I. Macroeconomic Outlook

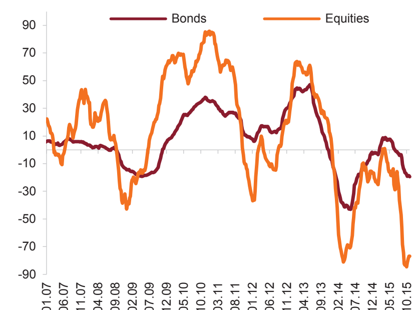
Volatilities in financial markets continue, while portfolio movements and risk indicators regarding the emerging economies follow a fluctuating course. The change in the risk indicators for the emerging economies was triggered by concerns about the Chinese economy, the downtrend in commodity prices and the uncertainties regarding the US monetary policy. Measures taken in emerging economies to boost resilience against external shocks bear a particular importance.

Leading indicators regarding the Turkish economy suggest that domestic demand was moderate and net external demand improved moderately in the second half of the year. The consumer price inflation rose slightly in this period due to increased food prices and exchange rate developments. Uncertainties surrounding the global monetary policies and the slow growth trend particularly in emerging economies affected the global risk appetite negatively in terms of portfolio investments. Nevertheless, resident banks kept their external borrowing at more reasonable and sustainable levels and costs in certain borrowing types were lower compared to the previous year. On the other hand, it seems impossible to anticipate when and how the uncertainties related to external developments will come to an end. Therefore, supporting the rebalancing process with excessive borrowing-oriented macroprudential policy measures has been important in terms of keeping macro financial imbalances at reasonable levels. In this context, implementations supporting core liabilities and encouraging longer term external borrowing started yielding results.

I.1. International Developments

In the second half of the year, portfolio investment outflows from emerging markets accelerated and financial indicators followed a fluctuating course. Outflows from the stock market are particularly significant (Chart I.1.1). During this period, risk premia of emerging economies also increased. Meanwhile, due to capital movements, the exchange rates and stock markets of these economies plummeted and recorded their

Chart I.1.1
Capital Flows to Emerging Economies
(Weekly, Billion USD)



Source: EPFR

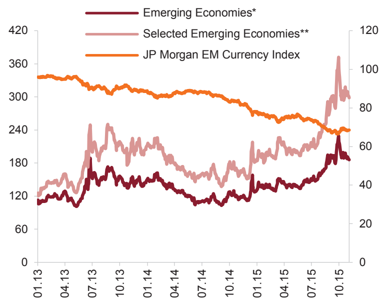
lowest levels after the global crisis (Chart I.1.2). The uptrend in credit and exchange rate risk premia was also reflected as an increase in the bond yields of emerging economies (Chart I.1.3). Recently rising risk appetite enabled a slight recovery in interest rate, exchange rate, equity prices and credit default swap (CDS) indicators, yet uncertainties regarding global markets are still significant.

The risk perception towards emerging economies was shaped by three main developments. Growth concerns in emerging economies, particularly in China, and the downtrend in commodity prices as well as the US monetary policy and the uncertainties related to communication strategy of this policy have affected the macro financial outlook for emerging economies.

Expectations regarding the US monetary policy continue to be effective on global financial markets. The economic recovery in the US continues. Accordingly, the labor market has improved and the unemployment rate has converged to pre-crisis levels. However, the number of part-time employees is still above pre-crisis levels and wages have not exerted an upward pressure on inflation yet (Chart I.1.4). Commodity prices stand at low levels and the US dollar remains strong, which suggests that the inflation will be below the targets for a bit longer. These developments signal that the pace of the Fed's interest rate hike may be considerably slow. In fact, the Federal Reserve Board members revised the interest rate forecasts downwards in the September meeting compared to the June meeting. The ongoing differentiation in the expectations of the market and the Federal Reserve Board members regarding the interest rate hike suggests that the sensitivity of financial markets to data and Fed communication may continue in the short term (Chart I.1.5).

