ANNOUNCEMENTS

RESULTS OF THE MONETARY PROGRAM OF

THE CENTRAL BANK OF TURKEY

FOR THE FIRST HALF OF 1998 AND

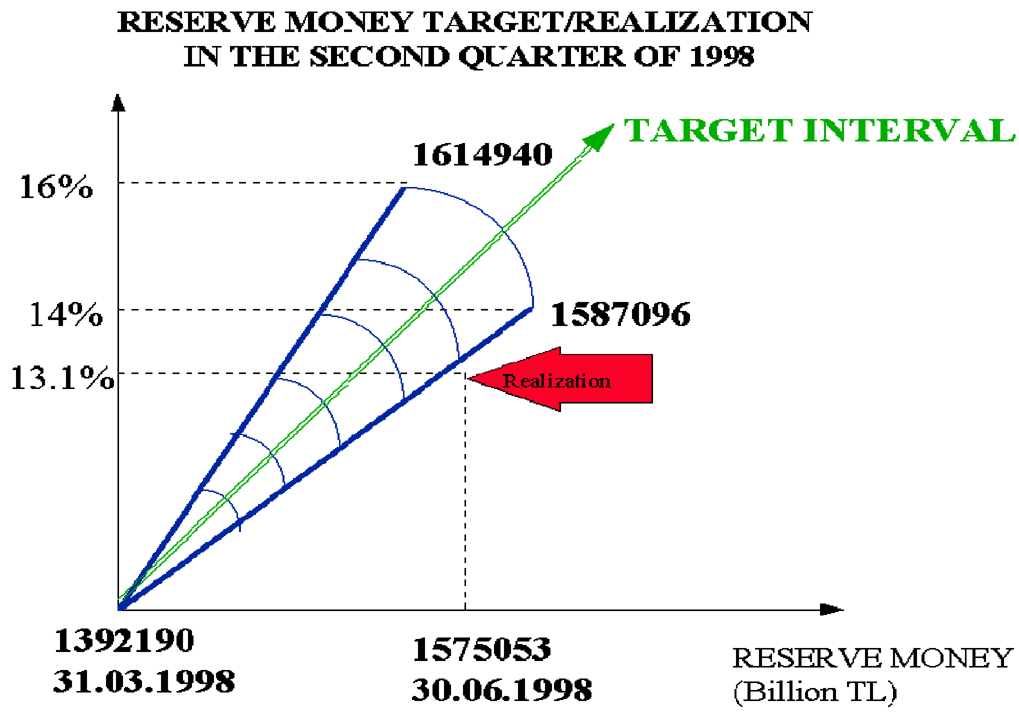
THE IMPLEMENTATION OF MONETARY POLICY

FOR THE SECOND HALF OF THE YEAR

The Central Bank announced its 1998 monetary program at the beginning of the year. As the monetary authority, the Bank declared that it would influence the monetary conditions through controlling the reserve money on the liability side of its balance sheet whereas the exchange rate policy would be conducted under two opposing constraints, namely, current account sustainability and inflation. In this context, the Central Bank used its main instruments, which are operations via foreign exchange and foreign currency markets, open market and interbank money market operations, effectively in line with the targets.

As it can be observed in the figure below, as of 30 June 1998, reserve money increased by 13.1 percent compared to the end of March 1998 and reached TL 1575 trillion. This amount is below the second quarter target range of TL 1587-1615. Beside this, reserve money increased by 32.8 percent in cumulative terms compared to the beginning of the year. As a result, the rate of growth of the reserve money remained below the target ranges increasing by 17.3 percent in the first quarter and 13.1 percent in the second quarter.

