Development Policy and Analysis Division ◆ Department of Economic and Social Affairs

World Economic Situation and Prospects
Monthly Briefing

No. 69 August 2014

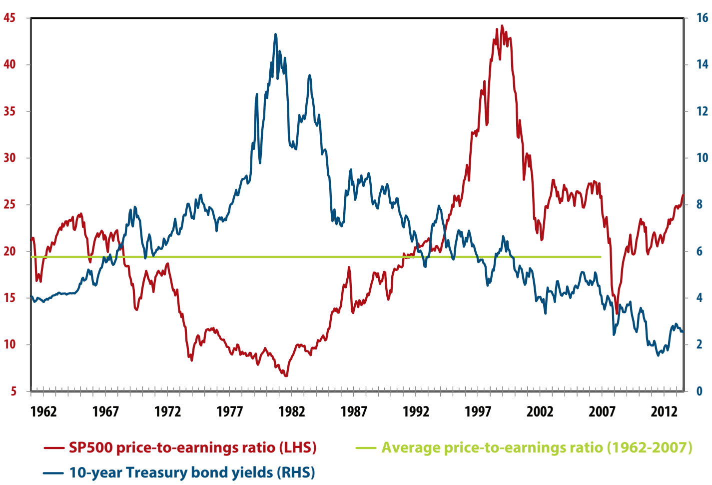
Global Issues

Global equity markets face potential policy shocks

Extremely loose monetary policies adopted by major monetary authorities in developed economies over the past few years have helped equity markets in both developed and developing economies to bounce back from the low of 2009. In North America, several stock price indices (Dow Jones Industrial Average, Standard & Poor's 500, and Toronto Stock Exchange index) reached historical highs in July of this year. Volatility indicators for those indices also fell to the lowest levels ever reported. Similar but less spectacular changes are also noticeable in other countries' stock price indices, such as the German DAX index and the Malaysian KLSE index.

Consequently, the real price for stocks, as measured by the ratio of equity prices to dividends, is back to the level observed just before the beginning of the Great Recession (*Figure 1*), when it was significantly higher than its long-term average. Figure 1 also reveals a significant negative correlation between interest rates (represented by the 10-year United States Treasury bond yields) and equity markets activity. Considering this relationship, a major upward movement of interest rates may trigger a downward adjustment of stock prices, which could cause a disturbance to the global economy and financial markets. The rapid downward movement of many stock price indices already observed in late July, underpins the potential risk of current elevated equity prices. The risk is especially high for equities whose prices have been supported by share repurchase programs, which were funded through debt issuance. Such stock prices will be more sensitive to higher funding costs.

Figure 1: Price-to-earnings ratio for Standard & Poor's 500 and 10-year United States Treasury bond yields (January 1962 to July 2014)



Source: UN/DESA, based on data from the United States Federal Reserve and calculation of Robert Shiller (available from http://www.econ.yale.edu/~shiller/data.htm).

Summary

- Global Equity Markets Face Potential Policy Shocks
- BRICS Announce the Creation of the New Development Bank
- Argentina Defaults on its Sovereign Debt

BRICS countries strengthen their international development agenda

During the sixth annual summit of the BRICS countries (Brazil, Russian Federation, India, China and South Africa), the creation of the New Development Bank (NDB) was officially announced. The BRICS countries, which together represent approximately 40 per cent of the world population and one fifth of the global economy, established the NDB with the purpose of mobilizing financial resources for infrastructure and sustainable development projects in emerging and developing economies. This announcement represents a turning point in the BRICS agenda, which so far had not included concrete development-oriented actions.

The NDB, whose headquarters will be located in Shanghai, has an initial subscribed capital of $50 billion divided equally among the members. The funding activities will be in the form of loans, guarantees, equity participation and other instruments for public or private projects, providing a new alternative for financing infrastructure projects in emerging and developing countries. As development financing needs in these economies are expected to be enormous in the coming decades, the NDB can complement the existing operations from the World Bank and other regional and national development banks in reducing the funding gap. The NDB will take two years to become operational and to define more clearly the details of its functioning.

