II. Domestic Economic Outlook[2]

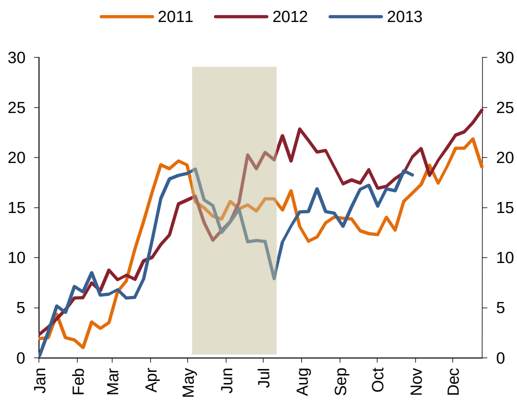
Economic activity presented a more positive outlook in the second quarter of 2013 compared to the first quarter. The revival in domestic demand and the base effect in gold trade led to a slight deterioration in the current account deficit. Increased volatility in global financial markets after May caused fluctuations in capital flows and exchange rates in emerging market economies including Turkey.

Increased uncertainties over global monetary policies as of the second quarter of 2013 have led to capital outflows from emerging market economies including Turkey. The recent tightening in financial conditions is expected to curb the increase in loans and the current account deficit in the upcoming period. Although financial and non-financial sectors had no trouble in borrowing from abroad, during the period from May to July, Turkey posted a capital outflow of approximately USD 10 billion. However, with the postponement of the expectations over Fed tapering, recovery of global risk appetite made capital flows rebounded again. The recent volatility in portfolio flows to Turkey was higher than that experienced after the Euro area debt crisis in 2011 (Chart II.1).

The current account deficit (CAD) makes the domestic economy more vulnerable to capital flows. Even if a slight deterioriation was observed in current account deficit due to the increase in imports demand as a result of revival in domestic demand as of the first quarter of 2013, this deterioriation was mainly driven by gold trade. The domestic demand and loans that are expected to display a moderate increase in the upcoming period might restrain the increase of imports. Furthermore, the signs of recovery in the Euro area economic activity also support the positive expectations regarding imports. In light of these developments, the recovery in the CAD excluding gold is expected to continue in the period ahead. Factors other than portfolio flows did not display a notable change in financing the CAD, which alleviates concerns over financing it (Chart II.2).

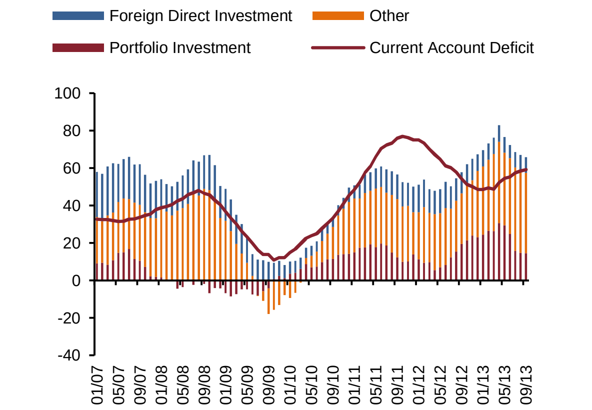
[2] This chapter has been prepared by E. Özgü Özen Çavuşoğlu.

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



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

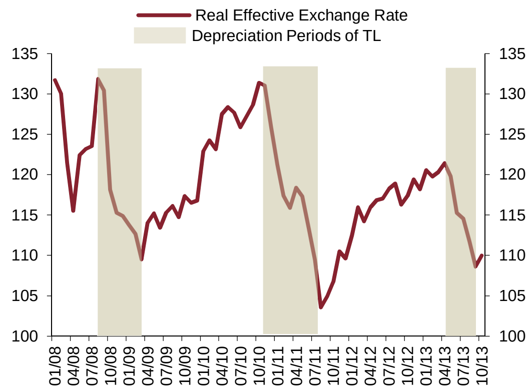
Chart II.2
Current Account Deficit and Financing Items[1]
(12-Month Cumulative Billion USD)



(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

Increased uncertainties over global monetary policies led to repricing of all financial assets including exchange rates. The real effective exchange rate that had gradually increased since mid-2011 depreciated after May 2013 due to nominal exchange rate developments. In September, though, the depreciation in the real effective exchange rate subsided amid developments that reduced concerns in global financial markets (Chart II.3). The course of the real effective exchange rate after May is considered to contribute to the economic rebalancing process.

