

9. International Environment

The International Monetary Fund adjusted upwards the global growth rate forecast given that recovery is faster than expected. Like in the previous quarter, China is the champion of growth amongst developing countries while East European countries are at the bottom of the list. States, which witnessed a plunge in the prices of their sovereign bonds during the crisis in Greece, should immediately launch reforms to keep future fiscal deficits in check. The European Union and the IMF forged an agreement on a historic 750 billion euro package to provide security to countries that may have difficulties in repaying state debts. A 110 billion euro package of measures to bail out Greece has also been agreed. The record high price of gold is ascribed to fears of inflation and increased currency risks.

World

The International Monetary Fund adjusted upwards its projection of the world growth rate in 2010 by 0.5%, to 4.25%. Recovery is faster than had been expected, primarily thanks to expansive monetary and fiscal policies agreed in most countries. Given that economic development still hinges on these measures, their abolition remains uncertain for now. Although countries have been pulling out of the crisis at different pace, China is clearly in the lead. Amongst the developed countries, the US has seen faster growth than Europe or Japan, while the Eastern European region faces the greatest difficulties amongst developing countries. Forecasts are that the developed countries will have a 2.25% and the developing countries a 6.25% growth rate in 2010. The growth rate in Eastern European countries is projected at 2.8%¹.

Table T9-1. World: Economic Growth and Inflation, 2007-2010¹⁾

	Real GDP							Inflation		
	real growth (%)			real growth, seasonally adjusted (%)				y-o-y (%)		
	2007	2008	2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q3 2009	Q4 2009	Q1 2010
USA	2.2	1.3	-2.4	-0.7	2.8	5.7	3.2	-1.6	1.4	2.4
Canada	2.5	0.6	-2.6	-0.9	0.1	1.2	..	-0.9	0.8	1.6
Japan	2.1	-0.4	-5.2	1.3	0.0	1.1	1.2	-2.2	-2.0	-1.2
China	11.4	9.0	8.7	7.9	9.1	10.7	13.1	-1.3	-0.4	2.2
Euro area	2.7	0.7	-3.9	-0.1	0.4	0.1	0.2	-0.4	0.4	1.1
Germany	2.5	1.0	-4.9	0.4	0.7	0.0	0.2	-0.2	0.4	0.8
France	1.9	0.7	-2.2	0.3	0.2	0.6	0.1	-0.4	0.4	1.3
UK	3.1	0.7	-4.8	-0.7	-0.2	0.1	0.2	1.5	2.1	3.3
Italy	1.7	-0.9	-4.7	-0.5	0.6	-0.2	0.5	0.1	0.7	1.3
Russia	8.1	5.6	-7.9	-10.9	-8.9	1.9	2.9	11.4	9.2	7.2
Bulgaria	6.1	6.0	-5.0	-4.9	-5.4	-4.8	-4.0	0.8	0.9	2.0
Romania	6.0	7.1	-7.1	-8.7	-7.1	-6.6	-2.5	5.0	4.6	4.6
Hungary	1.3	0.6	-6.3	-6.8	-7.1	-5.3	0.9	5.0	5.2	6.1
Croatia	5.6	2.4	-5.8	-6.3	-5.8	-4.5	..	1.3	1.6	1.0
FYR Macedonia	5.9	4.9	-0.7	-1.4	-1.8	1.2	..	-1.4	-1.6	0.5
BIH	6.0	5.9	-3.4	-1.4	0.0	1.0
Serbia	7.1	5.4	-3.0	-4.2	-2.3	-1.6	0.9	7.9	5.9	4.4

Sources: Eurostat, OECD, National Bank of Bulgaria, National Bank of Romania, National Bank of Republic Macedonia, Russtat, State Bureau of Statistics of the Republic of Croatia, National Statistical Institute of Bulgaria, State Statistical Office of Republic of Macedonia, National Bureau of Statistics of China.

1) The GDP growth rate for the USA is the seasonally adjusted annual rate; the growth rate for other OECD countries is seasonally adjusted quarter on quarter, while the rate for the other countries is adjusted quarterly, year-on-year.

