MEMORANDUM OF UNDERSTANDING SIGNED WITH THE EUROPEAN CENTRAL BANK

Governor Erdem Başçı and European Central Bank (ECB) President Mario Draghi signed a Memorandum of Understanding (MoU) between the ECB and the Central Bank of the Republic of Turkey (CBRT) on 4 July 2012 in Frankfurt, Germany.

The MoU is aimed at laying the ground for continued cooperation in central banking through regular dialogue at technical and policy level and the possibility of staff exchange.

Earlier this year, the CBRT had signed a three-year bilateral

CBRT Governor Erdem Başçı

ECB President Mario Draghi

currency swap agreement with the People's Bank of China and a MoU with Bank Negara Malaysia. The core objective of the three-year bilateral swap agreement concluded with the People's Bank of China is to facilitate bilateral trade in the respective local currencies of the two countries.
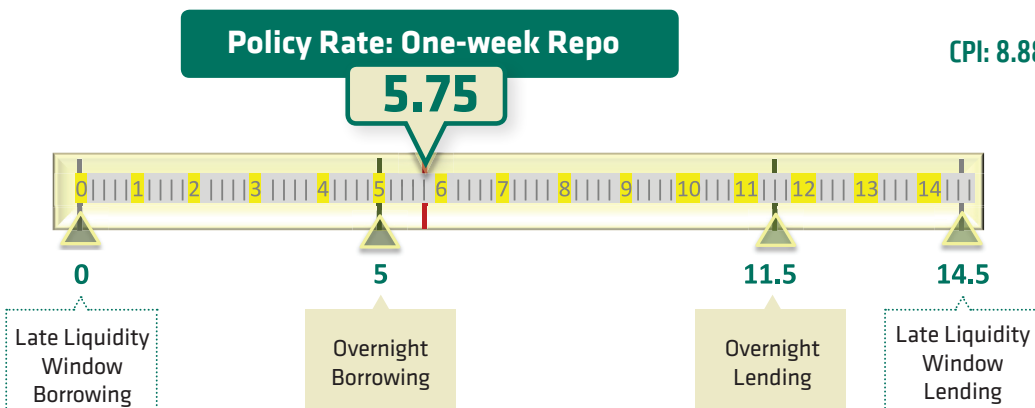
Similarly, the MoU with the Bank Negara Malaysia aims to foster

strategic cooperation between the two countries towards promoting bilateral investment and liquidity arrangements, to support the development of the financial services sector in both countries, and to enhance economic and financial linkages between the two countries through bilateral trade and investment.

CBRT Interest Rates % (As of 31 August 2012)

CBRT Foreign Exchange Reserves: 92.99 billion USD (As of 31 August 2012)

CPI: 8.88 % (Annual, August 2012)

Policy Rate: One-week Repo

5.75

0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14

0 — Late Liquidity Window Borrowing

5 — Overnight Borrowing

11.5 — Overnight Lending

14.5 — Late Liquidity Window Lending

A NEW POLICY TOOL FOR CENTRAL BANKS: POLICY PREDICTABILITY

Changes in Central Banking after the Economic Crisis

After the global economic crisis, central banks of developing countries have leaned towards putting more emphasis on designing policies to offset macro imbalances and fluctuations in asset prices.

Economists as well as policymakers have increasingly come to the conclusion that **short-term interest rates,** the conventional policy instrument of inflation targeting central banks prior to the crisis, are not alone sufficient to contain the macro-financial risks that emerged amid the global financial crisis. Central banks of developing countries have been using tools such as capital controls and macro-prudential measures to alleviate the negative consequences of **volatility in capital inflows.** Recently, utilizing the degree of **predictability** in short-term interest rates has been proposed as an alternative method to manage capital inflows.

Policy Predictability of the CBRT

Following the global crisis, the CBRT launched a new monetary policy strategy beginning from the last quarter of 2010. The Bank uses the **level of predictability** of its decisions as a policy tool to steer the Turkish economy amid the crisis environment.

