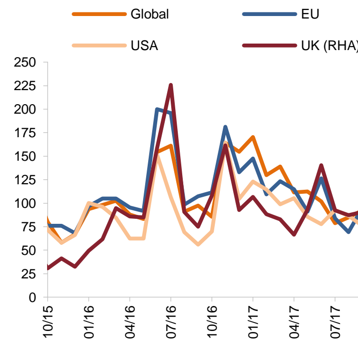
Overview

The recovery in global economic activity has continued since the May 2017 Financial Stability Report. In Turkey, thanks to the macroprudential policies that have been implemented in tandem with public financial incentives and support, credit growth has exhibited a stronger outlook than in previous years and economic activity has accelerated. The recent data show that the strong outlook in economic activity continued in the third quarter. In the third quarter of the year, credit growth converged to its historical average and stabilized at these levels as a result of the normalization in loan demand and the Credit Guarantee Fund (KGF) approaching its limit. In this regard, it is envisaged that the impact of the macroeconomic incentives and loans under the KGF scheme on growth will gradually decrease and the economy will start moving in tandem with its long-term trend.

The positive trend in global financial markets continues underpinned by the support from the positive outlook in the global economy, the rise in risk appetite, and the diminishing uncertainties in monetary policies of advanced economies. The Federal Reserve (Fed)'s decision announced in September to shrink its balance sheet under the monetary normalization process contributed to reducing the ongoing economic policy uncertainty in advanced economies (Chart 1). The completion of the round of elections in some European Union(EU) countries and the UK has also played an important role in the reduction of uncertainty. Even if the continued political uncertainty in Spain and the lack of a clear road map for the UK's exit from the EU add to the external risks stemming from the Euro area, the recovery in the economic activity in the US and other advanced economies and the normalization tendency in their monetary policies have been supporting the outlook for global financial markets. Global trade volume has also increased as the recovery in advanced economies became more pronounced. In this context, capital flows to emerging economies continued to remain high thanks to the positive outlook in global financial markets and the search for yield considerations, though sensitivity to geopolitical developments persists (Chart 2). This, however, may be interrupted if the normalization process expressed by the Fed as well

as central banks of other developed countries, is reversed. These risks may heighten if the geopolitical problems, especially in Asia and the Middle East, deepen.

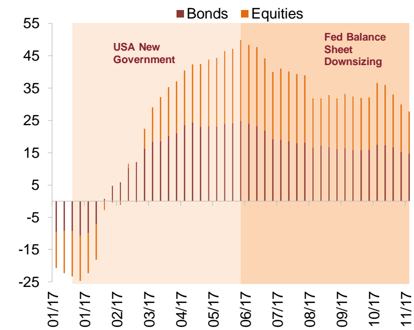
Chart 1
Economic Policy Uncertainty Indices
(Index, 2012=100)



Note: Indices are not comparable among themselves in terms of level.

Source: Bloomberg (Latest Data: 10.17)

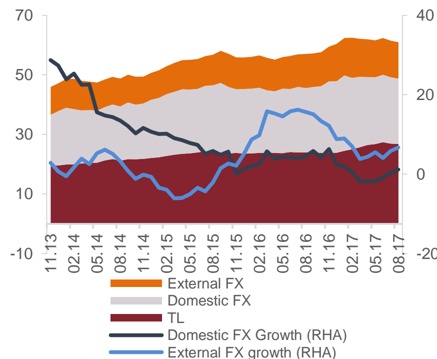
Chart 2
Weekly Capital Flows to Emerging Economies
(USD billion, 13 Week- Cumulative)



Source: EPFR (Latest Data: 08.11.17)

Corporate total financial debt to GDP ratio has remained flat since the beginning of 2017 (Chart 3). This mainly stems from the slowdown in the growth of FX credit stocks, received from both domestic and external financial institutions. The significant extension in the maturities of FX credits is one of the factors reducing exchange rate risk, and the ratio of FX non-performing loans (NPL) remains low. To monitor and analyze the exchange rate risk of the real sector The Systemic Risk Data Monitoring Model has been developed, and a comprehensive data set has been created for this purpose. On the other hand, as per the regulations in force, households cannot use foreign currency (FX) loans in Turkey and this protects households from currency risk.

