

MONETARY POLICY REPORT

JULY 2003



*CENTRAL BANK OF THE
REPUBLIC OF TURKEY*

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I. GENERAL ASSESSMENT*

Second quarter of 2003 was a period of recreation of confidence following the fluctuations originating from the Iraq Operation to a large extent. Positive effects of removal of intense uncertainties are evidently observed both on the interest rates of domestic borrowing and on inflation expectations. Therefore, with the removal of the “extraordinary” conditions which were dominant on the macroeconomic environment during the first quarter of the year, cost conditions supported the decreasing trend of inflation. Within this framework, as foreseen by the Central Bank, interruption in the disinflationary process during the first months of the year, was temporary and as of June decreasing trend is being observed again.

As of June 2003, annual price increases are realized as 29.6 percent in the CPI and 29.8 percent in the WPI. Increases in foreign exchange rates and petroleum prices being the basic causes of accelerating inflation during the first quarter of the year, slowed down rapidly during the second quarter, Turkish lira appreciated 11.1 percent on average vis-à-vis exchange rate basket during the period of April-June. Public prices except petroleum products, which were another factor affecting inflation adversely during January-March, decreased considerably during the second quarter.

WPI which was affected more by the cost factors than the CPI in the first quarter, showed a more significant drop than the CPI in the second quarter as a consequence of weakening cost pressure. At the end of June, it is observed that the annual rate of increase of WPI is below that of CPI.

Being the basic policy instrument, Central Bank continues to determine the short-term interest rates by analysing in detail the probable behaviour of the determinants of inflation in the forthcoming periods within several scenarios alongside the current inflationary trends. In order to reach the inflation target of 20 percent in 2003, foreign exchange rate, public

prices and developments of domestic demand head the list of the variables which have to be monitored carefully in the forthcoming periods. Upcoming fiscal policy implementation gains importance particularly in public pricing behaviour and domestic demand developments. On the other hand, it is thought that limited economic revival will not cause a demand pressure on prices in the near future, owing to negative developments both in the labour market and in the real wages and also owing to the positive course of foreign exchange developments and inflationary expectations.

Within this framework, Central Bank cut short term interest rates three times since the end of April by evaluating that the disinflationary process will continue in line with the set targets under the basic assumption that the economic program will be strictly implemented with a long term perspective and there will be no deviation from the financial discipline and structural reform process which both carry vital importance in maintaining and improving the current developments in inflation. The above-mentioned cuts in interest rates are realized on April 25, June 4 and July 16, and the overnight borrowing interest rate which was 44 percent during April, is reduced to 35 percent by the latest interest rate cut.

On the other hand, Base Money targets which function as additional nominal anchors in the implementation of monetary policy and other monetary targets determined by the current program with the International Monetary Fund have been reached during the second quarter of 2003.

Recent Developments in the Economy

Among macroeconomic developments, foreign exchange developments were one of the main topics of the agenda during the second quarter of 2003. Uncertainties related to Iraq operation led to a fluctuating course for foreign exchange rates during the first quarter of 2003. Since the beginning of April, cease of the operation and ease of uncertainties brought about the process of rapid appreciation of Turkish lira against foreign currencies. As of the end of the second quarter, dollar and euro

* Data until 17 July 2003 have been used in this report.

depreciated against Turkish lira by 16.8 percent and 11.4 percent, respectively. Main reason behind the decline in the foreign exchange rates was the increasing demand towards the Turkish lira financial instruments due to the ease of uncertainties related to Iraq operation.

Above-mentioned trend in the domestic foreign exchange markets since April prepared the conditions to restart the foreign exchange buying auctions which were temporarily interrupted. Following April, also taking into consideration the removal of demand pressure on foreign exchange rates, Central Bank initiated to hold foreign exchange buying auctions since May 6, with the aim of increasing foreign exchange reserves. The amount of the daily auction which was stated to be US dollar 20 million at the beginning of the implementation increased to US dollar 30 million as of June. Since June 16, the practice of stating the maximum price to be offered in the auction is terminated. Amount of the auction is increased to US dollar 40 million and then to US dollar 50 million with the press releases of June 30 and July 16, respectively. On the other hand, with the aim of decreasing the effects of fluctuations which are not caused by economic fundamentals, Central Bank directly intervened in the exchange rates three times in total, twice in May and once in June, by buying foreign currency. The total amount of foreign currency bought during the interventions reached US dollar 1.145 million.

Since mid-April with the cease of the Iraq operation, foreign exchange rates declined and interest rates in the secondary market showed a decreasing trend in line with this development. In the secondary market average compound interest rate decreased to 45.8 percent on June 17 from the 62.9 percent of April 11, but showed an increasing trend in the second half of June contrary to the movements in the exchange rates. Monthly average compound interest rates in the Treasury auctions showed a downward trend parallel to the interest rates of the secondary market during the period of April-June.

In the second quarter of 2003, compared to end-March, M1 and M2 money supplies increased by 11.4 percent and 3.5 percent, respectively, in real terms. The decrease

in demand deposits resulting from the effects of the uncertainties of the Iraq operation were reversed by the payments of the tax peace project in the period of April-June. This, together with the developments in the currency issued were the main sources of the high growth rate of M1 money supply in the said period. Developments in the currency issued show substantial increase in cash demand since mid-June, which did not exhibit significant changes other than periodical fluctuations since the beginning of 2003. During the second quarter of 2003, M2Y money supply contracted by 5.1 percent in real terms. The main reason behind the fall of M2Y money supply was the decline of Turkish lira equivalent of FX deposit accounts of residents due to the developments in foreign exchange rates.

General analysis of the developments in public finance can be summarized as follows: During January-June 2003, budget deficit is realized as Turkish lira 24.8 quadrillion whereas primary budgetary surplus is realized as Turkish lira 10.1 quadrillion. On the other hand, budgetary surplus for June 2003 is realized as Turkish lira 745 trillion.

In January-June 2003 period, budgetary income increased by 24.8 percent compared to the same period of the previous year and was realized as Turkish lira 44.7 quadrillion whereas tax income rose by 45.6 percent and was realized as Turkish lira 37.1 quadrillion. In the said period, VAT laid on imports and excise tax were the main items, which have positive effects on income tax. During the first half of 2002, while the share of indirect tax in tax income was 66.2 percent, the said ratio increased to 67.6 percent for the first six months of 2003. In the period of January-June 2003, ordinary income excluding tax decreased by 41.4 percent compared to the same period of the previous year. Basic reason behind the high rate of decline was the base effect created by the transfer of Turkish lira 3 quadrillion to the budget, from the term profit of the Central Bank in May 2002.

During the first six months of 2003, expenditures increased by 29.3 percent compared to the same period of the previous year. In the said period, non-interest

expenditures rose by 37.1 percent compared to the same period of the previous year.

Within the framework of these developments, cash deficit of consolidated budget is realized as Turkish lira 24 quadrillion in the period of January-May 2003. In the said period, the Treasury had the position of net borrower in domestic borrowing. When the structure of domestic borrowing is analysed, it is observed that the Treasury has the position of net borrower both in bonds and bills. In the said period, the Treasury realized net utilization of Turkish lira 23.7 quadrillion in bonds and Turkish lira 2.3 quadrillion in bills. On the other hand, net foreign borrowing is realized as Turkish lira 0.4 quadrillion in January-May 2003.

Domestic debt stock which was Turkish lira 149.9 quadrillion at the end of 2002 is realized as Turkish lira 162.6 quadrillion in March 2003. As of June, domestic debt stock increased by 16.9 percent compared to end 2002 and by 7.8 percent compared to March 2003, reaching Turkish lira 175.3 quadrillion. During the first half of 2003, structure of domestic debt stock with respect to borrowing instruments is changed. The share of fixed-income instruments increased while the share of FX, FX linked and CPI indexed instruments was decreasing.

The process of rapid growth of the Turkish economy, which started at the beginning of 2002, also continued in the first quarter of 2003. Compared to the figures of the same period of the previous year, GNP and GDP increased by 7.4 percent and 8.1 percent, respectively in the first quarter of 2003. Growth of the economy during the first quarter of the year owed to limited domestic demand recovery and to high rate of increase in exports. Furthermore, base effect formed by the low level of the economic recovery for the same period of last year also contributed to the rapid growth of economy.

