CENTRAL BANK OF THE REPUBLIC OF TURKEY

THE MONETARY POLICY FRAMEWORK

APRIL 2002

Outline of the Presentation

- **Monetary Policy under Floating Regime: A Brief Overview of 2001**
- **Adoption of a Medium-term Approach to Economic Policy Making: A New Strengthened Economic Program for 2002-04**
- **The Eventual Monetary Policy Framework: Inflation Targeting**
- **Conclusion**

Monetary Policy under Floating Regime: A Brief Overview of 2001

- With its operational and instrument independence secured, ***price stability*** became the overriding objective of the monetary policy ***under the floating regime.***
- ***Base money*** served as the ***nominal anchor*** for the economy.
- The absence of any experience with the floating regime, combined with the widespread borrowing in foreign currency, complicated the adjustment process: ***there had to be a real change in mind-set***.
- The progress with the implementation of key ***structural reform*** measures played an important role in shaping expectations.

Adoption of a Medium-term Approach to Economic Policy Making: A New Strengthened Economic Program for 2002-04

- To enhance the resilience of the Turkish Economy to shocks and reduce its vulnerabilities to future crises, a new strengthened economic program is adopted for 2002-04.

- Chief objectives of the program are:
  - ✓ Viable debt position;
  - ✓ Continued disinflation;
  - ✓ Sustainable growth.

The strengthened economic program for 2002-2004

- Achieving our key objectives entails the implementation of a multi-pronged agenda consisting of:
  - ✓ Continued sizeable public sector primary surplus;
  - ✓ Maintaining a well-functioning floating exchange rate regime under which price stability is the overriding objective of the monetary policy;
  - ✓ Completion of the banking sector restructuring;
  - ✓ Enhancing the role of private sector in the economy.

Monetary policy in the strengthened economic program

Indicative targets on the monetary base are converted into performance criteria

→ to ensure that a nominal anchor is in place

→ to strengthen the monetary program

- In spite of the widely-recognized limitations of the monetary base, base money is a very visible monetary aggregate that can serve as a monetary program guide.
- The monetary program aims to keep base money growth in line with the growth of real output and target inflation:
  - The target for the base money growth in 2002 is set at 40 percent;
  - This target, however, will be adjusted in accordance with changes in demand for base money.
- This procedure, together with the prudent fiscal policy and structural reform measures, will efficiently encourage economic agents' inflation expectations to converge towards price projections contained in the economic program adopted by the Government.

Monetary policy in the strengthened economic program

- The CBRT aims to improve the mechanisms of communication with the public and markets so that economic agents are in a better position to evaluate monetary policy implementation.

- In the context of increasing transparency of the monetary policy, CBT publishes Quarterly Monetary Policy Reports—the first one published in November 2001— to inform agents about the elements that the CBRT uses to analyze inflationary pressures and prevailing monetary conditions.

- To ensure accountability, the CBT provides information to the public and to the Government periodically regarding monetary policy implementation.

Monetary policy in the strengthened economic program

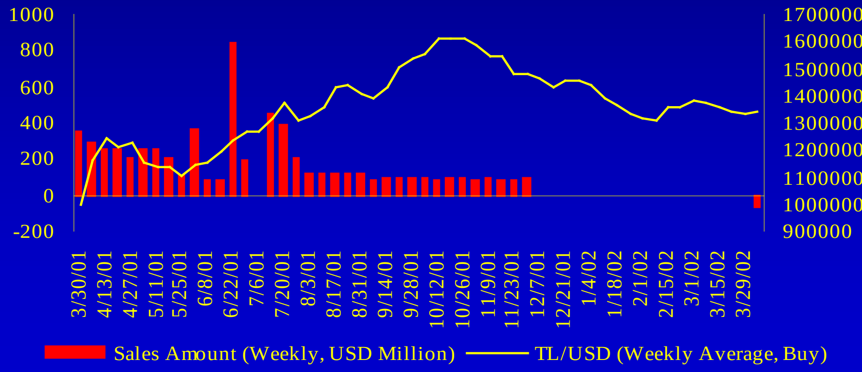
Interest rate decisions are based on the inflation outlook, not on past inflation, by assessing the effects of the following factors, inter alia, on the general price level:

- the international environment and the exchange rate;
- wages, employment, and unit labor costs;
- aggregate supply and demand;
- prices of the goods and services provided or regulated by the public sector;
- public finances;
- monetary and credit aggregates;
- surveys on inflationary expectations and the CBT's inflation forecasts.

Signs of stability are emerging

CBT's FX interventions have declined substantially and have been limited to pre-announced auctions.

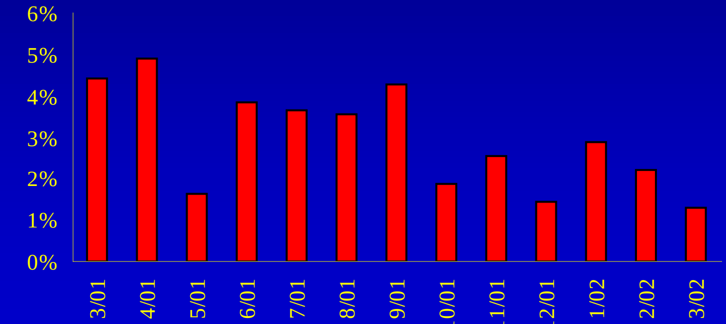
FX Auctions



* (+) indicates FX sales to the market

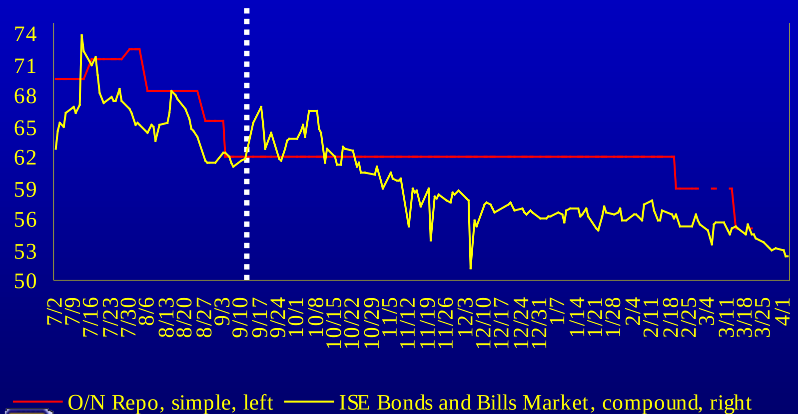
Volatility of the exchange rate has fallen markedly.

Volatility of the Exchange Rate (TL/USD, Coefficient of Variation)



Following the initial spike due to the September 11 event, interest rates display a downward trend.

Interest Rates



Eurobond spreads also exhibit a noticeable downward trend.

