



ECONOMIC OUTLOOK

CENTRAL BANK OF THE REPUBLIC OF TURKEY

February 2004

Stability Program

Is it an IMF Program?



National Program

The outline of the Program is determined in the State Planning Organization's annual programs, "Report on the Pre-Accession Economic program" and in the National Program signed by the Government.

Targets

**Achieving Price
Stability**



**Decreasing
Public Debt
Stock**



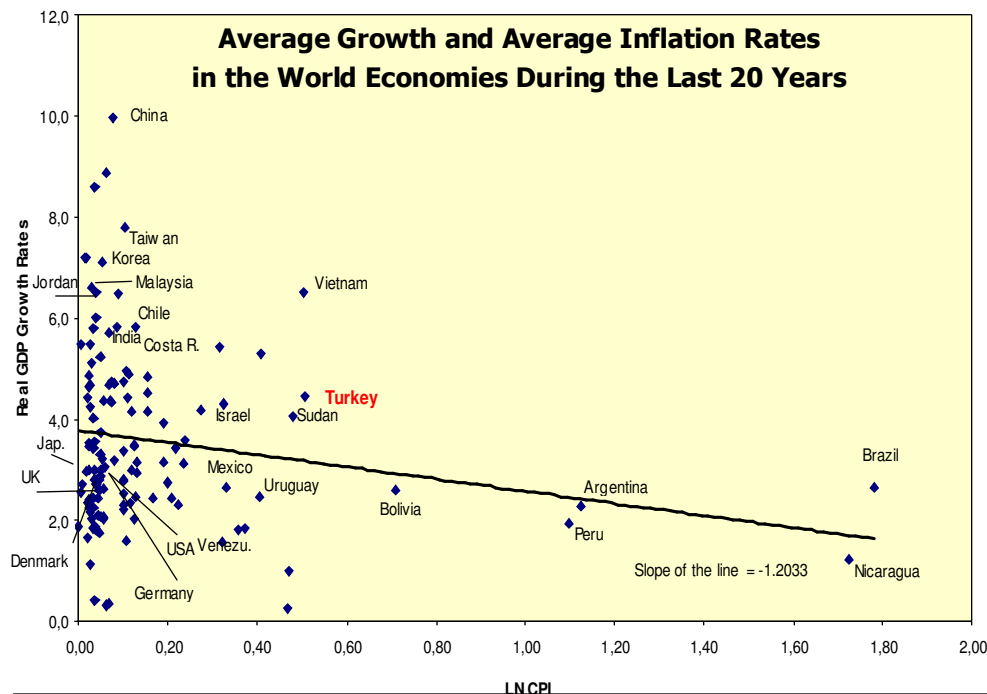
Sustainable Growth



PRICE STABILITY

Price Stability

The primary objective of the Central Bank is to achieve and maintain price stability.



Loose monetary policy for higher rates of growth

Misconception

- ✓ Early economics literature
- ✓ A static environment
- ✓ Low inflation rate
- ✓ For short-term

Instead

- ✓ Models developed after the 1980s
- ✓ Long-term
- ✓ High rates of inflation

Loose monetary
policies



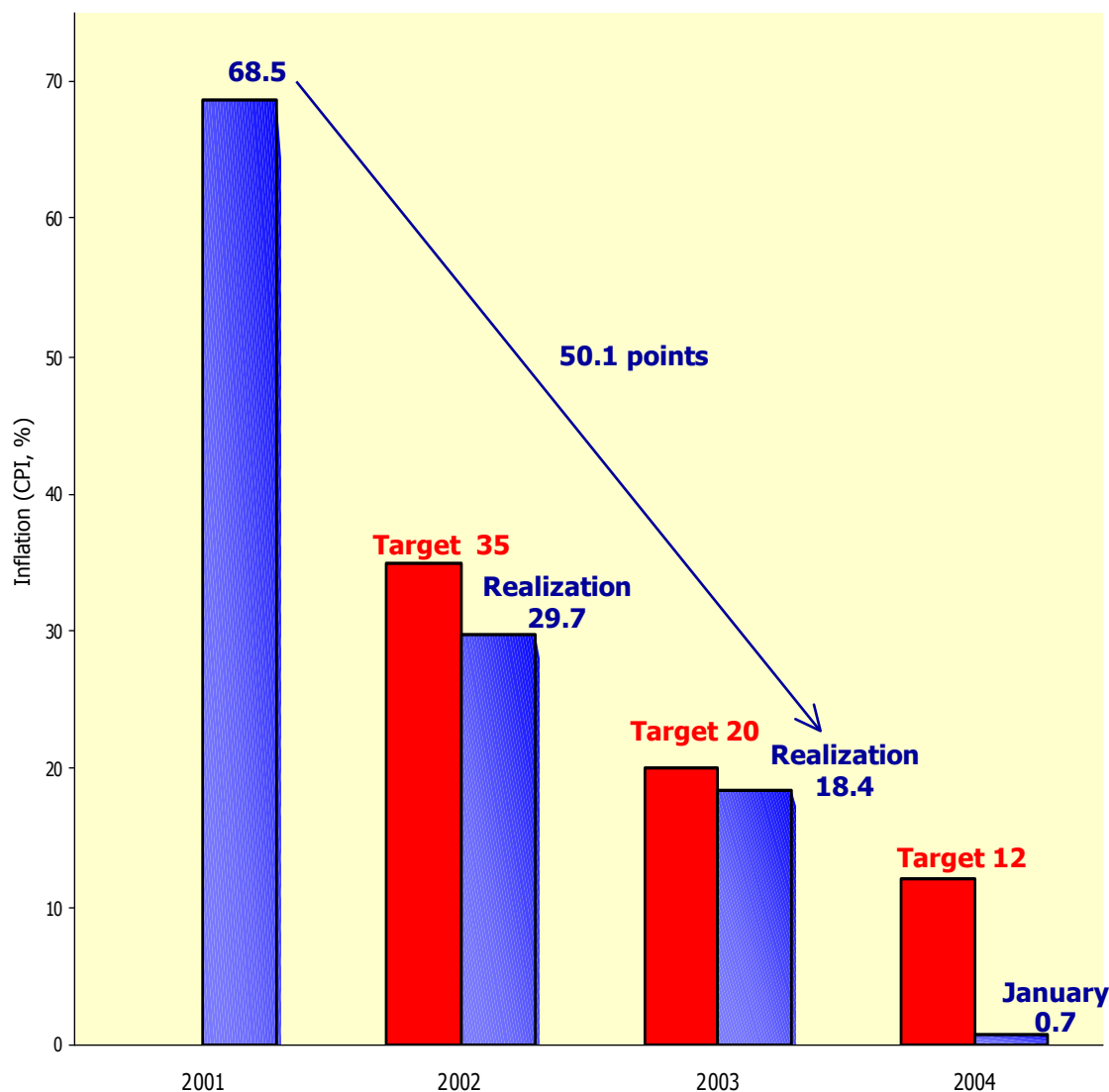
Only leads to
higher inflation

Conclusion:

- ✓ Price stability and growth do not conflict with each other. Price stability is a prerequisite for sustainable growth.
 - ❖ The Central Bank's priority is price stability.
 - ❖ The Central Bank supports sustainable growth and increase in employment by achieving price stability.
 - ❖ Only in countries where price stability is achieved, in other words, in countries whose inflation rates are below 10 percent, loose monetary policy can contribute to economic growth.

Price Stability

Why was price stability not achieved in the past?



Reasons behind inflation in the past:

- ✓ Chronic public deficits,
- ✓ 30-years of inflation inertia,
- ✓ Never-accomplished stability programs,
- ✓ Delays in structural reforms,
- ✓ Different priorities.

Today:

Structure of the economy has been changing.

- ✓ The Central Bank is independent and does not extend credit to public institutions since November 2001. Price stability is the only and the primary objective.
 - ✓ Inflation target is determined jointly with the Government, whereas monetary policy implementations directed to achieve this target are determined independently within the framework of the principles of the Central Bank Law.
 - ✓ Inflation inertia has diminished and confidence has increased, owing to effective communication in all policy actions; determination, integrity/ honesty and accountability.
- ✓ Consumer price inflation (CPI) has declined by 50.1 points since 2001.
- ✓ CPI inflation in 2003 was below the target of 20% and realized as 18.4%, which is the lowest year-end inflation rate in the last twenty-eight years.
- ✓ Target for 2004 is 12%. Our ultimate objective is to achieve **price stability** at single-digit inflation rates.

Price Stability

Micro factors that support the decline in inflation:



✓ Exchange rate?

➤ In the past, there were periods of real appreciation of the Turkish lira like today, however, inflation rate never declined to such low levels permanently.

➤ Accordingly, it is observed that the exchange rate pass-through weakened and inflation dynamics changed in the desired direction.

- ✓ Tight monetary and fiscal policies,
- ✓ Increased confidence and its favourable effects on expectations,
- ✓ Relative stability in the markets,
- ✓ Increase in productivity and the course of real wages,
- ✓ Change in the behavior of producers and consumers; increased competitiveness, sluggish domestic demand
- ✓ Incomes policies and price-setting behavior in line with the inflation target being more common

support the decline in inflation.

External Factors: Inflation + Growth

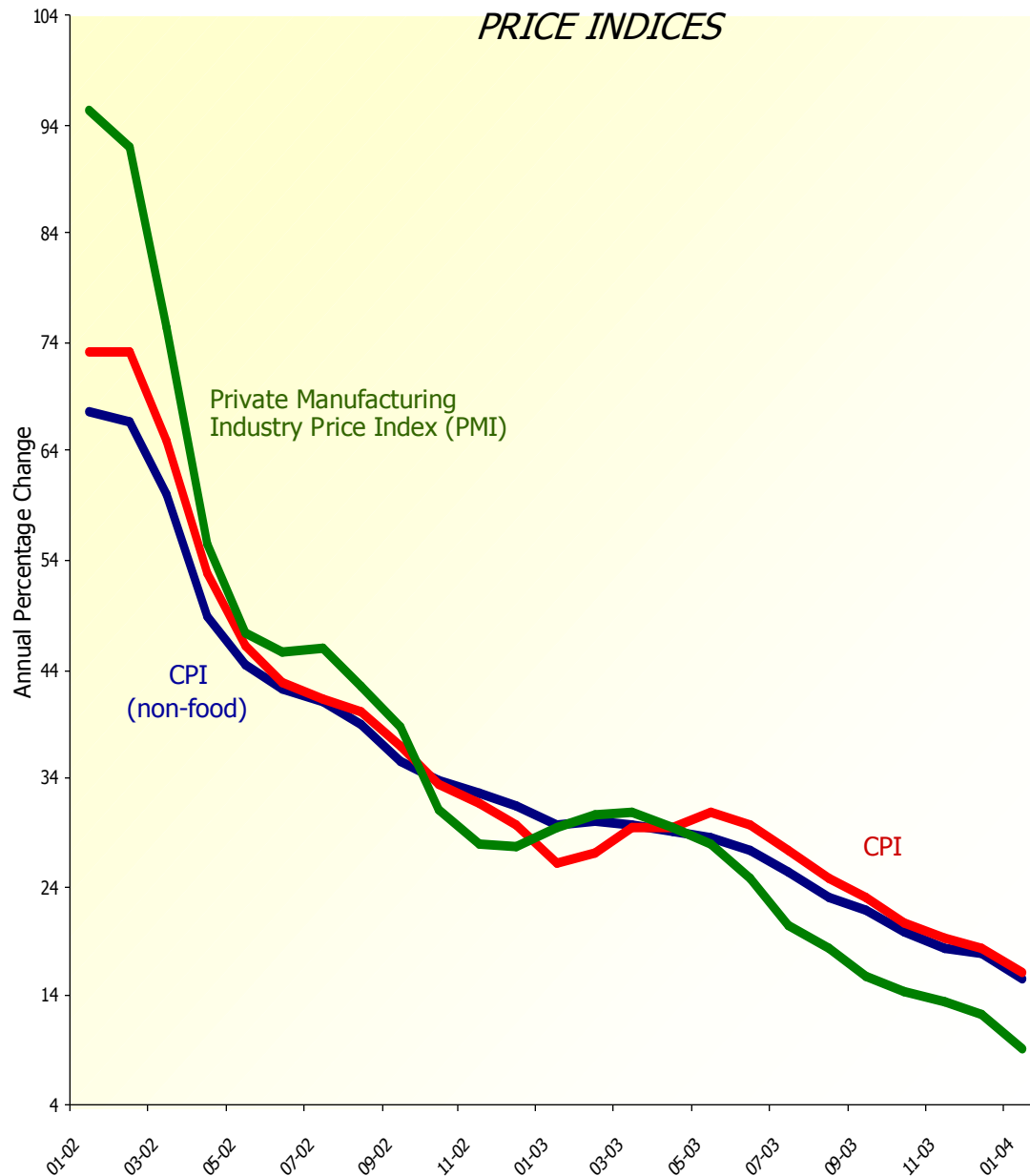
➤ The course of USD/EUR parity has contributed. Inputs are mostly denominated in US dollar, exports are mainly to the EU.

➤ Exports are more sensitive to foreign demand, so delayed recovery in the EU had adverse effect. Despite this factor, exports increased significantly.

➤ Although interest rates are low abroad, positive effect of this factor on the Turkish economy is quite limited, because the interest rates in the US and the EU are incomparably different from the interest rates in Turkey.

