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GENERAL FRAMEWORK OF INFLATION TARGETING REGIME and MONETARY AND EXCHANGE RATE POLICY FOR 2006

Central Bank of the Republic of Turkey

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TRANSITION TO INFLATION TARGETING REGIME

Introduction

1. Inflation targeting is a successful monetary policy regime implemented not only in developed but also developing countries. The number of countries which have adopted inflation targeting have been increasing steadily. The Central Bank of the Republic of Turkey (Central Bank) emphasized in its announcement of early 2002 pertaining to the general framework of monetary policy that the final target of monetary policy was the adoption of inflation targeting regime, but as the reliability of the regime would suffer in case this adoption was made prematurely – without satisfying the necessary pre-conditions – first there will be a waiting period to allow the factors that restrict the efficiency of monetary policy to weaken. It was also pointed out in the same announcement that "implicit inflation targeting" would be implemented until the adoption of the inflation-targeting regime. In line with this, inflation targets were set jointly with the government. While utilizing short-term interest rates efficiently in the fight against inflation, base money was set as an additional anchor with a view to increasing the reliability of inflation targets. This policy, supported by fiscal discipline, ongoing structural arrangements and the progress made towards Central Bank independence, paved the way for significant gains on the road to price stability.

2. In time, harmonization with the floating exchange rate regime increased and considerable progress was made in the formation of a suitable environment for the transition to an inflation targeting regime: all inflation targets were met, confidence was heightened and inflation expectations converged with the targets. Today, inflation is at its lowest in thirty years. While debates on the sustainability of public debt stock used to be at the top of the economic agenda in the past, this is no longer the case. Worries pertaining to the continuity of fiscal discipline have eased considerably. Financial markets started to become deeper, and the financial sector has become less fragile.

3. Progress made towards economic stability started the reverse-dollarization process, and although it was interrupted from time to time and more progress is necessary, the weight of Turkish lira denominated investments began to increase in portfolio preferences.

4. In the same time-span, six zeros were dropped from the Turkish lira and New Turkish Lira (YTL) was adopted. This step, we refer to as monetary reform, was a demonstration of our trust in the permanent nature of the gains achieved.

5. Following the agreement with the IMF, the announcement of the medium-term program and the start of the negotiation process with the European Union for full membership, the predictability of fundamental macroeconomic variables further increased.

6. During the period 2001-2005, very significant steps were taken pertaining to the improvement of the institutional infrastructure of monetary policy, and this is another pre-condition for the transition to the inflation-targeting regime. During this process, the Central Bank rendered its institutional framework more efficient, defined its communications policy in a more transparent way, expanded its information set and improved its inflation forecast methods. Besides these factors, significant progress was made during this time in the area of Central Bank independence, pertaining to its practice. This development strengthened expectations that the chronic inflationary process will not return.

7. All these developments pointed to the fact that the pre-conditions of the inflation-targeting regime had, to a large extent, been met and the appropriate time was approaching. The Central Bank did not adopt the regime in 2005 due not only to the changes made by the Turkish Statistics Agency in the price indices released by the agency, but also to the monetary reform that took place. Yet, the Central Bank announced that this was the final preparation period for the transition to the inflation-targeting regime. Steps taken in this preparation period for further institutionalization of monetary policy brought the practice of monetary policy strategy one step closer to the inflation-targeting regime. In the said period, Monetary Policy Committee meetings began to be held at pre-set and pre-announced dates and times, and interest rate decisions – taking into account the deliberations made at the meetings - began to be made public at 9 a.m., the next day. Such meetings were followed by the prompt release of a text outlining the rationale behind the decisions as well as providing the opinions of the members of the Monetary Policy Committee. These texts not only justify the immediate decisions but also provide signals for the future course of interest rate decisions. In addition, during the same period the organizational structure of the institution was renewed and the terms of reference pertaining to monetary policy were clarified. As a result, during the last four years, and especially during the last year, the predictability of monetary policy evidently increased, and significant developments took place pertaining to institutional infrastructure and transparency.

8. The Central Bank of the Republic of Turkey will begin to practice the regime of inflation targeting, within the framework of the institutionalization process of monetary policy in 2006. Together with this regime, it is planned to move towards the process of "price stability" from the "disinflation" process of recent years. Within this context, there will be increased transparency and accountability in the upcoming period, in terms of inflation targets and the policies for reaching these targets, within the general framework of monetary policy. This press release should be perceived as a main policy text for the framework of the inflation-targeting regime.

THE GENERAL DEFINITION OF INFLATION TARGETING REGIME

9. The primary objective and main priority of central banks is to achieve and maintain price stability. As for inflation targeting, it is a monetary policy strategy, becoming more widely used with the aim of achieving price stability. Although there are various definitions in academic literature, practices point to two main factors differentiating the inflation targeting regime from other regimes:

i. The central banks implementing an inflation-targeting regime announce their inflation targets numerically, commit themselves to achieving these targets and are accountable to the public in case targets are not attained.

ii. As monetary policy decisions affect on the economy with a time lag, central banks control future inflation rather than current inflation. With this aim, they develop inflation forecasts periodically and make them public. That is why the inflation-targeting regime is also frequently called "inflation forecast targeting". Along the same lines, the consistency of the forecasts with the inflation target and the risk of deviating from the target are explained to the public.

10. The monetary policy implemented in Turkey has gradually approached the inflation-targeting regime. Following the new steps to be taken in 2006 regarding transparency and accountability, the current monetary policy of that time will from then on be described as the inflation-targeting regime. Analysis of other countries, as well as Turkey's past experiences suggest that the inflation targeting regime is not an end in terms of monetary policy, but on the contrary, a component of an uninterrupted "evolution" process. Certainly, this evolution process holds true for not only the policy makers, but also for all the other economic units. Enhanced mutual interaction and information sharing with the public during this process will render the regime more functional and efficient. In line with this, the main items on the agenda for the Central Bank in the upcoming period will be to raise the level of transparency, accountability and predictability. The fundamentals of monetary policy in the coming period are summarized below.

