2. International Economic Developments

In the second quarter of 2015, global economic activity remained weak due to the sluggish growth of emerging economies. The ongoing deceleration in the Chinese economy and its implications for the commodity market and global trade continued to dampen the growth outlook in emerging economies. In fact, the growth forecasts for commodity-exporting emerging economies which have close trade ties with China have been revised downward recently. On the advanced economies front, the moderate growth continued into the second quarter, especially in the US and the Euro area. Yet, lower commodity prices weighed on commodity-exporting advanced economies as well. China's growth performance appears to be one of the major downside risks to the global economic activity for the upcoming period. Thus, in case the Chinese economy continues to slow down, resulting in even more slide in China's imports, commodity prices may slump further and global trade may remain subdued, causing the global economic outlook to remain sluggish for some time.

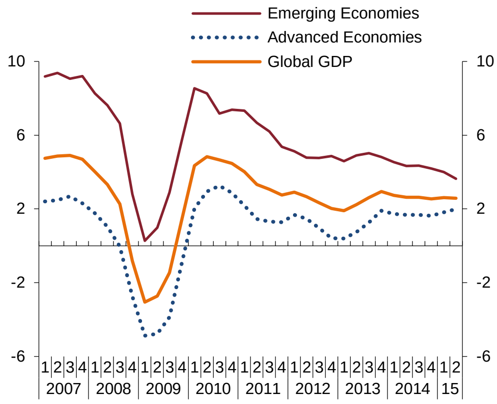
The fall in commodity prices, especially energy, persisted into the third quarter, which was mostly driven by stagnant Chinese economy and the weak course of demand in emerging economies. These effects are expected to pull commodity prices down further in coming months. Plunging oil and commodity prices continue to repress inflation rates across advanced economies. Additionally, exchange rate developments in advanced economies also pose downward pressure on inflation rates. On the other hand, the slump in commodity prices triggers capital outflows from commodity-exporting emerging economies, driving exchange rates and thus inflation rates higher. Assuming that the Chinese economy continues to grow mildly and the Fed decides not to hold off rate hikes for a long time, the divergence between inflation rates in advanced and emerging economies may continue into the upcoming period.

The third quarter was marked by risk aversion due to the Chinese slowdown, the weak growth in emerging economies and the expectations of a Fed rate hike; while emerging economies saw increasing capital outflows during the same period. Despite downside risks to their growth outlook, most emerging market central banks kept policy rates constant amid weaker capital flows and uncertainties over global monetary policies. The relatively tepid readings on the recovery of the US economic activity and labor market and the likely spillovers from the global slowdown to the US economy signal that the first rate hike, which was supposed to happen before the end of the year, will take place in the first quarter of 2016 at the earliest. Although the delay in the Fed rate hike might spur capital flows into emerging economies, the weak growth outlook for emerging economies remains the key downside risk to capital inflows.

2.1. Global Growth

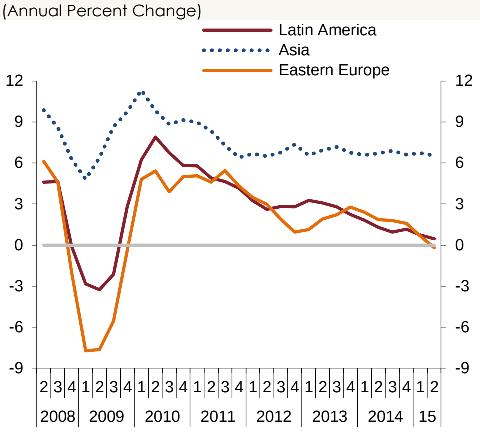
Global economic activity continued to decelerate through the second quarter mostly due to the ongoing sluggish growth in emerging economies (Chart 2.1.1). The Chinese economy slowed further, whereas Russian and Brazilian contraction deepened. In this period, the annual growth rate of emerging economies turned negative in Eastern Europe and approached zero in Latin America (Chart 2.1.2). On the other hand, advanced economies, especially the US and the Euro area, displayed a positive growth performance, recording a quarter-on-quarter increase in the second quarter (Chart 2.1.1).

