Credit growth in Turkey: drivers and challenges

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1. Introduction

After witnessing the most severe crisis of its recent history in 2001, the Turkish economy has rapidly recovered and is now among the fastest growing economies in the world. During the recovery period, inflation rate has declined sharply to single-digit levels for the first time in three decades. This positive trend is a consequence of tight monetary and fiscal policies together with a comprehensive agenda of institutional reforms.

During the last five years, the Turkish financial system has exhibited significant structural changes, fundamentally altering the nature of the risks that the system encounters (CBRT, 2005). Yet, credit risk remains at the top of the list, and its implications on both the macro economy and the financial system's stability need to be closely monitored. This paper aims to discuss the main drivers of the recent credit boom in Turkey and the potential problems and challenges associated with it.

2. Fiscal Consolidation and Credit Supply

The basic problem in Turkey during the last fifteen years has been the relatively large stock of public debt compared with the small deposit base in the banking system. The financial crisis of February 2001 added 30 percentage points to the already high public debt to GDP ratio (Figure 1). The following two years witnessed a collapse in credit, despite a temporary rise in deposits, which was mainly due to high levels of deposit-dollarization and the sharp depreciation of the Turkish lira in 2001.

The credit to GDP ratio, however, has recovered strongly, by a total of 8 percentage points, after 2003. The most important driver of this rapid credit growth observed during the last two and a half years has been fiscal consolidation. During this period, the debt to GDP ratio fell by around 12 percentage points, while the deposit to GDP ratio stayed roughly the same. Therefore, the banks have replaced government securities with predominantly private credit on their balance sheets.

Between the end of 2002 and mid-2005, total credit extended by Turkish banks tripled in US dollar terms (Table 1). More than 90% of the total credit is extended to the private sector, while the rest is used by state economic enterprises and other public institutions. The rapid growth in private sector credit growth is also confirmed in real terms. During the end-2002-June 2005 period, annual average real credit growth was 19.1%. As of June 2005, the year on year increase of the balance is 27.4% in real terms.

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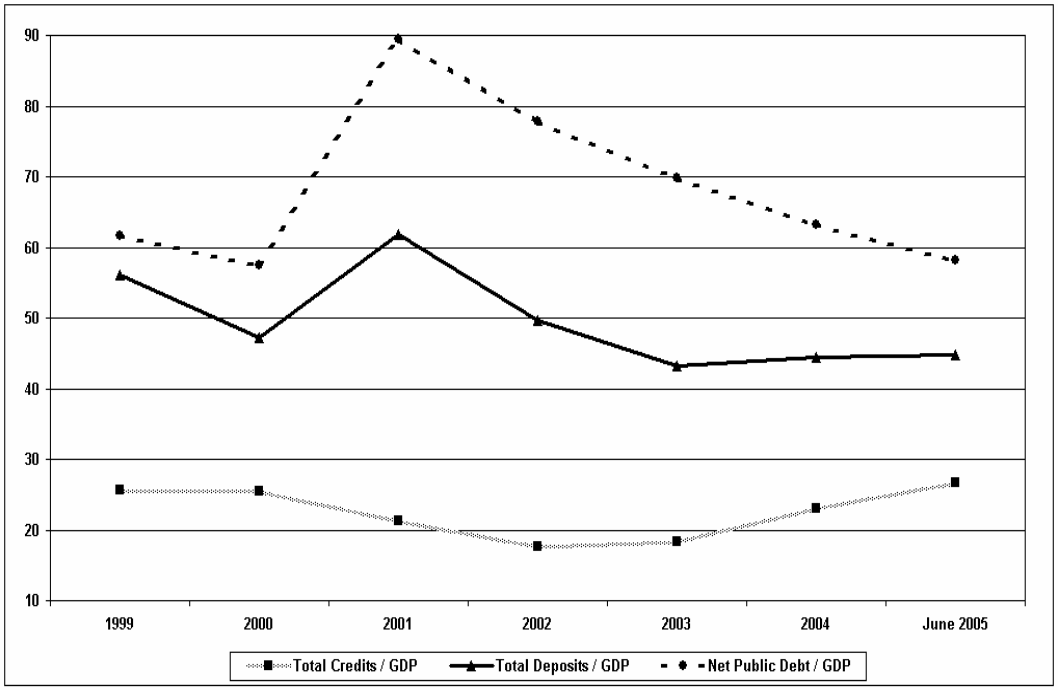
Figure 1

Credit, Deposits and Net Public Debt

As a percentage of GDP



Sources: CBRT and Treasury.

