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PRESS RELEASE

ON

MONETARY AND EXCHANGE RATE POLICY FOR 2005

Introduction

1. Just after the 2001 crisis, Central Bank of Turkey announced in its press release of 22 February 2001 that it was impossible to continue with the currency-peg regime as the anchor of the stabilization program that had been initiated at the start of 2000 and had eventually lost its credibility, it was necessary to switch to the floating exchange-rate regime, and the Bank would assume the inflation targeting regime in its monetary policy strategy when the time was ripe.

2. The post-crisis monetary policy was focused on the achievement of price stability, which is the primary objective of the Central Bank that has become independent by law. When the new program that was initiated in May 2001 started to yield results in fiscal discipline, bank rehabilitation, structural reforms and floating exchange rate regime, the Central Bank announced its monetary policy strategy with press release of 2 January 2002 titled "Monetary and Exchange Rate Policy in 2002 and Prospective Developments" and its intention of adopting the implicit inflation targeting.

3. The main reason of undertaking such a strategy was that the necessary conditions for a formal inflation-targeting regime were not in place. The second reason was that it was difficult to predict the course of money demand under chronic inflation environment, and relying exclusively on monetary targeting in the fight against inflation was inadequate due to the fact that there seems to be no stable relationship between monetary indicators and inflation. Both in the press release of early 2002 and in the successive announcements, the public has been made aware of the developments on macroeconomic balances and the role of monetary policy in order to help economic agents to understand the new regime. So far, many concepts, which the public was unfamiliar with, have been introduced by means of reports and press releases, emphasizing on every occasion that inflation is a chronic disease that must absolutely be overcome. It has been repeatedly underlined that price stability is the *sine-qua-non* pre-condition for a sustained growth in the medium- and long term; and that even in the short-term the decline in inflation could spur the economic growth along with the increased confidence in the current policies, the tight fiscal policy would not hinder the growth under high public debt environment, and the floating exchange rate regime could be sustained in our country, as is currently implemented in approximately 80 countries all around the world.

4. Today we have reached a turning point where inflation has declined to single digits after 30 years, and the large section of the public believes that the ongoing recovery in inflation is not temporary, and more importantly, believes that it should not be temporary.

Why "Implicit" Inflation Targeting?

5. As also discussed earlier in various platforms, the issue of sensitive public debt dynamics which can be called as "fiscal dominance" or "public debt dominance" was the main factor that marked the 2001-2004 period and limited the efficiency of post-crisis monetary policy. In economies that have suffered deep credibility crisis and undergone high debt burden, where maturities are short and most of the debts is either flexible rate or indexed to foreign currency, central banks cannot exert full control over the general level of interest rates by using short-term interest rates as policy instrument. Therefore, the general level of interest rates and exchange rates can be extremely sensitive to various endogenous and exogenous shocks in such economies. The volatility of such variables can damage both the quality of predictability of effects arising from these shocks and the effectiveness of monetary policy transmission mechanisms.

6. After the 2001 crisis, the Central Bank was faced with the similar restrictions. The Central Bank thought that an early transition to formal inflation targeting would not be right, which has been worked on intensively since 2000 and occasionally shared with business, financial and academic circles. In fact, the efficiency of inflation targeting depends largely on the level of credibility. No doubt, credibility is one of the necessary conditions for the success of any kind of economic policy. However, credibility becomes even more important in inflation targeting. The Central Bank, which has accumulated extensive information on inflation targeting since 2000, has acted according to the argument that switching to inflation targeting system when necessary conditions are not in place should not be viable. In this context, after the introduction of floating exchange rate regime, a gradual convergence strategy for formal inflation targeting was adopted, and it was decided to wait for the removal of elements that constrain the efficiency of monetary policy and hinder the functioning of transmission mechanisms. In other words, the Central Bank has adopted a cautious attitude for more than three years, seeking to provide the support of fiscal discipline, and to increase the credibility of inflation targets. Moreover, it has been emphasized that the structural reforms are vital for disinflation efforts in the medium- and long term, and every structural adjustment intended for clearing the way for price stability has been supported.

