

Durmuş Yılmaz: Economic outlook for Turkey

Speech by Mr Durmuş Yılmaz, Governor of the Central Bank of the Republic of Turkey, at the Bursa Chamber of Commerce and Industry, Bursa, 11 January 2007.

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Distinguished industrialists, businessmen, dear guests and members of the press,

This is the first of the series of meetings planned for 2007, which has become a traditional platform aiming at bringing the representatives of the real sector together directly. Firstly, I wish to thank Dünya Newspaper and Bursa Chamber of Commerce and Industry for organizing this meeting and thereby giving me the opportunity to exchange information and views about the economic outlook with the distinguished industrialists and businessmen like you.

In the first part of my speech, I would like to present a general evaluation of the year 2006 with a special emphasis on inflation, and to explain our policy implementations and to share our forecasts regarding 2007 in the light of the current data available. Then, I would like, once more, to mention about growth, employment and current account deficit that we have shared with the public many times, constituting the major items on the economic agenda. I will then elaborate on what should be done in this regard in the medium and long term.

Distinguished Guests,

The primary objective of the Bank is to achieve and maintain price stability, as laid down in the Central Bank law. The Central Bank pursues and will continue to pursue its monetary policy objectives with determination within the context of its historical mission and responsibility, as stated in the legal framework and the guidelines that were determined in 2001.

In this framework, inflation targets are determined jointly with the government; while the choice of the monetary policy tools and their implementation principles are determined by the Central Bank. In other words, the Central Bank was provided with the instrumental independence by its law. The instrumental independence enables the Central Bank to design and implement its monetary policies with a medium term perspective.

Distinguished Guests,

Following the establishment of the institutional and legal framework of the monetary policy in accordance with the modern central banking principles, significant steps were taken in the fight against inflation. Thus, a rapid disinflation process was experienced and all of the inflation targets were attained for four consecutive years due to the macroeconomic policies, especially the fiscal policy that were implemented consistently with the inflation targets. The inflation rate of 7.7 percent realized at the end of 2005 was the lowest figure, which was recorded in the last thirty-five years.

However, price stability could not have been achieved yet despite all these favorable developments and achievements. Our fight against inflation still continues. It should not be forgotten that this is a long and challenging process as confirmed by the inflation figures of 2006.

When we consider the deterioration that inflation brought about both in economic and social life, we see that this fight is indispensable and significant; that it is one of the determinant factors in shaping the future of an economy, a society, a country on solid foundations.

Distinguished Guests,

Now, let me briefly mention the developments in inflation in 2006, the basic reasons leading to divergence from the target and the applications of the monetary policy within this process.

2006 has been a year during which supply shocks, seasonal conditions and external factors were determinant on inflation.

As of the beginning of 2006, an upward trend in inflation was observed especially in the first seven months and the annual inflation went up to 11.7 percent in July.

The leading factor driving the inflation upwards in this period was the soaring unprocessed food product prices as of the end of 2005 due to the unfavorable weather conditions. Annual rate of increase in the prices of this group became 21.8 percent in July.

Fluctuations in the markets and depreciation of the Turkish Lira due to the negativities in the global liquidity conditions and the increase in uncertainty perceptions regarding our country during the May-June period led to an increase in the prices of commodities priced in foreign currency besides imported goods and affected inflation figures unfavorably.

Another important factor that was influential in the first half of 2006 was an accelerated increase in the prices of crude oil and other commodity prices in the international markets. This increase, accompanied by the depreciation of the Turkish Lira led to a rise in domestic energy prices and so played a key role in increasing the inflation figures.

A slow-down in price increases has been observed as of August due to the decrease in the prices of gold and oil in the international markets, stabilization in the financial markets with the re-appreciation of the Turkish Lira and the effect of the decisiveness in the fight against inflation over expectations.

Nevertheless, inflation remained high due to the sustained upward trend in the unprocessed food products, Ramadan-based effects and the belated reflections of the depreciation experienced in the Turkish Lira following that date.

Looking at the end-year inflation in the main expenditures groups, we see that the annual inflation remains below the target in clothing, footwear and communications groups, whereas it goes beyond the target in all other groups.

