VIII. International Economic Developments

8.1 Overview of the World Economy[1]

World economic growth has slowed down somewhat in recent months. This mainly reflects a number of transitory factors, such as high commodity prices and supply-chain disruptions following the natural disaster in Japan. As the impact of these factors is gradually diminishing, the global recovery, which has become more self-sustained since the end of last year, is likely to regain momentum. However, regional differences with respect to cyclical positions persist. Growth remains rather subdued in many advanced economies, while most emerging economies are operating at close to full capacity.

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In the United States, the economy continued its recovery in the first half of 2011, at a slower pace than in the course of 2010. The US real GDP increased at an annual rate of 1.3% in the second quarter of 2011 (i.e. 0.3% on a quarter-on-quarter basis) following the annualized growth of 0.4% in

the first quarter of the year. Weak economic developments in the second quarter reflected a slowdown in personal consumption expenditure as higher energy prices dented disposable income, while purchases of durable goods – in particular automobiles – declined partly because of supply disruptions caused by the Great East Japan Earthquake. By contrast, growth in private fixed investment recovered owing to a rebound in construction activity which had declined earlier in 2011 partly because of severe winter conditions.

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[1] 8.1 & 8.2 are Excerpted from European Central Bank monthly bulletin for August & September 2011

Looking forward, the fading impact of some transitory factors affecting growth in the first half of 2011 might support the recovery in the second half of the year. At the same time, weak developments in housing and labor markets, lower confidence and growing uncertainty surrounding the US fiscal outlook might have a more lasting impact, extending the moderation in economic momentum to the second half of the year.

The Japanese economy continued to show signs of recovery, with an easing of the supply-side constraints triggered by the Great East Japan Earthquake. Industrial production increased by 3.9% month on month in June 2011, following the 6.2% growth in the previous month, implying that, thus far, industrial production has recovered almost 66% of the losses arising from the earthquake. The recovery in manufacturing production also prompted a recovery in exports. Real exports of goods rose by 8.6% in June, after increasing by 4.6% in the previous month. At the same time, consumption continued to strengthen in June, as evidenced by the rise in retail sales and household spending. Business and consumer sentiment also continued to improve, from relatively low levels.

In the United Kingdom, according to the preliminary estimates, GDP growth declined to 0.2% in the second quarter, from 0.5% in the previous quarter, on a quarter-on-quarter basis. The growth rate was dragged lower by extraordinary factors, such as an extra bank holiday.

Looking ahead, the rebound in growth is likely to remain subdued in the short term, even though monetary stimuli should support economic activity. In the longer term, growth in domestic demand is still expected to remain constrained by tight credit conditions, household balance sheet adjustment and substantial fiscal tightening.

Overall, in the other non-euro area EU countries, the recovery has continued, but the pace appears to be slower than expected in the majority of countries. Sweden has been one of the exceptions, where real GDP growth continued to be robust in the second quarter, reaching 1% quarter on quarter after an increase by 0.8% in the first quarter of 2011. Growth in Sweden has been supported by both external and domestic demand, the latter reflecting, among other factors, buoyant house prices. In Denmark, real GDP growth was very weak at 0.1% quarter on quarter in the first quarter, but rebounded strongly in the second quarter, reaching 1%, reflecting the impact of public spending and inventory accumulation.

In the largest Central and Eastern European (CEE) EU countries, the mainly export-led recovery has continued in recent quarters. However, recent released data suggest that the recovery is slower than previously expected. According to preliminary estimates, real GDP growth declined to 0.2% quarter on quarter in the second quarter of 2011 in Czech Republic and Romania, while activity stagnated in the second quarter in Hungary. The slower growth in the second quarter was partly due to weaker than expected domestic demand reflecting weak credit and labor market conditions in a number of countries. In addition, weaker external demand from the euro area also contributed to weaker than expected growth. In Poland, where domestic demand is playing a more important role in the recovery than in the other CEE countries, real GDP growth stood at 1.1% quarter on quarter in the first quarter, while short-term indicators suggest continued recovery in the second quarter.