In addition, the BRICS countries launched the Contingent Reserve Arrangement (CRA) with an initial size of $100 billion. The mandate of the CRA is to provide liquidity through currency swaps, in response to potential short-term balance-of-payments pressures, currency crises or sustained capital flight. Thus, the CRA could function as a crisis mitigation tool as well as establishing a precautionary approach, while supporting and complementing the global financial safety net and other international agreements. Unlike the NDB, the contribution of each member to the CRA takes into account the relative size of their economies. The operational guidelines stipulate that a country requesting assistance

Prepared by the Global Economic Monitoring Unit: Pingfan Hong (Chief), Sergio P. Vieira (Coordinator), Clive Altshuler, Grigor Agabekian, Hung-Yi Li, Matthias Kempf, Ingo Pitterle, John Winkel and Sebastian Vergara, supported by Mary Lee Kortes, Nancy Settecasi, Leah C. Kennedy, Cordelia Gow, Ann D'lima, and Gabe Scelta.
Contact email: hong@un.org, http://www.un.org/en/development/desa/policy/wesp/wesp_mb.shtml

from the CRA will have to agree on a short-term swap with each BRICS member. China can request call on half of its contribution to the CRA and South Africa on double its contribution, while Brazil, India and Russia can withdraw the equivalent of their initial contributions.

Developed Economies

The United States: economic rebound from the earlier slump

Many institutional forecasters, including the International Monetary Fund (IMF), have recently made downward adjustments to their projections for the 2014 gross domestic product (GDP) growth of the United States of America. This adjustment mostly reflects a revision in the official statistics for the first quarter of 2014, rather than more pessimistic prospects for the rest of the year. The latest official revision shows that the United States GDP contracted by 2.1 per cent in the first quarter of 2014 instead of growing by 0.1 per cent, as initially estimated. The main reasons for this adjustment are the worse-than-anticipated effects of winter and the adoption of a new database to help measure health-care consumption.

Conversely, the most recent release shows that GDP rebounded in the second quarter of 2014 at an annualized rate of 4.0 per cent. Most factors that contributed to the downturn in the first quarter have faded out completely. The speed of inventory build-up reached the second highest level since the recession ended, and both personal consumption on goods and private fixed investment expanded solidly. The only factor that was still a drag on growth was net exports. Exports of goods and services recovered from a contraction of 9.2 per cent in the first quarter to 9.5 per cent growth in the second quarter. At the same time, the growth rate of imports for goods and services increased from 2.2 per cent to 11.7 per cent, which widened the trade deficit compared to the previous quarter.

Developed Asia: monetary tightening continues in New Zealand

On July 24, the Reserve Bank of New Zealand (RBNZ) increased its policy rate by 25 basis points to 3.5 per cent. This was the fourth time the RBNZ applied the same magnitude of monetary tightening since March 2014, after having kept it stable for three years. The RBNZ was concerned that the expected robust growth would absorb spare capacity and decided to anchor inflation expectations with a higher interest rate.

Recent statistics show that the Japanese economy was still adjusting to the higher consumption tax during the second quarter. In May and June, total retail sales increased gradually after the significant slump in April caused by the tax hike. However, its level was still lower than one year ago in both months. In mid-July, sales of major home appliances were still much lower than one year ago. Also, data from the Bank of Japan show that export volume declined again in June, while import volume bounced back. The trade deficit remained at an elevated level in June, as in the past few months. Weaker internal and external demand has driven industrial production downward during the past three months. Nevertheless, the employment level in June remained at the same level as May, which was about 0.9 per cent higher than one year ago.

Western Europe: moderate growth in the second quarter

After only 0.2 per cent growth (quarter over quarter) in the first quarter of 2014, GDP in the euro area is expected to grow at a similarly tepid pace in the second quarter of the year. Short-term activity indices and measures of confidence show no evidence of a significant pickup in activity. Industrial production fell sharply in May after a decent pickup in April, and the index remains more than 10 per cent below its 2008 peak. The construction sector also declined sharply in May. The improvement in retail trade during the early part of the year stalled in April and May. The European Commission's Economic Sentiment Indicator fell in July after stalling in June, but remains above its long-term average, which is consistent with continuing growth. The Markit Composite euro area Purchasing Managers' Index tells a similar story, after rebounding from a six-month low of 52.8 in June to 54.0 in July, where 50 is the point demarking expansion from contraction. The threat of deflation remains a concern, as euro area annual inflation weakened again in July, falling to 0.4 per cent year over year. Nevertheless, high energy prices have kept core inflation at 0.8 per cent. As growth remains weak, the unemployment rate continued its glacial pace of improvement, declining to 11.5 per cent in June, down from 11.8 per cent in January.