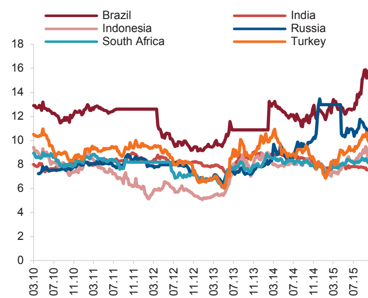
The slowdown in the Chinese economy and the current policy practices in China may have a significant impact on other emerging economies. China has been going through a change from an investment-based growth model to a consumption-based growth model. The country has vulnerabilities resulting from the high indebtedness level in the financial sector and firms as well as from the growing shadow banking sector. The

Chart I.1.2
CDS Premiums for Emerging Economies and JP Morgan Exchange Rate Index



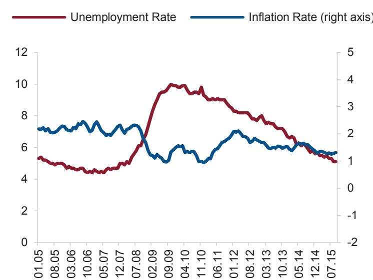
* Emerging economies include Brazil, Czech Republic, Indonesia, South Africa, Colombia, Hungary, Mexico, Poland, Romania, Chile and Turkey.
**CDS premia of Brazil, Indonesia and South Africa have been used to calculate the average of selected emerging economies.
Source: Bloomberg

Chart I.1.3
Government Bond Yields in Emerging Economies
(10 year, percent)



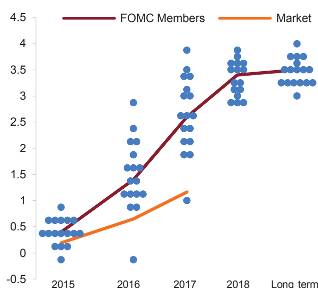
Source: Bloomberg

Chart I.1.4
Unemployment and Inflation Rate* in the US
(Percent)



* This rate reflects PCE Index.
Source: Bloomberg

Chart I.1.5
Expectations of the FOMC Members and the Market
(End-year, percent)



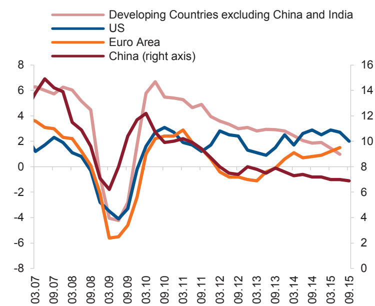
* Fed fund futures rates have been used for market expectations. Median of FOMC Members' interest rate expectations have been used.
Source: CME Group, Fed

tendency to shift to a market-based financial system and the efforts to reduce the current vulnerabilities pose a risk on the outlook of the Chinese economy.

The slowdown in the Chinese economy reinforces the downward movement in commodity prices. The downtrend in commodity prices, which was due to supply-side effects previously, has deepened especially in energy and metal prices with the impact of the weakened demand in China (Chart I.1.6 and Chart I.1.7). This downtrend in commodity prices reduces the input costs of commodity importing countries and accordingly constrains inflationary pressures. On the other hand, it negatively affects public finances of commodity exporting countries and debilitates the growth outlook. In addition, if the currency of China continues to depreciate in the upcoming period, then it may confine the competitiveness of other countries. Such concerns about the Chinese economy constitute another factor feeding into the volatility in global markets.

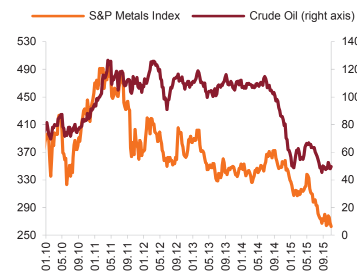
It is important that emerging countries continue to take steps towards boosting resilience against external shocks. The FX loan utilization of the non-banking sector in emerging economies has been in an uptrend since the global crisis (Chart I.1.8 and I.1.9). Therefore, the strengthening of the US dollar has the potential to affect firms' balance sheets negatively. It is crucial in such a conjuncture that measures to increase resilience against a likely additional tightening in external conditions are kept in place.

Chart I.1.6
Emerging[1] and Advanced Economies' Growth Rates
(Percent, Annual)



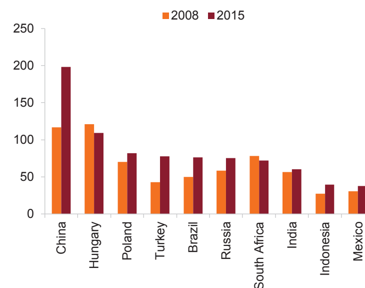
(1) Weighted by each country's share in global GDP.
Source: Bloomberg, CBRT.

