# 5. Financial Markets and Financial Intermediation

Global financial markets remained vague and volatile in the second quarter of 2015. Besides the unknown timing of the Fed's policy rate hike, controversial debates regarding the effects of a possible rate hike on the global economy also fed into the market volatility. In the Euro area, developments regarding the Greek debt crisis emerged as another factor that deteriorated the risk sentiment in global markets. On the emerging economies front, the recent plunge in the Chinese stock market had a negative effect on the global risk appetite. Accordingly, fund flows towards emerging economies remained weak in the second quarter.

Against this background, the domestic financial markets followed an undulating pattern, while the quarterly breakdown suggests that long-term market rates remained virtually unchanged in the second quarter compared to the first quarter. Short-term market rates posted a limited decline on a quarterly basis. Having depreciated at the start of the second quarter, the Turkish lira has diverged positively from other emerging market currencies as of mid-June, but started to depreciate again towards the end of July.

As projected in the April Inflation Report, the FCI for Turkey shows a moderate tightening slightly below the neutral mark in the second quarter. Except for the credit standards that stood a little above historical averages, all financial variables in the index caused tightening in financial conditions in the second quarter, albeit limited. The active use of policy instruments in the second quarter, which are engineered by the CBRT to curb the effect of the volatility in global markets, alleviated the fluctuations in the domestic markets and underpinned macrofinancial stability.

The annual growth rate of credits that slowed upon the CBRT's cautious monetary policy stance and macroprudential measures displayed a mild quarter-on-quarter increase in the second quarter. The recent limited tightening in financial conditions signals that the annual growth rate of credits may trend downwards in the last quarter. Accordingly, credits are expected to support the improvement in inflation and the current account balance in the upcoming period.

**Chart 5.1.**
Financial Conditions and Credit Growth*

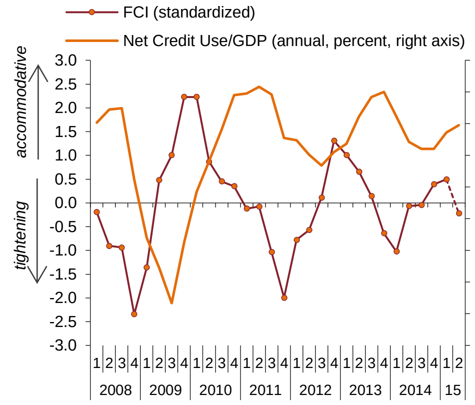
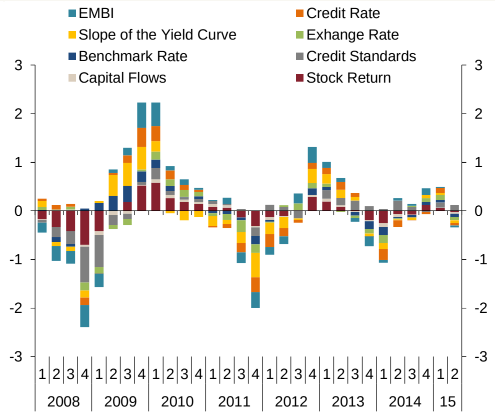



**Chart 5.2.**
Contributions to FCI**




* For further details on measuring FCI, see the CRBT Working Paper No. 12/31.
** Slope of the yield curve is measured by the spread between 10-year and 2-year interest rates.
Source: CBRT.

## 5.1. Financial Markets

### Global Risk Perceptions

The second quarter of 2015 was marked by ongoing uncertainty over global monetary policies. In particular, the timing of the Fed's first policy rate hike dominated global markets, while the course of the data released for the US economy led to fluctuations in global markets. The US economic data emitted mixed signals in this reporting period; however, the policy rate forecasts of the FOMC members announced in June were interpreted as the Fed would launch rate hikes this year. Growing uncertainty over the US monetary policy caused increased volatility in interest rates. Amid the expected rate increase, rates on 10-year US Treasury bonds posted an uptick (Chart 5.1.1). Meanwhile, policy rate forecasts of the members for 2016 and 2017 proved lower, and Janet Yellen, the Fed Chair, stated that the focus should be on the path and the pace of the process rather than the timing of the first rate hike. These two factors fed into the expectations that the policy rate increase will be slow and gradual, which in turn alleviated the interest rate volatility.

In the Euro area, owing to the accommodative policies implemented by the ECB, the economic activity as well as Euro area inflation, which stood far below the targeted 2 percent, both registered a slight improvement. However, the debt restructuring process of Greece as of the second half of June curbed the expectations for a rebound in the Euro area, and emerged as another factor of uncertainty that aggravated the risk sentiment in global markets. Economic activity in China exhibited a frail outlook in this period, and the panic in addition to the plunge in the stock market lowered the global risk appetite. Accordingly, the emerging market exchange rate volatility posted a slight decline in the inter-reporting period, yet remained higher than 2014 readings (Chart 5.1.2).

**Chart 5.1.1.**
10-Year US Treasury Bond Rates and MOVE Index

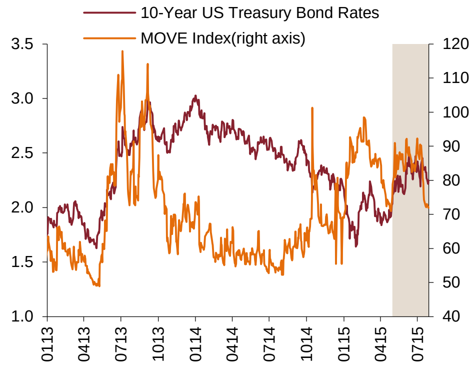
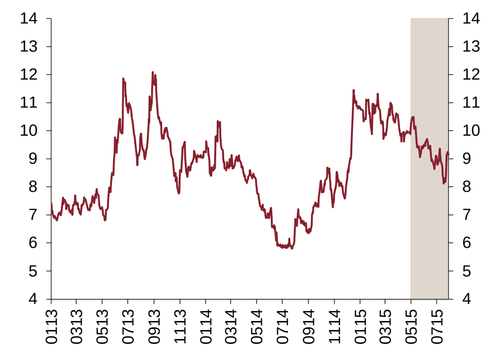


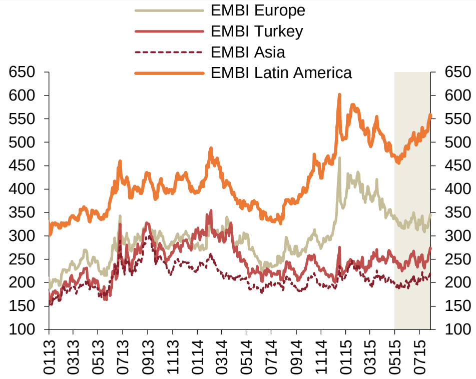

**Chart 5.1.2.**
JPMVXYEM Volatility Index
(Percent)




Source: Bloomberg.

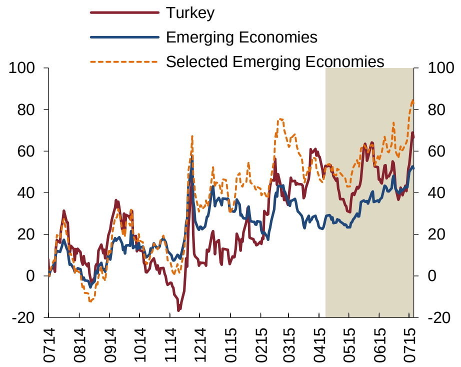
The uncertainty about a Fed rate hike and vagueness about Greece accompanied by worse-than-expected emerging market growth rates and geopolitical tensions led global risk appetite to stand at low levels. Moreover, the mixed signals given by the data regarding the US caused the EMBI to follow a fluctuating course (Chart 5.1.3). On the other hand, the CDS premiums of emerging economies posted more evident increases compared to the EMBI (Chart 5.1.4). As for Turkey, risk premium indicators recorded an increase in June due to the uncertainties over the election and recently climbing geopolitical risks.

