Bulletin

TÜRKİYE CUMHURİYET MERKEZ BANKASI

Issue: 26 / March 2013

ERDEM BAŞÇI, CENTRAL BANKER OF THE YEAR

The Banker, which is a monthly international financial magazine published by The Financial Times in over 180 countries, has chosen Erdem Başçı, the Governor of the Central Bank of the Republic of Turkey (CBRT), as the “Central Bank Governor of the Year 2013 in the World and in Europe”. The Banker’s awards celebrated the officials that successfully steered their countries through the economic turbulence of 2012.

The Banker’s article stated that “the CBRT had moved ahead of other emerging markets by adopting experimental measures designed to curb hot money while maintaining a free-floating currency regime.” The article went on to say that the CBRT delivered a series of interest rate cuts to reduce the appreciation of the Turkish lira, as well as setting a corridor around its policy rate which meant that high inflows led to an even lower return, further discouraging foreign capital seeking yield. It was mentioned that since bank lending was growing at more than 30 percent per year, the CBRT set higher deposit reserve requirements to be held in Turkish lira in order to offset low rates and prevent overheating. The Banker expressed that the CBRT adopted a Reserve Options Mechanism (ROM), allowing up to 60 percent of reserves against foreign exchange deposits to be held in foreign exchange, and up to 30 percent for gold.

The article emphasized that, at least so far, Turkey has been experiencing a soft landing rather than the boom and bust scenario, but Erdem Başçı was staying on full alert.

Central Banker of the Year 2013		
Global and Europe	Central Bank of the Republic of Turkey	Erdem Başçı
Americas	Bank of Canada	Mark Carney
Asia-Pacific	Central Bank of the Philippines	Amando Tetangco
Middle East	Saudi Arabian Monetary Agency	Fahad Al-Mubarak
Africa	National Bank of Angola	José Massano

Monetary and Exchange Rate Policy for 2013

The monetary and exchange rate policy of the CBRT for 2013 was announced on 25 December 2012 with a press conference. At the conference, Governor Başçı evaluated recent economic developments and explained in detail the monetary policy strategy to be implemented throughout 2013, the operational framework regarding exchange rates, liquidity policy and structural regulations regarding the banking sector and financial stability.

Main Pillars

- Achieving and maintaining price stability remains as the primary objective of the CBRT. The inflation target for 2015 is set as 5 percent, as was the case for 2013 and 2014.
- The uncertainty band set around the inflation target is maintained at 2 percentage points in both directions, the same as the last year. At the end of each quarter, should the inflation rate fall outside the year-end target by more than 2 percentage points in either direction, the underlying reasons of this deviation, along with the measures already taken and those that will be taken to achieve the target will be explained via Inflation Reports. Moreover, if the year-end inflation falls outside the uncertainty band, the CBRT will inform the Government with an open letter about the reasons of the breach of the target, as well as the measures that have been already taken and will be taken.
- While preserving price stability as the main objective, the newly-constructed monetary and exchange rate policy regime also takes into account risks to financial stability.
- In line with the new policy framework that was developed in the last couple of years, the CBRT continues to approach financial stability from a macro perspective. In addition to one week repo funding rate, which is the 'policy rate', the CBRT will use instruments, such as interest rate corridor, liquidity management, reserve requirement ratios and the ROM in 2013.
- A countercyclical and macroprudential policy based on the leverage ratio will be implemented gradually. Accordingly, banks with excessive leverage ratios will be subject to additional reserve requirements that will be based on these ratios.
- The Monetary Policy Committee (MPC) meetings will continue to be held once a month as shown below. The decisions of the MPC will be announced on the Bank's web site at 2 p.m. on the day of the meeting, as was the case last year.
- Monetary and Exchange Rate Policy for 2014 will be published on 24 December 2013.

	FORMER APPROACH	NEW APPROACH
OBJECTIVES	Price Stability	Price Stability Financial Stability
INSTRUMENTS	Policy rate	Structural Instrument Cylical Instrument (Policy Rate, Liquidity Management Interest rate corridor)

Monetary Policy Committee Meetings

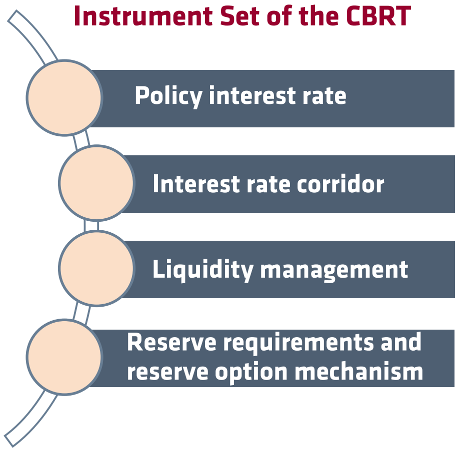
22 January 2013
19 February 2013
26 March 2013
16 April 2013
16 May 2013
18 June 2013
23 July 2013
20 August 2013
17 September 2013
23 October 2013
19 November 2013
17 December 2013

The New CBRT Policy Mix and Financial Stability

The 2008-2009 global economic crisis showed that price stability does not always guarantee macroeconomic stability. Thus, adopting a monetary policy framework, which simultaneously aims to achieve price stability and contribute to financial stability, has gained importance.