Table 1

Main Developments in Bank Lending

	2002	2003	2004	June 2005
Total Credit (Billions of US Dollars, Net)	30	47	74	91
Private Sector Credit (Billions of US Dollars, Net)	28	44	69	86
Private Sector Credit to Total Credit (%)	94.7	92.8	93.1	94.7
Private Sector Credit to GDP Ratio (%)	16.7	17.1	21.5	25.2
Real Annual Private Credit Growth (CPI 94=100)	–0.5	11.9	37.7	27.4

Source: CBRT.

The ratio of credit extended to the private sector to GDP shows an increasing trend after the end of 2003. The ratio is still low compared to those of the other central and eastern European (CEE) countries (Table 2). As a result of decreasing public sector borrowing requirements and falling interest rates, the loans to GDP ratio is expected to recover further in the coming years.

Table 2

Private Sector Credit to GDP in Eastern Europe

	2000	2001	2002	2003	2004
Ukraine	11.1	12.9	17.5	24.3	24.9
Latvia	17.2	21.3	26.5	34.6	45.4
Albania	4.6	5.9	7.3	8.4	9.9
Bulgaria	12.6	14.9	19.6	27.4	36.7
Lithuania	11.4	11.4	14.0	20.4	25.6
Russia	13.3	16.5	17.7	21.0	24.5
Belarus	8.8	8.2	8.9	11.9	13.9
Estonia	23.9	25.2	26.9	33.1	43.3
Moldova	12.6	14.7	17.1	20.5	21.3
Hungary	32.4	33.7	35.8	43.0	46.0
Croatia	37.2	42.2	50.7	54.2	57.5
Romania	7.2	7.7	8.3	9.5	10.0
Slovenia	36.4	38.4	38.9	41.5	46.3
Bosnia	43.3	30.1	36.3	41.4	45.2
Macedonia	17.8	17.6	17.7	19.5	23.6
Poland	27.3	27.9	28.4	29.0	27.7
The Czech Republic	47.9	39.6	29.8	30.7	32.2
The Slovak Republic	51.3	37.6	39.6	31.6	30.6
Turkey	24.4	20.1	16.7	17.1	21.5
Sample Average	23.2	22.4	24.1	27.3	30.8

Sources: Otker_Robe et al. (2005) and CBRT.

Likewise, many developing countries around the world have been experiencing a rapid expansion of bank credit to the private sector in recent years. In fact, Turkey is considered a “late riser”. There are several reasons for the credit growth in these countries. Macroeconomic stabilization, robust growth, a strong economic outlook, regained confidence, bank restructuring, external borrowing and increased foreign participation are some of the reasons typically cited.

In Turkey, deposits still constitute the main source of funding (Table 3). Despite the decline of their share, deposits are still an important source of funding. As of June 2005, the share of deposits declined to 60.7 percent from 64.9 percent in 2002. The significant increase in syndication and securitization credits plays an important role in this development.

The pace of increase in deposits is slower compared to that of gross loans. As of June 2005, the gross loans to deposit ratio increased from 43.1 percent to 62.9 percent since 2002. The rise in the loans to deposit ratio is a positive indication that banks have been regaining their main intermediation function after many years of the public sector crowding-out private lending.

Table 3

Source of Funds

	2002	2003	2004	June 05
Deposits (Billions of US Dollars)	84	111	142	153
Deposits/Liabilities (%)	64.9	62.2	62.3	60.7
Gross Loans/Total Deposits Ratio (%)	43.1	48.2	55.3	62.9
Securitization Credits (Billions of US Dollars)	2	3	4	7
Syndication Credits (Billions of US Dollars)	2	3	6	6

Source: CBRT.

State owned banks

State banks were founded for development and supportive purposes, especially for agriculture and small and medium-sized enterprises (SMEs). However, over time they started to create major distortions in the sector because of their large size and political interference in their operations. State banks incurred losses from their "duty" of lending at below-market interest rates.

These losses accumulated and reached 30 percent of state banks' total assets in 1999, increasing the liquidity needs of these banks. They began to meet their liquidity requirements through short-term financing, offering high deposit rates compared to private banks by distorting the market. This syndrome culminated and exploded in the 2001 crisis.

Today, the situation for state banks has changed. After the crisis, through a bank restructuring process, the Treasury issued "non-cash" government securities to clear its liabilities with the banks. The losses due to subsidized loans now have to be shown and financed through the government budget that is approved by the Parliament. Otherwise, they must operate under fully commercial principles. Moreover, the government aims to privatize all state owned banks. The privatization effort is expected to result in financial consolidation and/or foreign bank participation.

