Global issues

Sovereign debt problems and further fiscal austerity could hamper global recovery

The prospects for continued global economic recovery are at risk. Concerns have increased that efforts to deal with sovereign debt problems in the United States and peripheral countries of Europe may falter. Possible defaults could inflict on global demand and financial stability.

The amount of outstanding federal Government debt of the United States will reach the legal boundary of $14.3 trillion in early August, according to official estimates. Even if the debt burden against private and foreign holders (after netting out transactions with the Federal Reserve) would seem manageable (figure 1), congressional agreement is required to raise the ceiling on the total debt. Without an accord, the Government would enter into a serious impasse. Given the present political gridlock, a likely way out would be an agreement on significant spending cuts that would become effective soon. A rapid switch to fiscal austerity would likely slow the pace of recovery of the United States economy which has already lost momentum and has been too weak to push back unemployment. Further weakening of the world’s largest economy would have global repercussions.

Continued debt distress in parts of the euro area is adding to uncertainty regarding world economic prospects. The cost of borrowing for Greece, Ireland and Portugal hit new highs, with that of Spain on the rise since April (figure 2). In July, the credit rating for both Ireland and Portugal was downgraded to junk status. Much of the sovereign debt of these countries is held by European banks. Results of stress tests, expected to be made public in mid-July, could reveal the degree of fragility and exposure of Europe’s banking sector. Thus far, policymakers and the IMF have been able to avoid a full-blown sovereign and bank debt crises in Europe, as well as a possible crisis of the euro. Progress towards creditors’ voluntarily rolling-over maturing sovereign debt was halted after Standard & Poor’s declared this...
measure to be a selective default. Therefore, EU institutions and the IMF continued to work on a second bailout package for Greece, contingent on fiscal austerity efforts. Such a move could increase expectations of further bailouts for other countries in debt distress.

**Gyrating oil prices**

The surge in global oil prices hampered the global recovery over the past few months. Oil prices dropped by 6 per cent, however, after the International Energy Agency (IEA) announced on 23 June 2011 that its members would increase supply in response to the disruption of oil supplies in the Libyan Arab Jamahiriya and elsewhere. The decline was short-lived and oil prices returned to pre-announcement levels in subsequent weeks.

**Developed economies**

**United States: sub-par growth**

The final estimate for growth in the United States during the first quarter of 2011 (seasonally adjusted, annualized quarter-over-quarter) was 1.9 per cent, down from 3.1 per cent in the previous quarter. Main factors in the slowdown were a sharp deceleration in private consumption, from 4 per cent to 2 per cent growth, a decline in military spending (12 per cent) as well as state and local government spending (4 per cent) and a rebound in merchandise imports. These reductions were offset by an increase in inventories, which contributed 1.3 per cent to the GDP growth rate of 1.9 per cent.

Recent monthly indicators suggest that economic growth remained sub-par during the second quarter. In both April and May, real personal consumption expenditures contracted slightly, as the growth of household disposable income halted and energy prices increased. On the production side, the consequences of the earthquake in Japan continued to weigh on producers of motor vehicles and parts, with output declining by 6.5 and 1.5 per cent in April and May, respectively. Meanwhile, the declining trend of house prices which had so far held back the recovery of credit demand and domestic spending may have stabilized in April, but it is too early to tell if this was due simply to the Spring buying season.

**Developed Asia and Pacific: post-quake recovery in Japan is on the way**

Industrial production in Japan increased by 5.7 per cent in May (seasonally adjusted, month-over-month). So far, 40 per cent of the loss due to the March earthquake has been recovered. Total shipments of capital goods also increased by 15.5 per cent in May suggesting that firms are strongly investing in equipment again. Meanwhile, the business conditions index for June posted the largest rise since March 2009 and the forward looking index for July indicates a further increase. Consumption is also picking up, as retail sales rose 2.4 per cent in May on top of a gain of 4.1 per cent in April. Sales of motor vehicles, machinery and equipment are particularly strong. Real household spending rose 1.0 per cent in May after consecutive declines in March and April.

In the near future, however, further growth of industrial production could be constrained by energy shortages. Expected seasonable increases in electricity demand during July through early September, could exceed supply capacity in Tokyo and the Tohoku region, where a 15 per cent shortage is anticipated.

**Western Europe: activity is moderating while confidence indicators decline**

Activity continues at a moderate pace in Western Europe but with evidence of deceleration and continued vast differences in performance across countries. Industrial production expanded marginally in April driven by capital goods and durable consumption goods sectors after being flat in March. Orders rose and construction also increased, but signs of deceleration are clear. The European Commission’s Economic Sentiment Indicator declined in June as part of a downward trend since its February peak. However, the indicator is still well above its long-term average, consistent with continued moderate growth.

