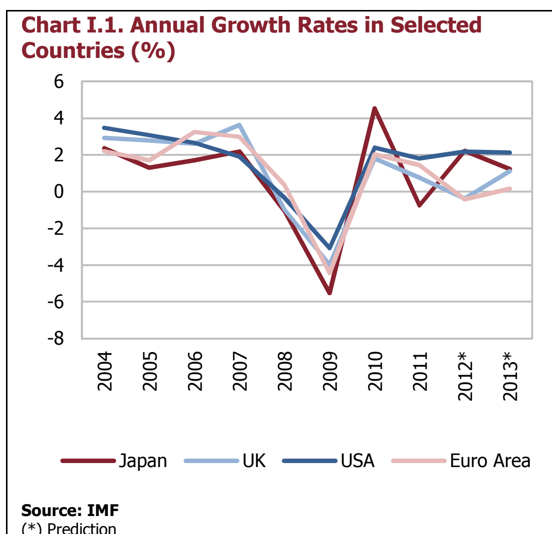
I. INTERNATIONAL DEVELOPMENTS

Uncertainties in global economic activity persist due to unfavorable growth indicators in advanced economies. Lingering concerns regarding the EU economy; and growth problems and fiscal constraints in the US and Japan fuel volatility in the markets. To tackle these problems, the authorities in the advanced economies are taking measures that are welcome by the markets while central banks are implementing expansionary monetary policies that cause a global liquidity surplus. Despite these measures and ample liquidity, the credit channel in advanced economies still fails to function as effectively as desired. Lingering uncertainties coupled with ample liquidity conditions do not only adversely affect growth and price stability in countries importing raw materials by pushing commodity prices up, but also pose a serious risk to financial stability in developing countries as they induce volatility in capital inflows. As these developments influence the growth momentum in developing countries, their growth projections have recently been revised downwards.

In the aftermath of the global financial crisis, the recovery in economic activity in advanced economies remained below expectations and growth forecasts were generally revised downwards. Credit supply problems and fiscal policy that is unable to support growth have hindered recovery in economic activity in advanced economies. Even if central banks have attempted to underpin growth and employment by implementing expansionary monetary policies amid low inflationary pressure, ongoing structural problems and deleveraging operations in the finance sector are limiting the effectiveness of these policies. Actually, the decline in growth rates of advanced economies continues and international institutions have been revising their growth forecasts downwards for 2012 and 2013 (Chart I.1, Chart I.2).

Chart I.1. Annual Growth Rates in Selected Countries (%)



Source: IMF
(*) Prediction

Chart I.2. Growth Prospects for 2012 (%)

Source: IMF

Employment rates in the US have not yet reached the desired level, and this has urged the Fed to introduce a third round of open-ended quantitative easing. The Fed announced that it would expand its holdings of long-term securities with open-ended purchases of USD 40 billion of mortgage backed securities a month in response to the still-high unemployment rates despite previous fiscal and monetary plans. It was stated that open-ended purchases would continue until employment rates improved significantly (Table I.1). Moreover, at the Fed's October meeting, various opinions were voiced about linking the Fed's expansionary policies to some specific

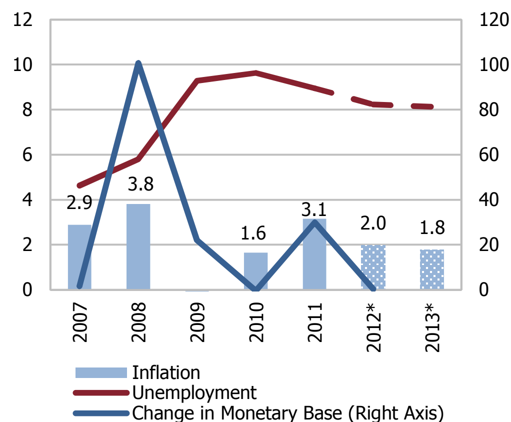
quantitative criteria. Accordingly, it was stated that the easing of monetary policy would continue as long as necessary to bring down unemployment unless there was an inflationary pressure. Therefore, the exact amount of liquidity to be injected into the market is unknown. Neither the impact of this new policy on employment nor their prospective reverberations on the global economy are clear as yet (Chart I.3).

