TÜRKİYE CUMHURİYET MERKEZ BANKASI

NBER CONFERENCE

Responding to Capital Flow Volatility: Reserves, Capital Controls and the IMF

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Contents

Fixed but not?

- Fixed exchange rate regimes
- Fixed income debt securities

The "Fixed but not" Syndrome

A Praise for Exchange Rate Flexibility

"Enhance exchange rate flexibility to reflect underlying economic fundamentals. Market-oriented exchange rates that reflect underlying economic fundamentals contribute to global economic stability."

(The G20 Toronto Summit, June 2010)

A Praise for Exchange Rate Flexibility

"We reaffirmed our shared interest in a strong and stable international financial system, and our support for market-determined exchange rates. Excess volatility and disorderly movements in exchange rates have adverse implications for economic and financial stability. We will consult closely in regard to actions in exchange markets and will cooperate as appropriate."

(The G7 Communiqué, Sep. 2011)

A Praise for Income Flexibility

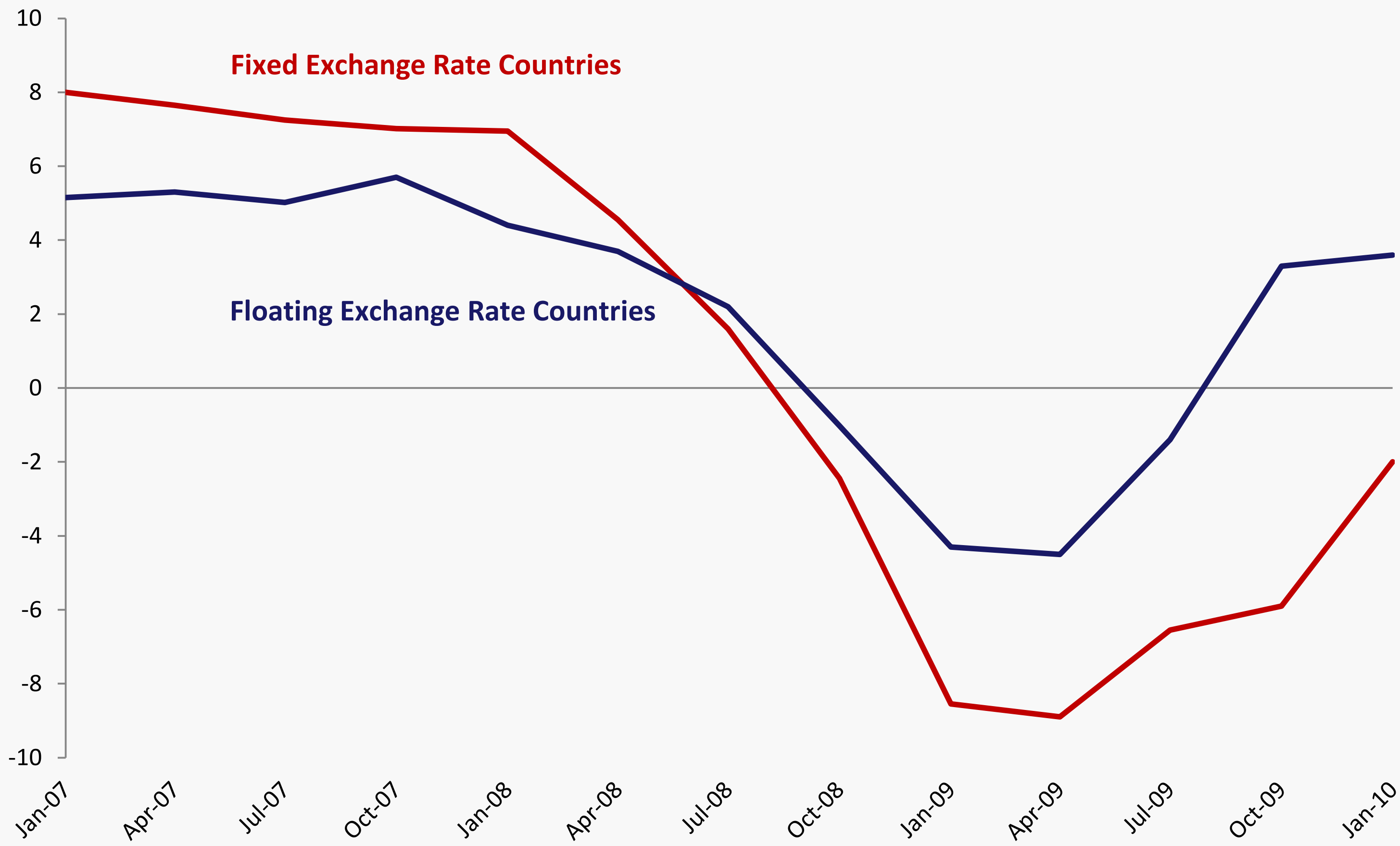
- More equity capital is required from banks. (G20, FSB, Basel Committee)
- Contingent Convertibles (CoCos):

"The Group of Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee on Banking Supervision (BCBS) will continue to review contingent capital, and support the use of contingent capital to meet higher national loss absorbency requirements than the global minimum, as high-trigger contingent capital could help absorb losses on a going concern basis."

(GHOS-BCBS Consultative Document, June 2011)

Floating vs. Fixed Exchange Rate Regimes

Real GDP Growth for Selected Countries



Note: Median growth rates are reported for each group of countries.

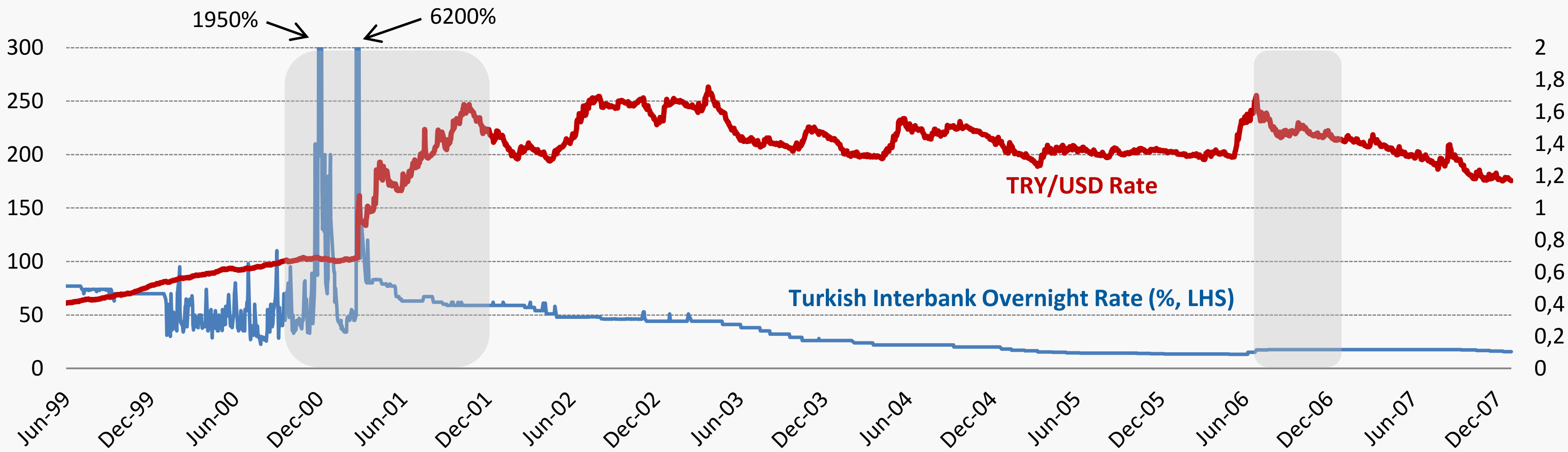
Fixed Exchange Rate Countries : Belarus, Bulgaria, Denmark, Hong Kong, Russia, Lithuania, Estonia, Latvia