1-2 % ➡ 24 %

Price Stability



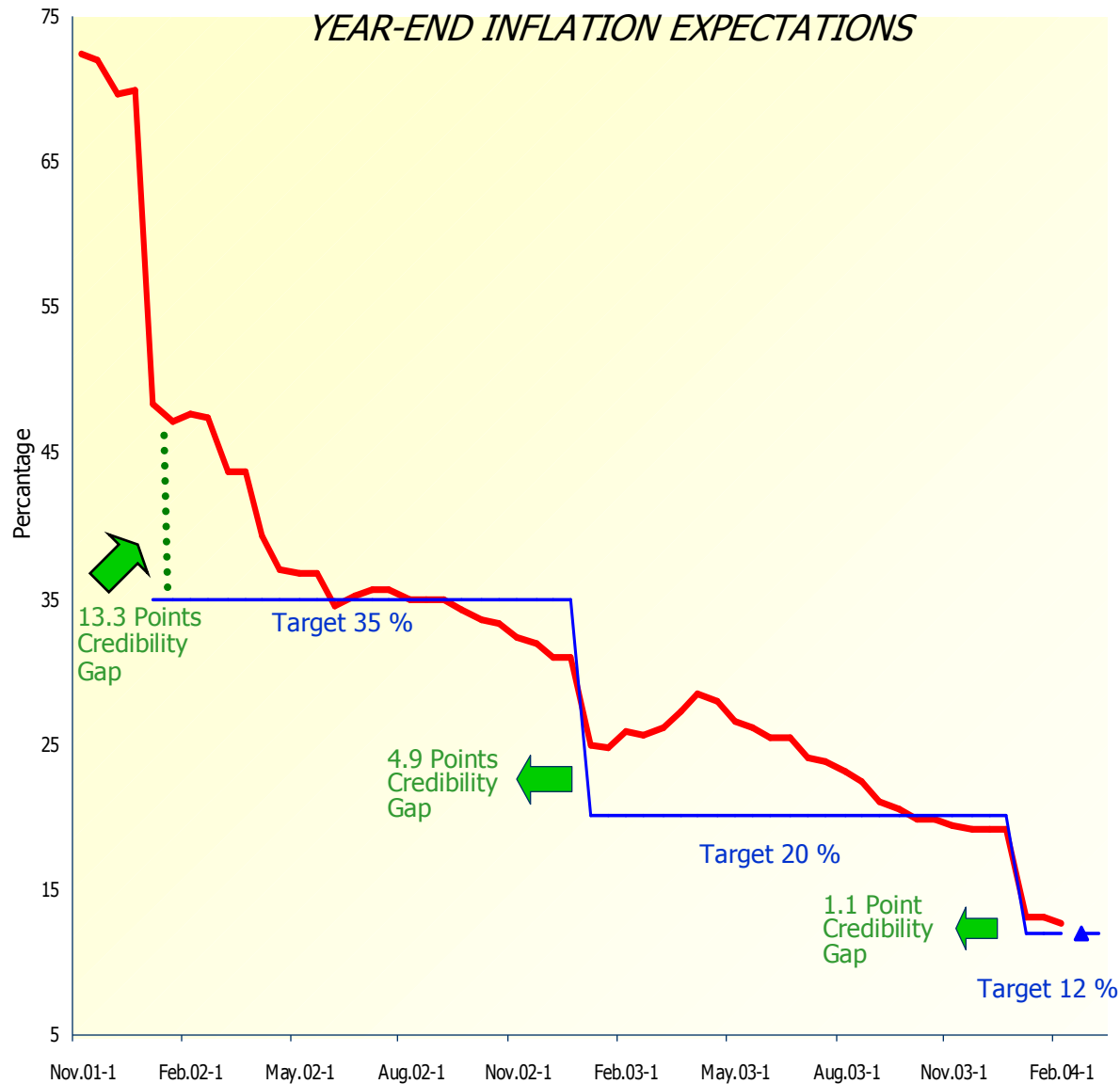
Today, inflation dynamics have been changing rapidly and irreversibly.

January 2004

- ✓ CPI: 0.7% monthly, 16.2% annual
 - ❖ Seasonally adjusted - 0.4 %
 - ❖ Quite below the expectations
 - ❖ Lowest rate on annual basis in the last 27 years
- ✓ WPI: 2.6 %monthly, 10.8 % annual
 - ❖ 9.3 % monthly increase in agricultural, 0.5 % rise in non-agricultural,
 - ❖ Declining trend still continues despite agricultural sector
- ✓ PMI: 0.6 % monthly, 9.1 % annual
 - ❖ Below 10 percent
 - ❖ An indicator of the declining trend in the inflation rate in the forthcoming period

In the first half of 2004, a rapid decline in inflation rate is expected due to the base effect, whereas in the second half of the year, there might be a break in the declining trend and even a possible rise in inflation rate. However, this trend is in accordance with the inflation target.

Price Stability



**Year-end inflation expectations
are in line with the target.**

Credibility Gap

2002 → 13.3 Points

2003 → 4.9 Points

2004 → 1.1 Points

Today → 0.7 Points

✓ Inflation target increasingly
becomes a more credible
nominal anchor for
economic agents.

Risks

In order to achieve the inflation target in 2004 and to have single-digit beyond permanently:

- ✓ **Sustaining discipline in incomes and fiscal policies** without compromise,
- ✓ **Local administrations** must pursue policies in line with their revenues,
- ✓ **Public price adjustment policies** in conformity with the **inflation target**,
- ✓ The breakdown of **backward-indexation mechanism**, especially in **education and health sectors**,
- ✓ Determined implementation of the **program and structural reforms**,
- ✓ **Avoiding developments which may worsen expectations**,
- ✓ Avoiding **price-setting behaviors intended to increase profit margins**,
- ✓ **Recovery in consumption** must continue **in a controlled manner** and should not put **pressure on inflation**.

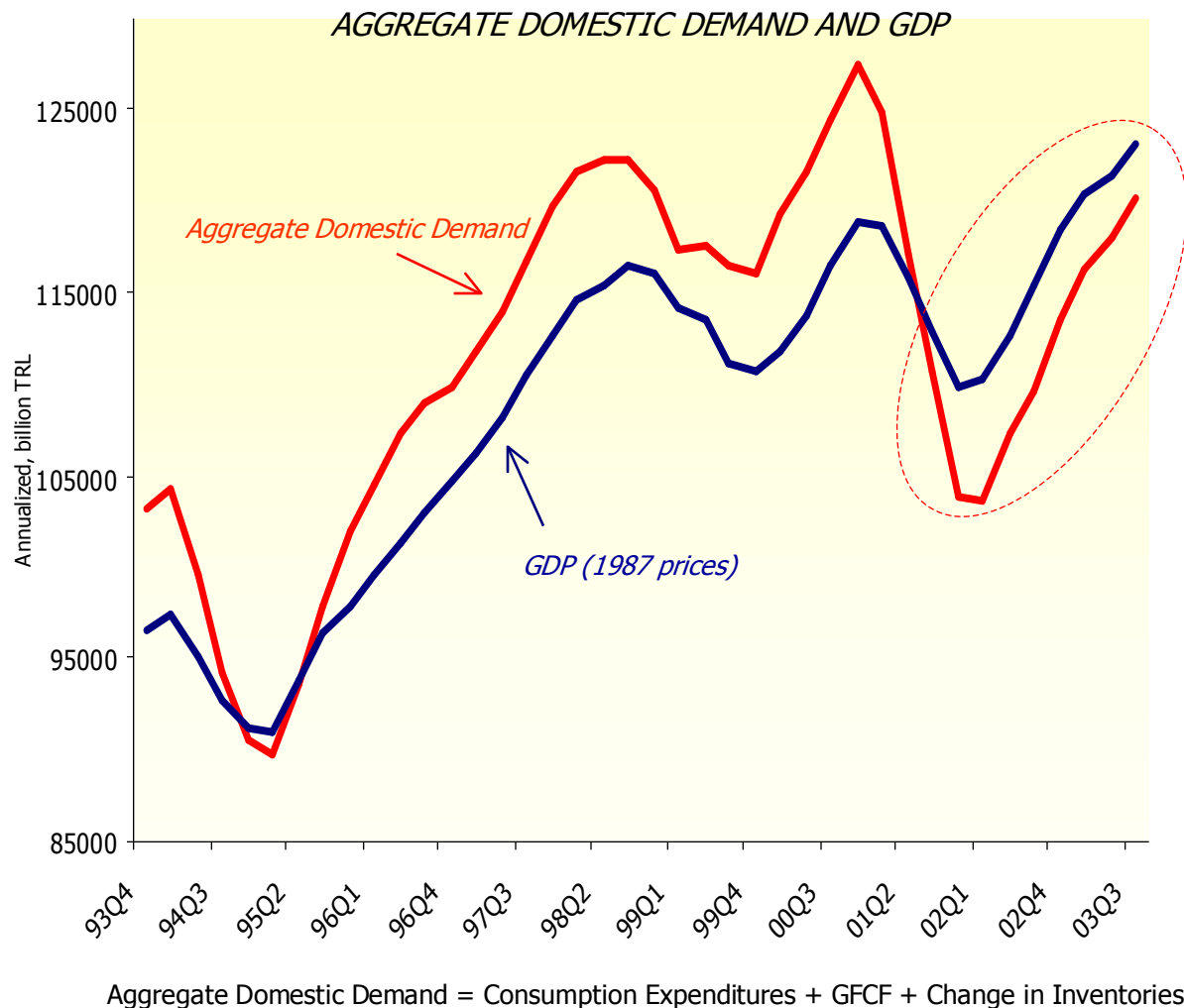
- ❖ Food, agricultural, oil and energy prices are always risks for the target.
- ❖ All of the above-mentioned risks are important and either of them may jeopardize the target.



HIGH AND SUSTAINABLE GROWTH

High and Sustainable Growth

The strong growth performance in 2002 and 2003 is expected to continue in 2004, as well.



2002

Estimation → 3 %

Realization → 7.8 %

2003, First 9 Months

Realization → 5.2 %

The increase in domestic demand has been lower than that of GDP.

Supporting factors:

- ✓ Exports
- ✓ Private Sector

High and Sustainable Growth

Supply-side and demand-side factors regarding growth:

- ✓ Growth based on private sector:
 - Increase in exports
 - Increase in industrial production
 - ✓ Stability in the financial markets and increasing confidence in the economy
 - ✓ Decline in real interest rates
 - ✓ Increase in productivity
- are expected to support growth.**

- ✓ Significant contraction in public sector
 - ✓ Limited increase in consumption expenditures
 - ✓ Low rate of employment
- are expected to keep domestic demand under control.**

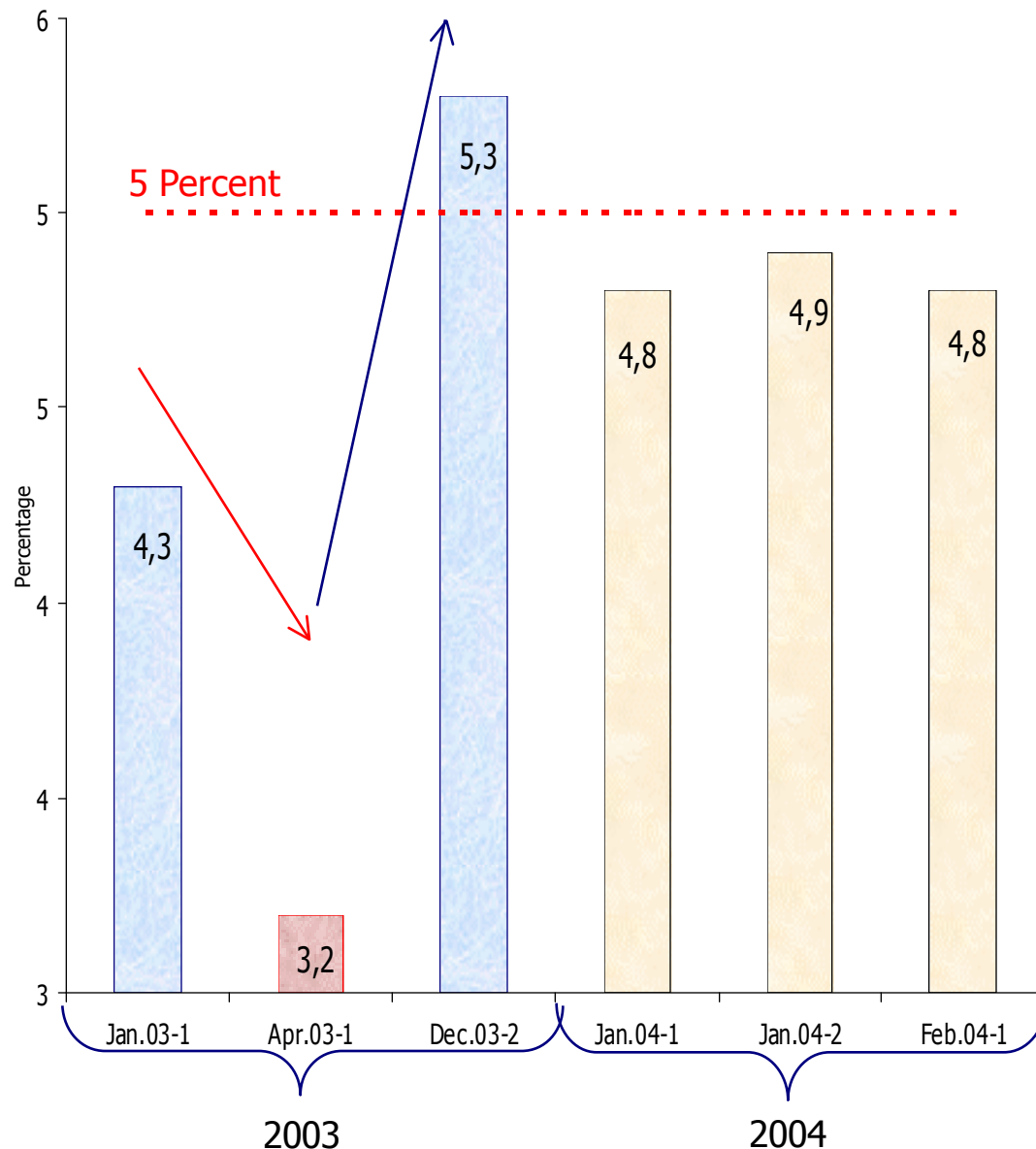
- ✓ A more sound growth of the private sector as a result of the change in capital accumulation process,
 - ✓ A sustained productivity increase and its prevalence
 - ✓ The changing nature of capital inflows
 - ✓ Improvement in governance indicators
- will ensure sustainable growth.**

High and Sustainable Growth

Growth expectations are in line with the Program's growth estimate

How?

