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Let me begin by pointing out that inflation damages national economies in seven basic ways. The first of these is the decline in the demand for money. The share of reserve money in GNP is rather small in countries with high inflation. In Turkey, this ratio is presently 2 percent, down from about 10 percent in 1985. I believe that Turkish inflation is the reason our reserve money is so low. Low reserve money puts limits on the process of money creation. Economic growth is impossible under these conditions, which are bound to lead eventually to recession.

Another way inflation harms the economy is by undermining the prosperity of persons with fixed incomes and distorting income

distribution. In the long run, it also affects the accumulation of capital, by causing the value of the capital stock, an important production factor, to shrink continuously. Obviously, all these effects prevent an economy from functioning properly.

The third way that inflation harms an economy is by reducing the amount of taxes collected. Tax avoidance, tax evasion, and poor tax regulations are among the reasons for this, but a look at the economic literature shows that low tax revenues are common among countries with high inflation. Such countries find it impossible to increase tax revenues or expand the tax base, no matter how hard they try. Turkey's tax revenues are, as a percentage of GNP, low compared with those of other countries.

The fourth kind of inflation damage is the introduction of uncertainty and risk into contracts. A look at the length of term contracts over the years shows that inflation has shortened their maturities.

Another negative effect of inflation is that it leads to basing price setting on several different sets of inflationary expectations. In countries with long-standing inflation, such important macroeconomic variables as savings, investments, and the growth rate are affected by changes in real (after tax) returns. Estimates of the real after-tax return must necessarily take account of the expected inflation rate or last year's inflation rate. These estimates are the basis for predicting savings, investments, and growth on the micro and macro levels.

Last, but definitely not least, high inflation exaggerates the effect of cyclical movements on the behavior of real aggregates. This has led to wide fluctuations, for example high growth rates for two or three years followed by negative real growth thereafter.

Taken together, these seven negative effects of inflation constitute an obstacle to sustainable economic growth and decrease the overall efficiency of the economy. The Turkish economy has struggled along under this burden for years. This has two major consequences. One is high real interest rates, which interfere with the functioning of the domestic credit market. As a result, the mechanism whereby funds are first raised and then transferred to public borrowers creates a destructive dynamic in the public debt. The other consequence is to depress per capita income. A recent study reveals that if inflation had fallen to 10 percent in recent years, Turkey's annual per capita income would now be US$ 6000, and if it had fallen to single digits, annual per capita income growth would now be 1 or 1.5 percent higher than that. As things are in fact, annual per capita income has been increasing by 2.25 percent points.

Now let me speak of four major causes of inflation that must be addressed by disinflation efforts. The inflationary effects of high public deficits are well known.

The same is true of the relationship between changes in exchange rates and inflation.

Credibility and transparency are two concepts whose importance is recognized everywhere in the world. The more clearly the markets are able to understand you, the better they will relate to you. Last month we were all able to observe the benefits of Turkey's greater credibility in the markets, and the way the perception of these benefits affected the public. This is equally true where the international markets are concerned.

It can thus be seen that there is a very close relationship between credibility and disinflation efforts. Lack of credibility is a formidable obstacle to successful disinflation. Simply stated, credibility is one’s reputation for keeping one's promises. Credibility cannot be bought or possessed. It is borrowed, and if abused will be withdrawn. It cannot be taken for granted. Credibility is strengthened by the continuation of right behavior over time. With strong credibility in hand, a disinflation program can much more easily attain its goal. For this reason great care must be taken to protect whatever credibility has already been earned.

The fourth factor is inertia, which often arises from the implementation of backward-looking policies. We must free ourselves from the seeming inevitability implied by formulations like "The reason the inflation rate was 100 percent in 1998 is because that was its level the year before." Our disinflation program must thus be based on a forward-looking approach. The forward-looking orientation does involve some problems with the case of rents, which has always been a difficult question to solve. Perhaps it would be possible to evade the backward-looking orientation in determining rents by contracting them in terms of foreign exchange, but these bad habits will be harder and take longer to break when the contracts are written in terms of domestic currency. Because rents were increasing by 60 or 70 percent a year ago, it will be extremely difficult to obtain acceptance of an increase of only 20 or 25 percent this year. Many countries have attempted to find solutions for this problem, and some have resorted to temporary adjustments to deal with similar issues.

Another important influence on inflation outcomes is the behavior of various economic agents. For our purposes economic agents fall into three groups: consumers, producers, and policymakers. The behavior of all of them affects the course of inflation. The behavior of consumers is probably the easiest to predict at the start, but the behavior of producers and policymakers has stronger effects on inflation.

Policymakers should translate their will into action and go straight for their goals without compromise. To start making needless "adjustments" in policies is to see the credibility of the fight against inflation begin to crumble.

