

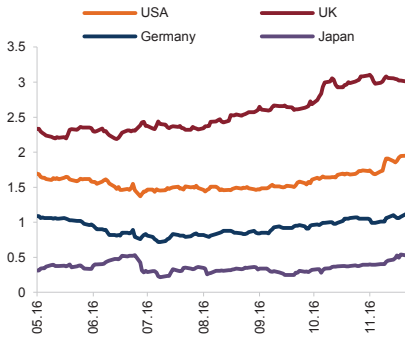
I. Macroeconomic Outlook

Following the US presidential election, uncertainty over the international financial outlook increased considerably. The possible changes in fiscal and foreign trade policies under the new administration in the US are expected by market participants to have repercussions on the Fed's monetary policy. The European Central Bank and the Bank of Japan have continued to implement expansionary monetary stances. Since the last Financial Stability Report, the capital flows to the emerging market countries have increased; however, these countries experienced extensive capital outflows following the US presidential election on the 8th of November. As an implication of capital flow movements, the returns on fixed-income securities increased while the US dollar appreciated against other currencies.

Leading indicators signal the continuation of domestic economic slowdown in the second quarter and thereby rising unemployment. The slowdown in global economies and ongoing geopolitical risks keep exerting their adverse impacts on economic activities through the foreign trade channel. The Brexit vote and volatilities in the aftermath of the US presidential elections worsen this negative outlook. Consumer prices declined in the third quarter of 2016 in contrast to the rise in the previous quarter due to the fall in basic goods and unprocessed food prices. The current account deficit narrowed due to the higher fall in imports than exports despite the decline in the tourism sector. The ongoing progress in the current account is expected to continue with the support of the normalization process with Russia. Turkey's risk premium recorded a decline despite its rise in June due partly to ongoing fiscal discipline. Volatilities in the foreign exchange markets are basically due to negative sentiment toward monetary policies in advanced economies.

I.1 International Developments

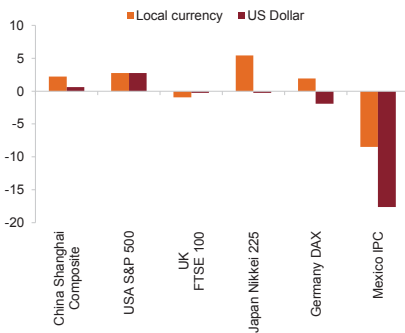
Chart I.1.1
Breakeven Inflation Rate in Selected Countries
(10 Year, Percent)



Breakeven inflation rate is the difference between the yield of a nominal bond and an inflation-linked bond of the same maturity.

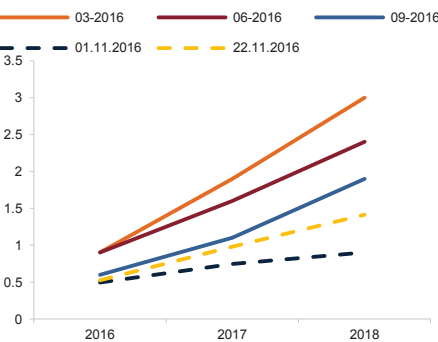
Source: Bloomberg (Latest Data: 22.11.16)

Chart I.1.2
Stock Market Indices
(Percent Change, 08.11.2016-21.11.2016)



Source: Bloomberg (Latest Data: 21.11.16)

Chart I.1.5
Median of FOMC Members' Interest Rate Forecast and Market Expectations¹



(1) Dashed lines represents 30 day Fed fund futures interest rates.

Source: Bloomberg

The US presidential election result led to an increase in volatility and uncertainty in financial markets. The new administration is expected to reduce taxes and increase public spending. It is assessed that the expansionary fiscal policy might cause a rise in growth as well as in inflation (Chart I.1.1). Hence, the sharp reaction in the stock markets shortly after the election turned into a recovery in the developed countries in a short period of time (Chart I.1.2). On the other hand, bond yields have increased while bond sales gained momentum (Chart I.1.3 and I.1.4).

Following the election, market investors increased their expectations for a more rapid normalization of the Fed's monetary policy. The Fed, however, maintains its policy stance regarding the normalization process, which will be gradual. With support of the leading indicators of growth, the expectations of a Fed rate hike in December 2016 have strengthened. Against this backdrop, market expectations and the projections of the FOMC members have recently converged (Chart I.1.5).

Chart I.1.3
US, Germany and Japan 10-Year Government Bond Yields (Percent)

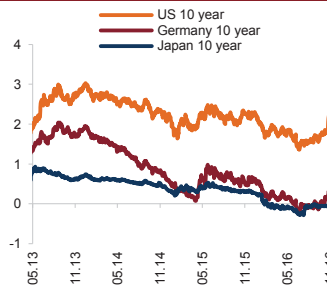
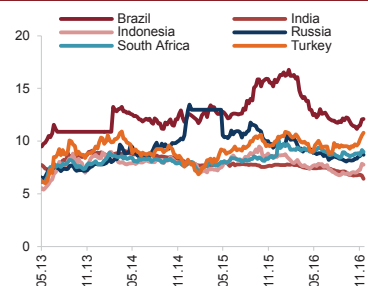