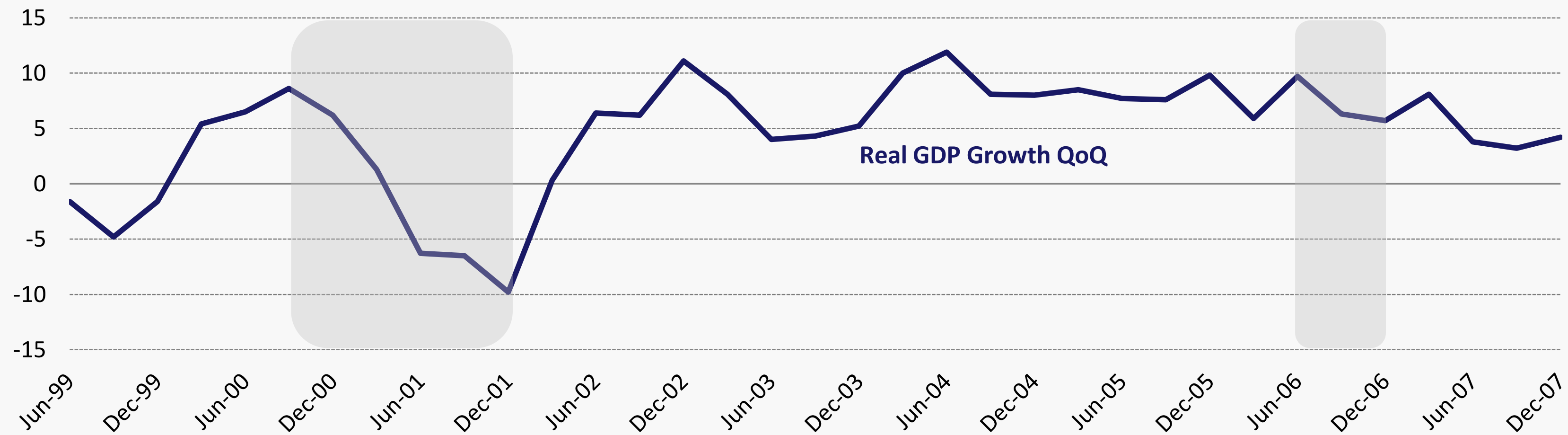
Floating Exchange Rate Countries : Indonesia, Peru, Norway, Poland, Israel, South Africa, Colombia, Switzerland, Brazil, Canada, Chile, United States, Czech Republic, Korea, Iceland, United Kingdom, Slovak Republic, Romania, Hungary, Sweden, Thailand, Mexico, Japan, Turkey

Source: IMF, IFS, TurkStat, CBRT.

Floating vs. Fixed Exchange Rate Regime

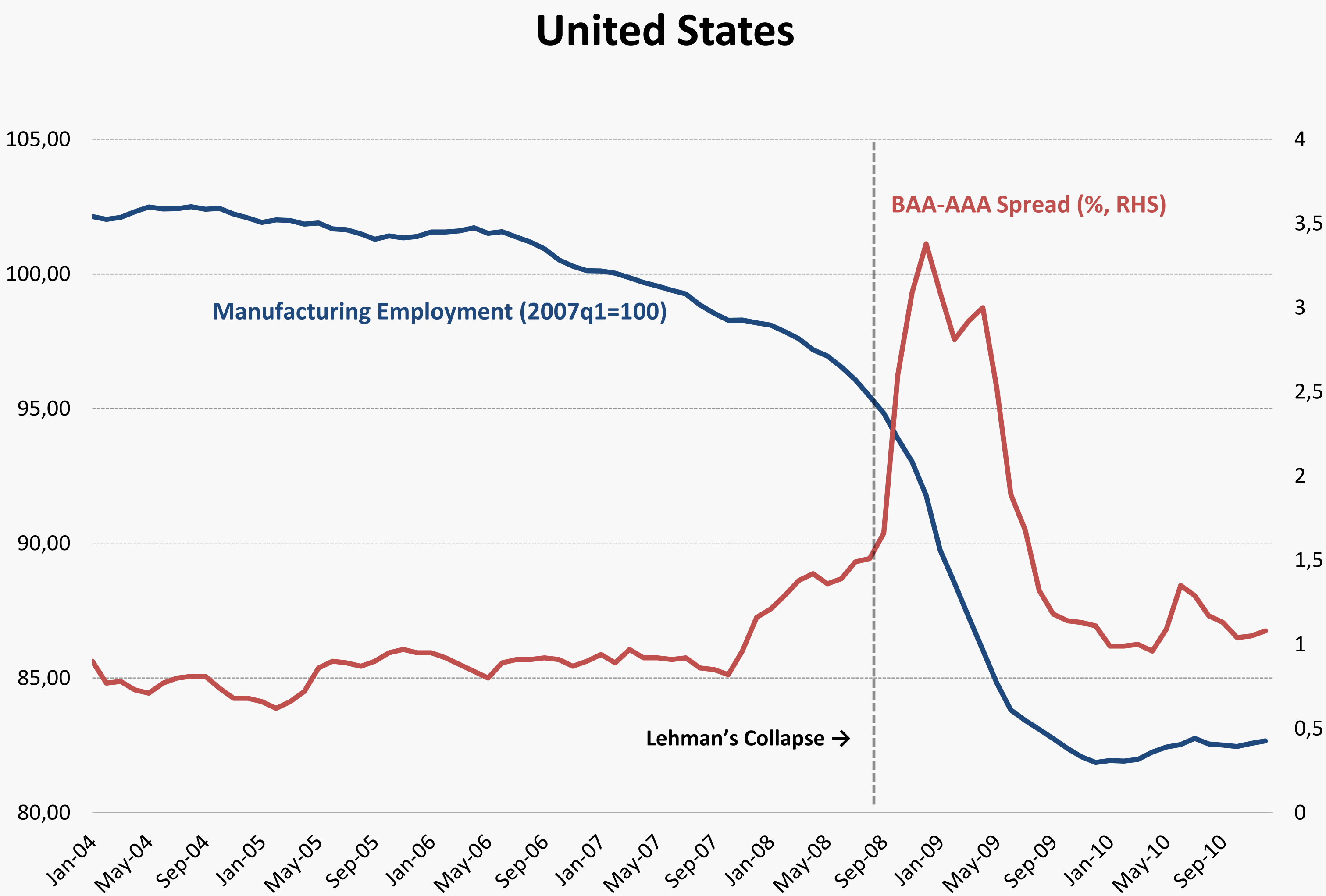
Turkish Experience





Source: TurkStat, CBRT.

