Süreyya Serdengeçti: Basic changes in the Turkish economy - problems and solutions

Opening speech by Mr Süreyya Serdengeçti, Governor of the Central Bank of the Republic of Turkey, on the occasion of the 73rd Shareholders' Ordinary General Meeting of the Central Bank of the Republic of Turkey, Ankara, 12 April 2005.

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Esteemed Shareholders, Distinguished Guests and Dear Members of the Press; Welcome to the 73rd Shareholders' Ordinary General Meeting of the Central Bank of the Republic of Turkey.

Before I begin my speech, I would like to share with you the happiness that we have this year been able to achieve the single digit inflation figures that we have wished for many years and the Turkish lira has once again gained credibility. The main framework of my speech will cover the process that has brought us up to this point and what we need to do in order to achieve and maintain price stability.

In other words, leaving aside the shallow evaluations stuck in the triangle of FX rates-exchange rates-interest rates-stock market rates; the core of my speech today will focus on apart the basic changes in the economy, deep-rooted problems and the ways out of these problems.

The Turkish economy has faced a problem of almost 30-years of high and chronic inflation. During this period, many programs have been implemented to push down inflation. In the same period, inflation has at times relatively declined, but it was impossible to maintain a permanent recovery that could be identified as price stability.

During the period between the first half of the 1970s and the early 1980s, studies and applications to fight inflation and to maintain price stability in developed economies intensified, whereas inflation accelerated due to the financing of public deficit by the Central Bank.

In the second half of 1980s, the inertia arising the Central Bank meeting public deficits brought about abandoning of discipline in public expenditure changes in production-consumption behavior together with inflation and deterioration in the social structure. In the early 90s, apart from relatively short-term periods of stability, lax fiscal policies continued to be implemented along with monetary policies aimed at preventing a possible crisis. Price stability was not a priority, moreover, inflation entered a self-fulfilling cycle. It is a fact that during this 30-year period, price stability was not the main objective and the necessary structural arrangements for maintaining economic stability, including price stability and sustainable growth, were not taken into consideration.

This period of long-term chronic inflation brought with it a lot of negativity. As it is known, price stability is the sine qua non for maintaining economic and social stability. The extent of the damage to the economy as well as political and social structure of a country caused by failing to achieve price stability is clearly in the in the state of the country during this period and in the experiences of other countries. At this point, it is important to underline once more the damage caused by high inflation in order to remind us why should do everything in our power to stick to the price stability objective. This is especially important in an environment where the benefits of overcoming inflation are not yet fully understood.

The consequences of failure to maintain price stability, in other words, the damage caused by inflation, can be clearly seen in our country both in society and in the economy, as is the case in all countries that have experienced high and chronic inflation.

High inflation, one of the main reasons for poverty, depravation, unfair distribution of income, and the economic instability environment it creates has been one of the most influential impacts of inflation on society. The legacy of inflation on poverty, depravation and the unfair distribution of income have been clearly felt by society.

Another effect of high inflation, which manifested itself in the short-term in society, is that of immoral behavior. High inflation led to moral corruption in our country. While Turkey ranked low in fields such as infrastructure, education, health and the fair distribution of income in international development indicators, it ranked high in indices of corruption.

Another factor worth mentioning in this context is the relationship between high inflation and political instability. Shortsighted policies by political instability and the resulting inflation as a result have featured several times in economic literature. However, the other side of causality has not been mentioned much. Economic instability triggered by inflation is one of the main factors that leads to political instability. In other words, political instability creates inflation and inflation invokes political instability. Hence, high inflation and political instability create a vicious circle.

When we look at the effects of high inflation on the economic sphere, we see that deposit savers put most of their savings into unproductive areas such as foreign currency and real estate with the aim of protecting themselves from the impacts of an inflationary environment. However, keeping most of their savings as foreign currency has achieved nothing and created real revenue loss. This is due to the fact that for economic units, the long-term revenue of foreign currency remained below the revenues of Turkish lira assets, despite devaluations in the Turkish lira.

When we look at this from the investment angle, since there is a kind of tax burden on investments, this creates an additional cost for investors and causes seasonal volatility in investment. This leads to diversifications in economic growth rates. As a result, growth rates drop in countries experiencing high inflation in the long-run, moreover the quality of growth deteriorates. The average growth in the last 20 years in Turkey has lagged behind most of the developing countries. In our country, continual high inflation, apart from having a negative impact on economic growth, has led to the erosion of the quality of products and services and has caused an unrelenting regression in our competitiveness. However, competition indexes show that the devaluation of the Turkish lira do not increase Turkey's competitiveness in any way.

The unfavorable impact of high inflation has also been the felt in the labor market and prevented it from functioning effectively. Economic growth within continuous expansion and contraction cycles made the labor force volatile. Those, who want to work in this volatile environment, especially unskilled workers, are the first ones to lose their jobs in periods of contraction and the last ones that are employed in expansion periods. This means that the period of high and chronic inflation experienced by Turkey is one of the underlying reasons for social problems triggered by the fact that sustainable employment growth has yet to be achieved.

Meanwhile, alongside the tendency of currency substitution with high and volatile risk premium created by high inflation, real interests, which were high due to the problematic public debts, caused a debt spiral and the vulnerability of the economy to exogenous shocks increased. This situation both clouded expectations and hindered the effective utilization of monetary policy

Inflation diminished the effectiveness of financial markets to intermediate. This is due to the fact that, in a highly inflationary environment, players in the market are unable to foresee the future as they lack the appropriate knowledge. This situation, combined with the problem of public deficit, led to a significant decline in the credits that the banking sector provides to the non-financial sector. Therefore, the banking sector failed to fulfill its core function as a provider of resources for the economy. At the same time, risk management principles were not put into practice in the banking system and the consequences were apparent in the 2000-2001 crises.

Another unfavorable impact of high and chronic inflation on the economy in our country is that economic units became used to operating in a highly inflationary environment. To put it more clearly, backward indexing behavior became common in pricing activities. Thus, wall of inertia evolved in inflation, which was difficult to break. Here "inflation inertia" simply refers to the situation of, yesterday's inflation designating today's inflation and today's inflation designating future inflation. Hence, as inflation increased, inflation expectations increased with it and a self-nurturing inflation cycle began.

In a period of high and chronic inflation, consumers were not inclined to control price and quality less and were also less concerned about diversity in selecting products. At the same time, producers were less concerned with cost and efficiency while pricing and were willing to determine profit margins freely, and invest less on increasing product diversity.

As a result of this behavior created by the inflation process, goods and services could be sold at any price since consumers did not control prices, while producers did not control cost. Thus, this attitude provoked a resistance against anti-inflationary policies that were introduced at intervals and significantly slowed down the decline of inflation. In other words, the main inertia, which needed breaking, was that stemming from the resistance in peoples' minds. This resistance still exists and repeatedly stands in the way of stability programs and efforts. However, since it is gradually being understood that inflation is also a moral issue, the fight against inflation is no longer the direct target.

My ideas on the fight against inflation are presented in detail the interview given on January 16, 2005, which is available on our website.

To sum up, the protracted chronic inflation made our economy highly vulnerable. It hindered the establishment of macroeconomic balances in the long run. Consequently, it induced a heavy cost on both our economy and social life.

During the last three years, we have repeatedly explained the damage caused by inflation in every possible platform. Today we are content to see that a significant part of the society agrees with us. In the rest of my speech, I would like to focus on where we stand on fighting inflation, how we got here and what should to be done to preserve these gains and maintain price stability.

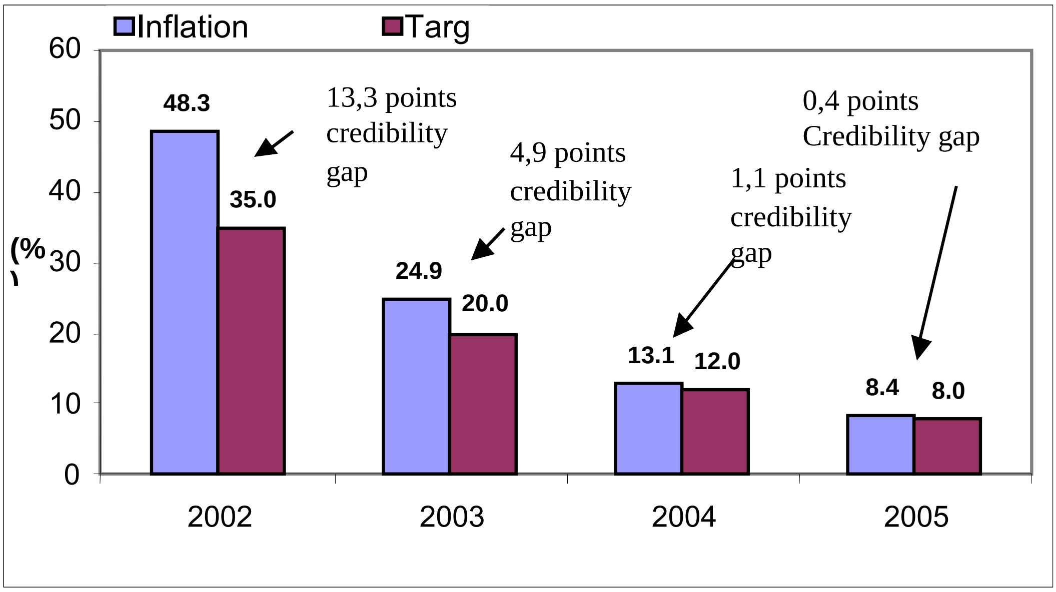
With strict and efficient implementation of the economic program devised after the crisis, the thirty-year period of chronic inflation has come to an end in our country, and the focus has shifted to the declining inflation environment and permanence of price stability. Besides, there is a persistent and visible recovery in inflation dynamics, and thus the inflation inertia has, to a great extent, been.

When we consider where we are after four years of fighting inflation following the crisis, we see that CPI inflation, which was 73.2 percent by January 2002, remained below the end year targets for three consecutive years, declining to single digit figures; annual CPI is realized as 7.94 percent in March 2005. The total decline in inflation during this period was more than 65 percent. This favorable development was apparent in the expectations as well. While the reliability difference, which is the difference between target inflation and inflation expectations, was 13.3 point at the beginning of 2002, it dropped to 0.4 points at the beginning of 2005. As of today, according to the results of the survey of expectations of the Central Bank of the Republic of Turkey, the year-end inflation expectation dropped to 7.5 percent. This figure is below the official target of 8 percent. As well as being a concrete indication of the fact that the inflation inertia has been broken to a great extent, this improvement in inflation expectations is clear evidence of the increased confidence in monetary policy.

