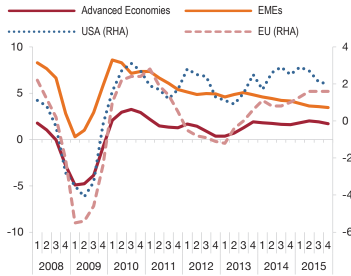
I. Macroeconomic Outlook

Global growth remained below the long-term average in 2015. The subdued commodity prices restrained any upside pressures on global inflation rates. It was revealed that the Fed rate hike was more gradual and cautious than expected, and central banks of other advanced economies responded to disinflation by additional accommodative monetary policies. While volatility in the financial markets has pursued a fluctuating trend, portfolio flows to emerging economies have increased since the turn of the year. Despite the rise in the global risk appetite as well as in the capital flows towards emerging economies, it is important for those economies to continue taking measures towards enhancing financial stability.

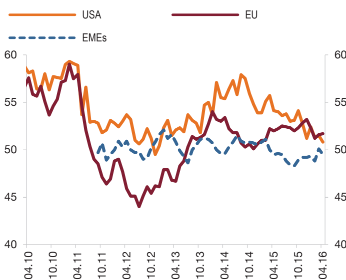
As for the Turkish economy, the growth in economic activities exceeded expectations and the increase in employment continued in 2015. Recently, inflation declined mainly owing to the food prices and with the support of the decreased cumulative impact of the exchange rates. The current account balance continues to improve on the back of the fall in energy prices, the favorable impact of the rise in demand from European Union countries, Turkish exports' successful flexibility for new markets supported by macroprudential measures and a cautious monetary policy. The current account deficit is mostly financed by direct capital investments and long-term sources. Throughout 2015, there was a significant decline in the short-term external debt stock. Sustained fiscal discipline does not only contribute to the decline in the risk premia but also to disinflation. Risk premia in emerging economies and in Turkey dropped owing to the recent rise in the global risk appetite, which in return brought about an appreciation in the Turkish lira and a decline in interest rates.

Chart I.1.1
Growth Rates in Advanced and Emerging Economies[1]
(Percent, Annual)



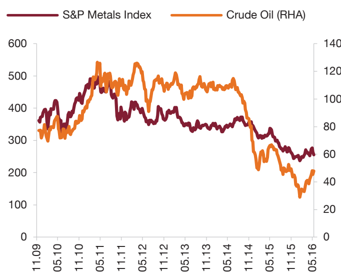
(1) Weighted by each country's share in global GDP.
Source: Bloomberg, CBRT.

Chart I.1.2
Manufacturing Industry PMI Indices



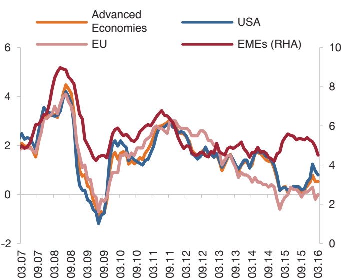
Source: Bloomberg (Latest Data: 04.16)

Chart I.1.3
Commodity Prices
(Index, USD)



Source: Bloomberg (Latest Data: 13.05.16)

Chart I.1.4
Inflation Rates in Advanced and Emerging Economies
(Percent, Annual)



Source: Bloomberg (Latest Data: 03.16)

I.1 International Developments

Global growth remained below the long-term average in 2015. While a subdued growth outlook continues in advanced economies, growth rates of emerging economies slowed down as well (Chart I.1.1). Growth in the eurozone is sluggish but still displays a moderate recovery trend. The US growth has been on a weakening trend since the third quarter. The leading indicators for 2016 suggest that the weak outlook continued in the first quarter of the year (Chart I.1.2).

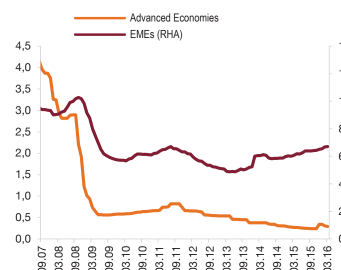
The slowdown in the global economic activity and commodity prices stabilized at low levels. The increased supply and weak demand caused a decrease in commodity prices. Meanwhile, oil prices remain low due to conflicting signals about supply from oil exporting countries (Chart I.1.3). Concerns over the Chinese economy and excess oil supply are likely to curb the uptrend in commodity prices in the near future.

The current position of commodity prices continues to be an important factor in the low global inflation rates. Inflation rates in advanced economies remain low (Chart I.1.4). Recovery in the employment market in the USA continues, while energy prices and import prices excluding energy curb any inflationary pressures. The annual headline inflation in the eurozone in April was below zero, suggesting that a disinflation threat continues. In emerging economies, low commodity prices are pushing inflation down. While low commodity prices affect the growth outlook of commodity-exporting countries negatively, they support the growth performance of commodity-importing countries.

