

# Chapter 6

## The Changing Role of the Central Bank of the Republic of Turkey and Its Financial Implications on Turkish Economy

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**Abstract** Central banks are extremely important institutions responsible from the coinage, monetary policy applications and healthy operations of the economies. The policies applied by Central Banks and their ongoing corporate structures cannot be disassociated from the political, social and the whole economic developments of the countries in which they are located. The concept of the central bank, which has been in development since the twentieth century first appeared in Turkey in the 1930s. In this chapter the monetary policies of the Central Bank and their effects on the Turkish economy are discussed in periods by examining the concept of the Central Bank of Turkey and its aims.

**Keywords** Finance · Central banking · Institutions · Policy · Economy

### 6.1 Introduction

The central banks which represent the monetary authority and organize the monetary structure were usually known as banks of issue or national banks until the twentieth century. The development of the identity of banks as central banks started with the necessity of the organizing the export of paper notes and the need of the state for short term loans ([www.tcmb.gov.tr](http://www.tcmb.gov.tr)).

The structural differentiation between the functions of the central banks and other banks brings the necessity to define “Central Bank” by keeping this function in mind. (Serdengeçti 2004, p. 3) Central Banks are usually seem like the bank of banks, the coordinator of the banking and monetary structure (Telman 2001, p. 31).

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The development of the central banks started mainly in the twentieth century. Especially the financial need created by the First World War, high inflation and the sudden rise in the economic growth increased the need for the central banks (Oktar 1996, p. 26). The first bank which has the qualities of the central banks is the Swedish State Bank (Riskbank) founded in 1668. Following the world's oldest bank of issue, the Swedish State Bank, the bank of England which is an example of the world central banking founded in 1694 (Zarakolu 1989, p. 5).

Although the idea of founding a central bank in Turkey was brought forward in the time of Committee of Union and Progress; the Central Bank Of Turkish Republic founded in 1931. Having the right of being a bank of issue, it has been authorized to carry out specific monetary and loan actions. The Law of Central Bank has been changed in the direction of being in conformance with the requirements of that time.

The central bank, in addition to its classical functions as working as a state bank and creating money as a governmental body; is also a part of the financial system as an institute which formulates and applies the monetary and loan policies by using specific instruments which effect the direction and use of the sources, cost, level and the state of funds (Aydın 1980, p. 25). The task of the central banks changes according to the level of development, size and the banking system of a country. The first and foremost task of the central bank, without question, is to create the price stabilization in a country (Tokgöz 1995, pp. 5–12).

The main task of the central bank is to preserve the domestic and foreign value of the money. While preserving the domestic value of the money means the preserving of the purchasing power of domestic market; the preserving of foreign value means preserving the value of the money against foreign money. (Capie et al. 2003, p. 4) The responsibility and duties within the scope of aforementioned Central Bank main functions, modelling of the world economies, improvements in the information technologies and new situations arising have affected the functions of the central banks (Erçel 1999, p. 12). Central banks meet the requirements of the governments and commercial banks by safe keeping the assets of the commercial banks, lending money to commercial banks when needed and accumulating assets for the treasury (Allen 2003, p. 101).

The main function of the central bank is to manage the money supply of the economy by making monetary and loan policies and applying them in accordance with the economic and social goals. While dealing with the liquidation problem of the economy; it tries to affect the money supply by making use of the rediscount rates, open market operations and deposit provisions tools. Thus it is a key institution being active mainly in the monetary market of the finance market. As a key institution in the money market, it is in a close relationship with other financial intermediaries, Commercial Banks, Liquidity management instruments and fund offering entities and users (Aydın 1980, p. 25).

Funding sources of the central bank consists of bank notes currently in use, asset reserves together with the partnership capital and retained earnings and the capital usages consist of gold, foreign currency, advances, rediscount actions and state bonds and bills. Since the central bank sources have a short term

characteristic, this situation impels the central bank towards making an investment to the short term capital markets, in other words money market. Thus the central bank is more an instrument of money market than capital markets and the effects of the central banks to the capital market occur indirectly rather than directly, in other words by way of financial intermediaries.

The direct effect of the central bank to the capital market is carried out by investing in treasury bills and open market actions and depositing the asset reserves gained from the banks into middle and long term loans. Its indirect effect is carried out especially by affecting rate of interest, money supply and macro conditions in which the intermediaries work together and the volume and conditions of the capital flow to the banks from the central bank and also affecting the activities of financial intermediaries in the capital market (Aydin 1980, p. 27). Central banks have the power and the inspection instruments which can return profit but the main goal of them is not gaining profit. They release banknotes which has no interest yield and which the public wants to keep as it is a legal currency for every kind of special and public debt and thus they lend money without interest.