Moreover, this situation shows that the inflation target will be a nominal anchor for economic units in their future decisions.

Figure 1: Credibility Gap

(Rates of Inflation Expectations and Targets as of the Beginning of the Year)



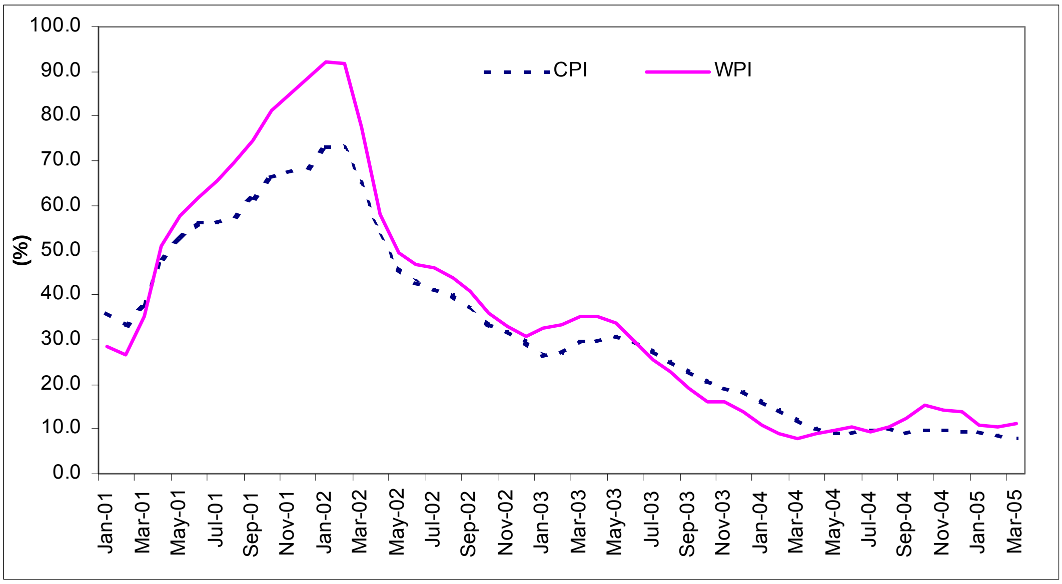
Source: SIS, CBRT.

In 2004, there were high increases in world commodity prices; mostly in oil and primary metal prices and in April and May there were fluctuations in the financial markets. Despite these developments, the fact that the inflation target was realized is owing to coherent implementation of disciplined monetary and financial policies. In addition, there are four other main factors that contributed to the steady decline of inflation; the controlled recovery of domestic demand, the continual increase of productivity in the economy, income policies almost coherent with inflation, and relative stability in FX rates.

The inflation figures of the first quarter of 2005 indicate that the positive outlook in price developments continues. In the new index with a 2003 basis year, the tendency to decline persists in the special CPI aggregates which were formed by adjusting inflation according to external factors- such as raw material prices around the world, prices affected by natural causes or determined by the public. In the first quarter of 2005 cumulative inflation figures remained historically low.

At this point, instead of going into detail about the inflation outlook, I suggest that you refer to the press release "March Inflation and Outlook", which is available on our website.

Figure 2: Inflation Developments *



*For the January-March 2005 figures, 2003 base year index was used.

Source: SIS.

I would like to briefly consider the underlying reasons for the success of the fight against inflation.

Along with the issues mentioned above, the implementation of firm and sound policies and important institutional reforms are crucial to the decline of years of inflation and finally getting rid of the label; "a country with chronic high inflation".

The first, and perhaps the most significant institutional development, is that the institutional structure of our Bank has become conducive to maintaining price stability. As you know, in 2001, in amendments to its law, the main purpose of the Central Bank of the Republic of Turkey was designated as maintaining price stability and the Bank was given the mandate to directly determine necessary monetary policy and monetary policy instruments.

Another essential change made in Central Bank law was the prohibition of advances and credits to the Treasury and public institutions and establishments. As is known, public expenditures can be financed through collecting taxes, privatization, borrowing from domestic and foreign markets or Central Bank's resources. Financing through Central Bank resources may cause inflationist pressures due to increases in 'fiduciary' supply. Therefore conducting monetary policy independently and preventing the use of Central Bank resources in public financing are significant factors for removing this effect. It is not a coincidence that in our country inflation followed a declining trend after November 2001, when the provision of public credit was prohibited. It has since dropped to single digit figures after 30 years.

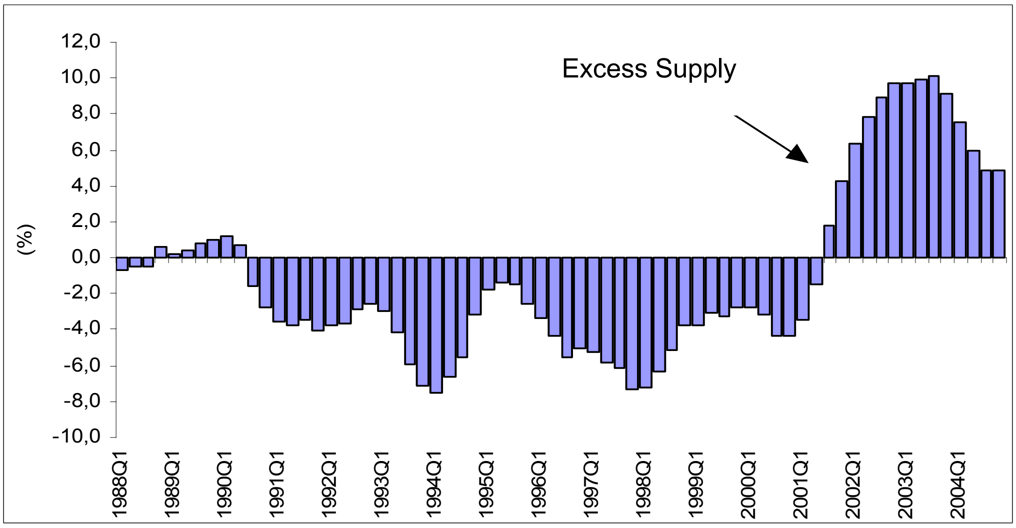
Another contributory factor to be mentioned in the process of fighting inflation is the communication policy of the Central Bank. The significance of efficient communication is undeniable in reducing ambiguity and increasing reliability by making Central Bank policies understandable, assessable and predictable. Since 2001, the Central Bank has placed communication policy at the core of its policies;

and consequently adopted an efficient policy, sharing all knowledge and forecasts with the public and explained its policies clearly throughout the country. I think efficient communication is highly important in terms of the point we have reached today.

Besides central bank independence and communication strategies, the tight fiscal and monetary policies implemented are two other important factors in the fight against inflation. It is very well known that it is really hard to implement price stability-oriented monetary policies in an environment of fiscal dominance environment stemming from budget deficits and excessive domestic borrowing. In order to solve this problem, under the current economic program, giant leaps have been taken towards decreasing interest rates and achieving sustainable borrowing by employing tight fiscal policies. In addition, steps have been taken towards eliminating the public debt sustainability problem in the medium and long run by achieving primary surplus. At this point, I would like to underline that the stability, confidence and positive expectations, which have emerged in the markets as a result of the tight fiscal policies, have significantly contributed to the downward trend in inflation.

Furthermore, continuous increases in productivity, the strong position of the Turkish lira and an income policy in line with inflation have to a large extent contributed to the favorable course of inflation in the recent period. Domestic demand has been kept under control as a result of the tight and prudent fiscal and monetary policies. The postponed consumption and investments, accompanied by advanced consumption, which was driven by worries stemming from old habits, have been instrumental in the rapid increase in domestic demand in the first two quarters of 2004. However, the increase in domestic demand slowed down evidently as of the second half of 2004, as expected. . Accordingly, the level of domestic demand did not exceed the production capacity, and thus no demand-side pressure was created on inflation. These developments were foreseen by the Central Bank and, after a brief interlude, short-term interest rates began to be reduced again from September 2004.e. No apparent pressure of this kind is expected in 2005 either, provided that the tight monetary and fiscal policies continue to be implemented and the incomes policy follows a course in line with inflation. However, as I have just mentioned, the recent press release “March Inflation and Outlook” needs to be read carefully.

Graph 3: Demand Deficit (Total Supply –Total Domestic Demand)



Source: SIS, CBRT.

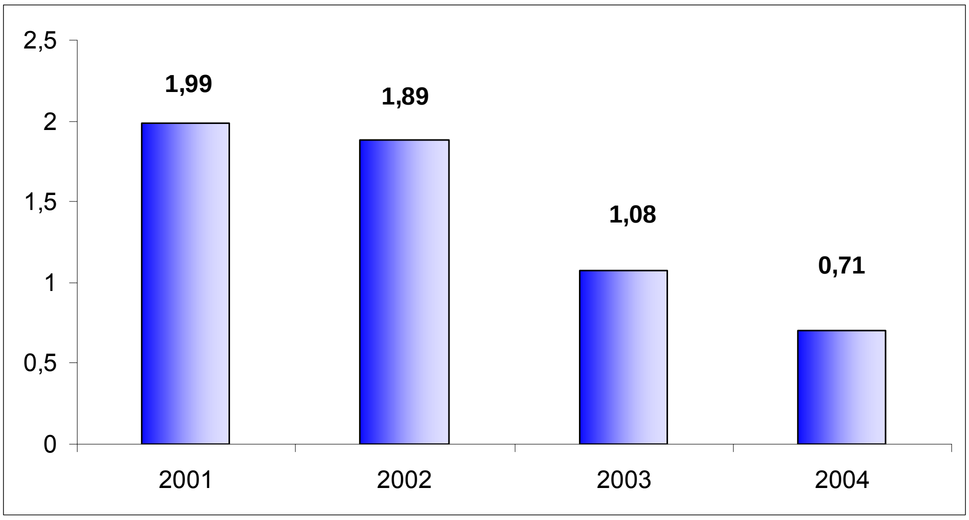
Although the period of chronic inflation has been left behind, a period of lasting price stability has not yet been entered. As I have occasionally emphasized in my speeches, we are still experiencing a period of “disinflation”. Having said that, the distance covered and the gains attained are significant.

