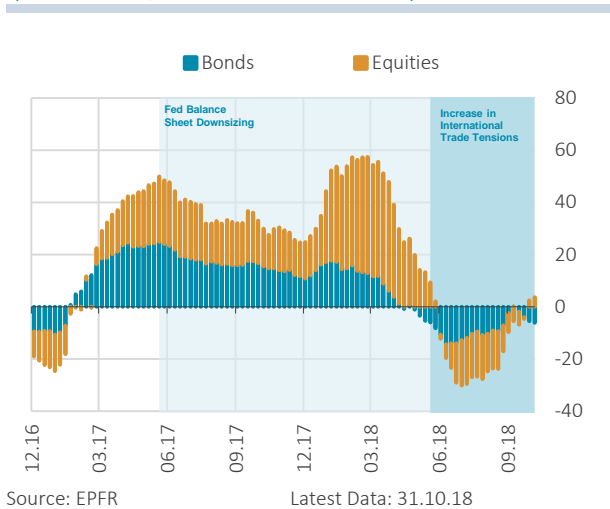


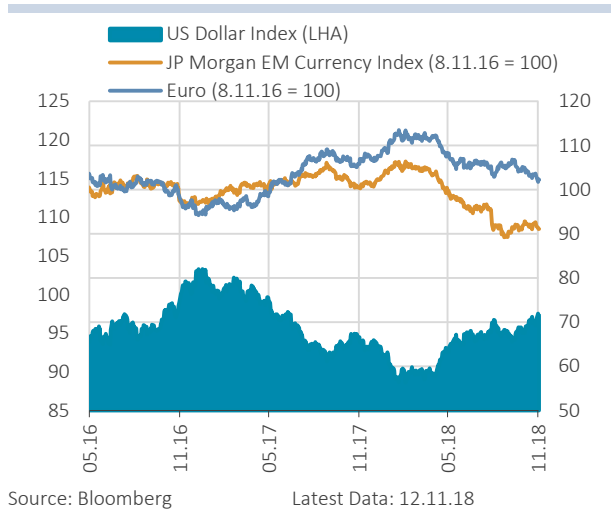
## Overview

In the current Report period, uncertainties over global economic policies have increased and risk appetite in financial markets have decreased due to the ongoing monetary policy normalization in advanced economies, the increase in global bond yields, the likelihood of proliferation of protectionist trade measures, concerns over Italian public indebtedness and the Brexit process. Thus, market volatilities in and perceptions of uncertainty over emerging market economies (EMEs) remained high, which resulted in net portfolio outflows, depreciation of local currencies and a rise in international borrowing costs in these countries (Chart I.1). The appreciation of the US dollar has negatively affected the EMEs, particularly those with high FX indebtedness (Chart I.2).

**Chart I.1: Weekly Capital Flows to EMEs**  
(Billion USD, 13-Week Cumulative)



**Chart I.2: Exchange Rate Indices**

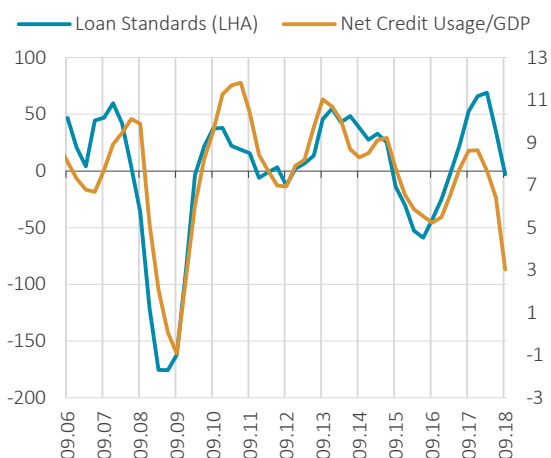


The global economic growth outlook remained positive, yet compared to the previous Report period the divergence between countries widened and the downside risks to economic growth increased. The acceleration in the US economic activity continued with support from expansionary fiscal policies, as protectionist trade measures pose a downside risk on expectations. Meanwhile, leading economic indicators for the euro area signal a loss of momentum in economic growth. The high level of global indebtedness, the likelihood of the proliferation of US-led protectionism, the persistence of the tightening in financial conditions, geopolitical developments and country-specific risks as well as the deceleration in global economic activity remain as the primary risk factors to the global economic growth outlook and financial stability. Timely completion, full implementation and impact analysis of financial regulatory reforms are crucial for maintaining global financial stability.

