Monthly Briefing
World Economic Situation and Prospects

No. 42 **UN/DESA** 18 April 2012

Summary

- Developed country central banks continue monetary easing
- China records significant trade deficit in January and February
- Hungary may become first country to face EU financial sanctions

Global issues

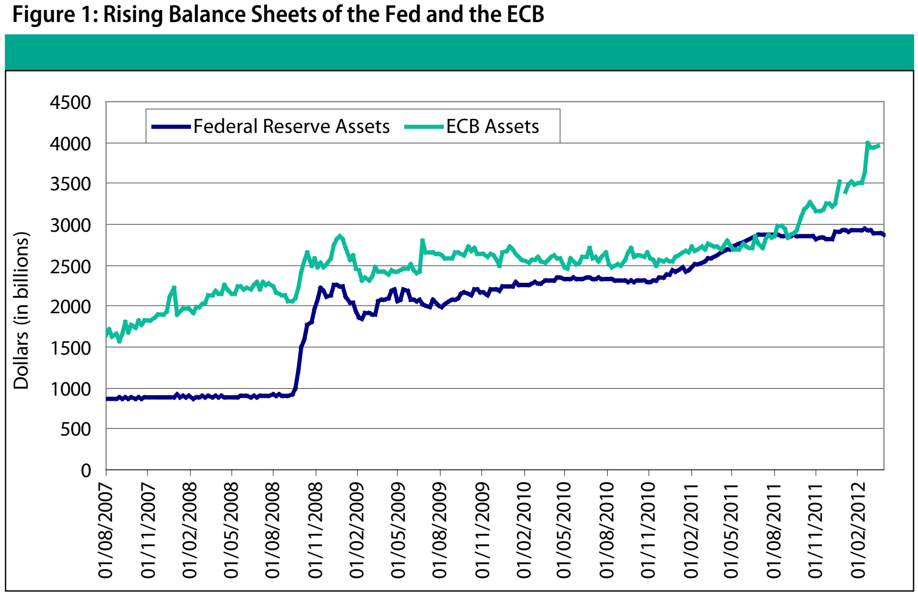
Central banks in major developed economies continue quantitative easing

In the United States, the Federal Reserve Bank embarked on a new scheme of quantitative easing (QE) aimed at lengthening the maturity of its securities holdings. The Fed is planning to purchase $400 billion in Treasury bills with maturities of 6 to 30 years and to sell an equal amount of short-term holdings by the end of June. In the euro area, as its statutes do not allow the ECB to act as a lender of last resort for financing of sovereign debts, the ECB has launched two Longer-Term Refinancing Operations (LTRO) since December 2011. These operations have provided commercial banks with three-year loans totalling more than €1 trillion, at an interest rate of 1 per cent, well below yields on government bonds of many euro zone countries. The Bank of Japan announced an increase in the size of the Asset Purchase Programme by about 22 trillion yen. The additional resources will be used to purchase Japanese government bonds.

With the continuation of the QE, the balance sheets of these central banks have been expanded rapidly. For example, the size of total assets of the Fed has increased from about $800 billion before the financial crisis to about $2.9 trillion at present, while that of the ECB has swelled from €1.1 trillion to €3.1 trillion ($4 trillion) (figure 1). Liabilities have also increased commensurately, mainly taking the form of excess reserves of commercial banks deposited with the central bank. As a result, the money supply has increased significantly in these economies.

The effectiveness of the QE policies has been disputed. As economic activity remains weak, the monetary easing has thus far not led to strengthening of credit demand from firms and consumers; it even continued to decline in Europe. As a result, the extra liquidity injected by the central banks has stayed mainly within the financial system. At the same time, emerging economies are concerned about the international spill-over effects of the continued expansionary policies of the major developed countries. They see surges in volatile short-term capital inflows towards their economies and the rapid rebound in the prices of primary commodities as risk factors. Over the past two years, they have felt the adverse spill-over effects in the form of currency appreciation and rising inflation.

