Global issues

Recurrent turmoil in financial markets as growth prospects weaken

Agreements to raise the debt ceiling in the United States and create space for sovereign debt resolution in Greece and other peripheral European countries have momentarily mollified default concerns. Yet, considerable uncertainties remain. In the United States, the agreement to raise the debt ceiling in exchange for caps on discretionary spending between 2013 and 2021 reinforced concerns of continued economic weakness. Equities in major markets fell in the days before the agreement and global equity markets underwent a precipitous sell-off in the next week, losing about 20 per cent in just several days, the largest fall since the recovery from the global financial crisis began. Adding to significantly dimmed prospects of global economic growth, Standard & Poor’s downgrading of US public debt from AAA to AA+ weakened market confidence.

Meanwhile, euro zone leaders allowed the Greek Government to roll over its maturing debt and pay a lower interest rate on its bailout loans, confident that spontaneous private involvement will help bring debt to a sustainable level. Aiming at preventing contagion, the European Financial Stability Facility was given broader powers (although not larger funds), including the ability to buy government bonds of debtor countries in the secondary markets and lend to countries whose banks need re-capitalization. These measures were, however, unable to eliminate market fears over the contagion of debt distress to larger euro members as borrowing rates for Italy and Spain grew, prompting the unprecedented move by the European Central Bank to purchase government bonds in the secondary market.

The sovereign debt problems also heightened volatility in foreign exchange markets, leading to notable depreciations of the United States dollar and the euro against the Swiss franc and the yen (which reached record highs), as well as the currencies of commodity exporters (see figure 1). The Central Banks of Japan and Switzerland intervened to mitigate the appreciation of their currencies, with limited success. Meanwhile, the currency appreciation in commodity exporting countries has reversed somewhat along with the moderation in commodity prices.

While headlines focused on these financial woes, recent indicators for the real economy suggest that the recovery from the global recession is faltering in the developed economies. Revised estimates of gross domestic product (GDP) for the United States show a deeper recession and a weaker recovery. Output growth in the first half of 2011 was disappointing. Growth in Europe is visibly slowing and the robust recovery in the major emerging countries is also decelerating. Global industrial production appears to be virtually stagnant, its “momentum”—estimated by the Netherlands...
CPB (change in the three-months moving average)—showing a decline of 0.4 per cent in May (latest data available). More recent estimates of the JPMorgan Global Manufacturing Index (PMI) recorded a value of 50.6 in July, a practical standstill of new orders (see figure 2).

**Lack of food is causing severe humanitarian disasters**

Famines are happening in Somalia and other parts of East Africa, while food shortages are also affecting countries in other continents, like Haiti and Mongolia. Meanwhile, international food prices increased since mid-2010, with cereals, oils and fats, meat and diary hovering around record highs since March. In the poorest countries, especially those depending on external supplies to meet food demand, space to shield the population with domestic subsidies or price controls is quickly running out, if it has not already.

**Developed economies**

**United States: economy weaker than expected**

Growth figures for the United States were revised downwards in July, based on lower estimates for private consumption and investment. Consistently, the economy only grew by 0.4 per cent in the first quarter and 1.3 per cent in the second quarter of 2011 (saar), a marked slowdown since the recovery started in the third quarter of 2009. The main causes of the growth deceleration were sluggish private consumption—consumer demand declined in June for the first time in the current recovery—and the continued contraction of government spending. By the second quarter of 2011, real GDP had not yet returned to pre-crisis levels. Employment recovery remains slow as the total number of jobs is still 5 per cent—or 6.8 million—below the pre-recession level. The unemployment rate was 5 per cent then, compared with 9.1 per cent today. Moreover, revised national accounts revealed that the recession was a full percentage point deeper than previously thought: by mid 2009, GDP had shrunk by 5.1 per cent from its peak in the fourth quarter of 2007.

**Developed Asia and the Pacific: supplementary budget in Japan and concerns over inflation in Australia**

In late July, the Government of Japan passed the second supplementary budget of ¥2 trillion (0.4 per cent of GDP) to provide support to victims of the March disasters. Additional government spending is estimated to boost real GDP by 0.3 per cent. Combined with the first supplementary budget of May (¥4 trillion), the Government has so far committed 1.2 per cent of GDP for actions in response to the March events. A more comprehensive budget plan for post-disaster reconstruction is under consideration.

Japan’s industrial production grew by 3.9 per cent in June (m/m), which is, however, not enough to compensate for the steep decline after the earthquake: overall in the second quarter it fell by 14.8 per cent. Full output recovery to pre-earthquake levels is not expected until September 2011. Retail sales also rebounded in June, rising 2.9 per cent (m/m). Sales of machinery and equipment and motor vehicles were particularly strong. Payroll employment continued to increase, albeit slowly.

In Australia, inflation reached 3.6 per cent in the second quarter (yoy), above the central bank’s 2-3 per cent target. Prices of fruits, oil and healthcare increased starkly.