In the second quarter of 2018, domestic economic activity started to rebalance. The contribution of domestic demand to the annual gross domestic product (GDP) growth decreased while that of net exports increased in this period. Leading indicators of growth suggest that the rebalancing process in economic activity continues in the second half of 2018. This development was mainly driven by the depreciation of the Turkish lira as well as the volatility in exchange rates and tightening in financial conditions. Despite sluggish domestic demand, the deterioration in pricing behavior and cost pressures stemming from the cumulative depreciation in the Turkish lira pose risks to price stability. Meanwhile, supported by the strong recovery in tourism, net exports continue to contribute to growth and curb the negative impact of domestic demand on economic activity. A faster-than-expected recovery is observed in the current account balance owing to the divergence between domestic demand and foreign demand coupled with the rebalancing in economic activity.

Credit conditions for both corporate and retail loans became tighter due to geopolitical tensions, the financial sector’s stronger liquidity preferences, tighter global financial conditions, and exchange rate volatility; and together with decelerating investment and consumption demand, annual loan growth remained below historical averages (Chart 1.3 and I.4). The CBRT and regulatory institutions have taken a series of coordinated policy actions to ensure market stability and support economic activity (Box I.1.I). The CBRT’s monetary tightening which took into account risks to price stability, and the New Economy Program’s emphasis on the rebalancing process, together played a role in the positive change in financial market perceptions.

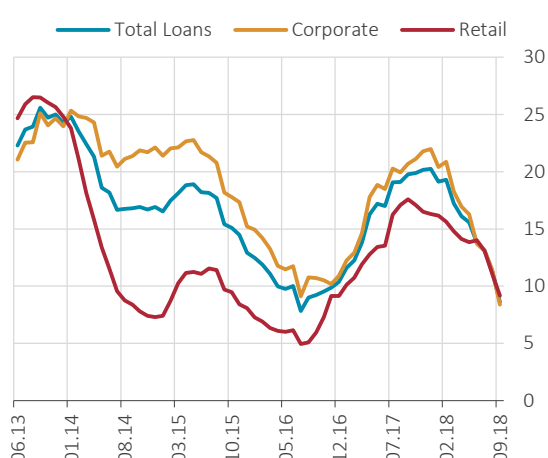
**Chart I.3: Credit Conditions (Annual, %)**



Source: CBRT, TURKSTAT Latest Data: 09.18

Note: Loan Standards series is the 4-quarter cumulative sum and the weighted average of banks' answers to the Loans Tendency Survey, represented as deviations from its historical average; whereas Net Credit Usage/GDP series is the ratio of annual change in the loan stock to the annual GDP.

**Chart I.4: Annual Loan Growth (FX-adjusted, %)**

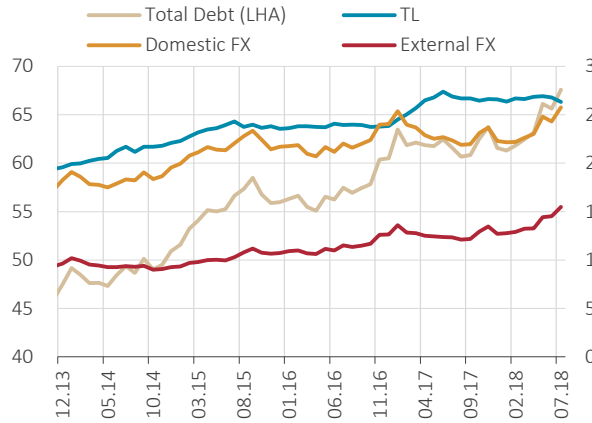


Source: CBRT Latest Data: 09.18

Note: FX-indexed loans are included in FX loans and adjusted for exchange rates by using a weighted basket of 0.3 for the euro and 0.7 for the US dollar

