Monthly Briefing
World Economic Situation and Prospects

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Summary

- Equity markets worldwide plunged
- Euro area dollar liquidity dries up in the midst of Europe's sovereign debt crisis
- G20 finance ministers maintain focus on fiscal consolidation

Global issues

Equity markets worldwide have plunged

Stock markets worldwide ended September with the largest quarterly loss since the final three months of 2008, after the collapse of Lehman Brothers bank. The recent fall has been driven by a combination of factors, including the fear of a double-dip recession in developed economies, concerns about the contagion of the sovereign debt problems of a number of European countries, and unease about lack of effective policy action in major economies to deal with these problems.

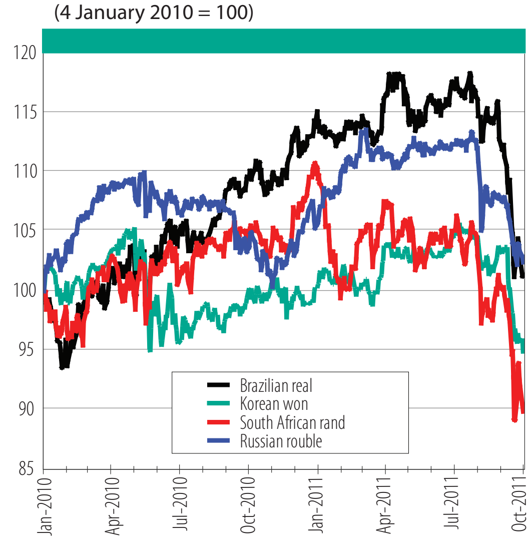
Equity prices in major developed markets declined by about 15 per cent in the third quarter. Stocks in emerging economies suffered even larger losses. The Morgan Stanley Capital International (MSCI) Emerging Markets Index dropped by about 23 per cent. International investors have been withdrawing capital from these economies. By the end of the third quarter, emerging market equity funds had already registered nine consecutive weeks of capital outflows.

As a result, currencies of major emerging economies depreciated strongly against the United States dollar, reversing the previous trend of appreciation (see figure 1). During the third quarter, for instance, Brazil's real fell 16 per cent, the Russian rouble 15 per cent and the South African rand dropped 17 per cent in September alone.

Euro area dollar liquidity dries up in the midst of Europe's sovereign debt crisis

The euro area sovereign debt crisis continues to simmer. Worries about its impact on the health of banks in the region have increased. Many European banks hold substantial amounts of sovereign bonds issued by debt-ridden countries. These worries have led to a drying-up of liquidity available in United States dollars as money market funds have retreated from euro area banks which in turn is increasing the risk of insolvency. The European Central Bank (ECB) and the central banks of England and Switzerland have responded in concerted fashion, providing 3-month dollar assets to banks to fund their liquidity needs. This move was coordinated with the United States Federal Reserve and supported further by the Bank of Japan. Nonetheless, the situation remains tense. Equity markets have continued to plunge and, in the third week of September, Moody's downgraded the credit rating for two major French Banks and placed another on review.

Figure 1:
Real effective exchange rate for selected currencies
(4 January 2010 = 100)



Source: JP Morgan Chase, rebased by UN/DESA.

G20 finance ministers keep focus on fiscal consolidation

Finance Ministers and Central Bank Governors gathered in Washington D.C. for the G20 meetings and the Annual Meetings of the International Monetary Fund and the World Bank from 22 to 24 September and reiterated their commitment to finding a path towards global recovery through a coordinated approach. They concurred in identifying four main challenges to the world economy: sovereign stresses, financial

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system fragility, weak economic growth and high unemployment. Their recommendations, however, mainly focused on the importance of strengthening the stability of public finances through fiscal consolidation in order to restore the confidence of investors, especially in the euro area. They also called to increase the flexibility of the European Financial Stability Facility. Measures proposed to reinforce the stability of the financial sector remained allusive, referring to the implementation of Basel III along the agreed timelines. No concrete actions were proposed to stimulate growth and employment directly, as policymakers have set hope that this will be the corollary outcome of credible fiscal consolidation plans. An action plan of coordinated policies for the short and medium term is to be agreed upon at the upcoming G20 Summit in Cannes.