THE GENERAL FRAMEWORK OF INFLATION TARGETING REGIME IN TURKEY

11. The Central Bank has been working on the inflation-targeting regime since the year 2000. The experiences of more than 20 - developed or developing - countries implementing the inflation targeting regime were used while constructing the main framework of the regime for Turkey. The country examples showed that, there is no system, which is "the unique and the best for all countries". Therefore, it has been taken into consideration that a model specific to Turkey needs to be formed while constructing the general structure within the framework of an inflation-targeting regime.

Inflation Target and the Period of Targeting

12. Owing to the advantage of being easily understood by the public, as well as its communication advantage, the inflation target was set as "a point target". As it is an indicator easily followed by all members of society and an effective way of accurately measuring the cost of daily life, the Consumer Price Index was the preferred means of defining the inflation target. Along these lines, the target variable is the end-year rate of inflation calculated by the annual percentage change of the Consumer Price Index with the base year 2003. Bearing in mind the transition from 2006 onwards to a three-year budget practice, the announcement of a three-year target path is believed to increase the internal consistency of inflation targets and their harmony with other macroeconomic projections. Therefore, during this initial stage of the inflation-targeting regime, targets are announced for a three-year period. In harmony with the Pre-Accession Economic Program and three-year budget plans, the end-year targets for 2006, 2007 and 2008 are set as 5 percent, 4 percent and 4 percent, respectively. The target for end-2009 will be announced in 2006.

Interpretation of the Target

13. End-year inflation targets for the period of 2002-2005 were announced within the framework of implicit inflation targeting, and inflation was realized below the targets for the first three years in a row. It is predicted that the realization for 2005 will most probably be below the target as well. Under normal conditions where inflation has stabilized at low levels, it can be considered as unfavorable for inflation to remain systematically below the target. However, as the primary objective while moving from the chronic inflation environment to single-digit figures in the 2001-2005 period was to bring down the high level of inflation, remaining below the target did not affect expectations adversely. On the contrary, it bolstered perceptions that the disinflation process would continue. Hence, in this period, the fact that inflation was below the targets was considered to be a more acceptable situation compared to inflation realizing above the targets. Within this context, the targets announced by the Central Bank were implicitly perceived as the “upper limit”. However, it is inevitable that this situation will change in the coming years. This is due to the fact that in economies where inflation has stabilized, monetary policy is in a position to aim for the coherence between inflation and the targets, rather than inflation realizing below the targets. Along these lines, in the process of the inflation-targeting regime, the Central Bank will from now on assess upward or downward deviations from the target on equal footing. This also means that an explanation will be made to the public in both substantial upward and downward deviation of inflation from the target.

Deviation from the Target and Accountability

14. Measured by the Consumer Price Index, which is a comprehensive index, the course of inflation may show fluctuations arising from the factors outside the control of monetary policy. Factors such as developments in oil prices, changes in international liquidity conditions and global risk perceptions, indirect tax and public price adjustments, and unforeseen movements in the prices of unprocessed food may lead to volatilities in inflation from time to time. Considering the data and model uncertainty in the economy in addition to the factors mentioned above, it is obvious that inflation realization is quite unlikely to be exactly the same figure as the point target That is why it is not possible for the Central Bank to ensure that inflation will not make even the slightest deviation from the point targets.

15. However, this does not stand for the lack of accountability. In case of a significant deviation from the target in any period, the Central Bank shall explain the reasons behind the said development to the public in its reports, in the framework of the inflation-targeting regime. In this context, the Central Bank will continuously be obliged to account for its actions to the public through the publication of its reports. Nevertheless, it is of paramount importance that the Central Bank establishes a separate mechanism, which will explain the situation to the public in cases where inflation realizations display an excessive deviation from the target. Thus, the provision in Article 42 of the Central Bank Law states that "The Bank shall submit information to the Government in writing and inform the public disclosing the reasons of incapability to achieve the determined targets in due time or the occurrence of the possibility of not achieving such targets and the measures to be taken thereof." As the said article provides accountability, it shall be implemented with utmost care in the framework of the inflation-targeting regime.

16. At this point, the main question to be answered is how to establish this mechanism. As it is stated explicitly in paragraph 14, the probability of achieving the point target is almost zero. In this case, will the accountability principle also apply to a small deviation, which can be defined in decimal or even in percentage points? How big should a deviation be in order to require such an explanation? It is clear that size matters however the perception of size is much more important. Determination of the size of the deviation stands for the expression of an "uncertainty band" per se. The critical point is that this band should not be perceived as a band for the inflation target.

17. Building a band around the target is an implementation preferred by most of the central banks that adopted inflation targeting and announced a point target.[1] The fact that central banks build a band around the point target does not indicate a slack monetary policy. It should be emphasized once more that the uncertainty band should not be perceived as any type of target. It is only an indicator for the bi-directional and "excessive deviation" thresholds of the band target, which was announced for 2006, and an element that facilitates the communication policy of the Central Bank. In the overall scenario in which big exogenous shocks do not occur, the public should understand clearly that the aim of the Central Bank is to be as close to the point target as possible and therefore, the Bank will consider upward and downward deviations from the 5 percent-target in the same manner. Furthermore, it should be noted by the economic agents that the uncertainty band is likely to shrink as a result of further approaching price stability in the upcoming years.

18. In light of the statements above, the "uncertainty band" for 2006 is set as 2-percentage point in both directions. The inflation path consistent with the end-year target and the uncertainty bands around the path are shown below. In case figures go outside the band, the Central Bank shall submit a separate report to the Government disclosing the reasons of the incident and the measures to be taken thereof and share this report with the public.

TABLE 1. INFLATION PATH CONSISTENT WITH THE END-YEAR TARGET AND THE UNCERTAINTY BAND

	March 2006	June 2006	September 2006	December 2006
Uncertainty Band (upper limit)	9.4	8.5	7.8	7
Path Consistent with the Target	**7.4**	**6.5**	**5.8**	**5**
Uncertainty Band (lower limit)	5.4	4.5	3.8	3

[1] International Monetary Fund, 2005, "Does Inflation Targeting Work In Emerging Markets?", World Economic Outlook, 4, Part 4, p.161-186, September Washington DC.