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 third quarter signal a persistent global economic slowdown (Chart 2.1.3). The readings on the US and Euro area manufacturing industry PMI suggest that both economies continued to experience a positive growth performance in the third quarter but at a decelerating pace (Chart 2.1.4). Specifically, the worse-than-expected US non-farm employment data of August and September and the resulting year-on-year drop in job openings reflect the slowing US growth. Meanwhile, the Japanese manufacturing industry PMI turned favorable in the third quarter (Chart 2.1.4). Both this PMI outlook and the base effect indicate that Japan might see a positive annual growth rate in the third quarter.

The emerging markets PMI for manufacturing and services continued to decline in the third quarter (Chart 2.1.5). The manufacturing PMI data for China, Poland and Mexico were particularly down quarter-on-quarter. Moreover, financial markets became highly volatile amid worries about China while emerging economies faced capital outflows. Therefore, the slowing economic activity across emerging economies is expected to continue into the third quarter of 2015.

Chart 2.1.3.
Global PMI

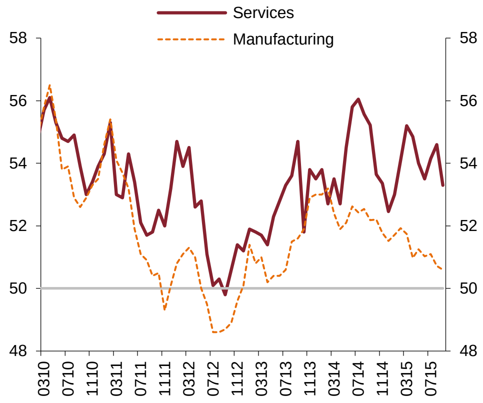
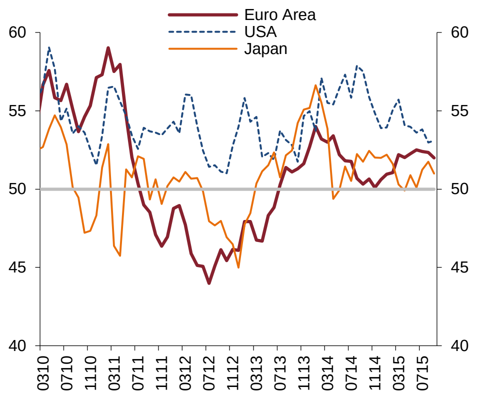


Chart 2.1.4.
Manufacturing Industry PMI



Source: Markit.

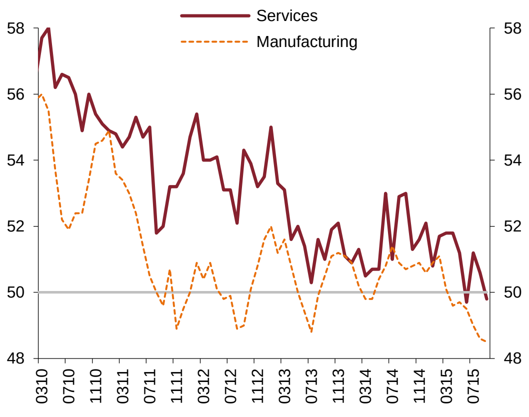
In sum, the global economy might continue to slow in the third quarter due to emerging economies. The October Consensus Forecasts bulletin shows that growth forecasts for 2015 hardly changed in the inter-reporting period (Table 2.1.1). Yet, on the advanced economies front, growth forecasts for 2015 were revised upward for the US and downward for Japan. On the emerging economies side, year-end growth forecasts for both 2015 and 2016 were revised downwards, particularly for Latin America (Table 2.1.1). Accordingly, the annual growth rate of the export-weighted global production index revised by October forecasts declined from the previous reporting period, which signals further weakness in Turkey's external demand in the upcoming period (Chart 2.1.6).

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

	July		October	
	2015	2016	2015	2016
Global	2.6	3.1	2.5	2.9
Advanced Economies				
USA	2.4	2.8	2.5	2.6
Euro Area	1.5	1.8	1.5	1.7
Germany	1.9	1.9	1.8	1.9
France	1.2	1.6	1.1	1.5
Italy	0.7	1.2	0.8	1.3
Spain	3.0	2.6	3.2	2.7
Japan	1.0	1.7	0.6	1.3
UK	2.5	2.4	2.5	2.4
Emerging Economies				
Asia-Pacific	5.9	6.0	5.8	5.7
China	6.8	6.7	6.8	6.5
India	7.7	8.0	7.5	7.8
Latin America	0.0	1.5	-0.7	0.5
Brazil	-1.6	0.6	-2.8	-1.0
Eastern Europe	0.0	2.1	-0.1	1.7
Russia	-3.5	0.4	-3.9	-0.1