Producers are also very important because they set the prices. A producer takes note of changes in consumer demand, considers their costs, and sets the prices by estimating their future course.

In designing a program the behaviors of all these groups has to be taken into account, as it was during the design of the Turkish program.

Before concluding these remarks, I must explain how monetary policy functions and its considerable role in the present disinflation program. The first function of a monetary policy is to establish a rule-based monetary environment. By "rules," I mean the following regulations: net domestic assets will be moved within a predetermined band. Liquidity will be created only when foreign exchange is bought, and the money so issued will be left in the market: in other words, there will be no sterilization. Another rule is that interest rates will be freely determined by market conditions. Here let me point out that in December, we announced that our exchange rate for the next 13 months would be based on a basket. We started by securing the exchange rate policy through fiscal policy, incomes policy, monetary policy, and other relevant policies. Any change in this area will have direct effects on the balance of payments.

We consider our exchange rate policy to be very important due to the painful experiences of the 1970s. We felt the need to devise a monetary policy that would safeguard the exchange rate, which especially since the Asian crisis has been recognized as one of the most important issues in the world economy.

The Treasury and the Central Bank interact to determine the amount of domestic currency in circulation and the movement of net domestic assets within the band. The taxes collected by the Treasury are deposited with the Central Bank. In essence, the Treasury's taxation withdraws money from the market. Unless a similar amount of money is put back into circulation via open market operations to replace the money withdrawn, interest rates will rise. It is essential that the money withdrawn be returned to the market. The Central Bank stabilizes market liquidity. Money obtained by the Treasury from the Central Bank in the form of short-term advances winds up in the market, where it causes excess liquidity and has to be withdrawn. The system works rather like a pump, which operates to prevent any change in liquidity. When the economy needs additional liquidity, the Central Bank will create it by a process called "increasing net foreign assets," that is by having the Central Bank buy foreign exchange. The more foreign exchange the bank has, the higher liquidity will rise. But since money created in this way cannot be withdrawn, interest rates will go down.

The system was designed to function in this manner. Its initial impact was very strong. As credibility increased, interest rates fell faster than we had expected. This extremely favorable development will lighten the interest burden on the public finances and make it easier to design budget policies for 2001 and 2002.

Another point worth noting here is that short-term interest rates are expected to fluctuate. Let me explain what we experienced two days ago. The Treasury deposited US$1.5 billion, which had been borrowed overseas in the Central Bank. This required us to inject TL 900 trillion into the market to keep net domestic assets within the limits of the band. Interest rates immediately fell to 13-18 percent. On Day Two, yesterday, the market,

seeing such a low interest rate, began buying foreign exchange and the amount of money we had to inject into the market fell to TL 350 trillion, which was extremely low compared with TL 900 trillion the day before. This predictably caused interest rates to rise immediately to 36-37 percent.

In other words, interest rates fell to 13-18 percent and then suddenly rose to 35-36 percent in two days. We are bound to see repeated instances of similar volatility. Interest rates will increase whenever foreign exchange is sold, and contrariwise will decrease whenever foreign exchange is purchased. Interestingly enough, it was the Treasury that provided all of the foreign exchange that has recently increased our net foreign assets, raising US$ 1.5 billion via bond issues on the international markets during December. These were long-term funds.

I consider this a very positive development, because up to then only short-term liquidity had been available. This has been an important advantage for the implementation of our program. Indeed, under our previous less optimistic assumptions, we expected that short-term funds would arrive and the banks would increase their short positions. Of course, it worked, but it was medium- and short-term funds obtained by the Treasury that really increased the net foreign assets and caused interest rates to fall to such levels. But I would like to draw your attention to the interest rates of 36-37.5 percent during the Treasury's last borrowing. In real terms, the interest rate will turn out to be 15 percent, since the change in the value of the exchange rate basket over 13 months is 19 percent. The

15 percent rate seems lower than those of the past, but it is a little higher than the 10-12 percent anticipated in the medium term. I think this should also be regarded as a positive sign.

The last point to be made about our monetary policy is that the Central Bank will no longer finance the public sector. The Central Bank has been preparing for such a change for the last four years. We have worked out policies that will prevent the Central Bank from extending direct funds to the public sector, and have paved the way for the public sector to obtain funds from the market. The goal of all these efforts is to make the disinflation program function more effectively. Now the public sector can meet its borrowing requirements on market terms. In sum, in accordance with our monetary policy, we will stop sterilizing capital inflows and outflows, interest rates will be determined by the marketplace, and there will be no direct financing for the public sector. We will obviously maintain these policies in the future. And from July 2001 onwards, we will be able to implement a more realistic and up-to-date monetary policy.

Thank you for listening.