Central Bank of the Republic of Turkey

Global Crisis, Effects and Monetary Policy

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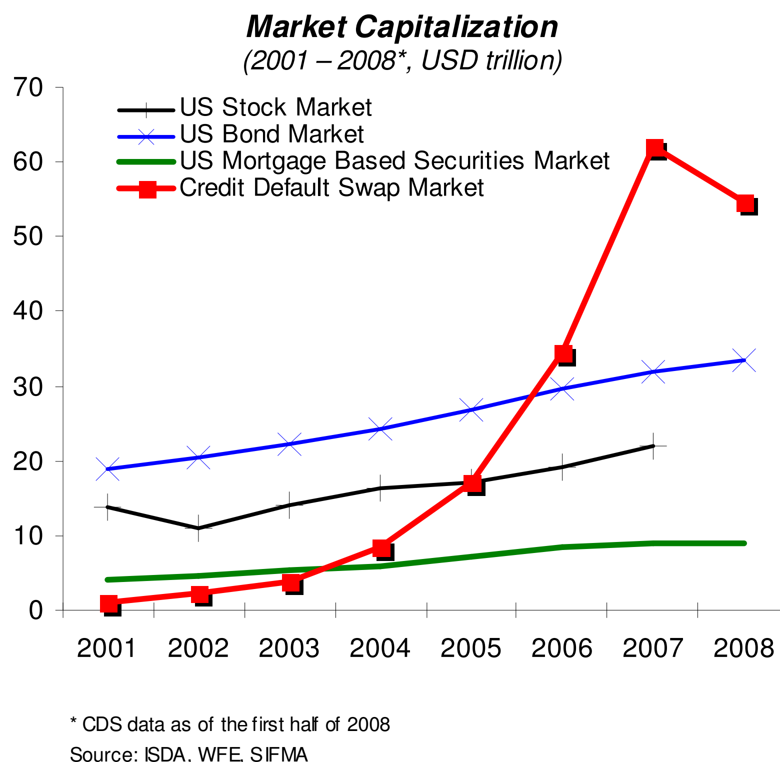
1. Recent Developments in International Markets and Global Economy

I would like to start my speech with a brief summary of recent developments in international financial markets and global economy.

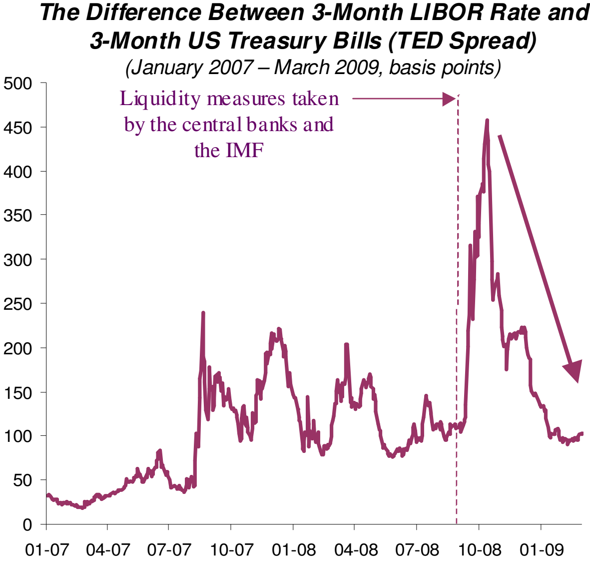
The turmoil in the global markets that emerged in July 2007 has not yet come to an end. What distinguishes this crisis from previous banking crises is that it is not a "classical banking crisis"; it covers complex and large-volume derivative products. The large volume of derivatives has necessitated extending the scope of financial support packages to unprecedented levels. Moreover, the complex structure of these products imposes technical challenges related to the content of support packages.

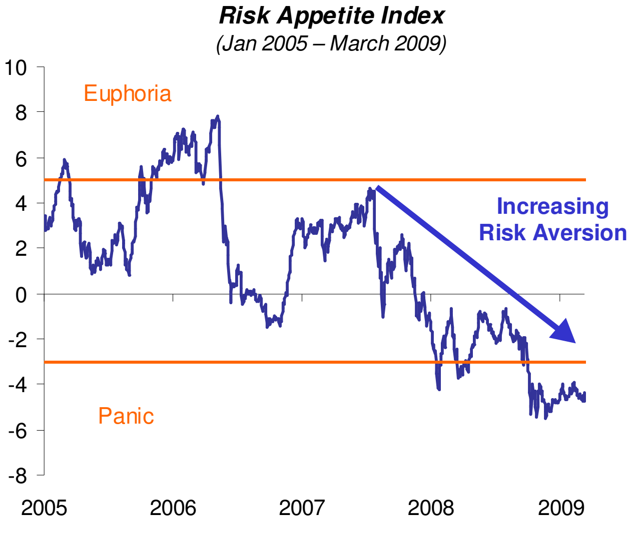


* CDS data as of the first half of 2008
Source: ISDA, WFE, SIFMA

The liquidity crunch that emerged as a result of the deterioration in risk perceptions and loss of confidence has been eliminated to a large extent thanks to measures taken by the monetary authorities. Nevertheless, asset write-downs at significant levels depleted the capitals of financial institutions and generated serious adverse effects on balance sheets. As a result, many banks and investment agencies were forced to file for bankruptcy or they had to be bailed out by the state. Those who managed to survive the crisis are reluctant to extend credits to the corporate sector

due to not only the high losses they incurred, but also the derivative products they carry on their balance sheets that cannot be priced. Another factor causing the liquidity crunch to persist is the prevailing credit risk at high levels due to the lack of establishing an environment of trust.

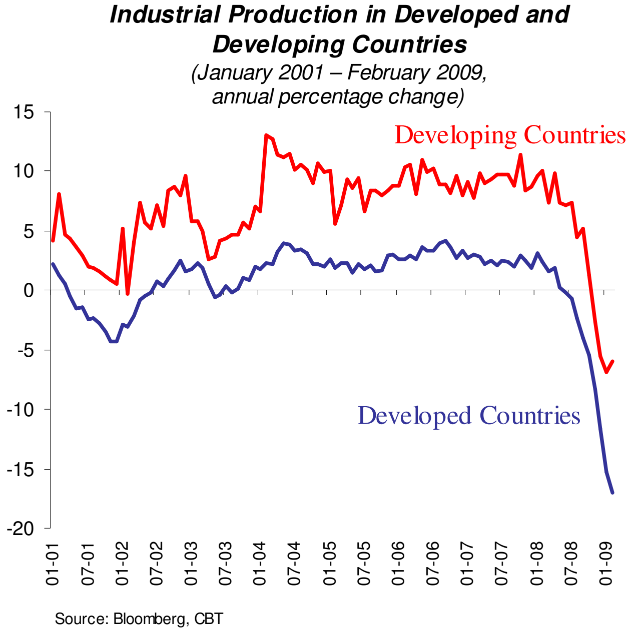




The effect of the global financial crisis on world economies has emerged in an abrupt and devastating manner since the last quarter of 2008. The increasing uncertainty impeded the functioning of the credit mechanism, which in turn raised borrowing costs while limiting the borrowing facilities of the corporate sector. Growth rates in global economies took a sharp plunge, industrial production narrowed down to levels not seen since the Second World War, unemployment rates soared, and household and real sector confidence indices saw their lowest-ever levels. Although the duration of the repercussions of the financial crisis on the corporate sector cannot be anticipated, it is believed that economic activity will continue to decelerate in the upcoming period and it will take a significant amount of time to recover. The extent of the devastation caused by the crisis to the corporate sector will be perceived more clearly with the announcement of balance sheets pertaining to the last quarter of 2008 and the first quarter of 2009.

Both developed and emerging economies have been seriously affected by the global economic turbulence in a period characterized by the progressively rising

interdependent nature of global economies. However, the scale of the impact differs from one country to another.



