

**CENTRAL BANK OF THE
REPUBLIC OF TURKEY**



MONETARY POLICY FRAMEWORK

September 2002

Outline of the Presentation

- ❑ Macroeconomic Prospects
 - ✓ Key Indicators of Financial Stability
 - ✓ Inflation
 - ✓ External Sector
 - ✓ Growth
- ❑ Recent Monetary Policy Actions
- ❑ A Brief Overview of the FX Policy
- ❑ Inflation Targeting: The Eventual Monetary Policy Framework

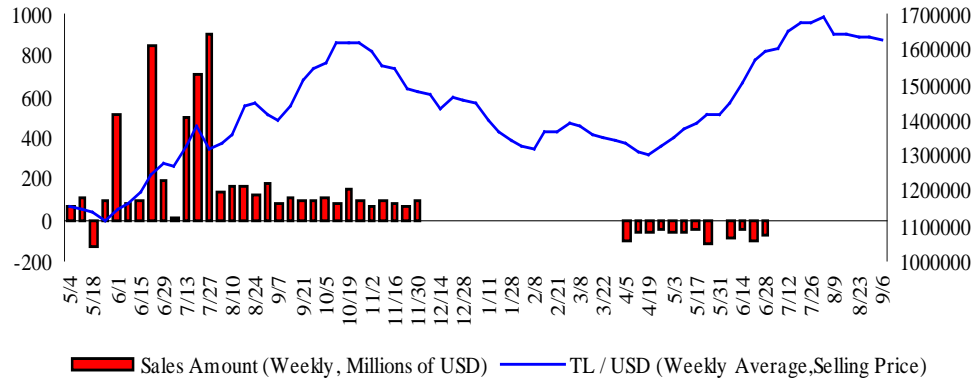


Signs of Stability are Emerging

The CBT continues to strictly limit its discretionary FX interventions. Pre-announced auctions have been suspended in June.

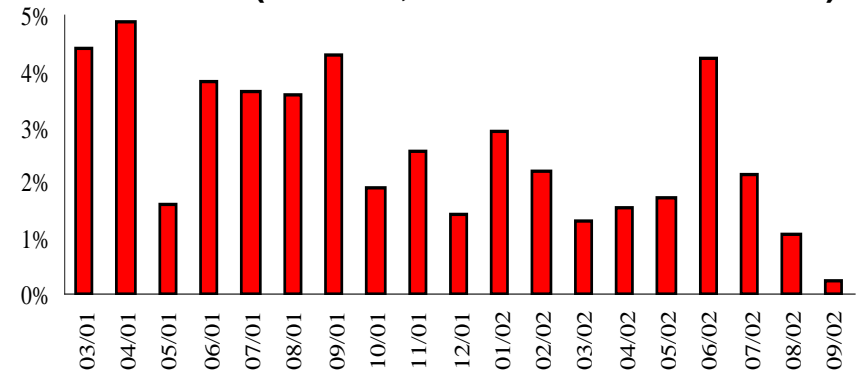
Volatility of the exchange rate has diminished compared to its peak in June.

FX Auctions



* (+) indicates FX sales to the market.

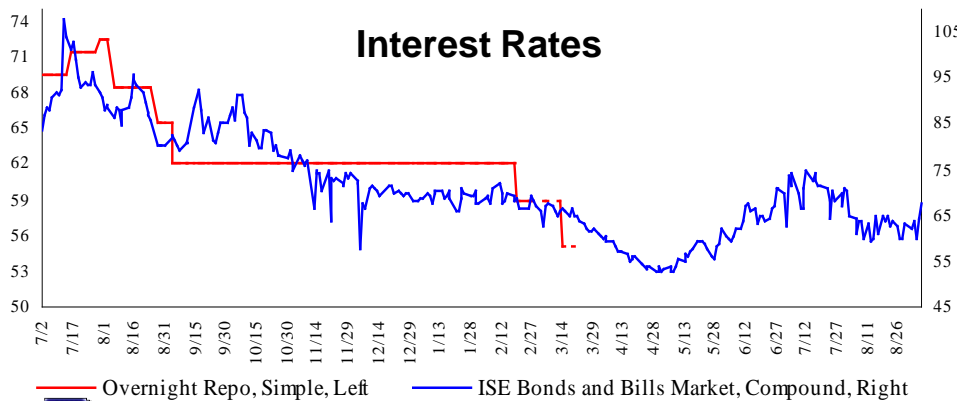
Volatility of Exchange Rate (TL/USD, Coefficient of Variation)



Following its upward trend caused mainly by increased political uncertainty in July, interest rates have been declining since August.

The upward trend in spreads between May and July was reversed in August in light of the improved political outlook.

Interest Rates



Turkish Eurobond Spreads (bps)



Spread = The difference between Turkish Eurobonds and US Treasury bills.

