Durmuş Yilmaz: Turkey's monetary and exchange rate policy for 2007

Speech by Mr Durmuş Yilmaz, Governor of the Central Bank of the Republic of Turkey, at the Central Bank of the Republic of Turkey, Istanbul, 13 December 2006.

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General framework of the monetary policy

A brief evaluation of the first year of the inflation targeting regime

The Central Bank of the Republic of Turkey (Central Bank) adopted the formal inflation-targeting regime at the turn of 2006, and since that time has implemented a policy consistent with the principles laid out in the policy statement entitled "General Framework of Inflation Targeting Regime And Monetary And Exchange Rate Policy for 2006" and released on 5th of December, 2006.

Four Inflation Reports have been published in 2006, in January, April, July and October. These reports have explicated the Central Bank's inflation forecasts and policy perspectives. The main messages of the reports have been shared with the public each time in by means of press conferences.

The Monetary Policy Committee (Committee) held regular meetings throughout 2006, in addition to the interim meetings held in June, in line with the pre-announced annual timetable to determine policy rates. Press releases explaining the rationale of decisions and the Committee's policy stance have been published along with interest rate decisions. Moreover, the summary reports of the Committee's discussions have been released within five working days following the meetings.

In the first year of the inflation-targeting regime, some supply-side shocks were experienced, which caused inflation to materialize above the path consistent with the target. The Central Bank explained the reasons of this deviation through open letters written to the Government, took the necessary measures to put inflation back on track consistent with the target and shared its evaluations pertaining to the timing of convergence to the target with the public in a transparent manner.

These implementations not only strengthened the communication framework of monetary policy, but also played an important role in shaping the expectations. Although the inflation rate has stabilized at around 10 percent-level for a long time due to the supply-side shocks experienced in 2006, the fact that the inflation expectations for the next 24 months is around 5.5 percent as of today is a clear evidence of the success achieved in the inflation-targeting. However, being ultimately focused on price stability, the Central Bank cannot be content with what has been achieved until medium-term expectations are consistent with the target.

As a result, important steps were taken in 2006 on the way to transparency, accountability and predictability, which are the main principles of the inflation-targeting regime. This press release aims to review the strategic as well as the operational framework of monetary policy in light of the first year's experience and to lay down the principles for 2007. In the first part of the text, the general framework of monetary policy will be presented, and in the second part exchange rate policy and liquidity management issues will be considered.

Inflation targets

Inflation targets will continue to be defined as the end-year rate of inflation calculated by the annual percentage change of the Consumer Price Index (CPI) in the upcoming period. In the press release regarding the monetary and exchange rate policy for 2006, the target horizon was set as three years and this time frame will be preserved for 2007. Taking into account the structural transformation of the economy, the transition from chronic high inflation to low inflation, and the process of convergence to the developed countries, a target of around 4 percent is considered appropriate for the medium-term. Therefore, inflation targets for 2007 and 2008, which were previously announced as 4 percent, are maintained and the inflation target for 2009, which was scheduled to be announced at the end of this year, has also been determined as 4 percent. As the structural transformation and convergence process is completed in time, it will be possible to target lower inflation rates.

Uncertainty band

In Article 42 of the CBRT Law it is stipulated that "The Bank shall submit information to the Government in writing and inform the public disclosing the reasons for the incapability to achieve the determined targets in due time published or the occurrence of the possibility of not achieving and the measures to be taken thereof". However, it does not specify the size of the deviation from the target that will require such an explanation. Therefore, in order to clarify this mechanism and facilitate its operation, the Central Bank has set a symmetrical uncertainty band of 2 percentage points in both directions around the point target.

It has been decided to keep the uncertainty band around the target at 2 percent for 2007 as well. The path consistent with the end-year target and the uncertainty bands defined for the end of each quarter of 2007 are shown in Table 1. In case the figures go outside the band, the Central Bank shall submit a separate report to the Government disclosing the reasons for the deviation and the measures to be taken for convergence to the target and share this report with the public. The path shown in Table 1 will also be used as performance criterion for the IMF reviews within the framework of the Stand-by program.

