TÜRKİYE CUMHURİYET MERKEZ BANKASI

MONETARY AND EXCHANGE RATE POLICY FOR 2012

Central Bank of the Republic of Turkey

27 December 2011
Ankara

I. THE MONETARY POLICY FRAMEWORK

Monetary Policy and Financial Stability: An Overview of 2011

1. Following the global financial crisis, monetary policy in many countries started to address financial stability, in addition to price stability. Having widened the purview of the central banks, this approach led to a wide use of tools, in addition to the traditional monetary policy tools, towards reducing macro risks. While advanced economies focused on solving their balance-sheet problems stemming from the crisis, emerging market economies started to design more comprehensive policy frameworks to manage capital flows and related macro-financial risks.

2. The Central Bank of the Republic of Turkey (the Central Bank) was assigned with the task of taking the required measures to ensure stability in the financial system in addition to the primary objective of price stability in accordance with the Central Bank Law as amended in 2001. Thus, in order to contain macro-financial risks driven by global imbalances, the Central Bank enhanced the inflation targeting regime and designed a new monetary policy strategy. Accordingly, the Central Bank started to take macro-financial stability into account as much as economic conditions permit while preserving the primary objective of maintaining price stability. Within the framework of this new structure, the Central Bank designed a policy mix in which the interest rate corridor, which is formed between the overnight borrowing and lending rates, and required reserves are jointly employed besides the policy rate to ensure the diversity of instruments that is required by the monetary policy implemented to achieve multiple goals.

Global Crisis, Quantitative Easing and Their Impact on the Turkish Economy

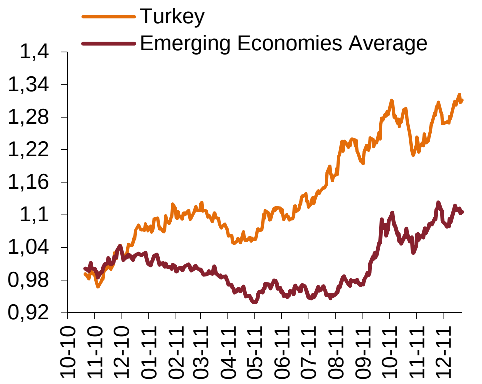
3. The monetary easing policies implemented by the central banks of advanced economies to mitigate the effects of the global financial

crisis had notable effects on Turkey as they did on many emerging market economies. Availability of ample and low-cost short-term external financing led to a rapid credit growth and gradual appreciation of the Turkish lira in this period, paving the way for the accumulation of macro-financial risks and external imbalances as of the second half of 2010.

4. In line with the new strategy put into force as of the last quarter of 2010, the Central Bank developed policies towards reducing macro-financial risks, thanks also to the favorable inflation outlook in the said period. Accordingly, in addition to the traditional policy tool of the one-week repo auctions, required reserves, interest rate corridor and other liquidity policies were put into use.

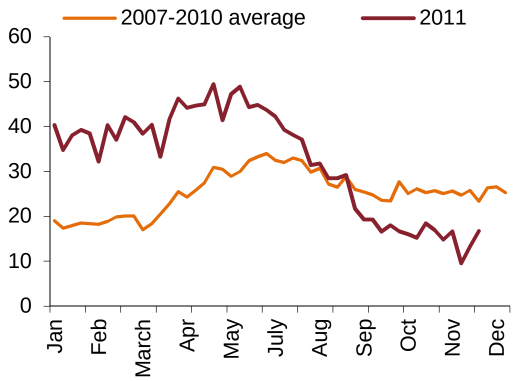
5. In the period from the adoption of the new policy framework in November 2010 to intensifying uncertainties in the European economy in August 2011, the Central Bank aimed at limiting short-term capital flows and preventing excessive appreciation of the Turkish lira on the one hand, and ensuring a more controlled growth in domestic credit and demand as well as balancing the divergence between external and domestic demand on the other. Due to the strong risk appetite and the surge in short term capital flows in this period, the Central Bank widened the interest rate corridor by reducing the overnight borrowing rate. Thus, interest rates in overnight markets were let to be lower than policy rates, which gave rise to an increase in the downward volatility of overnight market rates and a decline in very short-term capital flows. Meanwhile, required reserve ratios were raised significantly in the same period to avert excessive credit growth and contain domestic demand. Furthermore, the Central Bank aimed to make use of the short-term capital inflows as much as possible, through regular foreign exchange purchase auctions, in order to strengthen the reserves of the Central Bank in this period. These measures lifted the excessive appreciation pressure on the Turkish lira (Chart 1). Moreover, credits have recorded a marked slowdown since the midst of 2011 thanks also to the measures taken by primarily the Banking Regulation and Supervision Agency, as well as other institutions (Chart 2).

Chart 1.
TL and Emerging Market Currencies*



* 01.10.2010 values are normalized to 1 against USD. Average of the emerging economies is calculated by taking normalized averages of the currencies of Brazil, Chile, Czech Republic, Hungary, Mexico, Poland, S. Africa, Indonesia, S. Korea and Colombia. Increases denote the depreciation of the currency against the USD.
Source: Bloomberg, CBRT.

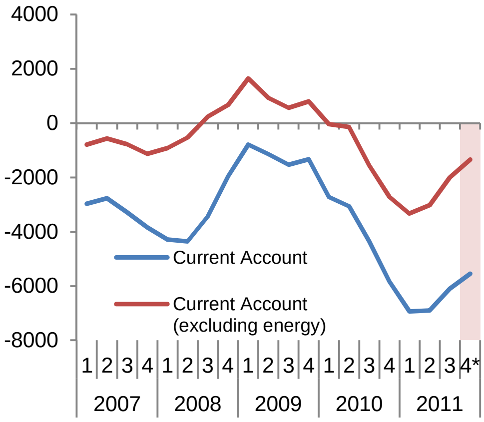
Chart 2.
Credit Growth Rate*
(13-week Moving Average, Annualized, Percent)



*Exchange-rate adjusted.
Source: CBRT.