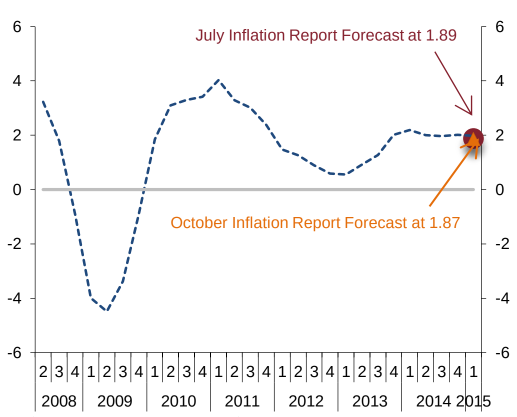
Source: Consensus Forecasts.

Chart 2.1.5.
Emerging Markets PMI



Source: Markit.

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

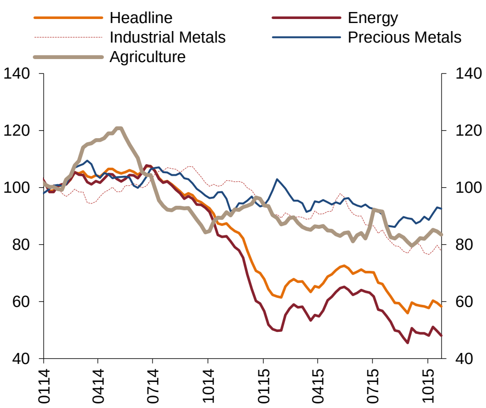


* Weighted by each country's share in Turkey's exports.
Source: Bloomberg, CBRT.

2.2. Commodity Prices and Global Inflation

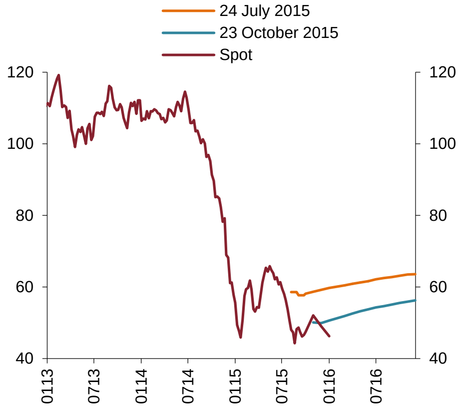
In the third quarter of 2015, the headline commodity price index dropped by 18.5 percent from the end of the previous quarter. In this period, precious metal prices remained horizontal while energy prices, industrial metal prices and agricultural prices slumped by 23.2, 9.5 and 11 percent, respectively, largely due to shortage of demand from emerging economies, particularly China. Although strikingly low commodity prices call for a correction in commodity supply, the rather slow correction, especially in the oil market, adds to the downside pressure on commodity prices (Chart 2.2.1).

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



Source: Bloomberg.

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

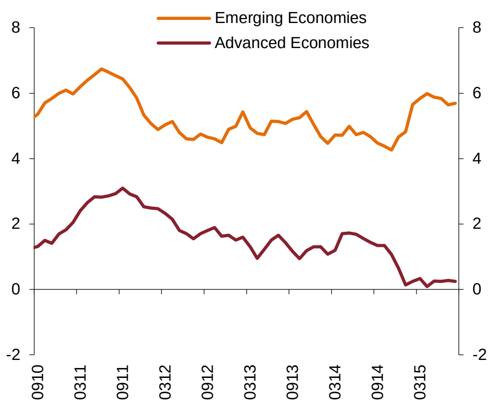


* 24 July 2015 and 23 October 2015 denote the arithmetic mean of the prices quoted at futures contracts during 1-24 July 2015 and 1-23 October 2015, respectively.
Source: Bloomberg.

