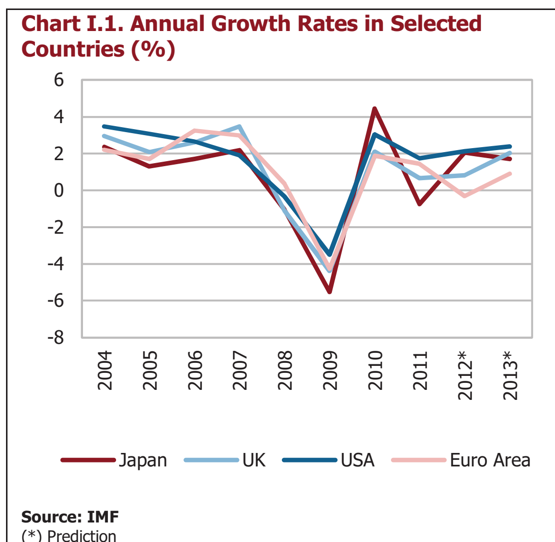
I. INTERNATIONAL DEVELOPMENTS

The impact of the global financial crisis still persists. Growth and unemployment ratios in advanced economies are more unfavorable compared to the pre-crisis period and due to the interconnected nature of markets, developing countries, which especially have close economic relations with EU countries, are faced with elevated risk of deteriorating economic performance. Fiscal problems in some EU countries', increased political uncertainties and failure to introduce lasting structural measures continue to have an adverse impact on the risk appetite of the markets and hamper the pace of exit from the crisis. The banking sectors of certain EU countries that have fiscal problems continue to carry most of the distressed assets on their balance sheets. Funding distress due to the decrease in the global risk appetite as well as the new capital requirements introduced by the EU put pressure on banks for deleveraging. Even if measures introduced by the authorities to overcome the liquidity squeeze in post crisis period eased the markets temporarily in the short run, in the long run, it is still crucial to take lasting structural measures towards minimizing the impact of the deleveraging of the EU banking sector on the corporate sector funding, credit flow between sectors, and consequently, on the global economic activity. Moreover, recent uncertainties about elections in some EU countries and concerns over Greece's future in the Euro area come to the fore as issues that spark hot debates. Should problems in the region fail to be settled and become more pronounced, they would have an adverse impact on global financial stability with a spillover effect.

Recovery in global economic activity since the crisis has remained subdued. The lower-than-desired level of credit supply in developed countries coupled with deficient domestic demand hampers recovery in economic growth. Rising budget deficits during the crisis, especially in EU countries, have evolved into sovereign debt problems making it difficult for the authorities to implement fiscal stimulus policies. In fact, the decline in GDP growth rates of developed countries continued and international institutions have recently been downgrading growth prospects for 2012 and 2013 (Chart I.1, Chart I.2).

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



Source: IMF
(*) Prediction

Chart I.2. Growth Prospects for 2012 (%)

Source: IMF

EU countries failed to introduce lasting measures to solve public finance problems and risks arising from some countries could not be contained due to political uncertainties in those countries. Many EU countries with sovereign debt problems have not yet introduced structural reforms due to political reasons. Even if there was a consensus on strictly monitoring budget deficit in EU countries and limiting the ratio of structural budget deficit to GDP by 0.5 percent, it is still unclear whether these measures will be put into practice or not in the upcoming period. Public reactions to the austerity measures introduced raise questions regarding the willingness of governments to continue with these measures. Meanwhile, concerns over debt sustainability of some EU countries, especially of Greece and Spain, fuels unrest in the market and bond auctions of these countries are closely monitored (Chart I.3, Chart I.4).