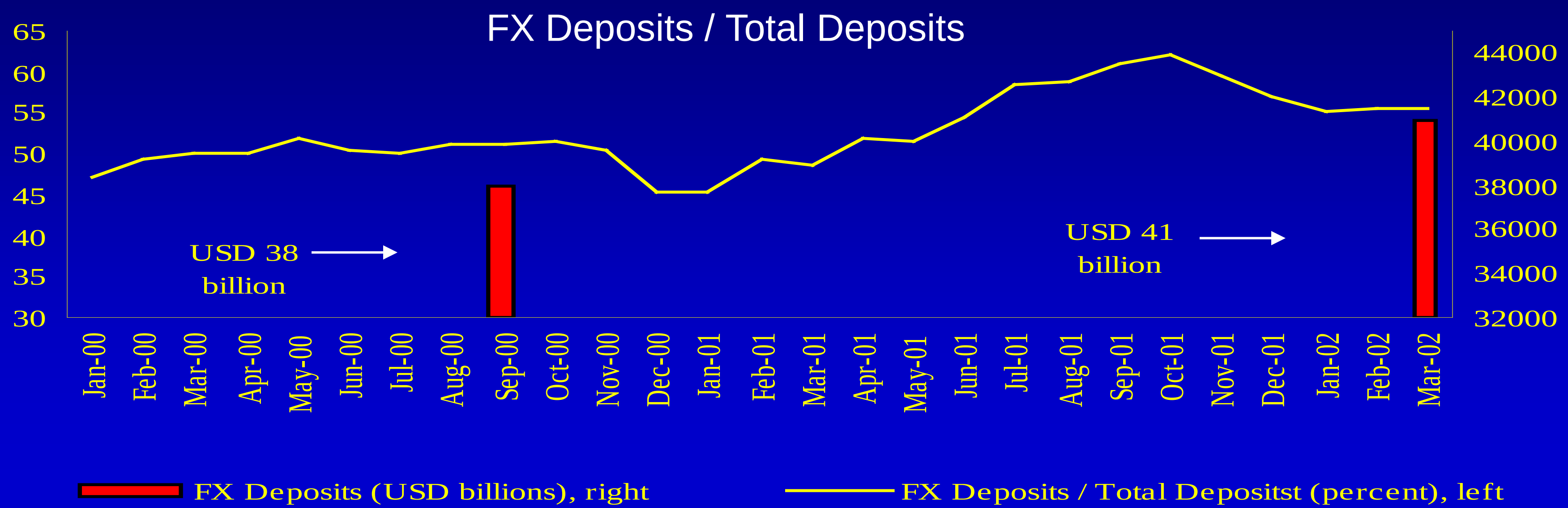
Turkish Eurobond Spreads (basis points)

Spread = Difference between the yields of Turkish Eurobonds and US Treasury Bonds

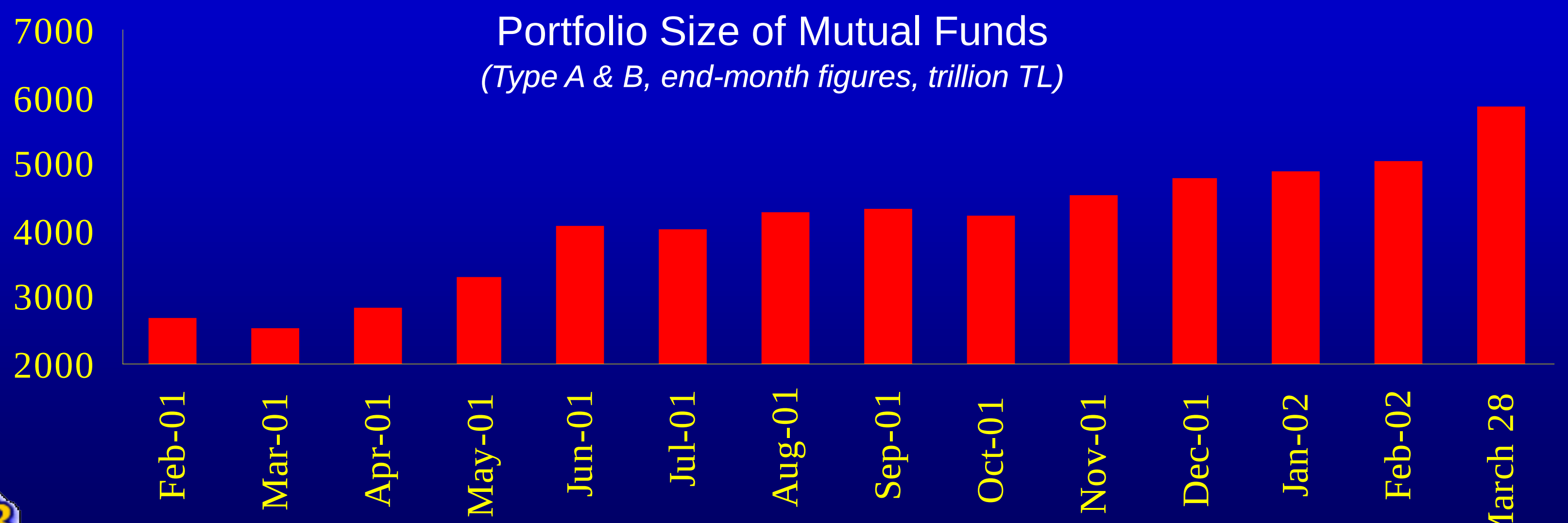
Source: JP Morgan

Signs of stability are emerging

Dollarization is subsiding in spite of the euro changeover process...



...and the investment in TL instruments displays an upward trend.



