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

World Economic Situation and Prospects

Monthly Briefing

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Summary

- Global financial turmoil amid expectations of tapering QE stance
- Significant capital outflows and sharp depreciation of domestic currencies in developing countries
- Western Europe struggling to move out from recession
- Large emerging economies continue to face domestic vulnerabilities

Global issues

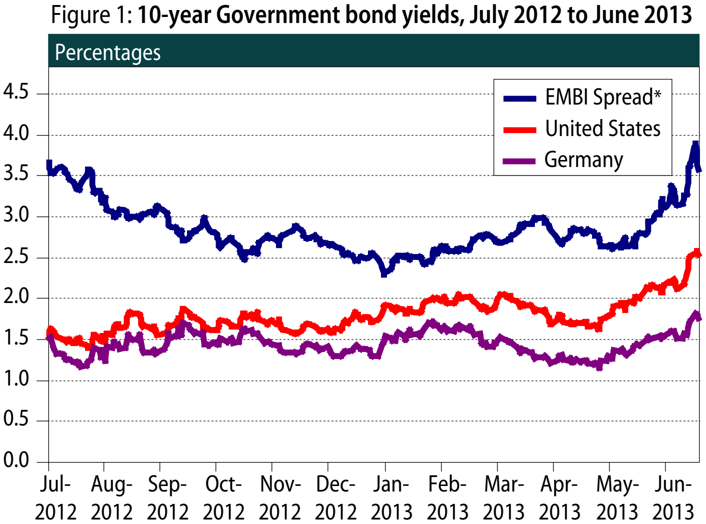
Global financial turmoil amid expectations of tapering QE stance

Expectations of an impending reduction in the size of the long-term securities purchases in the unconventional monetary policy programmes by major central banks, particularly the United States Federal Reserve (Fed), have caused turmoil in global financial markets. In June, the Fed signaled tapering off the quantitative easing (QE), particularly the bond purchases program of $85 billion per month, with a qualifier that the slowdown of the QE-cycle will be gradual and linked to substantial further progress in economic conditions. The Fed will continue with the current round of asset purchases until the unemployment rate falls to about 7.0 per cent, which, according to the Fed projections, is likely to happen by the end of 2013. The near-zero interest rates in the United States will also continue, at least until unemployment falls further to 6.5 per cent. Moreover, the outlook for continued low inflation in the United States still gives the Fed room for manoeuvre in adjusting the stimulus according to the economic conditions.

Meanwhile, there is no expectation of any pullback of the QE policies by other major central banks, as the Bank of Japan (BoJ) continues with its massive aggressive bond purchases programme and the European Central Bank (ECB) maintains its demand-driven provision of liquidity. Financial markets have reacted strongly to the uncertainties which the QE exit process might involve. Government bonds yields have increased significantly in developed countries, including in safe havens such as the United States and Germany (see figure 1). In the United States, 10-year Treasury bond yields jumped from 1.6 per cent in May to more than 2.5 per cent by the end of June.

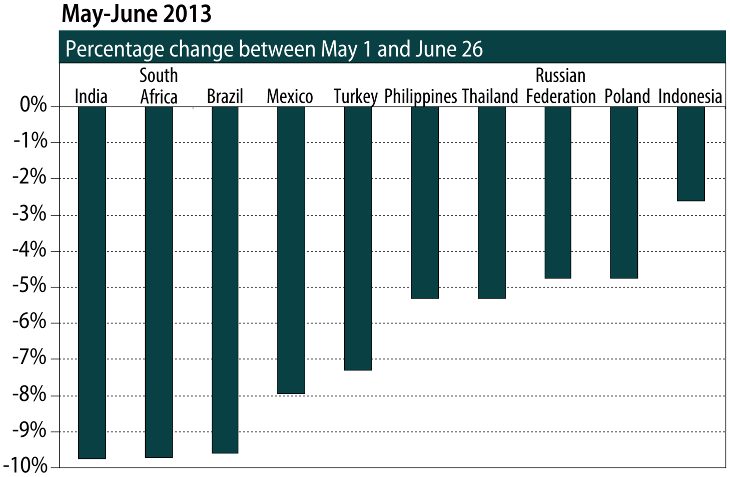
This financial turmoil has also had a noticeable effect on the developing countries. Until April 2013, capital inflows to the emerging economies were increasing, especially in bond markets, and most domestic currencies were under appreciation pressures. How-

Figure 1: **10-year Government bond yields, July 2012 to June 2013**



Source: UN/DESA based on JP Morgan.
* EMBI spread: Emerging market bond index spread over US bonds.

