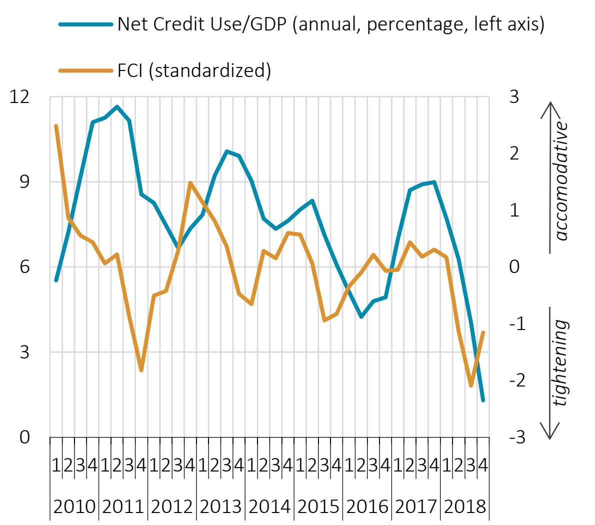
5. Financial Conditions and Monetary Policy

In the last quarter of 2018, marked by heightened global volatilities and increased protectionist tendencies regarding international trade, expectations of a longer-than-expected normalization process in advanced economy monetary policies strengthened. Risk premiums of emerging economies, which have been volatile partly due to geopolitical risks, have receded since January in tandem with the rise in the global risk appetite. The recovery in portfolio flows to these economies became more discernible in this period. Along with a limited depreciation in the US dollar, emerging market currencies appreciated slightly. Despite the geopolitical developments and global volatilities experienced in the current reporting period, there has been a slight improvement in domestic financial indicators partly due to the CBRT's maintaining of its tight monetary policy stance and the improving inflation outlook.

Credit growth rates remained on the decline in the last quarter of 2018. This decline is attributed to the tightening credit standards and the weakening domestic demand. As a result of the decline in credit growth, the ratio of the net credit use to GDP continued to decrease in the last quarter of the year (Chart 5.1). The Bank Loans Tendency Survey suggests that commercial loan standards continued to tighten and the demand for commercial loans continued to decline noticeably. According to the Survey, banks do not expect a change in standards, but do envisage that the credit demand will continue to decline in the first quarter of 2019.

Financial conditions remained tight, albeit with a significant decrease in the level of tightness, in the last quarter of 2018. In the last quarter, all financial components of the financial conditions index continued to contribute to the index in the tightening direction , however due to the flattening of the yield curve, the real appreciation in the Turkish lira, the decline in loan rates and the partial easing of loan standards, the tightness in financial conditions lessened compared to the previous quarter (Chart 5.2).

Chart 5.1: Financial Conditions and Credit Growth*

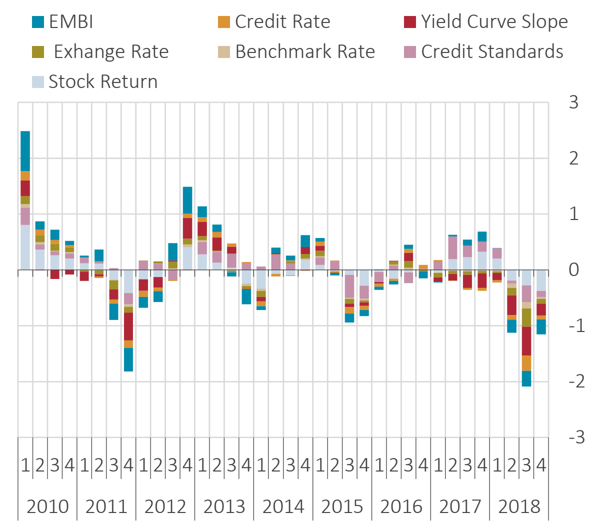


Source: CBRT.

* For further details on measuring FCI, see the CBRT Working Paper No. 15/13.

Net Credit Use is defined as the annual change in the credit stock and it is adjusted for exchange rate. GDP data for the fourth quarter of 2018 is forecast.

Chart 5.2: Contributions to the FCI



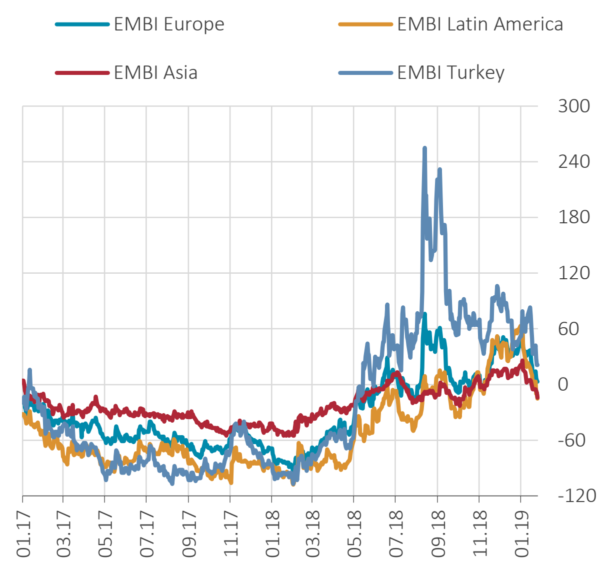
Source: CBRT.

