MONETARY POLICY AND EXCHANGE RATE POLICY IN 2002 AND PROSPECTIVE DEVELOPMENTS

I. BASIC ASSUMPTIONS ON THE ECONOMIC ENVIRONMENT

1. In designing the monetary policy and the exchange rate policy for the period ahead, it is assumed that (i) a fiscal discipline based on a high primary surplus will be attained; (ii) long-term commitments regarding fiscal discipline and public sector restructuring will be tackled; (iii) banking sector, already strengthened by additional measures taken in 2001, will be reinforced further; the banking reform that was initiated by the Transition Program for Strengthening the Turkish Economy will be completed; (iv) economic reforms boosting the economic fundamentals and prospects of Turkish economy will persist; and (v) concerns on short-term sustainability of government debts will be removed through official external financing.

2. First, it must be underlined that the likelihood of achieving this positive economic outlook is very high. This judgment is based on the realizations in 2001. In 2001, (i) a series of structural reforms was initiated; (ii) by international standards an ambitious primary surplus target was announced and reached; (iii) a series of measures was taken on banking area, state banks were returned to make profits for the first time over the years. Moreover, the November 2000 and The February 2001 crises, and the economic developments during the Summer 2001 have clearly showed to everyone what could be the consequences of a deviation from reform process or, if this process is halted. Experiences in Argentina are full of lessons in this respect. In short, the above-mentioned assumption for the economic environment, which was an exogenous variable in designing monetary and exchange rate policies, seems to be a realistic assumption in the light of experiences in 2001.

3. Yet, the experience in 2001 has demonstrated once again that correcting economic fundamentals does not always guarantee the success. In the period between the February 2001 crisis and August, and the one-month period following the attacks on September 11,

interest rates remained high and the Turkish Lira continued to depreciate despite improvements in the economic fundamentals. Thus, concerns were raised about Turkey's ability to roll over domestic debts. As a result, interest rate went further up due to increased risk premium, and exchange rate was in an upward trend. These dynamics have increased the concerns about the sustainability of domestic debts even further. In other words, a self-fulfilling process, feeding on itself, was observed.

4. For those who monitor the latest theoretical studies in economic literature and the country experiences it comes as no surprise that restoring economic fundamentals alone does not suffice for reaching the targets. Therefore, we announced on 17 August 2001 that similar economic fundamentals might generate much different results. This stems from the expectations of economic agents. Under similar economic fundamentals, optimistic expectations will direct the economy towards lower interest rate and exchange rate equilibrium, while pessimistic expectations will do the opposite. In technical terms, there can be more than one equilibrium to be attained at any time in an economy.

5. The developments that started in the second half of August and ended on 11 September 2001, and those experienced since the mid-October 2001 were the most obvious evidence in this regard. Particularly in this second period, the prospects of achieving fiscal discipline in 2002, the persistence in structural reforms and the impending supplemental reserve facility from the IMF have changed economic expectations into positive. As a result of the change in expectations, interest rates declined substantially and the bubble in the exchange rate exploded, to which we have already drawn attention in our earlier press releases.

6. The second basic assumption made in the design of Monetary and Exchange rate policies is that, in 2002, we do not expect to experience any crisis situation in 2002, which distorted the economic expectations despite the improvement in economic fundamentals. In fact, the Central Bank has contingency plans at hand containing the policy options to be used in case of emergency. However, there exist no such shocks in the basic scenario for 2002. In particular, we would like

to draw your attention to two different shocks. The first one is the anxiety on the part of the public concerning the doubt "whether the program is going to be shelved" by the authorities responsible for it. We have been observing with pleasure since August 2001 that these debates have come to an end. The second one is the occurrence of a financial crisis in emerging market economies. We must emphasize here that the Argentinean economy and the Turkish economy have turned out to be dissimilar from the standpoint of fiscal and monetary policy implementations.

7. In addition, the Central Bank has important tasks for improving the economic expectations. This relates to transparency, according to which a central bank should announce the framework of prospective monetary policy, the changes in operational rules and the rationale behind the decisions. That is why we are making this announcement.

II. SHAPING THE EXPECTATIONS

1. Decisions of economic agents have largely to do with the future. Forecastibility of the future course of interest rate, exchange rate, inflation and growth rate will reduce the uncertainties and generate sound decisions. Based on this general opinion, we may speak of an "ideal" equilibrium, in which interest rates, exchange rate, general level prices, and the growth rate may remain stable for a long time. Is it possible to reach such state of equilibrium?

