
Effect of Central Bank's Short-Term Interest Rates in The Economy After 2008 Global Financial Crisis: The Case of Turkey

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Abstract

The Central Bank tries to influence the level of money supply and demand in the economy in order to achieve price stability, which is its main objective. It uses short-term interest rates as the main tool in order to affect the money supply and demand conditions. The changes in short-term interest rates used by the Central Bank in trading with commercial banks may affect the lending costs of banks. The Central Bank is the institution responsible for the implementation of monetary policy in our country. Central Bank of the Republic of Turkey, with the revised Central Bank Act in 2001, is assigned to take measures to stabilize the financial system in addition to the primary objective of price stability. Since 2006 Central Bank of the Republic of Turkey in line with its main aim of price stability, switched to an inflation targeting regime, began to use short-term interest rates as the main policy tool. With this study, the effects of the Central Bank's change in short-term interest rates on the economy after the 2008 global financial crisis, were tried to be explained.

Keywords: Central Bank of the Republic of Turkey, Primary Dealer Banks, Interest Rates.

Introduction

The global crisis that broke out in the US housing market in the summer of 2007, although initially emerged as a mortgage crisis, turned into a liquidity crisis in the process, advancing in
the real sector after the financial markets and also in countries and regions outside the developed capitalist countries. In order to take control of the crisis, trillions of funds and loans were put into the markets by Western states, especially the US (Bedirhanoglu, 2009: 1).

Financial markets are where the ones with fond surplus came face to face with the ones with funding gaps. Financial markets include money-foreign exchange markets, bond and bills markets and stock markets. Today; Money, foreign exchange, bond-bills and capital markets are intertwined and the mobilization started in the money markets is felt instantly in other markets as well. (Uzunoglu, 2014: 5). In Financial markets of Turkey, when financial intermediation institutions are mentioned, banks come to mind first. In addition to banks, brokerage houses and insurance companies have a significant share in the financial system. In particular, banks are organizations in the money market and thus in the capital market which trade money, capital, loans and assist in capital accumulation and transfer (Pala, 1993: 3). In 2008-2009, as well as all over the world in Turkey has experienced the effects of the global financial crisis severely. The negative effects of the global crisis started to be felt in the last quarter of 2008 on the Turkish economy. The effects of the global crisis were felt in the economy in the form of a decline in foreign demand, a decrease in international and domestic credits. Unlike the previous crises, the decrease in the demand for exported goods meant that global contraction of the economy, decrease in the global level of income and the decrease in demand. After the 2001 crisis, while the increase in exports was experienced, the decline in the current crisis and the search for new markets were observed (Özatay, 2009: 143). Many global credit institutions suffer from bankruptcy or high rates of damage because of the negative impacts of the global financial crisis, decrease in confidence in financial markets, increase in uncertainties, shift of international capital flows from periphery countries to core countries has occurred as a decline in external credit resources in countries like Turkey, especially in terms of banking sector and corporate sector benefited from foreign loans (Selçuk, 2010: 22). In the period following the global crisis, a decrease was expected in the corporate / commercial, SME and consumer loans given by the banking sector. The reasons for this situation are as follows; due to the uncertainty in the global financial system, financial sector’s desire to remain in the cash, increase in risks in companies and banking sector, rising credit costs and the decrease in foreign credit facilities, and an increase in non-performing loans. For these reasons, banks were reluctant to give credit. It is stated that corporate / commercial, SME and individual loan demands decreased as a result of their abstention from investment and consumption expenditures (BDDK, 2008:9-34). After the global crisis, foreign banks and other financial institutions which affected by the crisis in their native countries, limitedly experienced negativity in their Turkey branches due to after effects of global crises. It did not create any impacts on fragility in the banking and insurance sectors in which they were actively involved after 2001. While some foreign partners declare that they will sell minority shares, the branches of foreign banks in our country are not affected by the problems experienced in the native country due to the global crisis (Selçuk, 2010: 22). The two major impacts of the global crisis have been envisaged for the financial sector. The first is the substantial reduction of funds from international markets and the increase in costs; secondly, in a similar manner slowing down of Turkey's economy and therefore the Turkish finance sector due to recession on a global scale, particularly in Europe where the majority of the exports carried out (Selçuk, 2010: 26).

