I. International and Domestic Developments Affecting Financial Stability

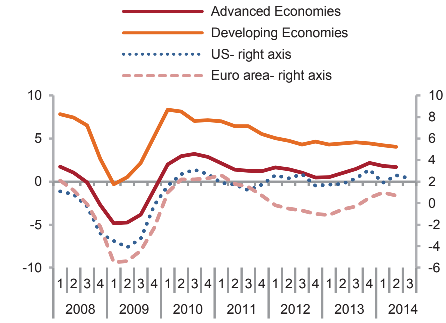
The recovery in global economic activity is still sluggish and the differences between countries' growth trends are remarkable. Inflation rates remain low on the back of the weak outlook in economic activity and the fall in oil prices. Although monetary policies of advanced economies continue to support growth, there is a policy divergence between the Fed and the ECB. However, the monetary easing policies implemented to back the recovery process also bring about some financial risks for advanced economies. In advanced countries, the banking sector does not provide a sufficient amount of support to economic recovery and risks are concentrated particularly on the non-bank financial activities. Expectations for a potential interest rate hike by the Fed and geopolitical risks cause the global risk appetite and capital flows to emerging economies to fluctuate.

Up-to-date leading indicators suggest that the Turkish economy, which slowed in the second quarter of 2014, will show a better performance in the third quarter. However, the ongoing volatility in financial markets and vulnerabilities in external demand pose downward risks to the recovery process. Macroprudential measures taken in this period of continued global uncertainties and the tight monetary policy stance prove to be instrumental in restraining the vulnerabilities that may jeopardize economic and financial stability.

I.1. International Developments

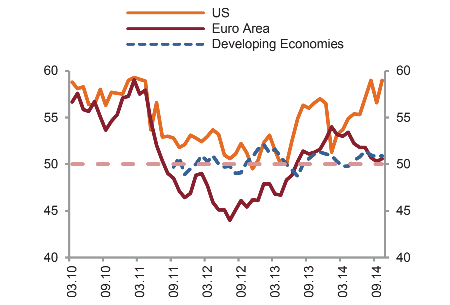
The recovery in global economic activity is still sluggish and growth dynamics differ across countries. The US economy is recovering, whereas economic growth in the euro area and Japan displays a considerably fragile and weak outlook (Chart I.1.1). Meanwhile, growth rate is losing pace in emerging economies. The recent downward movement in commodity prices may affect the growth dynamics of commodity-exporting emerging economies negatively. The manufacturing

Chart I.1.1
Global Growth Rates and Advanced Economies' Growth Rates[1]
(Percent, Annual)



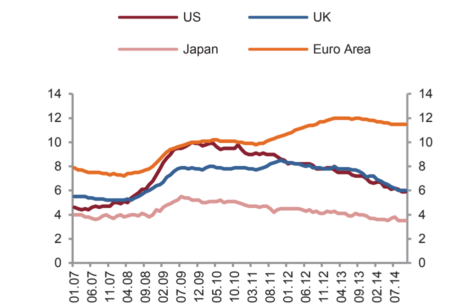
(1) Weighted by each country's share in the global GDP.
Source: Bloomberg, CBRT

Chart I.1.2
Manufacturing Industry PMI Indices



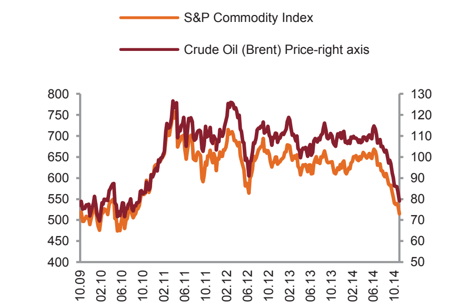
Source: Bloomberg (Latest Data: 10.14)

Chart I.1.3
Unemployment Rates in Selected Advanced Economies
(Percent, Annual)



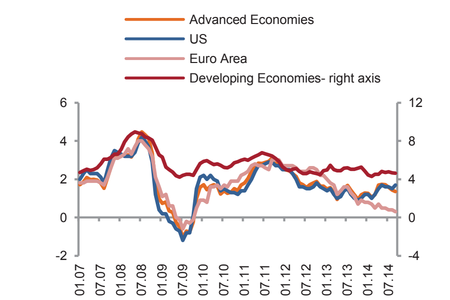
Source: Bloomberg (Latest Data: 10.14)

