompted the resignation of its governor in August. Investor uncertainty around the direction of monetary policy contributed to further depreciation of the currency. Since inflation in Serbia reached 6 per cent in July and the weaker currency would imply higher import costs for the second half of the year, the National Bank of Serbia increased its policy rate in August.

**Developing economies**

**Africa: growth still moving slowly in parts of Africa**

In Morocco, GDP growth was down from 2.8 per cent in the first quarter to 2.6 per cent in the second quarter on a year-on-year basis. Agricultural output was estimated to be down 9.8 per cent year on year and industrial and construction activity have both slowed. Imports of industrial equipment and cement are both down sharply from the first quarter.

GDP growth was up in South Africa in the second quarter to 3 per cent year on year, from 2.1 per cent in the first quarter. A significant portion of that growth came from a rebound in the mining sector, which grew 31.2 per cent after contracting 16.8 per cent in the first quarter. The mining sector has faced significant labour unrest this year and the issues have continued into the third quarter, so it is uncertain whether this growth can be maintained. Manufacturing contracted by 1 per cent in the second quarter and the overall outlook for growth going forward is relatively weak.

Inflation has fallen dramatically in both Kenya and Uganda. In Kenya, it was down for the ninth straight month to 6.09 per cent year on year from 18.30 per cent at the beginning of the year. In Uganda, inflation fell from 14.3 per cent year on year in July to 11.9 per cent in August.

**East Asia: growth trends diverge**

The economies of Indonesia, Malaysia, the Philippines and Thailand remained resilient during the global slowdown in the second quarter of 2012, as buoyant domestic demand offset markedly lower net exports. Year-on-year GDP growth picked up to 4.2 per cent in Thailand, 5.4 per cent in Malaysia and 6.4 per cent in Indonesia. In all three economies, gross fixed capital formation registered double-digit growth, spurred by low interest rates and increased public investment. In the Philippines, economic activity expanded by 5.9 per cent in the second quarter, after increasing by 6.4 per cent in the previous three months. Growth in the Philippines was mainly
driven by a significant rise in public infrastructure spending and strong private consumption, which was supported by increased conditional cash transfers to low-income households. The robust economic performance of these four economies is also reflected in positive employment trends. In Malaysia, the seasonally adjusted unemployment rate fell slightly to 2.8 per cent in June 2012.

The solid growth momentum in some East Asian countries contrasts with the weakness in the region's heavily export-dependent economies. Hong Kong Special Administrative Region of China, the Republic of Korea, Singapore and Taiwan Province of China have experienced a sharp economic downturn in recent quarters as a result of the double impact of recession in the euro area and a significant weakening of growth in China. Exports of China weakened markedly in July, growing at a pace of only 1 per cent year on year, compared with trend growth of 7 per cent in the first seven months of 2012. The value of China’s exports to various trading partners registered sharp declines: 20 per cent to India, 18 per cent to Germany, and 15 per cent to the Netherlands. Exports from China to both the United States and Japan registered almost no growth in the month. In comparison, China’s total imports grew by 4.7 per cent in July, but China’s imports from Australia and Malaysia registered large declines, by 10 and 5 per cent, respectively.

**South Asia: slowing consumption and investment impedes growth in India**

India’s economy continued to expand at a relatively sluggish pace in the second quarter of 2012. Year-on-year growth reached 5.5 per cent, slightly up from 5.3 per cent in the previous three months, mainly driven by a significant rise in government consumption. Growth in investment and household consumption, however, slowed further as persistent high inflation, high interest rates and a policy standstill negatively impacted private sector activity. In July, year-on-year consumer price inflation remained unchanged at 9.9 per cent. The Reserve Bank of India (RBI) reiterated its reluctance to ease monetary conditions until inflationary pressures have declined markedly.

The State Bank of Pakistan, by contrast, surprised observers by cutting its benchmark rate by 150 basis points to 10.5 per cent in August. The measure was taken in an effort to shore up investment demand, which fell by 13 per cent during fiscal year 2011/12. Total investment has declined for four consecutive fiscal years and now accounts for only 12.5 per cent of GDP. The collapse in investment is severely constraining Pakistan’s productive capacity.

**Western Asia: popular discontent resurfacing**

In the Syrian Arab Republic, year-on-year inflation reached 36.1 per cent in June following a 2.9 per cent rise in the month-on-month consumer price index. After its drop in value in January, the black market exchange rate has remained stable at about 70 Syrian pounds per United States dollar.

Facing popular discontent, the King of Jordan reversed a decision to raise fuel prices. A 10 per cent hike was expected to meet fiscal targets set by the $2 billion Stand-By Arrangement with the IMF. As a result, high oil prices will continue bloating subsidy payments and, together with the drop in foreign grants to one tenth of previous year’s level, the budget deficit is likely to exceed the projected level of 6 per cent of GDP.

Public discontent has also resurfaced in several Gulf countries, especially in Oman. Not unlike in the wake of the Arab Spring, the Sultan responded by announcing a series of directives including the creation of 56,000 jobs for nationals, 36,000 of them in the public sector.

**Latin America and the Caribbean: stagnation in developed economies weighs heavy**

The stagnation of developed economies keeps weighing on the region’s growth. In the second quarter of 2012, Brazil’s GDP grew by a mere 0.4 per cent from the previous quarter. Export earnings tapered off in the light of slowing world demand and the fading commodity price boom. Net exports decreased almost 6 per cent over the previous quarter. Private investment demand decreased by 0.7 per cent. Household and government spending slowed to 0.6 per cent and 1 per cent, respectively. The Government has responded with several measures aimed at sustaining long-term growth, including a $66 billion infrastructure investment plan, slashing the cost of electricity by as much as 28 per cent, and increasing import duties on about one hundred consumption and industrial goods. The Central Bank cut the SELIC rate for the ninth time in twelve months, to 7.5 per cent. Measures were also taken to force banks to lower retail interest rates. Annual rates on consumer loans, for instance, currently stand as high as 40 per cent.

Economic uncertainty, particularly in the United States and in the United Kingdom, has hit tourist flows to Caribbean countries that struggle with high debts, such as Barbados, Belize, Granada, Jamaica, Saint Kitts and Nevis and Santa Lucia.

In Haiti, a tropical storm caused massive flooding and further jeopardized the food security situation, which was already seriously compromised after poor cereal harvests resulting from the drought of June and July.