Figure 1: Rising Balance Sheets of the Fed and the ECB



Source: Federal Reserve and European Central Bank

Note to the Secretary-General prepared by the Global Economic Monitoring Unit
Development Policy and Analysis Division, Department of Economic and Social Affairs
Contact: Rob Vos, Director, e-mail: vos@un.org • http://www.un.org/en/development/desa/policy/index.shtml

Developed economies

North America: some signs of economic strengthening, but far from robust

The economy of the United States ended the first quarter of 2012 on a positive note: the job market continued to improve, adding more than 200,000 jobs to the non-farm payroll monthly; major stock market indices rose by more than 10 per cent for the quarter; credit conditions eased notably; and both consumer confidence and consumption spending increased. However, the economy is still far from being back to "normal". At more than 8 per cent, the unemployment rate still stands well above the pre-crisis level and employment growth in March was visibly weaker than earlier in the year. A large number of people remain unemployed for more than six months. Even though house prices have already declined by more than 30 per cent over the past five years, the housing sector remains in a slump. Recent data indicate a decline in housing starts by 1.1 per cent in February, while existing home sales decreased by 0.9 per cent and new home sales were down by 1.6 per cent.

With the phase-out of the fiscal stimuli injected during the crisis, government spending continues to decline, dragging aggregate demand growth lower in the short run. Uncertainty about medium-term fiscal sustainability remains high.

Developed Asia and the Pacific: Growth slows in Australia and New Zealand; Japanese manufacturing slows

After suffering from the largest monthly trade deficit in January 2012, Japan recorded a very small trade surplus in February. A key factor behind this improvement was the rebound of exports to East Asia from the depressed January level caused by the Lunar New Year seasonal factor. Nevertheless, the level of Japanese merchandise exports is still lower than before the March 2011 Tohoku earthquake.

The Japanese industrial production index declined by 1.2 per cent in February from the month before. Meanwhile, the Tankan business survey conducted by the Bank of Japan in February and March also showed no improvement from the previous quarter in the large manufacturing firms' perception of current business conditions. The perception for the near-term outlook improved slightly, though.

Data released in March show that output growth slowed in the fourth quarter of 2011 in Australia and New Zealand. For Australia, quarter-over-quarter GDP growth decelerated from 0.8 per cent in the third quarter to 0.4 per cent in the fourth. The slowdown was mainly caused by the weaker fixed capital formation and inventory stocking. For New Zealand, the growth rate for the fourth quarter of 2011 decelerated to 0.3 per cent, down from 0.7 per cent in the third quarter, mainly as a result of stalled inventory accumulation.

Western Europe: some mixed news while the growth outlook remains depressed

Industrial production and retail sales increased in January after declining for a number of months. Construction activity declined in February. The decline was particularly strong in Germany where construction output dropped by 17.1 per cent owing to severe winter weather. Survey data for March was less positive. The European Commission's Economic Sentiment indicator dipped slightly after increasing in the first two months of the year. The Composite Purchasing Managers Index, after rising strongly in January, has now fallen in both February and March. Both indices remain above their average values for the fourth quarter of 2011. They are, however, currently at levels consistent with a continuing decline in activity with the likelihood that GDP will continue to contract in the first quarter of 2012, although at a more moderate pace than in the last quarter of 2011.

Unemployment in the euro area rose again, reaching 10.8 per cent in February, nearly a full percentage point above its relative low point in April of 2011. Significant regional differences continue to be apparent. Since the end of 2011, unemployment in Germany has remained at 5.7 per cent, its lowest rate in twenty years, and there have been no significant changes in eight other countries in the region. In Spain, Italy, and Portugal, however, unemployment rates have increased by about half of a percentage point.

New EU members: Hungary may face financial sanctions

Although business and consumer sentiment in many of the new EU countries remains tenuous, industrial production rose in February by 3.9 per cent year on year in Lithuania and by 4.6 per cent in Poland. Manufacturing sectors in the Czech Republic, Hungary and Poland apparently defied the EU-15 trend in March with stronger Purchasing Managers' Indices, and the Polish National Bank raised its growth forecast for 2012. In Poland, where robust domestic demand has been a source of some inflationary pressure, prices increased by an annualized 4.3 per cent in February year on year and, in response, the central bank refrained from reducing the policy interest rate. In most other countries inflationary pressures are subdued despite higher energy prices. In Latvia, core consumer inflation declined in February by 0.3 per cent. In Romania, inflation eased to 2.6 per cent in February, allowing the central bank to lower its policy rate by 25 basis points at the end of March.

