

Monthly Briefing

World Economic Situation and Prospects

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Summary

- In addition to the massive human toll and environmental damage resulting from Japan's triple disaster (earthquake, tsunami and nuclear catastrophe), ensuing ripple effects are being felt on global trade, finance and industrial growth.
- Unrest in North Africa and the Middle East continues to contribute to a further surge in global energy and commodity prices.
- Inflationary pressures resulting from rising food and energy prices have led many Governments to tighten monetary policies.

Global issues

The earthquake in Japan is shaking global markets

Japan's triple disasters (earthquake, tsunami and nuclear catastrophe) are causing ripple effects for global trade, finance and industrial growth. Japan accounts for 9 per cent of world gross product and 4.5 per cent of world total trade, with 60 per cent of its imports coming from developing countries. Disruptions to economic activity in Japan will be felt by many economies (especially those in Asia), in the coming months, particularly through the global production chains of certain industries such as semiconductors and automobiles. The consequences of the damage to nuclear power plants are still difficult to foresee, but several countries have already implemented restrictions on food imports from Japan and intensified the debate on the safety of nuclear energy.

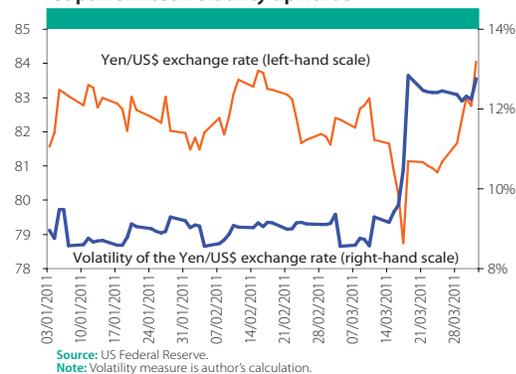
The yen appreciated strongly shortly after the earthquake as many Japanese companies repatriated capital invested abroad. A joint intervention of the G-7 reversed this initial impact, but Japan's currency remains highly volatile (see figure 1). Japan is a major exporter of capital, holding a large proportion of United States government bonds. If Japan felt the need to sell some of these holdings to finance the post-disaster reconstruction, interest rates in the United States could be pushed upwards.

Continued unrest in the Middle East and North Africa is keeping upward pressure on oil prices

Political unrest in the Middle East and North Africa continues to influence global markets. The massive protests led to the toppling of the Governments of Tunisia and Egypt. A civil war has broken out in the Libyan Arab Jamahiriya, while authorities in other Arab countries have responded to protests by violent crackdowns. Despite the primacy of political and country-specific factors, social discontent from food inflation, unemployment and corruption seem to have been the catalysts for the unrest in most cases. Governments in several countries have increased social support measures to ward off further tension.

Interruptions of oil production in the Libyan Arab Jamahiriya have pushed up global oil prices. They went above \$120 per barrel (pb) as military action escalated. Although the drop in Libyan oil output (2 per cent of worldwide production) can be offset by using Saudi Arabia's spare capacity, a prolonged conflict in Libya and continued unrest elsewhere in the region will likely keep upward pressure on prices for some time. Prospects of a continued rise in energy prices may influence the scope of policies in many countries where imported inflation might be significant (figure 2).

Figure 1:
Exchange rate appreciation in
Japan shifted volatility upwards



Developed economies

Falling unemployment and a federal government shutdown averted in the United States

The unemployment rate in the United States declined to 8.8 per cent in March 2011, down from 8.9 per cent in the previous month. Labour market conditions continue to improve at a slow pace, lagging output recovery. Since the beginning of 2010, less than 400,000 civilian jobs have been created on average per quarter. This makes up only very gradually for the jobs lost during the crisis, when about 1 million persons became unemployed each quarter. It is still insufficient to accommodate the natural growth of the working age population (500,000 persons per quarter).

An agreement on the budget cut for the current fiscal year at the eleventh hour has averted a shutdown of the Federal Government and any negative impact this might have had on the economy and financial markets. However, it is anticipated that the legally established public debt limit will soon be reached, keeping the political process focused on further budget negotiations.

