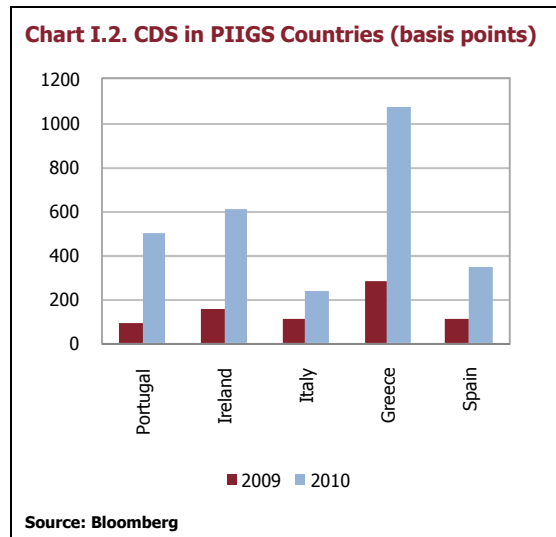
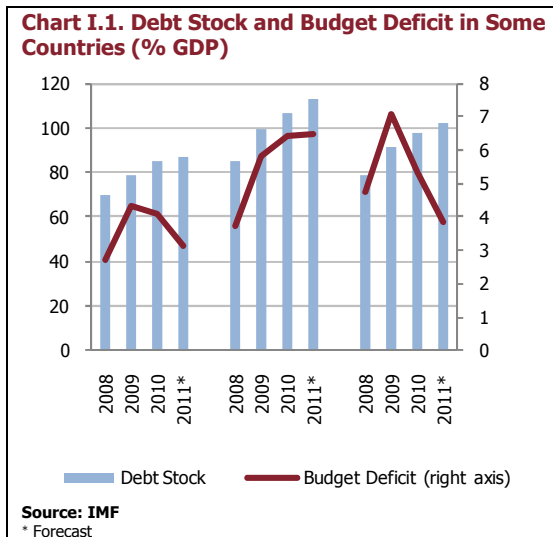


I. INTERNATIONAL DEVELOPMENTS

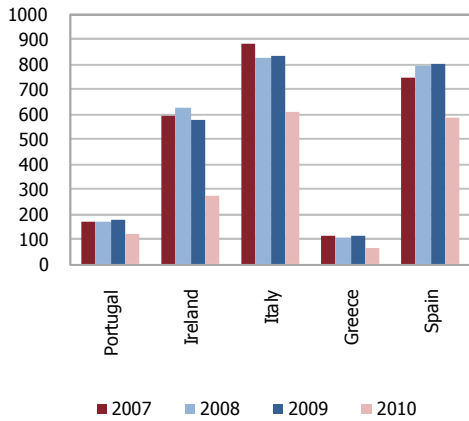
The general conviction at international level is that global growth performance has improved and that the markets are not likely to see a second dip on the back of expansionary monetary and fiscal policies. Despite this positive outlook for the overall global economy, the apparent divergence between the growth performance of advanced and emerging markets brings about distinctive economic policies as well. Within this scope, emerging economies opt to contain the macro-financial risks driven by accelerated capital flows using unconventional policy mixes. Meanwhile, advanced economies tighten their fiscal policies in order to restore the deteriorated public finances due to the measures taken in the aftermath of the crisis. The global macro-economic implications of political unrest in the Middle East and the North Africa In the first quarter of 2011, and the natural disaster in Japan are expected to remain subdued.

The high level of budget deficits and public debt in advanced economies increase fragility by raising a need for funding in large amounts. Widening budget deficits in many advanced economies, primarily in Euro area (EA) states have increased the public borrowing need and hence the debt stock reached record highs (Chart I.1 and I.2).



Concerns regarding debt sustainability in Portugal, Ireland, Italy, Greece and Spain (PIIGS) have increased borrowing costs particularly in the EA. While the debt stock in peripheral EA countries became unsustainable, concerns over capital and liquidity adequacy ratios of banking sectors of core EA countries, with PIIGS debt securities on their balance sheets, remain (Chart I.3). While the credit ratings for EA countries excluding Italy were lowered, the CDS's were increased and these countries faced troubles with external borrowing. Against this background, Greece, Ireland and Portugal received fiscal stimulus from the EU and the IMF (Table I.1). The high level of interest expenses and the high burden imposed by nationalized banks exacerbate concerns about a potential restructuring of debts by these countries.