**Chart 5.1.3.**
Regional EMBI Indices
(Basis Points)




Source: Bloomberg.

**Chart 5.1.4.**
Changes in CDS*
(Basis Points)

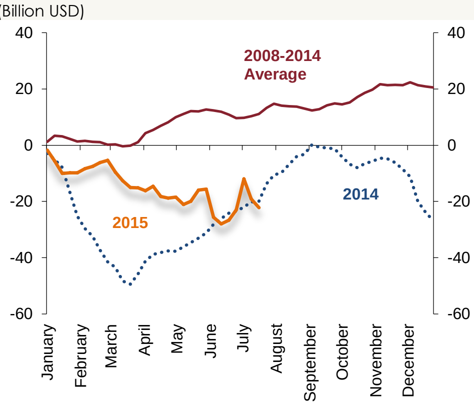



* Emerging economies include Brazil, Chile, Colombia, Hungary, Indonesia, Mexico, Poland, Romania and South Africa. Selected emerging economies are Brazil, Indonesia and South Africa. Denotes changes since 24 July 2014.
Source: Bloomberg.

## Portfolio Flows

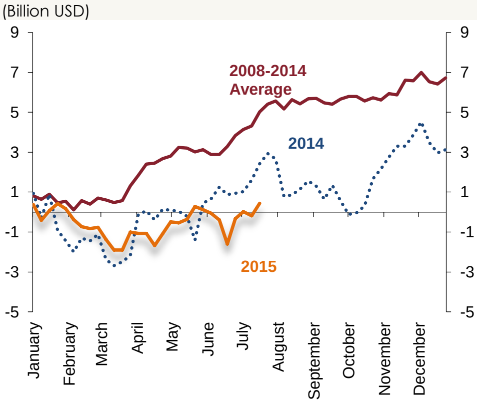
In line with the global developments, portfolio flows to emerging economies followed a weak and volatile pattern in the second quarter of 2015. Fund inflows amid the global risk appetite, which proved favorable in the first half of May, were reversed in the second half of May due to waning demand for emerging market assets, which was caused by the positive data for the US economy and concerns over Greece (Chart 5.1.5). As of mid-June, portfolio flows towards emerging economies exhibited some recovery, which is yet to become permanent. In this period, having improved slightly since mid-June, portfolio flows to Turkey also displayed a similar pattern and remained far below the average of past years (Chart 5.1.6).

**Chart 5.1.5.**
Portfolio Flows to Emerging Economies*
(Billion USD)




* Includes equity and bond flows.
Source: EPFR.

**Chart 5.1.6.**
Portfolio Flows to Turkey*
(Billion USD)

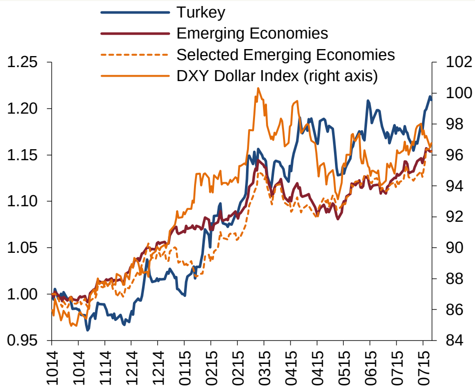



* Excludes repo and includes equity and bond flows.
Source: CBRT.

## Exchange Rates

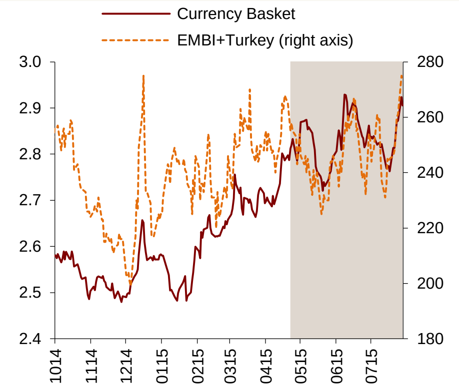
In the first quarter of 2015, markets had the perception that the Fed might normalize the monetary policy earlier than estimated, while the FOMC members' forecasts for the US economy announced in June fed into the expectations that the Fed would maintain its accommodative monetary policy stance for an extended period. In this context, the first-quarter uptrend in the DXY dollar index was interrupted in the second week of March, and the index remained volatile, yet stood at lower levels in the second quarter of 2015. Emerging market currencies moved largely consistent with the DXY dollar index. Following the decline in the index, previous depreciation of the emerging market currencies was somewhat compensated (Chart 5.1.7).

**Chart 5.1.7.**
TL and Emerging Market Currencies vs USD*
(01.10.2014=1)




* Emerging economies include Brazil, Chile, Colombia, Czech Republic, Hungary, Mexico, Poland, Romania, South Africa, India, Indonesia and Turkey. Selected emerging economies are Brazil, Indonesia and South Africa.
Source: Bloomberg.

**Chart 5.1.8.**
Currency Basket and the Risk Premium



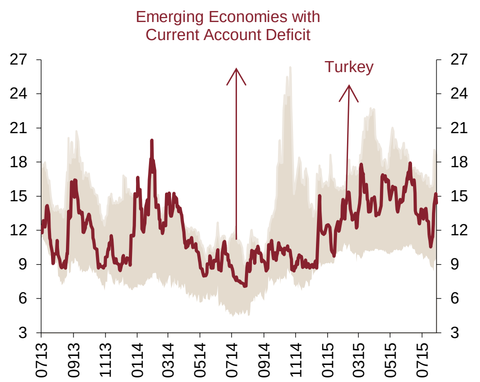

Source: Bloomberg.

The Turkish lira was affected by the decline in the DXY dollar index with a lag compared to the other emerging economies and followed an almost horizontal and volatile course at the start of the second quarter of 2015 due to the strengthened co-movement between the exchange rate basket and the risk premium in addition to the increased domestic political turmoil. From mid-June to mid-July, the ending of general elections and the announcement of some favorable data allowed the Turkish lira to diverge positively from other emerging market currencies against the USD. In the second half of July, the Turkish lira depreciated faster than other emerging market currencies owing to the elevated geopolitical risks (Chart 5.1.7). Thus, the Turkish lira has been volatile since the publication of the April Inflation Report, and the exchange rate basket stood at 2.91 TL on 28 July 2015 with an increase by 2.5 percent from 2.84 TL at the end of April. The EMBI+ index that measures the sovereign risk premium also fluctuated, yet remained only 20 basis points above its first-quarter reading (Chart 5.1.8). Contrary to the first quarter, the exchange rate basket stayed quite close to the EMBI+ index in the second quarter.

Against this background, implied exchange rate volatilities of the emerging market currencies and the differences in volatilities among countries posted relatively decreasing figures in the second quarter of 2015. The implied volatility of the Turkish lira rose in mid-May, and hit the highest level in early June, the time of the election, which has been recorded since January 2014 (Chart 5.1.9). In the succeeding weeks of June, partly due to the fall in oil prices, the implied volatility of the Turkish lira displayed a parallel pattern to the decreasing exchange rate volatility of countries that run a current account deficit. However, recent developments pushed this figure upwards.