Throughout this whole process, inflation dynamics not only changed as a result of the policies implemented, but also the effect of disinflation itself. This, in turn, helped inflation to be pushed down in an irreversible way.

Breaking inflation inertia is the first clearly noticeable achievement in terms of the changing dynamics of inflation. As I have mentioned before, due to increased confidence that the fall in inflation is permanent and the effective communications policy implemented in the last three years, the inflation target has become an increasingly reliable anchor for economic units and there have been significant breaks in the inflation inertia.

Another change observed in inflation dynamics is that the decline in inflation also led to reducing its volatility. With less volatility in inflation, it can be seen that prices have resumed their signaling role in the economy. This development, which shows ease in uncertainty, has been instrumental in the decline of the risk premium and thus the nominal and real interest rates. It has also helped to reduce the borrowing cost for consumers and the opportunity cost of investment for producers. In fact, during this period not only real interest rates eased, but also the general level of interest rates and the extension of maturities. During the last three years, ex-ante real interest rates declined more than 20 points and nominal interest rates more than 50 points. The Turkish Treasury borrowed for the first time ever with a 5 year-maturity in the domestic market. Long-term housing credits, known as “mortgages” and widespread in developed countries for a long time, will start to be extended for the first time in the country’s history. This is the most striking evidence that enough confidence has been established in the economy. Uncertainty has eased owing to reduced volatility in inflation and economic units have been able to foresee longer maturities, thus that the risk premium has declined.

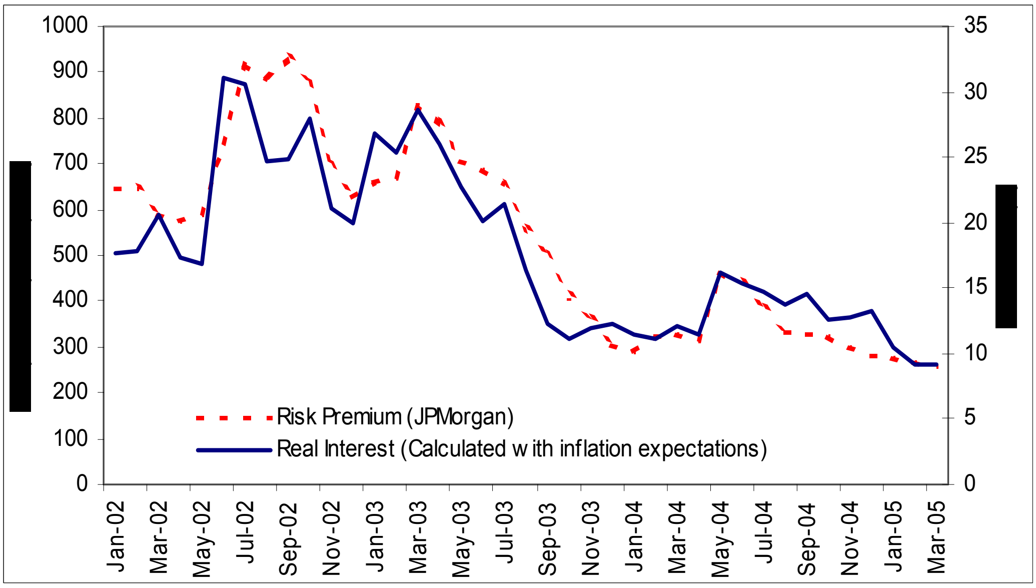
Graph 4: Volatility in Inflation*



* Volatility is calculated as the 12-month moving averages of the standard deviations of monthly inflation rates.
Source. CBRT.

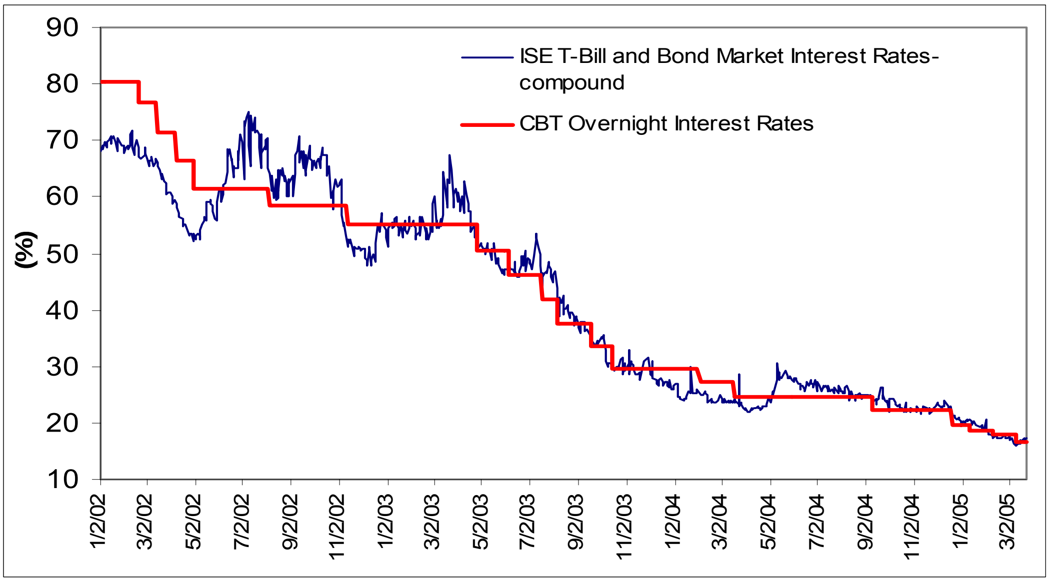
Another significant point I will mention in relation to the changing dynamics of inflation is the apparent change observed in the pricing behavior of producers and consumers. Hand-in-hand with the start of the disinflation process and the acknowledgement to a large extent in economic units that this is a permanent state, producers and consumers have adopted a different approach. Producers have started to pay more attention to cost control and the increase in productivity, while setting their profit margins in pricing policy and consumers have begun to be more actively involved in the pricing process by conducting price and quality controls, using the advantage of a more competitive market.

Graph 5: Risk Premium and Real Interest Rates



Source: CBRT, JP Morgan.

Graph 6: CBRT Interest Rates and Secondary Market Nominal Interest Rates



Source: CBRT, ISE.

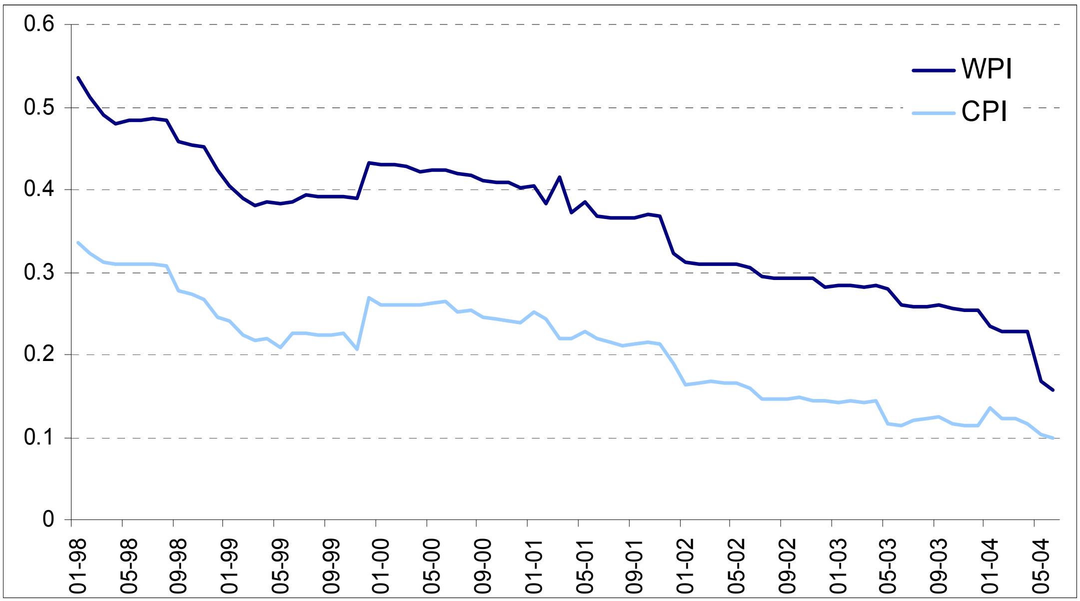
At this point, within the scope of the changing dynamics of inflation, I would like to talk about the pass-through effect of the exchange rates on inflation, which is quite significant not only in terms of the determinants of inflation, but also the current exchange rate regime. The pass-through effect has been gradually becoming weaker, as a consequence of the transition to the floating exchange rate regime, increasing competitiveness, inflation targets increasingly assuming the role of being an anchor owing to reliable economic policies, as well as changes in the pricing behavior of producers and consumers. Especially in the recent period, the effects of the changes in the exchange rate on inflation were lower than expected, and at the same time were weaker and more lagged compared to previous periods.

As a matter of fact, worldwide examples also show that in economies that have achieved price stability, the pass-through effect on prices of exchange rate movements becomes weaker owing to the prevalence of pricing in terms of the domestic currency, thus perceiving any depreciation of the national currency as temporary, and companies resort to price adjustments much less frequently.

In fact, it is inevitable that exchange rate developments will influence prices in Turkey due to the fact that the goods basket of the CPI mainly consists of imported goods and imported intermediate goods make up a significant portion of input costs. Another contributory factor is that Turkey is a small size-open economy obtaining goods at global prices. Yet, studies conducted under the umbrella of the CBRT point to an evident breach regarding the reflection of exchange rate developments on prices following the 2001 Crisis. The pass-through effect of the historically high exchange rates on prices seems to have weakened especially in case of non-tradable goods.

On the other hand, compared to the CPI index with the base year 1994, the CPI index with the base year 2003 includes more of the commodities groups with prices susceptible to exchange rates, and thus causes the effects of exchange rate movements on the general index to be somewhat higher. As for the PPI, the start of the release of those prices, excluding taxes, together with the index with the base year 2003 heightened the susceptibility of this index to exchange rates. Having said that, independent of the nature of the index, when compared with the pre-2001 period, the exchange rate-inflation relationship is forecasted to have been at lower levels and is concluded to have weakened structurally.

