Monthly Briefing
World Economic Situation and Prospects

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Summary

- ECB supporting private banks amidst fears of a credit crunch
- EU leaders agree on a new fiscal compact enhancing fiscal discipline
- Foreign reserves in Egypt hit dangerous low

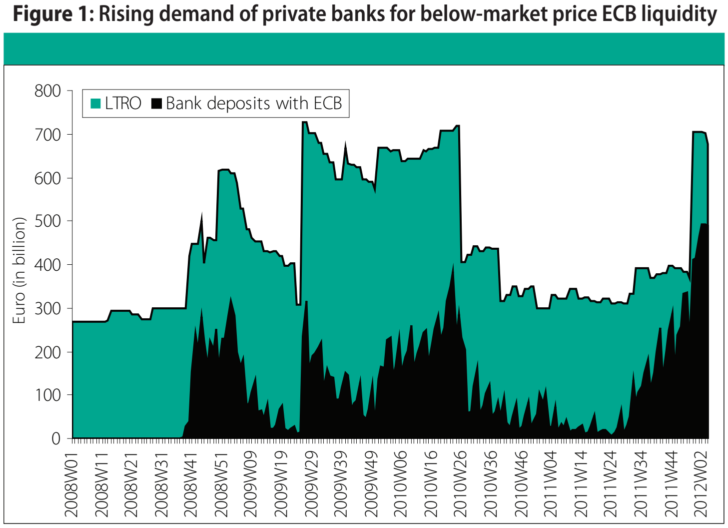
Global issues

ECB supporting private banks to avoid a credit crunch

The sovereign debt crises continue to place stress on European banks. The value of government bonds has fallen with the lowering of credit ratings for many European countries. This has eroded the balance sheets of banks holding substantial amounts of those assets. Subsequently, banks have cut lending — especially to other banks — and have opted instead to deposit money with the European Central Bank (ECB), even more so in the final months of 2011 (see figure 1). As a result, liquidity available in the European banking system has dried up, reducing the lending available to households and businesses and inducing investors to move money out of the euro and into other currencies which are perceived to be safer, including the United States dollar, the Swiss franc and the Brazilian real. These effects may have been exacerbated by the increase in bank capital requirements stipulated by financial regulators. In order to comply, European banks seem to have further tightened commercial lending and have sold assets, especially those held in operations in Eastern Europe and Latin America.

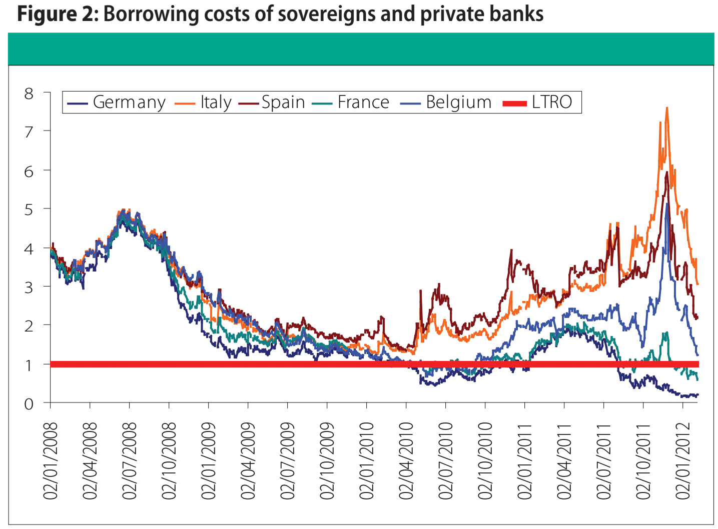
In December 2011, the ECB stepped in to avert a credit crunch. Because its statutes do not allow the ECB to act as a lender of last resort to sovereigns, it launched a new phase of the Longer-Term Refinancing Operation (LTRO). The LTRO supplies private banks with unlimited three-year loans at an interest rate of 1 per cent, well below what most governments need to pay when borrowing in private capital markets (figure 2).

Figure 1: Rising demand of private banks for below-market price ECB liquidity



Source: ECB.
Note: Maturity of LTRO loans is a maximum of 3 years.

Figure 2: Borrowing costs of sovereigns and private banks



Source: JP Morgan.
Note: 2-year sovereign bond yield and 3-year LTRO interest rate.

