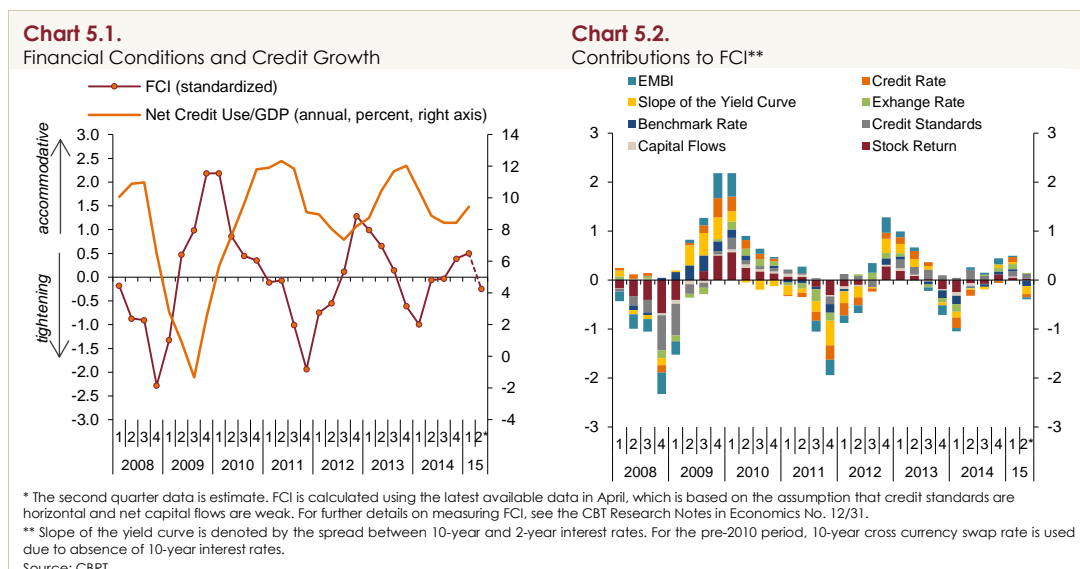


5. Financial Markets and Financial Intermediation

Exchange rates and portfolio flows were highly volatile in the first quarter of 2015 due to uneven economic growth across the globe and the resulting divergence of monetary policy actions. In addition to the heightened volatility across global financial markets, the ongoing negative outlook for countries such as Russia and Brazil dampened the risk appetite for emerging economies. The fall in oil prices induced by weak global demand and the excess supply place energy-importing Turkey in an advantageous position in terms of inflation and external balance. Moreover, hovering at low levels despite the uncertainty over global monetary policies, long-term market rates also appear accommodating. Yet, the weak external demand and the developments in EUR/USD parity in favor of the US dollar stand out as factors that might challenge Turkey's external trade performance.

The FCI for Turkey signals some loosening for the first quarter of 2015 due to base effects (Charts 5.1 and 5.2). However, financial market data available in April indicate that financial conditions began to tighten again in the second quarter. Accordingly, the FCI shows a moderate tightening below the neutral mark in the early second quarter. The soon-to-end low policy rate environment in advanced economies, such as the US and the UK, and the ongoing cautious monetary policy stance in Turkey feed into the possibility of further financial tightening for the remainder of the quarter. Thus, loan growth may also continue to follow a pattern consistent with financial stability in the upcoming period. The reasonable levels of loan growth as well as the faster growth of commercial loans compared to consumer loans contribute to macrofinancial stability and disinflation.

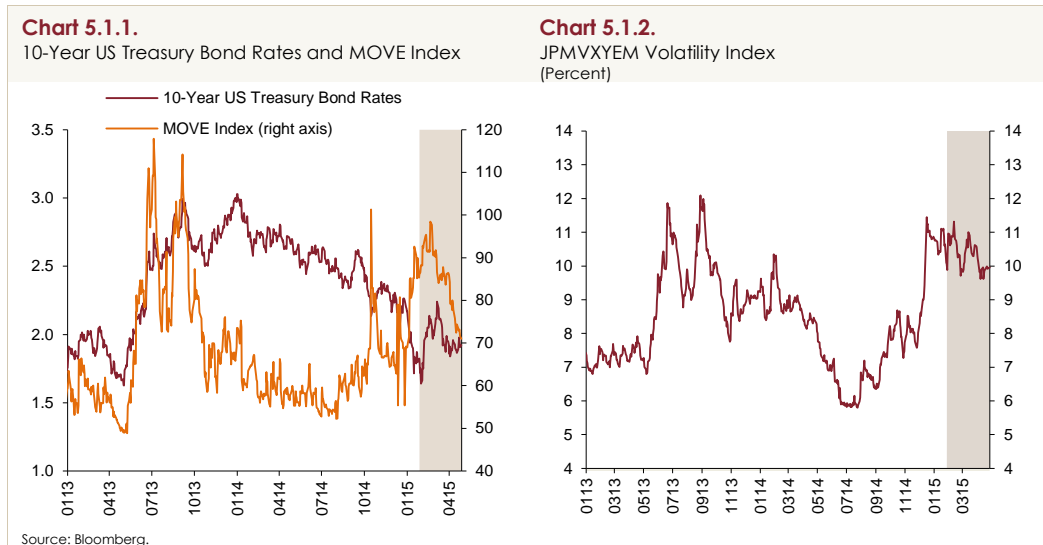


5.1. Financial Markets

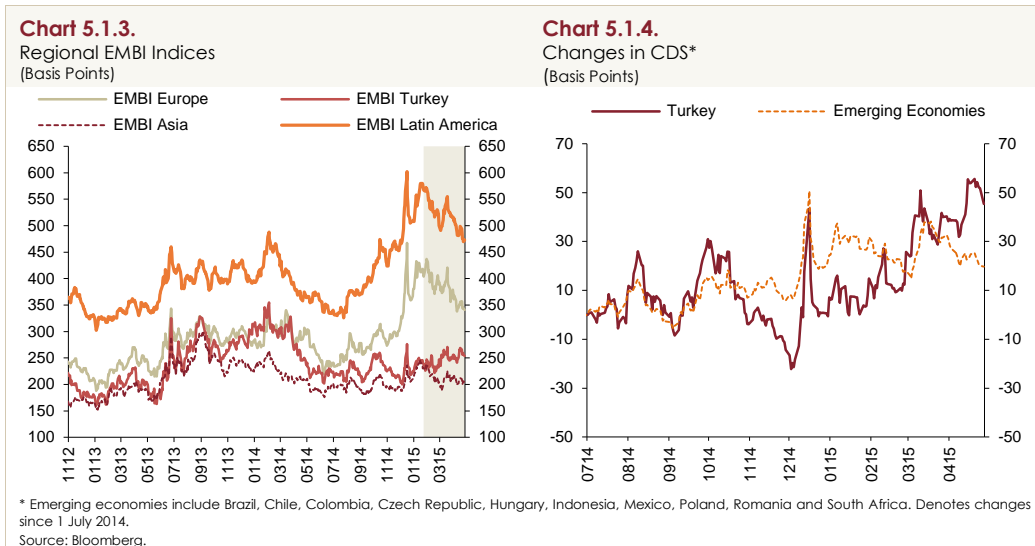
Global Risk Perceptions

Amid continued uncertainty over global monetary policies, the US and Euro Area monetary policy actions diverged remarkably in the first quarter of 2015. For the US economy, the growth in 2014 and the early first quarter recovery in leading indicators strengthened the expectations that the Fed would start normalizing monetary policy soon. On the other hand, the ECB kept the key interest rates on marginal lending and deposit facility within a negative territory in view of the ongoing weakening in Euro Area economic activity and the current deflationary environment, and started to purchase government bonds as part of its program to buy asset-backed securities to revive the economy. Meanwhile, BoJ continued with its quantitative and qualitative easing programs to both support the economy and raise inflation up to 2 percent.

