

## OVERVIEW

The global financial crisis, which started in the United States of America in the second half of 2007 and expanded its area of impact by subsequently spilling over to Europe and Asia, entered a new phase when Lehman Brothers—one of the leading investment banks in the US—filed for bankruptcy protection in September 2008. The situation, which emerged as a liquidity problem in the interbank markets during the early stages of the crisis, gradually turned into concerns regarding the reliability of financial institutions. Accordingly, deposit owners and other investors headed for reliable means of investment, particularly US government bonds. This tendency led not only to rapid appreciation of the US dollar but also to repricing of financial assets and a significant decline in market capitalizations of financial institutions. Therefore, in addition to the liquidity support they have been providing for quite some time to maintain financial stability, the authorities of developed countries took measures, such as offering various levels of guarantees for deposits and other liabilities of financial institutions, providing capital support to these institutions and easing monetary and fiscal policies. Although a certain amount of improvement was observed in the functioning of credit markets following these measures, the volatility in the markets is still high and indicators of global economic activity are negative.

Parallel to these developments in the markets of developed countries, the impact of the crisis started to be strongly felt by developing countries in the second half of 2008, due to the reversal of international capital flows and the start of a slowdown in the global economy. Developing countries, including Turkey, faced capital outflows owing to the decline in the risk appetite of investors and hence, their currencies and investment instruments depreciated significantly.

The effects of the global crisis-based credit contraction on growth rates of countries are becoming increasingly pronounced. Growth expectations either diminish or change to expectations for contraction in many economies, particularly in developed countries. In the meantime, this expected slowdown in the global economy and the downward trend in commodity prices started to have favorable effects on the inflation rates of developed and developing countries. It is anticipated that the downward trend in global inflation will become more apparent in the upcoming months.

In Turkey, although the decline in external financing prospects and the acceleration in capital outflows stand as factors that may pose difficulties for the financing of the current account deficit in the upcoming period, the fall in energy prices, the slowdown in domestic demand and the depreciation of the YTL will possibly lead to a rapid narrowing of the current account deficit and hence a reduced need for external financing.

The ratio of public debt stock to gross domestic product (GDP) and the share of debt stock susceptible to movements in exchange rates continued to decline in September 2008. Moreover, both the ratio of expenditures covered by central government budget revenues and the ratio of non-interest expenditures covered by tax revenues increased in the first ten months of 2008. The 2009 Program envisages 2008 central government budget revenues and expenditures to exceed the initial targets and the central government budget deficit to narrow. However, it is expected that the IMF-defined primary surplus target will fall short, as the majority of central government revenues is composed of privatization revenues and other revenues items. Maintaining fiscal discipline and improving its quality will continue to be critical for economic stability in the upcoming period.

Although the ratio of household financial liabilities to GDP increased in recent years, it is still lower than many countries including new members of the EU. The low level of FX-indexed and variable rate portion of household liabilities leaves households in Turkey less vulnerable to unfavorable developments in the economic conjuncture compared to other countries.

It is likely that individuals will increasingly resort to credit cards as an instrument of credit in the upcoming period, as banks will apply stricter terms on consumer loans. This tendency of consumers to meet their credit needs with credit cards, for which higher interest rates are charged compared to consumer loans, may lead to an increase in the number of defaulters. Therefore, applying caution to the use of credit cards in line with their essential function as a payment instrument is critical for maintaining the soundness of financial markets.

The debt roll-over ratio of external long-term loans of the non-banking private sector has never been below 100 percent, not even during the 2001 crisis. However, when making assessments for likely future developments, it should be kept in mind that the problem in the 2001 crisis was rather Turkey-specific, whereas currently the global crisis is the main culprit for the scarcity of external borrowing facilities.

2007 was a year, in which firms maintained their profitability and sound financial structures. However, it is expected that there will be a deterioration in the financial conditions of firms, especially those with short FX positions, and a corresponding decline in their debt repayment capacity in the upcoming period, owing to the depreciation of YTL, appreciation of the US dollar against the Euro and the increase in financing costs in the second half of 2008. Such a development will probably lead to a certain amount of increase in the NPLs of the Turkish banking sector.

In a period where the leading banks in the world are supported by serious amounts of capital injection, the Turkish banking sector maintains its strong capital structure as a result of the reforms implemented decisively in the aftermath of the 2001 crisis. The banking sector continues to grow, accompanied by an ongoing rise in the ratio of deposits and loans to the GDP and the ratio of loans to deposits.

The share of loans in banking sector assets has continued to rise. Nevertheless, credit growth in Turkey has remained moderate in recent years compared to other developing countries, due to the influence of monetary tightening. Considering that external borrowing will be more difficult due to the global financial crisis, the rate of increase in credits is expected to decelerate further in the upcoming period.

The exchange rate risk aversion tendency of the banking sector continues. Both the levels of on-balance sheet short position and off-balance sheet long position of the banking sector declined in line with liquidity conditions in international markets.

Deposits stand as the main funding source of the banking sector. The dependency of the sector on wholesale funding sources is low and liquidity adequacy ratios are far above the legal requirements. However, developments in global liquidity conditions increase the importance of liquidity management of banks. The Central Bank has taken and will continue to take necessary measures to enable emergence from this period with minimal adverse impact and to maintain the sound functioning of the payments system. However, it is crucial that banks continue their prudent and effective liquidity management in order to ensure the effectiveness of these measures.

The profitability performance of the Turkish banking sector declined albeit moderately in the third quarter of 2008. It is anticipated that unfavorable developments in the economic conjuncture will increase the non-performing loans of banks and hence, have a negative impact on their profitability performance.

The capital adequacy ratio of the sector increased in the third quarter of 2008, due to both the rise in equity and the decelerated rate of increase in risk-weighted assets, and maintained a high level above both the legal requirement and the target ratio. According to scenario analyses, the current capital structure of the sector is strong enough to absorb the losses likely to be incurred under various shock assumptions. Moreover, the decision of the BRSA to make the distribution of 2008 profits of banks subject to approval will help maintain the strong capital structures of banks.

In this period of increased risks, the soundness of the banking system becomes more critical. The Financial Strength Index, monitored closely as an indicator of the soundness of the banking sector, remained favorable despite a decline in September 2008 due to declines in Profitability, Capital Adequacy and Interest Rate sub-indices compared to end-2007.

In the current period where the effects of the global crisis is becoming more pronounced in Turkey as well as in other developing countries, effective risk management by all economic agents is considered crucial for the soundness of financial markets. In this respect, it becomes especially important for the safeguarding of economic stability that fiscal discipline is maintained without concessions and public authorities take the necessary measures in a concerted and prompt manner as they have done up to now.