The mainly export-led real GDP recovery has also continued in the smaller non-euro area EU economies in recent quarters. While real GDP growth slowed to 0.1% and 0.2% on quarterly bases in the second quarter of 2011 in Bulgaria and Lithuania respectively, it accelerated to 2.2% in Latvia. The fall in unemployment rate in recent months partly reflects increased labor demand in some sectors, but also labor outflows to other EU countries.

In Russia, the recovery slowed in the first half of 2011 after a relatively strong rebound in the last quarter of 2010. According to the preliminary figures, the annualized real GDP growth was 4.1% in the first quarter of 2011 and 3.4% in the second quarter. This primarily reflected weak investment demand and declining net exports on the back of strong import growth. Industrial production growth declined somewhat, reaching 5.1% year on year in July 2011 from close to 7% in the second half of last year.

In emerging Asia, economic growth moderated slightly in the second quarter of 2011, albeit from a very high level. In particular, industrial production and export growth were lower than in the first quarter of the year, partly owing to supply-chain disruptions following the Japanese earthquake. On the other hand, domestic demand, driven by private consumption and investment, continued to be buoyant in a context of rapid credit growth and monetary policies that remain accommodative.

In China, the economy continued to grow at a strong pace despite the ongoing tightening of monetary policy. In the second quarter of 2011, real GDP increased by 9.5% year on year, slightly down from 9.7% in the first quarter. Investment has remained the major source of growth, while the contribution from consumption has declined somewhat compared with the previous quarter. The trade surplus rose to USD 22.3 billion in June 2011, from USD 13.1 billion in preceding month, mainly on account of weaker import growth

In India, real GDP grew by 8.5% year-on-year in the second quarter of 2011, compared with 7.7% in the first quarter of 2011. This was driven by strong investment growth, while private consumption growth moderated slightly. In South Korea, annualized real GDP slowed to 3.3% in the second quarter of 2011, vis-a-vis 3.9% in the first quarter of 2011. The contribution of net exports and investment was weaker than in the previous quarter, while private consumption remained resilient with an annual growth rate of 3.2%.

Among the ASEAN-5 countries (i.e. Indonesia, Malaysia, the Philippines, Singapore and Thailand), Indonesia’s economy continued to grow strongly by 6.5% year on year in the second quarter of 2011, driven by private consumption, fixed investments and net exports. In Malaysia, Singapore and Thailand, real GDP growth slowed somewhat in the second quarter, mainly on account of weaker external demand and lower growth in the manufacturing sector.

Economic growth in emerging Asia is expected to remain robust in the short term. Private consumption, investment and export growth (in particular intra-regional) are projected to stay resilient. In this context, concerns about overheating might continue in a number of countries, given the persistence of inflationary pressures.

In Latin America, growth in economic activity moderated in the second quarter of 2011, albeit remaining strong. The pace of growth has been easing as policies are being tightened more aggressively, global demand growth is slowing and the volatility in global financial markets is weighing on the region's financing conditions.

In Mexico, annual real GDP growth stood at 3.6% in the second quarter of 2011, compared with 4.4% in the previous quarter, supported mainly by external demand and related service activities. The economic growth in Argentina continued to benefit from strong demand and high prices for agricultural commodities, while the accommodative policy stance continued to provide impetus to domestic demand. As a result, industrial production expanded rapidly in the second quarter of 2011, at an annual rate of 8.5%. In Brazil, there are increasing signs of an economic slowdown with industrial production growing by, on average, 0.7% year on year in the second quarter of 2011 after growing at double digit rates in the course of 2010. The transition to a slower pace of economic growth is primarily being driven by the weakening of domestic demand and, in particular, private consumption, which is the main focus of the countercyclical policies.

Looking ahead, economic activity in Latin America is expected to grow at more sustainable rates. Domestic demand will be the primary driver of growth while robust demand for commodities, in particular stemming from other emerging market economies, will support export demand.

In several of in the Middle East and North Africa countries, political instability and security challenges continued to thwart economic growth during the second quarter of 2011. On the other hand, economic activity surged in those countries (mostly members of the Gulf Cooperation Council) that introduced fiscal stimulus measures in response to the unrest. In addition, relatively high oil prices and oil output contributed to the economic growth of the oil exporters countries (except Libya) in the region.

