2. International Economic Developments

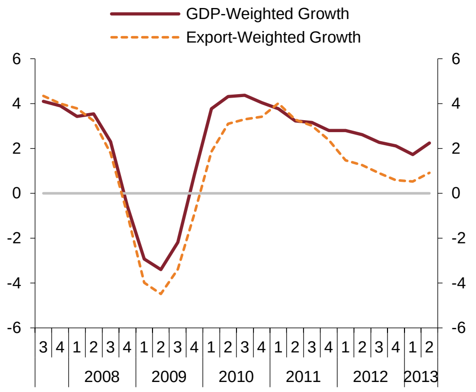
The last quarter data indicate that global growth picked up slowly in the second quarter, mostly thanks to rebounding advanced economies. Emerging economies, on the other hand, continued to slow down in this period. Data released since the July Inflation Report suggest that advanced and emerging economies will remain on divergent growth paths for the remainder of the year. The modest pickup in global growth also led to a slight increase in commodity prices over the past quarter, but this increase created no upward pressure on inflation in advanced or emerging economies.

The most important development in global monetary policy over the past quarter was the Fed's September decision to continue its bond-buying program, yet offering no hints on the timing for a cutback despite the May announcement of a near-term taper. The fact that the Fed will maintain the pace of its asset purchases helped to alleviate some of the fears that global liquidity may become less abundant starting from September, providing some market relief in the short run. However, due to the absence of positive knowledge on the amount and timing of a possible change in the Fed's bond-buying program, the uncertainty about the Fed's monetary policy normalization appears to have risen from the previous reporting period. Thus, in the upcoming period, emerging economies will continue to face downside risks regarding their already slowing inflows of capital. In this context, financial stability in emerging economies may be adversely affected should uncertainty surrounding global monetary policy persist and result in further capital outflows.

2.1. Global Growth

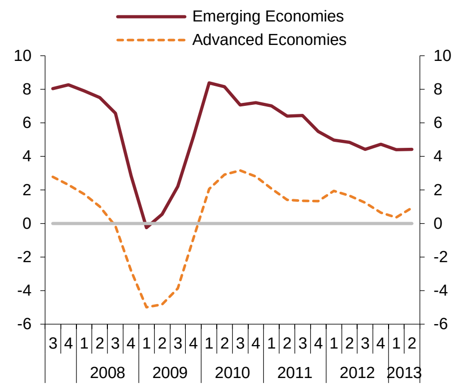
Global economic activity went up in the second quarter, albeit moderately (Chart 2.1.1). This rise was mainly driven by the improved growth in advanced economies. The US, Japan and the UK provided positive contributions to growth in advanced economies, while the Euro Area recession lost momentum. Meanwhile, growth rates decelerated across emerging economies (Chart 2.1.2).

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



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

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

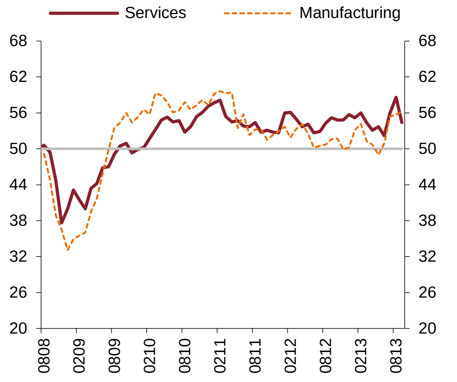


* Weighted by each country's share in global GDP.
Source: Bloomberg, CBRT.

During the first two quarters, the US GDP grew by an annualized 1.1 and 2.5 percent, respectively, from the previous quarter. The second-quarter acceleration was mostly driven by private consumption spending, exports and non-residential fixed investment expenditures. Public spending contributed negatively to growth due to the tight fiscal policy in place since early 2013. The US PMI data show that the growth outlook will continue to improve in the third quarter (Chart 2.1.3). In fact, the ongoing decline in unemployment in the last quarter and the simultaneous rise in home prices reinforce this view.

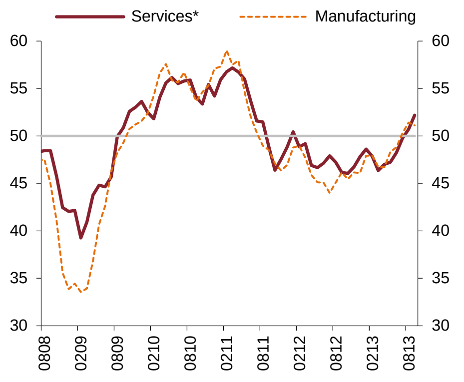
The Euro Area economy continued to contract in the second quarter, albeit more slowly, with the GDP down by 0.5 percent year-on-year. Euro Area PMI indices soared to a two-year high in the third quarter. In particular, the manufacturing PMI rose above the neutral 50 mark (Chart 2.1.4). Despite these positive developments, the ongoing elevation in unemployment rate in the third quarter suggests that the lasting recession will continue, though slowly, over the rest of the year.

Chart 2.1.3.
The US PMI Indices



Source: Markit.

Chart 2.1.4.
The Euro Area PMI Indices



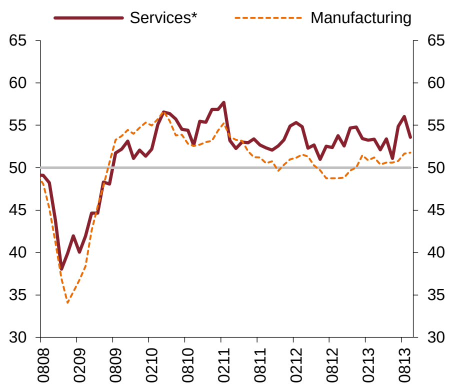
* Denotes the economic activity index.
Source: Markit.