Chart I.1.4
S&P GSCI and Brent Oil Prices
(Index, USD)



Source: Bloomberg (Latest Data: 14.11.14)

Chart I.1.5
Inflation Rates in Advanced and Emerging Economies
(Percent, Annual)



Source: Bloomberg (Latest Data: 09.14)

industry PMI indices in the US and the euro area suggest that the recovery in the euro area may slacken and the US will be the driving force behind the growth in advanced economies (Chart I.1.2). The same indices also show that the deceleration in the growth rate of emerging economies will continue in the third quarter of the year as well. The positive outlook in the US labor market persists, whereas the unemployment rate in the euro area continues to be high (Chart I.1.3). However, the downtrend in labor force participation rates still plays an important role in the drop in US unemployment rates. Moreover, the fact that part-time employment remains above the pre-crisis levels indicates that the US labor market outlook is not robust enough yet.

Inflation rates remain low due to the weak outlook in global economic activity and the downward trend in commodity prices. The output gap is still high in advanced economies. Oil prices are on a downtrend in line with the weak economic activity (Chart I.1.4). In addition, wages have not exerted an upward pressure on inflation, especially in the US. Owing to these developments, inflation in advanced economies continues to be below the targets (Chart I.1.5). The deflation threat in the euro area lingers. In emerging economies, inflation follows a horizontal course.

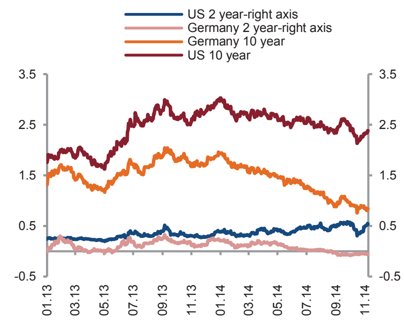
Advanced economies' monetary policies continue to spur growth. Yet, the Fed's and the ECB's policies diverge due to the differences in growth outlooks. The Fed decided at its October 2014 meeting to end the asset purchase program, which it had been tapering off since January 2014 parallel to the improvement in the economy. The Fed is expected to start interest rate hikes in the upcoming period. Yet, since inflation remains low and there has not been a permanent improvement in the labor market, the interest rate hike may start later than expected and be slower. Contrary to the normalization in the US monetary policy, the ECB introduced a negative interest rate policy and started an asset purchase program in October. However, the ECB may be urged to take more steps if the inflation outlook in the euro area does not improve. Likewise, in October 2014, the Bank of Japan (BoJ) raised the amount of asset purchases, which it has been conducting in the framework of the monetary policy easing program since April 2013.

The low interest rate environment created by accommodative monetary policies leads to some financial risks for advanced economies. With the impact of these policies, bond yields and risk premiums decline, whereas stock indices and price to earnings ratios rise (Chart I.1.6 and I.1.7). The strong upward trend in housing prices continues (Chart I.1.8). The volatility in financial markets has dropped to low levels, while transaction volumes and market depth decreased.

In advanced economies, financial market risks are concentrated especially in the non-banking sector. While the banking sector's leverage drops, hedge funds and exchange traded funds that engage in shadow banking activities have high leverage ratios and are subject to maturity mismatch. This fact shows that the non-bank financial sector will be the one on which the re-pricing will have the greatest effect (Special Topic IV.6). The critical role that the non-bank financial sector plays in the funding of the corporate sector suggests that the problems likely to emerge in the non-bank financial sector may have more apparent adverse effects on the corporate sector. In the coming period, macroprudential policies rather than the monetary policy is expected to be on the forefront of the fight with risks that may originate from the low interest rate climate, if global growth dynamics continue to be vulnerable.

