Monthly Briefing
World Economic Situation and Prospects

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Summary

- Effects of quantitative easing on emerging markets weakening
- Fiscal cliff looming for the United States
- Economic situation in Japan deteriorates further
- Signs of a mild strengthening of economic activity in China

Global issues

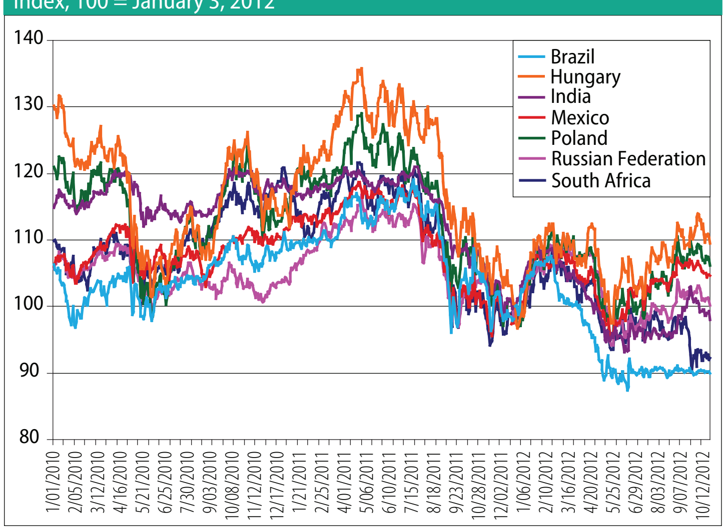
Impact of quantitative easing on emerging market economies is weakening

The initial rounds of quantitative easing (QE) by developed country central banks in 2008 and 2009 are estimated to have had mixed effects on emerging market economies (EMEs). Brazil, among others, faced sudden and strong inflows of hot money causing currency appreciation. The real appreciated by more than 35 per cent over that period, perhaps exacerbating the general slowdown in exports during that time. Asian EMEs showed more limited appreciation pressures and substantial reductions in government bond yields. Hong Kong Special Administrative Region of China (where the exchange rate is managed by a currency board) felt strong effects on equity prices and bank credit.

The effects of more recent QE measures seem to have been more limited, however, especially on exchange rates. Exchange rates of a number of EMEs depreciated with respect to the United States dollar after peaking in mid-2011 (figure 1). Despite injections of over $1 trillion in liquidity by the European Central Bank (ECB) in the Long Term Refinancing Operations (LTRO) in late 2011 and early 2012, exchange rate effects have been mild, showing initial minor appreciations of the currencies of EMEs, followed by small depreciations in a context of generalized volatility. Further, there was appreciation in some countries running up to the QE3 announcement in August, but since then there has been a return to depreciation. More frequent foreign exchange market interventions by the central banks of the EMEs, drawing on ample reserve holdings, have been one factor in mitigating swings in exchange rates. Flexible capital account regulation has likely also been a factor. For example, the Central Bank in Brazil relaxed one of its capital controls in December—the "advanced receipts for exports"—in an attempt to counteract depreciation pressures.

Figure 1: **Exchange rates of selected emerging market economies relative to the dollar**

Index, 100 = January 3, 2012



Source: JPMorgan.

G20 recognizes downside risks

The Group of Twenty (G20) Finance Ministers and Central Bank Governors met in Mexico City on 4-5 November. Concerns were expressed in its communiqué that global growth remains modest and downside risks are elevated, including the possible delays in policy actions in Europe, fiscal tightening in the United States, budget challenges in Japan and weaker growth in emerging markets. Finance ministers recognized the fact that the reduction in global imbalances had not been sufficient, and committed to achieving external and internal adjustment in a way that supports and sustains growth and leads to global rebalancing. The main focus of the G20 in the near future was identified as rebuilding confidence and reducing risks and volatility in international financial markets, which ostensibly would contribute to a faster pace of recovery and job creation. Warnings, including those from the International Monetary Fund (IMF),

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that fiscal austerity is putting a greater-than-expected brake on economic recovery in developed economies, did not lead to any suggestion for change in current policy stances.

Developed economies

United States edging towards the fiscal cliff

A number of temporary tax relief measures will expire by the end of 2012, including the tax cuts endorsed during the administration of George W. Bush, the payroll tax reduction, and the emergency unemployment compensation introduced during the Obama administration. At the same time, if Congress cannot reach an agreement on how to reduce the government deficit in the next decade, the Budget Control Act will be activated at the beginning of 2013, cutting government expenditures by about $98 billion per month. Unless Congress reaches agreements to extend those tax relief measures and avert the automatic spending cuts, the United States will face a sharp change in its government spending and tax policy, or the so-called fiscal cliff, which will lead to a reduction in aggregate demand by about 4 per cent of gross domestic product (GDP). The bipartisan negotiations were still ongoing by mid-December, with no agreement in sight.

