2. International Economic Developments

In the third quarter of 2015, global growth remained well below its long-term average. This sluggish outlook in the global economic activity was largely driven by the persisting slowdown across emerging economies. Among these countries, Brazil and Russia continued to experience recession while the Chinese economy decelerated. The gloomy outlook of the Chinese manufacturing industry fed into worries over a deeper-than-expected slowdown, weighing further on the economic activity across emerging economies that have close trade ties with China. Additionally, the weakening demand for commodities led by the Chinese slowdown continued to dampen the growth outlook for commodity-exporting emerging economies. On the advanced economies front, the moderate growth was sustained in the third quarter. The major factors that will boost growth in advanced economies in the upcoming period include commitment to growth-stimulating macroeconomic policies, lower commodity prices and the improving labor market.

In the third quarter, commodity prices, energy prices in particular, remained on the decrease amid a sluggish global economy. The uncertainty over the Chinese economy and the ongoing oil supply glut may continue to repress commodity prices over the upcoming period. Despite plunging commodity prices, global inflation rates inched up in the inter-reporting period. In the last quarter of 2015, inflation was up in both advanced and emerging economies, largely due to a continued moderate growth in the former and depreciation of local currencies in the latter.

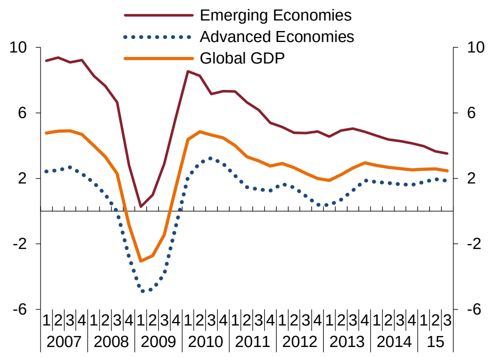
The most striking development regarding global monetary policy in the inter-reporting period was the Fed's anticipated policy rate hike at its December 2015 meeting. Expectations about the speed and size of future Fed policy rate hikes will have a major impact on international financial markets and portfolio flows in the upcoming period. Although the latest forecasts of the FOMC members indicate four rate hikes over a total of eight meetings scheduled in 2016, the downward pressure on inflation rates, mostly driven by commodity prices, suggests that the policy rate may follow a flatter path.

The negative growth performance across emerging economies, geopolitical risks and especially worries about a deeper-than-anticipated slowdown in China caused the global risk appetite to remain subdued in the fourth quarter. Thus, sovereign risk in emerging markets surged while stock and bond markets witnessed further outflows in the final quarter. Yet, with the Fed hiking its policy rate as expected, portfolio flows to emerging economies saw no additional negative impact. On the other hand, the weak economic activity across emerging economies, particularly China, feeds into the downside risks on capital inflows for the upcoming period.

2.1. Global Growth

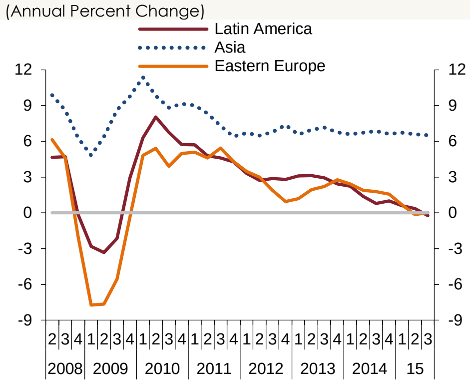
The global economic activity, which has been stagnant due to emerging economies, decelerated further in the third quarter of 2015, causing global economy to grow at a slower pace than a quarter earlier (Chart 2.1.1). The growth rate across advanced economies was down slightly quarter-on-quarter but remained on a modest track. Despite the robust performances of the EU and Japan, the slowing US growth created a drag on advanced economies in this period. On the emerging economies front, the slowdown in China worsened, while the ongoing contraction in Russia and Brazil was deepened. On a more regional level, the growth rate neared zero for Eastern Europe and turned negative for Latin America during the third quarter (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.

The global PMI data of the fourth quarter signal a more positive growth performance for the manufacturing industry and a more negative growth performance for the services industry compared to the previous quarter (Chart 2.1.3). The readings on the manufacturing industry PMI of the Euro area and Japan suggest that both economies maintained a positive growth outlook (Chart 2.1.4). On the other hand, the US PMI posted a negative performance quarter-on-quarter both for manufacturing industry and services. Thus, the US economy is estimated to have grown at a much slower pace in the fourth quarter than in the third quarter.

