Development Policy and Analysis Division ◆ Department of Economic and Social Affairs

World Economic Situation and Prospects

Monthly Briefing

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Summary

- Policy initiatives improve the situation in global financial markets
- Japanese yen depreciates significantly after new policy stances
- Further monetary easing in South Asia

Global issues

Recent major developments in macroeconomic policies worldwide

A number of new policy initiatives adopted by major economies in late 2012 and early 2013 seem to have measurably improved the situation in global financial markets. However, the uncertainties and downside risks remain elevated.

Bold policy actions in Japan

Bucking the trend of fiscal tightening in most developed economies, in January 2013, the Japanese Government proposed a new stimulus package of 20.2 trillion yen, including 10 trillion yen of extra government spending (2 per cent of GDP), to be financed largely by issuing bonds. Meanwhile, Bank of Japan raised its inflation target to 2 per cent and expanded the size of its assets purchasing. Growth trends in Japan did warrant some action, but the fiscal stimulus bears implications for the budget deficit that already stands at 10 per cent of GDP and the public debt at 230 per cent of GDP, the highest among all developed countries. If these new measures are successful in boosting growth, they will disprove the doctrine of fiscal austerity other developed economies have followed; a failure, however, may increase the risk of Japanese sovereign debt.

Targeting the unemployment rate

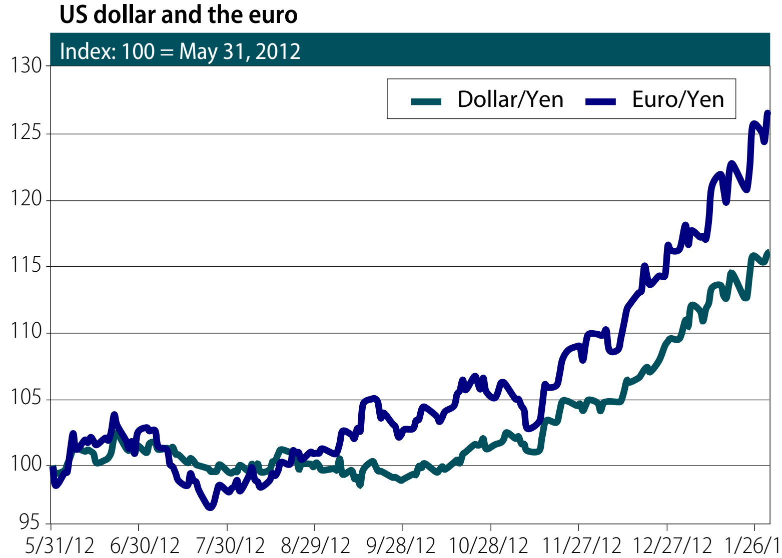
The United States Federal Reserve (Fed) has recently announced that it will continue monetary easing until the unemployment rate drops to 6.5 per cent, or until the projected inflation rate for the next 12 months rises to 2.5 per cent. Although the Fed has the dual mandate of promoting full employment and stable prices, this is the first time in history for a central bank to set a numerical target on the unemployment rate for its monetary policy. While some analysts have claimed the advent of a new era for monetary policy, others are cautious about the implications.

Open-ended strategy by major central banks

In launching a new round of the assets purchasing programme in the second half of 2012, the Fed defined neither the total amount nor the duration of its purchasing of government bonds or other securities. At the same time, the European Central Bank (ECB) also emphasized the undefined duration and unlimited amount of its purchasing of the bonds of the euro members when it announced the new Outright Monetary Transaction (OMT) programme. Joining the league of key central banks, the Bank of Japan decided to adopt a similar open-ended strategy of assets purchasing by 2014.

This open-ended strategy seems to be working better than the previous fixed targeted intervention strategy in terms of anchoring financial market expectations, as reflected in the recent improvement in global equity markets. Market sentiments improved in Europe since the ECB announced the OMT programme even though no euro members have

Figure 1: **Exchange rates of the Japanese Yen against the US dollar and the euro**



Source: JPMorgan.

