Global Issues

Heterogeneous founding members mark major step for the Asian Infrastructure Investment Bank

The decision of over 47 countries—including 13 of the Group of Twenty economies—to join the Asian Infrastructure Investment Bank (AIIB) as its founding members, marks a significant step forward for the multilateral development bank, initiated by China in 2013, with the goal of providing financial support to infrastructure development in Asia’s developing economies. Japan and the United States of America have decided not to submit an application for founding-member status, citing concerns over potential governance issues, but the United States indicated recently to look forward to cooperating with AIIB, acknowledging important infrastructure needs in the region. The Asian Development Bank (ADB), International Monetary Fund (IMF), and World Bank have welcomed the idea of collaborating with AIIB.

ADB estimates that the infrastructure investment needs of Asia and the Pacific amount to $8 trillion during 2010-2020. Comparing the period of 2002-2007 and 2008-2013, UN calculations show that investment growth in a group of selected emerging Asian economies, including China, India, the Republic of Korea, Taiwan Province of China, Thailand and Viet Nam, slowed down in the latter period. Such drops in investment growth average 5.2 percentage points (unweighted) across the economies and took place despite the region’s overall conducive financial condition. This drop reflects the uneven nature of the ongoing economic recovery in the region and uncertainty over the future economic conditions, although overinvestment and diminishing absorption capacity in certain economic sectors, particularly in China, also plays a role. By working with national governments and other multilateral development banks operating in the region, AIIB could potentially play a substantive role in injecting financial resources into countries with an infrastructure funding gap and in spurring private investment. The establishment of the bank would also come at a time when fiscal positions of numerous economies in the region worsen, relative to the 2002-2007 average, which could hamper governments’ ability to step up infrastructure spending in the future. In this light, AIIB, with an authorized capital of $100 billion and an expected initial subscribed capital of $50 billion (ADB had subscribed capital of $162.8 billion by the end of 2013, in comparison), could provide alternative funding support.

Prospective founding member countries are negotiating over the AIIB Articles of Agreement, which are expected to be finalized by mid-2015. A key issue to be discussed is the allocation of voting shares. China is reportedly said not to seek veto power. Other key issues to be deliberated include governance of the bank, establishment of the board of directors, and enforcement of environmental and social safeguards for investment projects. The effectiveness of AIIB in supporting infrastructure investment and promoting broader development would depend critically on these factors, among others.

The impact of low oil prices on household buying power differs widely across countries

The dramatic decline in the price of oil beginning in the second half of 2014 will lead to a significant shift in the global balance of demand. The impact on individual economies depends on a wide range of factors, including the share of national income derived from oil production; the oil intensity of production and consumption; the share of government revenue derived from fuel taxes; the share of government expenditure on energy subsidies in total public spending; and the pass-through of the international oil price to the domestic price level.

One possible way to ascertain the impact of oil prices on overall buying power is to focus on the link to motor fuel and then derive wider implications. While motor fuel is only one of several components of the consumption basket that may be linked to the oil price, and the weight on this good differs significantly across countries, the differences observed in this historical sensitivity offer some insight into the expected impact of recent oil price movements on inflation and household buying power in individual economies. According to UN calculations, in a cross-country panel covering 150 countries, the median pass-through from the oil price to gasoline pump prices between 2000 and 2015 was 50 per cent. The figure below indicates the post-tax subsidies for petroleum products in a subset of countries, distinguishing countries where the historical pass-through of the oil price to gasoline pump prices has been relatively weak (less than 25 per cent) and those where it has been stronger than average (more than 75 per cent).

The overall picture indicates that higher subsidy levels seem associated with a lower pass-through of oil prices to motor gasoline prices. In this context, energy subsidies tend to be higher in the

Summary

- Progress in the creation of the Asian Infrastructure Investment Bank
- GDP growth diverges among developing economies
- Sharp currency depreciations in many emerging economies
fuel-exporting countries, although those in the Commonwealth of Independent States (CIS) are exceptions, and domestic motor gasoline prices in this region have followed global oil prices more closely. At the same time, gasoline prices in developed economies tend to be less sensitive to the oil price, reflecting the level and structure of taxation on energy usage, although there is a greater sensitivity in New Zealand and several of the new European Union (EU) member States. In Africa, prices tend to be more sensitive in Southern and West Africa, and somewhat less sensitive in North, Central and East Africa, although in Sudan and Tunisia domestic prices have historically been relatively sensitive to the oil price. In Asia, price sensitivity has been relatively strong in several East Asian countries, such as China, the Philippines, Indonesia and Thailand, suggesting that domestic households and firms may benefit more from the recent oil price decline than average.

