II. Macroeconomic Outlook

The global policy uncertainties have been increasing since the beginning of 2018. Risk appetite towards EMEs waned and EMEs saw net portfolio outflows due to rising indebtedness, sustained tightening in monetary policies in advanced economies, appreciation of the US dollar, protectionist trade policies, and ongoing uncertainties in monetary policies in some advanced economies particularly in Italy and the UK. Although the global economic outlook remained positive, divergence between countries grew stronger and downside risks to economic growth aggravated compared to the previous Report period. The acceleration in the US economic activity supported by expansionary monetary policies, the country-specific risks, geopolitical developments and tightening in global liquidity conditions continue to pose risk to the economic growth outlook of the EMEs. The uptrend observed in commodity prices since 2016, which was stimulated by global demand and protectionist trade measures, has been replaced by a fluctuating trend.

In the second quarter of 2018, domestic economic activity has started to rebalance, while the contribution of domestic demand to GDP growth decreased and that of net exports increased. Leading indicators of growth suggest that the rebalancing process continued in the second half of the year, more clearly observed in domestic demand, on the back of the depreciation of the Turkish lira as well as the volatility in exchange rates and tightening in financial conditions. Despite the weak outlook in domestic demand, there has been a rise in inflation due to the deterioration in pricing behavior and the cost pressure stemming from the cumulative depreciation of the Turkish lira. The slowdown in economic activity has started to have implications on employment as well. Meanwhile, net exports continued to support growth with the contribution of the strong recovery in tourism and curb the unfavorable impact of domestic demand conditions on the economic activity. The change in the composition of economic activity in favor of net exports brings along a significant rebalancing in current account deficit. The lingering elevated levels of volatilities and uncertainty perceptions in financial markets of EMEs, the ongoing normalization process in global monetary policies, increased protectionist trends in international trade, geopolitical factors and tightening in financial conditions keep downside risks to economic activity high.
II.1 International Developments

Increase in uncertainties over global economic policies gained momentum (Chart II.1.1). The protectionist trade stance of the US government accompanied by considerations regarding the normalization process of the Fed’s monetary policy remains influential in the predictability of the US economic policies. Waning uncertainty in policies in the EU countries following the end of the elections increased again due to concerns over Italian public indebtedness and differing statements on the partially-defined Brexit road map.

The US labor market, growth outlook, and the course of overall price level together with fiscal policy preferences are among the determining factors for the path of policy rate hikes. Given the promising prospects for growth and the labor market in the US and the fact that inflation hovers around the Fed’s target of 2, the Fed Federal Open Market Committee (FOMC) members project policy rate hikes for the period ahead as one in the rest of 2018, three in 2019 and one in 2020. Market expectations that converged to these projections in the short term have recently retrieved some decline (Chart II.1.2).

Despite the plans to end the European Central Bank’s (ECB) asset purchasing scheme at the end of 2018, the ECB is not likely to change policy rates in the first half of 2019 due particularly to the public debt stock in Italy and policy concerns originating from Brexit coupled with the growth and inflation prospects in the EU. On the other hand, the weak inflation outlook is believed to lead the Bank of Japan to maintain the expansionary stance in monetary policy. Likewise, the People’s Bank of China is likely to continue implementing an expansionary monetary policy through macroprudential policy tools as a measure against shrinking market liquidity.

Global indebtedness has gained momentum since the global financial crisis, exceeding three-fold the global GDP in March 2018. Similar to the uptick in global indebtedness, the general level of indebtedness in EMEs recorded an increase both in amount and ratio to GDP terms (Chart II.1.3). Total borrowings of EMEs are made mostly in local currency (Chart II.1.4). On the other hand, there is divergence among EMEs in terms of local currency and FX debt decomposition. As a result of the appreciation in the USD against currencies of advanced and emerging market economies since April 2018 accompanied by the rise in the US bond rates, EME indebtedness levels and FX-denominated borrowings of some countries and sectors played a role in portfolio flows towards EMEs.
Rising indebtedness and FX borrowing at a country level as well as the ongoing trend of tightening in monetary policies of advanced economies, fast appreciation in the USD, protectionist trade policies, and uncertainty in policies of some advanced economies - particularly in Italy and the UK - led towaning risk appetite towards EMEs and as a result EMEs saw net portfolio outflows (Chart II.1.5). On the other hand, led by the high external financing need and deteriorated economic outlook, the worsening in EME’s risk premiums in the second quarter has recently recorded a limited improvement owing to the policy measures taken by some countries (Chart II.1.6).
Currencies of advanced and emerging market economies have depreciated against the USD since April 2018 (Chart II.1.7). Meanwhile, having seen relatively adverse effects of the appreciated USD, the depreciation in the currencies of Argentina and Turkey particularly in the third quarter, have recently been compensated for to some extent. Moreover, uncertainty in policies, geopolitical risks, increased protectionism in trade, and concerns over global growth outlook led stock indices to perform weakly both in advanced economies and EMEs since the last Report period (Chart II.1.8).

