

# **THE 67TH SHAREHOLDERS' ORDINARY GENERAL MEETING**

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THE CENTRAL BANK OF THE REPUBLIC OF TURKEY**

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Dear Shareholders and Distinguished Guests,

Our Annual Report, already delivered to you, contains a detailed account of international and domestic economic developments during 1998. Now, I would like to describe the Central Bank's expectations for 1999, with special attention to inflation, and a brief evaluation of the progress achieved on the inflation front during 1998. I believe we have reached a critical stage in our fight against inflation, and that the importance of the measures to be taken from this point onward cannot be overstated.

Last year witnessed some interesting developments in the Turkish economy. The high growth rate that prevailed for the last three years began to slow, and inflation also declined substantially. In addition, 1998 was a year when the Turkish economy, increasingly integrated into the world economy as a result of liberalization movements started in the 1980s, was put to the test by a world economic crisis that is still continuing.

As just mentioned, the Turkish economy slowed in the second half of 1998. The reduction of public expenditures in connection with budgetary discipline played a key role in slowing down demand growth. The fact that the GNP share of non-interest expenditures declined by about two percentage points in 1998 shows how much total demand was reduced by cutting public spending.

Trade with Russia and other former Soviet-bloc countries was one of the main factors driving the rapid growth of the economy during the last three years. But the substantial decline in trade with these countries following the Russian economic crisis of 1998 led to a slow-down in the Turkish economy too.

In the second half of the year, higher real interest rates and deferred consumer spending brought down the growth rate by squeezing total domestic demand.

In addition, the output surplus created by the global crisis in major sectors like textiles and the iron and steel sector caused world prices to decline, and domestic output to shrink in response to reduced export prospects.

**Since the world economy, and especially Russia, cannot be expected to recover rapidly, it seems a safe bet that the slowing output trend stemming from the crisis will continue into 1999 as well.**

As we know, a medium-term program aimed at bringing down inflation was launched in 1998. This program had three fundamental goals, which were (1) to achieve budgetary discipline, (2) to implement a monetary policy directed at an inflation target consistent with budgetary discipline, and (3) to accomplish structural reforms.

In response to the success of the government's efforts in these three areas, the inflation rate showed a downward trend during 1998, which was reinforced by favorable movements in the prices of imported inputs.

There can be no doubt that the improved budget performance was a key factor in reducing inflation. Tax revenues increased more than expected and non-interest expenditures were limited. The primary fiscal surplus, which is expected be 4.7 percent of GNP for 1998, is an index of the new level of budgetary discipline achieved last year.

In turn, the improvement in budgetary discipline made it possible to keep Turkey's internal and external balances sustainable despite the worldwide environment of crisis. For example, it is known that starting in 1998, a slackening of foreign demand for Turkish domestic borrowing drove up TL interest rates. The point at issue here is that the depth of Turkey's domestic market, and our strict adherence to budgetary discipline, made it possible for the Treasury to accomplish its domestic borrowing even though the crisis abroad had driven foreign investors out of the market. This experience teaches us that as long as nothing interferes with market pricing and there is no deviation from budgetary discipline, the Treasury can carry out its domestic borrowing relying on domestic demand only. As a result of this lesson, the maturities of domestic borrowings have begun to lengthen. It is no longer extraordinary for the Treasury to borrow for a year or more.

The achievement of real budgetary discipline has also made it possible for the Central Bank to conduct an effective monetary policy. **The primary target of monetary policy in 1998 was to stabilize prices in parallel with the fiscal efforts to reduce inflation, which were backed by political will and determination.** The Central Bank made its aims explicit by publicly announcing monetary programs in 1998.

**Basically, the Central Bank's announcement sent two messages to the markets. The first message was that the Central Bank endorsed the inflation target for 1998 and would keep exchange rate policy in line with it.** This message was quickly and accurately understood by the markets. And the private manufacturing price index, which is the most sensitive to exchange rate policy, likewise moved in parallel with changes in the exchange rate basket in 1998.

**The second message conveyed by the Central Bank's monetary programs was that public deficits would not be monetized in any way whatsoever.** The substantial decrease in the credit granted by the Central Bank to the Treasury under

the protocol signed with the Treasury, and the suspension of all credits to other public enterprises, were concrete reflections of this message.

