RESULTS OF THE MONETARY PROGRAM OF THE CENTRAL BANK OF THE REPUBLIC OF TURKEY FOR THE FIRST HALF OF 1998 AND PLANS TO IMPLEMENT THE MONETARY PROGRAM FOR THE SECOND HALF

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July 2,1998

The Central Bank announced its monetary program for 1998 at the beginning of the year. As the agency responsible for monetary policy, the Bank declared that it would control monetary conditions by its management of reserve money on the liability side of its balance sheet. It further announced that at the same time its exchange rate policy would steer a course aimed at satisfying the divergent objectives of protecting the sustainability of the current account on the one hand, and coping with inflation on the other. Under this arrangement, the Bank's main instruments, which are the operations in the foreign exchange-foreign banknote markets, the open market operations, and the interbank money market operations, were effectively used in pursuit of these targets.

Figure 1, below, shows that by June 30, 1998, reserve money had increased to TL 1575 trillion, an increase of 13.1 percent over the end of March, but still below the second quarter target range of TL 1587 to TL 1615. The cumulative increase in reserve money from the beginning of the year was 32.8 percent. At 17.3 percent in the first quarter and 13.1 percent in the second quarter, the growth rate of reserve money remained below the target ranges.

FIGURE 1

I will review the conduct of monetary policy during the second quarter of 1998 in terms of the exchange rate, interest rates, the Central Bank's balance sheet, and the principal monetary aggregates, before moving on to the last half of the year.

I. Monetary Policy During the Second Quarter of 1998

The level of stocks involved in open market operations, which was very high at the beginning of the year due to heavy repo operations by the Central Bank, gradually declined in parallel with a large increase in net foreign assets. March 1998 marked the beginning of a new era in the Turkish economy. Inflationary expectations began to decline, domestic borrowings by the Treasury fell below the level of its repayments, and the improvement in the primary budget surplus began to be reflected by a decline in the interest rates attached to government securities in the secondary market (see Figure 2). The Central Bank mopped up the excess liquidity in the market by means of open market and interbank money market operations consistent with the reserve money target band. In other words, the second quarter of 1998 saw the Central Bank become indebted to market participants as a result of open market operations.

FIGURE 2

<u>Exchange Rate and Interest Rate Developments</u>

Under its monetary program at the beginning of 1998, the Central Bank announced that its exchange rate policy would be geared to the estimated inflation rate in such a way as to minimize the volatility of real exchange rates. This became more difficult during the second quarter for the following reasons: Both inflation and nominal interest rates were declining; high growth continued; exchange rate policy was subject to opposing constraints imposed by inflation and the current account balance and by the need to control reserve money and build up Central Bank reserves rapidly. In other words, the need to sterilize rapidly increasing net foreign assets required the Central Bank to change its exchange rate and interest rate policies.

Accordingly, in May the Central Bank made five decisions modifying some of its policies.

- The Central Bank announced that effective May 4, it would not conduct overnight operations in the repo-reverse repo market of the Istanbul Stock Exchange (ISE) except on days when interest rates show unusual volatility.

- The Central Bank narrowed its quotation margins in the interbank money market as of May 4.

- Compulsory foreign exchange-foreign banknote transfer and selling rates were set at "zero percent" for June and July 1998, effective June 1.

- The Central Bank lowered its bid-ask quotations in the interbank money market by 3 points, effective June 2.

- The quotations on the bid side were decreased by 10 points effective June 8.

After the removal of the Central Bank's quotations from the ISE repo-reverse repo market, interest rates in this market became more volatile, although interest rates on government securities in the secondary market were not affected thanks to long-standing policies aimed at promoting systemic stability in the financial markets. The Central Bank's bid quotation on overnight transactions usually set the bottom line for the ISE's overnight repo-reverse repo market, but sometimes interest rates in the secondary market fell below the Bank's overnight rate.

In addition it was observed that interest rates in the repo-reverse repo market became more sensitive to the liquidity of the market. The amount of TL liquidity, which is determined by the Central Bank's interest rate and exchange rate policies, affects the pattern of market sales and purchases, both directly and through the repo-reverse repo market. At the same time, the increased sensitivity of interest rates to the sterilization operations of the Central Bank indirectly affected the sensitivity of secondary market interest rates to the amount of liquidity.

The Central Bank signaled to the market that it would support the lowering of interest rates by narrowing its bid-ask quotation margins in the interbank market in May. At the same time, by increasing the bid rates, the Central Bank showed its determination to follow a restrictive sterilization policy. Accordingly, excess liquidity was withdrawn through the operations in the repo-reverse repo and the interbank markets (Graph 3).

