# World Economic Situation and Prospects

## Monthly Briefing

No. 53 9 April 2013

## Global issues


### Summary

- Renewed concerns about banking fragility in the euro area
- Capital inflows into emerging markets gain momentum
- The Bank of Japan discloses its new monetary stance which is beyond market expectations
- United States housing market strengthens further


### *Agreement reached in Cyprus, setting questionable precedents*

Agreement was finally reached on a rescue programme for Cyprus. Cypriot banks were hard hit by the write-down of their holdings of Greek sovereign debt resulting from the Greek bailout agreement. Cypriot bank assets are over seven times the size of the country's GDP, making a government bailout impossible without external support. The Government officially applied for assistance from the European rescue fund earlier in 2012, but final negotiations were delayed until after the presidential election. The banks were kept afloat by emergency liquidity assistance from the European Central Bank. The bailout required about €17 billion, to be generated through a combination of bank restructuring and aid. However, Cypriot banks are funded primarily via deposits, so that a bailing-in of both junior and senior bondholders would be insufficient, requiring deposit holders be involved.

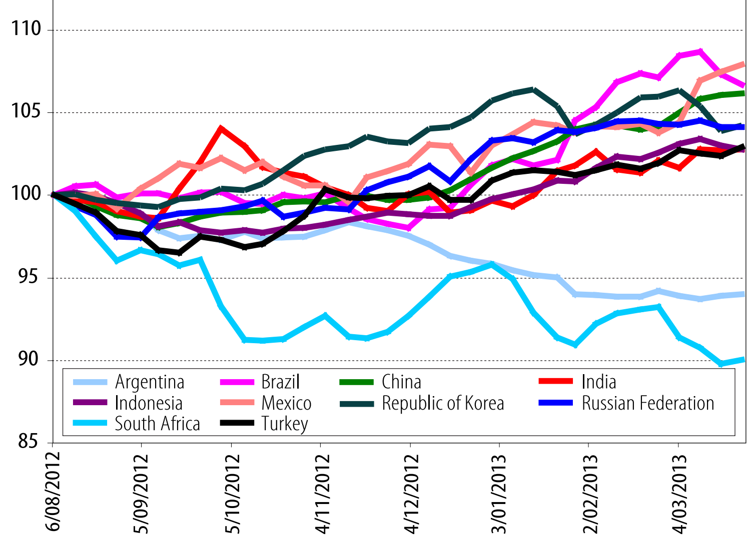
A potential agreement on March 16 included a levy on all bank accounts, even accounts below €100,000 that were supposed to be protected by deposit insurance. The agreement was rejected by the Cypriot parliament. The final plan, agreed on March 25, includes a bail-out fund of €10 billion (including €1 billion supplied by the IMF) to support government financing needs in exchange for an IMF supervised reform program and a complete restructuring of the two largest banks. The restructuring calls for closing the country's second largest bank, Laiki, freezing and placing its large deposits in a "bad bank", wiping out junior and senior bondholders (in other bailouts, senior bondholders have not faced such losses), and transferring the remaining small deposits to the Bank of Cyprus (BOC), the nation's largest lender. The BOC will inherit the €9 billion that Laiki owes the eurosystem for central bank loans, and Laiki will be completely restructured. No bailout money will be used to recapitalize BOC; rather, large deposit holders will be "bailed in" to reach capital levels mandated by the European Union (EU). For the first time in a euro area country, temporary capital controls were introduced. A key question is whether this plan sets a precedent for future possible bailouts or not. With depositors now included, and deposit guarantees less ironclad, any hint of weakness in a bank could lead very rapidly to deposit flight and insolvency.

### *Higher capital inflows to developing countries*

By the end of 2012, global liquidity and improvements in financial markets along with enhanced economic outlook in some emerging economies encouraged investors' risk appetite and the search for higher yields. As a result, capital inflows increased notably to developing countries. Despite some volatility, this trend has continued in early 2013. According to estimates by the World Bank, capital inflows to developing countries increased by 47 per cent in January and February in comparison to the same period in 2012. In January, capital inflows reached $53.7 billion, more than 20 per cent higher than last year's monthly average. Portfolio investments, especially in the bond markets, have driven the rising trend so far in 2013. In January, capital inflows on bond issuances reached a record of $36.9 billion, especially into East Asia.

