

Monthly Briefing

World Economic Situation and Prospects

No. 25

UN/DESA

12 November 2010

Summary

- Surges in private capital flows pose challenges to emerging economies and enhance tensions over currencies
- European countries go deeper into fiscal austerity
- Industrial production growth is slowing worldwide
- Heavy floods in Central and West Africa threaten food security

Global issues

Dealing with rapid capital inflows to emerging economies

Capital inflows have been returning to emerging economies since the second half of 2009, after a sharp decline during the height of the global financial crisis. Portfolio investment inflows have been particularly strong. Portfolio inflows to emerging economies are estimated to be about \$150 billion in 2009 and \$190 billion in 2010, well above peak levels registered before the crisis in 2007. The strong new inflows of mostly short-term portfolio investment are causing concerns in emerging economies fearing the inflation of new asset bubbles and the loss of export competitiveness as their currencies are appreciating (see figure 1). Several emerging economies in Asia and Latin America have responded by intervening in foreign exchange markets in an attempt to curb the upward pressure on their exchange rates. In addition, some countries have also imposed controls on short-term capital inflows to stem the surge as well as the risk of sudden reversals. Brazil, for instance, tripled the tax rate on foreign purchases of its domestic debt, while Thailand announced a 15 per cent withholding tax for such purchases.

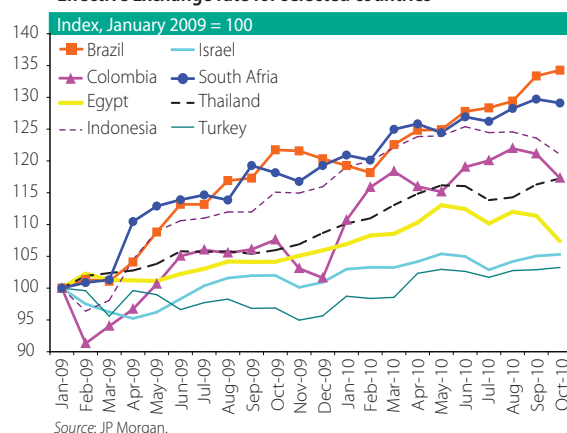
More multilateral policy cooperation is needed

Leaders of the G20 recognized during their most recent meeting in November that uneven growth and widening imbalances were fuelling the temptation to diverge from global solutions into uncoordinated actions. They warned that uncoordinated policy actions would only lead to worse outcomes for all. The meeting concluded that advanced economies, especially those issuing reserve currencies, should be vigilant of disorderly movements in exchange rates. The leaders agreed to enhance exchange rate flexibility to reflect underlying economic fundamentals, and refraining from competitive devaluation of currencies. The G20 still is to develop the precise guidelines to help identify large trade imbalances and the preventive and corrective actions needed to adjust these in support of balanced and sustainable global growth.

Slowdown in global industrial production

Growth of industrial production, as key indicator for global economy, decelerated visibly during the third quarter of 2010 (see figure 2). The slowdown is notable in both developed and emerging economies, as sign that global economic recovery will weaken further in the remainder of the year.

Figure 1:
Effective Exchange rate for selected countries



Developed economies

United States of America and Canada: another round of monetary easing

First estimates show that GDP of the United States increased by 2 per cent in the third quarter of 2010 (annualized quarter-on-quarter rate). This is a modest improvement compared with the 1.7 per cent growth during the second quarter. Growth of private consumption has now accelerated for four quarters in a row bringing household consumption back to its pre-crisis level. The inventory re-stocking and investment in equipment and software continued to contribute to growth though with less strength than in previous quarters. During the third quarter, import demand increased by 17.4 per cent, but this is only half of the rate of growth recorded in the second quarter. As a result, net exports continued to drain GDP growth in the United States though not as much as earlier in the year.

Early November, the Fed decided to purchase \$600 billion of longer-term Treasury securities at a rate of about \$75 billion per month. The measure is intended to stimulate aggregate demand as it is expected to lower interest rates and push up equity prices. There are doubts about the effectiveness of the further quantitative easing as interest rates are already low and there is ample liquidity in financial markets. It has also raised concerns in Europe, Japan and emerging markets as the measure is expected undermine their export competitiveness by weakening the dollar. There are also fears that the measure will further fan capital flows to emerging markets as investors seek higher yields.

