2. International Economic Developments

The global economy continued to recover in the first quarter of 2011 as expected. The contribution of public spending and inventory build-up slowed, yet rising private demand continue to drive growth in advanced economies. Meanwhile, emerging economies grow further amid strong domestic demand and massive capital flows.

Although expectations for global economic activity are positive, risk factors remain a major concern. The increasing likelihood of debt restructuring in European countries with sovereign debt problems and the surge in crude oil prices fueled by geopolitical concerns may hamper growth. In addition, the fact that the quantitative easing in advanced economies will end in the upcoming period is likely to slow down capital flows into emerging economies.

The rapid fourth-quarter growth in the U.S. economy, driven largely by private final demand, was well received. The brighter-than-expected first-quarter data releases providing indicative information and the accelerated employment growth are other positive developments in the last three months. Following these developments, although some of the U.S. Fed officials called for an early end to the second round of quantitative easing and stressed the need to start a tightening cycle sooner rather than later, the minutes of the FOMC meeting on March 15 revealed that the easing program would proceed as planned. Thus, the expectation for a policy hike to start in late 2011 is preserved.

The contribution of private consumption spending to euro area growth increased in the fourth quarter, while fixed investment spending made a negative contribution. Leading indicators point to an ongoing mild growth in the first quarter of 2011, yet growth rates continue to differ across the region. The increase in resources available through the European Financial Stability Fund (EFSF), Ireland's banking sector stress tests showing no need for extra capital and Spain's attempts to differentiate itself from other EU economies are all considered an improvement. On the other hand, Portugal's plea for international assistance, structural problems of the peripheral economies and ongoing debt concerns despite bailouts as well as the unfinished negotiations over the design of the European Stability Mechanism (ESM), a permanent anti-crisis mechanism, pose a downside risk to euro area growth and global risk appetite.

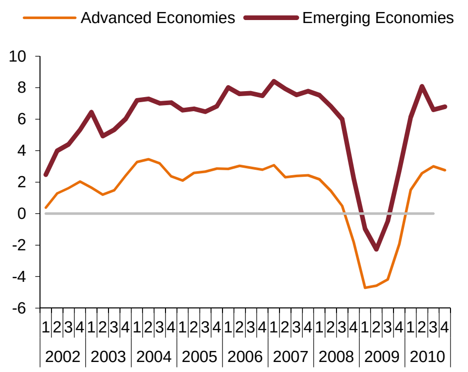
Emerging economies continued to grow rapidly in the first quarter, while the mounting inflation pressure points to a sooner- and a stronger-than-expected monetary tightening. The most important risk factor for emerging economies are the massive capital inflows that cause loss of competitiveness and credit growth. Emerging market central banks adopt macroprudential measures to cushion their economies against the side effects of massive capital flows.

Commodity prices remained a major source of uncertainty in the first quarter. As energy and precious metal prices were mainly driven by the political tensions in the MENA region, prices of these commodities may ease once tensions fade. However, due to supply constraints and higher demand, prices of some commodities may continue to face upward pressure, and further weigh on inflation.

2.1. Global Growth

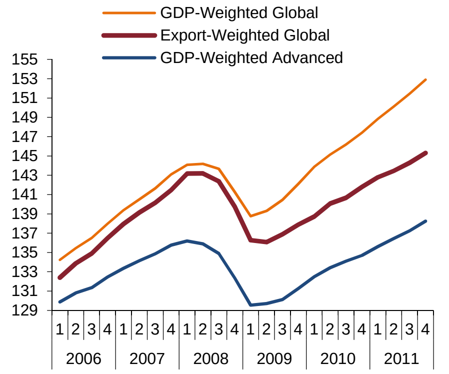
Global economic activity continued to recover during the first quarter. Although the later-recovering advanced economies returned to pre-crisis growth rates, economic activity remains below pre-crisis levels as of the final quarter of 2010. The strong growth across emerging economies continues. Yet, the global production index weighted by the share of each country in Turkish exports continued to hover below pre-crisis levels in the fourth quarter. The export-weighted global production index is expected to surpass pre-crisis levels in the second quarter of 2011 provided that advanced economies accounting for a major share of Turkish exports continue to recover (Charts 2.1.1 and 2.1.2).

