IX. International Economic Developments

9.1 Overview of World Economy[4]

Global economic activity is expected to remain resilient despite the economic weakness in the United States, global repercussions of the ongoing financial market tensions and elevated levels of energy and food prices. The slowdown in global growth concerns mainly developed economies, while economic growth remains sustained in emerging markets.

In the United States, economic activity recovered somewhat in the second quarter of 2008, but growth remained below its long-term average. According to preliminary estimates, real GDP growth picked up to a quarterly annualised rate of 3.3% in the second quarter of 2008, compared with 0.9% in the first quarter. This reflects not only the strong contribution of net exports, but also some acceleration in personal consumption expenditure, boosted by temporary fiscal stimulus measures. Residential investment continued to contract, although the quarterly pace of decline was slower than in the previous periods.

In Japan, economic activity has slowed noticeably, reflecting weakness in both exports and domestic demand. According to preliminary estimates, real GDP decreased by 0.6% quarter on quarter in the second quarter of 2008. This contraction, largely offsetting the fairly strong increases recorded for the first quarter of 2008, was relatively broadly based across the various demand components. Private consumption declined by 0.5% quarter on quarter, following an increase of 0.7% in the first quarter, reflecting lower real incomes and uncertain labour market prospects. Residential investment declined strongly, contracting by 3.4%, down from +4.3% in the first quarter. Public spending wend down by 0.9%, driven largely by a 5.2% decline in public investment. With both exports and imports falling substantially (-2.3% and -2.8% quarter on quarter respectively), the contribution of net external demand to GDP was effectively nil.

[4] Excerpts from European Central Bank, Monthly Bulletin, August and September 2008

Following GDP quarterly growth rate of 0.7% in the first quarter of 2008, euro area real GDP contracted by 0.2% in the second quarter, as consumption declined and investment weakened. The euro area economy is currently experiencing an episode of weak activity characterized by high commodity prices weighing on consumer confidence and demand, as well as by dampened investment growth.

In the United Kingdom, GDP growth has come to a standstill. The quarterly rate of output growth has gradually slowed over the past year. The estimated quarterly output growth of 0% in the second quarter of 2008, which was well below the long-term average of 0.7% confirmed the ongoing slowdown. In line with weak growth in retail sales, private consumption did not grow at all in the second quarter.

In emerging Asia, in the first half of 2008 economic activity decelerated, especially in small open economies such as Singapore, Taiwan and Hong Kong Special Administrative Region, but overall it remained robust. Although the global economic slowdown has broadened and intensified in recent months, exports from this region as a whole have held up well. Growth was mainly driven by domestic demand, which remained resilient in most countries despite the erosion of consumer purchasing power owing mainly to higher food prices.

In China, year-on-year real GDP growth declined slightly in the second quarter to 10.1%, down from 10.6% in the first quarter. This slowdown was driven by external demand and, to a lesser extent, by investment, while private consumption remained strong. The upsurge in import values, driven by rising commodity prices, and the deceleration in exports resulted in a trade surplus of USD 99 billion in the first half of 2008, which is 12% below the level recorded in the same period last year.

In Korea, real GDP grew at an annual rate of 4.8% in the second quarter of 2008, slowing from 5.8% in the previous quarter.

In India, economic activity remained sustained, with GDP growing by 8.8% in the first quarter of 2008, similar to the previous quarter.

In Latin America, the pace of economic activity moderated somewhat during the first half of 2008, as the impact of the global economic slowdown and some domestic factors came into play. In Mexico, real GDP grew by 2.8% year on year in the second quarter of 2008. In Brazil, available information suggests that domestic demand remained robust in the second quarter, with retail sales growing by 10.1% compared with the previous quarter. Industrial production growth was broadly the same as in the first quarter, increasing by 6.4% year on year. In Argentina, economic activity decelerated in the second quarter, with industrial production rising by 5.5% compared with the previous year, down from 6.9% in the first quarter. This deceleration in industrial activity can be attributed mostly to energy constraints.

9.2 Inflationary Developments

Inflationary pressures continued to intensify both in the developed and emerging economies mainly driven by high energy costs. Annual CPI[2] inflation in the US increased to 5.0% in June from 4.2% in the previous month, reaching its highest level in 17 years. This increase was due to the recent pick-up in energy costs, which now account for about half of the annual rate of inflation. Annual core inflation (as measured by the CPI excluding food and energy) remained broadly stable at 2.4% in June, which is the same as the average growth rate during the first half of 2008.

CPI inflation in Japan has increased since the beginning of the year, mainly as a result of rising commodity prices. Annual CPI inflation went up to 2% in June from 1.3% in May, reaching the upper limit of the Bank of Japan's definition of price stability. This rise in inflation was driven in particular by increases in food and oil prices. Prices excluding food and energy rose by 0.1% in annual terms.

In June 2008 euro area HICP[3] inflation further increased to 4.0%, from 3.7% in May, most likely owing to renewed increases in energy prices.

Annual HICP inflation in the UK rose to 4.4% in July, up from 3.8% in June. This was mainly due to higher food and

[2] Consumer price index

[3] Harmonized index of consumer prices

energy prices, while HICP inflation excluding food and energy was more moderate.

