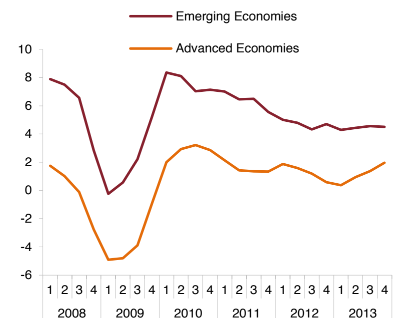
I. International and Domestic Developments Affecting Financial Stability

I.1. International Developments

The normalization process in the Fed's monetary policy on the back of the economic recovery had an adverse impact on capital flows to emerging markets. While emerging market currencies have generally depreciated, central banks of emerging economies have introduced monetary tightening measures to restore financial stability. While volatile capital flows and tight monetary policies restrict domestic demand in emerging markets, the positive economic outlook in the US and the euro area's exit from the recession underpin growth through external demand. Even if uncertainties have dissipated over the Fed's termination process of asset purchases, the timing and speed of interest rate hikes will be a determining factor of capital flows to emerging markets. However, the rate hikes are expected to be measured and start in the second half of 2015 as accommodative monetary policy still remains important for recovery in the US, the improvement in the employment market is yet to reach the desired level and inflation still hovers below the target. Meanwhile, there are those who expect the European Central Bank (ECB) to adopt monetary easing due to the deflationist pressures in the euro area. Moreover, the normalization process of the US monetary policy fuels the external borrowing risk of emerging economies; thus, sectors' resilience against exchange rate and interest rate shocks become more important with respect to financial stability in these countries.

Recovery in global economic activity is mainly driven by advanced economies. While growth rates of advanced economies displayed an upward trend throughout 2013, those of emerging economies remained flat (Chart I.1.1). The rise in growth rates of advanced economies can mainly be attributed to the recovery in the US economy and the euro area's exit from stagnation. The manufacturing industry PMI indices in

Chart I.1.1
Global Growth Rates[1]
(Percent, Annual)



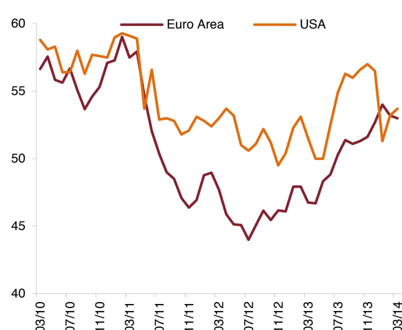
(1) Weighted by each country's share in global GDP.
Source: Bloomberg, CBRT.

the USA and the euro area suggest that the contribution of advanced economies to the global growth will continue (Chart I.1.2). The recovery in advanced economies, especially in the euro area, is expected to underpin growth rates of emerging economies through external demand. Meanwhile, growth in advanced economies is still vulnerable and mostly relies on accommodative monetary policies. The timing of an exit from those accommodative monetary policies and the interest rate hikes are important factors with respect to sustainability of recovery in economic activity.

The rise in growth rates of advanced economies led by the US economy had positive reverberations on the labor market. As non-farm employment increased in the USA, the US unemployment rate fell to 6.5 percent in April 2014 (Chart I.1.3). Hence, the downtrend in labor force participation rates played an important role in the drop in the US unemployment rates (Chart I.1.4). The rise in the number of part-time workers and people who have been unemployed for more than six months suggest that the improvement in the US labor market is not a permanent one. Meanwhile, unemployment rates in the euro area are still high and remain flat.

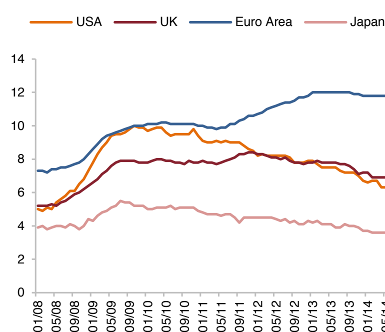
Despite the favorable growth performance in advanced economies, inflation rates are still below the targets. Inflation rates are below the targets due to the global economic activity hovering below the pre-crisis levels coupled with the absence of a demand-driven pressure on commodity prices stemming from the slowdown in emerging markets (Chart I.1.5). Wages in the USA do not pose any upward pressure on inflation (Chart I.1.6). This suggests that despite the recovery in economic activity, there is still a significant amount of idle capacity in the USA. The low inflation trend in the euro area fuels concerns over a deflation threat. While low inflation in the USA prevented the Fed from raising interest rates earlier, the deflation threat in the euro area urges the ECB to question the monetary easing option.

