II. Macroeconomic Outlook

The development of the coronavirus outbreak into a pandemic has significantly weakened the global growth outlook, while uncertainties over the recovery remain high. Pandemic-related developments and uncertainties have resulted in a tightening in global financial conditions, a decline in global risk appetite and an increase in international market volatility since February 2020, and led to significant portfolio outflows from EMDEs. With increased concerns over the global growth outlook, central banks of advanced economies and EMDEs adopted accommodative monetary policies through rate cuts, asset purchases and macroprudential tools to facilitate effective functioning of the financial system. The policy measures have contributed to the decline in excessive volatilities in global markets in the early periods of the pandemic. Meanwhile, the uncertainty about the duration of the pandemic and of the isolation measures introduced to prevent the spread of the coronavirus outbreak, the weakening global economic activity, the persistently high levels of indebtedness in both advanced and emerging economies, and the weak outlook for banking sector profitability pose significant risks to financial stability.

Stronger capital and liquidity positions of the global banking system and the monitoring framework set up for non-bank financial intermediation activities as a result of comprehensive reforms implemented after the 2008 Global Financial Crisis, have been the main factors that contributed to the resilience of the global financial system against the effects of the pandemic. During this period, it is critical to maintain a balance between ensuring effective financial intermediation activities by financial corporations through comprehensive expansionary monetary policies, supportive fiscal policies, flexibilities in the regulatory framework and preserving the achievements gained by the post-crisis reforms. Moreover, it is important that countries act in cooperation and coordination to counter the pandemic and its adverse impacts. In this context, led by the G20 and coordinated by the Financial Stability Board (FSB), countries' policy implementations are closely monitored, and intensive studies are being carried out to analyze the effects of the pandemic on global financial stability and economic activity.

Economic activity in Turkey remained strong in January and February 2020. However, the coronavirus pandemic is expected to have a significant contractionary effect on economic activity and labor market in the second quarter of the year. Additionally, the pandemic-driven uncertainties on interrupted international transport, global supply chains, trade networks and on global economic activity that has weakened and almost come to a halt in some sectors, may temporarily restrain export and tourism opportunities in the period ahead. That said, domestic demand conditions restrain imports, and accompanied by the recent fall in crude oil prices, support the current account balance. Despite the depreciation in the Turkish lira in line with global developments, inflation expectations and aggregate demand conditions as well as commodity prices are supportive of the inflation outlook. The recent monetary and fiscal measures implemented to contain the adverse effects of the pandemic-related developments on the Turkish economy are expected to contribute to financial stability and post-pandemic recovery by supporting the production potential of the economy.

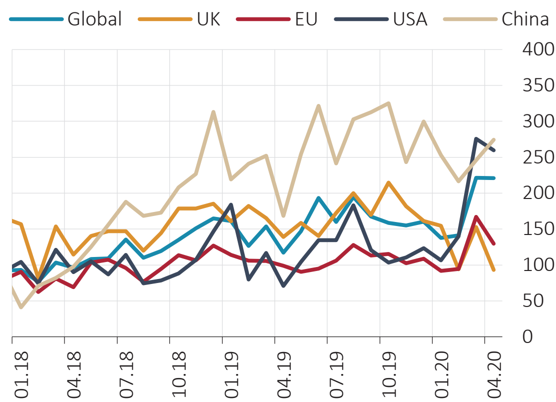
II.1 International Developments

The global economic policy uncertainty that had declined in the first month of 2020 thanks to positive developments in global trade policies increased significantly in March over concerns related to the global growth outlook and tightening financial conditions as the coronavirus outbreak turned into a pandemic (Chart II.1.1). The noticeable weakening in global economic activity and growth outlook as well as global lockdown measures reduced the predictability of economic policies of advanced economies and EMDEs. Economic policy uncertainty of the United States of America (USA) rose sharply in this period. In the period during which the coronavirus outbreak evolved into a pandemic, the European Union's (EU) economic policy uncertainty, which had been on a moderate course, increased after February. Meanwhile, although the UK policy uncertainty has been declining over the last Report period, this is mainly attributable to Brexit, which took place on 31 January 2020. On the other hand, China's economic policy predictability is fluctuating depending on the impact of the pandemic-driven shock on global supply chains and trade, along with the tightening in global financial conditions.

The Federal Reserve (Fed), which had delivered three rate cuts that amount to a total of 75 bp in 2019 over concerns related to global growth, cut its policy rate two times by 50 bp and 100 bp, respectively, to bring it in the range of 0 to 0.25% in March 2020 as the pandemic-led economic and financial conditions changed economic activity and the growth outlook. Market expectations suggest that the policy rate will remain at low levels for a long period of time (Chart II.1.2). However, the Fed announced an extensive and sizeable asset purchase policy to ensure continuation of an effective credit intermediation activity by financial markets. Moreover, it engaged in currency swaps with a number of central banks including those of EMDEs to meet the US dollar-denominated funding need in external markets.

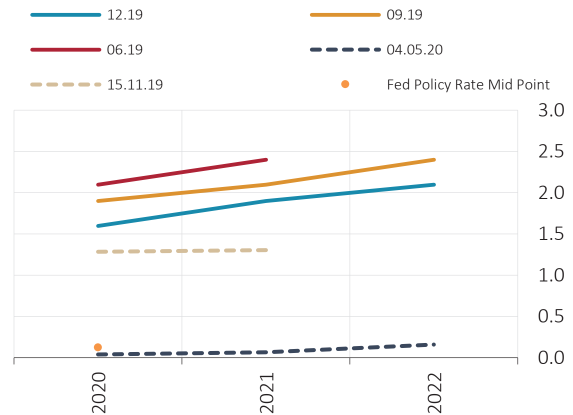
Driven by the pandemic, financial conditions in the euro area have also tightened significantly due to unexpected price movements in equity, bond, currency and money markets. In the face of unusual volatility and liquidity crunch, the European Central Bank (ECB) took major steps geared towards the banking sector in order for financial markets operate smoothly and to support the most severely-affected firms and households. In this context, as a part of the asset purchase program that it had restarted in November 2019, the ECB engaged in temporary additional purchases in March 2020 and launched its Pandemic Emergency Purchase Programme of EUR 750 billion. The 6.8% annual contraction of the Chinese economy in the first quarter of the year marked the first episode of quarterly contraction seen since 1992. China's Central Bank implemented an expansionary monetary policy through injecting liquidity into the financial system by reducing lending, particularly the RR ratios. Likewise, the Bank of Japan expanded its asset purchase policy to secure uninterrupted operation of financial intermediation. The Bank of England, on the other hand, cut its policy rate for the first time since 2016 and announced that it would provide direct financing to the UK Treasury temporarily.

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



Source: Bloomberg Last Observation: 04.20
Note: Indices are not comparable in terms of level.

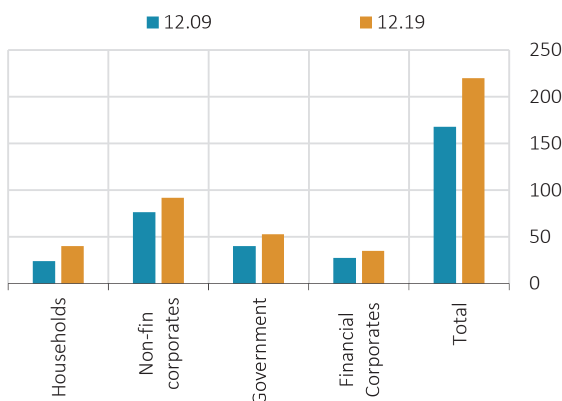
Chart II.1.2: Median Policy Rate Forecasts of FOMC Members (Solid Lines) and Market Expectations (Dashed Lines) (%)



Source: Bloomberg Last Observation: 04.05.20
Note: Dashed lines indicate 30-day Fed fund futures implied rates.

