



World Economic Situation and Prospects

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Global issues

Economic implications of the strong United States dollar

The citizens of the United States of America elected the country's 45th President on 8 November. There are still considerable uncertainties regarding the direction of policy under the new Administration. One major development since the presidential election is that the dollar has risen notably against other currencies, reaching its highest value since mid-2002. The 3 per cent gain in November has come on top of the sharp rise seen in 2014-15, when the dollar appreciated by about 22 per cent in nominal terms.

A key factor that has driven the dollar higher is the prospect of diverging monetary policies among major economies, which is in part underpinned by investors' perceptions of economic fundamentals. The outcome of the United States presidential election has led many investors to expect a change in the country's macro-economic policy mix in the coming months, with a shift towards looser fiscal and tighter monetary policy. In contrast, monetary policy in other developed economies is projected to remain exceptionally accommodative, amid significant uncertainties over their respective growth outlooks. In Europe, concerns over political risks, the stability of the banking sector and the Brexit continue to affect investor sentiments. The rejection of proposed constitutional reform in Italy has further compounded these uncertainties. At the same time, emerging market currencies weakened significantly in November as worries over the future direction of United States trade policy triggered large capital outflows from certain developing economies. As interest rates in the United States rise relative to other developed economies, the United States dollar is expected to appreciate further, although it is difficult to determine how much of the divergence is already priced into today's exchange rate.

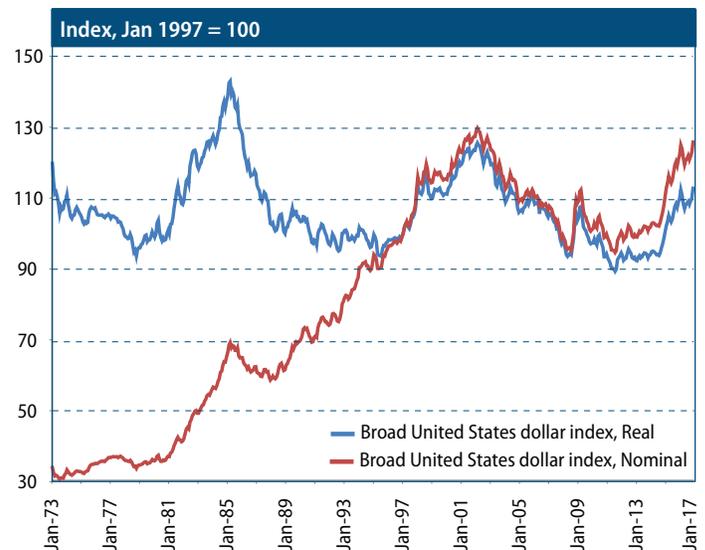
Figure 1 illustrates two of the Fed's trade-weighted dollar indexes for the period January 1973 to November 2016. These broad indices measure the value of the dollar against a basket of other currencies. The basket includes all trading partners that capture at least 0.5 per cent of exports or imports from the United States.¹ The nominal index is based on the nominal market exchange

¹ The currencies of the following countries and country groups are included: Argentina, Australia, Brazil, Canada, Chile, China, Colombia, euro area, Hong Kong Special Administrative Region of China, India, Indonesia, Israel, Japan, Malaysia, Mexico, the Philippines, Republic of Korea, Russian Federation, Saudi Arabia, Singapore, Sweden, Switzerland, Taiwan Province of China, Thailand, United Kingdom, and Bolivarian Republic of Venezuela. For more information on the construction of the broad U.S. dollar index see Federal Reserve Bulletin Winter 2005 "Indexes of the Foreign Exchange Value of the Dollar."

Summary

- Dollar strengthens in the aftermath of the United States presidential election
- OPEC agrees to first production cut since the global financial crisis
- India announces demonetization policy

Figure 1
Nominal and real trade weighted US dollar index,
January 1973 – November 2016



Source: Board of Governors of the United States Federal Reserve System

rates, while the real index, in addition, corrects for differences in the evolution of consumer prices in the United States and its trading partners.² In nominal terms, the dollar is currently near the all-time high recorded in February 2002. When correcting for inflation differentials, however, the dollar is still about 12 per cent below the 2002 peak and even further away from its all-time high in 1985. Although clearly elevated, the current strength of the dollar is not without historical precedence, and there remains room for the dollar to appreciate further.

² The divergence between the trends of the two indexes prior to the mid-1990s was largely a result of sharp depreciations and high inflation in several of the emerging-market economies included in the basket.

The latest dollar rally impacts economic prospects through three main channels: (1) competitiveness and purchasing power; (2) inflation and monetary policy; and (3) balance sheet effects.