Signs of stability are emerging

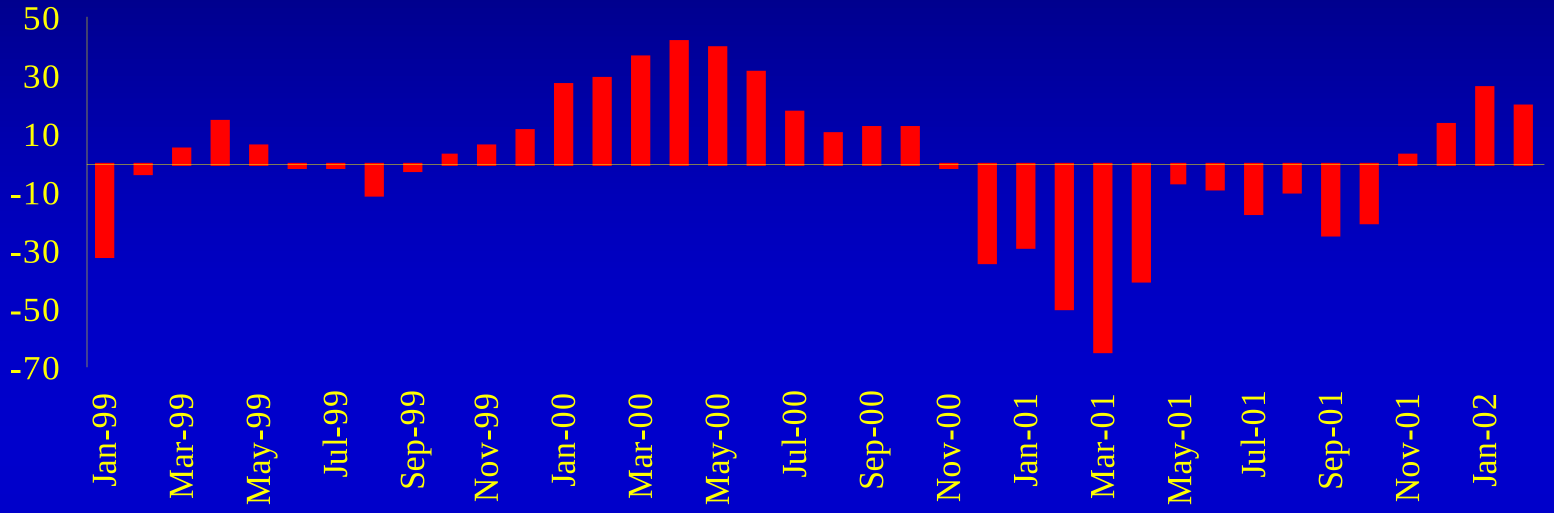
Economic Growth

- In 2001, GNP declined by 9.4 percent.
- However, a recovery is expected in 2002: GNP is projected to increase by 3 percent. The main contributing factors to the recovery are expected to be:
  - ✓ A sharp recovery in business confidence since October 2001 because of stability in financial markets and the new stand-by agreement with IMF;
  - ✓ Increase in agricultural production: The growth rate of agricultural value added is expected to be around 5 percent in 2002 ;
  - ✓ Inventory building and replacement investment in industrial sector;
  - ✓ Increase in exports;

Signs of stability are emerging

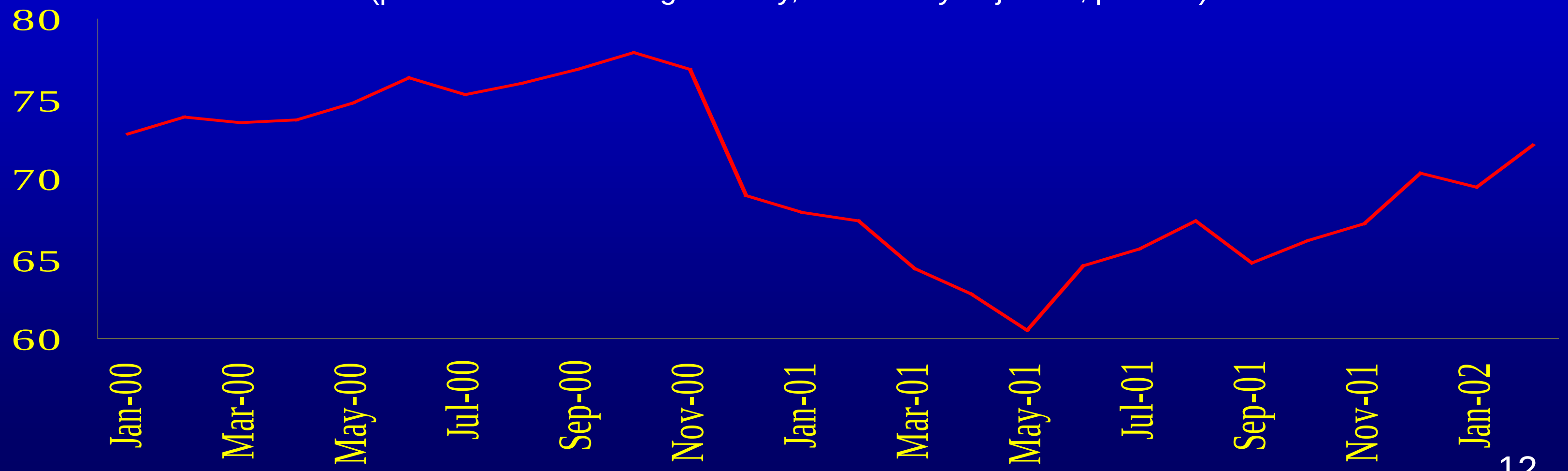
Business Sentiment is improving.

(Opinions about the general business sentiment compared to the previous month, optimistic-pessimistic, percent)



The evolution of the capacity utilization rate displays signs of economic recovery

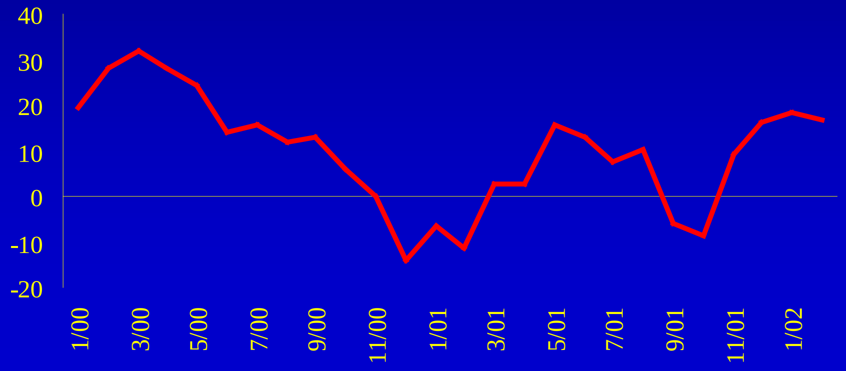
(private manufacturing industry, seasonally adjusted, percent)



