World Economic Situation and Prospects

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Global issues

Emerging economies face new round of pressure on their national currencies

In January 2014, the currencies of several developing economies depreciated sharply vis-à-vis the U.S. dollar once again, repeating the episode of the summer of 2013 when the United States Federal Reserve (Fed) announced its intention to begin tapering the purchase of long-term assets in the near future. This new episode may indicate a revaluation of financial positions in emerging economies, triggering further capital outflows and requiring painful monetary adjustments, particularly for countries that have relied on relatively accommodative monetary conditions to boost their economies.

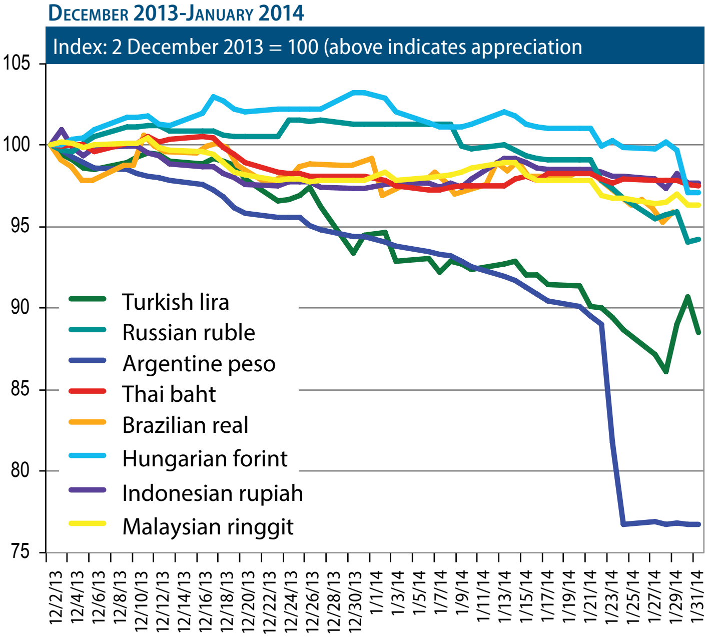
In the past month, several currencies depreciated significantly against the U.S. dollar (figure 1), with notably extreme cases in Argentina and Turkey. The Argentinean peso experienced the biggest plunge since the devaluation of 2002, when Argentina had to default on its debt. In just two days—January 22 and 23—the value of the Argentinean peso plunged 15 per cent. In the last six months, the peso dropped by more than 30 per cent against the U.S. dollar. The Turkish lira also depreciated significantly during the last six months, almost 20 per cent against the U.S. dollar.

Summary

- Emerging economies face renewed financial turbulence
- U.S. economy registered robust GDP growth in the fourth quarter of 2013
- Last quarter of 2013 revealed a heterogeneous economic performance in developing world

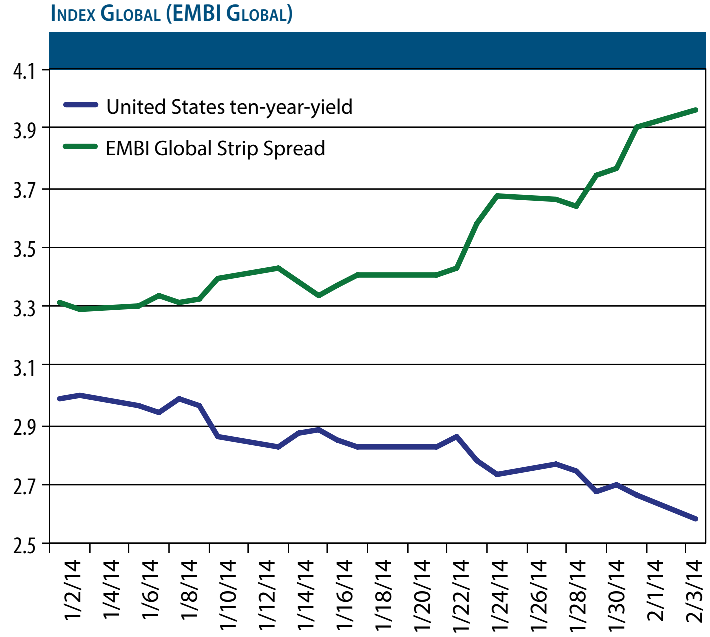
Currencies of other major emerging economies, such as Brazil, Hungary, Indonesia, the Russian Federation, and South Africa, also depreciated notably. One main cause of currency depreciations across emerging economies has been the surge in capital outflows, as financial investors, both international and domestic, became more risk averse and moved funds to safer and higher-return assets in developed economies—particularly in the United States of America, but also in Western Europe. The United States Treasury yields have been trending downward while the spreads of emerging market bonds have been moving in the opposite direction. The global emerging market government bond yield spread rose by over 50 basis points in January, while United States Treasury ten-year yields dropped 30 basis points (figure 2).