The ongoing global monetary policy uncertainty caused volatility indices to see record highs in this period (Charts 5.1.1 and 5.1.2). The US long-term rates rose due to the sentiment that the Fed would start a sooner-than-expected normalization at the beginning of the quarter, but followed a fluctuating path since global markets are highly data and news-sensitive (Chart 5.1.1).

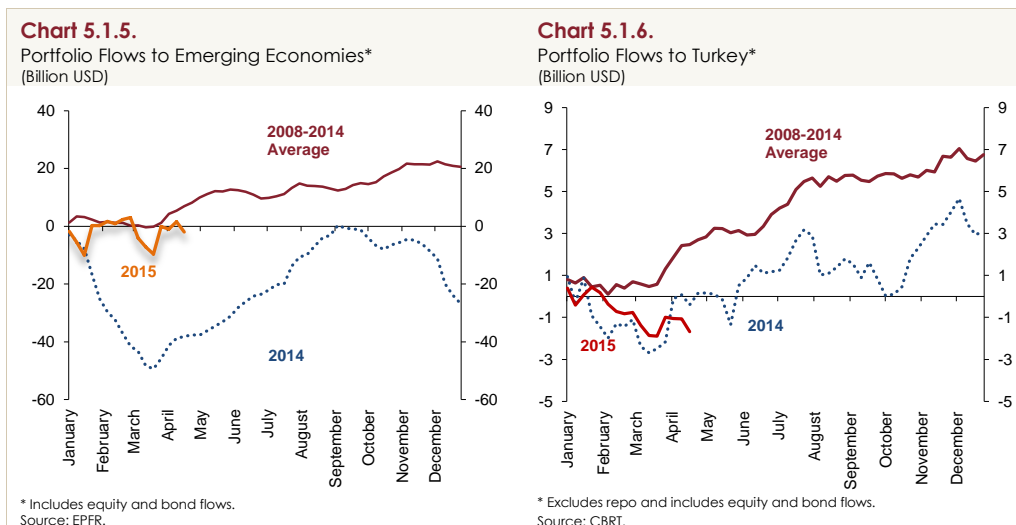


In the first quarter of 2015, the continued uncertainty about a Fed rate hike, lingering concerns over the Euro Area economic activity, worse-than-expected emerging market growth rates and geopolitical tensions caused volatility in risk indicators. After the fourth-quarter increase in 2014, the EMBI saw some decline in the first quarter of 2015 yet followed a fluctuating course (Chart 5.1.3). On the other hand, having remained extremely volatile through the fourth quarter of 2014, the CDS premiums assumed a slightly upward yet similarly volatile course in the first quarter of 2015 (Chart 5.1.4).



Portfolio Flows

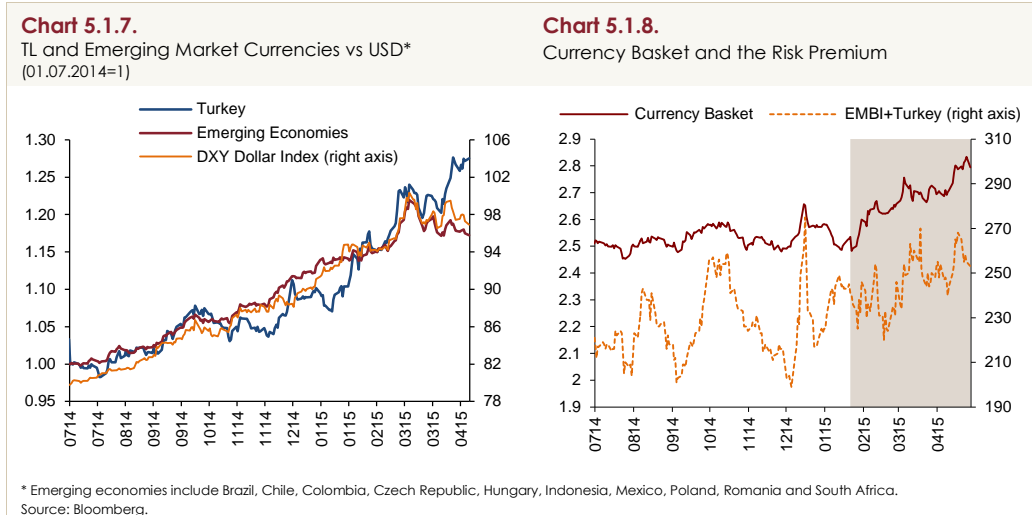
Against this background, cumulative portfolio flows to emerging economies neared zero in the first quarter of 2015 (Chart 5.1.5). In this period, portfolio flows to Turkey decreased slightly, albeit following a volatile pattern (Chart 5.1.6).



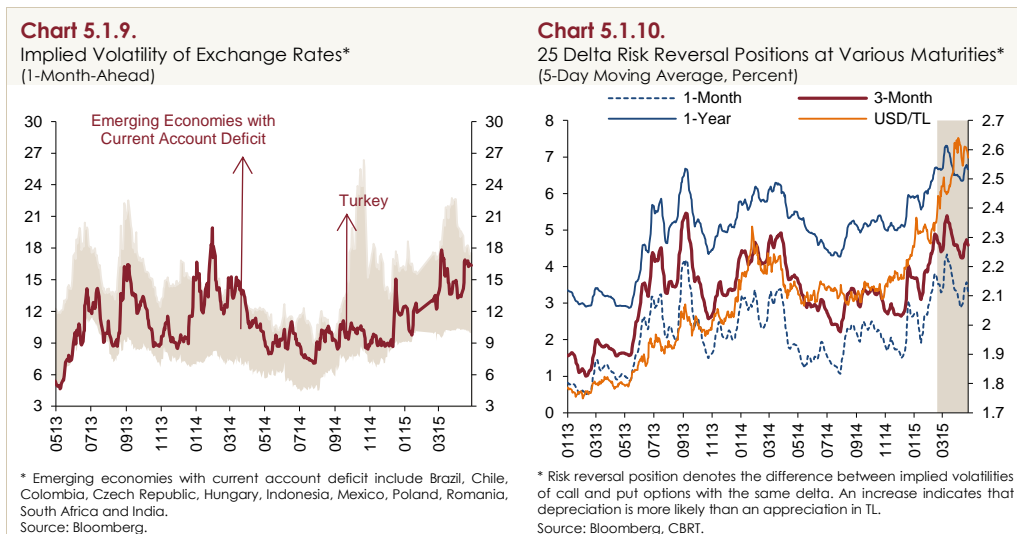
Exchange Rates

The benign first-quarter US data on growth and employment, the economic recovery hinted by leading indicators and the Fed's announcements led to an expectation in the markets that the Fed might start to normalize monetary policy earlier than estimated. On the other hand, the ongoing loose monetary policy maintained through accommodative quantitative easing measures by the ECB and BoJ caused the US dollar index to rise sharply. Since the latest reporting period, emerging market currencies have depreciated substantially against the US dollar. In this period, the Turkish lira followed a slightly different pattern vis-à-vis the US dollar compared to other emerging market currencies (Chart 5.1.7).

