Central Bank of the Republic of Turkey

"Reform Strategies and Expectations in the New Normal: A Public Perspective"

Active Academy

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Distinguished Participants and Esteemed Guests,

Before starting my speech, I would like to thank the directors and staff of the Active Academy for their efforts in organizing the 8th International Finance Summit.

The Turkish economy, which has achieved stronger macroeconomic fundamentals and a sound financial system thanks to steadfast implementation of structural reforms since 2001, has been one of the economies that exited the crisis very rapidly. In the upcoming period, the new economic conjuncture needs to be managed wisely in order to sustain macroeconomic stability. Therefore, today I would like to devote my speech entirely to macroeconomic stability.

Distinguished participants,

The recovery observed in the aftermath of the crisis continues albeit being slow and gradual. However, the downside risks pertaining to the future global growth outlook persist. Vulnerabilities continue especially in developed countries that experience serious deterioration in budget balances and an excessive rise in public debts. Perceptions are growing that the accommodative fiscal policies and expansionary monetary policies adopted by these countries fall short of achieving the desired results in unemployment and growth. Meanwhile, developing countries, which have stronger financial structures, are enjoying a faster recovery process. The decoupling observed between these two groups of countries is expected to continue in the upcoming period as well.

Global liquidity has increased significantly as central banks of developed countries, which eased policy rates rapidly, adopted quantitative easing policies. Recently, capital flows to developing countries such as Turkey have been accelerating owing to expectations that short-term interest rates in developed countries would remain low for an extended period, the decoupling in growth performances of countries and increased risk appetite.

In the face of growing capital flows, some developing countries are introducing measures to prevent capital inflows. However, past experiences of countries show that restricting capital inflows is not really effective in terms of the volume of capital inflows while it is only partially effective in terms of the type of incoming capital. In other words, due to reasons such as financial innovation and the integration of markets, it is not possible to effectively prevent capital flows, unless they are fully controlled.

The current conjuncture is conducive to benefiting wisely from capital flows and implementing policies that would reinforce financial stability and enhance financial depth. In this respect, the Financial Stability Report, which was prepared by the Central Bank of the Republic of Turkey and made public yesterday, is an important policy text delineating the strategy to be implemented in the upcoming period to maintain and reinforce financial stability in Turkey. Therefore, I suggest that the report be examined in detail.

The policy framework, which the Report outlines in detail, has four pillars. One of the main pillars of policy implementations in this respect is to encourage economic units to borrow less and to use more equity capital (in other words to have lower leverage ratios). Recent implementations such as increasing required reserve ratios, the termination of remuneration of required reserves, the sustained fiscal discipline in the public sector as underlined in the revised Medium-Term Program, the increase in Resource Utilization Support Fund deductions imposed on consumer loans, the introduction of limitations to loan/value ratio in mortgages, the 12-percent target for banks' capital adequacy ratios are deterring measures against an excessive rise in indebtedness ratios.

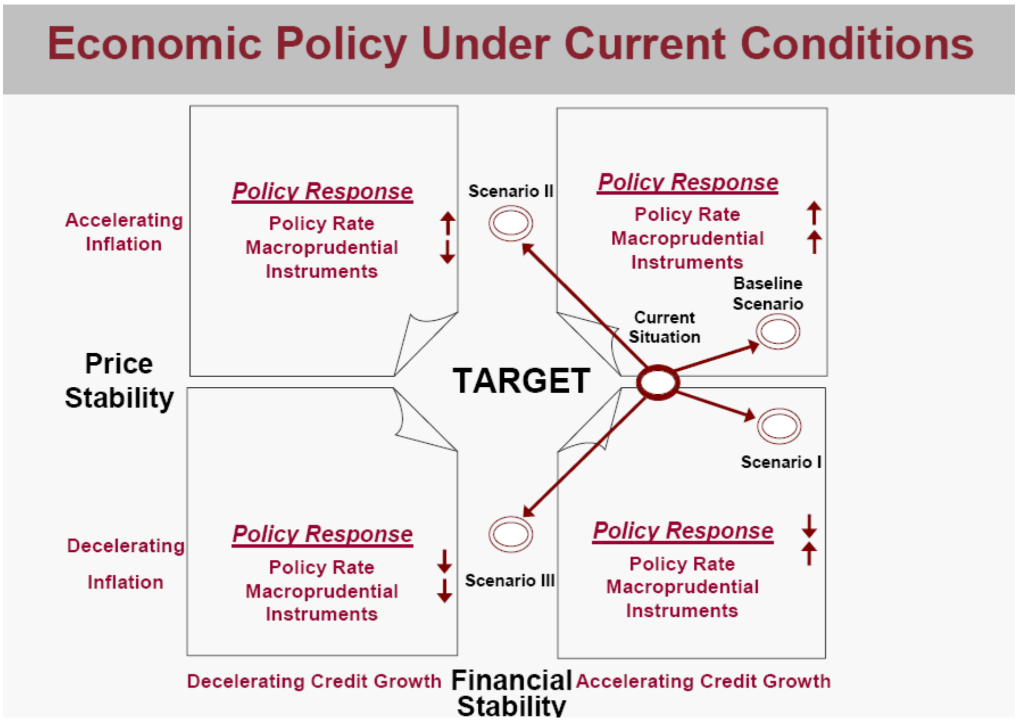
Secondly, the extension of maturities regarding the borrowings of economic units is encouraged. Under the aegis of the Undersecretariat of Treasury, studies for extension of maturities in public borrowings are being carried out successfully. An important development is that The Banking Regulation and Supervision Agency has permitted the issuance of Turkish lira bonds so as to extend the maturities of liabilities in the banking sector. Additionally, the Central Bank decreased overnight borrowing by 400 basis points last month enabling short-term swap interest rates to go down when required. Besides, the Central Bank aims to encourage long-term deposits with the new arrangements to be made in required reserves.

