2. International Economic Developments

The slowdown in global economic activity in the first half of the year continued into the third quarter both in advanced and emerging economies. On the advanced economies front, displaying a positive growth performance, the US economy diverged favorably from others, while Japan and the Euro Area continued to record weak economic activity, thus driving the slowdown in global growth. As for the emerging economies, China and India presented a sluggish outlook, while the negative growth performances of Brazil and Russia also imposed a downside risk to global growth. Last quarter indicators show that the global growth continues to decelerate.

In the last quarter of the year, the headline commodity price index recorded a quarter-on-quarter decline by 27 percent mainly due to energy prices. Accordingly, the fall in oil prices, which started in the second half of the year owing to high demand and supply conditions, continued with an accelerated pace in the last quarter of the year. This sizeable fall in commodity prices pulled down inflation rates in both advanced and emerging economies.

Monetary policy in advanced economies followed a loose course in the third quarter; and the Fed's monetary policy continued to diverge significantly from that of other advanced economies. In line with the favorable growth performance, the Fed will likely raise policy rates to normal levels soon, while additional easing measures are being debated in the Euro Area and Japan. On the other hand, the monetary policy adopted by the central banks of emerging economies in the last quarter was shaped by the plunge in oil prices that started in the second quarter and the resulting fluctuations in financial markets. Accordingly, the most aggressive response to the fall in oil prices proved to be the 750 basis points policy rate hike by the Bank of Russia to prevent the depreciation of the ruble in the last quarter of the year. Policy divergence on a global scale and expectations for an impending tightening by the Fed aggravate the uncertainties about the future policies. Additionally, the slowdown in both the global growth outlook and economic activity in emerging economies feed risks on capital flows, which have continued to fluctuate in the last quarter. Also, given the concerns over Russia and the Middle East, fluctuations in global risk appetite and the volatility in portfolio flows are expected to persist in the upcoming period as well.

2.1. Global Growth

The slowdown in global economic growth in the first half of 2014 continued through the third quarter. Growth rates of both advanced and emerging economies lost momentum in this period. Compared to the first half of the previous year, growth rates registered a notable decline, especially in emerging economies (Chart 2.1.2). In the third quarter of 2014, in contrast to the brisk growth in the US economy, the deepening recession in Japan played a key role on the deceleration of the global growth. On the emerging economies front, the slower-than-expected growth in China and India, the ongoing recession in Brazil and the persisting slowdown in the Russian economy stood out as the factors that led to weak global economic activity.

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

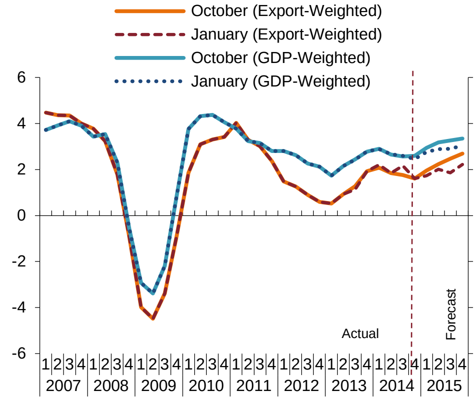
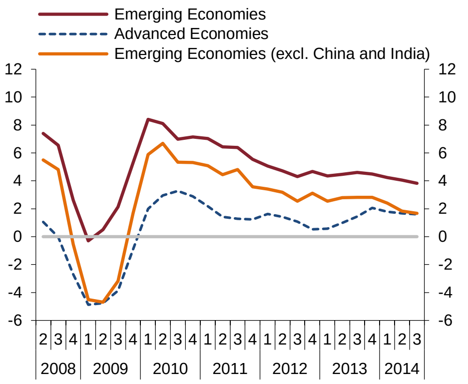


Chart 2.1.2.
Global Growth Rates*
(Annual Percent Change)



* Weighted by each country's share in Turkish exports and by each country's share in global GDP for export-weighted growth and GDP-weighted growth, respectively.
Source: Bloomberg, CBRT.

Global PMI data for the last quarter of 2014 exhibit a worse growth performance than past quarters (Chart 2.1.3). Manufacturing industry PMI readings for the Euro Area remained flat in this period, while those of the US displayed a notable decline (Chart 2.1.4). However, the steady fall in the US unemployment rate continued into the last quarter of 2014. Moreover, consumer confidence and industrial production increased at an accelerating pace in this period. The declining PMI notwithstanding, all these developments indicate that the US economy grew further in the last quarter of the year. In the October-November period, the declining year-on-year growth of the industrial production in Japan besides the worsening consumer confidence show that the Japanese recession has continued in the last quarter.

