Remarks by

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at

THE PLAZA HOTEL,

NEW YORK

OCTOBER 4, 1996

TURKEY MOVES TOWARD THE 21ST CENTURY

It is indeed a great privilege for me to address this distinguished group. This meeting gives me a chance to explain our intention to continue our integration with the international financial markets and our adjustment efforts to achieve sustainable growth in the medium term. Let me begin by describing the **current state of the Turkish economy**.

Turkey has a dynamic economy whose productivity has grown at an average rate of 2 percent a year over the last decade. With its young population of over 60 million, its dynamic and outward looking private sector, its modernized and competitive industrial base, and its well established service sector, the Turkish economy has great potential. Except for 1994, Turkey's economy has grown continuously.

However, we have triple problems namely budget deficits, current account imbalances and inflation.

One would expect high growth rates together with a high Public Sector Borrowing Requirement (PSBR) to have an adverse affect on the balance of payments. First, let me comment on some developments in the **external sector**.

Estimated balance of payments figures for the first half of 1996 show the current account deficit to be larger than for the same period last year. The main reason for this is a rapid increase in imports, brought about by two factors: the removal of customs barriers, and high import demand fed by the strong economic growth during the first half of the year. The rapid increase in imports is ascribed to increased imports of investment goods, mainly in the textile sector.

In addition, a considerable part of Turkey's export revenues go unrecorded. If these unrecorded revenues were included in trade statistics, the trade deficit would be much lower. The unrecorded revenues come from the so called "luggage trade" with East European tourists, particularly in Laleli, Istanbul. It is estimated that these transactions total between

US$ 5 and 10 billion. Although exports of "luggage trade" goes unrecorded, it is captured by reserve accumulation of the Central Bank and by the increase in foreign exchange deposits. On the other hand, contributions of external sector to GNP have not been clearly analyzed.

Interestingly, import figures from these same countries are captured by the official statistics, but the exports are not, because they involve cash transactions that are not taxed. The result is that Turkish exports are really much higher than reflected by the official figures. Otherwise one cannot explain the financing of the US$3 - 4 billion current account deficit and US$4 billion increase in official reserves during the first half of 1996.

There was an other important development in our balance of payments statistics during the first half of 1996. The gap between the interest rate differential and exchange rate changes, which appeared at the beginning of 1995, has been shrinking since the first months of 1996. Even though there is no direct measurement of "hot money", this gap can be used as an indicator of the movement of hot money. Since the first months of 1996, domestic interest rates have been moving downward and the differential between domestic and foreign rates has been decreasing, while nominal exchange rate changes have been accelerating. These trends have caused the gap to narrow, indicating that the volume of hot money is decreasing. As a matter of fact, our provisional balance of payments data show short-term capital inflows diminishing in the first half of the year. These developments indicate that the importance of "hot money" in our financing of deficits has been decreasing since the first quarter of 1996.

Turkey's international reserve position in both absolute and comparative terms, taking account of estimated imports and short-term borrowings from abroad, is sufficiently strong to give confidence to the financial markets.

However, persistent high **inflation** has been Turkey's main economic problem for the last two decades. The size of the public deficits have kept inflation high and stable at a certain level, and deeply entrenched inflationary expectations feed the inflation dynamics. Instead of analyzing inflation in Turkey in detail, I will just emphasize that the high inflation is the major concern at all levels of society, including, I am sure, the political authorities.

Consolidated budget figures for the first half of 1996 indicate that **budget deficits** have increased rapidly. Taking account of this seasonality and the figures for the first seven months of the year, we can be sure that the budget deficit will exceed the targeted level by the end of 1996.

Let me talk a little about the sources of the increase in public deficit for 1996.

As you all are aware of, 1996 could also be defined as the year of political uncertainty. In 1996 we had two coalition governments. The time exhausted in between the elections and establishment of the new government and accompanying uncertainty has reflected in the maturity structure and interest paid for the Treasury's domestic borrowing. Heavy burden of interest payments that accrued to the 1996 budget has increased the share of interest payments from 33.5 percent to 44 percent, in a year. But the good news is, during the last four weekly auctions, which include a foreign currency denominated 3 year, 1.2 billion US dollar Treasury bond. Treasury succeeded to borrow with less than the year average interest rates and longer than six month. As the market confidence is re-sustained for the rest of the year, I do not expect any extra increase in public deficits.

