# IX. INTERNATIONAL ECONOMIC DEVELOPMENTS

## 9.1 Overview of World Economy[1]

Global economic activity continued to be robust despite economic slow-down in the United States. Global growth is increasingly being supported by buoyant activity in emerging economies. In particular, Asia has remained the main engine of global growth as the larger countries in the region continue to record very high growth rates.

In the United States, quarterly annualized growth rate of real GDP rebounded to 4.0 percent in the second quarter of 2007 (from March to June 2007) compared to just 0.6 percent in the first quarter. A rebound in the contributions from net trade, inventories and government consumption as well as a pickup in non-residential investment was the major factor for the increase in real GDP growth. Looking ahead, assuming that the negative effects of the housing market on consumption and residential investment would continue, the US economy is expected to expand at a rate below trend in the second half of 2007.

In the second quarter of 2007, real GDP growth in Japan was 0.1 percent on a quarterly basis compared to 0.8 percent in the preceding quarter. The decline in growth during the second quarter was due to a slowdown in private consumption and private residential investment. However, the outlook for the Japanese economy remains favourable. Real GDP growth is expected to be supported by both domestic demand and net exports.

Euro area real GDP growth in the second quarter moderated to 0.3% quarter on quarter, compared with 0.7% in the previous quarter. However, it is expected that Euro area real GDP will continue to grow at sustained rates during the remainder of 2007.

GDP growth has remained robust and stable in the United Kingdom, reaching

[1] The figures in this section are obtained from European Central Bank, Monthly Bulletin, September 2007.

0.8% (quarter on quarter) in the second quarter. Growth in the second quarter was driven by private consumption, whereas investment and export growth declined, and the contribution of net exports was negative. In the second half of 2007, the pace of quarterly GDP growth is expected to decelerate moderately.

In emerging Asia, economic activity has continued to expand at a sustained pace, especially in the largest economies of the region. In China, lower growth in industrial production and investment in July seem to suggest that economic activity has moderated somewhat after growing vigorously in the first half of 2007. China's trade surplus grew to a cumulative USD 136.8 billion in the first seven months of 2007, an increase of 81% compared with the same period in 2006. Its foreign exchange reserves also continued to rise reaching USD 1.33 trillion at end-June 2007. In South Korea, real GDP grew at an annual rate of 5.0% in the second quarter of 2007, up from 4.0% in the first quarter while in India it grew by 9.3%. Overall prospects remain favourable for emerging Asia, underpinned by steady growth in domestic demand, as well as robust growth in exports.

Economic activity has remained sustained overall in Latin America although there is some heterogeneity in the growth performances of the major economies. In Brazil, industrial production rose at an average annual rate of 5.8% in the second quarter of 2007 compared with 3.8% in the first quarter. Meanwhile annual industrial production growth in Argentina declined to 6.0% in the second quarter from 6.7% in the first quarter. In July 2007, it further declined to 2.3%. In Mexico, real GDP growth on annual basis rose from 2.6% in the first quarter to 2.8% in the second quarter. The outlook for Latin America as a whole continues to be favourable, with domestic demand expected to remain the main engine of growth.

For the third year in a row, sub-Saharan Africa (SSA) recorded an average growth rate of 5.7 percent in 2006 on account of good performance by oil producing as well as oil importing countries. The short-term economic outlook for sub-Saharan Africa remains very positive, against the backdrop of strong global growth, continued progress in cementing macroeconomic stability, the beneficial impact of debt relief, increased capital inflows, rising oil production in a number of countries, and strong demand for nonfuel commodities. Real GDP growth is expected to accelerate to 6.1 percent in 2007.

## 9.2 Inflationary Developments

Global price developments continued to be significantly affected by changes in commodity prices. In the United States, annual consumer price inflation averaged 2.6% in the six months from February to July 2007. Recently, however, a slowdown in the annual rate of increase in energy prices has led to a slight fall in inflation rates with annual CPI inflation declining to 2.4% in July 2007, from 2.7% in the previous month. Meanwhile, inflation has remained subdued in Japan where consumer price inflation on annual basis was zero in July 2007 compared to -0.2 percent in June.