Hungary may become the first EU country to face financial sanctions because of its fiscal policy. In March, the EU finance ministers approved the recommendation of the European Commission to withhold €495 million in cohesion funds for 2013, as Hungary's budget deficit for 2013 is expected to exceed the agreed threshold. The country can still avoid the sanction if it presents a credible long-term deficit reduction strategy by mid-September.

Economies in Transition

CIS: inflation moderates across much of the region

Industrial growth in the Russian Federation accelerated in February to 6.5 per cent year on year from 3.8 per cent in January, as utilities output rebounded and the construction, manufacturing, mining and oil products sectors performed robustly. However, sustainability of this growth may be in question once seasonal factors are taken into account (e.g., higher utilities output due to the cold winter and sales of light vehicles). Nevertheless, the Russian Purchasing Managers Index improved in March. In Ukraine, despite higher utilities output, industrial production in February grew by a meagre 1.6 per cent year on year due to weak demand for the country's exports, which are expected to stagnate in 2012. The country meanwhile has to repay around $11.9 billion of foreign debt in 2012.

Inflationary pressures in the CIS, triggered earlier by higher food and energy prices, continued to ease in February. In the Russian Federation, due to lower food, utilities and housing prices, inflation decelerated to 3.7 per cent. In Kazakhstan, inflation moderated to 4.7 per cent and the National Bank of Kazakhstan reduced its policy rate by 50 basis points in response. In Georgia, consumer prices actually dropped by 2.1 per cent in February (year on year). The National Bank of the Republic of Belarus cut its refinancing rate in early March as inflation, spurred by devaluation earlier in 2011, slowed considerably.

South-Eastern Europe: industry is weakening

In Croatia, industrial output dropped by 5.2 per cent year on year in February in response to weakness in the country's main export markets. In Serbia, industry declined by 2.7 per cent year on year in January, dropping to 16 per cent below the average for 2011. Croatia adopted an austere budget in late February. While slashing other expenditures, the Government intends to spend €1.66 billion investing in new infrastructure and energy projects, mostly funded by multilateral lenders. In March, the National Bank of Serbia continued its interventions to support the currency, which has been weakened by investors' concerns over the freezing of IMF loan disbursements, a decision by US Steel to abandon its steel mill, and uncertainty emanating from the parliamentary elections to be held in May 2012. In March, as inflation subsided, Albania's central bank cut its key rate by 25 basis points aiming to boost the economy.

Developing economies

Africa: Nigeria posts relatively strong growth for 2011; Egypt still running down foreign reserves

The central bank of South Africa, warned about the country's challenging macroeconomic environment, particularly increasing inflation, moderating output growth and persistent high unemployment. Given the situation, the Government limited the increase in energy prices to 16 per cent (instead of 25.9 per cent as was approved earlier) in order to soften the impact on households and industrial consumers, such as mining companies.

In Nigeria, the economy expanded by 7.7 per cent in the fourth quarter of 2011. With that result, GDP growth averaged 7.4 per cent for the year 2011 as a whole, a slight deceleration from the 8.0 per cent posted in 2010. The non-oil sector (especially, telecommunications, construction, hotels and restaurants) was a major driver of overall economic growth.

The Moroccan central bank cut its benchmark interest rate from 3.25 to 3.00 per cent. GDP growth prospects for 2012 have dimmed owing to bad weather conditions affecting agriculture. The trade deficit widened to $3.88 billion in January, reflecting an increase of more than 27 per cent from a year ago. Inflation remains at a very low level, however, at a mere 0.4 per cent year over year.

Egypt registered a balance of payments deficit of $5.65 billion in the fourth quarter of 2011. Foreign exchange reserves continue at critical lows. Capital has moved out of the country, including because of disinvestment in the petroleum sector, and the central bank has used significant amounts of reserves in efforts to support the Egyptian pound.

East Asia: China records significant trade deficit in early 2012

China recorded a significant trade deficit in the first two months of 2012 owing to seasonal factors and weak demand from developed economies. For January and February combined, the trade deficit was $ 4.25 billion, about 5 times higher than a year ago. The weaker-than-expected export performance, combined with a sharp drop in the HSBC Purchasing Managers' Index for March, has fuelled concerns of a hard landing of the economy. However, with inflation slowing to an 18-month low of 3.2 per cent in February, China's monetary authorities have gained additional room to stimulate activity.