In the first quarter, the relationship between the exchange rate basket and the risk premium weakened slightly as the exchange rate basket recorded a significant increase whereas the risk premium remained volatile yet almost horizontal (Chart 5.1.8). The exchange rate basket, which was around 2.52 TL on 27 January 2015, the publication date of the January Inflation Report, stood at 2.79 TL on 27 April 2015. The Turkish lira depreciated by around 12.2 and 7.8 percent against the USD and the EUR, respectively.



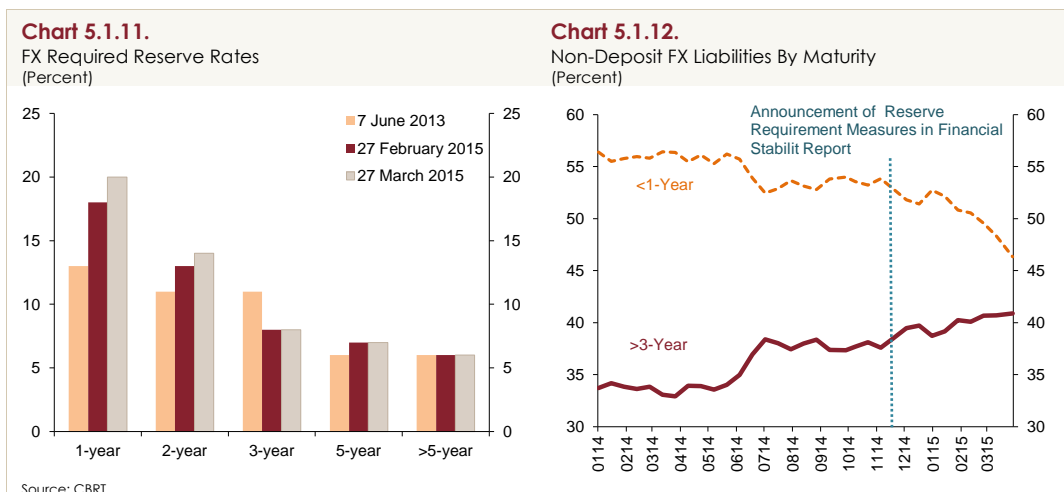
Against these developments, implied exchange rate volatilities of the emerging market currencies showed an undulating pattern of increase in the first quarter of 2015 (Chart 5.1.9). In line with the recent unfavorable course of the global risk appetite, the implied volatility of the Turkish lira has heightened on par with the currencies of other emerging economies. Additionally, the movement in exchange rates observed as of the middle of the last quarter was also reflected in risk reversal positions that denote the differences among the volatilities implied by call and put options. Amid developments in implied exchange rate volatilities since December, risk reversal positions have also increased (Chart 5.1.10.). The increase in this difference shows that expectations for depreciation in the Turkish lira outweigh those for an appreciation.



Monetary Policy

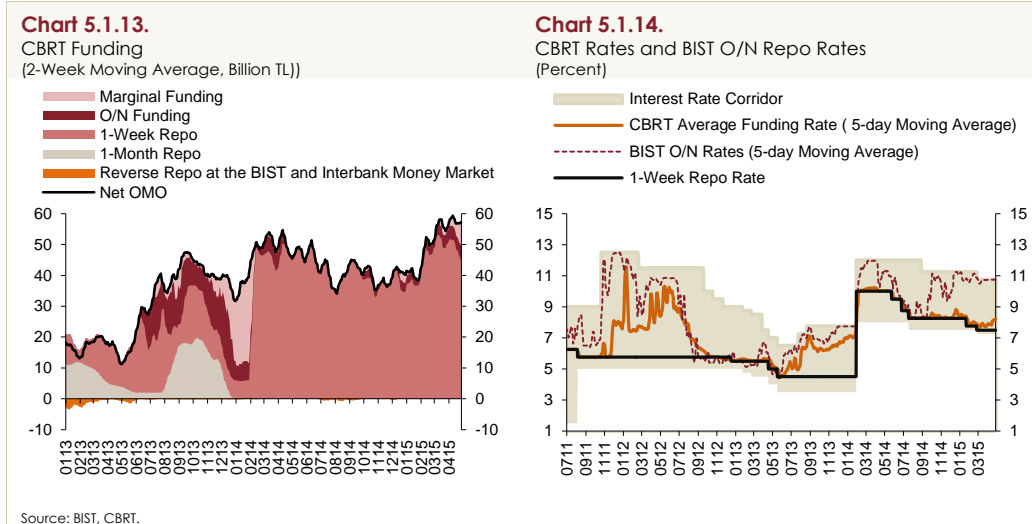
The increased uncertainties amid the divergence among the monetary policies of advanced economies, the reduced predictability of the global economy and the low levels of inflation in advanced economies cause global markets to remain highly data-sensitive. Thus, the CBRT maintained its cautious monetary policy stance and implemented measured rate cuts in view of the improved indicators on inflation excluding energy and food, and inflation expectations. Accordingly, the CBRT cut the 1-week repo auction rate from 8.25 percent to 7.75 percent in January. In February, the 1-week repo auction rate was lowered to 7.5 percent; the overnight lending rate was cut from 11.25 to 10.75 percent; the interest rate on borrowing facilities provided for primary dealers via repo transactions was reduced from 10.75 to 10.25 percent and the overnight borrowing rate was lowered from 7.5 to 7.25 percent. Moreover, the late liquidity window lending rate was reduced from 12.75 to 12.25 percent. In March and April, policy rates were left unchanged given global market uncertainties and elevated food prices.

Amid global developments in policy rates, the CBRT lowered the 1-week FX deposit interest rate from 7.5 to 4.5 percent for USD and from 6.5 to 2.5 percent for EUR on 10 March 2015 in order to support a balanced growth and steady capital flows in Turkey. Additionally, effective as of 24 April 2015, the FX deposit interest rate was cut a second time to 4 percent for USD and 2 percent for EUR. Moreover, in an effort to support financial stability, the CBRT announced on 10 March 2015 that the required reserve ratios applied to non-core FX short-term liabilities of banks and financing companies were raised to encourage banks to extend the maturities of their external borrowing (Chart 5.1.11). These measures are believed to support prudential borrowing and lessen macrofinancial risks caused by the uncertainties surrounding global financial markets and economic activity. Since the announcement of reserve requirement measures on non-deposit liabilities in the Financial Stability Report of November 2014, the maturity of liabilities has tended to rise (Chart 5.1.12).