Table 1: Inflation path consistent with the end-year target and the uncertainty band

	March	June	September	December
Uncertainty Band (upper limit)	11,2	8,7	7,3	6,0
Path Consistent with the Target	**9,2**	**6,7**	**5,3**	**4,0**
Uncertainty Band (Lower Limit)	7,2	4,7	3,3	2,0

The difference between the targets and forecasts

In last year's policy statement regarding the general framework of the inflation-targeting regime, it was stated that the inflation target would only be changed in the event that sharp and long-term deviations from the target are expected or the medium-term targets no longer make sense due to factors beyond the control of monetary policy. It was also stated that temporary shocks would only change inflation forecasts rather than inflation targets and the points of reference to be used by economic agents would be inflation forecasts for the short-term and the inflation target for the medium-term. This policy approach was put into practice after the supply-side shocks of 2006. The inflation forecasts were updated in July and it was announced that inflation would stand well above the end-year inflation target; however, the target for end-2006 was not changed. Accordingly, the economic agents have taken the inflation forecasts announced by the Central Bank for end-2006 as a point of reference instead of the end-year inflation target for 2006. In fact, inflation expectations for end-2006 are in line with the Central Bank's forecasts.

It is not something exceptional for the countries implementing inflation-targeting regime to experience significant deviations from the inflation target. What matters most here is to be able to explain the reasons for the deviation, to take necessary measures to ensure that the target could be attained again and to inform the public of the convergence period. If the Central Bank had changed its inflation target for end-2006 as 10 percent, it would have achieved the end-year target and would not have been liable to be called to account to the public. However, instead of changing the target, the Central Bank preferred to render account to foster its communication policy. Within this framework, the Central Bank will inform the Government through a new open letter in January 2007 and explain the reasons for overshooting the end-year inflation target, in addition to sharing its projections pertaining to the convergence process with the public.

In conclusion, the Central Bank considers that frequent changes in targets are likely to have adverse effects on inflation expectations and pricing behaviors, which could damage the credibility of the future commitments. For this reason, it is important in the upcoming period that targets should be left intact as long as inflation is expected to converge to targets within a reasonable period of time.

Transmission mechanism and control horizon

Central banks in both developed and developing countries experience serious uncertainties regarding the lagged effects of monetary policy on inflation. Considering the fact that the relationship between macroeconomic variables changed remarkably along with the structural transformation in the economy after the 2001 crisis, it is assessed that the mentioned uncertainty in Turkey is at least as high as those in other countries.

However, in light of the recent normalization experience, it is possible to produce forecasts about the period required for monetary policy to influence inflation. The latest observations indicate that the period needed for monetary policy measures to affect domestic demand varies between 3 to 9 months, while the change in demand influences inflation in a period between 3 months and 1 year. This leads us to the conclusion that the impacts of monetary policy on inflation spread over a period of one and a half years on average.

In this context, taking into account the lagged impacts of monetary policy, the Central Bank defined the policy horizon as approximately one and a half years in the main policy statement published last year. Although it is forecasted that the impact of monetary policy on inflation will show itself in a more lagged manner and that the control horizon may be extended as the normalization process of the economy continues, the control horizon is maintained as one and a half years at this stage. There is no doubt that this period may be extended or shortened depending on the extent of shocks and the period needed for their influence to reflect on prices. The impacts of various shocks on inflation may differ according to time and period. As a consequence, the period required for inflation to converge to the target again will be announced after the occurrence of shocks and the determination of their sources, if there is a significant deviation from the target.

Forecast horizon

The forecasts presented in the Inflation Reports published throughout 2006, covered a period of one and a half years. From 2007 onwards, forecasts will refer to a two-years period. This change aims to help economic agents to predict the future better. Furthermore, forming a comparable forecast period with the results of the Expectations Survey will provide us with the opportunity to analyze and assess inflation forecasts more easily.[1]

Inflation forecasts and interest rate path

While producing inflation forecasts, one of the most critical questions to be answered is how the monetary policy is shaped over the forecast horizon. Country experiences reveal that there are many different approaches related to the presentation of forecasts and the method of signaling future monetary policy. Accordingly, central banks can be classified into three groups:

(i) Countries in which central banks produce inflation forecasts by considering their own potential policy responses: New Zealand, Norway, Canada, Sweden, Czech Republic, Turkey, Columbia, Peru, Rumania. In addition, these countries announce their forecasts on the interest rate path in verbal or numerical terms.