Reduced taxes on financial intermediation

The extensive use of transaction taxes in Turkey was a major obstacle to the development of a more diversified financial system. Taxes on financial intermediation, the Banking Insurance and Transaction Tax (BITT), the Resource Utilization Support Fund (RUSF), and stamp duties used to increase spreads significantly. The government's weak fiscal position had made it difficult to abolish these taxes, which discouraged bank-financed investments and encouraged offshore operations.

However, taxes on financial intermediation, which were a significant restriction on extending credit, were either abolished or decreased. For instance, the taxes levied on loans, like banking and insurance transaction tax and stamp duties and fees, are no longer applied for export credits. While the RUSF rate for consumer loans is 15 percent, the rate for corporate loans has recently been reduced to zero.

Consolidation and scale effects

The information gathered from the experiences of other countries emphasizes that there is a significant financial consolidation process taking place in developed and developing countries and a tendency towards universal banking and oligopolistic structures. Moreover, there is still not a consensus on the effects of financial consolidation. It is mostly accepted that financial consolidation has positive effects on effectiveness, efficiency and financial stability, and adverse effects on competition.

Table 4

Financial Consolidation

	1999	2000	2001	2002	2003	2004	June 05
Concentration[1]	46.3	47.8	54.4	58.4	60.3	59.5	60.8
Number of Banks	81	79	61	54	50	48	48

[1] Bank concentration is defined as the five largest banks' share of the banking sector's assets.

Source: CBRT.

The Turkish banking sector has experienced a significant financial consolidation process since the crisis. As seen in Table 4, the number of banks in the Turkish banking system has declined since the implementation of the new bank restructuring program after the 2000-01 crisis. In 1999, the number of banks was 81, and in 2004 it dropped to 48. As of June 2005, the number of banks is still 48. The concentration ratio confirms the continuation of the financial consolidation process. As seen in Table 4, the concentration ratio increased to 60.8 percent in June 2005, from 46.3 in 1999.

Foreign participation

With the successful implementation of the economic program, increased confidence, political stability and EU accession prospects, foreign bank participation in the Turkish banking system has become a reality after many years.

Table 5

Foreign Bank Participation

	2002	2003	2004	July 2005
Share of Foreign Banks in the Sector (%)	3.6	3.2	3.9	13.6

Source: CBRT.

Foreign bank participation doubled during the credit boom period. The aggressive credit policies of new arrival foreign banks also positively affected credit growth. As seen in Table 5, the share of foreign banks in the Turkish banking system increased to 13.6 percent in July 2005, from 3.9 in 2004. This increased share also confirms foreign investors' increased confidence in the Turkish economy and may add to the pace of private credit expansion.