Central Bank of the Republic of Turkey and Primary Dealers

Central Bank of the Republic of Turkey is the institution responsible for the implementation of monetary policy in our country; it conducts policy with the Primary Dealers.
Fundamental Duties and Powers of the Central Bank of Turkey

According to the Central Bank Law, one of the Bank's main duties is "to ensure stability in the financial system and to take regulatory measures related to money and foreign exchange markets." The Central Bank of the Republic of Turkey (the Central Bank) was assigned with the task of taking the required measures to ensure stability in the financial system in addition to the primary objective of price stability in accordance with the Central Bank Law as amended in 2001.

In order to contain macro-financial risks driven by global imbalances, the Central Bank enhanced the inflation targeting regime and designed a new monetary policy strategy. According to this new framework, the Central Bank started to take macro-financial stability into account as much as economic conditions permit while preserving the primary objective of maintaining price stability. Within the framework of this new structure, the Central Bank designed a policy mix in which the interest rate corridor, which is formed between the overnight borrowing and lending rates, and required reserves are jointly employed besides the policy rate to ensure the diversity of instruments that is required by the monetary policy implemented to achieve multiple goals. (TCMB, 27 December 2011).

“The core duties and powers of the CBRT specified in the Law No. 1211 are as follows.
- to carry out open market operations,
- to take necessary measures in order to protect the domestic and international value of Turkish Lira and to establish the exchange rate policy in determining the parity of Turkish Lira against gold and foreign currencies jointly with the Government
- to determine the procedures and conditions of reserve requirements and liquidity requirement by taking into consideration the liabilities of banks and other financial institutions to be deemed appropriate by the Bank
- to conduct rediscount and advance transactions
- to manage the gold and foreign exchange reserves of the country
- to regulate the volume and circulation of Turkish Lira, to establish payment, securities transfer and settlement systems
- to take precautions for enhancing the stability in the financial system and to take regulatory measures with respect to money and foreign exchange markets
- to monitor the financial markets,
- to determine the terms and types of deposits in banks” (www.tcmb.gov.tr).

Fundamental Powers of the Central Bank of Turkey

CBT has the authority to issue banknotes in Turkey since the establishment of the Bank. The Bank shall determine the inflation target together with the Government and shall in compliance with the said target adopt the monetary policy. The Bank shall be the ultimate body authorized and responsible to implement the monetary policy. The Bank shall, with the objective to achieve and maintain price stability, be authorized to utilize monetary policy instruments described in the Law and shall also be authorized to directly determine and implement other monetary policy instruments that it deems appropriate. The Bank shall, as the lender of last resort, carry out the operations of extending credits to banks. The Bank shall, in accordance with the procedures and conditions that it shall determine, be authorized to request from banks, the interest rates to be charged in credit operations and deposit – taking.
**Governing Bodies of the Central Bank of Turkey**

Governing bodies of the Bank shall be as follows: General Assembly, Board, Monetary Policy Committee, Auditing Committee, Office of the Governor and Executive Committee.

Duties and powers of the Monetary Policy Committee are ([www.tcmb.gov.tr](http://www.tcmb.gov.tr));

a) To determine the principles and strategy of monetary policy in order to achieve and maintain price stability,
b) To determine the inflation target together with the Government within the framework of the monetary policy strategy,
c) To provide information to the public in line with the principles set forth, and provide information to the Government within specified periods by preparing reports regarding monetary policy targets and its implementations,
d) To take necessary measures in order to protect the domestic and international value of Turkish Lira and to establish the exchange rate policy in determining the parity of Turkish Lira against gold and foreign currencies jointly with the Government.

Monetary Policy Committee decisions are executed by the Governor and are provided to the Board.

In Turkey, monetary policy decisions are taken by the Monetary Policy Committee at prescheduled meetings. The decisions taken in relation to the interest rates in the Monetary Policy Committee meetings, together with the reasons, are explained on the same day of the meeting with the Central Bank web page.

**Primary Dealer Banks**

Primary Dealer Banks; are banks and other financial institutions that are selected according to certain criteria by treasury or central banks and performs financial transactions such as issuance of debt securities, foreign exchange intervention in order to increase efficiency in primary market transactions and facilitate the functioning of secondary markets.

