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

World Economic Situation and Prospects

Monthly Briefing

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Summary

- Commodity prices decline as global trade remains weak
- The ECB cuts interest rates, returning to conventional monetary policy
- Economic momentum weakens in East Asia; another interest rate cut in India

Global issues

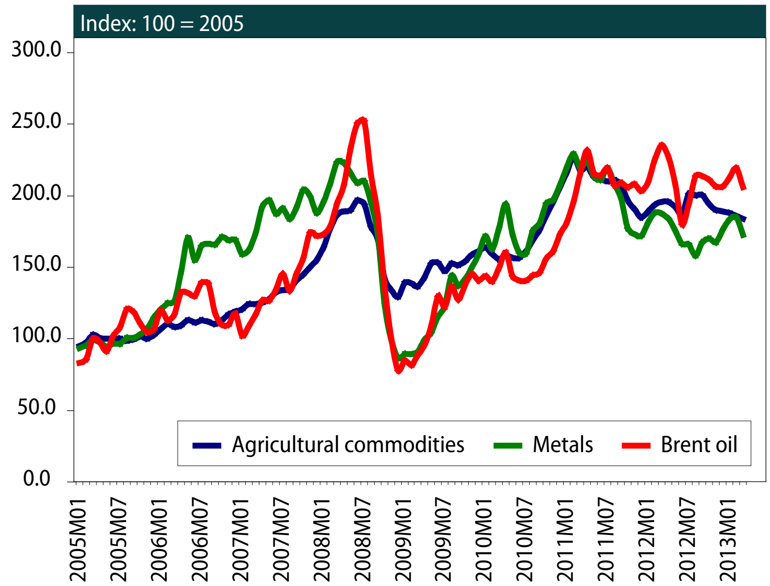
Commodity prices under downward pressures; global trade continues to be subdued

The global economy continued to expand at a subdued pace in the first quarter of 2013. The euro area is still in a recession and the recovery has been feeble in most other developed countries. In addition, many emerging economies, including Brazil, China, India and the Russian Federation, are growing below pre-crisis levels and exhibiting major difficulties. The weak global demand is affecting the performance of trade and the evolution of world market prices for primary commodities.

Primary commodities prices decreased in early 2013, though they remain at comparatively high levels in historical terms. Agricultural commodities prices fell by almost 5 per cent between March 2013 and December 2012, following relatively feeble global demand and higher supply for some key staples. Expected further improvements in harvests in the next months may soften commodities prices further this year, particularly in maize, soybeans and wheat. Prices for minerals and metals fell by 3 per cent between March 2013 and December 2012, driven by the slowing demand from China. In the near term, downward pressures on prices are likely to intensify as supplies increase more significantly (especially by the end of 2013 for items like copper and aluminium) and investment demand in China moderates further. Oil prices also decreased early this year, particularly in March and April, supported by Saudi Arabia's activation of significant spare capacity in 2012, rising supply from the United States and Iraq, and weak oil demand.

The global merchandise of trade barely expanded over the first quarter of 2013, with the three-month average growth decelerating below 1 per cent—a consequence of a sluggish global aggregate demand. After growing slightly in January, global goods trade fell again in February as import demand contracted in the euro area as well as Central and Eastern Europe and United States. Chinese data indicated a strong rebound in March after a two-month decline in import demand, which also illustrates the unstable push provided by emerging economies to global trade. In the near term, import demand is expected to gradually improve in developed countries and to moderately pick-up in most developing regions, particularly in East Asia and Latin America and the Caribbean. Global trade is projected to recover, though only modestly this year, and as such will not be a strong engine of growth for the global economy.

Figure: **Commodity prices: monthly indices based on nominal US dollars, 2002-2013**



Source: World Bank.

Developed economies

The United States: noticeable growth for the first quarter

The advance estimate for the gross domestic product (GDP) of the United States shows an annualized growth of 2.5 per cent in the first quarter of 2013, a noticeable improvement from the 0.4 per cent for the fourth quarter of 2012. Private consumption and gross private investment were the two

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major contributors for the expansion. Residential investment and private consumption of durable goods have maintained a strong growth for the past few quarters. On the other hand, the real outlay from the Government diminished by more than 4 per cent. Spending on national defence showed the largest decrease among all types of government expenditures.

