Global issues

Rising food and energy prices could affect the recovery

According to the Food and Agriculture Organization of the United Nations (FAO), the world food price index (2002-2004 = 100) reached an unprecedented high of 231 in January, accelerating the recent upward trend that started in mid-2010 (figure 1). The prices of sugar, oil and fats, and cereals increased strongly (figure 2). Multiple factors are driving these trends, including supply shortages caused by droughts and floods in important production areas while demand—both for consumption and biofuel usage—continued to increase. The depreciating dollar has compounded upward pressures on commodity prices. Oil prices also shot up (figure 1), influenced by the recent political unrest in Northern Africa, which has compounded other upward pressures, including the recovery in global industrial activity, severe winter conditions in the Northern hemisphere, and insufficient investment in oil production capacity.

While commodity-exporting economies benefit from the higher prices, the price spike has increased the cost of living and of production in many parts of the world. Many countries are trying to counteract the inflationary pressures by tightening monetary policy, which—along with the cost increases—could slow the global recovery. The FAO and other observers worry further that countries may be inclined to protect the domestic supply of food by imposing restrictions on exports of certain products. This could risk exacerbating the rise in world market prices.

Developed economies

The recovery in North America continues, but unemployment remains high

The economy of the United States of America grew by 3.2 per cent (annualized, quarter-over-quarter) in the last quarter of 2010. With this estimate, GDP growth for the year 2010 as a whole would come out at 2.9 per cent, slightly higher than the 2.6 per cent estimated in the World Economic Situation and Prospects 2011. Major drivers of the fourth quarter expansion were personal consumption, fixed capital formation and exports. GDP growth was also helped by less leakage of demand to abroad, as imports declined at an annualized rate of 13.6 per cent, mainly owing to a drastic deceleration.
of inventory accumulation. Government spending did not stimulate growth, as it declined slightly as a result of lower outlays for national defence and spending cuts by state and local governments. The unemployment rate dropped to 9.0 per cent in January; down from 9.4 per cent in December. Job growth was disappointing, however, and about three quarters of the drop in the unemployment rate resulted from lower labour participation.

Canada, in contrast, saw labour force participation increased in January, reflecting sustained improvements in the labour situation over the last 18 months. Nonetheless, the unemployment rate increased to 7.8 per cent in January (up from 7.6 per cent), because job growth was insufficient to absorb the increase in the labour force. Meanwhile, concerns expressed by authorities about growing household indebtedness resulted in the decision to tighten the mortgage market by cutting the maximum amortization period from 35 to 30 years and the maximum refinancing amount from 90 to 85 per cent of the property value.

Economies of Japan and Australia are under strain

In January, the Standard and Poor's rating agency lowered the rating of Japan's sovereign debt for the first time since 2002. Japan's public debt represents about 200 per cent of its GDP, the highest among developed countries. Japan's situation differs, however, from that of the debt-distressed European countries. More than 90 per cent of its public debt is held by domestic creditors, compared with 30 per cent in some European countries. In addition, Japan has a surplus in domestic savings, while many of the European economies with high public-sector debt have a deficit. Despite being downgraded, public borrowing costs for Japan remain the lowest among developed economies.

Australia, a major primary exporter, suffered torrential rains in December and cyclone activity in January, especially in the northeastern region of the country. The country's worst floods in decades caused severe damages to agriculture and coal mining. The effect of these natural disasters on GDP growth is estimated to be about 0.4 percentage points. The floods are expected to cause a spike in the international contract prices of coal and push up domestic prices of fruits and vegetables.

Growth in Western Europe continues at a slow pace

Economic activity continues to expand at a slow pace in most of Western Europe with the notable exception of the United Kingdom, which suffered a contraction of 2 per cent (annualized) in the fourth quarter of 2010. Industrial production, excluding construction, increased for the second consecutive month in November but remains 11.3 per cent below its pre-crisis peak reached in February 2008. All sectors, except for consumer non-durables, increased. In contrast, the construction sector continued its decline with no evidence of a turnaround. Capacity utilization rates have been increasing since the lows reached in the third quarter of 2009, and are now just below their long-term averages.

