Summary

- Rising oil price complicates global recovery
- Agreement made for second rescue package to Greece
- Growth slowed in India and Brazil in 2011

Global issues

**Oil price rise complicates global economic recovery**

During most of February, oil traded above $120 per barrel, reaching levels not seen since May 2011. The increase was triggered in part by speculation about possible military action against the Iranian nuclear programme and the consequences of a scheduled ban on oil imports from Iran to be imposed by the European Union. Stalled oil exports from the Syrian Arab Republic and South Sudan have limited supply by several hundred thousand barrels a day, putting further upward pressure on prices.

Oil prices reached record levels in Europe. Measured in euros and British pounds, the price of Brent crude surpassed its peak of 2008 and is now 41 per cent above its level four years ago (figure 1). Owing to a strong yen, the price of oil in Japan is still 7 per cent below its January 2008 level. In the United States, West Texas Intermediate (WTI) crude is still traded at a discount of about $20 per barrel compared to Brent due to insufficient storage capacity in Cushing, Oklahoma. Yet, as two thirds of oil is imported, American consumers are also affected by the latest price spike. High oil prices could affect economic growth and inflation worldwide, but oil-importing developing countries with high fossil fuel-based energy intensity in production are particularly exposed to that risk.

**Agreement on second rescue package for Greece**

In late February, the euro area member States agreed on the second rescue package for Greece, averting the risk of a possible default on debt repayments, with about €14.5 billion due on 20 March. The package includes a refinancing provision of up to €130 billion until 2014, which is conditioned on Greece’s efforts to both turn its primary fiscal balance into surplus by 2013 as well as introduce bold reforms in labour and product markets and privatize several government-controlled activities. In addition, the Greek Government reached an agreement with private creditors to restructure its debt by swapping €200 billion of outstanding debt for new bonds. As a result, Greece’s public debt is expected to decline from 160 per cent to 120.5 per cent of GDP by 2020. Nonetheless, Standard and Poor’s classified Greece as a country in selective default as it downgraded some Greek debt to grade “D” (that is, in default).

Recognizing that their economies are slipping into recession, EU leaders further committed to undertake a series of structural reforms to stimulate economic growth. Yet, the fragile state of global growth means that the region could be vulnerable to another hit from the euro area. The latest forecast from the European Commission, for example, suggests that the euro area’s GDP growth will barely touch 1 per cent in 2012 and 2013. As it is, the Commission expects the euro area’s unemployment level to be 10.7 per cent next year, compared to 9.9 per cent in 2011. If the euro area did fall into recession, the prospects for global growth could deteriorate rapidly.

**Figure 1: Brent and WTI oil price since 2008 (rebased)**

Source: U.S. Energy Information Administration and JPM.
Note: Index: January 2008 = 100
growth. Meanwhile, the European Central Bank conducted a second large-scale long-term refinancing operation (LTRO). At the end of February, some 800 financial institutions took €529.5 billion in three-year loans. In the first round of December 2011, 523 institutions borrowed €489 billion.

**Developed economies**

**North America: signs of slow improvement in the United States economy, but headwinds remain**

After five years in decline, the housing sector in the United States has showed some signs of bottoming out. Both new and existing home sales have been trending upward in the last half of 2011, supported by modest improvements in job growth and consumer confidence, as well as lower mortgage rates. Existing home sales have increased by 27 per cent (seasonally adjusted annual rate) over the past six months, but the levels are still very low compared with the long-term average. House prices remained weak. While the Federal Housing Finance Authority (FHFA) house price index rose 1.4 per cent over the past six months, the Case-Shiller 20-city index continued to decline and in early March it was down to the pre-boom level of 2003.

However, some high-frequency indicators weakened recently. Real consumer spending stagnated, capital goods shipments declined, and private non-residential construction also dropped. The economic prospects are also threatened by the effects of higher oil prices. Meanwhile, the fiscal stimuli enacted in the aftermath of the financial crisis have faded. Tighter fiscal policy has become a drag on economic growth.