2. It is clear that nobody will object to achieving such equilibrium, apart from its repercussions on income distribution. What is important is how to achieve it. No doubt, in real life, economies do not run under "laboratory conditions", and they are permanently open to shocks to a lesser or greater extent. Therefore, it seems more reasonable to ask the following question. To what extent can we come close to this state of equilibrium?

3. The pre-condition for a stable economy is to have sound economic fundamentals. In a country where economic fundamentals are not correct, it will never be possible to create a stable economic environment no matter what monetary policy or exchange rate regime is pursued. Unfortunately, debates over the floating exchange rate regime in 2001 have ignored this simple fact. Actually, as stated above, on the one hand, while the basic economic fundamentals of the Turkish economy are being put on a right track; on the other hand, the poor structures that have led to a disorderly state in the past are being transformed permanently in a positive direction.

4. Undoubtedly, we may not attain the desired results by emphasizing only the tight monetary and fiscal policies and the structural reforms. Expectations should not be ignored. One of the main functions of monetary policy is to help shape the expectations. In 2002, we have three basic alternatives to be used for this purpose. These are: exchange rate anchor, monetary targeting, and inflation targeting. Exchange rate anchor suggests a fixed or a pre-determined exchange rate policy. In a looser version of this kind of exchange rate regime, central banks try keeping the exchange rate in a predictable range by frequent interventions, even though exchange rate starts

losing its function as an anchor. In the following section, the exchange rate policy to be pursued in 2002 is presented. Later, the monetary policy is explained along with monetary targeting and inflation targeting.

III. EXCHANGE RATE POLICY

1. In 2002, the Central Bank will not implement a fixed or managed exchange rate regime, nor try to keep an exchange rate level incompatible with economic fundamentals. First of all, this is partly so, because it is unrealistic to insist on the currency peg regime that was introduced in 2000 and collapsed in February 2001, and partly because many countries have, in recent years, abandoned these kinds of exchange rate regimes and switched to floating exchange rate regimes.

2. Moreover, we do not see any benefit of pursuing the currency peg regime in Turkey under the present conditions. In the first place why is a currency peg regime desired or favoured? The answer is simple, but very important. Long-standing deficiencies in the economic fundamentals have led the economic agents to hold foreign currency, and thus the exchange rate has become a significant variable to be taken into account in economic decisions. In an environment, where wages and prices are indexed or even fixed to foreign currency, major part of savings are held in foreign currency and assets and liabilities of balance sheets are denominated in foreign currency, the economic structure will be deficient and unsustainable. Such a fragile structure will make an economy extremely prone to crises.

3. We must absolutely reverse this trend. This cannot be realized by making the exchange rate "predictable" through artificial and unsustainable methods. Restoring economic fundamentals and achieving structural reforms is a pre-condition for changing this mechanism. The floating exchange rate regime, which will continue to be implemented in 2002, will help overturn this process. In 2002, the Central Bank's interventions will be kept at a minimum, just as it has been the case since August 2001. The Central Bank will only intervene in excessive fluctuations.

4. It should be borne in mind that, the Treasury's disbursement of financial support extended by the IMF for financing budget deficit prompted the Central Bank to give Turkish Lira liquidity to markets in a programmed manner in 2001. As announced in May 2001, the Central Bank started the planned foreign exchange sale tenders in order to mop up the excess TL liquidity. Therefore, the liquidity created by the use of financial support of the IMF was withdrawn by using the same support. The liquidity injected this way does not have to do with a "monetization," nor can this withdrawal be regarded as an intervention to keep the exchange rate in a certain level. In other words, the IMF extended significant amount of additional external financing in 2001 to cover budget deficit. According to the IMF's internal regulations, the Treasury was to utilize this credit by way of the Central Bank. As a result, Turkish Lira liquidity that was injected temporarily to the system was mopped up immediately. Unfortunately, this simple fact was ignored sometimes and these tenders were interpreted as intervention in the foreign exchange market. Having terminated in December 2001, we may perform tenders again in 2002 if the same conditions arise, by making a pre-announcement to the public.