Next Step: Formal Inflation Targeting

7. We have been experiencing an extremely important economic transformation since the 2001 crisis. Structural reforms and related steps taken for the Central Bank independence, monetary and fiscal discipline, and floating exchange rates have brought about undeniable achievements on the way to price stability. In line with this process, the structural reforms initiated in every sectors of the economy and determined economic policies have started to change swiftly the behaviors of economic agents both in the public and private sectors. Concerns over the sustainability of public debt stock have lost their importance among the economic issues. More significantly, perceptions that the current approach would be sustained with a medium-term perspective by embracing and deepening the structural reforms has been reinforced along with the introduction of a medium-term program that should even be a natural pre-condition for a gradual transition to formal inflation targeting. In this process, the credit transmission mechanism has started to function more effectively. All these developments are signaling the gradual formation of a proper environment in terms of inflation targeting.

8. The Central Bank will gradually move on to formal inflation targeting strategy that would enhance the credibility of price stability objective even further, which is the *sine-qua-non* condition of macroeconomic stability. The aim of gradual transition to inflation targeting is to make monetary policy decisions more predictable and transparent, which constitute an integral part of the inflation-targeting regime. Undoubtedly, being cautious and taking steps within the framework of a plan are crucial for not losing the flexibility that will be necessary in making monetary policy decisions. When considering the achievements obtained so far and the ever-increasing efficiency of monetary policy implementations, taking some steps about the decision-making process of monetary policy and sharing these steps with the public will very much contribute to the economic stability that has already started.

Monetary Policy Decision-Making Process in the Coming Period

9. In the coming period, the initial change on monetary policy decision-making mechanism will be focused on making the timing and direction of interest-rate decisions more transparent and predictable. Besides, in line with enhancing the principles of transparency and accountability, it is expected that more information related to other elements of decision-making process would be shared. Also at the beginning of 2006, formal inflation targeting will be launched.

10. The monetary policy strategy implemented during the recent years has been gradually converging to the inflation targeting. In the forthcoming period, the monetary policy actions will be even closer to the definition of formal inflation targeting. Accordingly, the inflation targeting system to be launched in the beginning of 2006 should be classified as a further step to be taken on the road to institutionalizing monetary policy decision-making mechanism and attaining price stability, rather than a new regime. It should be perceived as a natural outcome of the "normalization" process of our economy.

11. Currently the Central Bank's main policy instrument is the short-term interest rates in Interbank Money Market within CBRT, and Istanbul Stock Exchange Repurchase and Reverse Repurchase Market. Short-term interest rates can be changed on any business day. Whenever a change occurs, the new rates and the rationale behind the interest-rate decisions are announced. At interval periods when interest rates remain unchanged, there is no announcement regarding the interest rates.

12. In the next period, the general framework of monetary policy, decision-making process and timing, and the structure of these mechanisms when formal inflation targeting is launched will be as follows:

i) Starting from January 2005, the Monetary Policy Committee (MPC) will meet regularly under the chairmanship of the Governor on the 8th of each month, at 15:00hrs to discuss the developments in inflation and economy. Should the 8th of a certain month happen to fall on a holiday, than the committee will meet at the same time on the following business day.

ii) During the ordinary meetings, inflation trends and developments in domestic-international markets will be evaluated. Related departments will present their reports to the MPC and will open their analyses and views to discussion. The Undersecretariat of Treasury will provide a summary of the latest developments on fiscal policy and borrowing strategy.

iii) Decisions on interest rates will be announced taking into account the evaluations of the MPC meeting on the following business day at 09:00hrs. During the one-month period between the two decisions short-term interest rates will remain unchanged unless an extraordinary development occurs. Whatever the decision is, (even if the interest rates are not to be changed) an announcement on the rationale behind changing/not changing interests rates, including the Central Bank's evaluations on the general outlook of the economy will be made within two days. The announcement will also incorporate the monthly press release of "Inflation and Outlook."

