World Economic Situation and Prospects

Monthly Briefing

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Summary

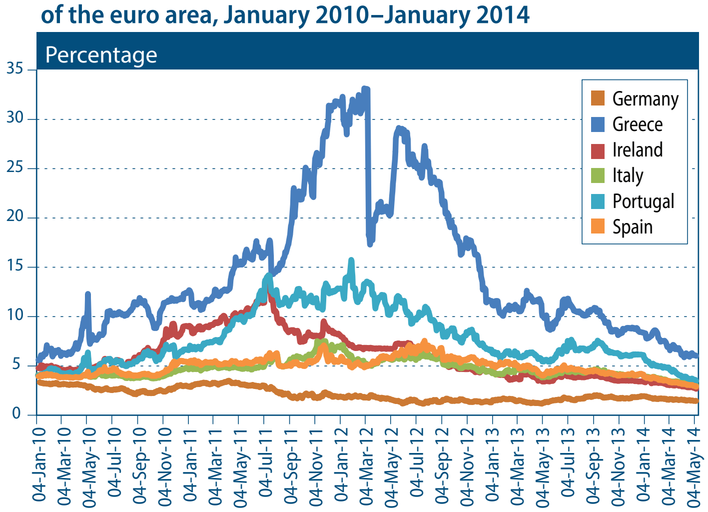
- Financing conditions improve in euro area peripheral countries and in emerging economies
- U.S. economy bounces back after a difficult first quarter
- China's first-quarter GDP growth the slowest in two years

Global issues

Bond yields fall sharply in euro area peripheral countries

Sovereign debt markets in the peripheral countries of the euro area have rallied since the fourth quarter of 2013, with yields on 10-year government bonds falling to pre-crisis levels and in some cases even below (figure 1). Yields on Spanish 10-year bonds, for example, fell below 3.1 per cent, their lowest level since 2005. In part, the euro area peripheral countries have benefited from the flight to relative quality capital flows of emerging economies. In addition, the improvements in economic prospects in peripheral countries have become a more relevant factor. Portugal, for instance, has decided to exit its rescue programme without a line of credit from the European Union (EU), as did Ireland earlier this year, demonstrating the extent of the improvements in their fiscal positions. Other factors are also at play, particularly the expectation that the European Central Bank (ECB) will embark on a new quantitative easing (QE) programme, consisting of large-scale asset purchases in the near future. Overall, lower borrowing costs may lead to a virtuous cycle, by strengthening Governments' finances and helping economic growth.

Figure 1: 10-Year Mid Yield for bonds in selected countries of the euro area, January 2010–January 2014

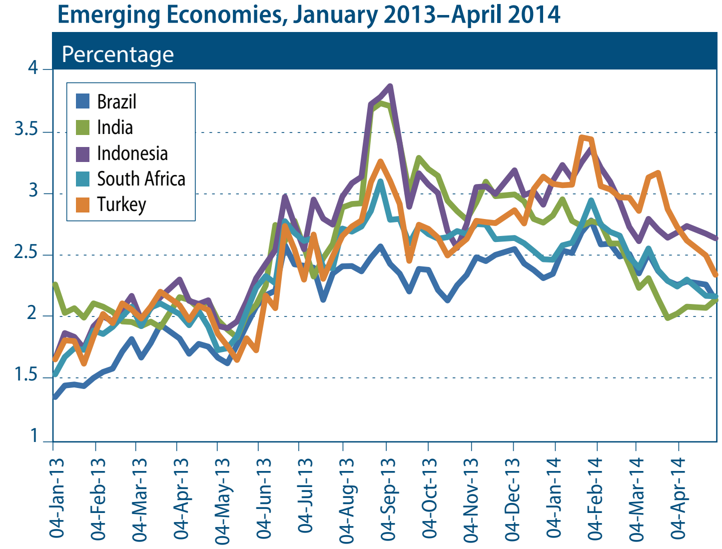


Source: J.P. Morgan Chase.