The labour market in the United States continues to recover, as non-farm payroll employment increased by 165,000 in April. The increase was concentrated mainly in the services sector, while little increase was registered for the payrolls in the construction and manufacturing sectors. Government payrolls continued to decline marginally. The average workweek for private non-farm workers declined by 0.2 per cent from the previous month while the average hourly earnings increased by 0.2 per cent. The unemployment rate decreased to 7.5 per cent against the backdrop of an unchanged labour force participation ratio. The share of long-term unemployment declined by 2.2 percentage points to 37.4 per cent, the lowest level since 2009.

Japan: initial effects of QQME appearing in financial markets

After the Bank of Japan (BOJ) announced the "Qualitative and Quantitative Monetary Easing" (QQME) on 4 April, its impacts have been seen in financial markets. The yields for Japanese government bonds (JGB) with more than 10 years to maturity have declined as intended. Nevertheless, the yields for shorter-term JGB rose owing to reduced purchases by the BOJ. Meanwhile, inflation expectations observed in the financial markets have also moved up, although it is still lower than the 2 per cent that the BOJ has targeted.

The statistics for economic production for the first three months were uneven, but most of them displayed noticeable quarter-over-quarter expansion. Industrial production increased by 1.9 per cent in the first quarter of 2013, and the export volume increased by 1.5 per cent over the same period. However, levels for those indicators were still much lower than one year ago. The unemployment rate fell to 4.1 per cent in March, partially owing to a reduction in the labour force. In the first quarter, employment slightly increased by 0.3 per cent from both one year ago and one quarter ago. Wages for regular workers have maintained their declining trend for the past few quarters and sustained the ongoing deflation.

Western Europe: The ECB takes further action

The economic situation in Western Europe deteriorated again in April, with confidence surveys registering another decline in sentiment and unemployment continuing to increase. The European Central Bank (ECB) responded by returning to conventional policy, cutting its main refinancing rate by a quarter of a percentage point to 0.5 per cent. It also reduced its marginal lending rate by 50 basis points to 1 per cent, but kept its deposit facility rate at zero. This narrowed the corridor bounded by these two rates to 100 basis points, where it had been only briefly during the great recession. (Typically it is 200 basis points). It also avoided experimenting with a negative interest rate for the deposit facility. However, there was a hint that the committee was open to a negative interest rate in the future.

There were also announcements on unconventional policies. The quantitative easing programmes of special liquidity facilities will be maintained until at least mid-2014. It was also announced that the ECB will hold discussions with other European institutions regarding improving credit flows to small- and medium-sized enterprises (SMEs) through the packaging of loans into asset-backed securities. This would be designed to counteract the financial fragmentation within the region, whereby firms in the crisis countries, particularly SMEs, are paying much higher rates of interest than firms elsewhere in the region.

New EU members: Slovenia sells bonds despite credit downgrade

In Poland, industrial output in March declined by 2.9 per cent year on year, increasing by 9.2 per cent month on month, however. In April, consumer sentiment indexes slightly improved in Poland, while worsening in the Czech Republic. In these two countries, car manufacturing production declined in the first quarter. Meanwhile, inflation continued to subside in March, with 1 per cent annual inflation in Poland and only 0.1 per cent monthly inflation in the Czech Republic, which triggered fears of deflation. On the back of low inflation and weak domestic demand, the Hungarian National Bank again cut its policy rate in April, to a record low of 4.75 per cent, and announced a "funding for lending program", aimed towards channelling $1.1 billion in loans to SMEs.

Although most of the Governments in the region have followed the fiscal austerity path, pro-growth measures are being sought to revitalize private investment. Tax incentives for businesses were adopted in the Czech Republic and are being considered in Slovakia. As portfolio inflows are gaining momentum and investors are trying to reduce their exposure to Japanese bonds, many of the new European Union (EU) members enjoy record-low borrowing costs. In early May, Slovenia successfully placed $3.5 billion worth of bonds, despite its credit rating being downgraded by Moody's to "junk" following a weak banking sector and a shaky fiscal position.

