OPENING SPEECH

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IN THE 72nd ORDINARY GENERAL MEETING OF SHAREHOLDERS

I. Introduction

1. Esteemed Shareholders, Distinguished Guests and Dear Press Members; Welcome to the 72nd Shareholders' Ordinary General Meeting of the Central Bank of the Republic of Turkey.

2. Today, I will dwell upon the inflationary process in Turkey, the changes in inflation dynamics before and after the floating exchange rate regime, implementations of 2003 monetary and exchange rate policies, the outlook for 2004 and I will elaborate on the necessary conditions for a high and sustained growth under low inflation.

I.1. Objectives of the Current Economic Program

Primary Objective of the Central Bank: Disinflation

3. Some basic measures were taken in order to eliminate the confidence problem and the instability arising from the February 2001 crisis. These measures were followed by the introduction of the current stability program, intended for a structural transformation in the economy. In the monetary policy design of the program, which ultimately aims at a sustainable growth on the basis of strong macroeconomic fundamentals, the achievement of permanent price stability was highlighted as a *sine qua non* for this aim. In this framework, the Central Bank has been aiming at carrying out the struggle against inflation unreservedly and without interruption in line with an inflation-focused, transparent, effective and forward-looking monetary policy under the floating exchange rate regime.

Budgetary Discipline is a Necessary Prerequisite

4. Another objective of the program is to alleviate the public debt burden. Imbalances arising from public budget limitations, namely budget deficit and its financing method, put direct and, through expectations, indirect pressure on inflation. As you know, budget deficits

can be financed through various methods. Increasing revenues through tax adjustments may be an appropriate way to finance the budget deficits, but it may prove unfeasible due to physical limitations and political concerns. Privatization can be another revenue item for financing budget deficits as well. However, this is not a preferred method because of its temporary and short-term nature. Borrowing from international markets in order to balance the budget deficits cannot be used frequently as a plausible method due to its dependence on the credibility of countries in foreign markets. On the other hand, borrowing from domestic market and/or resorting to the central bank resources are more preferred methods because they are easier to reach, can be used in a longer run, and are considered to have lower social costs in the short-term.

5. Covering budget deficits with central bank resources will put pressure on inflation, as money supply increases through fiduciary money issued by the central bank. Therefore, , it is crucial to conduct an independent monetary policy to avoid this pressure and to prevent by law the use of central bank resources in financing the budget deficit. However, this does not provide a sufficient condition because financing budget deficit through domestic borrowing brings about the necessity of interest payments by the government in the future. In cases where real interest rates surpass the real growth rate, the ratio of the public debt to GNP will increase and the sustainability of financing deficits through domestic borrowing will become more difficult. In cases where debt rollover becomes unsustainable as a result of a self-fulfilling process of interest payments, financing the deficit by increasing money supply, rather than establishing fiscal discipline, will lead to a stronger inflationary pressure than that of caused by creating seignorage revenues.

6. In this context, the extent to which the debt is financed with primary surplus gains importance for an effective monetary policy. In other words, the capability of budget revenues to pay non-interest public debts determines the power of monetary policy. If both the ratio of public debt to GNP and the ratio of primary surplus to GNP increase at the same time, the public sector balance will not exert pressure on the economy. By this way, the Central Bank can make and implement independent policies effectively, which is defined to be the monetary dominance. However, when debt dynamics are ignored in targeting the ratio of primary surplus to GNP, slippages in the public sector balance will put pressures on the monetary policy because of the above-mentioned reasons, and reduce its effectiveness.

7. To sum up, in order for the Central Bank to pursue monetary policy effectively in accordance with its objective, it is very important to determine whether a monetary or a fiscal dominance is in place in the economy. The long-standing budget deficits and high domestic borrowing observed in Turkey can be defined as fiscal dominance and put pressure on the functional independence of monetary policy – i.e. the independent policy implementations regarding price stability. Therefore, fiscal discipline is a *sine qua non* pre-requisite for achieving price stability. Thus, a program that aims at price stability must incorporate measures intended for establishing fiscal discipline, and cease the heavy debt burden in the medium- and long-term.

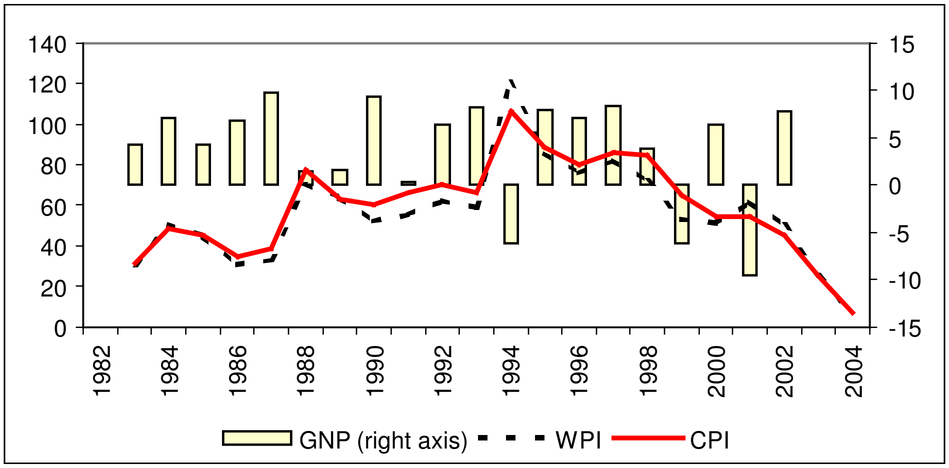
8. The current economic program seeks to carry out an easy domestic borrowing in the short term by reducing real interest rates on one hand, and to remove gradually the public debt problem by producing primary budget surplus with a tight fiscal policy in the medium-long term on the other.

9. The achievement of price stability and the removal of the burden of high debt stock on the economy can bring permanent stability in the other economic aggregates. Thus, it is only in this way that the primary objective of a sustained high growth of the economy and a sustained growth in employment can be attained.

II. Inflationary Process in Turkey (1980-2000)

10. After touching briefly upon the objectives of the current economic program, I would like to dwell on the historical background of the inflationary process in Turkey and the changing dynamics of inflation throughout this process. As we all know, the chronic high inflation has been the main characteristic of the Turkish economy for over 30 years. Despite the high growth rates achieved in the economy from time to time, the economic growth followed a very irregular course, and the low average growth and macroeconomic instability became the hallmark of the post-1980 period. As a result, inflation has become rigid and turned into a self-fulfilling process.

Figure 1: CPI-WPI Inflation, GNP Growth (1983-2003)

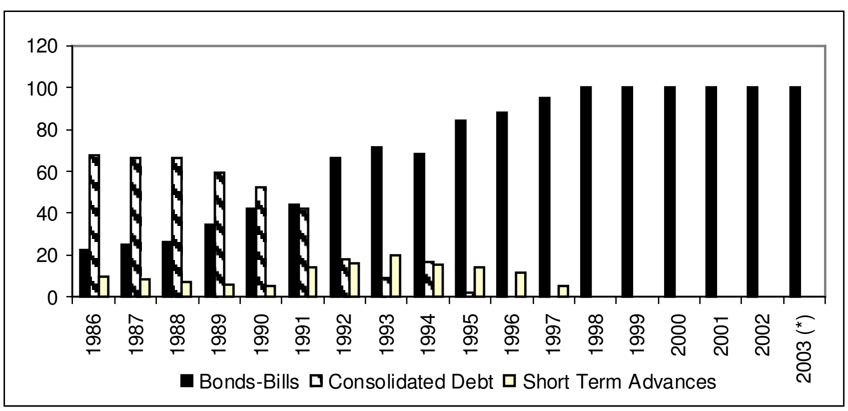


Source: SIS.

Before 1980

11. The root causes of inflation before 1980 can be attributed to the big supply shocks affecting the whole world and to financing the deficits of SEE's (State Economic Enterprises) with monetization. Effects of public sector on the economy led to important consequences in terms of inflation process in the following years. The Turkish economy underwent a great structural transformation in early 1980s, and the import substitution policies were replaced by export-oriented policies.

Figure 2: Respective Shares in the Domestic Debt Stock (1986-2000)



Source: Undersecretariat of Treasury.
* Provisional.

1980-1990 Period

12. Two structural changes made in this period have had important consequences in shaping the inflation dynamics. First, public deficits started to be financed by domestic borrowing in 1986. As I have mentioned at the beginning of my speech, the policy of domestic borrowing to cover public deficits has exerted pressures on inflation dynamics and in time has prevented the economic system from functioning properly, by disrupting the banking system.

13. Starting from 1989, liberalization of capital movements was another structural break in the formation of dynamics. The resulting effect was the sudden increase in foreign exchange demand, in an environment where chronic inflation was already in place. Moreover, the effects of exchange rate developments on the economy and especially on inflation have steadily increased with the liberalization of capital movements and in an outward-oriented economy.

1990-2000 Period

14. Towards the end of the 1980s and especially in 1990s, the interest rates soaring over 100 percent, unsustainable level of real interest rates due to the pressure of continuously increasing domestic borrowing of the fiscal sector, high real interest costs on debt stock due to increasing risk premium, and the increasing fragility of the banking system shaped the economic structure. On the other hand, the exchange rate policy after the financial liberalization shifted towards managed float. At the same time, political instability and lack of determination in the fight against inflation, and insisting on different priorities further fed the weak structure. Throughout this process, monetary policy has sought to pave the way for the political authority to buy time to accomplish the necessary reforms.

15. Such a structure has made the economy more vulnerable to crises. For example, the government had to resort to a high devaluation in early 1994 and nominal interest rates reached extremely high levels due to the realization of budget deficit above the expectations in 1993. The well-known 1994 crisis was the first serious warning of the weak economic structure, which disrupted it even further.

16. In early 1998, Turkey initiated a new economic program by which monetary aggregates were used as nominal anchor, and important fiscal measures were taken. Despite the early success of the program, high capital outflow was observed due to the Russian

crisis, interest rates rose again and the public debt stock increased considerably. While public finances were deteriorating, the economy contracted. The deterioration process gained momentum with the earthquake disaster in 1999, and economic problems became aggravated by the end-1999.