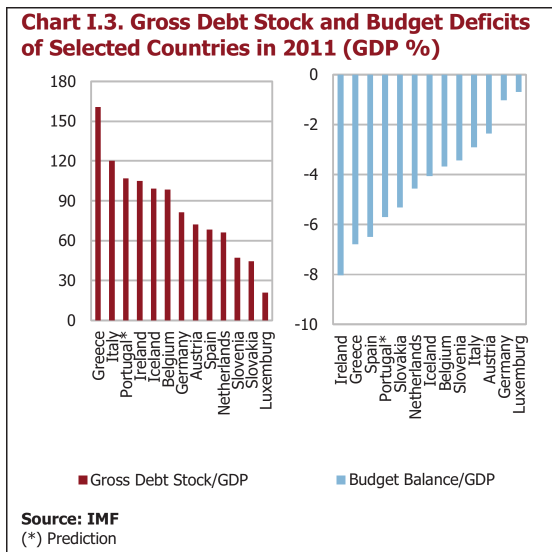


Chart I.3. Gross Debt Stock and Budget Deficits of Selected Countries in 2011 (GDP %)

Source: IMF
(*) Prediction

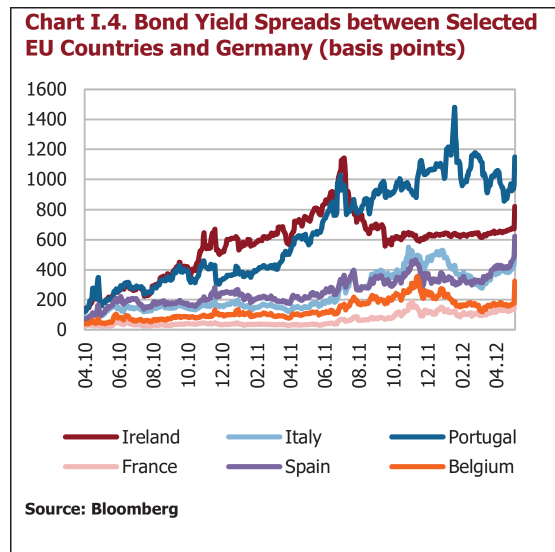
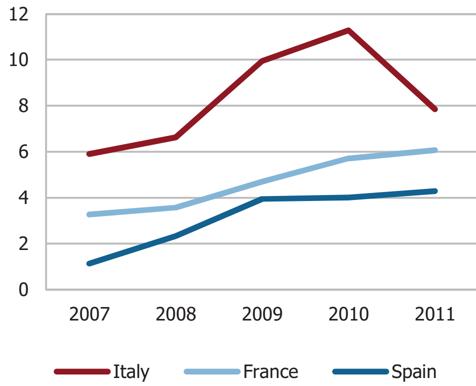


Chart I.4. Bond Yield Spreads between Selected EU Countries and Germany (basis points)

Source: Bloomberg

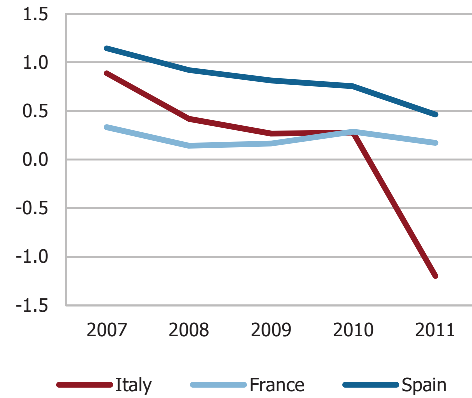
Banking sectors of EU countries that faced with rise in country risks experience a rise in credit risk and deterioration in profitability indicators. Banks are faced with the risk of deterioration in their asset quality due to decelerating economic activity and the persistent high level of unemployment. Moreover, the write-off part of the troubled assets on banks' balance sheets leads to a decline in these banks' profitability performances. In the upcoming period, banks are expected to write off additional losses especially in the framework of the Greek debt swap agreement (Chart I.5, Chart 1.6).

Chart I.5. Average NPL Ratios of Some Big Banks in Selected European Countries [1] (%)



Source: Bloomberg
(1) BNP, Credit Agricole, Societe Generale, Santander, BBVA, Unicredito, Intesa, Banco Monte dei Paschi di Siena, which have undergone the ECB stress test, have been included in the analysis.

