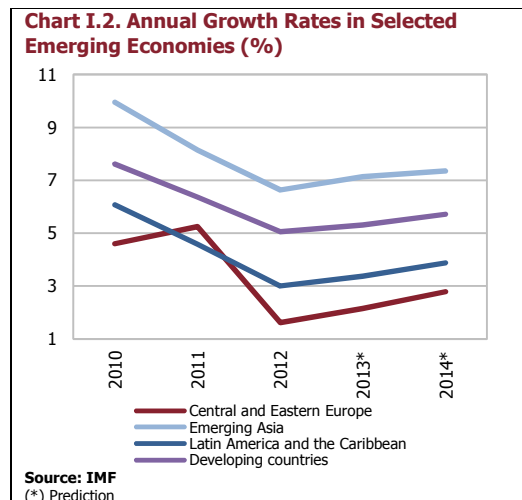
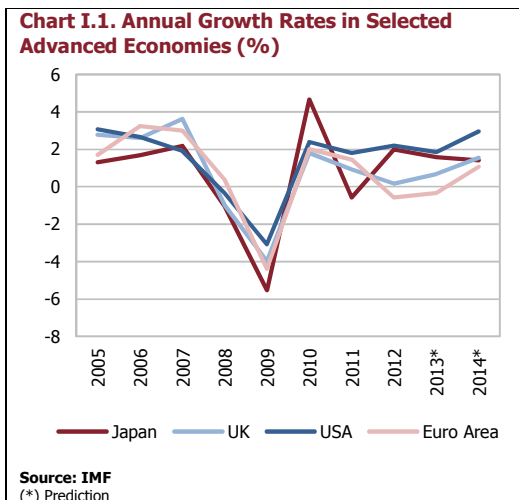


I. INTERNATIONAL DEVELOPMENTS

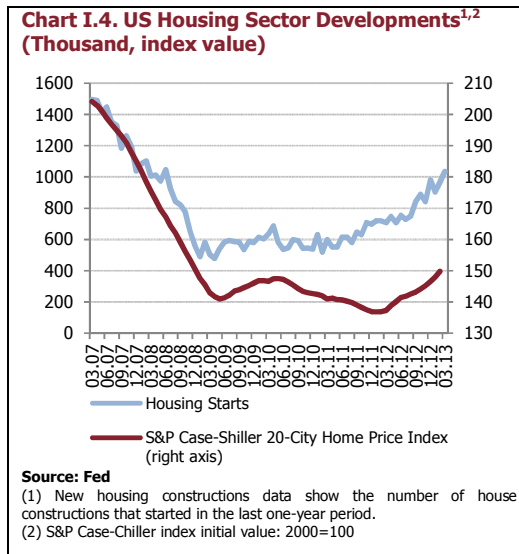
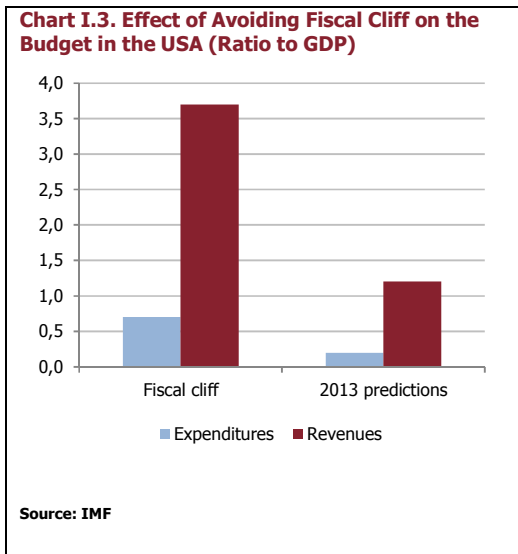
A limited recovery has been observed in global growth and advanced economies do not offer a homogenous picture in terms of growth performance. In fact, the USA and Japan have a more favorable economic outlook compared to the Eurozone. Despite the monetary policy measures taken by the European Central Bank and the structural reform decisions taken by policy-makers, the fragmented financial structure remains the same in the Eurozone. Expansionary monetary policy measures adopted by advanced economies have considerably boosted capital inflows to emerging economies via encouraging the search for yield. To establish and maintain global financial stability, it is critical to closely monitor capital flows and exchange rate volatility as well as the level of indebtedness of households and firms. Likewise, it is important for emerging economies to take necessary policy measures against systemic risk factors from domestic and foreign origins.

