I. INTERNATIONAL DEVELOPMENTS

The recovery observed in the aftermath of the crisis continues with the differentiation among country groups. It is observed that the downside risks in the future global growth outlook persist. Vulnerabilities especially in developed countries, which suffer from serious deterioration in budget balance and excessive public debts, still continue. In the developed countries, since the problems in the financial sector have not yet been fully overcome and the desired increase could not be attained in employment, these factors affect the pace of economic recovery negatively. Although negative expectations have partially reduced global instability by encouraging savings, the lingering low level of resource utilization and the limited rise in consumption expenditures keep the deflation risk alive. Besides, the vulnerability of the financial sectors of developed countries to the possible shocks still continues. While developed countries struggle with vulnerabilities, developing countries with relatively strong public finance and financial structures have overcome the impacts of the crisis rapidly and experienced a serious recovery process; and thus, became the engine of global growth. However, as a result of the integrated structure of the global economy, it is uncertain as to how long developing countries can sustain this growth unless problems in developed countries are fully resolved.

Especially in developed countries, it has been observed that accommodating fiscal policies and expansionary monetary policies have failed to generate the desired results on unemployment and growth. While the balance sheets of central banks of developed countries, that have rapidly eased policy rates, scaled up excessively, global liquidity soared and asset prices shot up. Due to expectations that short-term interest rates would remain low for an extended period in developed countries coupled with increased risk appetite, capital flows to developing countries accelerated. While local currencies of developing countries appreciated rapidly on the one hand; on the other hand, these countries were faced with the risks of deterioration in the current account balance, rapid acceleration in external borrowing and ballooning asset prices. So as to safeguard financial stability, some countries raised their reserves and introduced measures against capital inflows.

While the global economy is recovering gradually driven by developing countries, the probability of a new global recession is decreasing. While the recovery is weak and vulnerabilities persist in developed countries, developing countries continue their robust growth performance, and the decoupling between developed and developing countries with respect to growth dynamics continues. In fact, while the global growth forecast for 2010 was 4.3 percent, this rate was 2.4 percent for advanced economies and 7.1 percent for emerging markets (Chart I.1). One of the primary reasons for the low growth rates in advanced economies is the slow recovery of consumption expenditures due to existing problems in their labor markets. In developed countries, savings ratios are above pre-crisis averages due to the unstable recovery trend in unemployment, decline in household wealth and low consumer confidence, which in return constrains the effect of private consumption expenditures on economic recovery in the aforementioned countries (Chart I.2).

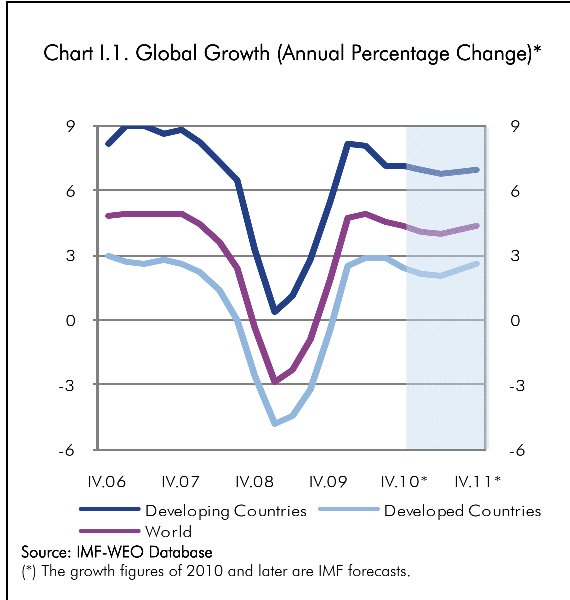


Chart I.1. Global Growth (Annual Percentage Change)*

Source: IMF-WEO Database

(*) The growth figures of 2010 and later are IMF forecasts.

