VIII. International Economic Developments

8.1 Overview of the World Economy[5]

The global activity has shown some strengthening since the middle of the year. The main impetus for growth in the world economy stems from advanced economies, which are increasingly benefitting from waning private sector deleveraging, less fiscal drag and monetary accommodation. By contrast, in several emerging market economies, structural challenges, such as infrastructure deficits, product and labor market rigidities, and domestic and external imbalances, as well as tightened financial conditions are restraining the growth potential. Geopolitical risks, relating mostly to the conflict between Ukraine and Russia and tension in major oil-producing countries remain present, but their impact on oil prices and global activity has been rather limited so far. Furthermore, a potential reversal of global risk sentiment following a period of compressed risk spreads and very low volatility in financial markets could have negative repercussions for the global economy.

Growth in global trade is recovering gradually from low levels. According to the CPB Netherlands Bureau for Economic Policy Analysis, the volume of world imports of goods increased by 0.5 percent in August on a three-month-on-three-month basis, following a revised 0.0 percent in July, driven by significant improvements in emerging market economies, notably emerging Asia and, to a lesser extent, Latin America. Meanwhile, trade momentum slowed in advanced economies, mostly on the back of weaker trade activity in the United States and the euro area. Overall, world trade developments remain volatile and are subject to high levels of uncertainty, partly owing to geopolitical tension and subdued economic activity in several world regions, suggesting a very gradual recovery of global trade going forward.

In the United States, the recovery in economic activity has become more sustained over the past six months. Following an increase in GDP in the second quarter at an annualized rate of 4.6 percent,

[5]Sections 8.1 – 8.4 are excerpted from European Central Bank monthly bulletin of September, October and November 2014.

real GDP rose by 3.5 percent at an annualized rate in the third quarter according to the first estimate by the Bureau of Economic Analysis. The expansion in the third quarter was supported by a turnaround in the contribution from net trade as exports grew robustly and imports declined, and by the continued strength of domestic demand. However, the housing market continued to be a relatively weak spot, as indicated by the rather sluggish increase in residential investment.

In Japan, the recovery in economic activity following the sharp drop in output in the second quarter of 2014 has been muted so far. Monthly indicators available up to September were generally soft, signaling that real GDP growth in the third quarter is likely to have returned to positive territory, albeit at a slower pace than initially anticipated. Despite picking up in September, industrial production has declined in the third quarter following weak demand. At the same time the rebound in private consumption has been limited in part by declines in real incomes and consumer sentiment. Meanwhile net exports of goods together with public and private (non-residential) investment are likely to have supported growth in the third quarter.

In the United Kingdom, according to preliminary estimates, real GDP growth slowed to 0.7 percent quarter on quarter in the third quarter of 2014 from 0.9 percent in the second quarter. Growth was particularly robust in the transport and communication sectors and the business services sector. In the first half of the year growth was driven by private consumption and housing investment. The labor market continued to strengthen, and the unemployment rate fell to a five-year low of 6.0 percent in the three months to August. Latest data and surveys suggest that this softening in growth will extend to the last quarter of the year. The need to repair private and public sector balance sheets and the weakness in external demand are the main downside risks to economic activity.

In Sweden, real GDP increased by 0.2 percent quarter on quarter in the second quarter of 2014, following a slight decline in the previous quarter. In Denmark, economic activity was robust at the beginning of 2014 and grew by 0.8 percent quarter on quarter in the first quarter of the year, after a weak performance at the end of 2013. These dynamics were driven mainly by domestic demand in both countries. Looking ahead, in

2014 as a whole real GDP growth is likely to gain strength in both countries.

