Remarks by

GAZİ ERÇEL

GOVERNOR

THE CENTRAL BANK OF THE REPUBLIC OF TURKEY

at

ANKARA UNIVERSITY, FACULTY OF POLITICAL SCIENCES

ANKARA

NOVEMBER 14, 1996

IMPLEMENTATIONS AND OUTCOMES OF MONETARY POLICY IN TURKEY

Ladies and Gentlemen,

It is noteworthy that since the beginning of the 1990s, a valuable consensus on the macroeconomic and monetary methods and purposes of central banks has replaced the variety of sometimes conflicting views that had previously prevailed.

There are four main elements to be considered in judging the outcome of any monetary policy implementation. These are its final goal or target, its intermediate target, the instruments for reaching the targets, and the manner in which the instruments are applied.

The final goals of central banks' monetary policies can be either medium or long term. The consensus view is that the only useful medium-term goal for central banks is maintaining price stability, and that this goal can only be achieved by means of monetary policy.

Having chosen its final target, the central bank should define an intermediate target. The choice of the variable to be used as an intermediate target is based on four criteria: It should have some stable or consistent relation to the final target. It should be a variable which the central bank is able to control. It should be insulated as much as possible from the effects of other policy goals. And finally, it should be clear how the variable chosen as the intermediate goal can reach its targeted value.

Establishing and announcing the intermediate target not only brings the direction and methods of monetary policy to public attention, but increases public support for the goals of the central bank.

Many variables satisfy the above four criteria and are therefore potential intermediate targets. The choice depends on the final goal and the strategy for pursuing it. Potential intermediate targets include monetary aggregates, the exchange rate and interest rates.

Of all these variables, monetary aggregates are the ones that can most directly be controlled by central banks through the instruments of monetary policy. Examples of such aggregates are the Base Money aggregate from the balance sheet of the central bank, or the M1 aggregate consisting of all deposits in the banking system. Exchange rates are a good alternative intermediate target variable, because, unlike monetary aggregates they are little effected by financial innovations. When using exchange rates as the intermediate target, the central bank makes sure that short-term interests are continuously consistent with the targeted level of the exchange rate. **It is precisely because interest rates would otherwise be the object of political pressures that the autonomy of the central bank is absolutely necessary for the successful conduct of the monetary policy. Political interference with central bank autonomy to influence interest rates can cause wide fluctuations in the exchange rate. For this reason, the interest rate is the least preferable choice as an intermediate target.**

After setting and announcing its monetary policy targets, a central bank must choose the tools it will use and the manner of their use. Monetary policy instruments include liquidity tools and interest rate tools. Liquidity tools are supposed to be short-term, since central banks must be able to control the assets on their balance sheets and liquidate them when necessary. As for interest rate tools, there are two main considerations. A central bank should be free to set the interest rates for its own assets. And a central bank should be able to control short-term interest rates in the market.

Presently, central banks in many countries including Turkey, are operating under free market mechanisms. The markets' reactions to central bank decisions show up first in short-term interest rates. Central banks generally pursue the targets defined by their macroeconomic and monetary policies through open market operations, rediscount credits and compulsory ratio requirements.

Open market operations are used to control the liquidity of the banking system. It is important to keep central bank intervention in these markets to a minimum. **In other words, they should appear in the markets rarely, ensure that transactions are two-way, and stay out of operations as much as possible**.

Another instrument available to central banks is their ability to set **reserve and liquidity requirements**. This instrument enables central banks to control their reserves by taxing the banking system.

And finally, **rediscount** credits enable central banks to meet the liquidity needs of the banks on the one hand, and to control short-term interest rates on the other.

Once the targets are set, the success of monetary policy depends on the central bank's having sufficient authority and adequate policy tools to reach them. The central bank's authority and means are closely related to the issue of central bank autonomy.

Having established the main outlines of the implementations of monetary policy, it is time to define the relationship between monetary policy and exchange rate policy. Monetary policy and exchange rate policy are intertwined, since the implementation of both relies on the same policy tools. And since central banks are sometimes obliged to conduct exchange rate policy as well as monetary policy, the necessities of the two kinds of policies can sometimes conflict. This is particularly problematic under a managed floating exchange rate regime in an open economy. Such conflicts cannot be totally eliminated by legal arrangements, but have to be resolved by the actions of autonomous acting central banks aided by adequate public and political support for the aim of price stability. **For this reason it is important for central banks to educate the public about the costs of inflation and the limitations of short-term monetary policy.**

Another very important factor affecting the implementation of monetary policy is permanent or at least very persistent inflationary expectations. Where such expectations are present, or when there is no suitable monetary aggregate to be chosen as intermediate target, price stability may be very difficult to achieve. Under these conditions, the central bank must regain or strengthen its credibility and convince public opinion of its determination to stabilize prices.

