OVERVIEW

The unfavorable effects on financial markets of the problems experienced in the US subprime mortgage markets in 2007 also persist in 2008. In this period, financial stability has continued to be a priority for the central banks of developed countries. Meanwhile, inflation has been increasing in both developed and developing countries owing to the rapid increase in food, energy and commodity prices, and, at the same time, growth rates have started to decline all over the world. Despite the positive contribution of developing countries to growth and the ongoing capital flow into these countries, the global economy may be affected adversely in case the stagnation period in developed countries lasts longer.

GDP growth in Turkey stayed at 4.5 percent despite the 5 percent expectation in 2007 due to increased global uncertainty especially in the last quarter of the year. Meanwhile, the current account deficit continued to expand mainly due to price hikes in energy. Although, the current account deficit has been mainly funded by long-term capital inflows, since the full impact of global volatility is not yet known, the related risks still prevail.

The primary surplus of the consolidated government sector remained below the target in 2007 due to primary expenditures surpassing tax revenues. Nevertheless, the central government budget target was achieved thanks to the favorable performance of privatization revenues and lower than expected interest expenditures. The ratio of public debt stock to GDP continues to decline. Moreover, the share of debt stock sensitive to interest rate and exchange rate fluctuations continued to shrink as a result of the borrowing strategy implemented by the Treasury.

Despite an increase in the ratio of financial liabilities of households to GDP, which indicates higher access by households to financial services, it is still far below the average of EU countries. Since the majority of financial liabilities of households are fixed rate, they are not subject to interest rate risk. Nevertheless, the increase in FX indexed consumer loans, albeit their modest share in overall consumer loans augments the exchange rate risk of households. Therefore, it is still important that those who do not have foreign exchange income should avoid borrowing in foreign currency.

Despite their declining share in household liabilities, credit card balances incurring interest charges have been increasing. If households meet their credit needs via credit cards, which incur higher interest charges than other consumer loans, this will adversely affect their debt repayment capacity. For that reason, it would be in the households' interest to use credit cards as a means of payment and to prefer consumer loans for their financing needs.

In 2007, the leverage ratios of firms declined and the upward trend in their profitability ratios continued. Despite limited growth in gross sales, the decline in financing costs was instrumental in the increase of profitability. From the perspective of the banking sector, the decline in the financing costs to assets ratios and also the surge in the interest coverage ratios, especially in the manufacturing industry, imply that firms have a high debt repayment capacity.

Corporate sector open positions continue to rise in line with increased external borrowing. It is important that firms without foreign exchange income avoid borrowing in foreign currency or manage their risks with derivatives. It is advisable that banks adopt a more cautious stance to curtail credit risk when lending to firms with high open positions and no foreign exchange income.

The Turkish banking sector continued to grow in 2007 and foreign participation also increased. The ratio of deposits and loans to GDP and the ratio of loans to deposits, important indicators of financial depth and intermediation level of the banking sector, kept rising.

The share of loans in banking sector assets continued to grow. However, in the upcoming period, the pace of growth in credit volume will be dependent on the developments in international markets and therefore on banks' liquidity preferences. While the downward trend in the Non-Performing Loan (NPL) ratio, though mainly as a result of higher increase in loans, continued, consumer loans display a higher NPL ratio.

The short position aversion tendency of the banking sector continues. The on-balance sheet short position resulting from funding a portion of YTL denominated loans with foreign currency resources is leveled off with off-balance sheet derivatives.

Liquidity risk maintains its importance due to ongoing global volatility. Though its dependency on wholesale funding sources is relatively low and liquidity adequacy ratios are far above the legal requirements, the Turkish banking sector, which is becoming more integrated with global markets, should act more cautiously with regard to liquidity management.

Despite high losses incurred by prominent international banks due to the global turmoil, the profitability performance of the Turkish banking sector improved in 2007 and the return on assets as well as on equity of the sector increased. A slight decline was observed in profitability in March 2008. Although the capital adequacy ratio (CAR) of the sector followed a downward trend due to the increased credit volume and the regulations made within the framework of convergence to Basel II, it markedly stood above the minimum capital requirement of 8 percent and the target ratio of 12 percent. The results of scenario analyses indicate that the current capital structure of the sector is robust enough to survive losses that may arise under various shock assumptions.

The Financial Strength Index, monitored closely as an indicator of the soundness of the banking sector, remained favorable albeit a limited decline in March 2008 due to slumps in Profitability, Capital Adequacy and Interest Rate sub-indices.

Ongoing turbulence in global markets, increased inflationary risks due to the upsurge in food, energy and commodity prices and the stagnation threat faced by developed economies require all our economic units to act cautiously in their decisions for the sake of financial stability in the upcoming period. Although the impacts of global volatility on Turkish economy have so far remained limited, because of its dependency on external financing and hence, its potential vulnerability to unfavorable developments in the international risk appetite, it is deemed critically important that a stable provision of external resources are retained and the fiscal and monetary discipline is maintained to prevent increases in risk premiums and to reduce fragilities. It is of vital importance that all economic units raise their risk awareness and take necessary precautions in order to limit risks and to allow the sound operation of financial markets.