Figure 2: **Variation of nominal exchange rate vis-à-vis US dollar, May-June 2013**



Source: UN/DESA based on JP Morgan.

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ever, the higher risk aversion and the sudden change in market expectations surrounding the QE exit process by the Fed have radically reversed these trends. Since May, equity and bond flows have reversed in many emerging economies. As a result, equity markets have plunged and the spreads on sovereign bond yields have increased (see figure 1). Domestic currencies, particularly in countries such as Brazil, India, Mexico, South Africa, and Turkey, have depreciated sharply (see figure 2). This adds further to macroeconomic instability and narrows policy space, especially in economies that were already struggling to return to higher economic growth, like Brazil, India and the Russian Federation. Changes in liquidity conditions and risk aversion in global financial markets make it more difficult to finance current account deficits and put pressure on the balance of payments. However, many emerging economies are in a better position today than during past episodes of capital flow reversals and financial turmoil because of their higher levels of international reserves and lower levels of foreign indebtedness. Furthermore, the medium term economic growth prospects of emerging economies are still much higher than of the developed world.

Developed economies

The United States: a new plan to reduce carbon emissions

On 25 June, the President of the United States announced a plan to reduce the emission of greenhouse gases and to prepare for the negative impacts of climate change. The plan intends to increase funding for clean energy technology by 30.0 per cent in the budget of fiscal year 2014. It also intends to establish new carbon pollution standards for both new and existing power plants by 2016 and double the capacity of the electricity generated by wind and solar power by 2020, from its current level. This plan also aims at increasing the energy efficiency in transportation, homes, business and factories over the long run.

The housing market has remained on the path to recovery. In the past twelve months, all major housing price indices have increased by 7.0 to 12.0 per cent. Construction activity for new houses has bounced back from the slump of more than two years and has contributed positively to gross domestic product (GDP) growth in the past eight quarters. The delinquency ratio for all loans secured by real estate, after jumping up to 10.0 per cent in early 2010, has gradually dropped down to around 7.0 per cent in the first quarter of 2013.

Japan: QQME's effect on bond yields fading out

The BoJ announced the Quantitative and Qualitative Monetary Easing (QQME) in April 2013, which significantly increased the amount of longer-maturity Japanese Government bonds purchased. The yields for 20- and 30-year government bonds have declined, as expected. The decline in the 30-year bond yield peaked in the range of 60 to 70 basis points compared to its level at the start of the year. Nevertheless, this effect faded quickly. Toward the end of June, the decline in yields shrank to only about 15 basis points. As part of a new strategy, the BoJ switched away from the purchase of Government bonds with shorter maturity. The yield for that cluster of bonds has actually started to rise. The 5-year government bond yields increased by around 14 basis points from early 2013 to June 2013. This development has caused commercial banks to increase the interest rate for new credit. According to the BoJ, the long-term prime lending rate has increased three times since the introduction of QQME, reversing the declining trend of the previous two years. The equity market also endured extremely strong volatility in 2013. The Nikkei 225 stock price index spiked by 50.0 per cent during the 20 weeks leading to 22 May, but then lost more than 45.0 per cent of the gain in the following 5 weeks.

Western Europe: economic activity stabilizing, but at a low level

The negative effects of the flare-ups of the euro area crisis in the early parts of 2013 appear to have waned and after some months, confidence and activity have stabilized, but at low levels. Despite this stabilization, GDP is likely to have contracted again in the second quarter of the year.

Industrial production rebounded from a slump in the first quarter of the year and increased in April for the third consecutive month, bringing the level of the index back to where it was in September of 2012. Construction also picked up in April, with the index nearly flat—apart from distortions due to bad weather—since the beginning of the year. The European Commission's Economic Sentiment Indicator improved for the second consecutive month in June, but remains well below its long term average. The Markit Eurozone PMI Composite Output Index rose again in June for the third consecutive month, but remains consistent with continued contraction. The unemployment rate remained at 12.3 per cent of the labour force, with youth unemployment almost double that rate at 24.4 per cent.