The implementation of this new policy is as follows: The CBRT sets the average funding rate at any point within the **"interest rate corridor"** between overnight lending and borrowing rates through liquidity operations.
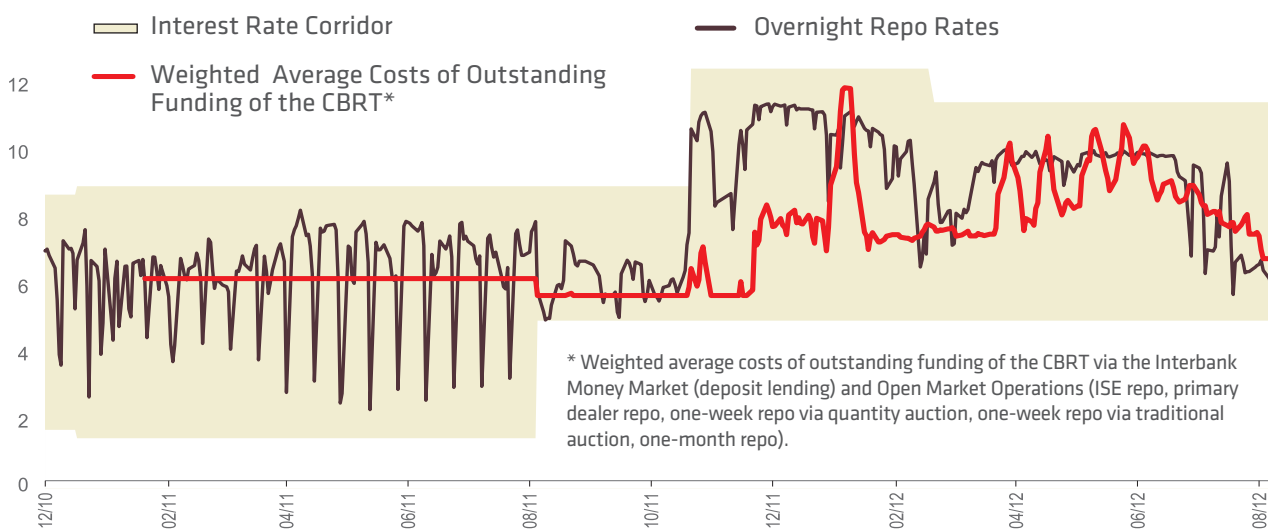
The interest rate corridor provided the CBRT with more **flexibility** in monetary policy. The Bank can change its policy stance on a daily basis and does not need to wait until the next Monetary Policy Committee Meeting for a monetary policy action. The effect of the "interest rate corridor" tool is similar to unsterilized foreign exchange intervention and reduces the need to buy or sell foreign exchange.

On the other hand, if need be, the CBRT can also change the width of the interest rate corridor and set the degree of its policy predictability to manage the variability of capital flows. A wider corridor enables to reduce the volatility of exchange rates by increasing the volatility of the short-term interest rates.

Since the last quarter of 2010, with the help of the positive inflation outlook in Turkey, the CBRT designed policies to contain macro-financial risks in addition to its primary objective of price stability. The CBRT started to actively use reserve requirements and other liquidity tools besides its policy rate (the one-week repo auction rate).

Legend:
- Interest Rate Corridor
- Overnight Repo Rates
- Weighted Average Costs of Outstanding Funding of the CBRT*

* Weighted average costs of outstanding funding of the CBRT via the Interbank Money Market (deposit lending) and Open Market Operations (ISE repo, primary dealer repo, one-week repo via quantity auction, one-week repo via traditional auction, one-month repo).

x-axis: 12/10, 02/11, 04/11, 06/11, 08/11, 10/11, 12/11, 02/12, 04/12, 06/12, 08/12

In the period from November 2010 to August 2011, when uncertainties regarding the Euro zone prevailed, the CBRT aimed to limit short term capital flows and prevent excessive appreciation of the Turkish lira on the one hand, and to ensure more controlled growth in domestic credit and demand as well as to balance the divergence between external and domestic demand on the other.

Due to the strong risk appetite and surge in short term capital flows in this period, the Central Bank widened the interest rate corridor by reducing the overnight borrowing rate.

With the acceleration of capital outflows from emerging market economies since August 2011, the interest rate corridor was narrowed by raising the overnight borrowing rate.

Due to the depreciation of the Turkish lira since August 2011, which was a consequence of the lower global risk appetite and the adjustments in administered prices in the last quarter of 2011, the CBRT widened the interest rate corridor by increasing the lending rates in October 2011. In this context, the Bank allowed, through liquidity adjustments, overnight interest rates in the money market to be higher than the policy rate.

THE HOUSE PRICE INDEX (HPI)

The countrywide HPI is constructed for the purpose of monitoring price movements in the Turkish housing market.

