I. International Developments[1]

Despite the recovery trend observed in the U.S. economy and some favorable signals in the Euro area economies, global economic activity remains weak as a result of the slowdown in the growth rate of emerging economies, which were the driving force of growth in the post-crisis period. Moreover, monetary policies implemented by the advanced countries' central banks continue to be a determinant of the global financial markets. The global risk appetite has recently followed a fluctuating course due to expectations that the Federal Reserve (the Fed) will taper asset purchases in the near future. International capital flows will be driven by the Fed's short term exit strategy and the interest rate hikes in the medium and long term. External financing conditions are likely to follow a fluctuating course in emerging economies in the upcoming period due to the decline in global liquidity as well as new financial regulations to be introduced, which will lead the banks to be more cautious. Therefore, the economic performance of emerging economies will be determined largely by the question of to what extent the adversities arising from the deterioration in external financing conditions may be compensated by the favorable impacts of foreign trade triggered by the recovery in advanced economies. In this respect, it is significant to monitor whether normalization in the Fed's monetary policy will go in tandem with the recovery in economic activity both in the U.S. and the Euro area.

The weak course of global economic activity persists although advanced economies such as the U.S. and Japan have registered a moderate recovery. The U.S. has carried out a strong fiscal consolidation throughout 2013 and its economic growth has been backed by the ongoing accommodative monetary policy, the recovery in financial conditions, the favorable course of the real estate market and finally the increase in consumer demand, although recent data releases suggest that the recovery in the U.S. economy has not stabilized yet. In the Euro area, which still undergoes problems in the functioning of the monetary transmission mechanism and public finance, the slowdown of the contraction in periphery countries and the partial recovery in core countries observed as a result of the supportive monetary policy have facilitated the recovery from recession. The expansionary monetary and fiscal policies implemented in Japan continue to promote economic growth (Chart I.1).

[1] This chapter has been prepared by Mehmet Onay and Ahmet Deryol.

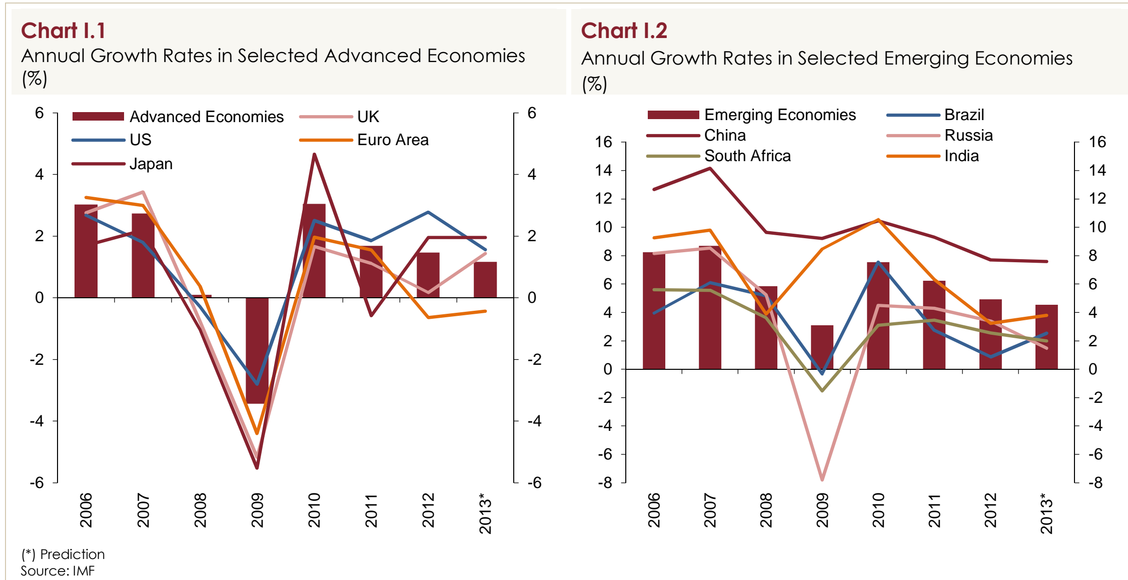


Chart I.1
Annual Growth Rates in Selected Advanced Economies
(%)

Chart I.2
Annual Growth Rates in Selected Emerging Economies
(%)

(*) Prediction
Source: IMF

In the post crisis period, the growth rate of emerging economies - the driving force of the world economy – recorded a slowdown, which was triggered by both structural and conjunctural factors. The deceleration in the growth rates of India, Brazil and South Africa, which are classified as emerging economies, is attributed to temporary factors such as the stimulus packages that have been phased out in the post-crisis period and the problems in the regulatory infrastructures of these countries. Conversely, the slowdowns in the growth rates of China and Russia are believed to be permanent due to structural problems in these countries' growth models (Chart I.2).

