MACROECONOMIC FEATURES AND PROSPECTS OF TURKISH ECONOMY

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I would like to make a brief description of the inflation phenomenon Turkish economy has experienced in the last 25 years. Then, I will touch on the progress achieved so far on the inflation front and prospects for the future, within the context of the Disinflation Program that was put into operation in 2000.

Although Turkey is one of the world's largest emerging markets with a young and growing population of around 65 million, high and prolonged inflation over the past 25 years made Turkish financial markets more vulnerable than other emerging market economies. Thus when we look at the level of foreign portfolio investment and direct investment in Turkey, we see that it is very small relative to the size of the economy. **Chronically high inflation and budget deficits are two key problems preventing the country from realizing its full potential.**

The primary effect of the inflation on the economy is the unstable economic growth dynamic. Growth has not only been volatile, but has also been well below the average of the most successful emerging markets.

It is well known that the cause of Turkey's inflation is fiscal in nature, in particular the existence of structural weaknesses in public sector finances. The budget deficit increased steadily throughout the last decade, finally reaching double-digits in 1999.

In the beginning of the year 2000, the government initiated a 3-year disinflation program which was supported by the IMF with a stand-by arrangement. Unlike previous programs, this one relies on political support and its most important aspect is its forward looking mentality. Moreover it is the first time that Turkey has launched such a comprehensive disinflation program. And additionally before the announcement of the program the government took prior actions and serious measures on the structural front.

The fundamental goals of the disinflation program are:

- To bring down the CPI inflation to 25 percent by the end of 2000, 12 percent by the end of 2001, and 7 percent by the end of 2002, via coordinated actions of consistent, powerful, credible, and persistent fiscal, income, monetary, and exchange rate policies, all supported by relevant structural reforms,

- To reduce real interest rates to reasonable levels,

- To increase the growth potential of the economy,

- To provide a more effective and fair allocation of the resources in the economy.

Within the context of the disinflation program supported by a Stand-by Arrangement for three years, **we, as the Central bank of Turkey, announced our monetary and exchange rate policy principles for the next three years at the end of 1999.**

According to the program the exchange rate basket which was composed of 1 US dollar+0,77 EURO would be announced on a daily basis covering one-year period. A pro-active role was assigned to monetary policy based on reduced rate of exchange rate depreciation in line with the targeted inflation, providing a nominal anchor for inflationary expectations. The exchange rate commitment was supported by strong fiscal adjustment and consistent income policies in the government sector.

This pre-announced exchange rate mechanism was to bring credibility to the government's efforts, which was in fact the most important variable affecting the overall market sentiment. It was also meant to be the most appropriate tool to break inflationary inertia and the pre-announced quarterly targets would create market confidence to adopt the official inflation target, which in turn would help to lower the inflation rate.

To avoid being locked in the rigid monetary framework beyond the disinflation stage, a pre-announced exit strategy had been incorporated in the program. The transparent, forward-looking exit strategy would allow increasing exchange rate flexibility over the time within a predetermined path and a specific time horizon. The gradual shift towards a more flexible exchange rate regime (with widening symmetric bands around the pre-announced exchange rate path) would be introduced in July 2001. This band will be gradually enlarged, as the total width of the band reaches 7.5 percent by the end of 2001, 15 percent in mid 2002 and 22.5 percent at the end of 2002. During the “band” practice, the central bank would scrutinize exchange rate fluctuations as long as they stay within the “band” and would use interest rates more actively in order to provide stability in the market.

The sequencing for the exchange rate mechanism - i.e. the transition from relatively fixed to increasingly flexible exchange rates- represents a credible approach to the trade-off between inflation reduction and competitiveness. The program correctly assumes that an exchange rate-based stabilization approach supported by fiscal and incomes policy, is the most convenient approach to breaking inflationary inertia decisively at the beginning.

On the other hand the conduct of monetary policy is guided by a rule, whereby base money is only be created by changes in the net foreign assets of the Central Bank. Central Bank operates the new monetary policy accommodating the government's disinflation program by specifying a ceiling for net domestic assets and a floor for net international reserves, which were also two performance criteria of the stand-by arrangement. The ceiling to the net domestic assets at the end of each quarter was fixed but during the period it was allowed to fluctuate roughly within a parallel band whose upper and lower limits were determined as ±5 percent of previous end-quarter base money figures. Thus, permitting volatility in the net domestic assets to some extent, sudden and extreme fluctuations in the interest rates could be avoided.

