Global issues

Automatic spending cuts activated in the United States

The Congress of the United States failed to agree on how to reduce the government deficit in the next decade, thereby automatically activating the Budget Control Act of 2011 on March 1 of this year. The automatic cuts, referred to as the “sequester,” include across-the-board automatic spending cuts worth $1.2 trillion, equally distributed between defense and non-defense programmes. Although the Act exempts Social Security, Medicaid and other entitlement programmes from sequestration, it will result in cuts to education, public health and a number of social programmes. The impact of the cuts will reduce the capacity of many government agencies to deliver their services.

The budgetary resource cuts are estimated to be $85 billion for the remainder of 2013. According to the Congressional Budget Office (CBO), the automatic spending cuts will reduce the fiscal deficit by $42 billion in fiscal year 2013, with the federal budget deficit expected to reach 5.3 percent of GDP, down from 7.0 per cent in 2012 (figure 1). At the same time, the CBO estimates that the cuts will lead to a 0.6 percentage point loss of GDP and a loss of 750,000 full-time jobs in 2013, compared with the baseline of no spending cuts. The impact will not be trivial given that the GDP of the United States increased by only 0.1 per cent in the fourth quarter of 2012. However, the possibility remains for policymakers to discontinue the automatic cuts by agreeing on a long-term budget plan in the next two months.

Weaknesses continue in the European Union

Tensions eased after the European Central Bank announced its policy of Outright Monetary Transactions (OMT) in August of 2012. Sovereign bond yields in the region narrowed significantly and a sustained pick-up in confidence was achieved. These positive conditions may be disturbed, however, by a number of developments that occurred during the month. The inconclusive result of the elections in Italy has raised doubts over the country’s continuing commitment to reforms and austerity. The OMT can only be deployed to combat a resurgence of heightened sovereign bond yields if the member Government requests formal assistance and submits to a monitored reform programme. Secondly, preliminary figures for GDP growth in the fourth quarter of 2012 were worse than expected (see Western Europe below). Finally, the European Commission’s winter forecast showed that a number of countries would miss their deficit targets by significant amounts and could be required to adopt additional austerity measures. In the case of France, the target would be missed by 0.7 percentage points in 2013, and more in 2014, and would require significant additional austerity measures to be put in place.

Figure 1: Budget projections in the United States*

Source: Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2013 to 2023”.
* Figures correspond to fiscal years.
Depreciation of Japanese yen raises international concern
The Japanese yen depreciated by 16 per cent against the United States dollar and by 24 per cent against the euro in the past few months. The depreciation started in July 2012, coinciding with the deterioration in the trade balance of Japan, but precipitated recently when it became clear that the new Japanese Government would adopt bold expansionary measures in both the fiscal and monetary dimensions.

The sharp depreciation of the yen—combined with the quantitative easing policy adopted by the Bank of Japan and the possibility of purchasing foreign bonds to drive down the exchange rate—is worrying other countries. In East Asia, countries such as China and the Republic of Korea have expressed their concerns over Japan’s macroeconomic policies. The Korean won has gained about 25 per cent against the yen over the past six months—a trend that is likely to have a negative impact on Korean exports. In mid-February, statements from both G7 and G20 meetings reiterated that they would refrain from competitive devaluation.

Developed economies

The United States: housing sector recovery gains traction
The housing sector in the United States has been on a steady recovery path since 2012. Most recent data showed that new home sales increased 28.9 per cent in January 2013 over the previous year, with inventory continuing to decline. The median sales price of new houses sold was up by 2.1 per cent. The monthly House Price Index of the Federal Housing Finance Agency rose by 5.8 per cent during 2012, in line with the 6.9 per cent increase in the S&P/Case-Shiller National U.S. Home Price Index for twenty cities. Nevertheless, in absolute terms, both the volume of sales and the prices of houses are still far below their peaks prior to the financial crisis. In the outlook, while the low mortgage interest rates resulting from the extremely accommodative monetary easing will remain supportive for the housing sector, a further recovery will largely depend on strengthening of employment and household income.

Developed Asia and the Pacific: signs of improvement prevailing in Japan
In Japan, survey-based indictors released recently show that the economic sentiment has improved since the end of 2012. In January 2013, the consumer confidence index recovered strongly and reached the level observed before the great recession. Business confidence, for both large and small firms, also improved noticeably in January and February.

Statistics for economic activity follow the same patterns. In January, industrial production increased by 1 per cent from the previous month and it is expected to maintain that growth rate for the coming months. Export volume resumed its expansion in January after three months of decline. The labour market situation has also improved. The ratio of job offers to applicants has increased three months in a row up to January and brought employment back to the level of one year ago. However, readings for these indicators are still significantly lower than the levels before the natural disasters of 2011.