It was revealed that the Fed rate hike would be more gradual and cautious than expected, and central banks of other advanced economies responded to disinflation by additional accommodative monetary policies. In its December 2015 meeting, the Fed raised interest rates for the first time since 2009 as expected, however the Fed gives signals that the rate hike would be gradual due to concerns over the global economy (Chart I.1.5). In March, the European Central Bank took some additional measures in the framework of the expansionary monetary policy in response to negative inflation rates. The ECB lowered all key interest rates and increased the amount of asset purchases by including the euro-denominated bonds issued by non-bank financial corporations. The ECB also announced that it would launch a new series of long-term refinancing operations. Despite the measures taken by the ECB at its March meeting, the recent data pertaining to the eurozone indicate that the recovery in economic activity has not yet reached the desired level. The developments in the European loan market will be a determining factor in the effectiveness of the ECB's monetary policy (Box I.1.I). Similarly, the Bank of Japan also introduced negative interest rates in January. The monetary policy stances in emerging markets are varied. While some commodity-exporting countries like Mexico and S. Africa raised policy rates in response to depreciation in their currencies and changes in their inflation rates, India and Indonesia lowered policy rates.

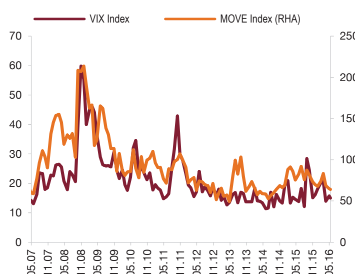
The volatility in financial markets follows a fluctuating trend. The volatility indicators increased at the end of 2015 and at the beginning of 2016 (Chart I.1.6). The long-term treasury bond yields of the USA and Germany remained low due to the decline in the global growth expectations, the deterioration in risk appetite and the tendency to head to safe havens (Chart I.1.7). The global volatility indicators recently declined and the global risk appetite slightly improved on the back of oil prices that have started to rebalance around 40-50 USD/barrel, the market understanding that the Fed rate hike will be gradual and cautious and the accommodative measures taken by central banks.

Chart I.1.5
Global Policy Rate
(Percent)



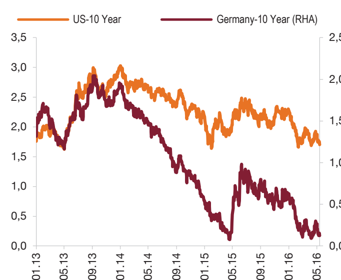
Source: Bloomberg (Latest Data: 03.16)

Chart I.1.6
Risk Appetite Indicators



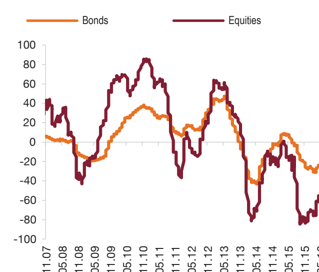
Source: Bloomberg (Latest Data: 13.05.16)

Chart I.1.7
US and Germany 10-Year Treasury Bond Yields
(Percent)



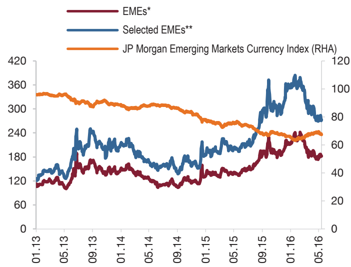
Source: Bloomberg (Latest Data: 13.05.16)

Chart I.1.8
Weekly Capital Flows to
Emerging Economies (Billion USD, 52-week cumulative)



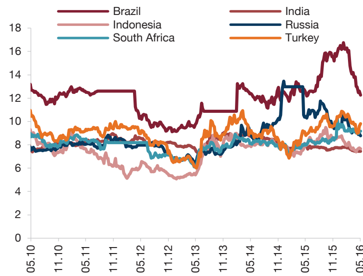
Source: EPFR (Latest Data: 04.05.16)

Chart I.1.9
CDS Premiums for Emerging Economies and JP Morgan Exchange Rate Index



* Emerging economies include Brazil, Czech Republic, Indonesia, South Africa, Colombia, Hungary, Poland, Romania and Turkey.
** CDS premia of Brazil, Indonesia and South Africa have been used to calculate the average of emerging economies.
Source: Bloomberg (Latest Data: 13.05.16)

Chart I.1.10
Treasury Bond Yields in Emerging Economies
(10 year, Percent)

