2. International Economic Developments

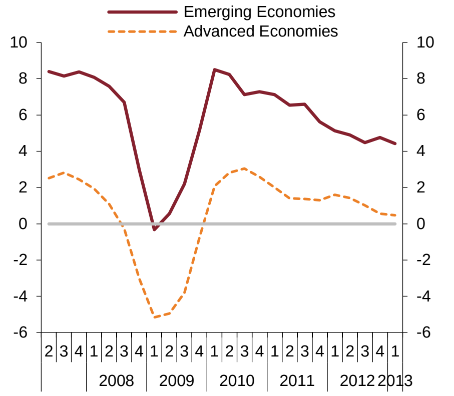
Data released in the previous quarter indicate that global economic activity followed a sluggish course in the first quarter of the year, which persisted into the second quarter of the year. This sluggish course by global economic activity was mainly driven by the negative growth performance of emerging economies, while the ongoing stagnation in the Euro Area and the slowdown in the Chinese economy also pulled the global growth down. On the other hand, capital flows to emerging economies, which trended downwards in the first quarter due to weak growth performance of emerging economies, also plummeted in the second quarter. Amid the unfavorable course of global growth, commodity prices went down in the second quarter of the year, supporting the low course of global inflation rates. However, in emerging economies experiencing capital outflows, probable distortions in inflation expectations due to the depreciation of their currencies may pose upside risks to inflation.

In line with the languishing course of global economic activity, global monetary policy remained loose in the second quarter. However, at the end of May the signs given by the Fed for a cutback followed by a complete termination of bond purchases in the near future followed largely shaped the monetary policy in the previous quarter. Subsequent to the declarations of Federal Reserve Chairman Ben Bernanke, the global risk appetite weakened while financial market uncertainties heightened and capital flows fluctuated sharply in emerging economies. On account of these declarations, monetary policy in emerging economies are likely to be tightened further, should capital outflows from these economies persist in the forthcoming period. This may weigh further on growth in emerging economies, and pose a significant downside risk to the future global growth outlook. In sum, the Fed’s stance regarding bond purchases in the forthcoming period will largely determine the future course of the global monetary policy, and thus, the global growth outlook.

2.1. Global Growth

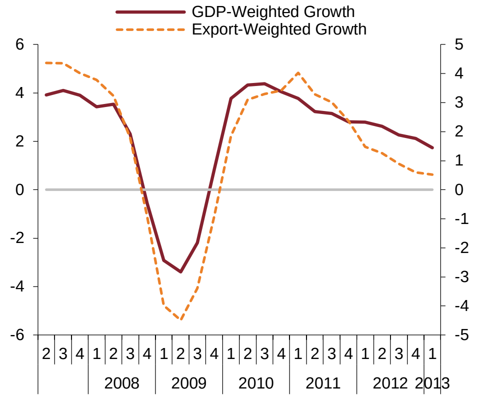
Global economic activity trended downwards both in advanced and emerging economies in the first quarter. In the ongoing recession in the Euro Area and the decelerating growth of the Chinese economy were particularly influential on the weak course of global economic activity. The economic growth in countries with significant shares in Turkish exports remained on a downward track in the quarter , sustaining this sluggish outlook (Charts 2.1.1 and 2.1.2).

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



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

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

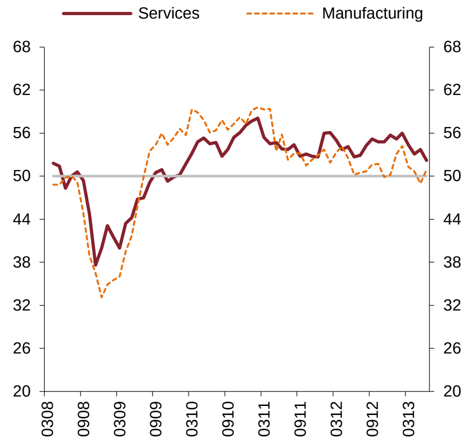


* Weighted by each country's share in Turkish exports for export-weighted growth.
Source: Bloomberg, CBRT.

The US economy, which grew by 1.8 percent in annualized terms mainly on the back of private consumption spending in the first quarter, is expected to grow further in the second quarter of the year. However, the emerging uncertainty in May due to implementation of contractionary fiscal policy since early 2013 in addition to the Fed's declaration to terminate the bond purchasing program under the third monetary easing package may bear an adverse effect on economic activity in this period, and growth may remain below the first-quarter figures. In fact, the US PMI data tumbled in the second quarter compared to the first quarter of the year (Chart 2.1.3).