In the Republic of Korea, export earnings declined by 1.4 per cent year on year in March. Shipments to the United States rose by 28 per cent, boosted by the bilateral free trade agreement that came into effect on March 15, 2012. In contrast, exports to the European Union fell by 20 per cent.

Economic growth in Viet Nam decelerated to an estimated 4 per cent year on year in the first quarter of 2012, the slowest pace in three years. Industrial output grew by only 2.9 per cent as the construction sector contracted. Activity was hit by high interest rates and weak bank lending, following aggressive monetary policy tightening in 2011 as the central bank fought inflation. Consumer price inflation slowed to 14.2 per cent in March 2012, after peaking at 23 per cent in August 2011. In response, the central bank introduced the first policy rate cuts since 2009.

South Asia: Sri Lanka's growth cooling after record high in 2011

Sri Lanka's economy maintained its strong growth momentum in the fourth quarter of 2011, expanding by 8.3 per cent year on year. As before, activity was boosted by reconstruction spending and tourism. Full-year growth accelerated from 8.0 per cent in 2010 to 8.3 per cent in 2011, the fastest pace in six decades. The central bank lowered its GDP growth target for 2012 to 7.2 per cent. The adjustment follows a tightening of monetary policy in February as authorities try to rein in credit growth and reduce the country's large trade deficit. The United States asked Sri Lanka to reduce crude oil imports from the Islamic Republic of Iran by 15 per cent in 2012. Sri Lanka imports about 93 per cent of its annual crude oil requirements from the Islamic Republic of Iran.

India's Government unveiled the budget for the new fiscal year 2012-13, in which it aims to reduce the deficit from an estimated 5.9 per cent of GDP in 2011-12 to 5.1 per cent. The bulk of the adjustment is expected to come from an increase in indirect tax rates.

Western Asia: external and fiscal balances affected by high oil price

By closing its daily one-week repo auction where the interest rate was set at 5.75 per cent and raising the effective funding rate to 10 per cent, the Turkish central bank returned to the tighter stance it had adopted in October 2011. It had previously loosened in January 2012 following a slight drop in inflation, an appreciation of its exchange rate and the first reduction in its current account deficit in two years. These trends weakened, however, in the first months of the year, but the recent policy decision is expected to further cut inflation and dampen the current account deficit.

In Israel, the Government reduced the gasoline tax for the fourth time in one year to satisfy popular demand, despite a budget deficit projected to increase slightly to 3.4 per cent of GDP in 2012. As social unrest has waned in Jordan, the fiscal deficit, including grants, is expected to fall from 6.1 to 5.9 per cent of GDP this year. Oil-exporting countries, in contrast, have largely benefited from growing government revenue deriving from elevated oil prices. The Kuwaiti government, for instance, plans to increase spending by 13 per cent in the coming fiscal year, including a 7 per cent increase in public sector wages.

Latin America and the Caribbean: bond markets rally while exports of manufacturing goods slow down

March data indicates that the region's economic slowdown, which set in during 2011, is continuing. The deceleration of economic growth in the region's major trading partners, including China, is a major factor. In Brazil, industrial production contracted by 3.4 per cent (year on year) in January, with the automobile industry recording a drop of 30 per cent. The Government reacted by cutting payroll taxes for manufacturing industries that are among the largest employers, such as textiles, footwear, trucks and busses and electrical materials. The Government also increased its purchases from domestic firms, and boosted loans to the sector by R45 billion ($26.6 billion) through BNDES, the national development bank. It also extended the tax on foreign capital inflows to foreign loans with five-year maturities.

Recent data show that Chile and Colombia saw GDP growth of, respectively, 4.7 per cent and 6.1 per cent in 2011. In both cases this reflects a significant slowdown (from, respectively, 13.2 per cent and 7.7 per cent in 2010). In Mexico, industrial production grew by 4.2 per cent (year on year) in February, compared with 6.3 per cent a year earlier. Bond markets rallied throughout the region in the first half of March. Bolivia's Government announced its first international bonds issuance since 1920 in an effort to raise $500 million for investment, including for the development of minerals processing. In the Caribbean, the Government of St. Kitts and Nevis agreed to a restructuring of one tenth of its total debt worth $1.1 billion, almost twice the size of GDP.