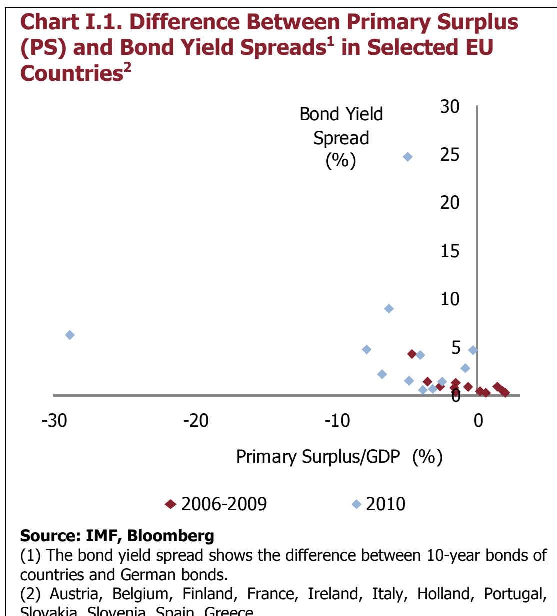
I. INTERNATIONAL DEVELOPMENTS

Due to post-crisis measures supportive of growth and fiscal stimulus provided to the financial sector, problems in the financial structure of some European Union (EU) countries deepened. The increase in sovereign risks spilled over to the banking sector especially due to the government securities on banks' balance sheets and the banking sector started facing funding pressures. Along with problems spreading over to other countries due to the interconnected nature of financial markets, the global risk appetite decreased significantly and global economic activity was adversely affected. Parallel to these developments, even though overheating concerns in emerging market economies weakened, it is still of importance to address price stability and financial stability in a coordinated manner. Even though some measures were taken by the EU and national authorities to mitigate the effects of the crisis and reduce the speed of contagion, these measures failed to avoid concerns. Within that respect, policy decisions to be taken promptly and implemented decisively by policy makers are essential for alleviating the concerns.

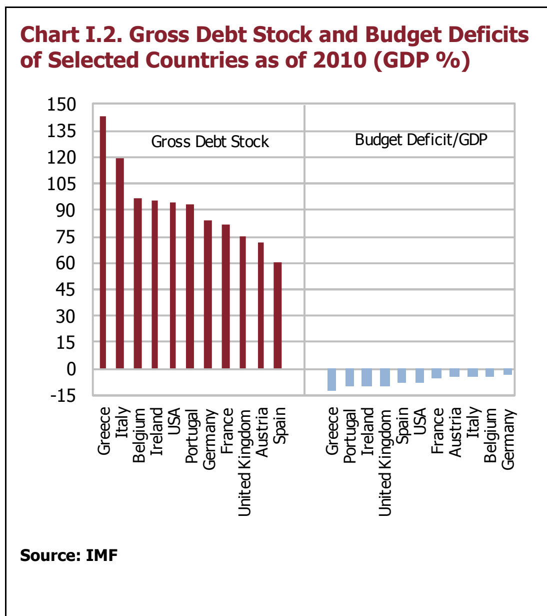
High debt stock and budget deficits along with low growth performance in some European countries have further heightened the concerns regarding debt sustainability in these countries. The financial turmoil, which started as it became obvious that public debt and budget performance of Greece had been worse than assumed and further deepened on the back of lower savings ratios due to increased social security spending, spread across other EU countries through weak banking sectors. Particularly countries with high budget deficits and with structural budget deficits in recent years were considered more risky by markets and bond yields of these countries increased further. In other words, their bond yields became more sensitive to primary surplus and budget developments. As a result, the distinction between risky countries and safe countries within the EU became more apparent (Charts I.1 and I.2).

Chart I.1. Difference Between Primary Surplus (PS) and Bond Yield Spreads[1] in Selected EU Countries[2]



Source: IMF, Bloomberg
(1) The bond yield spread shows the difference between 10-year bonds of countries and German bonds.
(2) Austria, Belgium, Finland, France, Ireland, Italy, Holland, Portugal, Slovakia, Slovenia, Spain, Greece.

