2. International Economic Developments

After a modest post-crisis recovery, the global economy continued to grow by about 3 percent in the third quarter of 2016. The uncertainty over the global growth outlook was aggravated further in the final quarter, largely due to advanced economies. The UK's exit from the EU (Brexit) and its implications for the global economy remain unclear, while the result of the US presidential election heightened the uncertainty about economic policy in the US. These two incidences, which are likely to trigger some policy responses in other countries through spillover effects, will determine the future path of global economic policies.

The uncertainty surrounding global economic policies is likely to have implications through various channels (Box 2.1). Despite the difficulty of estimating the final impact of the transmission channels on the global economy, recent developments had their first-round effects on the global financial markets, with interest rates rising and assets being re-priced in the fourth quarter. Long-term bond rates rallied across advanced economies, leading to steepening and upward-shifting yield curves in emerging economies amid increasing prospects of a tighter post-election US monetary policy and the ensuing December policy rate hike by the Fed.

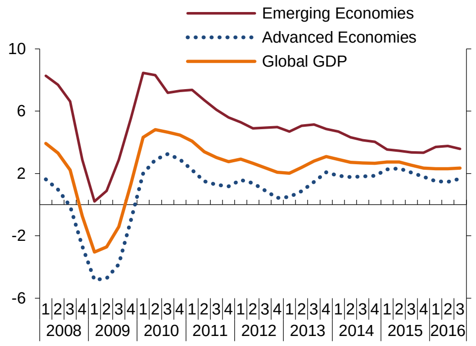
Higher interest rates in advanced economies led to massive portfolio outflows from emerging economies in the last quarter, causing local currencies to depreciate. This is likely to pose risks to financial stability, particularly across emerging economies.

The effective use of fiscal policy is crucial for the global economy to escape from the low-growth trap in an environment of already existing accommodative monetary policies. It is expected that the global economy could benefit from a strengthening US growth in the upcoming period assuming that the Trump administration opts for expansionary fiscal policies to stimulate domestic investment and consumption. Similarly, the likely adoption of expansionary fiscal policies in other advanced economies as well as China's fiscal stimulus packages may also boost the global economy. However, the growing tendency for foreign trade protectionism may put severe downward pressure on the currently sluggish global trade volume; thus, on the global growth, and may therefore offset the benefits from expansionary fiscal policies. In this regard, macroeconomic policies should be used jointly and effectively to stimulate aggregate demand in the short term and boost potential growth in the long term, which would eventually help to veer from the low-growth path.

2.1. Global Growth

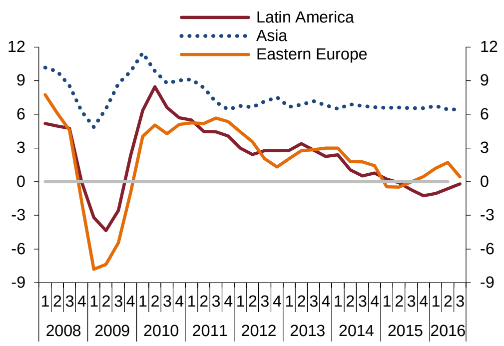
Global economic growth performed well in the third quarter of 2016, gaining momentum across advanced economies and slowing across emerging economies (Chart 2.1.1). Among advanced economies, the US, the Euro area, the UK and Japan posted accelerated growth, with the US and the UK economies growing at a particularly stronger pace compared to previous periods.

Chart 2.1.1.
Global Growth Rates*
(Annual Percent Change)



* Weighted by each country's share in global GDP.
Source: Bloomberg, CBRT.

Chart 2.1.2.
Regional Growth Rates*
(Annual Percent Change)



* Weighted by each country's share in regional GDP.
Source: Bloomberg, CBRT.

In the third quarter of 2016, emerging economies, excluding China and India, suffered from poor growth performances, which weighed heavily on emerging market growth. The abating, yet ongoing, recession in Russia and Brazil, the economic slowdown in Eastern European economies such as Romania, Hungary and Czechia, and the contraction in Turkey caused emerging markets to grow at a slower pace. On the other hand, emerging Asia's growth remained steady, while Eastern European growth was significantly slower; yet, Latin America posted a more robust growth compared to the previous quarter (Chart 2.1.2).