iv) The Central Bank will start the formal inflation targeting system in the beginning of 2006. As stated above, in the transition period MPC will be in an advisory position while making the final interest rates decisions. When the inflation targeting is launched officially in 2006, interest rate decisions will be subject to the approval of MPC and a summary of the meeting will be published. Moreover, in the Inflation Report that will replace the current quarterly Monetary Policy Report inflation forecasts will be announced quantitatively. Thus, transparency in monetary policy applications will be attained to a great extent.

v) The overall operational framework of formal inflation targeting and details of the decision-making mechanism will be explained at a later stage.

vi) In 2005, which is the transition period, Monetary Base and Net International Reserves will continue to be monitored as performance criteria; Net Domestic Assets will be monitored as indicative target.

vii) The main objective of the Central Bank, as stipulated in the Bank's Law, is the price stability. For this reason, and as reiterated by the Central Bank on every occasion since 2001, short-term interest rate decisions are taken by evaluating the inflation outlook and the inflation target. Entitled by its law to collect all kinds of information, the Central Bank will continue analyzing all economic indicators in terms of their influence on the inflation outlook. Therefore, it will be crucial from now on that the monthly press releases of the Bank on "Inflation and Outlook" and Monetary Policy reports should be well read and understood, as before.

Exchange Rate Policy and Foreign Exchange Buying Auctions

13. The economic transformation process as explained in its general framework above has produced undeniable achievements on the way to macroeconomic stability. As a natural consequence of this process, unstable macroeconomic policies of the past and the "dollarization" effect caused by high inflation started to lose importance. Economic agents have been increasingly holding more

Turkish lira-denominated financial assets in their portfolios since 2002. Although there have been some deviations from this main trend due to exogenous shocks, it is obvious that the current program has initiated the “reverse dollarization” process, which is one of the favorable outcomes.

14. Three years ago in its “Monetary and Exchange Rate Policy and Prospective Developments in 2002” announcement dated 2 January 2002, the Central Bank informed the public that the developments would take the above-mentioned course as long as the economic program was implemented uninterruptedly. As emphasized in the said announcement and in those made in the subsequent New Years, an important consequence of the reverse dollarization process is that, taken along with the favorable developments in balance of payments, it progressively pushes up the level of foreign exchange supply in the economy while not increasing foreign exchange demand at the same amount or even reducing it.

15. In countries where floating exchange rate regime is implemented, it is naturally expected that the level of foreign currency reserves should not bear much significance since the level of exchange rate is determined according to supply and demand conditions in the market – in other words, since central banks do not intervene the market. However, some central banks have to carry out the external debt service of the public sector. In such countries including Turkey, level of foreign currency reserves becomes important even if the floating exchange rate regime is in effect. Moreover, considering the need to reduce gradually in the long-term the costly Foreign Exchange Deposit Accounts with Credit Letters, which are peculiar to our country and occupy a crucial position on the liabilities side of the Central Bank balance sheet, the level of foreign currency reserves becomes even more important. The Central Bank has been pursuing an interest rate policy for these accounts in line with this necessity since 2002. However, it is natural that this does not bear as much importance as it does in fixed or predictable exchange-rate regimes, since there is no such an exchange rate that should be preserved.

16. Therefore, foreign exchange buying auctions were held when foreign exchange supply increased more than foreign exchange demand, considering that the robust foreign currency reserve position could contribute to the enhancement of the confidence in the current program. In this framework, foreign exchange buying auctions were commenced on 1 April 2002, and carried on in 2003 and 2004 as long as the conditions were available. In other words, the Central Bank followed a moderate reserve-raising strategy, not in all circumstances, but only when the discrepancy between foreign exchange supply and demand grew significantly in favor of the first one.

