TRENDS IN THE TURKISH ECONOMY AT THE BEGINNING OF 1999

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This is an extremely interesting period, for the Turkish economy and other economies of the world as well. Numerous unexpected economic developments have been occurring, both in the international arena and in our country. Besides the normal succession of political changes and events, the ongoing process of "globalization" is bringing more permanent changes and adding new dimensions.

Looking at recent years, we find the Asian crisis emerging suddenly at the end of 1997, at a moment when the world economies were performing well. Nobody expected it. And while the extent of its repercussions was still being discussed, another unforeseen crisis erupted in Russia. It was unforeseen because no one imagined that any country would find itself unable to repay its domestic debts on the eve of the 21st century. But that is just what happened. Russia declared that it could not repay its debts. Russia's total debt amounts to US$100 billion, no small amount.

All these unexpected developments suddenly changed the positive expectations for the world economy into expectations of crisis and the need for crisis policies. And although there is not yet full agreement on the definition of crisis, the economies of the world recognize the need to protect themselves from unexpected crises. The international capital markets began to devise anti-crisis measures. They could see that the theoretical and practical knowledge of how to behave under normal conditions did not work very well in a crisis environment.

This was all the more true following the Russian crisis. During the World Bank and IMF annual meetings held in early October 1998, the bankers were in a state of near panic. At that moment, the world's political decision-making processes were nullified by a vacuum of world political leadership, and these frightening circumstances caused financial circles to fear for the future.

And in the end, all these factors came home to us in Turkey as well.

Of great importance is a feature that makes Turkey unique among the world's economies. This is the inflation with which we have lived for twenty years. Our first task is to lower this inflation or at least hold it steady. Our second task is to strengthen further those of our internal and external balances that are already strong, and restore the weak ones. And we must try to avoid being drawn into recurrent worldwide financial crises by keeping their damage to Turkey as slight as possible.

In 1998, developments intensified on three fronts, and the government decided, early this year, to give the highest priority to the disinflation effort. The final reason for this decision was that toward the end of 1997, Turkey once again found herself among the most seriously troubled "problem countries," or at least was perceived as such. That winter, scenarios based on the implications of the Treasury's borrowing spiral indicated that shortly the Treasury would no longer be able to borrow, at which point we would be headed for trouble.

The government's most plausible alternative was first to halt this trend and then launch a deflation program that would reduce the inflation rate to 50 percent in the first year, 20 percent in the second year, and then to single digits. And the government did indeed begin to execute this program. The main points of the program were (1) the GNP share of the foreign and domestic public debts would be held constant; (2) the budget would be tightly restrained; and (3) monetary policy would support the disinflation effort. Then, when the domestic financial balance once more began to be supported by external resources, we would launch the economic program and achieve the required tight budget policy through a slight relaxation of monetary policy. This was the essence of the planned strategy.

In reality, the Treasury's foreign and domestic debts in GNP terms are not all that large. Turkey's level of public indebtedness is around 40 percent of GNP. If this indebtedness ratio should increase, the availability of market financing for this purpose will gradually diminish and the prospects for borrowing will shrink.

For this reason it is very important to maintain this ratio. In addition, we should increase the central government's primary surplus by increasing it to around 4 or 5 percent of GNP in order to bolster market confidence.

Here I would like to point out that the primary surplus is an indicator of a government's determination and ability to prevail in the struggle with inflation and to correct imbalances. The strength of the disinflation effort increases as the primary surplus grows. In this, the monetary authorities must observe developments in the fiscal sector and act accordingly. We must also consider the behavior of GNP. A loosening of monetary policy will cause economic activities to increase. Maintaining the external equilibrium of the exchange rate policy is still another objective. And when we have added our structural problems and their solutions to all these other elements, we will have a strong and meaningful set of policies.

In May 1998, once we had obtained parliamentary approval of the tax reforms and the program had showed results, substantial inflows of external resources began. It is well known that we at the Central Bank do not generally approve of such short-term "hot money." We took all the necessary precautions against the probable consequences. And it is somewhat comforting to know that our reserves are increasing, even if only in the short term. But resources so vulnerable to sudden reversal cannot be relied on. In mid-1998, Turkey entered into a Staff Monitored Program with the IMF, and the IMF verified the credibility of this program. Then we concerted all our efforts to bring Inflation down to between 50 and 60 percent. But even though WPI inflation did fall to the 50 percent range at the end of the year, Turkey was suffered two significant blows.