- ✓ Relative stability in TRL and FX markets
- ✓ Better-than-envisioned economic data
- ✓ A favorable confidence environment



Year 2003

Estimate → 5 %

Expectations

April → 3.2 %

Dec. → 5.3 %

Year 2004

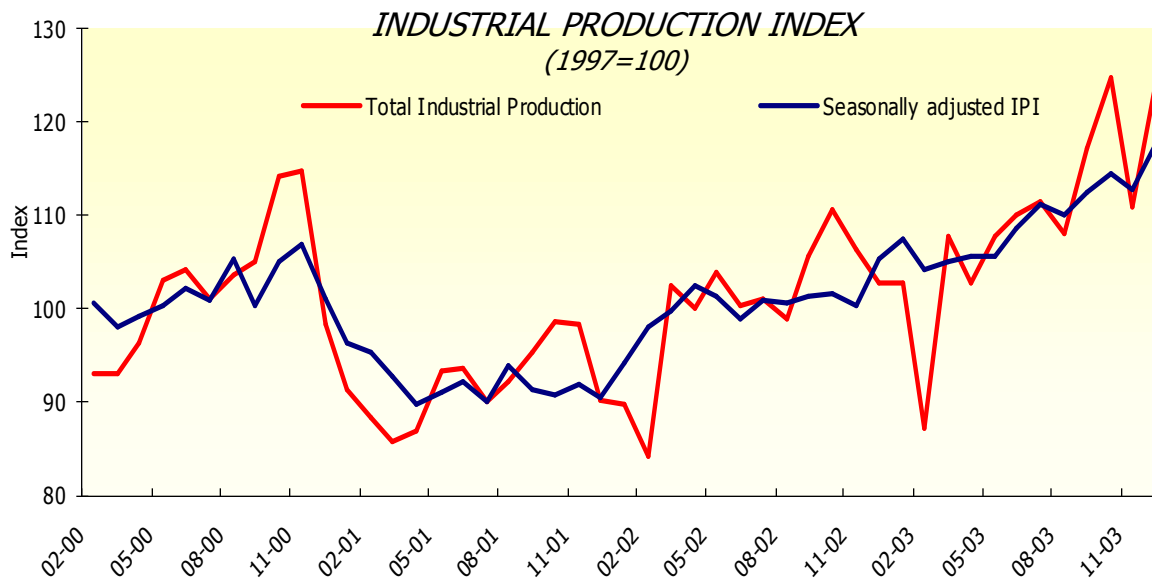
Estimate → 5 %

Expectations

Feb. → 4.8 %

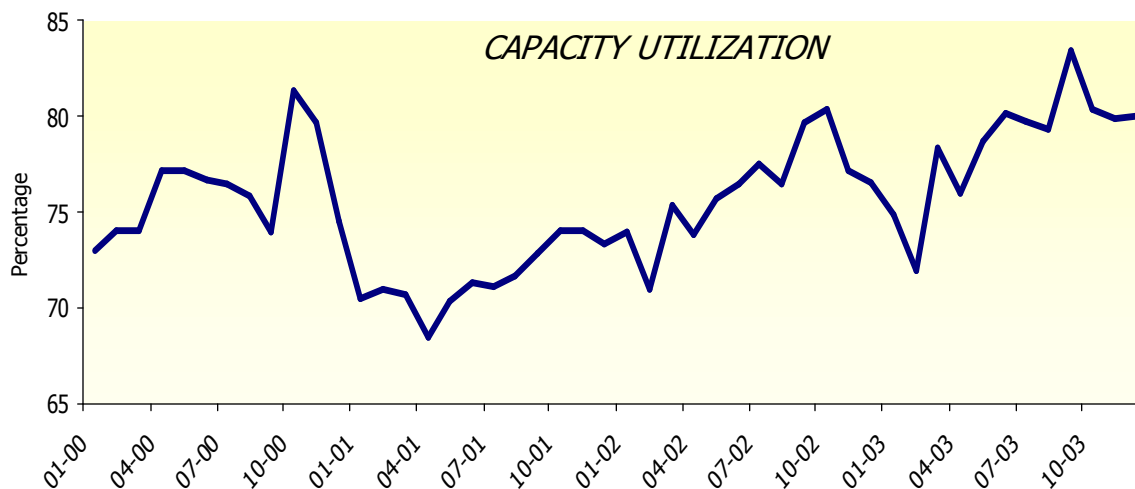
High and Sustainable Growth

Industrial production data verify the growth prospects of 2003 and 2004.



Industrial Production Index (IPI)

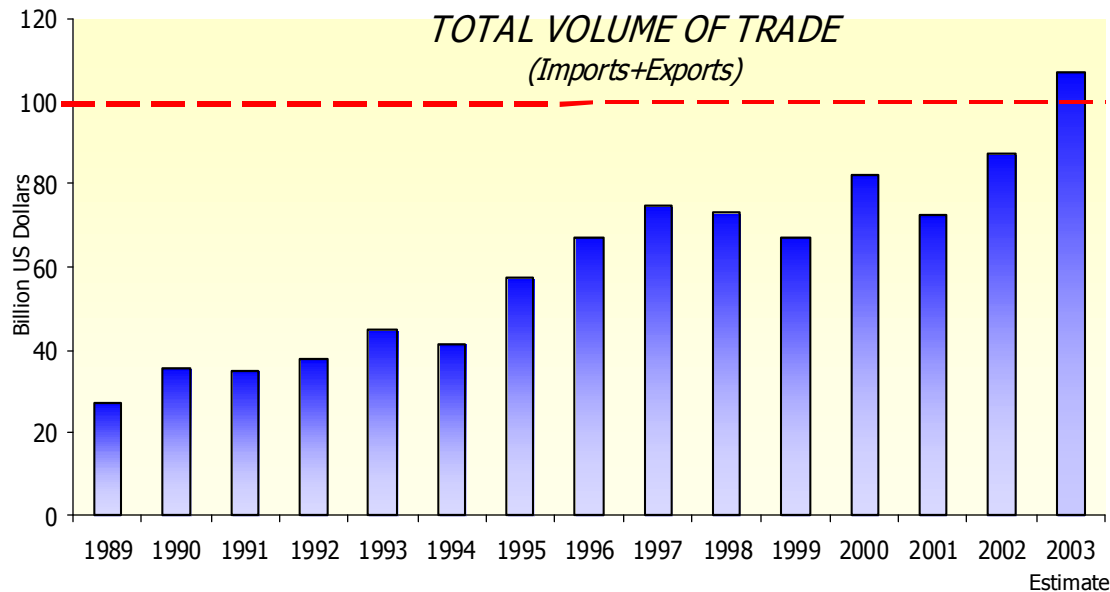
- ✓ **Historically the highest increase with a ratio of 21.1 %** in December 2003
- ✓ Rate of increase is quite above the expectations
- ✓ **Very close to the record levels** with a value of 124.4 in December 2003
- ✓ **Seasonally adjusted value reached record levels with a value of 117.9**
- ✓ Average annual increase for 2003 is 9.1 %



Capacity Utilization

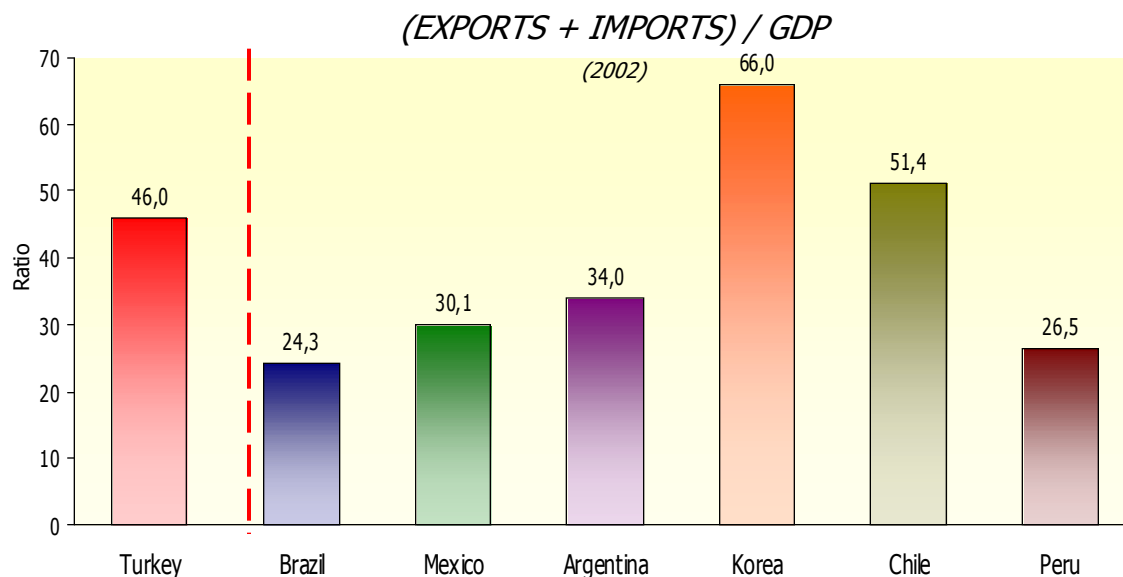
- ✓ 80 % in December 2003
- ✓ 79.6 % in private sector corresponds to 11 % on annual basis.

High and Sustainable Growth



Foreign Trade Data

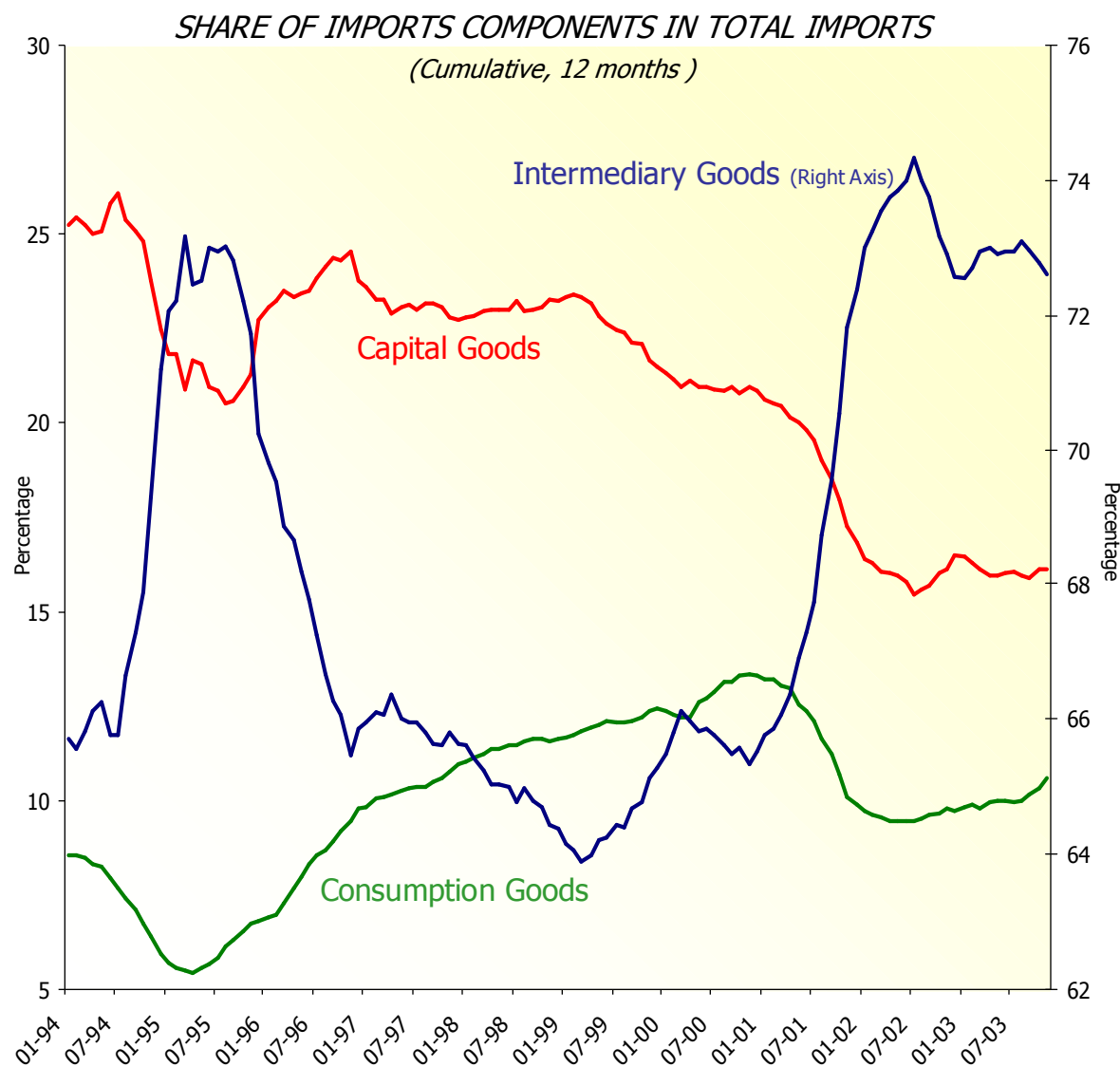
- ✓ Total volume of trade is estimated to exceed USD 100 billion for the first time ever and be realized around USD 110 billion.



Source: SIS, IMF

- ✓ The data reflect stronger integration of the Turkish economy into the world economy.

