MONETARY POLICY IMPLEMENTATIONS
MACROECONOMIC OUTLOOK AND EXPECTATIONS

I. MONETARY POLICY IMPLEMENTATIONS

I.1- General Framework of the Monetary Policy and Exchange Rate Regime

1. In an economy, the choice of exchange rate regime is the key determinant of the monetary policy implementations. In other words, monetary policy implementations of central banks may differ according to which exchange rate regime is chosen.

2. By the Central Bank Law, Turkey's exchange rate regime is determined by the joint decision of the Government and the Central Bank. Besides the fundamental economic policy priorities, the current structure of the economy also plays an important role when choosing the regime.

3. It is possible to arrive at the following conclusions considering the recent developments of the exchange rate regimes and monetary policies in the world and in Turkey: In the economies that are closed or partly open to international capital movements, due to this characteristics of the economy, Central banks can play an important role in determining both the exchange rate and the interest rates. As a matter of fact, Turkey's monetary policy had been based on the "fixed exchange rate, managed interest rate" system before 1980s, as was the case in almost all developing countries.

4. However, all around the world the inward import substitution and the restrictive foreign trade policies were replaced by liberal policies open to outside world in 1980s. In line with these global trends, also Turkey tried to lay, the groundwork for an outward-looking liberal economy, the money, foreign exchange and securities markets were established and developed, besides liberalizing foreign trade during the 1980s. In this period when there were little capital movements, the Central Bank opted for controlling the exchange rate, but managed to retain control over interest rates as well.

5. In 1990s, capital movements became more and more liberal, and gained momentum. This led to huge and sudden capital inflows and outflows that resulted in the crises especially in developing countries. These developments have shaped the course of the world economy.

6. The common peculiarity of the monetary policies pursued in developing countries in this period was that, while fixed or pre-announced exchange rates were in place, the central banks' influence on domestic interest rates remained extremely limited due to the fact that the economies were more open to the world. Under such system, the central banks try to keep the exchange rate levels they have committed, while monetary aggregates and interest rates are largely determined according to the foreign capital inflow and outflow. In other words, the central banks had little control over monetary aggregates in this period. The predictability of exchange rate may accelerate the capital inflows with speculative intentions, as the belief that the sustainability of the exchange-rate regime would continue. However, whenever expectations deteriorate, the speculative capital will run away suddenly, triggering serious crises. In fact, these sudden capital flights triggered the crises in Turkey along with some Far-eastern Asian and Latin American countries.

7. In the world of today, the main concept, which is gradually becoming widespread in the area of the exchange-rate regime, is the "floating exchange rate regime". To put it another way, the central banks are conducting a more active monetary policy, trying to control the short-term interest rates in particular, and allowing exchange rates to be determined under market conditions. Under this system, since exchange rate can no longer be used as the nominal anchor, inflation itself is chosen as the anchor especially to influence expectations. The central banks shape their implementations according to the targeted inflation only.

8. Consequently, there are three basic policy options. Considering these options in the context of Turkey's experience, we may divide the whole period to three sections: **i.** Before 1980's and partially in the 1980-1990 period, in which interest rates were controlled and fixed exchange rate regime was implemented, in an environment where capital movements were constrained; **ii.** The 1990-2001 period, in which a fixed-but-adjustable or pre-announced exchange rate regime, in other words passive monetary policy, was implemented with the liberalization of capital movements; **iii.** After 2001, in the framework of an active monetary policy, free capital movements, and controlled interest rates was chosen and implemented.

9. In light of this information, a closer look into the monetary policy and exchange rate regime being implemented since 2000 reveals that two separate periods are in question in terms of different underlying conditions, despite their final goals are the same. The first one is the currency-peg-based stability program that was initiated at the start of 2000. The second one is the "Transition Program for Strengthening the Turkish Economy", which has been implemented since May 2001. This is a stabilization program that gives emphasis on reinforcing the structural elements of the previous program, and is based on the floating exchange rate regime under which the exchange rate no longer functions as an anchor.

10. While the targets of monetary policy have stuck to the same objective of price stability in these two periods in which different exchange rate policies were in place, they have had different implementations and reflections on the market. As the exchange rate was the anchor in the 2000 program, the monetary policy had almost no influence on short-term interest rates. In this period, the Central Bank born the exchange-rate risk due to its commitment on the predetermined level of exchange rate, leaving the interest-rate risk directly to the market. Under the current floating exchange rate regime, in which the exchange rate has become an exogenous variable, the monetary policy has enabled the Central Bank to increase its influence on the short-term interest rates. In this period, the short-term interest rates have become the basic monetary policy instrument. Under the current implementation, the exchange rate is basically determined in line with demand and supply conditions in the market. The Central Bank makes no commitments whatsoever regarding the level of the exchange rate. Thus, the exchange-rate risk has become an important variable that the market players should consider directly.

11. The above-mentioned different exchange rate regimes implemented in two periods were chosen by taking the prevailing conditions, the goals and peculiarities of the program implemented into account. At this point, it should be remembered that, the currently implemented floating exchange rate regime was also the ultimate goal of the previous program. However, the switch to the floating exchange rate regime became inevitable right after a crisis at a time when the economic foundations were not yet reinforced.

12. When we look into these two regimes, it is observed that both regimes have their pros and cons. As it is easily understandable and followed by the public, the fixed or pegged exchange rate regime can be used as an effective anchor in directing expectations, as long as the fiscal policy is conducted in agreement with the exchange-rate regime, and there is a sound banking system. Moreover, the strong interaction between exchange rate and inflation especially in the developing countries enables the exchange rate to become an effective tool against inflation so long as it is sustainable. However, along with its advantages, such a regime requires the central banks to hold a great amount of international reserves in order to safeguard the exchange rate. Some additional reserve facilities should also be available to preserve the committed exchange rate level for crisis situations. The other disadvantages of the fixed or pegged exchange rate regime are the lack of flexibility to exogenous shocks, and the increase in short-term speculative capital movements.

13. As is also seen in Turkey, under the floating exchange rate regime, a new anchor is needed since the exchange rate is no longer the anchor. And generally, it is the inflation itself that assumes this role within the framework of a monetary policy regime, called inflation targeting. As no exchange rate level is targeted in this regime, keeping a sizeable amount of foreign exchange reserves is no longer needed to defend the exchange rate. As has been seen in similar country cases, a certain amount of reserve is thought to be necessary for a smooth external debt servicing, and for building and preserving confidence that would result in exchange-rate stability. The floating exchange rate regime is quite flexible towards exogenous shocks. In the event of such shocks, any change that may occur in the exchange rate would provide the demand and supply conditions in the markets to be balanced again. Likewise, since such a regime allows the exchange rate to be determined directly in the market, in other words, since the exchange rate risk is born by the market, it would have a discouraging effect on the speculative capital movements referred as "hot money". Although market players make transactions by having their eyes on the sustainability of the committed exchange-rate level under the currency peg regime, they have to consider all other market players' behaviors towards exchange rate before taking any action under the floating exchange-rate regime. This structure not only constrains short-term speculative capital movements (hot money) by urging all market players to be more careful, but also contributes to the achievement of exchange rate stability by preventing high movements in the exchange rates.

14. Under such regime, the factors that determine the short-term exchange rate level are as follows: the changes in the residents' and non-residents' preferences in their domestic currency and foreign currency portfolios depending on domestic and international interest-rate differentials and expectations; the domestic and international political and economic developments, and the prospects and realizations for balance of payments. In Turkey, exchange rates are subject to volatility because of the frequently occurring political instability, or the politically-motivated decisions that are not based on the requirements of the economy, giving the impression that there would be a deviation from the current economic program; the fact that the foreign exchange and forward transaction markets are not yet established; and the culture of managing exchange-rate risk is not yet taken root sufficiently in both financial and real sectors. The level of exchange rate is mainly determined by all these factors. As to the long-term exchange rates the gap between domestic and foreign countries' inflation rates also becomes crucial. This issue is elaborated in detail in the following 99th, 100th and 101st paragraphs.

15. As to the concern that the floating exchange-rate regime might increase the uncertainty and then the risk premium on the borrowing instruments, the international academic studies show that, when borrowing, there is no evidence that the countries adopting floating exchange-rate regime pay more risk premium than those adopting fixed or pegged exchange rate regime.[1]

16. Similarly, the floating exchange-rate regime is an easy-to-follow and visible system, under which there is no commitment for the exchange rate level, and the determination of which is left to market. Therefore, any positive or negative effect of other policy implementations would have direct implications on the

[1] Felipe Larrain B., Velasco Andres, "Exchange Rate Policy in Emerging Markets: The Case for Floating", April 2001.

exchange rate. For this very reason, the fiscal and monetary discipline can be achieved more effectively under the floating exchange rate regime, as evidenced in the Latin American countries

17. Another advantage of floating exchange regimes is that since the exchange rate risk is born by markets, the economic agents are encouraged to bear their risk exposures arising from their short foreign exchange positions to the extent that that they can control by themselves. Accordingly, the floating exchange-rate policy should exert a more effective control on the extent of short positions than the currency-peg regimes does, when it is considered that sizeable short positions held by economic agents is the primary reason of the huge slump in the output after crises, due to deterioration in the balance sheets and cash flows resulting from a jump in the exchange rate.

18. Success of our monetary policy strategy under the floating exchange-rate regime depends on the existence of certain factors. These are; the continuation of the effective conduct of the floating exchange rate regime with strict determination in order to achieve price stability, which is the ultimate goal of the monetary policy; the maintenance of the primary surplus in line with the targeted limits to decrease the public debt stock; the completion of process of restructuring of the banking system; the activation of fund transfer channel between the financial sector and real sector permanently; and the strengthening of the role of private sector in the economy.

19. The point we have reached today allows no return to fixed or predictable currency peg regimes. The confidence in such regimes has been lost due to bad past performance that ended up in crises. In Turkey, the resumption of a fixed or predictable currency peg regime is impossible, since it has lost confidence, and the current monetary policy is targeting inflation itself without making any commitment to any other variable like exchange rate for the success of the inflation targeting system. When we look at international practices, we also see that currency peg regimes are disappearing rapidly.