In May, the unemployment rate still stood at 9.9 per cent for the euro area as a whole, but it declined to 6.0 per cent in Germany and 9.5 per cent in France. In Italy, the rate increased slightly to 8.1 per cent. Also Spain saw its jobless rate increasing further, reaching 20.9 per cent. Headline inflation in the euro area ticked down from 2.8 per cent to 2.7 per cent. Similarly core inflation dipped from 1.6 to 1.5 per cent.

**The new EU members: slowdown in the second quarter, with variations**

In the Baltic States, Estonia became the EU growth champion in the first quarter, with its gross domestic product (GDP) growing by 8.5 per cent, as export-oriented industries continued to rebound and industrial output jumped by 30 per cent. Poland in the first quarter registered a strong growth at 4.4 per cent and a 6 per cent increase in investment, and has maintained this momentum in the second quarter. In Romania, first quarter GDP increased by 1.7 per cent, after several quarters of contraction. For most countries, available indicators of industrial production and new industrial orders suggest slower growth in the second quarter, in line with the cooling of the euro area economies.
Labour markets in the region improved somewhat, especially in the Baltic States. The unemployment rate in Estonia declined to 14.4 per cent in the first quarter, down from 19.8 per cent a year ago, the largest drop in the EU.

Inflation in some of the new EU members remains a concern. It reached 5 per cent year on year in Poland in May. The National Bank of Poland increased interest rates in June for the fourth time in a row.

**Economies in transition**

**CIS: slowing growth**

Tighter monetary policy is having a dampening effect on economic growth in the CIS. In the Russian Federation and Kazakhstan, growth of industrial output (year on year) weakened in May: 4.1 per cent and 4.7 per cent, respectively. In Ukraine, which has not yet raised interest rates, growth in industrial production remained steady at 8.5 per cent.

Inflation in the CIS continues to remain high, reaching 9.4 per cent in the Russian Federation and 8.4 per cent in Kazakhstan in June. Food price increases exceeded 12 per cent in both countries. In Ukraine, inflation accelerated to 11 per cent in May.

Investment agreements totalling $3.5 billion were signed between China and Ukraine in June.

In Belarus, massive state spending and strong growth in wages and credit supplies have pushed up domestic demand, triggering a large current-account deficit. The subsequent drain of foreign-exchange reserves prompted authorities to devalue the Belarusian rouble from 3,155 to 4,930 roubles per dollar at the end of May. Belarus has since approached the IMF for $8 billion loan and secured a three-year, $3 billion loan from the Russian-led Eurasian Economic Community’s anti-crisis fund.

**South-Eastern Europe: inflation apparently peaked in Serbia**

The Croatian economy remained in recession in the first quarter, with its GDP contracting by 0.9 per cent, despite the increase in exports. The weak labour market undermines the recovery. In the former Yugoslav Republic of Macedonia, first quarter GDP increased by 5.1 per cent. Investment demand increased by 60 per cent, though from a very low base.

The Serbian economy expanded by 3.4 per cent in the first quarter. Recent indicators suggest, however, that the economic recovery slowed in the second quarter. Industrial production growth sharply decelerated in April in most key sectors. As inflationary pressures in Serbia subsided after peaking at 14.7 per cent year on year in April, the National Bank of Serbia reduced its policy rate to 11.5 per cent in June and early July.

**Developing economies**

**Africa: solid growth and rising inflation triggered by food and energy prices**

GDP growth figures paint a picture of continuing solid growth in a number of economies in Africa. In South Africa, economic growth reached 4.8 per cent on an annualised and seasonally-adjusted basis in the first quarter, up from an expansion by 4.5 per cent in the fourth quarter of last year on the back of a solid performance of the manufacturing sector. In Ghana, the economy expanded by 23 per cent year on year in the first quarter, driven by the start of oil production.

At the same time, numerous countries are seeing increasing inflation rates, especially in light of higher food and fuel prices. In Nigeria, inflation reached 12.4 per cent in May, while Kenya saw an increase in prices by 13 per cent. The Kenyan central bank raised its policy rate by 25 basis points to 4.75 per cent.

A number of countries registered a positive agricultural sector performance. Cocoa production in Cameroon has already reached a new record high this year, well before the end of season. Côte d’Ivoire is also on track for a solid cocoa harvest, although heavy rains could have a negative impact on the cocoa quality. On the negative side, Kenya expects a sharp drop, by almost 40 per cent, in its maize harvest due to poor rainfall.

**East Asia: growth momentum has started to weaken**

High-frequency indicators such as industrial production and trade suggest that economic growth in East Asia has moderated significantly in the second quarter of 2011, following a strong first quarter. In Malaysia and Thailand, manufacturing output declined in April 2011 compared to a year ago. In China, export growth decelerated to 19.4 per cent in May (year on year), down from 26 per cent during the first quarter. The slowdown reflects the impact of tighter monetary conditions on domestic demand, supply-chain effects of the Japanese earthquake and tsunami and weaknesses in major developed economies. Despite slower growth, inflation has continued to move higher in most countries. In China, consumer prices rose by 5.5 per cent (year on year) in May 2011, the fastest rate since July 2008. Food price inflation increased to 11.7 per cent. However, slower growth in bank lending and money supply point to an easing of inflationary pressures in China in the second half of the year. In the Republic of Korea, consumer price...
inflation stood at 4.4 per cent in June, exceeding the Central Bank’s target of 2 to 4 per cent for the sixth consecutive month; and in Viet Nam inflation reached 20.8 per cent in June.