Figure: **Effective exchange rates of emerging economies of the G20**

Index: 100 = August 1, 2012




**Source:** JP Morgan.

Note for the Secretary-General prepared under the general guidance of ASG Shamshad Akhtar by a team in Global Economic Monitoring Unit including Pingfan Hong (Chief), Sebastian Vergara (coordinator), Clive Altshuler, Grigor Agabekian, Hung-Yi Li, Matthias Kempf, Ingo Pitterle, Pierre Kohler and John Winkel, supported by Mary Lee Kortes, Nancy Settecasi, Leah C. Kennedy, Cordelia Gow, and Ann D'lima.
**Contact email: hong@un.org, http://www.un.org/en/development/desa/policy/wesp/wesp_mb.shtml**

Official data in some countries also illustrate this trend. In Brazil, capital inflows in January and February reached $18 billion, more than double the monthly average of 2012. In Turkey, capital inflows reached $6.7 billion in January, 15 per cent higher than the monthly average for 2012. In Mexico, portfolio investments increased sharply in the fourth quarter of 2012, reaching a second quarterly record high of $23 billion. Higher capital inflows to Mexico have continued in early 2013, thus raising concerns about the potential effects in the monetary stance (see section on Latin America and the Caribbean below).

As a result of these developments, emerging market domestic currencies have appreciated. Though the appreciation has been moderate so far, it is a common trend among most economies (see figure below). In China, the nominal effective exchange rate increased by 7 per cent in the last 6 months, and the yuan reached a 19-year high against the dollar in late March 2013. In Brazil and Mexico the nominal effective exchange rate increased by 6 and 5 percent, respectively. In Indonesia, the Republic of Korea, the Russian Federation and Turkey the appreciation was about 4 per cent.

## Developed economies

### *The United States: housing sector continues to improve*

In the United States, the housing sector has seen sustained recovery since 2011, when construction activity for residential housing started to pick up after a five-year slump. In 2012, residential fixed investment grew by 12.1 per cent from the previous year and accounted for 13 per cent of GDP growth. For the first time since 2006, residential investment did not drag down GDP growth.

In early 2013, transactions in housing markets moved upward at a strong pace, with the number of houses sold increasing about 20 per cent from one year ago. The major indices for housing markets, including the Standard & Poor/Case Shiller home price index, the Federal Housing Finance Agency house price index and the Census Bureau average sale price, all reported noticeable increases from the previous year. According to the flow-of-funds data from the Federal Reserve, towards the end of 2012, the value of real estate for household and non-profit organizations had recovered by 8.9 per cent from the bottom of Great Recession. Combined with the deleveraging process in the household sector, the ratio of outstanding mortgages to the value of real estate has declined to 47.4 per cent from the peak of 56.0 per cent.

### *Japan: QQME announced*

On 4 April, the Bank of Japan (BOJ) surprised markets by announcing a "Quantitative and Qualitative Monetary Easing (QQME)" program which was much more aggressive than expected. Under the QQME, the BOJ intends to raise the headline inflation rate to 2 per cent within two years. In order to raise inflation expectations by boosting asset prices, the BOJ will massively increase its holdings of Japanese Government bonds (JGB) and other securities. Correspondingly, the BOJ decided to switch the operation target from the overnight call rate to the monetary base, which the BOJ plans to double by the end of 2014.

Under the new "quantitative" easing, the BOJ will increase the monetary base at the pace of 60-70 trillion yen per year, including net increases of about 50 trillion yen worth of JGBs per year. The "qualitative" easing means the BOJ will expand the purchase target to JGBs with all maturities, including 40-year bonds. Consequently, the average remaining maturity of the BOJ's JGB purchases will increase to 7 years from the current level of less than 3 years. It will also increase holdings of exchange-trade funds and Japan real estate investment trusts, with a view to lowering risk premia of asset prices. In the five days after the announcement, the Japanese yen depreciated by 5.5 per cent and 6.9 per cent vis-à-vis the United States dollar and the euro, respectively.

### *Western Europe: rising uncertainty dents confidence*

After a number of months of gradually improving confidence in the euro area, tensions have resurfaced and confidence has deteriorated. The unresolved political situation in Italy, followed by the eruption of the long simmering financial crisis in Cyprus, have both stoked tensions. So far, sovereign bond markets have remained quiet with only a slight up-tick in crisis country yields from the lows in February. However, indicators of confidence have deteriorated. The European Commission's Economic Sentiment Index fell in March after four consecutive months of improvement. It remains low by historical standards. Both Germany and France saw deteriorations, which were also confirmed in national indices. The Markit Eurozone PMI Composite Output Index fell for the second month in a row, and remains in the contraction zone.