20. Another issue brought on the agenda regarding the exchange-rate regime is whether it would be possible to switch to Euro unilaterally before becoming a member of the European Union. In our opinion, this is certainly not possible. Because in such event, the Central Bank would be deprived of its function of "lender of last resort". In other words, the Central Bank would not be able to intervene in the situations that might occur in financial markets and that would require the elimination of liquidity problems. Because it is not be possible for the Central Bank to provide liquidity in a currency that it does not issue. When evaluated in the framework of the current economic conditions in Turkey, it is all the more important to preserve the Central Bank's function of "lender of last resort" in view of the high public debt stock, and the relative fragility of the banking sector. Another drawback of switching to Euro unilaterally is that the Central Bank would no longer be authorized to issue money and the Central Bank, which has the exclusive privilege of printing money, would be devoid of real revenue, namely the seigniorage that is generated by printing money, and then is transferred to the Treasury. Moreover, the European Central Bank is known to be against to the switching to Euro unilaterally.

21. Finally, the adoption of floating exchange rate regime was decided upon jointly by the Government and the Central Bank. Therefore, the Government and the Central Bank are jointly responsible for the current exchange-rate regime. This joint power and responsibility in choosing the exchange rate regime is stated in the current legal framework, as it was in the past. However, the exchange-rate policy, in other words, the proper implementation of the chosen exchange-rate regime, is the Central Bank's responsibility.

I.2- Inflation as a Policy Target and Interest Rates:

22. Today, the Central Bank makes all its decisions by considering the future inflation with the aim of achieving price stability, which is its primary goal. Under the current policy implementation, taking just the future inflation into account is providing clearer signals to the economic agents unlike past experiences, when conflicting signals were given by targeting and considering variables such as exchange rates, balance of payments, growth, and supporting public finance and banks, directly or indirectly. This is very important for decreasing risk premiums on investment instruments and bringing real interest rates down to a reasonable level in harmony with the economic fundamentals. Only then can a sustainable growth and an increase in employment be attained in Turkish economy.

23. High real interest rates have long been a problem in our economy. Having soared above the reasonable levels and the world averages for a long time, high real interest rates have become both the cause and effect of many crises and distorted economic structure. Today we see that, high real interest rates cannot be attributed to the elevated nominal interest rates, but to the crises occurred, to the high inflation, and to the resulting fragile environment. It is extremely important to decrease the high reel interest rates to a reasonable level, in line with the reinforced macroeconomic fundamentals under the current economic program. Reducing the cost of using capital to acceptable levels is the precondition for a sustainable growth and a sound global integration. To this end, the inflation must be fought with determination, the current tight monetary and fiscal policies must be pursued uncompromisingly in the future as well, and structural reforms aiming at productivity increase in economy must be realized rapidly. Once these policies and arrangements are brought to life, the economic units will gain confidence in the policy-makers and in the policies implemented.

And the risk premium, which exists within the interest rates and results from the uncertainty, will then decrease, and both real and nominal interest rates will be stabilized at much lower levels.

24. Within the framework of the program, the main instrument we are using towards our main goal i.e. the price stability is the short-term interest rates. By managing short-term interest rates, we are aiming to shape expectations and economic decisions with a view to our targets. Therefore, it is vital for the public to fully understand how we take our decisions on interest rates, if are to demonstrate our determination to beat inflation and to get the anticipated results of our implementations in due course. When we take interest rate decisions, we consider a number of variables to forecast the future inflation. These are:

- Expectation surveys and the Central Bank's internal inflation forecasts,
- Price-setting behaviors of public and private sectors,
- Exchange rates and balance of payments,
- Wages, employment and labor-force unit costs,
- Total supply and demand,
- Fiscal policy indicators,
- Monetary policy indicators and credit aggregates
- International economic developments.

25. In the conduct of our policies, we have considered the developments in all these variables in the context of the targeted inflation rate and we have taken decisions for the realization of the targets. In the January-April period, we proceeded to cut our short-term interest rates successively in a controlled manner in the light of the evaluations made on the indicators above. In this period, our overnight borrowing rates dropped from 59 percent to 48 percent, by 11 points, while one-week borrowing rates dropped from 62 percent to 49 percent, by 13 points. However, starting from May, despite the increasingly positive economic indicators, the volatility that occurred in the money and foreign exchange markets especially due to the political uncertainties, and the resulting slowing-down in the favorable expectations stood as a serious obstacle to short-term interest rates cut. In August 2002, since the date for the general elections was set, important steps were taken in the process of accession to the European Union, public sector price increments, which had been delayed, were made within the limits of the program, and the problem of deficits of public economic enterprises was resolved for that period, we had seen encouraging developments taking place on inflation expectations and realizations, then we cut interest rates.

Table 1. Developments of the Central Bank Short-Term Interest Rates

Maturities	Quotations	Previous Rates	Feb.20 2002	Mar. 14 2002	Apr. 8 2002	Apr. 30 2002	Aug. 5 2002	Nov. 11 2002
(O/N)	Borrowing	**59**	**57**	**54**	**51**	**48**	**46**	**44**
	Lending	**62**	**62**	**61**	**58**	**55**	**53**	**51**
1 Week	Borrowing	**62**	**59**	**55**	**52**	**49**	**46**	**44**

26. Since August 2002, the Central Bank has been focused on the 2003 inflation in its monetary policy application. There was no cut in the short-term interest rates until November 2002 due to the risk that inflation expectations might be worsened by the uncertainty resulting from the elections, the deterioration in the public finance, and the delays in some structural reforms.

27. With the removal of the perception of political uncertainty, and considering the favorable effect of the increasing likelihood of continuation of structural reforms and fiscal discipline due to the successful track record of the current program, on the inflation expectations and the other issues that determine the inflation, the short-term interest rates were reduced again on November 11, 2002. As envisaged at the start of the ongoing stabilization program, further cut in interest rates is expected provided that the fiscal discipline is restored by ending the relaxation of the last six months, the structural reforms are continued, and inflation forecasts are influenced favorably.

I. 3- Monetary Targets

28. Under the current monetary policy, the Central Bank has set periodic targets on the base money aggregates to function as a nominal anchor needed by the economy until the adoption of official inflation-targeting regime. However, it is envisaged that, rather than base money developments, it is the prospects of future inflation that should be considered first in the monetary policy decisions. In other words, the nominal anchor of the current program becomes an implicit inflation target, and the Base Money also functions as an additional anchor. Despite some of its disadvantages[2], the base money has been chosen because it is an aggregate that can put the monetary program on the right track in the transition period, and it can be easily understood and followed by the public. However, the Central Bank will make the necessary adjustments in its monetary policy in line with the targeted inflation by raising the interest rates in the event of a predicted increase of inflationary pressures in the future, even if the the targets for base money are met.

[2] There are some important disadvantages to use a monetary aggregate as a nominal anchor: i. Because of the difficulty to forecast the demand for the money in an economy, it can be difficult to determine the target of a monetary aggregate. ii. In the economies with chronic inflation history, the relation between inflation and monetary aggregates lessens and this becomes an obstacle against fighting with the inflation.

29. Under the current monetary program, the Base Money target has been set to be consistent with the real GNP growth and the targeted inflation rate. In this context, base money is targeted to increase by 40 percent in nominal terms as end of 2002. Nevertheless, it has been stated at the beginning of the current program that target values may be revised due to developments in money demand like strong reverse currency substitution until the adoption of the inflation targeting.

30. The entire framework of monetary policy and its applications are influential for economic agents in directing their inflation expectations toward program targets.

31. At this stage, it will be helpful to underline once again that the continuation of tight fiscal policy and planned structural reforms are reducing the cost of fighting inflation on one hand, and are supporting the efficiency of monetary policy by reducing the differences between inflation expectations and targets on the other hand.

I. 4- Inflation Targeting

32. In the final design of our monetary policy, it is envisaged to switch to inflation targeting regime when proper conditions are established. Under the inflation-targeting regime, the monetary policy will directly target at the inflation itself and this target will be the nominal anchor of the system. In other words, inflation target will become a reference point for the economic units to be used in their decision making process and in their expectations for inflation. In this regime, the Central Bank will make use of its monetary policy instruments exclusively for achieving the inflation target. Success in meeting the announced targets will enhance the public confidence in the Government and policy makers.

33. Under the floating exchange-rate regime, the Central Bank does not have any exchange rate target in the design of inflation targeting policy, which is being conducted implicitly at present, and which will be conducted officially in the future. During the conduct of such system, it is the inflation itself that will become the sole target, and the Central Bank will, at its discretion, take action against the shocks causing inflation considering their roots and expected duration, within a large room of maneuver, without feeling itself restricted by any other factors and limitations.

34. The inflation targeting policy will increase the Central Bank's responsibilities and powers and expand its scope of movement. Therefore, the fundamentals in drafting the policy must be defined very clearly.

35. Bringing the inflation down is the common objective of the Government and the Central Bank, as it directly concerns all sections of society, and it is the *sine qua non* pre-condition for sustainable growth, which is the main goal of the current program.

36. As beating inflation becomes the primary objective, the inflation targeting policy has precedence over the other policy targets when it comes to inflation. In this context, financial stability is an auxiliary goal that has to be pursued due to its effect on inflation.

37. With the inflation-targeting regime, the aim is cutting inflation rate to one-digit figures, and remaining at these levels. Therefore, the targeting is expected to cover a long period. However, achieving a 35 percent inflation projected for 2002 is vital for the prior credibility of its implementation, and this has been realized.

38. Under the inflation-targeting regime, choosing an index, which will determine the inflation target, is of great importance. This index should be easily understandable and it should reflect the realities of daily life in order to elicit the public support. The consumer price index (CPI) is the most appropriate index for this purpose. On the other hand, the said index may have some drawbacks. Since the CPI index includes items such as food and energy that can directly be influenced by weather conditions and external developments that are beyond our control, there may arise difficulties in keeping it under control. In order to monitor the inflation tendency more efficiently, we are also monitoring and using in our policy evaluations the core indexes that do not include items like energy, foods and indirect taxes that are open to exogenous effects (energy prices, seasonal factors, fiscal policy, etc.). What is important here is that, the choice of target and index involves a trade-off between the credibility and flexibility. Setting targets in a wide interval, excluding some elements from price indexes, and designing a flexible framework may mean that inflation-targeting policies enjoy less credibility.

39. At this point, it is important to ascertain the nature of the target. There are a variety of applications like point targeting, interval targeting, and interval targeting around a central value. In literature, the discussions are concentrating on the point target, the interval target, and the interval bandwidth. If a point target is chosen by announcing the inflation target as a single figure, the chances of deviation from the target are high due to food and energy price increases that are beyond control in the early periods of inflation targeting regime. On the contrary, point target has the advantage of being easily monitored by the public. In the event of choosing an interval target it should not be ignored that, although the Central Bank may respond to the shocks in the economy more flexibly, the inflation expectations would tend to materialize closer to the upper limit, creating difficulties for monetary policy. Nevertheless, a narrow interval would make the inflation targeting more binding, increasing the volatility of interest rates. There is view that band targeting is more suitable for countries where the inflation-targeting regime gets started with high inflation figures.