Chart I.1.7
Commodity Prices
(Index, USD)



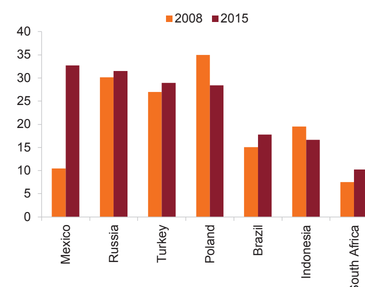
Source: Bloomberg

Chart I.1.8
Total Loans in Emerging Economies
(Percent of GDP)



Source: BIS

Chart I.1.9
FX Corporate Loans in Emerging Economies
(Percent of GDP)



Source: BIS

Box I.1.1 International Financial Regulation and Reform Studies

Since the global financial crisis, a broad reform agenda has been created for the global financial system to eliminate vulnerabilities and make financial institutions more resilient. This reform agenda has been developed and implemented by the leadership of the G20, which was established to increase coordination of economy policies and reinforce the financial system in the aftermath of the global financial crisis. Building resilient financial institutions, ending the too-big-to-fail problem, making the derivatives markets safer and decreasing the shadow banking-based risks are the core elements of the reform agenda. There has been significant progress in the completion of the reform agenda which has been put into practice in certain areas. The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB), under the leadership of the G20 of which Turkey holds the presidency, play a significant role in reform studies. The following three headings lead the priority list regarding financial regulations:

- Timely, consistent and full implementation of financial reforms,
- Finalizing remaining post-crisis financial reforms,
- Addressing new risks and vulnerabilities.

Basel Committee's Studies

Several reforms have been put into practice since 2008 to strengthen the international banking regulatory standards. The Basel III framework developed by the BCBS is an important element of these reforms. Risk-based capital requirements have been reviewed with Basel III. The quality and the quantity of capital have been increased. The common equity Tier 1 capital ratio, which has the highest capacity to absorb losses, has been raised from 2 percent to 4.5 percent. The capital framework has been supported with macroprudential elements. Accordingly, a 2.5-percent capital conservation buffer has been introduced. To strengthen capital and reduce procyclicality in times of rapid credit growth, a countercyclical buffer has been imposed within a range of 0 to 2.5 percent. An additional Tier 1 capital requirement of 1 to 3.5 percent has been introduced for global systemically important banks to address systemic risk originating from financial interconnectedness. Moreover, the definition of "large exposures" has been narrowed and the exposure of a bank to a single counterparty has been limited to 25 percent of its Tier 1 capital. This ratio is tighter (15 percent of the Tier 1capital) for exposures of global systemically important banks to each other. To capture all risks better, capital calculations for the market risk, securitization exposures and counterparty credit risk have been revised. A leverage ratio has been introduced to constrain leverage in the banking sector, supplement the risk-based capital requirement and reduce model risk and measurement errors. The leverage ratio is not risk-based and is calculated by dividing the Tier 1 capital by the exposure measure composed of on-balance sheet and off-balance sheet exposures, derivative exposures and securities financing transactions. The Basel III has also been the first regulation to introduce global liquidity standards, develop the liquidity coverage ratio and the net stable funding ratio. The objective of the liquidity coverage ratio is to ensure that banks have sufficient high quality liquid assets to offset their net cash outflows lasting for 30 days, while the objective of the net stable funding ratio is to ensure that banks fund their long-term assets with long-term liabilities and to increase the share of core funding in total funding.

With a view to enabling the banking sector to function accurately and reducing incentives that encourage taking excessive risks, governance and compensation principles at banks and banking supervision principles have been reviewed.

To facilitate timely, full and consistent implementation of reforms, the BCBS has adopted a Regulatory Consistency Assessment Program through which it monitors the adoption of Basel III standards. Up to this date, assessment reports of 22 countries have been released.

