2003 MONETARY AND EXCHANGE RATE POLICY

TARGETS, DEVELOPMENTS, RISKS

February 2003

CENTRAL BANK OF THE REPUBLIC OF TURKEY

Outline of Presentation

- 2003 Monetary Policy and Exchange Rate Policy
    - ✓ General Framework
    - ✓ Where are we in growth?
    - ✓ Where are we in inflation?
    - ✓ Stability Program: Points to be underlined
    - ✓ Inflation and Interest rates as policy target
    - ✓ Risks

General Framework

Fundamentals of “Transition Program for Strengthening the Turkish Economy;”

- ✓ **Structural reforms;** especially banking reform
- ✓ **Fiscal discipline**
- ✓ **Tight monetary policy**

Price Stability

Removal of risk for the sustainability of domestic debt stock

General Framework

Basic assumption: **floating exchange-rate regime**

✓ Exchange rates are determined according to the supply and demand conditions in the market.

✓ **Excessive volatility** in exchange rate **may be intervened in a transparent way, if it poses danger to price stability.**

✓ Interventions may be made also in the form of **warnings, announcements** and **controls**.
The less Central Bank intervenes in markets, the less volatile is exchange rate. Adaptation to floating rate regime has increased.

✓ Part of excess fx liquidity in markets may be withdrawn by **transparent and rule-based mechanisms.**

WHERE ARE WE IN THE GROWTH?

Where Are We in the Growth?

- There were serious concerns about the **growth forecast of 3 percentage** made at the start of 2002. However, as the Central Bank we had announced the elements that would positively affect the growth rate both in our press releases and in Monetary Policy Reports. These were:

  1. Turkey's competitiveness edge, which was strengthened in 2001, was destined to exert positive effects on the exports and the growth.
  2. There were signs that reverse currency substitution; in particular the stability in exchange rates could spur domestic demand.
  3. Stability in financial markets was expected to stimulate the deferred investor and consumer spending.
  4. The banking system was being restructured, and the credit volume was expanding.
  5. Inventories that had been rapidly depleted in 2001 began accumulating.
  6. Agricultural output was expected to increase.

- Looking back today, we see that almost all of these issues have been accomplished as predicted, except for the ongoing banking reform.

Where Are We in Growth?

- As of the second quarter of 2002 the economy started to grow.
- GNP grew by 6.2 percent in average in the first nine months of 2002. This development shows that the growth forecast that had been first envisaged as 3 percent for 2002, and that was later revised upward as 4 percent could be surpassed.
- Growth expectations for 2002 reached the level of 6 percent.
- The growth in 2002 stemmed mainly from,
  - ✓ improved expectations due to financial stability ensured by confidence in the program,
  - ✓ high export performance,
  - ✓ increase in agricultural output,
  - ✓ replenished inventories due to expected increase in demand.
- Nevertheless, the basic effect of contraction in output in 2001 due to crisis environment has, to some extent, contributed to the growth.

Where Are We in Growth?

At this point, we must clarify some issues regarding the GNP growth.

1. In 2002, it was frequently asserted in the media organs that the program does not envisage the growth, and that the program cannot get anywhere without promoting the growth. We know from the experiences of other countries implementing stability programs that there are some sections that may become disturbed by the serious fight against the inflation, which is a sort of irregularity.

2. The current program and the reforms in the public sector are also modifying the capital accumulation model in Turkey.

   - ✓ Either voluntarily or unvoluntarily, the capital accumulation model supported by the public sector is being gradually replaced by a model where market conditions prevail, standards of international markets are applied,

   - ✓ However, the reforms in public and private sectors must be well coordinated in order that this process may continue in a sound manner without incurring high costs.

Where Are We in Growth?

3. It is impossible for the real sector to recover itself without completing the banking reform, enabling the banks to resume their credit allocation. Therefore, the real sector should support the banking reform.

   - ✓ The main contribution of the program to the real sector will come from the macroeconomic stability.

     The private companies that are short of capital may obtain long-term financing and grow, only if the inflation, and therefore real and nominal interest rates are reduced, and long-term credit markets are established.

