ECONOMIC OUTLOOK

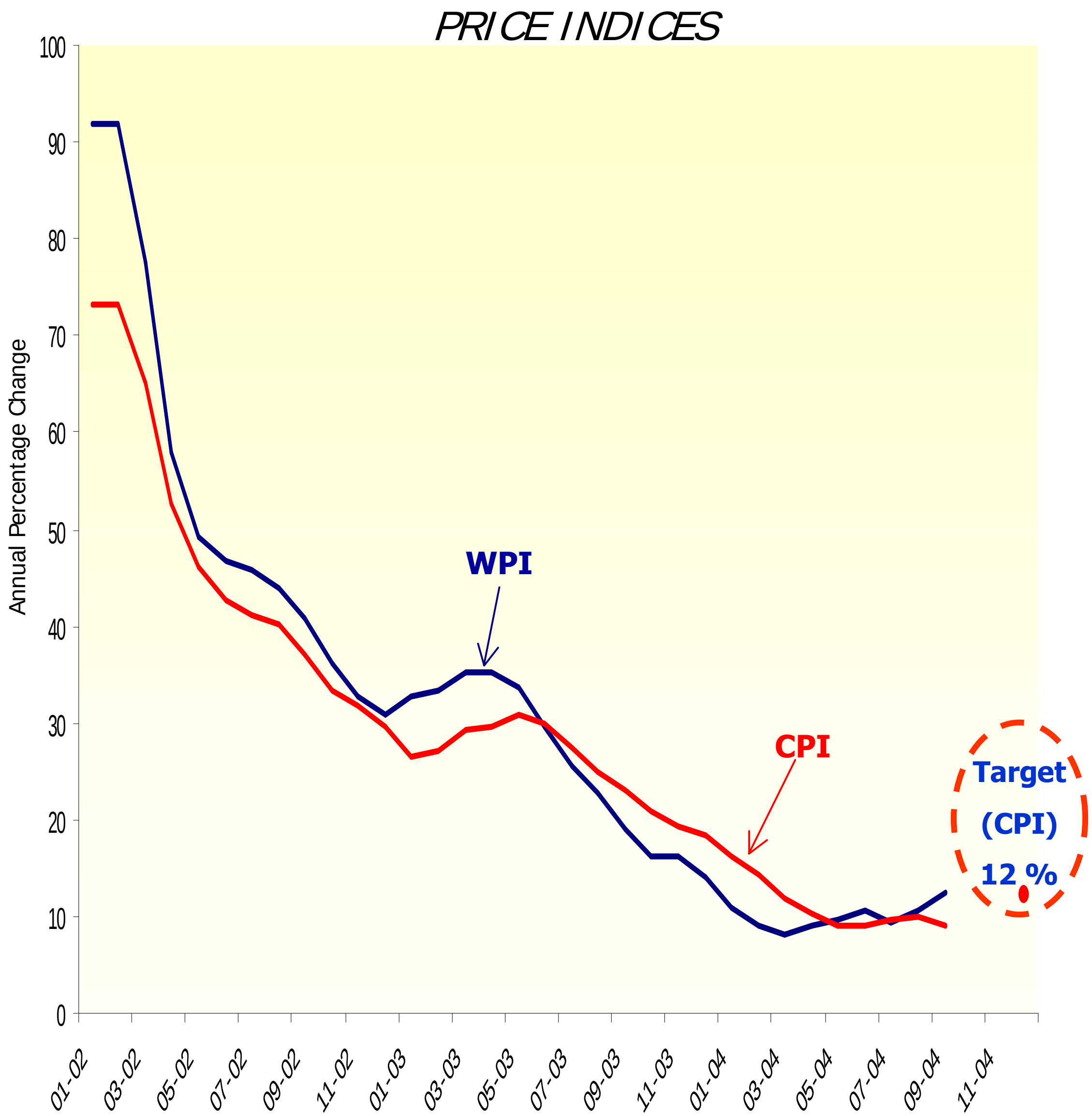
CENTRAL BANK OF THE REPUBLIC OF TURKEY

October 2004

Past	Present	Future
Chronic Inflation	**Disinflation**	Price Stability
Unsustainable ? Public Debt	**Decreasing Public Debt**	Sustainable Budget Finance
Boom-bust Growth Cycles → Crises	**Positive Growth Rates**	Sustainable Growth

INFLATION

Disinflation



CPI: 2001 - 2004

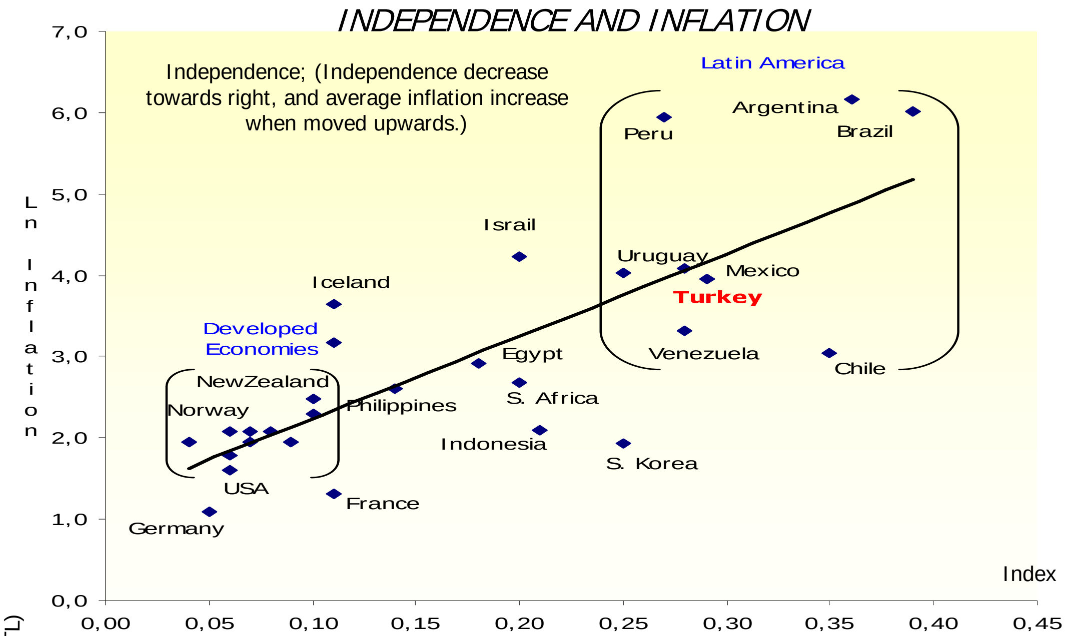
2001	68.5 %
September 2004	9.0 %

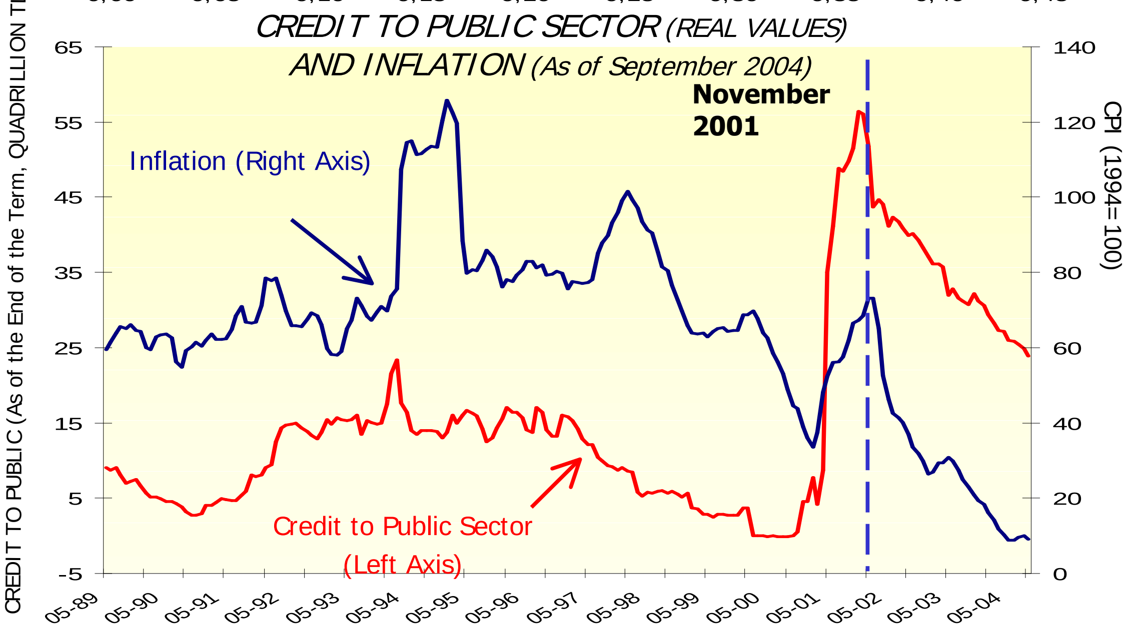
Dropped 60 points.

What Caused Lower

CPI?

Disinflation





1- The Central Bank Independence

There is a negative correlation between independence of Central Banks and inflation: **Inflation decreases as independence increases.**

Within this context, in our country, May and November 2001 are milestones in fighting inflation.

✓**May 2001: New Central Bank Law**;

- Clearly defined target: price stability

- Target: Government + CBT

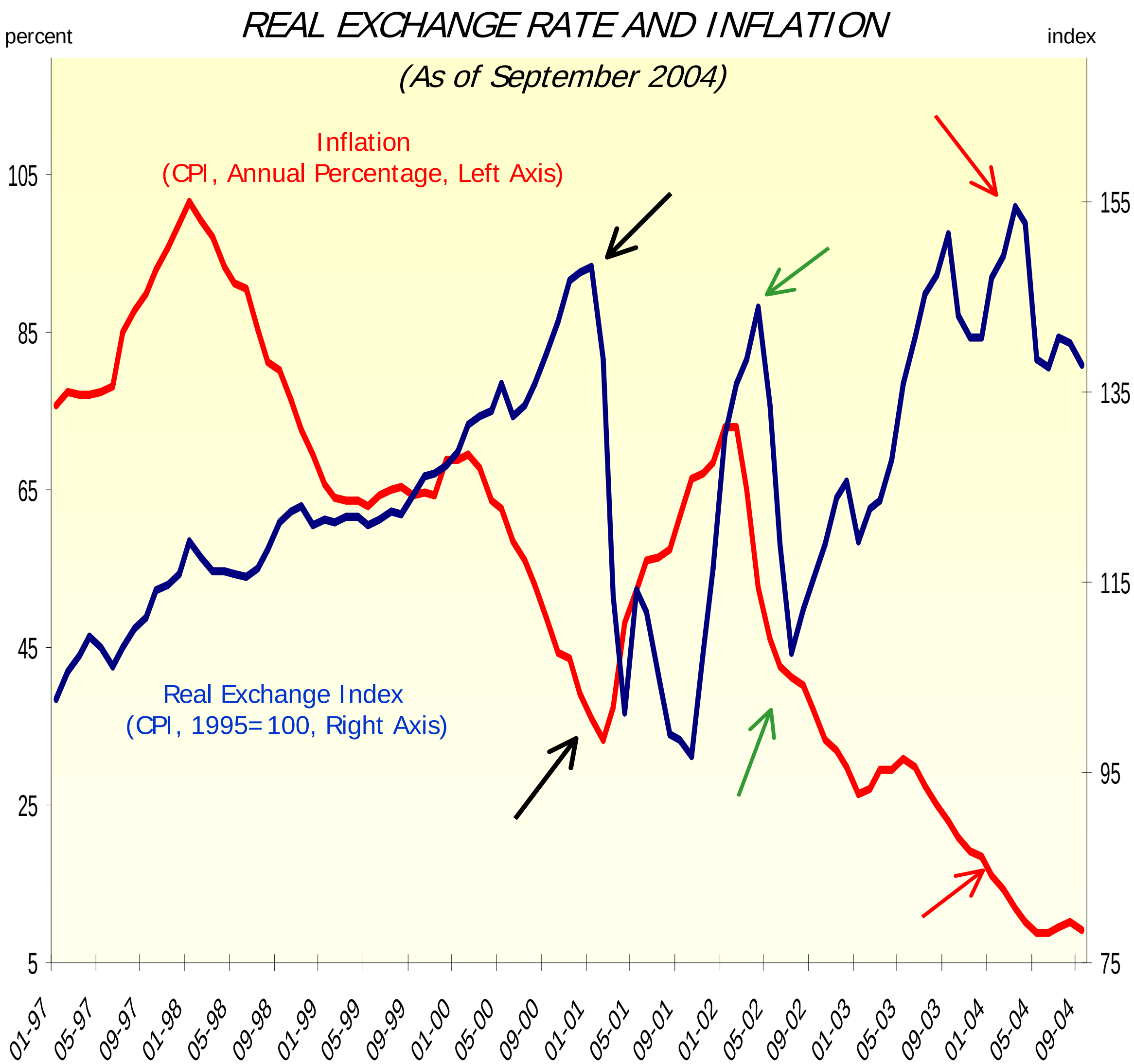
- Operational independence:

The CBT formulates policy and sets instruments

✓ **November 2001: No more credit to public sector**

Disinflation

2- Weakening of the Pass-through Effect



In the past there were periods when Turkish lira came close to its current value, even went beyond that. However, during none of these periods inflation decreased to this extent.

Disinflation

2. Weakening of the Pass-through Effect

✓ Today, together with changing dynamics of the Turkish economy, the exchange rate pass-through is;

- Lower compared to high inflation periods,
- More lagged.

✓ As evident from the the experiences of other countries:

Lower and lower inflation

⇩

higher and higher monetary policy credibility

- More common use of pricing in terms of domestic currency,
- Perception of depreciation in domestic currency as transitory, due to low and more stable inflation environment,
- Less frequent price adjustments by firms,

Exchange rate pass-through has been weakening.

Disinflation

3- Changes in Producer and Consumer Behavior

In the past:

Chronic inflationary environment

✓ Backward-looking indexation attitudes in terms of prices and wages

✓ Prices did not work as a signal in decisions of investment and consumption.

✓ Consumers failed to do price and quality control and producers failed to do cost control.

✓ Necessary attention was not given to productivity.

In such an environment goods and services were sold at any desired price.

Today

Declining and predictable inflation environment

✓ Rising competition and

✓ Low domestic demand coupled with

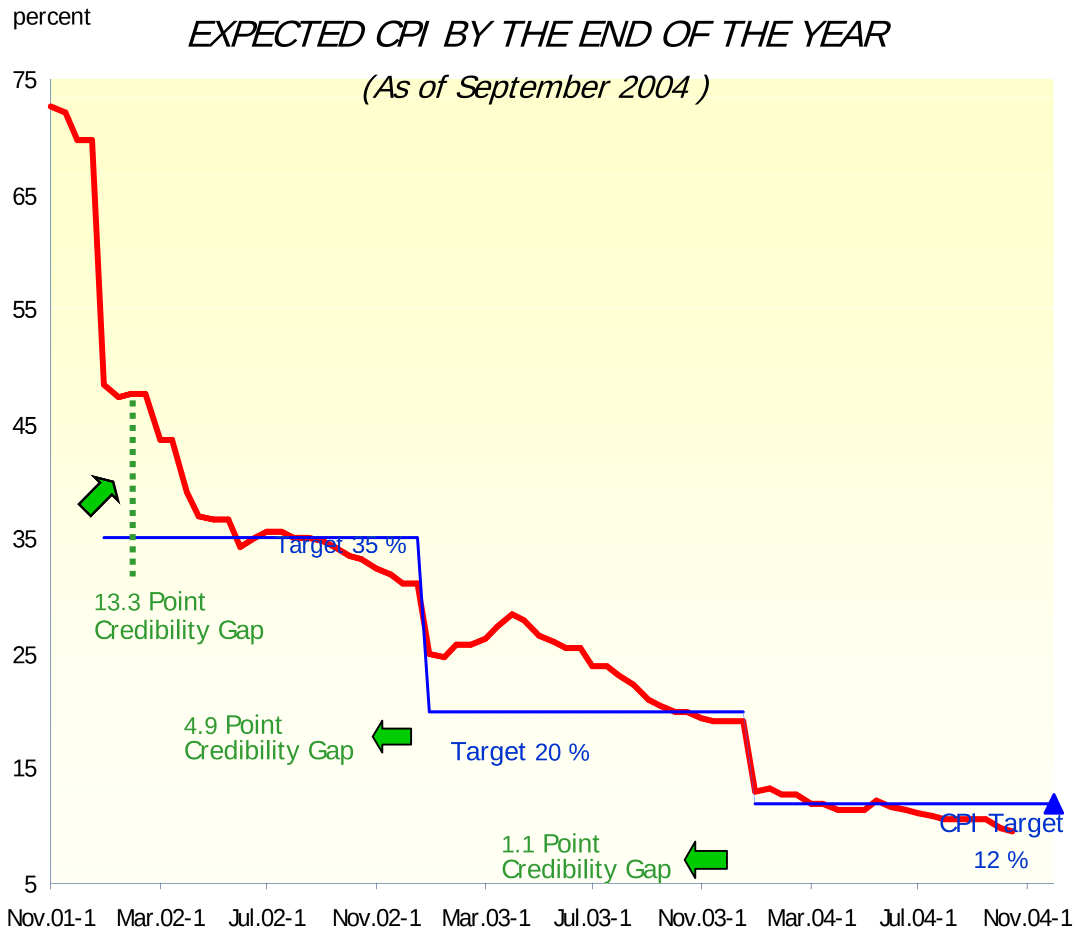
✓ Consumers started do price and quality control.

✓ Margin of profit declined, producers tended to apply cost control. Increase in productivity became the main factor in competition.

✓ Prices started to work as a signal, influencing investment and consumption decisions.Informing function of prices, which is a crucial condition for a healthy economy, strengthened.

Disinflation

4- Decreasing Inflation Inertia



The CBT put managing expectations and effective communications policy at center of its policies: **Transparency, honesty** and **accountability**; shared knowledge and projection with public.

⇩

Confidence in obtaining results from the policies applied and realizing the inflation target increased.

⇩

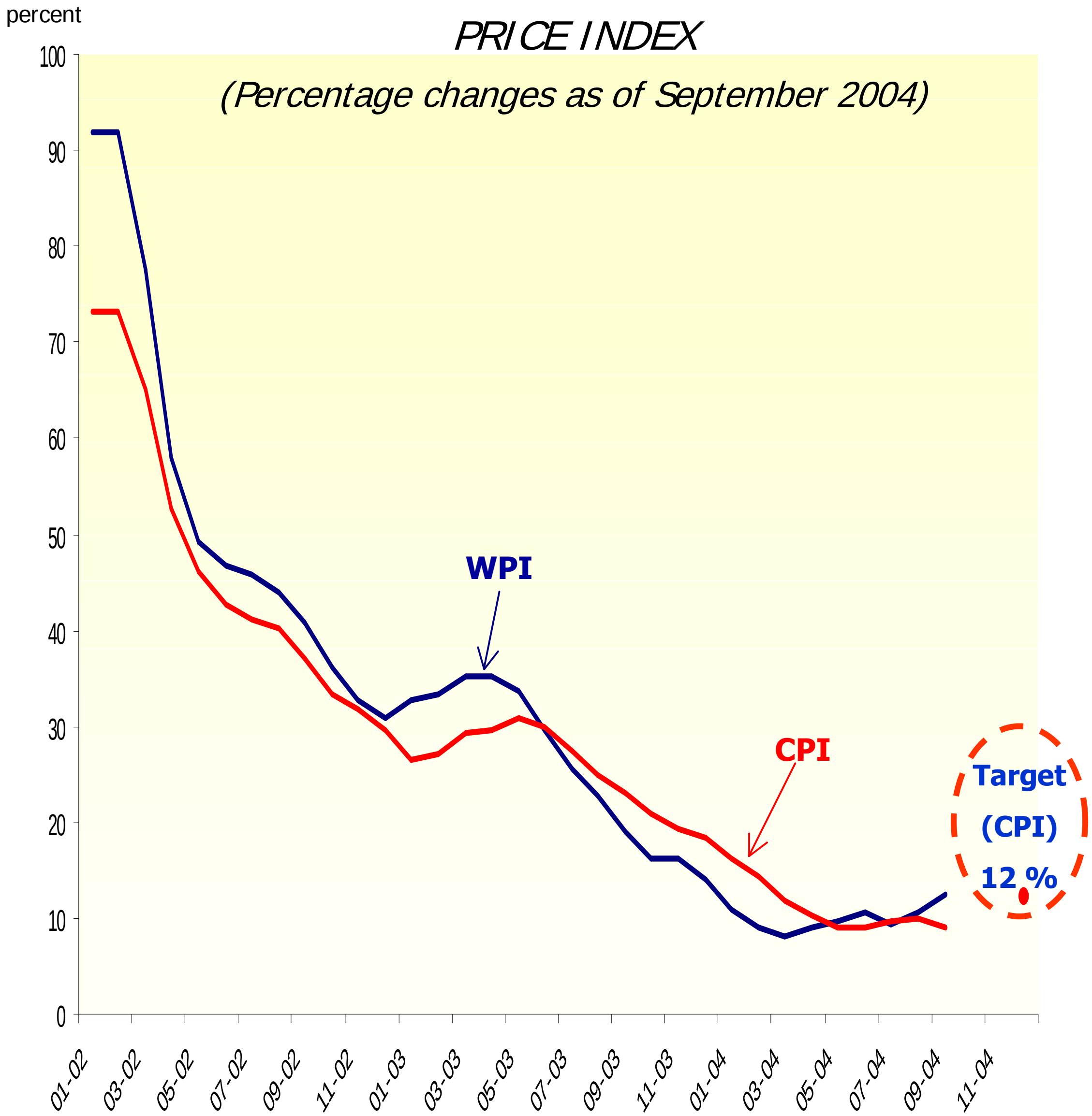
Credibility Gap:
(Expectations – Target)

2002: 13.3 Points
2003: 4.9 Points
2004: 1.1 Points

At present, October 2004: **- 2.5 Points**

Inflation inertia is decreasing.

Disinflation



CPI : 2001 - 2004

- Independence of the Central Bank
- Weakening of the pass-through effect
- Changing behaviors of the producers and consumers.
- Inflation inertia is decreasing

- Tight fiscal and monetary policies,

- Income policies largely in line with the target,

- Course of the real prices.

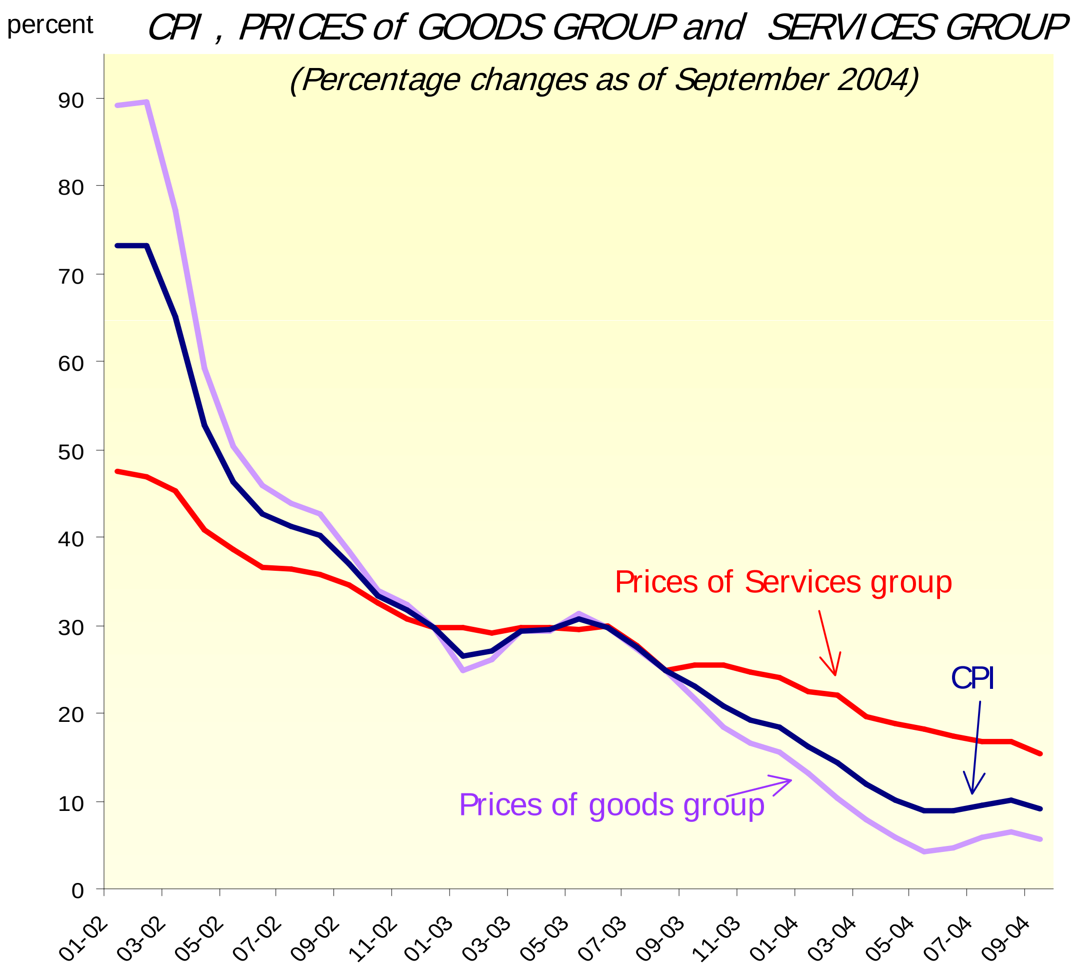
WPI: January – September 2004

The first nine-month cumulative; 4.85 %

✓ The revival in demand and increase in consumer credits are limited to a certain sector, so the pressure exerted on prices were also limited.

