

## OVERVIEW

Global economic conditions display a more positive outlook compared to the previous reporting period on the back of measures taken to improve economic activity especially in advanced economies following the crisis. However, these policy measures caused significant deterioration in the budget deficits of advanced economies.

Based on divergence of countries with respect to interest rates and long-term growth potential, domestic demand has accelerated on the back of capital flows towards emerging economies, which have recently gained impetus, and increased the risk of excessive borrowing in these countries. Considering the risk of a potential sudden change in capital movements, country authorities continue to implement macroprudential policy mixes. The policy framework that has been designed embodies a countercyclical objective, capable of ensuring medium and long-term sustainable growth in economies, in addition to efforts to prevent vulnerabilities that may arise from excessive borrowing. As a matter of fact, in addition to operational measures taken in the aftermath of the crisis, both advanced and emerging economies have embarked on significant changes in their institutional structures with regard to financial stability.

In the upcoming period, advanced economies are expected to implement their exit strategies gradually, based on developments in their growth and inflation. This situation might have limited impact on global growth rates, whereas it might affect international capital movements in the extent of volatility it would cause in terms of investment decisions. Furthermore, the increased default risk in some European Union countries increases the risk of contagion especially in economies with debt securities of the said EU countries in their portfolio. Meanwhile, the impacts of developments in the Middle East and North African countries on the global economy through the channel of energy prices should be monitored carefully.

Capital inflows to Turkey, which has relatively stronger economic fundamentals among emerging economies, continued; the economy continued to grow on the back of domestic demand; unemployment rates declined while industrial production and capacity utilization increased. The rapid recovery in the economy has raised concerns about excessive borrowing in Turkey as in many other emerging economies. In the meantime, the capacity utilization rate remaining at low levels and production volume hovering below its potential due to weak external demand contain the pressures on inflation.

Although there is no overheating in the economy in terms of aggregate demand conditions, the divergence of growth rates of internal and external demand along with short-term capital inflows bring concerns over financial stability to the forefront. In this context, considering the economic conditions peculiar to our country, the Central Bank of the Republic of Turkey (CBRT) implements a new policy mix consisting of low policy rate, a wide interest corridor and higher reserve requirement ratios, with a view to containing the rise in credits and current account deficit and reducing short-term capital inflows to ward off concerns over financial stability.

The impacts of our new policy mix have become visible. Following the measures taken, acceleration in the credit growth rate halted and the average maturity of deposits started to lengthen. The tightening impact of the new policy mix on credits is expected to become more pronounced in the upcoming period.