4. It is a fact that the public confidence has been reinforced by the current program and the Central Bank's determination in the price stability. With the stability achieved as a result of the continuation with the program and structural reforms, the confidence of economic units will increase even further.

Growth Outlook

- Estimated growth rate for 2003 is **5 percent**.
- Growth expectations for 2003 is **4,2 percent**.
- Factors that will support the economic growth in 2003 as of today:
  - ✓ Acceleration in **exports**,
  - ✓ The completion of the **banking recapitalization** that will increase the efficiency of the resource transfer to industry will support the growth in this process,
  - ✓ Expected productivity increase with the priority and importance to be given **to policies that will increase productivity** in all economy, **to reforms** and **to tight fiscal policies**,
  - ✓ Favorable developments in expectations arising from strict implementation of the current program,
  - ✓ Expected increase in **investment** and **consumer** spending due to **stability** achieved in interest rates **at lower levels,** and **reduced volatility** in exchange rates resulting from favorable expectations,
- Despite exogenous shocks like the conflict in Iraq, we believe that the public confidence will increase and the growth forecast will be realized, provided that tight fiscal policy is implemented, and structural reforms envisaged in the program are introduced.

WHERE ARE WE IN INFLATION?

Inflation - 2002

In 2002 there are 3 separate periods in terms of price movements.

1st Period (January – May)

- **January: Above expectations**;
  - ✓ Price increase in agriculture goods and food sector due to unfavorable weather conditions,
  - ✓ Rise in some indirect taxes,
  - ✓ The effect of backward-looking indexation mechanism in both public and private sectors.
- **February: Turning point**
  - ✓ Significant retreat in inflation expectations,
  - ✓ Rapid downward trend in inflation.

- Main factors determining the price developments in the first five months of 2003;

  1. **Expectations turned positive**, **stability in** TL and foreign exchange **markets** were achieved and **Turkish lira appreciated nominally** with the restored confidence in the program,
  2. Domestic demand was brought under control with **tight fiscal** and **monetary** policies,
  3. **Good harvest** after March with favorable weather conditions,

2nd Period (May – July)

- **Starting from the second half of May**:
  - ✓ Rapid increase in interest and exchange rates due to uncertainty led to a cost-push pressure on prices.
  - ✓ Increase in public prices and TL depreciation affected consumer prices negatively.

Inflation - 2002

3rd Period (August and thereafter)

- **August and thereafter:**
  - ✓ Inflation returned to its trend as in the first five months of 2002.
  - ✓ With the removal of mood of uncertainty after the general elections, the relative stability in interest and exchange rates improved the expectations.
  - ✓ Although cost-push pressure has been lessened, domestic demand has put no pressure on inflation and price increases remained limited.

In all these periods, sporadic political uncertainties have **influenced short-term inflation expectations negatively**, but **there has been no change in long-term inflation expectations.**

The CPI inflation that dropped to **29.7 percent** as end of 2002 has realized below our 2002 year-end target of 35 percent, which is the lowest end of year level **in the last 20 years**.

Inflation: Outlook

- CPI inflation for 2003, announced jointly by the Government and the Central Bank on 17 December 2002, is **targeted as 20 percent**.
- In this context, 2003 January:
  - ✓ CPI: 2,6 %; annual 26,4
    - ❖ Realizations are within expectations,
    - ❖ The de-seasonalized rate of increase is the lowest since March 2002,
    - ❖ Limiting factors are items from food, durable consumption goods and clothing sector,
    - ❖ Increase in domestic demand is modest.

✓ WPI: 5,6 %; annual 32,6
  - ❖ Above expectations,
  - ❖ The highest rate of increase since November 2001,
  - ❖ Input costs are increased by hikes in crude oil prices and nominal TL depreciation, Basket decreased in December by 0,5 %; increased in January by 6,4 %; Their effects are on prices are delayed.
  - ❖ Price and tax adjustments of public sector, especially in petrolium and chemical products and in monopoly goods.
  - ❖ Hikes in agricultural prices due to adverse weather conditions.

✓ The effect of WPI on CPI will depend on the factors influencing domestic demand, production cost and the developments in Iraq.

