5. Financial Conditions and Monetary Policy

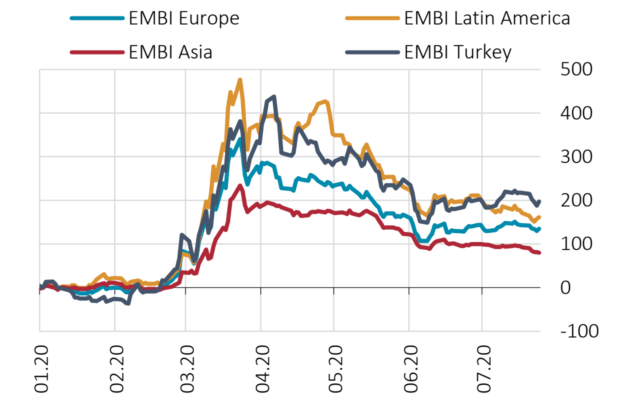
In the second quarter of 2020, owing to the monetary and fiscal policies in effect in addition to the start of the post-pandemic normalization period , global risk appetite improved somewhat and the risk sentiment towards emerging economies improved. In the current reporting period, the pace of capital outflows from emerging economies slowed, and increased risk appetite pushed asset and commodity prices upwards. In this period, emerging economies witnessed a fall in risk premiums and some appreciation in currencies. In the second quarter of the year, financial conditions proved more supportive of economic activity than the previous quarter, yet they have not retained pre-pandemic levels.

The CBRT made a more measured cut in May compared to April, but left the policy rate unchanged at 8.25% in June and July in view of all the factors affecting inflation. In tandem with the CBRT's rate cuts, the easing trend in domestic funding conditions, which started in the third quarter of 2019, continued in the second quarter. TL loan rates, which remained relatively flat in the first quarter of the year, decreased in the second quarter amid the decline in funding costs. Owing to the declining rates as well as the support packages to mitigate the adverse impacts of the pandemic on households and firms, consumer and commercial loan utilization displayed an upsurge.

5.1 Financial Markets and Monetary Policy

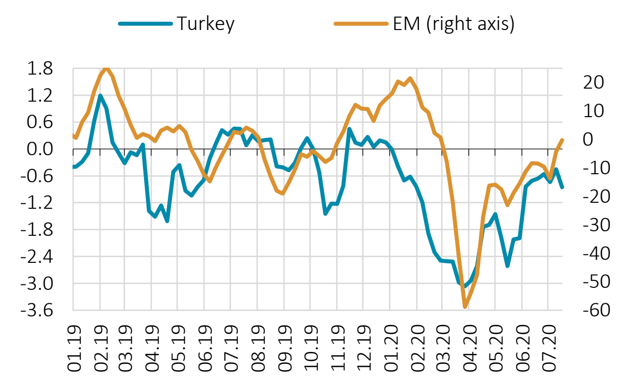
After a notable pandemic-driven downturn in the first quarter of the year, global risk appetite recovered somewhat in the second quarter. This is mainly attributed to the gradual commencement of the normalization process as well as the accommodative steps of central banks and comprehensive fiscal measures announced by governments. Amid increased risk appetite, stocks of advanced economies appreciated and commodity prices increased. Risk premiums of emerging economies receded in the second quarter of the year, yet remained above pre-pandemic levels. Turkey's sovereign risk premium receded, along with those of other emerging economies, yet remained high (Chart 5.1.1). In the current reporting period, capital outflows from emerging economies including Turkey continued, albeit at a slower pace (Chart 5.1.2). In this period, GDDS markets of emerging economies recorded limited capital inflows, while Turkey saw further outflows from the GDDS market. Despite capital outflows, returns on GDDS receded due mainly to the increased bond demand amid the asset ratio measures applied to banks and partly to the bond purchases of the CBRT (Box 5.1). In the stock markets, outflows both from emerging economies and Turkey continued in the current reporting period.

Chart 5.1.1: Change in Regional Risk Premiums* (2 January 2020 = 0, Basis Points)



Source: Bloomberg.
* Shows cumulative changes since 2 January 2020.

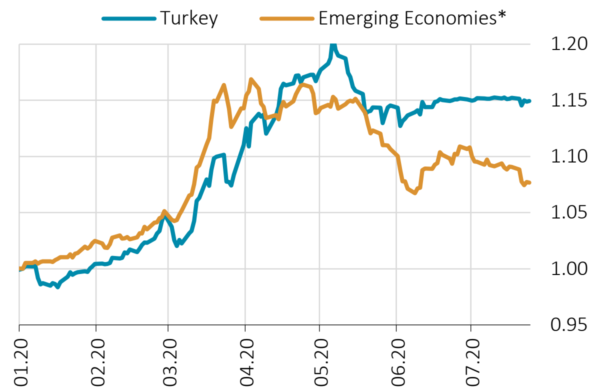
Chart 5.1.2: Portfolio Flows in Emerging Economies* (4-Week Cumulative, Billion USD)



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.

