2. International Economic Developments

In the last quarter of 2012, global economic activity accelerated moderately. Growth forecasts for 2012 remained virtually unchanged despite the better-than-anticipated performance of the global economy, with markedly growing divergences across regions. As a matter of fact, downward revisions in the growth prospects for the Euro Area are notable, especially in debt-ridden countries.

In the inter-reporting period, the possibility of a disorderly default in Greece has been alleviated, thus attenuating risk perceptions regarding the region. However, the weaker growth outlook in heavily-indebted countries caused renewed concerns. Spain, which is troubled by high unemployment rates, unsettled problems in the real estate market and the failure to control local government spending is at the center of concerns regarding the region (Box 2.1). The surge in Spain's borrowing costs not only affected Italy and other neighboring countries, both also worsened the performance of the global markets through the risk appetite. The unfavorable course of the Euro Area growth in addition to elevated borrowing costs heighten controversies over debt sustainability, while the social resistance against the adopted measures besides the imminent elections feed into uncertainties. Meanwhile, the failure to establish European Financial Stability Facility (EFSF) as a permanent funding institution, besides the inability to create an efficient security wall by merging EFSF with the European Stability Mechanism, the permanent rescue funding program, weakened the possibility for a notable financial contribution to be provided by G-20 countries.

Overall, finding a permanent solution to the problems in the Euro Area is likely to take up a long time. This fact coupled with the pursued monetary easing in advanced economies implies that global risk appetite may continue to be volatile.

The early-2012 data releases for the U.S. economy indicated a better-than-expected outlook for the economic activity, while the favorable course of employment invigorated the prospects for growth. On the other hand, Fed maintained its cautious stance throughout the period despite this positive outlook. As a matter of fact, the employment data for March, which lagged below the expectations, confirmed the Fed's cautious stance. In the period ahead, the U.S. economic outlook and the global risk appetite will mostly depend on the developments regarding the extension of the Fed's bond swap, which entails the exchange of short-term securities with the long-term ones, as well as the possibility for the implementation of a new round of easing.

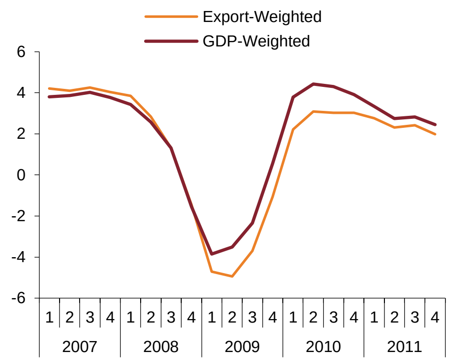
Having been adversely affected by the global turmoil, economic activity in emerging economies decelerated in the last quarter of 2011, while leading indicators suggested a recovery in the first quarter of 2012. Accordingly, central banks in emerging economies adopted a remarkably less aggressive stance. Despite the favorable outlook in the first quarter, the experience of the Euro Area debt crisis reveals that emerging economies are instantly affected by the problems in the advanced economies. Hence, in the forthcoming period, problems regarding advanced economies, especially the Euro Area countries, are likely to relapse, weighing on emerging economies through foreign trade and interrupted capital flows.

Amid soaring energy prices, commodity prices surged in the last quarter. Rather than demand-side pressures, soaring prices were mainly fuelled by supply-side problems that emerged due to the contemplated embargo to be applied to Iran. In view of the fact that Iran is a major oil producer, price increases are likely to persist in the event of a further deepening in the political unrest.

2.1. Global Growth

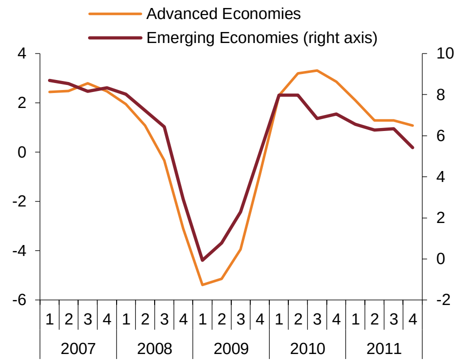
The year-on-year change in GDP-weighted global production, which has decelerated since mid-2010, declined further in the last quarter of 2011. Export-weighted annual growth has also continued to slow down, indicating that uncertainties in advanced economies, and especially the unfavorable growth outlook in the European countries with a major share in the export-weighted global production index, continued to curb global trade in the last quarter of the year (Chart 2.1.1).

Chart 2.1.1.
Global Production*
(Annual Percent Change)



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

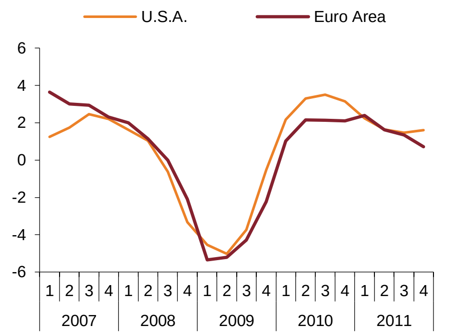
Chart 2.1.2.
Global Growth Rates*
(Annual Percent Change)



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

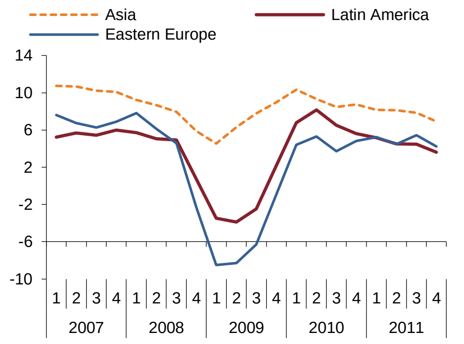
The composite indices indicate that in the last quarter of 2011, the year-on-year growth of the economic activity lost pace both in advanced and emerging economies (Chart 2.1.2). The U.S. economy, which presented a favorable outlook in the last quarter of the year, contributed positively to growth in advanced economies, while the Euro Area growth continued to display an acute outlook amid the aggravating debt crisis in the second half, thus pulling down growth in advanced economies (Chart 2.1.3). The regional breakdown of growth in emerging economies indicates a continued deceleration across regions in the last quarter (Chart 2.1.4).

Chart 2.1.3.
Growth Rates in Selected Advanced Economies
(Annual Percent Change)



Source: Bloomberg.

Chart 2.1.4.
Growth Rates in Emerging Economies by Regions
(Annual Percent Change)



Source: Bloomberg, CBRT.