In the upcoming period, the BCBS will work to ensure a simple, comparable and risk-sensitive calculation of risk-weighted assets. To this end, standard methods for credit risk, market risk and operational risk are being revised. The use of internal models will be reviewed. The use of internal models will be confined to certain risks and portfolios, parameters used in internal models will be restricted or a standard approach-based capital framework will be set for the capital level calculated with the internal model. Calibration of the capital framework will be completed with the calibration of the leverage ratio. Capital calculations will be differentiated for simple, transparent and comparable securitizations. The interest rate risk in the banking book is under review. The BCBS is planning to finalize the ongoing reform studies at end-2016. In addition, the Committee has initiated a study to review the sovereign exposures and policy options. The related policy suggestions are expected to be offered for consideration at end-2016.

FSB's Studies

Although significant progress has been made in reform studies, there have been delays in certain areas. The greatest progress in the over-the-counter derivatives markets reform has been made in the reporting to trade repositories and the capital regulations for non-centrally cleared derivatives. On the other hand, many countries lack margin requirements for non-centrally cleared derivatives, or regulations in this area are not fully implemented yet. There is very little progress regarding the settlement of cross-border issues. Legal barriers to countries' deference to each other's regulations, reporting to trade repositories and data sharing with authorities should be removed.

Regulations regarding banks have been completed to end the too-big-to-fail problem. In this framework, the FSB has published the regulation on the total loss-absorbing capacity for global systemically important banks (See Box IV.1.1). There are also studies for too-big-to-fail non-bank institutions. In this scope, the International Association of Insurance Supervisors (IAIS) issued higher loss absorbency requirements for global systemically important insurers. Moreover, there are ongoing studies on the possible effects of liquidity risks in asset management activities on financial stability. Finally, the role of central counterparties (CCP) in the financial system has increased. In this respect, studies on the CCP resilience, recovery planning and resolvability are important in terms of preventing the CCPs from becoming too-big-to-fail.

The growing importance of market-based finance necessitates the monitoring of this sector for risks and vulnerabilities. On the market liquidity and the activities of asset management companies, the FSB points to the importance of stress testing of funds. In 2016, the FSB will work on likely structural vulnerabilities and policy measures.

The market misconduct risk has the potential to create systemic risks by shaking the confidence in financial institutions. The FSB has devised an action plan regarding this issue, which includes the identification of the current situation and the measures to be taken if needed. The action plan covers subjects such as the effectiveness of post-crisis reforms in reducing market misconduct risk and how the standards in the fixed income securities, commodities and currency markets can be improved.

The decline in correspondent banking services, driven by concerns about money laundering and terrorism financing risks as well as rules for paying due diligence to know the customer, limits the access of local banks and economies of some countries to the global economy. Therefore, the task force established by the leadership of the FSB and the World Bank has launched an action plan to address this issue.

Finally, there are ongoing works on the potential risks to the financial sector from climate change. Climate change is expected to affect the financial sector through physical risks (surges in insurance costs due to a rise in disasters such as floods and storms), liability risks (compensation demands for damages stemming from climate change) and transition risks (transition to a lower carbon economy).

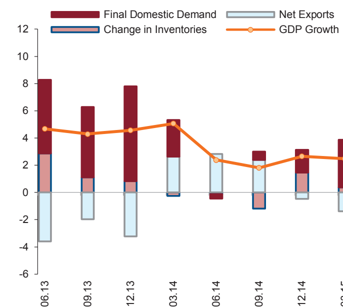
I.2. Domestic Developments

In the second quarter of 2015, the stable growth trend in the economic activity continued. The largest contribution to economic growth came from final domestic demand in this period, whereas the contribution of net exports was negative (Chart I.2.1). Meanwhile, up-to-date data indicate that the net external demand's contribution to growth will surge in the second half of the year, while domestic demand will be more moderate. The employment growth was strong in the first quarter of the year but decelerated in the second quarter. The rise in labor force participation rates observed since April has led to a slight increase in the unemployment rate.

Inflation climbed on the back of food prices and exchange rates. Hikes in unprocessed food prices played a significant role in the rise in consumer inflation both directly and indirectly through their impacts on food service prices (Chart I.2.2). Although dollar-denominated import prices declined, cost pressures on inflation intensified due to exchange rate developments. Inflation is estimated to float above the target for a bit longer because of the lagged effects of exchange rate movements.