5.1 Relative Performance in Financial Markets

Risk Perceptions and Portfolio Flows

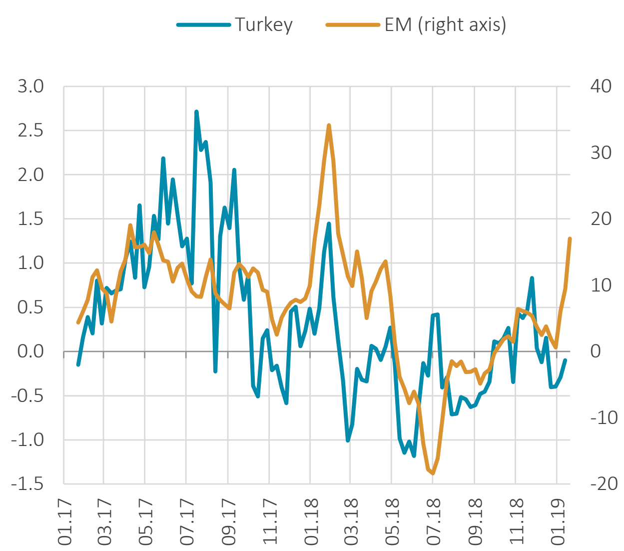
In the last quarter of 2018, heightened volatilities in global markets and declines in asset prices paved the way for expectations of a potential slowdown in the normalization process in monetary policies of advanced economy central banks. Fed rate hike expectations for 2019 dropped to two following the downward revision of the US growth forecasts in particular. Amid persistently low levels of inflation in Japan, the Bank of Japan announced continuation of its accommodative monetary policy. In the meantime, although the ECB announced the end of its net asset purchases, prospects of a significant tightening in the monetary policy were muted by both the Brexit process and budget-related problems in Italy, and global risks. These developments in global monetary policies drove long-term bond rates in advanced economies down compared to the previous reporting period. Nevertheless, global risk appetite remained weak until mid-January due to heightened volatility in global financial markets, protectionist tendencies in international trade and geopolitical risks, and regional risk premiums of emerging economies rose. In response to a slight decline in concerns over protectionist tendencies in international trade and geopolitical risks, global risk appetite increased while risk premiums of emerging economies declined in January. Turkey's risk premium moved in tandem with other emerging economy risk premiums (Chart 5.1.1). Portfolio outflows in emerging economies that had been in place since mid-2018 due to global volatilities and decreased risk appetite were replaced by portfolio inflows in the current reporting period. In this period, portfolio flows in Turkey also followed a similar trend. Portfolio inflows were predominantly observed in equities markets, while portfolio outflows were seen in Government Domestic Debt Securities (GDDS) markets (Chart 5.1.2).

Chart 5.1.1: Regional Risk Premiums*
(2 January 2017 = 0, Basis Points)



Source: Bloomberg.
* Shows cumulative changes since 2 January 2017.

Chart 5.1.2: Portfolio Flows in Emerging Economies*
(4-Week Cumulative, Billion USD)



Source: EPFR, CBRT.
* Turkey data includes portfolio inflows to stocks and GDDS market. Repo is included in the GDDS data. Emerging Economy data is from the EPFR database. It includes all the database-covered funds' weekly net investments in equity and GDDS markets in emerging economies.

Exchange Rates and Market Rates

In the inter-reporting period, emerging economy currencies appreciated slightly on the back of the limited weakening in the US dollar as well as expectations regarding a possible slowdown in the normalization of advanced economy monetary policies despite volatile global financial conditions. Backed by the tight monetary policy stance of the CBRT and the recovery in inflation outlook, the Turkish lira positively diverged from other emerging economy currencies. In line with these developments, the implied volatility of the Turkish lira declined.

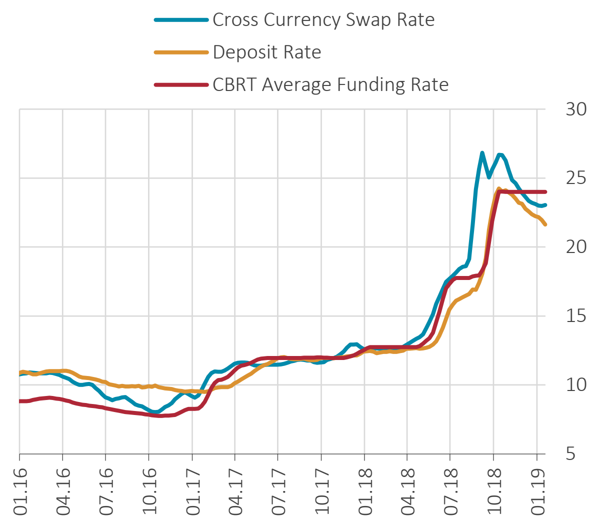
In the current reporting period that witnessed limited declines in short and long-term interest rates of emerging economies, Turkey's short and medium-term market rates decreased on the back of the tight monetary policy stance and the recovery in the inflation outlook.

