

## 2. International Economic Developments

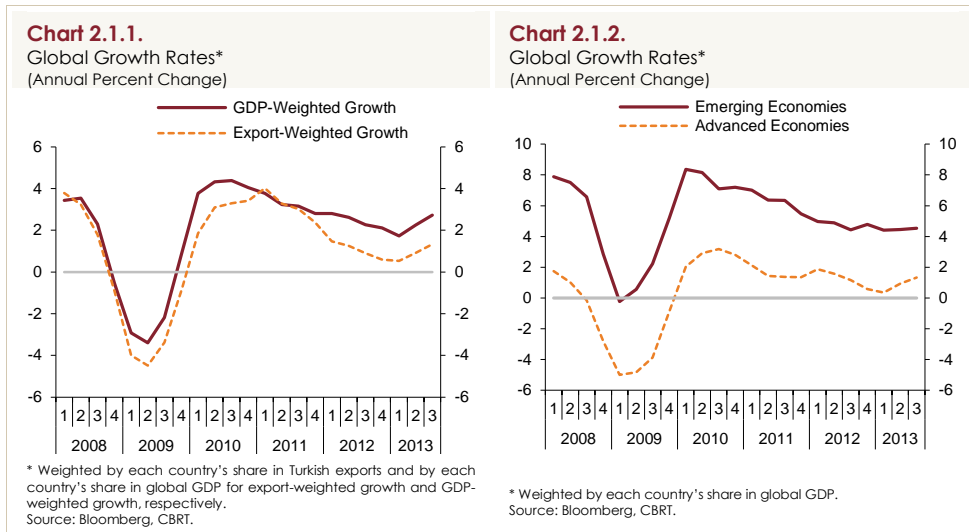
Data for the third quarter of 2013 show that the recovery in the global economy continued in the third quarter. This recovery was mostly driven by the favorable growth of advanced economies, while economic activity in emerging economies increased as well, albeit modestly. Data for the final quarter of the year suggest that both advanced and emerging economies will maintain the third-quarter trend. With the recovery of the global economy, the headline commodity price index picked up slightly during the second half of the year. As indicated by the inflation developments in the fourth quarter, advanced economies saw an inflation uptick in line with the rising economic activity. Similarly, inflation trended upward across emerging economies during the final quarter. The acceleration of inflation is assessed to be fuelled by the exchange rate depreciation resulting from capital outflows, rather than the modest recovery in economic activity.

In the last quarter of 2013, the Fed's decisions towards normalizing monetary policy and hints at future action continued to have a strong influence on the global economy. In view of strong growth and favorable labor force data, the Fed decided to trim its monthly bond purchases to 75 billion USD from 85 billion USD at its December meeting. This partially reduced uncertainties about the Fed's monetary policy normalization regarding asset purchases. Yet, the question of when and how much the Fed will raise its policy rate, another component of its monetary policy, remains as a major source of uncertainty over the global economic outlook.

After the first tapering hint by the Fed in May, capital flows to emerging markets dropped significantly, plunging in the last quarter of the year. For the upcoming period, conditions are present to bolster downside risks to capital flows into emerging economies. While the gradual decline in global liquidity is one of the key factors that will feed into these risks, the divergence of growth in favor of advanced economies may remain a factor that will help capital flows to also diverge in favor of advanced economies over the upcoming period. Financial stability in emerging economies may be adversely affected should the uncertainty about global monetary policy persist and lead to an increase in capital market volatility.