FIGURE 1

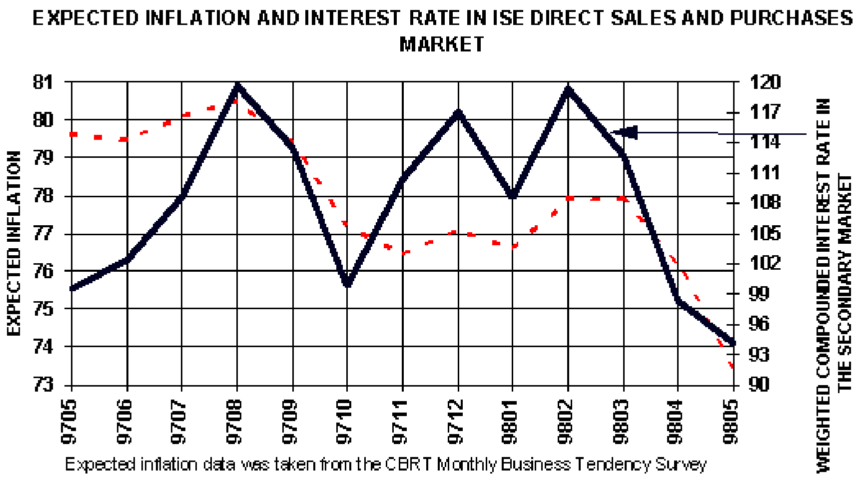


Before examining details of the monetary policy implementation for the second half of the year, the conduct of the monetary program during the second quarter will be briefly analyzed with reference to foreign exchange rates, interest rates, balance sheet of the Central Bank and main monetary aggregates.

I. The Implementation of the Monetary Policy in the Second Quarter

The stock level of the open market operations, which was very high due to the heavy repo operations of the Central Bank at the beginning of the year, declined gradually parallel to the rapid increase in net foreign assets. A new era started in the Turkish economy as of March in line with declining inflationary expectations, domestic borrowings of the Treasury below its repayments, improvement in the primary surplus of the budget and thus interest rates on government securities in the secondary market began to decline (Figure 2). In this era, the Central Bank withdrew the excess liquidity in the market through open market and interbank money market operations in accordance with the reserve money target band. In other words, the Central Bank became indebted to the market participants via open market operations in the second quarter.

FIGURE 2



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Exchange Rate and Interest Rate Developments

The Central Bank, in its monetary program of early 1998, announced that its exchange rate policy would be conducted in accordance with the estimated inflation rate; in other words, the Central Bank aimed to minimize the volatility in the real exchange rates. During the second quarter of the year, the number of the dilemmas of the Central Bank increased for the following reasons: the declining trends of both inflation and nominal interest rates, the sustaining high growth rate, implementation of exchange rate policy under the opposing constraints of inflation and current account balance, controlling reserve money and the rapid increase in Central Bank reserves. More clearly, the need to sterilize the rapid increase in net foreign assets necessiated the Central Bank to change its exchange rate and interest rate policies.

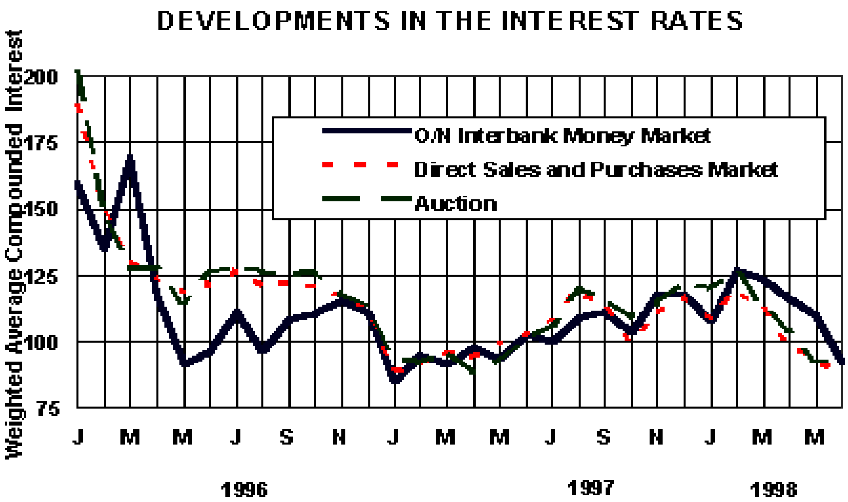
Consequently, the Central Bank modified some of its policies in May and took five major decisions in the second quarter of the year;

- The Central Bank announced that, as of 4 May, the Bank would not conduct overnight operations in the Istanbul Stock Exchange (ISE) repo-reverse repo market, except the days in which unexpected interest rate volatility is observed.
- The Central Bank narrowed its quotation margins in the interbank money market as of 4 May.
- Compulsory foreign exchange-foreign currency transfer and selling rates were set as “0 percent” for the June-July 1998 period applicable as of 1 June.
- The Central Bank decreased its bid-ask quotations in the interbank money market by 3 points as of 2 June.
- The quotations on the bid side were decreased by 10 points as of 8 June.