40. Moreover, under inflation targeting, it is also important to determine how often the index chosen as target is controlled. Targeting of an annual inflation figure by controlling this figure once a year appears as disadvantageous due to the negative impact on the credibility of the Central Bank. However, at the same time it has some advantages that the Central Bank would focus on the fight against inflation for a longer term and smooth the shocks in the economy more efficiently. In this context, one of the applications is that annual inflation figures are being monitored on a quarterly basis as an indicator. Good communication must be established between the Central Bank and the public in pursuing a policy of relating the annual inflation figure, measured in quarterly periods, to the annual target.

41. After setting the inflation target together with the Government, the Central Bank has a joint responsibility for achieving this target with the Government. Therefore, the Central Bank will freely employ all its policy instruments for achieving this target only. This responsibility requires that the Central Bank should only focus on beating inflation, without pursuing any other target. In addition, it is normal for the Government to pursue the fiscal and incomes policies that are consistent with the inflation target.

42. Under inflation targeting, all decisions are made by considering future inflation. The decisions like a change in interest rates will have impact on the inflation with a time lag. Therefore, it is of utmost importance to have efficient forecast models and to ensure that transmission mechanisms operate in a sound manner.

43. Setting long-term targets and showing determination in achieving the targets are the other important factors that shape the expectations as desired.

44. The pre-conditions for the successful implementation of inflation targeting are:

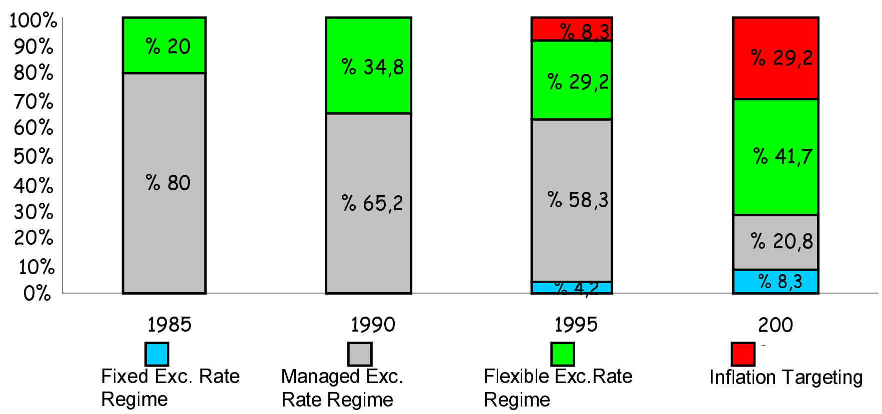
i. To establish the concept of responsibility in the public finance,

ii. To ensure financial deepening,

iii. To stop the past inflation from determining the future inflation; to reduce backward-looking indexation mechanisms in wages and prices,

iv. To resolve the problems that may arise in relative prices with the flexibility to be established in goods and factor markets.

Figure 1. Monetary Policy Regimes in Developing Countries



Source: IMF, World Economic Outlook, May 2001, p. 134.

45. When we look at the worldwide inflation-targeting implementations, the picture that appears as following: The number of countries that have openly switched to inflation targeting has rapidly increased in the course of time. While none of the developing countries was implementing such regime in 1985, their monetary policies having been based on exchange rates. 29 percent of these countries explicitly adopted to inflation targeting in the year 2000. In the light of the implementations up to now, it has proved to be the most appropriate regime especially for developing countries.

46. Following the implementation of the inflation targeting, we see that inflation has dropped in these countries, because the inflation targeting has reduced the pass-through effect of past inflation to current inflation, decreased the inflation expectations and increased its effects on the current inflation. It is also observed that the rigidity in inflation has weakened gradually. This structure was tested successfully against unfavourable shocks as was observed during the 1997 Asian Crisis, in the 2000 petroleum shock, in Australia, in Chile and in Israel.

47. The said countries have switched to floating exchange rate regime along with the inflation targeting. Over time, it has been observed that the central role of the exchange rate in guiding the economic activities has lessened and its effect on the inflation has weakened. In other words, the exchange rate has progressively lost significance for the central banks as a policy target.

48. It is debated that disinflation programs may lead to inflation-growth trade-off in the short-term, and that this trade-off becomes more evident under the inflation-targeting regime. This issue is elaborated in more detail in the presentation of "Price Stability". However, when we look at developing countries adopting the regime, the sacrifice ratios, in other words, the initial shortcoming occurred in the economic growth with starting to the serious disinflation efforts after a crises has decreased; the ability of the current policies to react to slump in production has improved: likewise, volatility in growth rates has somewhat been reduced, and the growth rate has increased.[3]

[3] Corbo, V. and others, 2001, "Assessing Inflation Targeting After a Decade of World Experience", Journal of Economics and Finance, Vol.6, pp. 343-368.

49. As of today, when we evaluate the pre-conditions needed for switching to inflation targeting, we see that significant progress has been made in many fields.

50. The Central Bank independence, one of the crucial issues in this regard, has been achieved and guaranteed by our amended Law. By Law, achieving and maintaining price stability has become our sole and primary objective. The instrument independence is in place in order to accomplish the inflation target, after being set jointly by the Government and the Central Bank. As a stipulation of the responsibility assumed and the independence granted accordingly, all essential issues on transparency and accountability are also stated in the Central Bank Law.

51. Fiscal policy is very important, if the inflation targeting policy is to succeed. The Treasury's new Borrowing Act is a significant step in this regard. The Act will bring an automatic discipline and transparency to the public sector, and thus will facilitate the adaptation process of fiscal policy to inflation targeting. Naturally the coordination between the borrowing and monetary policies should be given a special emphasis.

52. Another important issue is to make sound forecasting and policy analyses and to expand the information base as well. Our Bank has attained a significant progress in this regard. Technical support is being obtained from international institutions and other central banks. We continue undertaking works on short and long-term forecasting models; statistical models based on leading indicators; time series models; structural dynamic models; judgmental models and general equilibrium models. As to expanding the statistical information base, "Industrial and Financial Sectors Expectation Surveys" are conducted. In addition, a basket of goods and service prices that is determined according to certain criteria is monitored on a daily basis to analyze the course of retail prices in a month. The planned study on measuring the consumer confidence in order to follow the developments in expenditure pattern of the economy, and on the price-setting behaviors of the firms are underway. Moreover, the compiled data, and the analyses are being increasingly made public through our Web site.

53. However, there exist a number of risks that may have an impact on the successful conduct of this regime, as seen also in other developing countries. Drawing attention to these risks at the moment is important in order to be prepared for such risks in the future.

54. These are:

- Perception of domestic and foreign political and economic uncertainty, exogenous shocks,
- Deterioration in expectations in the event of a failure in executing structural reforms as planned, and a failure in reducing the cost of lowering inflation,
- Inflation rigidity in housing (rent), education and health sectors,
- Persistence in the habits of backward-looking price-setting, failure in bringing the price-setting and incomes policies in line with the inflation target,
- Failure in establishing a permanent rehabilitation in banking sector that is necessary for an effective and timely functioning of the monetary policy transmission mechanism, failure in improving the competitiveness by increasing essential measures on managerial and legal issues and the resilience to external shocks,
- Losing the harmony between the fiscal and monetary policies,

55. Following the favourable developments during the transition process to inflation targeting, it was planned that implementation of inflation targeting would be started at the end of the year 2002. However, a number of factors have obliged us to set a later date for switching to inflation targeting regime.
These are: Developments in the political sphere affecting expectations, pressures exerted on the debt management in 2003 due to rising interest rates in the period before the general elections, deficits arising from social security system, the risk of deterioration in the public finance, due to delays in tax collection and the resulting probable increments in public sector prices, relaxation in incomes policy, lack of clear-cut information on the 2003 fiscal policy due to election process, which is vital for the design of the inflation-targeting regime. We intend to start the implementation of inflation targeting regime officially in 2003, after we have had a clearer picture.

56. At the initial stage of inflation targeting policy, the monetary policy conducted by the Central Bank must be prudent, fiscal and incomes policies involving structural reforms must be stronger within the framework of the economic programs implemented. This is very important for the developing countries like Turkey, where domestic debt stock imposes pressure on domestic markets.

II. MACROECONOMIC OUTLOOK AND PROSPECTS

II. 1- Outlook for Financial Markets

57. The initial conditions are one of the crucial elements on the success of any policy implementation. Therefore, it is useful to make a comprehensive evaluation of the current economic situation under the heading of the macroeconomic outlook and prospects.

58. After what has been done under the "Transition Program for Strengthening the Turkish Economy," which was introduced in May 2001 aiming at putting the economy on a non-inflationary sustainable growth path, the resulting financial indicators show that the Central Bank intervention to foreign exchange markets has been reduced, as required in a floating exchange-rate regime. The level of exchange rate is being determined by market players under the market conditions. Under such environment, while the Central Bank intervention is reduced, the exchange rate volatility tends to decrease despite the fragility of expectations from time to time. The realization of these two facts together points out that the market players are increasingly adapting themselves to the floating exchange rate regime.

