

VAKIFBANK TURKISH ECONOMY WEEKLY

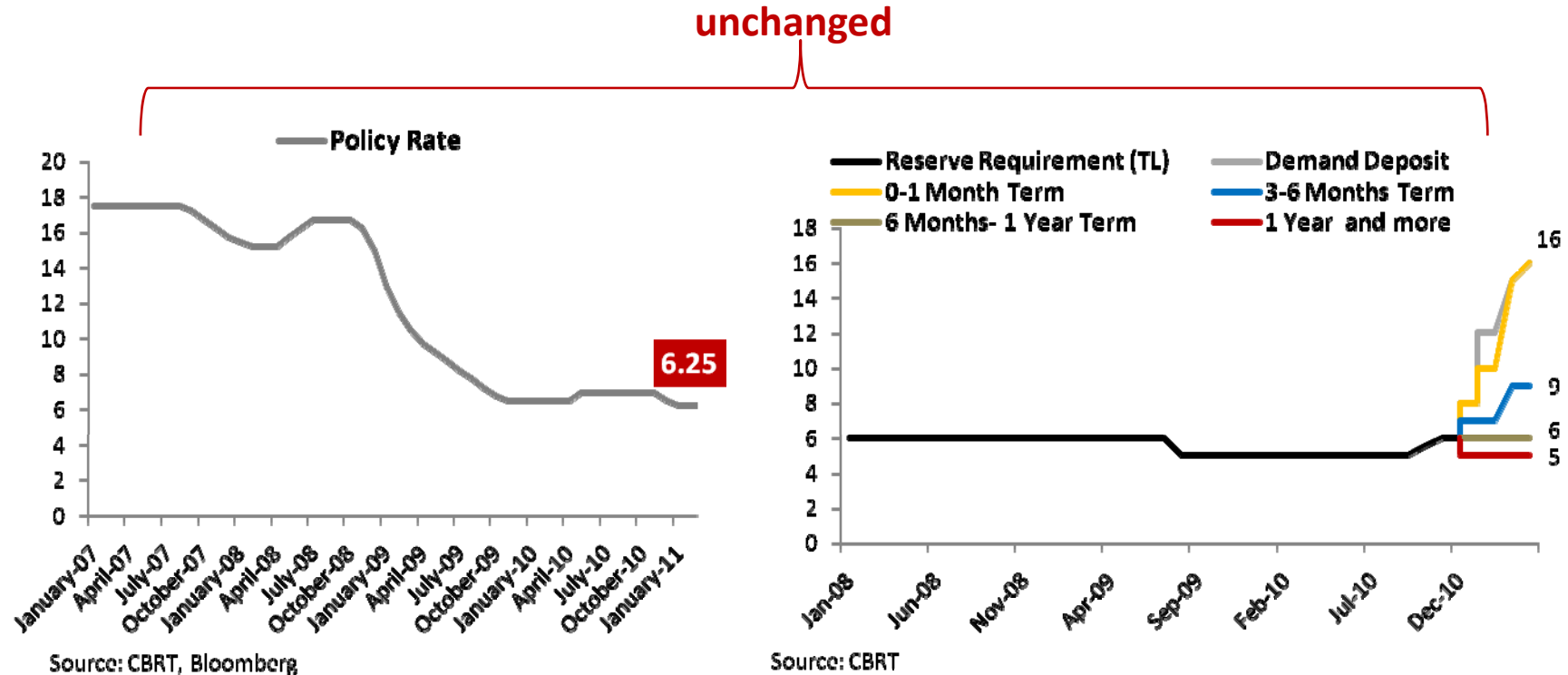
*CBRT left policy rate and RRR
unchanged...*



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In the last MPC meeting, CBRT kept its policy rate unchanged at 6.25% and did not change the lending and borrowing rates. Contrary to expectations CBRT also kept TL and FX RRRs constant with adopting a wait and see stance...



