

# CHANGING STRUCTURE OF THE TURKISH ECONOMY

**March 2004** 

**CENTRAL BANK OF THE REPUBLIC OF TURKEY** 

1



# INFLATION DYNAMICS Past - Present





### INFLATION EXPECTATIONS



### In the Past;

### Strong inflation inertia:

- 30 years of chronic inflation
- Backward indexation: The price-setting behavior and incomes policies of both public and private sectors
- Low credibility of policies and targets

### ✓ The Central Bank puts:

- Effective communication policy
- Managing expectations

### at center of its policies

Transparency; Accountability;

Determination in policy implementation

## Inflation inertia has been disappearing:

Expectations approximate to the target

5

 As of March, the credibility gap is minus 0.2 points



### In the Past;

### ✓ Fixed or pegged exchange rate regimes

- Exchange rate served as a nominal anchor
- Short-term interest rate was not a main policy tool
- Fragile structure of the economy against shocks

### Present;

### $\checkmark$ Floating exchange rate regime

- Exchange rate is not a nominal anchor anymore
- Shock absorber
- The Central Bank is able to focus on inflation
- Pass-through effect on inflation is relatively weaker

### $\checkmark$ Inflation target becomes a nominal anchor

#### Main policy tool is short-term interest rates

- Decisions are based on the inflation outlook only
- Comprehensive data and information are used to foresee the future trend of inflation
- The Central Bank can **increase** or **decrease** the rate, based on the available data and estimates, anytime it deems necessary

#### INFLATION TARGETS AND REALIZATIONS



### And, as dynamics changed

- Inflation declined by 50.1 points → 2004 Target: 12 % Afterwards: Single-digit inflation ✓ CPI: 0.6 % monthly, 14.3 % annual
  - Increases in both food and non-food prices are in line with the target
  - But, some stickness in service sectors:

Rental prices: 3.6 % increase in two months

Price adjustments in health sector relatively better than 2003, but need further improvements

- ✓ WPI: 1.6 % monthly, 9.1 % annual
  - Single-digit after 28 years
  - Increase mostly caused by seasonality in agricultural prices: 5.4 % in February
  - Non-agricultural prices inflation 5.2 % annual
- ✓ PMI: 0.1 % monthly, 7.7 % annual
  - Indicator of declining trend in inflation

The target will be achieved by the end of the year, after a substantial decline in the first five months and a possible rise during summer: Base effect

## Inflation target becomes a more credible nominal anchor

## Inflation – Outlook

In order to achieve the inflation target of 12 % in 2004 and the single digit beyond, we have to be careful about the following issues:

- ✓ Reform fatigue
- Continuing with the structural reforms in a decisive manner
- Ease of backward indexation in the economy, especially in the services sector and rental contracts
- Incomes policies and price adjustments of both public and private sector in conformity with the inflation target
- The avoidance of private sector's opportunistic attitude in increasing their profit margins
- Increase in domestic demand

Increase in food prices or energy prices is always a risk factor for the target.



## **REAL SECTOR AND GROWTH DYNAMICS**

## **Past - Present**

### Growth Dynamics In the Past;



✓ Public-led capital accumulation model

- Dominance of public sector over private sector in terms of both consumption and investment expenditures
- Limited participation of private sector in the investment process
- As a result of the reforms in the public sector and implementation of the current program

## Capital accumulation model has been changing irreversibly

### Present;

### ✓ Private sector-led market economy

- No leading role of public sector in either investment or consumption expenditures
- Considerable impact of private sector on the investment process
- Public investment expenditure aimed to be limited with infrastructure investment

## Growth Dynamics



### In the Past;

- ✓ Domestic demand was above GDP
- Increase in money supply was followed by growth in the economy.

High inflation

Crises

Unsustainable growth

### Present;

- ✓ Domestic demand is below GDP
- Growth is mainly driven by industrial production and export
- Production is followed by the increase in money supply

## **Growth Dynamics**



#### PRODUCTI VI TY GROWTH IN PRI VATE MANUFACTURING INDUSTRY \* (Seasonally Adjusted)

SIS Private manufacturing industry quarterly industrial production index / SIS Index of production workers working in manufacturing industrial establishments
Increases are calculated according to the 1990-1994 average.

### Higher productivity growth in the manufacturing sector

- Average seasonally adjusted productivity growth in manufacturing sector increased by more than 50 percent between 2002-2003 period and 1990-1994 period
- Productivity growth exceeding GDP growth results in slow recovery in labor market

- Jobless growth  $\backslash$  recovery is a worldwide problem as in USA or EU

- Employment should be supported not only by macroeconomic policies, but also by microeconomic measures

Current policies are not demand side policies, but they aim to increase supply.

## Foreign Trade



Turkey is integrating into the world economy and becoming more competitive.

- A record high level of total trade volume in 2003, which surpassed USD 100 billion, is attained for the first time ever, despite sluggish European and world demand in general, considering the sensitivity of exports to external demand.
- Substantially higher export growth rate compared to similar emerging economies

✓ Also, a large number of companies began to export.