FIGURE 3

After the policy reversal establishing compulsory transfers and sales of foreign currency and foreign exchange, it was theoretically expected that the resulting increase in exchange rate volatility would strengthen the relationship between interest rates and exchange rates as long as there was minimum intervention in the foreign exchange market. We thus entered a period of increased sensitivity of interest rates to liquidity, and increased sensitivity of exchange rates to interest rates and thus to liquidity. For this reason it can be argued that both the Central Bank and other market participants should be very cautious in the period ahead.

After the announcement of the regulation requiring compulsory transfers and sales, market uncertainty increased and the banks began to manage their liquidity position more effectively. And although the compulsory rates were also announced in June, the indicative power of the "official rate" announced at 3:00pm became stronger. Nevertheless, the daily rates, set by the Central Bank for the compulsory transfers, was also effective. Moreover, this decision showed that the Central Bank's conduct of exchange rate policy by means of buying and selling interventions would be consistent with the 50 percent inflation rate target.

These decisions brought exchange rate and interest rate levels down, and the greater day-to-day volatility of the exchange rate increased the uncertainty regarding monthly devaluations and thus slowed the accumulation rate of foreign currency reserves, which had been increasing due to large purchases of foreign currencies.

Examination of the behavior of the currency basket for the first five months of the year reveals that the cumulative nominal depreciation of the basket was 25 percent, while the WPI increased 24.4 percent during the same period. Figure 4 shows the annual percentage changes in both WPI and the currency basket.

FIGURE 4

We observe that the stability of the exchange rate continued to promote the accumulation of Central Bank reserves. Net international reserves, including the gold account, reached US$26.6 billion dollars as of June 30, 1998, an increase of about $8 billion over 1997 (Figure 5).

FIGURE 5

The Current Account Balance

The South Asian crisis made foreign investors reluctant to invest in emerging market countries, and negative developments in the Russian financial markets at the end of May did further damage. However, neither of these occurrences had adverse effects on the Turkish financial markets.

Turkey's current account balance for the first quarter of 1998 suggests that the trend of 1997 still persists. The foreign trade deficit for the first quarter was $3.3 billion, while the current account deficit was $875 million dollars, a decrease of 30.8 percent from the same period of 1997. Net capital inflows excluding reserves amounted to US$ 3.7 billion from January to March of 1998.

There was no major change in the real exchange rate, calculated using the private manufacturing industry price index relative to the base year. This is consistent with the low current account deficits for 1997 and the first three months of 1998 (Graph 6). At the same time, the real exchange rate index had depreciated by 3.1 percent in May 1998 from its value at the end of 1997.

FIGURE 6

Principal Balance Sheet Items and Monetary Aggregates

When we look to see how these developments are reflected in the Central Bank's balance sheet, it will be seen that the source of the increase in reserve money during the first three months was the rise in net foreign assets. In the second quarter the Central Bank's net foreign assets increased by 58 percent in terms of Turkish lira and by 43.7 percent in terms of US dollars, reaching US$ 16.7 billion by June 30, 1998. But following the above mentioned decisions by the Central Bank, the increase of net foreign assets in TL terms was only 1 percent during the second half of June (Figure 7).

FIGURE 7

The Central Bank's net domestic assets continued to decrease during the same period, falling by TL 1319 trillion in nominal terms relative by the end of March. The increase in the revaluation account caused by the rapid increase in net foreign assets, the effectiveness of sterilization via open market operations, the Treasury's non-use of short-term Central Bank advances, and the non-use of Central Bank credit by other public-institutions, were the main factors making the decrease in net domestic assets possible (Figure 8).

FIGURE 8

In its turn, the improvement in the primary surplus of the budget that accompanied the slowing of the growth rate of the domestic debt stock reduced the pressure on monetary aggregates. The behavior of both the monetary aggregates and reserve money was positive during the first half of the year. According to preliminary data dated June 5, the five-month cumulative rises (since December 26, 1997) in M1, M2 and M2Y were 23 percent, 38 percent and 36 percent respectively (Figure 9). Annualized, the rates of increase were 59 percent, 97 percent, and 101 percent respectively. The cumulative increase in the aggregate M2YR, which can be obtained by adding the repo transactions to M2Y, was 36 percent for the first five months of the year, and the annualized increase was 110 percent.

FIGURE 9

II. Monetary Policy During the Second Half of 1998

The Central Bank will continue to conduct its monetary and exchange rate policy during the second half of 1998 in a manner consistent with the 50 percent inflation target.

The monetization that occurs in an economy making the transition from a high inflation period to a low inflation period is not symmetric with the monetization that takes place during as an economy passes from a low inflation period to a high inflation period. In other words, attempting to predict, on the basis of past data, a money demand function that will be consistent with the low inflation target, may result in overestimation of the degree of monetization required in an economy. This could damage the credibility of the policies aimed at lowering inflation. For this reason, the possibility of unforeseen developments in the demand for money that will arise during a period of decreasing inflation requires the Central Bank to choose a new indicator as a target for influencing monetary conditions.