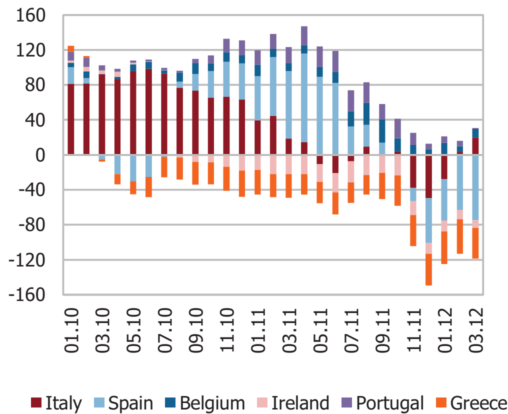
Chart I.6. Average Return on Assets of Some Big Banks in Selected European Countries[1] (%)



Source: Bloomberg
(1) BNP, Credit Agricole, Societe Generale, Santander, BBVA, Unicredito, Intesa, Banco Monte dei Paschi di Siena, which have undergone the ECB stress test, have been included in the analysis.

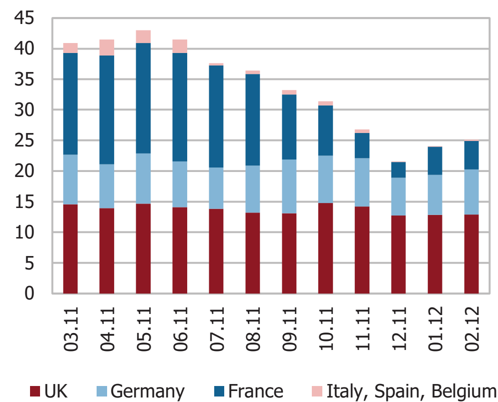
Funding problems of the banking sectors still continue in distressed EU countries. Squeeze in the funds acquired via bond issues, deposits and US Money Market Funds (MMF) continued and thus, funding costs increased (Chart I.7, Chart I.8). As of the last quarter of 2011, deposits in banking sectors of distressed EU countries decreased significantly and accordingly, banks were in need of funding support from authorities (Chart I.11).

Chart I.7. Deposit Flows to Distressed EU Countries[1] (Billion Euro)



Source: ECB
(1) Flow data of 12 months.

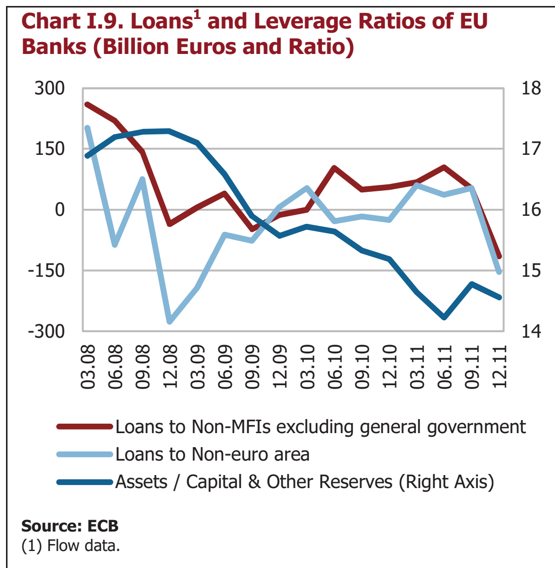
Chart I.8. US Money Market Funds to Selected EU Countries[1] (%)[2]



Source: Fitch
(1) EU countries, which receive the highest funding from MMFs, have been selected.
(2) Shows the share of MMFs in total assets.

