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Dear Shareholders, Distinguished Guests and Valuable Press Members;

Welcome to the 70th Shareholders' Ordinary General Meeting of the Central Bank of the Republic of Turkey.

Today, I will dwell on the last year's economic program, discussions, and realizations thereon and the inflation targeting regime, which we have decided to introduce openly in the period ahead.

As you know, the exchange-rate-based stabilization program, which was initiated at the onset 2000 and intended to transform the economy structurally, became unsustainable due to the financial turbulences experienced in November 2000 and in February 2001. It lasted until the currency peg system was abandoned in the wake of the February crisis, which was the main pillar of the program.

After the crisis, a number of opinions appeared, trying to explain the causes lying behind the crisis, the deficiencies of the program, the structural problems, the timing of the crisis and so on.

A look into the recent history reveals that delays in reforms, fragility of the banking sector, the fact that problems in the banking system should have been resolved well before the implementation of the program and the lack of front-loaded additional reserve facility were among the reasons for the crisis. Moreover, the lack of public confidence in the institutions that designed and pursued policies during the last 25 years with no avail, and the pessimistic expectations arising from delay in reforms did not allow the program to obtain the most wanted results in a desired period of time.

In the wake of the crisis, a new program called "Transition Program for Strengthening the Turkish Economy" was initiated in May 2001 to review the 2000 disinflation program and to reinforce structural elements particularly. The goal of this program is to secure the economic stability and to put the economy on a sustainable growth path by overcoming the inflation problem.

However, the conditions, which were valid before the design and implementation of this program, are quite different from those of other previous programs. The program has two pillars. The first one is the Central Bank's full independence given by the new Central Bank

Law, and the second one is the implementation of free-floating exchange rate regime. At the core of the program are the banking and public finance reforms along with tight monetary and fiscal policy.

Basically, all these programs have been aiming to eliminate a structure that has become unsustainable as a result of wrong policy implementations without economic rationale. Getting rid of this apparatus is quite a painful process, and you may appreciate that it cannot be coped with by solely monetary policy. To meet the targets envisaged in the program, every aspects of the social life, both public and private sector must undergo structural transformation.

With the new program called “Transition Program for Strengthening the Turkish Economy,” the priority of the monetary policy was to stabilize financial markets and to support structural reforms. After that, the primary objective was to achieve price stability.

Since restoring the financial system was the main concern of the program, the Central Bank has provided financial support to the financial system within the framework of restructuring process, and then has successfully mopped up the excess liquidity so that the liquidity expansion might not create an inflationary pressure.

About TL 21.7 Quadrillion was transferred to state and SDIF banks through outright purchase and repurchase operations. Therefore, there was no need for banks to resort to overnight borrowing anymore. After these operations, the item “Net Domestic Assets” on the Central Bank balance sheet, which denotes the funds provided to the system, was estimated to increase by 130 percent from the end of May until the end of the 2001, and the monetary base was targeted to rise approximately 31 percent only at the same period. The estimated increase of 130 percent corresponded to TL 22.4 Quadrillion. The realization was TL 19.4 Quadrillion, which matched up 10.8 percent of the GNP in 2001. The difference between the increase in monetary base and the increase in Net Domestic Assets shows clearly that the Central Bank assumed a great amount of responsibility and risk in the liquidity management. By looking at the year-end figures following such a large-scale operations, we may easily see that the realizations have fallen below targets and that the Central Bank was very successful in the conduct of these operations.

In this context, the success of our present and future policies will depend on the continuation of banking rehabilitation by enhancing the quality of management and the level of productivity. The banking system must be reinforced by taking measures on supervision, capital adequacy, and by adopting international standards and transparency.

The distinctive feature of the new monetary policy is that it is being conducted under the free-floating exchange rate regime. With the free-floating exchange rate regime, the exchange rate plays no longer a central role as in the case of the previously implemented policies and has now become an independent variable, which functions as an "effect" instead of a "cause."

Let me point out here that the currency-peg-based program had envisaged switching to free-floating system progressively in the second half of three-year period. It should therefore be kept in mind that the current exchange rate regime, which we had to shift to prematurely before reinforcing the economic fundamentals and achieving stability due to the crisis, is actually the system that would have been adopted, if the 2000 program had been successful.

Since the free-floating rate regime has no historical background in Turkey, market participants have, at the beginning, had trouble in adapting themselves to the new system. This can be regarded as completely natural, when we look at the experiences of many countries shifting to free-floating regime unexpectedly due to crises in the last four years.

