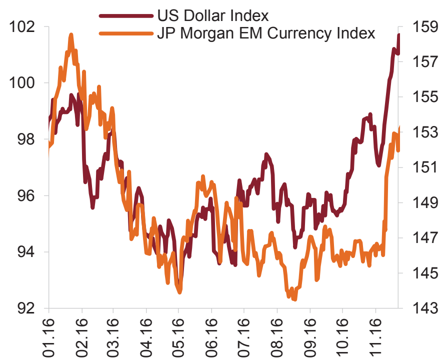
Overview

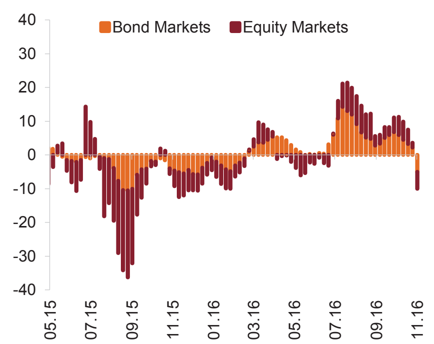
Global markets followed a relatively calm path from the beginning of the second half of 2016 leading up to the US presidential elections. The Bank of Japan and the ECB continued quantitative easing, which supported global liquidity during this period. While the markets reacted negatively to the results of the UK referendum, the after effects were short-lived. The moderate outlook of international investors' risk appetite supported portfolio flows to emerging countries up until the announcement of the US election results. However, the election results led to a perception of uncertainty pertaining to US economic policies, which in turn increased the volatility of financial markets remarkably. Following this period, the US dollar appreciated against developed and emerging country currencies substantially (Chart 1). Consequently, emerging economies have faced intensive capital outflows (Chart 2).

Chart 1
Exchange Rate Indices



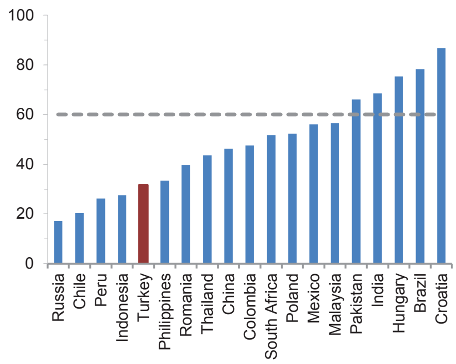
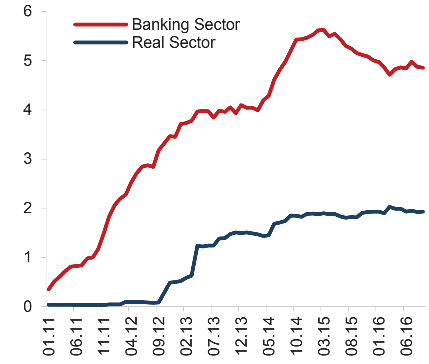
(1) JP Morgan EM Currency Index is inverted.
Source: Bloomberg (Latest Data: 22.11.16)

Chart 2
Weekly Capital Flows to EMs
(Billion US Dollar, 4-Week Cumulative)

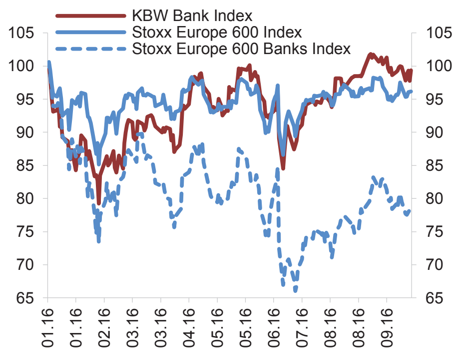
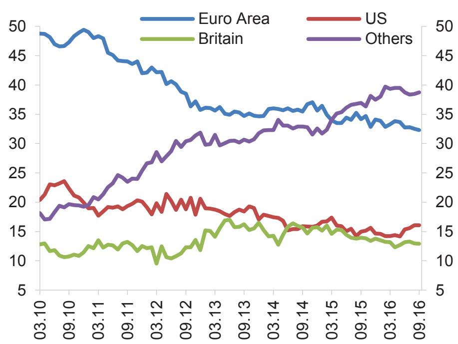