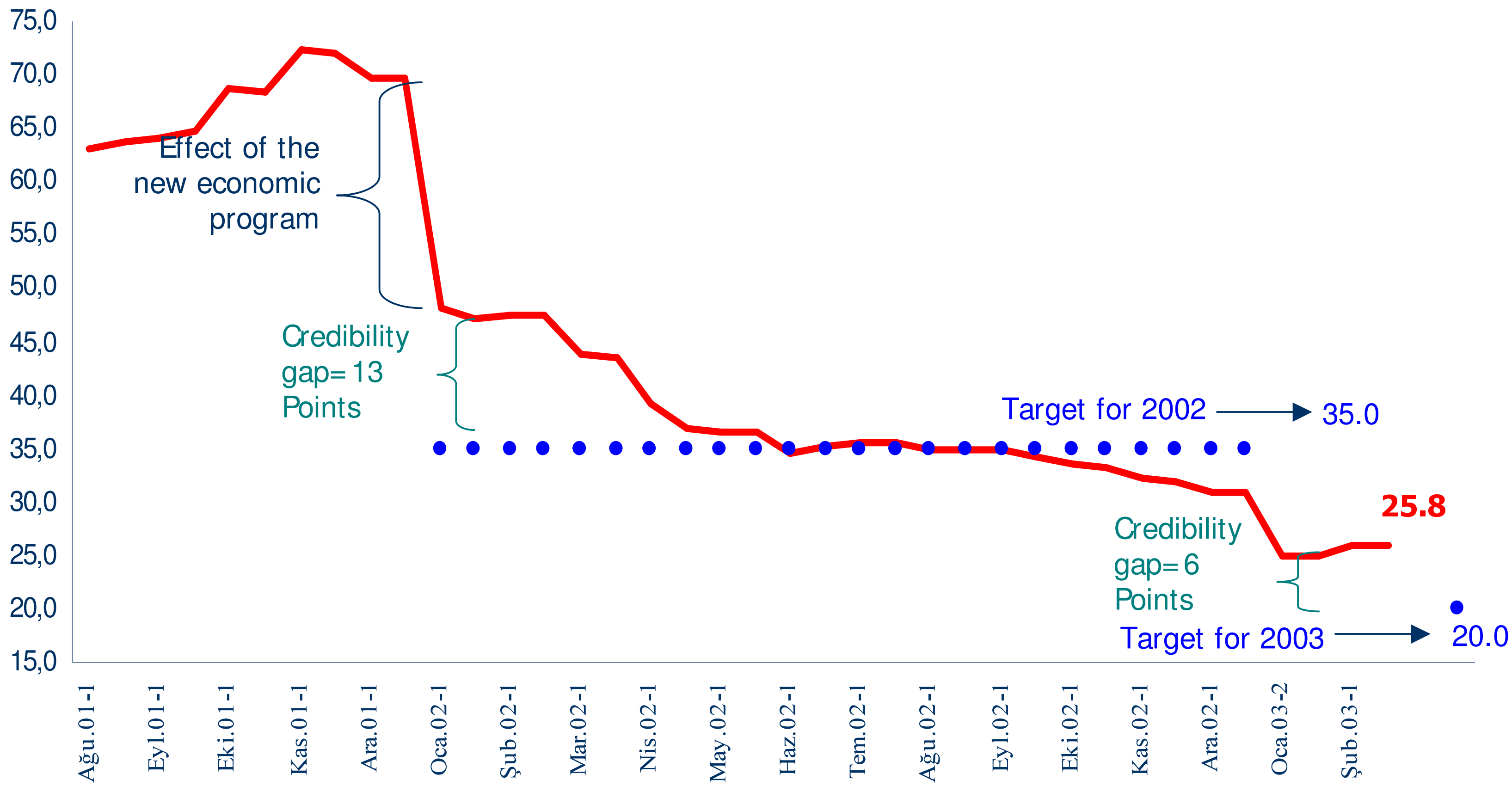
✓ Fiscal discipline and the quality of measures are instrumental in the efficiency of monetary policy and in the achievement of targets.

✓ The rise in WPI is considered to be a temporary deviation, provided that the current program is implemented uninterruptedly and fiscal discipline is attained and carried on.