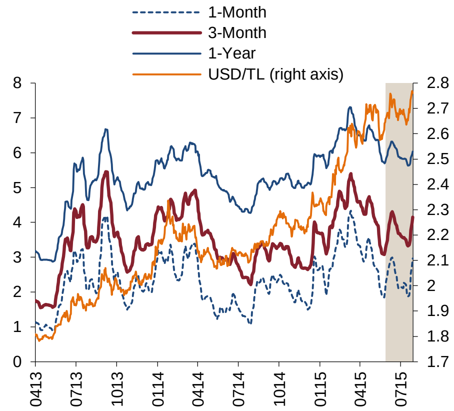
In line with the course of the risk premiums and the implied exchange rate volatilities, risk reversal positions that denote the differences among the volatilities implied by buy (call) and sell (put) options have showed an undulating pattern since the previous Inflation Report. Parallel to the favorable developments in the Turkish lira until mid-July, risk reversal positions displayed decreases. However, the depreciation of the Turkish lira towards the end of July caused the expectations of depreciation to outweigh those for an appreciation (Chart 5.1.10).

**Chart 5.1.9.**
Implied Volatility of Exchange Rates*
(1-Month-Ahead)




* Emerging economies with current account deficit include Brazil, Chile, Colombia, Czech Republic, Hungary, Indonesia, Mexico, Poland, Romania, South Africa and India.
Source: Bloomberg.

**Chart 5.1.10.**
25 Delta Risk Reversal Positions at Various Maturities*
(5-Day Moving Average, Percent)




* Risk reversal position denotes the difference between implied volatilities of call and put options with the same delta. An increase indicates that depreciation is more likely than an appreciation in TL.
Source: Bloomberg, CBRT.

## Monetary Policy

In early 2015, in view of the favorable core inflation figures, falling oil prices and improved expectations, the CBRT implemented measured rate cuts and maintained its cautious monetary policy stance by keeping the liquidity policy tight. In the second quarter, financial markets displayed fluctuations owing to the volatile global markets in addition to the domestic turmoil. Given the volatility in food and energy prices, the exchange rate movements, delayed recovery in the core inflation outlook and the lingering uncertainty in the markets, the CBRT maintained its cautious monetary policy stance. Not opting for a change in the policy rate in May, June and July, the CBRT kept the one-week repo auction rate at 7.5 percent, the overnight borrowing rate at 10.75 percent, the interest rate on borrowing facilities provided for primary dealers via repo transactions at 10.25 percent, and the overnight lending rate at 7.25 percent.

In this period, the cautious monetary policy was backed by a tight liquidity policy against possible risks to the core inflation and inflation expectations. One-week repo auctions remained as the leading tool for the CBRT funding, while the share of the marginal funding was raised gradually (Chart 5.1.11). Accordingly, the average funding rate settled at a higher level compared to the previous reporting period. In the second quarter of 2015, the average funding rate, the first-quarter average of which was 7.9 percent, rose to 8.4 percent. Moreover, the BIST overnight repo rates were kept at the upper band of the interest rate corridor in this quarter as well (Chart 5.1.12).

**Chart 5.1.11.**
CBRT Funding
(2-Week Moving Average, Billion TL)

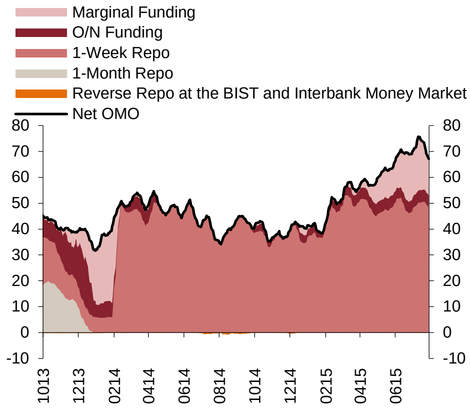
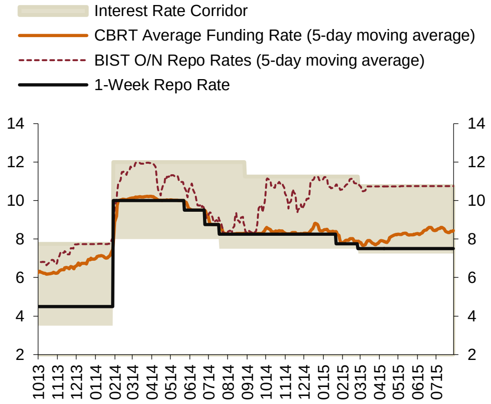



**Chart 5.1.12.**
CBRT Rates and BIST Repo Rates
(Percent)




Source: BIST, CBRT.

In addition to funds provided by the CBRT, short-term funds provided from various markets also play a significant role in meeting the Turkish lira liquidity requirement of the banking system. Funds provided from swap markets lead the funds provided from market players other than the CBRT with up to one-week maturity. These are followed by funds transacted under the BIST Interbank Repo and Reverse Repo Market and those, which are exchanged by intermediaries under the BIST Repo and Reverse Repo Market (Chart 5.1.13). The market-weighted average funding rate calculated in consideration of the transaction volumes and rates in these markets excluding the CBRT funding closely follows the BIST overnight repo rate, which is mainly determined by the CBRT's policy rate and liquidity policies (Chart 5.1.14). The effective funding rate calculated by the weights of the CBRT and non-CBRT funds in total funds was around 9.3 percent in July. This rate stood at a higher level than the CBRT average funding rate that hovered around 8.5 percent, and reflected the recent rise in the CBRT average funding rate.

**Chart 5.1.13.**
Market Funding
(10-Day Moving Average, Billion TL)

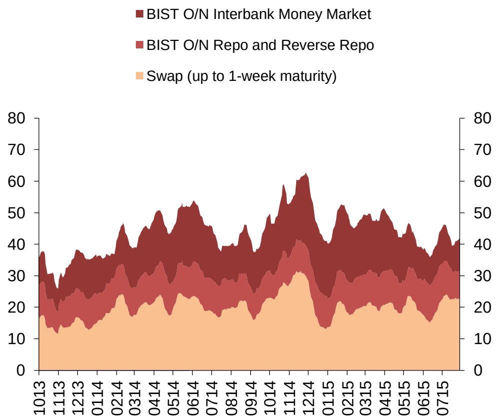
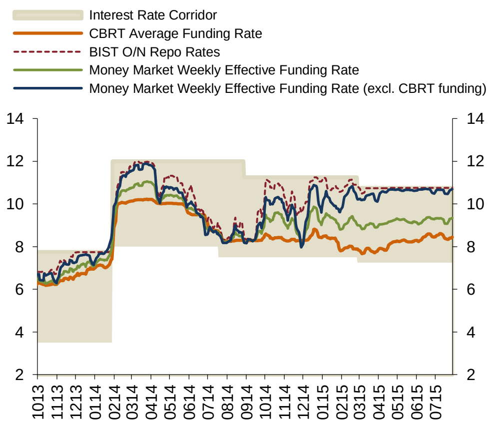


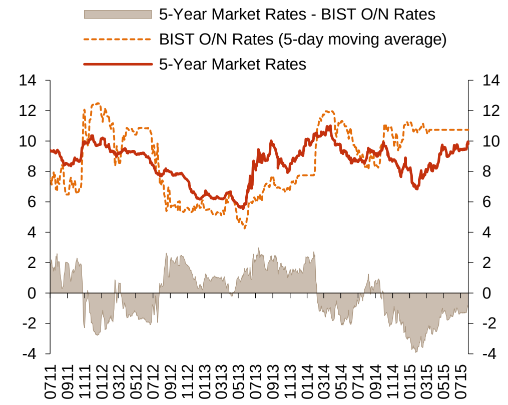

**Chart 5.1.14.**
Bank's Funding Costs at the Money Markets
(5-Day Moving Average, Percent)




Source: BIST, CBRT.