Manufacturing industry PMI of the emerging economies registered an overall increase in the last quarter of 2014. This points to a stronger economic activity for emerging economies in the last quarter of 2014 compared to the third quarter. However, manufacturing industry PMI displayed a decline in China, Russia and Brazil in this period. Given the weight of these countries in emerging economies, economic growth is likely to lose pace in emerging economies in the last quarter of 2014. In fact, the year-on-year growth of Chinese industrial production recorded a notable fall in the October-November period of 2014.

In sum, the slowdown in the global growth rate in the first nine months of 2014 will probably persist in the last three months of the year due to the decelerating growth in both advanced and emerging economies. In particular, Japanese, Chinese, Brazilian and Russian economies are expected to pull the global growth rate down in this period.

Chart 2.1.3.
Markit Global PMI

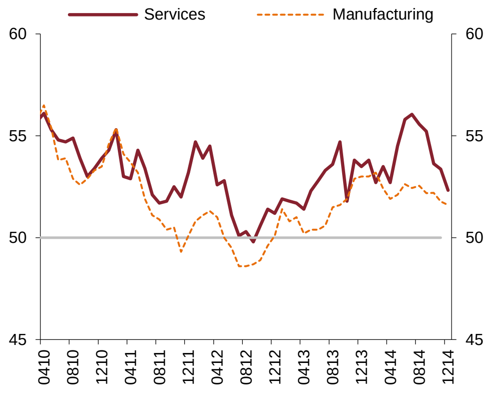
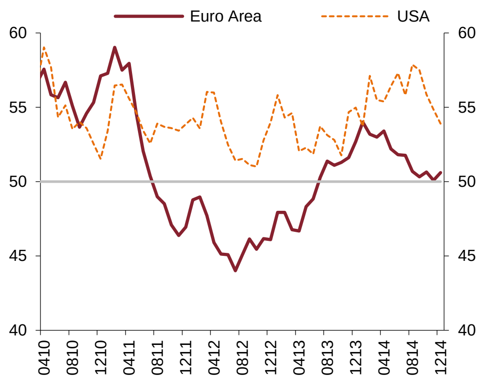


Chart 2.1.4.
Manufacturing Industry PMI



Source: Markit.

As of January, the global growth forecast for end-2014 has remained unchanged since the previous reporting period. Growth forecasts were revised upwards for the US and downwards for Japan and the UK in this period. In particular, the growth rate of the Japanese economy was revised remarkably downwards. Compared to the previous report projections, growth forecasts for 2014 remained unchanged for the Asia-Pacific region, but were revised slightly upwards for Eastern Europe, and notably downwards for Latin America (Table 2.1.1). The GDP and export-weighted global production indices revised by January forecasts indicate that the global economy continued to grow in the last quarter of 2014. However, in comparison with the October Inflation Report, the GDP-weighted index lagged behind projections, whereas the export-weighted index remained unchanged (Chart 2.1.1). Thus, Turkey's external demand continued to exhibit a weak outlook in the last quarter of 2014. On the other hand, amid the sluggish growth prospects for emerging economies, January Consensus Forecasts envisage a slower global growth for end-2015 than stated in the October Inflation Report (Table 2.1.1). The downward revisions, which were rather notable for Brazilian and Russian economies, indicate that the deceleration in the global growth will continue in 2015 due mainly to emerging economies (Chart 2.1.1 and Table 2.1.1).

Table 2.1.1.
Growth Forecasts for end-2014 and 2015 (Annual Percent Change)

	October		January	
	2014	2015	2014	2015
World	2.7	3.2	2.7	3.0
Advanced Economies				
USA	2.2	3.1	2.4	3.2
Euro Area	0.8	1.2	0.8	1.1
Germany	1.4	1.5	1.5	1.4
France	0.4	0.8	0.4	0.9
Italy	-0.3	0.5	-0.4	0.4
Spain	1.3	1.9	1.3	2.0
Greece	0.2	1.9	0.8	1.8
Japan	1.1	1.2	0.2	1.2
UK	3.1	2.6	2.7	2.6
Emerging Economies				
Asia-Pacific	6.0	6.1	6.0	6.0
China	7.3	7.1	7.4	7.0
India	5.6	6.3	5.6	6.3
Latin America	1.2	2.0	0.9	1.3
Brazil	0.3	1.0	0.1	0.4
Eastern Europe	1.4	2.0	1.5	-0.2
Russia	0.2	0.4	0.4	-4.1

Source: Consensus Forecasts.

