

**REMARKS MADE BY SÜREYYA SERDENGECİ,**  
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**ON**  
**THE FALLING INFLATION**  
**29 SEPTEMBER 2004**

Dear Guests;

In my speech today, I would like to dwell on the “environment of “falling inflation”, its main impacts on economy both in other countries and Turkey and finally, the significance of maintaining price stability for Turkey’s economy.

The achievements obtained on the inflation front in the last three years under the current program allow us to speak about falling inflation environment and permanent price stability.

Now, let me briefly review the point we have reached in the fight against inflation: CPI inflation, which was 68.5 percent at the end of 2001, remained below the targets set in 2002 and 2003 and fortunately, it realized as 18.4 percent at the end of 2003. In 2001-2003 period, the total decline in inflation exceeded 50 points.

In August, CPI inflation fell to 10 percent thanks to the stability program, which was determinedly carried out in 2004, and the tight monetary and fiscal policies implemented within the framework of this program. Looking at the CPI inflation today, I do not see any serious problem that would prevent us from reaching the 12 percent-CPI inflation target for 2004.

However, despite the success attained in reducing inflation, I would like to underline the fact that we have not reached our final target yet. Turkey is one of the very few countries where double-digit inflation prevails. As I have mentioned repeatedly both at the very beginning of the disinflation program and the point we reached today, our final target is to achieve and maintain price stability.

Now let me emphasize once more what price stability stands for.

The well-known definition of price stability relates to the currently low inflation rate in one hand, and the expectation of economic agents that the ongoing decline in inflation will

continue in the future. Such an inflation rate is so low that people do not need to take it into account in their investment, consumption and saving decisions.

At the point we have reached in inflation, it is clear that our economy is surviving from chronic inflation. However, I would like to draw your attention to the fact that we have not fully maintained the price stability that I have just mentioned, and our economy is still in a “falling inflation” period.

Honorable guests,

The point we reached in the fight against inflation is remarkable. Both the dynamics of inflation and economy go through changes along with the transition from chronic inflation to falling inflation process.

Looking at the countries, which experienced a similar process that Turkey went through, it is clear that the falling inflation period differs from the environments where chronic inflation had previously existed or price stability is maintained afterwards. **The falling inflation process is a transition period.** Therefore, the features of the targeted price stability environment and the former high-inflation period can appear together. This can be explained by the fact that some sectors and economic agents can adapt themselves to the process relatively fast, while some sectors, failing to adapt to the new environment, take on different expectations and perception of risk factors shaped in the framework of their former habits.

Let me elaborate this point as it is of great importance with regard to the achievement of price stability.

In relatively fragile economic environments such as Turkish economy, where price stability has not yet been fully maintained and current policies have not gained credibility, some economic agents may take the exchange rate, monetary aggregates, interest rates and similar aggregates as reference while making their decisions. Therefore, as you will agree with me, expectations and risk perceptions in the economy will change according to the size of the referenced aggregate.

In this period, some of the economic agents that I have mentioned are negatively affected by the referenced aggregates, which are adopted in accordance with the former habits that contradict with economic realities. Moreover, these economic agents tend to put the blame on the falling inflation for the worsening of their situation. These economic agents that fail to

harmonize with this new process are the ones who resist the most to the fight against inflation. This adaptation problem also prevents these economic agents from seeing the advantages offered by price stability.

In this context, the most important development in fight against inflation is that credibility of current policies have improved, whereas the inflation target has increasingly become a more credible nominal anchor for a majority of the economic agents in Turkey. In other words, the inflation target was taken as a reference more extensively. Further developments will facilitate the adaptation of economy to changing dynamics and support maintenance of the price stability as well.

Distinguished guests,

Before discussing the effects of the falling inflation on economy, let me elaborate the importance of price stability for economies.

As we all know, the primary objective of economic policies is to provide sustainable growth and to increase employment throughout the country. The role of monetary policies has been misunderstood for a long time. This wrong assumption is that the increase in inflation and growth are parallel to each other and growth rates can be accelerated by loosening the monetary policy. Frankly speaking, in the framework of early economics literature, this assumption can only be verified in the short term, in countries where inflation rates are low and there is no credibility gap in monetary policies.

However, the models developed and long-term analysis made after 1980s revealed that the loose monetary policy under high inflation conditions could only end up raising the inflation rate and growth would slow down due to uncertainties arising from inflation.

We very well know from our own high inflation experiences in the past three decades and other countries' experiences that average growth slows down when inflation climbs and average growth accelerates when inflation falls. The high growth rates we achieved in the past three years, which were marked by the stability program, is a good evidence of this generalization. Attaining price stability is a prerequisite for achieving sustainable growth.

For this very reason, today, the primary objective of the Central Bank is to achieve and maintain price stability, which makes the biggest contribution to sustainable growth and increase in employment.