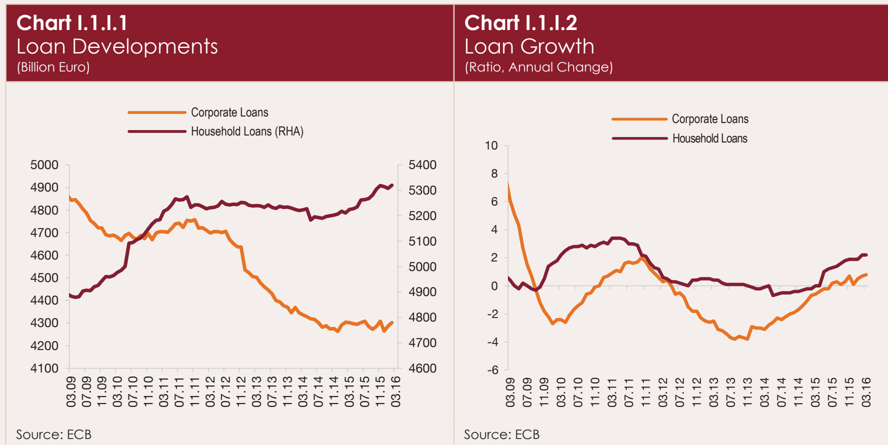


Source: Bloomberg (Latest Data: 13.05.16)

Portfolio flows to the emerging economies have been increasing since the turn of the year. This rise was mainly driven by the improvement in the risk appetite despite the slowdown in the growth rates of emerging economies and the geopolitical risks (Chart I.1.8). As a result of the increased risk appetite, portfolio flows have accelerated and helped partly compensate the depreciation in exchange rates in emerging economies (Chart I.1.9). As an interconnected development, risk premia improved as well. The improvement in loans and exchange rate risk premia affected emerging markets' bond rates (Chart I.1.10). Despite the rise in the global risk appetite and accelerated capital flows to emerging economies, it is vital for the emerging economies to continue taking measures towards enhancing financial stability.

Box I.1.I Credit Developments in the EU and the Measures taken by the ECB

The problems in the EU banking sector have continued since the last global financial crisis. And it is seen that banks have not been able to increase their capacities to provide loans to the corporate sector as needed. According to the data received from the European Central Bank (ECB), the seasonally adjusted corporate loans have been recovering slightly since the third quarter of 2015. Meanwhile, the uptrend in household loans observed in the last three quarters continues (Chart I.1.I.1 and Chart I.1.I.2).



According to the ECB'S bank lending survey of April 2016, banks are trying to support loan growth by easing loan standards. Compared to the previous quarter, banks increased their business credit supply in the first quarter of 2016. In this period, banks were more willing to give more loans to big corporate firms rather than SMEs. On the demand side, the rise in business loans continued in the first quarter of 2016. Although this rise was lower than what banks had expected, demand for business loans is expected to increase in the second quarter. The rise in credit demand in the first quarter of 2016 in the EU countries were mainly driven by factors such as the stock increases, working capital, the general level of interest rates, acquisitions and mergers and fixed investments. On the supply side of household loans, even though it was reported that banks had not changed their credit standards in the last quarter of 2015, banks tightened their credit standards in the first quarter of 2016. While there was a net tightening in household loan supply in the EU in the second quarter, loans conditions for consumers purchasing their first homes are expected to be eased. On the demand side, the net housing loan demand increased.

According to the European Banking Authority's (EBA) data, compared to the first quarter of 2015, the average capital adequacy ratio of banks in EU countries increased in the last quarter of 2015 and reached 17.7 percent while the rise in the tier 1 capital ratio continued. While profitability in the EU countries is still very low, the asset quality is problematic. The average return on equity in the EU countries was 4.7 percent in the final quarter of 2015. Even though this ratio points to a 1.2 percent rise compared to end-2014, both return on equity and return on assets declined quarter-on-quarter (Table.I.1.I.1).

