RESULTS OF THE MONETARY PROGRAM OF THE CENTRAL BANK OF THE REPUBLIC OF TURKEY FOR THE FIRST QUARTER OF 1998 AND PLANS TO IMPLEMENT THE MONETARY PROGRAM FOR THE SECOND QUARTER

Gazi Erçel
Governor
The Central Bank of The Republıc of Turkey

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I. Introduction

In its monetary program of early January, the Central Bank announced that its inflation target would be in the range of 70 percent for the first half of the year and that exchange rate policy and monetary policy would be conducted in accordance with the estimated inflation rate. The main feature of the monetary program was that the rate of increase in reserve money would remain in the range of 18-20 percent during the first quarter of 1998. The increase of reserve money was to come mainly from the growth of foreign exchange reserves.

It can be observed that, as of April 1, 1998, the conduct of the monetary program in the first quarter has been consistent with the anticipated framework.

Before examining monetary program implementation for the second quarter, let us briefly evaluate the conduct of monetary program during the first quarter on the basis of the data available now.

II. The Conduct of Monetary Program in the First Quarter of 1998

Reserve Money

The improvement in the primary surplus has helped the Treasury to accomplish its repayments of the domestic debt that had accumulated in the first three months of the year. It has also decreased the rate of growth of the domestic debt stock by lightening the burden on monetary aggregates. During this period, the Central Bank has been able to increase its control over reserve money and keep the growth of reserve money on within the anticipated target path. Reserve money increased by 17,3 percent to reach TL 1,392 trillion during the first quarter of 1998. This total is below the target range of TL 1,397 - 1,421 trillion that had been forecast for the end of March. Monthly averages of reserve money show that the March average was 18,5 percent above the average for December 1997. (Graph 1)

Graph 1

Reserve money, which increased because of cash demand on national and religious holidays and on days of salary payments, was withdrawn from the markets as the Central Bank mopped up the liquidity supplied through open market operations. In this way, the creation of liquidity that might lead to increased demand in the economy was prevented. The fact that the Central Bank bought US dollar 2,6 billion from the markets in March exerted no pressure on reserve money.

The increase of reserve money came mainly from the growth of net foreign assets of the Central Bank during the first quarter of 1998. As of March 31, 1998 the net foreign assets of the Central Bank reached US dollar 11,6 billion, increasing 33 percent over the end of 1997. (Graph 2)

Graph 2

During the same period the Central Bank□s net domestic assets continued to trend downward, declining by TL 636 trillion in nominal terms as of March 31, 1998 below its December 1997 level. The Treasury did not use any short-term credits from the Central Bank and the Central Bank did not extend credits to other public enterprises. All these factors, and the decline in liquidity supplied to the markets through open market operations, contributed to a drop in net domestic assets. (Graph 3)

Graph 3

The Central Bank and Reserve Money

At this stage, it will be useful to look at Central Bank Money (CBM) and compare it with reserve money. As is well known, CBM represents the total liabilities of the Central Bank expressed in Turkish lira and is computed by adding "public TL deposits" and " the balance of open market operations" to reserve money. By definition, an increase in the public deposit accounts with the Central Bank and/or a withdrawal of money from the markets by the Central Bank via open market operations will cause CBM to increase in relation to reserve money.

Contrariwise, a decrease in public deposits with the Central Bank and/or the injection of liquidity into the markets by the Central Bank via open market operations will cause CBM to decrease in relation to reserve money. In short, a slight increase in CBM means an inflow of TL to the public and/or to the markets, while a higher increase represents an outflow of money from the public and markets. For this reason, one must take care when evaluating increases and decreases in CBM. An increase in CBM may be seen as implying the implementation of tight monetary policy, and a decrease as implying that of an expansionary monetary policy.

The reserve money aggregate is easier to explain and better understood by the public, and it is a better indicator for predicting medium - term money demand in the economy.

On the other hand, the CBM is directly affected by short-term liquidity movements in the market through open market operations and involves variables such as public deposits which are subject to sharp changes and are beyond the Central Bank's control. This increases the fluctuations of CBM and makes it less predictable. In Graph 4, the monthly standard deviation for CBM and for reserve money are shown in time series to illustrate these fluctuations. it will be seen that during the period covered by the graph, the monthly movements of reserve money are less than that of CBM (Graph 4). For this reason, reserve money is preferred as a target variable in conducting monetary policy.

Graph 4

The behaviour during the first quarter of 1998 of monetary aggregates other than reserve money also supports the use of tight monetary policy. According to the tentative data dated March 27, 1998, the annualized rates of increase in M1, M2 and M2Y were 61 percent, 90 percent and 99 percent, respectively. (Graph 5)

Graph 5

Exchange rate developments

The Central Bank□s exchange rate policy is affected by two factors. These are the sustainability of the current account balance and inflation. A rapid increase in exchange rates could encourage inflation, while increasing the sustainability of current account balance. The contrary effect of the exchange rate on these two variables oblige the Central Bank to steer its exchange rate policy between these two constraints to maintain equilibrium in the economy. In periods when the fight against inflation has priority in economic policymaking, exchange rate policy is pursued with by its inflationary effects in view. But when the fight against inflation recedes, exchange rate policy is redirected to strengthen the current account balance.