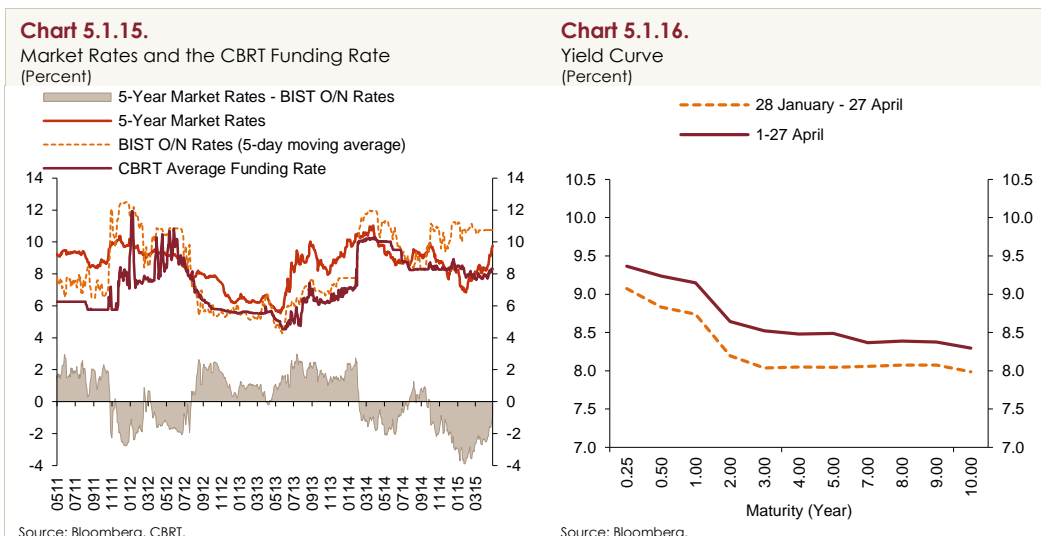


The CBRT funding has been provided mostly through 1-week repo auctions since the publication of the January Inflation Report (Chart 5.1.13). Meanwhile, given the volatility in financial markets since September 2014, the cautious monetary policy has been supported by a tight liquidity policy. Thus, the

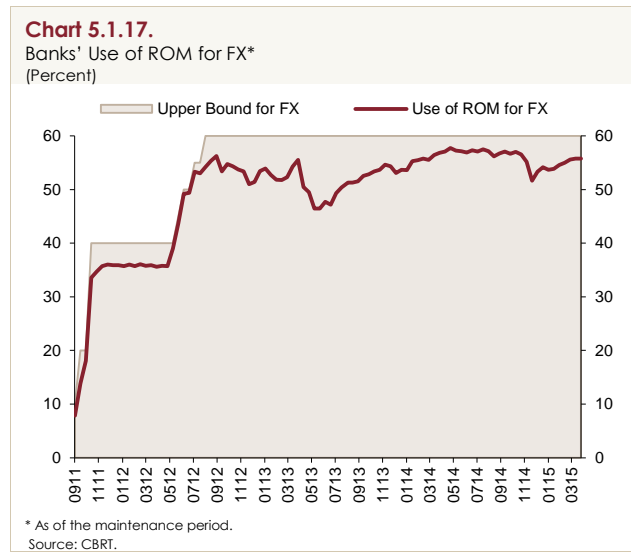
BIST overnight repo rates have remained close to the upper band of the interest rate corridor since the publication of the January Inflation Report due to the liquidity policy (Chart 5.1.14).



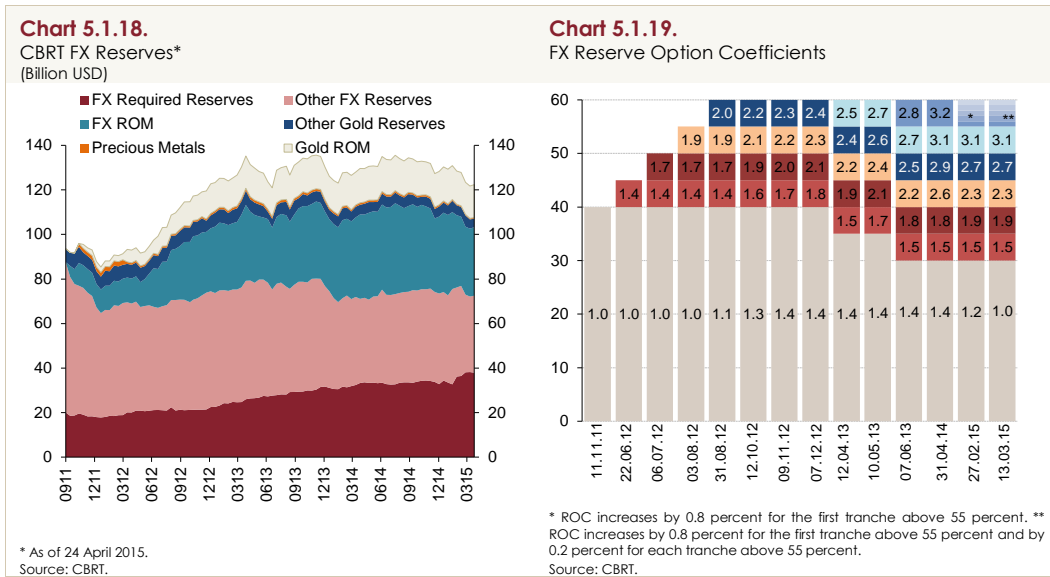
The CBRT implemented measured policy rate cuts in January and February and maintained its cautious monetary policy stance by keeping the yield curve flat. The spread between 5-year market rates and the BIST overnight repo rates has been taking negative values since the last quarter of 2014 (Chart 5.1.15). Owing to the tight liquidity policy stance, market rates have posted some increase and the yield curve has remained nearly flat (Chart 5.1.16). The CBRT will continue to closely monitor inflation expectations, pricing behavior and other factors that affect inflation in the forthcoming period and maintain its cautious monetary policy stance by keeping the yield curve flat until there is a significant improvement in the inflation outlook.



With the announcement on 10 March 2015, the CBRT introduced changes to reserve option coefficients in order to meet the temporary FX liquidity needs of the financial system. Accordingly, the ROC in the first 30 percent tranche was lowered by 0.2 points. The ROC for tranches above 55 percent, on the other hand, was raised by 0.6 points (Chart 5.1.19). Moreover, to reduce the TL-denominated intermediation costs, the MPC decided on 22 April 2015 that the remuneration rate for the required reserves maintained in Turkish lira would be raised by 50 basis points, effective as of 8 May 2015. The use of ROM by banks stood at 93 percent (55.8/60) for FX and 91 percent (27.4/30) for gold as of the 24 April 2015 maintenance period (Chart 5.1.17).