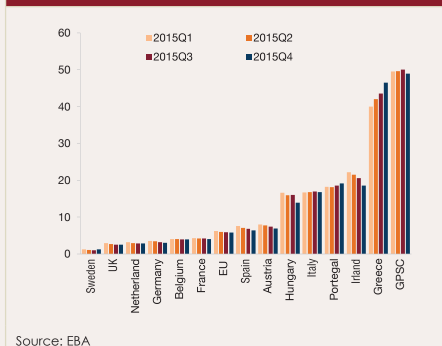
Table I.1.I.1
EU Banks' Average Capital, Profit and NPL Ratios
(Percent)

Period	CAR	CET1	NPL	Coverage Ratio of NPL	ROE	ROA
2014Q4	16,2	12,5	6,5	43,3	3,5	0,20
2015Q1	16,1	12,4	6,2	42,9	6,9	0,40
2015Q2	16,7	12,8	6,0	43,6	6,8	0,41
2015Q3	17,0	13,0	5,9	43,7	6,4	0,38
2015Q4	17,7	13,6	5,8	43,8	4,7	0,29

Source: EBA

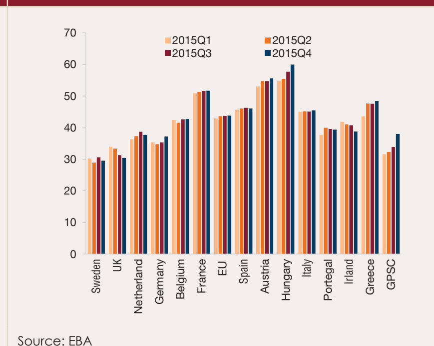
Another problem in the EU countries is that non-performing loans (NPL) ratio is still high. At the end of 2015, the EU average of this ratio improved by 10 basis points quarter-on-quarter and reached 5.8 percent (Chart I.1.I.3). Croatia, Bulgaria, Hungary, Italy, Portugal, Romania, Ireland, Greece and the Greek Cypriot Administration of Southern Cyprus are the countries with the highest NPL ratios; however, there has been some improvement in these countries. Meanwhile, the non-performing loan ratios increased in those countries which had ratios between 3 to 8 percent. The discrepancy among countries is still high.

Chart I.1.I.3
NPL Ratios in EU
(Percent)



Source: EBA

Chart I.1.I.4
NPL Coverage Ratios in EU
(Percent)



Source: EBA

Italy, which is in the group of countries with the highest NPL ratios, distinguishes itself from other countries in the risky group with its high volume of banking assets. Italy's non-performing loan stock reached euro 360 billion in March 2016. The ratio of non-performing loans to total loans became 18 percent, which makes one-sixth of Italy's GDP. To solve the problem, the Italian government has established a euro 5 billion funding vehicle to support some lenders. The fact that 70 percent of non-performing loans of the Italian banking sector stem from SMEs and collaterals of these loans are also troubled are elevating concerns in the Italian banking sector. The state-guaranteed non-performing loan securitization plan that the Italian Government is trying to introduce, has been found too costly by the market. According to EBA's data, Hungary was one of five countries whose NPL ratios increased in 2015 (The others were Italy, Greece, Portugal and Greek Cypriot Administration of Southern Cyprus). In Hungary, a private company guaranteed by the Hungarian Government will purchase these non-performing loans to solve the problem of non-performing loans. Both Italy's and Hungary's plans to transfer non-performing loans off the balance sheets of banks are deemed consistent with EU norms.

In the EU, in the last quarter of 2015, the coverage ratio of NPL ratios improved by 10 basis points quarter-on-quarter to 43.8 percent; however, the discrepancies among countries persist (Chart.I.1.I.4). In banks with average coverage ratio higher than 55 percent, this ratio has not changed remarkably in the last quarter of 2015 while the ratio has slightly improved in banks with an average above 40 percent.

It is seen that it became necessary for the ECB to develop a detailed policy due to the deceleration in recovery in the EU member economies. Interest rates that fell below zero necessitated the use of different instruments and the ECB has introduced three new instruments: the targeted long-term refinancing operations – TLTRO, the deposit facility rate - DFR and the asset purchase program - APP. The aim of the TLTRO instrument is to provide direct financing to the corporate sector and to decrease non-performing loans by increasing collateral quality by purchasing both asset-backed securities and covered bonds. The aim of a negative DFR is to prevent banks from accumulating excess liquidity, to encourage banks to extend loans with the liquidity they have and to prevent pressure on interest rates. The APP, which is designed as a "portfolio rebalancing channel" instrument, will be continued until March 2017. These measures are expected to boost corporate sector financing by simplifying borrowing conditions by way of the transmission mechanism.

In the March 2016 meeting, the ECB raised the asset purchase amount to euro 80 billion from euro 60 billion and announced that investment-grade euro-denominated bonds issued by non-bank corporations established in the euro area will be included in the list of assets eligible for regular purchases under a new corporate sector purchase program, and the long-term refinancing operations would be launched. Moreover, the ECB lowered all interest rates as follows: the main refinancing operations rate to zero percent, the deposit facility rate to -0.40 percent and the marginal lending facility rate to 0.25 percent.