Hurricane Sandy wreaked havoc in the north-eastern United States in late October, causing significant loss of lives, property damage, capacity destruction, and disruption of economic activities. The damage to New York State alone is estimated at about $32 billion. While significant, the impact on the United States economy will be very minor.

Real GDP growth in the United States for the third quarter of 2012 was revised upward to 3.1 per cent, mainly reflecting higher estimates for exports and consumer demand, while State and local governments added to growth for the first time in three years. The uncertainty weighing on consumers and businesses along with the more general global economic slowdown are likely to cause restrained growth in the fourth quarter.

Developed Asia and the Pacific: monetary easing in Australia and Japan

The economic situation in Japan continues to deteriorate. Trade statistics for September and October 2012 showed a decline in the value of exports by more than 8 per cent from a year ago. In September, the industrial production index registered the biggest month-over-month decline since the earthquake in March 2011. Although production partially rebounded in October, shipments remained flat.

Against this backdrop, the Bank of Japan (BoJ) decided to pursue further monetary easing on 30 October. The new action increased the size of the Asset Purchase Program from ¥80 trillion to ¥91 trillion with the increased amount mainly to be used for the purchase of Japanese government bonds and treasury discount bills. The time frame for this programme was not extended. More significantly, this policy action also included the "Framework for Fund-Provision Measure to Stimulate Bank Lending". Under this framework, depository institutions can request funds from the BoJ up to the full amount of their net increase in lending to the non-financial private sector, denominated in either Japanese yen or foreign-currency. The BoJ will provide an unlimited amount of loans under this framework and will charge a long-term fixed rate equivalent to the BoJ's target for the uncollateralized over night call rate which is currently less than 0.1 per cent per annum. This new facility was designed to prompt the financial institutions to provide more credit.

On 4 December 2012, the Reserve Bank of Australia (RBA) decided to cut its policy rate again by 25 basis points to 3 per cent. This is the fourth time the RBA lowered its policy rate this year and the cumulative cuts amount to 125 basis points since the beginning of year. The slowdown in Europe and uncertainty about the fiscal stance in the United States are behind the move.

The euro area has fallen into recession

GDP contracted in the euro area by 0.1 per cent in the third quarter of 2012, after a 0.2 per cent fall in the first quarter, marking two successive quarters of contraction, and, hence, is technically in recession. Germany and France still registered positive growth, but the economies of Italy, Spain, and the Netherlands contracted. The United Kingdom exited recession, growing at its fastest pace in five years. However, this positive outcome was boosted by one-off factors, both Olympic related and statistical (the adjustment for the number of working days substracted from growth in the second quarter but added to growth in the third).

This contraction was in line with high frequency data for the period that showed activity in industry, construction and retail sales broadly stable in the first two months of the quarter but dropping off sharply in September. Confidence surveys for that period were much gloomier, but picked up in October. The European Commission's economic sentiment index increased in November after eight consecutive monthly declines. The Markit Eurozone Composite PMI also increased in November. While these are the first positive signals in many months, a real turning point would require a number of months of significant improvement, as both surveys rest at very low levels, consistent with a significant contraction in activity. The unemployment situation continues to deteriorate. In October, the rate of unemployment in the euro area reached 11.7 per cent.

After intense negotiations, the troika of the European Union (EU) the ECB and the IMF finally agreed to release a long-delayed €34.4 billion aid payment to Greece in concert with a series of measures designed to put Greece's debt-to-GDP ratio on a more sustainable path and facilitate a gradual return to market financing. The debt ratio is planned to decrease to 124 per cent of GDP by 2020 through significant, front-loaded debt reduction measures worth 20 per cent of GDP. These measures include: a debt buyback scheme; a return of Securities Market Programme profits to Greece; a reduction of Greek Loan Facility (GLF) interest rates, a significant extension of GLF and European Financial Stability Facility (EFSF) maturities, and the deferral of EFSF interest rate payments.