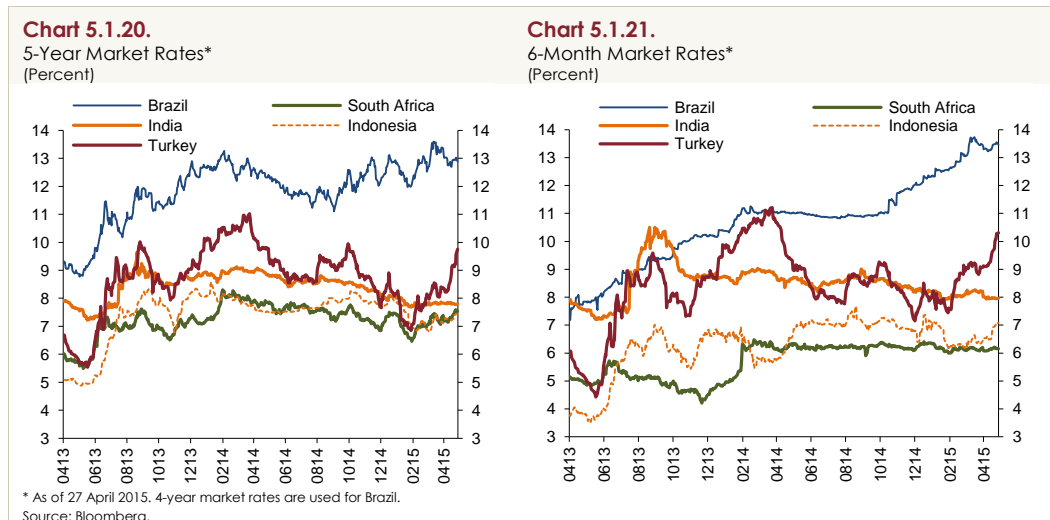


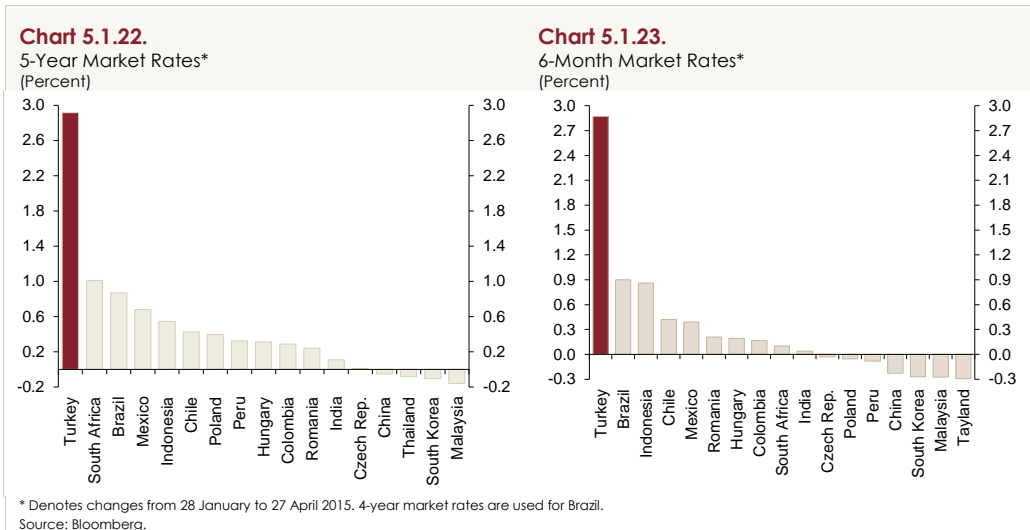
CBRT reserves have declined slightly compared to the previous reporting period (Chart 5.1.18). In this period, banks' reserves maintained under the FX reserve option decreased due to adjustments to the ROM, which, however, was partially offset by the growth in the reserves maintained against the FX reserve requirement. In view of the recently heightened volatility in exchange rates, the CBRT announced that it would set the amount of FX selling auctions on a daily basis depending on the conditions in the FX market starting from 27 February 2015. To this end, the CBRT announced that, on days when deemed necessary, it might increase the FX selling auction amount by up to 50 percent above the pre-announced minimum amount. On 10 April 2015, the wording "up to 50 percent above" was changed to "up to USD 30 million above". In the upcoming period, continuing with FX selling auctions and direct FX sales to energy-importing SEEs will lower CBRT's FX reserves, while export re-discount credits will add to them. As the use of reserve options will decline in case the remuneration rate on required reserves is raised, the system will require more CBRT funding, delivering the same effect as FX sales.



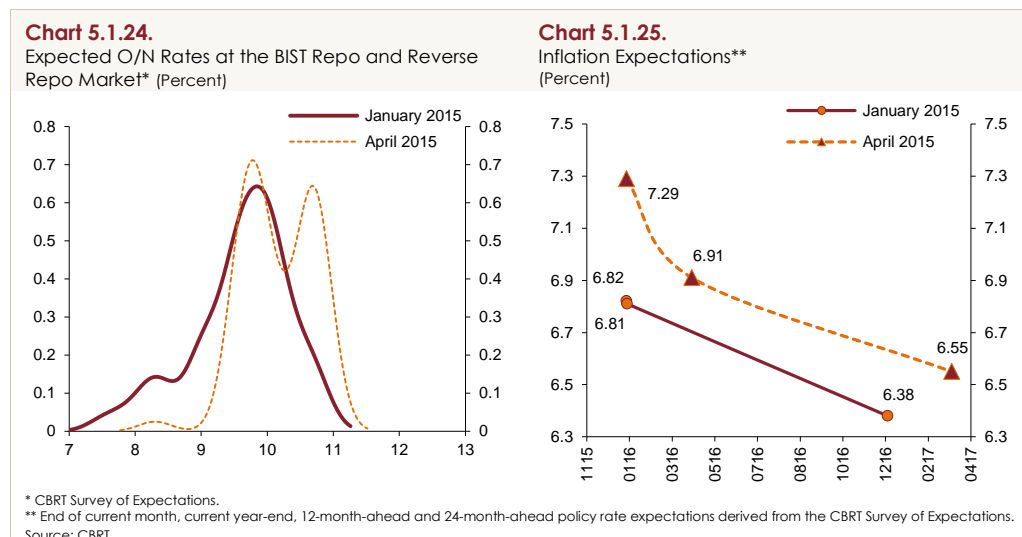
Market Rates

The volatility driven by the uncertainty over monetary policies in advanced economies caused market rates to rise in the first quarter of 2015. The heightened interest rate volatility that started in the previous quarter in Brazil, Indonesia, South Africa and Turkey continued into the first quarter of 2015 (Charts 5.1.20 and 5.1.21). Looking at individual countries, Turkey has stood out with the highest jump in 5-year and 6-month rates. This relative increase is largely attributed to the base effect from the fall in the first half of the previous reporting period as well as to Turkey's proximity to regions dominated by geopolitical and economic risks (Charts 5.1.22 and 5.1.23).



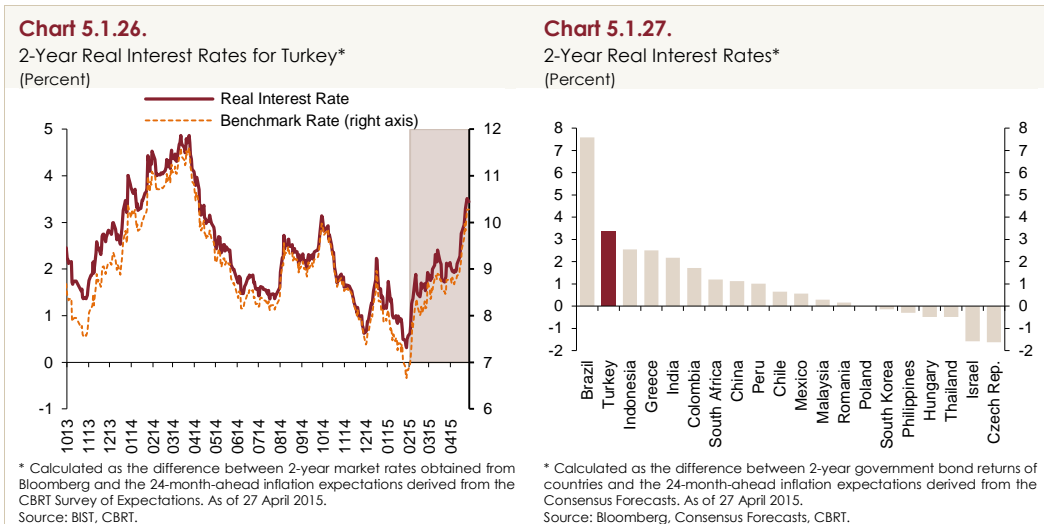


Thanks to the CBRT's cautious monetary policy stance backed by a tight liquidity policy in the first quarter of 2015, BIST overnight repo rates remained close to the upper limit of the interest rate corridor (Chart 5.1.14). Thus, the median of the expected overnight rate distribution at the BIST Repo and Reverse Repo Market shifted right in the inter-reporting period, partly due to the rising fluctuation in financial markets (Chart 5.1.24). Meanwhile, April expectations for the current year-end inflation posted some increase compared to January (Chart 5.1.25). However, the increase in expectations for the 12-month and 24-month-ahead inflation was minor compared to that for the current year-end inflation, suggesting that the recently heightened exchange rate volatility has a greater impact on short-term inflation expectations.