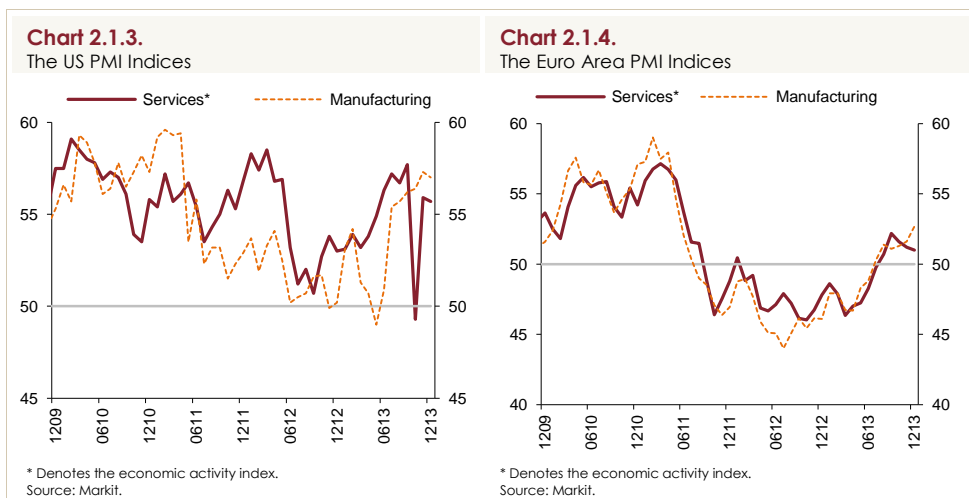
### 2.1. Global Growth

Having turned positive in the second quarter, the global growth outlook continued to improve in the third quarter of 2013 (Chart 2.1.1). In this period, the pace of growth in advanced economies, particularly the US, UK and Japan, surged dramatically, while the persisting recession in the Euro Area lost momentum. Meanwhile, growth rates accelerated, albeit modestly, across emerging economies in the third quarter of 2013, which stood as another favorable factor to support global economic recovery (Chart 2.1.2).

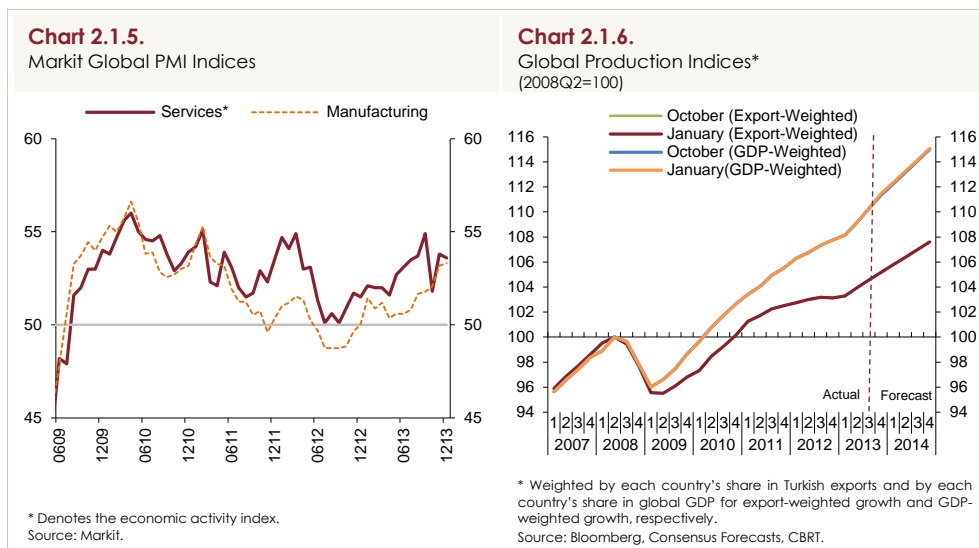


The US economy continued to grow rapidly during the third quarter of 2013 and the GDP increased by an annualized 4.1 percent quarter-on-quarter. Private inventory investment, private consumption, non-residential fixed investment and exports provided a positive contribution to growth. Moreover, after contributing negatively in the first half of the year, public spending added 0.1 points to growth in the third quarter, which indicates that the tight fiscal policy in place since early 2013 has a broadly subsiding negative effect on growth. Yet, the federal government shutdown in October is expected to have an adverse, though limited, impact on public spending's contribution to growth in the last quarter. PMI data for the fourth quarter suggest that the US growth will remain favorable (Chart 2.1.3). The better-than-expected labor data for this period reinforce this view.

After a positive growth performance in the second quarter of the year, the Euro Area continued to improve in the third quarter and grew by 0.3 percent quarter-on-quarter. In addition to the favorable growth outlook, the second-half halt in the ongoing rise in unemployment shows that the economic recession has waned. In fact, the Euro Area PMI data indicate that the recession will continue to moderate in the last quarter of 2013 (Chart 2.1.4). However, current expectations suggest that a full exit from the recession may only be possible in 2014 given the present elevation in the unemployment rate (Table 2.1.1).



Displaying a positive outlook amid the economic activity in advanced economies, global growth is expected to pick up further in the fourth quarter of 2013. Although global PMI data for the fourth quarter receded slightly in services compared to the previous quarter, they were up in manufacturing, which reinforces the above view (Chart 2.1.5). In the January issue of Consensus Forecasts, growth forecasts for 2014 are revised upward for advanced economies, especially for the US and the UK, and downward for emerging economies, excluding China, compared to the previous reporting period (Table 2.1.1). Thus, the global growth forecast for 2014 remained unchanged from the previous reporting period. The GDP- and export-weighted global production indices revised by January growth forecasts remained virtually unchanged from the October reporting period (Chart 2.1.6).



