

Remarks by
GAZÝ ERÇEL
GOVERNOR
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SOME REMARKS ON THE TURKISH ECONOMY

I. Some Recent Trends on Turkish Economy

The most important trends prevailing in the Turkish economy in the first eight months of 1997 can be summarized as follows: strong growth in the real sector, lengthening of the maturity structure of the domestic debt, acceleration of the inflation rate, deterioration of the budget balance, lack of enough access of the public sector to foreign borrowing and stable outlook in the balance of payments.

Here, I will comment on the first three trends for reasons I will explain in a short while.

First of all, 1997 has been the third consecutive growth year of the Turkish economy. The growth rate of the real GNP was around a sound 6 percent in the first half of the year. The source of this growth was mainly domestic demand, but the rise in export demand also contributed to it.

Second, the main source of financing the budget deficit has been domestic borrowing by the government as in recent years. Mainly as a result of this pressure from the supply side, the maturity of the domestic debt has been short. With a coordinated effort led by the Treasury, maturity of the domestic debt was extended significantly to around 14 months as of September 1997.

Third, in the first five months of this year, inflation was on a downward trend, falling to 74 percent in May 1997. This trend, however, reflected the usual effect of elections on prices. As it will be remembered, early general elections had been held on December 1995. In the pre-election period, the required adjustments in the prices of public goods had been delayed. In the first half of 1996, on the other hand, the prices of public goods had been increased significantly. Because of this "periodical" factor, the inflation rate has declined in the first five months of 1997 when compared to the previous year. Starting in June, however, the inflation rate resumed its upward trend.

These three trends reflect some important features of the Turkish economy. First of all, the strong growth performance shows the very dynamic nature of the Turkish economy.

Turkey has a dynamic economy whose productivity has grown at an average rate of 2 percent a year over the last decade.

With its young population of over 60 million, its dynamic and outward looking private sector, its modernized and competitive industrial base, and its well established service sector, the Turkish economy has great potential. Except for 1994, a crisis year for the economy, Turkey's economy has grown continuously. And even after a deep crisis period such as that of 1994, the economy was able to recover rapidly and strongly.

This suggests that the real cost of a structural adjustment program to pin down inflation might be less severe or expand into a shorter time span than we expect.

Second, the lengthening of the maturity structure of the domestic debt shows that, no matter how deeply rooted an economic problem is, it can be solved if one approaches it in a serious and programmed manner.

And finally, high inflation is the most important problem of the Turkish economy at present and it should also be approached with a comprehensive way.

Now, after briefly commenting on the monetary policy, I will explore the last issue in more detail.

II. Monetary Policy Issues of 1997

As in the previous year, the Central Bank prepared a monetary program for 1997. The basic features of this program are the controlling of the growth rate of reserve money and the close monitoring the foreign exchange rate.

In the current monetary policy implementation, daily operations of the Central Bank of Turkey have widely used two instruments, namely buying and selling of foreign exchange and open market operations (repos and reverses). These two instruments are used to cope with two systematic constraints which are beyond the control of the Central Bank. These are the net domestic financing requirement of the public sector and the volatile balance of payments flows. The Central Bank has also two main objectives broadly stable rate of inflation and a stable real exchange rate. There is clearly a target-instrument conflict in these circumstances. Therefore the Central Bank has focused in its practice on the financial market stability, rather than the inflation objective.

Although the Central Bank did not have an official inflation target for 1997, it announced its inflation forecast for the first half of 1997 to be around 70 percent. The reason for such an announcement was that, although the data showed a decline in the inflation trend for the first half of the year due to the reason explained earlier, the public hesitated to adjust its inflation expectations downward for the period. By announcing its forecast, the Central Bank aimed at lowering those inflation expectations down to the forecasted level so that they would not create additional costs for the economy.

Controlled reserve money growth constituted one feature of the monetary policy practice. It means that the source of the reserve money increase would come from the rise in the foreign assets of the Central Bank and not from the increase of its domestic assets. This is important because the rise in the reserve money due to an increase in domestic credits has immediate inflationary repercussions and, depending on the rate of increase, it can easily result in a hyperinflationary environment in the economy.

On the exchange rate policy, the Turkish Central Bank has closely monitored the nominal exchange rate on its daily practices, keeping an eye on developments. According to our annual inflationary expectations, we send signals to the market and the market has also well understood policies followed by the Central Bank. It is not a policy to keep up the annual depreciation of TL with past inflation. It is an unannounced band designed by the expected inflation. Though we know that there are limits to this approach, the mechanism propagating financial stability through the foreign exchange market is operational for most emerging market economies.

Now, I will explore in detail the most important problem of the Turkish economy.

