

## SNAPSHOTS FROM ACROSS THE GLOBE

*The global economy is in a state of flux today with different pictures emerging from across the globe. The immediate concern is of course Ireland, where a crisis has generated hysteria in the markets.*

### **Burning issues: It's now Ireland**

The genesis of the crisis in Ireland is centered on growth built around the property market which has collapsed since 2008. Home values have fallen by between 50% and 60% leading to NPAs on account of developers defaulting which have affected the country's main banks. The bailout for these banks by the government involved around 4 bn Euros which has in turn put pressure on the Irish government's finances where it is expected that the budget deficit will ascend to 32% of GDP this year. Another challenge facing the country is the very sharp deterioration in tax revenues. As the economy has slowed, unemployment has risen, and there are fears that the country is about to experience a double-dip recession.

### **Why should we bother?**

This has implications for weak euro economies such as Spain and Portugal as the common elements between them are severely stretched government finances, which make lenders in the financial markets worry about whether they will be repaid, and therefore wary of making new loans. The worry is that if Ireland is in trouble, then other weak euro zone countries might be too. It was the same in March-April when the Greek crisis unfolded.

### **Possible contagion impact**

The manifestation of this fear is witnessed in increased cost of borrowing in international markets (where the credit default swap rates are at 530 bps in Ireland and 950 bps in Greece). The problem is more acute for the other countries that are relying on markets to borrow money on account of increased risk perception. In fact the reverberations were also heard in the USA where the 10-year yields have already moved up towards 2.91% from the rather stable 2.46% witnessed in the last couple of months.

### **Chinese dilemma**

The other crisis zone is China where inflation has raised its head at 4.4% against a target of 3% maintained by the central bank. High inflation in particular means that there are doubts on sustainability of growth in this region as it could lead to policy action given the possibility of social unrest. Growth trends otherwise appear to be steady (to be discussed subsequently). High inflation tends to make even conservative savers turn more speculative in terms of investment. Matters are serious here given that China has already increased its reserve requirements which now are as high as 18% for the large banks in a bid to curb excess credit creation.

The unresolved issue of G20 is policy response to monetary easing in the west. The USA will continue with monetary easing by buying up

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bonds and inducing fresh currency to support the economy. While some countries like China, Colombia, South Africa and Turkey are accumulating dollars, others like Brazil, Indonesia and Thailand are taxing inflows.

### **Growth Perspectives for 2010**

Industrial production in USA remained flat in October after declining by 0.2% in September. However, retail sales was buoyant growing by 1.3% in this month and it is expected that there will be a pick up in the next two months till the end of the year on account of the approaching festival of Christmas. This is reflected in the business confidence levels in November as well as lower jobless claims. The retail sales increase was driven by consumer spending on motor vehicles and parts followed by building materials and garden equipment. Consumer spending, which is yet to reach its pre-crisis level, accounts for 70% of GDP and has been weak during the recovery, unlike business investment spending. Hence the recent retail sale increases bodes well for the contribution of personal consumption to GDP in the last quarter of the year. However, new housing starts registered a slowdown in October, the lowest annual pace since April 2009 which could drag down Q4 GDP growth. But, with the Fed pursuing the quantitative easing programme for credit availability, economic activity may get the required boost.

*Mixed signals, but, the USA may just be back on track*

Japan's GDP expanded at a 3.9% annualized pace in Q3 after expansion of 1.8% in Q2. Consumer spending was once again responsible for this performance as Japanese households took advantage of the government's incentive program for automobile purchases neared its expiration. Consumption accounts for around 60% of GDP just as it is in India. The government is expected to extend the stimulus program by another 500 bn yen with another incentive program for household appliances to dampen the effects of a strong yen and hence support consumer spending into next year.

*Government providing the impetus in Japan*

Germany has continued to witness strong growth impulses through the year with consumer spending providing a boost to the economy. Industrial output however declined by 0.8% in September, after posting a 1.5% increase in August. Output of manufactured goods was down 0.6%, with increased energy output of 1.2% and construction activity of 0.4% supporting the overall production index for the month. While demand for German manufactured goods is expected to remain positive for the remainder of the year, the dynamic growth seen in the first half is unlikely to be sustained. Increasing fiscal tightening by European governments taken along with a strong euro and weakening world trade growth are slowing demand for German manufactured goods. The business Sentiment index however, has increased from 72.6 to 81.5 in November and is expected to increase in December too.

