II. Macroeconomic Outlook

Due to the easing of mobility restrictions around the world in May and June 2020 as well as the supportive measures taken throughout the pandemic period, the global economic activity recovered more than expected and uncertainties partially eased. In the current Report period, central banks of advanced and emerging economies mostly retained the expansionary monetary policy stances they adopted to offset the adverse effects of the pandemic. The relatively increased global risk appetite triggered net capital inflows to EME bond markets and capital outflows from equity markets reversed as of end-September.

Uncertainties about the course of the pandemic, vaccine developments and the duration of pandemic measures as well as policy space, the weak economic activity and banking sector profitability, possible implications of increased credit risk, high levels of indebtedness, and sudden liquidity shocks stand as vulnerability factors for global financial stability. However, comprehensive international reforms brought in after the Global Financial Crisis, strengthened capital and liquidity strıcture of the banking sector, prompt and unprecedentedly large measures implemented by central banks and fiscal authorities have contained the pressure that the pandemic and social isolation measures exerted on the financial sector. To maintain financial stability, it is important that national and international authorities decisively continue with their reform projects through strengthened cooperation.

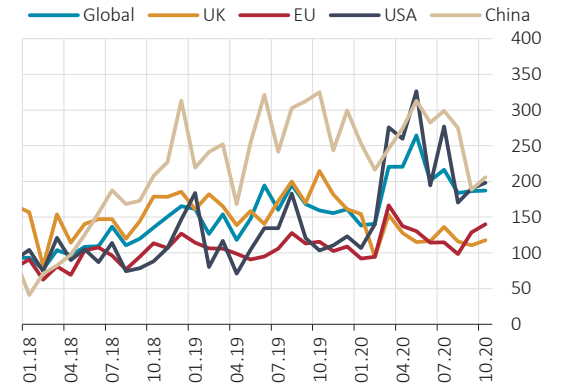
Turkey registered a strong recovery due to measures that supported economic activity and employment. Various measures and regulations introduced to take the pandemic under control and minimize the negative effects that it might cause on economic activity through financial markets were gradually phased out with the pandemic assuming a milder course. However, the partial continuation of global travel restrictions is impeding the recovery in the services sector, particularly in tourism activities.

The current account deficit increased due to the deterioration in the foreign trade balance driven particularly by credit impulse and gold demand, and low tourism revenues. The phasing out of pandemic-specific measures and the monetary tightening spurred a rebalancing in loan growth that may curb the current account deficit in the upcoming period. The fall in real effective exchange rates and the low levels of crude oil prices are expected to be the other factors that will support the current account balance in the period ahead.

II.1 International Developments

With the coronavirus outbreak evolving into a pandemic, the global economic policy uncertainty rapidly increased in the first quarter of 2020 and economies slowed sharply. Due to the easing of worldwide quarantine measures in May and June as well as the supportive measures taken throughout the pandemic period, the global economic activity posted a recovery that exceeded expectations. Accordingly, the global economic policy uncertainty started to decrease as of May (Chart II.1.1). Likewise, after sharply increasing from early 2020 to May, the economic policy uncertainty in the US and China declined in the following period. However, uncertainty remained high in the US compared to the pre-pandemic period due to the presidential election in November. Economic policy predictability continued to increase though it displayed a fluctuating course after the UK formally left the EU on 31 January 2020. The change in the economic policy uncertainty in the EU was more contained relative to the US and China.

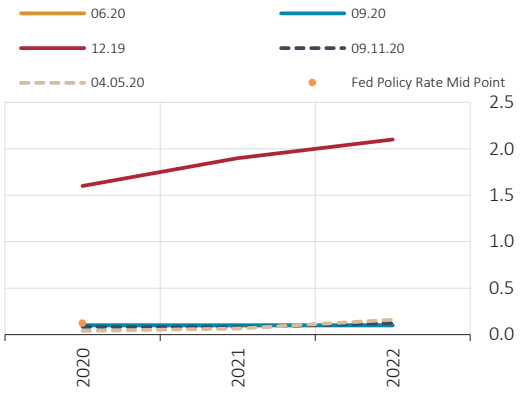
Chart II.1.1: Economic Policy Uncertainty Indices (Index, 2012=100)



Source: Bloomberg Last Observation: 10.20

Note: Indices are not comparable in terms of their levels.

Chart II.1.2: Median Policy Rate Forecasts of FOMC Members (Solid Lines) **and Market Expectations** (Dashed Lines) (%)



Source: Bloomberg Last Observation: 9.11.20

Note: Dashed lines indicate 30-day Fed fund futures implied rates. Policy rate forecasts of FOMC members remained the same for both September 2020 and June 2020 meetings.

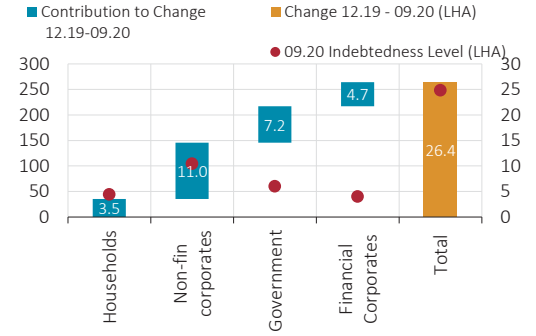
To reduce the economic and social impacts of the pandemic and related worldwide quarantine measures, advanced countries and EMEs introduced strong fiscal measures and central banks took expansionary monetary policy steps starting from March. The US Federal Reserve Bank (Fed), which had set the policy rate at a range around 0%-0.25% in March 2020, revised the long-term 2% inflation target to average inflation targeting via an adjustment in its monetary policy strategy in August. Accordingly, tightening steps in monetary policy were made conditional on the inflation rate floating above 2% for some time, thereby providing additional room for monetary policy. Market expectations are also consistent with FOMC members' expectations that the policy rate will be close to 0% until 2023 (Chart II.1.2). Due to its extensive and large-scale asset purchase policy and expansionary monetary policy, the Fed's balance sheet size has increased by more than 70% since the beginning of 2020.

