CENTRAL BANK OF THE REPUBLIC OF TURKEY

INTERNATIONAL SEMINAR ON THE FINANCIAL CRISIS AND ITS IMPACT ON RESERVE MANAGEMENT AT CENTRAL BANKS

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Distinguished Guests,

It is my pleasure to welcome you to the Central Bank of the Republic of Turkey Seminar on “The Financial Crisis and its Impact on Reserve Management at Central Banks”.

In recent years, issues related to the management of foreign exchange reserves have gained importance and reserve management practices have developed rapidly. The financial crisis that we have witnessed since mid-2007 had a significant impact on the financial landscape that has led to further changes in reserve management practices. With changing risk perceptions central banks have started to attach higher importance to keep their assets safe and protected, reassessing credit and liquidity risks. In this seminar, we would like to share opinions about how central banks tackle this challenge and discuss the new trends in reserve management in an innovative platform. Reviews and modifications to asset allocation methodologies, portfolio construction techniques and risk models in the light of the recent financial crisis deserve particular attention.

I am sure that analysis of crisis, changing structure in capital markets and the new outlook for reserve managers will be covered in detail at this seminar. To set the scene, let me recall briefly the origins and propagation of the financial market crisis of the last two years and try to illuminate the changing financial landscape thereafter with its repercussions on reserve management practices. I will also briefly touch on Central Bank of Turkey’s policy response to the crisis and reserve management strategy.

The current financial crisis was triggered by increasing defaults on subprime mortgages in the US. However, we all know that the crisis had deeper roots that extend back to the preceding years of exceptionally low interest rates and high global growth. On the one side, low interest rates prompted investors to search for yield and high growth together with low volatility induced overoptimistic assessments. In this environment easy access to credit led to debt accumulation. On the other side, financial innovation contributed to debt accumulation. A continuous flow of new and increasingly complex instruments was created to fulfill the demand for investments with higher yield. These new instruments seemed to offer higher risk-adjusted yields, but were in fact more risky than they appeared. In particular, the originate-to-distribute model made it possible to originate loans to

households, securitize them in large quantities, package them into differently rated tranches, and then sell them to both risk-averse and risk-seeking investors. In this process loan origination became less limited by the balance sheet capacity of banks.

Under these conditions market discipline deteriorated as optimism prevailed and due diligence was left to credit rating agencies. Investors depended too much on credit ratings in risk evaluations, rather than deeply examining themselves the nature of assets they bought. This led to missing the growing conflicts of interest in these agencies. The "too big to fail" nature of the most interconnected institutions also eroded the market discipline. Moreover, a compensation scheme based on maximizing profits in the short-term also encouraged risk taking. On the other hand, policy-makers, regulators and supervisors in some advanced countries, did not adequately appreciate and address the risks building up in the financial markets. The fragmented surveillance system of global financial architecture compounded the inability to identify growing vulnerabilities.

In this environment, the problems that started in the US financial system have turned out to be a global financial turmoil. Investors, shocked by losses on assets they had believed to be safe, began to pull back from a wide range of credit markets. Meanwhile financial institutions, suffering from losses on mortgages and other loans, reduced their lending drastically.

We all know that in order to support financial markets and revive economic activity, extraordinary policy measures, including capital injections, new liquidity facilities, policy rate cuts and increased deposit guarantee schemes, have been taken in many countries. On the other hand, the financial sector has responded to crisis by increasing capital and reducing leverage. Looking ahead, wide-ranging reforms are underway aimed at improving market and institutional resilience. It seems that, in the future the financial sector would operate with higher capital and liquidity buffers than before the crisis.

At this point I should emphasize that the unprecedented events and far-reaching changes in functioning of financial markets have increased risk aversion and central banks have not been exception.

For some time ago, in the context of reserve management, asset backed securities were regarded as good alternatives that produced extra spreads for

central banks. But today, the market fluctuations and credit concerns arising from crisis have exposed new vulnerabilities and risks attached to such kind of investments.