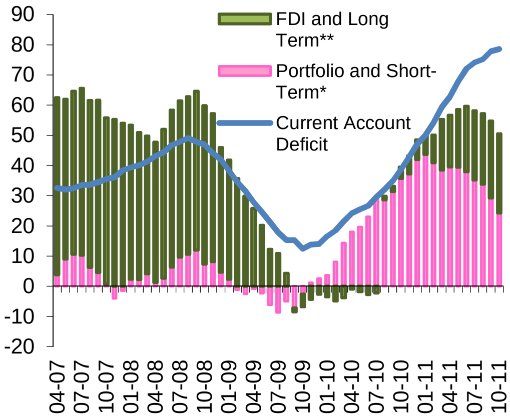
6. As a result, demand composition and capital flows started to change in the desired direction, and a rebalancing process in the economy started as of the midst of 2011 (Charts 3 and 4).

Chart 3.
Current Account Balance
(Seasonally Adjusted, Quarterly Average, USD Million)



*Estimate.
Source: TurkStat, CBRT.

Chart 4.
Main Financing Resources of Current Account Deficit
(12-month cumulative, USD Billion)

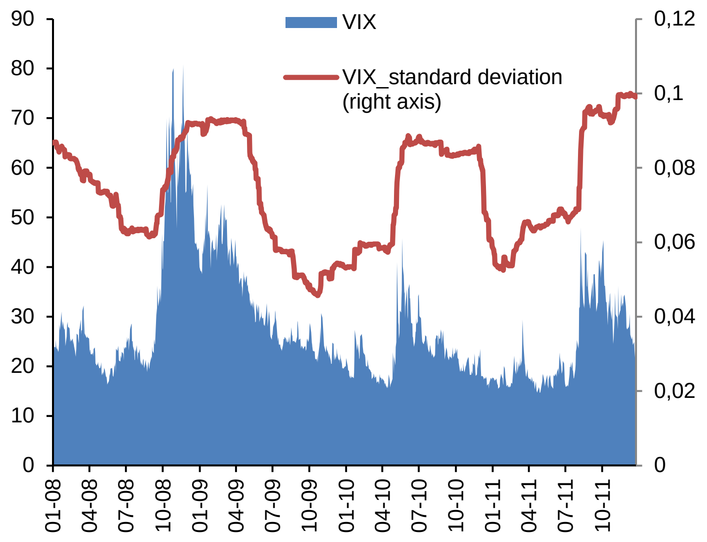


*Short term capital movements are the sum of short term net credits of the banking and corporate sector's and the deposits at banks.
**Long term capital movements are made up of net long term credits of banks and the corporate sector besides the bonds issued abroad by banks and the Treasury.
Source: CBRT.

Aggravating Problems in the Euro Area and Monetary Policy

7. Since August 2011, intensified concerns over global growth and sovereign debt problems in some European countries led to a global increase in risk aversion and a record-high volatility in risk appetite (Chart 5).

Chart 5.
VIX*

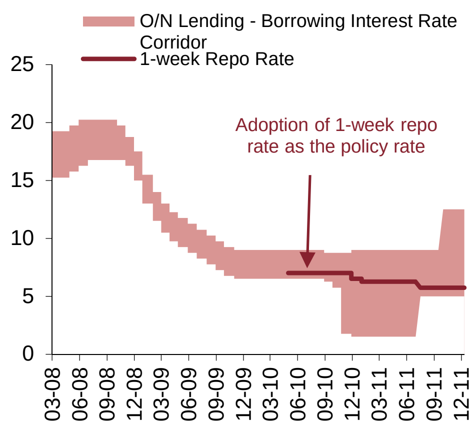


* Standard deviation of 150 days of the daily percentage change in the VIX index.
Source: Bloomberg, CBRT.

8. Upon the acceleration of capital outflows from emerging economies in this period, the Central Bank, in accordance with the new policy implementations, utilized its policy tools in the opposite direction of what it did in times of accelerated capital inflows. As such, the interest rate corridor was narrowed through raising the overnight borrowing rate and the Turkish lira required reserves were rearranged to reduce the liquidity needs of the banking system. Furthermore, a set of liquidity measures were taken to limit fluctuations in the foreign exchange market.[1] In addition, the policy rate was reduced moderately in order to minimize the risk of a recession in domestic economic activity posed by gradually aggravating problems in the global economy (Chart 6 and 7).

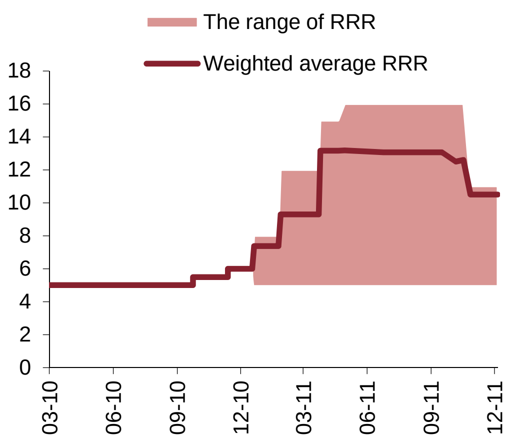
[1] Details on the said arrangements are laid down in the second part of the document.

Chart 6.
CBRT Interest Rates
(Percent)



Source: CBRT.

Chart 7.
TL Required Reserve Ratios
(Percent)

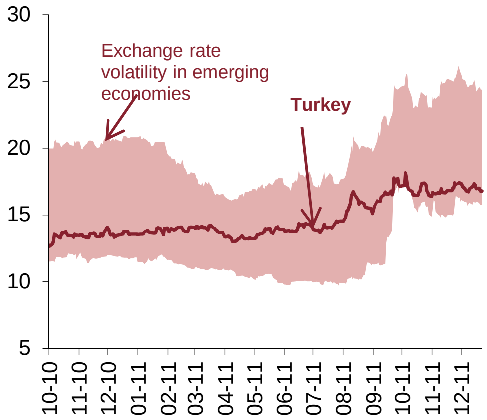


Source: CBRT.

9. Due to the excessive depreciation of the Turkish lira since August, which was a consequence of the deterioration of the global risk appetite, and the adjustments in administered prices in the last quarter of the year, it became obvious that the rise in inflation would be higher than envisaged in the short-term. In order to prevent this from influencing medium-term inflation expectations and outlook, the Central Bank widened the interest rate corridor upwards by delivering a sizeable rise in lending rates in October. In this context, the Central Bank let overnight interest rates in the money market be higher than the policy rate through liquidity adjustments. On the other hand, required reserve ratios were slightly decreased so as to avoid an unfavorable tightening in liquidity conditions due to the increase in overnight interest rates.

