

## **Turkish Economy and Monetary Policy Framework**

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It is a great pleasure for me to join this conference and to share my views on Turkish Economy and Monetary Policy with such a distinguished audience. I would also like to thank to the Central Bank of Albania for this opportunity.

In my presentation, first, I will shortly touch upon the period before the real stabilization efforts started, then I will talk about the 2000 and 2002-2004 stabilization programs and in the last part, I will be talking on our achievements under the latest stabilization program.

Going back to 1970's, Governments pursued inward looking import substitution policies and Turkey's monetary policy had been mainly based on the fixed exchange rate, managed interest rate system. When we came to 1980s, import substitution and restrictive foreign trade policies were replaced by liberal policies. Besides liberalizing the foreign trade during 1980s; the money, foreign exchange and securities markets were established. During 1980s, Central Bank conducted a monetary policy, which basically supported the export led growth strategy, through controlling both the exchange and interest rates.

In 1990s, capital movements became more and more liberal and gained momentum. This led to sudden capital inflows and

outflows that resulted in crises, especially in emerging countries. During this decade, Central Bank of Turkey monitored financial system and tried to smooth out financial fluctuations caused by huge and sudden capital inflows and outflows. In other words, Central Bank adopted a middle way under the fixed-but-adjustable exchange rate and freely market determined interest rates system. When we reached to the end of 1990s, despite all the efforts to stabilize the economy, what we had were increased inflation, volatile growth rates, soared public sector deficit, deteriorated current account balance and a highly dollarized economy.

Looking at the developments of the last twenty to thirty years, we had realized the fact that Turkey needed a comprehensive program to stabilize the economy. In this respect, Turkey launched an IMF supported stabilization program in 2000 to provide a stable macroeconomic environment by decreasing both the inflation and real interest rates so as to improve the long term growth potential of the Turkish Economy.

2000 program was an exchange rate based stabilization program. In an economy where pass through from foreign exchange to inflation is high, exchange rate based stabilization program with its front loaded credibility seemed to be a viable solution to inflation problem. In this respect, exchange rate basket was announced on a daily basis, covering one year period. This was the main policy tool to break the inflationary inertia and to provide a long-term perspective to the economic agents. Besides this, conduct of monetary policy was guided by a rule. According to this rule, the base money can only be created by changes in the net foreign assets of the Central Bank.

One other central component of the program was fiscal discipline. Performance targets were set for the primary surplus of the consolidated government sector.

Incomes policy, in line with the targeted inflation, was another pillar of the program. Public wages and administrated prices were set in line with the inflation target and in order to lessen the costs of disinflation process, structural reforms were designed in a way to increase the efficiency in public sector.

At the beginning, the program produced very good results. Interest rates sharply came down as a result of the removal of exchange rate uncertainty, confidence to the program was gained and expectations turned into positive. Later on, banks started to increase their foreign exchange open positions and also increased their Turkish Lira denominated assets with relatively longer maturities in the form of consumer credits and government securities. This structure left the domestic banking system fully exposed to potential shocks.

Higher than expected inflation, mainly caused by boosted domestic demand and higher oil prices led to appreciation of pegged Turkish Lira. Appreciation of domestic currency in real terms together with increased consumer credits further amplified the domestic demand and as a result current account deficit widened to around US dollar 10 billion, which was about 5 percent of GNP and all these raised the concerns about the sustainability of the peg. In addition, delays in structural reforms were perceived by market participants as weakening government's commitment to the program. These developments affected the expectations negatively and the movement of market participants in unity led to

increased interest rates and this, in turn, deteriorated the banks' financial conditions, which in turn resulted in loss of confidence. After experiencing two subsequent crises, credibility was lost and government had to abandon the crawling peg regime on 22nd of February 2001.

During the period between February 2001 and January 2002, the transitional program was implemented under the floating exchange rate regime. The main focus of this program was on reinforcing the structural elements of the previous program. Starting from January 2002, Turkey embarked on a new IMF supported program. The main aims of the program are almost the same with year 2000 stabilization program, but the design is totally different.

In the new program, ambitious primary surplus targets were set and the structural transformation process, started with the 2000 program was accelerated. In order to establish more transparent and healthy banking system we started to implement a restructuring program and imposed new regulations on banking system.