The crisis in Greece has not been resolved yet. Growing uncertainty of it spreading to Portugal and Spain, alongside the recent unrest in Greece, raised tensions amongst investors and led to the euro's plunge. This is why a package of measures worth 750 billion euros has been adopted, but it remains to be seen whether it will suffice to allay the investors' apprehensions.

The expansive fiscal policy in developed countries led to the increase in the budget deficit to around 9% of GDP. Forecasts are that the public debt of this group of countries will rise to over

¹ Although Serbia belongs to this region, comparison with its immediate neighbors is more relevant (see Box 1 Section 3: Economic Activity in this issue of *QM*). Poland and Turkey are credited the most for the higher growth rates in the Central and Eastern European region than the ones achieved in the neighboring countries.

100% GDP in 2014, which equals circa 34 percentage point growth compared to the pre-Great Recession level². Countries with high risk premiums on their securities ought to begin cutting state spending immediately. Most of the other developed countries will probably face a fairly restrictive policy in 2011 and would do well to plan medium-term fiscal reforms.

Eurozone

After stagnation in the last quarter of 2009, the GDP growth rate stood at 0.2% q/q in Q1 2010. Growth in France and Spain stood at 0.1% q/q, and at 0.2% q/q in Germany, but was somewhat higher in Italy – 0.5% q/q. More detailed data will not be available before early June, but there is no doubt that the industry sector's contribution to growth was significant. In Q1, industrial production recorded the highest growth (4% q/q) since the early nineties. Global demand is recovering, while the euro weakened quite a lot. Both of these developments led to the consolidation of industrial production.

The construction sector in the eurozone probably contracted due to poor weather, especially in Germany. This sector is therefore expected to encourage growth in the following quarter, once construction work continues. Domestic demand is still weak and, despite recovery, the capacity utilization rates are still not much higher than the record low level recorded during the recession. Investment growth is probably still low. The GDP is expected to continue growing in the following quarters, but recovery will be gradual.

Italy's 0.5% growth in Q1 came as a surprise after the 0.3% q/q decline in Q4. Although all GDP growth components contracted in late 2009, exports and the inventory growth appear to have contributed to the unexpected positive growth. Surveys show that export companies are forecasting increased deliveries. Exports to non-EU member states are also gaining in significance. Exports to China in the first two months of 2010 stood at as many as 32.7%. Companies focusing on the markets in China, India and Brazil will play a crucial role in the rise in exports and the overall economic activity in Italy. If Italian companies position themselves strongly in these markets, medium-term stability will be easier to achieve; only one third of the goods are exported to developing countries now. Competition will be strong because other eurozone member-states are also fighting for these markets – Germany in particular.

Although Italy is frequently mentioned alongside Greece in the context of the state debt problems, its budget deficit stood at a mere 5.3% GDP, which is below the eurozone average, but the total percentage of its public debt to GDP ratio was high – 115.8%. Notwithstanding the quite restrictive fiscal policy, the interest rate on Italian securities grew significantly during the crisis in Germany due to fears that Italy may encounter serious problems in repaying its public debt in the event of a credit crunch and lesser demand for eurozone state securities.

Total inflation in the eurozone stood at 1.1% in Q1. Inflation at the monthly level increased in March due to the low base of food and fuel prices and the rise in the price of oil in March. Core inflation, which accounts for around 70% of total inflation, is on a downward trajectory due to the economic circumstances. The impact of unused capacities is expected to continue adversely affecting core inflation, while the growth rate of labor costs, the main factor of core inflation, is expected to continue falling. Total inflation is projected at 1.4% in 2010, which is quite lower than the ECB's 2% target. This is why an increase in the policy rate is not expected before the latter half of 2011.

The labor market is expected to consolidate in the second stage of economic recovery; greater personal spending will thus further stimulate production. Instead of declining, unemployment increased in Q1. The unemployment rate grew to 10.1% in March notwithstanding the significant rise in industrial production. The situation was more complex in this economic cycle because manufacturers are still hesitant about employing workers, while the euro crisis has merely exacerbated the business climate.