Chart 2.1.3.
Global PMI

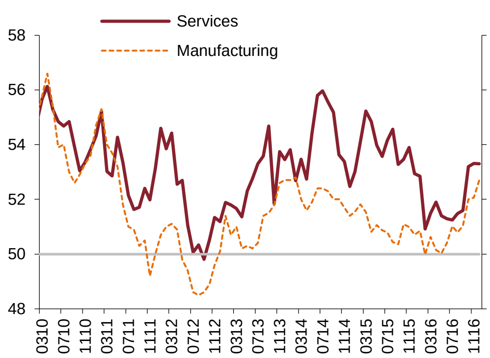
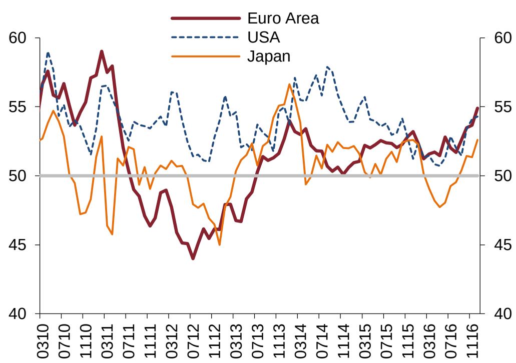


Chart 2.1.4.
Manufacturing PMI

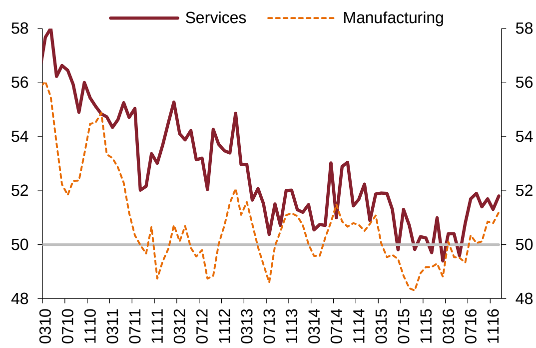


Source: Markit.

PMI data for the fourth quarter signal a more favorable economic growth compared to previous periods (Charts 2.1.3 and 2.1.4). Both PMI and other leading indicators suggest that growth is likely to gain momentum in the US, the Euro area and Japan in the last quarter.

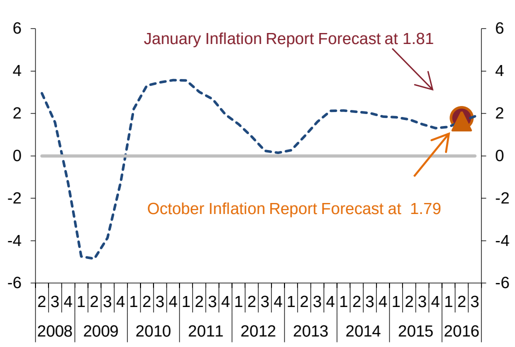
In the final quarter of 2016, the emerging markets PMI increased quarter-on-quarter for the manufacturing, but remained horizontal for services (Chart 2.1.5). The manufacturing PMI registered a quarterly upturn in Eastern European countries such as Poland, Czechia and Russia. As a major energy-exporter, Russia is likely to benefit from the fourth-quarter energy price hike. However, the manufacturing PMI for Latin America, especially Mexico, deteriorated in the fourth quarter, particularly in December. Therefore, emerging Latin America may see a more subdued economic growth in the final quarter. The election of Trump, who advocated protectionist foreign trade policies throughout his presidential campaigns, the Fed's December rate hike and the subsequent accelerated capital outflows from emerging markets were the key drivers of the weakening Latin American growth. On the other hand, the manufacturing PMI increased quarter-on-quarter for China but remained flat for India in the fourth quarter. In this period, the Chinese economy grew at a slightly accelerated pace by 6.8 percent in year-on-year terms. Thus, the growth performance of Asian economies is expected to register a minor improvement in the fourth quarter compared to the third quarter of 2016.

Chart 2.1.5.
Emerging Markets PMI



Source: Markit.

Chart 2.1.6.
Export-Weighted Global Production Index*
(Annual Percent Change)



* Weighted by each country's share in Turkey's exports.
Source: Bloomberg, CBRT.

Against this backdrop, global economic activity is expected to accelerate in the fourth quarter of 2016, particularly on the back of advanced economies, while emerging economies will make a smaller contribution to global growth. According to January's Consensus Forecasts for end-2016 and end-2017, global growth remained unchanged from the previous reporting period (Table 2.1.1). Across advanced economies, forecasts were revised upward for the US, the UK and Japan, yet hint at only a modest rise for the Euro area for end-2017. On the emerging economies front, growth forecasts for Latin America and India were revised down from the previous reporting period (Table 2.1.1). Accordingly, the 2016 growth rate of the export-weighted global production index, which is revised by the January growth forecasts, has barely changed since the October Inflation Report (Chart 2.1.6). Therefore, the external demand outlook for Turkey remained horizontal in the fourth quarter.