This was one of the most important reasons for uncertainties occurred in markets in that period.

I wish to go into details at this point. It is agreed both in theory and in practice that market players try to understand the central banks' actions by considering their announcements and past implementations. Therefore, not only central banks' announcements regarding the implementation of an exchange rate regime, but also the concerns over its future course will bear importance. Also in Turkey, although the Central Bank had made publicly known how the free-floating exchange rate regime would be implemented, the reason the exchange rates did not stabilize especially in the first few months was that this regime did not have any past record. In other words, how the Central Bank would act under this regime was somewhat unknown to market players.

Similarly, the economic agents have tended to increase their foreign currency (i) assets in order to protect themselves from inflation, and (ii) liabilities being less expensive than those of Turkish Lira under the currency peg regime. This is why the high dollarization tendency brought about rigidities, made the implementation of free-floating rate regime difficult, and postponed the stabilization in exchange rates.

Today we are delighted to see that the market players have now a better understanding of how the Central Bank would act in foreign exchange markets as the floating rate system gets established. All in all, the exchange rates have become less volatile as a result of a better adjustment of markets to the current implementation.

However, banks have adopted different attitudes due to their own structural characteristics. The different attitudes were criticized at that period, and it was rumored that some market players had directed the exchange rates as they wished. In particular, it was speculated on the discrimination between domestic and foreign banks. Let me express at this point that the Central Bank has been monitoring the markets very closely although it has hardly intervened in exchange rates since August 2001. The Central Bank has found out that the different adaptation rates of domestic or foreign banks caused difficulties for market players. It must be underlined once again that such discrimination is a serious mistake in a country where capital movements have been freed, foreign exchange restrictions have been removed, and persistent savings gap has been supposed to be covered by foreign capital for more than 10 years.

Moreover, there were criticisms for compelling banks to square their short positions within the framework of the financial system reform, and it has been asserted that such policy would accelerate the depreciation of exchange rates under the free-floating regime. On the contrary, however, it has become obvious that elimination of these short positions has greatly helped stabilize exchange rates.

At this point, I wish to draw your attention to the fact that although the free-floating exchange rate regime came once under intensive criticism as I have just mentioned, it should be kept in mind that what is important for a stable economy is to have sound economic fundamentals. If there is no such environment, it will not be possible to create a stable economy by using exchange rate or monetary policy only.

Therefore, we do not think it is realistic to approach the current program with one-sided considerations. It is not reasonable either to use the free-floating rate regime as a benchmark for the success or failure of the program, although it may serve as an indicator. It should not be misinterpreted, making subject to unending discussions.

Our exchange rate policy is open and clear-cut. We will by no means interfere in the long-term equilibrium rate. It is only in the event of temporary and excessive volatility that we will intervene in exchange rates by informing markets in advance. This can be clearly seen in all our policy actions pursued so far.

Besides these interventions, the Central Bank resort to planned foreign currency selling auctions last year in the context of the Treasury operations to mop up excess liquidity. As the program started to yield good results in 2002, the Central Bank opted for conducting foreign currency buying auctions to withdraw extra foreign exchange supply arising from strong balance of payments position and reverse currency substitution, and to build up reserves without distorting long-term tendency and equilibrium of exchange rate. As can be seen, all our foreign exchange operations, either selling or buying, are carried out transparently under a pre-announced program and in compliance with the free-floating exchange rate system.

However, since the exchange rate lost its function as an anchor with the new program, we were faced with a new problem. We had to choose a new anchor for the economy.

Now let me go into some details of the concept of "anchor," as it is also closely related with our future monetary policy.

Anchor denotes a variable that is taken as a reference in economic decision-making processes. Every economy absolutely needs such reference point. A variable is chosen according to certain predictions made by monetary authority. Then all economic decisions are based on this variable, as the confidence of other economic units in the predictions builds up. Decisions and expectations on prices, wages, and investments are shaped around this policy. If there is no confidence in such anchor or policy, the variables chosen will lose their function as an anchor.

It is clear that a reliable anchor is needed in order to make sound decisions in an economy. Now let me turn to the variables that we had at hand in choosing a nominal anchor for the new program last year.

We were not in a position to use the exchange rate as a nominal anchor anymore. It was used as an anchor under the currency peg regime, which had been implemented before the crisis. Since the currency peg regime was abandoned and replaced with the free-floating rate regime after the crisis, it was not possible to push ahead with using the exchange rate as a nominal anchor in the post-crisis period. Therefore, we had to discard this alternative.