Table I.1 Fed's Policy Decisions

	Starting Date	End Date	Explanation	Total Effect (Billion USD)
QE1	Dec-08	Mar-10	Purchasing 600 + 750 billion USD Mortgage-Backed Securities (MBS) and 300 billion USD Treasury Bond	1650
QE2	Nov-10	Jun-11	Purchasing 75 billion USD Treasury Bonds monthly	600
Operation Twist	Sep-11	Dec-12	Purchase 400 + 267 billion USD of bonds with maturities of 6 to 30 years and to sell bonds with maturities less than 3 years	0
QE3	Sep-12	Open-ended	40 billion USD a month, open-ended, bond purchasing program of agency MBS	Uncertain

Source: Fed

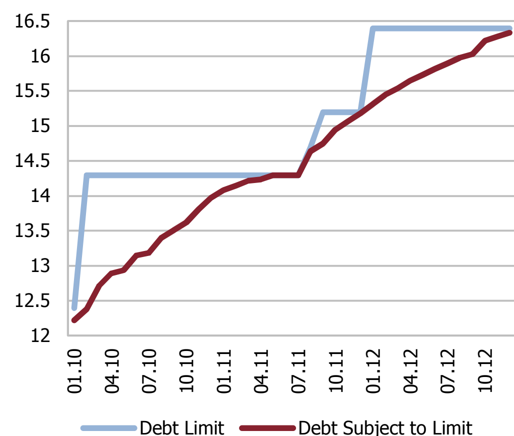
Chart I.3. Change in US Inflation, Unemployment and Fed Balance Sheet[1] (%)



Source: IMF and Fed
(1) Shows annual change in Fed Base Money.
(*)Inflation and Unemployment are IMF forecasts; shows change in Fed base Money between October 2012-December 2011.

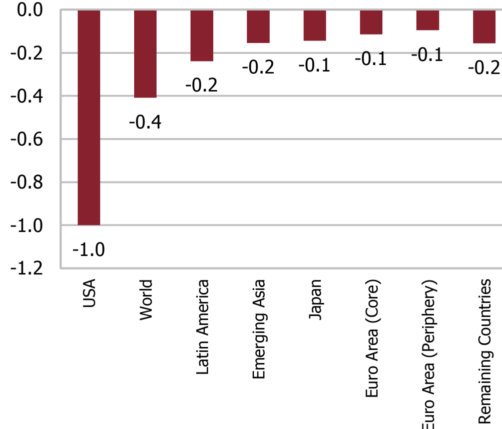
Problems with public finances in the US continue to pose risk to global growth. The arrangement, which calls for automatic tax hikes and spending cuts, is likely to lead to a "fiscal cliff" that will adversely affect growth. Moreover, the debt limit has already been reached and the necessity to raise the limit again further fuels political risks (Chart I.4). In the worst-case scenario, rapid tax growth and drastic spending cuts can make a negative impact on the recently recovering US growth and employment performance (Chart I.5). Recent experiences of EU countries emphasize the importance of establishing budget discipline before market pressure and of opting for a gradual transition period instead of a tight austerity policy.

Chart I.4. US Debt Limit and Public Debt Subject to Limit (Trillion USD)



Source: US Department of the Treasury and Office of Management and Budget, White House

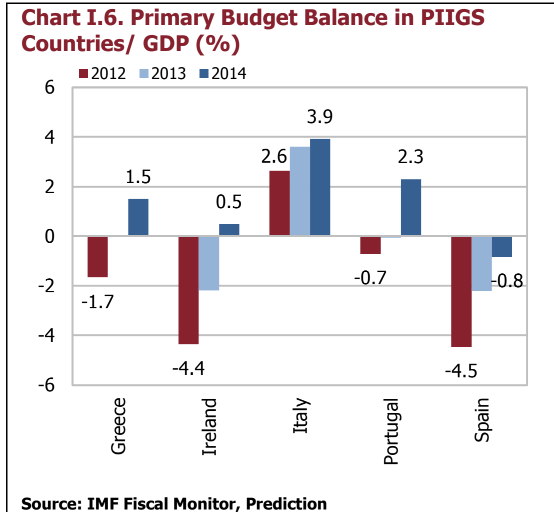
Chart I.5. Possible Impact of Fiscal Cliff on 2013 Global Growth (Deviation from the Baseline Scenario, %)