Figure 1
United States dollar exchange rates for selected emerging market economies, December 2013-January 2014



Source: Central Bank of the Argentine Republic, Central Bank of Turkey, IMF.

Figure 2
United States ten-year treasury yields and the Emerging Market Bond Index Global (EMBI Global)



Source: JP Morgan Market.

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There are several factors underlying recent currency depreciations in emerging economies. A first group of factors relates to domestic vulnerabilities and instabilities in emerging economies. The depreciation of the Argentinean currency, for instance, is mainly the result of the country's own economic instabilities of the last few years, which have lead to a wider budget deficit and double-digit inflation. Ultimately, the recent sharp depreciation of the Argentinean peso was ineluctable, as the central bank's intervention to defend its currency during the past year had become unsustainable (see the section on Latin American and the Caribbean). Countries with large current-account deficits have also been more prone to suffer currency depreciations. For instance, South Africa and Turkey are running current-account deficits of about 6 per cent of gross domestic product (GDP). Uncertainties associated with forthcoming elections in some countries, such as Brazil, Thailand, and Turkey, are also concerning investors.

In addition to country-specific vulnerabilities and instabilities, the recent sell-off of emerging economies' assets can also be linked to the perception that growth in these emerging economies will not be as high as in the previous decade. In particular, China, the main commodity importer in the world, is expected to grow at a measurably slower pace than its average growth in the past three decades. The Chinese economy is still expected to expand at a robust rate of 7.5 per cent in 2014, but since its demand for commodities will be considerably weaker, many emerging economies that had benefited from the commodity boom cycle will face additional growth challenges.

Above all, however, concerns about emerging economies are mainly triggered by the Fed's decision to taper the quantitative easing, which will lead to a reduction in global liquidity and higher long-term interest rates.

The key question for the rest of 2014 is how this episode will unfold. In order to relieve some of the pressure on national currencies, several central banks have reacted quickly, tightening their monetary stances. Even those countries which were reluctant to raise interest rates before, such as South Africa and Turkey, have introduced aggressive tightening measures. Turkey, for instance, raised the repo rate by 550 basis points to 10 per cent (see the section on Western Asia). The central bank of Brazil, which has been raising interest rates more gradually since May 2013, raised them again in January 2014, from 7.25 per cent to 10.5 per cent. In addition, some countries had already introduced macroprudential measures since the second half of 2013 to cope with the normalization of the monetary stance in the United States. For instance, Brazil reintroduced some capital controls previously established, such as reserve requirements in short-dollar positions of banks and taxes on foreign purchases of bonds.

Such monetary readjustments in emerging economies may help to stabilize financial markets temporarily, even though many of the underlying concerns for investors will remain. At the same time, however, tighter monetary policies will slow down economic expansion while hurting domestic businesses and households directly. If economic prospects deteriorate for emerging countries, pessimistic views will be reinforced, leading to further withdrawals by investors and higher risk premiums. Thus, in the near future, emerging economies will have the difficult task of avoiding raising interest rates excessively, while reducing risk premiums for their assets.