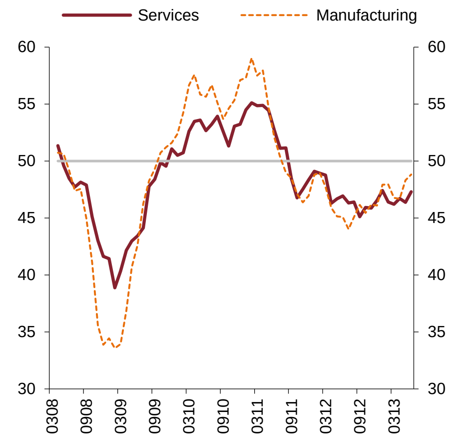
The Euro Area economy continued to contract in the first quarter and the GDP recorded a year-on-year decline by 1.1 percent. PMI indices show that the economic contraction will persist in the second quarter and the rise in the unemployment rate, which lingered in April and May, supports this assertion (Chart 2.1.4).

Chart 2.1.3.
The US PMI Indices



Source: Markit.

Chart 2.1.4.
The Euro Area PMI Indices

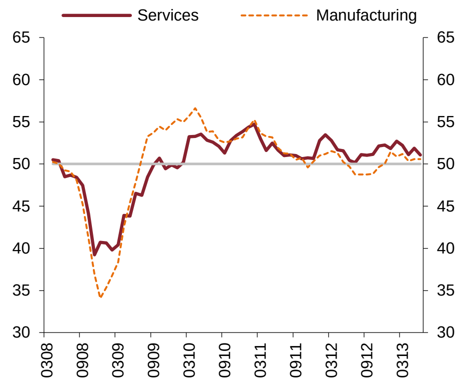


Source: Markit.

As for the emerging economies, China continued to decelerate after registering a year-on-year growth by 7.7 percent in the first quarter and grew by 7.5 percent in the second quarter. Investments provided the largest contribution to the growth by 5.9 percentage points, and the contribution of consumption remained limited, while external trade pulled the growth down. Therefore, the Chinese economy lacked a demand-driven growth outlook in the second quarter as well. Due to strong perceptions that the slowdown will continue, the Chinese economy is more likely to undershoot the growth target of 7.5 percent by the end of 2013. In such a case, it will be striking for China to fall behind the growth target for the first time since the Asian financial crisis 15 years ago.

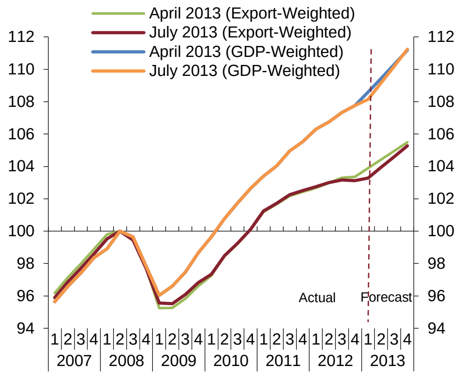
The economic slowdown in both advanced and emerging economies in the first quarter of the year is estimated to persist in the second quarter. More specifically, the growth outlook of emerging economies may deteriorate the rest of the year, should emerging economies continue to experience capital outflows in the upcoming period, due to mounting uncertainties in May regarding the Fed's expansionary monetary policy in the form of bond purchases. In fact, the global PMI data pertaining to the second quarter point out that the global economic activity posted a quarter-on-quarter decline both in the manufacturing and the services sectors (Chart 2.1.5). In addition, growth forecasts from the 2013 Consensus Forecasts were revised considerably downwards in July compared to the previous reporting period (Table 2.1.1). Accordingly, the GDP and the export-weighted global production indices updated by July growth forecasts were revised downwards in the inter-reporting period (Chart 2.1.6). In sum, the unfavorable global growth performance will persist in the upcoming period, and continue to weigh on Turkey's external demand.

Chart 2.1.5.
Markit Global PMI Indices



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

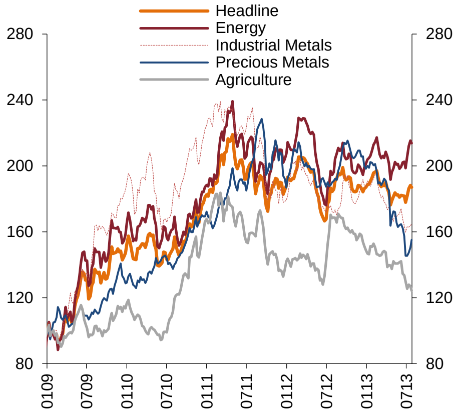
	Consensus Forecasts (Average Annual Percent Change)			
	April		July	
	2013	2014	2013	2014
World	2.6	3.2	2.4	3.1
Advanced Economies	-	-		
USA	2.1	2.7	1.8	2.7
Euro Area	-0.4	0.9	-0.6	0.8
Germany	0.7	1.7	0.4	1.6
France	-0.1	0.7	-0.3	0.6
Italy	-1.4	0.5	-1.8	0.4
Spain	-1.6	0.2	-1.6	0.3
Greece	-4.9	-1.4	-4.8	-1.0
Japan	1.3	1.3	1.9	1.5
UK	0.7	1.6	1.0	1.7
Emerging Economies	-	-		
Asia-Pacific	6.6	6.7	6.1	6.4
China	8.2	8.0	7.5	7.6
India	6.1	6.8	5.9	6.6
Latin America	3.4	3.8	3.0	3.7
Brazil	3.1	3.7	2.5	3.2
Eastern Europe	2.7	3.6	2.3	3.3

Source: Consensus Forecasts.

