Monthly Briefing
World Economic Situation and Prospects
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Summary

- Quantitative easing by developed countries imposing a tax on the rest of the world
- IMF resources boosted by $430 billion
- Unemployment continues to rise in Europe

Global issues

Quantitative easing imposing a tax on the rest of the world

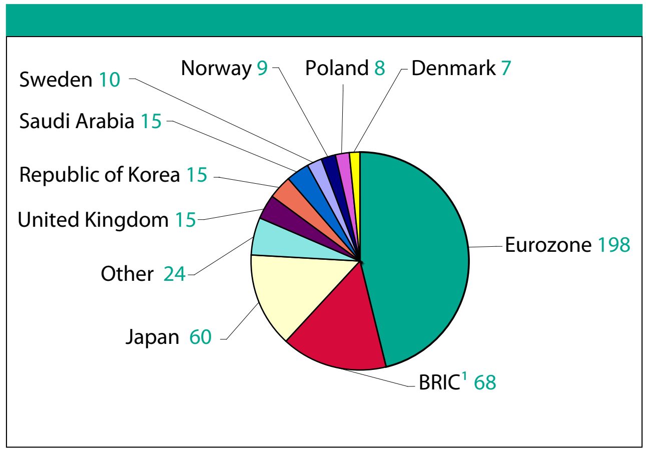
Central banks of developed countries collected an enormous amount of seigniorage through "quantitative easing" (QE) in two parts over the last three years. The first part of seigniorage comes from the increases in the monetary base of these central banks through appropriating the equivalent amount of sources from those who are holding the money. The seigniorage earned in this part over the past three years is estimated at about $3 trillion (or 8 per cent of GDP of developed countries). In the three years prior to 2008, monetary authorities of developed countries only earned a cumulative 1 per cent of GDP in seigniorage. As much of the additional liquidity was created by reserve currency countries (the United States, Europe, and Japan), other countries, especially developing countries, holding substantial reserves in the form of dollars, euros and yen, have paid for an important part of the seigniorage. Foreign exchange reserves of the developing countries rose from $4.2 trillion before 2008 to $6.8 trillion in 2011.

In addition, those holding cash balances or large reserve holdings in the currencies of countries engaging in QE, may face an "inflation tax" if the liquidity injections are inflationary and/or lead to a depreciation of the reserve currencies. Accordingly, developing countries with large reserve holdings would also suffer losses in the purchasing power of their assets. Thus far, however, given low inflation in developed economies, this "inflation tax" has been modest and similar in magnitude to that of the pre-crisis. Emerging and developing economies may have to worry more about the capital flow and exchange rate volatility caused by continued uncertainty in currency markets, the sovereign debt crises and financial fragility to which the QE operations have been responding.

IMF resources boosted by over $430 billion

During the most recent spring meetings, a number of countries made pledges to the IMF totalling over $430 billion in order to increase funds available for dealing with any future crises. Notable contributions include $198 billion from the euro area, $60 billion from Japan and $15 billion each from the United Kingdom, the Republic of Korea and Saudi Arabia (see Figure 1). The pledged resources will not affect the structure of quota and voting power within the IMF. In total, this will bring resources available in the IMF to above $1 trillion. To put this into context, the IMF provided Greece with €30 billion in May 2010 and another €28 billion in April 2012 as part of joint EU-IMF packages. While these new resources are explicitly excluded from those being used to deal with the euro crisis, they will give the IMF more space to use already existing funds for that purpose. Combined with funds from the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM), this is hoped to be sufficient to

Figure 1: Breakdown of new lending to IMF



Source: IMF
1 Expected contribution.

cope with a potential crisis in Spain, although that could deplete additional funds that might be needed if the crisis were to spread to Italy.

Developed economies

North America: growth moderated in the first quarter of 2012

Recent data show GDP growth in the United States moderated to 2.2 per cent in the first quarter of 2012, from the pace of 3 per cent in the previous quarter. Business investment has lost momentum, as investment in non-residential construction fell 12 per cent at a seasonally adjusted annual rate, and capital spending on equipment and software increased only 1.7 per cent; the weakest performance in a year. Another drag was the 3 per cent decline in real government spending. On the other hand, growth of real consumer spending accelerated to 2.9 per cent, and residential investment, which had been declining for most of the past five years, showed a gain of 19 per cent.