Devastating earthquake in Japan

A massive earthquake that struck Japan on 11 March was followed by two accompanying disasters: a tsunami and a crisis of nuclear contamination. An estimated 27,000 people lost their lives or are still missing. A tentative official estimate values the damage to buildings and infrastructure at 25 trillion yen (about \$300 billion), equivalent to about 5 per cent of Japan's annual gross domestic product (GDP).

The colossal disruptions to Japan's economic activity will likely push the country into another contraction in the second quarter of 2011. However, reconstruction efforts may be expected to induce a gradual recovery in the second half of the year.

How the Japanese Government will finance the reconstruction works is yet to be determined. Financing needs are estimated at 8-9 trillion yen per annum over the next three years. Additional public borrowing would push Japan's government debt to astronomical heights, given that it already stands at more than 200 per cent of GDP.

The situation at the Fukushima nuclear plant remains uncertain. Radiation contamination has spread to tap water, agricultural products and sea water in the neighbouring area.

Rebounding industrial activity in Western Europe, but mixed trends for unemployment and inflation

The economic recovery remains broadly on track in Western Europe. Industrial production increased in January for the fourth consecutive month, but still remains 11 per cent below its previous peak. Some sectors saw a significant rebound in activity in January after the harsh December weather. Construction increased by 1.8 per cent in the euro area, having fallen 2.0 per cent in December. Germany saw a particularly strong rebound of 36.3 per cent in January after a fall of 24.2 per cent in December; France also experienced a significant recovery. Meanwhile, the construction sector continued to decline in the United Kingdom, but at a slower pace than in December. Retail trade in the region also rebounded after a marked fall in December.

The rate of unemployment in the euro area dropped slightly in February to 9.9 per cent, down from about 10.0 per cent. The decline was mainly on account of lower unemployment in Germany. Joblessness remained very high in Spain, Portugal, Ireland and Greece (data for Ireland and Greece are for December 2010).

Headline inflation accelerated to 2.6 per cent in the euro area in March, continuing its gradual increase from a low of 0.9 per cent in February 2010. Core inflation remains close to 1 per cent, but survey data indicate that inflation expectations are increasing.

New EU members face fiscal challenges

Estonia is leading the recovery in the Baltic region. It recorded a 3.1 per cent GDP growth rate in 2010, owing in part to a strong performance of 6.7 per cent growth in the fourth quarter. The recovery is driven by manufacturing and energy production. GDP expanded by 1.2 per cent in Hungary in 2010 and by 4 per cent in Slovakia. The economy in Poland maintained its strength in the first quarter of 2011, growing at an estimated 4 per cent. Latvia's economy continues to face headwinds. Industrial output declined by 2.5 per cent in January from the previous month.

Governments continue to face fiscal challenges. In Bulgaria, the Government proposed a constitutional amendment in February—the "Financial Stability Pact"—guaranteeing stable State finances. The Hungarian Government announced a budget reduction plan in March to bring down the deficit below 3 per cent of GDP in the medium term.

Consumer prices were up by 5.2 per cent in February (year on year) in Bulgaria, by 4 per cent in Latvia and by 3.5 per cent in Slovakia; weak consumer demand should contain inflation in the course of the year, however. To mitigate the social impact of rising food prices, the Government of Slovakia is planning to distribute flour and pasta to low-income families.

Economies in transition

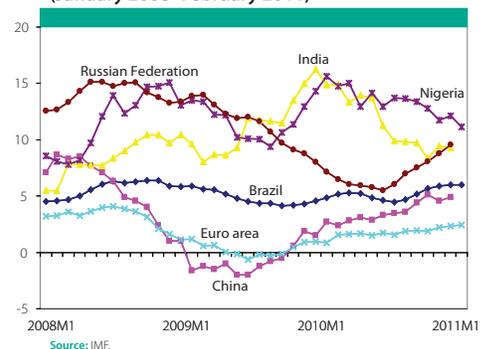
Inflationary risks persist in the CIS

In Kazakhstan, inflation accelerated to 8.8 per cent in February, its highest rate since April 2009. This prompted an increase of 50 basis points in the refinancing rate in March, the first increase since September 2009. In contrast, inflation in the Russian Federation declined somewhat, to 9.5 per cent, as a result in part of the appreciation of the rouble and the related decline in the domestic cost of imports. The central bank responded to this strengthening by widening the rouble's trading band in March. Even so, Russia's foreign reserves further increased by 5 per cent. For the first time since October 2008, reserve holdings now exceed \$500 billion.

