World Economic Situation and Prospects

Monthly Briefing

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Global issues

Summary

- World trade continues sluggish recovery
- Oil prices soar amid political instability in Iraq
- Disappointing first quarter for developed economies

World trade still sluggish in the first months of the year

Despite expectations for a return to previous growth rates this year, world trade has grown relatively slowly for the first months of 2014. Prior to the crisis, world trade grew at about double the growth rate of world gross product (WGP), but in the past two years trade growth has slowed to just barely matching the growth of WGP. The hope was that a rise in economic activity in developed countries, which still account for a major portion of world trade and are important trading partners for many developing countries, would provide the necessary impetus to boost world trade. However, as several developed economies, and the United States of America in particular, had a disappointing first quarter, there has been limited expansion in world trade. Statistics from the Netherlands Bureau for Economic Policy Analysis (CPB) point to a decline of world trade growth in February and March (figure 1). There has been some rebound in April, but that still makes growth for the year only slightly positive.

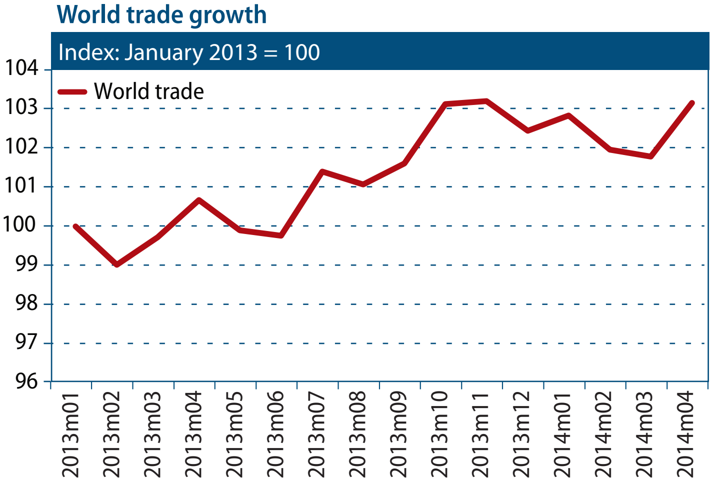
Statistics for merchandise trade for the first quarter of 2014, produced jointly by the World Trade Organization (WTO) and the United Nations Conference on Trade and Development (UNCTAD), corroborate this trend to some degree. The UNCTAD/WTO estimates for March and April are reversed from those of the CPB, with a significant rise in March and a fall in April. Trade statistics are notoriously volatile and have had frequent revisions, but the overall trend is the same for both months' estimates with little growth for the year so far.

The sluggishness appears to be relatively broad based with declines in developed and developing regions, particularly among major importers and exporters. On a quarter-on-quarter basis, exports were down in North America and flat in Europe, while imports were down in both of those regions. World trade volume growth has declined in the first quarter in the past four years, but it has declined more rapidly in the first quarter of 2014. In each of the previous three years, trade volume growth rebounded and ended positive for the year; it appears that may be the case this year as well as there are some indications of a possible rebound in the second quarter, with United States imports up in April. Trade in commercial services statistics are somewhat more delayed, but they point to a decline in the last quarter of 2013, particularly in services imports to Asia.

Oil prices rise amid Iraq's political instability

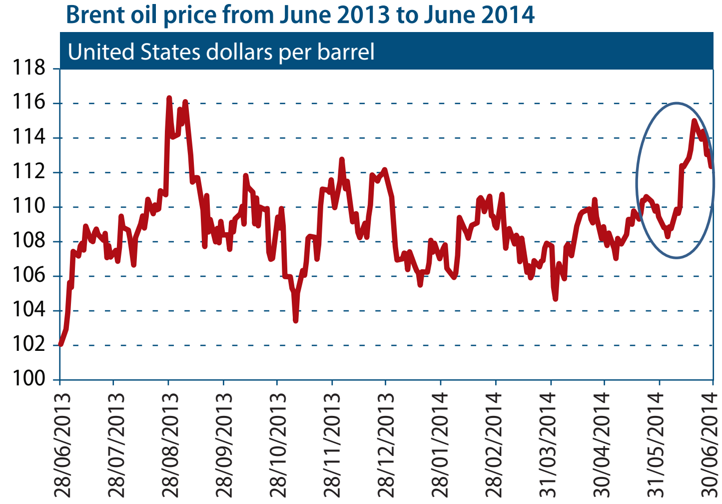
Against the backdrop of political and military tensions in Iraq, oil prices have been on the rise, as investors worried about supply disruptions. On 20 June 2014, the Brent oil price reached $114.72, a new nine-month record (figure 2). United States crude oil also traded above $107 per barrel on the same day, the highest price during