The asset purchase program of the European Central Bank (ECB), which was among various measures it introduced to ensure effective functioning of financial markets and support firms and households in the face of unusual volatility and liquidity crunch during the pandemic, was extended to the end of the year through additional purchases. The ECB also emphasized that the program might continue further if needed. Moreover, the size of the Pandemic Emergency Purchase Programme was revised up by EUR 600 billion to EUR 1.35 trillion from the initial amount of EUR 750 billion in the scope of the monetary policy

decisions taken in June. On the back of the measures, the balance sheet size of the Eurosystem has expanded by more than 40% since early 2020.[1]

Central banks of China, Japan and the UK maintain the monetary policy stances that they eased through the measures they took at the start of the pandemic period to support the financial system. Currency swap agreements made between the central banks of advanced economies, particularly with the Fed, to ensure healthy continuation of US dollar-denominated funding were revised. Accordingly, the frequency of currency swap operations with the Fed was lowered in line with the reduced need.

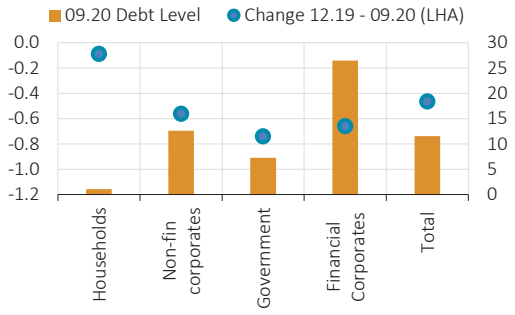
Chart II.1.3: Sector-Based Indebtedness in EMEs (% of GDP)



Source: IIF Last Observation: 09.20

Note: Average is calculated based on countries' GDP weights. EMEs: Argentina, Brazil, Chile, China, Colombia, Czechia, Egypt, Ghana, Hong Kong, Hungary, India, Indonesia, Israel, Kenya, Lebanon, Malaysia, Mexico, Nigeria, Pakistan, Philippines, Poland, Russia, Saudi Arabia, Singapore, South Africa, South Korea, Thailand, Turkey, Ukraine and United Arab Emirates.

Chart II.1.4: Sector-Based FX Borrowing in EMEs (% of Total Borrowing)

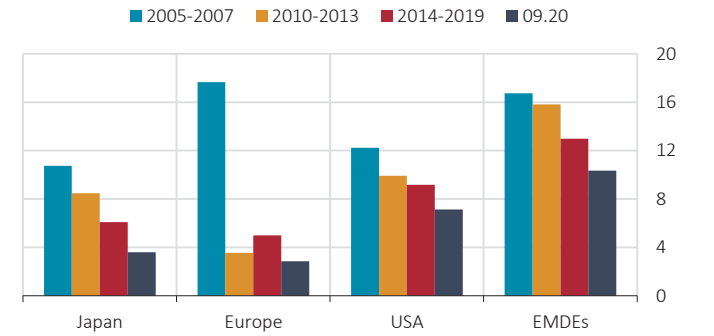


Source: IIF Last Observation: 09.20

Note: EMEs: Argentina, Brazil, Chile, China, Colombia, Czechia, Hong Kong, Hungary, India, Indonesia, Israel, South Korea, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand, Turkey and Ukraine.

Corporate sector and public sector indebtedness continues to be a source of vulnerability in advanced economies and EMEs (Chart II.1.3). Faced with liquidity pressure after the pandemic, the private sector's credit debt increased while indebtedness as a ratio of GDP rose in all sectors from end-2019 to the third quarter of 2020. Fiscal policies geared towards limiting the adverse effects of the pandemic played a role in the increase in public sector indebtedness. FX indebtedness that decreased in EMEs due to regulations after the Global Financial Crisis remains low, particularly that of households (Chart II.1.4). In 2020, FX indebtedness continues to decrease across all sectors.

Chart II.1.5: Banks' Return on Equities (%)



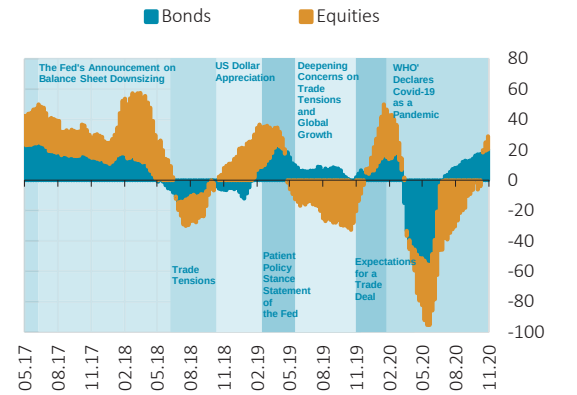
Source: Bloomberg Last Observation: 09.20

Note: Tokyo Stock Exchange TOPIX Banks Index, Bloomberg European 500 Banks and Financial Services Index, S&P 500 Banks Industry Group Index, MSCI EM Banks Index have been used.

[1] Euro area central banks and the ECB.

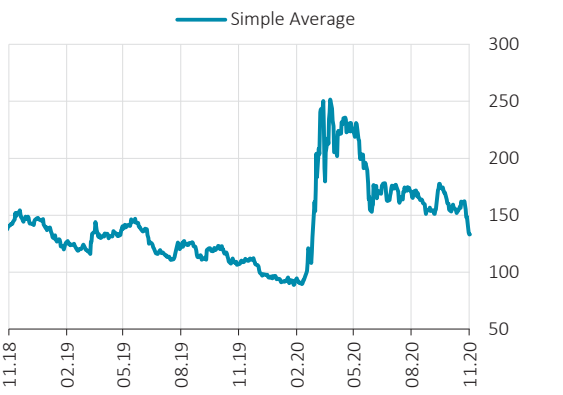
Capital adequacy regulations introduced after the Global Financial Crisis have furnished the global banking system with a stronger capital structure. However, despite the unprecedented expansionary monetary policies implemented by central banks to offset the adverse effects of the pandemic, the continued flat course of yield curves and the weak growth outlook harbor some challenges for national financial sectors. The significant contraction in the global economic activity, likely impacts of increased credit risk on asset quality, and the expected continuation of the persistently low levels of interest rates put additional downward pressure on the banking sector's returns on equity that have already been on the decline since the Global Financial Crisis (Chart II.1.5).

