THE TURKISH ECONOMY AND THE MONETARY POLICY IN THE FIRST EIGHT MONTHS OF 1998

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Ladies and Gentlemen

I would like to thank DEIK, first, for inviting me to speak to this and other distinguished gatherings here in London, and second, for this opportunity to comment on Turkey□s situation in the presently troubled global environment.

The Turkish economy continues to enjoy robust growth, a manageable external current account deficit, a broadly stable public debt ratio, and high official reserves. Chronic high inflation, and large nominal fiscal debt, are our principal economic problems.

At the beginning of 1998, the Turkish government announced an anti-inflation program. Monetary and fiscal policies are being closely coordinated to ensure its effectiveness, and policy efforts are benefiting from a strong increase in the primary fiscal surplus and a surge in the pace of privatization. The program aims at overcoming inflation inertia by switching from backward-looking to forward-looking indexation and some structural measures. The other major components of the program are a commitment to transparency and to avoid, this year and next, the weakening of fiscal discipline all too often seen in countries where elections are approaching.

The initial results of this program have been positive. In order to strengthen it, we asked the IMF in July to make it a staff monitored program, and IMF management agreed to monitor it quarterly.

Now I will describe, briefly, developments in the Turkish economy during the first eight months of 1998.

Growth

Though slower than during the last three years, the growth of the Turkish economy was strong during the first half of 1998, with GNP increasing by 6.3 percent and GDP by 5.2 percent. For the year as a whole, GNP is expected to grow by 4.5 percent. This slowing of the growth rate is an expected side effect of the stabilization efforts aimed at bringing down inflation.

Budget

The first year of this three-year program focused on improving the primary surplus of the budget, thereby creating an environment favourable for domestic borrowing and controlling monetary aggregates.

Primary budget surplus has been targeted at 4.1 percent of GNP for 1998 as a whole. For the first half of the year, the actual figure was 7.3 percent of GNP, compared with 2.7 percent of GNP for the same period of 1997. The significant improvement of the primary balance came mostly from tax revenues, which rose in response to strong income growth in 1997 and falling inflation in 1998. To make the increase in tax revenues permanent and enlarge the tax base, parliament passed a new tax law which took effect in July 1998.

Balance of Payments

The current account deficit was US$1.5 billion at the end of June 1998, down from US$2.3 billion at the same time last year. In GNP terms, the current account deficit was 1,89 percent for the first half of 1998. The stability of the real exchange rate helped exports to grow, and falling import prices, especially of imported oil, held down the bill for imports despite a significant increase in their quantity.

The capital account, on the other hand, recorded inflows of $7.8 billion during the first six months, pushing Central Bank reserves to $8.2 billion.

Inflation

Inflation has been decreasing during the first eight months of 1998. Since February, the monthly percentage change in inflation has been less each month than last year. The cumulative change the first eight months is 32.7 percent, bringing wholesale price inflation to its lowest level since 1995.

Several factors are responsible for inflation’s downward trend. Not in order of importance, they are:

- The government’s willingness to reduce the inflation rate, as reflected in a series of privatizations and anti-populist measures, such as the new tax law approved by parliament.

- The consistent implementation of the anti-inflation program throughout the year, with close coordination among economic units.

- The positive cost effects of the present world economic conjecture; ie. low world oil prices.

A steep increase in the primary budget surplus and a shift to forward indexation of civil service wages and agricultural price supports.

 Pursuit of an exchange rate policy consistent with the inflation target.

A credible monetary policy aimed at reducing inflation to the targeted level.

These are snapshots of the Turkish economy at the end of August 1998. They show that inflation, GNP growth and the current account deficit are lower than last year. It appears that the widening of the budget deficit is being contained by the improvement in the primary surplus.

Monetary Policy

In 1996 and 1997, monetary policy was preoccupied with preserving the stability of financial markets and the real exchange rate. The Central Bank of Turkey directed its monetary policy in accordance with expectations based largely on the stance of fiscal policy. The relatively stable nominal exchange rate combined with short-term interest rates kept high by the pressure of public sector borrowing to attract capital inflows provide the banking system with ample liquidity. The Central Bank responded to shifts in foreign investor sentiment by injecting liquidity to offset capital outflows and by sterilizing excessive inflows. At the time, this policy succeeded in maintaining market stability and competitiveness. It was not an anti-inflationary policy, but it kept inflation under control.

During the two years we implemented this monetary policy, we were hesitant to announce a target to the public. Let me define a nominal anchor of the system as a monetary policy indicator that the markets are expected to watch and use as a guide. There are three indicators which could serve as such an anchor: reserve money, the exchange rate, and net domestic assets. I should say that all three are problematic.

The main problem with reserve money targeting is that under conditions of reasonably high capital mobility and an exchange rate that is more or less fixed, monetary policy cannot be implemented independently. The problem with exchange rate targeting is that we are reluctant to commit ourselves to a preannounced path or fixed exchange rate because of the risk of a real appreciation, followed by current account deterioration and a foreign exchange crisis. And the drawback of using Net Domestic Assets as the anchor is that it may protect the balance of payments objective but by itself does little to reduce inflation.

At the beginning of this year, based on the large increase expected in the primary fiscal surplus, we announced a quarterly reserve money program aimed at promoting stability in the markets as part of the government's stabilization effort. We also decided to announce a tough stance for interest rate policy, aimed at supporting the program by curbing aggregate demand. Reserve money growth in the first and second quarters of the year was held within the target range.

Predictably, interest rate differentials remained high and money kept flowing in through the capital account. The restoration of investor confidence in 1998 also resulted in massive capital inflows whose absorption was a major challenge. The stock of open market operations went from a positive TL 720 trillion at the end of 1997 to a negative TL 1.100 trillion as of June 26, which clearly reflects a change of some $8 billion.

