2. International Economic Developments

The global economic slowdown of the second quarter of 2018 continued into the third quarter. This downturn was driven by the simultaneous slackening of momentum across advanced and emerging economies. Slowing Euro Area and Japanese growth dragged down growth rates on the advanced economies front, despite buoyant US and UK economies. In particular, the ongoing slowdown in Euro Area growth has become quite evident. On the emerging economies front, growth rates were down across Asia and Eastern Europe. Rising protectionism heightened the uncertainty surrounding global economic policies and increased the downside risks to the global growth outlook for the upcoming period. Thus, after weakening through the second half of 2018, the global economy is likely to remain sluggish in 2019.

In the final quarter of 2018, commodity prices were largely affected by the US policy actions. Industrial metal prices continued to decline as the assumption that the US barriers to foreign trade would dampen demand passed through into prices. Meanwhile, headline inflation was down in advanced and emerging economies due to falling crude oil prices. The ongoing US shale oil boom and expectations of sluggish economic activity across the globe pose downside risks to crude oil prices, whereas geopolitical tensions and volatile international financial markets pose upside risks to crude oil prices.

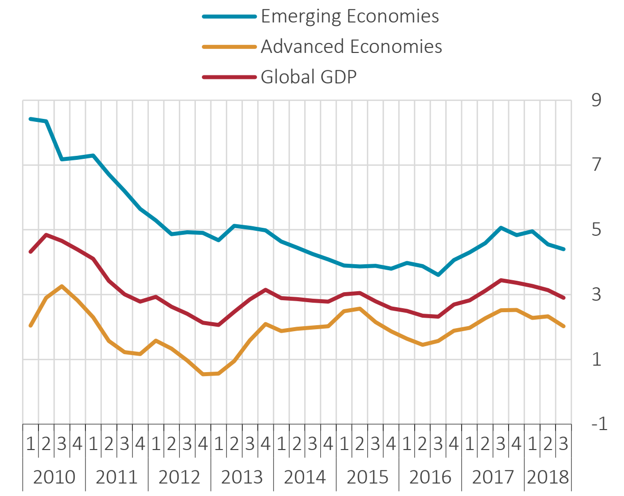
The gradual monetary tightening by major central banks continued into the fourth quarter of 2018. The Fed ended the year with four rate hikes as expected, while the ECB announced the end of its asset purchase program in December. In this period, the sluggish global growth and the increased uncertainty over the global economy led to the expectation that the pace of policy normalization in advanced economies might decelerate, causing sovereign bond yields to decline. As many believe that advanced economies are poised for a less tight path of monetary policy normalization than in the previous period, portfolio flows to emerging economies may rebound in 2019. In fact, portfolio flows to emerging economies have been stable since September while both equity and bond markets have seen recovery since early January. However, it should be noted that the uncertainty over global economic policies, the high volatility in financial markets in advanced economies and ongoing geopolitical tensions can reverse this prediction.

Historically low unemployment rates, on-target inflation rates, financial risks caused by low interest rates and the desire to create more room for policy maneuver prompt central banks across advanced economies to normalize their policies. Nevertheless, the mounting uncertainty over the global growth outlook, the global financial market fluctuation and the volatile growth despite long-standing quantitative easing programs in advanced economies make it difficult for central banks to make policy decisions. Accordingly, a slower process of policy normalization in advanced economies is expected to bring country risks down for emerging economies. However, as this loss of momentum is caused by financial volatility and has adverse effects on the risk appetite, emerging market central banks may also find little room to take any action. Therefore, to reduce vulnerabilities, it is important that macroeconomic policies be implemented not only effectively and in a coordinated manner but also be supported by structural reforms and appropriate trade policies.

2.1 Global Growth

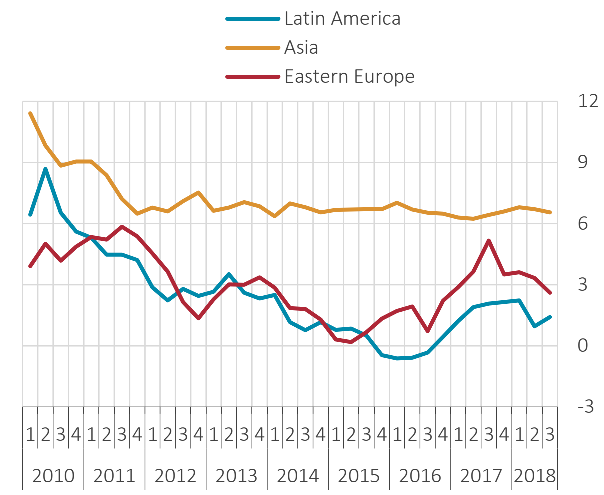
Global economic activity continued to lose momentum in the third quarter. This deceleration was driven by the subdued pace of growth across both advanced and emerging economies, with global growth posting a quarter-on-quarter drop in the third quarter of 2018 (Chart 2.1.1). Despite an upbeat growth outlook for the US and the UK, slowing Euro Area and Japanese growth put downward pressure on the growth rate of advanced economies. The slowdown was particularly marked in the Euro Area. Meanwhile, emerging economies grew at a slower pace compared to the previous quarter (Chart 2.1.1). By region, the pace of growth was down for Asia and Eastern Europe but slightly up for Latin America (Chart 2.1.2).