Due to the expectations for sustained tightening in monetary policies of major central banks, bond returns in advanced economies registered an overall increase mainly in the US (Chart II.1.9). The rise in EME’s bond rates was driven by the tightening in global liquidity conditions and waning risk appetite for these countries (Chart II.1.10).

Although the global economic growth outlook remains promising, divergence grew among countries, and risks to the economic growth have been aggravated compared to the previous Report period (Chart II.1.11). Economic activity in the US is accelerated by expansionary fiscal policies, yet protectionist trade measures constitute a downside risk to expectations. On the other hand, leading indicators in the euro area signal loss of momentum in economic growth (Chart II.1.12). Country-specific risks, geopolitical developments and tightening in global liquidity conditions are among the risk factors regarding the prospects for economic growth of some EMEs.
Stimulated by global demand, the upward trend in commodity prices since 2016 was replaced by a fluctuating course (Chart II.1.13). On the other hand, global metal prices decreased amid deceleration in economic activity in China and trade limitations imposed on that country. Supply shocks emanating from Venezuela, Canada and Libya played a role in the increase in both oil prices and oil price volatility. Oil prices have recently registered some decline in amount. Meanwhile, the OPEC’s decision to increase the oil supply and global economic outlook are expected to affect the course of prices in the period ahead.

High global indebtedness, spreading protectionist trade policies that bloomed in the US, sustained tightening in international financial conditions, the loss of momentum in global economic activity, and geopolitical developments as well as country-specific risks are among the risk factors for global financial stability. Meanwhile, international standard-setting institutions and financial regulatory reforms implemented by countries’ authorities since the global financial crisis aim at essentially enhancing the resilience of the global financial system. Among these studies, financial interconnectedness (Box II.1.1) and benchmark interest rates (Box II.1.2) occupy a significant place. Moreover, full, timely and consistent implementation of financial regulation reforms and analyzing of their effects remains important to the maintenance of global financial stability.
Box II.1.1
Analysis of Financial Interconnectedness

“Financial interconnectedness”, a natural outcome of an open and integrated global financial system, has recently been on the international financial agenda and the subject of various analyses along with the “contagion risk”. Financial interconnectedness covers connections stemming from all types of services and infrastructure activities among financial institutions (IMF, 2010). This phenomenon affects risk transmission between financial institutions and services, can cause systemic risk build-up in addition to the idiosyncratic risk build-up at financial institutions, and is monitored meticulously due to the transmission of risks from one financial institution to another through the contagion risk (ECB, 2017; ESRB, 2017; Gabrieli, Salakhova and Vuillemey, 2015; Yellen, 2014). Meanwhile, contagion risk means transmitting a risk that is related to a financial institution, financial asset or portfolio to the other parties of financial assets or to the portfolio of the stakeholders of this financial institution. If the contagion risk is spread across the whole system through high interconnectedness, it is transformed into a systemic risk (Schoenmaker, 1996). The leading risks that trigger systemic risk are credit risk, funding risk and operational risk.

Financial interconnectedness, built from relationships among different factors of the financial system, is divided into two types: direct interconnectedness and indirect interconnectedness. Relationships shaped by financial transactions, liabilities and contracts and risks stemming from these relationships are analyzed under direct interconnectedness. Particularly loans, financial market infrastructure services and lease agreements with third parties are examples of such interconnectedness. On other hand, in indirect interconnectedness, there are channels by which the stress in an institution spreads into other institutions. In this type of interconnectedness, analyses are made considering CDS movements, option prices and stock price return rates. Moreover, factors such as the spillover effect of fire-sales in the financial system, leverage in derivative and synthetic products, and fragilities led by the interconnectedness in non-bank financial institutions become the subjects of evaluations of indirect interconnectedness.

