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PRESS RELEASE

GENERAL FRAMEWORK OF THE MONETARY AND EXCHANGE RATE POLICY IN 2003

A- THE IMPORTANCE OF PRICE STABILITY

1. We have just left behind 2002, which marked a significant milestone towards the stabilization of the economy. In 2002 the Turkish people came to understand how important it is to achieve price stability, being the precondition of a sustainable growth and high employment.

2. Economic growth does not conflict at all with the price stability in the medium- and long-term. Various international studies have shown that there is a strong correlation between price stability and growth. The average growth rate is higher in the low-inflation countries where price stability is attained, whereas it is lower in the countries that suffer from high inflation.

3. In fact, it can be observed that also in Turkey there has been an inverse relationship between growth and inflation in the last 30-years. Examining the ten-year periods in Turkey, we can clearly see that the average inflation rate has increased, while the growth rate has slowed down on one hand, the output and employment level have become increasingly

unstable on the other. Despite this fact, we see that some arguments are being put forward claiming that a looser monetary policy or a little inflation could relieve the employment problem and boost the economic growth. This misleading idea is based on the view that according to the Article 4 of the Central Bank Law concerning fundamental duties and powers, the Central Bank could well support the growth and employment policies of the Government in the post-crisis recession and so the economy could recover quickly. However, the same Article states openly that the primary objective of the Central Bank is the price stability, and the Central Bank will support the Government's growth and employment policies on condition that they do not conflict with the price stability. In other words, after having experienced many crises, what Turkey needs most is the sustainable growth and this will be possible only if the price stability is achieved. Our country has been living with countless crises in the last 30 years. What our country has lacked in the meantime are sustainable growth and sustainable employment level, which is possible only if inflation is reduced to single digit levels.

4. Inflation is not only an economic problem, but also a social and a moral problem. As we often explain to the public under the heading of "price stability," if the drawbacks of inflation are better understood by all sectors of the economy, the fight against inflation will become easier.

5. Many stabilization programs have been implemented in order to reduce the inflation that our country has been faced with for nearly 30 years. As a matter of fact, although some of these programs have succeeded in bringing down the inflation rate, political instability, delays in structural reforms, and lack of fiscal discipline due to short-term political considerations have made these achievements temporary.

6. The absence of a lasting success in the fight against inflation has caused the economic units to consider every new stabilization program as "business as usual". This lack of confidence has become an obstacle to elicit much needed public support for programs. For that reason, every new stabilization program has lost its credibility simply at the beginning, and the ambitious targets have been far from convincing.

B- AN EVALUATION OF THE MONETARY POLICY IN 2002

7. The current economic stabilization program that was initiated in 2002 aims at bringing inflation down to 12 percent in a three-year period, and then to single digits. However, this program differs greatly from the previous programs. In fact, the current program got started on a solid footing by making use of several advantages the other past programs did not have. These were; the amendments made in the Central Bank Law for the Central Bank independence, the radical measures taken for a healthy banking system, the realization of basic structural reforms to a great extent by gaining momentum in 2001 and 2002, and the measures taken for the continuation of fiscal discipline. All of them are important for achieving a stable economy.

8. At the beginning, the targets of the 2002 program were considered as being somewhat ambitious by markets according to the then prevailing conditions. The annual inflation target was calculated as 35 percent, the primary surplus was determined to be 6,5 percent of the GNP, and the GNP growth rate was envisaged to be 3 percent.

9. Several assumptions were made when designing the 2002 monetary and exchange rate policy that was announced on January 2, 2002. It was assumed that there would not be any deviation from the budget discipline, and economic reforms including the banking reform that were initiated in 2001 and aimed at laying the foundation of a long-term sustainable economic growth would continue uninterruptedly. It was believed that these measures would eliminate concerns over the sustainability of public debt stock.