Keeping the net domestic assets unchanged in 2000, the Central Bank aimed at creating Turkish Lira through the change in the net foreign assets. In order to do this, one has to be sure that the level of foreign exchange reserves would be adequate to back up the domestic liabilities. This was working like a currency board without fixing the exchange rates to a certain currency like US dollar, Deutsche Mark or Euro. The Central Bank also abandoned the policy of decreasing net domestic assets through sterilization that it had implemented during the periods of surge in foreign exchange inflows.

Now I would like to talk to make a brief summary about the developments in the Turkish economy within the context of disinflation program so far.

Significant progress has been made towards achieving the program's goals. In spite of some unfavorable external developments, such as the sharp rise in international oil prices, Euro's weakness, and a decline in fund flows to emerging markets, inflation in the first eight months of 2000 fell to the lowest level since 1986. The evaluations can be classified in 3 groups, such as; better than expected performance, realizations in line with targets and lower than expected performance.

Better than expected performance.

There has been an impressive progress on fiscal side. During the first eight months of the year revenues increased beyond projections while a discipline on spending was maintained. Primary surplus of 10.8 billion US dollars was achieved in the mentioned period which was 1.3 billion US dollars in the same period last year. **This would help to reduce the interest burden on the budget in the long term and to stabilize debt to GNP ratio.**

The most evident effect of the disinflation program has been the dramatic decline in interest rates. The average interest rates during the first eight months of the year fell to 35 percent, down from 100 percent of last year, leading to a substantial interest savings for the coming period. The decline reflects the significant decrease in the domestic debt risk premium mainly due to the reduced uncertainty in exchange rate by announcing the monthly depreciation rate against the basket for the year ahead. Through this pre-announced exchange rate mechanism, the Government gained a great deal of credibility, which, as we all know, plays an important role in overall market sentiment.

The privatization program has had a strong start. In the first eight months of 2000, a total of 5.1 billion US dollars (2/3 of the targeted value of 7.6 billion US dollars for 2000) was realized from sale of POAS (Petroleum retailer), TUPRAS (Oil refinery) and GSM licenses (Mobile telephone). **This amount is higher than total privatization revenues of more than 15 years.**

External Borrowing target for the whole year has already been reached. With increased investor's confidence as a result of EU candidacy, a credible disinflation program backed by IMF stand-by arrangement and the positive assessment of rating agencies, our Treasury borrowed successfully from the international markets and has gained access to 7.1 billion US dollars so far.

In 2000, Turkey has been successful in extending the maturity of its external debt portfolio and has developed a flexible borrowing plan which enables Turkey respond quickly to market developments. For the first time, the Treasury has borrowed with a maturity of 30 years in international capital markets at the beginning of 2000. 1.5 billion US dollars of 30-year bond issue was the largest bond deal up to now and highest investor demand was achieved. The bonds were sold to 180 investors, 93 in Europe and 87 in the USA.

As a result of successful timing, carefully targeted placements and pricing, Turkish bonds outperformed expectations as measured by the JP Morgan Emerging Markets Bond Index (EMBI). Also, the inclusion of Turkey's three US dollar bonds on the JP Morgan's EMBI Global Index in August 1999 had a positive impact on attracting the funds in the USA and therefore widened our investor base.

In addition, Turkey has made successful Euro and Dollar Eurobond issues. These bonds perform well in the secondary markets and spreads of Euro eurobonds have been lower than the Argentina's and Brazil's bonds, having the same maturity whereas the spreads of dollar eurobonds have been lower than Argentina's, Brazil's, Mexico's and Colombia's bonds.

In Line with the Targets

The program has produced very good results in terms of economic growth, and is fulfilling the expectations that it will produce growth-oriented adjustment and reform. In 1999, due to the political instability, high real interest rates and the negative effects of the earthquakes, the economy contracted by 6.4 percent. In the first half of 2000, the economy expanded by 4.3 percent mainly as a result of increase in domestic demand.

A recovery in the economy for the entire year is expected, mainly due to increasing domestic demand, expected recovery in Europe (largest trading partner), larger output after weak performance in agriculture sector, and rebound in tourism receipts. Also important are credit growth through lower interest rates, and successful external financing, both of which are the result of fiscal discipline.

The implementation of exchange rate and monetary policy is on track. So far the exchange rate basket has depreciated according to the targets of crawl, 2.1 percent per month in the first quarter, 1.7 percent in the second quarter and 1.3 percent in the third quarter. Official reserves have maintained a strong level since the beginning of the program and are well above the minimum level of net international reserves performance criterion.

The net domestic assets are also consistent with the performance criterion of keeping the NDA level at minus 1200 trillion TL.