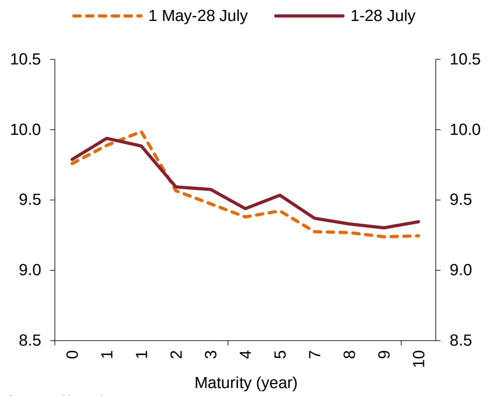
The CBRT maintained its cautious monetary policy stance by keeping the yield curve almost flat in this period as well. The spread between 5-year market rates and the BIST overnight repo rates has been taking negative values since the last quarter of 2014 (Chart 5.1.15). Owing to the tight liquidity policy stance, market rates posted some increase and the yield curve remained nearly horizontal in this period (Chart 5.1.16). The CBRT will continue to closely monitor inflation expectations, pricing behavior and other factors that affect inflation in the forthcoming period and maintain its cautious monetary policy stance by keeping the yield curve flat until there is a significant improvement in the inflation outlook.

**Chart 5.1.15.**
Market Rates
(Percent)




Source: Bloomberg, CBRT.

**Chart 5.1.16.**
Yield Curve
(Percent)




Source: Bloomberg.

Besides interest rate and liquidity policies, the CBRT continues to employ other policy instruments actively against the volatility in global markets. These measures aim at limiting macrofinancial risks and setting the environment needed to achieve price stability. The CBRT has recently adopted some structural measures to support prudential borrowing, which is the basis of financial stability, as well as to contain non-core funding resources of banks and extend their maturities. These measures, announced in the Financial Stability Report of November 2014, include the arrangement of FX required reserve ratios to extend the maturity of non-core liabilities and remuneration of Turkish lira required reserves at varying rates according to core liability ratios.

With respect to the arrangement of FX required reserve ratios, the CBRT announced on 3 January 2015 and 10 March 2015 that the required reserve ratios applied to non-core FX short-term liabilities of banks and financing companies were raised to encourage banks to extend the maturities of their external borrowing. In fact, maturities of non-deposit FX liabilities have tended to extend substantially since November 2014 (Chart 5.1.17). Regarding the remuneration of the Turkish lira required reserves, banks with a core liability ratio (ratio of deposit and equities to loans) above the sector were paid 500 basis points below the CBRT average funding cost and other banks were paid 700 basis points below this cost in the beginning. The remuneration rate for the required reserves maintained in Turkish lira was raised by 50 basis points, effective as of the maintenance period of 8 May 2015. Owing to these arrangements, the loan to deposit ratio has settled on a relatively more stable track as of November 2014 (Chart 5.1.18).

**Chart 5.1.17.**
Non-Deposit FX Liabilities by Maturity
(Percent)

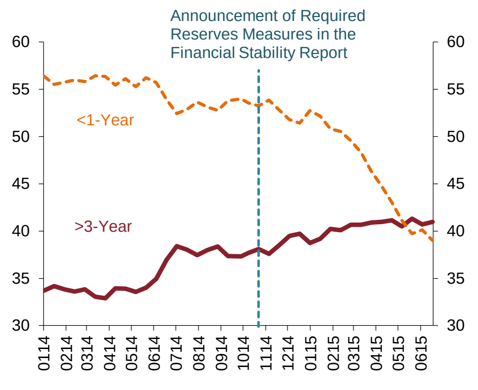
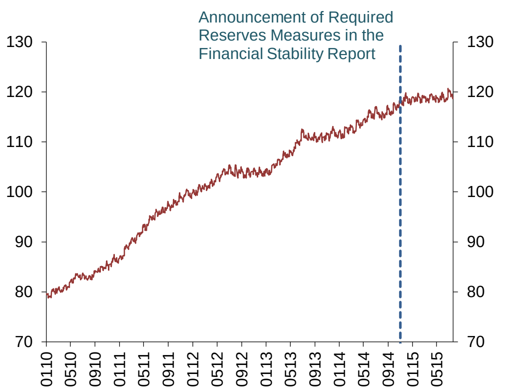


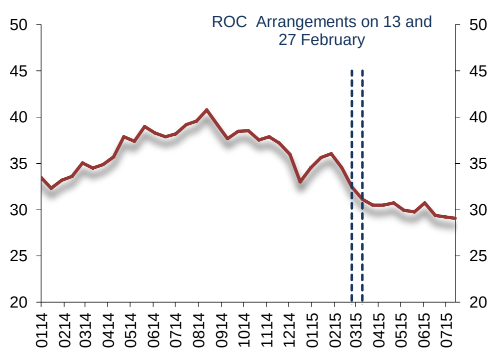

**Chart 5.1.18.**
Loans/Deposits
(Percent)




Source: CBRT.

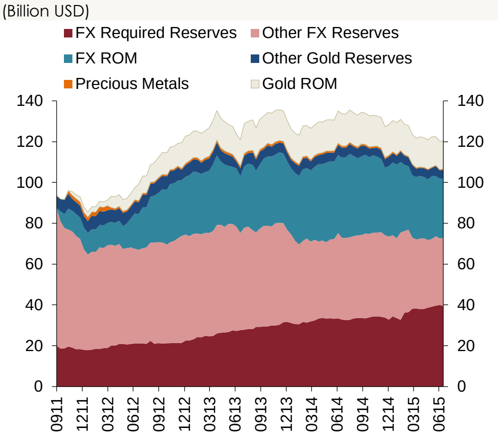
In addition, a series of measures have recently been adopted to adjust the FX liquidity and raise confidence in the financial system. Accordingly, as of 27 February 2015, the CBRT has started to set the FX sale auction amount on a daily basis in order to gain flexibility in FX liquidity policy against market volatility. From the start of the year to 28 July 2015, around 6.2 billion USD was sold through flexible FX sale auctions. In addition to direct FX sales, the ROM was also employed to smooth out volatilities. In order to meet the FX liquidity need arising from the adjustments in the FX required reserve ratios, the FX ROC in the first 30 percent tranche was lowered by 0.2 points via the ROC arrangements effective as of 13 February 2015. Accordingly, an FX liquidity of 1.5 billion USD was provided to the market from the CBRT's ROM FX reserves. Similarly, with the announcement on 10 March 2015, the same rate was reduced by another 0.2 points and 1.3 billion USD was emitted to the market. Thus, having provided about 5.5 billion USD via its ROM FX reserves as of the start of 2015, the CBRT has supported the FX liquidity in the market (Chart 5.1.19). These measures not only provide the market with FX liquidity, but also support the financial system by reducing the intermediation costs of banks.

**Chart 5.1.19.**
ROM FX Reserves
(Billion USD)




Source: CBRT.

**Chart 5.1.20.**
CBRT FX Reserves*
(Billion USD)




* As of 16 July 2015.
Source: CBRT.

In order to support balanced growth and steady capital flows to Turkey given the expected normalization in global monetary policies, the CBRT lowered the interest rates on FX deposits that banks can borrow from the CBRT within their borrowing limits in the FX Deposit Market gradually, starting from 9 October 2014. After the arrangement introduced in the first quarter, the rate applied to banks' one-week USD and EUR borrowing facility from the CBRT, which was 10 percent before 9 October 2014, was reduced to 3.0 and 1.25 percent, respectively, following the decisions announced on 9 June, 24 July and 27 July 2015. The CBRT announced on 24 July 2015 that when deemed necessary, without any need for a press release, these rates for the USD and EUR will be adjusted in either direction at 9:30 a.m. on business days, and will be valid for the same business day. Although banks have not resorted to this facility yet, the arrangements introduced to the upper band of one-week FX deposits and the interest rates applying thereto function as a buffer for the banking sector to boost confidence in financial markets.

