



World Economic Situation and Prospects

Monthly Briefing

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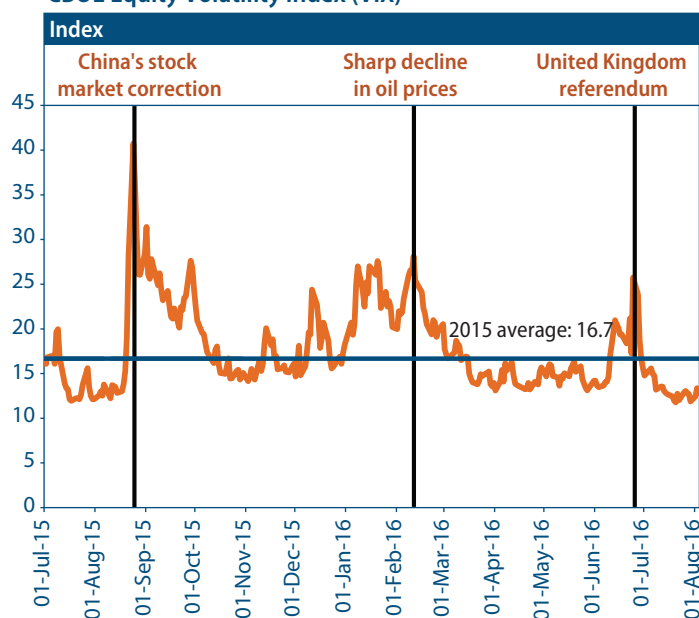
Global issues

Central banks respond to increased global uncertainty in the aftermath of the UK referendum

The sharp initial reaction of global financial markets to the referendum decision of the United Kingdom of Great Britain and Northern Ireland to leave the European Union (EU) has largely subsided. Equity market volatility has declined (figure 1), while major exchange rates have broadly stabilized. Investor sentiments, however, remain fragile amid a lack of clarity over the United Kingdom's future relationship with the EU. Financial markets remain susceptible to a rapid escalation of risk aversion and renewed bouts of heightened volatility.

The high degree of uncertainty generated by the “Brexit” vote prompted central banks worldwide to undertake measures to minimize macroeconomic and financial instability. To support financial intermediation and credit flows, several central banks, including the Bank of England (BoE), the Norges Bank, the Bank of Japan (BoJ) and the Bank of Korea, injected short-term liquidity into their respective banking systems. In addition, the Swiss National Bank announced that it had intervened in the foreign exchange market to stabilize the value of the Swiss franc.

Figure 1
CBOE Equity Volatility Index (VIX)



Source: Chicago Board Options Exchange (CBOE).

Summary

- Brexit triggers policy responses from central banks in both the developed and developing regions
- The weak global economy restrains remittance flows
- China's GDP growth stabilizes

The additional headwinds arising from Brexit have reinforced the pressure on central banks in developed countries to further ease monetary policy, amid modest growth and low inflation. Given the significant downward revision to its growth outlook for the United Kingdom, the BoE reduced its policy rate by 25 basis points to a historic low of 0.25 per cent. It also announced a package of stimulus measures to support economic activity, which include the purchase of up to £10 billion of corporate bonds and an expansion of government bond purchases by £60 billion during the next six months. However, the corporate bond purchase will be limited to companies that make “material contribution” to the UK economy. The BoE also launched a new Term Funding Scheme to provide funds to banks at interest rates close to the policy rate, aimed at ensuring that the lower policy rate actually benefits households and businesses. Meanwhile, the BoJ increased its exchange traded fund purchases, while the European Central Bank indicated its readiness to introduce further monetary stimulus, should economic and financial conditions deteriorate significantly. In the United States of America, prospects for an interest rate increase by year-end have declined relative to widely held expectations before the referendum.

Among the developing economies and economies in transition, several central banks have announced changes to key policy rates. Many cited concerns over a deterioration in global growth prospects following Brexit, with potential adverse spillover effects on domestic macroeconomic conditions going forward. The policy responses were, however, not uniform, with policy rates moving in both directions. This, in part, reflected differing assessments over the impact of increased external risks on the domestic growth and inflation outlook. Given a weaker outlook for external demand and hence domestic growth prospects, central banks in Malaysia, Mauritius, Serbia and Taiwan Province of China lowered interest rates to support domestic economic activity. In contrast, the Central Bank of Mexico raised its policy rate, despite signs of weakening growth. Amid elevated global risk aversion, the move was aimed at preventing a further depreciation of the peso and to contain rising inflation expectations.