Today, the economies most affected by the global contraction of foreign trade are those with a large share of exports in their gross domestic product and especially the ones that export investment and durable goods. This can be observed in the 6.4 percent contraction in the US economy, the main driver of the crisis, as opposed to the 12.4 percent decline in case of Japan, and deeper economic stagnation experienced by Germany as opposed to France, despite both being members of the European Monetary Union.

A similar difference also applies in view of the exchange rate regime in place. Countries implementing fixed or administered exchange rate regimes experience sharper slowdowns both in terms of economic activity and the pace of inflation, compared to those implementing floating exchange rate regimes. The reason for this difference is that central banks implementing a fixed or administered exchange rate regime has to withdraw local currencies from the market against the sale of foreign exchange in order to keep the exchange rate intact in the face of capital outflows. This causes market interest rates rise and liquidity conditions tighten beyond anticipation. Whereas, in countries implementing floating exchange rate regimes, the depreciation of local currencies and slackening of interest rates by monetary

authorities in a controlled manner curb the extent of the contraction in economic activity. In other words, in a country with free capital flows, floating exchange rate regime acts as a safety valve preventing over-contraction of the economy, under rapidly deteriorating international liquidity conditions.

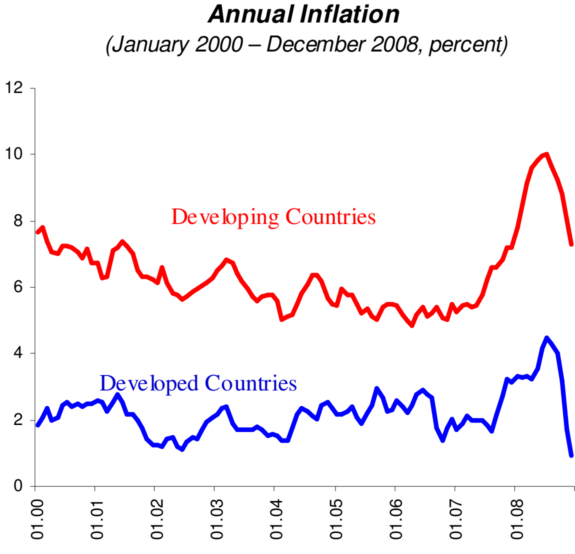
2. Policy Response

In a fast-changing global economic conjuncture, the forecasts, upon which the monetary policy is based, are by a great margin in line with every new data released. These frequent revisions call for a fairly flexible monetary policy.

Coupled with worries related to a slowdown in economic activity that is above anticipations due to the economic crisis, inflation concerns were replaced by deflation risk. In such a period, central banks of developed countries are struggling to contain the financial crisis by lowering their policy rates significantly. Central banks of developing countries initially adopted a cautious stance in view of falling exchange rates and concerns over financial stability. They have recently shifted their stance towards loosening their monetary policies as aggregate demand conditions declined sharply during the later stages of the crisis and as inflation no longer stood as a source of concern. In the period between September 2008 and February 2009, when the financial turbulence turned into a crisis, developed and developing countries lowered their policy rates by 260 and 140 basis points on average, respectively.

Annual Inflation

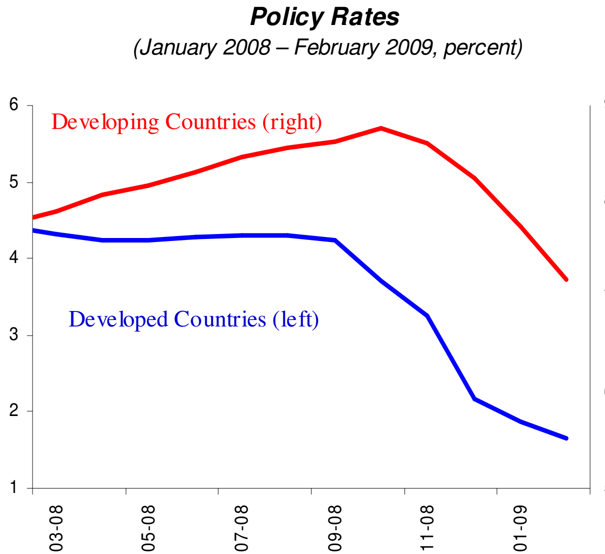
(January 2000 – December 2008, percent)



Source: IMF

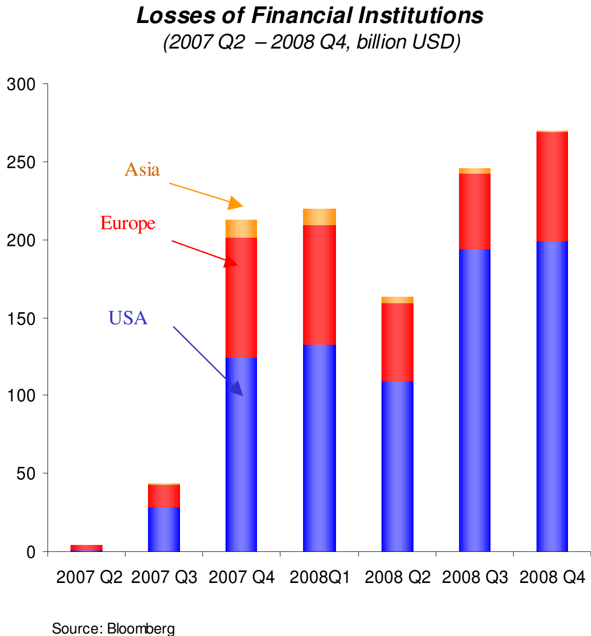
Policy Rates

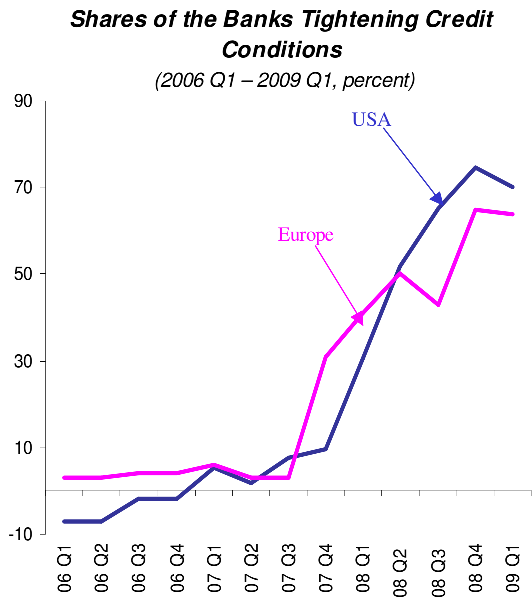
(January 2008 – February 2009, percent)



Source : Central Banks, CBT

It is observed in this period that, especially the central banks of developed countries aimed to speed up the disposal of toxic assets on balance sheets of financial institutions and firms by expanding the range of bills that they accept as collateral and the number of tradable institutions, and to reactivate the credit mechanism. As a result, balance sheet aggregates of many central banks reached historical high levels. Despite massive liquidity injections into the market by central banks, credit risk perceptions remain high; hence banks act cautiously while lending. The persistent tightening of credit facilities and mishaps in transmission channels restrain the effectiveness of monetary policy.