Chart I.3. Net Receivables of International Banks from Certain Countries (Billion USD)^{1,2}



Source: BIS

(1) Data for 2010 are provisional.

(2) Net receivables are calculated by subtracting all the receivables (credits, securities, etc.) from PIIGS countries on balance sheets of banks subjected to BIS reporting, from all liabilities (deposits, etc.) to these countries.

Table I.1. PIIGS Countries Receiving Fiscal Stimulus (Billion Euro)

	EFSF	IMF	Treasury	Program
	-EFSM*		Contribution	Duration
Greece	80	30	-	3 years
Ireland	45	22.5	17.5	3 years
Portugal	52	26	-	3 years

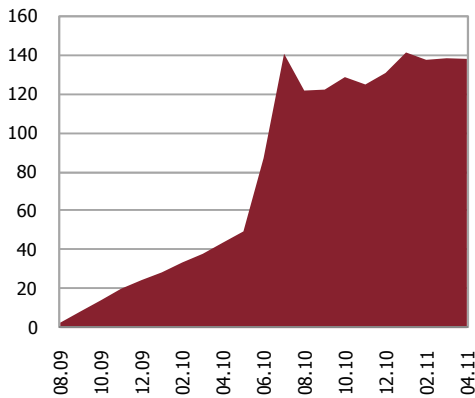
	Ratings (S&P)		
	2009	2010	2011
Greece	BBB+	BB+	B
Ireland	AA	A	BBB+
Portugal	A+	A-	BBB-

Source: European Union Commission

(*) European Financial Stability Fund and European Financial Stability Mechanism

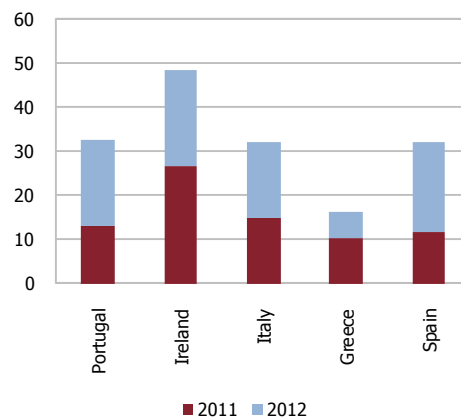
The increased funding cost due to difficulties in accessing non-depository funds in addition to risks stemming from PIIGS bonds in the European banking sector increases the dependency of banks on central bank resources. Banks, whose funding costs have increased in line with higher sovereign risk on the back of problems in public finance, are oriented towards central bank resources to meet their funding needs (Chart I.4). Furthermore, contracting interest margins and declining profitability performance affect the financial structures of banks with unqualified and inadequate capital. Given the elevated level of debt that must be financed by banks in the short-run, vulnerabilities of advanced financial markets still remain (Chart I.5).

Chart I.4. Liquidity Provided by the ECB to Banks (Billion Euro)



Source: ECB

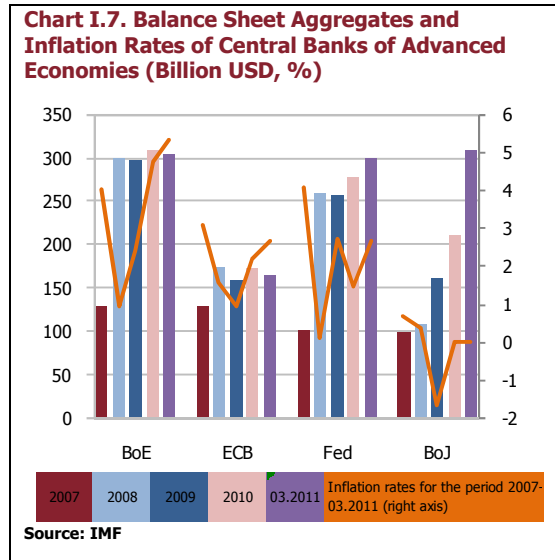
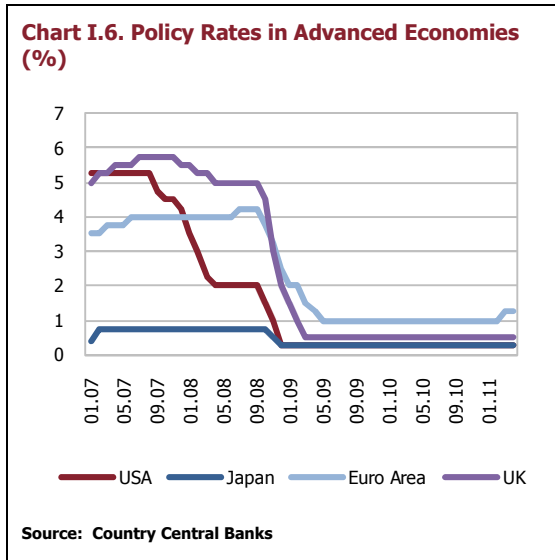
Chart I.5. Debts of PIIGS Banks Maturing in 2011-12 (% Total Debt)