Although some important short-term risks to the global economic outlook seem to be controlled, the weak growth performance observed in advanced economies continues particularly due to Eurozone-related problems. Global financial markets have been relatively relieved by the steps taken by the authorities in advanced economies in the second half of 2012 and onwards. However, efforts to reduce the public debt burden, weaknesses in balance sheets of firms and households, problems in the credit mechanism and the failure to establish an environment of confidence in a real sense stand as factors hampering a strong and sustainable growth. Under the assumption that there will be no new financial or political risks in the upcoming period and that the authorities will continue to implement growth-boosting policies, the growth performance in advanced economies is expected to improve only in a gradual manner (Chart I.1).

Growth performance of emerging economies that displayed a marked slowdown in 2012 due to weak external demand conditions and prudent policies against global risks is expected to register a recovery in the forthcoming period. This recovery is expected to come mainly from low public debt and strong domestic demand of countries (Chart I.2). In the current conjuncture where global liquidity is abundant and interest rates are low, sudden changes in risk appetite that may occur due to new problems in advanced economies may be dangerous for growth dynamics of emerging economies that are sensitive to capital flows.

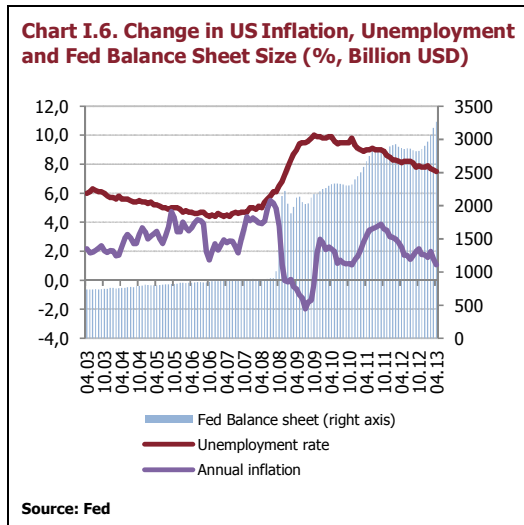
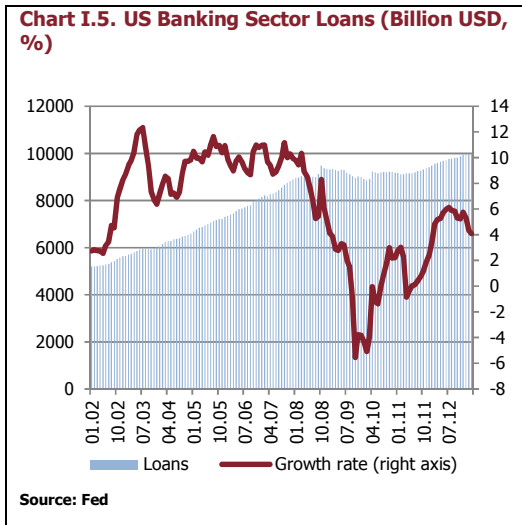


Automatic spending cuts and tax hikes that were put in place in the USA in the first quarter of 2013 stand as significant factors impeding growth. Although a great portion of temporary tax cuts was left intact in the US Congress and thus “fiscal cliff” concerns were dispelled, spending cuts are expected to draw the growth for 2013 down by approximately 0.6 points according to Congressional Budget Office estimates¹. Other factors negatively affecting growth are the uncertainties caused by the problems in the Eurozone, weak external demand conditions, political controversy over the raising of the public debt ceiling and concerns arising from the failure to introduce a medium-term fiscal plan. Nevertheless, the recovery in the housing sector, increased access to loans and the strong course of private consumption due to the recent optimistic atmosphere in financial markets stand as factors supporting growth despite the fiscal tightening in the USA (Chart I.3, Chart I.4, Chart I.5).