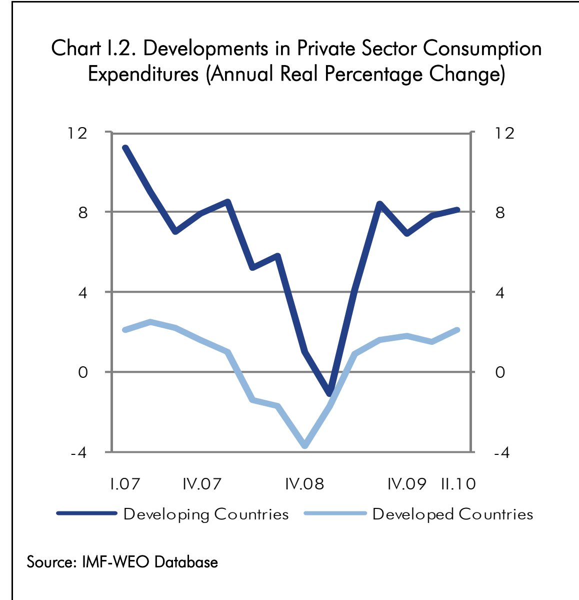


Chart I.2. Developments in Private Sector Consumption Expenditures (Annual Real Percentage Change)

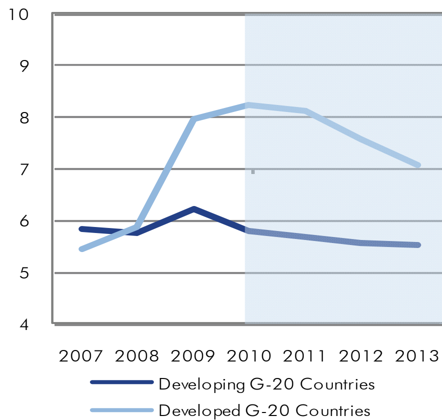
Source: IMF-WEO Database

High unemployment rates in advanced economies indicate that problems in the labor market continue in these countries. The recent growth rates in developed countries have not led to any improvement in unemployment rates. It is estimated that more than 210 million people are unemployed worldwide, an increase of more than 30 million since the pre-crisis period and 75 percent of the increase has occurred in the advanced economies[1]. Meanwhile, the strong recovery in emerging markets has had a positive impact on unemployment rates underpinning the rise in consumption expenditures in these countries. The unemployment rate in developing G-20 countries, which was 6.2 percent in 2009, is expected to come down to 5.8 percent in 2010, and that of the developed G-20 countries, which was 8 percent in 2009, is expected to increase to 8.3 percent (Chart I.3).

While deflation risk still persists in advanced economies, inflation risk has become an issue for some developing countries. The weak total demand during the crisis period led to a rapid decline in inflation rates. Nevertheless, while low inflation rates continue in developed countries, inflation rates in developing countries have reached 2007 levels due to strong consumer demand and the rise in commodity prices (Chart I.4).

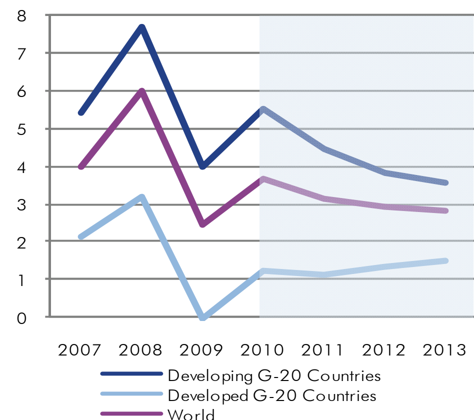
[1] IMF World Economic Outlook, October 2010.

Chart I.3. Unemployment Rates in G-20 Countries[1,2] (%)



Source: IMF-WEO Database, CBRT Calculations
(1) Calculated by weighting total populations of countries. India was not included in developing G-20 countries.
(2) The data of 2010 and onwards are IMF forecasts.

Chart I.4. Inflation Rates in G-20 Countries[1,2] (%)



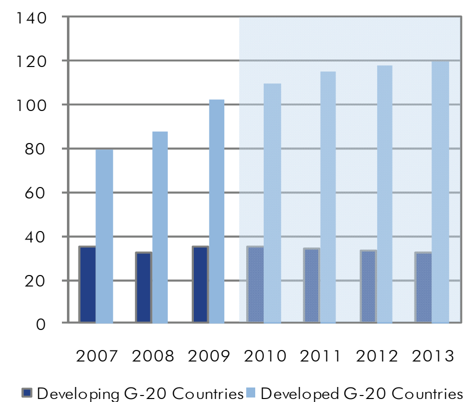
Source: IMF-WEO Database, CBRT Calculations
(1) Calculated by weighting with GDPs of countries.
(2) The data of 2010 and onwards are IMF forecasts.

