

Durmuş Yılmaz: Central Bank monetary and exchange rate policies and economic outlook

Speech by Mr Durmuş Yılmaz, Governor of the Central Bank of the Republic of Turkey, at a meeting organised by the Aegean Industrialists and Businessmen Association, İzmir, 8 June 2006.

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Distinguished Guests, Ladies and Gentlemen,

It is, indeed, a great pleasure for me to address another information meeting – yet another one in a series held since 2003 – organized in cooperation with Dünya Newspaper with a view to informing the business world. Today's meeting is the first meeting of 2006. I would like to take this opportunity to thank the Aegean Industrialists and Businessmen Association for their organization.

Considering recent inflation figures, I am sure you are all expecting me to inform you of developments in the economy, especially those regarding inflation. However, before moving on to topical subjects, at this very first meeting of 2006, I would like to briefly touch on what the transformation process the Turkish economy has been undergoing since 2001 means to us. I also want to give you a framework of the macroeconomic outlook.

My speech will cover the developments in inflation, the Central Bank's interest rate and exchange rate policies, the developments in financial markets, growth, employment and the current account deficit.

As I have mentioned earlier, the Turkish economy has been undergoing a structural transformation process. This dynamic process, which started in 2001 and has reached a certain point today – though it still has a long way to go – is the process that will reveal the potential of our economy and determine its place in the world.

Since that time only five years have passed. This is a short span of time for an economy that needs structural changes and whose policies are formulated towards to this end, in order to implement reforms, achieve results and ensure the sustainability of such results.

Yet, the achievements attained in macroeconomic aggregates have been even beyond the program forecasts.

CPI inflation declined to single digit figures after 35 years, from 68.5 percent as of end-2001. While inflation was in decline, high growth rates were achieved. Annual growth in GNP, which was realized as 3.9 percent on average between 1970 - 2001, became 7.8 percent between 2002 - 2005.

The ratio of public net debt stock to GNP, which had led to concerns about the sustainability of public debt, decreased to 55.8 percent as of 2005, from 90.5 percent.

With the contribution of all these favorable developments in economic aggregates, the Turkish economy has continued to integrate with the world and Turkey's foreign trade volume has expanded by nearly 170 percent since 2001, reaching USD 196 billion on an annual basis, by April 2006.

The main factors that lie behind this rapid change that is clearly observed in the macroeconomic aggregates are; confidence, stability and the enhancement of predictability. The success attained in these three areas, which are interlinked with each other and shape expectations, has activated Turkey's economic potential.

In my opinion, the milestone in attaining enhanced confidence, stability and predictability of economic policies and especially of monetary policies, was the Central Bank of Turkey becoming independent in 2001 with the amendment to Central Bank Law, and its becoming primarily committed to achieving and maintaining price stability.

Starting from 2001, when the Central Bank achieved its independence, Turkey has been experiencing a 'disinflation process'. In the four years to follow, inflation targets were announced, these targets were achieved and a strong and reliable monetary policy history was established.

With determined implementation of macroeconomic policies, particularly of fiscal policy, accompanying a large number of significant structural reforms, the strong support of international institutions and the perspective of the European Union, this process, as a whole, has established a more reliable, stable and predictable economic environment.

This environment should definitely be maintained and any kind of efforts and discourses that may raise doubts about the determination of economic policies or worsen expectations should be avoided.

The stage Turkish economy has reached is the concrete proof to what extent price stability-centered macroeconomic stability is significant and vital for achieving sustainable growth, an increase in employment and an improvement in welfare, which are the ultimate objectives of economic policies.

Within this framework it can be clearly seen that price stability is not a monetary policy cliché. The efforts towards establishing price stability are the efforts towards creating an environment where people can find jobs and make a living; make investments; and look confidently to the future.

Price stability, in this context, is not an option for economic policies, but a sine qua non condition.

It is evident that the high and chronic inflationary environment, which has persisted for decades, has cost us very dearly not only in the economic field but also in the social field. High inflation has led to a large number of problems in economic and social fields, such as the deterioration in resource allocation, inequitable income and wealth distribution, low growth and employment rates and an increase in short-term approaches in the economy. All of this damage caused by inflation should always be kept in mind.

