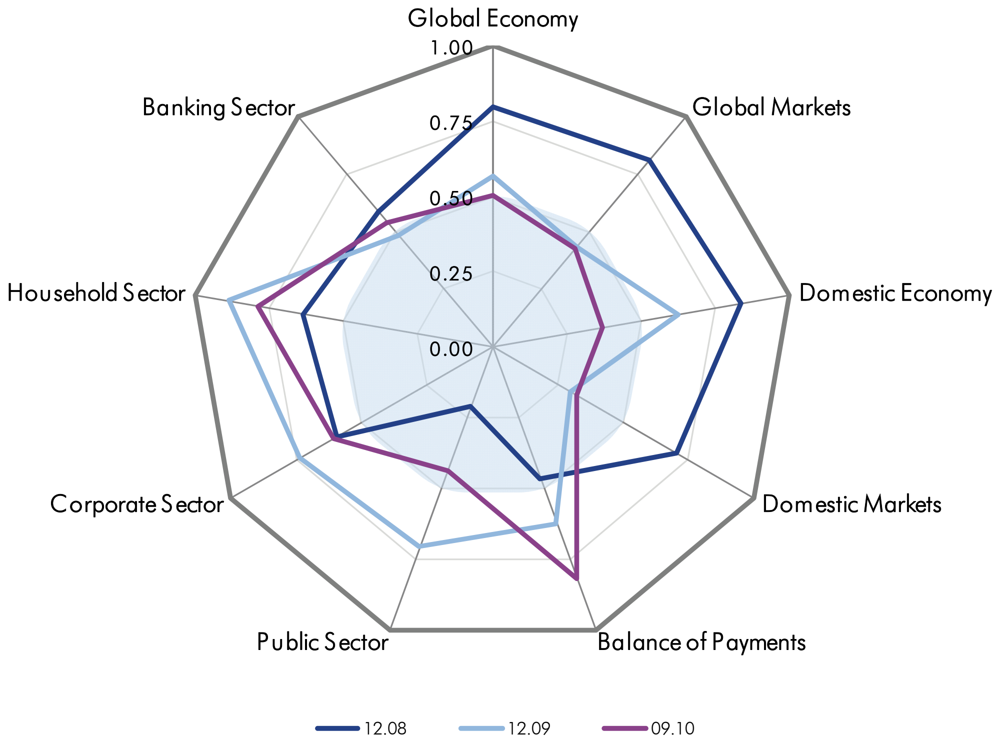
OVERVIEW

Considering the importance of evaluating the system regarding financial stability with a holistic approach, the Report examines the stability of the financial system in Turkey from a macro-perspective by analyzing national and international developments.

Financial Stability Map[1]



(1) The closer to the center, the more stable a sector is. Analysis allows time series comparisons within each sector. Among the sectors, the comparison can be done in terms of the directional change in position with respect to the center.

As also shown in the chart above, the crisis was initially felt in the domestic economy and the domestic markets. From the crisis to the recovery stage, an improvement has been seen in almost all fields except for the balance of payments. As for the rest, despite the loosening of fiscal policy and the increase in corporate and household non-performing loans in the first phase of the crisis; starting from the last quarter of 2009, the rise in tax revenues, the increase in profitability performance of firms and the slowdown in unemployment rate have led the rate of non-performing loans to start to decrease. Analyses in the Report indicate that Turkey's banking sector has a structure that supports rapid loan growth and maintains its resilience against shocks.

Although there is significant decoupling between the economic outlook of developing and developed countries, as a whole the global economy has gradually recovered. However, the risks primarily originating from developed economies remain, and especially the increasing problems in the banking and public sector of some European countries adversely affect the markets. There are still downside risks embedded in the future global growth outlook. Meanwhile, expansionary monetary policies and ample liquidity has favorably affected financial markets by alleviating worries of a "second slump". Emerging economies with relatively stronger public finances, financial structures and growth potential overcame the effects of the crisis faster and assumed a period of recovery prior to others. Nevertheless, considering the integrated structure of the global economy, it will be uncertain as to how long the fast recovery trend will continue as it relies mostly upon domestic demand as long as the problems in developed countries are not completely solved.

The weak outlook of global growth has led central banks of developed countries to continue with expansionary monetary policy implementations and the balance sheets of central banks have grown dramatically in size. In line with this, capital inflows to developing countries gained pace with the increasing global liquidity. Expectations that short-term interest rates in developed countries will remain low for a long time pushed investors to seek high returns, hence the demand for investment instruments in developing countries increased. While the volatility indicators of asset prices have improved, the relief felt in interbank markets also contributed to the improvement in international markets. However, risk perceptions especially regarding countries in the euro area, that have trouble paying public debts have caused worries in international markets to persist.

In Turkey, the pace of recovery in economic activity was faster than expected and the Medium-Term Program (MTP) indicated that the fiscal discipline would continue. Additionally, the stability of the financial system, the favorable assessments of credit rating agencies, the fact that risk premium indicators are below pre-crisis levels all point to a favorable outlook for the Turkish economy. As a result of these developments, along with the stimulated demand for consumption and investment, firms and households' use of loans has accelerated, and the economy is growing mostly on account of the domestic demand. Coupled with these factors, capital inflow gains pace also being triggered by the increase in the global risk appetite, while market interest rates decrease; asset prices increase and the Turkish lira appreciates.