5.2 Credit Conditions

Loan Rates, Funding Costs and Interest Rate Spreads

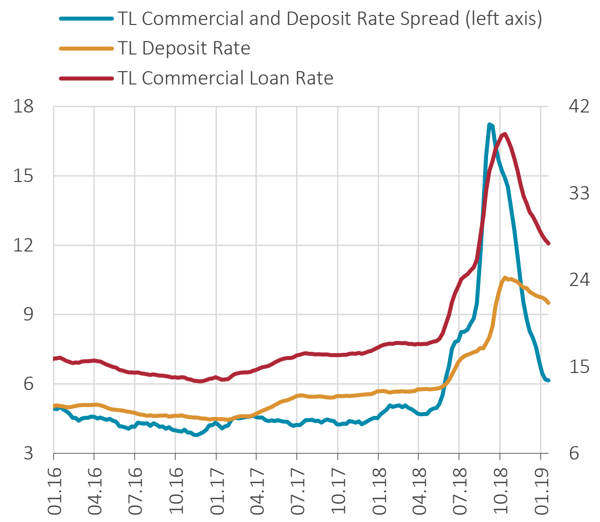
Banks' funding costs have increased since the second quarter of 2018 due to the rise in risk premium and the depreciation of the Turkish lira. Additionally, a lower appetite for lending also pushed TL commercial loan rates, which were flat in the first quarter of 2018, up in the second and third quarters. Whereas in the last quarter, implementation of measures and coordinated policies alleviated the uncertainty in financial markets and pulled deposit and currency swap rates down (Chart 5.2.1). However, despite this decline, the loan-deposit rate spreads hover above their historical averages (Chart 5.2.2). Besides, the Bank Loans Tendency Survey suggests that banks maintained their tight stance in commercial loan standards also in the last quarter. This was mainly attributable to prospects for overall economic activity, outlook for the sector or firms, risks related to the collaterals required, access to money and bond markets and capital adequacy constraints.

Chart 5.2.1: Indicators of Banks' Funding Costs (4-Week Moving Average, %)



Source: Bloomberg, CBRT.

Chart 5.2.2: TL Commercial Loan Rates and TL Deposit Rates* (Flow, Annualized, 4-Week Moving Average, %)

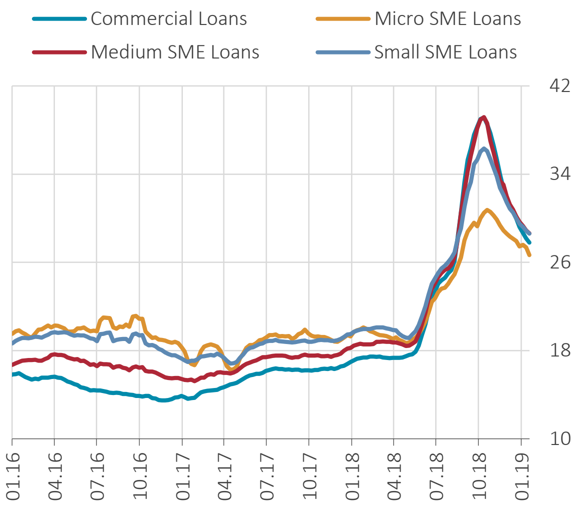


Source: CBRT.

* TL commercial loan rate series excludes overdraft accounts, credit cards and zero-rate loans.

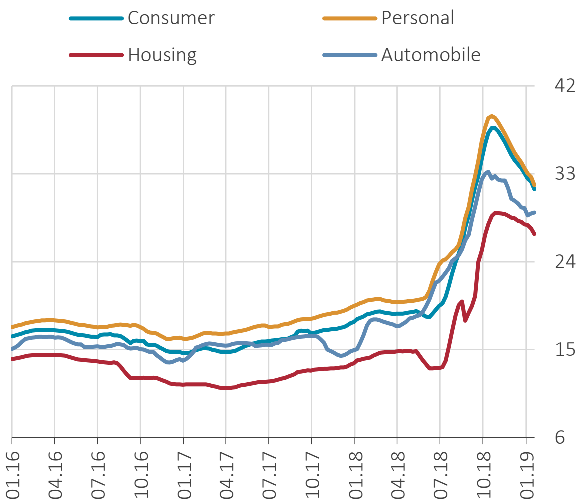
Across firm size, a decrease is observed in all subcategories of commercial loan rates in the current reporting period (Chart 5.2.3). Moreover, consumer loan rates declined, and the fall was more pronounced in personal loans (Chart 5.2.4).

Chart 5.2.3: TL Commercial Loan Rates*
(Flow Data, Annualized, 4-Week Moving Average, %)



Source: CBRT.
* Excluding overdraft accounts, credit cards and zero-rate loans.

Chart 5.2.4: Consumer Loan Rates
(Flow Data, Annualized, 4-Week Moving Average, %)

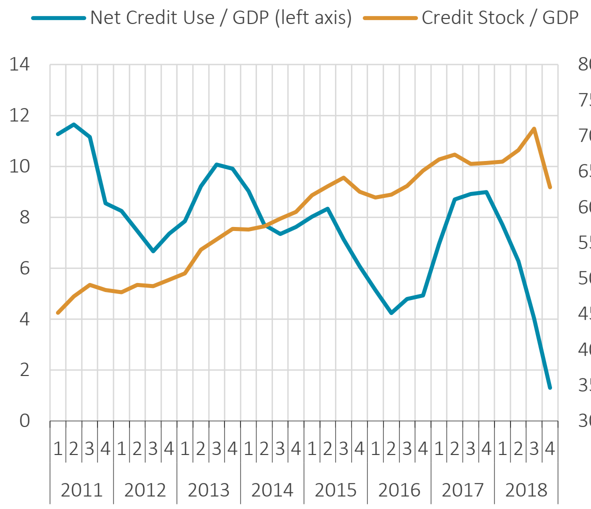


Source: CBRT.