As stated in the program, inflation targeting cannot be a nominal anchor in a transitional period. As I will soon explain in detail, the success of inflation targeting regime depends on some pre-conditions and technical preparations. Otherwise, we cannot speak of the faintest chance of success.

As a result, we decided to choose monetary aggregates to function as a nominal anchor under the transition program. This choice was a necessity. It suggested that backing the financial sector at that time would not create a monetary expansion and that the inflation would not be allowed to raise up.

The monetary base, which was earlier an indicative target, has become a performance criterion to reinforce the program. In 2002, the monetary base is targeted to increase by 40 percent as much as the growth rate of nominal national income and the projected inflation rate. Together with the fiscal discipline and the other structural measures, this increase will adjust the economic agents’ expectations to the target. The monetary base will be revised only if the reverse currency substitution continues. We do not expect an inflationary pressure to build up following this revision, since any increase in monetary base will originate from a rise in demand for TL due to favorable inflation expectations.

Another element is the sustainability of domestic debts, which is not on today's agenda but had, in the past, played an important role in the failure of earlier programs, and in creating pessimistic expectations. Especially in the first months of the transition program, the concerns about the sustainability of domestic debts persisted due to some setbacks that emerged during reform process but are now eliminated. Such discussions rendered the monetary policy implementations ineffective and increased the vulnerability of the system. However, continued fiscal discipline, making debt structure clearer, as well as obtaining external financial support have terminated the discussions on sustainability of domestic debts over time.

At this point, I would like to draw your attention to the significance of the expectations for an economy. Expectation, which is not an abstract concept at all, is based on realizations. Negative expectations create unfavorable realizations. And unsuccessful realizations make the current expectations pessimistic, as the past negative expectations are proved right. Therefore, it is a vicious circle that must be absolutely broken in order to get the best results from the policy actions. Favorable realizations are needed to break this mechanism. Favorable realizations will give rise to positive expectations and will accelerate obtaining positive results from policy implementations in real terms.

However, expectations are very fragile. Particularly in Turkey, the long-standing instabilities are shaping the expectations in extremities, either optimistic or pessimistic, due to unsound or invalid reasons in general. This variation in expectations is an important obstacle we are faced with in the conduct of the Central Bank's policies.

Looking back over, we all may see that, despite many achievements, especially unnecessary discussions and concerns over the sustainability of the program for its future course turned the expectations into negative by making it difficult to obtain the desired results from the program, and by creating a negative process, feeding on itself as a result. What we have witnessed in this process is that under similar macro-economic fundamentals, the differing expectations could bring the economy into diverse equilibrium points. For this reason, we must be very cautious about the expectations.

As of today, we are pleased see from the latest surveys that overall expectations, which turned into positive in November 2001 for the first time after a one-year period, are being broken both in financial and in private sectors. The “Business Tendency Survey,” made on real variables such as employment, income, investment expenditures, has recently shown that the negative tendencies have already ended, and they are being changed into positive. Expectations on exports, which are a significant variable under the current program, are keeping their positive outlook for the future. Similarly, the “Inflation Survey,” which is conducted bi-weekly, has demonstrated that the inflation expectations are falling down to the levels we have targeted. Such encouraging tendencies are helping us greatly in the shaping of our current policies, in making decisions for the future.

The economic outlook is giving strong signals that the predicted growth target could be hit. With the downward trend in inflation, declining interest rates will stimulate the economic growth without creating inflation. In addition, the recovery in the world economies coming out from recession will help keep on the same exports performance of the last year despite unfavorable environment and will positively affect the growth rate. Re-capitalization is the final phase of the banking rehabilitation process. Thus, banks will be able to provide more funds to the economy. This is vital for a healthy growth. Moreover, we think that the economic causes giving rise to reverse currency substitution would have a positive effect on the consumers' demand. However, economic agents should put aside the past habits, and the price-setting policies should be based on economic foundations in order to get benefit from this process.

As I have just touched on, behind these positive expectations are positive realizations. Decisive steps have been taken in the restructuring of the public sector on one hand, and in the rehabilitation of the banking sector on the other hand. Tight monetary and fiscal policies have been implemented. External financial support has been obtained. Consequently, economic fundamentals have started to invigorate, exchange rate stability has been achieved under floating rate regime, and the concerns over the sustainability of domestic debts have come to an end. However, this is a dynamic process, and we should not loosen the grip. Many more things must be done in order to achieve the goal. In the past, we all have paid the price of the lethargy after the interest rates had declined and the exchange rate had been stabilized. We must absolutely refrain from these tendencies and react to any signs of relaxation. The public opinion has important duties in this regard and should be well aware of this.

