CENTRAL BANK OF THE REPUBLIC OF TURKEY

Presentation at the Banks Association of Turkey

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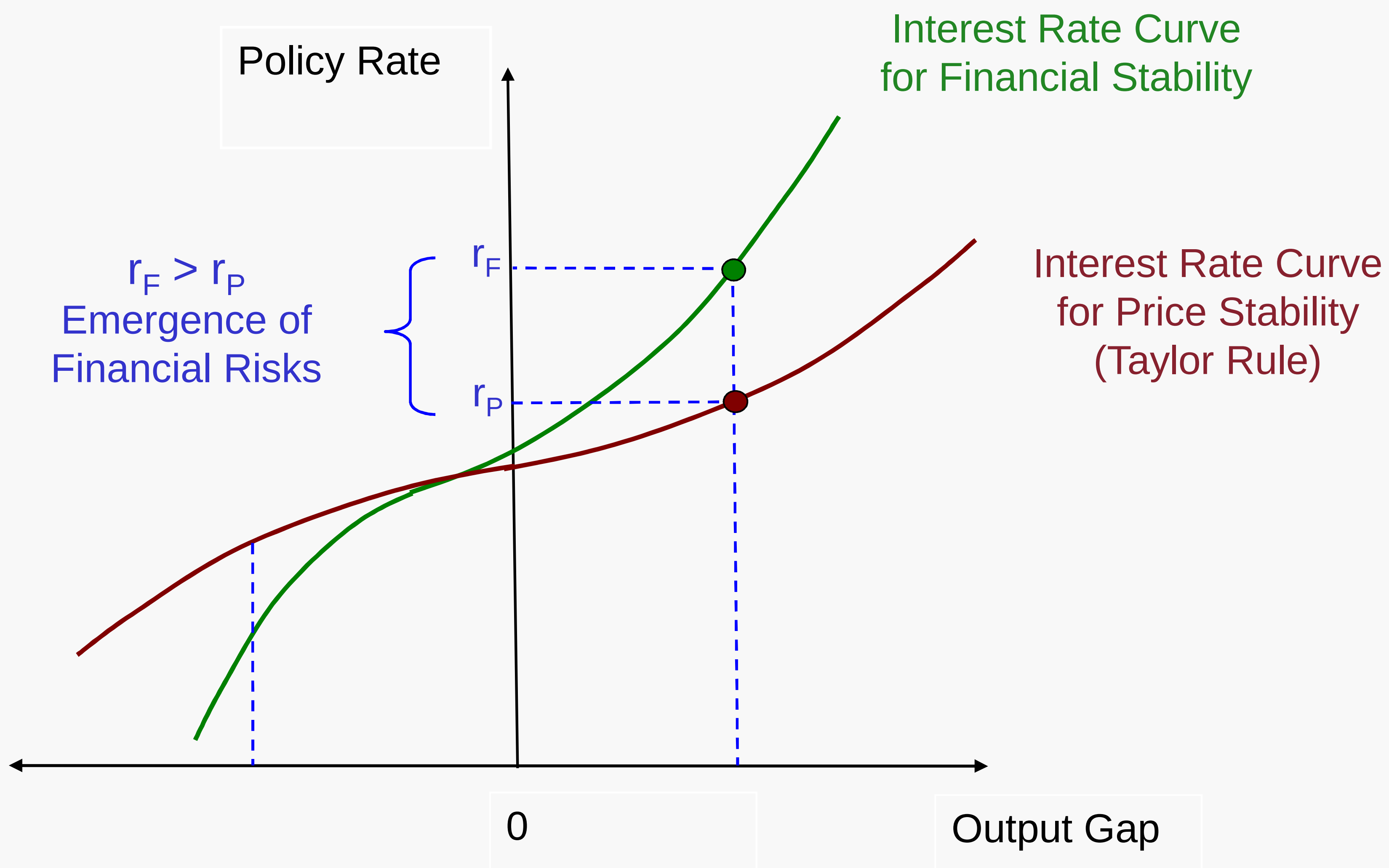
Presentation Outline

