2. International Economic Developments

The first quarter of 2014 was marked by an ongoing moderate growth of global economic activity, but the rate of growth slowed quarter-on-quarter. This slowdown was mainly attributed to the US economy that shrank sharply amid severe weather conditions and emerging economies whose growth rates were down from the previous quarter. Data on the second quarter of the year suggest that the slowdown across emerging economies will persist, but global economic activity will remain robust largely due to advanced economies. In fact, leading indicators for the US economy, one of the main drivers of the course of global economic activity, point to growth in the second quarter after the sharp contraction in the first quarter.

The effects of the global economic recovery on commodity prices, albeit marginal, have been observed since the second quarter. The upsurge in industrial metal prices during this period was largely driven by the recovery of the Chinese economy, while, in the upcoming period, the course of commodity prices will be determined by the global economic recovery as well as the upward pressure on oil prices triggered by geopolitical risks. In line with the rise in commodity prices, inflation rates increased slightly from the previous reporting period across both advanced and emerging economies. Nevertheless, as inflation rates still hover mostly below targets and economic recovery is yet to reach the desired level, monetary policies in both advanced and emerging economies were on the easing side in the second quarter.

It is remarkable that global financial markets were generally filled with optimism in the second quarter although there was no significant improvement in global economic activity. In this period, the risk appetite was favorable and the downtrend in capital flows to emerging economies reversed. Despite the limited recovery across emerging economies, the reduced downside risks on the global growth outlook and the favorable course of the risk appetite will encourage more portfolio flows into these economies over the upcoming period. The lower prospect for a sooner-than-expected tightening in monetary policy by the Fed compared to the previous reporting period will also support capital flows to emerging economies in the forthcoming period. All these developments suggest that the global monetary policy that was unexpectedly loose in the second quarter will tighten a little in the rest of the year. This tightening will become more significant in 2015.

2.1. Global Growth

The global economy continued to recover in the first quarter of 2014, but the rate of growth was slower than that in the fourth quarter of 2013 (Chart 2.1.1). The first-quarter slowdown of global growth was essentially driven by the weather-related contraction in the US economy. However, the favorable growth outlook for the Euro Area, one of Turkey's biggest export destinations, continued into the first quarter of the year. The pace of growth in emerging economies, on the other hand, slowed quarter-on-quarter in the first quarter (Chart 2.1.2).

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

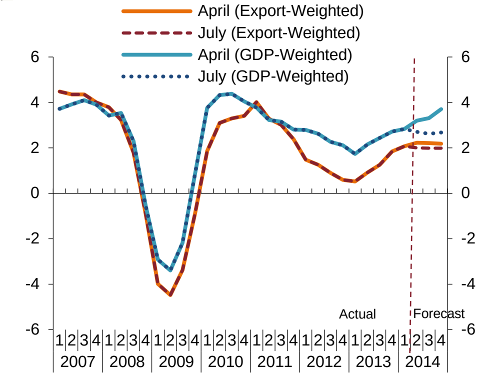
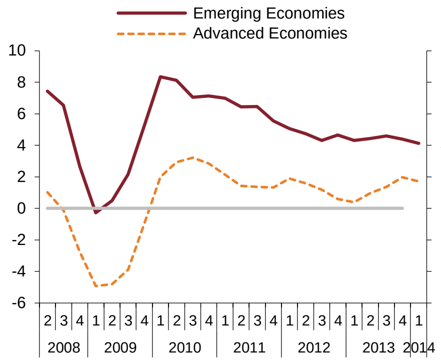


Chart 2.1.2.
Global Growth Rates*
(Annual Percent Change)



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

Second-quarter readings on global PMI suggest that the manufacturing industry was on a negative growth path while the services sector was on a positive one, compared to the first quarter (Chart 2.1.3). In this period, manufacturing PMI indices were down, especially in a large number of emerging economies. Similarly, manufacturing PMI data for the Euro Area pointed to a quarter-on-quarter decline in the second quarter. Yet, manufacturing PMI data for the US were more favorable in this period. Combined with labor market data, these readings indicate that the US economy will expand in the second quarter (Chart 2.1.4). In conclusion, the pace of growth in emerging economies will continue to slow in the second quarter, while the Euro Area recovery may lose some momentum. However, the global economic activity is expected to grow further in the second quarter mostly due to advanced economies, particularly the US. The fact that capital flows to emerging economies were on the rise during May and June is expected to have a positive effect on emerging economies and therefore on the global economic activity in the upcoming period.

