Global issues

The United States dollar falls to its lowest level since the 1970s

The value of the United States dollar continued to fall in April against a large number of other currencies. Measured by the trade-weighted nominal exchange-rate index vis-à-vis other major currencies, the dollar has reached its lowest level since the 1970s (see figure). The dollar has also depreciated against the currencies of many emerging economies. The current dollar depreciation trend is being driven by a confluence of factors. Firstly, the process of “flight to safety” amidst the uncertainties in the aftermath of the crisis has now given way to a revived appetite for riskier and higher returns. As other economies raise their interest rates, the United States of America maintains its policy rate near zero, causing international interest-rate differentials to become increasingly more unfavourable for financial investments in the United States. Concerns about the sustainability of the public debt of the United States have also been transformed into expectations for a weaker dollar. Even though the external deficit of the United States has narrowed, it continues to contribute to further increases in the vast accumulated net foreign liability position of the country, putting continued downward pressure on the dollar. As a result of the dollar depreciation, the loss in the book value of dollar reserve holdings of many emerging economies is substantial when measured in their local currencies.

Oil prices continue to rise

Crude oil prices (Brent) edged up further in April, hovering around $125 per barrel for the majority of the month. The rise is mostly driven by political unrest in Western Asia and North Africa, which has caused a shock of confidence as well as supply shortages. The most recent data show that the world oil supply declined by 0.7 million barrels per day (mb/d) in March. Most of the decline was the result of disruptions in production in the Libyan Arab Jamahiriya, but strikes in Yemen, Oman, Gabon and Côte d’Ivoire led to a combined reduction of about 0.1 mbd of crude oil. These production losses could not be offset by the 0.2 mbd increase in oil production by non-OPEC producers. While the supply shocks push up oil prices, there is still considerable slack capacity as OPEC’s effective spare capacity stands at 3.9 mbd, of which 3.2 mbd in Saudi Arabia.

The 30 per cent increase in oil prices since the beginning of 2011 has already entailed a notable impact on the global economy—as visible in recent macroeconomic data—including softening of household consumption demand and rising inflation in a large number of economies. Without an immediate and effective resolution to the unrest in Western Asia and North Africa, or an increase in oil supply, upward pressures on oil prices will persist, with further adverse effects on the global economy.
Developed economies

Outlook for United States public debt downgraded

On 18 April the credit-rating agency Standard and Poor’s revised its long-term outlook for the United States debt from “stable” to “negative”, though it did maintain the current “AAA/A-1+” rating. In support of its decision, Standard and Poor’s argued that the United States is experiencing large budget deficits and rising government indebtedness, and the path towards addressing these issues remains unclear. Besides the unfunded entitlement programmes, the credit-rating agency also quoted the potential for assistance to large players in the United States financial or other sectors as additional risks.

According to the preliminary estimates, the United States economy grew by 1.8 per cent (annualized quarter-over-quarter rate) in the first quarter of 2011, which is lower than the 3.1 per cent reached over the fourth quarter of 2010. The slowdown was mainly caused by the rebound in import demand, further decline in real government expenditure and slower growth of private sector demand.

Canada’s economic recovery also weakened. In February 2011, gross domestic product (GDP) declined by 0.2 per cent from the previous month, having expanded by 0.5 per cent in January. In April 2011, both monetary authorities in Canada and the United States have decided to keep their policy rates unchanged despite the recent spikes in headline inflation.

Japan: economic contraction in the aftermath of the earthquake

Recent data confirmed the severity of the impact of the earthquake on the economy of Japan. Industrial production plummeted 15 per cent (annualized rate) in March, the sharpest monthly decline on record. In the same month, retail sales declined 8 per cent, household spending fell by 2 per cent and employment dropped by 1 per cent. As a result, GDP for the first quarter is expected to contract by more than 1 per cent.

The Government announced the first supplementary budget for restoration and reconstruction. Additional spending totals 4 trillion yen (0.8 per cent of GDP), including 2 trillion yen for public investment, building of temporary housing and restoration of schools and nursing facilities. The rest is for current expenditures, including income transfers to the victims of the earthquake. The supplementary budget will be financed by cutting other expenditures and transfers out of reserve funds and the public pension system, thereby avoiding a further widening of the fiscal deficit. However, the transfer of funds from the pension system may require the system to sell some of its assets which would lead to a further increase in the net debt position of the Government.

Weakening confidence running ahead of fiscal austerity and monetary tightening in Western Europe

The recovery in Western Europe continues to be driven by a rebounding industrial sector, but stronger headwinds are blowing. Industrial production increased in February for the fifth consecutive month and capacity utilization increased to 81.3 per cent for the euro area as a whole, approaching its long-term average of 85.2 per cent. Only construction remains on a declining trend. However, the European Commission’s Economic Sentiment Indicator deteriorated for the second consecutive month. The overall index remains close to its pre-crisis peak, consistent with continuing moderate expansion, but expectations about future trends are turning less optimistic. The German IFO Business Climate Index revealed that the fall in German sentiment is driven entirely by the expectations component, with the current conditions component continuing to increase.