Graph 7: Pass-Through Effect of Exchange Rates on Prices



Source: Kara, H., Küçük-Tuğer, H., Özlale, Ü., Tuğer.B., Yavuz, D. ve Yücel, E.M. (2005),"Exchange Rate Pass-Through in Turkey: Has it changed and to What Extent?', TCMB, Working Paper.

Another significant development stimulated by the disinflation process and the environment of relative macroeconomic stability was the launch of the operation to drop zeros from the Turkish lira, i.e. the eventual launch of the monetary reform in 2005.

Plans put forward from time to time from the early-1990s, which proposed dropping zeros from the lira continually had to be postponed as the structural economic problems could not be solved, nor could the rate of inflation or the inflation expectations be brought down to acceptable levels. The chronic and high inflation experienced during this period gradually took its toll on banknote denominations and monetary values. As you all know, this process eventually not only led to the Turkish lira having the highest denominated banknote numerically all over the world, but also adversely affected someof its functions, namely as a medium of exchange and a store of value.

Following the program under implementation, the distance covered in terms of economic stability prepared a suitable environment for monetary reform, and six zeros were dropped from the Turkish lira as of 1 January 2005 when the New Turkish Lira was put into circulation.

The experiences of other countries that dropped zeros from their currencies differ in those which suffered from hyperinflation and those , which had relatively, lower rates of inflation. In the former, it can be seen that monetary reforms were generally carried out as part of the stability program, without waiting for inflation to go down considerably. Whereas, in the case of the latter, reforms were implemented after inflation was brought down sufficiently. In other words, reforms were carried out after a certain distance had been covered in the fight against inflation. Also, in the case of Turkey, monetary reform was launched, not as part of the stability program, but after having monitored the results of the program and achieved macroeconomic stability to a large extent.

At this point, I would like to point out that the realization of monetary reform up to now has been mainly in tune with our forecasts and has followed a favorable course. As of 8 April 2005, the amount of YTL banknotes in the total amount of banknotes made up 73.5 percent.

Within this framework, it has come to our attention that some foreign financial enterprises have recently begun to issue bonds denominated in the New Turkish Lira. Another positive impact of monetary reform which also strengthens the macroeconomic stability process is that the securities issued in international markets in New Turkish Lira can now be cleared. Due to the inability of the technical facilities of foreign financial enterprises to keep records of a currency unit with all those zeros, issues denominated in Turkish lira could not be cleared in the international systems of safe custody such as Euroclear or Clearstream before the transition to the New Turkish Lira. This obstacle has been removed with the dropping of six zeros from the Turkish lira and the introduction of the New Turkish Lira.

After all, monetary reform is one of the most prominent indicators of the permanence of macroeconomic stability and of the fact that price stability will be attained within this context.

At this point in my speech, I would like to underline that price stability has not yet been achieved in Turkey. As I have just mentioned, significant distance has been covered in the fight against inflation. However, it is a fact that inflation is still relatively high in Turkey compared to fellow developing countries. The process of the fight against inflation still continues.

Within this framework, there are certain factors that need to be paid attention to, for price stability to be achieved in the upcoming period. The first one of these is ensuring that the increase in domestic demand continues to materialize in a controlled fashion.

The second factor I would like to emphasize is avoiding reform fatigue. Several structural reforms have been made in the Turkish economy up until now. Yet there are still more reforms pending. . It should be remembered that maintaining the reforms made up to this point is not sufficient to attain positive outcomes from them, but making new reforms is also equally important.

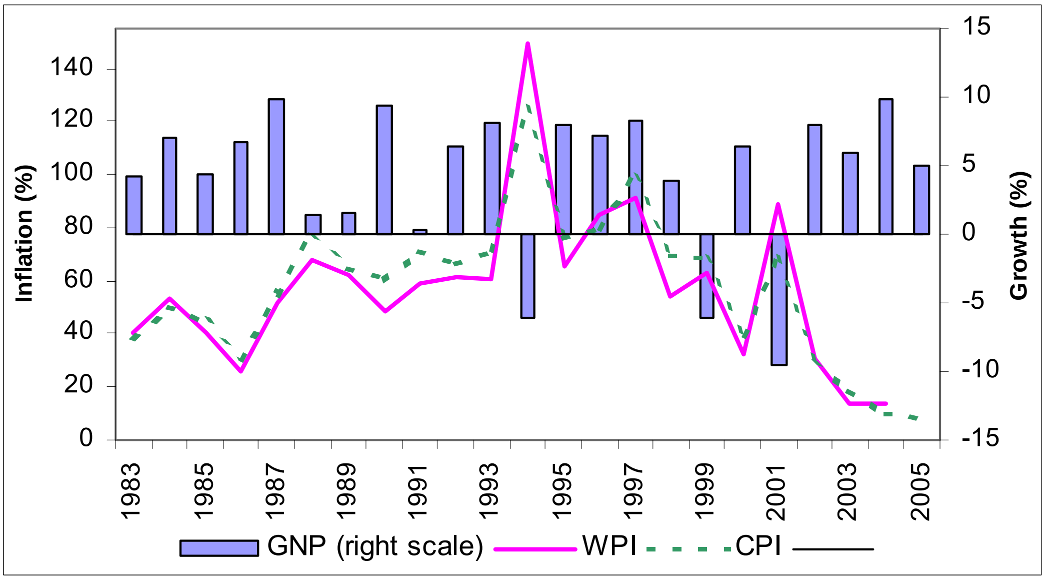
The third factor that requires attention within the framework of achieving price stability is the susceptibility of established economic balances to expectations. Therefore, developments that may adversely affect expectations should not be allowed to occur.

The last factor that should be taken into consideration in this respect is the fact that since policy-makers, both agricultural, cannot control them and energy prices may at times have adverse effects on the course of inflation. Yet, it should be kept in mind that these effects may be temporary and do not have an evident impact on the basic trend of inflation.

After assessments on inflation, monetary reform and the risks, I would now like to share with you certain points I consider significant with respect to growth.

As you all know, the Turkish economy has been enjoying high rates of growth for three consecutive years. The GNP growth rate was realized as 9.9 percent in 2004. Accordingly, the real growth rate compared to 2001 was 25.5 percent. A growth rate of 5 percent is forecasted for 2005. Thus, positive growth rates will be attained for a period of four years owing to a determined and sustainable stability program, as well as the gradual increase in the role of the private sector. Whereas in the past, in an environment of high inflation and uncertainty, the Turkish economy displayed a rather unstable growth performance. At this point, I would like to draw your attention to the changing dynamics of growth: High growth rates were achieved while inflation was in decline. Now, the growth process is driven by productivity increase, the private sector and exports.

Graph 8: Growth and Rates of Inflation*



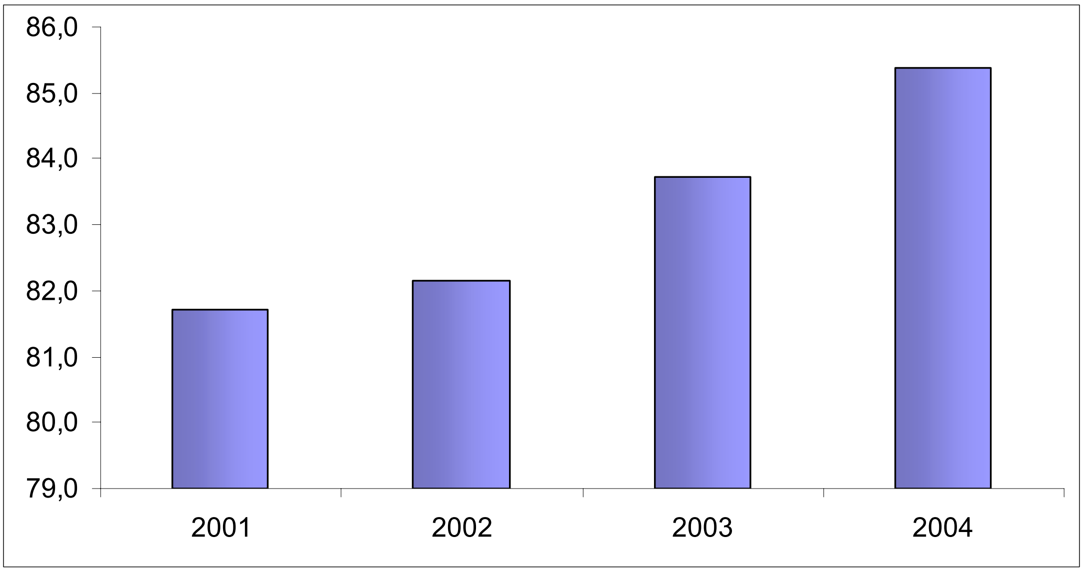
* The data for 2005 is the forecast value for growth and the target value for the CPI.

Source. SIS, CBRT.

Together with the fall in interest rates in recent years and the appreciation of the Turkish lira, the production of private firms has acquired a capital-intensive nature. Besides, firms resorted to a series of measures in the post-crisis period, to remedy the inefficiency of the production process. All these developments led to high-rated increases in productivity in recent years. Productivity increases not only raised the return on capital, but also encouraged investments.

The positive impact of these favorable developments in productivity increase as well as the high growth performance of the last three years began to be seen in employment. Total employment increased by more than 5 percent in the last quarter of 2004 compared to the same period the previous year. The implemented stability program naturally enabled the share of the private sector to increase. As a result of this, the increase in employment is recorded mainly in this sector. The increase in productivity and investments will contribute to sustain growth in the medium term. Hence, the increase in employment is also expected to continue in the coming periods.

Graph 9: Employment (Index for those Employed in the Manufacturing Industry, 1997=100)



Source: SIS.

A reflection of the high rate of growth recorded in 2004 was the increase in the current account deficit, as often discussed by the public. It is useful to point out before anything else that it is a natural outcome for economic growth above forecasts to widen the current account deficit. The realization of the rate of growth as 9.9 percent in 2004, which had been forecasted as 5 percent, led to a parallel increase in the current account deficit above forecasts. However, the rise in the current account deficit today should not be interpreted as resulting in crisis as in the past. The world trend also supports this assessment: Deepening of commercial and financial integration makes it possible for countries with macroeconomic stability to sustain higher current account deficits than before. Within this context, in order to have a clear understanding of the situation Turkey is in today, we need to reflect on what happened in the past. At this point, I would first like to give you a brief overview of what we experienced in the past.