In this respect, rigidity of inflation in the services group constituted an important handicap against the fight against inflation in 2006 as it did in the previous years. End-year inflation became 12.2 percent in this group. Rents in the services group showed a great increase and an annual inflation rate of 20 percent remained above the general consumer inflation. Inflation figure of 12.9 percent in transportation services is another important factor that determines the inflation rate in the services group.

Distinguished Guests,

Consumer prices increased by 0.23 percent on monthly basis and remained below the expectations in the last month of 2006 and the year 2006 ended with an annual inflation of single digit as 9.65 percent. This figure is well above our end-year target of 5 percent. Although divergence from the inflation targets is experienced in the countries implementing this regime, it is very upsetting for us to observe such a great divergence from this target in the first year that we embarked on full-fledged inflation targeting regime.

As a requisite of the principle of accountability, the detailed "Open Letter" elaborating the reasons of this divergence together with the policy measures to be taken will be sent to the government as soon as possible and be made public.

Dear Guests,

Due to the rapid increase in inflation in the first seven months of 2006, its being quite higher than expectations especially in April and May, fluctuations experienced in the financial markets and the uncertainty perceptions created by political developments, inflation expectations diverged from the inflation target. Inflation expectations of 12-months increased to 8.1 percent in July from 5.5 percent in April; while that of 24 months increased to 6.1 percent in July from 4.7 percent in April.

Upon the emergence of the possibility of a permanent deterioration in expectations causing inflation to diverge from the targets in the medium term, the Monetary Policy Committee made effective use of the short-term interest rates as the basic policy instrument. Within this context, the Committee implemented a strong tightening policy and increased the policy rates by 425 bps to 17.5 percent in the June-July period in order to put an end to the deterioration in medium and long-term inflation expectations and also to render the inflation targets attainable in the medium term.

Following this strong monetary tightening of the Monetary Policy Committee and the measures taken for financial stability, fluctuations in financial markets gradually decreased and medium and long-term inflation expectations partially improved. In this regard, inflation expectations of 12 and 24 months decreased to 7.1 percent and 5.6 percent respectively, as of the end-2006.

The Monetary Policy Committee kept the policy rates unchanged in the period between August-December in 2006 due to this improvement observed in inflation expectations, mild progress in international liquidity conditions and a gradually favorable outlook of the future course of inflation compared to the first half of the year.

Dear Guests,

I would like to draw your attention to two rather important factors about our decisions regarding short-term policy rates.

Firstly, the decisions that the Central Bank took regarding the short-term policy rates affect the economic activities with a certain lag, as is the case with the other economies. That is why the Bank considers the course of inflation in the medium term rather than the current course while taking decisions about policy rates. The Bank also pays attention to the consistency of the course of inflation in the medium term with the targets. However, settlement of such a medium-term approach in the countries having experienced chronic inflation for a long time like ours takes time and this is an important handicap for the fight against inflation. Therefore, recognition and adoption of the medium-term approach by all units within the economy bears great importance so that policy decisions can be interpreted accurately and implemented effectively. Thus, we put special emphasis on this subject in all reports and announcements made by the Bank.

Secondly, the Bank makes use of a wide set of data in order to foresee the medium-term course of inflation. The Bank publishes an "Inflation Report" quarterly. This report announces to the public the numerical inflation forecasts with a medium-term approach together with the consistent policy response. However, all the new information we obtain and all the new developments can change our projections and numerical inflation forecasts regarding the course of inflation. The forecasts published by the Bank should be evaluated within this framework and it should be noted that they can change when the conditions regarding economic environment change.

Distinguished Guests,

Now I would like to briefly talk about the significant factors, which may affect the outlook of inflation.

First of all, the support of the private consumption demand for inflation in a downward direction, caused by the tight monetary policy stance, is expected to continue in forthcoming period.

Although the developments in the crude oil prices which have strong repercussions on the course of inflation has indicated a positive outlook recently, oil and energy prices still constitute a major risk factor that can affect inflation targets.

Unprocessed food prices, which have a remarkable weight within the inflation basket, is another factor of uncertainty for the future course of inflation due to the fluctuations in its course by showing sharp moves owing to the seasonal conditions.

Elimination of price rigidities in the services sector also bears great importance in the fight against inflation. Practices to increase supply and competition in this sector are needed.