Credit Volume

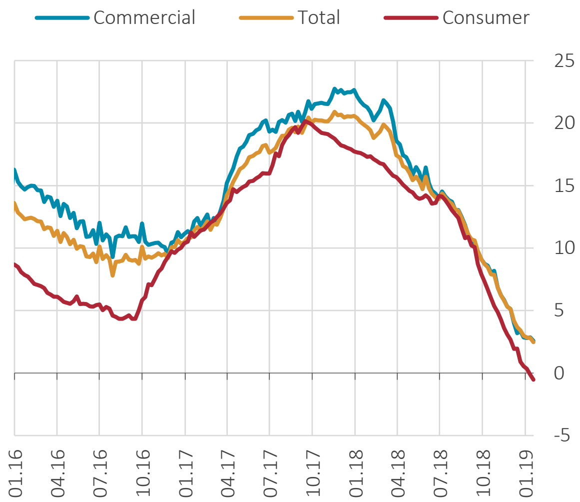
The total loan growth has shown a trend of deceleration since the first quarter of 2018, which prevailed throughout the rest of the year (Chart 5.2.5 and Chart 5.2.6). The deceleration in the rate of annual growth of loans was mainly triggered by supply and demand-side dynamics in addition to the base effect stemming from the acceleration in the loan growth in 2017. Tightening global financial conditions and the resulting increase in risks related to liquidity preferences of the banking sector and exchange rate developments were effective in the tightening of the loan supply. Additionally, the weakening domestic demand led by the slowdown in economic activity and the rise in loan rates in the first three quarters of 2018 were the determinants of the decline in the credit demand.

Chart 5.2.5: Domestic Credit Stock and Net Annual Credit Use* (%)



Source: CBRT.
* GDP data for the fourth quarter of 2018 is forecast.

Chart 5.2.6: Y-o-Y Loan Growth (Adjusted for Exchange Rates % Change)

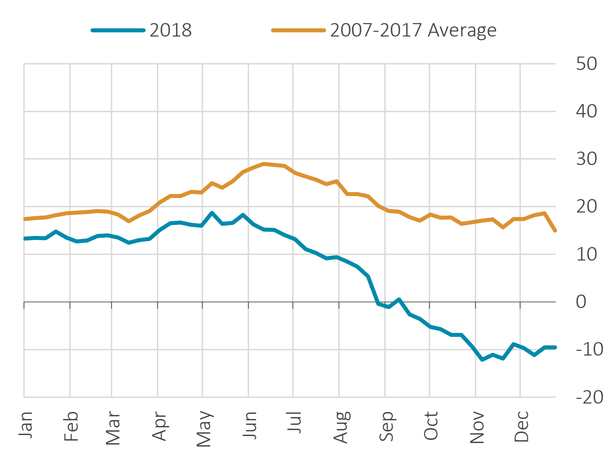


Source: CBRT.

The Bank Loans Tendency Survey reveals that the increase in domestic and external funding costs and banks' tightening their credit standards on account of the risks to economic activity were the leading factors that affected the credit supply throughout the year. On the credit demand side, while the effect of fixed investment and the decrease in the amount of loans needed for inventory buildup and working capital were the determinants of the decline in the demand for commercial loans, the weakened domestic demand and expectations regarding the economy were influential in the consumer loan demand.

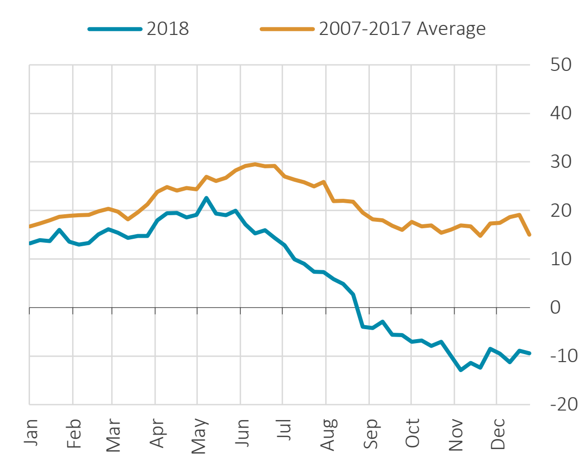
Commercial and total loan growth rates are hovering below their historical averages (Chart 5.2.7 and Chart 5.2.8).

Chart 5.2.7: Annualized Total Loan Growth (13-Week Moving Average, Adjusted for Exchange Rate, %)



Source: CBRT.

Chart 5.2.8: Annualized Commercial Loan Growth (13-Week Moving Average, Adjusted for Exchange Rate, %)

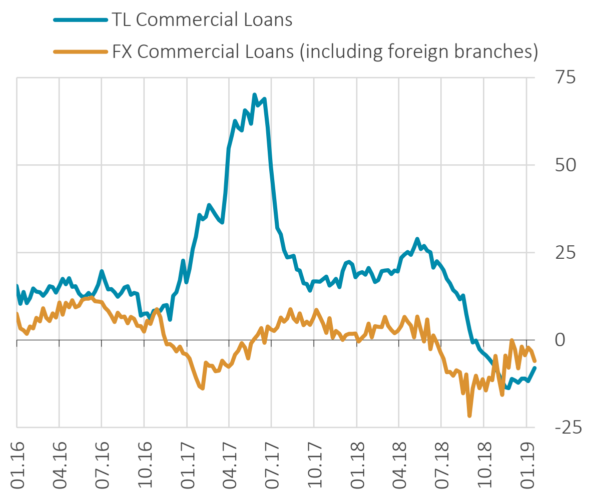


Source: CBRT.