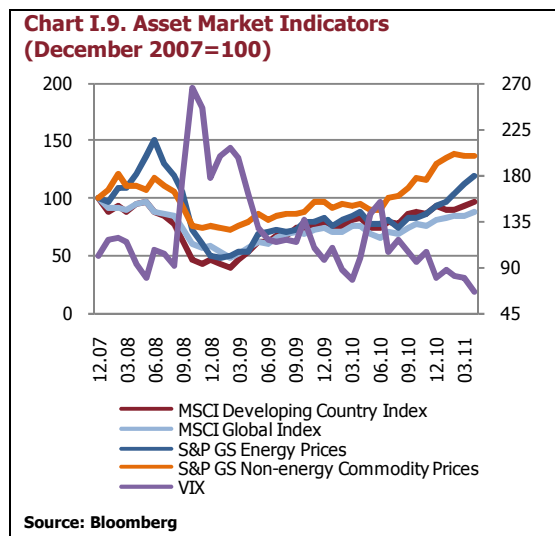
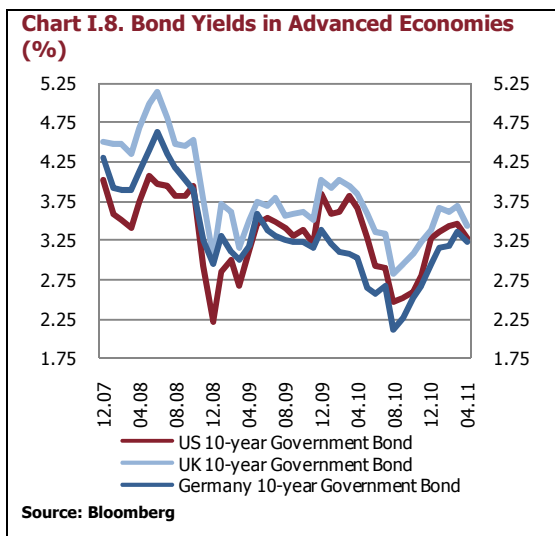
Source: IMF

Within this scope, while the ECB maintained quantitative easing, it tightened its monetary policy stance through the interest rates. The ECB enlarged its balance sheet by purchasing the securities of distressed EA countries and increased the policy rate by 25 basis points for the first time in a long time in response to inflationary concerns in April 2011. On the other hand, the fact that the interest gap between the Fed and the ECB widened in favor of the euro leads to appreciation of the euro and therefore constitutes a risk on growth rates of EA countries. This situation hampers further increase in the ECB's policy rate and implementation of its exit strategy.

Despite the policies of the ECB; the Bank of England, the Fed and the Bank of Japan continue to stick to the expansionary monetary policies. While these three central banks continue to keep policy rates at record lows, they do not opt for a new quantitative easing. However, these central banks are not expected to launch their exit strategies in the near future (Chart I.6 and I.7).