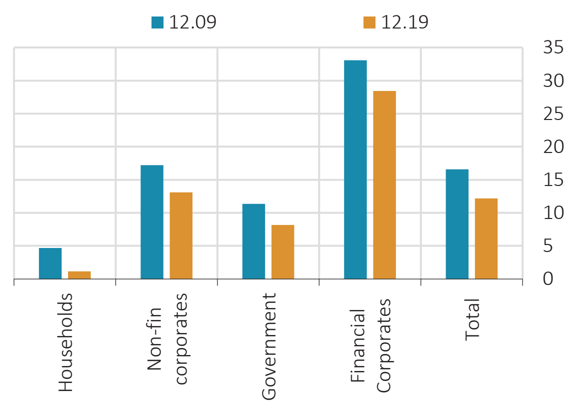
Due to the coronavirus pandemic, global economic activity contracted, global financial conditions tightened making it harder to access financing, and corporate insolvency as well as unemployment rates became more likely to increase. As a result, corporate sector and public sector indebtedness, which had been a key source of fragility in advanced economies and EMDEs before the coronavirus pandemic, became a focal risk to financial stability (Chart II.1.3). In this context, private sector cash flows, the maturity and currency structure of liabilities, as well as the effectiveness of government incentives are the main factors that need to be monitored closely. FX indebtedness in EMDEs showed a decline in response to the limitations introduced on FX borrowing, particularly on household FX borrowing, after the Global Financial Crisis (Chart II.1.4). Policy instruments such as currency swaps between central banks may also contain risks arising from FX indebtedness.

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



Source: IIF Last Observation: 12.19
Note: Average is calculated based on countries' GDP weights. EMDEs: 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.

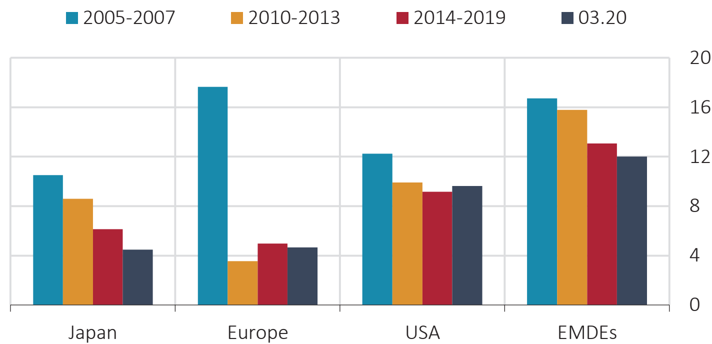
Chart II.1.4: Sector-Based FX Borrowing in EMDEs (% of Total Borrowing)



Source: IIF Last Observation: 12.19
Note: EMDEs: Argentina, Brazil, Chile, China, Colombia, Czechia, Hong Kong, Hungary, India, Indonesia, Israel, South Korea, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand, Turkey and Ukraine.

Despite expansionary monetary policies implemented worldwide in response to the coronavirus pandemic, the flat course of the yield curve and the deteriorating growth outlook have significant implications on countries’ financial sectors. The recent contraction in economic activity and tightening of the financial conditions, corporate sector debt restructuring demands and increased credit risk caused by likely downgrades in corporate credit ratings may cause NPLs to increase noticeably. The asset quality that may deteriorate as a result of likely NPL increases and a protracted low course in interest rates further depress the banking sector’s return on equities that is already hovering at low levels compared to the pre-global financial crisis period (Chart II.1.5).

Chart II.1.5: Banks’ Return on Equities (%)

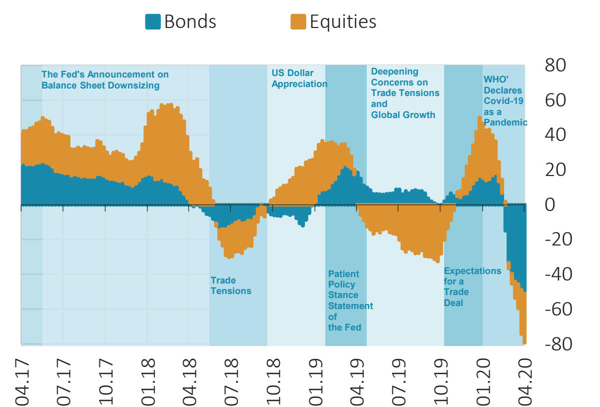


Source: Bloomberg Last Observation: 03.20

Note: Tokyo Stock Exchange TOPIX Banks Index, Bloomberg European 500 Banks and Financial Services Index, S&P 500 Banks Industry Group Index, MSCI EM Banks Index used.

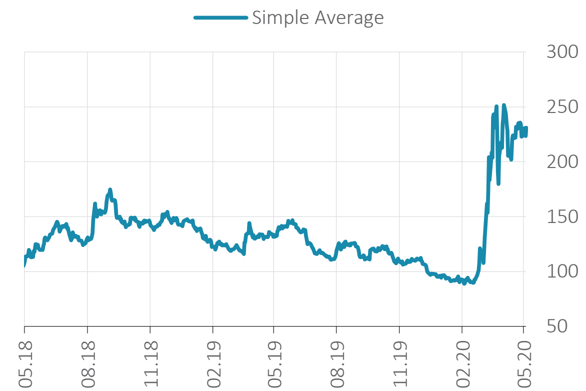
Expectations of global stagnation, the unusual decline in oil prices and the global risk-averse tendency caused portfolio outflows of large amounts from EME bond and equity markets (Chart II.1.6). The decline in global risk appetite and investors flight towards assets considered safe haven have put an upward pressure on EME risk premiums (Chart II.1.7).

Chart II.1.6: Weekly Capital Flows to EMEs (13-Week Cumulative, USD Billion)



Source: EPFR Last Observation: 29.04.20

Chart II.1.7: CDS Premiums in Emerging Economies (Basis Points)



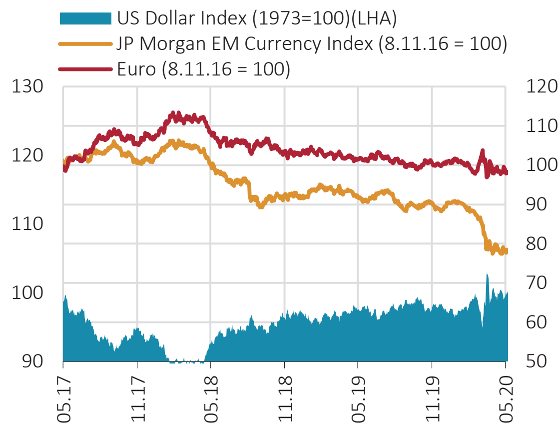
Source: Bloomberg Last Observation: 04.05.20

Note: Emerging economies include Brazil, Czechia, Indonesia, S. Africa, Colombia, Hungary, Poland, Romania, Turkey and Chile.