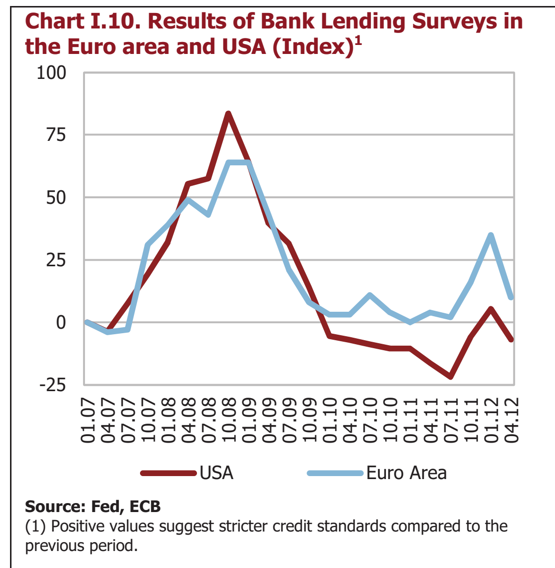
Deterioration in credit quality, funding problems and additional capital requirements of EU banks urged these banks to deleverage or restructure their balance sheets. As a matter of fact, the result of the ECB's Bank Lending Survey suggests that banks in the Euro area are more reluctant to extend loans and further tightened credit conditions. This not only adversely affects credit growth in EU countries, but also hampers the recovery of economies. The conditions that EU banks are in might indirectly affect all sectors worldwide that have credit relations with these banks (Chart I.9, Chart I.10).

Chart I.9. Loans[1] and Leverage Ratios of EU Banks (Billion Euros and Ratio)



Source: ECB
(1) Flow data.

Chart I.10. Results of Bank Lending Surveys in the Euro area and USA (Index)[1]

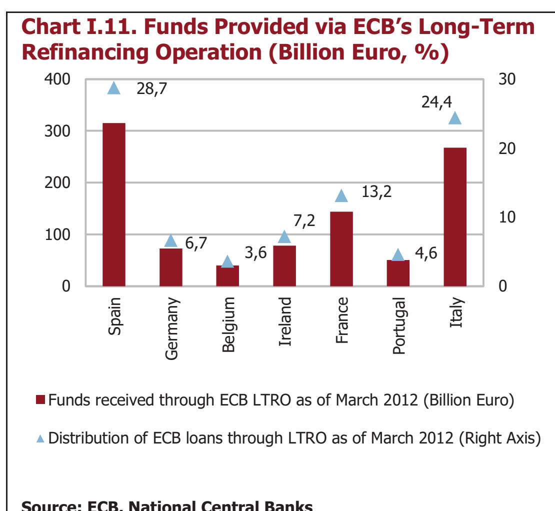


Source: Fed, ECB
(1) Positive values suggest stricter credit standards compared to the previous period.

Rapid deleveraging in EU banks may have adverse consequences on a global scale. A rapid deleveraging trend of EU banks might have a negative effect on asset prices and in turn asset quality, and moreover, this could lead to deterioration in overall economic activity by causing contraction in the credit channel for the corporate sector. Nevertheless, such a trend could contribute to financial sector soundness by lowering the high leverage ratio of the non-bank sector in the medium term and encouraging banks to have a sounder balance sheet structure.

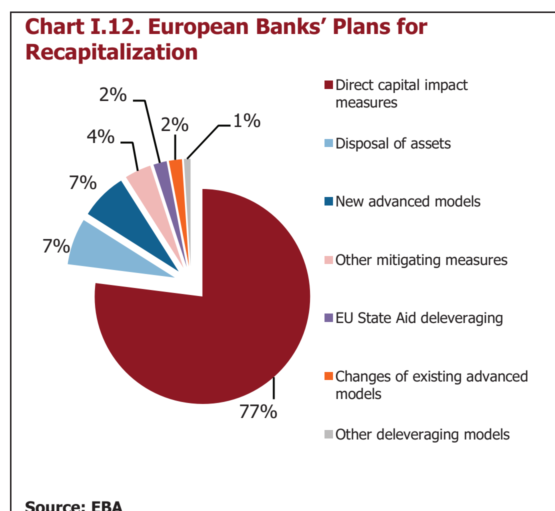
The ECB has introduced several measures to address European banks' funding problems while banks have revealed plans to strengthen their capital structures. The ECB provided Long-Term Refinancing Operation with a 3-year maturity to banks in December 2011 and February 2012 and extended the asset pool that can be accepted as collateral. Furthermore, it lowered the reserve requirement ratio from 2 percent to 1 percent. The said operations partly eased the funding problems of the banks. Meanwhile, according to the European Banking Authority's (EBA) assessments on banks' capital plans, most of the banks, which are in need of recapitalization to comply with the new EU capital standards, are expected to meet recapitalization needs by capital increase (Chart I.11, Chart I.12, Box I.1).