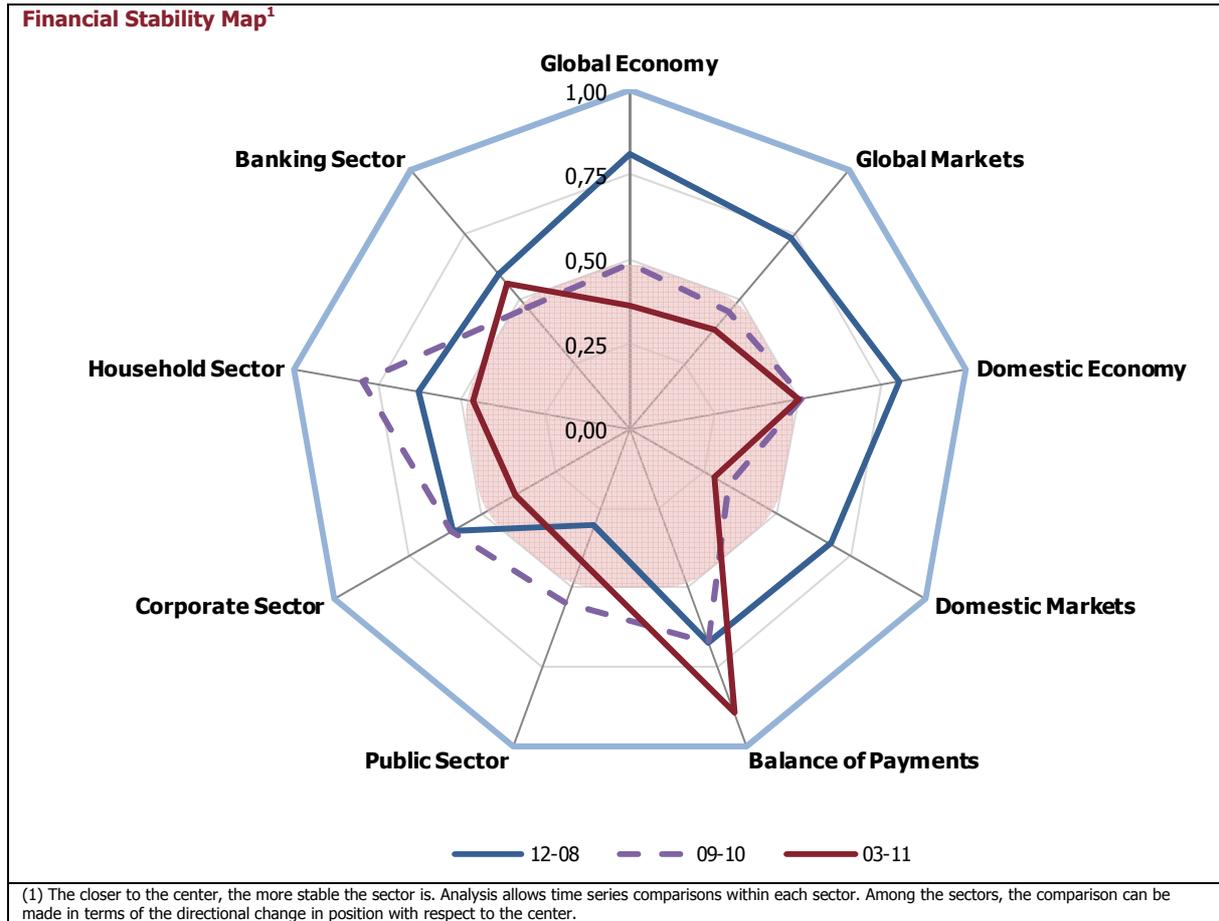
As it has been reiterated on several occasions, it is essential for both the public and private sector to avoid excessive borrowing, prefer longer maturities in all borrowings, opt for borrowing in Turkish lira as much as possible and manage risks appropriately in order to increase the effectiveness of these measures and to strengthen the resilience of our economy in the face of exogenous shocks.

Indicators related to the banking sector point to the financial soundness of the system. The improvement in credit conditions, low level of interest rates, declining unemployment rate and the increased debt service capacity of borrowers has reduced non-performing loan ratios. Deposits continue to be the main funding source in the banking sector. Additionally, banks increase the funds they provide from abroad and find additional resources through issuance of bonds and bills.

The ongoing upward trend of the share of credits in banks' portfolios due to increased credit supply on the back of the economic recovery has an impact on liquidity ratios as well. Although liquidity ratios started to decline in early 2010 on the back of the decrease in the securities portfolio and the increase in repos and debts to foreign banks, they hover above legal ratios. The surge in funds provided by banks from abroad contributes to the extension of maturities of liabilities. Meanwhile, it is essential for banks to monitor maturity matching in their borrowings through short-term cross currency swap (CCS) transactions and to maintain effective risk management under current economic conditions dominated by rapid credit expansion.

Despite a slight decline in profitability ratios, which surged owing to increased competitiveness in contrast to the improvement in credit quality, the said ratios still hover at high levels. It is considered that thanks to price adjustments made, the profitability of the banking sector will not be as low as envisaged by the market during the rest of the year. On the other hand, although the capital adequacy ratio declined on the back of credit growth, it maintains its high level above the minimum and target ratios.

Within the framework of the aforementioned evaluations, the financial stability map, which illustrates developments related to financial stability in Turkey in a macro-perspective, addresses the financial system with a holistic approach and enables comparison by quarters, is given below.



As also shown in the chart above, while risks related to the global economy and markets reduced slightly compared to the previous reporting period, credit and labor markets in advanced economies still lag behind pre-crisis levels, causing persisting weakness in global economic activity.