5. It was rumoured just before and after the Ramadan feast that the Central Bank had indirectly intervened in the foreign exchange market by way of state banks to prevent a further drop in exchange rates. However, this was not the case. Such indirect intervention would have been in contradiction with the aim of getting economic agents to fully accept the floating exchange rate system and ensuring its smooth operation. As can be seen in the countries implementing floating exchange-rate-based program, it is quite likely that an excess supply of foreign exchange could materialize in the economy due to a prospective reverse currency substitution and a strong balance of payments position, in contrast to 2001. If and when these conditions may prevail, the Central Bank will use transparent methods destined to increasing foreign exchange reserves in compliance with the floating exchange rate regime without distorting the long-term trend of exchange rate and its natural equilibrium point. Whenever the need to use these methods arises, the measures of the Central Bank will be pre-

announced simultaneously to the banks and the public pursuant to the principle of transparency.

6. The following point must also be underlined. To say that the economic structure based on foreign exchange transactions and foreign exchange rate has to be changed does not mean that the existing set up can be put aside or the desired change can be accomplished in a day. On the contrary, the Central Bank must accelerate this transformation process as much as possible and make some adjustments when needed.

7. To this end, we are in the process of making a series of new arrangements in the interbank money, foreign exchange and banknotes markets. The main purpose of these arrangements, details of which are given in the section "Arrangements for the Operational Framework of Monetary and Foreign Exchange Policies", is to gradually strip the Central Bank of its "intermediary" function that was undertaken in the earlier phase of these markets. Thus, market participants will be able to better evaluate the credit risks they are exposed to, and such risks will be reflected properly on the prices by promoting the development of new financial instruments. The fact that the intermediation by the Central Bank come to an end will not cause any drop in the amount of liquidity available to the banks using these markets.

8. With the same purpose, we are planning to initiate forward foreign exchange market, in which forward contracts are to be traded. In addition, we deem it appropriate to introduce a new market regarding forward transactions based on Turkish Lira interest rate. Measures, envisaged for these markets that will lead to smooth operation of floating exchange rate regime, are listed in the section "Arrangements for the Operational Framework of Monetary and Foreign Exchange Policies".

IV. MONETARY POLICY

1. As explained above, there are two nominal anchors to be used in 2002 in order to lessen the future uncertainties and to influence the expectations. These are monetary targeting and inflation targeting. In 2002, we will begin by monetary targeting and at the same time implement a monetary policy focused on the "future inflation," details

of which are given below. In other words, this is an "implicit inflation targeting." We will openly switch to official inflation targeting when necessary conditions emerge later in the year.

2. Among the monetary aggregates, it is the "monetary base" that we have chosen to target. We get the monetary base from the Central Bank's balance sheet. It accounts for the net liabilities of the Central Bank toward the other institutions and economic agents. Monetary base is the sum of three variables: banknotes issued, required reserves denominated in Turkish Lira and free deposits. In 2002, monetary base is targeted to increase as much as the growth rate of nominal national income. Thus, the annual growth in monetary base will be realized at 40 percent at the end of 2002. Moreover, the monetary base becomes a performance criterion in the new Letter of Intent. As is known, an indicative ceiling was set for monetary base in the program implemented in 2001. We made the monetary base a performance criterion because we wanted to cast a stronger anchor against inflation. "Net international reserves," which is another performance criterion, will not be allowed to fall below a certain limit. Another sub-item on the balance sheet, "net domestic assets," which reflects the money created by the Central Bank through domestic credits, will be an indicative aggregate.

3. Disbursements from the additional external financing to be extended by international institutions to the Treasury under the new program will cause injection of extra liquidity to the market. In view of the targeted inflation, the Central Bank will mop up the excess liquidity in coordination with the Treasury by using transparent methods based on market mechanism.

4. Obviously, there is a close relationship between the target for monetary base and the forecast of money demand for 2002. As is the case in all forecasts, our forecast also contains a margin of error. Our Research Department has managed to minimize the margin of error by using modern techniques. In particular, the range of forecasting error may change according to the size of the reversal in currency substitution expected in 2002. Therefore, we may have to revise the monetary base growth target in line with the reversal in currency substitution in the future. At first glance, the likelihood of a revision in

an aggregate chosen as a nominal anchor may seem as a paradox. However, we can easily demonstrate that there is no such paradox when the following two points are taken into account:

5. First, with monetary targeting we aim to create a monetary expansion consistent with the macroeconomic targets, to convince the economic agents that we will never surpass the limits set for monetary base. In other words, we will not create excess money supply at all, and will persuade the economic agents that there would not be any excess money supply. Reverse currency substitution means that demand for Turkish Lira will increase against foreign exchange. In other words, the money demand will go up under these conditions. Revising the monetary base target in the light of increase in demand will not produce excess money supply. There is no probability of generating a higher inflation level than the projected one in the program due to this revision.

