X. INTERNATIONAL ECONOMIC DEVELOPMENTS[1/]

10.1 Overview of World Economy

The global economy is currently in the midst of a deep downturn, notwithstanding decisive policy measures across the globe in response to the adverse consequences of the financial turmoil. Overall, global GDP is estimated to have contracted by an alarming 6¼ percent (annualized) in the fourth quarter of 2008 (a swing from 4 percent growth one year earlier) and to have fallen almost as fast in the first quarter of 2009. All economies around the world have been seriously affected, although the direction of the blows has varied. The advanced economies experienced an unprecedented 7½ percent decline in the fourth quarter of 2008, and most are now suffering deep recessions. While the U.S. economy may have suffered particularly from intensified financial strains and the continued fall in the housing sector, western Europe and advanced Asia have been hit hard by the collapse in trade as well as rising financial problems of their own and housing corrections in some national markets.

Emerging economies too have suffered badly and contracted 4 percent in the fourth quarter in the aggregate. The damage has been inflicted through both financial and trade channels. Activity in east Asian economies with heavy reliance on manufacturing exports has fallen sharply, although the downturns in China and India have been somewhat muted given the lower shares of their export sectors in domestic production and more resilient domestic demand. Emerging Europe and the Commonwealth of Independent States (CIS) have been hit very hard because of

[1/] Sections 6.1 – 6.3 are excerpts from European Central Bank, Monthly Bulletin, April 2009 and International Monetary Fund, World Economic Outlook, April, 2009.

heavy dependence on external financing as well as on manufacturing and commodity exports. Countries in Africa, Latin America, and the Middle East have suffered from plummeting commodity prices as well as financial strains and weak export demand.

In the United States, the recession deepened in the final quarter of 2008 and economic activity remained weak at the beginning of 2009. According to final estimates, real GDP contracted by 6.3% in annualised terms in the fourth quarter of 2008, compared with a contraction of 0.5% in the preceding quarter. Personal consumption and private fixed investment remain major drags on GDP growth, as financial market strains and deleveraging by financial institutions have restricted the availability of credit. The outlook for consumer spending is further clouded by a sharp deterioration in labour market conditions and negative wealth effects stemming from house and equity price declines. In addition, export performance has been weak due to a downturn in global trade flows and deepening recessions affecting major US trading partners. Against this background, the sizeable stimulus measures under way should provide some support for economic activity. This, however, will come at the cost of increasing the projected US budget deficit for the current fiscal year to around 12% of GDP, according to the Congressional Budget Office.

In Japan, there has been a sharp decline in economic activity in recent months. Exports and imports have continued to contract sharply, falling by 49.4% and 43% year on year respectively in February 2009. According to the second preliminary data release by Japan’s Cabinet Office, real GDP contracted by 3.2% quarter on quarter in the fourth quarter (revised upwards from an estimated contraction of 3.3% reported in the first preliminary data release). The weakness in economic activity in the fourth quarter of 2008 was mainly due to the sharp fall in exports.

The pace of euro area activity declined markedly towards the end of 2008 and in early 2009. Euro area real GDP fell modestly in the second and third quarters of 2008 and then contracted very sharply in the final quarter of the year, falling 1.5% quarter on quarter. Surveys and monthly indicators point to a similarly sharp contraction in activity in the first quarter of 2009.

In the United Kingdom, real GDP contracted by 1.6% (quarter on quarter) in the fourth quarter of 2008, after a 0.7% contraction in the third quarter. Economic conditions continued to deteriorate in early 2009. Industrial production decreased by 2.6% between December 2008 and January 2009, and most recent survey indicators point to a further decline in manufacturing output looking ahead. The unemployment rate was 6.5% for the three months to January 2009 – 0.5 percentage point higher than in the previous three-month period – reaching its highest level since 1997.

Economic activity in emerging Asia recorded a marked slowdown, and even contracted in some countries, in the first few months of 2009. The negative impact of the dramatic drop in exports due to collapsing external demand spread to the domestic economy. Rising unemployment rates and weaker prospects for future income weighed on consumption in nearly all countries in the region, while private investment demand also suffered on account of the uncertain global outlook.