Chart I.1.2
Manufacturing Industry PMI Indices



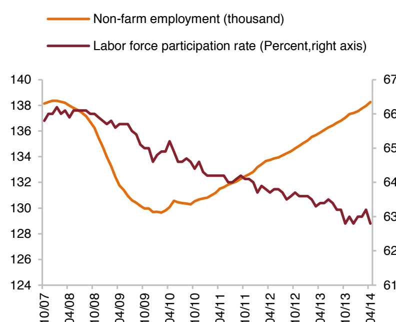
Source: Markit

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



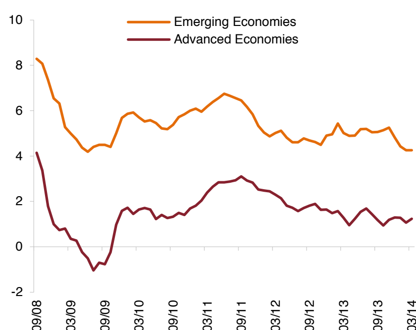
Source: Bloomberg

Chart I.1.4
Non-Farm Employment and Labor Force Participation Rates in the USA



Source: US Department of Labor

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

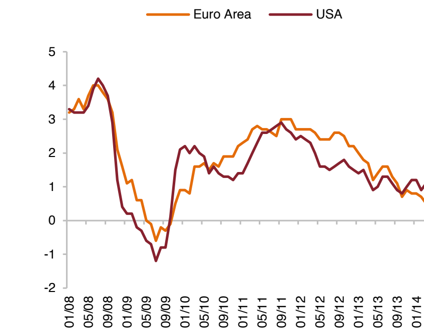


Source: Bloomberg

Despite the recovery in economic activity, the USA and the euro area still face a number of risks that could undermine financial stability. Amid the USA's low interest rate environment, investors are in search of returns, the demand for risky financial products is on the rise and lending standards are becoming looser. The yield spread between US Treasury bonds and corporate bonds is at historically low levels. The ratio of high-yield corporate bonds and credits with loose standards in the USA is higher compared to the pre-crisis period (Chart I.1.7). The lingering weakness in the balance sheets of banks and firms in the euro area is adversely affecting the functioning of the lending market (Chart I.1.8). The high corporate sector indebtedness and low economic growth push non-performing loan amounts upwards, which in return prevents the credit channel from functioning properly and curbs banks' lending capacities and profitability.

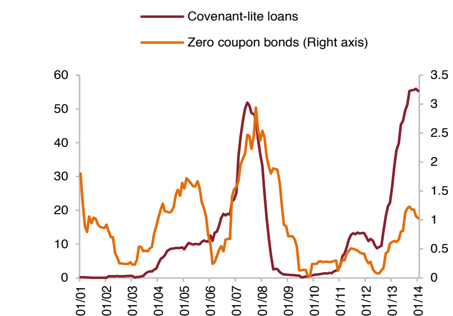
In response to the continued positive outlook in economic indicators in the US economy, the Fed started to taper asset purchases in January. In May 2013, the Fed signaled that it would start tapering asset purchases and did so in January 2014, and continued the tapering in the following months. As uncertainties pertaining to the Fed's policy eased, the long-term government bond rates followed a flat trend as of end-January (Chart I.1.9). In the upcoming period, the primary risk factor is expected to be the Fed's timing and speed of rate hikes. Meanwhile, in its March meeting, the Fed announced that it had no concrete timetable to raise the federal funds rate and made no reference to the unemployment rate of 6.5 percent as a threshold to consider tightening. Forward rates based on the Fed's federal funds rate point to expectations of a rate hike in 2015 that is concurrent with the FOMC members' forecasts (Chart I.1.10). The timing and speed of the Fed's rate hikes are not only important with respect to the recovery in the US economy but also important with respect to the possible unfavorable reverberations that these can have on capital flows to emerging markets.