At this point, I want to emphasize that the disinflation program was supported by a set of strong prior actions. A considerable portion of long-awaited structural reforms has been successfully put in place since June 1999. Structural reforms play a very crucial role in the program, helping to make the fiscal adjustment sustainable, improve economic efficiency, and through facilitate the decline of public debt through increased privatization receipts.

The government passed the new **Banking Law** anticipating a low inflation era that is expected to produce a series of mergers and acquisitions of the small and medium sized banks. With this law, an independent supervisory body was established to improve transparency and to reduce moral hazard in the banking sector.

The new **Social Security Law** that was passed from the Parliament just after the earthquake increased the minimum retirement age and created the legal framework for the unemployment insurance scheme.

Major changes introduced into **the fiscal area** were the introduction of better accounting system, further strengthening of tax administration to improve compliance and to reduce tax arrears, and the closure of extra-budgetary funds.

The **privatisation** was one of the key areas of the reforms. Privatisation would lead to significant efficiency gains in the key sectors of the economy and also would generate sizable budgeting proceeds. In this framework, the Parliament also passed a law authorizing international arbitration for business disputes and enabling retroactive application of the **Arbitration Law** to existing contracts. Moreover, passage of the **Turkish Telecom Law** was also an important step to widen the doors for a successful privatization program.

The Capital Market Law aimed at improving transparency, corporate governance and minority shareholder rights through strengthening the Capital Market Board's regulatory and supervisory power.

Some key structural changes have already taken place under the program in the area of **agricultural reform**, the most important one being the removal of credit subsidies from state banks. The effects of this removal have been cushioned by the sharp decline in market bank lending rates, including those on agricultural credit, caused by the improved macroeconomic framework.

In June, the price of wheat, which is the key variable for agriculture policy in Turkey, was increased in line with targeted inflation, **showing our determination to implement the disinflation program and eliminate populist economic policy–making in Turkey.** The decision will gradually end the isolation of domestic prices from world price movements, eventually resulting in an efficient allocation of resources in the whole economy.

Although the inflation rates in the first two months realized over the expected ones, in the next six months of 2000, the CPI and WPI reached the lowest levels since 1986.

Lower than expected performance

In the first half of 2000, the current account deficit widened to 5.6 billion US dollars, from a deficit of 103 million US dollars in the same period of last year. A surge in imports was the main reason for the deficit. This was mainly due to increasing domestic demand deferred from 1999 with the sharp decline in interest rates, the unanticipated rise in oil prices and the accelerated restocking of raw materials and unfinished products. In the third quarter, because of seasonal factors it is expected that the revenues from tourism receipts and workers remittances will compensate the deficit. For the whole year current account deficit is expected to reach 6-7 billion US dollars.

Under the exchange rate -based stabilisation program, when taking into account the real GDP growth and external debt to GDP ratio, the sustainable level for the current account deficit in Turkey is estimated around 4 or 5 percent of GDP. Thus, the level of current account deficit, which might be doubled in extreme cases will still be compatible with the program balances. In addition, strong official reserves will continue to support the sustainability of the current account balance while giving the necessary back up for the monetary program. Thus, a higher than expected increase in imports would not pose a threat to the success of the disinflation program.

Moreover, the exchange rate based disinflation program together with significant fiscal tightening created an environment running from lower interest rates to higher domestic demand, while causing a temporary deterioration in the current account balance. However, the positive impact of this fiscal discipline should bring down the overall public sector deficit beginning in 2001 and this will improve the current account imbalance.

As a concluding remark, I would like to emphasize that the enduring memory of inflation, as well as negative external developments, have prevented a decrease in inflationary expectations. These expectations play a key role in breaking down inflationary inertia. Overcoming inflationary inertia will require the will to act together on the basis of consensus. Thus, in the private as well as the public sector, both government and non-governmental organizations should act together in breaking down the inflationary expectations.

The 25 percent inflation target for this year was an intermediate one, the main goal of the program, which I should point out again that it is a three-year-disinflation-program, is to reduce inflation to single-digit levels by 2002. Macroeconomic performance for the first eight months of this year has raised our hopes of achieving single-digit inflation by 2002.

With the coalition government working in harmony to undertake crucial structural reforms and with the credible monetary and exchange rate policies in place, high growth and lower inflation rates will become a reality in our economy. As long as the program stays on track, single-digit inflation and a budget surplus at the end of 2002 remain a feasible target for Turkey.

We know that, Turkey’s market based and liberalized economy and the dynamic private sector have put the country a different path. **If we are able to reduce the inflation to single digits in 3 years time and achieve stable growth rates, Turkey will become one of the leading markets of the future.**

I present my respects and thank you all for listening.