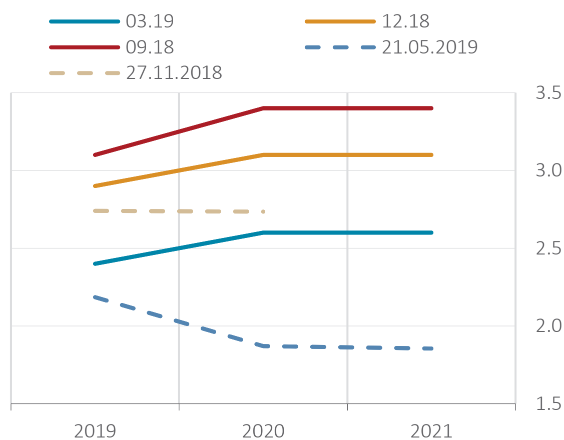
Overview

In the current Report period, global economic activity has shown a tendency to slowdown. While the US economy has registered a relatively strong growth, the euro area and Japan among the advanced economies and China, India and Brazil among the emerging market economies (EMEs) have witnessed a deceleration in their growth performance. Uncertainties over both the Brexit process and the bilateral trade talks between the US and China continue. In this period, due to increased concerns over global economic activity and uncertainties over global economic policies, major central banks seem to have taken a pause in their monetary policy normalization processes. In particular, declines in global bond rates following the Fed's statement that it would adopt a "patient" monetary policy stance (Chart I.1) have led investors to seek for yield, and increased risk appetite has stimulated net portfolio inflows to EME bond markets (Chart I.2). Due to the easier global financial conditions, borrowing costs of EMEs have dropped and risk premiums of EMEs have improved compared to the previous Report period.

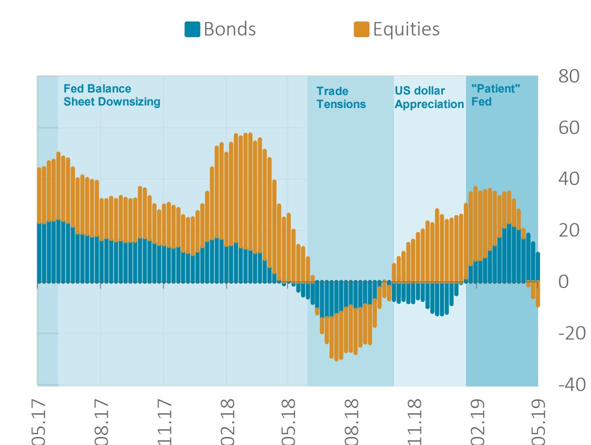
Chart I.1: FOMC Members' Median Policy Rate Forecasts (Straight Lines) **and Market Expectations** (Dashed Lines) (%)



Source: Bloomberg Latest Data: 21.05.2019

Note: Dashed lines indicate 30-day Fed fund futures implied rates.

Chart I.2: Weekly Capital Flows to EMEs (13 Week Cumulative, USD billion,)



Source: EPFR Latest Data: 15.05.2019

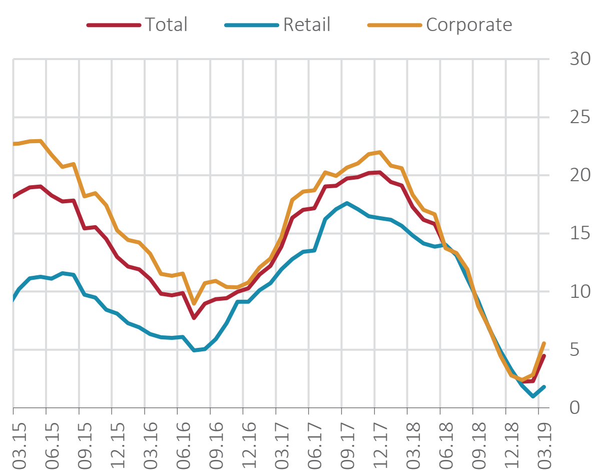
In the final quarter of 2018, the rebalancing process in domestic economic activity became more pronounced, and while domestic demand contracted, the strong increase in net exports partially offset the slowdown in the economy. Recently released data reveal that the economic rebalancing has continued through the first quarter of 2019. Leading indicators pertaining to this period suggest that the downtrend in economic activity that started in the second half of 2018 has lost its pace. Firms' orientation towards external markets driven by the real exchange rate level, and the narrowing domestic demand, and their flexibility in diversifying export markets boost the exports of goods; the weakening economic activity and the relative price effect limit the demand for imports; and together with the contribution of net travel revenues the current account balance continues to improve. Despite the deceleration trend in global growth, particularly in EU countries, the external demand outlook remains positive.