Chart I.1.6
Inflation rates in the USA and the Euro Area
(Percent, Annual)



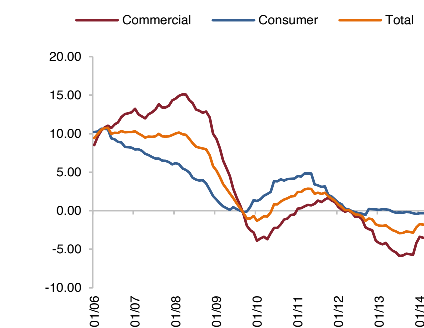
Source: Bloomberg

Chart I.1.7
Issue of High-Yield Bonds and Leveraged Loan Issuance with Lower Standards
(12-month issuance as a percent of market size)



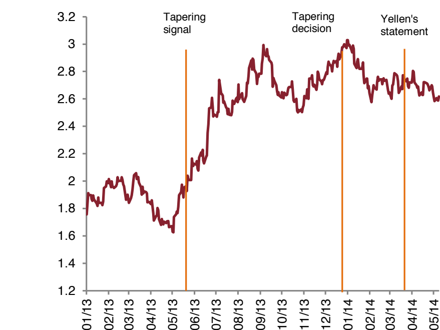
Source: IMF Global Financial Stability Report

Chart I.1.8
Loan Growth in the Euro Area
(Percent, Annual)



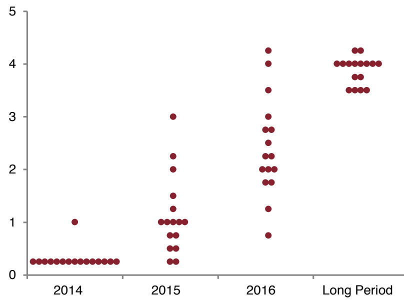
Source: ECB

Chart I.1.9
10-year US Treasury Bond Yield
(Percent)



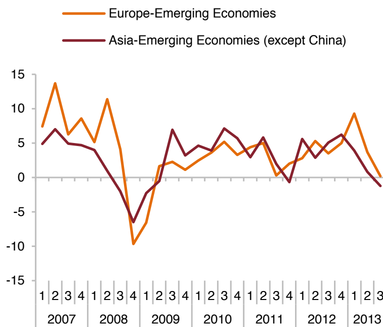
Source: Bloomberg

Chart I.1.10
Interest Rate Forecasts of FOMC Members
(End-year, percent)



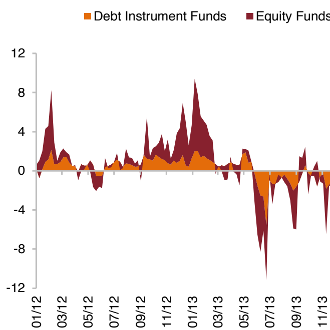
Source: Fed

Chart I.1.11
Capital Flows to Emerging Economies
(Percent GDP)



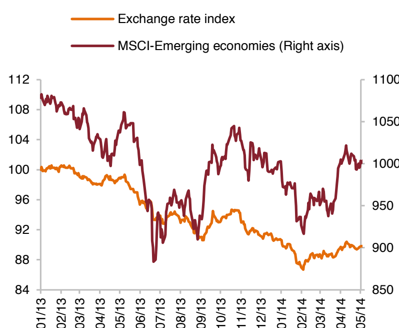
Source: IMF, World Economic Outlook (WEO)

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



Source: EPFR

Chart I.1.13
Exchange Rate* Index and MSCI Emerging Markets Index



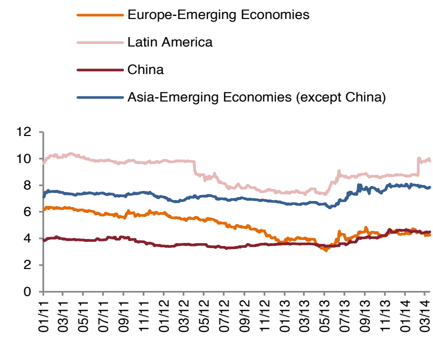
*The Exchange Rate Index is compiled by taking the arithmetic mean of the US dollar equivalent of local currencies of Argentina, Brazil, Chili, Colombia, Czech Republic, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Russia, South Africa, Thailand and Turkey. (01.01.2013=100)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

Capital outflows from emerging markets, which started with the Fed's signal in May 2013 that it would start tapering asset purchases, continued in the first quarter of 2014. The risk appetite towards emerging markets decreased and capital outflows from emerging economies significantly accelerated due to normalization signals in the Fed's monetary policy (Chart I.1.11 and I.1.12). However, portfolio flows towards emerging markets restarted in April. This rebound is believed to have been underpinned by expectations that the Fed will not start rate hikes in the near future and the low interest rate environment will continue. The weak portfolio flows and tighter financial conditions are adversely affecting growth in emerging markets by restricting domestic demand. In the upcoming period, the timing and speed of the Fed's rate hikes, the ECB's possible asset purchases, and various geopolitical risks will be the factors affecting capital movements.