Developed Economies

North America: international investment position deteriorates in the United States

The international investment position (IIP) of the United States has been deteriorating for years. According to data from the Bureau of Economic Analysis (BEA), the negative IIP has expanded by $1532 billion in 2014, to about 39.7 per cent of GDP a historic high; in 2013, that ratio was only 32.6 per cent. In addition to domestic and international structural factors, two special incidents in 2014 prompted the deterioration. The rapid appreciation of the United States dollar (USD) vis-à-vis a wide range of currencies, starting in mid-2014, has reduced the dollar value of foreign assets held by Americans. Market value for foreign assets (excluding financial derivatives) declined by about $860 billion from the end of second quarter of 2014 to year-end. The BEA estimates that the impact of the exchange rate alone led to a more than $440 billion loss in the value of foreign assets during the fourth quarter. Meanwhile, the continuous rising of equity prices has raised the market value for American assets (excluding financial derivatives) held by foreigners, which increased by $619 billion over the same period. BEA also estimates that higher equity prices increased the value of foreign investors’ liabilities by more than $360 billion during the last quarter.

Developed Asia: weakness persists in Japan

Recent data for February 2015 show that recovery in Japan might have decelerated. Both industrial production and export volume have dropped significantly after a strong acceleration in the previous month, with the industrial production level even lower than before the pre-tax hike. The slump in export volume and, correspondingly, in industrial production in February was triggered to a large extent by the Lunar New Year holiday observation in many export destinations for Japan.

Both headline and core inflation rates for Japan have remained on a declining trend from the elevated level that was catalyzed by the April 2014 increase in the consumption tax rate. The most recent figure implies that once the base effect of the higher tax fades out, the inflation rate will be null or even negative.

Dynamics in the labour market are somewhat more upbeat than in other sectors. Employment has sustained an upward trend over the past 12 months; the level in February 2015 is 0.6 per cent higher than one year ago. More importantly, after the gentle rebound of the female labour participation ratio in early 2014, male participation has stabilized over the course of the past few months. However, the ageing population may offset the recent improvement in the participation ratio.

Western Europe: deflation concerns on the rise

Headline prices continued to decline across much of Europe in March. While this is largely attributable to the steep drop in the oil price, core inflation excluding energy has also drifted down to 0.6 per cent in the euro area, raising concerns that deflation may become entrenched in expectations. In response, the European Central Bank (ECB) has stepped up its monetary easing measures, and the anticipated Expanded Asset Purchase Programme was launched on 9 March 2015. While it is far too early to assess the efficacy of the programme in terms of the ECB price stability mandate, financial markets have so far reacted as expected: the euro has depreciated, equity prices have risen, and yields on government bonds have fallen to historic lows, even to negative values. All of these factors should support economic recovery in the euro area this year.

In contrast to the rest of the euro area, government bond yields in Greece have continued to rise. Little concrete progress has been made towards establishing an agreement between Greece and the Eurogroup of Finance Ministers to ensure Greece’s continued access to financial assistance after June. There are signs that capital
outflows from Greece have increased in response to the uncertainty, and there is a risk that capital controls, along the lines of those imposed in Cyprus in 2013, may be needed to maintain stability in the banking system.

**The new EU members: record-low policy rate in Poland**

Most of the new EU member States registered steady gains in industrial production in January. Following strong export sales, seasonally-adjusted industrial output in Hungary increased by 4.4 per cent compared with December. The Czech Republic and Poland also reported positive trends. In the Baltic States, however, industrial output shrank, affected by the weakness of the Russian economy. The Croatian economy also remained weak, with industry contracting by over 4 per cent year on year.

Deflation, caused by lower oil prices and in some cases by oversupply of food, continued in February in most of the region, although it subsided in Bulgaria and Hungary. As inflation in Poland is projected to stay below the target by 2017, the National Bank of Poland in early March cut its main policy rate by 50 basis points to a historically low level of 1.5 per cent, announcing at the same time the end of the easing cycle. However, the ECB quantitative easing has led to a search for a higher return among portfolio investors, and the Polish currency rose to a seven-month high against the euro in March. This may lead to further rate cuts. As wages in the region continue to grow, deflation is boosting purchasing power and consumer spending, but if sustained, it may affect business profitability and investment decisions.