China, the key driver of growth in emerging economies, grew by 7.8 percent year-on-year in the third quarter, reversing the slowdown in the first half. This was largely on account of the loose monetary policy, yet increased investments provided a boost to growth as well. On the other hand, other leading emerging market economies such as India, Russia and Mexico grew at a slower pace in the second quarter. Growth rates in many emerging economies, particularly Latin American countries and India, may continue to decelerate in the second half of the year.

Global PMI data point to a slight increase in both manufacturing and services for the third quarter (Chart 2.1.5). The rebound across advanced economies, particularly the US, is regarded as the major driver of this increase. However, growth rates in these countries may remain sluggish in the third quarter due to the recent outflows from emerging markets. In addition, emerging economies may face significant risks to financial stability should a prolonged uncertainty over the Fed's policies trigger capital outflows from emerging economies.

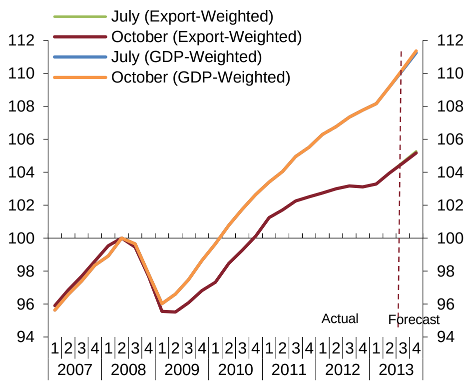
Against this backdrop, the growth outlook for the upcoming period appears to be more positive for advanced economies and more negative for emerging economies compared to the previous reporting period. In fact, in the October issue of Consensus Forecasts, global growth forecasts for 2013 and 2014 are left unchanged from the July reporting period, where forecasts for advanced economies and emerging economies are revised slightly upwards and downwards, respectively (Table 2.1.1). Moreover, the revised GDP- and export-weighted global production indices remained unchanged from the previous reporting period (Chart 2.1.6), suggesting that Turkey's external demand will continue to weaken in the forthcoming period.

Chart 2.1.5.
Markit Global PMI Indices



* Denotes the economic activity index.
Source: Markit.

Chart 2.1.6.
Global Production Indices*
(2008Q2=100))



* Weighted by each country's share in Turkey's exports for export-weighted indices.
Source: Bloomberg, Consensus Forecasts, CBRT.

Table 2.1.1.
Growth Forecasts for end-2013 and end-2014

Consensus Forecasts (Average Annual Percent Change)

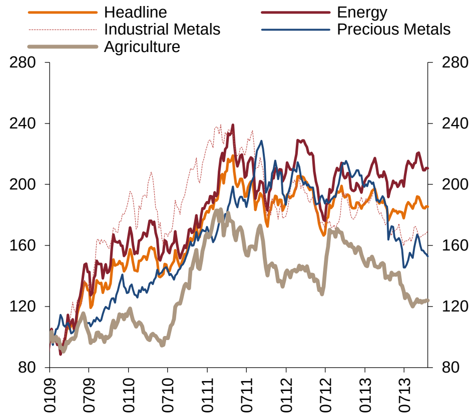
	July		October	
	2013	2014	2013	2014
World	2.4	3.1	2.4	3.1
Advanced Economies				
USA	1.8	2.7	1.6	2.6
Euro Area	-0.6	0.8	-0.3	0.9
Germany	0.4	1.6	0.5	1.7
France	-0.3	0.6	0.1	0.8
Italy	-1.8	0.4	-1.7	0.5
Spain	-1.6	0.3	-1.3	0.5
Greece	-4.8	-1.0	-4.0	-0.6
Japan	1.9	1.5	1.9	1.7
UK	1.0	1.7	1.4	2.2
Emerging Economies				
Asia-Pacific	6.1	6.4	6.0	6.2
China	7.5	7.6	7.6	7.4
India	5.9	6.6	4.6	5.7
Latin America	3,.0	3.7	2.6	3.1
Brazil	2.5	3.2	2.4	2.4
Eastern Europe	2.3	3.3	2.1	2.9

Source: Consensus Forecasts.

2.2. Commodity Prices

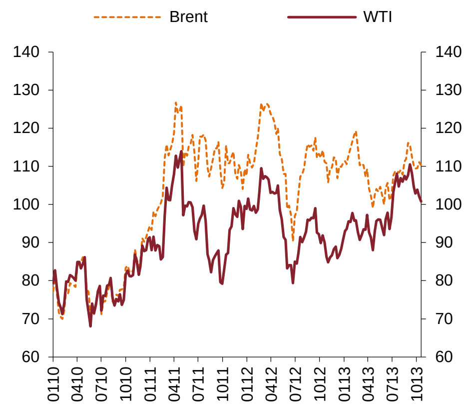
In the third quarter, the overall commodity index increased by 3.5 percent quarter-on-quarter. Energy prices, industrial metal prices, and precious metal prices were up 4.5, 5.6 and 8.8 percent, respectively, while agricultural prices dropped by 3 percent (Chart 2.2.1).

Chart 2.2.1.
S&P Goldman Sachs Commodity Prices
(January 2009=100)



Source: Bloomberg.

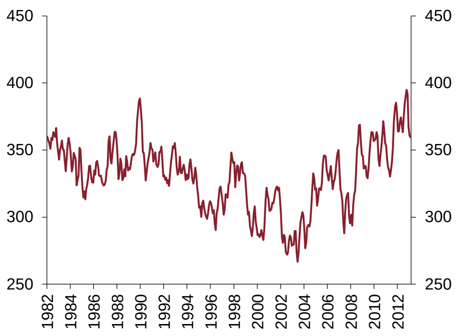
Chart 2.2.2.
WTI – Brent Prices
(USD/bbl)



Source: Bloomberg.