In the current Report period, there has been some improvement in inflation indicators driven by the contraction in domestic demand, decline in lagged effects of exchange rates, fall in imported input costs, and the tight monetary policy stance. However, deposit dollarization has increased due to the impact of the uncertainty channel. Additionally, uncertainties and geopolitical developments have caused Turkey's risk premium to diverge from those of other EMEs since March 2019. To limit the adverse impact of these

developments on financial markets and to support effective functioning of markets, policymakers have introduced a range of measures (Box I.1.I).

In the first quarter of 2019, annual loan growth recovered moderately as the high base effect stemming from Treasury-backed Credit Guarantee Fund (CGF) loans extended in 2017 abated, new CGF loan packages were introduced, credit conditions were slightly loosened particularly led by public banks, several arrangements in retail loans and loan campaigns were launched. The loans under the scope of the latest CGF loan facility, which are particularly extended to micro and small-scale enterprises, facilitate these companies' access to financing while contributing to banks' asset quality and supporting financial stability. In this Report period, despite the recovery trend, loan growth is still below the historical averages, which is attributed to differences between bank's risk appetites as well as weak loan demand. In March 2019, FX-adjusted total annual loan growth was 4.5 percent (Chart I.3). According to the results of the Bank Loans Tendency Survey, credit standards, which showed a partial improvement in the first quarter of 2019, remain tight (Chart I.4).

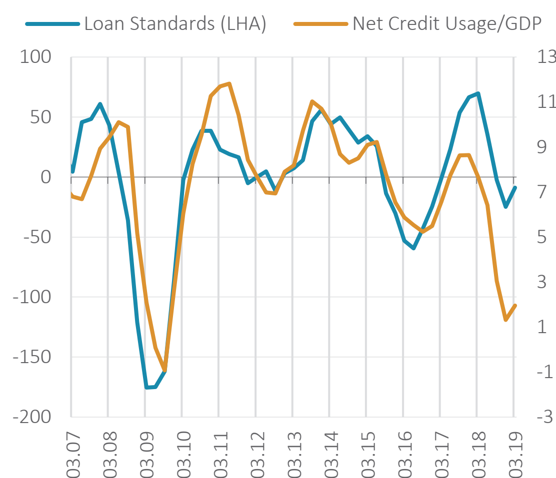
Chart I.3: Annual Loan Growth (FX-adjusted, %)



Source: CBRT Latest Data: 03.19

Note: FX-indexed loans are included in FX loans and adjusted for exchange rates by using a weighted basket of 0.3 for the euro and 0.7 for the US dollar.

Chart I.4: Credit Conditions (Annual, %)

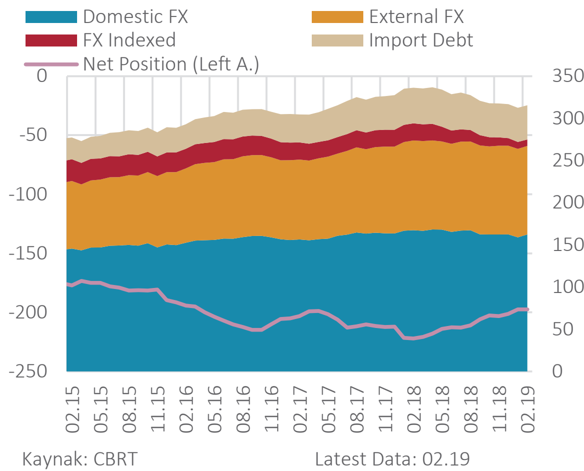


Source: CBRT, TURKSTAT Latest Data: 03.19

Note: Loan Standards series is the 4 quarter cumulative sum and the weighted average of banks' answers to the Loans Tendency Survey, represented as deviations from its historical average; whereas Net Credit Usage/GDP series is the ratio of annual change in the loan stock to the annual GDP. Data for 2019Q1 is the CBRT's estimation.