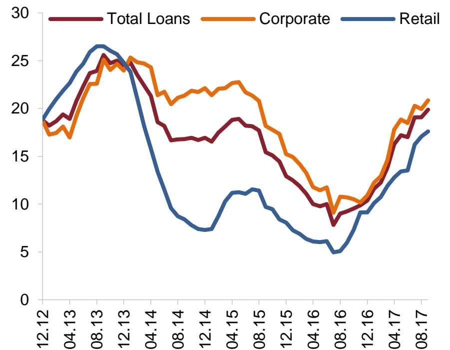
Chart 3
Share of Real Sector Financial Debt in GDP and Annual Growth of FX Loans
(Percent Share, Annual Percentage Change)



Note: FX growth rates are annual percentage changes of FX loans in terms of USD.

Source: CBRT, BRSA (Latest Data: 08.17)

Chart 4
Annual Loan Growth
(FX-Adjusted, Percent)



Note: FX-indexed loans are included in FX loans and adjusted for exchange rate using a weighted basket of 0.3 for euro and 0.7 for US dollar. Based on stock data, annual growth rates are calculated over monthly values.

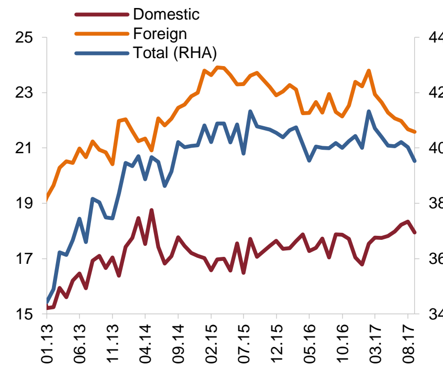
Source: CBRT (Latest Data: 09.17)

Since the last quarter of 2016, credit volume has increased significantly owing to the macroprudential policies, domestic public measures and incentives, and the KGF credit support (Chart 4). Supply and demand factors have been influential in this increase. While the housing and general-purpose loans displayed a significant increase due to longer maturities and base effects, credit facilities, especially the KGF guaranteed loans, supported commercial loans. Retail loans supported by macroprudential measures coupled with credit facilities provided to the real sector have led firms to respond to revived domestic demand, increase inventory that had been postponed, and restructure their debts. In this period, FX-denominated firm credits slowed down due to exchange rate movements and weak demand for machinery-equipment investment.

The transition from FX to TL in commercial loans continued in the current Report period as a result of both exchange rate developments and increased awareness of FX risk management. The rapid increase in FX deposits and the acceleration in TL loans urged banks to find additional TL funding in international markets through currency swaps.

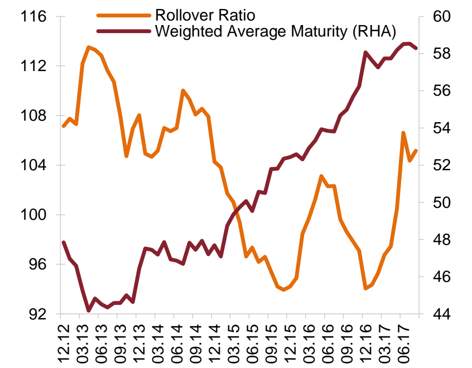
The banking sector preserves its strong liquidity position against possible shocks. Banks' liquid assets in gold and foreign exchange that they hold at the CBRT in the framework of the Reserve Options Mechanism (ROM) facility have recently increased. An important part of the funding sources of the sector is composed of core liabilities, and the rise in the share of core liabilities and other domestic sources in foreign sources points to a deepening in the domestic market (Chart 5). The maturities of banks' non-core liabilities are trending longer and this also increases the resilience of the sector to possible shocks in international markets (Chart 6). Despite the recent increase in credit growth, strong growth in deposits offers banks an additional protection for their liquidity positions and supports credit supply. Thus, banks have not faced a significant funding constraint due to the movements in credits and deposits, and they have responded to loan growth mostly with core liabilities.

Chart 5
Ratio of Non-Deposit Funding to Funding Sources
(4-Week Moving Average, Percent)



Source: CBRT (Latest Data: 09.17)

Chart 6
External Debt Roll-Over Ratio and its Average Maturity
(Percent, Month)

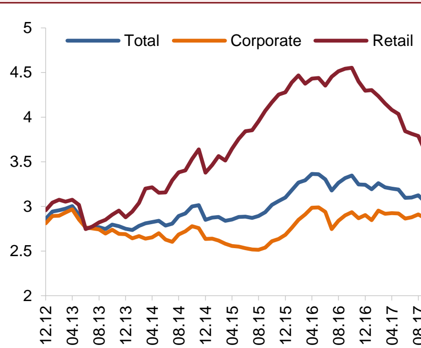


Note: The external debt roll-over ratio is calculated based on 6-month moving totals of banks' borrowings and repayments of total external liabilities including securities issued abroad.