TÜRKİYE CUMHURİYET MERKEZ BANKASI

Central Banks and Financial Stability

- Financial stability has come to the forefront in the agenda of policymakers due to the developments that took place during and after the global financial crisis.
- In an economy, the level of interest rate required for price stability and the level of interest rate required for financial stability are not always congruent with each other.
- In case of an overheating, an interest rate policy that contains inflation could fall short of preventing emergence of financial risks.
- On the other hand, in case of a severe recession, a much lower level of interest rate may be required in order to restore financial stability.

Central Banks and Financial Stability

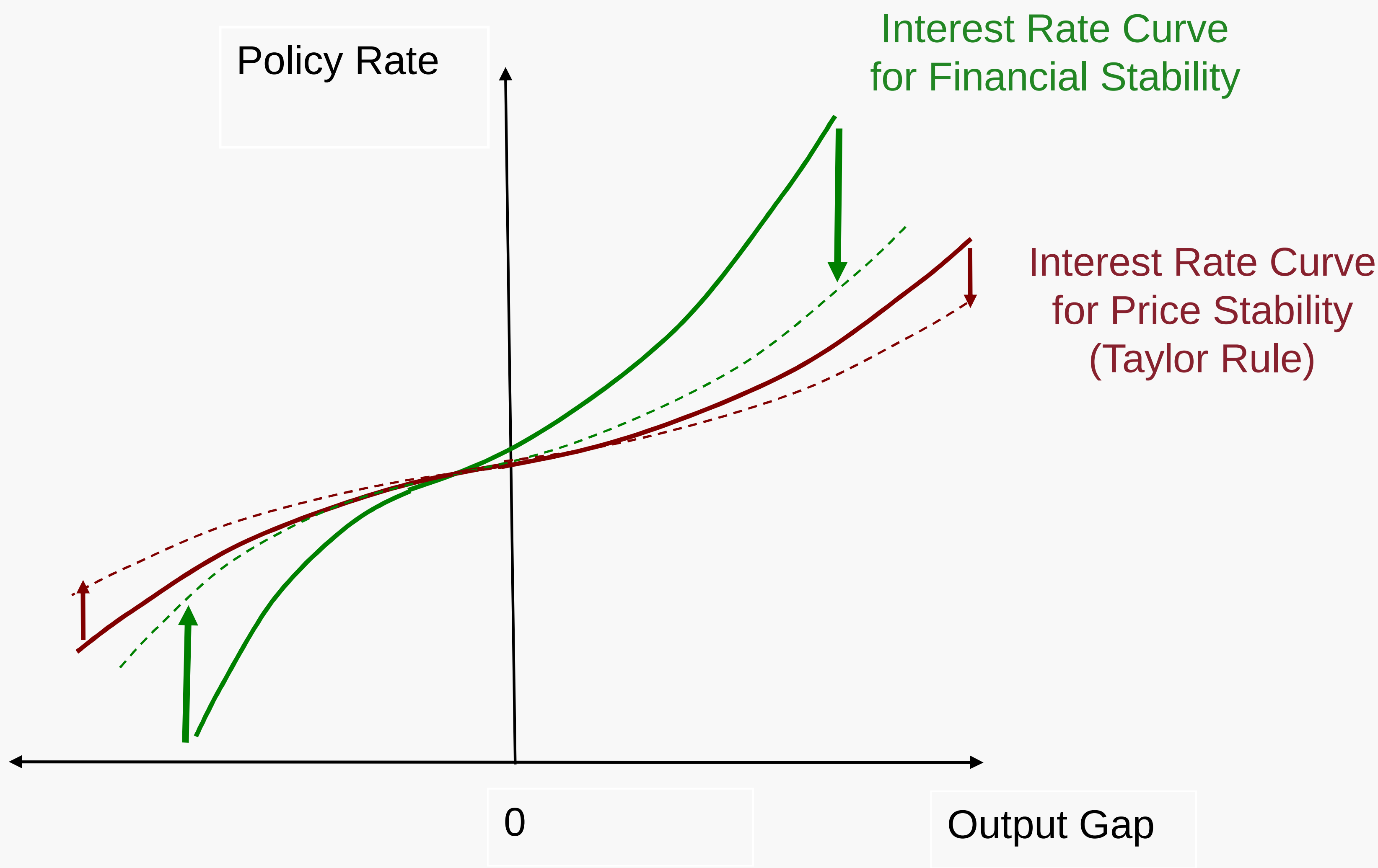


Note: Where non-interest instruments are not used

Central Banks and Financial Stability