As the economic activity in advanced economies has not adequately accelerated yet, the unemployment rate has remained high in these economies. While the unemployment rate in the Euro area is still at a historically high level, its upward trend has stopped. Yet, the high rate of unemployment especially in peripheral countries is expected to continue in the long term because of the structural problems in the labor market and the weak growth performance. In the UK, unemployment rates maintain a higher but more stable course compared to the figures of the pre-crisis period. The unemployment in Japan is at a modest level as it was in the pre-crisis period. There has been a gradual fall in unemployment rates in the U.S. recently but this fall partially results from the decline in the labor force participation rate (Chart I.3, Chart I.4). Changes in unemployment rates, which constitute one of the variables that the Fed takes into account in addition to the inflation rate when deciding on the timing of monetary tightening, are closely monitored by global markets.

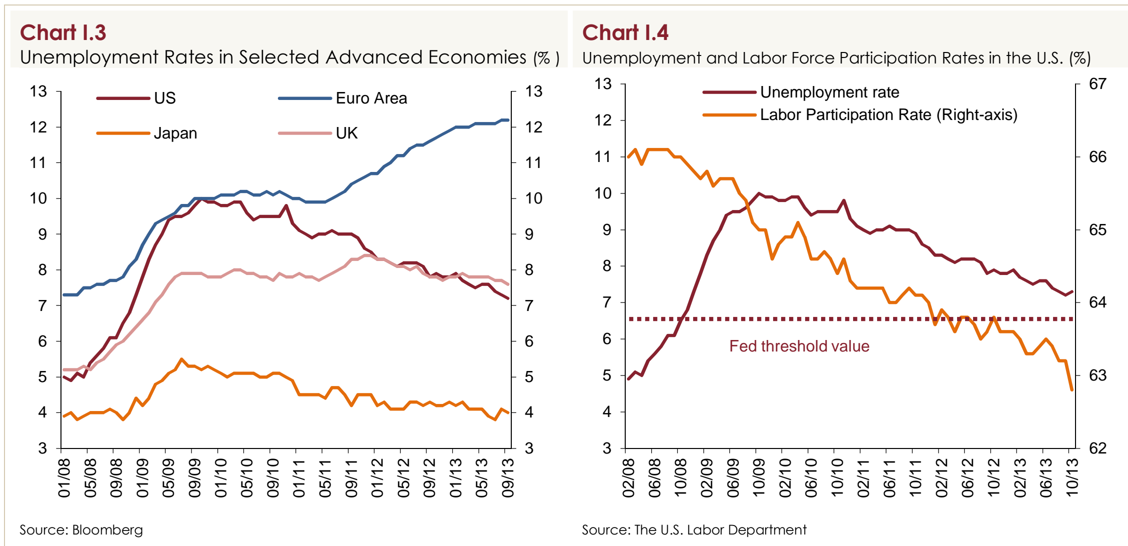


Chart I.3
Unemployment Rates in Selected Advanced Economies (%)

Source: Bloomberg

Chart I.4
Unemployment and Labor Force Participation Rates in the U.S. (%)

Source: The U.S. Labor Department

Despite the expansionary monetary policies implemented in advanced economies, there has been no serious inflationary pressure on a global scale. The absence of an inflationary pressure is attributable to the fact that the recovery in advanced economies has not yet led to a significant impact on output gaps and commodity prices have been following a stable course due to the slowdown-driven fall in demand in emerging economies. As a result of slow economic recovery in emerging countries and ongoing downward pressure on costs, inflation is expected to stay below target rates for a long time. Recently, the emergence of the risk of deflation in the Euro area has urged the European Central Bank (ECB) to cut interest rates after a long period of time. In emerging economies, factors such as capacity constraints, pass-through of exchange rates and revival in domestic demand have made it relatively difficult to achieve price stability (Chart I.5, Chart I.6.).