In the largest central and eastern European (CEE) EU Member States, economic activity continued to recover in the first half of 2014, albeit at a decelerating pace. In Hungary and Poland, real GDP growth was strong in the first quarter of 2014, at a quarterly rate of 1.1 percent, but slowed to 0.8 percent and 0.6 percent respectively in the second quarter of the year. In the Czech Republic, real GDP increased by 0.8 percent at the beginning of the year, before stagnating in the second quarter. Economic activity contracted in Romania as the quarterly rate of change in GDP fell to -0.2 percent and -1.0 percent in the first two quarters of the year. Looking forward, economic activity is expected to remain resilient, increasingly supported by domestic demand. Notwithstanding risks associated with potential geopolitical tensions, exports are likely to perform well, reflecting the impact of several foreign direct investment projects that are expected to reach full capacity in the course of the year.

In Turkey, despite the domestic and external headwinds with which the economy was confronted in the second half of 2013, real GDP performed strongly in the first quarter of 2014, expanding by 1.7 percent quarter on quarter, as an ongoing slowdown in domestic demand was offset by robust export growth. For the remainder of 2014 high frequency and leading indicators point towards a continued rebalancing of output to the external sector, as the central bank's policy tightening and the implementation of macro-prudential measures to rein in retail lending in early 2014 feed into household consumption and manufacturing output. At the same time, the repeated monetary loosening since May is likely to cushion the impact of weaker domestic demand on activity going forward.

In Russia, following an already pronounced slowdown of economic growth in the course of 2013, real GDP fell by 0.3 percent quarter on quarter in the first quarter of 2014, as repercussions from the conflict with Ukraine started to take their toll on the economy. Despite high frequency indicators showing some near-term pick-up in growth, the recent escalation of the crisis has clouded the outlook. In particular, the funding restrictions imposed by the European Union and the United States on a sizeable part of Russia's banking sector, as well as renewed monetary policy tightening, are contributing to a considerable worsening of the financing environment.

In China, GDP growth slowed slightly to 7.3 percent annually in the third quarter, from 7.5 percent in the previous quarter, as the effect of the modest monetary and fiscal stimulus started to unwind. On a quarterly basis, growth decreased to 1.9 percent from 2.0 percent. Consumption and trade contributed most to growth, while the contribution from investment weakened, reflecting a slowdown in housing investment and more moderate credit growth.

Turning to other emerging Asian economies, following a period of weak economic growth, there are signs of improving prospects, as more export-oriented economies will benefit from increased demand from advanced economies. At the same time, several emerging Asian economies have significantly reduced their external imbalances, which should reduce their exposure to capital flight.

Going into more detail, in India real GDP grew in the second quarter of 2014 by a robust 5.8 percent year on year. Following the election of a new prime minister, there are more signs of a significant revival of economic confidence in India, including a strong upturn in stock markets. Furthermore, there has been a significant improvement in the current account balance from -5.3 percent of GDP in 2012 to -0.3 percent of GDP in the first quarter of 2014 following the depreciation of the rupee in 2013 and on the back of improving global prospects. This suggests that India is less exposed to contagion risks and capital flight, and also indicates improving short-term prospects for the country. Looking forward, if the new government is successful in implementing its reform agenda, there could be a boost to potential growth.

In Indonesia, following weak real GDP growth of 0.9 percent quarter on quarter in the first quarter of 2014, the election of a new president coincided with a pick-up in confidence and stronger growth of 1.2 percent quarter on quarter in the second quarter. Restrictions on credit growth over the past year helped to curb imports and contain the current account deficit.

In Korea, weak economic growth in the second quarter of 2014, at 0.6 percent quarter on quarter, was mainly due to a contraction in private consumption. In order to stimulate domestic demand following a ferry accident in April 2014, a $40 billion stimulus package was announced, which included measures such as relaxing the limits on mortgage loans and increasing the ceiling for loans to small companies.

Economic growth in Latin America slowed in the first half of 2014 after gaining some traction towards the end of last year, while developments continued to reflect divergent trends within the region.

In Brazil, the sharp tightening of financial conditions over the past year and high inflation have weighed on real wages and consumption growth. At the same time, the deterioration in business confidence and moderation in credit growth have contributed to low private investment. Real GDP growth declined in the second quarter of 2014 by 0.6 percent quarter on quarter, following a contraction of 0.1 percent in the previous quarter. The development reflected a strong drop in investment spending, which was only partially offset by the positive contribution of net exports, while consumption spending stagnated.