Chart II.1.6: Weekly Capital Flows to EMEs (13-Week Cumulative, USD Billion)



Source: EPFR Last Observation: 4.11.20

Chart II.1.7: CDS Premiums in EMEs (Basis Points)

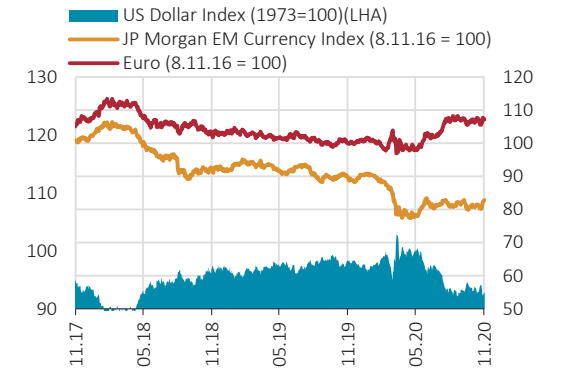


Source: Bloomberg Last Observation: 9.11.20

Note: Emerging economies include Brazil, Czechia, Indonesia, S. Africa, Colombia, Hungary, Poland, Romania, Turkey and Chile.

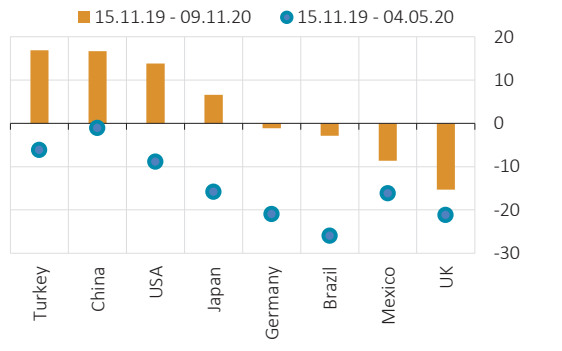
In the early period when the coronavirus outbreak turned into a global pandemic, EME bond and equity markets saw large portfolio outflows due to the global contraction, the unusual decline in oil prices and the increased global risk aversion. Starting from May, portfolio inflows to EME bond markets accelerated as the pandemic-related uncertainties in the global economy decreased to some extent, social isolation measures were gradually eased in a large number of countries, and leading indicators for the growth outlook pointed to a recovery. In the same period, portfolio outflows from equity markets decelerated at first, followed by portfolio inflows as of end-September (Chart II.1.6). The partial increase in the global risk appetite limited the upward pressure on country risk premiums in EMEs (Chart II.1.7).

Chart II.1.8: Exchange Rate Indices (Index)



Source: Bloomberg Last Observation: 9.11.20

Chart II.1.9: Stock Indices (% Change)



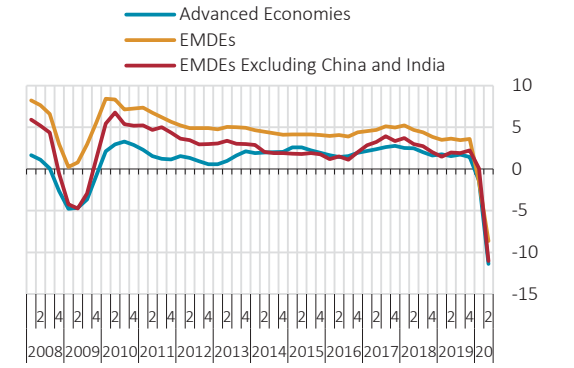
Source: Bloomberg Last Observation: 9.11.20

Note: Turkey - BIST 100, Germany DAX, UK – FTSE 100, Mexico – IPC, Japan – Nikkei 225, China – Shanghai Composite, USA – S&P 500, Brazil – IBOV indices have been used.

While the US dollar depreciated against major advanced country currencies as of May 2020, EME currencies index remained flat (Chart II.1.8). Expansionary monetary policies, increased risk appetite, and reduced tightening in financial conditions contributed to the recovery in EME stock indices (Chart II.1.9). Meanwhile, the divergence in countries' stock index performance was driven by the sectoral composition of indices, the risk appetite and the investor base. Actually, the pandemic and social isolation measures affected the sectors at different levels. The energy sector and the highly-interactive services sector were more severely hit by the pandemic whereas technology and telecom sectors positively diverged.

In the first half of 2020, the global economic activity significantly contracted due to the adverse effects of the pandemic and quarantine measures (Chart II.1.10). The recovery trend in global economic activity, which was registered in the leading indicators for growth following the phasing out of quarantine measures in May and June, continued through the end of the third quarter (Chart II.1.11).

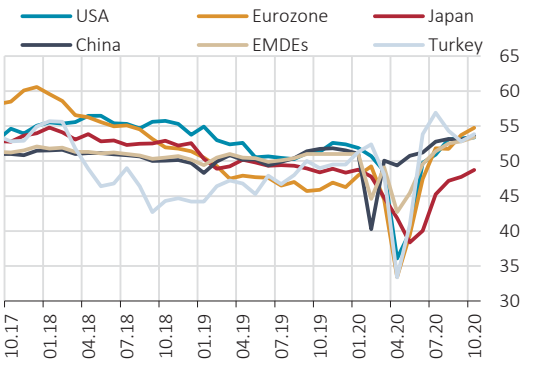
Chart II.1.10: Y-o-Y Growth Rates in Advanced Economies and EMEs (%)



Sources: Bloomberg, CBRT Last Observation: 06.20

Note: Advanced Economies: USA, Euro Area, Japan, UK, Canada, S. Korea, Switzerland, Sweden, Norway, Denmark, and Israel. EMEs: China, Brazil, India, Mexico, Russia, Turkey, Poland, Indonesia, S. Africa, Argentina, Thailand, Malaysia, Czechia, Colombia, Hungary, Romania, Philippines, Ukraine, Chile, Peru, and Morocco.