Sovereign and corporate borrowing costs have declined in emerging economies

Most emerging economies, with the notable exception of the Russian Federation, have seen a visible decline in sovereign and corporate borrowing costs in recent months, after the notable increases in mid-2013 and early 2014. The spreads for sovereign debt instruments in Brazil, India, Indonesia, South Africa and Turkey have fallen considerably from the levels registered in late January (figure 2). In most cases, current spreads are only slightly higher than they were prior to the financial turbulence in mid-2013. Dollar-denominated corporate spreads have also declined in a similar manner over the past few months. The risk appetite for emerging market debt is returning, which reflects, in part, a more robust global outlook and greater stability in the United States Treasury market as the tapering by the United States Federal Reserve (Fed) has proceeded as planned. At the same time, monetary policy tightening in sev-

Figure 2: EMBI Global Strip Spreads in Selected Emerging Economies, January 2013–April 2014



Source: J.P. Morgan Chase.
Note: The JP Morgan Chase Emerging Markets Bond Index Global (EMBI Global) measures the total returns for U.S. dollar-denominated sovereign debt instruments. A higher index indicates higher default risk. The sovereign spread is calculated over the entire duration of the strip Treasury curve using zero coupon rates in basis points.

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eral emerging countries, such as Brazil (see below), India and Turkey, and some improvements in macroeconomic conditions (e.g., lower current-account deficits in India and Indonesia) have made emerging market debt funds more attractive, triggering considerable capital inflows in recent months. However, despite the improving financing conditions, investors' behaviour remains sensitive to the changes in the U.S. monetary stance and country-specific weaknesses in emerging economies.

Developed economies

The United States: the economy is bouncing back from the winter freeze

According to the latest estimate, GDP in the United States of America stagnated in the first quarter of 2014, growing at an annualized rate of 0.1 per cent. Among several measures of economic activity, business investment and residential investment declined by 2.1 per cent and 5.7 per cent, respectively, while exports and government spending decreased 7.6 per cent and 0.5 per cent, respectively. In contrast, household consumption increased 3.0 per cent, driven mainly by a 10 per cent increase in expenditure on health care. The overall weakness in the first quarter was mainly caused by exceptionally adverse weather conditions during the winter. However, the most recent labour market report points to a notable rebound in the economy from the winter lull. Nonfarm payroll employment increased by 288,000 in April, the largest increase since early 2012. The unemployment rate declined from 6.7 per cent in the previous month to 6.3 per cent, although the decline was largely accompanied by a drop in the labour force participation rate. The Fed has reconfirmed that it will keep interest rates at current low levels for a considerable time, even if the unemployment rate and inflation rate approach the targets set by the Fed.

Developed Asia: Japan's consumption tax rate increased, leading to higher inflation

On 1 April, the consumption tax rate in Japan increased from 5 per cent to 8 per cent. The consumer price index (CPI) for the Tokyo area already reflected this hike; the year-on-year headline inflation rate in April jumped to 2.8 per cent, from 1.3 per cent in March. The core inflation rate also jumped to 2.0 per cent in April, from 0.4 per cent in March. The national CPI for April will become available toward the end of May and is expected to display the same pattern of response. Other statistics for March show that consumers in Japan have brought forward the purchases of durable goods to avoid the higher tax rate. In March, the retail sales value increased 11 per cent from one year ago, the highest increase since March 1997, just before the tax hike on 1 April 1997. As a result, industrial production and import volume increased significantly over the first quarter of 2014, in order to meet the spike in demand.

The Reserve Bank of New Zealand (RBNZ) raised its policy rate from 2.75 per cent to 3.0 per cent on 23 April, just about six weeks after it raised the rate by 25 basis points from a level unchanged since early 2011. RBNZ has sustained its intention to raise the rate further in the next two years.

