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PRESS RELEASE
ON THE CBRT INTEREST RATE CUTS

I. GENERAL EVALUATION

1. The primary objective of the Central bank of Turkey (CBRT) is to achieve price stability as stipulated in its Law. Accordingly, the CBRT's first priority is to hit the inflation target, determined together with the Government. Short-term interest rates, which are the main policy instrument of the CBRT, are adjusted by considering only and only to which extent the future trend of inflation is compatible with the inflation target. In other words, the CBRT's decisions on the short-term interest rates are never destined to affect any variables other than inflation.

2. It is no doubt that, the inflation rate cannot be considered separately from other variables in the economy. As has been announced several times by the CBRT, there are a series of variables influencing inflation. The common conviction of various academicians who have studied the inflationary process in Turkey is that the main variables shaping the course of inflation are i) the rate of increase in exchange rate, ii) the expectations about the future trend of inflation, iii) the prices in long-term contracts made in line with these expectations such as wage increases, and iv) the demand pressure determined according to the direction and the size of discrepancy between the current output level and the potential output level.

3. In this framework, the following points must now be very clear:

a) The CBRT is carefully monitoring the factors having an effect on inflation by considering not only the current indicators, but also the future probable trend of variables.

b) The current and future probable movements in the variables affecting inflation are drawing the course of future inflation. And these considerations, in turn, are influencing the decisions of CBRT on short-term interest rates.

c) For example, the gradual appreciation of Turkish lira suggests that the downward trend in inflation will be strengthened, provided that the other variables do not act against this trend.

d) It is obvious that bringing short-term interest rates down by looking at such a trend has nothing to do with the current exchange rate level. The aim is only to come closer to an interest rate level in line with the inflation target in the disinflation efforts, and to give a signal to the public that the general course of economy is in good progress.

e) In addition, the relationship between short-term interest rates and exchange rates is many-sided and complex. The following three examples can be considered to provide sufficient proof for the complexity of the situation.

f) Firstly, other variables being the same, the declining yields of financial instruments in TL may exert an upward pressure on exchange rate by increasing the demand for foreign exchange in the detriment of Turkish lira demand. This is what expected of those who establish a reverse correlation between interest rate and exchange rate.

g) Secondly, the CBRT's short-term interest rates cut in line with the price stability goal will enhance the confidence in the current program, and will reinforce the reverse currency substitution process even further, being a favorable signal both for inflation and for general business climate. In this case, the pressure on exchange rates will be relieved, in contrast to the above-mentioned effect.

h) Thirdly, contrary to the first two effects based on economic fundamentals, there may be some movements in exchange rates unrelated to economic rationale. Although such developments tend to be temporary, it is obvious that they can continue for a certain time and make the relationship between short-term interest rates and exchange rate even more complex.

i) In the economics, exchange rate is one of the areas that has mostly been made subject of academic discussions, and there is nearly a consensus that the theories developed thereon are not at desired level yet. Moreover, if we consider the influences of expectations on debt sustainability over exchange rate and interest rate, not found in standard text books, it becomes clear that the subject of exchange rate calls for the expertise at an advanced level.

j) It must be kept in mind that in line with the increased confidence in the current program, the portfolio shifts from foreign exchange to Turkish lira is a desired result. It is true that such a development or increase in the foreign direct investments in the longer term may result in excess foreign exchange supply, putting pressure on exchange rates. The solution lies not in cutting short-term interest rates with the aim of intervening in exchange rate only independently from future trend of inflation, but in sterilizing the excess foreign exchange supply by the CBRT through transparent methods consistent with the floating exchange rate regime. In fact, the excess foreign exchange supply resulting from reverse currency substitution started in May 2003 is being sterilized through buying auctions. The CBRT will continue to pursue effectively its sterilization policy in the medium and long-term as well considering the developments in foreign exchange and Turkish lira liquidity, in compliance with the public domestic debt management policies.

k) The exchange rate and interest rate relationship should be evaluated in the light of the above-mentioned information and the analyses thereof should be made more comprehensively and multi-dimensional.

4. On the other hand, the main determinant of the variables affecting inflation and real interest rates is the current economic policies. In this context, especially fiscal policy comes first due to Turkey's *sui generis* conditions. Undoubtedly, the reason is the still high level of public sector debt, despite its downward trend under the current program.

5. As has been underlined many times in our previous announcements, the fiscal discipline is the *sine qua non* condition for reducing the ratio of public debt to the GNP permanently. Such a declining trend will boost the public confidence in the debt sustainability and then both the borrowing maturities will extend and the real interest rates will come down.

6. As clearly understood by majority of the public, real interest rates cannot fall by reducing nominal interest rates artificially. Such a behavior would only disrupt the equilibrium established with great efforts, and would not bring real interest rates down. Correct treatment can only be possible with a correct diagnosis. Accordingly, real interest rates can be reduced through achieving a permanent fiscal discipline and reducing inflation. In fact, when the program implementation is examined since the beginning it can be easily seen that all increases in real interest rates have resulted from the likelihood of a deviation from the current program, or just a perception thereof, except for exogenous shocks.

7. The current program is an indivisible integrity. The main goals of the program are to achieve price stability, which is the pre-condition of the sustainable growth, and to reduce the ratio of public debt stock to GNP, and the main pillars are the monetary discipline and structural reforms. Failure in any of these pillars or the likelihood of failure would cause the disruption of the whole program. Therefore, what must be done is to remove convincingly the failure or the failure possibility, instead of looking for solutions in the areas that are unrelated to the source of the problem.