Chart II.1.11: Manufacturing Industry PMI (Index)



Sources: Bloomberg, CBRT Last Observation: 10.20

While pandemic-led uncertainties persist in the global economy, primary effects and short-term risk factors for financial stability have been contained thanks to the prompt introduction of extensive measures. Relative to the market volatility in March 2020, financial markets started to recover partially, liquidity risk started to decrease, and investor confidence started to increase while continued credit flow to the corporate sector was secured. However, besides the course of the pandemic and vaccine developments, the duration of pandemic measures, the room for policy maneuver and the weak global economic outlook are among the risk factors that may damage financial stability (Box II.1.I). In addition, likely impacts of increased credit risk, vulnerabilities due to increased indebtedness both in advanced economies and EMEs, and particularly the probability that firms' current cash flow difficulties may evolve into solvency problems in the upcoming period constitute the other major risk factors. Also, it is critical that the development of non-bank financial intermediation activities and their interconnectedness with the banking system are monitored closely.

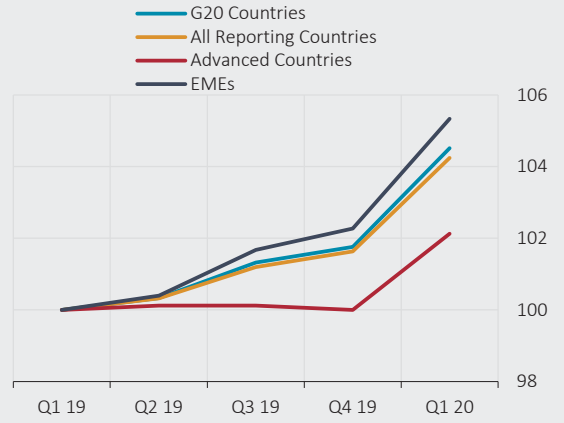
Comprehensive reforms implemented after the Global Financial Crisis have strengthened the capital and liquidity position of the banking sector. This has limited the likely pressure of the pandemic on the banking system's capital structure as of the current Report Period. In addition to safeguarding the gains from these reforms, it is important that national and international authorities decisively continue with their reform projects through strengthened cooperation. Effects of the pandemic and other reform areas are closely monitored through global financial stability-oriented projects that are led by the G20 and run under the FSB coordination.

Box II.1.I

The Assessment of Escalating Vulnerabilities During COVID-19 Pandemic in the Global Financial Stability Context

Thanks to measures taken to alleviate the economic and social impact of the coronavirus pandemic and the ensuing lockdowns across the world financial markets have rebounded, specifically since May 2020, along with reduced liquidity risk and growing investor confidence, which ensured a continuous flow of credit to the real sector. After experiencing outflows due to investors' increased liquidity requirements, AE fixed-income funds have been attracting some inflows lately. Meanwhile, there has been a modest pickup in capital flows to EMEs, which suffered large portfolio outflows amid the decline in global risk appetite as a result of the pandemic. Corporate bond spreads continue to widen while bond issuance has slightly increased. The impact of the pandemic on the banking sector has been limited because of the comprehensive post-global financial crisis G20 reforms that strengthened capital and liquidity ratios of the sector. The banking sector continued to fulfill its intermediation role and maintained a steady flow of funds to the real economy during the pandemic. The ratio of bank credit extended to the private non-financial sector to GDP was significantly higher across AEs and EMEs in the first quarter of 2020 compared to a year earlier (Chart II.1.I.1).

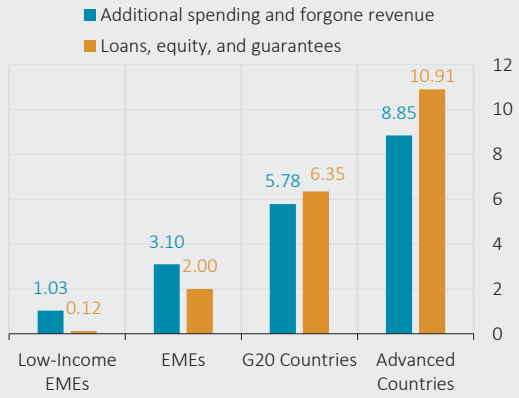
Chart II.1.I.1: Bank Credit to the Private Non-financial Sector (% GDP) (2019Q1=100)



Sources: BIS, CBRT Last Observation: 03.20

Note: Non-financial private sector: real sector firms and households.

Chart II.1.I.2: Size of Fiscal Measures in Response to Pandemic, by Country Groups (% GDP)



Source: IMF WEO (June 2020 update) Last Obs.: 06.20

During the pandemic, central banks sought to contain the preliminary effects of the outbreak through policy rate cuts and liquidity support. With asset purchases, G7 central banks expanded their balance sheets by USD 7 trillion in eight months (IMF, GFSR, October 2020).[1] Governments, too, have prepared comprehensive stimulus packages since the outbreak of COVID-19, and both AEs and EMEs have adopted similar measures. Stimulus packages amount to 20% of GDP in AEs and 5% of GDP in EMEs (Chart II.1.I.2). Such packages include additional spending, tax relief, credit support for firms and households or capital support for firms, and credit guarantees.

Meanwhile, international institutions continue to implement various measures. The Financial Stability Board (FSB) delayed the implementation deadlines by one year for its policy recommendations related to minimum haircut standards for non-centrally cleared securities

[1] IMF, GFSR, October 2020.

financing transactions.[2] The Basel Committee on Banking Supervision (BCBS) announced that they would encourage the use of capital and liquidity buffers to maintain the flow of bank lending and provide banks sufficient time to restore these buffers when the crisis no longer has any impact.[3] After this announcement, many countries, especially from the EU, allowed the use of capital buffers and the ratio of liquidity buffers to be reduced below the statutory minimum.