6. Second, the Central Bank will use short-term interest rates against inflation before switching to inflation targeting policy. In other words, although some problems might arise in forecasting monetary base demand or the relationship between monetary base and inflation may prove to be weak as observed in some countries, "implicit inflation targeting" policy will minimize these setbacks and function as an extra anchor. The Central Bank may alter short-term interest rate by considering the future course of inflation. Not satisfied with a monetary base anchor only, we commit ourselves to take additional measures in line with the projected inflation.

7. We deem it appropriate to highlight an important economic reality that is often ignored, in view of the ability of the Central Bank to use short-term interest rates more efficiently. In every economy, current inflation rate is the accumulation of past experiences. Namely, current inflation rate is determined by recent cost and demand dynamics along with the expectations of economic agents with a time lag. If these factors determining the current inflation rate persist in the future, it is no doubt that the future inflation will be no different from the present and the past. In contrast, if there is a strong probability for the reversal of these trends, then the likelihood for the future inflation to be different from the previous one will be very high. For these reason, central banks aiming to achieve price stability should

evaluate the reasons behind the past and current inflation, look into their validity in the future, and take decisions in accordance with the results of this analysis.

8. To achieve price stability, the Central Bank bases its monetary policy decisions on looking ahead, not on recent developments in the factors determining inflation. For this reason, it will be misleading for market participants to evaluate the prospects of short-term interest rates of the Central Bank by considering the current inflation rate only. For example, the inflation rate of a given month may materialize at a high level due to temporary developments. However, the movements in factors determining inflation may indicate that inflation would enter into a downward trend and stay there permanently. So, trying to predict the Central Bank's attitude by evaluating the current inflation rate only will lead to extremely wrong results.

9. With a monetary policy, focused entirely on the inflation, the Central Bank's opinions for the current rate of inflation and its prospects for the future will bear significantly on the public. These evaluations will be announced to the public opinion in accordance with the principle of transparency. The Central Bank analysis on monthly inflation rate, and its expectations, based on the Inflation Expectation Survey and the Business Tendency Survey, will be made known to the public. We expect that the risk of making wrong evaluations stated in the above paragraph will be minimized.

10. We will openly initiate the inflation targeting regime whenever the necessary conditions emerge. We had to postpone the introduction of inflation targeting due to concerns about the sustainability of domestic debt. Deepening concerns did not allow the short-term interest rates to be used against inflation. As stated above, recent positive developments have dropped the discussions on the sustainability of domestic debt. With the realization of the economic environment envisaged for 2001, there will be no place for such discussions in 2002. Therefore, the continuation of reform process in 2002 without interruption and the realization of primary surplus will remove one of the obstacles in the way of inflation targeting.

11. There are two more factors why this regime has not yet been adopted. The first one is the deep-rooted habit of price setting based on past inflation. Instead of this backward indexation, when the price setting behaviour based on the expected inflation becomes very prevalent among the economic agents, the inflation targeting will deliver the result that is expected from it. In this regard, it is utmost importance that the pricing mechanisms adopted in some areas of the public sector must be reduced to a minimum. Undoubtedly, one of the hurdles in front of the elimination of these mechanisms is, of course, the income loss. However, schemes must be designed so that these losses can be compensated. The second is the still strong relationship between the inflation and the rate of exchange rate increase.

12. It is clear that our policy of putting constraints on the growth rate of monetary base and "implicit inflation targeting" aims not only to shape inflation expectations, but also to try to control the factors affecting domestic demand and costs directly and in a way to reduce inflation. Undoubtedly, it is not possible to fight inflation by merely using monetary policy. The battle against inflation can only be won by achieving fiscal discipline and by sticking to the reformation process with determination. The new three-year program that will be initiated in 2002 is comprehensive in this respect and aims to disinflate the economy.

V. ARRANGEMENTS FOR THE OPERATIONAL FRAMEWORK OF MONETARY AND FOREIGN EXCHANGE POLICIES

1. These arrangements are set to determine the Central Bank's short-term interest rates, to regulate the Turkish Lira liquidity and to phase out the Central Bank's intermediation in the Interbank Money Market, and the Foreign Exchange and Banknotes Markets. Main elements and framework of these arrangements are given below.

2. With the instrument independence introduced by the new legislation in May 2001, achieving price stability has become the Central

Bank's primary objective. In this context, the main goal of the monetary policy will be to reduce inflation in 2002. As mentioned above, the Central Bank will start using short-term interest rates against inflation before switching to inflation targeting policy. In other words, the Central Bank will set the short-term interest rates in view of future movements of inflation.