Adoption of a Medium-Term Perspective

19. There is a close relation between building an uncertainty band and a "medium-term perspective". In order to minimize macroeconomic fluctuations while struggling against the exogenous shocks that increase or decrease inflation remarkably, we need an "uncertainty band" around the point target to serve as a reference. Rather than temporary fluctuations in inflation, what matters to the Central Bank in the medium-term is that inflation becomes 5 percent in one year and 4 percent in two years by displaying a gradual decline and achieves a degree of stability. It should be noted that a medium-term inflation target stands out in such an implementation. In a medium-term perspective, the Central Bank does not instantly react to the temporary impacts of large exogenous shocks on inflation, but spread out the policy reactions over a period of time by putting emphasis on medium-term targets. In this context, the Central Bank will clearly explain to the public how a shock that threatens the inflation target is handled (such as the evaluation of temporary or permanent features of a shock). In the framework of Article 42 of the Law mentioned in paragraph 15, the Central Bank will not only implement policies aimed at reconvergence to the target but also notify the political authority of the steps to be taken and inform the public of the amount of time needed for converging to the target again.

20. For instance, it is a widely accepted idea that central banks should not have a reaction to the primary effects of an increase in oil prices. However, as the implementation of this idea requires certain flexibility, an uncertainty band should be built around the target.

21. Let us explain this matter with an example: In a scenario in which oil prices rise by USD 100 per barrel and maintain their high trend throughout 2006, their primary impacts on inflation might reach 3 or 4 points and naturally, the Central Bank would let the end-2006 inflation exceed the 5-percent target. In case the Central Bank strived to reach the 5-percent target in 2006 in spite of the supposed increase in oil prices, the Bank might be obliged to increase interests significantly and therefore, cause a negative impact on social welfare by creating a contraction in economic activity. Instead of this, the Central Bank in the supposed situation, would allow the deviation from the 2006 target, but pledge to decrease the inflation to 4 percent in 2007 in order to prevent secondary effects and keep expectations under control. A similar action plan could be followed against probable developments such as changes in international liquidity conditions, adjustments in indirect taxes and public prices, pricing differentiations of institutions stemming from structural adjustments and sudden movements in agricultural product prices.

22. The important point here is that in the periods where inflation deviates from the target, the Central Bank clearly explains the reasons for the deviation to the public and informs them of the timing of re-convergence to the target and the relevant monetary policy. There is no doubt that the said time band may differ according to the type and size of shocks. As various shocks may have different impacts on inflation according to timing and periods, in case of a significant diversion from the target, the re-convergence period shall be announced after the occurrence of the shocks and the determination of their sources.

Special CPI Aggregates

23. The CPI occasionally displays unpredictable changes as a result of fluctuations in energy, unprocessed food and public prices and in indirect taxes. Therefore, the CPI inflation, which is taken as the target criteria in the framework of the inflation-targeting regime, may occasionally be affected by factors that are beyond the control of monetary policy. For this reason, in order to achieve a better understanding of the main inflation trend, Special CPI Aggregates (SCA) will continue to be a part of the forward-looking inflation analysis of the Central Bank and its communication policy. As the shocks affecting inflation may differ according to their periods, there is a very small probability that a sole "core inflation" indicator excludes all the factors that are outside the control of monetary policy. Therefore, instead of considering a single so-called core indicator, more than one indicator is used in the differentiation of various exogenous shocks. There is no doubt that some of the said indicators may stand out in the future. However, for now, core inflation it is not likely to be defined with a single indicator. In this process, the Central Bank will openly inform the public of the type of relevant indicator and the degree of its importance. Moreover, after reaching a satisfactory number of observations, new indices can be compiled based on different techniques and SCA definitions can be updated according to the changing economic conditions.

Conditions for Changing Targets

24. A pre-announced inflation target shall only change in the event that very sharp and long-term deviations from the target are expected or medium-term targets no longer make sense due to factors beyond the control of monetary policy. At this point, a new target will be set with the Government with respect to the Law.

25. Temporary shocks can change inflation forecasts rather than inflation targets. For instance, even though a one-off adjustment in indirect taxes diverts inflation from the targets, a change in the target will be out of the question due to its limited effect on one-year ahead inflation forecasts. Instead, the short-term forecasts will be changed. In this case, the points of reference to be used by economic agents will be inflation forecasts for the short term and the inflation target for the medium term. In conclusion, it is fundamental in the upcoming period that the targets do not change except in cases of extraordinary developments.

Public Sector's Role in the Inflation Targeting Regime

26. Sound monetary policy is a necessary condition on the way towards price stability, but not sufficient. In order to attain price stability, the continuity of fiscal discipline should be maintained in the upcoming years as in past years. In Turkey, fiscal discipline has the potential to affect the inflation-targeting regime through four channels. The first channel comprises long-term expectations. Further enhancement of fiscal discipline through its continuity will increase the effectiveness and predictability of monetary policy by extending the borrowing maturities and reducing the risk premium and the volatilities in risk premiums and contribute to the credibility of the inflation targeting regime.

27. The second channel works through the prices of goods and services produced by the public sector itself. Naturally, the consistency between the prices of goods and services produced by the public sector and inflation targets is crucial for attaining price stability.

28. The third channel works through the incomes policy of the public sector. One of the main determinants of the expectations for price and wage inflation in Turkey are the wage increases made by the public sector to its own employees. In this context, the consistent trend of the incomes policy with the inflation target is a sine qua non for the success of the inflation-targeting regime.