- One of the primary factors leading to the global financial crisis is that central banks of developed countries ignored financial stability while focusing on price stability.
- For instance, although the Federal Reserve with its monetary policy between 2003 and 2007 kept inflation at low levels, it caused an excessive increase in debt ratios and asset prices , leading to deterioration of financial stability.
- Prudent monetary and fiscal policies followed in Turkey since 2002, and cautious policy implementations by institutions responsible for financial stability, primarily the Banking Supervision and Regulation Agency (BRSA), coupled with monetary tightening implemented in the post-2006 period and cautious monetary policy stance adopted after that prevented emergence of risks in our financial system.

Cases Where Non-Interest Instruments are Used



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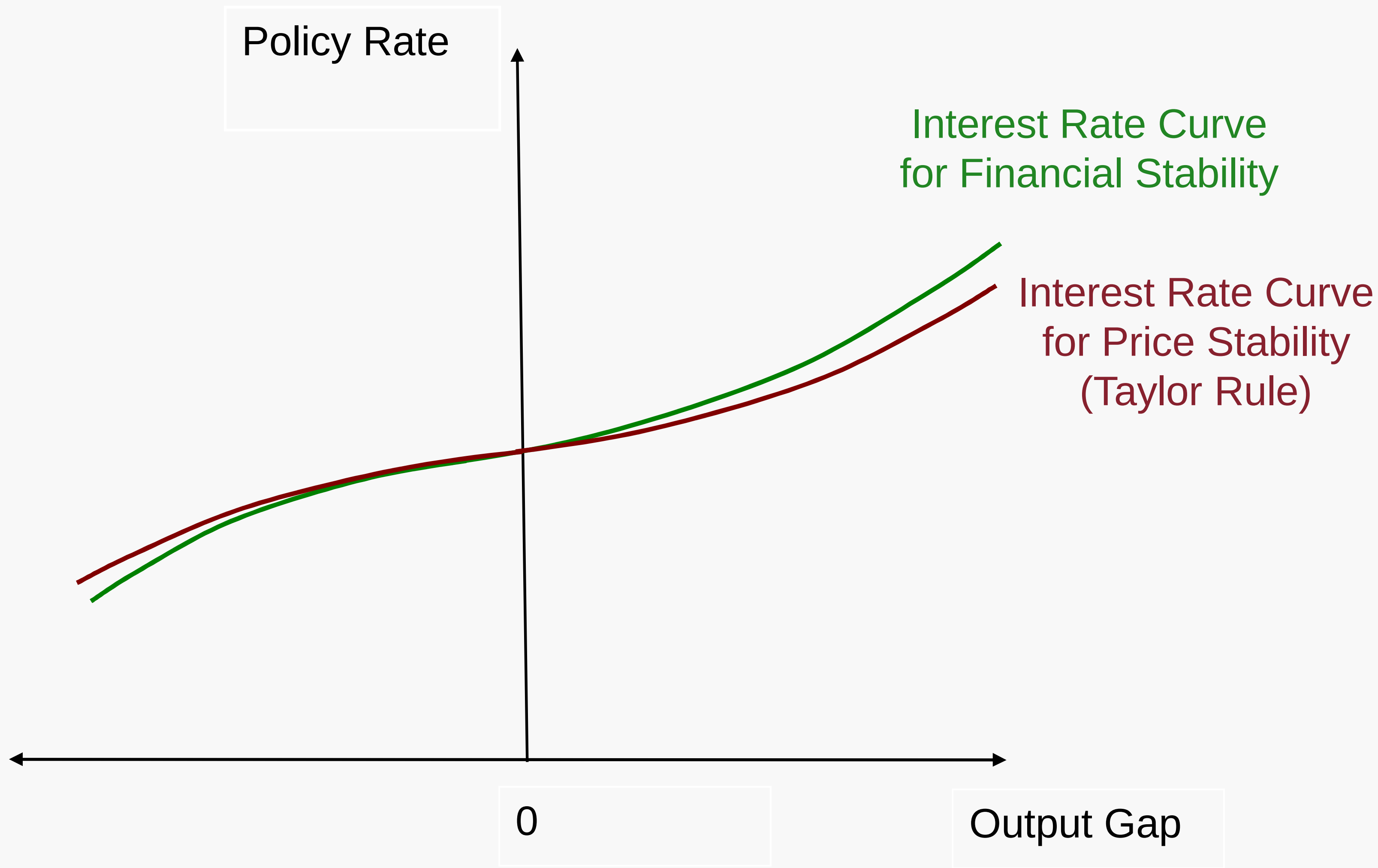