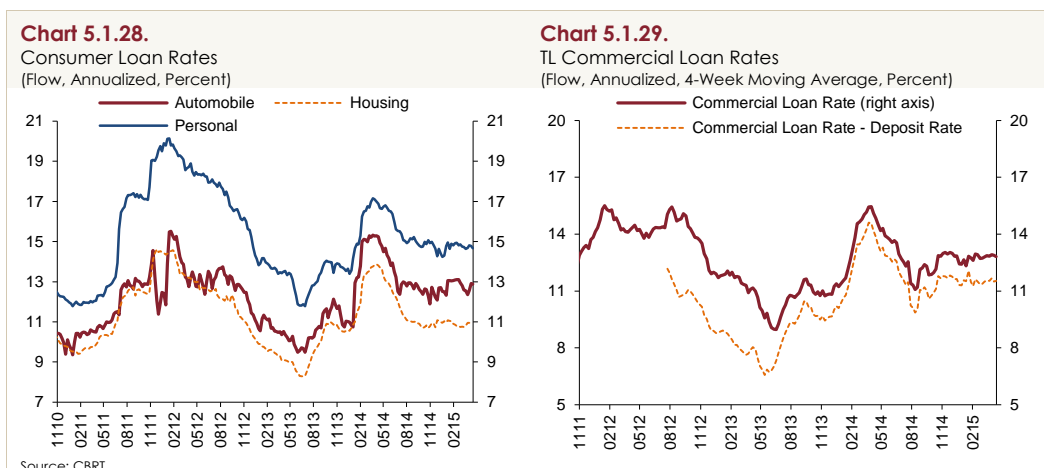
In the first quarter of 2015, real interest rates in Turkey continued to follow a fluctuating course on par with the developments in global markets and recorded an increase compared to the previous reporting period. Due to the limited surge in 2-year inflation expectations in April, the course of nominal interest rates continued to be the main determinant of the real interest rates in this quarter (Chart 5.1.26). After increasing in February and March, the benchmark rate continued to hover below

9 percent during the first half of April following the MPC's March decision, which stated that the CBRT would maintain the cautious monetary policy stance until there is a significant improvement in the inflation outlook. Yet, with the increased exchange rate volatility in the second half of April, the benchmark rate neared its 2014 reading. However, Turkey's 2-year real interest rate did not diverge from other emerging economies despite ranking notably high (Chart 5.1.27).



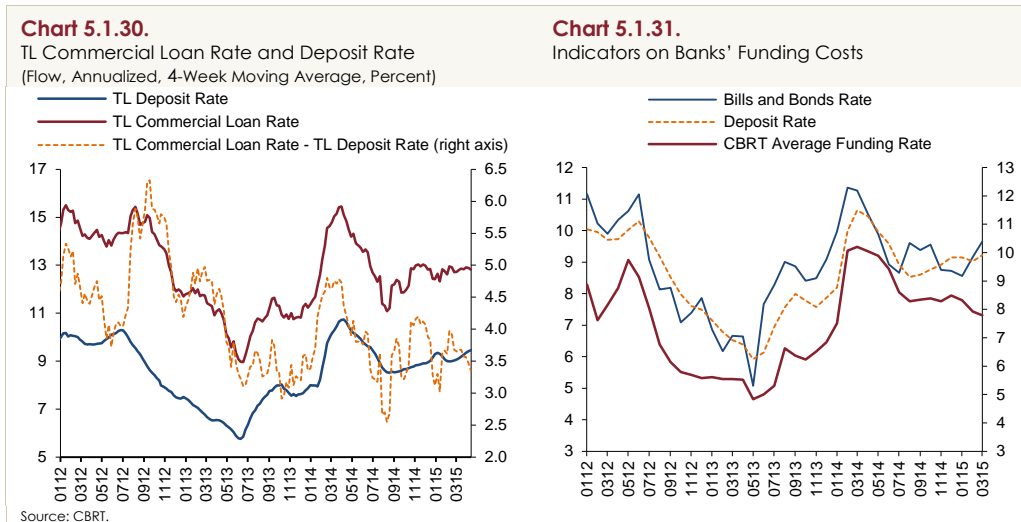
Loan Rates and Banking Sector Funding Costs

Rates on loans extended to the non-financial sector remained flat in the first quarter of 2015. Housing loan rates dropped by 20 basis points quarter-on-quarter, whereas personal loan rates rose by 30 basis points quarter-on-quarter (Chart 5.1.28). Commercial loan rates were up 40 basis points quarter-on-quarter (Chart 5.1.29). According to the Loan Tendency Survey results, commercial loan standards remained basically unchanged from the previous quarter in the first quarter of 2015. Meanwhile, across subcategories of consumer loans, standards for personal loans tightened whereas standards for housing and automobile loans barely changed.



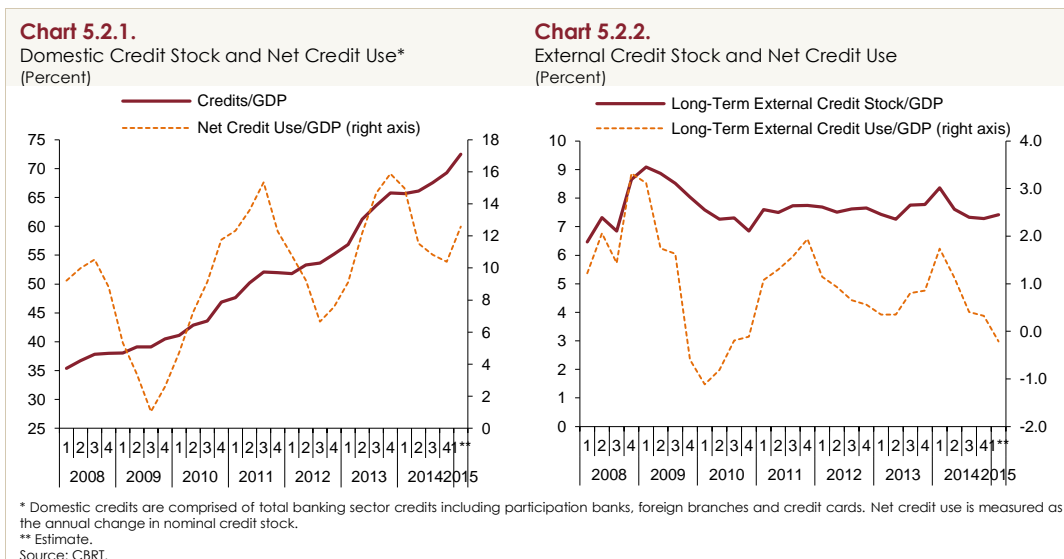
After declining in the first months of 2015, deposit rates picked up again in March, increasing by 11 basis points quarter-on-quarter in the first quarter. In the Loan Tendency Survey, banks claimed that both domestic and external funding conditions were tighter in the first quarter. Commercial loan rates

rose higher than deposit rates in the first quarter, widening the spread between commercial loan rates and deposit rates up to 3.57 percent (Chart 5.1.30). The CBRT average funding rate fell in the first quarter of 2015, while both rates on bills and bonds issued by banks and deposit rates increased on par with rising short-term rates (Chart 5.1.31).