The emerging markets PMI recorded an increase for the manufacturing industry but declined across services in the fourth quarter (Chart 2.1.5). However, the manufacturing industry PMI still stayed below the neutral mark of 50. The Chinese economy continued to slow, growing by only 6.8 percent year-on-year in the fourth quarter. Meanwhile, country-level indices show that the Brazilian economy fell deeper into contraction whereas the economic recession in Russia lost some momentum in the final quarter of 2015. Moreover, the manufacturing industry PMI data were significantly down quarter-on-quarter for the Czech Republic, India and South Africa but were more favorable for other emerging economies. Hence, the slowing economic activity across emerging economies appears to have continued into the fourth quarter of 2015.

Chart 2.1.3.
Global PMI

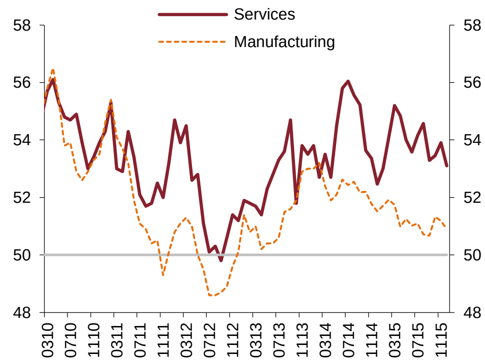
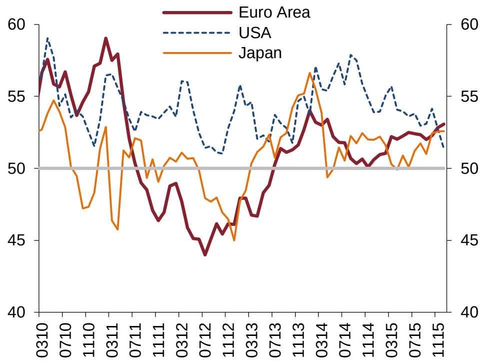


Chart 2.1.4.
Manufacturing Industry PMI



Source: Markit.

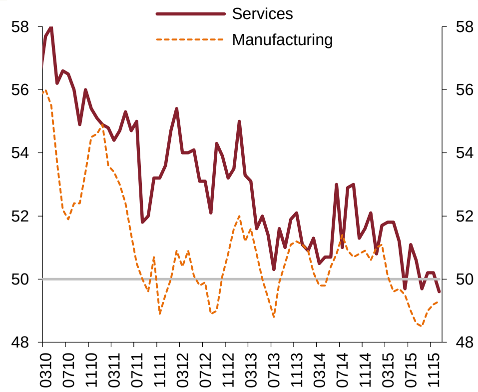
In sum, the global economy might continue to decelerate in the fourth quarter largely due to emerging economies and grow at a slower pace quarter-on-quarter. The January Consensus Forecasts Bulletin shows that growth forecasts for 2015 were revised upward by about 0.1 percent in the inter-reporting period (Table 2.1.1). Yet, on the advanced economies front, growth forecasts for 2015 were revised downward for the US and the UK. On the emerging economies side, end-2015 growth forecasts were revised upward for Latin America and Eastern Europe. However, the growth forecast for Brazil was revised notably downward. Forecasts for Asia-Pacific were left unchanged (Table 2.1.1). Accordingly, the annual growth rate of the export-weighted global production index revised by January forecasts declined from the previous reporting period (Chart 2.1.6). Thus, Turkey's external demand appears to have weakened further in the last quarter of 2015.

Table 2.1.1.
Growth Forecasts for end-2015 and end-2016
(Average Annual Percent Change)

	October		January	
	2015	2016	2015	2016
Global	2.5	2.9	2.6	2.7
Advanced Economies				
USA	2.5	2.6	2.4	2.4
Euro Area	1.5	1.7	1.5	1.7
Germany	1.8	1.9	1.7	1.8
France	1.1	1.5	1.1	1.4
Italy	0.8	1.3	0.7	1.3
Spain	3.2	2.7	3.2	2.7
Japan	0.6	1.3	0.6	1.2
UK	2.5	2.4	2.3	2.3
Emerging Economies				
Asia-Pacific	5.8	5.7	5.8	5.7
China	6.8	6.5	6.9	6.5
India	7.5	7.8	7.4	7.8
Latin America	-0.7	0.5	-0.3	0.0
Brazil	-2.8	-1.0	-3.6	-2.7
Eastern Europe	-0.1	1.7	0.0	1.5
Russia	-3.9	-0.1	-3.8	-0.5