II. EVALUATION ON THE INFLATIONARY TREND

8. Especially since April, cost-push pressures have started to lessen together with the declining exchange rates and oil prices. By predicting that these favorable developments would cause an obvious break in inflation expectations the CBRT cut the interest rates by 3 points on April 25, 2003. In fact, April inflation remained well below the market expectations, which were 2,1 percent and 2,8 percent. Moreover, increases of private manufacturing industrial prices stood at 0,7 percent. The depreciation in exchange rates continued in May and reduced the cost-push pressures considerably. An improvement was observed in general business sentiment. With the atmosphere of confidence and the removal of cost-push pressures, the expectations have turned favorable since the mid-April. The year-end CPI inflation expectations, increasing from 24,8 percent in January to 28,4 percent in the first period of April, retreated to 26 percent in the second period of May, although not satisfactory.

9. However, in the design of its interest rate policy the CBRT is taking great pains in establishing whether the break in inflation trend is permanent or not. It is obvious that the failure or delay in taking steps specified under the program will immediately disrupt the favorable atmosphere started in April. Such delays are leading to discrepancies between those who expect a fall in inflation and a reduction in short-term interest rates by looking at the current indicators only, and the CBRT's expectations and evaluations that considers also the future course of fiscal policy and the variables affecting inflation.

10. Since the beginning of May, the CBRT has observed some delays in structural reforms and measures envisaged in the program such as restructuring the social security system and addressing the redundancy in public sector. The CBRT has also observed the possibility of extra burdens to the budget due to deficits in the energy sector, and the necessity of taking some measures in order to meet the target of primary surplus. Under these conditions, a monetary authority that is focused on disinflation efforts should be well advised to be cautious in its decisions on interest rates, waiting for the whole picture to become clearer. As a matter of fact, due to the developments stated above the CBRT refrained from reducing interest rates in May.

11. However, the determination to achieve the program targets has recently been observed during the 5^{th}. IMF Review, by compensating for the delays. In fact, some measures for improving the social security system, which is the biggest obstacle to reaching the year-end primary surplus target, have already been taken. Cost-reducing steps are being taken in the energy sector. These developments are promising for the future inflation.

12. Yesterday's announced annual CPI inflation figures as of May, which rose from 29,5 percent to 30,7 percent, should not be perceived as unfavorable. The reason is twofold. First, as we have already announced, the downward trend in annual inflation rates will be observed starting from the second half of the year. This can be accounted for the "base" effect created by fluctuations around the main downward trend in inflation during 2002. There are two distinct movements around this main trend in 2002: The seasonally adjusted monthly inflation rates during the first half of 2002 stood at low levels due to nominal appreciation of Turkish lira and low rate of increase in food prices. However, monthly inflation rates rose relatively in the second half of the year owing to the high increments in public prices and the increasing exchange rates following the political uncertainty occurred in May 2002.

13. Second, the developments in agricultural and food prices, which are greatly influenced by natural conditions that are not under the control of economic policy, should be taken into account. However, for a healthy analysis of the main trend in inflation the course of consumer prices excluding foods becomes important. In this framework, the annual CPI inflation figures excluding foods are giving promising signals for the inflation trend. CPI inflation excluding foods has been falling since the first months of 2002. The annual CPI inflation excluding foods, which stood at 31,5 percent at the end of 2002, went down to 29,3 percent in April and to 28,6 percent in May. Another promising development for the inflation dynamics is being observed in private manufacturing industry prices. Not much affected by seasonality aspects, this index shows that the monthly prices have been on a downward trend since the

New Year. As a matter of fact, the rate of increase in private manufacturing industry prices, which stood at 3,6 percent in January, came down to 1,6 percent in March, to 0,7 percent in April, and to 0,3 in May.

14. Despite the reduction in cost elements, the favorable expectations and developments in the consumer prices excluding foods and in the private manufacturing industry prices, a relaxation in fiscal discipline in the future will be a serious economic policy mistake. As the Central Bank we believe that the utmost care will be shown by those concerned in order not to commit such a policy mistake. The other sections in the economy must share the same belief, and must be convinced that i) the fiscal discipline would be continued uncompromisingly for bringing inflation expectations in line with the program targets, ii) public sector incomes policy would be implemented in line with the program targets and iii) structural reforms would be completed as scheduled. In this context, apart from the speed of structural reforms, the increments in public sector wages and salaries will be a vital indicator for the markets.

15. On the other hand, domestic demand starts showing signals of revival in line with the increased confidence. Although it is early to pronounce a definite judgment, it is thought that the increase in domestic demand is slightly limiting the downward trend in inflation. In the next period, the fight against inflation will be greatly helped if the public sector as well as private sector pursues their incomes and price-setting policies in line with the inflation targets, and do not adopt an opportunistic behavior by taking advantage of revived domestic demand to increase their profit margins with short-term considerations. Otherwise, we have to underline once again that the fight against inflation will become more difficult and costly.

III. THE CENTRAL BANK INTEREST RATES

16. In the light of the evaluations above, starting from June 4, 2003, the CBRT has decided to cut short-term interest rates applied at CBRT Interbank Money Market and Repo-Reverse Repo Market at Istanbul Stock Exchange as follows:

- **a) Overnight Interest Rates:** Borrowing interest rate was cut to 38 percent from 41 percent and lending interest rate to 45 percent from 48 percent.
- **b) Other Maturity:** One-week borrowing interest rate was cut to 38 percent from 41 percent.
- **c) Late Liquidity Window Interest Rates:** In the framework of Late Liquidity Window application, the CBRT overnight lending interest rate applicable between 16:00 – 16:30 at Interbank Money Market was cut to 50 percent from 53 percent. Borrowing interest rate of 5 percent remained the same.

Moreover, the interest rates on overnight and one-week maturity borrowing facilities provided for primary dealer banks via repo transactions in the framework of open market operations were cut to 41 percent from 44 percent.