Süreyya Serdengeçti: Recent developments in the Turkish economy

Speech by Süreyya Serdengeçti, Governor of the Central Bank of the Republic of Turkey, made at the 69th Shareholders' Ordinary General Meeting of the Central Bank, Ankara, 24 April 2001.

*   *   *

Dear Shareholders, Distinguished Guests and Valuable Press Members;

I would first like to welcome you to the 69th Shareholders' Ordinary General Meeting of the Central Bank of the Republic of Turkey.

As you know, the year 2000 differed widely from the previous years for the Central Bank of Turkey and for the Turkish economy as well. The Disinflation Program, which had been initiated in December 1999, was the most important element that shaped the economic developments in 2000. In the medium-term, the program had aimed to bring down inflation to single digits in three years, to reduce real interest rates to reasonable levels, to increase the growth potential of the economy, and to provide a more efficient resource allocation in the economy.

The main pillars of the Program were; tight fiscal policy focusing on improving the primary surplus; speeding up the structural reforms and privatization efforts; an incomes policy geared to targeted inflation; and a pre-announced exchange rate basket. The specifics of the program and extensive analyses of economic developments of last year have been elaborated in our 2000 Annual Report.

In 2000, although the inflation targets that were envisaged in the program could not be reached, significant progress was made in the fight against inflation, which reached its lowest level ever in the last 14 years. In addition, the fiscal balance improved considerably, and the structural reforms were underway.

Interest rates came substantially down in 2000 as a result of the decreased exchange rate risk and the improved foresight of public. Declining interest rates reduced the cost of the Treasury's domestic borrowing. Rising domestic debt stock was put under control.

After the recession in the economy in 1999, falling interest rates boosted the deferred consumer demand, particularly for durable goods. Moreover, increased demand for credit, driven by the banks' favorable consumer loans, put the economy back on the growth track. Besides the decreasing tendency in interest rates, the stable exchange rates and the private sector's renewal investments, directed to productivity increase, also contributed to the growth in the economy. As a result, the GNP grew by 6.1 percent in 2000.

However, the economic expectations became confused in the second half of 2000. Starting from May 2000, the gap between the optimists and pessimists in the CBRT's Business Tendency Survey began to decrease and in November, the pessimist expectations started to gain ground. It is observed in this survey that also the expectations for inflation, employment and exports began to deteriorate in the same period. The propensity for investments started to decline during the summer of 2000 and continued to do so at an accelerating rate later on.

Keeping public expenditures under control and rising tax revenue due to supplementary tax adjustments led the primary surplus to pick up significantly. However, the growth in domestic demand, the price hikes in energy sector, especially in crude oil, and the real appreciation of Turkish lira were all the factors that caused the imports to grow rapidly and this, in turn, led to deterioration in current account balance. In addition, the depreciation of the euro against the US dollar by an average 13 percent in 2000 raised Turkey's imports from the EU countries, while Turkey's exports to the EU countries were negatively affected. As a result, the external current account deficit in 2000 grew by 4.8 percent of the GNP.

While the current account deteriorated rapidly, delays in privatization and structural reform agenda in the second half of 2000 adversely affected the capital movements and interest rates starting from August, arousing concerns in domestic and international markets. The increase in the interest rates, on which the monetary policy similar to a currency board regime is ineffective, resulted in deterioration of the financial structure of the banks which held large amount of government securities in their portfolios. This further weakened the confidence in financial markets in the second half of November.

Although the targets for Net Domestic Assets and Net International Reserves had been met until mid-November 2000, the Central Bank had to inject substantial liquidity to the markets due to the shortage arising from the turmoil in the banking system in November 2000. The liquidity, which was injected by means of open market operations, amounted to TL. 3.9 Quadrillion between 22 and 30 November 2000. The target for Net Domestic Assets was overshot due to excess liquidity. In addition, the Central Bank sold US dollar 6 billion to the banking sector in view of the rising demand for foreign exchange. These developments prompted us to revise the targets for Net Domestic Assets and Net international Reserves. In December, the Supplemental Reserve Facility extended by IMF and the additional measures taken by the Government provided a partial relief to the financial markets. The revised post-crisis targets were met as end of the year.

It has become clear that, the crisis in November 2000 should not be simply regarded as a liquidity crisis. Rather, it started as a banking crisis, which later transformed itself into a liquidity crisis. As stated in the economic literature, banking crises, which cause huge liquidity demand, may begin either by a run on banks or by the inability of some banks to meet their economic or legal liabilities. And then comes “a currency attack”, as we can observe in many emerging markets, where the currency peg system is in practice and foreign exchange liabilities of the banking system reach high levels.