Volatility in financial markets increased due to the outflows from emerging countries. Capital outflows led to a depreciation of national currencies in these countries (Chart I.1.13). Countries with rapid credit growth, high current account deficits and high inflation were more seriously affected by the fluctuations of May 2013. The fluctuation in January, when the Fed first started trimming asset purchases, was mainly attributed to concerns over growth in emerging markets and the geopolitical developments. The emerging economies raised interest rates to keep inflation under control and to curb the macro-financial risks. Financial markets slightly recovered after January as uncertainties pertaining to the Fed's timing for the termination of asset purchases were eased and monetary policies of emerging countries were tightened. As expectations grew that the Fed would not start raising funds right away and the rate hike would be a gradual one, the portfolio flows towards emerging markets started again in the second quarter; meanwhile government bond yields decreased and depreciation in national EME currencies were partly compensated (Chart I.1.14).

The normalization process of the US monetary policy fuels the external borrowing risk of emerging economies; therefore, resilience against the exchange rate and interest rate shocks become more important with respect to financial stability in these countries. As a result of the unorthodox monetary policies introduced in advanced economies in the aftermath of the global financial crisis, global liquidity increased, external borrowing opportunities for emerging markets proliferated and rapid credit growth and debt ratios climbed (Table I.1.1). Following the crisis, amid a low interest-rate environment allowing lower borrowing costs, corporate sectors of emerging economies increased their leverage ratios and raised their debts substantially between 2009 and 2013. However, deceleration in economic growth restricts profitability and the debt service capacity of firms. Meanwhile, the rise in exchange rates and interest rates are pushing firms' financial costs up. In the upcoming period, depending on the course of the monetary policies of advanced economies, emerging economies' susceptibility to exchange rates and interest rates will continue to be an important risk factor.

Chart I.1.14
Government Bond Yields in Emerging Markets
(10-Year)



Source: IMF, World Economic Outlook (WEO)

Table I.1.1 Change in the Gross Debt Levels and Banking Sector Credits of Selected Emerging Economies [1]
(Percent of GDP)

	Brazil	China	Indonesia	S. Africa	India	Mexico	Poland	Russia	Thailand	Turkey
Government	2.9	5.4	-7.1	18	-7.8	3.6	10.4	5.5	8	-4.1
Households	8.2	13.6	4.2	-5.4	-1.8	0.8	5	3.6	24.1	7.1
Corporate Sector	7.2	42	2.3	-3.2	2.8	1.4	2.3	3.4	1.1	11.4
Banking Sector Loans	22.8	28.8	5.7	-12.7	0.5	1.1	3.6	5.4	20.6	24.2

(1) 2008 -2013 year-end change or change as of 2008- latest data
Source: IMF Global Financial Stability Report

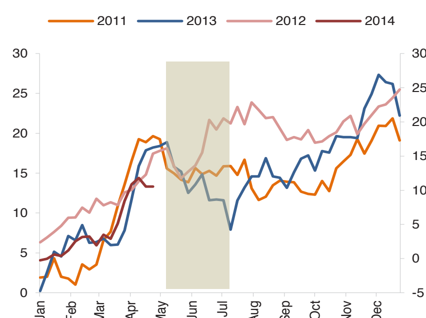
I.2 Domestic Developments

The global uncertainties pertaining to monetary policies, weak capital flows towards emerging economies, uncertainties in the first quarter and the resulting rise in risk premiums in national markets have been the main factors affecting Turkey's economic outlook. Meanwhile, exchange rate movements, the relative deterioration in the inflation outlook and volatility in financial markets have been the factors affecting the outlook of macro-financial stability. However, there has been a partial decline in the volatility in financial markets as well as in the risk premium, bolstered by the sustained cautious stance in the monetary policy and abated uncertainties.