Chart I.11. Funds Provided via ECB's Long-Term Refinancing Operation (Billion Euro, %)



Source: ECB, National Central Banks

Chart I.12. European Banks' Plans for Recapitalization



Source: EBA

Due to the adverse macroeconomic outlook persisting in the post-crisis period central banks of developed countries continue to implement growth and financial stability-oriented monetary policies. While the ECB introduces measures to help the banking sector, the Federal Reserve maintains accommodating monetary policy on the grounds that unemployment rates are still high and the growth rate has not yet reached the desired level. Recent evaluations suggesting a slowdown in recovery in the US increase the probability of kick starting the third wave of quantitative easing. The Bank of England (BoE) and Bank of Japan (BoJ) continue to stick to expansionary policies amid growth concerns (Chart I.13, Chart I.14).

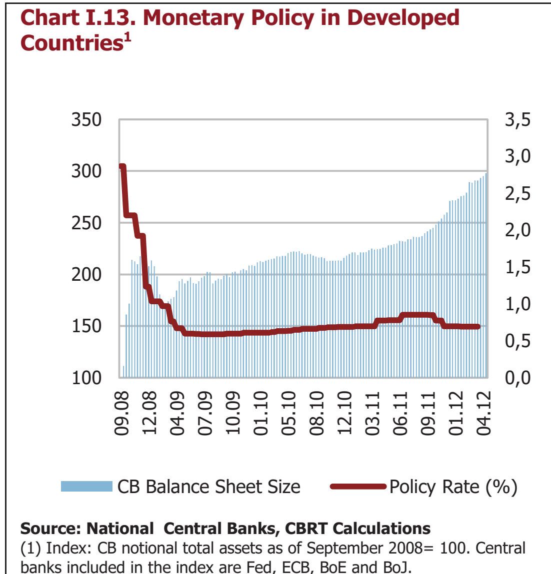


Chart I.13. Monetary Policy in Developed Countries[1]

Source: National Central Banks, CBRT Calculations
(1) Index: CB notional total assets as of September 2008= 100. Central banks included in the index are Fed, ECB, BoE and BoJ.

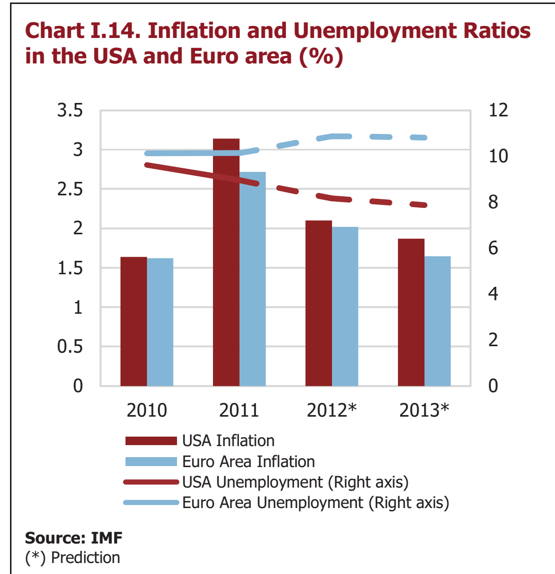
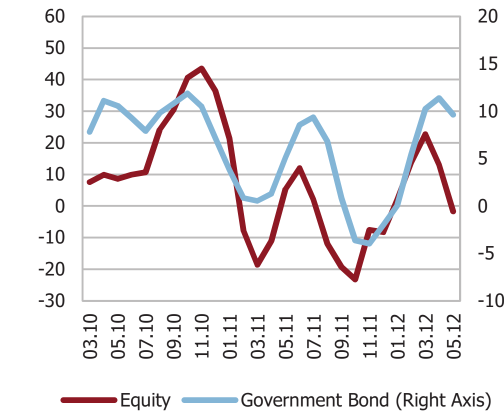