Since 1994, the share in total expenditures of interest payments on domestic debt has increased considerably, while the share of public sector wages has declined continuously. In the first half of 1996, the primary balance, which excludes interest payments, continued in surplus and increased by 66 percent to 3.4 percent of GNP, while the overall deficit reached 6.6 percent.

Public indebtedness is growing in spite of the primary surplus. Domestic borrowing is still the major means of financing the deficits. Even if the ratio of domestic debt to GNP is below 20 percent, which may show a mild public indebtedness, the ratio of (cash) domestic debt to M2Y, which represents financial savings in our banking system, is close to 40 percent. This shows that our financial system is small and shallow in terms of the PSBR. Since the PSBR is large by comparison with our financial system, the maturities of the borrowing are short and the interest rates are high. In addition, financing the considerable debt service payments with private capital inflows put extra pressure on domestic financial markets.

The GNP share of public external debt, representing the external indebtedness of the government, fell to 44 percent. At the same time the ratio of our international reserves to our total external debt rose to 33 percent, indicating an improvement in our external debt position. In addition, Turkey has been a net re-payer for the last two and a half years. The net repayments of public sector during these periods was US$9.3 billion, of which $2.3 billion represented principal and $7 billion interest payments, were financed without any considerable decline in official reserves. As mentioned above, however, these repayments put a lot of strain on the domestic financial markets. Let me remind you briefly that Turkey's total public sector indebtedness was US$66 billion at the end of July 1996, of which $39 billion is external debt, $25 billion is domestic debt, and $2.6 billion represents short-term advances from the Central Bank. Analyzing the maturity and interest rate structure of Turkey's public borrowing reveals that the average maturity is 12.7 years for external debt and 5.6 months for domestic dept. The average real interest rate for external debt is 1 percent, while the real rate on domestic debt is 25 percent. Domestic debt worth about $18 billion has to be rolled over about every six months, or about $700 million in continuous weekly auctions. This is a tiresome business.

Let me now turn to Turkey's capital market. The Turkish equity market is currently one of the best performing of the emerging markets. Portfolio inflows from abroad have made share prices soar. The portfolio investment item in Turkey's balance of payments reflects a splendid inflow, even though US$2 billion of it represents the Treasury's borrowings abroad. Our equity market is now playing a more important role in financial intermediation. The GNP share of equity market capitalization has increased rapidly, approaching the M2Y/GNP ratio. Equity market capitalization is simply the total market value of the firms whose shares are traded on the Istanbul Stock Exchange.

Turkey's financial system is still dominated by the banking sector. High interest rates on government securities, economic recovery, and the reduction of credit and foreign exchange risks by the rise in foreign exchange reserves-all have helped the banking system earn strong profits. The capital adequacy and non-performing loan positions of Turkey's banks have generally improved.

At this point I would like to make some comments on **monetary policy**. The main objectives of monetary policy in 1996, can be summarized as keeping inflation from exceeding the expected levels, and the protecting the financial sector and the economy generally from large and unexpected changes that can possibly be caused by excessive volatility in monetary aggregates and exchange rates. The political instability and macroeconomic imbalances have led us to adopt this objective.

The Central Bank has established limits for monetary aggregates based on econometric models which assume that the inflation rate will be 80 percent by the end of the year and that the macroeconomic targets set by the plan for 1996 will be met. Under this program, monetary aggregates such as M1 and M2 are controlled by limiting Reserve Money. So far, this monetary program is performing as expected. In May, June and July, the annualized rate of increase of Reserve Money was around 65 percent: an in August it increases by 73 percent. With the annual inflation rate at around 70-80 percent and real interest rates at 25-30 percent, the slow growth of Reserve Money represents a pragmatic approach to monetary policy which is in fact producing a monetary contraction in real terms.