After the crisis, Turkey enjoyed a very strong recovery, with two consecutive years of relatively strong Gross Domestic Product (GDP) and credit growth. However, the economic literature has identified that the change in the total credit supplied by the banking sector measured as a proportion of the GDP is a key leading indicator for an impending crisis. Meanwhile, with the impact of global economic conditions and short-term capital flows, the Turkish lira has been under pressure of appreciation. Hence, since the last quarter of 2010, the CBRT has adopted an unorthodox approach to monetary policy, where multiple instruments such as policy rate, interest rate corridor, liquidity management and reserve requirements have been utilized. The CBRT has kept the short-term interest rates as low as possible while implementing tightening via macroprudential instruments.

Instrument Set of the CBRT

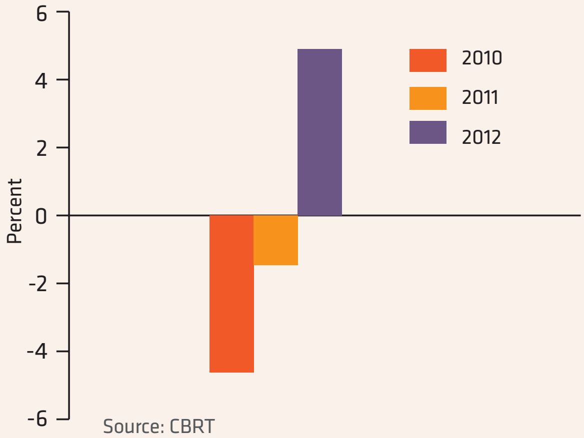


A relatively new instrument in this policy mix is the ROM that has been developed with the aim of mitigating the adverse effects of excessive volatility in capital flows on macroeconomic and financial stability. The ROM is designed as an auto-stabilizer since it enables banks to use their foreign exchange holdings in line with their liquidity requirements. A recent analysis conducted by the CBRT showed that exchange rate volatility decreased during the period when ROM was employed as a new instrument.

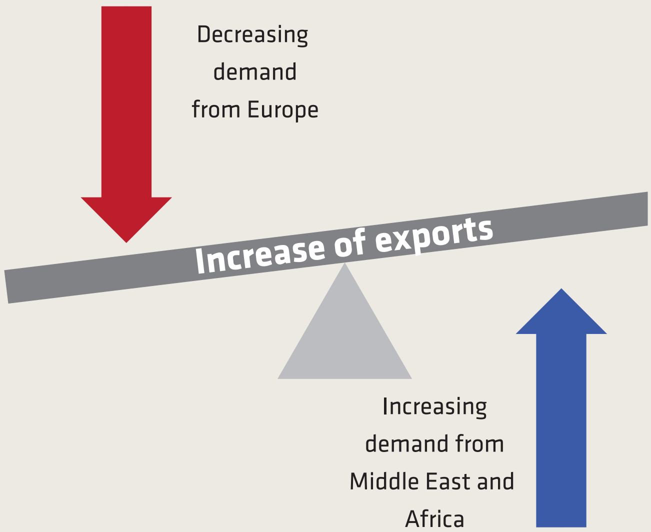
Excessive deviation of the real effective exchange rate from economic fundamentals is considered a risk to financial stability by the CBRT.

Gold exports contributed to Turkey's export growth in 2012, triggering a decline of 13 billion US dollars in the current account deficit. Yet, the major contribution to the decrease in the deficit came from the change in the composition of the GDP growth. Moreover, the decline in credit growth rates, with the help of new policy tools from around 35 percent to sustainable levels, has also made a considerable contribution. A recent analysis made by the CBRT reveals that the 7.5 percent change in the credit growth rate in proportion to the GDP (△C/GDP) is supportive of financial stability in Turkey.