Figure 1
World trade growth



Source: Netherlands Bureau for Economic Policy Analysis.

Figure 2
Brent oil price from June 2013 to June 2014



Source: Energy Information Administration.

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the same nine-month period. Since then oil prices have softened, but are still higher by more than 3 per cent this year. The main question remains whether this is a temporary pause while investors assess the reality in Iraq or if prices will continue to decline, as originally expected in our previous forecast (see *World Economic Situation and Prospects: Update as of mid-2014*).

On the one hand, there are serious risks of major export disruptions, with longer-term implications for global supply and oil prices. Before the conflict, Iraq was producing more than three million barrels per day (bpd), becoming a major pillar of global supply, ranking just behind Saudi Arabia, the largest exporter in the region. So far, only a small portion of Iraq's oil output has been threatened, as conflicts have been taking place in northern parts of the country where production is lower. But if the turmoil escalates and spreads towards the southern regions of the country, home to more than three-quarters of the Iraq's total crude output, major export disruptions can be expected. On the other hand, even considering further disruptions in oil exports from Iraq, other Organization of Petroleum Exporting Countries (OPEC) members could compensate by boosting their own production. Saudi Arabian officials pledged to respond to any shortage, as the country can sustain supply at 12.5 million bpd. In addition, the United States Government has started to relax a ban on United States oil exports, which could also help avoid shortages in global supply and reverse the recent trend of rising oil prices. As of 25 June, the Brent oil price had already fallen, following the decision by the United States Government to permit exports of lightly refined oil, although United States crude oil price increased concomitantly. It is therefore still unclear if the global economy will face an oil price shock this year, but the risk is considerably higher than it was a few months ago.

Developed economies

The United States: first quarter worse than anticipated

According to the final estimate from the Bureau of Economic Analysis, economic output of the United States declined at the annualized rate of 2.9 per cent in the first quarter of 2014 from the previous quarter. This was the worst performance since the first quarter of 2009. More than half of the decline can be attributed to the rapid deceleration of gross investment and private consumption, both of which were affected by the severe winter weather conditions. Inventory build-ups decelerated significantly after rapid accumulation in the first three quarters of 2013. In addition, export growth plunged from 9.5 per cent in the previous quarter to negative growth of 8.9 per cent, contributing as well to the overall poor performance.

In May 2014, the year-over-year headline inflation rate increased to 2.1 per cent from 0.9 per cent in October 2013. The core inflation rate also increased mildly from 1.6 per cent in early 2014 to 1.9 percent in May 2014. This gradual bottoming-out of inflation coincided with discussions regarding the stronger impact of short-term (versus long-term) unemployment on the wage rate and inflation. The same cluster of discussions also underlined that the short-term unemployment rate is now lower than the average level for the past 20 years.

Developed Asia: Japanese Government releases revised Japan Revitalization Strategy

On 24 June, the Government of Japan released the revision of the Japan Revitalization Strategy, the third arrow for "Abenomics". Foremost, this revised package seeks to enhance corporate governance and to reform the corporate tax system with the intention of regaining international competitiveness. It will also seek to increase labour mobility, participation of women in the labour market, and the integration of foreign workers. Reforms of the agricultural sector, as well as the health-care industry and its provision framework are also included in the package.