**Europe: modest and further moderating growth**

In May, growth of industrial production slowed from its modest pace of the first three months of the year. Construction activity, which has never turned up convincingly since the end of the recession (growing by only 1.4 per cent in the first quarter), continues to move sideways, declining in May after increasing in April. These indicators suggest that GDP growth in the second quarter was slower than in the first and will likely decelerate further. The European Commission’s Economic Sentiment Indicator declined in July, remaining above its long term average but falling significantly from its peak. Most countries in the region are seeing a marked deceleration. In Germany, the current economic conditions component of the IFO index dropped for the first time since January; the forward looking component has been falling since March. Capacity utilization measures released this month showed a slight decrease, the first since the recovery began. Given the weakening growth outlook, substantial near-term fiscal consolidation adds further downward pressure. It also leaves little room to address the key issue of unemployment. In the United Kingdom, riots triggered by the shooting of a man by the police highlighted a staggering 20 per cent unemployment among some sections of the youth.

**Abbreviations:** m/m: month on month; q/q: quarter on quarter; saar: seasonally-adjusted annual rate; yoy: year on year; ytd: year to date
**The new EU members: domestic demand strengthening in the Baltic States**

Lithuania’s economy continued its strong rebound in the second quarter of 2011, with GDP increasing by 6.1 per cent (yoy). The recovery, initially driven by exports, is becoming more broad-based, as reflected in the volume of retail sales, which increased by 22 per cent in January-May (yoy). In other Baltic States, domestic demand is also picking up, in parallel with partial gains in employment. In June, retail sales increased by 4 per cent (yoy) in Estonia and by 5.4 per cent in Latvia (yoy).

However, indicators for industrial production suggest that economic growth weakened in most new EU countries in the second quarter, along with the slowing economy of the euro zone.

Inflationary pressures, triggered by higher food and fuel prices, are abating. In Poland, inflation slowed in June to 4.2 per cent (yoy), down from 5 per cent in May. Growth of producer prices also slowed.

**Economies in transition**

**CIS: second quarter slowdown in industrial production**

Industrial production in the Russian Federation slowed in the second quarter. The economy expanded by 3.9 per cent in the first half of 2011 (yoy). In Kazakhstan, strong growth in the production of metals and machinery was partially offset by a slowdown in mining activity during the first half of 2011. GDP growth reached 7.1 per cent in the first half of the year (yoy) supported by strong private domestic and foreign investment demand. Government spending and household consumption were also up. Consumer demand recovered in both countries, thanks to the gradually easing of inflation. In May, retail sales were up by 11.3 per cent (yoy) in Kazakhstan; more than twice the rate of increase registered in the Russian Federation.

Meanwhile, the Russian Federation and Ukraine resumed grain exports on July 1, lifting the restrictions introduced after the poor harvest of 2010. Bumper harvests are expected for this year in these countries as well as in Kazakhstan and may lead to lower international wheat prices.

**South-Eastern Europe: slowdown in Serbia**

According to the flash estimate, GDP growth in Serbia decelerated to 2.2 per cent in the second quarter (yoy). Domestic demand remains feeble, as the Government is undertaking austerity measures. The volume of retail trade declined by 16 per cent in June (yoy). The resulting weak VAT collection is straining public finances, as government spending proceeds as planned. The country’s budget deficit for the first half of the year reached 56 per cent of the target agreed with the IMF for the full year. Thus, a budget revision may be needed. At the same time, although Serbia completed its program with the IMF in April, the country might opt to apply for another loan. Inflation in Serbia slowed, allowing the central bank to cut its policy rate in July. Price pressures are expected to taper off further.

Albania’s GDP is estimated to have increased by 3.4 per cent in the first quarter of 2011 (yoy). In Croatia, the labour market improved somewhat in June. Registered unemployment fell to 16.9 per cent from 18.2 per cent in April, owing to seasonal factors related to tourism.

**Developing economies**

**Africa: diverging inflation trends**

Continued high commodity prices weigh differently on inflation in Africa. The United Republic of Tanzania and Namibia saw inflation accelerate to 10.9 per cent and 5.4 per cent (yoy), respectively. Higher food and energy prices were key drivers, with energy shortages compounding the situation further in the case of the United Republic of Tanzania. In Nigeria, by contrast, inflation fell to 10.2 per cent in June from 12.4 per cent in the previous month (yoy). Even so, Nigeria’s central bank announced a further increase in its policy rate by 75 basis points to 8.75 per cent, citing the “dark clouds on the international horizon and the rising spectra of a structural fiscal deficit” as the reason for the monetary tightening. Ghana also saw a slight drop in its inflation rate to 8.6 per cent in June (yoy), but cut its policy rate by 50 basis points to 12.5 per cent. In Kenya, the world’s leading exporter of black tea, production of tea fell by 16 per cent in the first half of 2011 (yoy) owing to hot and dry weather. Tea exports were also affected by the political unrest in Egypt, which was the biggest export market for Kenyan tea last year.

