



World Economic Situation and Prospects

Monthly Briefing

No. 72

November 2014

Global issues

Lowest oil prices in the past 4 years

On October 15, the Brent oil price fell to \$84.02 pb, the lowest price since November 2010 (figure 1), as a result of weak demand, abundant supply and a stronger U.S. dollar. Growth in oil demand has been slowing down throughout 2014, following sluggish economic growth in several key economies, including Western Europe and Japan. In addition, weaker-than-expected gross domestic product (GDP) growth in China has also weighed on weaker oil demand. Although demand from the United States of America is expected to partially offset the weaker demand from other developed economies, as a whole, global demand for crude oil should continue to grow at a moderate pace in the next year, in line with the overall demand for commodities.

Figure 1
Brent oil price per barrel in U.S. dollars,
January 2008 to October 2014



Source: Energy Information Administration.

Conversely, oil supply has been growing strongly, both from OPEC and non-OPEC members, reaching 93.2 million barrels per day (bl/day) in the third quarter of 2014, which is 2.8 million bl/day higher than one year earlier. Oil output from OPEC members has been relatively steady, despite conflicts in Iraq, and the non-OPEC supply has also been growing strongly, especially in the United States, which recently became the largest oil producer in the world. In addition to the gap between

Summary

- Sharp decline of oil prices and renewed volatility in financial markets
- Low inflation in Europe remains a concern
- Diverging monetary policies in developed economies

supply and demand, the strengthening of the U.S. dollar weighs on oil markets as it makes commodities denominated in U.S. dollars more expensive for countries holding other currencies.

Lower prices will be a relief for oil-importing countries, in particular to boost private consumption and investment, as well as to improve their trade balance. For oil-producing countries, however, the current situation in the oil market raises two main questions. First, what would be the economic consequences if prices continue their downward trend? Second, are these countries expected to cut part of their production to support prices?

Regarding the first question, many oil-exporting countries, such as Algeria, Angola, Bahrain, Oman, the Russian Federation and Venezuela (Bolivarian Republic of), among others, face fiscal break-even oil prices above the October price, which will require them to revise their public spending strategy. Although those countries benefited from higher fiscal revenues during the past decade, they also bolstered public spending accordingly, worsening their public finances. If prices continue to dwindle, fiscal and current balance conditions will worsen for many oil-exporting countries, while refinancing options will become limited. However, some of these countries hold significant financial reserves and may therefore delay restrictions on fiscal spending.

As to the second question, it seems unlikely that OPEC members will agree on restraining production to support prices at their November 27 meeting. Saudi Arabia and some other members can cope with extended low oil prices, as they have either considerable financial resources or much lower fiscal break-even prices. Recently, Saudi Arabia cut prices for its biggest customers, signaling that it would rather defend its market share than support prices. Instead, pressure to restrain oil production may exist in countries where extraction activities are expensive, such as in Canada and the United States. Several companies in the United States announced that they would defer drilling, given lower profit margins with current oil prices.

Volatility in financial markets

Weighed down by concerns over growth prospects for the world economy, equity and bond markets across the world saw significant rises in volatility throughout the month of October (figure 2). In developed countries, equity markets fell rapidly through the middle of the month, followed by some returns to previous levels. Bond prices saw their yields (which move inversely to prices) fall to their lowest level of the year in some countries, such as Germany and the United States.

The VIX index, an index designed to proxy for the volatility of the S&P 500, also reached its highest level for the year in mid-October. Standard deviations of market intra-day high and low prices also point to increased volatility over the same period in other developed-country markets (figure 2).

A number of factors led to the drop in major indices, such as downgrades of forecasts for growth in the European Union (EU), some pessimism about growth in China, fears over the spread of the Ebola outbreak, as well as growth concerns in some major emerging markets, such as Brazil and Russia. The prospects for the upcoming end of the Fed's QE 3 programme also led to further uncertainty. Over the latter half of the month, markets appear to have stabilized with some indices rising again, bond yields moving up slightly and volatility moving down. This reversal has been helped along by relatively solid third-quarter earnings figures for a number of companies, some prospects for stable growth in China and the United States, and finally at the end of the month, an expansion of Japan's QQME programme. Emerging market composite indices remain lower, pulled by a fall in Brazilian equities, which declined during the process of the presidential election and its aftermath.

