No: 2010 - 12 **14 April 2010**

PRESS RELEASE OF THE CENTRAL BANK OF THE REPUBLIC OF TURKEY ON THE MONETARY POLICY EXIT STRATEGY

1. Recently, one of the most discussed issues in monetary policies is “exit strategies”, which include withdrawing measures taken during the global crisis and normalization operations of monetary policies. In fact, for some time the general public has also started to discuss the exit strategies that will be carried out by the Central Bank of the Republic of Turkey (Central Bank). Due to the importance attached to transparency and predictability, the Central Bank has decided to inform the public about the general framework of its exit strategy before starting to implement it.

2. The global economy experienced the deepest crisis since the Great Depression in 1929. However, the very courageous, decisive and effective measures taken by central banks in a coordinated way reduced the destructive effects of the crisis and shortened the exit duration from the crisis. During the crisis, especially the central banks of developed countries provided extraordinary levels of liquidity to the markets and all kind of monetary policy tools were used courageously, without hesitation about risks of deterioration of their balance sheets. Due to the financial support programs implemented during the crisis period, government budget deficits also reached very high levels. However, implementing unusually loose monetary policies and expansionary fiscal policies for an extended period, on the one hand, may cause new potential economic imbalances, on the other hand increases the risk of inflation, which might be very costly to control in the future.

3. Indeed, many central banks have been working on exit strategies for a long time as the adverse effects of the crisis diminish and the signals of economic recovery strengthen, and they have been preparing the markets for the normalization process. Of course, each central bank will form its own exit strategy according to their country specific conditions, such as improvements in their financial markets, economic recovery and inflationary pressure. Turkey, with both a very strong and well-regulated banking system and a flexible and effective liquidity management framework suitable for every condition, formed with the experience gained from several crises, was fairly well prepared for the global crisis period. These conditions have reduced the need for the

Central Bank to take additional radical measures and the structure of the Central Bank's balance sheet was not damaged during the crisis period. Therefore, the Central Bank's exit strategy from the crisis period will be more simple and easier than that of other central banks'.

4. As the crisis began to deepen in October 2008, the Central Bank established a strong line of communication with the public about details of the existing liquidity management strategy and its robust structure, and the liquidity facilities to be provided were outlined step by step, in a clear and transparent way. Subsequently, the announced measures for both Turkish lira and foreign exchange markets have gradually been introduced, and tensions and volatilities in the markets have been reduced considerably.

Measures and Exit Strategy for Foreign Exchange Markets

5. The Central Bank has taken the following measures related to the foreign exchange markets and the foreign exchange liquidity of the banking system during the crisis:

- **a.** Foreign exchange buying auctions were suspended starting from 16 October 2008, providing the liquidity, which has been permanently withdrawn from the foreign exchange market through foreign exchange buying auctions, to be kept in the system.
- **b.** As unhealthy price formations were witnessed in the foreign exchange market due to a decrease in the depth of the market, USD 100 million in total was sold to the market through foreign exchange selling auctions on 24 October 2008 and 27 October 2008.
- **c.** In October 2008, the Central Bank resumed its intermediary functions related to foreign exchange deposits and gradually increased the transaction limits of banks in the Foreign Exchange Deposit Market to USD 10.8 billion. Moreover, the maturity of foreign exchange deposits borrowed within the predetermined borrowing limits by the banks from the Foreign Exchange Deposit Markets was extended from 1 week to 1 month, and the borrowing rate for transactions where the Central Bank is a counterparty was reduced from 10.0 percent to 7.0 percent for US Dollar, and 9.0 percent for Euro. In February 2009, the maturity of the foreign exchange deposits have been extended from a maximum of 1 month to 3 months and the foreign exchange deposit rate, for transactions in which the

Central Bank is a counterparty, was reduced to 5.5 percent for US Dollar and to 6.5 percent for Euro.

d. On 5 December 2008, the FX required reserves ratio, which was 11.0 percent, was reduced by 2.0 percentage points, providing the banking system with an additional foreign currency liquidity amounting to approximately USD 2.5 billion. In addition, with the new measures that have been taken related to export rediscount credits, the limit for export rediscount credits has been increased and the utilization of these credits has been eased.

e. As the depth of the foreign exchange market decreased and unhealthy price formations were witnessed, foreign exchange selling auctions have been resumed as of 10 March 2009 to ensure smooth operation of the foreign exchange market through supporting foreign exchange liquidity. 900 million US dollar was sold through foreign exchange selling auctions.