Developed economies

United States: declining working hours and earnings

The recovery of the United States labour market stalled in August. Besides the flat payroll employment, the average hourly earnings and weekly working hours declined mildly. As a consequence, total wage and salary earnings declined in August for the first time in two years and caused a drop in real disposable income of households by 0.3 per cent from the level reached in July.

The turmoil in equity markets led to a decline in the value of financial assets owned by households during the second quarter of 2011, according to recently released flow-of-funds data. With the plunge in equity markets, the balance sheets of households have likely worsened further in the third quarter. As the housing market also remains feeble, declining household wealth will likely depress consumption growth in the remainder of the year.

On 21 September, the Federal Reserve announced its plan to swap $400 billion of its holdings of shorter-term Treasury securities for longer-term Treasury securities by the end of June 2012. The Fed expects that this will bring down the interest rate for longer-term financial assets.

Developed Asia and Pacific: recovery in Japan from the earthquake weaker than anticipated and New Zealand's debt downgraded

Recent data indicate that the rebound in economic activity in Japan from the aftermath of the earthquake of March 2011 is tapering off. GDP growth will be weaker than expected in the third quarter as well as in the next quarter. For the year 2011 as a whole, Japan's economy is expected to contract. Household data show that consumption declined in August. Industrial production increased by a mere 0.8 per cent (month over month). Meanwhile, the Government is finalizing the details of post-quake reconstruction projects, totalling ¥13 trillion (2.6 per cent of GDP) to be spent over the next five years. The reconstruction efforts are expected to provide some stimulus to economic growth in 2012 and following years.

Two of the three major ratings agencies downgraded New Zealand's sovereign debt rating in September. This was triggered by concerns over the elevated level of the country's external debt which stands at about 80 per cent of GDP, higher than many other countries with the same rating. The high external debt compounds the country's external vulnerability being also heavily dependent on primary exports. In addition, household indebtedness is also high. Further stress in global financial markets could weaken the country's ability to access external financing.

Europe: slight rebound in the third quarter

Industrial production bounced back strongly in July after falling in June, with Germany registering a particularly robust 4.1 per cent growth, month over month. Construction also rebounded from its sharp drop in June. This could indicate that the very disappointing second quarter figures were likely affected by some unusual factors – the closing of German nuclear power plants, the disruptions from the Japanese tsunami and a normalization in the construction sector after its sharp rebound in the first quarter – so that third quarter growth may be slightly stronger than anticipated.

Nevertheless, the overall trend remains one of deceleration. Across the board, leading indicators show a clear and substantial decline in business and consumer confidence. The European Commission's Economic Sentiment Indicator fell sharply in September, continuing the downward trend that set in from March this year. At the sectoral level, confidence among economic agents in services, construction and retail trade as well as among consumers is well below the long term average. Consumer confidence, in particular, dropped sharply in recent months. Industrial confidence, in contrast, is still above the long term average. The composite purchasing managers index (PMI) for the euro area also continued to decline, pointing that a contraction in economic activity should be expected in the period ahead.

The new EU members: modest performance

After weakening in the second quarter, the strength of output varied across new EU members since July. Available data, however, suggest continued slack in production capacity. In Estonia, for instance, industrial output declined by 1.8 per cent month on month in August. Stock markets of most new EU members continued their downward trend in September. Inflation weakened in July and August, turning negative month on month in a number of countries, despite continued high prices of certain food items pushed up by international prices of basic grains.

