II. Macroeconomic Outlook

Global economic policy uncertainties displayed a fluctuating outlook driven particularly by global growth concerns. Global financial conditions eased in the final quarter of 2018 due to the stronger-than-expected expansionary monetary policies of advanced economy central banks, the Fed in particular, and also due to positive expectations for the settlement of trade disputes. Consequently, the risk appetite for EMEs increased while stock and bond markets registered net portfolio inflows. Additionally, stock exchanges of advanced economies and EMEs showed a positive performance compared to the previous Report period. However, as of May, the tension arising from increased tariffs imposed by the US on imported goods from China caused a deceleration in portfolio flows to EMEs and exerted a downward pressure on stock indices. Despite the easing of global liquidity conditions, there are significant conjunctural risk factors for global financial stability such as country-specific macroeconomic conditions, geopolitical developments, slowing global economic activity, high levels of indebtedness, likely adverse impacts of protectionist trade tendencies, and the possibility of a no-deal Brexit.

In the last quarter of 2018, the rebalancing process in domestic economic activity became more pronounced, and while domestic demand contracted, the strong increase in net exports partially offset the slowdown in the economy. Recently released data reveal that the economic rebalancing has continued through the first quarter of 2019 and the downtrend in economic activity has lost pace. Firms' orientation towards external markets due to the real exchange rate level and the narrowing domestic demand, and their flexibility in diversifying export markets boost the exports of goods; the weakening economic activity and the relative price effect limit the demand for imports; and with the contribution of net travel revenues, the current account balance continues to improve. Despite the deceleration trend in global growth – particularly in EU countries, external demand remains relatively strong. In the period between November 2018 and April 2019, there has been some improvement in inflation indicators driven by the contraction in domestic demand, decline in lagged effects of exchange rates, and the fall in imported input costs. However, deposit dollarization has increased in this period due to interest rate developments, the impact of the uncertainty channel, and the inflation-hedging motive. Additionally, uncertainties and geopolitical developments have caused Turkey's risk premium to diverge slightly upwards from those of other EMEs since March 2019.

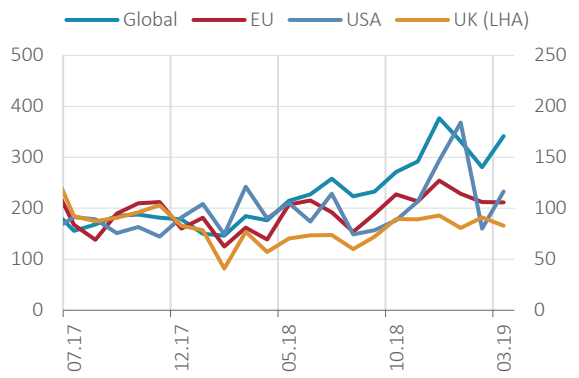
II.1 International Developments

Global economic policy uncertainties that intensified in 2018 waned in the first two months of 2019 but increased again in March as the global growth concerns became more evident (Chart II.1.1). The pause in the Fed's monetary policy normalization process and developments regarding the trade talks between the US and China continue to affect the predictability of US economic policies. On the other hand, the downtrend in uncertainties concerning the EU's economic policy has continued since the previous Report period due to the fact that the European Central Bank (ECB) has adhered to the monetary policy schedule it previously announced and the Brexit talks have been re-scheduled notwithstanding potential risks.

The Fed statement in early 2019 declared that it would adopt a more flexible and patient monetary policy stance. This change of policy is attributed to global economic and financial developments, despite the positive outlook in the labor market and the inflation hovering around the Fed's 2% target. Accordingly, there has been a downward revision in the Federal Open Market Committee (FOMC) members' median policy rate forecasts compared to the previous Report period while the markets expect rate cuts in 2019 and 2020 (Chart II.1.2).

The ECB ended its asset purchase program as of end-2018 and confirmed that it would not introduce a rate hike in 2019. Market expectations suggest that there will be no increase in the ECB's policy rate until the end of 2020. Such expectations are believed to be steered by global economic developments, the moderate course of EU exports, the growth outlook, possibility of a no-deal Brexit, and the concerns over the public debt stocks of some countries, Italy in particular. The Bank of Japan is expected to maintain its expansionary monetary policy stance on account of its moderate inflation and growth outlook. To mitigate the negative impact of tariffs and to ease the credit conditions in the face of shrinking market liquidity, the People's Bank of China maintains its expansionary monetary policy through macroprudential policy instruments including reserve requirement policies in particular.

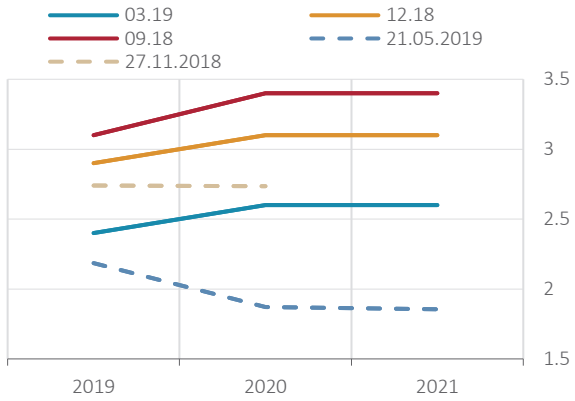
Chart II.1.1: Economic Policy Uncertainty Indices (Index, 2012=100)



Source: Bloomberg Latest Data: 03.19

Note: Indices are not comparable in terms of level.

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

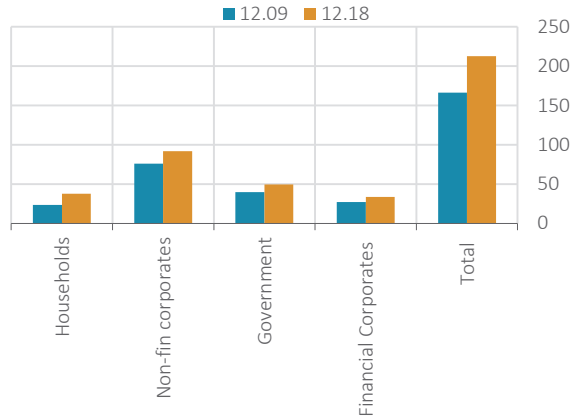


Source: Bloomberg Latest Data: 21.05.19

Note: Dashed lines indicate 30-day Fed fund futures implied rates.