(ii) Countries where central banks employ the market expectations: European Union (European Central Bank), Chile, Brazil, Czech Republic, Sweden, and England. In this framework, the expected short-term interest rate path is calculated via the yield curve, expectations survey and other sources and inflation forecasts are published under the assumption that this path will materialize.

(iii) Countries in which central banks assume that interest rate will remain fixed over the forecast horizon: England, Brazil, Peru, and Australia.[2]

In recent years, both academic literature and current central banking implementations increasingly support the approach adopted by the first group, including Turkey for sharing the own expectations of the central banks about future monetary policy with the public corresponds to the transparency and

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[1] In the survey, the farthest period of time given for inflation expectations is 2 years.

[2] Some central banks follow more than one method while producing forecasts about interest rates. For instance, Bank of England is in both the second group (expectations for market interest rates) and third group (fixed interest rate).

predictability principles of inflation targeting. In this context, it is observed that more countries from second and third groups join the first group each year.

Monetary policy and interest rate risk

As mentioned above, the Central Bank shares its forecasts about monetary policy verbally with the public. When evaluating the inflation and monetary policy outlook, a particular question to be answered is raised: How should the policy perspective that will keep inflation close to the target in the medium-term (in a period of one and a half years to two years) be? The answers to this question as provided in the Inflation Reports published in 2006 were as follows:

- JANUARY 2006: "... a short-term interest rate path remaining constant for the first couple of months in 2006 and displaying a gradual decline thereafter..."
- APRIL 2006: "...where the Central Bank continues to cut policy rates gradually..."
- JULY 2006: "... in addition to the measures of June, the Central Bank will implement measured monetary tightening in the rest of 2006 and cut policy rates gradually in 2007..."
- OCTOBER 2006: "under the scenario that the Central Bank maintains its tight stance until the last quarter of 2007 and cuts policy interest rates afterwards..."

As it is clearly seen above, as long as there was not a significant shock in the economy, the Central Bank acted in parallel to its earlier statements. However it had to revise its monetary policy stance after important shocks such as the market volatilities of May and June. It is more evident in light of these this example that, as it is frequently emphasized in our announcements, the interest rate path, which is used by the Central Bank in producing forecasts, should not be perceived as a commitment to be followed in every case. Hence, the interest rate risk should be assessed by considering the fact that the outlook presented in the Inflation Report is subject to change depending on the data flow, and thus, the policy perspective can be updated whenever necessary. Since the end of 2005, the Central Bank has repeatedly drawn attention to this matter via the Inflation Report and other policy documents.

Special CPI aggregates and core inflation

Instead of considering a single so-called core indicator, the Central Bank uses more than one indicator in the differentiation of various exogenous shocks. Thus, depending on the source of shocks, different indicators may stand out from time to time. For instance, the index that excludes the energy item in a period where oil prices display high increases or the index that excludes the unprocessed food group in a period where agricultural prices fluctuate excessively may contain more comprehensive information in order to achieve a better understanding of the main inflation trend.

Special CPI aggregates produced will continue to be a part of the forward-looking inflation analysis and the communication policy of the Central Bank. As of 2005, TURKSTAT started to publish 7 special CPI aggregates and beginning from September 2006 the H index composed by excluding energy, alcoholic beverages-tobacco, unprocessed food, and gold has started to be published. Currently, even though the H index seems to be relatively in the forefront, it should be kept in mind that this index is sensitive to developments in FX rates and it could provide incomplete information in periods when FX rates are highly volatile. In such periods it would be appropriate to support the data from the H index with other indexes that have low FX rate pass-through (for example; evaluating them with service prices inflation).

Hence, the Central Bank will not use only one indicator to assess the main trend in inflation and will openly inform the public of the type of the 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 the SCA can be updated.

Public sector's role in the inflation targeting regime

In the inflation-targeting regime, developments in the public sector are a matter of concern from the monetary policy perspective. The CBRT certainly cannot control polices implemented by the public sector. However, the fact that the size of the public sector relative to the economy is still large makes it necessary to closely monitor the developments in this area. In accordance with its law, a central bank, which focuses on price stability, has to monitor developments in budget and fiscal policy and has to react to the possible repercussions of these policies on inflation.

Policies of the public sector have the potential to affect the inflation outlook through various channels. The first channel comprises 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 risk premiums and the volatilities in risk premiums and facilitate the management of inflation expectations.

