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DEVELOPMENTS IN THE TURKISH ECONOMY DURING THE FIRST HALF OF 1997, MONETARY POLICY AND EXPECTATIONS FOR THE SECOND HALF OF 1997

The Turkish economy during the first half of 1997 has shown positive trends with continuing growth and declining inflation. The extension of the maturities of Turkey's domestic debt and decreased interest rates, especially at the beginning of the year, have contributed to these positive trends.

Although GNP figures for the first half of 1997 are not yet available, the average growth rate of manufacturing production was 6 percent during the first four months of the year. This indicates that the growth rate for the entire year will exceed the expected 4 percent. A survey of economic trends and the observed increase in the quantity produced in the industrial production sector indicate that this growth is due to an expansion of domestic demand. The main factors behind the increase in domestic demand are large wage increases in the last couple of years and a relative decline in interest rates, the inflation rate, and premium payments.

The most important accomplishment of the first half of 1997 was the lengthening of the maturities of Turkey's domestic debt and the decrease in interest rates. The improvement in the maturity structure of domestic debt began in 1996 and has continued during the first half of 1997. For a long time, the longest term for domestic debt was four to five months. It was the Treasury's determination and willingness to implement its domestic borrowing strategy that made it possible to extend the maturity structure of domestic debt 15 months. Interest rates on domestic debt have also fallen during the same period. The market's acceptance of the extension of the maturity structure of public sector borrowings, and the increased ability to roll over domestic debt, have lowered the risk premium attached to the increased Treasury's borrowing. The decline in both inflation and inflationary expectations have also helped lower domestic interest rates during this period.

The Central Bank can influence nominal interest rates by changing inflation and inflationary expectations, and can influence real interest rates by decreasing uncertainty in the financial markets. The decline in interest rates observed during the first half of this year was accomplished in this way by the Central Bank.

In this connection, I would like to add a few words about borrowing with indexed bonds, called WPI.X. This recently introduced instrument had the expected effect of extending the maturity structure of domestic borrowing. The continuation of this form of borrowing would add to the political will for fighting inflation, since the government that offers this instrument will benefit by decrease in interest costs. But even these advantages to do not yet apply to this year's budget, tax revenues are expected to rise in real terms due to last year's growth and the drop in the inflation rate during the first half of the year. The primary budget surplus is also expected to continue, because no factors that could cause an overrun of budget expenditures have occurred. This trend must continue if we are to have a financeable budget deficit during the second half of the year.

The balance of payments figures announced for the end of March 1997, the current account deficit for the first part of the year is not expected to be dangerously high. Exchange rate policy aimed at stabilizing the real exchange rates has a positive effect on exports and halting the "scale effects" of entry into the Custom Union with the European Union has led to a limited rise in imports. These developments make it possible to expect that the current account deficit at the end of 1997 will indeed be financeable.

The stable movements in exchange rates observed for the last couple of years also continued during the first half of 1997. The continued absence, in spite of the drop in interest rates, of demand pressure on exchange rates arising from current account imbalances and the attractiveness of investing in assets denominated in Turkish lira, provides the basis necessary for stable exchange rates to develop.

The real exchange rate index (base year 1987) continues to move within a narrow band (Graph 1).

<GRAPH 1>

I should emphasize that the Central Bank's exchange rate policy is a natural result of the economic situation in Turkey during this period.

Anti-inflation policies implemented by the Central Bank alone can have no durable effect on Turkish inflation, which today must be regarded as chronic inflation. Stable exchange rates can be seen as a cushion against a possible crisis in an economy where there is high inflation and a lot of uncertainty. Maintaining real exchange rates at a realistic equilibrium level can attract financing for the current account deficit and prevent fluctuations in short-term capital movements.

Developments in the Central Bank's Balance Sheet during the first half of 1997 indicate that the increase in domestic assets was limited and that the main source of the increase in the Turkish lira liabilities of the Central Bank was the growth of net foreign assets. Graph 2 shows the ratio of foreign assets to total foreign liabilities. A value for this ratio of less than one means that the Central Bank has an open foreign exchange position. This ratio, which has remained below one for years, rose above one for some time in 1995. Since last year the ratio has been above one. In other words, the increase in Turkish lira liabilities of the Central Bank during this period reflected an improvement in the net foreign exchange position of the Bank.