The growth rate of Turkish lira-denominated commercial loans that slightly picked up in the first half of 2018 started to trend down in the second half of the year. According to the Bank Loans Tendency Survey, although TL commercial loan standards remained less tight, the decline in the demand for TL commercial loans became slightly more pronounced in the last quarter of the year. Meanwhile, FX loans posted a limited growth in the first half of 2018, yet declined in the second half. In the last quarter, the decline in FX loans continued at a decreasing pace due to the reduced uncertainty in financial markets and exchange rate developments, driven by the policy coordination and measures taken (Chart 5.2.9). However, the Bank Loans Tendency Survey signals that the tightness in FX loan supply and the fall in FX loan demand continued in the fourth quarter of 2018.

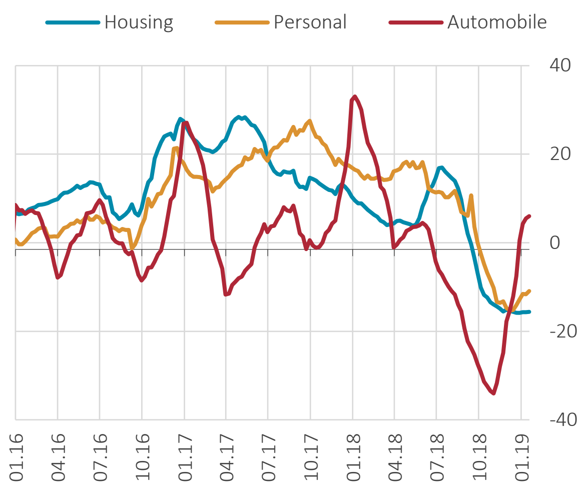
The slowdown in the growth rate of consumer loans that posted a decline throughout 2018 persisted in the last quarter of the year (Chart 5.2.10). It is also apparent from the Bank Loans Tendency Survey that the tight outlook in consumer credit standards and the decline in credit demand continued in that period.

Chart 5.2.9: Annualized TL and FX Commercial Loan Growth (13-Week Moving Average, Adjusted for Exchange Rate, %)



Source: CBRT.

Chart 5.2.10: Annualized Consumer Loan Growth (13-Week Moving Average, %)



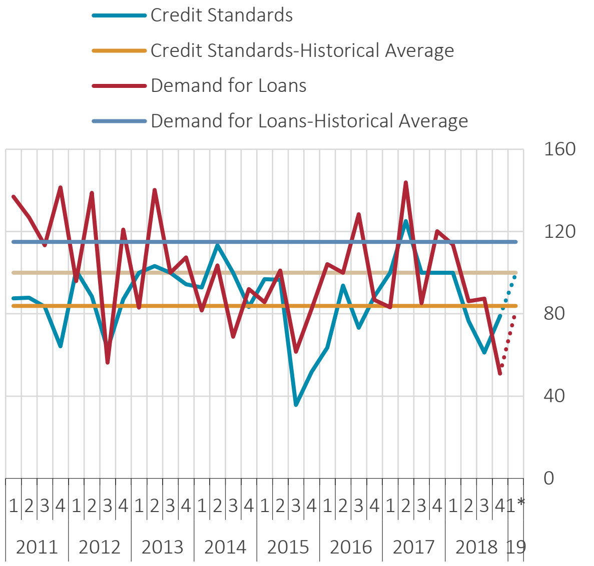
Source: CBRT.

Credit Standards

According to the Bank Loans Tendency Survey, banks, which continued to tighten commercial credit standards in the fourth quarter of 2018, expect no change in standards in the first quarter of 2019 (Chart 5.2.11). Commercial credit standards by scale, maturity and currency unit for the fourth quarter of 2018 reveals a similar outlook across all categories, yet further strengthening in standards for FX credits. On a subcategory basis, while a limited easing is expected in credit standards for SMEs, the tightening in standards for long-term and FX-denominated credits is anticipated to remain intact in the first quarter of 2019.

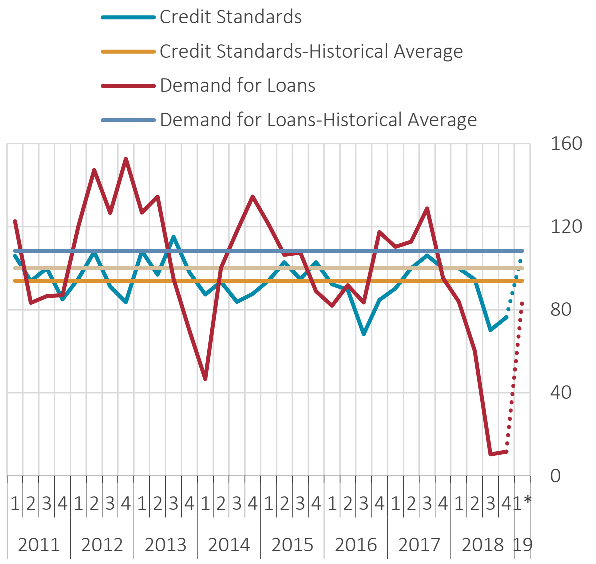
Answers of banks participating in the survey suggest that firms' demand for commercial loans continued to decline in the last quarter of 2018 (Chart 5.2.11). In the first quarter of 2019, credit demand is anticipated to decrease across all categories, more noticeably in the demand for SME and FX-denominated loans.