10. In the 2002 monetary policy, it was planned to conduct a monetary policy strategy focused on the future inflation, which is called as "implicit inflation targeting". Under this strategy, although targets for base-money are fixed as of periods consistent with the inflation target, monetary policy decisions are essentially made by considering the developments in future inflation. With this dual strategy, it is aimed to solve the problems created by difficulties in estimating the money demand in the process of declining inflation and currency substitution, as well as by weak relationship between monetary aggregates and inflation witnessed in recent years. Therefore, the implicit inflation targeting has become a strong anchor beside base money. Under the floating exchange rate regime it has been stated that short-term interest rates, which is the main policy instrument, would be used actively for the price stability goal only.

11. In 2002, it was foreseen that the floating exchange rate regime consistent with the economic foundations would be fully established. In this framework, the Central Bank announced in the New Year that it would intervene in a limited manner to exchange rates only to prevent excessive volatility without targeting a certain level. Moreover, the Central Bank announced that it would hold foreign exchange buying auctions in order to increase foreign exchange reserves.

12. At the start of 2002, 35 percent inflation target, and 3 percent growth target were found unrealistic to reach, as it has been in the past programs. The annual inflation expectation for 2002 was 48,3 percent, 13 percent above the target at the beginning of the year, while the growth expectation was 2,7 percent, 0,3 point below the predicted 3 percent growth.

13. However, the bubble in the exchange rate, which had emerged starting from June 2001, exploded thanks to the strong support provided by international institutions in view of the assurance given by the government that there would be no deviation from the fiscal discipline also in 2002, as well as the expectations for a strict implementation of an ambitious and consistent economic program. Accordingly, exchange rates showed a downward trend in real and nominal terms until April 2002. Persistence in tight fiscal and monetary policies and continuation of structural reforms increased the confidence of the public in the program. Inflation dropped to lower levels due to sluggish domestic demand and the downward trend of exchange rates along with the increased confidence in the program. In the beginning of June, the gap between the year-end inflation expectation and the year-end inflation target, which can be considered as the measure of the credibility of the Central Bank, narrowed from 13 points to (minus) – 0,6 point. This was achieved for the first time after long years.

14. During this period, an apparent reverse currency substitution process started in line with the improvement in inflation and inflation expectations. In other words, residents began converting their foreign currency savings into Turkish-lira denominated investment instruments. For this reason, the Central Bank decided to enhance its foreign reserves by means of foreign exchange buying auctions. On the other hand, expected real interest rates dropped to 15 percent in parallel to the recovery in expectations.

15. Starting from May 2002, exchange rates and interest rates entered into an upward trend markedly, as a result of the perception of political uncertainty and the concerns over the sustainability of the current program. The rise in exchange rates boosted the inflation trend temporarily. In this process, the Central Bank stated several times that the concerns were exaggerated and the likely negative impact of elections would not do a significant harm to the Turkish economy, since the majority of structural reforms were already realized. The Central Bank also expressed that the implementation of an election economy to the extent as experienced in the previous years was out of question, and it was highly likely that the current economic program would be sustained in the next period as well, without diverging from its fundamental principles.

16. The Central Bank set the short-term interest rates, the main monetary policy instrument in 2002, exclusively within the framework of its primary objective of price stability, and pursued a policy focused on the future inflation under the principles that were announced in the beginning of the year. In line with the favorable developments in inflation, short-term interest rates were cut six times during 2002. Overnight borrowing interest rate was decreased from 59 percent to 44 percent, while one-week borrowing interest rate from 62 percent to 44 percent.

17. Starting from August 2002, exchange rates started to stabilize. Moreover, the Turkish lira had appreciated until early December resulting from the expectations that the new government would stick to the current stability program after the general elections, and the favorable responses by domestic and foreign investors to the important steps taken in the process of accession to in the European Union. Furthermore, a remarkable improvement was observed in the expectations concerning the general economic situation starting from September 2002.

18. However, when it was understood that the primary surplus target for 2002 could not be reached, expectations began arising for necessity of taking concrete measures in order to eliminate the causes thereof, which might happen again. In addition, certain steps that caused concerns about the continuation of structural reforms and fiscal discipline had a negative impact on expectations, even though these steps were abandoned. Along with these reasons, the Iraq issue pushed the real interest rates up as a potential exogenous factor.