The downtrend in capacity utilization rates seen since end-2017 has had a dampening effect on the demand for new investments in the manufacturing industry. Even though aggregate corporate financial leverage has increased to around 65 percent since May 2018 due to exchange rate developments, the ratio of corporate loans to GDP remains below global, G20 and EME averages (Chart I.5). On the other hand, the downtrend in the household leverage ratio further accelerated, pushing the ratio below 45 percent. This was due to the supply and demand-driven deceleration in liabilities growth and the exchange rate-driven acceleration in asset growth. The household debt/GDP ratio stood at 16.6 percent as of March 2018, hovering below the 29.2 percent average of peer EMEs. The weak domestic demand due to the contraction in economic activity, exchange rate developments and price uncertainty played a role in the deceleration in retail loans triggered by tightened credit conditions. Recent regulations on consumer loans are expected to be effective on retail loan growth developments in the upcoming period. The macroprudential policy regulation regarding the maximum maturity of general-purpose loans effective from September 2018 may decelerate the credit demand of households who are responsive to monthly installment amounts (Box III.1.I). On the other hand, the recent tax cuts effective in the last two months of the year and changes in the maturity of general-purpose loans and credit card installments for some consumption items from the end of November 2018 may partially revive consumption and credit demand.

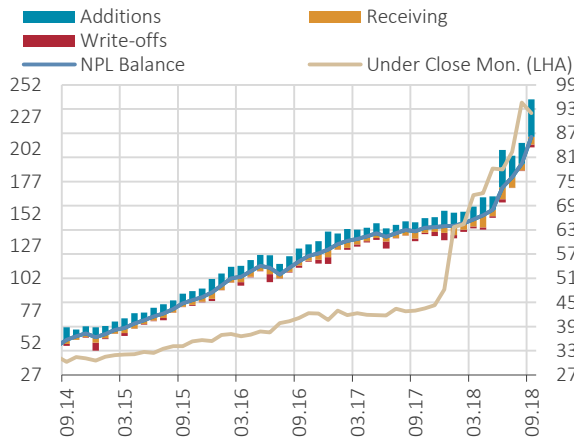
**Chart I.5: Share of Corporate Sector Financial Debt in GDP (%)**



Source: CBRT, BRSA Latest Data: 08.18

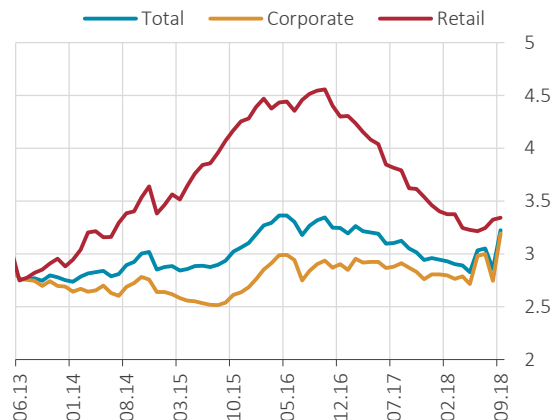
The impact of recent amendments to Decree No. 32 has become visible in the FX indebtedness of firms. FX credit balance has declined compared to the previous Report period, as this development is attributed to exchange rate developments driven by the volatility in global financial markets, the normalization process in monetary policies of advanced economies and weakened risk appetite as well as to the shrinking FX credit demand. Both domestic and external FX loans of the corporate sector have a long-term maturity profile. The increase, particularly in the share of domestic FX loans with a maturity of five years or longer, is a favorable development in terms of corporate FX risk. Recently, alongside the tightening in credit conditions credit demand has been declining.