Therefore, price stability is an indispensable objective that cannot be renounced for any other priority or aim. Accordingly, the Central Bank of Turkey sets its policies with a medium-term perspective – independent of daily policies and politics – entirely towards price stability, its primary objective.

In 2006, the Central Bank of Turkey adopted the formal inflation targeting regime as monetary policy strategy within the framework of its objective to achieve and preserve price stability.

It is of great importance to comprehend this regime and the accountability mechanism with regards to inflation targets and the course of inflation. Therefore, let me touch on a few elements of formal inflation targeting.

Before all else, the point that I would like to emphasize is that our inflation targets are point targets. These targets have been set as consumer price index inflation. Our policies are established solely with the aim of achieving these targets.

In our monetary policy implementations, we have announced our inflation targets for a three-year period in order to increase the emphasis placed on medium-term. In this context, the inflation target is 5 percent for 2006 and 4 percent for 2007 and 2008.

To apply a rule to the Central Bank's accountability in the event of any deviation or the possibility of deviation from the inflation target, a ± 2 point-uncertainty band has been established around the point target. Once again, I would like to underline the significance of this issue. This band, which has been formed around the inflation target, aims at setting the accountability criteria.

Looking at the practices around the world, we see that a 40 percent-uncertainty band has been formed around the point target in most countries. Our implementation is based on this approach. In the event that inflation is realized outside this band or, in case of such a possibility, the mechanisms specified with respect to accountability will start.

With the introduction of the formal inflation targeting regime, interest rate decisions are made by voting at the Monetary Policy Committee meeting. Monetary Policy Committee meetings are held once a month on pre-announced dates. Nevertheless, when deemed necessary, extraordinary meetings may be held, such as yesterday's meeting.

Despite the significant distance covered in the fight against inflation, price stability has not been achieved yet and there is still a long way to go. Recent inflation developments also confirm this fact.

At this point, I would like to summarize the inflation and monetary policy developments of the recent period.

The increase in inflation in the first quarter of the year was an expected development, which has been stated in the Bank's reports since January. In April and May, the increase in inflation was above the expected level due to unforeseen developments in seasonal pricing behaviors. Compared to March, consumer prices increased by 1.34 percent and 1.88 percent in April and May, respectively. As of May, annual inflation became 9.86 percent, which is obviously above the target path.

In May, the direct effects of exchange rate movements on inflation started to be observed through the channels of fuel oil, gold and durable goods. During this period, the upward pressure exerted by the

depreciation in the New Turkish lira on inflation reached 0.5 points. Adding the exogenous movements in gold and oil prices, the total impact amounts to 0.65 point. In other words, some of the direct effects of exchange rate movements on prices became evident in May. However, these effects are expected to be high in June, too. In the light of evaluations made in this respect, annual inflation figures may increase a little more for a temporary period of time in the upcoming months, due to the recent exchange rate movements observed after the fluctuations in financial markets. We foresee that these developments will mostly affect the short term, and the disinflation process will not be interrupted as long as the monetary and fiscal discipline continues in the medium-term.

Nevertheless, we have experienced many times that short-term developments might affect longer-term variables via expectations, due to past habits and the short-term perspective in Turkey. As a matter of fact, we observe that short-term developments seem likely to affect the medium-term inflation expectations and pricing behaviors recently. In order to prevent the said short-term developments from creating permanent impacts on pricing behaviors and to maintain consistency between the medium-term inflation trend and the targets, we have held an extra meeting and increased short-term borrowing interest rates to 15 percent from 13.25 percent. In this respect, the outlook we take as a basis is the one in which a relative slowdown is observed in domestic demand, the increase in unit costs stops and inflation enters a downward trend again in the coming months.

In light of information currently available, it can be said that inflation will be above the point target in end-2006. In this framework, we have adopted a policy perspective in which inflation will come close to the target towards the end of 2007. In other words, the critical point for the Bank is to assure that the impacts of the above-mentioned developments are confined to 2006 and avoid any deterioration in expectations, which stand as a significant determinant of the inflationary process, for the sake of achieving medium-term targets.

At this point, I would like to draw your attention to a few important points about the interest rate policy of the Bank and underline some issues once again.

Short-term interest rates are the main policy instrument of the Central Bank. The Central Bank makes its policies and interest rate decisions in line with its main goal of achieving price stability and inflation targets.