All these efforts aim at achieving a sustainable growth in the medium-term without causing inflation, keeping the economy away from potential turbulences, and laying the groundwork for a productive economy.

As of today, we see that the inflation has recently entered into a downward trend, which was in an upward trend due to the depreciation of Turkish Lira and the cost pressure arising from higher price increases in public goods on one hand, and the low performance in agricultural sector on the other hand. The February 2002 inflation represents a turning point in this process. The CPI inflation in February fell well below the expectations, and the inflation rate has declined on an annual basis for the first time since March 2001. The decline becomes much more obvious, if food is excluded from the price index. Basic factors lying behind this development are the absence of demand pressure, the stabilization of Turkish Lira and its appreciation a bit, the expectations turning into positive with the increased credibility of the program, and the influence of the expectations on the price-setting policies. The same trend persisted in March too. In March, the decline in food prices and in agriculture prices (well below the average of the last seven years) helped the realizations remain below the expectations, besides the factors bringing the inflation down in February. In March, the WPI inflation is the lowest of the last 21 years, and the CPI inflation is the lowest of the last 15 years among the March inflation figures.

The relationship between the exchange rate and the competitiveness, as well as the role of the Central Bank in this regard is also important. As we have underlined many times, the primary objective of the Central Bank is to achieve price stability. Preserving competitiveness edge directly, and targeting an exchange rate accordingly are not among the duties of the Central Bank. Therefore, nobody should expect any such action from our Bank. Moreover, the competitiveness edge depends on many factors other than real exchange rate. We may enumerate the price factors such as unit prices, profit margins of export goods, relative positions, and the structural factors such as the economic and social development level based on macroeconomic performance and qualitative elements, productivity level, qualified man-power, research–development investments, service after sale, product standardization, scope and time in guaranties etc. Exchange rate is simply one these factors, and is equally important. However, it should be kept in mind that the competitiveness of a country is best supported by an environment where price stability is achieved, uncertainties are decreased, and confidence is built up. Therefore, it is only in this way that the Central Bank will support the Turkey's competitiveness edge. This is much more important and extensive than the exchange rate.

Today, we are faced with important problems inherited from the past. The Turkish economy has suffered from a high and persistent inflation for 25 years. Although many programs have been implemented to disinflate the economy in this period, no enduring structure could have been achieved except sporadic successes. This long-standing process has generated a strong inertia in inflation, and caused the economic agents to shape their behaviors according to past experiences. All this mechanism has prevented monetary and other policies from being implemented properly and attaining their goals. Not having been supported by structural reforms, what the earlier program implementations could have done so far was to avoid creating bigger problems, and avoid worsening the situation.

As a result, a consciousness against inflation has not been formed properly. Living with inflation has become a way of life. This is because the inflation has never been transformed into hyperinflation in Turkey. Chronic inflation and its habits have brought about a resistance against structural reforms. Such climate destroys social life and is the biggest obstacle for a stable growth. Therefore, low inflation has become a pre-condition for the success of all other policies. Fighting inflation is also very important for restoring the lost credibility of governments and institutions.

At this point, I would like to refer to the fight against inflation and the Central Bank's policies in this regard.

As stated in the program that was initiated in May 2001, and in the new program announced in 2002, the Central Bank is determining its policies and decisions in line with the "implicit" inflation targeting for the moment, and will move over to the "official" inflation targeting regime when necessary conditions emerge later in the year.

Inflation has not been a problem on a global scale for the last 10 years. Turkey should not stay out of this process anymore. Turkey must first defeat the high and persistent inflation, which has caused serious damages in every aspect of economy and social life for the last 25 years, before realizing its claim to integrate to the World, and to become a member of the European Union.

Structural reforms, rehabilitation of the financial system and tight monetary and fiscal policies have so far laid the groundwork for the fight against inflation.

In this context, the Central Bank Law was amended in 2001. The scope of duties and responsibilities of our Bank has been re-defined. The task of achieving and maintaining price stability has become the primary objective of the Central Bank. Therefore, our Bank is no longer in a position to assume any other role, in view of the responsibility imposed by the new Central Bank Law and the seriousness of the inflation problem for all the sectors in the society.

A look into the worldwide practices reveals some important aspects in the monetary policy designs and in the institutional structures of the central banks that are successful in fighting inflation.