**Table 2.1.1.**

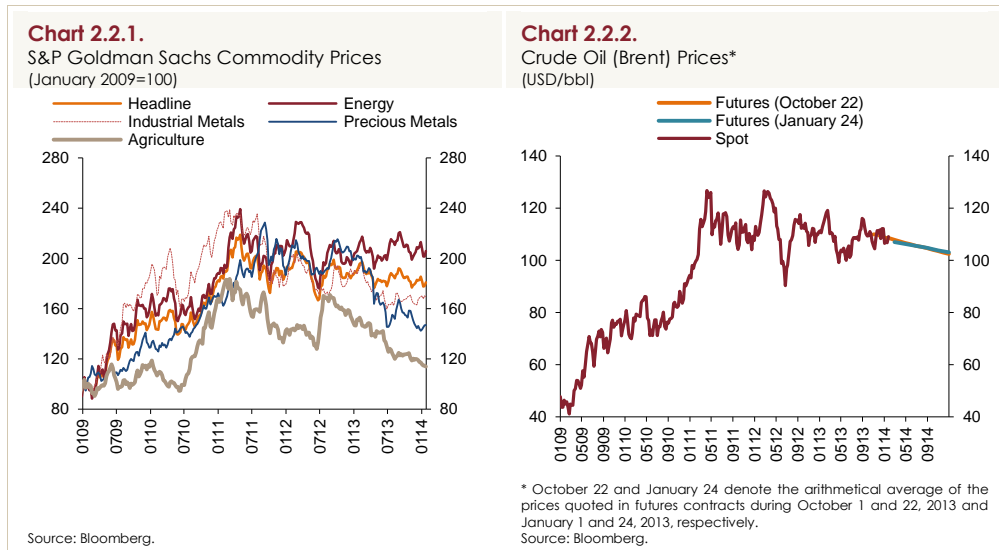
Growth Forecasts for end-2014

	Consensus Forecasts (Average Annual Percent Change)	
	October	January
World	3.1	3.1
<i>Advanced Economies</i>		
USA	2.6	2.8
Euro Area	0.9	1.0
Germany	1.7	1.8
France	0.8	0.8
Italy	0.5	0.5
Spain	0.5	0.7
Greece	-0.6	-0.3
Japan	1.7	1.7
UK	2.2	2.6
<i>Emerging Economies</i>		
Asia-Pacific	6.2	6.2
China	7.4	7.5
India	5.7	5.4
Latin America	3.0	2.8
Brazil	2.4	2.2
Eastern Europe	2.9	2.7

Source: Consensus Forecasts.

## 2.2. Commodity Prices

In the final quarter of 2013, the headline commodity price index remained unchanged from the end of the previous quarter, while energy prices and industrial metal prices increased by 1.3 and 0.7 percent, respectively. Meanwhile, agricultural and precious metal prices dropped by 5.7 and 9.6 percent, respectively (Chart 2.2.1).

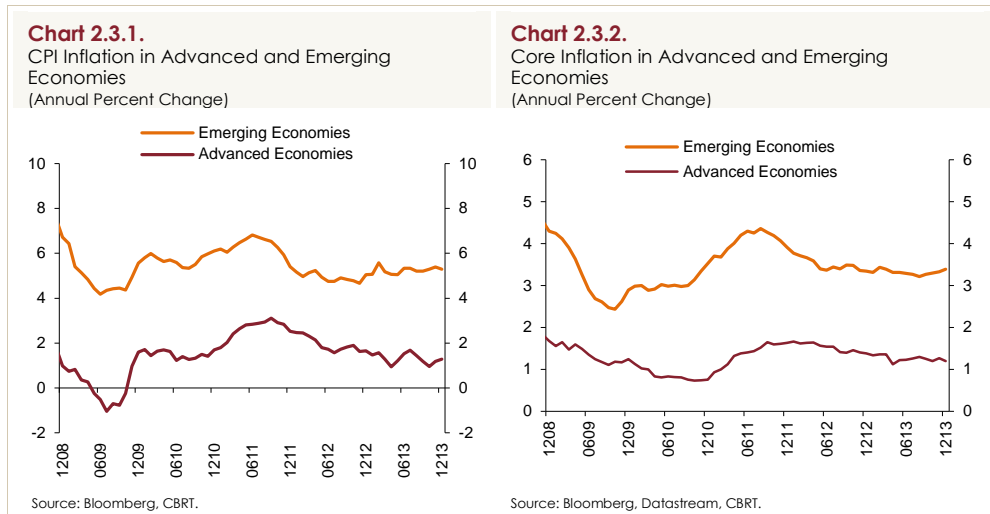


The weak course of growth, which marginally placed a demand-side pressure on oil prices, has largely shaped the course of commodity prices in emerging economies that have a commodity-intensive structure in manufacturing. The all-time high US crude oil production and inventories also provide a favorable outlook for oil prices. Meanwhile, output cuts resulting from technical issues as well as political risks add to the concerns over the Middle Eastern oil supply and may place upward pressure on prices. As a result, Brent crude prices settled at 112 USD as of the year-end. Yield curves derived from futures contracts on Brent crude oil appear to be unchanged from the previous reporting period (Chart 2.2.2).