The first was the Russian crisis of August 1998, which triggered swift and very strong reactions on the part of the international money and capital markets. Mr. Stiglitz, chief economist and vice president of the World Bank, coauthored an article with Mr. Grossman in 1981, which I want to tell you about because it is very interesting. According to them, some people know how to analyze and assess the markets and the economy, and some people don't. Those who know hire a consultant firm and employ economists to analyze the economy. Those who don't know must follow the others. Now, nearly 20 years later, the indicators being used by knowledgeable people are still the same despite many changes in the markets. They look at three or four indicators: the inflation rate, the size of the budget deficit, interest rate spreads, and political uncertainties and instabilities. When adverse developments occur, the better informed market participants disregard the criticism that they are looking at the wrong indicators and say it is time to abandon the market, and those who are poorly informed about the markets will follow them. As a matter of fact, Turkey's reserves suffered a loss of US$7 billion between early August and the end of September, and both those who were well-informed and those who were ignorant fled Turkey together.

Second, the struggle against inflation also requires that public opinion, namely individual citizens, companies, and everyone else including the government must take part. At present, consensus and solidarity among Turkey's social partners for bringing inflation down is lacking. In early 1998, nobody believed the inflation rate could be lowered to 50 percent. By that time, everybody was accustomed to regarding the high inflation was a normal state that had persisted for years, and believed they could protect themselves against the adverse effects of inflation through the use of various financial instruments. And there were also those who did not want inflation to be decreased because they had found ways of making money from the ever-rising inflation. Under these circumstances it is hard to convince most people that inflation will decline, and their behavior is consistent with expectations that inflation will be 70-80 percent. Although formerly this may have been appropriate, 1998's harmonization of tight budget policy with monetary and exchange rate policies contributed a lot to inflation's steep decline towards 50 percent.

Once the inflation rate began to fall, another factor came into play: because the real sector had planned its production based on expectations of 80 percent inflation, inventories began to accumulate as the demand shrank and sales declined. This

required either that the unsold goods be exported or their prices reduced for domestic sale. But although our exports were booming, the boom was chilled by the fallout of the Russian crisis. Starting in September 1998 problems emerged due to the capital outflows taking place in the second half of the year and the global crisis. The year ended with doubts about how the Treasury could borrow money and how the political uncertainties would be resolved. There were rumors about a devaluation. I repeated my view that a devaluation would be unreasonable and economically unjustified.

Let me insert a brief parenthetical comment on Turkey's foreign competitiveness. Three major points enter into our evaluation of the appropriateness of the "I" level of the exchange rate. The first is to take account of the wholesale price index, the consumer price index, and the private sector manufacturing cost or unit labor cost, all for the base year. Based on these, we set an "I" level for the exchange rate. Calculations show that the Turkish lira neither appreciated nor depreciated according to the indices for the base years 1987 and 1999.

The second significant indicator to assist us in maintaining the balance of payments and setting exchange rate policies is productivity. The more productive the economy, the stronger its competitiveness. Turkey is a country that increases its productivity every year, though there is not clear-cut rate of increase. There are many reasons for this: computerization, the vigor of the private sector, the cost of capital and its sources, all explain why productivity has risen every year. This increase provides an additional competitive edge benefiting the balance of payments. The third reason for Turkey's successful competition is that the exchange rate should be stable. By making it possible to estimate with reasonable accuracy what the Turkish lira will be worth in US dollars, euros, deutsche marks at the end of six months or a year, such stability will also increase the demand for Turkish exports. Both exporters of goods and exporters of services take advantage of consistent exchange rate behavior to prepare their business plans and programs a year or six months ahead. Academic studies have clearly demonstrated the importance of this consistency for Turkish competitiveness.

A look at all three indicators reveals that Turkey's present competitiveness level is appropriate. The main question facing us is, how will exchange rate devaluations on the part of the Asian countries affect Turkey's situation? While it is certain that we will not be affected in the short term, we cannot be so sure about the medium term. As a matter of fact, the customs union between Turkey and the European Union is sheltering us. It is very difficult for Asian or South American exports to penetrate the European market and sell goods there, but the customs union enable us to do so easily. This is why we are so attentive to the exchange rate issue. And in point of fact, the balance of payments position moved from deficit to surplus in 1998, contrary to expectations.

Turkey's budget deficit accounts for around 7-8 percent of GNP. In theory, the combination of a budget in deficit and high inflation will depress the balance of payments position and give rise to problems. But this has not happened in Turkey. Despite a persistent budget deficit and high inflation, the balance of payments has long been performing well. A review of the current accounts reveals that the our income from the sale of goods and services amounts to US$63 billion, half from the sale of goods and

half from the services provided. For example, Turkey obtains interest income of US$2 billion from services alone. Half of this income is earned on the reserves of the Central Bank. There is not doubt that this is a substantial contribution to the balance of payments. In addition, there are the revenues that Turkish businessmen have been receiving for years from their investments abroad. I do not foresee, either now or next year, any problems with Turkey's balance of payments position or its supply of foreign exchange.