3. Success in disinflation efforts through short-term interest rates can only be obtained if the volatility in short-term interest rates is kept under within a narrow band control. To this end, the Central Bank will efficiently manage the Turkish Lira liquidity by Open Market Operations, and will regulate the Turkish Lira borrowing and lending rates.

4. Restructuring of the banking system has been continuing. Substantial progress has been achieved in (i) strengthening private banks; (ii) prompt liquidation or sale of the SDIF banks; (iii) reformation of state banks; and (iv) supervision and regulation of the banking sector. We believe that these efforts will keep up momentum in the period ahead. It is expected in 2002 that the economic program, which is reinforced by external financing, will preserve the recent improvement observed in financial markets.

5. Pressure on the monetary policy will be relieved with the continuation of strengthening the banking system in 2002. With the participation of reinvigorated banks in the Turkish Lira liquidity operations, the Central Bank will begin implementing "late liquidity window" facility in the interbank money market between 04:00 pm and 04:30 pm within the framework of its function as the "lender of last resort." The Central Bank will provide funding to the banks without any limitation against collateral through this facility. What this facility means in practice is that, there will be an appropriate environment where a threat of any liquidity squeeze spreading to the banking system would not cause a financial instability. On the other hand, if it's the liquidity need of a single bank without being a systemic risk, it will enable the public authorities to get informed by the situation earlier and take the necessary steps to cope with the problem before spreading to the whole system.

6. Since February 2001, when floating exchange rate regime was introduced, the volatility in interest rates has diminished considerably. Therefore, the conditions for deepening the interbank money market and for setting interbank "Turkish Lira reference interest rate" have started to emerge. Setting the reference interest rate will play an important role in the pricing of credits and other financial instruments, including forward foreign exchange. Intensive works on reference interest rates are being conducted in coordination with the Banks Association of Turkey. In addition, as mentioned before, the measures that have been taken and to be taken in the near future on the selling or liquidation of the bulk of SDIF banks, and the strengthening of private banking system will enable the Central Bank to gradually end up its intermediation function undertaken in the interbank money and foreign exchange markets in 2002.

7. Bringing the Central Bank's intermediation function to an end gradually will not cause any decrease in the amount of Turkish Lira or foreign currency liquidity provided to the banks via these markets. In other words, the banks' current borrowing limits will continue to be valid. Moreover, as a new liquidity facility, banks will be able to borrow unlimitedly from the "late liquidity window" being the Central Bank's most expensive funding. However, under normal conditions and when there is no systemic problem, the "late liquidity window" is expected to be used rarely.

8. Successful implementation of a floating exchange regime requires the forward markets, which lessen the future uncertainties. Istanbul Stock Exchange introduced the foreign exchange futures market in August 2001. Works are underway for removing the obstacles to deepening and developing this market. Additionally, we will undertake works in the months to come for setting up an organized market, in which interest rate futures contracts will be traded.

9. We think that the interbank markets will benefit from the Central Bank's gradual phasing out of its intermediary role. As can be seen in the following timetable for the interbank money and foreign exchange markets, the preparations for a gradual transition to leaving the intermediary operations are made with extreme care and prudence. Particularly, we thought that the restructuring of the banking system

and the improvement of Turkish Lira money and foreign exchange markets would be realized in the first half of 2002 and new arrangements are intensified in the second half of 2002.

10. As a matter of fact, the Central Bank acts as an intermediary in the Turkish Lira and foreign exchange markets by assuming the credit risks of market participants, due to particular conditions of the period when these markets were established. This implementation no longer contributes to the well markets, and creates distorted pricing mechanisms, in which risk perceptions are not fully reflected.

11. Furthermore, markets may sometimes get the wrong idea about transactions carried out among the market participants, as if the Central Bank were the counterpart to thereof. This misunderstanding can give rise to wrong or mixed signals about monetary and exchange rate policies. Making the achievement of price stability its primary objective, the Central Bank must also restructure its role in the Turkish Lira and foreign exchange markets so that its monetary policy and exchange rate policy may be better pursued and understood. In this context, workings of "Open Market Operations", "Interbank Money Market" and "Foreign Exchange and Banknotes Markets" at the Central Bank are re-arranged as follows.

V.1 Open Market Operations

12. The Central Bank has long been managing the Turkish Lira liquidity mainly through open market operations. Open market operations will continue to play a key role in Turkish Lira liquidity operations in 2002.

