Durmuş Yilmaz: The Central Bank of the Republic of Turkey – the history, recent developments and the future of monetary policy in Turkey

Opening remarks by Mr Durmuş Yilmaz, Governor of the Central Bank of the Republic of Turkey, at the Conference on the occasion of celebrating the 75th anniversary of the Central Bank of the Republic of Turkey, Ankara, 1 June 2007.

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Governors,
Colleagues, Friends, and
Distinguished Guests,

It is a great pleasure to welcome you to this Conference on the occasion of celebrating the 75th anniversary of the Central Bank of the Republic of Turkey. As this conference is also President Trichet's first official visit to the Central Bank, I would like to express my heartfelt gratitude to him for joining us at this special event.

On occasions like these, I believe, it is appropriate to look back and make an assessment of the institutional progress the Central Bank of Turkey has made since its inception. I would therefore like to take this opportunity to share with you the most significant changes taken place in the Bank's history, and then focus on the recent developments in the implementation of monetary policy. Finally, from a medium to long-term perspective, I would like to say a few words on the future of monetary policy in Turkey.

As we know during the 30 years or so immediately preceding the First World War, major world currencies were based on gold, in the sense that the value of the currency in one way or the other was closely linked to the intrinsic value of the metal itself. However, after the First World War, countries one after another abandoned the gold standard and adopted what is called the fiat money. That is, paper money and the gold had gone through a divorce. Therefore under the prevailing circumstances printing money and managing the financial system had become more important, which created a more compelling need for the establishment of strong institutions to take care of banknote issuing and to safeguard the value of money.

In this regard, Turkey did not and could not stay uninvolved in this general tendency. Having won the War of Independence, the founders of the Turkish Republic were aware of the need to establish a central bank. The establishment would have been the economic crowning of the political achievements and was considered to be the most significant symbol of sovereignty as well as economic independence. Thus, the idea of establishing a national central bank was debated intensively at the 1st National Economic Congress held in Izmir in 1923.

The ideas discussed and the deliberations made were crystallized in the preparation of "The Draft Law on the Republic Issue Bank" with the contributions from European scholars. It was enacted on June 11, 1930 as the Law on the Central Bank of the Republic of Turkey. Accordingly, the Bank started to operate on October 3, 1931 and Mr. Selahattin Çam was appointed as the first General Director, or as we now refer to, as our first Governor.

The Law did not involve any explicit provision for the independence of the CBT. However, this did not mean that Lawmakers then did not have any idea about the relationships among money, politics and price level. On the contrary, the founders of the Republic were fully aware of the idea that a central bank should be independent in order to get the best outcome from its policies. Let me quote, for example, _smet _nönü, the Second President of the Republic, in one of his various speeches on the establishment of the Central Bank; *"I knew from the very start that the Central Bank had to be an independent institution, operating with the integrity and robustness that would be required against even the Government and the Ministry of Finance, let alone its relations with other private banks".*

The law did not stipulate any provisions for granting short term advances to the government to prevent the use of the Central Bank resources for financing government expenditures, and thus to avoid inflation and to maintain fiscal discipline.

These are enough evidence that despite no formal provisions for the independence, the CBT was *de facto* an independent authority in conducting monetary policy. In order to safeguard this informal, implicit independence, the CBT was established as, and still is, a joint stock company, in which the state and other local entities hold shares. This structure was by no means a coincidence, but of deliberate design aiming at minimizing government intervention. However, in today's world, the relationship between ownership structure and central bank independence has become less significant. Nowadays, the most independent central banks are wholly state-owned and the central bank independence involves much more than just ownership.

The early years of the establishment were the years in which autonomous functioning of the CBT was at the forefront. The central bank operations were respected and at times demand for short-term credit by the governments was then resisted. The outcome was low inflation. The basic aim of the Bank was to support the economic development of the country. To this end, the Bank's main operational tools were to set rediscount rates, regulate money markets, execute the Treasury operations and take, jointly with the Government, all measures to protect the value of the Turkish currency.

During and after the Second World War, central banking underwent drastic changes in the world in line with the gradual global economic and political transformation. The scope of the central bank's mandate to manage and control the circulation of currency was extended. Its responsibility now ranged from issuing banknotes, functioning as a lender of last resort, achieving and maintaining low inflation to being the guardian of financial stability.

Except the temporary amendment concerning the short-term advances to the government before the Second World War, no major amendments were made to the Central Bank Law. 1950s and 60s were relatively easy years. However, the authorities thought that the provisions of the Law of the Central Bank fell short of meeting the necessities of contemporary central banking. Therefore, on January 14, 1970 a new Law on the Central Bank of Turkey was adopted.