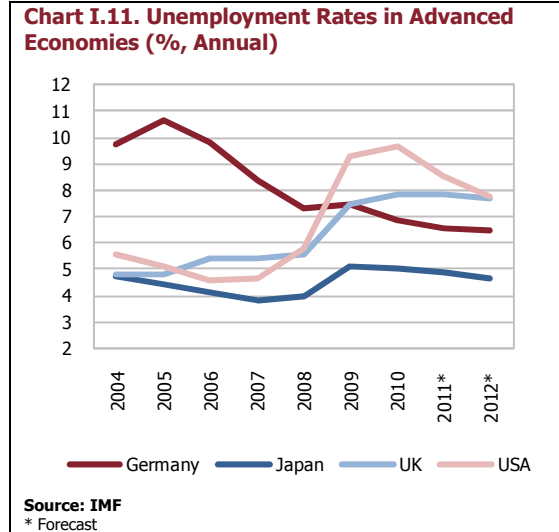
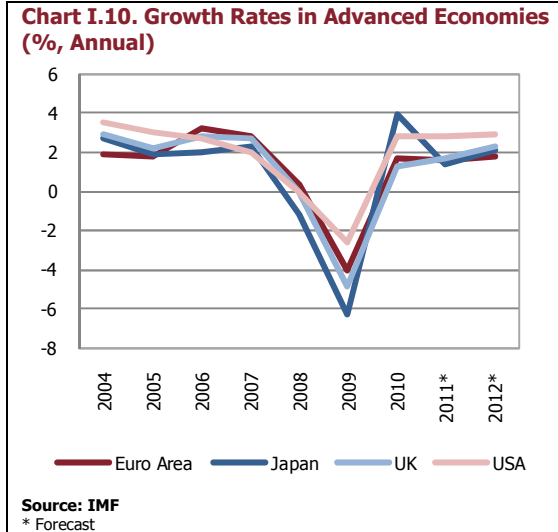


Asset prices increased, market interest rates decreased and volatility in the markets attenuated due to ample global liquidity driven by expansionary monetary policies of advanced economies. The low yields from debt securities increased the demand for financial products and resulted in further use of commodities as an investment instrument (Chart I.8). Stock markets regained their pre-crisis highs owing to the increased risk appetite, whereas asset prices rose significantly. Prevailing concerns about the financial sector in the EA, along with those related to the earthquake and exports in Japan, led stock markets to underperform compared to US markets. While metal and gold prices increased to historically high levels, oil prices exhibited a rapid increase as well (Chart I.9).

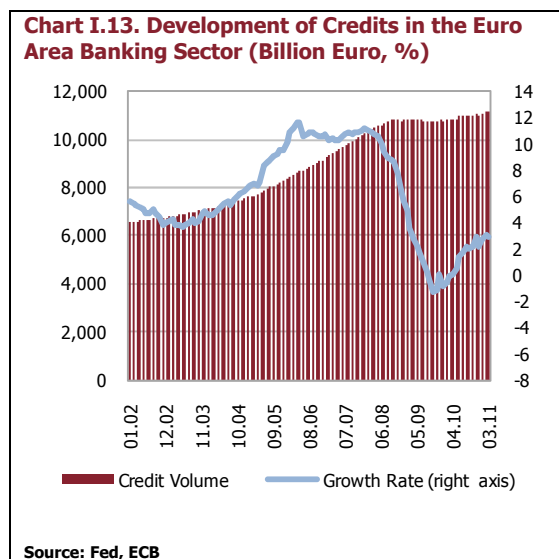
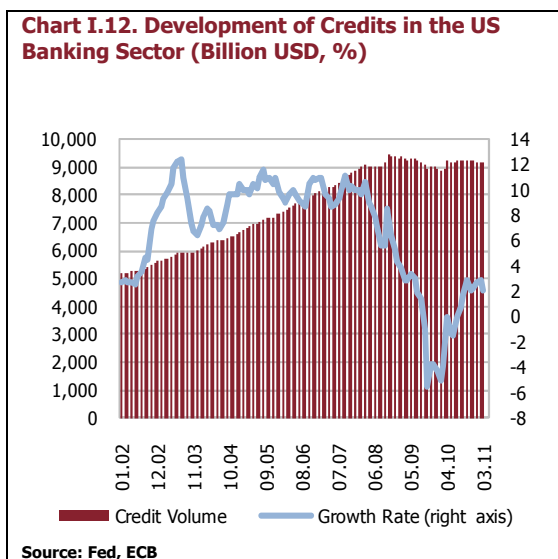


The gradual recovery of demand, recently observed in advanced economies, is considered to be mainly due to the income and wealth effect rather than the credit

channel. No significant recovery was observed in employment and household incomes in advanced economies, primarily in the USA, largely led by the increase in asset prices and tax rebates; however, these economies enjoyed an improvement and gradual growth in terms of domestic demand (Chart I.10 and I.11).