Chart 2.1.3.
Markit Global PMI Indices

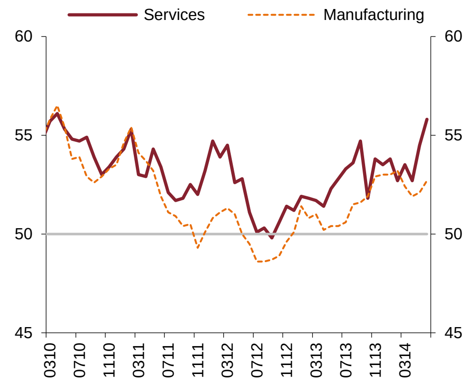
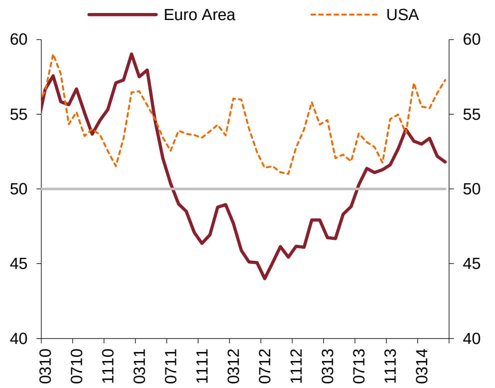


Chart 2.1.4.
Manufacturing Industry PMI Indices



Source: Markit.

In the July edition of Consensus Forecasts bulletins, end-2014 growth forecasts were revised downwards for the US and the Euro Area and upwards for Japan and the UK compared with the previous reporting period. Growth forecasts for emerging economies, on the other hand, were revised downwards overall, except for China and India (Table 2.1.1). The duly-revised GDP and export-weighted global manufacturing indices indicate that the global economy will continue to grow in the rest of the year, but the pace of growth will be slightly below the level projected in the previous reporting period (Chart 2.1.1).

Table 2.1.1.
Growth Forecasts for end-2014 and 2015 (Average Annual Percent Change)

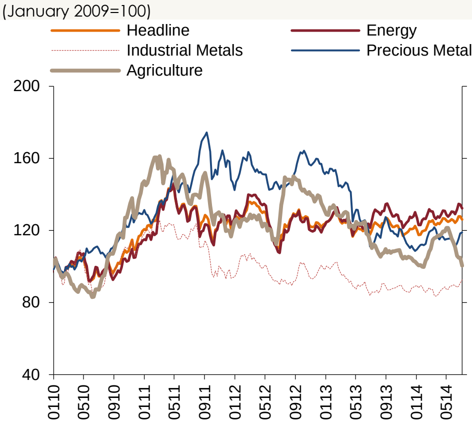
	April		July	
	2014	2015	2014	2015
World	2.9	3.2	2.6	3.2
Advanced Economies				
USA	2.7	3.0	1.6	3.0
Euro Area	1.2	1.5	1.1	1.6
Germany	1.9	2.0	2.0	2.0
France	0.9	1.3	0.7	1.2
Italy	0.6	1.1	0.3	1.1
Spain	1.0	1.5	1.1	1.7
Greece	0.1	1.5	0.2	1.8
Japan	1.3	1.3	1.5	1.3
UK	2.8	2.4	3.0	2.6
Emerging Economies				
Asia-Pacific	6.0	6.1	6.0	6.1
China	7.3	7.2	7.3	7.2
India	5.4	6.0	5.4	6.2
Latin America	2.2	2.8	1.9	2.7
Brazil	1.8	2.0	1.5*	1.8*
Eastern Europe	1.7	2.8	1.5	2.6

* As of June.
Source: Consensus Forecasts.