Chart I.2. Gross Debt Stock and Budget Deficits of Selected Countries as of 2010 (GDP %)

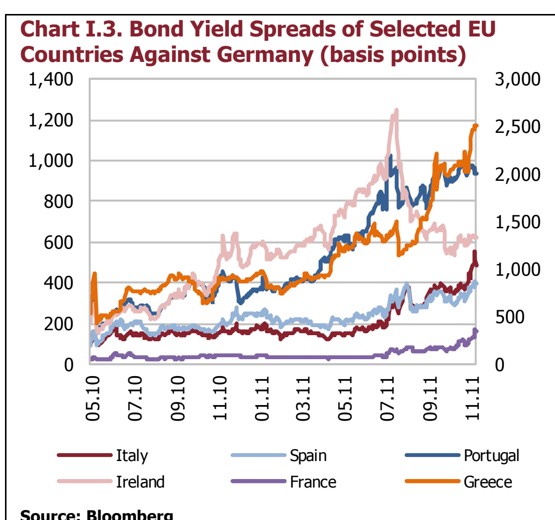


Source: IMF

In order to restrain negative market perceptions over debt sustainability, various measures were put into practice within the EU. On October 26, 2011, Euro area leaders set out

a plan covering five essential areas in order to ease distressed markets and to restore confidence (Box I.1). There are fears over insufficiency of measures including the increasing of the capacity of the European Financial Stability Facility (EFSF), which has been established to contain increased concerns of default and to provide funds to those EU countries facing difficulty rolling over their debts. Moreover, countries have been striving to alleviate concerns regarding debt sustainability by taking the necessary steps to narrow their budget deficits and by announcing savings packages. Nevertheless, as can be seen from the high yield spreads between the bonds of risky EU countries and Germany, the measures taken has not been sufficient to provide relief to the markets effectively due to the rapid deterioration in CDSs and borrowing costs and the unfavorable future outlook. These developments suggest a need to implement and expand savings packages sooner (Chart I.3 and Table I.1).

Chart I.3. Bond Yield Spreads of Selected EU Countries Against Germany (basis points)



Source: Bloomberg

Table I.1. Debt and Budget Expectations in Selected EU Countries (2011-2016)

	Projected interest rate–growth differential 2012–16 (percent)	Average Primary Balance	Estimated Gross Debt Stock 2011	Estimated Gross Debt Stock 2016
Greece	2.5	3.0	165.6	162.8
Portugal	2.0	1.5	106	110.5
Ireland	0.8	-1.2	109.3	114.3
Spain	1.0	-2.2	67.4	77.4
Italy	2.2	3.5	121.1	114.1
Belgium	0.0	0.1	94.6	93
France	-0.3	-0.8	86.8	87.7
Germany	0.5	1.4	82.6	75

Source: IMF

Box I.1. Plan Introduced for Restoration of Confidence in EU Markets

Euro Area leaders, who gathered on October 26, 2011, agreed on a plan which covers five essential areas to restore confidence and address current tensions in the financial markets. The plan includes the following points:

- *Securing decline of the Greek debt to GDP ratio to a level equivalent to 120 % by 2020.* (The nominal discount of 50 % on the national Greek debt held by private investors is a step towards this end).

- *Putting in place a new EU-IMF multiannual program financing up to 100 billion Euros by the end of the year.*

- *Leveraging of the EFSF resources and enhancing its ability to extend loans, finance bank recapitalisations and conduct bond purchases in the primary and secondary markets.* (Though the details have not yet been cleared, it is planned to increase EFSF's capacity to provide funds through leveraging existing EFSF resources by up to 4-5 times).