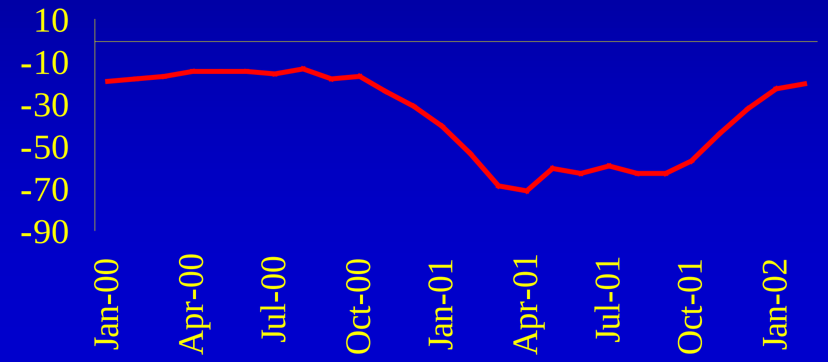
Signs of stability are emerging

Economic Growth

Export Prospects

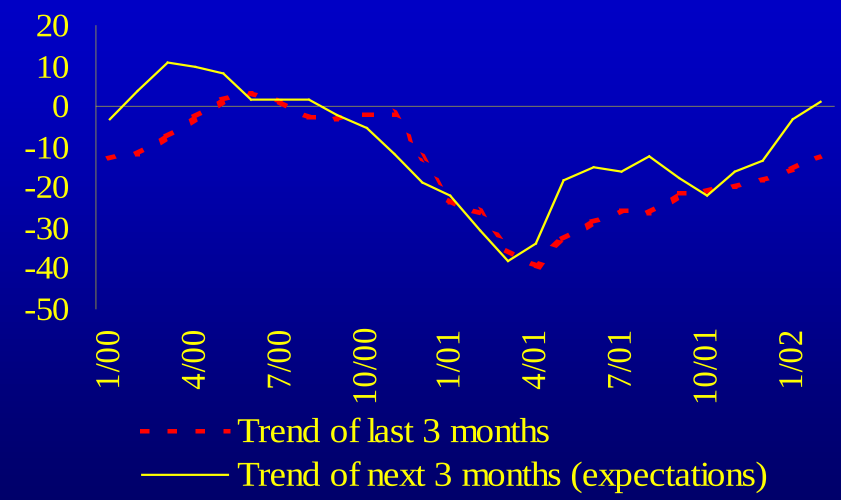


Investment Expenditure Tendency



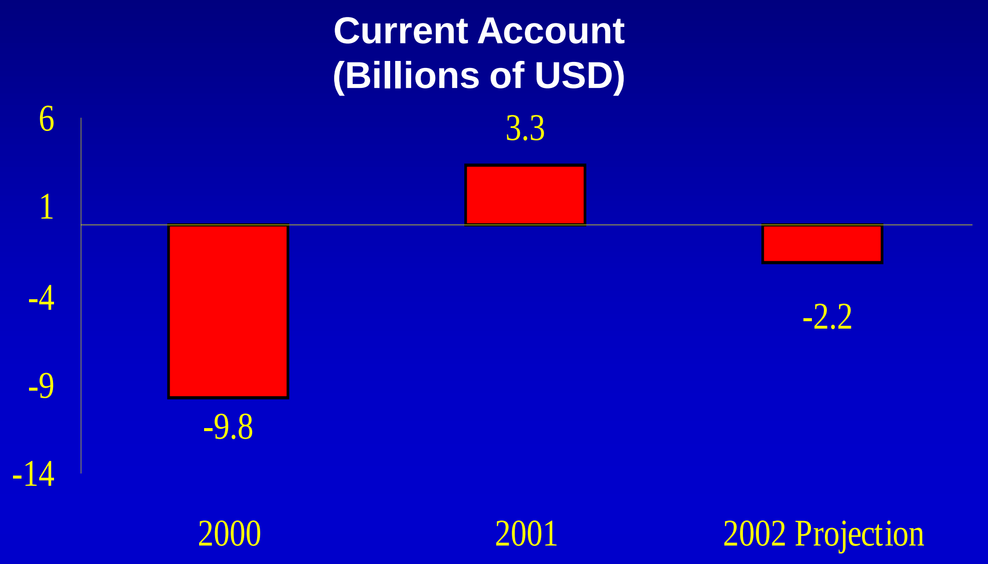
Sales Revenues

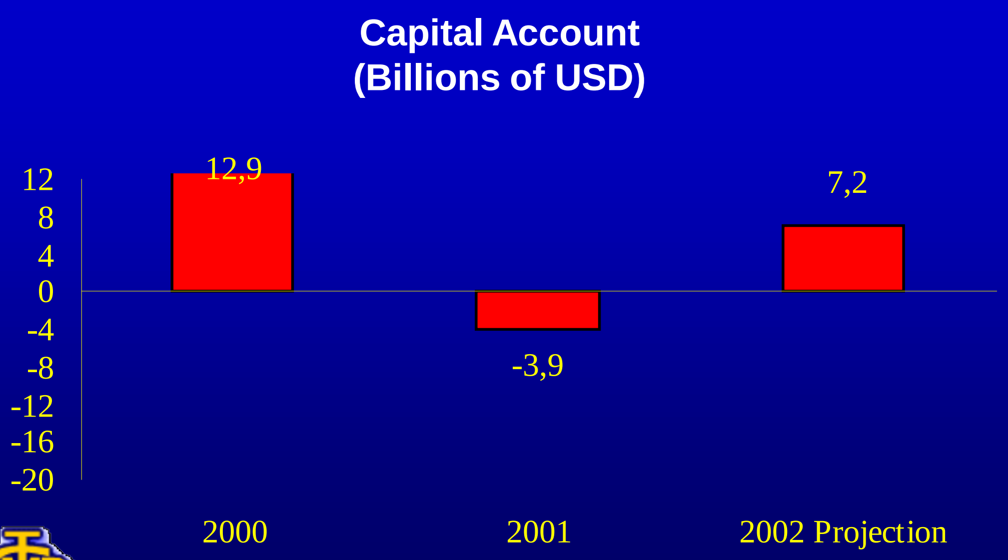
Total Employment



Signs of stability are emerging

Balance of Payments



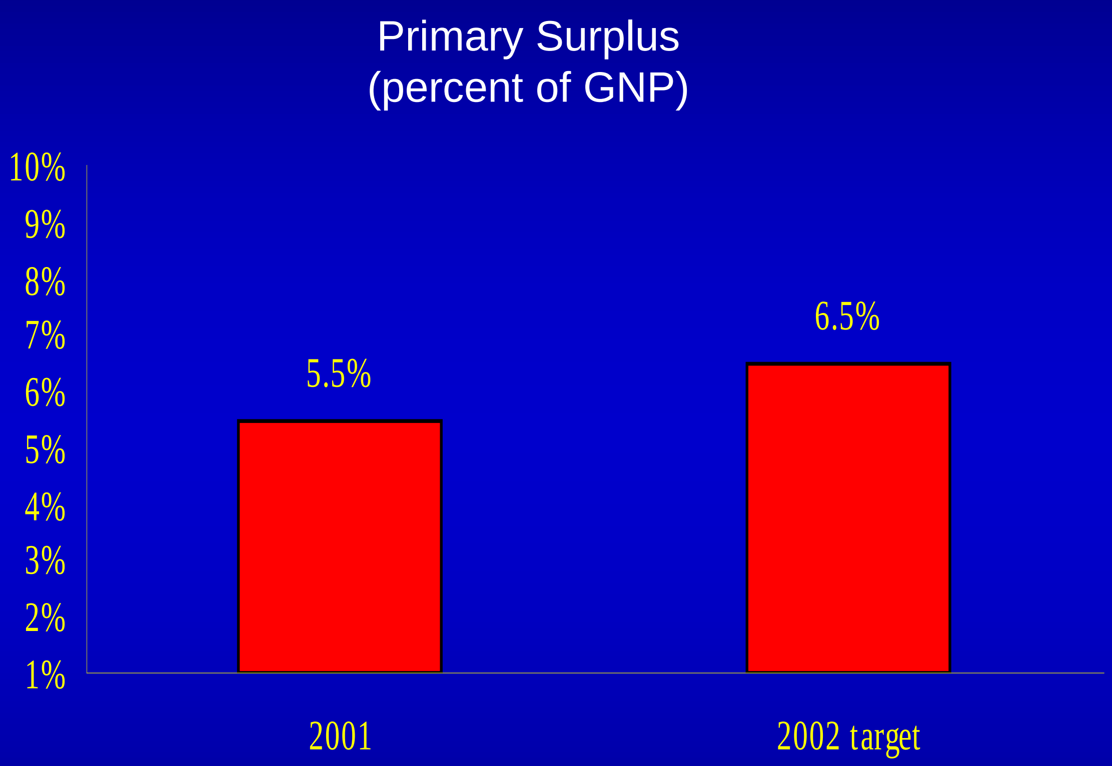


INCLUDING IMF CREDITS

- The economic slowdown and the depreciation of the Turkish lira have led to a noticeable turnaround in the external current account in 2001, with a surplus of US$ 3.3 billion from a deficit of US$ 9.8 billion in 2000.
- A current account deficit of US$ 2.2 billion is projected for 2002.
- February 2001 crisis and resulting confidence loss in TL left the capital account with a deficit of 3.9 billion in 2001 from a surplus of 12.9 billion in 2000.
- Capital inflows are projected to be US$ 7.2 billion in 2002