In the Euro area, annual HICP inflation was 1.8% in August 2007, remaining unchanged from its level of the previous month. HICP inflation declined gradually to 1.9% in July 2007 in the United Kingdom after peaking at 3.1% in March 2007.

Inflationary pressures remained broadly stable in the large economies of emerging Asia except China. Consumer price inflation in China reached 5.6% in July 2007, mostly driven by rapidly rising food prices while in South Korea annual consumer price inflation declined to 2.0% in August 2007. Inflation also continued to decline in India reaching 4.0% in August.

Looking at Latin American economies, annual consumer price inflation in Brazil increased to 3.7% in July 2007, after remaining stable in the first quarter of 2007. In Argentina, meanwhile, annual consumer price inflation declined in the second quarter to an average of 8.8%. In Mexico, inflation has remained relatively stable since the beginning of the year and stood at 4.1% in July 2007.

## 9.3 Commodity Markets

Oil prices remained very volatile during the first eight months of 2007. Prices were persistently increasing until July 2007 after which they declined substantially in August. The price of Brent crude oil reached a pick of USD

79.09 per barrel on July 20, 2007. The fall in oil prices in August were due to concerns over the potential effects of the global financial turmoil on the global economy and the possibility of dampening effects on energy demand. However, the price declines were limited as the Organization of the Petroleum Exporting Countries (OPEC) maintained production discipline, global oil demand remained very high and US oil inventories were low. Looking ahead, robust demand, limited crude oil supply growth and spare capacity are likely to keep oil prices at high levels and fairly sensitive to unexpected changes in the supply/demand balance.

Following a period of significant volatility, the prices of non-energy commodities fell substantially in August 2007, reflecting mainly a decline in the prices of industrial raw materials, particularly non-ferrous metals. Food prices, which had increased in recent months, also declined slightly in August in monthly terms, despite an increase in the prices of cereals. Nevertheless, the overall non-energy commodity price index (denominated in US dollars) was on average approximately 12% higher in August than a year earlier.

Coffee prices continued to rise with International Coffee Organization's composite indicator price reaching 113.20 US cents per pound in September 2007 compared to 107.98 US cents/lb in August and 106.20 US cents/lb in July. This monthly average for September 2007 was the highest recorded since May 1998.

## 9.4 Relationship with the IMF

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. The summary of the Fund's appraisal of the country's economy that emerges from the bilateral discussion and assessment of data from independent sources is transmitted to the country's authorities using Public Information Notices (PINs). On June 15, 2007 IMF issued PIN No. 07/68 announcing the Fund's appraisal of Ethiopia's economy based on the bilateral consultation concluded between IMF mission and the government of Ethiopia, and assessment of facts on economic fundamentals obtained from independent sources.

According to the PIN, Ethiopia's favorable economic performance in recent years has significantly contributed to poverty reduction and progress toward the Millennium Development Goals (MDGs). The economy has enjoyed a strong and steady growth in the past three years after a significant drought-related contraction in 2002/03. This strong growth performance resulted in real per capita income increasing at 7 percent per annum-the fastest in Ethiopia's recent history. However, this has been accompanied by rising inflation, with consumer price accelerating to 19 percent in February 2007.

Net domestic borrowing for budget financing rose to 3.1 percent of GDP in 2005/06 from 0.2 percent of GDP in 2003/04, reflecting declining domestic revenue effort and significantly reduced budget support from donors (a shortfall of 2 percentage points of GDP from what was budgeted) in view of political governance concerns following the 2005 election. Thus, despite efforts to reduce government expenditures by cutting large-scale infrastructure projects and constraining recurrent outlays, the overall budget deficit (including grants) remained large at about 4½ percent of GDP in 2004/05-2005/06.

Broad money growth remained fast in 2005/06, driven by credit expansion to both the government and nongovernment sectors. The demand for bank credit rose sharply to finance large-scale investment projects by the public enterprises and the rapidly expanding private sector. Substantial negative real interest rates and commercial banks' excess reserves facilitated the rapid expansion of credit.