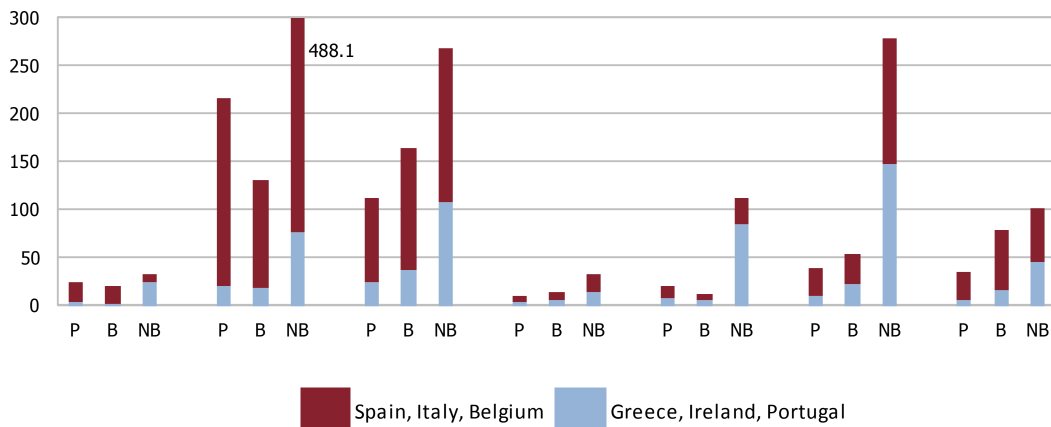
- *Increasing the capital position of banks to 9 % of Core Tier I by the end of June 2012 and facilitating access to term-funding through a coordinated approach at the EU level.*

- *Strengthening of economic and fiscal coordination and surveillance, introducing a set of very specific measures going beyond the recently adopted package on economic governance.*

The said plan, details of which have not been finalized yet, did not have the expected impact on markets and engendered a conviction that the measures envisaged will not be sufficient to overcome the problems.

Excessive falls in the values of certain sovereign bonds and increased credit risk due to economic tensions in Europe has fed risks related to banking sectors in some countries. Loss incurred due to risky sovereign bonds held by the banking sector caused deterioration in the financial structures of banks across Europe due to the interconnected structure of the financial sector. Moreover, parallel to the slowdown in economic activities of the risky countries, increased counterparty credit risk exposure of banks to these countries is likely to further deepen the deterioration (Chart I.4).

Chart I.4. Consolidated Foreign Claims of Selected National Banking Sectors from Distressed European Countries (Billion USD)



Source: BIS Consolidated Banking Statistics, June 2011
(1) The mentioned data are provisional.
P=Public, B=Banking Sector, NB=Non-Bank Sector

Sovereign risk-driven problems in markets led to the narrowing of funding channels and increases in funding costs of the banking sectors. In such an environment of lack of confidence, banks faced difficulties in raising funds through money markets and maturity mismatches began emerging in the balance sheets of banks that opted for short-term sources. European banks are facing strains in wholesale funding channels. As a matter of fact, US money market funds (MMF), a significant fund provider to European banks, curbed funds they provide to banks remarkably. Moreover, there also exist problems in renewal of due bonds (Chart I.5). In addition to these problems in the wholesale funding markets, the increase in deposits is not sufficient to meet funding needs (Chart I.6).

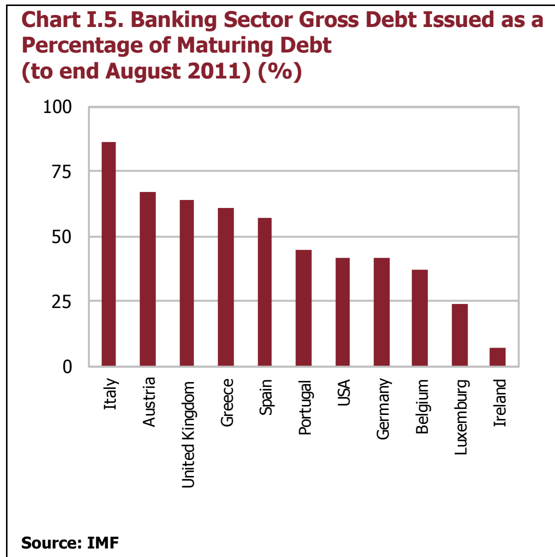


Chart I.5. Banking Sector Gross Debt Issued as a Percentage of Maturing Debt (to end August 2011) (%)