In the last quarter of 2011, the U.S. economy posted a quarter-on-quarter GDP growth by 3 percent in annualized terms. Meanwhile, labor market followed a benign course, adding to the consumer and investor confidence, thus contributing positively to the U.S. economic outlook. However, as underpinned by the Fed officials, the aggregate demand shortfall is likely to persist, thus growth will remain on a slow track. The analysis of the labor market developments indicates that despite the favorable course in the last quarter of 2011 and early-2012, March readings fell behind expectations, and main indicators on unemployment hover below the pre-crisis levels (Table 2.1.1).

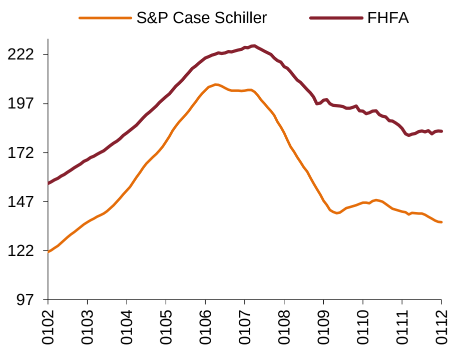
Table 2.1.1.
The U.S. Employment Indicators

			2011				2012		
	2007	2010	Q1	Q2	Q3	Q4	January	February	March
Unemployment (seasonally adjusted, percent)	4.6	9,6	9.0	9.0	9.1	8.7	8.3	8.3	8.2
Educated	2.7	6.3	5.8	6.0	6.0	5.8	5.5	5.5	5.6
Non-Educated	5.0	11.4	10.5	10.8	10.6	10.1	9.5	9.4	9.1
Employment (non-farm, private, million)	115.4	107.4	108.5	109.1	109.5	110.0	110.5	110.7	110.8
Average Duration of Unemployment (week)	16.9	33.1	37.8	39.2	40.3	40.3	40.1	40.0	39.4
Discouraged Workers (million)	1.4	2.5	2.7	2.5	2.6	2.6	2.8	2.6	2.4
Part-time Workers (million)	4.4	8.9	8.4	8.6	8.8	8.5	8.2	8.1	7.7
First-time Appliers to Unemployment Benefits (average monthly, thousand)	319	460	409	438	404	393	381	373	357

Source: Bloomberg.

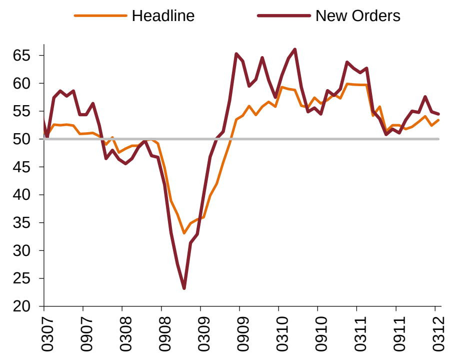
In addition, the U.S. real estate market has yet to recover fully, thus feeding into concerns over the sustainability of the last quarter's favorable outlook (Chart 2.1.5). The ongoing deleveraging by households, real estate market problems, elevated oil prices and concerns over the Euro Area continue to pose downside risks to U.S. growth. As a matter of fact, the headline PMI edged up in the first quarter, while declining back to December figures in March (Chart 2.1.6).

Chart 2.1.5.
Real Estate Prices in the U.S.



Source: Bloomberg.

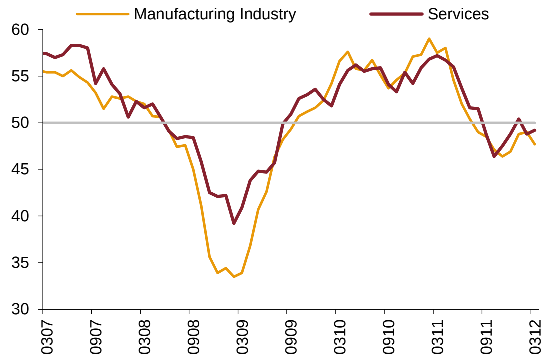
Chart 2.1.6.
PMI Indices in the U.S.



Source: Bloomberg.

In the last quarter of 2011, the Euro Area growth slowed down to 2-year low, by registering a quarterly growth of 0.7 percent in annualized terms. Having posted the 2-year low by end-2011, manufacturing industry and services PMI edged up in the first quarter of 2012, still registering a reading below 50 (Chart 2.1.7).

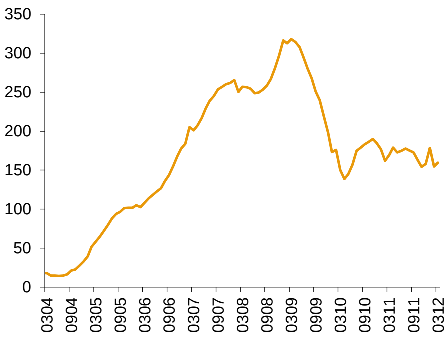
Chart 2.1.7.
PMI Indices in the Euro Area



Source: Bloomberg.

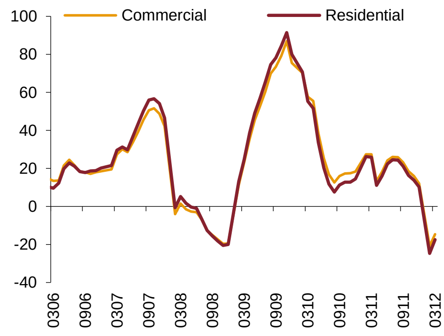
The Chinese economy, which provided the highest contribution to growth in emerging economies during the post-crisis recovery period, decelerated further in the first quarter of 2012, registering a lower-than-expected growth by a year-on-year 8.1 percent. The Chinese economic growth was mainly driven by consumption, while slightly fuelled by external demand (Chart 2.1.8). In the period ahead, leading indicators imply an accelerated GDP growth for China, while the recent fluctuations in the Chinese housing market should be carefully monitored in terms of their possible effects on growth. As of March, commercial and residential property sales declined notably by a year-on-year 15 percent and 18 percent, respectively (Chart 2.1.9).

Chart 2.1.8.
Trade Balance
(12-Month Cumulative, Billion USD)



Source: Bloomberg.

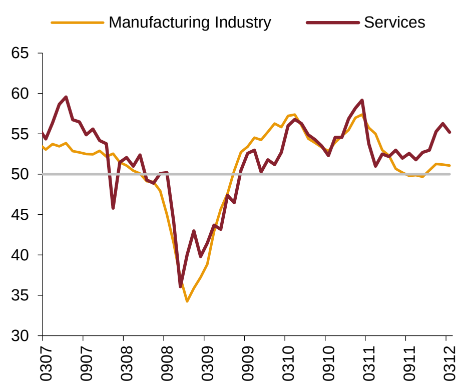
Chart 2.1.9.
Property Sales in China
(Annual Percent Change)



Source: Bloomberg.

