OVERVIEW

The year 2007 was marked by concerns over the effects of problems experienced in the USA subprime mortgage markets on global liquidity conditions and financial stability. Easing the unfavorable effects of these problems has become a priority for central banks. Meanwhile, the impacts of the turmoil remained limited in developing countries, including Turkey owing to the lack of mature subprime mortgage markets, and to the recent recovery in economic fundamentals.

Despite the slowdown in consumption and investment expenditures, the Turkish economy maintained its growth trend in the first half of 2007 owing to net exports that grew on account of strong foreign demand. Due to the fact that high growth rates, which were achieved thanks to macroeconomic stability of recent years, have been primarily driven by the high course of the investment trend compared to savings, the current account deficit remains large despite significant hikes in exports. Although this deficit was funded chiefly by long-term investments in 2007, as it was the previous year, it constitutes one of the most important risk factors with respect to financial stability; due to the fact that it is not yet known how and to what extent the recent global volatility will affect developed countries in particular and global liquidity conditions.

Annual inflation assumed a downward trend as a result of the effect of monetary tightening on private consumption demand. Accordingly, medium-term inflation expectations maintained their downward trend. Nevertheless, inflation is expected to exceed the upper limit of the uncertainty band by the end of 2007 due to recent increases in food and energy prices as well as tax adjustments.

The primary surplus of the consolidated government sector, which surpassed the program target in 2006, remained below the target in the first eight months of 2007 as a result of the rapid rate of increase in primary expenditures compared to tax revenues and the year-end target was foreseen to be unattainable in the 2008 Annual Program. In the meantime, the ratio of public net debt stock to gross national product continued to decrease, the share of debt stock sensitive to the exchange rate declined and the average maturity of government domestic debt securities was extended. Achieving the primary budget surplus target and conducting structural reforms in the field of public finance are deemed to be of great importance in terms of achieving macroeconomic targets, improving the country’s resilience to possible fragilities and consequently maintaining financial stability in the upcoming period.

Though household liabilities showed some increase in 2007, they are still at low levels compared to many other countries. However, it is believed that the household liability in Turkey will rise gradually close to the level of EU countries in the long run as a result of the increased utilization of housing loans against a backdrop of sound economic stability, decreased interest rates and a mortgage system that has become prevalent. Even though fixed interest rates in consumer loans protect households against any rise in interest rates, the increase in FX-indexed liabilities compared to the previous period pushes up foreign exchange risk exposure. Therefore, it is still crucial that Turkish citizens lacking foreign currency income should avoid borrowing in foreign currency.

The level of indebtedness of firms has risen, chiefly in line with their utilization of bank credits. Nevertheless, the not-so-high share of bank credits in total debts is believed to limit credit risk. There has been a recovery in the short-term debt repayment capability and the profitability ratios of firms. In 2006, the sales of firms continued mainly to foreign markets due to sluggish domestic demand and despite a slight increase in the share of financing expenses in net sales, their profit margins climbed due to the reduction in the cost of goods sold.

The foreign currency short positions of firms increased compared to year-end 2006. The number of non-exporting firms with a short position and the amount of their short positions tended to rise. Therefore, it is advisable for firms to use derivatives to hedge against foreign exchange risk and for banks to adopt a more cautious stance to curtail credit risk when lending to firms with high short positions and no foreign exchange income.

The Turkish banking sector continued to grow in 2007 and the ratio of aggregate balance sheet of the sector to GDP increased. Foreign investors' ongoing interest in the Turkish banking sector points to favorable expectations and hints at sector's potential for growth.

The rate of increase in loans, which slowed down until June 2007, displayed a moderate rise from then on. This rise was mainly driven by the easing in political uncertainties despite the lack of significant changes in interest rates. The enhancement in external financing sources of banks is considered to be the main factor that will determine the course of the rate of increase in loans in the upcoming period. Moreover, the fixed interest rate nature of consumer loans, whose share in total loans tends to increase, stands out as a factor that intensifies the susceptibility of banks to interest rate risk. Meanwhile, the ongoing rise in the ratio of loans to deposits indicates an improvement in banks' intermediation functions. Likewise, the ongoing stable course of NPL ratios and the high provisioning policy of the sector are also considered favorable developments in respect of credit risk.

The short position aversion tendency of the banking sector continued in 2007 as well. The main reason for the banking sector, which levels off its on-balance sheet short position via its off-balance sheet long position, to have a high short position on the balance sheet is the funding of YTL denominated loans by foreign currency resources.

Even though the liquidity adequacy of the banking sector is above the limits stipulated by law, recent volatilities in global markets once more highlighted the importance of liquidity risk management. The Central Bank has the ability to provide Turkish currency liquidity against collateral within the framework of the program in implementation. Nonetheless, banks should keep focusing on cautious and effective liquidity management.

The net profit, return on assets and return on equity of the banking sector increased in 2007. Though the capital adequacy ratio showed a slight decline due to the enforcement of the regulation that obliges banks to hold capital for operational risk as of June 2007, it was realized 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 meet losses that may arise under various shock assumptions.

The Financial Strength Index, which we closely monitor as an indicator of the soundness of the banking sector, remained at high levels throughout 2007 despite slumps in the Capital Adequacy Index, Interest Rate Risk Index, and Liquidity Index.

The problems faced in external markets in recent times have posed a threat both to the economies of relevant countries and the global financial system. In particular, in the event of a rise in default rates in US subprime mortgage loans, as foreseen, the pressure on financial markets may persist in 2008, thus leading to instability in financial markets. Though the 2007 nine-month data relating to the Turkish banking sector have not yet shown any signs of negative impacts of the financial volatility on the sector, in order to ease risks, it is of vital importance to maintain policies that will ensure the sound functioning of markets; to hasten the pace of structural reforms; to continue prudent regulations and to decisively implement the economic program.