Having maintained the downtrend that started in mid-2012, agricultural commodity prices continued to fall in the fourth quarter thanks to positive expectations about production and inventory levels for agricultural commodities. However, the uncertainty over weather conditions requires caution about agricultural prices.

## 2.3. Global Inflation

In the fourth quarter of 2013, consumer inflation was slightly up from the end of the previous quarter across advanced and emerging economies (Chart 2.3.1). The favorable outlook for advanced economies and the depreciation of emerging market currencies driven by strong capital outflows were the main factors that supported this development. Core inflation, on the other hand, increased slightly in emerging economies and remained flat in advanced economies (Chart 2.3.2).



Inflation forecasts for end-2014 are revised downward from the previous reporting period for all advanced economies except Japan. Across emerging economies, forecasts were revised down for Asia-Pacific and Eastern Europe and substantially upwards for Latin America and India (Table 2.3.1). The uncertainty about the inflation outlook will diminish as the possible effects of the Fed's taper and the direction of capital flows are clarified over 2014.

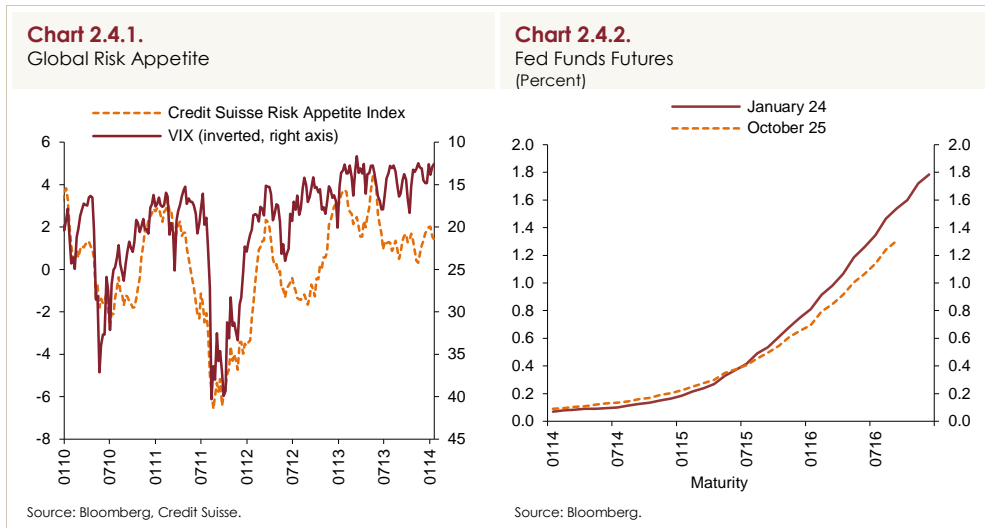
**Table 2.3.1.**  
Inflation Forecasts for end-2014

	Consensus Bulletins (Annual Percent Change)	
	October	January
World	3.0	3.0
<i>Advanced Economies</i>		
USA	1.8	1.6
Euro Area	1.4	1.1
Germany	1.9	1.6
France	1.5	1.2
Italy	1.6	1.1
Spain	1.3	0.9
Greece	-0.5	-0.8
Japan	2.3	2.3
UK	2.5	2.3
<i>Emerging Economies</i>		
Asia-Pacific	3.7	3.3
China	3.1	3.1
India	7.6	8.0
Latin America	7.3	8.7
Brazil	5.9	5.9
Eastern Europe	4.8	4.6