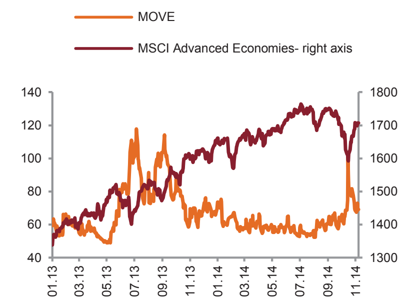
In advanced economies, particularly in the euro area, the banking sector has not contributed to economic recovery at a sufficient level. While the banking sector loans are on the rise in the US, loans continue to decrease in the euro area (Chart I.1.9). Banks in the euro area are downsizing their balance sheets and trying to avoid risks. These actions are believed to be driven by both demand and supply factors. The high indebtedness level has constrained the loan demand, while the loan supply of the banking sector, which has faced high non-performing loans and balance sheet-related problems in the aftermath of the crisis, has narrowed. Banks continue to put effort in strengthening their capital positions and achieving a more sound balance sheet structure. The comprehensive assessment study that the ECB conducted before it became the single supervisory authority responsible for banking activities is believed to restore trust in euro area banks and allow the banking sector to give more support to economic recovery (Box I.I.1).

Chart I.1.6
US and Germany Treasury Bond Yields
(Percent)



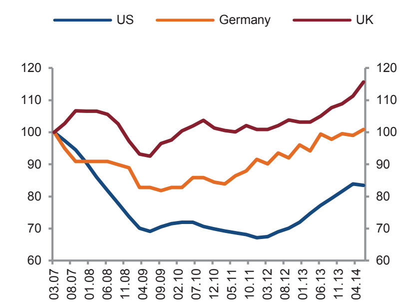
Source: Bloomberg (Latest Data: 7.11.14)

Chart I.1.7
MSCI and MOVE Indices in Advanced Economies



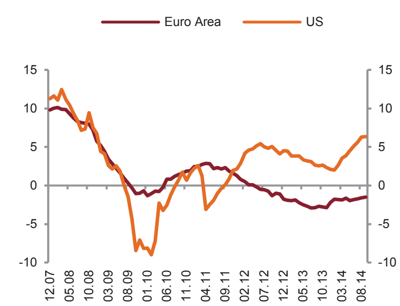
Source: Bloomberg (Latest Data: 7.11.14)

Chart I.1.8
House Price Index in Advanced Economies*



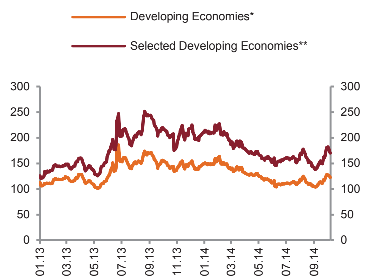
*31.03.2007=100
Source: Bloomberg (Latest Data: 06.14)

Chart I.1.9
Loan Growth in the USA and the Euro Area
(Annual)



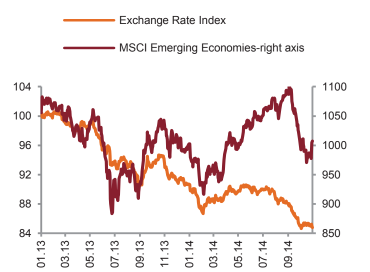
Source: Fed, ECB (Latest Data: 09.14)

Chart I.1.10
CDS Premiums of Emerging Economies
(5-Year)



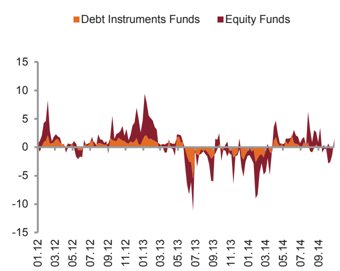
*Emerging economies include Brazil, the Czech Republic, Indonesia, South Africa, Colombia, Hungary, Mexico, Poland, Romania, Turkey and Chile.
** CDS premiums of Brazil, Indonesia and South Africa have been used in the calculation of the average CDS premium of selected emerging market economies.
Source: Bloomberg (Latest Data: 7.10.14)

Chart I.1.11
Exchange Rate* Index and MSCI Emerging Markets Index



*The Exchange Rate Index is compiled by taking the arithmetic mean of the US dollar equivalent of local currencies of Argentina, Brazil, Colombia, the Czech Republic, Hungary, India, Indonesia, Korea, Malaysia, Peru, the Philippines, Poland, Russia, South Africa, Thailand and Turkey. (01.01.2013=100)
Source: CBRT Calculations, Bloomberg (Latest Data: 30.10.14)

Chart I.1.12
Weekly Portfolio Flows to Emerging Countries
(Billion USD)



Source: EPFR (Latest Data: 29.10.14)