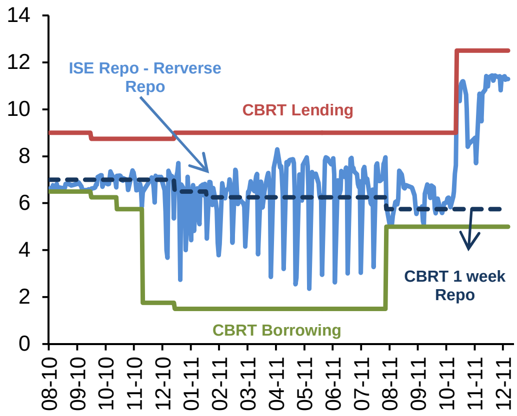
10. The measures taken by the Central Bank as of August 2011 were effective in limiting the adverse effects of fluctuations due to soaring uncertainties in the European economy on economic activity in Turkey. Thanks to the arrangements in the foreign exchange market and the policy decisions taken in August and October regarding the interest rate corridor, the volatility of exchange rates were restricted compared to other emerging market economies (Chart 8). Moreover, widening of the interest rate corridor upwards upon the decision taken in October and the tightening of liquidity conditions led to a significant rise in overnight market rates (Chart 9).

Chart 8.
Exchange Rate Volatility*
(Percent, volatility implied for the 12 months ahead)



*Emerging economies include Brazil, Chile, Czech Republic, Hungary, Mexico, Poland, S. Africa, Indonesia, S. Korea and Colombia.
Source: Bloomberg, CBRT.

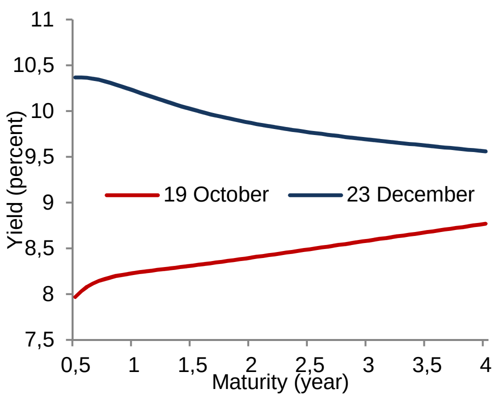
Chart 9.
Overnight Interest Rates
(Percent)



Source: CBRT.

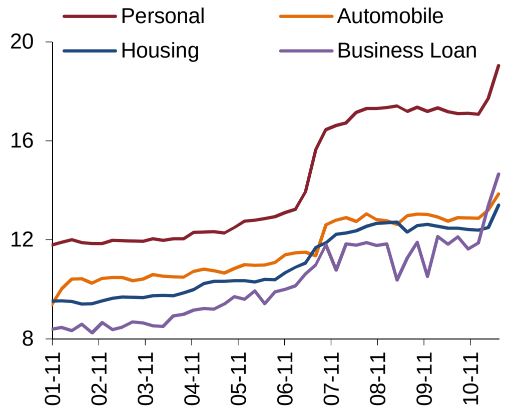
11. Amid the monetary tightening, the yield curve shifted upwards for all maturities, and more remarkably for the short-term (Chart 10). There was also a sizeable increase in loan rates in the same period (Chart 11).

Chart 10.
Yield Curve*



*Calculated by taking the returns of bonds quoted in ISE Bonds and Bills Market by the use of Extended Nelson-Siegel (ENS) Method.
Source: ISE, CBRT.

Chart 11.
Loan Rates*
(Percent)



*Annual interest rates.
Source: CBRT.

Inflation Outlook in 2012

12. In the upcoming period, while focusing on price stability, the Central Bank will continue to safeguard financial stability as well. Policies implemented to reduce macro-financial risks in 2011 yielded favorable results and a rebalancing process in the economy started. Nevertheless, the excessive depreciation of the Turkish lira led by the deterioration of the global risk appetite as of August and the adjustments in administered prices in the last quarter of the year drew inflation markedly above the target. The Central Bank implemented a sizable tightening in October 2011 in order to contain inflation expectations and balance the risks to medium-term inflation. Effects of the mentioned tightening on inflation will become apparent as of the onset of 2012. However, due to the cumulative effects of foreign exchange movements, annual inflation will remain high for a while. The effect of exchange rates and commodity prices on inflation is expected to reach approximately 5 percentage points by the end of 2011. The effect of adjustments in administered prices is estimated to be 1.6 percentage points for the same period. With the gradual elimination of these effects, inflation is expected to converge to the 5 percent target in 2012.

Monetary Policy Tools

13. High levels of uncertainty regarding the global economy accompanied by excessive volatility in risk appetite require that the Central Bank maintains the flexible framework for monetary policy. The implemented interest rate corridor policy contributes to the smoothing of adverse consequences of fluctuations in capital flows on the exchange rate and the economy as a whole. Hence, the interest rate corridor will be utilized as an active policy tool as long as uncertainty regarding the global outlook and volatility in capital flows persists. In other words, overnight interest rates can be adjusted in response to economic and financial developments through an effective liquidity management. In addition, one-week repo auctions, required reserves and other liquidity tools will also remain in use to balance the risks regarding price and financial stability.

Inflation Targets

14. The target variable is the year-end inflation rate, which is calculated as the 12-month change of the Consumer Price Index (CPI), and inflation targets are determined jointly with the government as point targets. The recent structural transformation in the Turkish economy, the rigidities brought about by high-inflation in the past, biases in measured inflation due to improvements in quality, and convergence to the European Union render targeting a higher level of inflation compared to advanced economies more appropriate. Accordingly, the medium-term inflation target will be preserved as 5 percent. Thus, as it was for the 2012-2013 period, the inflation target for 2014 is set as 5 percent as per the agreement reached with the government while drafting the Medium Term Program (MTP).

15. Being an element of the accountability of the Central Bank, the uncertainty band will be maintained at 2 percentage points in both directions, as it was before. Should the inflation rate at the end of each quarter deviate from the year-end target by more than 2 percentage points, the reasons for the deviation as well as the measures that were taken and those that will be taken to achieve the target rate will be explained via the Inflation Report. The Central Bank will submit an open letter to the government should inflation at the end of the year realize outside the uncertainty band.