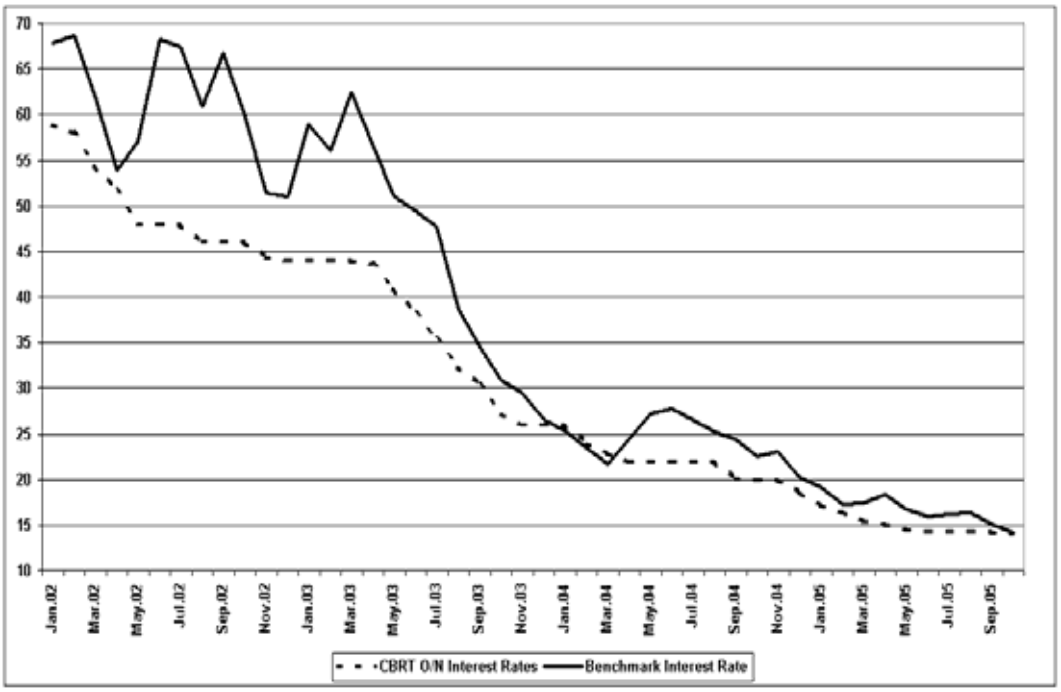
3. Disinflation and Credit Demand

With the successful implementation of a mix of prudent monetary and fiscal policies, bank restructuring program and structural reforms, economic and financial stability were strengthened. These developments also contributed to credit expansion, mostly from the demand side, due to the remarkable fall in inflation and the associated reduction in nominal as well as real interest rates (Figure 2).

Right after the crisis in February 2001, the instrumental independence of the Central Bank was approved by the Parliament, and the primary goal of the Bank was set as maintaining price stability. In that context, the Central Bank switched to the floating exchange rate regime and declared its new policy framework as "implicit inflation targeting".

Figure 2

CBRT Policy Rate and Benchmark Interest Rate on Government Securities



Source: CBRT.

In 2004, yearly change in the consumer price index decreased to single digits after more than 30 years, and most of the public believes that the ongoing recovery in inflation is not temporary. Inflation expectations improved significantly, and both consumer and corporate confidence were regained. As a result of these improvements, both investment and consumption spending that were deferred following the crisis started picking up and have manifested themselves in credit demand to the banking system.

EU prospects and convergence expectations also played an important role in the pace of credit demand growth. Moreover, political stability, as well as the new three-year economic program announced at the end of 2004, with sound fundamentals and endorsement by both the EU[2] and the Bretton Woods institutions,[3] helped reduce the risk premia on all securities issued in Turkey.

Demand by types of loans

A key way of looking at credit growth is by the type of borrower, in particular, the distinction between households and companies (Table 6). There has been a substantial increase in credit extended to the household sector. In an environment of increasing certainty, decreasing domestic and foreign funding costs and inflation levels, banks began to restructure their assets, which has supported this growth in credit demand. Furthermore, deferred consumption expenditure, especially on durable goods, has been realized and has contributed to rapid credit growth.

[2] Pre-Accession Economic Program, 2004.

[3] Moghadam et al. (2005).

Table 6

Real Credit Growth By Borrowers

Yearly Change, %[2]

	2002	2003	2004	June 2005
Households (Billions of US Dollars)	4	10	20	26
Corporate Sector (Billions of US Dollars)	24	34	49	60
Corporate Sector[1] to Private Sector Credit Ratio (%)	85.7	78.1	71.4	69.6
Real Household Credit Growth (CPI 1994=100)	2.9	72.0	79.5	54.4
Real Corporate Sector Credit Growth (CPI 1994=100)	–1.1	1.9	25.9	18.3

[1] Corporate sector = private credit - consumer loans - credit cards. [2] All items are calculated in net terms.

Source: CBRT.

The increase in corporate credit has been slower compared to household loans. The share of household loans surged to 30 percent of total credit extended to the private sector in July 2005, from 14 percent in 2002.

When consumer credit is analyzed based on subcategories, it is seen that in 2004, the fastest increase was in automobile loans. This is partly due to the tax incentive on new car purchases that was eliminated as of 2005. After May 2005, housing loans gained momentum and their share exceeded that of automobile loans. While all types of consumer loans increased in 2005, housing loans increased most. It is expected that housing loans will become more widespread and that their maturity will further extend. Apart from this development, with the introduction of the legal framework for the mortgage system in 2006, the construction sector and its subsidiary industries are expected to grow further.

Demand by currency[4]

Due to high degrees of asset and liability dollarization, the currency denomination of loans is another key element in understanding the nature of credit growth in Turkey. Borrowing in foreign currency, which is related to currency risk, has generally been driven by lower foreign interest rates compared to domestic rates and the appreciation of domestic currency. Since customers cannot hedge against currency risk, exchange rate risk may translate into sizeable credit risk for the banking sector.

As for currency composition, the share of YTL denominated loans has exceeded the share of FX denominated ones since 2003 (Table 7). The main reasons behind this improvement in balance sheet are reverse currency substitution and the preference of borrowers due to the explicit currency risk associated with the floating exchange rate regime. Therefore, real credit growth stemmed mainly from YTL denominated credits. Since 2002, FX denominated credit growth has increased by only 2 percent on average. However, YTL denominated credits have increased enormously: 35.5 percent on average.