2.2. Commodity Prices and Global Inflation

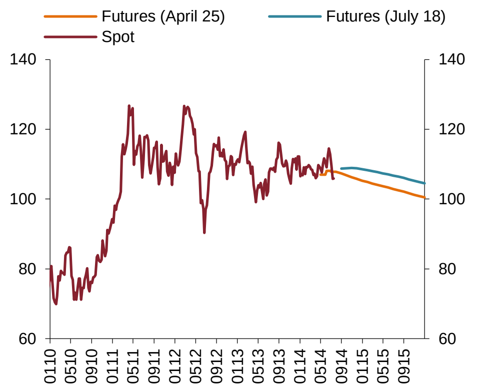
In the second quarter of 2014, the headline commodity price index displayed a quarter-on-quarter increase of 1.5 percent. In this period, energy, industrial metal and precious metal prices rose by 3.5, 7.5 and 3.4 percent, respectively, while agricultural prices dropped by 14.5 percent (Chart 2.2.1).

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



Source: Bloomberg.

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

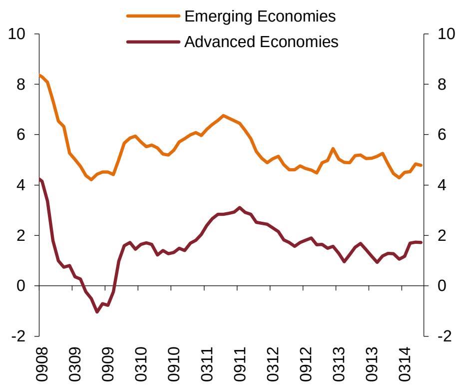


* April 25 and July 18 denote the arithmetical average of the prices quoted at futures contracts during April 1-25, 2014 and July 1-18, 2014, respectively.
Source: Bloomberg.

The global economic recovery appears to have become influential on commodity prices, albeit only marginally. In addition, concerns over oil supply, coupled with geopolitical risks, continue to put upward pressure on oil prices. Expectations for Brent crude oil prices, standing at 113 USD as of the end of the second quarter, have also increased from the previous reporting period (Chart 2.2.2). The second-quarter rise in industrial metal prices is attributed to the favorable growth outlook for the Chinese economy. Meanwhile, after the first-quarter increase, agricultural prices decreased substantially in the second quarter amid the favorable course of production.

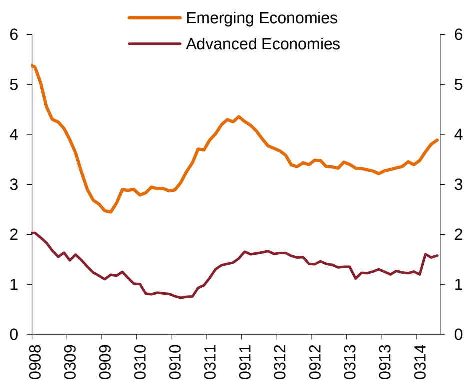
Compared with the previous reporting period, headline and core CPI inflation rates were up in advanced economies, mostly on the back of Japan and the US. Emerging economies saw a similar increase in their headline and core inflation rates, with core inflation showing a faster pace of increase (Charts 2.2.3 and 2.2.4).

Chart 2.2.3.
CPI Inflation in Advanced and Emerging Economies
(Annual, Percent)



Source: Bloomberg, CBRT.

Chart 2.2.4.
Core Inflation in Advanced and Emerging Economies
(Annual, Percent)



Source: Bloomberg, DataStream, CBRT.

End-2014 and end-2015 inflation forecasts were revised downwards for the Euro Area, the UK and China and upwards for the US, Japan, Latin America and Eastern Europe (Table 2.2.1). Upside risks on agricultural and oil prices and monetary easing policies across advanced economies continue to pose a major risk to global inflation for the upcoming period.