Chart 2.1.1: Global Growth Rates* (YoY % Change)



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

Chart 2.1.2: Regional Growth Rates for Emerging Economies* (YoY % Change)

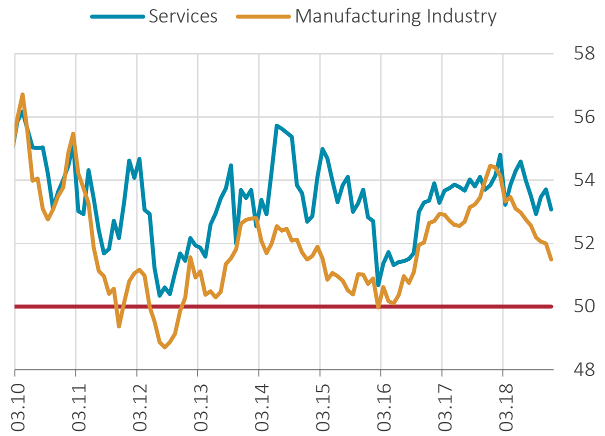


Sources: Bloomberg, CBRT.
* Weighted by each country's share in regional GDP.

Global PMI data for the last quarter of 2018 indicate a more negative growth outlook, particularly for the manufacturing industry, compared to previous periods (Chart 2.1.3). In this period, US and Euro Area manufacturing PMI declined significantly (Chart 2.1.4), which shows that both economies grew at a slower rate in the fourth quarter than in the previous quarter. In addition, the year-on-year contraction of 1.7% in industrial production in November implies a sharper slowdown in Euro Area growth during the last quarter. On the other hand, Japan's manufacturing PMI remained virtually unchanged from the previous quarter. However, the annual growth rate of industrial production was significantly down as of November while unemployment was slightly higher. Therefore, the Japanese economy is expected to deliver a weaker growth performance in the fourth quarter compared to the previous quarter. In sum, in the final quarter of 2018, growth is predicted to have continued to lose momentum across advanced economies, largely due to the slowing Euro Area economy, and fallen below the quarter-ago level.

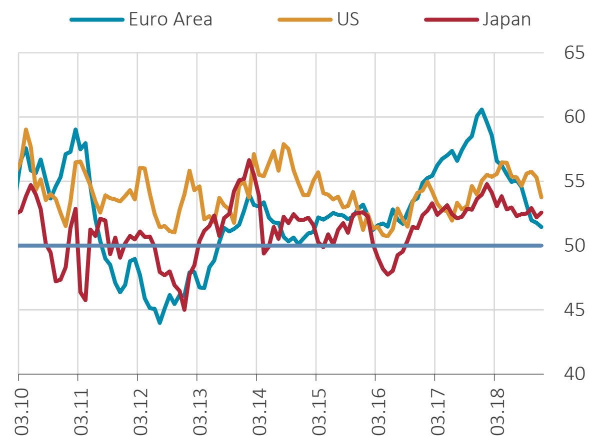
Emerging market(EM) PMI shows a fall in manufacturing industry for the fourth quarter, and signals that the outlook for services is no longer upbeat as in the previous quarter (Chart 2.1.5). EM bond markets saw further outflows amid volatile financial markets and a worsening risk appetite driven by the monetary policy normalization in advanced economies. Meanwhile, concerns over heightened US foreign trade barriers, Middle East-led geopolitical risks and fluctuating oil prices added to the uncertainty. In short, leading data and indicators suggest that emerging economies recorded slowing economic activity for the third consecutive quarter in the last quarter of 2018.

Chart 2.1.3: Global PMI



Source: IHS Markit.