While the increase in the indebtedness ratios of developed countries continues, the relatively positive outlook of public debt stock and budget performance indicators of developing countries persists. Owing to the broad-based fiscal stimulus packages introduced after the global economic crisis, the public support provided especially for the financial sector and decelerating economic activity, public incomes of advanced economies decreased and their public finances deteriorated. This fuelled concerns about the roll-over of debts of the developed countries. Accordingly, many developed countries led by EU countries launched a transition process towards tighter fiscal policies. On the other hand, it is observed that developing countries have maintained their pre-crisis strong fiscal structures (Chart I.5 and I.6).

Chart I.5. Public Budget Deficit / GDP[1,2]

Source: IMF-WEO Database, CBRT Calculations
(1) Calculated by weighting GDPs of countries.
(2) The data of 2010 and onwards are IMF forecasts.

Chart I.6. Public Debt Stock / GDP[1,2] (%)



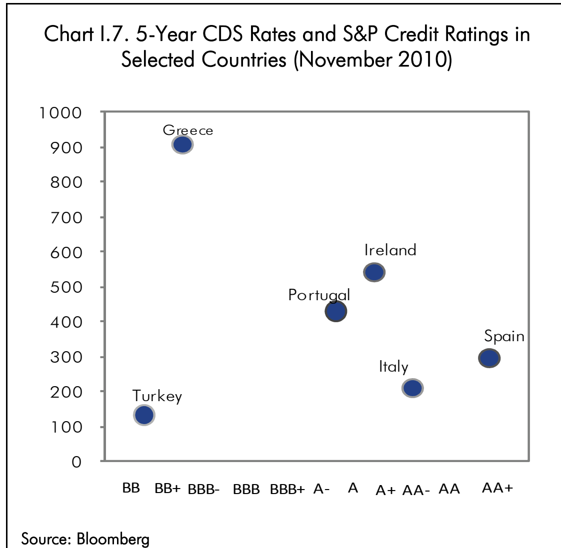
Source: IMF-WEO Database, CBRT Calculations
(1) Calculated by weighting GDPs of countries.
(2) The data of 2010 and onwards are IMF forecasts.

The deterioration in fiscal discipline in some European countries has led to the downgrading of credit ratings and record-highs in CDS rates. While the credit ratings of most of the 5 riskiest EU countries known as PIIGS[2] were lowered due to fiscal problems they had in 2010, their CDS rates reached historic highs (Chart I.7). The high budget deficits and indebtedness ratios of the PIIGS countries, which increase the default risk of these countries, have started to threaten the parties in a

[2] PIIGS countries are Portugal, Italy, Ireland, Greece and Spain.

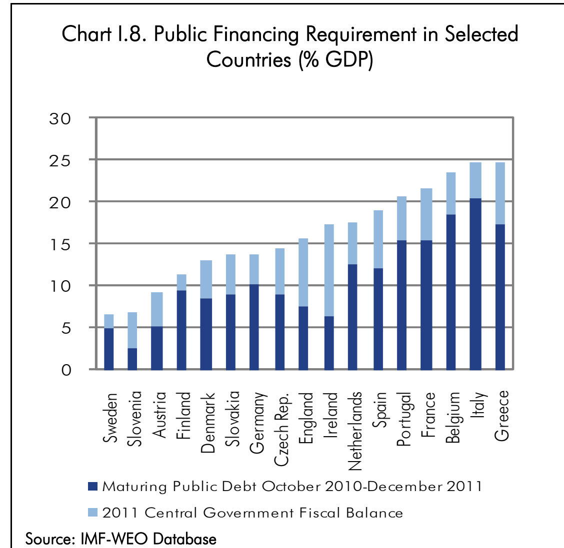
creditor position with these countries and hence, global financial stability. The failure of some countries to establish prudent and reliable medium-term fiscal policies in the face of these developments has also led to the continuation of bond market-driven risks. The maturing government bonds of several developed countries in the last quarter of 2010 and within 2011, may lead to an excessive financing requirement and a rise in borrowing costs due to intense competition (Chart I.8)[3]. Therefore, it is considered that the problems that could arise during the redemption of these bonds might disrupt financial markets via the bonds market and in return hinder global economic recovery.