Central Banks and Financial Stability

- **The additional measures we have taken recently should be evaluated as a preparation for the new economic climate, which, in our opinion, will dominate the whole world in the upcoming period.**
- **The main feature of this new economic situation is the emergence of the risks of overheating, excessive indebtedness and emergence of asset bubbles as a result of intensive capital inflows towards reliable and dynamic emerging market economies, and the probability of elevated levels of current account deficit threatening financial stability.**

Central Banks and Financial Stability

- **"To take precautions for enhancing the stability in the financial system and to take regulatory measures with respect to money and foreign exchange markets" (CBRT Law, Article 4)**
- **As stipulated by its Law, the Central Bank is one of the institutions responsible for financial stability in Turkey.**
- **Unlike other institutions in charge of supervision and regulation, the Central Bank approaches financial stability from a macro perspective.**

Financial Stability: Objectives

1. **Debt Ratios:** ***Use of more equity capital and more prudent borrowing***
2. **Debt Maturities:** ***Extending maturities of domestic and foreign borrowing and deposits***
3. **FX Positions:** ***Strengthening the FX positions of public and private sectors***
4. **Risk management processes and methods:** ***More effective management of exchange rate risk via instruments such as the Turkish Derivatives Exchange***

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Financial Stability: Instruments

1. Required Reserve Ratios
2. Liquidity Management of the Central Bank
3. Capital Adequacy Ratios
4. Liquidity Adequacy Ratios
5. Taxes
6. Primary Expenditures of Public Sector

Cyclical and Structural Objectives

For the purpose of maintaining financial stability, the current policy instruments might be used to:

1. **Offset cyclical effects:** **(Example 1: Global financial crisis; Example 2: Excessive Borrowing),**
2. **Attain structural targets:** **(Example: Extending the funding maturity of banking system),**