The new EU members: slower activity in some economies

Although the second quarter economic activity in the new European Union (EU) member States was more dynamic than a year ago, in June the region suffered from the slowdown of the leading EU-15 economies. In Poland, the largest economy of the region, industrial production grew by a mere 1.7 per cent year on year. Domestic demand remained robust, nevertheless, with the construction sector supporting investment activity and sustaining generally positive trends in the economy. A similar picture was observed in other parts of the region. Labour markets improved in June, owing in part to seasonal factors (especially in Croatia, where the tourism industry is an important source of employment).

Inflation in the new EU member States continued to undershoot their central banks' targets, curbed by falling agricultural prices, by previous administrative price cuts, and, in some cases, by the strong euro. In June, annual inflation stood at 0.2 per cent in Lithuania, 0.3 per cent in Poland, zero in the Czech Republic, and negative in Croatia, Estonia and Hungary. As a result, in July, the National Bank of Hungary cut its main policy rate to another record low of 2.1 per cent, while at the same time it announced the end of the two-year reduction cycle. The National Bank of Romania lowered the mandatory reserve requirement for foreign currency deposits.

Economies in Transition

CIS: broad economic slowdown

Many CIS economies exhibited lower dynamism in the first half of 2014 than a year ago. In the Russian Federation, which has a strong regional impact, GDP growth had initially strengthened in the second quarter—thanks to higher natural gas and energy output and weaker competition from the Ukrainian products, as imports from Ukraine declined—and consumer confidence slightly improved. However, in June, seasonally adjusted industrial output contracted by 0.7 per cent month on month and grew by only 0.4 per cent year on year, dragging down the quarterly figure. Retail sales expanded by just 0.7 per cent year on year, as high inflation (at 7.8 per cent) eroded real wage growth. Amid current tensions between the Russian Federation and Ukraine, new economic sanctions were introduced in July by Canada, the United States and the EU, targeting specific sectors of the Russian economy and a number of companies and banks, which complicates Russian institutions' access to external financing. In late July, the Central Bank of the Russian Federation hiked its policy rate by 50 basis points, due to higher inflation expectations, as a result of the geopolitical tensions and prospective changes in tariffs and taxes.

In Ukraine, GDP fell by 4.7 per cent in the second quarter and by 3.0 per cent in the first half of the year because of the ongoing military conflict. In mid-July, the IMF reached a staff-level agreement with the Government of Ukraine to deliver the second tranche of its Stand-By loan, amounting to about $1.4 billion. Acknowledging the current deteriorating economic conditions, the IMF has revised some of the loan requirements for 2014-2015. Nevertheless, to obtain the tranche, the Government still has to reduce public spending and compensate the increased military expenditure with cuts in other areas.

The economy of Kazakhstan has slowed down in the first two quarters, growing by only 3.9 per cent year on year, in part because oil output contracted by 9.1 per cent year on year in June. Kyrgyzstan registered 4.1 per cent real GDP growth for the first half of the year—much slower than a year ago, curbed by weaker gold prices and slowing household demand, which depends on remittances from Kazakhstan and the Russian Federation. In Tajikistan, GDP expanded by 6.7 per cent in the first half of 2014, also much less than a year ago, because of contracting aluminium output and weaker inflow of remittances.

South-Eastern Europe: addressing flood damage

In May, Bosnia and Herzegovina and Serbia were seriously affected by devastating floods. During a July conference convened by the European Commission along with France and Slovenia, donors pledged €1.8 billion in assistance.