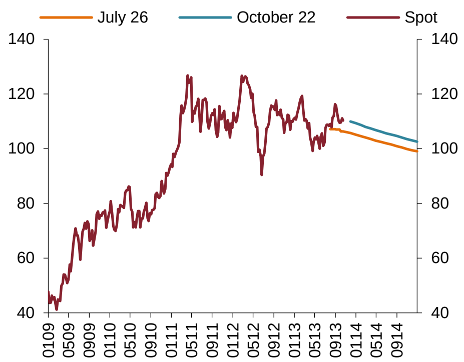
In the third quarter, supply-side developments were influential on oil prices. The ongoing political tensions in the Middle East stoke oil supply concerns, and thus pose an upward pressure on prices. In particular, the possibility of a US intervention following the use of chemical weapons in the Syrian civil war drove Brent crude prices up to 118 USD. With steps taken to find a political solution to the crisis, the possibility of a military action waned, and as a result, crude oil prices declined (Chart 2.2.2). Crude oil production issues in Libya, Nigeria and Iraq are other supply-related risk factors in the market. However, US crude oil stocks hovering around all-time highs, despite the recent slight decline, constitute a favorable outlook for oil prices (Chart 2.2.3). On the demand side, the weak course of growth across emerging economies helps to reduce the upward pressure on oil prices, notwithstanding the improvement in the growth outlook for advanced economies. More specifically, the downward revision to growth forecasts for emerging economies, whose currencies have recently gone through major depreciations, supports the weak crude oil demand. Hence, 15-month futures contracts suggest an uptick in oil prices compared to the previous reporting period (Chart 2.2.4).

Chart 2.2.3.
Crude Oil Inventories in the US
(Million barrel)



Source: US Department of Energy.

Chart 2.2.4.
Crude Oil (Brent) Prices*
(USD/bbl)



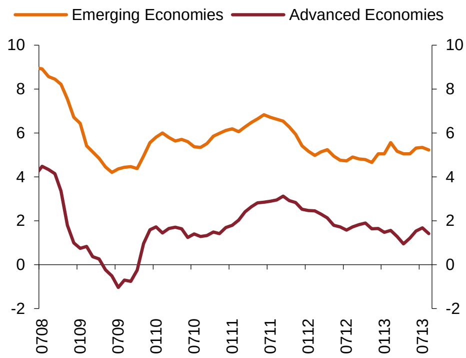
* July 26 and October 22 denote the arithmetical average of the prices quoted in futures contracts during July 1 and 26, 2013 and October 1 and 22, 2013, respectively.
Source: Bloomberg.

On the agricultural front, prices continued with the downtrend that started in mid-2012 and fell by 3 percent in the third quarter of 2013. Although prices of some agricultural commodities increased slightly due to weather conditions, expectations for agricultural production and stock levels were favorable.

2.3. Global Inflation

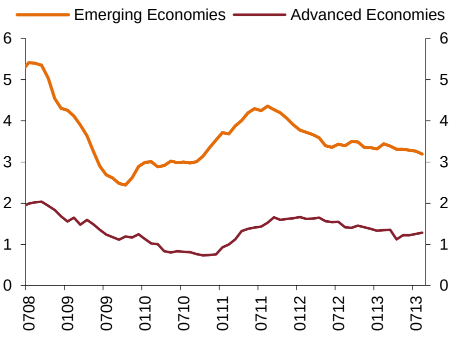
In the third quarter of 2013, despite the moderate increase in commodity prices, consumer inflation was slightly down from the previous reporting period across both advanced and emerging economies (Chart 2.3.1). However, core inflation went up in advanced economies amid signs of recovery, but continued to fall in emerging economies due to their weakening growth outlook (Chart 2.3.2).

Chart 2.3.1.
CPI Inflation in Advanced and Emerging Economies
(Annual Percent Change)



Source: Bloomberg, CBRT.

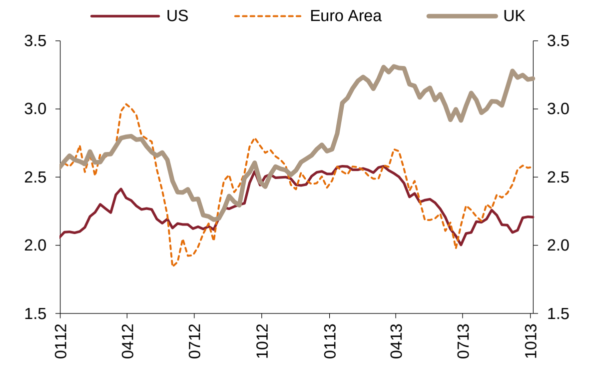
Chart 2.3.2.
Core Inflation in Advanced and Emerging Economies
(Annual Percent Change



Source: Bloomberg, Datastream, CBRT.

Inflation compensation was dramatically upward in the US, Euro Area and the UK during the third quarter, mainly on improved growth outlooks (Chart 2.3.3). Notwithstanding the slight August decrease amid expectations of a reduction in asset purchases, the US compensation rate has hovered above the readings of the previous reporting period as of October.

Chart 2.3.3.
Inflation Compensation in the US, UK and the Euro Area
(Percent)



Source: Bloomberg.

End-2013 inflation forecasts for advanced economies remained virtually unchanged from the previous reporting period, whereas end-2014 forecasts were revised slightly down for the US and the Euro Area (Table 2.3.1). In the meantime, inflation forecasts for emerging Asia-Pacific economies were revised downward amid waning growth prospects, while forecasts for India were revised substantially upwards due to the September policy rate hike to control inflation. The upward revision to forecasts for Latin American economies was mostly driven by the recent upsurge in Venezuela's consumer prices.

