Mr Erçel reviews the monetary side of Turkey's ambitious three-year disinflation program

Speech given by Mr Gazi Erçel, Governor of the Central Bank of Turkey, at the Merchant Taylor's Hall, in London on 25 January 2000.

*   *   *

Turkey's disinflation program: what we are doing and why

Starting this year, Turkey has embarked on an ambitious three-year program to disinflate its economy. I call it ambitious because Turkey has suffered from a high and persistent inflation for the past quarter of a century, and any program that hopes to correct such a long-standing problem needs to be ambitious. I will begin by reviewing this new program, especially the monetary side of it.

But first I will give you some snapshots, from the past, of the Turkish economy, which I think will give a clear idea why this was the right time to take action.

The history of Turkish inflation shows that for the last quarter century inflation has been gradually increasing, never falling below two digits. The average inflation rate for the whole period was 55%. During the last decade inflation has averaged 72%.

Reflecting the uncertainties inflicted on the economy by this chronic inflation, growth has been volatile and at the low end of the range of comparable emerging market economies. Turkey's average growth rate over the last two decades was 4.2%. Average growth for the emerging markets of Asia, where inflation is not a problem, has been much higher.

It is well known that the cause of Turkey's inflation is fiscal in nature. The last year in which Turkey had a budget surplus was 1970. The budget deficit increased steadily throughout the last decade, finally reaching double-digits in 1999.

The fiscal imbalances have also caused difficulties in financing the deficit. Over the last couple of years the amount of external financing available for the budget deficit has declined, causing increased pressure on the domestic financial sector and an increase in the domestic debt. The ratio of cash domestic debt to GNP grew rapidly during the 1990s, finally reaching 24% of GNP in 1999.

The increases in the deficit and in the level of domestic debt during recent years are mirrored in the levels of domestic interest rates. The increasing pressure on domestic borrowing has kept real interest rates at high levels, hovering around the mid-20s during the 1990s and rising to over 50% at frequent intervals.

I think this brief recital of facts should be more than sufficient to explain why it is high time to face the predicament of the Turkish economy. A radical program is urgently needed to address Turkey's deep-rooted problems, and it is my wish today to convince you that the program we have delivered to deal with them is well prepared and comprehensive.

Let me summarise our goals and the overall strategy by which this program aims to achieve them. The fundamental goals of the program are:

- to eliminate inflation,
- to achieve a sustainable fiscal position,
- to establish a more equitable and efficient distribution of resources,
- and to increase the growth potential of the economy.

The program will accomplish these goals through a number of policy reorientations. The primary fiscal balance will shift, in the first year, from deficit to a surplus position consistent with long-term fiscal sustainability, and will remain high until the price stability has been established in the economy.

To reinforce program credibility and support the fiscal stabilisation, the program's design is front loaded, with most of the required structural measures being taken at the outset.

A first priority will be to diversify the financing of the deficit. Net external financing for the public sector will increase, and this, together with the primary surplus and other measures, will make it possible to lower the level of real domestic interest rates.

A strong and credible exchange rate policy, established at the beginning of the program, will break the cycle of the public's inflationary expectations based on past experience. Both monetary policy and public sector wage policy are being subordinated to the exchange rate target.

Now let me go into some details of this strategy.

Action to eliminate, quickly and permanently, the high public sector deficit is among the priorities of the program. Specifically, the primary balance of the public sector is targeted to shift from a deficit of 2.75% of GNP in 1999 to a surplus of 2.25% of GNP in 2000. This primary surplus will increase further to 3.7% of GNP in 2001, and will remain around that level in 2002 as well.

Most of the measures needed to achieve an improvement of over 5% in the public sector primary balance in the year 2000 have already been taken. It will be recalled that these measures included increasing the rates of the VAT and of the withholding tax on bank deposits and repo transactions by two percentage points; increasing the rate of withheld taxes on income from fixed assets and self employment by 5 percentage points; imposing a windfall tax on interest earned on government securities; and various one-off measures, including raising the rates of personal income taxes, corporate taxes, and property and motor vehicle taxes. These revenue measures were accompanied by spending cuts as well. For example, the social security reform law passed by the parliament last fall is expected to save 0.5% of GNP in social security expenditures in 2000.

As a result of the improvement in the primary balance, and the increase in privatization receipts, some of which can be used to retire public debt, the cash debt-to-GNP ratio is expected to level off at around 24% this year and to begin a gradual decline in coming years.

Privatization proceeds are expected to reach US$ 17.7 billion over the program period. A number of important measures have been taken to ensure that this ambitious goal is met. The constitution has been amended to allow for international arbitration between the Turkish State and foreign investors. A streamlining of the regulations governing operations in the energy and telecommunications sectors is expected to attract privatization, and Parliament is even now considering the necessary enabling legislation, which will be enacted very soon.

These actions in the fiscal, privatization and structural reform areas are a part of the front-loading mentioned above, and the authorities have already taken most of the measures.

Now let me turn to the program's nominal strategies, most of which are the responsibility of the Central Bank.

In an economy like Turkey's, where inflation has a long history, expectations and inertia play important roles in the inflationary dynamics. This represents a major problem for the program, which needs to be addressed thoroughly.