[4] We mainly focus on bank credit to the private sector, excluding bank credit extended to the public sector and credit extended by non-bank financial institutions. However, currency and maturity composition of bank credit to the private sector is not available, so total credit extended by the banking sector is used in this analysis.

Table 7

Credit Growth By Currency

	2002	2003	2004	June 2005
Real Credit Growth (CPI 94=100)	–0.6	14.2	37.2	25.8
YTL Denominated Credit (Billions of US Dollars, Net)	12	26	48	62
YTL Denominated Credit to Total Credit	41.1	54.6	64.8	68.1
YTL Denominated Credit Growth (CPI 94=100)	–16.3	51.8	62.7	43.9
FX Denominated Credit (Billions of US Dollars, Net)	18	22	26	29
FX Denominated Credit to Total Credit	58.9	45.4	35.2	31.9
FX Denominated Credit Growth (CPI 94=100)	14.3	–12.0	6.5	–0.9

Source: CBRT.

4. Challenges for Financial Stability

Experience in Eastern Asia and elsewhere has shown that macroeconomic instability and deterioration of loan quality may be triggered by excessively rapid credit growth. Although Turkey is far from that point, the rapid expansion of loans may nevertheless add to the current account deficit and inflationary pressures. However, perceived risk of loans may be underestimated by the banks. During such lending boom periods, the loan quality typically deteriorates due to optimistic risk assessments based on the current strong economy and the higher value of collateral. From this perspective, this section examines the risks and opportunities produced by rapid credit growth in the Turkish banking system, and its macroeconomic effects.

Changing nature of risks

The banking sector, whose balance sheet has improved significantly since the 2001 crisis, is still highly exposed to government securities despite the decline of its share in the balance sheet. As of June 2005, the ratio of the net debt stock of the government to GDP declined to 58%. Furthermore, the budget deficit of the general government is expected to be around 3 percent of GDP in 2005 and to improve further in 2006-2008. Therefore, fiscal dominance and the associated risks on the Turkish financial system are expected to decline further in the future.

Nevertheless the banking sector is now much more resilient against currency risk. The banking sector's net FX short position to capital ratio is close to balanced despite the observed appreciation of YTL, reverse currency substitution and higher yields of YTL instruments. This can mainly be attributed to the floating exchange rate regime.

Regarding credit risk, risks stemming from household loans are much less than those from the corporate sector. The reason for this is the fact that consumer loans have the most diversified customer base and an adequate collateral structure (especially for automobile and housing loans), which is considered as a favorable condition for credit growth in this category.

In the real sector, the profitability of corporations has recovered, but a combination of short-term foreign currency debt and still limited equity capital would pose a risk. The corporate sector should learn to hedge their currency risk under the flexible exchange rate regime.

On the household side, despite presenting a decreasing trend, foreign currency assets are still considerable. The debt stock of households is expected to increase with the increase in consumer loans and enforcement of the mortgage law.

Maturity mismatch

The main new risk area for the Turkish banking system is the interest rate risk that stems from maturity mismatch and fixed rate consumer lending. In general, in emerging countries, the maturities of loans tend to be shorter than in developed countries, due to the lack of long-term domestic and foreign funding. This observation is true for Turkey as well (Table 8).

Table 8

Maturity Composition and Interest Rate Structure

As a Share of Total Credit, %

	2002	2003	2004	June 2005	Sample Average
0-12 Months	56.2	57.6	55.7	51.2	55
12-24 Months	17.3	14.1	17.9	21.6	18
Greater than 24 Months	26.5	28.3	26.4	27.2	27
Fixed Interest Rate Loans	70.2	82.3	86.2	90.4	82
Floating Interest Rate Loans	29.8	17.7	13.8	9.6	18

Source: CBRT.

Table 8 shows that the share of short-term loans is falling. Even though the majority of total loans are short-term (0-12 months), the share of short-term loans has decreased in 2005. The rise in the share of long-term loans has stemmed from consumer loans, the majority of which are longer than one year. However, depending on developments on the liability side, the increase in the maturity of loans could adversely affect the maturity mismatch problem and the liquidity risk of the Turkish banking system.