The Bank makes all its policies and decisions in view of medium-term trends rather than daily or short-term ones, and these policies and decisions are grounded on main trends.

In this framework, while making its interest rate decisions, the Bank uses a very wide data set including supply-demand conditions, costs, model forecasts, expectations, domestic and external developments; and evaluates all these data with a forward-looking perspective. This process is certainly a dynamic one, and every new piece of data and development is being closely monitored within the framework of the Bank's inflation forecasts. Another significant fact about the interest rate decisions of the Bank is that the impacts of these decisions are observed with a time lag. The impact of the decisions on economic activity becomes evident within a period of 3-9 months, while their impact on inflation is observed within a period of 9-18 months.

However, it can be said that this period of time is much shorter in case of the expectations channel, which is a part of the transmission mechanism and operates in a very effective manner in our economy.

At this point, I would like to emphasize that the Turkish economy has entered a normalization process. As a matter of fact, in comparison with previous periods, the banking sector has a more robust structure and fiscal dominance has decreased considerably. As a result of this structure, any measures to be taken regarding the policy instrument should be evaluated in terms of the impacts of the monetary policy on inflation, rather than in view of the likely effects of these measures' consequences on the above-mentioned areas. In other words, the increase in short-term interest rates, which are the policy instrument, should be evaluated merely as a necessary reaction of monetary policy for achieving the medium-term inflation targets.

When the sub-indicators demonstrating the main trends in inflation are analyzed, it is observed that the targets for 2007 and 2008 seem achievable in light of the medium-term outlook as of the present date, as long as the cautious stance in monetary policy is maintained.

Certainly, for the course of inflation to follow a path in line with the forecasts of the Bank, certain conditions need to be satisfied. In other words, there are some risks to the sustainability of the disinflation process in the medium-term.

The first one of these risks is the continuance of the increase in oil and commodity prices.

Moreover, continuance of the controlled course of the increase in total demand provided by tight fiscal and monetary policies is a must for preventing a demand-based inflationary pressure.

Prices of public goods and services, indirect taxes and the incomes policy should be consistent with inflation targets.

Developments in the risk premium, which result from monetary policies of developed countries and are likely to cause fluctuations in global liquidity conditions, also pose risks to the disinflation process.

As I have mentioned before, attempts and statements that may damage expectations can also lead to unfavorable effects on the disinflation process. In this framework, relations with the IMF and the European Union are two critical anchors in terms of medium and long-term expectations. Support from international institutions is a significant factor bringing about additional confidence. European Union negotiations for full membership provide support to the national program in the framework of the improvement of the Turkish economy's investment environment and increase the predictability of the economy in the medium and long term.

Uninterrupted implementation of structural reforms is of critical importance. The continuance of the reform process is the only way to sustain and build on the achievements made up to now. Social Security Reform is a significant step in this respect.

The ongoing rigidity in prices of the services group and the volatilities in prices of agricultural products due to weather conditions are being closely monitored for the achievability of inflation targets.

After dwelling on the latest developments in inflation and the interest rate policy of our bank, I would like to present the general outlook of the floating exchange rate regime and the exchange rate policy. The floating exchange rate regime applied under formal inflation targeting is the main element of our policies as it has been during the past five years.

When the legal framework for setting the exchange rate regime is analyzed, we see that the exchange rate regime is set with the Government, while the design and application of the exchange rate policy to be conducted in the framework of the regime is under the authority and responsibility of the Central Bank.

The essence of the floating exchange rate regime is that the value of the Turkish lira against foreign currencies is formed under market conditions and according to developments in supply and demand conditions.

In this respect, the Central Bank conducts two kinds of transactions in markets: Firstly, the Central Bank purchases foreign exchange to build up reserves. These purchases are made via FX purchase auctions. In 2006, the daily purchase amount for these auctions including options is USD 60 million. These auctions were suspended on May 16, 2006 due to market conditions and the decline in FX supply. When the conditions for these auctions mature, they will be resumed. As a result of our strategy to increase reserves, which is applied in this framework, the amount of our reserves reached USD 60 billion as of May 26, 2006.

