THE SPEECH OF THE GOVERNOR OF TURKEY

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I would like to thank the organizers of this conference, especially governor Cani of Bank of Albania, which gave me the opportunity to visit Albania, with whom Turkey has a long historical relationship. When we look at the role that central banks play at the convergence of national economies into economical integration to Europe, we see that the Maastricht criteria are used as a benchmark – it is not only the low inflation but also central bank institutional, personal, financial independence including no central bank credit to government. Also, GNP ratios are very important as thus has important implications for effective monetary policy. At least, Turkish experience shows a lot of evidence on that.

On the other hand, the development of a sound financial system, based again on the Turkish experience, also seems to be indispensable in the convergence process. When we look at the exchange regimes though, we see that some countries have currency board, some others, on the other hand, are floating their currencies and still, some others have managed float systems.

There seems to be another single model on the road to Monetary Union.

We are aware that all models can be successful provided that sound economic policies are in place. A national economy can use managed float, for instance, to lower inflation and then float its currency for a while before joining the Monetary Union. If it is not successful in doing so, maybe a stronger exchange commitment is needed going as far as a full currency board, passing through a quasi-currency board, as in the Turkish case. In the possibility of failure of all these models, for one reason or another, a unilateral adoption of Euro is also being debated now. Of course, converging the currency without being able to converge the national economy is not without risks, as there are questions as to whether in that case the Central Bank of Europe will play the lender of last resort, specially if a sound financial system is not existent in the national economy.

Now, I want to move to the Turkish case. Turkey, as you know, is a chronic inflation country for about 25 years now, where inflation never turned into hyperinflation, giving the Turks, in general, the false impression that their country is unique, almost immune from the laws of economy as we know them. That was not true. What determined the chronic inflation in Turkey was mainly the public sector deficit in the past and in the '90s it was rather the inflation expectations based on the past inflation and of course, the exchange rate.

So, the government in 1999 finally decided to stabilize the economy and the exchange rate was obviously chosen as the anchor of the program. The central bank had to act as a quasi currency board, as we now call it, meaning that the domestic credit would be constant and exchange rate would follow a pre-determined path of depreciation in line with the targeted inflation.

What the program brought well, for a while, is that interest rate came down, inflation came down, but problems arose. Failure to reform the banking system, in time, the growing half hearted government in showing efforts for other structural reforms, and the adversing current account balance led to a two-staged attack on national currency. Confidence in the central bank exchange rate commitment was totally lost, despite that numeric targets for monetary and fiscal policy were reached at all times. Finally, the central bank and the government decided to float the currency last February.

The float, therefore, came at an unexpected moment for the banking system and the public, in general. Instead of moving to the float at the end of a three-year program, during the second part of which there would be a gradually withering band around the exchange rate path, the country woke up one day to see its currency floating. Suddenly, there were no anchors in the economy anymore. Banking system and corporate sector had large opening positions in foreign exchange. Therefore, a painful process had started, whereby the central bank and the treasury conducted a number of operations to get the banking system adapt itself to the new environment. The independent supervisory authority, which was rather new in the country, took a lot of pressures and acted a lot of regulations to rehabilitate the banking system, which had been neglected for almost a decade. The fact that there were no anchors was one of the most important problems: exchange rate was already used and confidence was no longer there. A match between monetary aggregates and inflation could not be established in a chronic inflation environment, as there were difficulties with money demand estimations. That was the diagnoses long time ago. So, despite high inflation, we are left now with only one option – to move to inflation targeting regime as soon as it is feasible to do so.

Where are we now? Well, when we look at what we have done in the last eight months or so in that area, the first thing that I have to mention is that after 25 years of chronic inflation the central bank is finally independent. Amendments in law have been brought to parliament in May and they have become effective. All the Maastricht criteria concerning the central bank and monetary policy are in the law now.

We have done, so far, substantial work at the central bank in various areas. One area is the development of a the inflation forecasting models that, of course, we will need in the future when we do the inflation targeting, and in that area I think we have come a long way already. Another area where we have worked at central bank was the enlargement of information base, so, in addition to many surveys w conduct with corporate sector so that we learn more about the prospect of the economy, we now have new surveys that we conduct with financial sector, which are more frequent and they give us more information about the general level of expectations in the economy.

Still, another area in which we worked, and that proved to be a very difficult one by the way, is developing a proper and sound communication strategy so that central bank is able to explain its already transparent monetary policy and its operations to the public. And that is one of the most difficult areas so we are still working on that.

But we need to see some more developments in other areas as well. These are areas that are not obviously fully under central bank control. One area is that we have to see a weakening post-traumatic effect from exchange rate to inflation in time if we want to do a proper inflation targeting. That post-traumatic effect has been very strong historically and it seems to be still there. Another area, which is very important and in fact lies behind our problems in the last decade or so, is the fiscal dominance issue. The fact that the Turkish treasury has dominated the domestic debt market for almost a decade seems to be a big problem if we are to do inflation targeting in the near future. We are showing all kinds of efforts to weaken the position of the treasury in the domestic debt market, so that central bank is more free in changing its short-term interest rates, so that it can conduct a proper monetary policy.

Another problem that we have been struggling with in the last eight months or so, is ensuring some kind of exchange rate stability under the floating exchange rate regime. Because the float came at a very unexpected time and the banking system and public were caught suddenly with very large opening positions, as I have mentioned, we had to conduct a lit of operations. These operations seem now to be over and in the last two months or so, we see that the exchange rate has become quite stable, despite the fact that the central bank intervention is almost non-existent.

So, under the current program, we are planning to go ahead into inflation targeting, despite the still high inflation rate in the country, sometime in the next year. As we know that this is the only way out of the Turkish chronic inflation, we will have to work more on that area.

So much for my brief presentation here. Thank you for listening.