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TURKEY INTO THE FUTURE

Ladies and Gentlemen,

I can summarize the most important feature of the Turkish economy in a single sentence: our economy is robust despite the persistence of high inflation for over a decade.

How can an economy possibly be strong with persistent high inflation?

First, I would like to explain the robustness of our economy. Then, by stating the main reasons for the inflation, I will attempt to show the negative effects of the environment of high inflation on our economy.

Despite the continued high inflation, output growth is still strong. For the last couple of years the average growth rate has been 7 percent. This growth rate is well above that of OECD countries with much lower, single-digit inflation rates. Despite its erratic pattern, Turkey's growth rate over the last 15 years has averaged 4.5 to 5.0 percent, which indicates fairly rapid growth.

Along with rapid growth, the composition of our GNP has changed dramatically. The increase in the shares of the services and manufacturing sectors in gross domestic production has been remarkable. At the same time, the share of the public sector in industrial production has decreased.

The dynamism of the Turkish economy comes essentially from the private sector, which has also been mainly responsible for capital formation.

In 1980, Turkey made great progress by opening its economy and integrating it into the world economy by reducing protectionism. During the 1980s, foreign trade was the main motor of the Turkish economy. Today, the share of the external sector in GNP is around 40 percent, indicating a considerable degree of openness of the economy.

In addition to these advances and its dynamic population, Turkey enjoys a unique geographical situation. Turkey is located at the crossroads between Europe, the Middle East, and Asia. As an emerging market and a destination for investment, and in light of developments in Central and Eastern Europe and the Black Sea region, this location gives Turkey an advantage from the standpoint of trade and investment flows.

I would like to mention another important aspect of our economy. While Turkey has had persistent high inflation for years, it has never let inflation get out of control. Unlike many other countries, Turkey's continuous high inflation has not led to hyperinflation. Turkey has had to weather serious balance of payments crises once or twice, but these were fairly easy to reverse. Indeed, the recovery of the non-agricultural private sector from the financial crisis of 1994, despite unsettled political conditions and high interest rates, was nothing short of astonishing.

Following the financial liberalization and reform program, the Turkish financial system showed remarkable improvement. The Turkish financial system has a solid technical base and is integrated quite well with the global financial markets. The Istanbul Stock Exchange is one of the best performing among the emerging market countries.

These facts demonstrate the robustness of our economy. Of course this vigor is threatened in several ways by the continuos high inflation. First of all, it keeps Turkey from growing at its potential. The uncertainty created by inflation has a damping effect on investment. This affects future output potential. In addition, a study by the Research Department of the Central Bank indicates that Turkey would have grown significantly faster without that high inflation rate.

Another important consequence of inflation is its effect on the budget. Since most government revenues are not indexed to inflation, while wages and transfer (interest) payments are indexed, the budget balance constantly deteriorates. High inflation also creates incentives to delay tax payments and encourages tax evasion. All these circumstances hinder fiscal management.

Another sector of the economy which is badly disrupted by high inflation is the financial sector. Under conditions of high inflation, financial intermediation between lenders and borrowers is less efficient. One indicator of poor financial intermediation is a low level of bank lending. The ratio of loans made by banks to M2Y (total bank deposits) fell from 75 percent in 1987 to about 50 percent in 1996. In other words, one-half of bank resources go to government financing or is held as Treasury bonds. This should be an important policy argument in favor of lowering inflation.

High inflation also gives an incentive to switch from domestic to foreign currencies as a store of value, which is called currency substitution. When currency substitution is widespread and volatile, the relationship between nominal GDP and domestic

currency monetary aggregates is unpredictable, robbing the monetary aggregates of their usefulness as an indicator for monetary policy.

Since the average maturity of domestic debt is short and there is widespread currency substitution, the effectiveness of monetary policy operations is reduced. Open market operations become ineffective for tightening or loosening monetary conditions since system-wide liquidity measured by M2 or M2Y doesn't change, because government securities, due to their short maturities and high liquidity, are similar to money deposits held for transaction purposes.

The Central Bank is providing, but at a diminishing rate, significant financing to the Treasury. By 1998, the Treasury's access to Central Bank advances will be lowered to 3 percent of the increase in total budget appropriations. Even though this looks like a small amount, if fully used all at one time it would still hamper the fight against inflation, since Turkey has a relatively low money base.