**Economies in Transition**

**CIS: some relaxation of monetary policy in the Russian Federation**

Lower oil prices continue to impact CIS economies, even the energy importers, which are exposed to the markets of Kazakhstan and the Russian Federation. In the Russian Federation, industrial production declined in February by 1.6 per cent year on year as many sectors, including automotive, sharply contracted. Inflation in February reached 16.7 per cent, eroding real wages, which plunged by 9.9 per cent, while the unemployment rate in January increased to 5.8 per cent. However, the currency mildly recovered and stabilized somewhat after its precipitous fall in early 2015. The Central Bank of the Russian Federation cut its key policy rate by 100 basis points to 14 per cent in March.

The IMF has approved a $17.5 billion loan to Ukraine, which should unlock increased financial aid. Earlier in March, the National Bank of Ukraine further hiked its main policy rate to 30 per cent and tightened the mandatory reserve requirements. The weaker Russian currency and the conflict in Ukraine have negatively affected the economy of Belarus, where industrial output in January-February declined by 5.8 per cent year on year. In Georgia, the economy also suffered a fall in exports and a decline in remittances. Its currency has lost about 30 per cent of its value since the beginning of the year, despite repeated central bank interventions. Kazakhstan also experienced difficulties in exporting to the Russian Federation.

**South-Eastern Europe: entry into force of the Stabilization and Association Agreement signed between the EU and Bosnia and Herzegovina**

In March, the EU decided to proceed with the conclusion and entry into force of the Stabilization and Association Agreement (SAA) signed with Bosnia and Herzegovina in 2008, after the country’s leadership promised political and economic reforms. This will allow the country to benefit from reduced trade barriers with the EU.

Inflationary pressures in the region remain weak. In the former Yugoslav Republic of Macedonia, consumer prices declined by 1 per cent on an annual basis in February as prices of agricultural goods dropped by 8.4 per cent. In Serbia, after hitting a historic low in January, inflation started to rise towards the tolerance band, reaching 0.8 per cent in February. Nevertheless, the National Bank of Serbia cut its key policy rate in early March by 50 basis points to 7.5 per cent, citing ample global liquidity conditions (as a result of the ECB quantitative easing) and the recently concluded agreement with the IMF.

**Developing Economies**

**Africa: growth picture improving in a number of countries**

In South Africa, the trade deficit decreased in the fourth quarter of last year, as imports fell by 4.6 per cent over the previous quarter, especially because of lower oil prices, while exports increased by 2.2 per cent. For 2014 as a whole, the trade deficit remained unchanged from the previous year and the current-account deficit amounted to 5.4 per cent of GDP, down from 5.8 per cent in 2013. In January, South Africa’s economy saw a contraction in manufacturing and mining as well as weaker growth in retailing, with electricity shortages being a major factor.

Growth has been picking up in a number of countries in East Africa. Rwanda’s GDP growth rose from 4.6 per cent in 2013 to 7.0 per cent in 2014. The Democratic Republic of the Congo reported growth of 9.5 per cent in 2014, up from 8.5 per cent in 2013. Tanzania estimated growth was maintained at above 7.0 per cent for the second consecutive year, with an expansion of 7.2 per cent in 2014. In North Africa, growth remained mixed, with Morocco’s GDP falling from 4.4 per cent in 2013 to 2.5 per cent in 2014 and Tunisia registering slightly lower growth of 2.3 per cent in 2014 versus 2.5 per cent in 2013. At the same time, GDP expanded by 4.3 per cent in the fourth quarter of 2014 in Egypt, up from only 1.4 per cent in the same period the previous year.

**East Asia: divergent currency performance across the region during the first quarter**

East Asian currencies had divergent performance against the USD in the first quarter of 2015. As of 27 March, while most currencies in the region have depreciated against the USD, the level of weakening varied. The Indonesian rupiah and Malaysian ringgit declined against the USD by over 5.0 per cent, followed by the Singapore dollar at 3.8 per cent. The Chinese yuan, Philippine peso, South Korean won, and Vietnamese dong only experienced small-scale depreciation of less than 1 per cent against the USD. On the other hand, the Taiwan dollar and Thai baht appreciated by 1.5 and 1.1 per cent, respectively. The divergent performance...
reflects cross-economy differences in overall economic strength, current-account balance, and government efforts in maintaining currency stability.