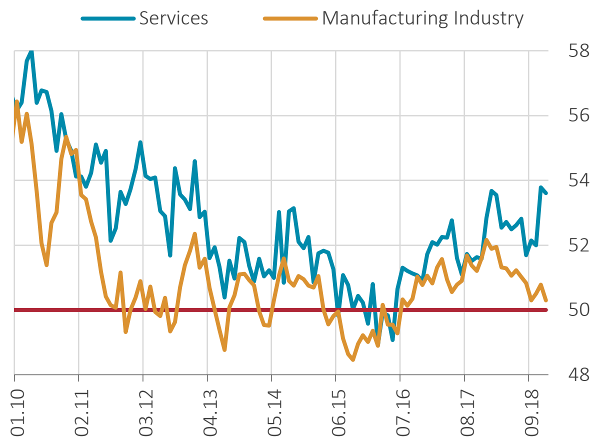
Chart 2.1.4: Manufacturing Industry PMI in Advanced Economies



Source: IHS Markit.

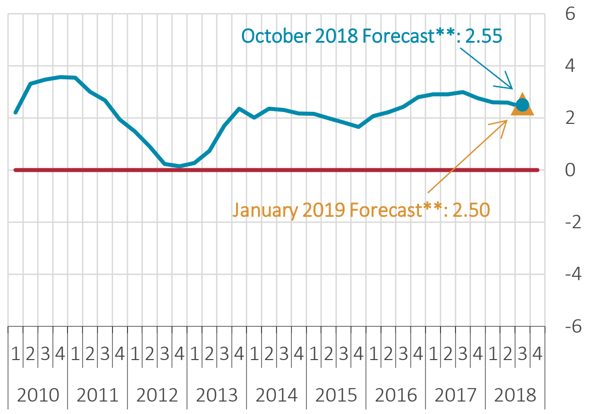
All in all, the global economy is expected to slow further in the fourth quarter of 2018 due to both advanced and emerging economies, depicting roughly the same pace of the previous quarter. This is backed by the global growth forecast for 2018 that was left unchanged from the previous reporting period in January's Consensus Forecasts (Table 2.1.1).

Chart 2.1.5: Emerging Markets PMI



Source: IHS Markit.

Chart 2.1.6: Export-Weighted Global Production Index* (Annual Average % Change)



Sources: Bloomberg, CBRT.
* Weighted by each country's share in Turkey's exports.
** Average growth forecast for 2018.

Among advanced economies, Consensus growth forecasts for 2018 were revised downward only for the Euro Area and Japan in January. On the emerging economies front, the end-2018 growth forecast was revised down for Asia but kept unchanged for Latin America and Eastern Europe (Table 2.1.1). Thus, the annual growth rate of the export-weighted global production index went slightly down compared to the October reporting period (Chart 2.1.6). This deceleration was primarily due to the downward revision to the year-end growth forecast for the Euro Area. Against this background, it is possible to say that Turkey's external demand outlook remained solid despite some weakening compared to the previous reporting period. On the other hand, the global growth forecast for 2019 issued in January's Consensus Forecasts was 0.2 points lower than in the previous reporting period. Growth forecasts for 2019 were revised down for the US, Euro Area and Japan on the advanced economies side; and Asia, Latin America and Eastern Europe on the emerging economies side. This shows that the global economic downturn of the second half of 2018 will likely continue into 2019.

Table 2.1.1: Growth Forecasts for 2018 and 2019 (Annual Average % Change)

	October		January	
	2018	2019	2018	2019
Global	3.2	3.1	3.2	2.9
Advanced Economies				
US	2.9	2.6	2.9	2.5
Euro Area	2.0	1.8	1.9	1.5
Germany	1.9	1.7	1.5	1.4
France	1.6	1.6	1.5	1.5
Italy	1.1	1.1	0.9	0.5
Spain	2.7	2.2	2.5	2.2
Japan	1.1	1.2	0.8	1.0
UK	1.3	1.5	1.4	1.5
Emerging Economies				
Asia Pacific	5.9	5.6	5.8	5.5
China	6.6	6.3	6.6	6.2
India	7.4	7.5	7.3	7.3
Latin America	1.4	2.1	1.4	1.9
Brazil	1.3	2.4	1.3	2.4
Eastern Europe	3.1	2.2	3.1	2.1
Russia	1.8	1.6	1.7	1.5

Source: Consensus Forecasts.