6. With the diminishing effects of the global crisis, some of the measures related to the foreign exchange market have already been removed. The foreign exchange selling auctions were suspended on 2 April 2009, as concerns pertaining to the depth of the foreign exchange market have been eased with the effect of favorable developments in the global markets. The foreign exchange buying auctions aimed at reserve accumulation, which were suspended during the crisis period, were resumed as of 4 August 2009 as the risk appetite regained strength with positive expectations related to the global economy and the foreign exchange market has become relatively stabilized.

7. A significant part of the foreign exchange liquidity measures implemented during the crisis by the Central Bank are still in effect. Even though the foreign exchange liquidity of the banking system has been strong, the facilities provided by the Foreign Exchange Deposit Market within the Central Bank eased concerns during the crisis period and also facilitated the foreign borrowing transactions of the system, by providing an important safeguard to the banking system. The Central Bank is the lender of last resort for Turkish lira and has broad flexibilities related to Turkish lira liquidity management, however the Central Bank is not naturally the lender of last resort for other currencies. For this reason, the banking system has to be much more discreet and prudent in its management of foreign exchange liquidity. The facilities provided by the Central Bank during the crisis should not result in complacency and the banking system should carry on with effective foreign exchange liquidity management. Therefore, in the upcoming period, as normalization in the global markets becomes significant, it is planned that measures related to foreign exchange liquidity will gradually be taken to pre-crisis levels, in an orderly manner.

8. Even the Central Bank's exit strategy related to foreign exchange liquidity may change as needs arise, it is foreseen to be as follows:

   a. The FX required reserves ratio may gradually be increased in a measured pace.

   b. Considering developments in global interest rates, foreign exchange deposit lending rates announced by the Central Bank may be increased.

   c. After the effects of the developed countries' exit strategies are monitored, the intermediary function of the Central Bank in the foreign exchange deposit market will be abolished. However, banks will be able to borrow foreign exchange deposits from the Central Bank within the predetermined borrowing limits. The maturity of the foreign exchange deposits borrowed within the predetermined borrowing limits by banks from the Central Bank will be decreased from 3 months to 1 week.

9. On the other hand, even if no change is considered in the current circumstances, the limits and conditions for export rediscount credits, that are provided to exporters by the Central Bank through Eximbank, may be revised gradually in case the need for credits disappear and utilization decreases.

Measures and Exit Strategy for Turkish Lira Markets

10. While evaluating the exit strategy for Turkish lira operations, the nature and purpose of the Central Bank's monetary measures, which have been implemented since the deepening of the global crisis period, should be properly understood. Monetary measures implemented during crisis could be classified into three main groups:

   a. The first pillar of monetary measures was the arrangements to eliminate the uncertainties in money markets caused by the crisis. Within this framework;

      i. In October and November 2008, in order to reduce the potential volatility in overnight interest rates, the corridor of the Central Bank's borrowing and lending interest rates was reduced from 3.5 points to 2.5 points.

      ii. After October 2008, to reduce the potential tension in money markets and to eliminate the volatility in overnight interest rates, the Central Bank started to inject more liquidity than needed. The excess liquidity created within this context was sterilized by O/N operations at the end of the day.

b. The second pillar of monetary measures was the arrangements to support the credit markets by taking the permanent decrease in liquidity levels into account. Within this framework;

i. On 19 June 2009 in response to the increasing liquidity shortage in the market and the possibility that the shortage may become permanent, the Central Bank started 3-month repo auctions.

ii. As the permanence of the liquidity shortage in the market became more evident, on 16 October 2009, in order to support the credit mechanism, the Turkish lira required reserve ratio was reduced from 6 percent to 5 percent.

c. The third and last pillar of the monetary measures is monetary policy decisions. After the crisis began to deepen, as it was predicted that the inflation rate would decline dramatically, after November 2008 the Central Bank policy interest rates were sharply reduced and the Central Bank's borrowing rate was cut from 16.75 percent to 6.50 percent.