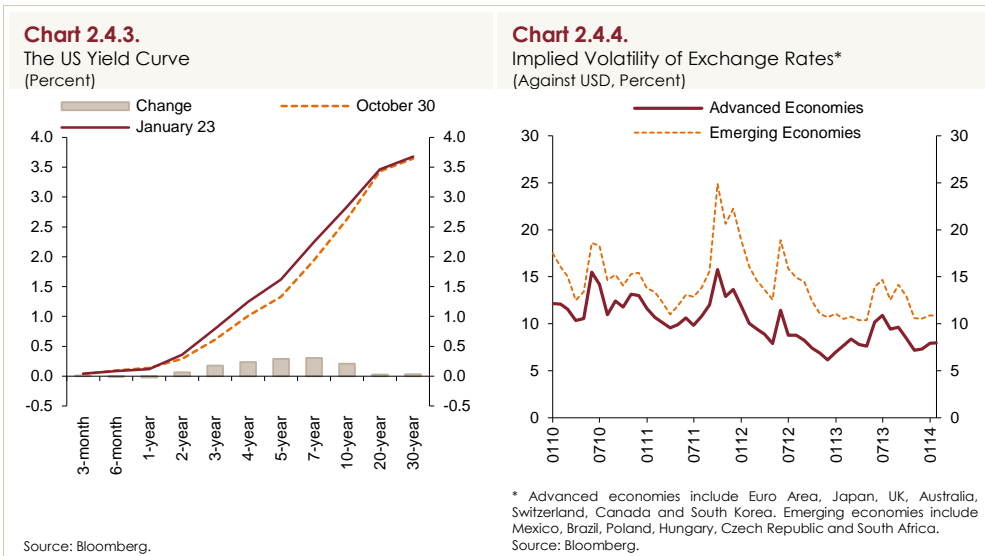
Source: Consensus Forecasts.

## 2.4. Financial Conditions and Risk Indicators

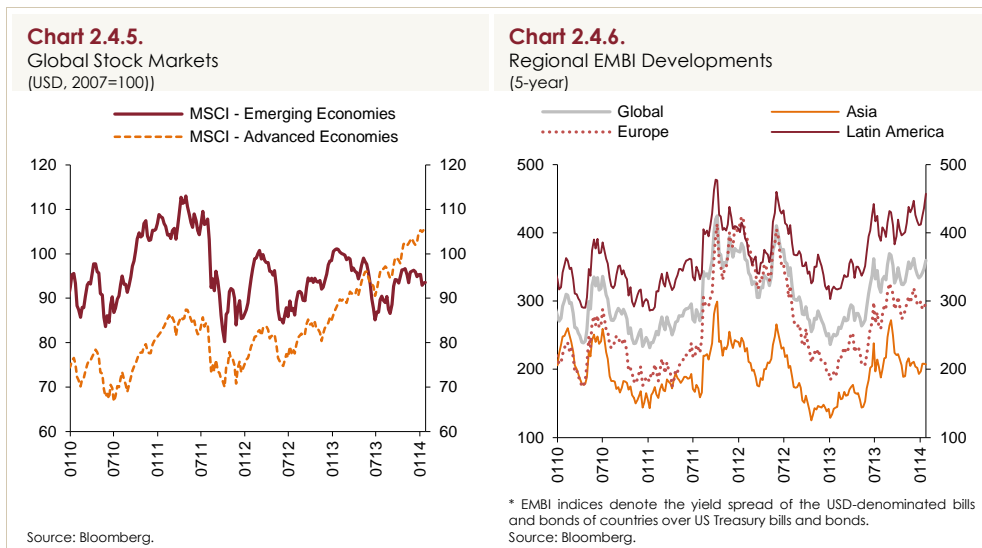
The fourth quarter of 2013 was marked by ongoing concerns over the US monetary policy and the volatile global risk appetite (Chart 2.4.1). The global risk appetite that started to recover early in the fourth quarter deteriorated due to the Fed's December decision that will trigger a global liquidity crunch. Against this background, the Fed funds future contracts imply that expectations about the timing of a policy rate hike remained unchanged. Yet, the amount of the expected hike has risen slightly (Chart 2.4.2).