High and Sustainable Growth

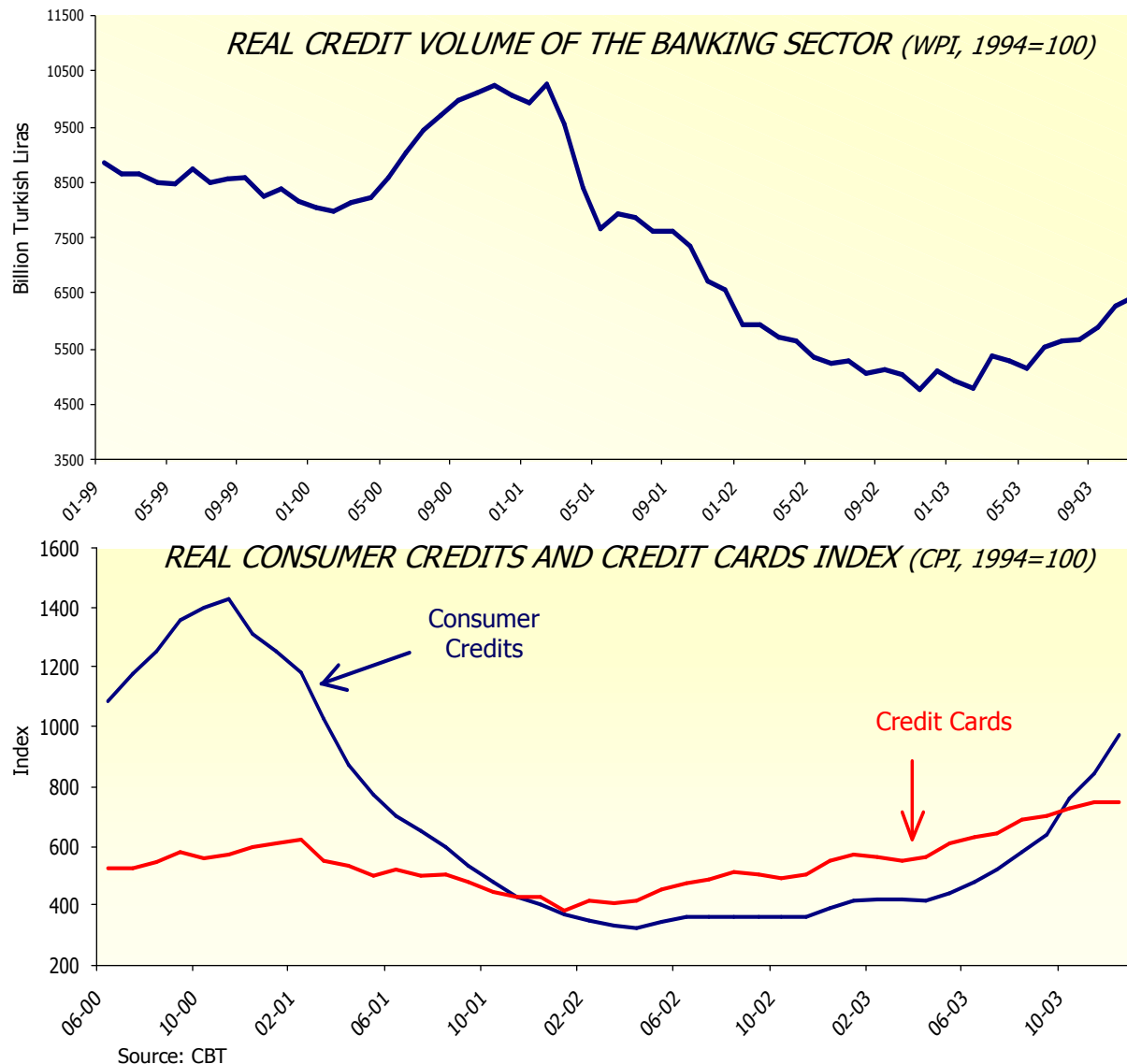


A closer look at the foreign trade data:

- ✓ Rapid increase in imports of intermediary goods
 - ✓ Imports of capital goods have reached the highest level in October 2003, since December 1997
 - Encouraging for new investment opportunities
 - ✓ Limited increase in imports of consumption goods
- ↓
- Imports directed to;
- ✓ Production
 - ✓ Exports

High and Sustainable Growth

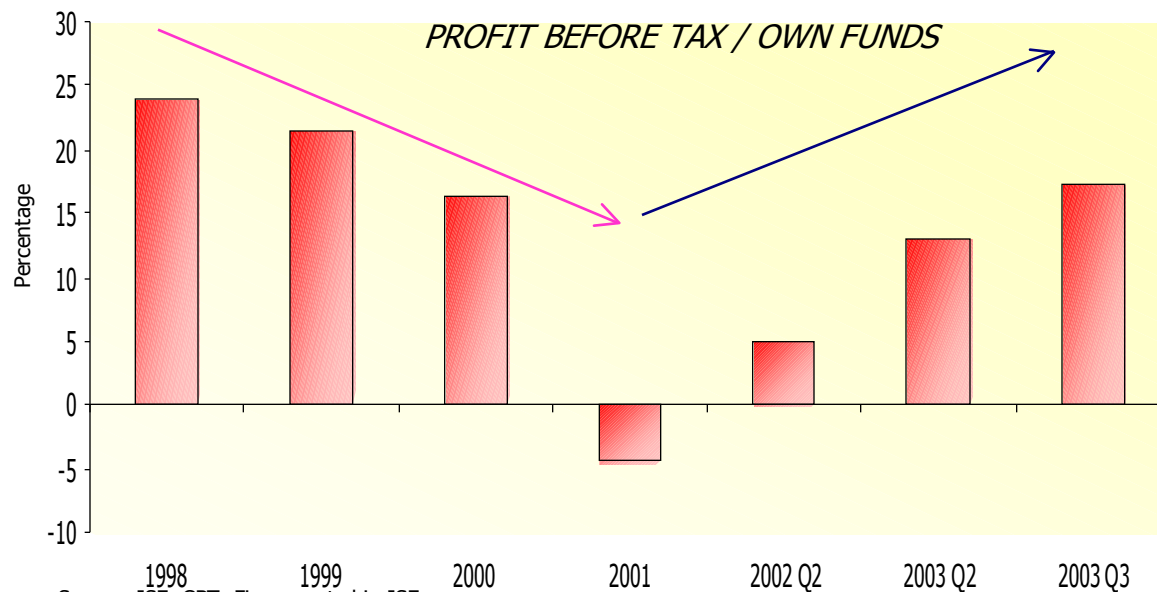
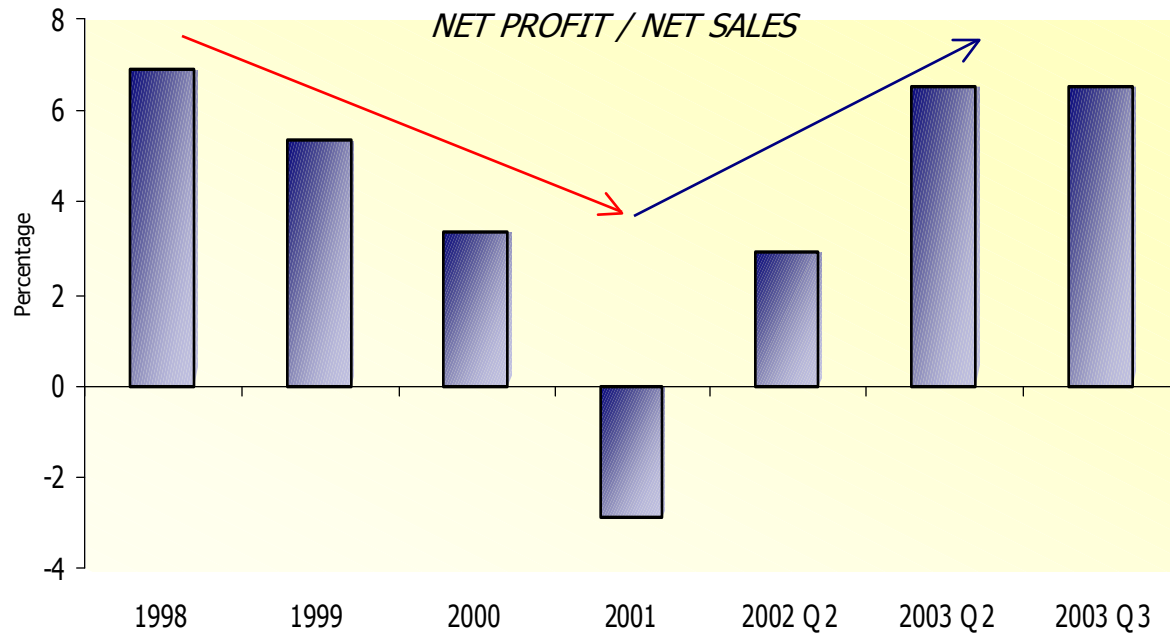
The contribution of the banking sector to growth performance increases, though not at the desired level.



✓ There is a revival in total credit volume of the banking sector and also an increase in the consumer credits and credit cards in real terms, which are the leading indicators.

✓ In order **to attain desired growth in the real sector**, the banking sector reforms **have to be put into practice immediately and be sustained without any interruption.**

High and Sustainable Growth

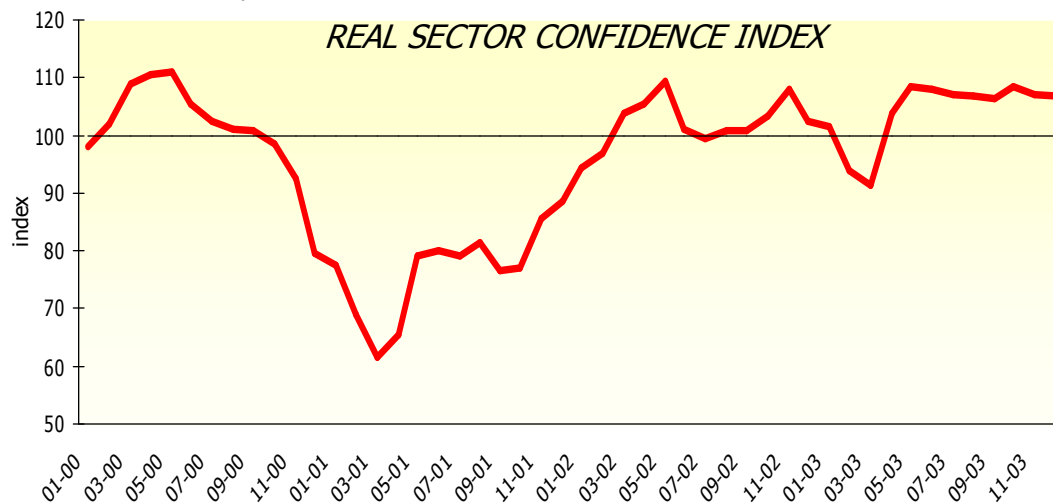
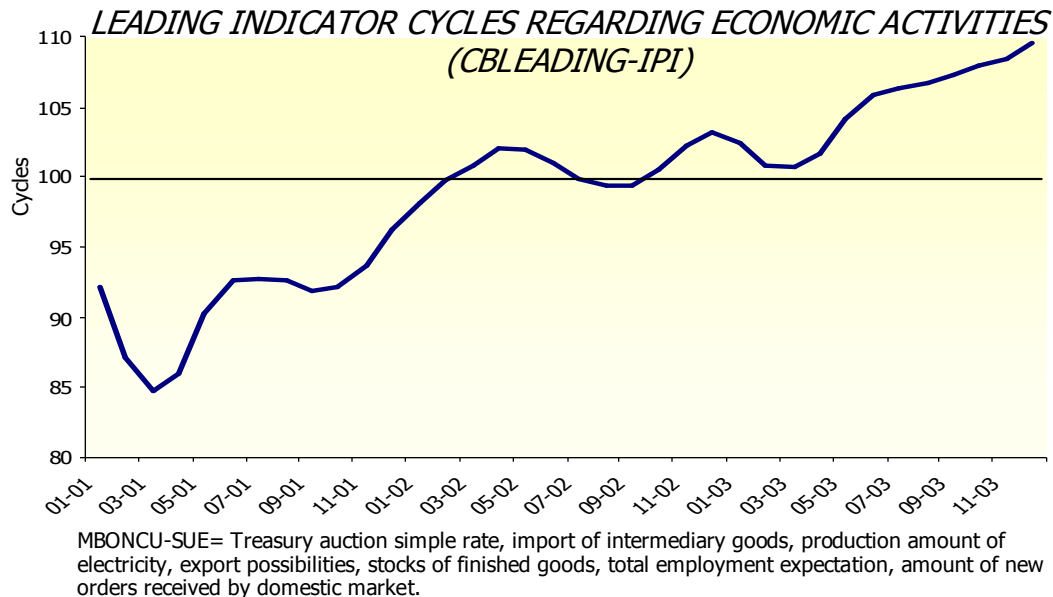


Source: ISE, CBT, Firms quoted in ISE

- ✓ A rapid improvement in the profit margins of companies is observed following the crises.
- ✓ This is a very favourable development for the future.

High and Sustainable Growth

Although expectations about economic outlook are positive, they have to be monitored closely.



Leading Indicators Index

- ✓ 126.9 in December 2003
- ✓ Accelerating since April

Real Sector Confidence Index

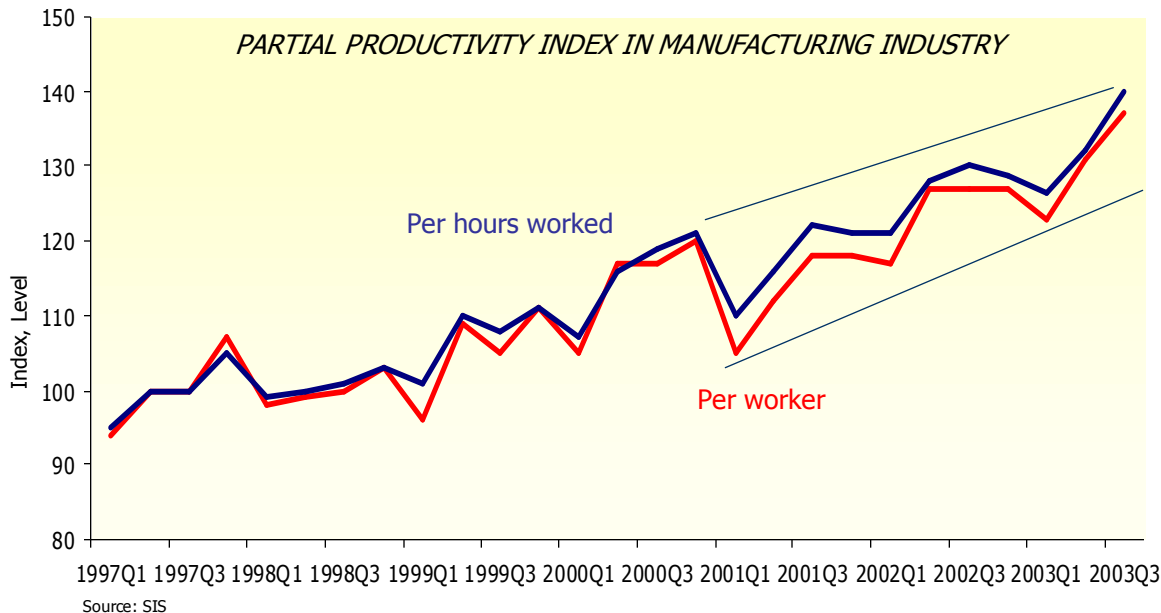
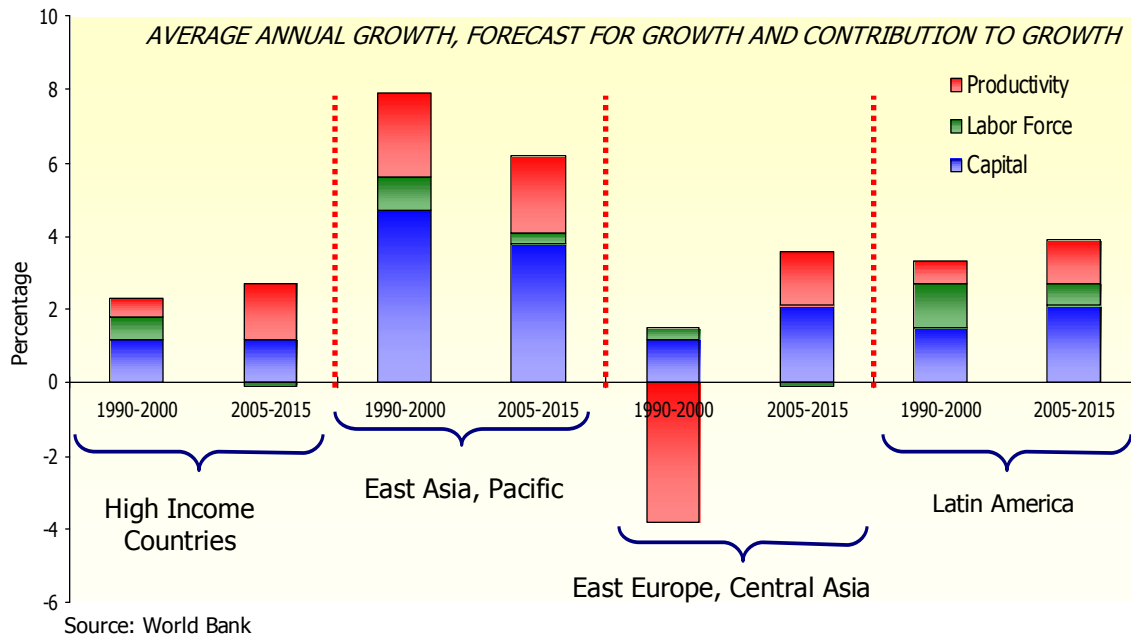
- ✓ 106.6 in December 2003
- ✓ Above 100 since April 2003 and follows a high course since then

There is no reason for the 2003 and 2004 growth projections not to be realized.