New EU members: mostly disappointing third quarter

The new EU member States in the third quarter of 2012 registered mixed economic results. In Central Europe, economic activity and industrial output remained weak. Poland's GDP grew by a meagre 1.4 per cent year on year, with shrinking fixed investment after the completion of the Euro-2012 Football Championship. In the Czech Republic and Hungary, both of which are implementing fiscal austerity measures, GDP fell by 1.5 per cent year on year, as only net exports made a positive contribution to growth. Slovenia saw a 3.3 per cent year-on-year decline in GDP, as the contribution from net exports was not able to offset the effect of plummeting private consumption. Slovakia performed better, with GDP increasing by 2.2 per cent year on year, as the automotive sector continued to drive the economy. Economic indicators for October and November reflect a similar picture, and economic sluggishness is expected in the fourth quarter, despite some strengthening in manufacturing Purchasing Managers Index (PMI) and in the indices of new orders in Hungary and Poland. In Bulgaria, GDP growth remained stable in the third quarter of 2012, at 0.5 per cent year on year.

By contrast, the economies of the Baltic States remained resilient to the global slowdown. GDP grew by 4.4 per cent year on year in Lithuania, as agriculture escaped drought, which affected many neighbouring areas, and oil refining boosted manufacturing. GDP growth of 5.3 per cent year on year was registered in Latvia, with good performance by most sectors, and of 3.4 per cent year on year in Estonia. In October, the Polish Government announced plans to spend $95 billion by 2020 on upgrading the country's infrastructure. The prioritization of growth over austerity was perceived favourably by investors, and Poland's euro borrowing costs declined below that of the Czech Republic in October.

The Governments in the region have little room for fiscal manoeuvring, but the relaxation in monetary policies is continuing. In November, the Czech National Bank further cut its benchmark rate to a record low of 0.05 per cent, 70 basis points below the ECB's level, and is apparently ready to weaken the currency through direct interventions. The National Bank of Poland also cut its policy rates in November and December, as inflation in October fell to a 22-month low of 3.4 per cent. In late November the National Bank of Hungary cut the benchmark interest rate by 25 basis points for the fourth consecutive time, although consumer price inflation stood at 6 per cent year on year in October, well above the central bank's target.

Economies in transition

CIS and Georgia: growth slows in the Russian Federation

Third-quarter GDP growth in the Russian Federation slowed to 2.9 per cent year on year, down from 4.0 per cent in the previous quarter. Weaker consumer and investment demand was the main factor behind the slowdown, compounded by lower growth of manufacturing output and a poor harvest. Manufacturing output and the index of new orders had improved markedly in late October, but figures for November showed a renewed weakening. Oil output increased in November to 1.5 million barrels a day. Inflation, mainly driven by volatile food prices, slightly decelerated to 6.5 per cent year on year in October. In November, the United States repealed the Jacson-Vanik amendment, which previously restricted trade with the Russian Federation. The impact on Russian exports is not likely to be felt soon, however.

In Ukraine, third quarter GDP contracted by 1.3 per cent year on year, in the aftermath of a weak grain harvest. The industrial sector, in turn, was dragged down by stagnant external demand for steel-based products and shrunk year on year in the January-October period. In December, Moody's downgraded the country's credit rating to B3 with a negative outlook, as the country has a significant amount of external debt to repay while facing foreign-exchange shortages. In Belarus, industrial output expanded by 6.6 per cent in January-October (year on year) and the grain harvest was favourable. Yet, the economy grew by only 2.2 per cent during the period because of declining investment and construction activity. In Azerbaijan, where oil exports suffered from the fall in production, total exports contracted by 9.9 per cent year on year in January-September. Manufacturing output, in contrast, expanded by almost 8 per cent year on year. Georgia recorded strong third quarter GDP growth at 7.4 per cent year on year. In Tajikistan, real GDP grew by 7.5 per cent year on year in January-September.

Inflation in Belarus, after jumping as a result of the earlier balance of payments crisis, slowed to 30.5 per cent year on year in October. Elsewhere, inflationary trends diverged. Annual inflation in Ukraine remained close to zero in October, for the third consecutive month. In Georgia, consumer prices fell by 0.5 per cent year on year in November, as the Government adhered to a conservative fiscal policy, and the central bank lowered its refinancing rate by 25 basis points. However, in Tajikistan inflation accelerated to 6.5 per cent year on year in November, following a rise food prices triggered by poor harvests in the CIS wheat exporters.

South-Eastern Europe: economies continue to shrink

Economic performance in South-Eastern Europe remains weak. Serbia's GDP fell by 2.2 per cent in the third quarter. In October, industry strengthened by 1.6 per cent year on year as car production doubled. In November, Serbia continued negotiations with the Russian Federation to obtain a $1 billion loan for budgetary support.