13. In the banking system, the funding facility provided for the state banks and SDIF banks through open market operations after the February 2001 crisis will continue in 2002 within the predetermined limits and as long as it is needed. Therefore, the banks will not have to borrow from overnight market, and they will not exert pressure over the short-term interest rates.

14. We will continue to withdraw the liquidity, given to the state banks and the SDIF banks, by reverse repurchase agreements at the Istanbul Stock Exchange and by borrowing from them in the interbank money market.

15. In 2002, it is expected that Turkish Lira market will have a positive reserve for a long time. However, parallel to the Central Bank's balance sheet developments, when there is a need for Turkish Lira liquidity, it will be provided through repurchase agreements.

16. The liquidity management via Open Market Operations will focus on making interest rates in money markets converge on the short-term interest rates to be set in line with inflation target.

V.2 Interbank Money Market

17. The Central Bank will gradually bring its intermediary role in the interbank money market to an end starting from 1 July 2002 until 1 December 2002. However, the Central Bank will continue to perform interbank money operations on its own behalf and for its own account, during the conduct of the monetary policy.

18. Although the borrowing limits of the banks will be the same for their transactions with the Central Bank, beginning from July 1, 2002, borrowing limits for the transactions among banks will be phased out and will be zero as of December 2, 2002 as illustrated in the table below.

Table

DATE	BORROWING LIMIT FOR TRANSACTIONS WITH THE CENTRAL BANK (TRILLION TL)	RATIO (%) TO BE USED FROM THE TOTAL LIMIT AVAILABLE TO OPERATIONS AMONG BANKS	LIMIT AVAILABLE TO OPERATIONS AMONG BANKS (TRILLION TL)	TOTAL BORROWING LIMIT (TRILLION TL.)
01.07.2002	10.0	75	7.5	10.0
01.08.2002	10.0	60	6.0	10.0
02.09.2002	10.0	45	4.5	10.0
01.10.2002	10.0	30	3.0	10.0
01.11.2002	10.0	15	1.5	10.0
02.12.2002	10.0	0	0.0	10.0

As can be seen on the above table, a bank having a borrowing limit of TL 10 trillion as of 1 August 2002 will be able to use TL 6 trillion corresponding to maximum 60 percent of this limit for the interbank operations among banks. In case a bank happens to use TL 6 trillion out of TL 10 trillion exclusively for its interbank operations with other banks, the borrowing limit for the operations with the Central Bank will be TL 4 trillion.

19. The Central Bank will continue to announce its bid rates for liquidity sterilisation on the Reuters CBTC page between 10:00 am and 04:00 pm, and offer rates in view of providing liquidity to the banks within the borrowing limits.

20. The Central Bank will carry out "late liquidity window" operations in the interbank money market between 04:00 pm and 04:30 pm within the framework of its function as the "lender of last resort." In this period, the Central Bank will announce lower bid rates and higher offer rates in comparison with those announced between 10:00 am and 04:00 pm. Maturity of bid and offer rates in the "late liquidity window" will exclusively be overnight. Starting from 1 July 2002, banks' borrowings from the "late liquidity window" will be limitless, provided that the operations are collateralised.

21. There will be no change in "Daylight Overdraft Limit" facility. Banks will be able to continue using this facility between 09:00 am and 03:00 pm within their borrowing limits.

V.3 Foreign Exchange and Banknotes Markets

22. In the foreign exchange and banknotes markets, the Central Bank exercises two functions. It acts as intermediary in foreign exchange transactions performed among institutions, and makes transactions in view of exchange rate policy, although it has not been utilized in recent months.

23. The Central Bank will stop its intermediary functions in the foreign exchange and banknotes markets in accordance with the following timetable in 2002.

MARKETS	DATE
FX deposits against TL deposits (Swap)	1 March 2002
Forward FX purchase/sale against TL	1 March 2002
Foreign banknotes purchase/sale against TL	1 July 2002
FX purchase/sale against TL	2 September 2002
FX deposits	1 July 2002 - 2 December 2002

24. The Central Bank will carry out transactions with institutions on its own behalf and for its own account in the markets above-mentioned, in line with the exchange rate policy.

25. The Central Bank will phase out its intermediary role in the foreign exchange deposits market starting from 1 July 2002 until 2 December 2002. However, the Central Bank will keep up its intermediary function for the foreign exchange deposits of the state-owned banks that were transferred from the SDIF banks in November 2001.

26. Although the Central Bank phases out its intermediary role in foreign exchange deposits, the borrowing limits of the institutions will be retained. However, The Central Bank would make some adjustments in the borrowing limits as before, considering the developments in the banks' balance sheets and financial structures.