Source: IMF

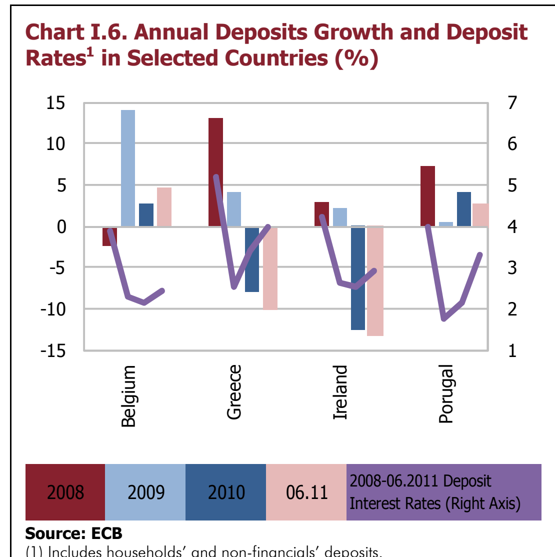


Chart I.6. Annual Deposits Growth and Deposit Rates[1] in Selected Countries (%)

Source: ECB

(1) Includes households' and non-financials' deposits.

Central Banks sought to prevent deterioration in functioning of markets by providing liquidity to the banks that face funding pressures through various tools. The European Central Bank (ECB) accelerated bond purchases and extended the liquidity facilities provided to banks not only to decrease the borrowing costs of distressed countries but also to fix the liquidity crunch of banks. The Federal Reserve Bank (Fed) started to shift from long-term to short-term securities on its balance sheet in order to reduce funding costs of banks and increase liquidity by pushing down the long-term interest rates. Other central banks took similar measures for the provision of liquidity to their banks (Charts I.7 and I.8). On 21November 2011, the International Monetary Fund (IMF) disclosed a set of measures to enhance the flexibility and scope of the tools in its use to provide liquidity and emergency funds more effectively to troubled countries.

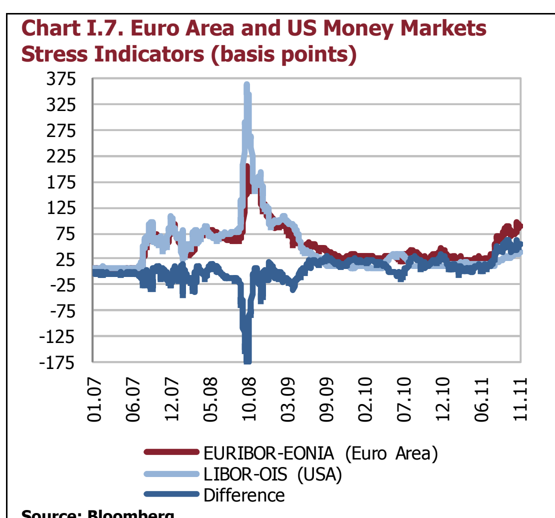


Chart I.7. Euro Area and US Money Markets Stress Indicators (basis points)