In Croatia, third quarter GDP fell by 1.9 per cent year on year, as deleveraging in the corporate sector continued and public investment remained below planned levels. Furthermore, industrial output fell in October by 5.8 per cent year on year. Although the central bank tried earlier to boost lending for projects in industry, agriculture, energy and tourism, the willingness to invest has remained scarce.

In Bosnia and Herzegovina, industrial activity was already depressed, but shrunk further in October. Energy production fell steepest, affected by the drought. Food and administered prices continued to increase faster than expected and inflationary expectations heightened, pushing up headline inflation to 12.9 per cent in October. In response, the National Bank of Serbia further increased its key policy rate by 20 basis points to 10.95 per cent in November.

Developing economies

Africa: deficits rise in South Africa and Egypt; growth slows in Kenya

The South African Government revised its projected budget deficit from 4.6 per cent to 4.8 per cent of GDP, owing to lower expected tax revenues caused by slower economic growth. GDP growth slowed to 1.2 per cent in the third quarter compared to 3.4 per cent in the previous quarter, dragged down in particular by the contraction of the mining sector by 12.7 per cent as a consequence of strikes.

Egypt's budget deficit reached 11 per cent of GDP for the fiscal year ending in June 2012. The projected deficit is well above the earlier forecast of 8.6 per cent of GDP. The further widening of the deficit is mainly on account of public sector wage increases and rising interest payments. Furthermore, Egypt is facing acute balance-of-payments problems and fears for a steep fall of the Egyptian pound mounted in December. Negotiations for a $4.8 billion loan from the IMF were still ongoing by the end of the year.

Real GDP growth slowed slightly in Kenya to 3.3 per cent in the second quarter, and first quarter figures were revised downward by 0.1 per cent to 3.4 per cent. Some of the growth slowdown has been blamed on high interest rates and subsequent weakness in private-sector credit expansion. There is likely to be some pickup in the second half of the year, as interest rates have come down significantly.

In Nigeria, consumer price inflation increased to 11.7 per cent in October from 11.3 per cent in the previous month, which represents the first increase after three consecutive monthly declines. While food prices underpinned the uptick in headline inflation, core inflation actually declined. Price pressures eased slightly in Ghana, with the inflation rate falling by 0.1 per cent to 9.4 per cent in September in view of the onset of the harvest season and falling food prices. The central bank of Zambia increased its policy interest rate by 25 basis points to 9.25 per cent, citing risks to its inflation target of 7 per cent. Food price inflation has slowed in Ethiopia and Tanzania, bringing inflation down in October to 15.8 per cent and 12.9 per cent, respectively.

East Asia: subdued third-quarter growth; signs of rebound in China

Most East Asian economies grew at a subdued pace in the third quarter of 2012 as weak external demand continued to weigh on net exports and capital spending. In China, year-on-year GDP growth decelerated to 7.4 per cent, the slowest pace since the first quarter of 2009. On a seasonally adjusted quarter-on-quarter basis, however, China's growth picked up in the third quarter. Recent data on China's manufacturing activity point to a rebound in the months ahead as looser monetary conditions, higher government expenditures and stabilization in the housing market are expected to support domestic demand.

In the region's higher income economies, weak exports and sluggish private sector demand resulted in lacklustre growth in the third quarter of 2012. In Hong Kong Special Administrative Region of China, the Republic of Korea, Singapore and Taiwan Province of China, GDP expanded by less than 2 per cent year on year. The outlook for these export-dependent economies is clouded by the ongoing euro area crisis and the potential fiscal cliff in the United States.

The sluggish pace of expansion in the higher income economies contrasts sharply with robust growth in Indonesia, Malaysia and the Philippines. In Indonesia, GDP expanded by 6.2 per cent year on year as buoyant private consumption and investment offset weak demand for exports. In the Philippines, economic growth accelerated to 7.1 per cent year on year, boosted by public construction and government consumption. Against the backdrop of significant global risks and ongoing low inflationary pressures in the region, several East Asian central banks further eased monetary policy. In October, policy rates were lowered in the Philippines, the Republic of Korea, and Thailand.

Governments in many East Asian countries remain concerned about high capital flow volatility. In the Republic of Korea, the Government decided to lower the cap on the foreign-exchange position ratio of domestic banks and local branches of foreign banks. In the Philippines, the central bank vowed to use a set of instruments, including macro prudential tools, to counter a potential surge in capital flows.

