I. Overview

Global financial conditions and the tight monetary policies implemented by advanced country central banks continue to weigh on global growth. Key economic indicators suggest that the US economic growth outlook diverges favorably from that of the euro area, one of Türkiye's main trading partners. Uncertainty surrounding rate cuts by central banks of advanced economies, particularly the US, and the developments regarding global risk appetite cause portfolio inflows into emerging economies to be volatile.

Domestic demand's contribution to annual growth has declined, but domestic demand remains resilient. While the contribution of consumption to growth declined, that of net exports increased. The current account deficit narrowed thanks to the rebalancing trend in domestic demand and improved expectations. Recently, the share of long-term borrowing instruments and portfolio flows in financing the current account deficit has been on the rise. On the public finances front, the impact of earthquake-related expenses persists and the budget deficit's share in GDP has increased. In the last reporting period, the annual inflation recorded an increase, mainly in the services group. The Turkish lira's relatively stable outlook, the tightening of financial conditions, and the rebalancing of domestic demand will result in a slowdown in price increases in the upcoming period.

Turkish lira commercial loan growth, which gained momentum in February and March, slowed down amid the policy rate hike and macroprudential measures, while FX loan growth picked up. Turkish lira commercial loan growth slowed as of April on the back of the increase to the policy rate, as well as the reduction of the credit growth limit and implementation of reserve requirement. Weaker exchange rate depreciation expectations, lower exchange rate volatility, and the widening of the expected cost differential between Turkish lira commercial loan and FX loan costs led to increased demand for FX borrowing. The increase in Turkish lira liquidity in the system led to a decline in banks' currency swap transactions against the Turkish lira. This, in turn, resulted in an increase in FX liquidity that banks could use for FX loans and supported FX loans through the supply channel. In light of this, FX loans, which have been declining since 2018, are on an upward trend in 2024 on the back of supply and demand conditions. An amendment to the regulation in May introduced a monthly growth limit for FX loans, and the implementation of reserve requirements in the event that the limit is exceeded. The status of FX borrowing is closely monitored with regard to the FX income of borrowers and the impact of credit growth on domestic demand and foreign trade.

Macroprudential measures introduced for retail loans and the policy rate hike weakened consumer loan growth. In the first quarter of 2024, accelerated loan demand amid heightened uncertainty perceptions led to a rise in consumer loan growth driven by credit cards and general-purpose consumer loans. Following the macroprudential measures for these loans and the rises in maximum credit card interest rates, growth in personal credit cards and general-purpose consumer loans decelerated in April, falling below the growth rates of the last two quarters. The utilization of credit card cash advances is also declining. Slower retail loan growth will contribute positively to the rebalancing of consumption spending and the current account balance. Housing and vehicle loans remain weak owing to the measures in place related to these loans.

The retail NPL ratio deteriorated slightly following the tightening in financial conditions. Despite the increase in the retail NPL ratio, the banking sector's NPL ratio remained flat due to the decline in the commercial NPL ratio. Nevertheless, NPL ratios maintained their low level below the historical average across all loan segments. While Stage 2 loan ratios for commercial loans continued to decline, the same ratio for retail loans was up due to overdue debt. The developments on retail loan quality are closely monitored.

The absence of a notable deterioration in economic activity and employment outlook in this period of tighter financial conditions stabilizes the credit quality outlook for households. Meanwhile, rolling over short-term debts such as credit cards, cash advances, and overdraft accounts at high interest rates may increase the debt service burden. Therefore, the rebalancing of household debt, income and consumption patterns will be important in the upcoming period. The high provisions that banks had prudently kept in the previous period serve as an effective buffer against asset quality-driven deterioration and support banks' balance sheets.

Firms' indebtedness is on the decline, profitability indicators hover above the historical average, and liquidity outlook remains strong. While rising Turkish lira loan costs have increased firms' propensity

to borrow in FX, the corporate sector's financial leverage ratio and FX open position remain at low levels. Despite the increase in FX loan debt, firms' export revenues and their capacity to cover their FX debt keep improving. With the introduction of regulatory limits on FX loan growth, no significant deterioration is envisaged in the FX risk outlook of firms.

While the low level of household indebtedness as a ratio of GDP continues, the share of personal credit card debt has been increasing. Indicators for per capita debt and debt-to-income ratio continued to decline in other retail loans excluding personal credit cards. In addition to the tightening in financial conditions, average maturities of retail loans that have become shorter may lead to an increase in the credit risk of households, particularly the ones with debt/income mismatch. In households' financial asset composition, the weights of TL-denominated assets have been increasing, while the share of FX-protected deposits has been decreasing. Households continue to diversify their savings by increasing their investments in alternative TL-denominated financial assets such as equities, mutual funds and pension plans.

Tight monetary policy stance and the accommodative macroprudential framework have been accelerating the transition of deposits to the Turkish lira, while banks' FX and TL liquidity has increased. Following the policy rate hike and macroprudential measures introduced, TL deposit rates have risen rapidly since the second half of March. As of the first week of April, in addition to shifts from FX deposits and FX-protected deposits to TL deposits, portfolio inflows from abroad and swap transactions with non-residents have increased rapidly. These developments have led to excess TL liquidity in the financial system, while banks' deposit auctions with the CBRT have increased and currency swap transactions have decreased. The excess TL liquidity in the system has been sterilized by additional reserve requirement steps.

The current policy mix has improved the risk perception towards Türkiye and lowered the risk premium. On the back of the improvement in the country risk premium, banks' external borrowing costs have decreased, while external debt rollover ratios have increased owing to additional new funding, particularly medium- and long-term instruments. While the cost of syndicated loan renewals decreased by 100 bp compared to the previous period, the renewal rate stood above 120%. Banks' long-term Eurobond and subordinated debt issuances have been robust. In the period until May 2024, banks secured new funding through subordinated debt instruments at the amount of USD 4.1 billion.

Effective management of balance sheets to address interest rate risk helped the impact of the policy rate hikes on banks' balance sheets to remain limited. The increase in floating rate and short-term loans as well as the extended maturities of deposits contributed to the management of the interest rate risk stemming from the re-pricing channel. Possible losses due to revaluation in the price of securities were offset owing to the classification of these securities mostly with regard to their amortized values. Accordingly, it is assessed that banks have a risk outlook and balance sheet structure aligned with regulatory thresholds against an upside interest rate shock.

Despite the fall in the net interest margin in the last two quarters, banks' profitability has stabilized to some extent thanks to loan growth as well as the contributions of fees and commissions income. Due to the effects of policy rate increases on the pricing of credits and deposits accompanied by the high cost of RR until February led to a decline in returns on equity. The sector's profitability outlook is expected to improve as of the second quarter on the back of the factors such as reduced re-pricing effect of policy rate increases on balance sheets, the sustained performance of fees and commissions income and the limited rise in the cost of risk.

The banking sector's capital adequacy hovers notably above the legal limits. The subordinated debt issuances of banks strengthened capital buffers. In addition to excess capital, prudent provisioning underpins the coverage capacity of capital for possible losses. It is expected that the contained rise in risk-weighted assets in the upcoming period by the decelerating loan growth coupled with the improved profitability performance, the positive outlook for banks' capital adequacy ratios will remain intact.