**East Asia: growth moderating, inflation accelerating**

Economic growth in East Asia slowed markedly in the second quarter of 2011. Investment and export demand weakened amid tighter monetary policies in the region and increased global uncertainty. Real GDP expanded by 3.4 per cent (yoy) in the Republic of Korea, 4.9 per cent in Taiwan Province of China and 0.5 per cent in Singapore. In the latter two economies, output actually contracted compared with the previous quarter. By contrast, China’s second quarter growth slowed only slightly to 9.5 per cent (yoy), down from 9.7 per cent in the first quarter. Domestic demand in China continues to expand at a robust pace as indicated by strong growth of industrial production and retail sales in June.
Despite significant monetary policy tightening, inflationary pressures have remained high in most economies. In June, consumer price inflation accelerated to 6.4 per cent (yoy) in China, 5.6 per cent in Hong Kong Special Administrative Region of China and 5.2 per cent in the Philippines. Food prices in China rose by 14.4 per cent (yoy), driven by a surge in retail pork prices, which were about 50 per cent higher than a year ago owing to a pig shortage and strong demand.

**South Asia: strong private consumption boosts economic growth**

In most South Asian economies, growth continues to be robust, driven in particular by strong private consumption. Bangladesh’s economy grew by 6.7 per cent in the fiscal year 2010/11 (which ended in June), the fastest annual pace on record. Domestic demand was supported by household income growth in recent years that also underpinned a significant decline in poverty. Recent estimates indicate that the national poverty headcount rate fell from 40 per cent in 2005 to 31.5 per cent in 2010. In the budget for 2011/12, the Government of Bangladesh focuses spending on key development needs such as energy and transportation.

Sri Lanka’s economy maintained its strong growth momentum in the first quarter of 2011. GDP expanded by 7.9 per cent (yoy) despite a sharp drop in agricultural output due to heavy flooding. Industry and services registered rapid growth of 11.1 per cent and 9.5 per cent, respectively. By contrast, economic activity in Pakistan has remained sluggish, with GDP growing by a mere 2.4 per cent in the fiscal year 2010/11. This reflects continuing energy shortages, a deteriorating security situation and damages caused by last year’s devastating floods. In view of weak growth and declining private investment, Pakistan’s central bank lowered the policy rate by 50 basis points to 13.5 per cent.

**Western Asia: social discomfort continues to affect growth and stability**

Social unrest continues in Bahrain, Jordan, Oman, Syrian Arab Republic and Yemen, adding some uncertainty over oil supplies. In Bahrain, the economic impact is mostly felt in tourism and business and financial services. Despite the positive effects of a widening trade surplus driven by oil exports and increases of government spending, aggregate economic growth is severely affected. In Yemen, output growth has come to a halt, affected by domestic spending and lower oil production. Protests in Jordan and Oman have led to government measures aimed at improving economic conditions and governance. It remains to be seen how much impact such measures will have in a context of falling tourism revenues and foreign direct investment.

In Israel, the 6.9 per cent GDP growth of the first quarter (yoy) is expected to moderate as inflation and reversals of policy stimuli are negatively affecting aggregate demand, while social discontent may turn disruptive. Higher prices of oil, food and housing, together with cutbacks on social spending and stagnating real wages, have led to protests and strikes.

**Latin America and the Caribbean: growth slows, while food prices push up inflation**

Growth slowed on average in the second quarter, ranging between an estimated 2.5 and 5.5 per cent (yoy) for most economies. Policy responses have been diverse. In order to support export-led growth Argentina introduced a “trade balance mechanism” that limits new imports of 4,000 commodities to the value of new exports. In Brazil, public investment expenditure rebounded in July. In Peru, the new Government announced its intention to introduce universal pensions, a higher minimum wage and a windfall tax on mining.

High food prices remain a source of concern, especially in Colombia, Costa Rica, Haiti and Honduras. Despite recent declines, maize prices in Brazil remain 72 per cent higher than a year ago. In El Salvador and Nicaragua, beans prices peaked in July at 154 per cent and 80 per cent respectively (yoy). Since food prices account, on average, for about 25 per cent of consumer price indices, international prices drive inflation whenever food supply relies substantially on imports. In this case, increasing interest rates is less effective or detrimental.

In Argentina, Brazil, Colombia, Mexico and other countries, central banks raised interest rates in July. Inflation remains in the 2-5 per cent range in the major economies except in Argentina and Brazil, where it reached 11 per cent and 6.8 per cent (yoy), respectively. Brazil raised the benchmark interest rate to 12.5 per cent amidst concerns over overvaluation of the real. In the first semester, portfolio investment plunged by 70 per cent, but foreign direct investment inflows remained strong.

**Least developed countries: severe food crisis in the Horn of Africa and Haiti**

The food crisis in the Horn of Africa has become extremely severe, with more than 12 million people in Djibouti, Ethiopia, Kenya and Somalia in urgent need of assistance, and neighbouring countries facing difficulties in border areas. The situation is especially critical in Somalia owing to the combination of drought, internal conflict and poverty. For several parts of the country, the United Nations has declared the crisis a famine, entailing, among other criteria, that more than 2 persons out of 10,000 die every day and that the acute malnutrition rate among children exceeds 30 per cent.

The Haitian economy has suffered a setback in the second quarter following poor harvests and higher import bills for cereals and oil. Haiti has been included in FAO’s list of countries requiring food assistance.