Despite these measures that cushion the short-term effects of the pandemic, global financial markets might see some vulnerabilities in the short run. Abrupt changes in investor confidence and volatility in liquidity demand might hinder the achievement of lasting easing in financial conditions. Concerns over corporate debt have increased over the course of the pandemic. Although business turnover picked up slightly due to policy actions and the easing of lockdown measures, corporate revenues are likely to register a decline as demand is weaker than its pre-pandemic level. Businesses face fewer obstacles in accessing finance thanks to a continuous flow of funds, but higher funding costs and debt service ratios as well as current cash flow problems might cause solvency and profitability issues in the near future. As most businesses rely on bank loans and banks seem reluctant to lend in the upcoming period, access to finance might be an issue. Other vulnerabilities that stand out for this period include firm revenue losses, increased financing costs due to reduced credit ratings, and high risk of bankruptcy due to probability of default. Even though banks have strong capital ratios, imminent credit losses and a potential worsening in asset quality may trigger a tightening of lending conditions.

On the other hand, nonbank financial institutions play an increased role in financial intermediation, which indicates that the credit risk has been migrating from the banking sector and the credit activity has become increasingly dependent on market liquidity. With a structural transformation, banks have been transferring these risks from their balance sheets to nonbank financial institutions or investors. Banks and nonbank financial institutions seem to have established a longer-term and more complex relationship, the latter now accounting for a larger share of cross-border lending.

Another challenge in the short run might be the room for policy maneuver that could change depending on how the pandemic progresses amid the weak global economic outlook, on vaccine trials and the duration of measures. The shrinking tax base due to lower production and fiscal stimulus packages in place since the coronavirus outbreak caused budget deficits to widen across many countries. Fiscal policy constraints are particularly acute for EMEs relying on external financing.

Meanwhile, the pandemic may lead to some structural changes in the medium and long run. The accelerated need for digital transformation amid lockdowns and its implications for consumer behavior might prevail in the upcoming period. Post-pandemic changes in business models, which calls for allocating resources into new sectors, will likely cause some economy-wide shifts in resource allocation.

The forthcoming period will be shaped by the uncertainty about how permanent the shock will be, how effective coronavirus policies are and how unwound measures will affect the financial sector and the economy. The uncertainty about whether the policy measures taken during the pandemic's early stages will return if there is a second wave causes many countries to pursue a more diverse and target-oriented policy mix. In this respect, risk and fragility promoting factors that may affect financial stability and the interconnectedness among them will be the focal point of future global policies.

[2] FSB Press Release, 7 September 2020: https://www.fsb.org/2020/09/fsb-extends-implementation-timelines-for-securities-financing-transactions/
[3] BIS Press Release, 17 June 2020 : https://www.bis.org/press/p200617.htm

Box II.1.II

Covid-19 and International Household Savings Developments

Individuals save the consumption-deducted portion of their disposable income to invest in various financial or non-financial instruments. Savings, as the main funding source of investment, are affected by many factors such as the development level of a country, its demographic structure, economic policies, and diversification of and return on savings instruments while they are also responsive to global, country-specific and cyclical shocks. Quarantine decisions taken due to the global coronavirus pandemic in 2020 have constrained individuals' consumption behavior other than spending on basic needs, and strengthened their preferences for precautionary savings.[1] On the other hand, the decline in incomes due to the pandemic-driven contraction of labor markets curbs the savings potential. While households may differ in terms of the portions of their disposable income earmarked for consumption and savings, countries may also diverge from each other due to country-specific conditions and shocks.[2] This box presents an analysis of trends of saving rates observed in selected countries over time and the impact of the coronavirus pandemic on the saving rates of these countries.[3] It also includes the details of household savings instruments and recent developments in Turkey.

Propensity of Households to Save During the Pandemic

While some advanced economies and the Euro Area have different levels of saving rates, global factors affect these rates in more or less the same direction, increasingly so in crisis episodes in particular (Chart II.1.II.1). Although the 2008 global financial crisis led to employment as well as household income losses, it also had the effect of increasing savings for precautionary purposes in all countries. On the other hand, country-specific developments affect the trade-off between spending and saving decisions, leading to cross-country differences. The negative saving rates seen in Japan for the first time in 2014 were a consequence of households bringing forward their pent-up demand, for durable goods in particular, just before the large increase in consumption taxes.

Chart II.1.II.1: Household Saving Rates by Countries (%)

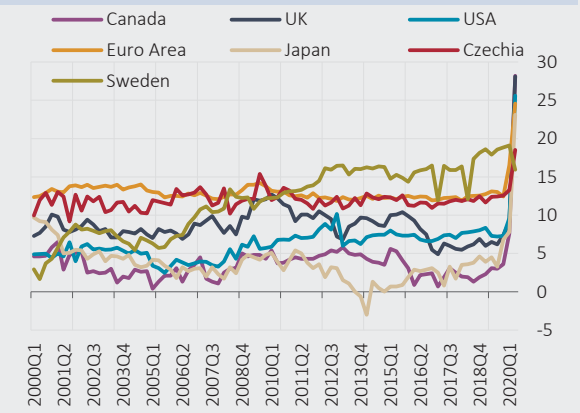
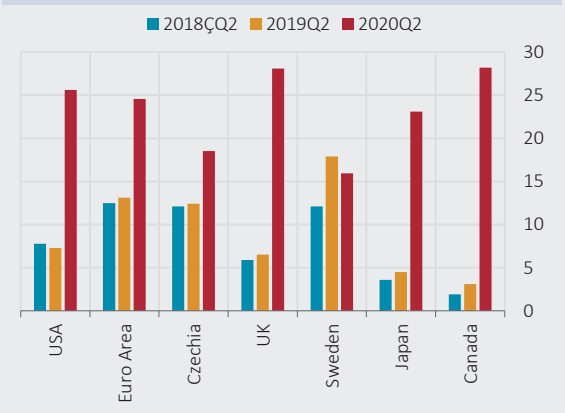


Chart II.1.II.2: Recent Household Saving Rates by Countries (%)



Sources: FED, Eurostat, ONS, Cabinet Office, StatCan
Last Observation: 2020Q2
Note: The household saving rate is calculated as the ratio of household savings to household disposable income plus the adjustment for the change in pension entitlements.