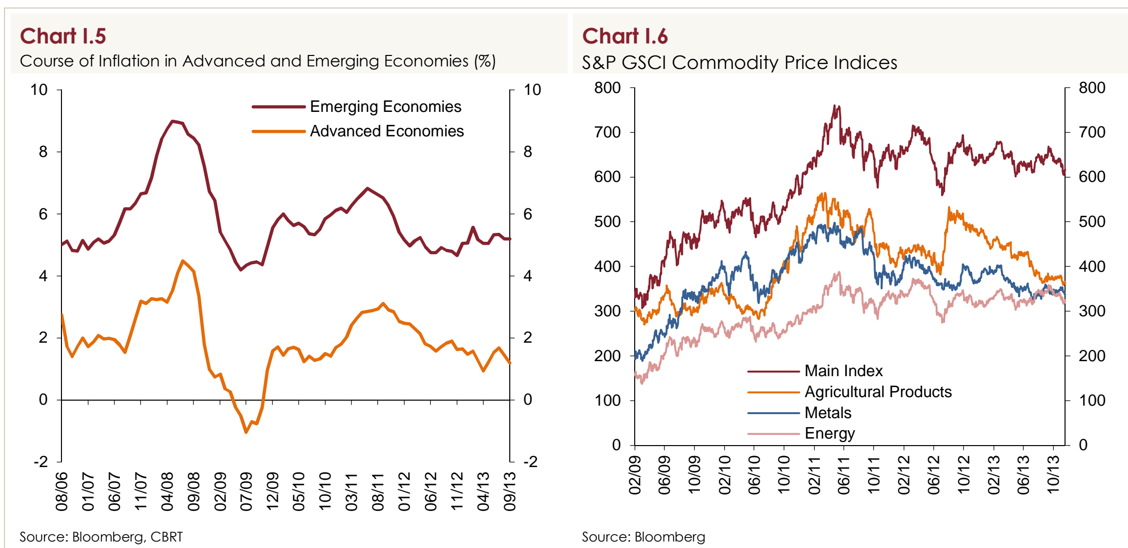


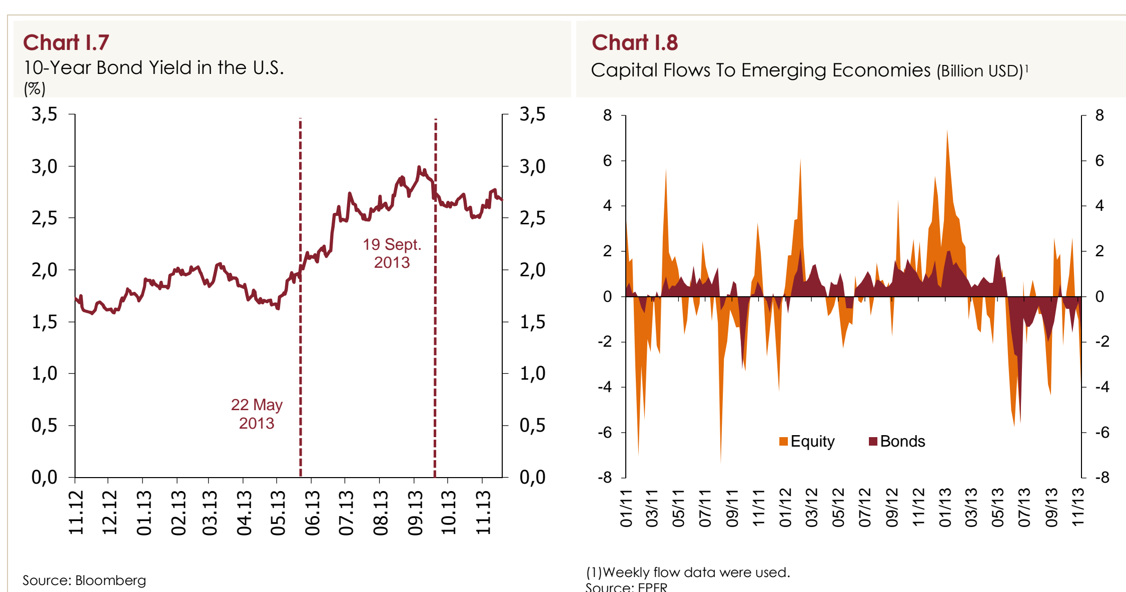
Chart I.5
Course of Inflation in Advanced and Emerging Economies (%)