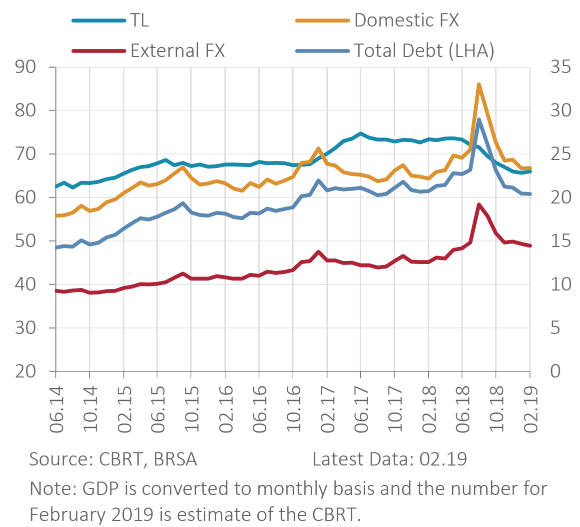
With the increased awareness regarding FX risk management and subdued investment trend, firms' demand for FX loans remains limited and the demand for loans is mostly for working capital needs in domestic currency. Several factors affect retail loan demand: the impact of market conditions on consumer confidence, changes in asset prices, the pricing of financial instruments, developments in employment and household real income. In the first quarter of 2019, while housing and vehicle loans remained weak, the increase in retail loan growth mainly stemmed from general purpose loans and credit cards. In this quarter, retail loan growth was underpinned by the decrease in interest rates; a facility introduced by public banks allowing customers to re-structure their credit card balances with general purpose loans; and the increase in the maximum number of installments for general purpose loans to 60 months. Meanwhile, another factor that supported financial stability was the fact that Turkey's household indebtedness ratio, which was 14.8 percent at the end of 2018, is significantly below the average household indebtedness ratio of EMEs.

Chart I.5: Corporate Sector's FX Liabilities and Net FX Position (USD Billion)



Kaynak: CBRT Latest Data: 02.19

Chart I.6: Share of Corporate Sector's Financial Debt in GDP (%)

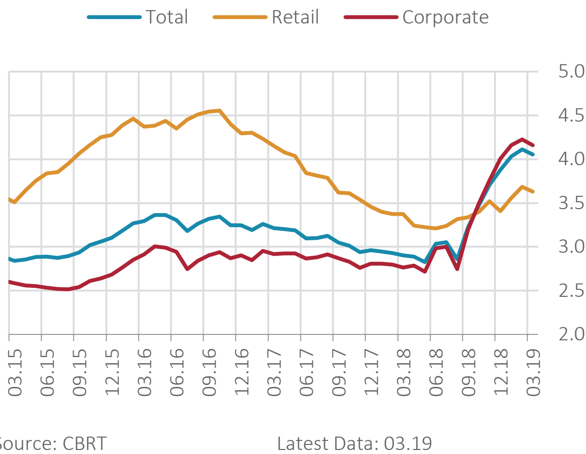


Source: CBRT, BRSA Latest Data: 02.19

Note: GDP is converted to monthly basis and the number for February 2019 is estimate of the CBRT.

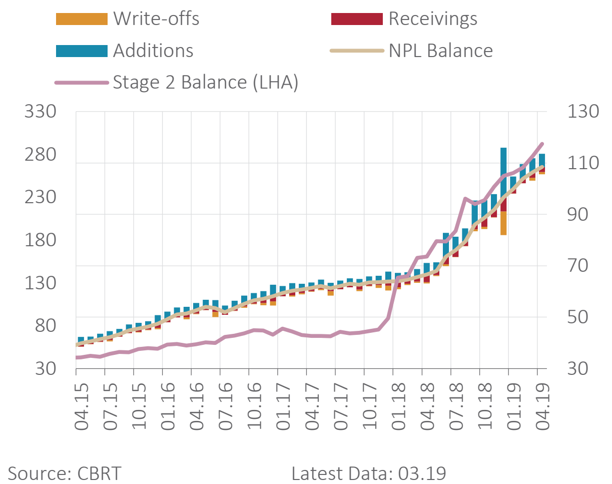
The corporate sector's FX short position, which was on the decline throughout 2018, maintained that trend in the first quarter of 2019. The FX short position stood at 197 billion USD in February 2019 (Chart I.5). FX-indexed loans that were not rolled over in the context of the Law No.32 Regarding the Protection of the Value of Turkish Currency, and the contraction in domestic FX loans became the drivers of the decline in corporate sector's FX liabilities. Additionally, the decrease in the demand for FX loans due to the exchange rate volatility, weak economic activity and the decline in the need for investment financing pulls the corporate sector's short position down. Changes in exchange rates shape the developments in corporate financial leverage via their effect on TL equivalents of FX loans (Chart I.6).