Liquidity Management Instruments of the Central Bank

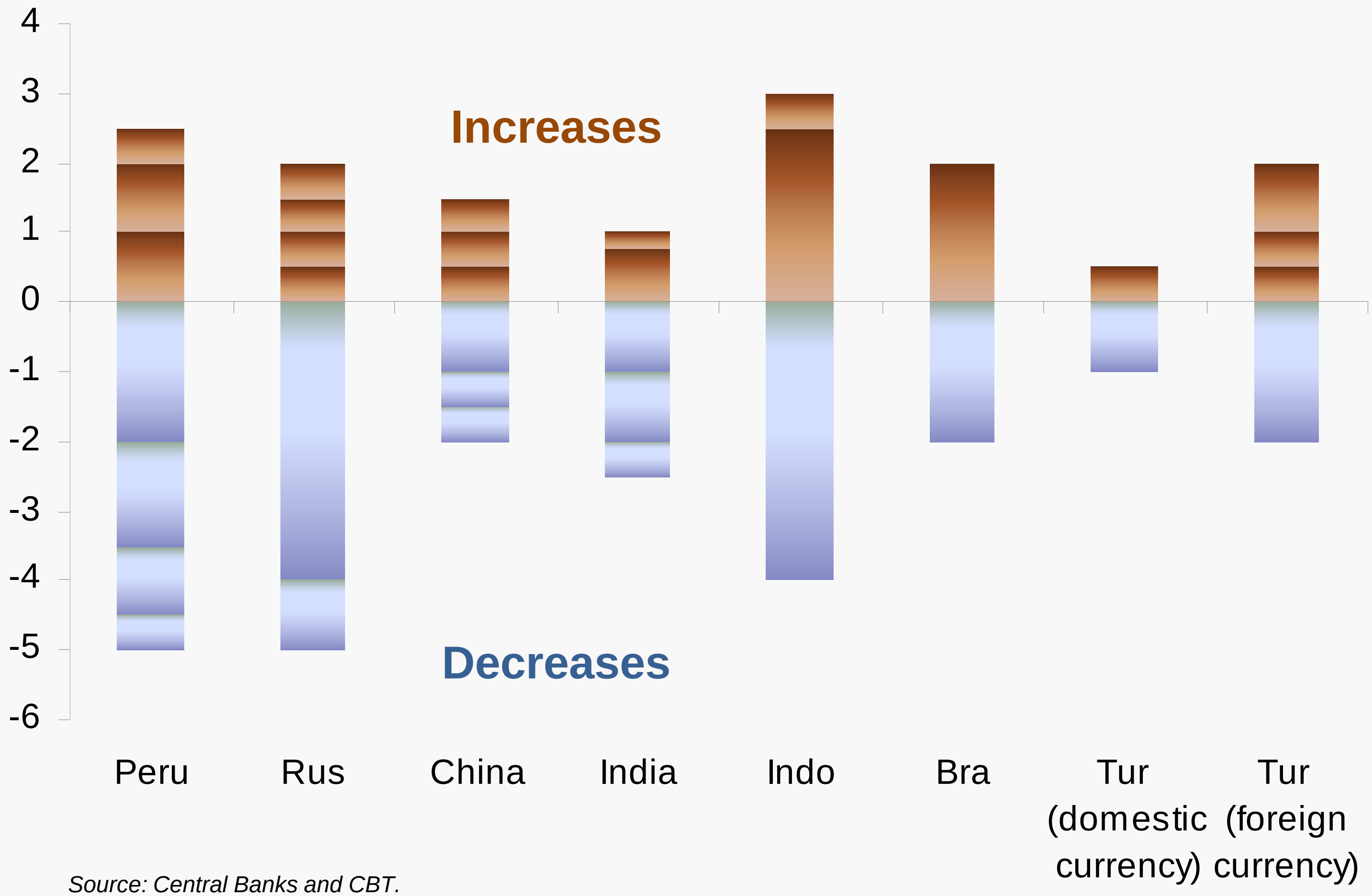
1. FX Purchases
2. Weekly Repo Auctions
3. 3-Month Repo Auctions
4. Corridor System
   - Either the difference between the overnight borrowing and lending rates, or the difference between these rates and the one-week repo auction rate will be determined as an element of the operational framework of monetary policy (Exit Strategy 2010, paragraph 16.b.iii)

Required Reserves

1. Liquidity Effect
   - Applies in every situation
2. Cost Effect
   - Effect fades when interest is paid for required reserves.