Under financial interconnectedness, risks accumulated in three types of institutions need to be monitored regularly:

- **Banks with large asset size**: Any stress in these banks may affect the whole system in a short time and these banks may have a significant role in triggering the systemic risk.

- **Banks or non-bank financial institutions that provide financial infrastructure services to many sectors at the same time**: Defaults of these institutions may spill over into the whole financial system in a short span of time. Particularly, remarkable risks may build up in institutions both acting as an intermediary for over-the-counter derivative products and offering infrastructure services at central counter-parties.

- **Systemically important financial institutions**: Financial connections of banks or insurance institutions with systemic importance at a global or local scale need to be monitored closely. Not all big banks with large volume of assets are considered as systemically important institutions, and these financial institutions are determined by taking various criteria into consideration. Kanno (2015) finds that a systemic risk does not arise if a medium-scale bank goes bankrupt; however, a spillover effect is triggered if a bank with Global Systemically Important Bank (G-SIB) status goes bankrupt. Malik and Xu (2017) reached a similar conclusion regarding the effects of interconnectedness in these institutions.

Due to the accumulated risks under financial interconnectedness after the global crisis, reduction of
risks led by financial interconnectedness was placed on the global reform agenda. Accordingly, international financial reforms designed after the global crisis and changes in market behaviors contributed to the reduction of the interconnectedness among banks and non-bank institutions (BIS, 2015). Among these reforms, capital, liquidity and leverage regulations occupy a large place. In addition, monitoring of interconnectedness was included as a risk factor to the frameworks of G-SIB and Global Systemically Important Insurers (G-SII) through various indicators and allowed the risks built up in financial institutions with systemic importance to be kept under close surveillance. Moreover, the Financial Stability Board (FSB) closely monitors the issue of interconnectedness in terms of monitoring non-bank financial intermediation activities.\(^1\)

Theoretical and empirical studies show that the contagion risk is high in interconnected institutions with high leverage. Particularly in the crisis period, direct bank interconnectedness is evaluated as a significant channel in the spreading of crisis (BIS, 2015; Malik and Xu, 2017). It is stated that after the global crisis, direct interconnectedness was normalized and decreased in some advanced economies according to various criteria (BoE, 2015). Developments in payments and funding liquidity in the banking sector and payments between banks and some non-bank institutions show that the contagion risk decreases. Meanwhile, some academic studies made using network and/or cluster analysis techniques show that when interconnectedness increases in regional banks, the degree of contagion risks also increases (Acemoglu, Ozdağlar and Tahbaz-Salih, 2015; Kara, Tian and Yellen, 2015).

Although financial reforms designed after the global crisis contributed to the reduction of interconnectedness, some new risks arose in this period as well. Interconnectedness among shareholders of central clearing institutions increased remarkably particularly after over-the-counter derivative products were subject to central clearing. Meanwhile, as interconnectedness increases in regional banks, the degree of contagion risk increases as well. Infrastructure and contracts with direct interconnectedness risks stemming from internationally active banks also stand out as significant risks. It is considered that a great portion of the activities of banks at a global scale are transactions of over-the-counter derivative products and financial interconnectedness among banks is quite high in this area. On the other hand, contagion risks stemming from financial interconnectedness are recorded in some studies on portfolio management, shadow banking and CDS markets as well (Cho, Choi, Chung, 2014; Bauguess, 2017; Yellen, 2013; ESRB, 2017).

The FSB, International Bank of Settlements (BIS), International Organization of Securities Commissions (IOSCO) and the Committee on Payments and Market Infrastructures (CPMI) published a joint study analyzing the interconnectedness of central clearing.\(^2\) Interconnectedness among central clearing institutions, clearing members and financial service providers is analyzed and examined in quantitative terms in this study. In many cases, it is stated that central clearing members are also the financial institutions providing infrastructure services to these institutions.\(^3\) It is also stated in the report that there are few institutions providing financial resources for the transactions under central clearing, and receivables are concentrated in a limited number of actors. This indicates that should any risk materializes regarding these institutions, the risk may spread.