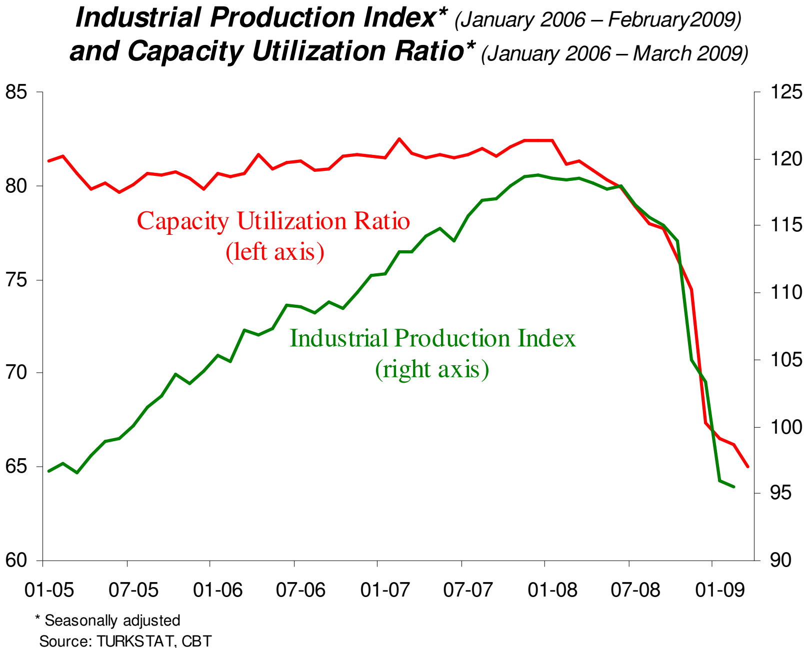


In addition to the measures taken by central banks, particularly the governments of developed countries have launched comprehensive financial packages covering tax reductions and new public expenditures. The magnitude of the current crisis and the recession in economic activity has spread around the world simultaneously and necessitated implementation of measures taken in a timely manner and in cooperation with other countries. Therefore, the financial measures taken in this period have been implemented more promptly and in coordinated action compared to the global crises experienced in the early 1980s and 1990s. Overall global financial measures that have been announced so far exceed USD 2 trillion in

total. Once they are implemented as planned in 2009, they are expected to reach 2 percent of the world economy.

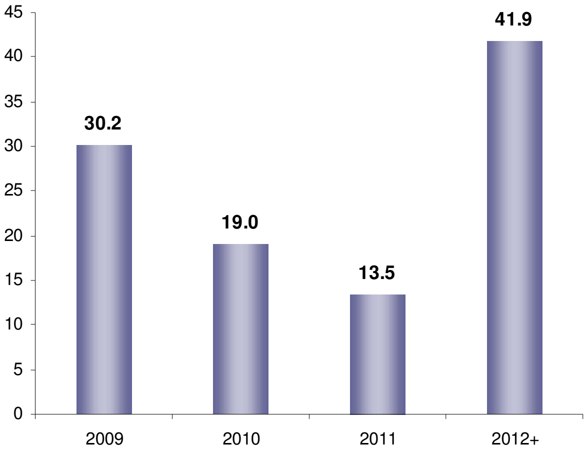
3. Effects of the Crisis on the Turkish Economy

Effects of the global crisis on the Turkish economy were felt heavily on both domestic and foreign demand in the last quarter of 2008. The downward course of the industrial production index gained pace as of October 2008 and in January 2009, the manufacturing industry capacity utilization rate declined to its lowest-ever level since 1991. The Turkish economy that has been growing steadily for 27 quarters in a row is expected to undergo a significant contraction in the last quarter of 2008. The slowdown in global economic activity has an adverse effect on Turkey’s export markets as well. In the last quarter of 2008, Turkey’s export growth lost pace considerably in terms of both price and quantity. Recent readings indicate that although consumer sentiment has shown signs of recovery, it has remained low by historical standards. The recovery in investment spending is expected to take time, given the historically low capacity utilization rates. Overall, it is estimated that economic recovery will be gradual and rather slow.



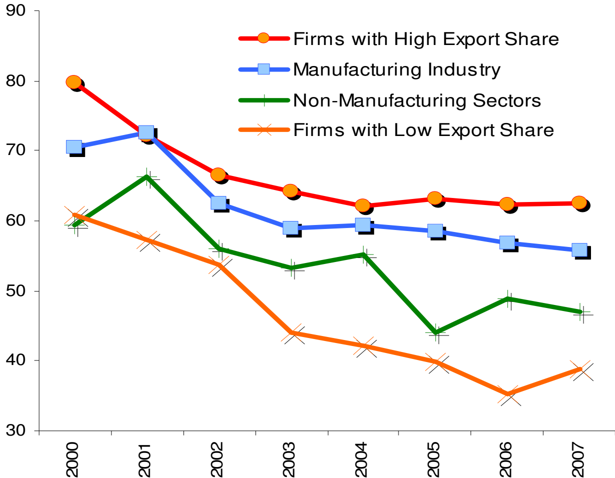
In current conditions, the sharp contraction in domestic and foreign demand affects companies' balance sheets through various channels. Although the cost of the borrowing by small and medium-scale enterprises, mainly TL-denominated, is high, the exchange rate risk borne by them is estimated to be limited. According to the Company Accounts, published by the CBT, 75 percent of small and medium-scale enterprises do not have FX-denominated debt. It is observed that the FX-denominated loans are utilized mostly by large-scale enterprises and export-oriented manufacturing companies, and their maturities are longer compared to previous periods. Besides, the FX short positions of enterprises, amounting to USD 85 billion in the third quarter of 2008, declined to USD 80.5 billion in the last quarter of the year.

Maturity Composition of Firms' Outstanding Long-Term FX Denominated Foreign Debt*
(February 2009, billion USD)



* Number of days to maturity
Source: CBT

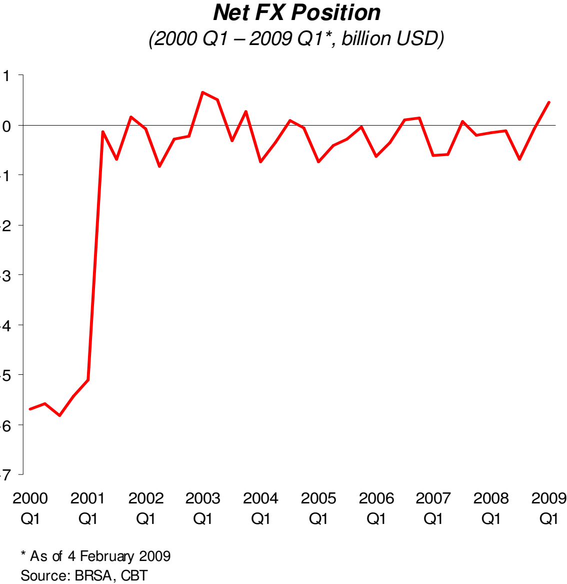
Debt Dollarization of the Real Sector
(2000 – 2007, percent)



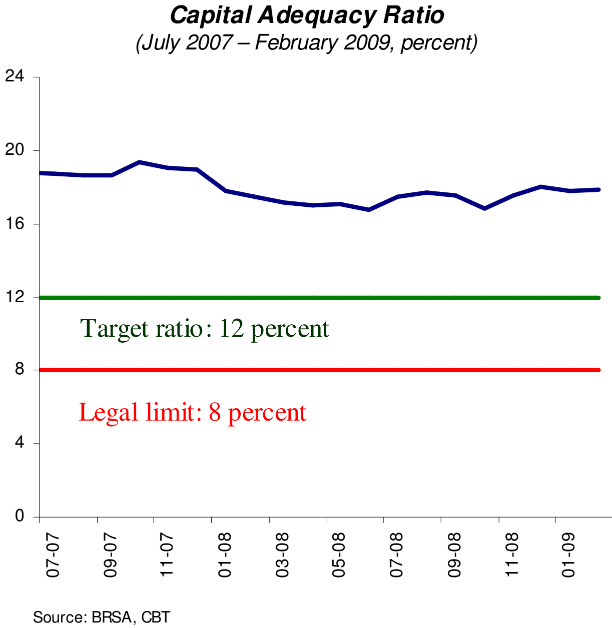
Source: CBT

Unlike its counterparts in the rest of the world, the Turkish banking system has not required a rescue package so far. Bailout plans and regulations that have only recently been adopted by many countries had already been put into practice in Turkey in the aftermath of the 2001 crisis at the cost of imposing a high burden on the public budget. In the following period, the resolute implementation of regulations related to and the supervision of the banking sector, backed by regulations pertaining to capital adequacy and particularly the FX-denominated liquidity ratios of banks have enhanced the resilience of the Turkish economy in the face of shocks,

compared to the banking systems of many other emerging economies. The strong level of capital adequacy of banks, reasonable levels for deposit to loan ratios and leverage ratios in comparison to those of developed countries, balance sheets that are free of toxic assets and with significantly low levels of FX short positions serve the resilience of Turkish banks.