The recovery of the economy mostly based on domestic demand raises the debt ratios of both households and firms and increases the current account deficit. In the upcoming period, the course of short and long-term capital flows and the current account deficit are indicators that must be closely monitored with regard to financial stability. It is of vital importance to carefully monitor these indicators and take macroprudential measures on time and in an effective manner.

The policy instruments, which developing countries generally resort to against strengthening capital flows, attempt to curb capital inflows (Special Topic IV.2). Contrary to other developing countries, in Turkey, the acceleration of measures to reinforce financial stability in periods of increased capital flows is preferred. Given the current conjuncture, the public and private sector's avoidance of excessive borrowing; preference of longer maturities in all borrowings, opting to borrow in Turkish lira as much as possible and managing risks efficiently will considerably strengthen the resilience of the Turkish economy against external shocks.

Encouraging economic agents to borrow less and use more equity capital (low leverage) is one of the major steps to be taken in this respect. The MTP updated for the public sector indicates that fiscal discipline will continue; the increase in deductions from the Resource Utilization Support Fund (RUSF) applied to consumer loans; the upper limit of loan to value ratio set as 75 percent for housing loans and the targeting of a capital adequacy ratio of 12 percent for our banks, are measures taken to this end.

Secondly, maturity extension is encouraged in economic agents' borrowings. The successful efforts of the Treasury to extend maturities of public borrowings continue. Regarding the banking sector, in order to extend the maturities of liabilities, the issuance of Turkish lira bonds have been facilitated and some advantages for long-term deposits using reserve requirements will be provided through some new arrangements. Additionally, the overnight borrowing rate was lowered by 400 basis points at the

Monetary Policy Committee Meeting (MPC) in November 2010, which in turn facilitated the decline of short-term swap interest rates when necessary. All these measures are aimed at maturity extension.

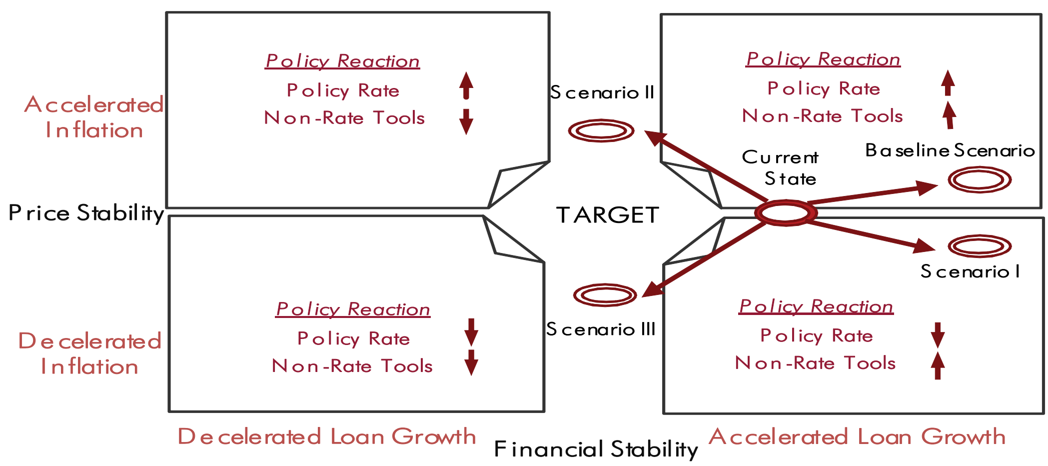
Another measure was to encourage borrowing in Turkish lira and to adopt a leading policy preference of decreasing net foreign exchange debts. To this end, the Treasury is oriented towards borrowing in Turkish lira for the public sector and the CBRT increased reserve accumulation in periods of accelerated capital inflows. Developments and measures such as raising awareness of the floating exchange rate regime and exchange rate risk, the decline in inflation and Turkish lira-denominated interest rates besides the setting of foreign currency required reserve ratios higher encourage households and the corporate sector to borrow in Turkish lira. In addition to the inability of households to borrow in foreign exchange, not allowing the use of foreign-exchange-indexed loans has also reinforced this process. The arrangement in the foreign exchange net general position (FXGNP) regarding the banking sector and controlled permission by the BRSA for our banks to issue Turkish lira bonds all serve this purpose.

Lastly, the importance of improving the risk management culture of all economic agents has become more noticeable. In this respect, the steps to be taken for financial education are of great importance for the sound functioning of the system (Special Topic IV.7).

The monetary policy implemented by the CBRT is embodied in a framework in which price stability and financial stability complement each other.

In this context, we can summarize how the CBRT will use its policy tools in the forthcoming period under the possible scenarios mentioned in the previous inflation reports that have been shared with the public.

Economic Policy in the Current Conjuncture



As illustrated in the figure above, while current economic conditions support keeping policy rates at low levels for a long period of time, developments in the aggregate demand composition necessitates that instruments other than the policy rate are brought to pre-crisis levels. Accordingly, this situation suggests that the CBRT has largely completed the exit strategy measures that it announced in April 2010.