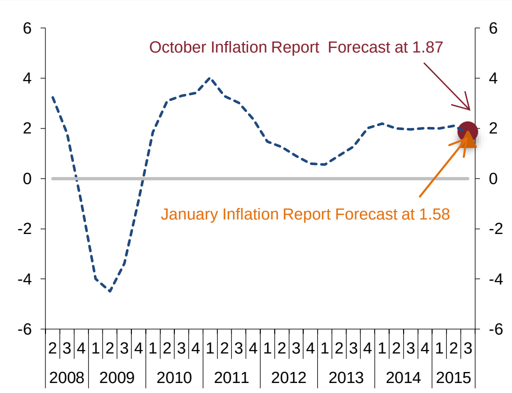
Source: Consensus Forecasts.

Chart 2.1.5.
Emerging Markets PMI



Source: Markit.

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

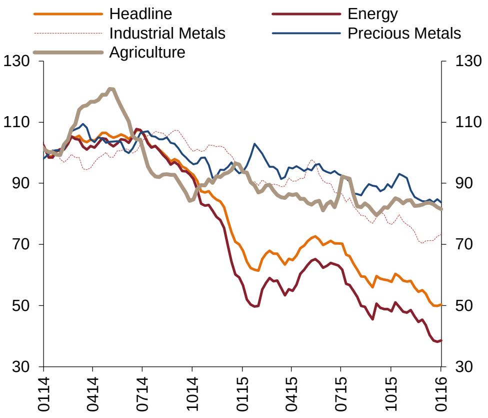


* Weighted by each country's share in Turkey's exports.
Source: Bloomberg, CBRT.

2.2. Commodity Prices and Global Inflation

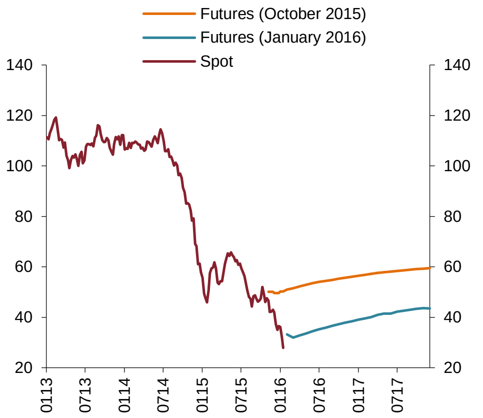
In the fourth quarter of 2015, the headline commodity price index dropped by 13.3 percent from the end of the previous quarter. Across sub-indices, energy prices, industrial metal prices and agricultural prices fell by 20.1, 6 and 2.4 percent, respectively, whereas precious metal prices remained basically flat. In this period, commodity prices continued to slide at an increased rate, largely due to output and stock levels outpacing the demand from emerging economies, particularly China (Chart 2.2.1).

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



Source: Bloomberg.

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

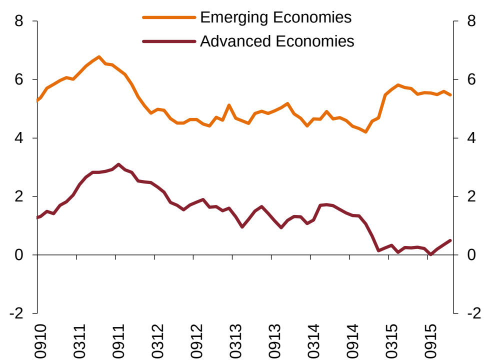


* Futures (October 2015) and Futures (January 2016) denote the arithmetic mean of the prices quoted at futures contracts during October 1-23, 2015 and January 1-20, 2016, respectively.
Source: Bloomberg.

Oil prices continued to plummet in the fourth quarter, hitting the recent lows. Although the negative implications of low oil prices on the budgets of oil-exporting countries, particularly Saudi Arabia and Russia, sow doubt about the sustainability of low price policies, the failure of OPEC to reach an agreement on an output quota at its December 2015 meeting, the lifting of the US oil export ban and the termination of sanctions against Iran suggest that competition over market share will continue to put downward pressure on oil prices for some time. Thus, December 2017 contracts for Brent crude oil, which were traded at 56 USD on average in October, have been trading at a monthly 43.5 USD on average as of January 20 (Chart 2.2.2). Yet, rising geopolitical risks in the Middle East and Africa are likely to put upward pressure on oil prices.