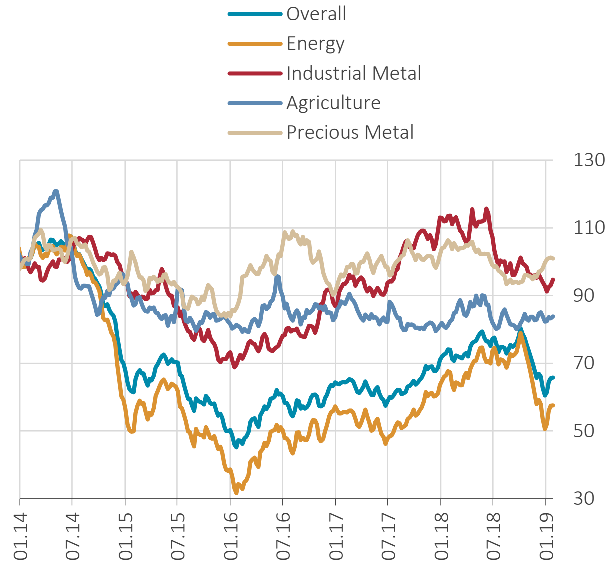
2.2 Commodity Prices and Global Inflation

The upsurge in the headline commodity price index reversed in the second half of 2018 and the index recorded a quarterly drop of 6% in the fourth quarter. The main driver of the decline was the weakening uptrend in energy prices. Accordingly, in the final quarter, energy and industrial metal prices fell by 9.7% and 2.5% quarter-on-quarter, respectively, while agricultural and precious metal prices rose by 1.6% and 0.8% quarter-on-quarter, respectively (Chart 2.2.1).

US trade and foreign policies continued to dominate commodity prices in the fourth quarter of 2018. The pass-through of the assumption that the US barriers to international trade would dampen demand and the US-China trade dispute that feeds into the environment of uncertainty caused industrial metal prices to remain on the decline in this period. The trade barriers that the US imposed on China also put pressure on agricultural prices throughout the year as China ranks first in worldwide agricultural output.

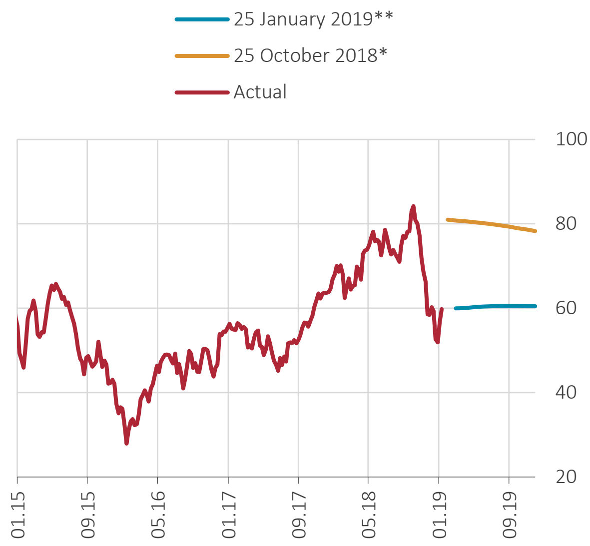
Crude oil prices were on a downward trend. Despite OPEC's larger-than-expected output cut in December, oil prices collapsed further due to booming US production and OPEC members refusing to commit to previous production quotas.

Chart 2.2.1: S&P Goldman Sachs Commodity Index (January 2014=100)



Source: Bloomberg.

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



Source: Bloomberg.
*The arithmetic average of price quotations on futures contracts between 1-25 October 2018.
**The arithmetic average of price quotations on futures contracts between 1-25 January 2019.

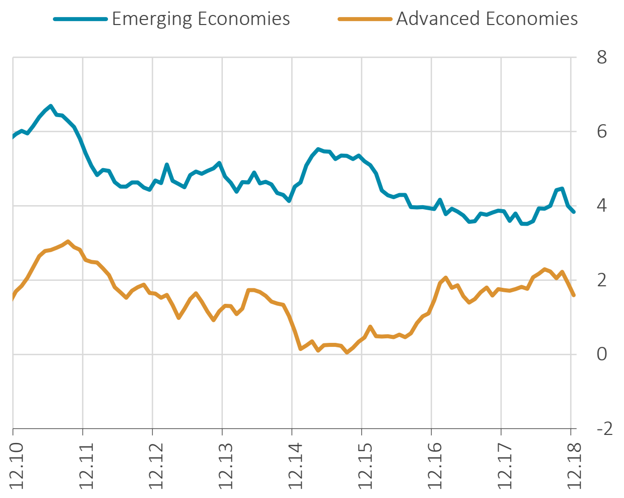
If US-China trade talks prove successful in the upcoming period, the uncertainty-driven slide in industrial metal prices might reverse and supply-side price pressures might become evident, particularly on aluminum and copper. Similarly, amid waning international trade tensions, agricultural prices may increase due to a China-led demand growth. In the event of ongoing uncertainty over global economic policies and a slower-than-expected monetary policy normalization across the world, gold prices may move higher.