[1] For individuals' liquidity preference, see Gabrisch 2017. "Explaining trade imbalances in the euro area: Liquidity preference and the role of finance", PSL Quarterly Review, v. 70. Dutta and Kapur 1997. "Liquidity Preference and Financial Intermediation", Review of Economic Studies, v.65. Schalck 2017. "Tax measures and household financial behaviour: Evidence from France", The Quarterly Review of Economics and Finance, v. 66.

[2] Huggett et al. 2000. "Understanding why high income households save more than low income households", Journal of Monetary Economics, v. 42(2).

[3] The analysis covers countries that publish household savings and disposable income amounts, or saving rates on a quarterly basis under the "National Accounts" statistics.

An analysis of the historical changes in the series highlights that the increase in saving rates observed in the second quarter of 2020 was different from the previous rates of increase. In this period, the impact of the pandemic was visible on a global scale, economies were shut down, and pandemic-specific economic policies and liquidity measures were implemented intensely. The household saving rates rose dramatically in this period compared to previous years (Chart II.1.II.2). The comparably more limited increase in saving rates in Czechia is deemed to be a natural consequence of the relatively lower income per capita in this country, consistent with the related literature. In Sweden's case, quarantine conditions did not largely affect the daily lives of individuals as the isolation measures for the pandemic were not enforced and thus, saving rates did not increase in 2020.

Saving Preferences in Turkey During the Pandemic

For Turkey, the ratio of household asset items to GDP has been used as the quarterly indicator of household saving rates. Households in Turkey invest a large majority of their savings in deposit accounts.[4] In the economic and social lockdown period during the pandemic, the share of time deposits remained flat whereas individuals' inclination to be able to meet their cash need led to a substantial increase in sight deposits (Chart II.1.II.3). The shares of other asset items also rose in the second quarter of the year compared to previous periods, which suggests that individuals saved with a precautionary motive (Chart II.1.II.4). Following the decline in deposit interest rates, the share of alternative investment instruments, equities and money market funds in particular, in total assets rose while total assets increased significantly in the second quarter of 2020.

Chart II.1.II.3: Change in Indicators of Household Savings in Turkey (Share of GDP, %)

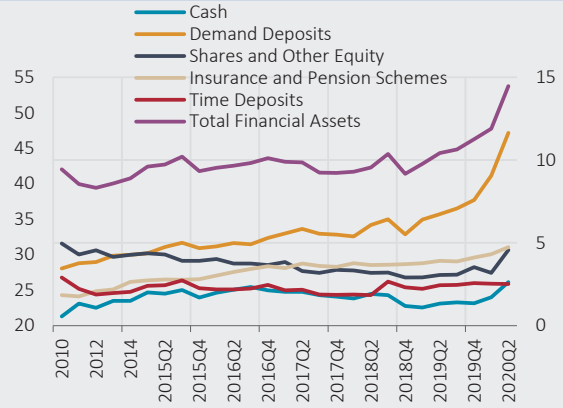
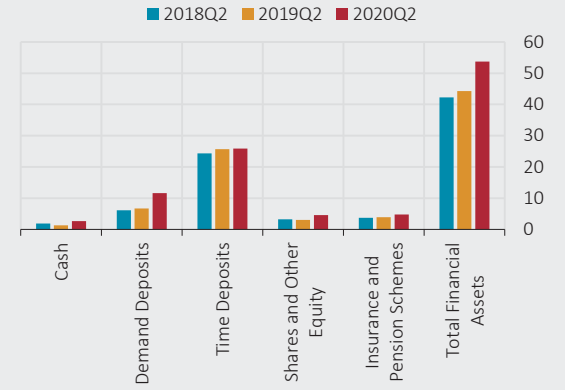


Chart II.1.II.4: Change in Indicators of Recent Household Savings in Turkey (Share of GDP, %)



Source: CBRT Last Observation: 2020Q2

Note: Data used in the analysis used to be published annually before 2015 and have been published quarterly since 2015.

Conclusion

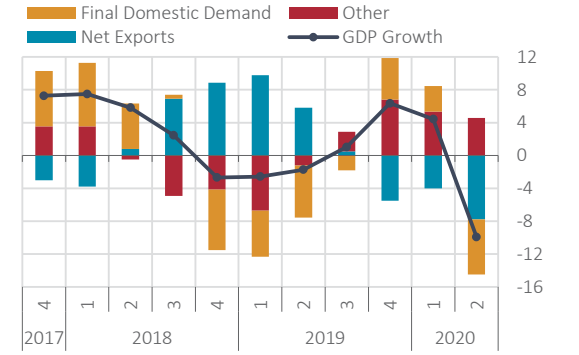
In the pandemic period, households increased their savings at unprecedented levels on a global scale. This increase was partly due to limited domestic and cross-country activities restrained by the uncertainty environment and mobility restrictions. The change in behaviors of individuals is associated with involuntary saving due to mobility restrictions and the decline in consumption means, as well as with precautionary savings triggered by the pressure of pandemic-led uncertainties and decelerated economic activity on employment and incomes.

[4] For details, see Table III.1.1 in the "Household Developments" section.

II.2 Main Domestic Macroeconomic Developments

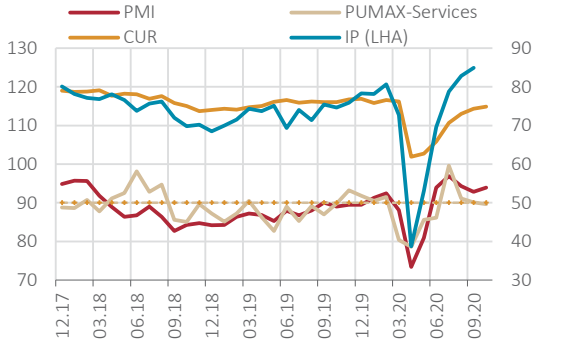
While net exports had a downward effect on annual growth in the first half of the year due to the impact of the coronavirus pandemic on global trade, the first quarter's relatively strong domestic demand also declined in the second quarter of the year (Chart II.2.1). Most recent indicators suggest a V-shaped recovery trend in economic activity starting from May, led by monetary and fiscal measures implemented both on a national and a global scale as well as by the rapid loan growth (Chart II.2.2). However, the recovery in the services sector is expected to be more moderate particularly due to the negative impact of the partial continuation of global travel restrictions on tourism activities and the pandemic-related limited mobility in services sector. The recovery in economic activity is envisaged to continue at a mild pace backed by domestic and external demand in the final quarter, following the monetary tightening process initiated in August in view of the side effects of pandemic measures on the current account balance, financial markets, and savings preferences, after the economic activity started recovering significantly.