Secondly, the Central Bank conducts interventions due to volatility. Taking into account the factors that cause volatility in either direction or potential developments, the Central Bank may intervene directly in the market or use announcements and warnings. These implementations do not have a mechanical nature. As the conditions of each intervention differ from each other, neither do they have a symmetrical nature.

At this point, I would like to share my views about the activity observed in the value of the Turkish Lira lately.

The international liquidity conditions, which change according to the monetary policies pursued by the central banks of developed countries, and the perceptions of uncertainty that emerged due to internal and external developments, had considerable effect on the exchange rate movements that have been observed almost for a month. In the short term, this activity is perceived to be more negative than the information it contains.

However, there is no deterioration in the macroeconomic fundamentals. There is no change in the program projections and targets. The movement of the exchange rate is mainly caused by external developments. Similar movements are observed in other developing countries, as well.

Today, the floating exchange rate regime performs its shock-absorbing function. We have observed similar developments in the past five years, as well. Exchange rates displayed similar fluctuations and movements in the short term, surpassed their immediate levels, but the main tendency did not change. Due to the nature of the floating exchange rate regime and the exchange rate policy, similar movements may also be observed in the future, as a result of similar or different factors.

The similar impacts of internal and external shocks on the exchange rate and interest rates and therefore, on the economy, will be weaker and last for a shorter period of time, on condition that the policies and implementations of the program continue without any compromise, the dynamism and the self-feeding nature of the reform process is kept in mind, the related steps are taken decisively in time and macroeconomic foundations get stronger.

It should not be forgotten that the macroeconomic foundations, current policies, structural reforms and long-term expectations have an impact on the long-term movements of the Turkish lira.

However, as the exchange rate is a variable that bears importance with respect to our economy and is a component of financial stability, the activity in the exchange rates is monitored closely by the Central Bank.

It should be kept in mind that such movements in the exchange rate pose a risk as well as causing uncertainty. It is possible to protect us from the upward and downward fluctuations in exchange rates. The techniques for risk aversion should definitely be used. The İzmir Derivatives Exchange provides an important opportunity in this respect.

After focusing on the developments in inflation and our policies regarding interest rates and exchange rates, now I would like to talk about the growth of the Turkish economy.

As you all know, the Turkish economy has been displaying a high growth performance for the last four years. Since 2001, cumulative real growth has been 35.1 percent, whereas the average annual growth has been 7.8 percent.

The point that stands out in the growth figures is that growth is led by the private sector and that the investment-originated base is growing.

In the 2001-2005 period, investment expenditures of the private sector increased by 105 percent, while those of the public sector increased by 15.5 percent. On the consumption side, expenditures of the private sector increased by 30.3 percent in the same period, whereas those of the public sector increased by 5.9 percent.

These developments indicate that the ongoing strong investment trend enhanced the growth potential and that the dynamics and actors of growth changed parallel to Turkey's structural change process. Growing with public resources is no longer the case.

In this respect, it is clear today that the public sector assumes and should assume, a strong supervisory and regulatory role in the framework of good governance principles. This is emphasized evidently in the Ninth Development Plan Strategy, which comprises the period between 2007 and 2013. The seven-year development strategy draws the framework of a plan that *"focuses on planning a strategy and adopting a perspective for today where the changes are rapid and multi-dimensional and the competition is huge"*.

In this framework, public policies are focused on enhancing the competitiveness of our economy. With this aim, it is aimed at ensuring the permanency of macroeconomic stability, enhancing the business environment, reducing unregistered economic activity and developing the financial system.

As a result of this role that is given to the public sector and the implementations of tight fiscal policy, public savings increase. This environment gives the private sector an opportunity to obtain new and low-cost resources with longer maturity.

The private sector undertakes a number of tasks in this respect. The private sector should create strong and transparent balance sheets and pay attention to risk management principles. Hence, the private sector should try to use capital markets and develop new financial instruments.

Now, I would like to underline a point. As you all know, total saving rates are low in our country. As we do not have the opportunity to increase private saving rates in the short term, the utilization of foreign savings to increase investments and competitiveness becomes a necessity for obtaining high growth rates. Hence, it is necessary to close the savings gap directly with foreign investments in order to

reach high growth rates. In this scope, activities regarding the improvement of the investment environment are highly significant.