✓ Increase in WPI had limited effect.

Disinflation

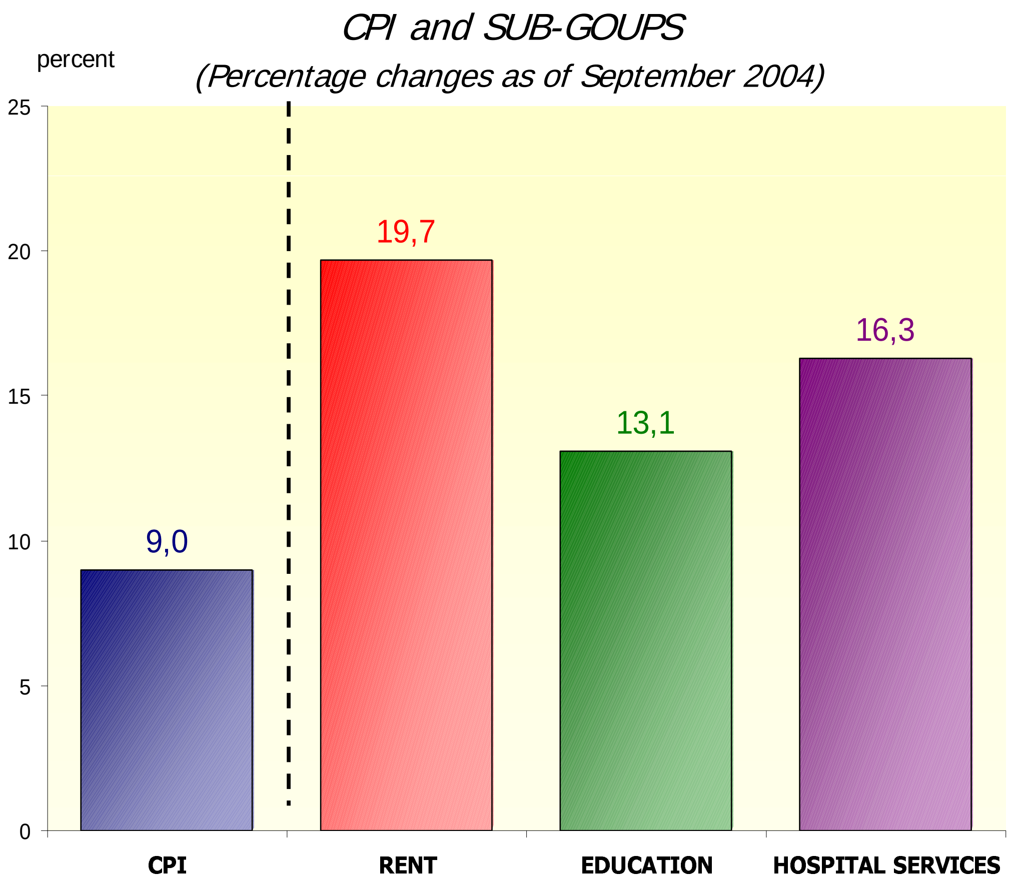


Differentiation in price increases between the services group and goods group has gradually become more apparent..

	Monthly	Annual
Goods Group	0.4	5.6
Services Group	1.8	15.3

Rigidity in the prices of the service group continues.

Disinflation



Price increase in rents, education and hospital services is remarkably above the increase in CPI.

	Monthly	Annual
Rents	2,5	19,7
Education	3,3	13,1
Health	0,4	16,3

Rent

- ✓ Backward-looking indexation habits while setting prices: Lease agreements can be devised according to end year CPI.
- ✓ Compensation of past losses is also effective.
- ✓ The weight of rent prices is high within CPI; 16 %
- ✓ Different methods are applied to CPI baskets of other countries.

Education

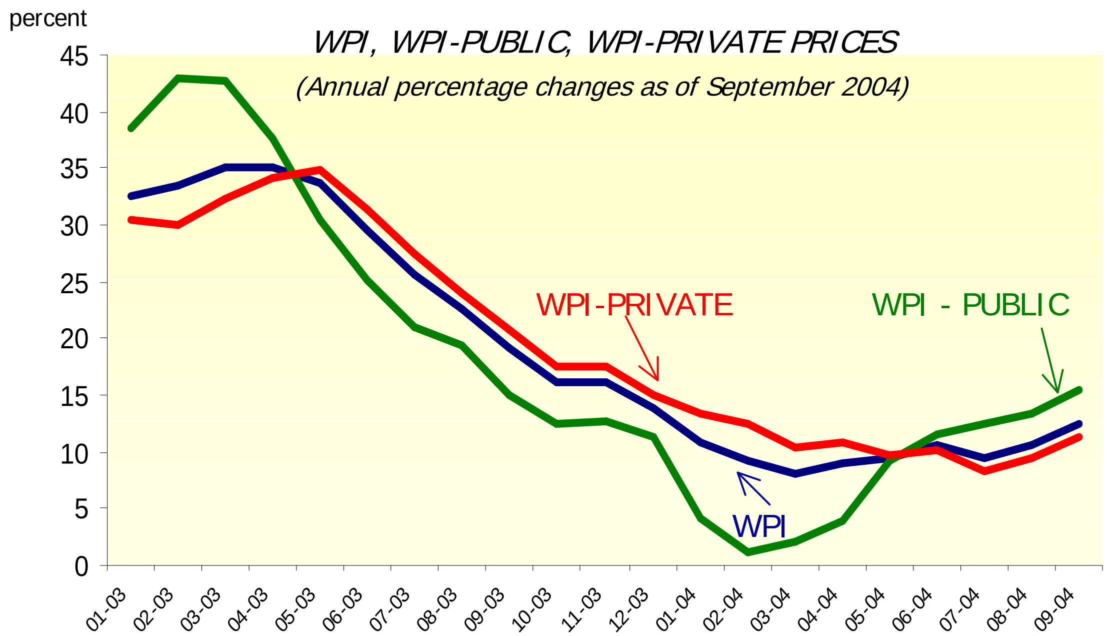
- ✓ Setting prices to increase the margin of profit is observed: Course and private school fees.
- ✓ Ministry of Education has favorable studies on the subject.

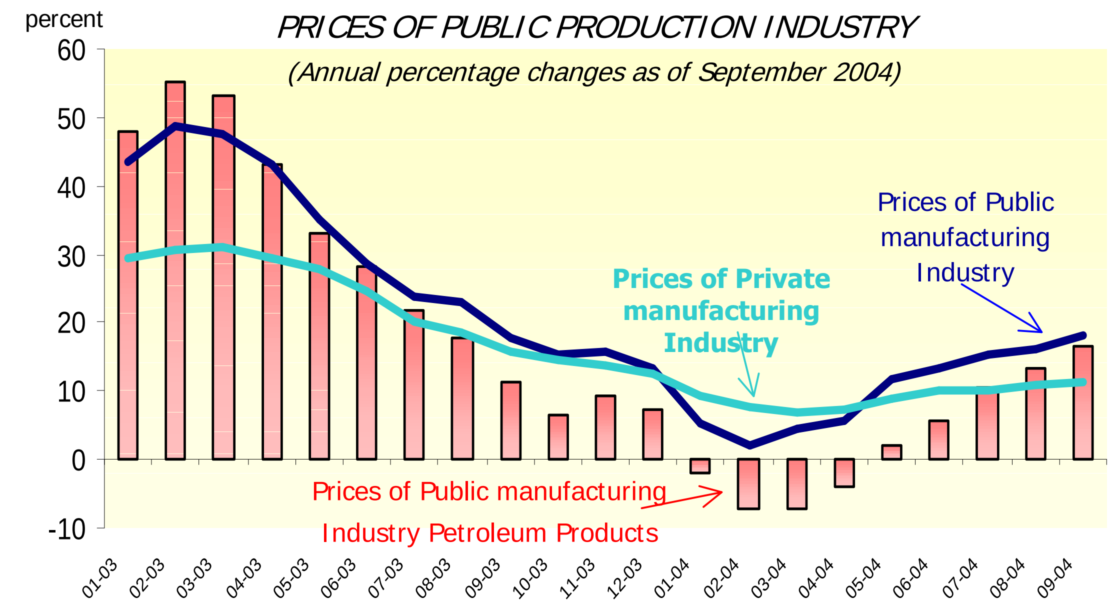
Rigidity in the prices of the service group should be eliminated.

For this reason,

- Precautions should be devised to increase competition and supply within this sector.

Disinflation





CPI: January-September 2004

✓ The first nine-month cumulative 9.31 %;
Annual 12.5 %

	Monthly	Annual
Agriculture	5,5	11,8

Public Manufac.	1,1	18,1
Private Manufac	0,6	11,2

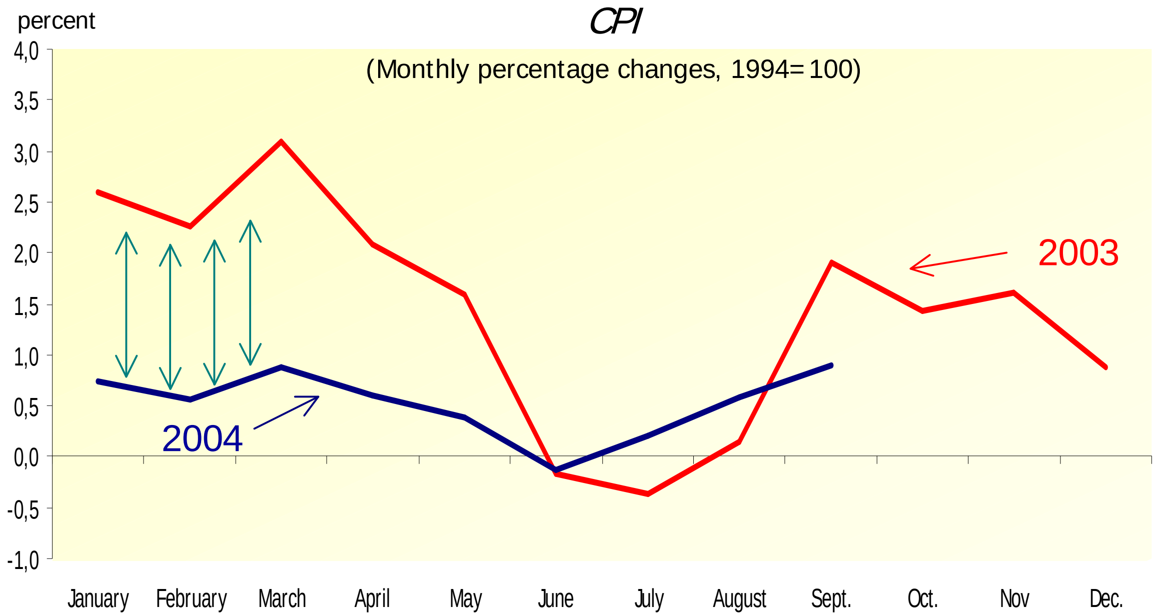
✓ As of the sixth month public prices were a determining factor.

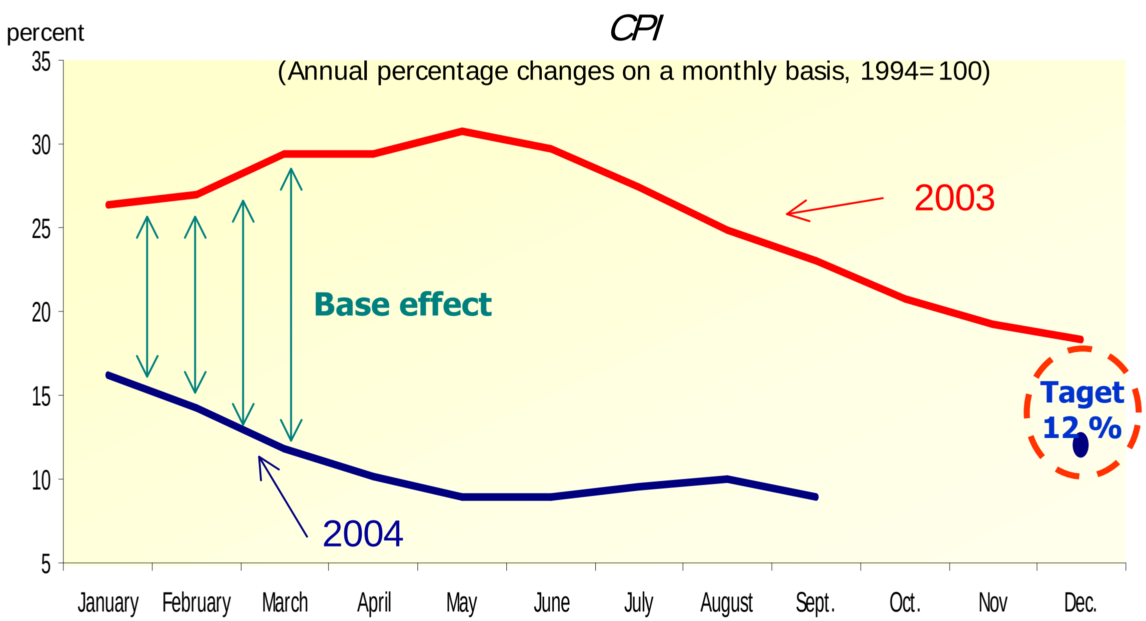
✓ Developments in crude metal and petroleum prices exerted pressure.

In the coming period, contributions of the increase in productivity and the course of real wages can be limited.

WPI is not the target.

Disinflation – Outlook





- ✓ The course of annual inflation rates of 2004 throughout the year is effected from the inflation figures of the same period last year.
- ✓ As a result of this effect, namely base effect, a rapid decline in inflation was seen in the first half of 2004, a minor increase occurred in the first months of the second half, and today with disappearance of the base effect inflation returned to its declining course.
- ✓ **This course of inflation throughout the year is in line with the target inflation and the 12 % CPI target will be met.**

In the first months of 2005, due to the base effect it may be possible to observe an other increase.

Disinflation – Outlook

ANNUAL CPI RATES AS OF SEPTEMBER 2004 (percent)

1. Israil	0,80
2. South Africa*	1,00
3. Chile	1,50
4. Malaysia	1,60
4. Singapore*	1,60
6. Czech Rep.	3,00
7. Slovenia	3,30
8. Thailand	3,57
9. Korea	3,85
10. Peru	4,00
11. Poland	4,40
12. India*	4,61
13. Mexico	5,06
14. China	5,20
15. Argentina	5,90
16. Colombia	6,00
17. Indonesia	6,27
18. Bulgaria	6,30
19. Hungary	6,60
19. Slovakia Rep.	6,60
21. Brazil	6,70
22. Philippines	6,90
23. Ukraine**	7,38
24. TURKEY	9,00
25. Uruguay	9,59
26. Romania	11,10
27. Russia	11,40
28. Belarus	15,48
29. Venezuela	20,81

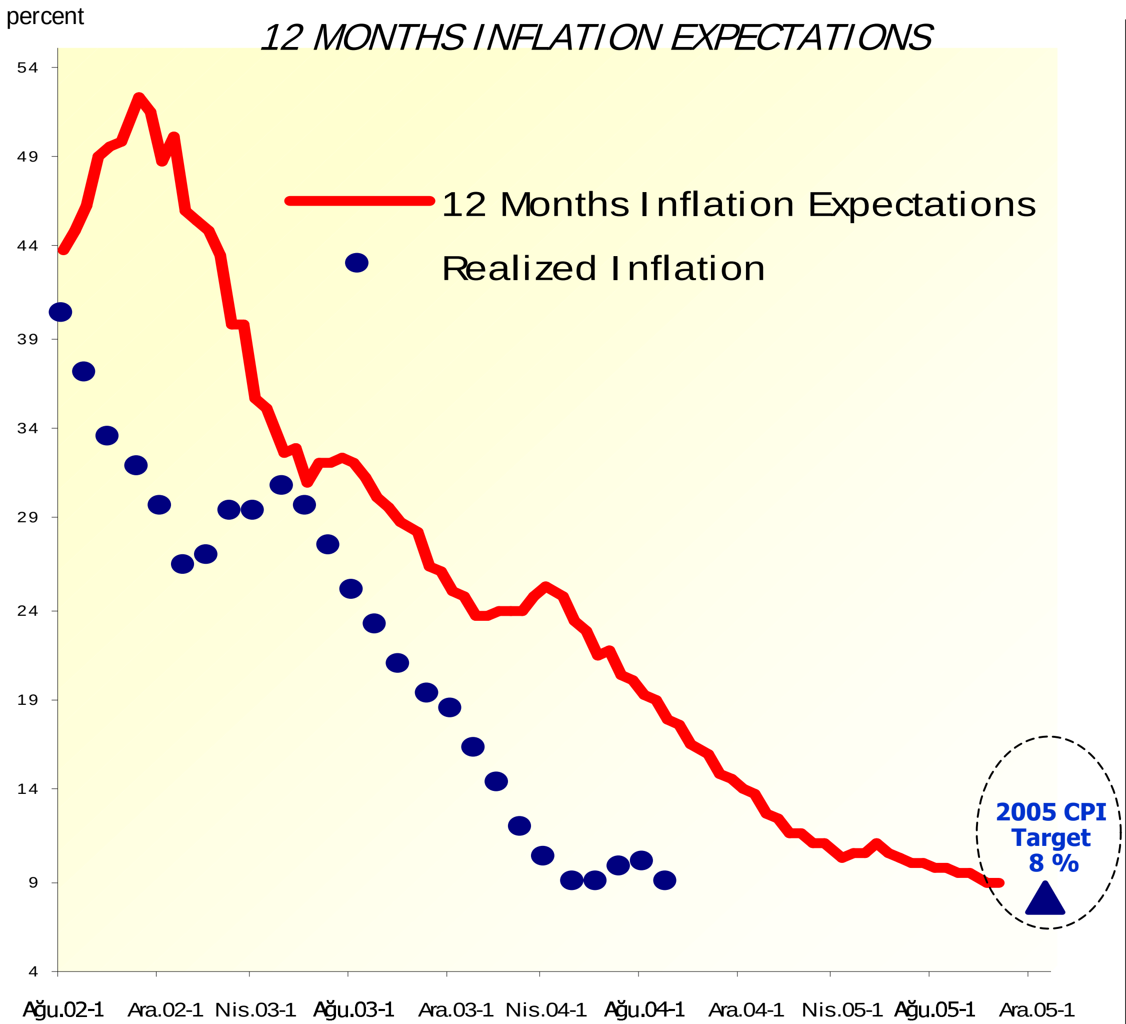
* As of August 2004, ** As of February 2004

✓ Today we have reached the lowest inflation figures of the last 30 years.

✓ However, **price stability** is **yet** to be achieved.

✓ Amongst similar countries, we are still one of the countries with the highest inflation figures.

Disinflation – Outlook



Target for **2005** ⇨ **8 %** CPI

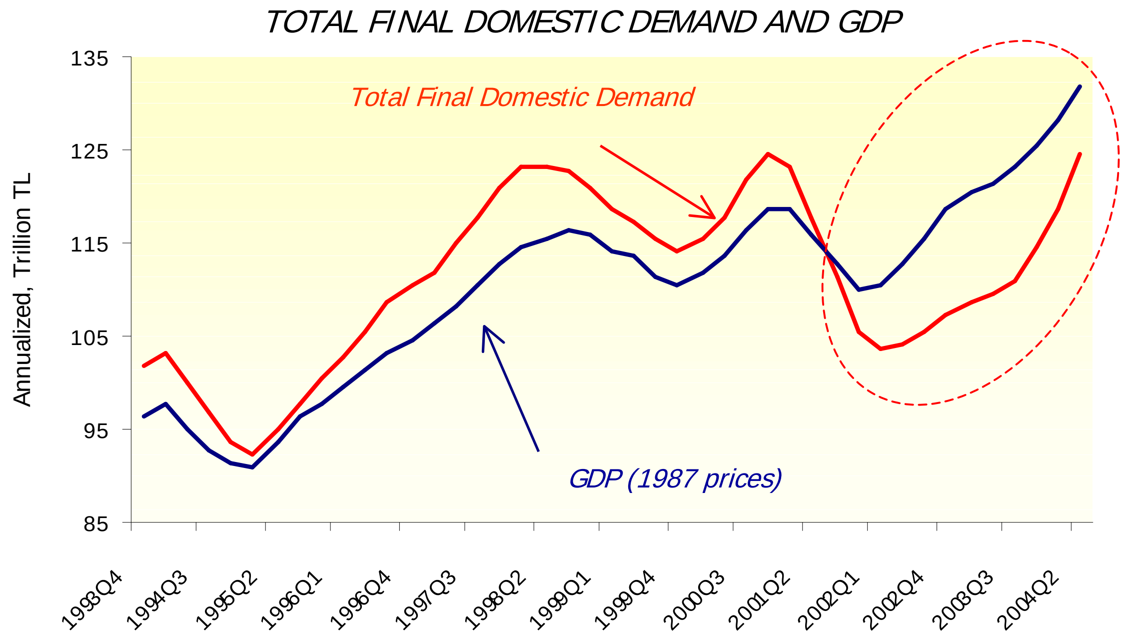
✓ **In the first half of 2005 base effect; a minor increase**

✓ **In the second half and in the following year permanent single digit**

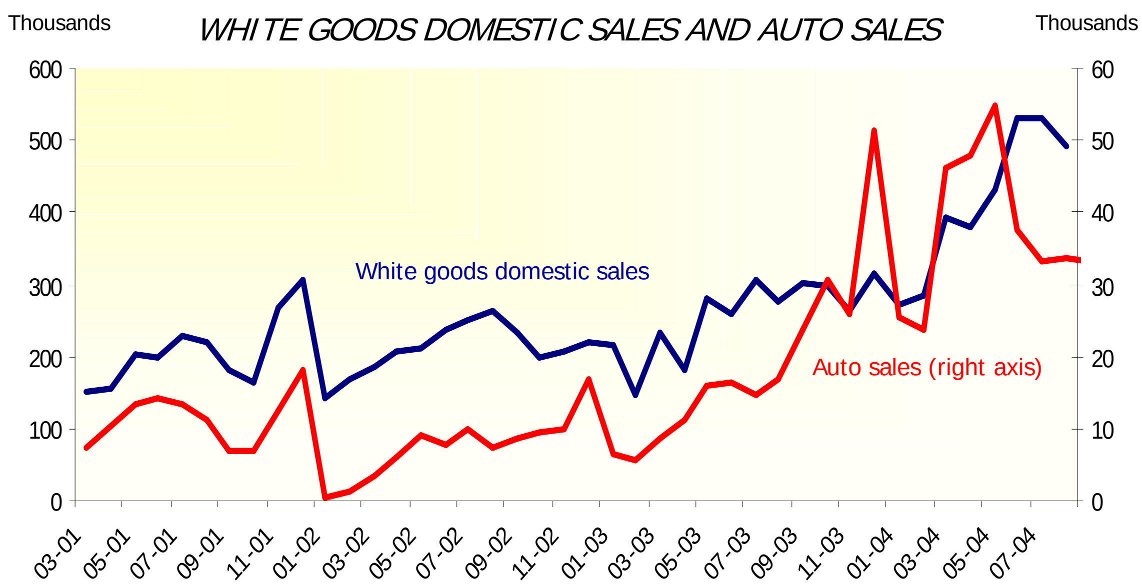
12-Month inflation expectations in the coming period are in line with the disinflation process created by our polices.

Inflation targeting is becoming a reliable nominal anchor.