Source: Bloomberg, CBRT

Chart I.6
S&P GSCI Commodity Price Indices

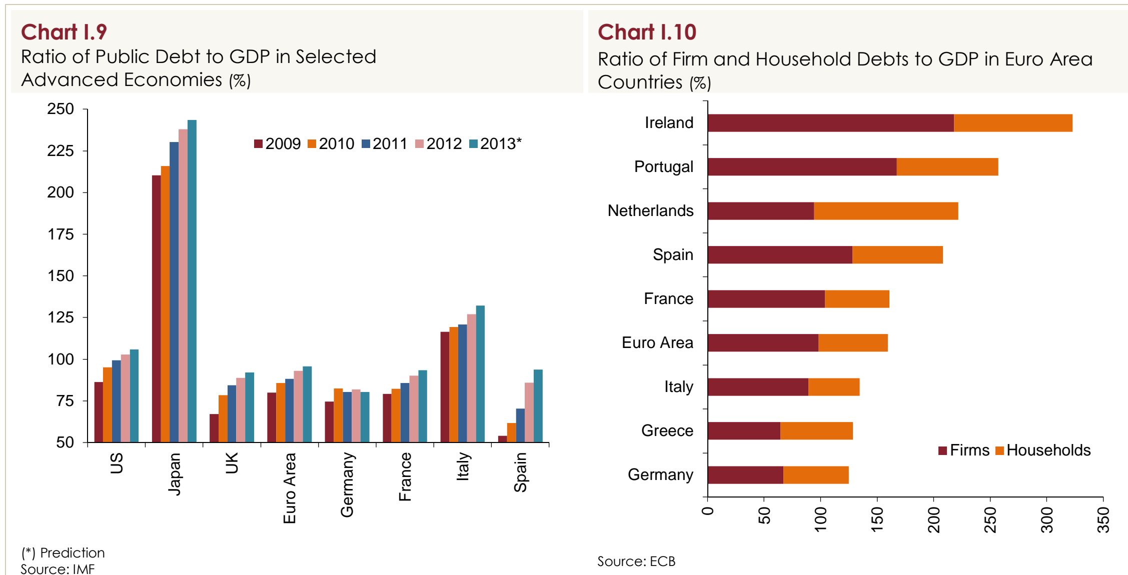
Source: Bloomberg

The global risk appetite has followed a fluctuating course in recent months due to the uncertainties regarding the monetary policy of the Fed in the forthcoming period. In May, Ben S. Bernanke, the chairman of the Federal Reserve, stated that the bond buying program could taper in a few months. Bernanke's statement led to a perception in the markets that the accommodative monetary policy implemented by the Fed came to an end and caused a global repricing of financial assets. Hence, long term U.S. Treasury bond yields registered a significant rise and emerging economies experienced capital outflows. While those emerging economies' currencies depreciated, their bond yields increased (Chart I.7, Chart I.8). At the September meeting, contrary to expectations, the Fed decided to maintain the bond buying program and thereby the normalization in the U.S. monetary policy was postponed for a while. Consequently, in the subsequent weeks, volatility in the markets edged down, long term U.S. Treasury bond yields slightly declined although they stayed at high levels compared to the figures in May and the losses from the foreign exchange and bond markets of emerging economies were partially compensated.



Macroeconomic risks originating from advanced economies were alleviated, but they still stand as an important factor. Although budget deficits have posted a decline thanks to recent fiscal consolidation in advanced economies excluding Japan, sovereign debts are still at historically high levels (Chart I.9). Meanwhile, there are significant uncertainties regarding the course of fiscal policies to be carried out by the U.S. and Japan in the upcoming period. In the U.S., disagreements about the budget for the new fiscal year led to the shutdown of the U.S. government on October 1, except for critical public services. As the debt ceiling deadline was 17 October 2013, disagreements on the budget started to pose a greater risk. Finally, with a last-minute agreement on a tentative budget to be effective until mid-January and the suspension of the debt ceiling until early February, the problem was

addressed with a temporary solution but has not been truly resolved yet. In the Euro area, high levels of public and private sector indebtedness, which originated especially from peripheral countries, continue to be an important risk factor (Chart I.10).

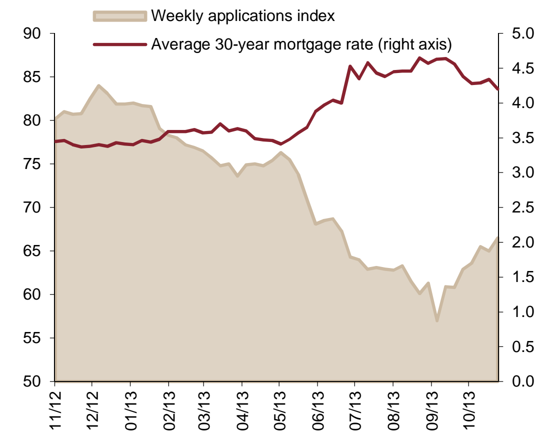


Following a period when global liquidity was abundant and cheap, the Fed will start a normalization process in monetary policy, which raises some risks in the U.S.. Major risks which may emerge in case of a sharp rise in long-term interest rates are the followings: sudden and significant depreciation in investor portfolios, durations of which have increased in recent years; panic sales due to reduced market liquidity and the appearance of weaknesses in some segments of the financial system such as shadow banking activities based on short-term repo financing (Chart I.11) (See Box I.1. Real Estate Investment Trusts Investing in Mortgage Backed Securities). Materialization of these risks will have an unfavorable effect on global markets and hamper the recent economic revival in the U.S.. As of May, when the first signals of a normalization process in monetary policy were received, mortgage loan rates have posted a remarkable increase and loan applications have fallen. These developments clearly show that the housing sector, which is important in terms of economic revival in the U.S., is sensitive to interest rates (Chart I.12).