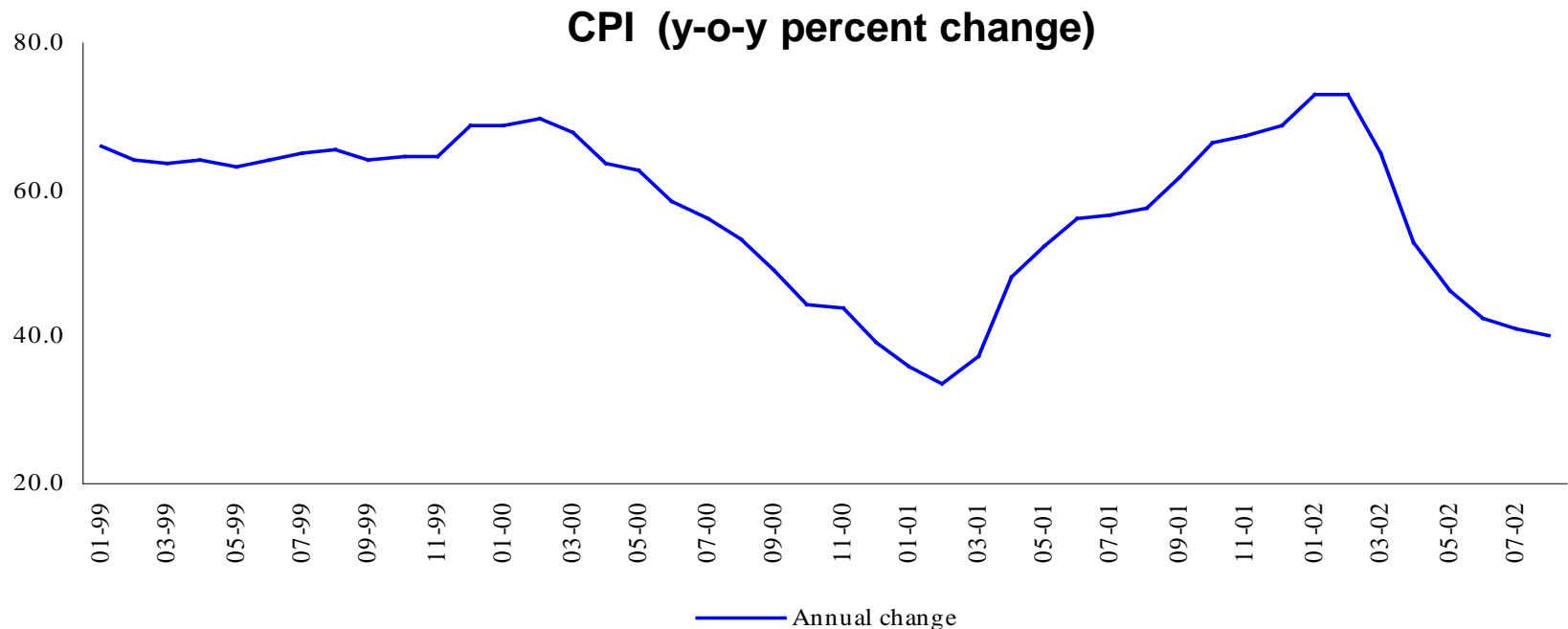
Source: JP Morgan



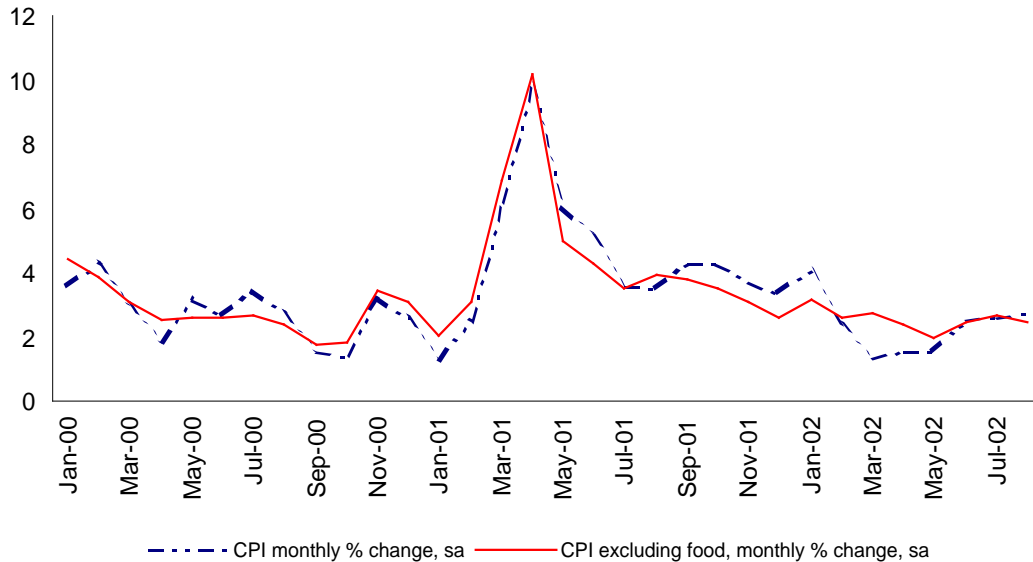
Price Developments between January-August 2002

■ Inflation displayed a declining pattern during this period owing to:

- ✓ The increase in the credibility of the program which, in turn, had a favorable impact on expectations;
- ✓ The absence of demand pressures;
- ✓ The relative stability of the exchange rate and the marked decline in the pass-through from the exchange rate.
- ✓ The significant slowdown in food and agricultural prices.