**Developed Asia and the Pacific: Japan’s economy shrinks 0.7 per cent in the fourth quarter**

According to the data released in February, the Japanese economy shrank from the previous quarter at an annualized rate of 0.7 per cent over the fourth quarter of 2011. The sharp decline of exports (down by an annualized 12 per cent from the previous quarter) and a still noticeable increase in imports have compensated for the tepid expansion in domestic demand. Exports suffered from the flooding in Thailand (an important node within the supply-chain for export production), the strong Japanese yen, and the weak demand from Europe. For 2011 as a whole, GDP was 0.8 per cent lower than 2010 and still 3.1 per cent lower than the pre-crisis peak.

In February, the Bank of Japan also decided to increase the scale of its Asset Purchase Program from ¥55 trillion to ¥65 trillion in order to purchase more government bonds. The Government committed to price stability for the medium to long term, setting an inflation target of 1 per cent. In Japan’s context, this implies that the Government aims to overcome deflation and resume growth. Given that Japan has suffered from deflation since 1999, a senior officer of Bank of Japan commented that “in order to raise prices appropriately, it is indispensable to strengthen Japan’s growth potential and growth expectations, and deflation cannot be overcome without such efforts.”

**Western Europe: sharp drop in output at the end of 2011; some signs of stabilization in early 2012**

GDP fell by 0.3 per cent in the euro area in the fourth quarter of 2011, contracting in all of the major regional economies except France. Both Italy and the Netherlands experienced a second consecutive quarter of negative growth and thus, technically speaking, are in recession. Among the debt crisis-affected countries, Greece and Portugal continued to be in deep recession, while Spain is very close. (Ireland has yet to release its fourth quarter figures, but saw a very sharp drop in output in the third quarter.)

Indicators of economic sentiment have been steady in the first two months of the year, which might signal the downturn is bottoming out. The European Commission’s Economic Sentiment Index rose for the second straight month in February, and the majority of the regional economies saw improvement or stability in the index. For most economies, however, the level of sentiment remains consistent with weak activity; the PMI composite output index hovered near the level that demarks expansion from contraction in the first two months of the year. Divergences within the region remain stark. Germany is the only country in the region where sentiment is above its long-term average.

**New EU members: growth momentum still present in several countries**

Poland reported an acceleration of economic growth to 4.3 per cent year on year in the fourth quarter of 2011 thanks to strong investment demand and rising exports stimulated by a depreciated currency. Despite weakness in the euro zone and subdued domestic demand, Hungary also managed to maintain the growth momentum in its economy during the fourth quarter of 2011, mostly due

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1 Speech by Mr. Masaaki Shirakawa, Governor of the Bank of Japan, at the Japan National Press Club, Tokyo, 17 February 2012.
to rising agricultural production. The closure in February of a major national airline company could cost an estimated 0.3 per cent of GDP because of loss of ticket sales in Hungary. Buoyant harvests also boosted fourth quarter grain exports from Romania.

In January, some new EU member countries also showed gains in industrial production. Manufacturing output increased by 4 per cent in Lithuania and by 8.9 per cent in Poland year on year. Fiscal austerity measures, however, continue to slow economic recovery.

Some of the new EU members successfully tapped international capital markets. In February, Lithuania raised about $1 billion through issuance of ten-year Eurobonds, while the Czech Republic was able to raise about $2.6 billion at a favourable yield of 3.9 per cent. In January and February, the stock markets in Central Europe bounced back and currencies modestly gained versus the euro, although the risk of disorderly deleveraging and withdrawal of parent bank capital is still present.

**Economies in Transition**

**CIS: capital returns to the Russian Federation**

Seasonally adjusted GDP growth declined in the Russian Federation by 0.1 per cent month on month in January due to weakening retail sales after their surge in December and weaker investment. However, the trade surplus increased with the rise in oil prices, reaching $21 billion during the month. Export growth and election-related spending are expected to stimulate overall economic activity in the first quarter of 2012. The Russian stock market also rallied after having fallen in December. Investors returned, encouraged by higher oil prices. In 2011, profits of the Russian banking sector increased by 70 per cent to a record high of $28.1 billion.