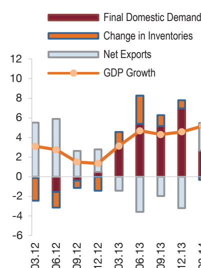
As a conclusion, on the back of all these measures, there has been some recovery on the credit side; however, the non-performing loan ratio is still high, the ratio of special provisions to loans is not at the desired level and corporate loans have not increased as desired.

I.2 Domestic Developments

In 2015, growth in the economic activity was realized above expectations. Despite the contraction in external demand stemming from the geopolitical risks and the slowdown in the global economy, the favourable domestic demand conditions have supported growth. By the end of 2015, net exports started to provide a positive contribution to growth again after a year of repose (Chart I.2.1). The favourable growth performance is mostly attributed to the income channel for wage increases and the low level of oil prices and to the confidence channel as uncertainties eased. The strong uptrend in industrial production, which started in the final quarter of 2015, continued in the first quarter of 2016 (Chart I.2.2). The rise in the perishable goods prices and intermediate goods supported this uptrend. In this framework, the leading indicators imply that the contribution from production and consumption dynamics to growth will continue in the first quarter of 2016 as well.

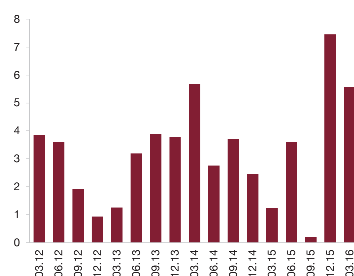
In 2015, the growth of the unemployment rate slowed down and remained almost flat throughout the year (Chart I.2.3). Employment denoted a moderate rise in 2015 which was mostly driven by the services sector. Nevertheless, the slowdown in labour participation restricted further increase in unemployment. The preliminary data for 2016 suggest that amid continued moderate rise in employment and the downturn in labour participation, a downtrend is observed in the unemployment rate. A likely decline in services exports might curb rise in employment in the rest of the year.

Chart I.2.1
Contribution to Growth from the Expenditure Side
(Percentage Point)



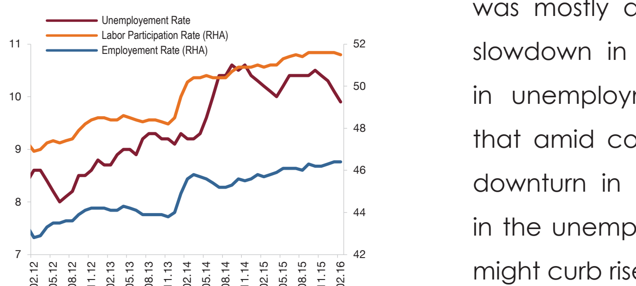
Source: CBRT, TURKSTAT (Latest Data: 12.15)

Chart I.2.2
Industrial Production Index
(Annual Percentage Change)



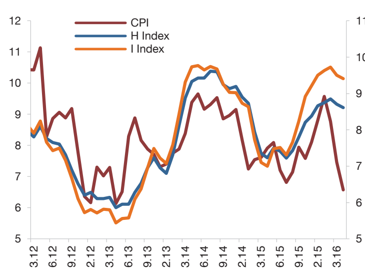
Source: CBRT, TURKSTAT (Latest Data: 03.16)

Chart I.2.3
Labor Force
(Seasonally Adjusted, Percent)



Source: TURKSTAT (Latest Data: 02.16)

Chart I.2.4
Price Indices
(Annual Percentage Change)



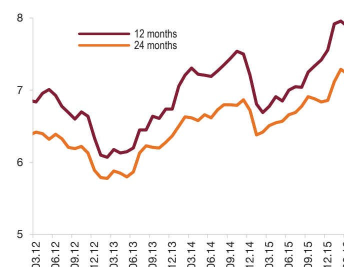
Source: CBRT, TURKSTAT (Latest Data: 04.16)

After the uptick in inflation in the final quarter of 2015, inflation recently dropped mainly owing to the food prices (Chart I.2.4). The unprocessed food prices inflation decreased significantly due to the base effect, especially on the back of the annual decline in the prices of vegetables and red meat. The ease in the cumulative impact of exchange rates on annual inflation continues. In relation, annual inflation in core indicators slightly decreased, while improvement in their underlying trend continued in this period. While inflation expectations climbed up in the final quarter of 2015, they declined slightly in March 2016 (Chart I.2.5).