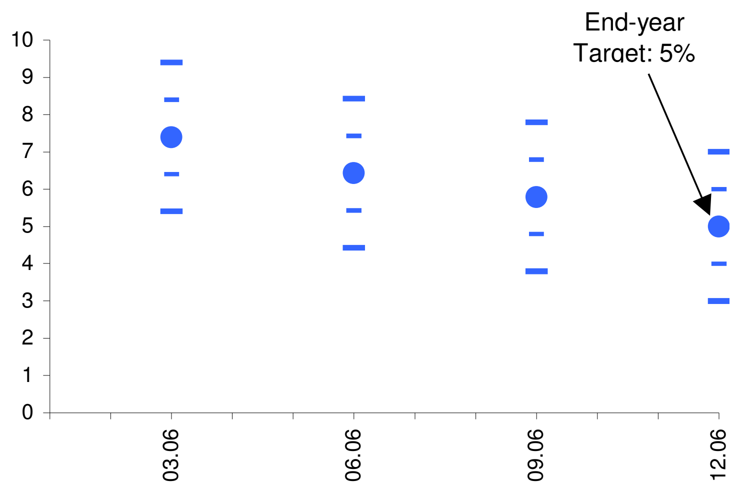
29. The fourth channel is the direct spending channel. The public sector's direct purchases of goods and services are reflected on inflation via total demand. The powerful position of these channels indicates the critical importance of the continuity of fiscal discipline in a period where the memories of chronic inflation are still fresh. In conclusion, continuity of fiscal discipline and consistent implementation of fiscal policies with targets are fundamentals in the success of the inflation-targeting regime.

Inflation Targeting Regime and IMF Conditionality

30. With the adoption of the inflation-targeting regime at the beginning of 2006, in the scope of "IMF Program Requirements", Net International Reserves will continue to be performance criteria, however performance criteria for Money Base and the indicative target for Net Domestic Assets will be replaced with the "inflation consultation criteria". To this end, from 2006 onwards, a path will be established consistently with the end-year target at the beginning of every year and this path will be used for the revisions made with the IMF within the framework of the program. As of the end of 2005, the inflation figures consistent with the end-year target are calculated for end-March, June, September and December; and the figures, which are set out in paragraph 18, appeared in the Letter of Intent.

31. Graph 1 shows the quarterly path of inflation consistent with the end-year target of 2006, which was prepared to be used in reviews within the framework of the agreement signed with the IMF. The specified path has been formed by taking into account factors such as base effect and seasonality. The path for 2007 is going to be formed at the end of 2006.

GRAPH 1. PROGRAM CONDITIONALITY: INFLATION PATH CONSISTENT WITH THE END-YEAR TARGET*



* Inner band: +/- 1 percentage point
Outer band: +/- 2 percentage points

32. As seen in Graph 1, revision criteria around the target-consistent path are established. For each quarterly period, if inflation remains below or above the target-consistent path by one or more points, there will be negotiations with IMF staff in each review. In case of such a development, the Central Bank will inform the public of the causes of the deviation via the issue of periodical reports.

33. If inflation falls below or exceeds the target-consistent path by two or more points, since such a fall or rise will be considered as a violation of the program conditionality, the Bank will announce the measures to be taken within the principles of the program. These measures will also serve the principle mentioned above in the part concerning accountability, which reads: "In case of a two-point deviation in the target-consistent path in either direction, the Central Bank will prepare a separate document that will serve to inform the public of the causes and measures to be taken, and also provide the Government with a written statement". The public announcement to be made in case of a likely violation of the program conditionality will also be presented to the IMF and thus a certain level of transparency will have been established.

34. There is a critical point that needs special emphasis: The program conditionality outlined above does not mean that monetary policy will focus on quarterly periods. The path designed within the framework of the program will have relative significance in evaluating the consistency between the yearly course of inflation and targets, and the Central Bank will maintain its medium-term perspective in making monetary policy decisions. For instance, if it is anticipated in January 2006 that a significant deviation from the target-consistent path will be observed in March, this anticipation will be shared with the public, while monetary policy will not react as long as the inflation outlook is consistent with medium-term targets.

Inflation Report and Forecasts

35. With the transition to the inflation-targeting regime, the quarterly issued Inflation Report will be the main communication instrument of monetary policy. In 2006 dates of issue of the Report have been determined as the last weeks of January, April, July and October. The first issue of the Report will be released at the end of January 2006. The Monetary Policy Report, which has been issued quarterly, will not be issued in the new period.

36. In the Inflation Report, inflation and general macroeconomic developments will be discussed in depth. The greatest change in the Report will be the inclusion of the inflation forecasts of the Central Bank. In case of a change in the forecasts of a previous Report, the new Report will provide information explaining why updated forecasts differ from those of the previous period. Moreover, the Report will also contain signals of likely future policies along with a general evaluation of the factors influencing inflation. In this way, a significant step will have been taken towards ensuring transparency and accountability stipulated by the inflation-targeting regime.

37. There is no doubt that the process of forming monetary policy and inflation forecasts involves many uncertainties due to exogenous shocks or the continuous transformation process in the economy. The said uncertainties apply to all economies in the world but are much higher in economies such as Turkey that undergo a structural transformation. It is inevitable that all these likely shocks and uncertainties will influence inflation forecasts. In this context, it is extremely important that the public becomes aware that forecasts reflect the stance the

Central Bank takes about inflation during the issue period of the Report. Therefore, inflation forecasts may change in line with unexpected developments that can emerge during the time between the two reports as well as with any new information acquired. What is more noteworthy here than the change in forecasts itself is that causes of the change will be clearly explained to the public through the Inflation Report. In other words, the Central Bank will always be liable to be called to account.

Minutes of the Monetary Policy Committee Meeting

38. Along with the Inflation Report, minutes of the Monetary Policy Committee meeting will also be a significant instrument of communications policy in the inflation-targeting regime. The Inflation and Outlook Report, which has served a similar purpose so far, will be replaced with a dual reporting system: Immediately after the monetary policy decision is made, a brief report on the decision and its rationale will be issued. The other report summarizing the evaluations of the Monetary Policy Committee and its stance about the inflation outlook will be issued within five working days following the meeting.

Other Instruments of Communication

39. Press conferences and presentations will constitute another significant instrument to be used in the context of the communications policy in the inflation-targeting regime. The Central Bank will share the general framework of the inflation-targeting regime with the public through presentations it will give in universities and non-governmental organizations from time to time. On the date of release of the Inflation Report in January 2006, the content of the Report will be outlined in a press conference. Every succeeding quarter, the main message of the Inflation Report will be conveyed to the public once again in a press conference.