Significant Factors for Price Stability



Total Final Domestic Demand = Consumption Expenditures + Gross Fixed Capital Formation

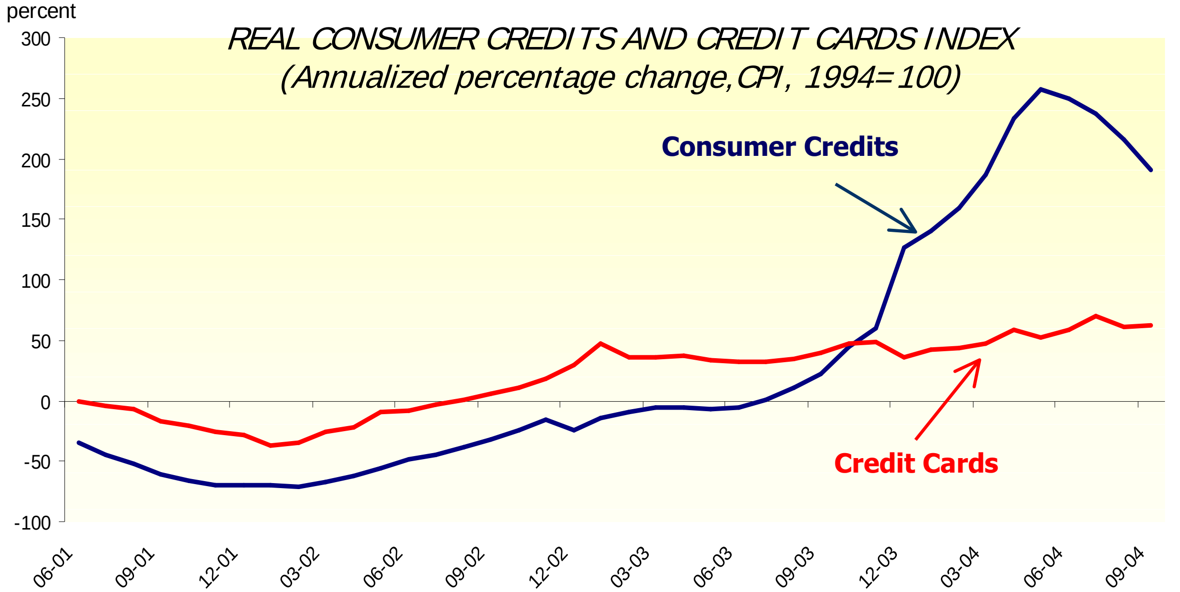


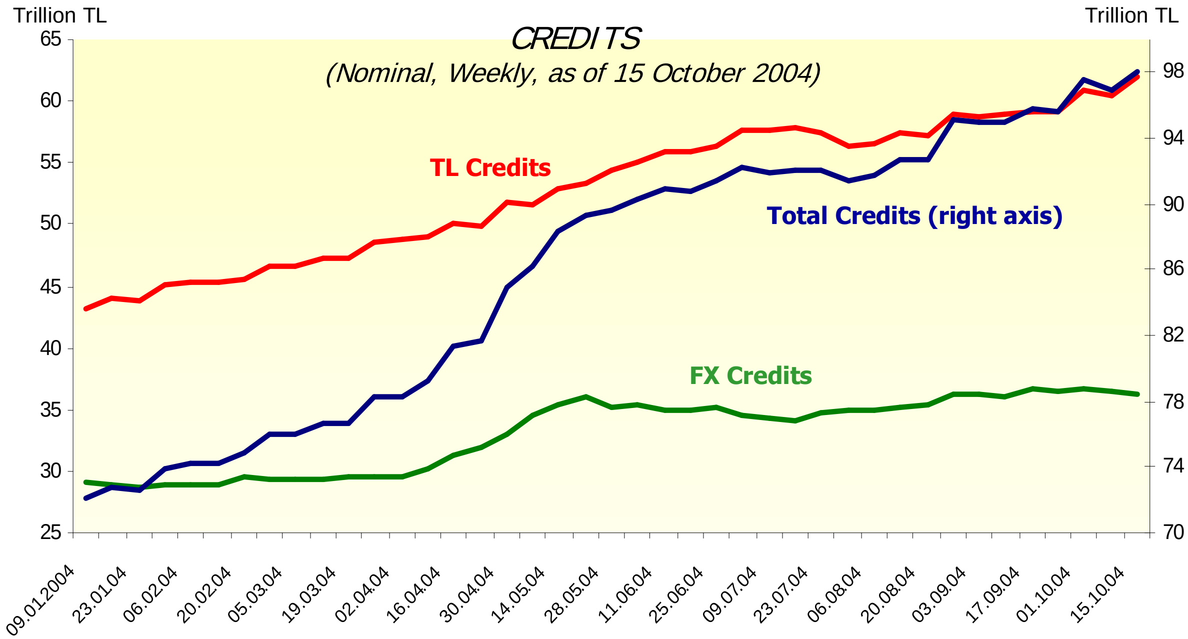
1- Caution is called for in terms of the recovery in domestic demand, as well as the revival in consumption.

<u>At present:</u>

- ✓ The increase in total final domestic demand is below the GDP increase.
- ✓ The increase in consumption is observed only at certain sectors so far. The source of recovery is pent-up demand.
- ✓ The upward trend observed in the sales of white goods and autos has not caused any inflationary pressure yet, thanks to the productivity increase.
- ✓ Demand for durables and semi-durables is also closely monitored.

Significant Factors for Price Stability





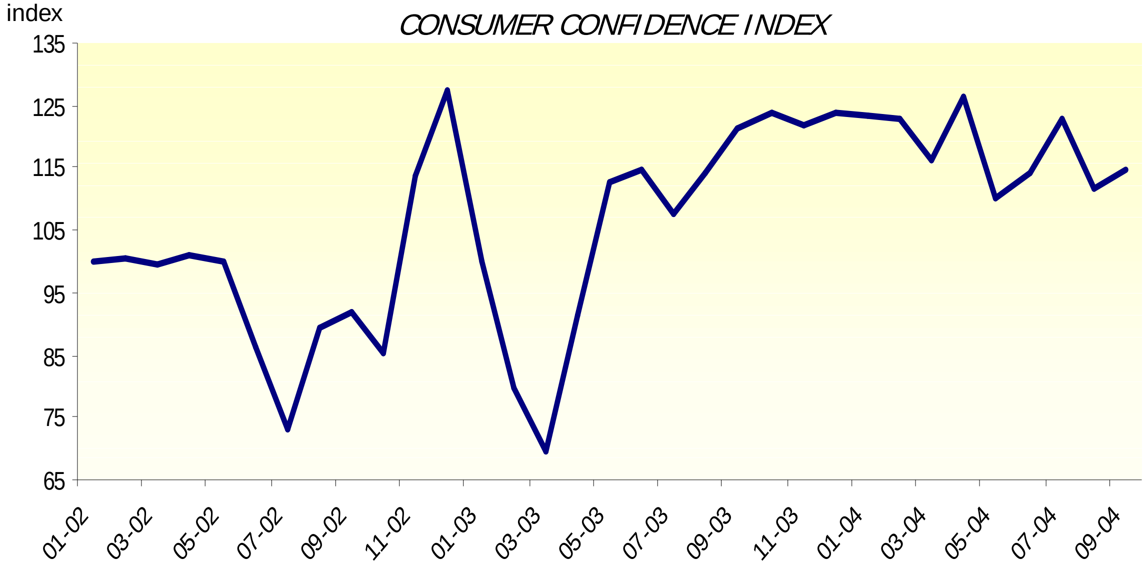
At present:

✓ A slowdown has been observed in the real growth rate of consumer credits and credit cards recently.

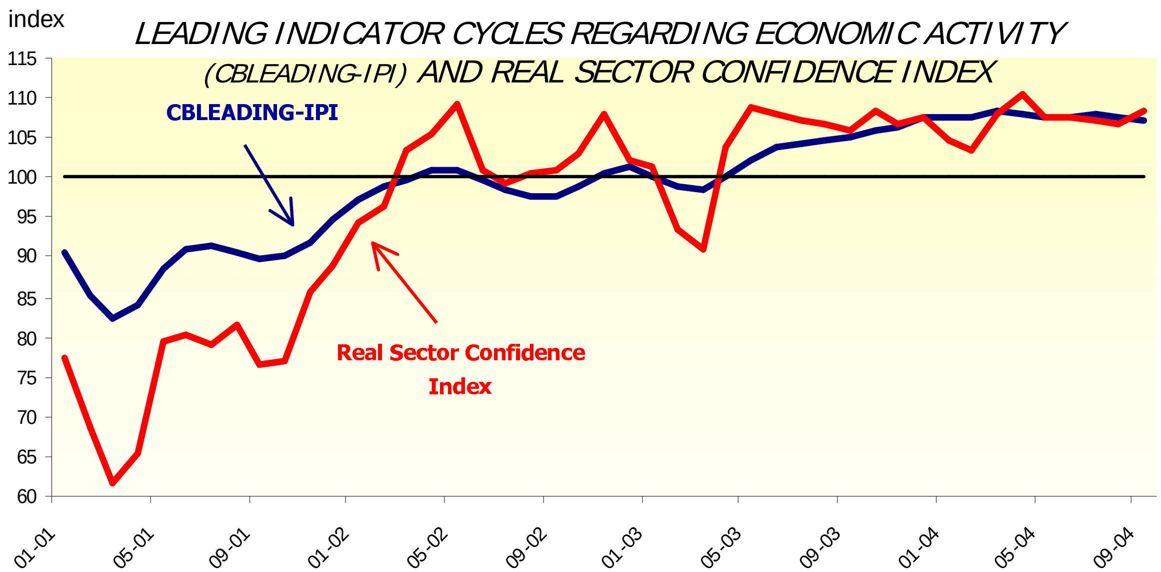
✓ As for the total credits; they have been in decline for the last three months.

✓Also observed are, relative slowdown in the money demand and decline in the excess market liquidity.

Significant Factors for Price Stability



Source: CNBC-E



CBLEADING-IPI= Treasury auction weighted simple interest rate, import of intermediate goods, electricity production, export expectation, stocks of finished goods, total employment expectation, expectation for the new orders received by the domestic market.
Real Sector Confidence Index above 100 indicates increasing confidence in economic activities.

At present:

Expectations about economic outlook are favorable and stable;

✓ Survey shows that consumer confidence has been in a stable course.

Leading Indicators Index;

✓ Assumed an upward trend since March 2003 and stabilized at these high levels.

Real Sector Confidence Index;

✓ At high levels since April 2003.

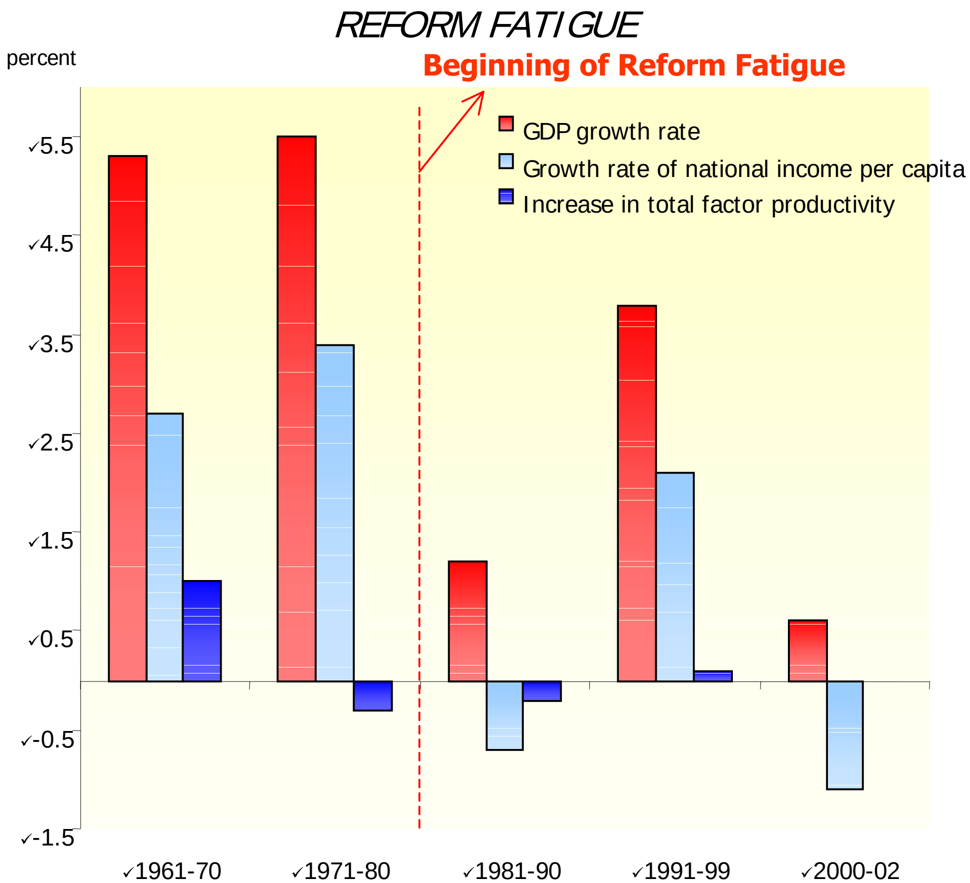
✓Follows a more stable path compared to the past.

The outlook does not call for an excessive increase in demand. Continues to be monitored closely.

Significant Factors for Price Stability

2- Reform fatigue should not be allowed:

Structural reforms should sustain.



Source: Lora, E., Panizza, U. and Quispe-Agnoli, M., *"Reform Fatigue: Symptoms, Reasons, and Implications"*, FRBA, Economic Review, Second Quarter 2004, 1-28.

* Cited in Merlevede, B., *"Reform Reversals and Output Growth in Transition Economies"*, Economics of Transition, Volume 11 (4) 2003, 649-669.

✓ In Latin America, reform fatigue was observed after more than ten years from the start of reforms.

⇩

Reform Fatigue was observed in the form of,

- Signals for a backtrack in reforms,
- Lack of enthusiasm in sustaining the reforms and
- A standstill in the reform process.

✓ Reform fatigue led to loss of economic growth, productivity and total factor productivity in Latin America.

✓ In transition economies as well, it was noted that a bactrack in reforms (even if this backtrack was one-off and the reforms were taken up again) resulted in giving up the gains in inflation, which in turn, caused a 4-5-year delay in achieving sustainable high economic growth.

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Sustaining and furthering the process as well as maintaining the current reforms is crucial for attaining favorable results from the reforms.

Significant Factors for Price Stability

3- Exogenous Shocks

Implementing the economic program with determination is the best way to handle these shocks. Achievements in economic stabilization will alleviate the impact of the shocks.

Exogenous shocks affect the economy through three channels:

1- They affect the prices of domestic financial instruments; leads to capital outflow.

2- They affect foreign credit facilities; thus, transactions need to be made over new interest rates and new amounts..

3- They affect the real economy directly; they influence exports, thus foreign exchange acquisition capacity, and consequently the imports and the capability to fulfill external obligations.

Severity of these three effects depends on the state of the economy:

Impact of exogenous shocks, which could end up with a crisis in the past, is rather limited and last for a shorter period today. Shocks affect our country **to the same extent they affect the rest of the world, depending on the achievements of the program.**

Today's relative economic stability is not sufficient: Still much has to be done. Thereby strengthened economic fundamentals will further alleviate the unfavorable effects of the shocks and make them temporary.

Significant Factors for Price Stability

1- Caution against the recovery in domestic demand and the revival in consumption.

2- Reform fatigue should not be allowed.

3- External Shocks

4- Managing expectations properly

Practices up to now paid off as increased credibility. However, expectations are subject to frequent shifts in Turkey. Especially in financial markets, suddenly, a wave of optimism or pessimism may rule. **Therefore, no mistake in the current program is tolerated.**

5- Public price adjustments in harmony with targeted inflation

6- Tendency to increase profit margins as the economy recovers

7- Agricultural and energy prices constituting risks in terms of inflation, just as the rest of the world.

Is there a need to revise the 8 % target?

The answer is No.

INTEREST RATES

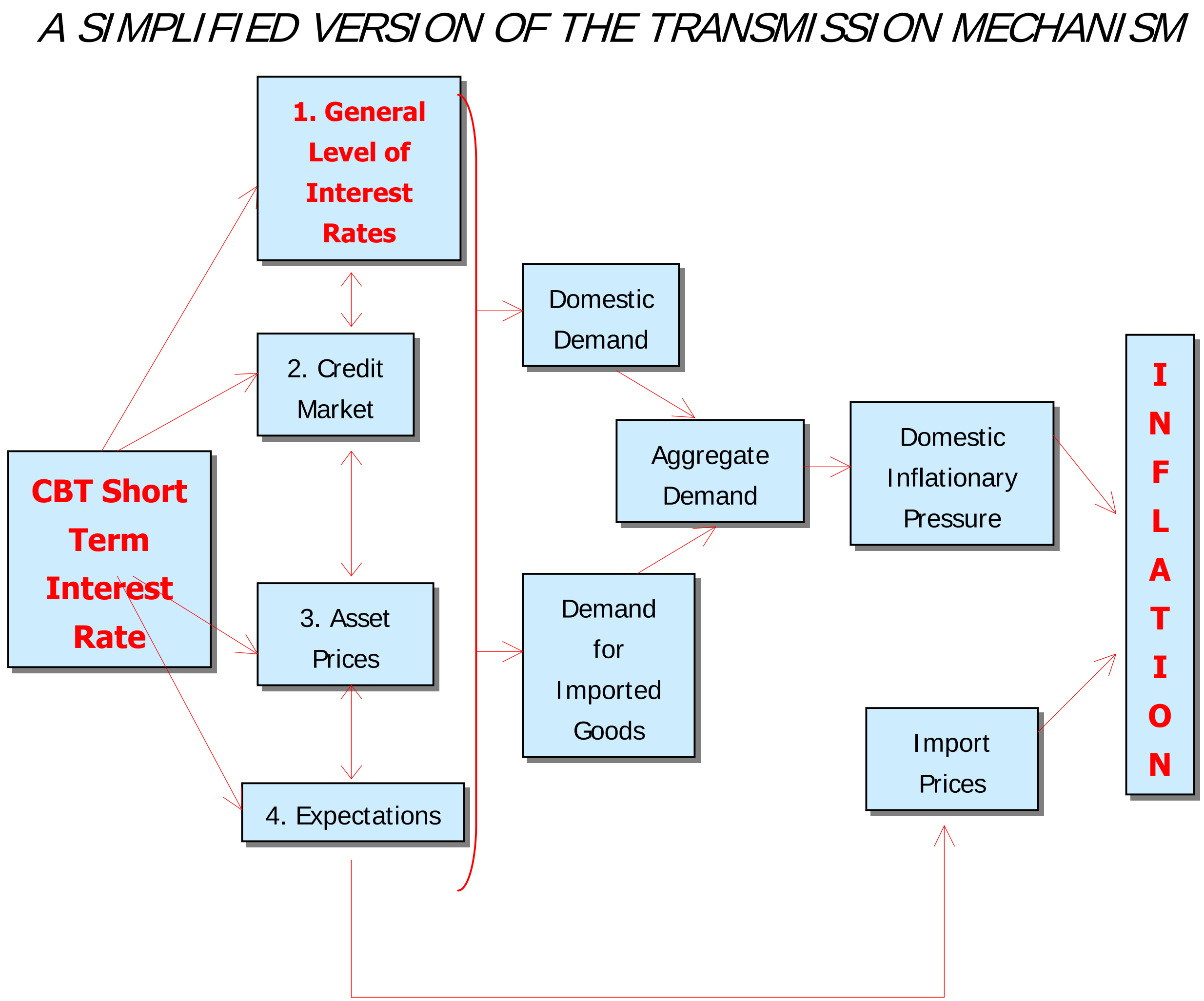
The Impossible Trinity

Capital Movements

Restricted	Free
1- Both the interest rates and the exchange rates can be managed.	2- While exchange rates are managed, interest rates are left to float freely: Passive monetary policy. 3- While interest rates are managed, exchange rates are left to float freely: Active monetary policy.

Result: Interest rates and exchange rates cannot be managed at the same time when capital movements are free.

Interest Rates



Short-term Interest Rates

Basic policy tool is short-term interest rates, and they are used only as directed to the inflation target and the course of the inflation forecast.

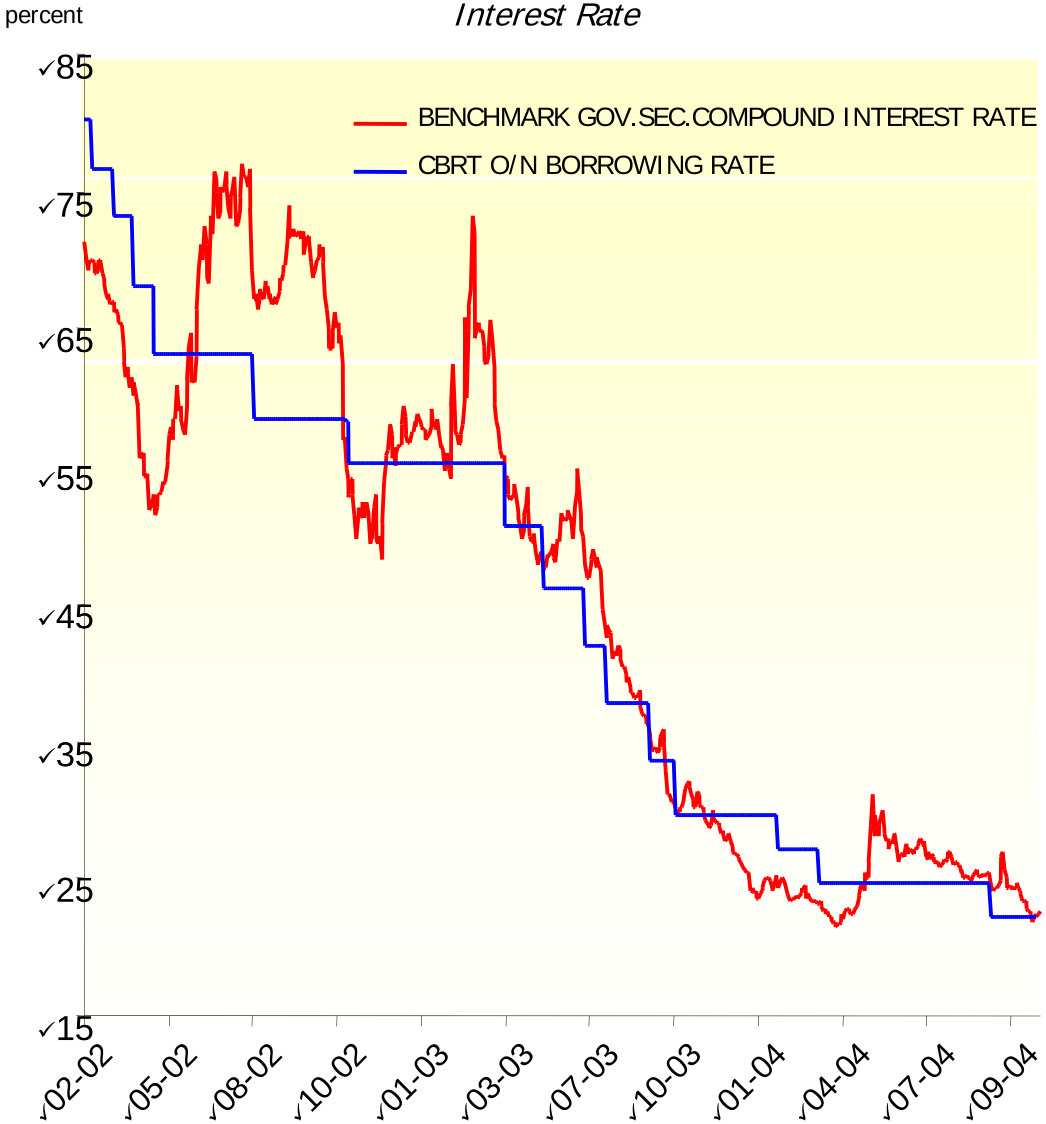
✓ CBT, through using the short-term interest rates, targets influencing the course of inflation through various channels via **the transmission mechanism.**

1 - <u>CBT Interest Rates – General Level of Interest Rates</u>

✓ One of the channels of the transmission mechanism is the general level of interest rates. CBT, by changing its interest rates, targets affecting the general level of interest rates in the same direction.

Interest Rates

CBT Short-term Interest Rate and Benchmark Government Securities Interest Rate



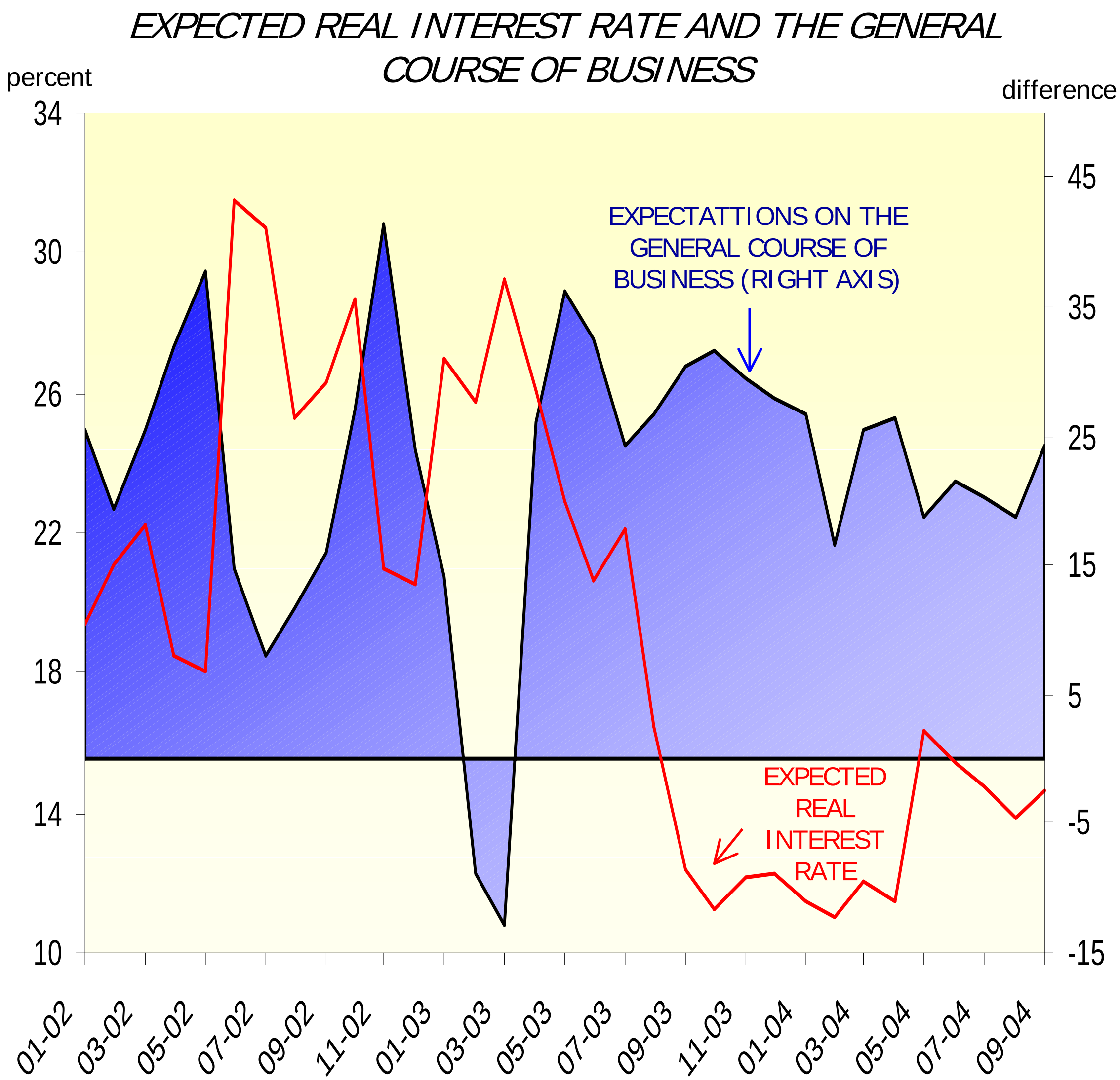
1 – <u>CBT Interest Rates – General Level of Interest Rates</u>

✓Consistent with the inflation target and forecasts, the CBT may **reduce, raise or leave the interest rates unchanged.**

✓ **However,** though getting stronger, the positive relationship between CBT short-term interest rates and the general level of interest rates has not yet reached the desired levels. Therefore, there has been periods when CBT reduced its interest rates, but the general level of interest rates went up or remained unchanged. There were also periods of the general level of interest rates remaining below CBT interest rates.