Looking at the past, we see lax fiscal policies and monetary policies, which had to accommodate them. The latter was accompanied by pegged or foreseeable exchange rate regimes. The outcome of this scenario was high inflation and periods of volatile and unbalanced growth. In such an environment, expectations deteriorated because the public sector led the excessive increase in domestic demand, maturities were shortened and uncertainty increased, the current account deficit widened, and measures continued to fell behind. With the addition of the adverse trigger-effect of domestic or external factors to this environment, an increase in foreign exchange demand and pressure on the foreign exchange reserves of CBRT was inevitable, resulting in crises and devaluation. However, the present circumstances of the Turkish economy are very different from those of the past.

To start with, as you all know, unlike the past, a floating exchange rate regime is being implemented. The most apparent feature of the floating exchange rate regime is that it is shock-absorbent. In other words, changes in the demand or supply of foreign exchange are reflected in the level of the exchange rate, and in contrast to pegged or foreseeable exchange rate regimes, the exchange rate goes up or down. The analysis of a total of 52 balance of payments crises experienced in the 1980-2001 period in 19 countries including Turkey show that 51 of these crises erupted under managed floating exchange rate regimes.[1] Thus, in almost all countries facing a balance of payments crisis it can be seen that pegged or foreseeable exchange rate regimes were being implemented. In addition, there were problems related to financial stability or the implementation of tight fiscal and incomes policies that were supposed to support the exchange rate regimes in these countries.

A second issue I would like to touch upon is that the open positions of the banking sector are so low that they are even comparable to those of the past. Within this framework, the amount of open positions of the banking sector is closely monitored and necessary warnings are given. Meanwhile, the real sector should also be cautious about open positions.

Another important issue that needs to be kept in mind in relation to the current account deficit is that the Central Bank does not try to artificially keep the New Turkish Lira overvalued. US dollar 21.7 billion worth of foreign exchange purchase since 2002 is an indicator of this. Besides, short-term capital is not encouraged, and market players are continually reminded that the exchange rate risk lies in the market. Moreover, the high level of foreign exchange reserves, the relatively low inflation environment achieved through tight fiscal and monetary policies and the distance covered in terms of macroeconomic stability are all indications of the changing circumstances.

Now, I would like to talk to you about a different dimension of the growth process, which I have already mentioned.

Sustainable growth

We know that the growth process of the Turkish economy was in the form of an expansion-contraction cycle, especially for the period until 2001. In the past, generally short periods of economic expansion used to be followed by drastic shrinkage. However, the fact that high rates of growth were attained three successive years, following the contraction in 2001, and that the rate of growth for this year is

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1 Kaminsky, G.L. ve Reinhart C. M. (June 1999). The Twin Crises: The Causes of Banking and Balance-of-Payments Problems. *The American Economic Review,* 89, 3, 473-500 and CBRT calculations.

forecasted to be 5 percent show that this cycle has, to a large extent, been broken. Yet, it is not possible to conclude that the Turkish economy has entered a process of sustainable growth.

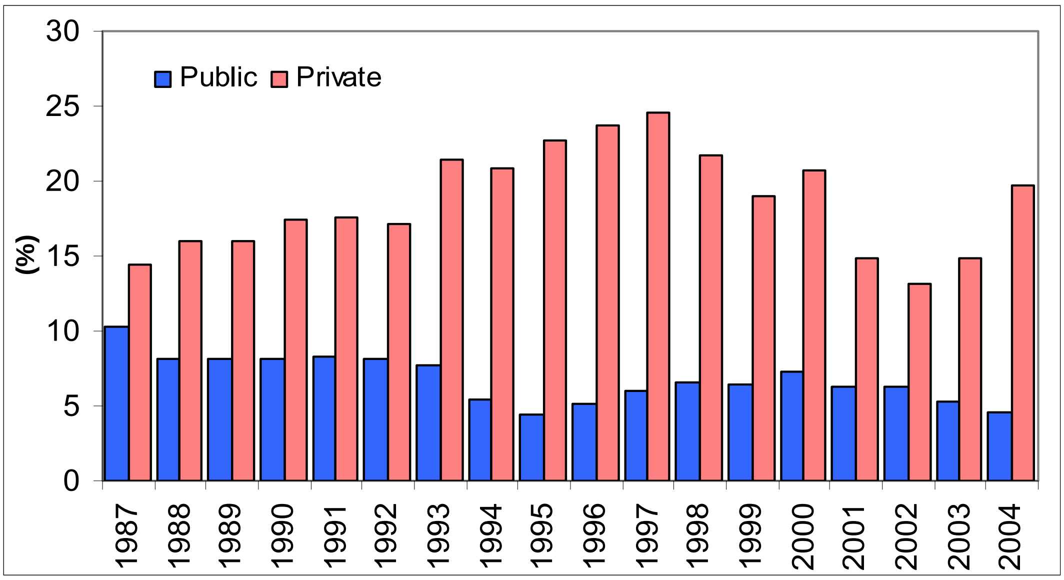
The same as price stability; sustainable growth is a vague notion to the Turkish economy. Sustainable growth can be defined as achieving permanent price stability, building consistency between economic indicators and macroeconomic balances and sustaining growth rates closer to the potential growth level for a period of five years or more. Therefore, we still cannot define the high growth rates observed in the last three years as sustainable growth. It should not be forgotten that strategies, which initiate growth and those, which achieve the sustainability of growth differ. . In this framework, the achievement of sustainable growth in our country requires more comprehensive and radical reforms. Now, I will explain the measures to be taken by outlining the reasons for the failure to achieve sustainable growth.

The main reasons behind the failure in achieving sustainable growth include a large underground economy, the inadequacy of domestic savings and capital accumulation of the private sector, the fact that increases in productivity may not be permanent due to deficiencies in institutional governance, problems concerning the quality of labor supply, poor relations between the banking sector and the real sector and the inadequate tax system.

According to predictions made in studies, the extent of the underground economy in Turkey ranges from 16 to 50 percent. As we cannot impose taxes on the underground economy, the state takes heavy losses. Moreover, the underground economy causes inefficient utilization of the country's resources and creates unfair competition. That is why it is of the utmost importance that policies aimed at the registration of the underground economy are carried out at once.

The domestic savings rate of our country is very low compared to that of both developing and developed countries. Actually, what lies beneath this fact is Turkey's low-income level. It is very difficult to increase the income level and change the saving tendency in the short term. For this reason, the domestic savings deficit should preferably be met by direct foreign capital investments.

Graph 10: The Shares of Public and Private Investments in GNP

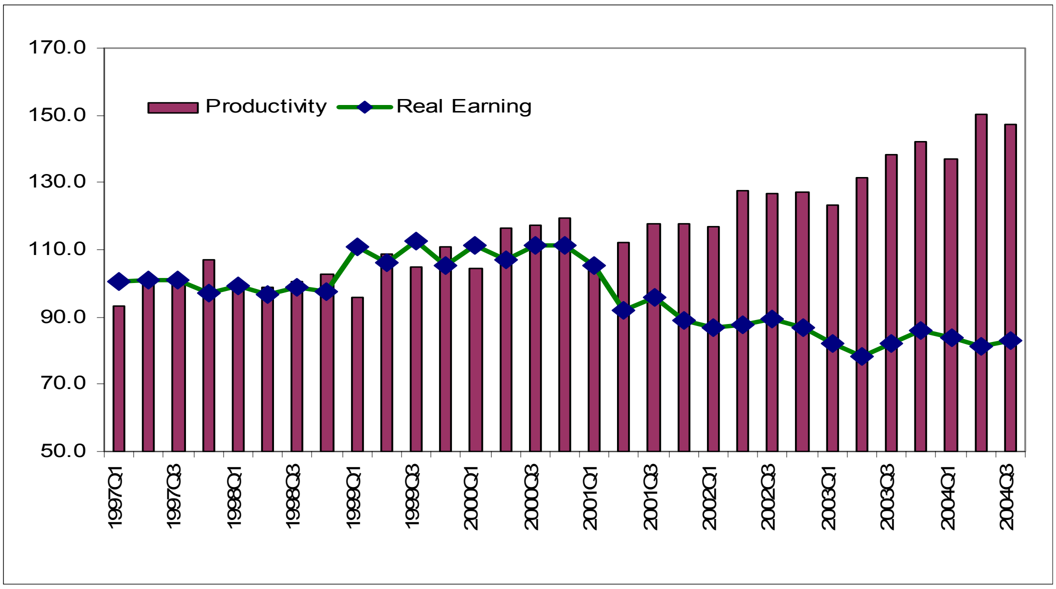


Source: SIS.

Due to the current economic program and the structural reforms in the scope of the program, a transition from a public sector-supported capital accumulation model to a private sector-supported accumulation model occurs, where market conditions are taken as indicators and criteria. The share of the private sector in the national income increases, whereas the share of the public sector declines. It is clear that the private sector-oriented growth plays a major role in achieving sustainable growth by boosting both exports and total industrial production. However, it should be noted that the private sector could not meet the expectations because it could not exploit sufficient resources. This was due to the dominance of the public sector borrowing requirement in the finance sector. Furthermore, the factors that slow down the capital accumulation process include the incomplete tax reform and the poor relationship between banking sector and real sector. I will explain tax and banking reforms in more detail in the forthcoming parts of my speech.

Improving economic productivity is fundamental for achieving price stability and concurrent sustainable growth in the long run, that is to say an increase in real income and welfare. A rise in total factor productivity is expected to be one of the core dynamics of sustainable growth to be attained in the next 10 years in Turkey. The manufacturing industry has recently witnessed a boost in productivity. The critical point here is that increases in productivity should be reflected on all sectors and become sustainable. Therefore, it is very important that labor education and institutional governance is improved through research and development of technology, which will provide a constant increase in total factor productivity.

Graph 11: Partial Productivity and Real Earning Indices (1997=100)



Source: SIS.

Sustainable increase in employment

In Turkey, sustainable growth depends on the increases in productivity and capital stock as well as on the enhancement of labor supply and labor quality. For this reason, determination of the structural obstacles standing in the way of employment and the establishment of policies aimed at their removal bear much significance.