Income Uncertainty and Employment



Source: BLS, Moody's, CBRT.

Quantifying The Impact

- A 1 percentage point increase in spread (Baa-Aaa) leads to a slow down in employment growth rate at the magnitude of 2.3 percentage points.

(Başcı, Başkaya and Kılınç, 2011)

The Double Impact

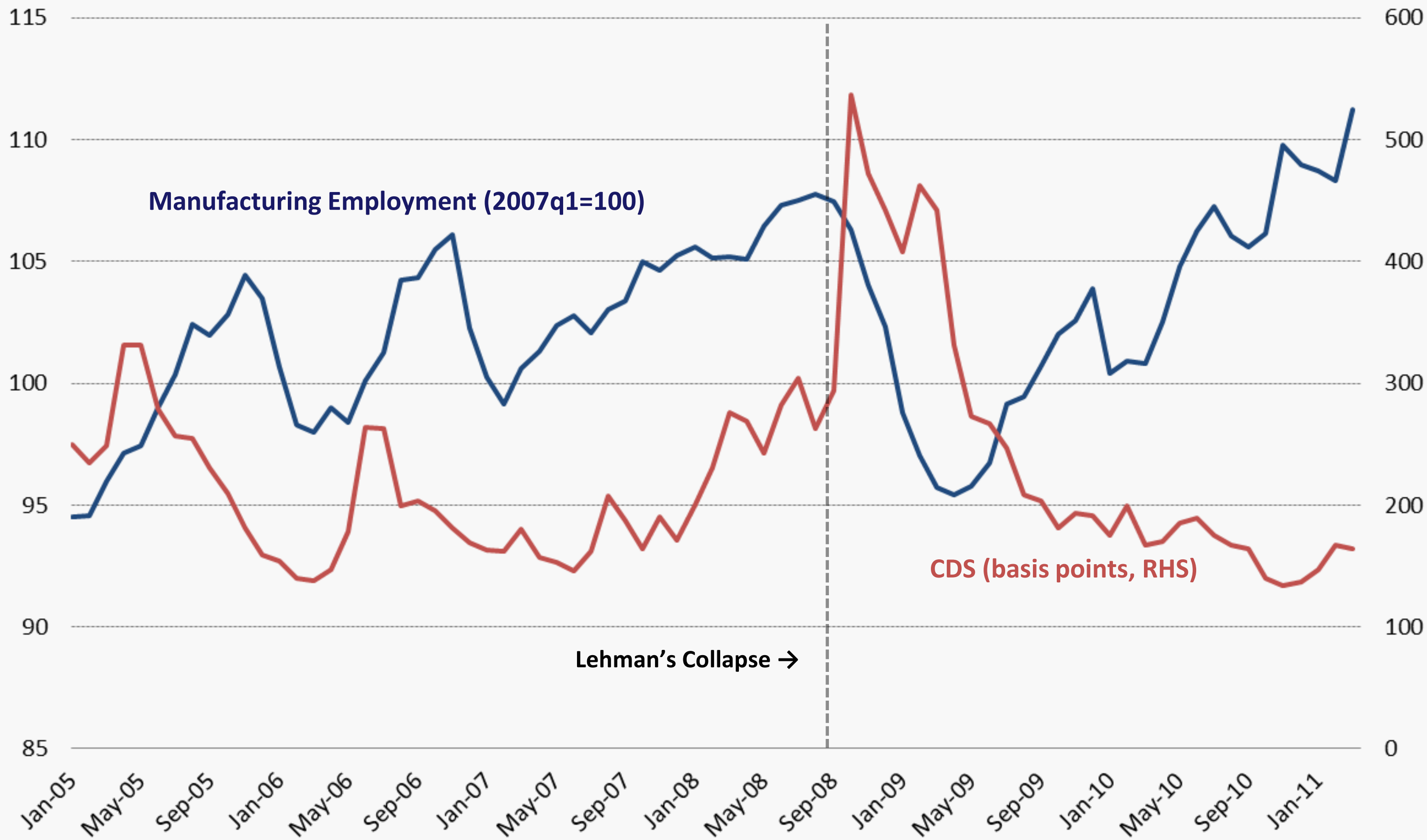
A spread shock affects the permanent income expectations of both the borrowers and lenders

1. Lender: "Fixed but not" impact on interest income
2. Borrower: Higher cost and lower availability of leverage implies lower profit income

… and hence affects both labor demand and total expenditure sharply!

Income Uncertainty and Employment

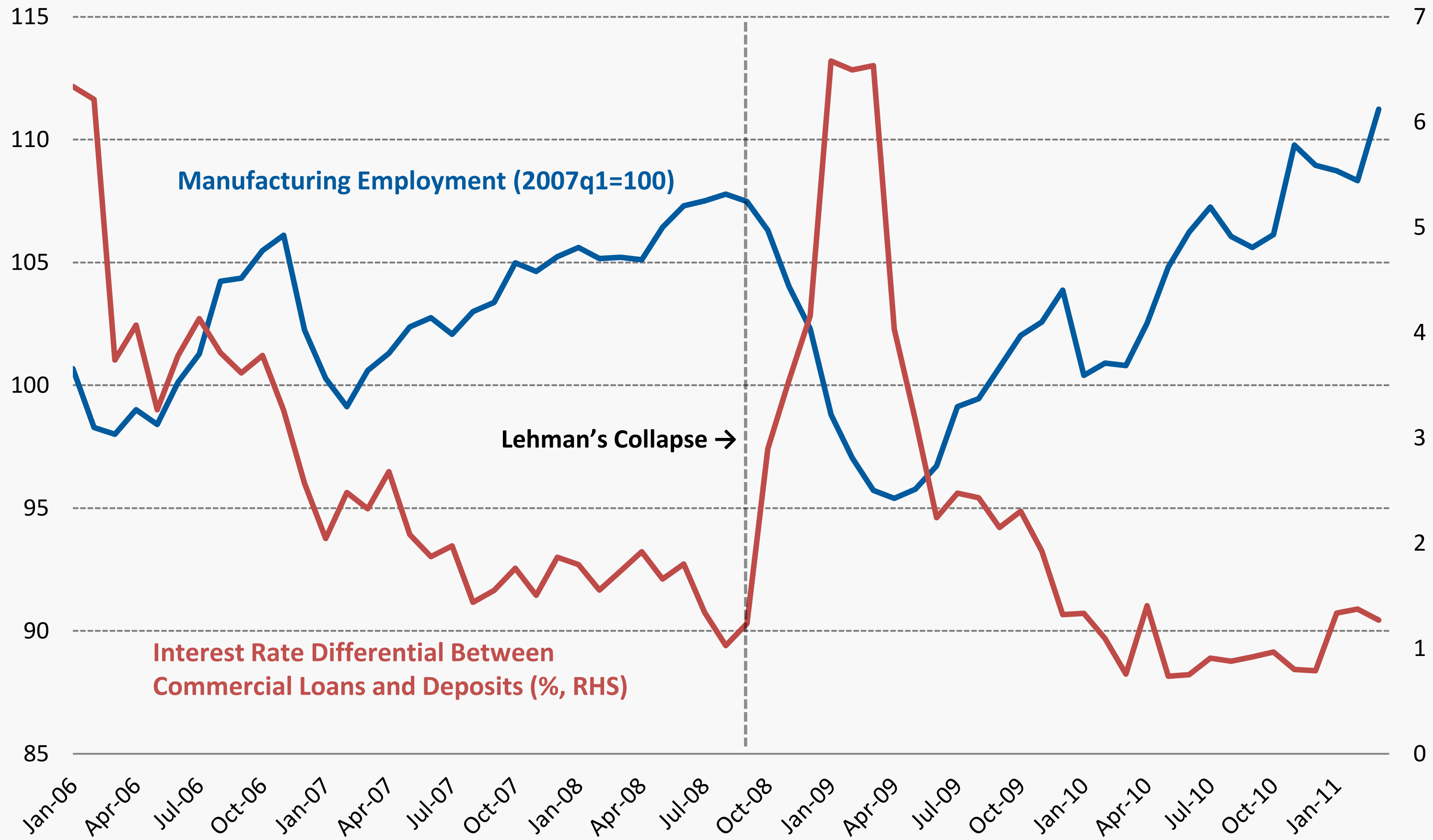
TURKEY (with CDS data)