In case of occurring an economic recession or depression, the central bank weakens the elements which bring down the economy by releasing additional money or loan to the system. In the case that the economic revival is too much, the central bank slows the growth by withdrawing money and loan from the market. The central banks are in a situation in which they inspect the money stock, interest rates and loan conditions themselves since they have the monopoly situation on the coinage and commercial bank reserves (Allen 2003, p. 101).

## **6.2 From a Historical Perspective: Policies and Implications of CBTR on Economy**

The thought of founding a state bank first came into light at the time of the Ottoman Empire and continued intensely later, at the time when Turkish Republic founded. The idea of founding a national central bank first came into the agenda in İzmir Economy Congress held in 1923 (Tekeli and Ilkin 1997, p. 246).

The first evidence of the idea to found a central bank appeared in the government program which had been read on 5th of November 1927 in the Turkish Grand National Assembly. Together with the background information which has been made by the foreign and domestic consultants CBRT has been founded on accordance with the Central Bank of the Turkish Republic Law numbered 1715 which has been accepted by TBMM on 11 June 1930 (Kazgan and Koraltürk 2000, p. 93). CBRT has been founded as an anonymous company which has the privilege of coinage (Parasız 1997, p. 220). The coinage privilege of CBRT which was for 30 years when it was first established later extended with an amendment made in 1955 up to 1999 and then extended indefinitely with a second amendment.

([www.tcmb.gov.tr/a](http://www.tcmb.gov.tr/a)) With the foundation of CBRT the system of reserve in the coinage has stopped to be used and instead of gold standard, the bank note system which has compulsory circulation has been adopted (Özdemir 1987, p. 7). Since CBRT has the authorization of printing bank notes and collecting the state deposits it has not been directed to collecting private deposits. Thus, it has not been made to compete with other banks and the superior bank status of CBRT has been preserved ([www.tcmb.gov.tr/a](http://www.tcmb.gov.tr/a)).

### ***6.2.1 The Period of 1932–1950***

Since the economy of Turkey is largely depending on agriculture; while the economy and inflation fluctuate, the exchange rates followed a steady route. While the coinage carried out in a limited amount in the first half of 1930s; in the second half of the 1930s the volume of bank notes issued has increased considerably due to the effect of 2nd World War. The main monetary policy instrument in this period is the rediscount rates which were determined by CBRT itself (Karluk 1996, p. 212). In these years the authority to determine the deposit and loan interest limits and compulsory reserves is not in the hands of CBRT and these reserves were allowed to be used by the banks (Hiç 1994, p. 429).

1940s are the years in which the negative effects of the 2nd World War have been felt and the start of tendency to the usage of the central bank sources aimed at public finance needs has begun. In this period the Central Bank in Turkey was active towards the deficit financing of the public rather than managing an independent monetary policy under this tendency. Thus the general price levels in the period of 1938–1948 have increased more than threefold (Serdengeçti 2004, p. 12).

### ***6.2.2 The Period of 1950–1960***

It may be said that this period is a milestone for CBRT. The financing of the economic growth and the budget deficits of the period with the sources of the CBRT caused the inflation to soar. The maximum interest rate to be applied by the banks to the lending actions and the maximum interest rates to be paid to deposit have been decreased. The principle of Amortization and Loans fund depositing on account of the CBRT has accepted and thus, the %20 of the total gathered deposit to be transferred to the public sector finances has become clearer. The idea of compulsory reserves to be extended as loan by CBRT has been accepted (Karluk 1996, p. 212). Another characteristic of the period is the raise of the negative real interest rate provided to the public enterprises by CBRT. Losses arising from the Agricultural Products Office price regulations have been compensated with the CBRT loans (Karluk, 1996, p. 213).