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



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

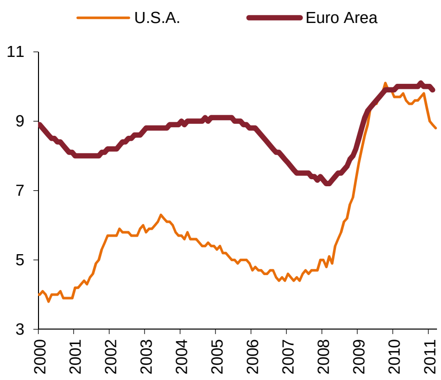
Chart 2.1.2.
Export and GDP-Weighted Global Production Indices (1996Q1 = 100)



Source: Bloomberg, CBRT.

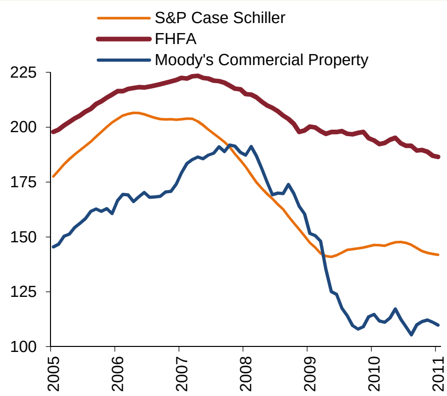
Although employment growth has accelerated across advanced economies, unemployment rates remain well above pre-crisis levels, posing risk to GDP growth (Chart 2.1.3). The fact that the U.S. unemployment rate is falling, albeit modestly, since November has sparked optimism. Moreover, the U.S. real estate prices continue to trend downward (Chart 2.1.4).

Chart 2.1.3.
Unemployment in Advanced Economies
(Percent)



Source: Bloomberg.

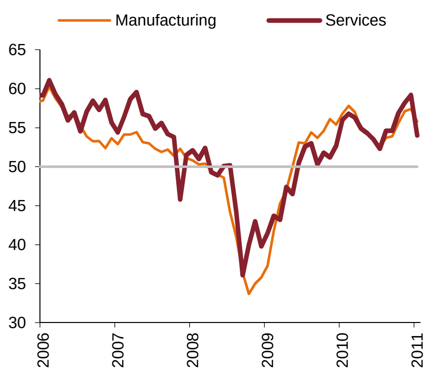
Chart 2.1.4.
Real Estate Price Indices in the U.S. Economy



Source: Bloomberg.

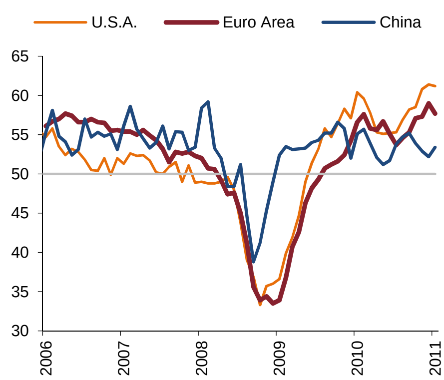
JP Morgan Global PMI indices, the most recent data for the first quarter of 2011, remained above the neutral level (Chart 2.1.5). The U.S. PMI hit the highest level in recent years, indicating a strong first-quarter growth. Despite tight fiscal policies as well as financial and fiscal problems in periphery economies, the euro area manufacturing PMI also remained high. Similarly, China's PMI exceeded the neutral level, implying a further rapid growth in the Chinese economy (Chart 2.1.6).

Chart 2.1.5.
JP Morgan Global PMI



Source: Bloomberg.

Chart 2.1.6.
PMI



Source: Bloomberg.

Consensus Economics kept its end-2011 global growth forecasts high. Although forecasts are revised slightly down after the January Inflation Report amid production cuts due to natural disasters in Japan and severe weather conditions in the U.S.A., expectations for 2012 are positive. The 2011 growth forecasts for Japan are slashed due to the devastating earthquake, leading to a downgrade for Asia-Pacific growth forecasts (Table 2.1.1).