The current account balance continues to improve (Chart I.2.6). The recovery in the current account balance is mainly attributed to the favourable developments in the terms of trade, the moderate trend in consumer loans and the macroprudential policies implemented. While imports decreased on the back of falling commodity prices and the decline in energy costs, the modest recovery trend in the European Union countries and the Turkish exports' high flexibility to switch markets have supported Turkish exports. As a result of these developments, the favorable trend in terms of trade has continued. As a consequence of the positive developments in the terms of trade, the ratio of exports to imports has been on a rapid rise as of the final quarter of 2015 (Chart I.2.7).

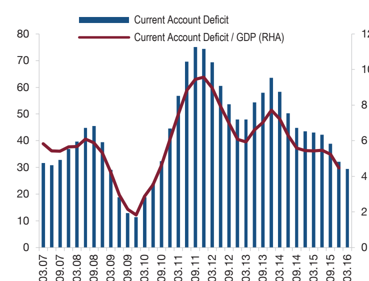
The current account deficit is mostly financed by direct investments and long-term sources (Chart I.2.8). Approximately one-third of the current account deficit is financed by direct investments. The foreign debt roll-over ratios of both the banking sector and other sectors are hovering above 100 percent.

Chart I.2.5
Inflation Expectations
(Percent)



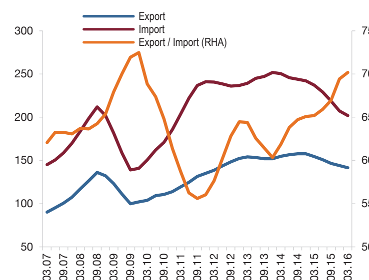
Source: CBRT (Latest Data: 04.16)

Chart I.2.6
Current Account Deficit
(12-Month Cumulative Billion USD)



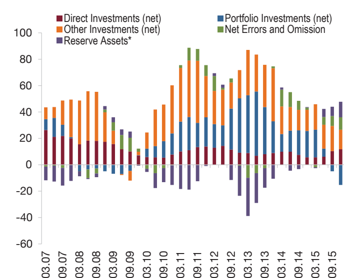
Source: CBRT (Latest Data: 03.16)

Chart I.2.7
Foreign Trade
(12-Month Cumulative, Billion USD, Percent)



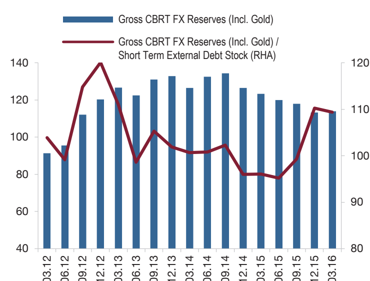
Source: CBRT (Latest Data: 03.16)

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



(*)Positive figures for FX reserve assests denote decrease in FX reserves, negative figures for FX reserve assests denote increase in FX reserves.
Source: CBRT (Latest Data: 03.16)

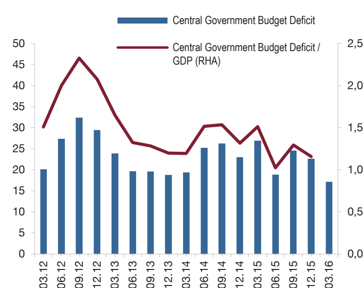
Chart I.2.9
Short-term External Debt Stock and CBRT Gross FX Reserves (Billion USD, Percent)



Source: Undersecretariat of Treasury, CBRT (Latest Data: 03.16)

There has been a significant decline in the short-term external debt stock and the ratio of reserves to debt stock has improved as well (Chart I.2.9). The decline in the short-term external debt stock is mainly driven by the macroprudential measures implemented and the decrease in external borrowing requirement owing to the continued improvement in the current account balance. Consequently, the ratio of the Central Bank's gross reserves to short-term external debt stock has increased significantly.

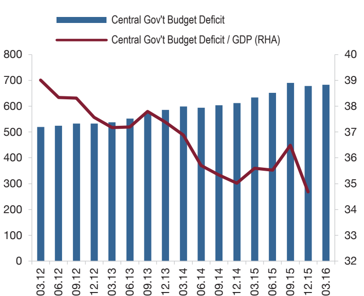
Chart I.2.10
Central Government Budget Balance
(12-Month Cumulative, Billion USD, Percent)



Source:Undersecretariat of Treasury (Latest Data: 03.16)