The Net Domestic Assets item in the Central Bank balance sheet has been chosen as the new indicator, and the target has been set at minus TL 1,514 trillion by the end of 1998. As shown in the figure, the target for net domestic assets foresees a small increase during the second half of 1998, instead of the decrease that has prevailed since early 1998. Taking into account the main items affecting net domestic assets, it can be said that the Central Bank will not target a rapid increase in foreign exchange reserves during the second half of the year, and that the excess liquidity that comes from reserve accumulation will therefore somewhat decrease. For this reason, the Central Bank intends to reduce its interventions aimed at daily liquidity management. Instead it will keep net domestic assets under tight control by continuing its policy of not extending credit to the public sector.

The target for net domestic assets is consistent with:

- The estimated increase in "net foreign assets", which in turn is consistent with the targeted increase in the net international reserves item in the balance of payments.
- The estimated increase in "reserve money", which in turn is consistent with the targeted inflation and growth rates.
- The behavior of the new net domestic assets item is presented in Figure 10 and its definition is given in the Appendix. As can be seen from the figure, though it displayed some volatility during certain periods, net domestic assets has declined steadily since 1997. Standing at TL 142 trillion at the end of 1997, this item fell substantially as a result of increased open market sterilization operations and a surge in the revaluation account necessitated by high capital inflows. During the same period, the Treasury received no short-term advances and the Central Bank extended no cash credit to the public sector, with favorable effects on net domestic assets, which declined to minus TL 1778 trillion as of June 30, 1998.

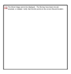


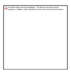
FIGURE 10

Appendix: The Interpretation of Item □Net Domestic Assets□ in the Central Bank□s Balance Sheet

If we define Central Bank balance sheet as:

Reserve Money (X) = Net Foreign Assets + Net Domestic Assets, then in a sense,

Reserve Money (X) by definition represents the sum of the total balance sheet. The sub-items of this newly defined balance sheet are summarized in Table 1.



In other words, the new definition of □Net Domestic Assets□ includes some items from the liabilities side of the Central Bank balance sheet, and reflects the mutual credit relationships of banks, the public sector, and the Central Bank. The "Foreign Exchange Deposits of the Non-Banking Sector" and the "Public Deposits" items on the liabilities side of the balance sheet can be interpreted as a credit from the public sector to the Central Bank. By the same token, if considered as a liability item the balance of "Open Market Transactions" is positive, then banks are extending credits to the Central Bank. If it is negative, then the Central Bank is extending credits to the banks. If the "Public Deposits," "Foreign Exchange Deposits of the Non-Banking Sector," "Open Market Transactions," and "Deposits of the Non-Banking Sector" items on the liability side are excluded from the domestic assets on the assets side, this reflects the net credit relationship of the Central Bank with the financial system.

According to the above definition of Net Domestic Assets (NDA), the following items will affect it:

Cash Credit to the Public Sector: This item is mainly affected by the changes in "Short Term Advances to the Treasury" and "Government Securities" items. The use of the short-term advance facility by the Treasury increases the Cash Credit to the Public Sector item. Since the Central Bank's securities portfolio changes in parallel with the direct sale and purchase of securities and repo-reverse repo transactions, the "Government Securities" item depends on the prices of the most recently traded government securities in the portfolio.

Credit Extended to the Banking Sector: No new money is extended to the banking sector.

Other Items (Net): This item includes the net balance of debts and credits of the Central Bank stemming from other transactions. A negative net balance in this item decreases NDA, and a positive net balance increases it.

The Revaluation Account: This item shows the foreign currency differentials stemming from the revaluation of foreign assets and liabilities of the Central Bank caused by depreciation or appreciation of the TL against foreign currencies. A negative net balance in this item decreases NDA, and a positive net balance increases it.

Public Deposits: This item includes the TL deposits of the public sector. An increase in this item decreases NDA, and a decrease increases NDA.

Foreign Exchange Deposits of Non-Banks: This item mostly represents foreign exchange deposits of the Treasury. While an increase in this item due to privatization and/or foreign borrowing decreases NDA and increases NFA, it has no effect on reserve money (X). But whenever the Treasury withdraws its foreign exchange deposits by converting them into TL, NFA remains unaffected but Reserve Money (X) increases due to the rise in currency issued.

Deposits of Public Funds and of Non-Bank Private Sector: An increase in this item decreases NDA, while a decrease increases it.

Open Market Operations (OMO): An increase in the cash debt of the Central Bank to the market caused by open market operations decreases NDA, while an increase in the cash debt of the market to the Central Bank increases NDA.