Table 2.3.1.
Inflation Forecasts for end-2013 and end-2014
(Annual Percent Change)

	July		October	
	2013	2014	2013	2014
World	2.6	3.0	2.7	3.0
Advanced Economies				
USA	1.5	1.9	1.5	1.8
Euro Area	1.5	1.5	1.5	1.4
Germany	1.6	1.9	1.6	1.9
France	1.0	1.4	1.0	1.5
Italy	1.5	1.6	1.4	1.6
Spain	1.7	1.4	1.6	1.3
Greece	-0.5	-0.2	-0.6	-0.5
Japan	0.0	2.1	0.2	2.3
UK	2.7	2.5	2.7	2.5
Emerging Economies				
Asia-Pacific	3.6	3.8	3.5	3.7
China	2.6	3.2	2.6	3.1
India	8.1	7.3	9.0	7.6
Latin America	7.0	6.7	7.8	7.1
Brazil	5.8	5.6	5.8	5.9
Eastern Europe	4.9	4.9	5.0	4.9

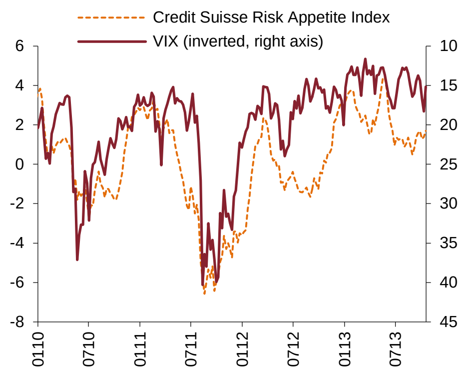
Source: Consensus Forecasts.

The moderate course of commodity prices is likely to pose no pressure on global inflation rates in the upcoming period. However, in case emerging economies continue to see capital outflows, the resulting depreciation of their currencies may not only put upward pressure on their inflation rates but also deteriorate their inflation forecasts.

2.4. Financial Conditions and Risk Indicators

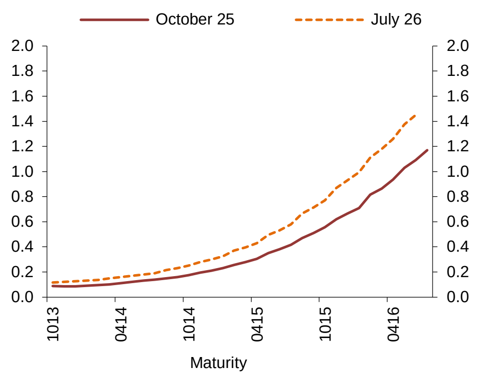
The third quarter was marked by a volatile global risk appetite as expectations for a Fed taper off were postponed despite ongoing concerns over global growth. Thanks to the Fed's decision to keep asset purchases steady, which helped to alleviate fears that global liquidity growth might slow, and the decreased political risks surrounding Syria, global risk appetite picked up in September (Chart 2.4.1). The Fed funds futures contracts suggest that expectations for a Fed rate hike are pushed out a little further and have edged down (Chart 2.4.2).

Chart 2.4.1.
Global Risk Appetite



Source: Bloomberg, Credit Suisse.

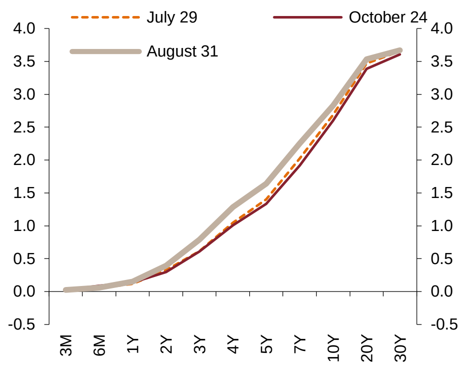
Chart 2.4.2.
Policy Rate Futures in the US
(Percent)



Source: Bloomberg.

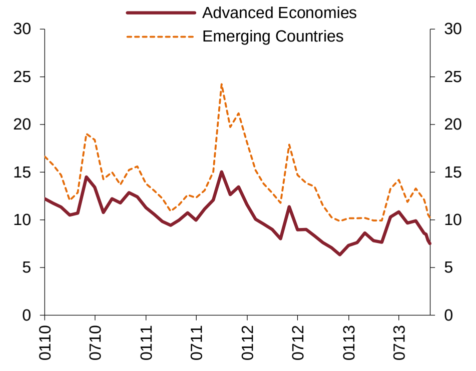
After an upsurge in August, medium- to long-term US yields went back to previous levels in September and October amid delayed expectations for a near-term cutback on asset purchases by the Fed (Chart 2.4.3). This delay somewhat reduced the uncertainty over the US dollar, the most commonly used reserve currency. As a result, 1-month implied volatilities on exchange rate options for advanced and emerging market currencies were down in the third quarter from the previous reporting period (Chart 2.4.4).

Chart 2.4.3.
The US Yield Curve
(Percent)



Source: Bloomberg.

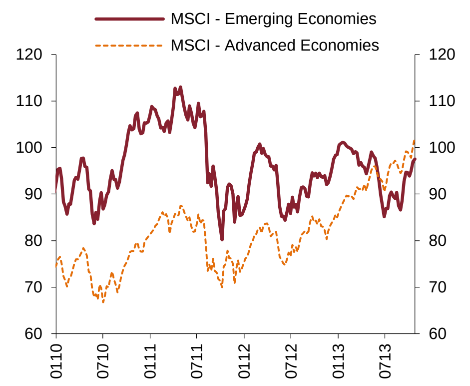
Chart 2.4.4.
Implied Volatility of Exchange Rates*
(Against USD, Percent)



* Advanced economies include Euro Area, Japan, UK, Australia, Switzerland and Canada. Emerging economies include Mexico, Brazil, South Korea, Poland, Hungary, Czech Republic and South Africa.
Source: Bloomberg.

