DALLASFED Economic Update
International

Politics Heightens Uncertainty, but Outlook Mostly Unchanged

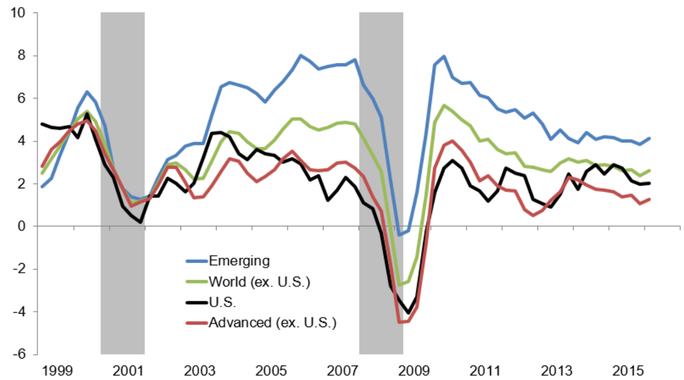
June 17, 2016

Global output growth (excluding the U.S.) ticked up to 2.6 percent year over year in the first quarter *(Chart 1)*.[1] The outlook remains broadly unchanged, with a slow expansion expected over the next two years.

Emerging-market growth increased to 4.2 percent despite Brazil's continued deep recession and China's slowdown. Advanced economies (excluding the U.S.) grew 1.3 percent due to slow but stable expansion in the euro area, increased economic activity in Canada and weak growth in Japan.

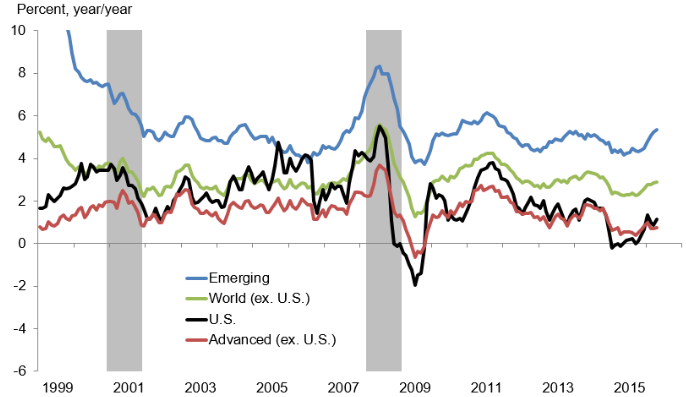
Global risks include low inflation in advanced economies and uncertainty surrounding the upcoming U.K. referendum to decide whether to exit the European Union (Brexit).

Chart 1
Real GDP Growth Ticks Up in First Quarter
Percent, year/year



NOTES: Calculations are based on a representative sample of 40 countries. Data are aggregated using U.S. trade weights. Shaded bars indicate global recessions.
SOURCES: Database of Global Economic Indicators; Haver Analytics; author's calculations.

Chart 2
Headline Consumer Price Inflation Low in Advanced Economies
Percent, year/year



NOTES: Calculations are based on a representative sample of 40 countries. Data aggregated using U.S. trade weights. Shaded bars indicate global recessions.
SOURCES: Database of Global Economic Indicators; Haver Analytics; author's calculations.

Low Inflation Persists in Advanced Economies

Year-over-year inflation continues to be low in advanced economies at 0.7 percent in April *(Chart 2)*. Inflation in the euro area was negative for the fourth consecutive month in May at -0.1 percent. As expected, the European Central Bank (ECB) kept interest rates unchanged at its policy meeting on June 2. ECB officials have noted that they plan to allow time for policies announced in March to go into effect this month. The central bank started its corporate bond purchase program on June 8, and a new program of long-term loans to banks will start on June 22.

Japan's year-over-year inflation rate was also negative in April at -0.3 percent. Prime Minister Shinzo Abe announced a further delay in plans to increase the national consumption tax from 8 to 10 percent. The planned hike, scheduled for April 2017 (originally October 2015), has been postponed until October 2019. The Bank of Japan kept its deposit rate at -0.1 percent and the pace of its asset-purchase program unchanged at 80 trillion yen per year at its monetary policy meeting June 15–16.

Monetary Policy Mostly Unchanged in Emerging Economies

The Reserve Bank of India kept its main interest rate unchanged at its policy meeting on June 7 after lowering the rate by 25 basis points in April. The Bank of Russia cut its key rate by 50 basis points to 10.5 percent at its meeting on June 10 after leaving it unchanged since last summer.