Required Reserves

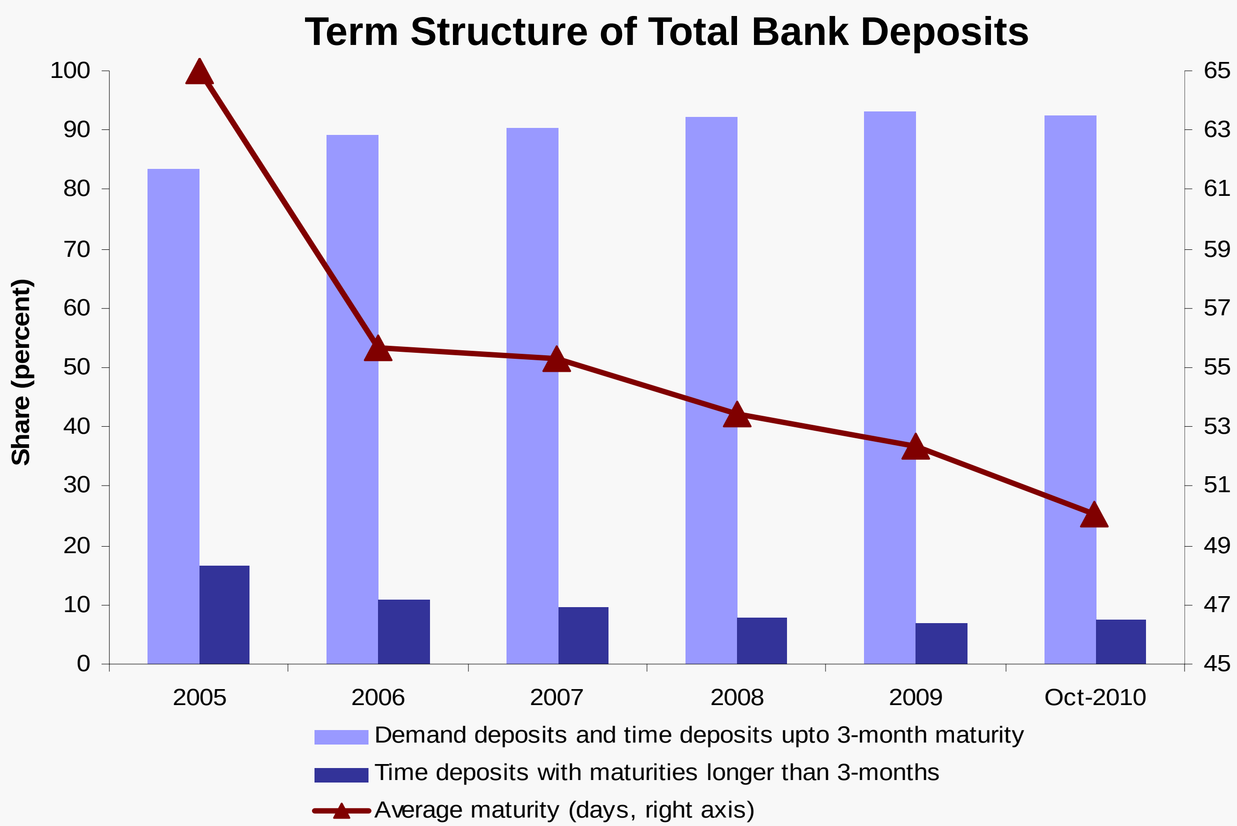
The Change in Required Reserve Ratios of Selected Countries During the Crisis and Afterwards (percentage points)



Source: Central Banks and CBT.

Maturity Structure of Bank Deposits

Maturity structure of deposits in Turkey is short and getting shorter.