The economy of Belarus grew by 2 per cent in January year on year. Falling oil production led to meagre GDP growth of only 0.1 per cent in Azerbaijan in 2011. However, the non-oil sector continued to expand at a pace of 5.9 per cent in January year on year, reflecting successful efforts to diversify the economy. In Central Asia, the economy of Kyrgyzstan was affected by massive electricity outages in January due to the cold weather and higher consumption needs.

**South-Eastern Europe: Croatia only marginally avoids recession in 2011**

Croatia reported only 0.2 per cent economic expansion in 2011, barely avoiding recession. Fourth quarter GDP declined by 0.2 per cent year on year. In Serbia, industrial production declined by 2.7 per cent year on year in January. Inflation in the region meanwhile continued to slow. In January, consumer prices increased year on year by only 1.2 per cent in Croatia and by 5.6 per cent in Serbia. In March, the European Union granted Serbia candidate member status, allowing the country to obtain pre-accession financial assistance and likely improving the country’s long-term investment prospects.

**Developing economies**

**Africa: oil dispute between South Sudan and Sudan continues**

A number of governments in the region projected improvements in fiscal positions for their current or approaching fiscal year. In South Africa, the fiscal deficit is expected to fall to 4.6 per cent of GDP this year, down from 4.8 per cent last year. However, controlling spending to achieve the fiscal adjustment may be difficult due to fiscal policies to address the continued high rate of unemployment, which reached 23.9 per cent in the fourth quarter of 2011, as well as the requisite unemployment benefits. The Namibian Government has proposed a major budget adjustment for fiscal year 2012/2013, which would bring down the fiscal deficit from 11.2 per cent to 4.4 per cent due to additional revenue from higher growth and the planned introduction of an export tax on natural resources. Spending cuts dominate Botswana’s 2012/2013 government budget, which is projected to show a surplus of 0.9 per cent of GDP reversing the fiscal deficit position sustained over the past three years.

The dispute between South Sudan and Sudan over oil pipeline revenues continues. South Sudan shut down oil production and has indicated it will continue to do so until both parties reach an agreement on the fees. The shutdown is having serious effects on South Sudan’s fiscal position. About 98 per cent of government revenue comes from royalties on oil production. Non-salary expenditures have been cut by 50 per cent since the shutdown. It is also affecting Sudan’s fiscal income and the Government may be forced to cut spending further following earlier major cuts after losing significant oil revenue due to the secession of South Sudan.

Inflation remains high in a number of countries of the region, although there have been signs of moderation recently. In Tanzania, year-on-year inflation fell slightly from 19.8 per cent in December 2011 to 19.7 per cent in January. It dropped to 16.7 per cent in Kenya in February (from 18.3 per cent in the previous month). The Bank of Uganda reduced its policy rate from 22 to 21 per cent after headline inflation fell from 25.7 to 25.4 per cent between January and February.
**East Asia: robust domestic demand partially offsets export slowdown**

Recent economic data from East Asia show a mixed picture, with robust domestic demand partially offsetting the slowdown in exports. In most economies, household spending remains firm, helped by low unemployment, easing inflation and, in some cases, lower interest rates. The economies of Indonesia and Malaysia showed a strong performance in the fourth quarter of 2011. In Indonesia, output growth remained stable at 6.5 per cent year on year. Gross fixed capital formation expanded by 11.5 per cent, the fastest pace since 2008, against the backdrop of strong business confidence, increased foreign direct investment inflows and rapid credit growth. Malaysia’s economy expanded by 5.2 per cent year on year in the fourth quarter as faster growth in investment and government consumption offset a sharp decline in net exports. By contrast, Thailand’s GDP contracted by 9.0 per cent year on year in the fourth quarter, following the worst flooding in decades. Net exports subtracted 6 percentage points from aggregate GDP growth. Exports fell by 6.5 per cent, whereas imports increased by 2.9 per cent.

