Mr Erçel reports on developments in the Turkish economy in the light of the recent disinflation efforts

Speech by Mr Gazi Erçel, Governor of the Central Bank of the Republic of Turkey, at the American-Turkish Council, held in Washington on 28 September 1999.

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Two years ago, in the summer of 1997, the crisis in Asia began to accelerate. One year ago, on 17 August 1998 a crisis erupted in Russia that threatened serious consequences not only for the Russian economy but also for the entire international financial system. By comparison, this year's summer has been uneventful, except my country, which was struck by an earthquake on 17 August 1999.

The earthquake has been devastating both in terms of human life and physical infrastructure. The death toll has risen to over 15,000 with over 25,000 injured. More than 200,000 houses were damaged or destroyed and over half a million people were left homeless.

The spontaneous and prompt support from the international community together with domestic resources will cover reconstruction costs and we will recover.

I have to emphasize that this tragic event will not derail our macroeconomic strategy, nor shall we allow it to jeopardize the hand-won disinflation achievements realized so far.

Since Turkey has a long history of inflation, which is the main cause of macroeconomic imbalances, we have directed our efforts to reducing the inflation for quite some time.

A disinflation program was launched at the beginning of 1998. This program is gradual in nature and aims to reduce inflation, which had reached 91% by the end of 1997, to single digits over the medium term.

All we know is that the disinflation program has three components: counter cyclical fiscal policies, structural reforms, and nominal policies.

Let me make some comments firstly on fiscal and nominal policies.

Turkey's inflation has a long history. It originated mainly from budget deficits and the way they have been financed, and for this reason fiscal policies should be the backbone of any Turkish anti-inflation program. Calculations indicate that a primary surplus of 4–5% during the first two years of the program should be enough both to relieve the pressure on domestic demand and on domestic borrowing and demonstrate that the fiscal authorities are serious about reducing inflation. A tight fiscal policy will also lighten the burden of stabilization efforts, making a more flexible monetary policy possible.

The monetary program is also consistent with these fiscal policies. At the Central Bank we have focused on net domestic assets since the second half of 1998. Bringing these aggregates under control conveyed two basic messages: first, that public sector deficits would no longer be monetized with the Central Bank resources, and second, that henceforward the Central Bank will increase its Turkish lira liabilities only to finance an increase in its net foreign assets. The substantial decreases in "credit to the Treasury" item and overall net domestic assets, and the large increase in the Central Bank's net foreign assets, are the result of these policies. Here, of course, we should take account of the damage done by the Russian crises. The capital outflows connected with these crises caused net foreign assets to decrease, which in turn produced an increase in domestic assets. Even so, the source of the latter increase was not the increase in public sector credits but mainly the increase in Central Bank funding to the banks.

Another aspect of the Central Bank's monetary program is related to exchange rate policy. The proposal to conduct exchange rate policy in accordance with the inflation target has important implications for expectations. First of all, it signalled to the market that the Central Bank endorsed the government's inflation target. Since the public can monitor the exchange rates daily, exchange rate policy becomes an important tool for moving the public's inflation expectations towards the government's inflation target. Of course the continued success of this policy requires the authorities to set a realistic inflation target, which is to say an inflation target consistent with the public sector's proposed budget balance.

Besides influencing inflation and inflationary expectations, exchange rate policy directly affects the external sector. A stable real exchange rate policy puts the Central Bank in a neutral position in this respect. That is, the Central Bank neither intends to use exchange rates to support exports, nor does it intend to harm Turkey's long-term trade competitiveness.

The implication of the Central Bank's stable real exchange rate policy is that the economy's current account balance is determined by real sector developments. Here the decline in domestic demand in recent months has made its mark. As imports decreased, the foreign trade balances improved significantly. As a result of this, Turkey ended 1998 with a current account surplus of US$1,871 million. In 1999, a small current account deficit is expected, mainly due to an expected rise in domestic demand in the second half of the year.

The coordination of fiscal and monetary policies has succeeded in reducing the inflation rate from 91% in 1997 to 54% in 1998. As of August 1999, the WPI-based inflation rate stood at 54% despite an unexpected change in the price of oil and a relative loosening of the fiscal stance in the first half of the year.

Since Turkey has a long history of inflation, inertia has played an important role in determining inflation. Breaking down this "inflation resistance" of the economy requires a high level of commitment on the part of the political authorities. One sign of this commitment may be their performance in the area of structural reforms. There is no doubt that the more successful the realization of the reforms, the stronger will be the credibility of the program. Now let me turn to these reform issues.

Turkey has a good record for structural issues. We have liberalized the trade and capital accounts of the balance of payments for about two decades. We have a flexible labor market. High domestic savings is one of the main characteristics of the economy. Market oriented economy is another aspect of the structural component of Turkey.

Right now, Turkey has four important structural reforms on its agenda, not only as a part of the disinflation effort but also because they are essential for changing the environment. Thus, these structural reforms are vital for adapting to the changing global environment. They consist of reforming the banking sector, the social security system, agricultural subsidies, and privatization. Some of these reforms have already been approved by parliament, and the others are in the pipeline.

The new Banking Act which was approved by parliament in June has the following four general objectives:

- to close the legal loopholes;
- to implement the international supervisory regulations;
- to assign the supervision of banking organizations to an independent agency; and
- to make some adjustments regarding the process of founding and operating banks.