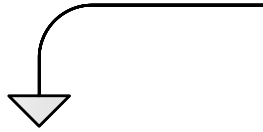
- After the sharp RRR increases in the recent months, CBRT made a moderate increase in RRR in April and left RRR unchanged in May to see the impact of tightening on credit growth. If the high credit growth continues in the forthcoming months, CBRT may start to implement conventional monetary policy in addition to RRR hike and may start to increase policy rate.
- We expect that CBRT will start rate hikes by 25 basis points in August or October by three times and policy rate will increase to 7% by the end of 2011. On the other hand, fiscal policies addition to conventional and non conventional monetary policies may be used to constrict credit growth in the near future.

The CBRT's leaving the RRRs unchanged signals that CBRT wants to follow 'a wait and see' approach to observe the impact of recent macro-prudential measures on credit growth and domestic demand. Using a policy mix of a lower policy rate coupled with higher reserve requirements, CRBT aims to preserve both financial and price stability. In this section the relationship between financial and price stability is analyzed. Moreover, short and long term effects of CBRT's last decisions are discussed.

The Relationship Between Monetary and Financial Stability...

-Related Literature

The relationship between monetary and financial stability has been continually discussed in the literature over the past few years. The question whether inflation targeting is consistent with financial stability has been analyzed in the literature and it is seen that there are two views that explain this relationship.



Traditional Hypothesis

The traditional view has claimed that the price stability contributes to financial stability.

Monetary policy that has a target of low and stable inflation will also tend to promote financial stability.

In contrast, when inflation is high the vulnerability of financial system tends to rise.

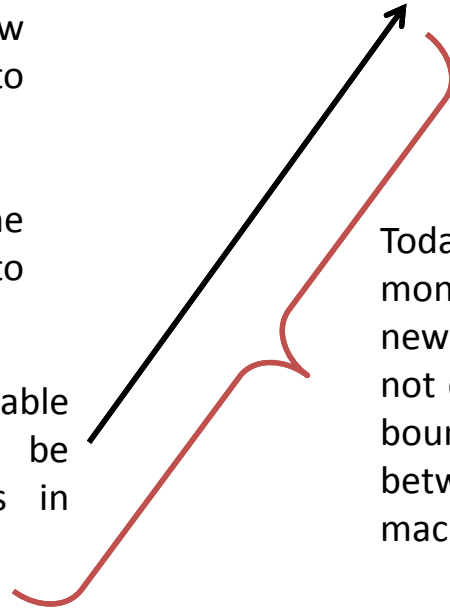
However, in an environment of stable prices, financial imbalances can be experienced like 1920 and 1990 crisis in America and late 1980 crisis in Japan.



New Environment Hypothesis

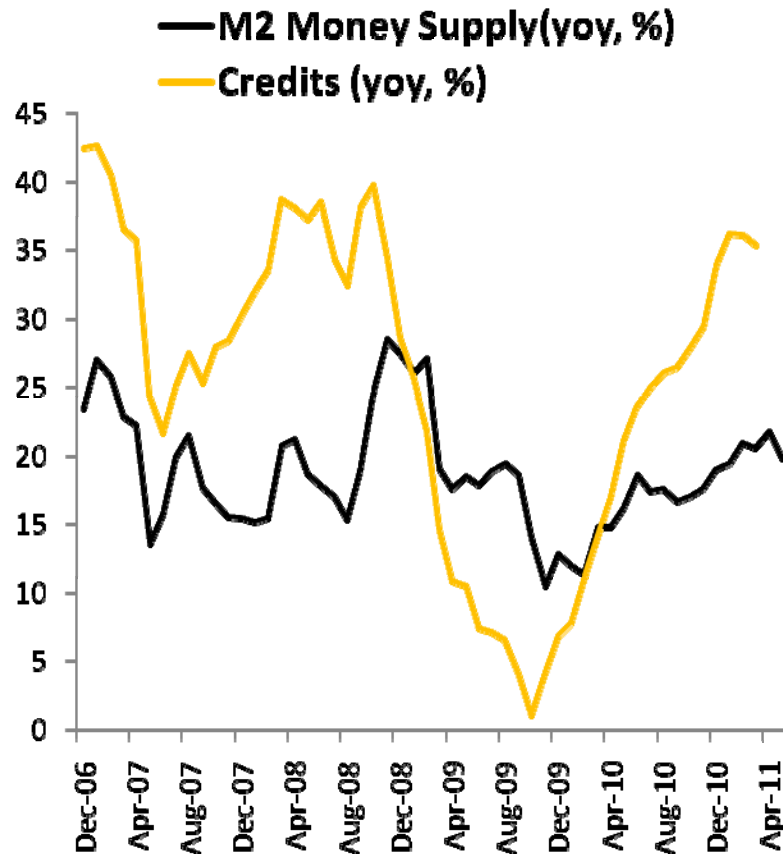
This signals that the price stability is necessary for financial stability but not sufficient. Financial instability has to be addressed directly as claimed in New Environment Hypothesis.