✓ Thus, under present conjuncture, it is not yet possible to pull down the general level of interest rates and real interest rates **in a lasting manner**, through reducing short-term interest rates.

Interest Rates



* CBRT Business Tendency Survey gathers perspectives on the general course of business tendency: Optimistic - Pessimistic

2- <u>General Level of Interest Rates and Real Interest Rates</u>

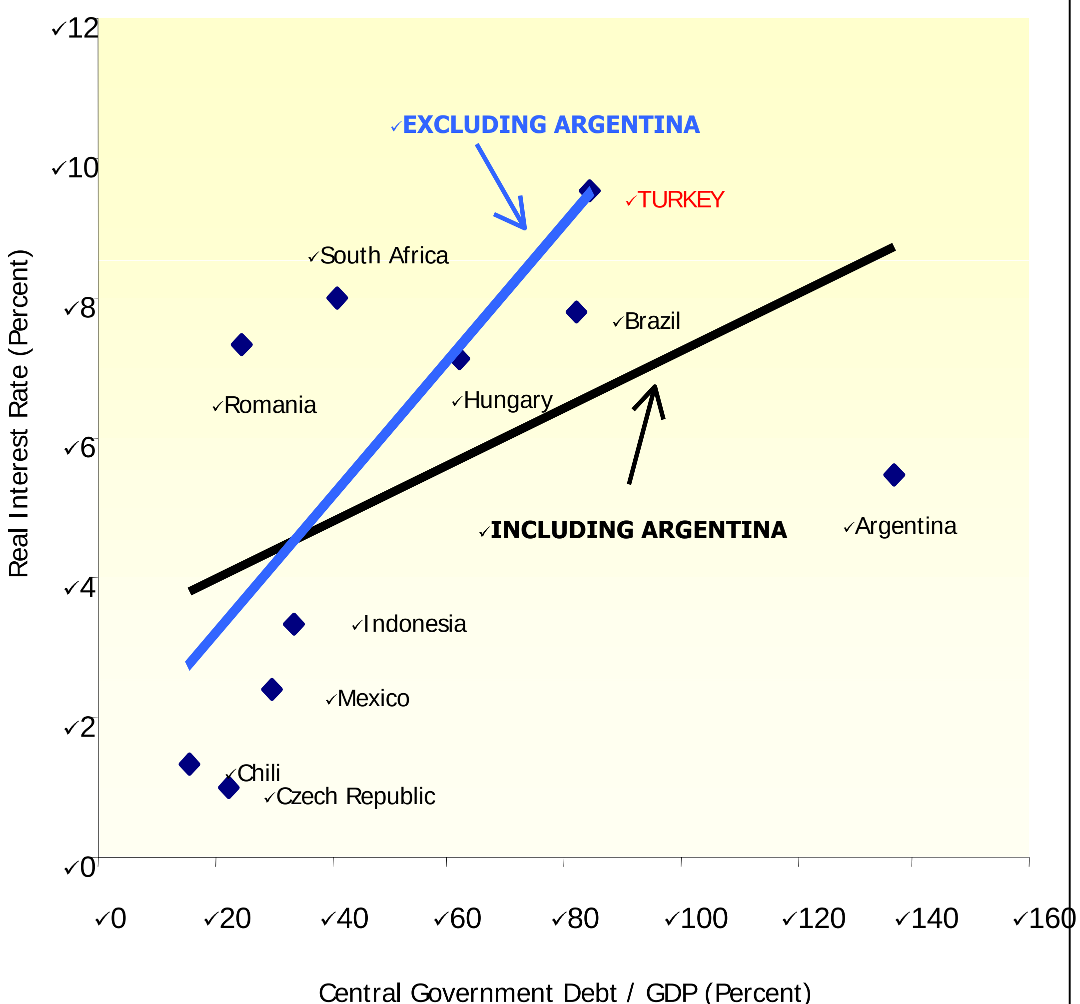
- ✓ Nominal interest rates are made up of two variables: One of them is the real interest rate, which is determined mostly by the **risk premium** under current conditions. The other one is **inflation expectations**. Decline in inflation expectations and the risk premium enables real interest rates, and thus the nominal interest rates to go down.

- ✓ Real interest rates declined more than 15 points and nominal interest rates as much as 45 points in the last two years, demonstrating the decline in the risk premium and inflation expectations on account of the favorable economic outlook.

- ✓Yet, interest rates are still at high levels.

Interest Rates

DEBT STOCK / GDP AND
REALIZED REAL INTEREST RATE



Evaluating the developments in inflation expectations and the risk premium within this context:

- **Inflation expectations** did not show any deterioration for the last year, despite the political and economic controversies, and expectations were consistent with the target.
- **However,** the high level of the public debt stock prevents **risk premium** to decline further.

- In developing countries in general:

-There is a strong positive relation between the domestic debt stock of the public sector and real interest rates linked to the risk premium.

-When public debt stock rises, real interest rates also rise, and when the former declines, the latter declines as well.

- **In conclusion,** real interest rates will fall as public debt stock declines, public financing attain a sustainable nature and the reforms to diminish the fragilities of the economy are implemented.

Interest Rates

3- CBT Interest Rates – Exchange Rate

Another channel of the transmission mechanism is asset prices – exchange rate.

However, when short-term interest rates are reduced, **three things may happen** under the current conjuncture:

1

The return on Turkish lira assets decline.

The demand for foreign exchange goes up.

Pressure for **depreciation** occurs on TL.

2

Positive signal on the course of the economy

Confidence increases.

Reverse currency substitution strengthens.

Pressure for **appreciation** occurs on TL.

3

The exchange rate may act independent of **economic fundamentals**: Foregn exchange liquidity, investors' behaviours, different expectations.

The Exchange Rate Policy

Exchange Rate Regime – Exchange Rate Policy

The choice of **the exchange rate regime** is made jointly with the Government.

Floating Exchange Rate Regime

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

How Does the Central Bank Implement the Exchange Rate Policy ?

I - Intervening against Excessive Volatility

- ✓ To prevent excessive volatility in both sides
- ✓ Depending on the causes of volatility
- ✓ May also be through announcements or warnings

II - Intervening with the Purpose of Reserve Build-Up

- ✓ To sterilize excess foreign exchange supply
- ✓ Without affecting the level, consistent with the floating exchange rate regime
- ✓ By using transparent methods

How Does the Central Bank Implement the Exchange Rate Policy?

Central Bank has no policy of keeping the Turkish lira overvalued.

TL suffered 7 sudden depreciations; with the transition to floating exchange rates, during the Telekom crisis, at September 11 incidents, during the political tension in Summer 2002, in the Iraq Crisis, in October 2003, and in April-May 2004.

⇩

No foreign exchange was sold to the market from the beginning of 2003, till 11 May 2004, for almost 16 months.

⇩

Central Bank held foreign exchange buying auctions when a surplus of foreign exchange occurred.

⇩

Central Bank bought more than US dollar 15 billion worth of foreign exchange in 2003 and 2004.

Determinants of Exchange Rate Level under Floating Exchange Rate Regime

Short-run

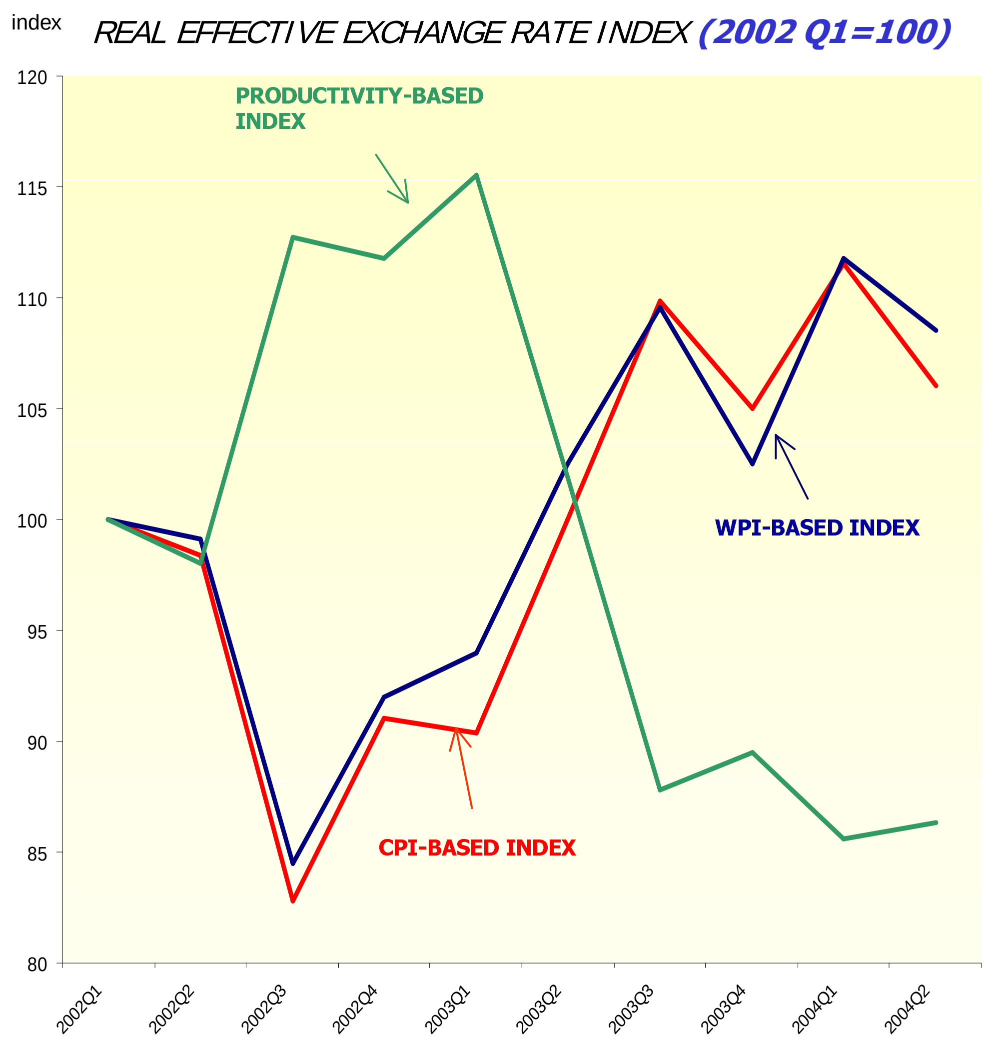
- ✓ Developments in Stability Program
- ✓ Public debt stock and risk premium
- ✓ Expectations: especialy expectations about balance of payments
- ✓ External Developments
- ✓ Actions of market players

Long-run

- ✓ Structural reforms and their effects on productivity
- ✓ Periodic movements in economy
- ✓ Economic fundamentals; inflation, growth

Is Turkish Lira Over-valued?

An important point about the level of exchange rates is the real exchange rate index and the way it is used.



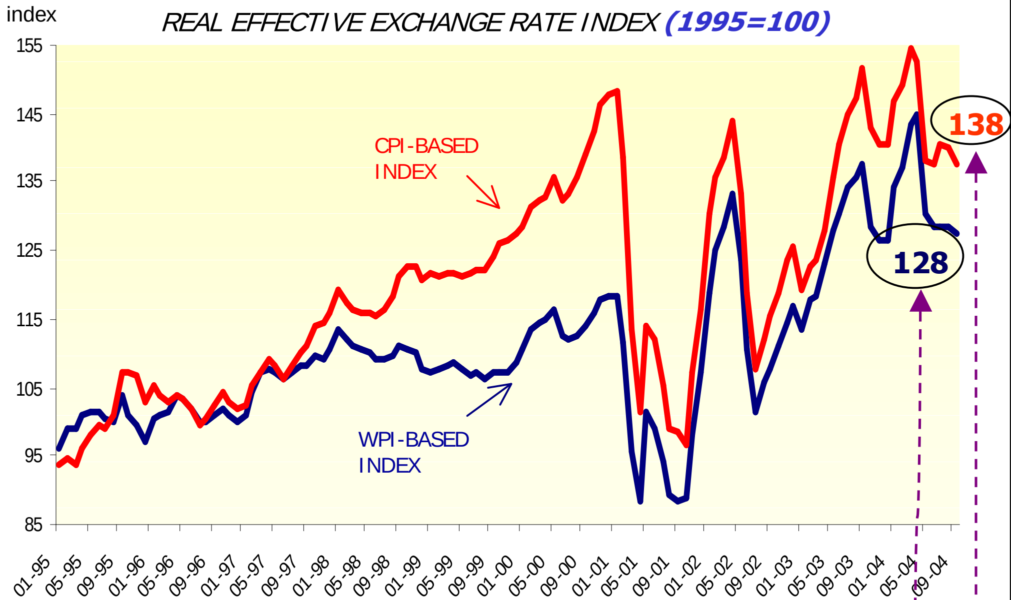
✓ Real exchange rate index, which denotes the relative position of goods produced abroad in terms of oodsproduced domestically, is an indicator commonly used in calculating international competition.

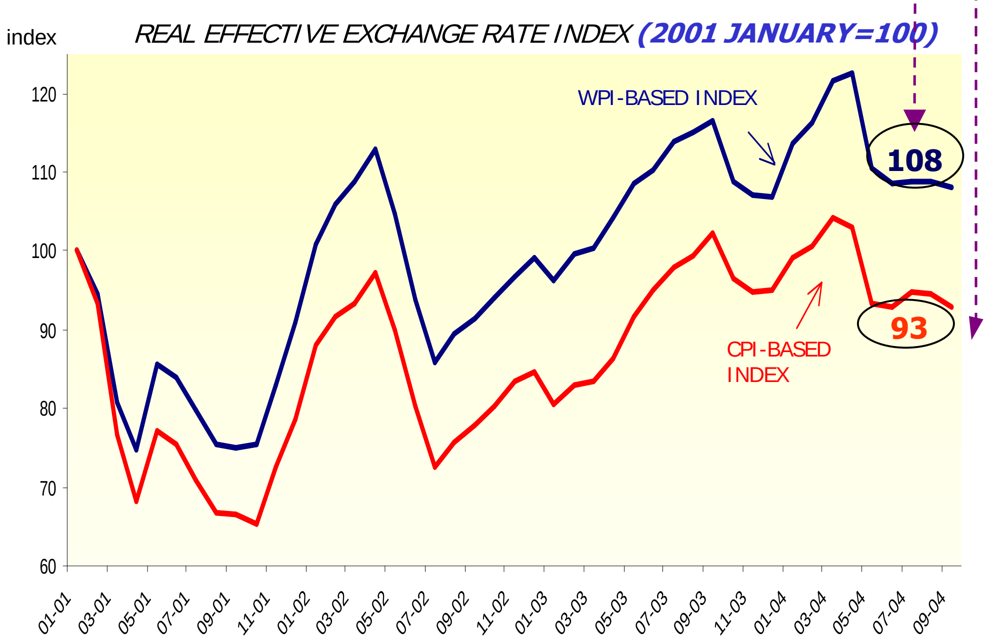
However,

<u>1. Different Indices</u>

The real exchange rate index is usually calculated by using consumer prices index or wholesale prices index. However the index can produce different results when different indices, like productivity index or unit labor cost index, are used and the results can be conflicting with the ones gathered according to price differences.

Is Turkish Lira Over-valued?





2. Base Year

Real exchange rate index can be interpreted properly only if the right base year is chosen, and index values can vary gravely according to the base year selected. Therefore, the base year to be chosen shall be qualifying both domestic and external stability criteria. Taking into account the economic conditions of our country, it is evident that it is very hard to determine such a period.

3. Long-term

It is believed that using short-term changes as indicators for the level of foreign exchange is not appropriate as exchange rates are determined according to relative changes between countries and the relative changes are reflected on the rates in the long run.

Appreciation or Depreciation of TL is an Outcome

Favorable Process

1. Improvement in Economy
- ✓ Diminishing public debt stock
- ✓ Decline in inflation
- ✓ Acceleration in growth
- ✓ Improvement in investment environment

2. Positive Exogenous Shocks
- ✓ Getting a date from EU for accession
- ✓ Signing a Stand-by Agreement with the IMF

3. Positive Expectations
- ✓ Enhanced confidence with the program and the policies adopted, etc.

⇨

Porfolio preferences change in favor of TL.

+

Either capital inflow or expectations for inflow increases.

⇨

- ✓ Risk premium declines
- ✓ Interest rates decrease
- ✓ Investments increase
- ✓ Growth accelerates
- ✓ Employment increases

⇨

Excess foreign exchange supply

⇩

Appreciation pressure on TL

⇩

What can the Central Bank do?

-Short-term interest rates are intended only at inflation

-Excess foreign exchange supply is mopped up through transparent policies: Foreign Exchange Buying Auctions

- In case of excess volatility, the market is intervened through direct purchases.

Appreciation or Depreciation of TL is an Outcome

Unfavorable Process

1.Deterioration in Economy
- ✓ Rise in public debt stock
- ✓ Rise in inflation
- ✓Decelaration in growth
- ✓ Decline in productivity
- ✓ Deterioration in investment environment

2.Negative Exogenous Shocks:
- ✓ Fail to get a date for accession from EU
- ✓ Fail to sign a Stand-by agreement with the IMF

3.Olumsuz bekleyişler:
- ✓ Deterioration in the confidence with the program and the policies implemented, etc.

Portfolio preferences change in favor of foreign exchange.

+

Either capital outflow or expectations for outflow increase.

- ✓ Risk premium increases
- ✓ Interest Rates rise
- ✓ Investments decrease
- ✓ Growth decelarates.
- ✓ Unemployment increases

Excess foreign exchange demand

Depreciation pressure on TL

What can the Central Bank do?

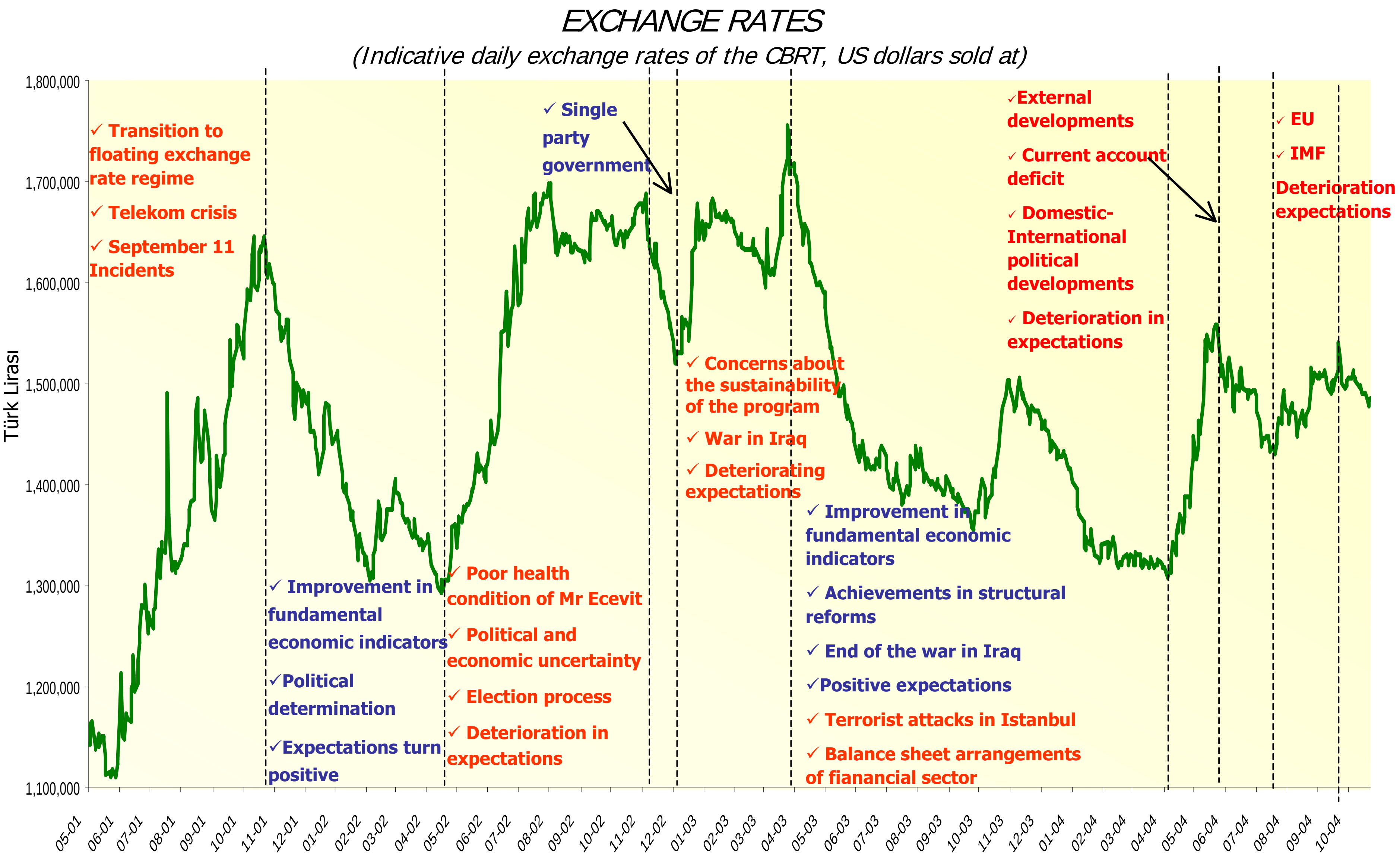
-Short-term interest rates are intended only at inflation

-Warn economic agents via press releases and announcements

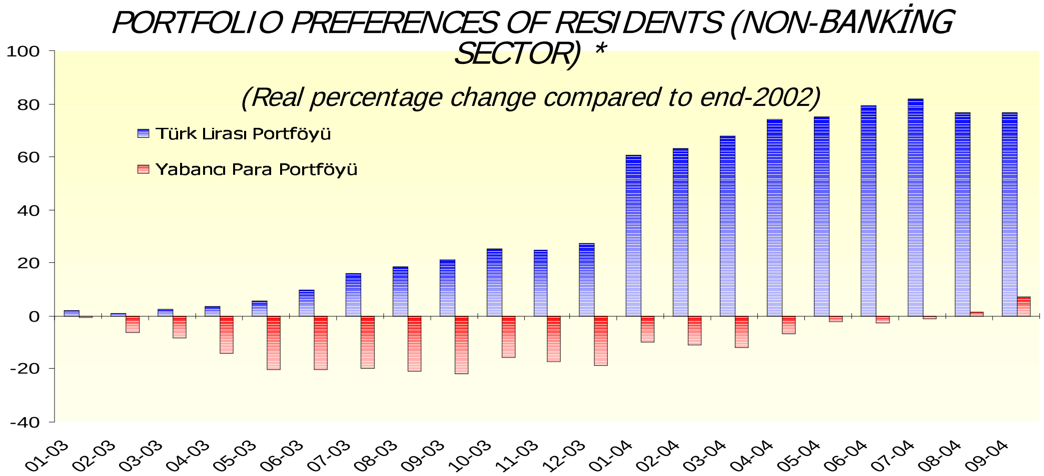
- In case of excessive volatility, the market is intervened through direct selling auctions

When we look at the past three years: Slide: Exchange Rate Figure

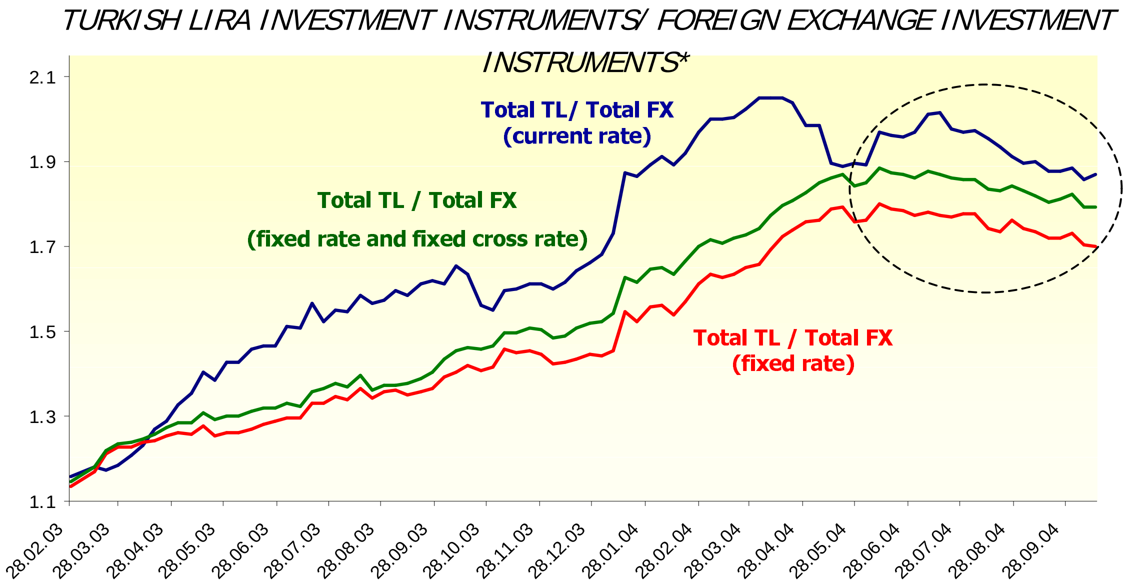
Appreciation or Depreciation of TL is an Outcome



Currency Substitution, Reverse Currency Substitution



* Deposit volume rapidly increased due to Imar Bank payments.
Foreign exchange portfolio = Deposit+ Government Paper+ Eurobond+ Othersr
Turkish Lira portfolio= Deposit+Government Paper+ Repo+ Mutual Funds+Others



* Deposit volume rapidly increased due to Imar Bank payments.
TL- denominated instruments= Deposit+Governments Papers (real person)+Mutual funds + Repo
FX-denominated Instruments = Deposit + Government Papers (real person) + Eurobond (real person)

[1] Conference on Financial Dedollarization: Policy Options, IADB, Washington, D.C., Aralık 1-2, 2003.