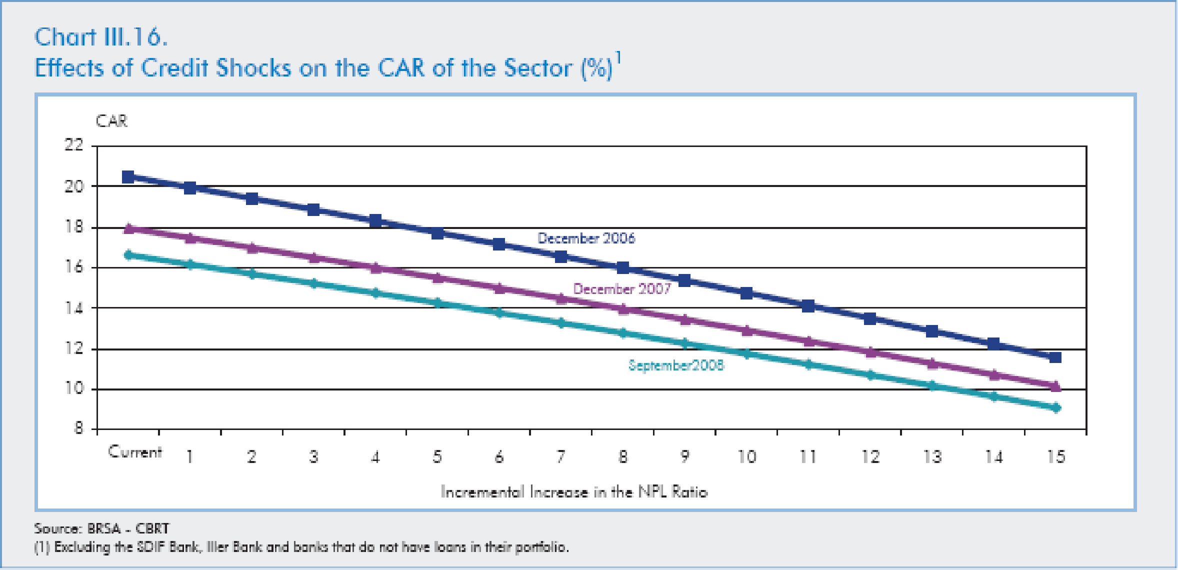


* As of 4 February 2009
Source: BRSA, CBT

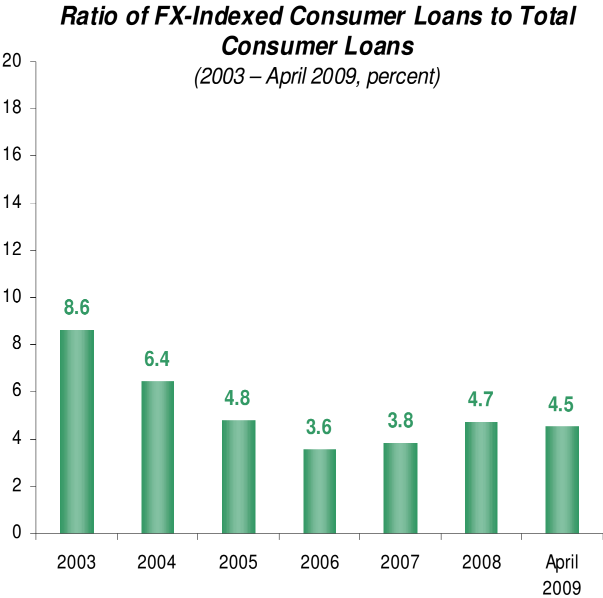


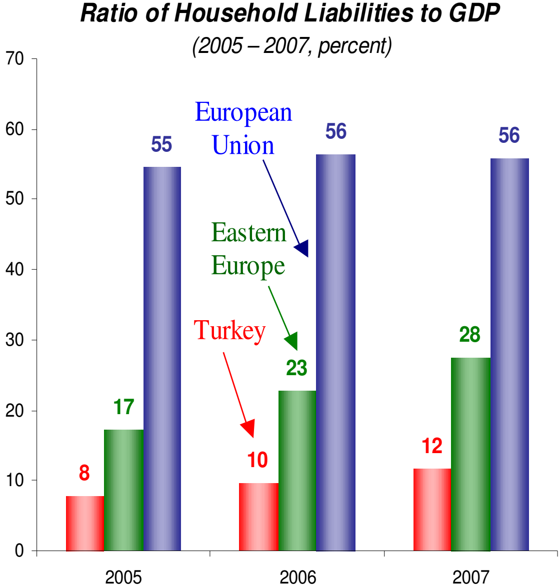
Source: BRSA, CBT

The scenario analysis conducted by the Central Bank indicates that the liquidity adequacy ratio of the sector would remain above the legal limit of 8 percent even in case of the non-performing loan ratio being exposed to a 15-point shock.

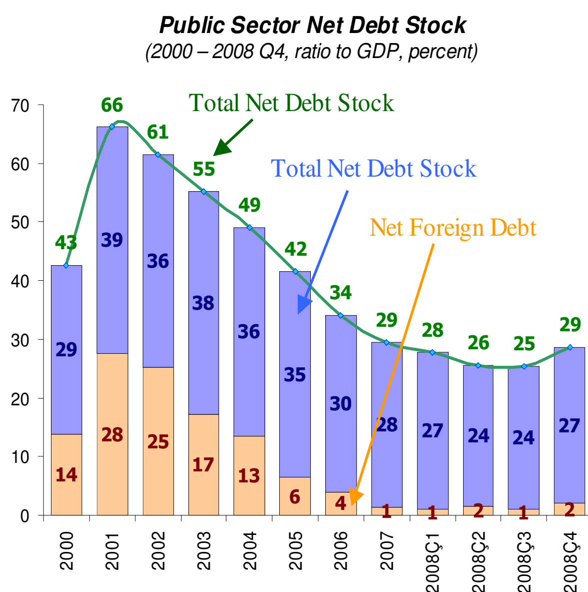


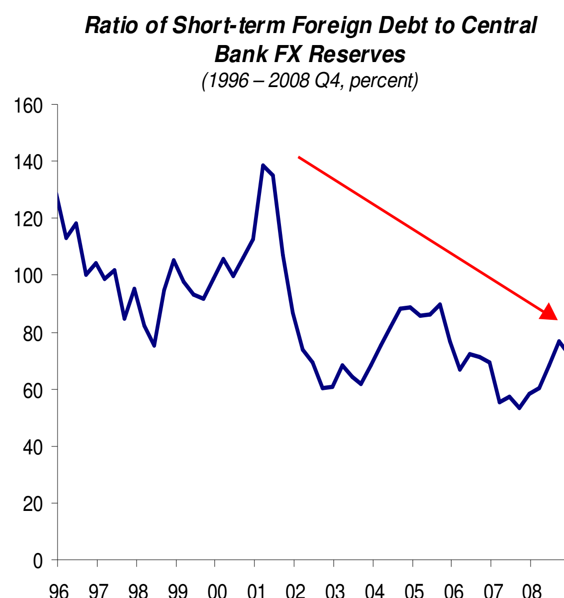
As for households, the ratio of household indebtedness in Turkey is at a low level compared to other developing countries. The share of FX-denominated loans in the current debt stock of households, which is rather small, puts Turkey in a more advantageous position over many developing countries and especially over Central and Eastern European countries. While total FX assets of households were USD 61.3 billion at the end of 2008, their liabilities were USD 2.7 billion. Therefore, households have a total FX long position of USD 58.6 billion.





The relatively long-term FX debt stock of the public sector coupled with the substantial amount of foreign exchange deposits at the Treasury curbs exchange rate risk exposure. It is estimated that the ratio of public sector net external debt stock to GDP will be 1.5 percent by the end of 2008.