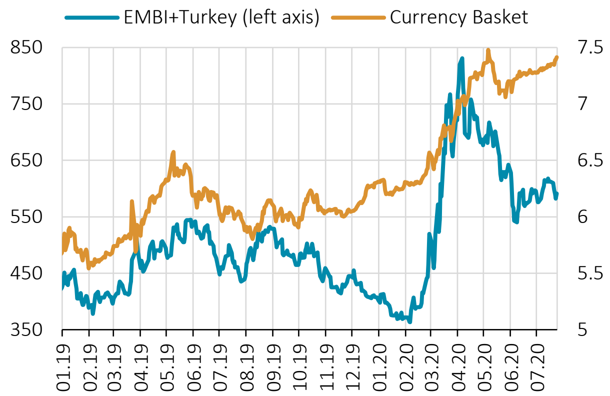
Currencies of emerging economies appreciated slightly against the US dollar in the current reporting period, while the appreciation in the Turkish lira remained more limited (Charts 5.1.3 and 5.1.4). Due to the upswing in global risk appetite, the pressure on the currencies of emerging economies alleviated to a lesser extent. However, the rise in oil prices led to a negative divergence in the currencies of oil-importing emerging economies that also include Turkey.

Chart 5.1.3: Turkish Lira and Emerging Market Currencies against US Dollar (02.01.2020=1)



Sources: Bloomberg.
* Emerging economies: Brazil, Chile, Colombia, Hungary, Malaysia, Mexico, Poland, Romania, S. Africa, India, Indonesia and the Philippines.

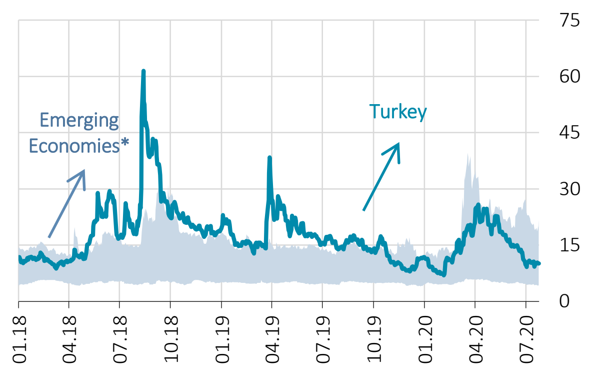
Chart 5.1.4: Exchange Rate Basket* and EMBI Index of Turkey



Sources: Bloomberg.
* Exchange rate basket represents the value of the Turkish lira against 0.5*USD + 0.5*euro.

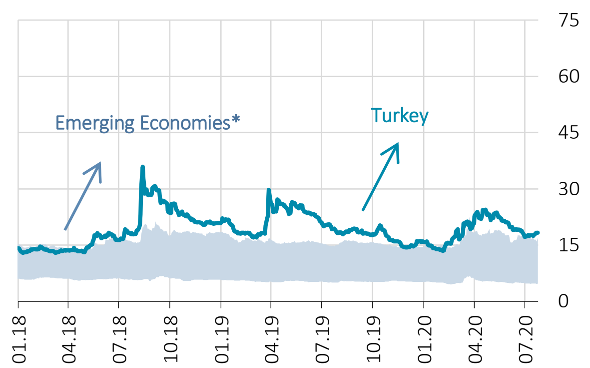
The implied volatility of the Turkish lira has decreased in the current reporting period, yet still hovers above the pre-pandemic levels. The one-month implied volatility of the Turkish lira receded as of late April and displayed positive divergence compared to other emerging market currencies. Nevertheless, the decline in the 12-month implied volatility of the Turkish lira proved more limited (Charts 5.1.5 and 5.1.6).

Chart 5.1.5: Exchange Rate Volatilities Implied by Options (1-Month Forward)



Sources: Bloomberg.
* Emerging economies: Brazil, Indonesia, the Philippines, S. Africa, Colombia, Hungary, Malaysia, Mexico, Poland, Romania, Chile.

Chart 5.1.6: Exchange Rate Volatilities Implied by Options (12-Month Forward)

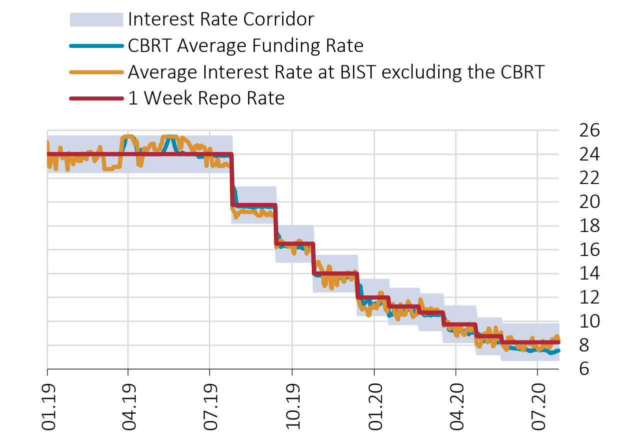


Sources: Bloomberg.
* Emerging economies: Brazil, Indonesia, the Philippines, S. Africa, Colombia, Hungary, Malaysia, Mexico, Poland, Romania, Chile.