Indebtedness in EMEs has significantly increased since the global financial crisis (Chart II.1.3). On the other hand, the share of FX debt in total debt has decreased (Chart II.1.4). This decrease is associated with the restrictions on households' FX borrowings in some EMEs and the public sector's preference for local currency borrowing. As for advanced economies, public and private sector indebtedness is monitored as a vulnerability factor.

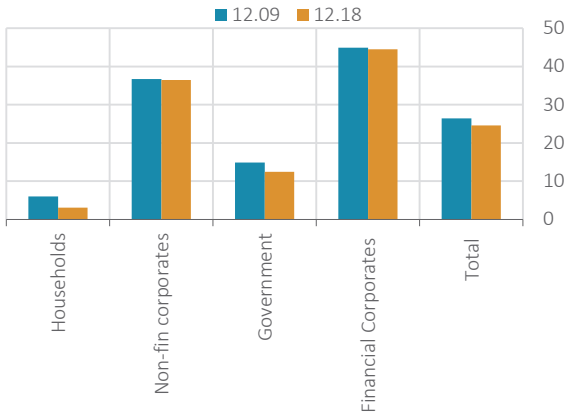
Chart II.1.3: Sector-Based Indebtedness in EMEs (% GDP)



Source: IIF Latest Data: 12.18

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

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

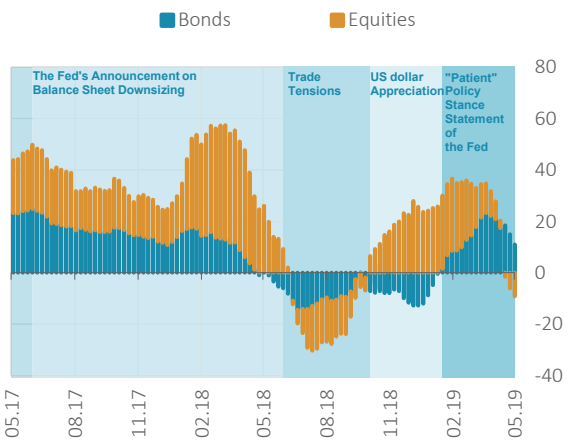


Source: IIF Latest Data: 12.18

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

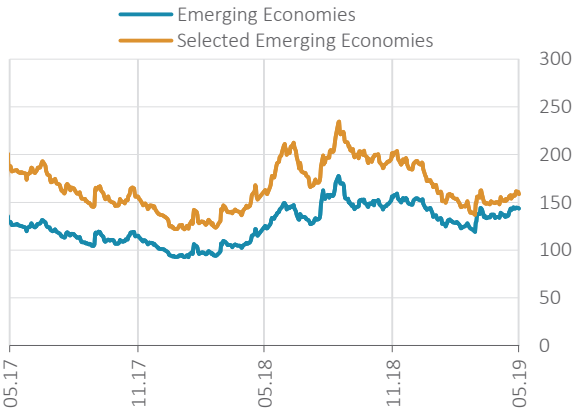
The Fed's statement that it would be patient in monetary policy normalization and positive expectations for the settlement of trade disputes between the US and China reversed the contraction in global financial conditions observed in the final quarter of 2018 while the risk appetite for EMEs increased and these countries witnessed net portfolio inflows (Chart II.1.5). Despite the favorable atmosphere in ongoing trade talks between the US and China, the tension arising from increased tariffs imposed by the US on imported goods from China as of May 2019 caused a deceleration in portfolio flows to EMEs. However, borrowing costs have declined and risk premiums have improved since early 2019 compared to the previous Report period (Chart II.1.6).

Chart II.1.5: Weekly Fund Flows to EMEs (13-Week Cumulative, USD Billion)



Source: EPFR Latest Data: 15.05.19

Chart II.1.6: CDS Premiums in EMEs (Basis Points)

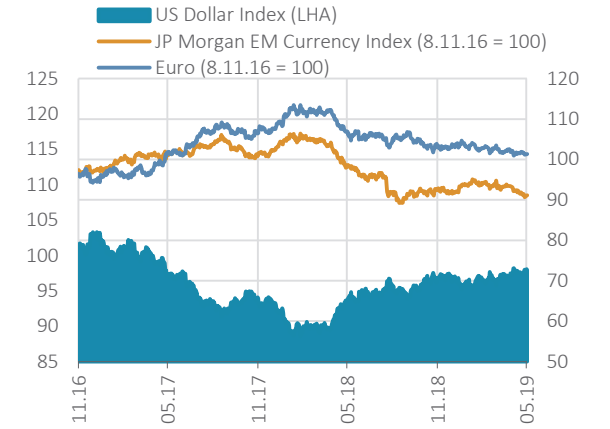


Source: Bloomberg Latest Data: 21.05.19

Note: EMEs include Brazil, Czechia, Indonesia, S. Africa, Colombia, Hungary, Poland, Romania, Turkey and Chile. Brazil, Indonesia and South Africa CDS premiums are used in the calculation of selected EMEs average.

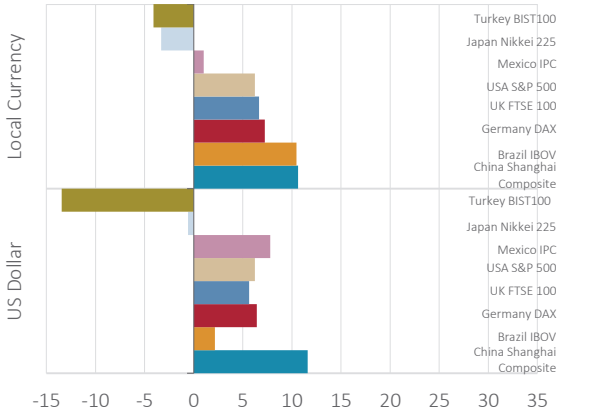
Currencies of advanced and emerging market economies have remained around the same level against the USD since the previous Report period (Chart II.1.7). On the other hand, stock indices of many EMEs, China in particular, performed well compared to the previous Report period. Meanwhile, stock exchanges of advanced economies also displayed a positive outlook due to the improvement in global liquidity conditions (Chart II.1.8). However, increased global trade tension as of May has led to a downward pressure on stock indices.

