Monthly Briefing
World Economic Situation and Prospects

No. 46 **UN/DESA** 24 August 2012

Summary

- Drought in large parts of the United States is pushing up world food prices
- Emerging markets ease monetary policy to stimulate growth
- The debt crisis in the eurozone remains a major source of uncertainty

Global issues

Drought causing rise in food prices

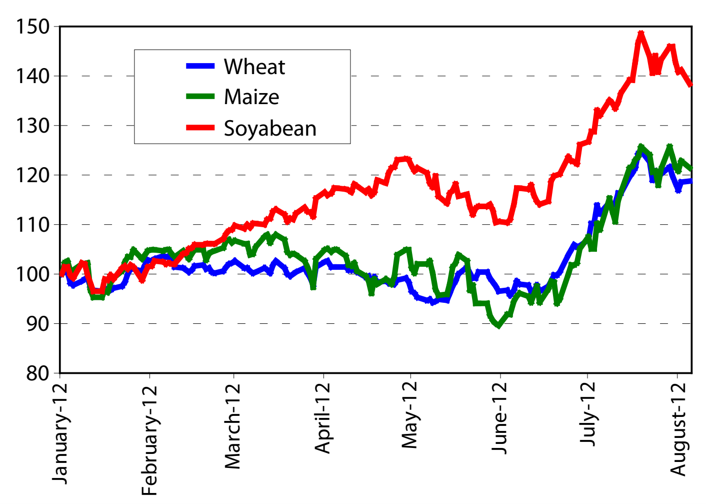
The severe drought affecting much of the United States is having a damaging impact on crops. The United States Agricultural Department (USDA) has downgraded its forecast for maize output by 12 per cent. Futures prices for maize have jumped by over 50 per cent since mid-June. In addition, soybean prices have increased by about 40 per cent this year, while the prices for wheat and maize are up by about 20 per cent (see figure 1). A previous drought in the southern hemisphere affected soybean crops in Brazil and wheat production in Australia. Moreover, in Thailand, the world's largest rice exporter, a Government programme to purchase domestic rice at above-market prices to boost inventory led to a reduction in exports by 45 per cent since January year on year. The driest monsoon season in three years is also pushing up prices of rice and wheat in India. In the Russian Federation, this year's wheat output is expected to be 20 per cent lower than that of 2011, and grain production in Kazakhstan is forecast to fall by 48 per cent year on year. Nonetheless, stocks remain relatively high in major producer countries as a result of much better harvests last season. This does not apply to countries already vulnerable to food insecurity, however.

Emerging economies ease monetary policy to stimulate growth

In response to slowing domestic growth and heightened uncertainty over the global outlook, monetary authorities in emerging economies are increasingly moving towards a more supportive policy stance. In July, the central banks in Brazil, China, Colombia, the Philippines, the Republic of Korea, South Africa and Taiwan Province of China cut their benchmark interest rates. In doing so, authorities are trying to stimulate domestic demand in the face of a sharper-than-expected slowdown in recent quarters. Export sectors in emerging economies continue to suffer from the crisis in the euro area and the still-sluggish demand in the United States and Japan. With external demand weakening and risks of a renewed global recession rising, investment activity has also lost strength in most of these economies, dragging down GDP growth. While the recent monetary easing by central banks is expected to provide some support to emerging economies in the second half of 2012, the overall policy response so far has been relatively cautious; more decisive action may be needed in the months ahead, including on the fiscal front. In this context, the gradual fall in inflation in emerging economies (with the exception of India) provides some space for policymakers.

Figure 1: World market prices for selected agricultural commodities

(index of daily prices, 2 January 2012 = 100)



Source: International Grains Council.

The debt crisis in the eurozone remains a major source of uncertainty

Financial market tensions rose again in Europe during July and early August. The deal to allow Spanish banks to be directly recapitalized from European "rescue funds" aims to offload pressure on sovereign debt. However, it will take time to fulfil the requirement to create a new banking supervisory entity. In the meantime, bailout funds for the banking system continue to be channelled through the Spanish Government, thus exacerbating sovereign debt concerns. The upshot is that the cost of 10-year Spanish government bonds spiked above 7 per cent in July and early August. The ECB initially managed to calm tensions by suggesting it might engage in a new round of purchases of selected government debt in the secondary markets. Uneasiness in financial markets returned, however, after it became clear that the ECB would only do so after formal requests made by euro area member states for support from the European Financial Stability Facility and the European Stability Mechanism, which might not be forthcoming given the conditionalities attached to such support.