Monetary Policy Response

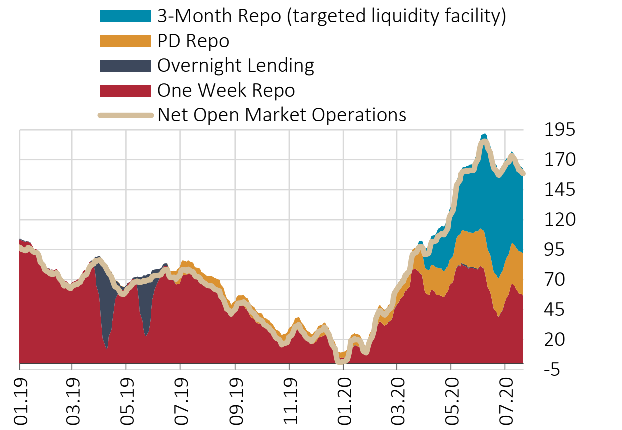
In view of the increased downside risks to the year-end inflation projections in March and April, the CBRT made a policy rate cut of 200 basis points in total. Highlighting the rise in unit costs resulting from declining production and sales in May, the CBRT made a measured policy rate cut of 50 basis points considering that inflation may increase slightly in the short term, but demand-driven disinflationary effects would be more prevalent. Despite the restraining effects of aggregate demand conditions in June, the CBRT left the policy rate unchanged emphasizing that the pandemic-related rise in unit costs had led to some increase in the trends of core inflation indicators. In July, the CBRT maintained the view that demand-driven disinflationary effects will become more prevalent in the second half of the year, but risks to the end-year projection are considered to be on the upside due to recent realizations in inflation. In view of all factors affecting the inflation outlook, the Committee kept the policy rate unchanged (Chart 5.1.7).

Chart 5.1.7: Short-term Rates (%)



Sources: BIST, CBRT.

Chart 5.1.8: CBRT Open Market Operations (2-week Moving Average, TRY Billion TL)

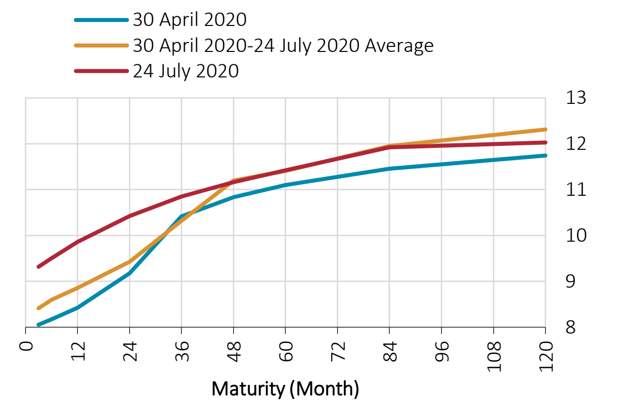


Sources: CBRT.

In the current reporting period, a large portion of the funding need of the system has been met by TL currency swap transactions at the CBRT and BIST. However, the composition of funding provided through open market operations (OMO) changed parallel to the new facilities launched following the pandemic (Chart 5.1.8). The amount of funding provided by 3-month repo auctions launched with the CBRT's package of measures announced on 17 March 2020 has displayed a significant rise in the current reporting period. Due to the large portion of long-term repo auctions in OMO funding held at lower rates than the CBRT policy rate, the CBRT average funding rate hovered steadily below the policy rate (Chart 5.1.7).

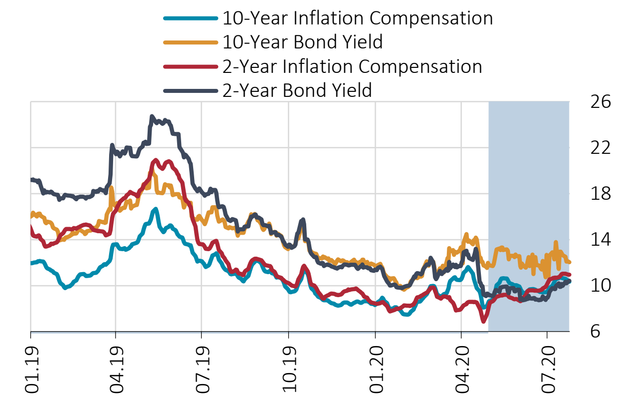
The yield curve has maintained its positive slope in the current reporting period, and has shifted upwards across all maturities due to the rise in the sovereign risk premium and inflation compensation (Chart 5.1.9). Due to the rising inflation and sovereign risk premiums that followed a high course in May and June, market-based inflation compensation increased. Increases in inflation compensation proved higher than the long-term inflation expectations in the CBRT Survey of Expectations (Chart 5.1.10).

