

# Bulletin

Issue: 25 / December 2012

## INTERNATIONAL CONFERENCES ORGANIZED BY THE CENTRAL BANK OF THE REPUBLIC OF TURKEY

The CBRT organized two high level international conferences in September and October 2012. The first conference, "G20 Conference on Financial Systemic Risk" was held on 27-28 September 2012 in İstanbul. The conference organized by the CBRT and G20 presidency of Mexico, was arranged with the motivation of providing a broad range of perspectives on the financial systemic risk issues. The main themes were measurement of systemic risk, discussion on the design and implementation of macro prudential policies and regulations in mitigating systemic risk and macro prudential regulations for the design of optimal monetary policy. Additionally, the conference provides a forum for the countries' experiences with the systemic risk management. In the Conference Deputy Prime Minister and Minister of State Ali Babacan, CBRT Governor Erdem Başçı and Bank of Mexico Governor Manuel Ramos Francia delivered the opening



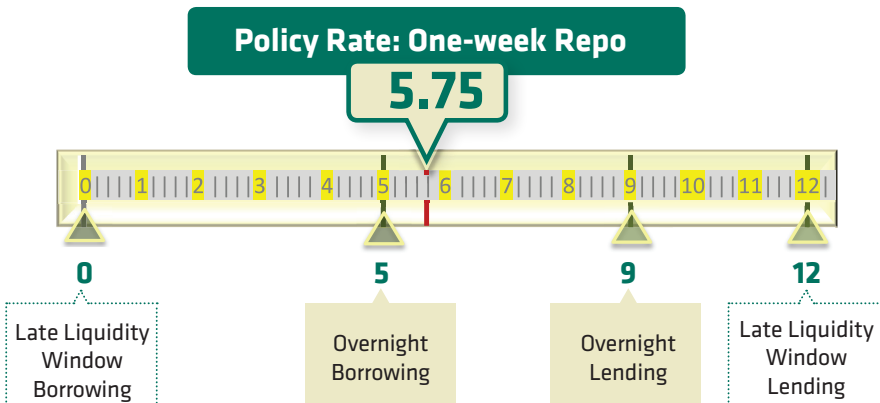
CBRT Governor Erdem Başçı

speeches. Several professionals from central banks, universities and international organizations attended the conference.

In October, the CBRT organized another conference on macro prudential policies: "Reserve Requirements & Other Macro prudential Policies: Experiences in Emerging Economies" (8-9 October 2012, İstanbul). The main objective of the conference was to provide a perspective on the use of macro prudential policies such as reserve requirements and the emerging market countries' experiences with the use of such policies, and

challenges faced by central banks in the aftermath of the global financial crisis. The two main themes of the conference were the use of reserve requirements and other macro prudential policies to mitigate the financial risk and the operational framework for incorporating macro prudential tools into financial stability framework. CBRT Governor Erdem Başçı delivered the opening speech of the conference. The conference bring central bankers and economists at other policy institutions together with academics to present recent advances in empirical and theoretical work on the reserve requirements and other macro prudential policies.

### CBRT Interest Rates (% as of 20 November 2012)



**CBRT Foreign Exchange Reserves:**  
**99.56 billion USD**  
**(As of 23 November 2012)**

**CPI: 6.37 %**  
**(Annual, November 2012)**

# RESERVE OPTION MECHANISM



Within the framework of the new policy mix adopted in the aftermath of the global financial crisis; the CBRT has started to effectively use reserve requirements. In the first stage reserve requirement ratios were gradually increased, then the remuneration of required reserves was terminated, reserve requirement ratios were differentiated across maturities and the scope of liabilities subject to reserve requirements was widened. In August 2011, risk aversion became globally widespread and the risk appetite became more volatile due to global developments, which paved the way for a reduction in the reserve requirement ratios in order to decrease the liquidity

demand of the banking system.

Recently, the Reserve Option Mechanism (ROM) has been added to the CBRT's set of instruments to reduce the adverse impact of volatile

capital flows on macroeconomic and financial stability, strengthen the CBRT's gross foreign exchange reserves and equip banks with more flexibility in liquidity management.