Table 2.2.1.
Inflation Forecasts for end-2014 and 2015
(Average Annual Percent Change)

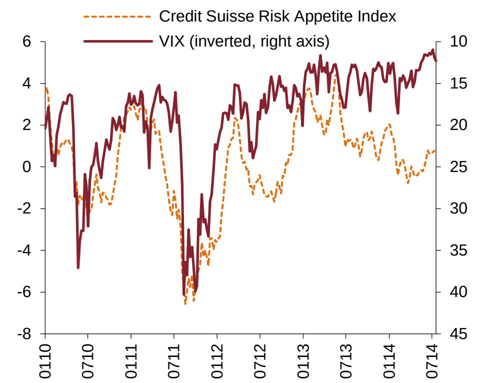
	April		July	
	2014	2015	2014	2015
World	3.0	3.1	3.2	3.1
Advanced Economies				
USA	1.7	1.9	2.0	2.1
Euro Area	0.9	1.3	0.7	1.2
Germany	1.4	1.8	1.1	1.8
France	1.0	1.3	0.7	1.1
Italy	0.8	1.1	0.5	0.9
Spain	0.3	1.0	0.2	0.8
Greece	-0.9	-0.1	-0.9	-0.1
Japan	1.9	2.1	1.7	2.0
UK	2.6	1.7	2.7	1.8
Emerging Economies				
Asia-Pacific	3.4	3.6	3.3	3.5
China	2.6	3	2.4	2.9
India	7.7	7.1	8.0	6.9
Latin America	10.8	9.4	11.3	10.0
Brazil*	6.3	5.8	6.4**	6.0**
Eastern Europe	5.2	4.9	5.4	5.0

* December to December.
** As of June.
Source: Consensus Forecasts.

2.3. Financial Conditions, Risk Indicators and Capital Flows

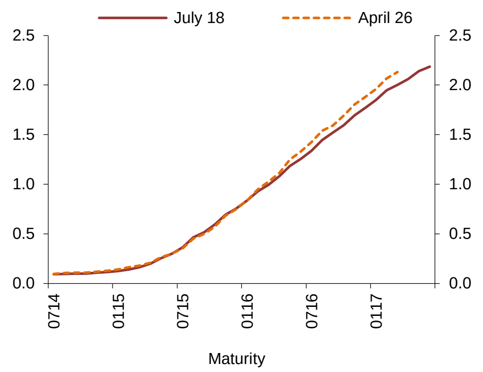
In the second quarter, despite ongoing concerns over global growth, the reluctance of the Fed to signal a rate hike any time soon and its downward revision to long-term interest rate forecasts and the ECB's new package of easing measures led to a recovery in the global risk appetite (Chart 2.3.1). As for the Fed funds futures contracts, the expected date of the first Fed funds rate increase remains unchanged but the expected size of the rate hike has decreased slightly (Chart 2.3.2). This was mostly due to the 25 basis-point cut in the Fed's long-term interest rate projections despite its barely changed monetary policy rhetoric. Moreover, this decrease in policy rate projections caused the US Treasury bond yields to fall slightly in the medium to long term.

Chart 2.3.1.
Global Risk Appetite



Source: Bloomberg, Credit Suisse.

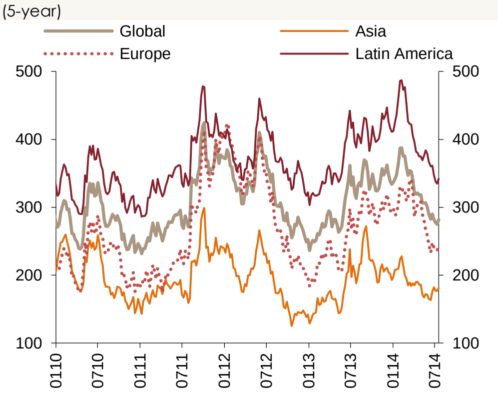
Chart 2.3.2.
Fed Funds Futures
(Percent)



Source: Bloomberg.

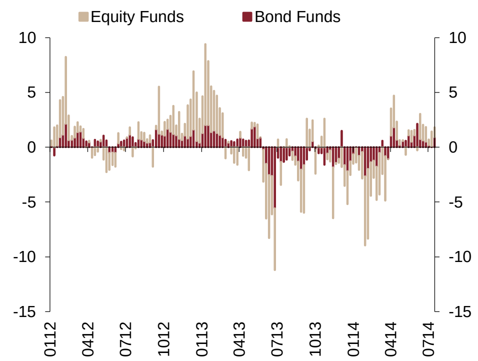
Although there was no significant improvement in the global growth outlook, financial markets were upbeat in the second quarter. In this context, thanks to the accommodative monetary policies of major central banks, stock markets continued to appreciate in the second quarter across both advanced and emerging economies. Moreover, yields on borrowing bills and bonds in emerging economies receded amid the waning emerging market risk sentiment and the return of capital flows to emerging economies (Chart 2.3.3).