Another change, which is created by the ongoing structural change in our country in growth dynamics, is closely related to the increases in productivity. According to SPO data, the contribution of total factor productivity to growth reached 51.3 percent in the 2002-2004 period, while this rate was 3.3 percent in the 1990-2000 period.

In other words, the largest contribution to growth comes from the increases in productivity. In the 2001-2005 period, productivity increases in the private manufacturing industry reached 36 percent, in cumulate terms. Hence, the increase in productivity was the main determinant of growth, during this period. Moreover, it should be kept in mind that the increases in productivity not only enhance the quality of growth, but also contribute to the sustainability of growth.

I would like to talk about another factor in the scope of the changing growth dynamics in the Turkish economy. That is the fact that our economy is getting more and more integrated with the world. High export rates have made a remarkable contribution to growth in the past four years. In this period, the average annual rate of increase of exports realized as 24 percent. In the 2002-2005 period, our exports increased by 104 percent. Parallel to this development, firms are increasingly shifting to exports and reaching international markets by quitting local production processes and local markets.

As our economy opens to the outside world, profit margins narrow, due to increasing internal and external competition in the sectors. In such an environment, the increase in productivity becomes the main determinant of competition.

When the data pertaining to sectors' productivity, growth and exports in the 2001-2005 period are analyzed, it is seen that the sectors, which grew most rapidly and increased their exports the most, are also the sectors that increased their productivity the most. This development clearly points to the importance of the continuation of the measures that increase productivity in sectors.

As you may assume, short-term approaches would not work in such a strongly competitive environment. It is necessary to develop medium term and long term strategies in order to be permanent and to gain a place. In this scope, public and private sectors should act together. The public sector should try to create a suitable environment for the private sector to compete with its rivals in international markets under market conditions.

Today, the Turkish economy is at a point where a significant progress has been made on the road to macroeconomic stability. Provided the achievements so far are maintained, the reform process is continued without interruption and reinforced by taking the necessary micro-measures, the growth potential would increase and growth would be sustainable.

After summarizing the growth process in Turkey and the changing dynamics, now I would like to move on to the developments pertaining to employment and the labor market.

It is conceded that employment is one of the top items on the agenda of the Turkish economy. Unemployment rates have been very high for some time. Unfortunately it is not possible to repeat the outstanding performance observed in macroeconomic aggregates in the labor market.

In February 2006, the unemployment rate increased by 0.2 percentage points compared to February 2005 and reached 11.9 percent. Meanwhile, non-agricultural unemployment decreased by 0.6 percentage points compared to the same period last year and came down to 14.8 percent. In the last one-year-period, the number of people working in sectors other than the agricultural sector increased by 829 thousand.

The rise in employment can mostly be attributed to structural factors. Non-agricultural sectors have a bigger potential for creating jobs. However, it is a fact that there are structural problems in the labor market, especially in the agricultural sector. Now, let me share these problems with you briefly.

The data pertaining to the labor market in Turkey point to a rapid shift of workers from the agricultural sector to other sectors for the last four years. The share of agricultural employment in total employment, which was 38 percent in 2001, came down to 25.1 percent by February 2006. However, when the EU-15 average of 3.7 percent recorded in 2004 is taken into account, it is obvious that 25.1 percent is still very high. Meanwhile, it is expected that the shift from the agricultural sector to non-agricultural sectors will continue and the share of the agricultural sector in total employment will gradually decrease. The decline in agricultural employment prevents a decline in the unemployment rate.

Another important factor affecting employment in Turkey is the country's demographical structure. In Turkey, population growth is fast and the ratio of young population to total population is high, which together lead to a high unemployment rate in young population. In February 2006, unemployment among the young population in Turkey was recorded as 21.9 percent.

The low labor force participation rate of women is another structural problem of the Turkish economy. This constitutes a serious loss in the labor force, leads to a dependence relationship between men and women, and increases the disturbance created by unemployment.

Meanwhile, the high rates of employment taxes coupled with very common informal economic activity prevents a permanent rise in employment and increases volatility. The low rate of employment among those who have received vocational training points to the fact that there is a lack of qualified labor force to support the structural change.

These structural problems call for the implementation of medium and long-term supply-side policies in order to reduce unemployment rates. Within this scope, the framework drawn in the Ninth Development Plan Strategy, which was prepared in line with the European Union's employment strategy and aimed at increasing employment, is kind of a road map for the solution.