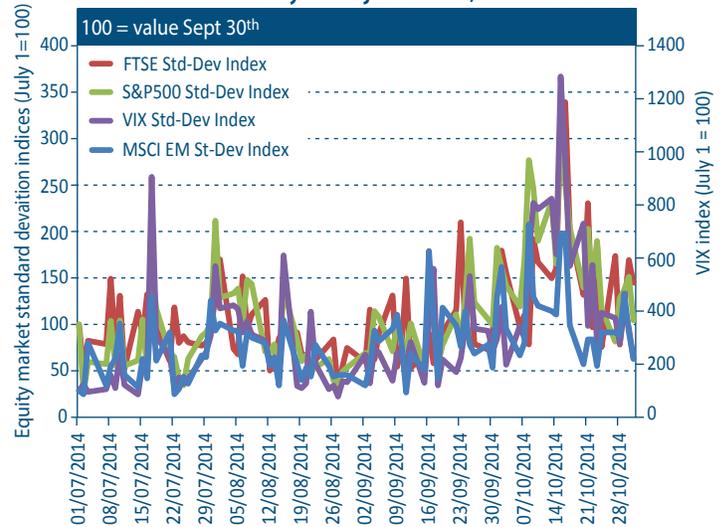
Developed economies

United States: the Fed concluded its asset purchasing programme

The Fed announced that it would conclude its asset purchasing programme by the end of October. However, it will continue to reinvest principal payments from securities holdings when they mature so as to maintain the size of its balance sheet and the size of the monetary base. In this sense, the Fed has not fully exited the QE yet. The QE programme, which was first launched in late 2008 when the financial crisis erupted, has in the last six years increased the size of the Fed balance sheet from below \$1 trillion to currently \$4.5 trillion, injecting a large amount of liquidity to the financial system. Meanwhile, the Fed has reiterated its intention to keep the federal funds rate at the zero level for a considerable time. In short, monetary policy stance in the United States will remain accommodative for 2015.

The latest data released showed that real GDP in the United States increased at an annual rate of 3.5 per cent in the third quarter of 2014, compared with 4.6 per cent in the second quarter. Household consumption, exports and business investment all contributed positively to GDP growth, and so did gov-

Figure 2
Increased in volatility of major indices, October 2014



Source: Yahoo Finance and UN DESA calculations.

ernment spending. These data support the projection of GDP growth at 2.3 per cent for 2014.

Developed Asia: monetary easing strengthening in Japan

On 31 October 2014, the BoJ decided to expand its QQME policy. The expansion included raising the target monetary base, by increasing it from 60-70 trillion yen per year to 80 trillion yen per year. It also included extending the average remaining maturity of Japanese government bonds purchased by the BoJ to about 7-10 years from 7 years. The BoJ will also triple the amount of its purchase of exchange-traded funds and Japanese real estate investment trusts. The stated reason for this decision was to pre-empt the potential risk of delaying the reversal of the deflationary mindset. Statistics released on the same day showed that the year-over-year headline inflation rate dropped to 3.2 per cent in September from 3.3 per cent in the previous month. This downward trend, although slow, has been constant since June 2014, two months after the consumption tax rate hike. According to BoJ, the inflation rate net of the consumption tax rate impact is only about 1.25 per cent.

Other statistics revealed that the Japanese economy remained on the recovery track in September. Industrial production increased by 2.7 per cent from the previous month. Export volume increased by 1.8 per cent from August, helping to stabilize the nominal trade deficit. Employment growth, although tepid and volatile, has pushed the employment-to-population ratio back to the pre-crisis level.

Western Europe: some stabilization, but low inflation remains a concern

Data released during October give some hints of stabilization in the region. High frequency data depicting the situation in August were mixed. On the one hand, retail trade was up sharply and the construction sector improved for the second consecutive

month. On the other hand, industrial production fell, led by a significant decline in the capital goods sector. In October, confidence indicators improved, with the European Commission's Economic Sentiment indicator (and all of its components) rising after four months of stagnation or decline. The Markit Purchasing Managers' Index also improved marginally, the first increase in three months. Both indices are consistent with weak growth, but suggest that the fourth quarter of the year may see a slight pickup in growth dynamics.

Other data released point to the continuing fragility of the recovery. The rate of unemployment remained at 11.5 per cent for the fourth consecutive month. Headline inflation rose slightly to 0.4 per cent year over year as the negative contribution from the energy component diminished. However, core inflation dipped to 0.7 per cent, so that fears of a fall into Japan-style deflation remain valid.