Chart 2.3.3.
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.

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



Source: EPFR.

The ongoing downtrend in capital flows to emerging economies reversed in the second quarter. Emerging economies, which experienced portfolio outflows as of May 2013 when the Fed first signaled its exit from the quantitative easing program, have been witnessing significant inflows since April 2014 (Chart 2.3.4). This was owed to the moderate course of global economic activity and the favorable risk appetite. Across portfolios, both equity and bond funds saw similar amounts of inflows.

Despite the slowing economic activity in emerging economies, the modest global growth outlook and the favorable risk appetite are expected to encourage more portfolio flows into emerging economies in the upcoming period. Yet, the likelihood of the Fed embarking on a sooner-than-expected tightening with regard to its exit strategy from quantitative easing may pose a downside risk to capital flows. Nevertheless, the ECB's latest decisions are expected to affect capital flows in favor of emerging economies.

2.4. Global Monetary Policy Developments

The slower-than-expected recovery in global economic activity caused a delay in the monetary policy normalization process in the second quarter and gave rise to expectations that it would take a longer time for policy rates to return to historical averages in advanced economies. The most significant indicator of this development was, without doubt, the 10 basis-point cut in the ECB's policy rate in June. Moreover, Sveriges Riksbank also reduced its policy rate by 50 basis points in July (Chart 2.4.1). On the emerging economies front, the tightening bias that was prevalent in the previous reporting period particularly against the fluctuations in capital flows and exchange rates was replaced by a more stabilizing, even easing bias (Chart 2.4.2).

Chart 2.4.1.
Policy Rate Changes in Advanced Economies from Jan. 2012 to Jul. 2014* (Basis Points)

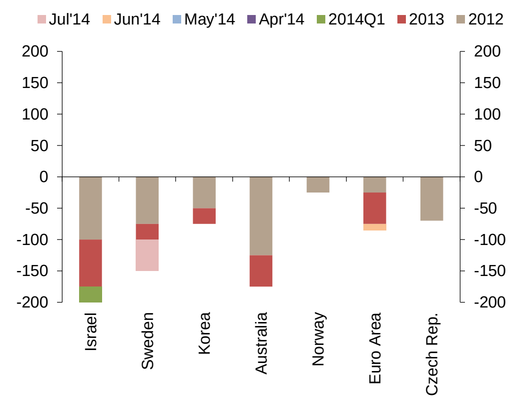
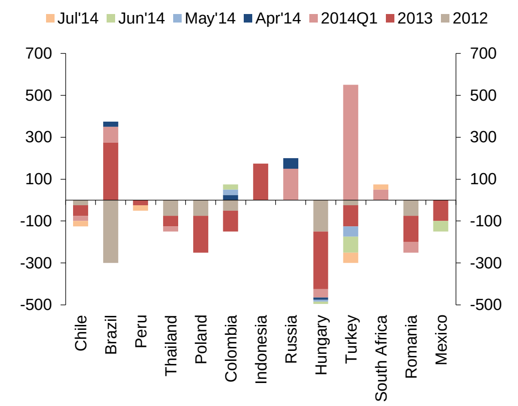


Chart 2.4.2.
Policy Rate Changes in Emerging Economies from Jan. 2012 to Jul. 2014* (Basis Points)



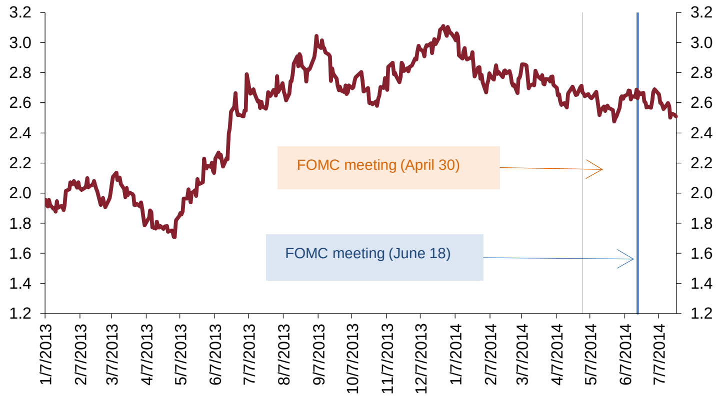
* As of July 21, 2014.
Source: Bloomberg, CBRT.