Year-End Inflation Expectations (Consumer Prices)

Inflation expectations have remained below the Government's and the Central Bank's targets for the first time after a long period.

Although coming closer to the target, inflation expectations for 2003 are still above it.



Credibility gap, which was 13 points when the inflation target was 35 percent, and expectation was 48,3 percent in early 2002, has declined to 6 percent with an inflation target of 20 percent and an expectation of 25,8 percent for 2003.

This shows the improvement of the credibility of the program in one year.

Inflation: Outlook

- Lately, there seems to be some disruption in expectations because of uncertainties related to conflict in Iraq and due to justified/unjustified concerns about the continuation of the program.
- We continue to believe that the year-end inflation target will be met, on condition that perceptions of uncertainty are removed and the program is strictly implemented.

Stability Program: Points to be underlined

- ✓ Is there any alternative to the current program?
  - Any alternative to solve public debt and inflation problem?
  - Crisis-program relationship.
- ✓ The position of the IMF.
- ✓ Consciousness against inflation has not yet developed in our country.
- ✓ - Not having experienced hyperinflation as a result of a high inflation environment in the last 30 years, economic units are not aware of what benefits the price stability could bring to them.
  - The loss of value of the national currency is a result.
- ✓ The fight against inflation necessitates a social consensus. In this context, developing a social consiousness towards inflation will be instrumental in the success.
- ✓ Inflation is no more a problem in almost all countries in the world.
- ✓ The Central Bank is in a stronger position to control money and credit supply.
  Balance Sheet.

Stability Program: Points to be underlined

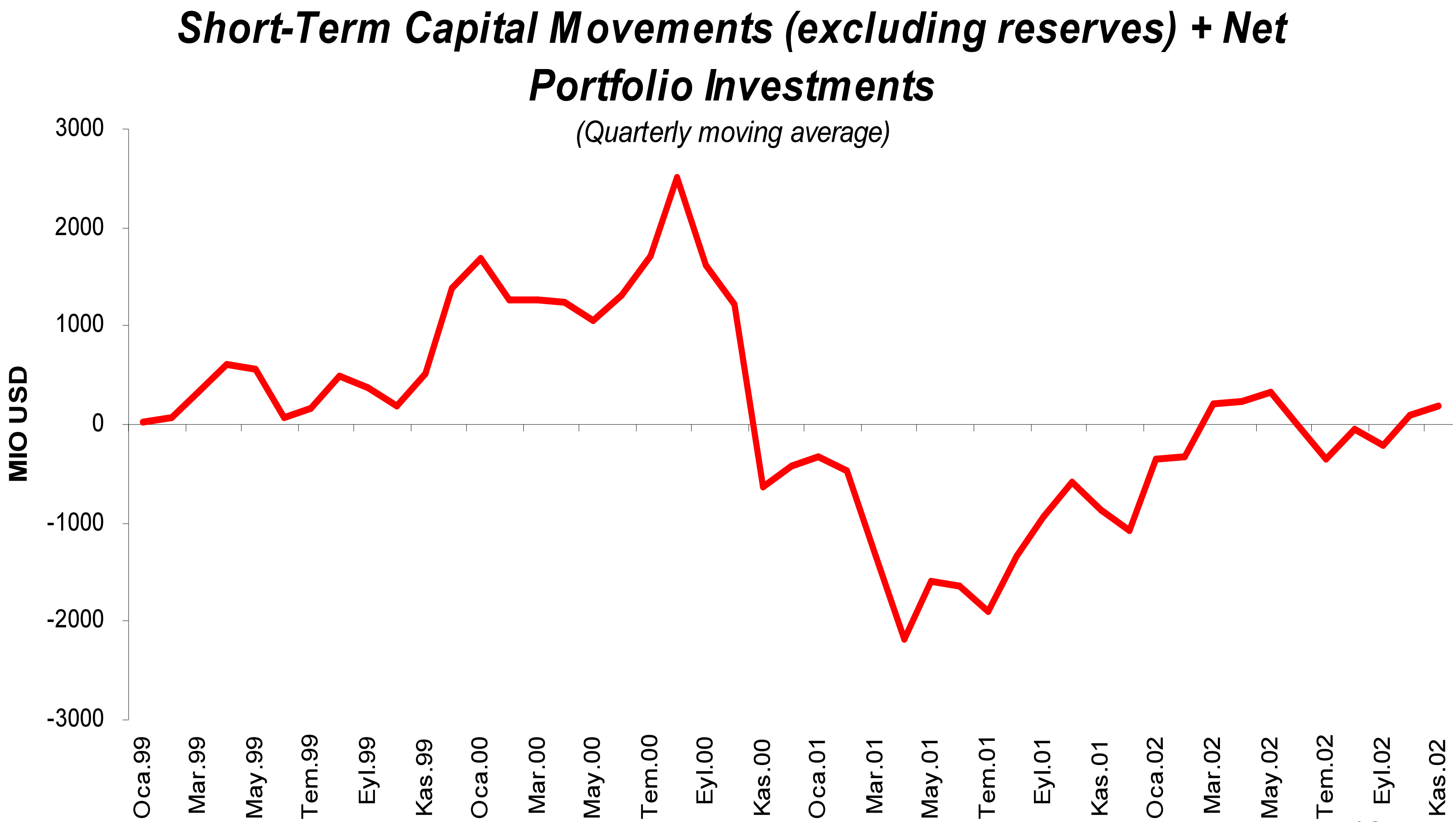
- ✓ Instruments to be used in monetary policy designs;
  - ❖ Before 1980, in which interest rates were controlled and exchange rates were fixed or pegged, in an environment where capital movements were constrained.
  - ❖ In the period of 1990-2001, in which a fixed or currency peg regime was implemented (passive monetary policy) with the liberalization of capital movements.
  - ❖ After 2001, an active monetary policy was chosen and implemented in the framework of free capital movements, and controlled interest rates.