January's Economic Sentiment Indicator of the European Commission remained stable at a level higher than its long-term average but below previous peaks. This indicates that growth is likely to continue at a slow pace in the outlook. A majority of countries reported either improving or stable business and consumer sentiments. Economic agents in Germany continue to be optimistic and its IFO Business climate index increased further to reach a 20-year high. Business sentiments in the countries facing sovereign debt distress remain well below long-term averages.

Headline inflation for the euro area continued its gradual upward trend, reaching 2.2 per cent (year-over-year) in December 2010. Sharp increases in the prices of energy and vegetables pushed up the overall inflation level. Core inflation, which excludes volatile elements like food and energy prices, remains low, though it increased to 1.3 per cent, up from a low of 0.8 per cent in April 2010.

Rising inflation is a concern for the new EU members

The recovery continues among the new EU member States. The statistical office of Poland recorded a strong growth performance in the fourth quarter of 2010 and calculated a flash-estimate of GDP growth of 3.8 per cent for the year as a whole. The main drivers of growth were private consumption and increased inventories. In contrast, the construction sector continued its decline with no evidence of a turnaround. Capacity utilization rates have been increasing since the lows reached in the third quarter of 2009, and are now just below their long-term averages.

Estonia smoothly joined the euro zone on January 1st. As required by the ECB, the minimum reserve requirements on bank deposits was gradually reduced during 2010, from 15 per cent to 2 per cent. The liquidity thus freed up for commercial banks was used to repay their external debts, rather than to extend loans to domestic investors. Also in Estonia, the recovery that started in the second quarter of 2010 is mostly driven by export growth.

Higher food prices are affecting all new EU member States and are posing policy challenges. Hungary, for instance, has imposed higher taxes on large corporations in order to meet ambitious fiscal targets. The tax increase has led to higher inflation, however, which is now compounded by the spike in food prices. Headline inflation reached 4.7 per cent in December 2010. Hungary's central bank has responded by rising interest rates twice in November-December. The monetary tightening could slow output recovery, which in turn could complicate meeting the fiscal targets.
Economies in transition

Robust industrial and weak agricultural performance in the CIS

Strong industrial growth offset the weak performance in agriculture and construction sectors in the CIS countries at the end of 2010. Although growth of industrial output in the Russian Federation did not accelerate further in the fourth quarter, its expansion by 6.5 per cent in the final quarter contributed to overall GDP growth of 4 per cent for the year 2010 as a whole. Similarly, robust industrial output growth supported the strong rebound of Kazakhstan’s economy. Even though growth of industrial output decelerated slightly in the fourth quarter, the sector’s activity expanded by 10 per cent in year 2010, lifting overall GDP growth to 7.1 per cent, according to preliminary official estimates.

The weak performance of agriculture, caused by the drought and wildfires experienced during the summer, contributed to the acceleration of food prices towards the end of 2010. In December, food price inflation reached 6.2 per cent (year-on-year) in Kazakhstan, 22.8 per cent in Georgia, and 14.7 per cent in the Russian Federation. Headline inflation accelerated to 8.7 per cent in the Russian Federation, prompting the authorities to increase the overnight deposit rate by 25 basis points to 2.75 per cent.

South-Eastern Europe: growth resumes with setbacks

The Croatian economy expanded by 0.2 per cent in the third quarter of 2010; a mild turnaround after the contraction of 2.5 per cent in the second quarter. Private consumption rebounded modestly, helped by the abolishment of the income surcharge tax in mid-2010, but investment demand continued to stagnate. In Serbia, the growth momentum of the third quarter could not be sustained in the fourth quarter; however, precise GDP figures have yet to be released. In Albania, heavy floods affected the north-west of the country in December, causing considerable damage to homes and infrastructure.