Developed economies

North America: growing well below its potential

The latest data showed that GDP in the United States grew by 1.5 per cent in the second quarter of 2012, a further deceleration from the 2 per cent of the previous quarter. While private consumption and investment continued to increase at an anaemic pace, government spending continued to decline. The worsened situation in the euro area and the uncertainties about the fiscal policy associated with the coming election may have combined to depress the already low confidence.

Meanwhile, total non-farm payroll employment increased by 163,000 in July. This was an improvement from the previous months, but the unemployment rate edged up slightly to 8.3 per cent nonetheless. The civilian labour force participation rate remained at a record low of 63.7 per cent and the broadly defined unemployment rate, including underemployment, stayed at about 15 per cent.

In the aftermath of the financial crisis, the United States has experienced a sharp deterioration in public finances not only for the federal government, but also for the state and local governments. A few cities in California filed for municipal bankruptcy recently, being confronted with rising costs of pensions and unemployment benefits along with declining revenue from property and sales taxes. Meanwhile, a recent study by the State Budget Crisis Task Force shows that state finances are short of about $4 trillion in unfunded liabilities to cover pensions and health care for public employees. The shortfalls are partly the result of declining revenue and increasing health-care costs.

Developed Asia and the Pacific: Australia implements carbon tax

Australia put a carbon tax into effect on 1 July 2012. The tax applies to major polluters emitting more than 25,000 tonnes of CO_2 equivalent per year. The carbon price is initially set at 23.00 Australian dollars (AUD) per tonne and will be increased stepwise to AUD25.40 by July 2014. After July 2015, the carbon price is set to become market-based. According to estimates by the Government and other organizations, the measure could reduce GDP growth by 0.1-0.2 percentage points and push up consumer price inflation by between 0.7 and 1.1 percentage points.

Due to the euro area crisis, the value of merchandise exports from Japan to the European Union declined by more than 21 per cent in June 2012 from a year ago. Imports contracted more than exports, however, leaving a small surplus on trade balance. Industrial output declined for three consecutive months from April through June.

Western Europe: the outlook continues to deteriorate

The eurozone saw a contraction in economic activity by 0.2 per cent in the second quarter compared to the first quarter of the year. While Germany registered growth of 0.3 per cent, Italy and Spain reported contractions by 0.7 per cent and 0.4 per cent, respectively. Greece reported a fall in GDP by 6.2 per cent for the second quarter, year on year.

Short term indicators for industrial production, construction and retail sales all improved in May but remain lower than levels observed at the beginning of the year. Capacity utilization declined for a second consecutive quarter, while unemployment continued its upward march, reaching 11.2 per cent in June in the euro area, an increase of 1.2 percentage points from a year ago.

Indicators of confidence paint an even gloomier picture for the rest of the year. The European Commission's Economic Sentiment Indicator has now fallen for four consecutive months and is well below the level observed during the fourth quarter of 2011. Unlike earlier in the year, all economies in the region are now seeing dramatic drops in confidence.

New EU members: Hungary starts talks with the IMF

The economies of the new EU member states are being affected by weak external demand. In Poland, industrial output increased in June by a meagre 1.2 per cent year on year, held back by the stagnating automotive sector. Construction activity declined by 5.1 per cent in Poland and also remains weak throughout Central Europe. As of June, industrial production declined by 1.4 per cent year on year in Estonia and by 0.4 per cent in Lithuania. Slower-than-anticipated growth has complicated efforts to meet budget deficit targets for many new EU members. Estonia and Latvia, by contrast, managed to record budget surpluses in the first half of 2012 due to strong economic recovery in the first quarter and austere fiscal policies. Greater fiscal space allowed the Latvian Government to lower the VAT rate by 1 percentage point in June.