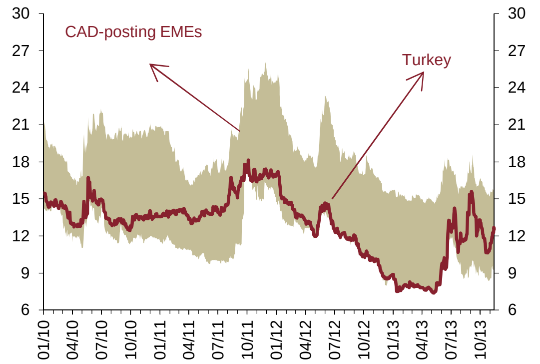
Chart II.3
Real Effective Exchange Rate
(CPI-based, 2003=100)



Source: CBRT

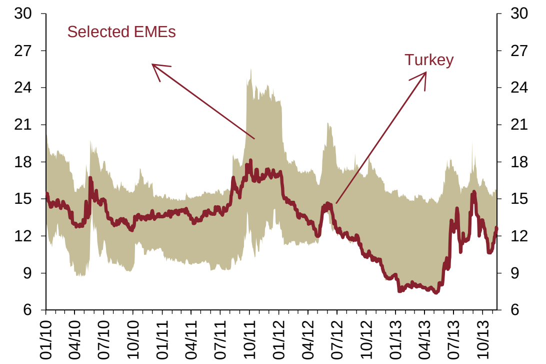
The relative deterioration in the risk outlook of emerging market economies has exacerbated the volatility of exchange rates. The Turkish lira, with the lowest exchange rate volatility among currencies of emerging market economies posting current account deficits, started to display higher volatility in the post-May period (Chart II.4). While Turkey's susceptibility to external financing was instrumental in increasing the implied exchange rate volatility relatively further, the Turkish lira displayed the lowest volatility compared to four other emerging market currencies that recorded the highest depreciation in the same period (Chart II.5).

Chart II.4
Implied Volatility of Exchange Rates[1]
(12-Month Ahead)



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

Chart II.5
Implied Volatility of Exchange Rates[1]
(12-Month Ahead)



(1) Selected emerging market economies include Brazil, India, Indonesia, South Africa and Turkey.
Source: Bloomberg

Economic activity gained pace in the second quarter of 2013. After significant growth in the first quarter of 2013, the final demand displayed a limited increase in the second quarter, compared to the previous one. The private sector's investment and consumption demand recorded a moderate increase on a quarterly basis, while the public demand that played an important role in the first quarter growth recorded a decline. On the other hand, the largest contribution to the second quarter growth came from the change in inventories. While net foreign trade had a negative contribution to growth after the boost of the imports demand, the contribution of net imports to growth is expected to increase in view of the recent developments (Chart II.7).

Chart II.6
GDP and Final Domestic Demand
(Seasonally Adjusted, Billion TL, Deflated by 1998 prices)

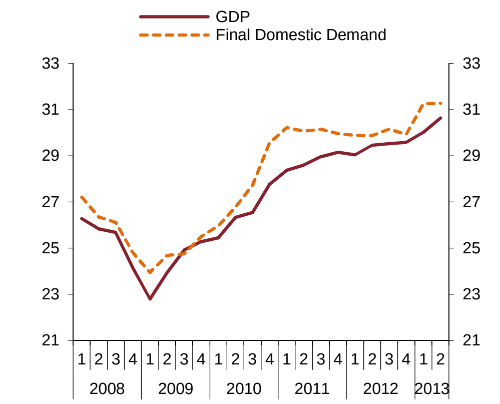
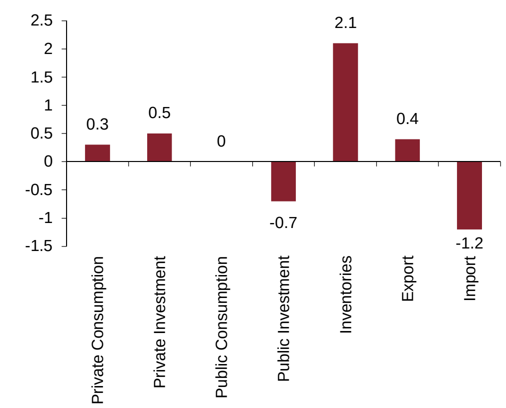