Western Europe: GDP growth continues to improve, but slowly

Economic growth is likely to have continued at a modest pace in the first quarter of 2014 with similar prospects for the second quarter of the year. Both industrial and construction sector production increased in February, confirming a longer-term upward trend. The volume of retail trade increased for the third consecutive month, suggesting that consumption spending is beginning to be more of a support to regional growth. But the March rate of unemployment in the euro area remained at 11.8 per cent, where it has been since December, with little prospect for significant improvement in the near term. Leading indicators are consistent with continuing growth going forward. The Markit Eurozone composite indicator increased again in April, attaining its highest level in the past three years. Conversely, the European Commission's Economic Sentiment Indicator dipped slightly in April, despite the fact that it remains well above its long-term average. Worries over deflation were postponed by an uptick in headline inflation in April, as the annual rate increased to 0.7 per cent from 0.5 per cent in March, while core inflation increased to 1.0 percent. Nevertheless, inflation still remains significantly below the ECB goal of less than 2 per cent, underscoring the pressure for some type of stimulus. The most recent ECB press conference signalled that such policy action is possible and most likely to initiate in the June meeting of the governing council, in concert with the release of the next ECB inflation forecast.

The new EU members: economic confidence strengthens further

Lithuania has reported the estimate of economic growth for the first quarter of 2014 of 2.9 per cent year on year, indicating a weaker rate than a year ago. In Estonia, GDP has apparently contracted by 1.9 per cent year on year during the same period. For most of the region, however, first quarter figures are expected to reflect a moderate upturn following stronger exports and mild recovery in domestic demand. In Romania, according to the preliminary assessment, the first quarter GDP increased by 3.2 per cent year on year. In April, economic confidence in the region strengthened further, with the confidence indicator reaching a 16-year high in Hungary. Inflationary pressures remained subdued in April; on an annual basis, consumer prices grew by only 0.9 per cent in the Czech Republic and declined by 0.1 per cent in Hungary. Despite the challenging environment for emerging markets, the external financing capacity of many of the new EU members has noticeably improved, thanks to the surpluses in their current and capital accounts. The Hungarian National Bank further cut its policy rate in late April by 10 basis points, to another record-low level of 2.5 per cent.

Economies in transition

CIS: a disappointing first quarter

In the first quarter of the year, economic performance was disappointing in many CIS economies, with weaker growth than one year ago. According to the initial assessment, the economy of the Russian Federation expanded by 0.8 per cent year on year, but it contracted by 0.5 per cent quarter on quarter and capital investment shrank. Growth is held back by structural bottlenecks and weak business confidence, as well as a significant outflow of capital. Economic sanctions introduced against the country in the context of the Crimean conflict have so far remained limited, but Standard and Poor's rating agency downgraded the Russian sovereign debt rating in April, together with the credit ratings of several major companies. Inflation in the Russian Federation accelerated to 7.3 per cent in April, forcing the central bank to increase its policy rate by 50 basis points.

The economy of Ukraine contracted in the first quarter of 2014 by 1.1 per cent year on year, amidst the continuing political crisis. The country's foreign-exchange reserves dropped to a critically low $12 billion in April, covering slightly more than a month of imports. In order to protect its currency, the National Bank of Ukraine has drastically increased its main policy rate in April, by 300 basis points. In late April, the IMF approved a $17 billion stand-by loan for Ukraine, $3.2 billion of which will be disbursed immediately. Additional financial assistance will be provided by the EU, Japan, the United States, and the World Bank to boost foreign-exchange reserves, attain macroeconomic stabilization, and support budget expenditure. The loan comes with tough conditions and should help to repay the country's debt to the Russian State gas company.

In Belarus, the economy expanded by only 0.5 per cent year on year in the first quarter of 2014. Both industrial and agricultural output declined, while the level of inventories remained high. Real wages grew in the first quarter, while productivity declined, creating inflationary pressure. Although the currency weakened versus the dollar by 4 per cent since the beginning of the year, the central bank cut its refinancing rate by 1 per cent in April. In Kazakhstan, the economy grew by only 2.9 per cent year on year. In Azerbaijan, real GDP in the first quarter grew by 2.5 per cent year on year, less than in the first quarter of 2013, mostly due to lower oil output. In May, the central bank cut its key policy rate by 50 basis points to support investment and to offset the impact of tighter fiscal policy. The currencies of those CIS countries came under pressure following the weakening of the Russian rouble. In Kyrgyzstan, for example, the currency weakened by almost 8 per cent versus the dollar since January.