Price data related to all houses subject to sale, regardless of year of construction, are used to develop the HPI. In the housing market, as prices of properties become available when they are actually sold, the house prices indicated in valuation reports prepared at the time of approval of individual housing loans are used as a proxy for price. The actual sale of the property and/or utilization of the loan are not required and all houses appraised are included in the scope of the index. To construct the House Price Index for Turkey (THPI) representing the whole country, all valuation reports are used, whereas, to construct the New Housing Price Index for Turkey (TNHPI), which again represents the entire country, valuation reports for houses built in the current year and previous ones are used.

The THPI covers data pertaining to all appraised houses in 73 provinces. Eight provinces are excluded from the scope due to insufficient number of observations. While constructing the TNHPI, data pertaining to valuations of new houses in 26 provinces, where there are sufficient observations, are used.

In the first stage of the study, strata (the smallest unit in which houses with similar characteristics are grouped together and which provides sufficient observations to calculate a reliable median unit price) that are defined at sub-provincial level are aggregated on the 3rd and 2nd levels of the Nomenclature of Territorial Units for Statistics (NUTS) respectively, and the overall indices for Turkey are constructed by aggregating the appraised values of houses on the 2nd level. NUTS is a regional unit classification designed for the whole country in compliance with the European Union Regional Statistics System for developing a comparable statistical database.

Valuation reports, which form a basis for housing loans, are prepared by real estate appraisal companies. Banks granting housing loans transfer their data regarding the monthly valuation reports to the CBRT online.

The "Stratified Median Price Method", which is a method where relatively homogeneous strata are established by grouping similar houses and where a general price index is computed by weighting the median unit price calculated for each stratum, has been implemented in constructing the HPI to develop a measure for price movements in the heterogeneous housing market.

The HPI relies on the assumption that the median unit price of appraised houses is indicative of the median unit price of all houses sold. The median unit price denotes the median price calculated by using a quarterly dataset of unit prices including both the reference month and the preceding and succeeding months by excluding the extreme values in each stratum.

The Tukey's Hinges method has been implemented in the analysis of extreme values in computing the median unit price used to construct the index.

Data on house sales registered by the General Directorate of Land Registry and Cadastre (LRC) are used as weights for aggregating the strata in constructing the THPI, whereas building occupancy permit statistics issued by TURKSTAT are used for weighting in computing the TNHPI. Weights used to produce the THPI are updated each year with the weights calculated using the number of houses sold in the related stratum in the previous year. Building occupancy permits issued in the two consecutive years preceding the reference year are used to calculate the weights for constructing the TNHPI.

The House Price Index, which measures changes in house prices compared with the base year (2010), is calculated using the Chain Laspeyres Index method. The reason for implementing the chain index method is that the weights are updated each year.
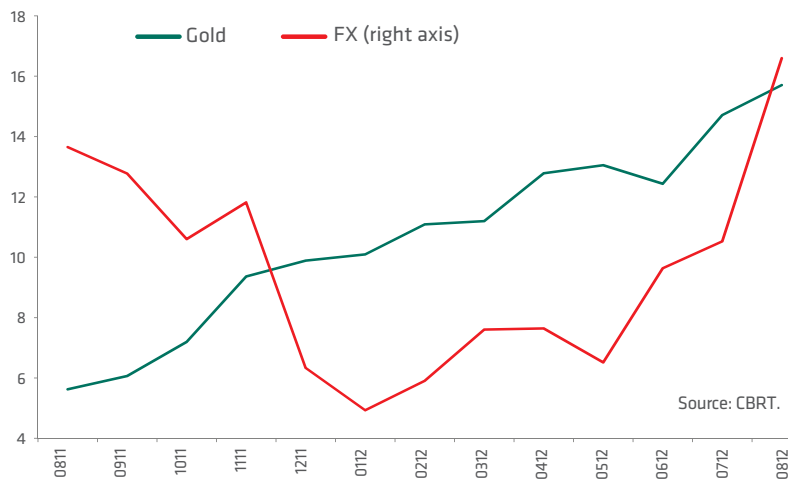
The HPI series, which starts in January 2010, are issued within forty days following the three-month reference period it covers. Indices produced are accessible under the Data/Periodic Data/ House Price Index menu on the CBRT website.