Regarding financial interconnectedness in Turkey, there is no bank considered as locally G-SIB and no remarkable increase is seen in the interconnectedness among financial institutions in our country following the global financial crisis. The share of the three major banks with the largest asset volume

---

1. The FSB decided to use the expression “non-bank financial intermediation activity” instead of the term shadow banking in a press release published on 22 October 2018.
3. Central clearing institutions are institutions that carry out submission, clearing and payment transactions of capital market tools quoted in stock markets, other organized market places or over-the-counter markets as well as the resulting transactions regarding the execution of collateral liabilities. In our country, Takasbank is established as the central clearing institution by the Capital Markets Board (CMB).
in our banking sector has been hovering around 37 percent for a long time, while the share of the first 7 banks remains stable around 75 percent. The ratio of the receivables of banks from money markets to total assets floats around 0.12 percent, while the ratio of the receivables of banks from other banks to total assets stands even below the levels recorded ten years ago (Chart I.1.I.1). Meanwhile, the ratio of bonds issued by resident banks to total banking sector assets hovers around 0.40 percent.

Chart I.1.I.1: Several Ratios of Banks (%)

International financial interconnectedness of the Turkish banking sector does not reveal any risks building up. Despite a slight rise in the foreign shares of the banking sector’s assets in 2014 and 2015, this share stabilized around 25 percent in 2017 and 2018 (Chart I.1.I.2). On the other hand, the share of non-residents within FX-denominated state bonds in our country recorded some increase in the last four years from 50 percent to 59 percent (Chart I.1.I.3).

Chart I.1.I.2: Foreigners’ Share in Banking Assets (%)

Chart I.1.I.3: Share of Foreigners in Government Bonds Denominated in Foreign Currency (%)

The counterparties of the external liabilities of Turkey’s banking sector suggest that the European Union, our largest trading partner, continues to have a significant share in total external liabilities of the banking sector, while the share of the UK has increased in recent years (Chart I.1.I.4).
In terms of payment systems, interconnectedness vis-à-vis central clearing institutions and the contagion risks in transactions related to over-the-counter derivative products is considered not to result a direct impact for our country as there is no increasing interconnectedness in these areas. According to diffusion indices measuring financial interconnectedness in stock markets, the spillover effect from our country to other countries is pretty low (Polat, 2018). As a conclusion, there is no rise in direct financial interconnectedness risk either in the global banking system or in our banking sector in recent years.

**References:**


ESRB. (2017). “Mapping the interconnectedness between EU banks and shadow banking entities.”


Box II.1.II
Reforming Benchmark Interest Rates

Benchmark interest rates such as the London Interbank Offered Rate (LIBOR), the European Interbank Offered Rate (EURIBOR) and the Tokyo Interbank Offered Rate (TIBOR) are widely used as reference rates globally in short-term borrowing and some derivative transactions. The volume of total financial transactions based on these rates exceeds USD 400 trillion. These rates represent the interest rates at which banks offer to lend funds to one another in the unsecured interbank money market for short term lending and the market that is taken into account during the transaction is the interbank money market of the country that announces the related reference rate. The reference interest rate is determined as follows: the quotes of a panel of banks contributing to the LIBOR setting session for different maturities on an electronic transaction platform are randomly picked up within a specified time frame, and the LIBOR rate is calculated by using a trimmed mean, throwing out the figures in the highest and lowest quartile, and averaging the remaining numbers. The rates may vary depending on maturities and currencies¹, the term spread, which means the additional rate on the interest rate, denotes the additional interest rate that banks charge customers based on their degree of credibility, in other words, it is the risk premium.

These benchmark rates were internationally accepted as they were formed in deep markets and calculated easily. In the aftermath of the global financial crisis, however, it was revealed that the rates had been manipulated. Moreover, after the crisis, it was almost impossible to establish a fair reference rate as liquidity was drying up in interbank money markets. As a result of this and similar developments, the reliability of reference interest rates were came under scrutiny by regulatory authorities and in financial markets.

Use of Reference Interest Rates in Financial Markets
Using reference interest rates in financial contracts mitigates complexity and allows uniformity in international markets. Moreover, if the financial instrument based on a reference interest rate is used widely, then transaction costs decrease and liquidity increases. Interest rates of loans, asset-backed securities, deposits and bills and bonds can be based on reference interest rates (Table II.1.II.1). Interest rate swaps and particularly over-the-counter derivative instruments are other fields where reference interest rates are used.