Of course, monetary policy is only one the factors shaping the macroeconomic environment. This is a good place to emphasis once more that it is critically important for Turkey's continued economic development that we reduce our budget deficits and complete the privatization of our public enterprises. This is because, in countries like Turkey with large public deficits, monetary policy has certain limitations. Let me explain this point briefly.

A **tight monetary policy** stance may activate debt dynamics, another name for a vicious circle in which the higher interest rates associated with a contractionary monetary policy cause higher debt service costs and larger budget deficits. The circle continues as the higher PSBR drives interest rates still higher. The process ends in the monetization of public debt, with high interest rates, low growth, and strong inflationary expectations.

On the other hand, an **expansionary monetary policy**, which increases liquidity and lowers interest rates, can only be only effective for a very short time. This is because people and institutions in the financial markets will expect this expansion to have inflationary effects and will add a risk premium making interest rates rise, causing the interest rates on government securities to rise as well.

Another limitation on monetary policy comes from the so called **"dollarization"** phenomenon. The ease of converting from Turkish Lira accounts to foreign currency accounts, and vice versa, naturally limits the effectiveness of monetary policy.

Given Turkey's budget deficit, the most important function of the Central Bank is to control liquidity and to keep monetary aggregates within the target range set by our monetary program. The following is a summary of our conduct of monetary policy at present.

1. By law, limits have been set on the so-called "short-term advances" which the Treasury is legally entitled to obtain from the Central Bank, and these limits have been incorporated into our program. According to a timetable set in 1994 by Law, the Treasury's annual use of short-term advances is to be reduced gradually over five years from 15 to 3 percent of its budgetary appropriations. For 1996, the total amount of short-term advances used by the Treasury should not exceed 10 percent of its appropriations. By 1998, the Treasury will be entitled to short-term advances totaling not more than 3 percent of its budget appropriations. On this point I would just like to emphasize once more that as the public deficits diminish, and with them their

monetary impact, monetary policy will become increasingly free to respond independently to the needs of the economy.

2. It is assumed that the budget will have a primary surplus of 2 percent of GNP in 1996. The continuing primary surplus of budget over the last three years implies that as long as the Treasury is able to roll over the principal-plus-interest of its domestic debt by new borrowings, there will be no need for monetary financing. It is thus a crucial goal of debt management to extend the maturities of these borrowings.
3. It is fortunate that the relationship between the Treasury and the Central Bank is very constructive, at both the technical and management levels.
4. The strong reserve position of the Central Bank, the amount of securities in its portfolio available for open market operations, and its sensitivity to high volatility in Turkish Lira interbank and foreign exchange markets, help the Central Bank to accomplish its mission within the limits which presently constrain the conduct of monetary policy.

Having all these considerations in mind, I will say that the Central Bank will continue implementing this kind of monetary policy and that our forecasts indicate that inflation will not exceed 80 percent annually through the end of the year.

The Central Bank's ultimate goal is to lower Turkey's inflation rate to single digits and to keep it there. Of course this can not be done overnight. It will require completion of credible medium-term anti-inflation program. I believe a program led by stabilization strategies developed by the Central Bank will go far to settle Turkey's macroeconomic problems. I can summarize our exchange rate policy in two words: pragmatic and forward-looking. While it is the market that determines the price of foreign exchange, the Central Bank has a role to play in protecting Turkish Lira rates against high volatility. Parity changes in the international markets and developments in the domestic financial market are also the determinants of daily exchange rate movements.

For Turkey, one of the most momentous political and economic events of 1995 was the accommodation of the Customs Union with the European Union, an important step towards full integration into the European Union. The customs union will lead to the removal of customs barriers between Turkey and the European Union. This will force Turkish companies to adapt to a more competitive environment, and access to European markets may lead to a burst of import growth which will put pressure on exchange rates. The Central Bank's exchange rate policy will have to accommodate this expected development, and the effects of a real appreciation will have to be very carefully considered. An analysis of our economy will help us identify the problems we need to overcome in the near future.