After the removal of the Central Bank quotations in the ISE repo-reverse repo market, the interest rates became more volatile in this market. Nevertheless, interest rates on government securities in the secondary market were not influenced from the Central Bank's policy change in the ISE repo-reverse repo market, thanks to the long-lasting policies aimed at achieving sistemic stability in the financial markets. The Central Bank's bid quotation at overnight transactions usually set the bottom line at overnight repo – reverse repo market at the ISE, but sometimes interest rates in the secondary market fell below the Bank's overnight rate. A parallel development is that the sensitivity of the interest rates in repo – reverse repo market to the liquidity in the market increased. The amount of the TL liquidity, which is determined by the interest rate and exchange rate policies of the Central Bank, affects the pattern of direct sales and purchases market directly or 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 increased the sensitivity of interest rates in the secondary market to the amount of liquidity.

The Central Bank signaled to the market that it would support the fall in interest rates by narrowing down the bid – ask quotation margins at the interbank market in May whereas by increasing the bid rates, the Central Bank showed that it was determined 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



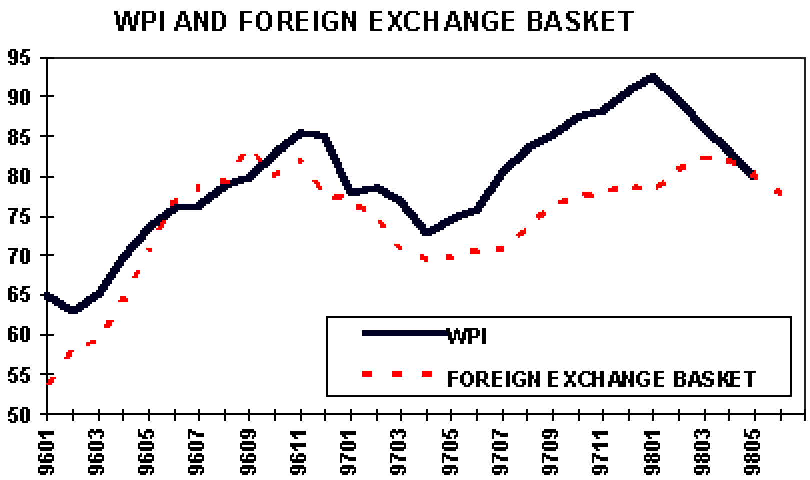
After the reversal of policy regime regarding the foreign currency and foreign exchange compulsory transfers and sales, it is theoratically expected that the relative increase in the volatility of the exchange rates will increase the relation between interest rates and exchange rates in cases where there is minumum intervention in the foreign exchange market. In this respect, we entered a period in which the sensitivity of interest rates to liquidity, and also of exchange rates to interest rates thus to liqudity, is increased. In other words, it can be argued that both the Central Bank and the market participants should be very cautious in the coming period.

After the announcement of regulation concerning compulsory transfers and sales, the uncertainty in the markets increased and bank began to manage their liqudity position more effectively. Although the compulsory rates were announced in June as well, the indicative power of the "official rate" announced at 15:00 PM increased relatively. Neverthless, the daily rates for the compulsory transfers which are determined by the Central Bank was also effective. In addition, this decision indicated that the Central Bank would determine the exchange rate policy in accordance with the 50 percent inflation rate target by its buying and selling interventions.

The recent decisions brought the exchange rate and interest rate levels down, and the rise in the daily volatility of the exchange rates increased the uncertainty regarding monthly devaluation and thus decelerated the growth rate of foreign currency reserves, which has been increasing by high amounts of foreign currency purchases.