## Benefits of the Reserve Option Mechanism

Reduces the potential volatility that might be caused by short-term capital flows.

Reinforces the CBRT's gross foreign exchange (FX) reserves.

Renders banks more flexibility in liquidity management.

Decreases the sensitivity of the credits to capital flows.

Allows each bank to solve its own liquidity optimization issues.

Reduces the need for using other policy tools.

## What is the Reserve Option Mechanism? How does It Work?

ROM is basically a mechanism that allows banks to hold a certain

fraction of their Turkish lira (TL) reserve requirements in FX (USD and/or euro) and standard gold. The mechanism permits banks to manage their FX assets in line with their TL liquidity needs at

their own discretion. The banks are provided with flexibility in holding TL reserve requirements and they also voluntarily accumulate foreign currency reserves at the CBRT. ROM, which is expected to work as an

automatic stabilizer, decreases the exchange rate volatility in domestic markets caused by capital inflows and thus, to some extent, reduces the need for the interest rate corridor. The maximum fraction of TL required reserves that can be held in FX or standard gold is set by the Reserve Option Ratio (ROR). The amount of FX or standard gold that can be held for per unit of TL is called the Reserve Option Coefficient (ROC). The extent which banks utilize the mechanism (optimal utilization ratio) depends on the availability of foreign currency funds and the “threshold ROC”, the level of ROC where banks are indifferent to either using or not using the facility. The threshold ROC mainly depends on the relative FX and TL funding cost.

For instance, during periods of accelerated capital inflows, the cost of FX funding is typically below that of TL funding. In such cases, the threshold ROC increases, leading the banks to hold a higher ratio of their TL reserve requirement liabilities in FX. In other words, a decline in the cost of external borrowing induces the banks to use the ROM facility more intensively.

Thus, a fraction of foreign exchange inflows is transferred to the CBRT by the banks to be held as TL reserve requirements at their respective accounts with the CBRT. In this way, not only the appreciation pressure of TL, but also the conversion of FX inflows to bank lending is contained. During such periods, increased capital inflows due to more abundant foreign resources result in a higher utilization ratio of the ROM facility and hence higher withdrawal of the increased FX liquidity via the mechanism. In this case, the amount of TL liquidity to be sterilized will be less than what should have been the case with the CBRT’s buying the same amount of FX.

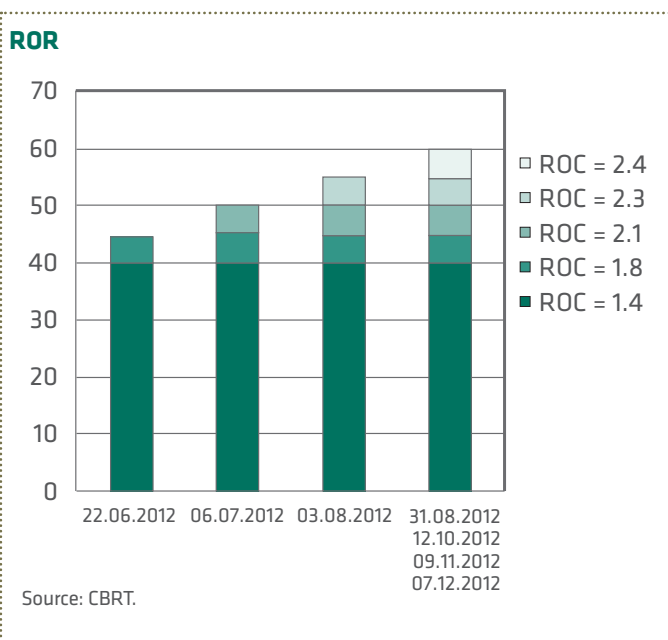
Currently, the mechanism is constructed such that the ROC increases in line with the utilization of the reserve option. Accordingly, in order to facilitate utilization, the ROR and related ROCs have been divided into 5 percent-individual tranches above a certain threshold. The CBRT announces the upper limit of TL required reserves that may be held in FX or standard gold. However, it is up to the banks to use the facility either fully or partially

depending on the relative cost of FX funding to TL funding.