The new EU members: new record low in policy interest rates in Hungary and Poland

Consumer price inflation in the region continued to subside and in May dropped to 0.5 per cent in Poland and 1.8 per cent in Hungary. Consequently, the relaxation of monetary policy continued in June, and the main interest rates in Hungary and Poland were reduced to new record lows of 4.25 and 2.75 per cent, respectively. Also in June, severe floods affected parts of Eastern Europe, causing damage to farming and infrastructure and putting pressure on the insurance industry. Amid expectations of the tapering of unconventional monetary policies in the United States, borrowing conditions for the new European Union (EU) members tightened and some of the domestic currencies weakened.

In Poland, the weak construction sector is holding back the recovery and the industrial production shrunk by 1.5 per cent year on year in May. However, the modest increase in the volume of retail sales in May suggests that consumer sentiment may be improving. Polish exports performed well in January-April, with exports to developing countries expanding especially strongly. In Romania, industrial output expanded by over 8.0 per cent year on year in April, mainly driven by exports. In Bulgaria, exports surged by 21.6 per cent year on year in April. Overall, regional export performance in January-May was favourable, indicating that in some parts of the EU import demand conditions are improving.

Economies in transition

CIS: Russian Federation concludes oil delivery agreement with China

In the Russian Federation, economic growth for January-May is estimated to be around 2 per cent year on year. Industrial production declined by 1.4 per cent year on year in May, as a result of a contraction in manufacturing, while investment expanded at a feeble rate of only 0.4 per cent. Despite the slowing growth, the unemployment rate in May fell to 5.2 per cent, from 5.6 per cent in April. However, real disposable income shrunk by 1.3 per cent year on year, as annual inflation reached 7.4 per cent. The Government's announcement of further foreign exchange purchases for the Reserve Fund and National Wealth Fund later in the year has led to a depreciation of the currency. In June, the Russian Federation concluded an agreement with China to supply 365 million tons of oil over 25 years, worth $270 billion.

In Ukraine, the Central Bank cut its discount rate by 50 basis points in June. In order to raise additional resources for lending and to limit deposit dollarization and the size of the shadow economy, a limit on daily cash transactions will be introduced later in 2013. Meanwhile, foreign exchange reserves fell by 2.7 per cent, or around $700 million, in May.

South-Eastern Europe: domestic demand rebounds in the FYR Macedonia

In the former Yugoslav Republic of Macedonia, first quarter GDP grew by 2.9 per cent year on year. Domestic demand is recovering, as investment surged by over 9.0 per cent year on year. The unemployment rate declined to 29.9 per cent, the lowest level in almost 20 years. However, inflows of remittances contracted in the first quarter, reflecting tough economic conditions in Greece and Italy. In Croatia, as the tourism season started in May, the labour market improved to some extent. The National Bank of Serbia reduced its main policy rate in May and in June, to 11.0 per cent. Facing a higher than anticipated budget deficit, in May, the Government of Serbia adopted a number of amendments to the tax code to enhance fiscal revenues.

Developing economies

Africa: inflation falls in several countries

As inflation has come down in East Africa, the Central Bank of Kenya cut interest rates by 100 basis points to 8.5 per cent in May and the Bank of Uganda cut rates from 12.0 to 11.0 per cent in June. Meanwhile, in South Africa, inflation decreased as well, from 5.9 per cent in April to 5.6 per cent in May. Following markedly lower inflation, the Bank of Botswana reduced its policy interest rate by 50 basis points to 8.5 per cent, the second cut in two months. By contrast, Ghana continued to see increasing inflation, which moved up to 10.9 per cent in May, from 10.6 per cent in the previous month, mainly driven by the non-food items in the consumer price index.

In Rwanda, GDP growth was estimated at 8.0 per cent in 2012, supported by growth in the construction and services sector. Growth for 2012 was revised upwards slightly in Morocco, from 2.4 to 2.7 per cent, but the official growth forecast for 2014 was cut from 5.0 to 2.5 per cent based on slower agricultural growth, weak international demand and tighter fiscal policy. In Egypt, the fiscal deficit was up to 11.8 per cent of GDP for the first 11 months of the fiscal year ending in June. Growth in the first three quarters was relatively weak at 2.3 per cent year on year, but slightly stronger than the 1.8 per cent growth rate of the same period last year. In Tunisia, the cereals harvest is expected to be 33.0 per cent lower this year after poor rainfall.