Table 2.1.1.
Growth Forecasts
(Annual Percent Change)

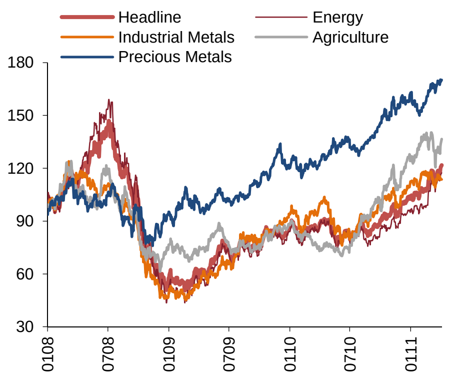
	2011		2012
	January	April	April
World	3.4	3.3	3.7
United States	3.2	2.9	3.3
Euro Area	1.5	1.7	1.7
Japan	1.2	0.3	2.7
China	9.2	9.3	8.9
Eastern Europe	3.9	4.1	4.3
Latin America	4.1	4.2	4.2
Asia-Pacific	5.1	4.8	5.7

Source: Consensus Forecasts.

2.2. Commodity Prices

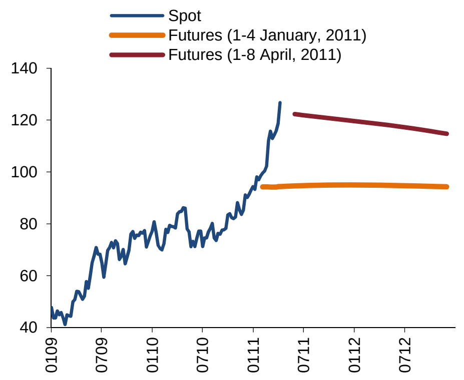
Global commodity prices continued to rise in the first quarter of 2011. Energy prices increased sharply on the back of oil prices surging to their highest since August 2008 due to problems in the MENA region. The political unrest in the region also caused precious metal prices to hit historic highs. The increase in agricultural prices for the last three months was rather limited compared to the January Inflation Report. Meanwhile, industrial metal prices continued to rise, however at a decelerating rate compared to the previous reporting period (Charts 2.2.1 and 2.2.2).

Chart 2.2.1.
S&P Goldman Sachs Commodity Prices
(January 2008=100)



Source: Goldman Sachs.

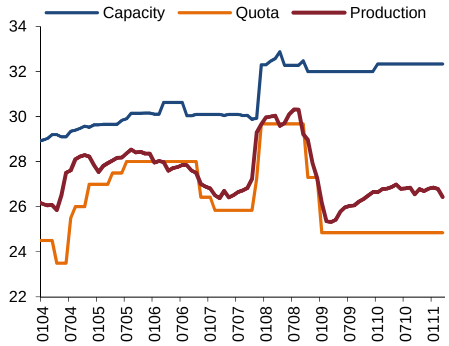
Chart 2.2.2.
Crude Oil (Brent) Prices
(USD/bbl)



Source: Bloomberg.

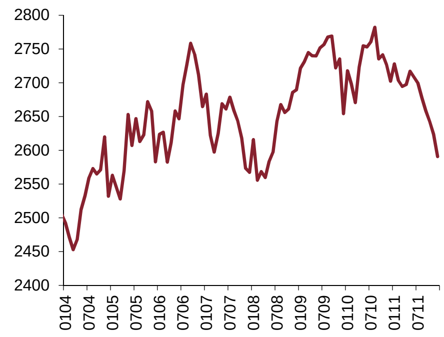
OPEC's decision to leave production quotas unchanged despite ample idle capacity puts upward pressure on crude oil prices (Chart 2.2.3). The political tensions in the MENA region add to this upward pressure due to production cuts and increased uncertainty. Moreover, the U.S. Department of Energy expects the decline in inventories since the middle of 2010 to continue throughout 2011 owing to supply shortages (Chart 2.2.4). Although prices are expected to fall once the geopolitical tensions end, OPEC's current decision is likely to limit this decline.

Chart 2.2.3.
OPEC Capacity, Quotas and Production
(Million Barrels)



Source: Bloomberg.

