2. International Economic Developments

The global economic outlook hints that global growth performance, which was sluggish in the first half of the year, will remain weak in the second half and register only a gradual recovery afterwards. In June, Britain's decision to abandon the EU (Brexit) posed a notable downside risk to the growth performance of advanced economies. Possible macroeconomic consequences of Brexit on the UK and EU countries are yet to unfold. Financial markets did not react as adversely as expected to Brexit; yet the increased economic and political uncertainty in the UK and the anticipated decline in financial flows and trade between the UK and other EU countries weigh considerably on the medium-term macroeconomic prospects of both sides. Moreover, US growth performance remains below expectations, fueling the sluggish economic activity in advanced economies. Emerging economies are expected to witness a modest rebound in 2016, yet downside risks to growth are still brisk despite improving external financing conditions. In particular, emerging economies are exposed to downside risks stemming from the probable adverse impacts of the shift from investment-led growth to consumption-led growth in the Chinese economy, the negative effects of the low-income environment in commodity-exporting countries and the languishing demand in advanced economies.

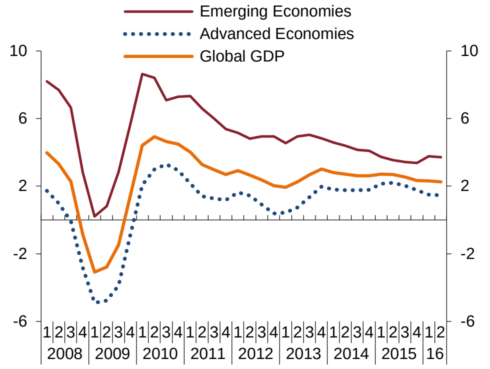
Weak economic activity and global trade volume lead to low commodity prices and inflation rates as well. This implies that loose monetary policy practices supporting economic activity will be maintained in the upcoming period, thus interest rates will remain low at a global scale. In this context, investors in search of high returns were oriented towards emerging economies amid improved risk sentiment, and emerging economies saw a considerable rise in portfolio inflows in the third quarter. In the upcoming period, portfolio inflows are expected to be sustained while also being subject to a downside risk due to the possible rate hike by the Fed.

The decelerated global growth since the global crisis despite the implementation of a loose monetary policy proves that currently enforced accommodative monetary policies should be accompanied by expansionary fiscal policies in the form of higher public investments in growth-oriented sectors. Adopting structural reforms that will provide permanent improvement in the labor market and increase productivity in the long run is critical to enhance the effectiveness of the macroeconomic policies.

2.1. Global Growth

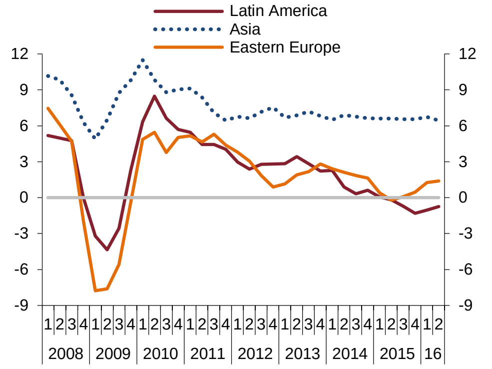
Global economic activity remained weak in the second quarter and the global growth was virtually unchanged compared to the previous quarter (Chart 2.1.1). Among advanced economies, the annual growth rate decreased in the US, the Euro area and Canada, but increased in the UK and Japan in this period. On the emerging economies front, growth in China, one of the major drivers of global growth, remained steady at 6.7 percent. On the other hand, recession in Russia and Brazil lost further pace, acting as a significant factor to spur growth in emerging economies in the second quarter of the year. Across regions, Latin America and Eastern Europe recorded more favorable quarter-on-quarter growth, while growth remained flat in Asian countries (Chart 2.1.2).

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.