Chart I.7: NPL Ratios (%)



Source: CBRT Latest Data: 03.19

Chart I.8: NPL Balance and Components (TRY Billion)

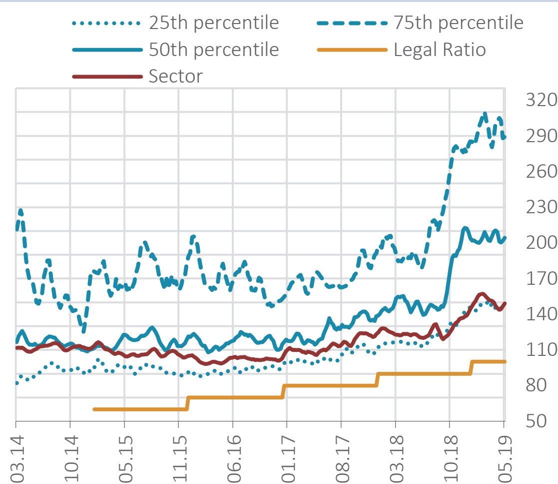


Source: CBRT Latest Data: 03.19

In the current Report period, the non-performing loan (NPL) ratio increased for both corporate and retail loans due to the slowdown in the economic activity and decelerating loan growth (Chart I.7). While this was attributed to the fact that NPL additions of large volumes concentrated mostly at the end of 2018, the corporate debt restructurings that are almost complete and the decline in the number of firms that have filed for bankruptcy will support the asset quality of banks in the upcoming period. In addition, the course of economic activity, financial conditions and employment developments will determine the sector's NPL ratio. Stage 2 loans increased due to a limited deterioration in asset quality, the increase in TL-dominated balance sheet values of FX loans, banks' prudent stance in an environment of uncertainty,

and implementation of Turkish Financial Reporting Standards 9 (TFRS-9) (Chart I.8). Stage 2 loan ratios, showing divergence across banks, are estimated to converge in time, following the implementation of the TFRS-9.

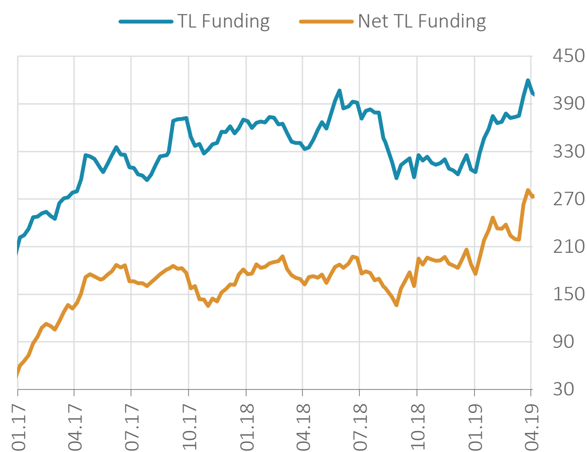
Chart I.9 Quantiles of Banks by Total Liquidity Coverage Ratios (4-Week MA, %)



Source: CBRT Latest Data: 10.05.19

Note: Development and investment banks are excluded. Based on non-consolidated reports. These quantiles represent the banks in the 25th, 50th and 75th percentiles, respectively, from the smallest to the largest in terms of liquidity coverage ratios

Chart I.10: Amounts of Currency Swap Transactions with Non-Residents (TRY Billion)

