CENTRAL BANKING IN TURKEY

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Distinguished colleagues, Ladies and Gentlemen,

First of all, I would like to thank Governor Gavriisky and the Bulgarian National Bank for arranging this conference, in which it gives me great pleasure to take part. At the same time, let me congragulate the Bulgarian National Bank on its 120th Anniversary.

In my speech today, I would like to talk about the history of Central Banking in Turkey, look back on Turkish monetary policy, and describe medium-term prospects for the Central Bank of Turkey.

It can be said that the history of Turkish central banking dates to Ottoman times. Some of the duties and responsibilities of a modern central bank were anticipated in 1863 by the Bank-ı Osman-i Şahane, a state bank that was originally founded in 1856 under the name of Bank-ı Osmani as a French and British joint venture.

The original bank, which was mostly owned by British and French interests, had a monopoly privilege to issue banknotes. The government undertook not to issue banknotes itself and not to license any other institution to do so during the privilege period. The Bank-ı Osman-i was also in charge of repaying interest and principal on domestic and foreign government debt. The new Bank-ı Osman-i Şahane became in addition the sole institution responsible for Tresury operations, collecting government revenues, paying borrowings as they came due, and discounting Treasury bills.

The establishment of a central bank wholly owned by domestic capital came to pass shortly after the founding of the modern Turkish Republic.

After a preparation period that started in 1926, the Central Bank was founded with the enactment of the Central Bank Law on June 11, 1930, and began operations on January 1, 1932.

Nowadays, the shares of the Central Bank of the Republic of Turkey (CBRT) which is a joint-stock company are mostly owned by the Treasury.

As a result of several changes in the original Central Bank Law, the Board of the CBRT presently consists of the Governor of the Central Bank, who is the Chairman of the Board, and six members elected by the General Assembly of stockholders. The Governor is appointed by the Council of ministers for a term of five years, and may be reappointed at the end of this term. The Governor is assisted by four Deputy Governors, who are appointed for a term of three years.

The responsibilities of the Central Bank have evolved in parallel with changes in the condition and structure of the Turkish economy. Under the first Central Bank Law, which reflected the recessionary environment of the 1930s, the Central Bank□s fundamental responsibility was stated as supporting the Turkish state through various economic development. This involved the setting of rediscount rates and improving money markets, conducting Treasury operations, and acting in concert with the Government to protect the value of the Turkish lira.

In the years that followed, most of the Central Bank Law were intended to make it easier to borrow to finance deficits in the government budget in principle, these changes allowed the Central Bank to extend credit to the Treasury and the State-Owned Economic Enterprises (SEEs).

More recently, however, as liberal policies have gained favor and inflation has become the major problem for the economy, the first priority of the Central Bank has shifted from promoting economic development to maintaining price stability, which in practical terms means reducing the amount of credit extended to the public sector. This change has been marked by two notable events.

The first was parliament□s 1994 enactment of a law gradually reducing central bank credit to the government each year for the last five years by up to 3 percent of the increase in annual budget appropriations. (The reduction was orriginally supposed to be 15 percent of the total budget appropriation.) The idea of giving the CBRT independence like other modern central banks has gained momentum since then.

The second, in 1997, was the signing of a protocol between the CBRT and the Turkish Treasury which limits or even stops CBRT financing for the state still further, and transfers to the Central Bank the power and responsibility of setting short-term interest rates.

Now, let me review the Central Bank’s monetary policies over the last seven decades. It can be said that Turkish monetary policy has had four general orientations over the last 70 years. These have been the traditional orientation, the orientation aimed at modernization, the reorientation in response to the 1994 Crisis, and the orientation towards financial stability and central bank independence. I will describe each in brief detail.

The traditional monetary policy aimed at controlling private and public sector spending directly by imposing lending limits on the banking system. The Public Sector Borrowing Requirement (PSBR) was primarily financed by the Central Bank, which meant that monetary policy was subordinate to fiscal policy. Under a financial structure where private sector credit demand is satisfied by deposit money banks lending at controlled interest rates and by rediscounting facilities that automatically supply credit to high priority sectors, the supply of money is largely determined by total credit demand.

In mid 1980’s, the CBRT undertook a modernization process. The new regime gave the Central Bank control over the banking system’s total reserves, enabling it to regulate the money supply in accordance with the chosen monetary policy. Doing things this way required new institutional arrangements. A first step was taken in early 1985, with the institution of weekly auction of government paper for domestic borrowing purposes. Because maintenance of a stable relationship between total reserves and money supply require deposit money banks to comply promptly with their reserve and liquidity requirements, additional arrangements for their timely management were put in place.

Since the rediscount facility dealt only in medium-term credits, the reserve needs of deposit money banks had to be supplied by the Central Bank. To enable individual banks to acquire reserves through the rediscount facility, a market oriented distribution system had to be established to mobilize the excess liquidity in the banking system. A market place was needed to bring banks with excess reserves and banks in need of reserves together. These measures were also preconditions for conducting open market operations, which would eventually become the means of controlling total reserves.