When contribution of demand components to economic growth are analyzed, it is observed that private expenditure and stock changes have contributed most to growth in the first quarter of 2003. Due to tight fiscal policy, public expenditures decreased significantly

during the said period and had a negative effect on growth. On the other hand, as the domestic demand for certain sectors is still slack, private firms headed to foreign markets and consequently exports of goods increased. However, contribution of net exports to growth turned out to be negative with the effect of rapid growth of imports.

Although the Turkish economy entered into a growth path, adverse effects of the crisis continue in the labour market. Unemployment rate which was 8.4 percent and 10.3 percent in 2001 and 2002 respectively, realized as 12.3 percent in the first quarter of 2003. Moreover, despite slowing down, decrease in real wages continued in the first quarter of 2003 compared to the same period of last year. This case leads to a limited domestic demand recovery. In fact, although the total final domestic demand inched by 6.3 percent compared to last year, the figure is still considered to be historically low. Sluggish domestic demand and increase in stock accumulation in the first quarter of 2003 following 2002, prevented a demand pressure on consumer prices.

Compared to the same period of last year, exports increased by 30.1 percent during the first five months of 2003 whereas imports grew by 31.3 percent during the same period. Consequently, foreign trade deficit increased by 34.6 percent whereas the ratio of imports covered by exports decreased to 71.1 percent.

In line with the growing foreign trade deficit, current account balance started to give deficit on annual basis since the last quarter of 2002. The ratio of current account deficit to GNP increased to 2.1 percent in the first quarter of 2003 on annual basis.

While a net inflow of capital amounting to US dollar 4.1 billion is observed in the first quarter of 2003, the trend reversed in the period of April-May and a net outflow of US dollar 921 million is realized during the said period. The mentioned net capital outflow observed in April and May was due to repayments of syndication credits of banks.

When the foreign economic developments are analysed, no growth is observed in the global economy during the first half of 2003 compared to the second half of 2002. For the second half of 2003 positive growth is expected. Growth rate of industrialized countries is anticipated to be below the long-term trend also in 2003. The continuity of the observed recovery trend has not gained certainty yet. Growth of the US economy decelerated due to the decline in private domestic demand. Although the risks stemming from the Iraq operation seem to be easing, it is thought that public sector deficit and current account deficit observed in the US increase the uncertainties of the course of the global economy. Although economic activity in general has a weak course in the industrialised countries which have close trade relations with the Asian countries, performance of the Asian countries except Japan, was one of the factors that supported the global economy the most.

financial markets by effective management of expectations.

Despite global stagnation, it is observed that the course of export performance is still high in the developing countries. North Asian countries were able to maintain high rate of growth due to the momentum of the intra-regional trade as well as the better-off condition of extraterritorial exports compared to global economy.

Conclusion

Second quarter of 2003 has been a period where stability is achieved once again in the markets and temporary adverse trends of the first quarter have been broken. Monetary policy which is compatible with the main macroeconomic developments and which focuses on price stability was implemented effectively and positive developments are observed towards bringing inflation down to the targeted figures.

However, following conditions are still indispensable in order to reach the end-year target and to maintain improvements in inflation; public price adjustments compatible with targeted inflation, domestic demand recovery not reaching the level of creating inflationary pressure, maintenance of financial discipline and structural reforms, minimizing fluctuations in the

II. PRICE DEVELOPMENTS

Due to the removal of the “extraordinary” conditions by the cease of the Iraq war during the second quarter of the year, cost push pressure which affected inflation adversely during the first quarter eased and inflation started to fall again. Moreover, not having domestic demand pressure on prices in the second quarter continued to effect inflation positively as well as the first quarter and as of June 2003, annual price increases are realized as 29.6 percent in WPI and 29.8 percent in CPI (Table II.1).

In the second quarter of the year, opposite developments are observed on the cost side compared to the first quarter. It is seen that increase in foreign exchange rates and petroleum prices which were the basic causes of accelerating inflation during the first quarter of the year, slowed down rapidly during the second quarter, Turkish lira appreciated 11.1 percent in average vis-à-vis exchange rate basket during the period of April-June.

Crude oil prices declined due to the cease of the Iraq war and by the appreciation of the Turkish lira this situation led to significant fall in domestic fuel prices. In the second quarter of the year, prices of petroleum products item under WPI decreased by 9.8 percent and played an important role in the decline of WPI in May and June.

Due to the removal of the “extraordinary” conditions by the cease of the Iraq war in the first quarter of the year, cost push pressure which had a negative impact on inflation during the first quarter of the year is weakened and inflation started to drop again.

Public price increase other than petroleum products which also effected inflation negatively in the period of January-March, slowed down significantly compared to the first quarter. Despite that, slowed down compared to the first quarter, public prices excluding petroleum products in CPI rose by 5.7 percent during April-June, was above the general rise of CPI and was one of the main factors limiting fall of inflation.

Table II.1. Annual and Cumulative Inflation

	Weight (%)	ANNUAL INFLATION		2003	
		2002 Dec	2003 June	Jan-Mar	April-June
WPI	100.0	30.8	29.6	12.4	-0.8
WPI (Public)	23.17	32.4	25.1	13.4	-3.9
WPI (Private)	76.83	30.3	31.4	12.0	0.4
WPI (Exc. Agriculture)	77.78	29.6	25.1	9.4	-0.7
WPI (Agriculture)	22.22	35.2	45.4	22.6	-1.0
CPI	100.0	29.7	29.8	8.2	3.5
CPI (Tradable)	58.16	30.1	28.6	7.6	3.2
CPI (Non-tradable)	41.84	29.4	31.1	8.7	3.9
CPI (Goods)	70.39	29.7	29.7	8.4	3.0
CPI (Services)	29.61	29.8	29.9	7.8	4.5
CPI (Administered)	20.72	31.3	31.4	10.5	2.6
CPI (Non-administered)	79.28	29.2	29.1	7.1	4.0
CPI (Food)	26.80	24.1	38.3	16.8	-0.8
CPI (Durable Goods)	7.33	45.0	17.8	3.1	1.9
CPI (Exc. Food)	73.20	31.5	27.3	5.6	4.9
CPI (Exc. Housing)	74.2	30.1	32.0	9.2	3.9
ER Basket (average)	-	15.8	2.3	7.3	-11.1
Export Prices ⁽¹⁾	-	4.9	11.8		
Import Prices ⁽¹⁾	-	9.6	11.9		

Source: SIS, CBRT

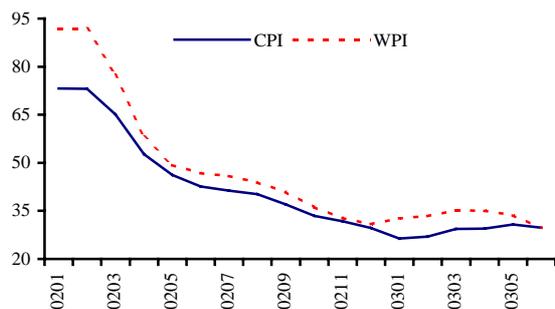
(1) 2003 January

In the first quarter of the year agriculture and food prices increased by 21.4 percent and 15.9 percent, respectively and these rates were significantly above the general increases of WPI and CPI. However, also with the seasonal effects this trend in food and agricultural prices reversed in June. It is observed that annual inflation in the groups excluding agriculture and food rapidly decelerated after March. Annual increase of WPI excluding agriculture which was 35.6 percent and CPI excluding food which was 29.7 percent at the end of the first quarter slowed down to 25.1 percent and 27.3 percent, respectively as of June.

WPI which was affected more by the cost pressures than the CPI, had a rapid rise compared to CPI in the first quarter and also had a significant decline due to the weakening cost pressure in the second quarter. At the end

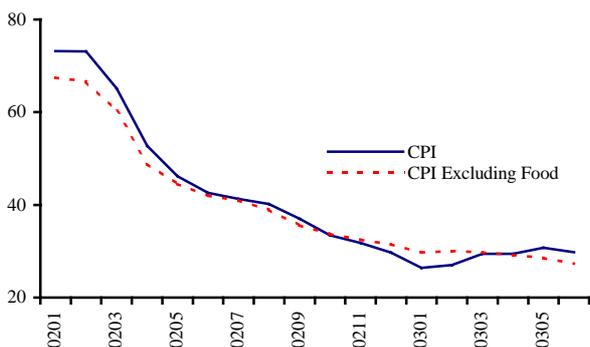
of June, it is observed that annual rate of increase of WPI is below that of CPI (Figure II.1).

