5. Financial Conditions and the Monetary Policy

In the second quarter of 2019, the deceleration in global economic activity continued while global risk appetite slightly weakened in May and June due to geopolitical problems and continued worries over international trade. Since end-June, the easing in advanced economies' monetary policy outlook has become more evident and concerns over international trade have faded to some extent, leading to a recovery in global risk appetite and a decline in risk premiums of emerging economies. Meanwhile, although Turkey's risk premium negatively diverged from that of other emerging economies due to domestic uncertainties and geopolitical factors, it has decreased rapidly since June. The favorable developments in macroeconomic indicators, primarily in the inflation outlook and current account balance, coupled with the decline in risk premium resulted in a decline in market rates across all maturities.

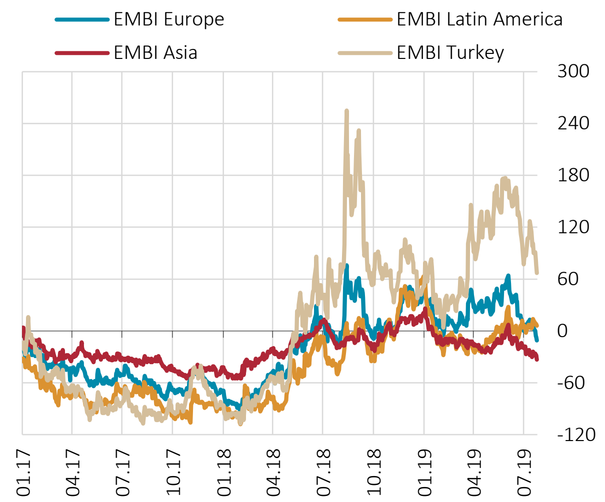
In the current Reporting period, portfolio flows towards emerging economies remained weak while particularly after June there has been a recovery in portfolio flows to Turkey, mainly in stock markets,. In tandem with these developments, stock prices have increased and the Turkish lira has displayed a relatively more positive performance compared to peer emerging market currencies on the back of the positive divergence in Turkey's risk premium since June.

In the second quarter, credit growth rates continued to decelerate due to the rise in loan rates, weakening in the overall economic outlook and expectations. The Bank Loans Tendency Survey indicate that the decline in credit growth rates was mainly driven by the tightness in credit conditions and weaker credit demand.

5.1. Financial Conditions and the Monetary Policy

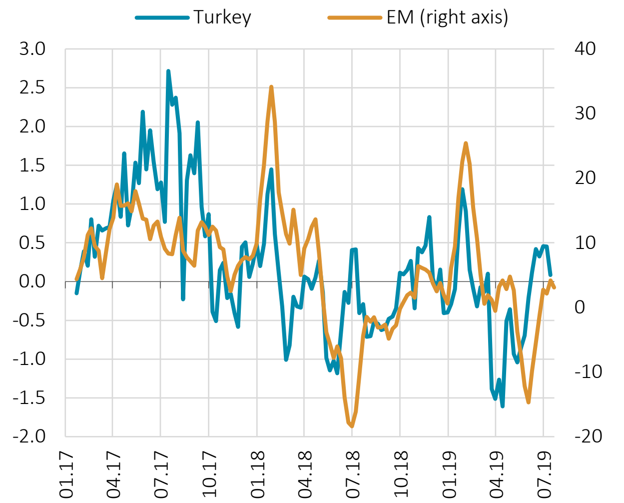
The deceleration in the global economic outlook continued in the second quarter and easing monetary policy signals from advanced economies had a positive impact on global risk appetite while persisting geopolitical problems and lingering uncertainties over international trade have driven global risk appetite down. Since June, the global risk appetite has rebounded as concerns over international trade have partly abated and the easing in the monetary policy outlook for advanced economies has become more evident. While risk premiums of emerging economies rose in line with the global risk appetite in the second quarter, they have assumed a downtrend again since June. Turkey's risk premium negatively diverged from that of other emerging economies due to uncertainties and geopolitical risks until June; nevertheless, it rapidly decreased after June (Chart 5.1.1). In this reporting period, portfolio flows to emerging economies have been weak. Turkey posted portfolio outflows until June, whereas portfolio inflows resumed after June, mostly in the stock market (Chart 5.1.2).