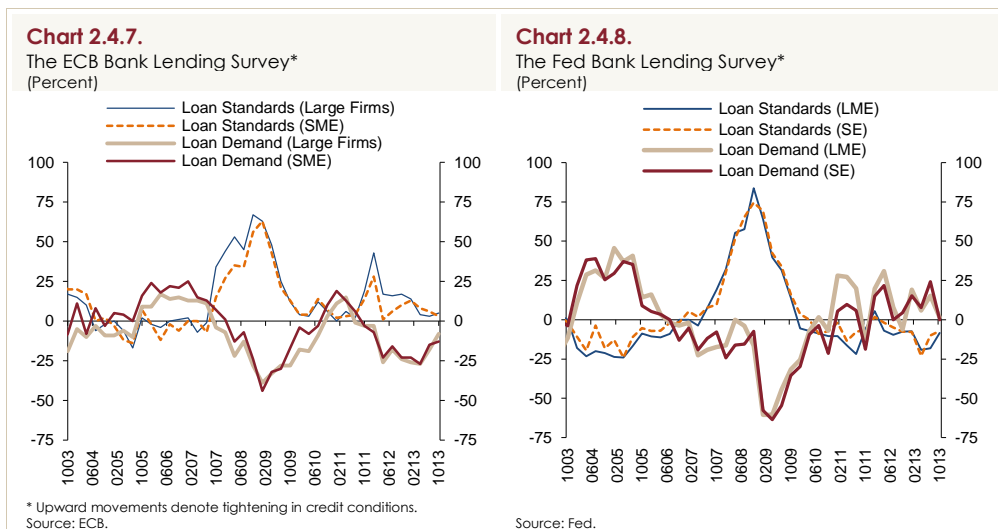
In line with the higher Fed rate hike expectation, medium- to long-term US yields increased by up to 30 basis points compared to the previous reporting period (Chart 2.4.3). Meanwhile, the impending tightening in the US monetary policy slightly raised the uncertainty over the US dollar and caused 1-month implied volatility of exchange rate options for advanced and emerging market currencies to rise from the previous reporting period (Chart 2.4.4).



Despite the expectation for a tightening in the US monetary policy, both the reduced uncertainty about the US monetary policy and the shift in global capital flows towards advanced economies favorably affected the stock markets of advanced economies in the fourth quarter. Having followed a volatile course, stock market indices in emerging economies have changed marginally from the previous reporting period as of January 2014 (Chart 2.4.5). In this period, yields on emerging market bonds fluctuated in line with concerns over capital flows to emerging economies, the volatile global risk appetite and stock market developments (Chart 2.4.6).

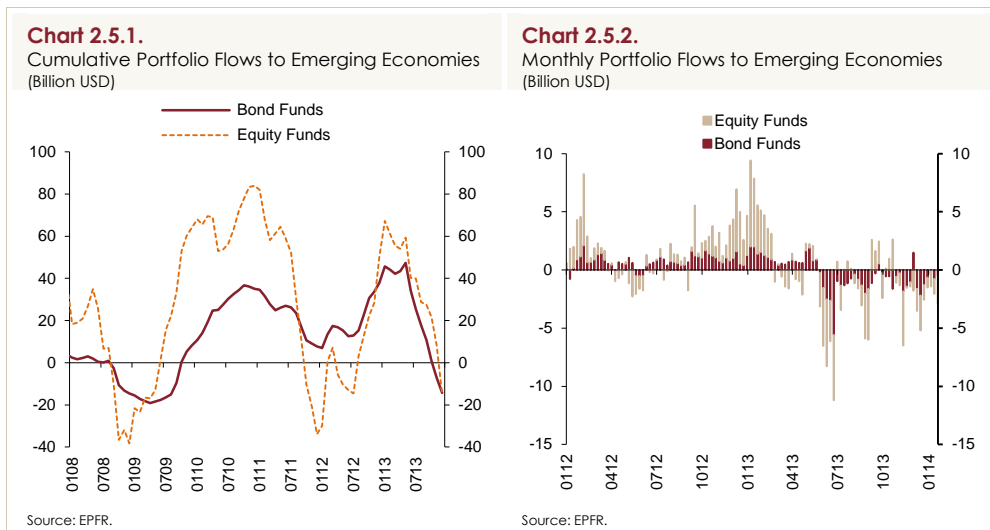


Similar to the second quarter, the ECB's third-quarter bank lending survey reported tightening of lending standards in the Euro Area and a continued contraction in the demand for loans (Chart 2.4.7). On the other hand, the Fed's bank lending survey for the same period showed further easing in the US bank lending conditions and an ended demand increase for loans from large and medium-sized as well as small firms (Chart 2.4.8).



## 2.5. Capital Flows

Capital flows to emerging economies, which have dropped significantly since May following Fed's hint at trimming asset purchases, continued to decline in the fourth quarter of the year (Chart 2.5.1). Capital outflows from emerging markets accelerated slightly in the fourth quarter compared to the previous quarter. The ratio of capital outflows to total emerging market funds, which was around 1.7 percent in the previous quarter, increased to 2.3 percent in the fourth quarter.



In terms of the portfolio composition, while fixed-income securities of emerging markets accounted for most of the capital outflows in the third quarter, both bond and equity funds of emerging economies saw a similar amount of outflow in the last quarter (Chart 2.5.2).