The increase of the consumption tax rate from 5 per cent to 8 per cent on 1 April 2014 may have had different effects, according to recently released economic indicators. The nominal value of retail sales plunged by 13.6 per cent in April, but bounced back by 4.6 per cent in May, even though it remained lower than the level in May 2013. Industrial production only increased by 0.5 per cent in May 2014, after declining by 2.8 per cent in April. The headline inflation rate for both Japan and Tokyo-area remained at an elevated level due to the higher tax rate. On a positive note, the employment level for May fully recovered the April loss and was about 0.9 per cent higher than one year ago.

Western Europe: growth dips in the first quarter of the year

In the euro area, gross domestic product (GDP) growth decelerated to 0.2 per cent in the first quarter of 2014, after 0.3 per cent growth in the fourth quarter of 2013. Growth was supported by domestic demand, evenly distributed across demand components, but was hit by a slight deceleration in investment and a sharp slowdown in exports. Net exports detracted from growth as imports were boosted by the strength of the euro. There was considerable heterogeneity across countries in growth during the first quarter of 2014. In Germany, growth accelerated from 0.4 per cent in the fourth quarter of 2013 to 0.8 per cent. The United Kingdom of Great Britain and Northern Ireland also grew by 0.8 per cent. Spain continued to rebound, growing by 0.4 per cent in the first quarter. However, in France there was no growth, Italy's GDP contracted by 0.1 per cent, and GDP fell in Portugal by 0.7 per cent. The Netherlands registered the worst performance, with GDP contracting by 1.4 per cent. Some of this divergence can be attributed to the mild winter, as demand for energy-related products sharply decreased, having a significant negative impact in the Netherlands. Conversely, the better than usual weather conditions helped the construction sector, boosting growth in Germany and Spain.

New EU member States: recovery trend is sustained

The available indicators for April and May suggest that, in the second quarter, the trend of moderate growth, very low inflation, recovering household sentiment, and a gradual improvement in labour markets continued in the new European Union (EU) member States. A pickup in investment, which was suppressed for several years in Central Europe, is a particularly positive development, underpinned by the utilization of EU funds. The crisis in Ukraine, however, has had a negative impact on some of those countries through weaker export demand. Purchase Managers' Indexes for the Czech Republic, Hungary and Poland have significantly weakened in June. In Poland, which is to some extent exposed to trade with the Russian Federation and Ukraine, industrial output growth slowed to 4.4 per cent year on year in May, from 5.4 per cent in April. Nevertheless, positive labour market developments in Poland continued, helped by the public sector infrastructure spending; also, the rate of unemployment, which stood at 14 per cent in January, declined to 12.5 per cent in May. Labour market conditions also improved in Hungary, with the rate of unemployment declining to 8 per cent in May.

Inflationary pressures in the region remained weak. As in the previous months, deflation was recorded in some of the new EU countries in May, such as Hungary and Poland, despite growing wages. On an annual basis, inflation in many countries was close to zero. The Hungarian National Bank continued its monetary easing policy, cutting its main interest rate by 10 basis points twice, in May and June, to a new record low of 2.3 per cent. In Bulgaria, the banking system came under stress in June, following a run on two of its biggest lenders, prompting direct intervention from the Bulgarian National Bank and an emergency credit line by the EU. In June, the European Commission recommended that Lithuania should be allowed to adopt the euro in 2015, becoming the nineteenth member of the euro area.

Economies in transition

CIS: two different agreements signed

The economy of the Russian Federation modestly strengthened in May. Industrial output increased by 2.8 per cent year on year, while the rate of unemployment dropped to 4.9 per cent. This increase may be attributed to higher public spending and a large order for railway equipment, while household spending remained weak and retail sales grew by just 2.1 per cent year on year. Capital investment continued to fall, although the rate of decline slowed to around 2 per cent year on year in May. The currency and the stock market have recovered in May and June. However, as imposition of broader economic sanctions still remains a possibility, the Government is working on an import substitution programme, which may boost output in 2015.