PMI data for the third quarter signal a more favorable growth performance in the global economy compared to the second quarter (Chart 2.1.3). The Euro area manufacturing industry PMI show that the positive outlook lasted through the third quarter, but growth rate has lost some momentum since the previous quarter. Meanwhile, the manufacturing industry PMI data of the US and Japan displayed a quarter-on-quarter improvement in the third quarter (Chart 2.1.4). Other leading indicators regarding the US and Japanese economies also signal accelerated growth in the third quarter, which will drive up the growth rate of advanced economies.

Chart 2.1.3.
Global PMI

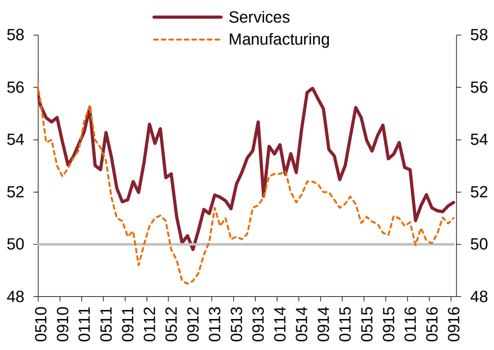
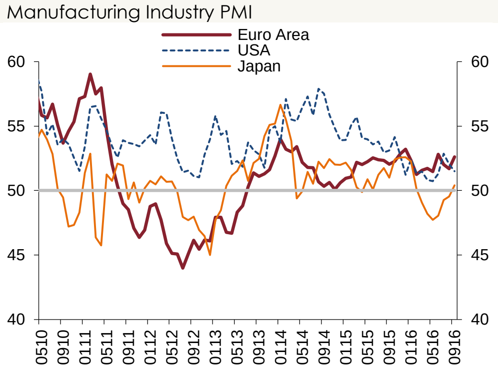


Chart 2.1.4.
Manufacturing Industry PMI



Source: Markit.

Manufacturing industry PMI in emerging economies exhibited an upsurge in the third quarter (Chart 2.1.5). In this period, the Chinese economy recorded a year-on-year growth by 6.7 percent, remaining unchanged from the previous quarter. The benign course of the Indian manufacturing industry PMI hints at a faster growth in the third quarter compared to the previous quarter. Similarly, the PMI data for Brazil and Russia indicate that economic contraction lost sizeable momentum in both countries. Therefore, in emerging economies, growth performance is expected to prove better mostly on the back of China and India, and the third-quarter growth may go above the second-quarter readings. Against this background, the economic outlook for advanced and emerging economies suggests a lingering weak global economic activity in the third quarter of the year; but the global growth rate may be higher compared to the previous quarter.

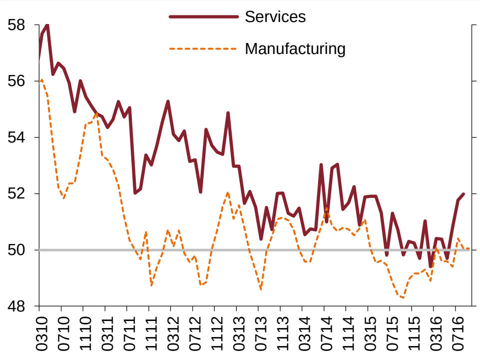
The global growth forecast for end-2016 has increased slightly since the previous reporting period, being revised upwards for Japan, the UK and the Euro area, and downwards for the US. On the emerging economies front, 2016 growth forecasts were revised mostly upwards compared to the previous reporting period (Table 2.1.1). Accordingly, the annual global growth rate of the export-weighted global production index, which was revised by the October Consensus Forecasts, has inched up since the July Inflation Report (Chart 2.1.6). Thus, the external demand outlook for Turkey remains sluggish in 2016, despite a slight improvement in the inter-reporting period.