  Result: While capital movements are free, interest rate and exchange rate cannot be controlled at the same time.
- ✓ Under the floating exchange rate regime, exchange rate is no longer a cause of monetary policy, but an effect. Since it is influenced easily by other policy implementations favorably or unfavorably, exchange rate can be easily followed by everybody. For this reason, fiscal and monetary discipline can be best achieved under this regime, as is seen in Latin Amerikan countires.
- ✓ Can the floating exchange rate regime be blamed for the high real interest rates?

Stability Program: Points to be underlined

- ✓ Since exchange rate risk is borne by markets under the floating rate regime, short-term speculative capital movements, which is also called “hot money,” are discouraged to flow in.

  Market players’ behaviors are changed.



Stability Program: Points to be underlined

✓ Under the floating exchange-rate regime, the level of exchange rates is determined according to the following factors;

- ❖ Different kinds of market players; those acting in line with economic fundamentals, technical analysts, speculators,
- ❖ Changes in portfolio preferences of investors,
- ❖ Structural reforms and their effects on productivity,
- ❖ Domestic and international political and economic developments,
- ❖ Expectations on current account balance and capital movements,
- ❖ Public sector debt stock, risk premium,
- ❖ Business cycles in the economy,
- ❖ Economik fundamentals; for example, terms of foreign trade, productivity, fiscal policy, international and domestic inflation rate differentials,

Is Turkish lira overvalued?

✓ Dilemma of growth - inflation.

Static analysis is valid in low inflation countries, in the long-term negative relationship.

✓ Tight fiscal policy and growth.

A long-term and sound fiscal policy is considered as highly positive especially in countries like Turkey which suffer from chronic budget deficit and domestic debt stock. Therefore, it contributes to the improvement of expectations and to the establishment of environment of confidence. As a result, tight fiscal policy helps interest rates to stabilize at lower levels and supports the economic growth by means of stirring consumption and investment, namely boosting total demand (Expansionary fiscal contractions). For example; Ireland, Denmark.