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



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

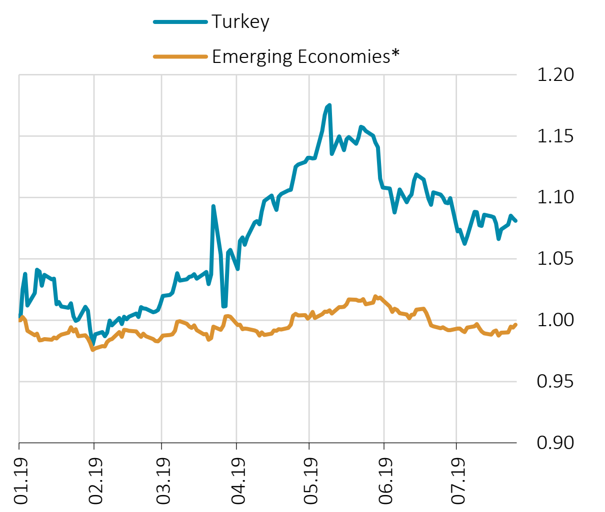
Chart 5.1.2: Portfolio Flows in Emerging Economies* (4-Week Cumulative, Billion USD)



Sources: 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.

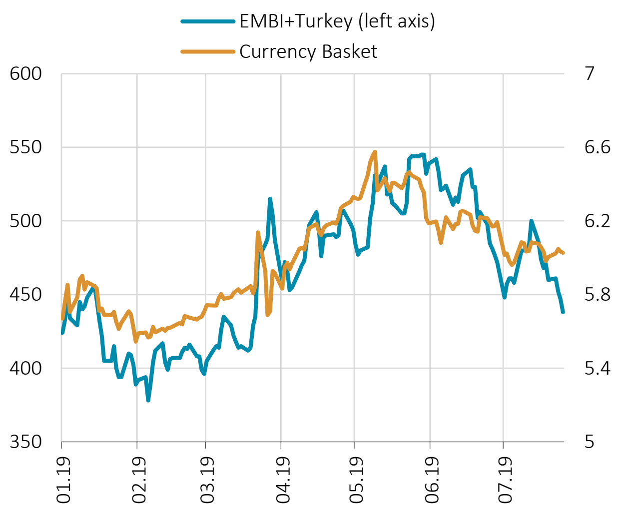
In the current reporting period, emerging market currencies slightly appreciated against the US dollar on the back of the Fed's signals of easing its monetary policy and the developments in global risk appetite. In April and May, the Turkish lira negatively diverged from currencies of peer emerging market economies due to domestic uncertainties and geopolitical risks, but rebounded from June (Chart 5.1.3 and Chart 5.1.4).

Chart 5.1.3: Turkish Lira and Emerging Market Currencies against US Dollar (01.01.2019=1)



Source: Bloomberg.
* Emerging Economies: Brazil, Chile, Colombia, Hungary, Mexico, Poland, Romania, S. Africa, India, Indonesia, the Philippines and Turkey.

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



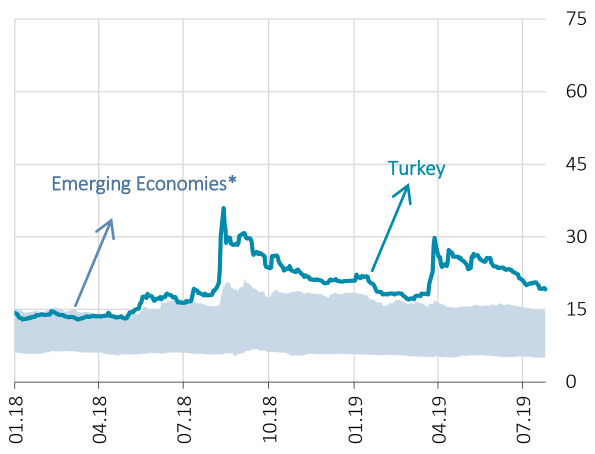
Source: Bloomberg.
* Exchange rate basket represents the value of the Turkish lira against 0.5*USD+ 0.5*EUR.

The implied volatility of the Turkish lira decreased in the current reporting period (Chart 5.1.5 and Chart 5.1.6). Meanwhile, the volatility in the Turkish lira implied by 12-month forward options is higher compared to that implied by one-month forward options, signaling that the current level of the volatility in the Turkish lira is expected to continue in the year ahead.