Chart 5.1.9: Recent GDDS Yield Curve (%)



Source: Bloomberg.

Chart 5.1.10: Bond Yields (%) and Inflation Compensation (5-day Moving Average, %)

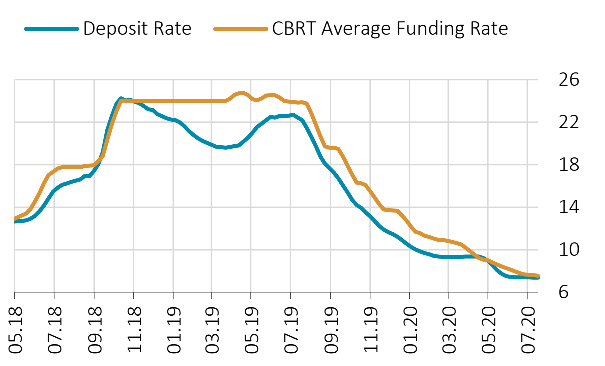


Source: Bloomberg.

5.2 Credit Conditions

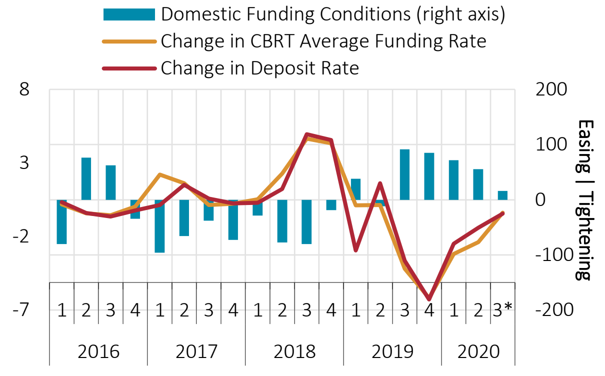
The downtrend in the CBRT average funding rate and deposit rate, which started in the third quarter of 2019, continued in the second quarter of 2020 (Chart 5.2.1). In addition to the CBRT's rate cuts, arrangements in required reserves based on loan growth implemented since August 2019 and liquidity facilities that support loan supply provided with the measures announced on 17 March 2020 have also improved funding conditions of banks. Consistent with the decline in banks' funding costs, as the data from the Bank Loans Tendency Survey (BLTS) suggests, the contribution of domestic funding conditions to easing in loan standards continued during the second quarter of the year, albeit with a diminishing pace (Chart 5.2.2). In the third quarter of the year, the proportion of banks expecting an easing in loan standards owing to funding conditions declined notably.

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



Sources: Bloomberg, CBRT.

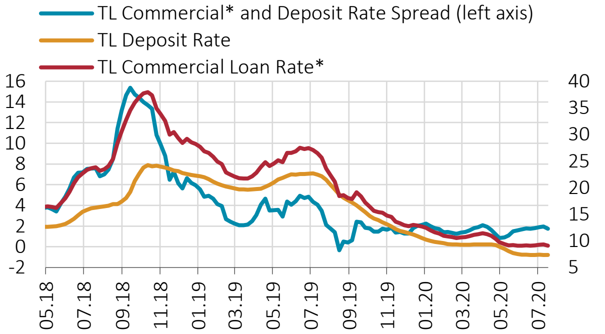
Chart 5.2.2: Banks' Domestic Funding Conditions (Quarterly % Change)



Source: CBRT.
* The BLTS indicate banks' expectations. July average is used as the third quarter in change in rates. *Note*: Blue lines indicate the contribution of domestic funding conditions to loan standards in the BLTS.

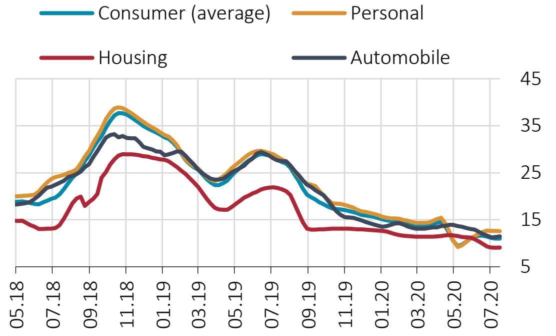
The CBRT's policy rate reductions made as of July 2019 spread strongly into loan and deposit rates. After remaining almost flat in the first quarter of the year, loan rates inched down in the second quarter (Charts 5.2.3 and 5.2.4). In the second quarter of the year, deposit rates receded, while the loan-deposit rate spread remained lower than past years in line with the easing in domestic funding conditions (Chart 5.2.3). After having followed a relatively flat course in the first quarter of the year, automobile and housing loan rates decreased somewhat towards the end of the second quarter. Meanwhile, general-purpose loan rates, which fell in April, increased at the end of the second quarter and converged to other loan rates.