On the other hand, we see that the unfavorable effects of the fluctuation period on inflation are eliminated thanks to the completion of the primary effects of the depreciation of the Turkish Lira on inflation as of the end of 2006. Nevertheless, rapid changes in the global risk perceptions, international liquidity conditions and the resulting fluctuations that can be experienced in domestic financial markets are other risk factors that may cause the inflation to go beyond the figures that we temporarily foresee.

Considering from the viewpoint of fiscal policies, we should note that one of the factors ensuring the maintenance of the downward trend of inflation in the medium-term is the sustainability of fiscal discipline and the revenues policy consistent with the targets without hesitations. Within this context, we closely monitor the effects of the adjustments in the revenues policy and the primary public expenditures on inflation and inflation expectations.

The achievements in structural reforms support the increase in efficiency via the improvements in competition and investment environments, contributing to the downward trend of inflation. The structural reform process has a determining effect also on the expectations. Unceasing maintenance of the steps in this area are important for the permanency of the downward trend in inflation.

Even if a considerable improvement is observed today in comparison with the first half of the year, medium-term inflation expectations that are higher than targets are the other risk factors regarding the inflation outlook. This is due to the possibility of these expectations to bring about deteriorations in the pricing behaviors.

Dear Guests,

Although some political developments regarding the negotiations with the European Union may come to the forefront, and some interruptions and delays may occur, this process itself does mean

convergence to the developed economies in economic terms. Together with the IMF, it also functions as an important anchor for the domestic and foreign economic units. This perspective, which is very influential on expectations, should be preserved.

When all these developments are evaluated altogether, we see that the Monetary Policy Committee preserves its cautious stance. The Bank implements its policies with aim of achieving the inflation target that is determined as 4 percent for the years 2007, 2008 and 2009. Currently, we foresee that the inflation targets can be achieved as long as the cautious stance of the monetary policy and fiscal discipline are maintained and the incomes policy is implemented in accordance with the inflation targets and the expectations are managed effectively.

Distinguished Guests,

The floating exchange rate regime is the basic element of the inflation targeting regime that we currently implement. The exchange rate regime is determined with the government. The Central Bank is responsible for the design and implementation of the exchange rate policy under this regime. Level of the rates under the floating rate regime is determined by the foreign exchange supply and demand under the market conditions. The short-term value of the Turkish Lira is determined by the developments in the foreign exchange supply and demand, behaviors of the market players and short-term expectations; whereas that of the long term is determined by the economic fundamentals, course of the structural reforms and medium and long-term expectations.

The basic policy instrument of the Central Bank in the inflation targeting regime is the short-term interest rates. Both the economic literature and the experiences of the countries show that, it is impossible for central banks to keep both the interest rates and foreign exchange rates under control at the same time in the economies where international capital movements are free as in ours.

Therefore, the Central Bank does not and will not have an implicit commitment regarding the level of the foreign exchange rate, or a policy towards rendering the Turkish Lira valuable.

When we look at the period starting from 2001 in which the floating exchange rate regime was embarked on up to now, we see a number of fluctuations in the foreign exchange rates, the most recent of which was observed in the May-June period. Similar fluctuations may be experienced in the future. The course of conduct of the Central Bank regarding the foreign exchange markets is quite clear. The risk of foreign currency is borne by the market players. The fluctuations that are experienced clearly display that these types of risks may arise any time and that they should be managed effectively. Economic units should ensure the required protection against the risks regarding their balance sheets in the modern sense within the scope of the risk management principles. Remarkable attainments were obtained in the banking sector within this context. The private sector also should need to adopt a similar approach in this respect.

The reason why I attach such a special importance to this subject and put emphasis on this with similar expressions in almost all my speeches is to draw attention to the possible risks that the economic units may confront under the floating rate regime and increase awareness. Otherwise, the deterioration brought about by the mis-management of risk affects the economy as a whole.

Dear Guests,

When the course of the value of Turkish currency versus foreign currency from 2002 up to now is taken into account, it is observed that as long as tight monetary and fiscal policies are maintained; structural reforms are implemented, political stability is maintained and the decisiveness for macroeconomic stability is sustained; the basic tendency will be in favor of the appreciation of the Turkish currency.

