Monetary Policy and Results

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Ladies and gentlemen,

It is indeed a pleasure for me to share my view of Turkish Economic Outlook and Monetary Policy for 1998 with such a distinguished audience.

Let me start by giving you some numbers comparing Turkey with other OECD countries. This may help us to arrive at a better understanding of the Turkish economy.

In terms of both population and area, Turkey is the fifth largest country in the OECD. It also has the largest area of the countries in the European Union, and the second largest population after Germany. Its population density is much lower than that of many European countries. More than half of the population is between 15 and 64 years old: young, active, and productive.

For the last two years our economy has been growing quite fast, at over 7 percent per annum. In 1996, Turkish GNP was about US$182 billion, and per capita GNP based on current prices and exchange rates will be $2900. Per capita GNP has averaged 5.5 percent for the last two years. These figures give Turkey the eighteenth largest GNP of the 31 OECD countries, and place it twenty-fifth in terms of per capita income. Turkey's low per capita income, and the increase in its Gini coefficient from 0.44 to 0.49, are consistent with a pattern common to countries facing structural changes and high inflation. The share of income the top quintiles received increased to 54.9 percent while the bottom quintiles received 4.9 percent of income in 1994 down 0.3 points from 1987, which may indicate a greater degree of inequality.

Over the past decade globalization has accelerated and many countries embracing free trade and economic restructuring realised wide disparities in their economic growth and income distributions. Even if the relation between economic growth and income distribution is ambiguous, deterioration in income distribution can be

attributed to a high and continuous inflation. As a matter of fact, Turkey has the highest inflation of any OECD country. The well known reasons of high inflation in Turkey are budget deficits and entrenched inflationary expectations.

Our unemployment rate, steady at about 6 percent for the few years, is the fifteenth highest figure among OECD countries.

The picture is brighter on the external side of the economy. For the last four years we have pretty stable balance of payments conditions. How the Turkish economy compares with the rest of the world is best shown by the balance of payments and the international reserve position of the Central Bank. Its high inflation and large public deficits are accompanied by a favourable balance-of-payments picture and a more comfortable international reserve position than some South Asian countries. Comparison of Turkey's foreign trade figures with those of other OECD countries shows that Turkey takes the 20th highest place among OECD countries.

According to the result of a study conducted by the Research Department, even if there is no big differences in growth rates, the ratio of current account deficits to GNP is lower for the period of greater economic openness. In other words, during 1950-83, when inward oriented import substitution economic policies were conducted the current account deficit to GNP is 1.7 percent which is higher than the ratio during 1984-96 when economic policies are outward oriented.

To these statements I should add a few words about our external debt. Turkey has been a net debt payer for the last couple of years. In other words, there has been no net inflow of foreign resources. On the contrary, based on Turkey's total principal and interest payments minus total disbursements received, we can say that the Turkish economy's net cash outflow has been US$13 billion since 1994.

An analysis of Turkey's external indebtedness shows that the ratio of short-term debt to total debt was around 25 percent at the end of September 1997. The nine-month figures for that year show the total debt stock of around $84.5 billion divided between $63 billion in long-term debt and about $21.5 million in short-term debt. The long-term debt was mostly credit to the public sector. In other words, the government's external indebtedness consists of about $48 billion including State Economic Enterprises, and another $11 billion of the Central Bank's Dresdner scheme.

The private sector's medium- and long-term debt is estimated at $15 billion, based on January-September 1997 figures. These figures show that the private sector's share in long- and medium-term external debt rose from 10 percent in 1996 to about 15 percent in 1997. But most short-term external debt belongs to the private sector. About $21 billion in short-term external credits, almost of it all private sector debt, consisted mostly of trade financing credits in the form of letters of credit, cash against goods, and pre-export credits.

I would like to make an important point concerning the rules governing economic systems. Turkey has not been practicing the so-called "crony capitalism," which is said to have played an important role in the Asian countries now facing currency crises. The system of crony capitalism that has long ruled Asian financial life is a perversion of the free open market. This outmoded practice can be seen a cause of

the recent economic distress in those countries. In contrast, the Turkish economy is mostly based on market principles. Having described the main characteristics of our economy, I will discuss Turkey's economic situation in 1997.

1. THE TURKISH ECONOMY IN 1997

In 1997, the Turkish economy has continued the growth trend of the preceding two years. GNP for 1997 is expected to increase by 6 percent over 1996 in real terms. A major source of growth over the last three years has been the rise in investment and consumption; in fact, the main factor behind the growth cycle is a surge in investments aimed at increasing the capacity of the economy. During these last three years, the achievement of general stability, and especially stability in the exchange market, has reduced uncertainty and increased investments. Favourable economic conditions in Turkey's main trading partners have also contributed to 1997's growth.