2.2. Commodity Prices

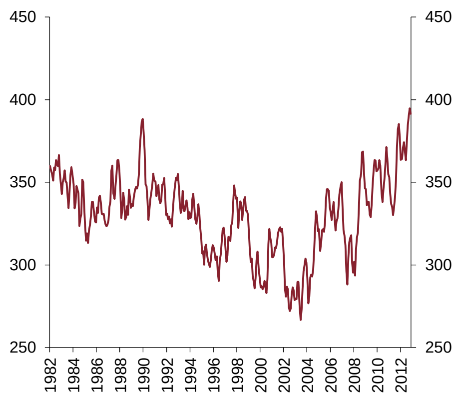
In the second quarter of 2013, all subcategories of the commodity price index declined and the headline commodity index posted a quarter-on-quarter decline by 6.4 percent. During this period, energy prices, industrial metal prices, agricultural prices and precious metal prices fell by 4.7, 9.8, 12 and 23.8 percent, respectively (Chart 2.2.1).

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



Source: Bloomberg.

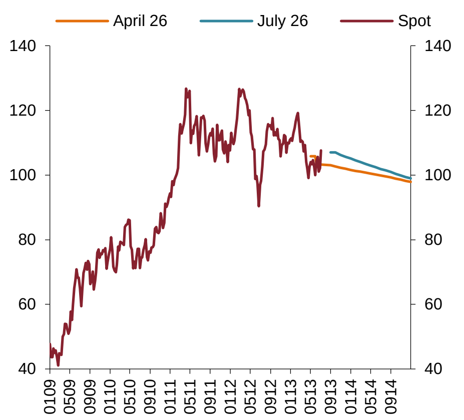
Chart 2.2.2.
Crude Oil Inventories in the US
(Million barrel)



Source: The US Department of Energy.

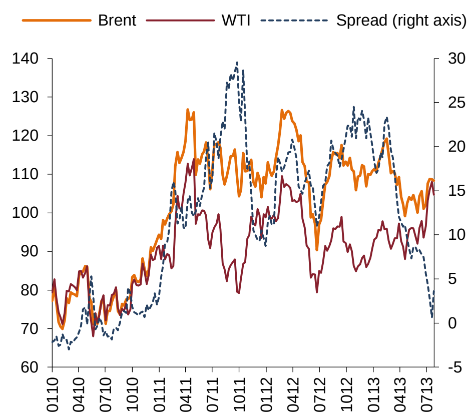
In the second quarter of the year, both supply and demand-side developments were influential on oil prices. As for demand, indicators of the weak global economic activity, particularly the slowdown in the Chinese economy, coupled with the declarations of the Fed regarding the future monetary policy posed a downside risk to oil prices. The high levels of oil inventories in the US due to rising crude oil production also draw a favorable outlook regarding oil prices (Chart 2.2.2). On the other hand, the ongoing political unrest in the Middle East is closely monitored for its potential to raise concerns over the oil supply. In particular, the developments in Egypt create a risk to crude oil transportation, while setbacks in crude oil production in Libya, Nigeria and Iraq are considered as other risk factors. In fact, oil prices, which hovered around USD 102 across the second quarter, climbed to USD 109 in the midst of July upon these developments. Against this backdrop, 18-month forward contracts indicate that oil prices increased in the previous reporting period, especially at the short-term maturity (Chart 2.2.3).

Chart 2.2.3.
Crude Oil (Brent) Prices*
(USD/bbl)



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

Chart 2.2.4.
WTI – Brent Prices
(USD/bbl)



Source: Bloomberg.

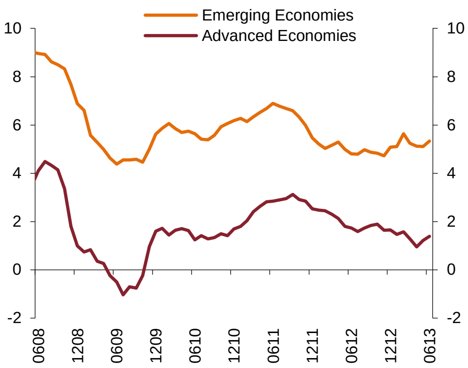
Having narrowed gradually in 2013, the WTI - Brent oil price spread has reached the lowest levels since early 2011 (Chart 2.2.4). This narrowing was fuelled by the alleviated demand-side pressure on the Brent crude oil due to the rising US crude oil production. Moreover, the insufficiency of oil pipelines in Oklahoma (price settlement point for the WTI) led to excess supply, which posed a downside pressure on the WTI prices. However, this excess supply is on the decline due to the new oil pipeline projects, and this is considered to be another factor that pulls the price spread down.