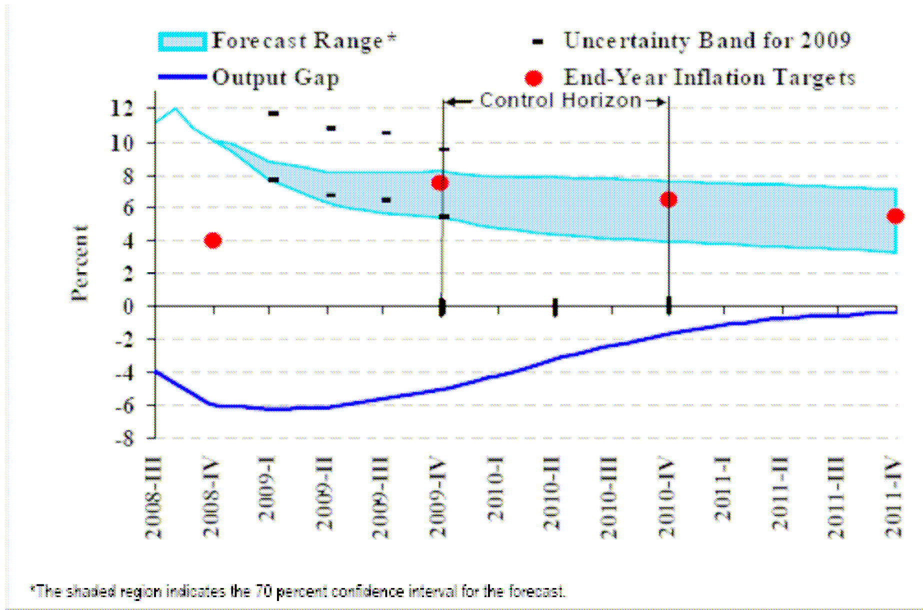


4. Counter-Cyclical Monetary Policy

What makes the current period extraordinary is that unlike the previous crises that were somewhat regional and localized, the ongoing crisis is of a global nature and it carries deflation and recession risks. Within this framework, to be able to comprehend the monetary policy pursued by the CBT, these policies should be assessed independent of the prescriptive mindset of previous years.

Article 4 of CBT Law stipulates "*The Bank shall, provided that it shall not be in confliction with the objective of achieving and maintaining price stability, support the growth and employment policies of the Government*". This clause was specially created for episodes such as the one that we are going through. With the reversal of the global developments fueling inflation in the last quarter of 2008, the Central Bank took prompt action to cut interest rates and played a pioneer role among emerging markets. Again, in the same CBT article "*taking precautions for enhancing the stability in the financial system*" has been listed among the fundamental duties of our Bank. Accordingly, a series of measures have been taken to avoid a liquidity squeeze in the market, besides the interest rate decisions. I would like to place special emphasis on an issue that I believe is particularly worth mentioning. In May 2008, when we decided to revise our inflation targets, we had stated that better-than-

expected outcomes in food and energy prices would be perceived as an opportunity to observe inflation realizing below the targeted level. This policy still applies. We still believe that keeping inflation slightly below the target path would be appropriate. However, keeping inflation below the target path by a significant margin is not desirable, as it would lead to significant social costs. The 525 basis-point-cut in policy rates in the last 4-month period should be assessed within this context.



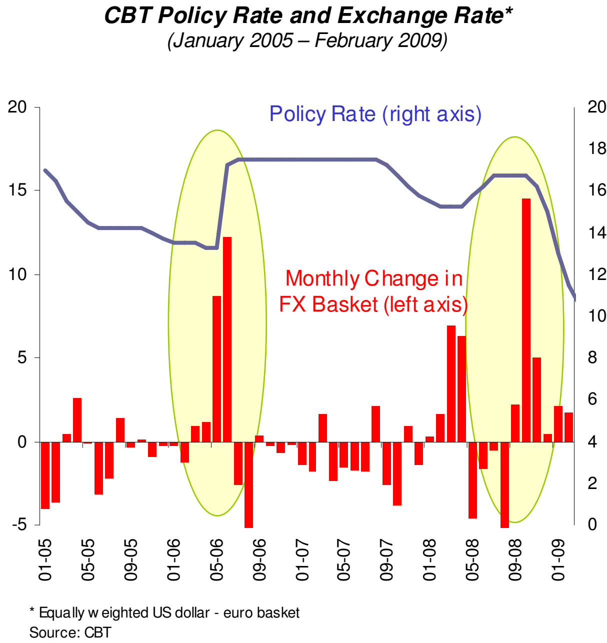
As an inflation-targeting central bank, I would like to remind you of the main factors that played an important role in determining our policy.

The first and most important factor is the Central Bank's own inflation forecasts and the inflation expectations for the medium-term inflation outlook. The second factor is domestic saving and investment tendencies. Finally, the third factor is developments in imported input prices and other cost factors with respect to their impact on inflation.

Maintaining such a perspective would help us understand why the Central Bank gave different policy responses to the exchange rate fluctuations of May 2006 and the current excessive rise in exchange rates. The rise in exchange rates in 2006 under strong domestic and foreign demand conditions had a potential to adversely affect inflation expectations and the medium-term inflation outlook, therefore the

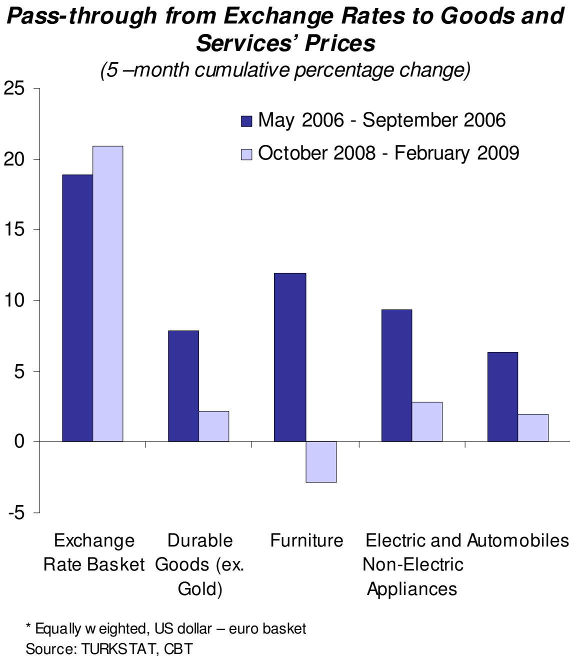
Central Bank had opted for a strong monetary tightening. However, currently, the rather low exchange rate pass-through under deficient domestic and foreign demand conditions coupled with the tightness of financing conditions for the corporate sector, the downward trend in import prices, accompanied by improving inflation expectations not only necessitated, but also made possible, a "controlled but rather rapid rate cut cycle".

CBT Policy Rate and Exchange Rate*
(January 2005 – February 2009)



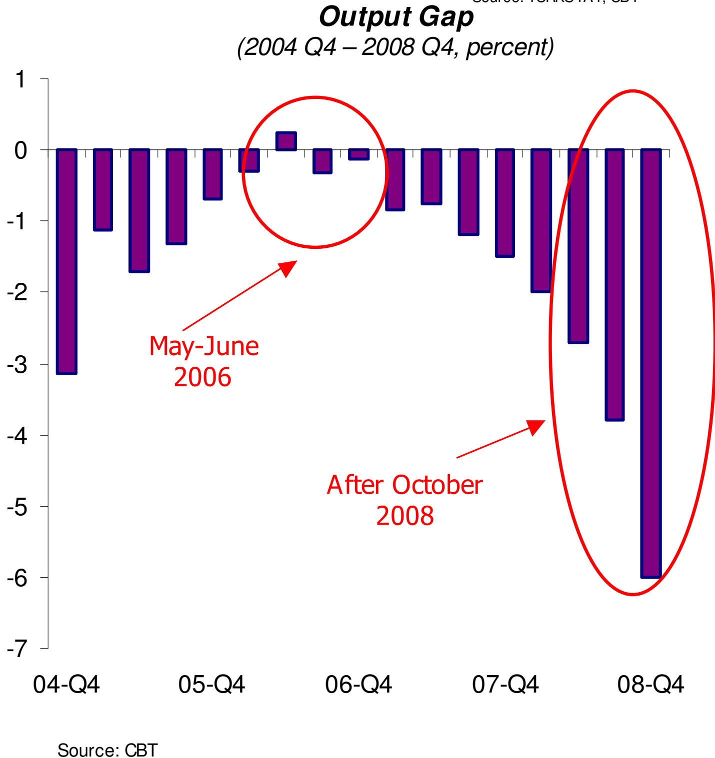
* Equally weighted US dollar - euro basket
Source: CBT