Having discussed the framework of monetary policy in general terms, let us now attempt to assess the situation in Turkey. This will involve a discussion of the policy targets of the Central Bank of the Republic of Turkey, the instruments it has at hand, and what variables should be observed in monitoring the conduct of Turkish monetary policy.

Today, the monetary policy instruments furnished by law to the Central Bank of Turkey include **open market operations** and the power to set **reserve requirements and other compulsory ratios, rediscount credit rates, and foreign currency surrender requirements.**

The Central Bank also has some tools that depend on its ability to regulate the short-term money markets. These are **markets** operating within the Central Bank. The Central Bank regulates liquidity and short-term fluctuations in the market through interbank money markets and open market operations. The Bank injects liquidity into the market or withdraws excess liquidity from the market by means of repo and reverse repo operations and by direct buy and sell transactions in the open market, and by dealings involving deposits in the interbank market.

Another instrument employed by the Central Bank is the **reserve requirement ratios**. The Central Bank can use these ratios to control the amount of money created by banks. Before 1994, these requirement ratios used to apply only to deposits. When deposits lost their primary importance in banks' balance sheets and the banks began to make more use of resources other than deposits in the credit creation process, the liability base subject to requirements was expanded and a new definition of the money supply was implicitly adopted. For years, the Central Bank's most important means for controlling the volume of credit in the market has been by raising and lowering of requirements ratios.

Another of the instruments provided by law to the Central Bank is **rediscount credits**. Before 1989, "support credits" had been provided to banks as medium-term credits and recorded in the Central Bank's balance sheets as an item called rediscount credits. This item's share in the balance sheet was about 15 percent during this period. Under an arrangement made in 1989, the practice of granting rediscount credits as medium-term credit was discontinued and they became short-term credits to meet the liquidity requirements of the banks. The purpose of the change was to give the Central Bank an effective monetary policy instrument for supporting price stability. However, this instrument was only used for two years. The Central Bank, which was obliged to finance the public sector borrowing requirement while controlling its balance sheet and the money supply, was forced to restrain the growth of its balance sheet by making substitutions among its asset items. Since the rediscount credits could no longer be used to regulate liquidity in the markets or serve as an instrument of monetary control, announcing the rediscount rate lost its usefulness as a means of giving signals to the market.

The instrument the most widely used in recent years is the **surrender requirement ratios**. Turkish law requires that a certain amount of the foreign exchange gained by economy be sold to the Central Bank. Recently a new regulation has also required that a certain amount of these transfers be sold to the markets within the Central Bank. The Central Bank makes adjustments in the surrender requirement ratios in order to regulate its balance sheet or control its growth.

The variables that are important to Turkish monetary policy can be divided into two groups: quantity variables, such as monetary aggregates and price variables such as interest rates and exchange rates.

The results of monetary policy can most easily be traced by examining the balance sheet of the Central Bank. For this reason, the transparency of our Bank's balance sheet is very important in terms of keeping public opinion informed. Monetary aggregates as reported in the balance sheet have been used as policy targets on numerous occasions. Such monetary aggregates such as M1 and M2, consisting of deposits in the banks, are also monitored as important indicators of total money creation in the economy.

The results of monetary policies can also be seen in the price variable. The Central Bank has always given a high priority to maintaining stability in the markets. Market stability can be monitored by observing interest rate and exchange rate movements. Naturally, changes in the level of inflation or the general price level are important variables for evaluating whether or not a monetary policy has achieved its final target.

Examining Turkish monetary policies over the last ten years in the light of these data, three distinct phases can be observed. The period from 1985 to 1989 can be termed the period of financial innovation, restructuring, and liberalization. Significant innovations were introduced into the financial system as part of an economic program. The first and most important of these novelties from the standpoint of financial and monetary policy was that the Treasury began to conduct its borrowings by an auction system. This was the first step toward adopting market mechanisms. Later, markets were gradually established within the Central Bank. The abolition of controls over interest rates and the acceptance of convertibility were the essential elements of this innovation. Another important development affecting Turkey and its financial markets during this phase was the taking of the first steps toward the liberalization of capital movements, a process completed in 1991. During this phase, the Central Bank began the practice of monetary programming, but would not be able to announce its programs to the public until the transition period was over.