40. Technical reports issued by the Central Bank, notes that would enable better perception of the transmission mechanism and presentations about the methods used in inflation forecasts will form another pillar of the communications policy. A forecasting and policy analysis system has already been developed within the Central Bank in order to support monetary policy decisions. However, the Central Bank will not rely on a single model at this stage. The Bank believes that due to uncertainties in the functioning of the transmission mechanism and the rapidly changing structure of the economy, it would not be reasonable to stick to a single model and it is important in monetary policy decisions that various models with various assumptions are evaluated together in light of the views of specialists. Academic literature and central banking experiences are also in consensus on the above-mentioned views. For this reason, no specific model will be put forward at this stage. As a matter of fact, many developing countries like the Czech Republic, Poland and Brazil did not develop any models during the first years of inflation targeting, either.[2]

41. So far, the Central Bank has at times shared its views about the functioning of the economy with the public through various presentations, reports and working papers. Although it has become clearer compared to previous periods, the transmission mechanism in Turkey still harbors a significant level of uncertainty like other country examples. Nevertheless, the Central Bank has to share its economic views with the public as a necessity for transparency principle. In this respect, the Central Bank will continue to share its views with the public about the effects of monetary policy on inflation through reports and presentations. In addition, studies in this direction will continue at an accelerated pace and information as to how inflation forecasts are made within the Central Bank will be shared with the public in stages.

42. It is of critical importance that the public properly follows and evaluates the reports and other documents issued by the Central Bank, particularly after the transition to the inflation-targeting regime in 2006. An example will be helpful here: Following the announcement of inflation figures for October 2005, some remarks were made by the public claiming that "the Central Bank acted more cautiously in October since inflation figures were above the expected level". In order to increase the effectiveness of economic policies, the short-term point of view underlying such remarks should be abandoned as soon as possible and our reports should be followed closely. As a matter of fact, the preceding Inflation and Outlook Report had anticipated there would be high price increases in October. For this reason, this development was not taken as a new and significant piece of

[2] Schaechter Andrea, Mark R. Stone, and Mark Zelmer (2000): "Adopting Inflation Targeting: Practical Issues for Emerging Market Countries", IMF Occasional Paper, No 202

information in the monetary policy decision made in November. Factors that affect the level of the Central Bank's cautiousness are projections about the consistency between targets and the outlook of inflation in the medium-term, rather than seasonal price increases in certain goods in any month.

Decision-Making Process

43. After the transition to an inflation-targeting regime, the Monetary Policy Committee will assume a "decision maker" role instead of an "advisor" role. Unless an emergency arises, the Monetary Policy Committee will continue to meet once a month in 2006 as it has done since 2001, as stipulated by Central Bank Law. Unlike 2005, meeting dates will not fall on the same day each month. However, in line with the principle of transparency, meeting dates for the whole year will be announced to the public in advance. As can be seen in the meeting dates of 2006 listed in the Annex, meeting dates are arranged so as to coincide with the second half of each month. Meeting dates have been determined by taking into account such factors as official holidays, national and religious festivals, the data flow process in a month and announcement dates of national income data. In the upcoming period, inflation projections will be renewed and the Inflation Report will be issued quarterly, following the announcement of national income figures. Hence, four of the twelve Monetary Policy Committee meetings held in a year will coincide with the release of the Inflation Report.

44. In the new period, meetings will be held in two sessions between 2.00 pm and 5.00 pm. The first session will host Central Bank authorities and specialists as well as authorities from the Undersecretariat of Treasury. In this session, related bodies of the Central Bank and authorities of the Undersecretariat of Treasury will present to the Monetary Policy Committee their reports on evaluations about economic developments, which will then be opened to discussion. In the second session, to be held on the same day, members of the Monetary Policy Committee will make the final evaluations about the outlook and put the decision to a vote. After the voting is concluded, members of the Monetary Policy Committee will prepare a brief report explaining the rationale of the decision. The decision and its rationale will be announced by the Central Bank in a press release between 5.00 pm and 7.00 pm on the same day, and it will also be posted on the website of the Bank.

II. EXCHANGE RATE POLICY, FX BUYING AUCTIONS AND LIQUIDITY MANAGEMENT

Exchange Rate Policy and FX Buying Auctions

45. On 20 December 2004, the Central Bank shared with the public the general framework of the current exchange rate policy and FX buying auctions in a press release called "Money and Exchange Rate Policy in 2005". According to this;

i. The economic transformation process experienced after the 2001 crisis has enabled significant achievements in macroeconomic stabilization and helped reduce the "dollarization" effect created by unstable macroeconomic policies and high inflation in the past. The main tendency of economic agents has been to hold increasing amounts of Turkish currency denominated assets since 2002. This "reverse dollarization" process, combined with favorable developments in the balance of payments, has supported the increase in foreign exchange supply in the economy.

ii. Taking into account the likely contribution of a strong foreign exchange reserve position to boost confidence in the current program, foreign debt payments of the Treasury and the need to gradually reduce the number of high-cost remittances accounts in the long-term, which are peculiar to Turkey and make up a significant part in the liabilities side of the Central Bank's balance sheet, the Central Bank held foreign exchange buying auctions to build up reserves at times where foreign exchange supply constantly increased compared to foreign exchange demand. Foreign exchange buying auctions, which have been held since 1 April 2002, also continued in 2003 and 2004 at bands as long as market conditions allowed.

iii. The main principles of a floating exchange rate regime are that the exchange rate is not used as a monetary policy tool and the Central Bank does not have any exchange rate target. That is why the Central Bank, which follows a moderate reserve-raising strategy, makes foreign exchange purchases via auctions, whose terms are announced in advance, in order to affect the supply and demand conditions in the foreign exchange market and thus the level of exchange rate at a minimum level and to abide by the basic principles and functions of a floating exchange rate regime.

iv. In the light of its prediction that the introduction of a new three-year economic program involving primarily fiscal and monetary discipline and structural reforms and the favorable developments in the process of negotiations aimed at full membership to the European Union will have a positive effect on both the reverse dollarization process and the balance of payments, the Central Bank announced that it will resume foreign exchange buying auctions, which had been suspended for a period of time, effective from 22 December 2004. Moreover, the Central Bank has decided to announce an annual program in order to minimize the impact of foreign exchange auctions on foreign exchange. The Central Bank has also decided not to make any amendments to the program, unless extraordinary differences are observed in foreign exchange liquidity.

v. Meanwhile, it was emphasized once again that the Central Bank will continue to closely monitor the volatility in exchange rates and will directly intervene in the markets in the event of excessive volatility that might occur in either direction. It was also underlined that volatility interventions are not only carried out by considering past data with a mechanical rule, but by evaluating the causes of realized and potential volatility in all aspects.