Trade and economic activity came to a standstill across the globe, causing a significant decline in energy consumption and oil demand. As a result, because of the oil price decline and the oil market volatility,

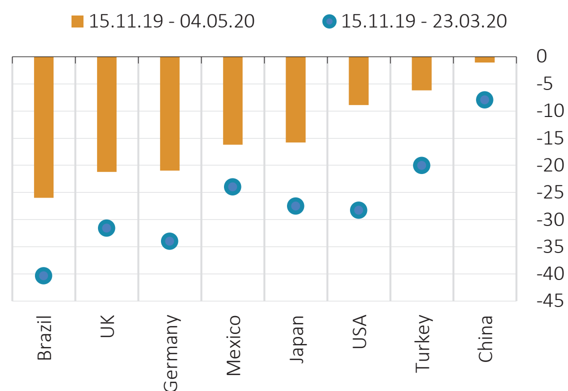
currencies of oil exporting EMDEs depreciated significantly against the US dollar, while a limited depreciation was observed in the currencies of EMDEs that are less vulnerable against the developments of the external markets and that can intervene against volatilities in their own currencies through FX market transactions and macroprudential policy tools. Currency swap agreements concluded with other advanced country central banks, especially with the Fed, would help to mitigate the liquidity risk and reduce the pressure on EMDE currencies. In this period, currencies of advanced economies show fluctuations (Chart II.1.8). The diminished risk appetite, tighter financial conditions and further liquidity need caused significant falls in advanced economy and EMDE stock indices despite a partial recovery seen in those in the recent period (Chart II.1.9).

Chart II.1.8: Exchange Rate Increases (Index)



Source: Bloomberg Last Observation: 04.05.20

Chart II.1.9: Stock Indices (% Change)

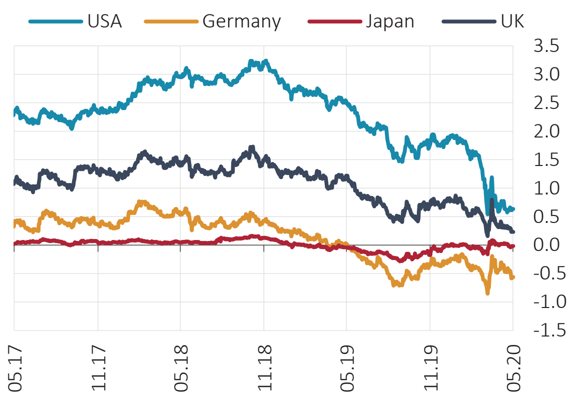


Source: Bloomberg Last Observation: 04.05.20

Note: Turkey - BIST100, Germany DAX, UK – FTSE 100, Mexico – IPC, Japan – Nikkei 225, China - Shanghai Composite, USA – S&P 500, Brazil – IBOV indices used.

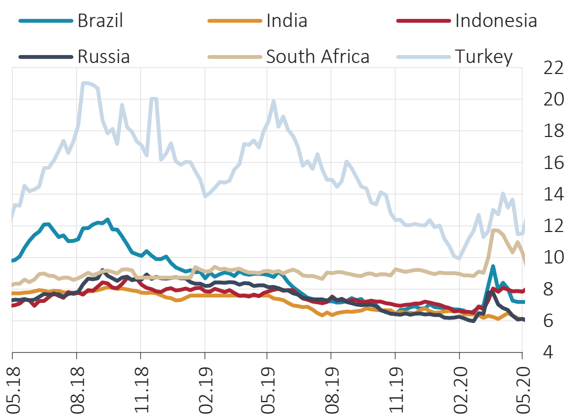
With the expansionary monetary policies, increased risk-averse behavior due to the coronavirus pandemic and the heightened uncertainty over the future decline trend in long-term bond returns of advanced economies, particularly in the US and Germany, became more pronounced in the current Report period (Chart II.1.10). Bond returns in Germany and Japan continue to hover at negative levels in response to the market expectations regarding inflation and growth. EMDE bond returns remain volatile on account of the decline in global risk appetite (Chart II.1.11).

Chart II.1.10: 10-Year Treasury Bond Returns in Advanced Economies (%)



Source: Bloomberg Last Observation: 04.05.20

Chart II.1.11: 10-Year Treasury Bond Returns in EMDEs (%)

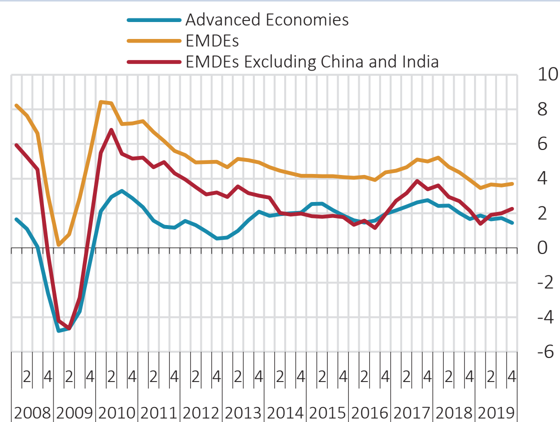


Source: Bloomberg Last Observation: 01.05.20

Global economic activity underperformed at end-2019 despite a partial recovery in EMDEs (Chart II.1.12). In the first quarter of 2020, though, the global growth outlook deteriorated significantly due to adverse

effects of lockdown measures. Leading indicators of growth point to a significant weakening in production in general across advanced economies with the EU and the US in the lead and in EMDEs excluding China (Chart II.1.13). Despite the contraction seen in the first quarter of the year, the sharp contraction, which was expected to prevail yearlong during the period in which China was impacted by the coronavirus, has been replaced by a moderate growth outlook.

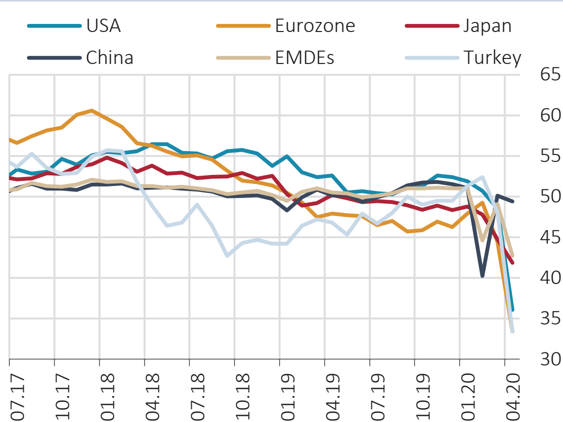
Chart II.1.12: Y-o-Y Growth Rates in Advanced Economies and EMDEs (%)



Source: Bloomberg, CBRT Last Observation: 12.19

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

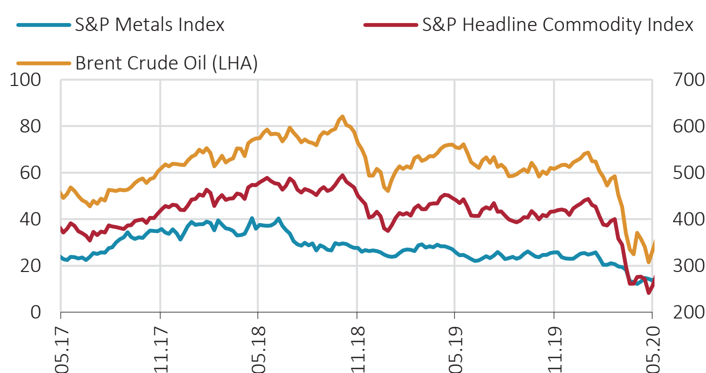
Chart II.1.13: Manufacturing Industry PMI (Index)



Source: Bloomberg, CBRT Last Observation: 04.20

The global supply and demand shock led by the coronavirus caused a significant fall in commodity prices (Chart II.1.14). Despite the oil cut agreement of the Organization of the Petroleum Exporting Countries (OPEC) that is equivalent to approximately 10% of the global supply, the significant weakening in the global growth outlook drove oil prices down. Moreover, the abstention from oil storage and transport costs primarily among US producers, led to unprecedented negative fluctuations in some WTI oil contracts that were close to falling due.