Chart 2.2.4.
OECD Crude Oil Inventories*
(Million Barrels)



* Estimate after February 2011..
Source: U.S. Department of Energy.

The most important factor that kept the increases in agricultural prices at minimum was the U.S. Department of Agriculture's upward revision to its wheat inventory forecast for end-2011 envisioning lower consumption and higher supplies. However, the positive outlook for wheat has no effect on other major agricultural commodities, such as corn and cotton (Table 2.2.1).

Table 2.2.1.
Production, Consumption and Inventory Estimates for Agricultural Commodities

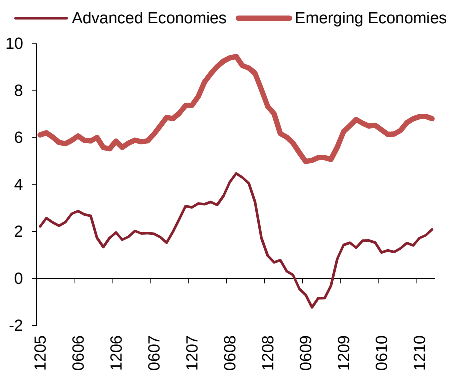
	2008/2009	2009/2010	2010/2011	
			January	April
WHEAT (million tons)				
Beginning Inventories	124.8	167.2	197.4	197.9
Production	684.2	682.6	645.8	647.2
Consumption	641.7	652.5	665.3	662.3
Ending Inventories	167.2	197.3	178.0	182.8
CORN (million tons)				
Beginning Inventories	131.4	147.8	147.1	145.8
Production	798.4	812.4	816.0	814.9
Consumption	781.9	815.7	836.1	838.3
Ending Inventories	147.8	144.5	127.0	122.4
COTTON (million bales)				
Beginning Inventories	60.7	60.5	43.9	44.0
Production	107.1	101.3	115.5	114.5
Consumption	110.0	118.5	116.6	117.1
Ending Inventories	60.5	43.8	42.8	41.6

Source: U.S. Department of Agriculture.

2.3. Global Inflation

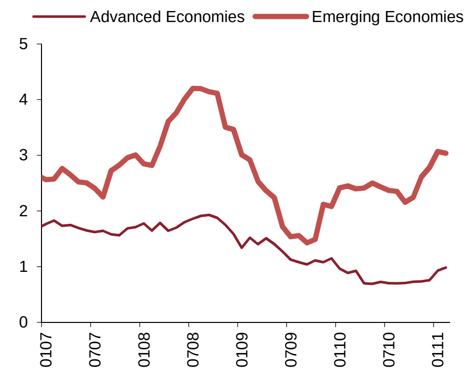
Global consumer inflation rates continued to trend upward in the first quarter amid ongoing global recovery and rising commodity prices (Charts 2.3.1 and 2.3.2). Core inflation rates maintained the historic lows in advanced economies, while remaining significantly higher in emerging economies.

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



Source: Bloomberg, CBRT.

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



Source: Bloomberg, Datastream, CBRT.

The global inflation forecast for end-2011 was revised substantially upward in April from the previous reporting period (Table 2.3.1). Inflation expectations are significantly higher for advanced economies poised for strong growth in the upcoming period. For emerging economies, inflation forecasts are revised upward only slightly.

Table 2.3.1.
Inflation Forecasts
(Annual Percent Change)

	2011	
	January	April
Consensus Economics		
World	2.8	3.4
United States	1.7	2.7
Euro Area	1.8	2.4
Emerging Economies		
Eastern Europe	6.0	6.3
Latin America	7.1	7.5
Asia-Pacific	2.8	3.3

Source: Consensus Forecasts.