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

	July		October	
	2016	2017	2016	2017
Global	2.4	2.7	2.5	2.8
Advanced Economies				
USA	1.9	2.2	1.5	2.2
Euro Area	1.5	1.3	1.6	1.3
Germany	1.6	1.3	1.8	1.3
France	1.5	1.3	1.3	1.2
Italy	0.9	0.9	0.8	0.7
Spain	2.8	2.1	3.1	2.1
Japan	0.5	0.8	0.6	0.9
UK	1.6	0.7	1.9	0.9
Emerging Economies				
Asia-Pacific	5.6	5.5	5.7	5.6
China	6.5	6.3	6.6	6.3
India	7.6	7.6	7.6	7.7
Latin America	-0.5	2.0	-0.3	2.1
Brazil	-3.3	0.8	-3.2	1.2
Eastern Europe	1.3	2.3	1.5	2.3
Russia	-0.8	1.2	-0.6	1.2

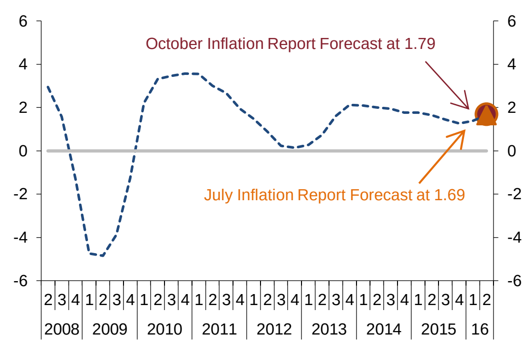
Source: Consensus Forecasts.

Chart 2.1.5.
Emerging Markets PMI



Source: Markit.

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

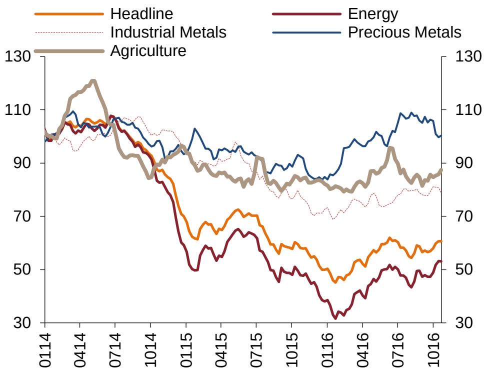


* Weighted by each country's share in Turkey's exports.
Source: Bloomberg, CBRT.

2.2. Commodity Prices and Global Inflation

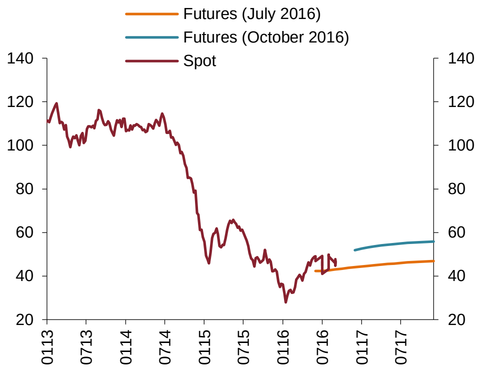
The headline commodity index followed a fluctuating course in the third quarter of 2016 and receded by 2.6 percent at the end of the second quarter. The agriculture index proved higher than expected owing to improved global weather conditions. Particularly due to the extraordinary rise in harvest in the US, the agriculture index tumbled by 5.2 percent in the third quarter of the year, leading to a decline in the headline commodity index. Meanwhile, industrial metals index increased by 4.1 percent in this period. The Chinese economy settled on a steadier path amid the adoption of accommodative measures, while the relatively strong growth performance of the Indian economy pushed up the industrial metals index. In the third quarter of the year, precious metals and energy indices remained almost unchanged compared to the end of the previous quarter. It should be noted that the languishing course of global economic activity and sustained accommodative monetary policies by central banks led to a decline in financial yields. This supported gold demand and caused precious metals index to remain elevated (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)

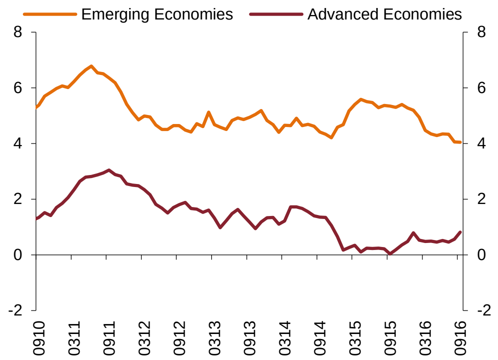


* Futures (July 2016) and Futures (October 2016) denote the arithmetic average of the prices quoted at futures contracts during July 1-21 and October 1-21, respectively.
Source: Bloomberg.