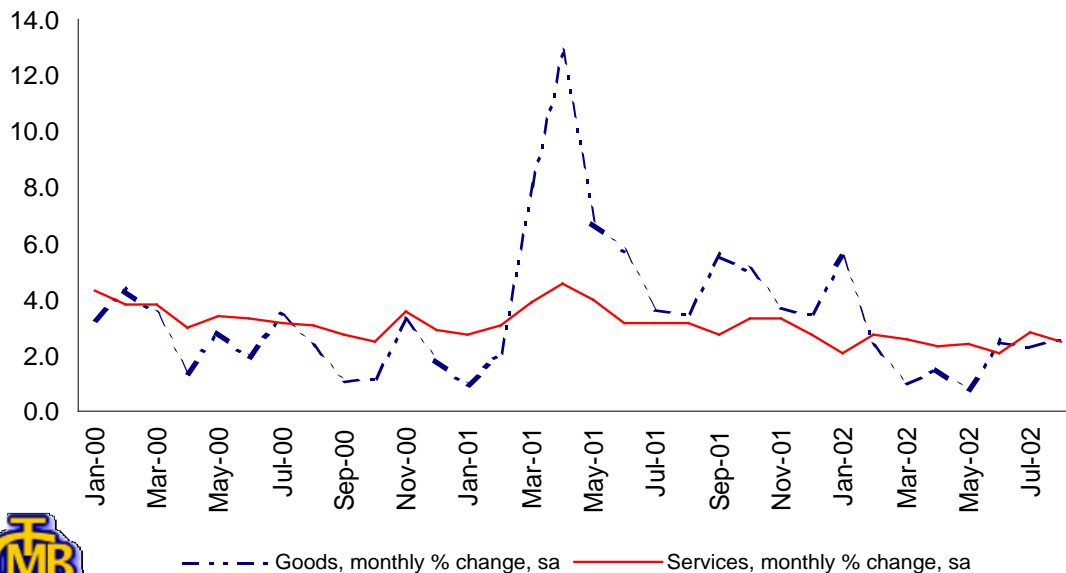


Price Developments between January-August 2002



❖ Due to the increased political uncertainty between May and July, both CPI and CPI excluding food displayed an upward trend. The acceleration in prices, however, was limited in August as a result of the improved market sentiment and political outlook.

❖ The current trend of inflation suggests that the end year target should be comfortably met.

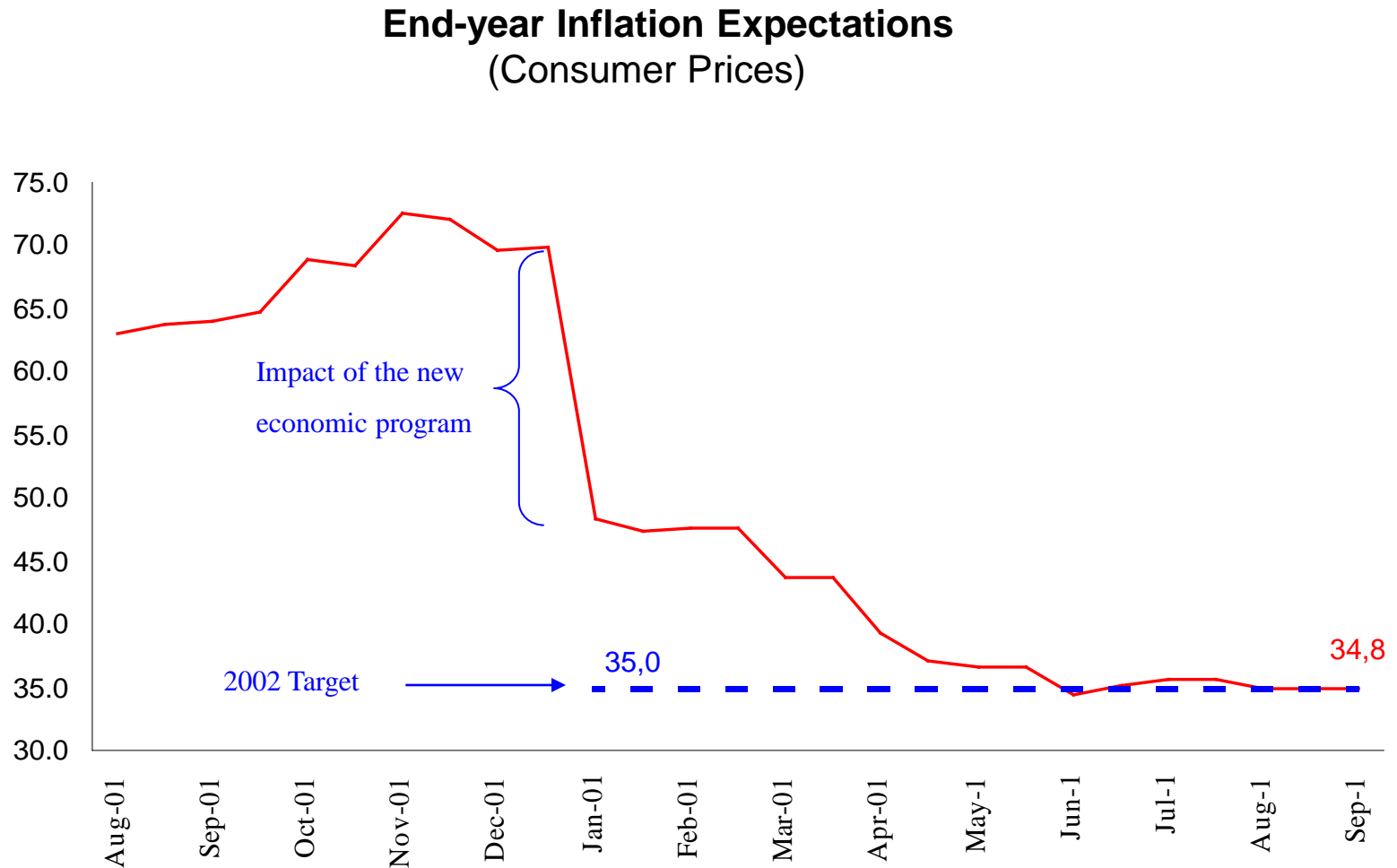


❖ The increase in price of services has been more subdued compared to that of price of goods.