11. Also, independent of these measures, due to the technical reasons announced at the release of the "Monetary and Exchange Rate Policy for 2010", dated 10 December 2009, the Central Bank started to purchase government securities from the secondary markets as of 23 December 2009. Although the outright purchase of government securities coincides with the crisis period, it has no direct relationship with the crisis. Hence, the outright purchase of government securities should be considered out of the scope of the exit strategy. In this respect, the outright purchase of government securities will continue in the framework of the previously announced program.

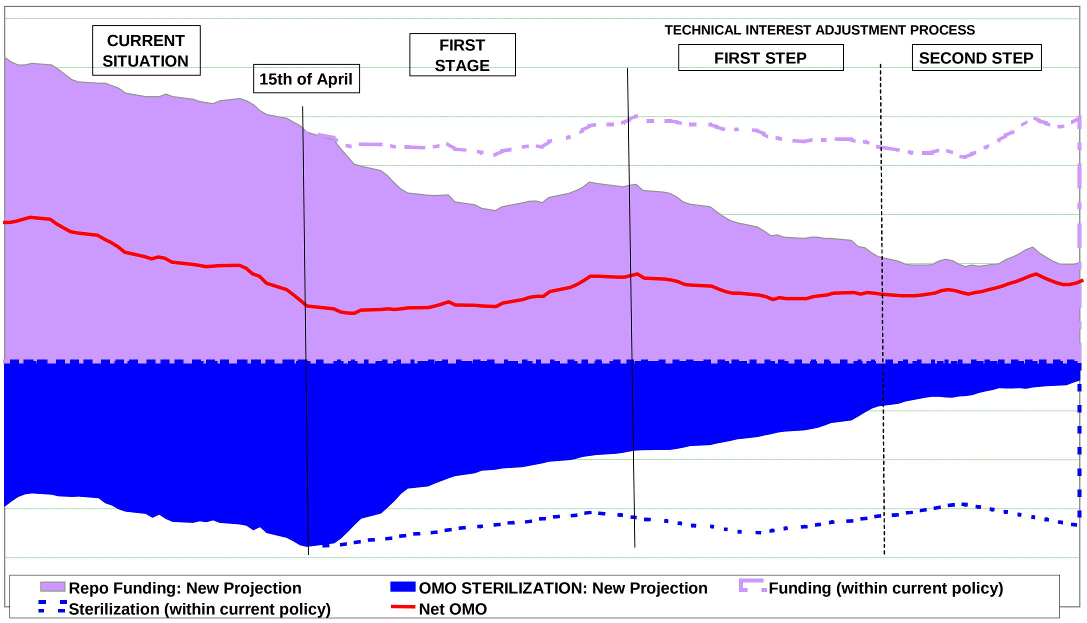
12. In the formulation of exit strategies, accurate understanding of the nature of the measures taken during the crisis is important. Some of the measures regarding the Turkish lira markets aim to eliminate the temporary risks of the crisis and others reflect the permanent changes emerged with the impact of the crisis. Overfunding of the markets is an application regarding direct crisis management to prevent fluctuations in interest rates. Therefore, this issue takes priority within the context of exit strategy. On the other hand, in the coming period it is foreseen that, the liquidity shortage in the market will continue and the conditions for technical interest rate adjustment mentioned in the release of the "Monetary and Exchange Rate Policy for 2010" dated 10 December 2009, will arise.

13. Considering the allocation of liquidity within the system in order to prepare the banking sector for technical rate adjustment, in order to reduce possible fluctuations in the money markets and to maintain liquidity management flexibility against unforeseen liquidity developments, the Central Bank decided to keep the integrity of both reducing overfunding in the context of the exit strategy and technical interest rate adjustment operations and to adopt a gradual strategy.