Agricultural prices trended downwards and slumped by 12 percent in the second quarter of 2013, after having soared in the summer of 2012 upon the severe drought. Despite favorable expectations for the production and inventory levels of agricultural products, the future course of agricultural prices remains uncertain due to weather conditions, keeping both downside and upside risks brisk throughout 2013.

2.3. Global Inflation

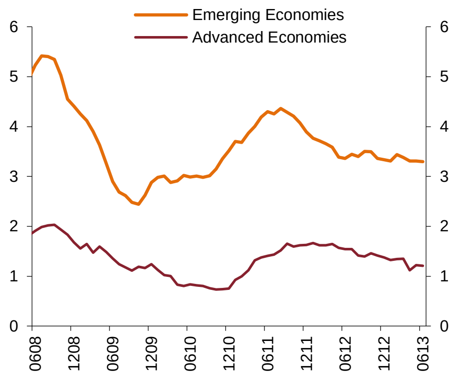
In the second quarter of 2013, headline and core consumer inflation rates in advanced economies have slightly risen since the release of the previous Report. Nevertheless, headline consumer inflation in emerging economies trended downwards due to the sluggish growth performances in the start of the second quarter; yet posting an increase in June, consumer inflation remained above the figures projected in the previous Inflation Report. However, core inflation rates in emerging economies followed a flat course and remained unchanged in the inter-reporting period (Charts 2.3.1 and 2.3.2).

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



Source: Bloomberg, CBRT.

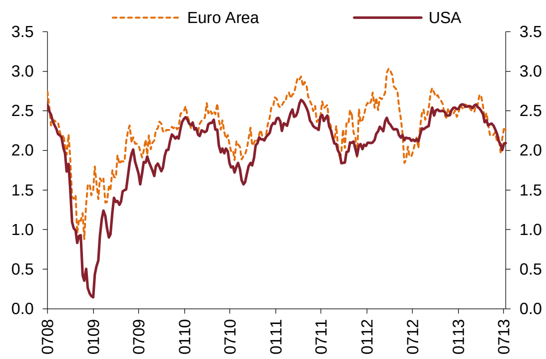
Chart 2.3.2.
Core Inflation in Advanced and Emerging Economies
(Annual Percent Change)



Source: Bloomberg, Datastream, CBRT.

As of the end of the third quarter of 2013, both the US and the Euro Area inflation compensation hover below the readings of the previous reporting period. The growing expectation that the contraction in the Euro Area will continue led to lower compensation rates in the region. Similarly, both the expectation for a slowdown in growth rates and the envisaged tightening in the monetary policy upon the recent declarations of the Fed pulled the US inflation compensation down in the second quarter (Chart 2.3.3).

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



Source: Bloomberg.

Global inflation forecasts suggest that parallel to the growth forecasts, which were revised downwards, inflation forecasts for end-2013 and end-2014 were mostly revised downwards as well (Table 2.3.1). Having experienced excessive capital outflows in the previous quarter, Latin America, which currently experiences soaring inflation rates, saw an upward revision in end-2013 inflation forecasts. Accordingly, inflation rates in emerging economies may see upside pressures should capital outflows from these economies persist in the forthcoming period and the depreciation of their currencies permanently deteriorate inflation expectations. On the other hand, commodity prices, which decreased in the second quarter of the year, are not expected to exert pressure on global inflation rates in the upcoming period given the weak global economic activity.

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

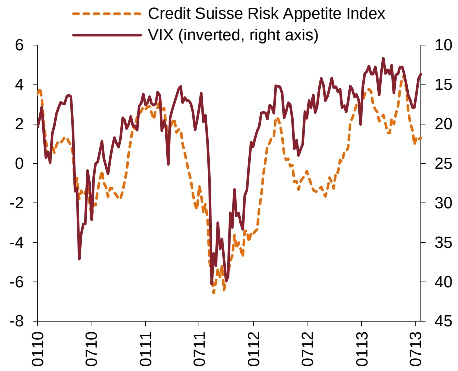
	April		July	
	2013	2014	2013	2014
World	2.8	3.1	2.6	3.0
Advanced Economies	-	-	-	-
USA	1.9	2..1	1.5	1.9
Euro Area	1.7	1.6	1.5	1.5
Germany	1.7	2.0	1.6	1.9
France	1.2	1.6	1.0	1.4
Italy	1.9	1.7	1.5	1.6
Spain	2.0	1.5	1.7	1.4
Greece	-0.1	1.3		
Japan	0.1	1.9	0.0	2.1
UK	2.9	2.5	2.7	2.5
Emerging Economies	-	-	-	-
Asia-Pacific*	3.9	4.0	3.6	3.8
China	3.2	3.5	2.6	3.2
India	8.2	7.4	8.1	7.3
Latin America	6.6	6.5	7.0	6.7
Brazil	5.7	5.7	5.8	5.6
Eastern Europe	5.2	5.0	4.9	4.9

* Excluding Japan.
Source: Consensus Forecasts.