Crude oil prices have been more volatile recently. Imminent upside risks to crude oil prices include: ongoing uncertainty and volatility in global financial markets, OPEC and Russia's commitment to agreed production quotas, and the success of US-China trade talks. On the other hand, the US shale oil boom and prospects of slowing global growth pose downside risks to crude oil prices. Thus, as suggested by the Brent crude oil futures contracts, crude oil prices are expected to average around USD 60 in 2019 (Chart 2.2.2).

In the fourth quarter of 2018, headline inflation was down in both advanced and emerging economies due to falling crude oil prices (Chart 2.2.3). In this period, core inflation inched up in advanced economies but fell across emerging economies (Chart 2.2.4). Inflation forecasts for 2019 have been revised downwards for advanced economies in the inter-reporting period (Table 2.2.1).

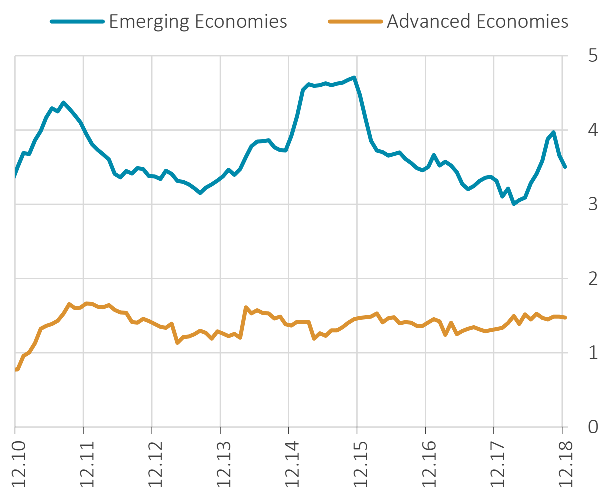
Although unemployment fell to a record low, wage growth is still sluggish in the US. Moreover, survey and market-based inflation expectations hover around the 2-percent inflation target. Meanwhile, lower crude oil prices caused headline inflation to be slightly down compared to the recent past. In the Euro Area, headline consumer inflation will likely converge to 2% due to the tightening labor market and rising wages in the 2019-2021 period. With inflation below 1% and inflation expectations largely unchanged, Japan might see its headline inflation rise modestly up to 2% in the medium term as long as the output gap remains positive and medium to long-term inflation expectations increase. On the other hand, the British pound that had been responding to any Brexit news and the wage growth that accelerated amid a tight labor market put upward pressures on UK headline inflation, which, however, was dragged below the 2-percent target by falling crude oil prices.

Chart 2.2.3: CPI Inflation in Advanced and Emerging Economies (YoY, %)



Sources: Bloomberg, CBRT.

Chart 2.2.4: Core Inflation in Advanced and Emerging Economies (YoY, %)



Sources: Bloomberg, Datastream, CBRT.

Given the monetary policy normalization in advanced economies, the upside risks to global headline inflation for the period ahead are the increased volatility in international financial markets affecting emerging market currencies through portfolio flows, and crude oil prices driven higher by US economic policies and geopolitical developments. In addition, the possible implications of tight labor markets for wage growth can be flagged as an upside risk to core inflation rates across advanced economies. Downside risks to global headline inflation may include the subdued global growth outlook caused by protectionist trade measures and thus the eased labor market pressures from advanced economies.

Table 2.2.1: Inflation Forecasts for 2018 and 2019 (Annual Average % Change)

	October	January
	2019	2019
Advanced Economies		
US	2.3	1.9
Euro Area	1.7	1.5
Germany	1.9	1.8
France	1.6	1.3
Italy	1.4	1.1
Spain	1.6	1.4
Greece*	1.1	0.9
UK	2.2	2.0
Japan	1.1	0.9
Emerging Economies		
Asia Pacific (excl. Japan)	2.6	2.4
China	2.3	2.2
India**	4.9	4.5
Latin America (excl. Venezuela)	6.9	7.1
Brazil*	4.2	4.1
Eastern Europe	7.0	6.7
Russia*	4.5	4.7

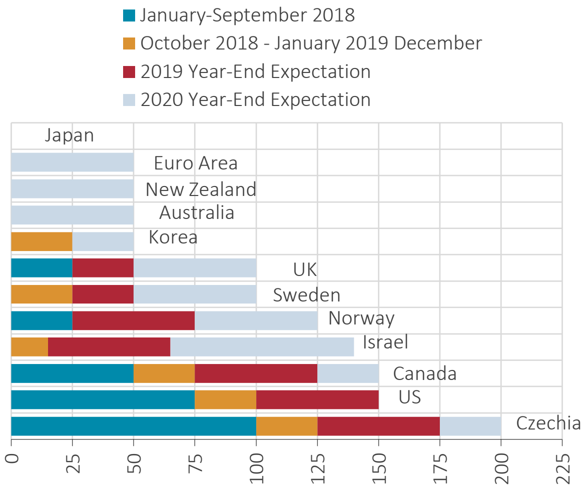
Source: Consensus Forecasts.
* Annual percentage change.
** Based on fiscal year.

