

# Monthly Briefing

## World Economic Situation and Prospects

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### Summary

- EU leaders agree to scale up measures to solve the simmering debt crisis, but hurdles remain
- Unemployment in developed economies still high and lasting longer
- The G20 falling behind the curve?

### Global issues

#### *Euro area debt crisis: a brief review of the main measures taken so far*

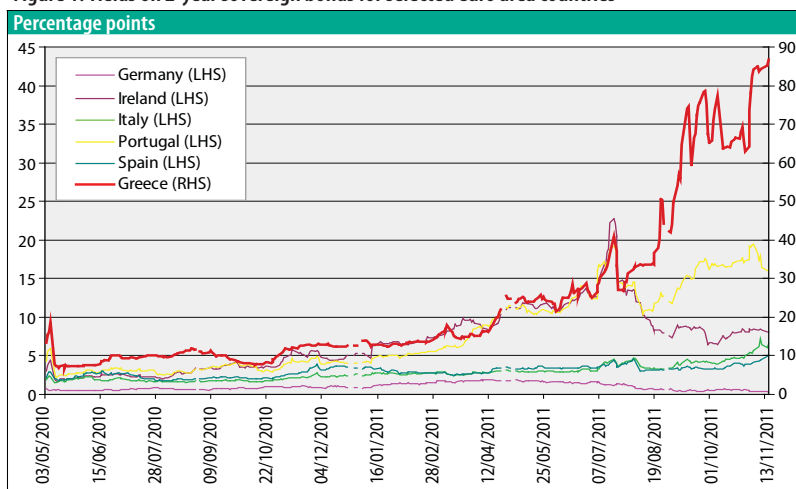
In late October, European leaders held a marathon negotiating session and finally agreed on a set of measures intended to solve the ever-simmering debt crisis. The measures include a 50 per cent write-down of Greek debt held by the private sector, based on a voluntary arrangement between the Greek Government and concerned parties. With this in place and, given the envisaged public sector reforms, the Greek debt-to-GDP ratio is targeted to reach 120 per cent by 2020. European leaders also agreed to recapitalize banks in the region to the tune of €106 billion. Finally, two options to leverage the resources of the European Financial Stability Facility (EFSF) were announced: provide credit insurance for new debt issued by EU member States; and enlarge the funding arrangements of the EFSF by combining resources from public and private financial institutions, as well as investors.

However, uncertainties remain on a number of issues, particularly the funding for enhancing the resources of the EFSF, which would be required if either Spain or Italy were to face acute financing difficulties. These issues are crucial to effectively arresting the contagion from the Greek crisis. Immediately after the agreement, turmoil returned as the Greek Prime Minister announced that there would be a referendum on the measures. Italian bond yields rose to a euro-era high over German bonds. Markets hardly calmed even after the idea for a referendum was abandoned. Confidence in the outcome of the debt resolution remains weak and both the Greek and Italian prime ministers had to resign amidst continued economic uncertainty.

Greece has been receiving emergency financing since May 2010, and so has Ireland since November 2010 and Portugal since May 2011. Both Portugal and Ireland are currently on track to meet their commitments as part of the rescue financing. In contrast, Greece has been less successful in meeting its target; hence, so in July 2011, a second Greek debt bailout was put together.

The major challenge in finding a solution to the sovereign debt crisis of the euro area is to prevent fiscal problems from causing a major banking crisis. Sovereign and bank risks have become closely intertwined as European banks own vast amounts of government bonds. Rising sovereign debt risk is thus threatening the liquidity and solvency of the banking system. The European Central Bank (ECB) has continued to provide liquidity to the banking system through refinancing operations. Since May 2010, the ECB has also been buying sovereign securities in the secondary market, via a Securities Markets Programme (SMP), to limit instability in sovereign debt markets. As the yields of the sovereign debts of Italy and Spain rose in August 2011,

Figure 1: Yields on 2-year sovereign bonds for selected euro area countries



Source: JPMorgan.

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the ECB enlarged the SMP. The measures taken so far have not been enough to calm financial markets and stop the upward trend in yields (and hence the risk premium) for larger euro area economies in debt distress.