In the oil-importing countries in the region, GDP growth stabilized at pre-crisis levels. An easing of domestic activity in several major economies and some weakness in external demand from advanced countries was partly offset by resilient (non-oil) commodity prices and the continuing robust expansion in emerging markets. At the same time, the drought in the Horn of Africa has caused a severe hunger crisis and higher inflationary pressures in the affected countries.

Despite the moderation in global growth, the economic outlook for the Middle East and Africa remains largely positive, especially for the net commodity exporters. However, the recovery from the adverse economic impact of the political turmoil in the region is expected to be protracted in many of the affected countries.

8.2 Inflation Developments

Indeed, while annual headline inflation has stabilized in advanced economies, inflationary pressures continue to be more pronounced in emerging markets, as evidenced by the continued increase in inflation rates in June 2011 to 6.4% in China and to 6.7% in Brazil. This reflects rising capacity constraints in a number of emerging economies as well as the higher weight of commodity prices in these countries' consumption baskets. In the OECD area, by contrast, annual headline inflation eased slightly to 3.1% in June 2011 from 3.2% in the previous month. Inflation excluding food and energy was unchanged at 1.7% in the OECD area in June 2011.

In United State, annual CPI inflation remained at 3.6% in June 2011, the same rate as in previous month. The increase in headline inflation since the start of the year continues to reflect the marked annual rise in energy prices of 20.1%. Excluding energy, annual inflation increased to 2.0% in June 2011 from 1.8% in last month. The upward pressure from energy prices on headline CPI inflation has eased somewhat as of late, as energy prices fell both in May and in June relative to the previous month. At the same time, the ongoing rise in core inflation suggests that the pass-through of costs will continue to push prices upwards as the economic recovery proceeds.

In Japan, annual headline CPI inflation eased slightly in June 2011 to 0.2% (from 0.3% in May 2011). Annual CPI inflation, excluding fresh food, also slowed to 0.4% in June 2011 compared with 0.6% in the previous month, while annual core CPI inflation, excluding fresh food and energy, remained at 0.1%.

In United Kingdom, annual CPI inflation has been elevated in recent months. However, it slowed down from 4.5% in May to 4.2% in June 2011. There was a broad-based deceleration in services and non-energy goods inflation, and core inflation (CPI inflation excluding energy and unprocessed food) slowed down to 3.5% in June from 3.9% in the previous month. Going forward, the gradual diminishing of certain temporary factors (higher commodity prices, the lagged effects of the depreciation of the pound sterling, and the increase in the rate of VAT in January 2011), as well as the existence of spare capacity, will contribute to the dampening of inflationary pressures.

HICP inflation has tended to moderating in the majority of other non-euro area EU countries. HICP inflation has been relatively stable in recent months, standing at 1.6% in Sweden and 3.0% in Denmark in July 2011. HICP inflation has been moderating in recent months in Hungary, Poland and Romania, mainly reflecting a declining contribution from food and energy prices and mainly for Romania, a result of the phasing-out of the base effect of the VAT increase in July 2010. By contrast, HICP inflation in the Czech Republic has remained at or close to 2% in recent months.

In Russia, annual inflation started moderating on the back of falling food price growth and stood at 8.2% in August 2011. Owing to base effects, a further and more substantial slowdown of annual inflation is expected in the second half of the year.

In emerging Asia, inflationary pressures have continued to be strong, initially because of high food and commodity prices, but increasingly also on account of rising core inflation rates. In this environment, gradual monetary tightening by way of interest rate hikes and quantitative measures has continued.

Annual CPI inflation in China accelerated to 6.4% in June 2011, up from 5.5% in preceding month. The increase in CPI inflation was mainly driven by base effects and rising food prices while non-food CPI inflation moderated slightly.