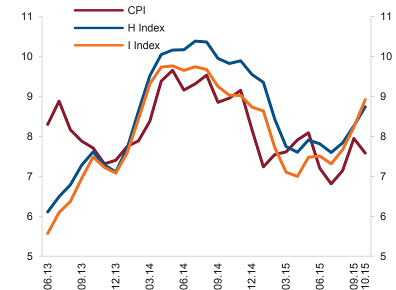
Uncertainties regarding global monetary policies and concerns about the global growth have added to the fluctuations in portfolio inflows to Turkey (Chart I.2.3). The contraction in portfolio flows resulted mainly from uncertainties regarding global monetary policies and global growth, while occasionally, domestic developments also had influence on the fluctuations in markets. On the other hand, portfolio flows have recovered slightly in the recent period due to the partial improvement in global risk perceptions. Uncertainties about the risk perceptions for emerging economies have had a significant effect on the Turkish lira in addition to the currencies of these countries (Chart I.2.4).

Chart I.2.1
Contribution to Growth From The Spending Side
(Percentage Point)



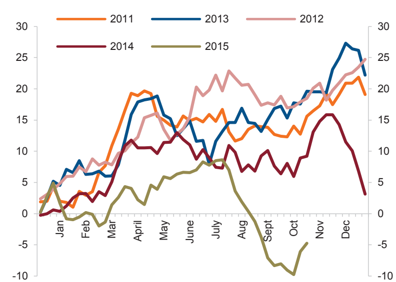
Source: CBRT, TURKSTAT

Chart I.2.2
Price Indices
(Annual Percentage Change)



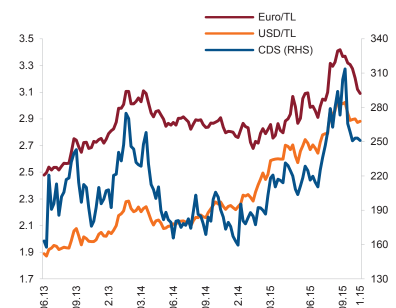
Source: CBRT, TURKSTAT

Chart I.2.3
Cumulative Portfolio Flows[1]
(Billion USD)



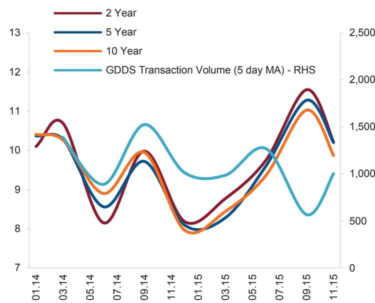
(1) Calculated by weekly net portfolio flows. Includes data on repo, GDDS and securities portfolio as well as banks' off-balance sheet FX position.
Source: BRSA, CBRT

Chart I.2.4
Exchange Rates and Turkey's 5-Year CDS Prices



Source: CBRT, Bloomberg

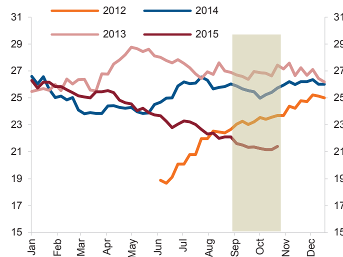
Chart I.2.5
GDDS Generic Yield and Transaction Volume
(Percentage, Million TL)



Source: Bloomberg, BIST

Government domestic debt securities (GDDS) yields, which had been in an upward trend at the start of the year, demonstrated a downward trend since September (Chart I.2.5). The liquidity in the GDDS secondary market improved moderately due to the decline in interest rates. However, there was not a strong growth in foreign investors' demand for these securities (Chart I.2.6).

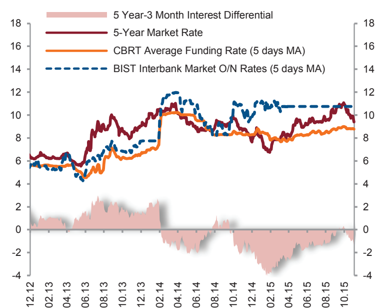
Chart I.2.6
Non-residents' holdings of GDDS [1]
(Percent)



1) Calculated by non-residents' holdings of government domestic debt securities (GDDS) over total GDDS
Source: CBRT

The CBRT implemented a tight monetary policy to contain the impact of exchange rate movements as well as energy and food price volatilities seen since the start of the year on inflation and inflation expectations. In this framework, the average funding rate was gradually raised. While the CBRT continued to offer funding predominantly via one-week repo auctions, the share of marginal funding was increased more and more. Accordingly, there was an upward trend in average funding rates. The overnight market interest rates hovered around the marginal funding rate. Thus, the difference between the 5-year market interest rate and the interbank overnight repo rate was kept at levels that were negative or close to zero throughout the year (Chart I.2.7).