The new EU members: interest-rate cut in Poland

Economic sentiment among the new EU members remains strong despite the deteriorating economic environment in the EU-15, with domestic demand rebounding after years of stagnation. In Hungary, business and consumer confidence approached record highs in October, as uncertainty about local elections is over, inflation stays low and labour market conditions have improved. Consumer confidence also strengthened in the Czech Republic. Although a temporary shutdown in the automotive industries in August had led to a weakening of industrial production in the Czech Republic and Hungary, output recovered in September. However, in Poland, available indicators point to some sluggishness in the third quarter. As anticipated earlier, the National Bank of Poland cut its benchmark policy rate by 50 basis points in October to another record-low level of 2 per cent. As inflationary pressures remain extremely subdued, like elsewhere in the region, further cuts are possible. In the Baltic States, despite the less favourable external environment and the Russian food import ban, GDP growth continued; the economy of Latvia, for example, expanded by 2.2 per cent year on year in the third quarter.

In late October, Lithuania received a floating Liquefied Natural Gas terminal, which will eventually allow annual imports of 4 billion cubic metres of natural gas. This will reduce the dependency of Lithuania—and, prospectively, other Baltic States—on Russian natural gas and provide an opportunity to negotiate lower prices for its imports.

Economies in transition

CIS: sharp interest-rate increase in the Russian Federation

The Russian food import ban stimulated domestic food production, leading to an increase of industrial output of 2.8 per cent year on year in September. However, the economy is operating at close to full capacity and the already high inflation in the Russian Federation was further spurred by the food import ban, reaching 8.1 per cent in September and, according to the initial estimates, 8.4 per cent in October. As the currency continued to depreciate against the backdrop of declining oil price and

hit record lows versus the U.S. dollar in October, the costs of servicing external debt have climbed up. In October, Moody's downgraded the country's sovereign debt, taking into account low growth expectations, ongoing capital outflows and gradually diminishing foreign-exchange reserves. At the end of October, the Central Bank of the Russian Federation again raised its key policy rate—this time by 150 basis points—despite sluggish output, in order to stabilize the currency.

In Ukraine, inflation also remained high, reaching 17.5 per cent in September, although capital controls helped to stabilize the exchange rate. The currencies of other CIS countries, especially those receiving significant inflows of remittances from the Russian Federation or the EU, are also under pressure. Efforts to protect respective currencies have led to a significant erosion of the foreign-exchange reserves in Kyrgyzstan and Tajikistan. In late October, the Russian Federation, Ukraine and the EU have reportedly reached an agreement on the terms of supplying the Russian natural gas to Ukraine in the near term.

South-Eastern Europe: the economy of Bosnia and Herzegovina affected by floods

The economy of Bosnia and Herzegovina took a heavy toll from the massive floods in May; the second quarter GDP has reportedly contracted by 1.2 per cent year on year, after several consecutive quarters of growth. Agriculture, mining and transport sectors were the ones most heavily affected by the floods. The construction sector, by contrast, expanded by nearly 8 per cent year on year, thanks to the reconstruction works that started almost immediately, supported by foreign donors.

Developing economies

Africa: Ebola outbreak continues to severely affect West Africa

The Ebola outbreak in West Africa has led to 13,540 official cases, with almost 4,940 reported deaths. The three countries hit hardest by the epidemic are Liberia, Sierra Leone and Guinea. Besides the humanitarian toll, the epidemic is causing severe disruptions to economic activity in these countries, further complicating already challenging conditions for economic development. The outbreak of Ebola was officially declared over in Nigeria and Senegal.

In Angola, the fall in global oil prices has led to the announcement of lower or deferred public spending. The current budget is based on an oil price of \$98 per barrel and entails a deficit of about 3.8 per cent of GDP. Consequently, the current level of oil prices of close to \$86 per barrel would entail significant fiscal challenges. The low oil prices are also affecting Algeria, which expects oil and gas earnings to be down by more than 5 per cent for 2014.

GDP growth figures from East Africa in the second quarter of 2014 continue to indicate some strength, with Kenya's GDP up by 5.8 per cent year on year and Tanzania's GDP up by 6.9 per cent year on year. The picture in North Africa is somewhat more muted, although improving slightly, with second quarter GDP

growth up to 3.7 per cent year on year in Egypt, and third quarter GDP at 2.6 per cent year on year in Morocco, up from 2.3 per cent in the second quarter. Inflation is also mixed, although falling in many countries. In September, inflation reached 1.4 per cent in Uganda, 0.6 in the Seychelles, 0.2 per cent in Rwanda and 0.1 per cent in Morocco. Such exceptional low levels of inflation are driven in part by falling commodity prices. Countries experiencing higher inflation levels have seen some declines as well. In Ethiopia, inflation fell from 7.2 per cent in August to 5.5 per cent in September, while in Tanzania it went down slightly from 6.7 per cent to 6.6 per cent over the same period.