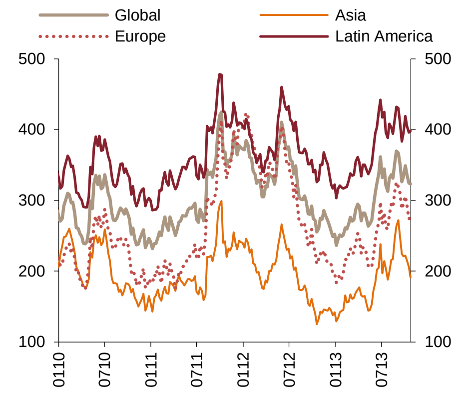
The uncertainty over the US monetary policy appears to have faded over the short term, which helped to lift stock market indices in both advanced and emerging economies. Yet, the rise was more limited in stock markets of advanced economies than those of emerging markets (Chart 2.4.5). Yields on emerging market bonds dropped in line with the global risk appetite and stock market developments (Chart 2.4.6).

Chart 2.4.5.
Global Stock Markets
(USD, 2007=100))



Source: Bloomberg.

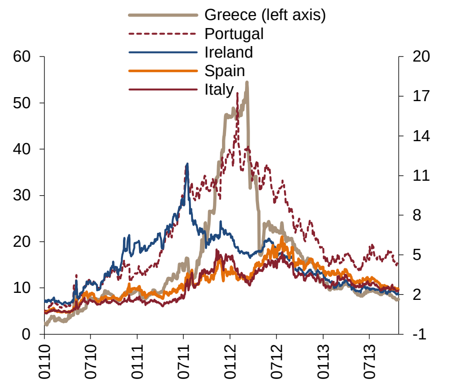
Chart 2.4.6.
Regional EMBI Developments
(5-year)



* EMBI indices denote the yield spread of the USD-denominated bills and bonds of countries over US Treasury bills and bonds.
Source: Bloomberg.

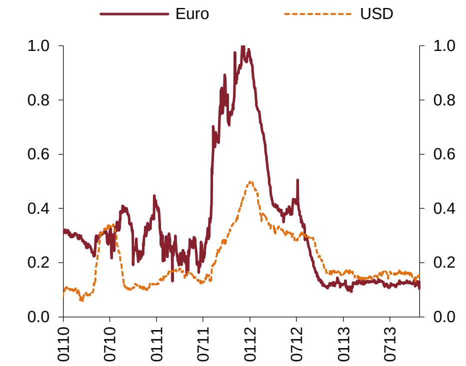
Similar to emerging economies, yields on bonds of troubled Euro Area countries have recently inched down compared to yields on safe-haven German government bonds (Chart 2.4.7). Meanwhile, the LIBOR-OIS spread, a measure of counterparty risk and liquidity conditions in the money market, remained flat in both the US and the Euro Area during the third quarter (Chart 2.4.8).

Chart 2.4.7.
Yield Spread over German Bonds in GIIPS Countries*(10-Year, Percent)



Source: Bloomberg.

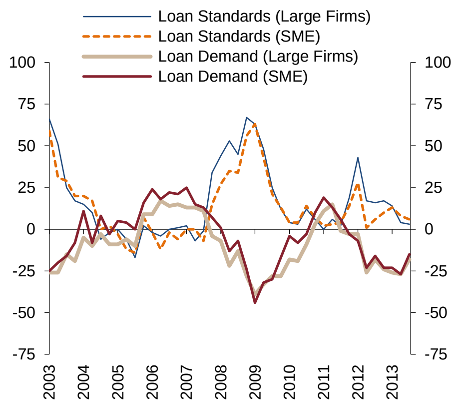
Chart 2.4.8.
LIBOR-OIS Spread
(3-Month, Point)



Source: Bloomberg.

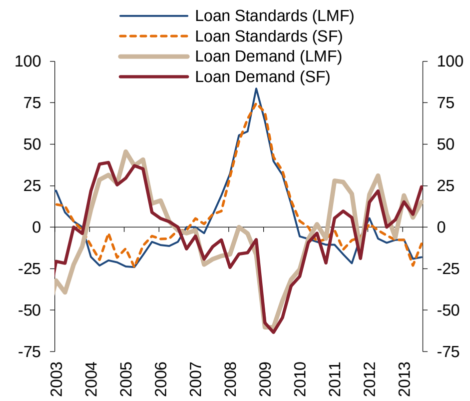
On the credits front, although the ECB's July bank lending survey reported less tightening of lending standards in the third quarter compared to the second quarter, credit demand continued to decline in the Euro Area (Chart 2.4.9). The Fed's July bank lending survey, on the other hand, showed further easing in bank lending conditions and a considerably stronger demand for loans from large and medium-sized as well as small firms in the US (Chart 2.4.10).

Chart 2.4.9.
The ECB Bank Lending Survey*
(Percent)



* Upward movements denote tightening in credit conditions.
Source: ECB.

Chart 2.4.10.
The Fed Bank Lending Survey*
(Percent)

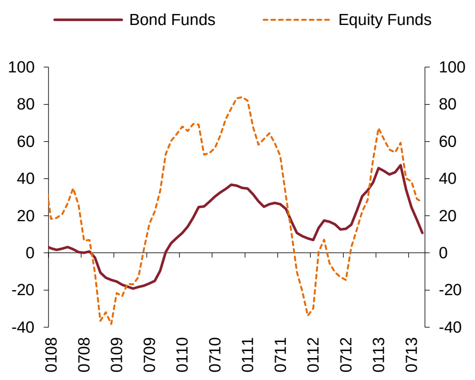


Source: Fed.

2.5. Capital Flows

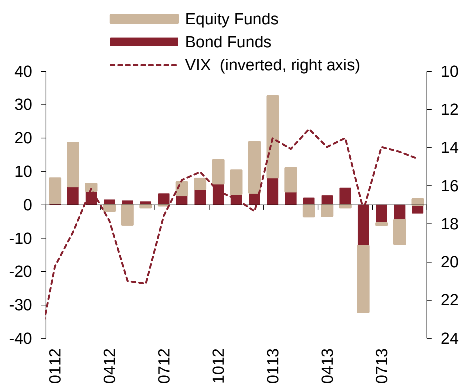
Having adopted a remarkable downtrend in the second quarter by the Fed's statement to trim asset purchases, capital flows to emerging economies continued to decline in the third quarter of 2013 (Chart 2.5.1). As a result of the sharp increase in yields on long-term US bonds, emerging economies saw capital outflows, unlike the general tendency, mostly from fixed-income securities (Chart 2.5.2). Outflows from stock markets were limited in July due to the improved global risk appetite, but continued in August before turning into inflows in September. Meanwhile, outflows from bond funds were increasingly slower than in June. In sum, capital flow volatility remained high over the third quarter of the year.