**Chart I.6: NPL Balance and Components (Billion TL)**



Source: CBRT Latest Data: 09.18

**Chart I.7: NPL Ratios (%)**

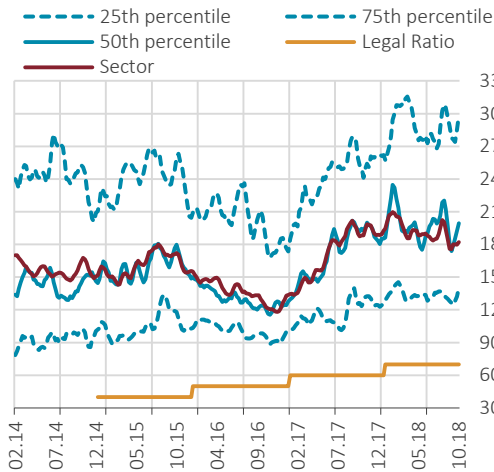


Source: BRSA Latest Data: 09.18

Following the transition to the Turkish Financial Reporting Standards 9 (IFRS 9) accounting system in early 2018, banks' utilization of subjective internal classification models and the financial market volatility in August 2018 have resulted in banks to become increasingly prudent in their classification of loans, which resulted in an increase in closely monitored loans (Chart I.6). Moreover, due to exchange rate developments and the deceleration in the economic activity, the rise in additions in non-performing loans (NPLs) exceeded collections and consequently, the outstanding NPL increased. Due to these developments and the denominator effect of slowing loan growth, the NPL ratio became 3.2 percent in September (Chart I.7). Financing costs as well as the size and duration of the slowdown in economic activity stand out as the determining factors of banking sector asset quality in the upcoming period.

Strong export growth, positive performance of the tourism sector, amendments to Decree No. 32, and macroprudential regulations support the asset quality outlook of the sector. In addition, it is expected that the loan-restructuring initiative led by sector representatives and regulatory institutions will contribute to financial stability.

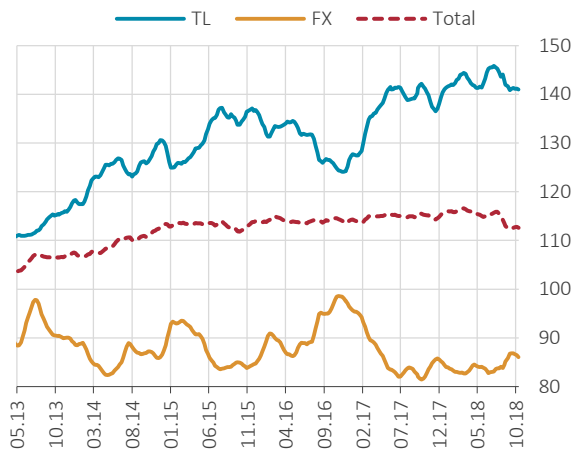
**Chart I.8: Quantiles of Banks by Total Liquidity Coverage Ratios (% , 4-Week MA)**



Source: CBRT Latest Data: 12.10.18

Note: Development and investment banks are excluded. Based on non-consolidated reports. These quantiles represent the banks in the 25th, 50th and 75th percentiles, respectively, from the smallest to the largest.

**Chart I.9: Loan/Deposit Ratio (% , 4-Week MA)**

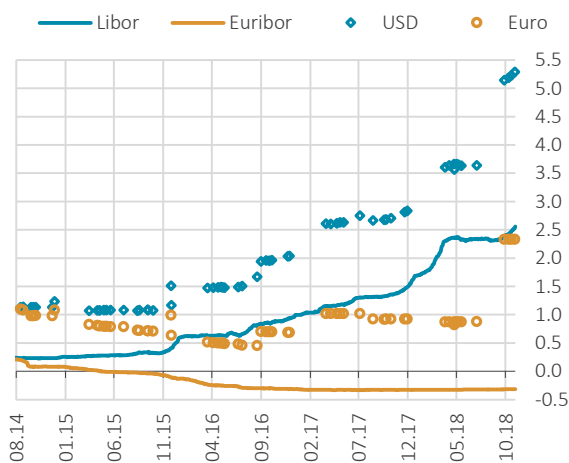


Source: CBRT Latest Data: 12.10.18

Note: Development and investment banks are excluded.

In the current Report period, tightening global financial conditions coupled with the volatility in the foreign exchange market brought the banking sector's liquidity risk indicators to the fore. Measures taken by the CBRT and other policy-makers to enhance the efficient functioning of the markets and banks' liquidity management contributed to the maintenance of banking sector resilience against liquidity risk. Meanwhile, short and long-term liquidity indicators are following a secure path (Charts I.8 and I.9).