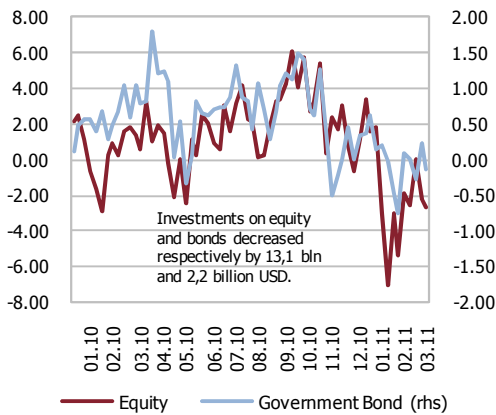


It is therefore considered essential that credit markets regain their pre-crisis effectiveness so as to ensure sustainable development in advanced economies. Nevertheless, vulnerabilities regarding credit supply prevail in advanced economies and the demand for credit has not reached the pre-crisis levels yet (Chart I.12 and I.13). Due to low funding costs, some banks in Europe and the USA continue to bear low-qualified assets on their balance sheets, expecting that the quality of these assets will improve in the future. Concerns about banks' capital adequacy and sovereign risks increase funding costs, which, in turn, slow down the restoration of credit supply conditions to their pre-crisis levels in Europe. Whereas the improvement in credit supply conditions is gradual and limited in the USA as well, the low demand puts downward pressure on credit growth.



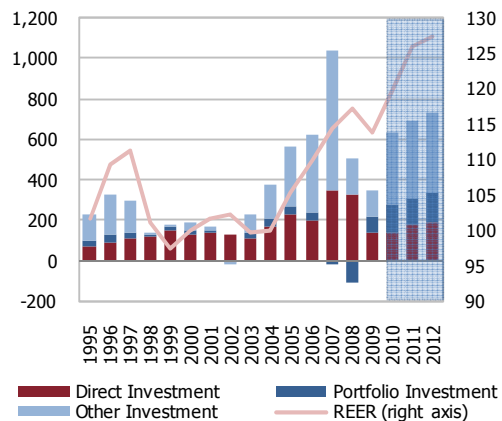
Another outcome of ample liquidity driven by expansionary monetary policies of advanced economies is the acceleration of capital flows towards emerging economies due to search for high yields. The slow recovery and low yields in advanced economies led to an increase in capital flows to emerging economies with a relatively stronger economic and financial structure. However, capital inflows slowed down in early 2011 on the back of increased geopolitical risks and macroprudential monetary policy measures (Chart I.14). In the meantime, capital flows are expected to continue for an extended period mainly because of, predictions that emerging economies will maintain their rapid growth performance, and the relatively low weight of developing country assets in the portfolios of institutional investors (Chart I.15).

Chart I.14. Flow of Funds Towards Emerging Economies (Billion USD)



Source: IMF

Chart I.15. Capital Flows Towards Emerging Economies by Type and REER (Billion USD, index 2000=100)¹

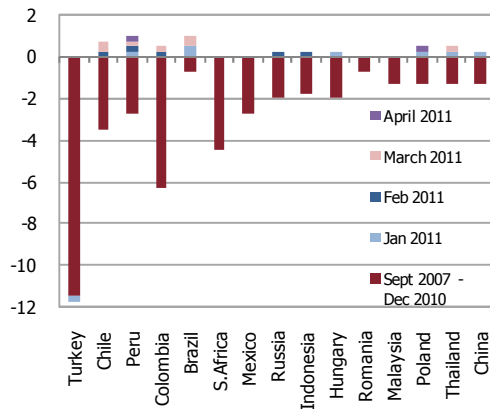


Source: IIF

(1) Forecast for 2010, Projections for 2011 and 2012
REER: Real effective exchange rate