17. Above-mentioned developments led to the introduction of a new and comprehensive economic program at the beginning of 2000. The aim of the program was to improve public sector and to reduce the public debt to a sustainable level through revenue-increasing and expenditure-curbing measures in order to minimize the effects of worsened debt dynamics on inflation and other economic indicators, along with a comprehensive structural reform program. With the implementation of the pre-announced exchange rate system (currency peg regime), it was planned to weaken the relationship between exchange rate and inflation, which was strengthened after the financial liberalization, and to disinflate the economy accordingly.

18. In the design of the program, it was planned to float exchange rates gradually after an 18 month-period, considering the likely pressure on the balance of payments due to the excessive appreciation of the domestic currency. With the implementation of the program, confidence increased considerably and capital inflow accelerated along with the optimistic expectations. Thus, a rapid and high decline was noted in interest rates. Decline in interest rates led to a recovery in consumption, which was deferred due to the Russian crisis and the earthquake, consequently expanding the credit volume. Meanwhile, real exchange rates rose sharply as inflation rates surpassed exchange rate depreciation due to the rigidities in inflation especially in the early periods of the program. The growth in domestic demand and the real appreciation of Turkish lira caused the imports to grow rapidly and this, in turn, led to a deterioration in the current account balance.

19. With the reduced interest rates and the increased credibility, the Treasury was able to borrow on easier terms. External borrowing and the first disbursement of the IMF loan led to excess liquidity in the domestic market. Moreover, as the Treasury borrowed less than the redeemed amounts from domestic market in the first half of the year, added to the liquidity in the market, and banks directed this excess liquidity to consumer credits and private sector credits. Developments in the banking sector during this process, the mismatch in maturities of their assets and liabilities, and the increased exchange rate risk aggravated the problems inherited from the past.

20. After partial improvement in the macroeconomic indicators, the lack of enthusiasm of the then government to carry out the structural reforms aroused concerns about the program. This development negatively affected the monetary expansion based on foreign exchange inflow and the liquidity in the markets, and interest rates started to rise again. Since the expectations were not managed correctly, and the structural reforms were not carried out after the first stage of the program, the program lost its previously established credibility and was abandoned before the 18 month-period.

II.1. Main Factors Affecting Inflation Dynamics in Turkey

Financial Dollarization

21. Now, let me elaborate on the main factors affecting the inflationary process in the period until the 2001 crisis that I have just summarized. Starting from early eighties, the opening up of the economy and liberalization policies led to an increasing currency substitution and financial dollarization in the economy. Consequently, exchange rate developments became more important on the inflation and other macroeconomic variables.

Exchange Rate

22. The relation between exchange rate and inflation can be explained in three ways. First one is related to imported goods prices. Prices of imported consumption goods increase in terms of TL along with the rise in exchange rates and are reflected on inflation in the extent of its weight on the basket of goods and services used directly in calculating the inflation. In addition, due to the use of imported intermediary and capital goods in production, the changes in exchange rates directly affect production costs and consequently the ultimate goods prices. As I have expressed at the beginning of my speech, pre-1980 import substitution policies along with the intensified outward-oriented policies in time, have changed Turkey's import composition into a capital- and intermediary-intensive one, and made domestic production dependent on imports. Likewise; a closer look at the goods basket, which is used in calculating consumer inflation, reveals that more than 50 percent of this basket is tradables.

23. Moreover, the economic units living with inflation for years tend to use some indexation mechanisms in their decisions concerning the future. The most common one is the exchange rate mechanism. Assuming that exchange rate is a good indicator under the inflation uncertainty, price makers would prefer to reflect the exchange rate changes on their prices to protect themselves. Under such circumstances, all prices are indexed to exchange rate regardless of whether they are tradable or using imports input in their production. The "managed float", implemented for a long period in Turkey, has indirectly affected the inflation expectations and strengthened the indexation mechanisms. Especially after 1994, the policy of increasing exchange rates in line with inflation to prevent the real appreciation of the Turkish Lira has considerably reinforced the indexation mechanism.

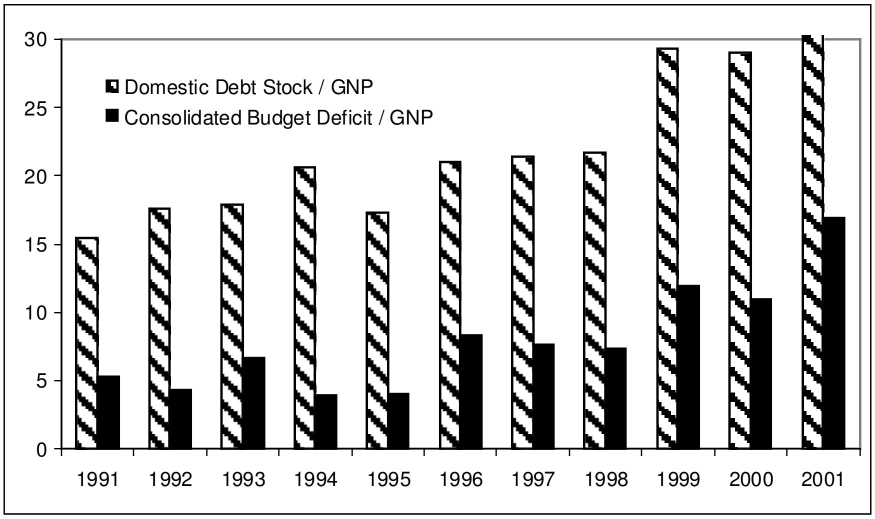
Public Deficits and Domestic Borrowing

24. As I have expressed at the beginning fo my speech, another important factor determining the inflation dynamics in the last 20 years has been financing the public deficits through domestic borrowing. By this way, the monetization of public deficits and hyperinflation were avoided, while the fragility of the financial system increased considerably. Moreover, since interest payments became a great burden on the public debt stock, it proved difficult to implement inflation-oriented, independent monetary policies. In other words, the increase in fiscal dominance has reduced the efficiency of monetary policies.

Backward-looking Expectations

25. Debt dynamics have also played a significant role in shaping the expectations and indirectly affected inflation dynamics. Rising debt stock boosted up the borrowing requirements and aroused concerns over the debt sustainability. Real interest rates rose with the growing risk perception, causing a vicious cycle. The expectations on the sustainability of debt made the economy extremely vulnerable to external shocks, political instability, and volatilities in exchange rates and interest rates. Consequently, even the smallest risk perception by economic units can affect the inflation and macroeconomic balances adversely.

Figure 3: Developments of Budget Deficit and Debt Stock (1990-2000)



Source: SPO, Undersecretariat of Treasury.

Public Prices

26. Besides domestic borrowing, the big share of the public sector in real economy has been another factor in inflationary process. Today, public prices comprise 20.8 percent of the goods and services basket that is used in calculating consumer prices. The low productivity level in the public sector, the compensation of deficits through price increases, and also the price adjustments made in petroleum and TEKEL products -since taxes levied on these products are important revenue items for the Treasury- had inflationary consequences.

Inertia

27. Long-standing high inflation also leads to a self-fulfilling process. In an economy with chronically high inflation, economic units try to protect themselves from inflation in their price and wage setting decisions for the future. Consequently various indexation mechanisms emerge. The most remarkable mechanism is the exchange rate indexation, I have just mentioned. Thus, as the inflation rises, inflation expectations become well established and consequently lead to chronic inflation . This structure, in turn, , make prices more rigid and the inertia in inflation appears to be one of the most important obstacles in disinflation efforts.

Unsuccessful Stabilization Programs

28. Unsuccessful stabilization programs are another important factor in the inflationary process. The stabilization programs, especially in the 1990s, are characterized by determined implementations at first and slipping into lethargy after obtaining favorable initial results . For example, with the determined application of the monetary and fiscal discipline in the 2000 program, a decline in inflation and an improvement in fiscal structure were observed at the beginning of the program. However, after the first six months, delay in structural reforms arose concerns about the continuation of the program. Also political uncertainties got in the way of the strict implementation of the program in this period. Political authority has always tended to be myopic especially in the period of elections.

II. 2. Change in Inflation Dynamics (2001-2003)

29. The ongoing economic program, which was introduced following the 2001 crisis, has led to significant changes in inflation dynamics and brought an end to the chronic high inflation period experienced for over 30 years. Although the objectives of this program coincide with the previous program in terms of its fiscal and monetary discipline as well as the structural reform program, the new program is distinguished from the previous one in two important aspects. These are the new Central Bank Law and the floating exchange rate regime.

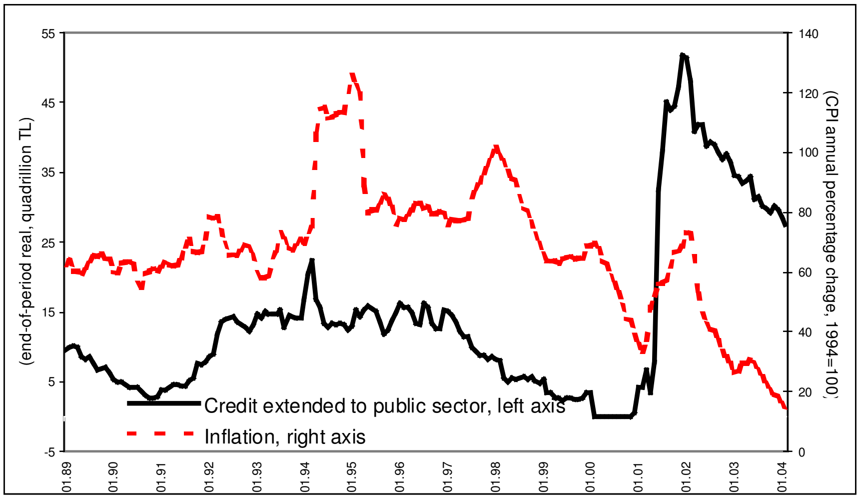
The New Central Bank Law

30. Under the legal amendments made in the Central Bank Law in April 25, 2001, the primary objective of the Central Bank has been defined as to achieve and maintain price stability. In addition, the instrumental independence enabling the Central Bank to freely choose its policy instruments in disinflation policies has been granted by law, and short-term interests has been defined as the main policy instrument of the Central Bank.

31. Another change is related to the credit extended to public sector. The credit extended to the public sector has been one of the most important obstacles before disinflation for a long time. To be effective from November 2001[1], no credits will be granted to the public sector, and no government domestic debt instrument will be purchased from the primary market according to the new Central Bank Law.

[1] The completion of post-crisis clearing transactions was delayed until November 2001.

Figure 4: Credit Extended to Public Sector and Inflation



Source: CBRT, SIS.