Chart II.1.7: Exchange Rate Indices (Index)



Source: Bloomberg Latest Data: 21.05.19

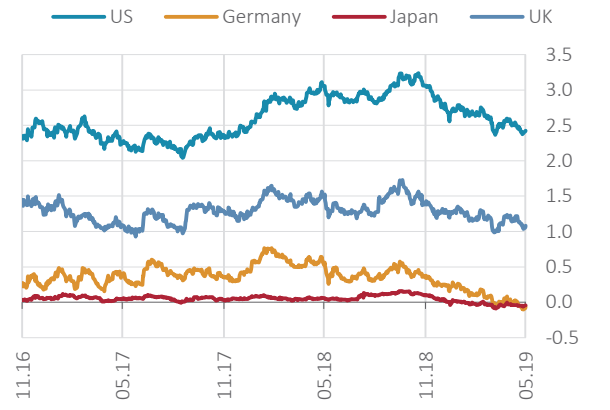
Chart II.1.8: Stock Indices
(12.11.2018-21.05.2019, % Change)



Source: Bloomberg Latest Data: 21.05.19

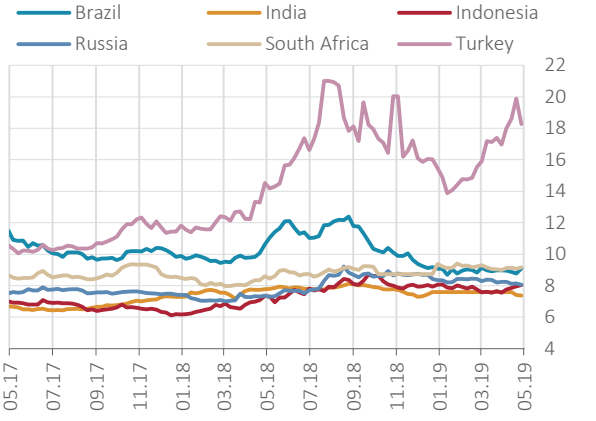
The Fed's statement that it would suspend its rate hikes affected the global financial conditions favorably, setting the ground for a downtrend in bond returns of advanced economies including the US markets in particular (Chart II.1.9). On the other hand, recent developments in global financial conditions have not been reflected in EME bond rates due to the increased global trade tension (Chart II.1.10).

Chart II.1.9: 10-Year Treasury Bill Returns in Advanced Economies (%)



Source: Bloomberg Latest Data: 21.05.19

Chart II.1.10: 10-Year Treasury Bill Returns in EMEs (%)

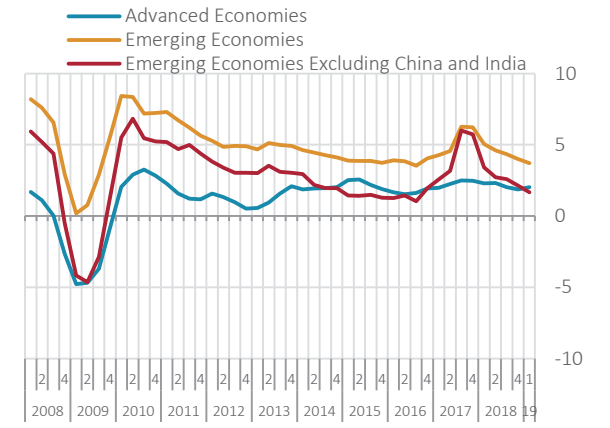


Source: Bloomberg Latest Data: 17.05.19

Note: As there is no recent 10-year Treasury bill issue in South Africa, data is based on 9-year bond returns after December 2017.

While downside risks to the global growth outlook linger, growth rates of advanced economies and EMEs excluding China and India have converged (Chart II.1.11). The relatively strong course of economic activity in the US continues due to expansionary fiscal policies. On the other hand, leading indicators in the euro area suggest that the negative outlook for economic growth remains unchanged (Chart II.1.12). Despite the easing in global liquidity conditions, country-specific macroeconomic conditions and geopolitical developments pose downside risks to growth rates of some EMEs.

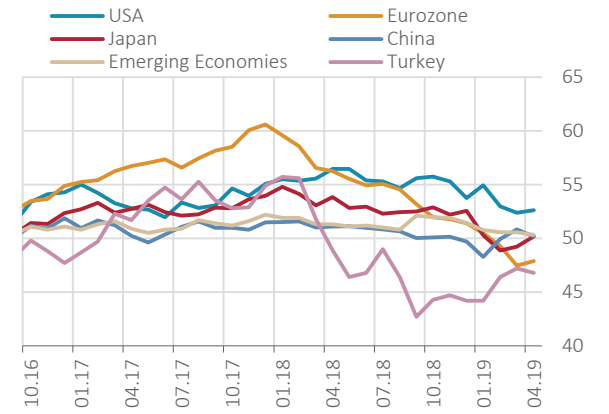
Chart II.1.11: Y-o-Y Growth Rates in Advanced Economies and EMEs (%)



Source: Bloomberg, CBRT Latest Data: 03.19

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

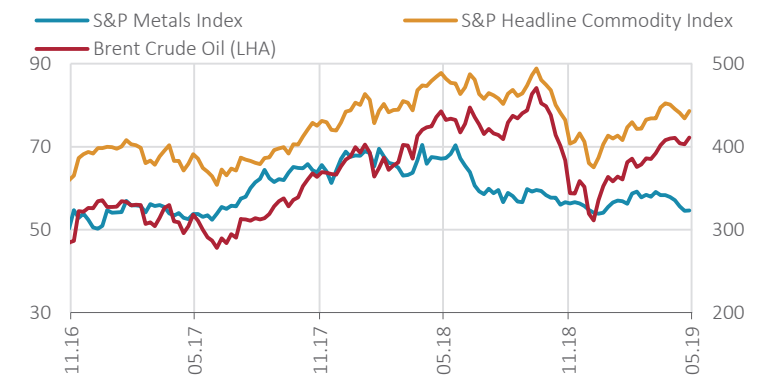
Chart II.1.12: Manufacturing Industry PMI (Index)