In China, foreign trade dropped considerably at the beginning of 2009. In January and February exports and imports decreased by 25.3% and 34.2% respectively, compared with the corresponding period last year. Industrial output increased by only 3.8% year on year in the first two months of 2009, mainly as a result of weak exports and a downward adjustment in the construction sector. On the positive side, the fiscal stimulus package approved in November 2008 considerably increased investment in infrastructure, thereby raising the annual growth rate of investment to 26.5%. Domestic consumption growth has also remained relatively resilient thus far, compared with other economies.

In Latin America, economic activity has continued to weaken on account of sluggish external and domestic demand. In Brazil, real GDP growth decelerated to an annual rate of 1.2% in the fourth quarter of 2008, from 6.8% in the third quarter. This was mainly due to a slowdown in investment and, to a lesser extent, in private consumption growth. Activity also weakened in Argentina, where real GDP expanded by 4.4% year on year in the fourth quarter of 2008. In Mexico, industrial production continued to fall in January and was 10.4% lower than it was a year earlier.

10.2 Inflationary Developments

In parallel with the rapid cooling of global activity, inflation pressures have subsided quickly. Commodity prices fell sharply from mid-year highs, undercut by the weakening prospects for the emerging economies that have provided the bulk of demand growth in recent years . At the same time, rising economic slack has contained wage increases and eroded profit margins. As a result, 12-month headline inflation in the advanced economies fell below 1 percent in February 2009, although core inflation remained in the 1½–2 percent range with the notable exception of Japan. Inflation has also moderated significantly across the emerging economies, although in some cases falling exchange rates have moderated the downward momentum.

In the United States, annual CPI inflation increased slightly, from 0% in January 2009 to 0.2% in February, but remains well below the 3.8% average for the previous year. The deceleration in recent months reflects a decline in energy costs as well as an increase in economic slack. The annual rate of inflation excluding food and energy stood at 1.8% in February, from 1.7% in the previous month.

In Japan, consumer price inflation fell further in February and was driven mainly by the increasing economic slack. Annual overall CPI inflation turned negative in February, falling to -0.1% compared with 0.0% in January. Excluding food and energy, annual CPI inflation remained negative, at -0.1%, in February.

Euro area annual HICP inflation fell further to 0.6% in March 2009, from 1.2% in February. The decline in inflation since last summer primarily reflects the sharp fall in global commodity prices over this period.

Annual HICP inflation in the UK increased slightly in February, to 3.2%, but some market surveys point to a decline to around 1.0% in 2009.

In emerging Asia consumer price inflation moderated further in most countries, allowing several central banks to continue to loosen monetary policy. In February 2009 China's annual CPI inflation turned negative, falling to -1.6% from 1% in January. The accommodative monetary policy and the fiscal measures have been reflected in very fast credit growth. At the end of February the stock of loans was 24.2% higher than one year before.

In Latin America, inflationary pressures have eased, albeit only gradually. Inflationary pressures remained strong in Argentina, however, with annual inflation at 6.8% in February 2009. In Mexico, annual inflation remained virtually unchanged, at 6.2%, in February, compared with 6.3% in January.

With inflation concerns dwindling and risks to the outlook deepening, central banks have used a range of conventional and unconventional policy tools to support the economy and ease credit market conditions. Policy rates have been cut sharply, bringing them to ½ percent or less in some countries (Canada, Japan, United Kingdom, United States) and to unprecedented lows in other cases (including the euro area and Sweden). However, the impact of rate cuts has been limited by credit market disruptions, and the zero bound has constrained central bankers' ability to add further stimulus. Some central banks (notably, in Japan, United Kingdom, United States) have therefore increased purchases of long-term government securities and provided direct support to illiquid credit markets by providing funding and guarantees to intermediaries in targeted markets, with some success in bringing down spreads in specific market segments such as the U.S. commercial paper and residential mortgage- backed securities markets. As a result, central bank balance sheets have expanded rapidly as central banks have become major intermediaries in the credit process. Nevertheless, overall credit growth to the private sector has dropped sharply, reflecting a combination of tighter bank lending standards, securities market disruptions, and lower credit demand as economic prospects have darkened.

