Global issues: global growth is shifting into a low gear

The world economy has been in recovery for about a year. World trade is now almost back to its 2008 pre-crisis level. But it has been the emerging market economies and other developing economies that have set the pace of the recovery. Trade flows to and from these countries already surpassed 2008 pre-crisis levels in February and have increased further since, albeit at a slowing pace. Trade by developed economies, in contrast, was still 8 per cent below the pre-crisis peak level in May 2010 (see figure 1).

Growth of global output is decelerating, however. The key impetuses to the initial recovery are waning: Governments in many countries are unwinding the fiscal stimuli and the inventory restocking is petering out. Meanwhile, recovery in business investment and household consumption is not on a solid footing. Consumers in major developed countries, accounting for more than 50 per cent of global consumption spending, are still grappling with heavy debt burdens, wealth losses and high unemployment (see figure 2). Business investment, which sharply declined in 2009, remains anaemic in most developed countries. A growing number of developed country Governments have announced public spending cuts for the coming years, which in the present context of weak private sector growth is further dampening global growth prospects. This will likely also affect growth in developing countries during the second half of 2010.

As global growth is slowing, an attendant problem is the increased risk of deflation, at least among a number of developed economies. While Japan has long been trapped in deflation, inflation rates in the United States and several European economies are now also hovering around zero. As overcapacities remain large and bank lending continues to be depressed despite very low interest rates, deflation seems just around the corner in those countries.

Developed economies

United States and Canada: financial regulation overhaul is approved

In July 2010, the Congress of the United States of America approved the Dodd-Frank Wall Street Reform and Consumer Protection Act, which is the most significant financial regulatory reform since the 1930s. This Act creates several new regulatory agencies: the Financial Stability Oversight Council, the Office of Financial Research (both attached to the Treasury Department), the Federal Insurance Office (within the Treasury Department), the Bureau of Consumer Financial Protection (attached to the...
Federal Reserve) and the Office of Investor Advocate (within SEC). The Act imposes significant restrictions on the investment activities of banks in hedge and private equity funds and requires most over-the-counter derivatives to be handled through a clearinghouse. It also introduces a new minimum standard for mortgages and a set of new rules on mortgage origination. For asset-backed securitization, the ‘securitizer’ will be required to retain an economic interest in a portion of the credit risk. While the Act has introduced significant regulatory changes, many details are yet to be worked out by various regulators in the coming years. The Act also does not take care of regulatory weaknesses which were among the causes of the problems now faced by Fannie Mae and Freddie Mac, the two large government-sponsored enterprises for residential mortgage loans.

The revised statistics for the United States economy revealed that the economic downturn had been even deeper than by the previous measure. Cumulative GDP growth during 2007-2009 is now estimated at -0.7 per cent, which is 0.8 percentage points lower than the previous estimate. In the second quarter of 2010, GDP expanded at an annualized rate of 2.4 per cent; a visible slowdown from the 3.7 per cent rate of growth reported for the first quarter. The recent slowdown was caused mainly by the increase in imports and a weaker contribution from inventory restocking. In July, another 131,000 workers lost their jobs in the United States, mainly owing to job losses in the public sector.

**Western Europe: sovereign debt crisis eased somewhat but growth remains sluggish**

Stress tests were conducted for 91 EU banks, representing two-thirds of the banking sector in the region. According to the Committee of European Bank Supervisors, only seven banks were considered to be highly vulnerable to potential credit and market risks. While the tests may not be conclusive, global financial markets responded positively to the release of the test results, along with a reconfirmation that the European Financial Stabilization Mechanism launched earlier would be available to any sovereign State that faces difficulties capitalizing its own banking system.

The growth prospects for the region remain, however, worrisome. After a minuscule expansion of 0.2 per cent in the first quarter of 2010 for the euro area, growth has picked up in the second quarter, but the pace of recovery will likely be sluggish in the years to come. Most EU governments have enacted fiscal austerity measures, including those countries that are not under market pressures. This will curb the growth of the region over the next few years. Meanwhile, exports are expected to slow down in the coming quarters, limiting the growth driven from the rest of the world. Spain’s victory in the FIFA world cup is expected to boost consumer confidence and this could provide a modest economic growth gain though it may be short lived. Although the country’s economic conditions showed some improvement in the first half of the year, the heavy fiscal austerity measures that were introduced recently most likely will be the cause of rather anaemic growth in the quarters ahead.

**The new EU member States: recovery continues, driven by industrial production**

The recovery continues in the new EU member States, although output and industrial production still exhibit some volatility. Lithuania’s economy emerged from its recession showing positive growth for the first time after six consecutive quarters of decline. In the second quarter of 2010, the country’s GDP expanded by 1.1 per cent. Industrial production in Poland increased by 14.5 per cent in June, especially owing to higher output of computers, electronics and transport equipment. Across the region, industrial sector growth compensated for the stagnation in construction activity.