Brazil's central bank kept its benchmark interest rate at 14.25 percent at its meeting on June 8. The central bank is still trying to combat elevated inflation, which came in at 9.3 percent year over year in May, despite a deep recession. Brazil's gross domestic product contracted 5.1 percent year over year in the first quarter; on a quarter-over-quarter basis, it was the fifth consecutive decline *(Chart 3)*. Brazil is also experiencing a political crisis, with President Dilma Rousseff stepping down in May for her impeachment trial.

Uncertainty Surrounds U.K. Referendum Vote

Geopolitical risks are also affecting economic activity in advanced economies. A referendum to decide whether the U.K. should remain in or leave the European Union will take place June 23. The latest polls indicate a close call after the "leave" campaign gained some ground, and the betting odds for Britain's departure are around 40 percent. A "leave" vote would not immediately change the status of the U.K. in the EU, but uncertainty over the outcome of negotiations could be disruptive. Possible benefits from exiting include increased trade deals and deregulation.

However, multiple economic studies by the Organization for Economic Cooperation and Development, International Monetary Fund (IMF), Bank of England, and the U.K.'s Treasury suggest a negative impact on the British economy, with possible global consequences. In the short run, uncertainty would have the largest impact on Britain's economy, giving way to trade implications in the long run. As the referendum date nears, the pound has been volatile. The sterling one-month implied volatility (the cost of insuring against the sterling/dollar exchange rate) soared to 28.7 percent on June 14—its highest level in the past six years and close to its 2008 peak *(Chart 4)*.

Aside from the referendum, challenges to European integration, including the refugee crisis and debt sustainability in Greece, will likely persist. After months of delays, euro-area finance ministers and the IMF agreed to a deal for Greek debt relief that postpones action until 2018.

–Valerie Grossman

About the Author

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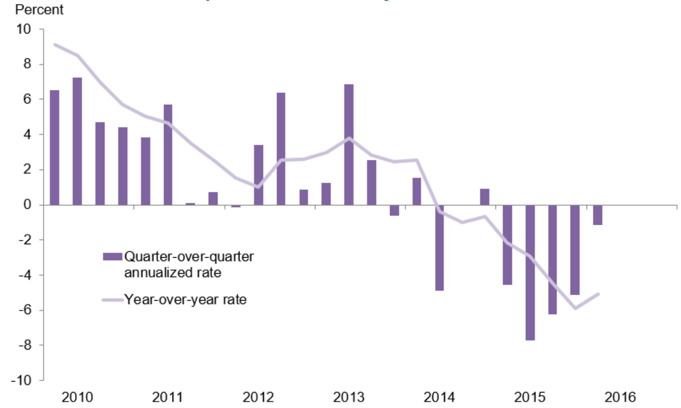
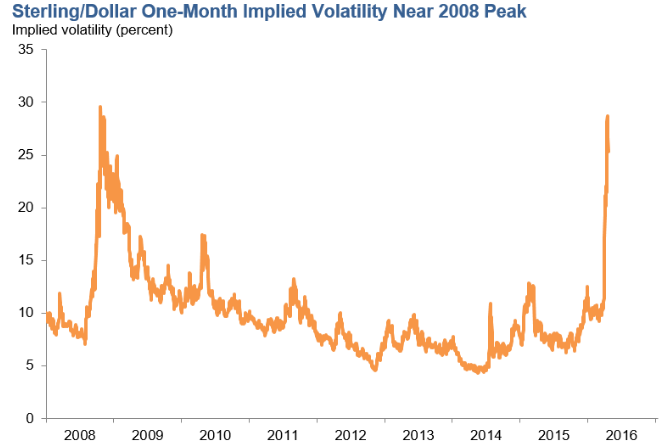
Chart 3
Real GDP Decline Keeps Brazilian Economy in Recession



SOURCES: Instituto Brasileiro de Geografia e Estatística (Brazilian Institute of Geography and Statistics); Haver Analytics.

Chart 4
Sterling/Dollar One-Month Implied Volatility Near 2008 Peak



SOURCE: Bloomberg.

Note

1. World (ex. U.S.), advanced (ex. U.S.) and emerging aggregate numbers come from a representative sample of 40 of the largest economies, ranked and weighted by their importance as U.S. trading partners. See "A New Database of Global Economic Indicators," by Valerie Grossman, Adrienne Mack and Enrique Martínez-García, *Journal of Economic and Social Measurement*, vol. 39, no. 3, 2014, pp. 163–97. For the methodology used for dating global cycles, see "A Contribution to the Chronology of Turning Points in Global Economic Activity (1980–2012)," also by Grossman, Mack and Martínez-García, *Journal of Macroeconomics*, vol. 46, 2015, pp. 170–85.