Communication Tools and the Decision-Making Process

16. The main communication tools of the monetary policy are the Inflation Report and Monetary Policy Committee (MPC) announcements. The MPC will continue to hold monthly meetings based on a pre-announced schedule. The monetary policy decision and its brief rationale, accompanied by its English translation, will be announced on the CBRT website at 2 p.m. on the day of the MPC meeting. The summary of the MPC meeting that entails detailed assessments of the Committee will be released on the CBRT website within five working days following the MPC meeting, along with the English translation thereof.[2]

17. The Inflation Report will be published on a quarterly basis as usual. The Report will be presented at press conferences to be held two times in Ankara and two times Istanbul in order to enhance the effectiveness of communication. Furthermore, the announcements regarding the monetary and exchange rate policy frameworks, the biannual presentations given by the Governor before the Council of Ministers and the Planning and Budget Commission of the Grand National Assembly of Turkey, the “Monthly Price Developments” reports released on the subsequent working day of the announcement of the inflation data, the biannual “Financial Stability Report”, meetings with the economists working in the banking sector, the presentations and speeches made by the Central Bank officials in Turkey and abroad and other press releases will play an important role in communicating with the public. Working papers, booklets, economic notes released besides the conferences and workshops held by the Central Bank will also remain as major components of the communication policy.

II. EXCHANGE RATE POLICY AND LIQUIDITY MANAGEMENT

Exchange Rate Policy

18. Along with inflation targeting, the Central Bank will continue to implement floating exchange rate regime in 2012. Under the current exchange rate regime, the foreign exchange rate is not used as a policy tool and the Central Bank of Turkey does not have a nominal or real exchange rate target.

[2] Meeting schedules and Inflation Report release dates for 2012 are provided in the Appendix.

19. As stated in the annual monetary and exchange rate policy announcements, which have been published since 2002, the foreign exchange rate is determined by supply and demand conditions in the market under the floating exchange rate regime. The main determinants of foreign exchange supply and demand are the monetary and fiscal policies in practice, economic fundamentals, international developments and expectations.

20. Even if they implement floating exchange rate regimes, possession of strong foreign exchange reserve positions is a great contributor for emerging economies like Turkey in curbing the unfavorable effects of potential internal and external shocks and boosting confidence in the country. Therefore, the Central Bank holds foreign exchange buying auctions to build up reserves at times when foreign exchange supply increases relative to foreign exchange demand.

21. Being meticulous to keep the impact on supply and demand conditions in the foreign exchange market at a minimum level, the Central Bank has been buying foreign exchange via transparent foreign exchange buying auctions under preannounced terms and conditions. Although the aim is to conduct auctions according to the pre-announced program, auction programs may be subject to changes with prior notice in the event of unexpected significant developments in the foreign exchange supply.

Accordingly,

i) The document on the monetary and exchange rate policy for 2011, stated foreign exchange buying auctions would be continued with flexible foreign exchange buying auction method, which was announced by a press release no. 2010-55 on 1 October 2010. Considering that the new method ensures adequate flexibility, implementation of options was terminated as of 3 January 2011 and auction purchasing amount was raised to USD 50 million.

ii) Liquidity conditions in advanced economies, a major factor in the robust course of capital flows, did not record a notable change. Nevertheless, concerns over the sovereign debt sustainability in some European countries had an adverse impact on the risk appetite and relatively slowed down the capital inflows towards emerging economies that also includes Turkey. Thus, for daily foreign exchange auctions, the amount to be purchased through flexible foreign exchange buying auctions on a daily basis was decreased from USD 50 million to USD 40 million on 30 May 2011, to be effective as of 31 May 2011.

iii) As the aggravating concerns over the sovereign debt sustainability of the European countries and global growth continued to deteriorate the risk appetite and attenuate capital inflows towards emerging economies including our country, the amount to be purchased via foreign exchange auctions was decreased from USD 40 million to USD 30 million on 29 June 2011.

iv) With a view to solving the sovereign debt problems of the European countries, European Union Leaders' Summit was held in July 2011 and major decisions were taken. Upon the assessment that it would be appropriate to suspend the foreign exchange buying auctions in the days in which the implementation of these important decisions and their reflections on the markets would be closely monitored, foreign exchange buying auctions were halted on 25 July 2011.

v) At the meeting held on 4 August 2011, the Monetary Policy Committee underlined the aggravating concerns over the sovereign debt problems in some European countries besides global growth and also stated that the risks indicated in the July Meeting became more pronounced. The Committee agreed on closely monitoring the developments and providing the market with foreign exchange liquidity by appropriate tools and methods when needed.

In this scope, with a view to ensuring the smooth functioning of the foreign exchange market and bolstering the foreign exchange liquidity during the rest of 2011, the following measures were taken:

a) When deemed necessary, the Central Bank started to provide the market with foreign exchange liquidity via foreign exchange selling auctions as of 5 August 2011.

b) In the foreign exchange deposit market of Foreign Exchange and Banknotes markets, the lending rate for transactions, which the Central Bank is a party to, was decreased from 5.5 percent to 4.5 percent for US Dollar and from 6.5 percent to 5.5 percent for Euro to be effective as of 9 August 2011.

c) According to the decision taken on 12 September 2011, in order to ensure a timely, controlled and effective use of the Central Bank's foreign exchange reserves, when the Central Bank decides to sell foreign exchange based on daily market developments, which are closely monitored by the Central Bank, the selling amount announced at 11:00 a.m. will be the maximum daily amount that can be sold. After receiving the offers, when deemed necessary, the Central Bank will be able to sell less than the determined maximum selling amount for that day.

d) On 5 October 2011, due to the excessive volatility unrelated to economic fundamentals and irregular movements in the foreign exchange rates of emerging economies, high amounts of foreign exchange liquidity were started to be injected to the market via foreign exchange selling auctions when deemed necessary.

e) Furthermore, as unhealthy price formations in exchange rates occurred due to speculative behavior stemming from a decline in market depth, the Central Bank directly intervened in the market through sale on 18 October 2011.

f) In order to enhance the mobility of foreign exchange liquidity in the Interbank Foreign Exchange Market, the Central Bank resumed its activities as an intermediary in the foreign exchange deposit markets in Foreign Exchange and Banknotes Markets as of 10 November 2011, until the elevated uncertainties in the international markets disappear.

g) With a view to contributing to the stability in domestic foreign exchange markets, the Central Bank started to announce on each working day following 29 November 2011 the maximum foreign exchange amount to be sold via auctions within the subsequent two working days.

h) As stated in the press release no. 86 of 26 December 2011, the daily foreign exchange auctions to be held besides the maximum amounts that can be sold within the subsequent two days thereof and the amount to be sold excluding the exceptional circumstances will be updated following the Monetary Policy Committee Meetings in order to enhance foreseeability.

i) As stated in the press release no. 87 of 27 December 2011, parallel to the global developments, in order to facilitate the provision of foreign exchange liquidity that may be needed by the Turkish banking system, the maturity of the foreign exchange deposits that the banks can borrow from the Central Bank within their borrowing limits in the Foreign Exchange Deposit Markets was raised from 1 week to 1 month to be effective as of 2 January 2012.