In order to maintain this structure and keep it permanent, all policies primarily the economy policies should encourage supply rather than demand from now on.

Three Factors are Crucial for the Future.

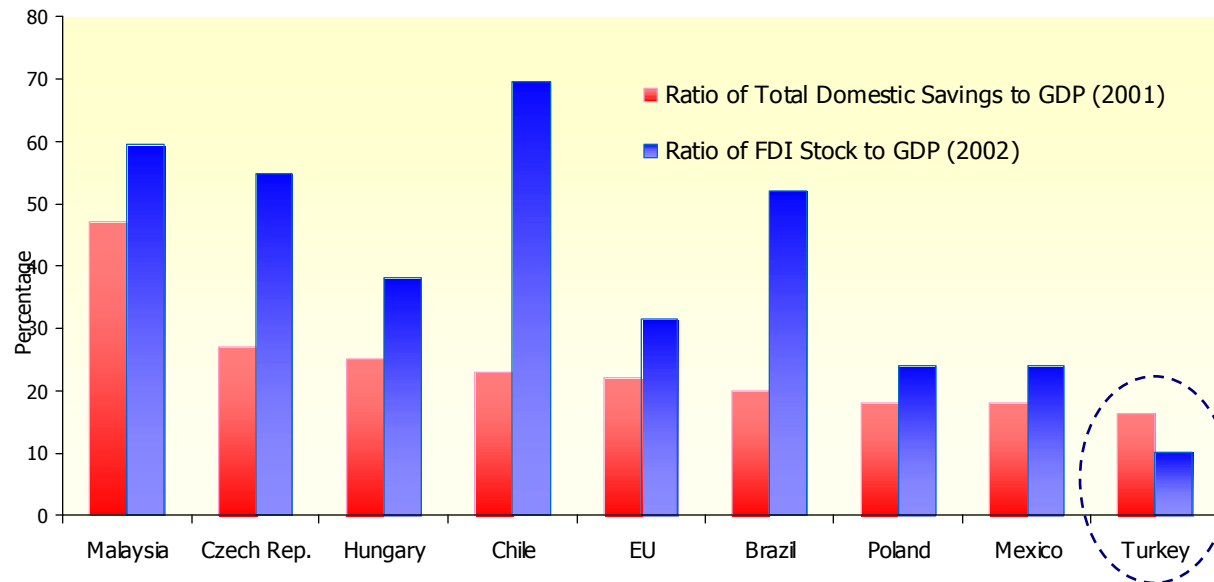
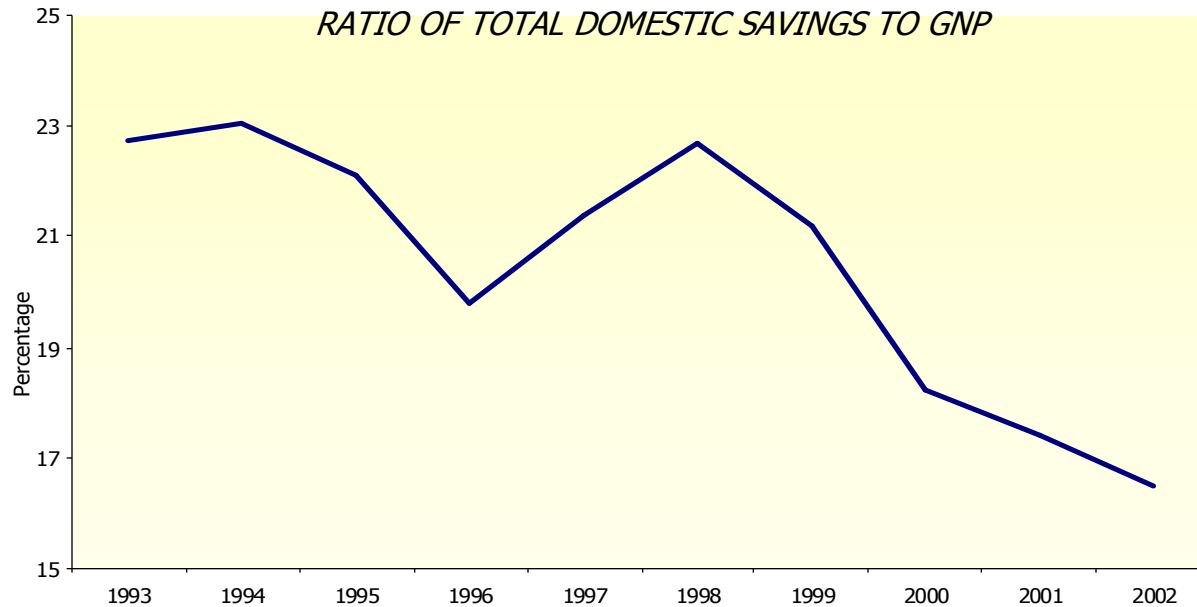
High and Sustainable Growth



1- Productivity

- ✓ A **significant factor of growth** in the next 10 years
- ✓ A **rapid productivity increase in manufacturing industry** has been observed recently in Turkey, as well.
- ✓ **However, increase in productivity should be sustainable and realized in all sectors.**

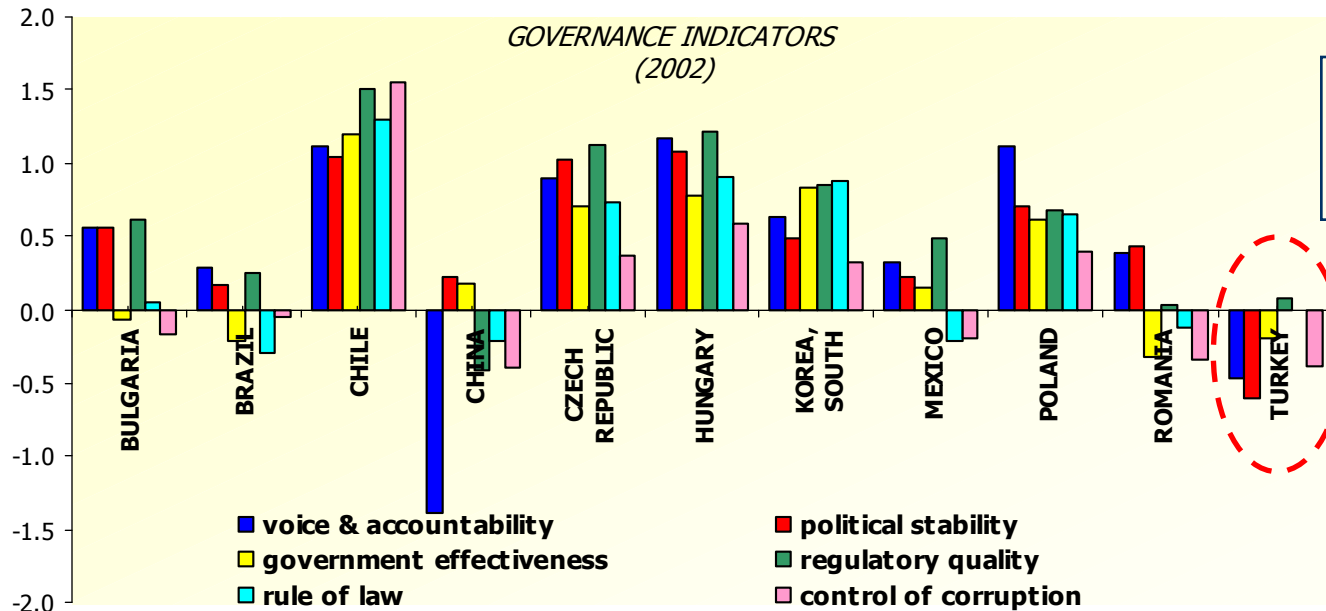
High and Sustainable Growth



2- Foreign Direct Investment

- ✓ Turkey has chronic savings deficit. Despite high real interest rates in previous years, the ratio of domestic savings to GNP has not increased, but decreased on the contrary.
- ✓ As compared to other countries, both domestic savings rate and foreign direct investment stocks are quite low in Turkey.
- ✓ It is quite difficult to increase income and **change savings behavior** in the short-term
- ✓ Savings deficit has to be met with **foreign direct investment**

High and Sustainable Growth

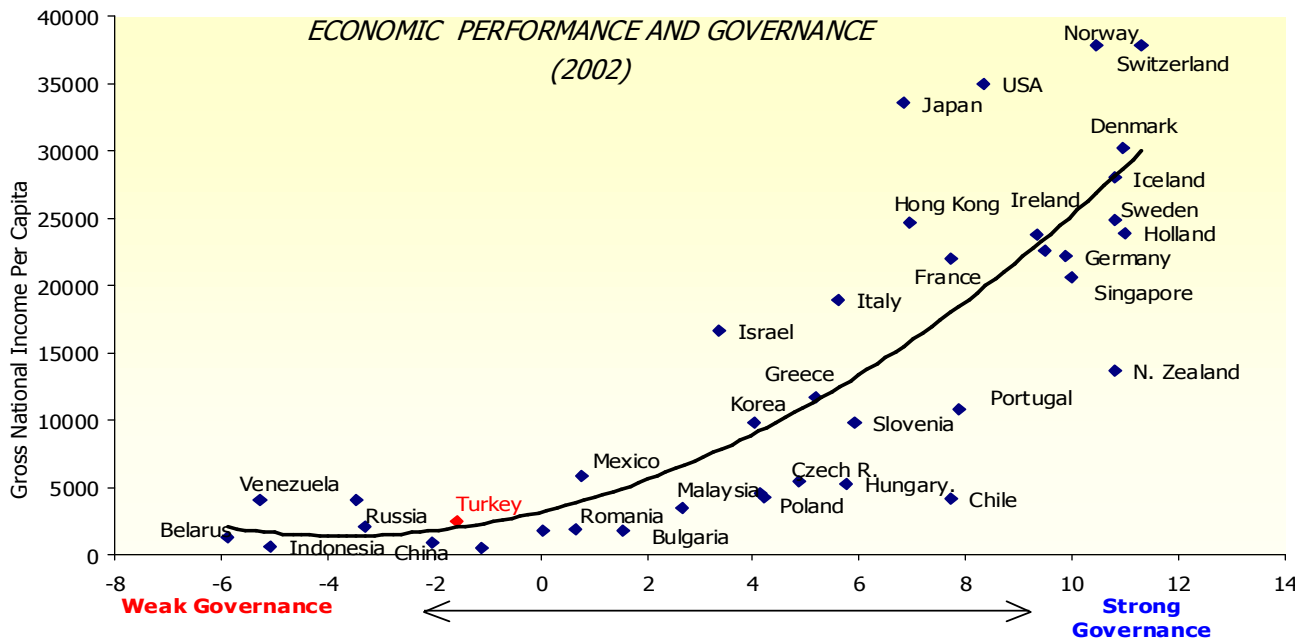


3-Good Governance

✓ Despite a slight improvement, Turkey still remains behind, as of 2002.

✓ **There is a strong positive relationship between income per capita and governance.**

✓ Good governance is a **crucial factor** to achieve a strong economic performance.



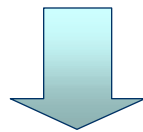


EXCHANGE RATE POLICY

Exchange Rate Regime

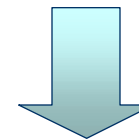
Considering monetary policy designs within the framework of exchange rate regime in Turkey, three different periods are observed depending on the regulations about capital movements.

Capital Movements



Restricted

- 1- Both interest rates and exchange rates are under control; pre-1980.



Free

- 2- Exchange rates are under control, interest rates are free: Passive monetary policy 1990 - 2001.
- 3- Interest rates are under control, exchange rates are free: Active monetary policy; post-2001.

Conclusion: When capital movements are free, neither interest rates nor exchange rates can be controlled at the same time.

Exchange Rate Regime

Under the current exchange rate regime;

- ✓ The choice of **the exchange rate regime** is determined jointly by the Government and the Central Bank.



Floating Exchange Rate Regime

- ✓ **Exchange rate policy** is implemented by the Central Bank of Turkey.

Under market economy, the exchange rate is determined according to the

- ✓ Developments in the economic program,
- ✓ Expectations, especially balance of payments expectations,
- ✓ Basic economic indicators,
- ✓ Behavior of market players,

Central Bank Exchange Rate Policy

Central Bank Interventions

I – Volatility Interventions

- ✓ In a limited and transparent manner
- ✓ To prevent excessive volatility in either sides
- ✓ Can be through announcements or warnings

II – Interventions Aimed to Build Up Reserves

- ✓ Sterilizing excess supply of foreign exchange
- ✓ Compatible with the floating exchange rate regime and with no effect on the level of the exchange rate
- ✓ Transparent and rule-based mechanisms.