Chart I.1.4
10-Year Government Bond Yields in Emerging Economies (Percent)



Source: Bloomberg (Latest Data: 18.11.16)

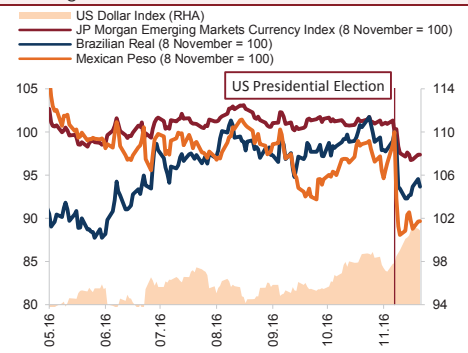
With the political change in the US, the US dollar has appreciated against major currencies, with the exception of the British pound (Chart I.1.6). Whilst the currencies of emerging economies declined to some extent, the Mexican peso and Brazilian real diverged negatively. The large portfolio outflows from emerging markets, especially in bond markets, have been influential on these developments following the US election.

In Europe and Japan, central banks continue to implement additional monetary policy measures. In addition to asset purchases, the Bank of Japan continued to take additional supportive measures by targeting the yield curve in monetary policy. Although the ECB has not taken any step towards interest rate cuts since the last reporting period, its asset purchases programme was extended to include non-bank corporate sector bonds, on the quantitative easing side. Any possible exit from the quantitative easing policy could be delayed due to the growing concern about political and financial stability towards the Eurozone after Brexit, in spite of the signs that the ECB monetary policy board will end its quantitative easing in March 2017. The possible uncertainty caused by political developments in relation to the future of the European Union depending on election results in some European countries in the upcoming period increases financial vulnerabilities.

Despite the limited response of the financial markets to the Brexit decision and the short-term fluctuations in the markets, it is likely that the decision will create some negative macroeconomic outcomes in the medium term. Given the size of the commercial and financial ties between the UK and the European Union, it is assessed that possible negative consequences may not be limited to Britain, but may have some consequences for the European Union and even the rest of the world. As of the year 2015, the UK accounted for 17.3 percent of the GDP in the EU, while, as one of the biggest members of the EU, the Germany accounted for 20.7 percent¹. In 2015, the Eurozone sent 13.6 percent of its exports to the

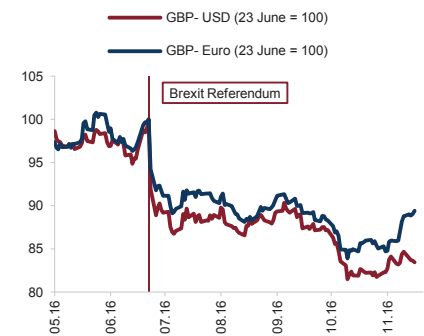
¹ IMF World Economic Outlook

Chart I.1.6
Exchange Rate Indices



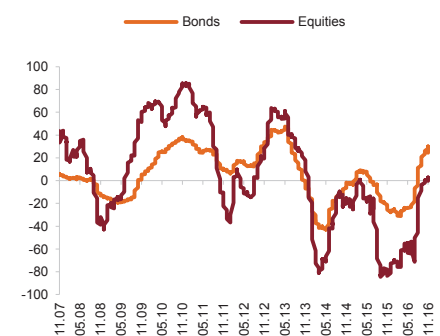
Source: Bloomberg (Latest Data: 22.11.16)

Chart I.1.7
British Pound – Euro/Dollar Parity



Source: Bloomberg (Latest Data: 22.11.16)

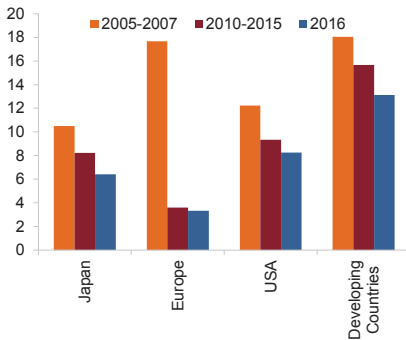
Chart I.1.8
Weekly Capital Flows to Emerging Economies (Billion USD, 52-week cumulative)



Source: EPFR (Latest Data: 16.11.16)

UK, while 9 percent of its imports are from the United Kingdom¹. With the UK's exit from the European Union, the loss of the privilege of the European single market might incur a cost for both parties. However, it is expected that the degree to which reciprocal financial and commercial agreements are substituted for the existing single market rules will be influential on the size of the cost. The commercial competitiveness power of the Eurozone may be adversely affected by the appreciation of the euro against the pound (Chart I.1.7).

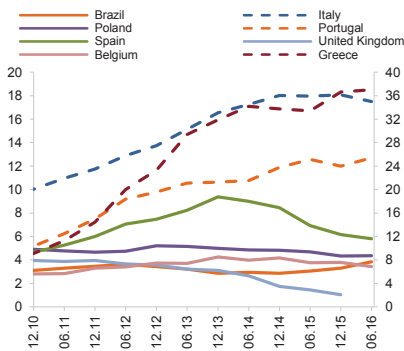
Chart I.1.9
Return on Equity of Banking Sector in Developed and Developing Countries (Percent)



Note: It is based on Banking indexes.
Source: Bloomberg (Latest Data: 17.11.16)

The recovery in capital inflows to emerging economies in the third quarter of 2016 has turned into strong capital outflows after the US elections (Chart I.1.8). It is expected that those countries that are sensitive to capital movements and with a high public debt to GDP ratio have been subject to capital outflows to a greater extent. The yield increase in the bond market leading to possible pressure on public borrowing costs has a role in this expectation.