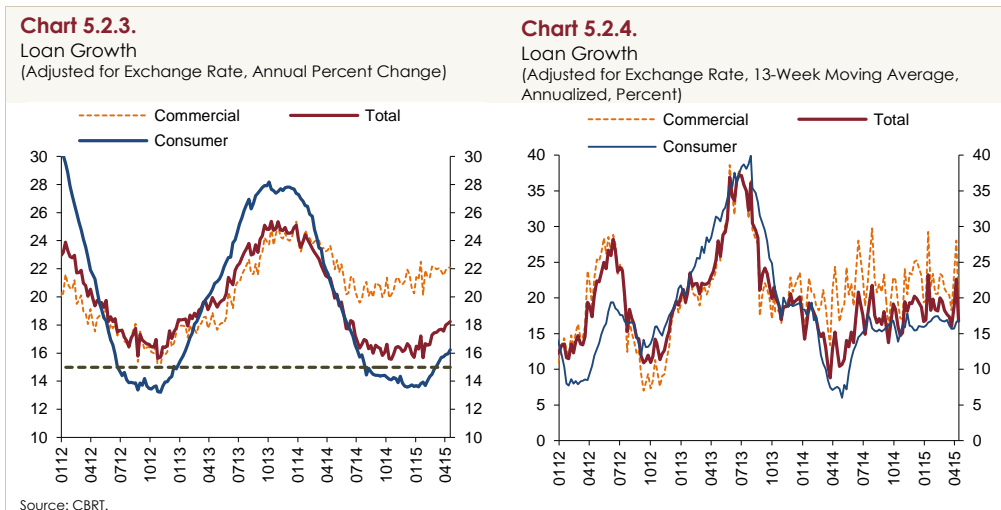


5.2. Credit Volume and Monetary Indicators

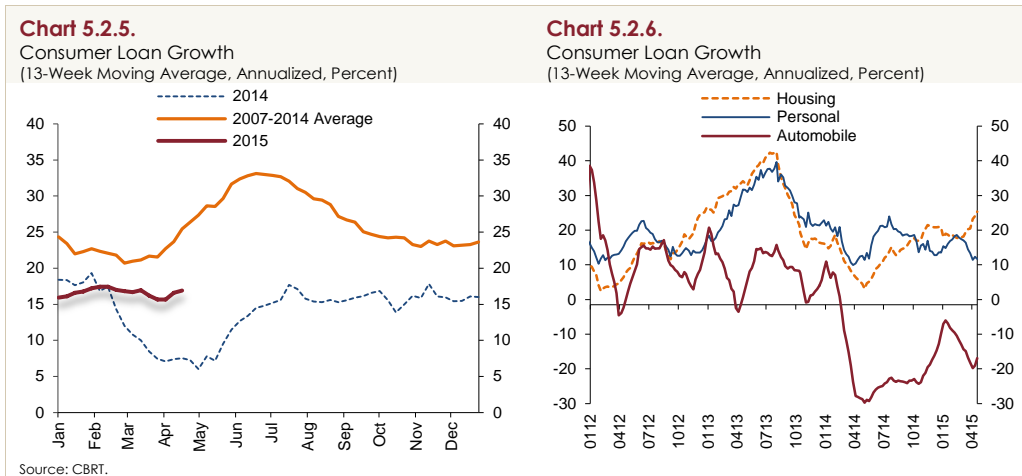
The net credits to the GDP ratio, which is critical to financial stability and an indicator of the relationship of credit growth with economic activity and aggregate demand, edged slightly upward from the previous quarter to 12.6 percent in the first quarter of 2015 (Chart 5.2.1). With the CBRT's prudent monetary policy stance and macroprudential measures, the net credits to the GDP ratio is expected to remain on a moderate track in the upcoming period. Meanwhile, firms' external credit use remained close to historical averages in the first quarter of 2015, implying that firms had easy access to external borrowing (Chart 5.2.2). However, firms' external credit use appears to have decreased year-on-year.



The annual growth rate of loans extended to the non-financial sector, which had been slowing due to the CBRT's cautious monetary policy stance and the BRSA's measures introduced in early 2014, increased modestly in the first quarter of 2015. The annualized total loan growth rate reflecting loan developments over the past three months remains close to past years' averages. Due to measures by the BRSA and the weak course of consumer confidence indices, commercial loans continue to grow at a faster pace than consumer loans. Against these developments, loans extended to the non-financial sector posted a 17.6 percent year-on-year growth in exchange rate adjusted terms at the end of the first quarter of 2015, while, in annualized terms, they recorded a 16 percent growth as suggested by the 13-week moving average rate covering the first quarter of 2015 (Charts 5.2.3 and 5.2.4). The similar course of growth in year-on-year and annualized terms implies that the total credit growth rate will remain nearly flat in the short term. The Loan Tendency Survey results indicate that commercial loan standards will see some tightening in the second quarter of 2015. By size of enterprises, loan standards are expected to remain unchanged for large-scale companies but tighten for SMEs in the second quarter. Additionally, standards of FX-denominated loans are likely to tighten significantly.

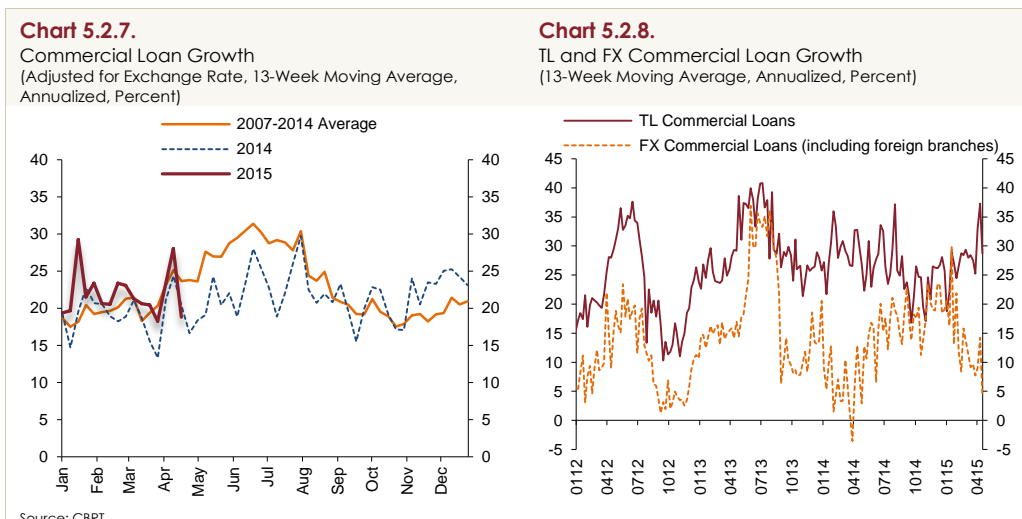


The annualized growth rate of consumer loans hovered slightly above 15 percent in the first quarter of 2015 (Chart 5.2.5). Among subcategories of consumer loans, the annualized growth rate of housing loans with an average maturity of 5 years and higher interest rate sensitivity was greater than others. The annualized growth rate of housing loans ended the first quarter at 20.5 percent, while the annualized growth rate of personal loans fell behind past years' averages with 13.4 percent for the same period (Chart 5.2.6). These developments are consistent with the Loan Tendency Survey results reflecting banks' statements that personal loan standards tightened in the first quarter of 2015, whereas standards for housing and automobile loans remained virtually unchanged. According to the results of the Loan Tendency Survey that covers the first quarter, banks project no change in standards for housing and automobile loans but a slight easing in standards for personal loans in the second quarter of 2015. On the loan demand side, banks expect the demand for housing loans to decrease and the demand for personal loans to increase in the second quarter.



