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CONFIDENTIAL

June 10, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Turkey - Real Effective Exchange Rate - Information Notice

Attached for the information of the Executive Directors is an information notice on the real effective exchange rate of the Turkish lira.

Mr. Kopits (ext. 8814) is available to answer technical or factual questions relating to this paper.

Att: (1)

INTERNATIONAL MONETARY FUND

TURKEY

Real Effective Exchange Rate - Information Notice

Prepared by the European Department and the
Exchange and Trade Relations Department

(In consultation with the Legal Department
and the Research Department)

Approved by L. A. Whittome and J. T. Boorman

June 9, 1986

The recent evolution of the real effective exchange rate of the Turkish lira, as measured by the standard index developed in connection with the information notice system, is set out in the attached table and chart. Based on this index, by March 1986 the Turkish lira had depreciated in real terms by 11.1 percent since the last occasion on which developments in the exchange rate for the Turkish lira were brought to the attention of the Executive Board, the 1985 Article IV consultation in January 1986.

In recent years, the Turkish authorities have conducted exchange rate policy in a flexible manner, adjusting the value of the lira on the basis of inflation differentials with major trading partners and developments in partner country exchange rates. A primary objective has been to encourage the growth of exports and to allow a transition to a more liberal trade regime. Quarter-on-quarter changes in the real effective rate of the lira were small during 1982-83 but have since been more significant, with the lira depreciating in real effective terms by some 7 percent on balance between the fourth quarters of 1983 and 1985.

An additional degree of flexibility was introduced in the determination of the external value of the lira in 1984, when commercial banks were permitted to set their own exchange rates within a band--of up to 8 percent in either direction--around the rate set by the Central Bank. The band was removed on July 1, 1985, when the Central Bank allowed commercial banks to determine their own buying and selling rates for foreign exchange. Up to the end of 1985, the exchange rates quoted by the commercial banks followed broadly the rate set by the Central Bank.

In early 1986, however, mounting pressures against the lira led not only to a gradual downward adjustment of the exchange rate set by the Central Bank, but also to the emergence of a gap between that rate and the rates quoted by the commercial banks. At the root was a weakening of the foreign balance, reflecting both lower workers' remittances and a

sharply wider trade deficit as imports increased strongly while export growth slowed under the influence of weak demand in traditional markets and of leads and lags fed by speculation against the lira. Meanwhile, a number of smaller commercial banks had reached their limits on short-term financing from abroad. The strong demand for foreign exchange that resulted was amplified by a requirement imposed on banks on January 1 to surrender 20 percent of all foreign currency receipts from exports and invisibles to the Central Bank. In response, commercial banks raised their buying rates for foreign exchange, offering rates 5-10 percent above the Central Bank rate. With its scope to intervene limited by a relatively modest reserve position, the Central Bank on March 15, 1986 ratified the market rates by devaluing the lira by a further 5 percent. At the same time--as a temporary measure--limits were reintroduced on the exchange rate that the commercial banks could quote, with the maximum margins around Central Bank buying and selling rates being set at 1 percent. In addition, the surrender requirement was reduced from 20 percent to 15 percent.

Staff Appraisal

In concluding the recent consultation with Turkey in January 1986, Directors noted the important progress achieved in 1985 in strengthening the balance of payments, maintaining a satisfactory rate of economic growth, and--to a lesser extent--reducing inflation. The further reduction in the external current account deficit was attributed for the most part to a combination of a flexible exchange rate policy and further liberalization of the exchange regime. However, referring to the medium-term balance of payments scenarios for Turkey, which demonstrated the continuing vulnerability of the external position, Directors stressed that the feasibility of Turkey's achieving reasonable rates of economic growth, while preserving a viable external position, would hinge on the resolute pursuit of the adjustment strategy, including prudent demand management and the maintenance of a realistic exchange rate, supplemented with structural measures aimed at further enhancing the country's export capacity and mobilizing domestic savings.