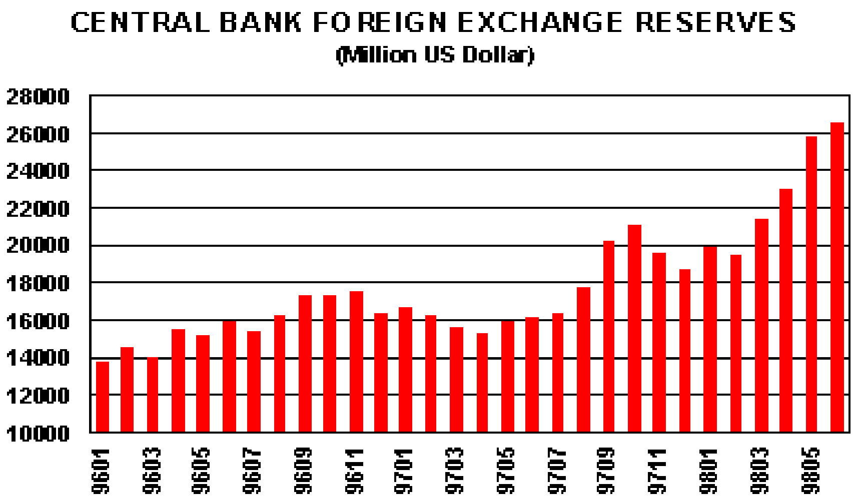
When the development in the currency basket is examined in the first five months of the year, it is observed that cumulative nominal depreciation of the currency basket was 25 percent. The increase in the WPI was 24.4 percent in the same period. Figure 4 shows the annual percentage changes in both WPI and currency basket.

FIGURE 4



We observe that the stability of the foreign exchange rates continued to support the increase in Central Bank reserves. Net international reserves including gold account, reached US 26.6 billion dollars as of June 30, 1998. Compared to the end of 1997, the rise in net international reserves approximately amounted to US 8 billion dollars (Figure 5).

FIGURE 5



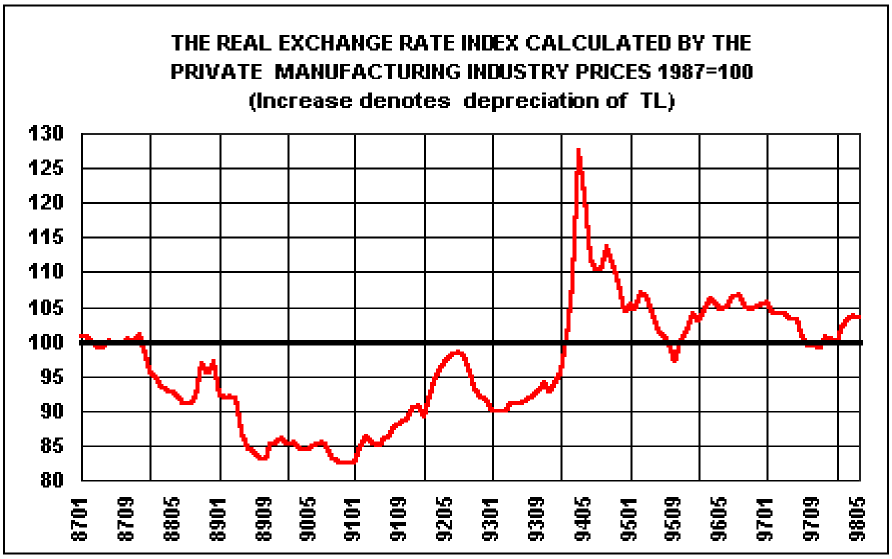
Current Account Balance

The South Asian crisis led foreign investors to invest in emerging markets with caution. The negative developments in the Russian financial markets by the end of May had a negative impact on this issue. However, this situation did not adversely affect the Turkish financial markets.

Current acount balance concerning the first quarter of 1998 suggests that the trend in 1997 still persists. In the first quarter, foreign trade deficit amounted to US 3.3 billion dollars while the current account deficit amounted to US 875 million dollars declining by 30.8 percent compared to the same period of the previous year. The net capital inflows excluding reserves amounted to US 3.7 billion dollars in the January – March 1998 period.

There was no important change in the value of real exchange rate, calculated by using the private manufacturing industry price index, relative to the base year and this supports the low values of current account deficits in both 1997 and in the first three months of 1998 (Graph 6). It is observed that the real exchange rate index, depreciated by 3,1 percent in May 1998 relative to the end of 1997.