Developed economies

The United States: GDP growth in 2013 was better than expected

The advanced estimate for the United States GDP shows an annualized growth of 3.2 per cent for the fourth quarter of 2013. The reported growth is broad-based. Growth rates for household consumption, private fixed investment and exports were all higher than the GDP growth rate. The key dragging factor was federal government expenditure, as the temporary shutdown in October helped to induce an annualized 4.9 per cent decline in general government expenditure. If the shutdown had not occurred, the GDP growth rate might have remained at 4.1 per cent as observed for the previous quarter. GDP of the United States for 2013 as a whole increased 1.9 per cent.

On 29 January, the Fed decided to continue the tapering of its asset purchase programme. Starting from February 2014, the Fed will purchase only $65 billion in agency mortgage-backed securities and longer-term treasury securities per month, a $10 billion reduction from the previous level. The reduction will be spread equally among those two types of assets.

Developed Asia: Japanese trade deficit persists

According to recent data, Japan has run a deficit in merchandise trade for 2013 as whole, the third year in a row. The magnitude of the deficit is more than two per cent of nominal GDP, the worst situation since 1970s. Although export volume has continued its increasing trend since early 2013, import volume has been increasing at higher speed. Another factor explaining the deterioration of the trade balance is increased import of natural gas. After shutting down nuclear power plants in 2011, more natural gas has been imported for power generation purposes. The import value of natural gas in 2013 was twice as much as in 2010.

The consumer price index (CPI) statistics reveal that inflation in Japan might have started to slow down. The national CPI for December 2013 increased by 1.6 per cent from one year ago, the same year-on-year increase as November 2013. However, the CPI for the Tokyo area, which is considered a good indicator for national CPI, increased only 0.7 per cent in January 2014, noticeably lower than the 1.0 per cent for both November and December 2013. This slowdown can be partially attributed to the stabilization of the exchange rate for the Japanese yen in late 2013, which lowered the prices of energy and imported goods.

Western Europe: continued positive growth likely in the fourth quarter of 2013

Western Europe continues to recover gradually, although growth remains weak and inflation continues to decelerate, flagging possible deflationary risks. Short-term indicators for November are consistent with this picture. Industrial production rose sharply in November and retail trade also posted a strong gain. In both cases, a clear upward trend over the past year has now been established. By contrast, construction continued to decline. Unemployment appears to have finally stabilized albeit at exceptionally high levels, registering 12 per cent in the euro area for the third month in a row. The unemployment rate has stopped its inexorable rise in some of the periphery countries; in Spain, for instance, it has now declined for three consecutive months. Inflation continues to decelerate, however, registering 0.7 per cent in January. Both headline and core inflation rates have now been below 1 per cent since October. Some preliminary GDP figures for the final quarter of 2013 confirm a gradually improving situation. GDP grew in Germany at a similar pace as that in the third quarter of 2013. The United Kingdom of Great Britain and Northern Ireland grew at its strongest pace since 2007, while Spain achieved a second consecutive quarter of positive growth.

The new European Union members: Latvia joins the euro area

Among the new European Union (EU) member States, positive economic trends were generally sustained in late 2013. Overall economic confidence continued to strengthen for the most part in January. The prospects for domestic demand also improved, in particular in the Czech Republic. Inflationary pressures in the region remain extremely weak, with annual inflation staying at historic lows in many new EU members in December. In Hungary, household energy prices were further cut by 11 per cent in November, which contributed to monthly deflation and a weaker inflation outlook. Thus, monetary easing has continued in Hungary, despite sharp currency depreciation. Latvia became a member of the euro area in January; the transition was smooth despite some increases in consumer prices. Nevertheless, the high share of non-performing loans (over 21 per cent in Romania) is seriously constraining revival of the credit markets and lending to the private sector. Since January, the citizens of Bulgaria and Romania are allowed to work in any member State of the EU, and although the assessments of prospective outward migration from those countries vary, this may alleviate pressure on those countries' labour markets.