This is a process in which the Turkish currency is increasingly preferred for investment as in every robust economy although it is subject to occasional interruptions. Therefore, the value of the Turkish currency emerges as a clear consequence. Determination of the foreign exchange rates under the market conditions as a requisite of the floating exchange rate regime does not imply that the Bank shall not undertake any transactions in the foreign exchange markets. As it was also explained in detail in our announcement called "Monetary and Exchange Rate Policy for 2007", the Central Bank undertakes transactions in the foreign exchange markets for two objectives.

The first one of these transactions is the daily foreign exchange purchasing auctions that are implemented transparently and under methods in accordance with certain rules to serve the Bank's purpose of reserve accumulation. The Central Bank purchases foreign exchange from the market via

these auctions when the supply of foreign exchange is abundant under a moderate reserve-increasing strategy.

The second situation in which the Bank undertakes transactions is the direct interventions in order to prevent existing or possible excessive volatilities in the foreign exchange rates. These interventions are neither mechanic nor symmetric. The Bank evaluates all the changes occurring in the foreign exchange rates with regard to its own conditions and takes the decision for intervention accordingly.

As a result of the foreign exchange purchasing auctions and the direct interventions implemented within the scope of the foreign exchange policy, net purchase of 44.8 billion USD from the market has been made in a period of five years as of 9 January 2007. Following the foreign exchange purchases embarked on as of April 2002, reserves of the Bank increased by 199 percent and reached 60.8 billion USD on 29 December 2006.

Dear Guests,

Now I would like to mention the growth performance of the Turkish economy and the things to be done in this respect. The Turkish economy has been growing consecutively for the last 19 quarters. Gross National Product grew by 8.8 percent in real terms in the second quarter of 2006; and the growth rate decreased to 3 percent in the third quarter due to the monetary tightening and the fluctuations in the financial markets in June and July. Therefore, accumulated real growth has been 41 percent and the average growth rate has been 7.6 percent as of 2001.

Looking at the possible short-term outlook of growth before moving on to the evaluation of the process of structural change in the dynamics of the growth in the Turkish economy, I wish to emphasize that the slowdown observed in the economic activities in the third quarter of 2006 does not necessarily mean that a stagnation will be experienced in the last quarter of 2006 or after that. Considering these, we foresee that the growth rate in the last quarter of 2006 may remain at a low level due to the basis effect created by high growth rate in 2005. However, the annual growth rate of 2006 may realize around 5 percent in accordance with the program. In the light of the current information, we foresee that the annual growth rates will start increasing again as of the second half of 2007.

The Turkish economy has recorded remarkable improvements towards overcoming the period of fluctuating growth rates thanks to the macroeconomic stability environment established in the last five years. The determining factors in growth rates have been the private sector consumption and investments. Private sector's consumption expenditures rose by 36.4 percent in real terms in the period from 2001 to third quarter of 2006, while public expenditures rose by 15.5 percent with the acceleration especially in the last two quarters. Looking at the investment side, we see that the private sector's investment spending increased by 134.3 percent in real terms while the public investment spending went up by 14.1 percent. The high increases observed in investment spending also indicate that the investment-oriented basis of growth is widening and so the production capacity is increasing.

Another resource for growth is the high increase in efficiency. Accumulated efficiency increased by 39.3 percent in the last five years. The high efficiency rates support the growth process without inflation on the one hand and they contribute to the sustainability of growth on the other.

The exports have had great contributions in growth in recent years and this contribution keeps growing gradually. The Turkish economy is opening its doors. Accumulated annual exports rose by 167.5 percent as of November 2006 compared to the year 2001. The total trade volume in the last year reached 220.8 billion USD and it constitutes 57 percent of the national income.

Dear Guests,

The new structure of the growing process in our country is an indicator of the significance of macroeconomic stability, which lies on the basis of price stability for growth and competition.

According to the Global Competition Index, Turkey became one of the countries that increased its competitive power at the most in 2006 and drawing ahead by 12 rows, ranked 59 within 125 countries¹.

Maintenance of this growth and establishment of a sustainable growth process are indispensable requirements for an increase in social wealth, which is the final objective of all economic policies. Therefore, today everyone should focus on the things to be done for the sustainability of the growth process in our economy rather than the daily market transactions.

When successful country samples regarding growth and development processes are considered, we see that there are certain phases in the growth process. These phases are growth based on factor accumulation; increase in efficiency; research and development activities and innovations respectively.