Accordingly, the years 1985 and 1986 saw the beginning weekly auctions of Government securities, the revision of the system of the general liquidity and reserve requirements, and the establishment of an interbank money market. These institutional changes enabled the central bank to take on the classical functions of a central bank and accelerate the transition to a monetary policy based on controlling the total reserves of the banking system. Since 1988, the most important aspect of monetary policy has been its reliance on the operations and interdependence of various markets and its use of market forces.

During this period, the central bank’s most important policy innovation was the implementation of the monetary program announced in January 1990. If we evaluate monetary developments in terms of that program, it can be said that the monetary targets were generally realized, giving the markets a new stability in 1990. The goals of the monetary program were realized largely by controlling the growth of the central bank’s domestic assets. This was possible because favorable conditions in both domestic and foreign financial markets made it possible to finance the public deficit.

But in subsequent years, the monetary program came under pressures from several directions. The proximity of the Gulf War of 1991 put large pressures on the banking sector in the form of massive withdrawals of large amounts of deposits, which caused an increase in the exchange and interest rates. In 1991, CBRT attempted to maintain the stability of the exchange rate while holding foreign reserves to a certain minimum.

The second dificulty was the impossibility of controlling the financial needs of the public sector and the budget deficits, which caused the monetary program to miss its targets.

And the third was the outbreak of the 1994 crisis.

Without going into the reasons for the financial crisis of 1994, it will suffice to say that this was a difficult year for monetary policy. The Treasury’s insistence on decreasing the interest rates on domestic borrowing despite the increase in the public sector deficit caused a falling off in bank demand for Treasury bills. On the other hand, prospects for foreign borrowing were unfavorable, mainly because of the downgrading of the Turkey’s foreign debt by the rating agencies, and this forced the Treasury to finance its deficit largely by means of Central Bank resources. In response to the rapid loss of a substantial amount of foreign exchange reserves and the rise in interest rates, the CBRT had to concentrate on building up reserves and restoring stability to the money markets. For this purpose, and to reach the inflation target under the stand-by program agreed with the IMF in April 1994, tight monetary and credit policies were planned. The program also targeted exchange rates, international reserves, and net domestic assets. The program got off on the right track, but early elections intervened and both the program and monetary policy were changed dramatically in August 1995.

Since the beginning of 1996, the Central Bank’s monetary policy has concentrated on slowing the growth of its own balance sheet and monetary aggregates. At the same time, the idea of independence for the Central Bank began to gather serious momentum. Advances made by the Central Bank to the Treasury remained within the legal limits. Exchange rate policy, which consisted of managed floating, began to encourage order in the currency markets while permitting some depreciation of the Turkish lira to offset wholesale price inflation. Also in 1996, Turkey’s domestic financial markets again began to exhibit positive trends, and interest rates came under the control of the Central Bank.

In 1996 and 1997, it was a major goal of monetary policy maintain stability in the financial markets. It became the policy to create reserve money only in parallel with increases in net foreign assets. Cash credit to the public sector continued to decrease in 1997. The monetary aggregates M1, M2, and reserve money declined, whereas M2Y increased in real terms. Exchange rate policy in 1997 directed toward maintaining stable real exchange rates.

The monetary policy for 1998 was announced at the beginning of the year. The main goal would be to support measures for decreasing the annual inflation rate of 70 percent by pursuing macroeconomic targets for the first half of the year. Reserve money would increase from 18 to 20 percent band during the first quarter. The Central Bank planned to continue limiting the increase of net domestic assets and create money only in parallel with the increase in net foreign assets. Exchange rate policy would be directed at keeping the rate consistent with the inflation target. As of April 1, 1998, the results of the monetary program during the first quarter were judged consistent with expectations, and it was decided to continue the monetary policies unchanged during the second quarter of the year. Exchange rate policy would also continue to be guided by estimated inflation rate during the second quarter. Reserve money growth in the second quarter was targeted to be less than during the first quarter.

On July 2, 1998, the Central Bank announced that for the second half of the year, monetary policy would be that laid out by the Staff Monitoring Program (SMP) with the IMF. This called for monetary and exchange rate policies to be consistent with the target of reducing inflation to 50 percent during the second half of the year. Satisfying the reserve money targets during the first two quarters of the year had required massive sterilizations that had kept interest rates high. Given the dificulty of predicting money demand and the money multiplier during a period of disinflation and strengthened fiscal policy, the Central Bank chose a new indicator, which was the net domestic assets item on its own balance sheet. The target is set as minus TL 1514 trillion at the end of 1998. By contrast, exchange rate policy would be more closely aligned with the disinflation effort, and it was announced to that the exchange rate would be kept consistent with the inflation target for the rest of 1998.

In October 1998, the monetary policy for the fourth quarter was revised to accommodate the new external situation while remaining consistent with the fiscal policy already planned and maintaining appropriate control over liquidity. The Central Bank has adjusted its year end net domestic assets target to TL 700 trillion. Monetary policy will aim first at maintaining Turkey□s international competitiveness and confidence in the lira, as required by its efforts to reduce inflation.