The new Law brought in changes on the structure of the Bank as well as changes in its policy implementations. The most important organizational change was replacing the General Director, the highest post in the Bank, with the Governor. As regards policies, the Bank was directly authorized to set monetary policy in line with the development plans and annual programs. The Bank was also authorized to conduct open market operations in order to manage money supply and liquidity and was entrusted with medium term discount credit facilities to real sector through the intermediary of commercial banks.

In the 70s, there were significant developments in the world economy. In the aftermath of the first oil shock in early seventies, inflation all over the world economies became rampant. Accordingly, the main focus was directed towards the fight against inflation.

The 1980s and 90s were the years where a number of structural and institutional changes were introduced in the Turkish economy. With various measures taken between 1980 and 1989 Turkey's both current and capital account transactions were fully liberalized. Trade restrictions were eliminated and the Turkish currency was made fully convertible.

There were also notable changes on the domestic financial market infrastructure. For the monetary policy to be effective what is needed is the existence of well-developed financial markets. For this purpose the Central Bank played a leading role in the creation of domestic money, foreign exchange and government bond markets.

To further strengthen the financial markets infrastructure the Central Bank established a well-functioning electronic payments and securities settlement system. Contrary to these developments, the performance of the Turkish economy in terms of inflation and growth was not satisfactory. Aside from short-lived periods of relative stability, loose fiscal policies along with accommodative monetary policies were the main causes of high inflation. Under these circumstances backward indexation became a common practice in pricing behavior; inertia evolved in inflation, which was very difficult to eliminate. As inflation increased, inflation expectations also increased and a self-nurturing inflation cycle began.

In the meantime, there were number of attempts to get out of this impasse. First, there was a monetary program introduced in 1990. This was very important in that it reorganized and re-structured the Central Bank balance sheet and explained to the financial community and to the general public how the monetary policy operated. It was the first time when certain monetary concepts like base money or central bank money were brought to the attention of the public. However external developments like the first Gulf war brought this program to an end. The second major program for disinflation was the exchange rate based stabilization program of 2000 under the IMF support. This program collapsed for known reasons in February 2001.

At this juncture, one might wonder why Turkey was not successful in her disinflation attempts. I believe the answer lies, as already mentioned, in the lax fiscal policies. As I have already mentioned the very first law of the Central Bank did not have any provision for financing the government. However the amendment made to the law just before the Second World War to extend temporary short-term advance facility to the government, in order to smooth out the difference between timing of taxes and expenditures, was firmly incorporated in its Law in 1970. The provision stipulated that the government had the access to the Central Bank financing to the tune of 15 % of the total budget spending. Although this facility was phased out after the 1994 crisis, it was one of the reasons of fiscal indiscipline and high and persistent inflation in Turkey.

As we all know, tough times call for tough decisions. The collapse of exchange rate-based stabilization program in 2001 was, in one sense, an opportunity for Turkey to "put her house in order". The fiscal cost of the crises brought every individual in the economy to his senses. Fiscal discipline and tight monetary policy were the immediate answers to the chronic problems of Turkey. But how would this discipline be achieved? The answer lied, and still lies in building a Chinese wall between the Central Bank and the Treasury in terms of government finances, by means of an independent Central Bank. Accordingly, the Central Bank of Turkey was granted independence by the Parliament in May 2001, as a response from the society to the previous 30 years of bad experience.

Since it takes time for the policy decisions to bring the intended results, economic agents must be patient for the policies to fully work out. If policies are changed in the middle, we are back to square one again. But the literature on time inconsistency has taught us that the change in the policies tends to occur in an untimely manner. Therefore the central bank independence means to eliminate the inconsistency between short-term temptations and full implementation of the designed optimal policies.

The amendments that granted the independence to the Central Bank in 2001 also prohibited granting advances and extending credits to the Treasury and other public institutions. The Central Bank cannot buy government securities from the primary markets. The new Law entrusts the Bank with the single mandate of achieving and maintaining price stability, and with instrument independence. By Law, the Central Bank shall support the general economic policies provided that they do not conflict with the price stability.

At this stage, it is impossible not to agree with President Trichet, in this statement: *"The undesirable social and economic consequences of inflation, namely inefficient allocation of resources, high levels of interest rates, the regressive inflation tax, arbitrary redistribution of income and wealth to the detriment of the most vulnerable, and, last but not least, economic instability, lower growth and lower job creation, are the benchmarks against which one has to assess the social benefits of price stability. This is why a credible commitment to maintaining price stability is so important for the living standards of European citizens."*[1]

Together with its independence, the Central Bank of Turkey was set to be accountable in various ways. In this sense, according to Article 42 of the Law on the Central Bank of Turkey, we are accountable to communicate with the Government and with the public if inflation deviates excessively from the target, or even a possibility of deviation becomes evident.

Moreover, in line with the transparency principle, we have started to give more importance to sharing our views about the general economic outlook, current inflation and inflation outlook and informing about monetary and exchange rate policies through press releases, announcements, reports and every other means such as press meetings, interviews, speeches and presentations.