East Asia: solid growth in the third quarter

Most East Asian economies recorded solid growth in the third quarter of 2014 amid challenging global conditions. In China, GDP expanded by 7.3 per cent from a year ago, only slightly down from 7.5 per cent in the second quarter. On a quarter-on-quarter seasonally adjusted basis, growth decelerated from 2.0 per cent to 1.9 per cent, as economic activity held up well in the face of slower credit growth and a weaker property market.

In the Republic of Korea, quarter-on-quarter growth picked up from 0.5 per cent in the second quarter to 0.9 per cent in the third, with stronger domestic demand offsetting weaker exports. Private and government consumption as well as construction activity increased notably, supported by new fiscal stimulus measures and a further easing of monetary policy. In October, the Bank of Korea lowered its benchmark interest rate for the second time in three months by 25 basis points, bringing the rate to a record low of 2 per cent.

In Taiwan Province of China, growth slowed in the third quarter from the previous three months, owing to strong imports and weaker private consumption. Household consumption, including restaurant sales, was negatively affected by a recent food safety scandal related to the adulteration of cooking oil with recycled waste oil and animal feed oil. On a year-on-year basis, however, growth in Taiwan Province of China remained fairly strong at 3.8 per cent as the economy is on track to record the fastest annual growth rate since 2011.

South Asia: decline in global oil prices pushes inflation lower

The recent decline in global oil prices, combined with slower-than-expected food price increases, has pushed inflation down in most South Asian economies. In India, consumer price inflation fell to a multi-year low of 6.5 per cent (year on year) in September, down from 7.7 per cent in August. In Sri Lanka, the central bank revised its full-year inflation estimate downward as consumer prices increased by only 3.5 per cent in September amid strong economic growth. Against the backdrop of lower global oil prices, India's Government unveiled a set of reforms in the energy sector. The authorities lifted state control on diesel prices and raised natural gas tariffs by 33 per cent. These decisions are aimed at lowering the country's massive fuel subsidy bill, which has been a main factor behind the large fiscal deficit in recent years. High-

er gas prices are also expected to encourage investment in the exploration and production of natural gas in India.

Western Asia: Qatar's economic growth continues to outpace regional average

Qatar's economic growth picked up slightly to 5.7 percent in the second quarter of this year, as non-oil activities continued strong on the back of public spending in infrastructure. Qatar's economy is expected to grow 6.4 per cent this year, well above other Gulf Arab oil exporters. Among non-oil exporters, Jordan's GDP grew by 2.8 per cent during the second quarter of 2014, following a strong quarter for the wholesale-retail trade and hotels-restaurants sector, which continues to post the highest contribution of 0.65 per cent.

Despite the ongoing conflict, Iraq's oil exports rose in September, to an average of 2.542 million bbl/day, as the southern part of the country, where the majority of the oilfields are located, has been relatively safe and stable. As oil prices decline, oil-exporting countries are urged to revise their fiscal spending strategies in order to keep public finances under control in the long run, despite the fact that many of these countries enjoy vast oil wealth. Kuwait's Government for instance, eliminated subsidies for diesel (with potential saving of 0.5 percent of GDP), and is in the advanced stages of preparing a plan to cut subsidies for kerosene and electricity.

Latin America and the Caribbean: inflationary pressures on the rise

During 2014, Latin America and the Caribbean countries have experienced a moderate rise in inflation, continuing a slow but permanent upward trend since mid-2012. In August, the regional accumulated twelve-month variation on the consumer price index was 9.2 per cent, higher than the 7.8 per cent in January. This regional trend is mainly driven by Venezuela (Bolivarian Republic of) and Argentina. In August, the variation of the consumer price index in Venezuela (Bolivarian Republic of) was 3.9 per cent, accumulating an overall variation of 39.0 per cent this year and about 63 per cent in the last twelve months. In Argentina, the national urban consumer price index rose by 1.4 per cent in September, leading to an overall increment of 19.8 per cent since December 2013.

However, other countries have also experienced moderate rises in inflation. In Brazil, for instance, inflationary pressures persist despite the monetary tightening cycle. In September, the consumer price index increased by 0.57 per cent, more than double the variation of the previous month. As a result the accumulated variation of the index in the last twelve months reached a record high of 6.8 per cent. In Chile, the consumer price index rose by 0.8 per cent in September, accumulating a multi-year record-high variation of 4.9 per cent in the last twelve months, above the upper limit of the central bank target range of 4.0 per cent. Despite this, and given the noticeable slowdown in economic activity, the central bank reduced interest rates by 25 basis points in October, which adds to similar interest rate cuts in August and September.