Employment differs according to the responses of a country's labor market, the financial structure of its firms and its institutional structure in the changing economic conditions. This diversity causes different rates of natural unemployment in countries with the same potential growth rates. Sustainable employment requires sustainable growth along with the adaptation of an institutional structure and labor market to match international standards of competition.

In Turkey, there has been an increase in the labor flow from the agriculture sector to the industrial and services sectors. Hence, the solution to the employment problem is becoming more complex considering the amount of growth in Turkey, which leads to a failure to create employment in the medium term. Migration from village to city raises the unemployed and unskilled labor supply in the industrial and services sectors. Meanwhile, the current production processes in our country are insufficient to switch to high value added products, which can compete in the international market. The high rate of unemployed skilled labor in Turkey underlines the need for a production process, which focuses on high value added products. In line with this aim, strategic plans should be made in order to mobilize investor potential, carry out labor planning and conduct labor education in chosen sectors within the framework of an encouragement model. Feasible finance and marketing techniques should be adopted in order to achieve effectiveness in these strategic plans and encouragement mechanisms.

The implementation of employment-oriented finance models and labor education will contribute to providing a solution to the employment problem by establishing stronger relations between the agriculture sector and the industrial and services sector. Other factors that will help to increase employment include establishing control of the underground economy by lowering employment taxes in the scope of reducing labor costs, sustaining increases in productivity, devising long-term plans compatible with the labor supply aimed at increasing skilled labor and formulating policies consistent with the European Employment Strategy.

Now, I would like to touch upon another topic, real interest rates and the problem of public debt.

The continuity of structural reforms, a stronger macroeconomic balance and the confidence of economic agents will surely contribute to a further decline in real interest rates in Turkey. Another main indicator of the relation between structural reforms and the level of real interests is the credit levels in the country and the inverse relationship between risk premium and real interest rates. As it is known, the credit rating of a country is assessed according to its economic principles and macroeconomic structure. The analyses indicate that real interest rates display a downward trend in economies with high credit ratings, while they maintain an upward trend in economies with low credit ratings. In other words, real interest rates are low in structurally sound economies, whereas they are high in structurally deficient economies. Therefore, it is obvious that structural reforms should be implemented immediately in order to bring real interest rates down.

Another point I'd like to mention about achieving lower real interest rates is that this anticipated decline cannot be realized without considering short-term interest rates and the inflation outlook, which are CBRT's policy instruments. For instance, real interest rates cannot be artificially reduced without observing the current and future trend of the rise in domestic demand. As I have mentioned earlier, economic expectations and the confidence in the authorities and policies, which are implemented within this framework, will contribute the most to the achievements made in macroeconomic stability.

In this framework, as the Central Bank has mentioned repeatedly, the future trend of inflation as well as the inflation target is considered while making decisions on short-term interest rates. The Central Bank also uses a wide set of information to analyze this trend. Therefore, if the Central Bank uses a variable other than the future trend of inflation in its decisions concerning interest rates, it may send the wrong signals to economic agents, reduce confidence and, contrary to a targeted decline; this may lead to a rise in real interest rates.

Despite the important achievements made in the economy, the main factors that limit the decline in real interests are the high debt stock and unfavorable dynamics of public debt.

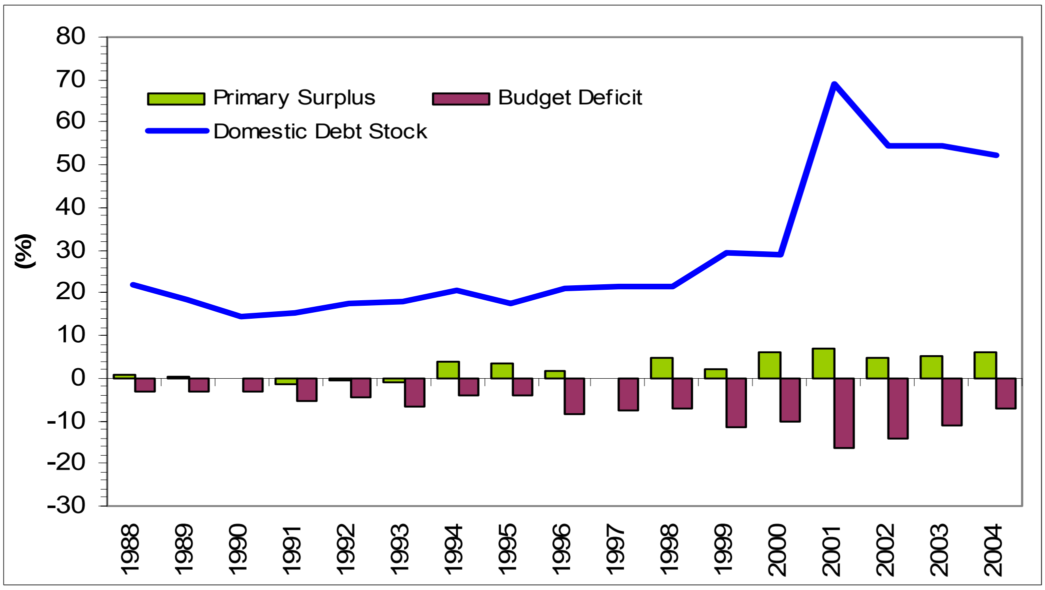
According to empirical studies, there is a direct relation between the ratio of debt stock to the national income and the realized real interest rate. Real interests display an upward trend in countries with high public debt stock, whereas they are low in countries with modest public debt stock. High public debt stock and concerns about the sustainability of public finance cause a direct rise in risk premiums and this leads to high real interests rates.

Although tough measures had been implemented several times prior to the 2001 crisis, strict discipline could not be established in public finance and the public deficit was mostly met by borrowing. Hence, along with the operations conducted in the banking sector after the 2001 crisis, the ratio of net public debt stock to national income recorded its highest level of 91 percent in 2001. In fact, many developing or developed countries can attain this ratio in the long run. However, until recently, sustainability of public debt had been a considerable problem on Turkey's agenda. This problem derived from the size of short-term debts, high real interest rates and doubts about policies that were being implemented at the time.

We targeted a high primary surplus comprising the 6.5 percent of the national income and reached our goals in the framework of the stability program, which has been implemented for the last three years. The same target has been set for the year 2005, as well. Thus, the commitment to continue the programme of tight fiscal policy has been strengthened. As a result of these achievements, significant developments were made in public debt dynamics in the last three years. The ratio of net public debt stock to national income declined to 64.5 percent end-2004 and the Treasury borrowed with a five-year maturity for the first time in the domestic market. Sustainability of debt will soon be taken off the agenda soon.

In this framework, it will be possible for the risk premium and consequently real interest rates to go further down in the upcoming period, as public finance has been equipped with a sustainable structure with the continuation of tight fiscal policy and the launch of structural reforms in the areas of banking, taxes and social security.

Graph 12: Budget Deficit, Primary Surplus and Domestic Debt Stock (% GNP)



Source: Turkish Treasury.

Now, I would like to underline a specific point related to the current tight fiscal policy. As I have mentioned earlier, tight fiscal policy played an important role not only in alleviating the public debt problem, but also in the improvement of expectations. The key factor regarding the tight fiscal policy in the said period was the target of a high primary surplus.

Until recently, heated discussions have been held about this matter and various views have been put forward both on the implementation of a tight fiscal policy and setting the primary surplus as the target, as well as its level. Some people even suggested that a tight fiscal policy could hamper growth. For this reason, let me briefly remind you of the effects of tight fiscal policy and, within this context, of the primary surplus target of the economy.

As it is known, in countries like Turkey with a high ratio of public debt to national income, which possessed lax fiscal discipline in the past, expectations towards the ability of debt roll-over are the main determinants of economic developments, especially the dynamics of inflation and growth.

For this reason, the main target of our fiscal policies has been to reduce the ratio of public debt stock to national income gradually and to equip public finance with a sustainable structure. Lowering the ratio of public debt stock to national income depends on mathematically higher growth rates, lower real interest rates, the stable course of the national currency and the primary budget surplus due to the effect of foreign currency borrowing on the debt stock. Primary surplus is the only one of these variables, which can be controlled by authorities under the current economic conditions. That is why, the primary surplus is the targeted variable and we set our goals high in order to increase the credibility of the policies, which aim to reduce the ratio of public debt to national income.

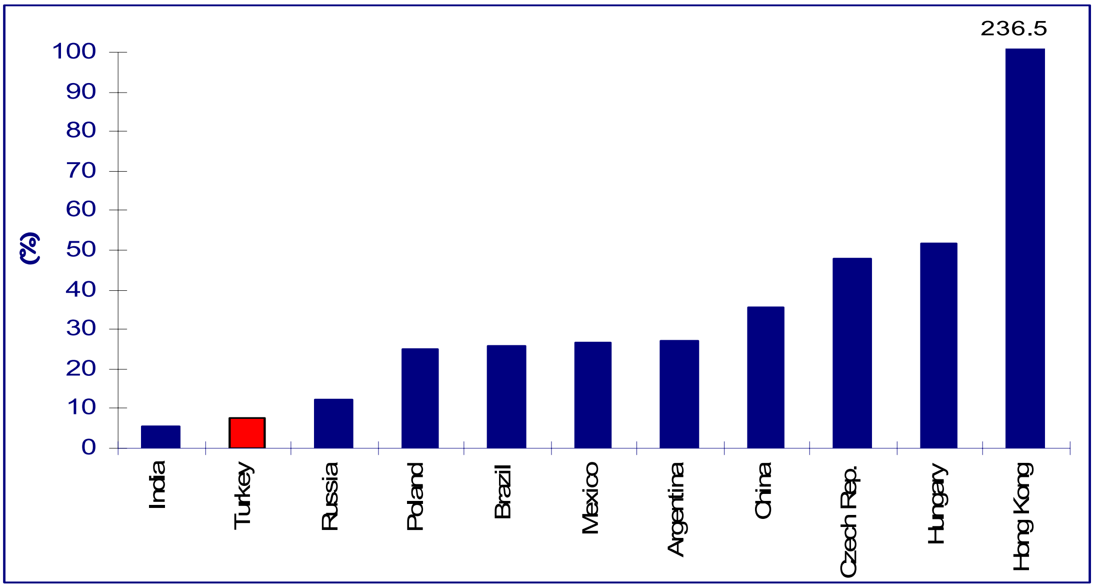
The high primary surplus target convinces economic units of the possibility of debt rollover as well as reducing public debt, improving expectations and generating confidence. Positive expectations lead to a decline in the risk premium and, as a result, real interest rates and contribute to the stability of the New Turkish Lira. This process is likely to directly affect growth. The most convincing proof of this is the implementation of tight fiscal policy in Turkey for the last three years and the realization of record high growth rates.