*Euro region presents a mixed picture*

France and Italy on the other hand has witnessed weaker growth with industry expanding by just 0.1% in September in France and 2.1% in Italy.

China posted strongly positive real GDP growth of 9.6% in Q3 fueled by rapid expansion in domestic demand. The government responded to signs of tightness, including the firming of inflationary pressures, by hiking policy rates—although real interest rates remain marginally negative. This growth reflects strong domestic demand and is consistent with a pick-up in industrial production of 7.9% in Q3, after a slowdown during the summer season to 3.9% in Q2. Robust retail sales underscore vibrant domestic activity. Inflationary pressures have been picking up since Q3 which is a concern. The contribution of net exports to growth was negative in Q3 as goods export growth slowed to 4.1% from 33% in Q2, while imports rebounded to 9% after declining 7% in Q2.

*The Chinese engine chugs on*

### **Inflation developments**

Inflation continues to rule at higher levels in case of the developing economies, while prices in developed nations have also started moving up, notably in UK where central banks may reassess their stance to interest rates. Bank of England has targeted 2% inflation and the present level of 3.1% may not be acceptable if it persists at this level. This would most certainly impact the future of monetary policy which in turn has taken an unchanged view with the USA, ECB and UK not changing interest rates so far this year. The reason for higher inflation has been attributed more to higher prices of farm products and hence supply shocks rather than demand pull pressures. However, as seen in India, such inflation may also be combated by conservative monetary policy measures.

### **Interest rates**

Interest rates have been held constant by the central banks of most developed countries to enable the continuation of the stimulus packages. The US has gone in for QE2, whereby it will be buying back \$ 600 bn of bonds to provide liquidity in the system. Given the crisis in Greece, followed by Ireland, such measures may continue to prevail that will keep pressure on monetary easing and hence lower interest rates for some more time. However, the emergence of inflation would be the countervailing force that will cause central banks to reconsider options. It is still a matter of conjecture as to whether or not some of them would consider increasing rates; and when this would happen.

### ***Inflation rates***

<b>Country</b>	<b>CPI (%)</b>
USA	1.6
Japan	-0.9
China	3.0
UK	3.1
Euro	1.6
India	11.4
Indonesia	5.2
Thailand	3.3
S Korea	3.1
Argentina	10.7
Brazil	4.9
Mexico	4.1
Russia	6.7

*Source: Economist*

*Interest rates will now be driven by inflationary concerns once growth concerns stabilize*

The tables alongside shows that GSec yields are higher for the selected emerging markets, though these rates for the developed nations have shown an increase over the last couple of months. The developing nations have already started increasing rates which includes China, Australia, India and South Korea. Clearly, the inflationary concerns are more palpable today and once again the tradeoff between monetary easing and potential inflation will weigh heavily on central banks. High interest rates typically deter investment which in turn will affect future growth.

### Currency movements

The global economy has been subjected to a multitude of economic and political currents that have determined exchange rates. With global funds flowing to the emerging markets, there should have been a tendency for their currencies to appreciate as they often have overwhelmed the current account deficits that prevailed. However, given the negative impact on trade flows, countries have resisted comparable appreciation which led to the discussions in Seoul. The table alongside gives a snapshot of the large holders of forex reserves, current account deficits, and changes in exchange rates vis-à-vis the USD over a year. As can be observed the emerging markets have all been revaluing their currency over a year and hence their concern over loss of export competitiveness on account of funds flows is justified, which has also been reiterated by the G20 in its recently concluded Meet. Also those with high current account surpluses are the ones which are rich in oil reserves or are foreign trade oriented economies such as those in East Asia.

### Yields on 10-Year GSecs as on Nov

Country	%	Country	%
USA	2.62	China	3.02
Euro	2.42	India	8.26
Japan	0.94	S Korea	4.33
UK	3.11	Russia	5.36
Canada	3.02	Brazil	6.16

Source: Economist

### Currency changes over November

Country	CAD/ GDP (%)	Forex reserves \$ bn	% change in exchange rate
China	+4.9	2,648	-2.1
Russia	+4.3	464	-5.2
S Arabia	+11.6	435	Nil
Taiwan	+9.3	380	-6.5
S Korea	+3.2	290	-7.2
Brazil	-2.7	273	-2.9
India	-1.7	269	-6.1
Hong Kong	+8.3	267	Nil
Singapore	+18.4	214	-7.6

Source: Economist.

CAD: Current account deficit.

Exchange rate is over November.

Forex reserves vary from Aug to Sep for various countries

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