22. In 2011, the Central Bank bought USD 6.5 billion from the market via foreign exchange buying auctions and provided the market with USD 10.1 billion liquidity via foreign exchange selling auctions.

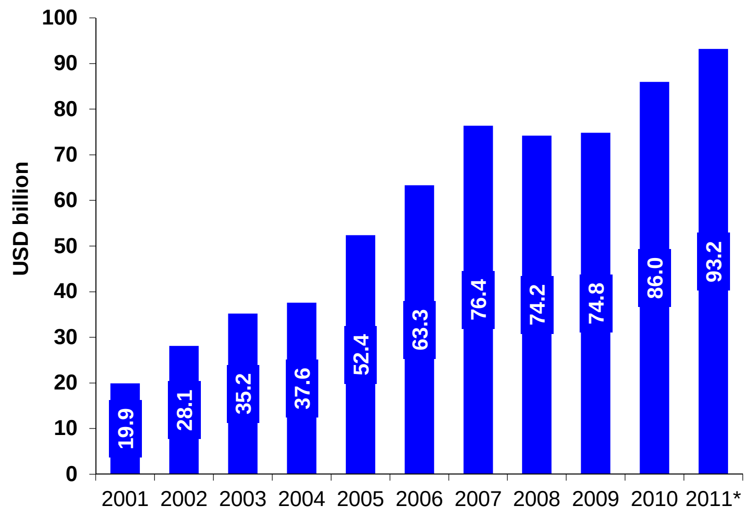
Table 1: Foreign Exchange Amounts Bought and sold by the Central Bank *
(2002-2011, million USD)

Year	FX Buying Auctions	FX Selling Auctions	FX Buying Interventions	FX Selling Interventions	Total Net FX Purchases
2002	795	-	16	12	**799**
2003	5.652	-	4.229	-	**9.881**
2004	4.104	-	1.283	9	**5.378**
2005	7.442	-	14.565	-	**22.007**
2006	4.296	1.000	5.441	2.105	**6.632**
2007	9.906	-	-	-	**9.906**
2008	7.584	100	-	-	**7.484**
2009	4.314	900	-	-	**3.414**
2010	14.865	-	-	-	**14.865**
2011*	6.450	10.110	-	525**	**-4.185**
Total	**65.409**	**12.110**	**25.534**	**2.651**	**76.182**

* As of 26 December 2011.
** The purchased/sold amounts via interventions will be announced within the subsequent 15th working day of the intervention.
Source: CBRT.

23. As illustrated in Table 1, the Central Bank has undertaken a net purchase of USD 76.2 billion in total since 2002. In the said period, Central Bank's foreign exchange reserves increased by USD 73.3 billion from USD 19.9 billion to USD 93.2 billion (Chart 12).

Chart 12.
CBRT Gross Foreign Exchange Reserves (Including Gold)



*As of 23 December 2011.
Source: CBRT.

24. With a view to alleviating the negative impact of the global crisis on the corporate sector, new arrangements were made on export rediscount credits and the credit limit was raised to USD 3 billion, USD 2.5 billion of which to be allocated to the Eximbank. Rediscount credits bolster the Central Bank's foreign exchange reserves as credits are extended in the Turkish lira, whereas repayments are made in foreign exchange. Export rediscount credit extensions, which reached USD 1.5 billion in the first 8 months of 2011, has accelerated in the last 4 months of the year, totaling nearly USD 3 billion across 2011. In the first four months of 2012, the amount of loans to be repaid in foreign exchange to the Central Bank is USD 1.5 billion. If credit utilization maintains the same pace in 2012, rediscount credit utilizations, which are repaid within 120 days, may provide an increase in reserves up to approximately USD 4.5 billion in 2012. Given this quality of credits and the increasing demand for them, the current limit of these credits may be increased to USD 4.5 billion in the first quarter of 2012, USD 4 billion of which will be provided through the Eximbank.

25. As it did in the past, the Central Bank will continue to closely monitor the developments in FX demand and supply and take the necessary measures within its means and act prudently in order to ensure the smooth functioning of the FX market and to support FX liquidity in 2012. In accordance with the decisions taken in the Monetary Policy Committee Meeting held on 4 August 2011, the Central Bank will continue to closely monitor the developments affecting the global risk appetite and provide the market with foreign exchange liquidity through eligible instruments and methods when needed in 2012. In this context, foreign exchange selling auctions will continue to be held when needed. The maximum selling amount for the required foreign exchange selling auctions, which is announced for the respective day, will continue to be set high. Nevertheless, the selling amount will be kept limited excluding the exceptional conditions. Moreover, so as to alleviate the adverse impacts of the problems that may deepen in global credit markets on the foreign exchange liquidity of the Turkish banking system, the maturity of foreign exchange deposits that may be lent by the Central Bank within the banks' borrowing limits in the foreign exchange deposit market may be gradually increased up to 3 months.

26. Should a change occurs in liquidity conditions upon the developments in the international markets and capital inflows towards emerging economies accelerate, the Central Bank may undertake purchases in foreign exchange markets to bolster its foreign exchange reserves in accordance with the long term reserve accumulation policy. Purchases will be conducted with a minimum impact on the markets and through auctions with preannounced terms and conditions.

27. In addition, the Central Bank will continue to closely monitor exchange rate developments as usual and will directly intervene in the market through purchase or sale, in case of any unhealthy price formations in exchange rates due to speculative behavior stemming from a decrease in market depth.

28. Moreover, the purchase/sale transactions of “foreign banknotes against foreign banknotes” conducted between the Central Bank and those institutions authorized to operate in the Foreign Exchange and Banknotes Markets will continue in 2012.

29. In view of the fact that financial stability is one of the prerequisites for price stability, the Central Bank has always taken the necessary measures in order to ensure the efficient functioning of Turkey’s foreign exchange market and will continue to do so. Nevertheless, bearing in mind that economic agents operate in an environment of exchange rate risk under the current exchange rate regime, they should establish and employ mechanisms that will ensure efficient risk management.