46. With respect to foreign exchange buying auctions held in 2005, it was announced on 20 December 2004 that the Central Bank would buy maximum USD 45 million in daily foreign exchange auctions, with USD 15 million of auction amount and USD 30 million of optional selling amount (200 % of the total amount sold). These amounts were not changed throughout the year. At foreign exchange buying auctions, which commenced as of 22 December 2004, USD 7,1 billion in total was bought until 2 December 2005. At a total of 231 auctions held during the said period, the average buying sum amounted to USD 30.9 million.

47. Furthermore, the Central Bank intervened in the foreign exchange markets six times in 2005 due to excessive realized or expected volatility in exchange rates. Within the transparency framework, which is a prerequisite for the implemented monetary and exchange rate policies in and has, the Central Bank has started to announce the data relating to direct foreign exchange buying/selling interventions in the section “Data/Financial Markets Data/Foreign Exchange Buying-Selling Interventions Against TRL” of its web site (www.tcmb.gov.tr) starting from 21 October 2005.

48. In 2005, net foreign exchange purchases through auctions and interventions became USD 21.5 billion by 2 December 2005. The amount of net foreign exchange purchases by the Central Bank since 2002 is shown on an annual basis in the following Table. The sum of foreign exchange purchases in 2005 is the highest amount that has been bought by the Central Bank in a calendar year to date. Hence, the amount of net foreign exchange purchases reached USD 37.5 billion in the 2002- 2005 period.

TABLE 2. THE CENTRAL BANK’S NET FOREIGN EXCHANGE PURCHASES

(2002-2005; Million, USD)

Year	FX Buying Auctions	Net FX Buying Interventions	Total Net FX Buying
2002	795	4	799
2003	5.652	4.229	9.881
2004	4.104	1.274	5.378
2005*	6.900	14.565	21.465
Total	**17.451**	**20.072**	**37.523**

* As of 2 December 2005

49. The economic program and the accession to the European Union, are expected to have a favorable effect on both the reverse dollarization process and the balance of payments. The general framework for exchange rate policy implementation announced in our press release of 20 December 2004, which is summarized in Article 45, will be valid for 2006. In other words, it was decided to carry on daily foreign exchange buying auctions, predicting that foreign exchange supply will continue to pursue a high course in 2006. The amount of daily buying in auctions will be raised to USD 20 million from USD 15 million in 2006. Unless extraordinary differences in foreign exchange liquidity are observed, the program will remain the same.

50. Guidelines for foreign exchange auctions are as follows:

i. The total daily amount of auctions is determined as USD 20 million for 2006, starting from 2 January 2006.

ii. Auctions will not be held on public holidays of the United States, even if it is a working day in Turkey. Neither will auctions be held on half working days or if when the Central Bank has started to intervene in foreign exchange market prior to auction hours.

iii. The additional optional selling amount priced over the average price of the auction will only be granted to the winner parties. The optional amount will be 200 percent of the total amount sold in the auction by each bank. Accordingly, the maximum daily amount that can be bought will be USD 60 million, with USD 20 million of auction amount and USD 40 million of optional selling amount.

iv. The auction number will be posted on Reuters page CBTQ at 1.30 p.m. and institutions may bid between 1.30 – 1.45 p.m.

v. After the auction results are posted on the CBTQ page of Reuters, the institutions may exercise their right to sell the optional amount till 2.00 p.m.

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

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

51. In conclusion, exchange rates will continue to be determined by supply and demand conditions in the foreign exchange markets in 2006 as well. The key determinants of foreign exchange supply and demand are the monetary and fiscal policies and the economic fundamentals determined by the structural reform process and expectations. Undoubtedly, the deteriorations in economic fundamentals and adverse developments in the stability program and expectations may lead to volatility in exchange rates. It should be borne in mind that in a floating exchange rate regime, economic agents operate in an environment of exchange rate risk. Nevertheless, as repeatedly emphasized by the Central Bank, exchange rate risk is a manageable risk and economic agents should establish the mechanisms that will enable the efficient management of this risk.

52. The Central Bank had announced in its press release of 2 January 2002 titled "Monetary Policy and Exchange Rate Policy in 2002 and Prospective Developments" that it would gradually strip itself of its intermediary function in Foreign Exchange and Banknotes Markets and would keep up its intermediary function only for the foreign exchange deposits of the state-owned banks that were taken over from the Savings Deposits Insurance Fund (SDIF) banks. However, foreign exchange deposits of state-owned banks, which were transferred to them from SDIF banks and used by these banks in the CBRT Foreign Exchange and Banknotes Markets, will be closed as of 26 December 2005 and the intermediary operations of the Central Bank in Foreign Exchange and Banknotes Markets will end as of the said date. On the other hand, banks will be able to borrow foreign exchange in terms of USD and euro from the Central Bank within predetermined limits with a one-week-maturity at the Foreign Exchange and Banknotes Market-Foreign Exchange Deposit Market in the coming period. Moreover, the transactions of purchase/sale of "foreign exchange against foreign exchange", "foreign exchange against foreign banknotes" and "foreign banknotes against foreign banknotes" conducted between the Central Bank and institutions authorized to operate in the Foreign Exchange and Banknotes Markets will continue.