Pricing behavior of goods and services produced or controlled by the public sector itself or the indirect taxation channel has a direct effect on inflation. In this framework, pricing goods and services produced by the public sector rationally and enhancing the quality of fiscal discipline is crucial in terms of the predictability of inflation.

Another channel, which affects inflation and inflation expectations, is the incomes policy of the public sector. One of the main determinants of expectations for price and wage inflation in Turkey is the increase in wages made by the public sector to its own employees. Wage increases in the public sector may set a precedent for the private sector. In this context, the consistent trend of the incomes policy with the inflation target is significant in terms of achieving the inflation-targets more easily and quickly.

One of the main components of total demand is the public sector's direct purchase of goods and services. Therefore, while evaluating developments regarding the inflation outlook, the Central Bank carefully monitors public expenditures as well.

The Central Bank takes into consideration the budget projections while setting the inflation targets and the monetary policy perspective and hence, makes various assumptions regarding the channels mentioned above. In case of an unpredicted development in one of the channels, the policy stance needs to be updated.

Monetary Policy Committee meetings and the decision-making process

The Monetary Policy Committee will continue to meet once a month in the upcoming period as it has done since 2001 and as stipulated by Central Bank Law. The meeting will continue to be held in two sessions. The first session will start at 1:00 pm and will host the Central Bank authorities and specialists as well as authorities from the Undersecretariat of Treasury. In this session, the related bodies of the Central Bank will present their reports on evaluations about economic developments and inflation outlook to the Monetary Policy Committee. At the same time, the authorities from the Undersecretariat of Treasury will present their evaluations on the developments in debt management and fiscal policy to the Committee. In the second session, the Committee members will make the final evaluations about the outlook and the decision will be put to a vote. After making a decision, members of the 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 before 7:00 pm on the same day, and it will also be posted on the website of the Bank. A significant change in the upcoming period is that the Turkish version and the English translation of the decision will be published on the same day.

Other policy statements and important dates

The Central Bank will continue to publish main policy statements regularly in 2007 as well. Within this framework:

- The *Inflation Report* will continue to be published quarterly.
- The *Financial Stability Report* will be published twice a year on previously announced dates.
- The statement entitled *Summary of the Monetary Policy Committee Discussions* will be published within *8 working days* following the meeting with the title *Summary of the Monetary Policy Committee Meeting,* alongside its English translation.
- As of July 2006 the "*Price Developments"* report started to be published to provide an accurate understanding of inflation data. This report will be published within *2 working days* following the announcement of inflation data.

- Besides all these statements, presentations and speeches made by the Governor and the Committee members will be shared with the public from time to time.
- Moreover, the research papers, booklets, and technical notes published by the Central Bank and organized conferences will continue to be a part of the communication policy.

The publication calendar for the Inflation Report and the Financial Stability Report along with the Monetary Policy Committee Meeting dates are presented in the Appendix. Meeting dates have been determined by taking into account such factors as official holidays, national and religious festivals, and the data flow calendar.

Exchange rate policy and foreign exchange buying auctions

Along with inflation targeting, the Central Bank will continue to implement a floating exchange rate regime in the upcoming period. In the floating exchange rate regime the FX rate is neither a target, nor a policy tool. The only variable that the Central Bank sets as target is inflation and the main policy tool to achieve this target is short-term interest rates. Therefore, the Central Bank targeting a variable such as FX rate, growth or current account deficit is out of the question.

The Central Bank shares with the public the general framework of the current exchange rate policy and FX buying auctions in the press releases it has issued each year since the start of 2002. As also stated in these press releases;

(i) In the current floating exchange rate regime, exchange rates are determined by supply and demand conditions in the market and the Central Bank does not have any exchange rate target.

(ii) Since there is no exchange rate level to maintain in countries with floating exchange rate regimes, the level of foreign currency reserves is much less significant compared to countries with fixed or flexible exchange rate regimes. However, especially in emerging economies such as Turkey, a strong FX reserves position is significant in removing the unfavorable effects of potential internal and external shocks and boosting confidence in the country's economy. In addition, taking into account the foreign debt payments of the Treasury and the need to gradually reduce the number of high-cost remittance accounts in the long-term, which are peculiar to Turkey and make up a significant part of the liabilities side of the Central Bank's balance sheet, the Central Bank holds foreign exchange buying auctions to build up reserves at times where foreign exchange supply constantly increases compared to foreign exchange demand.