2.3 Global Monetary Policy

The sluggish global growth and the increased global economic uncertainty of the last quarter of 2018 sparked concerns that the ongoing policy normalization in advanced economies might lose pace as well. With gradual tightening ongoing, surveys point to an uptick in median expectations for policy rates in both advanced and emerging economies for 2019 and 2020 (Charts 2.3.1 and 2.3.2). Nevertheless, the projected paths of policy rates of four major central banks, the Fed in particular, are significantly revised downwards. Current market pricing also implies a lower policy rate hike for 2019 by these banks compared to the previous reporting period (Table 2.3.1).

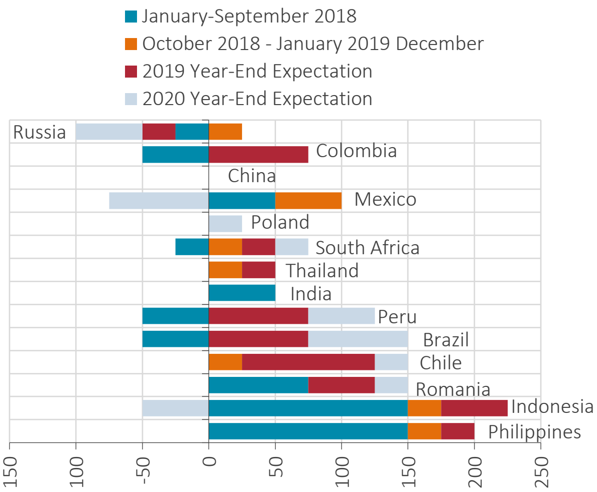
The Fed made its fourth rate hike of 2018 while the ECB concluded its bond purchases as previously announced in December. However, the weakening growth momentum in the Euro Area pushed back prospects of an ECB rate hike. The mounting Brexit uncertainty causes the Bank of England to tone down its policy response to rising inflation. Central banks of other advanced economies continue with gradual rate hikes but the Fed's much tighter stance among the four major central banks sends the US dollar soaring and puts downward pressure on the US growth outlook.

Chart 2.3.1: Policy Rate Changes and Year-End Policy Rate Expectations in Advanced Economies (January 2017 – December 2020* Basis Points)



Source: Bloomberg.
* Actual figures on 28 January 2019.

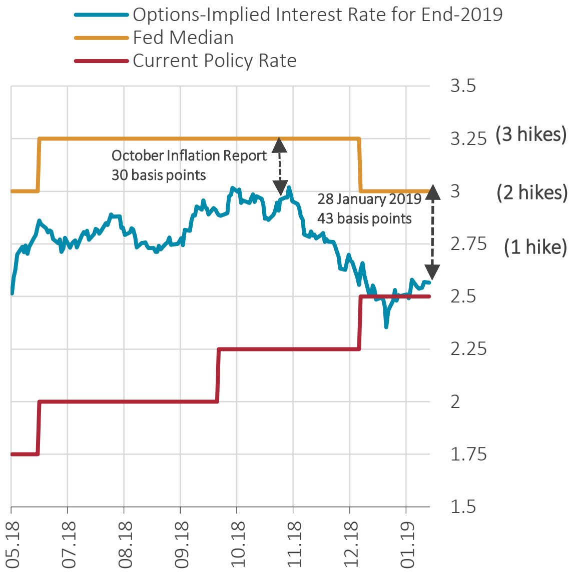
Chart 2.3.2: Policy Rate Changes and Year-End Policy Rate Expectations in Emerging Economies (January 2017 – December 2020* Basis Points)



Source: Bloomberg.
* Actual figures on 28 January 2019.