In mid-July the IMF and the EU suspended their review of Hungary’s funding program amid disagreements on the country’s strategy for fiscal consolidation. While the IMF insists on further austerity measures, it objects to the tax on banking activity introduced by the Government on grounds the tax would affect lending. Hungary is now not able to draw the remaining part of its IMF loan. There are, however, reserve funds, as the Government did not make use of the fourth and fifth tranches of the IMF loan, worth $6.5 billion, and in the near term will be able to borrow in the domestic currency market. Nonetheless, failure to reach an agreement with the IMF could put pressure on the currency, especially if the current account moves back to deficit. Further, since most of the private sector’s debt is denominated in foreign currency, the Central Bank could feel pressed to raise interest rates in order to defend the national currency. In 2011, the country has to repay $2 billion of its IMF loan. A possible downgrading of the country’s rating for sovereign bond emissions would raise the cost of and restrict access to additional external borrowing.

On July 13, the finance ministers of the eurozone gave their final approval for Estonia to adopt the euro in January 2011.

**Developed Asia and Pacific: bank lending continues to fall in Japan**

Bank loans continued to decline in Japan in 2010. While appetite of banks to lend has modestly improved in recent months, demand for loans from large and small firms as well as from households continues to be weak. One factor is the depressed business investment: corporate capital spending remains even far below the pace of depreciation despite some improvement in cash flows and profits of firms.
In contrast, bank loans in Australia have been on the rise, led by growth in business and housing credit, reflecting stronger investment demand. Demand for personal credit has been subdued, however, as a result of weakening consumer confidence and, more recently, rising interest rates.

**Economies in transition**

**CIS: continued economic strengthening in the first half of 2010**

The economic recovery strengthened in the first half of 2010 as industrial output increased and exports expanded. Although weak construction activity dragged growth in Kazakhstan and Ukraine, double-digit increases were registered in industrial production, fuelled by iron ore, mining and manufacturing sectors. Greater export demand contributed to a slight decline in Ukraine's trade deficit in the first five months of 2010. In the Russian Federation, the surplus of the current account more than doubled in the first half of 2010, largely on account of higher oil prices. Stronger economic activity contributed to the continued decline in unemployment rates and an increase in real incomes. Continued weak consumer demand dampened inflationary pressures in the first half of 2010 in Georgia and Ukraine. In contrast, retail trade increased by 13 per cent in Kazakhstan, signalling a recovery of domestic demand.

Large parts of the Russian Federation are currently experiencing drought and the highest temperatures measured in 130 years. This is hurting the agricultural sector in particular and the 2010 wheat harvest is expected to contract by a fifth compared to the previous year. Grain prices have already increased significantly, contributing to renewed inflationary pressures.

**South-Eastern Europe: weak first quarter performance in the former Yugoslav Republic of Macedonia**

The first quarter GDP of the former Yugoslav Republic of Macedonia declined by 0.9 per cent, following positive growth in the fourth quarter of 2009. The sharpest decline, at 46.6 per cent year-on-year, was registered in gross capital formation. Following weaker than expected first-quarter revenues, the Government proposed a revised budget for 2010, cutting both projected revenues and expenditures by 3.2 per cent, with less spending allocated for public investment.

Some areas of Bosnia and Herzegovina are recovering more quickly than others. The IMF has delayed the fourth tranche of its stand-by loan extended to the country citing insufficient progress in fiscal consolidation and in better coordinating state and entity level budgets.

**Developing economies**

**Africa: several large African economies near full recovery**

Economic development gained further strength in several African countries during the second quarter. Preliminary estimates suggest that Egypt's economic growth accelerated to an annualized rate of 5.9 per cent, partly owing to double-digit growth in the construction and IT sectors. Meanwhile, growth in Nigeria accelerated to 7.7 per cent as a result of increased activity in the non-oil sectors, particularly agriculture, retail trade, services and construction. This suggests a near-complete recovery from the global crisis for these two major African economies.

The FIFA world cup tournament in South Africa has catalyzed economic growth in the largest economy of the continent. According to the Government, it will contribute to an additional percentage point of GDP growth in 2010, taking into account the increase in spending and the improvement in infrastructure.

In June, Ghana also made a major step forward as annualised inflation returned to single digits for the first time since April 2006. The Bank of Ghana responded by cutting its policy rate by 150 basis points to 13.5 per cent in July. The Central Bank of Kenya also slashed its benchmark lending rate from 6.75 to 6.0 per cent to boost commercial bank lending.