Source: IMF

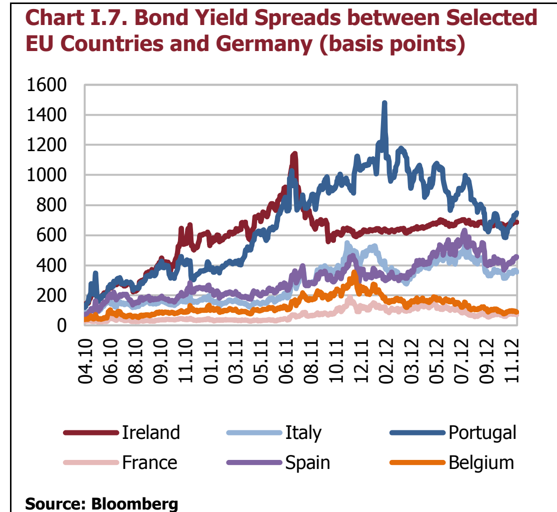
Unresolved problems on public finances and austerity policies introduced to narrow the budget deficit have caused EU countries to slide deeper into recession. The risk of Greece's bankruptcy has not yet completely dissipated; and banking and public finances problems in peripheral Euro Area countries like Spain have reached a level that threatens the future of Euro (Chart I.6). While tight fiscal policies suppress domestic demand across the EU, these policies are adversely affecting growth and employment amid the already deficient external demand. Actually, growth prospects for the EU are constantly being revised downwards. Nevertheless, the measures taken are partly offsetting the upward pressure on bond yields (Chart I.7).

Chart I.6. Primary Budget Balance in PIIGS Countries/ GDP (%)



Source: IMF Fiscal Monitor, Prediction

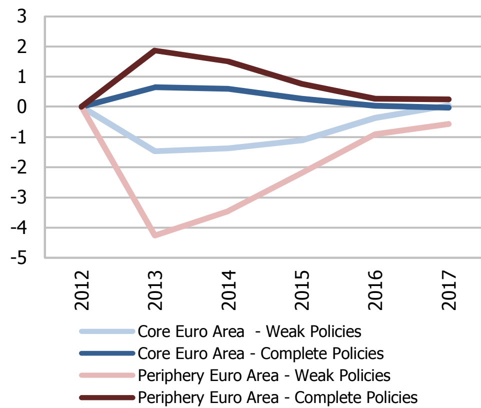
Chart I.7. Bond Yield Spreads between Selected EU Countries and Germany (basis points)



Source: Bloomberg

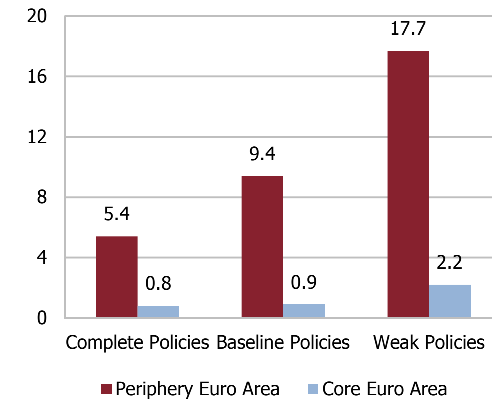
The nexus between public finances problems and the banking sector in the EU have accelerated efforts to establish a single banking supervision and regulation mechanism. Under this new system, the supervision and restructuring of banks within the EU is planned to be shifted from governments to European level. Hence, ECB supervision will be phased-in to cover systemically important European banks first and then all other European banks. However, it is has been discussed that the effectiveness of this plan would be limited if it is put into practice without establishing a single resolution mechanism. Moreover, even if the European Commission has presented its plan, the boundaries of supervision and oversight between national authorities and the ECB are not yet clear. Resolving these problems in the fastest way possible would be an important step because cutting the ties between the EU banking system and local authorities and country risk exposure is expected to spur growth and promote the efficient functioning of the credit channel (Chart I.8, Chart I.9).

Chart I.8. The Prospective Effects of Various Policy Scenarios on GDP (%) [1]



Source: IMF Global Financial Stability Report, October 2012.
(1) Core Countries: Austria, Belgium, Finland, Germany, the Netherlands
Peripheral Countries: Greece, Italy, Spain, Ireland, Portugal

Chart I.9 Prospective Downside Effects of Various Policy Scenarios on Credit Supply (Ratio to Total Loans, %)



Source: IMF Global Financial Stability Report, October 2012.
Baseline Policies: Envisages that the banking union will proceed as planned, the pressure on the spreads within the framework of the OMT (Outright Monetary Transactions) of the ECB will decline and peripheral countries will follow through with their adjustment programs.