2.2. Commodity Prices and Global Inflation

The headline commodity price index posted a quarter-on-quarter decline by 27.2 percent in the last quarter of 2014. Energy prices, which have plummeted by 38.4 percent since the end of the previous quarter, appeared as the main driver of this considerable fall. Industrial metal and precious metal price indices fell by 6 and 3 percent, respectively, while the agricultural price index rose by 10.3 percent in the same period (Chart 2.2.1). This rise in agricultural prices was due to concerns over a possible restriction by Russia on wheat exports and the lower-than-expected soy production in Brazil. Meanwhile, the decline in other commodity prices was owed to downside price pressures triggered by high supply and low demand conditions.

Chart 2.2.1.
S&P Goldman Sachs Commodity Prices
(January 2010=100)

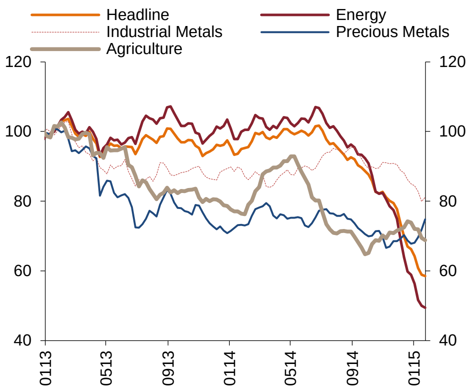
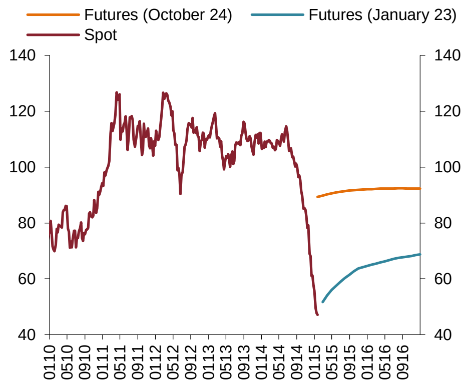


Chart 2.2.2.
Crude Oil (Brent) Prices*
(USD/bbl)

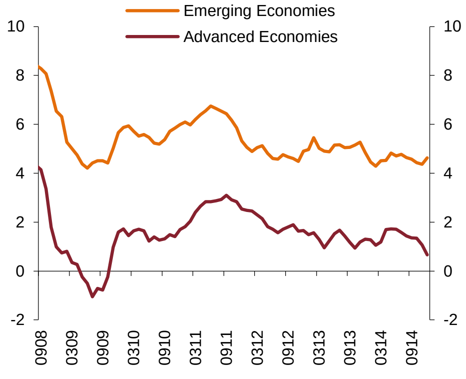


* January 23 and October 24 denote the arithmetical average of the prices quoted at futures contracts during January 1-23, 2015 and October 1-24, 2014, respectively.
Source: Bloomberg.

Following the no-quota decision made at the OPEC November meeting, crude oil prices continued to decelerate further and Brent crude oil prices dropped to 55.8 USD at the year-end. Forward contracts indicate that oil prices will remain well below the levels recorded in the first half of 2014 in the upcoming period. Accordingly, the Brent crude oil contract, expiring in December 2015, was traded at 64.5 USD on January 2 (Chart 2.2.2). A price correction in US crude oil supply or an OPEC decision to restrict production may push oil prices up in the upcoming period. The relatively weak course of the Chinese economy, on the other hand, indicates that the downside pressure on industrial metal prices will continue.

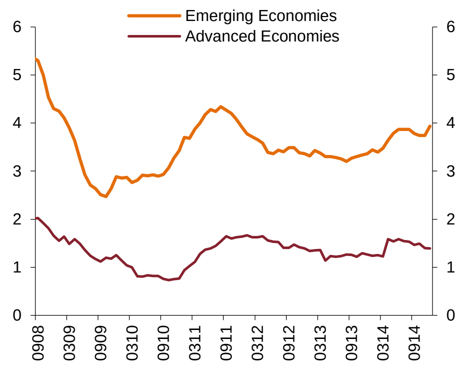
In the inter-reporting period, consumer and core inflation rates in advanced economies registered a decline mostly due to the tumbling energy prices. Meanwhile, emerging economies saw a slight increase due to developments in Russia and Latin America (Charts 2.2.3 and 2.2.4).