Chart 2.5.1.
Annual Portfolio Flows to Emerging Economies
(Cumulative, Billion USD)



Source: Bloomberg, EPFR.

Chart 2.5.2.
Monthly Portfolio Flows to Emerging Economies
(Billion USD)



Source: Bloomberg, EPFR.

On a quarterly basis, capital outflows represented only 1.7 percent of total emerging market funds in the third quarter, down from 2.9 percent in the previous quarter. In terms of the portfolio composition, bond funds accounted for about 80 percent of the outflows (Table 2.5.1). Across regions, outflows from Emerging Asia were relatively slow, while Latin America and Emerging Europe saw a capital outflow of 1.9 and 1.4 percent, respectively.

Table 2.5.1.
Composition of Portfolio Flows to Emerging Economies
(Quarterly, Billion USD)

		Total	Portfolio Composition		Regional Composition			
			Equity Funds	Bond Funds	Emerging Asia	Emerging Europe	Latin America	MENA
2012	Q1	32.4	21.2	11. 2	14.7	5.7	9.3	2.7
	Q2	-3.5	-7.8	4.3	-4.0	0.0	0.2	0.3
	Q3	19.2	7.0	12.1	6.2	4.5	6.8	1.7
	Q4	42.8	27.9	14.9	24.0	6.3	9.9	2.7
2013	Q1	42.9	27.8	15.1	24.5	6.2	9.2	3.0
	Q2	-24.5	-21.4	-3.0	-12.9	-3.8	-6.7	-1.0
	Q3	-13.1	-2.8	-10.4	-4.7	-2.9	-5.2	-0.3

Source: EPFR.

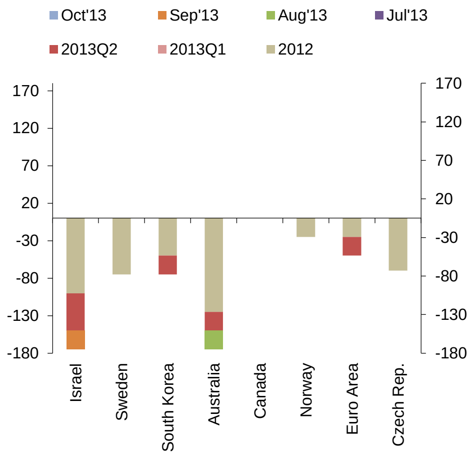
The Fed's decision in September to not implement a cutback on its bond-buying program provided some market relief in the short run, but also caused elevated uncertainty about the normalization of its monetary policy for the upcoming period. Accordingly, downside risks are expected to continue to weigh on emerging market capital inflows in the forthcoming period. Although the Fed's decision to maintain the pace of its asset purchases will help to alleviate some of the concerns about global liquidity and thus curb the drop-off in capital flows over the short term, the ongoing uncertainty surrounding global monetary policy and resulting capital outflows may threaten financial stability in emerging economies. Moreover, as in the previous reporting period, the fact that advanced economies continue to rebound while emerging economies face a weaker growth outlook may cause capital flows to decline further in the upcoming period.

2.6. Global Monetary Policy Developments

In the third quarter of the year, the most crucial development regarding monetary policy is the Fed's no-taper decision. In addition, the uncertainty about the amount and timing of any change in the Fed's bond-buying program has been the main driver of the fluctuations that financial markets have recently seen.

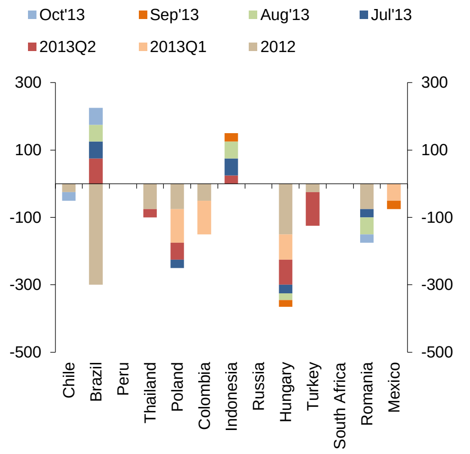
Across advanced economies, the Bank of Israel and the Reserve Bank of Australia continued to cut their policy rates by about 25 basis points each in the inter-reporting period (Chart 2.6.1). On the emerging economies front, the National Bank of Poland, one of the most aggressive central banks that cut policy rates for 1.5 years, lowered its policy rate by 25 basis points in July before deciding to keep it unchanged, while the Magyar Nemzety Bank maintained a loose monetary policy with a 65 basis point cut during July-October. Additionally, the National Bank of Romania slashed its policy rate by 100 basis points, while the Bank of Mexico and the Central Bank of Chile each announced a 25 basis point cut. After the second-quarter tightening, the Central Bank of Brazil and the Bank of Indonesia continued with the hawkish stance during July-October and hiked their policy rates by 150 and 125 basis points, respectively (Chart 2.6.2).

Chart 2.6.1.
Policy Rate Changes in Advanced Economies from Jan. 2012 to Oct. 2013* (Basis Points



* As of October 22, 2013.
Source: Bloomberg, CBRT.