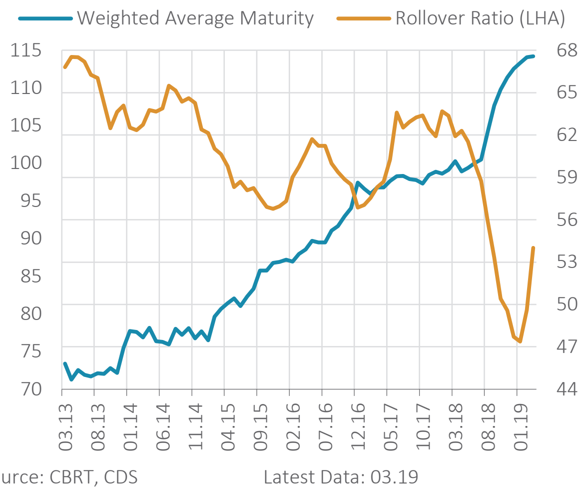


Source: CBRT Latest Data: 26.04.19

The banking sector's liquidity risk indicators remain benign. In the current Report period, liquidity coverage ratios edged up on the back of subdued loan growth rates and the sector's liquidity preferences (Chart I.9). As of March 2019, due to rising costs, banks have been trading increasingly in the CBRT currency swap market, the transaction limit of which was raised by the Bank, along with the international swap market. Therefore, net currency swaps with non-residents slightly decreased while the net TL funding went up in the current Report period (Chart I.10). The maturity for TL funding has recently been slightly shorter amid increased short-term swaps and a heightened share of overnight deposits in term deposits.

Given its positive liquidity outlook, the banking sector has lowered its use of external sources since the second quarter of 2018, resulting in a lower external debt rollover ratio. This owed more to rising FX deposits, subdued real sector investments due to sluggish economic activity, and the weakening FX-denominated loan growth caused by the reduced loan demand, than to banks' access to external debt. The external debt rollover ratio was driven slightly higher by renewed syndicated loans and securities issued abroad (Chart I.11). Nearly 85 percent of matured syndicated loans were renewed. Despite the recent limited decline, costs of syndicated loans remain elevated (Chart I.12). The growing demand for external borrowing in this period and the rise in the number of participating banks suggest that foreign investors are highly interested in investing in Turkey.

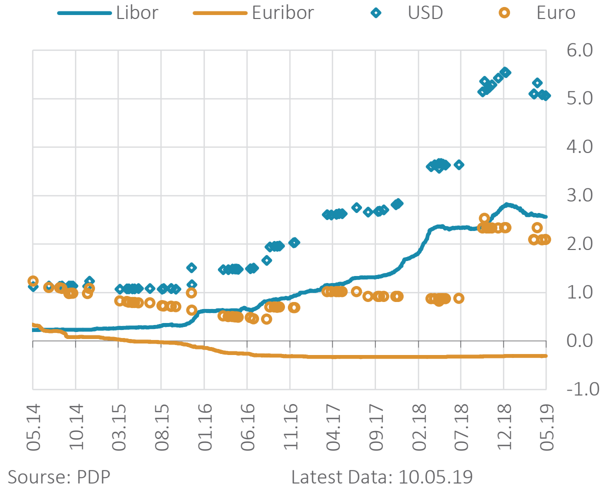
Chart I.11: External Debt Rollover Ratio and its Average Maturity (Month, %)



Source: CBRT, CDS Latest Data: 03.19

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

Chart I.12: Cost of Syndicated Loans with a Maturity of 367 days (Transaction Based, %)

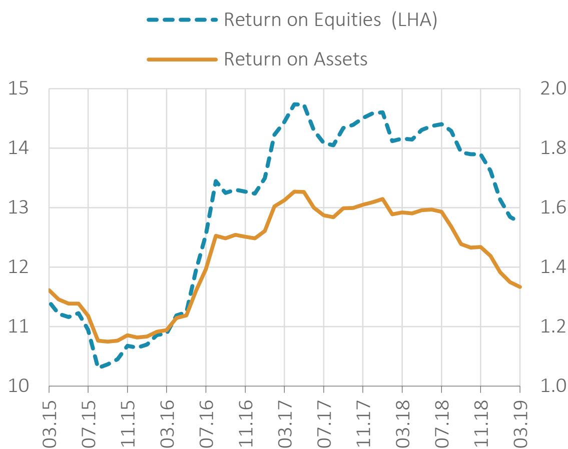


Sourse: PDP Latest Data: 10.05.19

Note: Calculated for 10 large-scale banks.