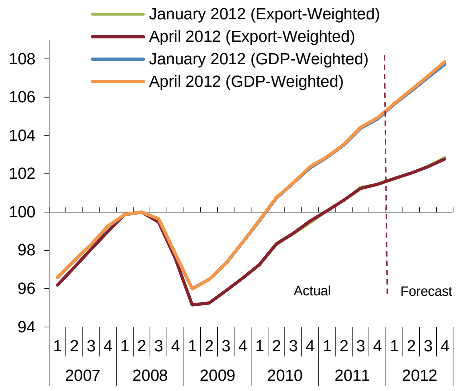
Global growth forecasts remained broadly unchanged in the inter-reporting period. Global PMI figures indicate that manufacturing industry and services edged up in early-2012, while declining back by March (Chart 2.1.10).

Chart 2.1.10.
JP Morgan Global PMI Indices



Source: Bloomberg.

Chart 2.1.11.
Global Production Indices*
(2008Q2=100)



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

Year-end global growth forecasts also remained unchanged in the inter-reporting period. On the other hand, year-end growth forecasts for the U.S. economy were revised slightly upwards, while growth projections in Italy, Spain and Greece were lowered, thus pulling the Euro Area forecasts down in April (Table 2.1.2). The revised GDP and export-weighted global production indices by April forecasts of the Consensus Economics remained in consistent with the outlook presented in the January Inflation Report, confirming that global problems will continue to weigh on external demand in the period ahead, given the absence of prospects for a strong recovery in external economies. Against this backdrop, the external demand outlook for the baseline scenario was kept unchanged from the previous Report (Chart 2.1.11).

Table 2.1.2.
Growth Forecasts for end-2012
(Annual Percent Change)

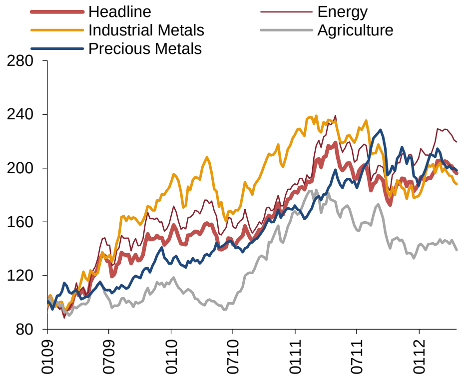
	January	April
World	2.6	2.6
Advanced Economies		
U.S.A.	2.2	2.3
Euro Area	-0.3	-0.4
Germany	0.5	0.7
France	0.0	0.3
Italy	-1.3	-1.5
Spain	-0.4	-1.6
Greece	-4.1	-5.4
Japan	1.9	2.0
U.K.	0.5	0.7
Emerging Economies		
Asia-Pacific	5.0	5.0
China	8.4	8.4
India	7.3	7.2
Latin America	3.5	3.7
Brazil	3.3	3.3
Eastern Europe	2.6	2.8

Source: Consensus Forecasts.

2.2. Commodity Prices

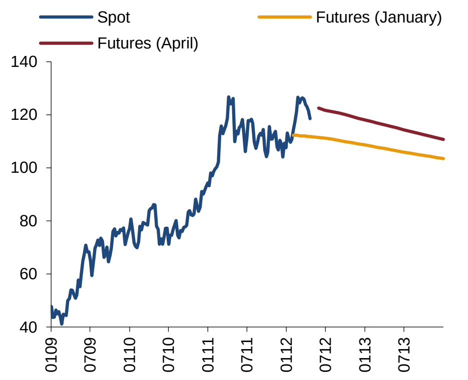
In the first quarter of 2012, the headline commodity prices hit the 4-quarter high on surging energy prices. Industrial metal prices initially trended upwards upon the favorable data releases for China and the U.S. economy, in addition to steps taken towards the solution of the Euro Area debt crisis, while declining back due to heightening downside risks to growth in these economies. Precious metal prices, which climbed in January on prospects for a new round of easing, went down amid weakening of these prospects. Moreover, the declaration of the Indian government to raise gold-import tax led to a contraction in physical gold demand in India, which is renowned with its traditionally strong demand for physical gold (Charts 2.2.1 and 2.2.2).

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



Source: Bloomberg.

Chart 2.2.2
Crude Ooil (Brent) Prices*
(USD/bbl)



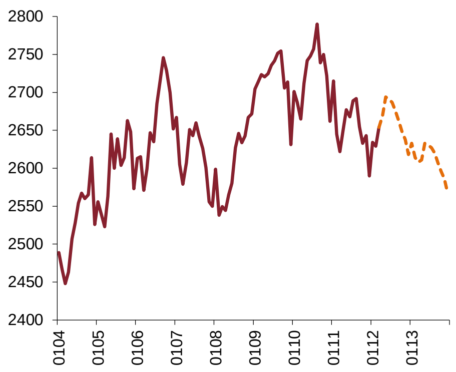
* Futures (January) and Futures (April) denote the arithmetical average of the prices quoted in futures contract during January 1 and January 16, and April 1 and April 16, respectively.
Source: Bloomberg.

Supply-side developments continued to pose upside risk to oil prices, causing oil prices to record ever high levels since the 2011 turmoil in Libya. EU's decision for an embargo on Iran will be put into effect on July 1, driving both European as well as other countries to seek for alternative oil suppliers in order to meet their crude oil need, thereby generating significant fragility by raising political risks in the region and decreasing the effective idle production capacity upon the withdrawal of Iran's crude oil from the international market. Meanwhile, the declaration by Saudi Arabia to raise production capacity in order to meet the need for crude oil in the event that Iran withdraws from the international oil market, stood out as a favorable development regarding the crude oil market.

In the last quarter of 2011, non-OPEC countries have also posed supply-side pressures on oil. Crude oil produced in Southern Sudan is refined and pipelined in Sudan to international markets. Following the dispute between the two countries on the duty rates to apply to transportation of oil trade, Southern Sudan shut down oil production. Additionally, the technical setbacks in the North Sea, besides the persisting turmoil in Syria and Yemen weighed on oil supply.