19. At this point, it should be kept in mind that in countries with high debt stock, the expectations concerning the sustainability of domestic debt would determine the fundamental dynamics of these economies. There is no doubt that reinforcing the economic foundations via fiscal and monetary measures, and making radical changes in the economic structure that leads to loose policies will have a positive impact on these expectations. But these alone are not sufficient. Providing accurate and clear signals concerning the current program and the additional measures to be taken is vital as well, in order to help shape expectations.

20. Despite the perception of political uncertainty and the climate of election, it is estimated that the inflation will realize at about 31 percent, which is 4 points lower than the annual target of 35 percent, while the growth at about 6.5 percent, more than two times than the estimated 3 percent. Actually, the Central Bank announced the potential sources of growth in the very beginning of 2002, and the developments materialized in this direction. These favorable developments took place thanks to the structural reforms, tight fiscal policies, despite some delays in the second half of the year, and the Central Bank's monetary policy, which is exclusively focused on inflation. When the inflationary developments during the last two years are examined, reducing the inflation rate from the 70's percent level by averting the danger of hyperinflation that might have arisen due to the monetary expansion after the February 2001 crisis, and despite the resistance of certain sectors, to the 30's percent level - the lowest level of the last two decades- should be deemed a great success. Nevertheless, this does not change the fact that Turkey is still among the countries with the highest inflation rate.

21. On the other hand, the monetary targets specified in the 2002 monetary policy were reached. The base money, which is used as nominal anchor in the monetary program, realized at TL 10.720 trillion calculated on the average of the last 5 working days of December 2002, remaining below the target of TL 10.850 trillion.

C- MONETARY POLICY STRATEGY FOR 2003

22. Pursuant to the Central Bank Law, the inflation target is set jointly by the Government and the Central Bank. The inflation target for 2003 has been set as 20 percent, and the growth rate has been forecast as 5 percent as announced through the joint press release of the Ministry of State and the Central Bank on December 17, 2002. If the slippage in the public finance is adjusted and the fiscal discipline is maintained, if the principles of the current program are fulfilled and the structural reforms are carried out, it will be possible to maintain the favorable economic developments in 2003 as well, despite the external shocks such as Iraq issue. In this context, it seems very likely to meet the inflation target of 20 percent, and the growth forecast of 5 percent, which have been set for 2003 together with the Government.

23. As was the case in 2002, the 2003 monetary policy of the Central Bank will again rest upon price stability goal, as stated in the amended Law; and the short-term interest rates, as the main monetary policy instrument, will be used actively to attain the inflation target exclusively. The "implicit inflation targeting" strategy, the success of which was proven in 2002, will be pursued until we openly initiate the inflation targeting regime, and the short-term interest rates will be determined according to the future inflation. The base money will continue to function as a supplementary anchor. However, it is not possible to fight against inflation by merely using monetary policy. The battle against inflation cannot be won unless fiscal discipline is ensured and the reform process affecting expectations directly is implemented without interruption. Therefore, the uninterrupted implementation of fiscal discipline and reforms will be necessary for the success of the disinflation efforts. It should be born in mind that the ultimate goal is achieving price stability, and it can only be attained with a long-run struggle without any relaxation.

24. The Central Bank has completed the technical groundwork for transition to inflation targeting regime. In this context, short- and medium-term inflation estimation models have been set up; surveys have been conducted to evaluate the expectations of economic agents for inflation, and the general course of the economy; detailed studies have been conducted on inflation developments, and the results have been made public. Moreover, the Central Bank is ready for the inflation targeting in terms of its duties and responsibilities entrusted by the amendments made to its Law. However, the success of inflation targeting regime calls for a predictable fiscal policy, in addition to the preparations made by the Central Bank. Accordingly, the exact date of the initiation of the official inflation-targeting regime will be announced after the targets of fiscal and incomes policies for 2003 have been finalized, and the effects of the external factors have been evaluated.

