

OVERVIEW

The Global economy started to recover on the back of stimulus packages introduced by governments and until recently, global growth estimates have continued to be revised upwards. Nevertheless, the recovery is expected to be driven mainly by the developing Asian countries and the US; and recovery in European countries is expected to be slower as they are struggling with big budget deficits.

The optimism in international markets was marred by elevated concerns over debt sustainability in some EU-member states. Risks pertaining to the sustainability of recovery without government stimulus persist; measures taken are adversely affecting debt dynamics by distorting public debt balances and these feed concerns over spillover effects. Within this framework, should the mentioned risks materialize, a new credit squeeze might emerge in the financial system and exit from the recession could be slower than expected worldwide.

In 2009, the Turkish economy contracted by a significant margin, mainly because of the serious decrease in external demand due to the global crisis, along with the decline in both domestic investments and in households' consumption expenditures. Economic activity, which plummeted in the last quarter of 2008 and the first quarter of 2009, started to recover as of the second quarter of 2009, thanks to re-balancing monetary and fiscal measures. Meanwhile, growth is mainly domestic demand-driven and acceleration in export performance has not yet reached the desired level. The weak performance of external demand continues to restrain economic activity and employment especially via the industrial sector. Even if the industrial production index and capacity utilization rates display double-digit-growth in the first quarter of 2010, economic activity is expected to remain below the pre-crisis level until the third quarter. Recent depreciation of the Euro due to the debt issues of European countries coupled with slow recovery rates in the countries concerned are expected to curb external demand's contribution to growth. Accordingly, it is estimated that it would take some time for private investments to reach pre-crisis levels because of persisting uncertainty in external demand.

Inflation displayed a rapid decline in 2009. Inflation, which climbed in the first few months of 2010 due to price increments resulting from the tax adjustments covering fuel-oil products, alcoholic beverages and tobacco products; the rally in unprocessed food prices and the low base created by last year's tax-cuts, is expected to assume a downward trend as temporary factors taper off and come down to a level consistent with the target in the first few months of 2011.

The current account deficit, which rapidly narrowed as of the last quarter of 2008 due to the slowdown in economic activity and decreasing energy prices, started to increase again as of the

last quarter of 2009 with the rise in imports driven by increasing domestic demand fuelled by the fading effects of the crisis. Meanwhile, growth in European countries is yet to accelerate and as Europe is the most important trade partner of Turkey, exports of Turkey are adversely affected and this has an expansionary impact on the current account deficit. Therefore, the current account deficit in the upcoming period will be determined by Turkey's export performance, which is closely related to the recovery in European economies and by energy prices that assumes an important place in Turkey's imports.

The decline in indirect tax revenues along with the rise in non-interest expenditures stemming from transfers made due to the slowdown in the Social Security Institution's premium collections led to a rise in budget deficit until the last quarter of 2009. In the following period, tax revenues, which increased parallel to the recovery in the economy, contributed to the improvement in budget balance. In a period when heated debates are going on pertaining to the high level and sustainability of public debt of European countries, the fact that its ratio of public debt to national income is lower compared to many developed countries is very important for Turkey. Moreover, a significant step will have been taken towards sustainability of fiscal discipline once the announced Draft Bill on Fiscal Rule is legislated.

Credit utilization of households, which decelerated as of the third quarter of 2008, started to rise again as of the first quarter of 2009. Nevertheless, the household indebtedness in Turkey is lower compared to many other countries and interest rate and exchange rate risk is limited. The rise in unemployment led to a decline in debt servicing capacity of households and has pushed up the non-performing loan ratio for consumer loans as of the last quarter of 2008. However, the recent improvement in employment conditions and the downward trend observed in the ratio of non-performing loans of households as of the last quarter of 2009 are regarded as favorable developments.

While credit card balances increased throughout 2009, the ratio of balances that incurred interest to credit card balances remained flat. However, recently, households' utilization of deposit accounts with overdraft facilities has increased and therefore the amount that turned into credit on these accounts increased as well. Taking into account the fact that interest rates incurred on such accounts are quite high compared to interest rates applicable to consumer loans, it would be wise to remind consumers once more to refrain from using deposit accounts with overdraft facilities except for their short-term cash requirements.

Although sales revenues of firms and their profitability declined due to the fall in aggregate demand, exchange rate-driven financial expenses decreased owing to the appreciation of the Turkish lira, and firms' profitability performance increased in 2009. The upswing in sales revenues of firms, which started as of the last quarter of 2009 on the back of the recovery in economic activity is expected to continue in 2010 as well. Meanwhile, susceptibility of firms' debt burden and profitability performance to exchange rate movements persists due to the dollarization of firms' liabilities and the high level of FX short position.

Parallel to the recovery in economic activity, corporate loans and especially loans extended to Small and Medium-sized Enterprises (SMEs), started to climb as of the third quarter of 2009. As a result of the amendment made to Decree No: 32, firms have decreased loans that they use from abroad and have opted for domestic banks for FX loans. Meanwhile, the downward trend in the non-performing loans of firms observed as of the third quarter of 2009 indicates a recovery in the corporate sector's debt servicing capacity.

Acceleration in the rate of increase in the credit volume of the banking sector and the improvement in asset quality is expected to continue in the upcoming period provided that the recent recovery in economic activity and the normalization process in global financial markets continue.

The main reason for the recovery in profitability performance of the banking sector in 2009 was that the net interest margins increased as a result of the maturity mismatch stemming from the decline in policy rates. Despite the unfavorable impact of the contraction in interest rate margins on profitability following the termination of the policy rate-cuts, the improvement in asset quality is expected to foster the profitability performance of the sector, as was observed in the first quarter of 2010.

In the period when the global crisis started to deepen, some timely and effective measures towards Turkish lira and foreign exchange markets were taken and the tension and volatility in markets were subdued to a great extent. Both the FX liquidity and the total liquidity adequacy ratios of the Turkish banking sector have been well above the legal thresholds. In Turkey, the most important funding source of the banking sector is deposits, and unlike many other countries, the fact that loans can be entirely funded by deposits curbs the susceptibility of the banking sector to the volatility of interbank funds and decreases the liquidity risk based on re-financing needs.

The banking sector continues its tendency to avoid exchange rate risk and balances its on-balance sheet short position with an off-balance sheet long position.

The capital adequacy ratio of the sector, which is well above the legal minimum of 8 percent and the target ratio of 12 percent, further increased in 2009 thanks to high profitability and the rise in risk-free government securities investments. The mentioned ratio is expected to decrease somewhat in 2010 as banks increase their loans. Compared to other countries, both the capital adequacy ratio and capital quality are higher in Turkey. Unlike many other countries, the equity capital of the banking sector in Turkey is composed of profit reserves and paid-up capital that has a higher capacity of covering losses. The scenario analyses conducted reveal that the capital structure of the banking sector is sound enough to cover losses that could emerge as a result of various shocks.

The Financial Strength Index, which is monitored as an indicator of the soundness of the banking sector, rose at the end of 2009 due to the rise in the capital adequacy, profitability and interest rate risk indices, and maintained its favorable level in March 2010.

So far, the impact of the financial problems in Europe on the Turkish economy has been limited. Nevertheless, unless these problems are taken under control in the upcoming period, they will become the primary risk factor with respect to global financial stability. Should this risk materialize, it would lead to the erosion of confidence in financial markets and interrupt the global recovery process and Turkey would be adversely affected by such developments.