Turkey's Banking System is relatively small. Total deposits of the Banking System amount to about US$ 50 billion. This is relatively low, whether by comparison with other (European) countries or with the public sector borrowing requirement (PSBR). This drives up interest rates to very high levels in real terms.

Under conditions of high inflation, an economy is in a precarious situation. Under such conditions a country cannot be succeed in attracting foreign investment. Turkey has been attracting much less foreign investment than any country in a similar position.

Consequently, persistent high inflation is sapping the vigor of the Turkish economy. Inflation is costly, both socially and economically, to our country. So we need to get to single-digit inflation as soon as possible. The first step toward achieving price stability is correct identification of the problem. That is, what are the reasons behind our "persistent" high inflation? Why have some attempts to achieve price stability been unsuccessful?

- The very first reason for Turkey's inflation is the continuing and growing budget deficit and PSBR. The PSBR as a percent of GNP was reduced during the two years 1994 and 1995. But in 1996, this trend was reversed and it rose again to 11.3 percent of GNP.
- The second important variable affecting inflation in Turkey is high inflationary expectations. Inflationary expectations feed inflation and can only be eliminated by persistent anti-inflation policies and credible public policies generally.
- Coordination between fiscal and monetary policies is poor. Sometimes monetary and fiscal policies have had conflicting objectives.

Even though Turkey's inflation has unique characteristics, other countries have encountered similar problems. Now it is well known how to bring inflation down. It will require a program supported by structural reforms. It will require perseverance. It will also require coordination of policies.

The fiscal dimension of inflation has always been very important. If the authorities increase their reliance on revenues from the inflation tax, they risk triggering hyperinflation.

Fiscal adjustment is the key to such a program, coupled with a tight monetary policy and strong measures for overcoming inflationary inertia. The elements of a fiscal adjustment program are now well known. Bold steps must be taken to accomplish these reforms. The necessary conditions for the success of such a program are the good coordination of policies and a strong political will.

As a first step toward achieving the necessary policy coordination, a protocol has been signed by the Treasury and the Central Bank. This protocol shows the intentions of the Treasury and the Central Bank to cooperate in policy implementation, and lays a solid basis for preparing and announcing a monetary program. Tight monetary policy aimed at price stability will be supported by the activities of the Treasury. According to the protocol, reducing inflation will be the first priority of both institutions.

Of course this step should be supported by a sound fiscal adjustment program. This program will include both measures to increase revenues and reduce expenditures. Reformation of the taxation and social security systems are immediate measures for improving the fiscal side of the economy.

I would like to add one more important point about developments in the Turkish economy. As a result of 30 years of policies and steady progress in reducing trade barriers, Turkey has concluded a Customs Union with the European Union last year. In addition to other benefits, this integration with the European Union is expected to stimulate Turkey’s private sector to become competitive in the world economy. On the other hand, this year in which we completed Custom Union with European Union, we did not have a large trade deficit contrary to our expectations. Our ultimate goal is complete integration with the European Union. This will require a strong and solid economy, able to satisfy a series of criteria for various macroeconomic variables.

On the way to integration with the global economy, Turkey must also have an independent, modern central bank. A modern central banking mentality must include the following elements, in order of importance:

1. The Central Bank should have a precisely defined target, and these targets should include price stability.

2. Recent monetary policy practices and theoretical studies reveal that there is a trend for Central Banks to announce short- and medium-term policy targets to the public.

3. Governments should give authority and independence to their central banks in making policy decisions and choosing policy instruments.

4. Central banks should not accept fiscal responsibilities. If the government relies on the central bank to finance its deficit and manage its debt, the central banks will move away from its primary objective. Under such circumstances, central

banks cannot be held responsible for their implementation of policies or their fulfillment of announced targets.

5. By their nature, central banks should be accountable institutions. This accountability has two aspects. It means that central banks can account for the policies they implement in order to meet the targets they have announced to the public. It also means that the central bank can explain and defend its short-term activist monetary policy practices to the authorities to whom it is responsible.

Today's central banks have a microeconomic responsibility that is inseparable from their macroeconomic objectives and functions: namely, financial stability. Especially in light of the importance of payments systems, central banks are supposed to prevent the occurrence of systemic risk in the financial system. In addition, the increasing integration of the financial markets is leading to the expansion of international capital movements and of foreign exchange operations. Consequently, it is becoming harder to establish and maintain stability in the financial system. But it must be kept in mind that a stable system is a prerequisite to price stability. And both financial stability and price stability are necessary for sustainable economic growth.