The global risk appetite and capital flows to emerging economies follow a fluctuating course due to uncertainties regarding the Fed's interest rate hikes and geopolitical risks. Accordingly, exchange rate, interest rate, stock exchange and risk premium indicators are also fluctuating in emerging economies (Chart I.1.10 and Chart I.1.11). While a probable interest rate hike by the Fed in 2015 may increase downward risks to capital movements, monetary easing policies of the ECB and the BoJ will offset these risks to a certain extent (Chart I.1.12). Nevertheless, susceptibility of capital movements to country-specific factors is expected to increase in the forthcoming period, with a likely fall in the risk appetite of international investors. The level of emerging market economies' resilience to financial shocks will be decisive for countries that will receive global capital flows. In this respect, growth outlooks, inflation rates and external vulnerabilities of emerging market economies will probably affect global capital flows (Table I.1.1).

Monetary policy preferences of advanced economies will continue to affect Turkey in the upcoming period. If the deceleration in global growth leads to a delay in the normalization of advanced economies' monetary policies, then there may be a risk of overborrowing. In such a case, measures to increase the resilience of the financial system and encourage prudent borrowing will be of critical importance.

Table I.1.1
Selected Indicators in Emerging Economies*

	Brazil	Hungary	India	Indonesia	Mexico	Poland	Russia	S. Africa	Turkey
Growth[1]	0,3	2,8	5,6	5,2	2,4	3,2	0,2	1,4	3,3
Inflation[1]	6,2	1,8	7,6	5,2	4,0	0,0	8,3	6,3	8,9
Fiscal Budget Balance / GDP[1]	-3,9	-2,9	-7,2	-2,5	-4,2	-3,2	-0,9	-4,9	-1,4
Current Account Balance / GDP[1]	-3,5	2,5	-2,1	-3,2	-1,9	-1,5	2,7	-5,7	-5,7
Government Debt / GDP[1]	65,8	79,1	60,5	26,2	48,0	49,4	15,7	47,9	33,1
Real Credit Growth[2,5]	6,4	-6,0	5,0	11,0	5,3	4,2	10,6	1,9	10,1
External Loans / GDP[3]	23,5	155,2	22,0	33,3	34,2	70,5	35,5	41,6	49,4
Short-Term External Debt / Reserves[3]	11,3	54,5	27,8	44,7	53,4	45,6	19,0	75,4	98,6
Household Debt / GDP[4]	-	28,1	8,1	16,3	14,2	34,6	81,2	37,9	19,2
Non-financial Corporations Debt / GDP[4]	-	87,5	45,9	20,3	11,4	41,8	31,0	31,7	45,1
Capital Adequacy Ratio[5]	15,5	16,6	12,6	18,9	15,9	15,7	12,8	14,6	15,9
Equity/Asset[5]	9,3	10,7	7,0	12,7	10,3	9,1	11,1	7,7	11,4
NPL Ratio[5]	2,9	16,3	4,0	2,1	3,2	5,0	6,5	3,4	2,9
Loan/Deposit[5]	85,0	110,0	89,5	100,2	111,1	115,7	152,9	187,6	119,9

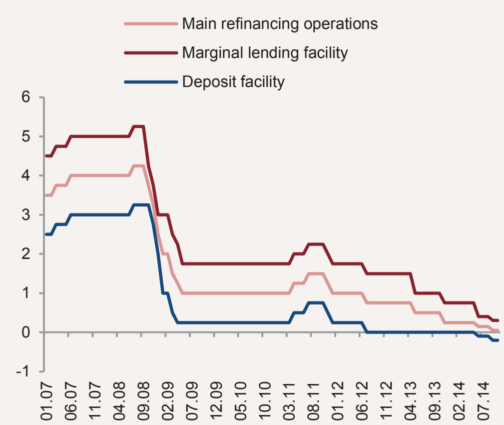
*Data for Turkey is based on CBRT's year-end inflation forecast, MTP and BRSA's monthly bulletin.
[1] Refers to IMF's 2014 year-end forecasts.
[2] Calculated based on BIS 2014-Q1 loan growth data and IMF's year-end inflation forecasts.
[3] External debt data include IMF's 2014-Q2 data. Original maturities were used in the calculation of short-term external debt.
[4] Calculated by dividing BIS 2014-Q1 indebtedness data into IMF's 2014 year-end GDP estimations.
[5] Refers to banking data pertaining to 2014-Q2. All data for Poland and loan/deposit ratio data for Hungary are as of 2013 year-end. Data for Turkey reflect 2013-Q3(end of quarter) data.
Source: BIS, Local Data, IMF