East Asia: significant capital outflows; temporary liquidity squeeze in China

Fears among investors of a reduction in global liquidity led to significant capital outflows from East Asia and a sharp depreciation of the region's currencies against the dollar. Stock market indices declined by more than 10.0 cent in many countries, including Indonesia, the Philippines and Thailand. Bond markets also recorded considerable outflows, with spreads of credit default swaps rising to their highest level in a year.

China's interbank market was hit by a temporary liquidity squeeze in June, which led to a spike in interbank rates and raised concerns over the stability of the financial system. In order to ensure properly functioning money markets, the People's Bank of China responded by providing additional liquidity to financial institutions which are facing funding shortages and comply with macroprudential requirements. The authorities also urged commercial banks to strengthen liquidity management by properly adjusting the size and maturity structure of assets and liabilities and by controlling the risks arising from overly rapid credit expansion. In late June, Indonesia's Government significantly reduced the fuel subsidies, causing petrol prices to increase by 44.0 per cent, and diesel prices by 22.0 per cent.

South Asia: macroeconomic challenges mount in India and Pakistan amid subdued growth and large capital outflows

Macroeconomic conditions continue to be challenging in many South Asian countries. In India and Pakistan, economic growth remains sluggish and balance of payments pressures have increased amid large current account deficits and significant capital outflows. India's economy expanded by 4.8 per cent year on year in the first quarter of 2013, similar to the previous quarter. A slight improvement in net exports was offset by further weakening of domestic demand as the private consumption, investment and public spending growth slowed. Against the backdrop of subdued growth prospects, a widening current account deficit (estimated at 4.8 per cent of GDP in the fiscal year 2012/13) and fears of a reduction in global liquidity, investors have increasingly pulled out of India's equity and debt markets. The Indian rupee has declined by about 10.0 percent against the dollar since May, reaching an all-time low in late June.

In Pakistan, economic growth slowed to 3.6 per cent in the fiscal year 2012/13 as activity was constrained by severe energy shortages. The budget deficit is estimated to have widened to 8.8 per cent of GDP. In early July, Pakistan's new Government reached an agreement with the IMF over a new loan of at least $5.3 billion that aims at averting a balance of payments crisis and providing support for the ailing economy.

Western Asia: Turkey affected by financial market volatility and social unrest

Turkey experienced capital outflows induced by a new bout of financial market volatility and social unrest. Within 10 days, foreign funds invested in Turkey fell by $1.3 billion, the main index of the Istanbul stock exchange sank by over 20.0 per cent and the exchange rate of the Turkish lira vis-à-vis the United States dollar dropped by more than 5.0 per cent. In Bahrain, enduring social unrest led the parliament to approve an 11.0 per cent rise in budget spending for 2013, reversing cuts originally planned to reduce the budget deficit. Since April, in Saudi Arabia, more than 1.5 million foreign workers attempted to regularize their situation, ahead of a planned crackdown on illegally registered expatriates. Many migrant workers, especially Yemeni workers, are unable to regularize their working permits. So far, more than 53,000 Yemeni workers have already exited the country and 100,000 more may soon join them in order to avoid sanctions. Remittances, which represented 4.2 per cent of Yemeni GDP in 2011, are expected to decline in the coming months. In the Syrian Arab Republic, the official price of diesel, gasoline and gas almost doubled recently, as the national currency continues its decline.

Latin America and the Caribbean: massive public protests in Brazil

During the first quarter of 2013, economic activity in the largest countries was lower than previously expected. Mexico exhibited a disappointing result in the first quarter: GDP expanded by a meagre 0.8 per cent year on year. In Brazil, the long-expected economic recovery is only gradually gaining momentum. In the first quarter, GDP expanded by only 1.9 per cent year on year, and 0.6 per cent quarter on quarter. However, gross fixed capital formation increased by 3.0 per cent year on year.

In June, massive and intense public protests—the largest demonstrations in decades—emerged in Brazil. Originally, the protests were in response to the higher cost of public transportation in some large cities. However, soon they also addressed a wider range of political, economic and social issues, revealing a profound discontent among the Brazilian population. In response to the protests Dilma Rouseff, the president of Brazil, personally received some of the protest leaders and proposed to discuss five pacts on issues concerning the political, fiscal, health, transportation and education field. The negotiation process on concrete reforms has just begun and there appears to be significant potential for tangible positive changes.