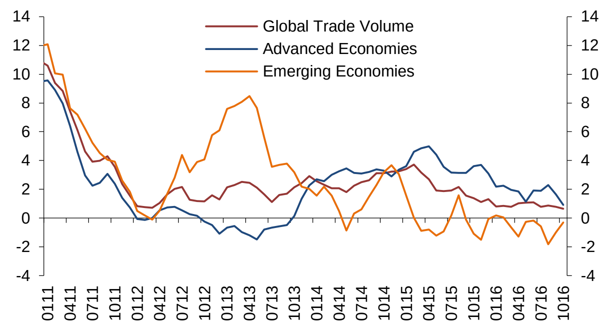
Table 2.1.1.
Growth Forecasts for end-2016 and end-2017
(Average Annual Percent Change)

	October		January	
	2016	2017	2016	2017
Global	2.5	2.8	2.5	2.8
Advanced Economies				
USA	1.5	2.2	1.6	2.3
Euro Area	1.6	1.3	1.6	1.4
Germany	1.8	1.3	1.8	1.3
France	1.3	1.2	1.2	1.3
Italy	0.8	0.7	0.9	0.7
Spain	3.1	2.1	3.2	2.4
Japan	0.6	0.9	0.9	1.1
UK	1.9	0.9	2.0	1.4
Emerging Economies				
Asia-Pacific	5.7	5.6	5.7	5.6
China	6,6	6.3	6.7	6.4
India	7.6	7.7	6.8	7.5
Latin America	-0.3	2.1	-0.5	1.7
Brazil	-3.2	1.2	-3.4	0.7
Eastern Europe	1.5	2.3	1.3	2.2
Russia	-0.6	1.2	-0.6	1.1

Source: Consensus Forecasts.

Global trade continues to expand at a sluggish rate amid the anemic global recovery and weak investments since the financial crisis (Chart 2.1.7). As a key driver of global trade, China's gradual shift from investment-led growth to consumption-led growth since 2011 remains a drag on global trade. Additionally, the growing protectionism in foreign trade, especially in advanced economies, appears to be one of the major hurdles to global trade growth.

Chart 2.1.7.
Global Trade Volume
(Reel, Annual Percent Change, 3-Month Moving Average)

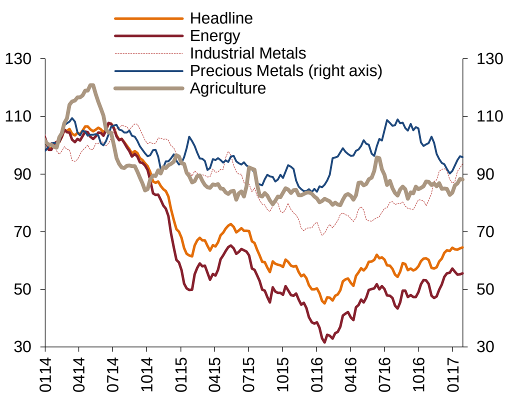


Source: Netherlands Bureau for Economic Policy Analysis.

2.2. Commodity Prices and Global Inflation

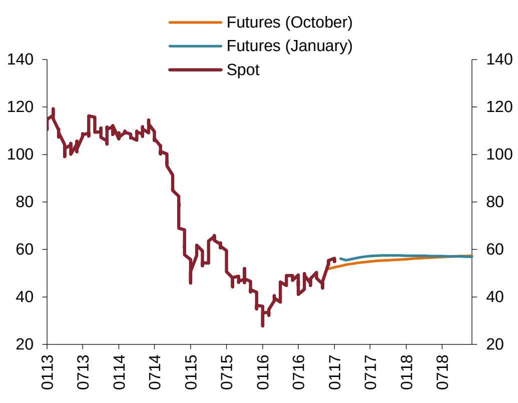
The headline commodity index edged higher in the fourth quarter of 2016, with energy and industrial metals indices up by 9.8 and 8.9 percent, respectively, by an average increase of 5.7 percent from a quarter ago. The rising construction demand in China and prospects for stronger infrastructure investment in the post-election US were the main drivers of higher industrial metal prices. The upsurge in energy prices, on the other hand, was due to the crude oil price jump after the end-November OPEC meeting. However, having fallen in the summer amid a record-high output in 2016, global agricultural prices remained flat on the back of high level of inventories, despite the fourth-quarter's harsh weather conditions. Mounting prospects of post-election stimulus packages in the US as well as the Fed's December rate hike and a more hawkish tone on monetary policy for the coming months caused gold prices to plunge toward the end of the year. Thus, the precious metals index was down 9.4 percent quarter-on-quarter in the fourth quarter (Chart 2.2.1).

Chart 2.2.1.
S&P Goldman Sachs Commodity Index
(January 2014=100)



Source: Bloomberg.