Chart I.14. Inflation and Unemployment Ratios in the USA and Euro area (%)

Source: IMF
(*) Prediction

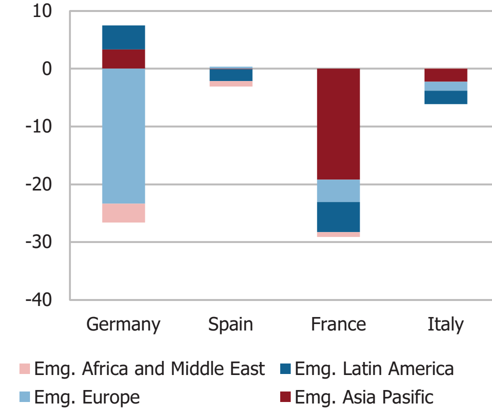
Problems in Europe expose banking sectors of developing countries to funding risk. Developing countries with high foreign participation in their banking sector have problems receiving funds from the parent country. Additionally, the funding channels of developing countries whose banking sectors rely mostly on wholesale funding from international markets are contracting due to deterioration in the global risk appetite**.** Moreover, the European bank's tendency to tighten credit conditions affects developing countries as well. In fact, cross-border positions are affected primarily from deleveraging operations of the banking sectors of distressed EU countries. The rising risk appetite owing to accelerating political uncertainties has caused a decline in capital flows to developing countries mainly through equity investments. Nevertheless, bond issues, other domestic funding sources and funds from non-European investors partly offset the decline in financing from European banks (Chart I.15, Chart I.16). The high capital adequacy and profitability ratios of banking sectors of developing countries act as a buffer for those countries.

Chart I.15. Capital Flows to Developing Countries[1] (Billion USD)



Source: IMF
(1) Data derived from the sum of previous quarters.

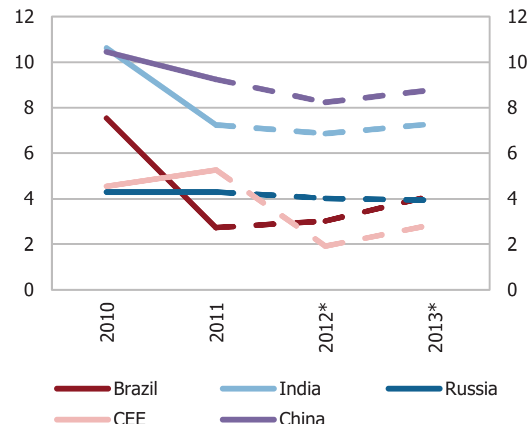
Chart I.16. Change in Receivables of Selected European Banking Sectors from Developing Countries by the end of 2011[1] (Billion USD)



Source: BIS Consolidated Banking Statistics
(1) Denotes change in cross-border receivables by end-2011 compared to end-2010.

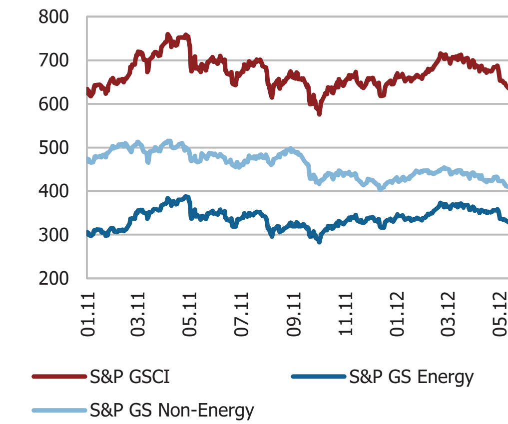
While countries with a savings gap are affected by the slowdown in Europe through the funding channel; those that have close commercial ties with the region are affected through the trade channel. Central and Eastern European (CEE) countries, which have close commercial ties with the EU due to geographical proximity and have substantial shares of EU-based banks in their banking sectors, feel the impacts of the crisis directly. Moreover, a slowdown is expected for countries that have intense commercial relations with EU and trade surplus like China, due to the contraction in demand in the EU. Meanwhile, the worldwide weakness in demand causes a decline in commodity prices (Chart I.17, Chart I.18).