(iii) 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. Despite some deviations from this main tendency due to exogenous shocks and changes in risk perceptions, decisive implementation of economic program has always enabled a return to the main tendency. This process, combined with favorable developments in the balance of payments, has supported the increase in foreign exchange supply in the economy.

(iv) In this framework, in order to minimize the impact on supply and demand conditions in the foreign exchange market, the Central Bank, which follows a moderate reserve-raising policy, has conducted its FX buying via auctions, whose terms and conditions are announced with due notice, since 1 April 2002. Moreover, the Bank has announced annual auction programs since 2005 and does not make any amendments to these programs, unless extraordinary differences are observed in foreign exchange liquidity.

(v) Meanwhile, as also emphasized in all its press releases, the Central Bank will continue to closely monitor the volatility in exchange rates and may directly intervene in the markets in the event of excessive volatility that might occur in either direction. These volatility interventions are not only carried out by considering past data with a mechanical rule, but by evaluating all aspects of realized and potential volatilities.

In the press release referred to as "The General Framework of Inflation Targeting Regime and Monetary and Exchange Rate Policy for 2006" dated 5 December 2005, the annual auction program for 2006 was announced in consistence with the aforementioned general framework. The maximum daily amount that can be bought was determined as USD 60 million, with USD 20 million of auction amount and USD 40 million of optional selling amount (200 % of the total amount sold), to be effective as of the 2nd of January 2006.

However, in line with the decline in foreign exchange supply due to global liquidity conditions, the depth of the foreign exchange market was lost and volatilities were observed in exchange rates. Therefore, the Bank decided to suspend daily FX buying auctions for a certain period of time, starting from the 16th of May 2006.

Moreover, as a response to the excessive volatility in exchange rates observed in 2006, the Central Bank directly intervened in the market via one FX buying intervention and three FX selling interventions. These interventions were as follows:

(i) Following the increase in foreign exchange sales due to developments in international markets, the Central Bank decided to directly intervene in the market by buying a total amount of USD 5.4 billion foreign currency on 15 February 2006, in order to prevent actual and expected excessive volatilities.

(ii) On 13 June 2006 and 23 June 2006, the Central Bank decided to directly intervene in the market by selling foreign currency in order to prevent the excessive volatility observed in line with the liquidity shortage in the foreign currency market due to global liquidity conditions. Total amounts sold were USD 0.5 billion and USD 0.8 billion, respectively.

(iii) In the Monetary Policy Committee meeting held on the 25th of June 2006 following the aforementioned interventions, it was stated that the liquidity shortage in the foreign currency market continued and once again underlined that an effective foreign currency market was a prerequisite for the price stability target. Thus, in order to provide foreign currency supply via its instruments and mechanisms, the Central Bank directly intervened in the market by selling an amount of USD 0.9 billion foreign currency on the 26th of June 2006. In addition to this intervention, two more FX selling auctions were held on the 26th and 27th of June 2006, in which a total amount of USD 1 billion foreign currency was sold.

Following the measures taken by the Central Bank against the volatility in financial markets in May and June 2006 and improved global liquidity conditions, the foreign exchange market has become relatively stable. For this reason, the Central Bank has decided to resume the foreign exchange buying auctions, which were suspended on the 16th of May 2006, as of the 10th of November 2006. Accordingly, the maximum daily amount to be purchased in the auctions has been set at USD 45 million, with USD 15 million for auction amount, and USD 30 million for optional selling amount (200 % of the total amount sold).

As of 12 December 2006, the total amount of foreign currency purchased via auctions and interventions is USD 9.4 billion, while the total amount sold is USD 3.1 billion for the whole of 2006. The total amounts of foreign currency purchased and sold by the Central Bank are shown year by year in the table below:

Table 2: The Central Bank’s net foreign exchange purchases and sales (2002-2006; million USD)

Year	FX Buying Auctions	FX Selling Auctions	FX Buying Interventions	FX Selling Interventions	Total Net FX Buying
2002	795	-	16	12	799
2003	5.652	-	4.229	-	9.881
2004	4.104	-	1.283	9	5.378
2005	7.442	-	14.565	-	22.007
2006*	3.961	1.000	5.441	2.105	6.297
Total	**21.954**	**1.000**	**25.534**	**2.126**	**44.362**

** As of 12 December 2006*

Unless extraordinary differences are observed in foreign exchange liquidity conditions, FX buying auctions will continue in 2007 in the framework of the aforementioned program. However, as was the case before, the Central Bank may, with prior notice, suspend the auctions temporarily for short or longer periods when the depth of the foreign exchange market is lost due to exogenous shocks or unforeseen extraordinary developments, and when the resulting excessive volatility and unhealthy price formation are observed in foreign exchange rates. On the other hand, the Central Bank will continue to closely monitor the volatility in exchange rates also in 2007 and will directly intervene in the market in the event of actual and potential excessive volatilities.

