

OVERVIEW

The first round effect of the financial crisis that first erupted in the USA in the second half of 2007 has been the contraction in liquidity and credit channels. Marred by unfavorable developments in financing conditions as well as the significant drop in trade volume due to deficient demand, 2008 was a year when growth performance worsened, employment decreased and expectations deteriorated worldwide. Within the context of the decisions made at the G-20 Summits since the last quarter of 2008, operations intended to increase liquidity in a coordinated manner and to support financial institutions were followed by comprehensive fiscal stimulus packages.

It is observed that, thanks to the measures taken, tensions in global financial markets have ceased to some extent, volatilities have declined and optimism has risen. Advances in stock market indices and a decline in the risk premia as of May 2009 are deemed to be the indicators of this optimistic atmosphere. Despite the measures taken, due to the fact that problems in the banking sectors of Europe and the USA, where the crisis first erupted, were not fully solved and therefore, credit channels are still not functioning well and an atmosphere of confidence has not yet been fully achieved, activity in financial markets is still far from its pre-crisis performance. Within this framework, many international institutions have revised their growth forecasts downward for 2009. Achieving positive expectations and restoring global growth primarily depends on the termination of problems in credit channels and the global recession, which mutually nourish each other.

The decline in energy and commodity prices due to the apparent slowdown in economic activities has led inflationary concerns in developed countries to be replaced by deflationary concerns since the first quarter of 2009. The deceleration in inflation still continues in Turkey on the back of the decline in energy and commodity prices besides the contraction in domestic and external demand. Considering that the global economy will not gain stability in the short-run, the downturn in inflation is expected to continue through the forthcoming period.

Deceleration in international capital movements due to the global financial crisis has created concerns in countries depending on external financing. Since the decline in energy prices coupled with the deterioration in domestic and external demand conditions caused imports to decline faster than exports, the current account deficit underwent a rapid contraction and the need for external financing decreased in Turkey. The current account deficit is expected to maintain its downward trend in the short-run.

As the implications of the global financial crisis on Turkey emerged, a contraction was observed in Gross Domestic Product (GDP) in the last quarter of 2008, compared to the same period of 2007, leading to the GDP growth rate to decelerate throughout 2008. A slowdown in

economic activity is expected in 2009. This adversely affects the central government budget on both the revenues and expenditures side. While tax revenues deteriorate due to the slowdown in economic activity on the one hand, fiscal measures taken to revive domestic demand increase expenditures on the other hand. Thus, the budget deficit has undergone an evident trend of increase.

Given the current economic conjuncture, rising budget deficit is a worldwide phenomenon. The current debt structure of the public sector provides some room for maneuver, albeit limited, to implement a counter-cyclical fiscal policy. However, it should be kept in mind that the average maturity of public debt is still short and financial depth is relatively low in Turkey. In order to obtain the desired outcome in the expansionary fiscal policy, it is of great importance to emphasize that there will be no concessions over fiscal discipline in the medium term.

Although the ratio of household financial liabilities to GDP has recently displayed an upward trend, it is still low compared to many countries. Besides, as the portion of household liabilities, indexed to foreign exchange and subject to a floating-rate, is limited, households are affected relatively less by unfavorable developments in economic conditions. This indebtedness structure of households has restrained the unfavorable effects of the crisis on the Turkish economy. In the meantime, the repayment ability of households might weaken in the upcoming period on account of the slowdown in economic activity and the increased unemployment rate.

Due to stricter credit conditions applied by banks, as expected, consumers more frequently resort to credit cards as an instrument of credit. Given that credit card interest rates are higher than consumer loans, the vulnerability of households increases. The effective utilization of financial services and products, which are becoming more diverse and complex, and informed decision-making on investments and savings by individuals are becoming more and more important. Within this scope, it is considered that special emphasis and priority should be placed upon financial education in order to raise financial awareness.

Despite the increase in sales revenue of firms in 2008, their profitability decreased. The decline of profitability was mainly attributable to climbing financing costs due to upward movements in exchange and interest rates. As the Central Bank has underlined on several occasions, this situation is a concrete indicator of the fact that upward movements in exchange rates, which may emerge under the floating exchange rate regime, will have a deteriorating effect on financial structures of firms that have no revenue but obligations in foreign exchange, due to the exchange rate risk that they bear.