32. The amendment of the Central Bank Law is very important because the monetary policy strategy has become so much inflation-focused for the first time and has given emphasis on price stability. The crucial point that must be underlined here is its goal independence. Governments mainly aim at attaining sustained economic growth in medium- and long term and increase in employment. Since price stability is a pre-requisite for this aim, there can be no contradiction between the goals. For this reason, inflation target is determined jointly with the government. However, governments may deviate from their long-term targets due to political considerations, by resorting to populist policies that produce public deficits contradicting with price stability. For this reason, there is a need for an institution that will adhere to the objective of price stability in the medium-term in order that the price stability may not endangered due to short-term considerations. As a result of the legal amendment, the Central Bank has gained the independence of pursuing a policy which would maximize the public prosperity in long-term.

33. Another innovation brought in by the amendments made on the Central Bank Law is the acceptance of accountability and transparency. In this context, monetary policy implementations are reported twice a year to the government and the parliament, and regular reports concerning monetary policy targets and implementations are made public. Since November 2001, monetary policy reports, which sum up developments in inflation and monetary policy actions including forward-looking evaluations, have been published. In addition, monthly inflation developments and outlook, as well as the expectations survey

results are made public through press releases. Sshort-term interest rate alterations, which are considered to be the main policy instrument to achieve the inflation target, and operations such as foreign exchange interventions, are announced immediately, by explaining the reasons thereof. All these reports are published at the Central Bank's web site at the same time.

Floating Exchange Rate Regime

34. Another important factor contributing to break the inertia was the choosing floating exchange rate regime as the official exchange rate policy of the new economic program that was put into practice after the crisis. The most important reason for the abandonment of the currency peg regime was to avoid the credibility problem, which might have arisen from the continuation of the previous exchange rate policy. Besides, experiences gained through the unsuccessful stability programs indicate that unless the weak links in economy are strengthened, fixed or managed floats cannot be sustained. Furthermore, such an exchange rate regime encourages currency substitution and financial dollarization under these circumstances, creates a vicious cycle strengthening the relationship between foreign exchange and inflation, which then supports the inflationary process. Under the current floating exchange rate regime, exchange rate is determined according to the supply and demand conditions in the market and may increase or decrease based on certain factors in the short and long term under market conditions. However, this process is rather complex.

35. Supply and demand for foreign exchange is determined by both the economic fundamentals and the expectations formed by such fundamentals. In countries of high debt stocks, positive expectations for the rollover and sustainability of the domestic debt will increase the demand for domestic currency. In fact, these conditions can only be achieved in fiscal and monetary discipline. In short, the gradual increase in macroeconomic discipline will reduce risk premium and real interest rates, and hence, increase the value of domestic currency.

36. While the appreciation of the domestic currency affects current account balance adversely, the fiscal and monetary discipline has a positive effect on the

capital account of the balance of payments. The effect of macroeconomic discipline on exchange rate is not limited with the above-mentioned ones. As a result of such discipline, the declining inflation reduces the discrepancy between domestic and foreign inflation, and contributes to the appreciation of our domestic currency.

37. On the other hand, structural reforms and their effects on productivity, in other words, the structural transformation process in the economy, cyclical movements, and leading economic indicators such as inflation and growth are the main factors influencing exchange rate level in the long-term. Undoubtedly, the trend of the exchange rate is also influenced by the behavior of market players.

38. The relationship between exchange rate and inflation has gradually weakened since the implementation of floating exchange rate regime. In this period, there have been both upward and downward movements in exchange rates which were not experienced before, and it has been understood that foreign exchange indexed-transactions may pose a risk. Unlike the previous fixed and managed exchange rate regimes, free float compels investors to make their investments by taking the exchange rate risk into consideration. Hence, this also limits speculative movements. In the past, under "managed float", exchange rates were one of the most widely used indexation mechanisms. However, as the exchange rate has been assumed as a risk factor in the new system, its effect on inflation has diminished and program implementations, forward-looking expectations, and inflation target have now gained importance.

39. On the other hand, it should be underlined that the change in exchange rate policy was not done with the intention of causing uncertainties. On the contrary, such a policy aims at bringing stability in exchange rates in the medium- and long-term against the short-term fluctuations. As we have frequently declared in press announcements, the Central Bank is against the predictability of exchange rate by artificial means. The floating exchange rate regime will be able to reach its goal and exchange rate will increasingly pursue a stable course in medium-and long-term when economic fundamentals are strengthened and structural reforms are realized.

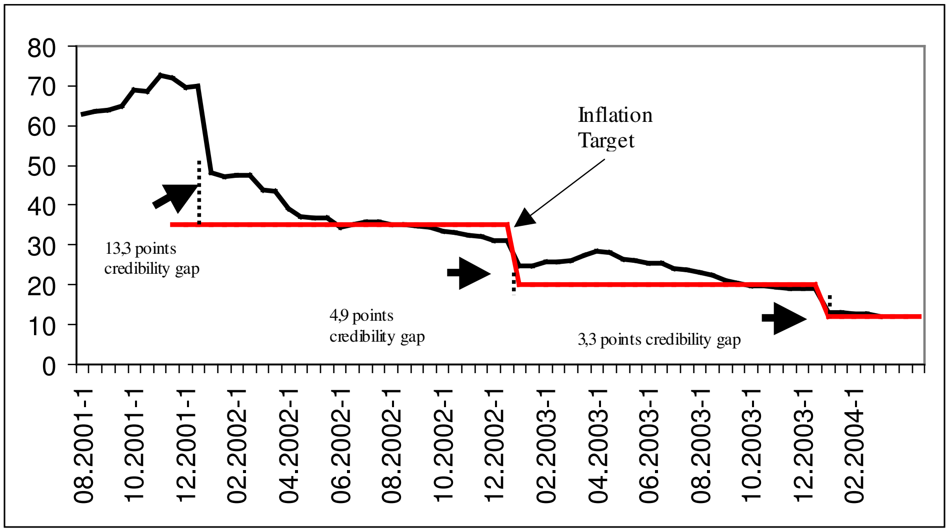
What we have achieved on inflation front

40. As a result of the determined implementation of the monetary policy in a transparent manner and the increased communication with the public, there has been a remarkable success in the management of expectations. Hence, much progress has been achieved in breaking of the inertia in inflation. The floating exchange rate regime has also contributed to the efforts of the Central Bank to break the inertia.

41. The main pillars of the new economic program implemented since April 2001 show clearly the root causes of the past inflation. As a matter of fact, the progress that we have made so far in disinflation efforts supports this opinion. Inflation rate was reduced to 18.4 percent at the end of 2003 from 68.5 percent in 2001. A decline of 50.1 points has been observed since 2001, and Turkey experienced its lowest inflation rate in the last 28 years. The realized inflation rates remained below the inflation targets in 2002 and 2003. According to the expectations survey results, the gap between end-year expectations and the targeted inflation is gradually narrowing. The gap, which was 13.3 points in 2002, contracted to 4.9 points in 2003 and to 1.1 points in early 2004. According to the March 2004 results, there is no difference between the end-year inflation expectations and the end-year target, which is 12 percent. To sum up, credibility of the monetary policy has increased significantly with the determined and transparent policy implementations and the increasing communication with the public in the framework of the new arrangements.

Figure 5: Credibility Gap

Difference between Targetted and Realized Inflation Rates



Source: SIS, CBRT.

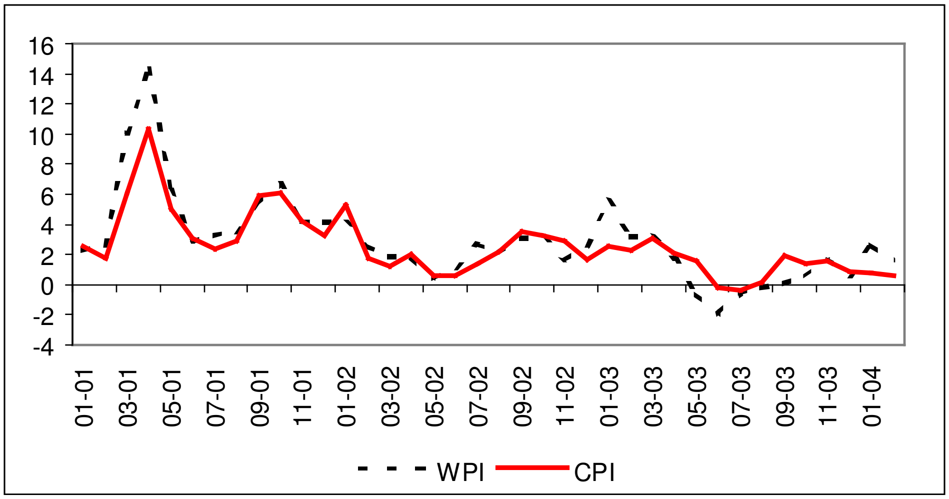
Factors Contributing to the Decline in Inflation

42. CPI inflation in February 2004 was 0.55 percent, and declined to 14.8 percent in annual terms. In the same period, WPI inflation became 1.6 percent and declined to 9.1 percent in annual terms. Private manufacturing industry prices stood at 0.1 percent and became 7.7 percent, by declining to single digits in annual terms. The effect of reduced costs on the private manufacturing industry prices can be clearly seen, along with the containment of agricultural prices due to good weather conditions, and with the automatically adjusted prices of petroleum products in line with the exchange rate.

43. Other factors affecting the decrease in inflation are food and agriculture prices. Price developments in these sub-groups have generally contributed positively to inflation. When seasonally-adjusted, it is observed that the rate of increase in food prices has slowed down significantly in the July-October period, compared to the first six months of the year. A similar tendency is also observed in agriculture prices, which are among the sub-groups of WPI. In November, food prices accelerated relatively due to Ramadan. Although sharp increases in fruit and vegetable prices due to unfavorable weather conditions has pushed agriculture prices upward; this effect remained temporary according to the February figures. As a result, the

increase in agriculture prices did not have an effect on food prices, which supported the downward trend in inflation in the first two months of 2004.

Figure 6: WPI-CPI monthly, 2001-2003



Source: SIS

44. Another important factor that has contributed to the recent positive course of inflation has been the public sector price adjustment policy mainly coherent with the inflation target. Public prices accelerated relatively in June and July. However, the price increases were far from affecting disinflation efforts negatively or threaten the end-year inflation target. Besides, exchange rate developments were also influential in limiting the public sector price increases, especially petroleum prices.

