

OVERVIEW

The impact and extent of the global financial turmoil have reached a level that has never been experienced before. Public sector, which at the onset of the global turmoil played a role supportive of financial and corporate sectors that were at the heart of problems, became the main risk factor at this stage of the crisis and the notion of "sovereign risk" started to be spelled out. Fiscal stimulus and policy measures taken with a view of settling the problems in financial structures of certain European Union countries failed to alter the negative perception in markets. Deterioration of the financial structures of the distressed countries has deepened further since the last reporting period.

Excessive falls in the values of particularly risky sovereign bonds due to increased sovereign risk, started affect the banking sectors of the countries via the government securities that they hold in their portfolios. Along with the problems spreading across Europe due to the interconnected structure of financial markets, the global risk appetite decreased significantly. Consequently, the central banks of many developed countries tended to implement "unorthodox" monetary policies. Due to the reduced opportunities for banks to raise funds through money markets, central banks took measures to provide funds in order to reduce banks' borrowing costs and to ease their liquidity crunch. Moreover, structural measures aiming to strengthen the capital structure of the banking sector negatively affected the credit supply of banks that were already risk-sensitive and created deleveraging pressure on banks.

Meanwhile, the loss of confidence in risky countries started to spill over to other countries as well, due to the concerns over inadequacy of measures taken by the authorities, both in scope and extent, to mitigate the effects of the crisis. Given the expectation that the environment of uncertainty will prevail in the upcoming period, exacerbation of the effects of problems on global financial system constitutes an important risk factor. Therefore, it is of utmost importance that the main contagion channels should be identified and closely monitored, and the authorities should implement policy tools effectively and in a coordinated manner taking macroprudential concerns into account as well.

Deterioration of the growth performance of developed countries reflects on developing countries through the channels of funding, expectations and trade. The excessive increase in public debts and the money supply also raises the volatility of capital flows to developing countries. It is therefore important to employ the monetary policy tools in a countercyclical way in developing countries as emphasized in the previous report.

Ongoing capital inflows in the first half of 2011, strong macroeconomic fundamentals and accommodative market conditions gave way to a high growth performance in Turkey. Parallel to measures taken to curb credit growth, the growth rate decelerated starting from the second quarter of the year, accompanied by a narrower gap between internal and external demand. In line with increased uncertainty over the global economy and the deterioration in the risk appetite, capital

outflows were observed in Turkey in the third quarter as was the case in other developing countries; and the Turkish lira depreciated, albeit within a narrower band compared to the said countries. Besides, imports have continued to weaken recently on the back of the deceleration in domestic demand and exports have displayed a limited increase. This situation has contributed to curbing the high growth trend of the current account deficit. Meanwhile, the increased share of long-term borrowings in financing the current account deficit has improved the quality of financing.

Credit growth lost pace starting from the third quarter and attained reasonable levels. For a lasting improvement in the current account deficit, credit growth should continue to record reasonable levels. It is considered that the slowdown in consumer credits will particularly contribute to the narrowing of the current account deficit by spurring the propensity to save in the period ahead.

Owing to the measures taken, the rate of increase in household liabilities has been slowing down gradually in 2011. Exchange rate risk and interest rate risk on consumer loans are quite low. Given the ongoing surge in corporate indebtedness, it is crucial for companies to be aware of the risk they are exposed to and to manage risks effectively for the sake of financial stability. Improvement in the budget balance and public debt stock continues thanks to increased tax revenues on the back of robust economic activity and containing public expenditures.