Since exchange rates have high public visibility, there was a broad consensus in Turkey that using the exchange rate as a nominal anchor would be an effective tool for interrupting the public's inflationary expectations based on the past. In addition, the openness of the Turkish economy to capital movements makes the commitment to an exchange rate anchor particularly effective in affecting nominal interest rates. Accordingly, the exchange rate regime has been designed to provide clear signals as a basis for price and interest rate expectations, while avoiding the medium-term drawbacks experienced in the medium term by some of the other countries pursuing exchange rate based stabilization.

Here is how exchange rate policy will be conducted during the program period. We are already announcing to the public the daily value of an exchange rate basket consisting of US$ 1 and Euro 0.77 for the coming 12 months. The monthly depreciation rate of the basket adds up to a 12-month depreciation rate of 20%, in line with the WPI target for the period. At the end of each quarter, we will pre-announce a depreciation rate for the quarter beginning nine months later, and leaving the pre-announced rates for the intermediate quarters unchanged. This means that at the end of every three-month period, the rate of increase in the exchange rate basket for the next 12 months will be publicly known.

The system will function in this manner for the first 18 months of the program. Then, starting in July 2001, a gradually widening symmetrical band will be introduced for the pre-announce exchange basket. From this point on, the total width of the band will be 7.5% by end-2001, 15% by end-June 2002, and 22.5% by end-December 2002.

It will be noted that while we are making strong commitment to a pre-announced exchange rate path, we are simultaneously announcing our exit strategy, which should allay concerns about the difficulty of making a smooth exit from such systems.

Of course, there are also some risks created by pre-announcing the path of the exchange rate. But the strength of the fiscal policies implemented so far, and the structural reforms undertaken by the political authorities, should substantially reinforce the chances that our exchange rate policy will succeed.

Our exchange rate policy will receive further support from monetary policy. To promote this, we are moving to a more rule-based monetary policy and away from one based on discretion, especially during the first 18 months. During this period, the Central Bank of Turkey will not increase its stock of net domestic assets. All fluctuations in base money will come from balance-of-payments flows. Accordingly, the ceiling on net domestic assets at the end of each quarter is fixed at TL –1,200 trillion (excluding the change in the revaluation account, which is part of the net domestic assets definition). In addition, during this period, net domestic assets will fluctuate within a parallel band whose upper and lower limits will be determined as plus-or-minus 5% of previous end-of-quarter base money figures.

In recent years, we have been limiting net domestic assets by decreasing credits to the public sector. This policy will be continued in coming years. In addition, we will also stop sterilising the capital inflows and outflows. This policy of no sterilisation will permit rapid, market-determined changes in money market interest rates, and will create an automatic mechanism for determining Turkey's international reserves, and hence *base money*.

When there is an excess of demand for foreign exchange, the withdrawal of Turkish Lira from the market will not be offset by increasing net domestic assets. This in turn will increase the demand for Turkish Lira, while decreasing the demand for foreign exchange.

Provided there are no major exogenous shocks to the system during the program period, we expect the Central Bank's net international reserves to remain at comfortable levels. The floors established for net international reserves for the four quarters of 2000 are US$ 12 billion, US$ 12.5 billion, US$ 12.5 billion and US$ 13 billion respectively. If for any reason net international reserves threaten to fall below these levels, the Central Bank will take measures needed to counter these trends.

The exchange rate band mechanism will provide greater flexibility for net domestic assets after the second half of 2001. And as a result of this greater flexibility, the contribution of monetary policy to the attainment of the inflation target will grow as the influence of monetary policy on interest rates increases.

Finally, I should explain the changes we are making in the reserve requirement system. We are beginning to implement reserve requirements more flexibly in order to make it easier to meet banks' temporary liquidity needs and enable them to manage their liquidity more efficiently in the course of their operations.

A sound banking system is an essential prerequisite for the efficient implementation of monetary policy. This is all the more true under a rule-based monetary policy regime. We announce the rules of the game clearly to the players in the expectation that they will follow them efficiently and fairly. The Banking Law that was enacted by Parliament in the summer of 1999, and the amendments made during the last month, were aimed at giving the banking system the necessary efficiency and soundness.

In conclusion, let me summarise recent history.

We have been working on this program for the past two years. Its technical excellence accurately reflects well the effort that has gone into it. I do not hesitate to say that the program is "comprehensive", "strong", "ambitious", "bold" and "imaginative", and most of all "achievable".

The willingness of the political authorities to execute this program is clear from the way they have taken the necessary but politically difficult economic decisions: quickly, without hesitation or second thoughts.

The IMF and the World Bank have strongly endorsed the program, the former by approving for Turkey a three-year standby arrangement, and the latter by extending project credit.

The prospect of membership negotiations with the European Union pursuant to the Helsinki decision provides an additional strong incentive to implement the program forcefully. There is a strong autonomous ownership of the program. The Government, the Parliament, policymakers, and the social partners all understand the great rewards, particularly in terms of reduced interest costs and stable growth, that will follow the program's successful implementation.

The markets' reactions to the program have also been very positive. Interest rate declined from 100% last October to the 30s recently.

I expect that these positive attitudes on the part of all participants in the program will continue until Turkey has achieved the long-sought and much desired goal of durable price stability.