The swift response of central banks to the referendum results, particularly in affirming their readiness to implement further monetary easing measures, led to further gains in stock and bond markets. Several US equity indices reached all-time highs in July. The widening divergence between buoyant financial market conditions and weak global economic activity represents a potential downside risk to global growth. In particular, a sharp and disorderly asset price adjustment may increase deleveraging pressures, with adverse implications on aggregate demand.

Diverging trends in remittance flows amid weak global growth

Although more stable than most other private capital flows, migrant remittances have been affected by the slower-than-anticipated expansion of the global economy. As many developing countries are highly dependent on remittance inflows, trends in these flows have important implications for growth and development prospects of these economies. In Tajikistan, remittances account for over 40 per cent of gross domestic product (GDP), while in Bermuda and Nepal, they amount to 23 per cent and 29 per cent of GDP, respectively.

In many ways, remittances have a similar economic effect as domestic wages, with both increasing the disposable income of households and private consumption. On the other hand, remittances' impact on savings, investment and output growth largely depends on what stage of financial sector development an economy is experiencing. Even when a financial sector is underdeveloped, remittances can support the housing sector (such as in Central Asia), facilitate the creation of small or medium-sized businesses and boost spending on education.

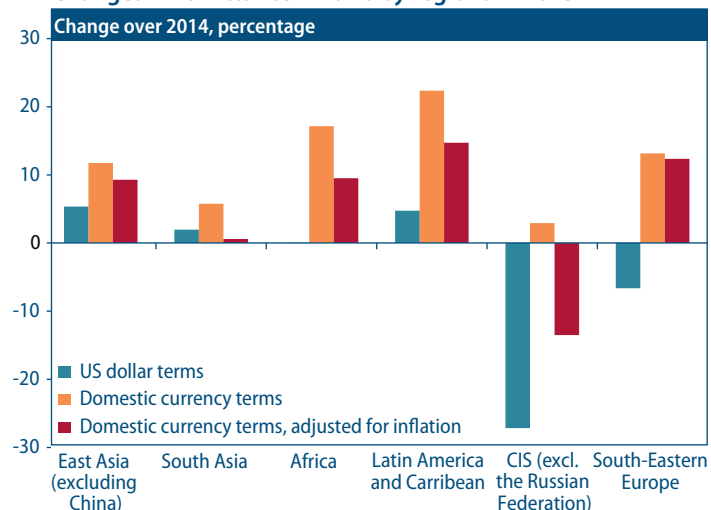
In addition, remittances have cross-border and balance-of-payments effects. Remittances can provide an important source of foreign exchange and help to cover a country's trade or current-account deficits. However, large-scale inflows of remittances may also put upward pressure on the exchange rate and erode export competitiveness. They may also drive up prices of non-tradable goods and spur inflation. Nevertheless, in many cases, remittances remain crucial to alleviating poverty and promoting economic development in many developing regions.

According to the World Bank's estimates, growth in remittance flows to developing countries slowed noticeably in 2015. Overall inflows to developing countries grew only marginally to \$431.6 billion, from \$430 billion in 2014, despite the declining average cost of sending remittances. This aggregate global dollar value of remittances masks significant regional variations. While remittances to Latin America and the Caribbean grew, they contracted slightly in the Middle East and North Africa, remained relatively stable in sub-Saharan Africa and increased moderately in Asia. At the same time, remittances to the Commonwealth of Independent States (CIS) area fell sharply, by 20 to 40 per cent in dollar terms. Those trends largely continued in the first two quarters of 2016. In Mexico, remittances increased by 8.6 per cent on a year-on-year basis in the first quarter. In contrast, the contraction in remittances to the CIS continued. In certain cases, the "reverse" flows of remittances to the Russian Federation in early 2016 increased, as families in home countries provided support to the migrant workers facing temporary difficulties.