Chart 5.2.3: TL Commercial Loan and TL Deposit Rates (Flow Data, Annual, 4-Week Moving Average, %)



Source: CBRT.
* Overdraft accounts and credit cards excluded.

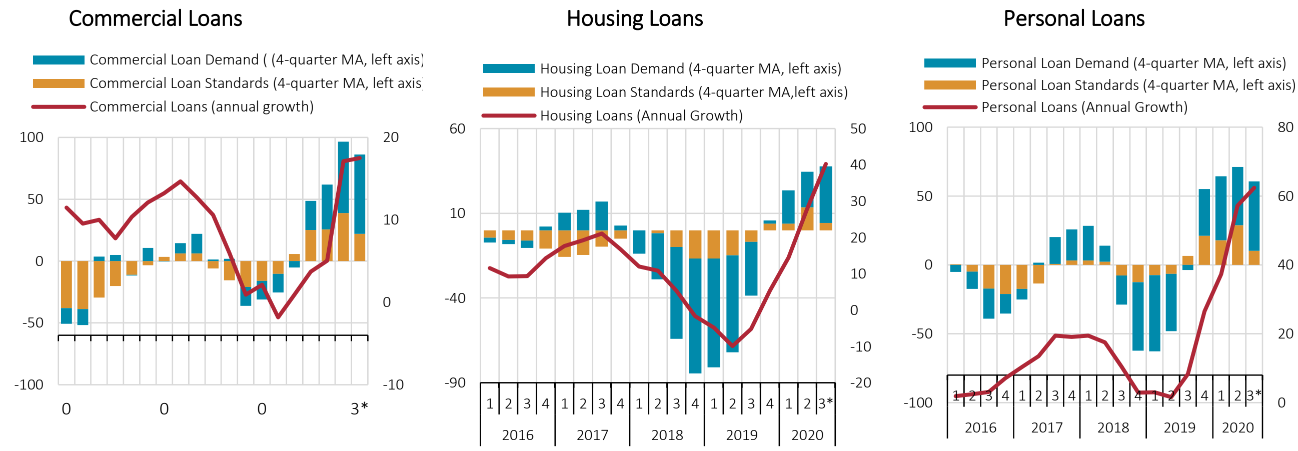
Chart 5.2.4: Consumer Loan Rates (Flow Data, Annual, 4-Week Moving Average, %)



Source: CBRT.

According to the results of the BLTS, both business and consumer loan standards eased, while loan demand increased in the second quarter (Chart 5.2.5). While banks expect a further increase in loan demand in the third quarter, the expectation for an additional easing in loan standards lost a little strength.

Chart 5.2.5: Credit Standards, Credit Demand and Annual Credit Growth



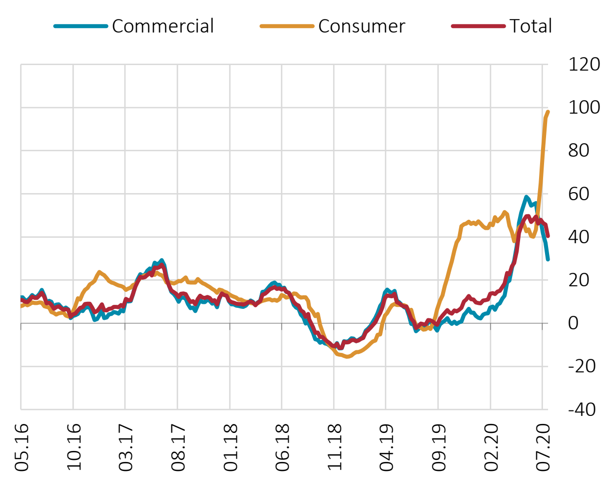
Source: CBRT.

* 2020 third-quarter data indicate banks' expectations of the value those variables will take in that quarter. Third-quarter loan growth is the July data.

Note: To calculate Credit Standards (Demand) Index, banks are asked how their credit standards (credit demand) have changed over the past three months. Net tendencies calculated based on response percentages indicate the direction of the change in credit supply (demand). The index is calculated as (Ease Somewhat+ Ease Considerably)-(Tighten Somewhat +Tighten Considerably). Index values above 0 indicate easing in credit standards (increase in credit demand).