2.4. Financial Conditions and Risk Indicators

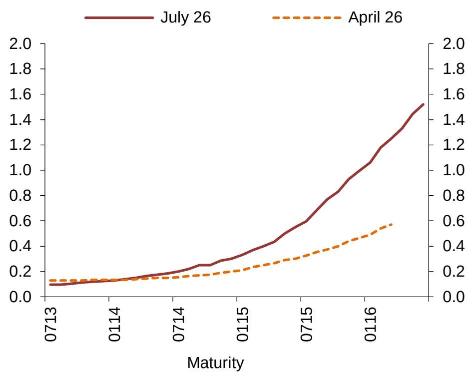
The second quarter of 2013 was marked by persisting uncertainties due to concerns over global growth and hints given by the Fed that the bond-buying program may end in the upcoming period. The global risk appetite displayed a decline in this period (Chart 2.4.1). Meanwhile, Bernanke's emphasis as of late June that the monetary policy would remain flexible has recently led the global risk appetite to re-settle on a path of recovery. Against this backdrop, Fed funds futures contracts imply higher prospects for an earlier-than-expected rise in the US policy rate, which has long been kept around zero (Chart 2.4.2). In addition, the expected policy rate hike also rose considerably.

Chart 2.4.1.
Global Risk Appetite



Source: Bloomberg, Credit Suisse.

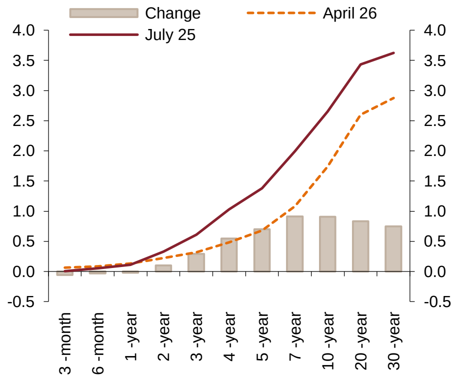
Chart 2.4.2.
Policy Rate Futures in the US
(Percent)



Source: Bloomberg.

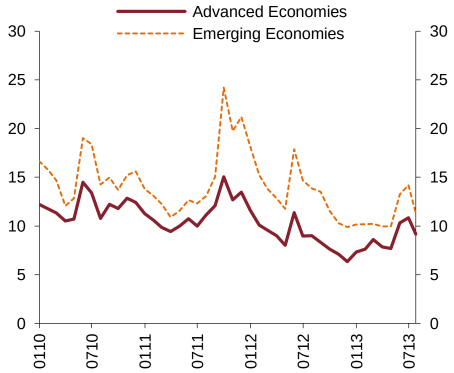
Parallel to the tightening of the US monetary policy expectations, medium and long-term yields recorded an upsurge (Chart 2.4.3). On the other hand, the US monetary policy developments besides fluctuations in the global risk appetite created uncertainties regarding the value of the USD, which is the reserve currency with the most widespread use on a global scale. As a result, implied volatilities of exchange rate options with 1-month maturity for the currencies of both advanced and emerging economies soared in the second quarter in the inter-reporting period (Chart 2.4.4). Meanwhile, the Fed's declarations that calmed the markets in July also reflected the implied exchange rate volatilities.

Chart 2.4.3.
The US Yield Curve
(Percent)



Source: Bloomberg.

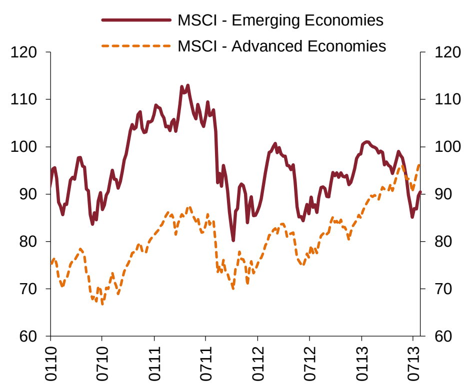
Chart 2.4.4.
Implied Volatility of Exchange Rates*
(Against USD, Percent)



* 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.