Chart 2.2.2.
Brent Crude Oil Prices*
(USD/bbl)



* Futures (October) and Futures (January) denote the arithmetic mean of the prices quoted at futures contracts during 1-21 October 2016 and 1-26 January 2017, respectively.
Source: Bloomberg.

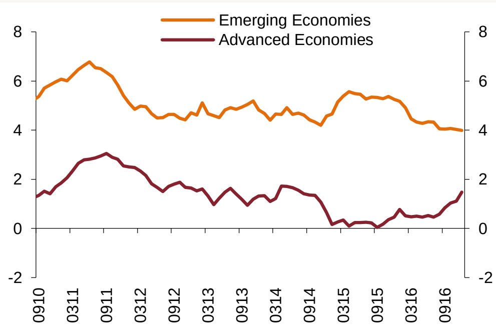
At its regular meeting on 30 November 2016, the OPEC decided to limit production in order to balance the oil market. The decision, to be effective as of January 2017, was endorsed by all 14 OPEC members, and also welcomed by other non-OPEC oil-exporting countries, particularly Russia, causing oil prices to jump after the meeting. After ranging between 40 to 50 USD in the third quarter of 2016, crude oil prices broke above 50 USD per barrel in the final quarter. The Brent crude oil price per barrel hit 55.5 USD as of 26 January 2017. Accordingly, the December 2017 contract for Brent crude oil was traded at 57.4 USD on average as of 26 January 2017, up from an average of 55.8 USD in the previous reporting period (Chart 2.2.2). However, there are both supply and demand-side risks that may limit the rise in crude oil prices in the upcoming period.

The OPEC production cut deal was determined to last for the first six months of 2017, but decided to be extended for another six months, if necessary. Saudi Arabia, the United Arab Emirates and Kuwait agreed to shoulder most of the output cut. Saudi Arabia offered to cut its production further to help bring the market into balance. Meanwhile, Libya, Nigeria and Iran were exempt from this deal. However, historically, OPEC members have usually escaped from quotas and have continued to overproduce to favor their fiscal balances. Moreover, after the plunge in crude oil prices, the US continues to ramp up shale oil amid lower extraction costs backed by technological breakthroughs. In fact, after hitting bottom in May 2016, the oil rig count recovered in line with rising oil prices, ending 2016 with a 50 percent increase.

On the demand side, the 2017 growth forecasts for oil demand were kept unchanged by the International Energy Agency. Especially, the assumptions for demand growth in China and India were left overly conservative. The crude oil demand is expected to decline should the protectionist foreign policies across advanced economies aggravate and dampen the already slow global trade in 2017. In fact, Brent crude oil prices at December 2017 and December 2018 contracts also remain flat (Chart 2.2.2). In short, oil prices may rise only modestly in the upcoming period, with the post-OPEC meeting upswing likely to be short-lived.

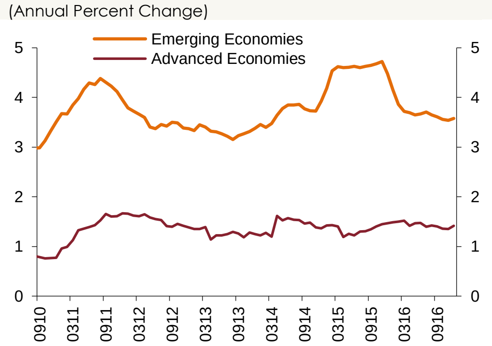
In the inter-reporting period, headline inflation rates increased in advanced economies but edged down in emerging economies (Chart 2.2.3). Meanwhile, core inflation rates inched up in advanced economies but were slightly down in emerging economies (Chart 2.2.4). Inflation forecasts for end-2017 were revised upward from the previous reporting period for both advanced and emerging economies (Table 2.2.1).

Chart 2.2.3.
CPI Inflation in Advanced and Emerging Economies
(Annual Percent Change)



Source: Bloomberg, CBRT.

Chart 2.2.4.
Core Inflation in Advanced and Emerging Economies
(Annual Percent Change)



Source: Bloomberg, Datastream, CBRT.

On the advanced economies front, the fourth-quarter rise in inflation was driven by the more benign economic outlook and soaring oil prices. The US dollar began to appreciate amid a post-election proposal for fiscal stimulus and expectations over the Fed's policies. In the upcoming period, Euro area inflation rates may also see a minor rise on the back of moderately rising energy prices, while Japan's medium-term inflation rate is likely to remain below the target for quite some time. On the other hand, due to the depreciation of the British sterling fueled by the uncertainty over the UK-EU relations following Brexit, the UK's inflation rate is estimated to hover above the 2-percent target in 2017 and 2018, before returning to the target afterwards. Major factors to impose upside risks to global inflation are possible hikes in commodity prices, particularly for oil, prospects for the near-term expansionary policies in the US, possible currency depreciations across emerging economies triggered by expectations over the Fed's decisions and protectionist measures to curb foreign trade on a global scale.