Signs of stability are emerging

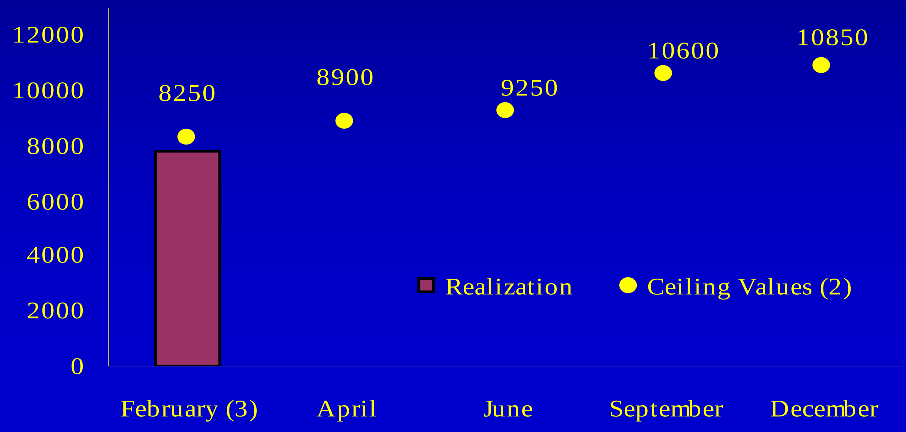
Fiscal Policy



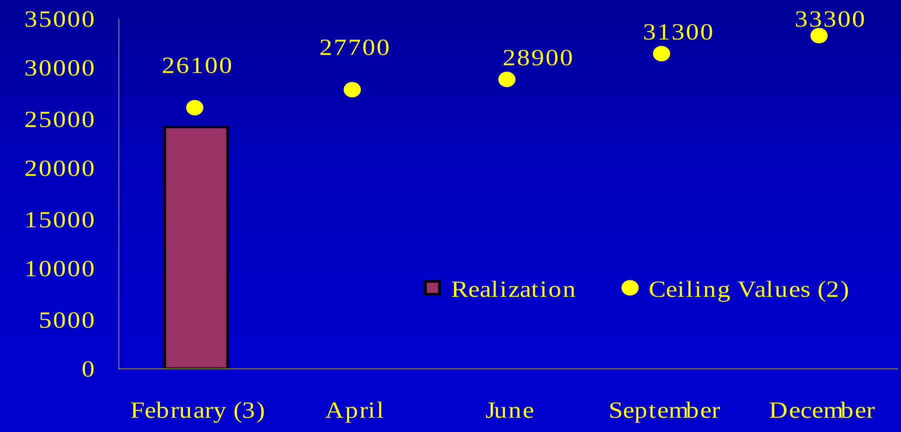
- Strong fiscal consolidation will resume: Following the realization of the ambitious program target for the primary surplus of 5.5 percent of GNP in 2001, the strengthened economic program aims to increase the public sector primary surplus to 6.5 percent of GNP in 2002.
- End-January target for consolidated government sector surplus is met

Quantitative targets are on track

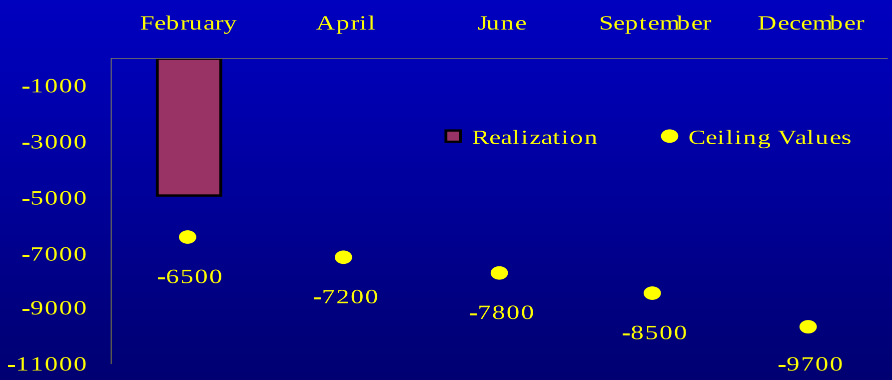
Base Money (TL Trillion)



Net Domestic Assets (TL Trillion)



Net International Reserves (USD Million)(1)



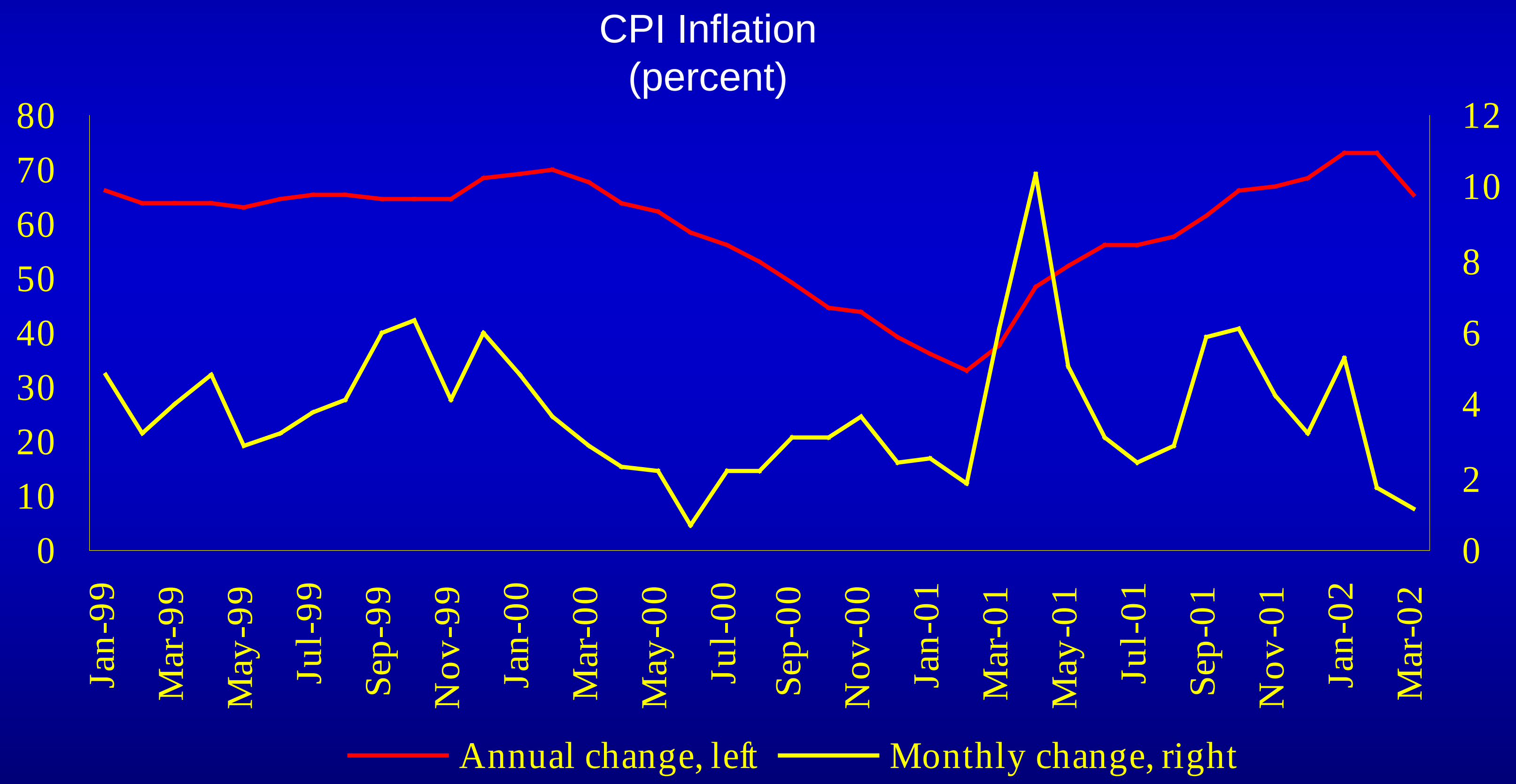
(1) Defined as Net International Reserves of CBT minus (i) Treasury liabilities to the IMF (ii) Treasury fx denominated borrowing with an original maturity of less than one year.