Developments in the first quarter of 1986 underscored the vulnerability of Turkey's position to changes in external conditions and market perceptions and led to a continuing depreciation of the lira in real effective terms. The real depreciation of the exchange rate during the first quarter--by strengthening competitiveness further--should help the continuing process of external adjustment. Care will, however, need to be exercised in the period ahead to ensure that policies are adequate to prevent a re-emergence of speculative pressures, as a further significant depreciation of the lira could complicate the task of bringing the rate of inflation down to more acceptable levels.

Exchange rate developments and policy will be reviewed by a staff team visiting Ankara in June, and by a mission later in the year to conduct the 1986 Article IV consultation discussions with the authorities.

Table 1. Turkey: Real Effective Exchange Rate and Related Series

(Indices: 1980 = 100)

	Real Effective Exchange Rate <u>1/</u> <u>2/</u>	Nominal Effective Exchange Rate <u>1/</u>	Relative Consumer Prices (Local Currencies)	Exchange Rate in Terms of U.S. Dollars <u>1/</u>	Consumer Price Index (Seasonally Adjusted)	Consumer Price Index (Not Seasonally Adjusted)
Quarterly						
1981						
II	104.3	86.5	118.1	71.4	129.6	130.9
III	103.8	80.2	126.7	62.1	142.6	141.6
IV	93.9	70.9	129.8	57.5	149.8	148.0
1982						
I	88.1	66.1	130.7	51.4	154.0	155.7
II	87.2	62.5	136.6	47.0	164.6	166.1
III	87.2	60.2	141.9	43.0	175.1	173.2
IV	89.1	58.0	150.5	40.4	189.1	187.3
1983						
I	88.1	54.1	159.5	38.0	203.5	206.0
II	86.5	51.4	164.7	34.8	213.8	215.5
III	86.5	49.1	172.7	31.4	229.1	226.0
IV	87.1	45.2	188.9	28.3	256.1	254.5
1984						
I	79.0	38.9	199.1	23.8	275.3	279.2
II	81.0	35.0	226.7	21.2	319.2	321.0
III	85.8	33.8	248.7	19.1	356.6	350.9
IV	88.2	32.6	265.5	17.5	388.1	386.7
1985						
I	91.3	31.2	287.0	15.7	428.4	434.6
II	84.1	27.3	302.0	14.2	460.2	462.8
III	81.0	24.8	320.0	13.7	494.9	486.5
IV	81.3	22.4	355.9	13.2	558.8	557.1
1986						
I	74.1	19.5	372.4	12.2	590.8	599.1
Monthly						
1986						
Jan. <u>3/</u>	77.7	20.7	368.1	12.6	582.8	589.8
Feb.	75.5	19.7	374.7	12.5	594.3	600.1
March	69.1	18.1	374.5	11.7	595.4	607.9
Percentage change						
Jan. 1986 - March 1986	-11.1	-12.6	1.7	-7.5	2.2	

Source: Information Notice System.

