

Tumultuous first quarter for global economies

Global economic update: June 2011

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The world economy is struggling to cope after some nasty surprises including political turmoil, higher oil prices and earthquakes. The good news is that developing economies are still strong and US recovery is on track.

While the risk of a return to recession conditions has diminished significantly in the past year, other risks have increased. These include: an uneven economic performance across regions, a potential debt default in the Euro-area, and significantly higher food and energy inflation.

While the growth dynamics of many developing countries (led by China, India and Sub-Saharan Africa) remain encouraging, economic conditions in the Euro-area, UK and Japan are subdued.

The key challenge for most economies in 2011, including South Africa, is to contain rising inflation while still maintaining a high growth rate.

Global turmoil in first quarter

The first quarter of 2011 delivered some nasty surprises for the world economy which have undermined the strength of global recovery and increased financial market volatility and uncertainty:

- Political turmoil in North Africa and the Middle East sent oil prices soaring.
- Food prices were driven higher by extreme weather conditions in many countries.
- The disastrous earthquake in Japan led to a massive disruption of the production of vehicles and electronic equipment.
- The re-emergence of financial tensions in the Euro-area could ultimately see a number of countries in the Euro-area having to restructure their national debt.

Oil prices drive inflation

The Libyan civil war and turmoil in other Middle East and North African (MENA) countries, including Syria, sent oil prices soaring. During December 2010 the international oil price averaged \$92 per barrel, but spiked to a high of over \$127 per barrel in early April, a rise of over 38%.

This led to higher inflation in most developed economies including the United States, United Kingdom and Euro-area, but also in many emerging markets such as China, India and South Africa.

A survey of the latest consumer inflation rate in 74 countries shows that global inflation is on the rise. More than 60 countries have shown an increase in their annual rate of inflation over the past year. While this is not a definitive indication of rising global inflation; given that some countries are coming off a very low base of inflation in 2010, it does appear to confirm a general upward trend.

Broad-based inflation picking up

While underlying or core inflation in most countries remains well contained, there are signs of the start of an increase in non-energy related inflation as well. Capacity utilisation levels are rising, which means that companies are using more of their production capacity: this could start affecting producer costs which in turn would be transferred to the consumer.

Monetary conditions remain extremely loose in most economies with negative real interest rates that encourage borrowing and spending. Under these circumstances, the risk of a broad-based increase in global inflation is clearly rising.

International food prices have also risen dramatically since the middle of 2010 aggravated by severe weather conditions in many countries, most notably Russia and Australia. According to the *Economist* Food Prices Index, prices are up a staggering 42% year-on-year over the past year in dollar terms.

The rise in international food prices has affected almost every category of food, leading to higher food inflation in numerous countries. South Africa will be affected more forcefully over the coming 12 months. We expect South Africa's food inflation rate to breach 10% year-on-year by year-end.

Japan re-enters recession

Japan is still reeling from one of the largest earthquakes on record. Besides the massive human tragedy, the event led to the closure of many electronic and vehicle production plants, a disruption to the supply of key motor and electronic components to factories around the world, and a sharp drop in confidence levels within Japan.

According to the Japan Automobile Dealers Association, vehicle sales plunged by 51% year-on-year in April 2011. This is the largest annual decline in sales recorded since the data series started in 1968 (following a decline of 37% year-on-year in March) and the lowest volume of vehicle sales in Japan since at least 1968.

This sharp decline in production and many other areas of business and consumer activity, including retail sales, will have a severe impact on both the Q1 2011 and especially the Q2 2011 estimates of Japan's GDP performance. The Japanese economy was weakening in the months prior to the earthquake and has probably re-entered recession conditions in the past 6 weeks.

Europe still in financial turmoil

Greece, Ireland, and most recently Portugal, have received significant financial assistance from the European Central Bank and International Monetary Fund (IMF), yet their financial difficulties have continued and they will probably require further financial assistance in the coming months.

National debt levels are extremely high, while economic growth rates remain depressed. The higher the level of government debt, the more the government has to pay to service the debts. If left unattended, this can reach a point where the government falls into a debt trap. Using a simple matrix that combines the total government debt with how much of that debt is funded by non-residents, it is possible to establish a very crude measure of how vulnerable the government's finances are.

Using this methodology the ten countries that currently have the highest level of fiscal vulnerability are: Greece, Belgium, Austria, Ireland, Italy, Portugal, France, Hungary, Finland, Netherlands, and Germany.

While Japan is the most indebted government in the world, its debt is held by residents and not foreigners, which reduces the country's vulnerability. This is a clear benefit of having a country with a savings culture.

Spain is not on the most vulnerable list simply because their absolute level of debt is still fairly manageable at 60.1% of GDP. It is fascinating to see that the countries that have the highest degree of fiscal vulnerability are mostly developed economies, while the least vulnerable are mostly emerging market economies. South Africa fares exceptionally well in almost all measures of fiscal vulnerability.

Now for the good news...!

Germany remains a stronghold

Germany, the largest economy in the Euro-area, has performed particularly well, helped by an improved export performance. The value of German exports rose by an all-time high in March 2011. Consequently, manufacturing sentiment has risen at a rapid pace, with demand for capital goods reaching a record high recently. In April, the IMF revised up their 2011 and 2012 growth projections for Germany.

Developing economies still strong

Developing Asia, which includes China and India, has continued to outperform the other regions of the world convincingly, although a number of other emerging economies have also maintained a consistently strong performance, including Sub-Saharan Africa.

During 2010, Sub-Saharan Africa grew by around 5% and in 2011 is expected to grow to around 5.5%, rising to 5.9% in 2012, due to the strength of domestic demand in many of the region's economies as well as rising global demand for commodities.

US recovery still on track

The economic recovery in the United States, which remains the world's largest economy, has broadened and become more consistent over the past six months. While the US is officially out of recession, it does not mean that the economic recovery is without risk.

There are a number of key structural economic concerns, including a weak housing market and high public sector debt, which suggest that the US will struggle to return to its historical average growth rate. However, the economy appears to have navigated the worst of the credit crisis successfully and has avoided a double-dip recession.

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