Now let me touch upon a subject that I frequently come across in the print media and peoples' comments, which shows there are mixed opinions on macroeconomic policies. In the scope of the entire Turkish economy and the definition of various economic variables such as growth, employment, inflation, debt stock, foreign trade statistics and current account balance, a fact determined not only technically, but also in practice, is that macroeconomic policies cannot affect all these variables directly and at the same time. Therefore, setting a figure for each economic variable and defining these as targets is not correct practice within the framework of the market economy. In market economies, the aggregates that can be controlled by authorities are set as targets while designing the policies. In our country, under the current economic conditions, these aggregates include consumer price inflation and the ratio of primary surplus to national income. Other variables, such as the growth rate, real interest rates, and producer price inflation are the outcomes in this sense and can only be forecasted. That is why I believe that the difference between the concepts of macroeconomic targets and forecasts should be taken into account in the opinions expressed.

Direct foreign capital investments and competition

As I have mentioned earlier, in order to achieve high rates of sustainable growth, the domestic savings gap should be offset by external resource inflow, namely, direct foreign capital investments. Historically speaking, it is clear that Turkey has displayed poor performance in attracting direct investments despite its large domestic market, proximity to developing-strategic markets owing to its geographical position, developed infrastructure and young population. As a matter of fact, net direct foreign capital investments to Turkey in the 1995-2000 period amounted to US dollar 1 billion on average. This corresponds to only 4 per thousand / 4 %0 of Turkey's GDP. The developments of the following years do not point to a lasting improvement in Turkey's performance in this sense either. In Turkey, the ratio of direct foreign capital stocks to the GDP had not changed since 1990 and still stood at 9 percent as of end-2003, while this ratio rose as high as 50 percent for the Czech Republic and Hungary and 30 percent for Argentina and Brazil during the same period.

Graph 13: FDCI/GDP: Turkey and Other Emerging Markets (2003)



Source: UNCTAD, WIR 2004.

When the conditions for foreign direct investment are analyzed from the perspective of international investors, two factors come to the forefront as prerequisites: The first one is related an investment environment with a healthy functioning legal system with legal security. The latter includes the attainment of sustainable macroeconomic balances and administrative stability in basic policies on international investments achieved irrespectively of changing governments. In other words, what is essential is the stability of the policies that are being implemented. Turkey's experiences show that partial improvements that are achieved without meeting these two prerequisites will not help to attract direct foreign investments to the country. Furthermore, other problems that should be noted include the unpredictability of legal arrangements, the amount of time wasted on administrative regulations, as well as the lack of transparency and consistency.

Studies aimed at removing these unfavorable conditions and attracting more direct investment have gained momentum in Turkey since 2000, followed by the enactment of a new Direct Foreign Investment Law. In this framework, the conditions for establishing companies were eased and the establishment process was shortened to 24 hours, while the number of official authorities to be referred to for the establishment procedures was reduced to 2 from 19 and the number of official documents to 8 from 56. Another positive development regarding foreign investments was the meeting of the Investment Advisory Council for Turkey in March 2004. This meeting gave foreign directors the chance to directly convey their evaluations about Turkey to top-level authorities. Meanwhile, Turkey had the opportunity to show her enthusiasm for foreign investments. However, despite all these favorable developments, no improvement was noted pertaining to problems regarding sectoral licenses, land acquisition and site development, taxes and incentives regulation, customs and standards, and intellectual property rights.

At this point, I should underline the fact that investment problems encountered by Turkish entrepreneurs and foreign entrepreneurs in Turkey do not differ that much. “Complexity of the administrative and bureaucratic process” stands as one of the most important barriers to both domestic and foreign capital investments. To ensure long-term development in Turkey, the investment environment needs to be improved. This, in turn, depends on an efficient legal system as well as sustainable macroeconomic balances and administrative stability in terms of basic policies. In this framework, policies regarding foreign trade, competitiveness and education-technology should be implemented in coordination and conformity.

Conditions for continued success

So far, I have tried to explain the relative macroeconomic stability and the structural transformation process observed in the Turkish economy in the last three years. I wanted to draw your attention to the radical changes experienced throughout this process. These radical changes have created an environment in which uncertainties and resulting volatilities have been eased. In this environment, it is now possible to make forward-looking policy suggestions that will enable the improvement of social welfare and necessary measures to be taken. However, despite the significant distance covered in terms of achieving lasting macroeconomic stability, we have not yet reached desired level. In order to make current achievements permanent, the immediate sound policies and the structural transformation process should continue in an uninterrupted manner.

As also stated in the 2004 European Union Progress Report on Turkey, structural reforms needed for establishing a healthy macroeconomic environment in the coming period can be categorized under a number of headings.

The first one is the necessity of assuring ongoing support to the achieved stability in the banking sector with the help of reforms that will strengthen the sector. Despite the important steps taken on the way to remove problems in the banking systems following the 2001 crisis, there are still shortcomings in this area. In line with the achievements observed in the banking sector, studies for an effective risk management scheme have started. However, banks have not yet been able to fulfill their intermediary functions as effectively as expected. This results mainly from the fact that the banks are still the principal fund-raisers to finance public deficits. Reducing the ratio of public deficits and debt stock to national income will increase disposable resources and this will remove the obstacles to credits extended to the real sector by the banking sector. The implementation of modern risk management in credit facilities will equip banks and companies with a more robust financial structure. Needless to say, all these developments mean that the banking sector supports the capital accumulation process in the private sector by providing the real sector with resources. This, in turn, shows that the current program is providing critical support for the real sector through banking reform.

The second issue is tax reform. Although important steps have been taken regarding tax reform in Turkey in the last few years, our tax system still has some flaws in matters of equality, effectiveness and management. In order to remove the unfavorable effects of the tax system on the economy and to assure permanent increases in income, the tax system should be simplified and the effectiveness of tax administration should be increased. The tax system should be equipped with a simple, comprehensible and fair structure that will avoid discrimination between different sectors.

Studies to broaden the tax base, formalize the informal economy and restructure income management, which are among the reforms envisioned in the current program, have not been completed yet. The finalization and immediate implementation of these reforms will make an important contribution to the sustainability of fiscal adjustment. In this context, tax reform will also provide extensive support for the stabilization program by allowing the fair allocation of costs in society.

Amendments to the tax system will play a critical role in reducing high labor costs, controlling the informal economy and also increasing direct foreign investments.

In addition, the outcome of reducing the deficiencies in the social security system through reforms will be felt in the long-term. In addition, studies for reducing the role of the public sector in the economy, putting good governance principles into effect and further improving the investment environment are on the agenda for the upcoming period.

It is clear that the establishment of a permanently stable environment and sustainable growth mainly depends on the continuation of fiscal discipline. The primary surplus recorded under the current program has greatly served to this end. The success in attaining the primary surplus target in recent years has played an important role in pushing down inflation expectations and interest rates by establishing confidence in the markets. Maintaining the primary surplus target in the upcoming period also will only be possible if the quality of fiscal adjustment is increased. Quality of fiscal adjustment refers to the question regarding whether fiscal policies are implemented in the framework of a set of options that boost growth and wealth. Sustainable fiscal adjustment in the medium and long-term will depend on the enactment of structural reforms in the public sector rather than on provisional measures. Besides jeopardizing the attainability of budget targets, a delay in structural reforms will also cause the supposedly provisional measures to become permanent. Such implementation might affect the quality of expenditures and revenues unfavorably and cause inflationary impacts due to revenue-boosting methods. Therefore, increased control and effectiveness in public expenditures are critical factors for the quality of fiscal adjustment. A study comparing the fiscal adjustment policies implemented at different times in OECD countries[2] revealed that a long-term improvement in public balance can be achieved through expenditure-curbing policies rather than revenue-boosting policies.

Besides controlling public expenditures, incomes policy also plays an important role in increasing the quality of fiscal adjustment. For this reason, the implementation of incomes policy must be coherent with the inflation target.

As I have mentioned before, important policies are pending in the upcoming period in the framework of the European Employment Strategy. These policies are aimed at ensuring that high growth performance affects employment in such a way to assure a sustainable increase in employment, to increase the additions to the labor force and to establish a more flexible labor market. Developing coordination in economic policies and a harmonization of the decision-making process is another outstanding factor. All these factors will not only establish macroeconomic stability and increase social welfare in Turkey, but also play a key role in the European Union integration process.

Exchange rate regime

Now I would like to focus on the floating exchange rate regime. As you know, Turkey made the sudden decision to adopt the floating exchange rate regime following the crisis in February 2001. This regime was adopted because the predictable exchange rate regime collapsed due to exogenous factors resulting from a loss of confidence in the economic policies of that period and it was impossible to establish the same confidence immediately after. In fact, the adoption of a floating exchange rate regime was already included in the economic program of the pre-crisis period.

The current regime has been implemented successfully for four years. In the early stages, economic agents experienced adaptation problems arising from the unprecedented nature of this regime; however, these problems have been overcome to a great extent. As a matter of fact, the floating exchange rate regime is successfully implemented in over 80 countries today.

As we have always emphasized, under the current floating exchange rate regime, the Central Bank does not set a specific exchange rate target. Indeed, the exchange rate is determined by supply and demand conditions in the market. These conditions are shaped by developments in the economic program as well as the public debt stock, risk premium, expectations, foreign developments and the behavior of market players in the short-term; while the determining factors in the long-term can be listed as structural reforms and their effects on productivity, net external debt position of the country,

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2 Alesina, A. ve Perotti, R. (1996), "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects", NBER Working Paper, No. 5730.

cyclical movements in the economy and economic fundamentals such as inflation and growth. To recap, the exchange rate level is not a cause, but an outcome in the floating exchange rate regime.