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

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

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

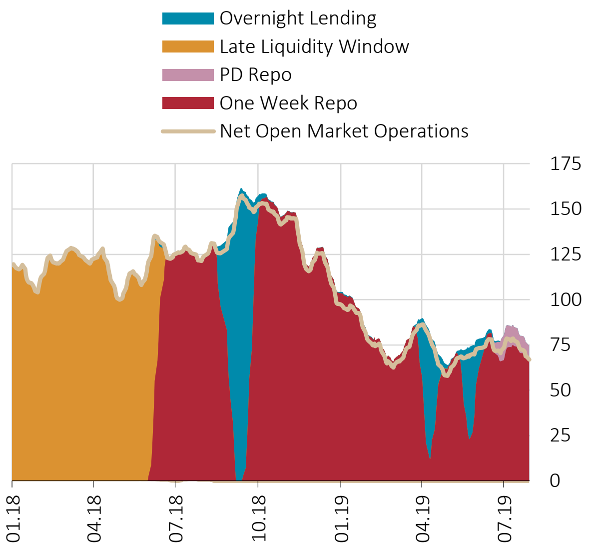


Source: Bloomberg.
* Emerging Economies: Brazil, Chile, Colombia, Hungary, Indonesia, Malaysia, Mexico, Poland, Romania, S. Africa, and the Philippines.

Monetary Policy Response

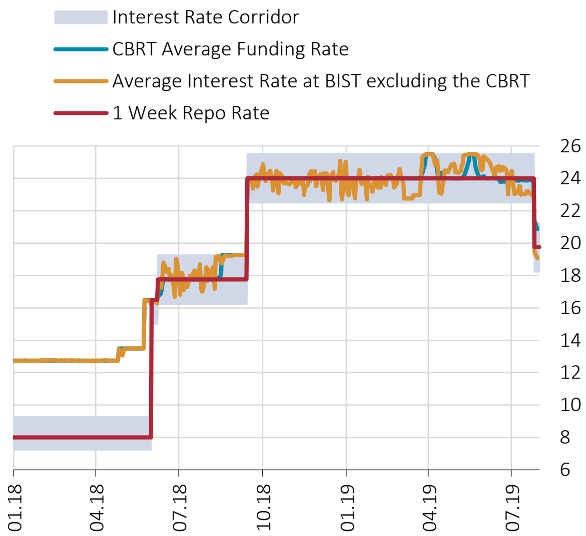
In the first half of the year, the CBRT kept the one-week repo auction rate constant at 24% and took a series of decisions related to the Turkish lira and FX liquidity management. In line with financial market developments, weekly repo auctions were suspended from 9 to 20 May 2019 and funding was provided at 25.5%, the overnight lending rate (Chart 5.1.7). In this period, the average interest rate on the BIST Repo Market, calculated excluding the CBRT transactions, increased and converged to the CBRT's overnight lending rate. The BIST overnight repo rates receded gradually after resumption of the one-week repo auctions and started to hoover slightly under the policy rate following the provision of Primary Dealer (PD) overnight liquidity facility, as announced in a press release dated 17 June 2019. In response to the use of this facility, which has a limited share within the overall CBRT funding, the CBRT average funding rate realized at 23.85% in the period from 18 June to 10 July 2019. In July, with the improvement in inflation outlook, the Bank decided to reduce the tightness of the monetary policy stance and lowered the one-week repo auction rate to 19.75% (Chart 5.1.8).

Chart 5.1.7: CBRT Open Market Operations (2-Week Moving Average, Billion TL)



Source: CBRT.

Chart 5.1.8: Short-Term Rates (%)



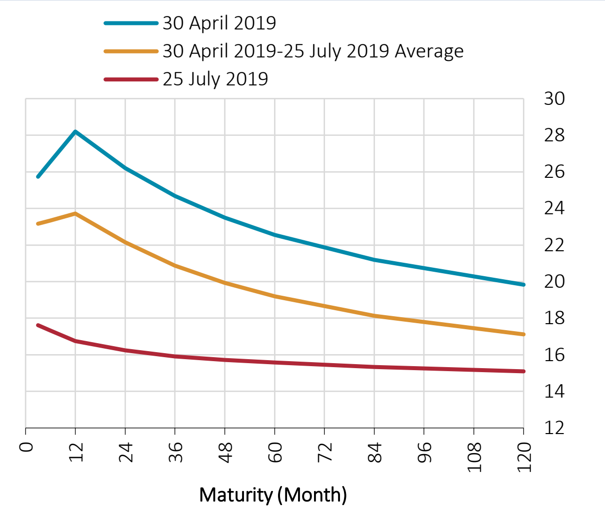
Sources: BIST, CBRT.