The Ninth Development Plan Strategy contains strategies for developing the labor market and increasing the responsiveness of education to the demand for labor with the final aim of increasing employment. To put it in another way, the framework in question is intended to establish a balance between flexibility and safety, gradually easing the burden on employment, increasing the firms' and workers' capacity to adopt to changes, increasing the quality of workers that are transferred from the agricultural sector, and developing active labor policies to meet labor market's needs.

In the last part of my presentation, I would like to briefly mention the current account deficit problem.

As it is known, in line with the high growth rate, an upward trend is observed in the current account deficit. Today, the primary reason of the current account deficit is that investments grow faster than savings.

In 2005, the current account deficit was recorded as USD billion 23.1 billion and the ratio of current account deficit to national income was 6.4 percent. In this ratio, the impact of energy prices, which is composed of the prices of crude oil, natural gas and coal, was 1.4 points and the impact of the rise in crude oil prices alone was 1.1 points.

By April 2006, the current account deficit increased to USD 26.8 billion. However, the question is not the level itself but its sustainability. When global trends are analyzed, it is observed that countries, which have succeeded in increasing financial and economic integration and reinforced macroeconomic stability, are able to sustain higher current account deficits compared to the past. The ratio of current account deficit to GDP is 11.8 percent in Bulgaria, 8.7 percent in Romania, 7.9 percent in Hungary and 7.2 percent in the Slovak Republic¹.

Another point that I would like to highlight about the current account deficit is that sustainability of high current account deficit depends on the financing quality of the deficit. Within this framework, I would like to present some figures on the maturity structure of capital inflows to Turkey.

In April 2006, net capital inflow excluding IMF credits was USD 53.6 billion. The share of direct foreign investments and long-term capital in financing of current account deficit increases rapidly. In April 2006, long-term capital inflow became USD 23.2 billion and credit utilization of the non-banking private sector became USD 21.1 billion.

The primary source of the capital inflow was long-term capital and credit utilization of the non-banking sector; 85 percent of which was long-term.

Making a projection, we expect this financing structure to continue. According to the "Foreign Direct Investment Confidence Index", which questions the countries' capacity to attract investments over a 1-3 year period and which is an indicator of foreign direct investments that will come to the country, Turkey was the 13th most attractive foreign direct investment destination among 25 countries in

¹ IMF, World Economic Forum, April 2006.

2005². According to the same survey again, Turkey took the 7th place among European investors and was the 8th destination that international executives are most optimistic about the economic outlook.

Lastly, I would like to touch upon the much-debated hot money issue pertaining to the financing of the current account deficit.

Hot money has several definitions. The basic definition of hot money is the sum of foreigners' purchase of securities, portfolio investments, short-term capital inflows and the net errors and omissions item. According to this definition, by April 2006, the annual hot money inflow has reached USD 17.3 billion. The most important component of hot money is portfolio investments composed of securities and government papers.

Some outflow was observed, with the last fluctuations. However, the floating exchange rate regime and strong macroeconomic fundamentals reduce the negative impacts of the outflow.

The structural transformation process that the Turkish economy is undergoing is very important with respect to the sustainability of higher current account deficits.

We are happy to see that within the framework of the transformation process, the finance sector is much stronger. In other words, open positions in the banking sector are fairly limited. Nevertheless, the private sector should be very careful about open positions.

Secondly, macroeconomic fundamentals grow stronger every day and a tight fiscal discipline and monetary policy are being implemented. We have a high level of foreign exchange reserves. The floating exchange rate regime has a shock-absorbing ability. The authorities responsible for the economy are in coordination and they are monitoring developments pertaining to the current account deficit very closely.

As long as the steadfast implementation of the current program is continued without concessions, the current account deficit's potential to pose a risk will diminish.

Today, I am delighted to be here with you and to have the opportunity to explain the latest developments in the Turkish economy, as well as the Central Bank's policies. I would like to take this opportunity to reiterate the message that our active communication strategy will continue together with the same transparent and steadfast attitude.

Thank you very much.

² A.T. Kearney, FDI Confidence Index, Global Business Policy Council 2005, Vol. 8.