Under this new environment, where the exchange rate is freely floating, Central Bank takes a more activist monetary policy strategy. Inflation, itself, was set as a new anchor. Today, Central Bank makes its all decisions by considering the future inflation with the aim of achieving price stability and the short-term interest rates are used as the main tool to this end. By managing short-term interest rates, we are aiming to shape the market expectations. This is very important for decreasing risk premiums resulting from uncertainty. As economic units gain more confidence, real interest

rates will come down to a reasonable levels in harmony with the economic fundamentals, and the decrease in the cost of using capital will assist us in achieving sustainable growth.

Under the current monetary policy, we have been implementing implicit inflation targeting until the adoption of full fledged inflation targeting. In this sense, inflation target was set as 20 percent for the year 2003. In addition, our medium term target is single digit inflation. Floating exchange rate is a corner stone of our monetary policy. Under this new regime, a new anchor is needed since foreign exchange is no longer the anchor. As I said before, inflation itself is the new anchor, but we also set periodic targets on the base money aggregates to function as an additional anchor. Despite some of its disadvantages, the base money has been chosen because it is an aggregate that can put the monetary program on the right track in the transition period to explicit inflation targeting. Under the current monetary program, the base money target has been set to be consistent with the real GNP growth and the targeted inflation rate.

We have also quantitative conditionalities on Net Domestic Assets (NDA) and Net International Reserves (NIR) within the framework of IMF supported program. These conditionalities' primary focus is to ensure that the program maintains or leads to external viability rather than to impose tight control over inflation. In this context, a floor on NIR is set to indicate whether a program is likely to achieve its external objective that is repayment of external obligations and a ceiling on NDA is set as an additional protection, since it seeks to ensure that the external objective is not jeopardized by excessive credit expansion.

At this point, I want to talk about our achievements in respect of program objectives. On the inflation front, we undershoot the 2002 CPI target. The CPI inflation dropped to 29.7 percent as of end 2002, which is well below our 2002 target of 35 percent.

In the first quarter of 2003, external developments mainly determined the trend of inflation, as the war in Iraq created uncertainties, we saw volatility in oil prices and exchange rates. The downward trend in inflation is disturbed by the rise in costs due to oil price increases and exchange rate depreciation. Besides these cost-push factors, rapid increase in agricultural and food prices as well as the public price adjustments played an important role in the rise of inflation in the first quarter. In this period, inflation expectations were also on an increasing trend.

Starting from May, cost-push effects began to diminish with the ongoing appreciation of the Turkish Lira and the increase in productivity. The CPI was realized as 24.9 percent y-o-y in August and expectations continue to converge our year-end inflation target. According to latest survey year-end CPI expectation decreased to 22.4 percent.

Despite some risks, the year-end inflation target of 20 percent is well within reach as long as strict commitment to the economic program is sustained. The structural reform process and measures for the budget discipline also reinforces our hopeful vision for the future trend of inflation.

Turkish economy started to recover in the first quarter of 2002, after 9.6 percent contraction in 2001. Indeed, at the beginning of 2002, growth rate was estimated as 3 percent in the program but then it was revised to 6.5 percent due to favorable

developments in economic activity. However, GNP posted a robust expansion of 7.8 percent in 2002.

Our 2003 GNP growth forecast was 5 percent at the beginning of the year, however, in the first quarter of 2003, GNP growth was realized as 7.4 percent, which is above the expectations and growth performance of the economy was robust in the second and third quarter of the year as well. Strong export performance and slight improvement in domestic demand were the main drivers of the growth performance and 5 percent growth rate is within reach for 2003.

As I said before, one of the main objectives of our economic program is the achievement of viable debt position. In 2001 and onwards, Net Debt Stock/GNP ratio increased substantially due to the cost of banking sector restructuring, new IMF lending and higher borrowing costs. As a result of strict implementation of the program, this ratio has been on a downward trend. Decreasing borrowing cost and higher than estimated growth rate of the economy has been supporting the decreasing trend of net debt stock. This is especially crucial for the success of economic program since concerns about government refinancing and debt rollover issues have been the main determinants of market expectations.

In conclusion, our experiences proved that prudent fiscal and monetary policies as well as structural reforms are indispensable for stabilization policies. By implementing the new program coherently, today, Turkey is well placed on the road of sustained non-inflationary growth. Today, we are more resilient to external shocks and less vulnerable to crisis.