Chart I.7. 5-Year CDS Rates and S&P Credit Ratings in Selected Countries (November 2010)



Source: Bloomberg

Chart I.8. Public Financing Requirement in Selected Countries (% GDP)



Source: IMF-WEO Database

The limited room for maneuver in fiscal policy coupled with the weak outlook of economic recovery for advanced economies fuel expectations that accommodating monetary policies will continue. While the Federal Reserve (Fed), the Bank of England (BoE), the Bank of Japan (BoJ) and the European Central Bank (ECB) keep policy rates near zero, they indicate that they will maintain policy rates at this level in the upcoming period (Chart I.9). On the other hand, some developed and developing countries with relatively strong fiscal structures have launched exit strategies and assumed a normalization process in their monetary policies (Chart I.10). In fact Canada, Israel, New Zealand, Norway, South Korea and Malaysia have recently increased policy rates (Chart I.9).

[3] According to the IMF-WEO October 2010 Report, Japan should issue treasury bills and bonds during the rest of 2010 and in 2011, amounting to 40 percent of its GDP, while this ratio exceeding 20 percent for France, Italy and the USA.

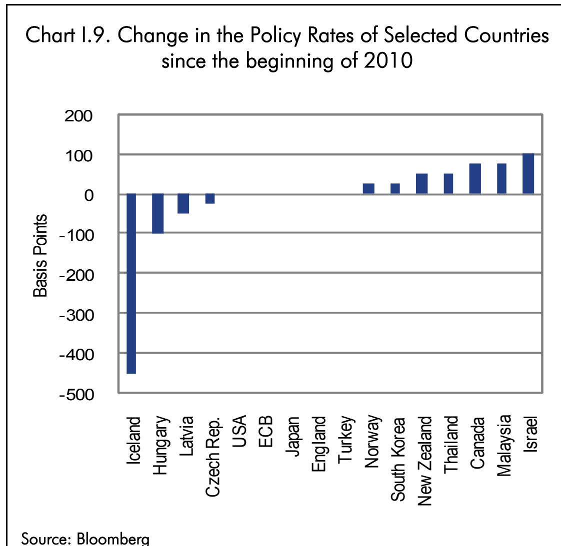


Chart I.9. Change in the Policy Rates of Selected Countries since the beginning of 2010

Source: Bloomberg

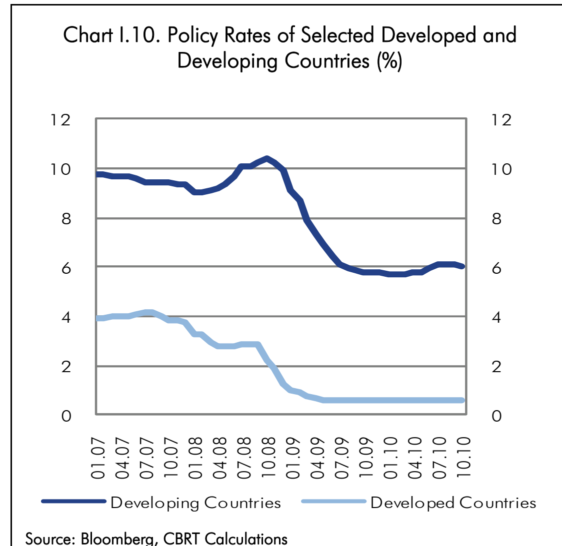


Chart I.10. Policy Rates of Selected Developed and Developing Countries (%)

Source: Bloomberg, CBRT Calculations

The balance sheets of the ECB, the BoE and especially the Fed had risen rapidly as a result of the expansionary monetary policies that they implemented in the face of the global financial crisis. As the intended macroeconomic results could not be achieved within the desired timeframe, at its meeting in November 2010, the Fed announced that with the second quantitative easing program, it is planned to purchase USD 600 billion-worth of long-term government bonds by the second half of 2011. The impact of the mentioned expansion on growth is questionable as the velocity of dollar is low in US. The expansionary monetary policies implemented by developed countries have increased global liquidity and led to sharp drops especially in bond rates. The consequences of the said quantitative easing policy would probably be felt on the bond market in the long run. The negative real returns of US Treasury notes that have 7-year or shorter maturities are considered as a risk factor in the financial system for the upcoming period. There are growing concerns that the bond market is over-priced and due to global economic recovery in the upcoming period, increases in interest rates might lead to some significant price movements in this market (Chart I.11 and Chart I.12).