In Serbia, industrial production declined by 7 per cent year on year in May, with mining and energy output particularly affected (mainly as a consequence of the floods). The restoration efforts, as well as the construction of the South Stream gas pipeline—initiated despite the European Commission's recommendation that construction be suspended until the project fully conforms to EU regulations—should provide some impetus to the economy.

Inflation in South-Eastern Europe remains low; in Serbia, it reached a record 50-year low of 1.3 per cent year on year in June, below the target range. However, the National Bank of Serbia refrained from further rate cuts, expecting subsidized lending to boost the economy instead. In Albania, inflation also remained below the central bank's target, at 1.5 per cent in June.

Developing Economies

Africa: monetary policy tightening amid a mixed inflation picture

In South Africa, the central bank raised its policy interest rate by 25 basis points to 5.75 per cent, amid persistent inflation pressures stemming from strong wage increases and a weaker currency. At the same time, the inflation rate for June remained unchanged at 6.6 per cent, exceeding the policy target range of 3 to 6 per cent. Likewise, the Bank of Namibia raised its policy interest rate by 25 basis points to 5.75 per cent to reduce domestic credit demand. Inflation was down in June across much of East Africa, even amid rainfall deficits in some agricultural regions. Inflation fell from 8.7 to 8.5 per cent in Ethiopia, from 1.9 to 1.4 per cent in Rwanda, from 1.4 to 1.1 per cent in Seychelles, and from 5 to 4.3 per cent in Uganda. Inflation is up slightly over the first half of the year in Tanzania, from 6.0 per cent in January to 6.4 per cent in June and up to 7.67 per cent in Kenya in June from a low of 6.3 per cent in February. A notable exception was Sudan, where inflation remains stubbornly high at 45.3 per cent year on year in June.

Nigeria's economy grew by 6.2 per cent in the first quarter, up from 4.5 per cent in the previous year. The non-oil sector proved to be a major driving force for this performance, with manufacturing registering a particularly strong expansion. Meanwhile, in Botswana, economic growth reached 5.2 per cent in the first quarter, following a strong expansion in the mining sector. GDP grew by 2.3 per cent year on year in Morocco in the second quarter of 2014, up from 1.7 per cent in the first quarter and mainly as a result of growth in the manufacturing, mining and tourism sectors. First-quarter GDP growth in Rwanda was 7.4 per cent, propelled by expansion in the services sector. Economic expansion was more muted in Uganda in the 2013/14 fiscal year, coming in at only 4.7 per cent, below previous government projections of 6.2 per cent, as industry and manufacturing faltered.

Tax revenues were up 10 per cent in Burundi for the first half of 2014, but still fell short of official forecasts. Growth has boosted tax revenue, particularly value-added taxes, but a tax cut on corporate profits implemented last year—from 35 to 30 per cent—reduced revenues. As a result of the shortfall, new taxes on alcoholic beverages, tobacco, mobile phones and some other products, as well as on airport departures and fuel, have been proposed.

East Asia: recent data indicate mixed GDP growth picture

Growth data for the second quarter of 2014 present a mixed picture for East Asia. The Chinese economy grew by 7.5 per cent year on year, up from 7.4 per cent in the first quarter. On a seasonally adjusted quarter-on-quarter basis, growth accelerated from 1.5 per cent to 2.0 per cent. The pickup in growth can be largely attributed to a set of stimulus measures recently implemented by the Government and the central bank. The data also indicate some progress in rebalancing the economy: In the first half of 2014, final consumption expenditure (private and public) accounted for 54.4 per cent of GDP growth (up from 50 per cent in 2013), while fixed capital formation contributed 48.5 per cent (down from 54.4 per cent in 2013) and net exports—2.9 per cent (up from -4.4 per cent in 2013). In Taiwan Province of China, economic activity in the second quarter was boosted by robust growth in exports and a recovery in investment. GDP grew by 3.8 per cent year on year, the fastest pace in the past six quarters. Growth in the Republic of Korea, by contrast, slowed from 3.9 per cent in the first quarter to 3.6 per cent in the second, as domestic demand lost momentum. In response to the weakening growth, the Government announced a new stimulus package that includes a relaxation of rules on mortgage lending and additional funding to small businesses.