Sales of new homes increased 15.6 per cent in the first quarter of 2012, although the level remains at the nadir after a slump of several years. Inventories of single-family homes shrunk 20 per cent over the past six months. The Case-Shiller 20-city housing price index rose 0.2 per cent at a seasonally adjusted monthly rate in February for the first time in a year, and other housing price indices also increased.

Developed Asia and the Pacific: further easing of monetary stances

On 27 April, the Bank of Japan decided to maintain the policy rate at the level of 0.0 to 0.1 per cent. In addition, it also decided to expand the size of its Asset Purchase Programme further from the level of about 65 trillion yen fixed in February to about 70 trillion yen by mid-2013. On 1 May, the Reserve Bank of Australia decided to lower its policy rate by 50 basis points. The stated reasons were moderating inflation and weaker-than-expected economic conditions.

In March, Japan recorded another minor deficit in its merchandise trade balance. The main reasons were the still sluggish exports to Western Europe which declined by more than 10 per cent from one year ago and the almost 30 per cent increase in the imports of mineral fuels. Over the same month, industrial production resumed its expansion and prompted the quarter-on-quarter growth rate to rise to 4.8 per cent for the first quarter of 2012. However, the same survey also reported that growth is expected to weaken in the second quarter of 2012.

Western Europe: outlook remains weak

High frequency data for February were mixed. Industrial production improved, but was boosted mainly by a strong increase in energy production in response to bad winter weather. Production of capital goods also improved, but consumer and intermediate goods declined. Construction fell sharply again, exacerbated by bad winter weather in some countries, while retail sales declined slightly. In March, unemployment maintained its nearly continuous upward drift since July 2011, reaching 10.9 per cent in the euro area. There is a wide divergence across the region with, for example, Spain and Greece at 24.1 per cent and 21.7 per cent respectively and Germany at only 5.6 per cent.

The United Kingdom released an estimate for GDP in the first quarter of 2012 which showed that the economy has returned to recession (defined as two consecutive quarterly contractions of GDP), with GDP falling by 0.2 per cent, quarter on quarter, following the 0.3 per cent decline in the last quarter of 2011.

Looking forward, business climate surveys were generally disappointing in April. Both the European Commission's Economic Confidence Index and the Markit Purchasing Managers Index declined to levels consistent with weak activity. Capacity utilization at the beginning of the second quarter is marginally lower than in the first quarter of the year and below its long term average.

New EU members: Hungary may obtain another bailout

Owing to deteriorating external demand, industrial output is weakening for many new EU members. In Estonia, for instance, industrial production declined by 8.5 per cent year on year in March. The Polish economy, which is less export-oriented, remained strong in March, with a 10.7 per cent increase in retail sales and a mild decline in the unemployment rate. However, indicators for April point to a possible slowdown. After a downward revision of growth forecasts for 2012, the Czech Republic approved additional austerity measures in April to meet the budget deficit targets. This triggered massive street protests. To offset the negative implications of fiscal tightening, the Government is aiming to increase the competitiveness of the economy by simplifying business regulations and improving the absorption of EU funds. In Romania, the Government collapsed in April in a no-confidence vote following disputes over spending cuts and the state of the economy.

The Hungarian Government, facing a real possibility of sovereign debt default against the backdrop of a weakening currency, high external debt, and the high cost of borrowing, asked the EU for a bailout package worth 15 to 20 billion euros. Hungary needs to roll over about €4 billion of its foreign debt in 2012. As a precondition for the start of credit talks, the European Commission required legislative changes in order to strengthen the central bank's independence.