Source: Bloomberg

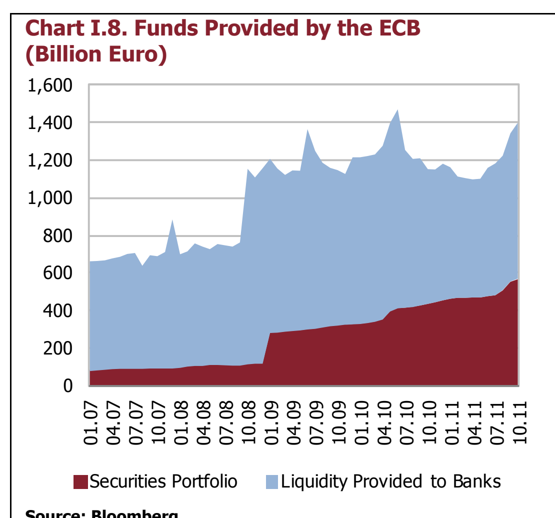


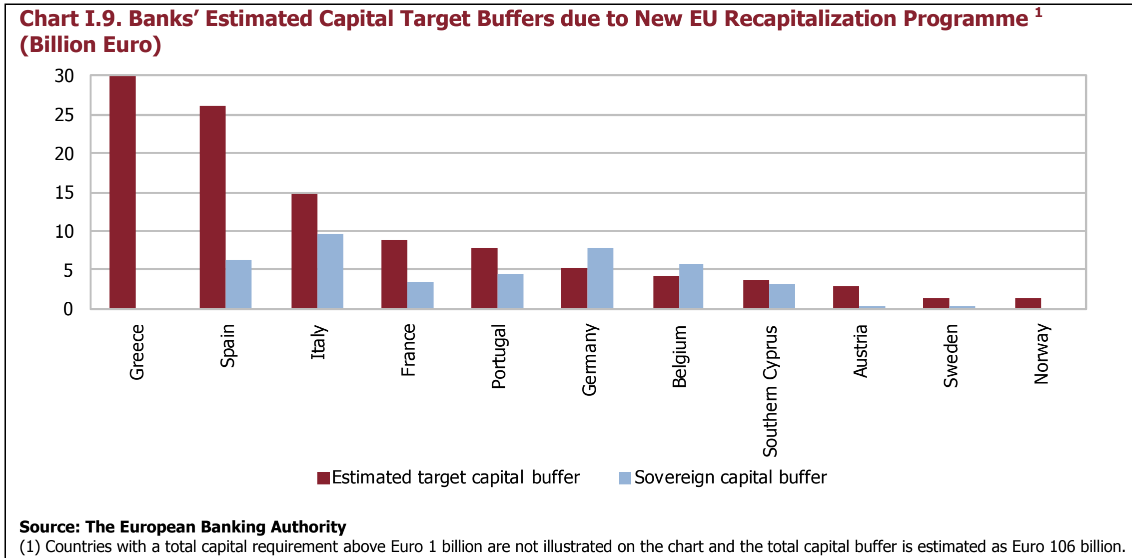
Chart I.8. Funds Provided by the ECB (Billion Euro)

Source: Bloomberg

In addition to the measures taken by central banks, it was aimed to strengthen the banking sector through a number of structural measures. With the Basel III framework, a gradual increase was envisaged in the Tier 1 capital ratio that banks had to maintain, to be fully effective as of 2019, and a minimum liquidity and net stable funding ratio (NSFR) were introduced. Moreover, higher capital adequacy ratios were introduced to be met by globally systemically important

institutions (See IV.5). The EU, on the other hand, decided to enforce the implementation of the minimum Tier 1 core capital ratio sooner to be effective by the end of June 2012, and set the minimum Core Tier 1 ratio as 9% in order to bolster the capital position of banks, in line with its plan to restore confidence in markets that was announced on 26 October 2011. Accordingly, banks are expected to create a capital buffer by marking to market their sovereign debt exposures. Hence, the required capital as a result of the new regulation is estimated to be Euro 106 billion (Chart I.9).

Chart I.9. Banks' Estimated Capital Target Buffers due to New EU Recapitalization Programme [1] (Billion Euro)

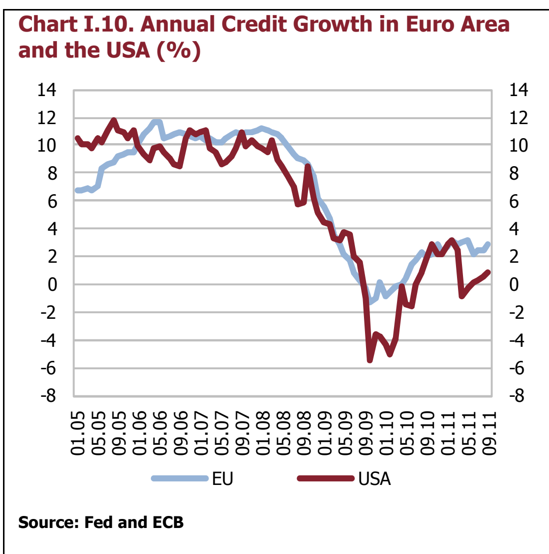


Source: The European Banking Authority

(1) Countries with a total capital requirement above Euro 1 billion are not illustrated on the chart and the total capital buffer is estimated as Euro 106 billion.