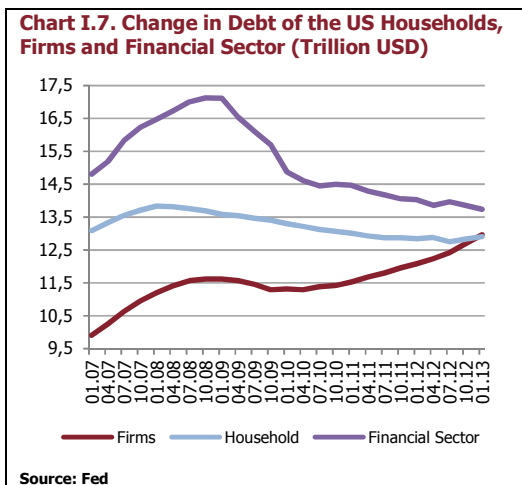


As unemployment rates are still high and the inflation threat is weak, the Fed continues its accommodative monetary policy backed by quantitative easing. The Fed, which set the third round of quantitative easing in motion in September 2012 and announced that it would continue the low interest rate policy at least until mid-2015, expressed its commitment in December to stick to the current interest rate policy unless unemployment rates fall below 6.5 percent and medium-term inflation expectations rise above 2.5 percent (Chart I.6). The Fed also gives signals that it may slow the quantitative easing until the end of this year depending on the recovery in economic activity. However, the monetary policy is believed to have only a limited amount of contribution to sustainable growth in the long run if it is not supported with a well-designed and efficient fiscal policy.

¹ <http://www.cbo.gov/publication/43961>

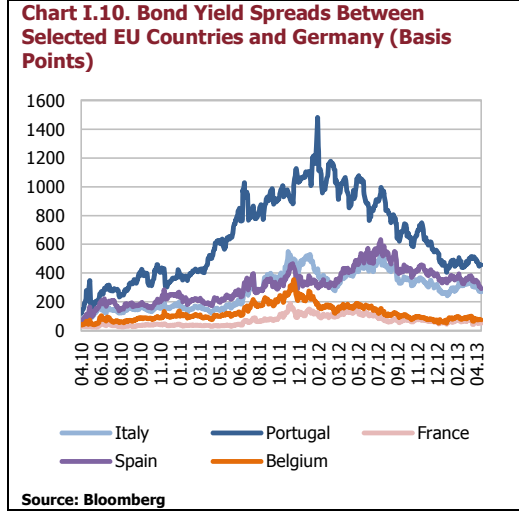
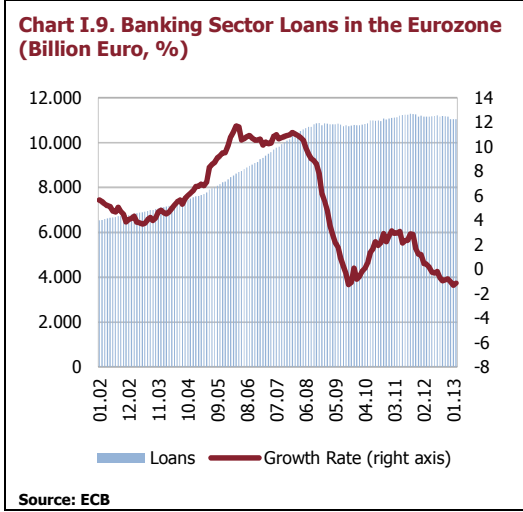


Abundant and cheap liquidity that emerged due to unconventional monetary policies in the USA encourages firms to increase their indebtedness via bond issues and also boosts investors' demand for risky assets. This situation, which may cause credit risk to shift from the banking system to other sectors and be inaccurately priced in an environment where banks under a more strict supervision after the crisis try to reduce their balance sheets and improve their asset quality, is seen as a threat to financial stability when combined with the market risk created by the probability of a sudden rise in long-term interest rates that are presently kept under pressure (Chart I.7, Chart I.8).