Source: BRSA, TurkStat, CBRT.

Income Uncertainty and Employment

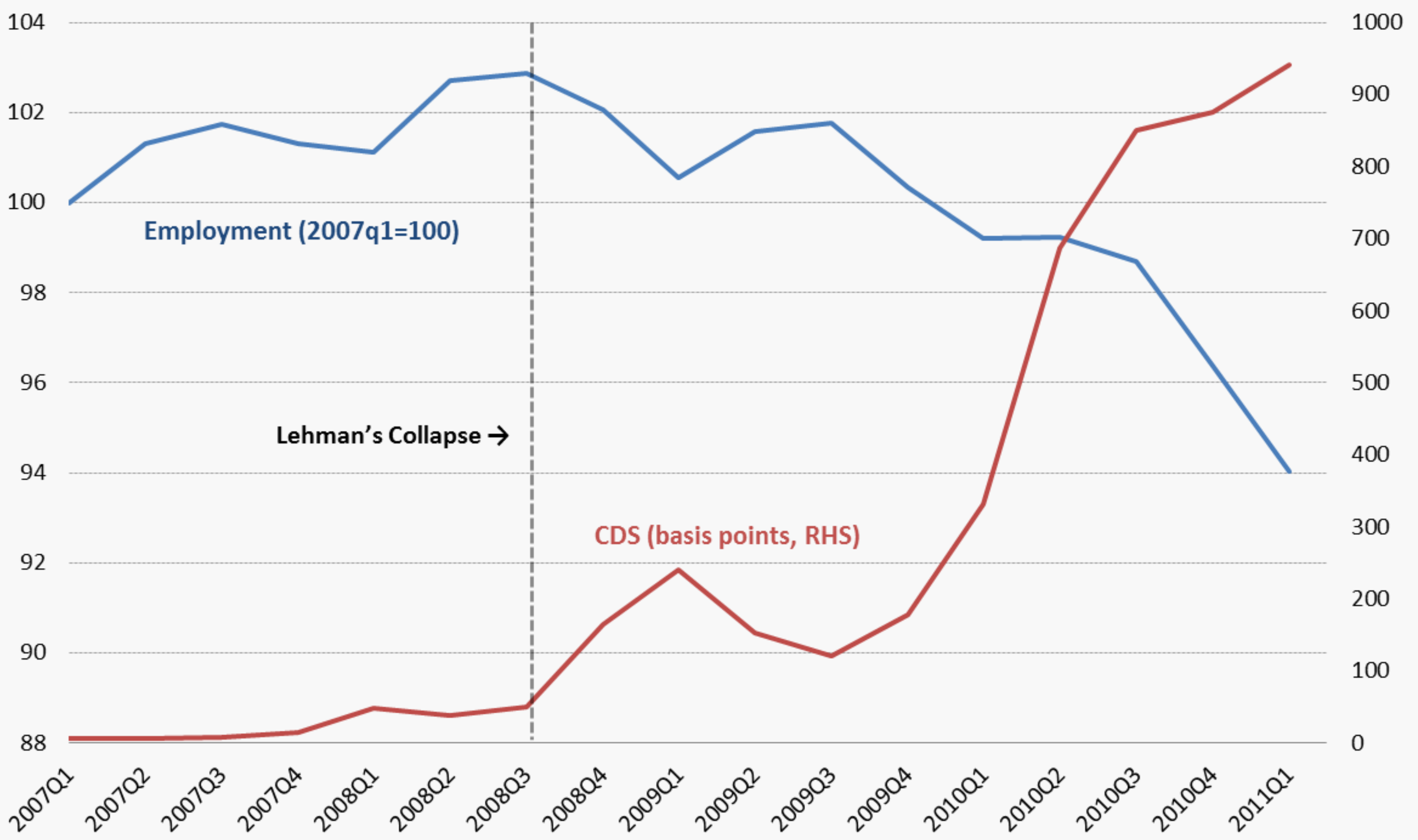
TURKEY



Note: Weighted average, flow interest rates.
Source: BRSA, TurkStat, CBRT.