A survey conducted by Central Banking Publications showed that global financial turmoil has had a major impact on the reserve management policies of two thirds of central banks and almost all are rethinking about the validity of diversification strategies. This survey of 39 central banks that control reserve assets worth $ 3.2 trillion, just under 42 % of the world's total, revealed that reserve managers were much more conservative and cautious last year than they were a year earlier. Reserve managers expressed "serious concern" about credit and liquidity risks, with over two thirds of respondents saying that they experienced bouts of illiquidity even in the major bond markets. Over 90 % of respondents to the survey said they have been forced to reassess counterparty risk and most emphasized the hunt for diversity and yield in recent years has been severely curtailed.

I should remind that extensive use of external fund managers had been an important trend in reserve management as the evaluation of new and innovative asset classes required technical skills and competencies. The survey findings suggest that central banks became more conservative along with the financial crisis. Accordingly, this trend to engage external fund managers would lose its pace in the coming period, as the central banks avoid these complex instruments in their portfolios.

Dear Guests,

Before I conclude my speech, let me summarize the changes in our liquidity implementation and measures taken by the Central Bank of Turkey in response to current crisis.

Like other emerging countries sensitive to global liquidity conditions, Turkey has been affected by the global turmoil. However, I should note that we were more prepared and resilient due to prudential macroeconomic policies and structural reforms, which had been carried out after the 2001 crisis.

With the reversal of the global developments fueling inflation in the last quarter of 2008, we took prompt action to cut interest rates and played a pioneer role among emerging markets. We adopted a strategy of front-loaded policy

easing by cutting overnight rates by a total of 750 basis points since November 2008. We will continue to take the necessary measures to contain the adverse effects of the global financial turmoil, provided that they do not conflict with our price stability objective.

We also progressively have put into effect other measures in order to get through this period with minor damage.

- We gradually decreased the band between borrowing and lending rates in order to reduce fluctuations in the overnight interest rates. Starting from October 2008 the market has been funded more than market needs while excess liquidity has been withdrawn from the market at the end of the day.

- Our activity as an intermediary in the Foreign Exchange and Banknotes Market was resumed as to contribute to the enhancement of the mobilization of foreign exchange liquidity in the Interbank foreign exchange market. Banks' transaction limits in the Foreign Exchange Deposit Market were increased. Moreover, foreign exchange buying auctions were suspended to keep the foreign exchange liquidity in the banking system.

- In response to unhealthy fluctuations in the foreign exchange market, we conducted two foreign exchange selling auctions in October 2008 selling 100 million USD and 18 auctions in March 2009 selling 900 million USD. We suspended selling auctions on April 2, 2009 as concerns regarding the depth of the foreign exchange market have eased.

-The maturity of the foreign exchange deposits borrowed by banks from the central bank in the Foreign Exchange Deposit Markets in terms of euro and US dollar was gradually extended to three months and the lending rates have been reduced to 7.5 percent and 5.5 percent, respectively.

-Additional foreign exchange liquidity was provided to the banking system through a 2% reduction of the foreign exchange required reserves ratio.

-The limit on the export rediscount credits extended by central bank through Eximbank was increased from 500 million USD to 2.5 billion USD and lending conditions have been eased.

I also would like to say a couple of words about the implications of the financial crisis on our reserve and risk management practice. As capital preservation and liquidity have always been our prior reserve management objectives due to our prudent investment policy, we had not been investing in risky

and complex structured products even before the crisis. We had been investing most of our reserves in securities issued by governments, supranational institutions and government guaranteed agencies. Hence, our credit risk exposure has continued to be limited to a great extend during the crisis, and we have not been directly affected from the deterioration in the credit market. Nevertheless, the crisis still had implications on our credit risk management practices. Due to the deterioration of the confidence and the increase in default risk, counterparty selection became more important than ever. In this context, we started to monitor market indicators of credit risk more closely for better counterparty management and continuously update the transaction limits of our counterparties. In order to further reduce our credit risk we decreased the share of deposit transactions.

Let me conclude by saying that we are living in very challenging times. I hope this seminar will produce fruitful discussions regarding financial crisis and its impact on reserve management, I believe the selected topics for this seminar will provide a good platform for reserve managers to share their opinions while exploring best practices in setting their policy frameworks. I wish you all an active, productive and successful discussion in the next two days and a good stay in this lovely facility.