Chart I.11
Average Duration of Bond Portfolios in the U.S.[1]
(Year)

(1) It includes all the bonds issued by private sector firms and the public sector
Source: Bloomberg

Chart I.12
Mortgage Loan Rates in the U.S. and Course of Weekly Loan Applications (Index Value, %)



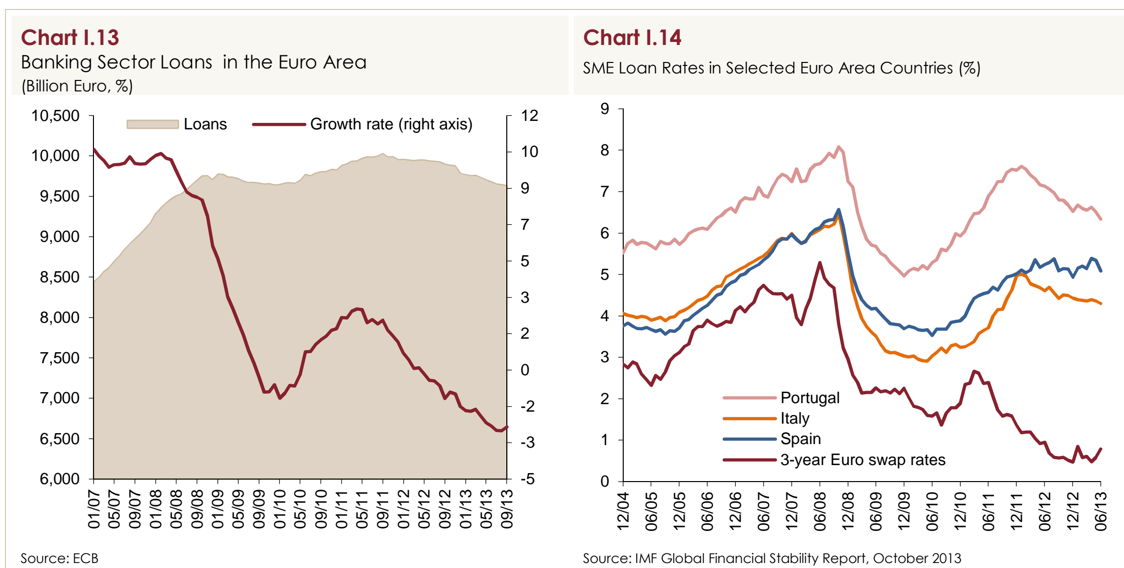
Source: Bloomberg

Box I.1 Real Estate Investment Trusts Investing in Mortgage-Backed Securities (AmREITs)

AmREITs are trusts founded in the U.S. that invest in real estates and mortgage-backed securities. The activities of real estate investment trusts, evaluated within the scope of shadow banking activities, have a potential to create fragility in the economy. These firms obtain funds particularly by borrowing through short-term repo market. Total repo liabilities of these trusts, which make up about 40 percent of their total liabilities, have exceeded USD 300 billion. The fact that repo funding is short-term while mortgage-backed securities are long-term brings about a maturity mismatch and sensitivity to interest rates edges up. The total size of mortgage-backed securities in the U.S. is USD 5.5 trillion, USD 365 billion (7 percent of total) of which is held by AmREITs. According to U.S. regulations, if these trusts distributed at least 90 percent of their total profits as dividend payments, they would get tax advantages. For this reason, investors' demand for Am-REITs has risen and these trusts have developed rapidly. At present, borrowings are made through short-term repo and the size of assets has reached ten times the size of the equity in certain firms. These facts show that a new structure has emerged which may pose a risk to financial stability. Parallel to the increase in interest rates, institutions' funding costs swell while the value of their mortgage-backed securities declines. Any funding problem to be experienced by these institutions would result in rapid disposals of assets and accelerate the downward trend in asset prices.

Consequently, interest rates which have increased due to the expectation for normalization in the U.S. monetary policy may cause depreciation in borrowing instruments such as mortgage-backed securities. The same increased interest rates also expose the Am-REITs, which have a short-term collateralized borrowing structure, to a significant funding risk and threaten financial stability by fueling asset fire sales.