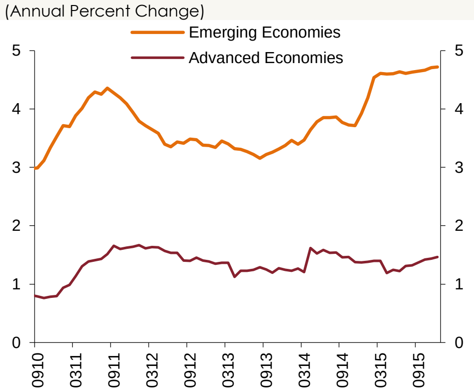
In the inter-reporting period, inflation and core inflation rates were up slightly across advanced and emerging economies (Charts 2.2.3 and 2.2.4). These increases were mostly attributed to the US, the Euro area, the UK and Japan among advanced economies, and to Brazil, India, South Africa and Turkey on the emerging economies front. Inflation expectations for end-2016 were revised upwards for Latin American and Eastern European economies amid worsened expectations in Brazil and Russia and slightly downwards for advanced and Asia-Pacific 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.

Although falling prices of oil and other commodities continue to dampen inflation rates, given relatively smaller price changes in 2016, inflation might soar across all country groups this year due to base effects. On the advanced economies front, core inflation rates hover at or above the readings in mid-2014, which is marked by plunging oil prices, suggesting that inflation rates may reach pre-2014 levels in 2016. The uncertainties surrounding the global financial implications of the Chinese slowdown and the course of the US monetary normalization remain as major risks for commodity prices and the inflation outlook. Especially, the depreciating Chinese yuan may spark disinflation on a global scale.

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

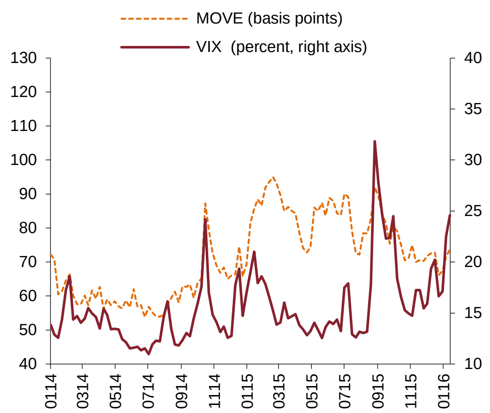
	October 2015	January 2016
Global	3.6	2.6*
Advanced Economies		
USA	1.8	1.5
Euro Area	1.1	0.8
Germany	1.4	1.1
France	1	0.8
Italy	0.9	0.6
Spain	0.9	0.7
Greece	2.1	0.1
UK	1.4	1.0
Japan	0.8	0.6
Emerging Economies		
Asia-Pacific*	2.6	2.2
China	2.1	1.6
India	5.4	5.3
Latin America	6.7**	10.4*
Brazil***	6.1	7.0
Eastern Europe	5.8	6.0

* Including Venezuela with the new methodology.
** Excluding Venezuela.
*** December-on-December.
Source: Consensus Forecasts.

2.3. Financial Conditions, Risk Indicators and Portfolio Flows

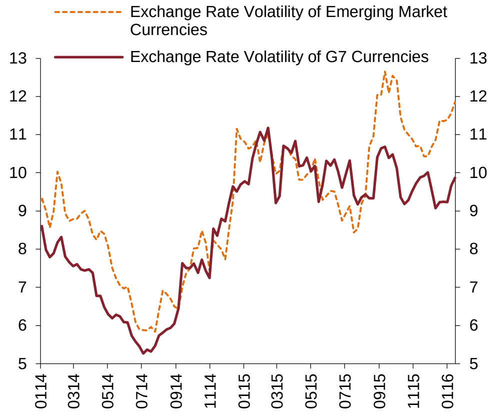
The global risk appetite remained subdued in the fourth quarter over the ongoing weakening across emerging economies as well as the mounting geopolitical risks and heightening fears over the Chinese slowdown. The Fed's December rate hike spurred the market perception that interest rates might increase moderately and gradually over the upcoming period. Accordingly, global volatility indices edged down following the Fed's decision (Chart 2.3.1). However, this drop proved to be shortlived and volatility indicators rose again in early 2016 amid growing concerns about China, which affected currencies of both advanced and emerging economies (Chart 2.3.2).