Hard economic data for January were generally poor. After increasing in December, both industrial production and construction activity fell, and show little evidence of a convincing turnaround. Retail sales rose, but again show no evidence for a sustained upturn. These results point to continuing contraction in the first quarter of 2013, albeit at a more moderate pace than in the final quarter of 2012.

### *New EU members: continued monetary easing*

The economic trends in Central Europe remain fragile. In Poland, industrial output dropped in February by 2.4 per cent year on year, as vehicle production shrank by 30 per cent. Several other sectors, including construction and energy, also contracted. In the Czech Republic and Hungary, industrial production fell by 4.1 per cent and 1.4 per cent year on year, respectively. By contrast, industrial output in some Baltic States has increased. In Estonia, industrial output increased in February by 5.5 per cent year on year, bolstered by manufacturing of electronic products.

Subdued domestic demand further slowed down inflation. Annual inflation in February subsided to 2.8 per cent in Hungary and 1.3 per cent in Poland. In both countries, the central banks continued their cycle of monetary easing, reducing the corresponding policy rates in March by 25 and 50 basis points, respectively. Labour markets in most of the region are slow to recover. In Poland the unemployment rate increased further in February, to 14.4 per cent. In the Baltic States, where the labour market trends are more positive, the share of part-time employment in total employment remains higher than in the pre-crisis period.

## Economies in transition

### *CIS and Georgia: Tajikistan joins the World Trade Organization*

Economic performance of the CIS countries remained diverse in early 2013. The economy of the Russian Federation is apparently loosing steam. In February, GDP growth was estimated at a meagre 1.6 per cent year on year. Domestic demand noticeably weakened following deteriorating consumer sentiment and slowing credit growth. In February, inflation accelerated to 7.3 per cent on the basis of higher food prices and rises in administered tariffs.

The Ukrainian economy also remained weak, with industrial output in February falling by 6 per cent year on year. The record snowfall in March will further complicate the economic recovery. In February, the Government of Ukraine approved a plan to stimulate the economy, in particular by creating a state-owned development bank. However, financing this initiative might be problematic. The Government also decided to raise tariffs on imported cars to protect domestic industry, which may trigger reciprocal increases in tariffs on Ukrainian exports, such as steel or agricultural products, by trading partners. In Azerbaijan, GDP increased by 3.5 per cent in January-February, as the non-oil sector expanded by 10.5 per cent. In Central Asia, Tajikistan officially joined the World Trade Organization in March, becoming its 159th member.

### *South-Eastern Europe: Croatia is set to join the EU*

Domestic demand remains depressed in Serbia, offsetting the impact of enhanced export performance. Although industrial production and exports increased in January by 2.4 and 19.9 per cent year on year, respectively, retail sales declined in real terms by 9.3 per cent year on year. In February, the Government of Serbia successfully placed $1.5 billion of seven-year Eurobonds, at a much lower rate than during earlier bond issues. Some upturn in industrial output in the region is partially related to a stronger energy output due to a harsh winter. Industrial production increased by 3.4 per cent year on year in January in Croatia and by 4.5 per cent year on year in the former Yugoslav Republic of Macedonia. In March, the European Commission in its final report concluded that Croatia is ready to join the EU in July 2013, becoming the twenty-eighth member of the block.

## Developing economies

### *Africa: more investment by China; Egypt's situation still precarious*

China signed an agreement with Tanzania to build a major port and industrial zone there, estimated to cost up to $10 billion — equivalent to 36 per cent of GDP. This comes after a new announcement by a major oil company of a third discovery of natural gas off the coast of Tanzania, bringing the estimated recoverable reserves to between 10 and 13 trillion cubic feet. As a result, the company announced plans to construct a $14 billion liquefied natural gas facility, for export.

The situation in Egypt remains precarious as wheat stocks are down to 85 days of import coverage, from 95 days in February, and food prices are up sharply. Fuel imports and stocks are running low as well. The central bank raised its discount rate by 75 basis points to 10.25 per cent in an effort to anchor inflation expectations. Meanwhile, South Africa's current-account deficit increased to 6.3 per cent of GDP in 2012 from 3.4 per cent in the previous year. On the trade side, export growth was limited to 2.8 per cent by weak external demand and strikes in the mining sector, while imports increased by 15.4 per cent on the back of consumption and investment demand.