Income Uncertainty and Employment

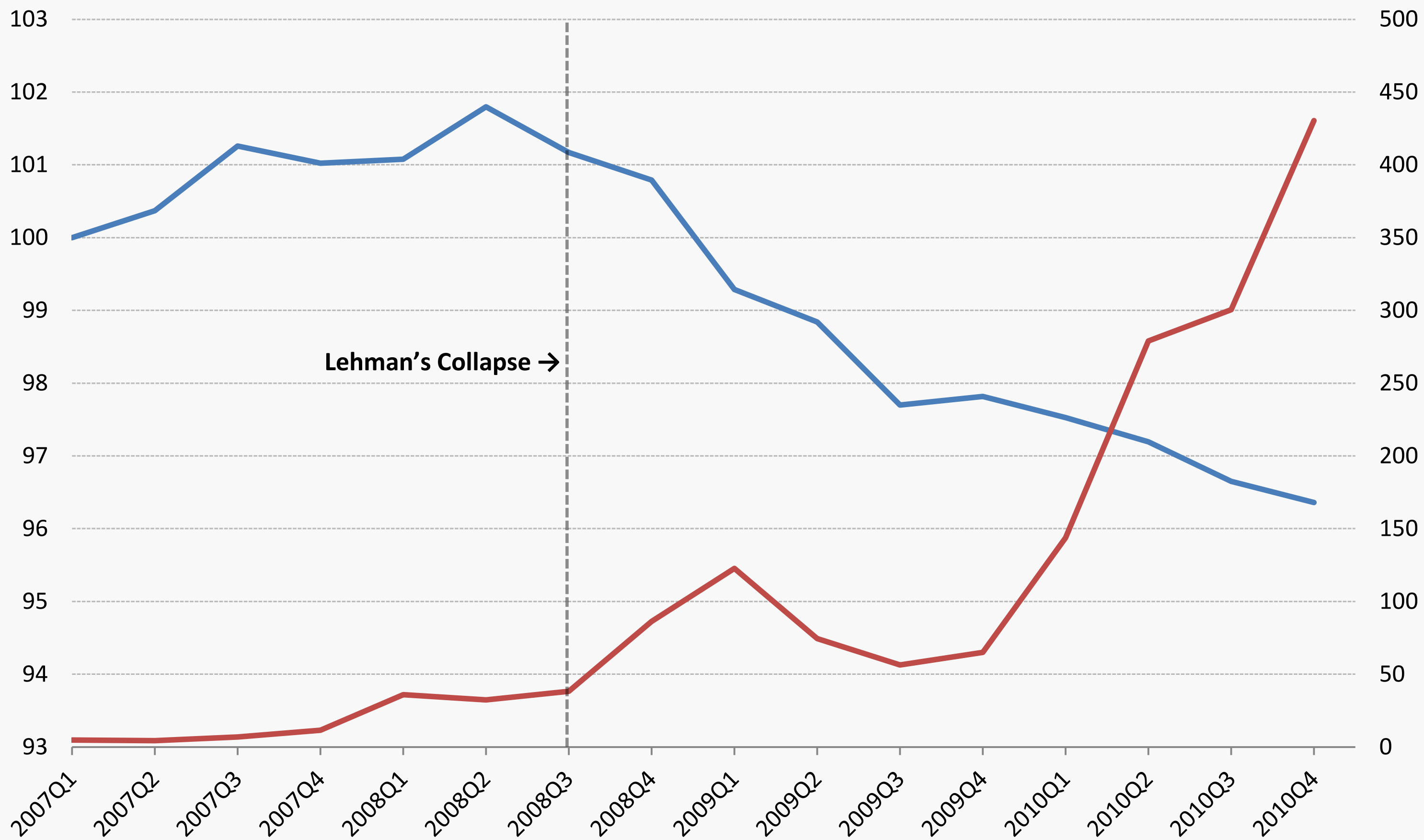
Greece



Source: OECD, Bloomberg, CBRT.

Income Uncertainty and Employment

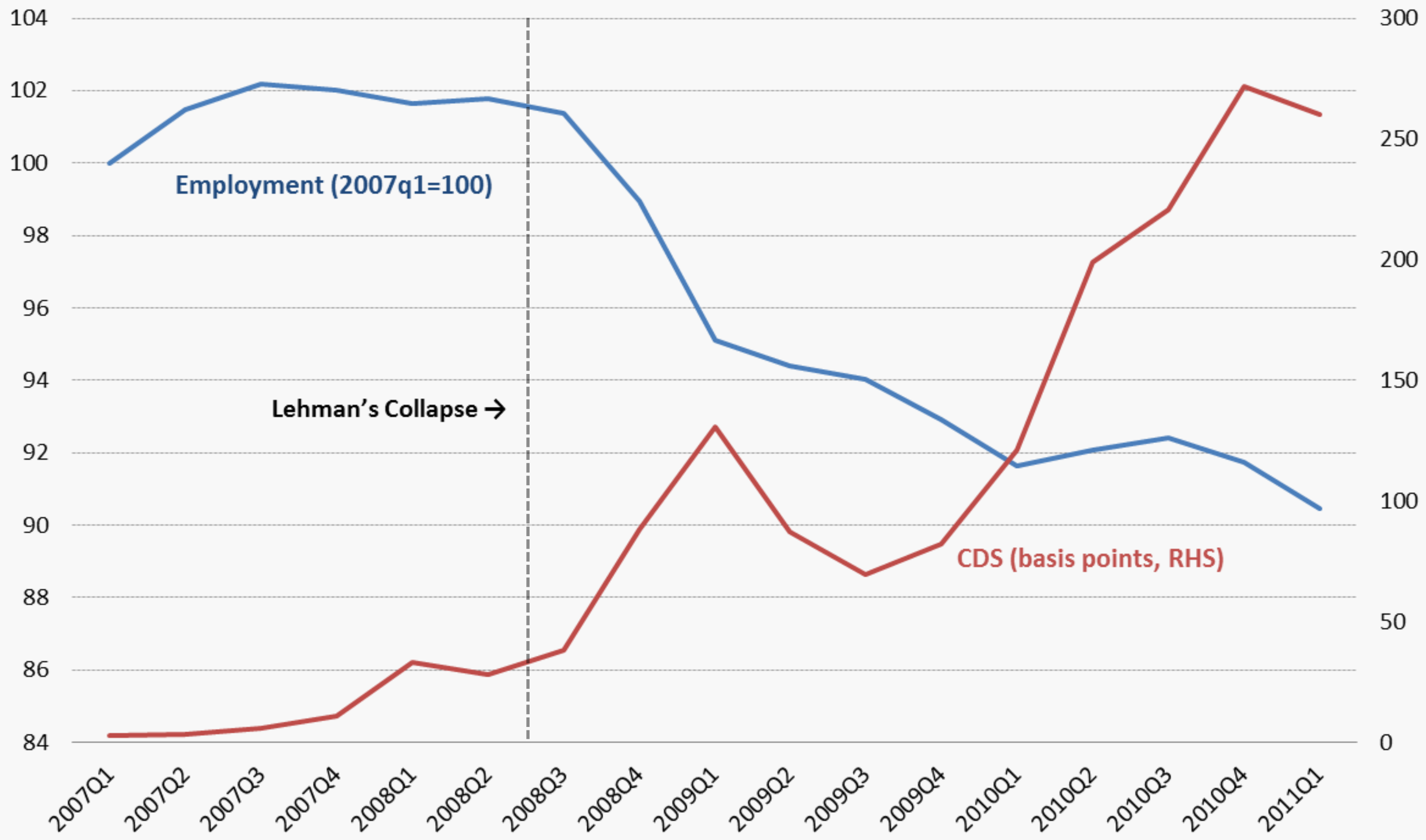
Portugal



Source: OECD, Bloomberg, CBRT.

Income Uncertainty and Employment

Spain



Source: OECD, Bloomberg, CBRT.

Policy Implications

1. Promote floating exchange rate regimes
   - Aim to minimize currency exposure
   - Intervene only to excessive moves until that aim is accomplished
2. Promote equity like contracts
   - Aim to avoid excessive exposure to leverage
   - Intervene to reduce spread shocks until that aim is accomplished

The Problem

Global monetary expansion fuels inflows to emerging economies with a tendency towards:

a) More debt, less equity,

b) More foreign currency, less domestic currency,

c) More short term, less long term.