The requirements for Primary Dealers are stated by the Treasury annually and a one-year contract is made with the banks providing the conditions. This agreement shall be signed with the banks that meet the criteria set forth in Articles 11 and 13 of the 'Primary Dealers Agreement', which regulates the rights, obligations and general principles that are provided to banks.

Primary Dealer Banks is a definitive buyer for the Treasury and investors who want to buy bonds in the secondary market; a definite buyer for investors who sell bonds and in the secondary market. The CBRT and the Undersecretariat of Treasury provide certain advantages to Primary Dealer Banks for these services. Primary Dealers can be a side on borrowing and lending at Government Domestic Debt Securities-DIBS market. (Piyasa Yapıcılığı Sözleşmesi, m. 5).

**The Reflection of the Change in the Central Bank's Short-Term Interest Rates on The Economy after the 2008 Global Financial Crisis**

The global financial crisis in the last quarter of 2008, which has an influence over all of the world, has brought unusual problems for both developed and developing countries. In this period, the monetary expansion policies implemented by the central banks of the developed countries had significant implications on the economies of developing countries which also includes Turkey. Risk appetite and volatility of short-term capital flows and increasing risks to financial stability have led central banks of developing countries to seek alternative policies.
As a result of these searches, the Central Bank reviewed the inflation targeting regime that it was implementing in the way that it was considering the financial stability at the end of 2010 and diversified the tool set. In addition to the short-term interest rates used as a policy instrument, the Bank began to use different complementary policy instruments such as reserve requirements, interest rate corridor, liquidity management and reserve option mechanism. With this, Bank aim to support financial stability without sacrificing price stability with these different monetary policy instruments (TCMB).

Monetary measures implemented by the Central Bank during crisis could be classified into three main groups: (TCMB, 14 April 2010):

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 was 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.

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.

Since the third quarter of 2009, the exit from the global economic crisis has begun largely. Extensive fiscal policies and economic measures have been effective in the exit from the crisis. The monetary and fiscal policies implemented in this period reduced the risk of international systemic crisis, provided the economic contraction to lose pace and alleviated the pressure on financial markets. The commonly used low interest rate policy accelerated global capital movements and positively affected the stock markets. (BDDK, 2009b: 1-7).

Turkey's economy is entering a phase of rapid growth driven by domestic demand since the middle of 2009, the recovery has been much slower at our main trading partners. Especially in 2010, this trend of short-term capital flows has become more evident. While capital inflows brought about excessive appreciation in the Turkish lira, it also accelerated domestic credit
usage. As a result of these developments, a serious deterioration in foreign trade and current account balance has been observed (Kara, 2012: 3).

The low interest rates on the global scale as well as the Central Bank's announcement to keep policy rates at low levels allowed market rates to fall and maintain to the historically lowest levels in 2010.

The monetary easing policies implemented by the central banks of advanced economies to mitigate the effects of the global financial crisis had notable effects on Turkey as they did on many emerging market economies. Availability of ample and low-cost short-term external financing led to a rapid credit growth and gradual appreciation of the Turkish lira in this period, paving the way for the accumulation of macro-financial risks and external imbalances as of the second half of 2010 (TCMB, 27 December 2011).

“In order to limit the accumulated macro financial imbalances, CBRT adopted two main targets: Reduce short-term capital inflows and slow down credit expansion. In order to ensure financial stability without compromising price stability, it was decided to use reserve requirements and interest rate corridor (difference between overnight lending and borrowing interest) as active monetary policy instruments in addition to policy rate”(Başçı ve Kara, 2011).

The difference between the overnight lending and borrowing interest (interest rate corridor) has been widened to create an operational framework that enables the volatility of short-term interest rates in the money market to be adjusted according to the conjuncture. Thus, it was aimed to deter short-term capital inflows by decreasing the average yield of short-term interest rates and increasing volatility.

The area between the interest rates that the CBRT can borrow from banks and lend money in the overnight term is called the, interest rate corridor (Kara, 2012, 8).

In addition, with “Monetary Policy Committee Decision” dated May 18, 2010, technical interest adjustment has been done by setting 1-week repo auction interest rate is determined as the policy rate (TCMB, 18 May 2010).