Bank of Korea (BOK) and Bank of Thailand (BOT) cut policy rates, joining central banks in China and Indonesia that did the same earlier this year. Both the base rate of BOK and one-day repurchase rate of BOT were cut 25 basis points to 1.75 per cent in mid-March. The BOK base rate is now at a record-low level.

In China, growth of key domestic economic indicators, including retail sales, industrial production and fixed asset investment, slowed further in the first two months of 2015. While merchandise export grew by 15 per cent on a year-over-year basis, import fell by 20.1 per cent. The significant drop in import value partly reflects price effects, but import volumes were also down across major commodities, notably edible oil, coal, fuel oil and copper. Overall, data suggest sluggish domestic economic momentum.

**South Asia: growth in Sri Lanka moderates amid weak agricultural output**

Sri Lanka’s economy grew by 6.4 per cent year on year in the fourth quarter of 2014, down from 7.7 per cent in the previous three months. The slowdown can be largely attributed to weak agricultural output in the wake of unfavourable weather conditions. Full-year growth in 2014 was 7.4 per cent, making Sri Lanka one of the fastest growing Asian countries.

Amid falling oil prices and lower inflationary pressures, the central banks of India and Pakistan further loosened monetary policy in March. The Reserve Bank of India cut its key lending rate for the second time in 2015, reducing the repurchase rate by 25 basis points to 7.25 per cent. The State Bank of Pakistan lowered its policy rate by 50 basis points to 8 per cent, bringing the total cuts to 200 basis points since November 2014. In both countries, the authorities responded to a broad-based decline in inflation and weakness in parts of the domestic economy. In Pakistan, consumer price inflation slowed to 3.2 per cent year on year in February, the lowest level in 11 years. At the same time, Pakistan’s current-account deficit narrowed considerably in the past six months owing to strong workers’ remittance inflows and declining import growth.

**Western Asia: turmoil in Yemen escalates, increasing risks for the oil market**

In Yemen, the turmoil escalated between Houthi forces and governmental forces, complicating the economic prospects for the country. Given Yemen’s strategic location for oil transportation through the Bab al-Mandab strait, the conflict also presents wider risks for the oil market. Those risks are exacerbated by the fact that the Yemeni conflict could widen into a broader regional conflict, especially after a coalition force, led by Saudi Arabia, launched several air strikes, as an attempt to limit the Houthi’s territorial control. As a result, oil prices surged by 8 per cent in two days, between March 24 and 26, before slipping back.

The Cooperation Council for the Arab States of the Gulf (GCC) countries faces weaker trade positions as a result of lower oil prices. A further weakening of the Iraqi dinar against the USD led the Central Bank of Iraq to suspend daily currency auctions, which had been used to manage the national currency value. This decision could be a sign that the CBI foreign reserves are declining fast, weakening its ability to support the national currency. In Turkey, the current-account deficit narrowed down to $2 billion in January 2015, according to data published by the Central Bank of Turkey, from $5 billion in January 2014. This confirms the continuous downward trend of the current-account deficit throughout 2014, although it is mainly due to weaker import demand, reflecting a sluggish economic activity.

**Latin America and the Caribbean: sharp depreciation of domestic currencies**

In recent months, domestic currencies have depreciated sharply across the region, amid expectations of normalization of the monetary policy in the United States and the plunge in oil prices. In some countries, enduring economic difficulties along with accommodative monetary policy decisions have also contributed to this depreciation trend. Since October 2014, the Brazilian real and Colombian peso fell by more than 25 per cent, reaching multi-year record lows in recent weeks. The Mexican peso also depreciated noticeably—close to 12 per cent—while domestic currencies in Chile and Peru fell by about 6 per cent. Given the relatively limited space for fiscal and monetary policies, the exchange-rate fluctuations have become crucial for regional economies to adjust to the new global economic conditions.

The depreciation of domestic currencies is expected to boost exports and to improve external accounts, counterbalancing to some extent the strong negative effects of lower commodity prices over the terms of trade. At the same time, the depreciation is pushing up consumer prices in countries such as Brazil and Chile—where inflation is already above central banks’ targets—although this is expected to be a temporary effect. Even more relevant the dollar appreciation is also raising concerns over dollar-denominated debt in the corporate sector. Given that corporate revenues are mostly denominated in domestic currencies, and that firms with dollar revenues are mostly in mining and oil sectors (where prices have decreased significantly), servicing the dollar-denominated debt might become difficult. In case the depreciation strengthens further, the impact over the debt burden might offset its positive effects on economic activity, spreading out additional financial turbulences across the region.