Economies in transition

CIS and Georgia: disappointing first quarter in the Russian Federation

In the Russian Federation, GDP growth slowed to a mere 1.1 per cent year on year in the first quarter. However, some pick-up was registered in March, as industrial production increased by 2.6 per cent year on year despite fewer working days, and consumer sentiment improved, after two consequent months of decline. Growth may still strengthen in the second half of 2013 if expectations of a better harvest are realized.

In Ukraine, the economy shrank by 1.3 per cent year on year in the first quarter, while industrial output contracted by 5 per cent year on year, as demand for its main manufacturing exports remains feeble. In Belarus, first quarter GDP increased by 3.5 per cent, year on year, and the Central Bank cut its policy rate in March by 1 per cent. In the Caucasus, the Armenian economy registered strong industrial production growth and, according to the Government, double-digit GDP growth in the first quarter of 2013. In Azerbaijan, the GDP in the first quarter increased by 3.1 per cent year on year, mostly driven by the non-oil sectors, such as construction and agriculture. In contrast, both oil and natural gas production contracted noticeably in the first quarter, by 4.4 per cent and 4.3 per cent year on year, respectively.

South-Eastern Europe: slight upturn in output, weak labour markets

In Serbia, the GDP in the first quarter grew by 1.7 per cent year on year, the first positive growth in five quarters, mostly driven by higher exports and increased production of car and fuels. However, domestic demand remains weak and retail sales in the first quarter declined by 15.5 per cent year on year in real terms. In April, Serbia secured a 10-year $500 billion loan from the Russian Federation for budget support, which also may be used to repay the country's debt to the London Club. In Croatia, industrial production increased in March by 4.1 per cent year on year. In Bosnia and Herzegovina, industrial output rebounded in February, and exports in the first quarter increased by 9.7 per cent year on year, although exports to the EU, the main export market, increased by only 5.7 per cent. However, these positive developments still did not improve labour markets, as unemployment rates in the region remain precariously high, with the rate of registered unemployment in Serbia close to 27 per cent in February.

Developing economies

Africa: Zambia's maize output expected to fall 30 per cent; no resolution in IMF-Egypt loan negotiations

In Botswana, the central bank unexpectedly reduced the benchmark interest rate by 50 basis points to 9.0 per cent in light of weaker growth and the expectation of receding inflation. Meanwhile, in Ghana, the domestic currency weakened further on the back of uncertainty created by the fiscal and current account deficits as well as dividend repatriation by foreign companies. In the agricultural sector, Zambia's maize output is expected to fall by 30 per cent this year owing to the delayed supply of subsidised inputs to farmers and poor rainfall. While the reduced harvest will still be enough to cover domestic demand, it will have a clearly negative impact on farmers' incomes and private consumption.

Another round of negotiations between the IMF and Egypt over a much needed $4.8 billion loan has ended without a resolution. The IMF has called for cuts to subsidies, which make up a large percentage of the Egyptian Government's expenditure, but cuts have proven politically difficult to implement. Qatar recently provided another $3 billion to Egypt, but it is uncertain if this was a loan or a grant. Rwanda's sale of $400 billion in 10-year Eurobonds was over seven times oversubscribed, pushing the yield down to 6.875 per cent. The revenue will help to fill a fiscal gap that has resulted from cuts in official development assistance.

East Asia: growth momentum weakened in early 2013

In most East Asian economies, GDP growth slowed early this year in the first quarter of 2013 as both internal and external demand weakened. In China, economic activity expanded by 7.7 per cent year on year and by 1.6 per cent quarter on quarter, down from 7.9 per cent and 2 per cent, respectively, in the previous quarter. The slowdown in China mainly reflects lower growth in consumption and investment spending. In Singapore and Taiwan Province of China, economic activity contracted in the first quarter of 2013 compared to the previous three months. In both economies, exports were held back by the slowdown in China and ongoing weak demand in most developed countries.