Profitability indicators of the banking sector have recently trended downwards due to the rise in special provisions and interest expenses on deposits (Chart I.13). In the current Report period, non-interest income contributed significantly to profitability. With the supportive arrangements to capital adequacy ratio (CAR) calculation made by the Banking Regulation and Supervision Agency (BRSA) revoked as of the end of 2018 and the downward trend in profitability, the CAR receded to the pre-arrangement levels (Chart I.14). The government domestic debt securities (GDDS) issued to boost state banks' capitals will underpin the state banks' and the sector's capital buffers in the upcoming period.

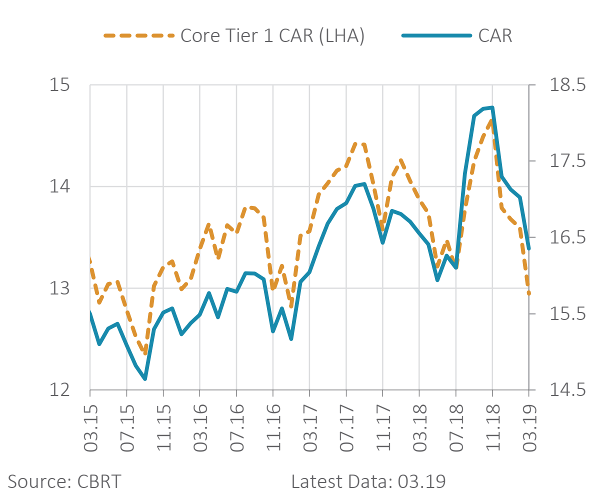
Chart I.13: Asset and Equity Profitability (%)



Source: CBRT Latest Data: 03.19

Note: Profitability ratios are calculated by dividing the 1-year cumulative profit by the 1-year average denominator.

Chart I.14: CAR and Core Tier 1 CAR (%)



Source: CBRT Latest Data: 03.19

In sum, concerns over global economic growth and global policy uncertainty paused the normalization in monetary policies of advanced economies in the current Report period, which improved global risk appetite and reduced EMEs' risk premiums. Turkey's sovereign risk premium has recently diverged from other EMEs due to uncertainties and geopolitical developments. In the first quarter of 2019, loan growth posted a mild increase due particularly to the support provided through CGF, coupled with the partial recovery in the banks' lending appetite that was led by state banks. Economic activity improved partially on a quarterly basis, while the recent volatilities in financial markets and the rise in risk premium indicators maintain the downside risks on the domestic demand outlook. The deterioration in the asset quality of the Turkish banking sector has remained limited, where the course of economic activity, financial conditions and employment developments will determine the sectors' NPL rate in the period ahead. The sector remains resilient against risks, with its high level of liquid assets, the prudent stance in the outlook for asset quality and its capital adequacy level.

Box I.1.I

Market-Oriented Steps

In the current Report period, the risk appetite for EMEs increased due to the deceleration trend in advanced economies and the pause in monetary policy normalization processes. On the other hand, Turkey's risk premium diverged from those of other EMEs as a result of uncertainties and geopolitical developments experienced since February 2019. To limit the negative impacts on financial markets of these developments and the increasingly visible rebalancing process in economic activity and to support the effective functioning of markets, a wide range of measures and regulations have been introduced.

Table I.1.I.1 summarizes the significant financial stability steps in the current Report period.

Table I.1.I.1 Measures and Regulations Addressing Markets

	Date	Measures and Regulations
Decree No. 32 on the Protection of the Value of Turkish Currency	19 December 2018	In the scope of the Circulation on Capital Movements, banks and financial institutions were allowed to restructure FX and FX-indexed loans of borrowers who failed or will fail to fulfill their liabilities due to financial difficulties.
	3 March 2019	The Communiqué on the Decree No. 32 regarding export proceeds introduced a revision in the practice of repatriating export proceeds and converting at least 80% of these proceeds into TL. Accordingly, the duration of this practice was further extended by six months to 4 September 2019. Consistent with this revision, the application duration of our Bank's Exports Circular dated 6 November 2018 that lays out the procedures and principles for the repatriation of export proceeds was also extended by six months.
Reserve Requirements	28 December 2018	To contribute to the deepening and effectiveness of financial markets, all repo transactions within Borsa Istanbul A.Ş. (BIST) were exempted from the reserve requirements obligation. After operational steps for this change were completed, the BIST Repo-Reverse Repo and Interbank Repo-Reverse Repo Markets were unified by the BIST.
	11 January 2019	Provisional Article 6 of the Communiqué on Reserve Requirements was annulled, and non-deposit/non-participation fund FX liabilities emerging before and after 28 August 2015 were made subject to the same reserve requirement ratios.
	8 February 2019	TL reserve requirement ratios were reduced by 100 basis points for deposits and participation funds with maturities up to one year and for other liabilities with maturities up to (and including) three years, and by 50 basis points for all other liabilities.
	3 May 2019	The upper limit for the FX maintenance facility was lowered from 40% to 30%. FX reserve requirement ratios were increased by 100 basis points for all maturity brackets.