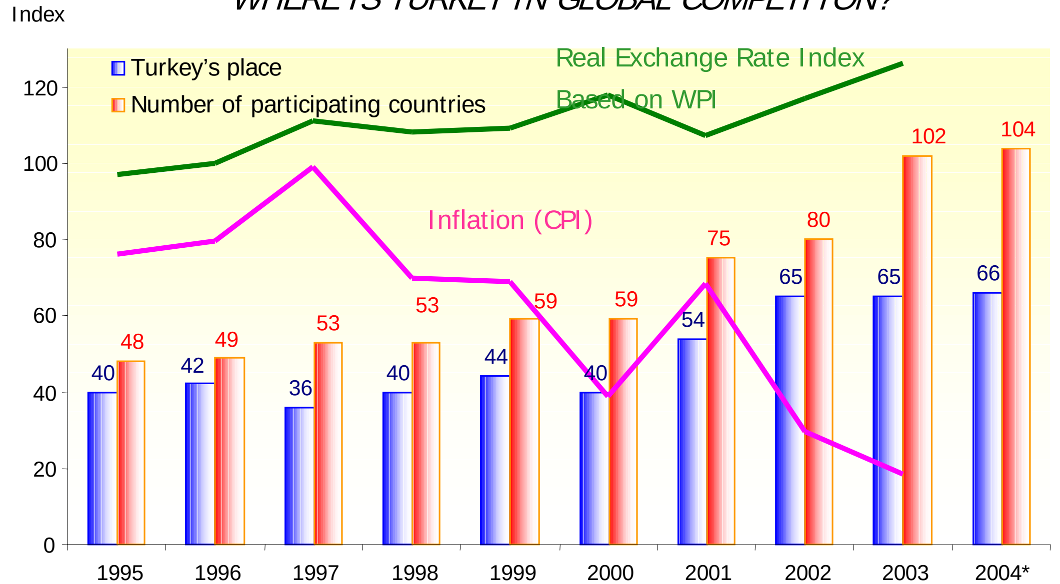
Reverse currency substitution **is not a self-generated process.** The Israeli, Chilean, Mexican and Peruvian[1] cases show that reverse currency substitution is a **side effect of struggle with inflation** and economic stability attained thereof.

- ✓ We have sarted to see the results of the economic program that has been implemented for the last three years and reverse currency substitution process has started; the share of TL-denominated instruments in portfolios of non-residents have been increasing since 2003.
- ✓ Recent pause is due to the IMF-primary surplus ad EU acesion process.

Establishment of macro-economic stability, **especially price stability**, and enhanced confidence will accelerate reverse currency subsitution.

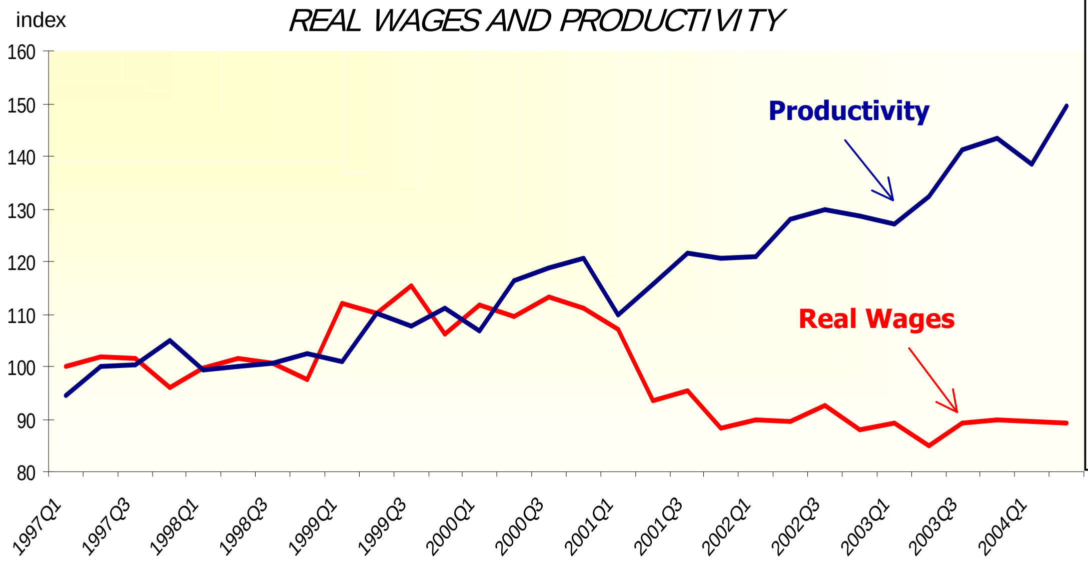
Exchange Rates and Competitive Power

WHERE IS TURKEY IN GLOBAL COMPETITON?



* In 2004, 3 countries have been excluded in calculations and 3 out of 5 countries that were added have ranked ahead Turkey.

REAL WAGES AND PRODUCTIVITY



Exchange rates is not the one and only factor in competition.

Factors of lasting competitive power:

- Price competition, relative position, unit prices

- Quality factors: After-sales services, standardization in products.

- Structural factors: Macro-economic performance, economic and social welfare level, productivity, skilled manpower, research-development activities

In other words, a country can not gain competitive power through devaluations.

Within this framework, the factors, which have been contributing to sustainable competitiveness, are as follows:

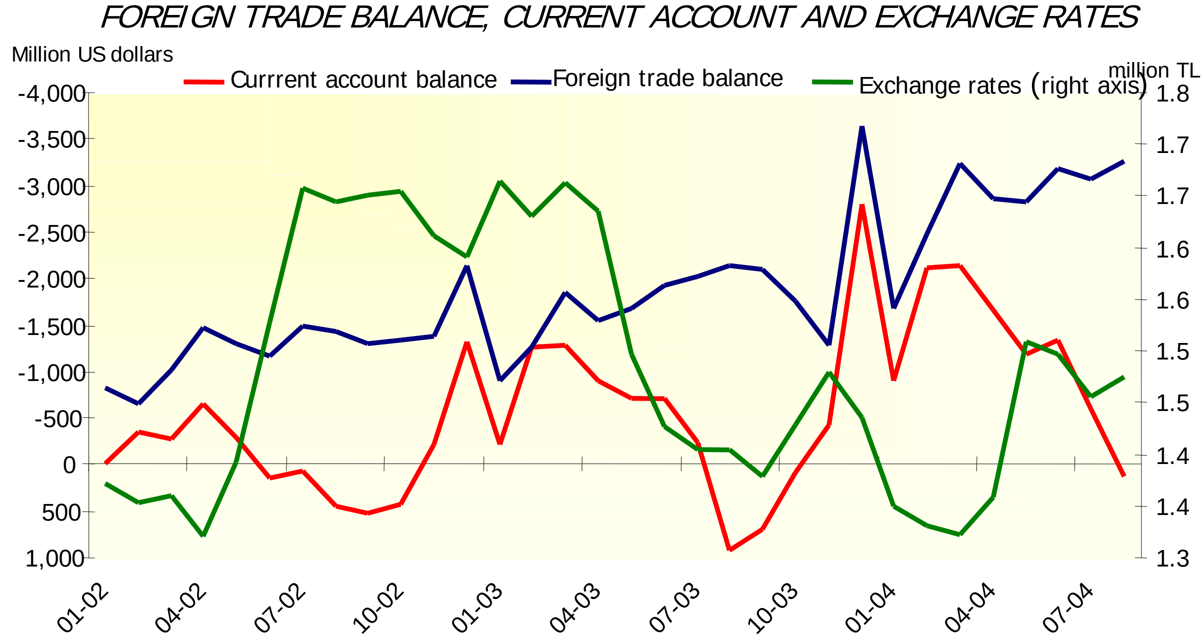
-Economic stability getting stronger every day

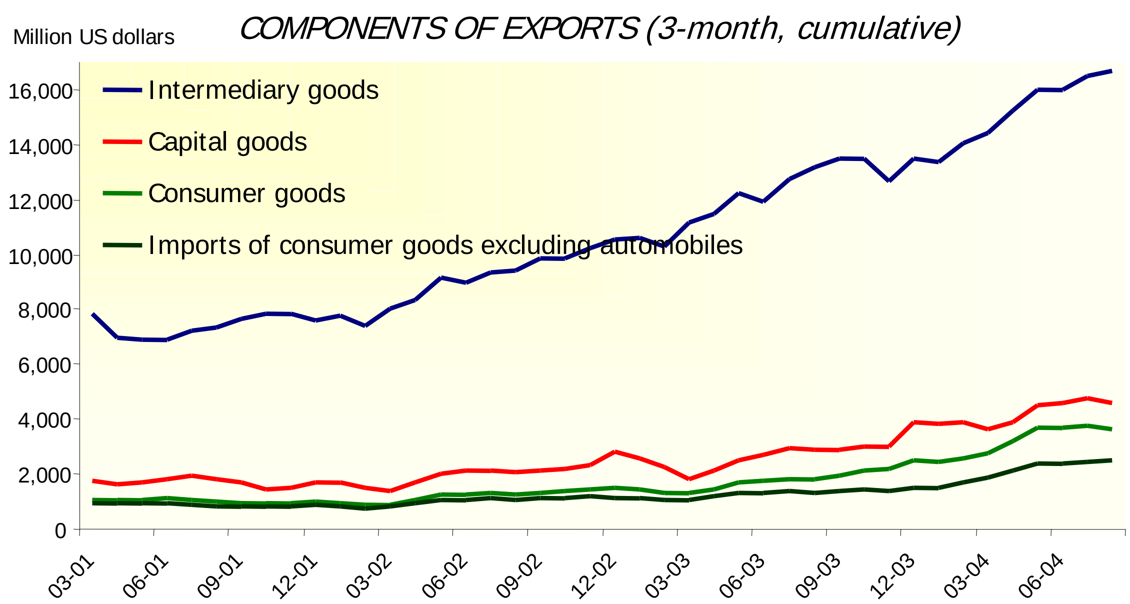
- Rise in productivity

-Course of real wages

- Real appreciation of TL rests upon the rise in productivity in sectors subject to commerical activity and contributes to exports.

Exchange Rates and Foreign Trade

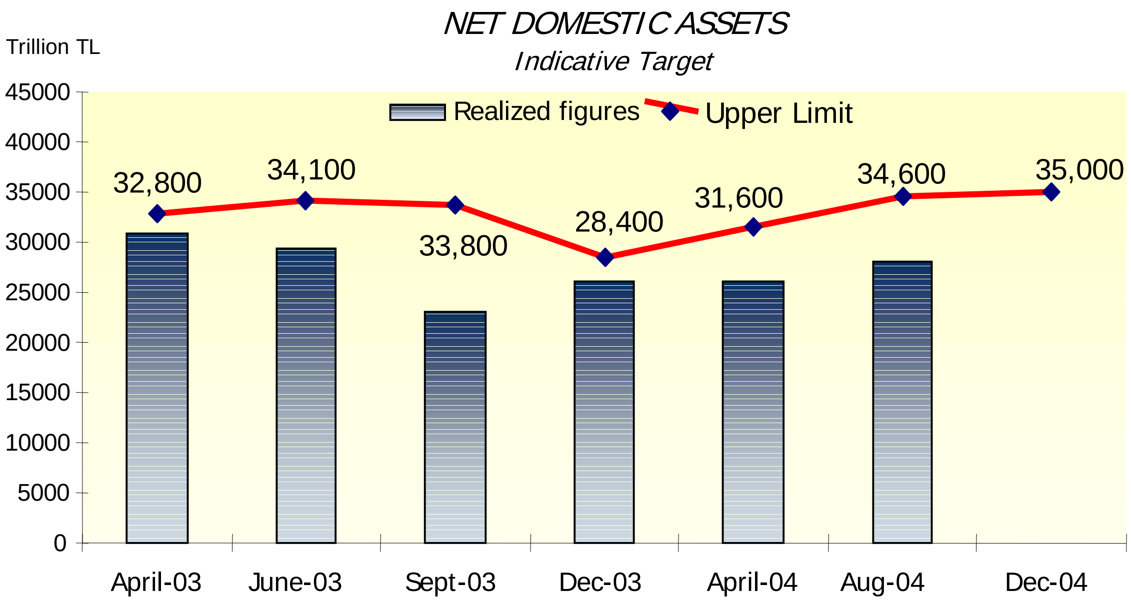


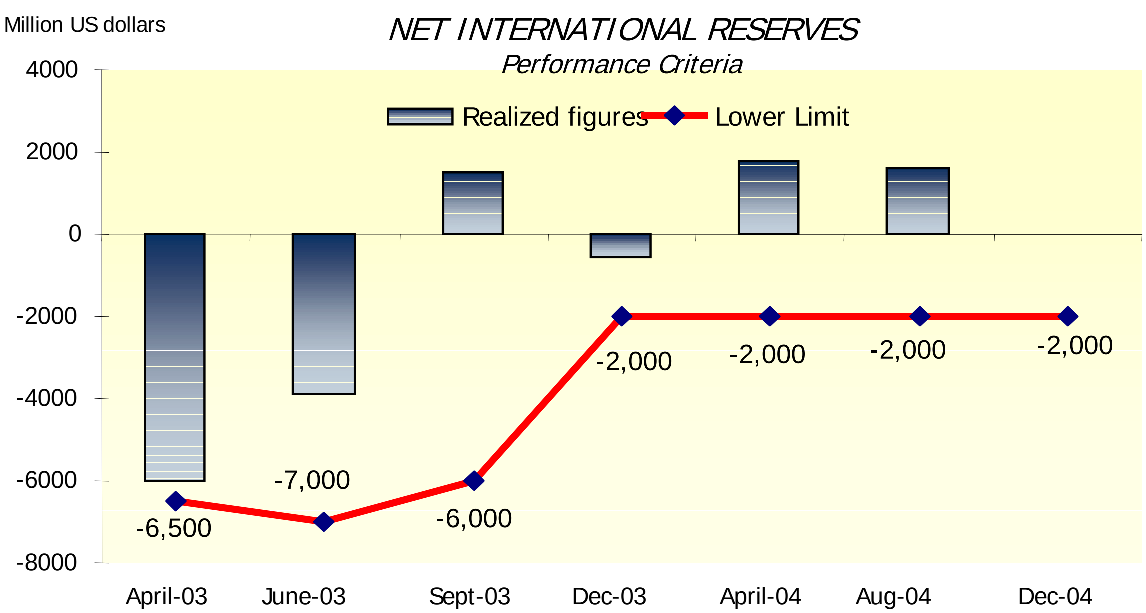


- ✓ Foreign trade is not only variable to which inflation shows reaction.
- ✓ **Exchange rates** do not react only to foreign trade but also to **entire balance of payments**, other economic developments, the program and expectations.
- ✓ It should be borne in mind that, exports and imports are susceptible to domestic and foreign demand rather than exchange rates.
- ✓ The item most susceptible to exchange rates among other imports items is the imports of consumer goods. The share of this item in total imports is 15 percent and 10 percent excluding imports of automobiles.
- ✓ Therefore, policies to be adopted should be considered from this viewpoint.

MONETARY PROGRAM AND MARKETS

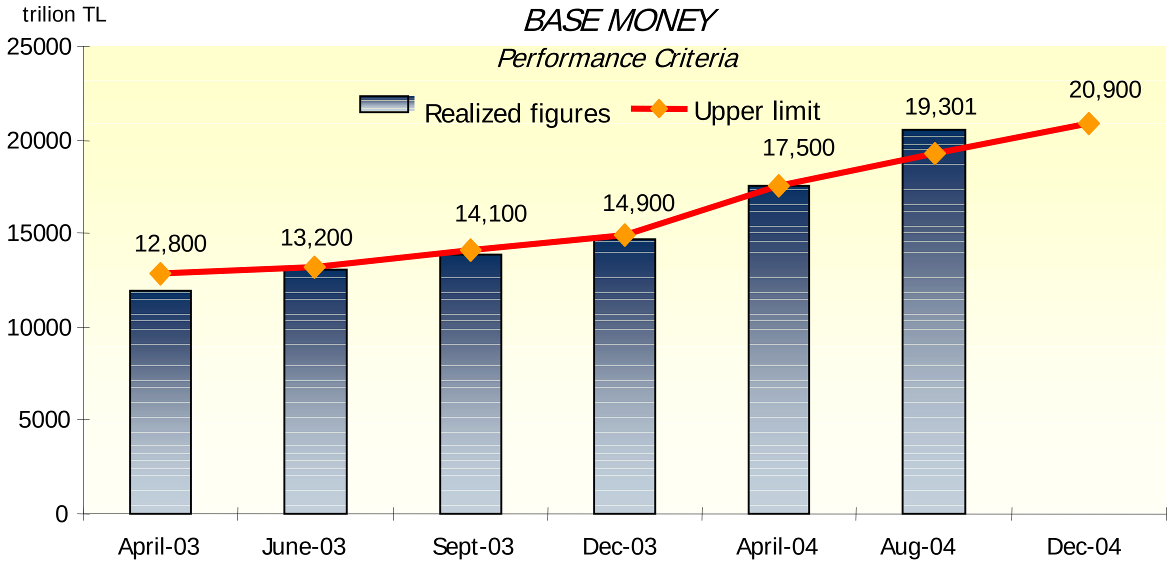
Monetary Program Realizations

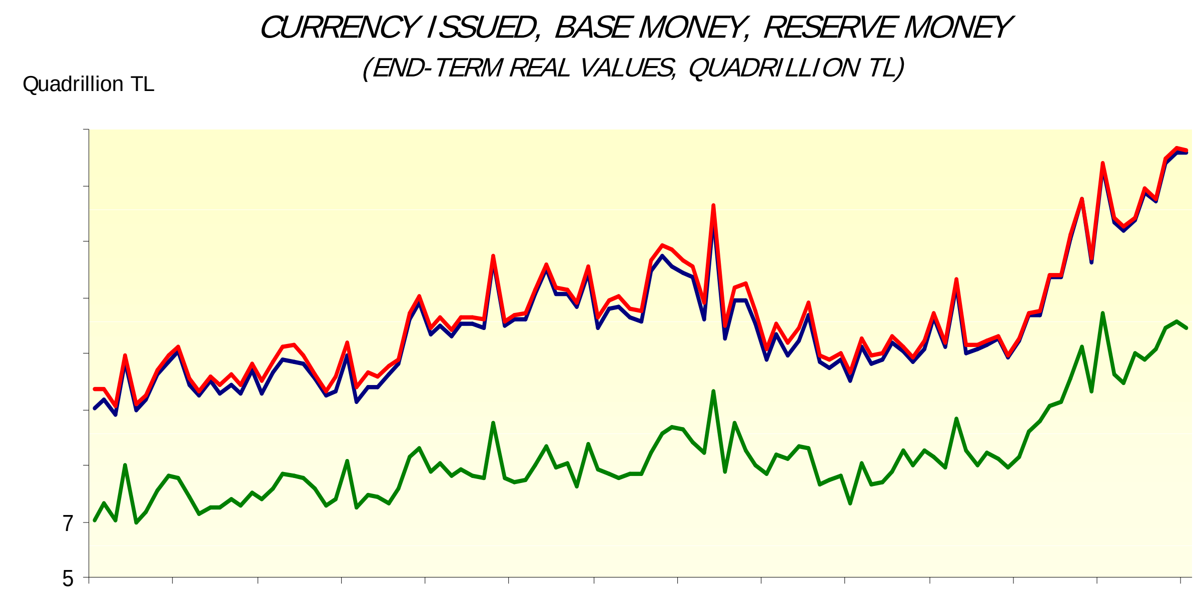




- ✓The tight fiscal policy is implemented as envisaged in the program.
- ✓ Targets for Net Domestic Assets and Net International Reserves have been achieved.

Monetary Program Realizations





✓ Base money slighlty exceeded the target due to rise in money demand.

✓ The rise in base money is not inflationary.

⇩

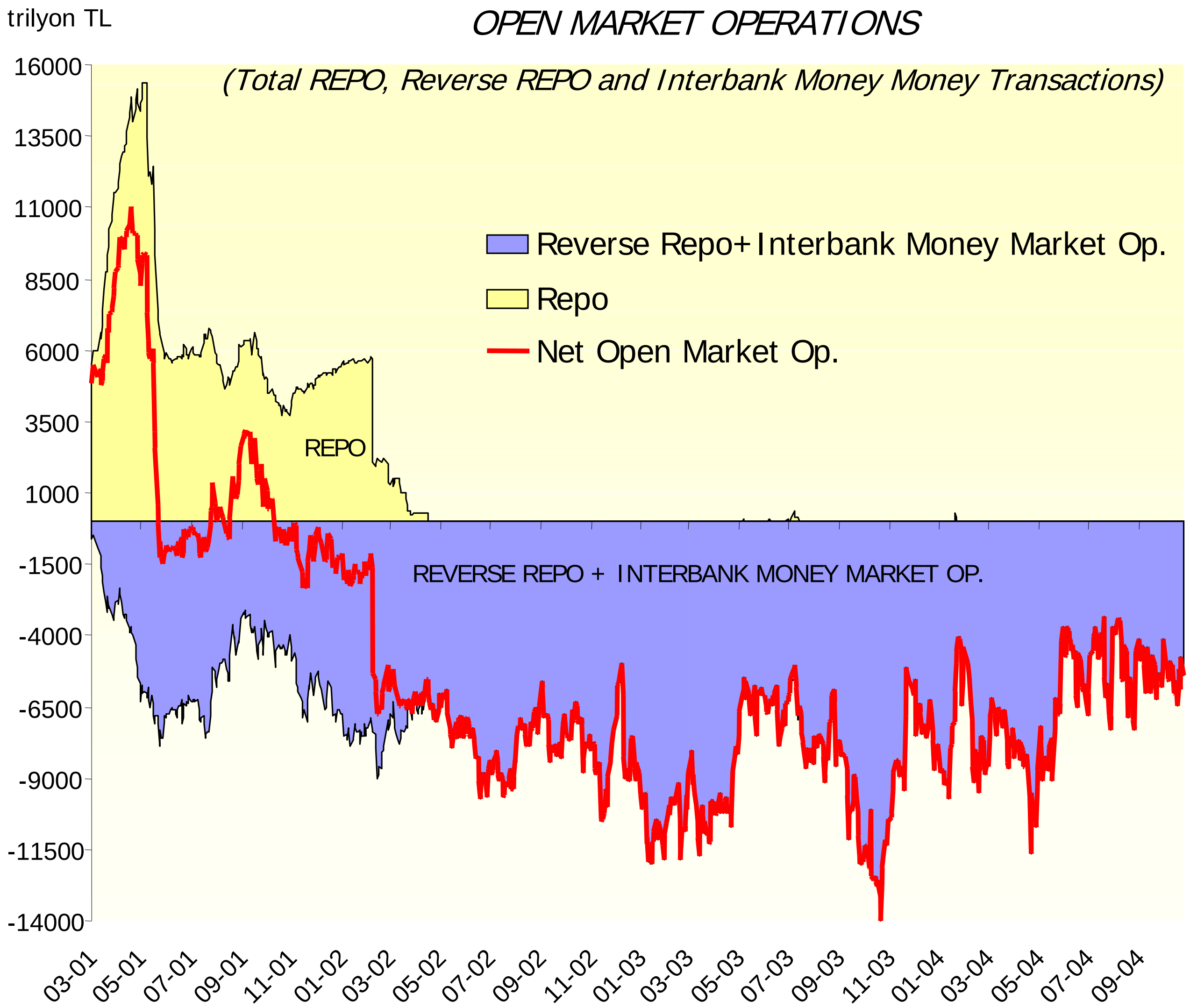
Decline in inflation and enhanced confidence helped decrease expected inflation rates and risk premium,

⇩

Demand for money, especially for cash, is increasing.