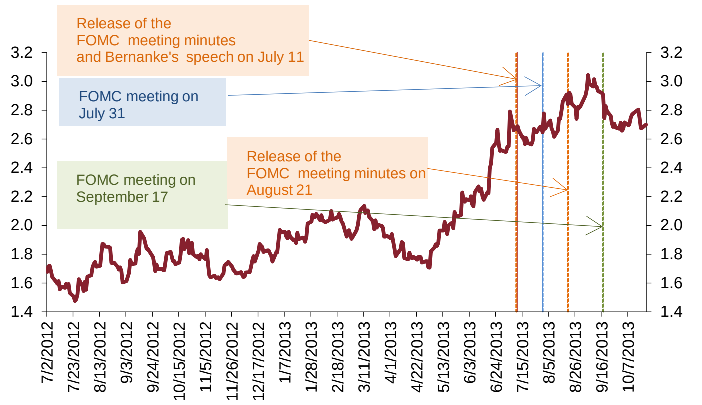
Chart 2.6.2.
Policy Rate Changes in Emerging Economies from Jan. 2012 to Oct. 2013* (Basis Points)



* As of October 22, 2013.
Source: Bloomberg, CBRT.

The uncertainty that emerged in May over the Fed's monetary policy continued into the third quarter of the year. After announcing plans to gradually cut down asset purchases with a wrap-up by mid-2014, the Fed provided additional statements that tapering would not mean tightening and the economy and labor market would continue to require the support of an accommodative monetary policy until the recovery is strong enough. However, these additional announcements by the Fed failed to keep long-term interest rates from rising. One of the main drivers of the spike in interest rates, which happened despite the Fed's attempt to separate its interest rate policy from the bond-buying program, was the expectation that tapering would begin in September. As a result, yields on benchmark 10-year Treasury bonds fell following the Fed's surprise September decision to maintain the current pace of bond purchases (Chart 2.6.3). Within 20 days after this announcement, long-term interest rates dropped by nearly 20 basis points. The FOMC meeting minutes released on October 10 revealed that members had mixed opinions on tapering, and offered no hint about the future Fed action.

Chart 2.6.3.
Yields on US Treasury Bills (10-Year, Percent)

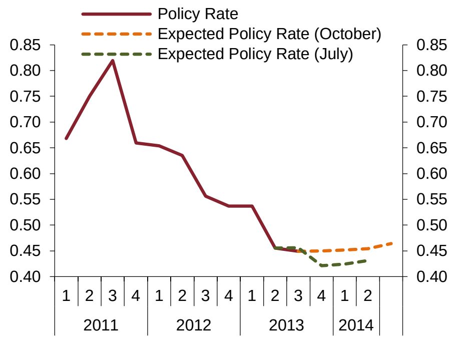


Source: Bloomberg.

Prospects of Fed tapering as well as the substantially improved leading indicators for advanced economies fed into expectations that policy rates would increase from near-zero to historical averages over the medium term. The unpredictability of when this monetary policy normalization will begin and how fast policy rates are likely to go up in advanced economies, particularly the US, is another factor that creates uncertainty about monetary policy in the medium and long term.

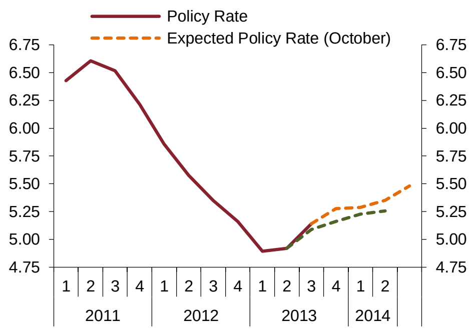
Major central banks, especially the Fed, have recently adopted forward guidance as a key policy tool to affect economic variables and longer-term interest rates by sending signals about the future path of monetary policy (Box 2.1). In the previous quarter, the Bank of England, like the Fed, tied policy rates to unemployment, and decided not to deliver rate hike until unemployment falls to 7 percent. Setting no threshold for forward guidance, the ECB stated that it expects policy rates to remain low for an extended period.

Chart 2.6.4.
Expected Policy Rates in Advanced Economies



Source: Bloomberg, CBRT.

Chart 2.6.5.
Expected Policy Rates in Inflation-Targeting Emerging Economies



Source: Bloomberg, CBRT.

The average policy rate in advanced economies was down by only 0.5 basis points quarter-on-quarter, consistent with the expectation that it would remain flat in the third quarter. Yet, policy rate expectations were revised upward compared to July. The July expectation of another ECB rate cut in the last quarter was given up in October on signs of a Euro Area recovery, and the path of expectations shifted up (Chart 2.6.4). Meanwhile, emerging economies saw a rate hike of around 22 basis points, 7 basis points higher than expected, in the third quarter. Likewise, the future path of monetary policy is revised upward, with October expectations pointing to an aggressive monetary tightening by mid-2014 (Chart 2.6.5).

Box 2.1 Forward Guidance in Monetary Policy Communication

In the post-financial crisis period, besides statements on recent monetary policy decisions, central banks of advanced economies have frequently used forward guidance in their monetary policy communication, which comprises of commitments on the future policy outlook. Forward guidance, which has recently gained relatively more weight in the monetary policy implementations by advanced economies, is thought to further play a major role on the monetary policy design in the period ahead. Hence, this box presents the role of various methods of forward guidance in the monetary policy communication and analyzes the recent forward guidance practices by major central banks.