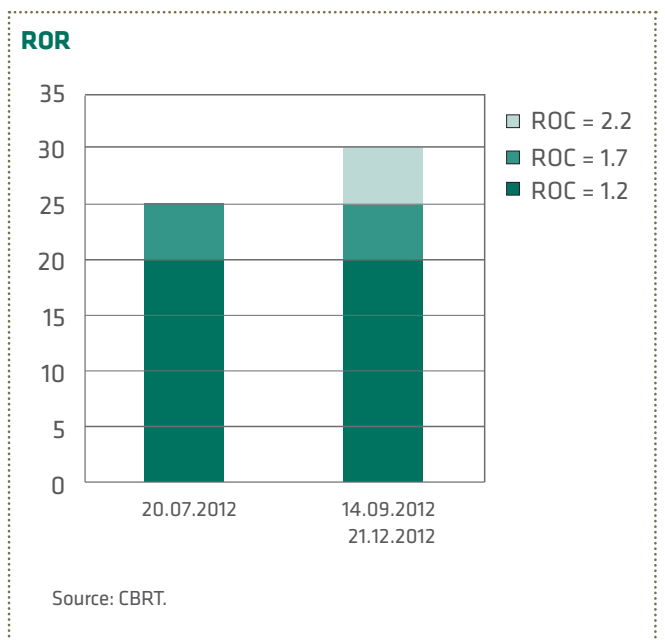
The banks that are to hold TL required reserves at the CBRT are allowed to hold a maximum of 60 percent of these reserves in FX. A bank that intends to fully use the FX facility must hold an amount of FX, which is calculated by multiplying the relevant amount of TL required reserves by “1.4” ROC for the first tranche up to 40 percent of TL required reserves. For each additional tranche of 5 percent, a similar calculation is made using the ROCs “1.8”, “2.1”, “2.3” and “2.4”, respectively (Chart - 1).

Likewise, the banks with TL required reserves at the CBRT are allowed to hold a maximum of 30 percent of these reserves in standard gold. Banks using this facility, must hold an amount of standard gold, which is calculated by multiplying the relevant amount of TL required reserves by “1.2” ROC for the first tranche up to 20 percent of TL required reserves and for each additional tranche of 5 percent, a similar calculation is made using the ROCs of “1.7” and “2.2”, respectively (Chart - 2).

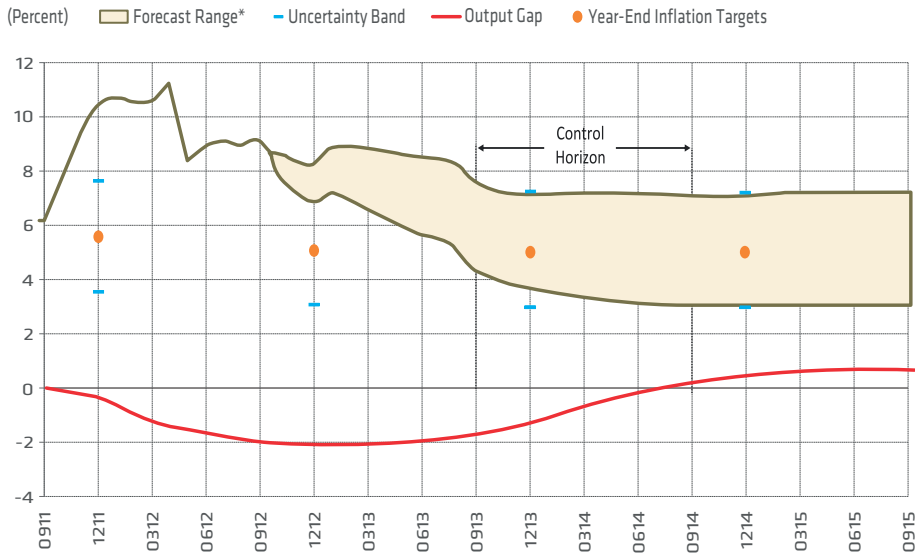
**Chart - 1: ROCs for FX Facility (%)**



**Chart - 2: ROCs for Gold Facility (%)**



## Inflation and Output Gap Forecasts



Source: TurkStat, CBRT.