Inflation also decreased slightly in Ukraine in February and was one of the reasons for raising grain export quotas.

The direct impact of the recent disaster in Japan on the CIS is likely to be limited. However, if longer-term consequences develop for the nuclear industry around the world, they could benefit fuel-exporting countries in the region.

Figure 2:
Monthly inflation in selected countries
(January 2008- February 2011)



South-Eastern European countries face hurdles on employment and food price inflation

Output in South-Eastern Europe remains volatile. In Croatia, industrial production declined by 6.7 per cent in December, and the economy contracted by 1.4 per cent in 2010. In Bosnia and Herzegovina, GDP grew by 0.9 per cent in 2010. Its underlying fragility is being seriously affected by the conflict in the Libyan Arab Jamahiriya, as operations of construction and civil engineering companies from Bosnia and Herzegovina in that country have been suspended. Serbia's economy, in contrast, expanded by 1.8 per cent in 2010, and year-on-year industrial growth accelerated to 5.8 per cent in February.

The region's employment recovery is still lagging, however. The rate of registered unemployment increased to 19.6 per cent in Croatia in January. The labour force survey puts the rate lower, at 12.6 per cent, but equally showing an increase.

In Serbia, rising food and fuel prices were mitigated by an appreciation of the currency in early 2011. Nonetheless, inflation edged up to 12.6 per cent in February, leading the central bank to increase its policy rate further in March. The Serbian Government also introduced a temporary ban on wheat and flour exports. This, in turn, could affect food supply in Montenegro, which relies heavily on wheat imports from Serbia. Authorities in Bosnia and Herzegovina decided to use commodity reserves in order to contain food prices.

Developing economies

Africa: military conflicts intensifying

North Africa remained in the grips of political uncertainty, especially with the further escalation of the armed conflict in the Libyan Arab Jamahiriya. At the same time, the political crisis in Côte d'Ivoire is evolving into a military conflict, displacing many people within the country and choking off economic activity, especially in core sectors such as cocoa farming and banking. A steep fall in cocoa prices has reportedly led farmers to abandon their land, with potentially severe social and economic consequences for local communities.

Several countries further tightened their monetary policies. Nigeria increased its interest rate to 7.5 per cent, with authorities citing higher inflation risks due to expansionary fiscal policy. Kenya increased interest rates by 25 basis points, to 6 per cent, in response to inflationary pressures from seasonal food shortages and a weaker exchange rate. Meanwhile, in Botswana, higher oil prices pushed consumer price inflation to 8.5 per cent in February, up from 7.9 per cent in the previous month. In Egypt, urban consumer price inflation stagnated at 10.7 per cent in February, compared to 10.8 per cent in the previous month, despite the fact that urban food and beverage prices, which constitute a major share of the urban inflation rate, increased by 18.2 per cent in February.

Disruptions to trade and manufacturing expected in East Asia

Economies in East Asia are likely to face disruptions in trade flows and manufacturing production due to the natural disaster that struck Japan. Japan is both a major export destination for the East Asian countries and an important supplier of parts and components to the region's manufacturing industries. Thus far, disruptions to production and transportation in Japan have led to supply shortages in only a few sectors and have pushed up prices of electronic components such as memory chips and auto parts. The magnitude of the impact on the region's economies will depend mainly on how long the disruptions will last and how quickly companies will run out of inventories. East Asia may also see a decline in foreign direct investment (FDI) flows from Japan in 2011 as the country focuses on domestic reconstruction.

Despite a potential economic slowdown in the months ahead, central banks across East Asia have continued to normalize monetary conditions in response to persistent inflationary pressures. The Philippine Central Bank has become the last major central bank in the region to tighten monetary policy in the current cycle, raising each of its main policy rates by 25 basis points. China, Taiwan Province of China, the Republic of Korea and Thailand also increased their interest rates in March.