### *Is the G20 falling behind the curve?*

The agenda of the G20 summit held in Cannes on 3-4 November was dominated by the political turmoil in Greece and the euro area sovereign debt crisis. The Action Plan for Growth and Jobs that was adopted puts high priority to employment generation but does not include any new commitment beyond existing government plans, mostly characterized by the phasing out of fiscal stimulus and phasing in of fiscal austerity. Meanwhile, the level of euro area unemployment increased to 16.2 million workers in September, the highest since the creation of the euro. In the United States, the unemployment rate remained at 9 per cent and currently, almost one third of the unemployed have been without a job for more than a year.

## **Developed economies**

### *United States: some positive signs despite continued weak business and consumer confidence*

Several monthly indicators released in September and October 2011 suggest some improvement in economic conditions in the United States. Private consumption expenditures, industrial production and orders for capital goods maintained the upward trends visible in preceding months. Business and consumer confidence indices, like the Philadelphia Federal index and University of Michigan Consumer Sentiment index, improved slightly from the bottom lows that were reached in August. No improvement was recorded for the housing sector.

During the third quarter of 2011, the United States GDP expanded at the annualized rate of 2.5 per cent from the previous quarter which is stronger than the 0.4 per cent and 1.3 per cent observed during the first two quarters. Private consumption, investments in equipment and software as well as exports were the main drivers of growth.

The number of payroll employees increased by 80,000 in October and the number of jobs created in September has been revised upwards from 103,000 to 158,000. The level of employment, however, remains at 4.7 per cent below its 2008 peak level and, at the present pace of recovery, may take another 4 or 5 years before rates return to pre-crisis levels.

### *Developed Asia and the Pacific: yen reaches record high before falling again*

The Japanese yen reached record highs against the dollar by the end of October 2011, peaking at 75.03 yen per dollar. In response, Japanese authorities unilaterally decided to intervene in foreign-exchange markets. Massive currency sales led to a sharp intra-day depreciation of the yen against all currencies and a drop of more than 4 per cent against the dollar.

Recent macroeconomic indicators sent mixed signals about the state of the Japanese economy. The unemployment rate fell by 0.2 per cent in September after having declined by 0.4 per cent in the previous month. Currently, unemployment is down to 4.1 per cent of the labour force, the lowest level since the beginning of 2009. Real household spending increased by 2.1 per cent in September. Industrial production, in contrast, declined by 4 per cent (month on month, seasonally adjusted) and the index is still several percentage points below the level reached before the earthquake in March. Amidst heightened global economic uncertainty, the Bank of Japan expanded its Asset Purchase Programme by another 5 trillion yen.

### *Western Europe: mixed signals amidst deepening gloom*

A wide range of leading indicators of sentiment portend a very sharp economic slowdown in Europe, perhaps even a recession, going forward. The European Commission's Economic Sentiment Indicator, for example, has moved down sharply from its peak in February and is now well below its long term average. By contrast, measures of current activity, available through August, have yet to show signs of significant downturn, but do show gradual deceleration of activity. Industrial production increased by 1.2 per cent after a similar increase in July. Construction increased as well and may have reached a weak turning point from its long downward trend. On the other hand, retail trade fell slightly and appears to be on a gentle downward trend. More ominously, the average unemployment rate increased to 10.2 per cent, 0.3 percentage points higher than the post-recession low of 9.9 per cent registered in April. Most economies saw a minor increase, but the rise was bigger in Spain and Italy. After having increased continuously since hitting bottom in mid 2009, capacity utilization rates declined again in the third quarter and the beginning of the last quarter of 2011. These factors point to further slowing economic activity towards the end of the year and into 2012.

### *The new EU members: strong third quarter in the Baltic States, but moderation ahead*

The strong recovery of the economies of the Baltic States continued during the third quarter. In Lithuania, GDP growth accelerated to 6.6 per cent (year on year). The recovery was initially export led, but is now increasingly relying on domestic demand growth. However, higher electricity prices, weakening business and consumer sentiments, slow corporate credit growth and suspended investment plans prefigure a likely moderation ahead. In Latvia, third quarter GDP increased by 5.7 per cent (year on year), but the country may also see some slowdown in the near outlook, as weakening exports are expected to offset positive domestic demand impulses.