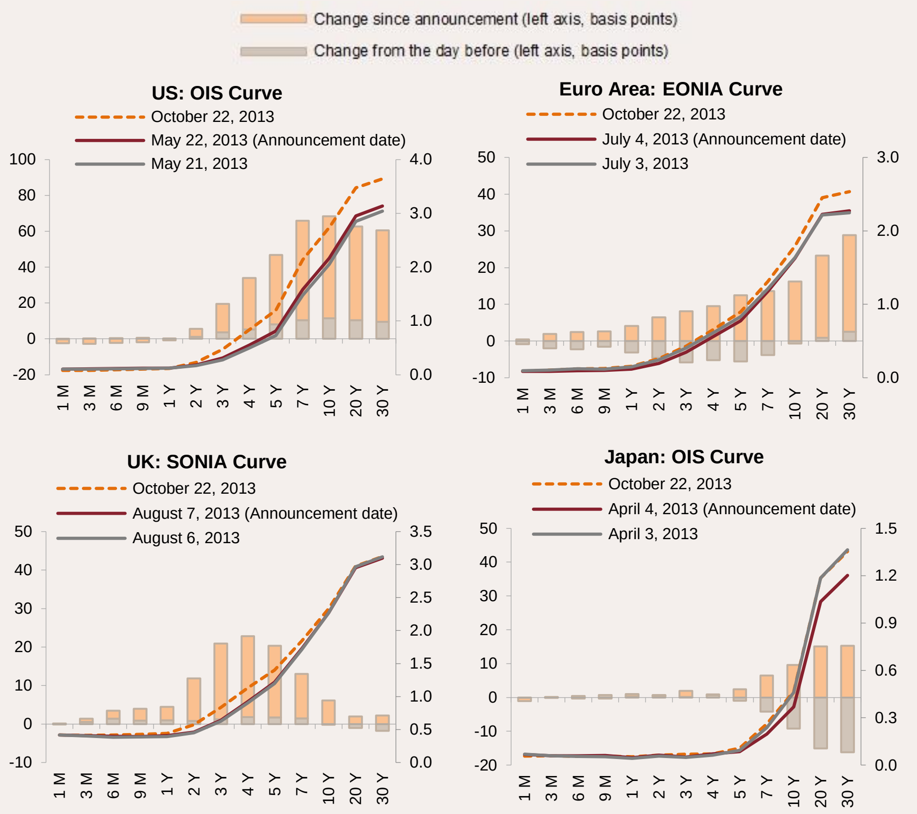
The main objective of forward guidance is to reduce uncertainty regarding the future course of the monetary policy. In recent years, forward guidance has mostly been used by major central banks as a commitment to maintain monetary policy easing for prolonged periods; whereas lately, forward guidance has been viewed as part of the exit strategy within the normalization process. Forward guidance changes the monetary policy reaction function, thus enabling it to differ from the reaction implied by the standard policy rule.

The analysis across countries reveals that forward guidance is used by central banks for various purposes like reducing uncertainty in the market, preventing an increase in long-term interest rates or strengthening the communication of the exit strategy within policy normalization. To give an example, open-ended guidance only provides qualitative information on the expected path of monetary policy. The Fed's guidance in the aftermath of the financial crisis on keeping interest rates low for a prolonged period is classified under this category. This type of guidance provides central banks with flexibility regarding policy reactions to unanticipated developments, yet leaving the door open for debate due to an absence of time-contingent or state-contingent strict commitments. Meanwhile, time-contingent guidance provides information on the timing of the change in monetary policy. The Fed's guidance in the first half of 2012 on keeping interest rates low at their current level at least until end-2014 is an example of this type of guidance. Despite providing markets with clarity, this type of guidance may hurt central bank creditability as it lacks information on how monetary policy would react to possible shocks that occur within the determined time frame.

Lastly, state-contingent guidance provides information on economic conditions that may lead to a change in the monetary policy. Forward guidance recently adopted by the Fed and the Bank of England that the policy rates would not be raised so long as the inflation outlook does not deteriorate and unemployment rates do not fall to 6.5 and 7.0 percent, respectively, is classified under this category. However, this type of guidance carries the risk of misunderstanding by the market, and may hamper communication of the monetary policy as threshold values for various economic variables are set by central banks, whose main objective is to maintain price stability. At this point, informing the public explicitly about the conditionality of the central bank commitment and the trade-off between policy reactions to possible shocks is crucial. Moreover, recent experiences of state-contingent forward guidance show that this type of guidance may lead to excessive volatility in the market in cases where high frequency data on the contingent variable are present and the transmission mechanism is ambiguous. On the other hand, in this type of guidance, central bank reaction to possible shocks can be better understood by the public than in time-contingent guidance (Bank of England, 2013).

Despite having mixed evidence on the effectiveness of forward guidance in managing expectations about the monetary policy stance, forward guidance is especially effective on the path of expected policy rates in the US. To illustrate to what extent forward guidance influences expectations, Chart 1 displays changes in OIS in 4 countries starting from the day of announcement until present as well as from the previous day of the announcement until present. Accordingly, Bernanke's testimony before the US Congress on May 22 seems to have strengthened expectations for further tightening in the monetary policy. As of October, the short end of the curve displayed a fall, while the long end exhibited a remarkable rise from the day of the announcement of the guidance. Meanwhile, medium-term maturities of the EONIA curve declined following the ECB's meeting on July 4, and as of October, the EONIA curve shifted upwards, displaying a particularly considerable rise at the long end of the curve. In Japan, the quantitative and qualitative easing policy decisions on April 4 to be implemented until inflation rate reaches 2 percent had a downward effect on the path of expected policy rates; however, this effect has waned as of October. Lastly, forward guidance in the UK had a more profound effect in the medium-term than on long-term expectations.

Chart 1. Forward Guidance Announcements and OIS Curves (Percent)



Source: Bloomberg.

Central banks using forward guidance certainly face various communication difficulties. In order for forward guidance to be effective, the central bank should have an explicit objective; this objective should be well-understood by the market and the transmission mechanism should be clear. On the other hand, it is crucial that the commitment by the central bank should not be binding for policymakers under changing conditions; hence, it should explicitly be communicated that the monetary policy stance will be adjusted and necessary measures will be taken against possible shocks. The conditionality of the central bank commitment to be well-understood by the public is crucial for preventing a credibility loss. In that case, a monetary policy mix strengthened by conventional and unconventional policy tools would help the central bank to more easily manage economic as well as financial shocks when supported by forward guidance.

REFERENCES

Bank of England, 2013, Monetary Policy Trade-offs and Forward Guidance, MPC document released on August 1, 2013.