In line with its new policy framework, which takes into account macro financial risks, the CBRT has been implementing policies aimed at managing macro financial risks without prejudice to the price stability objective. To this end, credit growth was brought under control and the exchange rate was aligned more with economic fundamentals. Data released for the first half of the year show that policies pursued were successful in delivering the intended results. The composition of growth has displayed a healthier outlook while the rebalancing process has become more significant. In fact, during this period, 12-month cumulative current account has continued to improve.

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

Current Account (excluding energy)
Current Account

*Estimate for June
Source: TurkStat, CBRT.
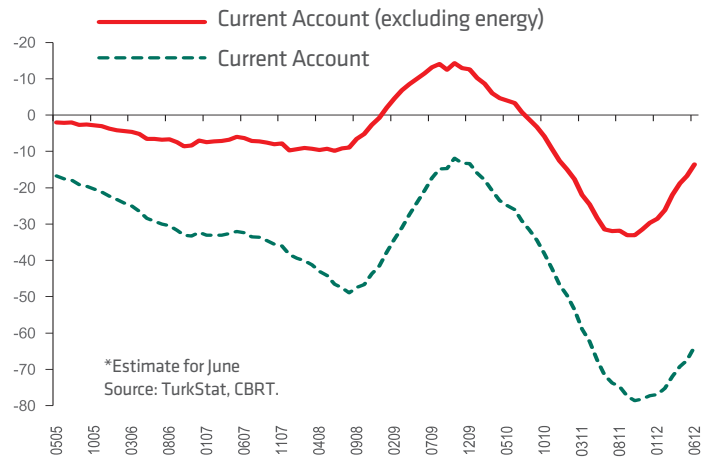
FX and Gold Reserves of the CBRT
(Billion USD)
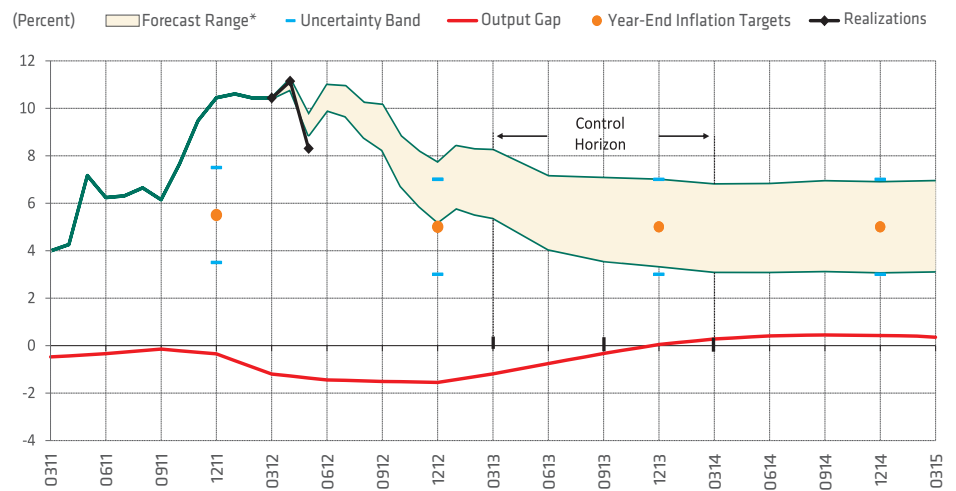

Gold — FX (right axis)

Source: CBRT.

The CBRT's FX sale auctions and direct sale interventions since August 2011, as well as reductions in FX required reserve ratios caused FX reserves to decline. On the other hand, the arrangements on TL reserve requirements and rediscount credits have largely compensated for this decline.

The arrangement which allows banks to hold up TL denominated required reserves in FX and/or gold has enhanced the CBRT's FX and gold reserves. Since the beginning of 2012, there has been an upward trend in total reserves.

Inflation and Output Gap Forecasts

In the second quarter of 2012, inflation has decreased by 1.6 percentage points and reached 8.88 percent, lower than that envisaged in the April Inflation Report. The fall in inflation has largely stemmed from the favourable course of unprocessed food prices and the setback in oil prices.

Inflation is expected to be - with 70 percent probability - between 5.3 and 7.1 percent (with a mid-point of 6.2 percent) at the end of 2012, and between 3.4 and 6.8 percent (with a mid-point of 5.1 percent) at the end of 2013. Inflation is expected to stabilize around 5 percent in the medium term.

(Percent)　Forecast Range*　— Uncertainty Band　— Output Gap　● Year-End Inflation Targets　◆ Realizations

Control Horizon

Source: CBRT.

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