High public indebtedness remains a concern and governments continued the implementation of announced fiscal austerity plans. Fiscal consolidation is on track in the Czech Republic, which enjoys favourable terms when accessing external finance. Estonia posted a budget surplus over the first six months of 2011. The Government of Hungary, by contrast, may feel pressed to introduce further budget cuts in order to meet fiscal targets in view of slower-than-expected economic growth. The Government has already introduced tougher social security laws. Despite the recent correction of the value of the Swiss franc, it still remains uncomfortably high for corporate and individual borrowers in Hungary, and may dampen domestic demand, given the high exposure of mortgages denominated in that currency.

Economies in Transition

CIS: slowdown in momentum

Signs of a modest slowdown became visible in the Russian Federation and in Kazakhstan in July. In Kazakhstan, industrial output contracted by 4 per cent partly owing to the closing of a refinery for maintenance, but also due to localized strikes in the energy sector. In the Russian Federation, the growth momentum in industry slowed as a result of weaker domestic demand.

Output growth weakened in the Russian Federation in August, while the inflation rate fell to 8.2 per cent (year over year). Authorities did not change monetary policy, however. In contrast, authorities in Georgia loosened monetary policy and cut the refinancing rate by 25 basis points following the decline in the annual rate of inflation from more than 14 per cent in May to 7.2 per cent in August. Reserve requirements for banks were also loosened. In Kazakhstan, inflation continued to rise despite the economic slowdown, reaching 9 per cent in August; the highest level since December 2008. The decision of the Government to lift the ceiling for the retail sales price of fuel contributed to the acceleration of inflation. The measure was a response to the fuel shortages that emerged in July caused by the earlier-mentioned problems in the energy sector and a reduction in imports of refined fuel from the Russian Federation.

South-Eastern Europe: Croatia's economy grows again

The Croatian economy expanded by 0.8 per cent year on year in the second quarter, mainly driven by a recovery in industrial production. Irregular orders for the shipbuilding sector continue to contribute to short-term volatility. Investment demand also remains a concern as it continued to decline for the tenth quarter in a row. To stop the currency from depreciating further, the Croatian National Bank decided to increase the minimum reserve requirement for commercial banks starting mid-October.

In Serbia, expectations are for a stronger growth in the third quarter thanks to a buoyant agricultural sector. In late September, the IMF approved a new precautionary stand-by loan worth about $1.5 billion. In the FYR of Macedonia, shrinking energy production caused a contraction of industrial activity, which stagnated at the lower level in August.

Developing economies

Africa: global financial market turmoil hits exchange rates

The turmoil in financial markets resulting from the debt woes in the euro area also took its toll on African markets. Foreign-exchange markets were especially affected, with currencies falling across the board as investors retreated from any perceived risk assets. Besides the fall of the South African rand (see figure 1), the Ugandan shilling hit an all-time low against the United States dollar and the weakening of the Kenyan shilling prompted the central bank to intervene several times in the currency markets by selling dollars.

In the energy sector, Libya's National Oil Corporation announced that its oil production is set to reach 500,000 barrels per day in October, representing one third of its pre-war output. Algeria's authorities projected a rise in revenues from oil and gas exports by 20 per cent this year compared to last year. Meanwhile, South Africa floated a proposal to build six new nuclear power plants. The country is currently operating the sole nuclear power plant in Africa and more than 90 per cent of the country's power is generated by coal-fired power plants. Economic activity in the country, which is a major platinum and gold producer, has been repeatedly hampered by tight power supply.

East Asia: national currencies weaken amidst massive capital outflows

East Asia's economies experienced significant capital outflows in the third quarter of 2011, leading to a drop in the value of national currencies against the United States dollar. Several central banks intervened to prevent their currencies from depreciating too rapidly. Increased risk aversion among global investors and concerns that the crisis in developed economies could lead to a marked growth slowdown in East Asia resulted in a sharp decline in the region's stock markets. In Hong Kong Special Administrative Region of China, the main stock market index lost more than 20 per cent over the past two months as investors also became increasingly concerned with the weakening of China's property market. In many Chinese cities, property prices have started to decline and there are growing fears about balance sheet problems of real estate developers. In the Republic of Korea, net equity outflows in August amounted to $5.8 billion and the Korean won depreciated by 10 per cent against the United States dollar in the second half of September, falling to its lowest level in over a year (see figure 1). The country's industrial production declined for the second consecutive month as external demand weakened. In most East Asian economies, inflationary pressures have started to ease.