Price Developments between January-August 2002

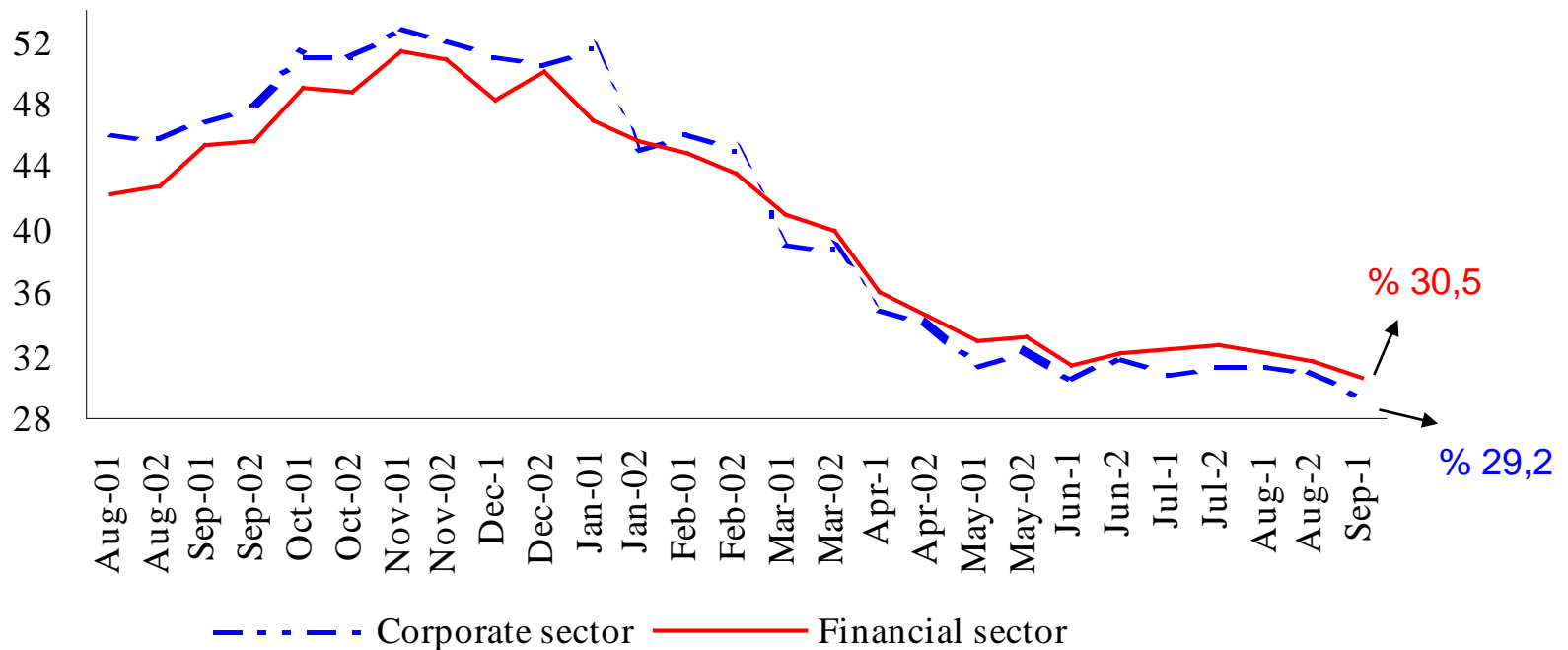
- ✓ Inflation expectations are rapidly converging to the target.



Price Developments between January-August 2002

- ✓ The implementation of the economic program is steering the inflation expectations for 2003 towards the target.

Inflation Expectations for the Next 12 Months
(Consumer Prices)



Outlook for Inflation

● Price stability:

- ✓ Price stability--the primary objective of monetary policy--is a prerequisite for rapid, balanced and sustainable growth.

● Risks:

- ✓ **Backward-looking indexation and price-setting behavior in the economy**
 - ❖ Price-setting behavior of the public sector: public service prices (natural gas, electricity, water), wages, backward re-evaluation coefficient, monopoly, tobacco, wheat etc.
 - ❖ Price-setting behavior of the health sector
 - ❖ Price-setting policy of the education sector
- ✓ **Oil price shocks**
- ✓ **Resumption of the political uncertainty and the spillover effect on financial markets**

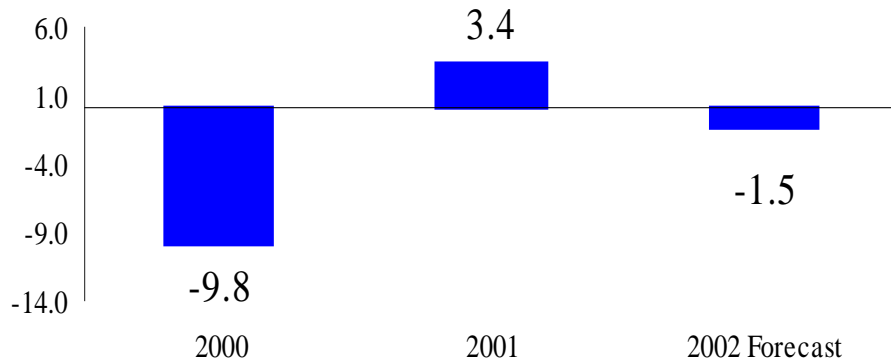
● Medium-term inflation

targets:

- ✓ 2002 → % 35
- ✓ 2003 → % 20
- ✓ 2004 → % 12
- ✓ 2005-... → Single digits

External Sector: Turnaround in BoP

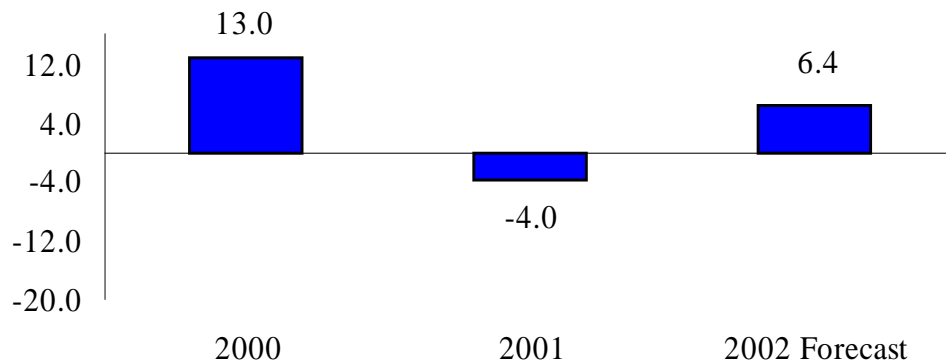
**Current Account
(Billions of USD)**



● The economic slowdown and the depreciation of the Turkish lira have led to a noticeable turnaround in the current account balance in 2001, giving a surplus of US\$ 3.4 billion from a deficit of US\$ 9.8 billion in 2000.

● **A current account deficit of US\$ 1.5 billion is projected for 2002.**

**Capital Account*
(Billions of USD)**



● February 2001 crisis and resulting confidence loss in TL left the capital account with a deficit of US\$ 4 billion in 2001 from a surplus of US\$ 13 billion in 2000.

● **Capital inflows are projected to be US\$ 6.4 billion in 2002.**



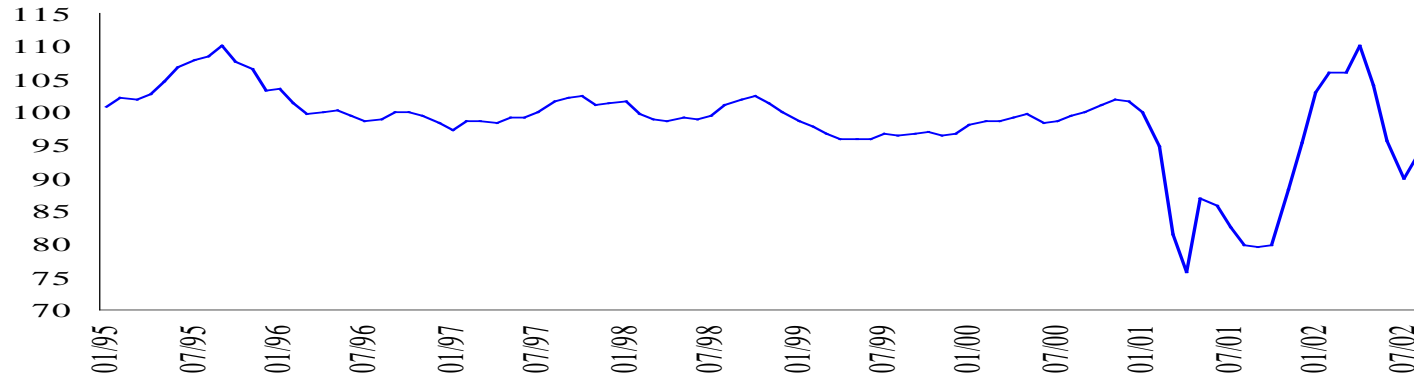
* Including Fund credits

External Sector: Evolution of the RER

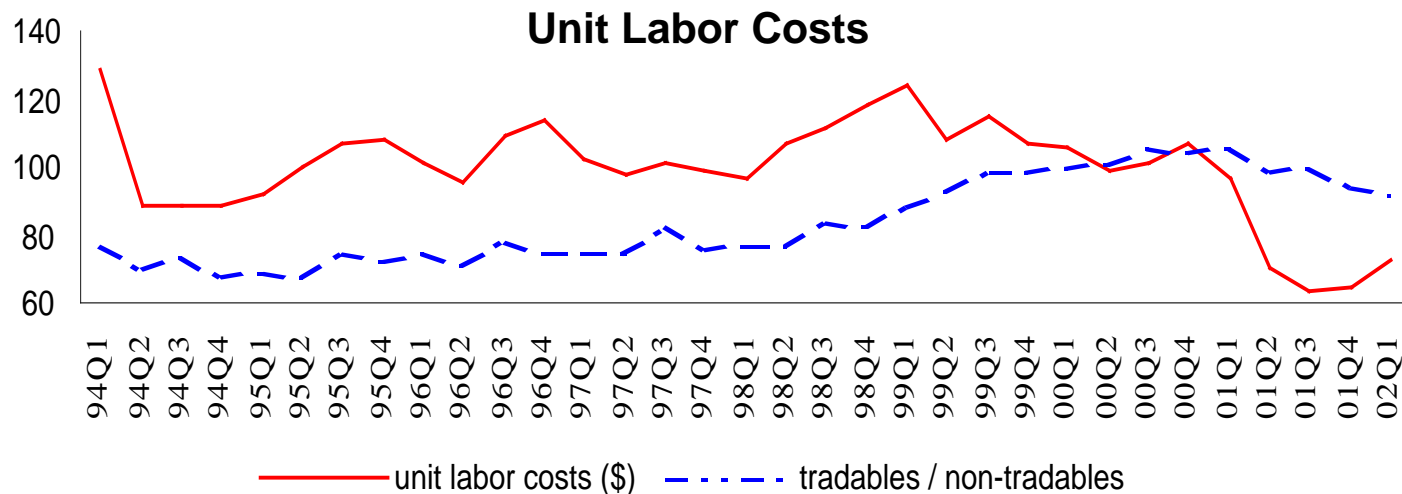
Turkish lira started to depreciate in real terms after May and...