	17 May 2019	Reserve requirement ratios for FX deposits and participation funds were increased by 200 basis points for all maturity brackets.
Capital	24 April 2019	To strengthen the capital of state banks and state-run participation banks, the Ministry of Treasury and Finance issued a total of 3.7 billion euros worth of government debt securities with a five-year maturity to the Turkish Wealth Fund's Market Stability and Balance Fund. Of this total amount, net 3.3 billion euros were issued for state banks and nominal 400 million euros for state-run participation banks.
TL and FX Liquidity Management Measures Taken by the CBRT	25 March 2019	Considering the developments in financial markets, the CBRT decided to suspend the one-week repo auctions. The auctions resumed on 8 April 2019.
	25 March 2019	The total TL swap sale limit in the CBRT's TL swap market was raised to 20% from 10% for swap transactions that had not matured.
	25 March 2019	FX deposits against TL deposits auctions were suspended.
	28 March 2019	The total TL swap sale limit in the CBRT's TL swap market was raised to 30% from 20% for swap transactions that had not matured.
	4 April 2019	The total TL swap sale limit in the CBRT's TL swap market was raised to 40% from 30% for swap transactions that had not matured.
	2 May 2019	The CBRT decided to set up a lira-for-gold swap transaction market. The total unmatured swap purchase amount in this market was set at 100 tons.
	10 May 2019	Considering the developments in financial markets, the CBRT decided to suspend the one-week repo auctions. The auctions resumed on 21 May 2019.
Deposit/Participation Accounts and Funds	1 December 2018	The income/corporate withholding tax rates for interest and profit shares arising from TL and FX deposit accounts, which were set for a temporary period of three months on 31 August 2018, were abolished. Accordingly, withholding tax rates applicable before 31 August 2018 were re-introduced.
	8 March 2019	The General Communiqué for Public Treasurership was replaced by the Regulation on Public Treasurership. To make use of financial sources of public institutions, the ceilings for deposit rates and for expected returns on participation accounts applicable in state-run banks for all maturities were both lowered by five points. This ceiling is set as a certain percentage of the weighted average TL deposit rate announced by the CBRT. A ceiling was imposed on reverse repo rates to be applied for financial sources of public institutions that they envisaged to use in reverse repo transactions. This ceiling was determined

		based on the ceiling to be applied for deposit and participation accounts.
	12 March 2019	The Capital Markets Board (CMB) decided that minimum 50% of the total value of money market funds would be invested in deposit/participation accounts. The same decision limited the amount of investment in a single bank to 6% of the total value of funds.
	21 March 2019	On 21 March 2019, withholding tax rates applicable for FX deposit accounts were revised to 20% for maturities up to one year, and to 18% for maturities longer than one year.
	22 April 2019	Variable interest rate was made applicable for TL deposits with a maturity of three months and longer.
	1 May 2019	It was decided that a withholding tax of 0% would be applied to rates for deposits with a maturity longer than one year that are subject to variable interest rate depending on the inflation rate.
	27 May 2019	With the regulatory amendment to the "Guidelines for Pension Funds", the CMB stipulated that minimum 10% of standard funds portfolio should be invested in dividends of the BIST Sustainability Index, BIST Corporate Governance Index and participation indices calculated by the BIST, whereas minimum 25% of money market funds portfolio should be invested in GDDS. The transition period for the compliance of existing funds with the new portfolio restrictions will last until 31 July 2019.

As demonstrated in the table, various steps have been taken in the current Report period to support financial stability and contribute to the effective functioning of financial markets.