Source: EPFR (Latest Data: 16.11.16)

The strengthening view that expansionary fiscal policies will take precedence in the US economy has increased inflation expectations and has put upward pressure on bond market rates. The rise in the US bond market rates and escalating global uncertainty resulted in a decline in the demand for emerging market assets. Interest rates in emerging countries have risen sharply as liquidity in bond markets declined. This implies a significant deterioration in terms of funding for borrowers in emerging countries that are highly dependent on bond markets. It is anticipated that in Turkey, where the public debt stock is at a low level and the share of bank and firm issuances in total resources is extremely small; the impact of negative developments in the global bond market will be limited in terms of access to financing (Chart 3, 4). Nevertheless, it is expected that financing costs will increase moderately as a result of the rise in global interest rates.

Chart 3 Public Debt Stock/GDP: Cross-Country Comparison (Percent)	**Chart 4** Bond Issuance/External Liabilities (Percent)
	
Source: IMF (Latest Data: 2016)	Source: CBRT-CSDI (Latest Data: 09.16)

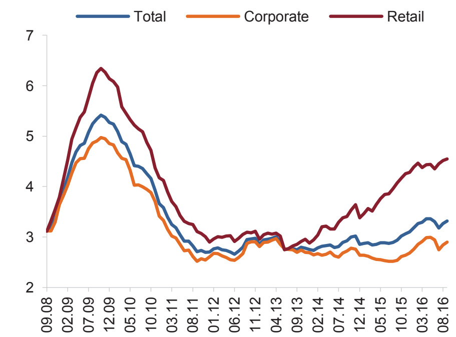
Recent developments in Eurozone banks, which played an important role in the allocation and intermediation of global liquidity, are closely monitored by international financial markets. The most important concern for Eurozone banks is their low profitability rates and this problem, if it persists, has the potential to adversely affect their intermediary capacity (Chart 5). Then again, the modest but steady growth trend in the Eurozone economic activity is considered a development that can ease the issues of bank profitability in the Zone. It is evident that the Turkish banking sector is not experiencing problems in rolling over debt from both the Eurozone and the UK banks, and that the US election results have not affected this situation adversely. The share of debt obtained from the Eurozone in total foreign debt has been gradually decreasing over the years. In this context, it should be emphasized that the diversification of Turkish banks' external funding across countries and institutions in recent years is a favorable development that can mitigate the risks arising from the Eurozone banking system (Chart 6).

Chart 5 Bank Indexes in Euro Zone and USA[1,2]	**Chart 6** Regional Distribution of External Debt[1] (Based on Headquartes, Percent)
	
(1) Indexed to January 2016=100 (2) KBW Bank Index serves as a benchmark of the US banking sector.	(1) Excludes external debt issuances.
Source: Bloomberg (Latest Data: 09.16)	Source: CBRT (Latest Data: 09.16)

The improvement that has been observed in the current account deficit since 2012 has contributed to the decline in the dependence on foreign funds. In the second half of 2016, the decline in the current account deficit paused, in particular due to the drop in tourism revenues and geopolitical developments. There are a couple of developments that may support the improvement in the current account balance in the medium term. These are: the sustained low momentum growth trend in the Eurozone, Turkey's most important trade partner; recovery in exports to Russia; moderate course of energy prices, and increasing competitiveness due to the depreciation of the TL. These factors are expected to support financial stability by reducing the need for external financing in a period of heightened uncertainty in global financial markets.