Source: Bloomberg, CBRT Latest Data: 04.19

The downtrend observed in commodity prices after October 2018 has reversed since early 2019 (Chart II.1.13). Oil supply cuts by oil-producing countries, production shortages in certain metal products such as iron, and expansionary fiscal policies in China have been effective in the upward movement in prices. While the persistence of the contraction in oil supply poses an upside risk to the oil prices outlook, the deceleration in the global growth outlook – that of China in particular, and protectionist trade policies may exert downward pressure on commodity prices.

Chart II.1.13: Commodity Indices (USD, Index)



Source: Bloomberg Latest Data: 21.05.19

Following the global financial crisis, financial regulatory reforms led by the G20 contributed to the resilience of the financial system to shocks. On the other hand, slowdown in global economic activity, high levels of indebtedness, likely adverse impacts of protectionist trade tendencies, a no-deal Brexit, geopolitical developments, and country-specific risks rank among the significant conjunctural risk factors for global financial stability. Although technological developments and products that have reached a wide range of implementation areas in the financial sector offer certain benefits and opportunities, they are closely monitored by national and international financial institutions in that they carry potential risks for financial stability and hold the possibility to cause a structural change in the sector (Box II.1.I). On the other hand, as global financial reforms have largely been completed, analyses of their impact have started to be conducted. These analyses are considered a significant step that will further enhance the impact and effectiveness of these reforms, and thus contribute to sustainable and inclusive global growth as well as to maintaining global financial stability (Box II.1.II).

Box II.1.I

Potential Financial Stability Implications of Financial Technology (FinTech) Developments

FinTech is defined as technology-enabled financial innovation that could result in new business models, applications, processes or products with an associated material effect on financial markets, financial institutions and the provision of financial services (FSB, 2019). In recent years, the use of artificial intelligence and big data sets, distributed ledger technology and cryptography applications, and developments in mobile and internet technologies have rapidly reached a wide range of application areas in the financial services sector, leading to new products, services and business models (Table II.1.I.1). Widespread use of financial technologies increases the product diversity and enables faster and more cost-effective access to financial markets and services. Increased competition and diversity in financial services, in areas such as credit intermediation, payment systems, insurance and asset trading in particular, may contribute to achieving a more effective and resilient financial system. On the other hand, financial technology innovations bring about some risks such as operational and cyber risks that have the potential to transfer into a systemic risk.

Table II.1.I.1: Main Technologies and Innovations Used in Financial Services

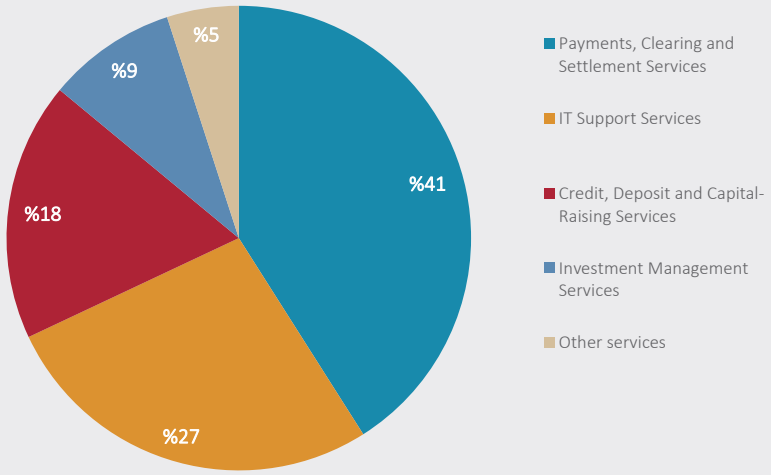
Technology		Financial Services				
Main Technology	Innovation	Payment	Savings	Borrowing	Risk Management	Financial Advice
Artificial Intelligence/Big Data	Machine Learning/ Predictive Analytics		Investment Advice			
				Credit Decisions		
		Compliance, Supervision and Insurance Technologies, BigTech Firms				
			Asset Trading			
Distributed Computing/Cloud Computing	Distributed Ledger Technology (Blockchain)	Settlement				
		Business-to-Business (B2B) and Peer-to-Peer (P2P) Financial Services				
				Back Office Operations, Information-sharing		
		Digital Currencies				
Cryptography	Smart Contracts/ Biometrics	Automatic Transactions				
		Security				
		Identity Protection				
Mobile Access/Internet	Application Programming Interfaces (APIs)/ Digital Wallet	Easy to Use Digital Wallets, Finance Dashboards, P2P				
		Crowd-funding				
		Inter-operability and Expandability				

Source: IMF (2017)

In line with the rapidly changing customer expectations, demand for digital financial services has increased while the progress in the information technology (IT) sector and the changes in financial regulations have been influential in the recent acceleration in the rate of progress and spread of financial technologies. These developments are projected to have a larger effect on the banking sector's activities and risk levels in the upcoming period and accordingly, sector-specific

financial regulations are expected to be reviewed and revised (BCBS, 2018). FinTech activities affecting different segments of the financial sector are mostly concentrated on payments and IT support services (Chart II.1.I.1). Therefore, these activities are monitored and analyzed by various international organizations.

Chart II.1.I.1: FinTech Activities by Sectors



Source: BIS (2018)

Note: Data used in this sectoral distribution are based on the results of the survey conducted with the member countries of the Basel Committee on Banking Supervision (BCBS) in 2016.