The Fed continued to cut asset purchases by 10 billion USD at its two meetings in the second quarter. In the statement following the FOMC meeting on June 18, it was reaffirmed that a highly accommodative stance of monetary policy remains appropriate for a considerable time. Following these developments, the expected date of the first rate hike was unchanged from the previous reporting period, while the expected pace of rate hike declined to some extent. Meanwhile, yields on

10-year bonds, an indicator for long-term interest rates, fluctuated for a while, particularly due to the political tensions in Iraq, and settled around 2.5 percent as of end-July (Chart 2.4.3).

The ECB's rate cut was mostly attributed to the inflation rate that has been hovering well below the target. In an announcement, the ECB emphasized its aim to keep inflation low, though around 2 percent, and stated that the annual inflation of 0.5 percent as of May was well below the target. In addition to delivering a rate cut, the ECB also adopted a number of measures to facilitate the effective use of the credit channel. The most outstanding among these measures is to allow banks to borrow from the ECB to finance a certain percentage of their loans to the private sector.

Chart 2.4.3.
Yields on 10-year US Treasury Bonds (Percent)



Source: Bloomberg.

As for emerging economies, monetary policy strategy has displayed a more heterogeneous pattern since 2013. Banco Central do Brasil and Bank Indonesia have been pursuing an aggressive monetary tightening since early 2013, owing to the risks fuelled by the high current account deficit and the aim to bring inflation closer to the target range. Other emerging market central banks, particularly in Eastern Europe, continued to ease monetary policy in this period as inflation remained mostly below the target. The first quarter of 2014 was marked by policy rate hikes across countries such as South Africa, Turkey and India that have been facing current account deficits due to rising exchange rates and capital outflows amid increased global uncertainty. Yet, monetary tightening glut came to a halt in the face of reduced uncertainty and heightened expectations of prolonged monetary easing across advanced economies, and only South Africa raised rates by 25 basis points in July.

In sum, both advanced and emerging economies saw monetary easing in the second quarter, contrary to anticipations. However, as of July, expectations for the upcoming period point to some tightening for both groups of economies in spite of the second-quarter easing (Charts 2.4.4 and 2.4.5).

Chart 2.4.4.
Expected Policy Rates in Advanced Economies
(Percent)

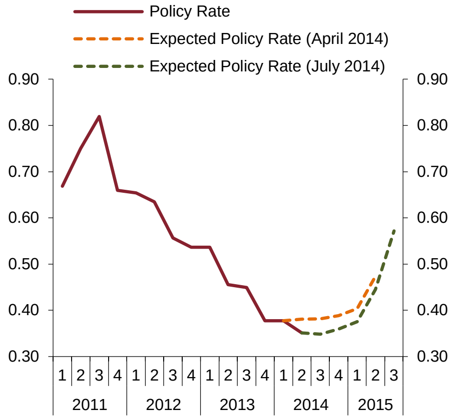
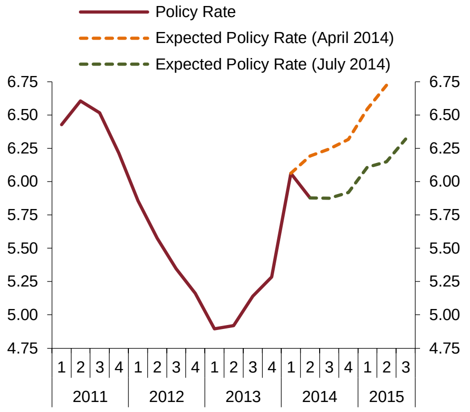


Chart 2.4.5.
Expected Policy Rates in Inflation-Targeting Emerging Economies (Percent)



Source: Bloomberg, CBRT.