At the same time, inflationary pressures in emerging Asia remained strong, driven largely by high food and commodity prices, and real interest rates have turned negative in most countries in the region. CPI inflation in China eased further to 7.1% in June, mainly due to a decline in meat prices. Producer prices, however, continued to increase at a faster pace than consumer prices, indicating strong price pressures in the production chain, which are being driven mainly by rising raw material prices. In Korea, annual CPI inflation edged up to 5.9% in July from 5.5% in the previous month. Wholesale price inflation in India, the Reserve Bank of India's main inflation measure, increased to 12% in July 2008 from around 4% early in the year.

Similarly, inflationary pressures in Latin America persist on account of rising food and commodity prices. In Mexico, annual CPI inflation continued to increase, reaching 5.4% in July 2008 and it also increased further to 6.4% in Brazil. On the other hand, annual consumer price inflation in Argentina decreased slightly to 9.1%.

Despite the slow down in economic activity in the developed economies, central banks in these economies were tightening their monetary policy to contain inflationary pressures. On 5 August the US Federal Open Market Committee decided to keep the target for the federal funds rate unchanged at 2.0% while the Bank of Japan also decided to leave its target for the uncollateralized overnight call rate unchanged at 0.50% at its meeting on 15 July 2008. Similarly, the Governing Council of the European Central Bank decided at its meeting on 7 August 2008 to leave the key ECB interest rates unchanged and the Bank of England's Monetary Policy Committee decided to keep its main policy rate unchanged at 5.00% for the fourth consecutive time on 7 August 2008.

Because of inflationary pressures, monetary authorities in emerging economies were also tightening their policy stances. For instance, the Banco de México raised the overnight rate by

25 basis points to 8.25% on 15 August 2008.

9.3 Commodity Markets

Oil prices continued to surge in June, reaching an all time high of USD 147.5 on 11 July 2008. Subsequently, prices declined sharply, standing at USD 111.5 on 2 September, which is still 18% higher than at the beginning of the year. This decline was triggered in part by better than expected figures on US inventories and less negative supply prospects. Over the medium term, market participants expect prices to remain elevated, with futures prices for December 2009 standing at USD 116.

Regarding developments in underlying market fundamentals, demand is reacting to higher prices and the slowdown in economic activity in OECD countries, which has resulted in an increase in US inventories. However, this is likely to be offset by robustly growing demand in developing economies. On the supply side, conditions have eased somewhat following a significant increase in production from OPEC countries in July. Notwithstanding these developments, the supply/demand balance in global oil markets continues to be relatively tight and the risk of future price increases remains high.

Having reached record highs in July 2008, the prices of non-energy commodities also decreased in August. Metal prices have been decreasing amid concerns over a global economic slowdown and reductions in freight costs. Looking at food commodities, maize and soybean prices fell from the levels recorded at the end of June amid favourable weather conditions which hinted at good crop prospects. By contrast, conditions in the wheat markets have been tighter, as a result of concerns over the crop in the southern hemisphere. In aggregate terms, the price index for non-energy commodities (denominated in US dollars) was approximately 21% higher year on year at the end of August.

Following a declining trend in March and April 2008 from their very high levels of February 2008, coffee prices rose in subsequent months. In June 2008, the International Coffee Organization’s indicative price reached 130.5 US cents per pound, 3% higher compared to May 2008. Coffee prices further increased to 132.8 US cents per pound in July 2008.

9.4 Exchange Rate Developments

The US dollar remained weak against the Euro in the three months through June 2008. The average exchange rate of the US dollar against the euro depreciated by 0.3% in June compared to its average rate of March. It further depreciated in July before showing a strong recovery in August. The average exchange rate in August appreciated by 5.1 percent compared to the average rate in July. On the other hand, the US dollar was relatively stronger against the Pound Sterling and the Japanese Yen in the first half of 2008 after dropping to very low levels during the second half of 2007. The average exchange rate of the US dollar against the Pound Sterling in June 2008 appreciated by 2.5% compared to the average rate for December 2007 while it appreciated by 4.9% against the Japanese Yen over the same period. In August 2008, it further appreciated by 4.1% against the Pound and 2.3% against the Yen over its June 2008 rates.

9.5 Impact of Global Economic Developments on Ethiopian Economy

The major risk to the Ethiopian economy remained the surging price of oil and other commodities in the international market. This continuous increase in oil prices has escalated the country's oil import bill contributing to the widening of the trade deficit. The trade deficit widened by 35.6% in 2007/08 fiscal year compared to a year earlier and reached USD 5.3 billion. Fuel imports alone surged by 85.3% in 2007/08, accounting for 24% of total imports.

The rise in the prices of oil and other commodities in the international market are also expected to have impacts on domestic prices through the pass-through effect contributing to the current high inflationary pressures in the economy.

On the other hand, higher prices for the country's export items such as coffee and oil seeds are expected to boost export earnings thereby to some extent offsetting the adverse impact of the rise in oil prices on the current account

The weakening of the US dollar against all major currencies is also expected to be favorable to Ethiopia, as it's expected to boost the demand for Ethiopia's exports in Europe and Asia, which are the two major markets for the country's exports.