Chart 2.3.1.
VIX and MOVE Volatility Indices
(Weekly Average)



Source: Bloomberg.

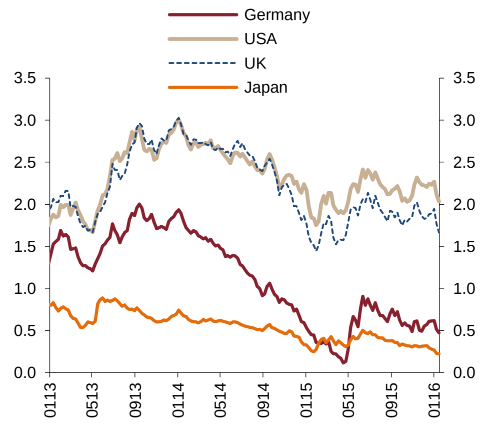
Chart 2.3.2.
Exchange Rate Volatility
(Percent)



Source: Bloomberg, JP Morgan.

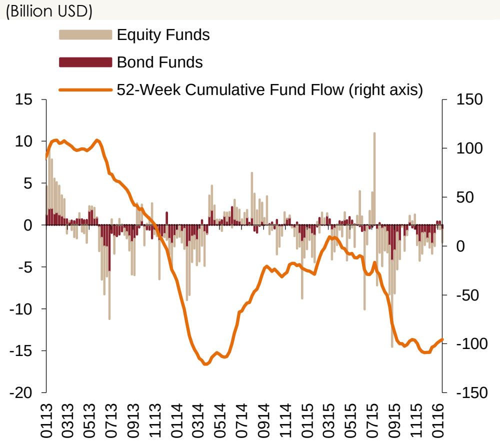
The Fed's rate hike decision conveyed the message that the normalization would be a quite gradual one and the economic recovery would be monitored closely. This caused long-term returns in advanced economies to remain unchanged after the decision (Chart 2.3.3).

Chart 2.3.3.
10-Year Treasury Bond Yields
(Percent)



Source: Bloomberg.

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



Source: EPFR.

Sovereign spreads in emerging markets tended to be more volatile and higher than in the previous reporting period amid the subdued global risk appetite, the sluggish growth in emerging economies and the gloomy outlook for the Chinese economy (Charts 5.1.3 and 5.1.4). Accordingly, stock and bond markets in emerging economies witnessed further outflows (Chart 2.3.4). The Fed decision had no adverse effects on portfolio flows as the rate hike was already priced and the message for a gradual normalization was communicated. On the other hand, the lower-than-expected December PMI data for China released in early January worsened the current negative outlook for the Chinese economy. This caused the Chinese stock market to experience a steep sell-off, which temporarily halted the trading. The uncertainty regarding the duration of the Chinese downturn as well as the weak economic outlook in other emerging economies, Brazil, Russia and South Africa in particular, contribute to the downside risks to emerging market portfolio flows in the upcoming period. Yet, signals of a gradual and moderate Fed rate hike indicate that the monetary normalization will not add to the downward pressure on portfolio flows to emerging markets.

2.4. Global Monetary Policy

In the last meeting of 2015 in mid-December, the Fed raised its policy rate by 25 basis points and initiated a hiking cycle. The monetary policy stance remained intact across advanced economies before and immediately after this decision, except for New Zealand, where the Reserve Bank of New Zealand lowered its benchmark interest rate by 25 basis points in December 2015 (Chart 2.4.1). Meanwhile, on the emerging economies side, some Latin American countries had already started to increase their policy rates before the Fed's decision. In this regard, the Central Bank of Colombia hiked its policy rate by 75 basis points while the Central Bank of Chile and the South African Reserve Bank each favored a 25 basis points rate increase during October and November. The Central Bank of Chile and the Bank of Mexico opted for a rate hike of 25 basis points right after the Fed decision, while the Central Reserve Bank of Peru raised its key interest rate by a total of 50 basis points on two occasions, in December and January. Bank Indonesia, on the other hand, lowered its policy rate by 25 basis points in January (Chart 2.4.2).