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.

The global inflation forecast for end-2015 was revised downwards by 0.5 points in the inter-reporting period. In general, inflation forecasts were revised significantly for all country groups. Inflation forecasts for advanced economies and the Asia-Pacific were pulled down substantially, whereas Latin America and Eastern Europe witnessed upward revisions (Table 2.2.1). The fact that the revision in Eastern Europe was mostly caused by Russia indicates that the depreciation of the ruble will mostly determine the course of inflation.

Table 2.2.1.
Inflation Forecasts for end-2015 (Annual Percent Change)

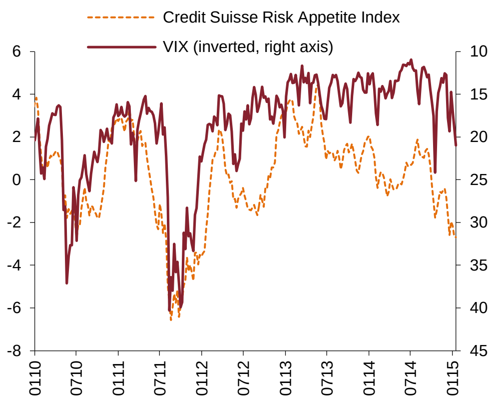
	October	January
World	3.1	2.6
Advanced Economies		
USA	1.8	0.7
Euro Area	1.0	0.1
Germany	1.6	0.7
France	1.0	0.3
Italy	0.6	0.2
Spain	0.7	-0.3
Greece	0.0	-0.6
Japan	1.9	0.9
UK	1.8	1.2
Emerging Economies		
Asia-Pacific	3.3	2.5
China	2.7	1.8
India	6.8	5.9
Latin America	11.7	12.3
Brazil*	6.3	6.4
Eastern Europe	5.3	7.1
Russia	6.2	10.8

* December to December.
Source: Consensus Forecasts.

2.3. Financial Conditions, Risk Indicators and Capital Flows

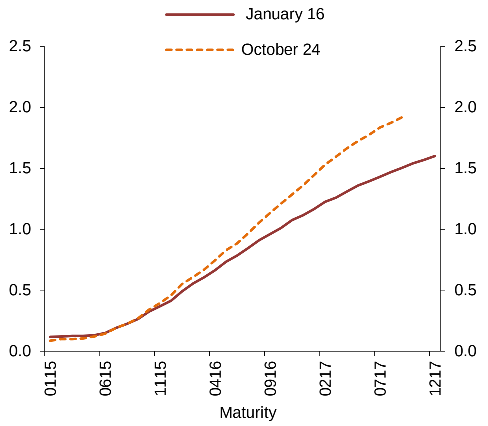
The last quarter of the year was marked by ongoing sluggish global economic activity and divergence among countries in addition to the weak global risk appetite due to financial volatilities in some countries driven by plunging energy prices (Chart 2.3.1). Fed funds futures contracts reveal that the timing of the expected policy rate hike has remained unchanged, yet long-term policy rate expectations have receded considerably (Chart 2.3.2). Accordingly, the fall in policy rate expectations was reflected in the US Treasury bonds, causing a decline in medium and long-term yields in the last quarter of the year (Chart 2.4.3).

Chart 2.3.1.
Global Risk Appetite



Source: Bloomberg, Credit Suisse.

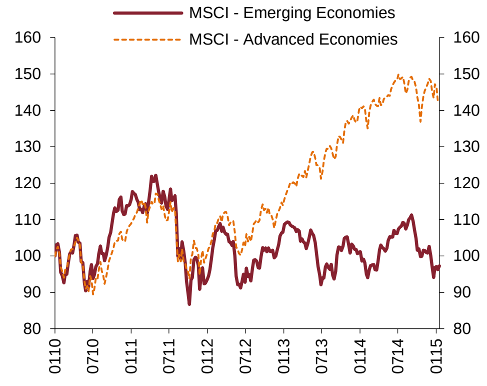
Chart 2.3.2.
Fed Funds Futures
(Percent)



Source: Bloomberg.