The relation between traditional financial institutions and FinTech firms may impact financial stability by causing changes in market structures. In particular, activities referred to as "open banking" performed by FinTech firms have the potential to affect and transform the traditional structure.[1] In this respect, it is likely that FinTech firms may stimulate a decline in banks' profitability by increasing the competition in payment services and credit intermediation activities, and lead to an increase in the risk appetite. The vulnerability of open banking activities to cyber risks constitutes one of the financial stability risks. On the other hand, greater decentralization and diversification of financial products as well as easier access to financial services contribute to financial stability.

BigTech firms either compete with traditional institutions through directly operating in the financial services sector or cooperate with them by offering support services.[2] BigTech firms have been intensifying their activities in areas such as payments, credit supply and portfolio management services in emerging market economies (EMEs), particularly in China. This enables diversification of borrowable funds by reducing dependence on banks, and contributes to financial inclusion by improving market transparency. Increased transparency is projected to facilitate expansion of pricing behavior in favor of consumers in particular. On the other hand, BigTech firms can achieve competitive advantage via business models developed based on highly concentrated consumer data. This may cause other financial institutions to be excluded from related financial services markets, leading to a risk of concentration in such markets and accordingly a risk to increase the systemic importance of BigTech firms. The competitive pricing behavior that these firms follow and subsidization of certain financial products also entail the risk of causing inaccurate pricing of risks and consumer activities with high leverage. Moreover, when BigTech firms cooperate with financial institutions, interconnectedness of the financial system

[1] Open banking activities include legitimate access to persons' data at different financial institutions through application programming interfaces (APIs), and providing financial products and services based on these data.

[2] Google, Amazon, Facebook and Apple in the US, and Baidu, Alibaba and Tencent in China are listed among the BigTech firms.

increases and the probability of systemic risk rises.

Traditional financial institutions may receive technological services from third-party service providers in certain areas.[3] Benefits of using third-party service providers include reduced costs of fixed investments and infrastructure, removal of market entry barriers, facilitation of appropriate use of technological innovations such as machine learning and artificial intelligence, and high-level cyber security. On the other hand, it should be kept in mind that increased dependence of financial institutions on third-party services such as cloud computing and data management also creates some financial stability risks. In this scope, potential risks include emergence of an information asymmetry between financial institutions and third-party service providers, issues related to data privacy, reliance on a small number of service providers, and conduct of critical activities under cloud computing. That the operational dependencies have turned into a risk transmission mechanism in financial markets brings the cyber resilience and security issues to the forefront also in terms of systemic risks.

Technological innovations are not only gaining ground in financial services but are also applied in reporting, compliance and supervision processes by financial institutions and regulatory authorities. Innovations such as artificial intelligence, machine learning and big data are employed by financial institutions in the compliance processes concerning data reporting and risk management (consumer risk profile and credit scoring) in particular. Regulatory authorities also use these technologies in reporting their oversight and supervision activities and in improving analyses. Thus, financial institutions achieve compliance at lower costs while regulatory authorities can gather and analyze larger amounts of data thanks to these technologies. Additionally, to support innovative firms in the financial services sector, regulatory sandbox practices are also implemented to allow more flexible regulatory and supervisory conditions. In this way, new services and business models can be tested with actual customers under the surveillance of financial regulatory authorities. This practice is expected to contribute to financial stability by setting the ground for an improvement in financial innovations and an increase in product diversity.

Against this background, close monitoring of the financial stability implications of the rapid progress in financial technologies, identification of potential risks, and introduction of necessary regulations in the related sectors constitute the primary requirements at this stage. In this framework, regulatory and supervisory authorities in Turkey also conduct necessary studies and introduce necessary regulations related to FinTech.

References

BIS (2018), “BCBS, Sound Practices: Implications of fintech developments for banks and bank supervisors”.
FSB (2019), “FinTech and market structure in financial services: Market developments and potential financial stability implications”.
FSB (2017a, 2017b), “Financial Stability Implications from FinTech” and “FinTech Credit: Market Structure, Business Models and Financial Stability Implications”.
IMF (2017), Staff Discussion Note, “Fintech and Financial Services: Initial Considerations”.
UNSGSA FinTech Working Group and CCAF. (2019). “Early Lessons on Regulatory Innovations to Enable Inclusive FinTech: Innovation Offices, Regulatory Sandboxes, and RegTech”. Office of the UNSGSA and CCAF: New York, NY and Cambridge, UK.

[3] IBM, Microsoft, Cisco, Apache, BMC, HPE, Huawei, VMware, Accelerite and Embotics are among the third-party service providers offering specialist cloud computing services.

Box II.1.II

Impact Analysis Studies on Global Financial Regulatory Reforms

Serving as an important platform for achieving global financial stability, the G20 has been working intensively to enhance the economic policy coordination and strengthen the financial system since the global financial crisis. The main items on the reform agenda prepared under the guidance of G20 jurisdictions have been set as making financial institutions more resilient, ending the "too-big-to-fail" problem, further strengthening the over-the-counter (OTC) derivatives markets, and lowering the non-bank financial intermediation-driven risks.[1] With the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) taking the lead, international standard-setting bodies have made significant progress in the reform areas, and many reforms including the Basel III regulatory framework have been finalized and put into practice.

Following the progress achieved in the implementation process of the reforms, to identify whether these reforms have produced the desired results, the FSB released a document drawing the framework for the evaluation of effects of G20 financial regulatory reforms on 3 July 2017 (FSB, 2017). After the Framework was set, studies were initiated on three issues: regulations concerning the encouragement of the central clearing of OTC derivatives, which constitutes a part of OTC derivatives market reforms; regulations aimed at ending the "too-big-to-fail" problem; and the effects of the reforms on the corporate sector with a focus on the financing of infrastructure investments and of small and medium-sized enterprises (SMEs). In this box, we share the findings on central clearing incentives and the effects of the reforms on infrastructure finance – the two issues for which the analyses have been completed.