Figure II.1. WPI and CPI; 1994=100 (Annual Percentage Change)



Source: SIS

Figure II.2. CPI and CPI Excluding Food; 1994=100 (Annual Percentage Change)



Source: SIS

II.1. Developments in Consumer Prices

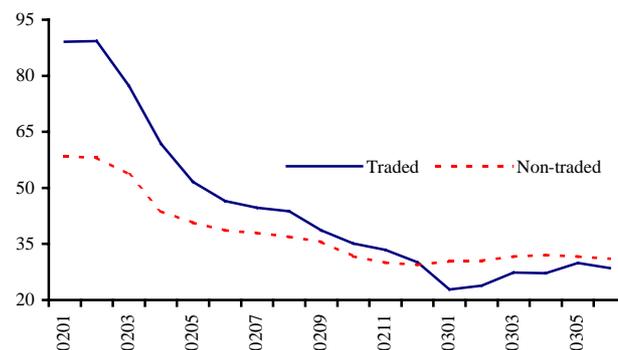
In the second quarter of 2003, consumer prices were adversely affected by the increase of public prices excluding petroleum products, but then decrease in foreign exchange rates had a positive reflection on CPI changes especially through the prices of durable consumer goods.

Developments in the Prices of Tradables:

Prices of non-tradable goods exhibited a faster course of increase in April-June 2003. Decrease in foreign exchange rate led to slow down in price increases of petroleum products and durable consumer goods and limited price increases in tradables. Consequently, it is observed that prices of tradables and non-tradables increased by 3.2 percent and 3.9 percent, respectively, in

the second quarter of 2003. When seasonally adjusted data is analysed, it is observed that the difference is more evident, prices of tradables increased by 4.8 percent whereas prices of non-tradables rose by 6.1 percent (Figure I.1.1).

Figure II.1.1. CPI Traded and Non-traded; 1994=100; (Annual Percentage Change)

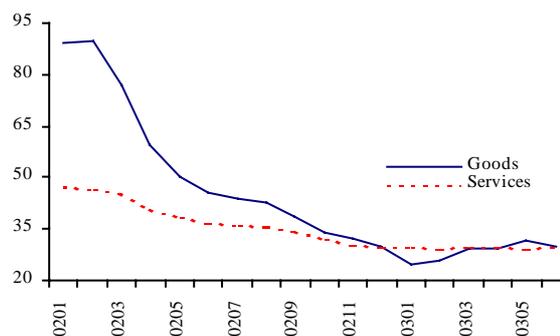


Source: SIS

Developments in Prices of Goods and Services:

Despite the increase of 21.2 percent in the clothing group, rate of increase in the prices of goods were still below that of services in the second quarter. It is observed that downward trend in CPI during April-June is more evident in the prices of group of goods; on the other hand prices of services increased rapidly, particularly due to price adjustments in transportation and communication services. When annual rate of increase is analysed, it is also observed that price increases in goods are in line with the inflation trend and cost developments, whereas increase rate in the prices of services follows a flat course (Figure II.1.2).

Figure II.1.2. CPI Goods and Services Prices; 1994=100 (Annual Percentage Change)

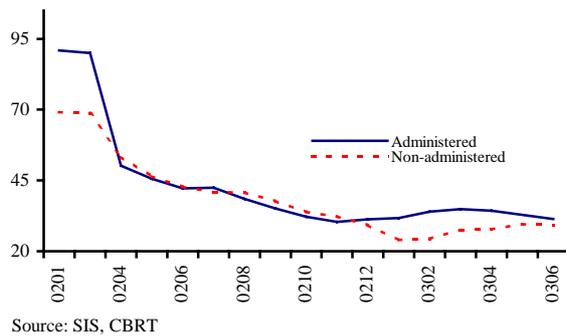


Source: SIS, CBRT

Developments in Administered Prices:

Administered prices increased 2.6 percent during April-June and were below the general increase rate of CPI for the same period. This case was due to the declining prices of petroleum products. On the other hand, excluding petroleum products, administered prices increased 5.7 percent in the second quarter and after the first six months of the year, it is observed that prices increased by 16.4 percent which is 4.2 points above the general CPI increase. In the period of April-June non-administered price increase is realized as 4.0 percent (Figure II.1.3).

Figure II.1.3 CPI, Administered and Non-Administered Prices; 1994=100 (Annual Percentage Change)



Source: SIS, CBRT

CPI Sub-items

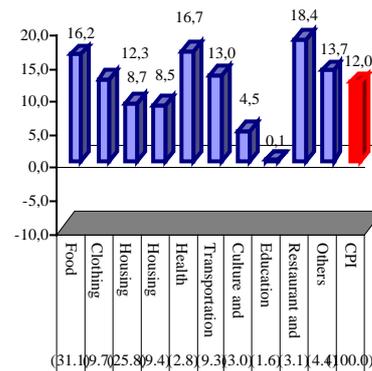
In the first six months of 2003, the highest rates of increase in CPI were recorded in food, beverage and tobacco group, health group and restaurants. Relatively lower rate of price increases in housing and household goods groups as observed in the first quarter of the year, have limited the CPI inflation (Table II.1.1).

Food Prices

It is observed that high rate of increase in food prices relatively slowed in the second quarter of the year. Positive trend of the seasonal conditions particularly had a supportive impact in the said improvement. Nonetheless, when seasonally adjusted food prices are analysed, it is determined that the rate of increase which

used to be 10.8 percent in the period of January-March, declined to 7.1 percent in the period of April-June.

Grafik II.1.4. CPI and Sub-items :1994=100 (January-June Cumulative Inflation)



Source: SIS

Table I.1.1. CPI and Sub-items; 1994=100

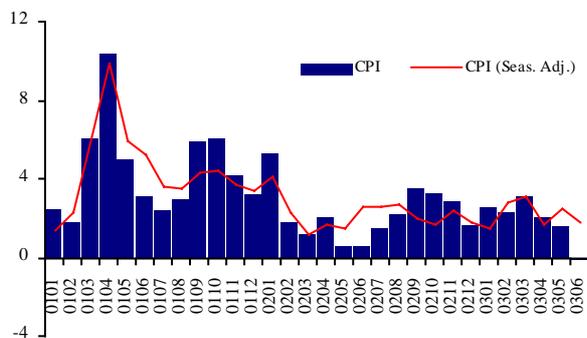
	ANNUAL			JAN – JUNE	
	2001	2002	2003	2002	2003
CPI	68.5	29.7	29.8	12.0	12.0
Food, Beverages, Tobacco	80.2	24.7	38.2	4.9	16.2
Food	78.4	24.1	38.3	4.0	15.9
Clothing and Shoes	65.2	40.1	30.9	20.2	12.3
Housing	59.6	28.9	24.7	12.3	8.7
Rent	39.7	29.0	25.9	12.9	10.2
Housing Equipment	72.7	25.9	19.7	14.1	8.5
Health	58.4	27.5	31.5	13.2	16.7
Transportation	77.5	36.8	28.0	20.8	13.0
Culture and Recreation.	61.7	24.5	15.0	13.1	4.5
Education	52.4	53.8	53.6	0.3	0.1
Restaurant and Hotels	46.2	32.3	34.1	16.8	18.4
Others.	81.2	30.5	29.1	15.0	13.7
Goods	80.9	29.7	29.7	11.7	11.6
Goods Exc. Food.	82.4	32.9	25.3	16.0	9.4
Services	48.2	29.8	29.9	12.5	12.6

Source: SIS, CBRT

Price Developments in Housing Group

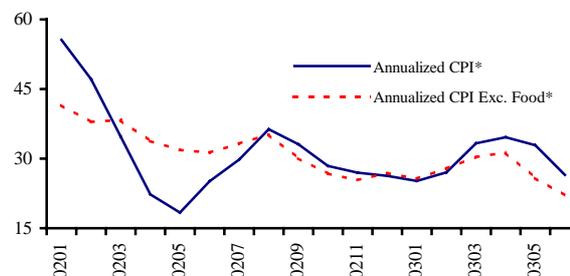
House rents preserved the low level of increase in the second quarter of the year and in addition, due to the decline of the fuel prices it is observed that heating and other costs slowed down significantly. Consequently, rate of increase in housing group which rose 5.9 percent in the first quarter of the year realized as 2.6 percent in the second quarter and had an important role in the decrease of inflation.