The majority of loans are extended at fixed interest rates. The share of fixed rate loans, which was 70.2 percent at the end of June 2002, increased to 91 percent as of June 2005, as a consequence of an enormous increase in consumer loans.[5] This shows that Turkish banks are becoming more vulnerable to unexpected interest rate increases. Within this framework, making new arrangements that allow floating rate consumer loans along with fixed rate ones and the use of derivative instruments would be beneficial for the sector to mitigate interest rate risk.

Non-performing loans

Even though non-performing loans (NPLs) are one of the main indicators of loan quality, they are a lagging indicator of banking system indicators. In Turkey, the NPL ratio has fallen since 2002 (Table 9) and is now at comparable levels to its peers (Figure 3). The aforementioned ratio decreased from 17.6 percent in 2002 to 5.4 percent in June 2005. The increase in the debt-servicing capacity of

[5] Article 10 of the Law on the Protection of Consumers (Law No: 4077), as amended by Law No: 4822, states that the aforementioned credit transaction cannot be changed against a consumer within the contract period. Consumers have the opportunity to close the loans they use prior to maturity.

The article regarding credit cards (No 10/A) states that if the minimum payment amount declared in the account summary is not paid at maturity, the consumer does not enter into an obligation under any name except for the default interest (the default interest rate cannot exceed the contract rate by more than 30 percent).

the borrowers, the effects of restructured loans under the "Istanbul Approach"[6] which was put into practice in the beginning of 2002, arrangements for enhancing effective risk management by banks and improvement in banks' risk perceptions are the major factors that contributed to the fall in NPL ratio.

The increased share of household NPLs in total NPLs stems mainly from the increase in non-performing credit cards. Starting from the end of 2002, this ratio increased continuously from 2.9 percent to 17 percent as of June 2005. Since there has been no significant change in the NPL ratio of consumer loans since the end of 2003, NPLs of credit cards are seen as the main factor for the increase in the aforementioned ratio. However, the draft law on credit and bank cards prepared by the Banking Regulation and Supervision Agency includes prudential measures on credit cards.

In addition to the decline in the NPLs to gross loans ratio, the provisions to NPL ratio has been increasing. As of June 2005, the ratio increased to 88.4 percent from 64.2 percent in 2002. This increase, however, indicates that banks are more robust against credit risk.

Table 9

Non-Performing Loans[1]

	2002	2003	2004	June 05
NPLs (Billions of US Dollars)	6	6	5	5
NPL Growth (CPI 1994=100)	–37.2	–30.1	–32.6	7.2
NPL Ratio[2] (%)	17.6	11.5	6.0	5.4
Household' NPL[3] to Total NPL (%)	2.9	2.8	11.4	17.0
NPL Ratio for Consumer Loans	3.1	1.1	0.7	0.6
NPL Ratio for Credit Cards	5.0	2.4	4.4	6.5
Provisions to NPL Ratio (%)	64.2	88.5	88.1	88.4

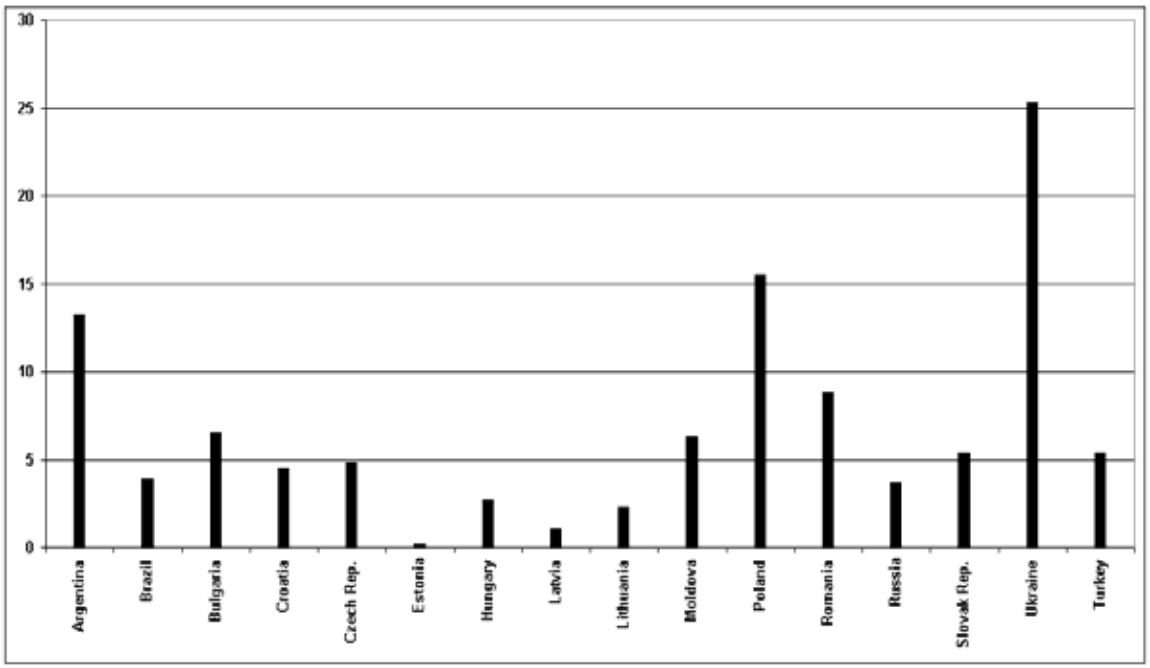
[1] NPLs include loans classified as substandard, doubtful and loss. These loans are recorded as non-performing receivables when they are 90 days past due. [2] NPL ratio is the ratio of non-performing loans to gross loans. [3] Non-performing loans (NPLs) of households include past due consumer credit and credit card obligations.