Note to the Secretary-General prepared by the Global Economic Monitoring Unit
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EU leaders agree on a new fiscal compact enhancing fiscal discipline

At the end of January, EU leaders met and agreed to back a new fiscal compact treaty. The formal signing of the new agreement will likely take place in March, after which it must be ratified by at least twelve of the euro area countries to come into force. All 27 EU members except the United Kingdom and the Czech Republic have agreed to join. After ratification (which may be subject to referendums in some cases), countries would need to change their constitutions to embody the new rules. In the long run, enhanced fiscal discipline is expected to bring down borrowing costs of sovereigns and could eventually also lead to allowing the ECB to substantially increase its sovereign bond buying programme without the costly intermediation by private banks.

Financial markets regain some stability, but credit remains tight in the real sector

Global financial markets regained some stability during January. Following the ECB intervention, bank bonds and stocks experienced substantial gains, with returns on bonds of European financial corporations recording the highest monthly returns since July 2009.

The MSCI All-Country World Index for equities rose 5.8 per cent, adding some $3 trillion to stock values. Commodity prices increased moderately and the euro, along with several other currencies, appreciated against the United States dollar, reversing the trend observed in late 2011 when escalated uncertainties induced the above-mentioned "flight to liquidity" in European financial markets.

Yields on sovereign bonds dropped in many countries, especially in the euro area. This is most likely due to the ECB's liquidity injections through the LTRO. Credit conditions for businesses, home owners and consumers tightened nonetheless, according to reports of the ECB and the United States Federal Reserve, stressing the slower and limited impact of monetary policy on the real sector under current circumstances. Another tranche of the LTRO is scheduled to be issued in February.

Developed economies

North America: the Fed indicates low interest rates for the next three years

The United States reported GDP growth of 2.8 per cent (seasonally adjusted annual rate) in the last quarter of 2011 and 1.7 per cent for the year as a whole. Inventory accumulation accounted for two-thirds of the growth in the quarter, while real final sales increased by only 0.8 per cent. Consumer demand increased by 2 per cent. Most recent high-frequency indicators give a mixed picture. Non-farm payroll employment increased by 243,000 and the unemployment rate declined to 8.3 per cent in January. Part of the decline in unemployment, however, is attributable to a further increase in the number of discouraged individuals leaving the labour force. Some confidence indicators improved, but new home sales decreased by 2.2 per cent and the median price of new houses sold dropped to 12.8 per cent below that of a year ago. Most indicators suggest a deceleration in GDP growth for the first quarter of 2012.

At its January 2012 meeting, the Federal Open Market Committee decided to keep the federal funds rate at between 0.00 and 0.25 per cent, and indicated that economic conditions would be likely to warrant exceptionally low levels for the federal funds rate at least through late 2014, one year longer than previously anticipated.

Developed Asia and Pacific: Japan records first trade deficit in 30 years

In December 2011, Japan's export volume and industrial production indices increased again after a two month decline that had been mainly caused by the flooding in Thailand. Nevertheless, the exports and manufacturing output remained below pre-earthquake levels. Japan's exports to the European Union have decreased continuously during the second half of 2011 while those to the United States increased.

For the year 2011 as a whole, Japan ran a trade deficit for the first time since 1981. The country saw a higher import bill because of increased demand for fossil fuels for electrical power generation and higher energy prices. Exports suffered because of the impact of the natural disasters on the production of electrical and transportation equipment.

The Japanese Government recently proposed a number of tax reforms that are to take effect during the next fiscal year beginning in April 2012. The proposed changes include a higher carbon tax, which will almost double for some types of energy. The tax increase will be phased in gradually over a four year period beginning in October 2012.

Western Europe: prospects differ greatly across countries

Western Europe's economy likely contracted in the fourth quarter of 2011, according to some preliminary GDP figures as well as falling industrial production and retail sales in November. In contrast, the European Commission's Economic Sentiment Index showed marked improvement in January, increasing for the first time since March 2011. The Purchasing Managers Index also rose significantly. Despite these recent improvements, however, both indices remain at low levels, indicating weak or declining activity.