Moreover, USD required reserves, reserve options and free reserves held at the CBRT have been remunerated as of 5 May 2015. Accordingly, the applicable interest rate will be set on a daily basis depending on varying conditions in the global and local financial markets, and this rate will be announced daily at 9.30 a.m. Accordingly, remuneration was set as 12 basis points up to 13 July 2015, as 15 basis points from 13 July to 27 July 2015, and as 21 basis points as of 27 July. Moreover, due to the recent developments in the Euro area, the per annum commission of 0.02 percent received from euro accounts of banks and financing companies at the CBRT as of 1 February 2015, was reduced to 0.005 percent to be effective on 1 July 2015, and to zero on 27 July.

The CBRT reserves have remained almost unchanged in the inter-reporting period (Chart 5.1.20). In this period, the CBRT's other FX reserves and reserves maintained by financial institutions under the FX reserve option decreased due to the FX selling auctions supporting the FX liquidity, yet this was partially offset by the growth in the reserves maintained against the FX reserve requirement. The use of ROM by financial institutions remained high in the second quarter and stood at 93.5 percent (56.08/60) for FX and 90.5 percent (27.16/30) for gold by the maintenance period of 16 July 2015.

### Market Rates

Long-term market rates in emerging economies followed a fluctuating course in the second quarter of 2015. As for Turkey, the course of market rates was upwards at the start of the quarter compared to the previous reporting period, while it returned flat at the end of the quarter due to the base effect as well as some favorable readings and the waning perception of domestic uncertainties.

In this period, 5-year market rates have remained flat in India since February, while they followed a horizontal yet fluctuating course in Brazil. As for South Africa and Indonesia, market rates have posted a surge (Charts 5.1.21 and 5.1.23). In Turkey, 5-year market rates assumed an upward trend from February until early June, and remained flat for a while due to some favorable developments in the succeeding period (Chart 5.1.21). However, amid the recent heightening in domestic uncertainties, 5-year market rates in Turkey rose by 35 basis points compared to the previous reporting period (Chart 5.1.23).

**Chart 5.1.21.**
5-Year Market Rates*
(Percent)

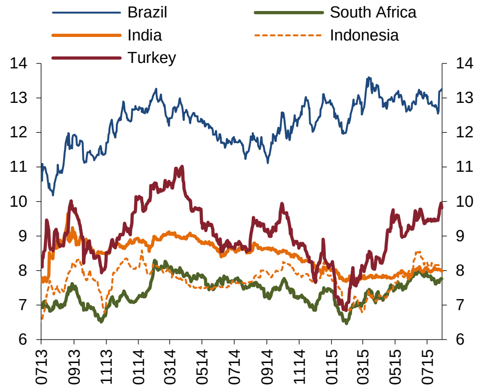
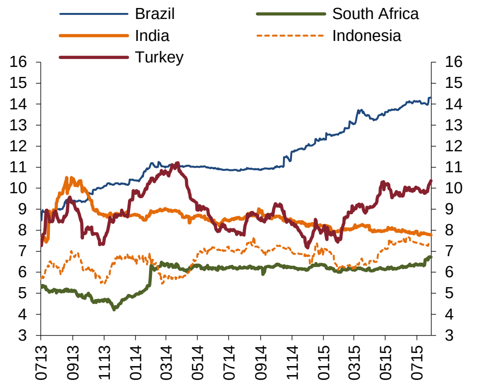



**Chart 5.1.22.**
6-Month Market Rates*
(Percent)




* As of 28 July 2015. 4-year market rates are used for Brazil.
Source: Bloomberg.

South Africa and India displayed a steady outlook with regard to short-term market rates, while Brazil and Indonesia diverged at an upward direction. As for Turkey, the rise in 6-month market rates is less notable (Chart 5.1.22). This is also evident through cross-country comparisons, where Turkey (with 15 basis points increase) stood among emerging economies with only a limited rise in 6-month rates (Chart 5.1.24). Market rate developments in the second quarter of 2015 demonstrate that Turkey has remained immune to the downside risks regarding the Euro area, and the moderate rise in short-term market rates was mostly attributed to the recent domestic unrest.

**Chart 5.1.23.**
5-Year Market Rates*
(Percent)

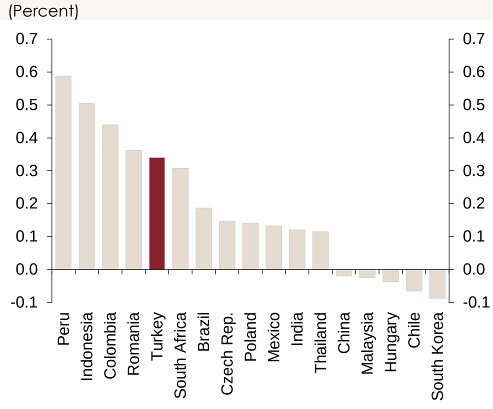
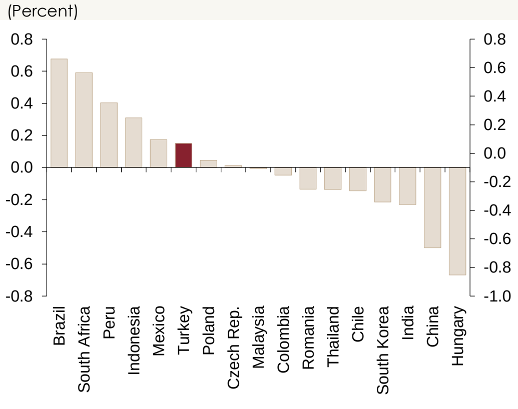


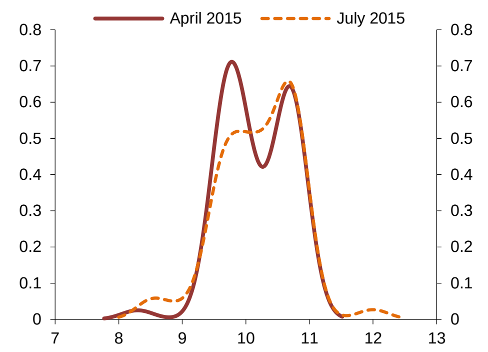

**Chart 5.1.24.**
6-Month Market Rates*
(Percent)




* Denotes changes from 1 May to 28 July 2015. 4-year market rates are used for Brazil.
Source: Bloomberg.

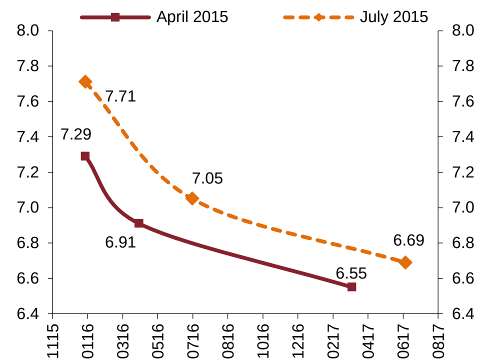
Thanks to the CBRT's cautious monetary policy stance backed by a tight liquidity policy throughout 2015, the BIST overnight repo rates remained close to the upper band of the interest rate corridor (Chart 5.1.12). Thus, given higher prospects for a cautious monetary policy stance due to the recently mounting domestic uncertainties and inflation developments, the median of the expected overnight rate distribution at the BIST Repo and Reverse Repo Market shifted right and settled at about 50 basis points above the previous readings (Chart 5.1.25). As for inflation expectations that are influential in long-term market rates, the year-end inflation expectation for the current year posted a notable increase by around 42 basis points compared to April (Chart 5.1.26). However, the adaptation of short-term expectations had a limited impact on 12-month and 24-month-ahead inflation expectations.

**Chart 5.1.25.**
Expected Overnight Rates at the BIST Repo and Reverse Repo Market* (Percent)




* CBRT Survey of Expectations.
Source: CBRT.