In line with these developments, currency issued increases.

Markets



✓ Increased cash demand

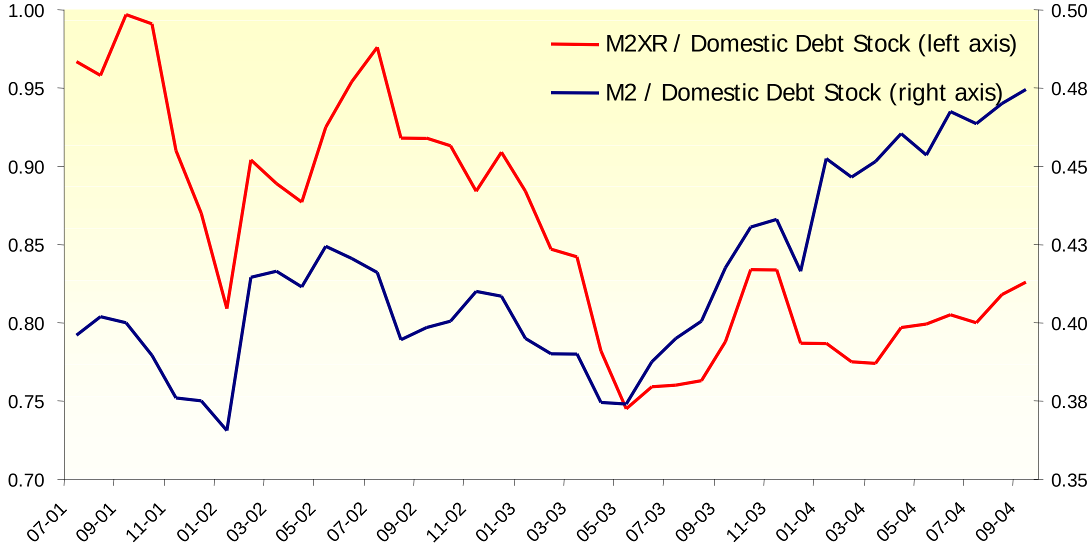
✓ Suspending FX buying auctions

✓The volume of excess liquidity in the market is decreasing:

CBRT lending rate has been decreased relatively faster.

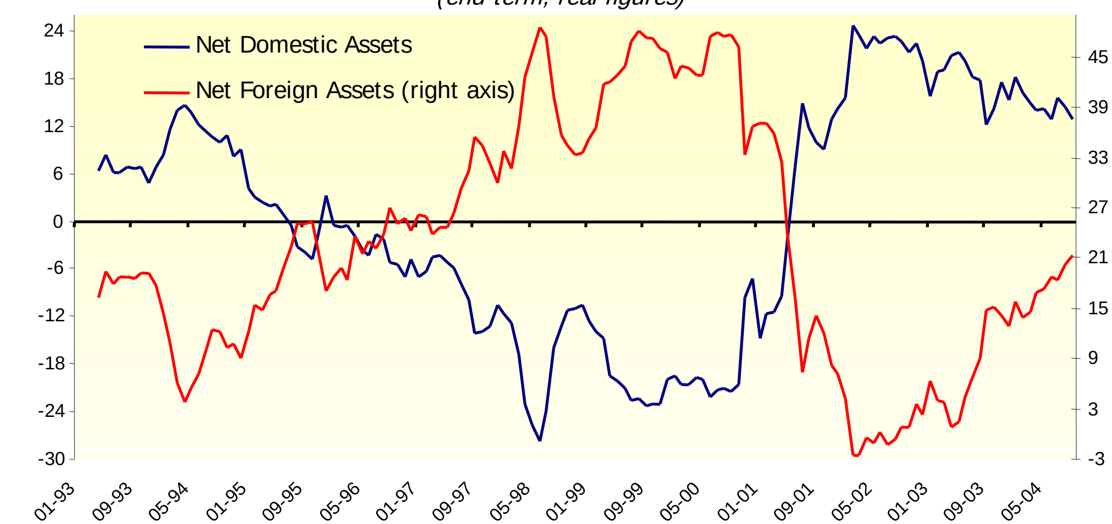
Markets – CBRT Balance Sheet

Ratio of M2 and M2XR to DOMESTIC DEBT STOCK



NET DOMESTIC ASSETS AND NET FOREIGN ASSETS

(end-term, real figures)



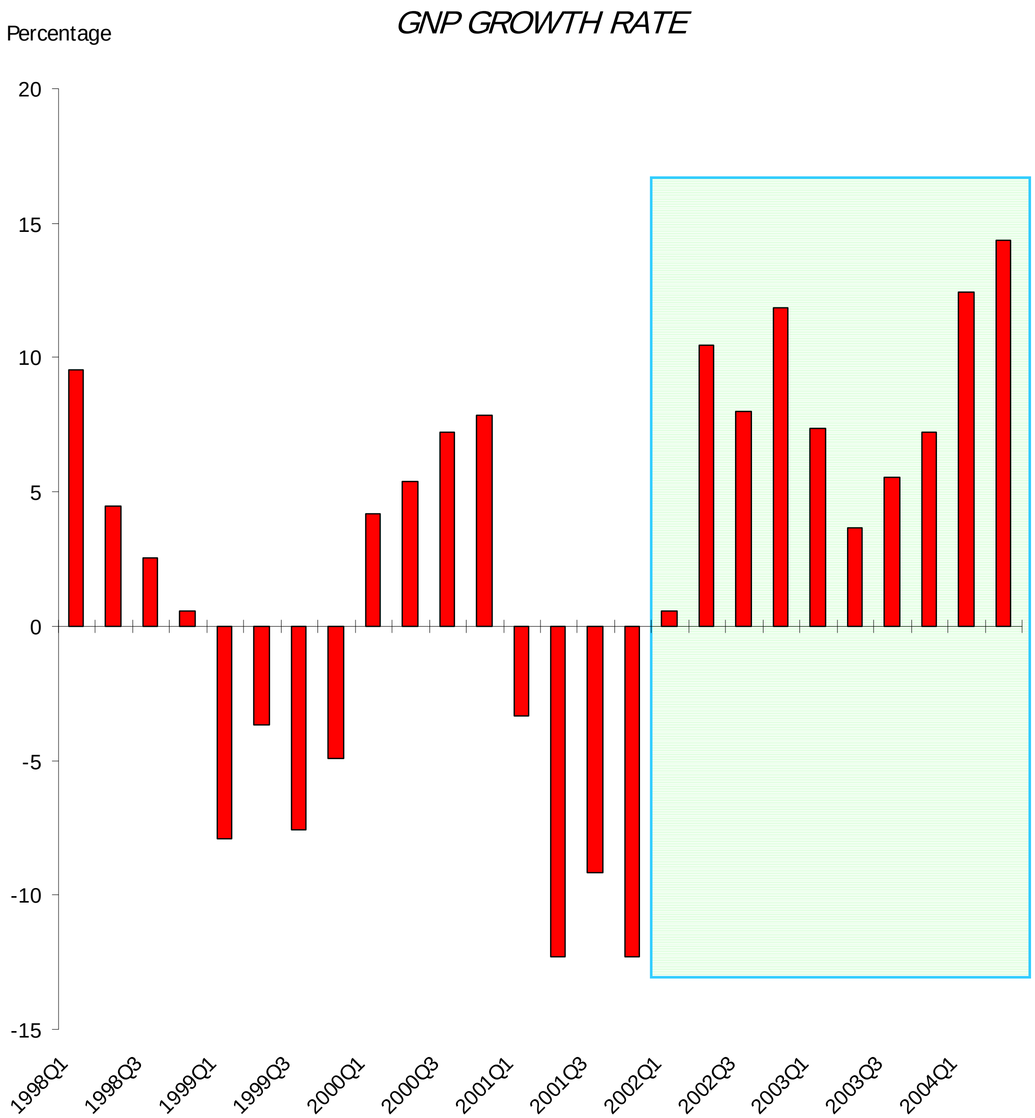
* Net Domestic Assets= Net Domestic Assets as stipulated by Stand-By Program – TL and FX deposits of the Banks + Requirements

Financial markets are deepening.

- ✓ Pressure on markets exerted by domestic debt stock is decreasing.
- ✓ Net Domestic Assets Item is progressing in line with the program targets.
- ✓ Net Foreign Assets Item is gradually increasing.

GROWTH

Positive Growth Rates



With the current program, Turkey reached positive growth figures in 2002 and has been rapidly growing for the last 3 years.

✓ Compared to 2001, our economy has grown by **20.8 %** in real terms today.

✓ Strong growth performance is expected to continue in 2004 as well.

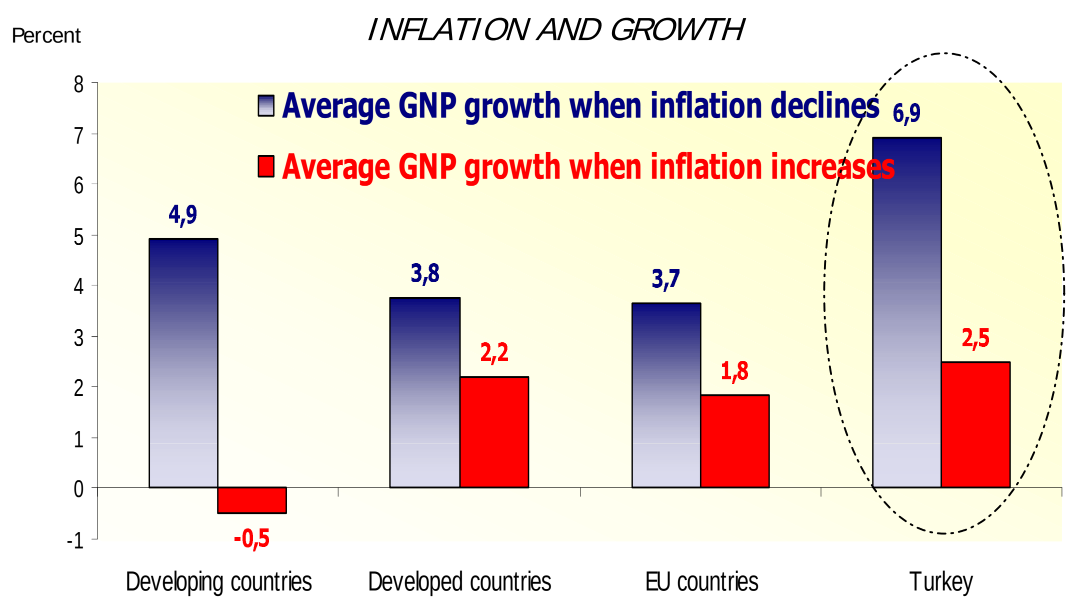
✓ Growth projection for 2005 is 5 %.

2004

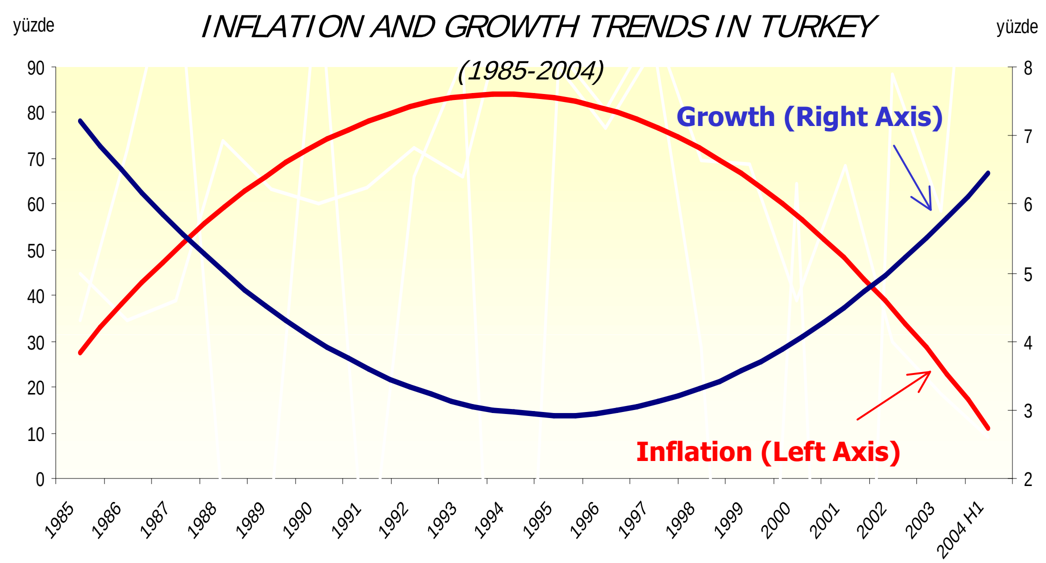
	Q2	First Half
GNP	14,4	13,5
GDP	13,4	11,9

✓Growth rate in the second quarter of 2004 is the highest rate achieved in the last **14 years.**

Positive Growth Rates– Changing Dynamics



Resources: IFS, WEO, CBRT



Trend lines are, $y=a+bx+cx^2r$. x=years, y=growth or inflation.

Today's growth dynamics are different from yesterday's

1. High growth rates have been attained while inflation is falling.

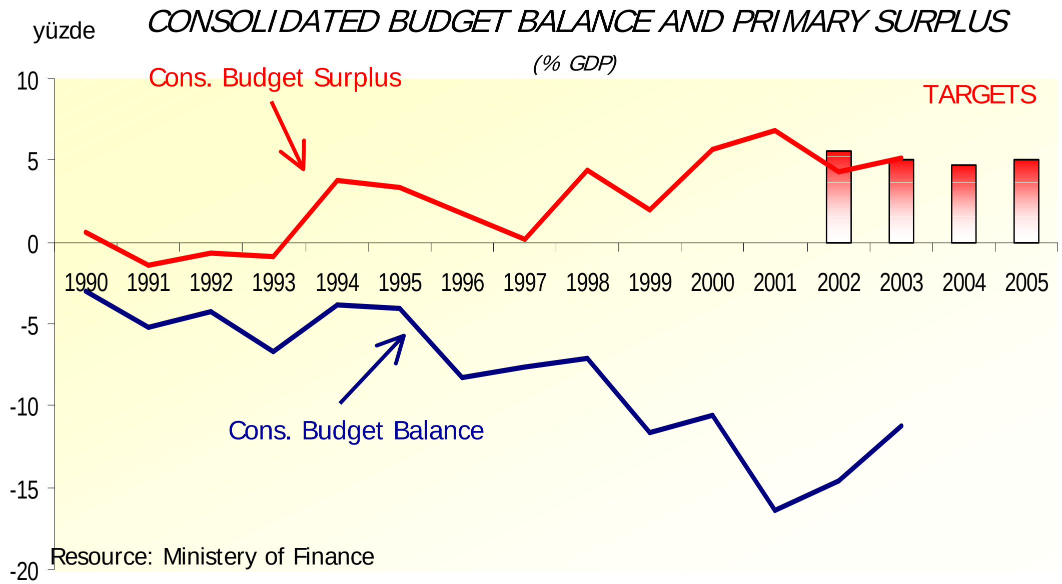
✓ There is an inverse and strong relationship between inflation and growth:

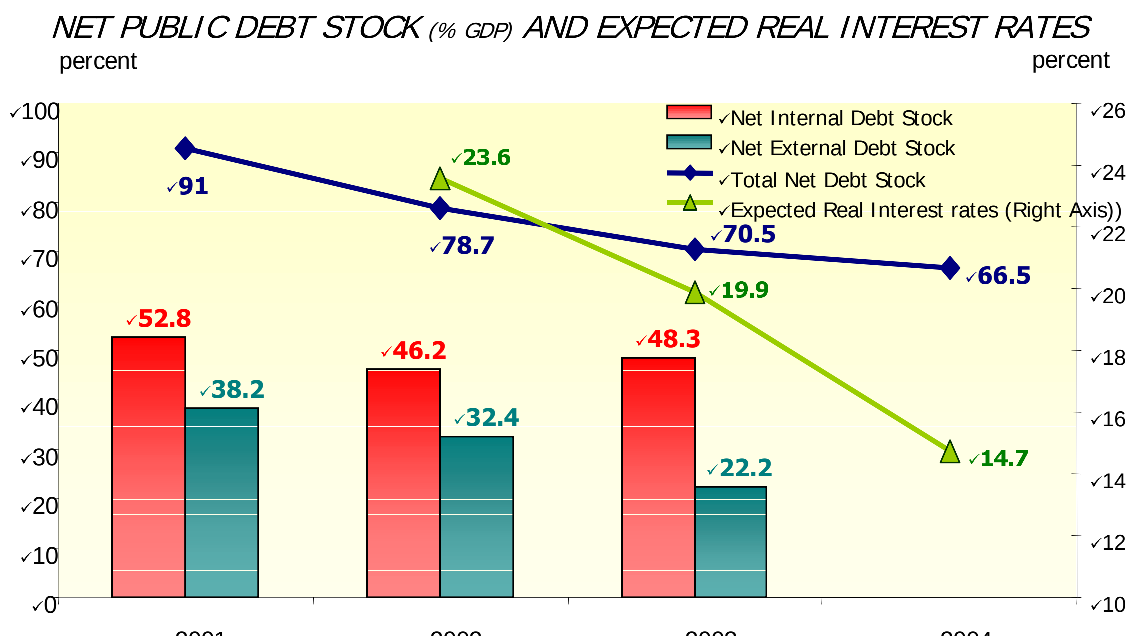
- Both in developed and developing countries, average growth increases while inflation decreases and inflation goes up whereas average growth shrinks.

- High and sustainable growth rates and increasing employment can only be attained by achieving price stability.

For this reason, CBRT's primary objective is to maintain price stability which contributes the most to growth and the increase in employment.

Positive Growth Rates– Changing Dynamics





Resources: Undersecretariat of the Treasury, IMF Turkey Report Total Net Debt Stock predictions for 2004); Expected Real Interest Rates in 2004 regards September

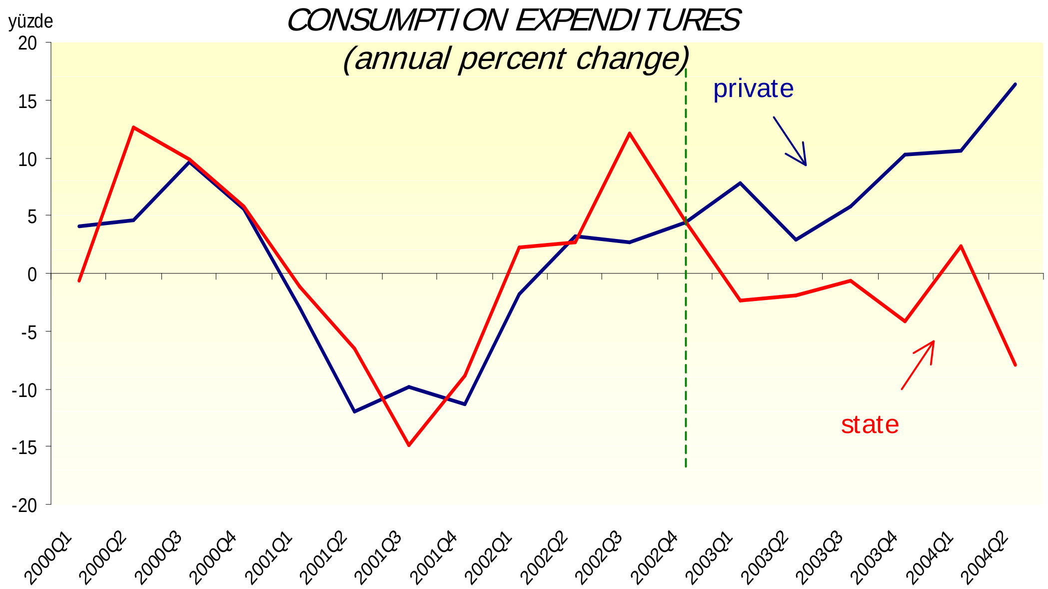
2. Tight fiscal policy stimulates growth;

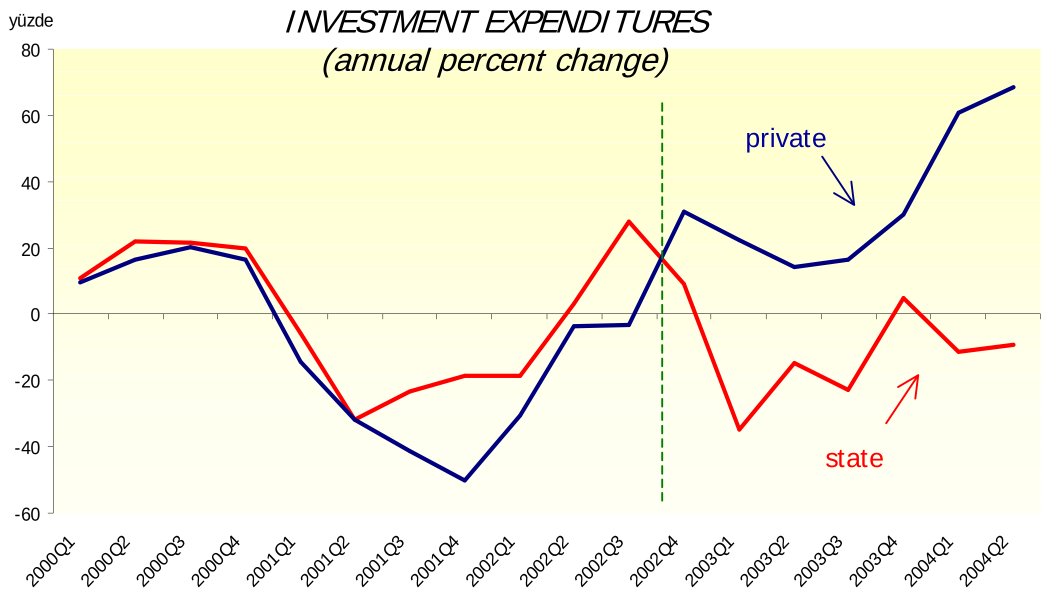
✓ The main source of growth is no longer the public sector, as tight fiscal policy eased its effects on the economy.

✓Tight fiscal policy affects expectations favorably; hence it stimulates growth.

In this framework, primary surplus is the most significant variable of tight fiscal policy.

Positive Growth Rates– Changing Dynamics





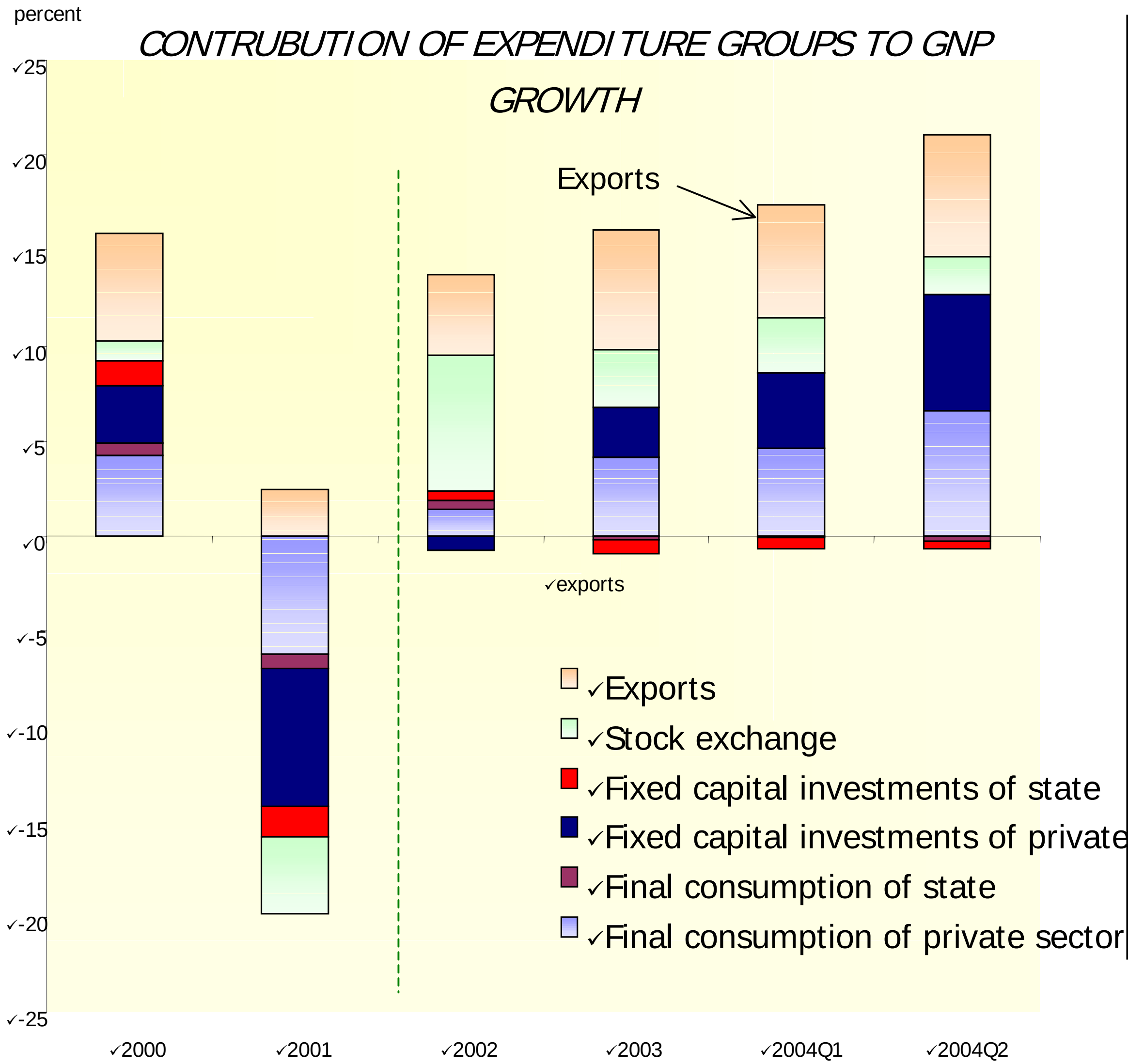
3. Growth is now driven by the private sector.