Chart II.1.14: Commodity Indices (USD, Index)



Source: Bloomberg Last Observation: 01.05.20

Currently, the duration of isolation measures introduced to prevent the spread of the outbreak, the weakening in global economic activity, the likelihood of a deterioration in credit and liquidity channels, and the persistently high levels of indebtedness in both advanced and emerging economies pose a significant risk to financial stability. Uncertainties regarding the course and duration of the pandemic will be determinants on financial stability. Nevertheless, stronger capital and liquidity positions of the global

banking system as a result of comprehensive reforms implemented after the Global Financial Crisis, and the monitoring framework set up for non-bank financial intermediation activities have been the main factors that contributed to the resilience of the global financial system to the effects of the pandemic.

Central banks implement coordinated expansionary monetary policies to contain the adverse effects of the pandemic on the global economy, while governments take measures through fiscal policies.. Among expansionary monetary policy actions, in addition to conventional methods such as policy rate cuts, unconventional methods have also been implemented such as diversification of asset purchase programs as well as the assets pledged as collateral, and, as in the case of the UK, direct financing of the Treasury temporarily. Among fiscal policy measures, direct supports, tax reductions and debt relief programs can be cited. Meanwhile, a wide range of actions has also been taken regarding the regulatory and supervisory framework. (Box II.1.I). It is critical to maintain a balance between ensuring an effective financial intermediation by financial corporations and preserving the achievements gained by the post-Global Financial Crisis reforms. With measures taken to counter the pandemic and its adverse effects, it is important that national and international authorities be prepared against existing risks as well as potential new ones and act in cooperation during this process. Upon the spread of the pandemic, led by the G20 and coordinated by the FSB, countries' policy implementations are closely monitored and intensive studies are being carried out to analyze the effects of the pandemic on global economic activity,with a focus on the corporate sector, and global financial stability.

Box II.1.I

Policy Measures Taken Against the Coronavirus Outbreak and Their Global Financial Stability Implications

Introduction

After the World Health Organization declared the coronavirus outbreak a pandemic, many countries and international bodies, such as the Financial Stability Board (FSB) and the Bank for International Settlements (BIS) in particular, introduced a wide range of measures (monetary, fiscal and macroprudential) to minimize the impact of the pandemic on financial stability. Liquidity support to markets and financial institutions, policy rate cut decisions, and asset purchase programs introduced by central banks, fiscal support packages for firms and households introduced by governments, and the regulatory flexibility provided to the financial sector by regulatory and supervisory authorities are among the prominent measures taken to fight against the economic and financial implications of the pandemic. In this box, we first summarize the impact of the pandemic on global financial markets. Then we examine the measures introduced, and evaluate the implications of the pandemic and of these measures for financial stability as well as the potential risks they may create in terms of credit risk, interconnectedness, contagion and financial infrastructure.

When the coronavirus outbreak first emerged in China at the end of 2019, its severity and possible implications could not be captured by global financial markets at first. However, with the rapid spread of the outbreak in Italy, Spain and the US towards the end of February, markets started reacting sharply. A look at the first-round effects of the outbreak on global financial markets reveals that it led to substantial falls in prices of high-yield bonds in particular and large losses in security exchanges. Due to the sharp decline in the risk appetite and increased cash demand, equity and fixed-income markets witnessed outflows and a consequent shift to short-term safe assets was monitored. Amid increased uncertainty during this process, there were early redemption demands from investors and outflows from funding markets. To meet increased demands for redemptions, many funds had to sell off their liquid assets. Concurrent with the fall in commodity prices, decline in market liquidity and heightened market volatility, EMEs saw large portfolio outflows and accordingly, US dollar funding strains came to the front. Exchange rate pressures, weak health systems, and the narrow fiscal policy room for maneuver were the prominent vulnerability factors for these countries.

Liquidity strains in the international markets increased the costs and volatility in US dollar funding markets in particular. This placed additional burdens on financial institutions that depend on those markets for funding sources rather than on deposits, due to the declines in the value of collaterals required to access funding in this market.

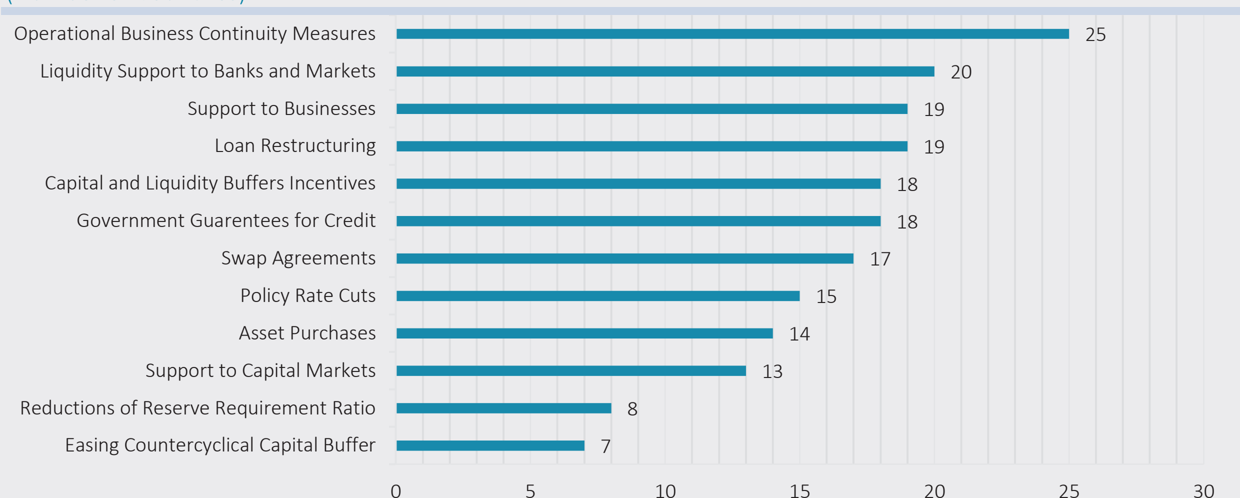
Despite differences across countries and sectors, access to funding has become a significant problem for many countries and sectors. In this period, firms and households recorded sharp declines in their cash flows, and firms' capacity to roll over debt weakened. Firms' increased demand for credits to meet their funding need and tightened financial conditions drove up the financing costs.

Policy Measures Taken to Maintain Financial Stability

Many countries and international bodies took steps to ensure the flow of fund transfers from financial markets to the real economy by supporting the credit intermediation activities. During this process, central banks and other regulatory authorities acted promptly to minimize the impact of

the pandemic on financial markets and the corporate sector through broad sets of measures, led by policy rate cut decisions and liquidity support in particular. Among these measures are the liquidity support to markets and banks via various channels, swap lines among central banks, asset purchases, providing banks with flexibility to use capital and liquidity buffers, release of countercyclical capital buffers, and reductions of reserve requirement ratios (Chart II.1.I.1).