As I pointed out earlier, for years the revenues of the public sector have fallen short of expenditures, creating public deficits. Until the 1994 stabilization program was adopted, we even had primary deficits. Since the program began, it has been possible to finance the non-interest expenditures of the public sector with public revenues, but expenditures for debt service have to be financed by new borrowing. In other words the public sector adds to the deficit in order to finance its previous deficit, completing the vicious circle known as the "debt trap." Since our financial system does not yet have sufficient breadth and depth by comparison with the PSBR, any mismanagement of the debt could threaten the stability of our entire financial system.

In our conduct of monetary policy, we at the Central Bank give the financial stability of the economy the highest priority. As I enumerate the major problems our economy faces, I will identify the **measures needed for the adjustment** of each.

Let me begin by reminding you that Turkey undertook a series of attempts at liberalization and institutional reforms related to the financial sector as part of a structural adjustment program pursued during the early 1980s. The accomplishments of this program were notable: The Turkish financial system was effectively liberalized, the Turkish Lira became fully convertible, and with the removal of all restrictions on international movements on capital, the Turkish financial system took a long step toward full integration into the international financial system.

But these achievements, though splendid, are not complete. We still need a durable improvement of the public sector deficit. **Reducing public sector involvement** in economic activity, and increasing the efficiency of what public sector activity remains, will help reduce public sector deficits. Further reductions can be achieved by enlarging the tax base and improving tax collection. Privatization is the key to increased efficiency. Improvement of the social security system is another important structural reform which still needs to be accomplished in Turkey.

I think these **structural reforms** should be supported by exchange rate and monetary policies that are consistent with sound public finances. If we can succeed in avoiding monetary financing of public deficits monetary control will be more sustainable and more credible. There can be no doubt that monetary control is essential to maintaining stability in the financial markets.

At the Central Bank, it is our aim to lower Turkey's **inflation rate** to single digits in the medium term. If we are consistent in our pursuit of the target of lowering inflation, we will be rewarded first with lower inflation rates and then with price stability. Persistence in fighting inflation is the surest way of breaking down the inflationary expectations that feed our inflation dynamics.

Throughout this speech I have stressed reducing our inflation rate because I believe **central banks** are by their nature more anti-inflationary than any other institution in the economic system. Monetary policy should be based on targeting inflation, even though such targets can only succeed if there is widespread public support for price stability. If we believe in becoming a part of Europe strongly enough to qualify for full membership in the EU, we will fine the means and the will to reduce Turkey's inflation to the single digit level.

Recent years have witnessed a movement all over the world toward more **independent, accountable** and **transparent central banks**. Especially in the developed economies are these seen as vital elements of a more effective monetary policy. Grater transparency in monetary policy decisions will increase the credibility and the effectiveness of monetary policy. One way for central banks to gain credibility is to educate the public so that it can understand monetary policy actions. It is not too much to say that it is on the credibility of the central bank that the success of the fight against inflation will finally depend.

Before I finish, I would like to emphasize that we are aware of the opportunities and challenges that "**Globalization"** presents for our country. Globalization means vanishing borders. In the global, and borderless, economy of the twenty-first century, everybody will confront more obligations and more opportunities. We see globalization as an opportunity that offers us direct access to the international financial markets and an incentive to build a more competitive and efficient domestic financial system. In fact I do not think that any country can afford not to take advantage of the global markets. But I must also warn you that to take advantage of the opportunities that globalization offers us, we must now make a much stronger commitment to macroeconomic discipline than we had in the past. With integration into the global economy, our domestic economies will be affected much more strongly by events that formerly, before globalization, had little effect on us.

The commitment to monetary stability, macroeconomic discipline, an efficient financial system, and more competitive market mechanisms are essential conditions that must be satisfied by countries adapting to globalization. The close surveillance of each country by other countries is also needed. The twenty-first century will be a turning point for the world economy toward unity. This global economy will provide new potential for stronger, higher-quality growth. We cannot keep our economy and the central bank safe from these trends. On the contrary, we must adjust our country's financial life to this new reality. We must prepare our economy, our financial system and our financial infrastructure. We must become both strong enough and flexible enough to adapt to these new conditions.

Thank you.
