

**Snapshots across the World** *August 13, 2010*

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**Overview**

The global economic environment has become volatile not just in terms of movements in monetary indicators such as interest rates, prices or currencies, but also growth prospects. The Greek crisis turned around the recovery process across the globe, while the bail-out package introduced subsequently appeared to have enabled some of the concerned countries to recoup some losses as they tried to return to their growth paths.

Different countries are following varied approaches to growth – choosing between gradual exit policies to maintaining the status quo of 2009. There has been no unique path chosen as may have been expected in early January when most countries spoke of a phased withdrawal of the fiscal stimulus. Countries have evidently looked at their own local conditions before taking a decision on the course to pursue.

The images presented by different countries are captured here as of August – the month is critical since the dynamic environment may turn the pages quite rapidly to depict a different view in September. Therefore, these images need to be viewed with some degree of flexibility.

While the US appears to have slowed down, the Euro region has a mixed picture to present driven mainly by Germany. UK seems better off in Q2 relative to Q1. Japan still has a problem with its strengthening currency, which has become a major concern for its exports, as it is the prime driver of economic growth. China appears to have slowed down, though the belief is that this has been a conscious move which is unlikely to be sustained.

Monetary policy has been unchanged in the three major regions: US, Euro and UK. Indications are that until inflation becomes a major issue, monetary authorities are unlikely to be in a hurry to alter interest rates.

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### **What is happening in USA?**

- The pace of recovery in output and employment has slowed down in recent months.
- GDP growth in Q2 was 0.6% as against 0.9% in Q1.
- Household spending is increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing and tight credit.
- Business spending on equipment and software is rising. But, investment in non-residential structures continues to be weak and employers remain reluctant to add jobs.
- Housing starts remain at a depressed level while bank lending continues to contract.
- The sharp rise in the US trade gap in June to \$49.9 bn was higher than expectations and reflected a surge in imports of consumer goods and cars. Imports of capital goods, used in industrial production, also rose, but raw materials and components fell. This is estimated to have reduced GDP on an annualized basis by 2.8%.

### ***Future views***

- It is expected that there will be a gradual return to higher levels of resource utilization though the pace of economic recovery is likely to be more modest in the near term.
- Economists feel that the global economy was failing to provide enough demand for US goods and services, with many countries trying to export their way out of recession.
- Goldman Sachs and PIMCO reckon a 25% to 30% chance the U.S. economy will fall back into a recession.
- A Bloomberg poll indicates that GDP will expand at a 2.55% in the last six months of 2010, down from the 2.8 percent pace projected in July.
- Inflation has trended lower in recent times. With substantial resource slack restraining cost pressures and longer-term inflation expectations stable, inflation is likely to be subdued for some time.

### ***What has the Fed decided to do?***

- Maintain the Federal funds rate at 0 to 1/4 %.
- Federal Reserve's holdings of securities would be maintained at their current level by reinvesting principal payments from agency debt and MBS in longer-term Treasury securities.

The US Federal Reserve has hence taken steps to extend its crisis-era monetary policy regime and has downgraded its view on the economic outlook amid rising fears of a "double-dip" recession. It also agreed to begin reinvesting more than \$150bn in annual proceeds from maturing mortgage-backed and agency securities into Treasury debt. This move signals a significant shift in thinking at the Fed, which only a few months ago was tilting towards tightening monetary policy to fend off inflation as the economic recovery gathered strength.

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## **Is UK different?**

- Output growth increased sharply in Q2 by 1.1% as against 0.3% in Q1, although some of this increase in growth is likely to be temporary. If this is averaged across the first half of 2010, growth would be close to its long-run average rate but still 5% less than the pre-recession peak.
- The recent increase in employment suggests that labour demand may be starting to recover. But there remains a considerable amount of slack in the labour market.
- Companies' effective supply capacity is likely to have fallen in the recession and substantial degree of spare capacity remains. There are now signs that it may be starting to close.
- The strength of the recovery will depend on whether private sector saving falls back as fiscal policy tightens, and on the support to net trade from the lower level of sterling and the recovery in global demand.
- CPI inflation was 3.5% in Q2, well above the 2% target. Inflation is likely to fall in the near term, as upward pressure from past increases in oil and import prices wanes. But inflation is likely to remain above the target for longer than was anticipated because of the forthcoming increase in the standard rate of VAT to 20%.
- The Bank rate has been retained at 0.5% and the next review will be on September 9th.