Box I.1.1 Measures Taken to Support Economic Activity and Struggle with Deflation in the Euro Area

A series of measures have been taken in the euro area to support economic activity and stimulate banks' credit intermediation functions. The most significant measures recently taken in the euro area have been to cut ECB lending rates close to 0 percent, drive the borrowing rate down to negative, start an asset purchase program, initiate longer-term refinancing operations and conduct comprehensive assessment studies on banks.

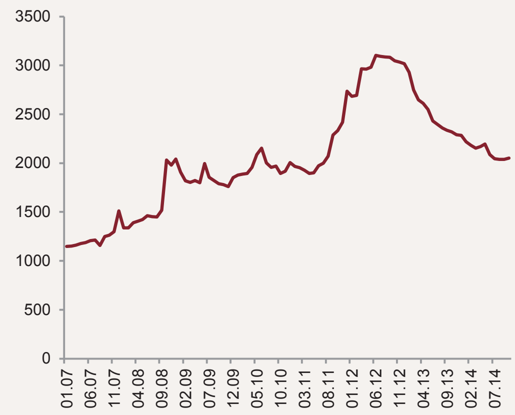
At its monetary policy meeting in June, the ECB decided on a negative deposit facility rate for the first time and set the interest rate applied to deposits in excess of the minimum reserve requirements that the banks hold with the ECB at -0.10 percent. At its September meeting, the ECB further cut the marginal lending facility, main refinancing operations and deposit facility rates to 0.3 percent, 0.05 percent and -0.2 percent, respectively (Chart I.1.1.1). On the other hand, an analysis of the borrowing amounts in the ECB balance sheet reveals that the amount of excess reserves, which was approximately EUR 88 billion prior to the negative deposit facility rate, has not registered a significant change despite the recent decisions. In this respect, the negative deposit facility rate is believed to have fallen short of leading to the expected impact.

Chart I.1.1.1
Changes in ECB Policy Rates
(Percent)



Source: Bloomberg

Chart I.1.1.2
Changes in the ECB's Balance Sheet Size
(Billion Euro)



Source: ECB

In October, the ECB announced that it would launch asset purchase programs that will last for at least 2 years. In this framework, the ECB started the covered bond purchase program in October and asset-backed securities purchase program in November. The ECB bought EUR 4.8 billion worth of covered bonds in October. Considering that the current qualified covered bond amount in the market is EUR 140 billion and the amount of asset-backed securities is limited, asset purchase programs may not have a big impact on the ECB's balance sheet. Recently, there have been some debates suggesting that the ECB should buy government securities to expand its balance sheet.

The ECB introduced targeted longer-term refinancing operations (TLTROs) in June 2014. It will hold a longer-term refinancing auction every 3 months between September 2014 and June 2016, and all TLTROs will mature in September 2018. The Bank plans to hold a total of 8 refinancing auctions. Financial institutions will initially be able to borrow an amount equal to 7 percent of the total amount of their loans to households and the corporate sector (excluding loans to households for house purchase), outstanding on 30 April 2014. Borrowing limits in September and December 2014 will be calculated on the basis of this amount and an institutiton's refinancing amount will not exceed this initial allowance. The refinancing amount in other issues will be limited to three times the additional lending of financial institutions to households and the corporate sector (excluding loans to households for house purchase) as per 30 April 2014. The interest rate on the TLTROs will be fixed over the life of each operation at the rate on the Eurosystem's main refinancing operations prevailing at the time of take-up, plus a fixed spread of 10 basis points. The TLTROs are expected to contribute to economic activity by supporting bank lending to households and the corporate sector. As of April 2014, the net lending of euro area banks to households and the corporate sector (excluding loans to households for house purchase) amounts to approximately EUR 5.7 trillion. Accordingly, the maximum amount of funding that banks can get from the TLTROs is EUR 400 billion. The refinancing amount of EUR 82.6 billion provided to 738 financial institutions through the TLTRO in September 2014 is considerably below the maximum amount of refinancing that banks can get. These institutions will be able to use their remaining limits in the December 2014 auction. On the other hand, even though the ECB's monetary policy decisions are expected to affect capital flows to emerging economies, statistical studies suggest that ECB implementations will not be as effective as the monetary policy decisions of the Fed (IIF,2014). All in all, the fact that banks have not made a serious change in the amount of excess reserves they hold with the ECB after the negative deposit facility rate decision and the TLTRO facilities have not been used intensely shows that credit supply and demand are still low in the euro area.