South Asia: exports and remittance inflows support economic growth

Economic growth in South Asia is supported by rising exports and remittance inflows. During the first half of 2011, India’s export earnings were about 40 per cent higher than a year ago as exports of engineering goods and petroleum products soared. Bangladesh, Pakistan and Sri Lanka have seen a surge in external demand for textiles and garments (their main export products), partly owing to significant cost increases in China and the political turmoil in North Africa and Western Asia. In the first quarter of 2011, Sri Lanka’s apparel exports grew by 74 per cent from a year earlier. Remittance flows to South Asian economies are also growing again at a robust pace. During the first five months of 2011, Pakistan saw an increase of 36 per cent compared to the previous year. In the same period, Bangladesh recorded growth of 11 per cent, following stagnation in the second half of 2010.

The Reserve Bank of India continued to tighten monetary policy, raising interest rates for the 10th time since the start of 2010 after inflation of wholesale prices accelerated to 9.1 per cent in May from 8.7 per cent in April. The monetary authorities stressed that in spite of increased global risks and a deceleration of domestic investment, policies will continue to focus on fighting inflation.

Western Asia: political instability and food and commodity price volatility accentuate economic uncertainty

Social unrest in Bahrain, Jordan, Syrian Arab Republic and Yemen, particularly the harsh regime responses in Bahrain and Syrian Arab Republic and the risk of civil war in Yemen, are eroding economic confidence and damaging growth prospects. Most clear indicators so far are falling consumption as unemployment levels and food prices rise, low tourism revenues and contraction of investment projects and foreign direct investment inflows caused by the insecurity.

Turkey continues to stand on a high growth path, reaching 11 per cent in the first quarter of 2011, but the outlook is clouded by uncertainties. The political leadership is shaken by post-election power struggles between the parliament and the executive, while signs of lack of confidence arise about the effectiveness of central bank policies, lowering interest rates to contain capital inflows while raising bank reserve requirements to contain domestic credit expansion. The rising costs of commodity imports will make it more difficult to reduce the chronic current-account deficit.

Israel, which had showed robust growth performance towards the end of 2010, exhibited signs of deceleration in the first half of this year following political tensions in the region, the slowdown of imports by troubled European neighbours, fiscal austerity and the effects of energy and food price inflation, as well as higher interest rates, on private spending.

Latin America and the Caribbean: struggling to maintain the pace of growth while fighting inflation

Growth in Latin America and the Caribbean as a whole tends to moderate amidst sluggish external demand, cautious fiscal and monetary responses to inflation and exchange-rate appreciation pressures. The policy mix reflects different realities within the region. Colombia and Mexico have prioritized interest rate hikes. Meanwhile, in combination with a series of interest rate increases in previous months, Chile has reduced fiscal spending. In El Salvador, Honduras and Nicaragua, fiscal constraints are limiting attempts to keep up social spending and maintain subsidies to provide their populations protection against higher food and energy prices. Economic growth in Uruguay and Peru is expected to moderate to, respectively, 5.5 per cent and 6 per cent, as fiscal and monetary policies have shifted to contain overheating.

Other countries in the region remain committed to support demand-driven growth in 2011. After raising interest rates in early 2011, Brazilian authorities are aiming at lowering the lending rate to 37 and 36.8 per cent in 2011 and 2012, respectively, down from 38.7 in 2010. Together with continued moderate fiscal stimuli this should help maintain a pace of GDP growth at 4.5 to 5.0 per cent. In Ecuador, a low debt-to-GDP ratio is allowing authorities to increase infrastructure and social spending. As a result, the country’s economy is expected to expand by 4 per cent in 2011 and 5 per cent in 2012, up from 3.6 per cent growth in 2010. In Argentina internal demand and export growth remain strong and the economy at large is expected to expand by a robust 6.7 per cent growth in 2011. Similarly, Panama’s Government is expecting growth of 6 per cent in 2011, supported in part by public investment in infrastructure.

LDCs: higher inflation rates remain a challenge

Rising inflation rates remain a challenge in many least developed countries. In Uganda, for example, inflation rose for the seventh consecutive month to 16 per cent in May, fuelling protests and tensions in the country. In Rwanda, inflation increased to 3.8 per cent in May from 3 per cent the previous month, although a more moderate increase in food prices contributed to a decrease in the urban inflation rate to 4.5 per cent. Meanwhile, in Uganda, coffee exports in May, the peak of the harvest season, were 43 per cent higher year on year, strengthening an important source of foreign-exchange earnings.