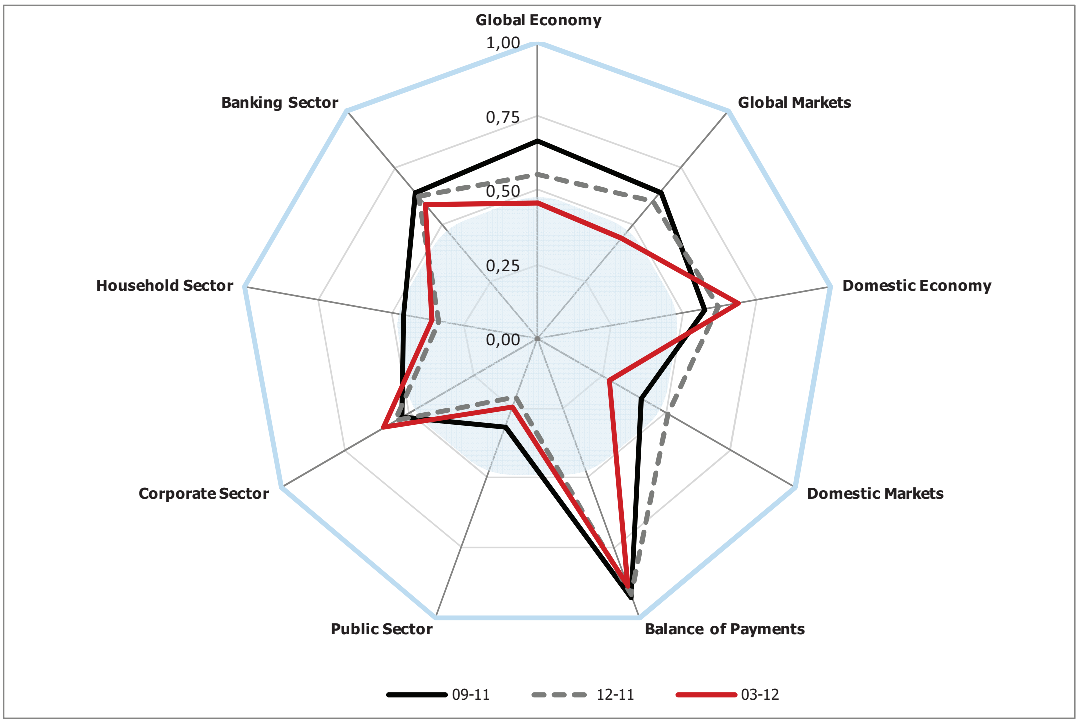
# OVERVIEW

The impact of the global crisis persists and policies implemented in advanced economies continue to steer the global economy. While developments in the US economy have a positive impact on this process, ongoing problems in the financial structure of some EU-member states and escalating political uncertainties make the global recovery difficult. Moreover, most of the distressed assets are still on the balance sheets of banks in these countries. Additional capital requirements that are necessary for strengthening capital structures exert pressure on banks to downsize their balance sheets.

Meanwhile, in the first quarter of 2012, a relative improvement in the risk appetite was observed thanks to the economic policies adopted to solve problems in the Euro area and significant steps taken in structural areas. This, in turn, led to a decline in Turkey's risk premium in tandem with the decline in those of developing countries. As a result of capital inflows and implementation of the flexible monetary policy framework, value of the Turkish currency remained more stable compared to those of other developing countries. In this context, the decline in Turkey's risk premium coupled with residents' positive expectations fuelled the improvement in the general economic outlook. Nevertheless, relapsing Euro area issues due to the political unrest in Greece in May caused the risk appetite to deteriorate again.

In 2011, growth in economic activity in Turkey remained strong, albeit with some slowdown, and domestic demand was contained as a result of measures taken by the CBRT and other authorities. Accordingly, growth is expected to follow a moderate track in 2012. Improvement in public finance indicators continued on the back of the rise in tax revenues due to strong economic activity and leashed public expenditures. Moreover, in the last quarter, contribution of net exports to growth increased significantly and the rebalancing between domestic and external demand continued. Accordingly, the favorable trend that started in the foreign trade balance and current account balance in the last few months of 2011, continued in the first quarter of 2012. Meanwhile, since the last few months of 2011, inflation has been rising manly due to the depreciation of the Turkish lira and the rise in administered/directed prices. In response, in October 2011, the Central Bank of Turkey introduced a monetary tightening to prevent any further deterioration in inflation expectations and succeeded in keeping pricing behavior under control. In this context, inflation, which reached a peak in April 2012, is expected to display a substantial fall in May and this decline is expected to further accelerate in the last few months of the year. The CBRT will maintain its price stability-oriented determined stance as well as its flexibility in monetary policy in the upcoming period.

**Financial Stability Map[1,2]**




(1) The closer to the center, the more stable the sector is. Analysis allows time series comparisons within each sector. Among sectors, the comparison can be made in terms of the directional change in position with respect to the center.
(2) For the set of variables and methodology used in the financial stability map, see Special Topic IV. 10 in FSR 13, dated November 2011.

Banking indicators suggest that the overall structure of the sector is strong. Credit growth, although it includes some seasonal factors, is at a moderate level with respect to financial stability. As anticipated, credit growth stemmed mainly from corporate loans while the growth in consumer loans remained limited. The fact that loans are predominantly medium to long term and Turkish lira-denominated is regarded as favorable with respect to credit risk management. It is observed that the non-performing loan ratio of the banking sector continues to be at historically low levels.