In this framework, the Central Bank operates in the foreign exchange market in two ways. Firstly, it holds foreign exchange buying auctions in order to carry out reserve accumulation. The external debt payment schedule of the public sector and plans for the liquidation of Foreign Exchange Deposit Accounts with Credit Letters in the long-term also increase the importance of the level of the Bank's foreign exchange reserves under the floating exchange rate regime. Therefore, the Bank holds foreign exchange buying auctions in order to increase the reserves at their disposal at times when the foreign exchange supply gradually increases above foreign exchange demand due to the rise in reverse currency substitution tendency and capital inflow. In the following periods, a reverse dollarization process will take shape and capital inflow will increase due to the favorable developments regarding European Union membership negotiations in addition to the completion of studies about the new three-year program concerning the continuance of fiscal and monetary discipline and structural reforms. Taking into account these predictions and the fact that a strong reserve position will boost confidence in the current program, the Central Bank has resumed the foreign exchange buying auctions that were suspended on April 27, 2004 starting from December 22, 2004. Unlike previous periods, a yearly program of auctions has been announced in order to minimize the effects of foreign exchange buying auctions on the foreign exchange market and exchange rates. In this way, it will be possible to minimize the effects on foreign exchange supply and demand conditions and stick to the main principles of the floating exchange rate regime.

Secondly, the Central Bank may intervene in the foreign exchange market directly in the event of excessive volatility in exchange rates in either direction that could threaten the price stability target. The Bank analyzes the reasons of the volatility in the foreign exchange market thoroughly in daily and periodical terms and takes the intervention decision by taking into account the likelihood of future volatility by considering past data. In the upcoming period, economic agents will probably continue to hold domestic currency as a result of further achievements in economic stability, and capital inflow will increase. Foreign exchange buying auctions to control volatility might continue in the event of actual or likely excessive volatility in the foreign exchange market induced by the above-mentioned conditions.

I would like to draw your attention to another point about the floating exchange rate regime. The exchange rate is determined in the market under supply and demand conditions, which may turn the exchange rate into a risk factor. Undoubtedly, the exchange rate should be accepted as a cost factor and closely monitored by decision-making bodies in open economies. In this framework, foreign trade firms and other agents, which hold short foreign exchange positions, may face significant risks as a result of exchange rate movements.

However, it should be noted that the volatility in exchange rate is a risk, not an uncertainty. So, it can be managed and avoided.

There are two points which should be clearly understood by those who advocate the view that a floating exchange rate regime harbors high exchange rate risk and can lead to excessive volatility in foreign exchange markets, bringing about negative outcomes in the economy – particularly in foreign trade. First of all, insofar as capital movements are free, exchange rate risk may also emerge under fixed and predictable exchange rate regimes. However, either public banks or, as the authority in currency matters, central banks, take on the exchange rate risk in these regimes, whereas in a floating exchange rate regime, it is taken on by individual economic agents. Secondly, due to the development of the derivatives markets, the foreign trade level in a floating exchange rate regime will be the same as the level in a fixed exchange rate regime. Hence, exchange rate risk will not affect the level of foreign trade[3].

Turkish derivatives exchange (Turkdex)

In this framework, the effective operation of derivatives markets is for enabling economic agents to hedge their balance sheets from exchange rate risks under the floating exchange rate regime. Macroeconomic stability and the structural transformation process have provided our economy with a

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3 Baron D. (1976). Flexible Exchange Rates, Forward Markets and the Level of Trade. *The American Economic Review.* Vol. 66. No. 3.

sound environment for risk management. And, the establishment of the Turkish Derivatives Exchange has been an important step taken on the way.

It would be useful to reiterate the potential favorable effects of derivatives markets on our economy.

First of all, derivatives markets offer economic agents the facility of risk management and make their future revenue flows predictable. Moreover, expectations can be measured and reflected on prices through these markets. This, in turn, increases the predictability and efficiency of spot markets. In this way, market prices provide economic agents with accurate information and excessive volatility decreases.

Analyzed in terms of their impact on the real economy, the use of derivatives markets increases resistance to shocks in the economy as a whole as it reduces weaknesses resulting from the imbalance on firms' balance sheets. These are created by the fact that the assets and liabilities sides denote different currency units or consist of securities with different interest rates. As a matter of fact, firms with reduced financial risks on their balance sheets can allocate more resources to production.

Moreover, derivatives markets introduce new investment instruments and encourage growth in the financial system. In this way, they increase the number of instruments investors can use to diversify their portfolios, and widen the financial markets.

As a result, derivatives markets contribute to the increase in national income and employment by ensuring more effective allocation of resources and they provide added value as a separate sector. At the same time, these markets enable the real and financial sector investors to manage diverse risks parallel to those in world markets as well as allowing integration with those markets.

Analyzed in terms of monetary policy, derivatives markets, whose development has always been backed by the Central Bank, support the continuity of financial stability by reducing volatility in the markets and help central banks to maintain financial stability. In addition, they enhance the information set used in monetary policy by providing information about the future, and increase the effectiveness of the transmission mechanism used to steer the economy. As a consequence, an improved flow of information about the future course of monetary policy makes the economy more predictable for economic agents.

In this framework, the Turkish Derivatives Exchange will make important and diverse contributions to the economy, especially in terms of monetary policy. Transactions on the Turkish Derivatives Exchange are expected provide more forward-looking and quantitative information for Central Bank reports, especially with the transition to explicit inflation targeting after 2006.

Hence, if we bear in mind that derivatives markets act as a "catalyst" in the economy, all kinds of arrangements concerning the operation of these markets should be handled carefully. In this context, orientation programs and training should be conducted in order to encourage banks and companies to operate in this market.

Central bank independence

In conclusion, I would like to say a few words about the maintenance and reinforcement of Central Bank independence. In addition to the points I will deal with here, you can also refer to the speech "Central Bank Independence" on our website, in which this issue is covered in detail from both economic and legal perspectives.

In democratic societies, the term 'independence' is used to define the institutions establishing that society, for instance, the independent central bank. This issue occasionally raises questions such as 'Independence from what or whom?' However, when looking at the historical background, it can be seen that "independence" was granted to institutions by the societies themselves as the consequence of a democratic process and their ultimate goal is to maximize social welfare. Central Bank independence becomes even more significant, not only as a concept, but in terms of its consequences. Therefore, in order to make sure that central bank independence is understood, internalized and safeguarded by the public, it is necessary for them to fully comprehend the rationale of independence, understand why it is important and become convinced that central bank independence does not imply independence from society. For this reason, I firmly believe that it is vital to talk about independence frequently.

As I have reiterated before, it is a globally accepted phenomenon that achieving price stability is the prerequisite of establishing a sound market economy and attaining sustainable growth and employment rates in the long run.

Another globally accepted phenomenon is that price stability can only be achieved by employing lasting, sound and stable policies.

For this reason, the public provides central banks with freedom from political authorities in order to enable them to implement the necessary long-term targets to control inflation and attain price stability, to achieve full employment and to sustain growth. This structure gives central banks the opportunity to reject the implementation of policies that pose risks to attaining price stability and creates an environment in which they can give warnings when required. These are the reasons why central bank independence is essential.

Monetary policy implemented by a central bank that is able to effectively exercise its independence, is accepted by all sections of the public and the political authority. The implementation of policies by institutions with clearly defined goals protected from short-term effects and able to communicate regularly, is crucial to creating the required confidence for economic units in their decision-making process.

Central bank independence is a concept that can be defined in various ways. The main pillar of independence is not to allow a borrowing-lending relationship with the public sector. There are three more pillars of independence. The first is goal independence that means the ability to freely determine monetary policy targets. Second is target independence, which means the ability to determine targets at its own discretion when price stability is set as the goal. Finally, the third pillar is the power to freely choose and use monetary policy instruments with the aim of achieving the targets.

It is again a widely accepted fact that the ability of the central bank to announce its opinion about the general course of economy and the risks using communication technologies is part of central bank independence. This means warning politicians, non-governmental organizations, financial circles, the real sector, in short all sections of the public.

After thirty years of chronic inflation and successive economic crises, the Central Bank of Turkey finally obtained independence in 2001, which was quite close to world standards.

As I have mentioned before, with an amendment made to the Central Bank Law in 2001, the primary objective of the Bank was set as achieving price stability and the Bank was granted the direct authority to draw up monetary policy and choose monetary policy instruments at its own discretion in order to achieve price stability.

Achieving central bank independence is in fact a very important structural reform in the economy, but unfortunately merely passing the law is not enough in itself for its success. Therefore, the real challenge is to make sure that every section of the public is aware of the rationale behind independence and to create a common understanding of these reforms before their success can be realized.

Although we have observed significant progress pertaining to independence, we are aware of the fact that there is still a long way to go and we know that there will always be room for improvement. .

The criteria set by the European Central Banking System regarding central bank independence will be provide significant guidelines in this field.

Another important point I would like to mention is that the more independent central banks are, the more transparent they become. Central banks share more information with the public about the design and implementation of policies and they attach great importance to having an efficient communication policy.

Now let me draw your attention to central bank accountability and further consider the transparency issue. The provision of independence obliges central banks to explain themselves to the public. In other words, for a central bank, being independent means being more transparent in the eyes of the public. This is the other side of the coin and is called “accountability”.

Accountability is an asset that makes the central bank answerable to all sections of the public for the policies it implements and their consequences.

This responsibility can only be fulfilled by central banks when transparency is completely achieved. Therefore, in time, central bank independence brought with it increased accountability, transparency and the employment of more efficient communication policies.

Generally, central banks exercise transparency by sharing their knowledge and opinions with the public about their final goals, current and future policies and the general outlook of the economy using various communication tools.

Within this framework, the most significant contribution increased transparency and effective communication could make to the economy and monetary policy is the reduction of uncertainty. Furthermore, a more transparent central bank that attaches more importance to communication policies helps economic units shape their expectations in line with central bank targets as the predictability of monetary policy is increased.

As is very well known, the Central Bank has been pursuing an “implicit inflation targeting strategy” since 2002. In our announcement regarding the monetary and exchange rate policy for 2002, it was announced that explicit inflation targeting strategy would be adopted when the necessary conditions were in place. Today, we see that much has been achieved in creating the necessary conditions for the transition to explicit inflation targeting. Therefore, in our press release of “Monetary and Exchange Rate Policy for 2005” dated December 20, 2004, it was announced that 2005 would be a transition period and an explicit inflation targeting strategy would be adopted in 2006. Before concluding, I would like to remind you that detailed information about our policies to be implemented in 2005 is available on our website in our press release “Monetary and Exchange Rate Policy in 2005”. You can also obtain a hardcopy of this announcement as an annex to my speech.

Thank you for your patience and attention.