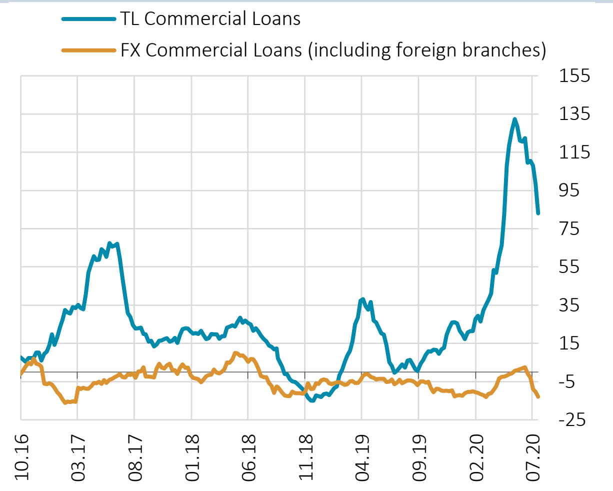
With decreasing loan rates, easing in loan standards and recovery in domestic demand loan growth accelerated in the third quarter of 2019, with a larger emphasis on consumer loans. Pandemic-related support packages as well as advantageous maturities and rates for housing and automobile loans provided in June caused consumer loans to gain an additional momentum. Parallel to the pre-pandemic mild recovery in economic activity in the first quarter of 2020, commercial loan growth displayed an uptick (Charts 5.2.6 and 5.2.7). Commercial loan growth, which accelerated with the support provided to enterprises with the Economic Stability Shield Package to curb the adverse impacts of the pandemic on economic activity, lost some momentum as the firms' loan demand reached a saturation point and economic activity registered a rebound as of the second half of June.

Chart 5.2.6: Loan Growth (13-Week Moving Average, Adjusted for Exchange Rates, %)



Source: CBRT.

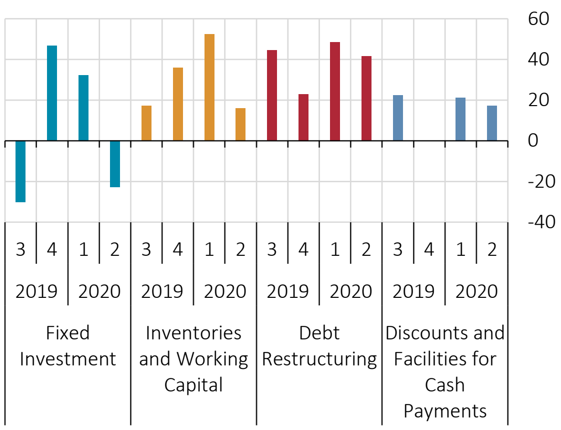
Chart 5.2.7: TL and FX Commercial Loan Growth (13-week Annualized, Adjusted for Exchange Rates, %)



Source: CBRT.

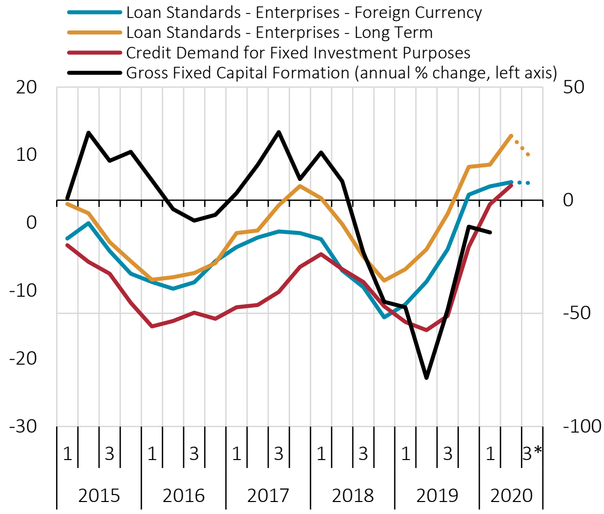
A breakdown of commercial loans by currency suggests that the acceleration in TL commercial loans, which started in the last quarter of 2019, increased remarkably in the second quarter of 2020 on the back of support packages, whereas the contraction in FX loans continued (Chart 5.2.7). According to the results of the BLTS, the business loan demand received positive contribution from fixed investments in the pre-pandemic period, while it was driven mainly by use for financial purposes, for debt restructuring in particular, in the second quarter (Chart 5.2.8). Following an easing in the last quarter of 2019, credit standards for FX-denominated and long-term commercial loans, generally used for investment purposes, remained flat in the ensuing period (Chart 5.2.9). In the second quarter, long-term loan standards eased further, while banks expect a more limited easing in the third quarter.

Chart 5.2.8: Leading Sub-factors of Firms' Loan Demand



Source: CBRT.
Note: Net percentage changes regarding factors are the difference between the percentage of the banks reporting that this factor increased the loan demand and those reporting that it decreased the loan demand.

Chart 5.2.9: Effect of Fixed Investments on Credit Demand and Fixed Capital Formation (4-Quarter Moving Average)



Sources: CBRT.
* 2020 third-quarter data indicate banks' expectations of the values those variables will take in that quarter.

