

Remarks by

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REMARKS ON THE TURKISH ECONOMY

When we look at the general course of the Turkish economy, we should focus on two points. These are what we have, and what we lack. In other words, what are the positive and negative aspects of the Turkish economy. In addition, we should take a much longer view when surveying Turkey's previous experiences, taking advantage of the pluses and converting the minuses into pluses. First of all, we need to understand that Turkey has been living in an economy based on free market principles for over 100 years now. When we look at most former Eastern bloc countries and similar economies, we realize that Turkey has a market oriented economy. It is also a responsive and growing economy. What I mean by a responsive economy is that when economy measures are taken, the economy reacts. I think this is important. One indicator of an economy's flexibility is its liberal foreign payments system. We can easily see that our financial sector has a sound and strong infrastructure. An additional important feature, distinguishing Turkey from the Latin American countries is that foreign capital doesn't flee Turkey.

These are the positive aspects of our economy. On the negative side, we see the fact of high inflation. An inflation rate averaging around 60 percent for the last 15 years is Turkey's main economic problem.

Deterioration of income distribution is the principal negative consequence of high and persistent inflation. Turkey's income distribution is second worst among the OECD countries. We also have a budget deficit problem. The financing requirements of the public sector, and the method of financing the deficit, are becoming more important today. In other words, the question is How can the public sector finance its deficit?

Under these conditions, a country's balance of payments needs to be powerful.

There are two kinds of financing in the economy. The first is public; the second is private. The private sector can accomplish its financing more easily than the public sector. Interest payments have always been an important part of public financing, due to structural problems of many years standing. There are three financing methods. The first is domestic borrowing, the second is external borrowing, and the last is monetization. Another type of financing is the renewal of principal and interest payments by new borrowing. We know all the financing methods, but in the end, we come up against our inflation problem.

If we can't reduce the inflation rate to single digits, we will not be able to take our rightful place in the global economy or the EC or in the world economy at all. I have repeated more than once: we should be in the first rank. But with our high inflation, we cannot even belong to the second rank, but must occupy a still lower rank.

Turkey's inflation is unique. The main factor keeping inflation high is a public sector deficient 15 to 20 years old. If we want to solve that problem, both the necessary political environment and the necessary political will must be present for vital and decisive measures to succeed.

At this point, I want to clarify these political factors. Political will by itself is not enough. A favourable political environment is also required. Looking back at the last 20 years, we can say that a period of political stability lasting four or five years occurred during the Özal era of 1984-1989. On the other hand, the anti inflation program launched by the Çiller government in 1994 gained the support of the IMF. The results were encouraging. Unfortunately the early election has reversed all the positive trends. This shows that a program has to be carried out for two or three years without interruption. There are two methods for reducing inflation. The first is to target the inflation rate. Say you want to reach a 10 percent inflation rate. The first step is to determine how many years it will take to reduce inflation to 10 percent. Then you must direct all macroeconomic policies toward that objective. You should take serious steps to impress on the public that these steps will lead you to your objective. The second method is to use heterodox or orthodox macroeconomic policies.

At this point I should emphasize that this program must be credible. People abroad--bankers in New York, London, or Tokyo should believe you. Also, people in İstanbul or even Anatolia should trust this program. First of all, the political environment must be favourable. And in addition to that, your implementation of the program must inspire trust.

In order to evaluate market opportunities in Turkey, we should look at private investment trends. The Central Bank conducts a survey that reports economic trends in the business sector. I am very interested in the results of this study, and I follow this survey every month. The survey, applied to 200 public and private firms, shows that there has been a positive trend in investment demand for the last two years. The survey started in 1988, but this positive trend has only been going on for the last two years, and no earlier period of expectations of rising investments has ever lasted longer. There is also a positive trend of realizations of these expectations. There are also studies showing that people in Turkey have positive attitudes about investing. Foreign investors, on the other hand, fall into two categories--direct foreign capital

investors and portfolio investors. In 1996, flows to developing countries totalled US\$285 billion dollars. Of this total, \$109.5 billion represented direct foreign capital investment, and \$91.8 billion represented portfolio investments. In Turkey, foreign direct investment amounted to \$612 million while portfolio investment accounted for \$570 million. Since total portfolio investment in the İstanbul Stock Exchange was \$4.6 billion in March 1997 (and \$3.5 billion in December 1996), we can see the gravity of our situation and how much Turkey missed because of it. Unfortunately Turkey did not get its share of the funds transferred to developing countries. The \$2 billion, \$3 billion or \$5 billion that Turkey did get is a very small fraction of the total of \$285 billion.

To fight effectively against inflation we need to implement an inflation reduction program for at least two or three years. It is difficult to foresee what will happen in the near future. I would like to stress that harmonious relations with the central banks and confidence on the part of markets in the policies being implemented will undoubtedly continue. These policies may not be able to reduce the inflation rate but at least they will keep it from rising.