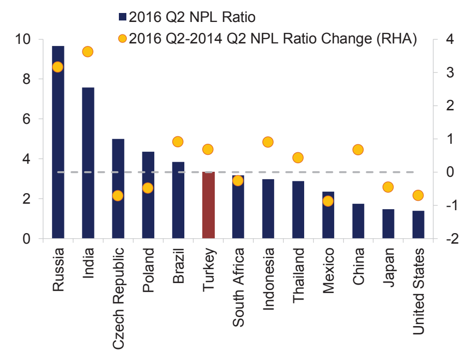
Non-performing loans (NPL) have been on a rising path due to slowing economic activity. Nevertheless, the increase in NPL ratios is far from historical highs and it is at reasonable levels compared to other countries (Chart 7, 8). The performance of foreign exchange (FX) loans is still strong, and historical data suggests that the link between the NPL ratios and exchange rate developments is weak. This is driven by the fact that the FX debt has long-term maturity, is clustered in large companies, and these companies are protected from foreign exchange risk through export revenues or state guarantees. High level of bank capital buffers and the recent profitability ratios indicate that losses due to rising NPL ratios will not have a significant effect on banks' lending capacity.

Chart 7
NPL Ratios
(Percent)



Source: CBRT (Latest Data: 09.16)

Chart 8
NPL Ratios for Selected Countries[1]
(Percent, Percentage Points)

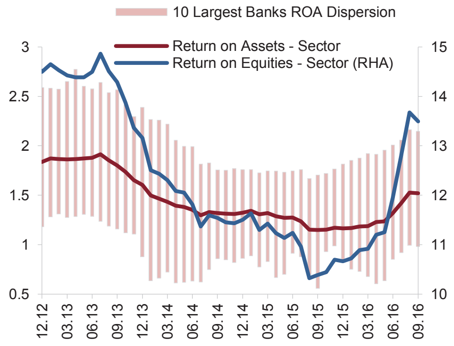


(1) Dashed line belongs to “change” figures.

Source: IMF-IFS, CBRT (Latest Data: 06.16)

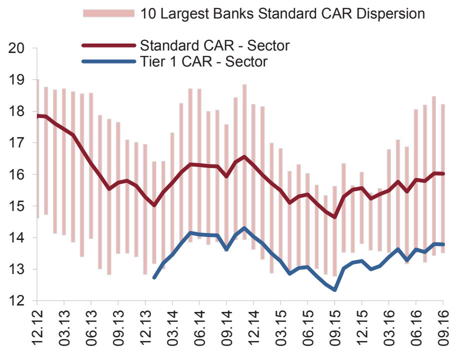
Profitability ratios that hit historic lows in mid-2015, started to recover as of the second half of 2016 (Chart 9). The profitability figures recorded in the third quarter of 2016 are sufficient to sustain high credit growth rates while preserving the current level of capital adequacy ratios (Chart 10). Although one-off factors have played some role in the strong recovery of profitability, their contribution has been indeed limited. In the last quarter of 2016, a limited decline is expected in profitability due to the valuation effects in securities owing to recent developments in bond rates. Yet, the positive outlook in profitability is expected to be mostly preserved in the forthcoming periods.

Chart 9
Return on Assets and Return on Equities
(12-Month Cumulative, Percent)



Source: CBRT (Latest Data: 09.16)

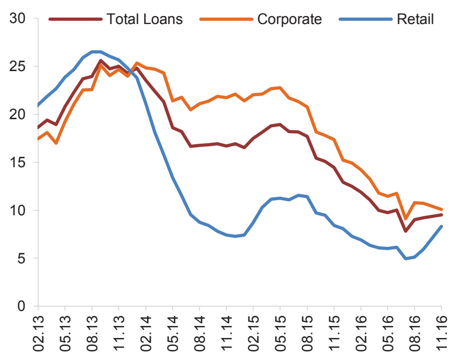
Chart 10
CAR and Core Tier 1 CAR
(Percent)



Source: CBRT (Latest Data: 09.16)

The moderate course of credit growth rates continues (Chart 11). Corporate lending has been on a weak trend while in consumer loans, housing and general-purpose loans have shown a strong recovery since September 2016 with the contribution of the decline in interest rates and easing in macroprudential measures (Chart 12). Although demand factors play an important role in the weak course of corporate lending, the cautiousness toward credit risk is also considered to be effective in reducing banks' lending appetite. The developments in the credit-deposit interest rate differential and the information provided by bank loan tendency surveys on bank lending standards point to the cautious stance of banks (Chart 13, 14).