The problems in public finance, the weak banking system and low growth rate continue to be the most significant risk factors in the Euro area. Thanks to steps taken by the authorities in the last two years, the monetary union has been preserved and tension in the markets has fallen relatively. However, the ongoing fragmented financial structure in the area continues to impair the effectiveness of the monetary transmission mechanism and delay the economic recovery particularly in peripheral countries. Although a single currency unit is used in the Euro area, the countries and financial systems are quite different in terms of risk profiles. These differences across countries and systems have led to a shift in savings towards the regions considered to be more reliable and to large gaps among countries in terms of loan rates. Accordingly, loans continue to decline due to both supply-side and demand-side problems (Chart I.13). The leading supply-side problem is high funding costs faced by the banks due to lack of confidence in banks' financial structures. These high funding costs, along with weak economic activity, hamper capital strengthening by unfavorably affecting profitability and restrain their capacity to provide loans. Underlying the demand-side problems are the efforts to reduce indebtedness of households and firms, the debt roll-over ratios of which have edged down due to high credit costs. Due to the problems in the credit mechanism, heavily indebted firms in peripheral countries face bankruptcy risks and particularly small and medium sized enterprises, which have limited alternative funding opportunities, experience financial difficulties. As a result, the economic activity in the Euro area is unfavorably affected (Chart I.14).



Creation of a banking union, which has been on the agenda in Europe for a long time, is of particular importance for the credit mechanism to operate again. In order to terminate the fragmented financial structure in the Euro area, EU governments, which aim to end the negative feedback loop between country finances and banking systems by establishing a strong banking union in addition to a monetary union, have not yet put the relevant reforms

into practice completely. The most important objectives of the banking union to be established are to standardize banking regulations across the EU, centralize the monitoring and supervision activities under the European Central Bank and establish a single resolution mechanism (See Box I.2. Establishing a European Banking Union). In recent months, the Capital Requirements Directive (CRD IV) package was accepted to be in effect as of 1 January 2014 and the bank recovery and resolution directive was approved, which are important steps taken to standardize regulations. The European Central Bank will ensure the relevant centralization by starting its monitoring and supervisory activities in November 2014. While the establishment of a single resolution mechanism has been accepted at the governmental level, work on the legislation has not yet been completed.

Box I.2. Establishing a European Banking Union

The global crisis revealed deficiencies in financial monitoring and supervision in many countries including EU member states. Following the outbreak of the crisis, in order to meet those deficiencies, the European Commission introduced several new regulations and implemented a significant number thereof. Those regulations include the basic rules which determine the general framework of the activities of the financial services sector in the 28 EU member states.

The outbreak of a debt crisis in the Euro area in 2011 highlighted the need for reforms to strengthen the monetary and economic union for the long-term sustainability of the common currency. The main reason underlying this need is the fact that the unfavorable interaction between country finances and banks increasingly deteriorated as a result of the bailout of many European banks by public resources, and this situation began to threaten the monetary union, disrupting the functioning of the credit transmission mechanism. Although a single currency unit was used in the overall region, the peripheral countries such as Greece, Portugal, Italy and Spain, which were affected the most by the crisis, faced a more severe financial deterioration compared to that of central countries such as Germany and France. As a result, a fragmented financial structure emerged in the region. The EU leaders agreed that they could not overcome this deterioration only with the amelioration in monitoring and supervisory regulations. Therefore, in June 2012, they decided to establish a banking union which primarily aims to strengthen the financial integration in the Euro area but which is also open to non-EU countries. The three main components of this union are as follows:

1) Standardization of Financial Sector Regulations across the EU (Single Rule Book)

In light of the lessons learnt from the financial crisis, four new institutions were founded in 2011 to improve the financial sector regulations in the EU, to remove divergences among country practices in the field of monitoring and supervision, to strengthen the cross-border

cooperation and information sharing and to impede emergence of systemic risks at the EU level. The European Banking Authority (EBA), the European Securities Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) were in charge of standardizing the monitoring and regulations in banking, securities markets and insurance sectors, respectively. Finally, the European Systemic Risk Board (ESRB) was established to monitor macro financial risks likely to emerge in Europe and develop macroprudential policy measures when required. Foundation of the EBA became the first and most significant step taken in standardizing banking regulations in the EU. In the following period, the EBA prepared the CRD IV package, the backbone of microprudential regulations in the EU, which was based on the Basel III standards that were set in view of the global financial regulations. The package, in line with the G20 commitments, was introduced in June 2013 to become effective from 1 January 2014. Moreover, in line with the G20 commitments again, a consensus was reached on a draft directive prepared for the harmonization of countries' resolution regimes with the relevant principles of the Financial Stability Board (FSB) across the EU. The directive is expected to take effect in 2015. Finally, The EU Commission developed a proposal package in 2010 to improve the deposit guarantee schemes and standardize them within the EU; however consensus is yet to be reached on this package.