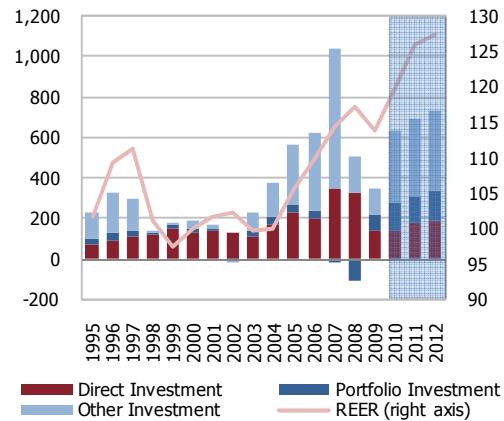
Acceleration of capital flows increases the risks of developing countries that are exposed to, and, in turn, these countries intensify macroprudential measures. Capital flows caused appreciation of local currency, swelling in asset prices, rapid credit growth, increase of leverage ratios and deterioration in the current account deficit. In line with the measures taken, many countries launched policy mixes including reserve accumulation (such as Indonesia, Peru), increase of reserve requirement ratios (such as Brazil, China, India, Turkey), change in policy rates and direct capital controls (such as Brazil, Peru). On the heels of the crisis, emerging economies generally opted for decreasing policy rates in order to underpin the economic recovery. With the economic recovery and revival of international capital flows to these countries, their policy stances diverged. Accordingly, while a number of emerging economies raised interest rates so as to prevent overheating of the economy, others kept interest rates at low levels considering the rapid capital inflows. Additionally, countries that underwent rapid credit expansion started to use required reserves as a more active policy tool (Chart I.16 and I.17).

Chart I.16. Change in Policy Rates in Emerging Economies (Basis Points)



Source: Country Central Banks

Chart I.17. Change in Reserve Requirement Ratios in Emerging Economies and Their Level (Points)¹

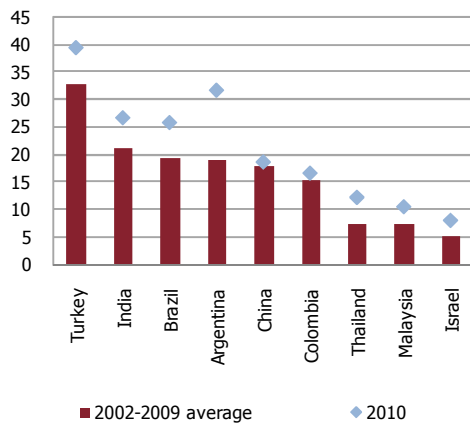


Source: Country Central Banks

(1) Each grade shows the change in ratio, values indicated above bars show the current level.

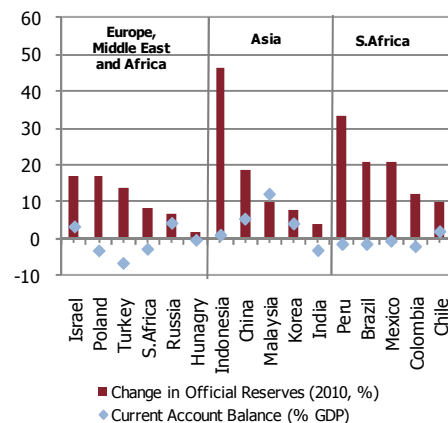
Ample global liquidity and high growth rates led to a rapid credit expansion in emerging economies. Rapid credit expansion increases vulnerabilities of the banking sector in these countries (Chart I.18). Banks resort to further wholesale funding in order to finance the credits increasing parallel to high growth and domestic demand. As a matter of fact, with increased external borrowing facilities, banks in developing countries issued dollar-indexed bonds at a record high of USD 110 billion in total throughout 2010¹. However, in the event of a massive capital outflow, banks in the said countries may face rollover risk. Meanwhile, some emerging economies started to accumulate reserves within the framework of macroprudential measures (Chart I.19).