Figure 2. FX Transactions

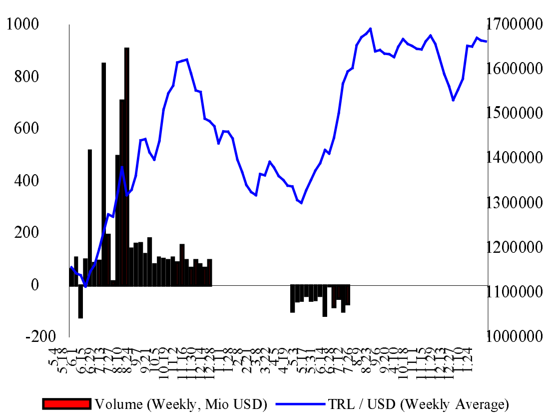
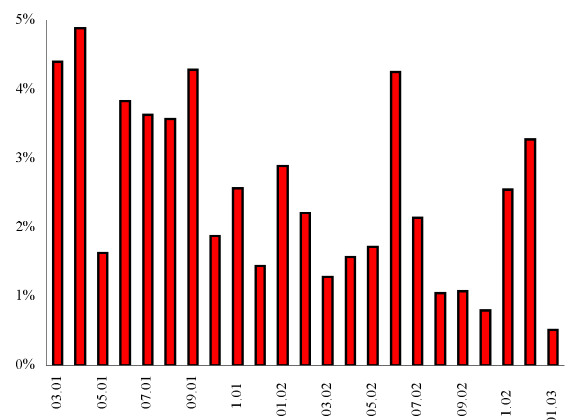


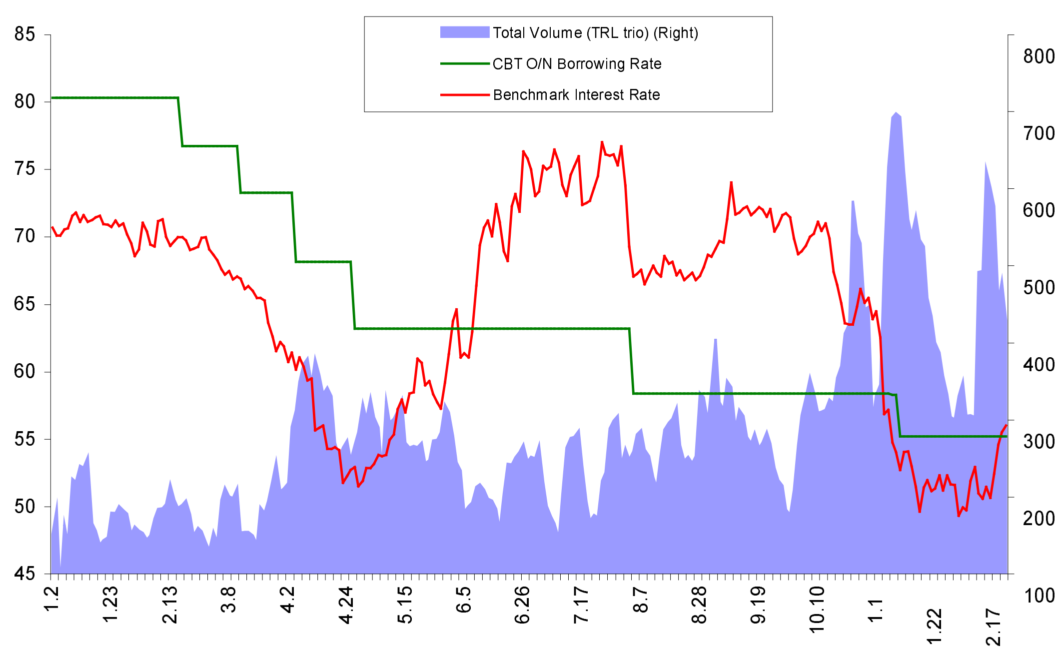
Figure 3. Volatility in FX Rates



59. A look into the course of interest rates reveals that there was a sharp decline in interest rates when the program had started and made progress thereafter, but then we see an upward tendency again due to uncertainties following political developments starting in May. The mood of political uncertainty exerted an adverse effect on the exchange rates and the Turkish Lira depreciated during that period too. Moreover, the risk premiums in Turkish Euro bonds in international markets increased and their yields declined in the same period.

60. In November 2002, the political uncertainty was relatively removed following the general elections. Domestic interest rates dropped, and transaction volumes expanded resulting from the stable environment created by the confidence felt in the continuation of the current program.

Figure 4. CBT Interest Rate, Treasury Bonds and Bills Benchmark Interest Rate and Transactions Volume



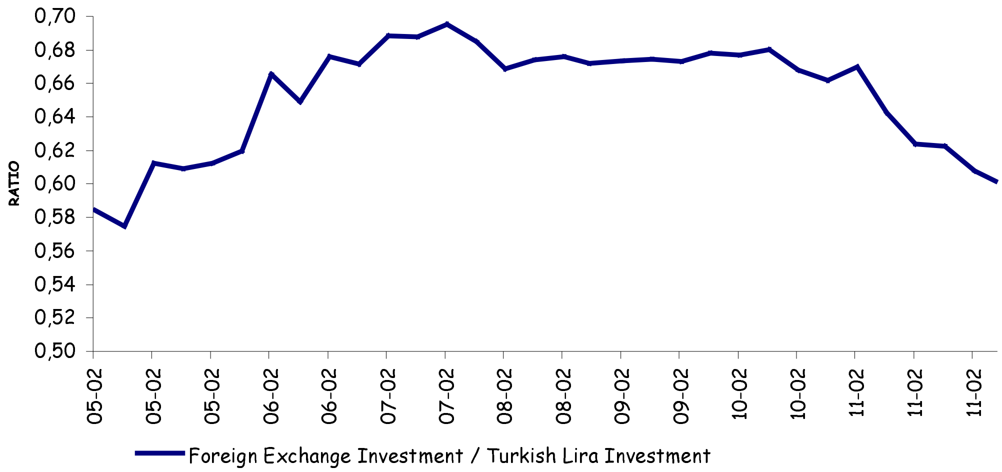
61. Significant drops were observed in the interest rates of Turkish bonds traded in international markets.

Figure 5. Turkish Eurobond Spreads*

Source: JP Morgan MB+ Index, Turkish Data.

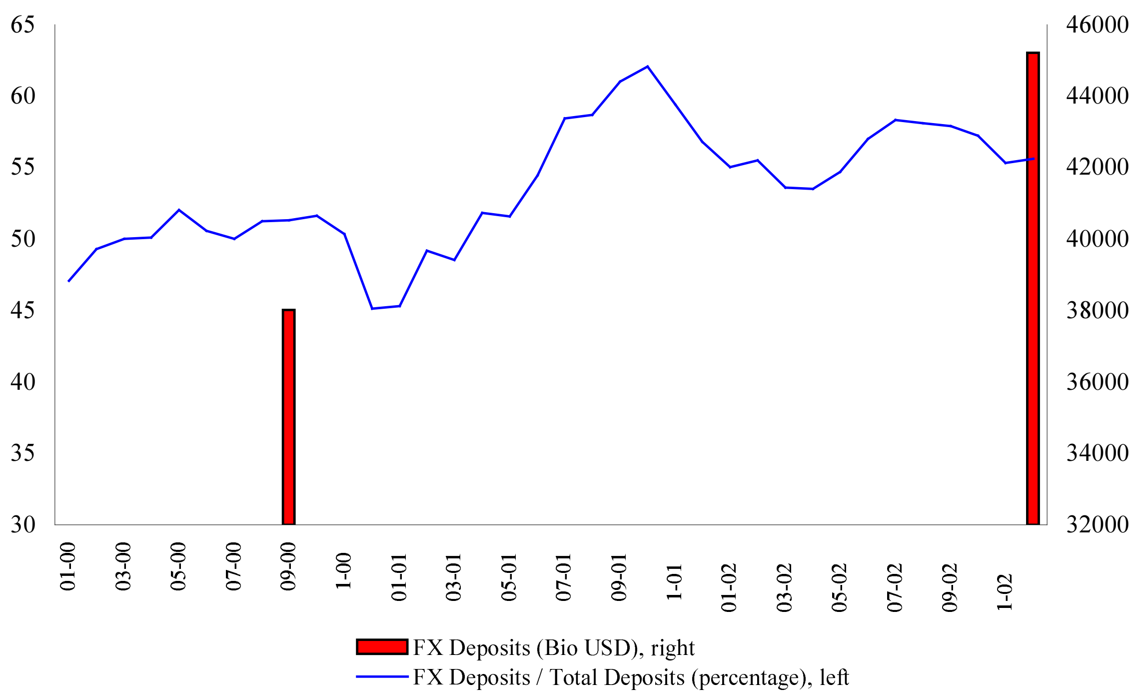
62. In terms of investors' portfolio preferences, we witnessed a rising tendency towards investments in foreign currency once again during that period of political uncertainty. However, this should not be taken as a resumption of currency substitution. The increasing tendency in foreign currency investments can be attributed to the fact that investors preferred to invest in foreign exchange due to the political uncertainty that started in May. In contrast, with the relatively stable environment achieved in the last period, we have been observing resumption in Turkish Lira investments since the beginning of September 2001 when the foreign currency denominated deposits within the total deposits stopped increasing, and the foreign exchange denominated investments declined, as it can be seen in the Figures below. This is another indicator of the progress that we have achieved in restoring the confidence in Turkish Lira despite the temporary ambiguities in the political field.

Figure 6.a. Non-Banking Sector Resident's Portfolio Preferences



Turkish Lira Investment = Banknotes in circulation + (Deposits + Government Issues + Special Financial Institutions Participation Account + Securities Mutual Found) in TRL+ Repo + Stocks
Foreign Exchange Investment = (Deposits + Government Issues + Special Financial Institutions Participation Account + Securities Mutual Found) in FX

Figure 6.b. Foreign Exchange Deposits / Total Deposits



63. As a result, although scores of economic indicators have rapidly turned out to be favorable with the implementation of the program, financial market indicators have stopped improving despite the better-than-expected performance of the economy, and have moved away from economic fundamentals by entering into a "wait and see" period due to political developments since May. The financial indicators started to recover again in November thanks to optimistic and stable environment created by political stability after the general elections, coupled also with the positive economic developments.

64. However, as witnessed in the recent weeks, some justified/unjustified concerns regarding to the continuation of the program may lead to sharp deteriorations in the expectations, putting the program targets in danger.

II. 2- Where Are We in Terms of Growth?

65. When we look into the economic data on the GNP growth, we see resumption in the GNP growth, leaving behind the contraction in output experienced after the crisis. In 2002, the Turkish economy re-entered into a growth process following the rapid contraction in 2001. Stability, optimistic expectations and structural arrangements that were brought in the merchandise and financial markets thanks to the post-crisis monetary and fiscal policies have contributed to the resumption of growth process in all sectors of the economy, mainly in industrial sector. In 2002, the GNP rose by 0.3 percent in the first quarter, 8.8 percent in the second quarter, and 7.8 percent in the third quarter. The GNP grew by 6.2 percent on the basis of nine-month average. The expectation of GNP growth, which was originally set as 3 percent for 2002, is expected to surpass the upwardly revised 4 percent level easily.

