I. Overview

Global economic activity continues to recover thanks to the easing of preventive measures for pandemic, a faster vaccine rollout and supportive economic policies. Inflation rates are rising globally due to supply constraints caused by global supply chain disruptions, demand-pull factors caused by reopening, and commodity prices. Signals for the possible changes in advanced economies' monetary policy stance weigh on fund flows to emerging economies (EMs). High levels of global debt, particularly across corporate and public sectors, emergence of new COVID-19 variants, and the effects of climate change on the financial system are among key sources of uncertainty for global financial stability.

Having picked up strongly since the third quarter of 2020, domestic economic activity remained robust in the third quarter of 2021 thanks to brisk external demand and recovery in services sectors. While economic activity lost some momentum in the second quarter amid pandemic restrictions and tightening in financial conditions, domestic demand as well as net exports made a significant contribution to annual growth in this period. According to leading indicators, economic activity displayed a strong course widespread across sectors due to the lifting of pandemic restrictions in the third quarter and external demand.

Current account balance improved significantly on account of buoyant exports, recovering services revenues, especially tourism, and the decline in gold imports. Current account balance posted a surplus in August and September, as previously projected, while seasonally adjusted data also confirmed the improvement in the external balance. After falling to USD 18.4 billion in September, the twelve-month cumulative current account deficit is expected to narrow further. Following the decrease in financing needs and the increase in other investments, the CBRT reserves have increased by USD 35.1 billion since the beginning of 2021 to USD 128.4 billion as of 19 November 2021.

Inflation outlook is largely shaped by supply-side factors. Recent increase in inflation has been driven by supply side factors such as rise in food and import prices, especially in energy, and supply constraints, increase in administered prices and demand developments due to re-opening. Temporary factors affecting inflation in the short term are expected to persist through the first half of 2022.

The household financial debt-to-asset ratio declined to historically low levels as the growth of liabilities slowed and the rise in financial assets continued. The increase in household indebtedness ratio in Turkey has been relatively limited during the pandemic period compared to peer countries, while it remained well below the EME average in terms of level. The number of individuals having consumer loan debts increased compared to the pre-pandemic period, whereas the decline in per capita indebtedness continues. Meanwhile, household borrowing is increasingly made by fixed-income earners, which supports the sustainability of debt. The upward trend in household financial assets continues in tandem with the robust increase in TL deposits and other alternative financial assets. The preference for TL deposits is evident across all client groups with respect to different brackets of the amount deposited. In 2021, the FX deposit preference of households remained broadly flat. In this period, the demand of households for non-deposit TL financial assets such as mutual funds is also noteworthy.

The indebtedness ratio of the corporate sector (Financial Debt/GDP), which increased during the pandemic, returned back to pre-pandemic levels. This is driven by the rebound in economic activity and the deceleration in TL commercial loan growth compared to last year. FX financial debt of the corporate sector rose to some extent on the back of loans provided from abroad, while net FX position improved further. Firms obtained considerable financing from abroad in 2021 and renewed external debts by 130%. Short-term net FX position remained favorable owing to the rise in short-term FX assets. The uptrend in commercial deposits that have a large share in the corporate sector financial assets has continued. TL commercial deposits grew on the back of cash inflows led by strong economic activity following the re-opening. On the other hand, the revival of tourism activities in summer months, the increase in export revenues and the flow of cash into the system thanks to non-resident citizens' visits to Turkey played a significant role in the growth of FX deposits.

Strong economic activity has been mirrored favorably in the corporate sector's profitability, liquidity and debt service indicators. The cash ratio of corporates quoted on BIST rose due to the increase in liquid assets kept with precautionary motives. This is considered positive with regard to keeping corporate sector firms prepared against risks stemming from new variants and uncertainties regarding

global financial markets. Moreover, the profitability and debt service capacities of firms exceeded pre-pandemic levels thanks to the strong domestic and external demand, with profitability showing a widespread improvement across BIST firms. This is expected to reflect positively on the asset quality of the banking sector.

While the slowdown in loan growth in 2021 was mainly driven by commercial loans, retail loan growth has remained strong. The recent revisions in the monetary policy stance since September 2021 have started a recovery in the commercial loan growth. The buoyancy in retail loans is not only associated with the strong deferred demand becoming active with the full re-opening as of the end of May 2021, but also with the motivation of banks to extend this type of loan. The effects of the macroprudential framework, strengthened to pull retail loans onto a mild growth path, are monitored. Containing retail loan growth to moderate levels is essential for limiting the risks pertaining to the external balance and inflation outlook.

The asset quality of the banking sector remains strong, well above the expectations made in the early pandemic. The non-performing loan (NPL) ratio remained relatively flat on the back of strong economic activity and the loan classification flexibility, which was in effect until the end of September 2021. NPL collections were strong compared to previous years. Although NPL additions have started to be seen with the gradual removal of the loan classification flexibility as of the end of September 2021, net effect is expected to be limited. Additionally, banks' prudent loan provisioning during the pandemic will limit the pressure on banks' profitability driven by additional NPLs that may occur following the removal of the loan classification flexibility.

The banking sector has strong liquidity buffers to manage the funding and liquidity risks. The rise in banks' total and FX liquid assets continues to support the liquidity outlook in the sector. The sector's total and FX liquidity coverage ratios are close to their historically high levels. Loans are funded with deposits which are stable funding instrument. With the deceleration of loan growth in 2021, the loan-to-deposit ratio dropped to the lowest level of the recent period. The large share of FX in deposits and the firms' weak FX loan demand reduced the external financing need of banks, and the external debt rollover ratio stood at 93%. The syndicated loan rollover ratio of banks was above 100% in 2021 while there was an improvement in syndicated loan interest rates for the rollovers made in the second half of the year. The FX liquid assets of the banking sector are sufficient to cover its short-term FX-denominated external debt. The banking sector's strong ability to access international financing sources as well as its liquidity buffers indicate that possible funding and liquidity-driven risks will continue to be manageable in the upcoming period.

The banking sector has a strong balance sheet structure against the TL and FX interest rate risk. In the current Report period, the maturity mismatch in the sector continued to decline. The maturity mismatch between the sector's assets and liabilities decreased to a limited extent while the share of floating-rate loans and securities in the balance sheet increased. The ratio of the possible loss under the related interest rate shock scenario to the regulatory capital remains below the legal limit (20% of capital) across all banks. On the other hand, the sector, which started to have FX liquidity surplus as of the last quarter of 2020, maintained this trend throughout 2021.

The profitability of the banking sector has been recovering since the second half of 2021, after declining in 2020 and in the first half of 2021 when the adverse effects of the pandemic became evident. The key factor behind the improvement in profitability has been the increase in net interest income driven by the repricing of loans and moderate course of deposit rates. On the other hand, the effect of the moderate course in NPL additions and the decrease in loan provisioning expenses following the reversals of provisions also support profitability. The improvement in the sector's profitability props up capital adequacy through the equities channel.

The banking sector maintains its strong capital adequacy outlook, and its capital adequacy ratios remain above legal limits. Banks in Turkey have additional capital above regulatory capital buffers. Banks' regulatory capital is composed of items with high loss coverage capacity. Banks' current capital stock is adequate to cover possible losses.