Economies in Transition

CIS: Russian economic growth slows

The economy of the Russian Federation expanded by 4 per cent in the first quarter year on year, however, the pace of growth slowed to 3.2 per cent month on month in March from 4.8 per cent in February. The phase of post-crisis recovery, driven in part by rebuilding inventories, appears to be over. Any further expansion will have to be backed by stronger consumer and investment demand. Although consumption and imports are growing rapidly, investment growth has slowed noticeably. In Ukraine, industrial production declined by an annualized rate of 1.1 per cent in March, mostly as a result of the slowing economies of the Russian Federation and the EU.

In April, Standard & Poor's revised its outlook on Belarus to stable from negative, as the economy shows signs of stabilization. The country's foreign exchange reserves strengthened and the pressure on the exchange rate tapered off, thanks in part to loans provided or facilitated by the Russian Federation.

In Azerbaijan, GDP expanded by 0.5 per cent year on year in the first quarter, with continuing expansion in the non-energy sector and subdued activity in the energy sector. In Central Asia, Uzbekistan's GDP increased at an annualized rate of 7.5 per cent in the first quarter, in part reflecting success of the Government's measures to support domestic manufacturers of consumer goods. After signing a new gas contract, Uzbekistan resumed supplies of natural gas to Tajikistan, which were cut on April 1, ending a situation that threatened to disrupt Tajikistan's economy.

South-Eastern Europe: Serbia's GDP declines

Affected by sluggish export demand and the unusually severe winter, Serbia's economy declined in the first quarter, with GDP shrinking by 1.3 per cent year on year. However, some sectors, including manufacturing and retail trade, saw some pick-up in March. To stabilize the currency, which faced depreciation pressures, the National Bank of Serbia adjusted mandatory reserve requirements in April, reducing reserve requirements on foreign currency and increasing reserve requirements in domestic currency. The Croatian National Bank reduced mandatory reserve requirements to release liquidity to stimulate credit growth. Inflation in the region is subdued, although planned double-digit increases in household gas and electricity tariffs in Croatia in May will have a one-off inflationary effect.

In April, the Government of Montenegro adopted a new budget for 2012, cutting its planned expenditure by €16 million in response to negative developments in the eurozone, low FDI, and state guarantees given to the aluminium plant, which was nationalized in February.

Developing economies

Africa: monetary policy diverges as inflation, though falling somewhat, remains an issue

Monetary policies continued to show divergence across the region. In Ghana, the central bank increased its policy interest rate by one percentage point to 14.5 per cent in order to support the currency and reduce the potential for imported inflation. Ghana continues to see solid growth, also on the back of the oil sector, so that the pressure on its currency has been largely import-driven. In contrast, the central bank of Mozambique reduced its policy rate by 25 basis points to 13.5 per cent to support growth amidst a sharp fall in inflation. Meanwhile, in South Africa, inflation decreased to an annualized rate of 6.0 per cent in March, putting it within the central bank's target range of 3-6 per cent.

While inflation has been moderating in a number of countries, as the rise in food prices abates and energy prices stabilize, the rates are still high enough to worry central banks. In Kenya, inflation fell significantly from 15.6 per cent year on year in March to 13.1 per cent in April, the lowest level since May 2011. Inflation in Uganda fell to an annualized rate of 20.3 per cent in April, down from 21.1 per cent. In spite of this, both Kenya and Uganda have maintained their policy rates at the same level, 18 per cent and 21 per cent, respectively, in an effort to maintain the downward trend in inflation. In Ethiopia, inflation has also come down slightly, from 36.3 per cent year on year in February to 32.5 per cent in March. Food price inflation has come down as well, but is still rising at 40 per cent year on year.