Chart 5.2.11: Commercial Credit Standards and Commercial Loan Demand**



Source: CBRT.
*Data for the first quarter of 2019 denote expectations.
**Index values above 100 indicate an easing in credit standards and an increase in loan demand.

Chart 5.2.12: Consumer Credit Standards and Consumer Loan Demand**



Source: CBRT.
*Data for the first quarter of 2019 denote expectations.
**Index values above 100 indicate an easing in credit standards and an increase in loan demand.

On the consumer loan front, the tightening in the credit standards and the decline in the consumer loan demand persisted in the fourth quarter of 2018. Standards for consumer loans are envisaged to be slightly eased whereas the decline in the consumer loan demand is expected to continue in the first quarter of 2019 (Chart 5.2.12).

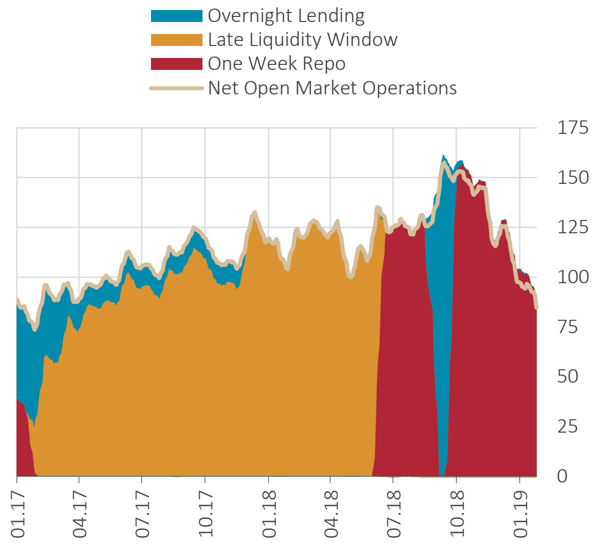
The factors affecting consumer credit standards reveal that the prospects for overall economic activity, together with funding costs and balance sheet constraints had a significant role in the tightening of credit standards, while, on the automobile and personal loan front, the consumer loan score had a further tightening effect on credit standards. Housing market prospects, consumer confidence, non-housing consumption expenditures, household savings and loans from other banks stand out as the leading factors reducing the demand for consumer housing loans. As for personal loans, all factors had a downward effect on the demand for such loans.

5.3 Monetary Policy

Monetary Policy Response and Market Developments

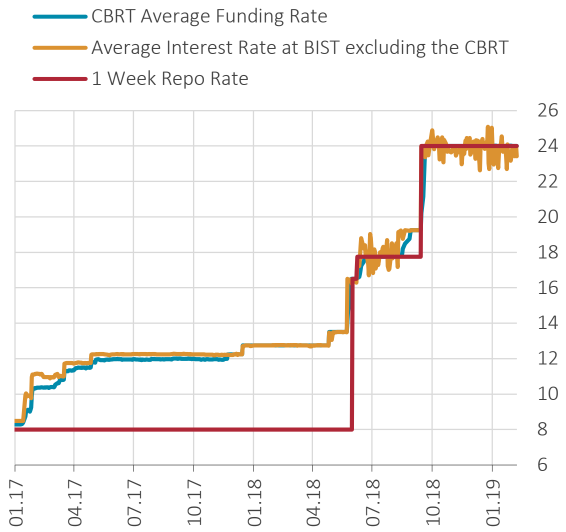
In the current reporting period, the entirety of the CBRT funding was provided via weekly repo auctions (Chart 5.3.1). Consequently, the average interest rate at the BIST Interbank Repo market, calculated excluding CBRT transactions, fluctuated around the one-week repo auction rate (Chart 5.3.2). The CBRT delivered a strong monetary tightening in September to support price stability by raising the one-week repo auction rate to 24% and keeping it constant thereafter.

Chart 5.3.1: CBRT Funding
(2-Week Moving Average, Billion TL)



Source: CBRT.

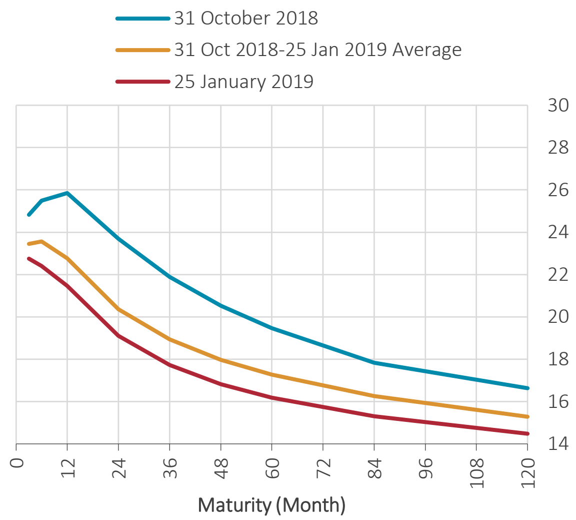
Chart 5.3.2: Short-Term Interest Rates (%)



Source: BIST, CBRT.