(2) Based on the average of the stocks prevailing during the five working days including and immediately preceding each of these dates.

(3) Calculated by using the four working day average of Feb. 11-12 and March 11-12, to take account of the transitory impact of the Bayram religious holiday on currency demand.

Price and exchange rate developments

The CPI inflation rose between June and November due mainly to cost pressures stemming from the depreciation of the exchange rate, increase in public prices, and poor agricultural performance.



Price developments

- January inflation figure turned out to be above expectations:

CPI inflation increased by → 5.3 percent (monthly change)
→ 73.2 percent (y-o-y)

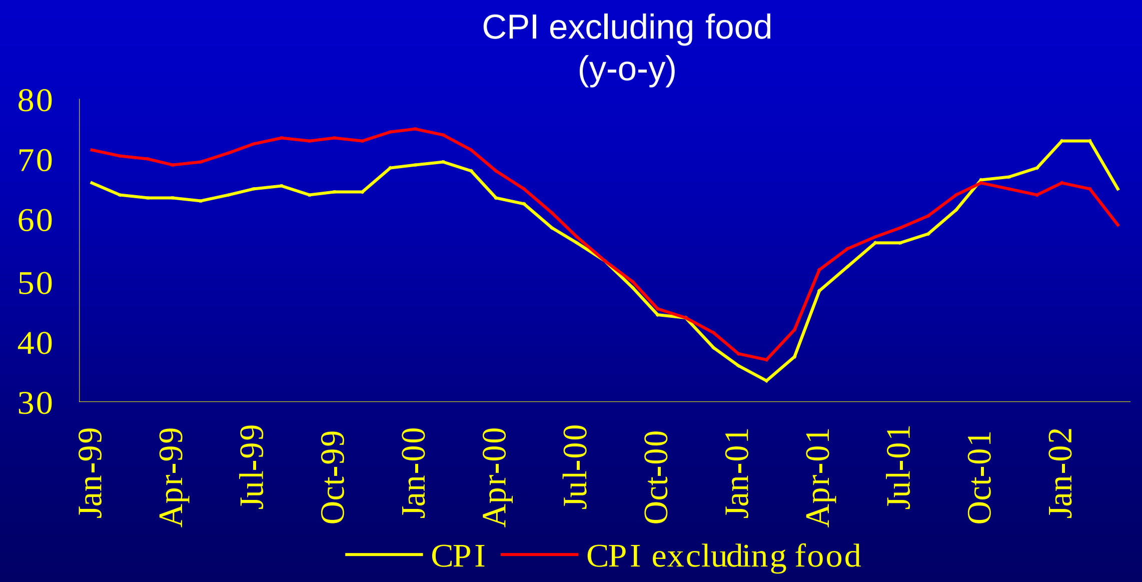
- Main factors behind the higher-than-expected January inflation were:
  - ✓ adverse developments in agricultural production due to unfavorable weather conditions
  - ✓ the sharp increase in food prices
  - ✓ reinstatement of the temporary reduction in the VAT rate for consumer durables

- Excluding food and consumer durables prices:
  - ✓ monthly CPI inflation → 2,5 %

- In short, the inflation outcome in January was above market expectations owing mainly to temporary factors.

Price developments

- The inflation outcome in February appears to be a turning point:
  - ✓ 1,8 percent increase in CPI is not only substantially lower than the average inflation during the last 14 years, but also well below the market expectations.
  - ✓ Annual inflation declined for the first time since March 2001 → 73,1 % CPI.
  - ✓ The noticeable slowdown in inflation is mainly due to:
    - the absence of demand pressures
    - the strengthening of the TL
    - the increase in the credibility of the program, which, in turn, had a favorable impact on expectations
  - ✓ Excluding food prices the downward trend in inflation is more prominent:
    - In February the increase in CPI (excluding food) → 1.3 %



Price developments

- The downward trend in inflation resumed in March: the inflation rate turned out to be lower-than-expectations.

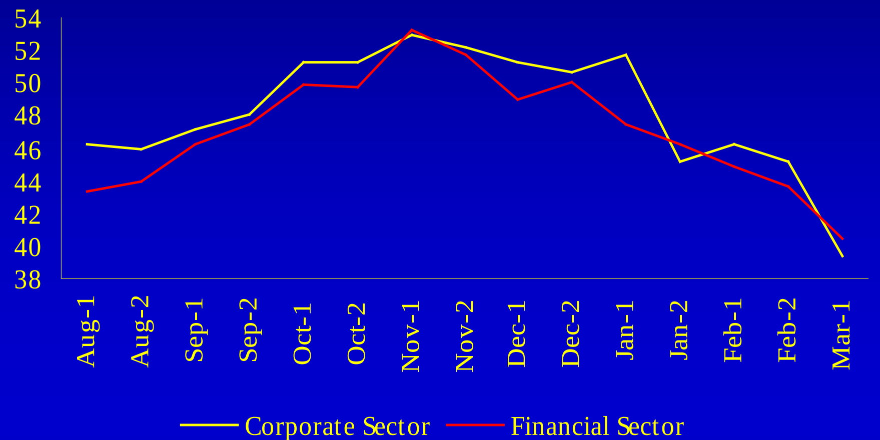
CPI Inflation → 1.2 percent (monthly change)

CPI Inflation → 65.1 percent (y-o-y)