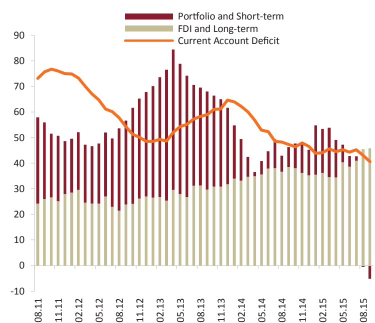
Chart I.2.7
CBRT Rates and BIST Interbank O/N Rates (Percent)



Source: CBRT, BIST

The current account balance continues to improve (Chart I.2.8). This improvement has resulted mainly from the decline in commodity prices, the ongoing cautious monetary policy stance and the reasonable level of loan growth achieved by macroprudential measures. The current account deficit is financed largely through long-term sources and direct capital investments. The share of portfolio and short-term fund flows in external financing has significantly weakened in recent months.

Chart I.2.8
Current Account Deficit and Financing Items[1]
(12-Month Cumulative, Billion USD)

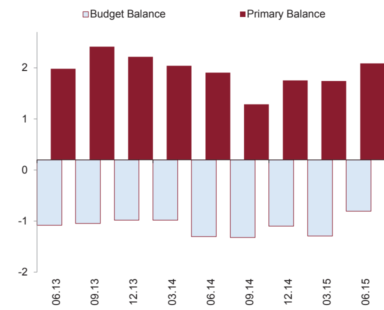


Source: CBRT

The fiscal discipline contributes to bringing down both the risk premiums and inflation. As of the second quarter of 2015, the central government budget deficit markedly decreased compared to the previous quarter's data (Chart I.2.9). The downward trend in public debts continues. The fact that borrowing is mostly fixed rate, Turkish lira denominated and with longer tenures increases the resilience of public finance against external shocks (Chart I.2.10).

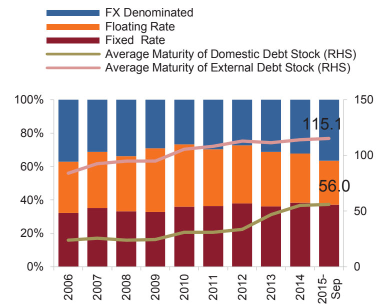
The ongoing stable rebalancing process and the macroprudential measures boost the resilience of Turkey's financial system against potential global financial markets-based risks. The uncertainty in global financial markets is expected to last for a bit longer. It is important in this process that the financial system's external borrowing remains moderate and borrowing maturities expand. In this respect, the increase in external borrowing's term to maturity is accepted as a very favorable development while the rebalancing in the current account deficit continues owing to macroprudential measures.

Chart I.2.9
Central Government Budget Balances
(12-Month Cumulative, Percent of GDP)



Source: Ministry of Finance

Chart I.2.10
Composition of Central Government Debt Stock and Average Days to Maturity[1] (Month)

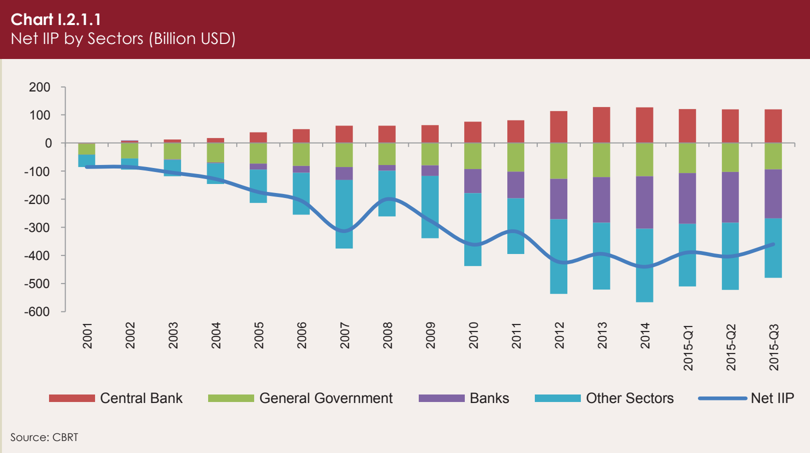


(1) Data of days to maturity pertains to September 2015.
Source: Undersecretariat of Treasury