66. Many people had serious doubts about the attainment of 3 percent target in the beginning of the year 2002. However, we, as the Central Bank, announced repeatedly in the press releases and Monetary Policy Reports that the growth foresight was achievable. In those announcements, we stated that there were some factors that would have a favorable effect on the growth. These factors were:

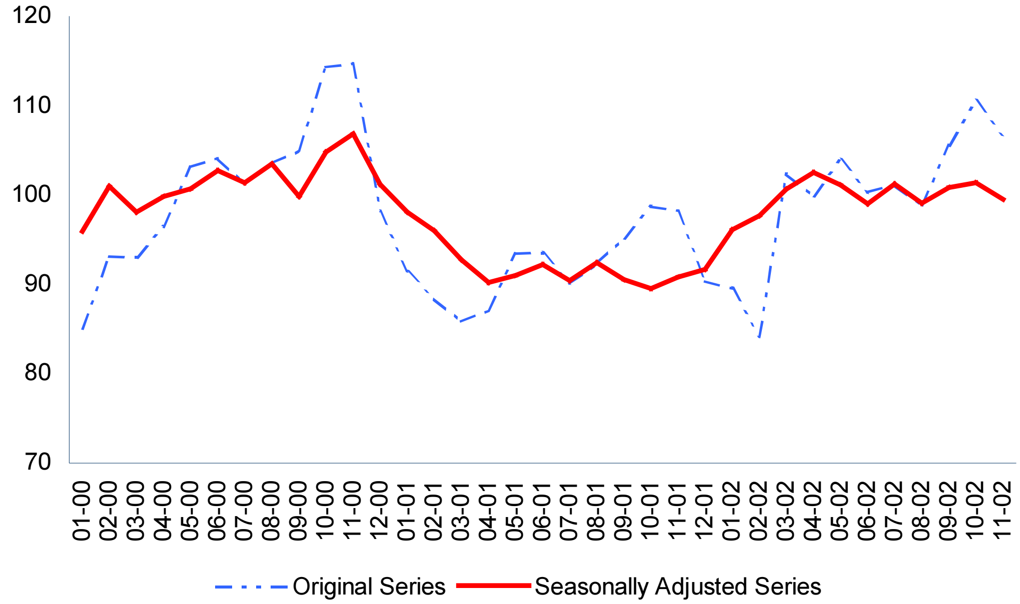
i. Turkey's competitiveness edge, which was strengthened in 2001, was destined to exert positive effects on the exports and the growth.
ii. There were signs that the results of reverse currency substitution; in particular the stability in exchange rates could spur domestic demand.
iii. Stability in financial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

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

68. Similarly, the growth trend in the first three quarter of 2002 is expected to continue in the last quarter of the year as well.

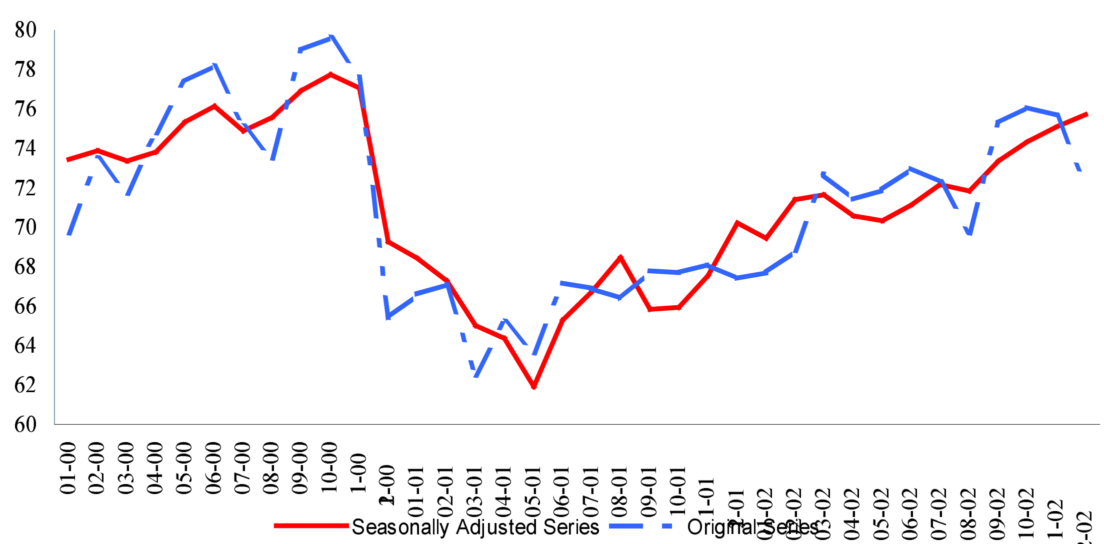
69. In fact, the manufacturing industrial production, which is the leading indicator of the recovery and growth in the economy, increased by 9.8 percent in November in relation to the same month of the previous year. The overall increase in the manufacturing industrial production for the January-November period reached to 10.2 percent.

Figure 7. Total Industrial Production (Index values)



70. Further evidence for the GNP growth can be traced in the capacity utilization ratio and in the foreign trade figures. The capacity utilization ratio, which was 76.7 percent in December 2002, has displayed an upward trend since the New Year (80.6 percent in October 2002, was the highest level since the beginning of 2001). The output growth in the sectors sensitive to foreign demand has largely contributed to this recovery, as envisaged in the program.

Figure 8. Capacity Utilization in Private Industrial Sector



71. Looking back, we can see that the political uncertainty that occurred since the second half of May 2002 led to increase in interest rates and exchange rate, making them somewhat unstable. This situation affected the production and demand adversely to some extent. However, although the political uncertainty has disappeared with the favorable climate after the November elections, a recovery in domestic demand is being observed evidently as a short-term result of deterioration in the public finances in the last seven months. Putting the public finances back on a stable track, which otherwise may bring about dangerous results in the long-term, will positively affect the output, by preserving the recently created favorable atmosphere, and by contributing to the stability in interest rates and exchange rates.

72. Moreover, the momentum caught in exports, and the completion of the banking recapitalization that will increase the efficiency of the resource transfer to industry will support the growth in this process.

73. According to the growth part of our recent survey on expectations, the GNP growth is expected to realize at 6 percent in the year 2002 with the improved expectations since the New Year. The GNP is expected to grow by 4.4 percent in the year 2003.

74. The other parts of the surveys conducted by the Central Bank show that the general economic indicators and the expectations for growth indicators like volume of output, total employment and exports follow a similar pattern; despite they were temporarily affected by the mood of political uncertainty.

Figure 9. Opinions About the General Course of the Industrial Sector (Optimistic - Pessimistic)

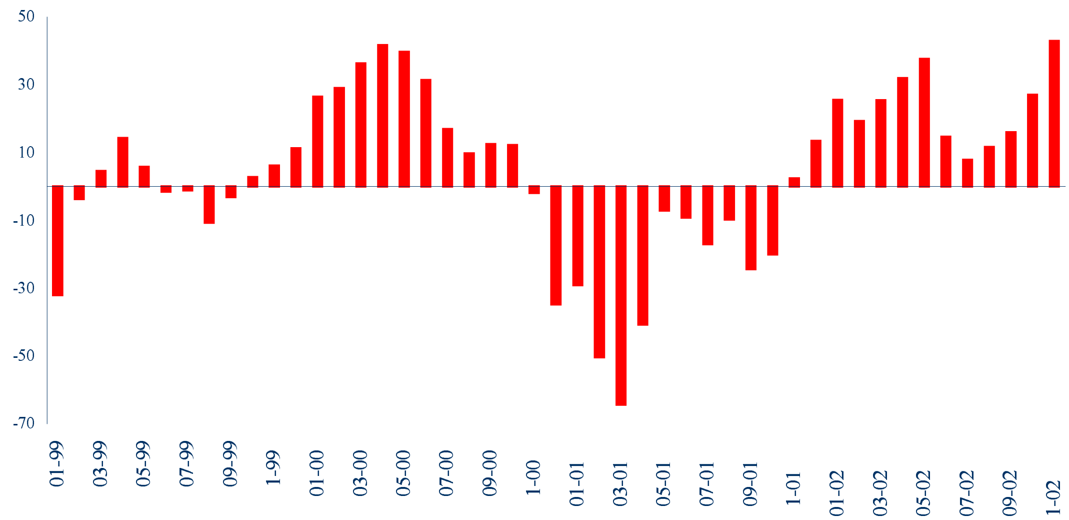


Figure 10. Tendency for the Goods Sold in the Domestic Market

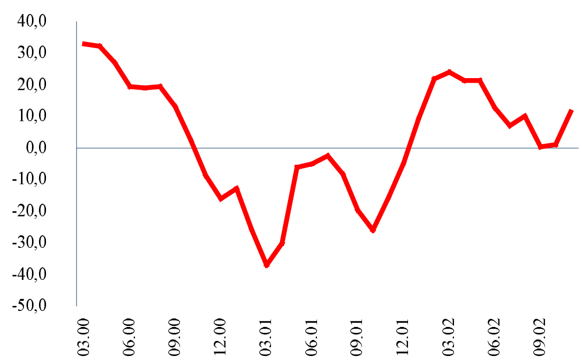


Figure 11. Tendency for the Volume of Output

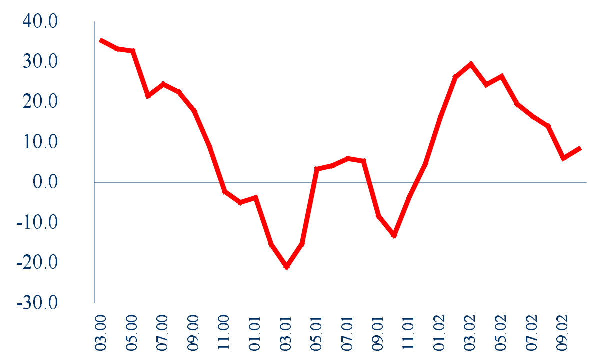


Figure 12. Total Employment

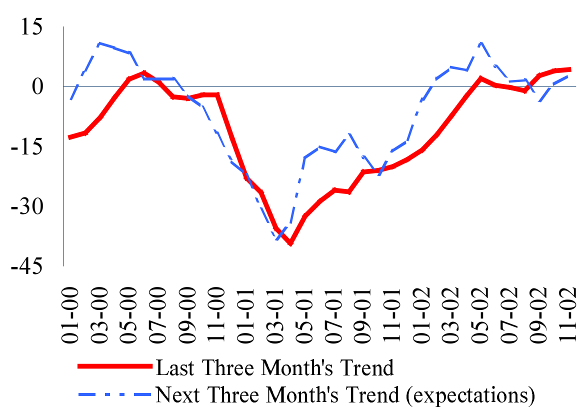
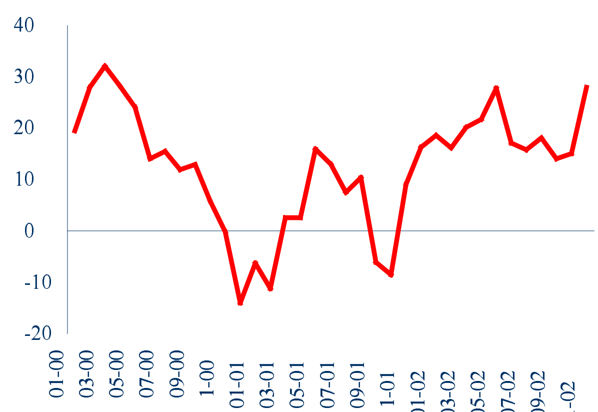


Figure 13. Expectations for Export



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

- 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. Nevertheless, the Central Bank maintained that the 3 percent growth rate would be realizable according to the data and forecasts at hand. In spite of this, the persistence in these speculations reminds us the experiences of the other countries. 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.