Pass-through from Exchange Rates to Goods and Services' Prices
(5 –month cumulative percentage change)



* Equally weighted, US dollar – euro basket
Source: TURKSTAT, CBT

Output Gap
(2004 Q4 – 2008 Q4, percent)

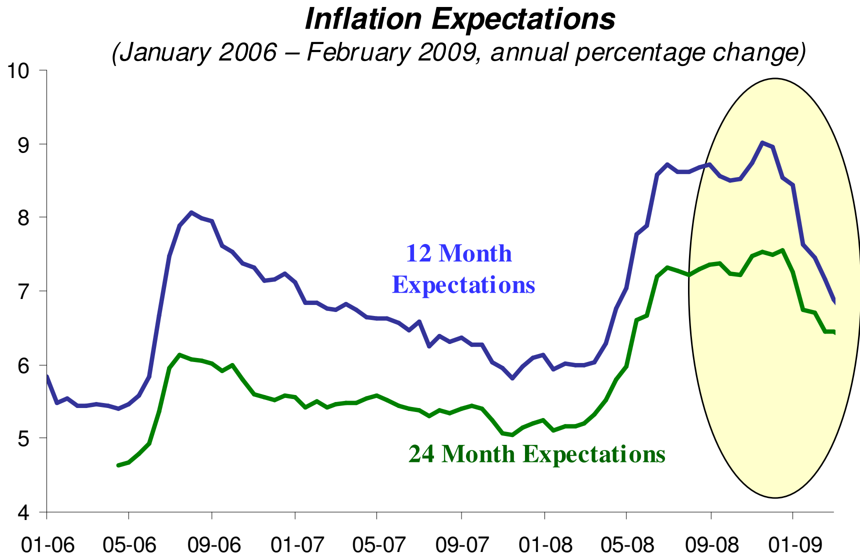


Source: CBT

The difference between these two policy responses is a natural outcome of the inflation targeting regime. It clearly demonstrates that inflation targeting regime is not a monetary-policy strategy that merely aspires to keep interest rates high in order to reduce exchange rates, which is briefly called “high interest rates, low exchange rates”.

In this part of my presentation, I would like to give more detailed information about the current monetary policy. The slowdown in aggregate demand became more evident in the second half of 2008 due the global financial turmoil. The uncertainties regarding the global commodity and finance markets and risks related to their reflections on inflation outlook required monetary policy to remain cautious. In this framework, the MPC decided to keep policy rates unchanged at September and October meetings. Likewise, the central banks of developing countries adopted a cautious stance in the same period and maintained the monetary tightening trend launched in early 2008.

In the following period, foreseeing that the pass-through from exchange rates to prices would remain limited despite continued uncertainties in global markets; a substantial decline would be observed in domestic and foreign demand; the rapid decline in commodity prices would continue; and decline in inflation would be faster than it was expected, the Central Bank launched a policy rate cut cycle by cutting policy rates by 50 basis points in November 2008. In the two subsequent Monetary Policy Committee meetings, policy rates were cut by 125 and 500 basis points, respectively.

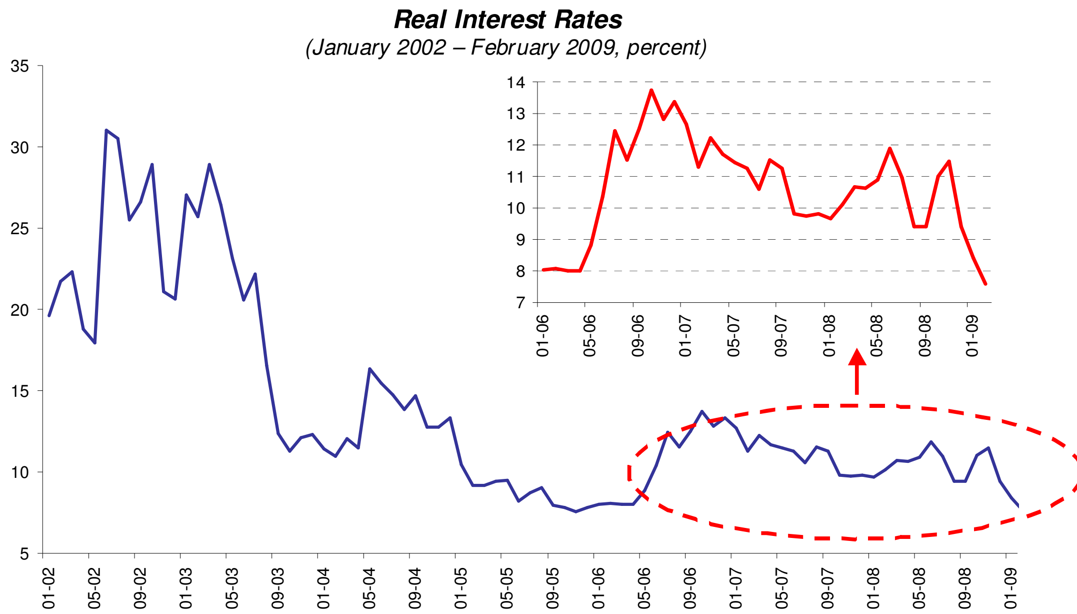


Source: TURKSTAT, CBT

It was stated in our January Inflation Report that the CBT aimed to compensate the impact of financial tightness by moving forward a sizeable part of the monetary accommodation envisaged for the incoming months, and particularly underlined that a decelerating pace of reductions in policy rates in early 2009 would be adopted. As a matter of fact, at the February meeting of Monetary Policy Committee, interest rates were lowered by 150 basis points instead of 200. In other words, the CBT continued to reduce the policy rates with a decelerating pace as previously announced and, stated in the Summary of the Monetary Policy Committee Meeting published on 3 March 2009 that the amount of the next rate cut would likely be slower.

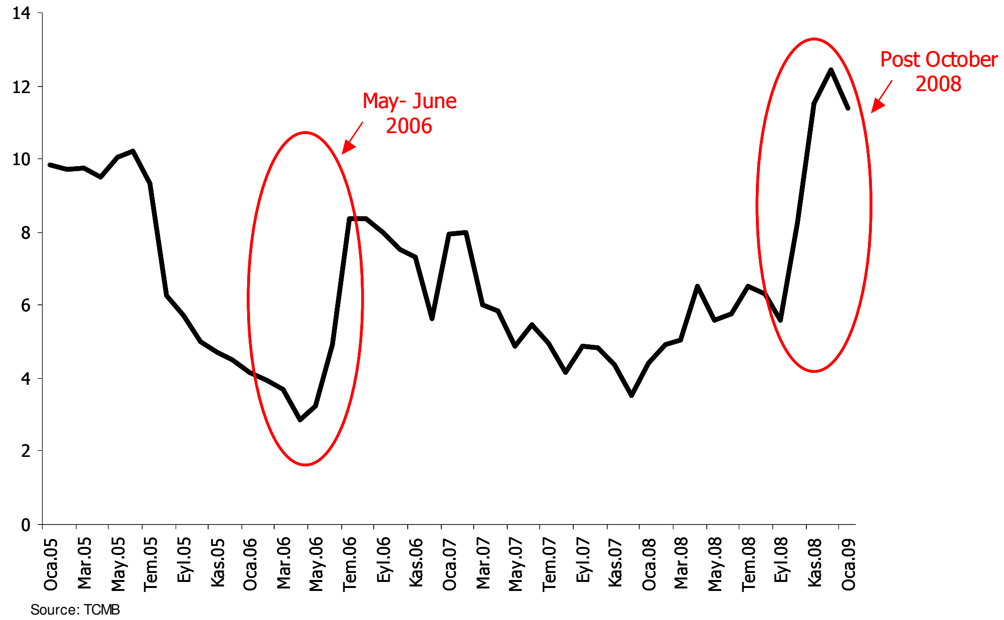
The developments occurred since November 2008, particularly the inflation data, confirmed the accuracy of the CBT's projections and the policy rate-cut decisions thereto, thus increasing confidence in the monetary policy. In the final quarter of 2008, pass-through from exchange rates to prices remained well below our expectations thanks to the considerable decline in imports prices. The continued decline in inflation despite depreciation in TL is a noteworthy development. In the same period, as a result of slight recovery in risk perceptions coupled with policy rate cuts supported by the inflation rates announced, market interest rates assumed a rapid downward trend and dropped by 900 basis points compared to end-October. The current steeping of yield curve is deemed an expected development due to the decline in risk appetite at global level. Particularly the nature of current crisis requires monitoring of the monetary transmission mechanism in respect of its impacts on private sector spending tendency via deposits and credit interest rates rather than via the Treasury's lending interest rates.

