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SOME COMMENTS ON THE RECENT ECONOMIC ISSUES IN TURKEY

HONG KONG

SEPTEMBER 1997

I. The Economic Trends of 1997

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

Here, I will first go over these trends briefly and then I will comment on monetary policy issues in Turkey. In that I will particularly dwell on the protocol the Central Bank has signed with the Treasury in July 1997.

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 to 13 and a half months as of September 1997.

Third, in the first five months of the year, the 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. 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 extension 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 and programmed manner.

Deterioration of the budget deficit in the first half of the year is another important trend of 1997. Despite a real increase in the total income and a real decrease in the total interest expenditure, the share of the budget deficit to GNP increased by about 1 percentage point to 8 percent. Increased transfer payment to social security institutions is to be blamed for this deterioration in the budget.

The lack of sufficient access of the public sector to foreign borrowing is another trend prevailing in the Turkish economy in 1997. Turkey has been a net repayer of its foreign debt for the fourth consecutive year now. In the last three years, Turkey repaid to abroad around 10 billion US Dollar on a yearly basis. This creates additional pressures on the cost of financing of the budget from the domestic sources.

The last trend I will mention is the BOP developments. Balance of payments developments are on the line. This is because of liberalization of balance of payments namely liberalization of capital and current accounts. The current account deficit is 4 billion US Dollar which is around 2 percent of GNP by the end of 1996. For the first six months of 1997, the current account deficit is 1.9 billion US Dollars. This figure is slightly higher than the last year's figure for the first half of the year. Despite the declining foreign suitcase trade, significant improvements have been observed in exports as well as tourism revenues. Export revenues increased by 10 percent while tourism revenues increased by 50 percent in the first half of the year. Increase in imports for the same period was a mere 7 percent. Official reserves of the Central Bank continued to increase and are close to 20 billion US dollar as of September.

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 controling 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.

III. Protocol Between the Central Bank and the Treasury

Before going through the implications of this protocol on monetary policy, its importance should be cleared out. The Treasury and the Central Bank are two authorities affecting the liquidity in the system. The Treasury is responsible for the cash and debt management on behalf of the government. The Central Bank's main task is to achieve and sustain the stability in financial markets. This objective can be realized by controlling the liquidity in financial markets. Because of its high public indebtedness, the government is the biggest player in the market. Because of this, the Treasury's and the Central Bank's objectives are very interrelated since the actions of both affect liquidity in money markets. Therefore, the coordination between the both daily and long-term policy implementations of the Treasury and the Central Bank is very important for the stability in financial markets.

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 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: 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 the inflation, the Central Bank should have more autonomy in implementing its policy and monetary policies (or programs) should be supported by fiscal policy.

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 well known recipes of a stabilization program.

I see this protocol as the initial step of such a stabilization program aiming at reducing the inflation in Turkey once and for all.

All of us here, have observed serious crises in South Asia recently. Thanks to the economic fundamentals in Turkey, we have not faced this unpleasant situation mainly because of a non-appreciated currency, strong balance of payments positions, 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.

Decisive efforts of the government in order to implement structural reforms and inflation reduction program will put the Turkish economy in a healthy and sustainable situation. I hope we will be in a position to observe this situation over the coming months.