Source: CBRT, MKK (Latest Data: 09.17)

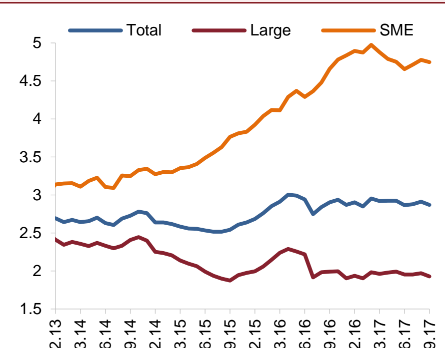
The asset quality of the banking sector is strong. With the revizatilization of the credit channel and the pick up in economic activity, the decreasing amount of additions to NPLs and write-offs as well as the rising amount of receiving compared to the previous Report period contributed to the preservation of asset quality (Chart 7). In the period when financial support policies were implemented more intensively, there was a decrease in SME's NPL ratios due to increased SME loans. NPL ratios differ across sectors and currencies, but NPLs have remained flat in sectors representing a significant portion of the corporate sector in terms of size (Chart 8). The preservation of the current levels of FX-denominated NPLs on company loans is an indication of the resilience of the banking sector's asset quality against external shocks.

Chart 7
NPL Ratios
(Percent)



Source: BRSA (Latest Data: 09.17)

Chart 8
Corporate NPL Ratios
(Percent)

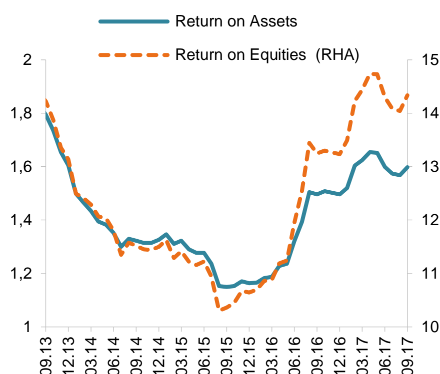


Source: CBRT (Latest Data: 09.17)

The profitability of the banking sector maintained its strong position despite a limited decline from the second quarter of 2017 onwards (Chart 9). This decline was mainly due to the loss of the one-

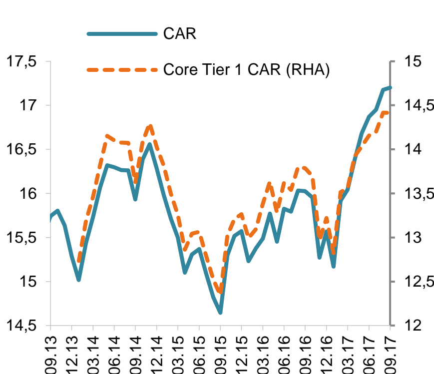
time income effect seen in 2016 and the cost of swap transactions conducted to meet the TL-loan demand. The profitability of the sector attained high levels due to the provision of a large portion of recent loans under the guarantee of the KGF scheme and exchange rate movements, which resulted in a significant increase in the capital adequacy ratios (CAR) (Chart 10).

Chart 9
Profitability Indicators
(Percent)



Note: Profitability ratios are calculated via dividing the 1-year accumulated profit by the 1-year average denominator.
Source: CBRT (Latest Data: 09.17)

Chart 10
Capital Adequacy Indicators
(Percent)



Source: CBRT (Latest Data: 09.17)

The banking sector sustains its strong capital structure. In the recent period, the increase in subordinated debt issuance and the favorable outlook in profitability provided significant support to banks' regulatory capital. In addition, some banks strengthened their capital by exchanging their subordinated debt for new issuances that are compatible with Basel III. While there is no significant change in the risk-weighted asset composition, regulations on the risk weights of FX-denominated assets and receivables and the increasing share of the KGF guarantees in the recent loan growth have reduced the calculated credit risk. The possible contribution of these developments to capital adequacy is that they will provide an additional capital buffer to the overall sector in the coming period. It is expected that the changes in corporate tax rates in the financial sector will have a limited impact on the banking sector's CAR in the upcoming period.

Despite the positive outlook in the global economy and financial markets, risks related to the upcoming period remain intact. The developments in the monetary policies of advanced countries,

global geopolitical risks and political developments in the Euro Area are among the possible factors of fragility for the financial system. Nevertheless, it is assessed that the Turkish banking sector will remain resilient against such risks thanks to its strong capital base, stable asset quality and adequate level of liquid assets.