The monetary program announced at the start of 1998 stated that the exchange rate policy of the Central Bank would be conducted with a view to keeping the annual inflation rate in the neighbourhood of 70 percent during the first half of 1998. This means the exchange rate basket (1 US dollar and 1,5 Deutsche marks) will be increased steadily and in parallel with the inflation rate. The stability of exchange rate policy enables the market to have a clear view of the increase in the monthly exchange rate basket by following the rates announced for surrender requirements. This offers the markets a parameter to help them shape their expectations accurately. In short, the exchange rate basket and the interest rates which are determined in accordance with this basket provide an important packet of information concerning the equilibrium of the nominal variables in the economy.

Considering the behaviour of the exchange rate basket during the first two months of the year, it can be seen that the monthly average rates of increase are 4,9 and 5,8 percent respectively. During the same period, monthly increases in the wholesale price index turned out to be 6,5 percent and 4,6 percent respectively. The fact that the increases for the first two months of the year in the cumulative exchange rate and wholesale price index were 11 percent and 11,4 percent, respectively, shows that the increase in the exchange rate basket was kept in parallel with the increase in the inflation.

The success in keeping the exchange rates stable is reflected by an increase in the Central Bank□s international reserves. In this connection, it is important to note that the Central Bank managed to hold on to its high volume of foreign exchange reserves despite the economic turmoil stemming from the South-East Asia crisis which began last year and continued during the first quarter of 1998, and the tensions connected with the escalation of the Iraq - U.S. dispute in February. Turkey□s international reserves minus gold had risen to US Dollar 21,2 billion as of March 27, 1998. This means an increase of US Dollar 2,5 billion over December 1997. (Graph 6)

Graph 6

Despite the many adverse developments of the global political and economic scene during recent months, exchange rates have continued to move in a steady manner and there have been no speculative fluctuations. This is evidence that, in real terms, the exchange rates were set at their long - term equilibrium levels. Similarly there has been no significant change in the value of a real exchange rate index based on a private manufacturing industry price index that is closely correlated with the competitiveness of foreign trade and uses the year 1997 as a benchmark. (Graph 7). This view is also supported by the low level of Turkey□s 1997 current account deficit and the improvement in foreign trade trough January of 1998.

Graph 7

Interest rate developments

During the first quarter of 1998, the Central Bank followed an active interest rate policy to combat inflation as outlined in the monetary program. The Central Bank changed its interest rate quotations in the money markets three times during this period. Basically, interest rates are modified in response to inflationary expectations, being raised during the periods when inflation shows an upward trend. When an inflation is declining steadily, interest rates are lowered accordingly. Great care is taken to ensure that short - term interest rates move well above the long-term interest rates. The setting of the interest rate for Turkish lira supplied by the Central Bank as lender of last resort, through open market operations by adjusting liquidity in the economy turns out to be consistent with the tight monetary policy also. (Graph 8)

Graph 8

In sum, the Central Bank has pursued monetary and exchange rate policies with great care to bringing down inflation and keep the financial markets stable during the first quarter of 1998. During this period, Turkey's domestic markets have been stable and Turkish inflation has begun to decline in spite of unfavourable economic and political developments abroad.

III. The Implementation of Monetary Program in the Second Quarter of 1998

The monetary policy pursued during the first quarter of 1998 will generally be continued in the second quarter of the year. The Central Bank's estimate that the inflation rate in June 1998 will be in the neighbourhood of 70 percent remains valid. Developments in the first quarter of the year have made it possible to attain the first half range of 70s as the end of the second quarter of the year. The exchange rate policy will continue to be implemented in accordance with the estimated inflation rate during the second quarter of the year. The growth in reserve money in the second quarter of the year is targeted to remain below the growth in reserve money in the first quarter of the year. One of the main features of the monetary program is that the rate of increase in reserve money is targeted to remain in the range of 14 - 16 percent during the second quarter of 1998 as the end of March. The continuing decline in inflation and decrease in the cost of holding cash have increased the demand for reserve money.

Therefore, it is expected that the growth of reserve money will slightly exceed the quarterly inflation rate during the second quarter.

On the other hand, the source of the demand for reserve money will be the increase in net foreign assets of the Central Bank, as in the first quarter. In the second quarter, it is not foreseen that the net domestic assets of the Central Bank will increase in real terms.

If the Treasury adheres strictly to its policy and does not seek short - term advances from the Central Bank, and if the improvement observed in the budget performance during the first quarter of the year continues, the Central Bank will be able to maintain its control over the growth of reserve money.