Chart-1: Contribution of Net Exports to GDP Growth



Source: CBRT



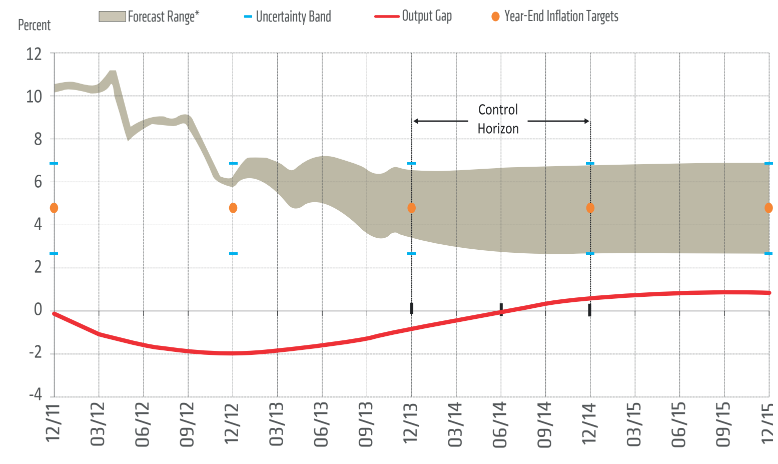
As an important indicator of financial stability, the CBRT closely monitors developments in the current account balance. In 2012, growth in external demand for Turkey's exports remained below expectations. Especially the demand from Europe, the main trading partner of Turkey, decreased due to the global crisis. Yet, increasing demand from African and Middle Eastern countries and the easing of the overvaluation pressure on exchange rates alleviated the negative impact of global slowdown on Turkey's exports and hence the current account deficit.

Inflation and Output Gap Forecasts

According to the latest forecasts of the CBRT stated in the January Inflation Report, inflation is expected to be, with 70 percent probability, between 3.9 and 6.7 percent (with a mid-point of 5.3 percent) at the end of 2013, and between 3.1 and 6.7 percent (with a midpoint of 4.9 percent) at the end of 2014. Inflation is expected to stabilize around 5 percent in the medium term. Forecasts are based on the assumption that annual loan growth rate will hover around 15 percent and there will be no significant change in the real effective exchange rate (Chart-2).

In February, consumer prices were up by 0.30 percent, while annual inflation fell to 7.03 percent. Contribution to the annual CPI inflation displayed a month-on-month decline by 0.32 percentage points in food group, whereas that of energy, services and core goods group did not post a noticeable change. The contribution of tobacco group, on the other hand, registered a slight increase.

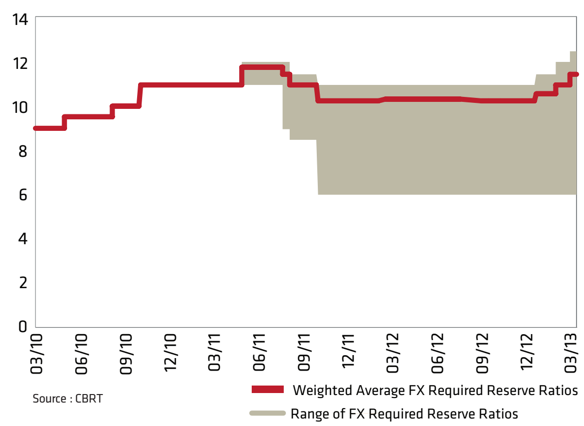
Chart-2: Inflation and Output Gap Forecasts



Source: CBRT.

* Shaded region indicates the 70 percent confidence interval for the forecas

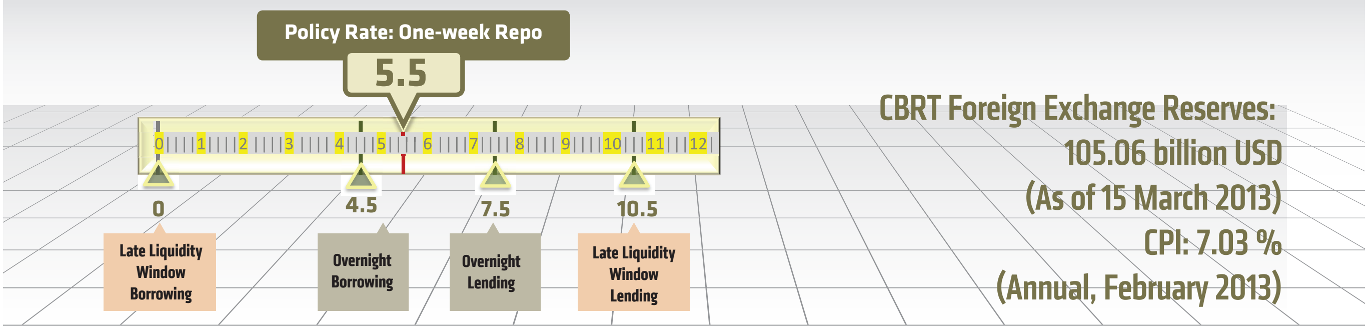
Chart-3: FX Required Reserve Ratios



FX Required Reserve Ratios

In order to bolster financial stability and extend the maturity of the FX denominated liabilities of the banking sector, FX reserve requirement ratio for deposits with 1 year or longer maturities besides other FX liabilities with maturities longer than 3 years was raised by 0.5 percent in December. Thus, the average FX required reserve ratio was raised from 10.2 percent to 10.6 percent. In January and February, within the same maturities, FX reserve requirement ratio raised by 0.5 percent, respectively, hence the effective reserve requirement ratio for FX became 11.5 percent. According to the CBRT's estimations, with the increase in FX reserve requirement ratios, liquidity amounting to approximately USD 940 million will be withdrawn from the market (Chart-3).

CBRT Interest Rates (as of 26 March 2013, %)



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