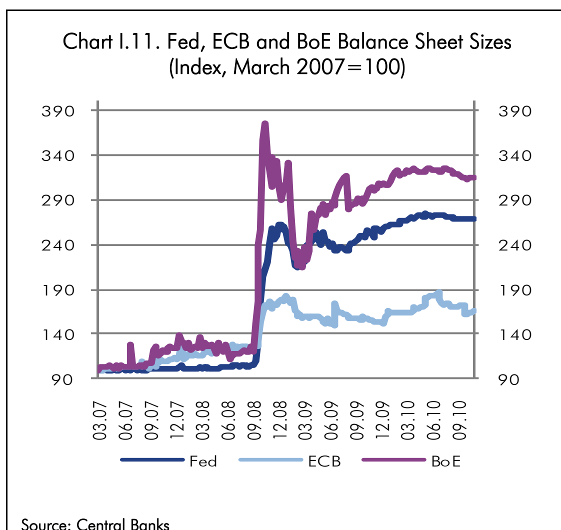


Chart I.11. Fed, ECB and BoE Balance Sheet Sizes (Index, March 2007=100)

Source: Central Banks

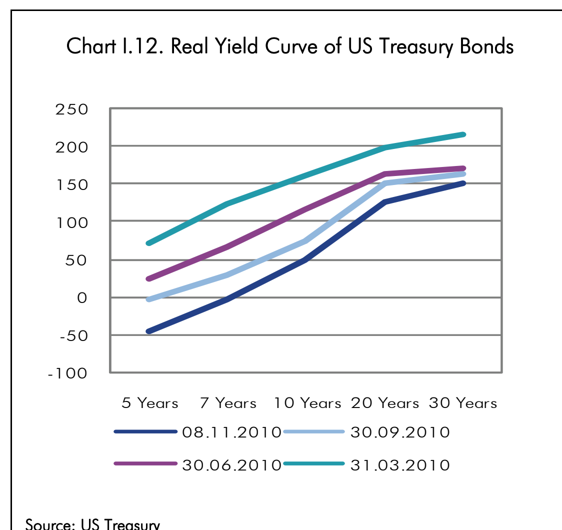


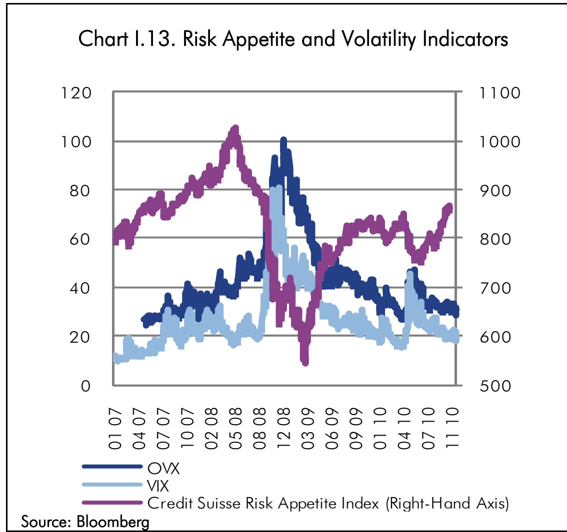
Chart I.12. Real Yield Curve of US Treasury Bonds

Source: US Treasury

The global liquidity surplus as a result of swollen central bank balance sheets and the elevated risk appetite led to a rise in asset prices. Besides other factors, it is expected that the rise in asset prices will continue in the upcoming period due to the demand from developing countries enjoying high growth performances and the impact of the second quantitative easing program of the Fed (Chart I.13 and Chart I.14). Although the level of the risk appetite and asset prices on the market is lower

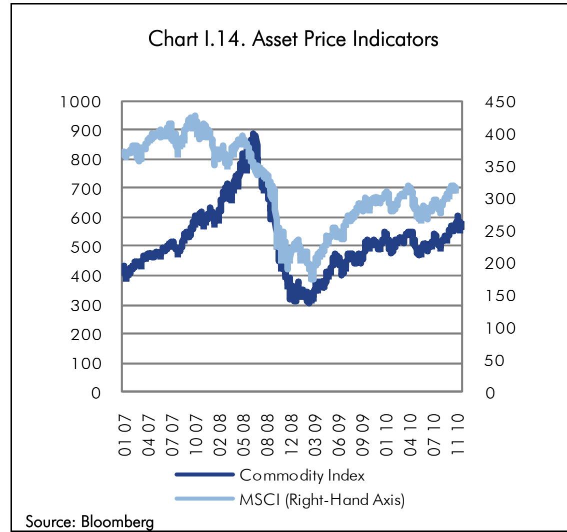
compared to the pre-crisis period owing to lingering perceptions that global vulnerabilities have not yet been eliminated, it is important to monitor developments in asset prices closely.