Changes in regulatory areas addressing OTC derivatives markets such as capital, liquidity and margin requirements, and the resilience, recovery and resolution of central counterparties intended to encourage the central clearing of OTC derivatives directly or indirectly. The findings of the analysis measuring the effect of these changes were made public via the FSB's report (2018a) released on 19 November 2018. These findings reveal that central clearing of many derivatives on the OTC derivatives market has increased in the direction implied by incentives. The central clearing rate has surged to 62% in 2017 from 24% in 2009. Another important finding is that lower capital requirements for centrally cleared trades in particular, higher margin requirements for non-centrally cleared trades, and other amendments in clearing regulations have encouraged the central clearing of OTC derivatives for intermediary institutions as well as for large and active customers. On the other hand, effects of incentives vary for small and less active customers. Moreover, market participants' preference for central clearing is also affected by non-regulatory factors such as market liquidity, counterparty credit risk and netting efficiency. It is found that regulations have encouraged central clearing for systemically important market players in particular.

The analysis of the effect of global financial regulatory reforms on financial intermediation was planned to be conducted in two stages: one on infrastructure finance and the other on SME financing. Accordingly, the effect of the reforms on infrastructure financing was analyzed at the first stage. The findings of this analysis were published by the FSB (2018b) on 20 November

[1] In line with the objective to increase the resilience of the OTC derivatives market, studies are conducted under four headings: (i) Reporting to trade repositories, (ii) Mandating central clearing for derivatives, (iii) Higher capital and margin requirements for non-centrally cleared trades, (iv) Trading on electronic platforms or on exchanges.

2018. In addition to empirical analyses relying on micro and macro data, the study employed a survey of trends in infrastructure finance that included contribution from Turkey's financial institutions, interviews with experts and market participants, outputs of the workshop with sector representatives, a literature review, and feedback from public consultation. The implications of other recent G20 reforms that may affect infrastructure finance, including particularly the Basel III reforms finalized in December 2017, were analyzed only qualitatively due to lack of data. The findings suggest that although infrastructure finance contracted temporarily during the global financial crisis, it has picked up again in recent years, albeit at a slower pace compared to the pre-crisis period. The increase in advanced economies was mostly due to the rise in financing options such as corporate bond issuance, non-bank finance, and project finance whereas the increase in EMEs was largely driven by bank loans. The findings reveal that Basel III reforms have not had a critical impact on the volume and costs of infrastructure finance. In terms of global systemically important banks, it is assessed that the reforms have led to shorter maturities in infrastructure finance loans, which is actually considered to be consistent with the objectives of the reforms that envisage to reduce the maturity mismatch. Basically, reforms reviewed through impact analyses are found to have no visibly negative effects on infrastructure finance.

Continuity of impact analysis studies and effective assessment of their results constitute a critical component of both the design and implementation of global financial reforms. Results of these analyses will serve as a guide for regulatory and supervisory authorities as well as for international standard-setting bodies in the upcoming period.

References

FSB (2017), "Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms", http://www.fsb.org/wp-content/uploads/P030717-4.pdf

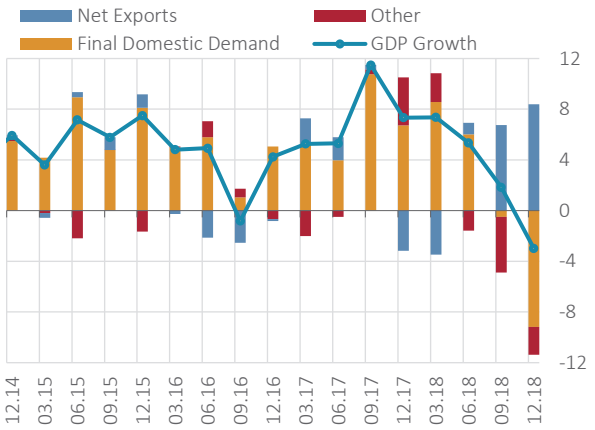
FSB (2018a),"Incentives to Centrally Clear Over-the-counter (OTC) Derivatives – A Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms – Final Report", http://www.fsb.org/wp-content/uploads/R191118-1-1.pdf

FSB (2018b), "Evaluation of the Effects of Financial Regulatory Reforms on Infrastructure Finance", http://www.fsb.org/wp-content/uploads/P201118-1.pdf

II.2 Domestic Developments

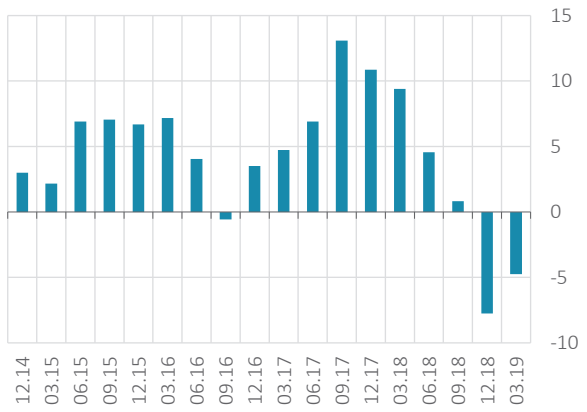
In the final quarter of 2018, the rebalancing in economic activity became more obvious; real GDP decreased by 3% on an annual basis and by 2.4% on a monthly basis. An analysis of contribution to annual growth from the expenditure side reveals that final domestic demand had a downward effect, while the increase in the contribution of net exports curbed the slowdown in the economy (Chart II.2.1). Data released in the current report period indicate that the rebalancing process in economic activity continues. The annual Industrial Production Index (IPI), which dropped by 7.8% in the final quarter of 2018, displayed a milder decrease in the first quarter of 2019 (Chart II.2.2). The relative recovery in the first quarter was backed by the export performance and the supportive stance of the public sector. Recently, despite the partial recovery signals in credit growth, continued tightness in financial conditions plays an important role in the slowdown in economic activity. Moreover, the downtrend in the global growth, particularly in Turkey's primary export partners - the EU countries - and geopolitical developments keep downside risks to domestic economic activity in place.