Chart I.17. Annual Growth in Developing Countries (%)



Source: IMF
(*) Prediction

Chart I.18. Commodity Prices (Index)



Source: Bloomberg

In conclusion, the global economic outlook displays a negative prospect due to the EU-based problems. Even if measures taken by the authorities in developed countries to solve the post-crisis problems have rendered some degree of ease, political uncertainties and the absence of structural measures still hamper economic recovery**.** The rapid deleveraging of the European banks might lead to deterioration in economic activity by slowing down the flow of funds to the corporate sector. Still, financial stability can be enhanced in the medium term if banks get rid of the distressed assets from their balance sheets and prefer safer assets. In this framework, finding alternative sources of funding becomes more important for countries that are affected by distressed EU banks via

the funding channel. Moreover, concerns over Greece's future in the Euro area have been escalating and the potential impacts of developments of this issue on the global financial system should be evaluated carefully.

Box I.1. Deleveraging of International Banks and Their Impacts on Developing Countries: An Overview

The banking sectors of developed countries, the leverage ratios of which had reached rather high levels in the pre-crisis period, were caught by the crisis with a vulnerable balance sheet structure suffering relatively low capital quality and ratios. In the post-crisis period, banking systems were urged to decrease the risks and high leverage ratios by international regulations such as systemically important financial institutions (G-SIFI), Basel III, resolution regimes, over-the-counter derivatives markets as well as some national and regional regulations. Currently, US banks have succeeded in decreasing leverage ratios while banking sectors in EU countries are behind the schedule. This is mainly driven by the fact that not only the banking sector, but also the governments in Europe have high indebtedness and that European banks are in need of more non-deposit funding. As a matter of fact, the policies that will probably affect developing countries in the upcoming period are expected to emanate from the European Union.

In the light of the experience gained from financial crisis, it can be asserted that lowering the levels of indebtedness of banks would contribute to global financial stability. On the other hand, the impact of policies to be implemented for deleveraging of the European banking sector on developing countries will vary depending on the type of policies. If the leverage ratio is defined as the ratio of assets to capital, then there are two methods to reduce this level: The first of these is increasing the denominator –the capital-; the second is decreasing the numerator –the assets-. Even if the first method – increasing the capital- is perceived as more preferable, sounder and a choice less harmful to developing countries; the views to support the chances of banks being able to realize this in the market under current circumstances is rather low. In the second method, European banks are expected to tighten the lending and funding facilities they provide to developing countries; in other words, to downsize their balance sheets. This would probably affect resources to be transferred to the corporate sector and thus growth rates.

The IMF's Global Financial Stability Report (April 2012), having mentioned the prevailing uncertainties, predicts a downsizing amounting to Euro 2.0 trillion, or almost 7 percent of total assets, in the consolidated balance sheet of the European banks. These figures are based on the assumption that the political authorities in Europe will implement the policies that they have decided on. It is also predicted that the level of impact of deleveraging on developing countries will vary and that emerging EU-member countries will be those most severely affected. This is a natural outcome of the close relations of those countries with banks based in developed countries in Europe. Accordingly, emerging EU member countries may face a 4 percent decline in private credits. The IMF predicts that this ratio would be 3 percent in emerging non-EU countries like Russia and Turkey and become even lower in other emerging economies in Latin America and Asia. Clearly, the impact of this deleveraging would change depending on countries' individual vulnerabilities, fluctuating capital movements and policies implemented in each country.

In this framework, it is crucial for developing countries to implement flexible economic policies that can adapt to changes swiftly. Moreover, these countries would have to find alternative sources of financing and start initiatives to this end to ensure deepening in their domestic markets. This is necessary for them to minimize the impact of particularly deleveraging policies and generally external shocks . Consequently, the timely introduction of structural reforms in the developing countries, to curb the impact of global imbalances emanating from the latest financial crisis, is of vital importance.