Overview

- Global manufacturing activity recovered in Q3, but growth remained soft.
- The probability of a hike in U.S. policy rates by year-end increased, contributing to an uptick in global bond yields.
- The growth divergence between commodity exporters and importers is narrowing, despite mixed Q3 data.
- Oil price forecasts for 2017 have been revised up to $55/bbl, from an estimated average of $43/bbl in 2016.

Chart of the Month

- After a weak patch in early 2016, actual and survey data suggest a recovery in global manufacturing in Q3.
- In particular, the global manufacturing purchasing managers’ index (PMI) has been on an upward trend since June, despite heightened uncertainty following the U.K.’s Brexit vote.
- The improvement was visible in both advanced and emerging market and developing economies.
- Positive momentum in new export orders also point to a stabilization in global goods trade, following a contraction in Q2.

Special Focus: Negative Interest Rate Policies and Financial Stability

- Negative interest rate policies (NIRP) could pose financial stability risks, such as the erosion of financial sector profitability and excessive risk-taking.
- Thus far, evidence of a significant negative impact of NIRP on bank profitability remains limited, and increases in asset prices have remained moderate in most economies implementing NIRP.
- However, financial stability concerns could intensify over time if rates go further below zero or if NIRP are employed for a protracted period.

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Monthly Highlights

Global manufacturing: diminishing headwinds. After marked weakness early in the year, global manufacturing activity improved in Q3. Global industrial production growth reached 3.7 percent in August (3m/3m annualized), its strongest reading since early 2015. Global manufacturing PMI also increased in September to its highest level so far this year (Figure 1A). However, it remained below its long-term average, suggesting still subdued growth. A gradual increase in manufacturing output in Q3 coincided with a pickup in new export orders and diminishing drag from an inventory drawdown in the first half of the year. Output trends improved most noticeably in consumer and intermediate goods sectors. Available data for October suggest continued recovery at the start of Q4.

Global trade: stagnation. Following a contraction in Q2, global goods trade appears to have stabilized in Q3. This was visible in an uptick in global goods trade volumes in August and improving export orders throughout Q3. Amid still-subdued global trade, persistent overcapacity in some industrial sectors, and a populist backlash against globalization, temporary trade barriers imposed over the last 12 months continued to exceed measures aimed at liberalizing trade. Moreover, there has been a shift toward more opaque forms of protectionism, such as localization requirements and preferential trade finance conditions, although subsidies and trade defense (safeguard) measures are still by far the most common forms of trade distortion (Figure 1B).

United States: recovering. Growth appears to have picked up in Q3 to around 2½ percent (q/q annualized), from 1.4 percent in Q2, as the drag from a contraction in capital spending and inventories lessened. Personal consumption growth slowed from a strong Q2, while industrial production recovered. Labor markets continued to tighten, with payroll gains averaging 192,000 per month in Q3, jobless claims at a four-decade low, and wage growth gradually picking up. The probability of a hike in U.S. policy rates by year-end continued to increase, pushing long-term yields and the U.S. dollar slightly up in October. Views about policy interest rates in the long run continued to diverge between market participants and Fed policymakers, highlighting the risk of bouts of volatility should markets suddenly reassess expectations upwardly (Figure 1C).

Euro Area: continued modest growth. Industrial production bounced back in August, more than offsetting a contraction in

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**FIGURE 1A Global manufacturing PMI**

Index, >50 = expansion

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**FIGURE 1B Trade restrictions enacted between Sept. 2015 and Aug. 2016**

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**FIGURE 1C U.S. Federal Reserve and market based expectations of policy interest rates**

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Sources: Bloomberg, Global Trade Alert, Haver Analytics.
A. Output index, 3-month moving average. Last observation is September 2016.
B. Last observation is August 2016.
C. U.S. Federal Reserve expectations are the median forecast of Federal Reserve Open Market Committee members. Market expectations are derived from OIS forward rates. Long-run market expectations are 10 years ahead.
July, while manufacturing PMI surveys improved in September and October. Following weak readings in June and July, retail sales recovered some momentum (Figure 2A). The composite PMI reached a 10-month high in October. Headline inflation increased to 0.4 percent (y/y) in September, the highest in two years, as the base effect of low energy prices wanes. Core inflation remained subdued, at 0.8 percent (y/y), and market-based long term inflation expectations continue to be significantly below the ECB’s target. The ECB left its policy stance unchanged in October, but confirmed a review of its strategy in December.