Distinguished participants,

In this part of my speech, I would like to dwell on the three pillars of the change observed in inflation dynamics under falling inflation process.

The first significant change observed in economies under falling inflation conditions is the decline in interest rates. If enough credibility has been established in the falling inflation process, significant decline is observed both in nominal and real interest rates and this process does not only lead to rise in expenditures but also in investments.

Within this framework, a more detailed examination of the struggle against inflation process in Turkey reveals that decline in inflation also helped mitigate the fluctuations in inflation and this means less uncertainty and less volatility in economy. While decreased uncertainty brings along decline first in risk premium and then in nominal as well as real interest rates, it decreases borrowing costs from the consumers' point of view, and opportunity cost of investments from the producers' view point.

At this point, I would like to draw your attention to a risk factor in which the decline in borrowing costs has a significant role. Under chronic inflation conditions, consumers tend to renew durable goods such as automobiles, white goods and alike less frequently. However, when a certain point is attained in the process of reducing inflation, the consumers start purchasing their postponed needs. Demand for durable goods that the consumers defer to purchase tends to increase rapidly in the face of decline in inflation and fall in the borrowing costs. The recovery in demand is not yet at a level that could create an inflationary effect since it is coupled with a rise in productivity. Provided this demand does not assume a permanent nature and lasting economic stability is attained, it is expected that such fluctuations will become less frequent and less intense, but still, it should be monitored very closely.

Meanwhile, there is another point that I would like to emphasize. Similar to other country experiences, in Turkey as well, the positive effects of falling inflation on investments are retarded relative to other effects such as rise in consumption. That is because it takes time for the firms to be convinced that the downward trend in inflation will continue and will be permanent and to make decisions for new investments. Therefore, under falling inflation conditions, it is natural for the firms to tend not to make as much investments as they actually can.

In Turkey, despite the economic recovery has a history of three years, investments have just started to increase in the last few months. This is an outcome of the fact that confidence has

recently been established that decline in inflation and achievements in inflationary expectations as well as stability established in economy will be lasting.

Consequently, while increase in investment demand is an outcome of the falling inflation, sustainability of this increase depends on attaining price stability.

Distinguished guests,

The second change that came along with the decline in inflation is that as a result of the ease in uncertainties, economic agents were able to foresee longer periods and financial intermediation activities became more active.

Within this framework, when we look back to the chronic inflation period, we regret to see that high inflation has led to chronic budget deficits and very high interest rates; caused deterioration in wealth transfer mechanism and forced banking sector to finance the public deficits. In this period, the financial sector has become very vulnerable and edged away from its main duty of financing production.

Today, we are happy to see that enhanced competition and economic stability following the decline in inflation and ease of the impact of inflation-oriented uncertainties on financial markets, financial intermediation mechanism has started to operate more efficiently. Moreover, serious steps are being taken towards establishment of banking sector-real sector relationship. The ratio of total credits to total deposits, which has been on the rise since 2003, is a clear indicator of this process.

However, let me draw your attention to one point. It is clear that, in order to maintain financial stability in the current environment of relative economic stability, the relationship between banking sector and the real sector needs to be developed not only towards credit utilization, but also with respect to risk evaluation. The progress of risk management in the banking sector will ensure that the companies have sounder financial structures, that they develop more transparent financial tables and adopt modern management style. To express it more openly, the progress of modern risk management in both the financial as well as the corporate sectors will prevent developments that may arise out of the imbalance between assets and liabilities, stemming from different perceptions in the process of transition to price stability, and jeopardize financial stability.

Esteemed participants;

In terms of the structural transformation programs, financial sector, owing to its significance, is the sector that is most and fastest affected from the process, as well as being the leading sector in terms of supporting the process. Accordingly, further steps need to be taken in this sector in the process of falling inflation.

Dear audience;

The third factor I will be conveying to you today within the context of the effects of falling inflation on the economy is that, together with falling and foreseeable inflation, prices resume their signaling task in the economy and thus their roles as indicators in the allocation of resources.

Departing from the example of Turkey, as we all know from the past experience of chronic inflation, consumers used to be inclined to make less price and quality controls, and attach less significance to diversity in their choices of goods. Producers on the other hand, used to set their profit margins freely to a large extent, paying little attention to their pricing, the costs and productivity. They also showed little interest in making investments for increasing the diversity of their products by adding them new ones. As a result of this structure, the quality of production declined in time, global competitiveness of our country weakened and integration with the world economy was delayed.

Nevertheless, with the absolute as well as the relative prices resuming their signaling task following the decline in inflation, the behavior patterns of producers and consumers in Turkey began to change.

At present, producers are in a position to differentiate, to a large extent, whether the increase in prices is attributable to inflation or to an increase in demand, and can take their decisions with regard to increasing production, making investments, etc., within this framework. They now give importance to cost control and productivity increase while determining the profit margins in their pricing policies.