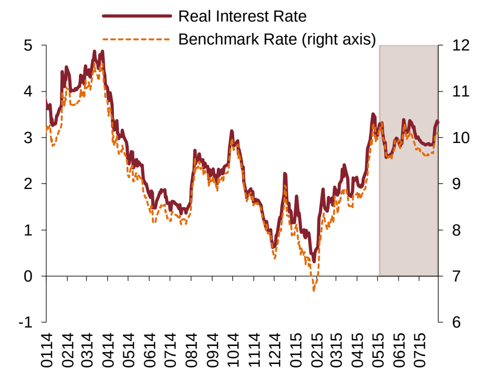
**Chart 5.1.26.**
Inflation Expectations*
(Percent)




* End of current month, current year-end, 12-month-ahead and 24-month-ahead policy rate expectations derived from the CBRT Survey of Expectations.
Source: CBRT.

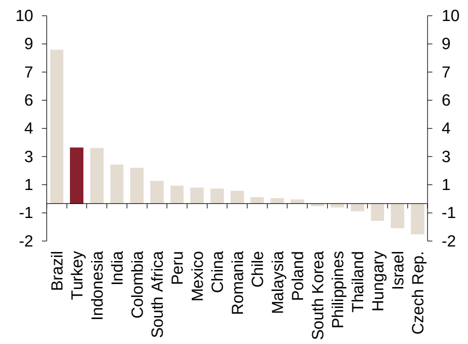
Having fluctuated in the second quarter of 2015, the benchmark interest rate in Turkey trended downwards following the first week of June, while it increased by 52 basis points from 10 to 28 July and neared the readings posted in the previous reporting period. The limited uptick in 24-month-ahead inflation expectations remained below the rise in the nominal yields for 2-year Treasury bonds in the same period, pushing 2-year real interest rates upwards by about 28 basis points (Chart 5.1.27). The comparison of 2-year real interest rates across emerging economies reveals that real interest rates in Turkey (after Brazil that is significantly above with 9 percent) have converged to those of Indonesia, India and Colombia, which have real interest rates ranging between 2 to 3 percent (Chart 5.1.28).

**Chart 5.1.27.**
2-Year Real Interest Rates for Turkey*
(Percent)




* Calculated as the difference between 2-year market rates and the 24-month-ahead inflation expectations derived from the CBRT Survey of Expectations. As of 28 July 2015.
Source: Bloomberg, BIST, CBRT.

**Chart 5.1.28.**
2-Year Real Interest Rates*
(Percent)




* Calculated as the difference between 2-year Treasury bond yields of countries and the 24-month-ahead inflation expectations derived from the Consensus Forecasts. As of 28 July 2015.
Source: Bloomberg, Consensus Forecasts, CBRT.

## Loan Rates and Banking Sector Funding Costs

Having remained flat in early 2015, rates on loans extended to the non-financial sector recorded an uptick in the second quarter upon the tightening in domestic financing conditions. Among consumer loans, housing loan rates posted a quarter-on-quarter increase by around 100 basis points, while rates on automobile loans recorded a more limited rise by 85 basis points. Personal loan rates registered the highest increase in consumer loan rates with 120 basis points (Chart 5.1.29). The rise in commercial loan rates lagged behind consumer loan rates in this period. Commercial loan rates increased by 70 basis points in the second quarter compared to the first quarter, while commercial loan rates excluding overdraft accounts rose by 100 basis points (Chart 5.1.30). According to the Loan Tendency Survey results, banks project tightening both in domestic and foreign financing conditions in the third quarter of the year. This projection implies that loan rates may increase further.

**Chart 5.1.29.**
Consumer Loan Rates
(Flow, Annualized, Percent)

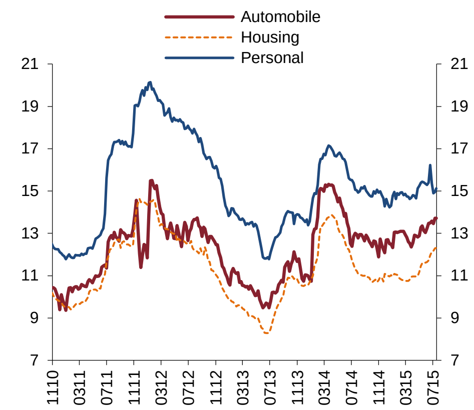
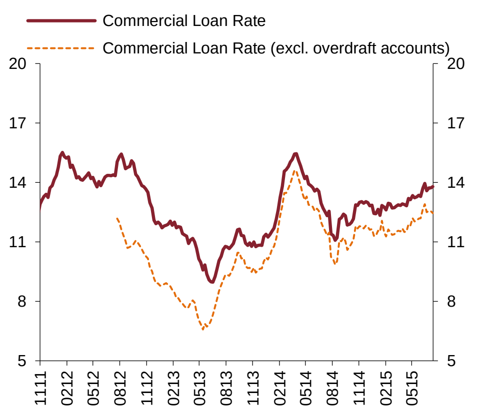



**Chart 5.1.30.**
TL Commercial Loan Rates
(Flow, Annualized, 4-Week Moving Average, Percent)




Source: CBRT.

Rates on deposits with maturities shorter than three months, which are the primary financing resources of the banking sector, rose by 40 basis points quarter-on-quarter owing to the CBRT's cautious monetary policy stance and rising weighted funding costs that increased within the quarter. As the commercial loan rates soared more than deposit rates in the first quarter, the spread between commercial loan rates and deposit rates widened as much as 3.79 percent (Chart 5.1.31). The weak and fluctuating fund flows towards emerging economies also affected rates on bills and bonds issued by banks. Upon increasing by around 100 basis points at the start of the quarter, rates on bills and bonds edged down in June and finished the second quarter at 10.3 percent (Chart 5.1.32).

**Chart 5.1.31.**
TL Commercial Loan Rate and Deposit Rate
(Flow, Annualized, 4-Week Moving Average, Percent)

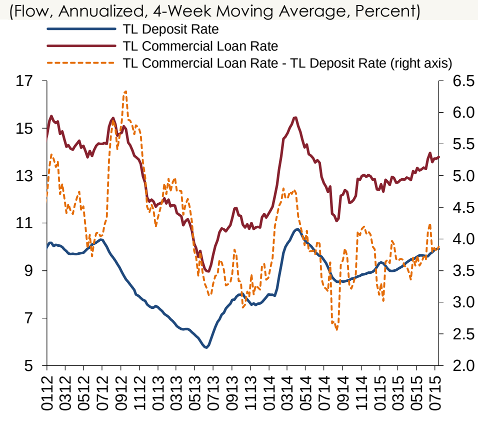
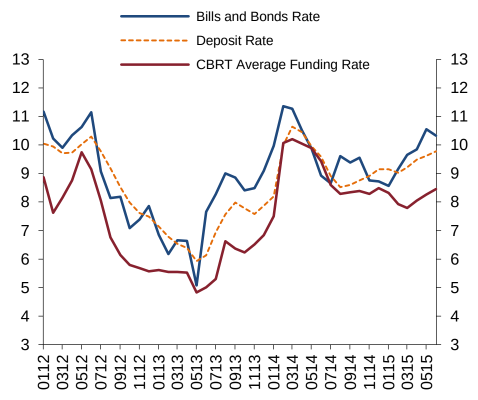



**Chart 5.1.32.**
Indicators on Banks' Funding Costs

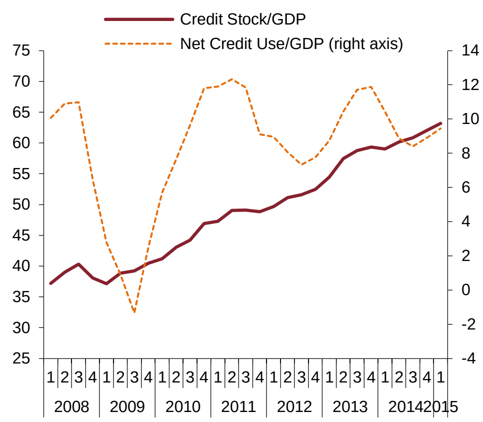



Source: CBRT.