Oil prices plummeted in the third quarter. With low oil prices beginning to have more evident negative implications on oil-exporting countries, China's expansionary economic policy and mounting concerns about the sustainability of OPEC's low price policy appear to have minimal impact on oil prices. Similarly, rising geopolitical risks in the Middle East affected oil prices only slightly. Thus, December 2015 contracts for Brent crude oil, which were traded at 59 USD on average in July, have been trading at 49.9 USD on average as of 23 October (Chart 2.2.2). Whether OPEC and non-OPEC oil exporters will announce a policy change to reduce oil supply and how geopolitical risks will unfold are among the main factors to shape oil prices in the upcoming period. While the US shale oil industry faces a contraction, Iran's likely return to the international oil market may balance the supply. Against this background, the global supply glut will support the current level of oil prices in the short term.

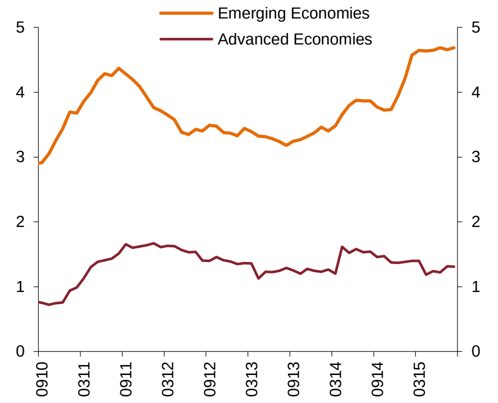
In the inter-reporting period, inflation rates were down across advanced and emerging economies amid falling oil prices. Core inflation rates, on the other hand, edged up in both country groups (Charts 2.2.3 and 2.2.4). Meanwhile, inflation soared in some commodity-exporting economies such as Russia, Brazil and Argentina.

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.

Global inflation expectations for end-2015 and end-2016 were revised upwards for emerging economies compared to the previous reporting period. Advanced economies, on the other hand, saw a modest downward revision. The rising inflation expectations for emerging economies were mostly fueled by Latin America and Eastern Europe. In particular, inflation expectations worsened further in Brazil and Russia (Table 2.2.1).

Falling prices of oil and other commodities continue to dampen inflation rates across advanced economies. For commodity-exporting emerging economies on the other hand, this downtrend drives inflation higher by worsening expectations. Meanwhile, exchange rate developments reinforce the course of inflation in related country groups. More specifically, the appreciating USD curbs the US inflation while the depreciating currencies of emerging economies, such as Russia and Brazil, push inflation rates higher in these countries. Assuming that the economic growth continues to slow down across the globe and especially in China, a major commodity importer, and the Fed starts to hike policy rates soon, the current inflation outlook may remain unchanged – repressed in advanced economies and elevated in emerging economies – in the short term.

Table 2.2.1.
Inflation Forecasts for end-2015 and end-2016
(Annual Percent Change)

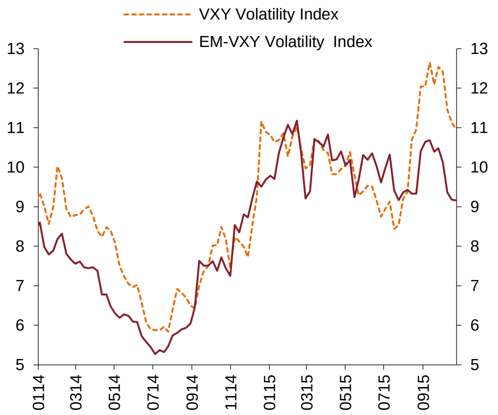
	July		October	
	2015	2016	2015	2016
Global	2.6	3.1	3.2	3.6
Advanced Economies				
USA	0.2	2.2	0.2	1.8
Euro Area	0.2	1.3	0.1	1.1
Germany	0.6	1.6	0.3	1.4
France	0.3	1.2	0.1	1.0
Italy	0.2	1.1	0.1	0.9
Spain	-0.2	1.1	-0.4	0.9
Greece	-1.3	0.3	-1.3	2.1
Japan	0.2	1.6	0.1	1.4
UK	0.8	1.1	0.8	0.8
Emerging Economies				
Asia-Pacific	2.0	2.5	2.0	2.6
China	1.4	1.9	1.6	2.1
India	5.4	5.6	5.0	5.4
Latin America	14.5	12.0	24.6	25.1
Brazil*	8.4	5.5	9.7	6.1
Eastern Europe	8.0	5.6	8.4	5.8
Russia	12.0	6.8	13.1	7.2

* December to December.
Source: Consensus Forecasts.