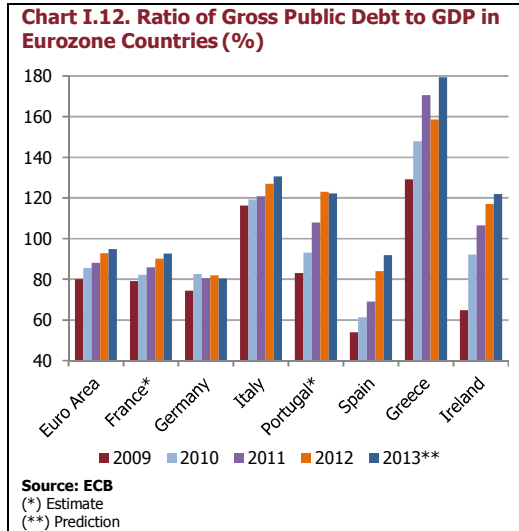
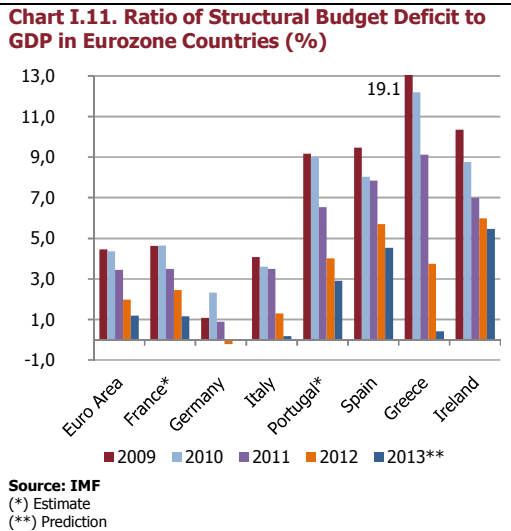
In the Eurozone where banking and public debt crises have led to deterioration in the credit mechanism and have urged a strong fiscal consolidation to be implemented, the contraction trend in economic activity has decelerated as a consequence of policy decisions taken in the second half of 2012. Yet, weak demand conditions in periphery countries especially like Spain and Italy, the ongoing fiscal tightening and limited access to credit are the most significant factors that hamper economic growth in the Eurozone (Chart I.9). Concerns over the collapse of the monetary union, which is a serious risk for the regional and global economy, eased after the conditional outright bond-buying program announced by the ECB in August 2012 and the public borrowing costs of especially periphery countries started to decline (Chart I.10). However, still

high levels of firm and household indebtedness in these countries, ongoing operations of the banking system to reduce balance sheets and the financial disintegration between core and periphery countries prevent loan growth and thus the financing of investment and consumption expenditures. For all these reasons, it seems difficult for periphery countries to free themselves from the loop of low growth, high interest rates and high budget deficit in the near future.

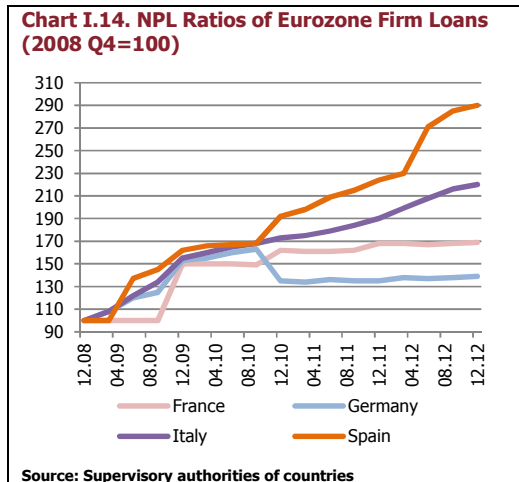
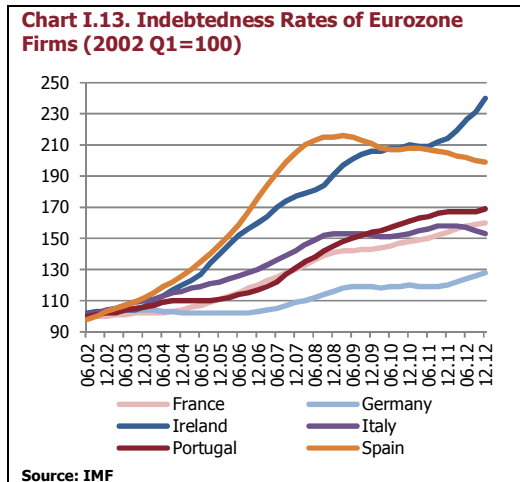


Although the ongoing fiscal tightening in Eurozone countries has helped reduce budget deficits recently, the ratio of public debt to GDP continues to rise in many countries (Chart I.11, Chart I.12). The increase in indebtedness rates is more apparent particularly in periphery countries which experience a contraction in economic activity and are obliged to pay high interests at the same time. Nevertheless, the bond-buying program announced by the ECB has dispelled concerns over the sustainability of public debt for now. Meanwhile, the Fiscal Compact introduced by the European Commission to avoid a repeated experience of the same problems originating from public indebtedness in the future and signed by 25 of 27 EU countries² was put into effect at the start of 2013. This treaty sets an upper limit for budget deficits of member countries and calls for automatic adjustment mechanisms and fiscal sanctions in case of breach of this limit. Enforcement of this treaty after the necessary changes are made in national legislations is important for building the fiscal unity among EU countries in the medium term.