Chart II.7
Contributions to Quarterly GDP Growth
(2013Q2, Seasonally Adjusted, Percentage Points)



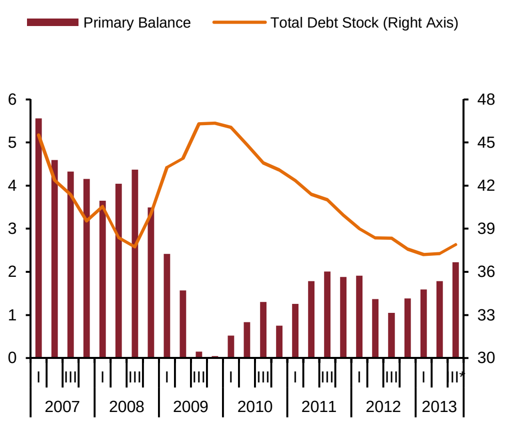
Source: CBRT, TURKSTAT

The recovery trend in public debt indicators has been continuing in line with the favorable outlook in the budget performance. The significant increases in tax and non-tax revenues in 2013 became the main determinant of the favorable outlook in the budget performance. The recovery trend in public debt stock indicators that started in 2010 on the back of the improvement in budget performance has continued in 2013 as well (Chart II.2.8). In line with these developments, internal debt rollover ratios have continued to hover below 100 percent throughout the year. Maintenance of the positive outlook of public finance and the fact that its susceptibility to the level of public debt stock as well as to interest rate and exchange rate movements is limited are essential for macroeconomic stability and for the stability of the Turkish banking system that bears significant amounts of GDDS on its balance sheet.

Chart II.8

Central Government Budget Balance-Debt Stock

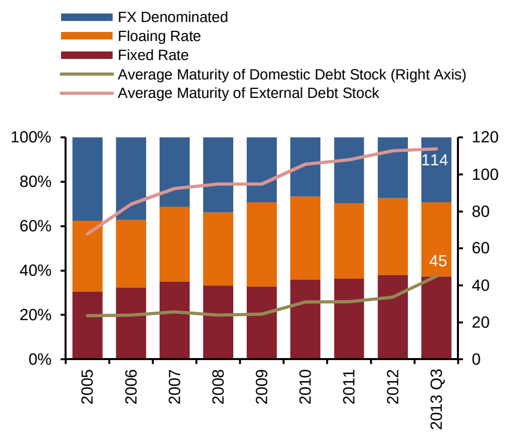
(Annualized, Ratio to GDP, %)



* GDP data related to the third quarter of 2013 is an estimate.
Source: Undersecretariat of Treasury, Ministry of Finance

Chart II.9

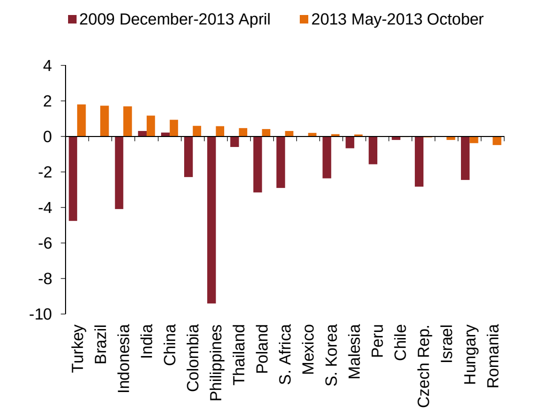
Composition of Central Government Debt Stock and Average Days to Maturity [1] (Month)