The CBRT's **baseline scenario** mentioned in the October 2010 Inflation Report was based on an outlook where "*domestic demand is stronger compared to the previous reporting period, external demand continues to restrain economic activity, and thus aggregate demand conditions continue to support disinflation, albeit to a lesser degree*". This baseline scenario assumes a policy framework that the measures outlined in our exit strategy will be completed by the end of the year, and that policy rates are kept constant at current levels for some time followed by limited increases starting from the last quarter of 2011, with policy rates staying in single digits throughout the forecast horizon (3 years). In this respect, non-rate tools will be actively used in order to address the risks on financial stability stemming from rapid loan expansion and deterioration in the current account balance.

The European Central Bank reluctantly joined the ranks of the Federal Reserve, Bank of England and Bank of Japan, which have engaged in monetary expansion, due to fast growing debt problems in Europe. As a result, materialization of the **Scenario I** has become more likely, as illustrated in the figure. In that case, the scenario described in the CBRT's October 2009 Inflation Report has become more likely, stating that: *"Another possible scenario is a surge in capital inflows to emerging markets owing to the relative improvement of credit risk across these countries. Ample liquidity driven by the expansionary fiscal and monetary policies on a worldwide scale, coupled with rising risk appetites, have led to large capital inflows to emerging markets. The current output gap would imply that a fall in the cost of imported inputs could be rapidly transmitted to consumer prices, suggesting that further acceleration in capital inflows may exacerbate downward pressures on inflation. Realization of such a scenario could lead to temporarily lower policy rates than envisaged in the baseline scenario"* (2009 IR-IV). In that case, along with temporary policy rate decreases, it would be appropriate to use non-rate tools effectively in the tightening direction in order to slow down the loan growth.

In the meantime, it should be noted that both recent economic developments in Europe and decisions taken by central banks of developed countries increase global economic uncertainty significantly. Should the measures taken lead to undesired inflationary effects on a global scale; the **Scenario II** illustrated in the figure might materialize. This implies the scenario mentioned in the October 2010 Inflation Report, indicating that: *"Food and commodity price inflation has soared recently. Currently noninflationary levels of the output gap and the strength of the Turkish lira have been limiting the pass-through from food and commodity prices to the prices of core goods and services. However, the potential second-round effects continue to be a risk if increases in food and commodity prices persist. Should such a risk materialize and lead to a deterioration in the price setting behavior, which would hamper achieving the medium-term inflation targets, an earlier-than envisaged tightening in the baseline scenario would be considered"* (2010 IR-IV). In that case, as domestic credit expansion would weaken, the use of non-rate tools might not be needed in the direction of tightening.

If measures taken in developed countries remain inadequate, the **Scenario III** might be considered. This situation points to the outlook described in October 2010 Inflation Report, reading: *"Recently, leading indicators of economic activity continue to slow down, underscoring the downside risks especially regarding the US economy. Furthermore, ongoing problems in credit, real estate and labor markets across advanced economies, and the uncertainties regarding the impact of a possible fiscal consolidation suggest that the downside risks regarding the pace of global growth are likely to persist for some time. Should the global economy face a longer-than-anticipated period of anemic growth, the monetary tightening envisaged during the final quarter of 2011 under the baseline scenario may be postponed. Moreover, an outcome whereby global economic problems intensify and contribute to a contraction of domestic economic activity may trigger a second round of easing"* (2010 IR-IV). In this case, the use of non-rate tools might not be needed in the direction of tightening, as domestic credit expansion will weaken.

Although public sector budget deficit and public debt ratios in Turkey displayed a limited increase during the crisis, as was the case worldwide, due to the decline in revenues and fiscal expansion, tax revenues increased and expenditures showed a moderate rise owing to the economic revival. This development affects public finance in a positive way. In an environment of widening current account deficit, it is essential for financial stability that public savings are increased and fiscal discipline is sustained in line with the perspective given in the Medium-Term Program.

Factors such as strong public finance, improvement of profitability performance of corporate sector, and the fact that the ratio of household liabilities to GDP is low compared to other countries and they are mostly Turkish lira-denominated, increase the resilience of the economy against potential shocks.

The banking sector, which constitutes the majority of the Turkish financial sector, suggests that the ratio of non-performing loans declined in the aftermath of the crisis, thanks to the economic recovery and low interest rates. Banks' funding from foreign markets improved while the share of public securities in balance sheets decreased. Although capital adequacy ratios declined slightly on the back of the increased growth rate of loans, they are somewhat higher than the minimum and target ratios. In the upcoming period, as the competition increases, it is important that banks continue to act diligently in risk management while lending, to keep the improvement in asset quality.

The analyses carried out in the report show that the Turkish banking system has maintained its resilience against endogenous and exogenous shocks. However, increased capital inflows and loan growth, as well as the differentiation between growth rates of domestic and external demand becoming more marked require a cautious approach to financial stability. Against this background, the CBRT will continue to use macroprudential policy instruments, particularly the required reserves ratios and liquidity management actively in the upcoming period as well.