² The United Kingdom and the Czech Republic did not sign the agreement.

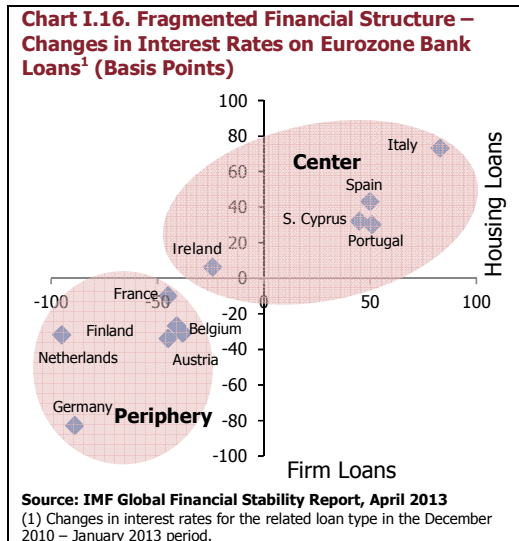
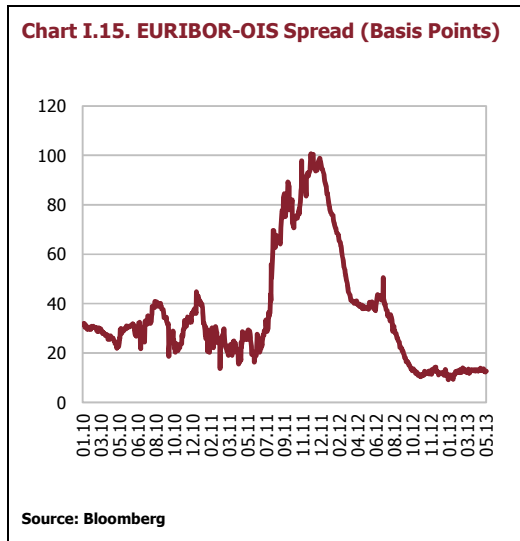


Firms in the periphery Eurozone countries that undertook a heavy debt burden in the favorable conditions of the pre-crisis period started to have problems about the sustainability of their debt in an environment of low growth and high interest rates in the aftermath of the crisis (Chart I.13). The fragmented financial structure has also played a role in this situation that comes in the form of rapid NPL increases in firm loans especially in Spain, Italy and Portugal, posing a threat to financial stability (Chart I.14). International institutions frequently emphasize the importance of making firms in bad condition sound and reducing the debt of firms in good condition in a controlled manner by enhancing their access to credit in order to avoid firms' insolvency in the upcoming period.



The ECB continues to ease its monetary policy as inflationary risks are low, but the fragmented financial structure in the Eurozone reduces the effectiveness of the monetary transmission mechanism. Actually, the difference between the loan rates of core and periphery countries increased in the last two-year period (Chart I.16). Measures taken by the ECB have reduced the risk perception in the financial system. Yet, the impact of these measures on the real economy may remain limited if not backed by structural reforms, due to the problems in the transmission mechanism (Chart I.15). To solve this problem, some reformist decisions were made in 2012 for the establishment of a bank association so as to strengthen the monetary union. Among these decisions