Central Bank has no policy of keeping the exchange rate level low



- ✓ The Central Bank did not sell any foreign exchange in 2003 and 2004, even when the Turkish Lira went down to the level of 1,780,000 TL against USD.
- ✓ The Central Bank bought almost US dollar 10 billion in 2003 through foreign exchange buying auctions.
- ✓ **Daily foreign exchange buying auctions were restarted as of January 23, 2004.**

Central Bank Exchange Rate Policy

The Central Bank does not find it appropriate to announce an exchange rate level at this stage of the economic program.

- ✓ The decline in inflation is not sufficient yet; the structural reforms have not been completed.
- ✓ Public finance policy and the expectations related to these policies have significant influence on the economic variables.

Stronger stability in the exchange rate will be maintained through

- ✓ Strengthening macroeconomic fundamentals,
- ✓ Reducing economic fragilities.

**The Exchange Rate is Not
a Reason Anymore.**



**It is only
a Result.**

Floating Exchange Rate Regime

Under the floating exchange rate regime;

The market bears the exchange rate **risk**.

On the other hand, an **uncertainty** like inflation disappears.

Uncertainty

Outcomes cannot be foreseen.

Various and severe impacts might occur in every aspect.

It cannot be managed or avoided.

Risk

Outcomes can be measured and assigned a value with certain probabilities.

It can be avoided and managed.

Markets are available for protection.

How to Manage the Exchange Rate Risk?

In fact, there is a notion of risk avoidance in Turkey.

However, risks have changed over time.

In the Past

Protection against
inflation uncertainty



Foreign exchange
purchases



At no cost for individuals

At a very high cost for the whole economy

Now

Protection against the
foreign exchange risk



Futures market
transactions



Being well-informed

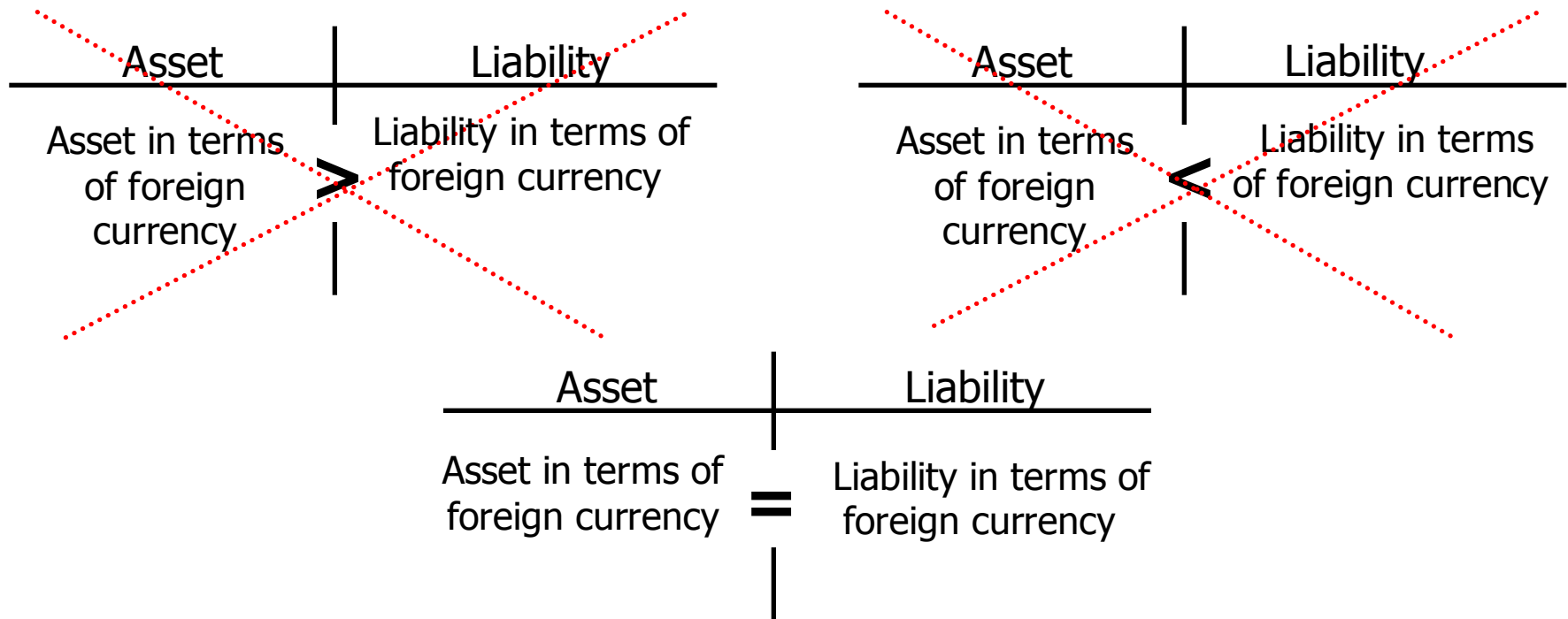
Working harder

- ✓ Now, it should be accepted that **this individual cost has to be paid.**
- ✓ It is inevitable that the economic agents learn how to protect themselves against the exchange rate risk. **How?**

Floating Exchange Rate Regime

How ?

Companies should adjust their assets and liabilities carefully.



How to make equal?

Companies should protect themselves against the exchange rate risk in their balance sheets by using futures market.

Floating Exchange Rate Regime

What are futures market transactions?

“Foreign Exchange Contracts” are the most widespread futures market transactions. These are the contracts where :

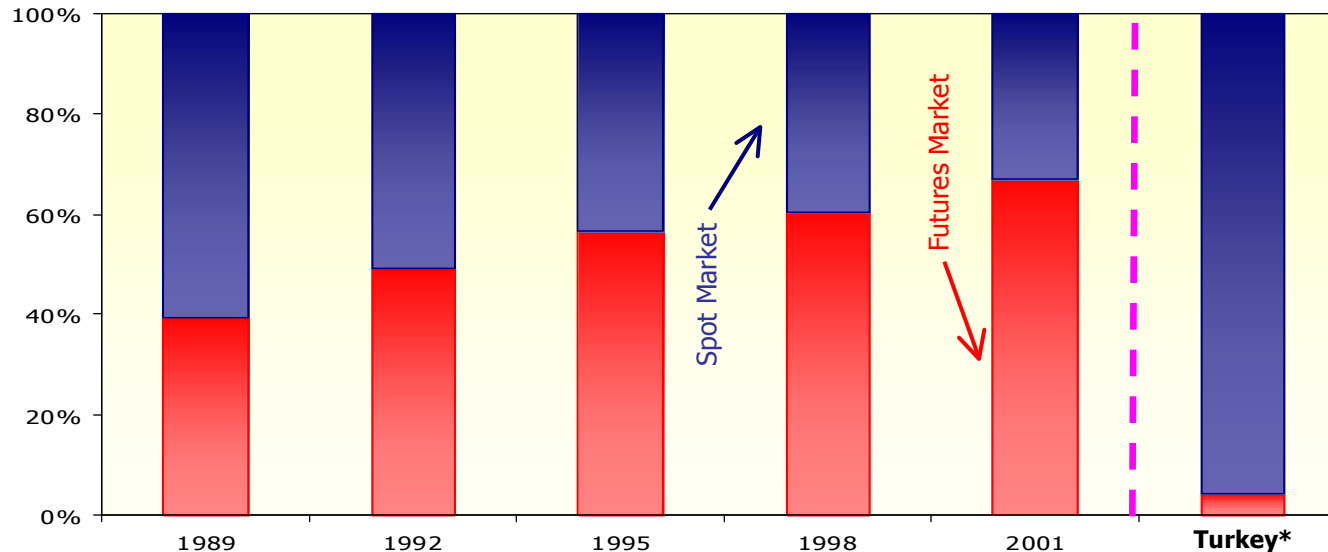
✓ Transaction
date exceeds
that of the
spot market.

✓ Foreign
exchange is to
be delivered at
a later date.

❖ Term/ Maturity
❖ Amount
❖ Price
are set today.

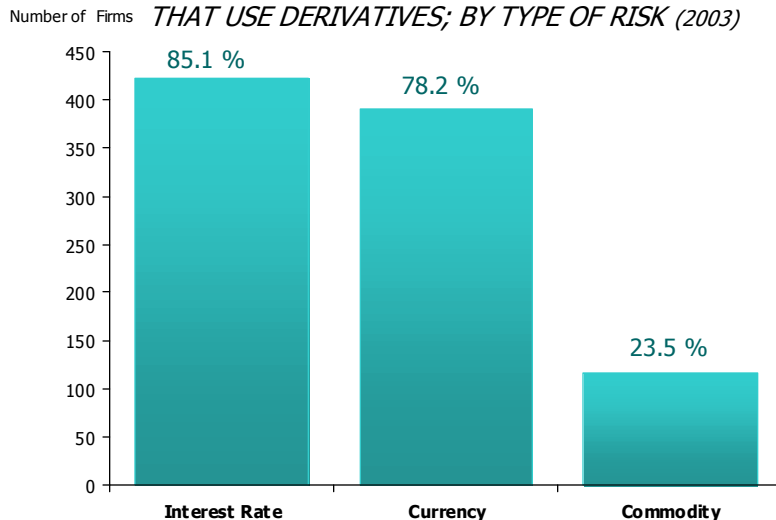
Futures Market

SHARES OF SPOT AND FUTURES MARKET TRANSACTIONS IN TOTAL TRANSACTIONS WORLDWIDE

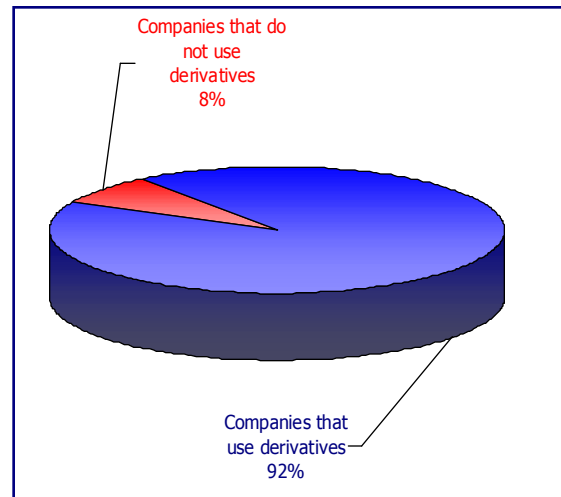


Average daily transactions volume of the global foreign exchange market in the fourth month of the related year was used in the calculation.
 *For Turkey, the daily average of April 2003 was used. Source: CBT, BIS.

NUMBER OF THE WORLD'S TOP 500 COMPANIES THAT USE DERIVATIVES; BY TYPE OF RISK (2003)



Source: ISDA (International Swaps and Derivative Association)



- ✓ The total volume of futures market is higher than that of spot in the world, while the total volume of futures market is very low in Turkey.
- ✓ 92 % of the top 500 non-financial firms of the world are hedging their balance sheets via derivatives instruments.
- ✓ It is no use to think that "it is not the right time" or "we cannot do this" just as in fighting with inflation.

Floating Exchange Rate Regime

Under the floating exchange rate regime, the Central Bank attaches great importance to the development of **futures market** and instruments of **hedging**.

As of today, to ensure widespread use of these markets,
it is necessary that;

✓ The derivatives market at the Istanbul Stock Exchange should be made known to the public.

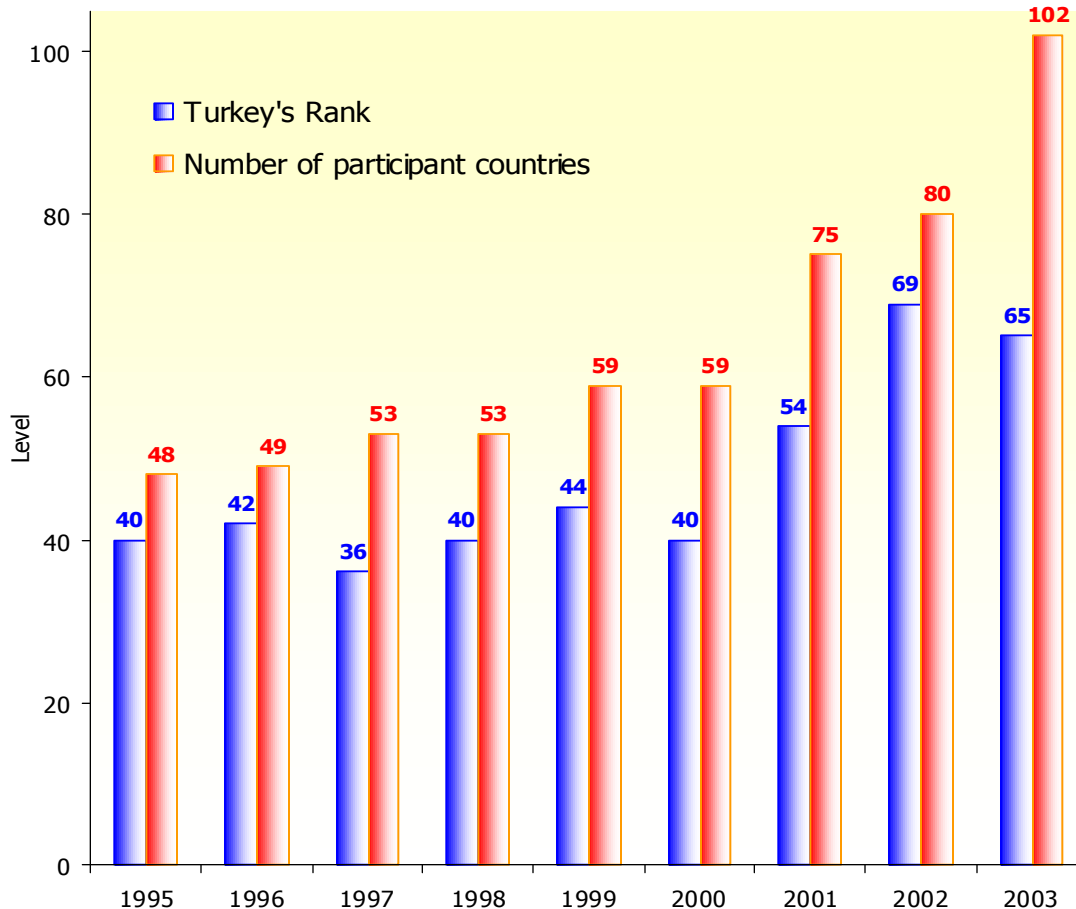
✓ The importance of **risk-avoidance** should be accepted in its modern sense.