45. The downward trend in inflation can also be attributed to the fact that the domestic demand has not yet reached the level that could force the production capacity. The recent monthly industrial production data are giving strong signals of recovery especially in the demand for durable consumption goods. However, high increases observed in production and sales figures of durable consumption goods can be explained by low costs and low prices in the mentioned sector rather than a general revival in domestic demand. The lack of a similar strong demand in semi-durable goods supports this view.

46. The Turkish lira appreciation should not be seen as the main factor reducing the inflation, as some groups may assert. Past experiences show that although TL appreciated in the past as it is today, inflation rate never fell down to its present level. The present-time is mainly distinguished from the past in that the pass-through from exchange rate to inflation has started to decrease gradually.

47. Considering the progress made in disinflation efforts at micro level under the policy implementations, many factors supporting and maintaining the downward trend in inflation can be observed. The main factor is the tight monetary and fiscal policies. Besides, the relative stability maintained in markets due to the determined implementation of these policies has increased the confidence, improved the expectations, and accelerated the decline in inflation. In this process, another important factor is the implementation of public sector incomes and pricing policies in line with the inflation target.

48. In addition to the current policy implementations, the change in producers' and consumers' price-setting behaviors, the sluggish domestic demand, especially the productivity increase in the manufacturing sector and its effects on the real wages have all contributed to the decrease in inflation.

49. Inflation expectations, deteriorated during the Iraqi war, have started to improve as it became clear that the reasons for the fluctuations in this period were arising from the exogenous and temporary factors rather than from a deficiency in the conduct of economic program or a weakness in basic policies. The Central Bank has also foreseen the positive developments in inflation and has cut the short-term interest rates five times in the April-November period. The sharing of the Central Bank's positive outlook for the future with the public has also played an important role in the amelioration of expectations.

50. In this context, as a sign of the determination to reduce inflation to single digits permanently, six zeros will be removed from the Turkish lira banknotes in the beginning of 2005. Hence, the public confidence in the national currency will be restored and it will help to break the resistance that might be inherent in expectations during the transition period.

51. Apart from its positive effects on expectations, the re-denomination of TL is not expected to cause a positive or negative effect on the general level of exchange rates and interest rates. As a matter of fact, the main determinants of the general level of exchange rates and interest rates are the economic fundamentals and the current stabilization program. Along with the transition to the new Turkish lira, price increases that may emerge due to the rounding-off operations and the monetary confusion are not expected to have a significant inflationary effect. The rounding-off effect has come into light during the transition to the euro. However, the effect of transition to the euro on prices, varied from 0 percent to 0.16 percent in among countries in the first six months of 2002, and did not surpass 0.2 percent. In addition, as inflation refers to permanent increase in prices, the minor effect to be created by the rounding-off operation will not be enduring.

52. Therefore, the minor price increases to be made by retailers to reflect the cost of transition to new TL on consumers, or the upward price adjustments arising from confusions are not expected to be permanent. In short, it is considered that the rounding-off effect should be hardly felt as it is already in effect in our country, and that the re-denomination of the TL will be perceived as an indication of the determination in the fight against inflation.

53. Despite the downward trend observed in inflation, much remains to be done to achieve and preserve price stability after reducing the inflation to single digits.

Probable Risks

54. An atmosphere of confidence has been created as a result of the tight monetary and fiscal policies implemented since mid-2001 and the consistent economic program. Hence, this favorable environment has improved inflation expectations and, along with the factors I have just mentioned, the decline in inflation has become more evident and annual inflation has approached to single digits. The inflation figures of the first two months of 2004 are consistent with the end-year inflation target of 12 percent. In case there will not be an important exogenous shock, the inflation target of 2004 is expected to be reached. However,

there are still some risks on the way to achieve and maintain price stability in the next period.

Risk of Relaxation

55. The successful implementation of the program in the last two years may relax the politicians' determination in this regard. The previous experiences have shown that the early successes obtained in the comprehensively started stabilization programs have had a negative effect on determination for the continuation of the program. The public opinion seems to be very keen in this regard. For this reason, it is essential that all policy makers should show the determination needed for the continuation of the program. In other words, both fiscal discipline and structural reforms should be carried out.

Discipline in Public Finances

56. Moreover, the effects of the incomes policy on the inflation bear much importance, considering the importance of fiscal domination. The effects of an increase in wages on inflation by boosting total demand would be higher than that of its costs. However, this is rather relative. It should be underlined that the negative effects of the mentioned developments on the budget deficits should be eliminated. Therefore, the lower-income groups should be protected, while the primary budget surplus target is not endangered. By this way, the effects of increased total demand will be greatly diminished, and their likely negative effects on inflation will be minimized as a result of the measures taken. What is important in drafting the measures is that the emphasis should be given to expenditure-curbing policies rather than to revenue-raising measures by public sector price adjustments and additional taxes.

57. These measures also play an important role in minimizing the negative expectations created by the burden on the budget. Another important way of breaking the backward-indexation mechanism of inflation is allowing price makers to base their decisions in line with the inflation target by steering expectations. For this reason, an unfavorable development in expectations may cause economic agents to

try to make their decisions according to past inflation, and may jeopardize the success of the program.

Price Rigidity in Service Sector

58. Since the price rigidity in service sector has not yet been eased, expectations management and domestic demand control are becoming even more important. At this point, the sustainability of budgetary discipline has become more critical than ever. Besides, the steps to be taken for the improvement of competitiveness will help reduce the rigidity in inflation, and avoid irrational and arbitrary price-setting behavior as well.

Cost Factors

59. The decrease in unit costs should be maintained with the increase in productivity and structural reforms. For this reason, especially structural adjustments encouraging good governance and direct capital investments are crucial.

60. Unexpected market developments that might jeopardize the financial stability are always a risk factor for inflation. To reduce such risk in time, the continuation of banking system reform, the elimination of fiscal dominance, and the proper management of expectations become important. In addition, the improvement of the competitive environment will help ease the pressures of the changes in exchange rates on prices.

Domestic Demand

61. For the continuation of the downward trend in inflation, the total domestic demand should not exceed the potential production level in the economy. Therefore, increasing production capacity and supporting the increase in productivity by sweeping away obstacles to investment and production are very critical.

62. In conclusion, to achieve and maintain price stability by continuing with the success obtained so far in disinflation efforts, the main points can be summarized as follows:

- Proper management of expectations, and implementation of credible policies for attaining macroeconomic stability,
- Reduction of public deficits and total public debt stock by sustaining fiscal discipline,
- Elimination of the fiscal dominance on the financial markets during the process of reducing total public debt stock by encouraging financial deepening,
- Continuation of monetary discipline,
- Conduct of incomes policy in the public and private sector in line with inflation targets,
- Removal of the rigidity in inflation completely, which is already in a downward trend, by fulfilling structural reforms started in legal and institutional areas,
- Raise of productivity and quality in goods and service sector for boosting the competitive edge of the economy.
- However, it must be borne in mind that agricultural goods, food and energy prices are always risk factors.

II. 3. Monetary Policy Instruments and Current Implementations

Interest Rate Policy

63. After having explained the progress we have achieved on the inflation front and the related risks, now let me go into some details of the current monetary policy. Monetary and exchange rate policy have been redesigned under the stabilization program that was introduced following the 2001 crisis and revised at the beginning of 2002 to cover the 2002-2004 period, and have been supported by a legal base with the amendments made in the Central Bank Law. According to this policy, the main criterion is the coherence between the future trend of inflation and the targets. In accordance with this policy and under the floating exchange rate regime, the Central Bank uses short-term interest rates as the main policy instrument in achieving the primary objective of price stability. On the other hand, under the current IMF backed-program, the Central Bank monitors the monetary performance criteria and the indicative targets as well, but always stressing that price stability is

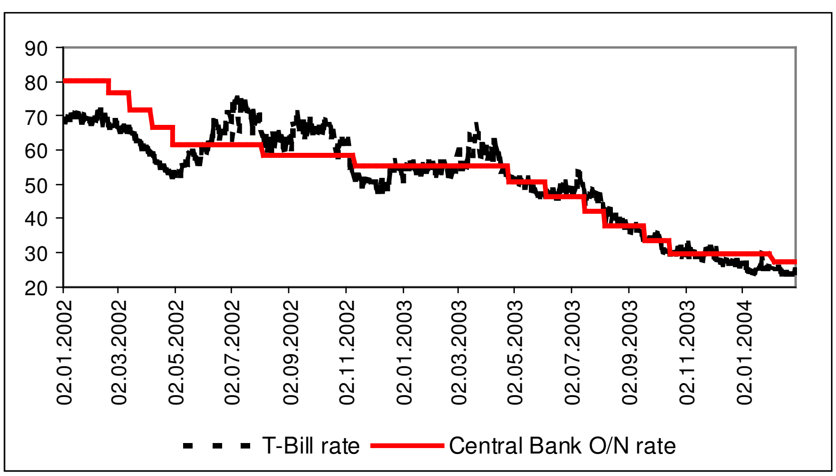
the primary objective and monetary targets and indicators may be revised if necessary.

64. The Central Bank employs short-term interest rates, which is the main policy instrument, in line with the primary objective of price stability, and by taking into account the probable developments in future inflation. The Central Bank does so because decisions on short-term interest rates taken in favor of alternative objectives as growth, exchange rate or employment can produce results contradicting the primary objective of price stability.

65. Therefore, the Central Bank specifies the factors that affect inflation by analyzing their prospective movements under various scenarios with a view to the price stability objective. Aggregate supply-demand balance, the course of fiscal policy, developments on wage, employment, unit cost and productivity, pricing policy of the public and private sector, inflation expectations, exchange rates and the factors that could influence them -for example developments in the balance of payments-, analysis of exogenous shocks and internal inflation projections are all taken into account when interest rates decisions are made. Decisions for cutting or increasing interest rates are made according to the results of these analyses.

66. Within this framework, the Central Bank's overnight borrowing interest rate, which was 44 percent on April 25, 2003, was gradually eased and decreased to 22 percent by March 17, 2004.

Graph 7: CB Overnight Interest Rate/Domestic Borrowing Rate



Source: CBRT, Undersecretariat of Treasury

67. As the main policy instrument under the current program, any movement in short-term interest rates should trigger a change in other interest rates in the market, and such a change should have a direct or indirect impact on aggregate supply and demand. In other words, the transmission mechanism from short-term interest rates to inflation should be functioning effectively. In this context, the extent of impact of short-term interest rates on other interest rates in the market, and to which factors this impact can be attributed are of great importance.

