OVERVIEW

The fluctuations that took place in May-June of 2006 have been an important experience indicating the resilience of both the Turkish economy and financial institutions. The structural reforms that have been implemented and the timely and effective monetary policy decisions have limited the impact of the global liquidity shock on the economy and institutions.

Despite the slowdown in the consumption expenditure during the second half of the year, the gross domestic product has grown beyond the expectations in year 2006 due to strong external demand. Additionally, the contribution of net exports to growth has been positive for the first time in the last five years. The trend observed in the second half of the year 2006 is expected to continue in the first quarter of 2007.

The high current account deficit, which has occurred as a result of rapid growth, increasing raw material prices and decreasing private sector savings in recent years, has mainly been financed by long-term investments throughout 2006. Considering a possible unfavorable shift in global liquidity conditions for developing countries, it is necessary to closely monitor the current account deficit. However, the continued strength of external demand and the decline in domestic demand together with the increase in estimated private sector savings, strengthen the expectations towards the decline in the ratio of the current account deficit to GDP.

In 2006, the high primary surplus continued to be attained and the ratio of public net debt stock to GNP fell. The share of the New Turkish lira denominated floating rate government debt securities in domestic public debt stock has been declining and this highlights the Treasury's decreasing vulnerability to interest rate risk. Moreover, inflation indexed bonds issued by the Treasury in February and May 2007 are expected to contribute to the deepening of the markets. On the other hand, in the first four months of 2007, budget realizations remained within the targets due to the increased contribution of non-tax income. Therefore, since 2007 is an election year, the implementation of tight fiscal policies remains to be of significance.

Although the household indebtedness ratio continued to increase in 2006, it is still below the Euro Area average. Since retail loans have fixed rates, the upward movement of interest rates during the second half of the year did not increase the household's interest burden on its total debt. On the other hand, the mortgage system, which was established in 2007 and which will become operative following the completion of the secondary legislations, is expected to further increase household liabilities in parallel to the declining interest rates. During this process, it is important that households consider their current and future income, the maturity structure, the level and type of interest rates while deciding to use a housing loan and, similarly that mortgage institutions act prudently.

There has been an increase in foreign exchange indexed consumer loans although their share in total consumer loans remained unchanged. Considering the fact that the depreciation of the Turkish currency would increase the debt burden of the household sector, it is obvious that households, which do not have foreign currency income, should avoid borrowing in foreign currency.

In 2006, the leverage ratio of firms has increased and their profitability has improved. In addition, the continued high level of the ratio of shareholders equity to total assets underlines the strong debt repayment capacity of firms. High current ratio of firms indicates that liquidity risk is manageable and considering their financial structure, firms are able to meet their short-term obligations.

Although the foreign exchange open positions of firms started to decline in the second half of the year, they increased significantly as of year-end 2006, compared to the previous year. Since a depreciation of the New Turkish lira would increase the default risk of debtors, the foreign exchange risk of firms might turn into credit risk for banks. For this reason, it is necessary for firms to improve their foreign exchange risk management capacity and for banks to act prudently in lending to firms with high open positions and no FX earnings, in order to refrain from credit risk.

Despite fluctuations in the financial markets, the banking sector maintained its growth trend in 2006; its asset size to GDP ratio has risen and the interest of foreign investors in the Turkish banking sector has continued.

In 2006, although the credit volume of the banking sector increased, its pace of growth declined. This slowdown stemmed from the continued high level of interest rates in the second half of the year. The increase in consumer credits in 2006 is mainly a consequence of the rising housing loans as in the previous year as well as the increase in other consumer loans. In 2007, the rise in other consumer loans has become more apparent, while the decline in vehicle loans has continued. This increase in other consumer loans is likely to be stemming from the consumers' tendency to use loans of this kind to pay back their credit card obligations.

In 2006, while the amount of non-performing loans kept increasing, the non-performing loan ratio followed a horizontal trend due to the increase in loans and this trend has also continued in 2007. Even though the trend of the non-performing loan ratio and the high provisioning policy are considered positive for credit risk, the ratio of provisions to loans is declining.

As of year-end 2006, net profit of the banking sector and thus, the return on assets and the return on equity increased. The capital adequacy ratio, which has declined compared to year 2005 due to the increase in risk-weighted assets stemming mainly from credit expansion, is still above the regulatory and target ratios.

According to the results of scenario analyses, the current capital structure of the banking sector is estimated to be capable of absorbing the losses which might arise as a result of possible shocks.

The Financial Strength Index, which is considered to be an indicator of the strength of the banking sector, exhibited a limited decline in May 2006 due to fluctuations in the financial markets. Following this, it started to increase in June, reaching its previous year's level as of year-end 2006.

As for future outlook, global liquidity and credit conditions and investment preferences of international funds emerge as factors that might affect the Turkish financial markets. Within this framework, the decisive implementation of the current economic program, process regarding convergence to the EU and the continuation of structural reforms maintain their significance in terms of financial stability.