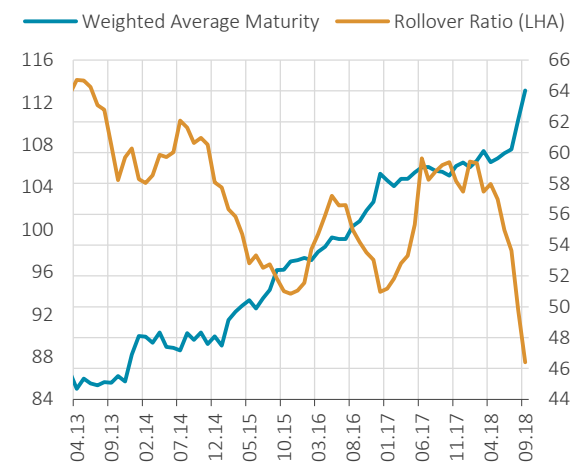
**Chart I.10: Cost of Syndicated Loans with a Maturity of 367 days (Transaction-Based, %)**



Source: PDP Latest Data: 31.10.18

Note: Includes largest 10 banks.

**Chart I.11: External Debt Roll-Over Ratio and Its Average Maturity (% , Month)**



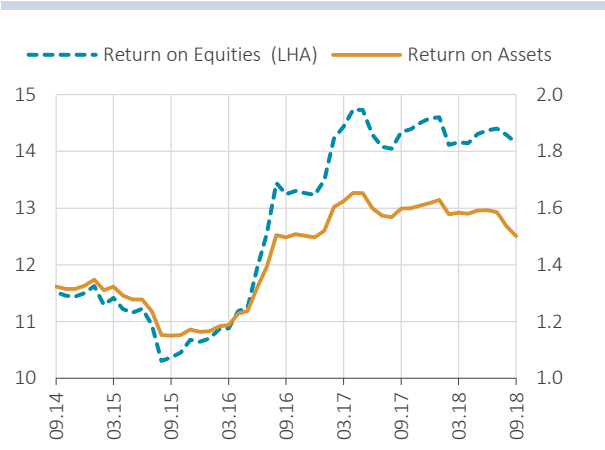
Source: CBRT, MKK Latest Data: 09.18

Note: The external debt roll-over ratio is calculated based on 6-month moving totals of banks' borrowings and repayments of total external liabilities including securities issued abroad.

Tightened financial conditions both at the global and local scale, and lower risk appetite towards EMEs led to an increase in banks' external borrowing costs (Chart I.10). In the current Report period, the high rates of roll-over ratios in matured syndication loans despite the increase in the cost of access to foreign resources indicates that the capability of banks to renew external debts remains robust. Due to corporates' decelerating investment and FX borrowing appetite, the external debt roll-over ratio declined following banks' narrowing demand for external resources (Chart I.11). FX liquidity buffers held by the sector are sufficient, and the total FX-denominated external debt maturing within one year can be met through the liquid asset portfolio of banks including FX required reserves (RR). In addition, the favorable maturity outlook in banks' domestic and external security issuances limits the potential risks in the sector.

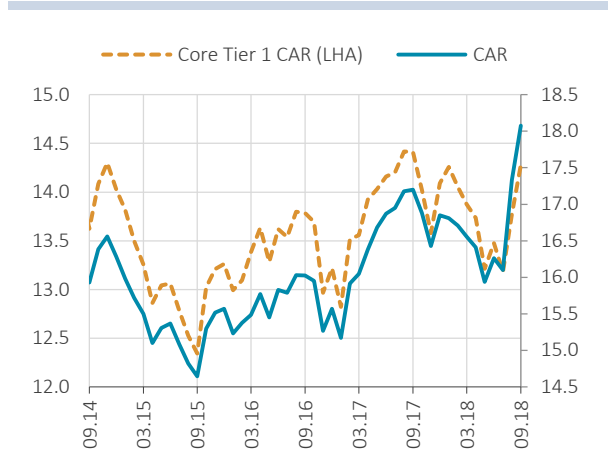
The banking sector's profitability indicators have recently remained flat, and the increased contribution of rising net interest margin drove up net interest revenues (Chart I.12). Profits from capital market transactions stemming from derivatives and foreign exchange losses largely offset each other. In the first half of 2018, the capital adequacy ratio (CAR) declined slightly due to interest and exchange rate developments (Chart I.13). Supportive regulations to CAR calculation made by the Banking Regulation and Supervision Agency (BRSA) in August enable stabilization of the exchange rate for foreign exchange assets in the calculation of risk-weighted assets and the unrecognizing of valuation differences in the securities portfolio at fair value through the other comprehensive income in equity amount. Asset quality, profitability, and the developments in exchange and interest rates will affect the sector's CAR in the upcoming period.