Turkey is currently going through a process of growth based on increase in efficiency. However, ensuring the permanency of growth in the medium and long-term necessitates focusing on the research and development activities besides increases in efficiency and going through a process of growth based on innovations.

Dear Guests,

It is obligatory for the private sector to establish medium and long-term strategies rather than short-term ones, in order to last long within the domestic and foreign competition environment that is gradually becoming more challenging owing to both the changing domestic dynamics and the increasing openness. Elimination of the unfavorable conditions in bureaucracy, politics and taxing regulations that are the primary items of the list of the factors affecting competition negatively in Turkey bear great importance in this respect.²

The key factor for this is ensuring development in the principles³ of governance both for the public and the private sector. A great improvement is recorded in terms of the principles of governance as of the year 2000 and improvements in almost all of the indicators are observed. It is not a coincidence that the improvement in the principles of good governance and the one in macroeconomic performance to intersect. However, it is clear that there is too much to achieve compared to the European countries. Good governance has a key role in ensuring the macroeconomic stability and rendering this process permanent. Therefore, it is one of the pre-requisites of a sustainable growth process.

Structural reforms bear great importance in this regard. The research carried out with respect to the OECD countries⁴ reveals that the economic growth rates of the countries engaging in rapid and comprehensive structural reforms increase in vast amounts. Additionally, structural reforms are complementary. Halt of the progress of structural reforms in one field prevents the attainment of favorable outcomes of the reforms made in other fields.

Reforms to remove the defects in the social security system; to prevent unregistered economic activities; to provide the labor market with a more flexible structure via education; to restructure the taxing system; to continue with the reforms in the financial sector incessantly and to increase efficiency in the agricultural sector should be given priority in our country.

On the other hand, considering that growth is a dynamic process, it is very important to strengthen the macro reforms with micro measures and being in a search for a strategic approach in accordance with the changing needs and newly emerging structures. The public and private sector should engage in cooperation in this field.

¹ Global Competitiveness Report 2006-2007, World Economic Forum.

² Global Competitiveness Report 2006-2007, World Economic Forum.

³ Indicators of good governance are prevention of corruption, the rule of law, efficiency of the legislation and regulations, quality of the state services, political stability and transparency and accountability.

⁴ Macedo, J.B. ve Martins, J.O. (2006). "Growth, Reform Indicators and Policy Complementaries".

The public sector should assume a supervisory and regulatory role within the scope of the principles of good governance and work towards creating an atmosphere in which the private sector can compete within the international markets under the market conditions and should absolutely prevent the unregistered economic activities.

On the other hand, the private sector should continue taking precautions to increase efficiency; establish strong and transparent balance sheets; shift towards capital markets; pay attention to the principles of risk management and pay effort for the allocation of resources to the research and development activities. Parallel to this, banks should increase their contributions to the sustainability of growth through diversification of credits they offer to the private sector.

Dear Guests,

Upon mentioning the growth process in our country, now I would like to dwell on another important item on the agenda, which is employment.

Looking at the data about the labor market, we see that the number of the employed has been on the increase as of 2002. This increase is more apparent especially in the sectors other than agriculture. 660 thousand new jobs were created in the last year in the sectors other than agriculture as of September 2006.

A comparative improvement in the unemployment figures was recorded parallel to the increase in employment. When compared to the same period of the last year, decreasing by 0.6 points, the unemployment rate became 9.1 percent in September 2006.

Nevertheless, these favorable developments in the labor market have not yet arrived at a satisfactory level. The main reason for the delay and weakness of the improvement in the labor market despite the results taken in the other fields of economy are the structural problems in the labor market.

Agricultural sector leads the list of these structural problems. A rapid transition process is experienced from the agricultural sector to the sectors other than agriculture as a result of the structural change that the economy goes through. The share of the agricultural sector in total employment decreased from 38 percent in 2001 to 28 percent in September 2006. It is expected that the transition from the agricultural sector to the sectors other than agriculture within the process of structural change in our country will continue in the coming years

Additionally, high employment taxes observed in the sectoral structure of employment restricts the rise in employment on the one hand; and causes employment to shift to unregistered activities on the other. The increase in the unregistered employment prevents the increases in employment to be permanent and increases volatility.

Working age population keeps growing due to the high rate of population growth in our country. The limited educational facilities to meet the labor power having the demanded qualifications vis-a-vis the increasing working age population and the lack of labor possessing the qualifications compatible with the structural change in the economy are the other problems detaining the possible improvements in the labor market.