In addition to these decisions, considering financial market developments, some revisions were made to reserve requirements to support financial stability. On 9 May, when weekly repo auctions were suspended, the Bank, by introducing some adjustments to reserve requirements, withdrew Turkish lira liquidity from the system without making any significant change to the FX liquidity. On 27 May 2019, in order to support financial stability, the Bank raised reserve requirement ratios for FX deposits/participation funds for all maturity brackets, thereby withdrawing FX liquidity from the market. Moreover, on 17 June 2019, the Bank decided to provide primary dealer banks with an overnight liquidity facility at an interest rate 100 basis points below the policy rate. It was assessed that the primary dealership system, which is supported by this new liquidity facility that would have a limited share within the overall CBRT funding, would contribute to the deepening of financial markets and the effectiveness of the monetary policy.

In the current reporting period during which a tight monetary stance was sustained, the yield curve remained inverted and the swap yield curve shifted downwards in the inter-reporting period on the back of the decline in the sovereign risk premium (Chart 5.1.9). Owing to the tight monetary policy stance, Turkey's yield curve slope remained the most negative among other emerging economies in the current reporting period (Chart 5.1.10).

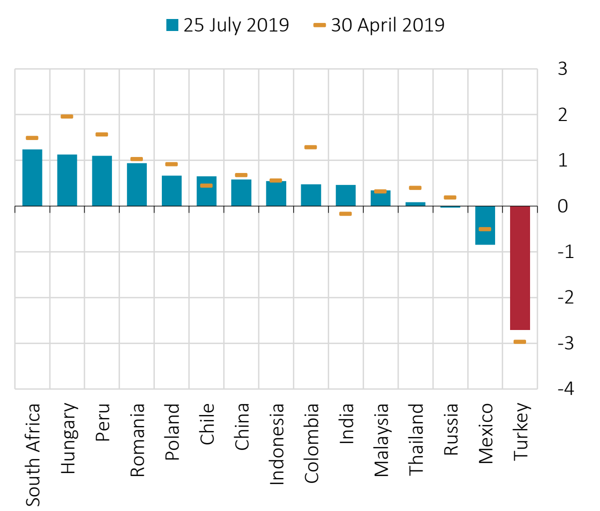
Domestic demand conditions and tight monetary policy stance support disinflation. However, at its meeting in June 2019, the MPC decided to maintain its tight monetary policy stance in order to contain the risks to the pricing behavior and to reinforce the disinflation process. During the period following the June meeting, the inflation outlook continued to improve, thus inflation fell noticeably in the second quarter of the year. By assessing that the indicators for underlying inflation, supply-side factors and import prices affected inflation outlook positively, the Bank decided to cut the policy rate by 425 basis points at its July MPC meeting. It was noted that keeping the disinflation process on track with the targeted path requires the continuation of a cautious monetary stance.

Chart 5.1.9: Recent Currency Swap Yield Curve (%)



Source: Bloomberg.

Chart 5.1.10: Yield Curve Slopes in Emerging Economies* (% Points)

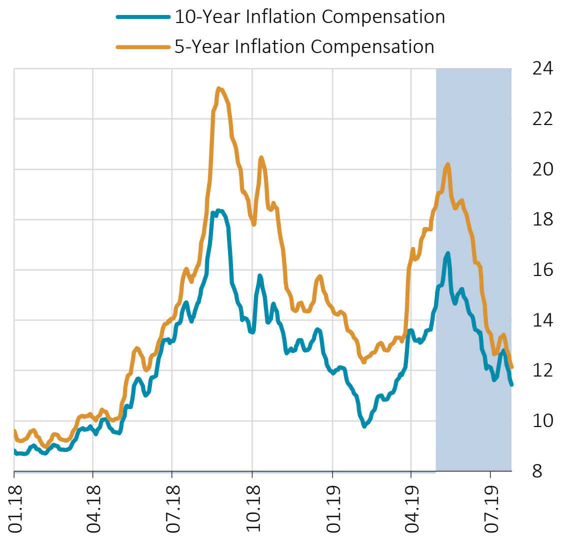


Source: Bloomberg.

* Slope of the yield curve is calculated as the difference between the 5-year bond yields and 6-month bond yields.