Furthermore, current account deficit (after official grants) widened to 10½ percent of GDP in 2005/06, reflecting rising domestic demand. Although exports grew steadily, imports, particularly for raw material and capital goods, rose even faster, while donor assistance was reduced significantly. As a result, the overall balance of payments moved from a significant surplus in 2003/04 to a cumulative deficit equivalent to 2 percent of GDP during 2004/05-2005/06. Gross official international reserves declined from the equivalent of 3.7 months of imports at end-2003/04 to 2.1 months of imports at end-2005/06. The official exchange rate for the birr, however, remained relatively stable against the U.S. dollar (the intervention currency) at around birr 8.7 per U.S. dollar in 2005/06. Strong economic growth is expected to continue in 2006/07. Real GDP growth is projected to hold at about 9½ percent as productivity gains in agriculture continue and nonagriculture activities, especially manufacturing and construction, expand further. Inflation is projected to decline to about 15 percent at the end of 2006/07, in light of the completion of the pass-through of fuel price increases and full adoption by farmers of the new pattern for food supply. After a period of relative stability, the depreciation of the birr against the U.S. dollar is expected to continue, reflecting the recent external balance developments.

The PIN states that Executive Directors of the Fund welcomed Ethiopia's recent strong and steady growth, which has also led to the fastest increase in real per capita incomes in recent years, and encouraging progress toward achieving the MDGs. At the same time, pressures on domestic prices and the balance of payments are emerging, the fiscal deficit remains large, and the economy continues to be vulnerable to weather-related shocks and shortfalls in donor support. Directors considered that, to further strengthen Ethiopia's growth prospects and to meet its poverty alleviation goals, structural reforms will need to be intensified in the period ahead. These should aim to eliminate infrastructural and administrative bottlenecks, and support the further development of the agricultural sector and the emergence of a robust and flexible private sector. Directors welcom ed the authorities' plans to adhere to a policy of fiscal restraint, as shown by the tightened 2006/07 budget and the intention to limit domestic borrowing. They supported the recent steps to enhance fiscal revenues, and encouraged the authorities to take further measures to restrain domestic demand, if required. Such measures could include stretching out expenditures on projects with a large import content and cutting low-priority outlays, while safeguarding poverty-reducing and growth-enhancing

spending. Directors encouraged the authorities to strengthen debt management capacity and develop a comprehensive public debt strategy over the medium term. In this regard, Directors suggested that the authorities avail themselves of Fund technical assistance. Directors called for a tightening of monetary policy to reduce inflation and prevent the entrenchment of inflationary expectations. To help mop up excess reserves in the banking system, and pending the introduction of more sophisticated indirect monetary instruments, the authorities could consider testing the efficacy of issuing longer-term bonds. A gradual move to positive real interest rates would also help to contain inflationary pressures.

Directors welcomed the recent increase in exchange rate flexibility, and recommended that it be continued. This should allow the exchange rate to better reflect balance of payments developments and lay the groundwork for the needed buildup in international reserves. Directors cautioned that continued appreciation of the real exchange rate could weaken external competitiveness over the medium term, and encouraged the authorities to adopt productivity-enhancing structural reforms.

Directors observed that a critical challenge for Ethiopia is to accelerate structural reforms to buttress and sustain growth while maintaining macroeconom ic stability. Emerging supply constraints need to be addressed expeditiously, and absorptive capacity expanded. Further efforts are needed to improve the investment climate, strengthen the financial sector, and promote trade openness. Directors encouraged the authorities to consider undertaking financial sector reforms within the framework of a developmental Financial Sector Assessment Program (FSAP).

Directors considered that data provided to the Fund are adequate for surveillance purposes, but that data shortcomings continue to complicate the analysis of economic developments, in particular with regard to the real sector and fiscal and balance of payments statistics. They called for further remedial efforts, and they supported the authorities' request for technical assistance from the Fund in this area.