South-Eastern Europe: slow GDP growth in Serbia

Real GDP growth in Serbia in the first quarter was only 0.4 per cent year on year, despite the strong expansion in exports, which increased by 22.1 per cent in value terms. Other countries in the region also reported strong export performance; in Albania, the value of exports grew by over 10 per cent in March, while in the former Yugoslav Republic of Macedonia exports increased by 17 per cent in the first quarter. Lower food and fuel prices have restrained inflation in the region. The consumer price index in April remained flat in the former Yugoslav Republic of Macedonia, resulting in negative annual inflation, while it increased only marginally in Serbia, bringing annual inflation down to 2.1 per cent. Considering that near-term inflation expectations and foreign-exchange market trends remain stable, the National Bank of Serbia decided to cut its policy rate by 50 basis points in early May.

Developing economies

Africa: economic conditions remain fragile in several countries and China announces further investments in the region

In Cameroon, coffee production continued to decline in the first months of the current growing season, extending a long-running contraction of the sector. A number of factors are driving this downward spiral, including bad weather, a lack of transport infrastructure, a lack of financing and farming inputs, and plant diseases.

Initial estimates are that Kenya registered GDP growth of 4.7 per cent in 2013, up marginally from 4.6 per cent in 2012, driven by improvements in manufacturing, financial intermediation, transport and communications, and building and construction. Agriculture and tourism were two significant areas of lower growth that pulled overall output below the Government's 5 per cent projection. GDP growth in Egypt was only 1.3 per cent year on year in the fourth quarter of 2013, with private consumption and imports falling and a significant impact from lower tourism revenues. GDP growth in Rwanda was 4.6 per cent in 2013, down from 7.3 per cent in 2012, and noticeably lower than previous government forecasts. Much of the drop is attributed to lower government spending in the services sector, due to aid cuts. Uganda's economy expanded by 5.7 per cent in 2013, driven by growth in the construction, mining and services sectors. Agricultural growth lagged for another year, increasing by only 1.5 per cent. In South Africa, the unemployment rate increased to 25.2 per cent in the first quarter. While seasonal factors underpin parts of this increase, insufficient job creation remains the more fundamental problem. Taking into account discouraged job seekers, the unemployment rate exceeded 30 per cent.

China announced a further investment of $12 billion in Africa. New credit lines worth $10 billion would be offered, on top of previous commitments of $20 billion in credit. There are also plans for a $2 billion increase to the China-Africa Development Fund, taking the total amount to $5 billion, and $100 million in aid for wildlife protection.

In Libya, there have been agreements between the Government, protesters, and rebel groups blockading some of the oil production and export facilities. The 110,000 barrel per day (bpd) Hariga port has reopened and the eastern oil port of Zueitina, which has an export capacity of 70,000 bpd, is expected to open soon.

East Asia: slowing growth in China and Indonesia

Economic growth in China slowed to 7.4 per cent year on year in the first quarter of 2014, down from 7.7 per cent in the previous three months. On a quarter-on-quarter seasonally adjusted basis, the economy expanded by only 1.4 per cent, the slowest pace since the first quarter of 2012. The slowdown reflects weakness in the real estate market, the heavy industry sector, and external demand. Export earnings declined by about 3 per cent in the first quarter of 2014, but returned to slight growth in April as demand from developed economies picked up. The Chinese Government announced in April a small-scale stimulus plan, which includes the extension of tax breaks for small businesses, additional spending on railways, and expansion of housing projects for low-income households. In Indonesia, GDP growth slowed to a four-year low of 5.2 per cent in the first quarter of 2014. Economic activity was weighed down by a decrease in overall exports, after an export ban on raw ore was implemented in mid-January. In the Republic of Korea, by contrast, the economy gained further momentum in the first three months of the year, supported by robust growth in investment and net exports. GDP expanded by 3.9 per cent year on year, up from 3.7 per cent in the previous three months.