27. Within this framework, for the operations of the Central Bank, the borrowing limits in the foreign exchange and banknotes markets will remain the same. However, the limits for the operations exclusively among institutions will gradually be reduced and zeroed as seen in the table given below, starting from 1 July 2002 until 2 December 2002.

Table

DATE	BORROWING LIMIT FOR TRANSACTIONS WITH THE CENTRAL BANK (USD MILLION)	RATIO (%) TO BE USED FROM THE TOTAL LIMIT AVAILABLE TO TRANSACTIONS AMONG INSTITUTIONS	LIMIT AVAILABLE TO TRANSACTIONS AMONG INSTITUTIONS (USD MILLION)	TOTALBORROWINGLIMIT (USD MILLION)

01.07.2002	10	75	7,5	10
01.08.2002	10	60	6,0	10
02.09.2002	10	45	4,5	10
01.10.2002	10	30	3,0	10
01.11.2002	10	15	1,5	10
02.12.2002	10	0	0,0	10

As it can be seen from the above table, a bank that has a borrowing limit of USD 10 million as of 1 August 2002 will be able to use USD 6 million, corresponding to maximum 60 percent of this limit for the transactions among institutions. In case an institution happens to use USD 6 million out of USD 10 million exclusively for its transactions with other institutions, the borrowing limit for the transactions with the Central Bank will be USD 4 million.

28. Moreover, purchase/sale of "foreign exchange against foreign exchange," "foreign exchange against foreign banknotes" and "foreign banknotes against foreign banknotes" realized in the foreign exchange and banknotes markets are attributed as commercial banking activities performed between the Central Bank and institutions operating in the said markets. Although it is considered appropriate for the said markets to continue activities within the Central Bank structure, our policy of encouraging the institutions to organize these operations among themselves outside of the Central Bank will continue in 2002, since, actually, such activities belong to the commercial banking area.

29. On the other hand, monitoring financial markets is among the Central Bank's main duties by Law. In 2001, the Central Bank observed the foreign exchange and banknotes markets carefully and took necessary measures immediately to ensure the efficiency of the floating rate regime within the framework of its Law. The Central Bank will continue to monitor closely the foreign exchange markets in the period ahead. In this context, in order to raise the operational efficiency of the foreign exchange markets, the Central Bank will introduce a monitoring system aiming to better overseeing the volume and quality of transactions, and the depth of the foreign exchange market. Once effective results are obtained from the monitoring

system, the information on the depth of the foreign exchange markets will be announced regularly.

VI. PROSPECTIVE MACROECONOMIC DEVELOPMENTS IN 2002

1. Realizing the fact that there can be more than one equilibrium to be attained in an economy depending on the expectations, as already stated above and in the Central bank press release dated 17 August 2001, is a pre-condition for a better understanding of the prospective macroeconomic developments in 2002. This is not only a theoretical assumption but also an obvious reality, especially in countries where domestic debt stock soars at high levels and concerns on sustainability of domestic debt are widespread.

2. This is significant for 2002, as expectations have already started turning into positive. Extra foreign currency demand is disappearing at a time when expectations have become optimistic and thus exchange rate has stopped going up continuously without any economic fundamental, forming a gradually growing bubble. In other words, besides the habit of holding financial assets in foreign currency due to long-standing deficient economic structure, the extra dollarization created by a bubble stemming from pessimistic expectations is expected to overturn, as this bubble will burst with the positive expectations. As a matter of fact, the positive developments in the last couple of months have burst the bubble, as we had previously warned the public.

3. With the reverse trend of extra dollarization, the residents will tend to hold more Turkish Lira financial assets in their portfolios. In other words, the demand for Turkish Lira and the supply of foreign currency are expected to increase in the next period in comparison with 2001. Therefore, exchange rate will likely become more stable. This stability is expected to strengthen reverse currency substitution tendency. However, we should not be overoptimistic regarding the extent of reverse currency substitution. It is clear that this process will spread over time, and will develop only if the policies and reforms, which are undertaken, are strictly implemented.

4. The main reasons behind the optimistic expectations in the last couple of months of 2001 were; the prospects of a higher primary surplus in 2002, the persistence in the restructuring process and the strong likelihood of obtaining additional external support. Keeping promises is the pre-condition for the continuation of this positive climate. Furthermore, transparency in monetary policy will also contribute to the encouraging atmosphere. Another condition is the rehabilitation of the banking system. In this respect, an important step was taken in 2001. The policies aiming to further strengthen the financial system must be carried on also in 2002.