2) Centralization of Banks' Monitoring and Supervisory Activities Under the ECB (Single Supervisory Mechanism)

The centralization of monitoring and supervisory activities, one of the components of the banking union, was ensured by the enforcement of the legal regulation on 3 November 2013, which assigned new authorities and responsibilities to the ECB. Accordingly, the ECB, which will *de facto* start its supervisory activities in November 2014, will be directly responsible for monitoring and supervising "significant" banks. Those "significant" banks will be determined according to criteria such as size, importance for any economy within the EU or the banking union and the intensity of cross-border activities. Regulation and supervision activities of banks other than those will be carried out by national authorities. According to the size criteria, "significant" banks will automatically include those:

i. Having assets of more than €30 billion,

ii. Having assets constituting at least 20% of their home country's GDP and standing at €5 billion at least;

iii. Deemed "significant" by the ECB and the relevant national authority.

Non-Euro area countries can also transfer the responsibility of monitoring and supervision of their banks to the ECB. The ECB will become directly responsible for monitoring and supervising 130 banks which are located in eighteen EU countries and determined pursuant to the criteria above. Those banks cover approximately 85 percent of the total Euro area banking assets.

A total of 130 "significant" banks to be supervised next year will first be subjected to a

one-year long comprehensive assessment by the ECB as of November 2013. This assessment, the results of which will be made public in November 2014, primarily aims to build confidence in banks. Hence, first the ECB will ensure transparency by enhancing the quality of information concerning the financial conditions of banks and later determine the steps to be taken for strengthening the banks' financial structures that are found weak.

The assessment to be conducted in cooperation with the national supervisory authorities of the countries will include the following steps:

i. A quantitative and qualitative analysis of the banks' intrinsic risk profile (leverage, liquidity, etc.).

ii. Identification of the real values of assets on bank balance sheets, taking into account collateral and provisions by end-2013.

iii. A stress test to measure the shock absorption capacity of banks' financial structures under different stress scenarios.

In all the analyses, banks will be expected to comply with the minimum core capital requirements of 8 percent (Common Equity Tier 1) according to CRD IV.

Following completion of the assessment, the country-based and bank-based results as well as measures suggested to the authorities will be reported to the public.

3) Establishment of a Single Resolution Mechanism

In July 2013, The European Commission proposed establishment of a single resolution mechanism (SRM) within the banking union for standardization of banking regulations across the EU and considering the fact that centralizing monitoring and supervision would not necessarily remove the difficulties that banks might encounter in the future. According to the proposal, the SRM will be based on the principles of the Bank Recovery and Resolution Directive, which will become effective across the EU and ensure centralized, fast and effective intervention and financing for any ailing bank that is subject to the supervision of the ECB. This mechanism is considered to be useful in reducing uncertainties in times of crises and particularly in assisting banks in resolutions in case of cross-border failures.

If a political agreement can be reached by Member States and if the SRM can be agreed by co-legislators before the end of the mandate of the current EU Parliament, SRM, which is planned to become operational in 2015, is expected to function as follows:

i. If a bank within the banking union needs to be resolved, the ECB will inform the Single Resolution Board (SRB), in which the European Commission delegates and national authorities participate.

ii. The SRB will decide upon how to resolve the bank and will make a proposal for the execution of resolution to the European Commission.

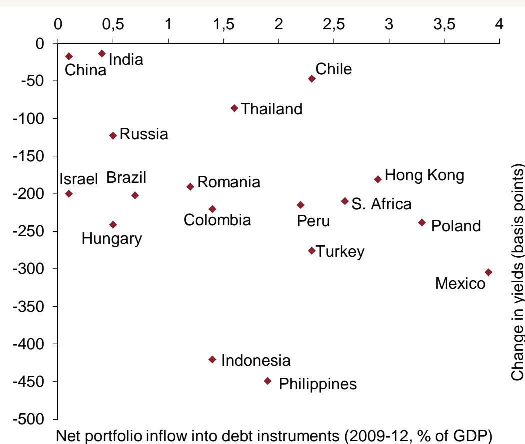
iii. The resolution will be executed by the national authorities under the monitoring and supervision of the SRB. During the resolution, the bank's unsecured loans will be converted into capital if needed and the relevant bank's creditors will be ensured to share the bank's losses (bail-in).

iv. A Single Resolution Fund to be established with resources provided from the banking sector will replace national resolution funds and be used for remedying the banks' capital deficits as envisaged by the SRB.

Asset quality assessment to be carried out by the ECB in 2014 has a critical importance in dissipating concerns over financial structures of the European banks. This assessment, which will be made before ECB's taking over the supervisory responsibility, is expected to clearly exhibit the capital needs of big banks. Yet, how to cover the capital needs to be identified by this assessment continues to be a source of uncertainty. In case this uncertainty is eliminated, it is expected that confidence in markets will be boosted, funding costs will decrease, profitability performance will recover and new capital issuance will be possible. If those expectations come true, the credit mechanism can be made functional again and economic growth can be spurred.