Liquidity Management

53. Following the February 2001 crisis, the Central Bank purchased government securities worth TL 14 quadrillion from state-owned banks and banks transferred to the 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 created a substantial amount of excess liquidity in the market during the 2001-2004 period. The Central Bank sterilized the excess liquidity in the market in an active manner, by means of Turkish lira deposit operations in the Interbank Money Market and reverse repo transactions carried out within the framework of open market operations in the Repo and Reverse Repo Market of the Istanbul Stock Exchange. Accordingly, overnight interest rates were steadily realized at the level of the borrowing rate of the Central Bank. Within this framework, the borrowing rate of the Central Bank has become an indicator for money markets.

54. In its press release, "Monetary and Exchange Rate Policy in 2005", dated 20 December 2004, the Central Bank had announced that the excess liquidity observed in the 2001-2004 period would gradually shrink in 2006, based on the main scenario, even it was not possible to make an accurate prediction for the entire amount of the Central Bank's foreign exchange purchases and the Treasury's net foreign exchange borrowing. Furthermore, the liquidity management strategy to be followed in case of liquidity shortage was explained in detail.

55. Accordingly, the Central Bank did not allow any excessive volatility in money market rates, when a liquidity shortage appeared from time to time. The Central Bank efficiently met the liquidity requirements of banks through repo auctions and the liquidity facilities offered to the primary dealers. However, even if temporary liquidity shortages were experienced, the excess liquidity conditions continued throughout the year as a result of Central Bank's foreign exchange purchases via foreign exchange auctions and direct buying interventions, far above the amount foreseen under the main scenario. The amount of excess liquidity in the market reached YTL 6.6 billion by 2 December 2005.

56. According to available data, for the rest of this year and 2006;

i. The rise in demand for base money,

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

iii. The increase in Treasury accounts will have a lowering effect on the amount of liquidity, while

i. The Central Bank's net foreign exchange purchases,

ii. Interests payments to be made by the Central Bank for reserve requirements and for excess liquidity absorbing transactions,

iii. The utilization of the Treasury's net foreign exchange inflows for the reimbursement of TL borrowing will have an increasing effect on liquidity.

57. Unlike the previous periods, the Treasury's income-expenditures balance in terms of foreign exchange will have a more significant effect on liquidity, since privatization revenues and revenues from SDIF sales of assets will reach high amounts. It is predicted that the part of these revenues, which will be transferred to the Treasury accounts with the Central Bank, will primarily be in terms of foreign exchange. Therefore, the Treasury's foreign exchange transactions might not have a decreasing effect on the liquidity in the market. In other words, in the rest of 2005 and in 2006, the income of the Treasury from privatization revenues and SDIF sales of assets, and the amount of FX borrowing may cover the FX debt repayment, including external and domestic debts, or it may lead to an insignificant deficit, unlike in the previous years.

58. Therefore, as in the previous years, it is not possible to make a precise forecast regarding the net foreign receipts of the Treasury and the Central Bank's amount of foreign currency purchases, which are the basic factors affecting liquidity. Depending on the fluctuations of these amounts, the market liquidity can change significantly. However, based on the assumption that the foreign exchange inflow of the Treasury would match the foreign exchange outflow, and by taking the Central Bank FX buying auction program into consideration, the continuity of excess liquidity conditions in the markets in 2006 as well as the continuation of the indicator status of the Central Bank borrowing rate, are most likely.

59. In the arrangements regarding the liquidity management strategy of the Central Bank in 2006, some technical interest rate changes for narrowing the potential volatility margins of the overnight interest rates are needed when the significant decreases in the New Turkish Lira interest rates are taken into consideration. However, such changes do not mean a change determined considering the inflation target of the Central Bank. Because, in the current excess liquidity conditions, the interest rate that the Central Bank determines for the daily borrowing transactions is a benchmark interest rate and no change has been made in the aforementioned interest rate to that end. In this context, the 2006 liquidity management strategy will be as follows:

i. The Central Bank will continue announcing overnight borrowing and lending interest rates between 10.00 – 12.00 and 13.00 – 16.00 in the Interbank Money Market. In case of a liquidity shortage during the day, banks can borrow at the Central Bank's lending interest rate within their limits. In case of a fall in the interest rates as the result of increasing liquidity, banks can make unlimited New Turkish Lira deposits at the Central Bank borrowing interest rate. Also, beginning from 2 January 2006, by lowering the lending interest rate by 1 point, the spread between the borrowing and lending interest rate which is currently 4 points will be lowered to 3 points.

ii. The Central Bank will continue to provide the Late Liquidity Window facility between 16.00-16.30 such that banks may borrow from the Central Bank against collateral without any limit or lend to the Central Bank. Moreover, starting from 2 January 2006, the Central Bank (CBRT) lending interest rate within the framework of the Late Liquidity Window facility will be determined as 3 points higher than the daily lending interest rate, and the borrowing interest rate will be determined as 4 points lower than the daily borrowing interest rate.

iii. Especially during the periods of interest rate decisions, the announcement made by the Central Bank's on one-week maturity borrowing interest rate leads the excess liquidity to be absorbed by the Central Bank, which causes market liquidity to decrease. Thus, there may be temporary fluctuations in overnight interest rates. To prevent such fluctuations, the Central Bank will not announce one-week maturity borrowing interest rate at the CBRT Interbank Money Market and at the Istanbul Stock Exchange Repo – Reverse Repo Market starting from 2 January 2006.

iv. In case of a temporary or permanent liquidity shortage, the Central Bank will continue to carry out liquidity management through one-week maturity repo auctions. When there is liquidity shortage in the market, the Central Bank will announce the amount of repo auction for that day on Reuters' CBTF page at 10.00. While determining the amounts of the auction, the Central Bank will endeavor to maintain the average of auction interest rate at approximately 1 point over the Central Bank daily borrowing interest rate announced at the Interbank Money Market.

v. The weekly repo auctions will be executed at 11:00 and the results will be posted on Reuters' CBTG page no later than 11:30. The traditional auction method will be used in auctions, in other words the successful bidders will be evaluated with their own rates.