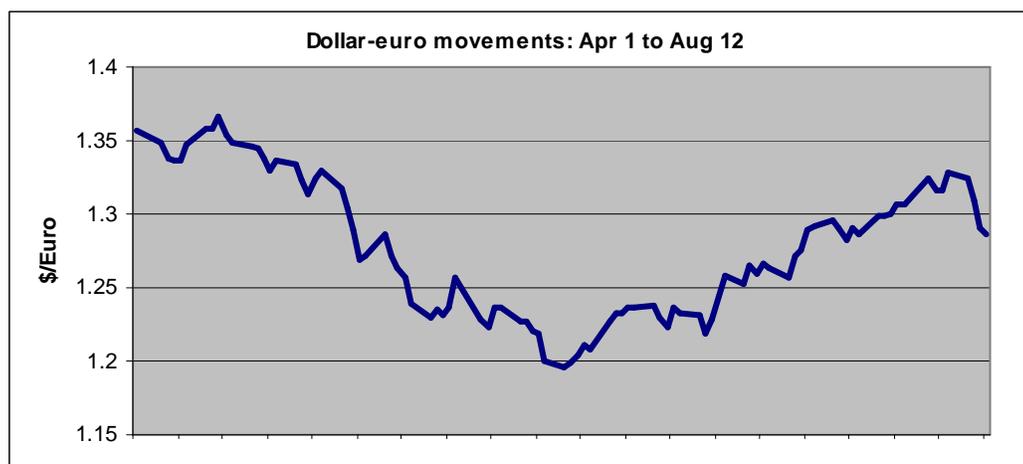
## **The Euro picture is mixed**

- The available economic data and survey-based indicators suggest a strengthening in economic activity in Q2 and the available data for the third quarter are better than expected. The Euro Governing Council expects the euro area economy to grow at a moderate and still uneven pace, in an environment of uncertainty.
- A cross-check of the outcome of the economic analysis with that of the monetary analysis confirms that inflationary pressures over the medium term remain contained, as suggested by weak money and credit growth. Overall, price stability is expected to be maintained over the medium term. Inflation expectations remain firmly anchored in line with the aim of keeping inflation rates below, but close to, 2% over the medium term.
- The firm anchoring of fiscal policies means that it is essential that budget plans for 2011 and beyond reflect a strong commitment to returning to sound public finances. As a minimum, countries' budgetary targets must comply with the fiscal consolidation requirements foreseen under the respective excessive deficit procedures. More ambitious targets, as already adopted by a number of euro area countries, may become necessary where current plans fall short of meeting the main objective of halting and reversing the increase in the government debt ratio.

## **Country snapshots**

- Germany's GDP expanded at 2.2% in Q2. Buoyant exports, aided by a decline in the value of the euro, helped it post its fastest expansion since reunification in 1991, equivalent to an annualized rate of more than 8%.
- France also exceeded market expectations, albeit more modestly, with a 0.6% rise in GDP growth for the period. It doubled its estimate of first-quarter growth to 0.2%.

- The fifth largest economy, Netherlands grew by 0.9% in Q2 on top of growth of 0.5% in Q1.
- Greek GDP is to fall by 1.5% in Q2 - the seventh consecutive period of contraction.
- Italy grew by 0.4% while Spain's progress was lackluster with 0.2%.



The relative strengthening of the Euro zone vis-à-vis the US has shown in the Euro regaining its position against the dollar with the rate settling at the 1.30 range.

### Japan's agony

- Japan's economic growth is expected to halve in Q2 to 0.6% from 1.2 % in Q1 as export growth and private consumption slowed.
- Most companies do not expect Japan's economic growth to accelerate rapidly and are hence are not increasing investment.
- Wholesale prices fell 0.1% in the year to July underlining the strong deflation in the country. Consumer prices have fallen from a year earlier for 16 straight months.
- The market expects that the Bank of Japan (BOJ) will have to relax its already loose monetary policy (central rate of 0.1%) while policymakers have raised an alarm over a fall in the dollar against the yen, which they fear could hurt exports. If the dollar slips below November's low of 84.82 yen, it would mark the currency's weakest level in 15 years.

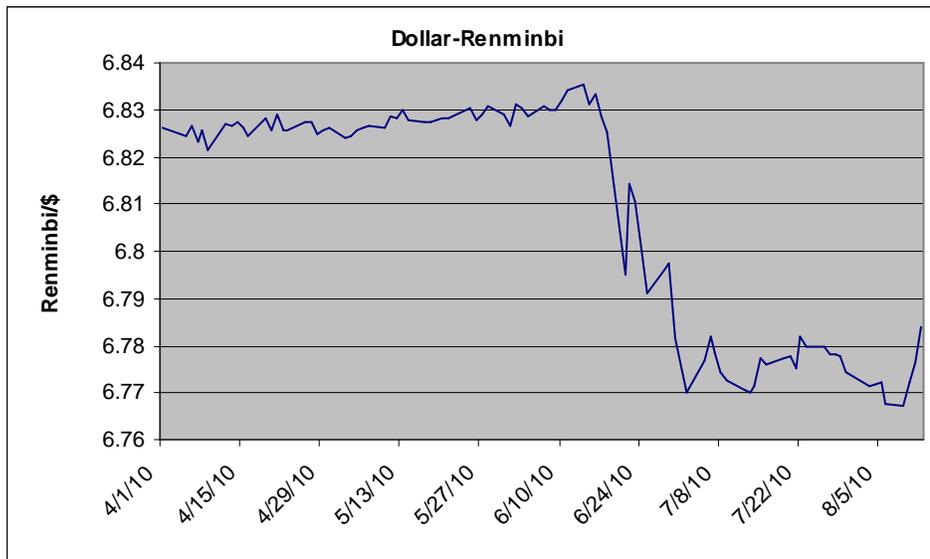
### The China Factor

- China's economy slowed down in July even as consumer price inflation rose intensifying the debate about whether recent efforts to tighten policy have gone too far.
- The rate of increase in industrial production, investment and retail sales fell in July. Factory output slowed down to 13.4% in July from 13.7% in June, while investment in fixed assets slowed form 25.5% to 24.9%.
- New bank loans and money supply growth also slowed. Growth in Chinese investment and factory output slowed further last month as the government

brought credit growth back to normal after a record lending spree in 2009 to counter the global financial crisis.

- Inflation was higher than the target of 3% and was at 3.3% from 2.9% in June.
- It is felt that China is witnessing a controlled slowdown rather than a new reverse. But a sharp slowdown in economic growth can be ruled out, because resilient household consumption will help compensate for a drop in investment

### ***The Renminbi revaluation***



On 18<sup>th</sup> June, China had revalued its currency ostensibly as a goodwill gesture before the G-20 Summit. The rate has however been stable of late. From 6.8253 prior to the announcement, it moved to 6.7948 on the first day when the adjustment was made, and strengthened at 6.7699 on 2<sup>nd</sup> July after which it has been in the 6.77-78 region. The so called market alignment has hence been very much restrictive.

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