At this point, let me jump ahead to early 1999 and talk about Turkey's prospects from 1999 onwards. The IMF has recently made a similar assessment. Generally speaking, the IMF too bases its judgment on the behavior of inflation. This is because inflation is the most important indicator included in the program. If the inflation targets are met, it is virtually certain that all will go well in the other parts of the program. Reviewing the specific individual elements of the program shows clear improvement in the budget, monetary aggregates, the exchange rate, and structural reforms.

The IMF's survey of Turkey's program is available, in Turkish and English, on the websites of the Central Bank and the Treasury. The IMF clearly stresses that the Turkish economy has made significant progress, but warns that this progress must be durable. All of us at the Central Bank are also aware that inflation must continue to decline in the period ahead. The preconditions for lowering inflation include implementation of a sound budget policy that avoids the "debt trap" (short-term borrowing with higher interest rates), and steady conduct of, namely so-called debt trap, and the persistent application of monetary, exchange rate, and structural policies are consistent with the budget policy or even on occasion seek actively to move it forward. Positive results will feed positive expectations about disinflation, and the credibility of these successes will be bolstered by the arrival of foreign capital inflows.

As you know, we are headed toward general elections. We have already been planning for the post-election period. We have made studies, now almost completed, of how to lower inflation even further and how to correct the imbalances that could jeopardize reasonable growth or even result in a negative growth rate. It is essential that a government that understands and accepts this program should be formed after the elections and should implement these policies for a certain period of time. We already see eye-to-eye with the IMF on the technical aspects. The Treasury, the Central Bank, the State Planning Department, and the Ministry of Finance are all making technical plans. We have not yet assigned precise figures to these policies: program design is in the stage of approximations. We will visit Washington in March and will take the first steps there. We will submit the program to the government that will take office after the elections.

As technocrats, we will propose whatever it takes. Backed by the political will and determination of the government, the program's credibility will receive a substantial boost. I think it will be beneficial to emphasize a one or two-year program aimed at ridding Turkey of her long-standing problems and pushing her forward in the international sphere.

At this point, I would like to comment on central bank autonomy. As a central bank should, the Turkish Central Bank is trying to follow the most unbiased and independent policy possible. The main pillars of this approach are the clarity of the central bank's monetary policy: its transparency, its accountability, and its predictability. The first requirement is transparency. Then the bank should account for any changes being made during the implementation of a monetary policy or measure. Last, policies should be consistent or predictable. I have been working at the Central Bank for nearly three years now. During this time, I have regarded three elements of the highest importance. And in my statements I have repeated many times that as a central bank it is our duty to resist "populist" policies, aimed only at buying the popular approval of the voters rather than at accomplishing the reforms needed for the good of the country. Turkey must absolutely abandon such "populist" practices from now on. And though there may have been some slips or weaknesses in the past, I personally have not witnessed any. Since the Central Bank continually exchanges views with our esteemed Prime Minister and Ministers, I can assure you that they, too, do not wish to involve the Central Bank in the promotion of "populist" policies.

If the government does not resort to populist policies, investors will act accordingly. I am not speaking of the Central Bank alone. Such a pledge should be made by the Treasury, the Minister of Finance, and the Government as well. Abandoning "popular" policies will foster an atmosphere and an environment of confidence and trust in general.

Let me take a moment to define "populist" policies in more detail. What we are calling "populist" policies are policies by which the government gives advantages or subventions to individuals, sectors, or production factors, which it does not have the means to support. As I stated earlier, in today's globalized world this can only be done by including the appropriations needed to support these "populist" policies in the budget. Otherwise the result will sooner or later be suffering.

Last year, there was no annexed budget, and the existing budget was put into effect initially. According to the IMF's Concluding Statement (on the Article IV consultation), Turkey's primary fiscal surplus turned out to be 4.7 percent of GNP in 1998. For 1999, we expect it will be around 3 percent of GNP. These figures are important. They have nothing to do with any populist policies; but even more important is the mentality that lies behind this. When you put an appropriation of a certain level into the budget, you may be certain that it will be spent. This should not be confused with "populist" policy. If your primary fiscal surplus is around 3 or 4 percent, you may act in this manner, and no one will object. What encourages me is that there appears to be little interest in resorting to populist policies before elections. If this situation can take root after one or two more elections, politicians will not be afraid that avoiding "populist" policies will cause them to lose an election. And this in turn, will be the guarantee of the legitimacy of a democratically chosen regime.

Once public opinion has accepted these principles and their reflection in policy, nobody will be tempted to question the validity of economic policies already proved

sound just before elections. We have a two-month pre-election period ahead of us. This time, Turkish voters seem well aware of the importance of avoiding the damage associated with election time in many countries. I do not believe they will vote to replace the valid long-term policies we have been pursuing with short-sighted, short-term benefits. I hope we can demonstrate this in future elections as well.