17. Here, the main principle is that the exchange rate is determined by supply and demand conditions, and the Central Bank does not have any exchange rate target under the current floating exchange rate regime. Undoubtedly, foreign exchange buying auctions exert influence on foreign exchange demand. However, the purpose of foreign exchange buying auctions is not to affect the supply and demand conditions structurally, but to increase the foreign currency reserves moderately in line with the reasons mentioned above or avoid a decline in these reserves in cases of gradual rise in supply. For this reason, foreign exchange buying operations are carried out through auctions whose terms are announced in advance. The intention here is to keep the impact on supply and demand conditions in the markets at a minimum level and to stick to the main principles and functioning of the floating exchange rate regime which has brought immeasurable benefits in recent years.

18. Studies for a new Economic Program to be implemented in the upcoming three-year period are about to be finalized. Fiscal and monetary discipline and structural reforms constitute the core of the new program as before. Structural reforms to be performed will have a favorable effect on the quality and sustainability of fiscal discipline as well. Meanwhile, the decision taken in the European Union summit on 17 December 2004 to start the accession talks with Turkey for full membership of the EU is expected to help sustain the structural reforms to be performed in the framework of the program.

19. In the absence of serious exogenous shocks, reverse dollarization process is expected to become more evident and capital inflows to increase under the new three-year program, which foresees sustaining of the fiscal and monetary discipline, deepening of structural reforms, and enhancing of the quality of fiscal discipline. Meanwhile, it is clear that favorable developments in the negotiation process for full membership to the European Union will positively affect both the reverse currency substitution process and also the balance of payments. In other words, the next three-year period will witness an increase in foreign exchange supply compared to foreign exchange demand. In light of these evaluations, the Central Bank of Turkey (CBRT) will resume holding daily foreign exchange buying auctions effective from 22 December 2004. The basic principle stated in the seventeenth paragraph above will also be valid from now on: In accordance with the said principle, it is decided to take a step forward and announce a yearly program to bring the effects of

FX buying auctions on the foreign exchange market to a minimum and not to resort to any changes in the program unless extraordinary changes are observed in terms of foreign exchange liquidity. This will also help prevent the misperceptions on the exchange rate policy of the CBRT, which are believed to have caused by the efforts in the previous periods trying to adjust the amount of foreign exchange buying auctions with the changing foreign exchange supply, and by the resulting necessary alterations made in the auction amounts from time to time before the end of the announced period.

20. Guidelines for foreign exchange buying auctions are stated below:

i. The total daily amount of auctions is determined as USD 15 million for 2005 and the rest of 2004.

ii. Auctions will not be held on the public holidays in the United States, even if it is a business day in Turkey. Neither will auctions be held on half business days.

iii. The additional optional selling amount priced over the average price realized in the auction will be granted only to the winner institutions (the banks and special finance houses). The optional amount will be 200 percent of the total amount sold in the auction by the institution. By setting a high optional amount, the CBRT aims to absorb the excess supply without changing the amount of the auction. Accordingly, the maximum daily amount that can be bought equals to USD 45 million, with USD 15 million of auction amount and USD 30 million of optional selling amount.

iv. The auction number will be posted on the Reuters page CBTQ at 1.30 p.m. and the institutions may bid between 1.30 - 2.00 p.m.

v. After the auction results are posted on the CBTQ page of Reuters, the institutions may use their right to sell optional amount till 2.30 p.m.

vi. The other rules for the foreign exchange buying auctions are not changed and will be applied as before.

vii. On the other hand, CBRT may, with a prior notice, suspend the auctions temporarily in the cases where the depth of the foreign exchange market is lost and thus excessive volatility in exchange rates, as well as unhealthy price setting are observed due to a serious exogenous shock or unforeseen extraordinary developments.

viii. Furthermore, the CBRT will continue to closely monitor the volatility in exchange rates as usual and will directly intervene in the markets in the event of an excessive volatility that might occur in either direction. It is crucial to understand that volatility interventions are not carried out by only considering past data with a mechanical rule. On the contrary, the CBRT takes volatility intervention decisions after evaluating the causes of volatility with all aspects.

21. In conclusion, as has been made clear by the CBRT for a long time with presentations, announcements and reports, exchange rates will continue to be determined by supply and demand conditions in the currency markets. Naturally, the key determinants of foreign exchange supply and demand are economic fundamentals and expectations. Current account balance and the expected course of capital movements, as well as the current stability program, are crucial not only for the establishment of economic fundamentals but also for the management of expectations.