Source: CBRT.

[6] In order to rehabilitate the companies that became insolvent due to the twin crises in 2000-01, Law No: 4743 dated 31 January 2002 on "Restructuring of Debts to the Financial Sector and Amendments to be Made to in Some Acts" was issued. Based on the aforementioned Law, "The Regulation on Terms Related to the Acceptance and Application of the Framework Agreements for Financial Restructuring" was issued on 11 April 2004 by the BRSA, and "The Financial Restructuring Framework Agreement" by the Turkish Banks Association was approved by the BRSA on 4 June 2002.

Figure 3

NPL Ratio of Selected Countries[1]



Source: IMF International Global Financial Stability Report, September 2005

[1] Data for Argentina are for June 2005; for Bulgaria, Croatia, the Czech Republic, Latvia, Romania, Russia, Ukraine, March 2005; for Brazil, Poland, Hungary, the Slovak Republic and Lithuania, December 2004; for Estonia, April 2005 for Turkey, July 2005.

Connected lending

Throughout the 1990s, most private banks belonged to family-owned industrial groups. These banks lent to their owners and to related companies due to lax definitions of related parties and broad limits in relation to capital. Moreover, these private banks had heavily funded themselves from international markets with a shorter maturity and invested in longer maturities in either government securities or loans to insiders or related parties, making them vulnerable to all types of shocks.

Following the 2001 crisis, in order to reduce credit risk, significant measures were taken which included revised lending limits made parallel to EU regulations, a broader definition of credit to include forwards, option contracts, similar derivatives and shareholding interests, and regulation of connected lending complemented with limitations on partnership in non-financial subsidiaries. Also, the recapitalization operation helped achieve a transparent picture of the credit risk of the private sector. Group connections and hidden exposures were identified so that more effective measures could be taken. The new Banking Act of 2005 includes additional regulations in this area.

Today, connected lending is becoming less significant in the Turkish banking system. The strong and independent Banking Regulation and Supervision Agency (BRSA) monitors and controls connected lending. This monitoring increases the robustness of the banking system. However, it should be kept in mind that most of the banks taken over by SDIF (Savings Deposit Insurance Fund) have been banks extending connected lending. Further reductions in connected lending would improve the health of credit expansion.

Deposit insurance

The consensus among academics, policymakers and international institutions on the effects of deposit insurance is that it benefits overall financial stability, but also imposes costs because of the encouragement of risk taking and misallocation of resources. Also, due to reduced market discipline and moral hazard, there is an intensified need for government supervision. The case of deposit insurance in general, or a particular deposit insurance scheme, thus depends on the relative strengths of these two counteracting forces. The risk-taking effect outweighs the stability effect, at least for full deposit insurance.

Demirgüç-Kunt and Detragiache (1998) find that deposit insurance increases risk by weakening market discipline and encouraging excessive risk-taking. Similar results have been obtained in more recent studies. However, Gropp and Vesala (2001), among others, claim that deposit insurance decreases crisis risk by preventing bank runs due to depositor panic, and that this effect is stronger overall than the adverse moral hazard effects.

In line with those two opposing views, deposit insurance has been a two-way street for Turkey. The introduction of full guarantees to all savings deposits after the 1994 crisis, coupled with regulatory forbearance in the past, inevitably increased moral hazard problems and ended with the inclination of banks and depositors towards taking more risks, leading to the deterioration of market discipline.