As to the monetary policy designs, we see that a certain target is specified, and is announced very clearly. The responsibility is shared with the governments with varying degrees according to the nature of the targeted variable.

In this context, many countries are increasingly adopting inflation as a final target of the monetary policy, and the responsibility is mainly shared between central banks and governments. Under this practice, the targeted inflation becomes a nominal anchor.

Expectations are shaped according to the targeted inflation rate, the changes in the short-term interest rates to hit the target, the announcements regarding inflation and interest rates, and the amendments made in the central bank laws to adopt inflation targeting. It is obvious that, the instrument independence of a central bank is the pre-condition for changing the expectations into positive. In other words, central banks should be in a position to freely use all policy instruments in order to bring inflation under control without becoming confused with other targets.

As to the institutional aspect of central banks, we see that the concepts of "independence," "transparency," and "accountability" are gaining importance.

By looking over all these aspects, we may say that our Bank meets all the requirements from the standpoint of independence, transparency, accountability, and institutional design. It is even ahead of many countries.

As I have just pointed out, our Bank will switch to the inflation-targeting regime shortly in the context of monetary policy design. With this policy implementation, the Central Bank will set an inflation target for a certain period jointly with the Government and announce it to the public opinion. After that, our policy implementations will be directed only and only to realize this target. Our aim is to reduce the inflation to single digits at the end of three-year period.

However, the success of such policy is linked to the meeting of some pre-conditions. Otherwise, it will not be possible to overcome inflation, the scope of which being so extensive, touching every sectors of the society. It is closely related with almost all policy implementations, directly or indirectly.

For this reason, before and during the implementation of such policy, it is necessary to maintain fiscal discipline, to achieve exchange rate stability under the floating rate regime with minimum intervention of central bank, to relatively reduce the pass-through of exchange rate on prices, to increase the efficiency of interest rates as a policy instrument on economic decision-making processes and on inflation, and finally to break the inertia in the inflation by abandoning the habits of backward-looking indexation, which is quite important.

By looking at the current situation regarding these pre-conditions, we see that some stability in the exchange rate has been achieved. The Central Bank has begun using short-term interest rates as an efficient policy instrument. Our decisions on interest rates are completely forward-looking, and are announced along with the reasons. By doing this, we consider a number of variables such as total supply and demand, wages, balance of payments, public sector prices, exchange rate, international goods and financial markets, and inflation expectations. Decisions on interest rates are taken by forecasting how any development in these variables could affect the future inflation.

Let me remind you here that, contrary to general belief, the inflation-targeting policy does not ignore targets such as growth and employment. By its nature, it is out of the question for the inflation-targeting policy to remain indifferent to the other macro-economic variables that should be compatible with the targeted inflation. In fact, this understanding is reflected on the new Central Bank Law.

In this context, expectations are among the most important variables, which the Central Bank will use for meeting its monetary policy target. In other words, all monetary policy instruments, specifically short-term interest rates, will be used actively to shape expectations.

All these implementations necessitate at the same time a very strong technical groundwork and forecasting modeling. The works conducted by our Bank in this area have reached an advanced level. Our Bank has begun conducting a new bi-weekly tendency survey intended for financial markets with aim of expanding the information basis.

Similarly, the Central Bank is gradually phasing out its intermediation role as a blind-broker undertaken in the interbank money and foreign exchange markets in order to make our policy implementations more functional. Our aim is to enable market players to better evaluate the interest rate, exchange rate, and counterpart risks they are exposed to under the market conditions, by improving the efficiency of the markets. Moreover, the Central Bank is in the process of introducing new arrangements such as “late liquidity window” operations in the interbank money market, with the aim of ensuring smooth functioning of the system.

Another important point under the inflation-targeting regime is to increase the communication with the public opinion. To this end, we have begun publishing a report containing our inflation analyses and expectations on a regular basis. In addition, the Central Bank’s announcements and other informative texts regarding our monetary policy implementations can be accessed on our Web Site. Press releases related to our decisions are made public simultaneously.

Having said all this let me leave you with the following conclusion. What we have done so far, and what we wish to do in the future monetary policy is all destined for providing Turkey with a better place both economically and socially in the near future. Achieving social consensus is vital in this process. The process seems to be a long and painful one. We have no other choice but to overcome the long-standing inflation problem. For this reason, the fight against inflation should not be abandoned to make way for other considerations such as growth, employment, or exports, as was the case in the past. As we all have observed in the past 25 years, neither a sustainable economic growth, nor a stable increase in employment and exports can be achieved, unless the inflation problem is solved.

Thank you all for listening.