Western Europe: a bad fourth quarter
GDP in the fourth quarter of 2012 fell sharply in the euro area and for most of the countries in the region. The drop in activity had been presaged by a swath of short-term indicators but was worse than expected, with GDP in the euro area falling by 0.6 per cent. All of the major economies contracted: Germany by 0.6 per cent, France by 0.3 per cent, Italy by 0.9 per cent, Spain by 0.7 per cent and the United Kingdom by 0.3 per cent.

However, leading indicators continue to point to a bottoming out of activity during the first quarter of 2013 and remain consistent with a gradual pick-up over the course of 2013. The European Commission’s economic sentiment indicator improved for the fourth month in a row, led by a strong improvement in Germany. Confidence in Germany is well above historic averages, consistent with a return to positive growth in the first quarter. Conversely, confidence in France, which had been rising, fell in February and remains low, increasing the likelihood of a further decline in GDP in the first quarter and a more significant growth divergence going forward between the two largest economies in the euro area.

New EU members: looser monetary policy does not feed into credit growth yet
Economic fundamentals in most of the new European Union (EU) member States remain weak. Most of the fourth quarter GDP growth figures point to a significant slowdown, which persisted in January. Although forward-looking indicators in some states reflect improvements in consumer sentiment, implying that domestic demand in 2013 may not weaken as sharply as in 2012, the turnaround point is not evident yet. In February, the European Commission downgraded its earlier growth forecasts for most of the region.
In Poland, industrial output expanded in January by only 0.3 per cent year on year, dragged down by the automotive, electronics and construction sectors. Labour markets in Central Europe deteriorated in January, with the unemployment rate reaching 14.2 per cent in Poland, a 6-year high, and 14.8 per cent in Slovakia. In February, the National Bank of Poland and the National Bank of Hungary cut their respective policy rates by 25 basis points. However, corporate lending remains slow. Benefitting from the eased financing constraints, the Government of Hungary raised $3.25 billion on the bond market in February, but still may need balance of payment support from the IMF later in the year. Large social protests in Bulgaria against higher energy prices lead to the resignation of the Government in February.

**Economies in transition**

**CIS and Georgia: weakening domestic demand in the Russian Federation**

Economic indicators for January in the Russian Federation reflected faltering domestic demand, the main driver of growth in 2012. Retail sales growth dropped to a three-year low and consumer sentiment remained weak. The labour market also worsened, with the unemployment rate increasing to 6 per cent. Although the Government repeatedly called on the central bank to loosen monetary policy, high inflation led to caution by monetary authorities. Inflation reached 7.1 per cent in January.

In Ukraine, industrial production declined by 3.2 per cent year on year in January. The Government raised $1 billion on the international bond market in February, benefiting from high global liquidity. However, as the country has to repay over $9 billion in external debt in 2013, it still may need a loan from the IMF. To mitigate its dependence on Russian natural gas, Ukraine signed a 50-year production sharing agreement with the oil and gas company Royal Dutch Shell to develop domestic shell gas reserves. In Kazakhstan, industry grew by only 0.7 per cent year on year. Oil and gas production remained virtually flat, while steel output sharply contracted, as the sanctions imposed on Iran, the main export market, affected the largest producer. In March, Tajikistan became the 159th member of the WTO, following 12 years of negotiations.

**South-Eastern Europe: continuing monetary tightening in Serbia**

Continuing weakness in external and domestic demand is restraining economic recovery in the region, where the impact of fiscal austerity measures is aggravated by continued deleveraging in the private sector. In Croatia and Serbia, GDP in the fourth quarter fell by 2.3 per cent and 1.5 per cent year on year, respectively. Weak demand keeps inflation relatively low for most of the region. However, annual inflation in Serbia accelerated to 12.8 per cent in January, following higher food prices and increases in administered prices. In February, the National Bank of Serbia continued its cycle of monetary tightening and raised the key policy rate by 25 basis points to 11.75 per cent. Tight monetary policy has lead to an appreciating currency and in February the National Bank intervened to stabilize exchange rate fluctuations. In Albania, by contrast, the central bank cut its policy rate to a record low of 3.75 per cent in late January. The Croatian Government privatized the country’s largest shipyard in February, meeting a key condition for entry into the EU, set for July.

**Developing economies**

**Africa: East Africa relieved after peaceful Kenyan elections; growth slows in South Africa**

There is some relief in East Africa as the recent Kenyan elections appear to have picked Uhuru Kenyatta as President with a minimum of violence. There were fears of a repeat of the post-election violence that led to the deaths of over 1,000 people, the displacement of hundreds of thousands, and caused major disruptions in the Kenyan economy and the surrounding economies in 2007. The results have yet to be confirmed, but they may be problematic for international relations given Mr. Kenyatta’s upcoming trial at the International Criminal Court for possible connections to the violence following the previous election.

