OVERVIEW

Steps taken by the authorities of advanced economies since the second half of 2012 have contributed to the efforts of controlling short-term risks. Yet, ongoing structural problems in these economies impede achieving a strong and sustainable growth. Unless new financial or political risks arise in the upcoming period, growth performance in advanced economies is expected to improve gradually. Meanwhile, emerging economies that acted as the source of global growth in the crisis period will most probably display a stronger growth performance as they have room to maneuver thanks to their low sovereign debt and relatively sound financial systems and as they have the potential for increased domestic demand. However, sudden changes in risk appetite that may appear as a consequence of new problems likely to be seen in advanced economies pose a risk to growth dynamics of emerging economies that are sensitive to capital flows.

As monetary policies implemented by advanced economies and historically low levels of interest rates have incited a search for yield in international investors, capital inflows to emerging economies have re-accelerated since the second half of 2012. In recent years, thanks to macroprudential policies implemented by authorities, risks such as deteriorations in the current account balance, excessive increase in asset prices and overborrowing have been reduced in many countries via the efforts to contain financial fragilities, especially excessive credit expansion. However, increased capital flows and low borrowing costs have triggered new risks and firms, especially in emerging economies, may increase their indebtedness and foreign exchange short positions. In such a case, the sensitivity to sudden changes in interest rates and foreign exchange rates may increase, which poses a risk to financial stability in emerging countries and increases the need for macroprudential measures. In this context, emerging economies should consider the systemic risk factors from both domestic and foreign origins, closely monitor firms' and households' indebtedness, act diligently to maintain their strong financial structures – especially capital adequacy and liquidity positions of banks – and back up these measures with mechanisms that will increase the resilience of the economy against likely shocks.

Taking into consideration the macrofinancial risks caused by ongoing global uncertainties, the Bank continues to implement its flexible monetary policy and uses structural and cyclical instruments that reduce the sensitivity of the economy to financial shocks in the framework of its main duties to achieve price stability and contribute to financial stability. While the facility of maturity-based reserve requirements – one of the structural instruments – is used to mitigate the maturity mismatch between assets and liabilities of the banking sector, the reserve options mechanism serves as an automatic stabilizer against capital flows and the facility of leverage-based reserve requirements aims to control the banks' indebtedness levels. Also, to contain the effects of cyclical risks on financial stability, the instruments of the policy rate, interest rate corridor and Turkish lira liquidity management are used effectively.

To rebalance the risks to financial stability and with the effect of the strong course of capital flows in the last quarter of 2012 and the first quarter of 2013, short-term interest rates were cut on the one hand and macroprudential measures to increase foreign exchange reserves continued on the other. Short-term interest rates have been gradually cut and thus, they approximated global interest rates. While the liquidity policy was normalized at early-2013 due to the level of loan growth being above the reference value in an environment of strong capital flows, reserve option coefficients and reserve requirement ratios were raised. Foreign exchange and gold reserves of the Bank continued to grow with the impact of increased reserve requirement ratios and the active use of the reserve options mechanism as well as export rediscount credits. In addition, the Turkish lira and foreign exchange reserve requirement ratios for short-term liabilities were raised to support financial stability and to extend the maturities of banking sector liabilities.

In the first quarter of 2013, favorable external financing conditions and the monetary policy in use have fostered the ongoing downtrend in loan rates. Loan growth, which was driven down to moderate levels for the sake of financial stability in 2012, started to accelerate in the last quarter of 2012 and has exceeded the reference level mainly due to the rise in retail loans, particularly in housing loans. Demand for corporate loans is predominantly towards working capital and demand for investment loans is relatively weak. Although deposits remain the principal source of financing for banks, sources other than deposits like securities issues and external loans are also increasingly used for financing.