Differences in economic prospects have widened further within the region. The German IFO index of sentiment has increased for three consecutive months and remains well above its long-term average. But in debt-ridden countries facing high borrowing costs, such as Greece and Portugal, indicators of sentiment remain near all-time lows. Unemployment rates also vary tremendously across the region, with Germany registering 5.5 per cent in December, while double digit unemployment rates prevail in Greece, Ireland, Portugal and Spain. Greece agreed to cut 15,000 public sector jobs by the end of 2012 as part of its bailout package.

New EU members: fears for another credit crunch

According to fourth quarter indicators on industrial production and trade, output growth moderated in most economies in the region. Poland, which is less export-dependent, however, sustained over 4 per cent year-on-year GDP growth and manufacturing orders picked-up at the beginning of 2012. In January, abnormally cold weather and heavy snowfalls led to serious power and transportation outages throughout Eastern Europe, affecting industry and construction and increasing consumption of natural gas.

The "Vienna Initiative" group of regulators and policymakers[1] warned about the risk of disorderly deleveraging and a credit crunch in Eastern Europe, as the biggest lenders in the region are raising capital and selling assets to improve balance sheets and to satisfy new core capital reserves requirements. In late 2011, the Austrian National Bank instructed domestic banks to limit their exposure to Eastern Europe. To avert a possible crisis, the group urged regulators and banks to coordinate actions.

Romania witnessed massive protests in January. The protests were geared against the Government's austerity policies introduced to comply with IMF and EU lending terms and led to the resignation of the Government in February. In an attempt to stimulate the economy, the National Bank of Romania reduced its policy rate in January by 25 basis points.

Economies in Transition

CIS: Russian Federation set to join the WTO

The economy of the Russian Federation expanded by 4.3 per cent in 2011 and inflation hit a 20-year low at 6.1 per cent. In December, the central bank cut the policy interest rate. Meanwhile, capital outflows from Russia more than doubled in 2011, reaching an estimated $84.2 billion. Nearly half of the outflow occurred in the fourth quarter, as the euro area sovereign debt crisis undermined investors' confidence.

The WTO approved membership of the Russian Federation in December, after an 18-year negotiation period. As a result, the country will have to reduce a wide range of import tariffs in the coming years.

In Ukraine, economic growth slowed to 4.6 per cent in the fourth quarter. The economy of Belarus grew by 5.3 per cent for the year 2011 as a whole, but growth was negative in the last quarter of the year. Most of the CIS was affected by severely cold weather in January, which, in particular, disrupted Ukraine's grain exports from the Black Sea ports. In Central Asia, Uzbekistan reported GDP growth of 8.3 per cent in 2011, thanks to strong industrial production and ample agricultural output. The economy of Tajikistan grew by 7.4 per cent.

South-Eastern Europe: third year of declining industrial output in Croatia

Industrial output in Croatia declined for the third year in a row. In 2011, it declined by 1.2 per cent. In Serbia, the economy slowed in the second half of 2011. GDP grew by only 0.8 per cent year on year in the fourth quarter. The central banks of Serbia and Albania both reduced their policy rates by 25 basis points, citing weaker inflation expectations as the reason why. Meanwhile, cold weather in January disrupted power supply and transportation throughout the region.

Developing economies

Africa: Egypt's foreign-exchange reserves dangerously low; Nigeria reinstates fuel subsidies

Egypt, while still in the midst of continuing uncertainty in the wake of the first anniversary of the uprisings, is facing dangerously low levels of foreign exchange reserves. The central bank left the discount rate unchanged at 9.5 per cent, despite the acceleration of inflation from 7.1 per cent in October to 9.5 per cent in December. Oil production in Libya has improved rather rapidly to around 1.3 million barrels per day, close to pre-conflict production. Nonetheless, the National Transitional Council predicts a $10 billion budget deficit for 2012. A plan to remove subsidies on imported fuel led to widespread protests in Nigeria, prompting the Government to a partial reinstatement of the subsidies.

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1 The members of the group include some European central banks, commercial banks, the European Commission, the IMF, the World bank and the EBRD.

A number of national currencies appreciated. This is believed to be the result in part of the announcement by the United States Federal Reserve Bank to keep its policy interest rate near zero for an extended period of time, thereby increasing the attractiveness of higher-yielding currencies. The South African rand, for example, hit a three-month high against the dollar. In Cameroon, the fifth-largest cocoa producer in the world, an infestation of pests linked to dry weather caused such significant damage to the mid-year crop that total output for the year is expected to drop sharply in comparison with last year's record harvest.