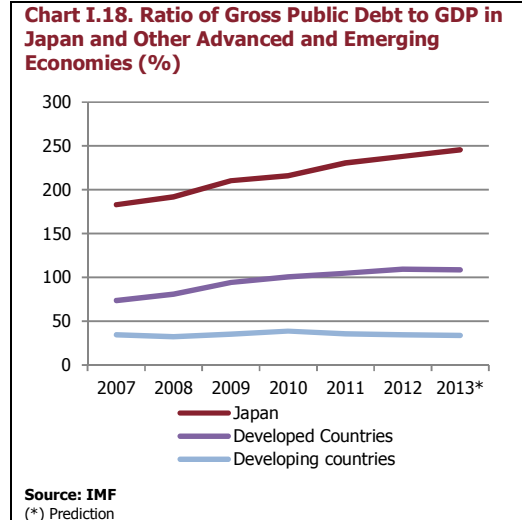
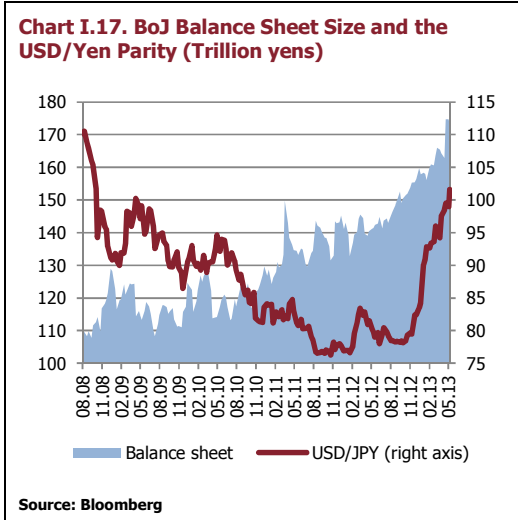
are gathering the surveillance and supervision activities of banks in the Eurozone under one roof within the ECB, developing a common deposit insurance system and establishing a bank resolution framework that will enable direct capital injection to banks from European Stability Mechanism resources. Once these reforms are implemented, the risk perception in financial markets is expected to fall, banks are expected to reduce their dependence on total funding and strengthen their capital structures by improving both their asset quality and profitability over time. These reforms have been on the agenda for a long time but they have not been put into practice yet and this has made it difficult to achieve financial stability in the Eurozone. The banking crisis experienced in South Cyprus in March 2013 and its repercussions can be viewed as an example in this sense.



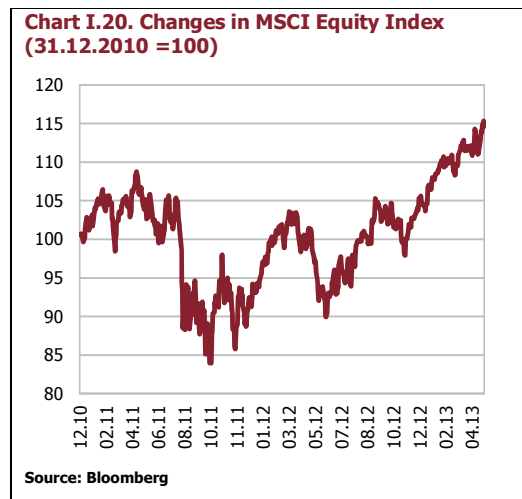
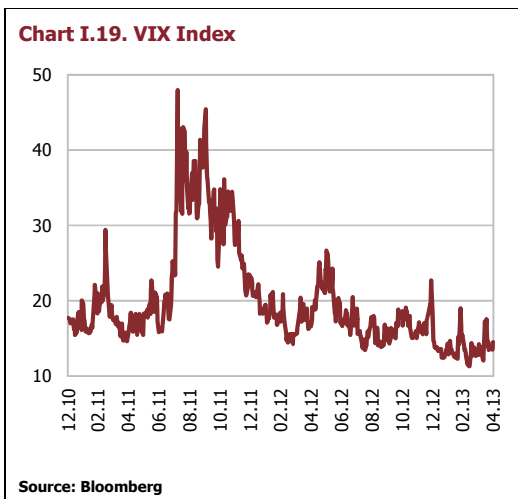
Another issue on the agenda of the Eurozone is the structural reform of the banking sector. The European Commission issued the Liikanen Report on the reform of the EU banking system in October 2012. The Report, which introduces various policy suggestions to avoid similar banking crises in the EU in the future, principally offers the categorization of risk-bearing treasury transactions that banks conduct on their own behalves and accounts under a distinct legal entity and separation of these transactions from deposit banking activities. In this way, the “universal banking” model that gathers the prevailing investment and deposit banking activities in Europe under one and the same legal entity will have been abandoned (See Special Topic V.3). The Report, which includes suggestions similar to the Volcker Rule put into legislation with the Dodd-Frank Act in the USA and the Vickers Commission Report that forms the basis for the banking reform law waiting for enactment in the UK, has received immense reactions from the sector. Taking into view the criticisms to the Report, the EU Commission is expected to announce its plan on this issue in the upcoming period.

