OVERVIEW

In this report, the developments related to banking, public finance, households, corporates and the external sector are discussed. Additionally, the implications of these developments on the financial system and the resilience of the system against shocks are assessed.

In regard to intersectoral interaction, it can be observed that the achievement of fiscal discipline has helped to reduce concerns in Turkey about the problem of public finance and its distorting implications on markets have gradually been diminishing. Sustained market discipline manifests itself in large amounts of primary surplus. In this regard, over the years, the ratio of budget deficit to GDP has shown a declining trend. While the budget deficit is still a cause for concern, due to decreasing risk premium and interest rates, a marked decline in the cost of public borrowing is being observed.

Both the improvement in financing opportunities due to macroeconomic stability and the implementation of the floating exchange regime have, to a large extent, reduced concerns about the current account deficit. Additionally, the capital inflows that continued in 2005 tend to have a longer maturity, which, in turn, has a positive impact on financing of the current account deficit. In addition to that, foreign direct investments are expected to increase with the favorable developments in the economy. However, when the growing external indebtedness of the private sector is taken into consideration, the effective management of foreign exchange risk by the corporate sector is becoming considerably more significant.

Although the financing needs of corporates have increased due to rapid growth, it is observed that they prefer to cover them with their equity. Furthermore, after the crises period, as a result of their increased creditworthiness, companies have been able to extend their financing opportunities outside the banking sector and increase the funds they borrowed from abroad. This, in turn, heightened the sensitivity of corporates to movements in exchange rates. Therefore, creating an awareness of managing this type of risk and the development of new products for hedging purposes have become significant. On the other hand, as an indicator of debt-servicing capacity, the capital and profitability performance of corporates have been maintained at adequate levels.

On the side of households, it is observed that deferred consumption spending has been rapidly increasing and intensely financed by consumer loans and credit cards. While there is a tendency towards increased indebtedness by households, the NPL ratio for consumer credits is decreasing, whereas that of credit cards keeps increasing.

Public finance and developments in the external sector have had a significant impact on the interest rate and exchange rate risks that banks are exposed to. The banks' tendency to invest in longer term credits rather than Government Debt Securities as a result of the decrease in the borrowing requirement of the Treasury, has made interest rate risk more significant. The increased awareness of banks towards exchange rate risk due to the floating exchange rate regime, leads to balanced foreign exchange positions and does not require additional capital. On the other hand, it is clear that the exposure of parties that borrow in foreign currency might be reflected on the banking sector as credit risk. However, based on financial strength indices and scenario analysis results on credit risk, it is our opinion that, the capital of the sector is stronger and more capable of covering such risks than in the past.

With the improvements in macroeconomic stability, banks prefer to remain less liquid. The continued asset-liability mismatch is still a concern from the perspective of liquidity risk management and requires that both Turkish Lira and foreign exchange liquidity of the sector is closely monitored.

Regarding the currency composition of the deposits, it is observed that the share of New Turkish lira deposits has increased compared to foreign currency deposits. Additionally, considering the fact that foreign currency demand in Turkey stems from the motive to "store value", it is our opinion that the steps taken to maintain both price stability and financial stability, will speed up the reverse currency substitution process.

In 2004, both return on assets and return on equity showed a slight decline when compared to the previous year. The negative impact stemming from the decrease in trading portfolio and foreign exchange gains has been compensated by a higher rate of decrease in the cost of liabilities than the rate of decrease in yield on assets. While net income from fees and commissions increased, operating expenses and provisioning expenses decreased in real terms. In the 2003-2004 period, the decline in the high income from treasury operations has encouraged the banking sector to widen the credit portfolio, to lower cost of funds quicker than the yield on assets and to increase their operating income more than their operating expenses. This has led to sustainable profitability in the banking sector.

The scenario analyses indicate that despite the growth in credit portfolios, the amount of capital is adequate to cover the credit risk. As a result of the interest shocks applied, it has been observed that the banks' short term FX open positions increased when compared to December 2003. If the shock period were extended, costs might increase due to maturity mismatch. However, when the strong capital position is taken into consideration, the impact of this would not be considerable.

Under new macroeconomic conditions, which are characterized by lower inflation and high growth, it is our opinion that banks should adopt strategies based on advanced risk analyses. Furthermore, when Basel II is implemented, corporate sector financial tables will need to be more transparent. Thus, under these conditions, banks will be able to realize their intermediary function much more effectively. Upon realization of this expectation and the raising of Turkey's country rating to "investment grade", it is expected that there will be a significant jump in funds flow to the corporate sector. Again within this context, bank loans for the financing of SMEs will be expected to increase in the coming periods.

Steps taken to maintain price stability and sustainable growth and to achieve fiscal discipline are very important in terms of strengthening both the financial condition of financial institutions as well as their function in transferring resources to the economy. Additionally, these developments increase the resilience of the financial system against shocks. However, during periods of economic expansion, it is important to bear in mind that financial actors may be less prudent in managing risk. For this reason, periods of economic expansion and financial upturn are good opportunities to upgrade regulations in line with international best practice and further improve structural reforms.

Basel II principles, which pave the way to more accurate measurement and effective management of the risks that banks are exposed to, will be implemented in the EU starting from 2007. In this context, the Basel II preparation process should be assessed under the alignment process to the EU. "The Basel II Road Map (Draft)" announced by the BRSA on May 30, 2005, is significant in increasing awareness in the industry and facilitating the smooth transition in this process and is positively received by the CBRT.

When the potential impacts of Basel II on the financial system are taken into consideration, it is very important for banks and corporates to fully prepare themselves and to take the necessary measures to strengthen their corporate governance. In order to assess the risks in the financial system, widening, by the related authorities, the content of data on households will strengthen the analyses made on the financial system.

Furthermore, it is our opinion that the new Banking Law, which is in the approval process, will contribute to effective risk assessment and management and will thus further enhance market discipline.

The share of foreign banks including both those in the private and investment banks groups, has reached 6.7 percent as of May 2005 and is expected to increase further when sales negotiations that are still being held on some private banks are finalised. Macroeconomic stability and the positive impact of structural reforms on financial markets have a significant role in the increasing share of foreign banks.

In order to minimize the potential impact of movements in foreign exchange and interest rates that may result from international liquidity conditions and global risk perceptions, banks should prudently manage maturity mismatch and current low short FX positions.

In the same way that the banking sector has improved itself regarding risk perception and management, it is necessary for corporates to have adequate risk assessment systems and to effectively use hedging instruments. In this regard, the establishment of the Forward Transactions and Options Exchange is a significant step and the effective use of it by both banks and corporates is of utmost importance.

Although widening of the credit portfolio is a positive development as regards to the improved intermediary function of banks, it is our opinion that proper pricing policies are also necessary. Additionally, when the increasing trend of retail loans in total assets is taken into consideration, it is also necessary from the interest rate risk management perspective to impose the option of applying floating rate on consumer loans, which are currently fixed rate. Within this context, it is our opinion that there is a need for new regulatory arrangements in line with international best practice.

The increased confidence in the markets, positive macroeconomic developments, determined application of current macroeconomic policies, effective adaptation of regulatory measures and the effectiveness of the supervisory authority are all indicators of the existence and permanence of financial stability in the financial markets. Within this context, it is of utmost importance to have a well-established risk culture in the system along with financial actors who adapt their risk perceptions to the dynamic conditions.