On 18 March the US Federal Open Market Committee decided to keep the target for the policy rate unchanged, at a range of 0% to 0.25%. In order to support the functioning of financial markets and stimulate the economy, the Federal Reserve System expanded its use of non-conventional policy measures to include purchases of long-term Treasury securities.

At its meeting on 18 March the Bank of Japan decided to leave its target for the uncollateralized overnight call rate unchanged, at 0.1%, while announcing that the amount of its outright purchases of Japanese government bonds would be increased.

At its meeting on 2 April 2009, the Governing Council of ECB decided to reduce the key ECB interest rates by a further 25 basis points. The interest rate on the main refinancing operations of the Eurosystem was lowered to 1.25% and the interest rates on the marginal lending facility and on the deposit facility were decreased to 2.25% and 0.25% respectively.

On 5 March the Bank of England’s Monetary Policy Committee decided to reduce the official Bank Rate paid on commercial bank reserves by 0.5 percentage point, to 0.5%, and to undertake a programme of asset purchases amounting to GBP 75 billion financed by the issuance of central bank reserves.

10.3 Commodity Markets

In March 2009 crude oil traded around USD 45 per barrel, and picked up towards the end of the month. Brent crude oil prices stood at USD 48.9 on 1 April 2009, which is 24% higher than at the beginning of 2009. Looking ahead, market participants expect higher prices in the medium term, with futures contracts for December 2011 trading at around USD 67.

The latest projections of the International Energy Agency indicate that oil demand in 2009 will contract by 2.8 million barrels per day with respect to the peak reached in the fourth quarter of 2007. This sizeable reduction foreseen in oil demand, which has emerged in the form of repeated downward revisions to the projections for both developed and emerging economies, has, however, failed to depress prices further. Indeed, OPEC members have demonstrated their commitment to the agreed production cuts, achieving an 80% level of compliance in February 2009. This more than offset the contraction in demand and led the global oil supply to a level which is now about 3.4 million barrels per day lower than it was one year ago.

The prices of non-energy commodities slightly increased in March. Metal prices have shown some signs of recovery. More specifically, copper was supported by signs of stronger demand from China. Movements in agricultural commodity prices were mixed and were mainly driven by specific factors, with maize and soybean prices showing particular strength. In aggregate terms, the price index for non-energy commodities (denominated in US dollars) was approximately 3% higher towards the end of March than at the beginning of the year.

10.4 Exchange Rate Developments

The US dollar was strong against both the Euro and the Pound Sterling during the second half of 2008 and the first few months of 2009. The exchange rate of the US dollar against the Euro which was USD 1.56/Euro in June 2008 appreciated to USD 1.35/Euro in December 2008 and USD 1.32/Euro in April 2009. Similarly, the dollar appreciated against the Pound Sterling from USD 1.97/Pound in June 2008 to USD 1.49/Pound in December 2008 and USD 1.47/Pound in April 2009. Meanwhile, the dollar was mostly showing depreciating trends against the Japanese yen in the second half of 2008 before regaining ground again in the first few months of 2009. The yen – US dollar exchange rate which was 106.92 in June 2008 went down to 91.28 in December 2008 before going up again to 98.98 in April 2009.

10.5 Impact of Global Economic Developments on Ethiopian Economy

The global economic slump is affecting an increasingly large number of countries. Ethiopia is also expected to feel its effect via declines in the prices of its export items which can contribute to a fall in export proceeds, lower remittance inflows and reduced external aid and loans. However, there is very little evidence that the global recession has yet affected the country in a significant manner. During the first half of 2008/09, export earnings grew by about 17 percent compared to the same period last year while remittance inflows also increased by 10 percent. Official loan and grant disbursement has also not shown any visible signs of reduction. Thus, the pace of growth in export earnings and remittance inflows might have declined a little bit but there has not been significant effects of the global economic down turn on Ethiopia so far.

On the other hand, the decline in global commodity prices which accompanied the global economic downturn is contributing to easing of the balance of payments problems. For example, according to information obtained from the Ethiopian Petroleum Enterprise, petroleum imports of the country during the second quarter of 2008/09 was USD 244.4 million, which was about 30 percent lower than the amount imported during the same quarter last year