In this respect, non-governmental organizations have important roles to play.

Floating Exchange Rate Regime

Exchange rate is not the single and the most important factor of competitiveness.

TURKEY'S RANK IN GLOBAL COMPETITIVENESS



Despite devaluations, Turkey's competitive power constantly deteriorates



Competitiveness is a comprehensive issue

- ✓ Exchange rate is only one of the factors affecting competitiveness.
- ✓ Sustainable competitiveness cannot be maintained through exchange rate adjustments.

Turkey's competitiveness somewhat improved in 2003, despite the appreciation of the Turkish lira.

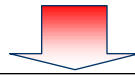
Source: World Economic Forum, Global Competitiveness Report, CBT.

The macroeconomic environment, quality of public institutions and technology factors are taken into account in preparation of the index.

Floating Exchange Rate Regime

Exchange rate is not the single and the most important factor of competitiveness.

Factors determining sustainable competitiveness



Price Competitiveness

Real Exchange Rates, Relative Position, Unit Wages



Qualitative Factors

After-sales Support Services, Product Standardization



Structural Factors

Macroeconomic Performance, Economic and Social Development Level, Productivity, Qualified Labor Force, Research – Development



Besides, in order for companies to be able to compete in international markets, their input costs need to be at reasonable levels by global standards.

Floating Exchange Rate

What is the risk of running current account deficit?

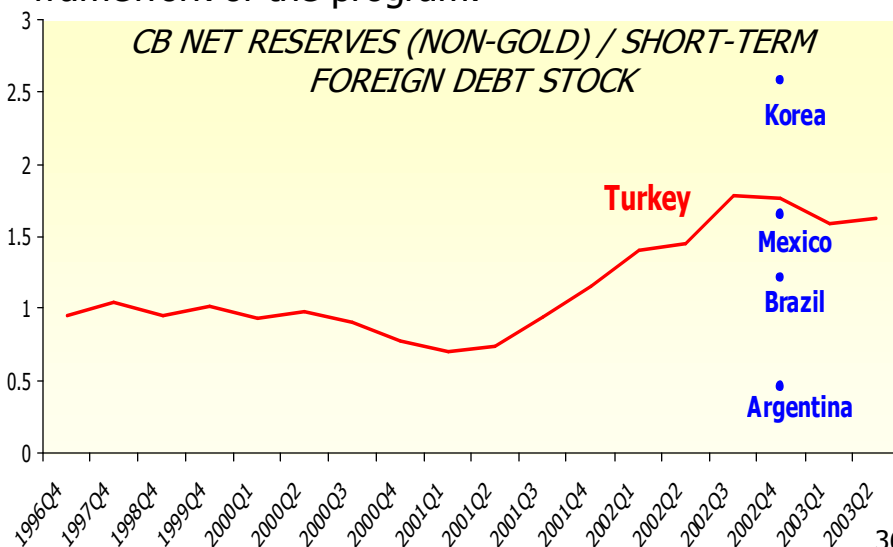
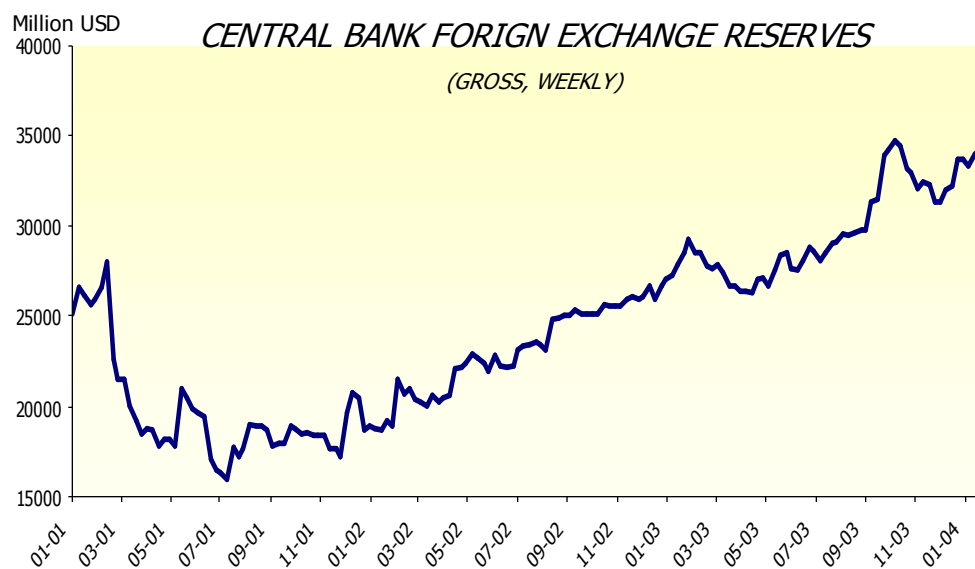
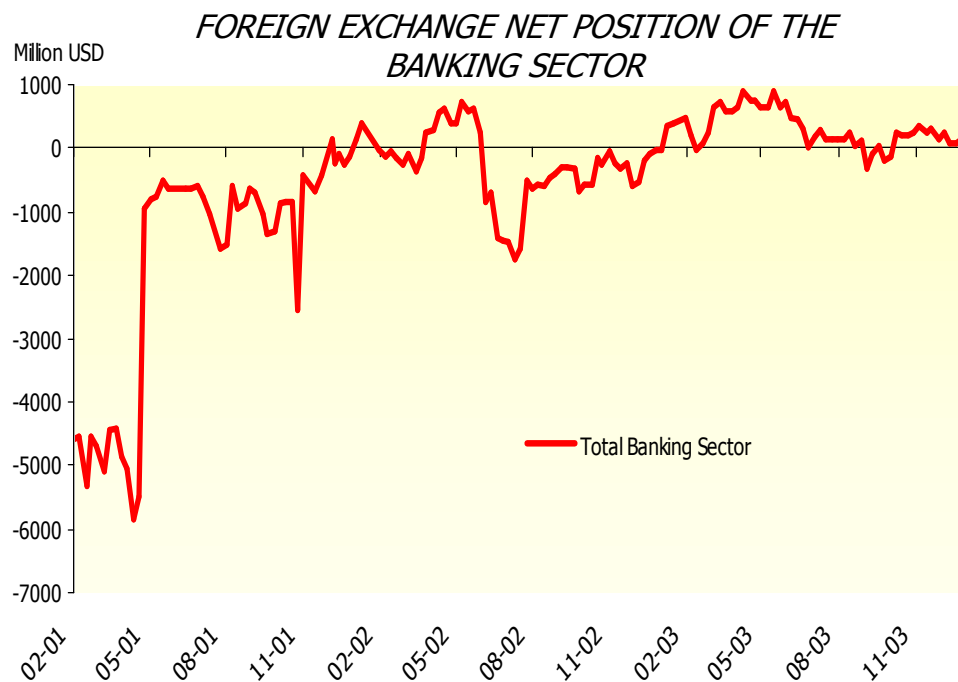
Current account deficit in January – November period is USD 4.2 billion,
Current Account Deficit/GDP is 2.3% in 2003 Q3

Circumstances are different:

1. Open positions in the financial system are much lower in the aftermath of the banking sector reform. Tendency to adopt past behavior is risky.
2. Turkish lira is not kept overvalued through foreign exchange sales of the CBT. On the contrary, CBT has bought foreign exchange.
3. Short-term capital flows is not encouraged, being aware of the exchange rate risk.

Central Bank's foreign exchange reserves has reached the record high levels as compared to the past.

Tight fiscal policy is implemented within the framework of the program.



Important Points Related to the Exchange Rate Within the Framework of the Current Interest Rate Policy

The relation between short-term interest rates and exchange rate is multi-dimensional and complicated:

When short-term interest rates are cut, **three types of cases might occur:**

1

Yields on Turkish lira assets decline.



Demand for foreign exchange increases.



Turkish lira comes under **pressure to depreciate.**

2

Positive signal regarding economic outlook



Confidence increases.
Reverse currency substitution gets stronger.



Turkish lira comes under **pressure to appreciate.**

3

Exchange rate, which is influenced by foreign exchange liquidity in the market, moves

independently of the economic fundamentals.

Important Points Related to the Exchange Rate Within the Framework of the Current Interest Rate Policy

The appreciation of the Turkish lira is, in fact, the natural outcome of the increasing confidence in the current program implementation.

➡ Virtuous Circle

- ✓ Reverse currency substitution
- ✓ Expected increase in capital inflows

Excess forex supply

Pressure on exchange rate

What can the Central Bank do?

Short-term interest rate cuts depend on inflation outlook, so

It is the best to sterilize excess forex supply via transparent and rule-based mechanisms consistent with the floating exchange rate regime.

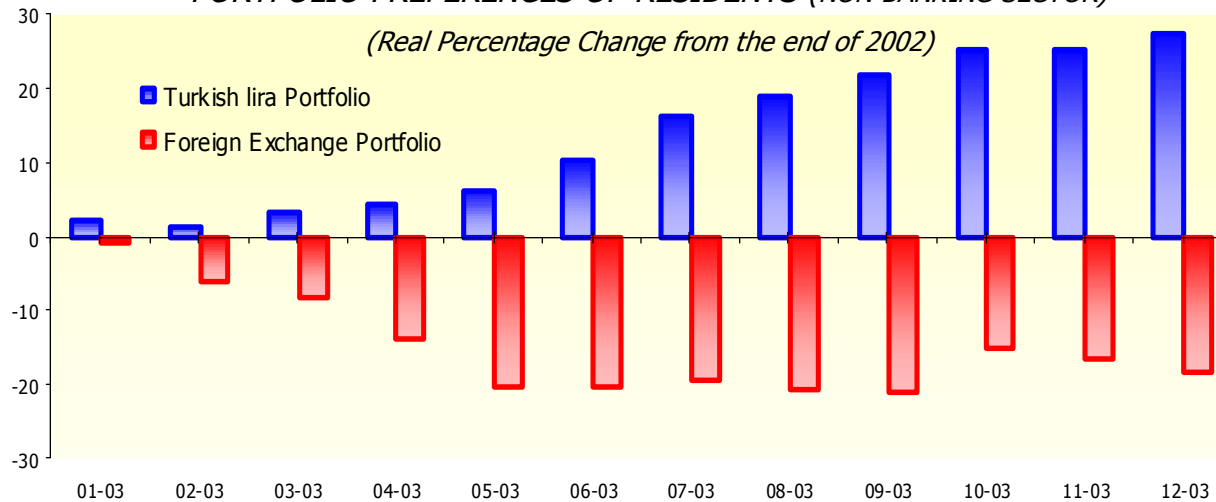
FX buying auctions

International reserve position strengthened

Markets

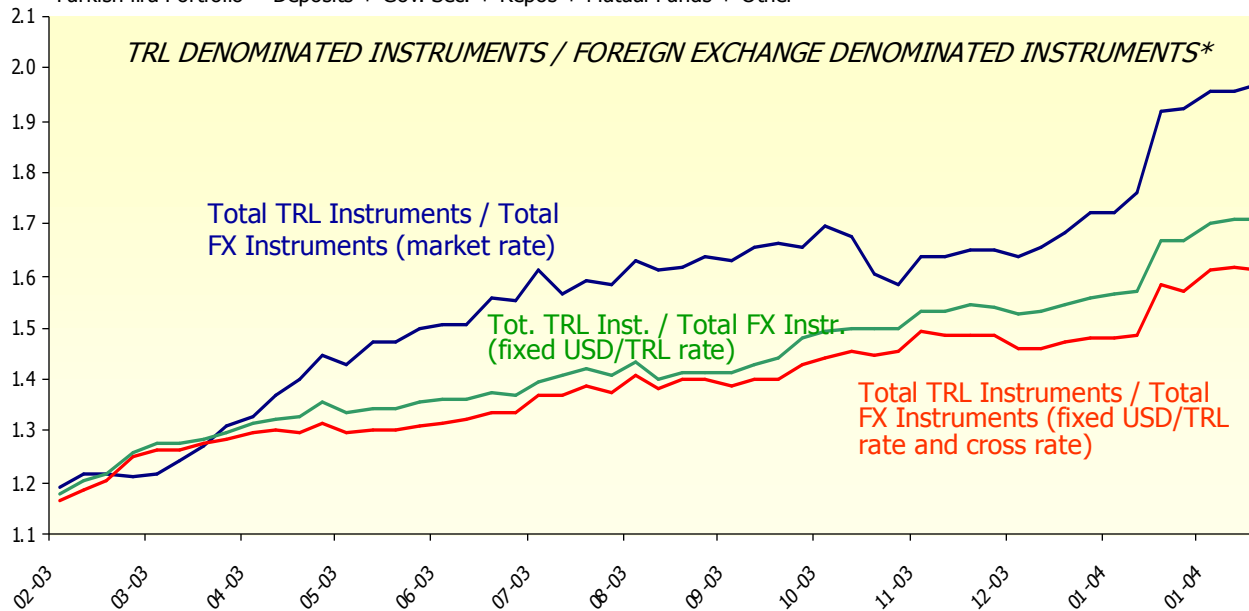
PORTFOLIO PREFERENCES OF RESIDENTS (NON-BANKING SECTOR)

(Real Percentage Change from the end of 2002)



Foreign Exchange Portfolio = Deposits + Gov. Sec. + Eurobonds + Other

Turkish lira Portfolio = Deposits + Gov. Sec. + Repos + Mutual Funds + Other



* The sudden jump observed in deposits is due to payments of İmar Bank.

TRL Denominated Instruments = Deposits + Gov. Securities + Mutual Funds + Repo + Other

Foreign Exchange Denominated Instruments = Deposits + Gov. Securities in fx, fx linked.

✓ Since the beginning of 2003, Turkish lira portfolio held by the non-banking sector has been increasing in real terms, while foreign exchange portfolio has been decreasing.

✓ The ratio of Turkish lira denominated instruments to foreign exchange denominated instruments has been rising substantially.

✓ The increasing trend of the ratio is clearly noticed even when considering USD/TRL rate and fixed EUR/USD rate. Moreover, it is observed to be at quite high levels in the recent period.

