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MONETARY POLICY AND THE CENTRAL BANK

Before explaining the role of the Central Bank and the application of monetary policy in Turkey,

I would like to describe the general framework and explain our policy actions in terms of developments in central banking all over the world.

It is accepted that central banks play an important role in keeping prices stable and stabilizing the functioning of the financial system. Now, it is universally agreed that in the context of macroeconomic monetary policy, the main task of central banks is to achieve and maintain price stability.

For central banks, price stability is neither a short-term goal, nor one which, once it has been achieved, will look after itself. Establishing price stability takes time. Maintaining price stability and ensuring stable economic growth under conditions of low inflation has to be seen as the ultimate goal of the central bank.

Indeed, the achievement of sustainable economic growth requires price stability and a strong financial system. The financial system must be stable before the price stability objectives of the central bank can be achieved. Because a stable financial system is needed as the efficient link between savings and investment and feeds economic growth. An institution playing such an important role in the economy also has important responsibilities and competencies.

Central banks apply short-term, activist monetary policy to reach their long-term targets. These short-term, activist policies need to be formalized to suit seasonal movements and business cycles. Policy implementation that disregards these factors can produce large swings in the financial markets. Short-term activist monetary policy actions may use intermediate targets which can be directly controlled by the central bank. These intermediate targets must be directly related to the ultimate goal.

Central banks must take account of three constraints when steering their monetary policy toward the ultimate goal of price stability. The effects of these constraints will vary according to how advanced and how fragile is the economy. Each of these constraints is important to our own economy. They are: 1) An excessive public sector borrowing requirement (PSBR); 2) Liberal international capital movements; and 3) The structure and vigor of the financial and banking systems.

Against this general background describing the goals of the monetary policies pursued by central banks, I would like to describe our country's situation.

Turkey suffers from two major problems which are also the basic reason for the high level of inflation over the last two decades. These are the high level of the public deficit which drives the ever increasing PSBR. To this we must add the existence of persistent inflationary expectations. The first is connected with the need for fiscal discipline and the need to reform the public finances. The second is related to the problem of gaining and keeping credibility.

While we are examining monetary policy actions in Turkey I would like to emphasize that we have central banking experience that goes back 60 years. In addition, as a result of the adopting of free market principles in the allocation of resources and the structural alterations this has brought to the financial markets since the early 1980s has changed the way we view central banking. Important steps have been taken in the area of monetary policy implementation to modernize central banking, including the establishment of money markets and the conduct of monetary policy according to free market principles. These changes require that the role and responsibilities of the Central Bank be redefined and have put the issue of central bank independence on the economic agenda. Since the late 1980s, the central bank has been using monetary programming: it sometimes announces its targets, and sometimes uses them for inner discipline.

Before reviewing the main points of our monetary policy implementations, let me explain what monetary policy instruments are available to us. We have two kinds of instruments for the conduct of monetary policy. On the one hand, we have market instruments; on the other hand is the Bank's power to set rate requirements. Let me explain each briefly. The Central Bank can control liquidity and short-term fluctuations in the markets by means of Turkish lira and foreign exchange operations in the interbank market and the open market. The Central Bank is also authorized to determine the rates at which banks are required to maintain reserves against their liabilities. The authority to set these rates gives the Central Bank the power to control the amount of money created by the banking system. The Central Bank can also determine the rate of the surrender requirement, which gives it the ability to affect the money and foreign exchange markets. In addition, the Central Bank can use rediscount facilities. At this point, I should also mention that these abilities of the Central Bank are limited by the public sector financing requirements.

Having explained the instruments available for active monetary policy implementation, let me now explain our fundamental view of monetary policy implementation. The Central Bank uses a monetary program that it does not announce because it is for inner use. The logic behind this program can be summarized as follows:

The aim of the Central Bank's current monetary policy is to meet liquidity demands without causing any monetary expansion that could feed inflation. This is done by controlling the growth of reserve money. The Central Bank provides liquidity to the market without disturbing the stability of the financial markets.

I can summarize our current conduct of monetary policy as aimed at keeping our intermediate goal of reserve money within the targeted range while minimizing the fluctuations in the exchange rate and adjusting the amount of liquidity to protect the stability and fragile equilibrium of the financial markets. While essentially targeting the growth of reserve money, the Central Bank also keeps close watch over developments in broader monetary aggregates.

The main features of the monetary policy we are implementing can be summarized under five headings.

- The Central Bank aims to limit the growth of domestic assets.
- The Central Bank wants reserve money to increase as much as its demand. The excess liquidity caused by the rise in net foreign assets is absorbed by open market operations.
- The Central Bank continues its close surveillance over the exchange rate and pays special attention to the maintenance of stability in the foreign exchanges markets.
- Coordination between the Treasury and the Central Bank and the continuous borrowing of the Treasury from the domestic financial markets has contributed to this outcome.
- Domestic interest rates are largely determined by the domestic borrowing strategy of the Treasury. The Central Bank is an observer, rather than a player, in the process by which the level of interest rates is determined.

In an economy where there is a persistent public deficit that is financed mainly from domestic financial markets and where interest rates and exchange rates are freely determined by the market, the efficiency and quality of monetary policy instruments would be different. In Turkey, as stated above, interest rates are determined by the domestic borrowing strategy. Likewise, exchange rates are determined by the level of interest rates and trade deficit, which itself is a function of economic growth. Under these circumstances it appears to be a necessity for the Central Bank to give its priority to the control of its balance sheet items.

As the Central Bank, we consider control over the growth of domestic assets to be the most important element of monetary policy implementation. This is the only way we can keep the increase in our Turkish lira liabilities in line with increasing demand. The gradual decrease in the limit on short-term advances to the Treasury, imposed by law and covering the bulk of our domestic assets, was of great assistance in preventing these domestic assets from increasing.

Central banks, by their nature, are society's strongest bulwarks against inflation, because above all, they want the money they print to be valuable. In addition to that, I would like to emphasize that the experience of nations shows that independent central banks are more successful in preserving the value of the money they issue than less independent central banks. In our country, recent events have demonstrated the importance of monetary stability, especially during times of political fragility and instability. Apparently monetary stability is a necessary condition for price stability.

Financial stability and price stability are necessary conditions for sustainable growth. Therefore, central banks must be allowed to achieve its aim of price stability and financial stability. Because a central bank that achieves financial stability and price stability also helps increase the public confidence in government policies and enhances the credibility of government policies. For this reason, central bank independence is also desirable from the standpoint of governments.