Table 2.2.1.
Inflation Forecasts for end-2017
(Average Annual Percent Change)

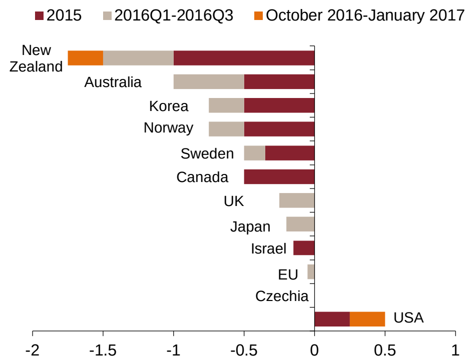
	October 2016	January 2017
Global	2.8	3.0
Advanced Economies		
USA	2.3	2.4
Euro Area	1.3	1.4
Germany	1.5	1.7
France	1.2	1.2
Italy	0.8	0.9
Spain	1.3	1.6
Greece	0.8	0.7
UK	2.3	2.5
Japan	0.4	0.6
Emerging Economies		
Asia-Pacific	2.3	2.2
China	1.9	2.2
India	5.1	5.0
Latin America	8.9	10.9
Brazil*	5.2	4.9
Eastern Europe	4.9	5.0
Russia*	5.3	4.8

* December-on-December.
Source: Consensus Forecasts.

2.3. Global Monetary Policy

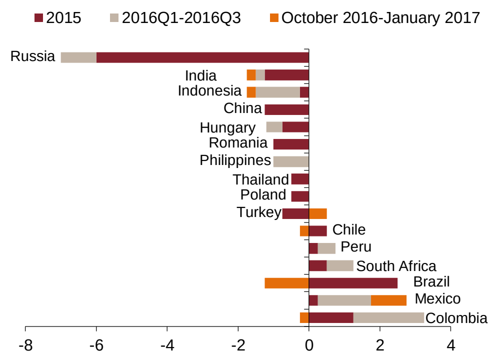
In the final quarter of the year, inflation expectations in the US were driven higher by a stronger recovery in the labor market, the accelerated pace of economic growth and prospects for the adoption of expansionary fiscal policies after the presidential election. Accordingly, the Fed delivered a policy rate hike by 25 basis points in December and also tightened its policy stance for 2017. Following the US presidential election, the Reserve Bank of New Zealand lowered its policy rate by 25 basis points, while other major central banks kept their policy rates unchanged (Chart 2.3.1). On the emerging economies front, the Reserve Bank of India and Bank Indonesia cut their policy rates by 25 basis points in October. Meanwhile, in Mexico and Turkey, the currencies of which were most adversely affected in the aftermath of the US elections, policy rates were hiked by 100 and 50 basis points, respectively, as opposed to Brazil, Colombia and Chile, where the respective central banks reduced their policy rates after the election (Chart 2.3.2).

Chart 2.3.1.
Policy Rate Changes in Advanced Economies*
(Basis Points)



* As of January 27 2016.
Source: Bloomberg.

Chart 2.3.2.
Policy Rate Changes in Emerging Economies*
(Basis Points)

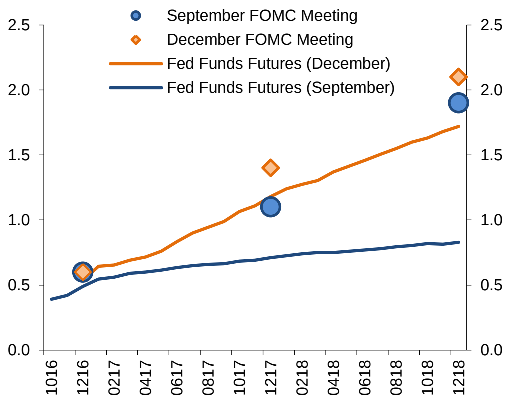


The Fed decided to increase its benchmark policy rate at the December meeting, as expected, and tightened its policy stance and forecasts for 2017 and beyond. Policy rate expectations signaled that interest rates would rise at a faster pace than previously projected and the median projection has been raised to three rate hikes in 2017, from the formerly predicted two rate hikes. In addition, in the inter-reporting period, the policy rate path implied by the Fed funds futures has moved closer to the policy rate projections of the FOMC (Chart 2.3.3). This indicates that market expectations have been more compatible with the policy rate projections of the FOMC. Meanwhile, the Bank of England delivered less monetary easing compared to the previous reporting period. Accordingly, in the November 2016 issue of the Inflation Report, the Bank of England has scrapped plans for a previously signaled policy rate cut against the deteriorated inflation outlook due to heightening exchange rate volatility and the depreciation of the British sterling led by the Brexit-driven uncertainty. Similarly, the Bank of Japan kept its policy rates constant despite expectations for further cuts in the already negative rate. The ECB, on the other hand, extended the bond-buying program, which was due to end in March 2017, until the end of 2017, but cut monthly purchases as of April from 80 billion EUR to 60 billion EUR. It was stated by the ECB that this reduction should not be interpreted as a tightening since the total amount of bonds to be purchased is increased.