Figure II.1.5. CPI and Seasonally Adjusted CPI; 1994=100; (Monthly Percentage Change)



Source: SIS, CBRT

Figure II.1.6. Annualized Inflation CPI (Annual Percentage Change)



*Three months moving average (annualized, seasonally adjusted)
Source: SIS, CBRT

Price Developments in Furnishings

Low rate of increase observed in the first quarter of the year continued and the prices of furnishings rose only by 3.9 percent in the second quarter. Sluggish domestic demand as well as the high rate of appreciation in Turkish lira during the second quarter played an important role in this development. Rate of increase in the first month in this group is realized as 8.7 percent which is 3.3 points below the general hike of CPI.

Price Developments in Transportation Group

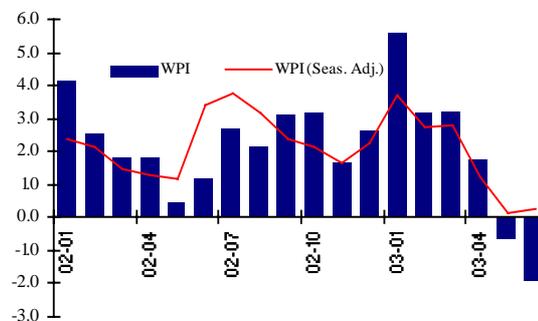
Decline in the prices of automobiles and fuel had a positive impact on prices of transportation group, and price increase was limited to 2.7 percent in the second quarter. Nonetheless, since the beginning of the year prices of transportation services increased faster than the rate of increase in the CPI and public price adjustments were effective on transportation group. Prices of transportation services increased by 23.2 percent for the first six months of 2003.

Within the framework of the above-mentioned developments, annual inflation calculated by using quarterly moving averages of the seasonally adjusted consumer price index started to decline after April. As of June seasonally adjusted annualized inflation realized as 26.5 percent for the CPI and 22.1 percent for the CPI excluding food (Figure II.1.6).

II.2. Developments in Wholesale Prices

In the second quarter of 2003, due to the cease of Iraq war as well as ease of the cost pressure on prices, WPI inflation showed a downward trend again, and the figure which was 35.2 percent as of March for WPI declined to 29.6 percent as of June. Along with the positive improvements in cost factors which are particularly effective on the prices of manufacturing industry, the relative slowdown in agricultural prices which considerably had a higher rate of increase in the first half of the year compared to the second half, supported the mentioned downward trend. The average rate of increase in seasonally adjusted WPI which was 3.3 percent in the first quarter of the year declined to 0.6 percent in the second quarter of 2003 (Figure II.2.1).

Figure II.2.1. WPI and Seasonally Adjusted WPI; 1994=100 (Monthly Percentage Change)

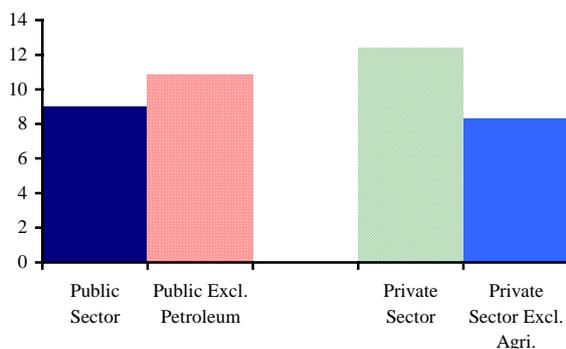


Source: SIS, CBRT

Along with the positive improvements in cost factors, relative slow down in agricultural prices supported the downward trend of the WPI in the second quarter of the year.

When the breakdown of WPI inflation by public and private sector prices is analysed, it is observed that private sector prices increased by 12.4 percent while public sector price increase is limited to 9 percent in the first half of the year. Excluding agricultural prices, rate of increase in private sector goes down to 8.3 percent, while that in public sector comes up to 10.9 percent when the prices of petroleum products are excluded (Figure II.2.2). In the second quarter of the year, prices of petroleum products, which were substantially affected by the rapid decrease in international crude oil prices and foreign exchange rates compensated the high rate of increase in the first quarter and also played a restrictive role in price increases of the public sector manufacturing industry within the year.

Figure II.2.2. Rates of Increase in the Prices of WPI Public, Private Sector and Subgroups in the First Half of 2003 (Percentage Change)



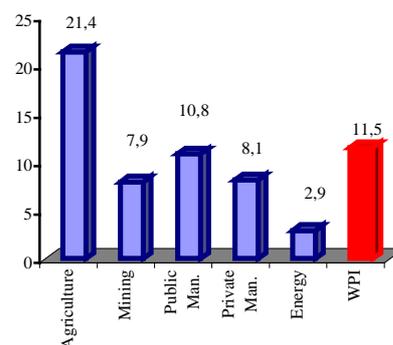
Source: SIS, CBRT

Agricultural Prices

Despite the fact that the increase rate of agricultural prices slowed down in the second quarter of the year compared to the first quarter, the said rate is realized as 21.4 percent for the period of January-June, and was considerably above the rate of increase of the WPI which was 11.5 percent for the same period (Figure II.2.3). When seasonally adjusted data is analysed, a slow down

is observed in the second quarter of the year for the rate of increase of agricultural prices. Seasonally adjusted agricultural prices which increased by an average of 3.2 percent in the first three months of the year, rose by 2.5 percent on average in the second quarter.

Figure II.2.3. WPI and Sub-items in the First Half of 2003 ; 1994=100 (Rate of Change)

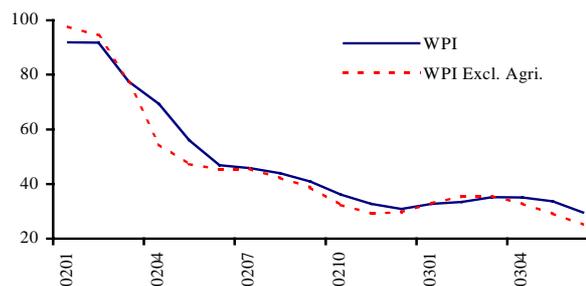


Source: SIS

When agricultural prices are excluded, cumulative increase in the WPI declines to 8.6 percent. Following the cease of the war and the weakening of the cost pressure, annual WPI excluding agriculture got into a steeper declining trend compared to the WPI (Figure II.2.4). As of June, annual increases are 29.6 percent in the WPI and 25.1 percent in the WPI excluding agriculture.

Rate of increase of agricultural prices, which realized as 21.4 percent in January-June period, is considerably above the rate of increase of the WPI which was 11.5 percent.

Figure II.2.4. WPI and WPI Excluding Agriculture: 1994=100 (Annual Percentage Change)



Source: SIS, CBRT

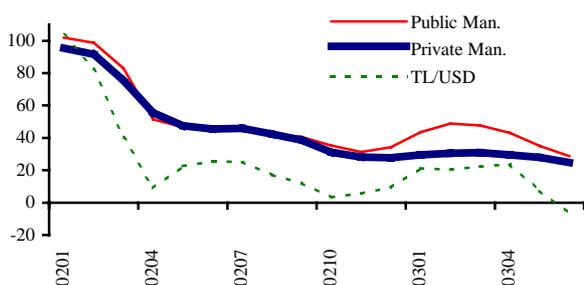
Manufacturing Industry Prices

Manufacturing industry prices, which constitute 71.1 percent of WPI, is the sub-group that is most severely effected by the developments in production costs and expectations. Rate of increase in the prices of the manufacturing industry, which accelerated due to unstable international crude oil prices and exchange rates in the first quarter of the year because of the Iraq operation, slowed down in the second quarter owing to the weakening cost pressure. In the period of January-March when an increase of 4.5 percent was realized in the average US dollar exchange rate, manufacturing industry prices rose by 9.3 percent. On the other hand, the mentioned prices declined by 0.4 percent during April-June period when the US dollar exchange rate fell by 14.1 percent. Consequently, cumulative manufacturing industry price increase realized as 9.0 percent in the first half of the year.

Rate of increase in the prices of the manufacturing industry, which accelerated due to unstable international crude oil prices and exchange rates in the first quarter of the year because of the Iraq operation, slowed down in the second quarter owing to the weakening cost pressure.