Today, in Turkey the relationship between monetary and financial stability is close to the new environment hypothesis. In other words, not only price and financial stability are tightly bound to each other but also the relationship between them depends on the macroeconomic conditions.



-The case of Turkey...

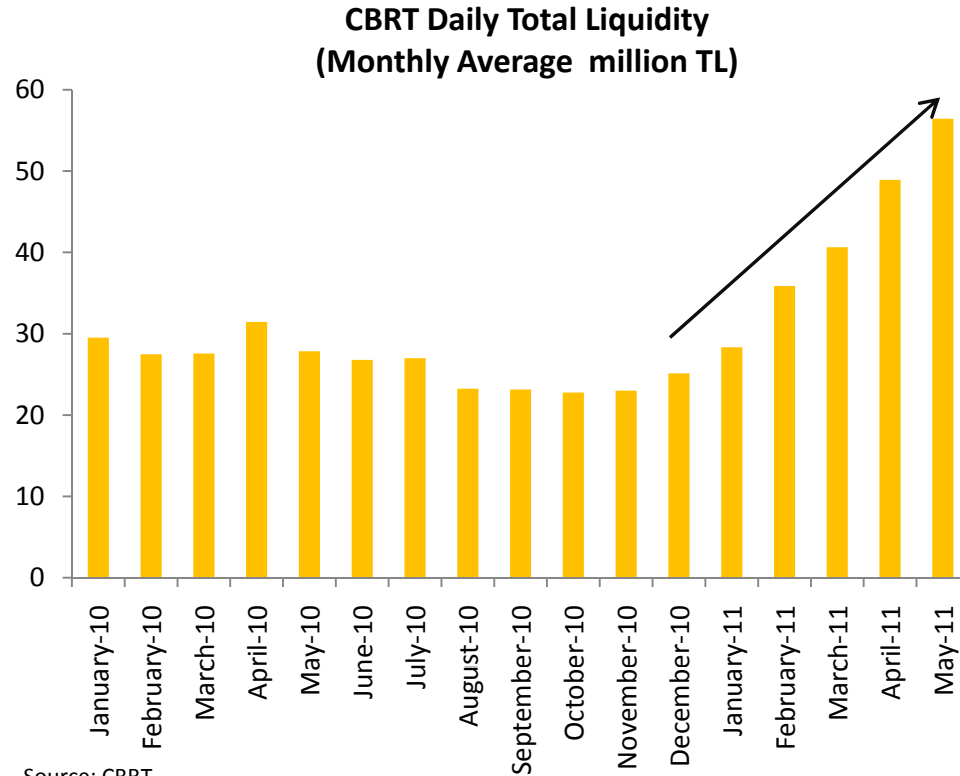
CBRT has followed the policy aims to preserve both financial stability and price stability



Source: CBRT, BRSA

- ✔ M2 money supply and credit growth have slowed down after the recent hikes in RRRs.
- ✔ While the policy measures can be effective in the short term, in long term they may lead to different results.
- ✔ Measures taken to decrease the credit growth and domestic demand, may result in an inefficient resource distribution in the long term.
- ✔ Moreover, the recent hikes in RRRs will change the amount and distribution of the liquidity in the market. This may lead to a wrong pricing in capital costs.

