

OVERVIEW

The impact of the crisis that started in developed countries before worsening and spreading globally as of the last quarter of 2008, decreased in the third quarter of 2009 with the contribution of monetary and fiscal measures that have been implemented. Despite the developments in the financial markets, slow and unstable improvements of leading indicators for the global economy, continuing high unemployment rates and unsolved problems of the banking sector still carry the risks regarding the sustainable and powerful recovery. Furthermore, concerns about the sustainability of the global economic recovery without the current governmental support measures remain significant.

During the global crisis, sharp decline in exports due to narrowed external demand and postponement of consumption and investment as a result of deteriorated expectations in our country, have led to a serious slowdown in economic activity. In the second quarter of 2009, Turkish economy has shown a rapid recovery, largely due to the tax incentives that increased consumption expenditures. However, after its remarkable rise in the second quarter, consumption demand is expected to be in a weaker trend for the rest of the year. Persistent uncertainty in demand and low capacity utilization will continue to limit investment expenditures. Within this context, it is perceived that a durable recovery in unemployment conditions will take a prolonged period of time. Therefore, recovery in economic activity is expected to show a slow and gradual trend for the rest of the year.

Decline in foreign trade deficit caused by falling energy prices and reduced demand for consumption and investment has led to a significant decline in the current account deficit since the last quarter of 2008. Moreover, it is observed that the financing structure of the current account deficit has changed due to the crisis. While the private sector was financing current account deficit by borrowing long-term external debt in the previous periods, they have recently become net external debt payer. Energy prices and the revival of economic activity are expected to be the determinants of development of the current account deficit in the forthcoming period as well.

Starting from the last quarter of 2008, roll-over rates of long-term foreign debt for both banks and non-bank sector are declining. In addition to the contraction and increased costs of external financing facilities, decline in external financing needs of banks and non-bank sector

due to the contraction of the domestic credit market and the slowdown in economic activity played a role in this development. As was made possible by an amendment in decree number 32 regarding the protection of the value of the Turkish currency, the fact that FX loans obtained from foreign branches of domestic banks have started to decline in favor of an increase in the outstanding amount of the same kind of loans obtained from their domestic branches was an important factor for the decline in roll-over rates of the non-bank sector. When compared with the end of 2008, it is seen that the real sector's usage of credit from foreign commercial banks and other organizations did not show a remarkable change. It is expected that FX loans obtained from foreign branches and subsidiaries of domestic banks will continue to decline in favor of an increase in the outstanding amount of the same kind of loans obtained from their domestic branches. Therefore, the abovementioned amendment should be taken into consideration while the decline in the rollover rates of long-term external loans used by the non-banking private sector is being assessed.

Sharp contraction in total demand and harsh decline in commodity prices led to a rapid decline in the inflation rates in Turkey, as is the case globally. In the coming period, while some periodic increases in the annual inflation rate could be observed due to the base effect, it is expected that core inflation indicators will remain at low levels.

As a consequence of the decrease in income and increase in expenditure in the year 2009 due to the global crisis, central government budget deficit has significantly increased similar to other countries, and thus, public borrowing need has shown a rising trend. Fiscal expansion in the short run should be counterbalanced in the medium term in order to prevent an increase of concerns over fiscal sustainability due to the budget deficit. As a matter of fact, the 2010-2012 Medium Term Programme (the Programme) has introduced a consistent framework with the aim of gradually reducing the budget deficit, which increased rapidly during the crisis period. It is very important that the measures proposed in the Programme are implemented without compromise in order to ease concerns over sustainability of debt and to take public borrowing needs under control.

Household liabilities are still low compared to many countries, although they continued to rise in the first half of 2009. Furthermore, the fact that the interest and foreign exchange risk of their liabilities is limited enables households to be relatively less effected by unfavorable developments in economic conditions. The amendments to the Decree No.32 prevented households from using foreign exchange indexed loans and thus, households were prevented from bearing foreign exchange risk due to their liabilities in the periods ahead.

On the other hand, economic contraction due to the global crisis has caused an increase in the unemployment rate, adversely affecting the repayment ability of households. Although a moderate recovery is expected in economic activity, problems experienced in debt repayments of households are expected to continue, though they are expected to be milder than those of the US and European averages, in particular for mortgage loans.