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



Source: TURKSTAT Last Observation: 12.18

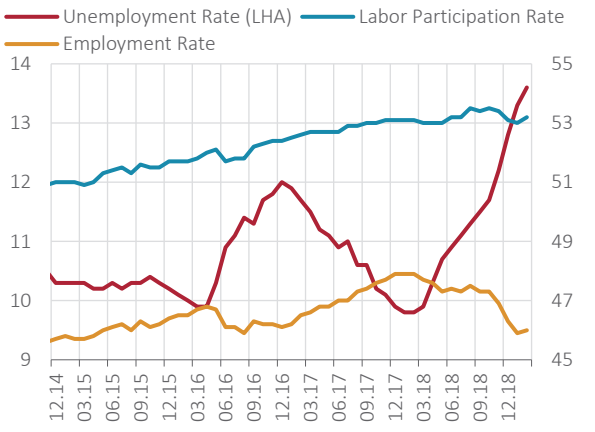
Chart II.2.2: Industrial Production Index
(Calendar Adjusted Annual % Change)



Source: TURKSTAT Last Observation: 03.19

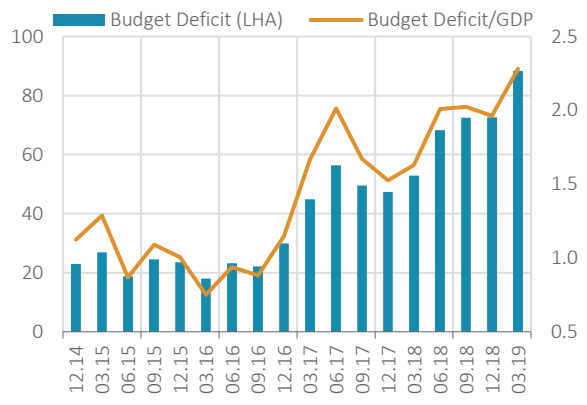
The impacts of the weak economic activity on unemployment rates and employment continued in the first quarter of 2019 and the seasonally adjusted unemployment rate increased to 13.6% in February 2019 (Chart II.2.3). The labor force participation rate, which had been on an uptrend for a while, displayed a partial decline after November 2018. The impacts of the moderate recovery trend in economic activity on the labor market are expected to be observed with a lag.

Chart II.2.3: Labor Force
(Seasonally Adjusted, %)



Source: TURKSTAT Last Observation: 02.19

Chart II.2.4: Central Government Budget Balance
(12-Month Cumulative, Billion TRY, %)

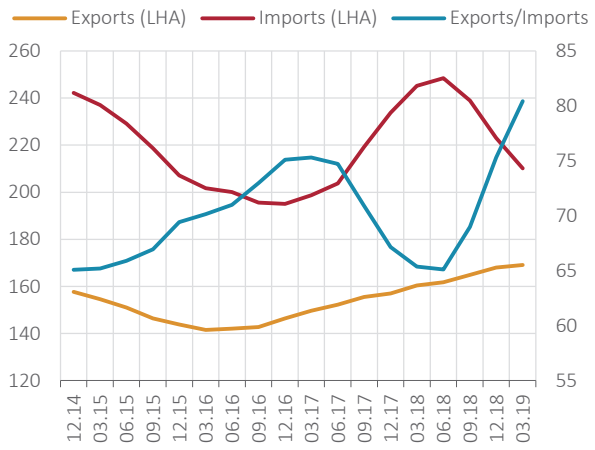


Source: Ministry of Treasury and Last Observation: 03.19

Recently, there has been an increase in the accommodative public policies aimed at curbing the impact of the weak domestic demand on economic activity, however, the budget deficit remains low. In the first quarter of 2019, the budget deficit/GDP ratio, which increased due to consumption and investment spending and particularly personnel payments, somewhat exceeded the 1.8% target for end-2019 presented in New Economy Program (NEP) (Chart II.2.4). Consistent with economic activity, tax revenues are also weak, although they are expected to display a gradual improvement in the upcoming period with the effect of the partial recovery that has already started in domestic demand and the termination of tax reductions. The steps towards increasing savings and income proposed in the NEP will be important for safeguarding fiscal discipline.

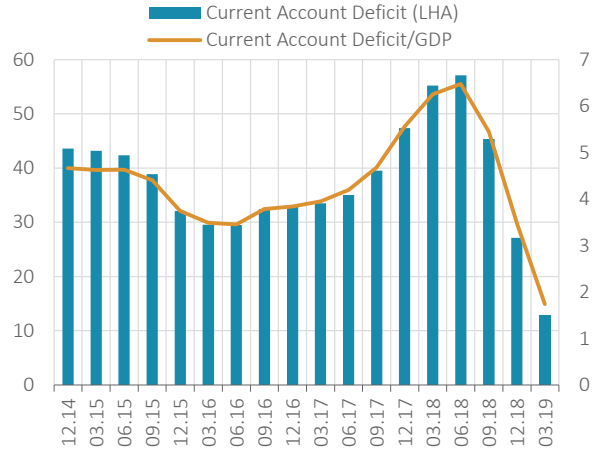
The export/import coverage ratio has been increasing since mid-2018 due to the weak domestic demand conditions (Chart II.2.5). An analysis of the 12-month cumulative data showing the long-term tendencies demonstrates that the recovery in both the headline and gold and energy excluded trade deficits continued in the first quarter of 2019. Contraction in imports, robust tourism and export revenues made a significant contribution to the recovery in the foreign trade deficit. Despite the recent slowdown signals in the global economic activity, particularly in the EU countries, foreign demand remains strong. Amid weak domestic demand, firms' efforts to do business in external markets and their flexibility about market diversification supports exports of goods; meanwhile exchange rate developments and the subdued economic activity curbs import demand, and the recovery in foreign balance continues on the back of net travel revenues (Chart II.2.6). The recovery trend in current account balance is expected to continue in the upcoming period.

