RECENT DEVELOPMENTS IN THE TURKISH ECONOMY AND PROSPECTS FOR THE MONETARY POLICY

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At the outset, may I say that good progress has been made in achieving the key main economic objectives of:

1. reducing inflation

2. strengthening public finance

3. furthering the ambitious structural reform agenda.

The decline in inflation has been accomplished by an initial strong recovery in economic activity.

Monetary policy has remained anchored by a pre-announced crawling exchange rate path and quasi currency board rules introduced in early January.

Business confidence has remained strong, as seen in CBT's surveys.

Turkish authorities have sent several key signals as continuous commitments to the program's targets before and after the implementation of the disinflation program.

Moreover, we are able to break the debt dynamics established in the financial markets in quite sometime.

Turkey does better than others with successful exchange rate based disinflation programmes. In Argentina (1991), Brazil (1994), Mexico (1988) and

Israel (1985) cumulative inflation and real appreciation during the initial stages of programs clearly show that Turkey seems to have progressed better in this comparison.

Following the severe recession last year, output growth in Turkey, is projected to rebound in 2000. The recovery is attributable to several factors, including falling interest rates, rebound in tourism, stronger growth in exports to Western Europe and Russia, and improving business and consumer confidence.

However, nothing can be perfect. The widening current account deficit of balance of payments appeared higher than our expectations. It reflects the combined effect of oil shock and a decline in domestic interest rates, coupled with an acceleration of private consumption and investments, which have stimulated the import demand.

I would like to stress here that the negative effect of currency appreciation on the foreign trade of Turkey has been minor so far. As a result of the previous three years' exchange rate policy, which prevented the appreciation of the Lira, Turkey started the program with a "strongly" competitive real exchange rate level.

Hence, despite the past eight months appreciation, which has ranged from 0.3 percent to 3.9 percent, depending on the price indices used in the calculations, the real level of the Lira, has stayed within the competitive ranges.

The productivity gain in the manufacturing sector in recent years has also provided an additional tool for exports to stay competitive within foreign markets during this period. Also, in the first half of this year, the labour productivity increased by 11 percent.

I want to underline here that the increasing trend in current account deficit does not constitute a risk for the balances of the economy for the near future. Capital account has the capacity of financing this enlarged deficit without creating pressures on the exchange and domestic interest rates. However, some measures have already been taken, and will be taken if necessary, for the long-term sustainability of the external balance. And for that, the cure lays in the increase of the public sector savings, which is already a major agenda item of the program's implementation.

I would like to point out that all of these outcomes have achieved an adverse external environment, namely:

1. Euro fell to an all time low.
2. Higher interest rates, mainly due to extremely tight monetary and fiscal policies pursued in advanced countries.
3. High oil prices.

All of these factors have encouraged international fund managers to re-imbalance portfolios in favour of cash, implying a retrenchment from emerging debt and equity markets.

In those circumstances, emerging markets assets and financing on international capital markets have been an enormous pressure during the first half of 2000.

I may say that Turkey has been the most successful in terms of meeting external financial needs, which have been programmed before. The Turkish Treasury and Turkish Banks have been active in the market place.

Lastly, but not least, our perspective on inflation is of a medium term. As long as the program stays on track, indicative by a strong willingness by the political authority, tight fiscal policy and continuous execution of structural reforms, a single digit inflation level at the end of 2002 remains a feasible target, and I believe this to be the case presently.

Now let me return to the monetary policy issues.

On the monetary policy side, the program envisages a rule based regime, especially within the first 18 month period, where the monthly devaluation rate for a basket of currency was pre-announced to the public and net domestic assets can fluctuate within a very narrow band. In this system, money supply can be changed, mainly in return of foreign exchange operations of the Central Bank.

This automatic system of money creation has practical advantages during the initial period of disinflation, where demand for money balances is expected to be unstable, therefore making it difficult for the monetary authority to manage the money supply. As a matter of fact, despite a declining trend of volatility in monetary aggregates, narrowly defined money supply has increased substantially in the first eight months of 2000, as a result of the increase in the demand for real money balances.

Since interest rate is fully market determined in this system, they carry important signals about the functioning of the program. At the very initial stage of the program, the interest rate for treasury bills and bonds declined rapidly, whereas an average of the domestic borrowing increased. This, I believe, is an important sign that the public found our currency regime credible, as well as the disinflation program.