Countercyclical monetary and fiscal policies implemented in order to contain the implications of the crisis in Turkey are expected to remedy bottlenecks in the credit channel to some extent and to mitigate the deterioration of expectations in general. Meanwhile, efforts to facilitate financing are believed to partly remedy the deterioration in financial status of firms. As a matter of fact, there are some signs that unfavorable developments dominating the corporate sector since September 2008 have started to be offset by positive changes, albeit limited, since early 2009.

Despite the global distress in the banking sector, thanks to enforced reforms after the 2001 crisis, Turkish banking sector remains sound.

Not only the fall in credit supply, which was due to contraction and thus the increased cost of the banking sector's international funding sources as a result of crisis in the global markets

and accompanying anxiety about the increase in troubled credits, but also the fall in demand for credit, stemming from the slowdown of economic activity, led to a decrease in credit volume since the last quarter of 2008. Nonetheless, positive developments in the global risk perceptions and the impact of monetary policy rate cuts on the domestic market rates resulted in relatively a slow recovery of credit growth.

On the other hand, non-performing loans (NPLs) are still growing. The fact that NPLs of SMEs are increasing faster than those of other firms, indicates that the effect of the crisis on SMEs is deeper. Although, the fall in debt repayment capacity of the firms and the rise in the unemployment rate may lead to a further increase in NPLs, it is observed that banking sector has the capacity to offset this.

The recent global crisis showed how vulnerable the banks, which are funded from the interbank markets, could be. Deposits, which are the main funding source of the banking sector, restrain the dependency of the sector on more volatile wholesale funds. This situation and the liquidity adequacy ratios, which stand above the legal requirement, are evaluated as positive developments in terms of liquidity risk. On the other hand, even the liquidity squeeze, which surfaced in the global financial markets due to deterioration in risk perceptions and loss of confidence, has diminished, Central Bank of Turkey continues to take necessary measures and monitors the market liquidity closely in order not to experience a liquidity squeeze and to ensure continued functioning of the credit markets.

The exchange rate risk aversion tendency of the banking sector continues. Although, 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, they started to rise again since March 2009.

As of December 2008, the net profit of the sector decreased compared to the end of the previous year, particularly due to the increase in special provisions for non-performing loans. Meanwhile, there is a significant increase in the profitability of the sector in the first quarter of 2009. This increase was mainly driven by the increase in net interest income resulting from the fact that the rate of decline in interest rate of loans lagged behind that of deposits. The increase in the profitability of the banking sector, which is critically important for financing economic activity, will strengthen its capital structure and this will in turn contribute to its intermediation function to work properly.

The capital adequacy ratio of the sector increased in the first quarter of 2009, due to the increase in own funds and the slowdown in the rate of increase in the risk weighted assets resulting from the change in asset composition that shifted from loans to securities, and the ratio maintained its level above both the legal requirement and the target ratio. According to scenario analyses that have been conducted, the current capital structure of the sector is strong enough to absorb the losses likely to be incurred under various shock assumptions.

Tangible common equity, which recently came forward as a critical soundness indicator of capital in the international arena, is significantly high in the banking sector of Turkey.

Although it followed a volatile course during 2008, the Financial Strength Index that is monitored as an indicator of the soundness of the banking sector, went up and reached its end-2007 value as of year end 2008. As of the first quarter of 2009, due to the increase in the Profitability and Capital Adequacy Indices, the index still maintains its favorable level.

Increased transaction volume in the financial markets makes an efficient and reliable payment system a necessity. Sound and efficient payment systems contribute to the implementation of monetary policy and overall financial stability. Central Bank of Turkey, which is responsible to take the necessary measures in order to maintain financial stability, took the necessary precautions to mitigate the risks related with the payment systems that might endanger financial system stability. In this context, no problems were experienced regarding the payment systems during the recent financial turmoil.

Maintaining financial stability is a policy priority to be carried out without any concession. In order to weather this global crisis with minor losses, necessary actions are being taken both globally and domestically. In this context, Central Bank will continue to take the necessary measures to limit the negative effects of the global crisis on our economy as it already had. Nonetheless, in order to achieve sustainable growth with economic and financial stability, continuation of European Union integration process and determined action on the structural reforms to increase the quality and endurability of fiscal discipline are of utmost importance.