Since mid-June, the Russian natural gas monopoly halted gas supplies to Ukraine amid disagreements over the price of future gas supplies and debt repayments. Industrial output in Ukraine contracted in May year on year, while inflation accelerated to 10.8 per cent. Belarus, Kazakhstan and the Russian Federation signed an agreement to establish the Eurasian Economic Union in 2015, on the basis of the existing Customs Union. In late June, Georgia, Moldova and Ukraine (Ukraine had signed part of the agreement earlier) signed an association agreement with the EU, which contains a provision on the establishment of a deep and comprehensive free trade area. This agreement, however, may trigger protective trade restrictions by the Russian Federation, which is an important export market for those countries.

South-Eastern Europe: floods cause significant damage

Parts of the South-East European region were affected by devastating floods in May, in particular, Bosnia and Herzegovina, and Serbia. The impact of the floods was severe, causing significant damage to housing and infrastructure (including bridges, energy and telecoms) and hampering economic activity. Economic growth projections were downgraded in the affected countries, while larger budget deficits in 2014 can be expected. To facilitate the recovery effort in Bosnia and Herzegovina, where the damage is estimated at 10 per cent of annual GDP, the International Monetary Fund has decided to double the next tranche of the country's stand-by loan.

Inflation in the region remained low in May, thanks to low energy and food prices and weak aggregate demand, with deflation continuing in Bosnia and Herzegovina. At the end of May, the Bank of Albania cut its policy rate by 25 basis points to another record low of 2.5 per cent, to boost consumer and investment demand and to move inflation back to the target range. The National Bank of Serbia cut its policy rate by 50 basis points twice, in May and June.

Developing economies

Africa: growth trajectories mixed for 2013 and the first quarter of 2014

GDP growth improved in Morocco in 2013, reaching 4.4 per cent, from 2.7 per cent in the previous year. Agriculture and, more broadly, domestic consumption were the main drivers of GDP growth. In Kenya, economic growth was 4.4 per cent in 2013, propelled by wholesale and retail trade and industrial production. In Tunisia, growth slowed in the first quarter of 2014 to 2.2 per cent year on year, with good weather contributing to growth in the agricultural sector, but industrial output fell and tourism was disappointing. In Ghana, real GDP growth in the first quarter is estimated to have reached 6.7 per cent, with strong growth in the agricultural sector. A subdued expansion in services was significantly offset by a strong contraction in manufacturing, following electricity and water shortages and higher imported-inputs costs due to exchange-rate weakness. Poor rains in Rwanda have reduced agricultural output in the second harvest season after the first harvest was already below normal. Agriculture contributes a significant amount to GDP and accounts for a large majority of employment. Below-average agricultural output contributed to lower-than-expected GDP growth last year, and the poor harvests may also contribute to rising inflation in 2014, as they did in 2011 and 2012. Rural food prices had already risen by an average of 7.8 per cent year on year through May.

Oil output in Libya remains severely diminished and highly volatile, down to only 167,000 bpd in April, but up to 300,000 bpd in June with the El Feel oil field increasing production. The Hariga oil port in the east has also recently reopened and is preparing for new shipments. Many other facilities remain blockaded, so production and exports are expected to average well below peak potential in 2014. In South Africa, a five-month strike in the platinum sector ended with a new three-year agreement between the union and employers. Meanwhile, South Africa's inflation rate increased to 6.6 per cent in May from 6.2 per cent in the previous month, driven by higher food prices.

East Asia: economic activity picks up in China, supported by policy measures

Recent data indicate that economic activity in China has picked up slightly in the second quarter, following the weakness of the first three months of 2014. Growth of industrial output, retail sales and exports accelerated in May. After GDP growth (quarter on quarter) slowed to a two-year low of 1.4 per cent in the January-March quarter, China's Government launched a mini-stimulus package that included significant infrastructure investment and tax breaks for small and medium-sized enterprises (SMEs). At the same time, the People's Bank of China introduced targeted reserve requirement ratio cuts, aimed to support lending to the agricultural sector and to SMEs.

The Republic of Korea, by contrast, recorded weaker-than-expected exports and industrial production in May, indicating a slowing recovery. Industrial output declined by 2.7 per cent month on month (seasonally adjusted) owing to subdued external demand and weak consumer spending.