Economies in transition

CIS and Georgia: sluggish economy persists in the Russian Federation

The economy of the Russian Federation remained sluggish at the end of 2013 and annual growth is estimated to have reached 1.3 per cent. Annual inflation in the country is estimated at 6.5 per cent in 2013, which exceeds the official target range of 5.0 to 6.0 per cent. The recently adopted budget for 2014 is based on a 3.0 per cent GDP growth assumption and is targeting a deficit of 0.5 per cent, based on an oil price (Ural brand) of $100 per barrel. Since the beginning of 2014, the national currency lost about 10 per cent of its value versus the U.S. dollar, as a result of investors' sell-off and the gradual move of the central bank towards a free-float exchange rate. In Ukraine, GDP growth in 2013 confirmed initial low estimates, as weak external demand impacted industrial output and investment. Although the foreign-exchange reserves increased in December, thanks to the $3 billion tranche of the $15 billion loan agreed with the Russian Federation, the currency continued to weaken in mid-January and plunged to a five-year low against the U.S. dollar in early February, while sovereign yields sharply increased. In late 2013, the Government of the Russian Federation approved a new $2 billion loan to Belarus. The economies of Central Asia meanwhile reported strong growth in 2013, at 10.5 per cent in Kyrgyzstan, 7.4 per cent in Tajikistan, and 10.2 per cent in Turkmenistan, according to the official figures.

South-Eastern Europe: growth in Serbia stronger than expected

According to preliminary estimates, real GDP in Serbia increased by 2.4 per cent in 2013. Although growth was driven by net exports, there are signs of strengthening domestic demand, reflected, in particular in a 3.1 per cent year-on-year increase in retail trade in November. Some positive developments were also registered in the labour market, while annual inflation declined to 1.6 per cent in November. The National Bank of Serbia further cut its policy rate in mid-December to 9.5 per cent. In the former Yugoslav Republic in Macedonia, the economy expanded by 3.3 per cent in the third quarter, driven by the construction sector and public infrastructure projects. In Albania, however, the economy contracted by 2.3 per cent year on year in the third quarter, despite the strong export performance, as construction output declined.

Developing economies

Africa: higher interest rate in South Africa to relieve pressure on the rand

The South African Reserve Bank increased its policy interest rate by 50 basis points to 5.5 per cent. While growth remains relatively weak and the inflation rate has stayed within the central bank's target range, this tightening of monetary policy aims at relieving some of the pressure on the rand. The currency has lost almost one quarter of its value against the dollar over the past year, driven by a number of factors (see section on global issues). In Libya, oil output has partially returned after the Government was able to negotiate with some of the groups that have been blockading oil production facilities and export terminals. Production was back to close to 50 per cent of normal levels after falling by over 90 per cent near the end of 2013. There are conflicting estimates as to the total cost of the protest, but it has been significant enough for the Government to say that if the remaining protests continue there may be issues with paying government salaries. Inflation has fallen to a three-year low in Burundi, from 18.2 per cent in 2012 to 8.1 per cent in 2013. In fact, inflation has fallen across East Africa, to 7.9 per cent in Tanzania from 16.0 per cent, to 5.7 per cent in Kenya from 9.4 per cent, to 4.2 per cent in Rwanda from 8.0 per cent and to 5.5 per cent in Uganda from 14.0 per cent.