Similarly, consumers have also begun to actively participate in the pricing process, using the advantage of a more competitive environment.

At this point, I wish to emphasize two issues I deem significant. The first one of these has to do with inflation falling at a slower pace compared to other sectors, also due to pricing behavior directed to increasing the profit margins, at those sectors where demand is relatively

rigid and competitive structure relatively weak. This situation, also expressed as rigidity in inflation, by way of causing differentiation in relative prices, forms an obstacle to prices to carry on their task of conveying information properly. The rigidity in inflation recently observed in Turkey, in sectors such as education, rental services and hospital services, with prices falling at a slower pace for the services group compared to the commodities group, is an example of this. It is crucial that measures to increase competitiveness in these sectors are taken promptly in order to eliminate this distorted structure and also in terms of the risk it constitutes to the inflation target in future.

A second point in connection with this is that; it is inevitable that in time, together with healthier price signals, the resources of our economy will shift to firms and sectors with higher productivity, as was the case in other countries. The firms and sectors that had benefited from the consumption and pricing habits of the inflationary environment, but could not work efficiently, will be leaving their places, in this process, to more competitive firms and sectors with higher productivity.

Dear audience;

At this point, I wish to mention an issue, regarding the changes in the pricing policy of producers, extremely significant in terms of its effect on the future course of inflation. This is the process of exchange rate affecting inflation, known also as the pass-through effect. The effect of exchange rate on inflation in Turkey is weakening day-by-day, due to the changing pricing patterns of producers as a result of the decline in inflation. As observed especially in the recent period, the impact of the movements in exchange rate on inflation began to materialize less than expected, and also at a lower level and in a more lagged fashion compared to the past chronic inflation period.

As a matter of fact, the pass-through effect of exchange rate movements on prices has been weakening worldwide, in environments where price stability has been ensured thanks to highly reliable monetary policies, attributable to the facts that pricing in domestic currency is widespread, and owing to low and stable inflation, losses of value in the domestic currency are perceived as temporary and firms resort to price adjustments less frequently.

At this point I would like to clarify one issue on the exchange rate policy of the Central Bank. The Central Bank has no policy towards keeping the Turkish lira overvalued. As always mentioned from the beginning of the implementation of the floating exchange rate regime, exchange rates are determined under the supply and demand conditions in the market. In case

of excessive volatility in both directions, the Central Bank intervenes or if there is an excess foreign exchange supply Central Bank holds FX buying auctions to increase foreign exchange reserves. So we should keep in mind that in the current design of the monetary policy, with the floating exchange rate regime, level of foreign exchange rates is determined according to the developments in economy, exogenous shocks, expectations and volatility in risk premium as a result of all these.

Dear participants;

I would like to briefly mention what the economy of our country can gain if the main goal, which is price stability, is accomplished after the disinflation process.

First of all, securing price stability will make permanent all that we have gained in the process of the falling inflation. When price stability is achieved, macroeconomic stability will sustain and efficiency in the economy will increase. You should remember that by attaining price stability, a precondition for sustained growth and increase in employment would be fulfilled.

As a result of all these macro economic gains, economic units will no longer take into consideration an uncertainty like inflation both in their investment and consumption decisions. They will be able to forecast for the long term and plan more securely.

Since economic units can forecast better while making decisions, in this stable environment labor market will work better, and people will be able to find more permanent jobs. In a continuous inflationary environment, growth also has ups and downs and in the period of growth for the unskilled labor force, which is very common in our country, it takes a lot of time to find a job and in the contraction period loses the job very easily and quickly.

Stable environment achieved with the falling inflation will accelerate the inflow of foreign capital and our competitiveness edge in the international markets will increase.

I would like to highlight one more matter in light of the above-mentioned issues. Inflation is not a fact that declines all by itself. It falls if decisive and correct policies are applied and low inflation and permanent price stability can be continuous if only these policies are carried on.

We should not forget that inflation was not only the most important problem of our country for years but also kept us from seeing the existing problems in the society and in the economy. Attaining price stability will repair the damage of the economy caused by high inflation and will help us see other unnoticed problems hiding behind inflation. The key to



erasing the traces of past period high inflation and to solving other problems of our country is structural reforms.

Today, the process of erasing these traces begins with operation of dropping six zeroes from Turkish lira. I would like to underline that an important issue here. In some countries that had dropped zeroes from their currencies this operation was conducted as a part of the disinflation policies. However, in our country it is the consequence of the successful implementation of the stability program that has already reduced inflation considerably.

Within this framework, YTL to be issued as of January 1<sup>st</sup>, 2005, depicts both the decline in inflation and our determination to achieve price stability.

Before I finish, I wish to repeat a remark I made two years ago at the start of the fight against inflation.

“Above all, people deserve to live in an environment where price stability is achieved.”

Thank you for listening.