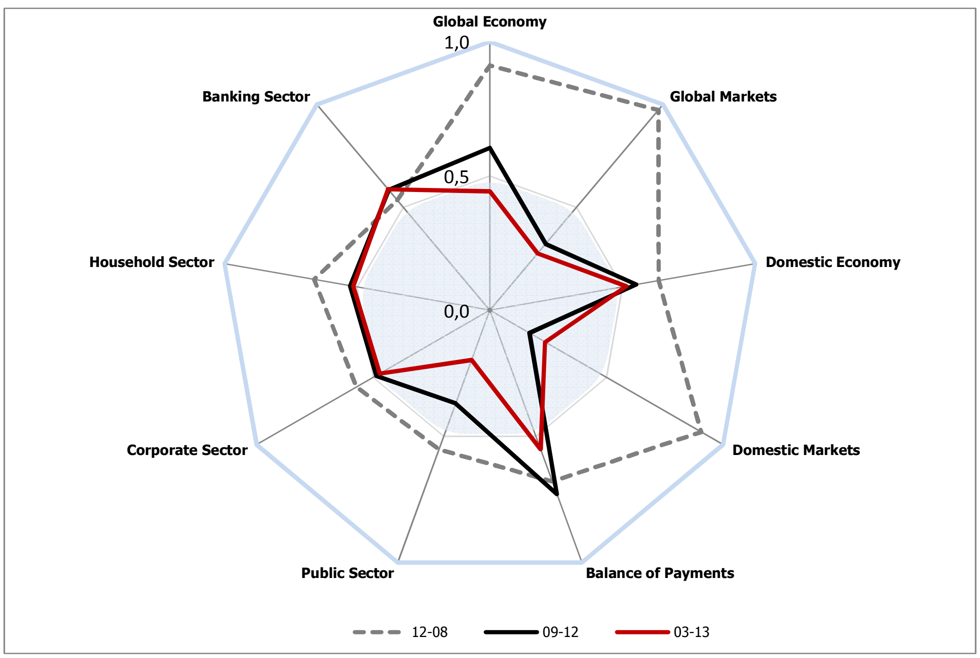
The banking sector continued to grow due to its strong liquidity ratios and capital structure and managed to maintain its assets quality. Non-performing loan ratios for the banking sector are at low levels on a horizontal course. There is no significant concern over the asset quality; yet, it is believed that it will be a cautionary move for the banks to hold reserves for non-performing loans in an amount above the legal requirement at times when the economic conjuncture is favorable and the banks' profitability is strong. The banking sector preserves the high capital adequacy ratios and the studies on the harmonization of current regulations with Basel III standards continue. The sector has a strong equity structure against likely shocks to arise from loan and market movements. Studies carried out on various platforms, particularly by the Financial Stability Committee, are expected to continue to support the sound functioning of the banking sector in the upcoming period.

Indebtedness and foreign exchange net short position of the corporate sector are closely monitored in terms of financial stability. A great portion of external loans is of long-term maturity and these resources offer diversity in terms of both quality and regional distribution, which stand as a factor restraining the risks regarding the indebtedness of the corporate sector. Despite the moderate recovery in domestic demand, the slow growth in the global economy and the weak trend of external demand have unfavorably affected the turnovers and profitability of firms quoted on Borsa İstanbul.

An analysis of household developments reveals that the annual rate of increase in consumption expenditures has slowed down whereas the demand for retail loans has increased recently parallel to the decline in interest rates. In line with credit utilization, both interest payments and total liabilities of households have increased; however, household indebtedness in proportion to the GDP and disposable income is still at a low level compared to G20 countries and interest rate risk and exchange rate risk have been avoided due to the regulations made previously. Meanwhile, the cuts in interest rates have provided households with the opportunity to restructure their loans, especially housing loans, and thus enabled a reduction in interest cost. Moreover, positive effects of the reforms made to boost savings and the steps taken especially in the private pension system have become apparent. Taking into account the positive effects of savings on investments, growth and financial stability, the Bank has started a nation-wide campaign to raise awareness to increase savings rates and to encourage the use of Kurus.

Effective financial market infrastructures are an important component of financial stability. Developments after the latest financial crisis have increased the role of financial infrastructures of systemic importance. In Turkey, studies on the legislations to strengthen the legal infrastructure related to payments are carried out as well. In this framework, the new Capital Market Law has been put into effect and the Central Bank has also prepared a new draft law on the adjustment of payments. The draft law, which is in the last phase of enactment, aims to help build a legislative framework that takes into account the best examples of payment and securities settlement systems, payment services and electronic money institutions as well as the needs of the country. The draft law defines the licensing, surveillance and supervision processes regarding the payments on the one hand, and prepares the infrastructure of a system that will enhance the financial access and competitiveness among actors on the other.

Financial Stability Map[1,2]



(1) Getting closer to the core means that the contribution of the related sector to financial stability has increased on the positive side. The analysis allows a historical comparison within each sub-sector. A cross-sector comparison is available only in terms of the direction of the change in the positioning as to the core.

(2) For the methodology used in the macro display of financial stability, see Financial Stability Report (FSR) November 2011-Special Topic IV.10.

In line with available evaluations, the schematic presentation of financial stability developments in Turkey can be seen in the financial stability map above. According to this diagram, the global economy and global markets abroad have displayed a favorable trend while at home, especially in the public sector, the economy and the balance of payments have offered a more favorable outlook compared to the September 2012 period analyzed in the previous Financial Stability Report, as also reflected in Turkey's raised credit ratings by international credit rating agencies. Concurrently, the levels of riskiness in the banking sector, households and firms have not changed significantly. Macroprudential measures taken to maintain financial stability have also been backed by structural reforms.