**East Asia: more central banks start to hike policy rates as economic growth remains strong**

The East Asian economies continued to expand at a rapid pace in the second quarter of 2010 mainly driven by strong growth in the manufacturing sector. While in most countries the rate of expansion is likely to slow in the second half of the year, the short- to medium-run outlook remains favourable. In China, GDP growth decelerated moderately from 11.9 per cent in the first quarter to 10.3 per cent in the second quarter, following government measures to slow credit expansion, investment spending and property speculation. Manufacturing data for July showed the weakest expansion since February 2009. Singapore's economy grew by a stronger-than-expected 19.3 per cent in the second quarter of 2010, with manufacturing activity surging by 45.5 per cent. The Republic of Korea and Viet Nam also posted strong quarterly growth of 7.2 per cent and 6.4 per cent, respectively. On
a quarter-on-quarter basis, growth in the Republic of Korea decelerated from 2.1 per cent to 1.5 per cent as an increase in exports and facilities investment only partially offset the slowdown in construction investment and government consumption spending. In response to strong domestic economic activity and to expectations of increased inflationary pressures, the Bank of Korea and the Bank of Thailand both raised their main policy rates by a quarter of a percentage point.

**South Asia: trade activity increases rapidly, but growth of remittance flows slows**

The economic recovery in South Asia has been accompanied by a rapid increase in trade activity in recent months. Import spending has generally grown faster than export revenues, giving rise to a worsening of trade balances. In India, total exports were 35.7 per cent higher in April and May 2010 than a year ago, while total imports increased by 40.9 per cent, primarily due to a surge in oil imports. As a result, the trade deficit rose by almost 50 per cent. In Bangladesh, the improved performance of the garment sector, which has benefited from the relocation of firms from China, supported the recovery in exports. Export earnings increased by 19 per cent year-on-year during the period March to June 2010, after declining by 3 per cent in the previous six months. In several South Asian economies, the growth of remittance inflows has slowed considerably in the first half of 2010. Bangladesh and Pakistan saw remittances increase by only 5 per cent during this period, following double-digit growth in recent years. Sri Lanka, by contrast, continued to register robust increases in remittances; during the first four months of 2010, total inflows were 14.5 per cent higher than a year ago.

**Western Asia: economic recovery remains intact**

Like the rest of the region, Turkey’s economy has shown a strong recovery. First-quarter GDP increased by 11.7 per cent, in large part due to a weak base of comparison. In terms of individual growth components, private consumption and investment both showed a strong expansion, with lagging contributions from government spending and exports. At the same time, industrial production expanded by 15.1 per cent in May on a calendar-adjusted year-on-year basis, with equally strong contributions from the mining, manufacturing as well as energy and utilities sectors. Likewise, both exports and imports increased by more than 30 per cent in May, again primarily owing to base effects. Meanwhile, in Israel, inflation fell to 2.4 per cent in June from 3.0 per cent in the previous two months. Core inflation excluding energy prices reached 2.6 per cent, slightly lower than in May.

**Latin America: positive economic signs in the smaller and medium-sized economies**

The strong economic rebound in the first quarter of 2010 registered in the larger economies such as Argentina, Brazil and Mexico (see Monthly Briefing No. 21, July 2010), has now also become noticeable in the smaller economies of the region. Colombia, Peru, Costa Rica and the Dominican Republic registered GDP growth of 4.4 per cent, 6.0 per cent, 6.1 per cent and 7.5 per cent, respectively in the first quarter of 2010. While the Chilean economy experienced only 1 per cent growth in the first quarter owing to the negative impact of the earthquake, it grew by more than 6 per cent in May, on the back of strong domestic demand. Concerns about an overheating of the economy have pushed the Central Bank of Chile to increase the policy interest rate twice by 0.5 percentage points in June and July to a level of 1.5 per cent. In Peru, reserve requirements for banks were increased in order to stem excessive lending. Paraguay and Bolivia have benefited from booms in key exports (soy and gas, respectively).

Some economies are not faring as well, however. Ecuador, for instance, registered only modest 0.6 per cent growth in the first quarter of 2010, in part owing to lower public investment and oil production, as well as shortages in electricity supply. The situation also continues to be particularly challenging for several Caribbean economies, such as Jamaica whose GDP contracted by 1.4 per cent in the first quarter.

**Least developed countries: donors have yet to deliver on their promises to Haiti**

The IMF cancelled $268 million of Haiti’s debt and will lend the earthquake-devastated country another $60 million for reconstruction plans. However, more than six months after the catastrophe, the situation remains extremely alarming. The number of homeless or people living in camps has increased to about 1.5 million, while rubble and collapsed buildings still dominate the landscape. In addition, only a small fraction of the promised $5.3 billion in foreign aid to be disbursed over the next year has been delivered.

The two Bretton Woods institutions announced another long-awaited debt relief of $12.3 billion for the Democratic Republic of the Congo.

The Sahel food crisis continues to worsen, particularly in Chad and Niger. In the latter country, nearly half of the population is now affected by acute food shortages. Humanitarian agencies have so far received about 46 per cent of the $190 million they requested in April to respond to the crisis in Niger.