Among the factors that have affected recent trends in remittance flows were: economic performance and labour market conditions in remittance-sending countries (the Latin America and Caribbean region has benefitted from improving US labour market conditions), commodity prices and exchange rates. The weaker euro versus the dollar partly explained the decline in dollar value of remittances to the small South-East European economies, where remittances are predominantly sourced from the euro area. The sharp contraction of remittances in the CIS, in turn, reflects the sharp depreciations of the Russian and Kazakh currencies in the second half of 2015, in line with falling oil prices and worsening labour market opportunities for migrants in those countries. However, fixed exchange rates and countercyclical fiscal spending mitigated the impact of lower oil prices on remittance outflows from several major oil-exporters in the Gulf region.

While measuring remittances in US dollar terms provides a convenient basis for international comparison, it does not fully capture balance-of-payments effects or changes in the real purchasing power of their recipients. For instance, the contraction of remittances in the CIS measured in Russian rouble or domestic currency terms was much milder (figure 2). This partially mitigated the impact on private consumption, although, after adjusting for inflation, remittances to the CIS still contracted by 13.5 per cent.

Figure 2
Changes in remittance inflows by regions in 2015



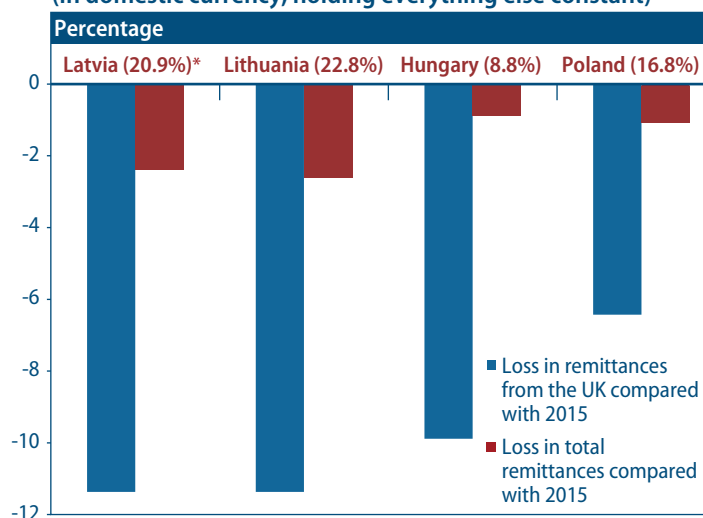
Note: Aggregation in domestic currency is made using each country's share in the total US dollar value of remittance inflows into the regions.

Source: World Bank, UN/DESA.

Looking forward, diverging trends in remittance flows are expected to continue in the near term. Inflows to Latin America may continue to grow as the labour market in the United States strengthens. Stabilization of emerging-market currencies versus the US dollar will alleviate some of the adverse exchange rate effects on remittance flows from those countries. However, in the CIS area, the recovery is likely to be very gradual.

For regions receiving remittances from Europe, the recovery is likely to remain slow, as the region faces increased risks to growth following the Brexit referendum. The weaker British pound sterling in the second half of 2016 will also affect the "real" value of the

Figure 3
Estimated loss of remittances to selected East European countries in 2016 as a result of the weaker pound sterling (in domestic currency, holding everything else constant)



Source: UN/DESA.

* Numbers in parentheses reflect the share of remittances from the United Kingdom in 2015.

remittances sent from the United Kingdom (figure 3). This is especially relevant for the East European countries that joined the EU in 2004 and 2007 and experienced noticeable labour migration to the United Kingdom. Going forward, possible restrictions on such migration may weigh further on these remittance flows. For those countries, however, their remittance-to-GDP ratio is relatively low, ranging from only 1 per cent in Poland to 5 per cent in Latvia. Nevertheless, they provide important lifeline support for migrant families in the countries of origin.

US dollar continues to strengthen

The US dollar has appreciated by 10 per cent against the British pound sterling since the United Kingdom's referendum on EU membership on 23 June. The bilateral shift in the dollar-sterling rate, however, is only one factor behind the continued strengthening of the US dollar, which has been ongoing since mid-2014. Over the last two years, the US dollar has appreciated by roughly 20 per cent against the euro, the Canadian dollar and the Australian dollar; by 7 per cent against the Chinese renminbi; by close to 50 per cent against the Brazilian real and the Russian rouble; and by more than 10 per cent against the Indian rupee. Of the major currencies, only the Japanese yen has strengthened relative to the US dollar since mid-2014.

