# EDC ECONOMIC MONITOR

**January 16, 2006**

**Articles Include:**



## *Global Perspective*

**No tightening in the air in Euroland…**
As expected, the ECB maintained interest rates unchanged to 2.25% at its last meeting on Thursday, following a ¼ point hike in the previous meeting in December. Given the weak state of the economy and the fact that inflationary pressure has eased recently, we continue to expect the bank to not alter its policy stance from its current levels in the near term.

**…but expect some upward movement in the Fed Fund.**
The FOMC minutes did not contain any veritable news, despite the ensuing rally in all US stock markets, following its release. In it, it was stated that 1) the Fed is about finished with policy tightening –after 325 basis points worth of gradual rate hikes in 18 months, one would only hope so; 2) if there is any further tightening, this will continue to be measured (read in 25 bps increments) and, more importantly, data-driven. 3) The Fed considers itself in neutral, as it has subtly removed the qualifier "accommodative" to current monetary policy. The bottom line? Expect another 25 bp increase in the Fed Funds by January 31 and maybe (depending on how inflation behaves) a further 25 bp hike in March. (Claudia Verno)

## *Africa & Middle East*

**Iran – a new expansionary budget**
President Ahmedinejad presented his 2006-2007 fiscal budget, which is at least 20% larger than last year. It aims at implementing his election promises to reduce economic inequality and "government waste". This means increasing programs and subsidies to lower-income people. It has been based on US$39.70 a barrel or roughly US$10 a barrel higher than last year. Iran is aiming again at GDP growth rate of 8%, higher than what has been achieved in the past few years (or 5-6%). With the president rhetoric, it will be very difficult for Iran to achieve it. Inflation is projected to remain at 12.5% to 13%, which is in line with average rates for the past three years. Interesting, the draft budget includes US$3bn in loans to export-oriented industries, to encourage

the export of technical and engineering services. Over the short run, Iran would be able to cope with lower revenues than projected in view of its more solid financial position, but it would be questionable over the longer run. (Jocelyne Lussier)

# Asia

**India – Growth of Auto Industry**
India's exports of manufactured goods has seen a noticeable compositional shift as engineering goods is now the largest item of manufactured exports, surpassing exports of textiles and gems and jewellery. Within engineering goods, transportation equipment has emerged as the key driver of export growth in 2005-06 (April-December), due to the increasing global competitive advantage of India's automotive industry.

Since the mid-1990s, India's automotive component industry has witnessed rapid transformation from a low-volume and fragmented sector into a highly competitive sector characterized by world-class technology. Some of the global automakers have set up subsidiaries for components manufacturing facilities in India taking into account its lower labour costs and highly skilled workforce. According to ACMA, India's automotive association, the auto component industry has the potential to reach export revenue levels of US $20-25 billion by 2015 from its current level of US$1.4 billion. For domestic production, the industry is targeting revenue growth of US$13-15 billion from its current level of US$8.7 billion. The latter figure is a 30% increase in output over the previous year. Magna, Canada's biggest auto parts supplier, has just announced plans to open a sales and engineering office in Mumbai, India. (Tabinda Haider)

# Central & Eastern Europe

**Recent East-Central Europe Economic Releases Show Continuing Economic Strength**
Recent data from east-Central European countries (Czech Republic, Hungary, Poland, and Slovakia) show continuing strong output growth in the region into November. Specifically:

- Output in the **Czech** republic grew by 0.9% month-on-month (m/m) in November - the same level as October. On a year-year (y/y) basis, output was up 7.2%, higher than October's 6.3% and September's 7.1%. The auto sector was the mainstay for growth for the second month in a row with growth of 28% y/y, up from 26.4% in October. This performance is the result of the Toyota-Peugeot joint venture in the country continuing to ramp up production.
- Industrial production in **Hungary** dropped by 0.8% m/m in November, partially reversing the previous month's 1.8% gain. But on a y/y basis industrial production rose 7.7% in November, slightly lower than the 9.8% recorded in October. On a y/y basis, chemicals, mining, and manufacturing registered the strongest growth with growth of 12%, 15%, and 9%, respectively.
- **Polish** industrial output increased by 8.5% in November (y/y), the fourth consecutive increase since July when growth was 2.6%. The sectors registering the strongest increases in November were: manufacturing (+9.4%) and construction (+5.9%).
- Data on **Slovakia** show industrial output rising by 9.9% in November, up from 5.8% in October. Mining and quarrying registered the highest growth (+29%), with manufacturing in second place at 12%. Electricity, gas, and water suffered a small setback, diminishing by 3.2% from a year ago.