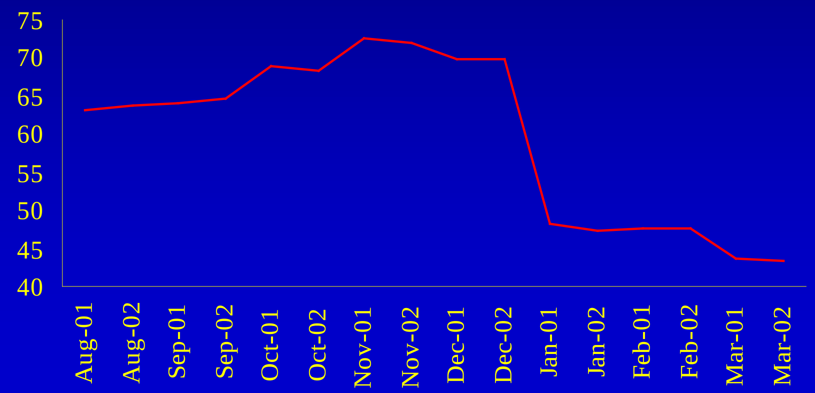
- In addition to the factors contributed to the lower-than-expected inflation in February, the decline in food prices by 0.5 percent played an important role in leading to the favorable March inflation outcome.
- The food prices turned negative in March 2002 for the first time since 1987: the lowest increase in food prices in March was 3.7 percent.
- The historically low March inflation figure is envisioned to buttress the confidence in the program in meeting the end-year inflation target of 35 percent.

Price developments

Inflationary expectations for the next 12-Months (CPI Inflation)



End-year Inflationary expectations (CPI Inflation)

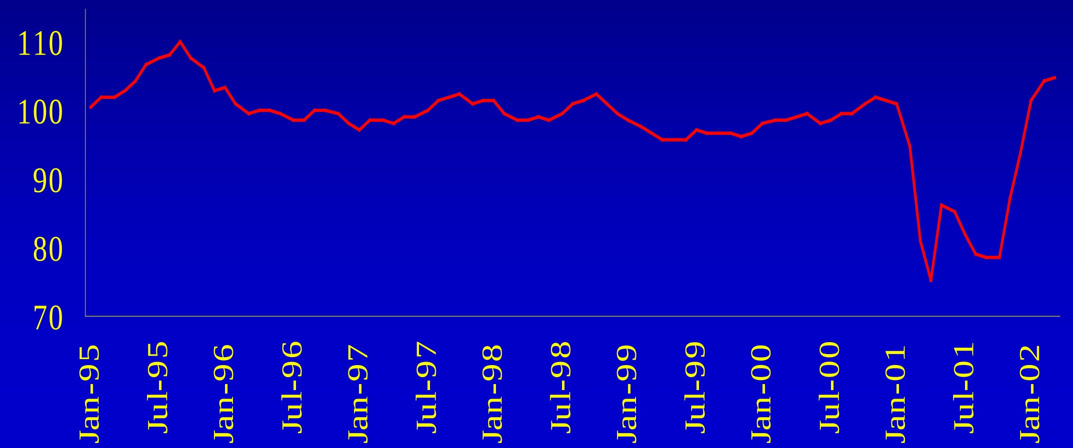


- Price stability:
  - ✓ A prerequisite for rapid, equitable and sustainable growth.
  - ✓ Overriding objective of the monetary policy.
- Inflation targets in the medium-term:
  - ✓ 2002 → 35 %
  - ✓ 2003 → 20 %
  - ✓ 2004 → 12 %

Evolution of the real exchange rate

Real Effective Exchange Rate

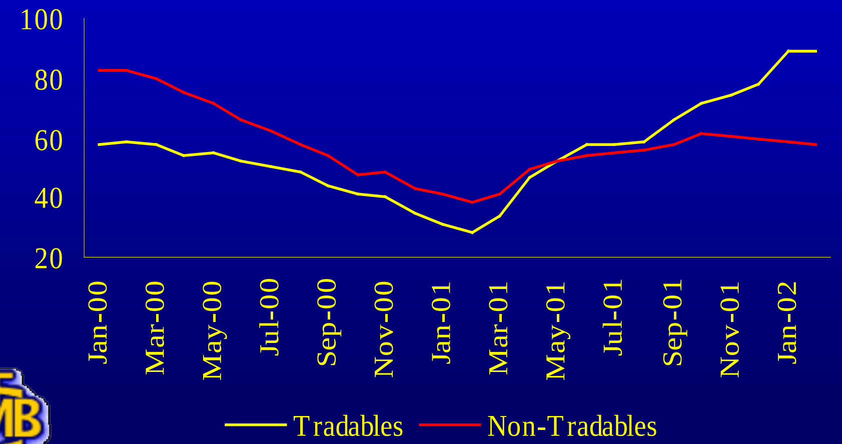
($1 + € 0.77, producer price index for foreign goods & private manufacturing index for domestic goods)



✓ The cost of domestically producing the tradable goods

RER= Price of tradable goods / Price of non-tradable goods

Tradables vs. Non-Tradables



Goods vs. Services

The rationale behind the CBT's recent rate cuts

		Previous Rate	February 20, 2002	March 14, 2002
O/N	Bid	59	57	54
	Ask	62	62	61
1 Week	Bid	62	59	55

- The noticeable decline in inflation expectations, arising mainly from:
  - ✓ Increase in the credibility of the program as a result of the implementation of prudent fiscal and monetary policy, which, in turn, had a positive impact on expectations;
  - ✓ Satisfactory progress with structural reform measures.

The rationale behind the CBT's recent rate cuts

- Strengthening TL and the return of relative stability in the exchange rate market
- The absence of demand pressures

alleviating the inflationary pressures

- Although the recent upward trend in oil prices constitutes an important risk for inflation, inflation expectations are envisaged to decline, provided that the stability of the exchange rate and increase in public prices in line with the inflation target are maintained.
- The price setting behavior of the private and the public sectors will also play a crucial role in the determination of the inflation outcome.

An overview of the FX policy

- As was the case in the latter part of 2001, the CBT remains resolute to keep discretionary FX interventions, aimed at counteracting the excess volatility, outside of the pre-announced auctions limited.

- In order to improve the functioning of the foreign exchange market, policy actions will focus on the following areas:

  - ✓ ***Development of forward and futures exchange markets,*** which will allow exporters and importers to hedge against exchange rate uncertainty;
  - ✓ ***Clarification of the taxation and accounting procedures of the futures contracts***;
    - ❑ A multi-agency working group chaired by the CBT
    - ❑ Remote access problem is temporarily solved by the ISE
    - ❑ Taxation problem solved
    - ❑ Accounting problem solved
  - ✓ ***Prevention of lumpy foreign exchange transactions,*** which disrupt the foreign exchange market, by improving financial management in the state economic enterprises.

- In order to improve transparency in the FX market,the CBT will gradually end its practice of acting as a ***blind broker***:

  - ✓ Forex / interest rate risk;
  - ✓ Counterparty risk.

An overview of the FX policy

- With the decline in interest rates, the CBT is in a *stronger position* to sterilize the liquidity engendered by the use of treasury's FX receipts for domestic payments via money market operations

- Further improvements in BOP
- Reverse currency substitution

Excess FX liquidity will be mopped up through transparent, rule-based mechanisms → FX reserves ↑

Market confidence ↑

Enable Turkey to better withstand external shocks

- Smoothing (temporary) excess volatility in the exchange rate.