2.3. Financial Conditions, Risk Indicators and Capital Flows

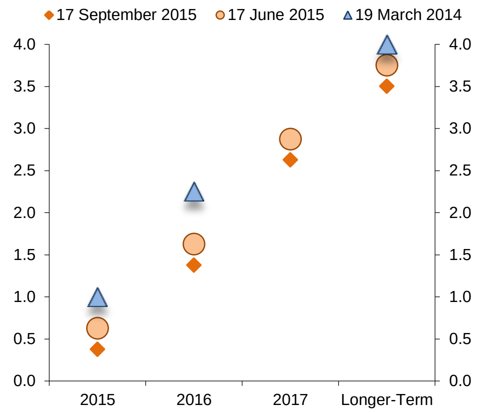
Following the ongoing global economic slowdown in the third quarter, concerns about the Chinese economy and the approaching date of a likely Fed rate hike caused the global risk appetite to decline sharply (Chart 2.3.1). However, owing to the end-August policy rate cut of the People's Bank of China and the Fed’s subsequent hints for delaying the first rate hike further, investors’ deteriorating appetite for risk was reversed (Chart 2.3.2). With rising risk aversion and the recent worse-than-expected non-farm employment in the US as well as fears of possible spillovers from the global economic slowdown into the US economy, financial markets’ expectations for the Fed's first policy rate hike were pushed to 2016.

Chart 2.3.1.
Exchange Rate Volatility
(Basis Points)



Source: Bloomberg, JP Morgan.

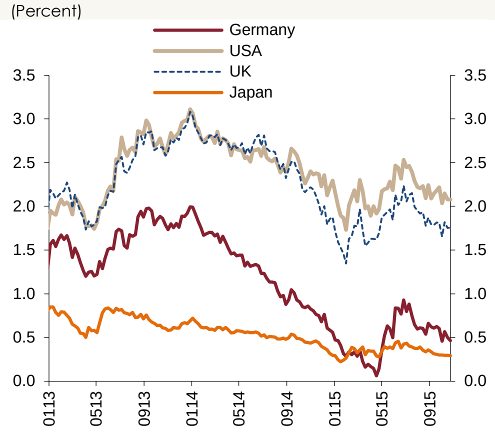
Chart 2.3.2.
Policy Rate Projections of the FOMC Members
(Median, Percent)



Source: Fed.

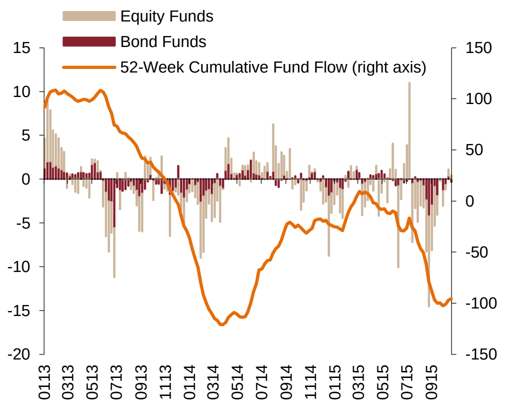
Amid a growing market sentiment that the Fed would delay the rate hike as well as expectations of continued monetary easing by other major central banks, long-term returns in advanced economies began to fall again in July (Chart 2.3.3). Yet, downturn in the stock markets of both advanced and emerging economies, which had been accelerating since August, was replaced by a rebound in October.

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



Source: Bloomberg.

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



Source: EPFR.

The recent rapid decline in the global risk appetite worsened the risk sentiment toward emerging economies, causing emerging market risk premiums to rise markedly in Asia-Pacific and Latin America until the end of September (Chart 5.1.1). This increase in risk premiums ended as of October after lowered expectations for a Fed rate hike. Accordingly, international investors grew more risk averse in August and September, and stock and bond markets in emerging economies saw sizeable outflows in the third quarter (Chart 2.3.4). Despite losing some momentum after September's FOMC meeting, these outflows continued until October. Capital flows are expected to be heavily influenced by the Fed's policy decisions and hints in the upcoming period. Signals of a further delay in the much-anticipated Fed rate hike seem to drive capital flows into emerging economies but the ongoing uncertainty about the timing of this policy rate increase and the weak growth outlook for emerging economies, especially China, contribute to the downside risks to emerging market capital inflows.