The likely causes of the turn in sentiment are increasing uncertainty stemming from inflationary pressures (headline inflation reached 2.7 per cent in March propelled by rising fuel costs), the strong appreciation of the euro against the United States dollar, and fiscal and monetary tightening. The ECB has raised its main policy rate for the first time since the end of the recession and fiscal consolidation programmes are increasingly coming into force.

The new EU members: producer prices on the rise

Most of the new EU members showed a strong export performance in the first quarter and there are indications that in some of the countries the recovery is becoming more broad-based. According to the flash estimate of GDP, Lithuania’s economy grew by 6.9 per cent in the first quarter.

Cost-push inflation remains a concern in the region. In Estonia, consumer prices increased by 5.6 per cent (year on year) in the first quarter of 2011. In Poland, the effect of higher fuel and food prices was amplified by strong domestic consumption, and inflation reached 4.3 per cent (year on year) in March. In response, the National Bank of Poland further increased its policy rate by 25 basis points in early April. Industrial producer prices are increasing at even faster rates. Producer prices increased in February by 12.5 per cent on year on year in Bulgaria and by 8.4 per cent on year on year in Poland. When the acceleration in producer prices is passed through to consumer prices, central banks will likely move to tighten monetary policy, which could dampen the recovery as credit markets are still weak.
In Slovenia, a law, introduced in 2010 to facilitate part-time employment but limiting the number of hours students are allowed to work was overwhelmingly rejected in a public referendum in April.

**Economies in transition**

*Continued monetary tightening in the CIS*

Monetary authorities in the CIS continue to tighten their policy stance in response to inflationary pressures. Inflation is picking up with the rising cost of food and other commodities in world markets. In Armenia, the refinancing rate was increased by 25 basis points, to 8.25 per cent, in April. This was the third increase in as many months since February. Meanwhile, in Belarus increases in inflation and low reserves triggered authorities to increase interest rates by 150 basis points in March, and another 100 basis points in April, bringing the refinancing rate to 14 per cent. In Kazakhstan and the Russian Federation, the need to offset increases in the money supply resulting from higher foreign-exchange earnings owing to higher oil prices formed another reason to raise the refinancing rate. In Kazakhstan, the rate was increased by 200 basis points, to 9.5 per cent, in April. The Russian Federation raised its rate by 25 basis points, to 8.25 per cent, in May. The monetary tightening could further weaken the still fragile recovery.

As of 1 May, duties on gasoline exports from the world’s largest oil producer, the Russian Federation, were increased by 44 per cent in response to domestic fuel shortages. This was triggered by the widening gap between domestic fuel prices, which are subject to price controls, and increasing international prices. Because of the gap, oil supplies are being diverted to export markets.

**South-Eastern Europe: increased reliance on external finance**

Export-led growth strengthened in Serbia in the first few months of 2011. According to a flash estimate, GDP expanded by 3 per cent in the first quarter. The Government of Serbia reached an agreement with the World Bank on a four-year $800 million loan in April, part of which will be used to cover the budget deficit and the rest to finance new investment projects. In addition, the World Bank approved a $100 million loan to support low-income families which will facilitate controlling salaries in the public sector. The level of public debt is rapidly approaching its legal limit of 45 per cent of GDP as existing debt obligations are being financed through new borrowing. To redress the spiral of rising indebtedness, the Government intends to privatize its telecommunications company and expects to generate over €1 billion in proceeds.

In March, the Government of the former Yugoslav Republic of Macedonia decided to draw €220 million from the IMF Precautionary Credit Line in order to finance the budget deficit. The country is facing difficulties in issuing a Eurobond on affordable terms.

**Developing economies**

*Africa: worsening security situation*

While the security situation in the Libyan Arab Jamahiriya remains dire, the region sustained a further blow with a bomb attack on a café in Marrakesh, Morocco, that killed 15 people. Besides the human toll, the Morocco is concerned in particular about the possible negative impact on the tourism sector. On the policy side, its budget situation worsened drastically in 2010, with the deficit rising from 2.2 per cent of GDP in 2009 to 4.6 per cent. While tax revenue remained largely unchanged, spending rose by almost 13 per cent as higher oil prices underpinned higher subsidy payments on fuel. Subsidies alone rose by almost 130 per cent over 2009 and constituted 18 per cent of total spending in 2010. In Egypt, urban consumer prices increased by 11.5 per cent in March. Food prices were a major driver, increasing by 20 per cent. Meanwhile, Ethiopia benefited from higher coffee prices in world markets. The boom in export earnings reduced the trade deficit and curbed the pressure on foreign-exchange reserves in the second half of 2010.