Real Effective Exchange Rate

(\$1 + €0.77, producer price index for foreign goods & private manufacturing index for domestic goods)



...the cost-based real exchange rate indices point to an increase in competitiveness.



Growth: Signs of recovery are becoming more apparent

- ✓ A stronger-than-expected recovery to date suggests that the 3 percent GNP growth projection for 2002 should be comfortably met: GNP grew by 8.5 percent in the first half of the year.

❖ Production

- ✓ **A sharp recovery in business confidence** since October 2001 as a result of stability in financial markets and the implementation of the new economic program supported by the international financial institutions.
- ✓ **Better than envisaged performance in industrial production:** Industrial production rose by 7.4 % (y-o-y) in the first six months of 2002.
- ✓ **Increase in agricultural production:**
Agricultural production rose by 1.9 % in the first half of the year and the growth rate of agricultural value added is expected to be around 5 % in 2002.
- ✓ Strong increase in **inventory building and replacement investments in industrial sector:** The contribution of inventory changes to GDP growth was 8.5 % in the first six months of 2002.



Growth: Signs of recovery are becoming more apparent

❖ Demand

- ✓ **Net Exports:** The contribution of net exports to GDP growth was 2.9 % in the first quarter and -5 % in the second quarter.
- ✓ **Improved expectations:** Decline in uncertainties had a positive impact on investment and consumption decisions
- ✓ **Improved exchange rate stability and the downward trend in short-term rates:** This development promoted consumption and created a more conducive environment for investment decisions. As a result, the contribution of private expenditures turned positive in the second quarter of 2002.

Contributions of Aggregate Demand Components to Growth

	2001		2002	
	Q1	Q2	Q1	Q2
Private Expenditure	-5.0	-14.9	-6.4	1.9
Government Expenditure	-0.3	-3.1	-0.5	0.4
Net Exports	9.8	16.9	2.9	-5.0
Inventory Accumulation	-5.3	-8.6	5.9	10.9
GDP	-0.8	-9.6	1.9	8.2



Growth: Signs of recovery are becoming more apparent

- ❖ Both the production and demand side indicators, except the credit volume, confirm that a solid recovery is underway.

Indicators Supporting the Production Growth

		IMPORTS*	VELOCITY OF EFT	NEW BUSINESSES*	DURABLES PRODUCTION*	CAPACITY UTILIZATION RATE (%)	PROTESTED BILLS*	NON-AGRICULTURAL EMPLOYMENT (Thousand)
2001	I	-4.9	3.25	18.1	-6.5	69.8	48.0	12,954
	II	-30.1	2.36	-19.7	-28.3	69.9	100.6	12,905
	III	-29.6	2.41	-11.4	-19.1	71.6	80.7	13,199
	IV	-32.9	2.47	-26.2	-3.8	73.5	80.6	13,310
2002	I	-10.7	2.53	-7.3	24.4	74.0	-26.5	12,843
	II	19.1	2.50	17.1	68.1	75.9	-42.8	13,650

Indicators Supporting the Aggregate Demand Growth

		EXPORTS*	CREDIT CARDS*	CONSUMER CREDIT*	VAT COLLECTION*	AUTOMOBILE SALES	PRIMARY BUDGETARY EXPENDITURE*	NON-AGRICULTURAL EMPLOYMENT (Thousand)
2001	I	8.9	-	-	55.7	-61.9	22.2	12,954
	II	13.4	55.30	0.9	32.8	-71.1	43.8	12,905
	III	13.7	32.80	-38.6	62.4	-73.3	45.2	13,199
	IV	12.6	12.90	-49.0	91.7	-71.2	49.7	13,310
2002	I	4.6	17.10	-45.2	74.9	-62.0	90.4	12,843
	II	2.3	30.70	-24.9	81.3	-16.7	65.0	13,650

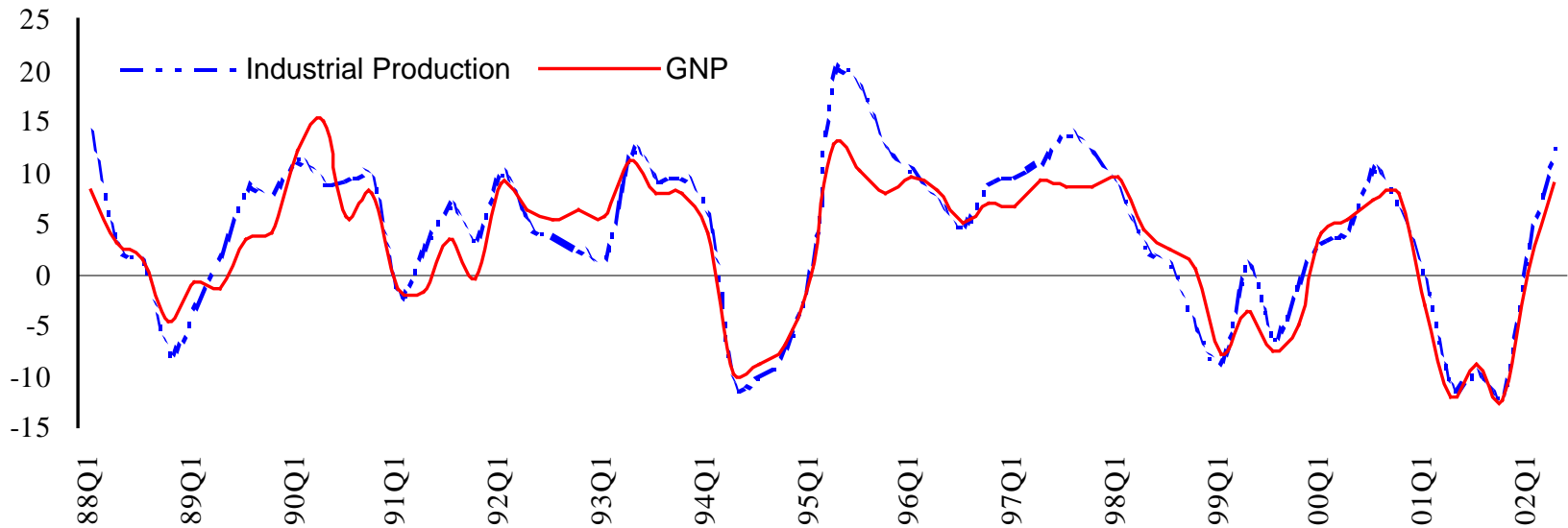
* Percentage change with respect to the same period of the previous year.