Table II.1.II.1: Reference Rate Estimated Notional Volumes and Maturity Concentrations (trillion US Dollars)

<table>
<thead>
<tr>
<th>Rate</th>
<th>Currency</th>
<th>Notional amount</th>
<th>Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>LIBOR</td>
<td>USD</td>
<td>150-160</td>
<td>1 week, 1 month, 3 months, and 6 months</td>
</tr>
<tr>
<td>GBP</td>
<td>30</td>
<td></td>
<td>1 month, 3 months, and 6 months</td>
</tr>
<tr>
<td>JPY</td>
<td>30</td>
<td></td>
<td>3 months and 6 months</td>
</tr>
<tr>
<td>CHF</td>
<td>6,5</td>
<td></td>
<td>3 months and 6 months</td>
</tr>
<tr>
<td>EUR</td>
<td>2</td>
<td></td>
<td>3 months and 6 months</td>
</tr>
<tr>
<td>EURIBOR</td>
<td>EUR</td>
<td>150-180</td>
<td>1 month, 3 months, and 6 months</td>
</tr>
<tr>
<td>TIBOR</td>
<td>JPY</td>
<td>5</td>
<td>3 months and 6 months</td>
</tr>
</tbody>
</table>

Source: Financial Stability Board (FSB)

¹ For instance, LIBOR is based on five currencies (the US dollar (USD), euro (EUR), British pound (GBP), Japanese yen (JPY), and Swiss franc (CHF)) and serves seven different maturities: overnight, one week, and 1, 2, 3, 6 and 12 months.
The Benchmark Interest Rates Reform

A benchmark interest rate’s reliability is proportionate to the depth and liquidity of the markets from which the rate is calculated as a representation of the funding cost. Benchmark interest rates are calculated as follows: a panel of banks reports their own borrowing costs to the regulatory and supervisory authority or banks association, then the average of the reported costs is calculated to find the reference rate. The calculated rate represents the unsecured interbank money market rate. In the aftermath of the crisis, the depth of interbank markets significantly dropped due to banks' increased demand for wholesale and secured funding sources. As a result, the gap between the use of IBORs (interbank offered rate) and the volume of transactions that took place in the markets that these rates are established have widened. Moreover, banks' misreporting because of their efforts to represent their balance sheets better than they actually were, significantly eroded confidence in LIBOR and urged investors to find alternative reference rates. Therefore, in the United Kingdom, for instance, LIBOR will no longer be announced as of 2021. This decision has brought about the issue of how to address the transition to a new interest rate/ base for LIBOR-based financial contracts due after 2021.

On the demand of the G20, the Financial Stability Board (FSB) has established the Official Sector Steering Group (OSSG) to review and rearrange the reference interest rates. The OSSG was mandated with reviewing and improving the existing standards and principles governing reference interest rates (IBOR+) and proposing additional reference interest rates. In 2014, the OSSG completed its work based on the Principles for Financial Benchmarks issued by the IOSCO in 2013. In its report on "Reforming Major Interest Rate Benchmarks", the OSSG has recommended that at least two additional types of reference interest rates be determined.

The FSB has evaluated that more than one reference interest rate should be developed to mitigate the risks arising from financial transactions solely relying on a single reference rate and to give financial actors more room for maneuver. Hinging on the lessons learned from banks' misreporting practices, the recommendations suggests determining benchmark interest rates entirely based on financial transactions instead of bank offers. At this point, discriminating the components of pricing of financial transactions is crucial. In simpler terms, the market interest rates are the combination of risk-free rates and risk premiums. While term premium, liquidity premium and credit risk premium are the major risk premiums, the IBOR rates also include credit and liquidity risk premiums excluding term premium in overnight transactions.

The first of the recommendations, the risk-free or low-risk Secured Overnight Financing Rate (SOFR) has been announced by the Fed since April 2018 and is based on US dollar-denominated derivative and credit transactions. The SOFR is expected to reflect overnight borrowing costs and reduce the market dependence on the LIBOR rate\(^2\). The SOFR is based on the Treasury repo market where investors can borrow or lend in overnight terms by using Treasury transactions. The euro short-term rate (ESTER)\(^3\) produced by the European Central Bank, is an important option as it reflects Euro area banks' unsecured overnight borrowing costs in euro. These two recommended interest rates as well as other overnight risk-free interest rates will allow financial actors to protect from general interest rate changes instead of fluctuations in bank risk premiums as in the IBORs (Table II.1.II.2). Nonetheless, for financial contracts entailing credit risk, it would be better to opt for

\(^2\) [https://apps.newyorkfed.org/markets/autorates/sofr](https://apps.newyorkfed.org/markets/autorates/sofr)

interest rates including credit risk premium instead of risk-free rates or rates close to zero. This would also be important for the sustainability of IBOR-based financial contracts.