FIGURE 6



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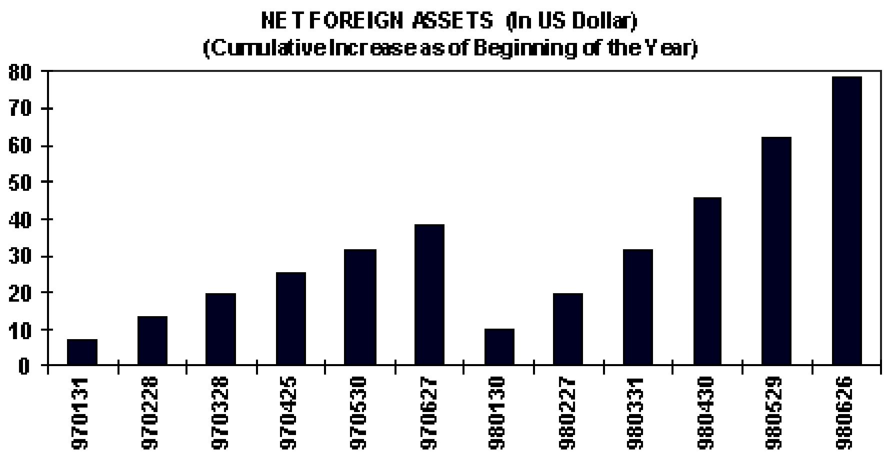
Main Items of the Balance Sheet and the Monetary Aggregates

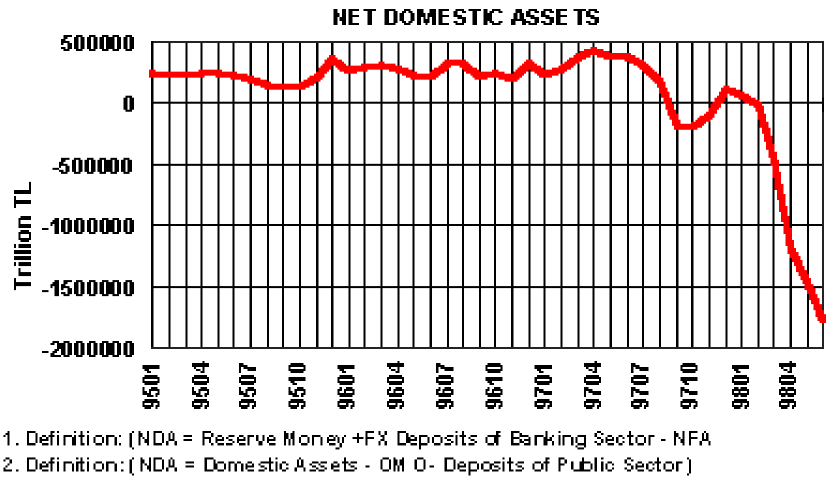
When the reflections of these developments on the Central Bank balance sheet is examined, it is observed that as it happened in the first three months of the year, the source of the increase in the reserve money from the supply side was the rise in net foreign assets. While net foreign assets of the central bank in the second quarter increased by 58 percent in Turkish lira, it increased by 43.7 percent in US dollars and reached US 16.7 billion dollars as of 30 June 1998. Net foreign assets increased only by 1 percent in TL in the second half of June due to the decisions of the Central Bank mentioned above in detail (Figure 7).

FIGURE 7



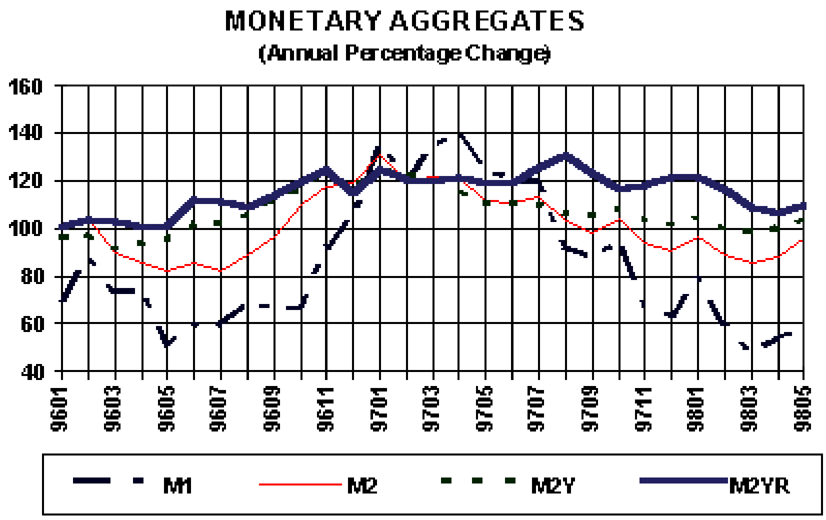
Net domestic assets of the Central Bank continued to decrease in the same period and the amount of the decrease reached TL 1319 trillion in nominal terms relative to the end of March. The increase in the revaluation account due to the rapid increase in net foreign assets, the effective sterilisation through open market operations, non-use of the short term advances from the Central Bank by the Treasury and non-use of the credit from the Central Bank by the other public-institutions are the main factors that enabled the decrease in net domestic assets (Figure 8).