**Chart I.12: Asset and Equity Profitability (%)**



Source: CBRT Latest Data: 09.18

**Chart I.13: CAR and Core Tier 1 CAR (%)**



Source: CBRT Latest Data: 09.18

Note: Profitability ratios are calculated by dividing the 1-year cumulative profit by the 1-year average denominator.

In sum, global financial conditions, which have tightened lately due to the monetary policy normalization process in advanced economies, protectionist trends in foreign trade, uncertainties originating from Italy and the UK in Europe, as well as geopolitical developments, led to attenuated capital flows towards EMEs, depreciation in their local currencies and an increase in their external financing costs. In this context, external developments in addition to the volatilities in domestic financial markets decreased banks' lending appetite. Moreover, loan demand contracted as a result of the slowing economic activity. Tightness in lending conditions keeps downside risks brisk in terms of the domestic economic activity. On the other hand, the Turkish banking sector maintains its resilience against risks with its strong capital structure and profitability, high liquidity buffers and prudent stance for asset quality.

## Box I.1.1

### Measures and Regulations for the Markets

In the current Report period, the ongoing normalization process in monetary policies of advanced economies coupled with spreading protectionist policies caused uncertainties to deepen in global markets and capital flows towards EEs to follow a fluctuating course. Accordingly, with a view to safeguard financial stability and contribute to the effective functioning of markets, a set of coordinated policy steps have been taken.

Endeavors made towards financial stability in the Report period are summarized in Table I.1.1.1.

**Table I.1.1.1 Measures and Regulations for the Markets**

	Date	Measures and Regulations
Decree No 32 on Protection of the Value of the Turkish Currency	25 January 2018 (to be effective from 2 May 2018)	FX credit utilization of firms with FX credit balance of less than USD 15 million was linked to their foreign exchange revenues of the last three years, and the use of FX-index loans was abolished.
	4 September 2018	An regulatory change was made on bringing export proceeds into Turkey.
	13 September 2018	Decision was made on the re-arrangement of the FX-denominated or FX-indexed contracts between residents into TRY within 30 days.
Reserve Requirements	7 May 2018	The upper limit for the FX maintenance facility within the ROM was lowered to 45% from 55%. This revision provided banks with approximately USD 2.2 billion of liquidity.
	30 May 2018	The method of determining the remuneration rate of TL RRs was changed. Accordingly, the rate which was implemented as 400bp less of the CBRT 1-week repo auction rate was changed to a fixed rate, which was set as 7% to be effective from 1 June 2018.
	6 August 2018	The upper limit for the FX maintenance facility within the ROM was lowered to 40 percent from 45 percent. With this revision, a liquidity of approximately USD 2.2 billion was provided to banks.
	13 August 2018	TRY and FX reserve requirement ratios were reduced, which provided the financial system with approximately TRY 10 billion, USD 6 billion and USD 3 billion equivalent of gold liquidity. The maximum average maintenance facility for FX liabilities was raised to 8 percent. In addition to US dollars, use of the euro was also facilitated for the maintenance against Turkish lira reserves under the ROM.
	18 September 2018	The remuneration for TRY RRs was raised to 13% from 7%.
	23 October 2018	Interest rate applied to RRs in USD, reserve options and free accounts was raised to 2% from 1.5%.
Foreign Exchange Deposits against TRY Deposits Auctions	24 May 2018	TRY interest rate applicable in foreign exchange deposits against TRY deposits auctions was raised to 16.50% from 13.50%. Following this, in the current Report period, TRY interest rates were raised to 17.75% on 8 June, to 19.25% on 14 August and lastly to 24% on 14 September. Auction amounts were raised to USD 1.5 billion from USD 1.25 billion on 9 May. This amount was revised as USD 1 billion on 27 September, USD 750 million on 19 October and USD 500 million on 6 November.