In particular, the twenty-five Core Principles for Effective Banking Supervision drawn up by the Bank for International Settlements in 1997 have been endorsed in the amendments to the Banking Act.

As a result, the amendments are consistent with modern principles of effective banking supervision. I believe this new law will rapidly improve the soundness of Turkey's banking system, which is crucial for the conduct of monetary policy. Just as the monetary authorities cannot achieve medium-term price stability without appropriate fiscal policies, they cannot pursue a price stability target without a sound banking system.

The banking law approved by parliament was a big step forward, but further action is also needed. One important additional issue is to restructure the state banks and reduce their role in the banking system. These banks not only operate in a competitive banking market, but also undertake operations on behalf of the government, such as providing preferential loans to the agricultural sector and to small and medium-sized businesses. Since it is intended to eliminate preferential credits in the medium-term, these banks can be commercialized by privatizing them.

Another reform that the Turkish government has recently undertaken is social security reform. Let me give you a brief summary of Turkey's social security system, which has caused major budgetary problems in recent years. The Turkish social security system includes three pension institutions. The first and largest, the SSE, is for corporate employees, the second is for civil servants, and the third is for the self-employed. All three operate on a "pay-as-you-go" basis, which means that pensions are paid out of the current contributions of the working population and not of the past contributions of the retirees.

The main reason for the growing deficits of recent years is not the ageing of the population, but early retirement. The pension system deficit has been growing rapidly since 1992, when the minimum retirement age requirement was abolished. A new bill to correct this situation has already been approved by parliament.

As regards privatization, public enterprises still play a central role in Turkey. We all know that a stronger privatization program would reduce the state's involvement in commercial and industrial activities, and that this in turn would reduce the budgetary burden of subsidies and deepen the capital markets by encouraging wider ownership of shares. Since privatization has come to be seen as a key element of policies aimed at improving resource allocation, it will be essential to modernize Turkey's legal and institutional framework for privatization and to bring it more in line with EU norms and the norms now prevailing in some of the region's more successful transition economies.

An adequate legal foundation will be the key element of such reforms. Important steps have recently been taken in this direction, and the constitution has been amended to reduce the legal obstacles obstructing the privatization process. And in order to attract foreign investors who could be interested in privatization, long awaited amendments to the constitution concerning international arbitration have also been approved by parliament.

The agricultural sector is especially important in Turkey. It still contributes around 15% of GDP and accounts for about 42% of all employment. In Turkey, total support to agriculture has more than doubled in the last 10 years, while in other western countries it has been reduced.

Turkey has a complex system of agricultural supports, which are delivered to the producers through two main channels: output-based market support schemes, and the state-owned Exert Benches (Agricultural Bank) which delivers payments based on the use of inputs. Additional measures cover the cost of general services provided to agriculture, which are financed through the budget.

The present agricultural support arrangements cannot be replaced overnight, and the authorities are working with the World Bank on projects aimed at making it possible to shift to a direct income payments system in the future. The move from the present subsidy system to a direct subsidy is supported by everyone in Turkey, but the change will be gradual and will take some time.

The new government that was formed after the April election seems serious about completing the above reforms, as shown by their quick action in passing the Banking Act, international arbitration, and the social security reform.

With the strengthening of credibility that will come with the completion of these reforms, I believe Turkey's disinflation program will shift into a new stage starting in 2000. While there has been considerable progress since last year's Staff Monitored Program, a new and comprehensive effort is now needed to eradicate inflation. A comprehensive program of macroeconomic and fiscal adjustment, aimed at lowering inflation to 10% by the end of 2001. This time the likelihood that the disinflation program will succeed is high for three main reasons. First, there is now political stability and consensus on implementing this inflation-reduction policy. Second, all parts of society are aware that there is no alternative to solving, now, our budget and debt burden problems. Third, the technical foundation has already been prepared. These three factors underline the importance of the new program.

Accordingly, the inflation targets have been set at 25% for the year 2000 and 10% for 2001. Consistent with these inflation targets for the next two years, fiscal policy will be conducted according to a broad-based approach aimed at improving all aspects of public sector revenues and expenditures.

With this effort, monetary policy will continue to be supportive of fiscal policies. Although we should not expect a radical change in the implementation of monetary policy, its efficiency will definitely improve in step with the improvement of the fiscal stance.

I would also like to underline once more the importance of Turkey's recent efforts towards disinflation. As you know, in the 1980s the Turkish economy succeeded in making the transition from a closed economy to a market-oriented one. Turkey aims, through this more recent effort, to build a macroeconomic infrastructure suitable for membership in the global economy, where low inflation and a sustainable growth rate, combined with sound and well functioning financial and real sectors, are the minimum standards.

The last but by no means the least point I would like to make is that we now have an occasion for showing, once more, the ability of the Turkish economy to overcome adversity by meeting the challenge to our resilience following a major earthquake. During the last two years, we have survived the South Asian, Russian and Latin American crises, and also an economic slowdown in the EU region that is an extremely vital trading, financial and economic partner for Turkey. We also had the uncertainties preceding the early election held in April 1999, which tested the resistance of the Turkish economy. I truly believe that we have already passed these exams, and also that we have gained enormous experience. I have always said that we are extremely good in bad times, although we don't like them. This time the situation and prospects are different, and we will show the abilities of the Turkish economy in good times as well as bad. If the program we have begun implementing is successful, that success will affect at least the next 50 years of Turkey's economic and social life.

I believe these messages are clear and will be well understood by our international partners.