South Asia: higher food prices drive up inflation

In most South Asian economies, consumer price inflation picked up in March and April, following a slowdown in late 2013 and early 2014. The increase mainly reflects higher food price inflation as the prices of vegetables and fruits rose markedly. In India, consumer price inflation stood at 8.3 per cent year on year in March, up from 8.1 per cent in February. Pakistan saw a more pronounced increase, with inflation accelerating from 7.9 per cent in February to 9.2 per cent in April. This renewed rise in inflation limits the ability of the region's monetary authorities to support growth in the short run. The central banks of India and Pakistan have remained in a wait-and-see mode in recent months after hiking their benchmark interest rates between August 2013 and January 2014.

Recent trends in workers' remittance flows vary across the region. In Pakistan, remittance inflows grew by 11.9 per cent year on year in the period July 2013 to March 2014. Over the same period, remittance flows to Bangladesh declined by 5.8 per cent. This fall can be attributed to several factors, including fewer job opportunities in the countries of the Gulf Cooperation Council (GCC) due to new labour market policies, and an appreciation of the Bangladeshi taka against the U.S. dollar in 2013.

Western Asia: the Syrian military conflict continues to weigh on the subregional economy

Monthly indicators again underline the significant spillover effects of the Syrian military conflict on neighbouring countries and their economic prospects. In Lebanon, exports fell by 37 per cent year on year in the first two months of 2014 and tourist arrivals were down 13 per cent over the same period. As a result, economic growth prospects for the year will remain weak and the twin deficits are expected to widen.

A report presented this month by the ILO indicates that long-term unemployment is particularly high in Jordan. Among the unemployed, 55.8 per cent have been looking for work for one year or more. Furthermore, 72.4 per cent percent of unemployed young Jordanians have been looking for work for at least six months; men with low education levels and women with higher education are particularly affected. In Turkey, financial markets and the exchange rate have stabilized after a sharp increase in interest rates at the end of January 2014. However, this month core inflation rose significantly again, reflecting in part the depreciation of the Turkish lira. This rise in inflation will limit monetary policy options to support the economy. Among oil exporters in the region, Yemen has registered a 50 per cent drop in oil production in four weeks during the month of February, due to acts of sabotage. Conversely, Saudi Arabia's economy expanded by 4.7 per cent in the fourth quarter of 2013 from one year ago, the fastest pace in five quarters. The world's biggest oil exporter has been benefiting from relatively high crude oil prices.

Latin America and the Caribbean: patchy economic situation in the region leads to different monetary policy decisions

In April, the Central Bank of Brazil continued with its monetary tightening cycle, initiated last year, and increased the interest rate (Selic) by 25 basis points to 11.0 per cent. This brought the total cumulative increase to 3.75 percentage points since April 2013. Recent monetary decisions seek to contain the persistent inflationary pressures in the Brazilian economy. The consumer price index increased by 0.67 per cent in April, leading to an accumulated variation of 6.3 per cent in the last twelve months, close to the upper limit of 6.5 per cent of the central bank target range. In Colombia, the central bank increased interest rates by 0.25 percentage points to 3.5 per cent. The change in the interest rate, the first since March 2013, is based on the expectation that inflation is getting closer to the central bank's target of 3.0 per cent and the economy is moving towards full capacity during 2014.

By contrast, the Central Bank of Chile decided to cut interest rates by 0.25 percentage points in both February and March, as the economy is experiencing a noticeable slowdown. In the first quarter of 2014, the economy expanded by only 2.4 per cent year on year, similar to the 2.7 per cent increase in the last quarter of 2013, but much lower than the average 4.6 per cent expansion of the three previous quarters. Economic activity in the mining and manufacturing sectors is particularly subdued. In March, the production indices of the mining and manufacturing sectors increased by only 1.0 per cent and 0.8 per cent year on year, respectively. Consequently, unemployment started to increase, although moderately. The unemployment rate in March (the three-month moving average) was 6.5 per cent, 0.4 and 0.3 percentage points higher than in February and March 2013, respectively. While the current slowdown in the Chilean economy encompasses cyclical factors, there are some concerns that it might also be associated with longer-term changes, as the super-cycle of commodity prices ends.