Chart II.1.I.1: Distribution of Policy Measures Taken in Response to the Coronavirus Outbreak in Selected Countries
(Number of Countries)



Sources: FSB, IMF Policy Tracker Data Set, websites of central banks Last Observation: 04.20

(I) Operational business continuity measures include business continuity plansand reducing operational burdens such as reporting and supervisory activities.
(II) Support to businesses policies include countries implementing any arrangement such as corporate tax reduction, wage subsidies, tax relief and deferral of tax payment, low-interest loans, cash support, and direct aid (grants) to affected businesses.
(III) Support to the functioning of capital markets includes measures such as short selling bans and circuit breakers.
(IV) Measures in the Euro Area include measures taken by all the jurisdictions that are members of the Euro Area or by the ECB.

The most intensely employed policy measures by countries are shown in the Annex table (Table II.1.I.1). These measures include steps to reduce the operational burdens in addition to business continuity measures aimed at boosting operational resilience, providing liquidity support to markets or financial institutions, restructuring of loan terms, and support packages for businesses in various forms. Monetary and fiscal policy measures are employed concurrently with regulatory measures. Standing as another widely used instrument during this process, policy rate cuts were delivered to support growth and employment predominantly by bolstering consumer confidence and reducing the financing cost. At this stage, it is notable that the functioning of the credit channel through financial institutions was on the forefront of the measures while possible secondary effects on banks' balance sheets due to increased credit risk were put on the back burner.

Selective credit support for businesses was launched in the form of providing loans to SMEs in certain sectors – tourism, food and transport in particular – via banks after the pandemic. In many countries, risk weights for sectoral loans were reduced to support banks' capital adequacy, particularly for sectors related to the manufacturing of medicines and medical supplies. Postponement of installment payments of SME loans and long-term housing loans to underpin the payment capacity of borrowers, extension of debt repayments, and reduction of fees and commissions for new utilizations of these loans are among other measures introduced. In addition, credit card limits were increased and interest rates and fees for credit card spending were reduced to relieve households.

To mitigate a likely market liquidity risk caused by the demand for the US dollar so that it will not affect all markets via triggering panic selling, swap lines were activated among central banks of 17[1] countries, thereby establishing mechanisms that will allow these countries to access US dollar liquidity swiftly in case of need. Many of these countries have not used currency swap limits so far but the environment of confidence created by the availability of this facility is intended to decrease the volatility in the markets.

During the pandemic, a number of amendments were made to ease the regulatory framework that banks are subject to. In this context, several changes were introduced such as providing flexibility for capital and liquidity liabilities, lowering the countercyclical capital buffer to zero or reducing it, and confirming that it will not be increased for a while. The Bank of England lowered the countercyclical capital buffer rate to 0%, which was 2% in December 2019, to support banks' loan supply conditions, and pledged that it would maintain this rate for at least 12 months.[2] On the other hand, many countries reduced the credit risk weights and encouraged banks to extend more loans with the excess capital released by the reduction of risk weights. In addition, banks' FX reserve requirement (RR) ratios were cut to maintain FX liquidity in the market.

Many central banks in advanced countries also took several measures to mitigate the impact of the pandemic on financial markets. Purchases of government bonds constitute another measure introduced by central banks to alleviate the impact of possible capital outflows from bond markets. As announced on 17 and 18 March 2020, the Fed established a Primary Dealer Credit Facility (PDCF), a Commercial Paper Funding Facility (CPFF), and a Money Market Mutual Fund Liquidity Facility (MMLF) to meet the credit needs of households and businesses. Accordingly, primary dealers were offered a funding facility, and issuers of credits for households and businesses were provided with a liquidity backstop through a special purpose vehicle (SPV). These measures that the Fed introduced as part of a clear plan were intended to support the cash flows and debt repayment capacities of households and firms as well as to increase the functioning of and liquidity in short-term funding markets. Moreover, to prevent market liquidity problems from triggering a new wave of panic selling, the Federal Reserve Bank of Boston started to make loans available to eligible financial institutions secured by high-quality assets purchased by the financial institution from money market mutual funds.[3]

The ECB temporarily allowed supervised banks to fully use capital and liquidity buffers to ensure that they can continue to fulfil their role in funding the real economy. Accordingly, the ECB eased the level of capital, the capital conservation buffer and the liquidity coverage ratio for banks. The ECB also stated that it expected banks to use the excess capital coming up from these measures to support the real economy, and also expected them to limit their dividend distributions.[4] Meanwhile, the European Banking Authority (EBA) decided to postpone the 2020 EBA stress test for EU banks. Additionally, countries such as the UK, Germany and France also launched funding schemes to support the non-bank financial sector. The majority of these schemes were designed to address FinTech companies.

Besides countries, international organizations also introduced some measures and provided various recommendations to counter the coronavirus outbreak. The communiqué released following the virtual meeting of the G20 Finance Ministers and Central Bank Governors held on 15 April 2020 stated that all available policy tools could be used to support the global economy, boost confidence, maintain financial stability and prevent deep economic effects. At the meeting, finance

[1] Total of swap lines established with the Fed and swap arrangements among other central banks.
[2] https://www.bankofengland.co.uk/news/2020/march/boe-measures-to-respond-to-the-economic-shock-from-COVID-19
https://www.bankofengland.co.uk/markets/market-notices/2020/term-funding-scheme-market-notice-mar-2020
[3] https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm and https://www.newyorkfed.org/markets/opolicy/operating_policy_200312a
[4] https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200312~45417d8643.en.html

ministers and central bank governors also endorsed the G20 Action Plan that sets out the key principles for measures taken in response to the COVID-19 pandemic.

The FSB is contributing to the assessment of risks and vulnerabilities by ensuring continuous sharing of information about risks to financial stability and the measures taken by authorities, and it is contributing to the process by coordinating the measures to be taken to maintain global financial stability. To support highly vulnerable economies, the IMF offered short-term liquidity facilities as well as emergency financing facilities provided through various means such as the rapid credit facility and the rapid financing instrument. Moreover, to enhance exchange of information and experience, the IMF and the OECD published policy measures tracking sets while the BIS started to inform its members of up-to-date developments about policy measures via weekly bulletins.

The Basel Committee on Banking Supervision (BCBS) extended the implementation timeline of the outstanding Basel III standards by one year. Additionally, it emphasized that countries could use capital and liquidity buffers but the gains from post-global financial crisis reforms should be maintained. The BCBS published technical clarifications on how the measures by governments, such as postponement of payments and provision of state guarantees on loans, would be reflected in the calculation of regulatory capital requirements. Accordingly, it was decided that in both the standardized and internal ratings-based approaches for credit risk, the relevant sovereign risk weight should be used for loans subject to sovereign guarantees. In addition, it was announced that the debt payment moratorium periods due to the pandemic could be excluded from the number of days past due set at 90 days for NPLs. The Committee warned that while calculating expected credit losses due to economic difficulties and uncertainty caused by the pandemic, banks should not adopt a mechanistic approach and should take into account long-term economic trends. The Committee and IOSCO also agreed to extend the deadline for completing the final two implementation phases of the margin requirements for non-centrally cleared derivatives by one year to 1 September 2022.