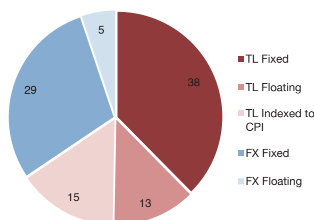
Sustained fiscal discipline contributes to bringing down both the risk premiums and inflation. In the first quarter of 2016, the central government budget deficit markedly decreased compared to the previous quarter's data (Chart I.2.10). Although public debt slightly increased compared to the previous quarter, the gradual decline in the ratio of debt stock to GDP continues (Chart I.2.11). In the first quarter of 2016, the rise in the central government primary surplus compared to end-2015 contributed to the decline in the central government budget deficit. By the end of the first quarter of 2016, the average days to maturity of debt stock was 4.7 years for domestic loans, 9.4 years for external loans and 6.3 years for total loans. The fact that the debt stock has a long-term maturity structure and borrowing is mostly fixed-rate and denominated in Turkish liras intensifies the resilience of public finance against external shocks (Chart I.2.12). Any measures that serve to achieve lasting fiscal discipline and decrease the domestic savings gap will support macroeconomic stability and help public borrowing interest rates remain low which, in return, will enhance the Turkish financial system's resilience in the face of shocks.

Chart I.2.11
Central Government Debt Stock
(Billion USD, Percent)



Source: Undersecretariat of Treasury (Latest Data: 03.16)

Chart I.2.12
Composition of the Central Government Debt Stock
(Percent)



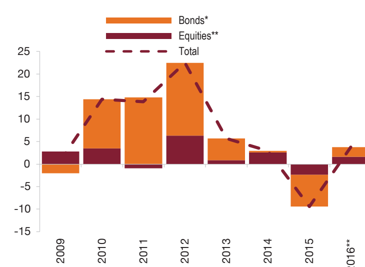
Source: Undersecretariat of Treasury (Latest Data: 03.16)

Portfolio flows towards Turkey have recently accelerated with the impact of increased risk appetite owing to the expectations that additional accommodative measures in advanced economies will continue and normalization will be delayed. An analysis of the net portfolio movements of non-residents reveals that there have been strong portfolio inflows to Turkey in both the stock market and the bond market since February (Chart I.2.13). The portfolio inflows were mainly driven by the recent improvement in the global financial conditions, the tight monetary policy, higher-than-expected growth and the favorable trend in other macroeconomic indicators in Turkey.

Risk premia in emerging economies and in Turkey dropped on the back of the recent rise in the global risk appetite, which in return brought an appreciation in the Turkish lira and decline in interest rates. With the contribution of stronger capital movements, the Turkish lira has appreciated against an exchange rate basket composed of the US dollar and the Euro. Moreover, as another reflection of the increased risk appetite owing to the projection that central banks of advanced economies will keep low interest rates for an extended period, Turkey's credit default swap premiums have declined remarkably (Chart I.2.14). Thanks to strong capital flows, demand for financial assets has increased and the indicative GDDS rates have assumed a downtrend since the beginning of 2016. Meanwhile, the spread between the 5-year and 3-month interest rates is almost flat which is also a sign of sustained tight monetary policy stance (Chart I.2.15).

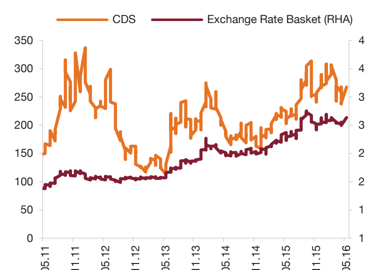
In the scope of the simplification of the monetary policy, the overnight lending rates were lowered in March, April and May. Factors that have recently reduced the need for a wide interest rate corridor are the improving global financial conditions and continued decline in volatility as well as the effective implementation of the policy instruments explained in the road map announced in August (Chart I.2.16).

Chart I.2.13
Cumulative Portfolio Flows
(Annual Cumulative, Billion USD)



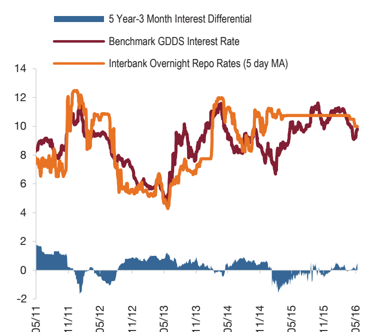
* Bonds markets include Repo transactions
**Portfolio flows to the emerging economies cumulative since the turn of the year
Source: CBRT (Latest Data: 06.05.2016)

Chart I.2.14
Exchange Rate Basket and CDS



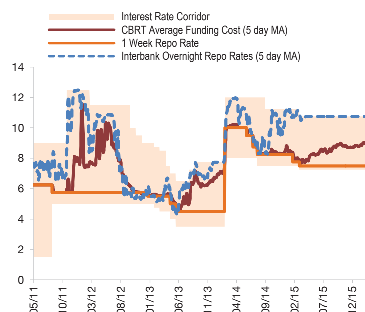
Source: CBRT (Latest Data: 06.05.16)

Chart I.2.15
Indicative GDDS Yield
(Percent)