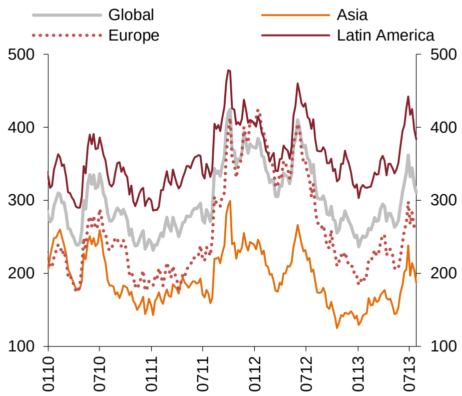
In the second quarter of the year, concerns over the global risk appetite and growth had adverse effects on the stock markets of both advanced and emerging economies. However, as investors were attracted to countries considered to be safe havens in this period, the downturn in the stock markets of advanced economies, particularly the USA, remained limited compared to emerging economies (Chart 2.4.5). In the same period, parallel to stock market developments, yields on emerging market bonds increased far above those of the US Treasury bills (Chart 2.4.6).

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



Source: Bloomberg.

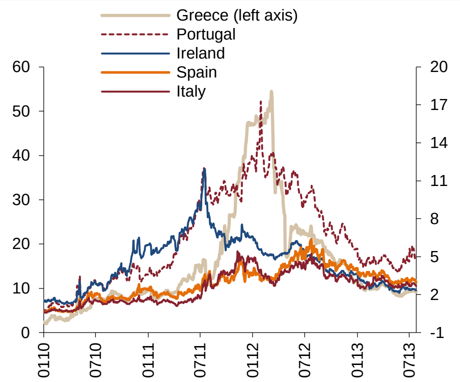
Chart 2.4.6.
Regional EMBI Developments
(5-year)



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

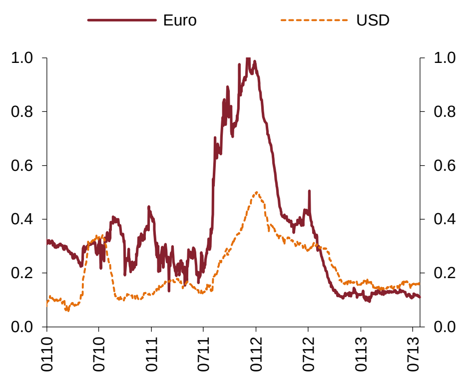
Similar to the emerging economies, bond yields of troubled countries in the Euro Area have recently trended upwards compared to the government bond yields of Germany, which is considered to be a safe haven (Chart2.4.7). Meanwhile, the LIBOR-OIS spread, which shows the counterparty risk and liquidity conditions in money markets, remained virtually unchanged both in the US and the Euro Area in the second quarter (Chart 2.4.8).

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



* GIIPS countries are Greece, Ireland, Italy, Portugal and Spain.
Source: Bloomberg.

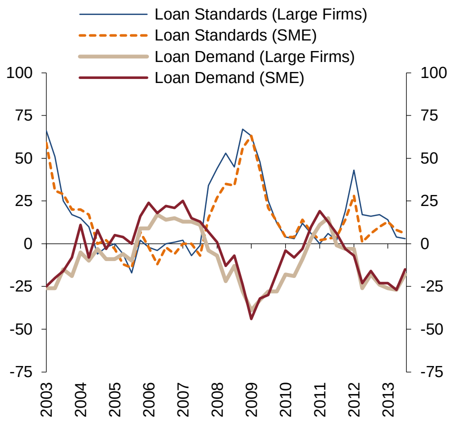
Chart 2.4.8.
LIBOR-OIS Spread
(3-Month, Point)



Source: Bloomberg.

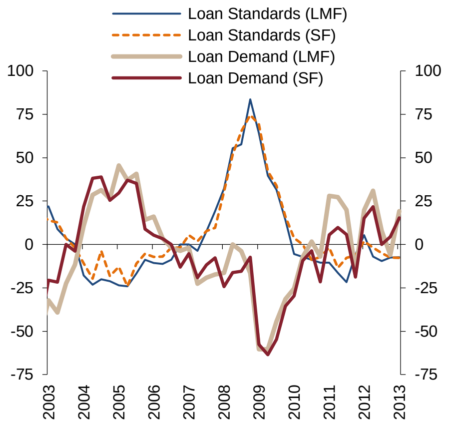
According to the ECB's bank lending survey for the July 2013, tight credit conditions in the banking sector were slightly alleviated, while credit demand contracted further in the Euro Area (Chart 2.4.9). As per the latest lending survey released by the Fed, easing in lending conditions continued throughout the first quarter, and the loan demand of not only the large and medium-sized but also of small firms increased 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)

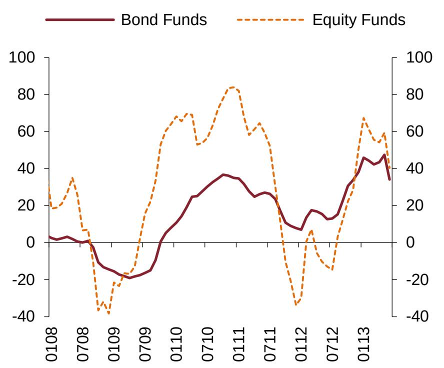


Source: Fed.