68. To achieve price stability, short-term interest rates should be set in line with the consistency between the future course of inflation and the targeted inflation. The Central Bank determines short-term interest rates according to the consistency between the future inflation rates and the targeted rates.

69. This mechanism can function flawlessly only if the central bank is highly credible, and the signals sent by the central bank are not lost among other messages given by other authorities. Otherwise, the effect of the signal regarding the general course of economy and outlook would be wiped out, and the monetary authority would lose its credibility undeservedly. As a consequence, discredited macroeconomic policies would cause the risk premium and the general level of interest rates to rise.

70. When the course of overnight interest rates of the Central Bank and interest rates applicable to government securities over time are compared, it is observed that although the Central Bank has been easing interest rates gradually since August 2001, interest rates applicable to government securities –despite following a similar trend- have been volatile, occasionally surpassing or falling behind the overnight interest rates.

71. The political instability that started in May 2002 opened the way for early elections and led to a rise in interest rates applicable to government securities. The favorable atmosphere incited by the adoption of EU laws by the Turkish parliament helped ease interest rates again. However, interest rates started a rebound in autumn due to the election process and the developments in Iraq. With the establishment of the single party government in November, expectations turned positive and interest rates turned downwards again. In early 2003, interest rates started to climb up once more due to concerns over the economic program, the Iraqi war and the EU accession process. The restored confidence after the Iraqi war, the target set for primary surplus in the budget for 2003, and the completion of the 4th IMF review helped decrease interest rates once again.

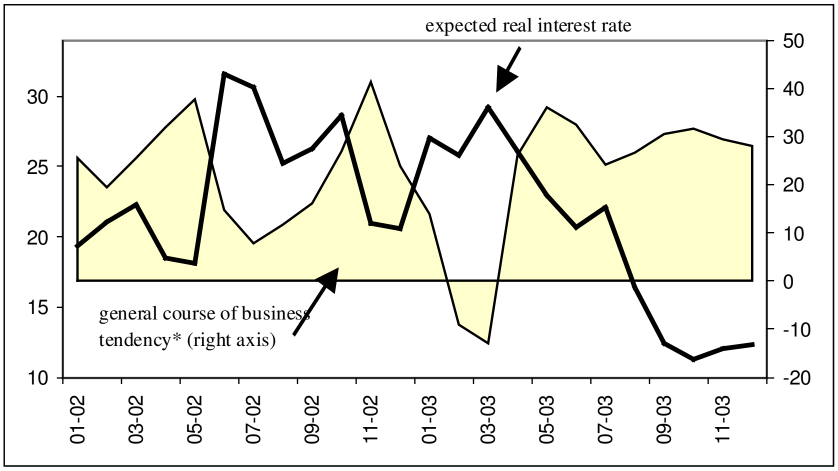
72. Within this framework, the level of risk perception at the time when the interest rates are cut becomes an important factor in assessing the impact of short-term interest rate cuts. In cases where the level of risk perception is low, interest rates for all maturities decline; however in cases where risk perception is high, a limited decline is observed in short-term interest rates and interest rates for longer maturities remain the same.

73. The structure of debt stock is important in the high-risk perception cases. Though declined relatively recently, the short-term borrowing requirement of the Treasury is still high. High debt service is characterized by high interest rates. This further aggravates the already fragile structure of domestic debt stock and worries over its sustainability continue. In case of an exogenous shock, concerns over debt repayment are deepened; risk perceptions become more intense, putting an upward pressure on interest rates.

74. Rising risk premium prevents real interest rates from declining as well. Risk premium has been very high for a long period, due to the long-standing macroeconomic instability coupled with chronic inflation and successive economic crisis. Therefore, real interest rates have risen and Turkey has long suffered from the burden of high real interests, due to the unfavorable impact on debt stock and real sector.

75. To sum up, an analysis of the movements of overnight interest rates and secondary market interest rates since the beginning of 2002, adoption of implicit inflation targeting strategy, reveals that, the main trends in both interest rates are common. However, a strong correlation, which is normally expected to exist between the two rates, has not been fully established yet. The secondary market interest rates generally rise above the overnight interest rates of the Central Bank. Almost all of these upward deviations can be attributed to endogenous or exogenous developments that lead to widespread fears that the current economic program, which is the *sine qua non* of debt sustainability, is at risk. In fact, real interest rates tend to decrease when expectations about the general course of the economy become favorable, and tend to increase vice versa.

Graph 8: Expected Real Interest Rate and The Business Tendency



Source: CBRT
* CBRT Business Tendency Survey, difference between optimistic and pessimistic views.

76. Excess liquidity in the market is sterilized through open market operations in order to enhance the efficiency the interest rate policy. The Central Bank prevents the interest rates from rising above the forecasted inflation by injecting liquidity in line with the increase in money demand, and mopping up the excess liquidity with open market operations in order to prevent the interest rate fall below the foresights.

Exchange Rate Policy

77. Following the 2001 crisis, the Central Bank and the Government opted for the floating exchange rate regime, and Central Bank was given the mandate to implement this policy. The failure of fixed and managed exchange rate regimes and the erosion of confidence in these systems paved the way for the adoption of floating exchange rate system. Under the floating exchange rate regime, the Central Bank started to control the short-term interest rates. The most important underlying reason for this is the impossibility for the monetary authority to control both the interest rates and the exchange rates at the same time in economies with free capital movements, as described in economics literature as the "impossible trinity." The Central Bank has been strictly pursuing the floating exchange rate regime, and the exchange rates have been determined under the market conditions. The Central Bank have not been performing any foreign exchange buying or selling operation with the aim of determining either the level or the direction of exchange rates, but only with the aim of preventing excessive volatilities. The Bank intervenes only in case of excessive volatility in the form of either buying or selling in a limited and transparent manner.

78. Exchange rate is a direct policy instrument in fixed or pre-determined exchange rate regimes where there is a target for the future level of the exchange rate. In such regimes, as the exchange rate risk is perceived to be relatively low, economic units have a stronger tendency to hold open positions . As a matter of fact, this tendency and the resulting hot money movements can be blamed for the past crisis. Whereas in the floating exchange rate regime, where there is no target for the level of the exchange rate, the movements in exchange rate are the result of the economic fundamentals, the current stabilization program, and the expectations.

79. Under an economic program with high credibility, the implementation of fiscal and monetary policies in line with the targets, and the determination in structural reforms has played a significant role in shaping the expectations. This has reduced the risk perception by increasing confidence in the Turkish lira. There has been a massive portfolio shift from foreign exchange to Turkish lira in connection with the increased confidence in the current economic program. The demand for Turkish lira investment instruments has accelerated especially when the foreigners began to speed up buying securities in Turkey starting from August.

80. It must be kept in mind here that the floating exchange rate system differs from the previous fixed and managed exchange rate systems in that, it requires foreign investors to consider the exchange rate risk they are going to take before making their investments. This is a factor that helps prevent the speculative movements. In sum, it is not appropriate to compare the foreign investment made under the floating exchange rate regime with those made in the previous periods. Therefore, it would be more appropriate to explain the excess foreign exchange supply as the natural outcome of all the positive developments I have just summarized above, not merely as a result of hot money.

81. The Central Bank has been absorbing the excess foreign exchange supply through buying auctions within the pre-announced limits from time to time, with the aim of strengthening the foreign exchange reserve position and without affecting the exchange rate level. Strong foreign exchange reserve position is a crucial factor that increases the efficiency of the Central Bank's monetary policy, and the market confidence, and facilitates domestic and external borrowing. This has positively contributed to the expectations, by increasing the chances of success of monetary and fiscal policies. Thereby, it helped the Central Bank to pursue an efficient monetary policy in line with the objective of price stability.

82. It may seen as contradictory at a first glance that, the Central Bank has been increasing its reserves through foreign exchange buying auctions, while stating that it implements the floating exchange rate regime. However, especially in emerging economies, a strong foreign exchange reserve position contributes to the systematic realization of the foreign debt service, as well as to the increase of confidence of the international financial environment and international markets in the country .

83. Risk perception that is effective in determining the course of interest rates are, undoubtedly, reflected in the exchange rates as well. Uncertainties arising from the Iraqi war caused the exchange rates to assume a volatile course in the first half of 2003. The reverse currency substitution and the excess foreign exchange supply that started right after the war and the removal of uncertainties led to a rapid appreciation of Turkish lira, bolstered also by a massive depreciation of the US dollar against Euro. However, starting from June, the rate of appreciation of TL has slowed down and exchange rates have assumed a more stable course.

84. During this period, the Central Bank began conducting daily foreign exchange buying auctions to build up its reserves in line with the strong balance of payments position, the developments related to the reverse currency substitution process which was consistent with the exchange rate policy announced in the program. On the other hand, the Central Bank made five direct foreign exchange buying interventions in the same period, in order to prevent excessive volatility. The amounts of foreign exchange buying auctions were gradually increased with a prior notice in line with the developments in the foreign exchange market. Total amount of foreign exchange bought by the Central Bank in the May-October period reached US dollar 9.9 billion. However, starting from the end-September, exchange rates began to show a tendency to rise, which can be attributed not only to the decrease in excess foreign exchange supply, but also to the increased foreign exchange demand of some banks trying to settle their end-year accounts. Within the framework of these developments, the Central Bank suspended the foreign exchange buying auctions as of October 22, 2003.

85. The Central Bank resumed foreign exchange buying auctions on January 23, 2004, with the aim of absorbing the excess foreign exchange supply arising from the positive economic developments at the beginning of 2004. The Central Bank has closely monitored the developments in the foreign exchange market, and made foreign exchange buying intervention amounting to US dollar 1.3 billion on February 16, 2004, due to excessive volatility in exchange rates.

The Relationship between Short-Term Interest Rates and the Exchange Rates

86. Having discussed the practices related to the floating exchange rate system now let me elaborate on the relationship between the short-term interests, which is the main policy instrument, and the exchange rates. This relationship is multidimensional and complex. In case short-term interest rates are reduced, there may be three types of developments in the exchange rate. *(i)* The falling return on the Turkish lira denominated assets would increase the demand for foreign exchange. Therefore, there would be a depreciation pressure on the Turkish lira. *(ii)* On the other hand, the interest rate cut may be perceived as a signal denoting a positive economic environment. Accordingly,there would be a strongerreverse currency substitution along with the resulting confidence, and Turkish lira would be under an appreciation pressure. *(iii)* Another possibility is that the exchange rate would move independently from the economic fundamentals, namely according to the foreign exchange liquidity in the market.