The composition of output has shifted, with agricultural production decreasing by around 2 percent and the industrial sector maintaining its astonishing average real growth rate of 10 percent.

On the negative side, inflation continued to be the Turkish economy's major problem in 1997. During the first five months of the year, both the wholesale price index and the consumer price index rose more slowly than during the same period in 1996, but this was because the rise in the price of public goods, which had been postponed during the election period in late 1995, accelerated more than usual in the first five months of 1996. Another reason for the temporary slowing of inflation in early 1997 was the absence of "seasonal price increases." But by the second half of 1997, inflation began to rise again. In early summer, the Central Bank targeted wholesale price index inflation at around 80 percent by the end of 1997, but the actual increase in the wholesale price index turned out to be 91 percent. The difference from the target was mostly caused by unexpectedly high public price adjustments, occurring in the second half of the year, that had not been included in the Central Bank forecast.

The budget deficit also continued to increase in 1997. The ratio of the consolidated budget deficit to GNP is estimated at around 8 percent. The budget deficit rose in spite of a substantial real increase in tax revenues, due to even larger increases in wages and transfers. It is therefore expected that unlike the preceding three years, 1997 will record a primary budget deficit. A primary surplus, which is the key to a balanced budget, must be achieved and maintained to keep the government finances in balance and help pacify creditors by demonstrating the capacity to service the existing debt.

Even with an increase in the budget deficit, there was a substantial improvement in the financing of the budget, with better cooperation between the Treasury and the financial markets, and the Treasury was able to extend the maturity of domestic debt to one year.

On the external side, Turkey has been a net foreign debtor since 1994. From 1994 to 1997, Turkey has repaid principal plus interest amounting to about US$14 billion on its foreign debt. In 1997, Turkey's net foreign debt repayment was almost US$3

billion. Turkey's inadequate access to foreign lending constrains the financing of the budget deficit and increases the pressure on domestic borrowing and interest rates. I should add one important development affecting Turkey's foreign borrowing. The private sector borrowing, which used to be mostly short-term, has now become predominantly medium- and longer-term borrowing.

As for the current account, the growth rate of imports slowed while that of exports rose. Revenues from tourism were high throughout the year. For the first nine months the current account deficit was around 2.0 percent of GNP, rising to an estimated 2.5 percent at the end of the year. This reasonable level of the current account deficit averted pressures on the domestic foreign currency markets and permitted Turkey to retain its access to foreign resources on favourable terms for financing the deficit.

Analysis of the Central Bank's balance sheet reveals that the total increased by 75 percent, indicating a contraction in real terms. In addition, net foreign assets rose by 195 percent and net domestic assets decreased by 61 percent. Net international reserves reached US$18.4 billion, and have since increased to over US$20 billion. The behaviour of the ratio of reserves to imports and short-term capital movements are evidence of our strong external position.

The Turkish lira exchange rate increased by 90.6 percent *vis-à-vis* the US dollar and by 78 percent *vis-à-vis* the foreign currency basket. On the other hand, the real exchange rate has been stable for the last couple of years.

In sum, the Turkish economy grew substantially in 1997, but inflation rate also continued to increase. And although the budget deficit increased, the current account deficit remained at a recoverable level. Overall, it can be said that even though domestic side of our economy has some ongoing problems, our external position is strong.

II. MONETARY POLICY IN 1997

Before discussing monetary policy for 1998, I would like to review the main points of the policies pursued in 1996 and 1997. In this period, the Central Bank conducted its monetary policy without publicly announcing the details. An assessment of the outcomes of the policies implemented during these two years will shed light on the Central Bank's policy implementation for 1998.

Basically, the monetary policies implemented during the last two years were aimed at stabilizing the financial markets. The Central Bank's intermediate objectives in pursuing the goal of stability are two: first, to prevent rapid short-term price fluctuations in the markets; and second, to reduce uncertainties in the markets. The Central Bank tried to calm price fluctuations in both the short-term Turkish lira market and the foreign currency markets by maintaining a consistent relationship between prices in these markets and the general balances of the economy. During this period, exchange rates moved in parallel with the expected inflation rate, and fluctuations of interest rates in the interbank money market subsided. The markets' eventual acceptance of these interest rates as reference rates reflects the successful attainment of the stabilization goal.

The second objective on the way to the stability goal was to eliminate market uncertainties, created by high inflation, which could cause losses to the economy. To this end, the Central Bank announced, every six months, its inflation forecasts and its monetary policy intentions based on those forecasts. This realistic approach on the part of the Central Bank had the desired effect on the markets' inflationary expectations and reduced the degree of uncertainty felt by the markets about the future of the economy.