Chart I.1.10
NPL Ratios in Selected Countries (Percent)



Source: IMF (Latest Data: 06.16)

It appears likely that the financial fluctuations experienced after the US elections might increase the funding cost for banks in emerging market countries and this situation might adversely affect credit conditions. On the other side, the negative interest rate policy applied in some countries, notably by the ECB and the Bank of Japan, appears to have significant effects on the financial sectors in developed countries. The most important impact has been observed as the decline in the profitability of the banking sector (Chart I.1.9). While the low level of profitability increases the risk that the developed country's banking sectors might not adequately support long-term growth, together with the high level of NPLs in Europe, this raises concerns about the robustness of banks (Chart I.1.10). In this context, the implementation of the leverage ratio based on core capital and the effect of leverage ratio regulations on financial stability have been evaluated (Box I.1.I). On the other hand, by adapting their infrastructures to new financial technologies and reviewing their business models, banks can contribute to their profitability performance and financial strength (Box I.1.II).

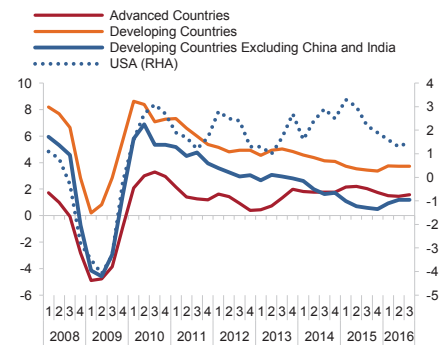
¹ ECB Database

Although global economic growth remains below the long-term average, leading indicators have recently pointed to a recovery. While economic growth in developed countries has lost its momentum, the growth outlook between the US and other developed countries has continued to diverge (Chart I.1.11). However, leading indicators point to the fact that deceleration in the growth performance of developed countries will not continue as it has been (Chart I.1.12). On the other hand, a possible protectionist shift towards protective foreign trade policies in some developed countries will pose a downside risk to the global economic growth outlook.

Although the growth outlook in emerging market countries, particularly Brazil and Russia, has recovered in the recent years, growth rates of emerging countries, excluding China and India, are below those of developed countries. In the second half of the year, there has been a limited increase in the growth performance of emerging market countries due to stabilized growth performance in China and relatively strong economic outlook in India. The contribution of China to global growth has decreased compared to previous years given a transition process that has been occurring in China from investment and exports-led growth model to the consumption-based growth model. In addition, concerns about the structural problems in shadow banking and capital markets in China remain on the agenda of international financial markets.

The fluctuating commodity prices have recently increased (Chart I.1.13). A more stable economic outlook for China has played a role in this development. In addition, the efforts of the OPEC members and non-OPEC oil exporters to control the oil supply while under pressure from increasing budget deficits, and possible expansionary fiscal policies in some countries, especially in the US, are expected to have an upward impact on oil prices. In this context, the OPEC meeting to be held on the 30th of November will be followed closely by the markets. Developments in commodity prices might contribute to the growth performance and current account balances of commodity exporter countries.

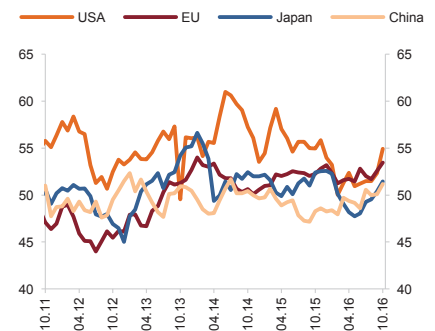
Chart I.1.11
Growth Rates in Developed and Developing Economies¹ (Percent, Annual)



¹)Weighted by each country's share in global GDP.

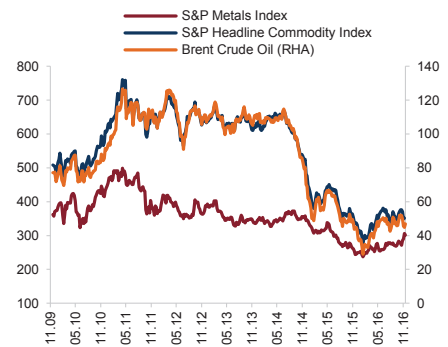
Source: Bloomberg, TCMB

Chart I.1.12
Manufacturing Industry PMI Indices



Source: Bloomberg, TCMB.

Chart I.1.13
Commodity Prices
(Index, USD)



Source: Bloomberg (Latest Data: 18.11.16)

The global financial crisis showed that a risk-based capital ratio mechanism is not enough to mitigate risks for financial stability. The Basel Committee on Banking Supervision designed leverage ratio which is simple, transparent and not a risk-based metric. The leverage ratio is expected to provide an additional support for the risk-weighted capital requirements and it aims to play a stabilizing role by creating a hard buffer during periods of rapid growth and a soft buffer during periods of sudden contraction for the banking sector, thus contributing to financial stability.