- The current program and the reforms in the public sector are also modifying the capital accumulation model in Turkey, either voluntarily or involuntarily. 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, and the capital can be accumulated under a production structure that is based on productivity and competition. This transformation process is essential for a sound economic growth. What is important for the start of this process is that some of the costs assumed by the public sector previously have now been transferred to private companies and consumers by means of structural reforms. The increase in labor costs of private sector that is envisaged by the Social Security Reform may be given as an example. 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. As a matter of fact, the cost of structural reforms that has not been distributed fairly among economic units, including the companies remained unaffected so far, and an environment where there is no more government support, tax reform is not yet in place, tax base is not expanded, and tax administration is not improved, impose a burden on the private sector and explains the troubles suffered by the above-mentioned groups.[3]

- In essential, it is impossible for the real sector to recover itself without completing the banking reform, enabling the banks to resume their credit allocation function. Revising the intermediation costs of the banks will help reactivate the credit channel, and also alleviate the vulnerability of the banking system, which is very important for the Central Bank's policy implementations as well. Therefore, the banking reform must be supported by the real sector. 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.

- It is true that there may be different opinions and evaluations on the growth and inflation figures and their calculation methods. We may discuss them as well. But what surprises us most is that no argument in this regard had been put forward when the GNP growth rate was minus 8 percent and the inflation rate soared above 70 percent. It is understood that the strict determination in the fight against inflation is disturbing some sections, providing clues for the resistance that might be encountered in the future.

- It is a fact that the current program and the Central Bank's determination in the price stability have reinforced the public confidence. It has largely contributed to the recovery in the economy following the February 2001 crisis as well. However, the continuation of this recovery can only be achieved by putting structural changes into effect such as "Public Financial Management and

[3] Sak, G., 2002, Unpublished Notes.

Internal Control Law", "Execution and Bankruptcy Act," and by persistence in banking reform. Once these structural changes are fulfilled, economic units will assume a "sense of stability" and return to their normal consumption behaviors, abandoning the "wait and see" attitude. As a consequence, confidence in the Turkish Lira will be restored; domestic demand will be revived in line with a drop in nominal interest rates, putting the economy on a sustainable growth path and stability.

II. 3- Monetary Indicators

76. When we look into the monetary indicators under the current program, we observe that all indicators chosen from the Central Bank balance sheet have met the targets.

Figure 14. Base Money (Trl TL)

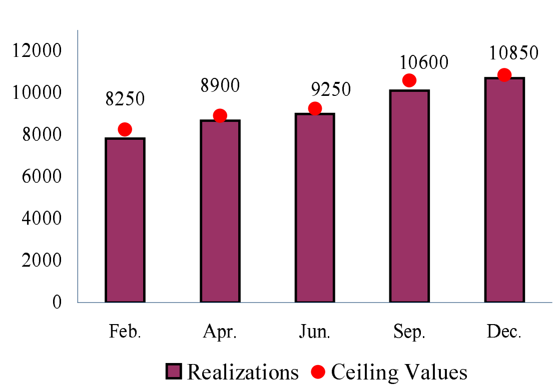


Figure 15. Net Domestic Assets (Trl TL)

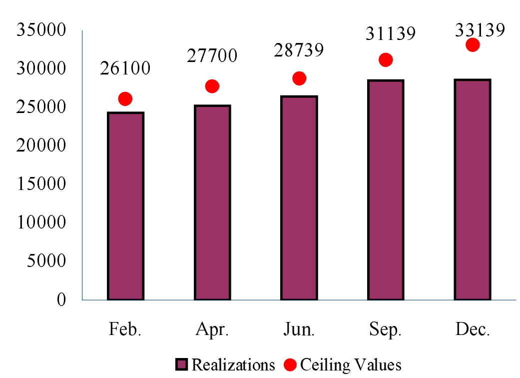
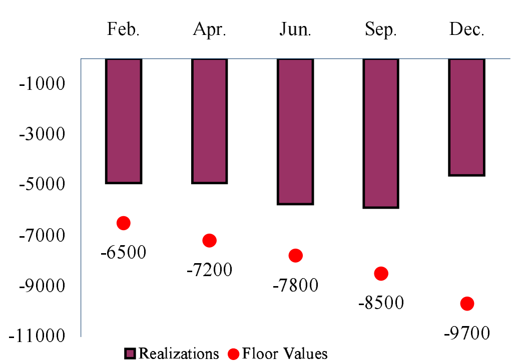


Figure 16. Net International Reserves (Mio USD)



77. However, an increase in money demand is being observed as a result of a revival in domestic demand due to the favorable climate after the elections and the fiscal deterioration that could have dangerous consequences if not corrected. Despite this, the Base Money target, which was set for end-2002 under the current program, has been achieved. As of year-end, the annual nominal increase realized at 37.4 percent, while the real increase at 5.9 percent. The nominal increase remained below the 40 percent, which was the upper limit of the increase in the Base Money.

II. 4- Balance of Payments

78. Realizations in the balance of payments are consistent with to our program projections.

79. The current accounts deficit that was USD 9.8 billion at the end of 2000 ran a surplus of USD 3.4 billion at the end of 2001 following the rapid depreciation of the Turkish lira.

80. It is estimated that the current accounts balance will realize somewhere near the equilibrium point. The current accounts posted a surplus of USD 594 million during the January-October 2002 period. The balance of payments is expected to yield a deficit of USD 1.9 billion in 2003.

81. At this stage, let me talk about an issue related to workers' remittances. During the January-October 2002 period, we observe a decline in the workers' remittances that is given within the item "unrequited transfers" under the heading of the current accounts. On the other hand, when we look at the Foreign Exchange Deposits Accounts with the Central Bank that is given under the heading of "capital movements", we see that there is an increase in the net balance thereof. This development reveals that Turkish citizens residing abroad have reduced their spending tendencies in Turkey, but have increased their investment tendencies despite falling interest rates. In our opinion, it is yet another indicator of the confidence felt in the current program. Of course, there will be increases or decreases in these inflows in line with domestic and international developments.

Figure 17. Current Account Balance (Bio USD)

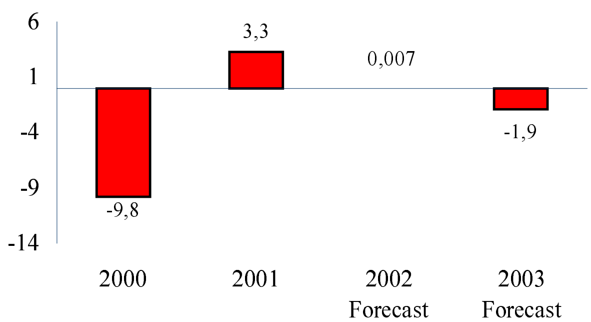
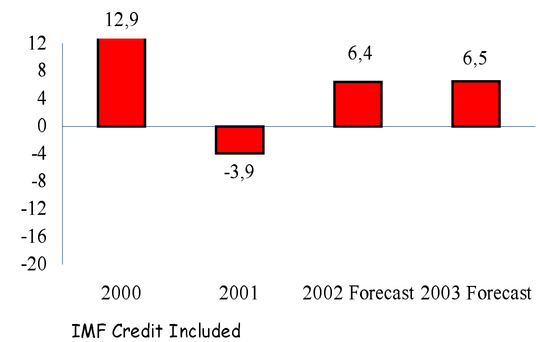
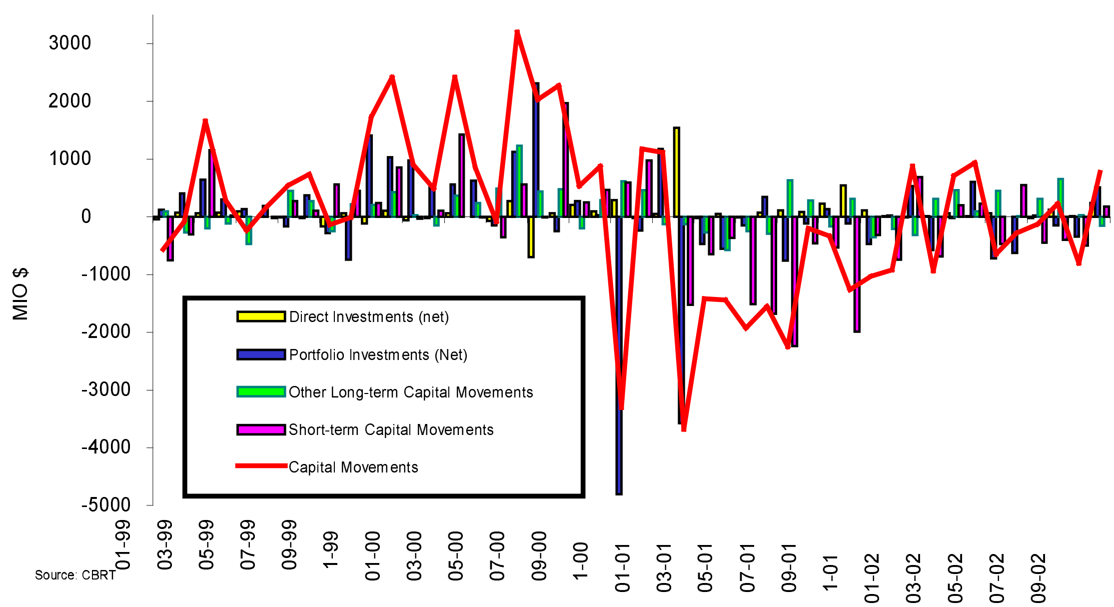


Figure 18. Capital Movements (Bio USD)



82. Net capital inflow, which was USD 13 billion at the end of 2000, turned to an outflow of USD 4 billion following the February 2001 crisis. It is predicted that capital inflows will realize at USD 6.4 billion in 2002, and USD 6.5 billion in 2003.