By contrast, economic growth picked up mildly in the Republic of Korea during the first quarter on the back of a recovery in gross fixed capital formation and the front-loading of government spending. Exports of goods and services grew faster than expected, but the strong depreciation of the Japanese yen is likely to weigh on the Korean export performance in the near term. However, private consumption declined for the first time since late 2011, raising worries about the sustainability of the recovery. In an attempt to support growth, the Government of the Republic of Korea announced additional fiscal stimulus measures in the form of a supplementary budget. About two thirds of the supplementary budget will be used to cover tax revenue shortfalls; the rest will be additional expenditures, including support for SMEs and local governments.

South Asia: building collapse puts spotlight on Bangladesh's garment industry

In Bangladesh, more than 1,100 people were killed when a building that mainly housed garment factories collapsed in late April. The tragedy triggered renewed strikes and widespread protests over the working and safety conditions in the garment industry. At the same time, fears have emerged that some Western retailers could stop manufacturing in Bangladesh. The garment sector accounts for nearly 80 per cent of the country's total export revenues and employs an estimated four million people, most of them women. It has seen rapid growth in recent years, as improved duty-free access to the European Union since 2011, along with rising production costs in China, led to a shift in textile manufacturing capacities to Bangladesh. The building collapse came less than six months after a fire in a garment factory left 117 workers dead.

In several South Asian economies, consumer price inflation slowed considerably in recent months. In April, year-on-year inflation dropped to a nine-year low of 5.8 per cent in Pakistan and to 6.4 per cent in Sri Lanka, as upward pressures on food prices declined. In India, wholesale price inflation moderated to 6 per cent in March, but consumer price inflation remained above 10 per cent. The Reserve Bank of India lowered its benchmark policy rate for the third time in 2013 by 25 basis points.

Western Asia: Israel still without a budget for 2013

In the absence of a political consensus, Israel continues to operate under the 2012 budget on a month-to-month basis. Spending cuts that would mostly affect lower-income groups and modest tax increases are under consideration as a means to contain a budget deficit projected to increase from 4.2 per cent of GDP in 2012 to 4.7 per cent of GDP in 2013. Meanwhile, Qatar's recently approved budget for the upcoming fiscal year plans an 18 per cent increase in total expenditures. By assuming an annual oil price of $65 per barrel and keeping the largest revenue-earner, liquefied natural gas, off-budget, the fiscal surplus is expected to drop from 8 per cent of GDP last year to 1 per cent of GDP.

Saudi Arabia stepped up its policy for the Saudization of the labour force by extending the quotas of national employees to SMEs. Migrants with an illegal status are believed to represent more than one third of the 7 million migrant workers who represent 90 per cent of the labour force. Migrant deportation already aroused official protest by India and Yemen and could generate disruptions in certain sectors. In Turkey, capital inflows, especially in corporate bond markets, continue to put upward pressure on the exchange rate. The twelve-month trailing current-account deficit and inflationary pressures continued to decline.

Latin America and the Caribbean: manufacturing production weakens

The manufacturing sector in the region performed weakly early this year. In March, the manufacturing output in Chile fell by 3.0 per cent year on year; Colombia's output fell by 4.5 per cent in February. Official estimates for Argentina on manufacturing activity also show an output reduction in March by 0.3 per cent year on year, seasonally adjusted. Other countries exhibited meagre growth. In Brazil and Peru, manufacturing production in January and February increased by 1.1 and 1.7 per cent, respectively, compared to the same period in 2012. On a seasonally adjusted, year-on-year basis, manufacturing production in Mexico marginally increased by 0.4 per cent in January and 1.2 per cent in February. The current appreciation trends of domestic currencies in some countries are adding new challenges to the manufacturing sector in the region by making exports less competitive.

For the first time in nearly two years, the Central Bank of Brazil raised the Selic interest rate to 7.50 per cent from the all-time low of 7.25 percent, following recent higher inflation. The consumer price index rose by 0.55 per cent in April. Thus, consumer price inflation reached 6.49 per cent in the last twelve months, close to the upper limit of the central bank's target of 6.5 per cent. The decision is expected to be the starting point for a modest monetary tightening cycle.