✓Contribution of final consumption and investment expenditures of the state to GDP, decreased as of the last quarter of 2002, while private sector's contribution continue to increase.

✓ Pivate sector investments increased by 69 percent in the second quarter of 2004.

✓In this period, as an investor and a regulatory body, public sector should focus on increasing the growth potential in the country **within the framework of good governance principles**.

Positive Growth Rates– Changing Dynamics

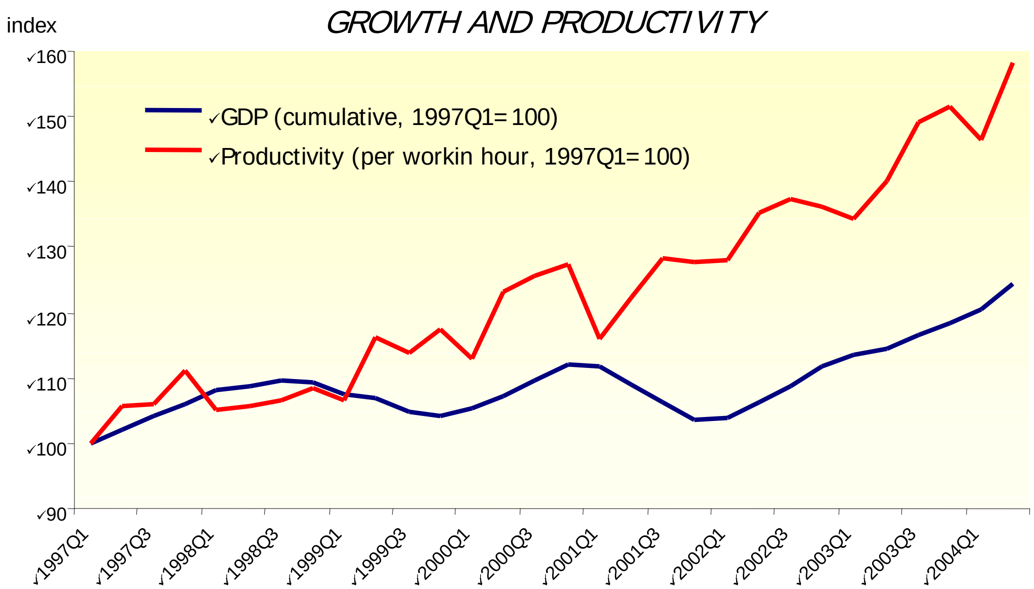


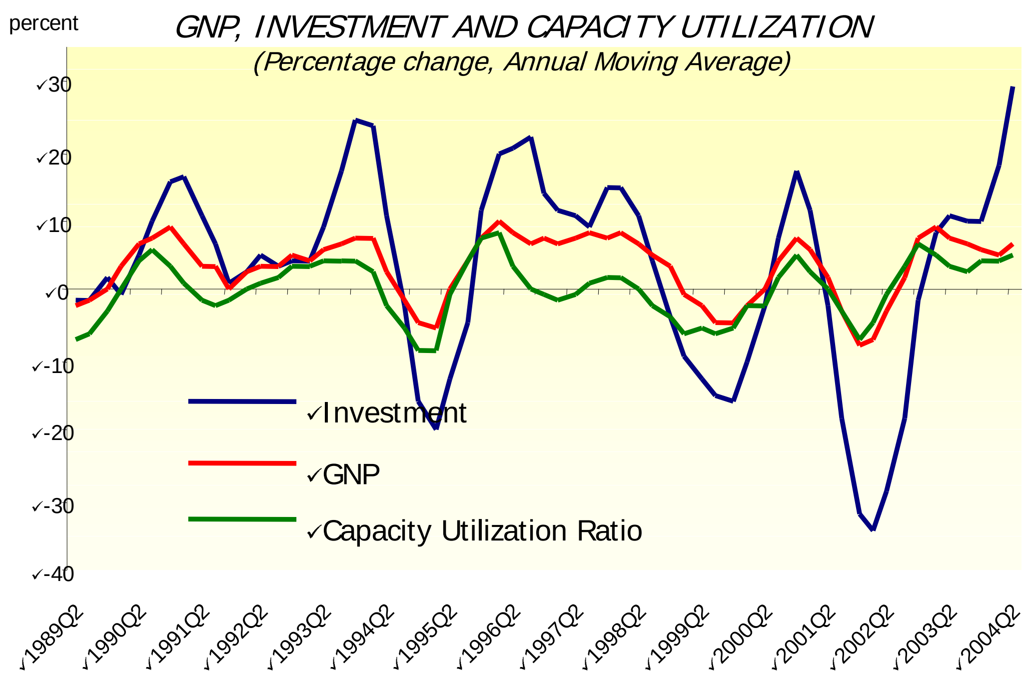
4. Exports contribute to economic growth with an increasing share.

✓ Turkey's total foreign trade volume is expected to reach 150 billion US dollar by the end of 2004.

✓The Turkish economy has become more integrated with the world economy, giving rise to a more competitive environment.

Positive Growth Rates– Changing Dynamics





5. Productivity-Investment-Employment

✓ Just like several countries achieving strong growth performances in post-crisis periods, the highest contribution to growth at the initial stage comes from the **productivity increase**. The cumulative productivity increase is around 26 % for the last three years.

✓**The increase in investment comes afterwards**.

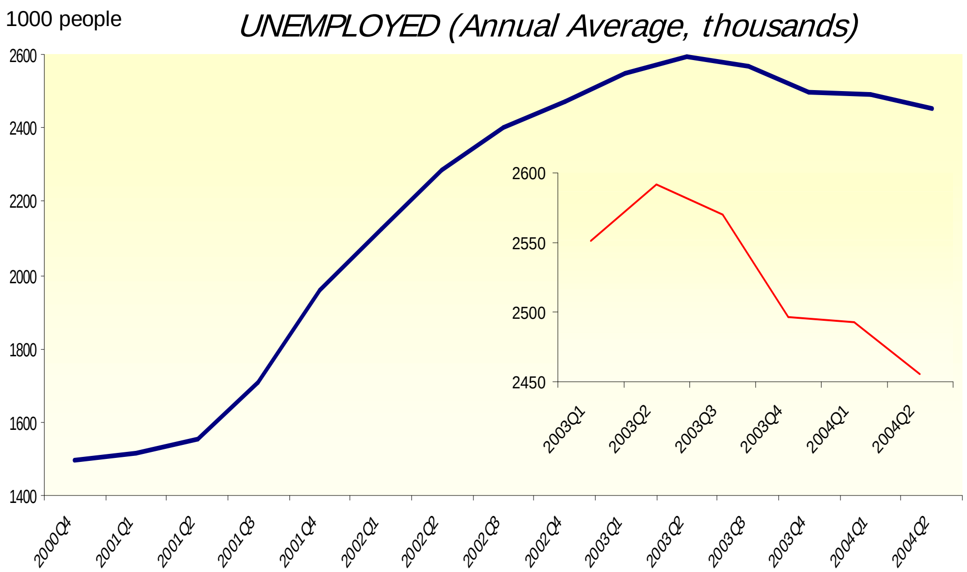
✓In other words, at the initial stage, growth does not follow investment, **investment follows growth**.

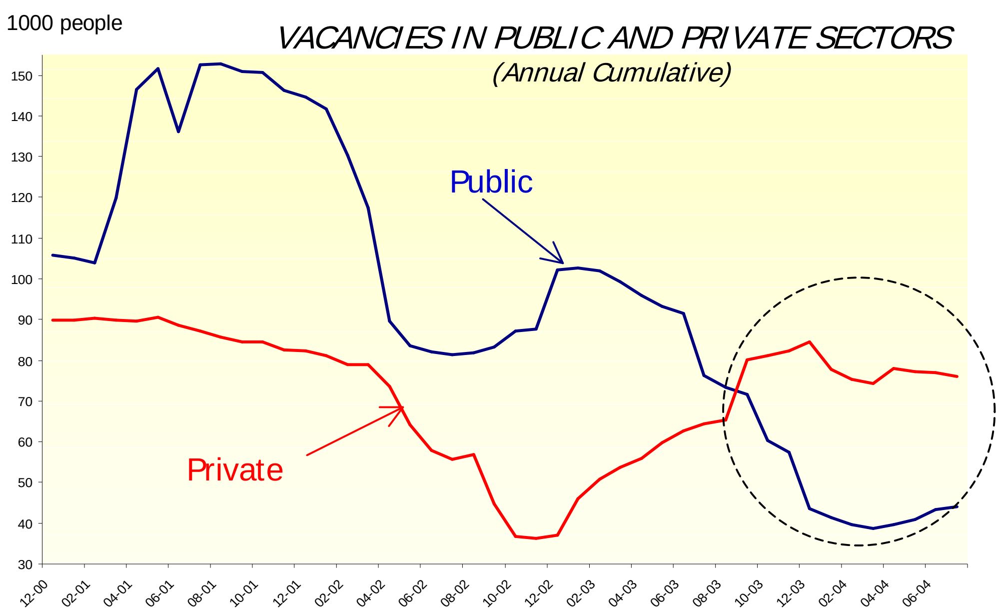
✓Main reason for this structure is that investors and real sector want to be sure about the permanence of the **achievements attained in economy and the decline in inflation**.

✓Productivity, which increases in this period, raises the return of capital on one hand, encourages investments on the other hand.

✓ This situation is also observed in Turkey. **Investments and employment will continue to rise** on condition that credibility displays an upward trend and the current achievements are maintained.

Positive Growth Rates– Changing Dynamics





Resources: SIS, Turkish Employment Organisation

- ✓ Due to negative impact of the crisis and contraction in economy, the number of unemployed has increased considerably since 2001.
- ✓The number of unemployed has been indicating a **downward trend since 2003-Q2**, and thus **unemployment rate decreased to 9.4 % in 2004-Q2.**
- ✓During this period, in line with the changing dynamics of the Turkish economy, the capacity of the **private sector** in **creating new jobs** shows **a robust expansion** especially in the last term, while **that of the public sector continues to shrink**. Vacancies in the private sector **exceed for the first time** that of the public sector.
- ✓ **The whole process of change in dynamics and rise in investment will accelerate job creation and ensure sustainable growth in employment.**
- ✓Growth of employment should be supported by macroeconomic policies as well as social and employment policies.
- ✓ Hence, direct foreign investments, structural reforms and labor market-oriented micro regulations shall contribute to this process.

Positive Growth Rates– Changing Dynamics

This structure indicates that growth relies on strong fundamentals. However can we describe it as "sustainable"?

✓ **Sustainable growth is described as** growth periods with **a potential growth rate** lasting for **5 or more years** in an environment where price stability is achieved **and the coherence between economic indicators including current deficit/GNP and total demand, and macroeconomic balance** is maintained.

The difference between the strategies that **initiate** growth and the ones that maintain its **sustainability** should be noted. Growth in the short term should not be deemed to **guarantee growth in the long term**.

⇨

Maintaining sustainable growth requires more comprehensive and complicated reforms than the ones needed for initiating growth: Banking, tax reform, preventing underground economy, good governance.

(See.Attached Slides)

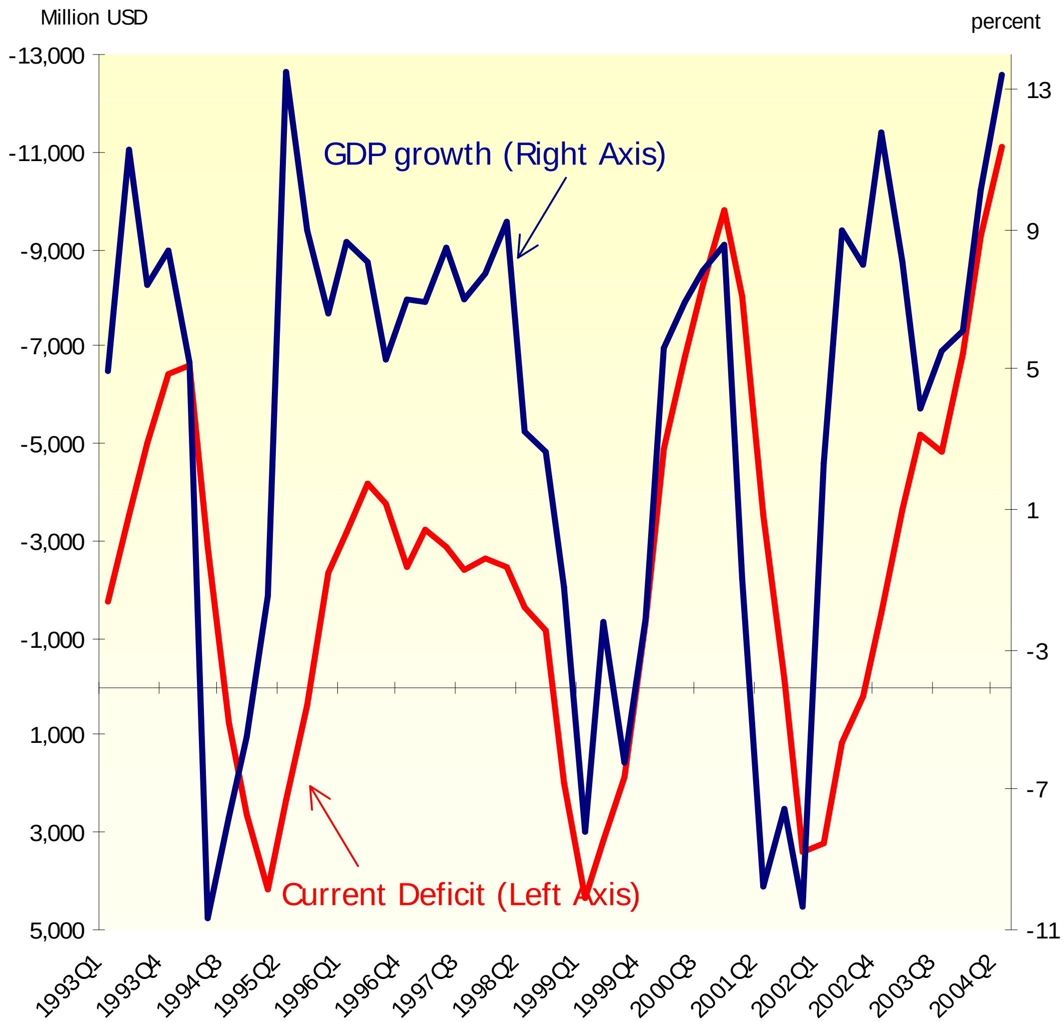
⇨

At the core of these reforms is establishing, protecting and developing a structure which will **increase flexibility against internal and external shocks with productivity**.

✓ **It should be kept in mind that our country does not need high rates of unstable growth but a sustainable growth in coherence with** macroeconomic targets.

Growth- Current Account Deficit

GROWTH AND CURRENT ACCOUNT BALANCE(1993-2004 Q2)



✓ Current account deficit is above the prgram forecast of % 5. **An increase in the current account deficit is a natural consequence of a growth**, which realized **above % 5.**

✓However, discussions, which aroused with the increasing current account deficit; are made in the scope of past habits instead of the measures to be taken within the current program.

Growth- Current Account Deficit

Although fragilities still exist and new measures are required in the economy, structure of the turkish economy is much better when compared to the past: Conditions are different.

WHAT IS DIFFERENT TODAY?

1. Floating Exchange Rate Regime:

- Looking backwards, fixed or predictable exchange rate regimes are put into practice in most of the countries, which experience "balance of payments crisis", unstable macroeconomic balance and production loss.

Slide: Balance of Payments Crises and exchange rate regimes

Balance of Payments Crises and Exchange Rate Regimes

CRISES		Pre-crisis exchange rate regime	Post-crisis exchange rate regime
Argentina	1981	Managed exchange rate regime1	Managed exchange rate regime
	1982	Managed exchange rate regime	Managed exchange rate regime
	1986	Managed exchange rate regime	Managed exchange rate regime
	1989	Managed exchange rate regime	Floating exchange rate regime
	1990	Floating exchange rate regime	Floating exchange rate regime
	2000	Managed exchange rate regime	Managed exchange rate regime
	2001	Managed exchange rate regime	Managed exchange rate regime
Brasil	1983	Managed exchange rate regime	Managed exchange rate regime
	1986	Managed exchange rate regime	Managed exchange rate regime
	1989	Managed exchange rate regime	Managed exchange rate regime
	1990	Managed exchange rate regime	Managed exchange rate regime
	1991	Managed exchange rate regime	Managed exchange rate regime
	1999	Managed exchange rate regime	Floating exchange rate regime
Chile	1982	Managed exchange rate regime	Managed exchange rate regime
	1984	Managed exchange rate regime	Managed exchange rate regime
		Transition to floating exchange rate regime in 1999.	
Venezuela	1984	Managed exchange rate regime	Managed exchange rate regime
	1986	Managed exchange rate regime	Managed exchange rate regime
	1989	Managed exchange rate regime	Floating exchange rate regime
	1994	Managed exchange rate regime	Managed exchange rate regime
	1995	Managed exchange rate regime	Managed exchange rate regime
		Transition to floating exchange rate regime in 2002.	
Colombia	1983	Managed exchange rate regime	Managed exchange rate regime
	1985	Managed exchange rate regime	Managed exchange rate regime
		Transition to floating exchange rate regime in 1999.	
Uruguay	1982	Managed exchange rate regime	Floating exchange rate regime
Bolivia	1982	Managed exchange rate regime	Managed exchange rate regime
	1983	Managed exchange rate regime	Managed exchange rate regime
	1985	Managed exchange rate regime	Floating exchange rate regime

CRISES		Pre-crisis exchange rate regime	Post-crisis exchange rate regime
Mexico	1982	Managed exchange rate regime	Managed exchange rate regime
	1994	Managed exchange rate regime	Floating exchange rate regime
Peru	1987	Managed exchange rate regime	Managed exchange rate regime
Thailand	1981	Managed exchange rate regime	Managed exchange rate regime
	1984	Managed exchange rate regime	Managed exchange rate regime
	1997	Managed exchange rate regime	Floating exchange rate regime
Indonesia	1983	Managed exchange rate regime	Managed exchange rate regime
	1986	Managed exchange rate regime	Managed exchange rate regime
	1997	Managed exchange rate regime	Floating exchange rate regime
Malesia	1997	Managed exchange rate regime	Managed exchange rate regime
Denmark	1993	Managed exchange rate regime	Managed exchange rate regime
Finland3	1982	Managed exchange rate regime	Managed exchange rate regime
	1991	Managed exchange rate regime	Managed exchange rate regime
	1992	Managed exchange rate regime	Floating exchange rate regime
Norway3	1986	Managed exchange rate regime	Managed exchange rate regime
	1992	Managed exchange rate regime	Floating exchange rate regime
Sweden [3]	1981	Managed exchange rate regime	Managed exchange rate regime
	1982	Managed exchange rate regime	Managed exchange rate regime
	1992	Managed exchange rate regime	Floating exchange rate regime
Spain [4]	1982	Managed exchange rate regime	Managed exchange rate regime
	1992	Managed exchange rate regime	Managed exchange rate regime
	1993	Managed exchange rate regime	Managed exchange rate regime
Turkey	1980	Managed exchange rate regime	Managed exchange rate regime
	1994	Managed exchange rate regime	Managed exchange rate regime
	2001	Managed exchange rate regime	Floating exchange rate regime
Russia	1998	Managed exchange rate regime	Managed exchange rate regime

1 Fixed Exchange Rate, Fixed Parity and Predictable Exchange Rate Regime are described as Managed Exchange Rate Regime.

2 Floating exchange rate rate is adopted although managed exchange rate regime is put into practice after crisis.

3 The countries that adopted floating exchange rate regime after ERM crisis.

4 Floating exchange rate regime is put into practice with the transition to Euro.

Resources: Kaminsky, G. and C. Reinhart (1999), "The Twin Crises: The Causes of Banking and Balance of Payments Problems", The American Economic Review, Vol.89(3), pg.473-500.

IMF Annual Report on Exchange Arrangements and Exchange Restrictions, 1980-2002.

According to the given data;

In 1980-2001 period, 19 countries including Turkey had 52 balance of payments crises*.

Crises under the Managed Exchange Rate Regime = 51

Crises under the Floating Exchange Rate Regime; Argentina = 1

Argentina adopted floating exchange rate regime due to a crisis,which occured during the managed exchange rate regime in 1989. However, as the crisis period continued, another crisis occured under the floating exchange rate regime in 1990. Afterwards, Argentina readopted the managed exchange rate regime and experienced two more crises.

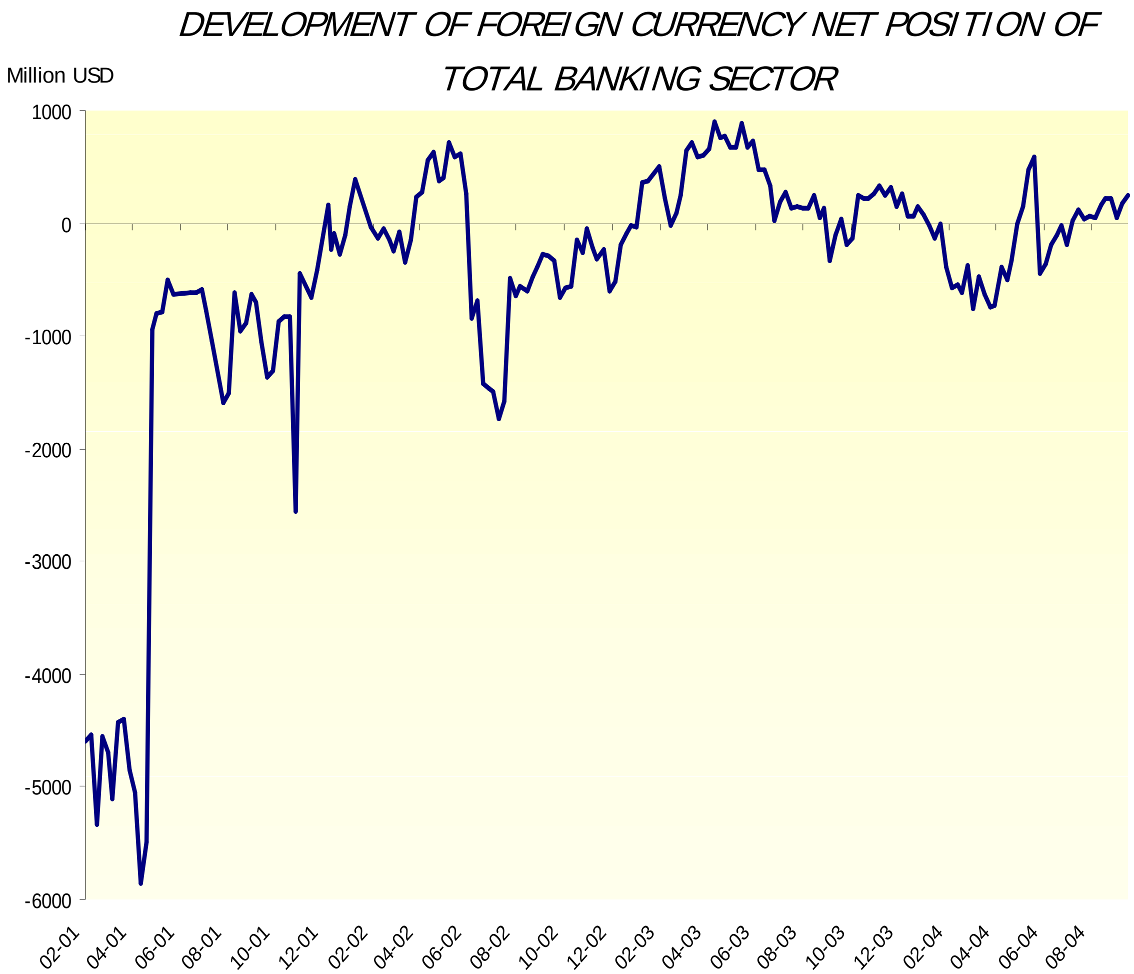
After the crises occured under Managed exchange rate regime, 12 of these countries changed their exchange rate regimes.

- ✓ **Floating exchange rate regime** is adopted.
- ✓ **Balance of payments crisis did not reoccur** after transition to floating exchange rate regime. Floating exchange rate has a shock absorbing characteristic.
- ✓ In countries, where a change in the exchange rate regime is not foreseen/ adopted and **the current regime is** pursued**, **economic fragility increased** due to several reasons and **consecutive crises** occured.