Chart 2.4.1.
Policy Rate Changes in Advanced Economies between January 2014 and January 2016* (Basis Points)

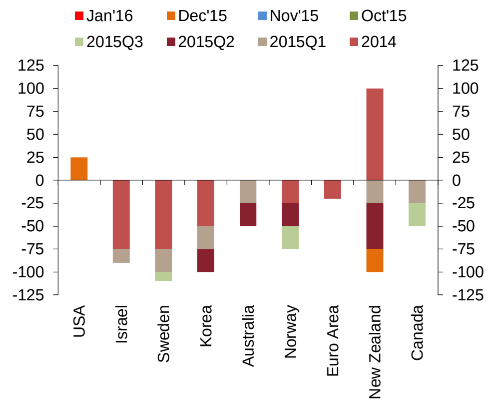
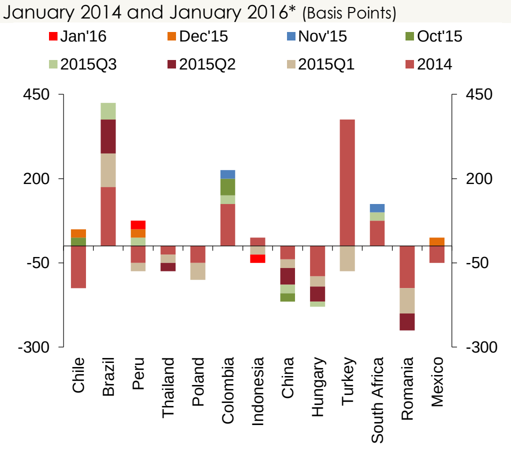


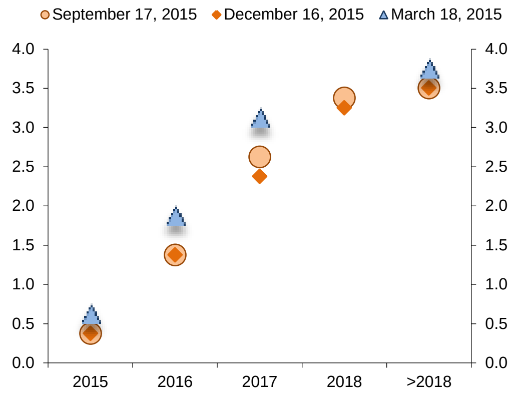
Chart 2.4.2.
Policy Rate Changes in Emerging Economies between January 2014 and January 2016* (Basis Points)



* As of January 21, 2016.
Source: Bloomberg, CBRT.

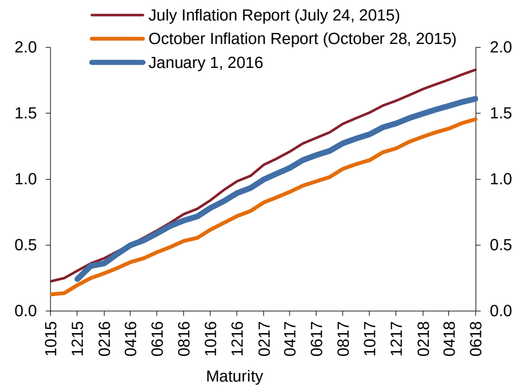
The US economic outlook at the end of the third quarter of 2015 had hinted that the Fed rate hike would be pushed to 2016. However, prospects changed in the fourth quarter and the Fed provided forward guidance about a likely year-end rate hike. Therefore, the policy rate hike was already anticipated by the markets. With the hiking cycle commencing, expectations about the speed of future rate hikes will be crucial to both international financial markets and portfolio flows. Despite the divergence of the US economy from both advanced and emerging economies due to its growth performance, the presence of downward pressure on US inflation, particularly through commodity prices, suggests that the Fed policy rate might follow a more horizontal path in the upcoming period. In fact, in its post-decision statements, the Fed emphasized that it would wait to see firm signs of rising inflation as well as stronger demand conditions before a new rate hike. Nevertheless, the median of the latest policy rate projections of the FOMC members points to a rate hike at four of eight meetings in 2016 (Chart 2.4.3). Moreover, rates on federal funds futures are higher compared to the previous reporting period (Chart 2.4.4).

Chart 2.4.3.
Policy Rate Projections of the FOMC Members
(Percent)



Source: Fed.

Chart 2.4.4.
US Federal Funds Futures
(Percent)



Source: Bloomberg.