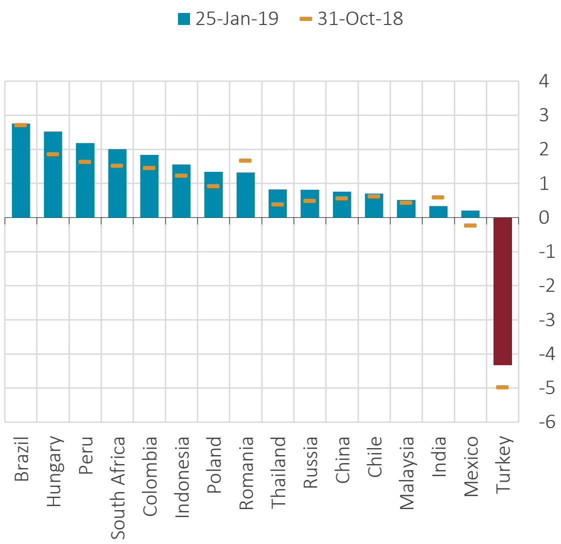
Due to the strong monetary tightening in September, along with the fading geopolitical risks, the country's risk premium declined. These developments prompted currency swap rates to decrease across all maturities compared to the previous reporting period. In response to the maintenance of the strong tightening, short-term currency swap yields continued to hover above the yields on long-term currency swaps (Chart 5.3.3). As a reflection of its tight monetary policy, Turkey continued to have the lowest yield curve slope among emerging economies in the current reporting period (Chart 5.3.4).

Chart 5.3.3: Swap Yield Curve (%)



Source: Bloomberg.

Chart 5.3.4: Yield Curve Slopes in Emerging Economies*
(% Points)

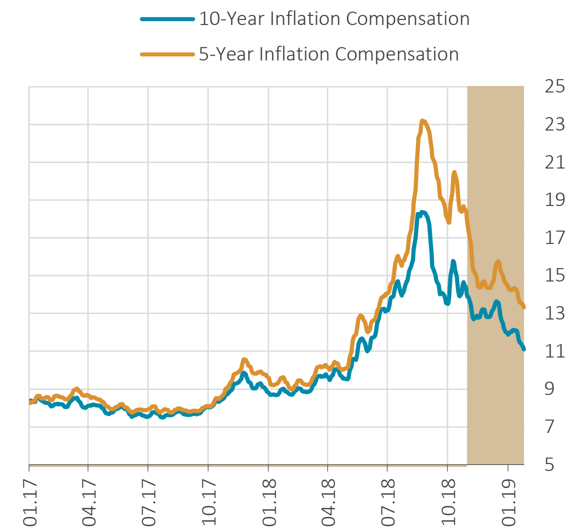


Source: Bloomberg.

* Yield curve slope is calculated by taking the difference between 5-year bond yields and 6-month bond yields. For Turkey, swap rates have been used instead of bond yields to calculate the yield curve slope.

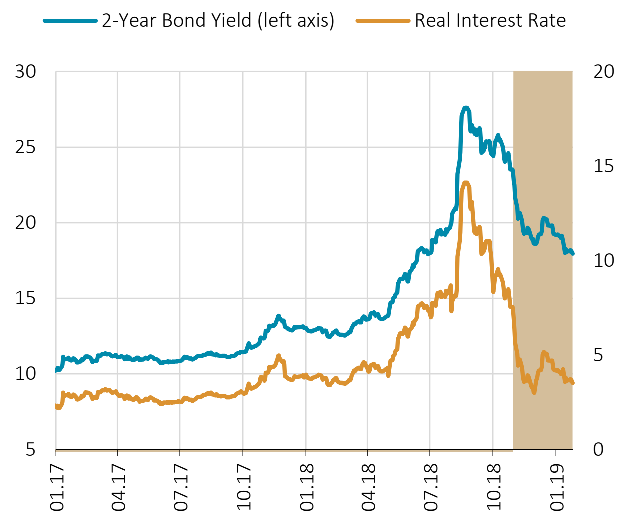
The decline in inflation compensation started on the back of measures taken in August and became more discernible following the strong monetary response at the September MPC meeting. In the current reporting period, inflation compensation decreased considerably in line with the improved inflation outlook thanks to the appreciation of the Turkish lira and slowdown in economic activity (Chart 5.3.5). Two-year real interest rates, calculated using inflation expectations data obtained from the CBRT Survey of Expectations, decreased over the previous reporting period as the decrease in nominal interest rates outpaced the decline in inflation expectations (Chart 5.3.6).

Chart 5.3.5: Inflation Compensation
(5-Day Moving Average, %)



Source: Bloomberg.

Chart 5.3.6: 2-Year Bond Yields and the Real Interest Rate in Turkey* (%)



Source: Bloomberg, CBRT.

* Real interest rate is calculated as the difference between 2-year bond yields and the 24-month-ahead inflation expectations data obtained from the CBRT Survey of Expectations.

Monetary Policy in 2018

The CBRT delivered a strong monetary tightening in 2018 to support price stability in the face of deterioration in pricing behavior and risks to the inflation outlook. While a tight monetary stance was maintained during the January–March period, a measured monetary tightening was delivered in April to support price stability. In May, the tight stance in monetary policy was strengthened taking into account the risks to general pricing behavior posed by unhealthy price formations in markets and the ongoing rise in inflation expectations.