Despite a decline in interest rates and a modest increase in capital inflows in January 2001, the damage of the crisis in November 2000 on the banking system, especially on the state-owned banks, increased the vulnerability of the system. In this period, the maturities of the funds obtained from both international and domestic markets gradually got shorter. It was observed that, while external funds began intensifying in overnight transactions, also residents preferred short-term investment instruments. In particular, TL deposits of one-month started to increase and its share in the total deposits rose to 35 percent in February 2001 from 12 percent in October 2000. In February, the unfavorable developments that had occurred on the day before the Treasury auction caused a panic in the already fragile markets. Market confidence in the system was completely lost and the Turkish lira was once more faced with a new currency attack on 19 February 2000. The banking sector purchased US dollar 7.6 billion from the Central Bank, to be settled the next day. This exerted pressure over the exchange rates. In order to alleviate this pressure, the Central Bank did not roll over the repurchase agreements maturing next day and US dollar 6.1 billion that had been purchased the previous day were sold back to the Central Bank. However, the remaining amount of TL caused trouble to the payments system due to the state-owned banks’ daily liquidity needs. On the other hand, the concerns that were raised about the sustainability of the currency peg system deepened the lack of confidence further and the Turkish authorities decided to allow the lira to float freely on 22 February 2000, in order to avoid further damage in the economy.

It is interesting to note here that, the turbulences occurred in November 2000 and in February 2001 differ from each other as regards their starting points. The crisis in November 2000 was started by the banks’ failure to meet financial obligations, and then was followed by a liquidity crisis that increased pressure on exchange rates. On the other hand, the crisis in February 2001 directly manifested itself as a direct attack to domestic currency, with the increased financial vulnerability after November 2000.

An analysis of the fundamental reasons behind the failure of the disinflation program implemented in 2000 reveals that the problems in the banking system should have been resolved well before the implementation of the program. It was natural that, pursuing a monetary policy similar to a currency board, forced the Central Bank to pay less attention to the liquidity needs of financial markets compared to previous years. Moreover, this practice reduced the flexibility of the monetary policy against external shocks. The continuation of problems in banking sector in 2000 put pressure on the rule-based monetary policy based on rule. Another problem encountered in 2000 was the lack of a front-loaded Supplemental Reserve Facility, which would support foreign exchange reserves when needed in the course of the program.

The adverse developments in November 2000 and in February 2001 compelled the Central Bank to pursue policies aimed at stabilizing the financial markets. Priority was given to make the payments system function again by providing liquidity to the market, after having been switched to the floating exchange rate system. In this context, the Central Bank lowered its bid and offer rates in the interbank money market starting from 26 February 2001. Liquidity was given mostly to the state-owned banks, and to the banks that had been transferred to the Saving Deposits Insurance Fund through overnight quotations under open market operations. Besides overnight funding via open market operations, the

Central Bank has also started providing the markets with liquidity through forward transactions since the mid-March. At the same time, the Central Bank withdrew the excess liquidity by way of repurchase and reverse repurchase transactions at the Istanbul Stock Exchange and by way of the CBRT interbank money market, when needed. The Central Bank has also provided banks with cash via foreign exchange deposits and limited foreign exchange interventions to help them fulfill their external obligations. Delay in the announcement of the new stabilization program prompted the Central Bank to implement a multiple price auction in buying and selling foreign exchange at the end of March 2000, in order to ensure that the exchange rates may be fixed according to the market conditions, avoiding excessive fluctuations.

At this point, let me touch on the operations for the state-owned banks. At present, higher overnight borrowing requirement, stemming from the state-owned banks' structural problems, is putting substantial constraints on the monetary policy actions, making financial markets more fragile. In view of this important issue, the state-owned banks have started to lessen their overnight borrowing from other banks and non-banking institutions in the short-term by obtaining liquidity from the Central Bank through repurchase or outright selling transactions against government papers given by the Treasury to cover their duty losses. A similar process is running for the banks taken over by the Saving Deposits Insurance Fund. The Central Bank and the Treasury are absorbing the excess liquidity from the market through reverse repurchase transactions and through selling government papers.

Dear Shareholders, Distinguished Guests and Valuable Press Members;

In view of the current economic conditions, the economic literature also indicates that, pursuing a tight monetary policy to stabilize exchange rate right after the emergence of crises has certain setbacks. Although a post-crisis policy implementation can reduce the fluctuations in the exchange rates, the resulting higher interest rates will negatively affect both the domestic debt stock and the real sector.

Furthermore, I believe that once the setbacks are eliminated right after the crisis and once the amendments are made in the Central Bank Act, we will be able to use short-term interest rates actively as a monetary policy instrument in the medium-term. A more efficient monetary policy implementation will be ensured through easing the fiscal burden on the financial markets and through reinforcing the banking sector, which will lay the ground for inflation targeting. In the near future, we will continue to do the technical works for inflation targeting. These works will include, choosing an appropriate price index; determining a transmission mechanism that would show how monetary policy instruments might influence the prices and how the pressures might come up on the prices; determining a targeting band and its period. In short, the Central Bank will shift from a post-crisis policy aimed at short-term financial stability toward price stability, once the necessary conditions have emerged.