All these problems prevent the unemployment rates to fall in a speed parallel to the increase in employment. However, the problem of unemployment having social consequences besides economic ones renders the solution of this problem inevitable.

Therefore, long-term supply-side policies should be put into effect in order to find a permanent solution to the problem of unemployment. In this respect, via ensuring the implementation of active policies to create employment and providing resources for new investments, the investment atmosphere should be improved by strengthening the relationship between the real and the financial sector. Additionally, educational policies oriented towards increasing the labor power compatible with the labor demand should be put into effect. Besides, having the unregistered employment registered, should be given priority because it leads to unfair competition and this necessitates decreasing the taxes and other burdens on employment gradually.

Dear Guests,

Finally, I wish to briefly mention current account deficit, which frequently occupies the agenda.

Current account deficit is one of the sensitive points of the Turkish economy. With a retrospective look, we see that current account deficit grew faster in the periods when growth rate accelerated due to the structural peculiarities of the Turkish economy. The periods when the current account deficit

decreased or surpluses were experienced have been the years in which the growth rate decreased or crises broke out. This structure shows us that the current account deficit bears a structural quality rather than a cyclical one.

This process can be identified as followings: improvements recorded with respect to the macroeconomic stability decrease the general level of interest rates. This decline in interest rates increase consumption and investment demand and so the credit demand accordingly on the one hand; while leading to a decrease in domestic savings on the other. The rising expenditures, especially the investment spending increase the demand for machinery and equipment; and this demand can be met by imports due to the structural peculiarities of the Turkish economy. This process leads to the enlargement of the difference between the domestic savings and investments, which is an indicator of the current account deficit and causes the need for foreign resources to arise. With the help of the macroeconomic stability and the inflow of foreign capital, Turkish currency is appreciated and the process is reiterated giving way to an increase in the current account deficit in the environments where this resource can be provided and foreign borrowing becomes an option.

A similar process was experienced due to the improvements recorded in the macroeconomic stability in the last five years and remarkable increases were observed in the current account deficit owing to the effect of high speed of growth.

The current account deficit reached 34.4 billion USD in October per annum and the ratio of the current account deficit to national income in the third quarter of 2006 became 8.5 percent.

However, the reasons besides the financing method should be examined in order to determine the extent of the risk that the current account deficit poses with regard to the macroeconomic balances.

Current account deficit today basically originates from the faster increase of investments in comparison with the savings.

Additionally, high increases observed in energy prices and especially crude oil prices influenced the increase in current account deficit in a vast amount. The calculations point that in the case that energy prices remain fixed at their level of the year 2002, the ratio of the current account deficit to national income will be 3.6 points lower in the third quarter of 2006 compared to its current level.

As a result of the process of the structural change and the progress obtained in the macroeconomic conditions in recent years, the quality of financing for the current account deficit improved. Long-term capital has been the prevalent resource of capital inflows as of October 2006 with an annual level of 25.3 billion USD. This figure alone meets 3.4 percent of the current account deficit. Foreign direct investment inflow to our country for the same period was in record levels with 21.4 billion USD per annum.

What is worth paying attention here is the lack of an interruption in the foreign direct investments flowing in our country even during the fluctuations experienced in the May-June period. This is an indicator of the improvements recorded in the macroeconomic stability and also the confidence for the future of our economy by the foreign investors.

Long-term capital inflows and foreign direct investments finance a vast amount of our current account deficit currently. This financing structure is expected to continue parallel to the implementation of the current program decisively.

While analyzing the sustainability of the high current account deficits in our country, it should be noted that the structure of our economy is different from the past. In this context, strengthening of the macroeconomic foundations in the Turkish economy and the gradually increasing financial integration with the world economy facilitates the sustainability of higher current account deficits. Floating rate regime and a strong financial system also alleviates the negative consequences of the current account deficit during a possible capital outflow.

The current account deficit is one of the risk factors for our economy today as it was in the past. Management of this risk like the other risks besides its control through medium and long-term structural measures considering its structural peculiarities are vital for the establishment of a permanent stability in the economy.

Finally, I would like to express my pleasure one more time for having this opportunity to communicate my views about the policies of the Bank and the macroeconomic developments.

Thank you.