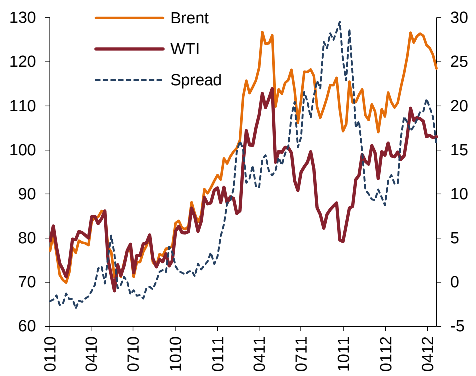
The cold winter season in Europe and Russia as well as Japan's rising demand for oil as an alternative to nuclear energy in electricity production caused an increased demand for crude oil, and posed an upside pressure on oil prices. The soaring unconventional oil production in the U.S. and the relatively milder winter season alleviated the upside pressures on oil prices. Against this background, the course of oil inventories varied by region, while assuming a downward trend when OECD countries are taken into account. Hence, the spread between WTI and Brent oil prices widened (Charts 2.2.3 and 2.2.4).

Chart 2.2.3.
OECD Crude Oil Inventories*
(Million Barrel)



* Dotted lines denote projections on oil inventories.
Source: U.S. Department of Energy.

Chart 2.2.4.
Oil Prices
(USD/bbl)



Source: Bloomberg.

Prices of agricultural products edged up in the first quarter. Despite the increase in cultivated lands and production, the dry and hot weather conditions in Latin America, Argentina in particular, coupled with the probability of an adverse impact of the cold winter season in Europe on the agricultural production of Russia and Ukraine in particular, are considered to create significant uncertainty on the prices of agricultural products (Table 2.2.1).

Table 2.2.1.
Production, Consumption and Inventory Forecasts for Agricultural Commodities*

	2009/2010	2010/2011	2011/2012
WHEAT(million tons)			
Initial Inventory	167.1	202.5	198.7
Production	685.6	651.1	694.3
Consumption	65.0,2	654.8	686.8
Period-end Inventory	202.5	198.7	206.3
CORN (million tons)			
Initial Inventory	147.6	144.1	125.0
Production	819.4	829.0	865.0
Consumption	822.8	848.1	867.3
Period-end Inventory	144.1	125.0	122.7
COTTON (million bales)			
Initial Inventory	60.8	47.1	50.5
Production	102.6	116.6	123.1
Consumption	119.0	114.5	107.7
Period-end Inventory	47.1	50.5	66.1

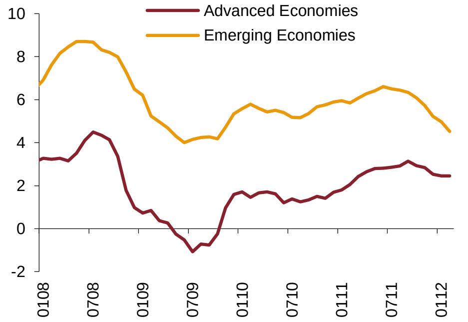
* The figures may be inconsistent due to discrepancies among countries on exports and imports data, as well as the loss and damage in the marketing network.
Source: US Department of Agriculture.

In sum, the fragile global growth outlook and the supply-side problems mainly fed by the energy sector generate upside risk on commodity prices, thereby constituting a major risk factor on the course of the global economic activity in the period ahead.

2.3. Global Inflation

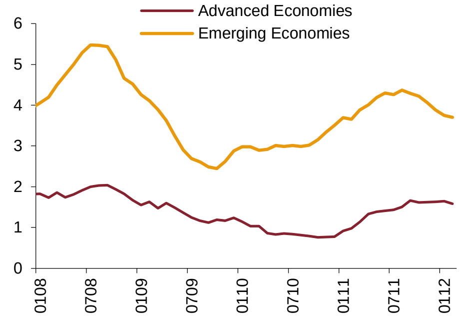
In the first quarter of 2012, inflation rates remained flat in advanced economies, while continuing to plunge in emerging economies (Chart2.3.1). The appreciation of exchange rate in emerging economies amid resurging capital inflows by early-2012 was influential on the course of inflation. Meanwhile, the high base effect in inflation due to elevated commodity prices in the first quarter of 2011 has started to wane, therefore accelerating the fall in inflation. In the meantime, core inflation rates moved in tandem with the headline inflation in both advanced and emerging economies (Chart 2.3.2).

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



Source: Bloomberg, CBRT.

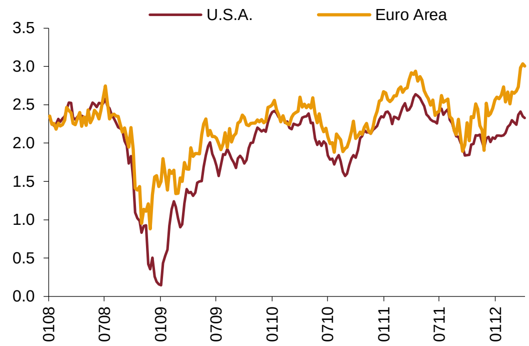
Chart 2.3.2.
Core Inflation in Advanced and Emerging Economies
(Seasonally Adjusted, Annual Percent Change)



Source: Bloomberg, Datastream, CBRT.

Inflation compensation soared in the first quarter, especially in the Euro Area, on the recently surging energy prices, as well as the expansionary monetary policies implemented by major central banks (Chart 2.3.3).

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



Source: Bloomberg.

Global inflation forecasts for 2012 were revised upwards in the inter-reporting period (Table 2.3.1). In the U.S. economy, the optimism brought about by the better-than-expected macroeconomic data led to notable upward revision of inflation expectations. In the Euro Area, the rising energy prices besides the tax rate hikes under the fiscal measures adopted by the debt-ridden countries were the major factors leading to upward revisions in inflation forecasts. The persistence of the surge in commodity prices may pose an upside pressure on global inflation in the period ahead.

Table 2.3.1.
Inflation Forecasts for end-2012
(Annual Percent Change)

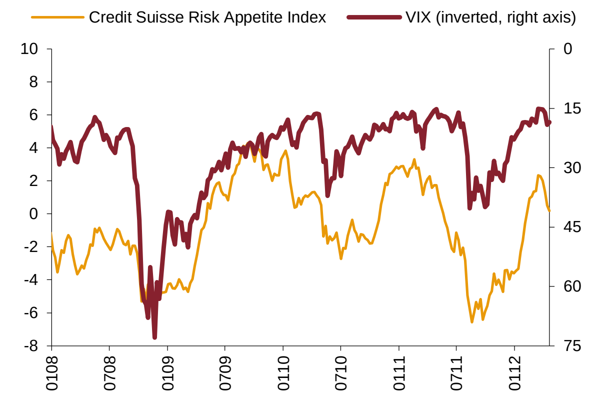
	January	April
World	2.8	3.0
Advanced Economies		
U.S.A.	1.9	2.3
Euro Area	1.9	2.3
Germany	1.8	2.0
France	1.7	2.1
Italy	2.3	3.0
Spain	1.6	1.8
Greece	0.8	0.9
Japan	-0.3	-0.2
U.K.	2.7	2.8
Emerging Economies		
Asia-Pacific	4.0	3.8
China	3.5	3.3
India	7.2	7.0
Latin America	6.2	6.0
Brazil	5.3	5.1
Eastern Europe	6.3	6.4

Source: Consensus Forecasts.

