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AN OUTLOOK FOR 1997

First of all I would like to thank the Economic Research Foundation, on whose administration I have the honor to serve, for inviting me to this seminar. I am very proud of the efforts which my dear master, Orhan Dikmen, has been making for many years on behalf of the Economic Research Foundation, and I wish to congratulate him once again.

Today it can be said that the world economy and the world of finance are experiencing their best time, and their prospects for 1997 are optimistic.

To create a strong and increasing tendency towards growth and make it stronger requires that monetary and financial policies be eased until they are compatible with growth. With a compatible environment, an increase in global growth rates can be anticipated. But such an environment requires that inflation be held to its present law levels and even brought down further.

The financial markets, on the other hand, depend on growth, and are planing their strategies accordingly. Their risk premiums are decreasing and cuts in their interest rates are stimulating activity in the market.

The basic question is whether the trend toward growth will last or not. It is generally believed that the trend will prevail. Economic expectations reinforce this view, while the gradual increase in competition reduces the risk that goods prices will rise. Optimism is further encouraged by the likelihood that oil prices will decline following their recent increase, that industrial production will rise and that wage pressures will be less than in recent years. In fact, the greatest risk comes from the possibility that growth will exceed expectations.

The financial markets are also pleased with the international environment. The foreign exchange markets expect no large up and down movements. Capital flows will likely remain strong. In the bond markets, it is expected that the decline in the spread between risk and interest rates will direct profitable transactions to higher risk paper. Another factor reducing profits is the approach of the European Monetary Union. All in all, it is not surprising that the securities markets are those most affected by this favourable environment.

In contrast to this rosy picture in the international financial markets is the environment in Turkey. It is well known that for the last 40 years, developments in the world economy and in Turkey have consistently been at odds. Here we see another example of this traditional contrast. Indeed, we in Turkey seem to exemplify Charles Wolf's observation that "Those who fail to learn from the past repeat their mistakes. Those who have learned from the past find other ways to make mistakes." In any case, despite extremely favourable conditions in the world economy, in Turkey the question being discussed is whether we are about to undergo a crisis.

Significant developments in Turkey during 1996 can be summarised under nine main headings:

1. Political instability was the main feature of 1996, a year which saw three governments.
2. The economic outlook, which at first was negative, began to show positive trends. Then another episode of negative trends, followed by positive trends. This pattern, which was repeated in each quarter of the year, resulted from short-term bursts of activity against a background of uncertainty. Whenever the uncertainty seemed to increase, crisis expectations appeared immediately.
3. The growth of exports to former Soviet states and East European countries produced higher inflows of foreign exchange to financial institutions which increase reserves even though they were not registered, and the feared current account deficit did not materialise. The problem of a trade deficit that could be caused by destabilising effects of Turkey's participation in the European Customs Union is gradually being overcome. And the increase in official reserves over the beginning of 1996 acted as an airbag to cushion the system against the drop in short-term inflows of hot money.
4. The Treasury's borrowing requirement results from the rolling over of its previous debts as they fall due. The limited availability of foreign facilities providing such rollovers has increased pressures on both the domestic markets and interest rates. Real interest rates remained at the previous year's level.
5. Due to the primary surplus, the Central Bank's unannounced monetary programme based on an economic model that takes a Keynesian approach to a non-expansionary fiscal policy, had a favourable effect on expectations.
6. Coherence and cooperation between the Central Bank and the Treasury have bolstered market confidence, thereby assisting monetary policy to achieve its aim of promoting stability.
7. The banking sector, whose wounds from 1994 are partly healed, has been moving much more cautiously since it learned the meaning of risk from first-hand experience. However, the public sector continues to be a burden on the banking and the financial sectors.
8. The capital markets' efficiency is increasing, as is the importance of their role in the financial system.
9. All of these developments contribute to the persistent increase of the inflation rate, now over 80 percent. High inflation is still the most serious problem of our economy.

Each institution in an economy is responsible for contributing to the attainment of macroeconomic targets. In recent years, the Central Bank of Turkey has added to its traditional functions by assuming important functions aimed at establishing stability. The Central Bank's most important task is to protect the value of the Turkish lira both at home and abroad by stabilising prices. A corollary purpose is to meet the money and credit requirements of the growing economy by preserving economic stability at the same time.

The Central Bank draws up monetary programs and determines what monetary measures should be introduced to bring down the rate of increase in price levels in the medium term. The object is to establish stability in the markets by controlling money and credit. The designers of stabilisation programs should choose targets for monetary variables in the Bank's balance sheet in such a way as to promote stability and influence economic agents to make decisions that also promote stability.

The monetary targets chosen from the balance sheet should involve all the monetary policy instruments at the Central Bank's disposal. It is also important for these targets to be attainable and relevant, essential conditions for program credibility.

With this in mind, scenarios were devised for various assumptions using an economic model developed by the Central Bank. Analysis of these scenarios confirms that current conditions in the Turkish economy call for a medium-term stabilization program.

The model, which traces the implications of various possible behaviours of monetary aggregates under the monetary program conducted by the Central Bank, consists of five main blocks: money, price, balance of payments, production, and interest rates. The blocks involve 15 behavioural equations and 14 identities. So far, the results available for studies using this model cover a period of one year. The studies are continuing.

In the **monetary** block, sight and time deposits and foreign exchange accounts are estimated by means of equations for the behaviour of M1. Then M2, M2Y, issue, reserve money, required reserves and banks' free reserves are obtained through identities.