Financial Implications of the Pandemic and Potential Risks

The pandemic brought economic activity to a halt in many sectors due to compulsory quarantine and isolation decisions taken by countries. Financial markets are expected to experience a sharper contraction in global economic activity than during the global financial crisis period. This expected contraction is defined as the biggest economic recession since the Great Depression in 1929 (IMF-WEO, 2020). An announcement by the European Commission put it that mobility restriction measures in EU countries helped reduce the spread of the pandemic but they also created a substantial economic cost that amounted to EUR 3 trillion by April. According to an assessment based on the ratio of policy measures in countries to their 2019 GDP (total of package size, cost of deferrals and liquidity measures), this ratio reached 12.2% in the US, 20.8% in the UK, and 50.1% in Germany.[5]

The first-round effects of the pandemic on financial markets reveal that banking and insurance sectors as well as financial service providers across the globe have not seen a considerable rise in risks yet, whereas risks for portfolio management companies and the corporate sector have increased (IMF-GFSR, 2020). However, being able to predict the second-round effects of the pandemic on credit intermediation activities, portfolio investments, and financial service providers is important. In this context, due to margin calls and the deterioration in cash flows, non-bank financial institutions that operate with funding sources relying on bank funding and/or securitization may face setbacks in their credit intermediation activities that became prominent in the aftermath of the global financial crisis. Fund outflows caused by early redemption demands

[5] https://www.bruegel.org/publications/datasets/covid-national-dataset/. Estimations do not include the volume of asset purchase programs of central banks.

from portfolio investors may increase the contagion risks concerning portfolio management companies and further affect the market liquidity adversely by triggering panic selling. Measures addressing the non-bank sector are very important to prevent vulnerabilities that materialize mostly in the form of liquidity risk in the first phase of the shock from translating into solvency risk in the following phases. The private sector indebtedness has increased by 50% on a global scale since 2008 to USD 72 trillion, which has initiated a debt spiral by negatively affecting the debt rollover capacities of businesses shut down due to the pandemic. This is considered an important risk to financial stability.

On the other hand, although various analyses show that the risk management framework of financial infrastructure providers has been operating well so far without any problem in their liquidity, the heightened concentration risk in central counterparties should not be ignored. It is important to monitor the credit risk carried by central counterparties regarding the risks that may increase through the interconnectedness channel and the counterparty risks that may occur.

Conclusion

To conclude, it is observed that all the relevant authorities in many countries have taken several measures against the pandemic with a broad set of tools, and these measures have contributed to global financial stability by reducing excessive volatilities in the markets as well as supporting the economic activity and employment via the continuation of direct credit intermediation activities. During the period of the pandemic spread, capital outflows from EMEs lost momentum after the introduction of these measures. Although Basel III banking reforms have strengthened the capital structure of banks, improved liquidity management and enabled banks to be more resilient compared to the global financial crisis period, the NPL problem that may arise in corporate sector loans may strain banks' capital and liquidity positions if the pandemic is prolonged. In this context, the second-round effects of the measures taken to counter the increasing vulnerabilities in the corporate sector on banks should be taken into account, and the policy measures should both support economic activity and maintain financial stability in a balanced manner. It is critical that the liquidity created is used in a proportional and selective manner based on the needs of the targeted sectors. The legal requirements that the international banks are subject to and their reluctance to lend abroad may have a negative impact on the loans provided to banks in EMEs. Supporting the effectiveness of the measures with simultaneous health sector measures and fiscal policy measures will continue to be important to contain the risks to financial stability.

References

IMF (2020), “Global Financial Stability Report”, April 2020.

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ANNEX

Table II.1.I.1: Selected Countries' Policy Measures in Response to the Coronavirus Outbreak

	Monetary Policy					Fiscal Policy			Macroprudential Measures		Capital Market	Operational Resilience
	Policy Rate Cuts	Liquidity Support	Swap Lines	Reduction of RR	Asset Purchases	Restructuring of Loan Terms	Support to Businesses (I)	Government Guarantees on Loans	Easing of the Countercyclical Capital Buffer	Encouragement to Use Capital and Liquidity Buffers	Support to Capital Markets Functioning (II)	Operational Business Continuity Measures (III)
US	√	√	√	√	√					√	√	√
Germany		√	√		√	√	√	√	√	√		√
Argentina				√		√		√		√		√
Euro Area (IV)		√	√		√					√		√
Australia	√	√	√		√	√	√			√		√
Brazil	√	√	√	√			√			√	√	√
Indonesia	√	√	√	√	√	√	√	√			√	√
France						√	√	√	√		√	√
S. Africa	√	√			√	√				√	√	√
S. Korea	√	√	√		√	√	√	√		√	√	√
China	√	√		√		√	√					√
India	√	√	√	√	√						√	√
Netherlands						√	√	√				√
Hong Kong	√	√				√		√	√			√
UK	√	√	√		√		√	√	√	√		√
Spain						√	√	√		√	√	√
Switzerland		√	√	√			√	√	√	√		√
Sweden	√	√	√		√	√	√	√	√	√	√	√
Italy						√	√	√			√	
Japan		√	√		√	√	√	√		√	√	√
Canada	√	√	√		√		√	√	√	√	√	√
Mexico	√	√	√			√				√		√
Russia		√	√		√	√	√	√		√		√
Singapore			√			√	√	√		√		√
Saudi Arabia	√	√				√	√	√				√
Turkey	√	√	√	√	√	√	√	√		√	√	√
Total Number of Countries	15	20	17	8	14	19	19	18	7	18	13	25

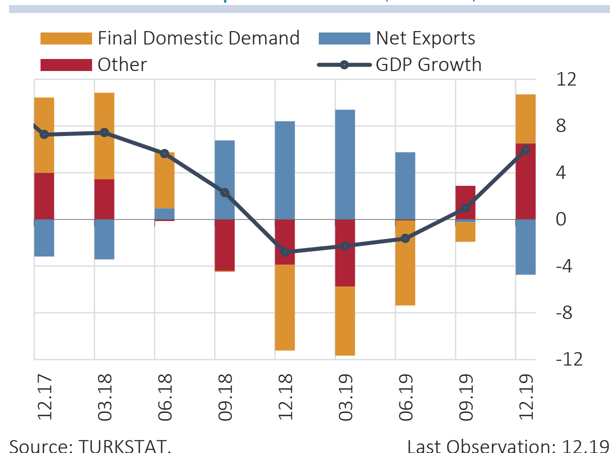
Sources: FSB, IMF Policy Tracker data set, websites of central banks

(I) Support to businesses policies include countries implementing any of the arrangements such as corporate tax reduction, wage subsidies, tax relief and deferral of tax payment, low-interest loans, cash support, and direct aid (grants) to affected businesses.
(II) Support to the functioning of capital markets includes measures such as short selling bans and circuit breakers.
(III) Operational resilience measures include business continuity plans and reducing operational burdens such as reporting and supervisory activities.
(IV) Measures in the Euro Area include measures taken by all the jurisdictions that are members of the Euro Area or by the ECB.