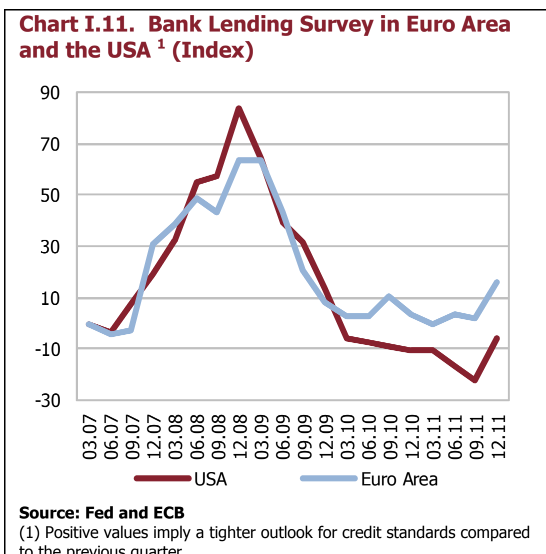
The capital requirement that emerged due to the measures taken to strengthen the capital structure, along with increased riskiness of assets and losses incurred has an adverse effect on banks' lending capacity. Banks are required to increase their capital or reduce their risky assets in a short period of time primarily due to the EU's implementation of capital adequacy regulation sooner. In addition, the fall in capital due to EU, primarily Greek debt write-offs, and high cost of a capital increase created a deleveraging pressure on banks. This situation is expected to hamper the recovery in currently weak credit markets (Charts I.10 and I.11).

Chart I.10. Annual Credit Growth in Euro Area and the USA (%)



Source: Fed and ECB

Chart I.11. Bank Lending Survey in Euro Area and the USA [1] (Index)



Source: Fed and ECB

(1) Positive values imply a tighter outlook for credit standards compared to the previous quarter.

The strains in credit markets negatively affect the growth performance of developed countries. The functioning of credit markets that started to improve on the back of

measures taken began deteriorating again due to increased risks in the financial structures of banks and risks over the soundness of national financial sectors. This situation led to an underperformance in economic growth of primarily developed countries. The worsening in the growth performance of developed countries curbs global growth through funding, expectations and trade channels (Charts I.12 and I.13).

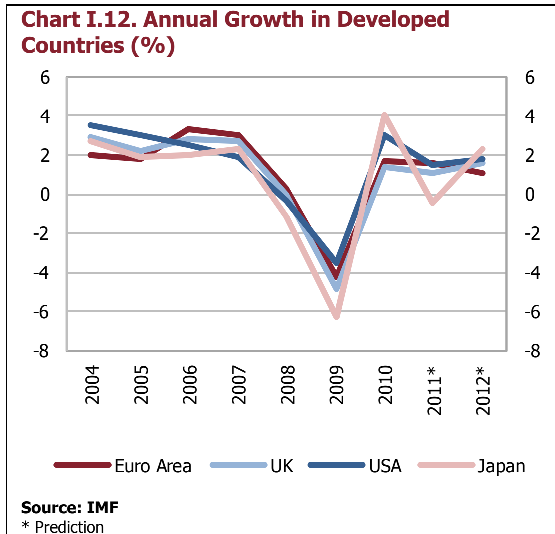


Chart I.12. Annual Growth in Developed Countries (%)

Source: IMF
* Prediction

Chart I.13. Annual Change in Global Growth Estimations

Source: IMF

Decelerating economic activity, deteriorating public finance and financial stability cause unemployment rates to rise and push central banks to seek new policies. Developed country central banks started to focus more on financial stability concerns while formulating their monetary policies. In fact, despite the slight increase in inflation, the said central banks still keep their policy rates at low levels (Chart I.14). Moreover, the decrease in the global risk appetite parallel to the deteriorating global economic activity has increased investments in safe haven currencies. This situation led central banks of the mentioned countries to intervene in foreign exchange markets so as to prevent the overvaluation of their national currencies (Chart I.15).