Liquidity Management

30. The main policy instrument of the Central Bank is the one-week repo auction rate. Therefore, the Committee determines the monetary policy stance by setting the level of the one-week repo rate. However, in order to enhance the efficiency and flexibility of the monetary policy, the reserve requirement policy, the interest rate corridor and the relevant liquidity management strategy are highlighted as supplementary tools to be used actively by the Central Bank. As a matter of fact, the Central Bank has been using the arrangements on the reserve requirements and the operational framework of liquidity management as tools supplementary to the monetary policy since the last quarter of 2010.

31. While determining the framework of liquidity management, the Central Bank targets the following: i) maintaining the level of short term interest rates within the interest rate corridor and around the level determined by the Committee ii) ensuring the efficient and stable operation of money markets in accordance with the liquidity management strategy iii) ensuring the smooth functioning of payments systems, iv) ensuring that the tools used support the efficiency of the monetary policy, v) having an operational structure with sufficient flexibility against unexpected developments in the markets. In order to attain these objectives and enhance the efficiency of the monetary policy, the liquidity level in the market and the distribution of liquidity in the banking system are also taken into consideration while formulating the framework of liquidity management.

32. The types and maturities of liquidity management tools to be used are determined with a view to the liquidity level in the market besides the economic conjuncture. So long as the liquidity surplus or liquidity shortage in the market remains at reasonable levels, it is adequate to manage liquidity via open market operations with overnight or one-week maturities. However, if the liquidity surplus or shortage becomes excessive, monetary policy may become looser or tighter than what the policy rate set by the Committee implies. If the liquidity surplus reaches excessive levels, the banking system may ease credit conditions leading to a rapid growth in credits. However, if the liquidity shortage reaches excessive levels, as the funding will concentrate on short-term maturities, the banking system may act extremely cautious and tighten credit conditions, leading to a less effective monetary policy. Accordingly, the diversification of both tools and their maturities depending on the level of liquidity enhances the efficiency of liquidity management.

33. Liquidity in the market is mainly determined by the following factors:

i) Changes in monetary base,

a. Changes in the volume of currency issued,

b. Changes in banks' free deposits (almost all of these accounts consist of required reserves).

ii) The Central Bank's transactions against TL in the market,

a. Net foreign exchange purchase/sale transactions against TL,

b. Interests paid/earned, current expenditures,

c. Export rediscount credits (extended in TL, collected in foreign exchange),

d. Government securities (GDDS) purchase/sale transactions in the market.

iii) The Treasury's transactions against TL,

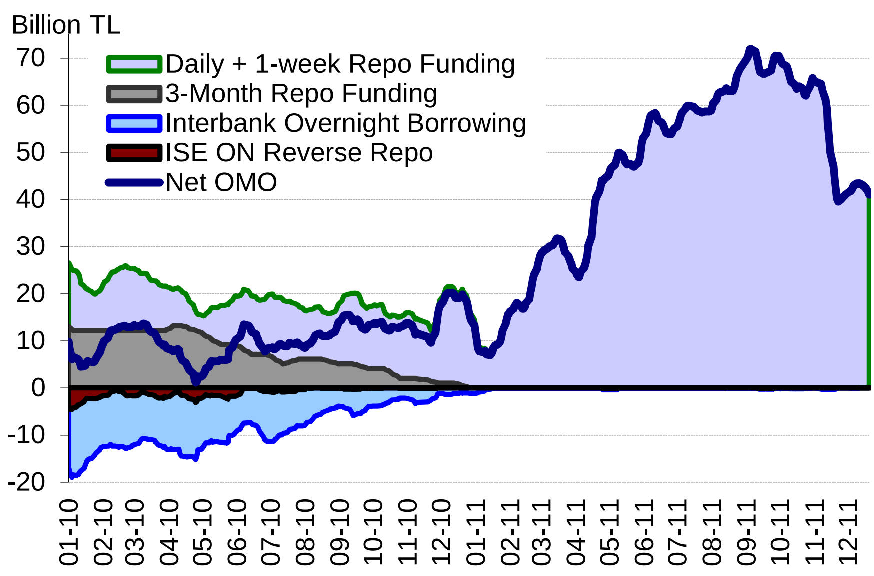
a. The difference between the redemption and issuance of net TL government bonds, excluding redemptions to the Central Bank,

b. Primary surplus/deficit inflows/outflows,

c. Privatization and Savings Deposit Insurance Fund (SDIF)-related TL transfers and other public transactions.

Meanwhile, as they determine the TL-denominated borrowing requirement, the Treasury's net FX-denominated collections or payments including domestic and external borrowing, the Treasury's redemption to the Central Bank and the Central Bank's profit transfers indirectly affect liquidity in the market.

Chart 13.
Liquidity Provided by the CBRT to the Market (Two-week moving average)



Source: CBRT.

34. As, the effects of the crisis, which deepened in October 2008, have started to fade and economy has given strong signals of recovery the Central Bank decreased the funding in excess of the market's needs as the first phase of exit strategy from crisis, announced on 14 April 2010. In its second phase, the method for one week repo auctions was switched to fixed interest rate quantity auction method as of 20 May 2010. Thus, interest rate on one week repo auctions has become the policy interest rate with regard to the monetary policy. In addition, as stated in the exit strategy, the Central Bank has started to use required reserves and interest rate corridor as supplementary monetary policy instruments, particularly after September 2010.

35. In this context, low policy rate, wider interest rate corridor downwards and high required reserve ratios were assessed as an appropriate policy mix, Overnight borrowing rate was reduced by 500 basis points in total, and the policy rate was cut by 75 basis points in total on 17 December 2010 and 21 January 2011. Furthermore, required reserve ratios were differentiated according to maturity to encourage the extension of the maturities of TL deposits, and the base for required reserves was widened by subjecting the repo transactions to reserve requirement excluding the repo transactions that banks conduct with each other and the Central Bank. In accordance with the decision taken on 23 September 2010, the Central Bank continued its policy not to remunerate required reserves.

36. With a view to mitigating the risks on both price and financial stability, required reserve ratios were increased significantly, and nearly TL 40 billion was withdrawn from the banking system in the first half of 2011.