II.2 Main Domestic Macroeconomic Developments

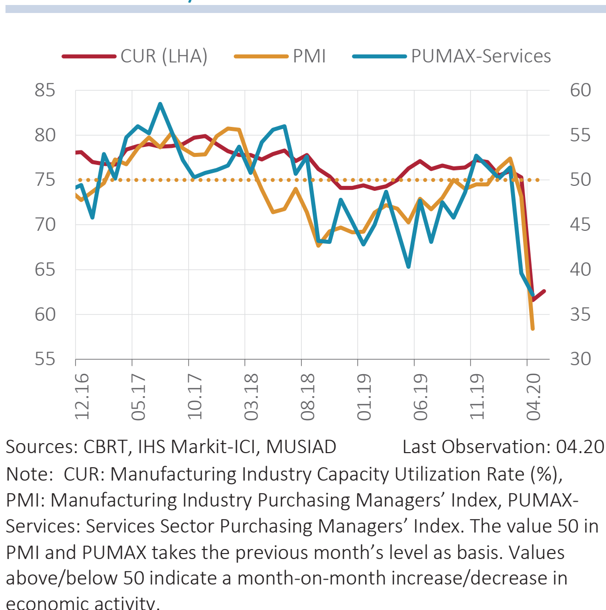
Economic activity displayed a moderate and gradual recovery trend in 2019 and mostly maintained its robust course in the first quarter of 2020, covering the current Report period. Net exports, which significantly contributed to growth in the first half of 2019, had a dampening effect on annual growth in the third and fourth quarters of the year due to the rebound in imports. Meanwhile, domestic demand stood as the main driver of growth on the back of the improvement in financial conditions and the acceleration in loans (Chart II.2.1). Most recent indicators show that the strong course of economic activity also continued in January and February 2020, backed by improved financial conditions (Chart II.2.2). However, as suggested by leading indicators for the manufacturing industry and the services sector that was particularly affected by the pandemic, the coronavirus outbreak is expected to have had a significant dampening effect on economic activity and the labor market as of mid-March through supply and demand channels. As detailed in Section II.1, advanced economies and EMEs introduced expansionary monetary and fiscal measures to counter the marked weakening in global economic activity and growth outlook amid the economic and financial uncertainty caused by the pandemic (Box II.1.I). The recent monetary and fiscal measures implemented in Turkey to contain the adverse effects of the pandemic-related developments are expected to contribute to financial stability and post-pandemic recovery by supporting the production potential of the economy (Box I.1.I).

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



Source: TURKSTAT. Last Observation: 12.19

Chart II.2.2: Selected Leading Indicators Regarding Economic Activity



Sources: CBRT, IHS Markit-ICI, MUSIAD Last Observation: 04.20

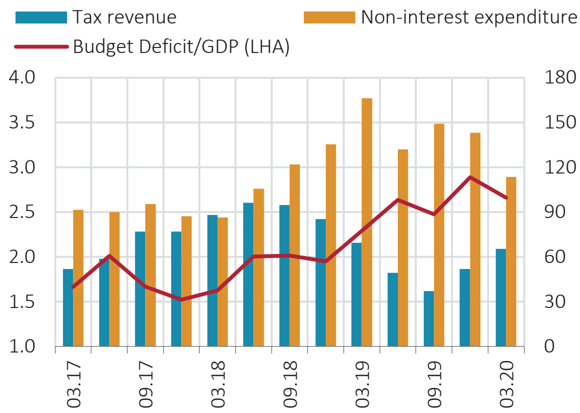
Note: CUR: Manufacturing Industry Capacity Utilization Rate (%), PMI: Manufacturing Industry Purchasing Managers' Index, PUMAX-Services: Services Sector Purchasing Managers' Index. The value 50 in PMI and PUMAX takes the previous month's level as basis. Values above/below 50 indicate a month-on-month increase/decrease in economic activity.

In addition to fiscal incentives and measures that support the recovery in economic activity, the increase in public expenditures was also reflected in budget indicators, with annualized primary expenditures standing significantly above tax revenues since the last quarter of 2018. Consequently, the ratio of budget deficit to GDP, which had been almost flat until late 2018, has tended to increase from 2019 onwards (Chart II.2.3). Due to increased expenditures to mitigate the adverse effects of the pandemic and expected income losses to be driven by the weakened economic activity, the budget deficit is projected to increase significantly in the second quarter of 2020 in particular.

In the labor market where the impacts of economic rebalancing are observed with a lag, the recovery trend became visible as of the third quarter of 2019. The employment incentives and measures coupled with the decline in the labor force participation rate contributed to the fall in unemployment rates in this period (Chart II.2.4). However, the pandemic is projected to affect employment negatively starting from the second quarter of 2020 while measures to maintain employment such as short-time work allowances

and employment oriented loans in particular are expected to curb the adverse effects of suspended activity -especially in the services sector- on the employment market (Boxes III.1.I and IV.1.II).

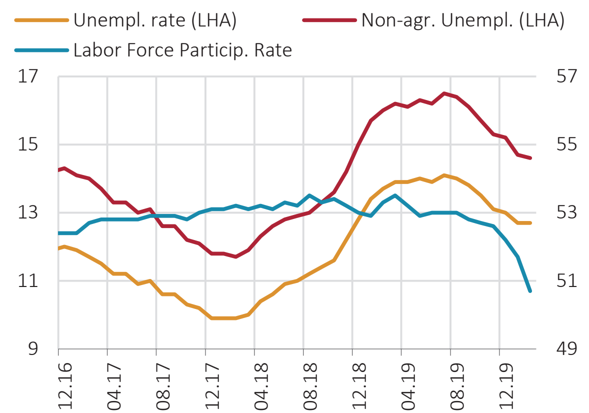
Chart II.2.3: Central Government Budget Indicators (12-Month Cumulative, Billion TL and %)



Source: MTF Last Observation: 03.20

Note: GDP data for 2020Q1 is the CBRT's estimate.

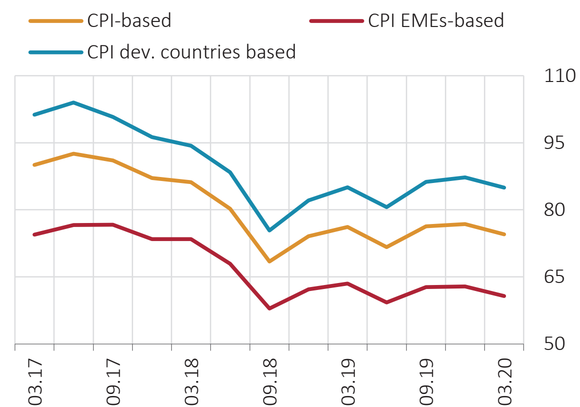
Chart II.2.4: Labor Market (Seasonally Adjusted, %)



Source: TURKSTAT Last Observation: 02.20

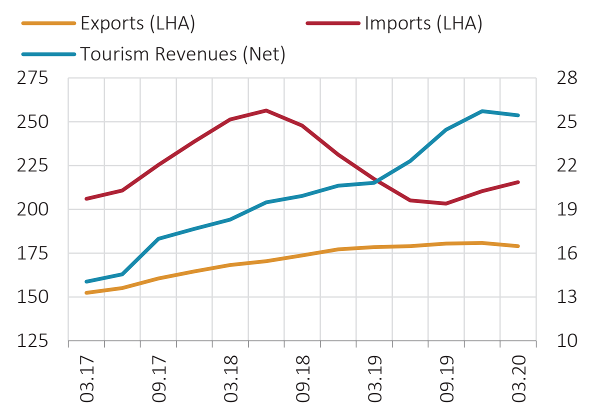
The real depreciation in the TL observed since the second half of 2017 has provided a significant price competitiveness advantage to FX-earning sectors such as exports and tourism (Chart II.2.5). In an environment where the weakening global growth outlook has somewhat slackened external demand, competitiveness gains, exporters' flexibility in diversifying their markets, and the robust course of tourism registered until 2019 have positively affected exports of goods and services in that period. While import demand continued to increase on the back of the recovery in domestic demand, the current levels of the real exchange rate have curbed the rise in imports (Chart II.2.6). The marked slowdown in domestic demand during the pandemic period will substantially weigh on imports in the upcoming period. On the other hand, export opportunities may be limited as Turkey's external markets are expected to contract due to the decline in external demand driven by the weakened global economic activity led by the coronavirus outbreak as well as the decrease in demand in crude oil producing countries driven by the fall in oil prices. Given the impact area of the pandemic and the current levels of oil prices, demand from our export markets such as the Middle East and Africa as well as Russia may also remain weak in the upcoming period. However, exporters' flexibility in diversifying their markets and competitiveness gains are expected to mitigate these unfavorable effects to some extent.