United Kingdom: financial market volatility. Activity appeared to be resilient in the immediate aftermath of the Brexit vote in June, with growth estimated at 2.0 percent in Q3 (q/q annualized), following 2.7 percent in Q2. However, financial markets have been volatile. Reflecting expectations that the government could favor a hard stance on immigration over access to the EU single market in upcoming negotiations, the pound sterling dropped to a 31-year low against the U.S. dollar. Ten-year government bond yields climbed back to their highest level since June, as inflation expectations increased (Figure 2B).

Japan: low inflation. According to the Tankan survey, business sentiment was unchanged in Q3, while manufacturing and services PMIs also pointed to soft activity up to September. However, an uptick in the manufacturing PMI in October signals improving conditions at the start of Q4. Headline inflation in August was negative and core inflation close to zero. The yen’s 18 percent appreciation in trade-weighted terms since January makes a recovery in core inflation unlikely in coming months. As a result, inflation forecasts for 2017 continued to be downgraded (Figure 2C). Following the Bank of Japan’s decision to target a stabilization of long-term bond yields around zero, scheduled purchases of government bonds for October showed a reduction from previous months.

China: steady growth. Growth stabilized at 6.7 percent (y/y) in Q3, unchanged from the first half of 2016, with continued support from infrastructure spending and robust credit growth. In September, credit growth increased to 12 percent (y/y), lifted by a rapid expansion of loans to households (21.4 percent y/y). Some local governments and cities have tightened property investment regulations against the backdrop of rapid house price increases, and new debt-to-equity swap guidelines were issued to reduce corporate leverage. Industrial production, retail sales, and
investment growth remained broadly stable in September (6.1 percent, 10.7 percent, and 8.2 percent y/y, respectively). Producer price inflation turned positive in September, for the first time since 2012, after raw material prices bottomed out (Figure 3A). However, exports unexpectedly dropped in September (-5.6 percent y/y in nominal terms), contributing to renewed downward pressures on the renminbi.

**Commodity exporters: mixed.** In Russia, the composite PMI rose to 53.2 in Q3, and a stabilization of retail trade suggests a recovery in consumption (Figure 3B). In Brazil, industrial production shrank 3.8 percent (m/m) in August, wiping out the cumulative gains of the previous five months, and retail sales continued to contract. However, the Brazilian composite PMI reached a six-quarter high in Q3, although it remained well in contraction territory (45.6). Indicators in Nigeria suggest that activity may have worsened further. Manufacturing output contracted more sharply in August, while the composite PMI fell to an average of 47.3 in Q3, extending a decline underway since end-2015. In South Africa, the growth pickup in Q2 does not appear to have continued in Q3. Although the composite PMI improved marginally, manufacturing PMI averaged 49.4, well below 53.5 in Q2, and mining sector activity continued to contract, while declining exports drove the trade balance into deficit. Activity continued to be robust in Q3 in more diversified and resilient commodity exporters such as Indonesia and Malaysia, with August industrial production increasing by 7.4 percent and 4.9 percent (y/y), respectively, and retail sales by 14.4 percent and 8.2 percent (y/y). However, for September, manufacturing PMIs for these two countries were mixed.