Draft 2012 budgets being prepared by Governments in several of the new EU member states envisage enhancing revenues to meet tighter deficit targets. The Hungarian Government, for instance, is planning to increase the top VAT rate to 27 per cent, the highest in the EU. This could push up inflation in the short-run.

Inflation trends diverge. In Estonia inflation accelerated to 5.1 per cent in September, the highest in the EU. Romania, by contrast, saw inflation drop to a record low in September and expectations of continuing disinflation created room for the Central Bank to cut interest rates by 25 basis points to 6 per cent in early November, aiming to revitalize the economy.

## **Economies in Transition**

### *CIS: strong harvests boost agriculture*

Industrial production in the region slowed in the third quarter, mainly due to weaker demand. In Ukraine and Kazakhstan, industrial output expanded by 8.6 per cent (year-on-year) and 4.3 per cent, respectively, in the first three quarters of 2011. Growth in industrial output slumped in September in the Russian Federation, reaching the lowest year-on-year growth rate recorded since October 2009. Seasonally adjusted, the sector has almost stagnated since June.

Agriculture production benefited from favourable weather and several countries registered exceptional harvests. With a record-breaking harvest, Kazakhstan's wheat exports could reach 15 million tons this year, the largest amount since independence. At more than 50 million metric tons by the end of October, Ukraine's grain harvest was up by more than a quarter from last year's. Meanwhile, in the Russian Federation, grain output doubled with respect to that of 2010, when farmers were hit by the worst drought in half a century. Large crops have exerted downward pressure on prices, contributing to declining inflation in the region. In September, inflation rates fell to 7.2 per cent in the Russian Federation and 10.9 per cent in Georgia. Also in Kazakhstan, inflation reversed its upward trend, decelerating to 8 per cent.

### *South-Eastern Europe: economic activity slows in Serbia*

In Serbia, third quarter flash estimates suggest GDP growth may slow down to 0.7 per cent year on year, along with the observed contraction of industrial output. Domestic demand remains weak and, in September, retail trade turnover was 18 per cent lower than a year ago. As inflation continued to decelerate, the National Bank of Serbia further cut its policy rate in early October. In the FYR of Macedonia, second quarter GDP increased by 5.3 per cent year on year, bringing growth in the first half of 2011 to 5.2 per cent. This expansion was broad-based, driven by construction, retail, industry and mining sectors. Growth of industrial output, however, decelerated notably in the third quarter and turned negative (year on year) in September.

## **Developing economies**

### *Africa: rising fiscal pressures*

Signs of increasing pressure on fiscal budgets have emerged in a number of countries. In South Africa, for example, the Treasury now expects a budget deficit of 5.5 per cent in the fiscal year ending March 2012, up from the previous forecast of 5.3 per cent. Lower revenues are underpinning this revision, coupled with the impact of fiscal spending aimed at supporting the economy throughout the global financial crisis. Meanwhile, Egypt announced budgetary support from Qatar in the form of a grant of \$500 million. Egypt is further negotiating financial support from Saudi Arabia and the United Arab Emirates and is considering assistance from the IMF. The political unrest in the country led to a withdrawal of foreign investors as well as a sharp slowdown in core sectors such as tourism, implying lower tax revenues and a greater need for social spending measures. Consequently, the government is forecasting a budget deficit of 8.6 per cent for the fiscal year ending in June 2012. Two rating agencies downgraded the credit rating of Egypt by one notch, citing as reasons economic weakness and financial strains.

### ***East Asia: regional growth moderates, Thailand's economy hit by major floods***

Economic growth in East Asia slowed in the third quarter of 2011 mainly as a result of weak external demand. In the Republic of Korea, real GDP expanded by 0.7 per cent compared to the previous three months, following growth of 1.3 per cent in the first and 0.9 per cent in the second quarter. In Taiwan Province of China, quarter-on-quarter GDP declined by 0.3 per cent as investment fell sharply amid slower export growth. China's economy grew by a robust 2.3 per cent in the third quarter, but sluggish global demand points to a slowdown in the coming quarters.