87. In 2003, while the short-term interest rates were on decline, Turkish lira appreciated, except for a few exceptional cases[2]. A similar trend is observed in the first quarter of 2004 as well. The most important reason is the reduced risk perception in line with the increasing confidence in the current program. Favorable inflation expectations and the fall in inflation continued. At the same time, the firm implementation of the economic program, as well as the continuation of the recovery in the economic fundamentals without interrupting structural reform process, have reduced the risk perception created by the fiscal imbalance. The switch to Turkish lira gained momentum in line with the rising confidence. Capital inflow and the expectation that this inflow would continue gave rise to excess foreign exchange supply. For this reason, there was a pressure of appreciation on the Turkish lira .

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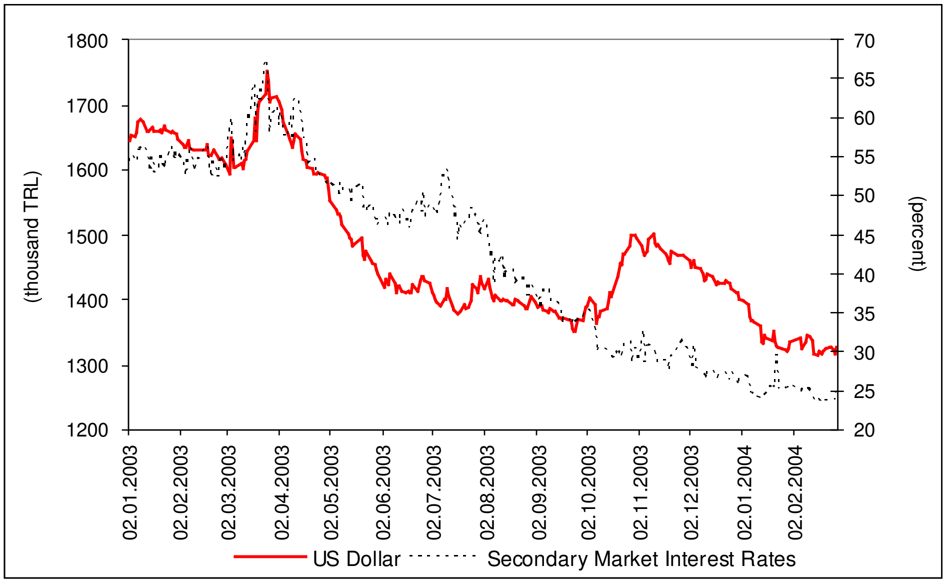
[2] There may be some temporary upsurges in the interest rates attributable to the news on domestic politics.

Graph 9: Interest Rates and Exchange Rates (2003-2004)



Source: CBRT.

88. At this part of my speech, I would like to talk about some significant benefits of the floating exchange rate system.

Exchange rate as a risk factor;

89. Under the floating exchange rate regime, the exchange rate has become a risk factor, since exchange rates can move both up and down, and are determined under market conditions. However, it is important to underline here that the exchange rate risk does not suggest uncertainty. It is extremely useful to make this distinction. Uncertainty is a phenomenon that cannot be measured, avoided, managed, or foreseen. It may have wide-ranging and severe repercussions in every area.

90. Risk, on the other hand, is a phenomenon, which can be measured and managed, can be assigned values to the results with certain probabilities. Furthermore, it is possible to avoid risks. As a matter of fact, many markets and instruments have been developed in the world with the aim of risk-aversion and/or risk management. As the exchange rate has become a risk factor with the floating exchange rate system, it is extremely important to introduce and operate such markets and instruments in Turkey for ensuring the asset-liability balance.

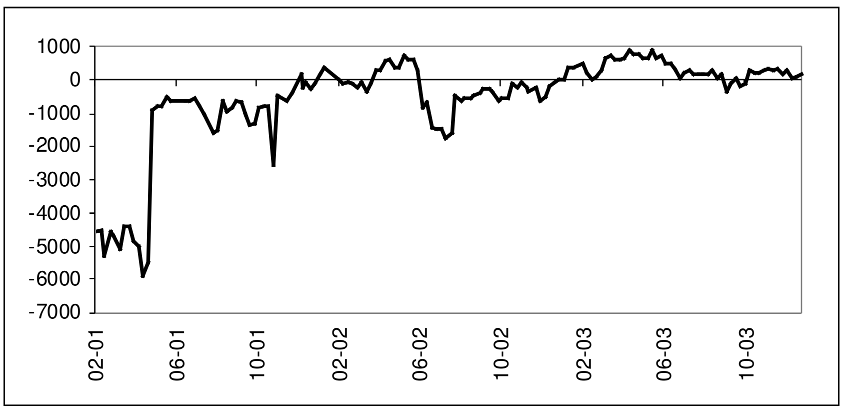
91. In the world, the volume of transactions in forward markets is higher than that in the spot markets. The 92 percent of the world's top 500 non-financial companies are managing their risks via forward markets. Banks in Turkey also give price quotations for forward

foreign exchange transactions. Under the floating exchange rate regime, the Central Bank attaches great importance to the development of the forward markets and the instruments for risk-aversion. Forward markets will develop in Turkey as well, in line with the examples in the world. Non-governmental organizations have important roles in this regard.

Current Account Balance Risk

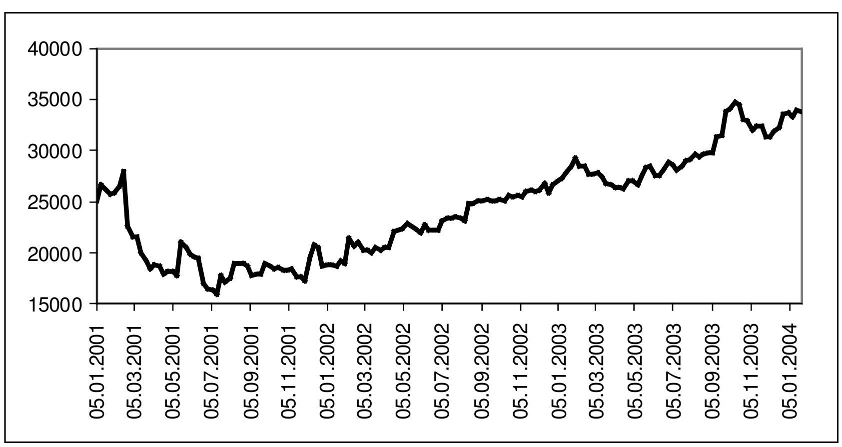
92. The floating exchange rate system has also changed the perceptions on the current account balance. The current account deficit stood at US dollar 6.8 billion in 2003, and was 2.3 percent of the GNP as of the end of third quarter. However, it is important to put forth the conditions and their differences from the past before deciding whether these figures are risk factors or not.

Graph 10: Total Change in the FX Net Position of the Banking Sector



Source: CBRT.

Graph 11: Central Bank Foreign Exchange Reserves (Gross, Weekly)



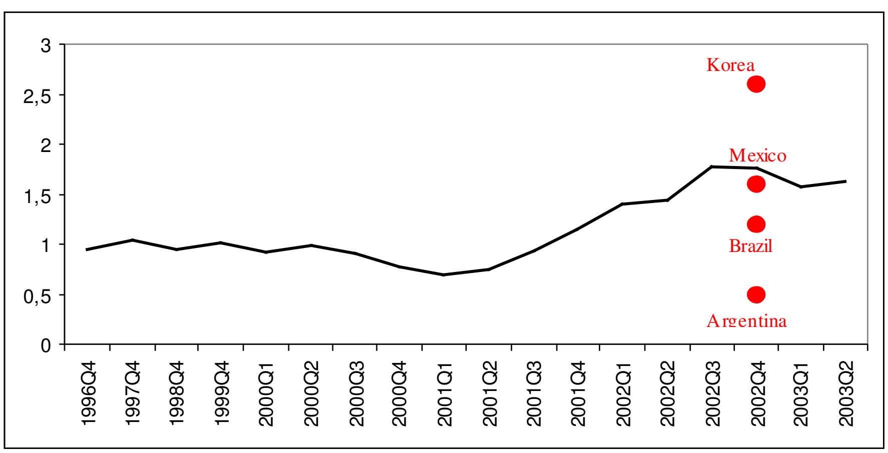
Source: CBRT.

93. After the banking reform made in the post-crisis period, open positions in the financial system have been greatly reduced. Besides, the Turkish lira has not appreciatedby artificial means. As I have emphasized in my speech, the Central Bank does not keep the exchange rates artificially low by selling foreign exchange. On the contrary, during this period, the Central Bank bought foreign exchange via foreign exchange buying auctions and foreign exchange interventions, and accumulated reserves.

94. As a characteristic of the floating exchange rate system, the exchange rates can move both upwards and downwards, making therefore the risk management a necessity. That is why short-term and speculative capital inflows are not encouraged. Besides, it may be misleading to evaluate the current account deficit alone to conclude that external financing requirement has increased. External financing requirement results from the total of current account balance and net errors and omissions. In 2003, the net errors and omissions item gave a surplus of US dollar 5.2 billion, and thus the external financing requirement stood at US dollar 1.6 billion. The Central Bank reserves increased by US dollar 4 billion during this period, since the capital inflows were higher than the financing requirement. In sum, the differences that I have emphasized in evaluating the current account balance risk, and the net errors and omissions item have all to be taken into consideration.

95. Under the current policy actions, the Central Bank will continue to fight against inflation with the same determination in the future. In accordance with the primary objective of price stability and the floating exchange rate system, short-term interest rates will be used effectively as a policy instrument.

Graph 12: Net Reserves / Short-Term External Debt Stock



Source: CBRT, Undersecretariat of Treasury, IMF.