In Canada, GDP grew by 0.3 per cent in August, after declining by 0.1 per cent in July from the previous month. This is still a relatively weak economic recovery compared with growth recorded in the beginning of 2010. In October, the Bank of Canada decided to introduce a pause in monetary tightening, in response to slower-than-expected growth and lower inflation.

Europe: more fiscal austerity

Fiscal worries permeate the region following the recession, with most economies either enacting or planning significant fiscal consolidation. In the United Kingdom, the fiscal deficit rose from less than 3 per cent of GDP in 2006 and 2007 to more than 11 per cent in 2009. The public debt ratio increased to near 70 per cent of GDP. The new British government laid out an emergency budget in June which is to be implemented in the period up to the 2014/15 fiscal year. The plan entails drastic fiscal adjustment with the aim to fully eliminate the structural budget deficit and reduce the debt burden. Most of the belt tightening is to take the form of spending cuts (77 per cent of the fiscal savings). Tax increases will make up the rest. Details of the 81 billion pounds in expenditure reductions were revealed on October 20. Most of the cuts will hurt general public services and defence. The National Health Service is to be spared, however, as is the foreign aid budget which will be allowed to increase with the aim of delivering on the commitment to reach the target of 0.7 per cent of gross national income by 2013.

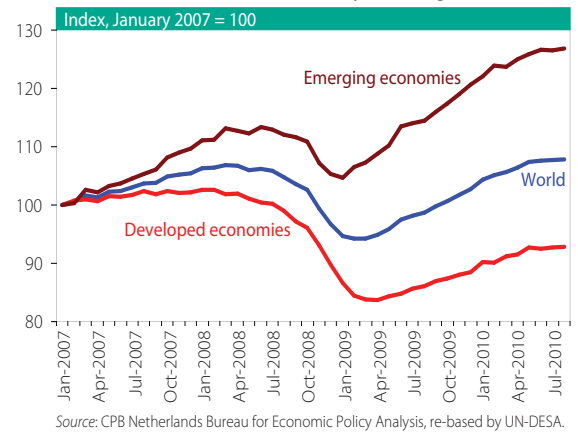
Among the new EU members, Lithuania's economy expanded by 0.6 per cent in the third quarter, down from 1.1 per cent growth posted in the second quarter of 2010. Growth was mainly driven by exports with linkages to industry and services. In contrast, construction and retail trade sectors continued in decline. The economic recovery in most other countries in Central and Eastern Europe also continues to be driven by net exports. The exception is Poland, where GDP growth rests on solid domestic demand expansion, giving a further boost to consumer and business confidence.

Concern over rising budget deficits has also pushed Governments in the Central and Eastern European countries towards fiscal austerity. Slovakia is planning for a massive fiscal adjustment, aiming to reduce its budget deficit from the estimated 7.8 – 8.0 per cent at present to 4.9 per cent of GDP by the end of 2011. The fiscal cuts are highly unpopular and have met severe protests from trade unions in Romania in October.

Developed Asia and the Pacific: new economic woes for in Japan?

The latest survey data shows the possibility of a sharp contraction in economic activity in Japan in the final quarter of 2010. This would be a severe setback after the relatively strong gains, by Japanese standards, in the previous three quarters. Business confidence among manufacturing firms plunged in October, according to the Reuters-Tankan survey for October. The business sentiment index in eight out of the nine branches of manufacturing industry indicates double-digit declines. The sentiment index for other sectors of the Japanese economy also slipped further into negative territory. The survey also indicates that consumers are becoming increasingly cautious and are withholding spending. The appreciation of the yen appreciation is part of the problem as the expected adverse impact on exports will affect the economy at large. The additional quantitative easing in the United States is causing further concerns. Against this backdrop, the Bank of Japan is expected to engage in deeper monetary expansion.

Figure 2:
World Industrial Production, January 2007-August 2010



Economic trends in Australia continue to be at odds with what is happening in other developed countries. While unemployment continues to be high more or less everywhere else, jobs growth in Australia during 2010 has accelerated to double the pace of the past decade. Nonetheless, since early 2009, the rate of unemployment remained unchanged at more than 5 per cent, because fast jobs growth was matched by substantial increases in labour force participation rates. Robust economic conditions have motivated more people to look for work. Many first-time job seekers managed to find work.