In the April-June period, monthly rate of increase in private manufacturing sector realized below the historical levels. Aforementioned positive cost conditions prevailed to a great extent in the said improvement. In fact, prices of petroleum products, basic metal, metal goods and chemical products, which are known to be sensitive to foreign exchange rates decreased. Therefore, annual rate of increase in private manufacturing sector declined to 24.7 percent from the 2002 year-end value of 27.7 percent (Figure II.2.5).

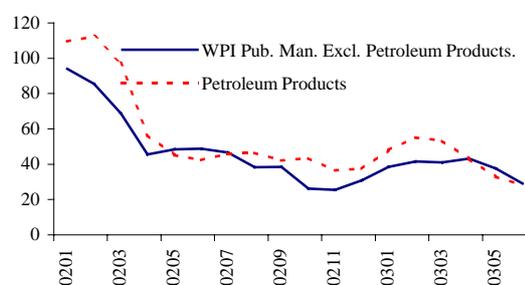
Figure II.2.5. Exchange Rate, Public and Private Manufacturing Sector Prices;1994=100 (Annual Percentage Change)



Source: SIS, CBRT

Public manufacturing industry prices which were affected more by the cost pressure compared to private manufacturing industry in the first quarter of the year, got into a decreasing trend due to the reversal of the cost pressure. Prices of petroleum products manufacturing sector, which have the highest weight in public manufacturing sector and which are directly affected by the foreign exchange rates and international crude oil prices, were effective in the said improvement. Moreover, when the annual rates are analysed, it is observed that both the increase in the January-March period and the decrease in the April-June period were sharper in the petroleum products sector than the non-petroleum public sector manufacturing industry (Figure II.2.6). Annual rate of increase of public manufacturing industry prices which was 34.3 percent in December 2002 declined to 28.6 percent as of June 2003 (Figure II.2.5).

Figure II.2.6. Prices of WPI Public Sector Petroleum Products Manufacturing (Annual Percentage Change)



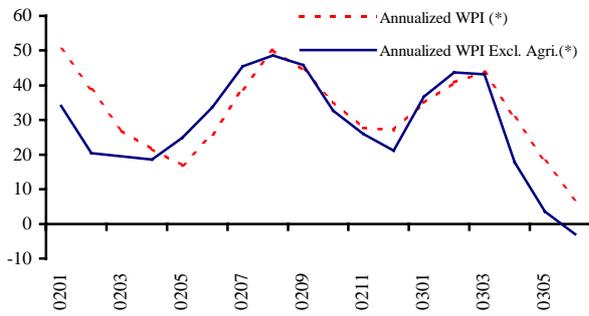
Source: SIS, CBRT

Energy Prices

Rate of increase in the prices of the energy group remained quite low in the first six months of the year. While energy prices had increased by 11.8 percent cumulatively in the first six months of 2002, they increased by a mere 2.9 percent in the first six months of 2003. This was due to the 0.8 percent decline of prices in the sub-group electricity and gas despite the 18.9 percent increase in the sub-group of water. Thus, in annual terms, rate of increase of energy prices which was 24.3 percent in December decreased to 14.4 percent.

To sum up, WPI inflation started a downward trend in the second quarter of 2003. Declining international crude oil prices and decreasing production costs due to nominal appreciation of the Turkish lira after the Iraq operation were effective in this development. As of June, on annual basis, WPI inflation realized as 29.6 percent which is below the CPI inflation.

Figure II.2.7. Annual Inflation Trend, WPI (Annual Percentage Change)



*Three Months Moving Average (Annualized, Seasonally Adjusted)
Source: CBRT, SIS

It is observed that, annual inflation calculated by using quarterly moving averages of seasonally adjusted wholesale prices continuously decreased in the period of April-June 2003. A similar decline is observed in the annual CPI inflation calculated likewise for prices excluding agriculture (Figure II.2.7)

III. DEMAND AND PRODUCTION

In the first quarter of 2003, the Turkish Economy continued its progress on the high growth path it entered in 2002. GNP and GDP increased by 7.4 percent and 8.1 percent respectively in the said period, compared to the same period of the previous year. The decline in net factor income earnings from abroad attributable to the increase in interest payments, caused the growth in GNP to be lower than that of GDP (Table III.1.1).

Table III.1.1. Main Expenditure Groups (Annual % Change)

	2002				2003	
	I	II	III	IV	Annual	I
Total Consumption Exp.	-1.5	3.1	3.4	4.3	2.4	5.6
Private Consumption Exp.	-1.8	3.2	2.5	4.2	2.0	6.5
Public Consumption Exp.	2.2	2.6	12.0	4.5	5.4	-3.0
Gross Fixed Capital Formation	-28.8	-2.3	5.9	22.2	-0.8	9.3
Public Fixed Capital Investment	-18.1	3.0	29.8	22.7	14.5	-37.8
Private Fixed Capital Investment	-30.9	-4.2	-3.7	21.8	-7.2	20.4
Machinery-Equipment	-40.8	6.8	15.2	71.0	1.4	53.0
Construction	-15.1	-16.7	-16.3	-14.7	-15.8	-15.5
Total Investment Expenditures	0.8	59.5	27.9	57.7	35.7	33.2
Total Domestic Demand	-1.0	14.9	8.2	14.7	9.2	11.6
Total Final Domestic Demand	-7.5	1.9	3.9	8.1	1.7	6.3
Exports of Goods & Services	10.4	5.0	15.8	12.3	11.0	14.5
Imports of Goods & Services	2.1	20.3	19.3	22.1	15.7	23.9
GDP	2.1	8.9	7.9	11.4	7.8	8.1

Source: SIS

Furthermore, the base effect of the low economic activity in the same period of the previous year also played an important role in the strong economic growth. In this respect, the economy is expected to continue growing during the rest of 2003, though at lower rates, as a consequence of the fading of the base effect.

The ease of political uncertainties following the November 2002 elections, enabled the economic agents to increase their optimistic expectations rapidly. Industrial production and the rates of capacity utilization continued to rise within this framework, in the beginning of 2003.

The economy is expected to grow during the rest of 2003 as well, though at lower rates.

However the Iraq War, which started in March 2003, brought about political and economic uncertainties and led to the deterioration of optimistic expectations. This in turn, caused domestic demand to be deferred in the first quarter of 2003. Yet, owing to the facts that the Iraq War, contrary to forecasts, lasted only for a short period of time, and also that the oil prices rapidly resumed their pre-war level, helped contain the negative effects of the war on both the Turkish Economy and the world economy.

III.1. Demand Developments

There was a limited recovery in the domestic demand in the first three months of 2003. Having increased by 6.3 percent in the first quarter, the increase in total final domestic demand realized lower than the growth in GDP. The main source of the resurgence in domestic demand was the private machinery-equipment investment and the expenditure on durable goods (Table III.1.1).

Table III.1.2. Contributions of Demand Components to GDP Growth (Percentage Points)

	2002					2003
	I	II	III	IV	Annual	I
Private Expenditure	-7.2	1.4	1.2	4.9	0.3	7.2
Public Expenditure	-0.5	0.4	2.3	2.7	1.3	-1.4
Net Exports	3.1	-5.0	0.5	-2.2	-0.9	-3.4
Stock Changes	6.7	12.2	3.9	6.0	7.0	5.6
GDP	2.1	8.9	7.9	11.4	7.8	8.1

Source: SIS, CBRT

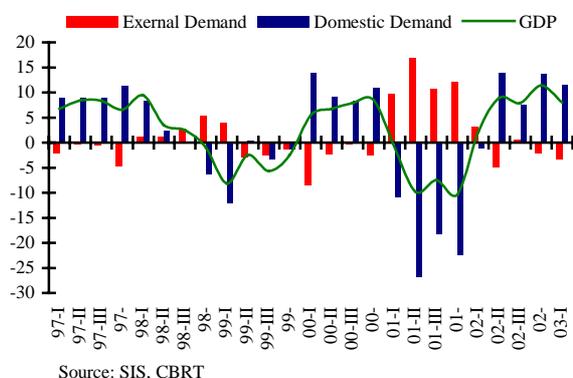
Alternatively, total domestic demand increased by 11.6 percent in the same period, attributable to the increase in stock accumulations. The uncertainties created by the Iraq War gave rise to deferred expenditures. This in turn, resulted in an unintended stock accumulation for the final goods of private firms, in March.