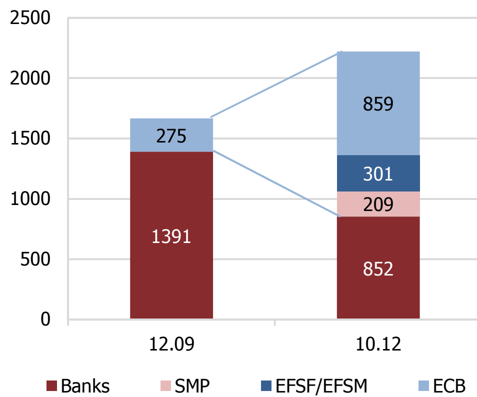
Weak Policies: Envisages that the measures stated in the baseline scenario are not taken.

Strong Policies: Envisages that Euro Area policymakers advance timetables for actions assumed in the baseline scenario and they present a clear roadmap to a banking union and fiscal integration and deliver a major down payment toward those goals.

The additional capital requirement, which emerged as a result of the new regulations in the EU banking system, has been pushing EU banks to accelerate deleveraging and decrease their investments in risky countries. Therefore, in response to the additional capital requirement and increased funding costs, European banks have been decreasing their assets and squeezing the credit supply. European banks' downsizing operations on their balance sheets and funding problems are limiting the credit supply to especially to Central and Eastern European countries and some Euro Area countries.

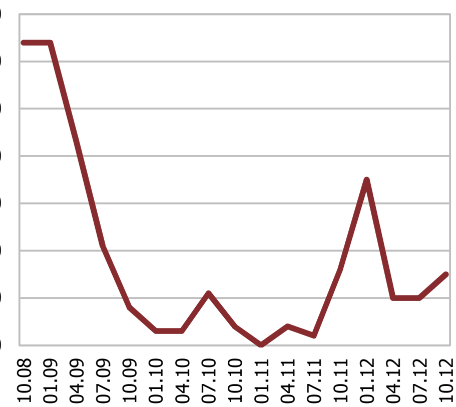
Meanwhile, there are signs that the European financial system has a "fragmented structure". According to this assumption, the more confidence in peripheral countries wanes, the clearer the discrepancies between core and peripheral European countries become. While international capital flows towards these countries are gradually decreasing; demand for other temporary ECB substitute instruments – LTRO (Long-Term Refinancing Operation), the SMP (The Security Markets Program) and EU funds are increasing (Chart I.10) Growing fears of a Euro exit by the weakest Euro Area countries urge European banks to try to balance their assets and liabilities with these countries. Moreover, as a consequence of the decline in investments in these countries, credit conditions in peripheral European countries have become tighter (Chart I.11).

Chart I.10. Total Liabilities of Eurozone Banks from PIIGS Countries (Billion euro)



Source: IMF Global Financial Stability Report, October 2012.

Chart I.11. Results of Bank Lending Surveys in the Euro area (Index)[1]

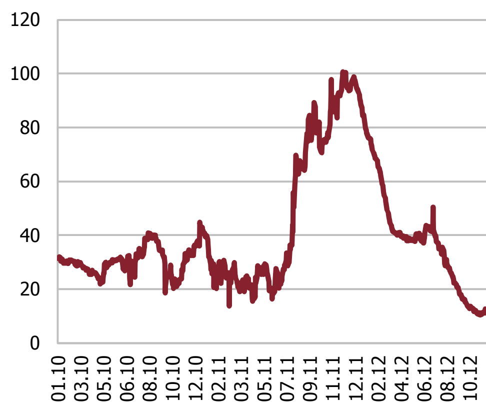


Source: ECB

(1) Positive values suggest stricter credit standards compared to the previous period.

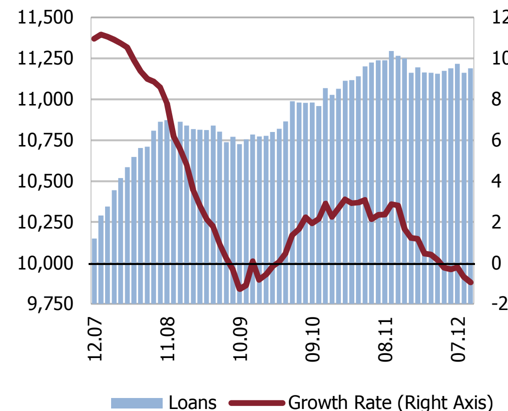
The ECB introduced some new policy measures to clear blockages in the credit channel and avoid further deepening of financial instability. In this framework, the ECB's announcement that it would implement the Outright Monetary Transactions program provided that member states accepted IMF and EU-backed macroeconomic policies and the long-term refinancing operations it carried out proved to be effective in the short run. However, the long-term effectiveness of these measures in remedying credit supply problems due to structural troubles in the finance sector is still being debated. While countries that are struggling with growth and public finances challenges are pushing the ECB to implement an expansionary monetary policy; countries led by Germany urge the ECB to implement policies that focus on price stability (Chart I.12, Chart I.13).