Now, let me touch briefly on our banknote issuing policy. We, as central bankers, prepare a banknote-printing program every year based on estimation of the need, and the Banknote Printing Plant produces banknotes according to this plan.

In doing this we must keep the amount of excess banknotes in the range of 100 to 150 percent of total banknotes issued. This is a rule applied worldwide. However, let me mention certain peculiarities of the U.S. Federal Reserve System and of the Bundesbank. The Bundesbank prints money not only for Germany but to meet the printing needs of many other countries. So does the Federal Reserve. In Turkey, the ratio of banknotes in circulation to the total balance sheet was high in 1970. For a variety of reasons it decreased over time. Individuals began to carry fewer banknotes. The principal reasons for this were high interest rates, wider use of credit cards, and the high inflation. Since banknotes were not a good store of value, individuals either spent them or deposited them in a bank. The banks then brought the deposited banknotes to the Central Bank.

But there is another point regarding banknotes. The Central Bank has noticed that there is currently an increase in the number of banknotes in circulation on the fifteenth day of each month, which is payday, and during religious feasts. We must therefore be ready to meet increased money demand at these times. But the printing of money also deserves to be discussed in a theoretical framework, aside from its daily fluctuations. Why is the money supplied? The simple answer is, because there is demand for it. But a look into the economic literature reveals that the behavior of money demand depends oh the growth rate of the economy, on the inflation rate, and (inversely) on the interest rate--that is, if interest rates rise, money demand will decline. Expectations are another factor. In Turkey, expectations about the exchange rate will generally affect money demand.

Once money demand and money supply are in balance, it will be possible to conduct monetary policy smoothly. If the money supply happens to fall short of money demand, interest rates will rise. This means that either inflation rate or the growth rate will also rise. The central bank, as the monetary policymaker, should look at this first. We have also observed that falling inflation is not necessarily matched by a fall in money demand. Let us assume, for example, that you have TL 1 million in your pocket. You will continue to hold it there even if the inflation rate drops from 80 percent to 50 percent. As a matter of fact, the monetary aggregates M1, M2, M2Y, and M2YR do not exhibit any tendency to drop in line with falling inflation.

This is a good place for me to repeat and reemphasize the basic principles of the Central Bank's monetary policy. We do not administer or interfere in setting interest

rates. We do manage the exchange rate and monetary aggregates. In addition, our monetary strategy observes four additional principles, which I will now explain.

First, we do not directly finance the public sector or the Treasury. Second, we inject liquidity only into the market. Based on the daily liquidity gap in the market, we provide money to the banks through repurchase agreements. It is no business of ours whether this money eventually goes to the public or private sector. It is certain that it will go where it is needed. Third, we observe the requirements for transparency, accountability, and predictability, all of which are the special features of our monetary policies. Fourth, we always favor a forward-looking approach. Our policy design process looks first at past figures or developments and then thinks about the future. This is the approach we have used to bring inflation down and ensure price stability. Theoretical and empirical studies show that monetary policy contributes to disinflation primarily in the long term and almost not at all in the short term. Monetary policy must therefore be pursued consistently over long periods. The money base is an important element in guiding monetary policy. We monitor the growth of Net Domestic Assets and take care to maintain a sound relationship between net domestic assets and net foreign assets by trading in foreign exchange. Purchasing foreign assets to increase liquidity will also increase our foreign reserve holdings and bolster confidence. It also provides a handy indicator for the balance of payments.

When the liquidity is supplied in domestic currency, its effects will be inconsistent and inflationary. This must be taken into account when evaluating net domestic assets. In addition, we must look at the total amount of money in the money base, which is the sum of net domestic assets and net foreign assets. Obviously this must also be consistent with inflation. In considering how money creation affects inflation we have to look at the so-called "transmission mechanisms" extensively discussed in economic literature. Central banks can influence banks' time deposits, sight deposits, and foreign exchange deposits by expanding or contracting the money supply. We analyze the relationship between these aggregates and inflation. If we could demonstrate from the literature that such a relationship exists, this would mean the transmission mechanisms are functioning well. Unfortunately, Turkey has no effective transmission mechanism as a result of its long-standing inflation. The best we can do is to sketch some blurred relationships. I believe that this mechanism will work more efficiently and smoothly in once we have resolved the inflation problem. Let me give an example: The European Central Bank has harmonized the transmission mechanisms that have been operating smoothly in eleven European countries. The ECB maintains that M3, which denotes the broad money supply including all time and sight deposits in banks, will increase by 4.5 percent a year. When asked why, the ECB says that inflation and monetary aggregates are closely interrelated. They estimate that a monetary expansion of 4.5 percent, combined with a productivity increase of 0.5 percent and a growth rate of 2 percent, will suffice to attain the inflation target of 2 percent. In other words, the amount of increase in the money supply needed to ensure attainment of the targets for inflation, growth, and increased productivity is estimated to be 4.5 percent. M3 is presently growing at 4.75 percent. The authorities are confident that they can mop up the remaining minor deviation of 0.25 percent within three months, external conditions permitting.