Banks will be able to borrow foreign exchange in terms of USD and euro from the Central Bank within the predetermined limits with a one-week maturity in the Foreign Exchange and Banknotes Market-Foreign Exchange Deposit Market in the upcoming period too. Moreover, the purchase/sale transactions 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.

In conclusion, as can be understood from the general framework and our exchange rate policy implementations described above, exchange rates are established by supply and demand conditions in the foreign exchange markets under the implementation of the floating foreign exchange regime. 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. 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 ensure the efficient management of this risk.

Liquidity management

Excess liquidity, which was created by the Central Bank’s purchases of government securities worth of YTL 14 billion from state-owned banks and banks transferred to the Savings Deposit Insurance Fund (SDIF) in order to meet their liquidity needs following the February 2001 crisis, as well as the intensive foreign exchange purchases during the 2003-2005 period, persisted in 2006.

The Central Bank, withdrew the excess liquidity in the market mainly via New Turkish Lira deposit operations in the Interbank Money Market within the CBRT and Repo transactions in the Repo and Reverse Repo Market of the Istanbul Stock Exchange, on an overnight basis. Accordingly, overnight interest rates were constantly realized around the borrowing rate of the Central Bank. Hence, the borrowing rate of the Central Bank has continued to be an indicator for money markets.

Based on the information currently available, the level of the liquidity in the market in 2007

(i) The increase in base money,

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

(iii) Treasury’s foreign exchange debt payments financed by its domestic currency borrowing

will have a lowering effect, while

(i) The Central Bank’s net foreign exchange purchases,

(ii) Interest payments to be made by the Central Bank for reserve requirements and for excess liquidity absorbing transactions,

(iii) The decline in Treasury cash accounts with the Central Bank will have an increasing effect on liquidity.

Based on the assumption that the foreign exchange payments of the Treasury would exceed the foreign exchange inflow, and by taking the Central Bank FX buying auction program into consideration, the excess liquidity in the market is expected to continue within reasonable limits in 2007, even though temporary liquidity shortages may occur. However, as in previous years, it is not possible to make a precise forecast regarding the net foreign exchange payments of the Treasury, the amount of the Central Bank’s foreign currency purchases and the balance of Treasury cash accounts with the Central Bank. Depending on the variations of these variables, the market liquidity may change significantly.

As long as the excess liquidity in the market remains at reasonable levels, as foreseen in the main scenario, the Central Bank will continue to withdraw the excess liquidity in the market, on an overnight basis, via New Turkish Lira deposit operations in the Interbank Money Market within the CBRT and Repo transactions in the Repo and Reverse Repo Market of Istanbul Stock Exchange. Accordingly, overnight interest rates will continue to realize at the level of the borrowing rate of the Central Bank. Thus, the overnight borrowing rate of the Central Bank will continue to be the benchmark interest rate with respect to monetary policy.

In case of a permanent liquidity shortage in the market, the benchmark short-term interest rate will be the average interest rate of the repo auction, not the daily borrowing interest rate of the Central Bank. Therefore, in case of liquidity shortage, the interest rate taken as a benchmark by the market would have become higher merely due to the decline in liquidity. In order to avoid any negative impacts, the Central Bank could revise its interest rates – provided that the inflation outlook is stable – so as to encounter the pressure created by the liquidity shortage. However, such an interest rate cut would only mean a technical arrangement stemming from the change in liquidity conditions. Therefore, such a move should not be perceived as a loosening or tightening of monetary policy.