2.4. Global Monetary Policy

In the third quarter of 2015, global monetary policy decisions generally reflected unchanged policy rates. On the advanced economies front, after the Bank of Canada and the Sveriges Riksbank opted for a policy rate cut in July, the Reserve Bank of New Zealand and the Norges Bank lowered their policy rates by 25 basis points each in September (Chart 2.4.1). Emerging economies displayed a similar pattern, with the Magyar Nemzeti Bank and the Central Bank of Brazil deciding to keep policy rates constant at their September meetings after a prolonged stable cut in Hungary and a steady increase in Brazil. However, the People's Bank of China lowered its policy rate by 25 basis points in August and the Reserve Bank of India opted for a rate cut of 50 basis points in September, whereas the Central Reserve Bank of Peru and Central Bank of Colombia hiked their policy rates by 25 basis points each in September and the Central Bank of Chile favored a 25 basis point rate increase in October (Chart 2.4.2).

Chart 2.4.1.
Policy Rate Changes in Advanced Economies between January 2014 and October 2015* (Basis Points)

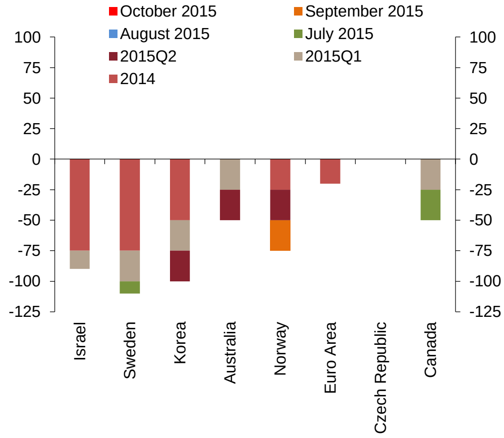
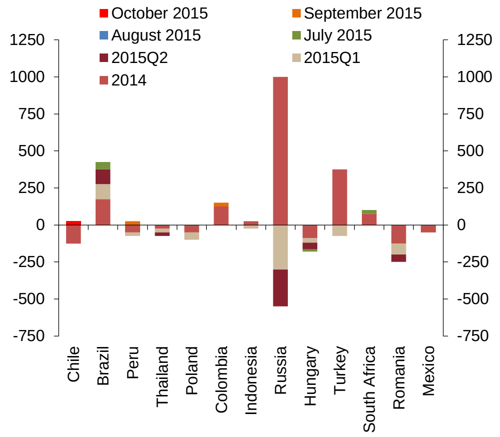


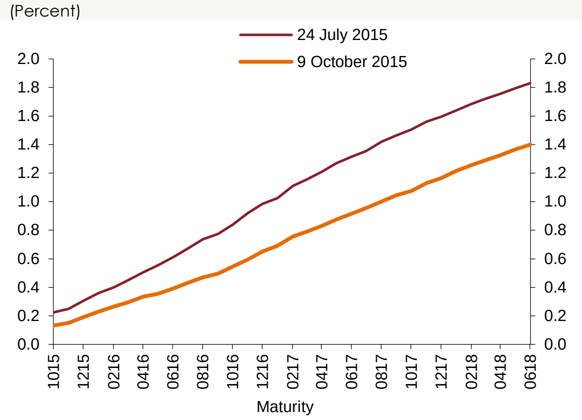
Chart 2.4.2.
Policy Rate Changes in Emerging Economies between January 2014 and October 2015* (Basis Points)



* As of 23 October 2015.
Source: Bloomberg, CBRT.

The fact that the Fed's September meeting delivered no rate hike had major implications for global monetary policy. The post-meeting statement of the FOMC underlined that economic conditions had yet to warrant a policy rate increase but indicated that a policy rate hike would be likely over the remainder of the year. The timing and pace of a Fed rate hike remains crucial to financial markets. According to the forecasts announced in the September statement, the FOMC members lowered their expectations for the federal funds rate at all maturities; yet the expectation for a one-off rate hike in 2015 is still valid, albeit less strong (Chart 2.3.2). In conclusion, market expectations for the federal funds rate were revised significantly downward compared to the previous reporting period, with forecasts for the first rate hike now being shifted into the first quarter of 2016 (Chart 2.4.3).

Chart 2.4.3.
US Federal Funds Futures
(Percent)



Source: Bloomberg.