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applied for the policy. The open-ended commitment of the ECB has lowered the spreads in sovereign debt markets. The OMT programme, combined with other policy initiatives, has led to a rebound in confidence across in Europe, and the rise in the euro, from a low of 1.22 $US/euro at the end of July 2012 to the current 1.33. Bond yields for the crisis countries have fallen dramatically. For example, the spread for Spanish 10-year bonds over those of Germany has fallen from 630 basis points in July of last year to 350 in January. Recently Spain was able to raise 7bn euro in a successful 10-year bond sale at this far lower yield, while Portugal returned to the bond market for the first time since being bailed out in 2011.

Nevertheless, this strategy has also heightened some concerns about inflation, exchange-rate volatility, and difficulties for the central banks to unwind in the future. For example, the new monetary policy stance in Japan, which includes a new inflation target of 2 per cent, has significantly increased the depreciation of the yen against other major currencies (see figure 1). Since mid-October, the Japanese yen has depreciated by 16 per cent. Some Governments and analysts have expressed their concerns on competitive devaluations and "currency wars".

From fiscal cliff to debt ceiling in the United States

As the Congress of the United States failed to reach any agreement by the end of 2012, all temporary tax relief measures expired on 1 January 2013. Two days later, the Congress passed a new bill to reduce the income tax rates for 99 per cent of families to the same levels as before, but did not extend the 2 percentage points of temporary reduction in payroll taxes. The Congress deferred the Act of automatic spending cut until 1 March. The decision to extend the public debt ceiling, which is already hitting the limit of $16 trillion, has also been postponed to March 2013. Although the United States managed to avert a full-scale fiscal cliff scenario, some taxes have indeed increased, and looming uncertainties about the negotiations on spending cuts and the debt ceiling still weigh on the economy.

Developed economies

The United States: decline in GDP, but improvement in employment

Real GDP in the United States fell 0.1 per cent in the fourth quarter of 2012, driven mainly by a substantial (but temporary) decrease in defence spending and inventories, and a drop in exports. However, personal income, consumer spending, residential investment, and business fixed investment have all accelerated from the previous quarter, with the housing recovery gaining some traction.

Payroll employment added 157,000 in January, not a strong pace but the statistics for the past few months was revised upward notably. The economy added 181,000 jobs per month on average in 2012, higher than 153,000 as originally announced. The unemployment rate for January, however, moved marginally higher to 7.9 per cent, up from 7.8 per cent in the previous month. The broad measure of underemployment, including those working part time who would rather work full time was still at 14.4 per cent. While the labour force participation rate was still near the record low, the employment-to-population ratio did not change. At this pace, the unemployment rate is unlikely to reach the target of 6.5 per cent set by the Fed for mid-2015.

Developed Asia and the Pacific: continuing weaknesses in Japan

The Japanese economy remained under stress at the end of 2012. For three consecutive months ending in December, the export volume remained at low levels, close to those seen following the natural disaster of March 2011. In addition, real wage maintained its downward trend over the second half of the year and survey-based indices for business and consumers compiled by the Government pointed to a downbeat outlook. In contrast, industrial production and retail sales managed to both break away from the declining trend and edge up in December. According to other surveys compiled by business groups, segments of some industries have started to show an improvement in near-term outlooks.

Western Europe: turning point reached?

Economic sentiment indicators continued to improve in January. For example, the European Commission's Economic Sentiment Index rose for the third consecutive month, as did the PMI Composite Index for the euro area. The improvements in these indices reflect the improvement in industry, services and consumers sectors. These indices and the capacity utilization that also increased after three consecutive quarters of decline continue to remain low by historical standards.

Hard data released for November confirms marked contraction in output during the final quarter of 2012. Industrial production and construction activity both declined, while retail sales ticked up slightly, but in all three cases, the trend over the previous three months was of stagnation or decline. Unemployment remained at 11.7 per cent in December, a full percentage point higher than one year ago.