Chart II.2.1: Annual GDP Growth and Contribution to Growth from the Expenditure Side (% Points)



Source: TURKSTAT Last Observation: 06.20

Chart II.2.2: Selected Leading Indicators Regarding Economic Activity (Index, %)

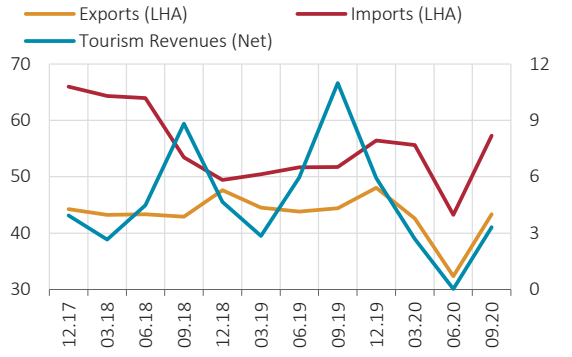


Sources: CBRT, IHS Markit-ICI, MUSİAD Last Observation: 10.20
Note: CUR: Manufacturing Industry Capacity Utilization Rate (%), IPI: Industrial Production Index, PMI: Manufacturing Industry Purchasing Managers' Index, PUMAX-Services: Services Sector Purchasing Managers' Index. CUR is seasonally adjusted while IPI and PUMAX are seasonally and calendar adjusted. Dashed line shows the stable state in PMI and PUMAX indices compared to the previous month.

Due to pandemic measures that restrained global mobility, tourism activities almost came to a halt during the April-June period in 2020. Although tourism revenues posted a partial improvement as of July on the back of easing travel restrictions in some advanced countries and EMEs that constitute a significant share of foreign visitors, they remain notably below the figures in previous years (Chart II.2.3). While imports have increased in 2020 due to gold demand and the strong credit impulse, the fall in the real effective exchange rate is limiting this increase (Chart II.2.4). With the gradual improvement in global growth, exports may maintain their strong course and the tourism sector's contribution to economic activity may increase in the upcoming period. However, the persistent spread of the pandemic and the new waves of infection in some advanced countries and EMEs create a high uncertainty over this outlook.

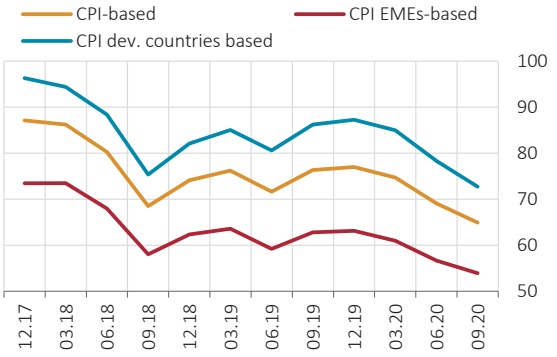
The export/import coverage ratio, which tends to decrease as imports display a relatively stronger course, has been in a more positive course since mid-year when gold is excluded (Chart II.2.5). The slowdown in economic activity and loan growth that was spurred by the phasing out of pandemic-specific measures and the monetary tightening, and oil prices that still remain low relative to the pre-pandemic period despite the recent upward trend are expected to curb the current account deficit in the upcoming period.

Chart II.2.3: Foreign Trade and Tourism Revenues (3-Month Total, Billion USD)



Sources: CBRT, TURKSTAT Last Observation: 09.20
Note: For foreign trade, exports (f.o.b.) and imports (c.i.f.) data according to the general trade system have been used.

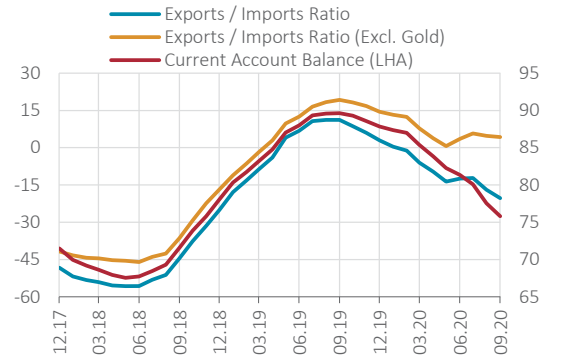
Chart II.2.4. Real Effective Exchange Rates (2003=100, 3-Month Average)



Source: CBRT Last Observation: 09.20

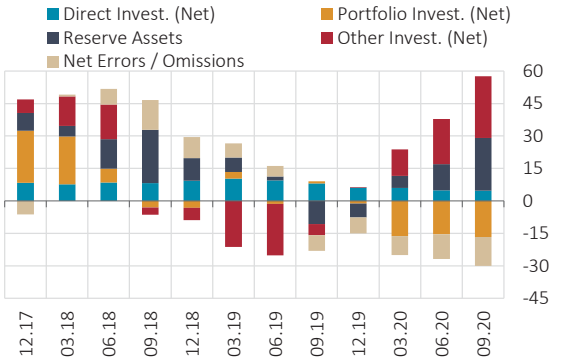
The current account balance that has posted a deficit in annualized terms since the first quarter of 2020 which has increased the financing need. In the financing structure of the current account, the contribution of direct investments has continued in recent months despite a decline compared to previous years (Chart II.2.6). While Turkey has been a net payer of cash loans due to the fall in debt rollover ratios that was largely driven by reduced demand for FX loans, net inflows have been recorded in other investments on the back of currency and deposits. Meanwhile, portfolio outflows have been registered in Turkey since the start of the year due to country-specific factors and geopolitical developments.