III. The Problem of the Economy and the Policy

The central problem of the economy is inflation which, in principle, is the result of the government's budget deficit. The inflation is about 85 percent year on year basis as of August 1997.

The inflation history of the Turkish economy was started in early 70's as a supply side effect of the oil shocks. It then turned into a demand side inflation with the effect of the increasing budget deficits. As inflation became a permanent phenomenon in the Turkish economy, its inertia component also got larger.

After a quarter of a century now, inflation is a complex process with its both supply and demand push features, and with a build-in character.

Although it might be complex in its features, it can not be considered as unique or in other words it can be said that the main unique character of the Turkish inflation is its duration. I don't remember any other country which had inflation as long as the Turkish one.

Other than that its path quite resembles the inflation processes of the Israel in the eighties, Argentina and Brazil in eighties and nineties. In all of these three countries inflation has been chronic, prolonged, high and accelerating yet quasi stable as in inflation in Turkey now.

A fiscal led program, that is, a program targeting a significant rise in the primary surplus at the forefront with appropriate and timely structural reforms in the process are the main recipes of programs which cured the inflation problem in those countries. The central banks' responsibility in those processes will then be providing a strict control of the monetary aggregates. It also seems appropriate to use some incomes policy together with the exchange rate, especially during the early stages of the programs to combat the inertia component of the inflation.

These are the so called mechanical requirements of a disinflation program. But I believe the most important part of it lies in the credibility issue. The level of political willingness to fight with inflation, the appropriate dosages and the coordination of the policies are the three important determinants of the credibility. One can also add to this the level of consensus build-up among various segments of the society in fighting inflation.

An optimum mix of credibility and the mechanical requirements will bring us the desired low inflation just like they did in Israel, Argentina and Brazil.

I think it is now our turn to concentrate on such an economic program, applied it in a determinate manner and pin down inflation.

IV. Protocol Between the Treasury and the Central Bank

As you all know the Treasury and the Central Bank signed a protocol in July. I see this protocol as the very initial step of such a credible stabilization program effort aiming at reducing inflation in Turkey once and for all.

There are mainly three implications of this protocol.

First, it restructures, furthermore strengthen, the relation between the Treasury and the Central Bank. This implies stronger collaboration between these two institutions. The Treasury, in all kinds of pecuniary relationship with the Central Bank including the short term advances, will act in accordance with the Central Bank and its policy objectives. This by itself will provide a sound infrastructure for establishing and

implementing a monetary program by the Central Bank.

Second, the Central Bank and the Treasury indicate by this protocol that they will cooperate to reduce inflation. Both institutions will give proposals to the government, after discussing with the related public institutions, on the monetary and fiscal measures to be prepared jointly with regard to curbing inflation as a first step.

Finally, this protocol suggests more transparency. Transparency will be provided by the announcement or by a joint press release explaining policy actions, targets and meetings' minutes whenever necessary. Two institutions will do their best separately or jointly to promote transparency. More transparency will also make these institutions more responsible for their policy implementations.

The next question should be how this protocol can affect the monetary policy of the Central Bank. The protocol mainly gives the general principles for the coordination between the Treasury and the Central Bank. These general principles imply two main ideas: first the relation between the Treasury and the Central Bank will go in a programmed manner, in other words there will be no surprises to money markets. This will contribute to the stability in those markets.

The second idea implies that in order to be able to reduce inflation, the Central Bank should have more autonomy in implementing its monetary policy and program, and the monetary policy and programs should be supported by fiscal policy and program.

Now, let me turn to the last point I like to touch on. All of us here, have observed serious crises in South Asia recently. Economies in these regions suffered mainly from an over appreciated currencies.

I firmly believe that choice of exchange rate regime is crucially important. Particularly real exchange rate overvaluation which has inflationary pressures leaves some profit in the hands of commercial banks so that they continue to bring short term capital and keep dolarization tamed. This is a perfect crises recipe.

Of course under certain conditions, especially high inflation and disorderly financial conditions, fixed exchange rates provide highly visible and effective anchor as part of a broader program and therefore over valuation of the currency can be acceptable. However policy makers sometimes fail to recognize the cost and the benefits of a fixed or pegged exchange rate which can change over time as the economy stabilizes and inflation subdues. Thus, an appreciating exchange rate is not necessarily the optimal exchange rate regime in the longer run. There should be an exit strategy while implementing it.

Thanks to the economic fundamentals in Turkey, we have not faced this unpleasant situation of the South Asian Countries, mainly because of a non-appreciated currency, strong balance of payments position, high official reserves, low short term capital inflow, close and positive relationship between the real and the financial sectors, despite a strong import demand caused by the entry into the Customs Union with EU and high budget deficits. The market based and liberalized Turkish economy together with dynamic private sector activities have put Turkey in a different path.



info@tcmb.gov.tr