In the area of monetary policy implementation, I would like to stress that we care about the exchange rate but we do not intervene to influence interest rates. We allow the market to determine the level of interest rates. Unfortunately, all interest rates in Turkey are short term rates. We do not have any medium term interest rates. In addition, we have a monetary program which we cannot announce to the public. Our monetary program includes control over our balance sheet and uses policy instruments to influence the monetary aggregates. These policy arrangements will continue. But if there are any unexpected large fluctuations in the market, the Central Bank will not hesitate to intervene there.

In this connection, let me look at the movement in our international reserves. Our reserves amounted to US\$16.3 billion at the end of 1996. Today they amount to \$15.6 billion, reflecting an apparent \$700 million reduction. Of this, \$500 million is accounted for by movements of the US dollar/Deutsche mark exchange rate. Our Defence Industry Fund has a \$1 billion foreign exchange account, a \$300 million decrease in which is also reflected by the drop in reserves. Taking into account these developments, I can say there has not been an actual decrease in our reserves. Turkey's foreign reserves are high compared to other countries. One important index of reserve adequacy is the ratio of imports to reserves. Total reserves in the Turkish economy, meaning reserves held by the Central Bank and commercial banks, can finance six months of imports. For other countries, this figure is typically three months. Turkey's international reserves are obviously abundant.

On the issue of announcing the monetary program, I should stress that there must be an infrastructure for the announcement. The first requirement is for the monetary program to be in harmony with the current macroeconomic policy environment, so that the outlook for implementing the two of them together over the long term is good. This requires a high degree of credibility and political stability. In the absence of this kind of favourable conjunction of conditions, announcing the monetary program can be dangerous. If targets are missed, the costs in terms of lost credibility will be high. We did not announce our monetary program. However, we can and do use it for inner discipline. So first let me explain that we apply the monetary program to maintain

inner discipline. Second, the Central Bank has various tools that are really qualified. At the Central Bank, we target reserve money. If there are any unexpected changes in reserve money, we maintain the monetary program by drawing excess liquidity from the market.

The objective of such a program has to be related to the inflation rate. We have to reach that target. In December I made an estimate of six-month inflation for 1997. I announced that we expected a 70 percent annualized inflation rate for the first part of 1997. But it is not convenient for the Central Bank, the monetary authorities, or the government to announce an estimate for the exchange rate. In general, the market has its own estimate depending on the current macroeconomic situation. This is an important factor in credibility. If you cannot reach the target, you lose credibility in the markets. This is why we do not make an estimate for the exchange rate. It is also hard to estimate the US dollar/deutsche mark cross rate in the international markets. But our target is related to inflation. Our estimate of 70 percent for the first half of the year also reflects our exchange rate expectations.

There is a method for calculating the budget deficits of countries living with high inflation. You calculate a deficit that includes the interest payment for domestic debt by considering its rate of interest. We call it the operational deficit or surplus. The ratio of the budget deficit to GNP is 1 percent for Turkey in 1996 calculated by this method. I can use the method as follows: If Turkish inflation had been lower and if the government could have borrowed from abroad or if domestic interest rates had not been 25-30-35, then the budget deficit would not have been 8.2 percent of GNP in 1996. The deficit, which was estimated at 5 percent of GNP (excluding privatization revenues) for the end of this year will most likely be lower than expected. As a result, the operational deficit method can prevent any misjudgement. Now I want to explain briefly TUFEX. This is a new instrument which can extend the term of borrowing. While it provides significant advantages to the purchasers, it also provides more power in the fight against inflation. I mean when the government, as a seller, at the same time decreases the inflation rate, it knows that the interest expense will also decrease. Of course, this also works in the opposite direction.

In the United States, which is a well developed market, there are around 50 kinds of borrowing instruments. Some of them are public and others private. All have different pricing methods, different markets, and different functions. The financial markets make money by pricing the instruments or by borrowing and participating in the secondary markets. It is also our target to diversify borrowing instruments and have manage debt more actively. A new instrument has been added to the earlier Treasury bills with fixed interest and term. It will take at least one or two years for the system to settle down. A pricing method is needed and our financial intermediaries will learn it. The aim is increase diversification with respect to term, instrument, and also pricing, in order to improve borrowing conditions. This is the way to reasonable debt management. By applying it with sound macroeconomic policies and in the context of a medium-term program, it will enable us to increase the effectiveness of our debt management.

As I explained at the beginning of our conversation, we will look at both the positive and negative aspects of our situation and will study both. We will continue by increasing the first and reducing the second, and implementing policies aimed at

increasing the quality of life and raising the standard of living. We will achieve modernization. The Central Bank will make the greatest possible contribution to this effort.



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