² This phrase is used for the recession that ensued after Lehman Brothers collapsed. Since it is the greatest recession after the Great Depression, the economists dubbed it the Great Recession.

Exports grew by 13% and imports by 9% y/y in Q1, but insufficiently to yield a surplus in the period. The trade deficit amounted to two billion euros, an improvement over Q4 2009, when it stood at 11.5 billion euros. Exports to China grew by as many as 46% year over year in the first two months of 2010, while the growth rates of exports from and imports to the United States were negative (-2% and -12% respectively). China is becoming an increasingly important trade partner of developed countries because it increased imports from this group of countries after the crisis.

After several-month talks, a package of measures worth 11 billion euros was agreed to bail out Greece. Greece thus secured funding of its state spending over the next three years. The European Union and the IMF subsequently agreed a historic package of financial measures, totaling 750 billion euros, to mitigate the crisis in the state securities market - 440³ of the 750 billion euros will be provided by the eurozone members, 60 billion by the EU Emergency Fund⁴ and 250 billion by the IMF. The European Central Bank (ECB) said it would begin buying the eurozone member-states' bonds to ensure the liquidity and depth of the financial markets. Three- and six-month repo operations, abolished after the recession ended, have also been reintroduced. The FED reopened swap lines with other central banks to ensure a sufficient inflow of dollars and prevent a panic-induced plunge of the euro.

The 440 billion euros are not immediately available; if necessary, a special body⁵, will borrow from eurozone member-states and then lend the funds to countries asking for assistance. The legal clause preventing a eurozone member from assuming responsibility for the public debt of another member has thus been sidestepped. This mechanism has to be ratified by the member-states' parliaments.

Budget spending cuts are to amount to around 40 billion euros or around 0.4% GDP of the eurozone this year. Plans are to cut budget spending in 2011 by around eight billion euros, or by 0.9% GDP. Investors fear that the latest austerity measures may adversely affect growth in Europe. However, according to a Merrill Lynch analysis⁶, although the initial austerity measures were raised by another 0.5 percentage points of the eurozone GDP during the deterioration of the crisis in Greece, projections are that growth should not be sharply adjusted downwards. Growth in 2010 was adjusted from 1.7% to 1.4% before the latest austerity measures. As the euro exchange rate declined more than had been expected, Merrill Lynch analysts predict that this will encourage eurozone exports and more or less reverse the adverse effects of the additional austerity measures over the past six weeks during which the crisis culminated. The main risk comes not from the austerity measures but from the credit crunch similar to the one that ensued after Lehman Brothers went bankrupt.

United States of America

According to initial results, the GDP grew by 3.2% in Q1⁷. Growth in the US was positive for the third consecutive quarter and the trend is likely to continue, albeit at a somewhat lower level. BNP Paribas expects the 2010 annual growth to range between 2 and 3 percent. Although company surveys and better labor market conditions suggest stronger growth, some components of demand, above all state spending and investments in infrastructure, will contribute less. Although growth was lower in Q1 2010 than in Q4 2009, the breakdown of components that contributed to growth is more favorable. Growth was based more on final demand than on increased levels of supply. Exports witnessed lower growth than imports, which also indicates that conditions in the domestic market are improving.

Real spending has increased because households decreased their savings rates. State spending has declined for the second consecutive quarter because the rise in costs at the federal level could

³ European stabilization mechanism.

⁴ EU Emergency Fund.

⁵ Special purpose vehicle.

⁶ "How much of austerity?", May 17, 2010, Bank of America Merrill Lynch.

⁷ Seasonally adjusted annual growth rate.

not make up for the fall in expenditures at the level of the states. Residential investments dropped visibly, which indicates the lack of solid recovery in that market and reduces the likelihood that recovery will be V-shaped.

Total inflation in Q1 stood at 2.3% with the tendency of declining, because mild deflation was recorded m/m in April. Core inflation in Q1 stood at 1.3%, below the informal target, wherefore the FED can continue implementing its accommodative policy without fear that it will cause inflation in the short term. The policy rate was not changed.