In fact, the Tendency of Final Goods Stock - one of the indicators of the CBRT Business Tendency Survey - reached its highest level in March 2003 since 2001 which

was the year when domestic demand and the economy as a whole suffered a serious contraction. However, it is observed that the final goods stocks of private firms depleted rapidly in the second quarter of the year. This demonstrates the relative strengthening of the domestic demand in the second quarter of the year.

The real earning index per worker in the manufacturing industry continued to go down in the first quarter of 2003, after having declined in 2001 and 2002. The low level of household income causes both the labor force participation rate in the cities, and also the unemployment rate to rise. As a matter of fact, the unemployment rate which retreated to 6.6 percent in 2000, advanced as high as 12.3 percent in the first quarter of 2003. This development curbs the revival in domestic demand (Graph III.1.1).

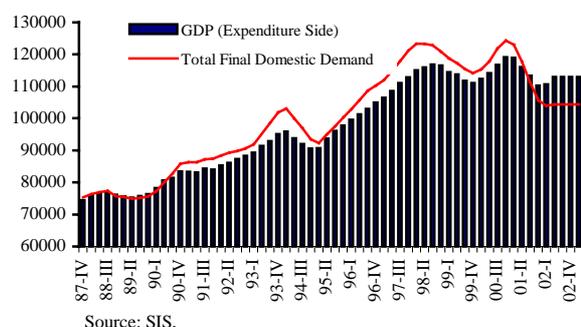
Figure III.1.1. The Contributions of Demand Components to GDP Growth (Percentage Points)



Annualized data show that despite the limited revival in the first quarter of the year, domestic demand remains at a low level.

On the other hand, owing to the economic growth process, the number of the employed increased by 4.4 percent in the first quarter of 2003, compared to the same period of the previous year. The level of employment is expected to continue its rise in line with the growth process. The Total Employment Tendency, which is one of the indicators of the CBRT Business Tendency Survey, supports this idea.

Figure III.1.2. Annualized GDP and Total Final Domestic Demand (1987 Prices, Billion TL)



When the economic growth is analyzed in terms of the components of demand, private expenditures appear to be the one making the highest contribution, with 7.2 points. The contribution of private expenditures to economic growth was negative 13.4 points in 2001, when the economy suffered a serious contraction. Yet private expenditures contributed a mere 0.3 points to economic growth in 2002, the year characterized with rapid growth. Along the same lines, private expenditures are expected to make high rated contributions to growth in the remaining periods of 2003 as well (Table III.1.2).

Annualized data show that despite the limited revival in the first quarter of the year, domestic demand remains at a low level. Besides, the level of total final domestic demand continued to remain lower than the GDP, after the crisis in 2001. The low level of domestic demand and the ongoing stock accumulation ensured that no demand-oriented pressure appears on the consumer prices (Graph III.1.2).

The upturn observed in private consumption expenditures since the second quarter of 2002, gained momentum in the first quarter of 2003. The private consumption expenditures increased by 6.5 percent in the first quarter of the year, compared to the same period of the previous year. However, the uncertainties created by the Iraq War and the continuing deterioration in the real wages, restricted the increase in the private consumption expenditures.

Table III.1.3. Private Consumption Expenditures (Annual % Change)

	2002					2003
	I	II	III	IV	Annual	I
PRIVATE CONSUMPTION	-1.8	3.2	2.5	4.2	2.0	6.5
Food	-1.0	-0.5	2.8	1.5	0.9	3.9
Durable Goods	-7.0	8.7	1.8	6.2	2.1	20.4
Semi-durable & Non-durable	-1.9	4.4	1.7	10.8	3.1	1.9
Energy-Transpor.-Communi.	-2.6	1.8	-1.9	-0.1	-0.7	4.5
Services	2.4	11.1	9.1	10.9	8.7	10.9
Ownership of Dwelling	2.0	1.9	1.7	1.4	1.8	1.3

Source: SIS

In the said period, the expenditures on durable goods and services increased by 20.4 percent and 10.9 percent respectively. On the other hand, the expenditures on food and semi-durable goods went up slightly during the same period. This demonstrates the fact that the revival of the domestic demand has not yet been reflected to all consumer groups in the economy and that the domestic demand is still at a low level (Table III.1.3).

The private consumption expenditures soared by 20.4 percent in the first quarter of the year, compared to the same period of the previous year, mainly owing to the rapid increase in the machinery-equipment investments. While the private investment expenditures on machinery and equipment increased by 53 percent during this period, expenditures on the construction investments dropped by 15.5 percent.

The public consumption expenditures recorded a decline of 3 percent in the first quarter of the year, compared to the same period of the previous year. As for the sub-items of public consumption expenditures; in the first quarter of the year, while the compensation of employees item maintained the same level it recorded during the same period of the previous year, purchases of goods, services declined by 10.8 percent in the said period, also due to the provisional budget practice (Table III.1.4).

Table III.1.4. Public Expenditures (Annual % Change)

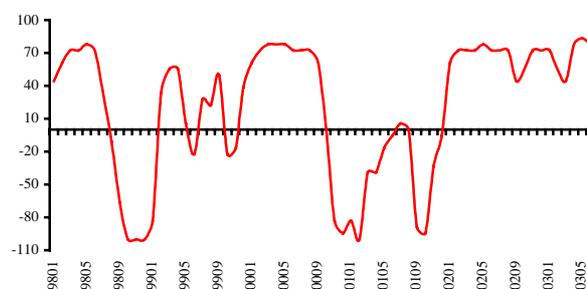
	2002				2003	
	I	II	III	IV	Annual	I
Total Public Expenditures	-4.8	2.8	19.8	12.6	9.2	-13.3
Public Consumption	2.2	2.6	12.0	4.5	5.4	-3.0
Compens. of Employees	1.9	0.2	0.2	0.6	0.7	0.0
Purch. of Goods & Services	3.0	5.7	27.9	7.1	10.8	-10.8
Public Fixed Capital Inv.	-18.1	3.0	29.8	22.7	14.5	-37.8
Machinery-Equipment	-19.3	10.8	71.2	52.8	29.3	-42.3
Building Construction	-17.8	27.1	34.1	25.2	23.9	-38.0
Other Construction	-16.8	-13.0	12.7	6.5	1.1	-31.9

Source: SIS

Goods and services exports advanced by 14.5 percent in the first quarter of 2003, compared to the same period of the previous year. The inadequacy of domestic demand in some sectors triggered the private firms to direct their production to foreign markets and thus exports of goods to increase. The upsurge in domestic demand and the high growth in the industrial production helped imports gain speed. Goods and services imports increased by 23.9 percent in the first quarter of 2003, compared to the same period of the previous year.

The progress of the Expectations Index, which is compiled by the aggregation of quarterly expectations of Business Tendency Survey, in the direction of optimistic expectations slowed down in the first quarter of 2003 (Graph III.1.3).

Figure III.1.3. Expectations Index for Demand and Production (Private Industry Sector, Next Three-Months Period)



Source: CBRT Business Tendency Survey

Expectations Index shows that the limited revival in domestic demand has been gaining momentum in the second quarter of the year.

This development is attributable to the uncertainties created by the Iraq War and the deferred domestic demand. Nevertheless, the Expectations Index continued its progress in favor of optimistic expectations in the second quarter of the year. This shows that the improvement in domestic demand has been gaining momentum in the second quarter of the year.

III.1.1. Production Developments

After having contributed to rapid economic growth in 2002, high performance in the production sectors ensured continued rapid growth in the first quarter of 2003 as well. In this period, value added increased in all sectors except the financial institutions and construction sectors. Furthermore, agricultural sector and industrial sector value added displayed a high rate of increase. Agricultural sector value added advanced significantly in the first quarter of the year owing to the upsurge in fruit production, as well as the base effect. Industrial sector value added rose during this period, as a consequence of the increase in exports, as well as the limited revival in domestic demand. This rise in the industrial sector production caused imports, and thus the import tax item to go up. Besides the value added growth in production sectors, the rapid increase of imports positively influenced the services sector, and especially that of trade, transportation-communication, and business and personal services. However, economic growth was adversely affected from the considerable deterioration in the value added of financial institutions and construction sectors during this period.

Agricultural sector value added increased by a high rate of 7 percent in the first quarter of 2003, compared to the same period of the previous year (Table III.I.5). The high growth in fruit production and the base effect played a significant role in this increase. However, the growth rate of the agricultural sector value added is forecasted to drop compared to last year - especially in olives, hazelnut and wheat products -, due to the cyclical decline in agricultural production in odd years.