The Solution

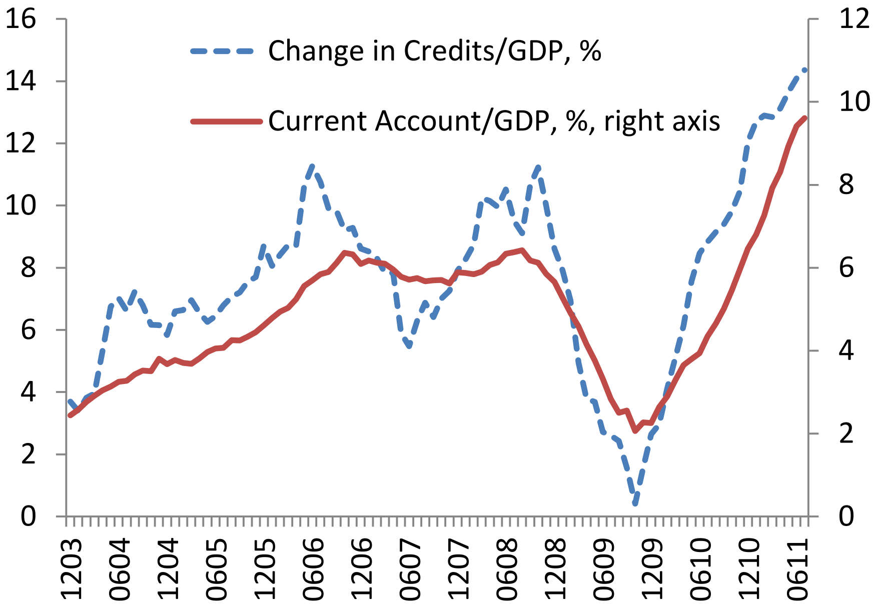
In contrast, emerging economies should provide incentives for financial inflows with a tendency towards:

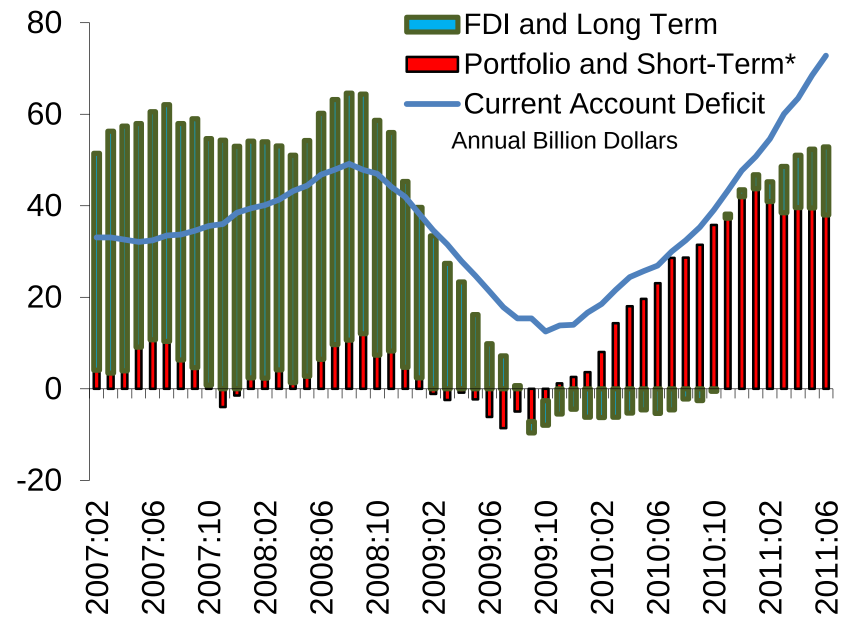
a) More equity, less debt,

b) More domestic currency, less foreign currency,

c) More long term, less short term.

Problems Posed by Strong Inflows



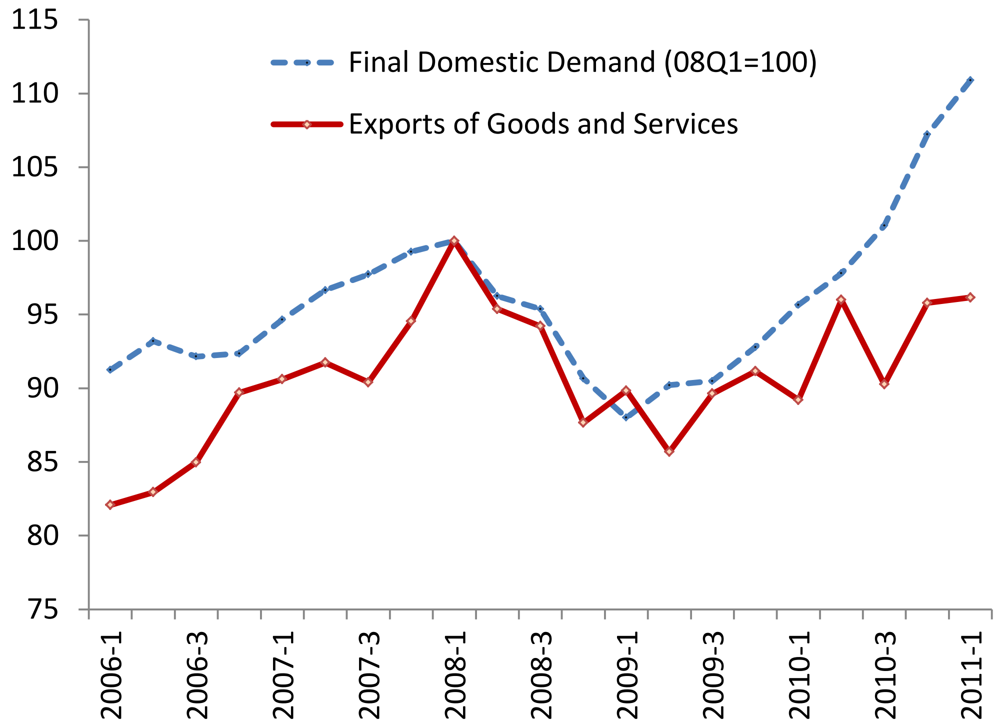


Financial stability concerns:

Capital inflows fueling a surge of domestic credit and inflows of mostly short-term nature

Regulations have eliminated the currency mismatches risks to a great extend : Limitations on Banks open positions, No FX loans to HH , Restrictions on FX loans to Firms

Problems Posed by Strong Inflows



Macroeconomic Stability Concern:

Along with weak external demand for Turkish exports, surge of capital inflows after the global monetary extension led to an unbalanced growth mismatches Turkey where domestic demand and exports diverged.