In June, the simplification process regarding the operational framework of the monetary policy was completed. Thus, the predictability of the monetary policy was improved to a significant extent. Accordingly, the one-week repo auction rate became the CBRT's policy rate. Moreover, it was decided that the CBRT’s overnight borrowing and lending rates would be determined at 150 basis points below/above the one-week repo rate. In the new operational framework, the CBRT started to provide entire funding via weekly repo auctions.

In early August, to avoid excessive volatility in financial markets and to ensure efficient operation of markets, the CBRT introduced a series of financial stability-oriented measures that supported Turkish lira and foreign exchange liquidity management. In view of price increases that showed a generalized pattern across sectors due to the movements in exchange rates, the CBRT implemented a strong monetary tightening in September and raised its one-week repo auction rate to 24%.

As risks to price stability persisted, the MPC decided to maintain its tight monetary policy stance throughout the last quarter of the year and at its January 2019 meeting.

In 2018, besides these policy decisions, the CBRT widened and employed in the most effective way its set of tools to ensure efficient functioning of the markets and to support the transmission mechanism in the face of exchange rate volatility and unhealthy price formations. In this scope, the CBRT launched Turkish lira-Settled Forward Foreign Exchange transactions at the Derivatives Market operating under Borsa İstanbul. In November, the Turkish Lira Currency Swap Market was opened. The aim of these steps was to contribute to the deepening of the Turkish derivatives market and indirectly to the foreign exchange risk management of the corporate sector.

Table 5.3.1: Recent Monetary Policy Decisions and Their Rationale

Date	Policy Decision	Rationale
18 January 2018	• The late liquidity window (LLW) lending rate was kept constant at 12.75%.	• The CBRT emphasized that the tight stance in monetary policy would be maintained decisively until the inflation outlook displayed a significant improvement, independent of base effects and temporary factors, and became consistent with the targets.
7 March 2018	• The LLW lending rate was kept constant at 12.75%.	• In addition to the previous MPC explanations, the CBRT noted that underlying trend indicators displayed inertia and the core inflation remained elevated, thus emphasized that the tight stance in monetary policy would be maintained decisively.
25 April 2018	• The LLW lending rate was increased by 75 basis points to 13.50%.	• The CBRT implemented a measured monetary tightening noting that current elevated levels of inflation and inflation expectations continued to pose risks to the pricing behavior and that upside movements in import prices increased such risks.
23 May 2018	• The LLW lending rate was increased to 16.5% from 13.50%.	• The CBRT decided to implement a strong monetary tightening considering the risks to the pricing behavior posed by unhealthy price formations in markets and the ongoing rise in inflation expectations.
28 May 2018	• The CBRT decided that the one-week repo rate would be the policy rate and that this rate would be equal to the current funding rate (16.50%). • Central Bank overnight borrowing and lending rates were determined at 150 basis points below/above the one-week repo rate.	• The simplification process regarding the monetary policy operational framework to enhance the predictability of monetary policy and strengthen the transmission mechanism was completed.
7 June 2018	• The policy rate (one-week repo auction rate) was raised to 17.75% from 16.50%.	• The CBRT emphasized that elevated levels of inflation and inflation expectations continued to pose risks to the pricing behavior.
24 July 2018	• The policy rate (one-week repo auction rate) was kept constant at 17.75%.	• The CBRT noted that elevated levels of inflation and inflation expectations continued to pose risks to the pricing behavior, so it might be necessary to maintain a tight monetary policy stance for an extended period.
6 August 2018	• The upper limit for the FX maintenance facility within the reserve options mechanism (ROM) was lowered to 40% from 45%.	• Approximately 2.2 billion US dollars of liquidity was provided to banks to prevent excessive volatility observed in financial markets in early August.
13 August 2018	• Turkish lira and FX reserve requirement ratios were reduced and flexibility was	• A series of measures were introduced to prevent the excessive volatility in financial

	provided in Turkish lira and FX liquidity management. • The CBRT did not hold weekly repo auctions between 13 August and 14 September 2018, thereby raising the average funding cost to 19.25% from 17.75%.	markets and to ensure effective functioning of markets in early August.
13 September 2018	• The policy rate (one-week repo auction rate) was raised to 24% from 17.75% and the entirety of the CBRT funding started to be provided via weekly repo auctions again.	• The CBRT decided to implement a strong monetary tightening to support price stability noting the generalized pattern of price increases across subsectors, reflecting the movements in exchange rates.
25 October 2018	• The policy rate (one-week repo auction rate) was kept constant at 24%.	• The CBRT decided to maintain the tight monetary stance, emphasizing upside risks to pricing behavior despite weaker domestic demand conditions.
13 December 2018	• The policy rate (one-week repo auction rate) was kept constant at 24%.	• The CBRT decided to maintain the tight monetary policy stance, emphasizing the persistent risks to price stability despite some improvement seen in the inflation outlook led by developments in import prices and domestic demand conditions.
16 January 2019	• The policy rate (one-week repo auction rate) was kept constant at 24%.	• The CBRT decided to maintain the tight monetary policy stance, emphasizing the persistent risks to price stability despite some improvement seen in the inflation outlook led by developments in import prices and domestic demand conditions.