37. Upon the increasing concerns over the sovereign debts in some European countries and the global growth, the Central Bank reduced the policy rate by 50 basis points on 4 August 2011 in order to minimize the risk of recession in domestic economic activity stemming from the aggravating global economic problems. Likewise, with the aim of reducing the downward volatility in short term interest rates, overnight borrowing rate was increased by 350 basis points, resulting in a narrower interest rate corridor. Furthermore, in order to enhance the efficiency of liquidity management in Turkish lira markets and to contribute to a more balanced distribution of the Central Bank liquidity within the system, the total bids to be offered by each institution is limited to a maximum of 20 percent of the announced amount of the auction.

38. In order to avert the adverse impacts of the excessive depreciation of Turkish lira, the base effect of unprocessed food prices and the adjustments in prices of administered/directed products on medium term inflation expectations and outlook, lending rate was increased from 9.00 percent to 12.50 percent, resulting in a wider interest rate corridor upwards at the MPC Meeting of 20 October 2011. Accordingly, to attain the desired goal, the one-week OMO funding at one-week repo rate was reduced, ensuring the banks to meet their funding requirements from sources of higher costs within the widened band.

39. Upon the increasing uncertainties regarding the global economy, so as to meet the Turkish lira liquidity requirement of the banking system through a longer lasting method and with a lower cost, as well as to use the foreign exchange reserves in a prompt, controlled and effective way, the Central Bank allowed a certain ratio of the reserve requirements for Turkish lira liabilities to be held in USD and/or euro. The Central Bank set this ratio as 10 percent at maximum in September 2011; and elevated it to 20 and 40 percent, in October and November respectively. Moreover, the Central Bank reduced Turkish lira required reserve ratios in October and November and provided the banking system with permanent Turkish lira liquidity. In addition to these, in order to boost gold reserves and provide the banks with more flexibility in their liquidity management, the Central Bank facilitated the holding of up to 10 percent reserve requirements for Turkish lira liabilities in "standard gold".

40. The reductions in Turkish lira required reserve ratios as of August provided the banking system with approximately TL 14 billion permanent liquidity while the liquidity requirement of the banking system declined by around TL 24 billion by 23 December 2011 with the extensive use of the facility to hold the required reserves for Turkish lira liabilities in USD, euro and gold.

41. The net liquidity gap in the market became TL 10.9 billion at end-2010, the Central Bank funded the market with TL 12,0 billion through one-week repo auctions and withdrew the liquidity surplus of TL 1.1 billion at the day-ends through overnight transactions. By 23 December 2011, the Central Bank has provided funding of TL 41.0 billion in total, TL 26.0 billion of which was made through one-week repo transactions, and TL 15.0 billion through primary dealer repo facility at overnight maturity and repo transactions at the ISE. At the end of the day, the Central Bank withdrew TL 0.5 billion via overnight Interbank Money Market transactions (Table 2).

Table 2: Change in Liquidity and CBRT Funding (Billion TL)

	31.12.10	**23.12.11**	**Change**
Liquidity Gap in the Market	**10.9**	**40.6**	**29.6**
Funding by 1-week Repo Auctions	12.0	26.0	14.0
Overnight Funding in OMO, IMM and ISE	0.0	15.0	15.0
Overnight Withdrawal in IMM and ISE	-1.1	-0.5	0.6

Based on provisional data, the main items that affected liquidity in the market in year 2011 are listed in Table 3.

Table 3: Items Affecting Liquidity
(Billion TL)

	31.12.10	**23.12.11**	**Impact**
Monetary Base	**75.7**	**89.9**	**-14.2**
Currency Issued	48.9	55.5	-6.5
Free Deposit	26.8	34.4	-7.6
CBRT Transactions Affecting Liquidity			**-3.2**
Net Foreign Exchange Sales to the Market Against TL			-8.4
CBRT Interest Collections and Other Payments			-2.2
CBRT GDDS Purchases			2.3
Export Rediscount Credits			5.1
Public Transactions (Excluding Redemptions to the CBRT)			**-12.3**
Net GDDS Redemptions in TL (Redemption-Issuance)			13.2
Primary Surplus			-24.0
Privatization in TL and Other Transactions			-1.4

Accordingly, in the 3 January – 23 December 2011 period, monetary base increase, Central Bank transactions and Treasury transactions had a reducing effect on liquidity by TL 14.2 billion, TL 3.2 billion and TL 12.3 billion, respectively.

42. Leading factors to influence the liquidity conditions in the market in 2012 are the change in the monetary base, the difference between redemption-issuance of GDDS in TL by the Treasury and the amount of the foreign exchange purchase/sale transactions against TL to be conducted by the Central Bank with the market. It is likely that quite rapid changes in the outlook of global markets and the risk appetite can lead sizeable fluctuations in capital inflows towards emerging economies including Turkey. Therefore, uncertainties regarding the amount of the foreign exchange purchase/sales transactions of the Central Bank with the market against TL are a challenge against making clear-cut projections about liquidity conditions in 2012. In the case that the Central Bank does not hold regular foreign exchange purchase/sale auctions across 2012, the liquidity gap in the market is envisaged to remain at manageable levels.

43. Nonetheless, considering all possibilities in liquidity conditions, to be able to control interest rates in the ISE Repo-Reverse Repo Market, and to preserve instrument variety for liquidity management and operational flexibility, the Central Bank needs to hold sufficient amount of GDDS in its open market operations portfolio for technical purposes. Accordingly, total nominal TL 4.3 billion out of the Central Bank open market operations portfolio securities, which were built in 2010 and the matured portion of which was renewed in 2011, are due in 2012. Those GDDS to mature are planned to be renewed as follows;

i) Maturing GDDS will be renewed in months deemed appropriate in 2012 through the GDDS buying auction programs to be announced on the Reuters "CBTL" page at 10:00 a.m. on the first working day of the respective month,

ii) Buying auctions will be held on Wednesdays and Fridays with value dates as the subsequent working days,

iii) Each auction amount will be nominal TL 100 million,

iv) Other issues related to the auctions will be subject to the current regulations.

Reserving the right to make additional purchases in case of extreme liquidity shortage conditions, no extra purchases of government securities is envisaged.