Ladies and Gentlemen,

It can be said that Turkey□s monetary policy in its present form follows four main rules and recognizes two principles. The rules are: 1) No directed central bank credits to the public sector; 2) Creating liquidity for the markets only in parallel with foreign exchange purchases and open market operations; 3) Greater emphasis on transparency and accountability; and 4) A forward-looking approach to interest and exchange rate determination. The principles are: 1) Monetary policy supports, but does not lead the effort to reduce inflation, an effort which we firmly believe must be led by fiscal and structural policies; and 2) Financial stability in the markets and the payment system must be pursued carefully.

Our main tools as we conduct monetary policy in accordance with these rules and principles are short-term interest rates, open market operations, reserve requirements, and overnight facilities.

Now let me turn to the future, with some comments on the medium-term prospects of the Central Bank of the Republic of Turkey.

Recent years have seen a worldwide trend toward simplifying the goals of central banking which has somewhat diminished their responsibilities. Funding the governments, for example, is no longer the main purpose of a central bank. No modern Western central bank still aims at achieving full employment of the highest level of production. Today's central banks have only one aim: to maintain price stability. It is therefore no surprise that the CBRT, one of the most important institutions of the Turkish economy which aspires to become integrated with the Western economies, takes these trends modern central banking into account while mapping its medium-and long-term strategies.

And it will be no surprise to learn that the Central Bank of the Republic of Turkey, like other central banks, has taken the maintenance of price stability in the economy as its main goal.

This will be a good time to clear up two points about the price stability target. First, the Central Bank’s price stability target, and its responsibility for price stability, are two different issues. Price stability can only exist under conditions of low inflation. Before the central bank can assume responsibility for maintaining price stability, the economy will have to undergo a “disinflationary process.” It is also well known that for Turkey, where inflation has been high for years, bringing inflation down to a level common in the Western economies will require a wide-ranging effort and is not a goal that can be attained by the efforts of the Central Bank alone, acting by itself. The Central Bank’s role must be to track the price stability target as a part of the larger disinflationary program. It is believed that once low inflation has been made a reality by means of a concerted effort in all parts of the economy, It will then be possible for the Central Bank to take over the responsibility for maintaining price stability.

The second point to be stressed about the price stability target concerns the microeconomic functions of central banks. The efficient operation of a payments system, and stability in the financial markets, are two more basic functions of a central bank. These two functions can also be carried out in a way that supports price stability targets: Indeed, a sound, effective financial sector and payments system are necessary for price stability.

The economic duties assumed by the Central Bank of Turkey, which is in the first instance responsible for price stability have to be consistent with that goal. Functions that conflict with the price stability goal or that make its achievement more difficult should not be assigned to the Central Bank. Avoiding such conflicts should be a basic theme of the Central Bank's medium-and long-term strategic planning.

There are several criteria for judging whether or not functions which fallen to the share of the Central Bank by reason Turkey’s size, geografic location, history, legal structure, and degree of technological development are likely to impede the achievement of the stability goal. The effective use of monetary policy is an absolute must for a central bank that accepts price stability as its first priority. This calls, then, for eliminating any functions of the central bank that interfere with the effectiveness of monetary policy.

This clearly means increasing the Central Bank’s control over its own balance sheet, which is a major requirement for ensuring the effectiveness of policy, and especially monetary policy. The importance of this control for achieving the price stability target should be underlined. The past decade has seen substantial improvements in the Central Bank□s balance sheet, especially on the asset side. Foreign assets have increased and domestic assets fell off sharply, thanks to the decrease in loans to the public sector, including valuation accounts. The final step in this process will be a law reducing to zero the advances that the Central Bank is obliged to make to the Treasury. The protocol signed between the Central Bank and the Treasury in the second half of last year led directly to an increase in the effectiveness of the monetary policies pursued by the Central Bank. An amendment to Central Bank Law would preserve this increased effectiveness. Thus revising the financial relationship between the Central Bank and the Treasury, and increasing the Central Bank□s control over its balance sheet, will greatly aid the achievement of the price stability target.

Unfortunately, the structural improvements visible in recent years on the asset side of the Central Bank□s balance sheet have not been matched by similar improvements on the liability side. The Bank□s Turkish lira liabilities represent a minor share in our total liabilities. Correcting this unfavorable situation, which is the reflection in our balance sheet of high inflation, will require durably reducing the inflation itself, as the main source of this problem. Converting our liabilities into Turkish lira is a major goal for the medium term.

Independence is another very important factor affecting the medium-and long-term prospects of the Central Bank. A central bank with independent choice of its goals can chose to promote the achievement of the price stability target. A central bank with independent choice of its instruments can implement its monetary policy effectively.

It is also well-known that a central bank that is independent of political authority can do much to minimize economic fluctuations arising from political uncertainties. Today it can clearly be seen that the economies where independent central banks have maintained monetary and financial stability are very strong.

In conclusion, let me repeat once more the basic features of the Central Bank□s medium-and long-term strategies. These are: to choose price stability as its main target, to establish consistency between its functions and its principal target, and to modify or eliminate any functions that can interfere with the accomplishment of its monetary mission, and to do all this aided by independence and autonomy of action.

Thank You.