The decline in capital flows to emerging economies continued due to the uncertainties pertaining to global monetary policies and the relatively low growth rates of emerging markets. In the first quarter, capital flows remained limited as the Fed continued to gradually trim asset purchases and postponed rate hikes while the prevailing monetary policy framework was retained in the euro area. Although Turkey experienced portfolio outflows mainly due to elevated uncertainties and the rise in risk premium in the first quarter, recently, there has been some acceleration in portfolio inflows on account of the tight monetary policy stance and the eased uncertainties in the national economy, but the amount of inflows is still lower than those in the past years (Chart I.2.1).

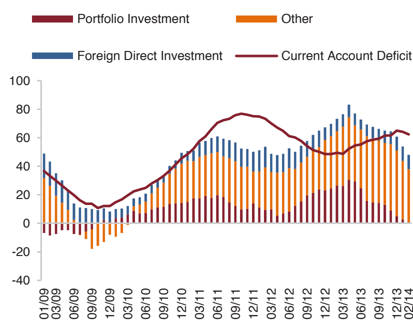
Measures taken towards rebalancing the current account deficit have started to yield results. The recent non-accommodative monetary policy stance, the tightening in financial conditions and the macroprudential measures taken have helped achieve reasonable levels in credit growth and the demand for imports have decreased pinned by the general deceleration in the domestic private sector demand. Meanwhile, external demand and exchange rates are supporting exports and net exports is contributing to growth. The current account deficit financing is balanced (Chart I.2.2).

Chart I.2.1
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 I.2.2
Current Account Deficit and Financing Items[1]
(12-Month Cumulative Billion USD)

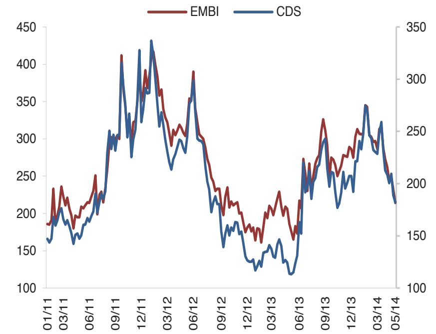


(1) Portfolio includes equities and government domestic debt securities. Other is composed of the total of short and long-term net loans of banks and other sectors, bonds issued abroad by banks and the Treasury, and deposits at banks.
Source: CBRT

Uncertainties in global financial markets and the elevated risk premiums led to fluctuations in nominal exchange rates over the last year (Chart I.2.3). The depreciation in the Turkish lira became more remarkable with the Fed's exit signals from its quantitative easing policy as of May 2013. The uncertainties in the domestic market at the end of 2013 led to a second depreciation episode and a rise in volatility in Turkey. Nevertheless, owing to the front-loaded non-accommodative monetary policy steps taken and the signals of normalization in global markets, the Turkish lira appreciated and the implied volatility decreased (Chart I.2.4 and I.2.5). The normalization in global markets, the sustained cautious stance of the monetary policy and an exchange rate level that is stable and consistent with economic fundamentals are expected to contribute to financial stability in the upcoming period.

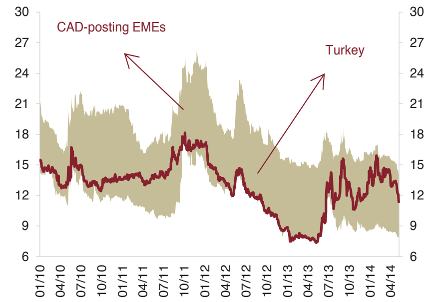
The nominal exchange rates, which followed a moderate trend from end-2012 till the first quarter of 2013, started an uptrend as of April 2013. This uptrend was reversed after the MPC decisions of 28 January 2014 and dropped to the end-2013 values by mid- May in 2014. In line with these developments in nominal exchange rates, the downtrend in real effective exchange rates observed since April 2013 was replaced by an uptrend as of January 2014. An overall analysis of the period -excluding the recent move that is likely to be temporary- suggests that the developments in real effective exchange rates and the recovery in external demand will contribute to the narrowing of current account deficit and support economic growth (Chart I.2.6 and I.2.7).