In Argentina, economic growth improved in the second quarter of 2014, as suggested by the economic activity indicator, which increased by 0.4 percent quarter on quarter. However, this improvement is considered to be temporary, as growth was benefitting from a boost in agricultural exports as the harvest season reached its peak.

By contrast, after a period of economic weakness in last part of 2013 and early 2014, in Mexico economic activity gained momentum supported mainly by higher external demand, as the effects of the temporary factors affecting growth last year continued to fade away. Real GDP growth accelerated in the second quarter of 2014 to 1.0 percent quarter on quarter, up from 0.4 percent in the previous quarter. On the supply side, the lift to growth reflected an acceleration of growth momentum in industry and services activities, whereas in the agricultural sector growth decelerated slightly, while remaining robust.

8.2 Inflation Developments

Global inflation softened in September on the back of falling oil prices and spare capacity. Headline consumer price inflation in the OECD area eased slightly to 1.7 percent year on year in September, down from 1.8 percent in August, primarily owing to a weaker contribution from the energy component. Excluding food and energy, OECD annual CPI inflation also softened somewhat to 1.8 percent in September.

Consumer price inflation stabilized in the United States, but further moderated in the United Kingdom, Japan and China. Looking ahead, inflationary pressures are expected to remain contained against the backdrop of output gaps that are closing slowly and weakening commodity prices.

In United States, annual CPI inflation remained steady in September, with headline CPI inflation standing at 1.7 percent which is the same as the rate of inflation excluding food and energy. Although on a monthly basis inflation was mostly supported by an increase in the food and shelter indices, energy prices posted their third consecutive monthly decline, in line with recent developments in oil prices. Looking ahead inflation is expected to increase only slowly, driven by a gradually diminishing amount of slack in the labor market, while recent oil price declines and the appreciation of the US dollar will exert downward pressure.

In Japan, in terms of price developments, annual CPI inflation continued to ease further in September. Annual CPI inflation declined to 3.2 percent in September from 3.3 percent in the previous month, driven to a large extent by a lower positive contribution from energy prices. Excluding the direct impact of the April increase in VAT, annual CPI inflation stands currently close to 1 percent, while annual CPI excluding food and energy inflation has remained in a range of 0.5 percent -0.8 percent since late 2013.

In United Kingdom, annual CPI inflation declined further to 1.2 percent in September, falling by 0.3 percentage point compared with the previous month. Consumer price inflation excluding food and energy declined to 1.5 percent in September from 1.9 percent in August. Overall, inflationary pressures are expected to remain subdued owing to moderate wage growth and the effects of the appreciation of the pound sterling. HICP inflation has remained broadly subdued over the past few months and stood at 0.5 percent in Denmark and 0.4 percent in Sweden in July.

In CEE economies, over the past few months annual HICP inflation has declined further reaching historical lows in several countries, mostly on account of low food and energy price inflation, cuts in indirect taxes and administered prices, and subdued domestic cost pressures.

In Turkey, inflation has stabilized at levels considerably above the central bank's target, as higher food prices and pass-through from the lira's depreciation are sustaining elevated rates of inflation, although both effects are expected to subside in the near term. Nonetheless, inflation expectations are high and maintain an upward trajectory.

In Russia, inflation has continued to climb further above the central bank's target, mainly reflecting the ruble's depreciation in late 2013 and early 2014, as well as rising food prices, triggering a series of interest rate hikes since the beginning of the year.

In China, inflationary pressures have also weakened, with CPI declining to 1.6 percent in September, while PPI inflation continues to be negative.

In India, inflation has been coming down over the past two years, reflecting declines in food and energy prices, as well as tight fiscal and monetary policy. However, risks have not yet abated, and food prices are particularly dependent on the monsoon season.