Oil prices settled on a 40-50 USD band in the third quarter of the year. At the extraordinary OPEC meeting held in Nigeria on September 26-28, 14 member countries decided to cut down on production. This leading decision is expected to become clear and official at the ordinary OPEC meeting to be held in Vienna on November 30. A long-awaited consensus among OPEC members was welcomed by the market and Brent crude oil prices climbed to an average 50 USD in the third week of October. Consequently, December 2017 contracts for Brent crude oil, which were traded at 46.9 USD on average in July, have been traded at 55.8 USD on average since October 21 (Chart 2.2.2). At the World Energy Congress held in early October in İstanbul, Russia declared support for the suspension of production by OPEC. However, there are also downside risks to oil prices in the upcoming period. In particular, Iran was exempted from quantity limitations so that oil production can recover following the enforced sanctions. In addition, this decision by OPEC is projected to stimulate the US shale oil extraction, which is currently on the rise. Moreover, in line with the mitigated troubles in Nigeria and Libya, which emerged in early summer, oil production trended upwards. Thus, the rise in oil prices may remain limited in the upcoming period and the upward movement in prices following the September OPEC meeting may not last long.

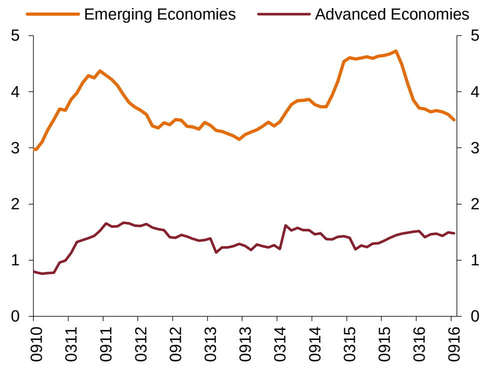
Parallel to the sluggish global economic activity, global inflation rates also remained low. Compared to the July Inflation Report, headline and core inflation rates crept up in advanced economies, but inched down in emerging economies (Charts 2.2.3 and 2.2.4). Brazil, India and Russia contributed to the decline in the headline inflation of emerging economies, while Brazil, Russia and Turkey drove core inflation down. Year-end inflation expectations for 2016 and 2017 suggest downward revisions both in advanced and emerging economies from the previous Report (Table 2.2.1). Higher-than-targeted inflation rates are expected to decline in line with the waning depreciation of the exchange rate in Russia and Brazil, thereby contributing favorably to inflation prospects in emerging economies.

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 inflation rate inched up due to the fall in the positive base effect stemming from low oil prices. The decelerating appreciation of the US dollar since August 2015 impeded the fall in non-oil import prices in the US. In the upcoming period, the course of the US dollar, which shifts mood according to the Fed's expected policy actions, will remain as the leading determinant of imported inflation in the US. The Euro area may witness a slight rise in inflation due to the decline in the output gap, while Japan is expected to see a lower-than-targeted level in inflation. The depreciation of the British sterling, which was driven by uncertainties in the UK-EU relationship after the Brexit referendum, may pose an upside risk to inflation in the UK. Stable metal prices, on the other hand, restrict the possible pass-through from exchange rate to inflation. As a result, global inflation is expected to remain low in the upcoming period due to the weak global demand prospects. Among the factors to exert an upside risk to global inflation are the possible hikes in commodity prices, chiefly oil, and the potential increases in the exchange rate in emerging economies owing to the Fed's policy rate decisions.