East Asia: policy measures aim to mitigate the economic slowdown

Economic growth in East Asia slowed markedly in the fourth quarter of 2011, as export sectors were hit by the crisis in the euro area and the devastating floods in Thailand. On a quarter-on-quarter basis, economic activity contracted in Singapore and Taiwan Province of China and grew by only 0.4 per cent in the Republic of Korea. While private investment weakened significantly in most economies, consumer demand has so far remained robust. This has helped mitigate the slowdown, particularly in countries with large domestic demand bases. In China, GDP expanded by 8.9 per cent year on year in the fourth quarter, bringing full-year growth to 9.2 per cent.

Across the region, fiscal and monetary authorities have taken measures to cushion the impact of slowing global demand. In the Republic of Korea, the Government decided to frontload the 2012 budget expenditures to support domestic demand. The central banks of the Philippines and Thailand reduced their policy rates by 25 basis points in January. The impact of the floods on Thailand's economy was greater than expected and the recovery process likely will take longer than anticipated. Thailand's manufacturing index showed some improvement in December, but was still 25.8 per cent lower than a year ago.

South Asia: Inflation moderates as food prices soften

Across South Asia, headline inflation moderated in recent months as a result of lower food price increases. In Pakistan, consumer price inflation decelerated to 9.7 per cent in December 2011, the lowest level in more than two years. In India, higher production of vegetables led to a sharp drop in prices from last year's record highs. However, non-food inflation continues to be high in most countries. Central banks have thus remained cautious in easing monetary policy despite weaker growth prospects and increased downside risks. The Reserve Bank of India lowered the reserve requirements for banks by 50 basis points in January but left interest rates unchanged.

In the Islamic Republic of Iran, interest rates on bank deposits were raised by up to 6 percentage points in an attempt to curb the depreciation of the currency. With year-on-year inflation estimated at about 20 per cent, banks can now pay up to 21 per cent interest on deposits. Pressure on the domestic currency rose sharply after the United States introduced new sanctions on financial transactions, including those of Iran's central bank, and the European Union's ban on the import, purchase and transport of Iranian oil.

Western Asia: devaluation of the Syrian pound

In January, the Syrian central bank changed its exchange-rate regime to a managed float mechanism in an attempt to reduce the discrepancy between the official and black market exchange rates and allow commercial banks to take advantage of the strong demand for United States dollars. Between February and December 2011, the official exchange rate of the Syrian pound depreciated by 20 per cent against the dollar, but in the black market the pound lost 47 per cent of its value.

In Israel, the central bank cut interest rates by 25 basis points for the third time since mid-2011 over continuing fears that the euro zone banking and sovereign debt crises will hurt the country's exports. In Turkey, monetary tightening introduced in November was accompanied by a narrowing of the current account deficit for the first time in two years. Over the past three months, renewed capital inflows led to a 4 per cent appreciation of the nominal effective exchange rate. Although this trend may hurt Turkish exports, it also reduces the energy bill which represents two thirds of the current account deficit, contributing to Turkey's external rebalancing.

Latin America and the Caribbean: slowing economic activity, but easier issuance of dollar-denominated bonds

Industrial production increased strongly in Colombia and Mexico, year on year. In Brazil, output levels were still 1.2 per cent lower than a year ago, despite an increase of 1 per cent (month on month) after three months of stagnation. In Chile, industrial production and sales decelerated markedly, both having increased less than 1 per cent year on year. Employment continued to expand in most countries, especially in Brazil and Chile where unemployment rates dropped in December to 4.7 and 6.6 per cent respectively, compared to 5.3 and 7.1 the year before.

Agriculture suffered a serious setback as a drought hit major cash crops, especially in Argentina and Mexico. In Argentina, the drought also affected public finances, as taxes on agricultural exports are an important source of revenue. It also caused a further reduction in the external surplus. The latter development prompted the Government to tighten import restrictions by making import licences harder to obtain, as part of an effort to boost manufacturing activity via import substitution.

Lingering financial turmoil in the euro area has favoured the issuance of dollar-denominated government bonds in Latin America. In January, demand for Brazilian and Mexican bonds far exceeded supply.