A comprehensive assessment study has been conducted on banks in the euro area. The study focuses on revealing whether the current financial conditions of banks are presented accurately, identifying problems, developing remedial action plans and assuring that banks have a healthy and reliable structure. Total assets of 130 banks covered in the assessment make up 82 percent of the euro area's total bank assets. The study is based on 2013 year-end data. The comprehensive assessment consists of two main components: the asset quality review and the stress test of the banks. According to the results of the comprehensive assessment released in October, a capital shortfall of EUR 25 billion was detected at 25 banks which failed the asset quality review and the stress test. On the other hand, an analysis of October 2014 data shows that some of the banks have already covered their capital shortfall and the remaining capital shortfall has declined to approximately EUR 9.5 billion. Banks with shortfalls must prepare capital plans in November.

I.2. Domestic Developments

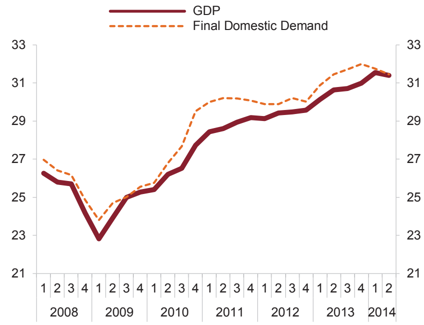
The GDP posted a year-on-year increase of 3.3 percent in the first half of 2014, hovering below the historical averages (Chart I.2.1). The weakness of domestic and external demand was the main factor in this development (Chart I.2.2). Although the leading indicators point to a slight improvement in the economic outlook in the second half of the year, uncertainties regarding global monetary policies, geopolitical developments and the weak external demand pose risks to the recovery process.

The economic slowdown has led to an apparent surge in unemployment rates. Total and non-farm unemployment rates were 9.6 percent and 11.6 percent, respectively, as of the release of the previous Financial Stability Report in May 2014, whereas they stood at 10.4 percent and 12.4 percent as of August 2014 (Chart I.2.3). On the other hand, the labor force participation rate maintains its relatively high level of recent years.

The current account deficit is expected to keep improving. This improvement is attributed to the reasonable level of loan growth achieved with the tight monetary policy and macroprudential measures. Meanwhile, taking into account the weakening in the long-lasting uptrend in exports due to the fall in global demand and geopolitical developments as well as the signs of a revival in domestic demand, the contribution of net exports to growth is expected to wane relatively in the second half of the year on the back of the moderate rise in imports (Chart I.2.4).

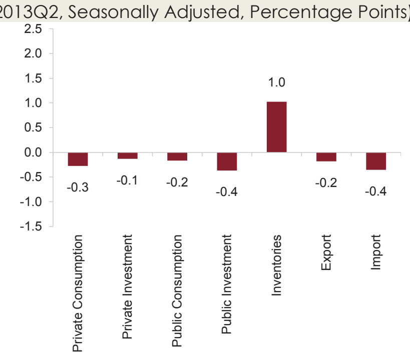
In the second half of the year, capital flows to Turkey displayed a weak and fluctuating outlook due to the globally increasing volatility. Turkey's risk premium plunged in the second quarter of the year owing to the improvement in both global and Turkey-specific risk perceptions. However, driven by the uncertainties in global monetary policies, the geopolitical risks intensifying around Turkey and concerns about the vulnerability of global recovery, there have been acute fluctuations in Turkey's risk premium since the third quarter, similar to those in the risk premiums of peer emerging economies. CDS premiums

Chart I.2.1
GDP and Final Domestic Demand
(Billion TL, 1998 prices)