The leverage ratio defined in the Basel III framework is calculated by dividing the tier 1 capital by the sum of assets and off-balance sheet items accounted for with specific conversion ratios¹. The leverage ratio will be supervised by a minimum of 3 percent by the beginning of 2017 and will be calibrated in 2017. While banks are subject to a leverage ratio of 3 percent, banks on the global systemically important bank (G-SIB) list are required to hold a leverage ratio of 5 percent.

The Basel Committee revised its leverage ratio in April 2016 and opened it to public consultation². As a result of the opinions received, the tests and analyses made, the leverage ratio will be reviewed and the final rate will be included in the "Pillar 1" as of the 1st of January 2018.

In the implementation of leverage ratio the choice of financial assets, especially those that are added to the denominator, affects market liquidity. The weights on assets applied for differentiation of assets such as interest rates, assets, stocks, swaps and credit default swaps (CDS) can have impact on market liquidity. On the other hand, there are arguments that assets held in the central bank should be exempt from the leverage ratio exposure measure. On the basis of these observations, it is claimed that the central bank reserves, without applying any weight, require banks to hold more capital in the application of the Basel III leverage ratio. In this sense, it is assessed that a design which directly affects the transmission mechanism of the monetary policy will affect both the market liquidity and the funding liquidity of the banks. In addition, opinions are expressed that cash should be excluded from this scope.³

According to the European Savings and Retail Banking Group (ESBG)⁴ announcement on the 6th of July 2016, the newly designed leverage ratio encourages banks to have fewer high quality liquid assets, which means less demand for liquid assets, and this in turn may damage the banks' liquidity position⁵. Therefore, it is recommended to exempt banks from holding high quality liquid asset stock in the calculation of leverage ratio. Asset management

¹ BCBS, 'Basel III leverage ratio framework and disclosure requirements', <http://www.bis.org/publ/bcbs270.pdf>

² BCBS, 'Revisions to the Basel III leverage ratio framework', <http://www.bis.org/bcbs/publ/d365.pdf>

³ Bank of England, Financial Stability Report, <http://www.bankofengland.co.uk/publications/Documents/fsr/2016/fsrjul16.pdf>

⁴ <http://www.wsbi-esbg.org/SiteCollectionDocuments/0576%20final%20BCBS%20consultation%20on%20Basel%20III%20leverage%20ratio.pdf>

⁵ <http://www.wsbi-esbg.org/SiteCollectionDocuments/0576%20final%20BCBS%20consultation%20on%20Basel%20III%20leverage%20ratio.pdf>

companies that report to the Basel Committee in 2016 indicated that there will be a decline in the activities of the central counterparties if the initial margin is calculated by central counterparties at the design of the leverage ratio. On the other hand, the European Commission will issue a report on the impact of leverage ratio on the 31st of December 2016 and announce an arrangement involving different levels of leverage ratio for banks with different business models¹. Therefore, it would be beneficial to design the leverage ratio so as to ensure a positive contribution to both market liquidity and financial stability, and not to damage the stability of the financial system.

On the other hand, it is known that some banks have increased their capital ratio by issuing convertible bonds into shares. To analyze how resistant these banks are to shocks from off-balance sheet transactions, it is necessary to look at the leverage ratios based on the Tier 1 capital. The leverage ratios of 30 global systemically important banks (G-SIB) according to the list of the year 2016 are shown in Table I.1.1.1.

Table I.1.1.1
G-SIB Leverage Ratio (2016 Q3)