While the strength of the US dollar is consistent with the stronger cyclical recovery in the United States and the diverging monetary policy actions by the United States Federal Reserve compared to most other developed-country central banks, it nonetheless raises concerns, especially for countries that hold large amounts of US dollar-denominated debt. The costs of servicing that debt continue to rise as the US dollar strengthens against the currencies of the debtor countries. The strong US dollar is also one factor behind the widening current-account deficit in the United States. The volume of exports from the United States in the first five months of 2016 was 1.5 per cent lower than a year earlier. The United States current-account deficit, at 2.7 per cent of GDP,

remains well below the levels of close to 6 per cent of GDP observed in the years leading up to the global financial crises. Nonetheless, a widening of global imbalances may pose an additional risk to the already modest global economic recovery.

Western Europe: inflation rates remain on diverging trends

In June, inflation trends in Western Europe remained divergent. In France, inflation reached 0.2 per cent—the first positive annual inflation rate after four months of deflation, in view of a diminished negative impact of energy prices. In contrast, prices fell by 0.2 per cent in the Netherlands, although core inflation, which excludes prices for energy and food, stood at 0.7 per cent. In both Norway and Sweden, inflation reached multi-year highs. In Norway, consumer prices increased by 3.7 per cent, driven by higher import prices. However, the fading impact of currency depreciation is expected to reduce inflationary pressures in the coming months.

Economies in transition: Russian rouble less sensitive to oil prices

The CIS economies are still adjusting to the 2015 terms of trade shock caused by the sharp fall in energy prices, which resulted in significant fiscal tightening, higher interest rates and currency devaluations. While overall public spending remains tight, Governments and central banks in the region are looking for policies to jump start growth. The policy options include privatization of state-owned assets or the provision of affordable credit. In July, the National Bank of Kazakhstan unexpectedly cut its key policy rate by 200 basis points, to 13 per cent, despite double-digit annual inflation. The monetary policy decision coincided with the announcement of additional fiscal stimulus, aimed at supporting business and infrastructure projects. In July, central banks in Georgia (not a member of the CIS), Moldova and Ukraine also reduced interest rates by 25, 300 and 100 basis points, respectively.

Despite weaker oil prices, the Russian rouble remained broadly stable in July, supported by tax and dividend payments. While this raised some concerns of an overvaluation, the Central Bank of the Russian Federation affirmed its commitment to a full float.

In July, the Russian Federation also tightened the terms of transit of Ukrainian goods through its territory. To a certain extent, this contributed to Ukraine's loss of around 50 per cent of its exports to Azerbaijan and Central Asian countries relative to the levels for the same period of 2015, as almost all exports are sent through the Russian Federation.

In South-Eastern Europe, the National Bank of Serbia reduced its policy rate by 25 basis points to 4 per cent to put inflation back in the target range. While inflation is likely to remain very low, further cuts are unlikely amid concerns over the consequences of the United Kingdom's referendum on the region.

Africa: elevated inflationary pressures pose a challenge for monetary policy

Inflationary pressures remain high in many African economies as weaker domestic currencies, compounded by the adverse impact of drought conditions, continue to exert upward pressure on consumer prices. In June, Nigeria's inflation rate rose to an 11-year high of 16.5 per cent. Energy and food prices have escalated in Nigeria due to the removal of fuel subsidies and the rapid depreciation of the

naira, which has lost more than 40 per cent of its value following the removal of its currency peg. Increasing domestic food prices were also the key driver of the higher inflation rates recorded in June for several countries, including Angola, Kenya, Mozambique, Rwanda, South Africa and Tanzania.

Against a backdrop of deteriorating growth prospects, elevated domestic inflationary pressures have complicated the conduct of monetary policy in the region. Recently, Angola, Mozambique and Nigeria increased their key policy rates with the objectives of stemming capital outflows and preventing currency depreciation while containing rising inflation. However, the increase in borrowing costs will likely weigh on domestic economic activity, further constraining short-term growth.

Developing East Asia: economic growth in China remains stable

China's GDP growth remains within the official target of 6.5-7.0 per cent for 2016, reaching 6.7 per cent in the second quarter of 2016. Growth was supported by robust retail sales, a strong property market, and investment by state-owned enterprises. While the services sector continues to drive growth, it has shown some weakness in the past two quarters. This can be partly explained by the high base effect arising from the strong stock market performance in the second quarter of 2015. The slowdown in the services sector's growth was partially offset by acceleration in the manufacturing sector's growth, a result of government stimulus efforts. However, private fixed investment grew by a mere 2.8 per cent in the first half of 2016, compared to 23.5 per cent growth in public fixed investment.

