OVERVIEW

It is observed that tight monetary and fiscal policy implementations, on-going structural reforms, the current economic program combined with economic and legal convergence processes towards European Union (EU) membership and the flexible exchange rate regime has strengthened the Turkish economy against external shocks. Indeed, the comparably low cost of the fluctuation in financial markets that occurred in the second quarter of 2006 verifies this observation.

The discipline in public finance continues to play an important role in maintaining financial stability. Considering the existing possibility of an unfavorable shift in global liquidity conditions for developing countries, full-fledged discipline in public finance and meeting the primary surplus targets has gained more importance.

The composition and level of public debt stock also continued to improve in 2006. The share of New Turkish Lira denominated floating rate instruments and foreign exchange (FX) denominated instruments in total public domestic debt stock decreased in 2006 compared to 2005 and this shows that the Treasury's exposure to interest and FX risk decreased. The Treasury's recent debt swap transaction in international financial markets indicates that the recent fluctuation has slightly affected the borrowing cost incurred by the Treasury.

Increased current account deficit due to high economic growth should be closely monitored with a view to financial stability. As a positive development, short-term portfolio investments, which have a considerable share in the financing of the current account deficit, have been observed to gradually decline, being replaced by direct investments and long-term credits acquired by the corporate sector.

In the first half of 2006, despite the recent fluctuation, the increase in private consumption and investment expenditures gave impetus to the Gross Domestic Product (GDP) growth rate. However, the rise in interest rates and depreciation of the New Turkish Lira might to some extent curb economic growth in the second half of 2006.

The ratio of household liabilities to financial assets increased considerably in the first half of 2006. However, parallel to rising interest rates, the increased rate of growth in consumer loans started to slow down and the above-mentioned ratio started to follow a horizontal trend after July 2006. Despite the recent increase in household liabilities, its size relative to GDP is below the EU average. Fluctuations in May-June slightly affected interest payments of household due to the regulation, which stipulates that consumer loans can only be granted at a fixed interest rate. Yet, FX-indexed loans amounted to 1.5 billion New Turkish Liras, while their share in total consumer credit declined. Considering that the rise in FX rates increases the household debt stock, the risk profile of households might deteriorate if they do not have FX income. Therefore, households should refrain from increasing their foreign currency borrowings.

The profitability of firms deteriorated in 2005, partly due to increased competition in the sector, and by using data of firms that are quoted on the Istanbul Stock Exchange (ISE) it can be observed that this trend continued in the first six months of 2006. In addition, external borrowings of firms and thus their short FX positions increased. Accordingly, depreciation of the New Turkish Lira might increase the default risk, leaving the banking sector with increased exposure to credit risk. Within this context, firms should improve their FX risk management and use more hedging instruments, whereas banks should carefully evaluate the credit risk that has arisen from firms' short FX positions.

Despite recent fluctuations in the markets, the banking sector, possessing the largest share of the financial system, grew by 9.1 percent on a real basis in the first nine months of 2006, and the interest of foreign investors in the sector continued.

The share of loans in the banking sector's total assets has continued to increase. The growth in credit volume has mainly arisen from the increase in retail loans. The increase in housing loans, which continued in the second half of 2006 has been driven by housing loan interest rates that were realized at low levels due to increased competition. It is also thought that consumers sought to acquire more consumer loans to cover up their credit card balances due to the fact that interest rates applied to credit card transactions are higher than those of consumer loans. However, after the recent fluctuations in financial markets, the increased interest rates caused a slowdown in the rate of increase of retail loans starting from June 2006. It is expected that the growth rate of credit volume will continue to slowdown.

Due to the fact that the interest rates of consumer loans are fixed, banks, which did not finance long-term loans with long-term funds at fixed interest rates, were affected more adversely by the recent fluctuations. It is expected that after the enactment of the Mortgage Law, it will be possible for banks to grant floating rate housing loans and this will contribute to the interest rate risk management of the banking sector.

Six months on from the May-June fluctuations, there is still no deterioration in the non-performing loans of the banking sector. In addition, it is considered favorable that the high provision policy regarding non-performing loans has also continued in the year of 2006. However, in recent periods the ratio of total provisions to total loans has decreased due to rapid credit expansion. On the other hand, it is a positive development that the general provisions for newly granted loans have been doubled by a recent prudential regulation of the Banking Regulation and Supervision Authority (BRSA).

Net profit of the banking sector increased by 118.1 percent in September 2006 compared to the same period of 2005. As of September 2005, the considerable amount of net loss announced by one of the commercial banks accounts for the major part of this increase. Excluding the above-mentioned bank, the net increase in profit is 30.7 percent. Banks have tended to keep their FX net general positions squared. Therefore, the depreciation of the New Turkish Lira since May 2006 has only affected the profitability of the banking sector to a limited extent.

The banking sector possesses own funds that are well over the minimum capital requirement for its risk exposure. By September 2006, banks compensated the erosion in their own funds led by recent fluctuations. First, the capital adequacy ratio of the banking sector had decreased from the end of 2005 to July 2006, then it started to rise again, reaching 20.5 percent as of September 2006. Scenario analyses results show that current level of the banking sector's own funds are adequate to compensate possible losses.

Despite the May-June fluctuations, the Financial Strength Index (FSI), a measure of strength of the banking sector, indicates that the banking sector is resilient to external shocks. In fact, parallel to the decline in all sub-indices except the one measuring asset quality, the FSI decreased from 117.2 in 2005 to 111.8 in May 2006 and rose again to 114.3, as of September 2006.

The reason why the recent fluctuations had only limited impact on the financial soundness of banks is the crucial role played by the strengthened regulatory and supervisory infrastructure and more developed risk management culture in the banking sector as well as prudential regulations. Within this context, the recent regulation of the BRSA stipulating a "target ratio" in order to encourage banks to operate with higher own funds, as a measure against possible fluctuations in financial markets, is thought to be a positive development.

In general, May-June fluctuations seem to have had limited effects on the banking sector in the short-term, however the likelihood of lagged implications should be considered.

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