In order to interrupt this cycle, we decided in June to shift to Net Domestic Assets targeting. This change was consistent with the staff-monitored program, which assigns to monetary policy a secondary role in the disinflation process. Since the process is gradual, inflation will come down as fiscal sector continues to behave well, progress is made with structural reforms, and agents become convinced that there is indeed a disinflation program in place.

A supportive, closely coordinated monetary policy has aided this process. As inflation comes down, money demand is supposed to go up. Net Foreign Asset will accumulate, but just enough to monetize the system against the rising money demand. The process is accommodated by monetary policy, but is not led by it.

In late July and August, however, developments in the international arena, together with tensions connected with the impending election and the new tax bill have kept interest rates high and kept the foreign exchange market under pressure. Although broad fundamentals remain unchanged and the fiscal sector is behaving well, the balance of payments is being unnecessarily squeezed. The months of August and September have seen a $4.5 billion decline in reserves. Clearly, the switch from Net Foreign Assets to Net Domestic Assets took place too fast.

We all know that over the last few years Turkey has in fact been operating like a currency board because there was no alternative to creating money through foreign exchange purchases. The Central Bank of Turkey does not create TL against TL except by open market operations, which by definition cannot grow indefinitely.

Under these conditions, with a high level of reserves and tight control of liquidity, three adjustments are possible: further fiscal measures, higher interest rates and progress on structural reforms. I do believe that tough and credible monetary policies combined with these adjustments would improve Turkey's credibility and bring a reversal of capital flows in the near future. Even though at the outset, we immediately increased short-term interest rates, we will keep our tough stance and not accommodate the outflows of reserves. In other words, liquidity should be kept tight. The expected behaviour of major monetary aggregates like broad liquidity and reserve money would be in line with the program announced above.

Exchange Rate Policy

On exchange rate policy, the Central Bank has tried to establish a consistent policy that balances inflation and foreign trade concerns. The fact that inflation is falling at the same time that the current account deficit is decreasing could be seen as "the confirmation of the numbers" of the fine-tuning approach of the Central Bank toward exchange rate policy.

The numbers clearly show that in August 1998, the Turkish Lira was undervalued. In the first eight months of 1998, in real terms the TL depreciated by 4.5, 0.9 and 1.9 percent against the currency basket followed by Central Bank vis-a-vis the Wholesale

Price Index, the Consumer Price Index, and private manufacturing sector based indices.

Since 1990, real effective exchange rates have been depreciated like these:

WPI-based, 17.9 percent; CPI-based, 10.0 percent; private manufacturing sector-based, 22.5 percent; Unit labor cost (WPI-based), 33.5 percent; unit labor cost (CPI-based), 41.9 percent.

These numbers make it clear that Turkey's international competitiveness is adequate, allowing exchange rate policy to be aligned in support of the disinflation effort.

In addition, we have enough instruments and foreign reserves at hand to protect the Turkish Lira against volatility.

The present situation in the world economy as a whole and in the emerging markets in particular could arouse concerns about the feasibility of Turkey's anti-inflationary efforts. But by keeping aligned with market economics, the Turkish economy is sailing through these restless waters in a relatively steady and orderly fashion.

Let me cite a number of reasons for the strength of the Turkish economy in a volatile global economic environment.

First, its markets are liquid and functioning efficiently.

Second, even after the recent drop, the Central Bank's official reserves still stand at $22 billion. The current level of reserves is equal to five or six months of imports, and almost equal to Turkey's short-term external debt. Furthermore, some $12 billion of Turkey's total reserves come from special deposits of Turkish workers abroad. This situation, unique in the world, reduces the volatility of Turkey's official reserves.

Third, the vicissitudes of the times have given the Central Bank of Turkey considerable experience in the pursuit of financial stability, using exchange rate and interest rate policies to support the stability of the marketplace.

Fourth, we maintain a very good, highly credible record of paying our external debts.

Fifth, Turkey's external trade and our financial and economic relations abroad have long been highly diversified among many regions, countries, goods and sectors. The Turkish economy has never tolerated concentration on one country, one product, or one sector. Fifty percent of our trade and financial relations are with EU countries. And at the moment, Turkish banks have very little exposure in terms of Russian government paper or Russian firms.

Sixth, much of the short-term international speculative capital visited Turkey—the so called "hot money"-- has already left the country.

Irrational fears on the part of international investors were the principal cause of these outflows. Nothing much is left.

Seventh, Treasury will be able to manage its domestic borrowing roll overs without recourse to external funds, which in any case was not the fault of the Turkish authorities. Please bear in mind that these Treasury borrowings will only be roll overs, and do not involve any additional financing requirements of the Treasury.

Last but not least, the short term external debt of the Turkish economy is not high by any standard. Total short-term external debt at the end of March 1998 amounted to $23.5 billion. The breakdown of this total is as follows:

• Trade related credit such as L/C, acceptance credits, cash-against goods, pre-export credits:	USD 11.9 Billion
• Foreign exchange credits by banks:	USD 4.6 Billion
• Foreign exchange credits by other sector:	USD 1.6 Billion
• Deposits:	USD 5.4 Billion
TOTAL :	USD 23.5 Billion

By any standard, then, Turkey's short-term external debt is much smaller than that of comparable countries.

Thus, the underlying fundamentals of Turkish economy remain strong, and the government's determination to stick to its anti-inflation measures give the Turkish economy a better than even chance of coming out on the positive side in the present highly volatile world economy. An even stronger commitment to structural policies and more active use of monetary policy would increase the economy's ability to weather adverse external developments.