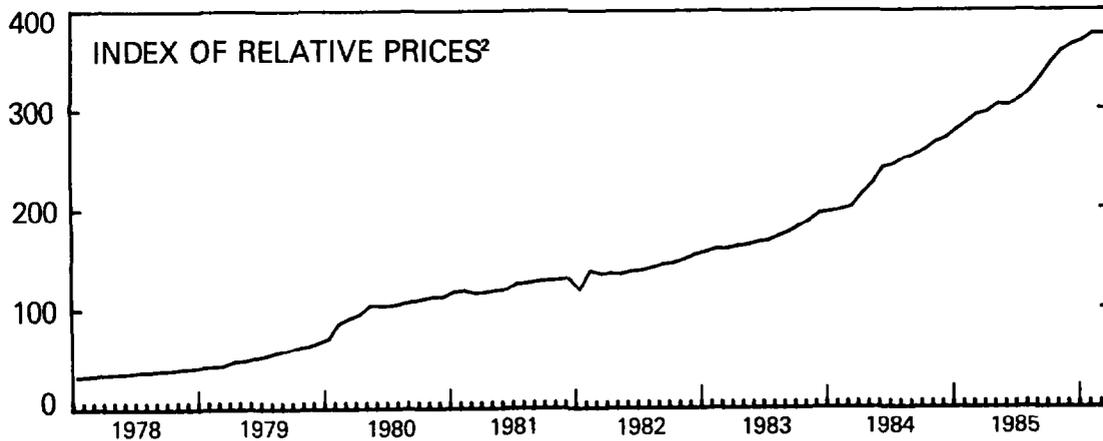
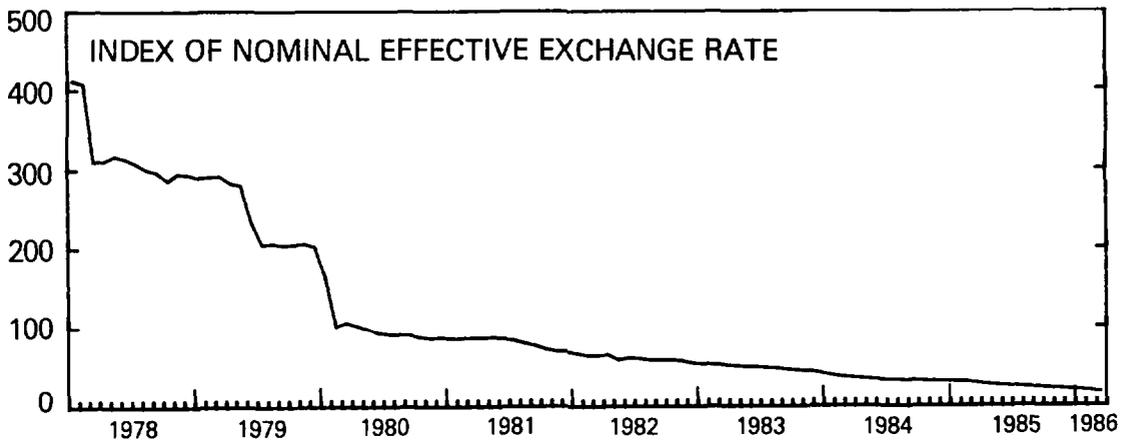
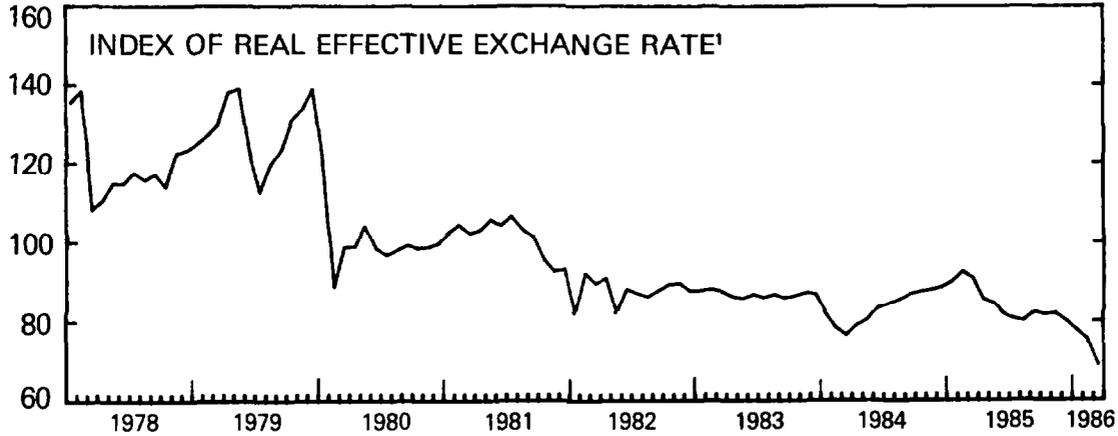
1/ Increases mean appreciation.

2/ Using seasonally adjusted price indices.

3/ Date of latest consideration by Executive Board.

CHART 1
TURKEY
INFORMATION NOTICE SYSTEM INDEX OF
EFFECTIVE EXCHANGE RATE

(1980=100)



Source: Information Notice System.

¹Trade weighted index of nominal effective exchange rate deflated by seasonally adjusted consumer prices; a rise (fall) in the index reflects an appreciation (depreciation).

²Relative prices as measured by seasonally adjusted consumer price indices.