The Republic of Korea's GDP growth exceeded expectations in the second quarter, reaching 3.2 per cent. It accelerated from the first quarter's 2.8 per cent and was the fastest growth rate since 2014's third quarter. Growth was supported by a strong rebound in private investment and gross fixed capital formation, especially in the construction sector. The Government's decision to introduce a stimulus package of 20 trillion won will support domestic demand, but the weak external environment will continue to pose uncertainty to growth.

South Asia: a faster-than-expected increase in oil production will lift growth in the Islamic Republic of Iran

Since the lifting of international sanctions in early 2016, oil production in the Islamic Republic of Iran has recovered to pre-sanctions levels. Recently, government officials confirmed that oil production reached 3.8 million barrels per day (mbd), with an increase of 0.8 mbd since January. Likewise, oil exports have also surged, reaching a four-year high in May. Despite the Government's commitment to further increase oil exports, it remains unclear to what extent it can do so. The expansion of the oil productive capacity will require substantial investments. However, foreign companies appear reluctant to invest in the country, amid fears of continuing restrictions on financial transactions and regulatory uncertainties. Policymakers are, however, trying to scale up the promotion of foreign investments through different mechanisms. For instance, the country will soon unveil a new oil industry investment contract for international firms, which is expected to significantly increase foreign investment in the coming years. The visible expansion of oil production and exports is expected to support the economy's growth prospects this year.

Western Asia: Israel and Turkey normalize diplomatic relations after years of freeze

Officials from Israel and Turkey recently confirmed the restoration of full diplomatic relations after six years, opening the door for renewed economic cooperation. The normalization of diplomatic relations paves the way to the possibility for Israel to significantly develop its energy sector and export natural gas to Turkey. This would considerably expand Israel's exports market and will also enable Turkey—a large energy importer in the region—to diversify its external sources of energy. Israel is currently initiating the development of the giant offshore Leviathan gas field. The ongoing negotiations with Turkey can generate substantial exports through a new pipeline in the Mediterranean Sea. Importantly, the restoration of diplomatic ties has also allowed Turkey to deliver much needed humanitarian supplies to the Gaza strip through the Israeli port of Ashdod.

Amid heightened uncertainties in the global economy, Israel's economy continues to perform moderately well. In 2015, it registered GDP growth of 2.6 per cent and a similar pace is expected for 2016. Recent labour market indicators are also favourable, including relatively low unemployment and high participation rates. Meanwhile, the Turkish economy is slowing down moderately in 2016, after an expansion of 4.0 per cent in 2015, amid lower investment demand and relatively tight fiscal and monetary policy stances. Turkey remains vulnerable to renewed instabilities in global financial markets, which might generate a sudden stop of capital inflows and exacerbate exchange rate volatility.

Latin America and the Caribbean: Argentina remains in recession as macroeconomic adjustment measures weigh on demand

South America's three largest economies—Argentina, Brazil and the Bolivarian Republic of Venezuela accounting for 75 per cent of the sub-region's total GDP—are in recession. While the Brazilian and Venezuelan economies have been contracting for the past two years, new official data shows that Argentina had slipped into recession in the third quarter of 2015. The revised GDP series also indicates that Argentina's growth in the past decade has been significantly lower and more volatile than previously estimated. Since 2008, the country has experienced four recessions, defined by two or more consecutive quarters of negative GDP growth. The most recent slump has, however, been milder than the other three recessions. In the first quarter of 2016, seasonally adjusted GDP was 1.2 per cent below the peak level reached in the second quarter of 2015, compared to a peak-to-trough decline of 10.5 per cent in 2008/09, 4.6 per cent in 2012 and 4.1 per cent in 2013/14. In the short term, output is projected to contract further as the Government's macroeconomic adjustment measures (including higher public service charges for utilities, fuel and transport) weigh on domestic demand. In view of continuing fiscal pressures and external headwinds, such as low commodity prices and a deep recession in its main trading partner Brazil, Argentina's recovery prospects largely depend on a rebound in private investment. The lifting of foreign exchange controls, a gradual decline in inflation and the Argentinian Government's recent return to international capital markets are expected to provide some support to growth in private investment.