Table 2.2.1.
Inflation Forecasts for end-2016 and end-2017
(Average Annual Percent Change)

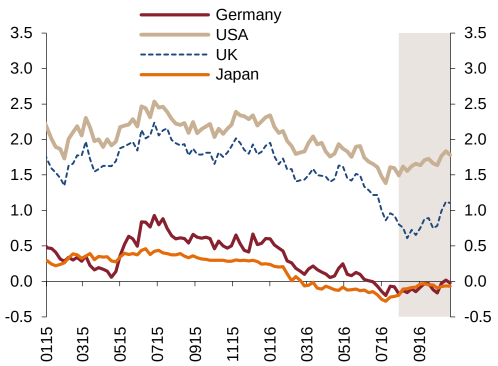
	July		October	
	2016	2017	2016	2017
Global	2.7	2.8	2.5	2.8
Advanced Economies				
USA	1.3	2.3	1.2	2.3
Euro Area	0.3	1.3	0.2	1.3
Germany	0.4	1.5	0.4	1.5
France	0.3	1.2	0.2	1.2
Italy	0.0	0.9	-0.1	0.8
Spain	-0.4	1.3	-0.4	1.3
Greece	-0.2	1.5	-0.1	0.8
UK	0.7	2.4	0.7	2.3
Japan	-0.1	0.6	-0.2	0.4
Emerging Economies				
Asia-Pacific	2.3	2.4	2.2	2.3
China	2.0	2.0	1.9	1.9
India	5.2	5.1	5.1	5.1
Latin America	15.7	9.8	14.1	8.9
Brazil*	7.2	5.4	7.1	5.2
Eastern Europe	5.5	5.0	5.1	4.9
Russia*	6.6	5.5	6.3	5.3

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

2.3. Financial Conditions, Risk Indicators and Portfolio Flows

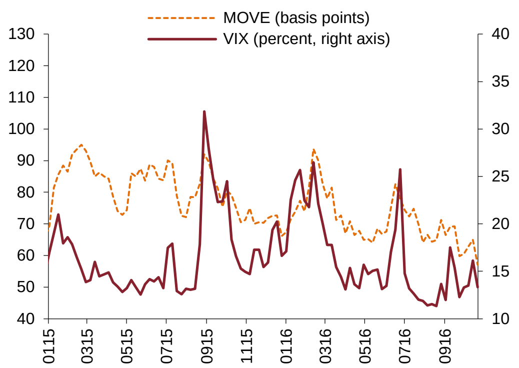
In the third quarter of the year, long-term interest rates of advanced economies stopped falling further despite the languishing global growth outlook (Chart 2.3.1). In this period, central banks of advanced economies continued with monetary easing practices but the strengthened expectations that the Fed will raise policy rates led to an increase in long-term rates. In addition, recent signals that Brexit will prove faster than expected caused a depreciation in the British sterling and also an increase in long-term yields through the rise in expected inflation in the UK.

Chart 2.3.1.
10-Year Treasury Bond Yields
(Percent)



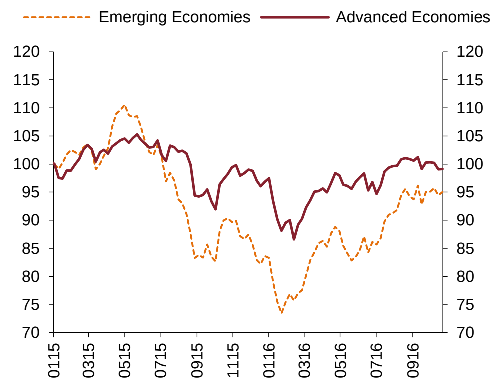
Source: Bloomberg.