The Central Bank quickly built its learning curve in this new system. Net domestic assets have fluctuated quite smoothly within their pre-determined band and net international reserves have always remained over their targeted floor.

As a matter of fact, international reserves of the Central Bank have increased gradually with the increase of the demand for reserve money. As of September 1, net international reserves stood at 24.5 billion US dollars, representing an increase of 1.4 billion US dollars, compared to the end of December 1999.

One draw back of limiting the TL liquidity in return of foreign exchange, is that the increased volatility of the overnight interest rates compare to the previous periods. During certain days, where the demand for liquidity increases or the supply of foreign exchange decreases due to “seasonal factors” like salary payments, foreign debt repayments or the last day of every month the overnight interest rate may rise to high levels. Although, the volatility of the money markets rate, does not reflect itself in the bill and bonds markets. As it is known, at the beginning of this year we provided new liquidity source to the banks by changing the status by two percent of their required reserves to liquidity ratio, meaning, that the banks are now able to use these amounts freely within the week, with the requirement of holding the average amount throughout the week. I believe a more efficient use of this facility by the banks will help to decrease the observed volatility of the overnight interest rates in coming periods.

Starting the program with the exchange rate as a nominal anchor has many advantages. Since the public can follow it easily on a daily basis, it embodies the transparency needed for such anchors, and provides a practical tool to manage expectations. However, long-term use of the exchange rate as an anchor may result in problems in the economy, especially on the external balance and may even create conflicts for monetary policy implementation.

In order to respond to these concerns, we have explicitly set out an exit scheme. According to the strategy starting in July 2001, we are imposing a band on the exchange rate basket.

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.

Let me comment briefly on our policy, during these 18 months of transition. Firstly, one should not expect a quick dramatic change of our policy for this period. The change will be a gradual one. As a matter of fact, markets also do not expect a dramatic change in our policies with the start of the transition period. If you look at the structure of the yield curve, it is relatively flat for maturities covering 11 to 18 months, which falls into the band period.

Since with the program, the Central Bank’s policy goal has moved to price stability, reaching the medium term inflation target will continue to have priority for the Central Bank. So, as long as the exchange rate continues to play an important role in the determination of the price level during this transition period, the Central Bank will closely scrutinise its movements.

Hopefully, the exchange rates will decline quickly by the anchor of inflationary expectations during this phase, so that the movement of the exchange rate does not transform to movement in the price level.

In an ideal setting, the passage through from the exchange rate to inflation fades away; the exchange rate fluctuates around the mid-points of the band without interruption, while the Central Bank uses its enlarged discretion on interest rate determination to forward its inflation target. It will be a learning process for all participants.

Another phase for the monetary policy implementation will probably start at the beginning of 2003. Since we will rule out the full currency board system at the start, alternatives for the monetary policy will be targeting either a monetary aggregate and or inflation itself by the Central Bank with floating exchange rates.

It is widely accepted that finding a suitable monetary aggregate, which has a stable relation with inflation and, at the same time, is under the control of the Central Bank, is quite difficult. Taking this fact and also the recent successful application of inflation targeting among developing countries, inflation targeting rises as a serious choice to follow for the Central Bank of Turkey. As a matter of fact, we have already started to experiment with this idea. If you follow our web site, you will have noticed our first inflation report that we posted there recently.

Our preparations for beyond 2002 are not limited to the inflation report. A fundamental prerequisite for effective conducting of monetary policy is the full operational independence of the Central Bank in pursuing its price stabilisation objective. In that context, a new law is under preparation, which sets a clear mandate for the Central Bank to maintain price stability, and contains clear accountability provisions to promote the conduct of monetary policy in a transparent fashion. The new law, which will also answer the requirements of EU accession in all respects, I believe, will enhance the already high credibility of the Central Bank.

In relation to transparency, I would also like to remind you that we will start to annually publish the Annual Financial Statement of the Central Bank, audited by an external body according to internationally accepted standards, by next year.

Before I finish, let me emphasise one more time that, the credibility of inflation targeting or any other system, depends mostly on the Government's ability to finance its activities without recourse to the Central Bank's resources or inflation.

With the successful implementation of the disinflation program, the present fiscal dominance in the economy will significantly decrease, thus clearing the way for the Central Bank to be accountable for the price stability of the economy.

In that respect, we are looking ahead with great enthusiasm.