Monetary Policy Responses

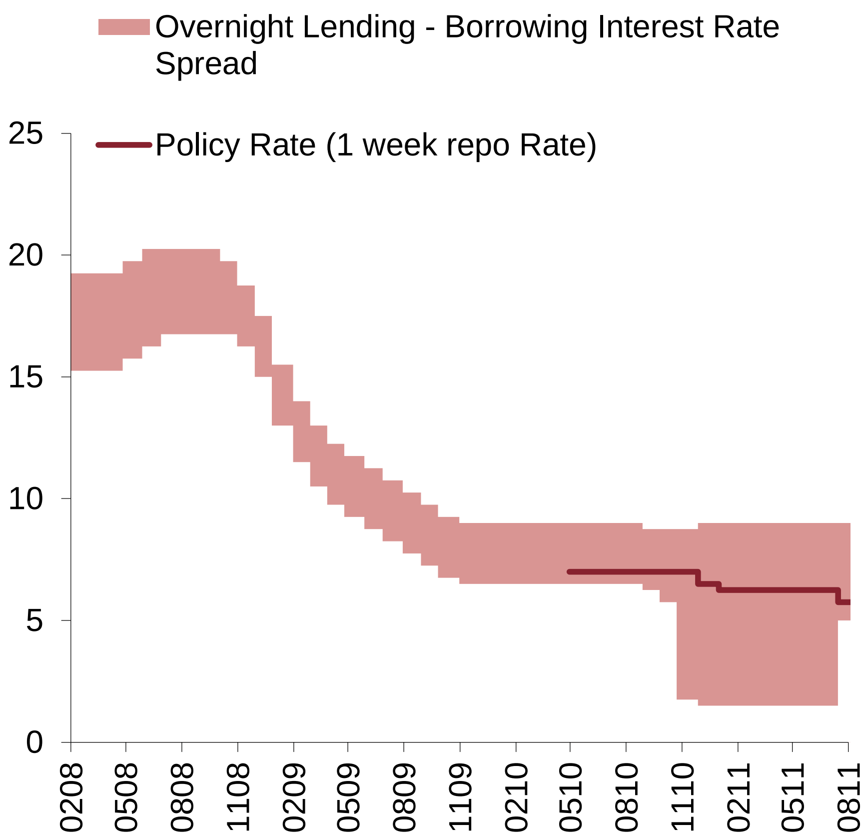
Tools Utilized:

- Policy rate
- Interest rate corridor
- Reserve requirements
- Liquidity Policy
- Communication Policy
- Reserve Policies

A combination of these tools utilized for discouraging capital inflows (especially the short-term) while taming the domestic credit growth and aggregate demand.

Macroprudential tools are assumed by the supervisory authority, Banking Regulation and Supervision Agency(BRSA). Financial Stability Committee for coordination of the institutions

Monetary Policy Responses I

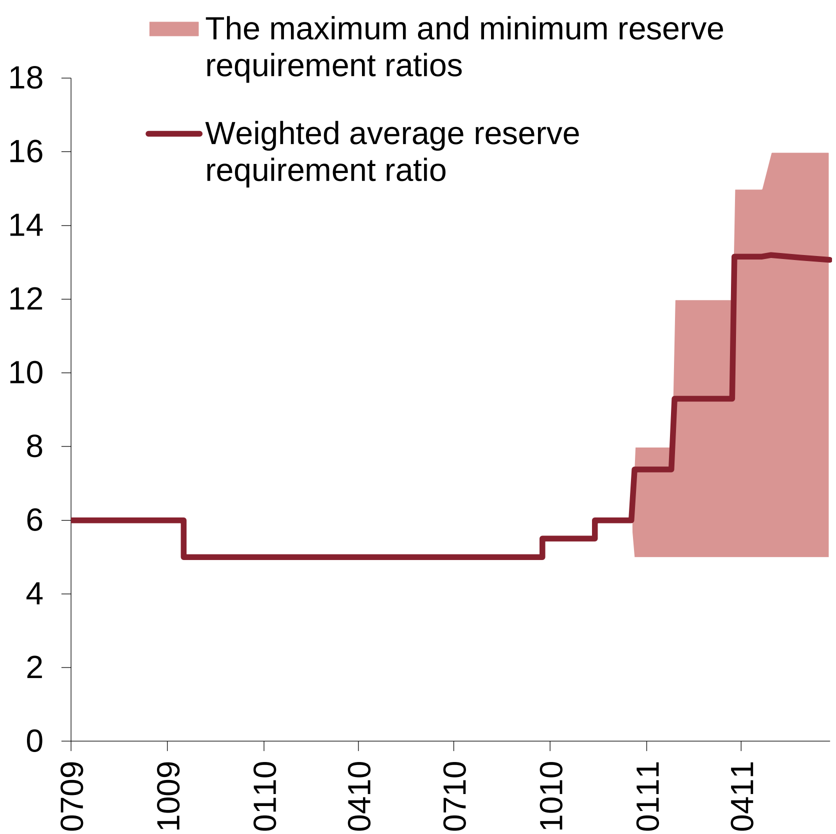


To discourage the capital inflows (particularly short-term)

- Lower Policy Rate,
- Lower O/N borrowing rates
- Wider interest rate corridor, to allow for greater volatility in short term rates

Open market operations (OMO) conducted via quantity auctions, intensifying the uncertainty at short-term interest rate