INFLATION AND INTEREST RATES

AS

POLICY TARGET

Inflation and Interest Rates as Policy Target

- Under the floating exchange-rate regime, the Central Bank takes its decisions **by considering the future inflation** only, on its way to achieving the primary objective of price stability.
- The most effective instrument of the Central Bank in the fight against inflation is the short-term inflation rates.
  - Interest rate decisions are based on the following factors:
  - ✓ Surveys on inflation expectations and the CBRT's internal inflation forecasts.
  - ✓ Price-setting behaviours of the public and private sectors,
  - ✓ Exchange rates and balance of payments position,
  - ✓ Wages, employment and unit labor costs,
  - ✓ Aggregate supply and demand,
  - ✓ Fiscal policy indicators,
  - ✓ Monetary and credit aggregates,
  - ✓ International economic and political environment

Inflation and Interest Rates as Policy Target

- Economic units are provided with clearer signals by taking inflation target and forecasts into account only, in other words, by giving up considering, as was the case in the past, targeting other subjects, directly or indirectly, like exchange rate, balance of payments, growth and public finances and supporting banks.

- This is extremely important for;

    1. Bringing **the risk premium** and hence **real interest rates** down.
    2. Achieving **a sustainable growth rate** and an increment in employment rate.

Inflation and Interest Rates as Policy Target

- High real interest rates in Turkey stems not from

  ✓ Nominal interest rates, but from the fragile environment due to previous crises, and high inflation.

  ✓ The result is scarce investments in productive areas, and volatile and low average growth rate.

Bringing the high real interest rates down to acceptable levels in line with the strengthening macro- economic fundamentals under the current program is very important. Keeping the capital cost at reasonable levels is the pre-condition for a sustainable growth and a healthy integration to the world.

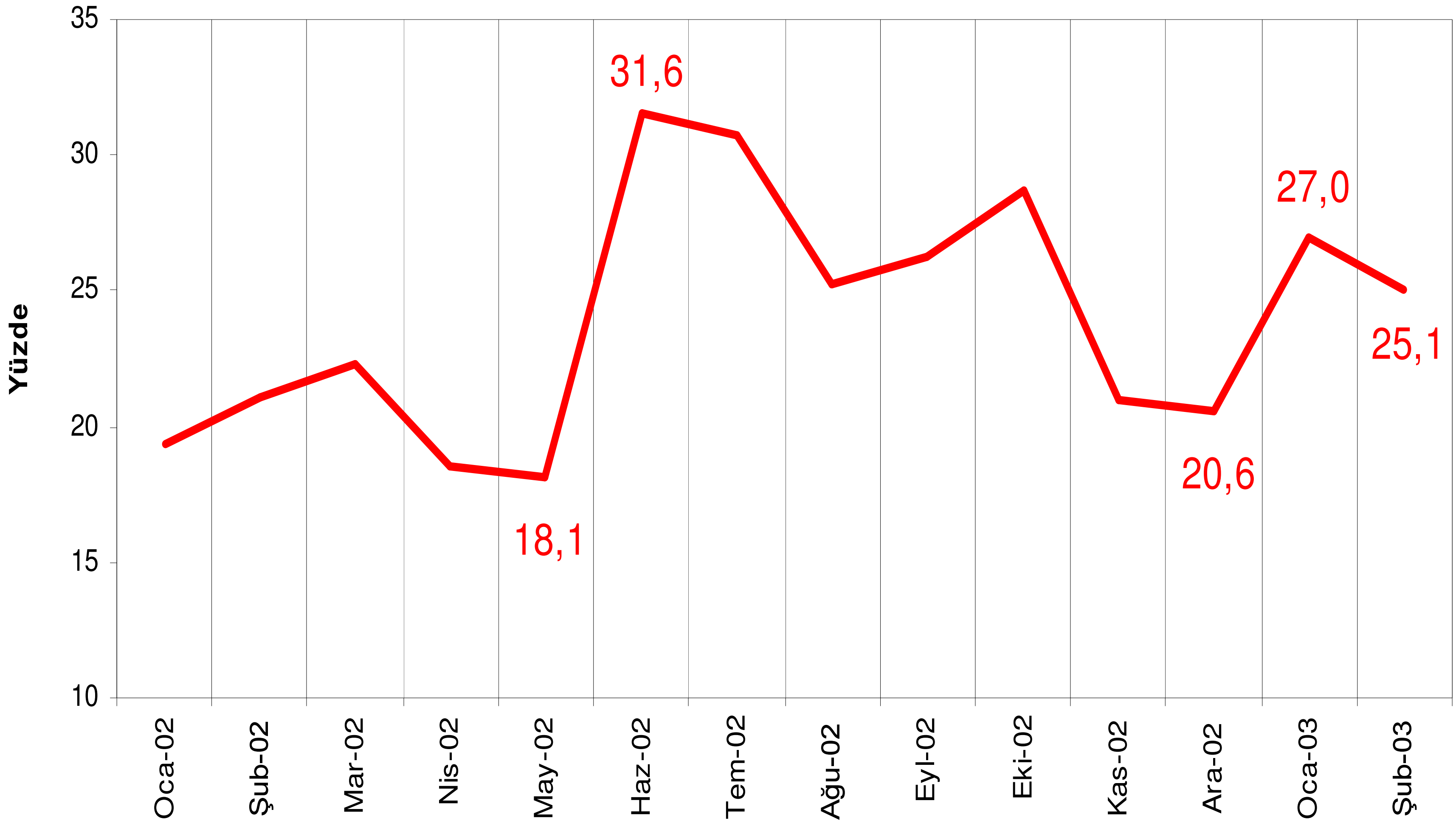
To this end, it is necessary to;