<table>
<thead>
<tr>
<th>Rate</th>
<th>Overnight</th>
<th>Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Dollar</td>
<td>SOFR (Secured Overnight Financing Rate)</td>
<td>Compounded overnight swap rate,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Compounded overnight interest rate</td>
</tr>
<tr>
<td>Euro</td>
<td>ESTER (Euro Short-Term Rate)</td>
<td>ESTER (Euro Short-Term Rate)</td>
</tr>
<tr>
<td>Yen</td>
<td>Uncollateralized overnight call rate</td>
<td>TIBOR+ (Tokyo Interbank Offered Rate)</td>
</tr>
<tr>
<td>Sterling</td>
<td>SONIA (Sterling Overnight Index Average)</td>
<td>LIBOR+, SONIA</td>
</tr>
<tr>
<td>Swiss Franc</td>
<td>SARON (Swiss Average Rate Overnight)</td>
<td>LIBOR+, SAR (Swiss Average Rate)</td>
</tr>
</tbody>
</table>

Source: Financial Stability Board (FSB)

In Turkey, IBOR started to be implemented in 2002, taking into account its prospective benefits. TRLIBOR, which stands for Turkish Lira Interbank Offer Rate, is announced for overnight, one week, and 1, 2, 3, 6, 9, and 12 month maturities. Banks, whose TL loans and TL deposits account for 5 percent, each, of their balance sheets, are eligible to offer rates for the reference rate. TRLIBOR is calculated by taking the arithmetic mean of the remaining values after trimming the highest and lowest 25% of the sample. As for the prevalence of TRLIBOR in financial markets, TRLIBOR has a narrow range of application and the volume of transactions based on TRLIBOR is limited.
II.2 Domestic Developments

In the second quarter of 2018, domestic economic activity has started to rebalance and the contribution of final domestic demand to the annual GDP growth decreased while that of net exports increased. The annual real GDP growth dropped to 5.2 percent by the second quarter of 2018 after posting a strong increase of 7.4 percent in 2017. In terms of contribution to annual growth from the expenditure side, the contribution of final domestic demand, which was the main driver of annual growth in 2017, started to decrease in the second quarter of 2018 (Chart II.2.1). Meanwhile, the contribution of the "other" item, which increased in 2017 on the back of net gold imports, registered a downward correction. In the second quarter of 2018, net exports contributed to annual growth by one percentage point due to the fall in real exchange rates and the slowdown in domestic demand.

Data released in the current Report period indicate that the downtrend in economic activity continued from the second quarter through the third quarter, most visibly in domestic demand, due to the sharp depreciation in the Turkish lira as well as to the volatility in exchange rates and the tightening in financial conditions. Consistent with other leading indicators, industrial production growth decelerated in the third quarter (Chart II.2.2). On the other hand, supported by the strong recovery in tourism, net exports continue to contribute to growth and partially curb the negative impact of domestic demand on economic activity.

Impacts of the deceleration in economic activity on unemployment rates and employment have been monitored since the second quarter of 2018. The seasonally adjusted unemployment rate, which had significantly lost pace throughout 2017 and dropped to 9.9 percent, reached 11.2 percent by August 2018 (Chart II.2.3). The uptrend in the labor force participation rate also exerts an upward pressure on unemployment rates.

Despite expansionary fiscal policies in the last two years, the budget deficit has remained at relatively low levels due to the increase in non-tax revenues. The ratio of central government budget deficit to GDP rose to 2 percent as of September 2018 from 1.5 percent at end-2017 (Chart II.2.4). As of the third quarter of 2018, the increase in public investments continued while current transfer expenditures swelled due to bonuses granted to retirees. Boosted by revenues generated from paid military service and zoning amnesty, the rate of increase in non-tax revenues has outpaced that in tax revenues recently. While the VAT on imports rose due to changes in exchange rates, domestic VAT and particularly SCT collections posted a rather limited increase due to the deceleration in domestic demand and tax adjustments on fuel oil. The ratio of central government budget deficit to GDP is expected to be flat in the upcoming period.
Implementing the austerity and revenue-increasing measures introduced under the New Economy Program will support fiscal discipline.