TÜRKİYE CUMHURİYET MERKEZ BANKASI

Maturity Structure of Bank Deposits

- **In this respect, as a measure to strengthen financial stability, required reserve ratios applied to one-year or longer term deposits may be slightly reduced by the end of the year.**

Central Bank's Policy Instruments

Instruments Used for Price Stability (in the order of priority):

1. **Short Term Interest Rates**
2. **TL Liquidity Management**
3. **Required Reserves**

Central Bank's Policy Instruments

Instruments Used for Financial Stability (in the order of priority):

1. **Required Reserves**
2. **TL Liquidity Management**
3. **Short Term Interest Rates**

Central Bank's Policy Instruments

<u>Frequency of Use of the Instruments (from the most to the least frequent)</u>:

1. **TL Liquidity Management**
2. **Short Term Interest Rates**
3. **Required Reserves**

Central Bank's Policy Instruments

<u>Predictability of the Instruments (from the most to the least predictable)</u>:

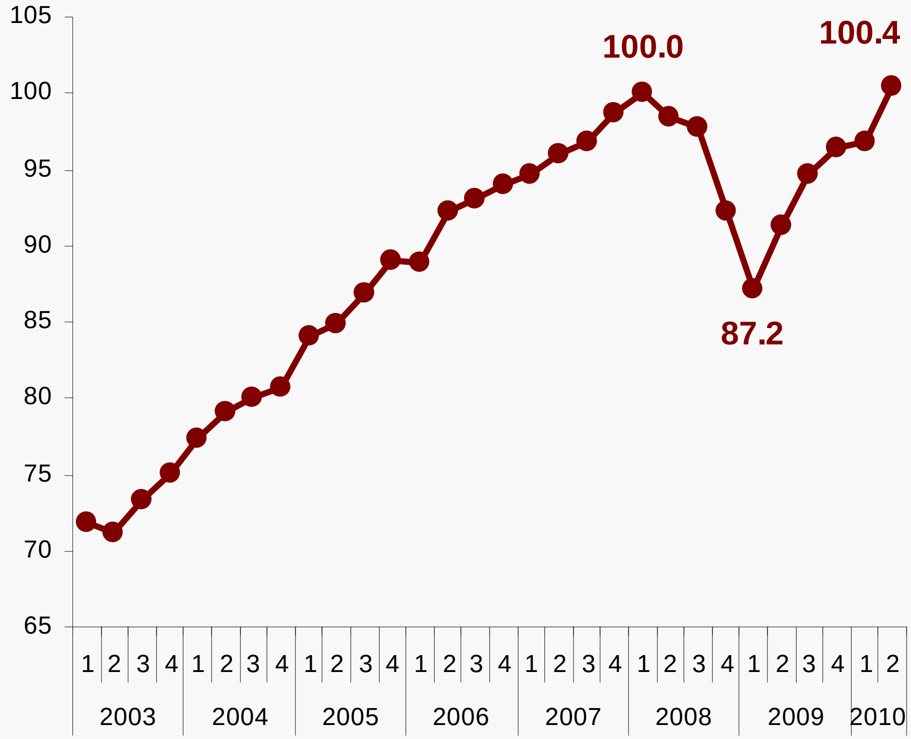
1. **Required Reserves**
2. **Short Term Interest Rates**
3. **TL Liquidity Management**

Economic Outlook and Risks

Economic outlook does not exhibit a marked acceleration, whereas credit volume experiences a boost.