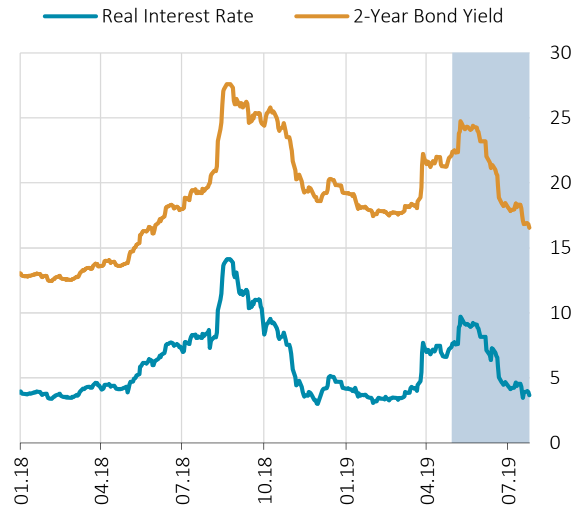
In addition to the CBRT's tight monetary stance, fading geopolitical risks and the stable course of exchange rates in the current reporting period became influential in the rapid fall of inflation compensations, which price in the medium and long-term inflation expectations as well as inflation premiums (Chart 5.1.11). The fall in the priced-in-inflation expectations and risk premium led to a decrease in bold yields across all maturities. Due to nominal interest rates that declined more compared to inflation expectations, the two-year expected (ex-ante) real interest rate fell significantly. (Chart 5.1.12).

Chart 5.1.11: Inflation Compensation (5-Day Moving Average, %)



Source: Bloomberg.

Chart 5.1.12: Two-Year Bond Yields and the Expected Real Interest Rate in Turkey* (%)



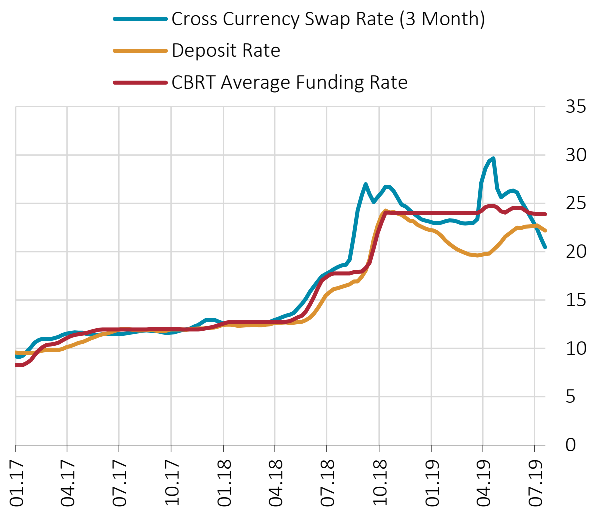
Sources: Bloomberg, CBRT.

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

5.2 Credit Conditions

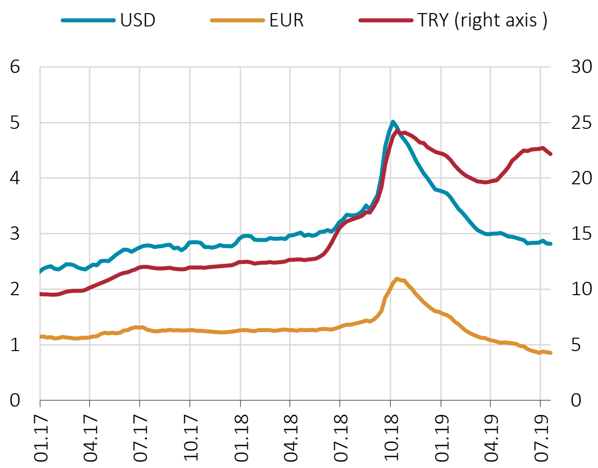
In the second quarter of 2019, , currency swap rates declined to levels lower than the deposit rates due to positive developments in the risk premium, and the CBRT weighted average funding cost hovered above those funding costs (Chart 5.2.1). In the current Reporting period, as a result of the decline in US dollar and euro-denominated market rates in foreign markets, the continued decrease in the need for foreign currency funding in domestic markets and slight appreciation of Turkish lira, the US dollar and euro deposit rates decreased further, while the TL deposit rates increased (Chart 5.2.2).

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



Sources: CBRT, Bloomberg.

