OVERVIEW

The uncertainties that swept through the world following the global financial crisis persisted in the second half of 2012 as well, and global economic activity is yet to reach the desired level. Constraints over capacities of public finances especially of advanced economies to support growth and the resulting policy uncertainties are the two factors that have been hampering recovery. In the United States, problems regarding public finance pose a risk to global growth; while uncertainties over the economic outlook in the EU fuel the recession risk. Despite regional discrepancies, growth prospects for emerging economies that displayed strong growth performance during the preceding period are also revised downwards due to the adversities of advanced economies and the contagion effect.

Recent fiscal measures introduced by the authorities towards resolving problems in the global economy are welcomed by the markets and this positive perception underpins the relative upward shift in the outlook of global financial markets. In this framework, the upside pressure on bond yields in the Euro area have been taken under control to some extent and the risk of deepening of financial problems in the region has been subdued for the current period. Meanwhile, the expansionary monetary policies implemented by advanced economies in order to revive their economic activities have led to a global liquidity surplus and limited the fall in stock markets and commodity prices. Such a liquidity surge also helped the risk appetite to continue its increasing trend and fuelled capital inflows to those emerging markets that have relatively better fiscal positions and growth prospects.

Global uncertainty driven mainly by the advanced economies necessitates emerging economies to adopt more flexible and efficient policies. In this period, many emerging economies have made structural reforms and introduced unconventional policy implementations to manage macro financial risks. In Turkey, relevant authorities implement their policies in a coordinated manner on various platforms, the Financial Stability Committee being the leading one.

Towards the end of 2010, the Central Bank of Turkey broadened the scope of its inflation targeting strategy to encompass financial stability, and started implementing a new policy mix. Within this framework, the interest rate corridor, effective liquidity management and reserve requirements started to be employed as active policy tools. Thus, a new policy framework has been designed that does not overlook excessive volatility both in credit growth and real exchange rates for the sake of supporting macroeconomic and financial stability. This approach was quite instrumental in mitigating the adverse impacts of the volatile capital inflows on domestic markets for the last two years.

Recently, a new policy instrument has been designed and introduced to restrict the adverse effects of excessive volatility in capital flows. This new policy instrument, called the "Reserve Option Mechanism", has aimed to incentivize banks to voluntarily accumulate foreign exchange and use these reserves in a controlled and efficient manner when needed. This mechanism, which is anticipated to function as an automatic stabilizer against external financial shocks in the upcoming period, will soon be completed.

As a consequence of the new policy mix and contributions of other relevant authorities, domestic demand in Turkey was reined in and economic activity slowed down while the contribution of external demand to growth increased and, consequently, the growth composition assumed a healthier outlook. Thus, the current account balance gradually improved during the last year. Inflation, which rose due to the accumulated reflection of the rise in costs in 2011, assumed a downward trend again once the temporary factors tapered off. Meanwhile, recently, a relative deterioration has been observed in the budget balance due to the slowdown in tax revenues coupled with the acceleration in non-interest expenditures. Nevertheless, the recent budget measures together with the low level of public borrowing requirement and costs support the positive outlook in public debt stock indicators.

The recent improvement in the global risk perceptions and risk appetite towards the Turkish economy is likely to pose an appreciation pressure on exchange rates. Hence, the steady appreciation trend in domestic currency in real terms that has been observed since the beginning of the year should be closely monitored from a financial stability standpoint. Under the current floating exchange rate regime, there is no commitment regarding the level of the exchange rates; yet, in terms of macroeconomic and financial stability, it is important to take measures against excessive volatility, as necessary.

The Central Bank of Turkey attributes special importance to credit developments under the new policy framework. From financial stability point of view, credit growth is at reasonable levels owing to the flexibility of the current monetary policy implemented and measures taken by relevant authorities. As the upper limits for FX and gold reserves that might be held to maintain Turkish lira reserve requirements were raised, banks' Turkish lira liquidity needs have decreased and credit interest rates have assumed a path that underpins growth. The current path in interest rates is expected to continue in the upcoming period and credit growth is envisaged to hover around 14 percent at the end of the year. Given the weak outlook for global demand, keeping the rate of credit growth at moderate levels is especially important for ensuring that both the level and the composition of the aggregate demand move towards the desired direction. In this context, average annual credit growth rates below the 15 percent level would support both price stability and financial stability in the periods ahead.

Banking indicators suggest that the overall structure of the sector is strong. In July 2012, Basel II standards started to be implemented in Turkey; banks' capital adequacy ratios remain high and the banking sector maintains its strong profitability. The scenario analysis, which tests the resilience of the banking sector against shocks originating from credit and market movements, shows that capital position of the sector has the capacity to absorb shocks.