A stronger dollar tends to reduce the competitiveness of exporting firms in the United States, while strengthening the purchasing power of United States consumers. This could lead to a further increase in the United States trade and current-account deficits, potentially contributing to a widening of global imbalances. Conversely, the trading partners of the United States tend to see improvements in competitiveness. The currency depreciations, which are the flip side of the dollar strength, are likely to have an expenditure-switching effect. This makes the adjustment processes that are currently under way in many commodity-exporting countries easier, especially in Latin America. However, if higher import prices lead to significantly lower imports of intermediate and capital goods, there could be a negative medium-term effect on growth.

On the inflation and monetary policy fronts, a stronger dollar is largely welcomed by monetary authorities in the euro area and Japan as it can help lift inflation closer to target. For many emerging economies, by contrast, the currency depreciations create monetary policy challenges, pushing up inflation and putting pressure on central banks to raise interest rates. Cases in point are Mexico and Turkey, where the central banks hiked their main policy rates in November. Higher interest rates, together with a lower purchasing power of the domestic currency, could weigh on domestic demand growth.

From a balance sheet perspective, the strong dollar has a significant impact on United States companies that generate a substantial share of their revenue in foreign markets. The depreciation of foreign currencies against the dollar would directly translate into lower revenue in dollar terms. For the emerging economies, dollar-denominated debt has risen sharply since the global financial crisis.³ A stronger dollar makes it more difficult to repay the debt and increases default risks, particularly for debtors that have not hedged their foreign currency exposure and with revenue streams denominated in domestic currency. However, economies that hold large foreign exchange reserves and dollar assets will benefit from positive valuation effects arising from the dollar strength.

OPEC agrees to first production cut since the global financial crisis

On 30 November, the members of the Organization of the Petroleum Exporting Countries (OPEC) agreed to cut oil production for the first time since 2008. The Organization decided to reduce oil supplies by 1.2 million barrels per day (bpd) for the next six months, with the cuts borne mainly by Saudi Arabia, as well as Kuwait, Qatar and the United Arab Emirates. OPEC's decision was followed by an announcement by the Russian Federation, a major non-OPEC producer, to also cut its oil output by 0.3 million bpd. The larger-than-expected production cuts drove investor optimism in global financial markets. Since the decision, Brent 1-month futures have increased by more than 18 per cent, rising above \$55 per barrel on 5 December.

OPEC's move to support oil prices marks a reversal in its strategy of defending market share that has been implemented

since the collapse of crude oil prices in mid-2014. Total supply from OPEC producers have expanded at a strong pace this year as the output of several low-cost producers, including Kuwait, Saudi Arabia and the United Arab Emirates reached a record high. Meanwhile, the Islamic Republic of Iran's production has also risen rapidly following the removal of international sanctions in January 2016.

Persistently low global crude oil prices, however, have resulted in a significant deterioration in oil revenue for these countries, adversely affecting fiscal positions and economic growth. For many of these economies, concerns over fiscal sustainability have prompted large new debt issuances and fiscal consolidation measures, including subsidy cuts and tax increases.

OPEC's move is expected to help reduce the global oil supply glut and support a modest recovery in crude oil prices in 2017. Nevertheless, a strong surge in oil prices remains unlikely. Subdued global growth continues to constrain oil demand. On the supply side, higher oil prices will incentivize shale producers in the United States to increase output. The new Administration has also indicated that it may lift certain environmental restrictions on shale and other oil sectors. Furthermore, given elevated global economic and policy uncertainty, oil prices will remain highly volatile and susceptible to shifts in investor sentiments.

Developed economies

Japan: declining imports reflect structural shift in energy demand

In the third quarter of 2016, Japan's economy expanded by 0.5 per cent, compared to 0.2 per cent growth in the previous quarter. The acceleration was driven by a strong positive contribution from net exports, without which the economy would have remained stagnant. Although export volumes continue to be restrained by weak global demand and the strong yen, import volumes contracted even more sharply, recording a decline of 1.8 per cent in the first three quarters of 2016 relative to a year earlier. Following the presidential election in the United States, the yen has depreciated by 8 per cent against the dollar. If this exchange rate realignment persists, net exports may continue to support the economy in 2017.

The decline in import volumes is partly attributable to a contraction in imports of petroleum and petroleum products. The share of oil in primary energy consumed in Japan is high relative to most other developed economies, and the decline in petroleum imports has been partly associated with a structural shift in the composition of power generation away from oil-fired power stations. Japan has started to reopen a portion of its nuclear reactors, after all 54 were closed following the devastating accident at Fukushima Daiichi in March 2011. To date only three reactors are currently operating, but applications to restart up to 21 more reactors are under review by Japan's Nuclear Regulation Authority. The loss of nuclear power generation increased energy dependence on imports; pushed up carbon emissions from power generation; and was associated with a significant rise in electricity prices. To address the high price of electricity, there has also been an expansion of coal-fired power generation. In contrast to the decline in petroleum, imports of coal increased by more than 7 per cent in the year to October 2016, and coal usage is expected to continue to rise in the near term, despite environmental concerns.