Chart II.2.5. Real Effective Exchange Rates (2003=100, 3-Month Average)



Source: CBRT Last Observation: 03.20

Chart II.2.6: Foreign Trade and Tourism Revenues (12-Month Cumulative, Billion USD)



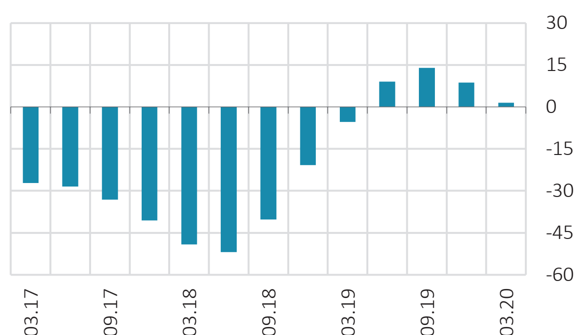
Sources: CBRT, TURKSTAT Last Observation: 03.20

Note: For foreign trade, exports (f.o.b.) and imports (c.i.f.) data according to the general trade system have been used.

In the rebalancing process accompanied by a growth composition with increased export contribution, the current account balance posted a significant improvement starting from the second half of 2018 (Chart II.2.7). The recent fall in crude oil prices is expected to stand as another factor that will support the current account balance over the coming period in addition to competitiveness. Prices in the tourism sector, which are more competitive compared to peer countries, have markedly boosted tourism revenues in recent years. On the other hand, the rapid slowdown in tourism activities led by pandemic measures that have strained global mobility and the expected shift in holiday preferences towards small/boutique establishments are projected to have a negative impact on Turkey's tourism revenues, albeit for a temporary period. Against this background, it is estimated that the current account will follow a moderate course in 2020 and will not cause an external financing need in the second half of the year.

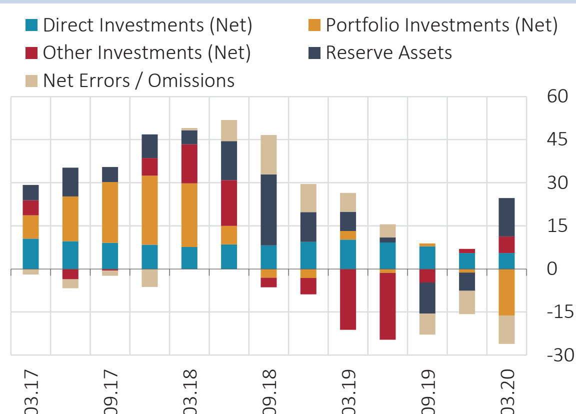
The current account has posted a surplus in annualized terms since the second quarter of 2019, which has reduced the financing need. An analysis of the financing structure of the current account reveals that the contribution of direct investments continues in recent months despite a decline, net portfolio outflows have been registered as of the first quarter of 2020, and there has been a net payer position in cash loans due to demand-driven fall in debt rollover ratios whereas net inflows has been witnessed in other investments on the back of currency and deposits (Chart II.2.8). Portfolio outflows in EMEs triggered by decreased risk appetite have also been likewise reflected in Turkey's data. Portfolio outflows in Turkey observed since early 2019, have accelerated during the pandemic period and led to fluctuations in exchange rates and FX reserves. However, the fact that the non-residents' share in both TL money market and domestic bond-bill markets has receded to the lowest level in recent years may significantly alleviate the impact of portfolio outflows on exchange rates and FX reserves.

Chart II.2.7: Current Account Balance (12-Month Cumulative, Billion USD)



Source: CBRT Last Observation: 03.20

Chart II.2.8: Financing Sources of Current Account Balance (12-Month Cumulative, Billion USD)



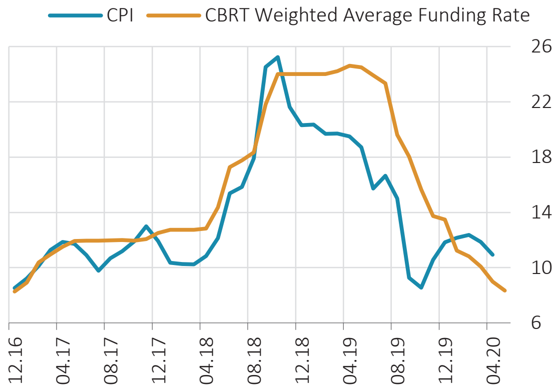
Source: CBRT Last Observation: 03.20

In the current Report period, the inflation outlook continued to improve and consumer inflation, which had dropped to 8.55% in October 2019, increased to a limited extent in the following months particularly due to the base effect. Aggregate demand conditions, commodity prices and the fall in inflation expectations were the main drivers of the favorable outlook in inflation. The weak course of fresh fruit and vegetable prices observed since the second half of 2019 also contributed to this decrease. In line with the continued improvement in the inflation outlook, the CBRT has delivered gradual rate cuts since July 2019 and gradually reduced the one-week repo rate from 24% to 8.25% as of May 2020 (Chart II.2.9).

With global financial conditions displaying a more favorable outlook due to expansionary tendencies in global monetary policies, the demand and risk appetite for financial assets of EMEs were relatively strong until early 2020. On the other hand, in addition to the effects of protectionist measures in trade, geopolitical developments and the Brexit process in the previous period, the pandemic-led global

economic uncertainties and risk aversion tendency in the recent period have increased the need for liquidity, causing fluctuations in portfolio flows to EMEs. In fact, due to these uncertainties, the downtrend in Turkey's risk premium and options-implied exchange rate volatility reversed starting from the early months of 2020, with the risk premium increasing significantly in particular (Chart II.2.10). The likely improvement in global liquidity conditions, particularly due to expansionary monetary policies implemented by advanced economies, is expected to suppress risk premiums with the improved outlook in the post-pandemic normalization process.

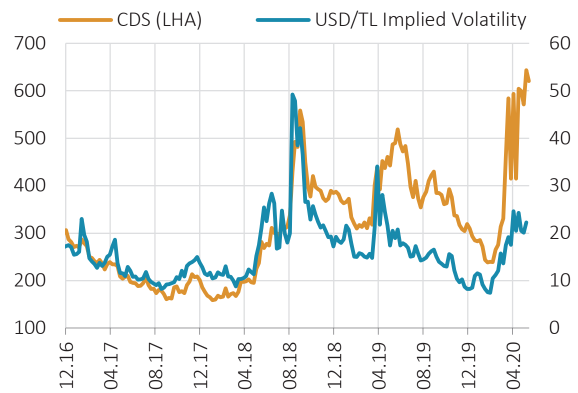
Chart II.2.9: Inflation and Policy Rates (Annual % Change, Monthly Average %)



Sources: CBRT, TURKSTAT Last Observation: 21.05.20

Note: WAFR shows the monthly average values weighted by daily amounts of funding.

Chart II.2.10: CDS Premium and Exchange Rate Volatility (5-Year Maturity, Basis Points, 1-Month Maturity)



Source: Bloomberg Last Observation: 15.05.20