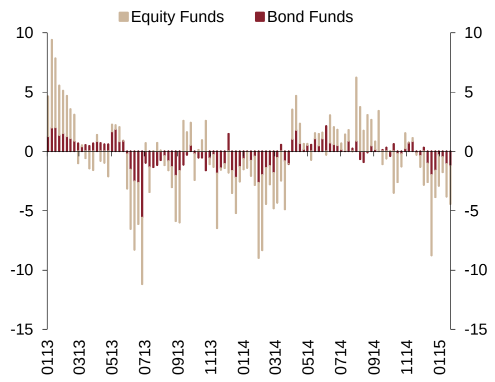
Due to the attenuating risk appetite coupled with the growth divergence among countries in the last quarter, stock prices in emerging economies declined in contrast to those of Asian countries, which gained value (Chart 2.3.3). On the other hand, the rising stock prices in the US economy caused a limited surge in advanced economies in the same period; yet, stock prices in the Euro Area and Japan experienced no hikes (Chart 5.1.1).

Chart 2.3.3.
Global Stock Markets
(USD, 2007=100)



Source: Bloomberg.

Chart 2.3.4.
Weekly Portfolio Flows to Emerging Economies
(Billion USD)



Source: EPFR.

Capital inflows towards emerging economies followed a volatile course in the last quarter of the year. The ongoing improvement in capital flows, which started in the second quarter, has resumed in the last quarter and capital outflows gained particular momentum in December (Chart 2.3.4). Marked by an evident quarter-on-quarter increase in volatility, the last quarter witnessed outflows, which mostly stemmed from equity markets in terms of portfolio composition.

The possibility of the Fed to exercise a higher-than-expected tightening under the exit strategy from the quantitative easing policy vis-à-vis stronger growth signals in the US and the divergence in global monetary policies are considered to aggravate the policy uncertainties in the upcoming period. Meanwhile, the slowdown both in the global growth outlook and the economic activity in emerging economies keep the downside risks to capital inflows towards emerging economies brisk. Given this atmosphere of uncertainties fed by concerns over Russia and the Middle East, fluctuations in the global risk appetite and the volatility in portfolio flows are projected to persist in the upcoming period.

2.4. Global Monetary Policy

The plunge in oil prices and the resulting fluctuations in financial markets in the last quarter of the year had apparent effects on the course of the global monetary policy as well. This sharp decline heightened deflationary risks in the Euro Area and Japan and led to growing concerns for central banks to slip into a deflationary spiral. Accordingly, having slashed the benchmark refinancing rate down to near zero through 10 basis points cuts, which were delivered twice in the first nine-month period of 2014, the ECB announced an expanded asset purchase program in the last quarter of the year. Although the ECB had smaller room to maneuver policy rates, these developments led the Sverige Riksbank and the Norges Bank, the central banks of Sweden and Norway, which are members of the European Union but not members of the Euro Area, to pull policy rates down by 25 basis points in the last quarter. The plunge in oil prices also led the Bank of Canada to cut its key rate by 25 basis points in the last quarter (Chart 2.4.1). Meanwhile, the Swiss National Bank both reduced its policy rate and scrapped the euro peg in January.

At the emerging economies side, developments in oil prices had the most devastating effects in Russia, causing a dramatic depreciation of the ruble, which called for a 750 basis points policy rate hike in December. Similarly, amid the persisting depreciation of the Brazilian real, Banco Central do Brasil also raised policy rates by a cumulative 125 basis points- 75 basis points in the last quarter of 2014 and 50 basis points in January 2015. Meanwhile, Bank Indonesia increased the policy rate by 25 basis points in November due to inflationary concerns. On the other hand, amid the developments in Europe, both the National Bank of Romania and the National Bank of Poland cut policy rates by 50 basis points in the last quarter. Likewise, the Central Bank of Chile and the Central Reserve Bank of Peru reduced policy rates by 25 basis points in order to bolster economic activity (Chart 2.4.2). Additionally, the People's Bank of China delivered 40-basis points cut in December, while the Reserve Bank of India lowered the policy rates by 25 basis points in January.