**Commodity exporters: different degrees of currency adjustment.** Despite a recent recovery in commodity prices and capital inflows, the adverse effects of a significant terms-of-trade deterioration over the last two years continue to unfold in many commodity exporters (Figure 3C). In countries with flexible exchange rate regimes, including Brazil, Colombia, Malaysia, and Russia, large currency depreciations in 2015 were followed by rebounds in 2016. In contrast, foreign reserves continued to be depleted in energy exporters with pegged or managed floating currency regimes, accompanied in some cases by delayed and abrupt currency devaluations in late 2015 and in 2016 (Angola, Azerbaijan, Nigeria). In large metal exporters, terms of trade have generally improved since 2014, but currency pressures have
diverged as a result of country-specific circumstances. In Indonesia, the real effective exchange rate appreciated in line with the improvement in terms of trade, while in South Africa, the currency remains under pressure.

**Commodity importers: robust.** GDP growth was broadly stable in commodity importers in the first half of 2016 (Figure 4A). High-frequency indicators suggest relatively robust growth in Q3 in Eastern Europe (Hungary, Poland, Romania) and East Asia (Philippines, Thailand). In India, despite ongoing solid growth, some indicators were mixed, with industrial production falling 0.7 percent (y/y) in August and the manufacturing PMI edging down to 52.1 in September. With the notable exception of India, where policy interest rates were cut in August in light of easing inflation, a rise in global food and energy prices is supporting an uptick in consumer price growth from very low levels in major commodity-importing economies, including those in Eastern Europe and East Asia.

**Capital flows: strong.** Supported by a search for yield and a recovery in commodity prices, flows into emerging-market bond and equity funds were strong in Q3. Inflows were mostly concentrated in July and August amid record-low advanced-economy bond yields, but moderated in September and October as the probability of U.S. interest rate hike by year-end increased (Figure 4B). Consistent with a renewed appetite for EMDE assets, bond issuance rose sharply during Q3. EMDE borrowers sold $75 billion of Eurobonds in Q3, up 85 percent from a year earlier, with corporate issuers accounting for 74 percent of the total. In October, Saudi Arabia raised $17.5 billion in its first sovereign bond issuance, surpassing the previous record issuance of Argentina in April this year.

**Commodity prices: recovery.** Most commodity prices continued to rise from their January lows, with some jumping markedly due to supply shortfalls, e.g., zinc, tin, sugar and some oils and meals. Crude oil prices are now projected to rise to $55/bbl in 2017, from an annual average of $43/bbl in 2016, assuming OPEC carries through with a planned production cut (Figure 4C). Metal and mineral prices are projected to rise by 4.1 percent y/y in 2017, reflecting supply tightness for some metals (notably zinc) and mine closures. Agriculture prices are projected to remain stable as expected gains in grain, oil and meal, and raw material prices more than offset a decline in beverage prices.

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Sources: J.P. Morgan, Haver Analytics, World Bank.
A: Last observation 2016Q2.
B: Net inflows into emerging market bond and equity funds. 4-week rolling sum.
Last observation is October 19.
Special Focus: Negative Interest Rate Policies and Financial Stability

New frontier of unconventional monetary policy. The unprecedented use of negative interest rate policies (NIRP) in multiple economies, which together account for one-fourth of world GDP, has not just extended the boundaries of unconventional monetary policies but also fueled an already polarized debate on the implications of these policies. A recent World Bank working paper, “Negative Interest Rate Policies: Sources and Implications” (Arteta et al. 2016), presents a comprehensive analysis of the sources and implications of NIRP.

How could NIRP affect financial stability? While the impact of NIRP may be analogous to very low but positive policy interest rates in many respects, NIRP could pose specific risks to financial stability, particularly if rates go substantially below zero or if NIRP are employed for a protracted period of time. Adverse consequences of NIRP could include erosion of profitability of banks and other financial institutions and excessive risk-taking by investors.

Impact on banks. NIRP could put pressure on banks’ profitability by narrowing net interest margins—the gap between commercial banks’ lending and deposit rates. The effect of narrowing net interest margins on bank profitability under NIRP depends, among other factors, on the source of bank funding (i.e., whether it primarily depends on retail deposits or on wholesale markets) and the degree of downward stickiness of retail deposit rates (i.e., whether retail rates move in tandem with negative policy rates). Euro Area bank lending surveys indicate concern among banks that NIRP has already hurt or is expected to hurt profitability (Figure 5A). The decline in Euro Area bank equity prices since mid-2015 could partially be ascribed to market concerns about future profitability. Despite these concerns, bank lending margins remain within post-crisis ranges across countries utilizing NIRP, albeit with some signs of compression (Figure 5B). Credit growth is higher now than before NIRP in the Euro Area and Denmark, and is particularly strong in Sweden, where a real estate boom is ongoing, but remains moderate elsewhere (Figure 5C).