2.5. Capital Flows

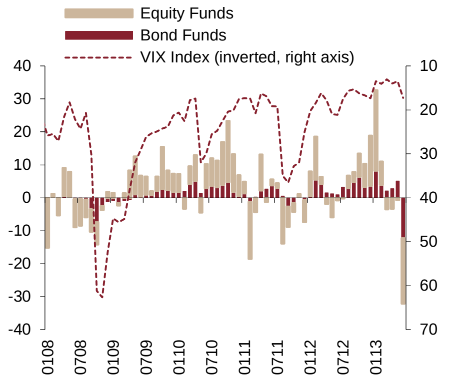
Having trended downwards in the first quarter of 2013, capital flows towards emerging economies plummeted in the second quarter (Chart 2.5.1). The new quantitative easing policy announced by BoJ in April had a limited impact on capital flows towards emerging economies. On the other hand, declarations by Bernanke in May and June besides hints given by the Fed that it would cut down on asset purchases by the end of 2013 and quantitative easing policy would completely be terminated in the midst of 2014, triggered capital outflows from emerging economies. Fund inflows towards fixed-rate security markets continued at a diminishing pace in April and May compared to the previous quarter, while stock markets saw outflows (Chart 2.5.2). Parallel to the deteriorated risk appetite in June upon concerns over the probable decline in the global liquidity, both equity funds and bond funds saw severe outflows. In sum, the second quarter was marked by increased volatility in capital flows.

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



Source: EPFR, Bloomberg.

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



Source: EPFR, Bloomberg.

On a quarterly basis, more than half of the capital inflows in the first quarter were redeemed in the second quarter of the year (Table 2.5.1). As for portfolio composition, most of the outflows were composed of equity funds, while in terms of regional distribution, the Latin American countries experienced a quarter-on-quarter increase in capital outflows.

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

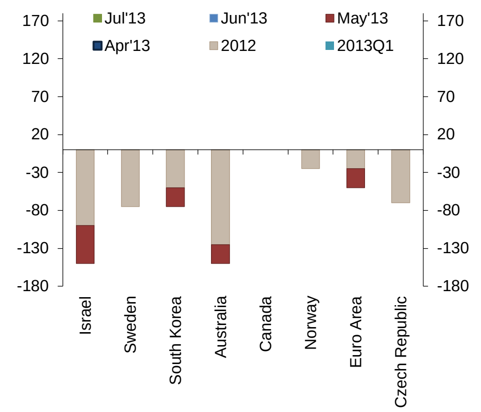
Source: EPFR.

In the inter-reporting period, the downside risks regarding push and pull factors determining capital flows towards emerging economies increased in the upcoming period. Alongside the higher probability of a fall in global liquidity, the elevated risk aversion of international investors is considered to be a factor that may weigh on capital flows. Moreover, the US gave signs for economic recovery, while emerging economies posted a weaker-than-expected growth outlook. This may lead capital flows to decline further. In this respect, due to the probable weak course of capital flows in addition to increased volatility, risks to financial stability in emerging economies are likely to remain brisk in the upcoming period.

2.6. Global Monetary Policy Developments

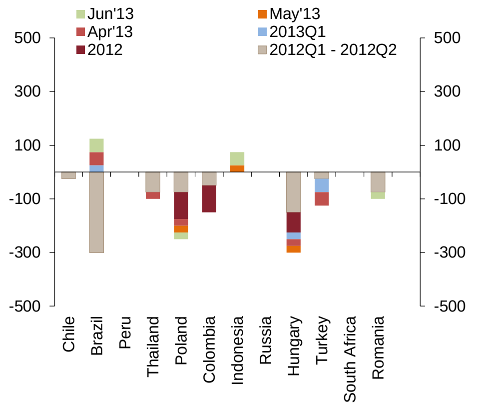
Policy rates were pulled down in advanced economies, while policy rate changes across emerging economies were mixed in the second quarter of 2013. The central banks of many advanced economies, which kept policy rates unchanged in the first quarter, opted for reductions mainly upon the deterioration of expectations regarding global growth. In this context, especially the ECB as well as the Bank of Israel, the Bank of South Korea and the Reserve Bank of Australia implemented policy rate reductions in the second quarter (Chart 2.6.1). As for emerging economies, Hungary and Poland, opting for the most aggressive policy rate reductions in 2012 and in the first quarter of 2013, implemented further policy rate cuts in the second quarter of the year (75 basis points each in April and July). Due to inflationary concerns besides the volatility that emerged in financial markets subsequent to the declarations of Bernanke, Banco do Brasil and the Bank of Indonesia raised policy rates by 125 and 75 basis points, respectively (Chart 2.6.2).

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



* As of July 12, 2013.
Source: Bloomberg, CBRT.