New EU members: Latvia aims to join the euro area

Growth in Poland slowed to less than 1 per cent year on year in the fourth quarter of 2012, bringing annual GDP expansion to a mere 2 per cent. Industrial output shrank in December by 10.6 per cent year on year. Core inflation in late 2012 was low and in early January, for the third month in a row, the National Bank of Poland cut the reference policy rate by 25 basis points. However, consumer and business sentiment remains weak. In late January, the Hungarian National Bank also cut its policy rate by 25 basis points. In the Czech Republic, where official interest rates remain at an all-time low, the central bank expressed readiness to weaken the exchange rate to promote exports. Despite that, confidence indicators in January declined.

The economic picture was brighter in the Baltic States. Latvia recorded a 3.9 per cent increase in industrial output in November year on year and is likely to report the highest annual growth rate in the European Union (EU), at around 5 per cent. In February, the Government of Latvia intends to send an official request to the EU for permission to adopt the euro.

Economies in Transition

CIS and Georgia: Ukraine negotiating a deal with the IMF

Output continued to weaken in the Russian Federation by the end of 2012 as fixed investment fell. Industrial output in December grew by only 1.4 per cent year on year. Credit growth decelerated, prompting the Government to call on the central bank to cut interest rates. Inflation, driven in the second half of 2012 by a poor harvest and earlier easing of monetary policy, reached 6.6 per cent in December.

In Ukraine, GDP contracted in the fourth quarter by 2.7 per cent year on year, bringing annual growth to just 0.2 per cent. The country's fragile balance-of-payment position was aggravated in January by the demand from the Russian Federation to pay a $7 billion gas bill. The country is seeking a loan from the International Monetary Fund (IMF); however, the Fund's requirement to increase natural gas tariffs remains difficult for the Government to accept. In Belarus, annual GDP increased by 1.5 per cent, significantly below original estimates. By contrast, most of the Central Asian countries reported stronger growth, bolstered by commodity exports and public spending. GDP increased by 5 per cent in Kazakhstan, 11.1 per cent in Turkmenistan and 8.2 per cent in Uzbekistan.

South-Eastern Europe: continuing stagnation

Feeble domestic demand subdued by continued deleveraging, high unemployment, and weakness in the EU continue to restrain economic activity in the region. In Croatia, indicators suggest that fourth quarter GDP has declined on a year-on-year basis, along with public investment, while the unemployment rate surged to 20.4 per cent. The private sector is reluctant to invest despite officially allocated funds for projects in agriculture, energy, industry and tourism. In January, the country signed an agreement to join the South Stream pipeline project, which is intended to carry Russian natural gas to Europe.

In Serbia, the fourth quarter GDP dropped by 1.5 per cent year on year while inflation continued to accelerate, following the earlier poor harvest and increases in value added and excise taxes. Inflation reached 12.2 per cent year on year in December. As the planned administrative price hikes fuel inflationary expectations, the National Bank of Serbia raised its policy rate in January to 11.5 per cent. In the former Yugoslav Republic of Macedonia, industrial output shrank by 8 per cent year on year in December, in part because the struggling construction sector dragged down supplying industries.

Developing economies

Africa: new oil production lower than projected, but still spurs growth in Niger; Sudan faces a severe dollar shortage

In its first year as an oil producer, Niger saw lower levels of oil production than expected. Actual output reached only about 60 per cent of the originally targeted level. This reduced Niger's growth rate for 2012, although the economy is still expected to have expanded by about 10 per cent. In Zambia, fiscal revenue from the mining sector rose by 25 per cent in 2012 as a result of higher royalty rates. In Nigeria, food production rose by 8.1 million tonnes, or about 8 per cent, in 2012.

In the midst of further political unrest, Egypt continues to face significant currency pressures. Sudan is also facing a serious exchange-rate crisis. The official rate was dropped last July from 2.7 to 4.4 to the dollar, but the unofficial rate has risen to 7.0. A crackdown on unofficial selling last month temporarily brought the pound down to 6.5 to the dollar, but resulted in a severe dollar shortage. The inflation rate in December was at 44.4 per cent.

