Short term fund inflows are harmful for banks

Sarp Kalkan
Economic Policy Analyst

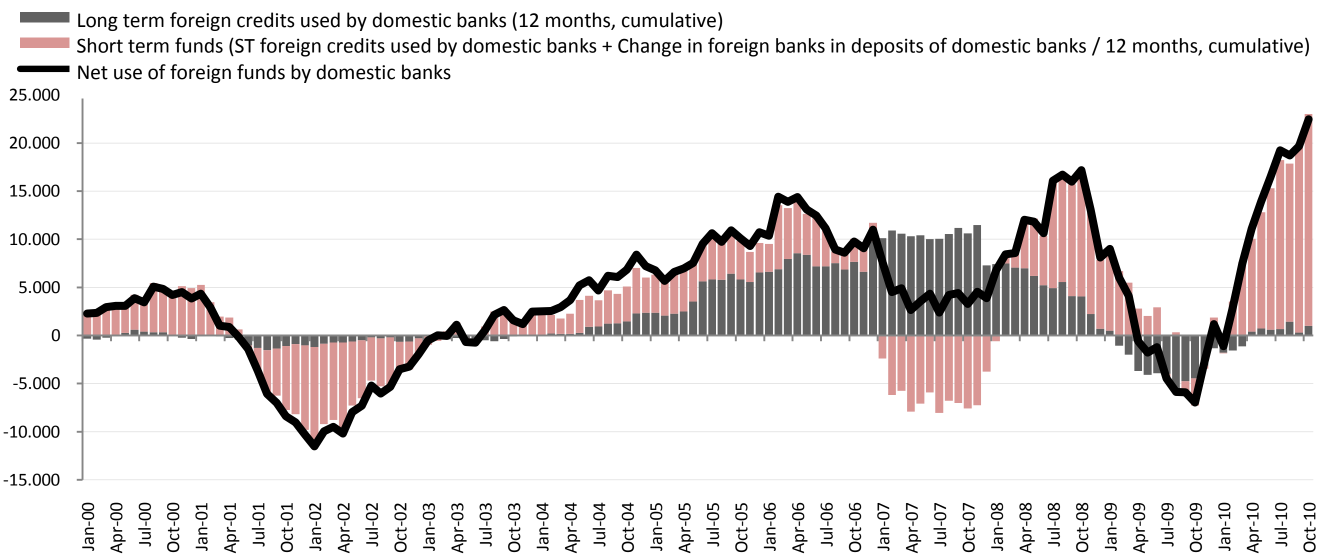
TEPAV Evaluation Note
December 2010

The monetary easing followed by the central banks in developed countries, FED to begin with, elevated short term fund flows towards developing countries including Turkey. Since the primary channel of entry for fund flows is the banking sector, the balance sheets of the sector became more risky. Buoyant domestic demand coupled with the hike in fund flows gave way to a rapid expansion in domestic credit volume. Total credit volume and consumer loan volume increased by 23 and 31 percent respectively over the first ten months of 2010.

Central Bank of Turkey, concerned about the expansion in domestic credit volume, put into effect a number of critical measures to mitigate the expansion which included increasing required reserve ratio and overnight borrowing rates. Lately in December 22nd, Minister Ali Babacan met with chief executives of 49 banks in Ankara. The meeting also hosted senior officials from the Central Bank, Treasury, Bank Supervision and Regulation Authority and Capital Markets Board who are responsible for financial stability and regulations. It was highlighted in press that during the meeting, Mr. Babacan stressed that credit expansion threatened financial stability and monetary policy and called banks for slowing down credit expansion.

Nonetheless it was not widely discussed why the economic administration is highly concerned about rapid credit expansion. The debates witnessed underlined that expansion of domestic credit volume would trigger imports and thus elevate current account deficit. But is the problem related only to current account deficit? The figure below indicates that the concerns are also associated with a severe hike in the systematic risks of the banking sector.

Figure 1.Foreign fund usage by domestic banks over the last 12 months (million $)



Source: Central Bank of Turkey, Balance of Payments

Figure 1 shows net foreign funds used by domestic banks over the last twelve months together with the maturity structure. Net foreign fund usage has reached as high as

US$17 billion in the last quarter of 2008 when the impacts of the crisis on Turkey's economy turned to be devastating. After that, the amount dropped rapidly down until an outflow of US$7 billion by October 2009. As of October 2010, foreign fund usage by the banking sector elevated to US$22.5 billion.

Another important characteristic of the foreign fund usage over the last year is that 98 percent of the said funds are short term funds. Over the questioned period, volume of long term credits used by banks rose by US$1 billion whereas that of short term credits increased by US$9 billion. Furthermore, along with the US$13 billion rise in deposits foreign banks keep in domestic banks, net short term foreign fund usage reached US$22 billion.

In light of the above figure two conclusions can be drawn on the disrupted balance sheet structure and rising risks across banks. To begin with, substantial proportion of the hike in domestic credits is financed through foreign fund. Foreign fund usage increasing with such a high pace validate that the world goes through an unprecedented period with respect to international fund flows. In this perspective, banks can witness challenges in the medium term when sources of funds are expected to narrow down. The given structure of fund inflows reinforces the risk of permanent and systematic disruption of bank's balance sheets.

Second aspect is related with restricting short tem fund flows as has been widely debated over the recent period. 57 percent of the financial inflows witnessed over the last year are composed of short term funds used by banks. For instance, portfolio movements defined as hot money stood at US$15 billion over the last year. Given that the short term fund usage by the banking sector is US$22 billion, regulations and measures to be introduced in this respect can play an important role in improving the structure of the current account financing.

At this side of the coin, measures, recently introduced by the Central Bank and the Bank Regulation and Supervision Agency in relation to rapid credit expansion, are of great importance. It is debated widely that credit expansion can put an upwards pressure on current account deficit through stimulating domestic consumption and import demand. Nonetheless, as the figures suggest, hike in fund flows has also caused a serious change in the capital structure of banks which implies that financial system can encounter severe risks in the period ahead. Efforts to slow down credit expansion can play a role in mitigating the rapid deterioration in banks' capital structure. In addition, highlighting measures to reduce short term fund usage by the banking sector in the agenda can secure an improvement in the structure of current account deficit finance.