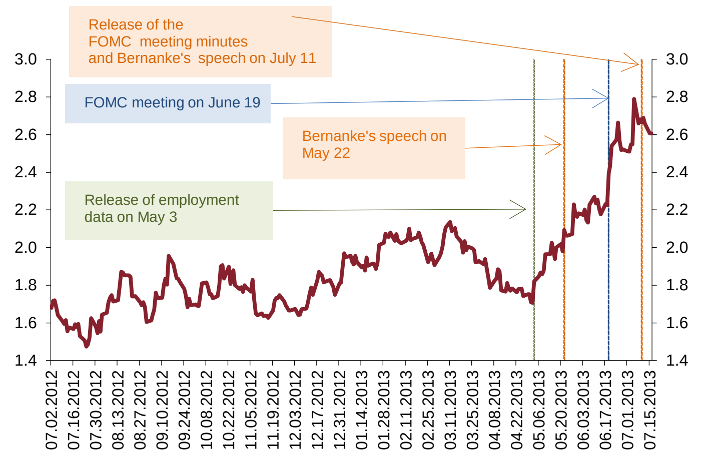
Chart 2.6.2.
Policy Rate Changes in Emerging Economies from Jan. 2012 to Jul. 2013* (Basis Points)



* As of July 12, 2013.
Source: Bloomberg, CBRT.

Despite diversity in policy rates, the most striking development regarding the monetary policy has been the recent signals given by the Fed that it will cut down on bond purchases, and then terminate them in the close future. Firstly, a perception arose that tightening might start in markets upon the favorable outturn of employment data on May, 3 and long-term interest rates posted an increase (Chart 2.6.3). Following this, in a speech on May 22, Bernanke stated that bond purchases might be reduced due to the relatively positive course of labor markets. This prompted higher prospects for an earlier-than-expected policy rate hike, which has long been kept around zero in the US and also led to an increase in the expected policy rate hike (Chart 2.4.2). Moreover, following this announcement, market rates were boosted across the globe, including the US, and emerging market currencies depreciated upon capital outflows. This announcement was also confirmed by declarations following the FOMC meeting of June 19. The Fed stated that the policy rate would remain low until the unemployment rate fell below 6.5 percent and bond purchases would be reduced gradually towards the year-end and might fully end when the unemployment rate declines to around 7 percent in the midst of 2014.

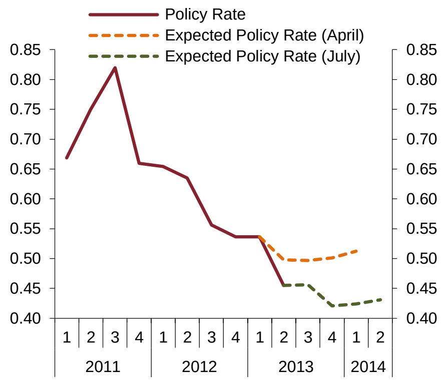
Chart 2.6.3.
Yields on US Treasury Bills (10-Year, Percent)



Source: Bloomberg.

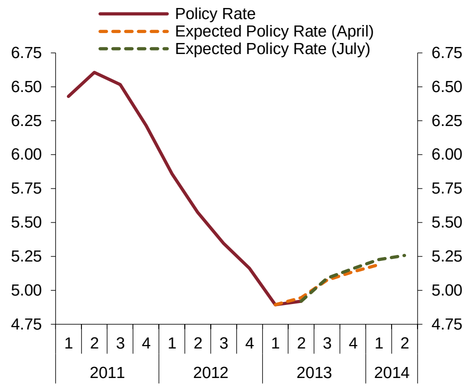
Following the announcements, the yields on 10-year US Treasury bills-climbed from 1.93 percent in the first quarter to 2.52 percent in the second quarter. According to Bloomberg's July survey, the expected rise in long-term rates, which increased compared to the June survey, points out that the Fed's statement on June 19 supported the expectations for a contraction in liquidity. Meanwhile, upon the release of the minutes of the FOMC meeting, Bernanke emphasized at a conference on July 11 that the unemployment rate overstates the condition of labor markets, and a highly accommodative monetary policy is needed for the foreseeable future. In his statements, Bernanke conveyed the message to the markets that the reaction as well as the panic was excessive.

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.

In the second quarter of 2013, the average policy rate in advanced economies receded more than envisaged in April to 0.45 percent (Chart 2.6.4). The average policy rate in emerging economies increased in tandem with the April Inflation Report expectations by 2 basis points to 4.92 percent (Chart 2.6.5). Expectations for forward 12-month average policy rates remained broadly unchanged for emerging economies in the inter-reporting period. Expectations were revised downwards for advanced economies because of the expectation of another policy rate cut of 25 basis points by the ECB. Currently, the average expected policy rates give no clear signs of tightening in neither advanced nor emerging economies. However, emerging economies are expected to opt for tightening, should they experience an accelerated pace of capital outflows, which have already been ongoing upon Bernanke's statements.