The situation in the labor market is obviously improving, as corroborated by the 290 000 increase in the number of non-agricultural jobs in April, while the data for March and February were revised upwards by 121 000. The average work week increased from 34 to 34.1 hours. Employers usually hire new workers after the number of working hours per week increases. An increase in the number of working hours also brings additional income to the workers, which increases spending. Another positive aspect of this development is that most of the new jobs are in the private sector, 231 000 vis-à-vis only 59 000 in the public sector, which means that the real sector is starting to “pull” recovery. The rise in the unemployment rate from 9.7% to 9.9% appears as bad news at first glance, but actually bodes well. The rate increased due to the return of the inactive population to the labor market, which is another sign of recovery. The participation rate grew by 0.3 percentage points, to 65.2%.

The trade deficit in Q1 stood at 153.4 billion USD, rising by 23.7% over the same period last year. The much slower growth of exports over Q4 2009 should be ascribed to the high volatility of the series and not be qualified as a major slowdown. Surveys suggest continued growth of export orders. The trade deficit with China finally fell from 263 to 228 billion in the March 2009–March 2010 period. Exports to China grew at a higher rate than total exports, while imports from this country grew at a slower pace than total imports. Interestingly, exports to developing countries have been growing at a faster rate than exports to developed countries. Exports to Europe are particularly weak. At the annual level, exports to Europe grew by 2.4% and total exports by 20.1%. Exports to Europe were weak because of the poor demand in Europe and the strong euro and they now account for only 13% of total exports. Trade with developing countries has been gaining in momentum, possibly indicating rebalancing of global spending from the developed countries to emerging markets, which, in the IMF’s view, is necessary to rapidly exit recession and avoid double dipping.

East Europe and Neighboring Countries

Bulgaria

Bulgaria’s GDP declined 4% y/y in Q1, i.e. less than in Q4 when it fell by 5.4% y/y. Economists had predicted a 3% contraction. Domestic demand accounted the most for the contraction, because personal spending fell by 6.8%. Fixed investments visibly improved – they decreased by 15.8%, much less than in Q4, when negative growth stood at 26.9%. Imports grew more than exports. The Bulgarian government adjusted its 2010 growth projections to 1% (from 0.3%), as opposed to its central bank, which forecast 0.5% growth.

Bulgaria pulled out of deflation in December 2009 and annual inflation stood at 2% in April. Monthly inflation in April stood at 1.1%, i.e. it was much higher than in the preceding months. If Bulgaria is to fulfill the Maastricht criteria for joining the eurozone, its inflation may be no more than 1.5% higher than the average of the three best-performing EU member states. The Central Bank raised the policy rate from the record low 0.17% to 0.18%. The Government predicts a 2.2% annual inflation in 2010 while the central bank projects it to range between 1.5% and 2.5%.

Bulgaria recorded a 5% contraction in 2009. The measures to cut state spending have adversely affected domestic demand, wherefore the growth rate in 2010 is expected to approximate zero

or be mildly negative. The solution to the problem is seen in external demand - the growth of exports would encourage recovery. Devaluation could make exports more competitive but the lev is currently fixed to the euro and reducing the value of the national currency is not a desirable option because, in his election campaign, Prime Minister Borisov vowed that Bulgaria would join the eurozone. Moreover, around 60% of the corporate loans are denominated in euros and a severe devaluation would make a part of the companies insolvent.

Romania

Romania's GDP growth rate in Q1 was negative (-2.5%) but still better than the projected -3.4%. Nevertheless, the IMF adjusted Romania's growth rate downwards. Zero growth is expected in 2010. As only *flash* data, which are often imprecise, have been published, it is impossible to draw reliable conclusions on the structure of the GDP in Q1.

The total annual inflation was at its lowest in the last three years at the end of Q1, when it stood at 4.2%. After a rise in inflation in January, its monthly growth rate fell to 0.2%. The mild growth of monthly inflation in April was above all caused by the increase in the food prices. The central bank cut the policy rate by 25 basis points - to 6.25% to encourage the economy's growth and liquidity during the disinflation period. The central bank projects total inflation will reach 3.5% in 2010 and fall to 2.7% in late 2011.