Chart 2.3.2.
VIX and MOVE Volatility Indices
(Weekly Average)



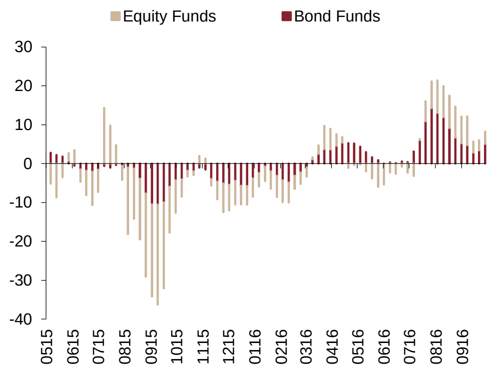
In the third quarter of the year, which witnessed persisting concerns over global growth, central banks of advanced economies maintained their loose monetary policy stance, preventing a deterioration in the global risk appetite (Chart 2.3.2). Risk appetite started to worsen as of mid-August due to the increased prospects for a Fed rate hike; yet it rebounded as the rate hike was postponed. Parallel to the elevated risk appetite and the still languishing global economic activity in advanced economies, stock prices in emerging economies saw notable increases compared to advanced economies in the third quarter (Chart 2.3.3).

Chart 2.3.3.
MSCI Indices
(January 2015=100)



Source: Bloomberg.

Chart 2.3.4.
Weekly Portfolio Flows to Emerging Economies
(Billion USD, 4-Week Moving Average)



Source: EPFR.

In the third quarter of the year, sustained accommodative policies in advanced economies limited the adverse effects of fluctuations in the global risk appetite on portfolio flows towards emerging economies and risk perceptions regarding this country group remained benign. Hence, investors in search of high returns were oriented towards emerging economies in the third quarter of the year. Accordingly, portfolio outflows from emerging economies, which have been observed since the last quarter of 2014, decelerated considerably in the second quarter of 2016 and were reversed in the third quarter (Chart 2.3.4). On a monthly basis, portfolio flows, which proved quite high immediately after the Brexit decision, declined slightly in the second half of August amid increased prospects for a Fed rate hike, and re-settled on a high course as of the first week of September. Portfolio inflows towards emerging economies hit a two-year high in the third quarter of 2016. However, having soared notably in the inter-reporting period, portfolio inflows towards emerging economies have recently assumed a weakening track.

The analysis of the composition of portfolio flows reveals that inflows towards emerging economies were mostly composed of bond funds in the third quarter. In addition, inflows to equity funds also proved considerably high compared to the previous quarter. With regard to regional distribution, portfolio inflows were oriented mostly towards Asian and Latin American markets (Table 2.3.1). Asian countries saw a balanced distribution between bond funds and equity funds, while Latin American countries, which have higher interest rates, attracted inflows for mostly bond funds.

Table 2.3.1.
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	Middle East and Africa
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	-2.9	-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

Source: EPFR.

Overall, portfolio flows towards emerging economies are likely to fluctuate in the upcoming period. Sustained high levels in global liquidity, the continuing tendency of international investors to take risks and high interest rate returns in emerging economies pose an upside risk to portfolio flows towards these countries. On the other hand, the possible rate hike by the Fed and the persisting weak growth in emerging economies are the foremost downside risk factors to portfolio flows.

2.4. Global Monetary Policy

The global monetary policy stance remained increasingly accommodative in the third quarter of 2016. The uncertainty regarding the Fed rate hike and shifting expectations were influential in the monetary policy decisions at a global scale. The Fed kept the policy rate unchanged in the July-October period, while among other major central banks, the Bank of England, the Reserve Bank of Australia and the Reserve Bank of New Zealand reduced policy rates by 25 basis points (Chart 2.4.1). Similarly, on the emerging economies front, policy rates were lowered by 25 basis points by the Reserve Bank of India and the Central Bank of Brazil, and by 50 basis points by the Bank of Indonesia and the Central Bank of Russia. Recently, the Fed's monetary policy stance diverged more remarkably from that of other major central banks. Accordingly, central banks of Latin American countries, which are more directly affected by the US economy, and the South African Reserve Bank, which has troubles with inflation, differed from the central banks of other emerging economies in a tightening way with respect to their policy stance. In the same period, the Central Bank of Colombia and the Bank of Mexico raised policy rates by 25 and 50 basis points, respectively (Chart 2.4.2).