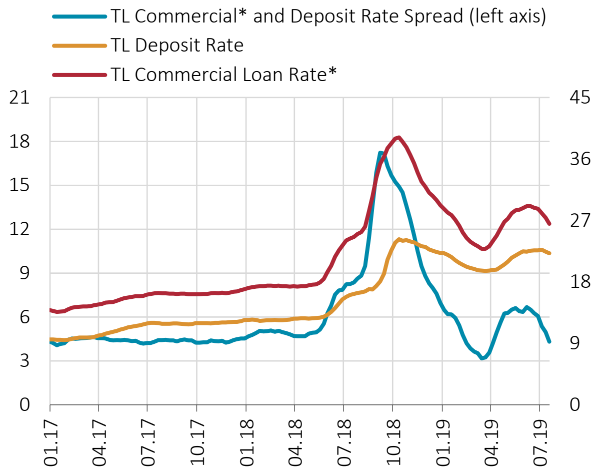
Chart 5.2.2: Deposit Rates, by Currency Breakdown (Flow Data, Annual Rate, 4-Week Moving Average, %)



Source: CBRT.

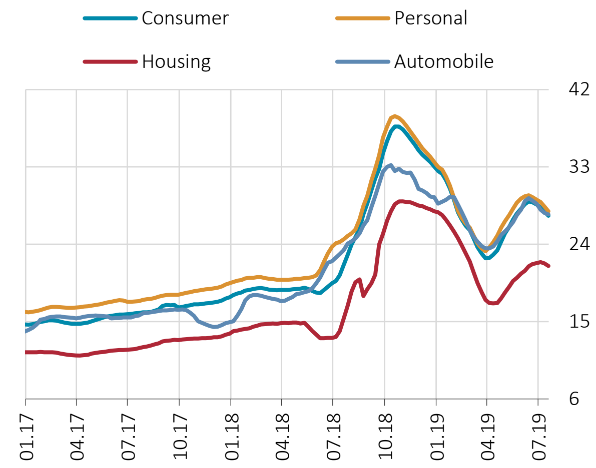
According to the Bank Loans Tendency Survey (BLTS), banks' domestic funding conditions tightened further in the second quarter of 2019, leading them to reflect the increased Turkish lira funding costs to commercial and consumer loan rates. However, since mid-June, all loan rates posted a decline in line with favorable developments in financial markets. The spread between commercial loan rates and TL deposit rates has declined and converged to its long-term average since the second half of June (Charts 5.2.3 and 5.2.4).

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



Source: CBRT.
* Overdraft account, credit card and zero-rate loans excluded.

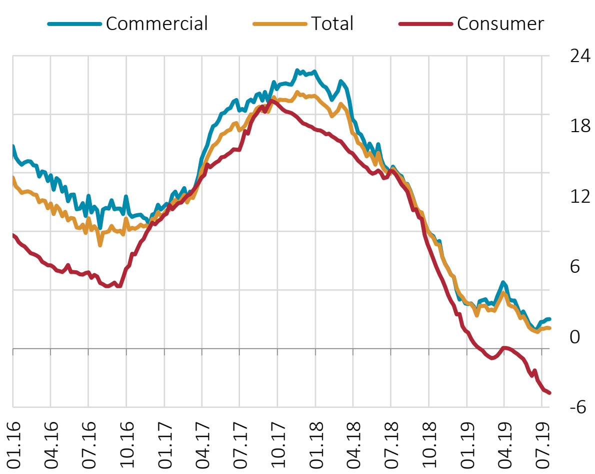
Chart 5.2.4: Consumer Loan Rates
(Flow Data, Annual, 4-Week Moving Average, %)



Source: CBRT.

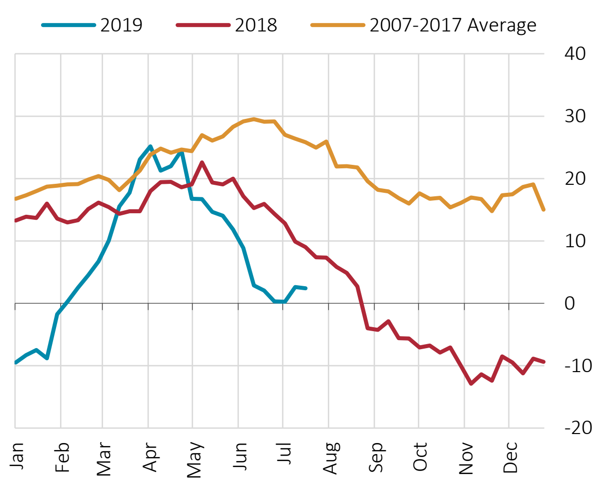
Throughout the current reporting period, the increase in commercial loan and consumer loan rates and as indicated by the Bank Loans Tendency Survey weakened expectations in the relevant markets and deterioration in overall economic outlook particularly in consumer loans, became instrumental in the deceleration of the credit growth (Charts 5.2.5 and 5.2.6). Nevertheless, on the back of commercial loan rates that had been on the decline since the second week of June, growth rate of commercial loans started to gain pace. Besides, it is envisaged that the Ekonomi Değer Loan package extended under the Treasury-backed Credit Guarantee Fund guarantees, which was launched in the third week of June with the intention of providing the corporate sector with a financing facility of TRY 25 billion may, to some extent, support the commercial loan growth during the rest of the year.