Chart 2.4.1.
Policy Rate Changes in Advanced Economies from Jan. 2014 to Jan. 2015* (Basis Points)

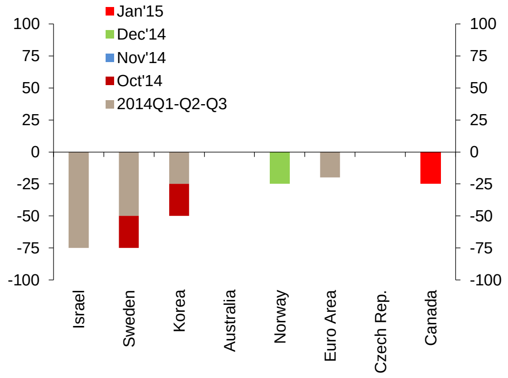
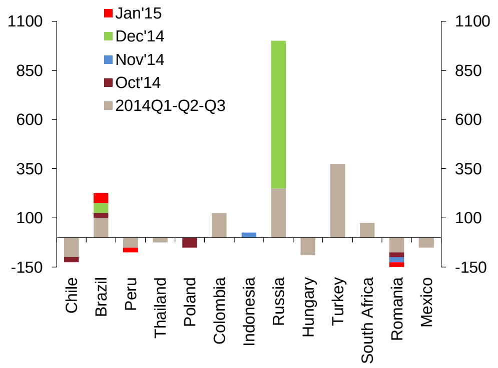


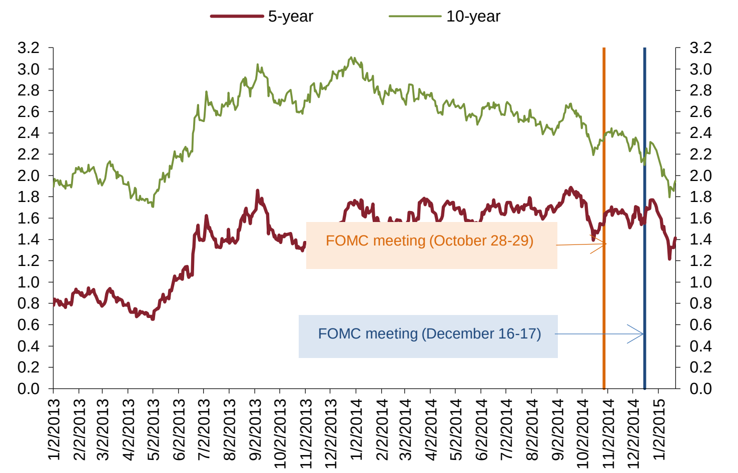
Chart 2.4.2.
Policy Rate Changes in Emerging Economies from Jan. 2014 to Jan. 2015* (Basis Points)



* As of January 23.
Source: Bloomberg, CBRT.

Expectations for a global economic recovery in early 2014 changed course in the middle of the year by the US economy diverging favorably from other major economies, whereas the positive outlook in the Euro Area and Japan in the start of the year was replaced by risks of deflation and recession. This led to a growing policy divergence among advanced economies. As of the last quarter of 2014, the timing and the pace of the Fed's first policy rate hike has been debated, while for the Euro Area and Japan, additional easing measures have been questioned. Following its last meeting on December 16-17, the FOMC stated that the real economy and especially the labor market continue to witness favorable developments and that the FOMC expects inflation to rise gradually toward 2 percent as the labor market improves further and the transitory effects of lower energy prices and other factors dissipate. However, the FOMC also stated that it can be patient in beginning to normalize the stance of monetary policy.

Chart 2.4.3.
Yields on 5-year and 10-year US Treasury Bonds (Percent)



Source: Bloomberg.

In line with the Fed's communication regarding policy normalization, bond yields with varying maturities also followed a divergent course throughout 2014. More specifically, 5-year bond yields remained flat across the year, while that of 10-year bonds followed a downward course (Chart 2.4.3). The fact that the expectations for a policy rate hike by the Fed reflect more on short-term rates whereas long-term rates are trending downwards, suggests that the adverse effects of the policy normalization may be more limited, especially on emerging economies, compared to the negative effects experienced after May 2013 during the first tapering talks.

In its January meeting, the ECB announced an expanded asset purchase program. Accordingly, the ECB will expand purchases to include bonds issued by Euro Area central governments, agencies and European institutions, in which the monthly asset purchases will amount to 60 billion euro. The program will start in March 2015 and is intended to be carried out until at least September 2016. The program, which includes some constraints to render the asset purchases effective, may be extended without any notified time, if deemed necessary. Against this background, the euro has depreciated against the USD to a sizeable extent.

The ongoing heterogeneity in the global monetary policy stance is likely to continue in the upcoming period. If the Fed's monetary policy assumes a normalization process, central banks are expected to maintain the tight monetary policy stance to prevent their local currencies from depreciating. This is particularly true in countries running a current account deficit. Meanwhile, the ECB and other central banks in the Euro Area are expected to maintain their loose monetary policy for a while to support the weak economic activity.