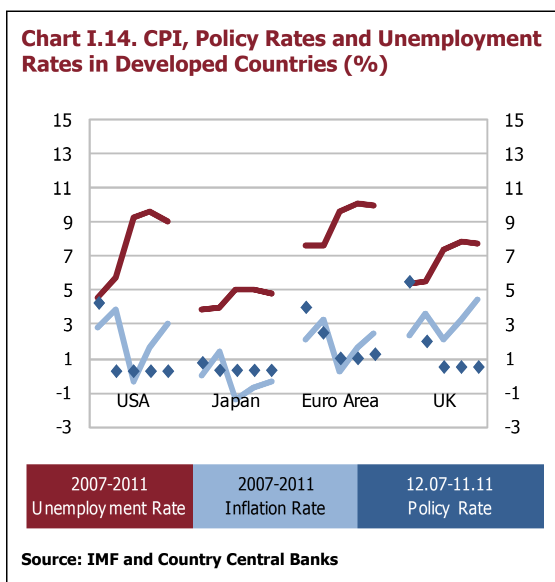


Chart I.14. CPI, Policy Rates and Unemployment Rates in Developed Countries (%)

Source: IMF and Country Central Banks

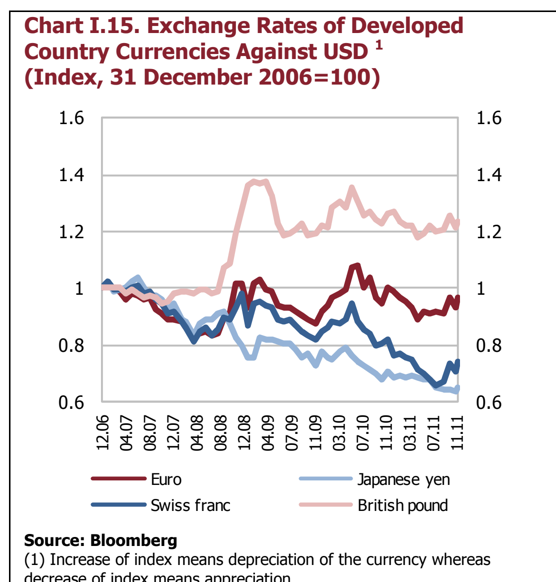


Chart I.15. Exchange Rates of Developed Country Currencies Against USD [1] (Index, 31 December 2006=100)

Source: Bloomberg
(1) Increase of index means depreciation of the currency whereas decrease of index means appreciation.

The problems in developed country markets and the measures taken affect emerging markets, as well. The excessive rise in public debt and money supply in developed

countries increase the volatility of capital flows to developing countries. Currencies of developing countries depreciated due to recent capital outflows (Charts I.16 and I.17).

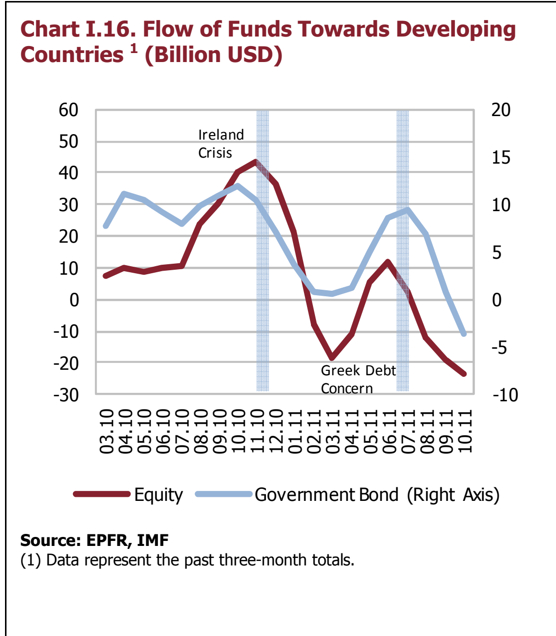


Chart I.16. Flow of Funds Towards Developing Countries [1] (Billion USD)

Source: EPFR, IMF
(1) Data represent the past three-month totals.