In China, the Government lowered the GDP growth target for 2012 from 8 to 7.5 per cent with a view to prioritize the quality over the speed of economic growth. Several local Governments have recently announced significant minimum wage hikes, responding to a shrinking labour surplus and aiming to spur consumer demand. In Shanghai, the monthly minimum wage for workers will increase in April by 13 per cent to 1,450 yuan (about $232).

**South Asia: India’s economy cooling further**

Economic growth in India slowed to 6.1 per cent year on year in the fourth quarter of 2011. Investment activity remained very weak following the aggressive policy tightening by the Reserve Bank of India over the past year. With exports hit by the crisis in the euro area, the trade deficit widened significantly. At the sectoral level, agricultural output rose by only 2.7 per cent and growth of manufacturing output slowed to a meagre 0.7 per cent. The central bank has indicated that it will ease monetary conditions in the months ahead, but remains concerned about the impact of the rising fiscal deficit. The Government will likely miss its 2011/2012 fiscal deficit target of 4.6 per cent of GDP by about 1 percentage point. The Indian rupee has appreciated by 8 per cent against the dollar since the start of the year, thus partially reversing its decline of the second half of 2011.

Remittance flows to Bangladesh reached a record high of $1.2 billion in January 2012. This has supported a recovery of foreign exchange reserves, which now provide slightly more than three months of import cover. The country is currently negotiating the terms of a $1 billion loan from the IMF under the Extended Credit Facility.

**Western Asia: Sino-Turkish bilateral currency swap arrangement**

In February, the Turkish and Chinese central banks signed a bilateral currency swap arrangement. The deal has been concluded in the amount of 3 billion Turkish lira (10 billion Chinese yuan) for a period of 3 years, with the objective of facilitating bilateral trade in the respective local currencies.

Rising geopolitical risks in the region pushed the oil price per barrel above $120 in February. While this is beneficial to the external balances of oil exporters, it may also increase the risk premium paid by governments in need of external financing, including Dubai. In order to reduce the reliance on transfers from Abu Dhabi to smaller Emirates, the United Arab Emirates plans to issue a dollar-denominated federal sovereign loan. As long as federal authorities do not have the power to levy taxes, however, the federal bond loan is likely to be traded more widely than bonds issued by Abu Dhabi.

**Latin America and the Caribbean: authorities intervene to contain appreciation of currencies**

Economic activity slowed in both Brazil and Mexico. In February, Brazil’s unemployment rate increased from 4.7 to 5.5 per cent and Mexico’s from 4.5 to 4.9 per cent. Last year, output growth in Latin America’s largest economies slowed to 2.7 per cent in the case of Brazil (down from 7.5 per cent in 2010) and to 3.9 per cent in the case of Mexico (down from 5.5 per cent).

Major Latin American currencies rallied for the second consecutive month, driven by unprecedented international demand for private and sovereign bonds. Since the start of the year, the Brazilian real and the Chilean peso gained approximately 6 per cent, and the Colombian peso and the Mexican peso approximately 7 per cent against the United States dollar. To mitigate further exchange rate appreciation and reinvigorate growth following January’s record low trade surplus ($1.3 billion), the central bank purchased dollars on the currency market and cut the Selic rate by 75 basis points to 9.75 percent. Further, fearing a new surge in capital inflows, the Brazilian Government extended the withholding tax on capital inflows to three-year loans from abroad shortly after the ECB’s liquidity injection through the LRTO. The tax was previously levied only on shorter-term operations.

In Colombia, strong growth generated fears of an overheating economy, prompting the central bank to raise the policy rate by 25 basis points to 5.25 per cent. At the same time, the central bank started purchasing $20 million per day in the foreign exchange market in order to keep the peso competitive and support exports, particularly flowers and bananas.