<GRAPHIC 2>

Credit extended to the public sector by the Central Bank is declining both as a share in Balance Sheet and real terms. For the last three years, comparing May to May figures, credits to the public sector increased by 45 percent, 25 percent, and 39 percent, while the inflation rates were 78 percent, 75 percent, and 72 percent respectively. By the end of May 1997, taking as a basis for comparison the figures for May 1994 for price index and public sector credits, we can conclude that the credit extended by the Central Bank to the public sector has decreased by 50 percent in real terms, with about 25 percent of the decline occurring in 1997. (Graph 3)

<GRAPH 3>

The share of total public sector credits in the Central Bank's balance sheet shows a similar trend. This ratio, which was 50 percent at the end of 1994, had declined to 23 percent by the end of May 1997. (Graph 4)

<GRAPH 4>

The share of this item should be lowered further until it only includes Treasury bills being held for the purpose of conducting efficient open market operations in the medium term.

As a result of policies pursued by the Central Bank since the late 1980s, the Central Bank now has a sounder balance sheet. Today's policy implementations indicate that this trend will continue. Having a sounder balance sheet will help the Central Bank to conduct an effective monetary policy. If the same path is followed by other state-owned commercial banks, our financial system will have a stronger structure.

To sum up, I can say that during the first half of 1997, the Central Bank, in cooperation with the Treasury, has reduced its credits to the public sector in real terms and extended money at the expense of increasing its net foreign assets. During the same period, temporary increases in liquidity demand (due to salary payments and religious holidays) were met by the Central Bank through open market operations. The decreasing trend of inflation and interest rates and the continuation of economic growth fed the demand for liquidity during this period. The issuance of currency was determined accordingly.

As to inflation developments during the first half of this year, the annual increase in the wholesale price index turns out to be 75 percent by the end of May 1997, compared to 85 percent at the end of 1996. It is expected that by mid-1997 the 12-month inflation rate will be about 70 percent. This figure is close to the rate foreseen by the Central Bank and announced at the end of 1996.

By analyzing inflation developments during the first five months of the year, we can say that price increases in the energy sector are above the average, those in the agriculture sector were smaller than average, and those in the manufacturing sector were at the average. As a matter of fact, developments in the agricultural prices prevented inflation from falling further.

In addition by the end of May 1997, the 12 month inflation rate in the manufacturing sector is equal to the rise in the exchange rate basket during the same period. This development showed that the Central Bank had made a credible announcement about inflation and that the manufacturing sector had shaped its pricing behavior accordingly to that forecast.

Despite a temporary and relative drop in the inflation rates, today's inflation rate is at an unacceptable level and represents the main problem of the Turkish economy.

The economic developments sketched above in broad outline paint a rosy picture for us for the rest of this year. The economy grows and inflation falls temporarily. The financial markets are stabilized, and the maturity of domestic debt has been extended. To take advantage of these positive developments and to prolong them, the Central Bank has started discussing the implementation of a medium-term plan. Now there is a consensus in each part of society about implementing a disinflation program. Technical studies undertaken by the Central Bank in support of such a program are continuing. The main purpose of these technical studies is to provide the necessary infrastructure for implementing this program as soon as the political will is achieved.

By June 1997, some positive developments seem to be losing their effects on the economy. There are signs that the decreasing trend of the inflation rate has halted.

The high agricultural support prices announced last month and a rise in employee wages seem to be encouraging already high domestic demand. This development may generate increasing inflationary pressures.

The emergence of a rising trend in inflation for the second half of the year shows that there is “sufficient” reason to implement a tight monetary policy.

During the second half of the year, it would not be advisable to ease government spending and worsen budget deficits because of a relaxation due to low domestic debt service. Otherwise there will be upward pressure on inflation.

Two factors supporting the Central Bank’s anti-inflation policies will be the continuation of budgetary discipline during the second half of the year, and the primary budget surplus.