The second phase, from 1990 to 1992, was less consistent in terms of monetary policy practice. During this phase the Central Bank announced two monetary programs. The 1990 program was unique both in terms of being the first ever announced and thus a model for subsequent programs, and also in terms of the message that it conveyed. This program has several basic elements. First, the balance sheet of the Central Bank was rearranged and made transparent, and aggregates taken from this balance sheet were used as declared targets. Second, the program had a medium-term framework, which is to say that time was allowed for the transition to a flexible balance sheet structure that would strengthen the Central Bank's ability to fight inflation. And finally, the announcement of the new balance sheet structure that would emerge in the medium term provided signals about what policy instruments the Central Bank would use and how it would use them. For example, the Central Bank planned to abandon its function of financing the public sector and confine itself mostly to regulating liquidity in the markets. It was accordingly planned to revive and expand the use of the rediscount credit instrument. The Central Bank also sought to balance the foreign exchange position of its balance sheet.

However, before these targets could be achieved, there was an outbreak of financial turbulence at the end of 1993 and the beginning of 1994. The public sector applied for access to Central Bank resources, and the Treasury cancelled its auctions, and eventually there was an increase in liquidity. The Central Bank resorted to selling foreign exchange to avoid its effects on prices. At the same time, the fact that interest rates were not free to move in response to market conditions put pressure on the exchange rate. Due to the liberalization of capital movements and the short positions of the banks, the reserves of the Central Bank eroded swiftly. These developments led to increasing markets swings and in the end, to a larger devaluation and a stand-by agreement with the IMF. The stand-by agreement included the monetary targets taken from the balance sheet of the Central Bank and defined in terms of what was needed to reach the exchange rates chosen as an anchor. If we look at what this program stood for, without going into the details, the monetary policy of the Central Bank was based on exchange rate policy: in other words, **the monetary policy implemented by the Central Bank was to pursue an exchange rate policy based on current account equilibrium**.

Having outlined the framework of generally accepted principles in monetary policy and shown where Turkey stands in terms of its monetary policy applications, let me attempt a final, summary evaluation under several headings.

First, it is now generally accepted that Turkey's public deficits are large for the size of our financial system. This imbalance has plunged the domestic debt into a vicious circle, and as a natural consequence **the public finance deficit is the largest strain on the monetary policy of the Central Bank**. This highlights the importance of the relationship between the Central Bank and the Treasury. Fiscal policies that are not compatible with the financial sectors of the economy cause damage to this relationship and impose heavy burdens on monetary policy.

Second, Turkish inflation is both persistent and high. Inflationary expectations are well entrenched. In such an environment, one key to bringing inflation down is to establish credibility and confidence in the Government's determination to do so. **The Central Bank must therefore gain and preserve public credibility and market confidence.**

Third, when conducting monetary policy it must be kept in mind that capital movements are now completely free. Substantial capital outflows will result if interest rate pressures result from the mismatch between the size of the public deficits and the size of the financial system. This must particularly be recalled when monetary policy is invoked to cover current account deficits, since the current account is affected not only by the exchange rate but also by fiscal policies and demand trends, variables that are very little affected by monetary policy. In other words, **the "binding constraint" on monetary policy is the balance of payments, not the current account equilibrium.**

Fourth, the Central Bank must have instruments that it can use freely for its monetary policy purposes. At present, the instruments available to the Bank include requirement ratios, open market operations, surrender requirement ratios and rediscount operations. Even though the Bank is not using the last mentioned effectively at present, its use can be expected to increase with development of the Risk Centralization Unit. **Naturally, the other important point to be made here is the need to limit the credit extended to the public sector.** The Central Bank has neglected the needs of the banking sector for years in order to minister to the needs of the public sector.

Fifth, it is not possible to insulate Turkey's Central Bank from the effects of the internationalization of financial markets and increasing globalization. Technically speaking, our financial markets are on the way to being integrated into the international markets. Financial innovations in the international markets can show up in our domestic financial markets at any time. The Central Bank must therefore keep its technical infrastructure strong to ensure that it does not lag behind world financial markets.

Lastly, nowadays when our Country is on its way to becoming a member of the European Union, our Bank will have to match a number of external conditions. Above all, as in other member countries of the European Union, the Central Bank should bear less responsibility for financing the public sector.

The reduction of inflation is a long and arduous task, and the final outcome cannot be precisely predicted. However, it is certain that until the authorities are able to act in a resolute manner in the fight against inflation, it will be impossible to achieve the environment of "financial stability" that is a precondition of rapid economic growth.