India's growth momentum weakens despite a strong export performance

India's growth momentum has weakened in recent months as tighter monetary policy, combined with uncertainty about energy and commodity prices, has slowed investment activity and industrial output. In January 2011, industrial output increased only 3.7 per cent year on year, while the export sector, by contrast, continued to perform strongly, registering year-on-year growth of nearly 50 per cent in February 2011. Despite a less buoyant growth outlook, the Reserve Bank of India is keeping its focus on controlling inflation, which has remained stubbornly high. In March, interest rates were raised for the eighth time in a year after wholesale price inflation rose slightly to 8.3 per cent. In an attempt to boost FDI, India's Government has relaxed some restrictions, especially in the agrarian sector.

Sri Lanka continues to reap the benefits of the end to its civil war in 2009. In the fourth quarter of 2010, GDP growth accelerated to 8.6 per cent, lifting full-year growth to a three-decade high of 8.0 per cent. Notably, all major economic sectors—agriculture, industry and services—registered strong growth of at least 7 per cent. On the expenditure side, private consumption and investment remain the main drivers of the expansion.

Economic consequences of the Arab social and political upheavals

Following the political unrest in Western Asia, most Governments in the region have promised to implement economic support measures to compensate income losses caused by unemployment and higher food and energy prices. Increased expenses may be fiscally sustainable for oil-exporting economies like Saudi Arabia, where \$35 billion worth of additional social spending was announced. However in Jordan, for instance, the announced measures will boost the fiscal deficit from 6 to 10 per cent of GDP in 2011, making the country more dependent on foreign development assistance and international financial markets. Beyond issues of sustainability for countries with limited fiscal space, the open question for all of these countries is whether short-term social spending increases will be sufficient to resolve any of the structural problems that contributed to the outburst of political and social unrest, such as capital flight, minimal investment efforts towards economic diversification, persistent high unemployment and income inequality.

The Central Bank of Turkey moving to contain inflation

In an attempt to curb inflation without affecting interest rates and the Turkish lira, the Central Bank has raised the reserve requirement ratio on deposits to bring the yearly loan growth rate from 40 per cent down to a targeted 25 per cent.

Inflationary risks and lower growth prospects in Latin America and the Caribbean

The region is facing growth moderation in 2011 owing to the relatively slow recovery in developed economies and the heightened risks of inflation triggered by rising import prices and increased capital inflows. Higher fuel prices are driving up consumer price inflation in Chile, which is now projected to reach 3.8 per cent in 2011, up from 3 per cent in 2010. For Mexico, Colombia and Brazil, growth prospects remain robust, and short-term inflationary risks are mainly related to a possible overheating of their economies. In Brazil, the consumer price index hit 6.1 per cent in February, the highest level since the 2008 food price crisis.

Brazil, Chile, Peru and Colombia tightened monetary policies in response to inflationary pressures. Chile's Central Bank increased its policy interest rate by 25 basis points, to 3.5 per cent, on 17 February. In Brazil, the lending rate is projected to reach 37 per cent during 2011, which is lower than the rate of 38.7 per cent seen in 2010.

There is concern across the region that social tensions may emerge from attempts to curb inflationary pressures by cutting government spending at the expense of social programmes. Nicaragua and Bolivia are considering cutting subsidies to the poor in order to reduce fiscal pressures.

Least developed countries: higher food and energy prices pushing up inflation

Inflation remains a major concern in a number of least developed countries. In the United Republic of Tanzania, consumer price inflation increased to 7.5 per cent in February, from 6.4 per cent in the previous month, driven by higher food and fuel prices. In Ethiopia, despite a slight fall from the previous month, inflation reached 16.5 per cent in February on the back of higher food prices. Meanwhile, the central bank of Uganda intervened in the currency market by selling foreign currency in order to support the shilling, which has been on a downward trend owing to increased demand for foreign currency from importers. In Bangladesh, inflation accelerated further in January, reaching 9.0 per cent. The increase was primarily driven by food prices, which rose by 11.9 per cent, the highest since September 2008. ■