14. In the first stage, the amount of liquidity that has been provided as a part of the overfunding policy will be reduced gradually (Graph 1). In this process, the Central Bank will begin to determine the amount of funding via repo auctions in such a way that, at the end of the day there will remain less excess liquidity, so the amount withdrawn in Repo and Reverse Repo Market of ISE and Interbank Money Market within the Central Bank will lessen. In this period:

- **a.** As in the current situation, it will be paid attention on to keep the overnight interest rates about the announced borrowing rate.
- **b.** The overnight borrowing rate announced by the Central Bank will continue to be the reference rate of the monetary policy.
- **c.** The gradual decline in overfunding may cause quite a limited rise in weekly repo auction interest rates.

Graph 1: Illustration – Liquidity Shortage and Central Bank Operations in Exit Process



15. In case liquidity shortage evolves in line with expectations, in the second stage, the technical interest rate adjustment process will become operative. As stated in article 62 of the Central Bank's announcement published on 10 December 2009 (Monetary Policy and Exchange Rate Policy For 2010);

> "…In such a case, (as a permanent liquidity shortage emerges) the Central Bank, after considering the distribution of liquidity within the system, may opt for the one-week maturity repo auction rate to be the monetary policy reference interest rate and to adjust the overnight lending and borrowing interest rates downward in order to facilitate this. As elaborated below, a technical interest rate cut will merely imply a technical arrangement to facilitate a change in operational structure due to the permanent change in liquidity conditions where short-term interest rates are maintained at current level. Thus it shall not in any way imply the easing of monetary policy."

In article 68 of the same announcement, it is specified that;

> "…The Central Bank will also continue its practices to enhance the effectiveness of monetary policy and liquidity management in 2010. Accordingly, the Central Bank may change not only its liquidity management strategy, but also the overnight borrowing and lending interest rate margins when necessary."

In this respect, the change in the operational structure of liquidity management will not be in the form of a one time interest rate cut as mentioned in the announcement published on 10 December 2009. However, in order to maintain the flexibility of liquidity management against unexpected liquidity developments and not to create volatility in money markets, it is planned to be carried out in two steps.

16. Thus;

- **a.** In the first step (Graph 2);
  - **i.** The Central Bank's borrowing and lending interest rates for overnight transactions will not be changed. However, the one-week repo auction procedure will be subject to change by implementing amount auction procedure via fixed interest rate instead of the traditional auction procedure.
  - **ii.** In this step, the fixed interest rate for one-week repo auctions will be determined by adding 50 basis points to the declared overnight borrowing interest rate of the Central Bank. Therefore, the fixed interest rate for one-