| G-SIB | Leverage Ratio (%) | CAR (%) | CET1 (%) | RWA (Billion \$) | Total Assets (Billion \$) | G-SIB | Leverage Ratio (%) | CAR (%) | CET1 (%) | RWA (Billion \$) | Total Assets (Billion \$) |
|---------------|--------------------|---------|----------|------------------|---------------------------|------------------------|--------------------|---------|----------|------------------|---------------------------|
| HSBC | 5.4 | 20.1 | 13.9 | 904 | 2.557 | Grøpe BPCE | 4.7 | 17.8 | 13.7 | 428 | 1.350 |
| JP Morgan C. | 6.6 | 15.1 | 11.9 | 1.480 | 2.521 | Grøpe C.A. | 5.5 | 19.2 | 14.4 | 577 | 1.964 |
| Barclays | 4.2 | 18.8 | 11.6 | 484 | 1.717 | ICBC | 7.57 | 14.18 | 12.58 | 2.193 | 3.547 |
| BNP Paribas | 4 | 14.4 | 11.4 | 633 | 2.440 | ING Bank | 4.4 | 18.5 | 13.5 | 310 | 870 |
| Citigroup | 7.4 | 19.33 | 12.63 | 1.143 | 1.818 | Mizuho FG | 3.75 | 15.04 | 10.73 | 526 | 1.626 |
| Deutsche | 3.5 | 16.1 | 11.1 | 432 | 1.896 | Nordea | 4.6 | 24.1 | 17.9 | 152 | 737 |
| Bank of Ame. | 7.1 | 14.2 | 10.9 | 1.395 | 2.195 | Royal Bank of Scotland | 5.6 | 24.1 | 15 | 305 | 1.105 |
| Credit Suisse | 4.6 | 20.8 | 12 | 281 | 829 | Santander | 5 | 14.5 | 10.47 | 652 | 1.492 |
| Goldman S. | 6.3 | 16.2 | 12.4 | 591 | 879 | Société Générale | 4.1 | 17.6 | 11.4 | 396 | 1.577 |
| Mitsubishi | 4.79 | 16.63 | 11.63 | 944 | 2.460 | Standard Chartered | 5.6 | 20.5 | 13.1 | 292 | 660 |
| Morgan S. | 6.2 | 22 | 15.8 | 358 | 813 | State Street | 6 | 17.9 | 12 | 99 | 256 |
| ABC | 6.26 | 12.97 | 10.06 | 1.773 | 2.859 | Sumitomo Mitsui FG | 4.71 | 17.12 | 11.88 | 566 | 1.559 |
| BC | 7.08 | 14.12 | 11.29 | 1.673 | 2.678 | UBS | 4.4 | 24.8 | 14 | 223 | 962 |
| Bank of NYM | 5.7 | 12.6 | 9.8 | 175 | 374 | Unicredit Group | 4.33 | 14.02 | 10.33 | 442 | 987 |
| CCB | 8.8 | 18.3 | 15.3 | 1.720 | 3.075 | Wells Fargo | 7.7 | 15.4 | 11.34 | 2.645 | 1.942 |

RBA: Risk Based Assets, CET1: Common Equity Tier I
Source: Bloomberg and bank financial positions

In a situation where all G-SIBs have a leverage ratio of 5 percent, it is expected that the effects of problems of capital quality on financial stability will be reduced.

¹ www.wsbi-esbg.org/press/news-views/Pages/Leverage-ratio-versus-RWA.aspx

According to a study conducted by the European Banking Authority (EBA) based on data from year-end 2015, the average leverage ratio of 179 banks selected from the EU was 4.9 percent¹. At the end of 2016, the European Commission will determine the ultimate leverage ratio for banks in the EU after the EBA report. The UK also uses the counter-cyclical leverage ratio buffer as well as the leverage ratio of 3 percent. The Bank of England is discussing differentiating the leverage ratio on a bank basis with respect to the assets placed in the nominator and denominator of the leverage ratio to avoid the negative impact on market liquidity. Switzerland has been applying the leverage ratio of 4.5 percent since its implementation in June 2016, while the 3 percent rate is applied in the USA. In addition, the USA also applies an additional 2 percent leverage ratio for G-SIBs. Banks that hold this rate are not subject to the limitations of the bonus payment.

Within the framework of the measures taken against excessive credit expansion by the CBRT in 2012, the leverage based reserve requirement application was initiated proactively in order to contribute to the financial stability ahead of the Basel regulation schedule. Within the framework of this policy, which is used as a structural monetary policy tool, banks that have leverage ratios of less than 3 percent, calculated from the last quarter of 2015, should have an additional 2 percentage points required reserves. Similarly, an additional 1.5 percentage points required reserves is mandatory for banks that have leverage ratio of between 3 percent and 3.5 percent; and an additional provision of 1 point is mandatory for banks that have leverage ratio between 4 percent (including 4) and 5 percent. The leverage ratio, which was started to be implemented by the BRSA in a similar manner to the leverage-based reserve requirement application, has been in force since 2015. According to the BRSA practice, leverage ratio should be applied as a minimum of 3 percent per annum on both the consolidated and solo basis on a monthly basis, as a simple arithmetic mean of every quarter. The leverage ratios calculated in the reserve requirement application are quite close to the rates calculated by the BRSA. Currently, two different leverage ratios calculated in two different ways are used to closely monitor the risks of leverage of banks.

As a result, while the leverage ratio has been reviewed by the Basel Committee and local authorities, in the upcoming period the impact of these regulatory arrangements on market liquidity will continue to be discussed in international markets. While a properly calibrated leverage ratio contributes to financial stability counter-cyclically, it is beneficial to design this ratio in a comprehensive way and take interactions with other regulations into account. In the coming period, the simplification process of monetary policy in our country, with the aim of reducing the intermediation costs and the operational burdens of the banks, will play a decisive role in designing implementations based on leverage.

¹ European Banking Authority (EBA) QIS (Sept-2016) <http://www.eba.europa.eu/documents/10180/1360107/CRDIV-CRR+Basel+III+Monitoring+Exercise+Report+-+1309.pdf/fd57198b-6aa6-442e-bfea-eabd7d3e13c1>

The notion of financial technology (FinTech), which emerges from the combination of the words “finance” - activities involving the efficient use of required funds - “technology” - tools for production and information - is among the concepts that have become increasingly important for the financial system. Even though there is no common definition, it is possible to define FinTech as financial innovation that has an impact on financial services, markets and organizations.

In recent years, there has been a significant increase in the investments made in financial technology and the diversity of services and products offered. As of 2015, global FinTech investment has surpassed US \$ 22 billion, while the amount invested by private equity firms, venture capital investment trusts and hedge funds has reached US \$ 50 billion since 2010¹.