III. Transition to a Sustainable and High Growth Path

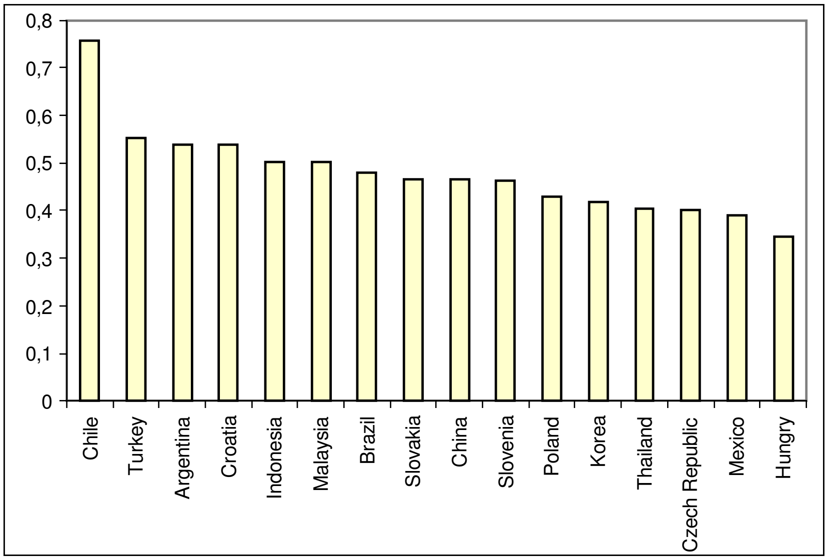
96. In this part of my speech, I would like to emphasize on the shift of economy to a sustained and high growth path, and the problems thereof. Many achievements have been obtained towards disinflation and economic stability thanks to the coordinated monetary and fiscal policies that have been implemented since 2001. Growth performance was strong in 2002 and 2003. Growth rate was 7.8 percent in 2002, in spite of a forecast of 3 percent, and became 5.2 percent during the first nine months of 2003.

97. Industrial production index rose above the expectations and the annual average was 9.1 percent in 2003. In the said period, the seasonally adjusted index skyrocketed, and reached the record levels with a value of 117.9. This also holds true for the increase in the capacity utilization ratio. As of the year-end, capacity utilization ratio in private sector reached 79.6 percent annually with an increase of 11 percent. Significant productivity increases were observed in the said period owing to the low employment in private manufacturing industry and modest level of real wages . Compared to the period of 1995-2000, the productivity increased by 23 percent in average in the private manufacturing industry sector during the 2001-2003 period, whereas real wages declined by 17.6 percent.

98. In 2003, the foreign trade volume also grew significantly and surpassed US dollar 100 billion for the first time, reached US dollar 115.6 billion. The share of foreign trade volume in GNP demonstrates that Turkey has largely integrated into the global economy.

99. As to the structure of foreign trade, it is observed that our export performance is rather good compared to the past, and to the similar country experiences. Diversity of exports is a strengthening factor for the structure of exports. In fact, Turkey seems to be in a good position compared to the similar countries listed in the exports diversification index, which is published by UNCTAD.

Graph 13: Exports Diversification Index, 2001



Source: UNCTAD.

100. Along with high exports performance, imports have significantly increased as well. At this point we need to draw attention to the production capacity of Turkey. In the Turkish economy there is a strong relationship between manufacturing industry imports and production necessitating the analysis of import components. Approximately 70 percent of total imports consist of intermediary goods, which constitute the main factor behind this relationship. Thus, at a time when the output increases, it is natural that imports of intermediary goods should rise as well. Likewise, capacity utilization ratio increased considerably in 2003. In line with this development, imports of capital goods, which constitute approximately 15 percent of total imports, also rose significantly. In short, the rise observed in imports results mainly from the production growth, and accordingly, from the increase in export-oriented use of inputs.

101. In this context, stability in the financial markets, improved confidence in the economy, decline in real interest rates and increase in productivity are expected to be the supporting factors for the growth also in the next period. Likewise, it is anticipated that the growth in the private sector will come from exports due to increases in industrial production. Furthermore, domestic demand is not expected to grow significantly due to substantial contraction in the public sector, modest increase in consumer spending and slow rise in employment.

III.1. Change in the Capital Accumulation Model

102. Current economic program and structural reforms performed under this program have started to change the capital accumulation model of the Turkish economy. Owing to the reforms that are being put into practice, a shift is occurring from a capital accumulation model supported by public sector to an accumulation model based on market conditions.

103. When the GNP figures of 2002-2003 and 1997-2000 are compared as an indicator of this transition process, it is clearly observed that weight of public sector in the economy is declining in the former, whereas the share of private sector is on the rise. The quality of public expenditures has great importance in the forthcoming process.

104. Structural reforms made under the current program aim at changing this structure. With the decreased domestic debt stock, and the reduced role of the public sector in the economy, there will be more resources available to the private sector. Accordingly, long-term credit market will develop after price stability has been attained and uncertainties regarding inflation have been removed. Together with these reforms, private sector will have a well-built structure, competitiveness will increase and the private sector will have the ability to obtain necessary resources in the transition process of the capital accumulation model.

105. On the other hand, in order to make such a transition process of capital accumulation healthier and less costly for the economic agents, comprehensive tax and banking reforms should be rapidly implemented.

106. Therefore, let me now go into the quality of fiscal discipline and banking reform, which are the other two necessary conditions for a sustained high growth, after achieving and maintaining price stability.

Quality of Fiscal Discipline

107. Producing primary surplus in the framework of the macroeconomic targets under the current economic program has become a significant indication in this regard. Primary surplus has increased the credibility of the program in the financial markets and has been effective

in bringing down the inflation expectations as well as the interest rates. However, the fact that should be considered carefully here is the quality of the primary surplus. Public expenditures need to be controlled, and efficiency and transparency in expenditures should be increased. Also, it is important to make structural changes in the organizational and functional aspects of the public sector. Employment rationalization, social security reform and strengthening the collection of insurance premium are of primary importance.

108. Effective tax rates, defined as the ability to convert incomes and expenditures into taxes, are extremely low in Turkey. Income created in the economy cannot be taxed effectively. Furthermore, the size of unregistered economy, in other words, untaxed economy accounts for between 16 and 50 percent depending on the underlying assumptions. Due to this structure, tax burden and cost borne by the registered economy is significantly high. Therefore, public sector reforms and private sector reforms have to be carried out simultaneously, and the existing costs as well as costs arising from the transformation process have to be divided equally among the economic agents by creating a competitive atmosphere. In other words, tax reform has to be carried out.

109. Instead of resorting to one-off taxes in order to increase revenues, emphasis should be given to indirect taxes, the enlargement of tax base, and the improvement of tax administration. The completion of the public sector reforms will prompt the changes in the organization and operation of the private sector.

Banking Reform

110. It is not possible to provide funds to the real sector, support the capital accumulation process of private sector, and consequently sustain the economic growth without achieving the banking sector reform and without increasing the credit potential.

111. While the real sector is heavily financed through the capital markets in Anglo-Saxon countries, it obtains funds mainly through banking sector in continental Europe. As the banking sector constitutes 90 percent of the financial system and due to the underdeveloped structure of the capital markets, banks play a prominent role in financing the real sector in Turkey. However, as I mentioned before, owing to fiscal dominance, the gradual strengthening of the relationship between the banking

sector and the public sector, gradually has weakened the relationship between the banks and the real sector.

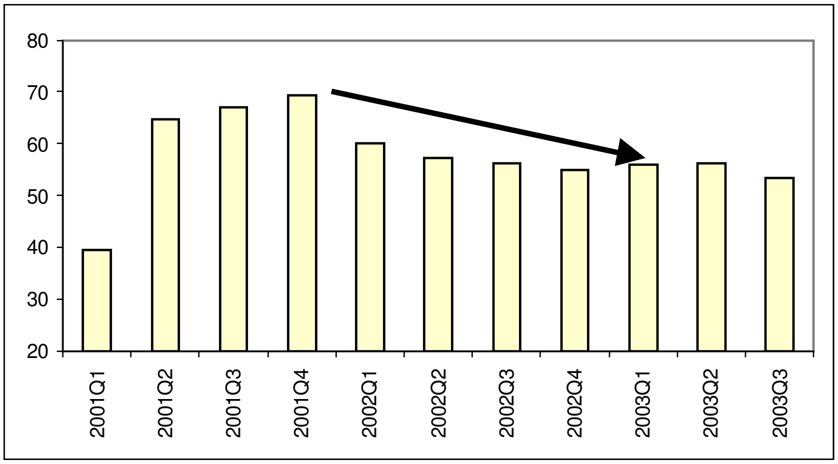
112. Under the current program, it is envisaged to break this cycle through reducing the domestic debt stock, and thereby enabling the banking system to create resources for the private sector instead of funding public deficits. However, it is essential to fulfill and implement the reforms in the banking sector in order to transfer the resources to the real sector in a healthy manner, after the rise in loanable funds. The banking system is not in a position to function properly particularly due to the macroeconomic instability occurred in the nineties, and the gradually increasing dominance of the public sector over the economy. The Treasury's guarantee on deposits, the widespread lending of holding banks to their own companies, and the considerable amount of short positions have put the banking system into a risky position. The risks were veiled as a consequence of weak regulation and supervision. The reforms, started following the 2001 crisis, are intended for improving the unhealthy structure of the banking sector.

113. Main pillars of the banking reform can be summarized as follows:

- Strengthening the independence of the Banking Regulation and Supervision Agency, the responsibility of the regulation and supervision being under this agency,
- Restructuring and privatizing the state-owned banks,
- Re-capitalizing the private banks,
- Introducing risk management in credit operations,
- Abolishing of guarantee on deposits.

114. A look at the implementation of the program reveals that the results have started to be seen. The ratio of domestic debt stock to GNP is declining. Moreover, it is observed that the total credit volume is on the rise and the maturities are extending, as the reforms are being put into practice.

Figure 14: Domestic Debt Stock / GDP, quarterly (2001-2003)



Source: SIS, Undersecretariat of Treasury.

115. The fulfillment of these reforms will support the transfer of funds to the real sector. Furthermore, the country outlook will improve and the resulting favorable atmosphere will attract foreign direct investments.

Foreign direct Investment

116. Foreign direct investments play a significant role in the capital accumulation process. In Turkey, domestic savings are about 22 percent. Both the developing country and the developed economies reveal that our saving rates are rather low. Since it is difficult to increase incomes and to change savings tendency in the short term, it will not be wrong to name Turkey as a country suffering from a chronic savings gap. Therefore, the domestic savings gap needs to be covered by foreign savings. In other words, foreign direct investment is a must.

117. In Turkey, foreign direct investments have historically remained low at around 8 percent. Long-standing economic instabilities, subsequent crises and structural deficiencies have reduced the appeal of Turkey in the eyes of foreign investors. This supports the fact that the development of the new capital accumulation model that I have previously explained is the precondition for attracting foreign investments.