2.4. Financial Conditions and Risk Indicators

The prevention of a disorderly Greek default amid the completion of debt restructuring improved perceptions about the Euro Area debt crisis, while ECB's embarking on the second 3-year liquidity operation also eased markets. Moreover, the better-than-expected macroeconomic data in the U.S., especially for the labor market, also contributed to the air of confidence. Accordingly, global risk appetite soared in the first quarter of the year. However, the resurge of bond yields in Spain due to worsening economic outlook and the lower-than-anticipated rise in the U.S. employment in March adversely affected the risk appetite, thereby interrupting the course of improvement as of early-April (Chart 2.4.1).

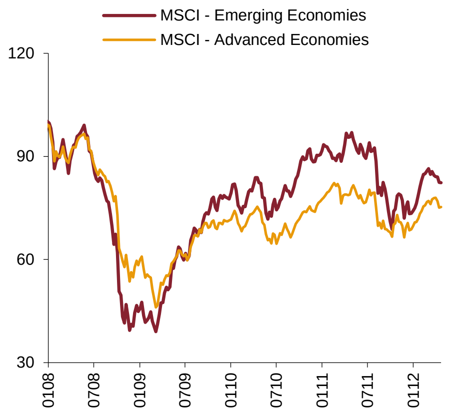
Chart 2.4.1.
Global Risk Appetite
(Point)



Source: Bloomberg, Credit Suisse.

In tandem with the soaring risk appetite, stock markets trended upwards in both advanced and emerging economies. Similarly, emerging market currencies, which saw notable depreciations in the second half of 2011 due to aggravating Euro Area debt crisis, re-appreciated in this period amid soaring risk appetite. However, emerging market currencies depreciated again amid the considerable deterioration in the risk appetite by early-April (Charts 2.4.2 and 2.4.3).

Chart 2.4.2.
Global Stock Markets
(December 2007=100)



Source: Bloomberg.

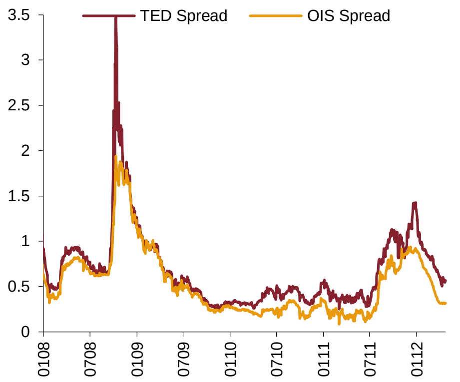
Chart 2.4.3.
Emerging Market Currencies*

* Arithmetical average of the exchange rates of emerging market currencies against the currency basket of 1 USD and 1 euro. Equals 100 on June 2007 and an upward movement denotes depreciation of the emerging market currencies.
Source: Bloomberg.

Despite adopted measures by the ECB and the capital enhancing plans proposed in accordance with the advice by the European Banking Authority, the Euro Area debt crisis continues to adversely affect the banking sector. As a matter of fact, the latest Global Financial Stability Report released by the IMF states that the Euro Area banking sector is expected to go through a substantial deleveraging, which will not only worsen the credit markets in the region, but also the international money and capital markets.

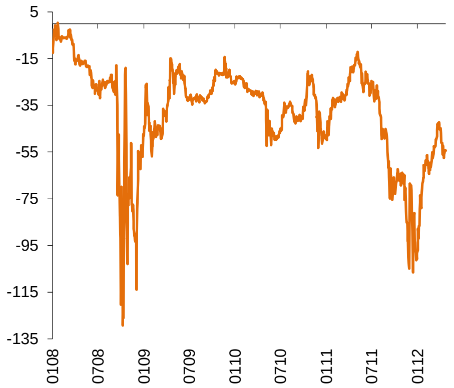
TED and OIS spreads narrowed after the completion of the first 3-year liquidity operation at the end of December 2011, while remaining high compared to pre-turmoil period before the second half of 2011 (Chart 2.4.4). The euro–USD swap rate also remained high, despite having declined as of end-2011, and trended upwards in tandem with the re-elevation of concerns over Spain (Chart 2.4.5). Notwithstanding the declining USD liquidity in the first quarter of 2012 provided by the liquidity swap agreement between Fed and other central banks in order to overcome the global USD liquidity crunch, the swap rate remained in the negative area, pointing that the counterparty risk is a major problem, thus confirming the outlook implied by the TED and OIS spreads.

Chart 2.4.4.
3-month TED and OIS Spreads
(Point)



Source: Bloomberg.

Chart 2.4.5.
Euro/USD Currency Swap Rate
(1-Year, Basis Point)



Source: Bloomberg.

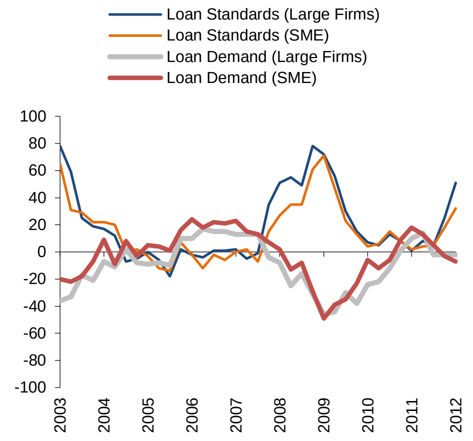
In fact, the current reading on the ITraxx Europe Senior Financials Index indicates the high level of premium paid against counterparty risk (Chart 2.4.6). The loss of confidence in the Euro Area banking sector results in higher cost of borrowing from alternative financing resources.

Chart 2.4.6.
ITraxx Europe Senior Financials Index
(5-year, Basis Point)

Source: Bloomberg.