Chart II.2.5: Foreign Trade
(12-Month Cumulative, Billion USD, %)



Source: TURKSTAT Last Observation: 03.19

Chart II.2.6: Current Account Deficit
(12-Month Cumulative, Billion USD, %)



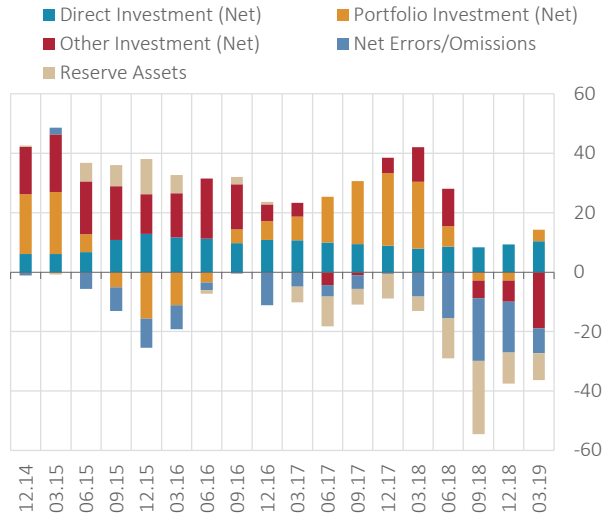
Source: CBRT Last Observation: 03.19
Note: GDP data for 2019Q1 is an estimate of the CBRT.

An analysis of the current account deficit on the financing front, as suggested by 12-month cumulative changes, reveals that foreign direct investments remained stable while there are net outflows from other investments, and the share of capital inflows in financing of the current account deficit decreased (Chart II.2.7).

Inflation indicators have been improving since November 2018 thanks to weaker cumulative exchange rate effects, the decrease in imported input costs, and domestic demand developments, where annual CPI inflation decreased to 19.5% in April 2019 (Chart II.2.8). In this quarter, the contribution from food and services groups to inflation increased. Annual inflation and the underlying trend in core indicators decreased faster, and the B and C indices stood at 16.8% and 16.3%, respectively, in April 2019. In the upcoming period, the tight monetary policy stance and the coordinated steps envisaged in the Structural

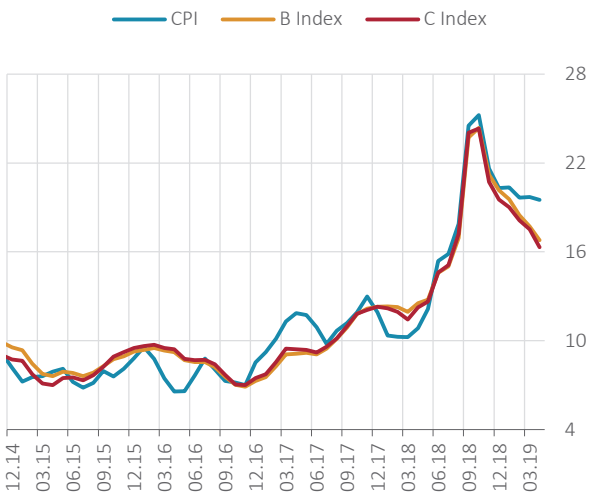
Transformation Steps for 2019 document in the framework of the NEP are expected to underpin the disinflation process.

Chart II.2.7: Financing Sources of Current Account Deficit
(12-Month Cumulative, Billion USD)



Source: CBRT Last Observation: 03.19

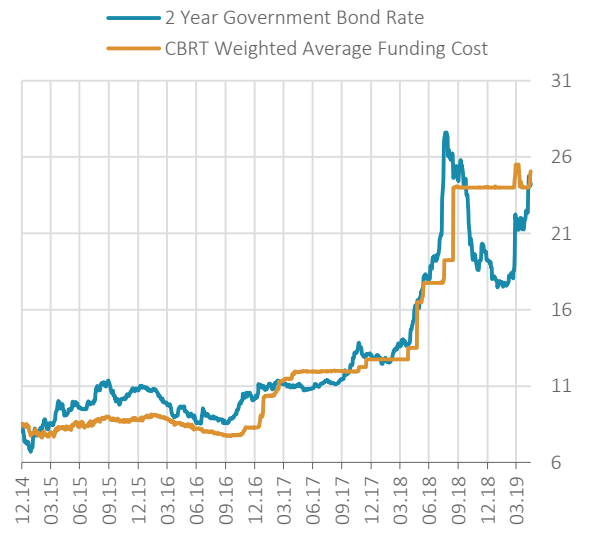
Chart II.2.8: Price Indices
(Annual % Change)



Source: TURKSTAT Last Observation: 04.19

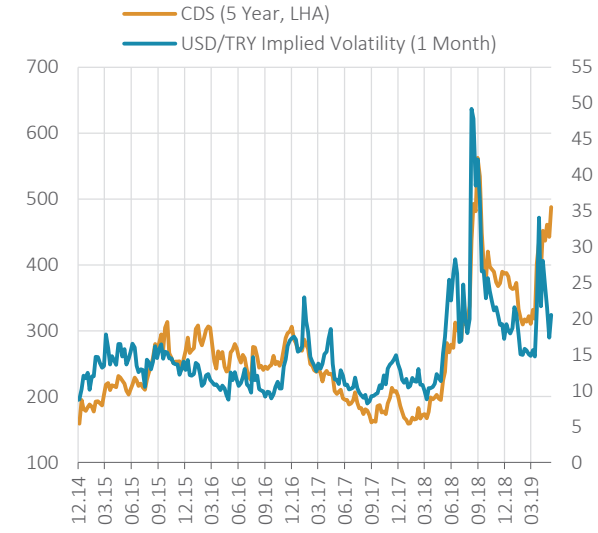
Despite some recovery in inflation indicators, the elevated level of inflation coupled with the rise in food and imported input prices continue to pose a risk to price stability. Therefore, the CBRT maintains its tight monetary stance. Between November 2018 and April 2019, bond rates remained below the CBRT weighted average funding rate, but recently came closer to the policy rate again (Chart II.2.9). Recently, there have been fluctuations in credit default swap (CDS) premiums and exchange rates due to uncertainties and geopolitical developments (Chart II.2.10). The TL and FX liquidity management tools used by the CBRT to support the effective functioning of the markets and the transmission mechanism curb further fluctuations in the markets.

Chart II.2.9: Interest Rates
(Annual, %)



Source: Bloomberg, CBRT Last Observation: 15.05.19

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



Source: Bloomberg Last Observation: 15.05.19