Growth: Signs of recovery are becoming more apparent

- ✓ The evolution of the industrial production until July suggests that economic recovery will continue in the third quarter as well.

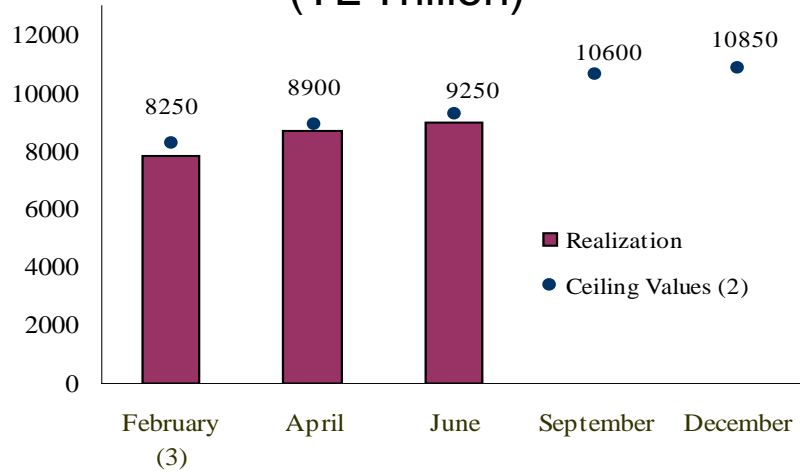
**GNP and Total Industrial Output
(Annual percentage change)**



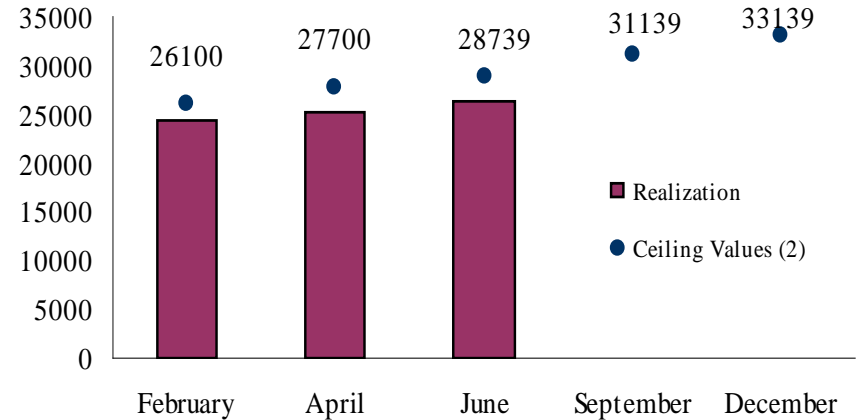
Recent Monetary Policy Actions

The CBT's Quantitative Targets are on Track

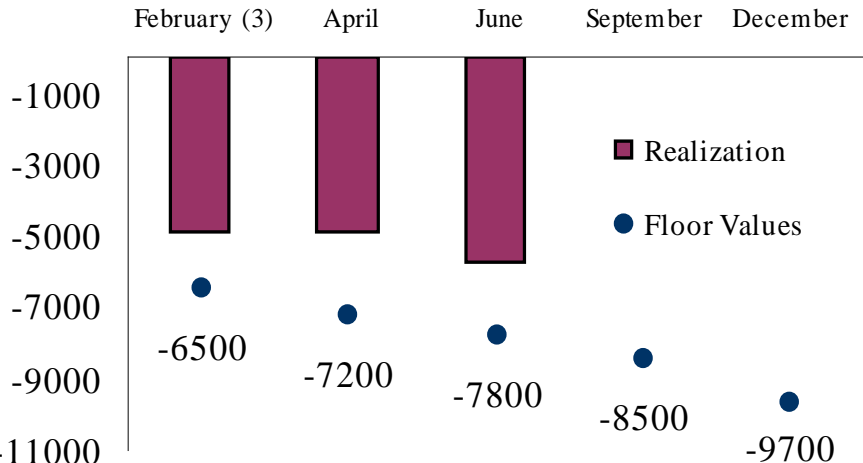
Monetary Base (TL Trillion)



Net Domestic Assets (TL Trillion)



Net International Reserves (USD Million)⁽¹⁾



(1) Defined as Net International Reserves of CBT minus (i) Treasury liabilities to the IMF (ii) Treasury FX denominated borrowing with an original maturity of less than one year.