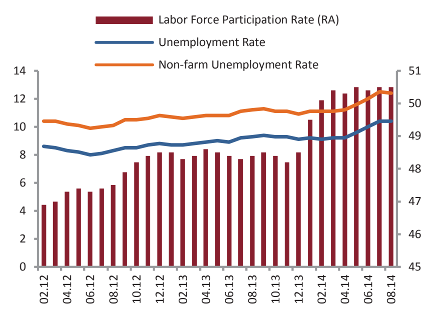
Source: CBRT, TURKSTAT

Chart I.2.2
Contributions to Quarterly GDP Growth
(2013Q2, Seasonally Adjusted, Percentage Points)



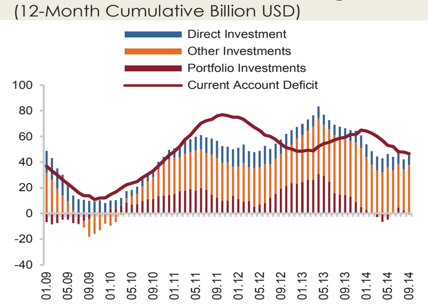
Source: CBRT, TURKSTAT

Chart I.2.3
Unemployment and Labor Force Participation Rates
(Seasonally adjusted, Percent)



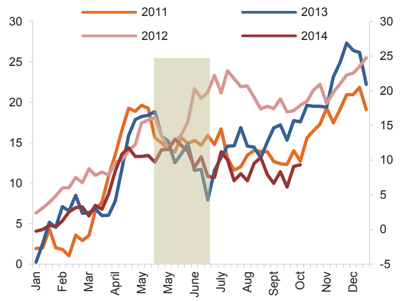
Source: TURKSTAT

Chart I.2.4
Current Account Deficit and Financing Items[1]
(12-Month Cumulative Billion USD)



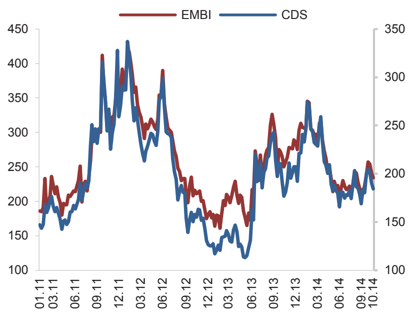
(1) Portfolio includes equities and government domestic debt securities. "Other" is composed of the total of short and long-term net loans of banks and other sectors, bonds issued abroad by banks and the Treasury, and deposits at banks.
Source: CBRT

Chart I.2.5
Cumulative Portfolio Flows[1]
(Billion USD)



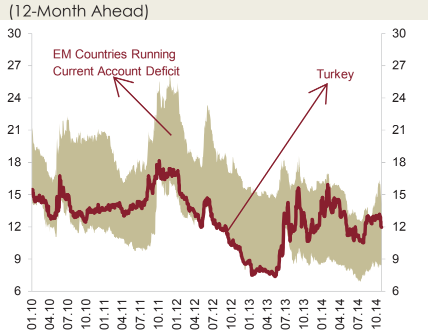
(1) Calculated by weekly net portfolio flows. Includes data on repo, GDDS and securities portfolio as well as banks' off-balance sheet FX position.
Source: BRSA, CBRT

Chart I.2.6
EMBI-Turkey and Turkey's 5-Year CDS Prices



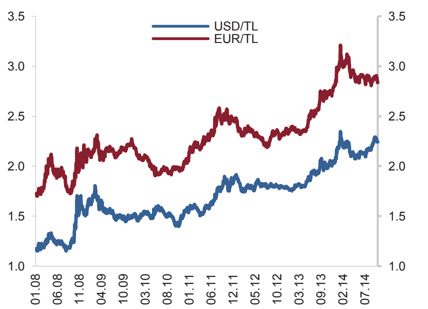
Source: Bloomberg

Chart I.2.7
Implied Volatility of Exchange Rates[1]
(12-Month Ahead)



(1) Emerging economies posting current account deficits include Brazil, the Czech Republic, Indonesia, South Africa, Colombia, Hungary, Mexico, Poland, Romania, Chile and Turkey.
Source: Bloomberg

Chart I.2.8
Nominal Exchange Rate
(CPI-based, 2003=100)



Source: CBRT

declined slightly due to the surge in the global risk appetite triggered by the Fed's statements that encourage economic growth (Chart I.2.6).

In the second half of 2014, implied volatility of exchange rates increased due to the fluctuating trend in the risk premiums of emerging economies. The implied volatility of the exchange rate for the Turkish lira also did not differ much from other emerging economies posting current account deficits (Chart I.2.7).