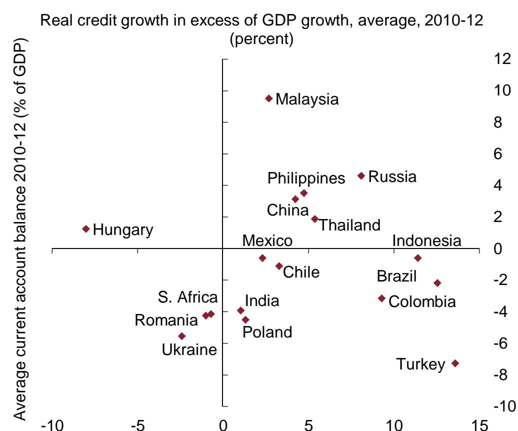
Adverse effects of the uncertainties in the Federal Reserve's monetary policy on capital movements are of importance for emerging economies with sizeable external financing needs. Ample and cheap liquidity emerged as a result of extraordinary monetary policy measures implemented due to the crisis has recently led to a significant increase in capital flows towards emerging economies, which display a stronger growth and higher rates of return compared to advanced economies. While international fund flows reduced yields and extended maturities on the one hand, they increased the sensitivity of these markets to portfolio movements of foreigners, on the other (Chart I.15). At the same time, the debt ratios of the firms, responsible for majority of the bond issues, registered a remarkable increase. Additionally, the policies implemented by some emerging economies to revive domestic demand in a weak global growth environment resulted in extremely rapid increases in loans (Chart I.16). Particularly the pick-up in shadow banking activities in China is considered an important risk factor (See Box I.3. Development of Shadow Banking in China). On the other hand, although the recent international regulations regarding the financial system are considered to contribute to global financial stability, they are expected to have a tightening effect on financial conditions in the short term. Therefore, in the forthcoming period, it is essential for the countries, which run a current account deficit and which have experienced a rapid credit growth in recent years, to give weight to macroprudential policies and make their economies more resilient to potential changes in external financing conditions.

Chart I.15
Impact of Portfolio Flows on Local Currency Bond Yields



Source: IMF Global Financial Stability Report, October 2013

Chart I.16
External and Domestic Vulnerabilities in Emerging Market Economies



Box I.3 Development of Shadow Banking in China

In China, loans surge particularly through non-bank sector. Due to strict regulations in the banking sector in the country, financial institutions have appealed to alternative ways to pool funds. Shadow banking, which is defined as a source of funding outside of the banking system, has recently recorded remarkable growth. According to the data of the Financial Stability Board (FSB), the size of shadow banking in China reached USD 2.1 trillion (almost 10 percent of the banking sector). The development of shadow banking is partially driven by restraints such as the 75 percent loan to the deposit ratio ceiling, which is currently applied to banks. Because the banking system is a more strictly regulated sector, the shadow banking activities create an additional funding source in economy, allowing firms to take advantage of regulatory arbitrage. However, the question of whether the system operates properly is controversial.

Shadow banking activities in China primarily rely on trust companies, wealth management products and entrusted loans. Wealth management products are financial instruments issued by trust companies. Banks act as the agencies marketing these products, which provide higher yields than deposits, to individual investors. Entrusted loan products are instruments which allow non-financial institutions to lend to each other in countries where firms are banned to extend loans directly to one another. These short-term products are generally used in funding long-term investments, which is the reason for maturity mismatch. This gap is maintained by borrowing through interbank markets and issuing new wealth management products. In this respect, the system is highly risky and criticized as creating a Ponzi economy. In order for banks to meet the loan to deposit ratio criteria in audits at each quarter-end, the wealth management products are arranged to mature just before the quarter-end and they are not issued again before the quarter actually ends. Thus, funds return to the banks as

deposits and contribute to the fulfilment of the loan to deposit ratio criteria. In this period, investment trusts face significant liquidity risks as they provide funding through interbank monetary markets.

In China, some investment trusts have not been able to fulfil their liabilities in the recent period. As a result, the regulations aimed at those products were accelerated. The China Banking Regulatory Commission introduced regulations in March 2013 to increase transparency, broaden the scope of information made public and develop accounting practices. Thanks to those regulations, asset growth of trust companies edged down to 8.3 percent, whereas it was 16.9 percent in first quarter of 2013. Although regulations decelerate growth, the unhealthy structure which results in loan supplies from non-bank financial institutions has a potential to create an unfavorable impact on the Chinese economy. That is why, in China, actions to be taken with regard to shadow banking are of great importance to achieve financial stability.