Figure 19. Capital Movements (December 1999 – September 2002)



83. The Figure 19 shows that volatility in the capital movements resulting from short-term investments (hot money) are disappearing gradually. At this point, we have to point out that the positive development in the volatility of capital movements can be attributed to the implementation of floating exchange rate regime, and the confident atmosphere that has been created as a result of successful track record of the program up to now.

84. When we take a closer look at the developments in capital movements during the January-October 2002 period, it is noted that while direct investments showed a net inflow of USD 491 million, portfolio investments recorded a net outflow of USD 746 million. In that period, sub-items of portfolio investments displayed a net borrowing of USD 306 million through bond issue, while residents made a net purchase of USD 1.6 billion in securities investments. The main reason for this movement in portfolio investments is that banks have managed to square their external credits, without resorting to borrowing from abroad. As to the short-term capital movements, a net outflow of USD 666 million realized in the same period. Besides, there was a net inflow of USD 1.8 billion in the long-term capital movements. This development in the long-term capital movements can be attributed to the disbursements of loans obtained from the World Bank, and especially to the increase in the utilizations of long-term FX loans by banks and non-public sectors.

II. 5- Price Developments and Inflation Expectations

85. Within the framework of the current program, the course of the inflation is our main point of reference. In this respect, the evaluation of the price movements from the January 2002 up to date is as follows:

86. Prices increased above expectations in January 2002. However, later in the February–May period, prices entered into a downward trend rapidly. Likewise a significant decline occurred in the inflation expectations after February. In other words, February was a turning point in terms of both price increases and expectations.

87. Monthly price increases in the February–May period, and those of some significant items materialized at their lowest level in the last 15 years. Considering the first five months of 2002, the main determining factors of price movements are as follows:

i. Restored confidence to the program turned expectations into positive and brought stability in the money and foreign exchange markets,
ii. The Turkish lira appreciated in nominal terms,
iii. With the conduct of tight fiscal and monetary policy, domestic demand increased under control,
iv. With the favorable weather conditions, agricultural output rose after March.

88. However, uncertainties, which had occurred outside the economic field after the second half of May 2002, put the interest rates and the exchange rate on a rapidly rising trend, imposing especially a cost-push pressure on the prices. As a matter of fact, the manufacturing industrial prices, which had moved between 0.6 and 2 percent in the first five months of the year, increased by 3.5 percent in June and by 4.3 percent in July. Price hikes in the petroleum and chemical products that utilize imported inputs to a large extent, as well as in the principal metal sector were conducive to this development. Moreover, price adjustments were observed for financial purposes in the sub-sectors of the public manufacturing industries.

89. The increase in the public sector prices and the depreciation of the Turkish lira after May 2002 had a negative impact on the consumer prices, which was evident in the July inflation.

90. However, it is observed that the inflation began going back to its trend of the first five months of the year starting with the August inflation and continued thereafter. Price increases remained limited because stability in interest rates and in exchange rates was restored following the removal of political uncertainties after the November elections, producing positive effect on the expectations, and domestic demand did not exert pressure on the inflation, despite the lessening of cost-push pressures. Especially with the favorable developments in exchange rate, the manufacturing industrial prices increased by 1.1 percent in November, and by 2.3 percent in December.

91. Although uncertainties, which appear periodically, and arise especially from the political climate, have had a negative impact on the short-term inflation expectations of the economic agents in the first half of 2002, there seems to be no substantial deterioration in the inflation expectations both for the year-end, and for the following next 12 months.

92. As also seen in results of the Central Bank Expectations Survey, the long-term inflation expectations have remained at the same level with the Central Bank's targets. The reasons are:

i. The mood of political uncertainty that had occurred in May began alleviating as of the last week of July, and is disappearing after the elections,
ii. The continuation of taking the structural and operational measures predicted under the current economic program, and the lessening of the

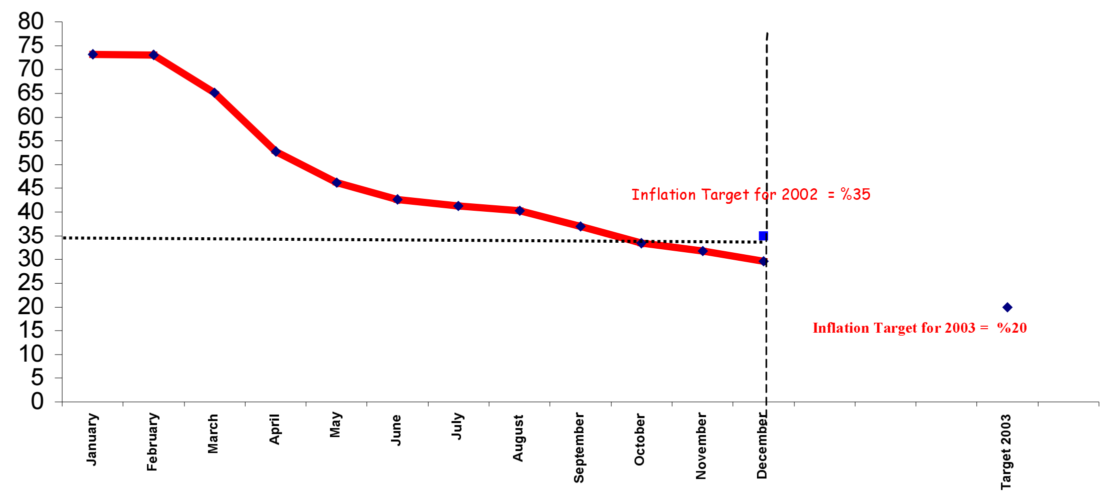
vulnerability of the economy resulting from tight monetary and fiscal policies.

iii. The general opinion that the economic program displaying an obvious success would not be disrupted by non-economic developments,

iv. The relative stability that has been achieved in the exchange rates since the second half of July.

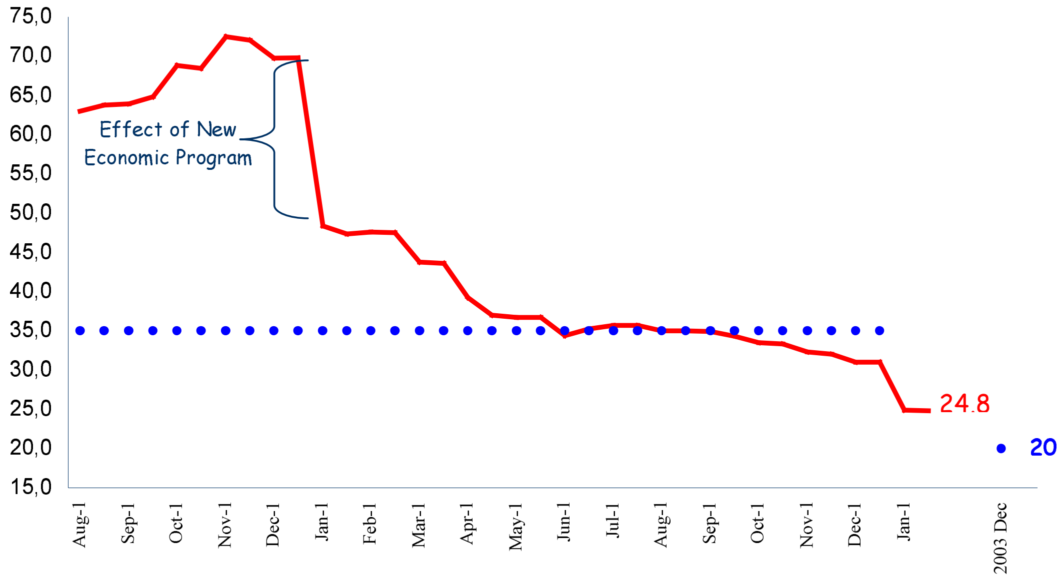
93. The CPI inflation that dropped to 29.7 percent as end of 2002 has realized below our 2002 year-end target of 35 percent, which is the lowest end of year level in the last 20 years as can be seen in Figure 20.

Figure 20. Annual Change in CPI and Target



94. Looking at the recent surveys on expectations since May 2002, we see for the first time after long years that the public's inflation expectations and the targets are following a similar pattern under the current program, and expectations are even somewhat below the target.

Figure 21. End of Year Inflation Expectations (CPI)



95. Our target for CPI inflation remained below the 2002 target and it is 20 percent in 2003. The inflation expectations for 2003 are above the target yet, but they are getting closer.

96. Our medium-term objective is to reduce inflation to single digits and to maintain price stability at these levels.

97. However, there are some risks we might face in our attempt to meet this objective. These are:

i. Relaxation in the implementation of the program: Our CPI inflation target of 35 percent for 2002 was reached, and even remained below this target. However, it does not mean that we are going to achieve price stability by simply reaching these levels. Turkey is still among the first-ranking countries in the world in terms of inflation. Hitting the target is only the first step of a long process. Consequently, once we reach the target, we must not allow ourselves the luxury of sluggishness as observed previously in many policy implementations. In the event of persistence in the non-programmed public-sector price increments to cover the deficits of the State Economic Enterprises (SEE), and in the event of a failure in restoring the fiscal discipline, which was relaxed somewhat, it is clear that the inflation target for 2003 will be put at risk. At this point, the primary balance of the budget, which is, in fact, a political document, should be considered not as a political, but as a technical indicator. It serves as a technical variable indicating how the public debt stock can be reduced over time. Therefore, the primary surplus needed for fiscal discipline must be attained by revenue increasing measures. The adverse effects of these implementations that increase input costs and narrow domestic demand can be removed by achieving tax reforms, in other words, expanding the tax base, and improving the tax administration.

ii. If some of the problems we faced in the 2002 budget realizations are left unresolved in the 2003 budget, it would constitute an important risk for the 2003 inflation target in respect of the fiscal discipline. The slowdown observed in the revenue collection for the 2002 budget points out that the revenue increasing measures should be taken for the future, and that the lack of coordination under the current policies should be eliminated. Moreover, structural measures should be taken to remove the burden of the social security system on the budget, which increased also in 2002, and these structural changes must immediately be put into practice. Once again, in the 2002 budget the increase in export tax rebates stems not from the increase in the exports, but from the considerations of using the rebates as a subsidy mechanism. There is a need to set up an assessment system in practice. Within this framework, a Ministry of Economics should be established as a political coordination mechanism in order to develop and conduct policies pertaining to the growth, productivity and real sector.

iii. Designing of price setting and tax policies in line with the public-sector borrowing requirement constitute a risk factor.

iv. The lack of sufficient confidence: in order to bring the inflation further down, we need a climate of more confidence that will keep on steady.

v. The continuation of backward-looking indexation in price-setting policies especially in education, health and real estate sectors is a major risk.

vi. The likelihood of adverse weather conditions might result in low harvest, contrary to 2002. In such event, the agricultural and food prices might not follow the same downward trend as they did in 2002.

vii. 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 service prices that have followed a steady course since 2001.

viii. The risk of giving emphasis to non-productive factors in the incomes policy, and the continuation of backward-looking indexation in wages.

ix. External shocks such as sudden increases in international oil prices and ensuing hikes in energy prices that are beyond the control of the Government and the Central Bank due to uncertainties like a military operation in Iraq.