As I have just explained, the Central Bank's strategy is to keep the money base, i.e. its reserve money, under tight control. For example, prior to the Russian crisis that is up until the beginning of July the Turkish economy had been flooded with enormous amounts of foreign exchange. As the Central Bank, we had bought these foreign exchanges by providing liquidity to the market. But when the crisis emerged, the foreign exchanges flows reversed and we had to mop up the liquidity. By this time we had also withdrawn, through reverse repo operations, about TL 1.8 quadrillion, equivalent to $6 billion.

But the capital flight of $6 billion prompted by the Russian crisis compelled us to provide liquidity to the market of around $5 or 6 billion in October. Because in this situation we were able to provide liquidity of $12 billion all at once and get the upper hand, we succeeded in avoiding a market panic. We had sufficient room for maneuver. As the Central Bank, we were able to supply liquidity of $5 or 6 billion immediately.

I am sure that you can easily imagine how desperate would have been the situation of the markets had these policies not been possible. Turkey would have been out of action. We are therefore very keen on the subject of providing and withdrawing liquidity. Every morning, my fellows in the responsible department determine how much liquidity will be needed by the market for the day, based on the amount of money to be returned to the Central Bank and the amount of money expected to be deposited by the Treasury from tax collection revenues. And of course forecasts and other probable developments are also included. We at the Central Bank maintain a very close and constructive dialogue with the Treasury, which enable us to predict the Treasury's daily cash flow pretty accurately. We receive the latest market information at around 9:30am. And then we set the amount of liquidity to be added to or subtracted from the market. This is accomplished both through daily repurchase transactions and through the interbank money market. Since the market is well accustomed to this, it will react at once in case an erroneous calculation is made. The market buys and sells foreign exchange and raises and lowers interest rates. Sometimes when we intend to buy foreign exchange, we will decrease the liquidity and the market will sell foreign exchange to us. When the market does not want to sell foreign exchange, we will know that interest rates have gone up. The interest rates are affected at once.

Any kind of mistake made by us will shortly be put right by the operation of automatic mechanisms. Knowing that we are making these calculations enables the market to operate with confidence. In other words, predictability brings composure. We supply what the market needs on any given day. If we reduce the amount given, we will explain our reasons for doing so. When we want to buy foreign exchange, we will clearly declare it and proceed to make the purchase. If we want interest rates to rise, we will have to decrease the liquidity. Recently we have refrained from squeezing the money supply extremely hard while tight budget policies are being implemented, thereby avoiding a disproportionate rise in interest rates. The market is well accustomed to these policies, which we have been following for over a year. The market has no fear that the Central Bank will fail to provide liquidity as needed, but counts on our credibility and predictability.

As you will see, the issues of liquidity and of the relationship between money supply and money demand must be considered separately. Of course there exists a theoretical relation between them, but in practice they can be regulated through day-to-day operations. This is accomplished by means of exchange rate policy. All these complex relationships are the reason that in the end, the tasks of central banking and the orchestration of central bank policies have been said to be as much an art as a science, and indeed they sometimes seem to be more an art than a science.

At this point, let me discuss another aspect of the movements of interest rates and the exchange rate. According to the economist Mishkin, the maturities of contracts made in the industrial countries are generally longer. For example, in the United States and Europe, contracts concerning wages, trade in goods, rents, or investment instruments have longer maturities. These contracts are denominated in local national currencies, which are considered sound. By contrast, in less developed countries like ours, the maturities of contracts are generally shorter.

In Turkey especially, contracts are extremely short-term and denominated in strong currencies like the US dollar or the deutsche mark. In the industrial countries, the value of contracts is affected primarily not by the exchange rate but by interest rates, which are extremely important in these countries. But in less developed countries like ours, the effect of interest rate fluctuations on contracts is minimal, since the contracts are short-term in nature. But exchange rate movements are another story, since they can change the values of contracts substantially. This is why exchange rate movements are very important in countries like Turkey, while it is the interest rate that is vital in the industrial countries.

In conducting monetary policy, we have to choose to control one or the other. If we try to control them both, we will have problems. At the Turkish central bank, we have chosen to control the exchange rate and leave interest rates to the market. The interest rate is expected to function as a sweeper in the market. Indeed, prior to the crisis, we had noted that the interest rate was used as the major instrument of monetary policy by the Asian and South American countries and Russia, while their exchange rates were generally free to float. The market was aware of this, and both favorable and unfavorable developments were reflected by upward or downward movements of the exchange rates.