FIGURE 8



On the other hand, the improvement in the primary surplus of the budget paralel to the slowdown in the growth rate of the domestic debt stock reduced the pressure on the monetary aggregates. It is observed that both the developments in the monetary aggregates and the reserve money were positive in the first half of the year. According to the preliminary data dated 5 June, the five month cumulative rise in M1, M2 and M2Y, was 23, 38 and 36 percent in order, compared to 26 December 1997 (Figure 9). The annual rates of increase were 59, 97 and 101 percent in order. While the cumulative increase in monetary aggreagate of M2YR, which can be calculated by adding the repo transactions to the monetary aggregate of M2Y, was 36 percent, in the first five months of the year, the annual increase was 110 percent.

FIGURE 9



II.Monetary Policy in the Second Half of 1998

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

In an economy monetization during the transition from a high inflationary period to a low inflationary period is not symmetric to the monetization during the transition from a low inflationary period to a high inflationary period. In other words, a money demand function that is consistent with the targeted low inflation rate but forecasted by using past data may overestimate the required monetization in an economy. The credibility of the policies targeting for low inflation can therefore be adversely affected. As a result, the posibility of any unforeseen developments in the demand for money during a period of decreasing inflation necessitates the Central Bank to target a new indicator in order to affect the monetary condition.

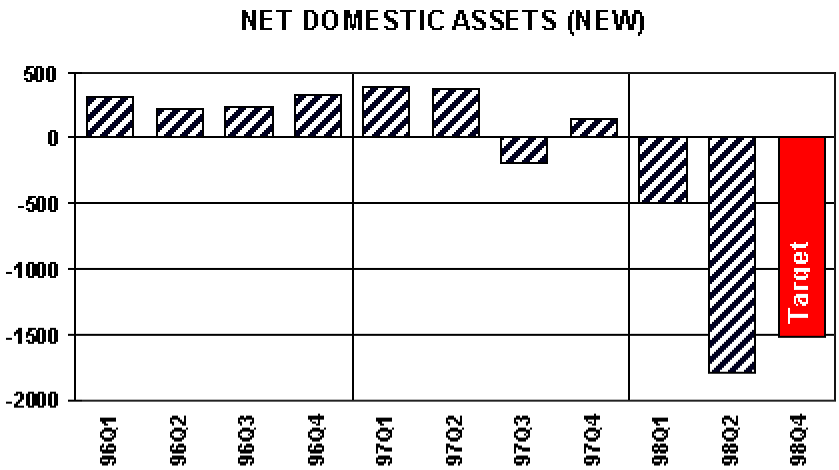
For this purpose, net domestic assets from balance sheet of the Central Bank is determined as the new target. The target is set as minus TL 1 514 trillion at the end of 1998. As shown in the figure, the target regarding net domestic assets has projected a small amount of increase in net domestic assets in the second half of 1998, which has been decreasing since the early 1998. In the second half of the year, when the main items affecting net domestic assets are taken into account, it can be argued that the Central Bank will not aim at a rapid increase in foreign exchange reserves and therefore excess liquidity, which may occur by reserve accumulation will partly decrease. For this reason, the Central Bank aims at relatively reducing its interventions in daily liquidity management. Nevertheless, it will continue to have 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 net international reserves in the balance of payments,
- the estimated increase in "reserve money", which, in turn, is consistent with the targeted inflation and the growth rate.