98. Having set the general outline regarding the inflation targets, implementations and realizations, it will be worthwhile to clarify our exchange rate and Turkish lira policies and some issues on the market arrangements made in this regard.

III.MONETARY POLICY IMPLEMENTATIONS - OPERATIONAL FRAMEWORK

III. 1- Exchange Rate Policy: General Analysis

99. Our foreign exchange rate policy is being conducted under the floating exchange rate regime. It is essential in this regime that the level of exchange rate be determined by the market players under market conditions. Under such regime, the factors influencing the level of the exchange rate are:

100. In the short- and medium term;

- Different types of players in the market; acting according to the economic principles, technical analysts, speculators,
- Structural reforms and its effects on productivity,
- Domestic and international political developments,
- Global shocks,
- The current accounts balance and capital movements expectations,
- The public sector debt stocks, risk premium,
- The time perspective of decision-making processes of the economic agents.

In the long-term;

The economic foundations; like terms of foreign trade, productivity, fiscal policy, the gap between domestic and foreign inflation rates.

102. Under the current program, the exchange rate has become an effect rather than a cause. Today, the level of exchange rate is supposed to reflect the result of the entire political performance. When considering the general trend of exchange rate, we see that while the conduct of structural reforms, the continuation of the fiscal discipline and the external financial support can boost the Turkish lira, the political uncertainties, and the resulting concerns over the sustainability of the program cause the Turkish lira to depreciate.

103. The Central Bank, which holds the responsibility of the exchange rate policy, will evaluate the exchange rate developments only in line with the inflation target. Adjusting the level of the exchange rate in favor of any section, banks, exporters, importers, foreign exchange debtors or creditors is out of question.

104. On the other hand, on the way to the inflation-targeting regime, it is vital to maintain the exchange rate stability by minimum Central Bank intervention as possible under the floating rate regime. As real and nominal interest rates drop together with the inflation rate, and especially as a healthier yield curve for the Turkish lira is developed, a stability area for the exchange rate will be established relying on the economic fundamentals.

105. At this point, it will be useful to refer to an issue that is often talked about on the level of the exchange rate. When the Turkish lira appreciated with the floating exchange rate system, it was asserted that the level of exchange rate was detrimental to Turkey's competitiveness edge, and that it was necessary to intervene in the exchange rate, which should not have been left to float freely. However, it is obvious that a country's competitiveness power is not determined by the exchange rate level only. The elements determining the competitiveness[4] are:

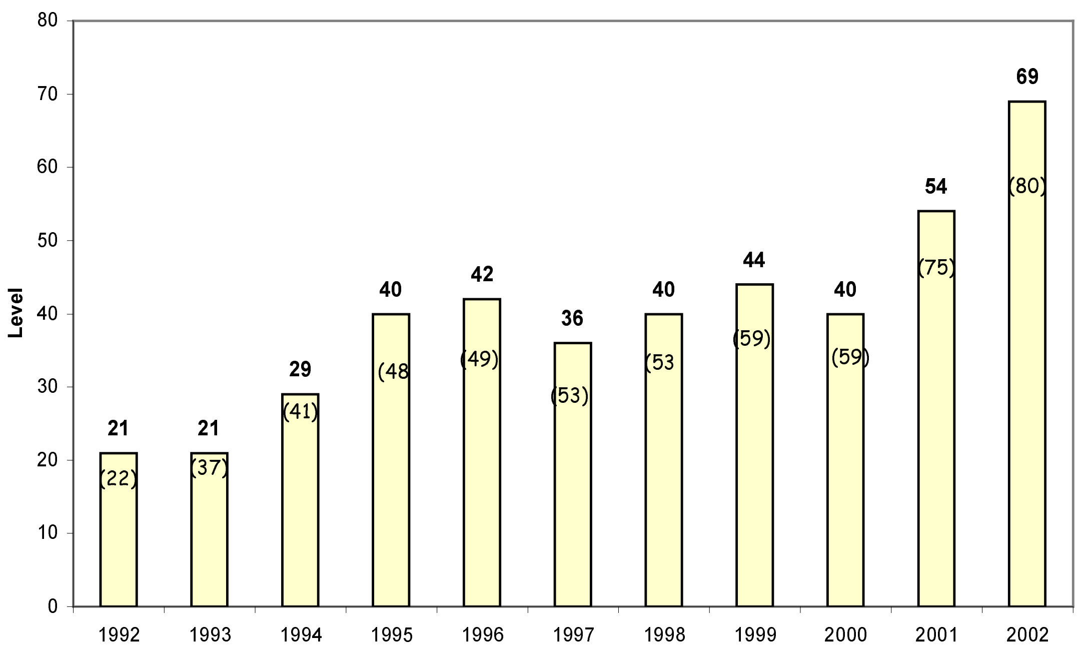
- Under the heading of price competitiveness; the real exchange rates, and the comparative positions denoting relative prices, the domestic exchange rate, and the unit costs,
- In the context of quality; service after sale, standardization of goods,
- Under the heading of structural elements; macroeconomic performance, economic and social development level, productivity, skilled labor-force and research-development activities.

[4] Kotan, Z., Feb. 2002, International Competitiveness Indicators: The Case of Turkey, Research Paper.

106. In this respect, if Turkey is to follow an export-oriented growth strategy, all the economic units should focus on increasing productivity and renovating technology to gain competitive power. In addition, the rising input costs of companies should be closely followed.

107. The Figure 22 indicates that over time our competitiveness power has never reached the desired level considering all of these factors. As can be seen, the devaluations of 1994 and 2001 have, in fact, not increased our competitiveness power.

Figure 22. Where is Turkey in the Global Competitiveness ?



The numbers in the paranthesis show the number of the countries evaluated and the numbers on the columns show the rank of Turkey among these countries.
Source: World Economic Forum, Global Competitiveness Report

III. 2- Exchange Rate Policy: Operational Arrangements

108. The Central Bank attaches great importance to the measures for developing foreign exchange markets and for improving their efficiency. In this context, the Bank fully supports the functioning and the improvement of the forward markets, under which the exchange rate risk is hedged. Moreover, the

Central Bank has gradually abandoned its intermediation role in order to allow the establishment of free market conditions, in other words, to make the operation of these markets more efficient. The end of the Central Bank’s intermediation role will necessitate the market participants to consider the counterpart risk in their transactions, and thus will restrict the speculative actions.

109. Similarly, through transparent and rule-based mechanisms the Central Bank has purchased and may continue to purchase the excess supply of foreign exchange arising from favorable developments in the balance of payments and reverse currency substitution in order to boost foreign exchange reserves only, as were done previously via foreign exchange buying auctions. The main purpose of such implementation is to build up confidence in the markets by means of increased foreign exchange reserves, and to reinforce Turkey's resilience against external shocks.

110. As mentioned before, the Central Bank does not have any commitment whatsoever related to the exchange rate level. It will intervene only in case of extreme volatile conditions, and whenever the objective of price stability is at risk. These interventions are and will be either in the form of outright purchase or sale, or in the form of evaluations, warnings and controls related to the size of risk born by the economic units due to their short positions, namely, in the event of a mismatch between their assets and liabilities in different currency denominations.

III. 3- Turkish Lira Policy

111. Under the current program, the Central Bank has initiated or supported a number of implementations with a view to running and developing Turkish lira markets. In this context;

- With the aim of bringing flexibility to the banks' liquidity management, making financial markets more stable, and reducing their intermediation costs, the calculation, maintenance and declaration periods of the liquidity and reserve requirements are set as being 2 weeks for each, without changing the ratios. Moreover, banks are allowed to keep 3 points of their foreign currency and Turkish lira reserves as the 2 weeks' average. Turkish lira and foreign exchange banknotes are excluded from the liquid assets, and it has been decided to pay interest on the required reserves maintained for foreign exchange and non- deposit TRL liabilities.
- The Central Bank terminated its "intermediation role" in the TRL markets completely on December 2nd, 2002, by beginning to gradually abandon it as of July 1st, 2002.
- In case of a temporary liquidity shortage, the Central Bank will inject extra TRL liquidity into the market by holding intra-day repurchase auction at overnight through open market transactions. As "the lender of last resort" our Bank will conduct operations through "Late Liquidity Window" when needed. These financial stability measures were taken in the September 11, 2001 crisis, and announced by press releases thereafter.
- In order to increase the efficiency of sterilization, on April 1st, 2002 the Central Bank began to hold scheduled four-week TRL Deposit Buying Auctions in a limited amount so as not to affect market liquidity to a great extent. By means of Deposit Buying Auctions; the Central Bank can increase the efficiency of its sterilization operations for withdrawing excess liquidity in TRL markets, a reference interest rate is set for the four-week maturity that is not used by markets, information on the market's risk perception is collected, and also a yield curve can be formed, which is very important for foreign exchange, money and securities markets.

112. In addition to the direct Central Bank arrangements on the Turkish lira markets;

- Under the organization of the Banks Association of Turkey, the application of Turkish Lira Inter-Bank Offer Rate (TRLIBOR) has been put into effect as of August 1st, 2002 in order to improve the liquidity and transparency of the interbank money market, to set a reliable reference rates for both bank loans and other financial instruments, to help establish a sound yield curve, and to pave the way for forward transactions by better pricing of financial instruments.
- The Treasury has resumed the "primary dealership" practice for the purpose of ensuring the efficiency of debt management, and increasing the liquidity of government papers in the secondary market.

113. In this respect, the Central Bank is providing the necessary support to all these implementations.