Liquidity Management

22. Another significant change to be observed in 2005 will be in the liquidity conditions of TL in the markets. Following the February 2001 crisis, the Central Bank purchased government securities worth TL 14 quadrillion from state-owned banks and the banks transferred to Savings Deposit Insurance Fund (SDIF) in order to meet their liquidity needs. The intensive purchase of foreign exchange in 2003 and 2004 and the purchase mentioned above in turn have created a substantial amount of excess liquidity in the market since 2001. The Central Bank sterilized the excess liquidity in the market in an active manner, by means of the Turkish lira deposit operations in the Interbank Money Market and of the reverse repo transactions carried out within the framework of the open market operations in the Repo and Reverse Repo Market of the Istanbul Stock Exchange Market. Accordingly, overnight interest rates constantly realize at the borrowing interest rates of the Central Bank. Within this framework, borrowing interest rate of the Central Bank has become an indicator for money markets.

23. However, excess liquidity in the market has been shrinking since the second half of 2004, due to the reimbursements made by the Treasury to the Central Bank and the rise in monetary base. Furthermore, net foreign currency debt reimbursement by the Treasury provided an impetus to this decline. Thus, the excess liquidity, which was TL 8.8 quadrillion at the beginning of 2004, decreased and became TL 1.4 quadrillion as of 17 December 2004.

24. In general;

i) The rise in monetary base,

ii) Coupon and principal redemption by the Treasury to the Central Bank,

iii) The increase in Treasury accounts, and

iv) Net foreign currency debt (both domestic and external) reimbursement by the Treasury via borrowing TL

will have a decreasing effect on the liquidity in the market until the end of 2004 and throughout 2005, while

i) Purchasing of foreign currency by the Central Bank,

ii) Interests payments by the Central Bank for reserve requirements

will be the increasing components of excess liquidity.

25. Today, net foreign currency debt reimbursement by the Treasury and the amount of foreign currency to be purchased by the Central Bank cannot be predicted by now. Any changes in these factors may have a major effect on the liquidity in the market. However, despite all these uncertainties, under the main scenario made by the Central Bank, the liquidity will continue to decrease gradually and liquidity shortage is expected in the first quarter of 2005**.**

26. With the transition from excess liquidity to liquidity shortage in the market, the effectiveness of the monetary policy will increase and liquidity management strategy will be revised according to the new environment. The Central Bank sees the stability and development of financial markets as a supporting objective for the effective implementation of the policies regarding price stability. Thus, the Central Bank has taken many measures (as was the case after the explosions occurred in Istanbul in November 2003) in the last four years in order to maintain financial stability within the framework of the floating exchange rate regime. Hence, The Central Bank whose legal task is to achieve price stability will continue to conduct its liquidity policy focusing on price stability in 2005 as in the previous years, and with its liquidity management strategy, it will contribute to the development and stability of financial markets under new liquidity conditions. With this aim, it is deemed appropriate to announce the liquidity management strategy to be adopted by the Central Bank to the markets by now in the event of a liquidity shortage in order to increase predictability.

27. In case of negative liquidity in the market, the liquidity management strategy of the Central Bank will be as follows:

i) In cases when liquidity shortage in the market increases, the Central Bank will cease its transactions at the Istanbul Stock Exchange Repo-Reverse Repo Market with a pre-announcement and conduct its liquidity management operations in its markets like the other central banks. Considering the liquidity management strategy mentioned below, a halt in the transactions of the Central Bank in the Repo-Reverse Repo Market is not expected to cause a significant fluctuation in the said market interest rates.

ii) The Central Bank will continue to announce overnight borrowing and lending interest rates in the Interbank Money Market between 10:00-12:00 a.m. and 01:00-04:00 p.m. In case of a liquidity shortage during the day, banks may borrow from the Central Bank over its lending rate within their existing limits. If interest rates decrease due to a rise in liquidity, banks may transfer TL to the Central Bank without any limits over its borrowing rates. The 4-point gap between borrowing and lending interest rates is planned to be 3 points in the upcoming period.