III.2. Productivity and Competitiveness Power

118. Boosting productivity and competitiveness edge in the economy is one of the necessary conditions for achieving and maintaining price stability and thus sustaining high growth. In

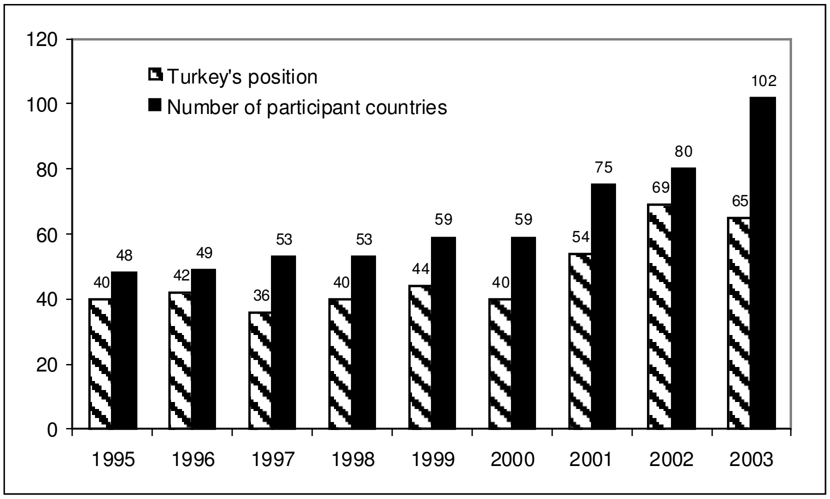
his book titled “International Competitive Advantage” on the competitiveness power, Porter (1991) has stated the following:

> *"A nation's primary goal is to provide high living standards to its citizens and sustain it by even enhancing more. Capability to achieve this end depends not on the ambiguous conception of competitiveness but on productive utilization of national resources (labor force and capital). Productivity is the unit labor force or the value of output produced per capital. This depends both on the efficiency of the production and on the quality as well as the features of the product, which determines the prices. The only meaningful concept of competitiveness at national level is national productivity"*

119. Following the first quarter of 2003, along with the end of the Iraqi war and the resulting reduced uncertainties, the Turkish lira started to appreciate rapidly due to reverse currency substitution and excess foreign exchange supply, as well as the significant depreciation of the US dollar against the euro. Based on these developments, it has been asserted that exchange rates could have negative impact over the competitiveness power. However, in 2003 following 2002, a rather significant rise was observed in the rate of increase in exports compared to the previous year and especially to the years of devaluation and to countries with similar experiences. In other words, despite the appreciation of Turkish lira, the competitiveness edge has improved.

120. The most widespread instruments used in measuring the competitiveness are mainly those used in measuring price competition, such as real exchange rates, relative positions, unit wages, and export profit margins. The analyses made through the said methods are necessary, but not a sufficient criteria. Analysis of a more comprehensive competitiveness power is considered to be a more plausible approach. Establishing a competitive atmosphere following an improvement in the fondementals will be more enduring and long-lasting than the price (cost) competitiveness.

Figure 15: Turkey's Position within Global Competition



Source: World Economic Forum, Global Competition Report.

121. In order to catch a competitiveness edge in general terms, the economic and social standards of the countries are important. The stable rise in GDP per capita, the low level of unemployment, disposable income level of households and the amount of social assistance are the indicators of the economic activity in a region. However, if the growth and output of a country are supported by the increase in productivity, then the growth ensued will be competitive.

122. Ensuring a productivity increase in output is one of the most robust dynamics of sustainable growth. Increase in productivity constitutes the basis of improvement in real incomes and in welfare.

123. Productivity increase driven by investments in the labor force seems to be more permanent. However, the investment made in the labor force alone cannot ensure the compatibility of production to the changing commodity composition in the world trade. The said commodity composition has been gradually shifting to capital and technology-intensive commodities. Increase in total factor productivity is gaining significance to ensure long-lasting advantage in international competition. Furthermore, investing both in the labor force and in technological innovation becomes even more important. Under the so restructured production model, it is observed that production can swiftly react against changes in demand and therefore can get an upper hand in competition.

124. Increased technological content of production through research and development investments raises the value added ratio of such companies. At the same time, such investments can have a rapid spreading effect, contributing to the industries in which the

companies are working in. Highly technological products that are gradually gaining larger shares in the world trade along with the increase in research and development efforts can cause the said production and thus exports to rise, and provide structural advantages to the country in terms of international competition.

125. Apart from the above-mentioned competitiveness indicators, there are some qualitative factors that are considered to have a positive impact on competition. These factors are mainly related to the services sector, comprising of post-sales period. Maintaining the standard of goods during delivery, complying with the delivery date, establishing post-sales services network, developing confidence for a fast and consistent solution to post-sales problems that might arise, and the scope of the guarantee can be listed as important factors in this regard.

Productivity in Public Sector

126. Widespread unregistered operations, and the resulting tax burdens imposed on registered companies more than necessary, the fiscal domination in the market as a result of high debt stock, and high real interests; cause the public sector to exert great pressure on the economy due to state economic enterprises leading to unfair competition, and also prevents the productivity increase of the private sector. Reduced efficiency in the public sector is also a barrier against an increase in competition. The fulfillment of the arrangements made under the structural reforms will bring productivity increase in the public sector.

IV. Institutional Developments of the Central Bank: Profit/Loss

127. Now I would like to refer to the developments of the Central Bank's balance sheet for 2003. As I mentioned earlier, excess liquidity occurred in 2003 was withdrawn from the market through open market operations. However, this policy implementation, which was intended for increasing the efficiency of the interest rate policy towards price stability, has produced a loss in the Central Bank balance sheet. Accordingly, the Central Bank has closed the 2003 with a loss of approximately TRL 1.5 quadrillion in its balance sheet accounts. Here there is one point that needs to be emphasized: the Central Bank's legal primary objective is to achieve price stability. Under the primary objective of fighting against inflation, it is possible to make profit or loss depending on the course of other macroeconomic variables such as exchange rate and interest rate, and on the influences of these variables on the balance sheet items.

128. Although having the power to increase profits through influencing non-income generating assets and the base money in its balance sheet, the Central Bank will not do so if this would lead to changes in interest rates in the financial system contradicting with the price stability. So the Central Bank will opt for price stability. In other words, the Central Bank does not pursue a goal other than the price stability, therefore profit maximization is not considered to be a goal. A monetary authority showing signs of pursuing other goals besides price stability would seriously reduce the efficiency of monetary policy, and therefore in the medium-term would damage the welfare level.

129. As a result, it should not come as surprise if the Central Bank produces a loss at certain periods. The likelihood of this situation will increase especially at times when interest rates run high and excess liquidity in the market should be sterilized. As a matter of fact, excess liquidity has developed as a result of state bank operations and loans received from the IMF utilized by the Treasury for budgetary purposes following the 2001 crises in Turkey. On the other hand, in the later stages of the program, the excess liquidity has persisted with the foreign exchange buying auctions held as a result of increased confidence in Turkish lira. Due to these developments, interests paid for sterilization together with interests paid for reserve requirements have prevented the Central Bank from making profits. Furthermore, interests paid to workers' remittances accounts, which is specific to the Central Bank of Turkey, has since long been a loss item.

130. Like all other joint stock companies, the Central Bank of Turkey allocates every year ordinary and extraordinary contingency reserves from its profits under Article 60 of its Law in order to meet likely future losses. Accordingly, the loss amounting to about TL 1.5 quadrillion by 2003 will be covered by ordinary and extraordinary contingency reserves of around TL 2.5 quadrillion.

131. Of course, the ideal situation is to achieve price stability while not incurring loss at the same time. However, the fact that should be underlined at this point is that in case of any contradiction between making profit and achieving price stability, the Central Bank's priority will be to achieve price stability, which is its primary objective. The primary objective is achieving price stability. Policies will be implemented towards this direction and their influence on the balance sheet will be determined according to the current conditions and to the stage at which the economic program stands.

V. Conclusion

132. Let me end my remarks by making a last point on the quality of organizational structure, rule of law and the close relationship between property rights and economic growth. According to general opinion, the existence of well-functioning organizations and a government restricted by law is the indicator of the economic and political development.

133. Organization concept is defined as "the constraints developed by people in order to structure their own political, economic and social interactions" by North (*1991)*. In a broader sense, organization concept is institutions, rules, sanction mechanisms and organizations that can be illustrated as constitutional law, laws and property rights. The factor, which makes organizations vital for the economy and market system, is the necessity to protect property rights. Failure in protecting property rights has an unfavorable effect on investment and growth processes. Hence, if we consider the importance of protection of property rights in achieving the targeted growth via market system in the long run, the necessity of a supreme legal mechanism, which is well defined and functions efficiently, can be better understood.

134. The World Bank lists the essential general criteria for the presence of supremacy of law in a country such as the existence of independent and absolute jurisdiction, the equality in legal treatment, the non-existence of laws specific to individuals or groups, the protection of acquired rights and the judicial supervision on the executive power.

135. At the same time, institutions can create a statistically comprehensible orderliness by shaping repetitive human behaviors, though they do not eliminate uncertainties in human behaviors. In other words, institutions transform uncertainties into risks. While uncertainties are not manageable, risks can be diversified. Thus, the reduction in uncertainties strengthens the infrastructure of growth in the long run.

136. Organizations also influence the production, collection, analysis and verification of information as well their dissemination to individuals or markets. Availability of information to general public will contribute to the economic performance via reducing the cost of information and making the information symmetrical.

137. Rather than doing business as an individual activity, performing the business through companies on a legal platform supported by sanctions of third party will help sustain the economic development. In this context, the public can make the most out of sectoral

specialization where there exists a meticulously designed legal framework coupled with the power to impose sanctions.

138. Institutions regulating the dynamics of market competition can contribute to the economic growth by directing the current and future investments as well as the related economic processes. The presence of an efficient legal order will increase the institutional quality by reducing irregularities, and help boost investments and growth in the long run.

139. In today's world, where long-term growth is sought in the efficient and productive functioning of markets, institutions are expected to provide guidance and framework for operation of markets. The common denominator of these works is the establishment of appropriate conditions for new investments that would support the sustained growth process in economies where institutional arrangements are strong and the principle of rule of law is adopted.