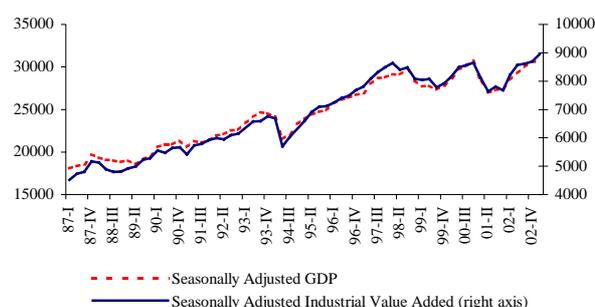
Table III.I.5. GNP and Value Added by Sectors (Annual % Change)

	2002					2003
	I	II	III	IV	Annual	I
AGRICULTURE	0.1	2.7	6.1	15.3	7.1	7.0
TOTAL INDUSTRY	2.8	12.6	10.5	11.4	9.4	7.8
Manufacturing Industry	2.3	13.7	11.8	13.5	10.4	9.2
SERVICES	1.7	6.4	6.0	8.7	5.8	7.0
Construction	-11.8	-9.6	-3.3	2.7	-4.9	-17.0
Trade	4.3	11.7	10.1	16.1	10.7	10.8
Wholesale and Retail	3.4	15.5	12.7	18.7	12.8	11.5
Hotel & Restaurant						
Ser.	9.7	-5.1	0.0	3.9	1.1	6.5
Transportation -						
Communication	2.1	8.3	5.4	5.6	5.4	13.7
Financial Institutions	-7.4	-9.6	-3.2	-8.2	-7.1	-8.1
Ownership of Dwelling	2.0	1.9	1.7	1.4	1.8	1.3
Business & Pers. Ser.	1.7	8.7	7.6	10.7	7.4	7.9
Government Services	1.9	0.2	0.2	0.6	0.7	0.0
IMPORT TAX	4.0	27.7	28.9	33.9	23.0	19.8
GDP	2.1	8.9	7.9	11.4	7.8	8.1
GNP	0.4	10.4	7.9	11.5	7.8	7.4

Source: SIS

Industrial sector value added increased by 7.8 percent in the first quarter of 2003, compared to the same period of the previous year (Table III.I.5). Seasonally adjusted data suggest that the industrial sector value added increased in the first quarter of 2003, in quarterly terms (Graph III.I.4). The growth of the industrial sector value added stemmed from the limited upsurge in domestic demand, as well as the increase in exports, attributable to the private firms directing their production to foreign markets. The rise in industrial production during this period, also caused the intermediate and capital goods imports to go up. Intermediate and capital goods imports went up by 36.9 percent in the January-March period of 2003, compared to the same period of the previous year.

Figure III.I.4. Seasonally Adjusted GDP and Industry Sector Value Added



Source: SIS, CBRT

Industrial sector value added increased by 7.8 percent in the first quarter of 2003, compared to the same period of the previous year.

Services sector value added increased by 7 percent in the first quarter of 2003, compared to the same period of the previous year (Table III.1.5). During this period, trade, transportation-communication, and business and personal services registered the highest rate of growth amongst the services sectors. Wholesale and retail trade value added rose significantly during the same period, owing to the positive developments observed in industry and imports. Moreover, the upsurge in agricultural and industrial production favorably affected the transportation-communication sector value added, as well as that of the trade sector. On the other hand, the financial institutions and construction sectors value added seriously deteriorated during this period. Having triggered the upswing in real interest rates, the atmosphere of uncertainty created by the Iraq War is believed to have been influential in the deterioration of the construction sector value added during the first quarter of 2003.

Data announced by the SIS suggest that the area of buildings that were granted construction permits increased by 6.5 percent in the first quarter of 2003, compared to the same period of the previous year. However, the deterioration of the construction sector value added by 17 percent in the first quarter of 2003, compared to the same period of the previous year, shows that it will take time for the construction sector to recover from the crisis it has been suffering since the earthquake disaster of August 1999. Furthermore the real interest rates, which are still at high levels, are believed to have been unfavorably affecting the building investment expenditures and thus the construction sector value added. It will be possible for the opportunity costs to decline and the construction sector to enjoy a revival, together with the retreat expected in the real interest rates, once the economic stability is ensured.

While the business sentiment, which reflects the expectations of private firms in industrial sector on the course of the economy, was in the direction of pessimistic

expectations in March 2003, it showed a rapid recovery and changed in favor of optimistic expectations in April owing to the short duration of the Iraq War. This favorable trend gained further speed in the month of May. The business sentiment maintained its high level in June 2003, and carried on with its progress in favor of optimistic expectations, despite a slowdown (Graph III.1.5). The high level of optimistic expectations of private firms on the state of the economy, are mainly attributable to the ongoing stability in financial markets, to the continuing high economic growth and also to the realization of the inflation rates in line with expectations.

Figure III.1.5. Business Sentiment in Business Tendency Survey

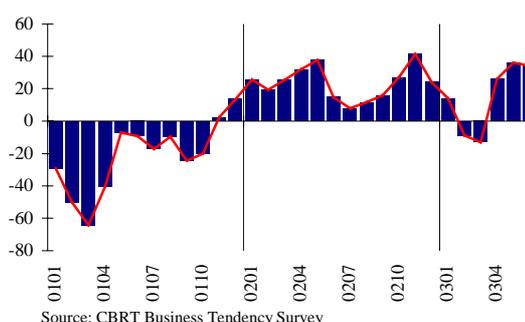


Table III.1.6. Industrial Production (Annual % Change)

	May		January-May	
	2002	2003	2002	2003
Total Industry	11.2	4.8	7.7	6.7
Mining	-15.3	-9.5	-5.4	-16.7
Manufacturing	13.0	5.1	8.6	7.8
Energy	8.5	7.1	5.7	7.4
Non-petroleum Industrial Production	12.0	5.0	6.8	7.4

Source: SIS Monthly Industrial Production Index

In January-May 2003 period, industrial production grew by 6.7 percent compared to the same period of the previous year (Table III.1.6). Excluding petroleum products, the increase in industrial production rises to 7.4 percent in the said period. In January-May 2003 period, manufacturing industry average capacity utilization rate advanced by 2 points compared to the same period of the previous year and reached 75.9 percent. The limited revival in domestic demand and the strong performance of exports were the main determinants in the increase of

industrial production. The favorable developments in exports stemmed mainly from the significant increase in motor vehicle production. According to data from the Automotive Manufacturers Association, total exports by the automotive sector increased by 41 percent in the January-May 2003 period compared to the same period of the previous year. This demonstrates that the motor vehicle industry was the leading sector in the first half of the year, in contributing to the economic revival.

Intermediate and capital goods imports, which have a significant share in total imports, went up by 22.2 percent in the April-May period of 2003 compared to the same period of the previous year. However, the strong growth in industrial production in the first quarter of 2003, slowed down in the months of April and May. The ongoing increase in industrial production despite the fading of the base effect in March 2003, points to the fact that the economic growth process continued in the second quarter of the year as well. In fact, according to data announced by the Turkish Exporters Assembly (TIM), exports upsurged by 35.2 percent in the April-June period compared to the same period of the previous year. Besides, May results of SIS Manufacturing Industry Monthly Tendency Survey indicate that firms expect a high rate of increase in June 2003, in the manufacturing industry production.

Due to the fading of the base effect in the second quarter of the year, the growth rate of the industrial sector value added is predicted to diminish from the said period onwards. Also predicted to decline from the second quarter of the year onwards, is the growth rate of the agricultural sector value added, which will be attributable to the cyclical decline in agricultural production in odd years. In line with these predictions, the growth estimate of 5 percent for 2003 is expected to materialize.

III.2. Labor Market Developments

The results of SIS Survey of Household Labor Force (HLF) show that the supply of labor force went up by 5.3 percent in the first quarter of 2003 compared to the same period of the previous year and reached 23,088 thousand people. As for the level of employment, it recorded an

increase of 4.4 percent compared to the same period of the previous year and reached 20,244 thousand people. Total level of employment rose both in the urban and in the rural areas compared to the same period of the previous year. In the first quarter of 2003, 54.4 percent of total employment realized in urban areas while 45.6 were in the rural areas. The unemployment rate which was 11.5 percent in the first quarter of 2002, advanced to 12.3 percent in the same period of 2003.