Annual wholesale price inflation – the Reserve Bank of India's preferred measure of inflation – has remained high, although falling from 9.6% in May to 9.2% in July 2011. In particular, the prices of manufactured products and commodities have contributed to the high inflationary pressures. Annual CPI inflation in South Korea stayed above the Bank of Korea's target band of 2% to 4%, rising to 4.7% in July 2011 from 4.1% in May mainly driven by the prices of agricultural products and oil.

Inflationary pressures remain elevated across most countries in Latin America countries. In Mexico, annual consumer price inflation stood somewhat lower compared with the preceding quarters, averaging 3.3% in the second quarter of 2011. In Argentina, the incipient demand pressures coupled with high commodity prices have resulted in rising inflationary pressures, with annual CPI inflation standing at 9.7% in the second quarter of 2011. Inflationary pressures continued to rise in Brazil, with annual inflation reaching 6.6% in the second quarter of 2011 higher by 0.5 percentage points from the first quarter of 2011.

In the second quarter of 2011, consumer price inflation in the oil-exporting countries was largely unchanged in year-on- year terms. The annualized inflation rate in Saudi Arabia was 4.7% in the second quarter of 2011, slightly down compared with the first three months of the year.

8.3 Commodity Markets

Oil prices showed increment in July 2011. Brent crude oil prices stood at USD 116.4 per barrel on 3 August, which are 25% higher than at the beginning of the year and 3.8% higher than at the beginning of July. Looking ahead, market participants expect lower oil prices in the medium term, with futures contracts for December 2012 trading at around USD 111.8 per barrel.

The increase in oil prices came against the background of continued robust demand figures. The International Energy Agency (IEA) has released its first demand projections for 2012, which show a solid increase in global demand. On the supply side, data for June indicate a strong increase in production in Saudi Arabia. However, the decision of the IEA to suspend the release of strategic reserves initiated in June may have added upward pressure on prices.

The prices of non-energy commodities increased moderately in the course of July 2011. Food prices posted some gains as a result of adverse weather conditions. Metal prices also increased slightly, driven in particular by copper prices. In aggregate terms, the price index for non-energy commodities (denominated in US dollars) was 2.1% higher towards the end of July than at the beginning of the year.

8.4 Exchange Rate Developments[2]

From April to early July 2011 the nominal effective exchange rate of the euro, as measured against the currencies of 20 of the euro area's most important trading partners, experienced rather wide swings. On 6 July, the nominal effective exchange rate of the euro was close to its level at the end of March 2011 and 1.1% above its average level for 2010.

In bilateral terms, in the past three months the developments in the euro nominal effective exchange rate were the outcome of partly counterbalancing movements' vis-à-vis most major currencies. The euro strengthened against the Swedish krona by 1.8%, the pound sterling by 1.3% and the US dollar by 0.8% between 31 March and 6 July 2011. By

[2] Excerpted from European Central Bank monthly bulletin for July 2011

contrast, the single currency depreciated significantly vis-à-vis the Swiss franc (7.3%) and against the Japanese yen (1.3%).

The appreciation of the euro against the US dollar did not correspond to a similar appreciation against the Chinese renminbi, as the latter appreciated by more than 1% against the US dollar. Volatility, as measured on the basis of foreign exchange option prices, increased significantly in the course of the period under review, especially in the EUR/USD and EUR/CHF currency pairs.

8.5 Impact of Global Economic Developments on the Ethiopian Economy

The external sector of Ethiopia has continued to expand largely in response of the global economic growth, though subdued in many advanced nations while moderated in emerging economies. Accordingly, the annualized growth in merchandize exports slowed to 19.2 percent in the fourth quarter of 2010/11 from 36.2 percent in the third quarter owing to the slow down in growth rates of volume and international prices of a few commodities. Similarly, official inflows of private transfers also grew by 16.1 percent year-on-year in the fourth quarter of 2010/11 compared to 34.6 percent in the preceding quarter. Estimated FDI inflows also surged by 30.1 percent in the same period.

Similarly, the annual growth rate of fuel import slowed down to 40.2 percent in the fourth quarter 2010/11 from 50.2 percent in the preceding quarter mainly due to the development of global oil price in association with the political unrest in Middle East and North Africa.