Let me point out that, developments in November 2000 and in February 2001 highlighted once again the importance of achieving the structural and financial reforms, which is one of the keystones for the medium- and long-term stability of the economy. At this point, I would like to underline that the existence of a healthy financial system can be considered as a public good with substantial positive externalities. Once the system is relieved from the burden of the state-owned banks, both the borrowing costs will decline and the Central Bank will get an upper hand in its monetary policy actions. One of the necessary conditions for the success of inflation targeting in the medium- and long-term is ensuring the soundness of financial sector, along with a central bank that can freely use its monetary policy instruments. These are just some of the important factors lying behind the restructuring efforts in the Turkish financial system in this period. With the increased efficiency resulting from adjustments in financial markets, the Central Bank will be able to pursue a monetary policy aimed at price stability.

Here I would like to present some information on the monetary policy to be implemented in this transition period that will pave the way for inflation targeting in the medium- and long-term. The Central Bank will keep its interventions in the foreign exchange markets limited under the floating exchange rate system, but will only move to reduce volatility in exchange rates in case of excessive fluctuations. The Central Bank will support disinflation efforts by keeping monetary aggregates under control, and in addition, the monetary policy will be directed at achieving financial stability. The Central Bank will continue monitoring the targets on Net International Reserves and Net Domestic Assets, which are among the basic items on its balance sheet. These targets will be set also by considering financial stability. The money creation of the Central Bank against the increase in the money demand will be carried out by considering the indicative path for Net Domestic Assets. On the other hand, the Bank will allow flexibility on its Net Domestic Assets, whenever unexpected negative developments emerge in the financial system. Moreover, the Central Bank will resort to use short-term interest rates efficiently as a monetary policy instrument through reducing Net Domestic Assets, should disinflation process be endangered by foreign exchange movements.

Dear Shareholders, Distinguished Guests and Valuable Press Members,

Now let me go into some details of the Draft-Law Amending the Central Bank Act, which will have a greater impact on the macro-economic policies in Turkey in the medium- and long-term. As you know, the Draft-Law, which has already been approved by the Planning and Budget Commission at the Parliament, will be debated in the Parliament's General Assembly, probably today. The Draft-Law was prepared by taking account of economic developments of the last 31 years since the enactment of the Central Bank Act No: 1211 on 14 January 1970, and the central banking norms agreed by the European Union. According to the Draft-Law, ensuring price stability becomes the primary objective of the Central Bank. The Central Bank will have the exclusive power and responsibility in designing and pursuing its monetary policy. The new Law will enable the Bank to choose and to use its monetary policy and instruments independently. If the Draft-Law is ratified in the Parliament just as adopted in the Commission, a *Monetary Policy Committee* will be established. It will be consisted of Governor, Vice Governors, one member to be elected from among the Board members and one member to be designated by Council of Ministers upon the proposal of the Governor. This Committee will play an important role in setting the targets and regulations, upon which the Central Bank will act jointly with the Government. However, the Central Bank will support the governments' policies on economic growth and employment, on condition that they do not conflict with the aim of achieving price stability.

The Draft-Law is removing a number of constraints of the present Law on the monetary policy actions and is bringing new facilities.

The concepts of *Transparency* and *Accountability* are underlined in the Draft-Law. For example, the Governor of the Central Bank will report to the Council of Ministers and will brief the Planning and Budget Commission in Parliament twice a year on the Bank's activities. Moreover, the Bank will disclose its monetary policy implementation to the public by means of reports and announcements. In addition to this, if by any chance inflation targets are missed or should there be a probability of failing to hit the targets, then the Bank will explain the reasons thereof to the Government and to the public. The balance sheet, profit and loss account of the Bank will be audited by independent agencies, which is another element increasing the Bank's transparency.

To ensure stability in the financial system and to increase its efficiency in achieving the price stability, the Central Bank will have the power of taking necessary measures to strengthen the financial system and to determine the systemic risks. Besides removing the burden of the state-owned banks from the financial system and restructuring the banking system, the measures that would reduce the public sector borrowing requirement will boost the economic efficiency and secure the price stability. The Central Bank will not in any manner whatsoever extend credit to the Treasury and to the public sector, including outright purchase of government papers, as envisaged in the Maastricht Criteria. However, a transition period of six months is needed, before we can adhere to this principle in view of the operations we have to conduct in this post-crisis environment.

Having said all this let me end my remarks by making a last point. The extraordinary period, which Turkey has undergone recently, should not create an obstacle for Turkey on its way to become a part of Europe in the medium-term. On the contrary, I think we should take advantage of the opportunities arisen from the turbulences, in order to reinforce the steps being taken by Turkey for the attainment of its goals.

We must take the necessary structural measures to disinflate the economy and to boost the growth potential of the economy. Decisive steps must also be taken to meet the requirements of the *Information Age*. In the near future, Turkey will unquestionably attain an economic and social level it deserves by reaching a social consensus and by taking appropriate policy actions today. Thank you all for listening to me.