Operational Framework for Liquidity Management

44. The operational framework for the liquidity management of the Central Bank for 2012 is formulated as follows:

i) The Central Bank will continue to announce overnight borrowing and lending rates between 10:00 a.m.- 12:00 p.m. and 1:00 p.m. – 4:00 p.m. on working days, between 10:00 a.m.– 12:00 p.m. on half working days, in the Interbank Money Market within the Central Bank. In case liquidity shortage arises during the day, banks will be able to borrow at the Central Bank's lending rate against collateral within their limits. In case of excess liquidity, banks will be able to lend Turkish lira to the Central Bank at the Central Bank's borrowing rate without any limit.

ii) The Late Liquidity Window Facility will continue as currently practiced: banks will be able to borrow from the Central Bank against collateral, and lend to the Central Bank without any limit between 4:00 p.m. – 5:00 p.m. on working days, between 12:00 p.m. – 12:30 p.m. on half working days and on the last working day of the required reserve maintenance period between 4:00 p.m. – 5:15 p.m. on working days, between 12:00 p.m. – 12:45 p.m. on half working days.

iii) The one-week repo auction rate will remain as the policy rate and the Central Bank will continue to hold one-week repo auctions as long as the market is in need of liquidity. Moreover, the interest rate corridor, which was actively used in 2011, will be employed in 2012 as well. Accordingly, the amount of Turkish lira funding through one-week repo auctions will be adjusted downwards or upwards, when deemed necessary.

iv) One-week repo auctions will continue to be held at the interest rate set for one-week repo auctions by the Committee via the quantity auction method. Moreover, the total amount of bids to be offered by each institution will continue to be limited to maximum 20 percent of the announced auction amount. In order to enhance the banks' liquidity managements and to assist them in making projections on their total funding costs, the Central Bank, as usual, will regularly inform the public on the minimum funding amount planned to be provided via one-week repo auctions.

v) As stated in the press release no. 61 of 27 December 2011, in order to balance global economic developments and to contribute to more efficient allocation of liquidity, in addition to one-week repo auctions, the Central Bank will hold one-month (four weeks) repo auctions every week on Fridays. One-month repo auctions will be held through the traditional method, and the total amount of bids to be submitted by the banks will be limited to the announced auction amount. Moreover, information about the maximum outstanding funding amount planned within a one-month maturity and the upper limit of the amounts of the auctions to be announced for each auction will be provided regularly to the public. The funding maturity, which is one-month, can be extended up to three months, if required by the global conditions.

vi) When the market needs funding, the Central Bank will announce the repo auction amount on the Reuters "CBTF" at 10 a.m., and when funding is not needed, auctions may not be held. One-week and one month maturity repo auctions will be held at 11:00 a.m. on working days, at 10:30 a.m. on half working days and the results will be announced on Reuters' "CBTG" page within 30 minutes. Institutions are required to notify the securities against their repo operations until 12:00 p.m. on working days, until 11:30 a.m. on half working days and fulfill their liabilities regarding open market operations until 4:45 p.m. on working days, until 12:30 p.m. on half working days.

vii) In case unforeseen excessive liquidity shortage emerges during the day, which may exert excessive pressure on money market interest rates, the Central Bank may announce "Intra-day Repo Auctions" with one-week maturity via traditional auction method in addition to the regular ones executed at

11:00 a.m. Bidding limitations of 20 percent that applies to regular one-week repo auctions will not apply to intra-day repo auctions.

viii) The Central Bank will continue to announce overnight borrowing and lending rates on a daily basis at İstanbul Stock Exchange Repo - Reverse Repo Market and Interbank Repo - Reverse Repo Market.

ix) The primary dealer banks will be able to conduct O/N repo transactions within the framework of open market operations, between 10:00 a.m.–12:00 p.m. and 1:00 p.m.– 4:00 p.m. on working days and between 10:00 a.m.– 12:00 p.m. on half working days.

45. The Central Bank, with the primary goal of achieving and maintaining price stability, as entrusted to it by law, will continue to guard financial stability by taking macroeconomic risks into consideration in 2012 as before. To this end, it will continue its practices to enhance the effectiveness of monetary policy and liquidity management. In the upcoming period, as before, the Central Bank may change its liquidity management strategy according to the emerging needs. In this scope, with an aim to bolster the efficiency of interest rates on one-week repo auctions, which is the main monetary policy instrument, and to contain the risks on financial stability, the Central Bank will continue to utilize other instruments like borrowing and lending interest rates corridor and required reserves.

46. Required reserves, which were utilized to encourage the extension of the deposits' maturities, to underpin long term Turkish lira and foreign exchange-denominated bond issues and to strengthen the Central Bank's reserves in 2011 for financial stability purposes, will continue to be used in 2012 if abrupt changes persist in the global conjuncture. Moreover, in the case of intensifying problems in the global economy and pronounced slowdown in domestic economic activity, required reserves may be used for easing purposes. On the contrary, in the case of a reacceleration in capital flows, arrangements for tightening in required reserves may be conducted.

47. The most remarkable lesson to be drawn from the recent global economic crisis is that operating of the financial system under a high leverage will cause economic damage in the medium and long term. In order to avert the risks that may stem from operating under high leverage before they emerge, the banks that raise the leverage ratios to excessive levels compared to the current circumstances may be subjected to additional reserve requirement.

CALENDAR FOR 2012 MONETARY POLICY COMMITTEE (MPC) MEETINGS, INFLATION REPORTS AND FINANCIAL STABILITY REPORTS

MPC Meeting	Summary of MPC Meeting	Inflation Report	Financial Stability Report
24 January 2012 (Tuesday)	31 January 2012 (Tuesday)	31 January 2012 (Tuesday)	
21 February 2012 (Tuesday)	28 February 2012 (Tuesday)		
27 March 2012 (Tuesday)	2 April 2012 (Monday		
18 April 2012 (Wednesday)	26 April 2012 (Thursday)	26 April 2012 (Thursday)	
29 May 2012 (Tuesday)	1 June 2012 (Friday)		31 May 2012 (Thursday)
21 June 2012 (Thursday)	28 June 2012 (Thursday)		
19 July 2012 (Thursday)	26 July 2012 (Thursday)	26 July 2012 (Thursday)	
16 August 2012 (Thursday)	24 August 2012 (Friday)		
18 September 2012 (Tuesday)	25 September 2012 (Tuesday)		
18 October 2012 (Thursday)	24 October 2012 (Wednesday)	24 October 2012 (Wednesday)	
20 November 2012 (Tuesday)	27 November 2012 (Tuesday)		29 November 2012 (Thursday)
18 December 2012 (Tuesday)	25 December 2012 (Tuesday)		

Note: Monetary and Exchange Rate Policy for 2013 will be published on 25 December 2012.