South Asia: India and Bangladesh tighten monetary policy further

Unlike other Asian central banks, the Reserve Bank of India and the Bangladesh Bank continued to tighten monetary policy in September. India's central bank lifted its benchmark rate for the twelfth time since March 2010, as it continues to focus on controlling inflation despite a weakening of domestic demand. Inflation has remained stubbornly high and well above the central bank's short-term comfort range of 4-6 per cent.

Economic growth in Sri Lanka accelerated to 8.2 per cent (year on year) in the second quarter of 2011 as buoyant conditions in the industrial and service sector offset weak agricultural growth. The textile and leather industry grew by 12.9 per cent in real terms on the back of strong external demand. During the first six months of 2011, total export earnings in dollars were 35.2 per cent higher than a year ago. Import spending was up by 46.5 per cent owing to increased domestic demand and high prices of commodities and intermediate goods. The resulting increase in the trade deficit has been partly offset by higher remittance inflows.

In Pakistan, heavy monsoon rains caused severe flooding for the second consecutive year, destroying nearly 1 million homes, damaging agricultural crops and affecting the lives of an estimated 5.4 million people.

Western Asia: energy consumption rising in the Gulf countries

Economic activity in the region continues to be dependent on politics and oil prices. Ongoing political unrest in the Syrian Arab Republic and Yemen has shattered any prospect of positive growth in 2011. Taking advantage of high energy prices, Bahrain and the United Arab Emirates have stepped up their production over the last quarter and Saudi Arabia's crude supply reached a record high of 9.8 million barrels per day (mbd) last month, well above the 8.05 mbd OPEC quota. As the already high domestic energy demand will soon consume 40 per cent of oil production, Saudi Arabia decided to build a first nuclear plant by 2020 in order to preserve its exports revenues. Kuwait, Egypt, Qatar, the United Arab Emirates and Jordan have similar projects.

In Turkey, economic growth accelerated to 10.2 per cent during the first half of 2011, but is expected to slow down as the unorthodox policy mix of the Turkish central bank proves to be efficient. By capping growth of the credit supply rather than raising interest rates to avoid overheating, the central bank managed to stabilize inflation while discouraging carry-trade, thus weakening the lira and reducing the current-account deficit.

Latin America and the Caribbean: robust growth threatened by global financial turmoil

The region continues to show robust economic growth. In the first half of the year, GDP in South America grew between 5.5 and 6.5 per cent, on average, year on year. Economic activity in Central America and the Caribbean is held back by weak growth in the United States. In Mexico, weaker external demand was offset by the strong growth of domestic demand.

Short-term capital moved out of financial markets in the region during August and September. The Brazilian Government intervened to support the real, which nonetheless depreciated by 13 per cent against the United States dollar in one month. The value of the Argentinean peso remained stable, however. Stock markets witnessed unusually wide fluctuations, but on balance equity prices declined by more than 22 per cent year on year in Brazil and Chile. Sudden price drops in commodity markets, especially of industrial metals, affected Argentina and Peru in particular. Amidst the increasing economic uncertainty, central banks in Brazil and Colombia have interrupted their policy of increasing the policy interest rate, while the Chilean Government announced it would deploy $18 billion in offshore savings should private funding dry up because of further capital outflows.

LDCs: worsening power supply problems in Burundi

Burundi is facing a worsening power supply shortage as drought conditions have led to diminished power output from the main hydroelectric power station. Only an estimated 3 per cent of the population has access to electricity. The authorities increased electricity prices by about 120 per cent in an effort to attract more financing for the urgently needed expansion of capacity.