These policy decisions imply a relatively tighter monetary policy stance for these major central banks compared to the previous period. Recently, there have been frequent debates about potential financial market fragilities in case advanced economies adhere to near-zero and even negative interest rates as well as large-scale asset purchases for a prolonged period of time. In this context, though uttered only by the Fed, a strong tendency has been observed in monetary policy normalization. Economic data for advanced economies, except the US, have yet to provide evidence for such a normalization, but the latest forecasts of central banks point to both an upward revision in the growth outlook and inflation rates nearing targets (Table 2.3.1).[1]

[1] The Bank of Japan's latest forecasts are as of October and signal a drop in inflation, but the MPC statement in December indicates improved economic outlook and increased inflation expectations, with the new forecasts to be released on 31 January.

Chart 2.3.3.
Median Policy Rate Projections of the FOMC and Fed Funds Futures*
(Percent)



* Fed Funds Futures (September) and Fed Funds Futures (December) denote fed funds futures expiring at 22 September 2016 and 15 December 2016, respectively.
Source: Bloomberg.

Table 2.3.1.
Central Banks' Forecasts for Growth and Inflation*
(Percent)

	2017	2018
Growth		
Fed	2.1 (+0.1)	2.0
ECB	1.7 (+0.1)	1.6
Bank of England	1.4 (+0.6)	1.5 (-0.3)
Bank of Japan	1.3	0.9
Inflation		
Fed	1.9	2,0
ECB	1.3 (+0.1)	1.5 (+0.3)
Bank of England	2.7 (+0.7)	2.7 (+0.3)
Bank of Japan	1.5 (-0.2)	1.7 (-0.2)

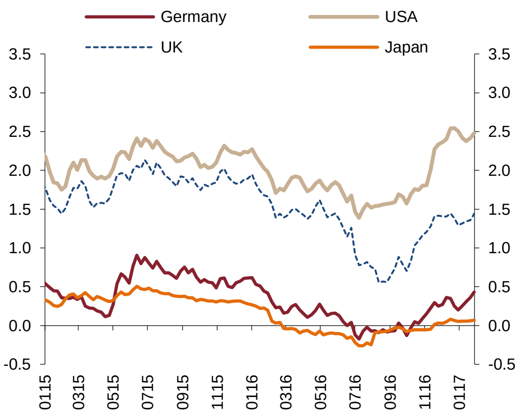
* Values in parentheses denote changes in forecasts in the inter-reporting period.
Source: Bloomberg.

Against this background, emerging economies are likely to face stronger challenges with regards to their monetary policies. Expectations for monetary tightening in advanced economies lead to higher inflation in emerging economies through increased import prices amid depreciated currencies, while higher interest rates increase borrowing costs, thus pose an additional burden on emerging economies, relying on external funds. Moreover, the uncertainty over fiscal and foreign trade policies to be adopted by the new US administration is another factor to hinder proper policy responses in emerging economies.

2.4. Global Risk Indicators and Portfolio Flows

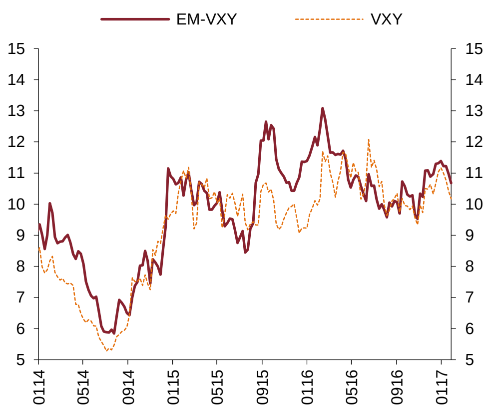
In the fourth quarter of 2016, long-term interest rates in advanced economies were mainly driven by the Fed policy rate (Chart 2.4.1). The rise in long-term interest rates was induced by the anticipation of a tighter Fed monetary policy in 2017 and the expected demand boost to be fueled by the US economy.