The Government of the former Yugoslav Republic of Macedonia obtained a two-year Precautionary Credit Line from the IMF in January, after adopting a budget with a deficit that is to stay below 2.5 per cent of GDP in 2011. The IMF loan amounts to €475 million.

Most monetary authorities of the region continue to maintain accommodative monetary policy stances. The exception is the National Bank of Serbia which continued to increase the policy interest rate and tighten reserve requirements in January, expecting to contain inflationary pressures originating from rising food and oil prices as well as from the pass-through effects of the devaluation of its currency depreciation against the euro (by almost 14 per cent) in 2010.

Developing economies

Africa: massive popular protests in North Africa

Popular protests emerged in several North African countries against the backdrop of continuing high rates of unemployment—particularly among workers between 15 and 29 years old, who account for one third of the population. The uprisings in Egypt and Tunisia likely have been spurred by a mixture of factors such as unease over longstanding, but unresolved political accountability issues, and dissatisfaction over the fact that fast economic growth has not translated into sufficient employment creation. In the short run, significant negative impacts are expected on a wide range of areas, including tourism and foreign direct investment. In Algeria, violent protests over rising food prices erupted in early January. The Government responded by intervening on prices of some staple foods.

Post-electoral conflicts intensified in Côte d’Ivoire, the world largest cocoa producer accounting for 40 per cent of the world production, amidst a rising number of people fleeing the country owing to ethnic tensions and outbreaks of yellow fever and cholera.

Overall, these events highlight the risk of increased political and economic instability in the continent in 2011, particularly given the extremely busy electoral agenda, with nearly 20 presidential elections planned across the region, and the impending secession of South Sudan following the outcome of the referendum held in January.

In January, Nigeria’s Government issued its first Eurobond—worth $500 million with a 7.0 per cent yield—which was 2.5 times oversubscribed, suggesting a renewed appetite of international investors for high-yielding assets. At the same time, however, there are growing concerns about the implications of the near depletion of the country’s oil stabilization fund, which now holds a mere $300 million, down from $20 billion four years ago.

Rising inflationary pressures in East Asia

After moderating in the third quarter of 2010, growth accelerated in most East Asian economies in the last quarter of the year. Economic activity expanded by 9.8 per cent in China, 7.3 per cent in Viet Nam, 7.1 per cent in the Philippines, and 6.9 per cent in Indonesia driven by buoyant private consumption and investment.

The strong output growth in the region has been accompanied by rising inflationary pressures, compounded by rising international prices of food and energy. In Viet Nam, for instance, consumer price inflation accelerated to 12.2 per cent in January 2011 owing to currency devaluations, a surge in bank lending and higher food prices. In Indonesia, food prices rose by 15.6 per cent in December, lifting consumer price inflation to 7.0 per cent. Soaring food prices, coupled with higher housing costs, have also pushed up the inflation rate in China, which reached a 28-month high of 5.1 per cent in November before dropping to 4.5 per cent in December. China’s authorities responded by expanding measures to curb bank lending, cool the housing market and contain inflation.
The People's Bank of China increased its main policy rates twice by 25 basis points and further raised bank reserve requirement ratios. The Government also introduced its first property tax for buyers of second homes in Shanghai and Chongqing. At the same time, steps were undertaken to promote wider international use of the renminbi, for example, by allowing selected domestic firms to use renminbi to finance overseas investments.

**Accelerating food price inflation in South Asia**

South Asia’s economies continue to face strong inflationary pressures as prices of many food items—especially fruits and vegetables—have increased rapidly in recent months. While the food price hikes are mainly attributable to supply disruptions, policymakers increasingly fear these will push up other prices. In Pakistan, consumer price inflation reached 15.5 per cent in December. In India, wholesale prices increased by 7.5 per cent in November 2010 and accelerated to 8.4 per cent in December. The prices of fruits and vegetables surged by 22.8 per cent on the back of a jump in onion prices, which was caused by unusually heavy rains in crop areas and has become a source of tensions between India and Pakistan. India’s Government responded to the price increase by temporarily banning onion exports and importing staples from Pakistan. However, in early January, Pakistan banned overland onion exports to India in an attempt to control rising prices at home.

