Monetary Policy in 1998

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1. THE TURKISH ECONOMY IN 1997

In 1997, the Turkish economy maintained its growth trend of the preceding two years. It is expected that GNP for 1997 will increase by 6 percent over 1996 in real terms. Substantial increases major source of growth in the last three years has been a surge in investments aimed at increasing the capacity of the economy. During this period, the achievement of general stability, and especially of stability in the foreign exchange market, reduced uncertainties and increased investments. In addition, economic conditions in countries that make up a major share of Turkey's foreign trade also contributed to the growth of the Turkish economy in 1997.

Inflation continued to be the major problem of the Turkish economy in 1997. During the first five months of the year, the rates of increase of both the wholesale price index and the consumer price index were slower than during the same period in 1996. However, this slowing was mainly due to the had been deferred until after the national elections, temporarily pushing up the rate of inflation increase. In addition, inflation temporarily slowed in the early part of 1997 due to the absence of such "seasonal price increases". But by the second half of 1997, inflation began to rise again. In early summer, the Central Bank announced its inflation target in the range of 80 percent based on the wholesale price index by the end of 1997. The increase in the wholesale price index turned out to be 91 percent by the end of 1997. The difference form the target was mostly due to unexpectedly high public price adjustments effected during the second half of the year which had not been included in the Central Bank forecast.

The budget deficit continued to increase in 1997. The ratio of the consolidated budget deficit to GNP is estimated at around 8 percent. Despite a substantial real increase in total tax revenues, large increases in wages and transfers caused the budget deficit to rise. It is expected that 1997, unlike the preceding three years, will show a primary budget deficit. Since the primary surplus is the key element in a balanced budget, it is essential to achieve and maintain a primary surplus in order to keep the government finances in balance.

Although the budget deficit increased, there was substantial improvement in the financing of the budget. With better cooperation between the Treasury and financial markets, Treasury was able to extend the maturity of domestic borrowing to one year.

On the external side, Turkey has been a net payer of her debt since 1994. During the period from 1994 to 1997, Turkey has repaid external debt principal plus interest amounting to US$13.7 billion on its foreign debt from her general budget. In 1997, Turkey's net foreign debt repayment was almost US$3 billion. Turkey's inadequate foreign borrowing constrains the financing of the budget deficit and increases the pressure on domestic borrowing.

As for the current account, the rate of increase of imports slowed while exports increased. Revenues from tourism were high throughout the year. During the first six months the current account deficit was around 2.0 percent of GNP, rising to an estimated 2.5 percent at the end of the year. The reasonable level of the current account deficits averted pressures on the domestic foreign currency markets and permitted Turkey to retain its access to foreign resources on favourable terms for financing the deficit.

Analysis of the balance sheet of the Central Bank reveals that the total by increasing 75 percent narrowed in real terms. On the other hand, net foreign assets rose by 195 percent and net domestic assets decreased by 61 percent. Net international reserves reached US$18.4 billion.

The exchange rate of the US dollar increased by 90.6 percent and that of the foreign currency basket by 78 percent.

In sum, the Turkish economy grew substantially in 1997, but the inflation rate continued its increasing trend. Meanwhile, despite the increase in the budget deficit, the current account deficit remained at a recoverable level.

II. MAIN OUTLINES OF THE MONETARY POLICY IMPLEMENTED IN THE YEARS 1996-97

Before discussing monetary policy for 1998, I would like to review the main points of the policies pursued in 1996 and 1997, when the Central Bank implemented its monetary program without publicly announcing its outlines. Assessment of the outcomes of policies implemented during this period will pave the way of the implementation of the Central Bank's policies for 1998.

Basically, the monetary policies implemented in the last two years aimed at stabilizing the financial markets. The central Bank's goals of stability can be summarized under two headings. The first is to prevent rapid short-term price fluctuations in the markets, and the second is to reduce uncertainties in the markets. The Central Bank tried to prevent rapid rice fluctuations in both the short-term Turkish lira and foreign currency markets by observing the consistency between the prices in these markets and the general balances of the economy. During this period, exchange rates moved in parallel with the expected inflation rate and the fluctuations of interest rates in the money markets subsided. In addition, the acceptance by the markets of these interest rates as reference rates is a reflection of the implementation of policies with the purpose of stability.

The second aspect of the stability goal was to eliminate the market uncertainties created by high inflation and thereby to avoid the risk that these uncertainties would cause losses to the economy. Therefore, the Central Bank announced, every six months, its inflation forecasts and its intention of basing its monetary policy implementation on those forecasts. This realistic approach on the part of the Central Bank had the desired effect on the markets’ inflationary expectations and reduced the degree of uncertainty about the future of the economy.

The stability goal was reflected in the Central Bank’s balance sheet by a decrease in domestic assets, a strong foreign currency position of the Central Bank, and a restriction of increases in reserve money to net foreign assets.

The slowdown in the rate of increase of the Central Bank’s net domestic assets, which had accelerated after 1994, has become constantly steeper over the last two years. This slowdown results mainly from the imposition of annual ceilings on short-term advances at lower rates within the credit to the public sector, which represent the major portion of net domestic assets, and from the Central Bank’s discontinuation of loans to public institutions (Graph 1).