Chart I.12. EURIBOR-OIS Spread (Basis Points)



Source: Bloomberg

Chart I.13. Banking Sector Loans in Euro Area (Billion euro, %)

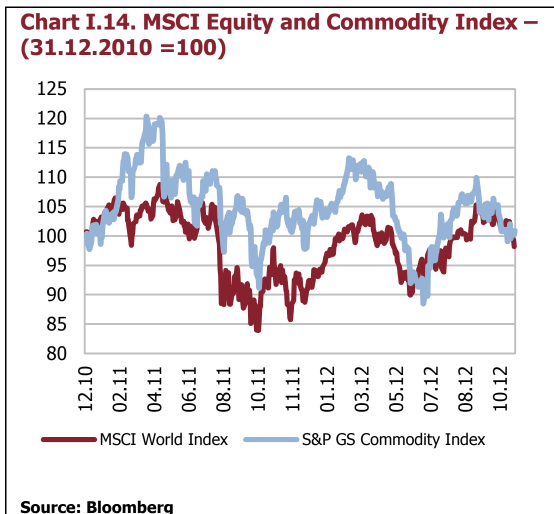


Source: ECB

While monetary expansion in advanced economies led to a surplus of global liquidity and stimulated recovery in asset prices on the one hand, it fuelled volatility in capital flows on the other. Ample liquidity following the crisis offset the loss in stock markets and commodity prices (Chart I.14). Nevertheless, deficient global demand limits the general inflationary pressure of commodity prices. Moreover, while liquidity and low returns cause increased international capital flows; high volatility is observed due to investors' over-sensitive reactions to developments amid global uncertainties and lingering low growth performance (Chart I.15). All in all, ongoing

problems in the banking sectors of advanced economies are restraining international capital movements.

Chart I.14. MSCI Equity and Commodity Index – (31.12.2010 =100)



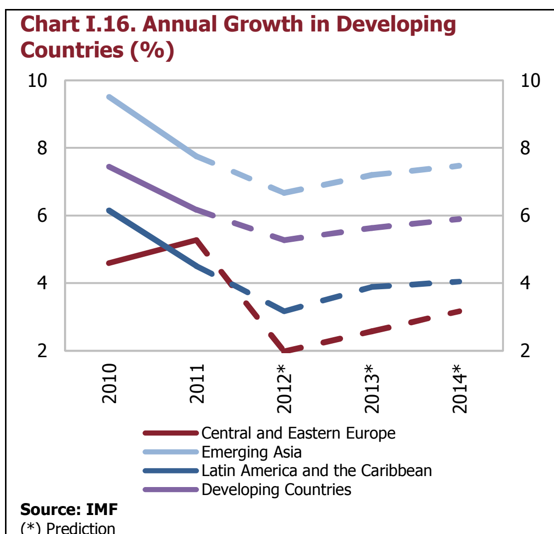
Source: Bloomberg

Chart I.15. VIX Index

Source: Bloomberg

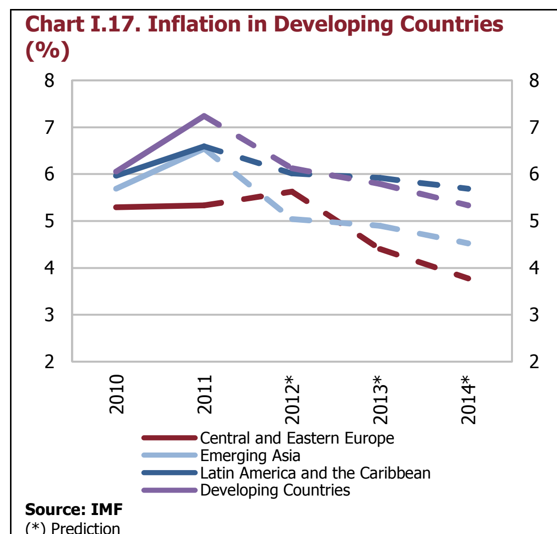
Growth in developing countries has been decelerating in parallel with global growth prospect. Many countries led by the BRIC countries are heading towards policies that support growth due to the economic slowdown (Chart I.16). The inflationary pressures in developing economies, which emerged as a consequence of the past years' rapid growth performance, have muted recently owing to the ongoing risk of global recession (Chart I.17). Therefore, the macroprudential tightening measures started to be replaced by accommodative fiscal and monetary policies.