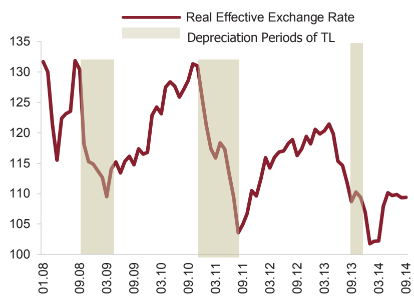
The Turkish lira has been very stable since the release of the previous Financial Stability Report (Chart I.2.8). The fall in the cost of euro-denominated funding and the weak euro may influence the borrowing preferences of financial and corporate sectors. Therefore, likely changes in the funding source preferences of financial and corporate sectors should be monitored. Real effective exchange rates, which are affected mainly by nominal exchange rate movements, had been on a downtrend since April 2013 but assumed an uptrend in January 2014 and have been more stable since June 2014 (Chart I.2.9).

The fact that food prices in Turkey increased due to adverse weather conditions despite the decline in global energy and food prices as well as the fact that the Turkish lira depreciated have had a negative effect on inflation (Chart I.2.10). In addition to these factors, electricity and natural gas prices were raised by 9.3 percent and 7.93 percent, respectively, further pushing the year-end inflation forecast to 8.9 percent. Current and likely future measures are projected to help in achieving a gradual fall in inflation in 2015.

Public debt stock indicators remained positive in the first half of 2014 and there has been no significant change in the borrowing structure in spite of the fluctuations in financial markets. The downtrend in the ratios of total net public debt stock and the EU-defined nominal debt stock to GDP continues, the average maturity of domestic and external debt stocks keeps expanding and the composition of the debt stock remains basically the same (Chart I.2.11).

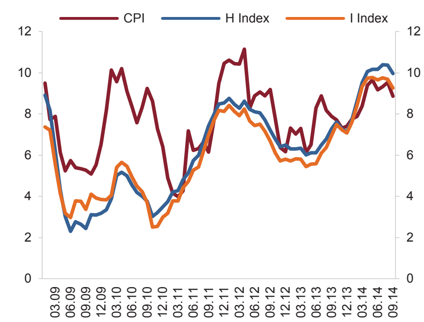
Maintaining its cautious monetary policy stance, the CBRT introduced measured policy rate cuts in the second and third quarters, following the easing of domestic and external uncertainties. Throughout this process, the Bank stuck to its tight monetary policy stance by keeping the yield curve almost flat. The CBRT quickly responded to the increased volatility in September and October by tightening its liquidity policy to the extent that the interest rate corridor allowed. It will continue to maintain the tight monetary policy stance in the upcoming period until there is a significant improvement in inflation (Chart I.2.12).

Chart I.2.9
Real Effective Exchange Rate
(CPI-based, 2003=100)



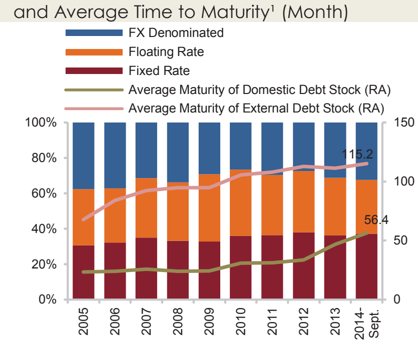
Source: CBRT

Chart I.2.10
Price Indices
(Annual Percentage Change)



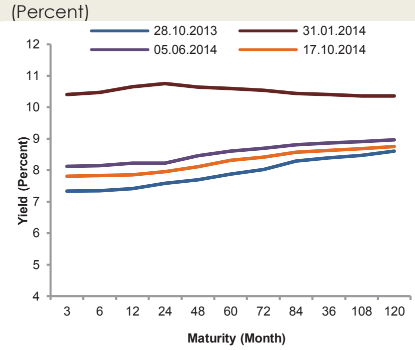
Source: TURKSTAT

Chart I.2.11
Composition of Central Government Debt Stock and Average Time to Maturity[1] (Month)



(1) Data of "Time to Maturity" pertains to October 2013.
Source: Undersecretariat of Treasury

Chart I.2.12
GDDS Yield Curve
(Percent)



Source: Bloomberg