iii) The Central Bank will continue to provide the “Late Liquidity Window Facility” between 16:00-16:30 hrs and the banks will be able to borrow unlimitedly from “Late Liquidity Window” against collateral or lend money to the Central Bank. It is planned that the difference between the intraday lending rate and the Central Bank’s lending rate within the framework of late liquidity window facility, which is currently 4 points, shall remain unchanged and the difference between the intraday borrowing rate and the Central Bank’s borrowing rate, which is currently 15 points, is planned to be fixed at approximately 5 points.

iv) The Central Bank will continue to provide the primary dealer banks with liquidity facilities in 2005 as well. The interest rate applicable to the overnight and one-week-maturity repo facility provided for the primary banks, which is currently 2 percentage points below the lending interest rate at the Interbank Money Market, is planned to be 1 percentage points lower than the latter. The primary dealer banks will be able to benefit from the repo facility between 10:00-12:00 a.m. and 13:00-16:00 p.m.

v) The Central Bank will start to manage liquidity via repo auctions with one-week maturity. To this aim, during the times of liquidity shortage, the CBRT will announce the repo auction amount on CBTF page on the Reuters system at 10:00 a.m. and it will aim to hold the average auction rate around 1 percentage point above the Central Bank borrowing rate at the Interbank Money Market.

vi) The repo auctions with one-week maturity will be held at 11:00 a.m. and the results will be announced on the CBTG page on the Reuters system by 11:30 am the latest. Traditional auction method will be employed in the auctions, which means the preferred bids will be evaluated with their own interest rates.

vii) In case an excessive decline in liquidity emerges due to some unforeseen reasons by exerting too much pressure on interest rates in the money market, the Central Bank might, if it deems necessary, hold an "Intraday Repo Auction" in addition to the regular repo auction held at 11:00 a.m.

28. As is known, with the aim of contributing to the process of decreasing the costs of the financial system, the Central Bank has been remunerating for the required reserves since 2001. The required reserve implementation will undergo some changes in the upcoming period as well. Currently, the institutions are allowed to keep at most 3 percent of their TL-denominated required reserves of 6 percent for two weeks on average and they are obliged to keep at least 3 percent at their blocked accounts. In order to help banks to conduct a flexible and effective liquidity management in the case of a liquidity squeeze, it is planned to calculate the banks' required reserve amount by taking the two-week averages of their free deposit accounts.

29. Meanwhile, with the aim of enhancing the effectiveness of the Central Bank's monetary policy and liquidity management, some changes may be made in the liquidity management strategy as well as in the above-mentioned interest rates according to the changes in market conditions and to the needs that may arise in the future.

30. Currently, liquidity is not spread evenly within the banking system. In the case of a decline in liquidity or liquidity shortage in the market, the allocation of liquidity among the banks will become more important and the depth of secondary market operations will be crucial to ensure the effective operation of money markets. In this process, it would be wise for the banking system to take the necessary measures to ensure liquidity flow by also considering risk principles. It should be borne in mind that Turkish lira liquidity policy can be implemented more easily under floating exchange rate regime than it can be under fixed/currency peg regime, in other words, the Central Bank is in a position to meet the Turkish lira liquidity needs of the banking system more flexibly and promptly. However, it is obvious that in this case the banking system is bound to handle liquidity management by strictly adhering to the risk management principles.

31. In the case of a liquidity shortage in the banking system, the benchmark short-term interest rates will be Central Bank's lending rates, not the borrowing rates. Therefore, once a liquidity shortage arises, the benchmark interest rates will only increase due to technical reasons. In order to avoid prospective shortcomings, the Central Bank might revise the interest rates at a time when excess liquidity moves from positive to negative. To re-emphasize, such a change in interest rates will be solely based on technical reasons about the liquidity management, and thus, will have nothing to do with loosening or tightening of the monetary policy.