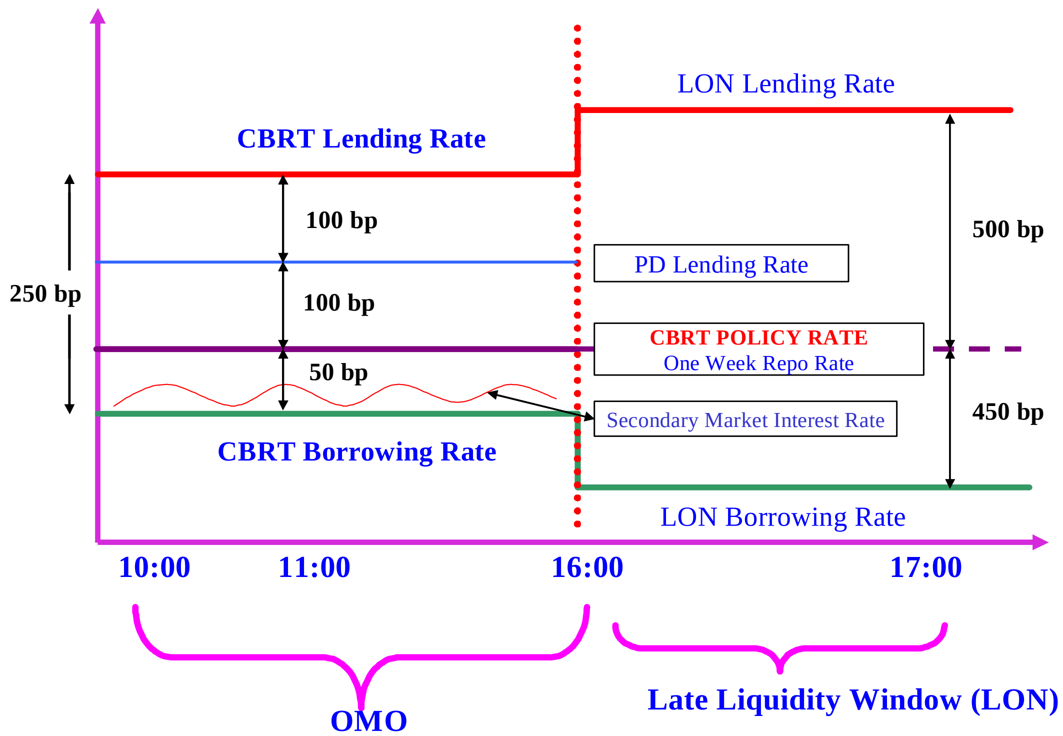
week repo transactions will become the reference (policy) interest rate of the monetary policy.

iii. For example, if the Central Bank's overnight borrowing interest rate is 6.5 percent and the lending interest rate is 9.0 percent on the date of this arrangement, while the Central Bank's overnight borrowing and lending rates will be kept at 6.5 and 9.0 percent respectively, the interest rate of one-week repo auctions will be determined as 7.0 percent, founded by adding 50 basis points to the overnight borrowing interest rate.

iv. Starting to use the one-week repo auction interest rate rather than the overnight borrowing interest rate, as the policy interest rate will not mean a change in monetary policy stance. Indeed, the one-week repo auction interest rates are already being formed above the announced borrowing rate for overnight transactions.

v. In this transition period, although in a relatively decreasing amount, the excess funding policy to the market will continue. While determining the funding amount through repo auctions, it will be considered that the overnight interest rates to be formed generally about the declared borrowing interest rate. In occasional cases of volatility, it will be paid attention that the overnight rates do not exceed the one week repo auction rate evidently.

Graph 2: Illustration – First Step of Technical Interest Rate Adjustment



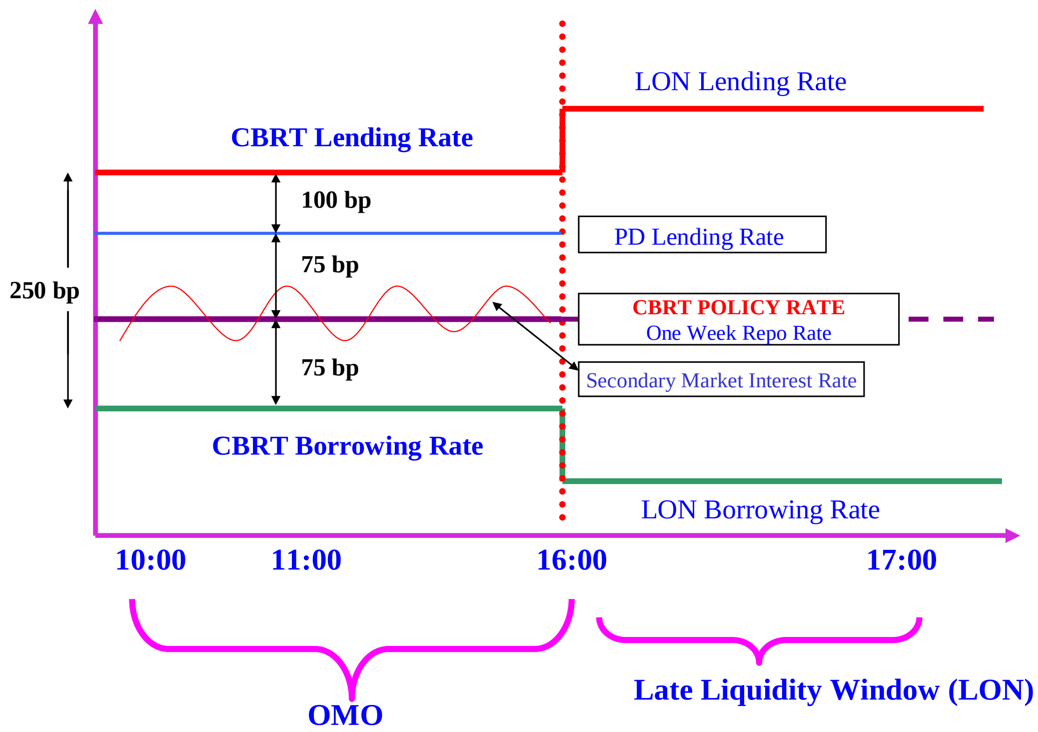
b. As the liquidity shortage increases in line with expectations, the second step of the technical interest rate adjustment process will become operational. In the second step (Graphics 3);