## **Foreign Trade**





### A closer look at the imports;

- ✓ Upsurge in intermediary goods
- A record high level in capital goods; USD 1.8 billion in December 2003
  - Encouraging for new investment opportunities
  - No unexpected increase in consumer goods



- Imports directed to
  - ✓ Production
    - ✓ Exports

## Growth Outlook





### Turkey's economic growth is now driven by;

- ✓ Private sector
- ✓ Productivity increase

### **GNP** Growth

2002	2003 First 9 Months	2004P	Three consecutive
7.8 %	5.2 %	5 %	years of growth

- ✓ Growth expectations are in line with the program's growth estimate
- ✓ In 2004, the private sector's expectations on outlook for real sector have reached the most favorable level

### For higher and sustainable growth:

- ✓ Productivity growth ✓ Banking reform
- ✓ Foreign direct investment ✓ Tax reform
- ✓ Good governance
- ✓ Property rights



## MARKETS

## Exchange Rate Policy Framework

Exchange rates are determined by supply and demand conditions in the market.

✓ The level of both real and nominal exchange rates can change depending on:

In the short-run:

- Developments in the program
- Expectations, especially expectations on balance of payments
- Behavior of market players
- Public debt stock and risk premium

In the long-run:

- Structural reforms and its effects on productivity
- Business cycles
- Economic fundamentals

Exchange rate will remain stable, not by artificial practices or interventions, but by the help of more solid economic fundamentals and decreasing fragility in the economy.

## Exchange Rate Policy Framework

### **Central Bank Interventions**

I – Volatility Interventions	<ul> <li>In a limited and transparent manner</li> <li>To prevent excessive volatility in both directions</li> <li>Can be through announcements or warnings</li> </ul>
II – Interventions Aimed	<ul> <li>Sterilizing excess supply of foreign exchange</li> <li>Compatible with the floating exchange rate regime</li></ul>
to Build-Up Reserves	and with no effect on the level of the exchange rate <li>Transparent and rule-based mechanisms.</li>

Central Bank has no policy of keeping the exchange rate level low



✓ Daily foreign exchange buying auctions were restarted as of January 23, 2004.

✓ In 2003 and 2004, more than 13 billion USD has been bought by the Central Bank.

## Floating Exchange Rate Regime

The appreciation of the Turkish lira is, in fact, the **natural outcome** of the increasing confidence in the current program implementation.

Virtuous Circle

 ✓ Reverse currency substitution

## Markets



\* The sudden jump observed in deposits is due to payments of Imar Bank. Foreign exchange portfolio = Deposits + Gov. Sec. + Eurobonds + Others Turkish lira portfolio = Deposits + Gov. Sec. + REPOs + Mutual Funds + Others ✓ As an indicator of reverse currency substitution, since the beginning of 2003, the volume of Turkish lira portfolio held by the non-banking sector in real terms has been increasing, while the volume of foreign exchange portfolio has been decreasing.

## Markets



✓ As another indicator of reverse currency substitution, the ratio of volume of Turkish lira denominated instruments to volume of foreign exchange denominated instruments has been increasing substantially over time, even when considering the fixed USD/TRL rate and fixed EUR/USD rate.

#### \* The sudden jump observed in deposits is due to payments of Imar Bank.

TRL Denominated Instruments = Deposits + Gov. Securities + Mutual Funds + Repo + Others Foreign Exchange Denominated Instruments = Deposits + Gov. Securities in fx, fx linked.

## Floating Exchange Rate Regime

The appreciation of the Turkish lira is, in fact, the Virtuous Circle **natural outcome** of the increasing confidence in the current program implementation. Short-term interest rate ✓ Reverse cuts depend on inflation currency Excess forex supply outlook, so substitution ✓ Expected increase in Pressure on exchange rate Sterilize excess forex capital inflows supply via transparent and rule based mechanisms.

> FX buying auctions International reserve position strenghtened

## Current Account



### ✓ Current account deficit:

- Reached USD 6.8 billion in 2003 which is,
  - In line with expectations.
- Estimated as 2.8 % of GDP in 2003

### $\checkmark$ The more important factors are:

- Circumstances are different:
- 1. Open positions in the financial system are much lower in the aftermath of the banking sector reform. Tendency to open positions is risky.
- 2. Turkish Lira is not kept overvalued through foreign exchange sales of the CBRT. Quite the contrary, CBRT has bought foreign exchange.
- 3. Short-term capital flows is not encouraged, being aware of the exchange rate risk.

- The Central Bank's foreign exchange reserves has reached the record high levels as compared to the past.

- Tight fiscal policy is implemented within the framework of the program.



During last year, the yield curve has
 shifted downward and flattened
 out with longer maturities



- Ease of uncertainties
- Decline in inflationary expectations



a historically low level of 289 bp in January 2004, from a year-high of 1,103 bp in March 2003.

24

## Monetary Developments



- Monetary aggregates have been increasing in real terms recently.
  - ✓ The highest increase is in the currency issued.

### Why?

 Due to the increase in money demand, which indicates an increase in the credibility of the Turkish lira;

Also, the Turkish Lira deposits increased considerably

- No inflationary effect is expected
- Revision of targets might be in the agenda

## New Turkish Lira

### The process of dropping six zeros from the Turkish Lira started:

- $\checkmark\,$  Getting more and more confident about the inflation outlook
- $\checkmark$  Progress in the program
- ✓ Fundamentals
  - Single digit inflation in 2005
- ✓ To be launched in January 1<sup>st</sup>, 2005
- $\checkmark\,$  All steps of the process are planned
  - Requires joint effort: CBT + Treasury + Ministry of Finance + Ministry of Justice
- ✓ The technical features will be announced towards the end of 2004
- $\checkmark\,$  No inflationary effect is expected

## Dropping six zeros from the currency is a clear sign of our commitment to the fight against inflation.



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