In light of continuing inflationary pressures and strong economic growth, the Reserve Bank of India further tightened monetary conditions, raising policy rates for the seventh time in the current cycle. By contrast, monetary authorities in Sri Lanka lowered interest rates in a bid to stimulate investment, assuming that the recent food price increases would only have a transient effect on inflation.

**Public protests heighten uncertainty in Western Asia**

Public protests in Jordan and Yemen and the possible wider impact of the demonstrations in Egypt have led to heightened economic uncertainty throughout the region.

Food prices increased in a number of countries in the region. They also increased in Turkey, although the overall consumer price inflation decelerated from 7.3 per cent in November to 6.4 per cent in December 2010. The recovery remained robust in Turkey, as evident from the strong increase in industrial production by 16.9 per cent year-on-year (and by 5.7 per cent over the preceding month) in December. The central bank of Turkey lowered its benchmark interest rate by a further 25 basis points to 6.25 per cent in January, in an effort to discourage speculative capital inflows. At the same time, the central bank increased some of the reserve requirements for commercial banks, aiming to rein in bank lending and import demand.

In Israel, GDP growth reached 4.5 per cent in 2010, according to official estimates. The rebound was driven mainly by exports and investment.

In Saudi Arabia, GDP grew by 3.8 per cent in 2010, with growth of government spending outweighing private demand growth. Official estimates show that inflation reached 3.7 per cent in 2010.

**Slowing economic rebound in Latin America and the Caribbean**

Short-term economic indicators confirm that the economic recovery in the region has been robust in 2010. Both the counter-cyclical policies conducted by many of the countries in the region and the revival of world trade and commodity prices were critical to the rebound. However, policymakers are starting to expect a moderation of economic growth in 2011. Recent forecasts indicate that GDP growth is expected to slow to 4.2 per cent for the region as a whole in 2011, down from 6 per cent in 2010. Growth in Brazil is expected to slow to 4.5-5.0 per cent, from 7.7 per cent; in Mexico to between 4 and 4.5 per cent, down from 5.3 per cent; in Argentina to 5-6 per cent, down from 8.4 per cent; and in Peru to 6 per cent, down from 8.6 per cent in 2010.

Several countries, including Brazil, Chile, Peru and the Dominican Republic, have tightened monetary policies in response to mounting inflationary pressures. Inflation in the Bolivarian Republic of Venezuela was decelerating throughout the second half of 2010 but experienced a setback in January due to food price hikes. It is yet unknown whether the currency devaluation of 50 per cent for non-essential imports could add further to inflationary pressures. In Argentina, inflationary pressures persist, exacerbated by setbacks in agriculture due to La Niña and the hike in international energy and commodity prices.

Elsewhere in the region, currencies continue under upward pressure as a result of capital inflows, notably in Mexico and Brazil. The exchange rate appreciation poses a dilemma to policymakers as interest rate hikes to tackle inflation could attract greater inflows of capital.

**LDCs: food security threatened in Southern Africa**

Several least developed countries in Southern Africa have been affected by severe floods. Risks of greater damage remain as the rain season is only halfway through and will be followed by the hurricane season. Among these, Lesotho and Mozambique, among the poorest LDCs, have been severely affected by the destruction of crops and loss of livestock, raising concerns about food security.

The International Monetary Fund and the World Bank granted debt relief to Togo under the multilateral debt relief initiative in December. The relief is worth $1.8 billion in nominal terms, corresponding to an 82 per cent reduction in the country’s outstanding external debt.