In the **price** block, the wholesale price index (WPI) is estimated from sub-items. Agriculture, private manufacturing, public manufacturing, and the energy and mining sectors are among the sub-items, with different shares. The model considers energy and mining prices to be exogenously determined, while prices in the agriculture and manufacturing sectors are described by behavioural equations.

In the **balance-of-payments** block, the current account balance sheet is obtained by means of identities after estimating foreign trade by means of behavioural equations.

In the **production** block, real gross national product (GNP) and the industrial production index, one of its most important determinants, are described by behavioural equations.

In the **interest rates** block, Treasury auction interest rates and real interest rates on quarterly deposits are estimated by behavioural equations.

The model has been used to generate various scenarios for 1997 under a variety of assumptions. However, the Central Bank plans to use the results of the program as a guide for the Bank's internal discipline without making any public announcement, as it did in 1996. The reason for the change is that the credibility and effectiveness of the monetary program must be preserved in times of increased activity and uncertainty if stability is to be established. This year, we have achieved our objectives. We have disciplined ourselves. We have applied our program to deal with possible developments. And we plan to proceed in the same manner in 1997.

In 1997, the Central Bank will continue its present policies. Preparations have been completed for introducing a new monetary program especially focused on the first half of the year. This program anticipates that the annual inflation rate will be in the 70 percent range by mid-1997. During the first six months the Central Bank will update this forecast. This figure seems all the more realistic because by 1997 the effects on the inflationary rate of the early general elections held at the end of 1995 will be entirely dissipated.

The most important factors operating during the first half of 1997 and after are as follows:

- Financial relations will be established with the IMF.
- Rapid progress has been made with Privatization.
- Foreign borrowings will be provided by the Treasury.
- Continuation of the non-interest budget surplus in 1997.

Developments in these four areas will first affect the budget balances and will then affect monetary policy and inflation. It is assumed that domestic borrowing will continue in a steady fashion, and that these four factors will determine the course of events in the second half of 1997. If things go well, it may be possible to bring the annual inflation rate below 70 percent during the second half of the year.

This monetary policy and foreseeable developments will not bring about any changes in the Central Bank's policies as implemented up to now. As in 1996, the Central Bank's new program is based on controlling reserve money and monitoring foreign exchange rates. In sum, we will maintain our policies based on monetary indicators determined by the model, policies that avoid interest rate interventions while supervising foreign exchange rates. In case of excessive fluctuations or immoderate activity, we will analyse the situation and recover stability by means of the available instruments.

The goal of the Central Bank in 1997 is to formulate and implement policies which have economic stability as their central goal.

ANNEX

PRICE DEVELOPMENTS IN 1996

Monthly increases in the WPI settled at around 5 percent, compared with about 4 percent the previous year. During October, wholesale prices rose by about 5.5 percent on a monthly basis, 82.8 percent on an annual basis, and 69.3 percent for the first 10 months of the year.

The factors causing this change of trend are summarised as follows:

1. The intensification of public price adjustments in the first half of the year continued in the second half of the year. Therefore, price increases for the first 10 months totalled 85 percent or 96.3 percent on an annual basis.
2. Price increases in the energy sector, which had come in the form of shocks at intervals several times a year in the past, rose by about 5.5 percent a month by indexing in 1996. As a result, the increase for the first 10 months reached 110 percent and 111 percent on an annual basis.

3. The rate of increase of agricultural prices, with a 22 percent share in the WPI, had accelerated during the preceding three years. By October, further acceleration during 1996 had brought the rate of increase to about 7 percent a month and 93.8 percent a year.
4. For seasonal reasons, the prices of crude oil and natural gas, sub-items of mining, coke, a sub-item of manufacturing, and refined petroleum products all increased steeply in October.
5. Price increases in the manufacturing sectors with the largest share in the WPI, which use agricultural, energy, and public sector goods as inputs, have increased the costs of delays, leading to a rapid expansion of the private manufacturing sector.
6. The US dollar, stable during the first half of 1996, depreciated rapidly in the second six months, reaching an annualised rate of 87 percent in October, slightly higher than the WPI.
7. Failure to lower inflationary expectations.
8. Though foreign trade data for the first 10 months of 1996 are not yet available, import prices which had been rising rapidly in 1995 maintained this trend in January 1996, which affected the prices of inputs used in investment and production.

Despite growth driven by the private sector starting in 1995 and continuing in the first quarter of 1996, consumer prices remained below wholesale prices. This was because the public price adjustments were postponed from 1995 to 1996 due to the general election. In fact, wholesale prices rose by 69 percent while the increase in consumer prices remained at 65 percent for the first 10 months of 1996. In October, a seasonal increase in the prices of shoes and clothing, and an increase in the prices of the food sub-item due to the increase in agricultural prices, caused consumer prices to rise by 6.5 percent on a monthly basis or 79.6 on an annual basis.

It can be said that monetary factors had no role in accelerating price increases. On the contrary, monetary factors prevented inflation from increasing further by establishing stability of the monetary indicators during the first half of the years.

In light of the developments summarised above, it can be concluded that the basic reason for the acceleration in price increases was that 1996 saw an intensified adjustment in the prices of the public goods used as inputs, the indexing of price increases in some sectors such as energy, and an acceleration in the rate of increase of agricultural prices.