**Starting in the first months of 1998, the behavior of both the exchange rates and monetary aggregates, which had begun to move as predicted by these messages, helped lower inflationary expectations quickly and get them closer to the inflation target.**

**The Central Bank reacted to the consequences of the foreign crisis without abandoning its goal of price stability, and the demand for liquidity in the markets, especially during the second half of 1998, was fully met without causing any significant movement in prices. The Central Bank's decision to satisfy, for the time being and without restricting the amount, all demand for either foreign exchange or Turkish lira, was a strategic one. The basic assumption of this strategic decision was that the fundamentals of the Turkish economy were quite strong, so that movements occurring in the markets did not necessitate permanent price adjustments. The Central Bank's policy of keeping the value of the Turkish lira in line with the external economic balance, which the Central Bank has been carefully following in recent years, made it possible to defend the Turkish lira without endangering price stability during this period.**

Parliament's passage of the tax reform bill was one of the most important events of 1998, even though many of the planned structural reforms have not materialized. The acceptance of the tax reform was a most significant signal of the political will to bring down inflation. It ensures that there will be permanent success in observing budgetary discipline. However, lack of specific rules for agricultural price supports and the impossibility of calculating the financial burden correctly has threatened Turkey's financial stability and raised some questions that will have to be addressed in the years ahead.

The last point to be made about our progress with inflation reduction in 1998 is that the inflation target, the first to be announced since the modern period of our history began, was actually met at the year's end. There is no doubt that this success endowed our anti-inflation efforts with prestige and credibility.

Now let us see what stage we have now reached in our struggle with inflation. The latest figures, announced in recent days, shows the annual inflation rate steady in the forty percent range. But ensuring that inflation will no longer rise above this level, will continue moving down toward the thirty percent range, which is the target for this year's end, will require additional intensive efforts.

The coming months will be very important in many ways, but nothing can be more important than strengthening inflation's downward trend. Getting the inflation rate to the 45 percent level, which is expected by the end of the first half of 1999, depends above all on determination and political will. It is most encouraging that the absence of populist rhetoric from the election campaigns is reinforcing already positive economic expectations, by demonstrating to domestic and international markets alike, the seriousness of our commitment to Turkey's disinflation.

**Parliamentary approval of the draft laws on structural reforms should be obtained as soon as possible so that the inflation rate can fall faster during the second half of the year. Enactment of the reform laws is vital for two reasons. First, successful completion of the reforms they call for will greatly add to the prestige of the program now being implemented. Prestige earned by performance will be essential for breaking the "inflation resistance" cycle, which is quite strong in our economy. And second, additional resources from abroad will become available once these reforms are accomplished. As is known, we have long been negotiating with international financial institutions to obtain support for the program, and these negotiations have now reached a certain ripeness. The institutions in question are taking Turkey's recent anti-inflation efforts seriously, and have declared that they are willing to support their continuation.**

**I believe that if budgetary discipline can be maintained in the framework of this program, which has high prestige and the ability to attract resources from abroad, then we in the Central Bank will be able to use our monetary policy instruments still more intensively and effectively to continue reducing inflation.**

Given all these circumstances, it seems a strong possibility that the decline in inflation will accelerate beginning with the second half of 1999.

Let me remind you of the behavior of inflation in 1986 and 1987 in order to underline the importance of the circumstances in which we now find ourselves. You will recall that in 1986 there was a conjuncture stemming from abroad which was favorable for prices, and the inflation rate was brought down to the twenty percent range. But later on, policies associated with the general elections of 1987 caused inflation to surge, and that low a level has not been seen since. Now, with a new conjuncture a dozen years later, we must act cooperatively and more wisely, and make sure that this opportunity does not slip through our fingers.

**The production losses which can occur when an economy undergoes a periods of disinflation should be regarded as an acceptable cost, since production will be on a path of durable growth once price stability has been achieved. Present conditions in terms of demand and prices, created by the world conjuncture, should be regarded as a valuable opportunity in the fight against inflation, and inflation's downward trend should be maintained by mobilizing the internal dynamics. Once the Turkish economy has attained a cycle of low inflation and rapid growth, the opportunities it will offer will far outweigh the short-term costs in terms of production losses.**

I wish to present my respects, and thank you all for listening.