

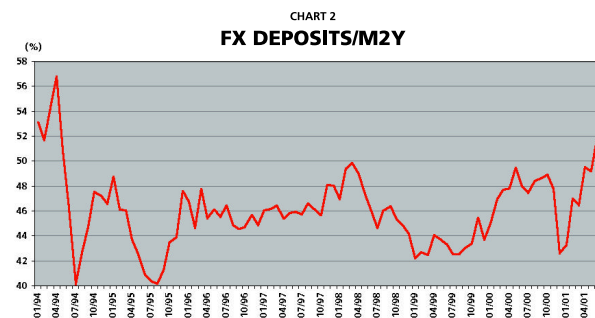
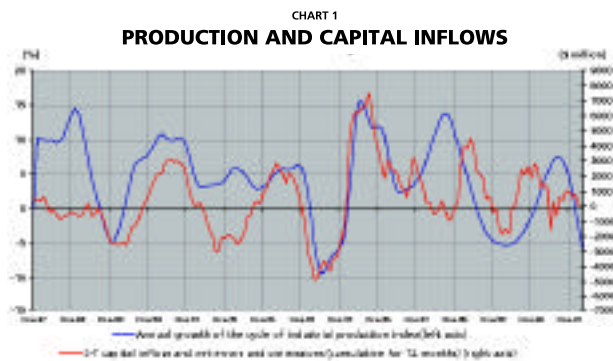
# THE EXCHANGE

After  
a brief review  
of the figures from  
the first half of 2001 and  
of the results from  
the first three months of  
the new economic program  
one can see how difficult  
it will be to put the economy  
back on track.

The figures prove that monetary and fiscal policies are strictly within the limits of the program. Almost all the structural reforms that the program promised have also been enacted despite stiff opposition and resistance even from within the cabinet. Be that as it may though, it is likely that the program's macroeconomic targets will not be reached. The program could have met its own macroeconomic targets had all the actors behaved properly on a very thin knife's edge. As the past few months proved the intricacies of the Turkish social and economic life did not lend themselves to such responsible behavior. The failure to attain the initial targets has two principal causes: 1. The lack of sufficient political determination 2. The unpredictability of the exchange rate.

1. Historically, in the Turkish economy, production is very sensitive to capital inflows. Chart 1 below shows the strong relation between production measured by the annual growth rate of the cycle of industrial production index and foreign capital inflow, measured as the sum of short-term capital inflow, portfolio investment and net

# RATE CHALLENGE



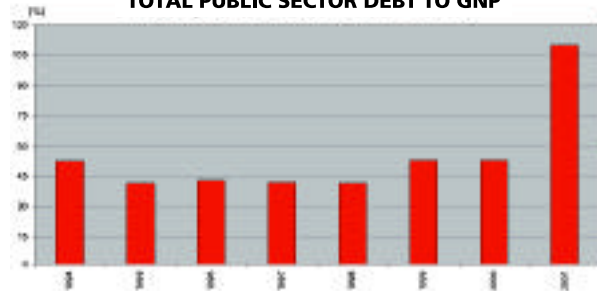
errors and omissions. There is no question that the recent crises devastated investor confidence. The following uncertainty with respect to the success of the new program, the (erroneous) belief that the option of a return to the old policies was still in the cards led to capital outflows and consequently resulted in huge output losses.

2. Turkey has experienced high and persistent inflation for approximately 30 years. Therefore, investors have always made an effort to preserve the real value of their savings by making very short-term investments and holding approximately half of their savings in foreign exchange denominated assets. FX denominated assets have dominated portfolio preferences that at times led to Dollar hoarding. This trend is now exacerbated under the free-floating regime because of the element of increased uncertainty. As a result, the ratio of FX deposits to M2Y has reached 52% at the end of July. It is a level which was only experienced for a short period during the 1994 crisis. The high level of dollarization reduced the power of monetary policies and hence weakened the option of a partial monetization of the domestic debt. (Chart2)

CHART 3  
INFLATION, NOMINAL INTEREST RATE  
AND USD EXCHANGE RATE



CHART 4  
TOTAL PUBLIC SECTOR DEBT TO GNP



In the  
absence of  
sufficient supply and  
a market maker,  
in an environment of  
very few transactions  
the smallest  
increase in demand  
leads to a rise in  
the exchange rate.

3. Due to continuing FX demand, arising not from economic transactions but from speculation and hoarding, the TL's value is depreciating consistently despite oscillations. As the value of the TL is lowered and the return on FX denominated assets increases, the demand for FX assets increases and causes a run away from the risky TL. Because of an identical behavior on the part of all investors as stated above, the FX market lacks much needed suppliers. In the absence of sufficient supply and a market maker, in an environment of very few transactions the smallest increase in demand leads to a rise in the exchange rate. In other words, the exchange rate moves beyond the rate of equilibrium in a market with numerous buyers having excessive artificial demands and being confronted with a very limited supply. In financial markets, the uncertainty is reflected on interest rates. The uncertainty with respect to the FX rate is one important factor that hinders the fall in interest rates. High interest rates, besides blocking a recovery in the economy, result in fruitless efforts to curb the cost of public borrowing and even causing them to elevate. Thus, the rise in the cost of public borrowing increases the concerns for the sustainability of domestic debt. In an uncertain environment producers tend to limit their output and increase their prices by adding a risk premium for any unforeseen risk associated with the FX rate. While this hinders the hopes to curb inflation, the decreasing demand and increasing production costs (caused both by inflation and devaluation effects) adversely affect employment. The high rate of devaluation that cause high interest rates and high inflation adds to a vicious circle in the economy. Chart 3 shows the trend in each of these three variables.

4. The uncertainty is not only detrimental for inflation, consumption, investment, saving and production decisions, but it is also creating a serious threat for the sustainability of internal and external debt. Total public sector debt is estimated to exceed 100% of GNP in 2001. The high level of interest rates, still being experienced, is the primary concern for the sustainability of domestic debt. Together with high interest rates, continuing high demand for foreign exchange, makes it more difficult to roll-over domestic demand in a shrinking TL market. Along with a shrinking TL market and high real interest rates, the lower growth rate of the economy compounds these difficulties.

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