Chart 2.4.1.
10-Year Treasury Bond Yields
(Percent)



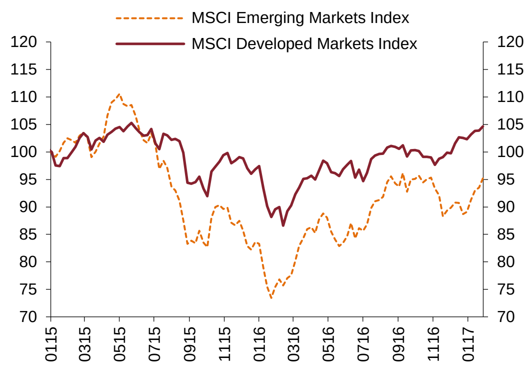
Source: Bloomberg.

Chart 2.4.2.
JP Morgan Volatility Indices
(Weekly Average)



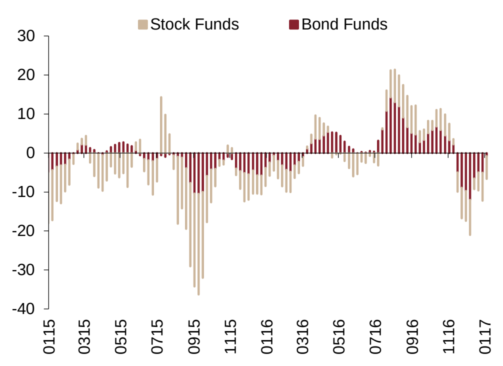
In the final quarter of 2016, global financial markets were dominated by the US presidential election and the Fed's policy rate decision. The uncertainty and the subsequent volatility that surrounded global markets before the November election mounted after Trump's win and the announcement of the fiscal spending proposal (Chart 2.4.2). Moreover, the early-December political turmoil in Italy and escalating Euro area banking troubles, again led by Italy, sent global financial markets into a tailspin in the fourth quarter. All in all, global financial markets fluctuated dramatically, while global funds flew away from emerging economies and into the US. Thus, stock prices tumbled in emerging economies but picked up in advanced economies over the fourth quarter (Chart 2.4.3).

Chart 2.4.3.
MSCI Indices
(January 2015=100)



Source: Bloomberg.

Chart 2.4.4.
Weekly Portfolio Flows to Emerging Economies
(Billion USD, 4-Week Cumulative)



Source: EPFR.

The third quarter's portfolio inflows towards emerging markets continued into October; whereas in November and December, emerging economies saw massive outflows. Along with the long-awaited Fed rate hike in December, the growing sentiment of a post-election tightening cycle prompted most of the portfolio outflows. Accordingly, both bond and stock markets suffered continuous outflows from the week after the election until the end of December (Chart 2.4.4). Across regions, the heaviest losses occurred in Asia and Latin America (Table 2.4.1). Outflows in Asia were mostly from stock markets and driven by China, while in Latin America, outflows were largely from bond markets and led by Mexico. As of January 2017, emerging stock markets continue to suffer from outflows, while emerging bond markets have enjoyed some inflows. These inflows were led by Brazil in Latin America and Russia in the Emerging Europe. Investors fleeing emerging stock markets after November shifted mostly towards US stocks.

Table 2.4.1.
Composition and Regional Distribution of Fund Flows to Emerging Economies
(Quarterly, Billion USD)

		Total	Fund Composition		Regional Distribution			
			Bond Funds	Equity Funds	Asia	Europe	Latin America	MENA
2015	Q1	-8.6	1.9	-10.5	-8.1	2.2	-2.4	-0.2
	Q2	-8.0	1.4	-9.4	-6.9	0.4	-2.0	0.4
	Q3	-45.3	-16.5	-28.8	-23.8	-6.5	-10.8	-4.1
	Q4	-22.3	-12.7	-9.6	-11.1	-3.0	-6.4	-1.9
2016	Q1	-4.5	-1.2	-1.6	-2.5	-1.4	-0.3	-0.3
	Q2	-1.4	7.3	-8.7	-4.5	0.7	1.9	0.6
	Q3	42.4	26.1	16.3	17.9	7.5	12.4	4.7
	Q4	-17.4	-9.3	-8.1	-12.6	-0.8	-2.7	-1.3

Source: EPFR.

Box 2.1 Recent Global Uncertainties and Its Implications

As the global economy is still struggling to recover from the latest financial crisis, current policies face growing aversion, and therefore the political ground has shifted in many countries. The uncertainty over economic policies has also increased in line with the changing political climate. Accordingly, the uncertainty about global economic policies has reached historic-highs since the previous peak in 2011 (Chart 1). This box gives an analysis of the reasons behind this mounting uncertainty and its potential implications for emerging economies.