An overview of the FX policy

Determining the Indicative Exchange rates

- Effective from 1 April, 2002, the CBT takes the average value of the averages of the buying and selling rates as quoted by banks in the interbank FX markets for 1 USD at the hours indicated in the table below to determine the CBT's indicative FX selling rate of 1 USD to be announced at 15.30.
- Similarly, the respective cross rates of the currencies for which the CBT announces indicative exchange rates, are collected at the exact times shown in the table and their average values are used in the calculations.

Averaging Hours	
10.00	1st Average
11.30	2nd Average
12.30	3rd Average
13.30	4th Average
14.30	5th Average
15.30	6th Average

→ Indicative Exchange rates

- At 15.30, TRL/USD and USD/EUR rates are posted on Reuters page of CBTR
- The 6 values and USD/EUR cross rates are posted in the following day in the "Market Data" section of the CBT internet-site.

An overview of the FX policy

The FX Buying Auctions

- The reverse currency substitution process is in progress.
- When the balance of payments forecasts and their realisations are considered, a better development in the capital account balance is expected.
- The aim is to enhance the FX reserve position of the CBT if and when excess FX supply situation develops without creating an additional volatility in the foreign exchange rates and without disturbing the FX positions of banks.
- The public will be informed in advance about the monthly FX buying auctions and the amounts thereof. In this regard, it has been announced that, FX buying auctions will be held and the daily auction amount is 20 million USD in April 2002.

Averaging Hours	
10.00	1st Average
11.30	2nd Average
12.30	3rd Average
13.30	4th Average
14.30	5th Average

Maximum bid price in the auction is the arithmetic average of these five averages obtained in the manner explained in the previous section.

•At 14.40, the maximum price is posted on Reuters page of CBTQ.

• Institutions may bid between 14.40 and 15.00.

•Auction results showing the total bid amount, average, maximum and minumum prices are posted on the CBT's Reuters page of "CBTQ" at 15.30.

An overview of the TL policy

The TL Deposit Buying Auctions

- As of end-March the total TL liquidity withdrawn from the system with overnight (O/N) and 1 week maturities which is about 6.8 quadrillion Turkish Lira. In addition to the existing liquidity, additional liquidity to be created in the system by the above mentioned foreign exchange buying auctions
- In order to enhance the effectiveness of its sterilization efforts, the CBRT launched a standart 4 week maturity TL Deposit Buying Auction which will be for a limited amount and will not effect the liquidity level of the system in a substantial way.
- The public will be informed in advance about the of the monthly TL Deposit buying auction program and the amounts thereof.
- In this regard, starting from April 3, 2002, in April 2002, on Wednesdays of each week, TL Deposit Buying Auctions with 4 weeks maturities are to be held and the total amount to be auctioned at each auction will be maximum 100 trillion Turkish Liras. The auctions are to be held under the multiple price auction method and Banks may bid between 10.00 and 11.00
- Auction announcements will be made on Reuters page of “CBTY” and the auction results on page “CBTZ”.

An overview of the TL policy

The Quick Repo Tenders

- Since the TL Deposit Buying Auctions are to be held for limited amounts, they will not cause a decrease in the daily excess liquidity.

- However, in the periods ahead, due to the CBRT and the Treasury operations, depending on the lengthening of the maturities of the liquidity withdrawn from the system, may lead to the reduction in the level of the excess liquidity.

- Under these circumstances, in order to alleviate the temporary liquidity shortage that may develop, the CBRT will inject liquidity into the system through the quick tenders to be held at any time between 11:00-15:00.

- In case the liquidity shortage begins to develop, the CBRT will in advance announce to the public the details of the intended quick tender.

- CBT will gradually end its practice of acting as a blind broker in the market in 2002.

- The CBT will carry out *late liquidity window* operations in the interbank money market consistent with its function as the lender of last resort.

Policy actions concerning required reserves and liquidity requirement

- Without changing the required reserves ratio and liquidity requirement ratio, the following measures are taken to:
  - ***Reduce the funding costs of financial institutions by*** remuneration of:
    - reserves on FX liabilities;
    - non-deposit TL liabilities in addition to TL deposits.
  - ***Simplify the system*** by:
    - excluding the vault cash in TL from the liquid assets;
    - making the period for calculation, maintenance and reporting for required reserves and bank liquidity requirements similar.
  - ***Provide more flexibility to the liquidity management*** by allowing 3 percentage points of reserve requirement rates for both TL and FX to be maintained as two -week averages***.***
- To reduce segmentation in the interbank market, there will be withholding for interest earned through transactions intermediated by Takasbank.

The Eventual Monetary Policy Framework: Inflation Targeting

- Under the floating exchange rate regime, IT will serve as the nominal anchor of the economy.

- Monetary policy will have a high degree of flexibility to respond to shocks, thanks to the absence of other objectives—i.e. exchange rate.

- Under IT, the CBRT will aim to find the clearest way to share with the public exactly where the CBRT is trying to make monetary policy go—i.e., what the target is and how the CBT is trying to achieve it—through periodic reports (Inflation Report) and other means of communication with the public and markets.

- Aligning the public's inflation expectations with the CBRT's inflation target and removing the uncertainty risk premium in the interest rate will also improve debt sustainability.

The Eventual Monetary Policy Framework: Inflation Targeting

- The introduction of the inflation targeting regime had to be postponed owing to unfavorable:
  - Domestic developments:
    - Resumption of the fiscal pressure;
    - High inflation;
    - Evolution of the exchange rate;
    - Agricultural prices.
  - External developments:
    - September 11th events;
    - Increased uncertainties in international financial markets.

The Eventual Monetary Policy Framework: Inflation Targeting

It is, however, important to highlight that IT is only one complementary ingredient in a broad strategy of institutional development and its success, among other things, hinges closely on:

- Fiscal responsibility;
- Financial deepening;
- Reducing backward indexation schemes in the economy;
- Flexibility in goods and factor markets to allow smooth adjustment to relative price changes.

Status of preparations for the introduction of IT

Significant Progress has been made to satisfy the preconditions for the implementation of IT:

- The Central Bank Law has been amended to ensure instrument independence, accountability and transparency;
- The technical capabilities at the central bank are being improved in line with the requirements of the inflation targeting framework:
  - ✓ Developing a forecasting and policy analysis system;
  - ✓ Improving the information base.
- In an attempt to improve its communication with the public and markets, the CBT inaugurated the first Monetary Policy Report and issued number of press releases to clarify its policies and actions.
- It is expected that the pre-conditions for IT will be satisfied by mid-year.

Conclusion

- All in all, prudent fiscal and monetary policies along with deep-seated structural reform measures included in Turkey's Medium-term Economic Program will lay the foundations of an economy that is:

  ✓ well-placed on the high road of sustained non-inflationary growth;

  ✓ more resilient to adverse shocks;

  ✓ less vulnerable to crises;

  ✓ more conducive to foreign and domestic investment;

  ✓ as a consequence, better positioned to integrate into European structures.