### *East Asia: China's growth recovery on track*

In China, recent data point to an ongoing moderate recovery in economic growth. Manufacturing indices moved up in March, signalling a solid expansion in activity. New home prices rose for the tenth consecutive month as demand increased ahead of property curbs by local governments. In Beijing and Shanghai, authorities announced a series of measures to cool the resurgent property market, including higher down payments.

The central banks in Papua New Guinea and Viet Nam further loosened monetary policy in March by cutting their main policy rates. In both countries, the monetary authorities responded to slowing growth and reduced inflationary pressures. Viet Nam's economy expanded by 4.9 per cent in the first quarter of 2013 year on year. In 2012, Viet Nam's annual GDP growth rate had declined to 5 per cent, the weakest pace in 13 years. Consumer price inflation fell to a multi-year low of 6.6 per cent year on year in February and domestic credit growth has remained subdued. In Papua New Guinea, growth is projected to decelerate markedly in 2013 owing to the end of the construction phase of a large liquefied natural gas project.

### *South Asia: Reserve Bank of India further cuts policy rate; inflationary pressures persist*

In response to the ongoing slowdown in GDP growth, the Reserve Bank of India (RBI) further cut its main policy interest rate, bringing the repurchase rate down by 25 basis points to 7.5 per cent. Persistently high consumer price inflation, however, continues to limit the RBI's room for monetary easing. In February, consumer prices were 10.9 per cent higher than a year ago, primarily owing to strong price pressures from food items, especially cereals and proteins. Inflationary pressures have also started to increase again in other South Asian economies. Year-on-year consumer price inflation rose to 7.9 per cent in February in Bangladesh and to 10.1 per cent in Nepal.

Sri Lanka's economy gained strength in the fourth quarter of 2012 driven by a rapid expansion of construction and mining activities. Economic growth accelerated to 6.3 per cent year-on-year, up from 4.8 per cent in the previous quarter. Full-year growth slowed moderately from 8.3 per cent in 2011 to 6.4 per cent in 2012, primarily owing to weaker growth in the service sector, which accounts for almost 60 per cent of nominal GDP. The outlook for 2013 continues to be favourable as strong private consumption and investment are expected to support growth of the service and industrial sectors.

### *Western Asia: Iraqi oil output target revised downwards for 2013*

The Iraqi Parliament has pushed through the delayed 2013 budget despite disagreements over payments to oil companies operating in the Kurdish region. The Government also announced oil production will fall far short of the 4.5 million barrel per day target set for the end of the year, as political tensions withhold required investments. In the Syrian Arab Republic, private firms are now allowed to import gasoil and diesel, but fuel prices are officially fixed at around half of world market prices. As a consequence, private firms sell imported fuel exclusively on the black market.

The Turkish economy grew by only 2.2 per cent in 2012, depressed by year-on-year growth of 1.6 per cent and 1.4 per cent during the last two quarters of last year. Private demand is picking up, however, as illustrated by loan growth increasing at an annualized rate of almost 25 per cent over recent months, well above the 15 per cent target. In Israel, GDP growth slowed to an annualized rate of 2.4 per cent in the last quarter of 2012, but the launch of pumping operations at the Tamar gas field in March is expected to add about one percentage point to GDP growth in 2013.

### *Latin America and the Caribbean: Mexico cuts interest rates; export performance weakens in the southern cone*

The Central Bank of Mexico cut the reference interest rate by 50 basis points to 4.0 per cent in March. The decision is explained by the recent slowdown in economic activity, especially in the external sector; in February, exports decreased by 2.9 per cent year on year. Meanwhile, central bank authorities highlighted that interest rates were also lowered in an attempt to confront higher capital inflows. Recent surges in portfolio inflows into the economy are generating increasing concerns about potential negative effects on the monetary stance and financial stability.

Export performance in the southern cone was poor in early 2013. In January, the export of goods in Peru and Uruguay fell by 18 and 11 per cent year on year, respectively. More moderately, the reduction reached 6.4 per cent in Ecuador and 1.1 in Colombia. Meanwhile, in Argentina exports of goods in January and February fell by 5 per cent in comparison to the previous year.