In sum, the CBRT's rate cuts and supportive policy measures that started in the third quarter of 2019 have contributed to loan growth. In this period, with low-rated housing and general-purpose loan promotions implemented chiefly by state banks, consumer loan growth gained momentum. The use of business loans, which increased due to support packages provided to curb the adverse impacts of the pandemic on the household and firms, lost some momentum with the rebound in economic activity. In the second quarter of 2020, the slowdown in economic activity and the rise in uncertainties led to a decline in investment-oriented loan demand, which had gained strength in the previous two quarters. Meanwhile, the easing in funding conditions and the support in housing loans led by state banks are expected to continue to support private consumption and construction activity.

Box 5.1

The CBRT's Bond Purchases in Response to The Pandemic

Emerging market economies (EMEs) have announced a series of measures for bond markets in response to the pandemic and have launched local currency bond purchase programs varying in size. The CBRT also shared the details of changes made in the bond purchase program as announced in the Monetary and Exchange Rate Policy for 2020, with press releases of 31 March and 17 April 2020. In this box, details of the CBRT's bond purchases and the course of the bond yields are presented in comparison with the other EMEs that launched bond purchase programs. When compared with other EMEs, the decline in the Turkish bond yields proves more notable and is attributed to the CBRT's rate cuts as well as the BRSA's asset ratio regulation announced on 18 April.

Bond Purchase Programs in EMEs

In response to the pandemic shock, central banks of many emerging market economies have launched local currency bond purchase programs to ensure effective functioning of the markets and to maintain market depth (Table 1).

Table 1: Bond Purchase Programs Announced by EMEs in Response to the Pandemic

Country	Security Type	Announcement	Country	Security Type	Announcement
Indonesia	Government	01/04	Hungary	Government, Mortgage Backed	07/04
Philippines	Government	10/04	Mexico	Government	21/04
South Africa	Government	25/03	Poland	Government	17/03, 08/04
India	Government	18/03,20/03	Romania	Government	20/03
Colombia	Government, Bank Bond	23/03	Chile	Government	19/03, 08/04
Korea	Government	19/03, 09/04	Thailand	Government, Corporate Bond	19/03, 22/03, 07/04
Turkey	Government	31/03, 17/04			

Source: BIS.

The recent bond purchase programs of EMEs are quite different from those of advanced economies in many aspects.[1] Firstly, purchases in EMEs, which are smaller in scale compared to the programs implemented in advanced economies, were made primarily to prevent unhealthy price formation in the bond markets and to strengthen the transmission mechanism rather than monetary accommodation. In addition to government bonds, central banks of advanced economies also implemented large-scale corporate bond purchases, which are primarily aimed at providing financial and credit support to firms.

The CBRT's Bond Purchase Program

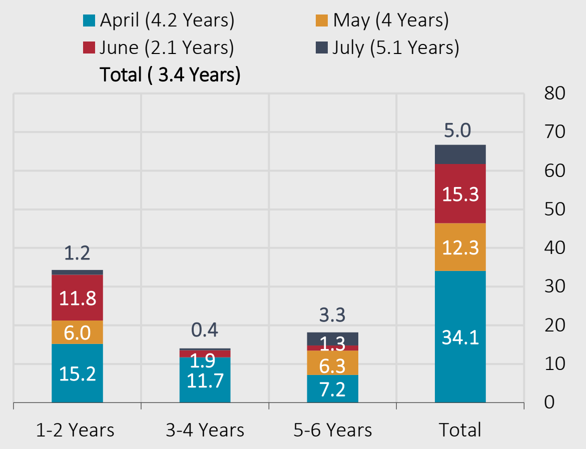
In the press release of 31 March 2020 on the additional measures taken against the economic and financial effects of the coronavirus, the CBRT announced that the outright purchase operations under the Open Market Operations (OMO) portfolio executed within the limits determined in the Monetary and Exchange Rate Policy for 2020 may be carried out in a front-loaded manner and these limits may be revised depending on market conditions.

[1] For a recent comparison of the bond purchase programs, see Arslan et al (2020).

In addition, it was stated that for a temporary period, the Primary Dealer (PD) banks would be able to sell the Government Domestic Debt Securities (GDDS) that they bought from the Unemployment Insurance Fund to the CBRT under the terms and amounts set by the CBRT, out of the scope of the limits set for the OMO portfolio.

With the press release of 17 April 2020, the maximum limit for the ratio of the OMO portfolio nominal size to the CBRT analytical balance sheet total assets, set at 5% for 2020 in the Monetary and Exchange Rate Policy for 2020 text, was revised to 10%. The same press release announced that the limits offered to PD banks for outright sales of GDDS to the CBRT would be applied independent of the repo transaction limits and that the GDDS selling limit for PD banks would be equal to the repo transaction limits. It was also announced that these purchases would be carried out within the total maximum limit of 10% set for the OMO portfolio.