East Asia: weak external demand weighs on growth in East Asia

Sluggish demand in developed economies, especially those of the European Union, continues to weigh on East Asia's growth. In China, gross domestic product expanded by 8.1 per cent year on year in the first quarter of 2012. This is the slowest pace in almost three years, as growth in the manufacturing and service sectors eased. However, a string of positive data, including a notable rise in the manufacturing index, suggests that the economy will see solid full-year growth in 2012. In the Republic of Korea, quarter-on-quarter growth accelerated slightly in the first three months of 2012, following a very weak performance in the fourth quarter of 2011. Growth was primarily driven by a recovery in investment activity and Government consumption, whereas net exports declined. In Taiwan Province of China, economic activity in the first quarter of 2012 was also held back by weak external demand, with real exports falling by an annualized rate of 3.3 per cent. The weakness in exports is likely to continue in the months ahead as European countries have slipped back into recession. Nominal merchandise exports from the Republic of Korea declined by 4.7 per cent year on year in April, with shipments to the European Union falling by 9 per cent.

South Asia: monetary policy loosened in India, but tightened in Sri Lanka

The Reserve Bank of India (RBI) cut interest rates for the first time in three years in an effort to stimulate the economy amidst challenging domestic and external conditions. The benchmark policy rates were lowered by 50 basis points each, after growth slowed to 6.1 per cent in the fourth quarter of 2011 and consumer price inflation moderated. However, the RBI indicated that space for further reductions was limited given the persistence of significant inflationary pressure.

The Central Bank of Sri Lanka, in contrast, tightened monetary policy further in April, lifting its main interest rates for the second time since the beginning of the year. The move aims at slowing credit growth and anchoring inflationary expectations. In April, year-on-year inflation accelerated to 6.1 per cent, up from 5.5 per cent in March and 2.7 per cent in February. Much of the recent increase in the inflation results from an upward adjustment of government-administered prices of fuel, electricity and transportation. Although Sri Lanka received the eighth tranche of a $2.6 billion IMF stand-by-agreement loan, the rupee continued to weaken in April. Since February, when the central bank stopped defending a specific value, the rupee has fallen by about 12 per cent against the dollar. Most of the pressure on the rupee stems from strong dollar demand from importers, in conjunction with a rapidly increasing trade deficit.

Western Asia: Israel coping with after-effects of regional shake-up and domestic discontent

Egypt's state-owned Natural Gas Holding Company annulled the deal that supplied Israel with 40 per cent of its natural gas. Although Israel may become self-reliant as soon as next year when gas from the offshore Tamar gas field starts coming on-stream, it will have to find alternative and more expensive suppliers in the short run. On the domestic front, the Israeli Government approved several recommendations of the Trajtenberg Committee, created in 2011 to address rising frustrations about the cost of living and income inequality. This includes the building of 187,000 new units of affordable housing over the next five years. The Government rejected the main recommendation to cut military spending which represents almost 7 per cent of GDP.

In Saudi Arabia, more than 1 million individuals have already joined the unemployment programme introduced in January. As more than 60 per cent of the Saudi working-age population of 14 million is currently not participating in the labour force, especially women, the attractiveness of the programme is likely to increase labour force participation rates and therefore unemployment rates, as well as government spending, in the years ahead.

Latin America and the Caribbean: Governments seek energy control in a slightly deteriorating macroeconomic situation

In April, two formerly state-owned companies, now controlled by Spanish corporations, were nationalized. The Government of Argentina re-nationalized the main oil producer in order to reduce the fuel import bill and invest savings in developing the country's vast reserves. The move aligns Argentina's resource ownership with that of most emerging markets. It did not cause immediate capital flight. The Government of the Plurinational State of Bolivia took control of the main electricity grid operator. It did so in accordance with the common regulatory orientation whereby public utility producers compete with each other, but the State controls the distribution.

In Brazil, subdued inflationary pressures and concerns over the global economy motivated the central bank to cut the SELIC rate by 75 basis points to 9 per cent. After six consecutive cuts, the rate is still among the highest in the region and seen by the Government as hindering investment and growth. Indeed, recent rate cuts reduced banks' funding costs without leading to an equal reduction of retail landing rates. The latter, however, may give way to higher inflation. Meanwhile, unemployment in April inched up to 6.4 per cent.

By contrast, in the rest of the region the inflation outlook and monetary policy did not change for the month, leading the Central Banks of both Colombia and Mexico to leave rates unchanged. Disappointing data on agricultural production in South America suggest that food prices may increase, reviving inflation.