³ See analysis in *World Economic Situation and Prospects Monthly Briefing No. 96* (November 2016).

Europe: lower unemployment despite continued labour market challenges

Unemployment continued to fall in several countries in the region. In Finland, the unemployment rate decreased to 8.6 per cent in October, 0.8 percentage points lower than a year before. This positive headline trend masks continued underlying challenges, including an unemployment rate of 17.1 per cent in the 15-24 age group and an elevated level of hidden unemployment, comprising those who have given up looking for a job. Likewise, in Switzerland, the unemployment rate decreased to 4.8 per cent in the third quarter, down from 4.9 per cent a year earlier. Youth unemployment increased to 11 per cent, compared to 10.6 per cent in the previous year.

Among the EU-13 countries,⁴ the Baltic States remain on a low growth trajectory, amid weak export performance. However, rapid real wage growth in a few countries, such as Lithuania, has been observed since early 2015. This has led to increasing concerns over higher unit labour costs and weaker competitiveness. Average nominal wage growth in Lithuania is estimated to exceed 7 per cent in 2016, driven mainly by a significant rise in the minimum wage and high levels of outward migration that have contributed to a tightening labour market.

Economies in transition

The Russian Federation to join efforts to stabilize oil prices

Following OPEC's agreement to reduce oil output, the Russian Federation announced its willingness to join efforts to stabilize the oil market. The Government stated that oil output will be gradually reduced by 0.3 million bpd over the first half of 2017, from its current record-high levels of over 11 million bpd. Nevertheless, the implementation of this plan may face challenges given that oil production in the Russian Federation is partially controlled by the private sector.

The region continues to experience negative spillovers from the Russian economy through trade and remittance channels. In Belarus, GDP contracted by 2.8 per cent in the first ten months of 2016. Among the smaller Commonwealth of Independent States (CIS) economies, growth in Armenia also remained on a weakening trend, with GDP declining by 2.5 per cent in the third quarter.

Against a backdrop of slowing inflation and relatively more stable currencies, several CIS countries further loosened monetary policy in November. The Central Bank of Armenia cut its policy rate by 25 basis points. Meanwhile, the National Bank of Kyrgyzstan reduced its policy rate by 50 basis points, bringing the cumulative decline in policy rates to 450 basis points in 2016. However, currency and inflationary pressures still remain in parts of the region. In Azerbaijan, inflation accelerated to 15 per cent in October.

In Georgia (not a member of the CIS), the Georgian lari plunged to a record low against the United States dollar in November. However, as it still remains strong against the currencies of its neighbouring countries, the depreciation is unlikely to exert inflationary pressures. In fact, inflation in Georgia remained very weak, at 0.2 per cent in November. However, the weaker currency

⁴ EU-13 comprises the 13 countries that joined the European Union in 2004 or later.

does add to concerns over the high share of dollar-denominated loans. In late November, the Government—jointly with the National Bank of Georgia—announced plans to convert some of those loans into domestic currency loans.

Developing economies

Africa: rising concerns over fiscal sustainability prompts policy responses in several African economies

Prolonged low commodity prices, weak domestic currencies and challenging growth conditions have continued to exert pressure on fiscal positions across the African region.

In recent months, rising concerns over the sustainability of public finances have prompted authorities in several African countries to undertake further fiscal consolidation measures or to seek financial assistance to bridge budget shortfalls. Faced with deteriorating crude oil revenue, the Congo and Gabon plan to cut public expenditure in 2017 by approximately 24 per cent and 5 per cent, respectively. In Zambia, fuel subsidies were removed, resulting in an increase in petrol prices by almost 40 per cent. The Zambian authorities also plan to raise electricity tariffs and introduce an import duty on copper next year. In addition, Mozambique, Nigeria and Zambia are negotiating loan programmes from international organizations. For Mozambique, the sharp depreciation in the Mozambican metical has contributed to a surge in the cost of servicing its foreign currency-denominated debt. The decline in commodity-related revenue has further exacerbated fiscal challenges. With public debt projected to exceed 130 per cent of GDP by end-2016, Mozambique recently announced plans to undertake debt restructuring in order to reduce debt to a more sustainable level.

Persistent fiscal vulnerabilities in many African countries pose a challenge for policy makers in achieving progress towards stronger and more sustainable growth. These economies need to prioritize economic diversification efforts and rebuild policy buffers in order to enhance resilience to external shocks and strengthen medium-term growth prospects.

East Asia: the region's currencies slide since the United States election

Since the United States presidential election, currencies across East Asia have seen considerable declines. Between 8 November and 2 December, the region's major currencies have depreciated by between 1.5 per cent (Chinese Yuan) and 6.2 per cent (Malaysian Ringgit). The broad-based depreciation can be partly attributed to uncertainties surrounding the incoming United States Administration's economic policies. Expansionary fiscal policy, as discussed by the new Administration, could impact the timing of interest rate hikes in the United States and subsequently affect capital flows in and out of the region, whereas trade policy changes could have significant implications for many East Asian economies that have close trade ties with the United States.