South Asia: growth picks up in several economies

In several South Asian countries, economic activity has picked up, supported by an improved policy environment, more stable macroeconomic conditions and generally good harvests. In Pakistan, GDP growth accelerated from 3.7 per cent in the fiscal year 2012/13 to 4.1 per cent in 2013/14, the fastest pace since the global financial crisis. The acceleration in growth can be primarily attributed to a recovery in the industrial sector, which has benefited from enhanced energy availability and stronger business and consumer confidence. In Bangladesh, real GDP is estimated to have grown by 6.1 per cent in 2013/14, slightly up from 6 per cent in 2012/13 and well above expectations. The domestic economy was largely unaffected by social unrest in the first half of the fiscal year and by a decline in remittance inflows. Output growth in the agricultural, forestry and fishing sector accelerated from 2.5 per cent in 2012/13 to 3.3 per cent in 2013/14. The short-term economic outlook has also slightly improved in India, where industrial production rose significantly in the second quarter of 2014, while wholesale price inflation and consumer price inflation eased. There are risks related to India's weak monsoon, however, as total rainfalls in the first two months of the season were 22 per cent below average.

Western Asia: economic expansion hampered by ongoing conflicts in the region

The conflict in the Gaza strip is expected to hurt economic growth and add pressure on governments' finances in the region. In Israel, the central bank reckons the current conflict may affect GDP growth by half a percentage point this year, based on the assumption that the conflict will not last long. Nevertheless, the Israeli economy was already expanding at a slower pace than previously expected and the growth forecast had been trimmed to 2.9 per cent in 2014 from 3.3 per cent anticipated earlier this year. As a preventive measure to compensate for the economic damage from the conflict, the Bank of Israel cut its benchmark interest rate by 25 basis points to 0.5 per cent. The conflict in Iraq is also affecting several economies in the region (see Monthly Briefing No. 68, July 2014), including Turkey's export sector, which fell almost 20 per cent in June. The impact on Turkey's exports was partially offset by a revival in European demand. Nevertheless, the trade deficit fell by 21.9 per cent year on year during the first half of 2014. This has helped to narrow Turkey's current-account deficit. In Iraq, oil exports from the southern regions rose in July, helping oil prices to fall back below $108 a barrel from a peak of $115 a barrel in June. Among other oil exporters, Saudi Arabia's economic growth eased to 4.7 per cent year on year during the first three months of 2014, after reaching 5 per cent in the last quarter of 2013. The main factor behind the slowdown has been the new labour market policy. Around one million foreign workers left Saudi Arabia in 2013 after a tight control on visa irregularities was implemented as part of the reforms aimed at providing more jobs for Saudi nationals. The non-oil private sector, which relied on a cheap foreign labour force, was more seriously affected.

Latin America and the Caribbean: Argentina defaults on its sovereign debt

In late July, Argentina defaulted on its sovereign debt, although the country is able to pay off its current bond debt obligations. In the previous month, a United States federal court in New York City ruled to prohibit Argentina's Government from paying its main bondholders, unless it settles an old debt dispute with a small group of hedge funds (called the "holdouts") from the country's previous default and debt restructuring in 2001. However, a potential agreement with the holdouts, who insist on full repayment of the original debt of $1.3 billion plus interest, would activate the "rights upon future offers" clause. As it stands now, the clause prohibits the Government from offering anyone a better deal than they offered to creditors who entered into the debt restructuring in 2005. If this clause prevails, the country will be exposed to $15 billion worth of payments. Continuing default will significantly affect Argentina's economy, which is already under a severe slowdown.

Investment demand continues to be subdued in many countries, significantly affecting the current economic situation and prospects in the region. During the first quarter of 2014, gross fixed capital formation in Chile fell by 5.0 per cent year on year. During the same period, gross fixed capital formation in Brazil decreased by 2.1 per cent, both year on year and quarter on quarter, while in Argentina it decreased by 0.3 per cent in comparison to the last quarter of 2013. In Mexico, gross fixed investment also decreased by 1.4 per cent year on year, between January and April, despite significant reform efforts in key sectors, such as energy and telecommunications.