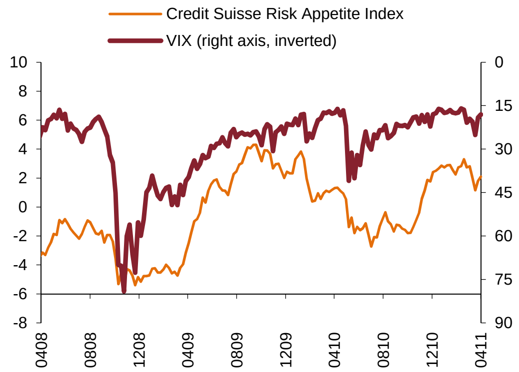
2.4. Financial Conditions and Risk Indicators

In the first quarter, financial markets mostly responded to the sovereign debt crisis in the peripheral Europe and to positive macroeconomic news. The

Japanese earthquake on March 11 created uncertainty, leading to a decline in risk appetite, albeit temporarily. While risk appetite improved on incoming positive data, inflationary pressures increased and the ECB announced its first post-crisis rate hike. Meanwhile, debates grew stronger that Fed should tighten monetary policy sooner. These developments suggest that 'push factors' would have less impact in the upcoming period than in previous periods and capital flows into emerging economies would decline.

Despite falling amid the euro area debt crisis and the Japanese earthquake, global risk appetite recovered on positive data releases, hovering close to levels observed during the previous reporting period (Chart 2.4.1).

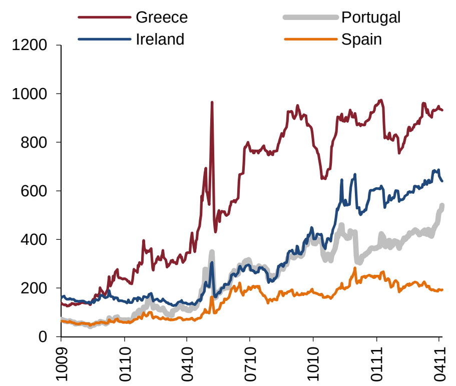
Chart 2.4.1.
Global Risk Appetite



Source: Bloomberg.

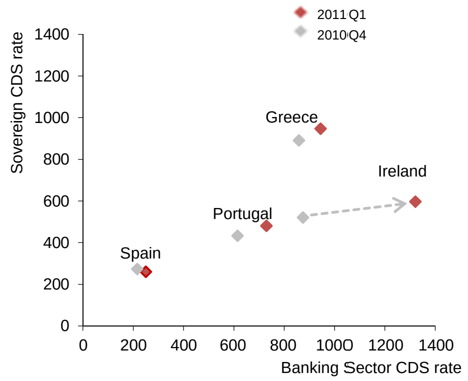
The possibility of a restructuring across debt struck euro area countries was heavily debated during the first quarter of 2011, while borrowing rates remained on the rise in these countries throughout this period. Adding a political crisis to debt woes, Portugal experienced a negative performance and the caretaker government called for international assistance in the first week of April. Although Spain's austerity measures helped the country to diverge positively from other indebted countries in the first quarter, the Spanish banking sector's high exposure to Portugal adds to the doubts. In Ireland, where problems primarily arise from the banking sector, the renewed stress tests yielding favorable results and thus indicating no need for new capital, boosted optimism. Despite the decline following the stress test results that replaced the sharp increase in the first quarter, Irish banking sector CDS rates remained elevated (Charts 2.4.2 and 2.4.3).

Chart 2.4.2.
Bond Spreads in Selected Countries over German Bonds (10-Year, Basis Points)



Source: Bloomberg.

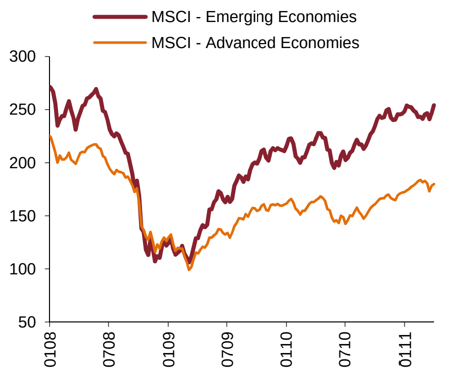
Chart 2.4.3.
CDS Rates in Selected Countries (5-year, Basis Points)*



* Period averages. Bank CDS rates based on data from Alpha Bank for Greece, Banco Comercial for Portugal, Allied Irish for Ireland and BBVA for Spain.
Source: Bloomberg.