The interest rate corridor system has three different interest rates. The first is lending interest rate, which represents the interest rate that a bank that is in need of liquidity and accepts to pay when borrowing from the central bank, also defines the ceiling of interest rate corridor. The second is the borrowing interest rate -the bottom line of the interest rate corridor-, which represents the gain that a bank with a surplus of funds can obtain by depositing these funds to central bank. Besides, the policy interest rate that is between the borrowing and issuing interest rates and generally determined close to the middle point (symmetric) of the band is the third interest rate forming the interest rate corridor (Özatay, 2012, 9).

The developments in global monetary policies in the post-May 2013 period were the main determinants of the movements in financial markets. In this period, almost all financial assets were re-priced on a global scale and outflows were observed in portfolio flows towards developing countries. In this process, CBT implemented policies to limit negative effects of global volatility on Turkey's economy, by using actively the tools of 1-week interest rate, interest rate corridor, Turkish lira and foreign currency liquidity policies and required reserves. Implementation of a monetary policy framework combining wide interest rate corridor and tight liquidity policy by CBT, supported price stability and financial stability of Turkey’s economy by reducing its sensitivity to global shocks (TCMB, 2015, p.3).

The Monetary Policy Committee (the Committee) has decided to keep the short term interest rates at the following levels(TCMB, 20.12.2016):

a) Overnight Interest Rates: Marginal Funding Rate has been kept at 8.5 percent and borrowing rate has been kept at 7.25 percent,

b) One-week repo rate has been kept at 8 percent,
c) Late Liquidity Window Interest Rates (between 4:00 p.m. – 5:00 p.m.): Borrowing rate has been kept at 0 percent, and lending rate has been kept at 10 percent.

The volatility experienced in foreign exchange markets following the significant global and geopolitical shocks experienced in the second half of 2016 and its impact on the inflation outlook has been decisive in monetary policy decisions in early 2017. As exchange rate developments increased upside risks to inflation, the CBRT performed a strong monetary tightening in January to limit the deterioration in inflation outlook; increased lending rates both in overnight lending and under the Late Liquidity Window (LLW). In addition, the CBRT took some liquidity measures, in order to eliminate the negative effects that these developments may have on price stability and financial stability. In this context, one-week repo auctions were interrupted, the overnight funding amount was gradually reduced, and the system’s funding needs began to be provided from the LLW at an increasing extent. In addition, the CBRT took measures to provide flexibility in foreign exchange liquidity management. For this purpose, the CBRT lowered the required reserve ratios of foreign currencies and opened the Turkish Lira Deposits against Foreign Exchange Deposits Market (TCMB, 5 December 2017).

“The CBRT announced that the simplification process regarding the operational framework of the monetary policy would be completed as of 1 June 2018. Accordingly, the one-week repo rate was set as the Central Bank’s policy rate.

The Bank also decided that:

• Central Bank overnight borrowing and lending rates would be determined at 150 basis points below/above the one-week repo rate,

• Central Bank borrowing rate for Late Liquidity Window operations would be 0 percent whereas the lending rate for these operations would be determined by adding 150 basis points to the CBRT’s overnight lending rate.” (www.tcmb.gov.tr)

Gathered on September 13, 2018 The Monetary Policy Committee (the Committee) has decided to increase the policy rate (one week repo auction rate) from 17.75 percent to 24 percent. Thus, the 1-week lending rate was set at 24 percent. The Monetary Policy Committee (the Committee) decided to keep the one-week repo rate, which is the policy rate, at a level of 24 percent.

Conclusion

The Central Bank of the Republic of Turkey was assigned with the task of taking the required measures to ensure stability on money and foreign exchange markets and financial system in addition to the primary objective of price stability in accordance with the Central Bank Law No.1211 as amended in 2001.

After the global financial crisis in 2008, which has affected the whole world, the monetary expansion policies implemented by the central banks of the developed countries had significant implications for the economies of developing countries that include Turkey. With increased risk appetite, volatility of short-term capital flows and risks to financial stability, Central Bank has reviewed the inflation targeting regime it is implementing in a manner that also respects financial stability as of the end of 2010 and started to use different policy instruments that complement each other, such as reserve requirements, interest rate corridor, liquidity management and reserve option mechanism, as well as short-term interest rates. With these different monetary policy instruments, it aims to support financial stability without sacrificing price stability.

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