(1) Data of days to maturity pertains to October 2013.
Source: Undersecretariat of Treasury

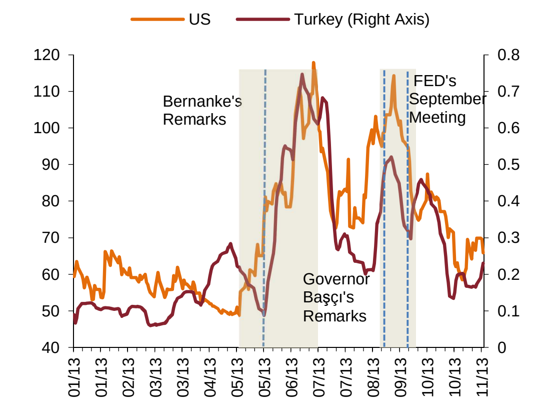
In the repricing process of financial assets, domestic interest rates soared in response to the increase in U.S. bond interest rate and in risk premiums of emerging markets. Interest rates on GDDS that had decreased to historic lows on the back of sovereign rating upgrades increased more than those of other emerging market economies during the post-May fluctuation (Chart II.10). Although the volatility in bond rates declined slightly due to the CBRT's predictability-enhancing actions and the recovery in global risk appetite, it remained above pre-May levels (Chart II.11).

Chart II.10
Change in Market Rates of Selected Countries with a 5-Year-Maturity
(Percentage Point)



Source: Bloomberg

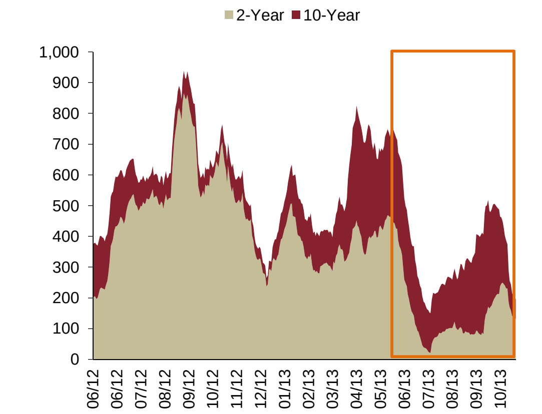
Chart II.11
Volatility of Interest Rates on U.S. and Turkish Treasury Bonds with a 10-Year-Maturity[1]



(1) The Move Index has been used for the volatility of US Treasury bond with a 10-year-maturity. A 22-day standard deviation has been calculated for the yields on Turkish Treasury bond with a 10-year-maturity.
Source: Bloomberg

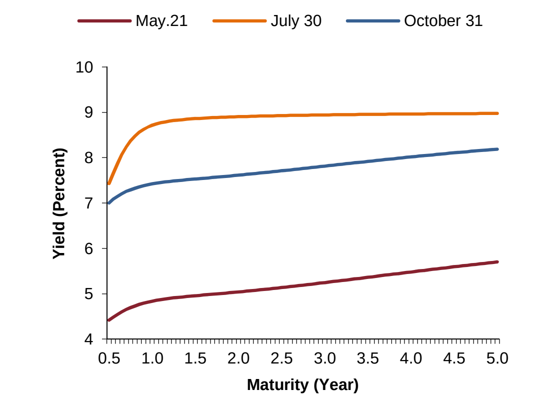
In the bond market, transaction volumes, particularly of bond with a two-year-maturity, declined significantly during the period of intensive sales by foreign investors, hence bond rates drastically moved. Although transaction volumes recovered slightly after July, the bond market could not gain the depth it used to have before the fluctuation (Chart II.12). On the other hand, the GDDS yield curve that flattened out after the fluctuation has returned to normal levels in the recent period (Chart II.13).

Chart II.12
Transaction Volume of Bonds with a Maturity of 2 - 10 Years
(Million TL)



Source: Bloomberg

Chart II.13
GDDS Yield Curve[1]
(%)



(1) Calculated from the compounded returns on bonds quoted in BIST Bonds and Bills Market by using Extended Nelson-Siegel (ENS) method.
Source: BIST, CBRT