Economies in transition

Countries of the CIS: inflation is on the rise

Most CIS countries saw surges in domestic price levels. Food prices in Ukraine increased as agricultural production declined further during July owing to bad weather conditions. The 4.4 per cent rise in food prices during September was the main cause behind the first increase in the overall consumer price index since June 2008. Also in Kazakhstan, the overall rate of inflation increased for the first time in September after having declined since February. Also here, higher food prices were the main factor. A severe drought caused prices of buckwheat to surge by as much as 49 per cent. In response, the Government of Kazakhstan announced a six-month ban on exports of several agricultural products (including oilseeds and buckwheat) commencing in October over worries about domestic food security. Inflation also accelerated in the Russian Federation during September as the hike in food prices caused by the drought and wildfires in July and August spilled over to other costs of living with a lag.

South-Eastern Europe: Monetary tightening in Serbia

The economy of the former Yugoslav Republic of Macedonia expanded by 0.4 per cent and investment by over 11 per cent in the second quarter of 2010. Investment demand was up from a very low initial level. Praising the country's sound fiscal policy and for having achieved one of the lowest budget deficits in Europe, the IMF offered a precautionary credit line of 400 million euro in the form of budget support, which should help cover the high cost of external debt servicing. The World Bank may provide another 200 million euro in long-term financing.

Serbia's agricultural production fell in July and August, causing domestic food prices to rise. Consumer prices were pushed up further by the rise in world market prices of food, currency depreciation, and expectations of domestic demand recovery. Anticipating that inflation will exceed the upper bound of 8.3 per cent of the inflation target zone in October, the National Bank of Serbia responded by increasing its policy interest rate by another 50 basis points. The IMF gave its consent to the Government of Serbia to deviate from the terms of the country's stand-by agreement and lift the freeze on public wages and pensions in January 2011. The policy change would support domestic demand growth, but at the same time could fan inflation.

Developing economies

Africa: diverging economic performance

Labour strikes compounded by weak export demand caused by the economic slowdown in developed economies have affected manufacturing production in South Africa. In August, industrial output growth slowed to 5.3 per cent, down from 7.2 per cent in July. Disinflation continued. The consumer price index increased by 3.5 per cent in August, down from 3.7 per cent in July. Lacklustre domestic demand and the appreciation of the South African rand explain the moderation of inflation. In September, the country's level of international reserves got a boost from short-term capital inflows and interventions by the South African Reserve Bank in the currency markets, buying foreign exchange in order to stave off a further appreciation of the rand. These events have fuelled expectations of further interest rate cuts in the near future.

Nigeria's economy, in contrast, grew by 7.5 per cent in the first half of 2010, owing in particular to a strong performance of non-oil sectors which expanded on average by 8.3 per cent. This strong showing in Africa's most populous country can be attributed to three key factors. The first is the strong growth of agriculture. The sector remains the mainstay of the economy and contributes 40 per cent of GDP. Agricultural output has increased at a sustained rate of between 5 per cent and 6 per cent for several quarters in a row now. Second is the double-digit growth of commerce, Nigeria's second-largest sector. The third factor is the fast-speed expansion of the telecommunication sector. The sector expanded by more than 30 per cent in the first semester of the year.

East Asia: slowing growth of manufacturing output and exports

Growth in East Asia decelerated in the third quarter of 2010. Both manufacturing output and exports expanded at a visibly slower pace. GDP of the Republic of Korea increased by 4.5 per cent and that of Singapore by 10.3 per cent. While still robust, these rates are significantly lower than those recorded during the first half of the year. In both countries, export growth decelerated sharply as a result of the cooling of demand from developed countries and China. Growth in China moderated to 9.6 per cent in the third

quarter - the slowest pace in a year - owing to weaker demand impulses from the fiscal stimulus package and to monetary tightening measures aiming to curb credit growth and house price inflation. The People's Bank of China raised interest rates for the first time in nearly three years after consumer price inflation accelerated to a 23-month high of 3.6 per cent in September. Food prices increased by 8 per cent. The authorities increased the one-year lending rate from 5.31 per cent to 5.56 per cent and the one-year deposit rate from 2.25 per cent to 2.50 per cent. The decision is part of the Government's strategy to gradually unwind the extraordinary measures put in place during the financial crisis.