The sales revenue of firms declined due to the deterioration in both domestic and foreign demand. Due to the decline in their sales revenues, operational profitability and repayment ability of firms also decreased. Nevertheless, the recent stability of Turkish lira has constrained further deterioration in repayment capacity of firms that have high levels of foreign exchange loans and open positions. While the weakening of firms' repayment ability resulted in the tightening of credit supply by banks, slowed economic activity reduced firms' credit demand and

thus, firms have become net debt payers. When firms are assessed by their size, it is observed that the contraction in credit markets has particularly influenced the small and medium size enterprises (SMEs).

Turkish banking sector, on the other hand, maintained its strength thanks to the reforms implemented decisively after the crisis of 2001.

A recovery, albeit limited, has recently been observed in loans with the impact on market interest rates of cumulative policy rate cuts since the last quarter of 2008, the liquidity measures taken and the improvement in risk perceptions. Nonetheless, non-performing loans (NPLs) are still rising and considering the fact that the economic recovery will be gradual, this rise might continue for a while. On the other hand, payment of past-due credit card loans rescheduled as stipulated in Law No: 5464 and on a voluntary basis in the subsequent period, is expected to have a positive effect on the NPL ratios.

Unlike many countries' banking sectors, the capital structures of which were severely affected by the global crisis, the fact that the capital structure of banks in Turkey grew even stronger on the back of recent high profits improved their lending capacity. Within this framework, it is expected that acceleration similar to the one recently observed in housing loans would also be observed in SME loans with the activation of the support provided to the Credit Guarantee Fund and a gradual improvement would take place in credit markets in general.

A relative recovery has been observed in liquidity conditions with the support of the measures taken by the CBRT and the recent improvements in global risk perceptions. Deposits, being the most important funding source of the Turkish banking system, restrain the susceptibility of banks to the volatility of interbank funds. Moreover, the fact that liquidity adequacy ratios of banks are maintained above the regulatory limits, supported also by the fact that banking sector has decreased the share of loans while increasing the share of securities in their portfolios since the end of year 2008, is an indication that the banking sector has pursued a prudent approach in liquidity risk management.

The exchange rate risk aversion tendency of the banking sector continues. The levels of on-balance sheet short position and off-balance sheet long position continues to rise parallel to the recovery in the global risk appetite.

Banking sector profits surged as a result of the increase in net interest income and the rise in net trading income in September 2009. This rapid increase is mainly attributable to the decline in funding costs as a result of the Central Bank's policy rate cuts, as these rate cuts were not reflected proportionally on the interest charged particularly on long-term loans. Nevertheless, competition in credit granting among banks that has spilled over onto prices and expected hikes in non-performing loans lead to an anticipation that the sustainability of a similar performance in profits in 2010 is unlikely.

Particularly in developed economies, in a period when the capital erosion of banks due to the consequences of the crisis was overcome through capital increases and/or government support, the Turkish banking sector maintained its strong capital structure and did not need any government support. As a matter of fact, the capital adequacy ratio (CAR), stayed above the eight percent regulatory ratio and twelve percent target ratio during all the periods examined. According to the scenario analysis, the capital structure of the banking sector is strong enough to absorb the losses likely to be incurred under various shock assumptions.

The Financial Strength Index, which is monitored as an indicator of the soundness of the banking sector, followed a volatile course during the year 2009 and, due to the increases in the capital adequacy and profitability sub-indices in September 2009, rose compared to end-2008 and maintained its favorable level.

In the forthcoming period, the main risks to financial stability are anticipated as the economic recovery being slower than expected, thus leading to high unemployment rates and possible new shocks that might be experienced in the global financial markets. CBRT will continue to take the necessary measures to contain the adverse effects of the global financial crisis on the domestic economy. It is important that, in the medium term, the monetary measures that have been taken are supported by fiscal discipline and structural arrangements. Within this framework, steps to be taken towards the implementation of the structural arrangements that are required by the Medium Term Programme and the European Union adaptation and convergence process maintains its significance.