Box I.2.1 An Analysis of the International Investment Position by Sectors

The International Investment Position (IIP) shows at a point in time the stock value of financial assets of residents in an economy that are claims on nonresidents, gold bullions and foreign currency held as reserve assets, as well as the value of the liabilities of residents to non-residents. The IIP has been compiled and released by the CBRT since 1996. It serves as an important data source for external debt and risk analyses as it offers detailed, comprehensive and comparable information in a breakdown by sector, financial instrument and maturity. In this framework, this box presents an analysis of the asset and liability positions implied by the IIP on a sectoral basis as well as the maturity breakdown of liability items for all sectors.

Chart I.2.1.1
Net IIP by Sectors (Billion USD)



Source: CBRT

In the IIP, the difference between total financial assets and total financial liabilities is called the "net IIP". In other words, the net IIP shows the difference between Turkey's claims on non-residents and its liabilities to non -residents. The net IIP increased in a negative direction until 2012, except for 2008 and 2011. In 2012 and after, the net IIP was relatively flat at approximately USD -400 billion.

External liabilities of all main sectors in the IIP are greater than their external assets, with the exception of the Central Bank. Other sectors and banks stand as the largest sectors composing the net IIP.

The largest liability item of the General Government is the portfolio investment that covers debt securities. Debt securities consist of GDDS issued by the Undersecretariat of Treasury in the domestic market and purchased by non-residents as well as the total bond stock (excluding the portion purchased by residents) issued abroad by the Undersecretariat of Treasury. The uptrend observed in this sector's liabilities until 2012 reversed in 2013 and liabilities started declining (Chart I.2.1.2). On the other hand, the official reserve assets is the largest asset item of the CBRT in terms of the IIP. This item refers to the total of external assets having a gold and foreign currency equivalent under the control of the Central Bank (Chart I.2.1.3).

Chart I.2.1.2
Net IIP of the General Government (Billion USD)

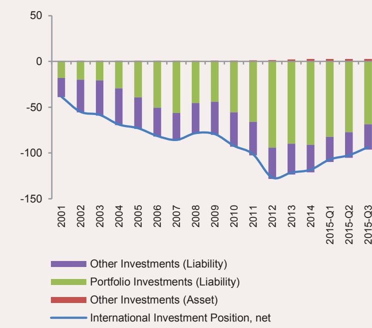
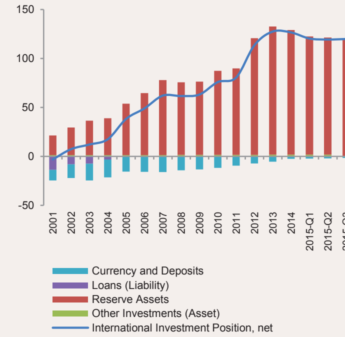


Chart I.2.1.3
Net IIP of the Central Bank (Billion USD)



Source: CBRT

Chart I.2.1.4
Net IIP of Banks (Billion USD)

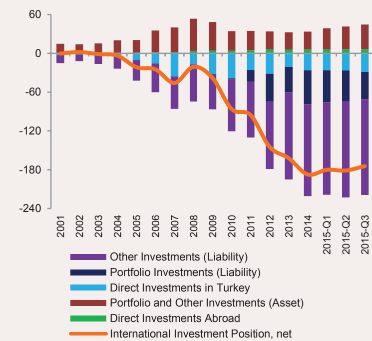
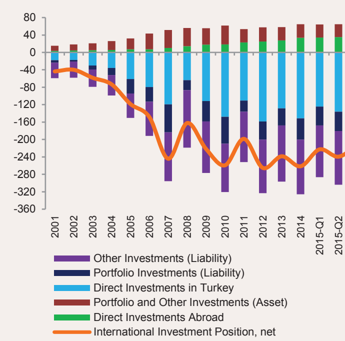