Chart I.2.3
EMBI-Turkey and Turkey's 5-Year CDS Prices



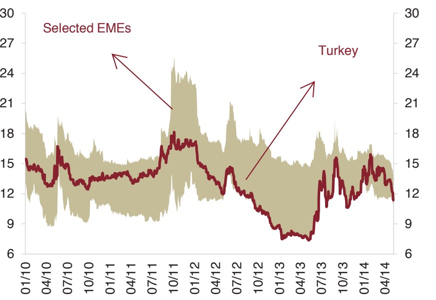
Source: Bloomberg

Chart I.2.4
Implied Volatility of Exchange Rates[1]
(12-Month Ahead)



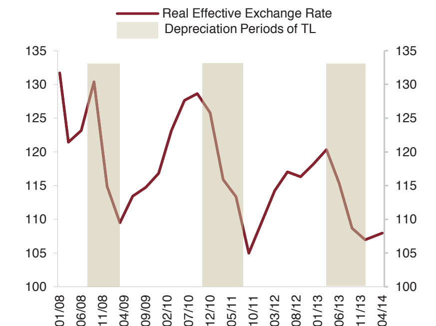
(1) Emerging economies posting current account deficits include Brazil, Czech Republic Indonesia, South Africa, Colombia, Hungary, Mexico, Poland, Romania, Chile and Turkey
Source: Bloomberg

Chart I.2.5
Implied Volatility of Exchange Rates[1]
(12-Month Ahead)



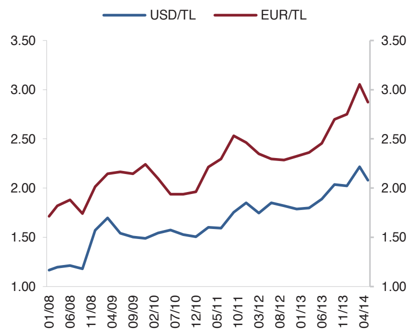
1) Selected emerging economies include Brazil, Indonesia, South Africa, India and Turkey.
Source: Bloomberg

Chart I.2.6
Real Effective Exchange Rate
(CPI-based, 2003=100)



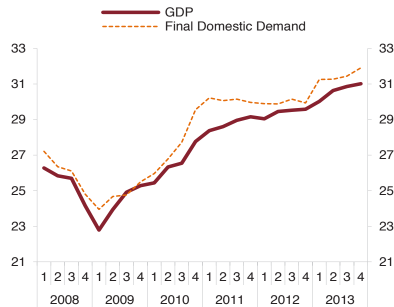
Source: CBRT.

Chart I.2.7
Nominal Exchange Rate
(CPI-based, 2003=100)



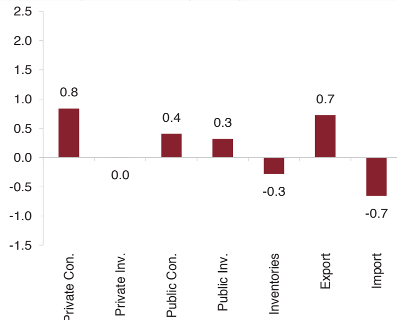
Source: CBRT.

Chart I.2.8
GDP and Final Domestic Demand
(Seasonally Adjusted, Billion TL, Deflated by 1998 prices)



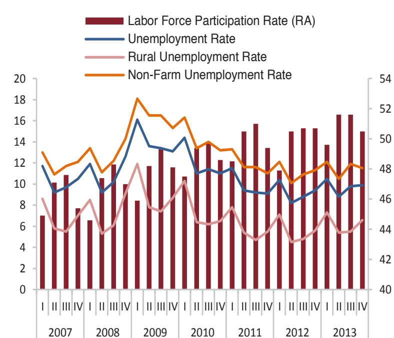
Source: CBRT, TURKSTAT.

Chart I.2.9
Contributions to Quarterly GDP Growth
(Seasonally Adjusted, Percentage Point)



Source: CBRT, TURKSTAT.

Chart I.2.10
Unemployment and Labor Force Participation Rates



Source: TURKSTAT

The GDP, which grew by 4.4 percent in the final quarter of 2013 year-on-year, grew by 4 percent in 2013 in annual terms. While economic growth continued in the final quarter of 2013, albeit with some deceleration, the rise in final domestic demand slightly accelerated (Chart I.2.8). Data pertaining to the final quarter of 2013 suggest that the moderate rise in economic activity continues. A study of the components of economic activity indicates that private sector demand decreases. The decrease in the private sector demand mainly stems from private sector investments. Meanwhile, net exports and public demand are projected to compensate for the decrease in domestic private demand (Chart I.2.9). Public demand supports both consumption and investment demand. Should the downside risks on domestic demand continue for an extended period, those risks would support the disinflation process and contribute to the recent improvement in current account deficit. The weak private sector demand would also help attain reasonable growth rates in credit demand.