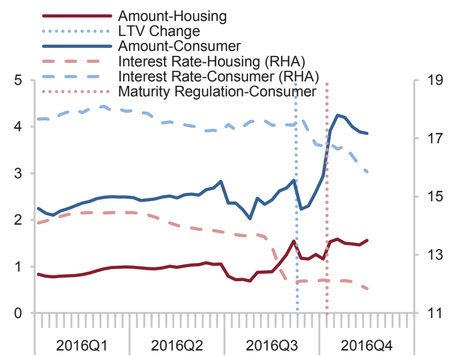
Chart 11
Annual Loan Growth[1]
(Percent, Adjusted for Exchange Rate)



(1) FX indexed loans are included in total FX loans and adjusted for exchange rate effects using the US Dollar and the Euro basket. Growth rates of weekly data for the last two months are appended to the graph of monthy data.

Source: CBRT (Latest Data: 18.11.16)

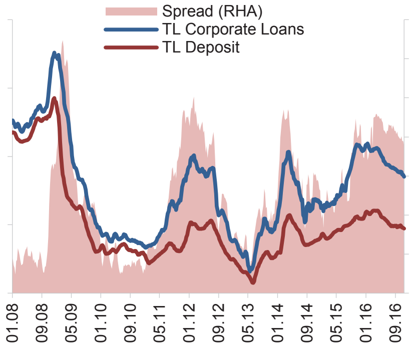
Chart 12
Interest Rates, Regulations and Consumer Loans
(4-Week Moving Average, Flow, Billion TL, Percent)



Source: CBRT (Latest Data: 18.11.16)

The interest rate cuts implemented by the Central Bank of the Republic of Turkey in the March-September period of 2016, supportive liquidity policies implemented through reserve requirements, stimulative fiscal policies, easing macroprudential measures and support to the credit market by state-owned banks that maintain their sound financial structures can be regarded as positive steps towards increasing the effectiveness of the financial intermediation. Economic activity, which has weakened recently due to geopolitical developments, the downturn in global growth, and the domestic developments, is likely to enter into a more favorable path in 2017 with the improvement in the outlook for both domestic demand and export markets.

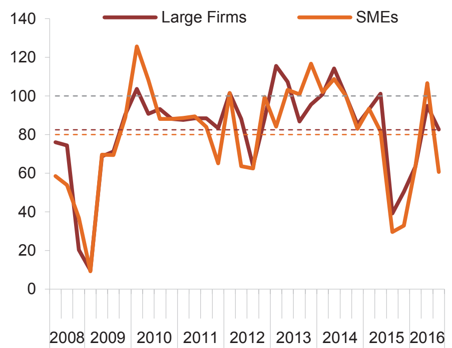
Chart 13
Spread between Loan and Deposit Rates[1]
(4-Week Moving Average, Percent)



(1) Overdraft accounts, credit card accounts and zero-interest credits since July 2015 are excluded.

Source: CBRT (Latest Data: 11.11.16)

Chart 14
Banks' Credit Standards by Firm Size[1]
(Net Percentage Change)



(1) Dashed line represents 100-line, which shows "neutral" level for long-term averages and standards. Figures higher and lower than 100 points shows easing and tightening, respectively.

Source: CBRT (Latest Data: 09.16)

In a period marked by increased volatility in financial markets where the pace of advanced countries' recovery is still weak, the Turkish banking sector remains resilient and continues to preserve its credibility in international markets. It is projected that the banking sector will continue to carry out its financial intermediation activities in a sound way in the upcoming period.