vi. In case of unforeseen excessive liquidity shortage, which would exert excessive pressure on interest rates in the money market during the day, the CBRT may announce "Intraday Repo Auctions" in addition to the regular ones.

vii. The Central Bank will continue to provide TRY liquidity to the primary dealer banks through open market operations. Currently, the overnight and one-week maturity interest rates applicable to the repo facility provided to primary dealers are determined 2 points higher than the Central Bank's daily borrowing interest rate. This facility will continue in 2006. The primary dealer banks will be able to conduct repo transactions between 10.00–12.00 and 13.00–16.00 hours.

viii. In case of a permanent liquidity shortage in the banking system, the benchmark short-term interest rate will be the repo auction interest rate not the Central Bank's daily borrowing interest rate. Therefore, in case of a liquidity shortage, the interest rate taken as a benchmark by the market would have become higher due to the decline in liquidity. In order to avoid any negative effects, the Central Bank could revise its interest rates – even in cases where the Inflation Outlook remains unchanged- so as to counter the pressure created by the liquidity shortage. To reiterate, such a change in interest rates would only mean a change stemming from liquidity conditions- therefore such a move should not be perceived as a loosening or tightening of monetary policy.

ix. In case of a permanent liquidity shortage in the market, the CBRT can terminate its transactions at the Istanbul Stock Exchange Repo-Reverse Repo Market with a prior notice and start to manage liquidity on its own markets, just like other central banks. When the CBRT's abovementioned liquidity management strategy is taken into account, the termination of CBRT transactions at Istanbul Stock Exchange Repo-Reverse Repo Market is not expected to lead to any significant fluctuations in market interest rates.

60. As stated in CBRT's Press Release Regarding the Communiqués on Required Reserves and Liquidity Requirement dated November 16, 2005, some new arrangements have been introduced regarding required reserves and liquidity requirement with the aim of helping banks make their liquidity management more effective:

i. With the termination of the liquidity requirement implementation, the banks will no longer be obliged to hold government securities with the CBRT, which will enable them to manage their liquidity more flexibly. This is an important step towards the harmonization of financial regulations with the acquis communautaire.

ii. As of the end of 2005, the entire amount of TRY required reserves would be maintained on average at free deposit accounts over a maintenance period of 2 weeks. Currently, half of the TRY required reserves are obliged to be kept on average at free deposit accounts over a maintenance period of 2 weeks and the other half are held in blocked accounts. The new implementation will enable the banks to manage required reserves more flexibly at times of temporary liquidity shortage and help reduce fluctuations in interest rates.

iii. Meanwhile, the sanctions to be imposed in cases where banks fail to deposit required reserves on time or fail to deposit in full amount have been revised. Accordingly, the practice of collecting the penalty interest to be imposed for default on required reserves liabilities in cash at once has been abandoned. Instead, two-folds of the deficient TRY required reserve amount and three-folds of the deficient FX required reserve amount will be deposited in non-interest bearing deposit accounts. The aim of the new practice is to alleviate the prospective unfavorable effects on financial bodies of the banks.

61. The Central Bank deems stability and deepening of financial markets as a supporting objective for conducting policies pertaining to price stability effectively. Actually, within the framework of the floating exchange rate regime, the Central Bank has taken measures towards maintaining financial stability several times in the last four years as it did in the aftermath of the terrorist attacks in Istanbul in November 2003. Therefore, the Central Bank, whose primary goal entrusted to it by law, is to establish price stability, will continue with its efforts towards enhancing monetary policy and liquidity management in 2006. Accordingly, the Central Bank may change both the liquidity management strategy and interest rate margins in cases of unpredictable changes in market conditions and according to new needs.

62. In our press release dated December 20, 2004, we had stated that liquidity was not homogenously distributed in the banking sector, however the banking system was expected to contribute to the development of secondary market operations by taking into account risk management principles, with the ultimate aim of ensuring liquidity flow to achieve a money market which functions effectively. Although currently liquidity is not evenly distributed in the banking system, it is observed that liquidity flow accelerated substantially in 2005 and money markets became relatively more effective. The gradual improvement in this trend would not only help increase the effectiveness of the monetary policy of the CBRT but also the deepening of financial markets.

63. While on the one hand, tight fiscal and monetary policies implemented since 2001, the structural reform process and increased confidence in the economic policies has helped financial deepening and growth in the overall balance sheet of the banking system, on the other hand these factors slowed down the rise in domestic debt stock. Thus, a gradual and uninterrupted decline in the ratio of debt stock to national income has been achieved. This development also helps reduce the share of public debt stock in the total balance sheet of the banking system. Assuming that fiscal discipline continued in 2006 and a substantial amount of privatization proceeds were attained, it is estimated that this process would further accelerate. The Treasury's debt servicing ratio, which is lower compared to previous years, would lead to a further decrease in fiscal dominance this year. Therefore, a rapid rise in the banking system's real sector and consumer credits and increased competition and extension in maturities in the credit market are all developments likely to occur.

64. Obviously, under the floating exchange rate regime the Central Bank is able to implement the TRY liquidity policy in a more flexible manner than it can under a fixed currency peg regime and can act more promptly and flexibly to meet the TRY liquidity needs of the banking system. The Central Bank can prevent excessive fluctuations in interest rates as long as they are consistent with the inflation target. The abovementioned liquidity management strategy manifests this fact very clearly. However, the banking system should not slacken risk management principles by simply relying on the more flexible and effective liquidity management of the Central Bank. Quite the contrary, it is obvious that increased competition, credit volume and extended maturities would necessitate a more effective risk management stance in the banking system.

Annex

MONETARY POLICY COMMITTEE MEETING DATES AND INFLATION REPORT PUBLICATION DATES

MPC MEETING DATES	INFLATION REPORT
23 January 2006	31 January 2006
23 February 2006	
23 March 2006	
27 April 2006	28 April 2006
25 May 2006	

20 June 2006	
20 July 2006	28 July 2006
24 August 2006	
26 September 2006	
19 October 2006	31 October 2006
23 November 2006	
21 December 2006	