The new government in Japan, where has been a struggle with disinflation and stagnation for many years, has made radical changes in its monetary and fiscal policies to achieve sustainable growth. In addition to various structural reforms, the new policy set that stipulates an inflation target of 2 percent, a strong quantitative easing and significant increases in public expenditures is expected to revive the country’s economy especially by boosting domestic and external demand in the short run. Yet, it is believed that this financial revival package introduced without a medium-term budget plan in the country where the public debt burden is already very high

may increase the borrowing costs of the country and thus lead to concerns over debt sustainability (Chart I.18). This situation poses a significant risk to Japanese banks that have a considerably higher sovereign bond position compared to banks in all other advanced countries. Another risk factor in question is the potential of the depreciation of the Japanese yen due to the full-scale quantitative easing in place to cause global competitive devaluations (Chart I.17).

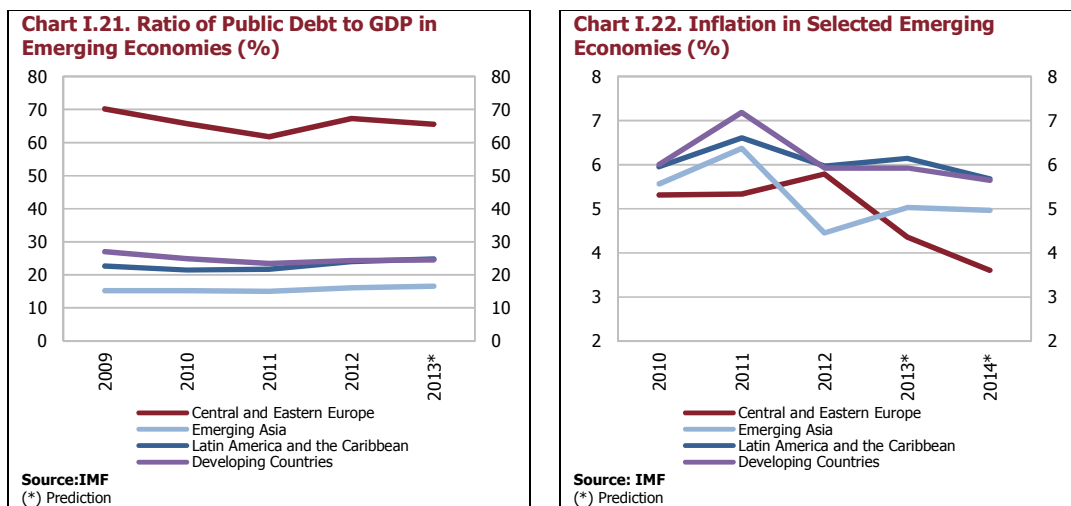


Growth performances of emerging economies have improved compared to 2012 due to domestic demand that has strengthened parallel to weakened global risk perception, favorable financing conditions and the recovery in external demand (Chart I.19). In fact, asset prices have started to climb in most of the emerging economies due to the improvement in global conditions (Chart I.20). "Hard landing" concerns referring to sudden and great falls in growth performance of some emerging economies like China, India and Brazil have also eased considerably. However, the lower-than-expected growth performance of these economies is likely to be related to declines in potential growth rates rather than provisional factors and this likelihood stands as an important risk factor in terms of global economic activity in the medium and long run.