Chart I.2.1.5
Net IIP of Other Sectors (Billion USD)



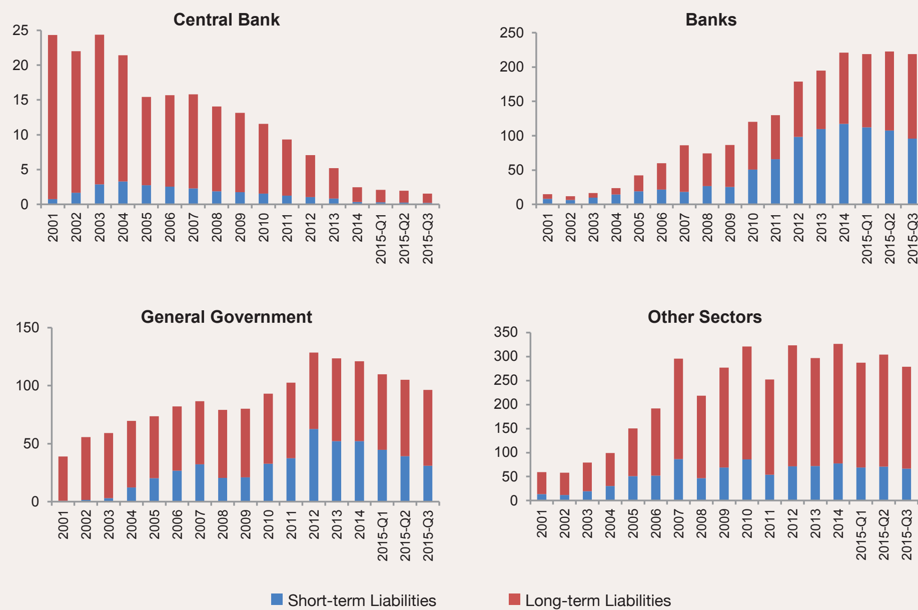
Source: CBRT

An analysis of banks' net IIP suggests that the uptrend in liabilities accelerated particularly after 2008 but followed a flat course after 2014. This development is attributed to the legal arrangement introduced in 2009 regarding FX and FX-indexed loans. In addition, loan utilization and bond issues abroad have surged in recent years.

The net IIP of other sectors remained on the liability side throughout the analysis period and posted a rapid increase especially in the period between 2001 and 2007. After 2007, it oscillated in a flat band. Direct investments in Turkey constituted the largest liability item of other sectors. This item constituted 40.8 percent of the total liabilities of other sectors as of end-September 2015. It was followed by long-term loans (32.1 percent) and equity securities (10.7 percent) (Chart I.2.1.5).

The maturity breakdown of sectors' liability items shows that long-term liabilities predominate in all sectors other than banks. As of the end of 2015-Q3, the ratio of long-term liabilities to total liabilities was 86.5 percent in the CBRT, 67.8 percent in the General Government and 76.2 percent in Other Sectors. An analysis of the maturity structure of the banking sector's liabilities reveals that the share of long-term liabilities was higher until 2010 but then dropped below 50 percent in line with the hike in short-term loans. In 2015, with a view to supporting financial stability, the CBRT changed the reserve requirement ratios for foreign exchange-denominated liabilities of banks and financing companies in order to encourage the extension of maturities of non-core liabilities. Consequently, there has been a shift from short-term loans to long-term loans. As of the end of 2015-Q3, the ratio of banks' long-term liabilities to the banking sector's total liabilities stood at 56.2 percent (Chart I.2.1.6).

Chart I.2.1.6
Maturity Breakdown of Liabilities (Billion USD)*



Source: CBRT.
* Long term liabilities consist of long term loan stock of banks and private sector, direct investment in Turkey, long term debt securities of banks and private sector and Eurobond issues of the Treasury. Short term liabilities consist of short term loan stock of banks and private sector, short term debt securities of banks and private sector, equities held by non-residents, deposits on resident banks and GDDS issued by the Treasury in the domestic market and purchased by non-residents.