As of today, the level of real market interest rates is below the pre-global crisis level. The realization of neutral interest rates at lower levels during stagnation periods is an expected development in well-functioning economies, which Turkey has never experienced. The current level of real interest rates in Turkey compared to those of 1994 and 2001 should be perceived as an indicator of normalized Turkish economy.



Despite recent policy rate cuts, extreme tightness in financial conditions still persists, albeit partly. It is noteworthy that the impact of short-term interest rates cuts on consumer loans has remained more limited compared to the interest rates of commercial loans. Moreover, the difference between the interest rates of commercial loan and policy rates of the Central Bank is still high. Along with the tightness in credit supply, the utilization of a major portion of the demanded corporate credits in restructuring of the outstanding corporate debt points to the limited role of credit channel in supporting production activities.

Difference Between Interest Rates on Commercial Loans and Policy Rates
(January 2005 – January 2009, percentage points)



Uncertainties about global economy, deterioration in expectations for financial outlook, tighter credit conditions and relatively weaker trend in disposable income all ended up in a contraction in credit volume. In this period, despite significant difference between the credit interest rates of the banks and the interest rates of the Government Securities, banks opted to shift their investments to Government Papers, which they perceived less risky. In the last quarter of 2008, the TL-denominated security portfolio of the banks increased by TL 20 billion in whereas, TL-denominated credits declined by TL 16 billion.

In order to elucidate the monetary policy implemented by the Central Bank since 2002, the date of transition to inflation targeting regime, I would like to particularly emphasize that apart from achieving and maintaining price stability, the monetary policy has no permanent effect on the long-term growth performance of the economy. Monetary authorities' contribution is limited to balancing downward or upward cycles around the potential growth trend of economy in the short term.

If the Central Bank had opted for strong loosening in policy rates in line with the decline of risk premium in 2006-2007 period, during which liquidity conditions were favorable, the Turkish economy would have undergone the current crisis under more disadvantageous conditions due to both additional rise in asset prices and

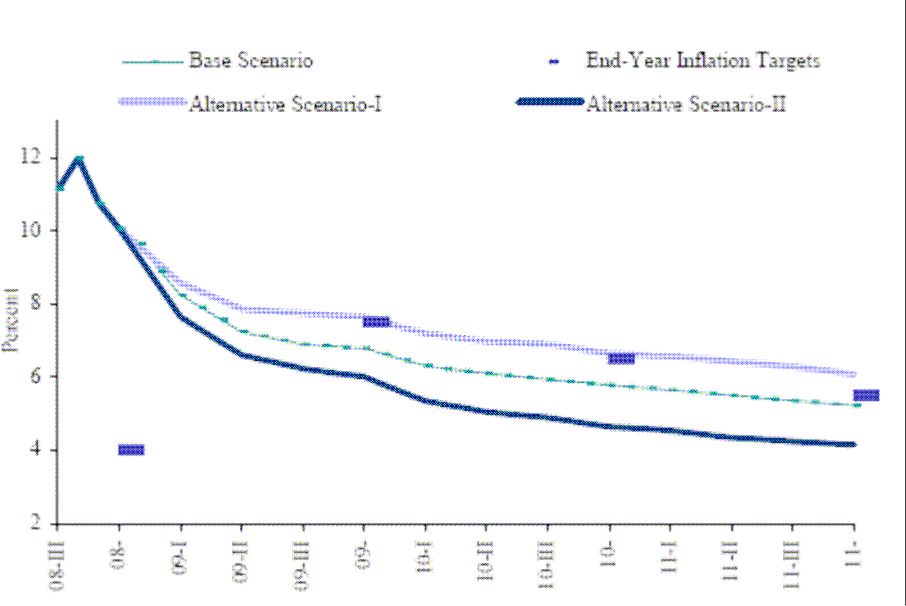
higher borrowing rates to be caused by rapid domestic consumption. Central banks, in order to maintain price stability, implement monetary tightening when economy signals for overheating and adopt monetary loosening when economy points to an excessive slowdown provided that it does not conflict with the objective of price stability. These measures alleviate the severity of undesired fluctuations in the economy and help the growth rate come back on its long-term track. Acting otherwise may lead to severe economic turbulences.

This type of monetary policy is also a natural consequence of inflation targeting regime. The gradual interest rate cuts made by the Central Bank since November 2008 should also be evaluated in this context. The Central Bank strictly adheres to the monetary policy stipulated by the inflation-targeting regime on the path to price stability.

Achieving price stability requires not only fighting against inflation but also preventing deflationary pressures. Current inflation targets are high enough to forestall the deflation risk. Likewise, inflation targets, which have been set as 5.5 percent for end-2011 to be decreased by 1 point every year in the next three years, are considered satisfactory to avoid deflation risk in this challenging period.

Given the current conjuncture, assumptions relating to economic activities abroad play more important role than ever in making medium-term forecasts. We had stated in the January Inflation Report that we based our baseline forecast on the assumption of a gradual recovery in the global economy starting from the first quarter of 2010. In the same report, in addition to the baseline scenario, we envisaged two more alternative scenarios under different assumptions relating to the timing and size of the recovery in the global economy. The late-recovery scenario was based on the assumption of a further deepening in global crisis in the first half of 2009, foreseeing that the global economy would start to recover not earlier than the second half of 2010. In that case, we would continue with measured sequel of policy rate cuts throughout 2009. In view of the latest data, our forecasts are shaped in a context similar to the baseline scenario. Nevertheless, we also consider the possibility of late recovery. Therefore, in the light of the available data, we believe that the probability of inflation to remarkably undershoot the target still prevails. We also believe that the monetary policy should maintain its downward flexibility for a longer period of time

depending on the conditions. The amount and timing of the potential policy rate cuts will be set in view of the developments in the factors affecting inflation outlook.



5. Counter-Cyclical Fiscal Policy

Deviating from the policy implementations that we used to adopt in the past economic crises requires the stabilizing role of both the monetary and fiscal policies.

High investment expenditures observed in many countries in the past led to a significant expansion in the global production capacity. The recent record low level in global capacity utilization ratios is a factor that might delay substantial increases in investment expenditures in the short term. Under the current conditions of increased precautionary saving behavior, relief of precautionary saving motive will depend on the restoration of confidence. Severe contraction in demand driven by the reduction of total investment and consumption expenditures of the private sector has to be immediately compensated. In the countries having enough room for maneuver, reviving private consumption through the central banks' policy rate cuts or increasing public expenditures through confidence raising measures are among policymakers' options. Nevertheless, It should be borne in mind that a marked increase in the public sector borrowing requirement may impair the effect of the monetary policy by curbing the decrease in medium term market interest rates. In this period, particularly in developing countries, adopting a fiscal policy, (i) whose priorities are clearly set, (ii)

which focuses on confidence building measures and (iii) which is sustainable in the medium term, assumes great importance. Implementation of a fiscal policy, which is capable of stabilizing the cyclical movements in the economy under a fiscal discipline sustainable in the medium term, will positively affect expectations relating to economic policies. This, in turn, will contribute to the decline in medium term interest rates and the efficient functioning of the credit mechanism and will enhance the efficiency of the monetary policy.