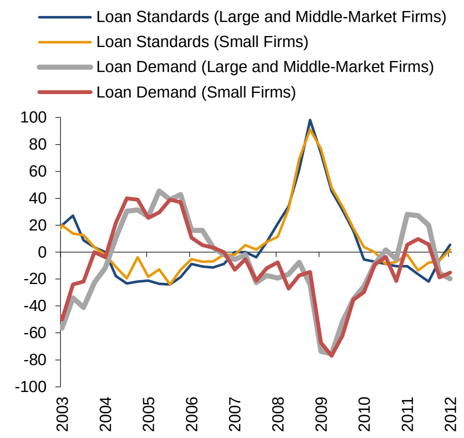
The Euro Area debt crisis and its adverse effects on the banking sector bring about setbacks in the credit mechanism, leading to heightened concerns over the sustainability of a steady growth. The recent lending survey released by the ECB pointed that credit conditions were significantly tightened in the second half of 2011, and credit demand edged down (Chart 2.4.7). Meanwhile, the latest lending survey of the Fed indicated a decline in credit demand despite the absence of a notable tightening in credit conditions (Chart 2.4.8).

Chart 2.4.7.
Lending Survey in the Euro Area*
(Percent)



* Upward movements indicate tightening in credit conditions.
Source: ECB.

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

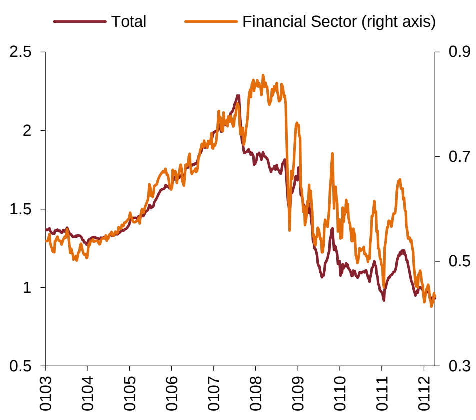


Source: Fed.

Analysis of the commercial paper market as well as the asset-backed securities market in the U.S. is crucial in order to better evaluate the debt market. The U.S. commercial paper market, which significantly met the liquidity needs of the financial and the corporate sector in the pre-crisis period, failed to improve markedly and remained quite below the peak in midst-2007 (Chart 2.4.9). The U.S. commercial paper market, which provides an important source of liquidity to the European banking sector[1], faced challenges regarding new issues and posted notable declines in the outstanding amount during May 2010 and the second half of 2011, which were both marked by the deepening of the debt crisis. Having expanded enormously in the pre-crisis period, and thus being criticized for generating asset bubbles, the U.S. asset-backed securities market has recently experienced a pause in the downward course of new issues, with the outstanding amount hovering quite below the pre-crisis period (Chart 2.4.10).

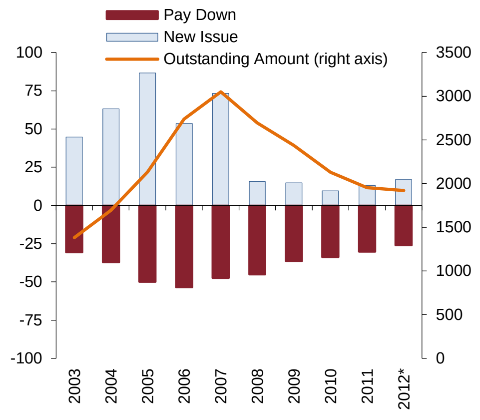
[1] Share of foreign financial sector participants is 18 percent as of April 2012.

Chart 2.4.9.
Outstanding Commercial Paper in the U.S.
(Trillion USD)



Source: Fed.

Chart 2.4.10.
U.S. Asset-Backed Securities Market
(Billion USD)



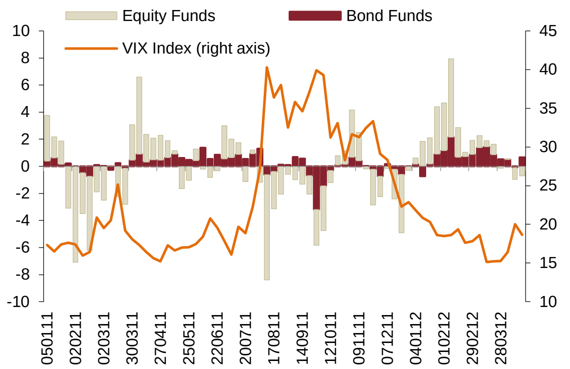
* As of March.
Source: Bloomberg.

The favorable performance of asset markets in the first quarter of 2012 amid declining risk perception and increasing risk appetite was interrupted by heightening concerns over Spain, thus signifying the severity of the Euro Area debt crisis as well as the fragility of the financial markets. Fragilities are also likely to soar in the event of a lower-than-anticipated economic growth, especially in the U.S. and China. Moreover, in a period of rapidly surging asset prices and globally eased monetary policies, inert debt markets besides mounting concerns over the acting institutions in the market necessitate further cautious stance.

2.5. Capital Flows

Having experienced outflows in the last quarter of 2011, emerging economies have seen capital inflows since early-2012. In tandem with the improving risk appetite, emerging economies witnessed a gradually accelerating capital flows in the first two months of the year. Capital inflows continued in March, albeit at a slower pace. Accordingly, capital inflows balanced the outflows in the last quarter of 2011, while also registering the 1-year high on a quantity basis. The breakdown of portfolio flows indicates that investors opted for equities in January and February, while mostly demanding bonds in March. Amid deterioration in the risk appetite as of early-April, emerging economies experienced capital outflows, especially from the equity funds (Chart 2.5.1).

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



Source: EPFR, Bloomberg.

Regional breakdown of portfolio flows to emerging economies shows that Latin American countries have recently attracted capital flows, which more than compensated for the outflows experienced in the previous quarter. Meanwhile, owing to the deteriorating growth expectations for the Euro Area, capital flows to emerging Europe, which has strong commercial and financial connections with the Euro Area countries, remained fairly limited.

Table 2.5.1.
Regional Breakdown of Portfolio Flows to Emerging Economies*
(Million USD, Percent)

	Total	Emerging Asia	Latin America	Emerging Europe	MENA
2011Q4	-11,553	-5,437 (47.1)	-2,552 (22.1)	-3,050 (26.4)	-514 (4.5)
2012Q1	32,429	14,744 (45.5)	9,333 (28.8)	5,685 (17.5)	2,667 (8.2)

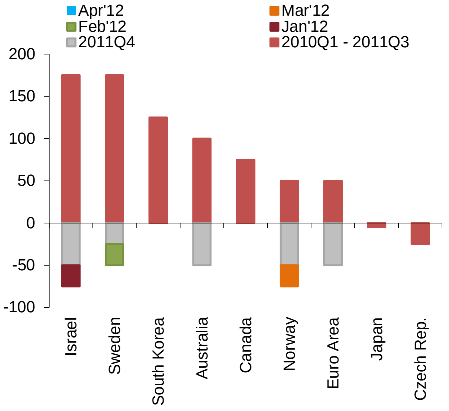
* Share of each region is given in parenthesis.
Source: EPFR.