Chart 1. Global Economic Policy Uncertainty
(6-Month Moving Average)

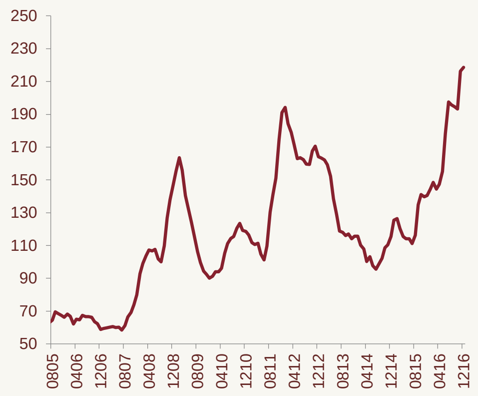
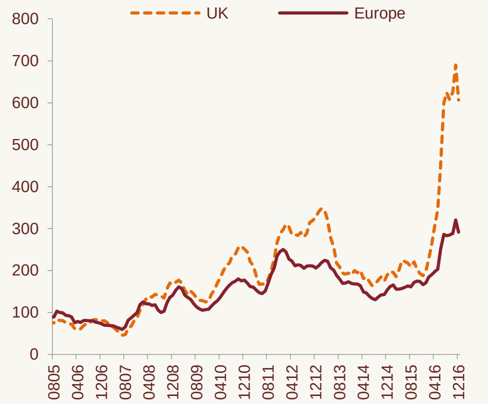


Chart 2. Regional Economic Policy Uncertainty
(6-Month Moving Average)



Source: Baker et al. (2016), www.economicpolicyuncertainty.com.

One key driver of the changing political climate is the UK's vote to leave the EU. Contrary to expectations, the UK opted to exit the EU at the referendum on 23 June 2016, sparking uncertainty over economic policies in Europe (Chart 2). Later, Trump's win in the US presidential election on 8 November 2016, who, as a candidate, vowed to implement more inward-looking policies, triggered additional uncertainty regarding the elections to be held across Europe.

Due to the uncertainty and volatility these events have caused, the ongoing global political ground has led to significant challenges for policymaking in both advanced and emerging economies. These developments might affect the world economy through trade, finance, monetary policy and capital flows. Although it is quite difficult, at this stage, to foresee the transmission and final impacts of these channels, the immediate reflections of the recent developments in global financial markets are observed as higher interest rates and re-priced assets.

The US policy path in the Trump era is one of the main sources of uncertainty for the future direction of the global economy. Changes in US economic policies are expected to occur mainly in trade, fiscal and monetary policies. The expectation of a more protectionist foreign trade policy might put upward pressure on US inflation rates and weigh on global growth, particularly through emerging economies. The imminent fiscal expansion will probably translate into stronger US growth, higher inflation and rising bond yields in the upcoming period. The spillover effects of strong expansionary fiscal policies may hint at better growth for emerging economies; yet, these may be outweighed by the negative effects of trade protectionism in the medium term. Hence, it may be concluded that the strength and timing of trade and fiscal policies remain highly uncertain, and measuring their net effects is rather difficult. However, both policies have fueled hopes of stronger US growth and higher inflation, therefore reinforcing prospects for a Fed tightening cycle, which sent bond rates soaring in advanced economies while local currencies plummeted across emerging economies. In the coming months, emerging markets may gain competitive advantage with respect to their net exports by the depreciation of their currencies. On the other hand, through balance sheet effects and international funds, the depreciation of local currencies may lead to contraction in emerging economies that borrowed in US dollar during the post-crisis period of ample liquidity. Capital flows are another fast spillover channel of the increased uncertainty about global policies and the expected US tightening cycle. Indeed, emerging economies suffered massive portfolio outflows in the aftermath of the US presidential election.

The uncertainty surrounding global economic policies is expected to linger over the medium term. These developments affect economies through various channels and in opposite directions. For instance, a strong US fiscal expansion might, on one hand, encourage emerging market capital inflows, by stimulating global demand, and thus emerging market growth, and on the other hand, discourage emerging market capital inflows as advanced economies would also raise their interest rates. In such an environment, one may expect emerging market monetary policies to be affected to ward off the negative spillover effects of exchange rates. Fiscal and macroprudential stimulus packages might be needed in order to offset any downward pressure from tight monetary policy on economic activity. The implementation of such a policy and possible challenges may be different for each country depending on the discrepancies in the prevailing domestic conjuncture in each country and country-specific factors. For example, countries with ample fiscal space may focus more on fiscal stimulus programs, whereas countries with already large debts may adopt macroprudential measures. Such macroeconomic and macroprudential policies save time for policymakers, yet it is common knowledge that policies, which enhance the resilience of economies against shocks are actually the structural policies. Therefore, tough periods are challenging as they provide set the ground to undertake structural reforms, and all relevant institutions and authorities should coordinate in order to build monetary, fiscal, macroprudential and structural reforms in both advanced and emerging economies.

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