25. With regard to price stability, 2003 holds favorable developments as well as important risks. The formation of a stable government after the elections, the positive economic growth, the fact that the floating exchange rate regime that enables the Central Bank to focus on inflation has got established largely, and the better inflation prospects compared with early 2002 are the principal favorable developments. Actually, while the gap between the inflation expectations and the targeted inflation was 13 points in 2002, the same gap for 2003 has come down below 5 points. This provides evidence that the confidence in the program has increased.

26. Risks can be divided into two groups as the ones emerging from external shocks, and those stemming from the policies implemented and economic developments. The developments concerning Iraq constitute a major external shock probability. It is evident that a military operation in Iraq would create pressure on exchange rates, and on oil prices at least for a certain period, and would have adverse effects on the Turkish economy. The adverse effects of such an operation on the general course of the economy, and on the inflation will be minimized, if the markets are persuaded in the continuation of structural reforms and the public finance discipline. The internal risks are as follows; inflation pressure exerted by increase in domestic demand, persistence in the backward looking pricing behavior, failure to restore fiscal discipline, obstacles to the reform process -especially to the banking reforms- and mismanagement of inflationary expectations.

27. It is essential to make a clear distinction between the risks stemming from economic developments we can almost fully control, and the risks stemming from external shocks like Iraq over which we have either little or no control at all. It should be born in mind that, even if it were not for the Iraq risk, adverse external shocks like the "event of September 11" or natural disasters are likely to occur. Therefore, we must absolutely stick to the economic stability efforts to lessen the vulnerability of economy to external shocks.

28. The growth rate, which is expected to be around 6.5 percent in 2002, stems mainly from the building up of inventories that have reached their normal levels again due to high exports performance and demand expectations, despite the lagged recovery in the European economy. Meanwhile, increase in consumption and investment spending has remained limited. The 2003 growth forecast of 5 percent is mainly based on the expectation that investment and consumption expenditures will increase, along with the continuation of increase in exports. Within this framework, domestic demand is expected to pick up substantially in 2003 with the return of confidence. At this point, the private sector pricing and incomes policies will become as much important as the public sector pricing, salary and wage policies. Increments in public prices, especially of public wages and salaries, which are considered as a test for the Government in fighting inflation, will have a direct effect on the expectations. Also, it has been earlier stated in the press releases of the Central Bank that any revival in domestic demand should not be perceived by the private sector as an opportunity to increase their profit margins. This is very important for the disinflation efforts, as well as for minimizing the cost of disinflation process. It should be underlined once again that any cut in interest rates will only be possible if the inflation rate comes close to the targeted level, when it is considered that the Central Bank sets the interest rates with the ultimate goal of attaining price stability and within the framework of the inflation target. Therefore, the sustainability of a revived domestic demand can only be achieved if the private sector determines its pricing and incomes policies in line with the targeted inflation. The restructuring process in the public sector should also be pursued by the private sector, and the profitability should depend on the productivity increase. Consequently, bearing in mind the economic, social and moral damages of inflation, the disinflation process must be supported actively. Such behavior will be in the benefit of all sectors of the economy.

29. Monitoring the inflationary expectations in a constructive way is an important factor in the success of disinflation efforts. Inflation expectations can be easily affected in the worst way, just by giving an impression of a deviation from the current program or the structural reforms -especially the banking reform-, even if there is actually no intention of it. Therefore, it is very important for the success of the program that each and every economic unit sticks to the program being implemented, fulfills its duties in coordination with other institutions. The public must be convinced that there will be no deviation from the main track. At this very point, the primary surplus becomes a significant element of the economic program. A primary surplus target that is consistent with the economic policy will alleviate the debt sustainability problem, which in turn decreases the risk premium. Any decrease in the risk premium will bring down the real interest rates, making the rollover process smoother. Increasing the capacity of debt rollover will stimulate an improvement in the expectations and confidence, alleviating the economic revival and the disinflation efforts. Within this framework, in countries where debt rollover is a problem due to high debt stock, a higher primary surplus is not an obstacle to growth, but mostly a contributing factor. Therefore, also in Turkey where sustainability of domestic debt is a major problem, the loose fiscal policies designed to improve income distribution or to accelerate the economic growth will yield just the opposite results. Income distribution will further deteriorate and the economy will not be able to grow due to high interest rates.