The third pillar of the policy framework is to encourage borrowing in terms of the Turkish currency and to strengthen the net foreign exchange position. To this end, the Undersecretariat of Treasury is oriented towards borrowing in TL; the FX-denominated domestic debt stock was pushed down gradually and Central Bank accelerated reserve accumulation at times of elevated capital inflows, through the flexible foreign exchange buying auctions. Reasons such as implementation of the floating exchange rate regime, the progress made in terms of attaining price stability and the decrease in TL interest rates have facilitated a wider use of Turkish lira in the economy as opposed to foreign currency. Moreover, measures like setting higher required reserve ratios for foreign exchange than those for Turkish lira and not permitting households to use FX-denominated or FX-indexed loans encourage the private sector to borrow in Turkish lira. The foreign exchange net general position arrangement for the banking sector and allowing the issuance of TL bonds by banks in a controlled manner can also be considered in this context.

The fourth and last pillar of the policy framework is to promote the risk management concept. In this respect, steps to be taken regarding financial training assume importance for the smooth functioning of the system. We welcome the efforts towards increased recognition of Turkish Derivatives Exchange, more diversified products and more widespread use of forward transactions. In addition, we believe that the floating exchange rate regime that has been in implementation since 2001 has significantly contributed to the embedding of awareness of exchange rate risk.

In short, given the current conjuncture, the avoidance of excessive borrowing both by the public and private sector; preference of longer maturities in all borrowings, opting to borrow in TL as much as possible and managing risks efficiently will considerably strengthen the resilience of Turkish economy against external shocks.

The monetary policy adopted by the Central Bank is composed in a way to make price stability and financial stability complementary. In this context, I would like to evaluate how the CBRT will use policy tools in the upcoming period within the framework of possible scenarios provided in the inflation reports.



As also demonstrated on the slide, the current conjuncture supports the CBRT's stance of keeping policy rates constant for some time, and at low levels for a long period. On the other hand, developments in the aggregate demand composition necessitated that instruments other than the policy rate be brought to pre-crisis levels. In this respect, we have largely completed the exit strategy measures that we announced in April 2010.

In the October Inflation Report, we stated that our baseline scenario was based on an outlook where domestic demand is stronger compared to the previous reporting period, external demand continues to restrain economic activity, and thus aggregate demand conditions continue to support disinflation, albeit to a lesser degree. This baseline scenario assumes a policy framework that the measures outlined in our exit strategy are completed by the end of the year, and that policy rates are kept constant at current levels for some time followed by limited increases starting from the last quarter of 2011, with policy rates staying at single digits throughout the forecast horizon (in other words, 3 years). In this respect, non-interest instruments will be actively used in order to address the risks on financial stability stemming from rapid credit expansion and deterioration in the current account balance.

The European Central Bank reluctantly joined the ranks of the Federal Reserve, Bank of England and Bank of Japan that have engaged in monetary expansion due to fast-growing debt problems in Europe. As a result, materialization of the first scenario has become more likely, as illustrated in the right-hand part of the chart. In that case, the scenario described in our Inflation Report of October 2009 might come up on the agenda. According to this scenario, on account of the expansionary fiscal and monetary policy on a worldwide scale, coupled with rising risk appetites and the relative improvement of credit risk across emerging markets including Turkey, capital inflows to these countries will continue to hold strong. The low level of resource utilization as well as the strong tendency of cost shocks, which reduce the prices of imported inputs, to reflect upon consumer prices suggests downside risks on inflation in the short term. Materialization of such a scenario could lead to temporarily lower policy rates than envisaged in the baseline scenario and the use of macroprudential instruments in the direction of tightening in order to cut the pace of credit growth in tandem with the temporary rate cuts.

The **second scenario** illustrated in the chart was shared with the public in our Inflation Report of October 2010. Both recent economic developments in Europe and decisions taken by central banks of developed countries increase global economic uncertainty significantly. Should the measures taken at a global level cause long-term and high-rated increases in food and commodity prices, and should such increases lead to a deterioration in the price setting behavior, which in turn, hampers achieving the medium-term inflation targets, an earlier-than envisaged tightening in the baseline scenario would be considered. In this case, as domestic credit expansion would weaken, the use of macroprudential instruments might not be needed in the direction of tightening.

If measures taken in developed countries remain inadequate, the **third scenario** illustrated in the lower left-hand part of the chart might be considered. In that case, as indicated in the latest Inflation Report, should the global economy face a longer-than-anticipated period of anemic growth, the monetary tightening envisaged to start in the final quarter of 2011 under the baseline scenario might be postponed. Moreover, an outcome, whereby global economic problems intensify and contribute to a contraction of domestic economic activity, may trigger a second round of easing. In this case, the use of macroprudential instruments might not be needed in the direction of tightening, as domestic credit expansion will weaken.

Distinguished Guests,

I would like to underscore once more that as the Central Bank, our primary objective is to achieve and maintain price stability, and that as stipulated by Article 4 of the CBRT Law, we are responsible for "*taking precautions for enhancing the stability in the financial system and taking regulatory measures with respect to money and foreign exchange markets".* Therefore, we will continue to act with due diligence in terms of financial stability in the upcoming period as well. However, the Central Bank is not the only entity in charge of financial stability. Other public authorities such as the Ministry of Finance, Undersecretariat of Treasury, Capital Markets Board of Turkey, and primarily the Banking Regulation and Supervision Agency, also have significant authority and policy instruments in this regard. It is essential that in the period we are going through, all policy instruments in hand should be deployed in a coordinated manner for the establishment of a sounder and more stable financial structure.

To close my remarks, I would once again like to thank everyone who has contributed to the organization of this event.