The export/import coverage ratio, which declined in 2017 due to domestic demand-driven growth, picked up on the back of the recent rebalancing process (Chart II.2.5). An analysis of the 12-month cumulative data that reveal the long-term tendencies demonstrate that both the headline and gold- and energy-excluded trade deficits substantially decreased in September 2018. Recent-period tendencies show that the foreign trade deficit has improved mainly due to the contraction in imports while robust tourism and export revenues have also significantly contributed to the rebalancing. The downtrend in imports has further strengthened while the imports of unprocessed gold decreased and converged to their historical average. Leading indicators point that the positive performance of exports will also continue in the period after September 2018. Meanwhile, the persistence of protectionist trends in international trade poses downside risks to exports and foreign trade directly and also through increased competition in alternative markets. Therefore, it is essential for exporting firms to remain focused on productivity, diversify their export markets and maintain their market shares. The iron-steel sector has managed to sustain its strong export performance in the recent period despite additional tariffs imposed by the US, which is deemed a positive development in this respect.
The brisk course of external demand conditions accompanied by the decline in real effective exchange rate enhances not only exports of goods, but also the services sector, particularly the tourism sector. Accordingly, in addition to the contraction in foreign trade deficit, the robust trend of recovery in travel and other transport revenues also contributes positively to the current account balance. The current account deficit widened amid buoyant import demand and the rise in energy prices in 2017; peaked in mid-2018. The current account deficit to GDP ratio stood at 5.6 percent in September (Chart II.2.6). In the upcoming period, it is likely that the exports of goods and services will boost growth more, and the slowdown in import demand led by the decelerated domestic demand will offer further positive contributions to the current account balance. There are upside risks to the current account deficit led by the increase in external financing expenditures in contrast to the downside risks stemming from stronger-than-expected increase in tourism revenues and weaker-than-estimated course in domestic demand.

The current account deficit on the financing front indicates a recently-widened gap between the current account deficit and net capital inflows as suggested by 12-month cumulative change (Chart II.2.7). The recent capital outflow is mainly attributed to the higher-than-average external free account balance, which is resident banks’ FX liquidity buffers held at correspondent banks. This was led by increased FX liquidity preference of banks as well as the decline in FX loan demand and balances in the sector. In August, RR ratios were reduced to support effective functioning of financial markets and provide banks with flexibility in liquidity management, which also facilitated banks to utilize some part of their FX holdings at CBRT in different areas. Moreover, banks’ external debt balance has been on the decline since August, and liquidity buffers of banks made up of cash, external free accounts, free eurobond, reserve option mechanism (ROM) reserves and FX required reserves, which can be resorted to in case of external financial shocks, are able to meet external debts to mature within a year. Banks’ net currency swap position coupled with the FX deposit facility provided by the CBRT constitutes an additional buffer against external shocks. Most of the external debts being long term and the wide scale of creditor profile are other factors to draw down the re-financing risk.

In October 2018, annual consumer price inflation stood at 25.2 percent (Chart II.2.8). Price increases spread across sub-groups, and the main drivers in annual inflation are core goods, food and energy groups. Reverberations of the exchange rate developments in August were manifest in many items, while notable price hikes were recorded also in items with relatively low exchange rate pass-through, particularly services. Producer price developments point out strengthened cost pressures particularly through energy and intermediate goods. Against this background, both the annual inflation and the
underlying trend of core indicators registered a sharp increase, and B and C indices reached 24.4 and 24.3 percent, respectively in October 2018. Exchange rate volatility has increased inflation uncertainty; the exchange rate pass-through to consumer inflation has grown stronger; backward indexation in inflation has trended upwards and the pricing behavior has registered a significant worsening recently. The deterioration in the pricing behavior and the cumulative depreciation in the Turkish lira that resulted in mounting cost pressures weighed on inflation expectations and the inflation outlook. On the other hand, domestic demand conditions, the tight monetary policy stance and coordinated steps envisaged within the New Economy Program are expected to support disinflation.

The high volatility in financial markets and unhealthy price formations coupled with cost pressures and their secondary effects have had an adverse impact on the inflation outlook since the second quarter of 2018, particularly throughout August. Accordingly, the CBRT tightened the monetary policy to enhance price stability, and increased the 1-week repo rate, the policy rate, to 24 percent in September. In mid-August, the spread between the 2-year bond returns and CBRT weighted average funding rate widened (Chart II.2.9); and credit default swap (CDS) premiums and exchange rates recorded an upsurge (Chart II.2.10). Waned uncertainties over external financing conditions, strong tightening in the monetary policy, improved geopolitical developments and coordinated measures have led to pronounced improvements in financial market indicators since mid-September.