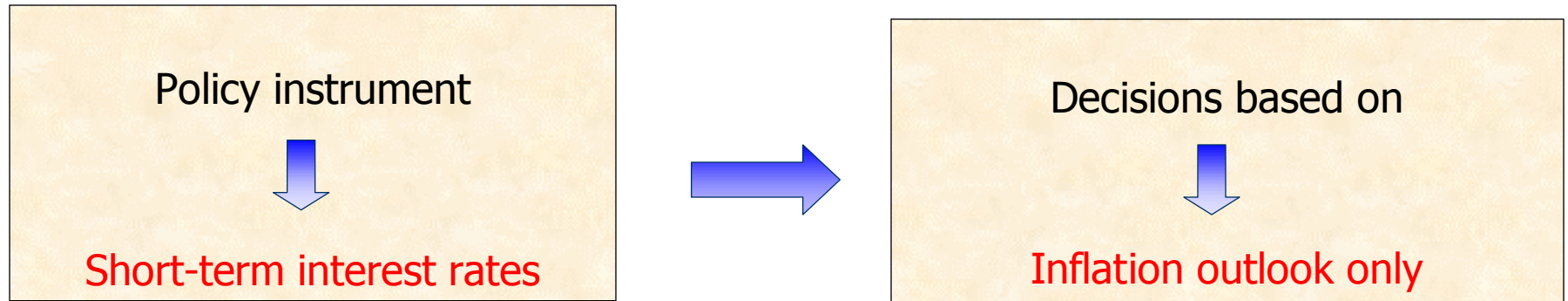
Conclusion:

Portfolio changes towards Turkish lira are associated with the confidence in the economic and political perspective.

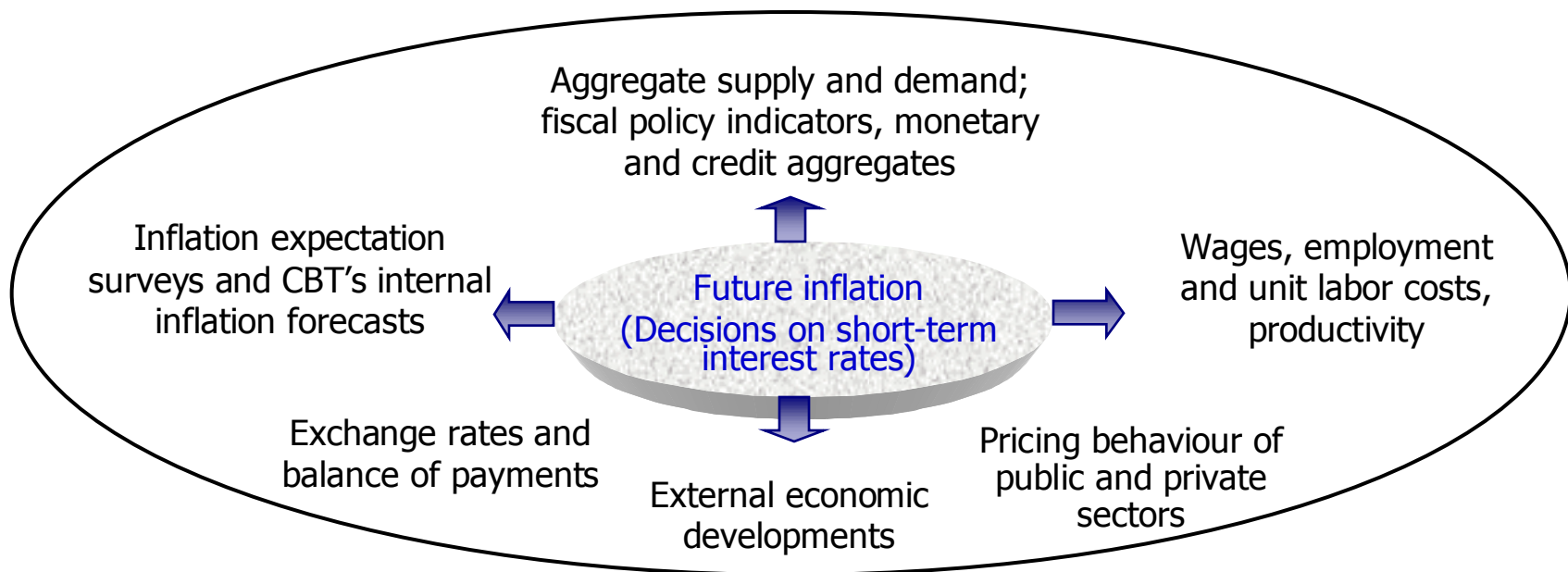


INFLATION AND INTEREST RATES

Short-term Interest Rates



Which factors are observed to foresee future inflation?



Short-term Interest Rates

Why is only inflation taken into account?

By taking merely the inflation target and forecasts into consideration,
and by no longer considering the targets such as exchange rate, balance of
payments, growth, public finance, supporting banking sector, etc.



Clear signals are given to the economic agents



Risk premium of investment instruments ↘



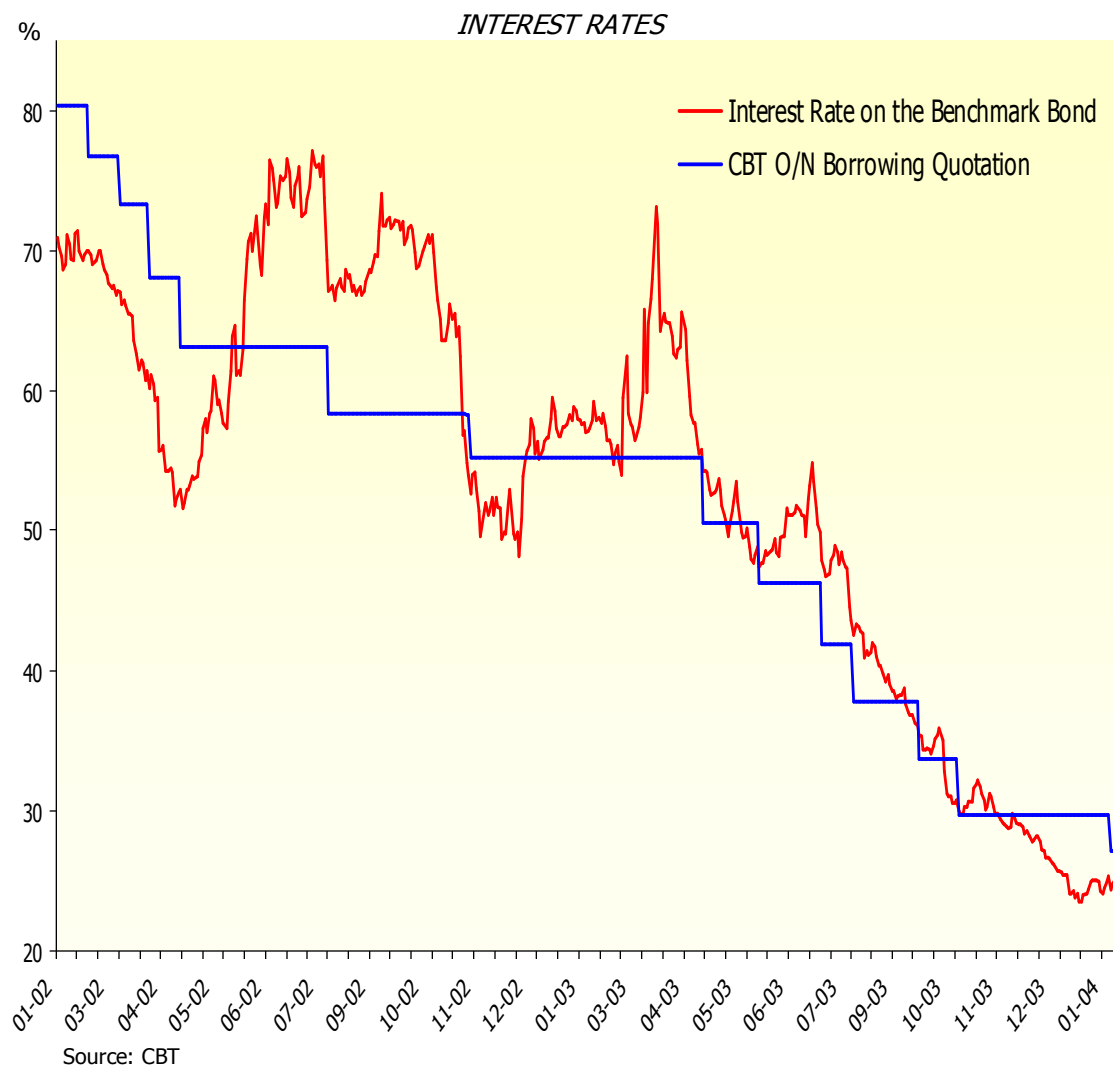
Real interest rates ↘



Sustainable growth environment and increase in employment

Interest Rates

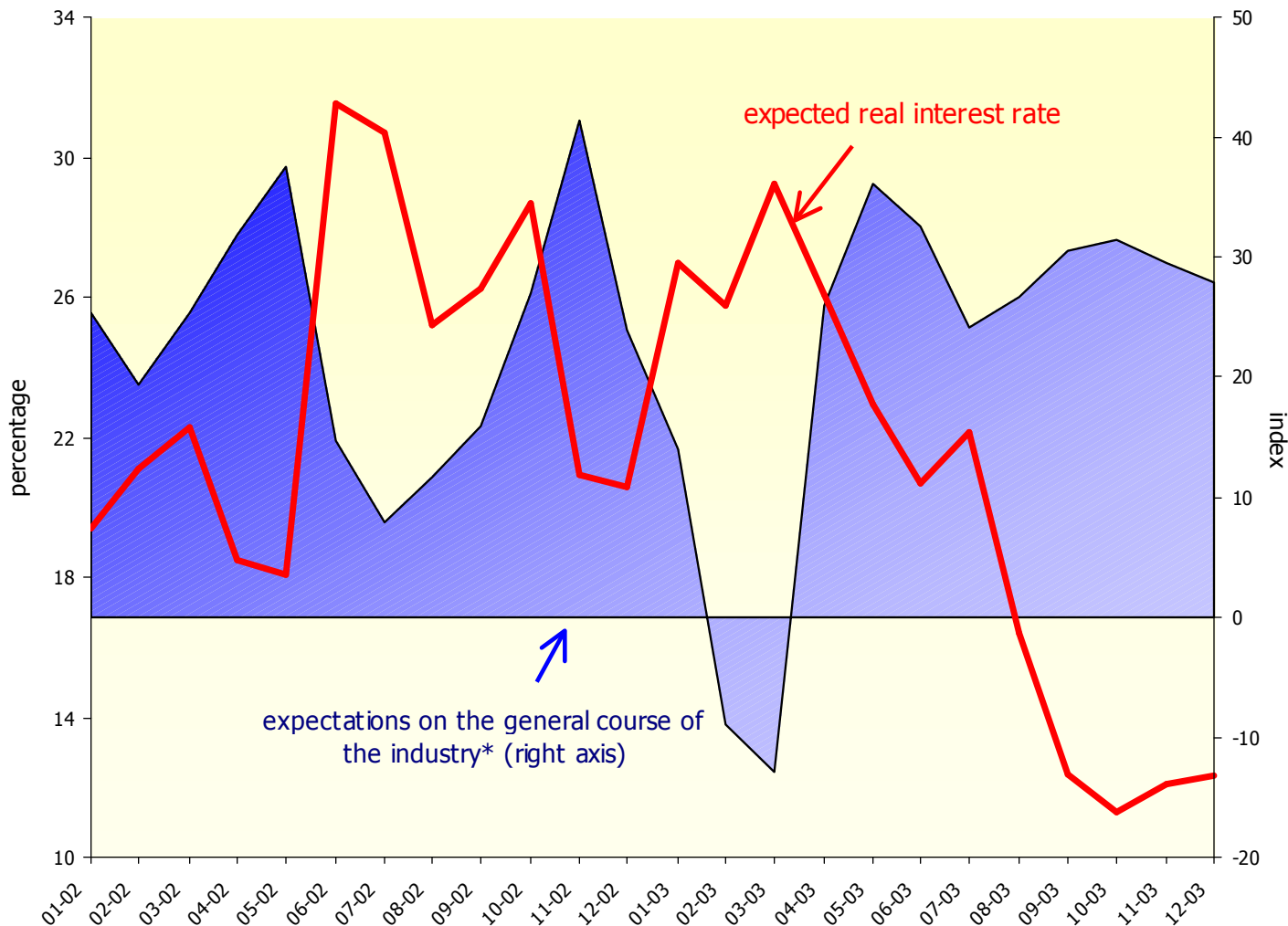
The relationship between CBT's short-term interest rates and the general level of interest rates shows periodical differences depending on the conditions.



- ✓ The necessary strong and positive relationship between CBT's short-term interest rates and the general level of interest rates has not been established yet.
- ✓ At present, factors that determine the general level of interest rates are;
 - ❖ public finance,
 - ❖ political developments and
 - ❖ consequently, expectations regarding the program.

Interest Rates

EXPECTED REAL INTEREST RATE AND THE GENERAL COURSE OF THE INDUSTRY



✓ Real interest rates decline as expectations on the general course of the industry become favorable, whereas they go up when expectations worsen.

* CBT Business Tendency Survey, expectations on the general course of industry: Optimistic - Pessimistic

Conclusion

As a result, things to do are;

- ✓ Decisive fight against inflation
- ✓ Implementation of tight fiscal and monetary policies in coherence and with determination
- ✓ Performing structural reforms, which are stipulated in the economic program, immediately and with great diligence,
 - ✓ Taking measures for the improvement of competitive environment
- ✓ Avoidance of practices that might endanger the economic program



THE NEW TURKISH LIRA

The New Turkish Lira

The process of dropping six zeros from the Turkish lira has started:

- ✓ The Law on the New Turkish Lira was published in the Official Gazette No. 25363 on 31.01. 2004.
- ✓ As of January 1st, 2005, Turkish lira will be converted into New Turkish lira by dropping six zeros.
- ✓ Technical features of the New Turkish lira banknotes will be announced towards the end of 2004.
- ✓ There is about an **11-month period** to complete technical preparations at the micro level. During this period, all public and private institutions and establishments should **accomplish** necessary preparations **on due time**.
- ✓ The Central Bank is taking necessary measures in order to ensure that the successful realization of the operation and studies are being carried out in coordination with other institutions.

The redenomination of the Turkish lira is a clear demonstration of determination to lower the inflation rate to single digits.



ECONOMIC OUTLOOK

CENTRAL BANK OF THE REPUBLIC OF TURKEY

February 2004