As portfolio investors look for an alternative to troubled eurozone countries, some of the new EU member states enjoy favourable borrowing terms. The Czech Republic brought its sovereign borrowing costs to a record low in July, thanks to austere fiscal policy. Employment recovery is proceeding slowly, with some countries suffering setbacks in the second quarter. In Hungary, however, the unemployment rate declined to 10.9 per cent in June from 11.2 per cent in May, reflecting seasonal factors and the impact of public works programs. In July, Hungary started talks with the IMF on a new loan worth about €15 billion, although the outcome of those talks is not certain given existing disagreements over tax policy.

Economies in Transition

CIS and Georgia: drought will affect grain harvest

Russia's GDP increased by 3.8 per cent year on year in June, slower than in May, as industrial production grew by only 1.9 per cent. As in the previous months, growth is mainly driven by domestic demand, while investment spending remains highly volatile. However, inflation accelerated to 5.7 per cent in early August on the back of food and utility prices, which may dampen consumption. After a net outflow of capital from January to May, the country experienced net inflows of about $5 billion in June. Nevertheless, total outflows for the first half of 2012 amounted to $43.4 billion. In Ukraine, output accelerated in the second quarter, with GDP increasing by 2.5 per cent year on year in the first half of 2012 and output in the agricultural sector increasing by 7.4 per cent owing to an earlier harvest season. However, drought is expected to cause a reduced harvest in the third quarter, especially of wheat and barley. The Government of Ukraine raised $2 billion by selling securities in the Eurobond market in July to repay its debt to the IMF. The borrowing costs were high, however. Across the Black Sea region, drought will affect grain harvests in the Russian Federation, Kazakhstan and Ukraine. In August, the Government of Kazakhstan abolished grain export subsidies that had been introduced in January 2012. In July, the National Bank of Kazakhstan cut its policy rate for the fourth time in a row to boost the economy as inflationary pressures subsided.

South-eastern Europe: a new IMF loan for Bosnia and Herzegovina

Economic weakness, caused by fragile external and domestic demand, continued in South-eastern Europe in June. Industrial production declined year on year by 1.6 per cent in Croatia, by 4.1 per cent in the former Yugoslav Republic of Macedonia, and by 3.1 per cent in Serbia. In most of the region, inflation remained moderate. The low inflationary pressure allowed the Central Bank of Albania to cut is key policy rate in July to an historic low of 4 per cent. In Serbia, by contrast, annual inflation increased to 5.5 per cent in July. The National Bank of Serbia therefore raised its key policy rate in July by 25 basis points to 10.25 per cent, in efforts to stave off an expected acceleration of inflation in the second half of the year. In July, the Government of Bosnia and Herzegovina reached a preliminary agreement with the IMF on a new two-year stand-by loan worth about $500 million to help to finance the budget deficit and to repay external debt. If the agreement is approved, funds from the EU and the World Bank will also be released.

Developing economies

Inflation moderates in Africa; tourism recovers in Egypt

Several African countries have seen a moderation in inflation rates. In South Africa, consumer price inflation receded further to 5.5 per cent year on year in June following weaker pressure on food and fuel prices. Similar trends were found in Namibia and Egypt. Nonetheless, inflation remains high in several countries, including Ethiopia and Tanzania where it still stood at 20.9 per cent and 17.4 per cent year on year, respectively, in June. The central bank of South Africa unexpectedly cut its policy interest rate by 50 basis points to 5 per cent in light of a weaker outlook for growth and inflation. Kenya cut its policy interest rate by 150 basis points to 16.5 per cent, referring to the success of its previous tightening stance. By contrast, Malawi increased its policy interest rate by 500 basis points to 21 per cent to counter the inflationary effect of a weaker currency. Ghana proposed extra spending that would increase the projected budget deficit from 4.8 to 6.7 per cent of GDP. The Government cited higher wages in the public sector, the need to finance the presidential and parliamentary elections in December, and the arrears of the previous Government as reasons for the additional expenditures.

The Egyptian Government expects tourist arrivals to the country to increase by 23 per cent in 2012 from last year. Yet, the expected 12 million tourist arrivals would be almost 20 per cent below the numbers reached in 2010 before the political transition. Tourism yields 11 per cent of GDP.