After hovering above past years' averages in early 2015, the annualized growth rate of commercial loans neared its long-term average towards the end of the first quarter (Chart 5.2.7). This uptrend in commercial loans, which followed a stronger course than consumer loans, mostly stems from TL-denominated loans. The annualized growth rate of FX-denominated commercial loans declined steadily to 7.7 percent at the end of the quarter (Chart 5.2.8).

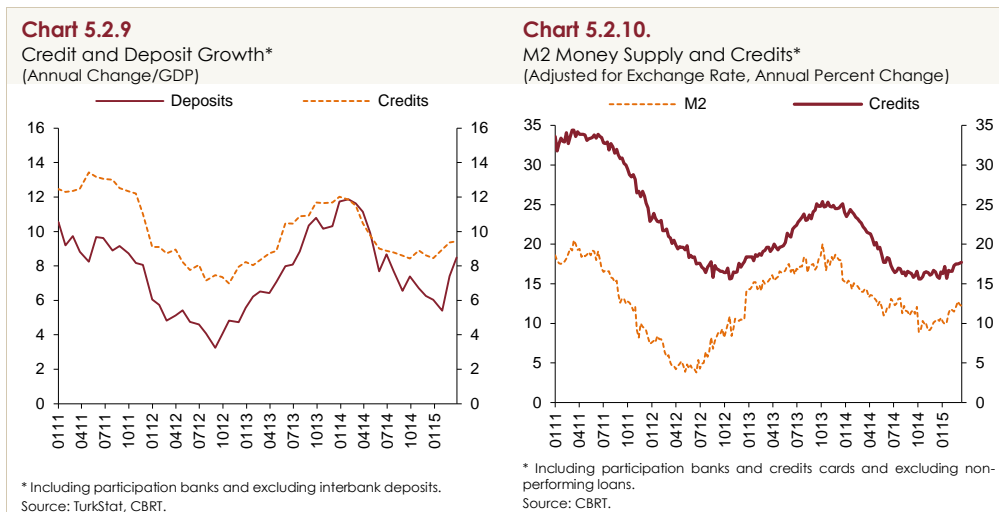
According to the first-quarter Loan Tendency Survey results, commercial loan standards hardly changed quarter-on-quarter. In addition, banks' responses reveal that commercial loan standards were no different in terms of firm size and maturity. Yet, the slight tightening in FX-denominated loan standards suggests a reduced appetite for FX-denominated lending, which is consistent with the first-quarter decline in the annualized growth rate of FX-denominated commercial loans. Among factors affecting commercial loan standards, expectations for overall economic activity continued to be the key factor putting downward pressure on loan standards in the first quarter.



In the first quarter of 2015, the annual growth rate of consumer loans was up quarter-on-quarter, while that of commercial loans remained flat. However, commercial loans continued to rise at a faster pace than consumer loans in the first quarter. The macroprudential policies in recent years

helped to bring the credit expansion rate to sustainable levels and to direct the loan composition towards encouraging production rather than consumption. In this regard, the faster growth rate of commercial loans contributes to both the re-balancing process and to financial stability.

While loan growth follows a moderate course thanks to policies adopted by the CBRT and the BRSA, deposit growth nears the pace of loan growth (Chart 5.2.9). The relationship between M2 and loans suggests that the growth rates of loans and money supply move on par and hover at reasonable levels (Chart 5.2.10). The convergence of loan and deposit growth rates is a factor that will enhance the resilience of the banking sector against possible financial fluctuations by also reducing the banking sector's need for external financing. According to the Loan Tendency Survey results, banks expect a tightening in both domestic and external funding conditions in the second quarter. Thus, providing funds to the banking sector mostly through core items such as deposits will improve the resilience of the system.

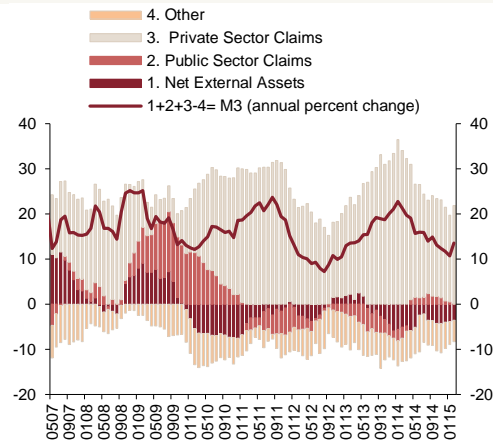


Monetary Indicators

The uptrend in credits extended to the private sector continued to determine the annual growth of M3, the broad measure of money supply, in the first quarter of 2015. The Private Sector Claims mostly including the credits extended by banks to non-financial private individuals and institutions constituted the main factor of the improvement in the M3 growth. Meanwhile, the item Other, which displayed a relatively steady course in line with bank profitability, is still a non-deposit funding source for the banking sector, yet contributed less negatively to money supply compared to the previous quarter. On the other hand, the positive contribution of Public Sector Claims to the M3 growth, which has been evident since the second quarter of 2014, dropped to very low levels in the first quarter of 2015 (Chart 5.2.11).

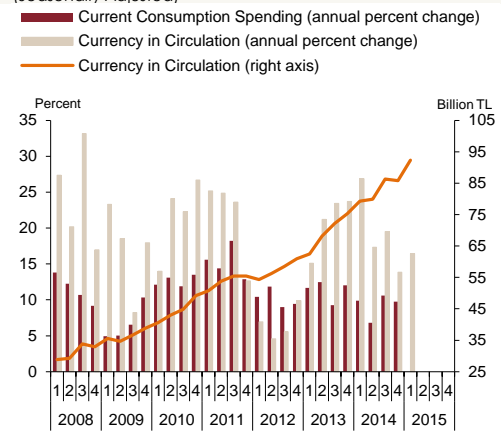
The annual growth of seasonally adjusted currency in circulation recorded a quarter-on-quarter increase in the first quarter of 2015 (Chart 5.2.12). However, this acceleration in the currency in circulation is expected to have a modest impact on private domestic demand due to the cautious monetary policy stance, the macroprudential measures and the weak capital flows.

Chart 5.2.11.
Balance Sheet Decomposition of M3
(Contributions to Annual M3 Growth)



Source: CBRT.

Chart 5.2.12.
Currency in Circulation and Current Consumption Spending*
(Seasonally Adjusted)



* Consumption spending includes private and public consumption excluding furniture, household appliances, and transport and communication services at current prices.

Source: TurkStat, CBRT.