Seasonally Adjusted GDP

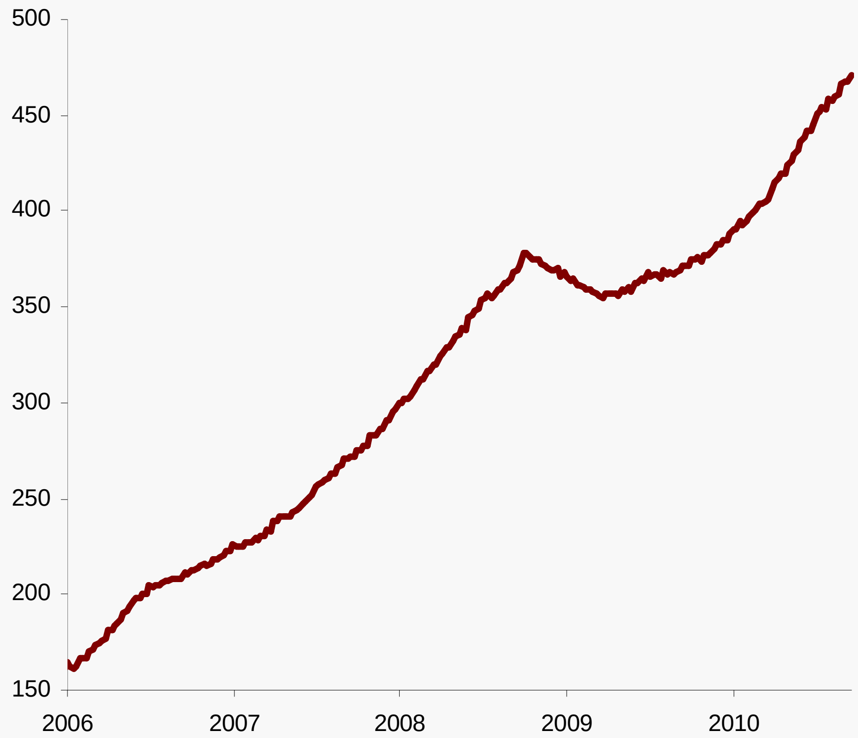
(2003 Q1 – 2010 Q2, constant prices, 2008 Q1 = 100)



Source: TurkStat, CBT

Total Credit Volume*

(Jan 2006 – Sept 2010, billion TL)



* Total credits extended by deposit, development, investment and participation banks along with consumer financing firms; based on constant exchange rates

Source: BRSA, CBT

Economic Outlook and Risks

- **Although no acceleration is anticipated in aggregate demand, due to the recent decoupling of paces of recovery in domestic and external demand, the composition of demand should be carefully evaluated as per the risks for current account balance and financial stability.**
- **Both the strengthening anticipation that developed countries will keep interest rates at low levels for an extended period and the decline in the relative riskiness of our country in the post-crisis period, along with the increase in capital flows to the developing countries foster the risks regarding the decoupling of paces of domestic and external demand.**

Economic Outlook and Risks

Risks to be monitored primarily regarding the current account deficit:

1. **Excessive Public Borrowing (Greece example)**
2. **Excessive Private Sector Borrowing (Ireland, USA examples)**

Policy Instruments Affecting CAD

1. Primary Budget Surplus
2. Taxes
3. Capital Adequacy Ratios (Basel III)
4. Liquidity Adequacy Ratios (Basel III)
5. Required Reserve Ratios
6. Central Bank’s Liquidity Management

Exit Strategy and Beyond

- **Inflation Report (July 2010): "…the measures outlined in our exit strategy to be completed to a large extent throughout the rest of the year, …" (baseline scenario)**

- **Decision of the Monetary Policy Committee (16 September 2010): "The Committee has indicated that it would be appropriate to proceed with the measures outlined in the exit strategy that were envisaged to be implemented by the end of 2010."**

Exit Strategy and Beyond

- In this respect, Turkish lira required reserve ratio can be increased to 6 percent by the end of the year.
- We will announce the signals regarding the course of required reserve ratios in 2011 with the Monetary and Exchange Rate Policy Strategy to be published in December.

Exit Strategy and Beyond

- **Termination of remuneration of Turkish lira required reserves is a step to facilitate the effective use of reserve requirement ratios as a policy tool to foster macroeconomic stability.**
- **We do not observe, in the short term, any overheating in the economic activity as a risk for price stability or excessive borrowing as a risk for financial stability.**
- **The decisions we took are the measures to enhance the resilience of our economy against the risks that we may be exposed to in the medium term.**
- **The Central Bank will continue to monitor the financial system in macro scale and fulfill its responsibilities to maintain financial stability.**

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