Source: CBRT (Latest Data: 11.05.16)

Chart I.2.16
CBRT Rates and BIST Interbank O/N Rates
(Percent)



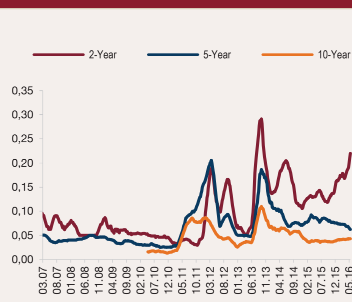
Source: CBRT, BIST (Latest Data: 25.05.16)

Box I.2.I GDDS Market Liquidity

Market liquidity, which is of critical importance for an effective allocation of economic resources for productivity purposes, efficient functioning of financial markets and sustainability of the effectiveness of the monetary policy, has remained an important topic on the agenda of regulators and market participants in the aftermath of the global financial crisis.

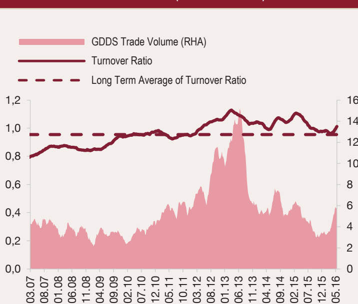
Market liquidity, in general terms, implies an asset's ability to sell quickly without a drastic drop in its price and at low transaction costs, even in the context of high volume transactions. Therefore, resiliency, depth and tightness are key concepts describing market liquidity. Moreover, the variety of investors and products available on the market are also closely related to market liquidity. This box addresses the benchmarks for the GDDS market liquidity.

Chart I.2.I.1
Benchmark GDDS Bid-Ask Spreads*
(Percent)



*13 week moving averages
Source: Bloomberg (Latest Data: 13.05.16)

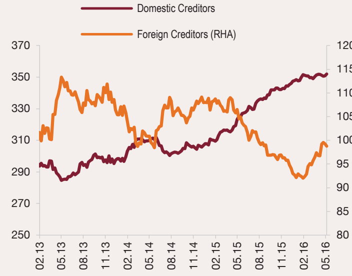
Chart I.2.I.2
Over-the-counter GDDS Trade Volume* and Turnover Rate** (Rate,Billion TL)



*13 week moving averages
**Turnover ratio is calculated such that trade volume of GDDS is divided by nominal value of GDDS.13 week moving averages have been used.
Source: BIST (Latest Data: 13.05.16)

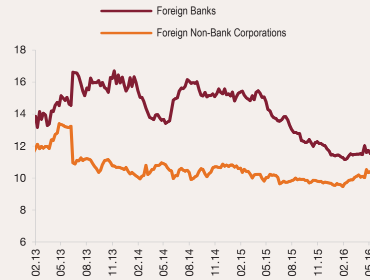
When bid-ask spreads, accepted as one of the indicators of tightness in the context of liquidity risk premium and market liquidity for primary dealers holding financial assets, are analyzed, two periods come to the forefront. During the global financial crisis of 2009, the bid-ask spreads of benchmark GDDS in Turkey remained low (Chart I.2.I.1). However, these spreads started to increase in May 2013, on the back of the Fed's signals towards tapering its asset-purchasing program. In the following period, the fading of uncertainties in the Fed's monetary policy and the expectation of a soon-to-be postponed normalization policy, accompanied by additional accomodative policies announced by the central banks of other advanced economies, resulted in a decline in the bid-ask spreads in overall terms. However, the 2-year benchmark GDDS bid-ask spread has presented a more sensitive outlook due to its relatively low volume of transaction and has diverged from the bid-ask spreads of medium and long-term benchmark GDDS in the recent period. The transaction volume of government securities, which is one of the indicators of depth, has recently assumed an upward trend (Chart I.2.I.2). Meanwhile, the turnover ratio, which is used as another depth indicator, has decelerated and converged to the long-term average.

Chart I.2.I.3
Developments of GDDS Holdings
(Billion TL)



Source: CBRT (Latest Data: 06.05.16)

Chart I.2.I.4
Composition of Non-Resident GDDS Holdings* (Percentage Share)



*Share of Total GDDS Nominal Amount
Source: CBRT (Latest Data: 06.05.16)

In the recent period, while non-residents' portfolio inflows via GDDS purchases have gained pace, the GDDS holdings of domestic creditors have posted a moderate increase (Chart I.2.I.3). However, while the share of GDDS holdings of non-resident banks in the total nominal GDDS amount has declined, the non-bank financial institutions residing abroad have been more inclined to hold GDDS (Chart I.2.I.4).