Thailand experienced the worst floods in half a century which have caused major damage to agriculture and manufacturing, with severe disruptions to global supply chains. The hardest-hit sectors are the automotive and consumer electronics industry as Thailand is the world's second largest exporter of hard drives. Gross domestic product is expected to contract in the fourth quarter of 2011 and full-year growth may reach only 2.5 per cent, about 1.5 percentage points lower than previously expected.

The Philippine Government announced new fiscal stimulus measures to strengthen domestic demand in the wake of weakening exports. The \$1.7 billion package focuses on low-cost housing construction and infrastructure projects. Export revenues declined by 15.1 per cent (year-on-year) in September as demand for electronics goods, which account for about 60 per cent of total exports, weakened significantly.

### ***South Asia: inflation accelerates, posing challenges for monetary policy***

Inflation continues to be stubbornly high in most South Asian countries, with both food and non-food prices increasing rapidly in recent months. In Bangladesh, year-on-year inflation accelerated to 12 per cent in September 2011, the fastest pace in more than a decade. Strong increases in the prices of clothing and footwear, transport and household equipment drove non-food inflation up to 8.8 per cent, more than twice the rate recorded at the beginning of the year. In response, the Bangladesh Bank aims to constrain growth of private sector credit, which reached 26 per cent during the past fiscal year.

In India, food inflation accelerated further in October on the back of higher prices of vegetables and milk. The Reserve Bank of India hiked its key policy rates for the 13<sup>th</sup> time since early 2010, but signalled an end to the current tightening cycle, pointing to the slowdown in domestic growth and increased risks to the near-term outlook.

In Pakistan, consumer price inflation edged up in October after declining steadily in the previous three months. The slowdown in inflation during the third quarter led the State Bank of Pakistan to cut its main policy rate by 150 basis points to 12 per cent.

### ***Western Asia: monetary policy in Turkey is facing trade-offs***

In Turkey, annual inflation rose sharply from 6.2 per cent in September to 7.7 per cent in October as the country's currency depreciated, which pushed up imported inflation. The effective nominal exchange rate depreciated by almost 20 per cent after the central bank surprised capital markets by keeping its policy rate constant and capital moved out of the country. Although this improved the competitiveness of Turkish goods, external demand declined in an increasingly depressed international environment, while import demand remained high given still strong domestic demand growth and typically slow responsiveness of imports to exchange rate changes. As a consequence, the already large current account deficit continued to widen and may reach 12 per cent of GDP in 2011. Although the central bank forecasts inflation of 8.3 per cent this year, 2.8 percentage points above the target, it has kept the policy interest rate unchanged in a bid to sustain economic growth. Monetary tightening nevertheless occurred through the rise of the overnight rate from 5.75 to 12.5 per cent, thus increasing the effective rate to commercial banks. The lira appreciated by 5 per cent as bond yields also increased by about one percentage point.

### ***Latin America and the Caribbean: investments grow but short-term capital movements threaten currency stability***

Retail data for Brazil, Colombia, Chile and Peru indicate consumption growth is still strong in these countries. In Brazil, domestic demand and credit continued to expand in September, but industrial production contracted by 2 per cent month on month, with investment goods and consumer durables declining by 5.5 and 9 per cent, respectively. As part of the worldwide financial turmoil, several countries in the region saw sudden reversals in portfolio capital inflows. As a result, the Brazilian real depreciated by about 10 per cent. The increased volatility gave monetary authorities the more reason to keep controls on short-term capital flows in place. In Argentina, a rapidly shrinking external surplus and capital outflows associated with fears of devaluation put the exchange rate under pressure. The central bank enhanced its capital account regulations by requiring tax authority approval of purchases of dollars. Argentina's international reserves fell from \$52.6 billion in January to \$47.5 billion by the end of 31 October.

The increased volatility is mainly visible in portfolio capital flows. Total foreign direct investment in the region continued its upward trend, with recent data pointing to a 30 per cent growth in 2011 year on year. By May 2011, foreign investments in the region originating from China had quadrupled from a year ago.