Under the assumptions regarding liquidity stated above, the Central Bank's 2007 liquidity management strategy will be as follows:

(i) The Central Bank will continue to announce overnight borrowing and lending interest rates between 10:00-12:00 and 13:00-16:00 in the Interbank Money Market within the CBRT. In case of a liquidity shortage during the day, banks will be able to borrow at the Central Bank's lending rate against collateral within their limits. In the event of a fall in interest rates due to increasing liquidity, banks will be able to lend New Turkish Lira to the Central Bank at the Central Bank's borrowing rate.

(ii) The Central Bank will continue to provide the Late Liquidity Window Facility in the Interbank Money Market within the CBRT between 16:00-16:30 such that banks may borrow from or lend to the Central Bank against collateral without any limit.

(iii) In case of a temporary or permanent liquidity shortage, the Central Bank will continue to carry out liquidity management through one-week 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 - as long as no extraordinary fluctuations are observed in the market - will endeavor to maintain the average auction interest rate;

    a. At maximum of 1 percentage point above the O/N borrowing rate of the Central Bank announced for the intra-day transactions and to reduce fluctuations in O/N interest rates, in cases where the liquidity shortage in the market is envisaged temporary and when the technical interest rate cut explained in paragraph 48 is not applied,

    b. At approximately the mid point of the O/N borrowing and lending rates of the Central Bank, in cases where the liquidity shortage in the market is envisaged permanent and the technical interest rate cut explained in paragraph 48 is applied.

(iv) The weekly repo auctions will be executed at 11:00 and the results will be announced 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 interest rates.

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

(vi) The primary dealer banks will be able to conduct repo transactions within the framework of open market operations, between 10.00–12.00 and 13.00–16.00 hours.

(vii) In case of an excessive increase in the liquidity surplus or the emerge of extraordinary fluctuations in the market even at reasonable levels of excess liquidity, to enhance the effectiveness and flexibility of monetary policy and liquidity management strategy, in addition to YTL deposit buying auctions with standard maturities, reverse repo auctions and Central Bank liquidity bills with maturity up to 91 days may also be used actively. As a matter of fact, technical procedures regarding the issue of the said bills were completed by the Central

Bank, by “the Communiqué on Liquidity Bills” published in the Official Gazette, number 26310, dated 5th of October 2006.

(viii) Currently, depending on liquidity conditions, whether there will be standard one week or two weeks YTL deposit buying auctions will be held or not, if there will be an auction, the maximum amount to be drained through the auction is announced at 10.00 at Reuter’s CBTY page. In 2007, the Central Bank may hold New Turkish Lira deposit buying auctions with standard maturities of 1, 2 and 4 weeks and continue to announce the maturity and the maximum amount to be bought in the auction(s) on Reuters’ CBTY page. Starting from 2007 onwards, no announcement will be made on the said page on days when no auction is deemed necessary according to liquidity conditions. In case the issue of liquidity bills is deemed necessary, the method of issue of the said bills and other related information will be announced to the public in advance by a press release.

As always pointed out, the Central Bank deems the stability and development of financial markets as a supporting objective for the effective implementation of policies pertaining to price stability. As a matter of fact, compatible with the floating exchange rate regime, the Central Bank has taken measures towards maintaining financial stability several times in the last four years. Within this context, the Central Bank, the primary goal of which, entrusted to it by law, is to establish price stability, will continue its practices to enhance the effectiveness of the monetary policy and liquidity management, also in 2007. Accordingly, the Central Bank may change not only its liquidity management strategy, but also the borrowing and lending interest rate margins in cases of unpredictable changes in market conditions and according to the new needs.

Obviously, under the floating exchange rate regime, the Central Bank is able to implement the YTL 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 YTL liquidity needs of the banking system. The Central Bank can prevent excessive fluctuations in money market interest rates as long as they are consistent with the inflation target. However, it is worth mentioning once more that the banking system should not slacken risk management principles by simply relying on the more flexible and effective liquidity management of the Central Bank; to the contrary, it should use risk management principles effectively.

ANNEX: Calendar for 2007

MPC Meeting Dates	Inflation Report	Financial Stability Report
16 January, Tuesday	29 January, Monday	
15 February, Thursday		
15 March, Thursday		
18 April, Wednesday	27 April, Friday	
14 May, Monday		31 May, Thursday
14 June, Thursday		
12 July, Thursday	27 July, Friday	
14 August, Tuesday		
13 September, Thursday		
16 October, Tuesday	26 October, Friday	
14 November, Wednesday		30 November, Friday
13 December, Thursday		