Monetary Policy Responses II



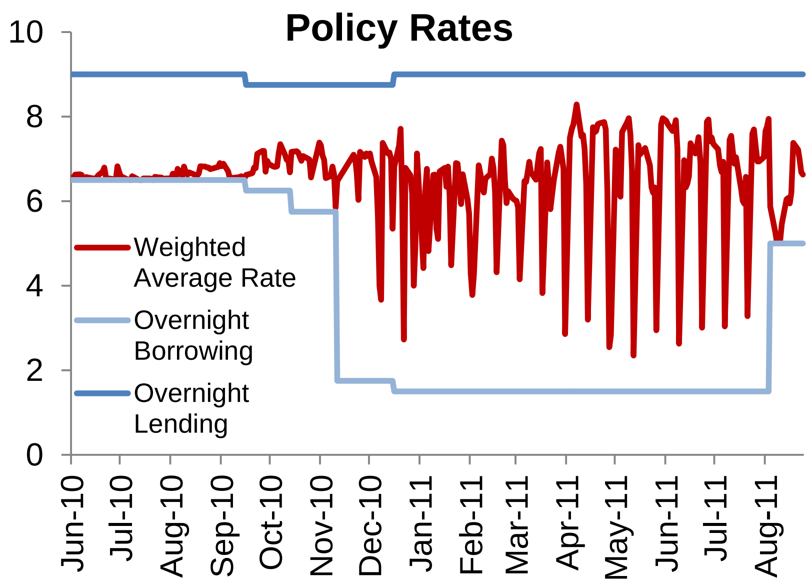
To curb excessive credit growth

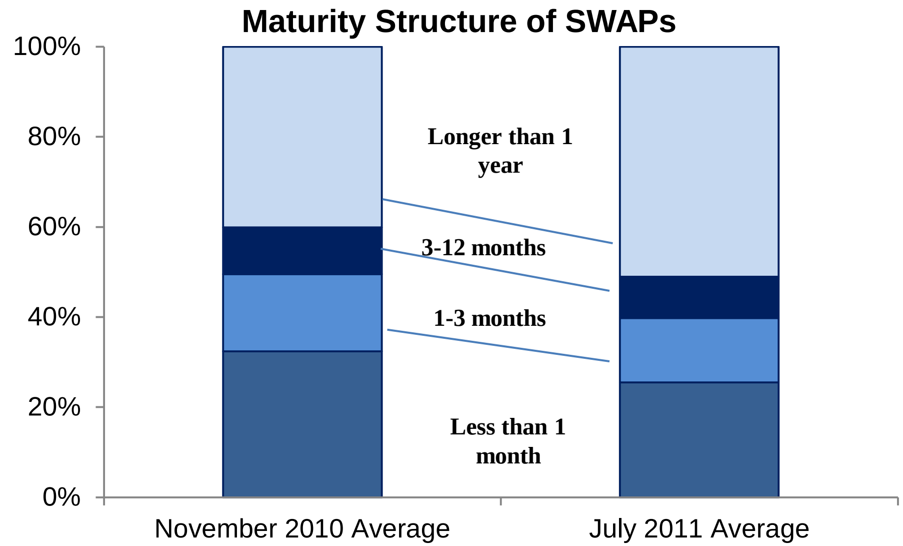
- Remuneration of the reserve requirement (RR) was halted
- RR ratios hiked significantly
- Coverage of RR extended to include repos

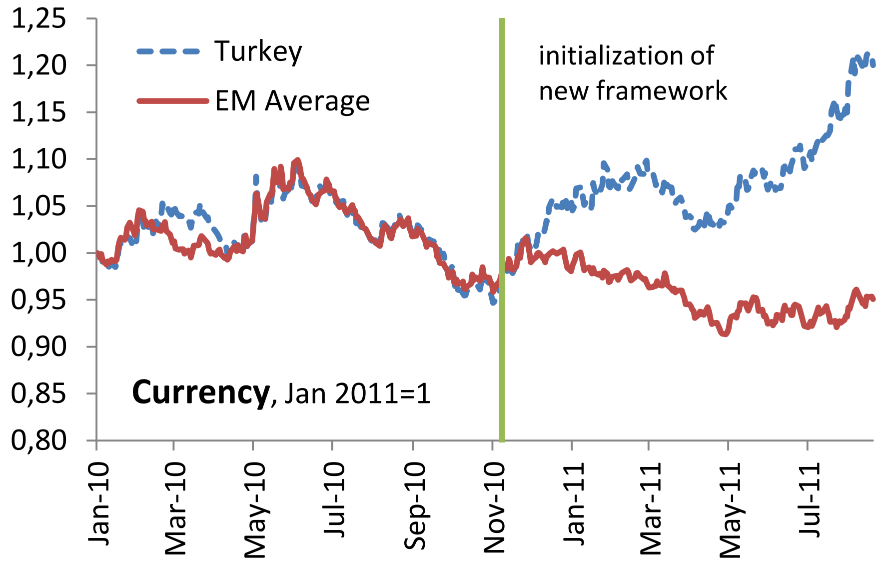
And to alleviate maturity mismatch

- RR ratios related negatively to deposit maturities

How Did the Policies Do?

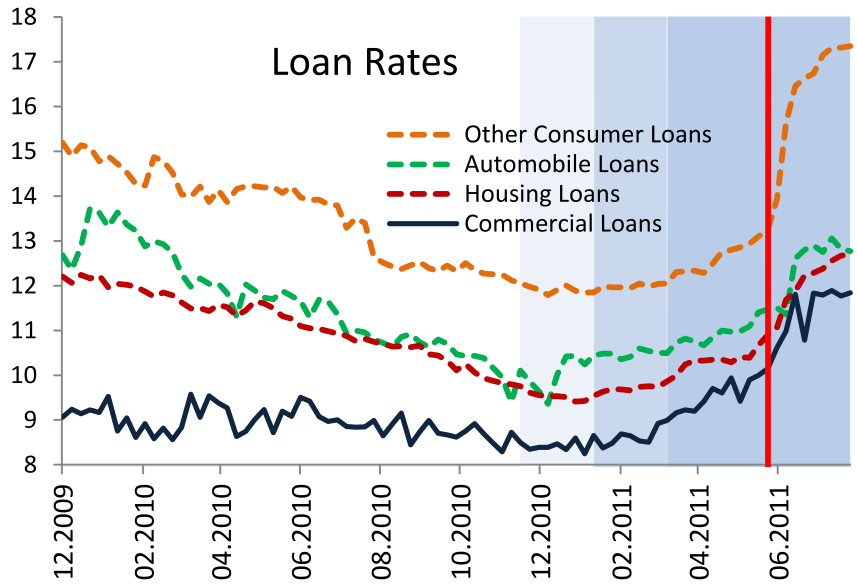




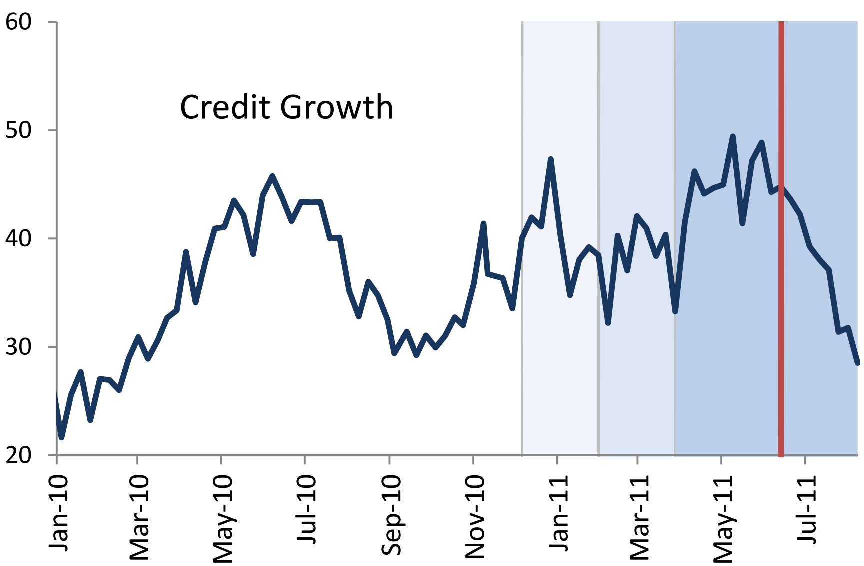


- Higher volatility in short term interest rates discouraged carry trade
- Maturity transformation in swaps

How Did the Policies Do?



- Hikes in RR by CBRT gradually shifted loan rates upwards, and hikes in provisions by BRSA accelerated loan rate increases



- Credit growth slowed down after especially BRSA measures

Summary and Final Remarks

- Successful reforms and credible policies implemented in tranquil times
  - strengthened the banking system and prevented excessive risk accumulation
  - attracted benign capital inflows
  - reduced the need for abrupt policies against shocks
  - alleviated the trade-offs between different objectives
  - (i.e. financial stability, price stability)

- As a result Turkey could manage the enormous CF volatility after 2008 crisis
  - by implementing an efficient policy framework and
  - without resorting to direct capital controls

- We have to deepen our understanding about bank/financial market behavior in order to gauge their reaction to policy decisions

- For designing more effective policies to counteract the volatility, CBs and the regulatory authorities should coordinate within well defined framework

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