I. Overview

The Russia-Ukraine conflict and China's lockdown measures against increasing number of cases pose downside risks to global economic activity. High inflation persists on a global scale due to increasing uncertainties regarding global food security, the high level of commodity prices and transportation costs. Geopolitical tensions, international sanctions and protectionist trade policies increase the uncertainties over commodity prices. Expectations on monetary policy steps of major central banks, as well as geopolitical developments, cause fluctuations in portfolio flows towards emerging economies. The global financial indebtedness, which increased significantly during the pandemic, began to decrease from the first quarter of 2021.

Having remained robust throughout 2021 with the contribution of domestic and external demand, economic activity also maintained this course in the first quarter of 2022. In the last quarter of 2021, the main determinant of growth was final domestic demand led by private consumption, and the contribution of net exports to growth continued.

The household indebtedness has been on a decline since the third quarter of 2020 on the back of robust economic activity, and is considerably below those of the EME average. Meanwhile, the fact that household borrowing is increasingly made by fixed-income earners support financial stability by providing predictable cash flows. The increasing trend in household financial assets continues in tandem with the strong growth observed in deposits and non-deposit financial assets. In this period, the demand of households for non-deposit TL financial assets such as equities and mutual funds is also noteworthy. These trends stand out with their features that reinforce financial deepening.

The corporate sector's ratio of financial liabilities to financial assets is still moderate, while liquidity, profitability and debt payment indicators of corporates continue to improve at a faster rate. The increase in costs caused by higher commodity and energy prices besides rising exchange rates has driven up financing needs for working capital and consequently financial liabilities of corporates. Firm assets, on the other hand, have been positively affected by the increase in exchange rates, while increased turnover amid strong economic activity has bolstered assets. The corporate sector continued to decrease its domestic FX loans and maintained its tendency to reduce its FX risk, while the share of TL in total loans continued to increase. Corporates' access to funds from abroad remained strong, and external debts have been rolled over at more than 100%. Exchange rate developments, rising production costs and inflationary pressures in the last quarter of 2021 caused corporates to hold more liquid assets, but brought their profitability down moderately. In the first quarter of 2022, liquid assets and cash ratios were slightly down due to a lower exchange rate, but corporate sector profitability increased thanks to strong economic activity, buoyant exports and inventory revaluations. After rising on the back of the exchange rate-driven increase in financing expenses in the last quarter of 2021, the financial expense coverage ratio of corporates improved in the first quarter of 2022 with strong profitability.

The accelerating loan growth in 2022 is mainly driven by TL commercial loans. Retail loan growth, on the other hand, follows a more moderate course compared to commercial loans thanks to macroprudential instruments introduced in 2021 and higher interest rates. Also, the inflation adjusted loan utilizations indicate that commercial loans have grown faster than their long-term trend while retail loans have grown at a pace similar to their long-term trend. Although factors such as increasing working capital needs due to rising commodity prices and increase in stock financing are also considered to be effective in TL commercial loan growth; it is of great importance that loans meet economic activity in a way that supports investment, exports and potential growth. The additional macroprudential measures taken are also expected to provide a supportive contribution in this direction.

The effects of the strengthened macroprudential framework to ensure that corporate loans meet economic activity in line with their intended purposes are closely monitored. TL and long term loan allocations, made in line with the target of sustainable price stability, and in a way that support the current account balance, and increase the efficiency and the potential production, are important elements of the liraization strategy decisively pursued by the CBRT. With the announcement of 23 April 2022, the required reserve ratios for TL loans were increased in proportion to the growth in TL loans extended to companies excluding agricultural loans, SME loans, export and investment loans. In addition, with the announcement

on 28 April 2022, the BRSA increased the risk weights of TL commercial loans. Long-term investments, efficient production areas and import substitution activities will be encouraged with the advance loans against investment commitment, which will be financed from the CBRT resources, and it will be ensured that the loans are used in accordance with their purpose without harming price stability and financial stability.

The asset quality outlook for the banking sector remains strong. The total NPL ratio decreased due to the rapid increase in TL lending and the exchange rate-driven growth of loan balances, while the expiry of the loan classification flexibility had limited impact on NPL ratios. The ratio of NPL collections to NPL additions remains strong. Migrations to Stage 2 loans and NPLs are less likely than in the pre-pandemic period, and banks' continued prudence for provisioning limits asset-quality risks. A significant portion of Stage 2 loans consists of loans that are not in default, and banks monitor these prudently restructured loans under the Stage 2 category.

The favorable outlook in banks' short and long-term liquidity indicators continues, and the sector has strong liquidity buffers against liquidity shocks. In addition to the already high FX liquidity of banks, the strong increase in TL liquid assets on the back of the contribution of the KKM (FX-protected deposit) scheme further supported the sector's general liquidity. In this period, banks' external borrowing costs increased due to the tightening in global financial conditions and geopolitical developments. Despite rising costs, more than 100% of due syndicated loans have been renewed implying that banks maintain their ability to access foreign funding. While banks have strong FX liquidity buffers against liquidity shocks, short-term FX external debt is at a level that can be covered by FX liquid assets including FX swap receivables.

The maturity mismatch between the sector's TL-denominated and FX-denominated assets and liabilities on banks' balance sheets has significantly improved. With the contribution of the FX-protected deposit instrument, the average maturity of liabilities has extended, maturities of fixed-rate loans have become shorter, and the share of variable-rate loans and securities in assets has increased which altogether positively affect the maturity mismatch between interest-sensitive assets and liabilities. In the current report period, under an interest rate shock scenario, there are no banks that are likely to incur an equity loss more than 10%. Meanwhile, the banking sector's FX long position continues to provide protection against exchange rate shocks. With the contribution of FX-protected deposit instruments to the liraization of balance sheets, the number of banks holding an FX long position increased.

The profitability of the banking sector, which has been recovering since the second half of 2021, continued to increase in the last two quarters in a stronger manner across the sector. In the first quarter of 2022, the sector's profitability points to a return on equity over 30% on an annual basis. The high net interest income in the first quarter of the year and the decrease in loan provision costs compared to the previous period played an important role in the increase in profitability. The rise in net interest income, on the other hand, was driven by the increase in core margin, loan growth stemming from TL commercial loans, and the contribution of CPI-indexed securities. The improvement in the sector's profitability supports capital adequacy via the equity channel.

Banks maintain their strong capital structures against possible risks. The capital adequacy ratios (CAR) of the banking sector, which are currently above legal limits, remain so even when adjusted for regulatory effects. Turkish banks have additional capital above regulatory capital buffers. Capital buffers are important for banks to meet unexpected losses and to provide the financing needed by the economy in times of stress.