Impact on other financial institutions. Under persistently low or negative bond yields, pension funds and life insurance companies

Sources: European Central Bank, Haver Analytics, World Bank.
A. B, C: For details, see Arteta et al. (2016).
A: Results from the ECB’s bank lending survey in April 2016. Questions start as: “Given the ECB’s negative deposit facility rate, did or will this measure, either directly or indirectly, contribute to...”
B. Last observation is August 2016.
C. Credit to the private nonfinancial sector. Last observation is August 2016.
may struggle to generate adequate returns. Consistent with the growing challenges faced by the insurance sector, equity prices of insurance companies in the Euro Area and Japan have moved down during the NIRP period (Figure 6A). Money market funds make conservative investments in cash-equivalent assets, such as highly-rated short-term corporate or government debt, to provide investors liquidity and capital preservation while paying a modest return. Because of their business model, these funds may face formidable challenges even at very low but positive rates.

Event study around policy announcements. While it is empirically difficult to disentangle the specific effects of NIRP from other economic and policy developments, an event study using a one-day window around policy announcements can help assess the immediate market reaction. Despite the presumption of adverse effects, the initial reaction of bank equity prices to NIRP announcements has been mixed, while financial sector credit default swap (CDS) spreads have generally declined. The average change in bank equity prices was negligible on the announcement day, while the median increase was about 1 percent (Figure 6B).

Other concerns. Like other unconventional monetary policies, NIRP could also encourage excessive risk-taking, which could contribute over time to the formation of asset price bubbles. However, increases in equity and house prices have thus far remained moderate in most economies where NIRP has been implemented, with the noticeable exception of Sweden (Figure 6C). There is no conclusive evidence as yet of a significant and broad-based increase in leverage, or of excessive asset price valuations that could signal looming financial stability risks.

How low can negative rates be? NIRP raise the question of how low negative rates can go before market distortions threaten financial stability. At the extreme, should central banks push policy rates too far into negative territory, there is a risk that sizable sectors of the economy could become cash-based. While some central banks have reduced their policy rates below -0.5 percent without any easily discernible financial market distortions, it is unclear whether rates could go much lower, or for a prolonged period, without disrupting financial stability.

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**FIGURE 6A Insurance company equity prices**

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<thead>
<tr>
<th>Index, Jan 2014 = 100</th>
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2014 2015 2016

**FIGURE 6B Financial sector asset price response to NIRP announcements**

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<th>Basis points</th>
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<tr>
<td>-2</td>
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Financial sector CDS

Financial sector equities (RHS)

**FIGURE 6C House prices**

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<th>Index, 2010Q1=100</th>
</tr>
</thead>
<tbody>
<tr>
<td>160</td>
</tr>
</tbody>
</table>

150 | Switzerland | Denmark |


Source: Bloomberg, MSCI, OECD, World Bank.
A. B. C. For details, see Arteta et al. (2016).
A. Last observation October 4, 2016.
B. Financial sector equities is the broad financial sector index for each nation or area. Financial sector CDS is, for all the events caused by central banks in Europe, a Europe-wide senior bank debt CDS index, and, analogously for Japan.
C. Data refer to nominal house prices. Last observation is 2016Q1.
### TABLE A: Major Data Releases

(Percent, y-o-y)