Open foreign exchange position of the real sector still applies as an important risk factor. In fact, ratio of corporate liabilities to equity capital has increased and the rise in profits has been limited due to expenses stemming from exchange rate differences. Meanwhile, the rapid rise in corporate liabilities observed in 2010-2011 stopped and the ratio of foreign liabilities remained flat throughout 2012. Moreover, it is observed that the sectors which are borrowing in foreign currencies are predominantly sectors with stable foreign exchange income and provide high amounts of cash as collateral for their FX-denominated borrowings, curbing their susceptibility to debt-rollover as well as exchange rates risks. Firms' FX-loans are predominantly long-term and this is also regarded as favorable. A provision of the "Law on Collection Procedure of Public Claims" that is being discussed at the Turkish Grand National Assembly, stipulates that non-financial firms cannot classify up to 10 percent of their interest expenditures as expenses. It is expected that this provision would encourage firms to opt for equity capital rather than borrowing and thus contribute to financial stability.

Growth in household liabilities has been decelerating since mid-2011 and non-performing loans and unemployment rates have been on the decline. Moreover, the fact that household liabilities do not bear interest rate and exchange rate risk is perceived as another favorable factor. The rise in income driven by recovery in the labor market coupled with the continued increase in consumer spending of households fuelled by consumer confidence lead to a decline in savings ratios despite the rise in income. In this framework, applying policies that encourage household savings such as the much-debated personal pension system, raising awareness about savings and carrying out activities on financial awareness are considered very important for financial stability.

Banking sector retains its high-quality and strong capital structure. Even if a moderate decline is expected in the sector's capital adequacy ratio once Basel II takes effect in July 2012, the ratio in question is expected to stay well above the legal limit of 8 percent and target ratio of 12 percent. Currently, Turkish banking system is already in the process of harmonization with Basel III and no major difficulties are expected in this process. In fact, in the framework of Basel III regulations, the share of core capital, which incorporates elements with high loss absorbency capacity, in Common Equity (Tier 1) Capital was 90 percent in March 2012.

The profitability of the banking sector started to increase again in the first quarter of 2012. Higher profitability compared to banks in other countries and building reserve items instead of paying dividends are factors that strengthen sector's equity capital.

Long-term maturity structure of external borrowing of banks extends the maturity of liabilities. Despite mounting uncertainties in the global financial markets, Turkish banking sector has no difficulty accessing external funding facilities. As the level of the Turkish banking sector's financial relations with distressed EU-countries is low, the impact of balance sheet downsizing operations of banks in the area is expected to be minimal. Moreover, it is worth noting that banks' ability to borrow from CBRT foreign exchange deposit markets, and foreign exchange and gold assets they keep to meet TL reserve requirements are adequate for the repayments of syndication and securitization loans coming due this year.

Even if the robust structure of the banking sector is favorable for financial stability, in the face of rapid changes in global markets, it becomes inevitable to implement macroprudential measures to minimize the impact of these changes on the sector. Decisions made regarding required reserves were policies implemented to meet this need. Moreover, upper limits for export rediscount credits extended through Eximbank, which is another important policy instrument that strengthens foreign exchange reserves and contribute to foreign trade rebalancing by supporting exports, have been raised and the utilization of these credits has been facilitated.

Required reserves have been actively used especially since 2010 to mitigate macroeconomic and financial risks and to maintain financial stability. Reserve requirement ratios have been differentiated across maturities and this has contributed to decreasing maturity mismatch between assets and liabilities. Taking into account the rapid rise in credits, required reserve ratios have occasionally been raised especially for short term liabilities. As of the second half of 2011, reserve requirement ratios have been eased taking into account the problems in advanced economies of Europe, the global economic slowdown triggered by these problems and domestic demand developments.

With a view to meeting the TL liquidity requirement of the Turkish banking system permanently and at a lower cost, facilitating banks' liquidity management, bolstering the build-up of the Central Bank's FX reserves and enabling timely, controlled and effective use of these reserves; a facility was introduced to allow banks to keep part of their reserve requirement for TL liabilities in foreign exchange and gold and to maintain a certain portion of reserve requirements for FX liabilities in gold.

With the latest change in reserve requirement implementation in May 2012, the upper limit for FX reserves that might be held to meet Turkish lira reserve requirements was raised from 40 percent to 45 percent. With the aim of narrowing the cost differential of maintaining the Turkish lira reserve requirements in Turkish lira or in FX and enabling banks to fully benefit from the facility, banks were allowed to hold Turkish lira reserve requirements in US dollar and/or Euro over the total amount calculated by multiplying the additional tranche, which corresponds to 5 percent of Turkish lira reserve requirements, by a coefficient of "1.4".

The upper limit of the mentioned facility might gradually be raised from 45 percent to 60 percent if necessary conditions are fulfilled. Likewise, the upper limit for standard gold reserves that may be held to maintain Turkish lira reserve requirements can be gradually raised from 20 percent to 30 percent with increasing coefficients. By using these facilities that are based on voluntary participation, banks will be able to adjust their FX assets at the CBRT according to their needs. Thus, the need for the CBRT to intervene in the market by either selling or buying foreign exchange will diminish and required reserves will contribute to decreasing exchange rate volatility by assuming the role of an automatic stabilizer.

Developments in technology and financial markets have once again demonstrated the importance of flawless functioning of payment and settlement systems with respect to the stability of the financial system. International principles on financial infrastructure are reviewed in light of new experiences gained during the crisis. As a member of the CPSS (Committee on Payment and settlement Systems), the Central Bank of the Republic of Turkey actively contributes to the review of existing principles and to setting forth new approaches. Meanwhile, the Bank continues its activities regarding the revision of legislation on financial market infrastructure and closely monitors payments and settlement systems to ensure the flawless functioning of these facilities.