(2) Target for end-February calculated as four working day average of February 11-12 and March 11-12, 2002, to take account of the transitory impact of the Bayram (religious holiday) on currency demand. NDA targets for June onward have been lowered by TL 161 trillion compared to January 18, 2002 to reflect the drop in required reserves following the SDIF's intervention in Pamuk Bank.

(3) Calculated by using the four working day average of Feb. 11-12 and March 11-12, to take account of the transitory impact of the Bayram (religious holiday) on currency demand.



Recent Monetary Policy Actions

Interest Rate Cuts

- ❖ **The favorable outlook for inflation led the CBT to lower the short term rates:**

Maturity	Quotations	Previous Rate	20 Feb. 2002	14 March 2002	8 April 2002	30 April 2002	5 August 2002
O/N	Bid	59	57	54	51	48	46
	Ask	62	62	61	58	55	53
1 Week	Bid	62	59	55	52	49	46

- ✓ In view of the interruption of the improvement in market sentiment and economic outlook between May and July, coupled with increased political uncertainty, the CBT refrained from further interest rate cuts.
- ✓ In August, however, improvements in the inflation outlook and favorable political developments led the CBT to lower its policy rate.

A Brief Overview of the FX Policy

- The CBT remains resolute to keep discretionary FX interventions outside the pre-announced auctions limited. If necessary, the CBT, without interfering with exchange rates reaching their market-determined levels over longer horizons, will smooth (temporary) excessive exchange rate fluctuations.
- Has there been a “fear of floating” in Turkey?

Evolution of the Volatility of Exchange rate, Interest rate, and Reserves

	Gross Reserves	O/N (Compound)	Dollar
Jan95 – Dec99	2.75 %	15.78 %	1.59 %
Jan00 – Feb01	2.62 %	95.93 %	1.91 %
Mar01 – Oct01	4.65 %	4.18 %	3.51 %
Nov01- Aug02	2.35 %	1.18 %	2.12 %

Floating Regime {

- Contrary to “fear of floating” argument, it seems that since the adoption of the float, the volatility of the exchange rate increased while the volatility of interest rates and reserves diminished. The role of the exchange rate as an adjustment variable has clearly increased since the adoption of the floating regime, while the role of interest rates and reserve movements as shock absorbers has declined noticeably.

The Eventual Monetary Policy Framework: Inflation Targeting

- **Nominal Anchor:** Under the floating exchange rate regime, inflation targeting (IT) will serve as the nominal anchor of the economy.
- **A High Degree of Flexibility:** Monetary policy will have a high degree of flexibility to respond to shocks, thanks to the absence of other objectives, i.e. an exchange rate target.
- **Communication:** Under IT, the CBT will aim to find the clearest way to share with the public the precise direction of monetary policy—what the target is and how the CBT is trying to achieve it—through periodic reports (Monetary Policy Report) and other means of communication with the public and markets.
- **Sustainable Debt:** Aligning the public's inflation expectations with the CBT's inflation target and removing the uncertainty risk premium in the interest rate will also improve debt sustainability.
- **Improved Policy Coordination:** Inflation targets are joint targets, determined together with the Government. The joint agreement on inflation targets will enhance the coordination between fiscal and monetary policy.
- **Increased Public Consciousness:** Evidence with the adoption of IT suggests that it fosters public awareness and acceptance of monetary policy decisions, which can help reduce the cost of disinflation and enhance credibility.



Monetary Policy Strategy–Inflation Targeting

- Significant progress has been made to satisfy the preconditions for the implementation of IT:
 - ✓ **The Central Bank Law** has been amended to ensure instrument independence, accountability and transparency; and the CBT enjoys full control over its credits.
 - ✓ **The Law on Public Debt Management** will bring about discipline and transparency in the public sector, and facilitate the adaptation of fiscal policy to inflation targeting.

- Progress on establishing the technical infrastructure:
 - Forecasting and policy analysis models**
 - The CBT is receiving technical support from international institutions and central banks implementing IT.
 - The CBT has been working intensively to develop:
 - ✓ economic databases and reporting packages
 - Inflation Expectation Survey for corporate and financial sectors
 - Daily retail prices analysis by using sampling methods
 - ✓ a near-term forecasting system incorporating a wide range of available information
 - ✓ a core quarterly macroeconomic model
 - ✓ a process for putting together a medium-term projection
 - ✓ procedures for presenting the results to the Monetary Policy Council



Monetary Policy Strategy–Inflation Targeting

- ❖ The CBT endeavors to enhance its credibility through:
 - ✓ *Achieving the established objectives.* Evidence to date suggests that the end year target of 35 will be achieved.
 - ✓ *Improving communication,* which is pursued with a view to communicate not only the CBT's quantitative objectives, but also the framework of mechanisms that will be used to attain these objectives. To this end, the CBT has been issuing Monetary Policy Reports and frequent press releases in addition to presentations by the senior Central Bank officials.



Monetary Policy Strategy – Inflation Targeting

It is important to highlight that IT is only one complementary ingredient in a broad strategy of institutional development and its success, among other things, hinges closely on:

- ✓ Fiscal responsibility
- ✓ Financial deepening
- ✓ Eliminating backward-looking indexation mechanisms in the economy,
- ✓ Flexibility in goods and factor markets to allow smooth adjustment to relative price changes



Conclusion

Overall, prudent fiscal and monetary policies along with deep seated structural reform measures included in Turkey's Medium-term Economic Program will lay the foundations of an economy that is:

- ✓ well-placed on the high road of sustained low-inflationary growth
- ✓ more resilient to adverse shocks
- ✓ less vulnerable to crises
- ✓ more equitable in income distribution
- ✓ more conducive to foreign and domestic investment
- ✓ as a consequence, better positioned to integrate into European Structures.