Chart I.13. Risk Appetite and Volatility Indicators



Source: Bloomberg

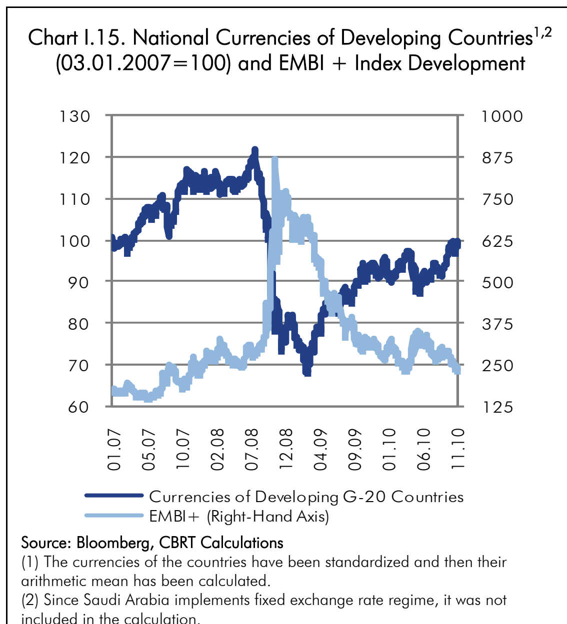
Chart I.14. Asset Price Indicators



Source: Bloomberg

National currencies appreciate on the back of improved risk perceptions pertaining to developing countries, elevated yield seeking and accelerated capital flows. Increased capital flows to developing countries depending on low short-term interest rates in developed countries -that are expected to remain at these levels for quite some time- and the elevated risk appetite caused the appreciation of their national currencies, which suffered sharp drops during the crisis (Chart I.15). According to IIF calculations, net capital flow towards developing countries, which was USD 928.6 billion in 2007, dropped to USD 581.4 billion in 2009. Net capital flows towards developing countries is expected to reach USD 825 billion in 2010 owing to the fact that the risk premiums of these countries in the post-crisis process came down to pre-crisis levels and credit rating agencies upgraded their ratings (Chart I.16).

Chart I.15. National Currencies of Developing Countries[1,2] (03.01.2007=100) and EMBI + Index Development

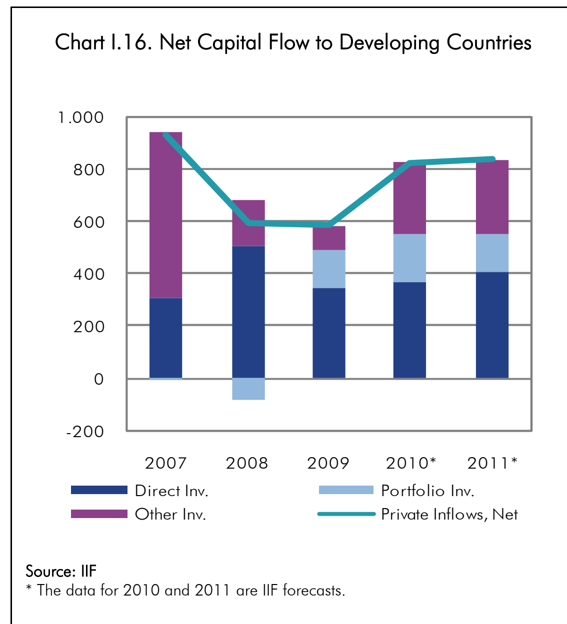


Source: Bloomberg, CBRT Calculations

(1) The currencies of the countries have been standardized and then their arithmetic mean has been calculated.

(2) Since Saudi Arabia implements fixed exchange rate regime, it was not included in the calculation.