Before the Asian crisis, some countries had adopted regimes based on fixed or pegged exchange rates. Since their exchange rates were not free to move, they did not reflect economic imbalances. But pressure on the exchange rates was eased by short-term inflows ("hot money"), saving the day. This process continued for some time, but when the Asian crisis erupted it was clear that it could not go on. Fixed exchange rate regimes were implicated as a major cause of the Asian crisis.

As I stated at the beginning, we in Turkey do just the opposite. The exchange rate is not fixed, and we adjust it daily, which is another advantage of a floating exchange rate system. Unlike the exchange rate however, the interest rate instrument sweeps the system, correcting imbalances. Remember how interest rates soared after the Russian

crisis? All of us were on the alert. We saw interest rates rising to the order of 150 percent. Such high real interest rates were hard to live with. But they protected us in two ways. First, they protected our balance of payments position. Second, they immediately reflected the opinions of the market. They indicated the degree of uncertainty. Over time, uncertainty slowly lessened and foreign exchange began to flow in after New Year's Day.

But the globalized reverberations of the Brazilian crisis beginning January 12 immediately caused interest rates to shoot up 20 points. Today, the tender for government securities is offered at around 120 percent. These securities enjoy substantial demand from foreign investors. We have shown the market once more that we will not touch interest rates even if they soar to 120 percent; and that we will adhere to these policies before, during, and after elections. As I said before, we are working in concert with the IMF to keep the economy sound and lower inflation. The sooner this can be accomplished, the lower will be the cost. Mishkin's theory can be considered valid. The right policy for less developed countries seems to be to keep tight control over the exchange rate and leave interest rates to the market. Of course, such a strategy could not work for the industrial countries. For them, Mr. Lafontaine, Finance Minister of Germany, has proposed a different system.

What he proposes is an old approach that has lately come back into fashion. Under this system, the US dollar, the euro and the yen would fluctuate inside a target "corridor." Any deviations beyond the upper or lower limits will be corrected. This corridor is called the "target zone." But as always, implementation of wrong policies will give rise to problems. Suppose, for example, that the budget deficit is too high or monetary policy too loose, but that these deviations are not reflected in the exchange rate. All goes well as long as the rate remains within the target corridor. But it is difficult to predict the effects of exchange rate interventions if the rates move outside from the upper or lower limits. Feeling the pressure being exerted by Germany, the other industrial countries are presently discussing this point.

A review of our domestic debt position reveals that it tends to increase year by year. In addition, there is the problem of rollover at maturity. Turkey's domestic debt amounted to US$9 billion at the end of 1994. This total was $12 billion at the end of 1995, $18 billion at the end of 1996, $26 billion at the end of 1997, and is now $32 billion. Close examination of these figures shows that real interest payments during this period were $9 billion, while the interests due on the external debt of $13-14 billion were transformed into domestic debt.

The markets began wondering what would happen when $25 billion fell due in October 1988 and April 1999. The answer was simple, but difficult to explain. First of all, we are bound to pay it one way or another. Turkey has always paid her debts on time. Second, in 1997 we rolled over debts equivalent to $20 billion, and we could also roll over the $25 billion due in 1998. But it is certain that we will find ourselves in the same vicious circle next year unless we take decisive action to cut the knot by adopting appropriate monetary policies. Otherwise, we will once more be faced with the rollover

problem, this time for $30 billion. Probably we could manage it as usual, this is certainly no way to live.

Although it is not difficult to roll over the outstanding debt during periods of economic boom, the costs of doing so can be very high. Let me give an example: just prior to the Brazilian crisis, the interest rate for government paper had no sooner dropped to 118 and 119 percent when it shot up abruptly to 140 percent or more. In fact, the Treasury was forced to borrow at interest rates 140 percent or more for three weeks until the interest rate fell back again to 120 percent, after the crisis. This cost us altogether TL150 trillion. It is an expensive business. Even though we succeed in rolling over the debt, the burden grows at an accelerating pace. Consider that if we had managed, in 1994, to transform our domestic debts of $9 billion (now $32 billion) into external debt, we would have paid real interest of $3 billion instead of $9 billion, and would not have fallen into the debt trap we are in today as a result of rolling over our domestic debt of $12 billion in 1995. We would not have paid such exorbitant interest. And if the external debt of $13 billion had not been transformed into domestic debt causing us to pay extra real interest of around $6 billion, we would have had a facility of US$20 billion. If this amount of money could have been directed to infrastructure investments or even to "populist policies," it would have made significant contributions to the well being of the country, and the interest bill would have been much lower. I find this situation extremely worrisome. We must put an end to it before its burden becomes unbearable.

Only strong, credible economic policies can maintain productivity and bring inflation down. I have already said that the market contains both actors who are knowledgeable and actors who are ignorant. The better-informed ones can see the signs of political instability early just by watching the behavior of inflation and the budget deficit. Of course one should not make a judgment based on only three indicators. Of course Turkey is affected by these crises, which have inflicted some costs. But she has always managed to find her way out of the woods. I have a list containing 16 plus factors and four minus factors. I say these are the pluses and those are the minuses of Turkey.