Chart 2.4.1.
Policy Rate Changes in Advanced Economies*
(Basis Points)

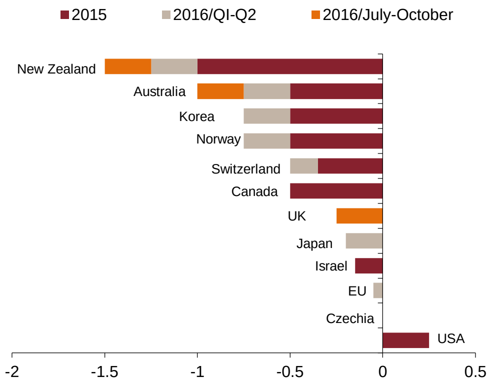
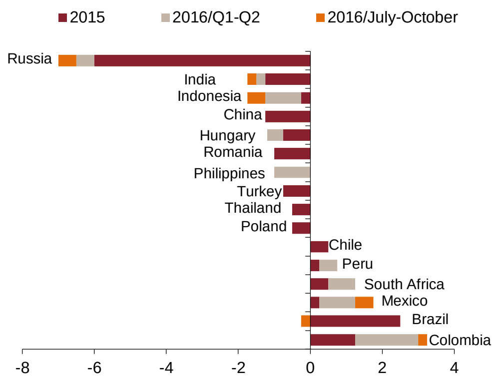


Chart 2.4.2.
Policy Rate Changes in Emerging Economies*
(Basis Points)

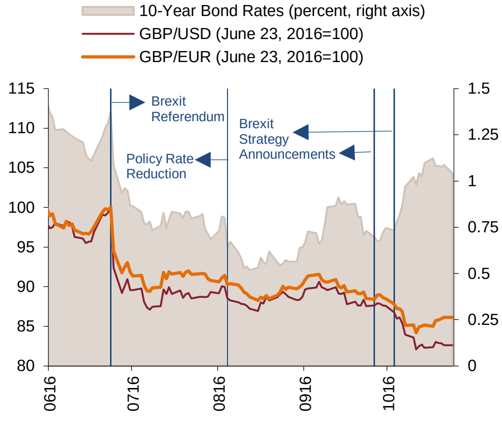


* As of October 24, 2016.
Source: Bloomberg.

Out of the largest four central banks that adopted accommodative policies previously, the Bank of Japan and the ECB were accompanied by the Bank of England following the Brexit decision, as expected. The Bank of England not only delivered a policy rate cut but also adopted a new bond-buying program, which included commercial bond purchases. Moreover, the Bank of England hinted at another rate cut in November if the outlook at that time is judged to be broadly consistent with the August projections. The impact of Brexit on the macroeconomic outlook remains vague, yet the recently increased perception that the exit will occur under more severe conditions led the British sterling to depreciate (Chart 2.4.3). All these developments hint at a possibly further loosening in the monetary policy stance of the Bank of England. Having implemented an extensive accommodative monetary policy for a long time, the Bank of Japan adopted the unconventional "yield curve control" in the September meeting in order to target yields on 10-year government bonds. It is expected that the currently negative policy rate imposed by the Bank of Japan will even be lower in the upcoming period.

There is a growing expectation that the Fed will deliver a rate hike in December following the presidential elections. This is confirmed by the upward trend in core and headline inflation rates, despite mixed signals from the real sector data. In this respect, the announcement at the September FOMC meeting hints at a policy rate hike, which is expected to be lower than projected previously by FOM members (Chart 2.4.4). Accordingly, even if the Fed raises the policy rate in December, the medium and long-term monetary policy will prove relatively less tight than anticipated in the previous Report. Growth forecasts for the US economy have recently been revised downwards, supporting this outlook. In sum, the global monetary policy is expected to remain loose in the upcoming period. However, a possible steepening in the Fed's rate hike path, depending on the US labor market and inflation developments, is the most evident upside risk factor on this outlook.

Chart 2.4.3.
British Sterling and Bond Rates



Source: Bloomberg.

Chart 2.4.4.
Median Policy Rate Projections of the FOMC Members
(Percent)