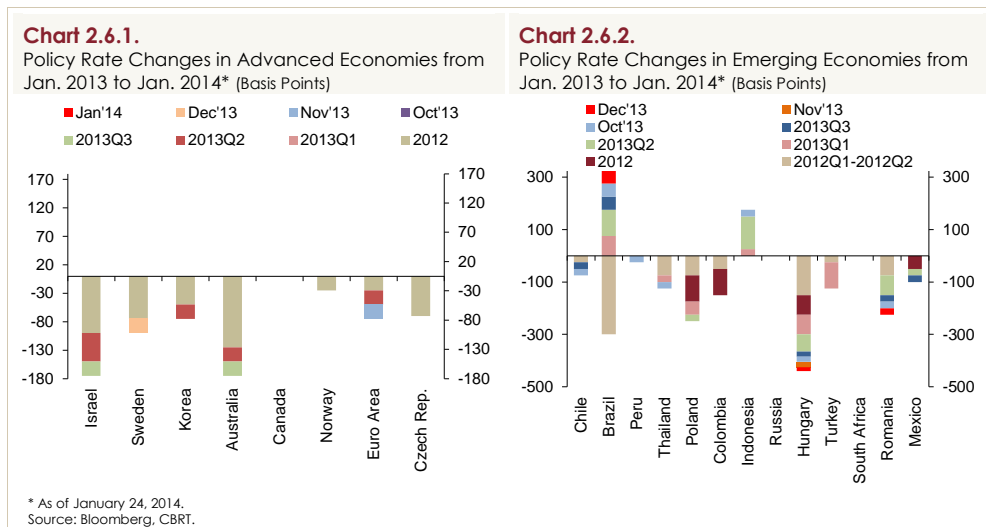
The Fed's decision in December to cut bond buying by 10 billion USD starting from January caused no sharp fluctuations in capital markets. The previously signaled yet timing-wise unknown decision helped to alleviate some of the uncertainty about the quantitative easing exit strategy. However, downside risks to capital flows to emerging economies, particularly the gradual decline in global liquidity, are expected to continue into the upcoming period, while volatility of the capital markets may heighten. Additionally, as in the previous reporting period, the ongoing recovery across advanced economies may further support capital flows in favor of emerging economies.

## 2.6. Global Monetary Policy Developments

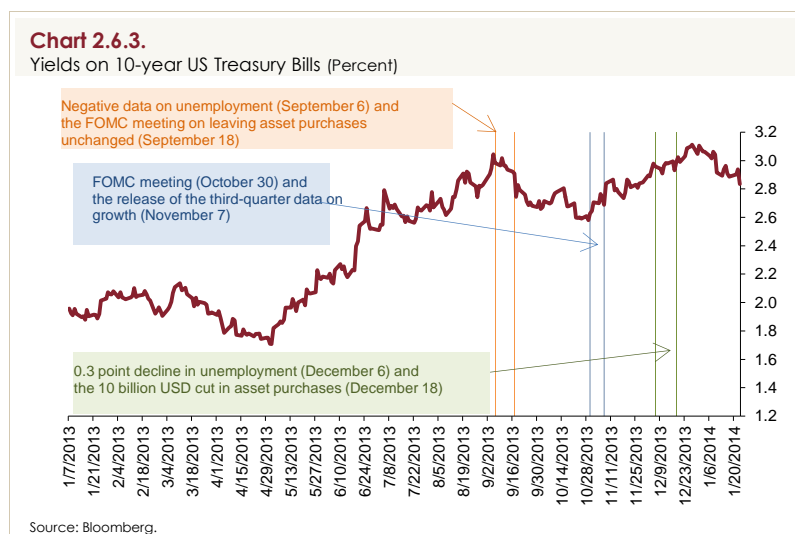
The Fed's December decision to cut asset purchases by 10 billion USD was the most important monetary policy development in the final quarter. Besides the strong emphasis by the Fed that the taper implied no tightening in monetary policy, the policies of other central banks also suggested that global monetary easing continued in the fourth quarter of 2013.

In 2013, policy rates continued to fall across advanced economies, albeit at a slower pace than in 2012. In the fourth quarter of the year, the ECB and the Sveriges Riksbank lowered policy rates by 25 basis points (Chart 2.6.1). On the emerging economies front, the divergence of the Central Bank of Brazil and the Bank Indonesia from other central banks continued in the October-January period, with the Central Bank of Brazil hiking policy rates by 150 basis points and the Bank Indonesia by 25 basis points. Meanwhile, the Central Reserve Bank of Peru, the Bank of Mexico and the Bank of Thailand each slashed policy rates by 25 basis points, while the Central Bank of Chile opted to cut rates by 50 basis points and the Magyar Nemzeti Bank and the National Bank of Romania each announced a 75 basis point rate cut. Against this background, it is possible to conclude that monetary easing was stronger throughout 2013 than in 2012 across emerging economies, except for Brazil and Indonesia (Chart 2.6.2).