✓ Act with determination in the fight against inflation first of all,

✓ Conduct tight fiscal and monetary policies in harmony and determinedly,

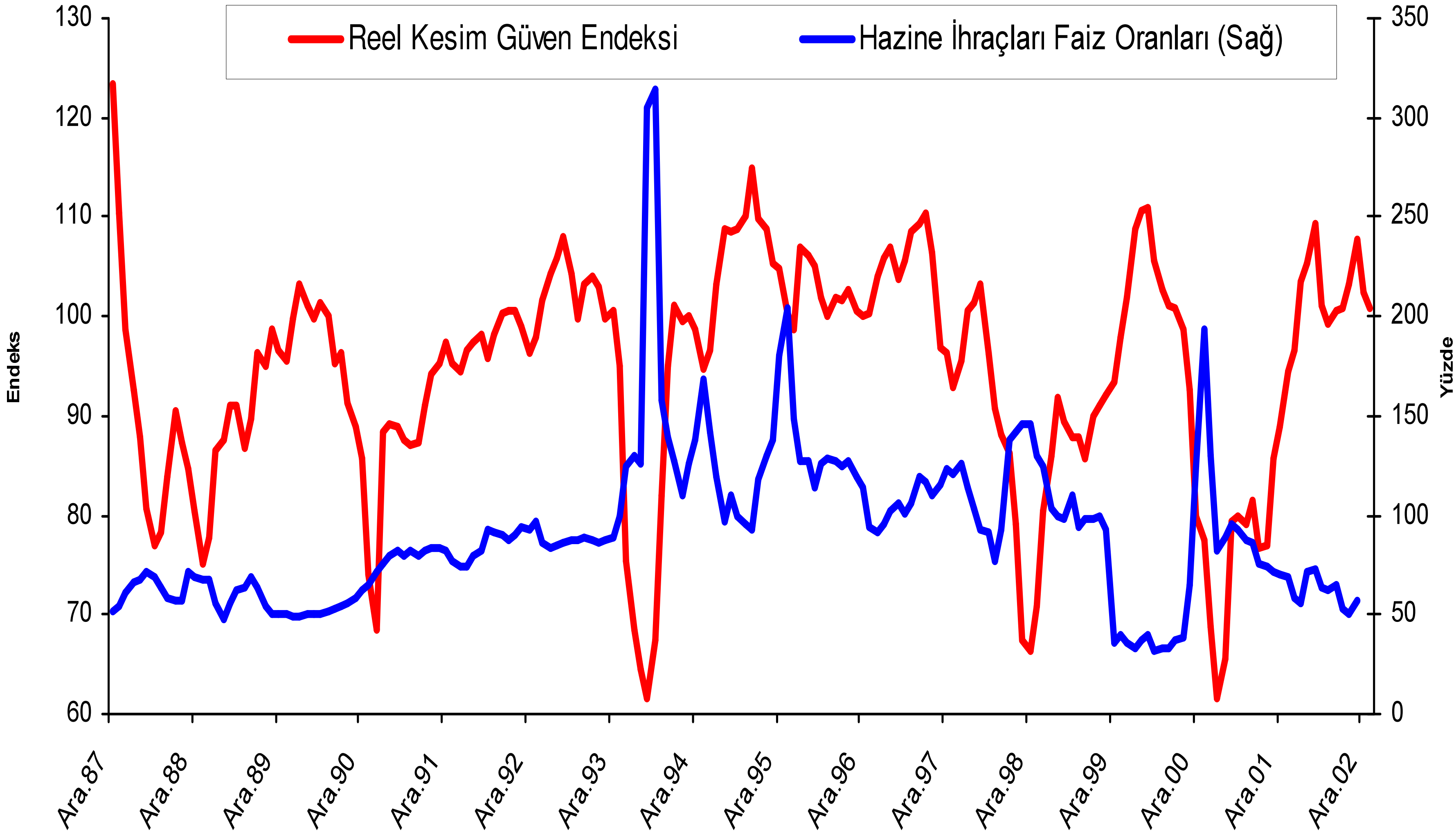
✓ Implement structural reforms that will increase productivity in economy beforehand.