2.6. Global Monetary Policy Developments

In the first quarter of 2012, monetary policy practices continued to remain loose, albeit at a slower pace, thereby underpinning the easing which was stated in the previous Report. The global economic activity remained non-inflationary, while supply-side problems, especially in oil prices, were interpreted by the central banks as the major factor to pose upside pressure on inflation. Against this background, policy rates were either lowered slightly or kept constant in general.

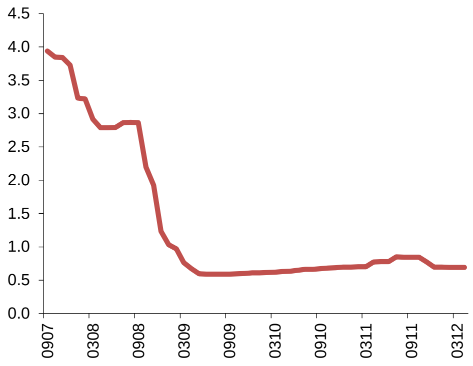
In the first quarter of 2012, the composite policy rate in advanced economies edged down on a quarterly basis, while Israel, Sweden and Norway opted for 25 basis points reduction (Charts 2.6.1 and 2.6.2).

Chart 2.6.1.
Policy Rate Changes in Advanced Economies from Jan. 2010 to Apr. 2012
(Basis Point)



* As of April 24, 2012.
Source: Bloomberg, CBRT.

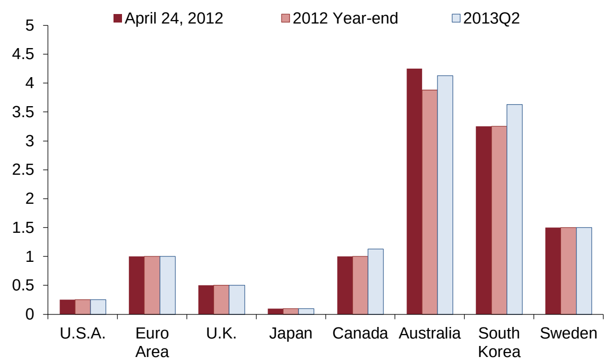
Chart 2.6.2.
Policy Rates in Advanced Economies*
(Percent)



* As of April 24, 2012.
Source: Bloomberg, CBRT.

Policy rates in advanced economies are expected to remain low for an extended period of time (Chart 2.6.3). In fact, Fed sent no signals for a deviation from its low long-term policy rate policy, which was announced at the start of the year. Given the unfavorable prospects for economic activity, especially in the Euro Area, other major central banks are also unlikely to opt for tightening until the year-end. In the inter-reporting period, policy rate expectations differed mostly for the Euro Area countries. In January, the ECB was expected to lower policy rate by an additional 25 basis points until the year-end, while in April, the policy rate was expected to be fixed until the second half of 2013. Central banks in advanced economies, excluding Fed, ECB, BoE and BoJ, are expected to deliver limited policy rate hikes, especially in the first half of 2013 (Chart 2.6.3).

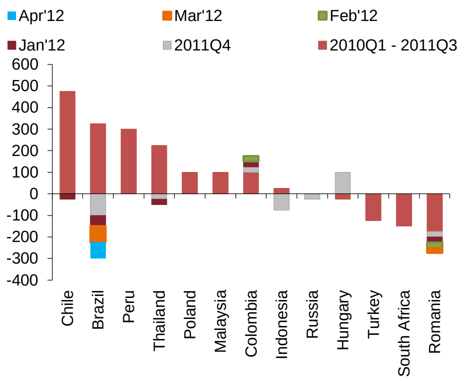
Chart 2.6.3.
Expected Policy Rates in Advanced Economies
(Percent)



Source: Bloomberg.

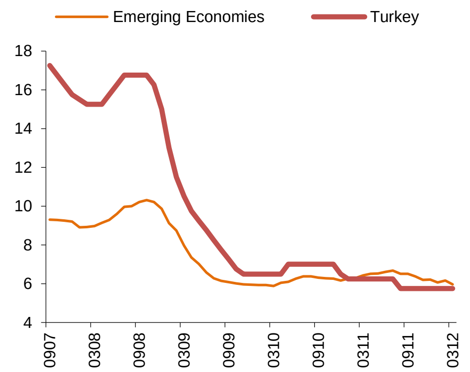
As for the emerging economies, Colombia continued with policy rate hikes in the first quarter of 2012, while Brazil and Romania diverged from peer-emerging economies, by opting for sizeable reductions of 125 and 75 basis points, respectively. Brazil continued to lower policy rates in April, delivering a rate cut by 75 basis points. Meanwhile, other emerging economies either kept their policy rates unchanged or imposed slight reductions (Chart 2.6.4). The composite index suggests that in the first quarter of 2012, the average policy rate in emerging economies posted a quarterly decline by 25 basis points to 5.97 percent, and further down to 5.79 percent, following Brazil's rate cut in April (Chart 2.6.5). Meanwhile, China and India[2] kept their policy rates unchanged in the first quarter, while pursuing monetary easing through other policy instruments. More specifically, China and India reduced required reserve ratios by 50 and 75 basis points, respectively, while India also opted for quantitative easing through bond purchases in March. Moreover, the Reserve Bank of India delivered a discount rate hike by 350 basis points, while also underlining that rather than being a monetary policy maneuver, the discount rate hike was a one-time technical adjustment.

Chart 2.6.4.
Policy Rate Changes in Emerging Economies from January 2010 to April 2012*
(Basis Points)



* As of April 24, 2012.
Source: Bloomberg, CBRT.

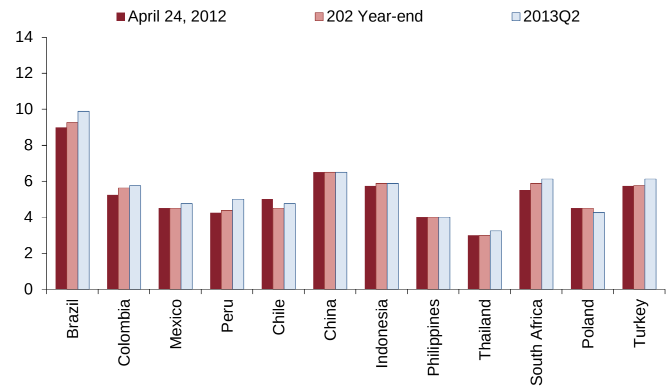
Chart 2.6.5.
Policy Rates in Inflation-Targeting Emerging Economies
(Percent)



Expected policy rates for end-2012 differ across countries. Accordingly, some countries are expected to keep their policy rates unchanged, while others are expected to deliver policy rates hikes (Chart 2.6.6). However, expected changes in policy rates are fairly limited, with no expectation for an aggressive policy response.