With regard to Turkey, the general trend in sub-items of the economy is improving. In line with the recovery in domestic economic activity, firms continue to increase their revenues from sales and maintain their strong profitability performance. Meanwhile, exchange rate risk remains important for firms. Households' indebtedness remains on the rise in response to the revival of economic activity and increase in consumer confidence. Nevertheless, due to the decrease in the ratio of interest payments to disposable income and the increase in employment, the risk outlook for households continues to improve.

The easing of financial policy, which served as a shock absorber in the early stages of the crisis, did not last and public finance discipline was restored in the following period. From the balance of payments perspective, short-term capital flows driven by global monetary expansion still constitute a risk factor. In the period ahead, it is essential to increase public savings in order to curb risks stemming from short-term capital flows which might potentially remain strong, the high level of credit volume and the current account deficit caused by the divergence between internal and external demand. Balance of payments developments will be monitored closely in the face of significant uncertainties arising from global economic conditions.

Meanwhile, within the context of financial stability, the Central Bank monitors developments in financial market infrastructures closely. Especially the rise in transaction volume in financial markets requires the use of effective and reliable payment and settlement systems. Recent experience gained from economic volatilities on a global scale has led countries to determine international standards related to financial infrastructure agencies. The Central Bank keeps a close watch on payment and settlement systems - one of the cornerstones of a sound financial structure that contributes to maintaining financial stability if it functions properly- and takes necessary measures to minimize any risks that may arise from these systems. Therefore, no problem was experienced due to payment and settlement systems during the period of financial turmoil.

Although the Central Bank's monetary policy priority is price stability, it also adopts a framework that safeguards both price stability and financial stability while addressing risk factors and takes monetary policy measures related to these risks under current conditions. In this scope, how the Central Bank would use policy tools in the upcoming period is announced in the Inflation Report of April 2011 through scenarios developed in this context.

Analyses included in this volume of the Financial Stability Report reveal that the Turkish banking sector has maintained its resilience against endogenous and exogenous shocks. However, from a macro perspective, the rise in credits and the current account deficit engenders concerns over financial stability. The increase in credits and the current account deficit follow a parallel trend. Rapid credit growth fuels an increase in the current account deficit by feeding domestic demand and reducing savings ratios. Besides, the increasing share of short-term capital inflows in financing the current account deficit has necessitated the adoption of the current policy approach.

Although it is expected that the credit growth rate in emerging economies, which are in the initial stages of financial deepening, would be higher than that of advanced economies, country cases suggest that important banking and balance of payments crises are related to rapid credit growth. In addition to the positive relationship between credit growth and the current account deficit, there is also a similar relation between the credit growth rate and credit growth rate volatility. High credit volatility also adds to the size of fluctuations in economic growth and imposes a risk on financial and macro stability. Therefore, reducing fluctuations in credits will support financial stability by reducing procyclicality in credit markets. Furthermore, it is always essential that banks maintain an effective risk management system while extending loans in robust and competitive credit markets.

The effects of measures taken by the Central Bank in the context of its new policy mix on credits and domestic demand became apparent from the second quarter on. However, both the high level of energy and other commodity prices and developments weakening external demand have postponed improvement in the current account balance to the final quarter of the year. The Central Bank will continue to monitor the impacts of the current policy mix on financial stability and will take additional measures when necessary.

Recent concerns especially over the sustainability of increasing public debt related to some Euro area countries has led to a relative decline in capital flows towards developing countries. In line with

this development, our daily amount of foreign exchange buying auctions was reduced from USD 50 million to USD 40 million.

If capital flows towards developing countries continue to weaken, the daily amount of foreign exchange buying auctions may gradually continue to be reduced. In such a case, as the amount of Turkish lira liquidity that will be provided to the market from this channel will also decline, with respect to credit growth, the need to make additional increases in reserve requirements will diminish in the second half of 2011.

Additional measures that might be taken by other authorities in coordination with the Central Bank will also reduce the need for additional increases in reserve requirement ratios in the upcoming period.