Chart I.18. Credit Growth in Emerging Economies (%)



Source: IMF

Chart I.19. Current Account Balance and Official Reserve Changes in Emerging Economies (%)¹



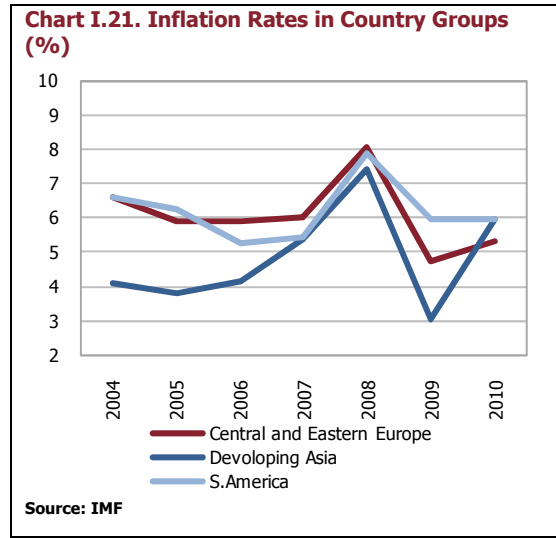
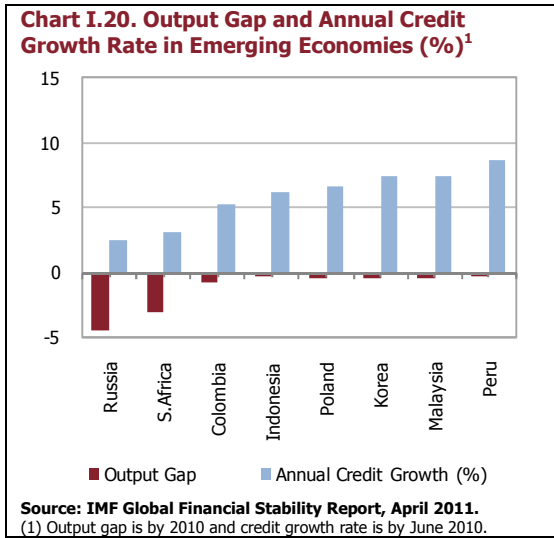
Source: IMF

(1) Annual change in gross international reserves excluding gold. Current account balance data are 2009 data for some countries and 2010 data for others.

Rapid credit expansion gave way to overheating signals in some economies. Certain countries faced the risk of overheating parallel to narrowing the output gap due to the improvement in economic activity and employment in emerging economies (Chart I.20). In countries, which were exposed to accelerated capital flows, the inflation trend started to rise on the back of increased domestic consumption against weak external demand (Chart I.21). Given the contribution of energy

¹ IMF Global Financial Stability Report, April 2011.

cost to external deficit, the increase in global commodity prices adds to inflationary pressures. Increased oil and energy prices driven by the political unrest in the Middle East and North Africa, blurs the outlook for growth and inflation in these countries.



In a general sense, although global economic conditions still remain weak, they are on a positive path owing to the measures taken to improve economic activity in advanced economies. However, the policy measures taken in the face of the crisis caused a significant deterioration in public finances; as a result, advanced economies resorted to fiscal discipline. Narrowing fiscal room for manoeuvre and the low rate of increase in credits restrain growth performance in advanced economies. According to international authorities, global growth, which regained its pre-crisis levels thanks to emerging economies, is not likely to see a second dip. Meanwhile, capital flows that have accelerated recently on the back of the decoupling among countries in terms of interest rates and long-term growth potential feed the risk of overheating in emerging economies. Considering potential setbacks in case of a sudden stop of capital inflows, policy makers continued to implement macroprudential policy mixes to cool down the economy. In addition to operational measures taken in the aftermath of the crisis, both advanced and emerging economies embarked on some changes in their institutional framework².

Advanced economies are expected to implement their exit strategies gradually in the medium and long run, based on their growth and inflation indicators. This situation is expected to have a limited impact on global growth rates; however, it might affect international capital movements to the extent of uncertainty it would create in terms of investment decisions. Furthermore, the increased default risk in PIIGS countries increases the risk of contagion especially to those countries having PIIGS debt securities on their portfolio. Meanwhile, the impacts of the developments in the Middle East and the North Africa countries on the global economy through the channel of energy prices should be monitored carefully.

² Please refer to: Special Topic V.8. Institutional Framework Regarding Macroprudential Policies.