<Graph 1>

Another important factor slowing the rate of increase of domestic assets is the decline in the revaluation accounts. During this period, improvements in the foreign currency position of the Central Bank caused the revaluation account, which reflects the loss from the open foreign currency position to shift from positive (reflecting loss) to negative (reflecting profit) by the end of 1996. The improvement in the foreign currency position and the decrease in the revaluation account continued in 1997 (Graph 2).

<Graph 2>

Graph 3 shows the behaviour of the domestic assets of the Central bank and the wholesale price index. It can be seen that the rate of increase of domestic assets trailed considerably behind inflation over the last two years.

<Graph 3>

Some of the items on the liability side of the balance sheet reflect the credit relations between the Central Bank and public institutions and other banks. In this context, of the liabilities of the analytical balance sheet, the foreign currency deposits of the non-banking sector, representing foreign currency deposited with the Central Bank by the public sector, and the Turkish lira denominated deposits of the public sector, can be considered as loans extended by the public sector to the Central Bank. If an open market operation item carriers a plus sign, it can be regarded as a loan by the banks to the Central Bank. If it has a minus sign, it can be regarded as a loan from the Central Bank to the banks. Subtracting these three items (foreign currency deposits of the non-banking sector, public deposits, and open market operations), which are on the liabilities side of the analytical balance sheet, from total domestic assets listed on the assets side, will give the net loan relationship between the Central Bank and the markets. Developments in the net domestic assets of the Central Bank, calculated as described here, are shown in Graph 4. It will be observed that net domestic assets have shown a slight increase in the last two years.

<Graph 4>

The foreign assets of the Central Bank followed an increasing trend during this period. The foreign assets, which amounted to US$16.1 billion at the end of 1995, rose to US$21.5 billion by the end of December 1997. The foreign assets of the Central Bank can also be netted out by the same method. When the foreign liabilities on the liabilities side of the analytical balance sheet of the Central Bank and the foreign currency deposits made by banks with the central Bank are subtracted from foreign assets, the amount of net foreign assets will be obtained. The increase in net foreign assets represents the amount of foreign currency obtained by the Central Bank by creating Turkish lira. The behaviour of net foreign assets in 1996 and 1997 is shown in Graph 5. During this period, net foreign assets of the Central Bank increased by US$3.2 billion to reach US$9.1 billion by the end of December 1997.

<Graph 5>

Reserve money, which may be viewed as the basic variable among the monetary aggregates on the economy, increased in parallel with the inflation rate (Graph 6). Theoretically, it is accepted that central banks keep increases in the monetary aggregates of the economy under control by controlling the increase of reserve money. It is expected that the control of monetary aggregates has an inflation-reducing effect, based on the assumption that it will limit nominal demand via interest and loans.

<Graph 6>

The source of the reserve money increase is as important as controlling reserve money increase. To the extent that the increase in reserve money results from loans extended to the public sector, it will have a stronger effect on inflation than a reserve money increase resulting from an increase in foreign exchange operations. Therefore while keeping the increase in reserve money under control, the Central Bank also changed the composition of the sources of that increase.

The Central Bank□s balance sheet, constructed on a solid basis, ensured calm and stable financial markets. This effect was especially felt in the exchange market.

The exchange rate policy of the Central Bank depends on the stability of real exchange rates. For this reason, Central Bank by keeping his eyes on the increase in the exchange rates wants to keep a parallel movement between exchange rate and the expected inflation rate. Graph 7 shows the behaviour of the real exchange rate during the period 1995-1997.

It will be seen that during this period the real exchange rate index fluctuated in the interval 96-106, and exchange rate policy became a determent of the current account balance. Stable exchange rates enabled the external sector to remain competitive and to predict future developments well enough to enter long-term contracts. Consideration of the crisis in South-East Asia makes the importance of the Turkey□s exchange rate policies during this period more clear. Turkey is weathering the crisis currently affecting the world without being trapped in an economic bottleneck created by its exchange rate policy.

<Graph 7>

The Central Bank□s interest rate policy during this period was dictated by the requirements of the economy. Increasing budget deficits and the need to finance them by increasing amounts of domestic borrowing obliged the Treasury to put supply pressures on the auctions of government securities, causing the interest rates fixed in these auctions and the secondary markets to substantially exceed the forecast inflation rate. Real interest rates rise when political uncertainties increase. Under these circumstances, short-term interest rates in the primary and secondary markets where government securities are traded. In this connection, the Central Bank observes two rules. First, in view of its lender of last resort function, interest rates determined when the Central Bank is supplying liquidity through the short-term Turkish lira markets should be kept higher than the interest rates attached to long-term Turkish lira transactions. Second, fluctuations in short term Turkish lira money markets should be reduced. To this end the Central Bank initiated new types of transactions, such as the Tomorrow/Next of T/N transactions (next-day value: overnight transaction) and Tomorrow/Week or T/W transactions (next-day value: one week□s maturity), in interbank money markets, which are under Central Bank□s auspices, to reduce uncertainties as a part of its purpose of maintaining stability in markets.