Financial technology covers payment systems, credit channels, currencies, digital contracts and many other financial services. The most evident examples of innovations in the financial services are listed in Table I.1.II.1.

There are several reasons for the spread of FinTech. Digitalization, low transaction costs, efficiency and a low interest environment, and post-crisis banking regulations have played a role in this widespread dissemination. For example, the provision of various services through the internet without a physical service point can reduce the fixed costs while ensuring that the transactions are carried out effectively. In addition, due to banking regulations, there might be some shifts toward alternative methods such as peer-to-peer lending or crowdfunding in credit intermediation activities. The low interest environment, on the other hand, is considered as a factor that accelerates these alternative credit channels.

FinTech influences the financial system through different channels. In some countries where the banking systems have not developed, thanks to technology, financial inclusion is improving; real persons and legal entities that cannot reach financing from traditional sources (banking and the market) have the opportunity to acquire resources from new intermediaries (crowdfunding, peer-to-peer lending etc.). In addition, technology has the potential of increasing efficiency and cost advantage through increasing the competition in the financial system. Some technologies, on the other hand, require a review of existing business models and adaptation. Possible deep-rooted changes in virtual money and payment systems and their implications on monetary policies are among the topics that will be on the agenda in the forthcoming period.

FinTech has important implications for the financial system and is closely monitored by

¹ Fintech and the evolving landscape - accenture.com. (n.d.) Retrieved November 9, 2016, from https://www.accenture.com/t20160427T053810_w_/us-en/_acnmedia/PDF-15/Accenture-Fintech-Evolving-Landscape.pdf

the international standard setting bodies and central banks in terms of financial stability. The Chairman of the FSB sent a letter to G20 Leaders on August 30, 2016, and indicated that at the beginning of 2017, the FSB and other standard setting bodies will start examining FinTech case studies and areas to be regulated will be raised for attention. Similarly, the FATF published guidance for a risk-based approach to virtual currencies in June 2015. Additionally, the CPMI, in its study published in November 2015, reviewed the digital currencies and their implications for central banks. Hence, FinTech will continue to be one of the most important trending topics of the international agenda.

Table I.1.II.1
Services Arising through Financial Technology

| Definition | Explanation |
|--------------------------------------|---|
| Peer-to-peer lending | A funding method linking persons and companies through a website. |
| Crowdfunding | Crowdfunding is a way of raising debt or equity from investors via an internet-based platform. |
| Smart contracts | Smart contracts are computer protocols that can self-execute, self-enforce, self-verify, and self-constrain the performance of a contract. With these contracts, it becomes possible to set the conditions for a financial transaction or exchange of assets. |
| Cloud computing | IT services reached through the Internet. |
| Robo advice | Applications providing portfolio allocation through algorithms and financial advice according to the client profile. |
| Distributed Ledger Technology | The database on a virtual network where the transactions (money or asset) are registered. Users can reach, verify, add or remove records. Records are separated and protected through digital keys and signatures. |
| Virtual Money | The digital correspondent of currency issued by a developer. It features a chain of digital signatures. |

I.2 Domestic Developments

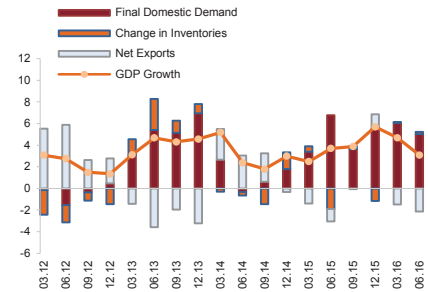
In the first half of 2016, the Turkish economy grew with the support of domestic demand (Chart I.2.1). The highest contribution to domestic demand was from the public sector while the contribution of public investments to growth was 1.7 percentage points in the second quarter. Meanwhile, the slowdown in the global economy and the ongoing geopolitical risks weakened Turkey's export and tourism revenues. Consequently, net exports, which made a positive contribution to the growth rate in the last quarter of 2015, had a negative impact on the overall growth figure in the first half of 2016.

In the second half of the year, the ensuing macroeconomic uncertainties from the Brexit vote and the volatilities in global markets in the aftermath of the US presidential elections were the determining factors on economic developments in emerging economies. Continued uncertainties in the Fed policies seriously affected capital flows, thereby elevating risk perceptions towards emerging economies, including Turkey. Meanwhile, oil prices, which remained considerably low compared to previous years, underpinned economic growth.

Leading indicators show the slowdown in economic activity that continued in the second half of the year. The seasonally and calendar adjusted industrial production index fell by 1.7 percentage points in the third quarter compared to the same quarter of the previous year (Chart I.2.1). However, the government has introduced several measures to address the economic slowdown and support GDP growth. Important steps have been taken via investment stimulation packages, which have been introduced recently, towards increasing production capacity.

Economic activity weakened in the first half of 2016.