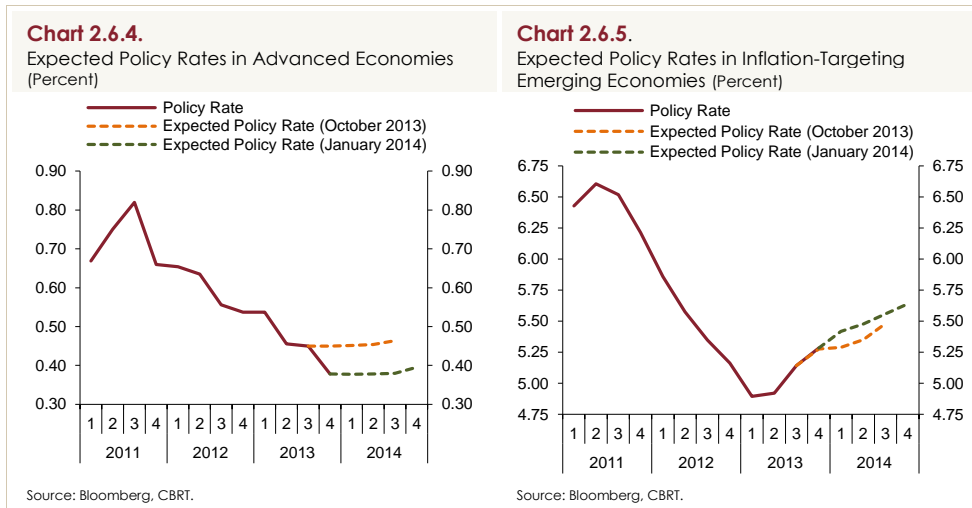
The negative US unemployment data released in early September and the unfulfilled expectation of a tapering decision at the Fed's mid-September meeting caused a fall in long-term interest rates, which continued until the end-October meeting. Announcements after the October meeting and data released on November 7 showing an improved third-quarter growth fueled expectations that the tapering would start in December and caused interest rates to rise again. The 0.3 point decline in unemployment during early December reinforced this expectation, and eventually, the Fed modified its bond-buying program at its December meeting as per expectations and cut asset purchases from 85 billion USD to 75 billion USD. In the meantime, long-term interest rates fell by about 45 basis points due to the surprise September decision to maintain the bond-buying program, and later, surged again at the same pace and returned to early September levels in early January (Chart 2.6.3). Thus, it is possible to conclude that the Fed's taper of asset purchases caused no higher-than-envisioned effect on the interest rate level.



When and how the Fed will begin hiking its policy rate, which is another component of its monetary policy, is a major source of uncertainty on the global economic outlook. The gradually improving recovery

signals about the US economy affect policy rate expectations as well. Yet, the Fed's quarterly releases, which include projections of the FOMC members, suggest that monetary tightening may start in 2015. According to these forecasts, tightening might happen in the 0.25 to 1 percent range in 2015 and in the 1.5 to 1.75 percent range in 2016.

Given the signals of an economic rebound in Europe, the future course of the monetary policy of the ECB and the Bank of England is considered to be a critical factor that should closely be monitored with respect to global monetary policy. In this context, the ECB's long-awaited policy rate cut in November that aimed at abating deflation concerns and supporting the rebound is a notable development in terms of global monetary policy. Similarly, the Bank of England's recent decision to set the date to achieve the 7 percent unemployment threshold for a policy rate hike nearly two years ahead of schedule provides valuable insight into the future course of the monetary policy.



The average policy rate in advanced economies was about 7 basis points lower than the October expectations during the last quarter. The ECB did not deliver the long-awaited rate cut, building up expectations that there would be no rate cut in 2013 as of October. Consequently, a 25 basis point rate hike in November led to a gap between the expected and the actual policy rate. Moreover, according to January expectations, policy rates of advanced economies are likely to remain flat in 2014 as in October (Chart 2.6.4). On the emerging economies front, the average policy rate increased in line with October expectations. In addition, January expectations for 2014 indicate a more aggressive policy rate hike in emerging economies compared to those of October (Chart 2.6.5). The future course of the GDP-weighted composite policy rate for emerging economies is mostly determined by the changes in Brazil's and Indonesia's policy rates. The average policy rate calculated by excluding these two countries has fallen by about 10 basis points since early 2013. However, expectations for 2014 show that prospects for an increase in the average policy rate are still even when excluding Brazil and Indonesia.