* Crises indicated in Kaminsky and Reinhart's (1999:492-494) article, economic crises observed in Brasil (1999), Argentina (2000,2001) and Turkey (2001) are taken into consideration

** Venezuela adopted to floating exchange rate regime due to a crisis however experienced further crises after readopting managed exchange rate regime.

Growth- Current Account Deficit



2. Stronger Banking System

✓ Banking sector has less open positions as a result of the banking reform and the conducted policies.

✓However, attention should be paid to open positions in the real sector.

✓Adoption of former tendencies poses a risk.

✓ Development of risk management in the banking sector in a modern sense, will have a favorable effect on fiscal structures of firms.

✓Hence, the solution is the auditing of the banking sector.

✓Within this framework, institutions should attract attention to this matter and conduct audits.

Growth- Current Account Deficit

Although fragilities still exist and new measures are required in the economy, structure of the turkish economy is much better when compared to the past: Conditions are different.

WHAT IS DIFFERENT NOW?

1. Floating exchange rate regime

- Looking backwards, fixed or predictable exchange rate regimes are put into practice in most of the countries, which experience "balance of payments crisis", unstable macroeconomic balance and production loss. Floating exchange rate has a shock absorbing characteristic.

2. Stronger banking system

3. TL is not kept overvalued.

- CBRT's foreign exchange purchase of 15 billion USD.
- High foreign exchange reserves

4. Short-term capital inflows should not be encouraged.

- It should be kept in mind that the exchange rate risk is at the market.

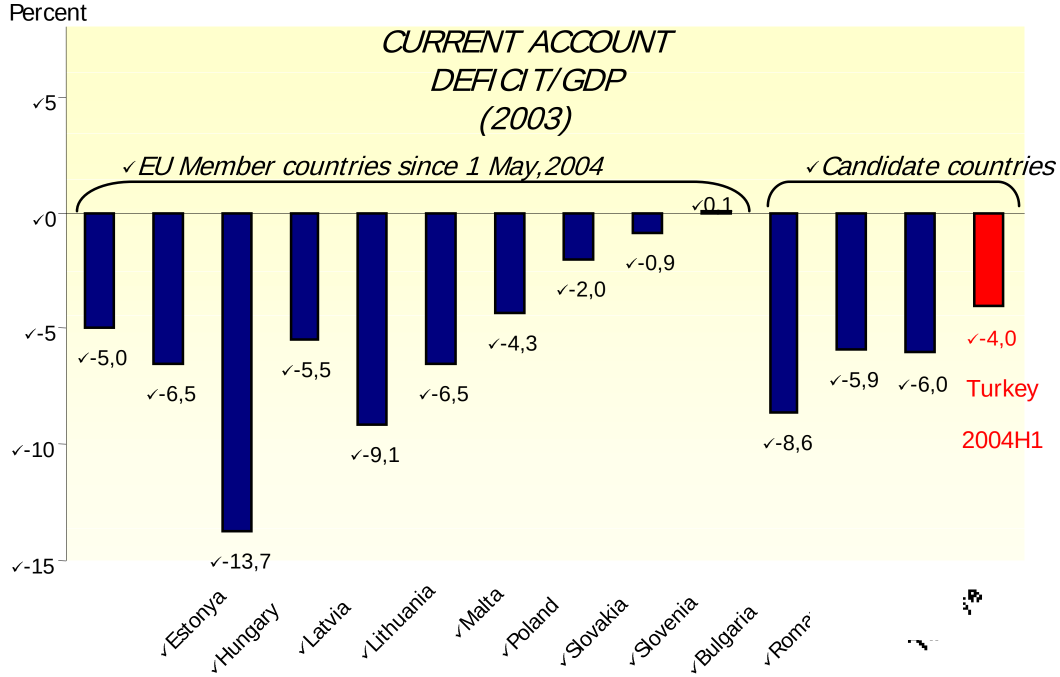
5. Tight monetary and fiscal policies are being implemented.

6. Low inflation:

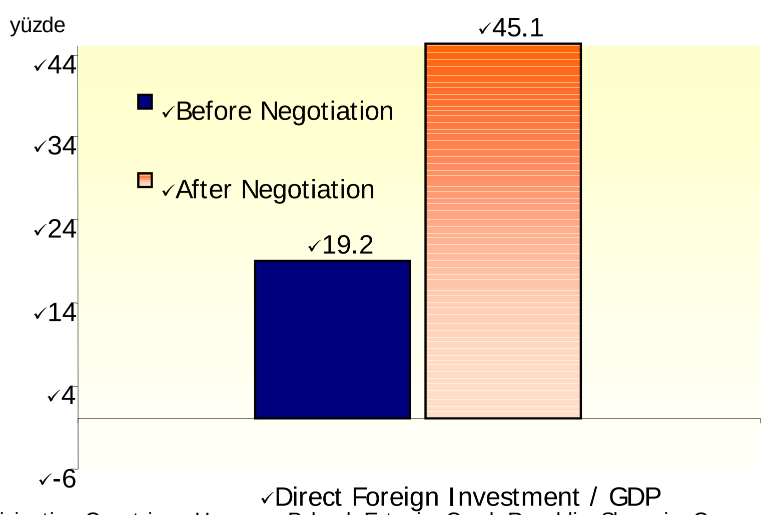
- It is the first time for twenty years that a program is being completed. A new program will be launched. The inflation target becomes a reliable anchor for the future, as economic units are able to see longer term and confidence in policies increases.

As a result, under the current circumstances, supplementary fiscal measures towards decreasing current account deficit will cost less compared to the changes to be made in interest rates and exchange rate.

Growth- Current Account Deficit



CHANGES IN FDI IN THE PROCESS OF EU MEMBERSHIP



Participating Countries : Hungary, Poland, Estonia, Czech Republic, Slovenia, Cyprus, Romania, Slovakia, Latvia, Lithuania, Bulgaria, Malta

It is also observed that;

Developments in the Turkish economy in the last 3 years carried economic balances such as inflation and growth to a higher plateau.

⇩

✓Deeper commercial and financial integration to the world enables higher current account deficits to be sustainable.

✓The ratio of Current Account Deficit / GDP is at much higher levels in some other developing countries.

✓ In case necessary conditions are fulfilled, achievements are sustained over a long-term period, obstacles shall be removed without confronting any crises or harming economic balances.

✓Forward-looking and positive steps, including IMF-supported national program and the EU accession process along with foreign direct capital inflows will enable balances balances to be sustainable.

THE NEW TURKISH LIRA

The New Turkish Lira (YTL)

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

The New Turkish Lira will be introduced as of January 1st , 2005.

✓Dropping six zeros off the Turkish lira is mainly a technical operation: It is not expected to affect **variables such as exchange rates, interest rates**, nor other economic aggregates. Hence, this operation will not affect Turkish Lira.

WILL THERE BE AN INFLATIONARY EFFECT?

✓**Price round-ups** as a result of the dropping six zeros **are not expected to have a lasting effect** on inflation.

✓ It is necessary to remind that prices have been and are continously **rounded-up,** due to the chronic inflation environment of the past and the consequent limited usage of coins in transactions.

✓ Small amount of rounding-up effect may occur in certain sectors, but this effect will not continue, and thus will not have any lasting effect on inflation.

✓ **Banknotes and coins are being printed and minted.**

✓ **Comprehensive publicity campaign is being carried out.**

Dropping six zeros off the Turkish lira is an indicator of the determination in bringing inflation to single-digit figures.

RELATIONS WITH THE IMF AND EU

Relations with the IMF in the Upcoming Period

Relations with the IMF

The current program is **a national program.**

✓ Upon the ending of this program in the beginning of 2005, a similarly national program will be put into implementation.

✓ Policies in the scope of these programs are of long-term nature.

✓ These long-term programs should be sustained with determination and economic agents should believe in this determination.

Because:

For ensuring determination and confidence in policies + decreasing risk premium,

⇓

A strong and plausible support favored by domestic and foreign markets is needed.

This is the role the IMF assumes in our program implementations.

An agreement with the IMF will reduce the cost of the policies to be implemented.

Analyzing the other country examples, 3 candidate countries sustain the IMF programs within the EU membership process:

Romania, Bulgaria, Croatia.

Slide: Table

Relations with the IMF in the Upcoming Period

*FUNDAMENTAL MACROECONOMIC INDICATORS AS OF 2003 * (percentage)*

	Growth	Inflation	Public Debt/ GDP
Bulgaria	4,3	5,6	48,3
Romania	4,9	14,1	26,6
Croatia	4,3	1,6	41,5
TURKEY	5,8	18,4	70.5[1]

* Growth: GDP growth rate, Inflation: Consumer prices, end-year

[1] Ratio of Turkey's public debt to GNP.

Of the European Union candidate countries;

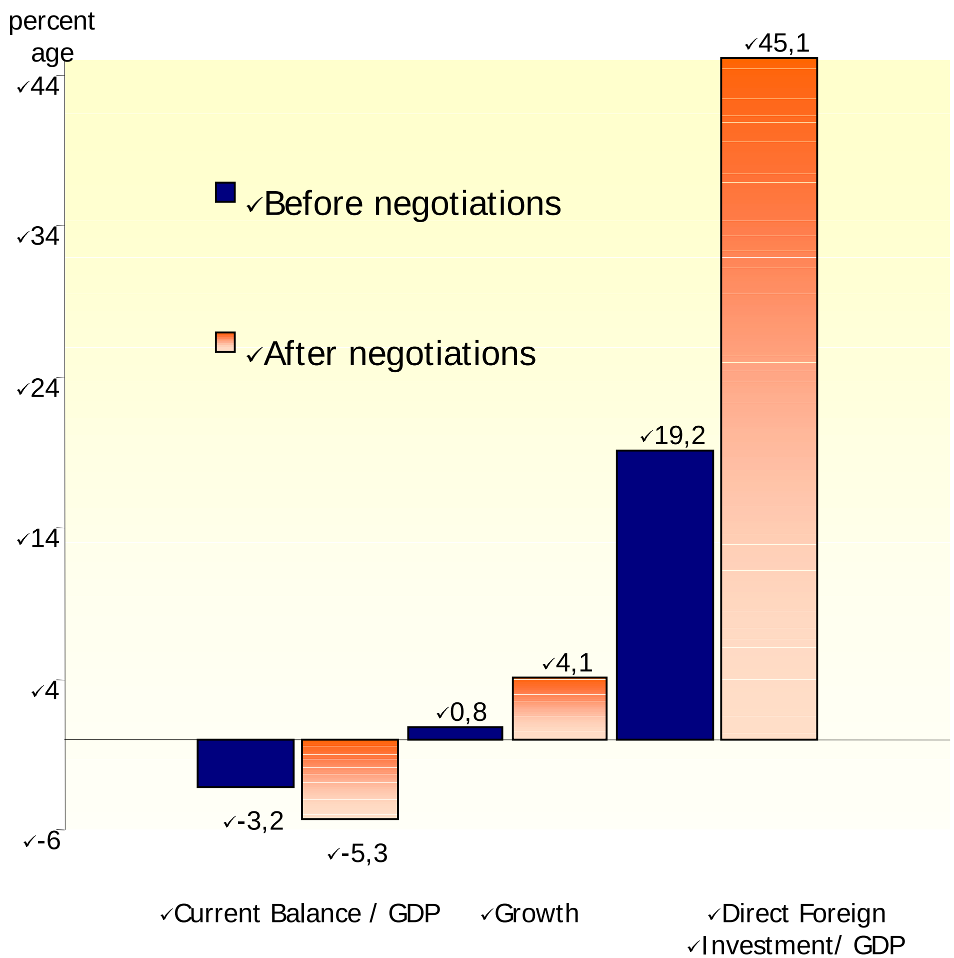
✓ Bulgaria made a 25-month stand-by agreement on August 6, 2004.

✓ On July 7, 2004; Romania started to implement a program, planned to end by July 2006, with a stand-by agreement.

✓ Croatia is implementing a 20-month program with the IMF in the framework of a stand-by agreement approved on August 4, 2004.

Relations with the EU

CHANGE IN MACROECONOMIC INDICATORS IN THE EU MEMBERSHIP PROCESS



EU membership is a national policy target and this process is carried out with an extensive support by the whole society.

✓ Turkey has attained an important level in meeting the economic criteria in the EU membership process, thanks to the economic program implemented for the last three years.

✓ Along with the advancement in our country's economy in the recent period, structural reforms as well as the policies to be implemented in the EU membership process will increase the international credibility of Turkey's economy and enhance the macroeconomic environment.

✓ Moreover, the view that a significant advancement in the EU membership process would contribute to our country's economy is supported by examples in other countries that followed a similar process.

✓ It should be kept in mind that the steps to be taken in the membership process are crucial for Turkey to reach the level of developed countries, whether the membership is approved or not.

ANNEX:

SUSTAINABLE GROWTH

Sustainable Growth

What needs to be done to attain a sound macroeconomic environment for **high and sustainable growth?**

1- Banking Sector Reform

2- Tax Reform

- Broadening the tax base
- Unregistered Economy ⇨ Registered Economy

3- Putting the principles of good governance into practice

1. Banking Sector Reform

Why important?

Banking Sector;

- ✓ Supports capital accumulation process of the private sector,
- ✓ Provides resources to and improves competitiveness of the real sector,
- ✓ Accelerates transition of savings into investment,
- ✓ Improves the quality of investments,
- ✓ Supports financial stability enabling efficient functioning of the transmission mechanism.

1. Banking Sector Reform

However, Turkish banking sector in the past could not perform its intermediary function efficiently. Why?

Instead of a relationship between

Real Sector ⟺ Banking sector

A relationship between

Public Sector ⟺ Banking Sector

had developed.

<u>How to Strengthen Real Sector - Banking Sector Relationship</u> ?

- Decreasing public debt stock
- Maintaining price stability
- **Banking sector reform**

1. Banking Sector Reform

Encouraging results so far;

- ✓ The ratiof of public debt stock / GNP has been decreasing and is expected to be reduced further in compliance with the 60 % Maastricht criteria.

  After downscaling the size of the public sector in financial markets, a considerable amount of resources will be available for the use of the private sector.

- ✓ Reducing and eliminating the uncertainty caused by inflation will set the conditions for the development of long-term credit markets and derivatives.

As we accomplish the reform, the banking sector will be sound and more competitive.

⇩

Banking Sector - Real Sector relationship will develop.

1. Banking Sector Reform

Major steps of the reforms on the sector:

- Comprehensive review of the Banking Act, **the new Draft Law on Credit Institutions:** bringing the legal framework more closely in line with the EU standards,
- Privatization of state banks as soon as their restructuring is completed and whenever market conditions are favorable,
- Transfer of regulation and supervision of non-bank financial institutions from the Treasury to the BRSA,
- Modern credit risk management methods to be applied,

  ⇩

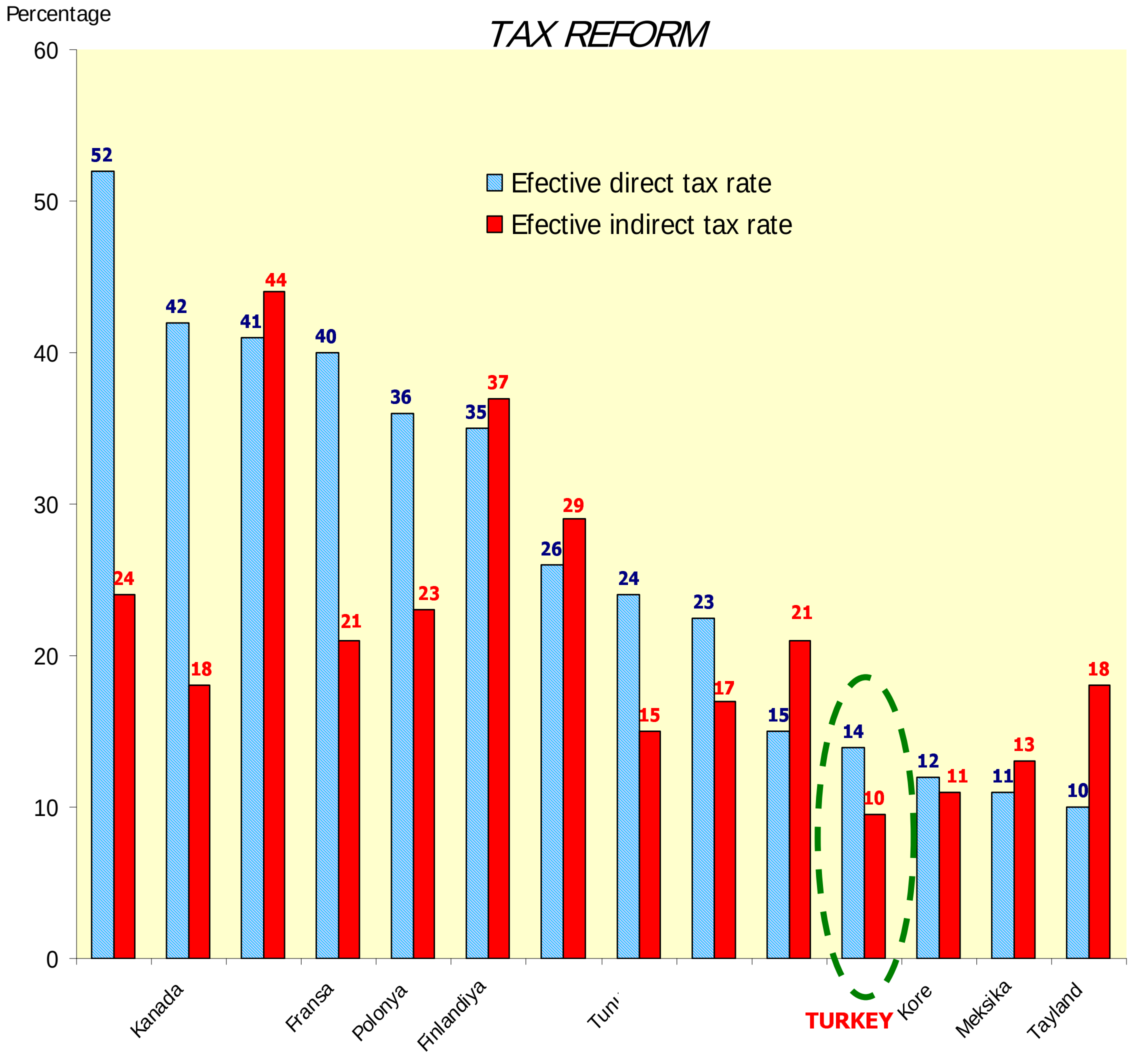
  Banking sector-real sector relationship should not be limited to credit lending only, but should involve active risk management as well,

  ⇩

  Financial structure of firms will be healthier.

  Firms having modern management techniques and preparing more transparent financial accounts will contribute to this process.

2. Tax Reform- Formalizing Unregistered Economy



Source: IMF World Economic Outlook, CBRT.

Effective Direct Tax Rates = Tax rates on one unit income produced in a country.

Effective Indirect Tax Rates = Tax rates on one unit spending made in a country.

In Turkey, both direct and indirect effective tax rates are quite low.

- ✓ A certain amount of income is produced.
- ✓ However, this income cannot be taxed effectively.

Due to this structure of taxation, the tax burden on the registered economy is quite heavy.

Reasons of **low effective tax rates;**

- ✓ Distortions in the tax system,
- ✓ Narrow tax base,
- ✓ Large size of the unregistered economy

2. Tax Reform- Formalizing Unregistered Economy

✓Size of the unregistered economy is between 16 % and 50 %, conditional on assumptions.

✓ 52 % of total employment and 37 % of private sector employment excluding agriculture are unregistered*.

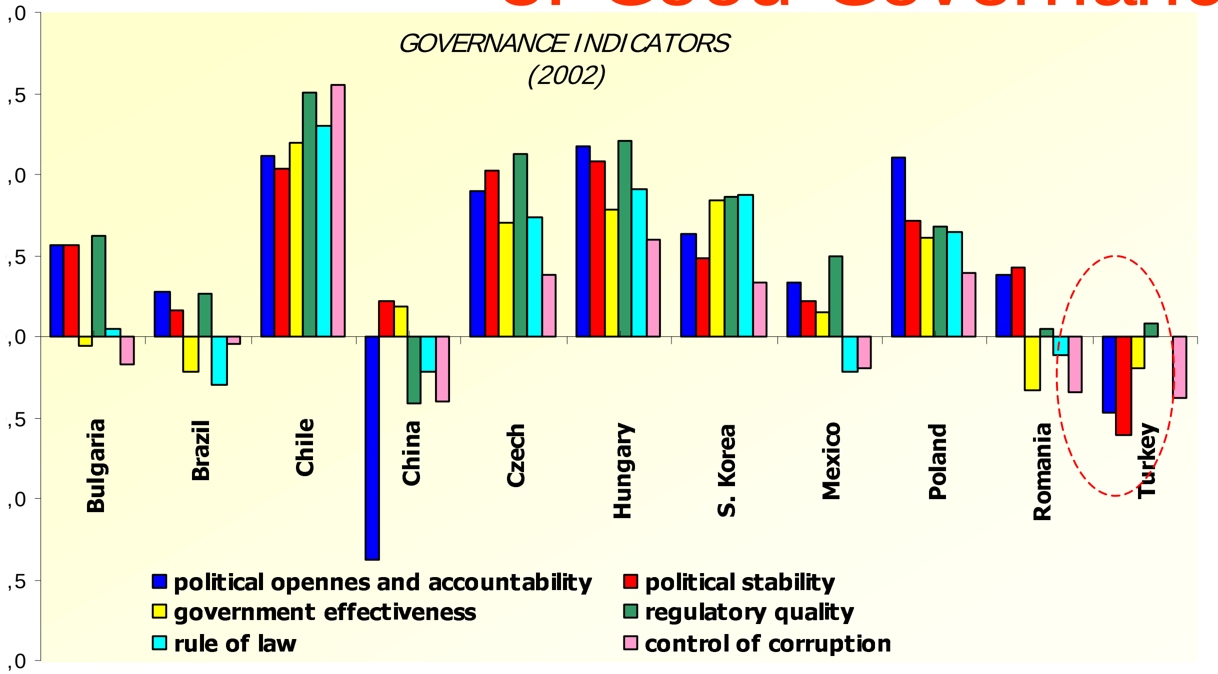
In the long-run, the unregistered economy causes:

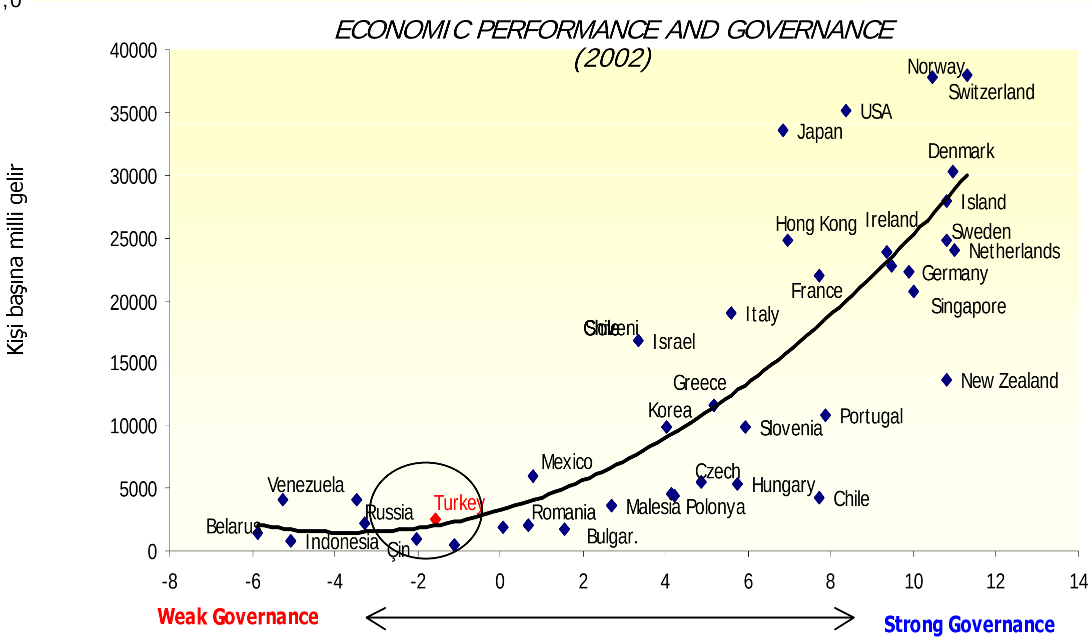
- ✓ Contraction in government revenues
- ✓ Unproductive use of the country's resources
- ✓ Sustainable growth rates to remain at low levels
- ✓ Sustainable growth of employment difficult to reach

Therefore, <u>the tax reform</u> should be given priority and unregistered economy should be formalized.

* Source: OECD

3. Good Governance





- ✓ **There is a strong positive relationship between income** per capita **and governance** in democratic countries based on market economy.
- ✓ Having progress in governance indicators is the key issue to increase domestic and foreign investments via improving investment environment.
- ✓ Good governance is crucial for a strong and lasting economic performance.

Source: Kaufmann, A.K. and Mastruzzi, M., 2003, *"Governance Matters III: Governance Indicators for 1996-2002"*, World Bank Policy Paper No:3016; and the Central Bank.

ECONOMIC OUTLOOK

CENTRAL BANK OF THE REPUBLIC OF TURKEY

October 2004