III IMPLEMENTATION OF MONETARY POLICY IN 1998

The distinctive characteristic of 1998 is the adjustment that will be made in the implementation of fiscal policy, rather than differences in monetary policy. As is well known, the government has announced its determination to fight against inflation in 1998. The 1998 budget to which this determination has given rise assumes substantial improvements, especially in the primary surplus. There is no doubt that such improvements in the budget balances in 1998 will have beneficial effects on the implementation of monetary policy as well as on inflation.

The implementation of 1998□s monetary policy is based on financial programming. The Balance of payments and budgetary aggregates are among the key variables that will influence the Central Bank□s determination of monetary aggregates for 1998.

The main goal of the Central Bank□s monetary policy is to support the implementation of measures aimed at decreasing the annual inflation rate to the range of 70 percent during the first half of 1998. This figure is consistent with the macroeconomic targets for 1998. All the monetary policy tools available to the Central Bank will be employed for this purpose. Basically, the Central Bank will continue to limit the increase in domestic assets the create money only against increases in foreign assets. The tool of short-term interest rates will be used more effectively to achieve this target.

The exchange rate policy will be conducted in accordance with the inflation rate estimated for the first half of 1998. Accordingly, beginning in January, the monthly rate of exchange rate increase will be tied to the estimated inflation rate.

I would like to emphasize that the control of monetary aggregates is very important at a time when a fight against inflation is planned. In this connection, the rate of increase of reserve money was set to be consistent with the growth rate of the economy and the inflation target.

One of the chief features of the monetary program is that the rate of increase in reserve money will remain in the range of 18-20 percent during the first quarter of 1998.

When the factors causing the increase of reserve money are analyzed, the importance of budget deficits and their financing, especially by domestic borrowing, becomes apparent. It is clear that such conditions endogenously lead to increased money growth and imposes restraints on the control of the money supply.

From this standpoint, the share of the primary surplus in GNP, estimate at 3.9 percent for 1998, is seen to be the key element making it possible to finance domestic debts and thus to achieve the inflation target.

A slowing of the rate of increase of the domestic debt stock, due to the primary surplus which is expected to be realized in 1998, will make it possible for an increase in reserve money to be consistent with the inflation target without endangering the financing of the domestic debt.

The 18-20 percent band for reserve money increase in the first quarter of 1998 was forecast on the basis of estimates of GNP and the budget deficit, on inflation targets, and on the financing program drawn up by the Undersecretary of the Treasury.

If financing the budget is based on increasing tax rates and decreasing domestic borrowing, rather than on Central Bank resources as during the second half of 1997, the Central Bank will be able to increase reserve money mainly on the basis of increased net foreign assets.

Having the Treasury to finance the domestic debt with tax revenues will ease the demand pressures on domestic borrowing and consequently, pressures on interest rates. On the other hand, the Central Bank□s policy for short-term interest rates will be consistent with the tight monetary policy that is an essential element of the fight against inflation. Consequently a persistent drop in the inflation rate will result in lower interest rates as well.

At this stage it must be stated that achieving the desired level of reserve money, which is the basic variable of monetary policy, is dependent on the realization of the forecast for the budget and other balances. It is possible that developments in foreign economies during the first half of the year could also affect Turkey□s domestic balances and the implementation of the monetary program. In this respect, our account of monetary policy has to underline which the variables it is most important to watch closely.

First, the monthly developments of the primary surplus must be observed carefully. The realization of the forecast primary surplus depends on success in meeting income and expenditure targets.

The method of financing the budget deficit is another significant indicator. In principal, Central Bank resources should not be used to finance the deficit. On the other hand, the lack of access to foreign financing and the consequent inescapable increase in the share of domestic debt in financing the deficit, will increase the pressures on interest rates and monetary aggregates.

While the Central Bank is fighting against inflation, the developments in the determining inflation, which are not under the control of Central Bank policies are also very important. Let me give you the developments in agricultural prices as an example. Agricultural prices that constitute 20 percent of wholesale prices, are mostly determined by the volume of production, which in turn has a significant seasonal movement. For example, a possible rise in the prices of agricultural products during the first half of 1998, due to conditions beyond human control, can bring an unexpected increase in overall prices.

Developments abroad during the first half of the year may also have unfavourable effects on the economic balances. In that context a possible increase in oil prices would be a development that would require additional measures for achieving the inflation target for the first half of the year.

While conducting an exchange rate and monetary policy aimed at reducing inflation to a desired level, inflationary expectations must rapidly be decreased. The rate of change in inflationary expectations must rapidly be decreased. The rate of change in inflationary expectations basically depends on the credibility of policies. This credibility can only be established with the determinance of the government on the implementation of the inflation fight program. The government has to show its commitment to the fight against inflation by putting into effect, on a definite timetable, the structural reforms that are crucial for creating a durably sound and balanced economy. In point of fact, the necessary structural measures should be completed by mid-year if the forecast inflation rate is to be achieved by year□s end. Significant progress has already been made on this front. We are extremely pleased with these developments. There is no doubt that this progress will motivate us to carry out our monetary policies more effectively and to succeed in the fight against inflation.