On top of that, concerns over global trade and the resulting US financial market volatility forced the Fed to adopt a more cautious tone on rate hikes. Thus, despite stronger labor data and higher wage growth, the Fed revised its median projection to two rate hikes for 2019 at its December meeting, down from three at the March meeting. Despite this 25 basis point drop, the spread between options-implied interest rates and the Fed's median widened substantially in the inter-reporting period (Chart 2.3.3). In fact, markets are predicting a much looser monetary policy and, as of mid-January, pricing in a nearly constant policy rate through 2019.[1] Over the upcoming period, market pricing is expected to come in line with that of the Fed if global economic uncertainty moderates and the US growth and labor data remain robust, or the Fed's median path is projected to move towards market pricing if downside risks priced in by markets materialize and tensions over international trade escalate.

Chart 2.3.3: Options-Implied Fed Policy Rate for End-2019 (%, Upper Band)



Source: Bloomberg.

Table 2.3.1: Options-Implied Policy Rates of Four Major Central Banks for End-2019 (%)

	Current Policy Rate (%)	2019 Year-end Market Implied Policy Rate (%)		Change From October IR (% points)
		October IR	28 Jan 2019	
Fed	2.5	2.95	2.56	-0.39
ECB	0	0.10	0.05	-0.05
BoE	0.75	1.02	0.84	-0.18
BoJ	-0.1	-0.06	-0.12	-0.06

Source: Bloomberg.

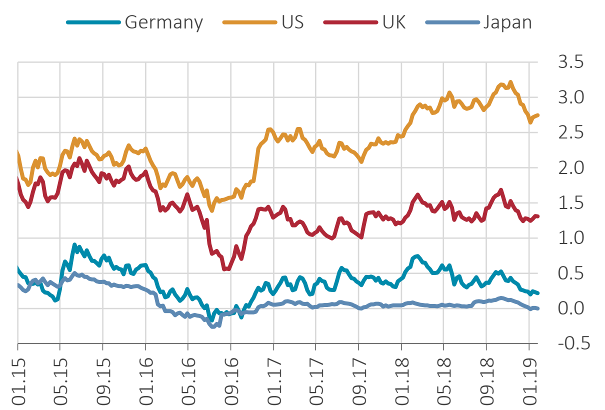
[1] As a matter of fact, markets priced in a rate cut for a short time, which drove options-implied interest rates below the current policy rate.

2.4 Global Risk Indicators and Portfolio Flows

Across advanced economies, central banks continued to normalize monetary policy gradually in the fourth quarter of 2018. Meanwhile, the sluggish global growth and the increased global economic uncertainty raised concerns that policy normalization might lose pace, sending sovereign bond yields lower in these countries (Chart 2.4.1).

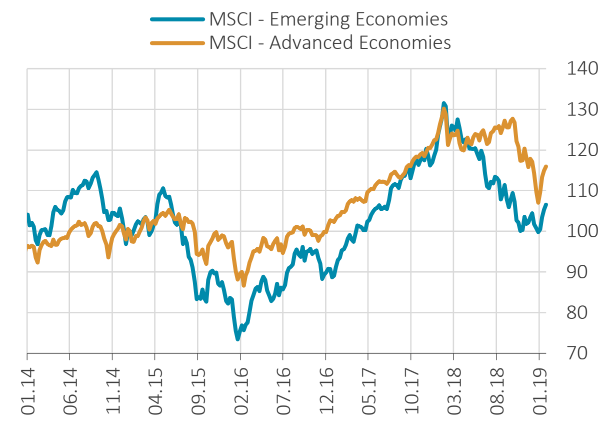
Developments regarding the US-China trade conflict, the ongoing Brexit uncertainty, Italy's massive public debt and plunging oil prices fed into worries about increased fragility in global financial conditions. After having started 2018 on an upbeat tone amid tax cuts and a buoyant growth outlook, the US saw its stocks end the year with the worst annual decline since 2008 while the reduced risk appetite prompted outflows from stock markets in other advanced economies (Chart 2.4.2). Yet, both advanced and emerging stock markets have seen some recovery as of early 2019.

Chart 2.4.1: 10-Year Bond Yields (%)



Source: Bloomberg.

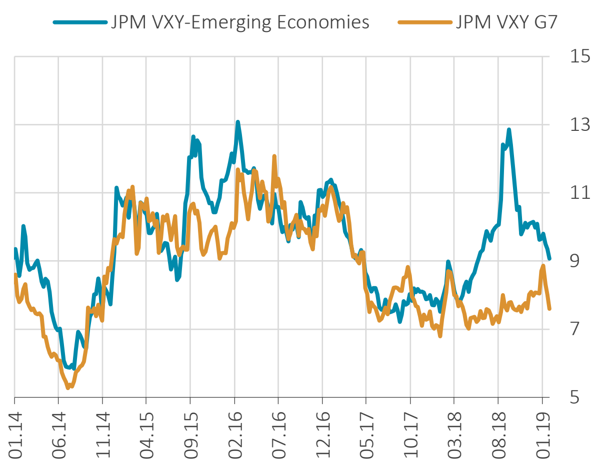
Chart 2.4.2: MSCI Indices (January 2015=100)



Source: Bloomberg.