Chart II.2.5: Export/Import Coverage Ratio and Current Account Balance (12-Month Cumulative, %)



Source: CBRT Last Observation: 09.20

Chart II.2.6: Financing Sources of Current Account Balance (12-Month Cumulative, Billion USD)

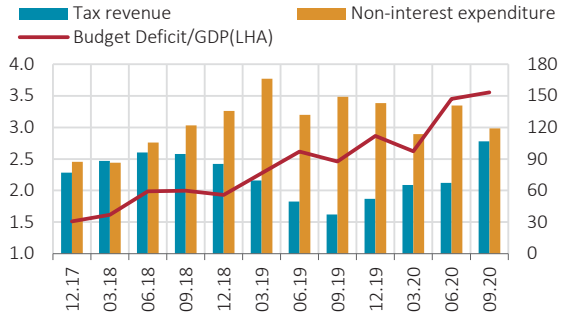


Source: CBRT Last Observation: 09.20

In addition to fiscal incentives and measures that supported the recovery in economic activity, the increase in public expenditures was also reflected in budget indicators, with primary expenditures standing significantly above tax revenues in the first half of 2020. However, tax revenues increased and primary expenditures decreased in the third quarter of the year due to the rapid recovery in domestic demand. This helped contain the deterioration in the budget balance (Chart II.2.7). If the favorable course of economic activity and the rise in the ratio of tax revenues covering primary expenditures continue, the increase in the ratio of budget deficit to GDP may be milder in the upcoming period.

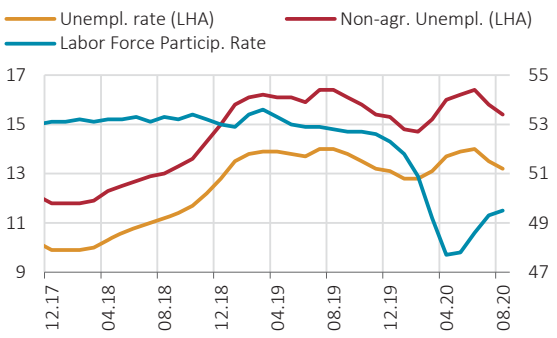
The labor market, adversely affected by the pandemic particularly through the services sector, saw the implications of the recovery in economic activity with a lag and to a more limited extent. While measures to maintain employment, such as short-time employment allowances and employment-oriented practices in particular, contributed to the decline in the unemployment rate, the reversal of the fall in labor force participation rate in recent months curbed the decrease in the unemployment rate (Chart II.2.8).

Chart II.2.7: Central Government Budget Indicators (12-Month Cumulative, Billion TL and %)



Source: MTF Last Observation: 09.20
Note: GDP data for 2020Q3 has been calculated using the annual growth rate of IPI.

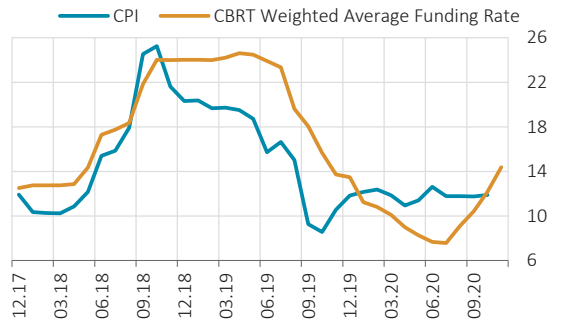
Chart II.2.8: Labor Market Indicators (Seasonally Adjusted, %)



Source: TURKSTAT Last Observation: 08.20

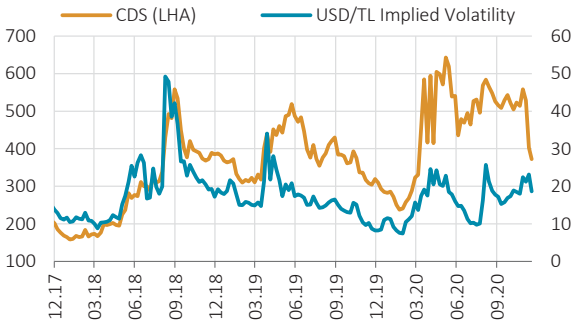
In the current Report period, pandemic-led cost increases and exchange rate and loan developments restrained the demand-side disinflationary effects while the trend of core inflation indicators displayed a high course. In view of the ongoing deterioration in the inflation outlook, the CBRT raised the one-week repo auction rate from 8.25% to 10.25% and the overnight lending rate from 9.75% to 11.75% in September 2020. The CBRT also increased the late liquidity window lending rate from 11.25% to 13.25% in September and to 14.75% in October. Within the liquidity management framework in which the markets are provided with funding via open market operations predominantly at the upper band of the interest rate corridor, the WAFR showed a tendency to increase in the third quarter (Chart II.2.9). Meanwhile, the CBRT raised the one-week repo auction rate to 15% in November, and decided to provide all short-term funding through the policy rate, via a change in the operational framework of its liquidity management to increase predictability and the effectiveness of monetary policy.

Chart II.2.9: Inflation and Policy Rates (Annual % Change, Monthly Average %)



Sources: CBRT, TURKSTAT Last Observation: 20.11.20
Note: WAFR shows the monthly average values weighted by daily amounts of funding.

Chart II.2.10: CDS Premium and Exchange Rate Volatility (Basis Points)



Source: Bloomberg Last Observation: 20.11.20
Note: CDS premium with 5-year maturity, exchange rate volatility with 1-month maturity.

As a reflection of the fluctuations in global portfolio flows caused by pandemic-led uncertainties, the downtrend observed in Turkey's risk premium and options-implied exchange rate volatility in 2019 took an opposite turn since the early months of 2020, and particularly the risk premium increased due to country-specific factors (Chart II.2.10). On the back of a gradual lifting of policy measures as the prospects for the pandemic turn positive as well as on the back of a significant monetary tightening and inflation-focused monetary policy, favorable global liquidity conditions likely to be driven by the expansionary monetary policies of advanced economies in particular may have a dampening effect on risk premia. In fact, following the policy rate hike and the simplification of the operational framework of monetary policy in November, risk premia decreased markedly.