i. The difference between the one-week repo auction interest rate and the overnight borrowing interest rate may be increased. The secondary market average overnight interest rate will be targeted to be formed around the one week repo auction rate.

ii. The difference between the one-week repo auction interest rate and the overnight borrowing interest rate may be increased; either by raising the one-week repo auction interest rate if the Monetary Policy Committee (Committee) decides that monetary tightening is required, or by lowering the overnight borrowing and lending interest rates if the Committee decides not to make any change in the policy interest rate.

iii. In this term, the differences between the one-week repo auction interest rate and the overnight borrowing and lending interest rates may not always be symmetrical. The Committee will determine the difference between the borrowing and lending rates, and the difference between the said rates and the one-week repo auction rate as an element of the operational framework of monetary policy.

Graph 3: Illustration – Second Step of Technical Interest Rate Adjustment



17. Of the measures taken since the last quarter of 2008 such as the initiation of 3 month repo auctions and the reduction of the Turkish lira required reserves ratio aimed to support effective functioning of the credit mechanism. During the global crisis, all around the world capital flows slowed down due to weakening capital flows, thus a permanent liquidity shortage emerged in our country. As long as the liquidity shortage continues at high levels, although the amount may change depending on the liquidity level, three-month repo auctions will continue to be a regular funding instrument. However, as no change is foreseen currently, if the liquidity shortage decreases noticeably and/or credit conditions ease, the Turkish lira required reserve ratios may be increased as well.

18. Although the rapid interest rate cut decisions taken by the Central Bank aimed partly to eliminate the negative effects of the global crisis on the corporate sector and the tightening in monetary conditions, the decisions are fundamentally shaped by the inflation outlook and the decline in the risk premium of Turkey. In other words, the policy interest rate cuts reflect the adaptation process for interest rates to levels that are compatible with price stability. In the coming period, the short-term interest rates will be determined with a view to harmonizing the inflation outlook with the medium term inflation targets.

19. The main policy instrument of the Central Bank is the short-term interest rates. However, one of the lessons learned during the crisis is that other monetary policy instruments may be required to reduce the macroeconomic risks, especially when the economy is overheated. In this context, depending on future developments, – for example if the credit expansion speed exceeds desired levels – the required reserve ratios may be used more actively as a policy tool to reduce the macroeconomic risks.

20. As a result, some of the measures taken in the foreign exchange and Turkish lira markets during the crisis are planned to be withdrawn gradually. In this context, primarily the measures taken in direct crisis management will be withdrawn, and as in the rest of the world, in our country the exit strategy will be a cautious and gradual process that safeguards financial stability.

21. On the other hand, the release of the “Monetary and Exchange Rate Policy for 2010” dated 10 December 2009, continues to be the main policy document regarding exchange rate policy and liquidity management issues. Henceforth, regarding issues that are not clarified in this release, the statements in the release dated 10 December 2009 will continue to be valid.