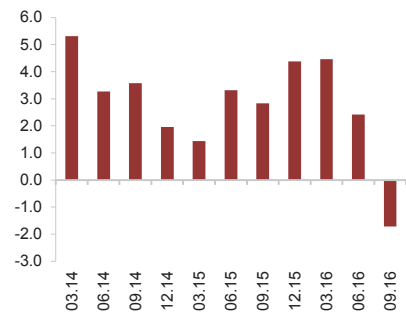
Chart I.2.1
Contribution to Growth from the Expenditure Side
(Percentage Point)



Source: CBRT (Latest Data: 06.16)

In the third quarter of 2016, seasonally and calendar adjusted industrial production index fell by 1.7 percentage points year-on-year.

Chart I.2.2
Industrial Production Index
(Annual Percentage Change)

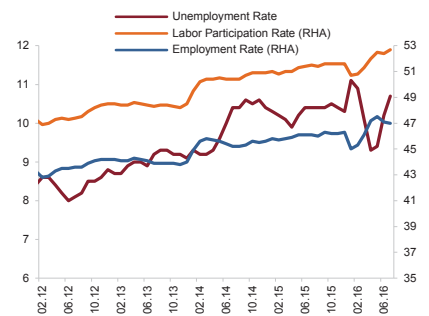


Note: Figures represent seasonally and calendar adjusted industrial production index.

Source: TURKSTAT (Latest Data: 09.16)

The unemployment rate picked up again after the beginning of 2016.

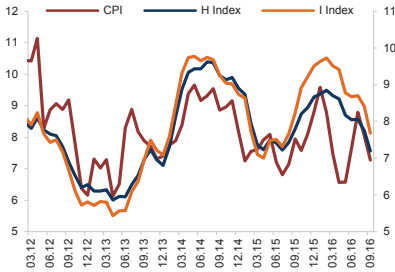
Chart I.2.3
Labor Force
(Seasonally Adjusted, Percent)



Source: TURKSTAT (Latest Data: 08.16)

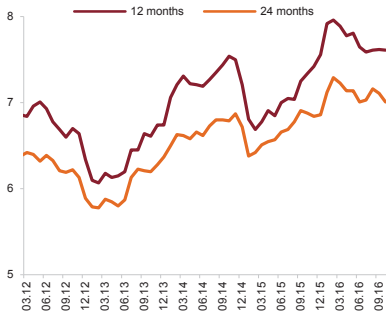
Consumer prices, which increased in the second quarter, decreased in the third quarter on the back of the decline in basic goods and food prices.

Chart I.2.4
Price Indices
(Annual Percentage Change)



Source: CBRT (Latest Data: 09.16)

Chart I.2.5
Inflation Expectations
(Percent)



Source: CBRT (Latest Data: 09.16)

In the first half of 2016, employment capacity continued to increase and unemployment rates regressed to single digits. Nonetheless, in the rest of the year, the number of unemployed increased due to strong labor force participation as well as slowdown in the economic activity. Since July, the decline in public sector employment fueled the rise in the number of unemployed. As a result of these developments, unemployment rates in the second half of the year climbed up to double digits again in the labor market (Chart I.2.3).

After a rise in the second quarter, consumer prices decreased in the third quarter owing to decreasing basic goods and unprocessed food prices. The basic goods prices declined on the back of the reduced cumulative impacts of foreign exchange rates and weaker demand conditions; whereas the fall in unprocessed food prices was mainly driven by the contraction in the tourism sector and declining trade with Russia. The moderate trend of imports prices supported the downtrend in inflation as well. Despite the decline in basic goods and unprocessed food prices, the services sector inflation remained high due to the rise in real unit labor costs and the outlook of the rental market. Meanwhile, tobacco products prices put upward pressure on consumer prices due to the tax adjustments accomplished for these products in January 2016. The downward trend of consumer and core inflation in the third quarter of 2016 had a positive impact on 12 and 24 month inflation expectations, which in turn decreased in accordance with the expectations (Chart I.2.5).

Improvement in net exports narrowed current account deficit.

Chart I.2.6
Current Account
(12 Month Cumulative Billion USD)

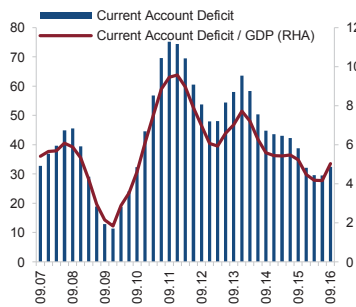
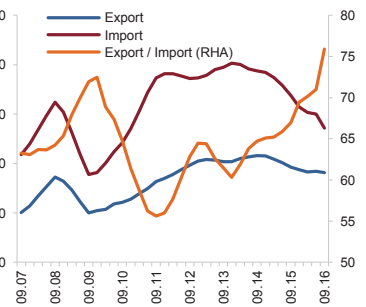


Chart I.2.7
Foreign Trade
(12 Month Cumulative, Billion USD, Percent)



Note: Third quarter GDP figure is CBRT estimate.

Source: CBRT (Latest Data: 09.16)

Despite the decline in tourism revenues, current account deficit narrowed down in this period as imports decreased more than exports (Chart I.2.6). As a result of this development in net exports, the ratio of exports to imports exceeded 75 percent and recorded the highest level in the last decade (Chart I.2.7). In the Turkish foreign trade market, mainly euro dominates the exports and US Dollar is used in imports; therefore, continued depreciation of euro against US Dollar in the upcoming period might have limited adverse effects on Turkey's foreign trade balance. Similarly, any rise in oil prices could exert upward pressure on the current account deficit. The ongoing normalization process with Russia is expected to have positive impacts on exports and tourism revenues in 2017.