The bottom line is that these four countries - all recent EU members - are continuing their strong output growth begun late in 2004. In comparison EU-15 average output growth was a tepid 0.1% y/y in October (November data has not yet been released). (Jean-Louis Renaud)

**Impact of Bird Flu on Tourism to Turkey Closely Monitored**
Travel companies are reportedly monitoring the spread of bird flu in Turkey, although they claim no business impact - yet. As of end of last week, Turkey had reported 15 people with bird flu

infections, with a further 70 undergoing tests. Russia has already warned its citizens against travel to Turkey in the face of the latest, news, although it was believed to be the only country to have done so. But Codacoms, a major Italian consumer rights group, has called on Italian authorities to ban all travel to Turkey, in an effort to prevent the spread of bird flu to Italy; while the Chairman of the British Medical Research Council said that he would advise British nationals to stay away from eastern Turkey where most cases are believed to be centered. Turkish authorities are closely monitoring the situation to check for declines in tourist inflows. The tourist sector generates about $19 billion annually, equivalent to almost 5% of GDP. An epidemic of bird flu would have severe consequences on the country's tourist sector, with a corresponding impact on the country's economic growth. (Jean-Louis Renaud)

# *Latin America & The Caribbean*

**Argentina: Amid Rumors of a Reopening of the Swap, the Government Would Do Well to Consider Full Normalization**

Immediately following Argentina’s decision to repay the IMF, rumors began circulating that perhaps the government would reopen the debt swap to the almost USD 20bn-worth of holdouts. Despite strong denials out of Buenos Aires, our sources indicate that such a proposal may well be in the offing. Indications that Argentina’s economic team may be preparing an offer to the Paris Club further support the notion that it may be acquiescing to suggestions that it normalize the country’s outstanding debt. Argentina’s current debt load sits at around USD 126bn, or 69% of GDP, according to official calculations. Note, however, that such calculations include holdout liability as if it had accepted the terms of the restructuring. Setting aside that assumption would raise the debt level to USD 135bn, or 74% of GDP. Therefore, a resolution of the holdout issue would clearly constitute a positive material development as far as EDC Economics is concerned. With Argentina currently allocating a mere 2.6% of GDP to debt servicing, among the lowest in the region, the estimated increase in debt servicing costs of USD 650mn per year would be well within reasonable limits. From a long-term perspective, resolution could set Argentina on a path toward debt sustainability. Some calculations show public debt growing by about USD1.2bn per year, due primarily to high levels of inflation. But increases in the country’s nominal GDP and continued appreciation of the real exchange rate could push debt/GDP down within acceptable levels over the next 10-15 years. In the short-run, the decision to reopen the swap may have a negative effect on the price of Argentine debt, as it would imply an increase in the supply of performing obligations. But the net effect, after taking into account market perceptions of a full normalization of the country’s debt status, would be positive. (Stuart Bergman)

**CAFTA Delayed**

The Central American Free Trade Agreement was set to become effective January 1st 2006, however the countries will now follow rolling dates for entry into the agreement. This move is to allow the governments of the Central American region and the Dominican Republic additional time to implement various reforms and synchronize their laws to line up with the terms set out in the agreement. El Salvador is the most ready and is expected to participate with the US ahead of the rest of the countries. The DR has announced it will be ready by July 1st. However, Costa Rica has yet to ratify the deal in Congress, and with the upcoming elections it remains uncertain as to when it will be passed. (Kathryn Dembinski)