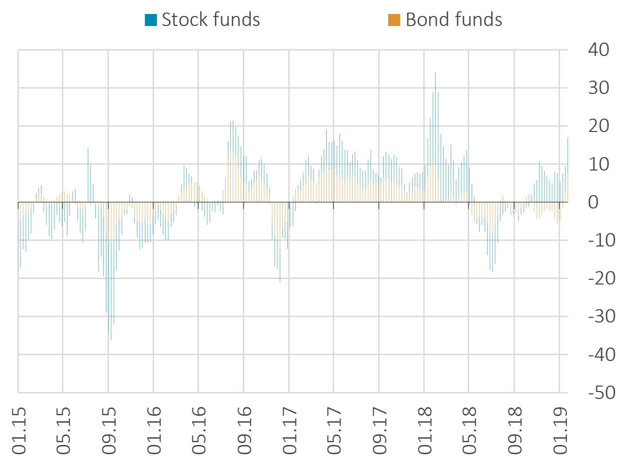
The improved risk sentiment since the beginning of 2019 helped lower the exchange rate volatility for advanced market currencies that remained elevated through the fourth quarter of 2018 (Chart 2.4.3). The first half's portfolio outflows from emerging economies continued into the third quarter of the year, albeit more slowly. Though still weak, portfolio inflows somewhat stabilized starting in September, and as of early January, both stock and bond markets are recovering (Chart 2.4.4).

Chart 2.4.3: JP Morgan Exchange Rate Volatility Indices (Weekly)



Source: Bloomberg.

Chart 2.4.4: Weekly Portfolio Flows to Emerging Economies (Billion USD, 4-Week Cumulative)



Source: EPFR.

Emerging bond markets saw outflows across all regions in the fourth quarter of 2018 whereas Asian stock markets received inflows (Table 2.4.1). China was the biggest receiver of portfolio inflows in this period. China's use of quantitative easing to stimulate domestic economic activity encouraged more portfolio flows into China. More specifically, Chinese stock markets reported larger inflows in the last quarter of 2018 and the country accounted for 28% of total inflows to emerging stock markets, up from 24% in 2017.

The growing anticipation that the path of monetary policy normalization across advanced economies might be less tight than in the previous period suggests that emerging economies might receive more portfolio inflows in 2019. However, it should be noted that the uncertainty over global economic policies, the high financial volatility in advanced economies and ongoing geopolitical tensions can reverse this prediction.

Table 2.4.1: Composition of Fund Flows to Emerging Economies (Quarterly, Billion USD)

		Total	Portfolio Composition		Regional Composition			
			Bond Funds	Stock Funds	Asia	Europe	Latin America	Middle East and Africa
2015	Q1	-8.6	1.9	-10.5	-8.1	2.2	-2.4	-0.2
	Q2	-8.0	1.4	-9.4	-6.9	0.4	-2.0	0.4
	Q3	-45.3	-16.5	-28.8	-23.8	-6.5	-10.8	-4.1
	Q4	-22.3	-12.7	-9.6	-11.1	-3.0	-6.4	-1.9
2016	Q1	-4.5	-1.2	-1.6	-2.5	-1.4	-0.3	-0.3
	Q2	-1.4	7.3	-8.7	-4.5	0.7	1.9	0.6
	Q3	42.4	26.1	16.3	17.9	7.5	12.4	4.7
	Q4	-17.4	-9.3	-8.1	-12.6	-0.8	-2.7	-1.3
2017	Q1	32.7	19.9	12.8	8.2	7.7	12.4	4.3
	Q2	52.6	24.4	28.2	25.2	7.6	14.5	5.4
	Q3	37.1	17.3	19.8	19.4	4.9	9.2	3.5
	Q4	29.5	11.8	17.6	14.8	3.7	8.3	2.7
2018	Q1	57.9	12.0	46.0	34.1	6.5	12.0	5.3
	Q2	-10.4	-10.4	0.0	-0.7	-4.3	-3.3	-2.1
	Q3	-9.9	-3.6	-6.3	-4.6	-1.4	-3.2	-0.7
	Q4	4.5	-14.0	18.5	14.1	-4.5	-3.1	-2.0

Source: EPFR.