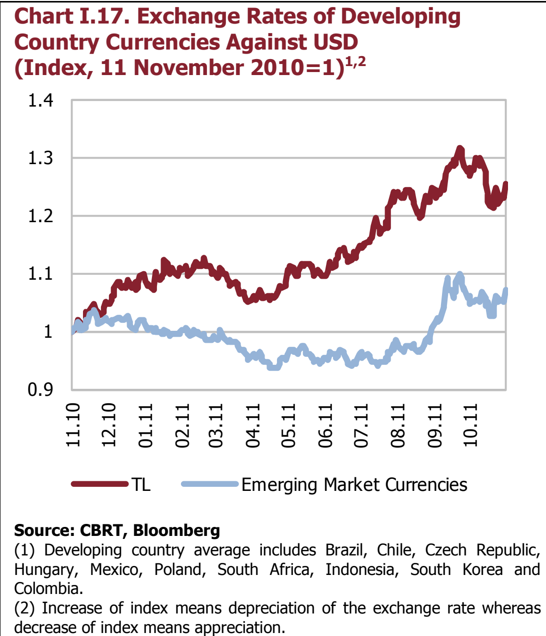


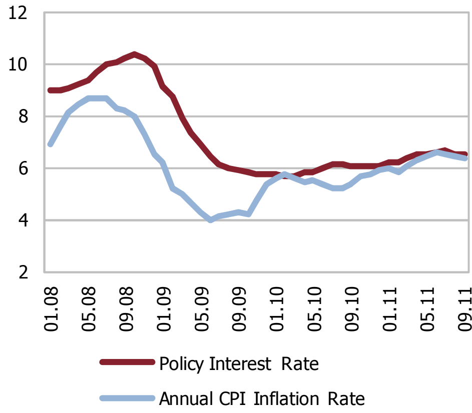
Chart I.17. Exchange Rates of Developing Country Currencies Against USD (Index, 11 November 2010=1)[1,2]

Source: CBRT, Bloomberg
(1) Developing country average includes Brazil, Chile, Czech Republic, Hungary, Mexico, Poland, South Africa, Indonesia, South Korea and Colombia.
(2) Increase of index means depreciation of the exchange rate whereas decrease of index means appreciation.

Banking sectors of developing countries, with significant foreign share and/or in need of external funding may be affected notably by the deterioration in the financial structures of EU banks. Banks in countries with high foreign ownership may have difficulty raise funds from the country of origin and those banks, which raise funds from abroad through wholesale funding, might curb their lending supply due to reduced funding from the said channel.

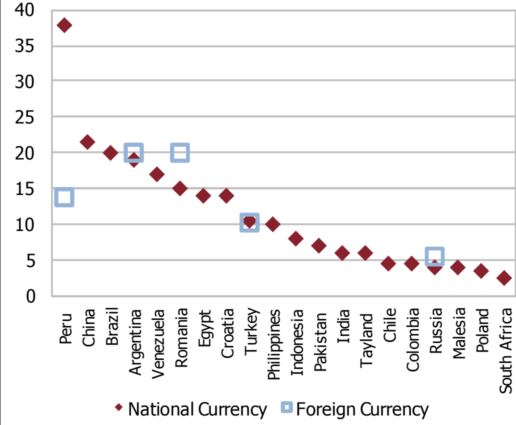
Although concerns of overheating in emerging market economies are subdued, it is still of importance to address price stability and financial stability together in a coordinated manner. Due to the re-emergence of concerns related to the slowdown of global economic activity and easing of concerns over inflation on the back of the decline in commodity prices, interest rates in emerging markets followed a stable course. Within this framework, a number of emerging market economies have been using their reserve requirement ratios as an easing tool and continue to actively use other macroprudential measures (Charts I.18 and I.19).

Chart I.18. Policy Rates and Annual Consumer Price Inflation in Emerging Economies



Source: Bloomberg and CBRT Calculations

Chart I.19. Reserve Requirement Ratios in Emerging Economies (%)



Source: Country Central Banks

In conclusion, despite all measures taken, problems arising from risky EU countries and affecting the whole Europe are still of utmost concern. It is important to dissipate concerns related to debt sustainability by supporting growth, in order to control inter-feeding sovereign and banking risks. This requires primarily a prompt decision-making process by the European Union and implementation of the necessary steps decisively by the relevant authorities.

The possibility of the crisis, arising from risky countries, spilling over to other countries and increase in its impact on the global financial system is a significant risk factor. Within this scope, it is essential to identify and monitor closely the main contagion channels. Although it is unavoidable for all national financial sectors to be affected from the global economic slowdown, national authorities should continue to use their monetary policy, fiscal policy and financial stability tools effectively.