5. Under these circumstances, we expect that four important developments will boost the economy. First, in 2001, Turkey gained a competitive edge that will have a positive impact on exports. Second, with the improving banking system, the balance sheets of banks will grow more soundly and there will be a real growth in the credit volume over time. Third, the reverse currency substitution, and especially the exchange rate stabilization will stimulate domestic demand. Within this framework, we presume that part of foreign currencies in the hands of the public will turn into demand for goods. Fourth, stability in the financial markets is expected to stimulate the postponed investment and consumption expenditures. Accordingly, we expect that the Turkish economy will enter into a growth path again. It can be noticed that there is a close relationship between the realization of these developments and the rehabilitation of the banking sector. The banking sector must certainly be strengthened in 2002.

6. At this stage, it will be beneficial to briefly look into the discussions regarding the primary surplus targets in 2002, which especially took place in fall of 2001. As is known, it has often been asserted that a reduction would have to be made in the primary surplus target to put our contracted economy back on the growth path. Accordingly, the economy would be boosted by increasing somewhat public expenditures and by reducing tax rates. However, it should be borne in mind that in 2001, the main reason behind the increasing tendency in the interest rates and exchange rates without any economic fundamental was the concerns about the sustainability of domestic debt. The widespread concerns made the economic

environment very risky, expectations turned out to be more pessimistic and caused economic agents to postpone their expenditures. Consequently, the economic contraction, which started after the crises, has also been intensified because of these factors.

7. On the other hand, the increasing tendency of real domestic debt stock may raise concerns that the sustainability of domestic debt might become less likely. As known, there are three reasons for real domestic debt to increase: high domestic real interest rate, primary budget deficit, and net external debt payment. Within this framework, reducing the primary surplus will cause an increase in real domestic debt stock. At a time when international and domestic markets are focused on sustainability of government debt, suggesting a decrease in the primary surplus will stimulate concerns over the ability of government to roll over its debt. For this reason, a lesser primary surplus will give rise to a higher real interest rate, and a lesser external financing. In other words, the three factors that determine domestic debt dynamics will increase the domestic debt stock in real terms under these circumstances. Undoubtedly, the exchange rate will be higher because of the increased risk premium. Under these circumstances, reducing the primary surplus will generate just the opposite of what is expected from it originally, and will deepen the recession even further, let alone reviving the economy. This might have been a remedy in different economic conditions. However, at a time when the sustainability of domestic debt and program is being questioned, adopting the policy of reducing the primary surplus will aggravate the problem.

8. In 2002, we expect important developments on the inflation front. The monetary base anchor will prevent excess money supply, and avoid domestic demand pressure beyond the program targets. Moreover, the policy of adjusting short-term interest rates in line with the future inflation will help mitigate the inflationary pressures. We believe that inflation expectations will turn into positive once the reasons behind these policies and the evaluations of the Central Bank on inflation are shared with the public.

9. For the actual inflation rate to come close to the targeted inflation, the backward indexation habits and behaviour, which are very

common in all sections of the society should be lessened or eliminated altogether. In this connection, the Economic and Social Council and the public sector, due to pricing policy of the State Economic Enterprises, have important obligations. Getting rid of backward indexation habits and behaviour of corporates and households will be depended on the success of the program, unless a specific incomes policy is implemented. However, abandoning the backward indexation habits and behaviour in the public sector is in the hand of the public sector itself. The more this behaviour is abandoned, the closer we come to the targeted inflation.

10. As mentioned above, the appropriate economic environment that starts the reverse currency substitution process, and the process itself will bring stability in the exchange rate. Especially in the beginning of this process, the Turkish Lira is expected to appreciate in real terms. In fact, in the last quarter of 2001 the Turkish Lira did appreciate in real terms. This event also is expected to bring the inflation down. Here, with the "real appreciation of Turkish Lira", it is meant that Turkish Lira will move toward its long-term equilibrium level. In considering the whole year 2001, we see that Turkey's competitive edge has not diminished. That is why we have included the external demand among the factors enhancing the economic growth.

11. In 2002, significant developments are expected in terms of exports while we will also see increases in imports. There are two main reasons for this. First, there is a close relationship between imports and the growth rate. Therefore, as the economy begins to grow it is natural to expect an increase in the imports volume. The second reason is the exchange rate stability. As a result of these developments, the current account is expected to run into a slight deficit.