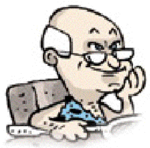
E C O N O M I C  O U T L O O K

NOTES ON THE CONTINUING QUEST FOR STABILITY: RECENT GAINS AND THE CHALLENGES AHEAD

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1. Loss of exchange rate stability and policy credibility

The latest quest for stability in the Turkish economy was disrupted by a severe crisis of international liquidity in February 2001. The crisis was triggered by the risks accumulated in opaque bank balance sheets to finance the domestic debt stock in November 2000. The existence of structured finance products in bank balance sheets has contributed to the massive portfolio shift from Turkish Lira instruments to foreign exchange. This massive portfolio shift has paved the way for the destruction of the main pillar of the exchange rate-based stability package designed at the end of 1999, namely, exchange rate stability. At the end of February 2001, the government has officially decided to float the Turkish Lira.

2. Exchange Rate Overshooting

With the float decision, restoring the stability of the exchange rate became a priority issue. After the float, an overshooting period has started not unlike the ones observed in other countries in the aftermath of a currency collapse. As analyzed by Goldfajn and Gupta with a sample of 80 countries between January 1980 and January 1998, the loss of policy credibility and the resulting negative expectations were the main factors behind the overshooting period led by a further portfolio shift towards foreign exchange.

3.Which way for correction?

In the case of an overshooting that leads to the undervaluation of the currency, there are two ways to correct the real exchange rate: The undervaluation could be reversed either through higher domestic inflation or through nominal currency appreciation. There is also the possibility for a middle-ground solution. Correction through higher domestic inflation could easily lead to an inflation/devaluation spiral further undermining exchange rate stability. Here discussions on the aftermath of the collapse of the Argentine Currency Board experiment are still very fresh. Correction through nominal currency appreciation could only be achieved through a reversal of the portfolio shift that led to the currency collapse in the first place. A portfolio shift towards TL instruments from foreign exchange requires policy credibility to be established and market expectations to turn positive. The question is how this could be achieved. Here we can finally turn to the salient features of the recent Turkish policy experiment.

4. Fundamentals were O.K.

Despite the loss of exchange rate stability in February 2001, Turkey has remained committed to the policy agenda it devised at the end of 1999. This was particularly true for the structural reform measures. There was an unmistakable need to strengthen the plans to redefine the role of the public sector in the Turkish economy. This amounted to taking steps to increase the role of the private sector and enhance the role of competition together with measures for increased transparency of public sector accounts. Steps were taken to prepare the legal ground for privatizing network industries and for the insertion of extrabudgetary funds into the budget framework. The new Central Bank Law defining the sole objective of the Central Bank as price stability and granting it the independence to pursue that objective should also be mentioned among the structural measures. The financial restructuring of public sector banks has also continued aggressively in 2001 through the rather well coordinated effort of the Central Bank, the Treasury and the Banking Regulation and Supervision Agency. Secondly, the efforts for tightened

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fiscal discipline have continued and at the end of 2001, the ambitious primary balance target could be met. This was achieved despite an economy that contracted severely due to the balance sheet effects of the currency collapse. Hence when the cyclical effects are taken into account, it could be seen that the primary balance was nearly an unheard of 10 percent of the GNP. Therefore, on the fiscal discipline front, the predetermined policy path has not been lost. Thirdly, the monetary discipline was maintained despite the currency collapse and the banking crisis. When the fundamentals are thus taken into account, there is a strong basis for a quick return to stability. However, due to negative expectations regarding the sustainability of the domestic debt stock, the economy continued to stay in the "bad" equilibrium.

5. September 11 was a further delaying factor

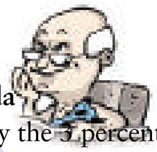
Policy credibility could not be established quickly amidst political quibbling and discussions about the need to take alternative routes to contain the crisis. Despite the latter, the first signals of exchange rate stability were detected in late August and then came the tragic events of September 11 that crushed the meagre improvements in expectations. In the aftermath of September 11, the need has emerged for a strengthened policy package to restore confidence and to gain policy credibility.

6. Features of the new policy framework are all well known

The new policy framework involved not only the official funding that provided a practical solution to the urgent debt sustainability discussion, but also a set of measures to continue with fiscal and monetary discipline. On the fiscal side, the three-year commitment to discipline is meant to guide fiscal expectations which will determine the policy performance. Notice that the commitment to fiscal discipline is juxtaposed with the changes taking place in the role of the public sector in the Turkish economy. On the monetary policy front, the discipline is imposed by a money base target together with an "implicit" inflation targeting framework. The Central Bank of Turkey has reiterated its commitment to disinflation by underlining the qualitative difference of the new legal framework that grants independence to the Bank. This is one way of saying that the recent attempt at disinflation is different from previous failed attempts. If the sole problem were one of restoring exchange rate stability in order to continue the policy agenda set at the end of 1999, this three-pronged strategy of official funding-fiscal discipline-monetary control might have sufficed. Especially in the context of the structural reform agenda. However, such is not the case.