The Law also set up the Monetary Policy Committee (MPC). Having got the instrument independence, the Central Bank moved from implementing monetary policies aiming at implicit inflation targets together with certain monetary aggregates as intermediary targets to an explicit inflation targeting regime.

There are certain preconditions to be met for a successful implementation of inflation targeting regime. First central bank must have strong team of economists, well functioning transmission channels and the instrument to guide the policies. In this respect the Central Bank of Turkey reorganized its Research and Monetary Policy Department and increased the number of economists with PhD's. We have strengthened the research capacity and the analytical power of the Department. At the start of the program, high debt to GDP ratio was a problem for debt sustainability and there were high uncertainties about the transmission mechanism. And also due to the high and chronic 30 years of inflation there was not a solid track record of credibility. Between 2002 and 2005, the period of implicit inflation-targeting

[1] Trichet, J.C. (2007). "Hearing Before the Economic and Monetary Affairs Committee of the European Parliament". Brussels, March 21, 2007.

regime, the Central Bank tried to build up its credibility by setting inflation targets together with the Government and achieving them. During the last 5 years' period debt to GDP ratio fell to sustainable levels, with significant developments in credit markets and a downfall in dollarization levels, which strengthened the transmission mechanism to a large extent. Also the MPC assumed the role of a decision making body, from an advisory one.

The currency reform was also a necessary condition for successful IT implementation as the currency with many zeros kept the inflation memories in the public mind alive. That is why we dropped 6 zeros from the currency during the implicit inflation targeting period. Meanwhile, economic agents adjusted to floating exchange regime and the short-term interest rates were set as the only policy instrument. And finally we established the Communication Department, which is a must for IT implementations.

Having fulfilled the necessary groundwork, the Central Bank adopted fullfledged IT in 2006.

At the beginning of my speech I said that the divorce between paper money and the gold was the reason for some countries setting up central banks anew and broadening the mandates of the existing ones. We must then ask why people are willing to hold and use paper money. This is a very important question, and the answer is they expect the future value of the money to remain stable because the future price level will remain stable. This is a matter of great trust. But to whom do the people trust? They trust to the body, which is responsible for the stable prices: the central banks.

Therefore the bottom line of the inflation-targeting regime is the management of the expectations. If expectations are anchored to the target, wage earners and price setters will behave in such a way that, at the end of the period, the target will be reached. Then the question is, how can we anchor expectations? The answer is: by building credibility through delivering what is promised. Once this is achieved, the volatility in interest rates, inflation and output would be lower.

How do we build credibility? Central banks can do this by anchoring inflation expectations through establishing a good track record and by demonstrating that the central bank adjusts its policy rates appropriately in response to the changes in the inflation outlook. This behavior is known as the central bank reaction function. That is to say, in order to keep the inflation in line with the target, the central banks react to economic news in a more or less predictable manner.

As economy changes over time, the available data set also changes. We get some of our guidance from the analysis of these data by using models or econometric tools. Models are useful but they are not sufficient; in formulating our decision we do and must put some weight on judgments as well. This is known as the art side of the monetary policy.

Central Bank of Turkey has been able to bring down inflation from 70 % in 2001 to 7.7 % at the end of 2005. Although the structural reforms over the last five years have been critical in the fight against inflation, the new monetary framework of inflation targeting also played an important role. Inflation expectations have somewhat been successfully anchored to the target, notwithstanding some deviations and deteriorations lately. At the end of May 2007, the Central Bank of Turkey is faced with a considerable credibility gap. Our strong reaction in 2006 have contained inflation expectations and we predict that inflation expectations will continue to move towards the medium term target of 4 percent as the headline inflation comes down in the next couple of months. However, it should be noted that there are also other important factors in determining the inflation expectations, such as incomes policy and the course of fiscal policy, or political aspects, etc.

Apart from short-term interest rates, communication skills are also critical tools in guiding the expectations towards the target. What we do is important, but equally important is how we convey this to our target audience. That is not only what we communicate but also to whom we communicate. Of course the target audience of central banks are financial markets in particular and the public in general.

When communicating we try to make our messages simple and straightforward. However this is easy said than done. Again this is the art side of monetary policy.

Ladies and gentlemen, before concluding, I would like to note that the existence of independent and autonomous institutions along with the practice of good governance principles is vital for Turkey.

An independent central bank has constituted and will continue to constitute a cornerstone for structural transformation towards good governance and good institutions in Turkey. The Central Bank of Turkey aims to fulfill expectations by operating as a sound institution through its independent, transparent and accountable status, by policy implementations focused on its sole mandate of price stability and by practices to increase efficiency in institutional design.

Hence, it is a great honor for me to be here with all the executives and former governors who have made the Central Bank of Turkey what it is today throughout this period. I would like to extend my thanks to them all again for all their valuable contributions to this important institution.

Thank you.