## 5.2. Credit Volume and Monetary Indicators

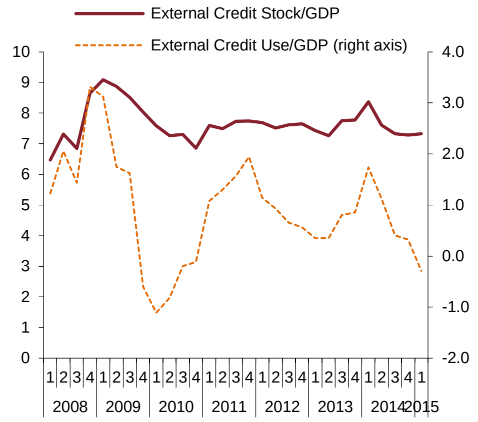
The net credits to the GDP ratio, which is critical to financial stability and an indicator of the relationship of credit growth with economic activity and aggregate demand, posted a mild quarterly increase and reached 14.4 percent in the second quarter of 2015 (Chart 5.2.1). With the CBRT's prudent monetary policy stance and macroprudential measures, the net credits to the GDP ratio is expected to remain on a moderate track in the upcoming period. Meanwhile, firms' external credit use remained close to historical averages in the second quarter of 2015, implying that firms had easy access to external borrowing (Chart 5.2.2). However, firms' external credit use appears to have crept up year-on-year.

**Chart 5.2.1.**
Domestic Credit Stock and Net Credit Use*
(Percent)




* Domestic credits are comprised of total banking sector credits including participation banks, foreign branches and credit cards. Net credit use is measured as the annual change in nominal credit stock.
Source: CBRT.

**Chart 5.2.2.**
External Credit Stock and Net Credit Use
(Percent)




Source: CBRT.

The annual growth rate of loans extended to the non-financial sector, which decelerated due to the CBRT's cautious monetary policy stance and the macroprudential measures introduced by the BRSA regarding consumer loans excluding housing, posted a mild quarterly increase in the second quarter of 2015. However, at the end of the second quarter, the annual growth rate of loans moved downwards. A breakdown of loans shows that commercial loans continued to grow faster than consumer loans on the back of the measures adopted by the BRSA and the weak course of consumer confidence. Accordingly, loans extended to the non-financial sector posted an 18.1 percent year-on-year growth in exchange rate adjusted terms at the end of the second quarter of 2015 (Chart 5.2.3). In 13-week moving average terms, which display the second quarter developments, these loans registered a growth by 21.2 percent on an annualized basis (Chart 5.2.4). However, loans extended to the non-financial sector are still expected to decelerate given the increase in consumer and commercial loan rates as well as the slowing economic activity and the expected tightening in banks' financing conditions in both domestic and foreign markets.

**Chart 5.2.3.**
Loan Growth
(Adjusted for Exchange Rate, Annual Percent Change)

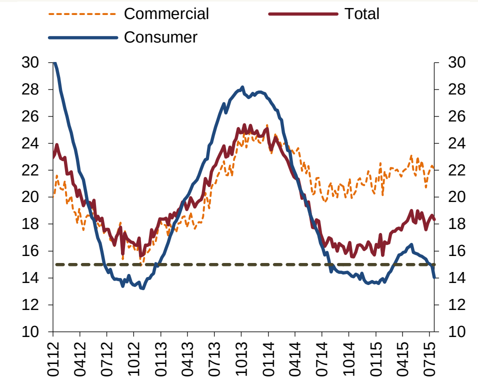
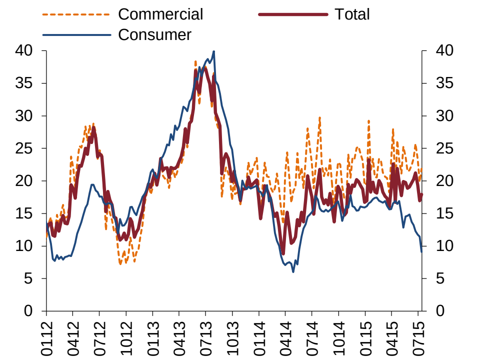



**Chart 5.2.4.**
Loan Growth
(Adjusted for Exchange Rate, 13-Week Moving Average, Annualized, Percent)




Source: CBRT.

Having hovered slightly below the averages of past years in the first quarter of 2015, the annualized growth rate of consumer loans recorded a decline in the second quarter. The growth rate of consumer loans, which declined in spite of seasonal effects, hit 12.3 percent at the end of the quarter (Chart 5.2.5). This quarter-on-quarter fall was driven by personal loans that grew by 4.3 percent on an annualized basis at the end of the quarter. Despite banks' statements in the Loan Tendency Survey that the standards and demand for personal loans remained unchanged in the second quarter, this fall is attributed to the sluggish economic outlook in addition to the developments in consumer confidence indices. Low readings in personal loan growth rates led to an acceleration in overdue personal loans, which also raised overdue consumer loans. The annualized growth rate of housing loans with a 5-year average maturity and higher interest rate sensitivity was greater than others. The growth of housing loans, which hovered rather close to past averages, reached 23.1 percent at the end of the quarter. According to the results of the Loan Tendency Survey, banks stated that the demand for housing loans will edge down in the next quarter and no easing is expected in loan standards. As a result of the macroprudential measures implemented by the BRSA, the growth of automobile loans, which was negative, has started to recover in line with seasonal effects. Given the revival in the automobile sector, this improvement is expected to continue in the third quarter of the year (Chart 5.2.6).

**Chart 5.2.5.**
Consumer Loan Growth
(13-Week Moving Average, Annualized, Percent)

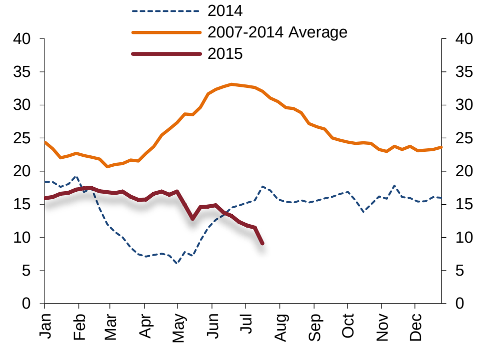
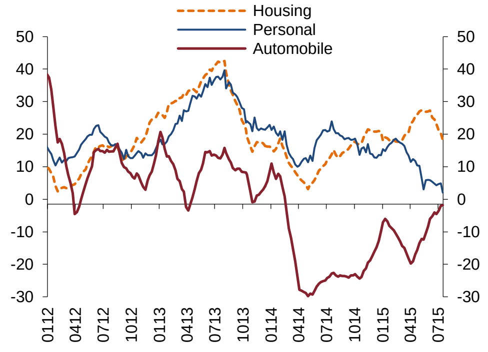



**Chart 5.2.6.**
Consumer Loan Growth
(13-Week Moving Average, Annualized, Percent)




Source: CBRT.