In Indonesia, CPI inflation fell from above 8% at the end of 2013 to below 5% in July 2014, primarily owing to lower energy prices. In Korea, although inflation has been increasing, it remained below target, and the Bank of Korea cut interest rates in August 2014 by 25 basis points to stimulate demand.

In Brazil, despite very low growth rates, the inflation rate remained elevated and prompted the central bank to maintain the main policy rate unchanged at 11 percent since the last increase in April 2014, which ended a substantial tightening cycle.

8.3 Commodity price

Oil prices, which are an important determinant of global inflation, have been declining since early July, driven by a well-supplied oil market. Brent crude oil prices stood at USD 96 per barrel on 1 October 2014, which is around 11 percent lower than one year previously. Against the backdrop of continued weak oil demand, current levels of oil supply in the market are ample and inventories are increasing. Consequently, oil prices have been under downward pressure. Despite geopolitical tensions in Russia, Iraq and Libya, global oil production remained robust as growth in US shale oil production continued to surge and Libyan oil output increased after the lifting of a year-long blockade of its export terminals. On the demand side, the International Energy Agency has lowered its global oil demand forecast for 2014 and

2015, driven in particular by weaker projections for Chinese and European oil demand. Looking ahead, oil market participants have priced in slightly higher oil prices over the medium term (December 2015 Brent futures contracts are trading at USD 97 per barrel), as geopolitical tensions in major oil-producing countries are mainly expected to affect the expansion of oil supply capacity in these countries in the future.

Non-energy commodity prices have also declined over the past month and are currently around 6 percent lower than early September, reflecting both lower food and metal prices. Food prices have continued to decline, mainly as a result of lower grain prices, with favorable weather conditions continuing to boost supplies. Metal prices have also declined, driven principally by concerns over faltering economic growth in China. In aggregate terms, the non-energy commodity price index (denominated in US dollars) is currently around 8 percent lower compared with one year ago.

8.4 Exchange Rate Developments

Over the past months, the exchange rate of the euro depreciated against the currencies of most of the euro area's main trading partners. On 1 October 2014, the nominal effective exchange rate of the euro, as measured against the currencies of 20 of the euro area's most important trading partners, stood 1.8 percent below its level at the beginning of September and 3.1 percent below its level one year previously. Movements in exchange rates were largely related to developments in expectations about future monetary policy, as well as to adjustments in market expectations regarding the economic outlook for the euro area relative to other major economies.

In bilateral terms, since early September, the exchange rate of the euro depreciated markedly against both the US dollar (by 4.0 percent) and the pound sterling (by 1.5 percent), but strengthened against the Japanese yen (by 1.1 percent). Over the period under review it also depreciated overall against the currencies of the major emerging market economies. Meanwhile, changes against currencies of other EU Member States over the past month were mixed but of low magnitude, ranging from a depreciation of 0.9 percent vis-à-vis the Czech koruna to an appreciation of 0.4 percent vis-à-vis the Croatian kuna. The Lithuanian litas and the Danish krone, which are participating in ERM II, have remained broadly stable against the euro, trading at, or close to, and their respective central rates.

8.5 Impact of Global Economic Development on Ethiopian Economy

During the period under review, the strengthening of the global economic recovery to some extent affected the external sector of Ethiopia. While export increased by 14.1 percent due to increased value and volume of major export commodities, net private transfers and net official transfers rose by 0.7 percent and 11.8 percent, respectively, in relation to last year same period. The net capital inflow also increased by 214.2 percent vis-à-vis last year same period. This was due to the rise in inflows of net official long-term capital (158.3 percent), other public long-term capital (105.3 percent) and foreign direct investment (105.2 percent).

However, despite the gradual recovery of the global economy, net services receipts fell by 83.4 percent due to declines in net travel services (69.2 percent) and net transport services (18.2 percent).

On the other hand, imports have risen by 26.6 percent vis-à-vis last year same period mainly driven by larger values of capital goods, consumer goods and semi-finished goods.

Consequently, the significant rise in current account resulted in USD 388.6 million balance of payments deficits narrowing in relation to the same period last year.