The BRSA has recently announced its plans to gradually reduce deposit insurance to EU levels. As of July 2005, the full guarantee on deposits was eliminated. The government insures up to 50,000 YTL of savings deposits. In this way, limitation of deposit insurance will decrease risk by strengthening market discipline and discouraging excessive risk-taking.

5. Challenges for Monetary Policy

Both in the literature and in practice, it is generally accepted that rapid credit growth poses potential risks for macroeconomic stability. Increased opportunity to borrow eases liquidity constraints on households and firms, leading to higher consumption and investment. Given the short-run constraints, this upward shift in credit-financed domestic demand would tend to exert upward pressure on prices in assets, goods and labor markets. Concurrently, demand for foreign goods - both consumption and investment - will rise, causing deterioration in the trade balance. Thus, a rapid increase in credit can put upward pressure on prices in a fixed exchange rate regime, while it may reduce international competitiveness and deteriorate the current account with a nominal exchange rate appreciation under a float. This section will discuss the macroeconomic risks and opportunities of rapid credit growth experienced in Turkey.

In Turkey, GDP grew significantly during the rapid credit growth period (Table 10). In 2000, GDP was 185 billion US dollars. Just after the crisis, it declined to 124 billion US dollars with devaluation and decreased demand and investment. However, after the successful implementation of the economic program, political stability and EU expectations, GDP increased to 341 billion US dollars as of June 2005.

Table 10

Macroeconomic Indicators

	2000	2001	2002	2003	2004	June 2005
GDP (Billions of US Dollars)	185	124	170	258	321	341
Current Account Balance (Billions of US Dollars)	–10	3	–2	–8	–16	–13
Private Sector Credit (Billions of US Dollars, Net)	45	25	28	44	69	86
Exports f.o.b. (Billions of US Dollars)	31	34	40	51	67	37
Financial Account Balance (Billions of US Dollars)	10	–15	1	7	18	19
Consumer Price Index (Base Year 1994=100) (Yearly Average)	54.9	54.4	45.0	25.3	10.6	9.6
Ex Ante Real Interest Rates		11.8	21.1	11.1	10.7	8.4
Real Effective Exchange Rate (CPI 95=100)	147.6	116.3	125.4	140.6	143.2	159.5

Source: CBRT.

Current account balance deterioration is observed during the same period. The current account balance reached a record deficit level of 16 billion US dollars in 2004, from a surplus of 3 billion US dollars in 2001. As of June 2005, there was a deficit of 13 billion US dollars.

A positive development is the increasing export performance of the Turkish economy. Despite discussion about the negative effects of rapid credit growth on international competitiveness, the export performance of the Turkish economy has improved. As of 2004, exports were 67 billion US dollars. In June 2005, the first six-month performance was 37 billion US dollars, which increases the hopes of reaching 70 billion US dollars at the end of the year.

The increase in domestic demand attracts capital inflows, which indicates higher profit opportunities due to increased domestic demand. It is observed that there has been a huge capital inflow during the rapid credit growth period. As of June 2005, the financial account generated a 19 billion US dollar surplus. This surplus indicates and confirms that the capital inflow is due to increased economic activity and higher profit expectations of foreign capital.

Despite credit expansion, consumer price inflation is decreasing. Inflationary pressures still remain at a manageable level, despite the surge in oil prices.

Another positive development is decreasing ex ante (expected) interest rates. In the credit boom period, although domestic demand has shown an upward trend, ex ante interest rates have been following a decreasing trend. As of June 2005, ex ante real interest rates declined to 8.4 percent, from 21.1 in 2002.

Moreover, the real effective exchange rate (CPI 95=100) indicates a strong currency appreciation during the credit boom period. As of June 2005, the real effective exchange rate (REER) has climbed to 159.5, which is a record level compared to 116.3 in 2001.

6. Conclusions

The rapid credit growth in emerging market economies, especially in central and eastern European countries, during recent years leaves policymakers with a number of difficult questions in deciding how to respond to the credit boom. Finding ways to reduce the risk of rapid credit growth and to improve the management of this boom is one of the big policy challenges in today's new financial architecture.

The two main drivers of the recent credit boom observed in Turkey have been fiscal consolidation and disinflation. The fast pace of public debt reduction and improvements in the public sector borrowing requirement have helped the growth in credit supply, through increased availability of funds. The disinflation process, however, has stimulated credit demand. So far this is a healthy credit expansion pattern that stems from two healthy developments on the macro side.

As far as the microprudential aspects are concerned, the main challenge of the future will be the gradual implementation of Basel II in Turkey. On the macroeconomic side, the continuation of prudent policies with a careful eye on financial stability will be essential.

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