The Government pledged to cut the budget deficit from 7.4% to 5.9% by dismissing 100 000 workers from public companies and freezing wages. The unemployment rate is expected to grow to 9% and result in a decline of personal spending. The negative growth rate is expected to persist in Q2 given lesser retail and credit activity in Q1.

Romania had difficulties fulfilling the requirements laid down in the plan it agreed with the IMF, because political disagreements prevented the parliamentary endorsement of the budget. This happened after the presidential elections, but trade unions, whose members work in public services, are the chief obstacle to the implementation of the measures agreed with the IMF. The trade unions have been pressuring the government to raise the salaries of the state sector employees but Romania's budget deficit increased after the crisis and the ruling coalition is having trouble fulfilling IMF's requirements and simultaneously preserving the electorate's support.

Asia

China

China's GDP grew by 11.9% y/y in Q1. Its growth was higher than in Q4, when it stood at 10.7% and it exceeded the expectations (11.5%). This was the highest quarterly growth of the GDP in the last two years. Domestic demand was the main motor of growth, as opposed to the previous period. The nominal growth of retail trade stood at 17.9%, much more than in Q4 (15.4%). Investments in infrastructure grew by as many as 26.4% because the state is encouraging and funding such projects. Imports grew much more than exports wherefore net exports have been contributing to growth less and less. Imports grew by 64.6% and exports by "only" 28.7% y/y in Q1. The nominal trade surplus thus dropped by as many as 76.7% over Q1 2009.

How to rein in the explosive growth of real estate is currently the main issue in China. All indications are that a balloon has been formed in the real estate market and that it may have extremely adverse effects on the macro-economic balance unless economic policy measures restrain the growth of real estate prices. This has led some Western economists to speculate that the Chinese central bank may soon raise the policy rate. Given that China in a way is the engine of global economy after the Great Recession, an abrupt tightening of the monetary policy in China would seriously retard global growth. This would increase the prospects of this recession double dipping. If the raising of the policy rate in China coincides with a crisis in the eurozone, it may

result in a synergetic effect which would undermine global economic recovery and cause a relapse of negative growth.

Japan

Japan's GDP grew by 1.2% q/q in Q1. Industrial production rose by 6.7% in the same period, due to the increase in exports, particularly to East Asian countries. Exports to China were 50% higher in March 2010 than in March 2009. The level of supplies grew in the industry sector and the rise in profitability led the major companies to begin investing in capital equipment.

Apart from the manufacturing sector, the tertiary sector also recorded growth (1.1% q/q) due to increased personal spending. The latter increased by 2.8% in Q1 year over year. The government measures, encouraging the purchase of eco-products and low emission cars, are losing in momentum. An increase in the purchase of other types of products has been observed in the past few months, indicating rising economic expectations of households.

The abatement of deflationary pressures has positively impacted on economic growth. The growth rate is expected to reach 2.7% in 2010 and 2% in 2011, which is much higher than the 0.8% potential growth rate in Japan. Although the degree of capacity utilization will increase, it remains to be seen whether Japan will finally manage to pull itself out of the long period of deflation.

Currencies and Commodities

The price of oil was on the upward trend despite the strengthening of the dollar in Q1 because investors began buying oil to avoid currency risk exposure. The investors' opinion, however, changed in the first week of May, when the crisis in Greece culminated and the price of oil was adjusted by over 25%, so that it now stands at around 70 dollars. Credit crunch risk in Europe has grown and it may seriously affect the global growth rate and, thus, the price of oil. Interestingly, investors had earlier bought oil to protect themselves from the fall of the dollar, but their prices began to be positively correlated in Q1, which indicates a change in the investors' investment motives.

The price of gold soared, approximating the record high 1250 USD, but then fell to under 1200 USD. Gold is becoming an investment with the aura of a safe haven because precious metals assume the role of a hedging instrument at times of high currency risks and increasing fears of inflation brought on by the inflated balance sheets of the developed countries' central banks.