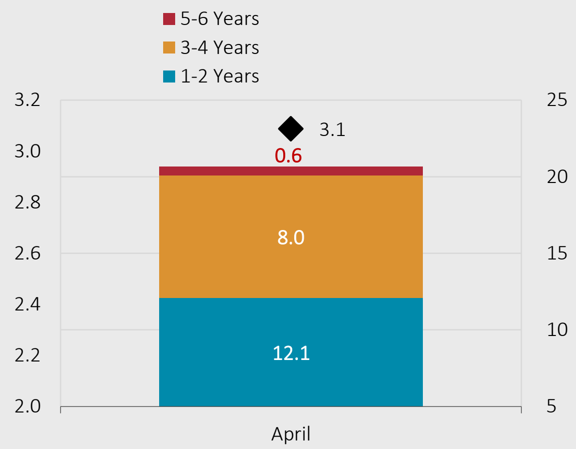
Chart 1: CBRT Outright Purchases* (Net Amount, Billion TRY, Years)



Source: CBRT. Last Observation: 24 July 2020

* Weighted average maturity of the securities purchased is shown in parentheses next to the relevant month.

Chart 2: CBRT's Bond Purchases From Unemployment Insurance Fund (Net Amount, Billion TRY, Years)

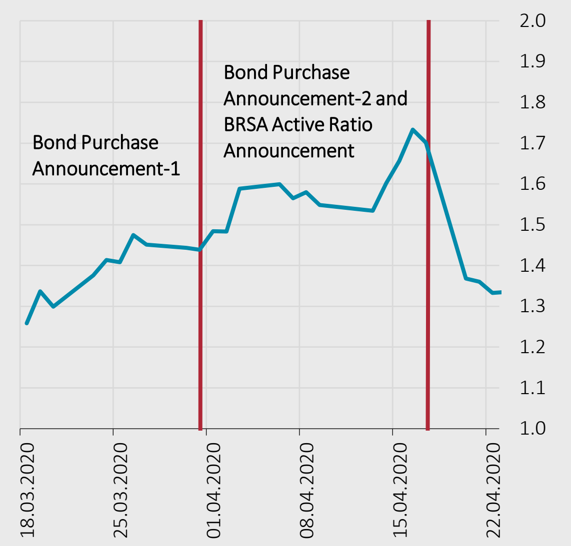


Source: CBRT. Last Observation: 24 July 2020

As of 24 July 2020, the CBRT's purchases of government securities, which started in April, reached a total of 67 billion TL (nominal 56 billion TL) (Chart 1). Purchases from the Unemployment Insurance Fund reached 20.7 billion TL, and the nominal equivalent of these transactions which is 12.2 billion TL, is excluded from the 10% limit (Chart 2). The CBRT purchased the highest amount of government securities in April and due to the Unemployment Insurance Fund transactions, all purchases were concentrated mostly on 1-2 year bonds (Chart 1). The weighted average maturity of all GDDS purchases of the CBRT in the April-July period is approximately 3.5 years.

When compared with other EMEs that launched bond purchase programs, Turkey's two-year bond yields fell more significantly (Chart 3). In addition to the CBRT's purchases, the banks' increased demand for government bonds after the BRSA's active ratio announcement on 18 April and policy rate cuts are also considered to have been effective in this decline (Chart 4).

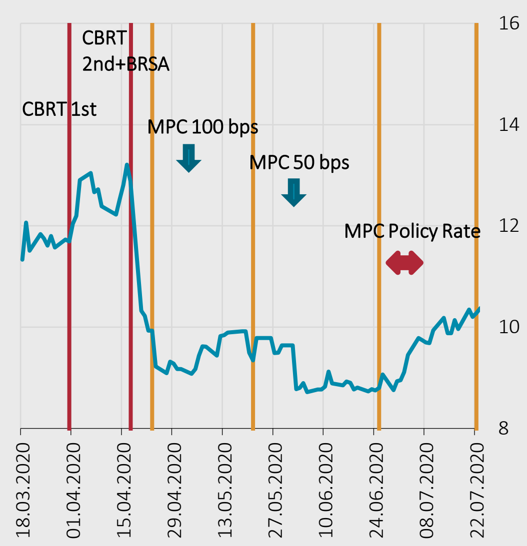
Chart 3: Relative 2-Year Bond Yield (Turkey/EME Yields For The Period Excluding MPC Meetings*)



Source: Bloomberg. Last Observation:22 April 2020

* Emerging market economies that announced bond purchase programs: Indonesia, Philippines, S. Africa, India, Colombia, Korea, Hungary, Mexico, Poland, Romania, Chile, Thailand. Bond yields are normalized to 1 as of 01.01.2015.

Chart 4: Turkey 2-Year Bond Yield (The Period Including MPC Meetings, %)



Source: Bloomberg. Last Observation: 24 July 2020

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