I. Overview

Central banks of advanced economies have initiated rate cut cycles while the monetary policy stances of emerging economies vary. With central banks of advanced economies starting to cut rates, the expectations regarding the global growth outlook have begun to gradually improve, whereas the uncertainty surrounding the economic growth paths of emerging economies persists. Global uncertainties driven by geopolitical risks as well as the course of bond yields and the growth outlook expectations affect the risk appetite and the capital flows to emerging economies.

While domestic economic activity slowed in the second quarter of 2024, the rebalancing in domestic demand has continued. The foreign trade deficit narrowed on the back of this rebalancing, and the improvement in the current account deficit was maintained with the support of surplus in the services balance. In addition to the fall in the current account deficit, the rise in portfolio investments and other financing supported international reserves. While consumer inflation dropped to 48.6% due to the improvement in core good inflation, food inflation has increased in recent months.

Turkish lira (TL) and foreign exchange (FX) commercial loan growth rates have converged, and commercial loan growth rates have receded to disinflationary levels. The tight monetary policy stance and the complementary macroprudential framework that supports the tight financial conditions have been effective in keeping commercial loan growth on a moderate path. The current level of TL commercial loan interest rates implies continued tightness in financial conditions. Financing costs for long-term TL commercial loans are in a downward trend due to the change in maximum prepayment fees for commercial loans and the improvement in inflation expectations. This trend is projected to continue in the upcoming period. As the growth limit imposed on FX loans became more restrictive in July, FX loan growth has also converged to TL commercial loan growth.

Retail loan growth is predominantly driven by personal credit cards (PCC) and unsecured consumer loans, while there has been an upturn in housing loan growth recently. Moderate growth in retail loans is an important component of the rebalancing in domestic demand. The tight monetary policy stance and the complementary macroprudential measures slowed retail loan growth significant in the second quarter of 2024. The growth in the PCC balance, which was up slightly in the third quarter of the year due to education expenditures, appears to have returned to a moderate path in the last quarter. Housing loans, which had been declining as a ratio of the Gross Domestic Product (GDP), have begun to increase despite the high levels of housing loan rates and the continuation of tight macroprudential measures related to loan to value ratios.

Despite the tightening in financial conditions, the deterioration in asset quality indicators remains limited. The banking sector's non-performing loan (NPL) ratio increased slightly, driven by the rise in the retail NPL ratio. Nevertheless, the NPL ratio is below the historical average across all loan segments. A new restructuring facility was introduced for overdue PCC debt and unsecured consumer loans. In addition, PCC contractual interest rates were differentiated based on personal credit card debt of period, with higher rates defined for credit cards with higher debt. While differentiating credit card interest rates aims to slow down credit card debt accumulation, the restructuring facility intends to ease the cash flow of individuals having difficulties in repayment. These steps are expected to curb the rise in retail NPL and Stage 2 loan ratios.

While firms have a tendency to delay trade credit repayments (checks/bills), this has a limited impact on the asset quality of the banking sector. Although bad check and protested bill ratios of non-financial corporates (NFC) have increased, they remain significantly below the historical average. Meanwhile, there has been a slight rise in the commercial NPL ratio. A significant portion of overdue commercial loans are repaid within the legal period and do not turn into NPLs. High provisions, which banks allocate prudently, serve as an important buffer against deterioration in asset quality and support banks' balance sheets.

Despite the growth in FX loans, firms' buffers and the decline in the ratio of NFC debt to GDP limit the impact of tight financial conditions on NFC balance sheets. While the NFC's tendency towards FX loans has increased, the export revenues of firms using FX loans give them the capacity to cover their FX debts. The NFC's short FX position increased by USD 48 billion to USD 130 billion compared to end-2023 as firms opted for TL assets and internal financing despite increasing FX credit utilization. The NFC's financial leverage ratio is at historically low levels despite the rise in FX loans and the slowdown in financial asset growth. In 2024, the profitability and financing cost-coverage indicators of publicly traded firms deteriorated slightly, while firms' liquidity has remained relatively strong. The NFC sector analyses suggest that high profitability in the past has enhanced debt servicing capacity of the firms and facilitated the accumulation of liquidity buffers.

The ratio of household debt to GDP remained at a low level, while the share of PCC and overdraft account debts increased in the overall composition. The debt per capita and debt to income ratio continued to decline for consumer loans, albeit to a lesser extent for personal credit cards. In addition to tight financial conditions, the short maturity of retail loans leads to an increase in the credit risk of individuals with debt and income mismatches. Accordingly, the restructuring facility introduced for debts on unsecured consumer loans and personal credit cards will contribute to risk management. While the weight of TL-denominated assets in households' financial asset composition has grown, the share of FX-protected products continues to decline. Households continue to diversify their savings through alternative TL financial assets such as mutual funds, in particular, money market funds and pension systems.

The share of TL deposits is on the rise, while banks' FX and TL liquidity remains robust. The tightness in monetary conditions, macroprudential policies, the improvement in exchange rate expectations and the discontinuation of the temporary tax exemption on FX-protected deposits ensured that the share of TL deposits continued to increase steadily, while the share of FX-protected deposits fell below 7%. The rise in TL deposits, the CBRT's FX transactions, and its Treasury account activities led to an excess TL liquidity in the system. This excess TL liquidity is effectively managed via reserve requirements, deposit auctions, and additional sterilization tools introduced by the CBRT.

On the back of the decrease in the country risk premium, and rating upgrades by credit rating agencies, the improvement in external financing conditions has continued and banks' long-term external borrowing has increased. Despite heightened volatility in global financial markets and geopolitical risks, foreign investors' interest in Turkish banks' borrowing instruments has remained high. Banks' medium- and long-term external debt rollover ratios have increased, with the external debt rollover ratio well above 110%. The maturity of banks' external funding has increased, while the quality of external funding has been improving.

The maturity mismatch between interest rate-sensitive assets and liabilities in the banking sector is below its historical average. The decline in the average remaining maturity of loans and securities has contributed to keeping interest rate risk at manageable levels. Banks continue to have a balance sheet structure that is aligned with regulatory thresholds, and that provides a buffer against possible interest rate shocks. The banking sector's foreign currency position remains low and within legal limits.

Despite a decline in the profitability of the banking sector, the sector's internal capital generation capacity remains sufficient to support capital adequacy. Tight monetary policy and the macroprudential policy framework have been weighing on the net interest margin. Meanwhile, strong income generation from fees and commissions coupled with the moderate course in the cost of risk support the profitability outlook.

The banking sector's resilience is supported by strong capital adequacy. Capital ratios increased due to profits, subordinated debt issuances and the alignment of retail loan risk weights with Basel standards. Excess capital as well as precautionary provisions have been underpinning banks' capacity to absorb possible losses.