South Asia: India's growth remains lacklustre

India's growth remained lacklustre in the third quarter of 2012, with GDP expanding by 5.3 per cent year on year. Full-year growth is forecast at 5.5 per cent, down from 9.6 per cent in 2010 and 6.9 per cent in 2011. Private consumption, capital spending and exports expanded at a subdued pace in the third quarter as domestic and international conditions remained challenging. At the sectoral level, agricultural growth slowed to 1.2 per cent year on year because of poor monsoon rains, and manufacturing output increased by only 0.8 per cent. There are, however, signs of a moderate recovery in the manufacturing sector, with the PMI rising to a 5-month high in November.

Slowing economic growth and large energy subsidy bills continue to strain public finances in many South Asian countries. In the first three months of fiscal year 2012/13, the Pakistani Government already spent more than 60 per cent of its total annual subsidies for the power sector, which faces severe structural problems. In 2011/12, the country's fiscal deficit reached 6.6 per cent of GDP well above the initial target of 4 per cent as the power subsidy bill was three times the budgeted amount. India's government budget deficit in the first half of 2012/13 amounted to two thirds of the full-year estimate. The target of reducing the deficit from 5.8 per cent in 2011/12 to 5.3 per cent in 2012/13 is therefore unlikely to be achieved.

Inflows of workers' remittances to South Asia continue to show robust growth. In the first four months of the fiscal year 2012/13, remittance flows to Bangladesh grew by 24.9 per cent year on year. This has contributed to a steady increase of the central bank's foreign exchange reserves, which covered four months of imports in October.

Western Asia: fuel subsidies removed in Jordan

After an aborted attempt to end fuel subsidies in September, the Jordanian Government finally decided to go ahead, despite popular protests. The unpopular move will result in a price increase of 50 per cent for bottled gas (used for cooking) and of 33 per cent for diesel and kerosene. At the same time, the bottom 70 per cent of the population should benefit from monthly compensatory cash payments. Those measures will contribute to reducing the budget deficit in 2013 and are in line with the $2 billion agreement Jordan recently reached with the IMF and which emphasizes budget consolidation. The price of electricity remains subsidized, however. Furthermore, recurrent attacks on gas pipelines in the Sinai compelled Jordan to replace cheap gas with expensive oil for the production of energy, thus raising the energy import bill and government expenditures. In Bahrain, government spending is now being scaled down after jumping by 19 per cent during the Arab Spring. As the oil break-even price for Bahrain in 2012 is estimated at around $115 per barrel, the Government plans to cut expenditures by 6 per cent in 2013, despite enduring social tensions.

As geopolitical tensions persist in the region, the Saudi state oil company Aramco provided details concerning its ability to bring about 900,000 million barrel per day of additional oil on stream by 2014. The construction of three new export refineries will further allow Saudi Arabia to process additional crude, thus adding value to its oil exports. In Turkey, inflationary pressures eased in October following weaker demand. Yearly inflation fell by 1.4 per cent to 7.8 per cent and the central bank cut the upper bound of the interest corridor by 50 basis points to 9 per cent.

Latin America and the Caribbean: mixed third quarter results and solid performance of foreign direct investment

Third quarter results show mixed trends in the region. In Brazil, GDP grew only by 0.6 per cent year on year, well below expectations. In particular, gross fixed capital formation showed a sharp decrease of 5.6 per cent. Continued weak output growth led Brazil's central bank to reduce the reference interest rate by 25 base points in October. The rate is now at a historic low of 7.25 per cent. So far, the impact on economic activity has been feeble, however.

In Peru and Chile, in contrast, third quarter economic activity expanded at a robust pace of 6.5 per cent and 5.7 per cent, respectively, year on year. In both case, growth was mainly driven by vigorous investment demand. Performance of the Mexican economy was more modest, with GDP increasing by 3.3 per cent between July and September. Over the first three quarters of 2012, GDP had expanded at an annualized rate of 4.1 per cent.

Foreign direct investment (FDI) flows towards the region continue to be strong. During the first half of 2012, FDI grew by 8 per cent year on year. Many multinationals investing in the region have posted solid profits in recent years. In some cases, such as Spanish multinationals, operations in Latin America are making up for losses at home. Countries with major increases in FDI inflows are the Dominican Republic (by more than 100 per cent), Chile (80 per cent), Bolivia (53 per cent), Guatemala (47 per cent), Argentina (42 per cent) and Colombia (18 per cent). Most FDI went into gas and oil and mining sectors. FDI inflows remain the main form of capital inflow in the region.