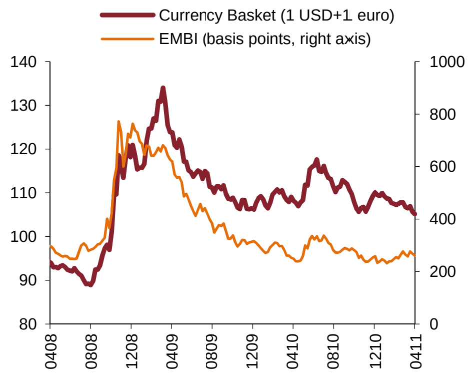
Stock markets remained volatile in line with changes in the global risk appetite, while emerging stock markets closed slightly higher in the first quarter (Chart 2.4.4). Risk premiums for emerging economies remained largely unchanged quarter-on-quarter, while emerging market currencies began to appreciate again after the fourth-quarter depreciation (Chart 2.4.5).

Chart 2.4.4.
Global Stock Markets



Source: Credit Suisse, Bloomberg.

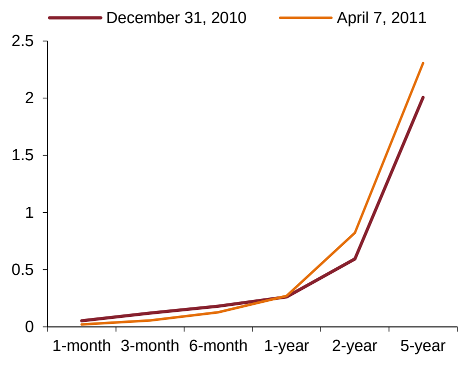
Chart 2.4.5.
Exchange Rate* and Risk Premium Indicators for Emerging Economies
(January 2007=100).



*Arithmetical average of the exchange rates of emerging market currencies against the currency basket of 1 USD and 1 euro. An upward movement denotes depreciation in emerging market currencies and
Source: Bloomberg.

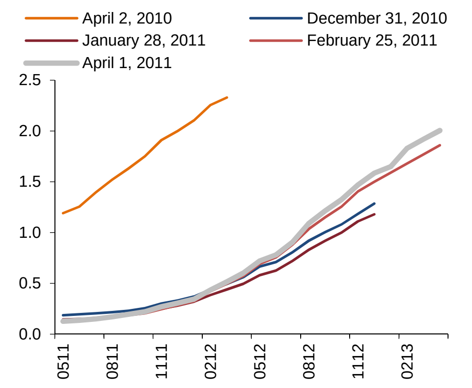
Notwitstanding expectations, long-term interest rates, having increased after the Fed's launch of the second round of quantitative easing in late 2010, remained broadly unchanged in the first quarter, hovering around year-end levels (Chart 2.4.6). Similarly, expectations of FOMC rate changes were largely flat, while the expectation for the first rate hike to come in late 2011 was maintained (Chart 2.4.7).

Chart 2.4.6.
U.S. Yield Curve
(Percent)



Source: Bloomberg.

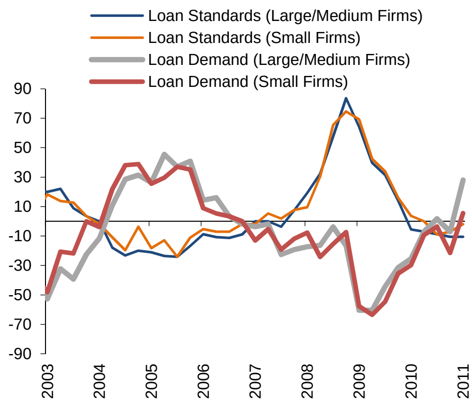
Chart 2.4.7.
Expectations of FOMC Rate Changes
(Percent)



Source: Bloomberg.

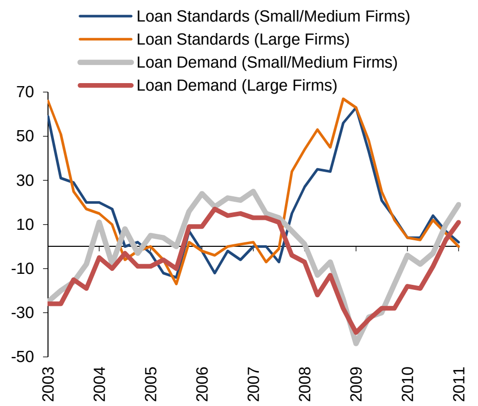
The Fed's Lending Survey results indicate that loan standards continue to ease, while loan demand increased for the first time in the post-crisis period (Chart 2.4.8). According to the ECB's Lending Survey, tightness in loan standards ended and loan demand continues to trend upward (Chart 2.4.9).