Chart 5.2.5: Annual Loan Growth
(Adjusted for Exchange Rate, % Change, Annual)



Source: CBRT.

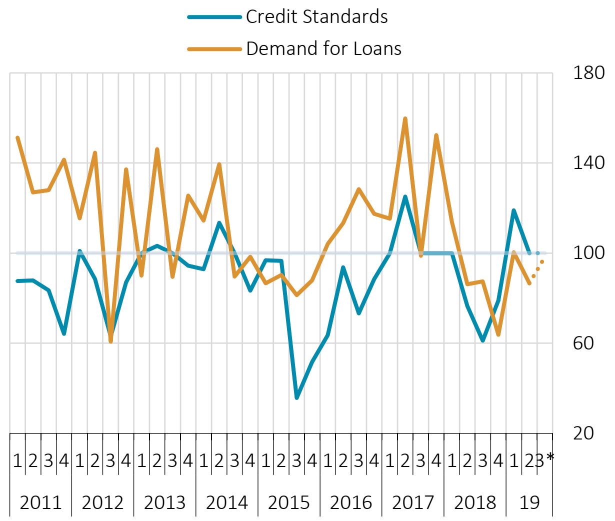
Chart 5.2.6: Commercial Loan Growth Showing Comparison with Previous Years (13-Week Annualized Moving Average, Adjusted for Exchange Rate, %)



Source: CBRT.

Meanwhile, responses to the (BLTS), indicate that the decline in the commercial loan growth was driven by the tightness in credit conditions and the weakening credit demand (Chart 5.2.7). This is attributed to the rise in commercial loan rates and to the fact that the SME value loans that attracted a good number of beneficiaries in the first quarter of the year advanced the credit demand, in addition to the weak course of demand for business loans for fixed investment, inventory buildup and working capital.

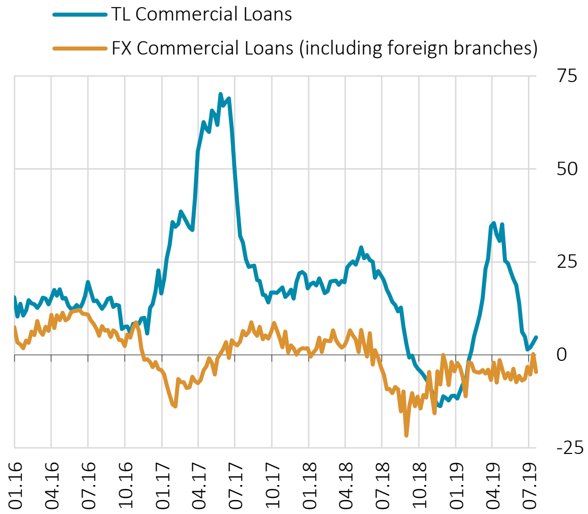
Chart 5.2.7: Commercial Loan Standards and Loan Demand*



Source: CBRT.

*Data for the third quarter of 2019 denote expectations. Index values above 100 indicate easing for loan standards and increase for credit demand.

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



Source: CBRT.

In addition to the regulations that constraint corporates' FX-denominated borrowings, the weak course of investment-driven corporate loan demand had a role in the FX-denominated commercial loan growth to remain weak compared to the TL loan growth (Chart 5.2.8). Banks' responses regarding the second quarter of the year in BLTS indicate a slight easing in tightness in credit standards for TL loans in contrast to a tightening in those for FX loans. It is anticipated that standards for TL-denominated commercial loans will mainly remain intact as opposed to a further tightening in FX loans also in the third quarter.