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<tr>
<th>Country</th>
<th>Date</th>
<th>Indicator</th>
<th>Period</th>
<th>Actual</th>
<th>Forecast</th>
<th>Previous</th>
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<td>Netherlands</td>
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<td>GDP</td>
<td>Q2</td>
<td>1.8 %</td>
<td>2.3 %</td>
<td>1.5 %</td>
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<td>Singapore</td>
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<td>SEP</td>
<td>0.3 %</td>
<td>-0.3 %</td>
<td>-0.4 %</td>
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<td>Germany</td>
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<td>CPI</td>
<td>SEP</td>
<td>0.5 %</td>
<td>0.6 %</td>
<td>0.4 %</td>
</tr>
<tr>
<td>Japan</td>
<td>9/29/16</td>
<td>CPI</td>
<td>SEP</td>
<td>-0.5 %</td>
<td>-0.5 %</td>
<td>-0.4 %</td>
</tr>
<tr>
<td>Italy</td>
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<td>CPI</td>
<td>SEP</td>
<td>0.1 %</td>
<td>0 %</td>
<td>-0.1 %</td>
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<td>0.4 %</td>
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<td>3.0 %</td>
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(Percent y-o-y)

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<td>11/16/16</td>
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</table>
### TABLE B: Economic Developments

(Percent change y-o-y, except quarterly data on industrial production, which are percent change q-o-q, annualized)

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<td>0.1</td>
<td>6.6</td>
<td>-1.2</td>
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### Inflation, sa

| World                     | 2.1  | 1.4  | 1.4  | 1.5  |
| Advanced Economies        | 0.5  | 0.1  | 0.1  | 0.3  |
| Emerging Market and       | 3.3  | 2.5  | 2.3  | 2.1  |
| Developing Economies      | 3.7  | 3.7  | 3.7  | 3.3  |
| Commodity-exporting EMDE  | 2.9  | 1.2  | 0.6  | 1.1  |
| Other EMDE                | 3.2  | 1.1  | 0.7  | 1.0  |
| East Asia and Pacific     | 1.6  | 1.7  | 1.8  | 1.4  |
| Europe and Central Asia   | 3.4  | 2.6  | 2.6  | 2.3  |
| Latin America and Caribbean | -0.8 | -11.9 | -8.8 | -5.4 |
| Middle East and North Africa | 2.7  | 1.7  | 2.1  | 1.8  |
| South Asia                | 6.8  | 3.5  | 2.4  | 3.0  |
| Sub-Saharan Africa        | 4.4  | 3.8  | 4.5  | 4.1  |

### TABLE C: Trade and Finance

(Percent change y-o-y, except quarterly trade data, which are percent change q-o-q, annualized, and international reserves data, which are percent change over the period 2015-2016)

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1 Total reserves excluding gold are used as proxies when total reserves data are unavailable.
TABLE D: Financial Markets

(Percent change y-o-y, except quarterly trade data, which are percent change q-o-q, annualized, and international reserves data, which are percent change over the previous period)

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<th>2016</th>
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<td>Advanced Economies ($ Index)</td>
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<td>United States (S&amp;P 500)</td>
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<td>Europe (S&amp;P Euro 350)</td>
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<td>Japan (Nikkei 225)</td>
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<td>Emerging Market and Developing Economies (MSCI)</td>
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<td>EM Latin America &amp; Caribbean</td>
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<td>Memo: U.S. nominal effective rate (index)</td>
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<td>2016</td>
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<td>2015</td>
<td>2016</td>
</tr>
<tr>
<td>Gold ($/toz)</td>
<td>2015</td>
<td>2016</td>
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<tr>
<td>Baltic Dry Index</td>
<td>2015</td>
<td>2016</td>
</tr>
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</table>

Source: World Bank, World Bank Commodity Prices Data (The Pink Sheet), Bloomberg.

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Table E: Commodity Prices

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<td>crude oil, average ($/tbd)</td>
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<tr>
<td>Gold ($/t oz)</td>
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<tr>
<td>Baltic Dry Index</td>
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<td>2016</td>
<td></td>
</tr>
</tbody>
</table>

Source: World Bank, World Bank Commodity Prices Data (The Pink Sheet), Bloomberg.

1 MRV = Most Recent Value.
2 Indexes, 2010 = 100.