Chart 2.4.8.
U.S. Lending Survey*
(Percent)



* Upward movements indicate tightened loan standards.
Source: Fed.

Chart 2.4.9.
Euro Area Lending Survey*
(Percent)



Source: ECB.

2.5. Global Monetary Policy Developments

In the first quarter, policy rates remained at historic lows across advanced economies, while the quantitative easing cycle came to an end. Meanwhile, emerging economies adopted macroprudential measures in response to capital flows and began to normalize policy rates (Table 2.5.1).

The quantitative easing across G3 economies that started in 2008 continued into the first quarter of 2011. However, in the light of incoming positive data, the U.S. and the European central banks hinted at an end to the easing cycle, whereas Japan eased monetary policy to compensate for the damage caused by the devastating earthquake. In the first quarter, emerging economies continued relying on quantitative tightening measures to counter potential spillovers from the additional quantitative easing programs in advanced economies. Many emerging economies continued to impose capital controls in order to contain the negative impacts of the massive capital flow into emerging economies, prompted by the ample global liquidity generated by the policy measures in advanced economies, on financial stability and the medium-term inflation outlook, with Latin American and the Asia-Pacific economies taking the lead. Moreover, required reserve ratios that were lowered during the crisis to enhance the functioning of credit channel were raised again in the first quarter, leading to a tighter monetary stance (Table 2.5.1).

Table 2.5.1.
Monetary Policy Actions in Emerging Economies

		Policy Rate Changes			Macroprudential Measures		
		January 11	February' 11	March' 11	Required Reserve Ratio Changes	Capital Controls	Reserve Accumulation
LATIN AMERICA	Brazil	0.5	-	0.5	√	√	√
	Chile	-	0.25	0.5	-	-	√
	Colombia	-	0.25	0.25	-	√	√
	Peru	0.25	0.25	0.25	√	√	√
ASIA-PACIFIC	China	-	0.25	-	√	√	-
	India	0.25	-	0.25	√	√	-
	Indonesia	-	0.25	-	√	√	-
	S. Korea	0.25	-	0.25	√	√	-
	Malaysia	-	-	-	√	-	-
	Taiwan	-	-	0.125	√	√	-
	Thailand	0.25	-	0.25	-	√	-
CEEMEA	Hungary	0.25	-	-	√	-	-
	Israel	0.25	0.25	0.5	√	√	√
	Poland	0.25	0	0	√	√	-
	Turkey	-0.25	-	-	√	-	√

Source: Relevant central banks websites.

The previous Report indicated that major central banks would postpone the policy normalization process. Accordingly, these central banks continued to keep policy rates mostly unchanged (Chart 2.5.1). Indeed, in aggregated indices, composite policy rates for advanced economies remained stable in the first quarter (Chart 2.5.3). In emerging economies, macroprudential measures and increased inflationary pressures brought policy rates up in the first quarter, adding to the tightening of monetary policy (Chart 2.5.2). Thus, composite policy rates for emerging economies increased by 0.5 percentage points quarter-on-quarter to 6.5 percent by the end of March (Chart 2.5.4).

Chart 2.5.1.
Policy Rate Changes in Advanced Economies from Sept. 2007 to Mar. 2011* (Basis Points)