D- LIQUIDITY MANAGEMENT AND EXCHANGE RATE POLICY IN 2003

30. After the February 2001 crisis, the Central Bank purchased government securities from state-owned banks and the banks transferred to the Saving Deposits Insurance Fund in order to meet their short-term liquidity needs, and this, in turn, created a substantial amount of excess liquidity in the market. This excess liquidity prevailed throughout 2002 and reached TL 9.7 quadrillion as end of 2002. Since excess liquidity is expected to persist in 2003, we do not predict any liquidity shortage to occur.

31. The Central Bank considers financial stability as a supportive goal required for the effective implementation of the policies destined to price stability. Therefore, the Central Bank, whose legal duty is to ensure price stability, will continue to protect financial stability as always without endangering the price stability goal together with other institutions concerned. Hence, the liquidity management policies of the Central Bank for 2002 and 2003 have been designed in a way to preserve financial stability without putting the price stability objective at risk.

32. As a preparation for inflation targeting strategy, and within the framework of the modern central banking practices, important changes were made in the operational structure of the monetary policy in 2002. Therefore, no substantial changes are to be made in 2003. Excess liquidity will continue to be withdrawn through Turkish lira deposit transactions in the Interbank Money Market, and reverse repos at the Istanbul Stock Exchange Repo-Reverse Repo Market under the open market operations. At this point, it would be helpful to reiterate the Central Bank's current market arrangements for liquidity management:

a) The intermediation function of the Central Bank in the Interbank Money Market (IMM) and Foreign Exchange and Banknotes Market (FEBM), which started to be gradually abandoned in March 2002, has been terminated on December 2, 2002. However, this arrangement does not generate any limitation on the Turkish lira and foreign exchange liquidity available to the banks via these markets. The Turkish lira and foreign exchange liquidity needed by the system will continue to be met through the below mentioned arrangements.

b) Banks will continue doing transactions within their limits making use of the Central Bank rates in the interbank money market between 10:00 a.m. - 16:00 p.m. Moreover, in order to meet the temporary daily liquidity needs in the system, the Central Bank will continue to provide the "Daylight Overdraft Limit" (DOL) facility to banks within their borrowing limits between 09:00 a.m.-15:00 p.m.

c) The Central Bank will continue to provide "late liquidity window" facility in the interbank money market between 16:00 p.m. and 16:30 p.m. as the "lender of last resort." Banks can borrow from the "late liquidity window" at the Central Bank lending rate without any limit, provided that their demands are fully collateralized, and can lend money at the Central Bank borrowing rate.

d) The Central Bank will continue to provide TL liquidity to the primary dealers through open market operations. As is known, as of July 22, 2002, the primary dealers are provided with limited liquidity through open market operations, which amounts to a maximum of 10 percent of the TL denominated and non-redeemed government securities that they will purchase from the primary market. The interest rates on the repurchase transactions carried out within the framework of this liquidity facility extended to primary dealers shall not exceed the average of the lending and borrowing interest rates, which in turn will be an important factor that will prevent volatility in the short-term interest rates.

e) As mentioned above, the markets are expected to open with excess Turkish lira liquidity for a long time. However, in the event of a temporary Turkish lira liquidity shortage that might occur, the Central Bank will begin to inject liquidity through quick repo tenders. Quick repo tenders will be used actively to hinder excessive rise of the daily overnight interest rates, (reaching the Central Bank lending rates).

f) In line with the arrangements in the interbank money market, the Central Bank has also abandoned its intermediation role in the foreign exchange deposits market. However, the Central Bank will continue its intermediation function limited to the foreign exchange deposits of the state-owned banks that were transferred from the banks under rehabilitation in 2001.