Now let me turn to the progress of banking reform. As technocrats, we are keen on the banking act. There are four main reasons for this.

The first has to do with the nature of the banking sector, which like other sectors is living, dynamic, and changing. Just taking measures to encourage bank soundness without following through will not suffice: the functioning of the banking sector must continually be reviewed and improved.

Second, after the Asian crisis in 1997 the world was watching the banking sector. Many international experts looked into the structure of banking sectors and wrote their reports. Turkey's banking system was one of those they examined. Compared with others they looked at, they declared that Turkey has a good system, although some

questions remained. Now we should answer these questions and remove any deficiencies.

The third point has to do with the Banking Act. The Constitutional Court annulled some sections of the Banking Act in 1994, but did not announce this decision until December 11, 1998, at which time it granted us six months to fill the resulting legal vacuum.

And fourth, in 1997 the Bank for International Settlements (BIS), an international leader and source of expertise concerning bank supervision systems and strategies, published 25 basic principles forming the basic elements of an effective bank supervisory system. Many governments felt the need to amend their laws to incorporate these principles, especially after the Asian crisis. In addition, there are the banking directives of the European Union.

In Turkey we combined all these and prepared a draft setting forth the outlines of a sound permanent banking system. Together with Mr. Temizel, Minister of Finance, we worked hard for two days and nights to get the final draft through the Budget and Planning Commission. We were determined to get the draft, together with structural reforms, through the Planning Commission, because we had promised the IMF and the international markets that we would do so. Once it was endorsed by Prime Minister Ecevit and the other ministers concerned, we expected Parliament to enact the draft, but this has not happened. I think the draft bank reform law will be acted on with priority after the elections; indeed, I expect this to be the first order of business for the new government.

Independence for the banking supervision system is one of the basic principles envisaged in the draft law. By "independence" we mean that the system should conform to internationally accepted rules and principles, and lend itself to interagency cooperation. The draft law envisaged a system under which access to the relevant information would be shared by the Central Bank and the Treasury who would examine them separately or together.

Now let me tell you something about Turkey's savings deposit insurance system. As you know, the government introduced a 100 percent guarantee on savings deposits in 1994, which averted a deepening of the crisis of that year. This system has continued to the present day. In establishing such a system we had to face the problem of what is called "moral hazard." Moral hazard occurs when the government gives a 100 percent guarantee not only to the banking sector, but also to industrial sector, the service sector, and other sectors. One of the most important principles in countries governed by market mechanisms is the principle that "profit is the sister of loss." Where there is profit, there could certainly be loss as well. But when entrepreneurs apply the principle "The profit to me, the loss to the government" in all their undertakings, it is the government that takes the beating. There were some suggestions to gradually reduce the original 100 percent guarantees to the financial markets over time. During my three years as Governor of the Central Bank, we have taken several initiatives to accomplish this. We have conducted

research, and carefully timed our steps to avoid the damage to medium- and small-sized banks that would have occurred if it were suspected that the 100 percent guarantee was to be removed. It was unanimously agreed that the best time would be a moment when sound macroeconomic policies are being implemented and inflation is coming down. No such moment has occurred during the last three years, however, and the problems that would result from bad timing could hurt the system.

In addition, the public banks are considered to be 100 percent guaranteed. Although the State's share in the banking sector amounts only to 35 percent, everybody thinks that State banks enjoy a 100 percent guarantee. This naturally creates inequities in the system. We must keep track of two factors while working to bring the Turkish banking system up to worldwide standards. Although a 100 percent guarantee is thoroughly unacceptable, even unthinkable, the public banks must absolutely be privatized or given autonomy to enable them to operate on a stronger footing before action is taken to alter things.

We should not forget Turkey's Savings Deposit Insurance System, established in Turkey in 1933, which is also very important. Following its amendment in 1983, the Savings Deposit Insurance Fund has collected $2 billion. This amount has been increased to $2.5 billion by investing the premiums at a return of 25 percent; and the Central Bank makes use of the Fund when needed to deal with problems in the banking system. There are several similar arrangements in various parts of the world, but none in Asia. In the United States, the deposits of less than $100.000, - are insured. And various systems in European countries are trying to comply with the standards of the European Union.