South Asia: inflation continues to be a major concern for policymakers

In India, monetary tightening only has had limited success in reducing inflationary pressures so far. The benchmark wholesale-price index rose by 8.6 per cent in September, slightly up from the level in August. Food prices increased by 15.7 per cent. The Reserve Bank of India will remain focused on controlling inflation and inflationary expectations in the coming months. In Pakistan, inflation has risen sharply as the worst flooding in the country's history has seriously affected food production in a large part of the country, sharply driving up food prices. In September 2010, the average consumer price level was up by 15.7 per cent from a year ago, but prices of perishable food had increased by 53.9 per cent. The State Bank of Pakistan increased the policy interest rate by 50 basis points to 13.5 per cent. The authorities pointed out that the impact of continued inflation was substantial and that continued heavy government borrowing could put economic growth and stability at risk, including by crowding out of private investment. In Sri Lanka, inflation has also picked up, rising from 5.8 per cent in September to 6.6 per cent in October.

Western Asia: capital inflows are driving currency appreciation

Following the broader global trend, currencies in the region have appreciated. The value of the Turkish lira increased by almost 13.0 per cent against the United States dollar over the past four months as a consequence of a sharp increase in inflows of speculative capital and despite currency market interventions by the central bank. Likewise, the Israeli shekel has appreciated by more than 9.0 per cent against the dollar since July, underpinned by solid growth and higher policy interest rates. In Saudi Arabia, consumer prices increased by 5.9 per cent in September, driven in particular by higher food prices. By contrast, Qatar remained in a deflationary cycle: prices declined by 2.1 per cent in August and were pushed down in particular by a decline in housing rents. In Iraq, authorities increased their official estimate of oil reserves almost 28.0 per cent; that is, from 112 billion to 143 billion barrels.

Latin America: several countries try to curb currency appreciation

Short-term private capital flows to Latin America also continued to increase. Along with the weakening dollar, many countries are facing currency appreciation as a result. The Mexican peso gained 7.3 per cent against the U.S. dollar between August and mid-October of 2010. Unlike Brazil and some other countries in the region, Mexican authorities so far have refrained from imposing capital controls or intervening in currency markets. Brazil, in contrast, increased the levy charged on foreign purchases of domestic securities twice during October. The tax is now 6 percent, up from 2 percent, and aims to curb further appreciation of the real as much as that it is meant to stem capital flow volatility. The value of the Brazilian real has already increased by 36 per cent against the United States dollar since the early 2009. It has undermined export competitiveness and increased the current account deficit. The Colombian peso appreciated by 12 per cent so far this year. Colombia's central bank managed to curb the after it started to intervene in the foreign exchange market from September 15.

Economic performance in the Dominican Republic has been strong, in contrast with the situation in much of the rest of the Caribbean. The economy expanded by 7.6 per cent during the first three quarters of 2010, supported by a strong recovery of activity in the tourism sector.

Least developed countries: heavy floods in Central and West Africa threaten food security

Exceptionally severe seasonal floods have been hitting Central and West Africa for several months, causing an outbreak of cholera. Benin has been hardest hit and 55 out of the 77 country's districts have been affected. The floods have wiped out 40 per cent of the country's production of rice, maize, millet and other staples. According to estimates of the Government and the United Nations about 9 per cent of Benin's population of eight million people was affected, with 50,000 people in urgent need of food. Also Burkina Faso, Chad, Gambia, Mauritania, and Niger have been affected by floods.

Bangladesh's export earnings rebounded in recent months owing to strong growth in garment exports. In the third quarter of 2010, total export earnings were 30 per cent higher than a year ago. Increases in market shares are behind the stronger-than-expected recovery of garment exports. The European Union shifted orders to Bangladesh after Sri Lanka temporarily lost its preferential duty concessions in July 2010. Bangladesh also captured market shares from Pakistan, which lost orders because of the extended floods, as well as from China, which lost competitive edge following a rise in labour costs. ■