### ***6.2.3 The Period of 1960–1970***

In this period which the planned economy mentality became prominent, it could be said that the monetary policy was applied within the scope of development plans and the monetary control was provided by CBRT. In the 1960s the monetary policy was managed by compulsory reserve policies, selective loans and effective usage of rediscount loan interests. Also it can be seen in this period the debts of the public to the CBRT turn into long term non-performing loans (Hiç 1994, p. 154). With the law dated 12.05.1961 and numbered 301, the obligation of the compulsory reserves to be deposited to CBRT has been accepted. Thus the effectiveness of the application of compulsory reserves and the monetary control ability of the CBRT has been improved. Work has been done towards blocking the compulsory reserves deposited to Amortization and Loan fund in CBRT and bringing a control mechanism property to the compulsory reserves (Hiç 1994, p. 155).

The tendency of the having the monetary policies in the central banks revealed itself for CBRT as well and it has been started giving place in the development programs to restructure the duty and authorities of the Central Bank according to changing economic conditions (Dogruel and Dogruel 2005, p. 57).

### ***6.2.4 The Period of 1970–1980***

With the 1211 numbered law it has been aimed that the CBRT to be equipped with the required monetary instruments and to become an institute which plays an active part in the development of the Country's economy.

All of the authorities which belong to the Bank Loans Organizing Committee have been transferred to CBRT. For the determination of the highest interest rates in the loans and deposits, authorization has been granted to CBRT via Higher Planning Council by the Council of Ministers. In order to regulate the money supply in the market, the authorization of carrying out the open market actions which is faster and more effective method than the rediscount mechanism has been given to the bank for the first time with this law (Hiç 1994, p. 432).

### ***6.2.5 The Period of 1980–1990***

Turkey has entered into a new economic era with the Decisions of 24 January 1980 and the CBRT monetary policy has changed a great deal depending upon these decisions. CBRT, while applying its loan policy; enabled the aim of using the loan system on accordance with the development plan and programs in such a way that it will make the management more appropriate by raising the shares of export

loans and investment loans in the private loans, raising the loan share of the private section by gradually lowering the share of the public loans in CBRT loans due to the not using the application of open financing (Önder 2005, p. 153).

The banks are set free to determine the interest rates of the loans they provide and to apply to the term deposits, the method of interest cap determination of the CBRT has been discontinued. Fixed exchange rate policy has been devalued on 25 January 1980 as 1TL = 70 US Dollars and a change has been made for the daily single exchange method rather than the multiple exchange rate method. The exchange rates started to be determined daily by the CBRT.

Since January 1986, a principle consisting of the necessity to transfer %20 of the foreign currency and effectives gained from the export to CBRT and in exchange for the foreign currency accounts opened in these banks a necessary %20 compulsory reserves to be made in CBRT has been brought forward (Dogruel and Dogruel 2005, p. 58).

In 1986, CBRT has started to try to make monetary aims without announcing to the public which is a pretty important policy change (Uygur 2001, p. 12). CBRT has aimed to control the TL reserves of the banking section for both following a more efficient interest policy and by the way of controlling the liabilities of the banks to control the money supply in a roundabout way (Dogruel and Dogruel 2005, p. 58). Since the middle of the 1980s the autonomy of monetary policy application using the market instruments has been given to CBRT and Eximbank, which enables CBRT to transfer its duty of encouraging the foreign trade and improving the export has been founded (Akgüç 1992, p. 19).

In 1988, the system of determining the foreign currency exchange rates in market conditions has been taken up and Directorate of Foreign Currency and Effective Markets have been founded. Another innovation is due to the limitation of the tender interests by the Treasury the lower than expected sales rate of the State Domestic Deed of Loan, the banks are set free to determine the interest rates they apply to their deposits in order to prevent the demand for the foreign currency since September 1988.

In this period the monetary policies of the CBRT has transformed into a more indirect instrument rather than direct instrument. Also the application of middle and long term rediscount has been discontinued since 1 January 1990 ([www.tcmb.gov.tr](http://www.tcmb.gov.tr)).

### ***6.2.6 The Period of 1990–2000***

With the 1990 monetary program, the central bank set some goals for total balance size, total domestic liabilities, total domestic assets and Central Bank money by limiting the expansion of the loans and wanted to take this under supervision (Kesriyeli 1997, p. 17). In 1993; a large proportion of the CBRT loans have been strengthened and activated in the CBRT balance starting with the short term advance provided to the Treasury.