33. When the above mentioned arrangements are taken into consideration, it can be seen that, besides the normal liquidity management, we have sufficient instruments at hand to prevent a liquidity shortage, which would put the sound operation of the markets in danger, and a volatility of short-term TL interest rates, in the event of any probable external shock. Furthermore, the general framework of the current monetary policy and the floating exchange rate regime enables the Central Bank to actively conduct its function of "Lender of Last Resort", in contrast to the quasi-currency board system based on a currency-peg regime and a limitation on Net Domestic Assets before February 2001. Within this framework, the Central Bank will be able to promptly take the necessary measures to enable the markets to operate efficiently, and to prevent excessive volatility in short-term interest rates in the event of any probable external shock. As a matter of fact, after the developments of September 11, 2001 the measures taken for preventing excessive volatility in interest rates and for the smooth operation of the payments system have proved their efficiency.

34. The floating exchange rate regime will be carried on in 2003, the exchange rates will be determined according to the market conditions. The Central Bank will not purchase or sell foreign exchange in any manner in order to determine an exchange rate level or its direction. As has been so far, the Central Bank will intervene under limited conditions either by purchasing or selling foreign exchange, in case of excessive volatility in exchange rates. On the other hand, under the floating exchange rate regime, achieving exchange rate stability with minimum Central Bank intervention is very important for the inflation targeting regime to be initiated in 2003 as previously stated by the Central Bank at various occasions. Contrary to the currency-peg regime implemented prior to February 2001, exchange rates under the floating rate regime are determined in the market as a result of the economic policy, and in line with changes in the economic fundamentals. Consequently, exchange rate stability will be attained through the improvements in the economic fundamentals, and the strict implementation of the stabilization program.

35. In the event of an excessive foreign exchange supply that might occur in the market as a result of a robust balance of payments position and reverse currency substitution, the Central Bank will conduct foreign exchange buying auctions in order to increase the foreign exchange reserves in compliance with the floating exchange rate regime, and in a way not to distort the long-term trend and the natural equilibrium level of the exchange rate.

36. At this point, it should be emphasized once again that there are many risks associated with holding short or long positions under the floating exchange rate regime. Under the floating exchange rate regime, exchange rates can display a sudden jump or fall as a result of external shocks or economic and political developments that change the expectations substantially and quickly, in addition to the reasons stated in the paragraph 34. Within this framework, financial institutions and corporations holding short or long foreign exchange positions are exposed to considerable risks. Such positions can also increase the intensity of the fluctuations that might occur in the exchange rates as a result of the above- mentioned reasons.

37. On the other hand, exchange rate in Turkey is still one of the significant variables determining the prices, although it has lost its speed and power in influencing the prices, a result of the success in the fight against inflation and introduction of the floating exchange rate regime. Thus, the tendency to hold short or long position, which increases the volatility of the exchange rates, may have a negative impact on the policies towards price stability, in addition to the risks arising from holding such positions.

38. The development of forward markets helps decrease volatility in the exchange rates and the risks generated by such volatility. Within this framework, the forward transactions market, where forward foreign exchange contracts are traded, was initiated at the Istanbul Stock Exchange in August 2001 with the support of the Central Bank. Furthermore, the preparations for determining the Turkish lira reference interest rate (TRLIBOR), which will play a significant role in the pricing of financial instruments including forward foreign exchange rates, were completed by the Banks Association of Turkey with the contribution of the Central Bank. Turkish lira reference interest rates have been announced since August 1, 2002. Although the necessary tax and technical arrangements have been made, eliminating the obstacles to the developments of the forward foreign exchange transactions market, this market could not be made operative efficiently. Besides financial institutions, also the corporations that are affected negatively from the volatility in exchange rates should provide training activities regarding forward foreign exchange transactions and cooperate with the financial institutions.