Expected Real Interest Rates in 2002 – 2003



R = (((1 + i) / (1 + ¶)) - 1)
R = Expected real interest rate **(ex-ante),**
i = Nominal monthly borrowing rate of Treasury,
¶ = Inflation expectations for the next 12 months as stated in the CBRT Expectation Survey.

Real Sector Confidence Index and Interest Rates



At times when the expectations of economic units are positive, nominal interest rates falls, and when confidence is lost, interest rates go up.

Real Sector Confidence Index = Expectations on (Business climate + export facilities + investment spending + total orders + inventory of finished goods + total employment + production volume + volume of goods sold to domestic market + raw materials inventory tendency).

When the index goes up above 100, we undertand that expectations have turned positive, when it goes down below 100, it means that expectations have turned negative.

Inflation and Interest Rates as Policy Target

- In the event that **fiscal discipline is achieved**, **structural reforms are continued** and **inflation expectations are improved**, interest rates **are expected to fall down even further** as envisaged in the current stability program.

Risks

Risks on the way to disinflation and growth:

1. **Wrong considerations** and **fixed ideas** pose risk by disrupting expectations.
2. **Relaxation:** CPI inflation remained below the target of 35 percent by realizing at 29.7 percent as end of 2002. However, there is still much to be done to build confidence, which is needed to achieve price stability. Prior credibility has been obtained in disinflation process. But it must be remembered that while it proves difficult to gain credibility, it can slip through our fingers easily by wrong policy implementations.
3. **Difficulty in restoring the public finances**, which has loosened.
   Budget is not a political, but a technical indicator. Bringing public finances under control is necessary for reducing risk premium and hence real interest rates.
4. Designing of **pricing and taxing policies** in line with public sector borrowing requirements,
   Price increments to cover SEE deficits, not envisaged in the program.
5. **Disruption in structural reforms** and continuation of fragility in the economy, Banking and others.
6. **Difficulties in restoring confidence fully** due to various reasons,
   Attention to expectations surveys.
7. **Continuation of backward-looking indexation and price-setting habits** (especially in education, health, housing sectors).

Risks

Risks on the way to disinflation and growth:

8. Higher rate of increase in **food and agricultural prices**, which are beyond our control, with the reversal of downward trend observed in summer,
9. The private sector might take advantage of the revival in demand resulting from the removal of uncertainty and the restored confidence in order to increase their profit margin. This may lead to increase in prices,
10. **Giving emphasis on non-productive considerations** in incomes policy, and continuation of backward-looking indexation in wage-setting.
11. Developments that might create uncertainty like operation in Iraq can cause external shocks such as hikes in International **oil prices** and rapid increases in **energy prices**.

Risk factors are important not only for price stability only, but also for a sustainable growth.

Conducting the current economic program determinedly will minimize the possible effects of these risks, which otherwise might be felt strongly.