The developments in the new net domestic assets item is presented in Figure 10 and its definition is given in the Appendix. As it can be seen in the figure, although there was some volatility in its trend during some periods, net domestic assets steadily declined after 1997. Net domestic assets, which amounted to TL 142 trillion as the end of 1997, decreased considerably due to the increase in sterilization operations through the open market necessitated by high capital inflows and in revaluation account in negative terms. During the same period, that the Treasury did not use short term advances and the Central bank did not extend cash credit to the public sector affected net domestic assets favorably. As a result, net domestic assets declined to minus 1778 trillion TL as of 30 June 1998.

FIGURE10



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

When we define Central Bank balance sheet as:

Reserve Money(X) = Net Foreign Assets + Net Domestic Assets,

in a sense, Reserve Money(X) represents the sum of the total balance sheet by definition. The sub-items of this newly defined balance sheet can be summarized as in Table 1.

TABLE 1

CBRT BALANCE SHEET				
	Realizations			**Target**
	Dec-97	Mar-98	June-98	**Dec-98**
End of Period Stocks (Trillion TL)				
ASSETS (1+2)	**1,934**	**2,299**	**2,641**	
1. Net Foreign Assets (a-b)	1,791	2,798	4,420	
a. Foreign Assets	4,337	5,786	7,770	
b. Foreign Liabilities	2,546	2,989	3,351	
2. Net Domestic Assets (a+b+c+d+e+f+g)	143	-499	-1,778	**-1,514**
a. Net Cash Credit To Public Sector (aa+ab+ac)	6	-154	-224	
aa. Cash Credit To Public Sector	892	654	693	
ab.Deposits Of Public Sector	-182	-280	-261	
ac. FX Deposits Of Non-bank Sector	-704	-528	-656	
b. Extra Budgetary Funds	-50	-51	-12	
c. Deposits Of Non-bank Sector	-7	-10	-11	
d. Cash Credit To Banking Sector	8	8	8	
e.Open Market Operations	720	197	-1,008	
f. Other Items	-342	-479	-339	
g.FX Revaluation Account	-190	-8	-193	
LIABILİTIES (1)	**1,934**	**2,299**	**2,641**	
1. Reserve Money(X) (a+b+c+d))	1,934	2,299	2,641	
a. Currency Issued	759	898	1,006	
b. Required Reserves	336	387	526	
c. Free Deposits Of Banking sector	34	46	20	
d. FX Deposits Of Banking Sector	804	968	1,089	

In other words, the new net domestic assets definition includes some items from the liabilities part of the Central Bank balance sheet and reflects the mutual credit relations of banks, public sector and the Central Bank. The “foreign exchange deposits of 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, as a liability item, if the balance of the “open market transactions” is positive (negative), this means that banks (the Central Bank) extend credits to the Central Bank (banks). If the “public deposits”, “foreign exchange deposits of non-banking sector”, “open market transactions” and “deposits of 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), following are the items which affect NDA:

- 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 short term advance facility by the Treasury increases the Cash Credit to the Public Sector item. Since the Central Bank’s securities portfolio changes parallel to the direct sale and purchase of securities and repo-reverse repo transactions, the “Government Securities” item is affected depending on the prices of the most recently traded government securities in the portfolio.
- Credit Extended to the Banking Sector: No fresh cash credit 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. While a negative net balance in this item decreases NDA, a positive net balance increases NDA.
- Revaluation Account: This item shows the foreign currency differentials which stem from the revaluation of foreign assets and liabilities of the Central Bank parallel to the depreciation or appreciation of the TL against foreign currencies. While a negative net balance in this item decreases NDA, a positive net balance increases NDA.
- Public Deposits: This item includes the TL deposits of the public sector. An increase(decrease) in this item decreases(increases) NDA.
- Foreign Exchange Deposits of Non-Banks: This item mainly includes the 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 leaves the reserve money(X) intact. However, whenever the Treasury withdraws its foreign exchange deposits by converting it into TL, while NFA remain intact, the reserve money(X) increases due to the rise in currency issued.
- Deposits of Public Funds and of Non-Bank Private Sector: An increase(decrease) in this item decreases(increases) NDA.
- Open Market Operations (OMO): While an increase in the cash debt of the Central Bank to the market due to open market operations decreases NDA, an increase in the cash debt of the market to the Bank increases NDA.