In Thailand, the military have taken steps to revive the ailing economy after the takeover in late May. The military authorities have extended tax cuts, disbursed overdue payments to rice farmers and resumed processing of investment applications. These measures have helped stabilize the economy, but the outlook for the second half is still relatively bleak. The Bank of Thailand cut its full-year growth forecast for 2014 to only 1.5 per cent.

South Asia: signs of a pickup in activity in India

India's economic growth remained subdued in the first quarter of 2014, but there have been recent signs of a pickup in activity. In the January-March quarter, GDP expanded by 4.6 per cent year on year, the same pace as in the previous three months. On a sectoral basis, the sluggish growth mainly reflects a continuing downturn in manufacturing, which contracted by 1.4 per cent. Agricultural output, by contrast, rose by 6.3 per cent, the fastest pace in three years, owing to favourable weather conditions. On an expenditure basis, private consumption gained momentum, but investment continued to slump, falling by 0.9 per cent. Preliminary data for the second quarter indicate that manufacturing production has started to recover, while export growth accelerated notably. India's new Government, which has vowed to revive investment and economic growth, will present its first federal budget in early July.

Sri Lanka's economy continued to expand at a strong pace in the first quarter, with GDP growing by 7.6 per cent. A contraction in agricultural output was offset by double-digit growth in industrial output, driven by a surge in construction. The tourism sector continues to be a major engine of growth and employment and also helps strengthen the country's external position. The number of tourist arrivals increased by 26.5 per cent year on year in the period January-May 2014.

Western Asia: recent turmoil in Iraq weighs on the regional economy

The current political instability and military conflict in Iraq threatens to undo recent years of economic progress. After several years of economic sanctions and a decade of war, Iraq's economy was finally expected to grow rapidly, around 5.5 per cent in 2014-2015 (see *World Economic Situation and Prospects: Update as of mid-2014*), in particular after rebuilding its energy sector in 2012. The country became the second largest oil producer among OPEC members, producing more than 3 million bpd. So far, conflicts have been taking place in the northern part of the country away from larger oil fields (see global section). Nevertheless, Iraq's growth plans included developing resources, notably through foreign investment, to explore untapped oil reserves located in the North. Given the current instability, foreign investors are already trimming operations in Iraq, which may reduce the country's ability to lift output in the near future.

In addition to Iraq itself, the turmoil is also affecting some of the neighbouring countries. As Iraq became Turkey's second-largest export destination, the current insecurity in the country is hampering Turkey's export sector and, consequently, efforts to reduce its current-account deficit. Similarly, Jordan exports to the Iraqi market were completely suspended this month, affecting several key economic sectors. By contrast, other neighbouring countries in the Gulf region seem to be more insulated from the current geopolitical risk. For instance, Saudi Arabian and Kuwaiti financial markets have continued to perform relatively well, as foreign investors' demand for Gulf bonds hasn't changed amid the current instability in Iraq.

Latin America and the Caribbean: Mexico's central bank cut interest rates

Unexpectedly, the Central Bank of Mexico decided, in early June, to cut the policy rate by 50 basis points to a multi-year record low of 3.0 per cent. This decision seeks to support economic activity, which is still struggling to gain momentum after disappointing GDP growth of 1.1 per cent in 2013. In the first quarter, the economy expanded by only 1.8 per cent in comparison to the same period of last year, due to sluggish industrial activity. The more supportive monetary stance is also consistent with relatively low and stable inflation rates. In May, the variation of the consumer price index was -0.32 per cent, leading to an overall variation of 3.5 per cent in the last twelve months.

The economy of Uruguay has been slowing down in 2014. In the first quarter, the Uruguayan economy expanded by only 2.4 per cent year-on-year, after expanding by 4.6 in the last quarter of 2013 and accumulating an overall expansion of 4.4 per cent in 2013. Furthermore, economic activity contracted by 0.4 per cent with respect to the last quarter of 2013 (seasonally adjusted). One of the major drags on growth has been the performance of the external sector, which is affecting agricultural activities in particular. In the first quarter, exports fell by 2.0 per cent year on year, while imports increased sharply by 10.8 per cent.