The recent depreciations constrain the ability of central banks in the region to embark on further monetary easing, as this could exacerbate the downward currency pressures. The current trend will also lead to rising debt-servicing cost, as more than 75 per cent of East Asian non-financial corporations' international debt securities

are denominated in dollars. At the same time, by elevating import costs, currency depreciation is adding to the inflationary effects of higher oil prices, which could hamper domestic demand. However, these negative forces may be partially offset by regional competitiveness gains for export sectors in economies with larger currency depreciations.

South Asia: India announces demonetization policy

In November, the Indian Government announced an immediate ban of the 500- and 1,000-rupee notes, which account for about 80 per cent of the economy's currency in circulation. Under this so-called demonetization policy, the population is given until the end of this year to change those notes or to deposit them into bank accounts. People converting more than 250,000 rupees will have to indicate the source of the cash. The Government's move is aimed at combatting corruption, black money, money laundering and terrorism. In the medium term, it is expected to reduce tax avoidance and lower the risks and costs associated with the handling of cash. The size of the shadow economy in India is estimated at between 20 to 25 percent of measured GDP. In comparison, the tax-to-GDP ratio in India stands at only 11 per cent. Despite the potential benefits for the economy in the medium term, the demonetization policy entails significant short-term economic and social costs. Given that the overwhelming majority of transactions in the economy are in cash, the move has not only created visible cash shortages, but also risks triggering significant social turmoil and distress. Many people, especially the poor, live on cash earnings and have no bank accounts. So far, the supply of new banknotes has been insufficient to meet the overwhelming demand from the population. In terms of economic activity, the cash shortages could be particularly detrimental to sectors that rely heavily on cash transactions, including jewellery, real estate, construction and restaurants.

Western Asia: Turkey's central bank increases interest rates

Amid a significant depreciation of the domestic currency, in November, the Central Bank of Turkey raised its overnight interest rate by 250 basis points to 8.5 per cent and the one-week repurchase rate from 7.5 to 8.0 per cent. This was the Central Bank's first policy rate hike in almost three years. In recent weeks, the Turkish lira had slumped to multi-year lows against the United States dollar, owing to heightened global financial uncertainty and volatility, and domestic economic and political turbulences. After the failed military coup in July, business and consumer confidence have deteriorated, which has been associated with a slowdown in private consumption and investment. Likewise, in the third quarter, seasonally adjusted

industrial production fell by 3.0 per cent, and net capital inflows, especially portfolio and cross-border bank lending, declined. With the monetary decision, the Central Bank seeks to maintain the inflation outlook under control. While consumer price inflation has been on a downward trend since July, slowing to 7.0 per cent in November, this still exceeds the upper-bound of the Central Bank's target range. Furthermore, the depreciation of the lira could significantly raise inflationary pressures in the near term. In addition, the Central Bank also cut the foreign exchange reserve requirements ratios by 50 basis points for all maturity brackets, which is expected to boost liquidity by injecting \$1.5 billion into the financial system. Looking ahead, a faster-than-expected tightening of monetary conditions in the United States, especially if coupled with a further deterioration of domestic conditions, could intensify financial pressures in the Turkish economy.

Latin America and the Caribbean: persistent weakness in economic activity amid higher uncertainty clouds growth outlook

Recent data show continued weakness in economic activity in several countries in the region, particularly in recession-hit Argentina and Brazil. The economic outlook for 2017 has become even more challenging amid heightened uncertainty over economic policy in the United States and increased volatility in international financial markets. Since the United States election, the Latin America and the Caribbean region has seen renewed capital outflows, causing stock prices to fall and bond yields to rise. Several major currencies, such as the Argentinian peso, the Brazilian real and the Mexican peso, have depreciated significantly against the United States dollar. A less benign external financial environment could hamper the process of disinflation, posing an important challenge for the conduct of monetary policy in the region.

The economies of Argentina and Brazil have not shown any signs of exiting recession. Argentina recorded sharp declines in industrial production and construction activity in September and October. Brazil's economy registered its seventh consecutive quarterly contraction between July and September, with GDP falling by 0.8 per cent from the previous three months due to a sharp drop in investment. In both countries, the central banks lowered interest rates in November, amid slowing inflation. Brazil's monetary authorities, however, reduced the benchmark rate only by the minimum of 25 basis points, while referring to a highly uncertain internal and external environment. Meanwhile, Mexico's Central Bank raised its main policy rate by 50 basis points to the highest level since 2009, in a bid to reduce the strong downward pressure on the peso and rein in inflation.