East Asia: Second-quarter figures show further weakening of the growth momentum

Economic growth across East Asia slowed further in the second quarter of 2012 as both external and domestic demand weakened. China's economy grew by 7.6 per cent year on year, the slowest pace since the first quarter of 2009. In the Republic of Korea, year-on-year growth decelerated to 2.4 per cent in the second quarter and in Taiwan Province of China, GDP contracted by 0.2 per cent from a year ago. The slowdown can be mainly attributed to falling exports and weak investment activity as firms have become increasingly concerned over the near-term outlook. Gross fixed capital formation decreased by 2.3 per cent year on year in the Republic of Korea and by 8.4 per cent in Taiwan Province of China. Underpinned by robust labour market conditions, consumption demand has remained resilient, however, mitigating the downturn.

China's stock of foreign exchange reserves declined in the second quarter of 2012. A moderate surplus in the current account was more than offset by a deficit in the capital and financial account as local firms and residents increased their holdings of foreign exchange assets. This was also a main factor behind the recent decline in the value of the yuan against the dollar.

South Asia: weak monsoon rains and massive power outage add to India's troubles

Weak monsoon rains are likely to have a negative impact on India's economy in the months ahead, adding to concerns over slowing growth and persistent inflation. During the first half of the monsoon season (June 1–July 31), total rainfall has been about 20 per cent below long-term averages. Furthermore, looming El Niño conditions may reduce rains in the weeks ahead. Insufficient and uneven rainfall could further drive up food inflation, which accelerated to 10.7 per cent year on year in June. Stubbornly high food prices and overall inflation have led the Reserve Bank of India to keep its policy rates unchanged since April, even though economic activity has remained weak. In late July, India suffered a massive power outage that left more than 600 million people without access to electricity. The blackout not only illustrates the country's inadequate infrastructure, but also serves as a reminder that in many developing countries, power supply is struggling to keep up with rapidly rising demand.

In Bangladesh, lower-than-expected agricultural output and weakening exports have prompted a downward revision in GDP growth for the fiscal year that ended in June. Growth is estimated to have slowed from 6.7 per cent in 2010/11 to 6.3 per cent in 2011/12 as agricultural output increased by only 2.5 per cent.

Across the region, export sectors continue to suffer from the crisis in the euro area. In the second quarter of 2012, total export earnings were about 5 per cent lower than a year ago in Bangladesh and about 8 per cent lower in Pakistan.

Western Asia: reliance on hydrocarbon and external demand

Following a decade of almost uninterrupted double-digit growth, Qatar's real GDP expanded by 6.9 per cent in the first quarter of 2012, down from almost 15 per cent in the previous quarter. As the boost from the hydrocarbon sector is fading, the construction sector is again becoming the main source of economic growth. In Iraq, the Kurdistan Regional Government officially started to export oil to Turkey in breach of federal law. The persisting disagreement between regional and federal authorities over the management of oil resources and revenues is hampering investment and the development of the hydrocarbon sector. Israel posted another large trade deficit in the first half of 2012, up by almost 50 per cent from a year ago. Weak external demand led exports to drop more sharply than imports, including for high-tech goods. Turkish exports that are less reliant on Western markets, by contrast, remain resilient and contributed to narrowing the 12-month trailing current account deficit, which remains high at 8.7 per cent of GDP. Economic growth, however, has slowed in recent months, lowering revenues and widening the budget deficit, which reached 2 per cent over the last year.

Latin America and the Caribbean: industrial production declines while natural resources attract capital from abroad

According to recent data, economic activity in Latin American and the Caribbean grew moderately through the second quarter of the year, compared with the same period of 2011.

In Brazil, after three months of declining output, industrial production grew 0.2 per cent in June month on month. Unchanged private bank lending and persistently high personal default rates suggest that private domestic demand is flagging, adding to the slowdown in commodities exports. However, unemployment remains low, supported by tax incentives extended to key industrial sectors such as automobile and textiles. Decreasing inflation in July fulfilled the condition set by the Central Bank for an increase in monetary stimulus.

In May, industrial production declined in Argentina (1 per cent), Colombia (0.2 per cent) and Mexico (1.4 per cent). The decline in Colombia came despite a 26 per cent increase in foreign direct investment during the first semester of 2012. Investments, however, went mostly into mining and other natural resource sectors. The country is now the latest in the region to face deindustrialization concerns as capital inflows caused the currency to appreciate 9 per cent against the dollar since the beginning of the year. To curb the appreciation, Colombia's Central Bank cut the overnight lending rate for the first time since 2010, from 5.25 per cent to 5 per cent.