Monthly average of CBRT's daily total liquidity has continued to increase...



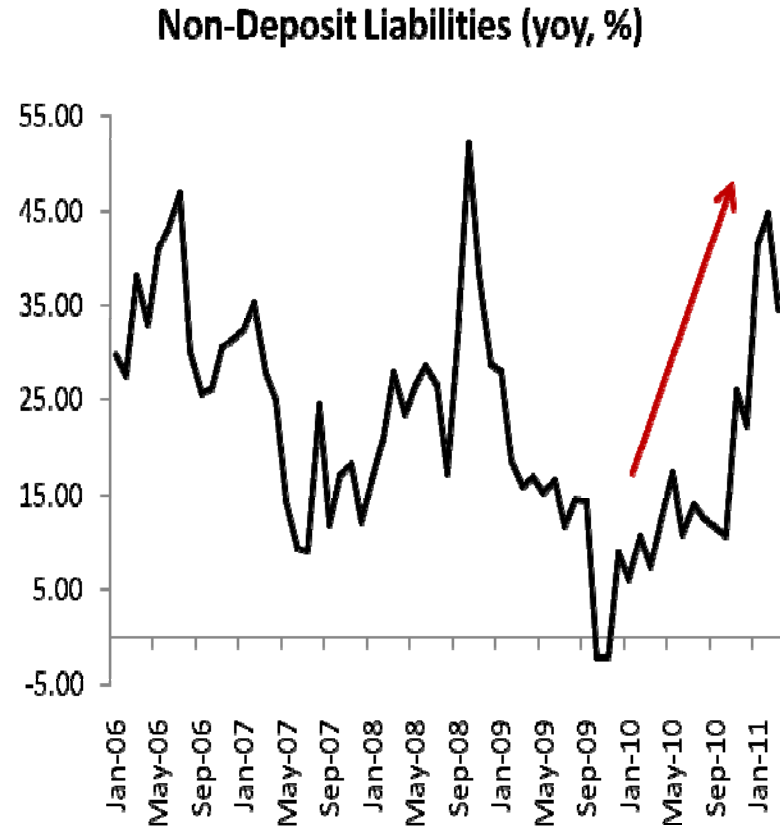
Source: CBRT

- With the aim of avoiding negative impacts of reserve requirement policy and to avoid upside risks in interest rates, CBRT has provided liquidity to the market.
- When monthly average of CBRT's daily total liquidity is analyzed (in the graph LHS), it is observed that the liquidity amount has started to increase since Q4 of 2010, so as to avoid banking sector's problems after RRR hikes.
- The liquidity which has started to increase after CBRT's reserve requirement rate diversification in terms of maturity for the first time in December 2010 MPC meeting, has continued its upward movement.

On the other hand, high current account deficit and possible volatility in global markets have seen as important risk factors for both price and financial stability. Moreover the upward movements in commodity prices has seen as an another risk factor for price stability as Turkey is an oil importer country.

High RRR's has prompted the banking sector to non-deposit liabilities...

- ✔ Due to high RRR's, Turkish Banking sector has to keep high amounts of deposits at Central Bank's accounts.
- ✔ This has restricted the credit growth and has prompted the banking sector to non-deposit liabilities.
- ✔ Although increasing rate of non-deposit liabilities in Turkish Banking Sector decreased in March 2011, it has been rising since November 2010.
- ✔ Usage of non-deposit liabilities especially through credits from abroad make the banking sector more fragile to the foreign shocks and crisis.



Source: BRSA

To sum up,

- *CBRT continues to follow “wait and see strategy” to see the impact of recent change in the policy mix on credit growth and domestic demand.*
- *It would be useful to continue to observe the lagged impacts of the measures taken. Especially the possible inconsistencies in the long term are the most important risks towards these measures.*
- *We expect that CBRT may start rate hikes by 25 basis points in August or October by three times and policy rate may increase to 7% by the end of 2011. On the other hand, fiscal policies addition to conventional and non conventional monetary policies may be used to constrict credit growth in the near future.*

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