

**Mr. Erçel reviews central bank operations in 1996 and discusses the philosophy of central banks** Remarks by the Governor of the Central Bank of the Republic of Turkey, Mr. Gazi Erçel, on the occasion of the 65th Shareholders' Ordinary General Meeting in Ankara on 15/4/97.

I expressed my views concerning the main functions of a central bank in my speech to last year's General Assembly. Today I would like to summarize the past year's operations and share with you my thoughts on the philosophy of central banking.

You will find detailed assessments of economic developments in Turkey and abroad in the Bank's Annual Report for 1996, which has already been distributed to you. Instead of repeating these details, I will describe the implications of the events of 1996 for the operations of the Central Bank.

The most important circumstance affecting the economy last year was the long-lasting period of political uncertainty. After the general elections, it took the first six months of the year to put together a coalition government. Political instability, Turkey's entry into the Customs Union, and lack of the political determination needed to fight inflation created uncertainty in the financial markets. The Central Bank responded by aiming its monetary policies at achieving and protecting stability in the financial markets instead of aiming them at decreasing the rate of inflation.

While withholding announcement of its targets for the second half of 1996, the Central Bank implemented a monetary program in keeping with its inner discipline. The main points of monetary policy under this program were as follows:

- The Central Bank set a ceiling on increases in net domestic assets.
- The Central Bank paid close attention to keeping increases in reserve money in line with increases in demand. Open market operations were actively used during the year to mop up excess liquidity created by the increases in our net foreign assets.
- The Central Bank monitored exchange rates throughout the year, with special attention to maintaining stability in the foreign exchange market.
- Continuous domestic borrowing by the Treasury made a positive contribution to achieving all targets.
- Turkish lira interests rates were determined mainly by the borrowing strategy of the Treasury. The Turkish Central Bank has played no direct role in the determination of interest rates.

In an economy with market-determined interest and exchange rates, where a persistent public deficit is being financed mainly through the domestic markets, the monetary policy tools available to the central bank are few and of limited effectiveness. As noted above, interest rates are determined primarily by the borrowing activities of the Treasury. By the same token, foreign exchange rates are determined as a function of the external trade deficit (itself a function of growth) and the level of interest rates. Under these conditions, the central bank is absolutely obliged to keep the items on its balance sheet under careful control.

I would like to point out that efforts since the second half of 1980 to keep the central bank's balance sheet healthy have greatly streamlined control over the items on that balance sheet. In 1998, the evaluation account held 45 percent of the assets of analytical balance sheet. In 1996, when it showed a negative balance for the first time, the evaluation account's share in the assets of the balance sheet fell to zero. Similarly, foreign assets accounted for 30 percent of total assets in 1988, compared to 76 percent in the balance sheet for 1996. In short, the principal source of the increase in central bank assets shifted from increased domestic assets to increased foreign assets, mainly borrowed.

The Central Bank considers controlling the increase in domestic assets to be the most important aspect of its monetary program. Only by controlling the increase in domestic assets can we keep the increase in Turkish lira liabilities in line with increasing demand. The 1994 law requiring the Central Bank to gradually phase out its advances of short-term credit to the Treasury, formerly the main source of domestic assets, has been of great assistance in curbing their increase.

The continued lowering of this ceiling in coming years will certainly make it much easier for the Central Bank to implement its monetary policy.

It is my wish that in the near future, the Turkish Central Bank will see this practice abolished altogether, as it has been in other modern central banks. The elimination of Central Bank credit to the public sector will go far to create the confidence needed to launch the crucial struggle with inflation.

Central banks are responsible for keeping prices stable as well as for ensuring that the financial system runs smoothly. A stabilized financial system and stable prices are essential conditions for steady economic growth in the medium term because only a stable financial system can provide the necessary link between savings and investments. Price stability is needed to reduce uncertainties for investors and encourage investments.

In the long run, stabilizing prices is likely to increase both living standards and productivity. For this reason, the price stability that is the main goal of central banks is valid and urgent not only in the short run, but also in the long run. And once countries like ours have achieved price stability after long effort, they must continue the effort to maintain it. For central banks, price stability is a permanent goal.

Inflation inflicts several burdens on a society:

- Overall, it introduces uncertainty into economic decisions and profit seeking.
- It reduces the discipline of price and market systems.
- It has negative effects on the cost of capital.
- It directs resources to unproductive activities. In periods of high inflation, investments in real estate and financial investments become more desirable.
- Growth declines as inflation rises.

In countries with high inflation, it has been observed that most resources are directed to the financial system. It is also known that the financial system undergoes a relative expansion during such periods. Resources which have accumulated in the financial system cannot be rechannelled by the financial system to more productive sectors.

A stable financial system and stable prices therefore represent the normal environment that central banks are committed to pursue and maintain. A central bank that stabilizes prices increases its credibility.

A central bank that protects the value of the currency also helps increase the credibility of the country.

The success of the monetary policy implemented to stabilize prices depends on whether or not the financial system is stable. And the price stability and financial system stability that are the primary responsibilities of the central bank are necessary for achieving economic growth in the medium term.

Let me mention some qualities that a central bank should have:

- It should have continuity. Central banks should not be diverted from their permanent goal of price stability by short-term political pressures.
- It should be competent. A central bank should be completely professional. It should be technically dedicated in its structure, thorough and clear in its expression, and transparent in its actions.
- It should be a responsible institution. In other words, it should be an institution that is reliable and able to justify its monetary manoeuvres.

These are the characteristics of a modern central bank. Central banks that have these qualities will unquestionably occupy a distinguished place in the international environment of the 21st century. I am sure that its long experience, accumulated knowledge and proficient staff make the Central Bank of the Republic of Turkey an institution that can fulfil these expectations. I am proud of this institution. I owe a great debt of gratitude to my colleagues, who have greatly contributed to our accomplishments and to our policy implementation.