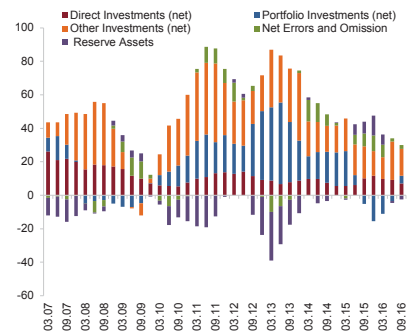
Direct investments slightly decelerated in the last quarter but still contributed to current account financing (Chart I.2.8). Portfolio outflows, which had started in the first quarter, continued. The downtrend in reserve assets continued due to portfolio outflows.

Due to marked fall in current account deficit and deceleration in the external borrowing requirement, the short-term foreign debt stock remains on a downward trend. The fall in short term debt stock coupled with the rise in the Central Bank reserves contributed to the significant improvement in the ratio of the Central Bank gross reserves to the short-term external debt stock (Chart I.2.9). Nonetheless, the upward trend in oil prices and the slow recovery in the tourism revenues might adversely affect the current account deficit in the short term.

In the first three quarters of the year, the central government budget balance improved slightly compared to the same period of 2015 mostly owing to the rise in non-tax revenues (Chart I.2.10). In this period, the moderate rise in tax revenues and cyclical fall in interest expenditures made a positive contribution to the budget performance despite the continued rise in primary expenditures. The central government budget performance is expected to deteriorate moderately in the upcoming period as a result of the rapid increase in primary expenditures and the slowdown in tax revenues despite the favorable impacts of the cyclical fall in interest expenditures and the rise in non-tax revenue increases.

Long-term sources continue to finance current account deficit.

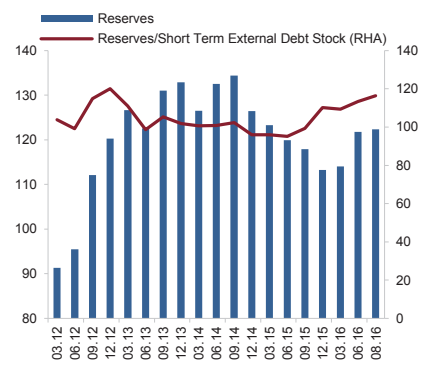
Chart I.2.8
Current Account Deficit Financing Items
(12 Month Cumulative Billion USD)



Source: CBRT (Latest Data: 09.16)

Short-term external debt repayment capacity of CBRT gross reserves is on the rise.

Chart I.2.9
Short-term External Debt Stock and CBRT Gross FX Reserves
(Billion USD, Percent)

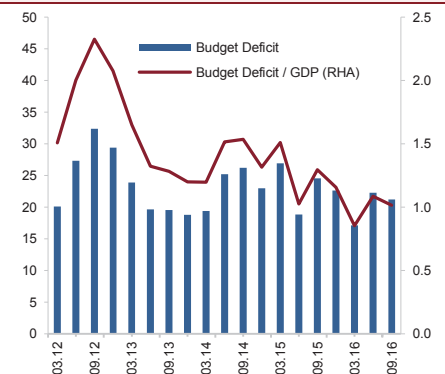


Not: Reserves are CBRT gross reserves including gold.

Source: CBRT (Latest Data: 08.16)

Favourable performance of central government budget continues.

Chart I.2.10
Central Government Budget Balance
(12 Month Cumulative, Billion USD, Percent)



Note: Third quarter GDP figure is CBRT estimate.

Source: Undersecretariat of Treasury (Latest Data: 09.16)

While the Turkish CDS premiums were adversely affected by the domestic volatilities in July, the impact on CDS premiums was partially taken back later (Chart I.2.11). Meanwhile, the appreciation in exchange rates is attributed to the uncertainties pertaining to advanced economies' monetary policy decisions in the upcoming periods (Chart I.2.12).

Chart I.2.11
Exchange Rate Basket and CDS

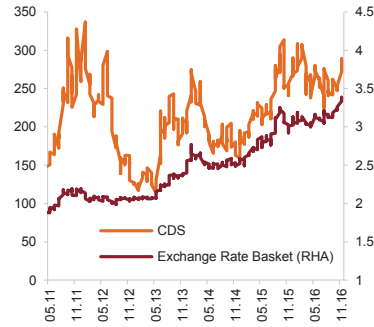
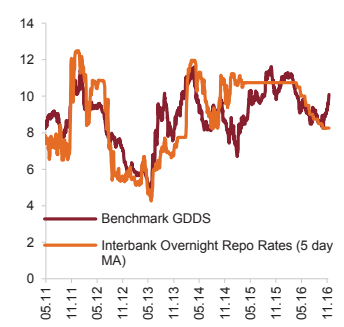


Chart I.2.12
Interest Rates (Percent)



Source: Bloomberg