In the second quarter of the year, the annualized growth rate of commercial loans stood slightly below the averages of past years and hit 25.7 percent at the end of the quarter (Chart 5.2.7). The analysis of the sub-categories of commercial loans reveals that the stronger course compared to consumer loans is driven by TL-denominated commercial loans. FX-denominated commercial loans, on the other hand, have been declining since the start of 2015 (Chart 5.2.8). This decline is interpreted as the attenuation in the use of commercial loans by firms and more apparent need for debt rollover through business capital financing. According to the second-quarter Loan Tendency Survey results, standards for commercial loans have not exhibited a noticeable change. In addition, banks' responses reveal that commercial loan standards were no different with respect to firm size and maturity. In terms of scale, loan standards that apply to SMEs got somewhat tighter. In the second quarter, expectations for overall economic activity stood out among factors, which affect commercial loan standards. On the demand front, the demand for investments waned, while the motivation for debt restructuring has increased. In the third quarter of the year, banks expect an increase in the TL-denominated commercial loan demand in contrast to a decrease in the FX-denominated loan demand. Meanwhile, aggregate demand for commercial loans is expected to post a slight increase. In the same period, banks expect no significant change in commercial loan standards.

**Chart 5.2.7.**
Commercial Loan Growth
(Adjusted for Exchange Rate, 13-Week Moving Average, Annualized, Percent)

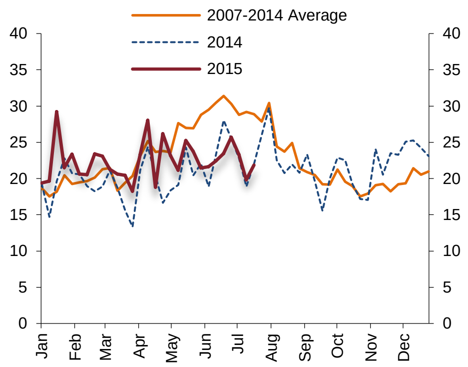
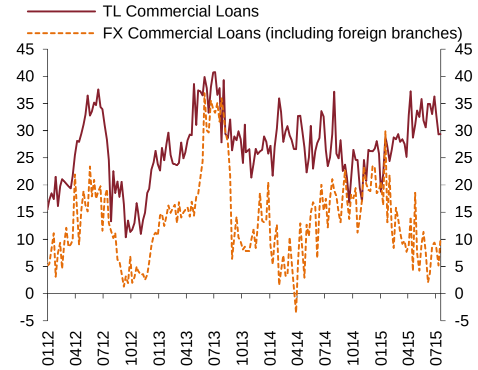



**Chart 5.2.8.**
TL and FX Commercial Loan Growth
(13-Week Moving Average, Annualized, Percent)



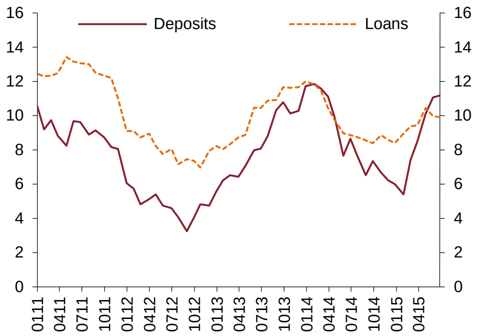

Source: CBRT.

In the second quarter of 2015, the annual growth rate of consumer loans was down quarter-on-quarter, while that of commercial loans remained flat. Accordingly, commercial loans continued to rise at a faster pace than consumer loans in the second quarter. Macroprudential policies exercised in recent years had a remarkable role in bringing the credit expansion rate to sustainable levels and directing the loan composition towards encouraging production rather than consumption. In this regard, the faster growth rate of commercial loans contributes to both the re-balancing process and to financial stability. In addition, the amendment to Law no. 6637, which was enforced in early July, is expected to contribute positively to the financing structure of the corporate sector.

Loan growth follows a moderate course thanks to policies adopted by the CBRT and the BRSA. Meanwhile, deposit growth also caught up with the pace of loan growth (Chart 5.2.9). This development is attributed to the CBRT's policies regarding reserve requirement and remuneration of required reserves, which stimulate core liabilities. The relationship between M2 and loans suggests that the growth rates of loans and money supply move on par and hover at reasonable levels

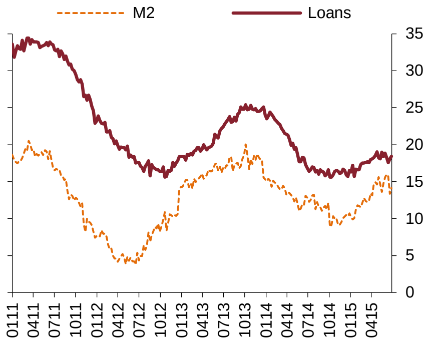
(Chart 5.2.10). The convergence of loan growth with that of deposits is a factor that will enhance the resilience of the banking sector against possible financial fluctuations by also reducing the banking sector's need for external financing. Thus, providing funds to the banking sector mostly through core items such as deposits will improve the robustness of the system.

**Chart 5.2.9.**
Loan and Deposit Growth*
(Annual Change/GDP)




* Including participation banks and excluding interbank deposits.
Source: TURKSTAT, CBRT.

**Chart 5.2.10.**
M2 Money Supply and Loans*
(Adjusted for Exchange Rate, Annual Percent Change)

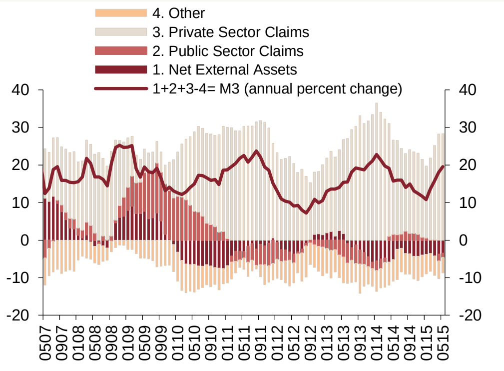



* Including participation banks and credits cards and excluding non-performing loans.
Source: CBRT.

## Monetary Indicators

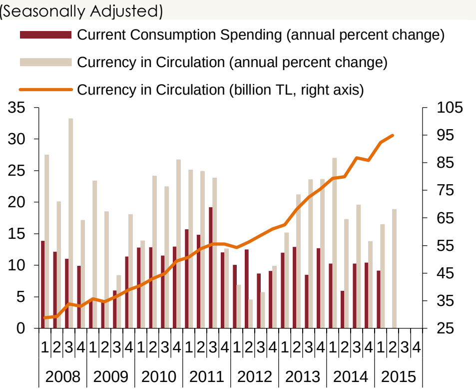
Credits extended to the private sector continued to determine the annual growth of M3, the broad measure of money supply, in the second quarter of 2015. Private Sector Claims, which mostly include credits extended by banks to non-financial private individuals and institutions, constituted the main reason for the acceleration in the M3 growth. Meanwhile, the item Other, which displayed a relatively steady course in line with bank profitability, is still a non-deposit funding source for the banking sector, yet contributed less negatively to money supply compared to the previous quarter. On the other hand, the contribution of Public Sector Claims to the M3 growth, which has been positive since the second quarter of 2014, turned negative in the second quarter of 2015 and started to reduce the money supply (Chart 5.2.11). Net Foreign Assets have also become another factor that has pulled the M3 growth down since early 2015.

**Chart 5.2.11.**
Balance Sheet Decomposition of M3
(Contributions to Annual M3 Growth)




Source: CBRT.

**Chart 5.2.12.**
Currency in Circulation and Current Consumption Spending*
(Seasonally Adjusted)




* Consumption spending includes private and public consumption excluding furniture, household appliances, transport and communication services at current prices.
Source: TURKSTAT, CBRT.

The annual growth of seasonally adjusted currency in circulation has been on the increase since the last quarter of 2014 (Chart 5.2.12). However, the annual growth rate of current consumption spending does not exhibit a notable increase. However, this acceleration in the currency in circulation is expected to have a modest impact on private domestic demand due to the cautious monetary policy stance, the macroprudential measures and the weak capital flows.