Chart I.16. Net Capital Flow to Developing Countries



Source: IIF

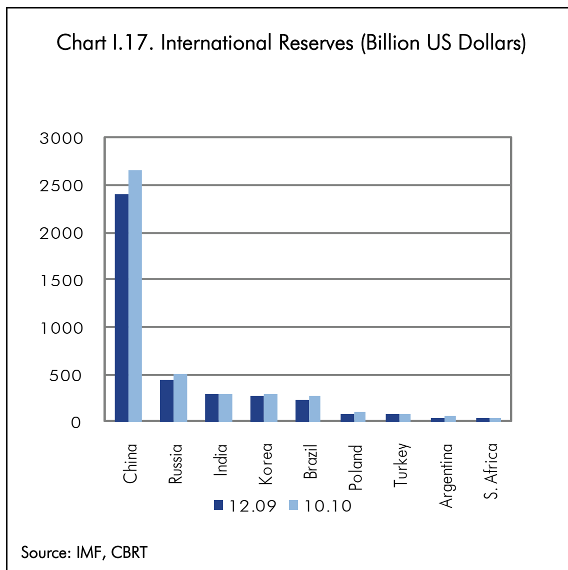
* The data for 2010 and 2011 are IIF forecasts.

It is observed that countries resort to macro-prudential policies in order to control the risks that short-term capital inflows can potentially cause and in this period some countries increase their international reserves. With the aim of decreasing the vulnerabilities driven by capital inflows, some

countries have increased their reserves (Chart I.17). In order to prevent capital inflows, some countries such as developing Asian countries, have introduced macro-prudential measures for both domestic and foreign investors, while others have implemented some measures only for foreign investors (see Special Topic IV.2). Nevertheless, owing to the liquidity surplus in global markets and the low yields of developed countries, it is still ambiguous how effective the measures taken will be. Developing countries' decoupling from developed countries in terms of growth and the Fed's second quantitative easing program, which will further increase global liquidity, together fuel expectations that capital flows towards developing countries will continue incrementally in the upcoming period.

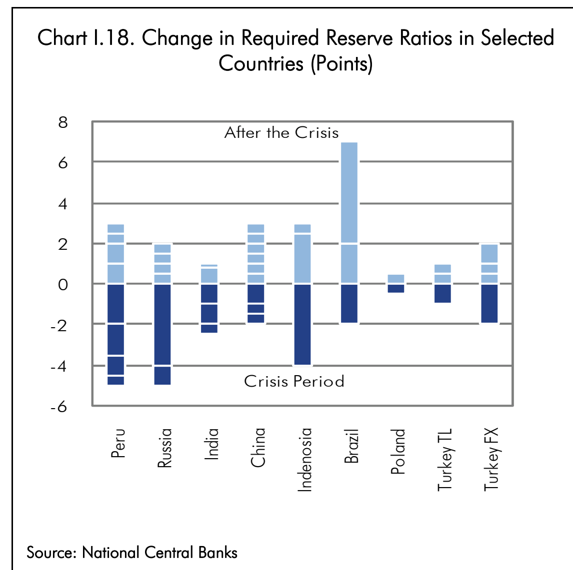
The required reserves, which are also used as a policy tool to decrease macro-financial risks, have been used intensively during and after the crisis. In this framework, some developing countries, including Turkey, have increased their required reserve ratios to pre-crisis levels within the scope of their exit strategy. Meanwhile, China and Brazil have even elevated their required reserve ratios above pre-crisis levels (Chart I.18).

Chart I.17. International Reserves (Billion US Dollars)



Source: IMF, CBRT

Chart I.18. Change in Required Reserve Ratios in Selected Countries (Points)



Source: National Central Banks

In the coming period; accelerated capital flows towards developing countries, any reversal in this trend and public finance problems in developed countries especially in EU countries are considered as the main risks that could potentially disrupt financial stability. While accelerated capital flows towards developing countries contribute to the fast growth of these economies, they also help the national currencies of these countries appreciate, which, in return, further increases the current account deficit of countries that had a deficit before. Should the public finance problems currently experienced in some EU countries spread to other developed countries, it is anticipated that the resultant negative developments in the markets would decrease the risk appetite. Furthermore, in case of changes in the current capital flow trend due to reasons such as the abandoning of expansionary monetary policies by developed countries, some vulnerability may emerge in the financial systems of developing countries in the upcoming period.