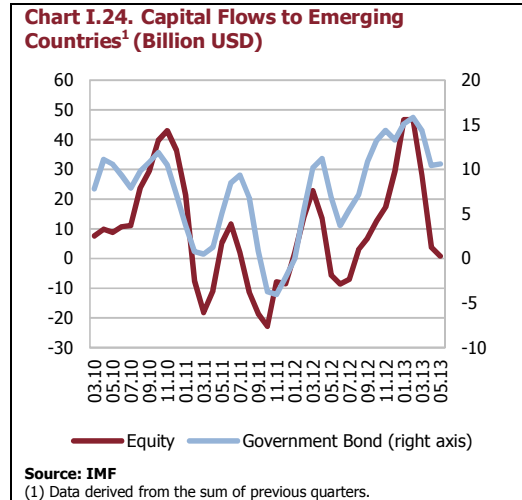
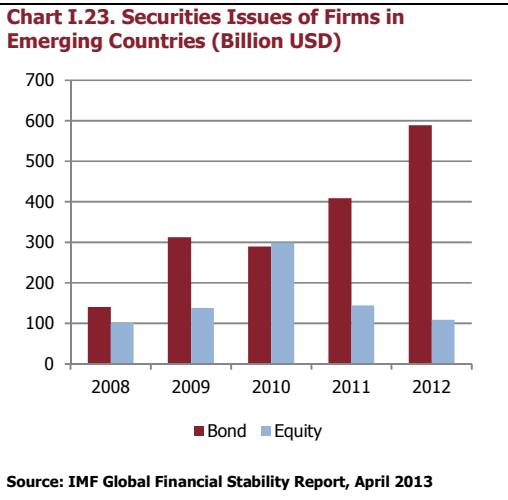


Despite a slight deterioration in the budget performance of emerging economies in 2012 due to the slowdown in economic activity, the downtrend in public indebtedness continues in general (Chart I.21). This downtrend provides emerging economies with more room to maneuver in fiscal policy compared to advanced economies. Yet, the cautious stance in fiscal policy remains critical as, depending on changes in the global conjuncture, a slowdown in growth in the medium term and a rise in borrowing costs may reverse the course and rapidly increase indebtedness rates.

The recent favorable trend of energy and food prices supports price stability in emerging economies (Chart I.22). However, inflationary pressures may increase in the forthcoming period due to the revival in external demand observed as a result of strong domestic demand and the recovery in advanced economies. Exchange rate volatilities caused by capital inflows to emerging economies stand as another factor making it difficult to control inflation.



Real policy rates in emerging economies still remain well below the pre-crisis levels but the improvement in global financial conditions from the second half of 2012 onwards has stimulated an uptrend in capital inflows to these countries again (Chart I.24). Macprudential policies mostly successfully implemented by authorities in recent years have controlled credit expansion in most of the emerging economies and thus helped reduce risks such as deterioration in the current account balance, excessive increases in asset prices and overheating of the economy. However, intensified capital flows and low borrowing costs boost indebtedness rates and foreign currency positions in emerging economies (Chart I.23). This situation, which increases sensitivity to likely sudden movements in interest rates and exchange rates, stands out as a risk to financial stability in emerging countries and enhances the need for macroprudential measures.



Flexible monetary policies implemented by central banks in advanced economies lead to a rise in the risk appetite of investors and a global search for yield even though the global economic activity has not yet recovered fully. The search for yield creates concerns that the risks are not priced accurately in an environment where asset purchase programs of central banks exert pressure on rates of return and reduce the amount of quality assets on the market. A consistent rise in issues of high-yield bonds and the uptrend in the share of issues with low credit rates in total issues in advanced economies show that these concerns are not in fact irrelevant.

The distorting effect of the search for yield on risk pricing is also true for emerging economies. Recently, the weight of portfolio investments in capital inflows to emerging economies and the weight of bond purchases in portfolio investments have increased. Accordingly, bond issues, predominantly issues of foreign currency bonds, have increased rapidly. Declines in bond prices to be observed in the medium term as a result of back-to-normal monetary policies in advanced economies and the uptrend in interest rates are likely to have a distorting effect on debt sustainability of firms both in advanced and emerging economies.

To conclude, though expansionary monetary policies in advanced economies have contained the deterioration in the economic outlook of these countries due to structural problems like flaws in money and credit channels, they fell short of bringing about the desired level of improvement in economic activity. These policies have led international investors to search for yield, accelerating capital inflows to emerging economies whereas returns on risk-bearing assets in advanced economies have fallen to levels before the global crisis for the first time. Moreover, in this period, external borrowings of firms have displayed a rapid rise on a global scale. Increased indebtedness levels and volatile capital movements have strengthened the need for measures to safeguard financial stability in emerging economies. In this context, countries should closely monitor firm and household indebtedness by taking into account systemic risk factors from domestic and external origins, banks should act with due diligence to maintain their strong financial structures, particularly their capital adequacies and liquidity positions, and back these measures with mechanisms to increase the resistance of the economy against likely shocks.