The success of the Central Bank's pursuit of stability is reflected in its balance sheet by a decrease in domestic assets, a strong foreign currency position of the Central Bank, and by creating reserve money only as a counterpart to increases in net foreign assets.

The slowing of the growth rate of the Central Bank's net domestic assets, which has been going on since 1994, has become progressively steeper over the last two years. This deceleration has been accomplished mainly by imposing annual ceilings on short-term advances at preferential rates to the Treasury, which had accounted for the majority of the Bank's net domestic assets, and from the discontinuation of Central Bank loans to public institutions. For controlling the increase of reserve money, the source of the reserve money is as important as its size. A reserve money increase resulting from loans extended to the public sector will have a stronger effect on inflation than a reserve money increase resulting from increased purchases of foreign currency. Therefore the Central Bank has not only sought to keep the increase in reserve money under control, but also to change the relative importance of its sources.

The Central Bank's balance sheet, being solidly based, ensures calm and stable financial markets. This has been especially true of the exchange market.

During this period, the real exchange rate index fluctuated between 96 and 106, and exchange rate policy became a determinant of the current account balance. Stable exchange rates enabled the external sector to remain competitive and made it possible to predict developments well enough to enter into long-term contracts. The success of these exchange rate policies during this period can be appreciated better in light of the crisis in South-East Asia. It was by implementing these exchange rate policies that Turkey has been able to survive the crisis which has affected the world without becoming trapped in an economic bottleneck.

The Central Bank's interest rate policy during this period was dictated by the requirements of the economy. Increasing budget deficits, having to be financed with increasing amounts of domestic borrowing, obliged the Treasury to put supply pressures on the auctions of government securities, and this caused the interest rates fixed in these auctions and the secondary markets to rise considerably above the forecast inflation rate. Real interest rates rise when political uncertainties increase. In such an environment, short-term interest rates basically follow the rates in the primary and secondary markets where government securities are traded. Here the Central Bank observes two rules. First, because of the Central Bank□s lender-of-last-resort function, the interest rates at which the Central Bank supplies liquidity through the short-term Turkish lira markets should be kept higher than the interest rates attached to long-term Turkish lira transactions. Second, the Central Bank works

to decrease interest rate volatility. To this end, in 1997, the Central Bank initiated new kinds of transactions in the interbank money market which is under its supervision, such as the Tomorrow/Next or T/N transactions (next-day value: overnight transaction) and Tomorrow/Week or T/W transactions (next-day value: one week's maturity).

III. IMPLEMENTATION OF MONETARY POLICY IN 1998

What is distinctive about 1998 is the adjustment that will come in the implementation of fiscal policy, rather than any change in monetary policy. As is well known, the government has announced its determination to fight inflation in earnest in 1998. The 1998 budget that has been shaped by this determination assumes that there will be substantial improvements, especially in the primary surplus. There is no doubt that such improvements in 1998's budget balances will have beneficial effects on the implementation of monetary policy as well as on inflation.

The implementation of monetary policy for 1998 is based on financial programming. The balance of payments and budgetary aggregates are among the key variables that will influence the Central Bank's determination of aggregates for 1998.

The main goal of the Central Bank's monetary policy will be to implement measures aimed at bringing the annual inflation rate down to around 70 percent during the first half of 1998. This figure is consistent with the macroeconomic targets for the year. The Central Bank will employ all the monetary policy tools at its disposal for this purpose. Basically, the Central Bank will continue to limit the increase in domestic assets by creating money only to match increases in foreign assets. The tool of short-term interest rates will also be used to achieve this target more effectively.

The exchange rate policy will be consistent with the inflation rate estimated for the first half of 1998. Accordingly, beginning in January, the monthly rate of increase in the exchange rate will be tied to the estimated inflation rate.

I want to emphasize how very important it is to control monetary aggregates at a time when a fight against inflation is to be made. For this reason, the rate of increase of reserve money was chosen to be consistent with the growth rate of the economy and the inflation target. And in this connection, the Central Bank announced, at the beginning of the year, a quarterly program to reveal its preference for controlling reserve money by controlling domestic credit.

In order for exchange rate policy to assist in reducing inflation to a given level, inflationary expectations must quickly be reduced. The rate at which inflationary expectations can be changed basically depends on the credibility of policies, and this credibility cannot be established without the support of the government in power. The government has to show its commitment to the fight against inflation by accepting and observing a definite timetable for implementing the structural reforms that are crucial for creating a durably sound and balanced economy. In point of fact, the structural measures needed by Turkey should be completed by mid-year if the forecast inflation rate is to be achieved by year's end. Significant progress has already been made on this front. We are pleased with these developments. There is

no doubt that this progress will motivate us to carry out our monetary policies more effectively and to win the fight against inflation.