Rediscount Credits	25 May 2018	The repayments of rediscount credits extended before 25 May 2018 to be due by 31 July 2018 (included) were allowed to be made in Turkish liras provided that they are paid at maturity.
Operational Framework of the Monetary Policy	28 May 2018	The CBRT decided to complete the simplification process regarding the operational framework of the monetary policy with the new operational framework to be effective as of 1 June 2018.
CBRT Measures on TRY and Foreign Exchange Liquidity Management	13 August 2018	As allowed by intraday and overnight standing facilities, the CBRT will provide all the liquidity the banks need. Discount rates for collaterals against TRY transactions were revised based on type and maturity, thus providing banks with flexibility in their collateral management. Collateral FX deposit limits for Turkish lira transactions of banks were raised to 20 billion euros from 7.2 billion euros. In addition to one-week repo auctions, which are the main funding instrument of the CBRT, traditional repo auctions or deposit selling auctions may be held with maturities no longer than 91 days. For the days with relatively higher funding need, more than one repo auction may be conducted with maturities between 6 and 10 days. Upon the request of banks, a portion of or the entire amount of the winning bids in one-week repo auctions were allowed to be used in deposit transactions instead of repo transactions at the Central Bank Interbank Money Market with the same interest rate and maturity. The CBRT resumed its intermediary function at the FX deposit market. Moreover, one-week repo funding was suspended on this date, and was resumed on 14 September.
	29 August 2018	The banks' borrowing limits for overnight transactions at the Interbank Money Market established within the CBRT were revised as twice the limits applicable before 13 August 2018.
	31 August 2018	The decision to open a Turkish Lira currency swap market at the CBRT was taken. The method for transactions was set as quotation with banks authorized in the Foreign Exchange and Banknotes Market within their pre-determined limits.
	31 October 2018	Transactions in this market on behalf of the CBRT started on November 1, 2018, and banks' limits were set as 10 percent of their pre-determined Foreign Exchange and Banknotes Market transaction limits.
Swap Operations	13 August 2018	TRY buying transactions of banks with non-residents at maturity was limited to up to 50% of the banks' regulatory capital as most recently calculated. This rate was reduced to 25% on 15 August. On 17 August, non-swap derivative operations were also limited.
	8 September 2018	Derivative operations conducted by banks with their non-resident partners subject to consolidation were excluded from limitations in the form of credit institutions or financial institutions.
	17 September 2018	Limitation was differentiated on maturity basis. Accordingly, it was deemed appropriate to take account of 75% of forward transactions with maturity between 90-360 days in the calculation of transactions included in the limitation of 25% and 50% of forward transactions with maturity more than 360 days.

TL-Settled Forward Foreign Exchange Sale Auctions	31 August 2018	In addition to the Turkish lira-settled forward foreign exchange sale auctions at the CBRT, transactions were allowed also at the Derivatives Market (VIOP) operating under Borsa İstanbul (BIST).
Withholding Tax on Deposit Accounts	31 August 2018	Withholding tax rates were raised for foreign exchange deposit accounts, but reduced for Turkish lira deposit accounts, to remain effective for 3 months.
Restructuring of Financial Debts	15 August 2018	The BRSA published a regulation on the restructuring of debts to the financial sector.
	11 September 2018	Financial Restructuring Framework Agreement was made on structuring credits of firms with total cash or non-cash debts of or above TRY 100 million to financial institutions, which subject to neither an appeal of legal proceedings or a decree of insolvency. The Agreement prepared by the Turkish Banks Association (TBA) and signed by the parties was approved and enacted by the BRSA on 19 September 2018, and some amendments were introduced on 21 November 2018.
	8 October 2018	A TBA recommendation was made regarding the maturity extension for non-restructured credits up to 24 months without reimbursements up to 6 months as of 30 June 2018. These credits must belong to the firms with no decree of insolvency and with credit remainder totaling less than TRY 25 million including TRY 15 million cash and non-cash credits to be due on 30 April 2019.

As indicated in Table I.1.I.1, some arrangements were introduced to support the effective management of the exchange rate risk and avert macroeconomic hindrances that may arise out of high FX demand in times of exchange rate volatilities. As a first step, FX credit utilization of firms with FX credit balances of less than USD 15 million was correlated to their foreign exchange revenues of the last three years, and the use of FX-indexed loans was abolished. Next, a system to collect detailed data obtained from firms with FX credit balances of or above USD 15 million was established at the CBRT. Currently, there are ongoing studies in light of the analyses made on the exchange rate risk and firms' hedging preferences using these quarterly-reported data.

In the period ahead, the construction of regulations and measures with the coordination of all stakeholders in consideration of the interaction between the corporate and financial sectors will offer a positive contribution to economic activity and macrofinancial stability.