For example, Germany has an extremely influential system which wields authoritative power over the German banking. The system guarantees individual depositors for up to two-thirds of a bank's capital under several conditions. But to be eligible to make use of this insurance, each bank must subscribe to the system set up by the banking association. On entering the system, the banks are required to meet strict conditions. Let me give an example. The group where I was working during my private sector experience set up the first foreign bank in Berlin in 1992. We then applied to this insurance institution to insure our depositors. They took guarantees from us. The bank's deposits amounted to DM40 million at the beginning of 1994 crisis. Given the risky situation in Turkey, the German authorities wanted us to lower our deposits from DM40 million to DM20 million. They made demands, and we were obliged to obey, by finding ways to decrease our deposits. By refusing to accept any deposits smaller than DM15 thousand, we managed to lower our deposits to DM29 million. The reason for their insistence was that if anything had happened to the bank as a result of the crisis in Turkey, the insurance institution would have been obliged to pay the depositors. So they took action ahead of time to minimize their exposure.

There are other insurance systems that work like this. In this manner, they avoid the advent of "moral hazard." Remember that the banking system depends upon confidence. To defame it with inaccurate judgments and negative statements can do great harm to the system. The government has all kinds of information. I began my

career as a sworn bank auditor 32 years ago, a duty I performed for ten years. My interest in the subject of bank supervision has never faded. My own experience tells me that supervising banks and judging the soundness of banks are no simple matters.

A decision is given only after a bank has been thoroughly examined. Meanwhile, the government must keep this information secret. This is true the world over. No government can disclose such kind of information in any manner whatsoever, to prevent any possible negative effects on the system. For example, Europe contains many countries whose banks granted credits to the Asian counties and Russia. There are U.S. banks that extended credits to Latin America. But there is no comment on the whereabouts of the money lost. Banking is a system built on confidence concerning matters about which one should speak only with knowledge.

You can get an idea of the structure of Turkey's banking system by examining published information. You will discover that the ten biggest banks accounted for 65 percent of the assets of the entire banking system at the end of November. Of course, these ten biggest banks include both private and public institutions. We know that there are some problems in the public banks, but these problems are caused by the budget and not by weaknesses of the banks themselves. We will not discuss them here because they call for a separate solution.

Besides the ten biggest banks, there are 20 foreign banks accounting for 6 percent of the banking system's total assets. Another 5 percent is held by Turkey's 14 investment banks. Altogether, the 44 banks in these three groups account for 76 percent of the system. The remaining 24 percent of assets are held by 30 more banks. The private banks in this last group are mostly very active and powerful.

The total of assets held by problem banks does not surpass 8 percent. This figure has not changed since the 1994 crisis. At that time I was at the helm of a private bank. During that crisis the familiar events occurred and rumors were circulated that might have lessened the confidence felt in the system. But the Turkish banking system managed to overcome the 1994 crisis without excessive damage.

I would like to conclude my remarks by describing briefly how Turkey was able to pass through the most recent, globalized crisis with minimum loss. The first factor was the exchange rate policy. Turkey's exchange rate policy is completely different from those of the Asian countries, of Russia, or of the South American countries. The amount of short-term capital flowing into Turkey is not very large. We can handle it by maintaining a high level of foreign exchange reserves. And our share in today's "globality" is relatively modest. This delivered us. If we had been fully globalized in our present state, the crisis would have caused several serious problems. Our financial sector is shallow. In fact the total assets of Turkey's banking system amount to $114 billion and Turkey's GNP is $200 billion. As I have already mentioned, we have a tight budget policy, and have been implementing a tight monetary policy that possesses high credibility. And we are rich in experience. Turkey's public debt is around 40 percent of GNP, which is a small ratio: it will be recalled that the Maastricht criteria call for it to be below 60 percent. Our exports are well distributed among goods, services, and sectors.

Half of the $60 billion seen in our balance of payments comes from the real sector's exports of goods, and the other half from the exports of the service sector. This is a good distribution. Turkey's rate of productivity increase exceeds that of the other industrialized countries. In addition, the rate of growth of GNP did not falter in recent years, except for the last period. We did not allow the exchange rate to appreciate, which left no room for so-called "exchange rate bubbles" to develop.

Unlike the Asian or Latin countries, Turkey's banking system, which was established 130 years ago, has a rich history, deep-rooted traditions, and a relatively sound structure. Our financial markets enjoy stability. And despite some recent political vicissitudes, our budget policies remain relatively free of politicization. Even though our budget is forced to struggle with a debt trap, the primary budget surplus (after subtracting interests) is around 4 percent. All these are pluses.

Looking at the negative side, our famous inflation comes first. Neither individuals nor economic agents are prepared for low inflation, because for them inflation has its attractions. The credibility of our policies is not extremely high. That is to say that the people do not fully trust them or believe in them. We asserted that the inflation rate would fall to 50 percent, but the naysayers did not believe us. Even while watching it fall they would be ready to score a negative point.

I will not talk about political instability, except to say it is the source, the breeding ground, of all these negatives. And in addition there are some flaws--some loopholes--in our structural policies.

But I think that all of us working together can wipe out these negative elements, and enable Turkey to reach a stage in the years ahead where she will be able to multiply her pluses. I truly believe this.