The South African economy grew by 2.5 per cent in 2012, down from 3.5 per cent in 2011. Output continues to fall in the critical mining sector in the wake of strikes in the third quarter and following weaker external demand. Meanwhile, Malawi saw a sharp increase in its external debt from 14.3 per cent of GDP in March 2012 to 27.8 per cent in September 2012. The main drivers were new borrowing and a significant valuation effect from the currency depreciation. Falling reserves and exchange rate depreciation continue to cause trouble in Egypt with reports of falling stocks and lower imports of wheat. Subsidized loaves of bread are provided to around 40 per cent of the population and any disruption to the subsidies could cause social unrest.
East Asia: economies continue to record strong growth

Several economies, including Indonesia, Malaysia, the Philippines and Thailand, continued to record strong growth in the final quarter of 2012 resulting from buoyant consumption and investment demand. Economic activity increased by 6.1 per cent year on year in Indonesia, 6.4 per cent in Malaysia, and 6.8 per cent in the Philippines. In Thailand, year-on-year growth surged to 18.9 per cent as output bounced back from the low level of the fourth quarter of 2011—that level caused by the worst floods in 70 years. On a seasonally adjusted quarter-on-quarter basis, Thailand’s GDP expanded by 3.6 per cent driven by a strong performance of the manufacturing and construction sectors. By contrast, economic growth remained lacklustre in the Republic of Korea, with GDP expanding by 0.4 per cent from the previous quarter and by 1.5 per cent from a year ago. This sluggish performance reflects slow growth in consumption and exports and a contraction in investment.

In China, the Government announced a new round of property tightening measures, including higher down payments and mortgage rates for buyers of second units in selected cities and a capital gains tax of up to 20 per cent for sellers. These moves follow a gradual upturn in housing prices since mid-2012, which gained momentum in recent months. In January 2013, the vast majority of major cities saw a significant rise in housing prices, both on a month-on-month and a year-on-year basis. The Government also set out a 7.5 per cent growth target for 2013, highlighting the need to restructure the domestic economy and improve the quality of growth.

South Asia: India’s growth falls to multi-year low

South Asia’s economies continue to face significant internal and external headwinds. In India, GDP growth fell to a multi-year low of 4.5 per cent year on year in the fourth quarter of 2012. A slight recovery in private demand was offset by a contraction in exports and a sharp slowdown in government consumption. In the budget for the upcoming fiscal year 2013/14, the Government of India announced a surge in public expenditures, with total budget spending projected to rise by 16 per cent. The spending increase is expected to be partly financed by the sale of government stakes in companies and temporary tax surcharges on firms and high-income earners.

Pakistan’s balance of payment position weakened further in recent months despite a slight improvement in the current account. During the period July 2012 to January 2013, the trade deficit declined by 12 per cent and worker remittances continued to grow at a robust pace. However, this positive effect was more than offset by higher capital and financial outflows, including significant repayments of IMF loans acquired in 2008. As a result, the Pakistani rupee fell to an all-time low against the dollar in February 2013 and the central bank’s foreign exchange reserves dropped to a level that provides less than three months of import coverage.

Western Asia: oil payment dispute grows in Iraq

Domestic tensions in Iraq further delayed the adoption of the 2013 budget, partly fuelled by the intensification of the oil payment dispute between the Iraqi Government and the Kurdish Regional Government (KRG). In protest of payments it deems insufficient, the KRG recently stopped contributing to Iraqi oil exports and increased its direct oil exports to Turkey using trucks. In Jordan, economic growth decelerated steadily in 2012, reaching 2.6 per cent in the third quarter. Economic activity is burdened by a high oil import bill, declining tourism activity, a shortfall in foreign grants and investments, and an influx of 300,000 Syrian refugees putting a strain on resources. Concerned by its growing budget deficit, the Jordanian Government removed fuel subsidies last November and may soon raise electricity tariffs to target a budget deficit of 5.4 per cent.

Facing a slow but progressive appreciation of the Turkish lira, the Turkish central bank cut the lower bound of its interest rate corridor by 0.25 per cent in order to discourage capital inflows. It also raised the reserve requirement ratio in order to temper expanding credit demand.

Latin America and the Caribbean: sharp devaluation in the Bolivarian Republic of Venezuela; debt restructuring in Jamaica

The Government of the Bolivarian Republic of Venezuela decided to devalue the Bolivar by 46 per cent, setting it at 6.3 to the dollar, from 4.3 previously. The decision was triggered by foreign currency shortages and the deteriorated fiscal position. The new regime will improve the government balance, mainly through higher revenues from the oil exporting activities by the state-owned company. Nevertheless, the devaluation is also likely to create additional and significant inflation pressures. In January 2013, the annual inflation rate was 22.2 per cent, one of the highest in Latin America.

Amid economic stagnation and an unsustainable debt burden of over 140 per cent of GDP, the Government of Jamaica is restructuring its local debt, the second time in the last three years. The Government implemented a debt swap programme on $9.1 billion domestic bonds that attracted almost full participation by current bondholders. The debt swap is also a critical condition to confirm a preliminary agreement with the IMF to receive a $750 million loan. The debt restructuring should favour the sustainability of the fiscal position, a chronic problem in Jamaica.