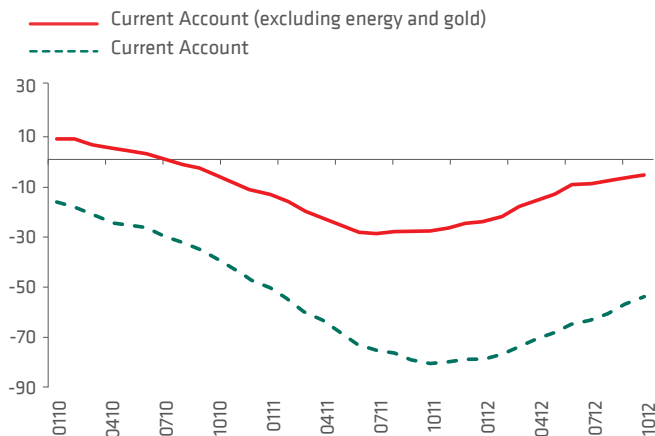
\* Shaded region indicates the 70 percent confidence interval for the forecast.

In the October Inflation Report, inflation was expected to be, with 70 percent probability, between 6.9 and 7.9 percent (with a mid-point of 7.4 percent) at the end of 2012, and between 3.8 and 6.8 percent (with a mid-point of 5.3 percent) at the end of 2013 and to stabilize around 5 percent in the medium term.

As of November, consumer prices were up by 0.38 percent and annual inflation fell to 6.37 percent. Contribution of the food group, which went down to 1.14 percentage points, exhibited the most noteworthy fall. Contribution of core goods went down to 1.20 percentage points; while that of the services group edged down to 1.88 percentage points. Under these circumstances, the largest contributor to inflation among subgroups became the energy group with 2.11 percentage points.

## Current Account

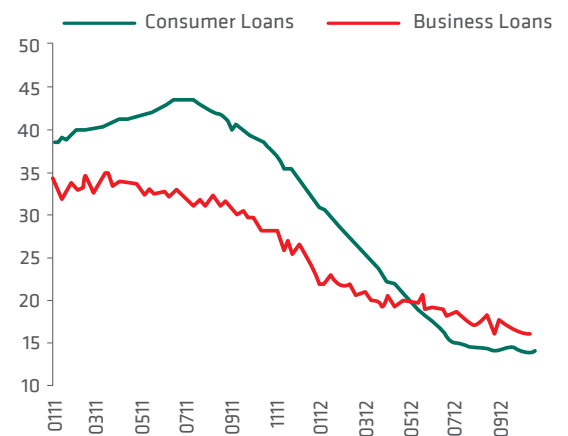
Current Account Balance  
(12-Month Cumulative, Billion USD)



Source: TurkStat, CBRT.

Since the end of 2010, the CBRT has designed and implemented a new policy framework which takes into account macro financial risks. The general framework of the inflation targeting regime was modified and additional policy instruments were developed to support the adoption of financial stability as a complementary objective. Policies implemented in this period aimed at managing macro financial risks without prejudice to the price stability objective. To this end, the composition of growth has displayed a healthier outlook, while the rebalancing process became more significant. In fact, during this period, current account has continued to improve and the contribution of net exports to growth has increased markedly.

## Growth of Consumer and Business Loans (Adjusted For Changes In Exchange Rate, Excluding Credit Cards, Annual, Percent)



Source: BRSA, CBRT

## Growth of Consumer and Business Loans

Annual growth rate of credits continued to slow down during the third quarter. Both supply and demand conditions are likely to be more supportive for the credit growth in the final quarter of the year. In fact, consumer loan rates have been trending downwards along with the falling market rates. Commercial loan rates are also expected to decline with the cuts in the upper bound of the interest rate corridor. Accordingly, annual rate of growth in total credits is expected to materialize around 14 percent at the end of the year.

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