Chart I.16. Annual Growth in Developing Countries (%)



Source: IMF
(*) Prediction

Chart I.17. Inflation in Developing Countries (%)

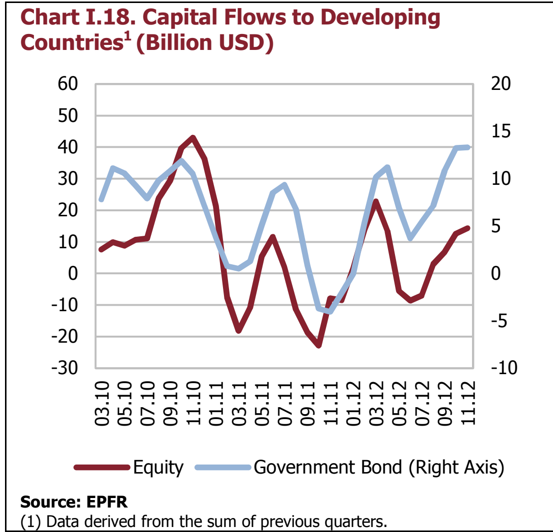


Source: IMF
(*) Prediction

Despite the slowdown in growth in developing countries, capital flows to these countries continue owing to their strong fiscal structures and growth potential. Although European banks carried out deleveraging operations in the face of the Euro crisis; developing countries saw no sudden drops in capital inflows as major central banks continued to implement expansionary monetary policies (Chart I.18). However, the discrepancy between developing countries became more remarkable after the Euro crisis. Central and Eastern European countries, which have close commercial and financial ties with the EU, have become the ones most severely affected by the Euro crisis; Latin American and Asian countries have been less affected. Capital flows were mostly

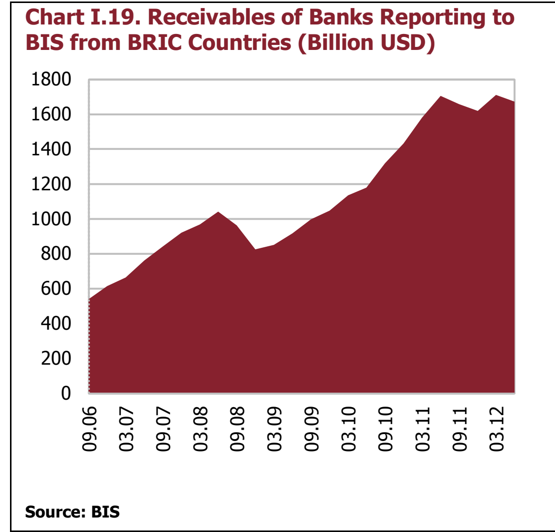
composed of investments in debt securities, since investors thought that these countries were safe heaven compared to the risk of advanced economies, as well (Chart I.19).

Chart I.18. Capital Flows to Developing Countries[1] (Billion USD)



Source: EPFR
(1) Data derived from the sum of previous quarters.

Chart I.19. Receivables of Banks Reporting to BIS from BRIC Countries (Billion USD)



Source: BIS

To sum up, the global integration, growth and development process in the pre-crisis period was replaced by regional discrepancies, vulnerabilities and contagion effects as the global financial crisis loomed. In this period, the restructuring process and new regulations both at national and international level, as well as trade protectionism are coming to the top of the agenda on the one hand, more weight is given to international coordination and cooperation on the other. However, ultimately, recovery is closely related to the policies a country implements and its political will.

Currently, advanced economies are undergoing a balance sheet deleveraging process while rapid credit growth is curtailing vulnerabilities in developing countries thanks to their growth potential and relatively strong public finance structure. Meanwhile, the European financial system is displaying a "fragmented" structure. Due to the problems in EU countries, the USA and Japan are taking extra credit for being "risk-free countries" and financing costs are decreasing in these countries. Nevertheless, fiscal cliff and debt ceiling issues are still at the top of the US and thus global agenda.

All in all, despite some recovery signals in the international financial system, confidence has not yet been restored. In this period, it is crucial to implement financial system reforms at the right time and in the right order; and support them with effective and innovative policies.