*East Asia: growth continues to be robust in the first quarter of 2011*

East Asia’s economies continued to register robust growth in the first quarter of 2011. In China, GDP increased by 9.7 per cent year on year, with total consumption contributing 5.9 percentage points to growth. Net exports lost 0.5 percentage points as China reported its first quarterly trade deficit since 2004 owing to rapid import growth. The deficit reflects high prices for oil and minerals as well as seasonal factors such as inventory building by firms and strong household consumption in the wake of the Chinese New Year. In the Republic of Korea, Singapore and Taiwan Province of China, growth accelerated in the first quarter of 2011 from the previous three months, partly due to a better-than-expected performance of the export sector. Strong domestic demand, along with rapidly rising food and energy prices, has led to an upturn in inflation. In March, consumer price inflation rose to 5.4 per cent in China and 4.7 per cent in the Republic of Korea, well above the central banks’ target rates.
The natural disaster in Japan has had only a limited impact on overall economic activity in East Asia. In most economies, growth of manufacturing output and exports thus far has remained robust as firms reduce inventories while looking for alternate input suppliers. Car manufacturers in the Republic of Korea have reported strong sales gains in recent weeks, benefiting from production losses at Japanese rivals. Nonetheless, as some sectors will experience supply shortages in the months ahead, manufacturing output is forecast to weaken in the second quarter.

South Asia: central banks tighten monetary policy as inflation remains elevated

Inflation in most South Asian economies accelerated further in early 2011, driven by sharp increases in food prices. In Bangladesh, year-on-year consumer price inflation reached 10.5 per cent in March, the highest level since July 2008. Food price inflation stood at 13.9 per cent as prices of essential food commodities, particularly rice and wheat, soared. In India, food price inflation returned to single digits in April, after reaching 17 per cent in February. However, this decline was partly offset by higher fuel and power inflation, pushed up by a rise in coal prices.

Inflation has been fuelled further by aggregate demand pressures, most notably in the fast growing economies of India and Sri Lanka. In Sri Lanka, core inflation rose from 3.6 per cent in March to 4.7 per cent in April, while in India, prices of manufacturing products have edged up steadily. Against this backdrop, central banks across the region continue to tighten monetary policy. The Reserve Bank of India raised the key interest rates by 50 basis points, while the Central Bank of Sri Lanka increased the reserve requirement for commercial banks by 100 basis points. In March, the Central Bank of Bangladesh increased its main policy rates for the first time since August 2010.

Costs of prolonged uncertainty in Western Asia

The violent crackdown by forces of the Gulf Cooperation Council that put an end to protests in Bahrain in March and the growing political instability in Yemen and the Syrian Arab Republic keep nurturing the risk of the unrest spreading throughout the region. The protests and (general) labour strikes have affected domestic production and are eroding business and consumer confidence in the region at large. Jordan and Lebanon will be the most affected by the observed decline in tourism, which accounts for 7 per cent and 9 per cent of employment, respectively. Including indirect effects, the sector generates 18 per cent of GDP in Jordan and 32 per cent in Lebanon. Uncertainty is also pushing up the cost of borrowing. Spreads on sovereign bonds as well as interbank rates remain above trend levels in most countries. At the same time, credit growth in Saudi Arabia, Qatar, Turkey and the United Arab Emirates, as well as government spending in Saudi Arabia, are boosting domestic demand and are expected to be significant drivers of output growth in 2011.

Meanwhile, food price inflation exceeded 10 per cent (year over year) in Syria in January and represents a threat to poor households across the region, while the Central Bank of Israel raised its policy rate for the third time since the beginning of the year in order to keep inflation expectations under control.

Latin America and the Caribbean: growth moderated by weaker demand and inflation risks

The strength of the recovery in economies of the region continues to be affected by a possible deceleration of global demand, the weakening or reversals of policy stimuli, and price increases triggered by international factors and domestic demand pressures. Brazil, Chile, Colombia, Mexico, Peru and Uruguay have tightened interest rates in varying degrees over the last two months, aiming to cool domestic demand and/or contain the credit expansion resulting from high capital inflows. The monetary tightening could risk attracting even more inflows, however, as it will further widen interest rate differentials. The lending rate in Mexico is expected to rise further and reach 7 per cent in 2011, up from 5.5 per cent in 2009 and 6.5 per cent in 2010. The lending rate in Colombia will likely climb to 13 per cent in 2011, up from 12 per cent in 2010.

The rise in world food prices affected the economies of the Plurinational State of Bolivia, Chile, El Salvador, Guatemala, Honduras, Nicaragua, Paraguay, and Peru, in particular, given their dependence on food imports. Rising inflation is affecting real incomes and poverty as cash transfer and other social protection programmes are also hitting fiscal constraints. Brazil, Colombia, Chile and El Salvador are limiting the growth of government spending. Chile projects an increase of 5.5 per cent in nominal government spending through 2011, well below the expansion during 2009 (18 per cent) and 2010 (9 per cent). The Government of El Salvador reduced its subsidies on electricity by allowing unit costs to rise by 12.5 per cent. Higher international prices of oil are giving some fiscal breathing space for Ecuador and the Bolivarian Republic of Venezuela.

LDCs: increasing public unrest

In Uganda, public protests continued over rising food and fuel prices and discontent with the political situation. Official data indicate that headline inflation reached 14.1 per cent in April, with food prices surging by about 30 per cent. A similar confluence of factors has been driving violent clashes in Burkina Faso, where the situation was compounded by the spillover effects from the political conflict that affected neighbouring Côte d’Ivoire. ■