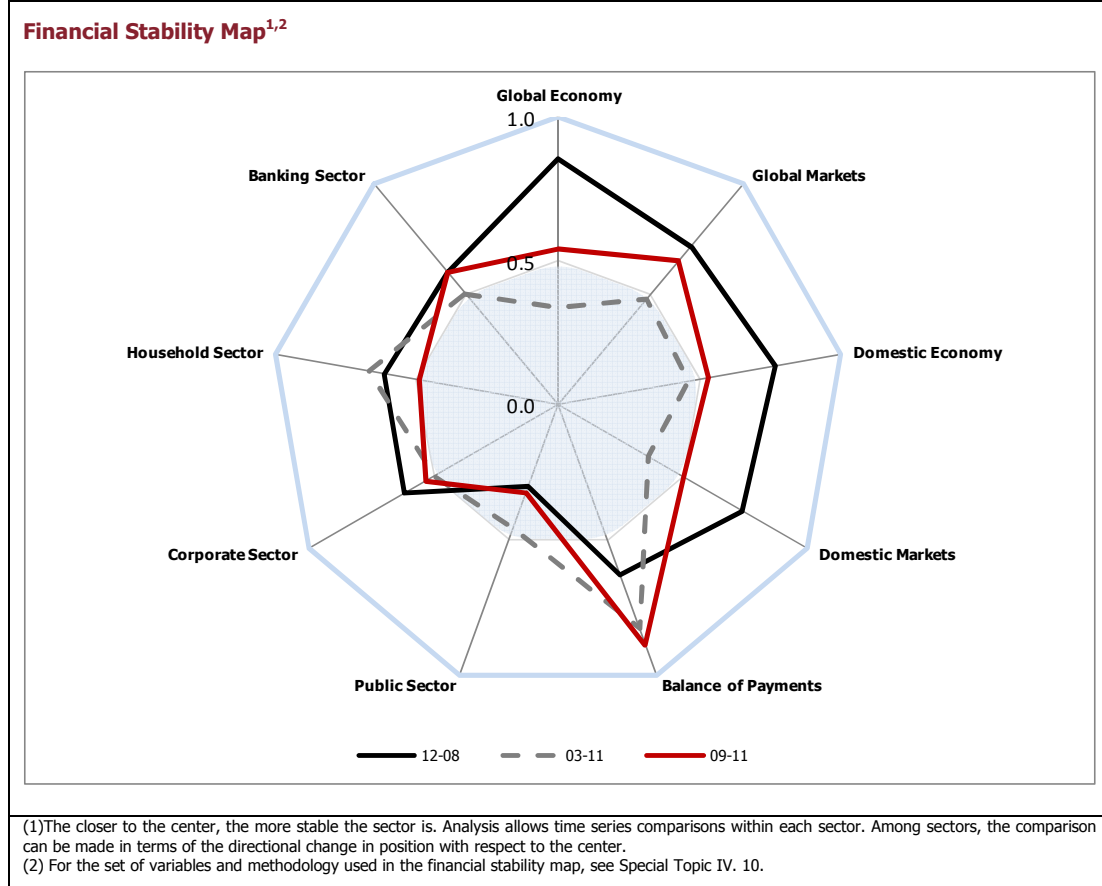
Meanwhile, the rise in exchange rate and administered price adjustments had a negative impact on inflation indicators. The Central Bank of the Republic of Turkey (CBRT) has taken a series of measures in order to contain fluctuations in the foreign exchange market and the adverse effects of global economic developments on domestic economic activity. Furthermore, a five-point action plan comprising price stability, interest rate policy, foreign exchange reserves policy, reserve requirement policy and financial stability, which will significantly reinforce the value of the Turkish lira, was made public on 26 October 2011.

On the back of measures taken by the authorities to bring the credit growth rate down to reasonable levels for financial stability, banks met their liquidity needs from primarily repo transactions, external borrowings and sale of securities. However, deposits continue to be the main source of funding for the banking sector. Banks' liquidity ratios still hover above legal ratios. Taking into account the limits for borrowing at the foreign exchange deposit markets provided by the Central Bank of the Republic of Turkey (CBRT), along with reserve requirements maintained in foreign exchange and in gold, it is considered that Turkish banks will not have any difficulty meeting their external liabilities throughout the upcoming year.

Net interest margin has narrowed down and primary expenditures have increased recently, as a result of which profitability of the banking sector has declined. However, profitability performance indicators remain robust compared to other countries. Meanwhile, despite a decline stemming mainly from the surge in credits, the capital adequacy ratio of the sector hovers above the minimum and target ratios. The quality of capital is above the levels stipulated by international standards, which

indicates robustness of the capital structure of the sector. Furthermore, the asset quality of the banking sector remains strong.

As can be seen from the illustration of determinants of financial stability, sectors other than households and public sector display a riskier outlook globally as of September 2011 compared to the previous reporting period, which is in general attributed to negative developments in global markets.



Negative developments regarding the global economy constitute a risk factor not only for Turkey but also for all other countries in the upcoming period. The Turkish Central Bank has the necessary flexibility to minimize the effect of global turbulence on the Turkish economy thanks to its sound balance sheet structure and strong policy tools.

In the case of worsening of global liquidity conditions, the CBRT will continue to take the necessary policy measures for a timely, controlled and effective provision of liquidity to the market. Within this framework, in order to increase predictability of daily foreign exchange selling options, the upper limit of the total foreign exchange amount planned to be sold through auctions in the next two working days will be made public on a daily basis.

Moreover, implementation of structural reforms to increase savings ratio and to decrease the dependence on foreign sources in the case of energy is of great importance for the purpose of implementing the fiscal framework stipulated in the Medium Term Program and a permanent solution to the current account deficit issue.