[2] India lowered policy rates by 50 basis points in April.

Chart 2.6.6.
Expected Policy Rates in Emerging Economies
(Basis Point)



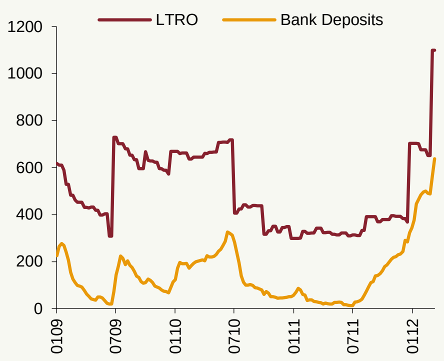
Source: Bloomberg.

Box 2.1 Recent Developments in the Euro Area

In the first quarter of 2012, the ECB conducted further operations regarding European banks. Completion of the Greek debt restructuring and the approval of the new aid package were important steps towards the improvement of the global risk appetite, which was interrupted owing to the resurge in borrowing costs in Spain and Italy from April onwards. In that respect, the failure to immediately enforce the fiscal consolidation measures across the region stands out as a major factor to heighten uncertainties regarding debt sustainability. Against this background, this Box briefly evaluates recent developments that stand out in the Euro Area.

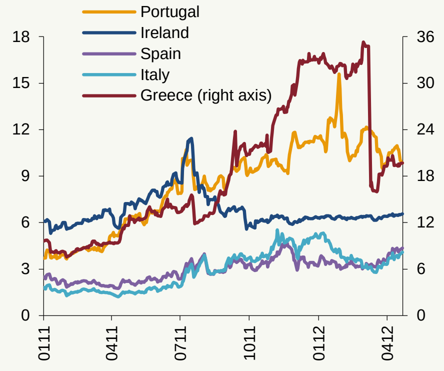
ECB conducted its second 3-year Long-Term Refinancing Operation (LTRO) on February 29, after running the first on December 21, 2011. With an increased number of participating banks from the previous operation, 800 banks within the Eurosystem were provided with a liquidity of euro 530 billion (Chart 1). Although a sizeable share of the provided liquidity was consequently retained as deposits at the ECB, the liquidity operations were deemed successful given the limited access of the Euro Area banks to alternative funding resources. As a matter of fact, the declining bond yields of the heavily-indebted countries following the operation alleviated the controversies over debt sustainability.

Chart 1. Long-Term Refinancing Operation and Bank Deposits
(Billion Euro)



Source: Bloomberg.

Chart 2. Bond Yield Spreads in Heavily-Indebted Countries over German Bonds (10-year, Points)

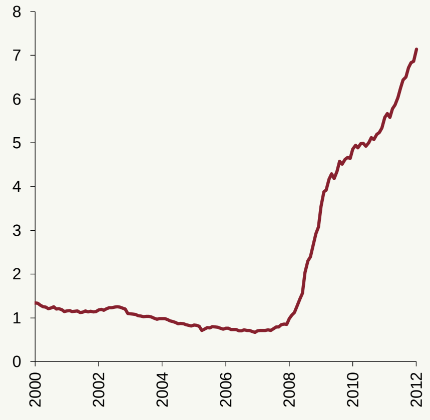


Source: Bloomberg.

The gradually deepening debt sustainability problem in Greece was resolved in March. Under the Private Sector Involvement, 86 percent of the Greek bondholders agreed to participate in the voluntary swap, and 96 percent of the outstanding debt was converted upon the government's retroactively insertion of the Collective Action Clause. Hence, the Greek debt stock was lowered by euro 100 billion. After the completion of the debt swap and the approval of the requested structural and cyclical measures at the parliament, EU countries and the IMF agreed on the release of the aid package amounting to euro 130 billion. Accordingly, the debt stock to GDP ratio in Greece, which was expected to reach 189 percent in 2012, is estimated to go down to 120 percent by 2020.

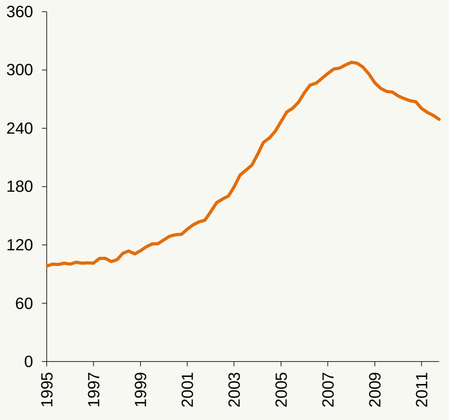
Following the debt swap, the bond yield spreads of the Greek bonds dropped, while bond rates in Portugal, Italy and Spain soared, thereby fuelling concerns over the region (Chart 2). Contraction of the economic activity, rising unemployment as well as banking sector problems caused bond yield spreads to surge, while also deteriorating the risk appetite, thus adversely affecting the non-Euro Area countries as well.

Chart 3. Bad Loans to Total Loans in Spain
(Percent)



Source: Bank of Spain.

Chart 4. Housing Price İndex for Spain
(Nominal, 1995=100)



Source: Bank of Spain.

Heavy job loss experienced by the contractual employees that constitute one thirds of the total labor force was the major source of unemployment in Spain with a rigid labor market structure.[3] Besides labor market problems, the ongoing fall in the real estate prices led to a surge in bad loans, thus affecting the banking sector adversely (Chart 3 and 4). The breakdown of bad loans by sectors show that construction and the related sectors constitute a major portion of the overall bad loans.

In the period ahead, the Euro Area debt crisis will continue to play a major role over the course of the global risk appetite. Thus, Euro Area countries should closely be monitored with respect to their growth and budget performances as well as their labor market developments. Furthermore, aggravation of the economic problems in Spain is considered to be the major risk factor in the short term.

[3] Spain ranks above the OECD average in the index for the strictness of the Employment Protection Legislation, thus implying that the Spanish labor markets are strict. The contractual employment conditions regulated by the reform program of 1980s constitute a dual structure in the labor market. Due to average maturity of contracts, which is less than 1 year, contractual employment declines rapidly and drastically during contractionary periods of demand. This dominating labor market structure in Spain leads to comparatively notable fluctuations in unemployment than in other advanced countries.