7. The emphasis is on both bank and corporate restructuring

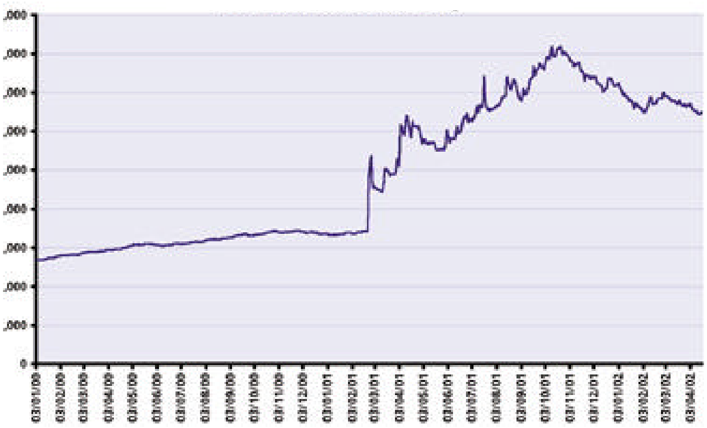
Banking sector balance sheets were adversely affected by the twin crises of November 2000 and February 2001. The crises have triggered a series of balance sheet effects ranging from bank balance sheets to corporate sector accounts. Regarding bank balance sheets, the ultimate impact is a loss of risk appetite and/or a decline in the risk carrying capacity of the banking sector. As noted in the literature, the latter development at first lowers the effectiveness of interest rates as a policy instrument considering possible further balance sheet effects. Secondly, it hampers any possible output recovery process which is also important for the overall performance of the economic program. Due to these reasons, the program in the new Letter of Intent(LOI) was strengthened by a bank recapitalization scheme and a corporate sector debt restructuring mechanism.



8. Exchange rate stability returns with partial gains in policy credibility

The program presented in the new LOI was officially approved by the IMF in January 18, 2002. However, the change in the sentiment started around mid-October in the financial markets. As can be followed from the figures, a reversal process could be observed in exchange rates as the nominal appreciation of the Turkish Lira accelerated. This was to be expected. Together with the decline in inflationary expectations, the Central Bank of Turkey has announced its downward bias on February 6 and the first cut in the interest rate was announced on February 20. The decline in secondary market rates started at an even earlier date. When the exchange rates are analyzed, it is possible to see that the volatility of the exchange rate has declined considerably in the wake of the Central Bank rate cuts. The stability in the exchange rate is finally re-established during a period of clean float as expectations changed. The determination of the authorities and the strong fundamentals have brought partial gains in policy credibility paving the way for stability.

US DOLLAR BUYING RATE



9. The credibility build-up period has not ended yet

The quest for stability has not ended but should be strengthened by the exchange rate reversal. To control and lower inflationary expectations, the determination of the authorities together with the enhanced coordination of their actions will be of utmost importance. These will be further tested throughout the policy implementation period. Policy credibility is always lost abruptly, but can only be regained gradually. It has to be understood that Turkey is still in the credibility build-up period following the twin crises. This looks to be the first challenge ahead.

10. Output recovery process is on the agenda

An output recovery process is envisaged by the 3 percent growth objective of the new policy framework. It has to be clarified at the outset that for 2002 the program objective is to regain only a part of what was lost last year. In this sense, the objective is a realistic one which matches the inflation target. The output recovery process will come as a result of the gains in consumer confidence following the crisis period. It is natural to assume that consumer confidence can only be re-established after the establishment of a "sense of stability" in financial market indicators. There are partial signals regarding positive developments in consumer confidence. However, the absence of a consumer confidence index is felt in the current environment. Substitution and income effects of lower prices together with the wealth effects of stable exchange rates and lower interest rates will be expected to appear in domestic consumption figures. The latter will provide the necessary spark for an output recovery process. In order to sustain thisprocess, the banking sector reform and the corporate debt restructuring have to be completed successfully.

11. Changing the mindset is the real challenge

The agenda depicted above is already tough. Yet, the real challenge still lies ahead. This is the challenge of changing our mindsets. It has to be understood that the existing mode of capital accumulation in this country where gains are private but "all" risks are socialized has irrevocably ended with the twin crises. The government could no longer transfer the resources to economic agents that these were accustomed to. The private sector in Turkey will also have to bite the bullet of hard choices and streamlining that the public sector had already begun to undertake. Turkey has to discuss the modalities of a medium term corporate sector restructuring. In this discussion, it has to be understood that even the reform process itself is creating adjustment costs for the Turkish economy. The effect of public sector restructuring on the medium term growth prospects and on the competitiveness of Turkish industry should be scrutinized more carefully. With public sector reform program on the agenda, time is ripe for a discussion concerning the scope of an enterprise reform program.

Goldfajn, I. and P. Gupta (2001) "Overshootings and Reversals: The Role of Monetary Policy" Central Bank of Chile Working Paper No. 126, November. (http://www.bcentral.cl/Estudios/DTCB/doctrab.htm)

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