Since there was no proper ground for foreign debts, in the first months of 1994 a leap in the loans provided to the public by CBRT has been noticed. On the other hand in the same period the reserve money has increased a little and the domestic assets are increased together with the foreign currency liabilities. CBRT tried to keep the stability by using the foreign currency reserves. However 1994 crisis occurred in the over-valued Turkish Lira (Karluk 1996, p. 236). After the crisis, the precautions taken on 5 April 1994 were aimed to raise the banking sector supervision and independent role of the CBRT and to lower the public deficits and to enable the permanent economic stability. The announcement of exchange rates which carry the indicator attributes of the exchange rates formed in free market by CBRT have started. According to the Stand-by agreement with IMF the compliance of CBRT to some goals similar to domestic assets, official reserves has made compulsory (Dogruel and Dogruel 2005,p. 71).

When looked at the monetary policies applied in 1995 it can be seen that the policy which started to be applied previous year was still in use. 1995 has become a year for CBRT in which the application of direct monetary policy instruments was discontinued and indirect monetary policy instruments were started to be used ([www.tcmb.gov.tr](http://www.tcmb.gov.tr)). It has been the priority of the CBRT to lower the foreign exchange rate fluctuations to a minimum while keeping the reserve money within the limits which is one of the main goals of the 1996 year monetary policy ([www.tcmb.gov.tr](http://www.tcmb.gov.tr)).

In the monetary policy of 1997 it has been aimed to prevent the sudden price movements in the market and to decrease the uncertainties in the market. As the main policy variable, money has been chosen. Acting with the view of together with the control of the reserve money, other monetary quantities can be controlled as well.

In 1997 with a protocol between the CBRT and Treasury, Treasury has given up the usage of the short term advance account. In the monetary policy of 1998 the reserve money has been chosen as the goal again. With the reserve money increase staying at a determined target range, the struggle with the inflation has become more important. CBRT, whose balance had begun to decrease, has been completely liquidized throughout the year for the medium term rediscount loans ([www.tcmb.gov.tr](http://www.tcmb.gov.tr)). The monetary policy of 1999 has been determined to create stability in the money markets and in compliance with the goals of keeping the inflation under control, just like the one in 1998 (Şahin 2007, p. 474). The buying and selling interferences of CBRT are for achieving the basket of currency exchange rate goal. In order to prevent the liquidation problem due to the exogenous shocks, the interest rates set free and work towards keeping the value of Turkish Lira within the determined rate policy scope has been carried out.

In 1999 CBRT has started two new applications. First one is the daily limit application for the needs of daily occurred urgent fund needs to be met and the obstructions in the payment system to be resolved. The second one is the allocation of the Futures Limit for gaining the Futures a depth and regularity except for the borrowing limits left for the Interbank operations.

### ***6.2.7 From 2000 to the Present***

As a result of the economic crisis of 2001 the floating rate regime has been started. A structural transformation has begun in the economy after the crisis. The main goal was the creating the required structure in order to present the inflation targeting regime which is a modern monetary policy strategy and started in 2006. CBRT has directed its monetary policy works within the scope of inflation targeting regime and stated that the end target is to use inflation targeting regime since the year 2000 (TCMB 2006, p. 16).

Thus, since it would be hard to make an assumption about the next term inflation when the preconditions of the inflation targeting regime and when the inflation is very high and unstable; is has been decided to start using the inflation targeting only when the inflation target is lowered to a certain degree and then to start the usage of inflation targeting regime. During the period which is called implicit inflation targeting, along with the inflation targeting, monetary indicators have also been set an aim for (Akgüç 1992, p. 29).

From the date of 1 January 2006, CBRT has changed from implicit inflation targeting to open economy inflation targeting. With the inflation targeting regime Turkey has gained important acquisitions. The most important of which are: breaking the chronic high inflation process and the approach of inflationist pricing, the trust to the domestic currency regained due to reverse dollarization, decrease of the financial domination and the disciplining of the public debts and the increase process of the general economy due to the loaning the fundable resources which transferred to the public debt, to the private sector (TCMB 2006, p. 24).

## **6.3 Conclusion**

With this work the activity of the Central Bank on the Turkish economy by certain periods has been stressed and is has been seen that the Central Bank which has an independent auditory structure, is one of the invariables of the economy and with the interventions it directs the economy. CBRT is a very active institution in the economy of Turkey having regulatory, directing and auditory power. CBRT is an institution which has been equipped with important authorities in the centre of the financial system and controls the sourcing.

As a result the Central Bank of which legal duty is to create the price stability will go on to its applications about activating monetary policies and liquidation management just as it has done until now and will do in the future. Within this scope according to the unexpected changes in the money markets and occurring needs, it will intervene the market with the applications of monetary policies in liquidation strategies.



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