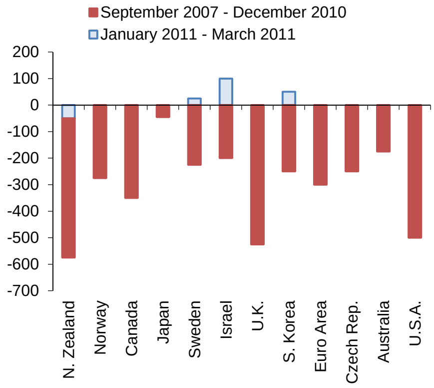
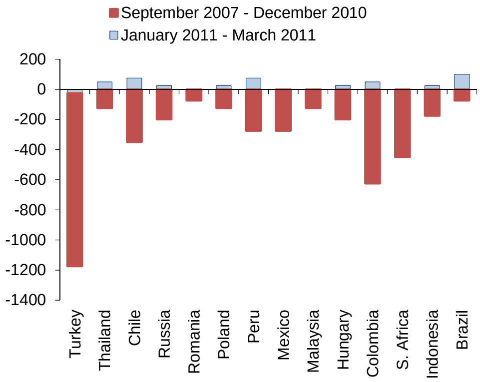


Chart 2.5.2.
Policy Rate Changes in Emerging Economies from Sept. 2007 to Mar. 2011* (Basis Points)



* As of end-March 2011.
Source: Bloomberg, CBRT staff calculations.

Chart 2.5.3.
Policy Rates in Advanced Economies (Percent)

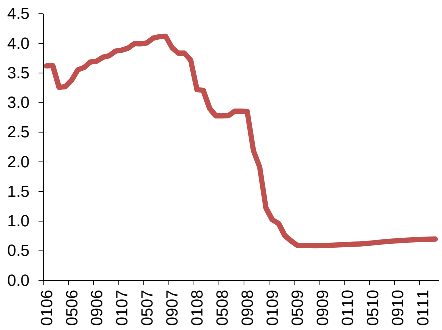
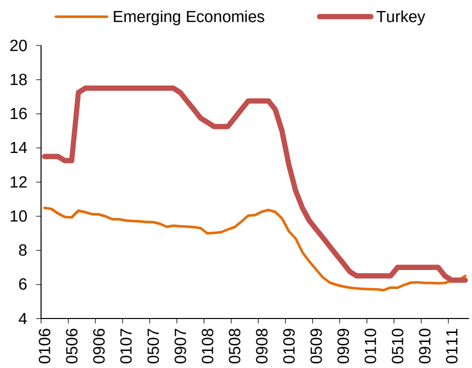


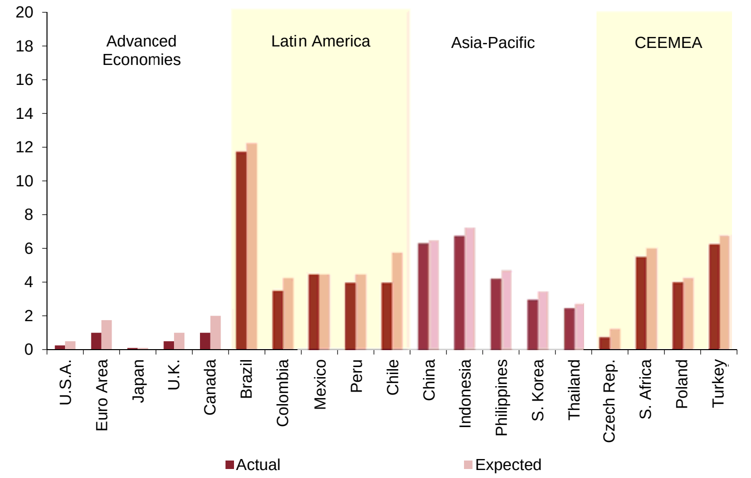
Chart 2.5.4.
Policy Rates in Inflation-Targeting Emerging Economies (Percent)



Source: Bloomberg, CBRT staff calculations.

Expectations that central banks of advanced economies would start normalizing policy rates soon are stronger compared to the previous reporting period. In view of the positive first-quarter growth and unemployment data as well as the rising core inflation, expectations for quantitative easing to end and policy rates to hike in 2011 grew stronger. Similarly, the ECB hiked its policy rate by 0.25 percentage points in April to keep a lid on inflation that hovers above 2 percent. Expectations of a sooner rate hike across advanced economies feed into expectations of upcoming rate hikes across many emerging economies that are exposed to massive capital flows due to ample global liquidity and avoid raising rates for fear of further acceleration in capital flows (Chart 2.5.5).

Chart 2.5.5.
Expectations of Rate Changes
(Basis Points)



Source: Bloomberg.