East Asia: growth momentum remained robust in the fourth quarter of 2013

Growth momentum in most East Asian economies remains fairly robust as evidenced by recently released figures for the fourth quarter of 2013. In China, GDP growth decelerated slightly to 7.7 per cent year on year as fixed investment and industrial production slowed amid tighter credit conditions. Full-year growth for 2013 was also 7.7 per cent, the same pace as in 2012 and above the official

Government target of 7.5 per cent. In the Republic of Korea, the economy expanded by 3.9 per cent in the fourth quarter, the fastest growth in three years. The pickup in growth was driven by a recovery in exports, particularly to developed economies, and strong investment activity. The Philippine economy continued to expand rapidly in the final quarter of 2013 despite the devastation caused by typhoon Haiyan. Year-on-year growth slowed only moderately to 6.5 per cent, bringing full-year growth to a stronger-than-expected 7.2 per cent. Growth in the fourth quarter was boosted by household consumption and net exports. Indonesia— considered to be particularly vulnerable to global financial turmoil—reported its largest monthly trade surplus in two years in December 2013. The improved outlook for the current account helped support the rupiah, which had come under renewed downward pressures amid the global financial turmoil in late January 2014.

South Asia: India's central bank underscores commitment to bring down inflation

Despite continuing sluggish economic activity, the Reserve Bank of India (RBI) further tightened monetary policy in January 2014, increasing its main policy rate by 25 basis points to 8 per cent. The move—not expected by most economists—underlines the central bank's determination to bring down the stubbornly high inflation rate. Consumer price inflation has remained close to double digits. The authorities view significantly lower and more stable inflation as a pre-condition to revive consumption and investment, which have slowed markedly over the past two years. The latest hike in the interest rate also provided support for the value of the rupee. Unlike in the previous episode of global financial turmoil in mid-2013, the rupee has held up fairly well in recent weeks even as many emerging market currencies fell sharply. This resilience can be partly attributed to a marked reduction in India's current-account deficit over the past year.

Western Asia: Turkey tightens monetary policy to relieve pressure on the lira

The Turkish economy was hit hard this month after a sharp decline of the external value of the Turkish lira. In the past six months, the Turkish lira depreciated almost 20 per cent against the U.S. dollar. In order to restore stability of its currency, the Central Bank of Turkey raised its key interest rates on January 28. The overnight lending rate was raised 425 basis points to 12 per cent, while the repo rate was raised 550 basis points to 10 per cent. This aggressive monetary tightening contrasts with several months of status quo, during which the central bank resisted any increase in interest rates in the face of currency depreciations in the second half of 2013. The main reason for refraining from monetary tightening was the concern about the low level of domestic demand in the economy and the high unemployment rate. Although the central bank is now ready to implement a restrictive monetary policy framework, external pressure on the exchange-rate is not expected to stem downward so easily. First, the Fed will continue to taper the quantitative easing, pushing higher premiums for Turkish assets. Second, higher interest rates will likely slowdown economic growth, which could cause further deterioration in investor sentiment.

Latin America and the Caribbean: current-account deficit on the rise, while domestic difficulties are mounting in Argentina

During 2013, Latin America and the Caribbean experienced an increase in its current-account deficit, mainly due to the declining performance of the trade balance. For the region as a whole, the deficit is expected to increase from 1.8 per cent of GDP in 2012 to around 2.6 per cent in 2013. For instance, the deficit substantially increased in Brazil from $54 billion in 2012 to more than $80 billion or 3.6 per cent of the GDP, while in Argentina it increased by almost 45 per cent in the first three quarters of 2013 in comparison to the same period in 2012. The situation in Argentina continues to deteriorate, as its economy suffers from strong capital flight and exchange rate depreciation pressures, falling international reserves, high inflation and low growth prospects, amid policy uncertainty and an overall lack of confidence from private investors. In January, the peso depreciated sharply (see the section on global issues), triggered by the decision of the central bank to stop intervening in the foreign exchange market. Since last July, reserves have fallen by more than 23 per cent to less than $30 billion, a seven-year low. In Argentina, international reserves are particularly crucial for financing energy imports, government spending and external debt payments, given the lack of access to international financial markets since the default of 2002. During January, the authorities announced a relaxation of the Government's ban on buying foreign currency for saving purposes, which seems to be an attempt to close the gap between the official and "blue dollar" exchange rates in the parallel market. However, many uncertainties remain on what strategy and policies the authorities will implement to restore investor confidence and to avoid a further escalation of the economic and financial turmoil.