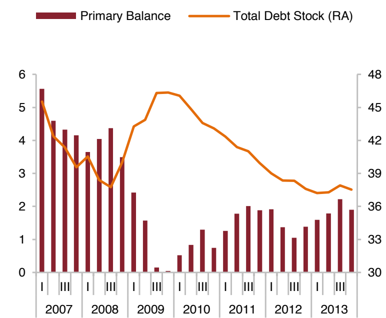
The positive trend in employment and unemployment indicators, which are important for the general economic outlook and macro-financial stability, continues. In the second quarter of 2013, unemployment ratios declined owing to the rise in non-farm employment observed as of the first quarter of 2013. The unemployment ratio reached the highest level of the year in the third quarter of 2013 on the back of the rise in rural and non-farm unemployment. In the final quarter of 2013, unemployment ratios remained almost the same as non-farm unemployment were unchanged quarter-on-quarter. There has been a significant improvement in total employment mainly due to the rise in non-farm employment and the relatively high level of labor force participation rates continued. Pulled by the positive development in employment ratios, unemployment continued to hover below 10 percent (Chart I.2.10).

The favorable outlook in the budget performance and public debt stock continues. Despite the partial deterioration in the general economic outlook, the public sector budget balance and the public debt stock indicators have a positive outlook. The downtrend in the ratio of the EU-defined nominal debt stock to GDP continues, the extension in maturities of debts continues and there is no significant change in the composition of the debt stock (Chart I.2.11 and I.2.12).

Recently, the upward risks to inflation became the primary factor in the course of key indicators pertaining to the national economic outlook and determining the monetary policy stance. The depreciation in the Turkish lira especially in the first quarter led to a rise in the core goods prices and, in turn, high inflation rates (Chart I.2.13). Moreover, the upward movement in food prices stemming from adverse weather conditions resulted in a partial deterioration in the inflation trend as well as in expectations. This change in inflation and expectations also influenced the pricing of financial assets; however, the tight monetary policy stance and expectations for a likely decline in inflation pressure brought along a partial correction in financial markets.

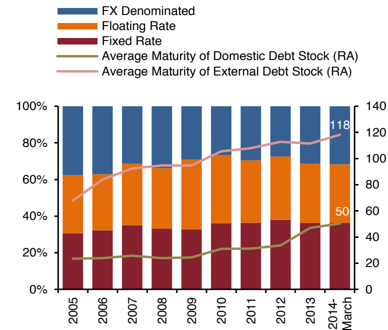
The tight monetary stance coupled with the recent improvement in risk premiums helped decrease interest rates across all maturities and achieve a flatter yield curve (Chart I.2.14).

Chart I.2.11
Central Government Budget Balance-Debt Stock
(Annualized, Ratio to GDP, %)



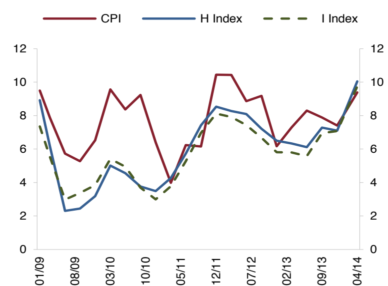
Source: Undersecretariat of Treasury, Ministry of Finance

Chart I.2.12
Composition of Central Government Debt Stock and Average Days to Maturity [1] (Month)



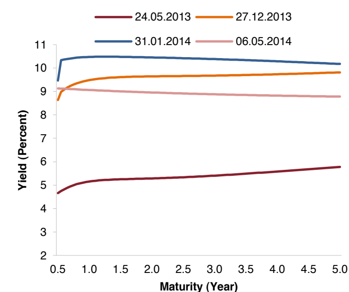
Source: Undersecretariat of Treasury.

Chart I.2.13
Price Indices (Annual Percentage Change)



Source: TURKSTAT.

Chart I.2.14
GDDS Yield Curve[1]
(Percent)



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