East Asia: economic growth accelerates in the fourth quarter of 2012, led by China

In most East Asian countries, economic growth picked up in the fourth quarter of 2012 as external demand improved slightly and domestic demand was supported by looser macroeconomic policies. In China, GDP expanded by 7.9 per cent year on year, up from 7.4 per cent in the previous quarter. The recovery can be primarily attributed to the policy measures undertaken by the Government and the People's Bank of China during 2012. These measures, which included an expansion of infrastructure programs, reductions in the benchmark interest rates and bank reserve requirements ratios, and an increase in credit availability, pushed up investment growth. Despite the recovery in the fourth quarter, China's full-year GDP growth was 7.8 per cent in 2012, the slowest pace since 1999.

The economies of Singapore and Taiwan Province of China saw a moderate growth recovery in the fourth quarter of 2012. However, full-year growth is estimated at only 1.1 per cent in Singapore and 1.3 per cent in Taiwan Province of China. The Philippines continue to be among the strongest economic performers in the region as GDP expanded by 6.6 per cent in 2012.

South Asia: central banks ease monetary policy; inflationary pressures build up again

Amid global uncertainties and weakening domestic demand, several South Asian central banks eased monetary policy in recent weeks. In January 2013, the Reserve Bank of India (RBI) and the Bangladesh Bank cut their main policy rates, following similar moves by the State Bank of Pakistan and the Central Bank of Sri Lanka in December 2012. The RBI reduced interest rates for the first time in nine months, lowering the key repurchase rate by 25 basis points to 7.75 per cent. The RBI also cut the cash reserve ratio to ease the liquidity conditions in the banking system and to support credit flows.

In most South Asian countries, the recent monetary easing was facilitated by a gradual decline in inflation during 2012. However, inflationary pressures have recently started to build up again. In Pakistan, year-on-year consumer price inflation accelerated to 8.1 per cent in January 2013. Similarly, consumer price inflation in India rose to double-digit levels in December owing to a surge in food inflation. The re-emergence of significant inflationary pressures and the continuing wide current-account deficits will limit the room for further monetary easing in the region.

Western Asia: weak labour markets and growing public expenditures

New official statistics indicated that the unemployment rate remained at 20 per cent in Iraq and at 12.2 per cent in Saudi Arabia. The Saudi Kingdom plans to further stabilize public expenditures. After a rise of 26 per cent in 2011, expenditures growth dropped to 3 per cent in 2012 and should remain below 2 per cent in 2013. Oil revenues are forecast to decline slightly, but the fiscal surplus is expected to remain strong at around 10 per cent of GDP. The Yemeni Parliament approved a record-high budget with public expenditures planned to reach $12.9 billion in 2013, relying on foreign donors to finance its budget deficit.

The Syrian Government decided to further liberalize imports of basic goods, such as sugar, rice, tea, wheat, soy and barley in order to avoid food shortages in government-controlled areas. Fuel shortages induced by Western sanctions also compelled the Government to raise the price of diesel for the fourth time in the last year. For the first time, the Government also allowed private firms to import gasoil and diesel, thus putting an end to the traditional state monopoly on fuel imports.

Latin America and the Caribbean: divergent economic indicators between Mexico and Brazil; more monetary stimulus in Colombia

At the end of 2012, there was a sharp contrast between the performance of the two largest economies of the region, Brazil and Mexico. Mexican exports increased in December by 3.6 per cent year on year in line with the growth in manufacturing output in November by 3.9 per cent year on year. In contrast, Brazilian exports decreased by 10 per cent and manufacturing output decreased by 1 per cent in December. Other South American countries also showed a poor performance in the manufacturing sector. In December, output in Argentina and Chile fell by 3.4 and 2.5 per cent year on year, respectively.

In January, the Central Bank of Colombia decided to further decrease the reference interest rate by 25 basis points to 4 per cent. While inflationary pressures eased, economic activity remains markedly below potential. Despite successive monetary stimulus, the unemployment rate only improved slightly last year, from 9.8 per cent in December 2011 to 9.6 per cent in the same month of 2012. Given recent appreciation pressures on the peso, the Central Bank also decided to increase its current program of foreign-currency purchases.