Debt and risk management policies that have been implemented in the framework of strategic criteria in Turkey since 2001 and the achievement of macroeconomic stability not only significantly eased the susceptibility of public debt portfolio against liquidity, interest rate and exchange rate risks, but also ensured a marked recovery in public debt burden. Nevertheless, it should be kept in mind that the room for maneuver for Turkey regarding fiscal policies is more restricted than the developed countries.

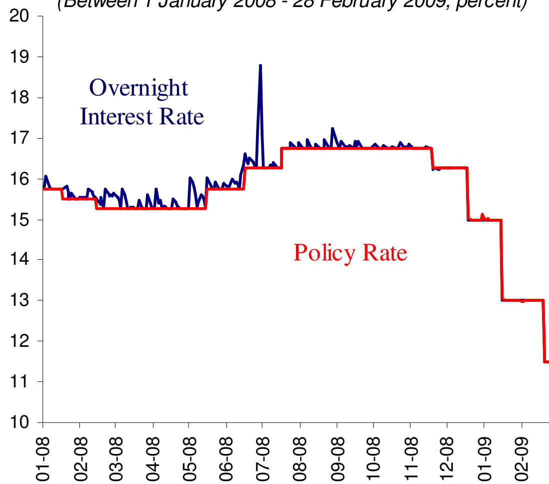
6. Liquidity Measures Taken by the Central Bank

One of the differences of the current economic crisis from the past financial turbulences is concurrent emergence of TL and FX funding requirements. Being aware of the importance of Turkish Lira and foreign exchange liquidity in respect of mobilization of the financial system and efficient functioning of credit markets, the Central Bank, promptly and duly enforces necessary measures relating to the Turkish Lira and foreign liquidity.

As the Central Bank can directly control New Turkish Lira liquidity, it can support smooth functioning of financial and credit markets by providing the required liquidity. With the measures on the Turkish Lira, the liquidity need of the market was met in due time and at the required amount. Moreover, overnight interest rates were meticulously attempted to be kept at close levels with the Central Bank borrowing interest rate and interest rate volatilities that might arise in money markets were not allowed.

Policy Rate and Overnight Interest Rate in the Repo-Reverse Repo Market

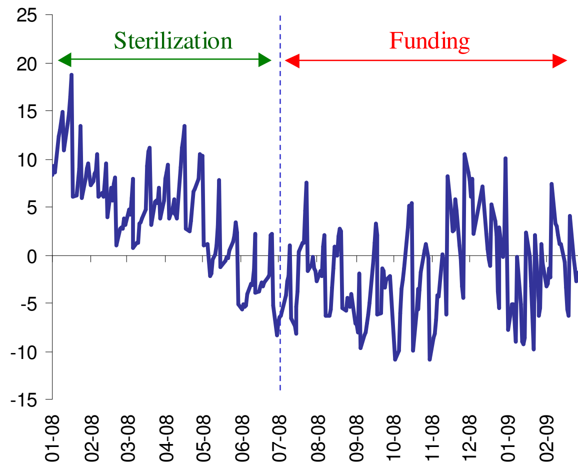
(Between 1 January 2008 - 28 February 2009, percent)



Source: ISE, CBT

TL Liquidity Provided by the Central Bank

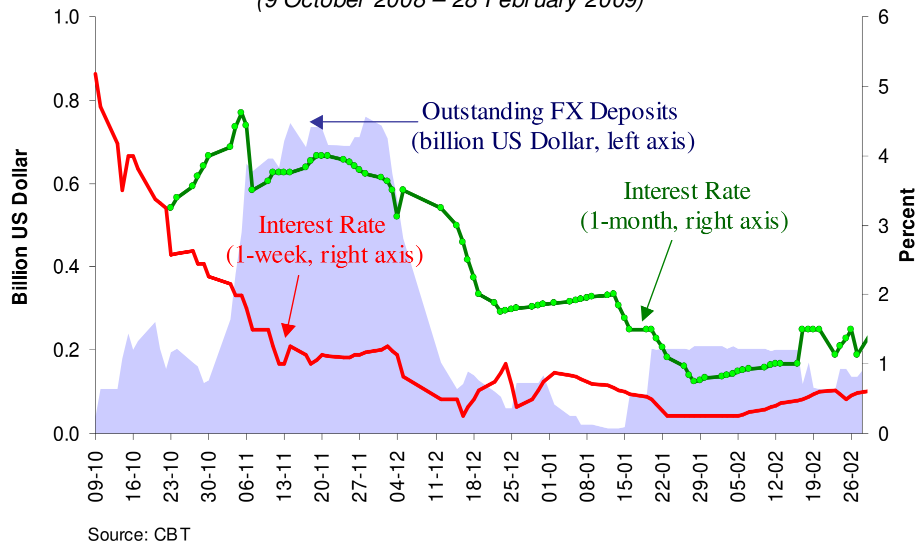
(1 January 2008 – 28 February 2009 , billion TL)



Source: CBT

As for foreign exchange liquidity developments however, external conditions are more influential. Therefore, in a period of elevated uncertainties in the global economy, the Central Bank adopted the strategy to use the foreign exchange reserves primarily to support our banking system. In this framework, the Central Bank resumed its activities as an intermediary in the Foreign Exchange Deposit Market; lending rates of this market was reduced and maturities were extended. Besides, during periods of ailing price movements, foreign exchange liquidity was injected via foreign exchange selling auctions.

An analysis of the course of interest rates in the Foreign Exchange Deposit Market indicates that that the measures have considerably eased the concerns over foreign exchange liquidity. On 9 October 2008, when the Central Bank resumed its intermediary activities in the Foreign Exchange Deposit Markets, the one-week US dollar-denominated interest rates standing at 5.18 percent declined sharply on the days ahead and became 0.63 percent on 3 March 2009. The first interbank foreign exchange deposit transaction in terms of US Dollars with a two-month-maturity was conducted on 3 March 2009 at an interest rate of 2 percent.



The Central Bank will continue to act prudently and take additional measures within its means, when deemed necessary, in order to ensure the smooth functioning of the FX market and to support FX liquidity. Potential measures were made public by the "Monetary and Exchange Rate Policy for 2009" and "January 2009 Inflation Report". In this framework, in the event of further intensifying of the financial turmoil in global markets, to minimize the potential adverse effects of such a development on the Turkish economy; foreign exchange selling auctions may be resumed or the foreign exchange market may be directly intervened under the basic principles of the floating exchange rate regime; transaction limits for banks in the Foreign Exchange and Banknotes Markets may be raised; borrowing maturities may be extended and lending interest rates may be reduced in the Foreign Exchange Deposit Market, and the FX required reserve ratio may be once again moderately reduced. I would like to emphasize that the Central Bank will adhere to the principle that exchange rates are set at the market. Moreover, measures like foreign exchange selling auctions and direct intervention to the foreign exchange market will only be considered in the event that unhealthy fluctuations are witnessed in the foreign exchange market due to a decrease in the depth of the market.

The Central Bank will continue to take the necessary measures to contain the adverse effects of the global financial turmoil on the domestic economy, provided that they do not conflict with the price stability objective. Furthermore, strengthening the commitment to fiscal discipline and structural reform agenda is critical for facilitating expectations management, for enhancing the simulative impact of the monetary accommodation and also for invigorating the resilience of our economy against the global financial crisis. In this respect, the efforts towards the maintenance of harmonization and convergence processes regarding the European Union accession besides timely implementation and revision of structural reforms envisaged in the Medium Term Program remain to be of utmost importance.