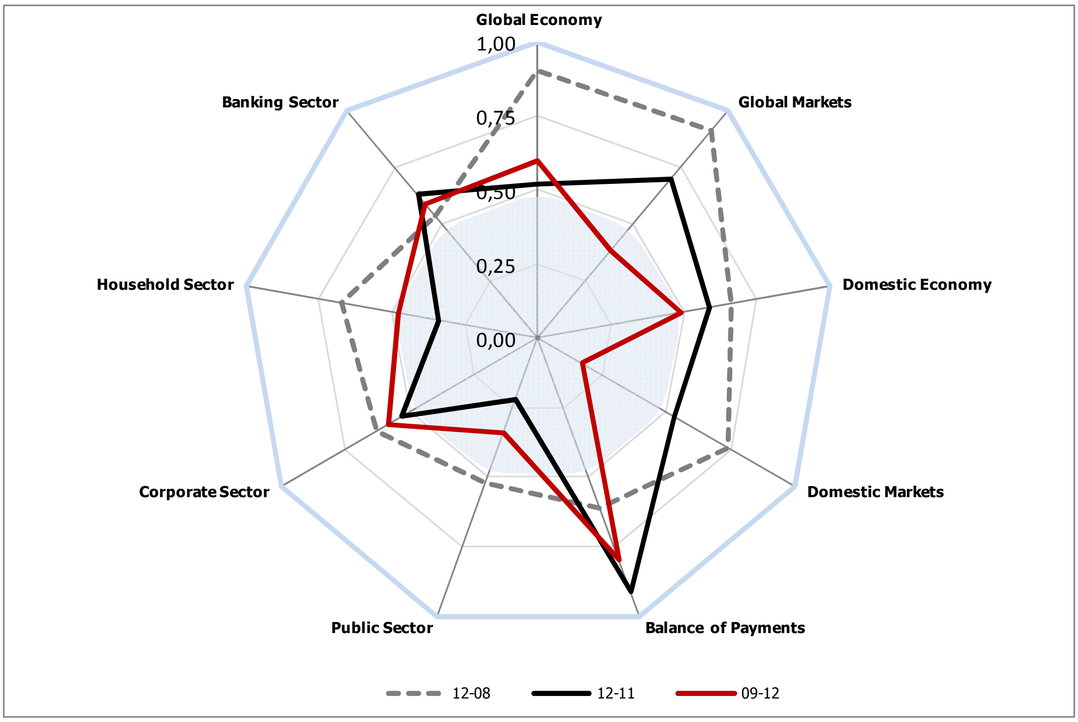
In this period, growth in firms' indebtedness ratios decelerated and the share of their external borrowing assumed a steady path. The fact that the majority of credits borrowed from abroad were long-term and their sources varied both in terms of quality and regions contained the risks to corporate sector's indebtedness. The ratio of corporate debt to equity capital, which had increased in 2011, decreased to some extent in this period. The ratio of firms' net profit to equity capital has increased recently due to the rise in sales and decline in financial expenditures. Meanwhile, firms continue to hold net FX short position and it is observed that foreign exchange exposure is still critical for firms. Accordingly, it is crucial to make the necessary regulations and continue to focus on measures that would on the one hand increase firms' usage of equity capital, and on the other, encourage them to borrow from domestic markets in Turkish lira.

The growth in household consumption and liabilities has slowed down on the back of the measures taken. The unemployment rate started to decline owing to measures taken to support employment and the rapid recovery in the aftermath of the crisis. However, the low level of household savings is still a concern for Turkey.

Recent measures taken to raise household savings by encouraging private pension funds together with the strategic investment incentives introduced to improve the external balance are expected to support macroeconomic stability in the long run. Meanwhile, it is crucial to take other measures towards increasing savings in order to contribute to the financial stability further.

Featured below is the financial stability map, which is prepared in the light of the above-mentioned assessments and shows financial stability indicators in Turkey in a comprehensive manner.

Financial Stability Map[1,2]



(1) The closer to the center, the more stable the sector is. Analysis allows time series comparisons within each sector. Among sectors, the comparison can be made in terms of the directional change in position with respect to the center.
(2) For the methodology used in the financial stability map, see Special Topic IV. 10 in Financial Stability Report-13, dated November 2011.

As illustrated above, global economy exhibits more adverse developments while developments pertaining to global markets display a more favorable outlook compared to 2011. This discrepancy indicates that problems in advanced economies linger and implemented measures have impact initially on markets via expectations while it takes time for them to impact the global economy as indicators are announced with a time lag.

In Turkey, indicators pertaining to the economy in general and to the markets point to a more favorable outlook compared to 2011. It is observed that this favorable outlook in the domestic economy and domestic markets is also valid for the developments of the banking sector and the balance of payments. Meanwhile, the slightly unfavorable outlook in households, corporate and the public sector compared to end-2011 should be more closely monitored in the upcoming period.