The number of unemployed people rose by 313 thousand people in the first quarter of 2003 compared to the same period of the previous year and reached 2,844 thousand people (Table III.2.1). In the said period, 16.6 percent of the unemployed in Turkey are those who lost their jobs and 17.2 percent are those who are seeking a job for the first time. The prevailing rise in the number of the unemployed, despite the recovery in the economy, is mainly attributable to the increase in the labor force participation rate. This increase in the labor force participation rate in turn, is caused by the decline in the level of household income after the economic crisis and also the prolonged period of unemployment

Table III.2.1. Labor Force and Employment (aged 15+)

	2002				2003	
	I	II	III	IV	Mid-Year.	I
Labor Force	21,917	24,233	25,247	24,347	23,818	23,088
Employment	19,387	21,975	22,833	21,658	21,354	20,244
Urban (%)	54.5	51.2	50.4	51.9	52.0	54.4
Rural (%)	45.5	48.8	49.6	48.1	48.0	45.6
Num. of Unemployed	2,531	2,259	2,414	2,689	2,464	2,844
Unemployment Rate	11.5	9.3	9.6	11.0	10.3	12.3
Urban (%)	14.7	13.5	13.9	14.9	14.2	15.4
Rural (%)	7.5	4.5	4.6	6.5	5.7	8.3
Educ. Young Peop. Unemp. Rate	29.2	26.9	30.7	29.8	29.1	27.9
Underempl./ L.Force (%)	5.9	5.8	5.0	5.1	5.4	5.0
Inactive Labor Force (%)	17.5	15.1	14.6	16.2	15.8	17.3

Source: SIS Household Labor Force Survey

The unemployment rate which was 11.5 percent in the first quarter of 2002, advanced to 12.3 percent in the same period of 2003.

The unemployment rate in urban areas realized as 15.4 percent in the first quarter of 2003, increasing by 0.7 points compared to the same period of the previous year. Besides, non-agricultural employment rose by 3.2 percent (423 thousand people) compared to the same period of the previous year. The high growth rate of the Turkish economy prevailed in the first quarter of 2003 as well, after year 2002. However, the unfavorable developments in the labor market further intensified, limiting the recovery of domestic demand. The employment level is forecasted to push up with the continuation of the growth process in the coming periods.

The unemployment rate of educated young people is still quite high at 27.9 percent, despite a decrease of 1.3 points in the first quarter of 2003 compared to the same period of the previous year. This rate realized as 29.5 percent in urban areas, in the same period.

The rate of underemployed people, which is defined as people who have been seeking another job although they already have one and/or those who are suitable to work for additional hours in either their current job or in another job, realized as 5 percent in the first quarter of 2003. Thereby, the rate of inactive labor force, the sum of the rates of underemployed and unemployed people, eased to 17.3 percent, after a 0.2 points retreat from the same period of the previous year.

The sectoral distribution of employment indicates that the share of agricultural sector in overall employment was 32.8 percent in the first quarter of 2003. The shares of industrial and services sectors during the same period realized as 18.6 percent and 39.5 percent, respectively (Table III.2.2). Together with the economic recovery in the first quarter of 2003, non-agricultural employment upsurged in urban areas compared to the same period of the previous year. The increase in non-agricultural employment in the urban areas mainly stemmed from the services sector. Revival in the trade sector along with the economic growth observed in the first quarter of 2003, favorably affected the services sector employment.

Table III.2.2. Employment by Sectors

	2002				2003	
	I	II	III	IV	Mid Year.	I
TOTAL	19,387	21,975	22,833	21,658	21,354	20,244
Agriculture	6,205	7,961	8,709	7,618	7,458	6,639
Industry	3,728	3,976	3,996	3,953	3,954	3,769
Services	8,663	9,029	9,011	9,173	8,964	9,173
Construction	790	1,008	1,118	913	958	676
Urban Employ.,	10,572	11,257	11,497	11,241	11,111	11,013
Rural Employ.,	8,815	10,717	11,336	10,417	10,243	9,231

Source: SIS Household Labor Force Survey

In the first quarter of 2003, manufacturing industry employment index rose by 5 percent, compared to the same period of the previous year. While public sector employment index declined by 4.1 percent compared to the same period of the previous year, the private sector employment index increased by 6.2 percent (Table III.2.3). Data from the SIS Quarterly Industrial Production Index suggest that, private manufacturing industry production recorded a high rate of increase, by 13.6 percent, in the first quarter of 2003 compared to the same period of the previous year. The public sector production advanced by 5.6 percent in the said period. This demonstrates that the increase in private manufacturing industry production contributed to the rise in employment.

Table III.2.3. Developments in Manufacturing Employment, Wages and Productivity (Annual Percentage Change)

	2002				2003	
	I	II	III	IV	Annual	I
Employment⁽¹⁾	-6.9	0.1	3.4	6.0	0.6	5.0
Public	-11.4	-12.0-8.0		-5.1	-9.1	-4.1
Private	-6.1	2.3	5.5	7.8	2.3	6.2
Wage⁽²⁾	-15.9	-4.3	-2.7	-0.5	-5.5	-0.9
Public	-12.6	5.9	4.1	6.9	1.4	-2.6
Private	-15.1	-3.3	-1.1	1.1	-4.2	0.9
Productivity⁽³⁾	10.3	10.4	7.0	6.6	8.6	3.8
Public	15.7	22.4	20.7	8.0	16.4	4.6
Private	9.6	9.0	5.0	7.9	7.8	4.5
Earnings⁽⁴⁾	-17.4	-4.5	-6.5	-2.2	-7.2	-5.5
Public	-14.7	4.4	-2.3	7.0	-1.0	-3.4
Private	-16.4	-3.6	-4.3	-1.6	-6.0	-4.3

(1) SIS, Index for Production Workers in the Manufacturing Industry, 1997=100

(2) SIS, Quarterly Index for Real Wages per Production Hours Worked, 1997=100

(3) SIS, Quarterly Index for Partial Productivity per Production Hours Worked, 1997=100

(4) SIS, Quarterly Index for Real Earnings per Workers in the Manufacturing Industry, 1997=100

The decline in real wages continued in the first quarter of 2003, though at a slower pace compared to the same period of the previous year. While the real wages registered an increase in the private manufacturing industry in the said period, they went down in the public sector. The decline observed in 2002, in the real wages per hour persisted but slowed down in the first quarter of 2003. Accordingly, the real wages per hour fell by 0.9 percent during this period compared to the same period of the previous year. This causes the revival of domestic demand to remain at a low level and prevents demand pressure on consumer prices. Private sector employment is expected to continue rising and real wages are expected to start going up in 2003, in line with the continuance of the economic growth process. This will favorably influence the resurgence of domestic demand and economic growth in 2003.

While the real wages per hour registered an increase in the private manufacturing industry in the first quarter of 2003, they went down in the public sector.

Analyzing the manufacturing sector productivity developments, it is seen that the productivity per working hour rose both in the public and private sectors, in the first quarter of 2003 compared to the same period of the previous year. This development stemmed from the fact that manufacturing industry production maintained its high rate of growth in the first quarter of 2003, while there was only a slight increase in the number of people employed and the number of working hours compared to the same period of the previous year. This increase in productivity allows unit costs of private firms to decline and thus enables price competitiveness in foreign markets.

IV. PUBLIC FINANCE AND DOMESTIC DEBT STOCK

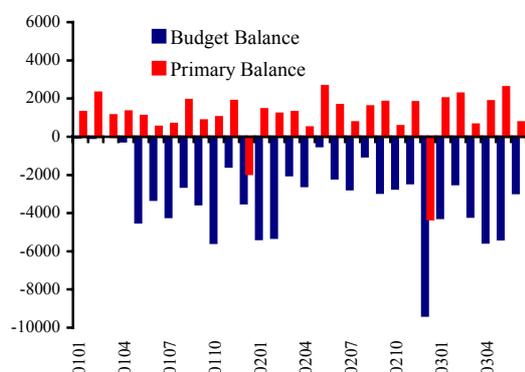
Primary budget surplus realized as Turkish lira 745 trillion, in June 2003 (Figure IV.1). As for the January-June 2003 period, budget deficit was Turkish lira 24.8 quadrillion and the primary budget surplus was Turkish lira 10.1 quadrillion (Table IV.1).

Table IV. 1. Consolidated Budget Balances (TL Trillion)

	2002 January-June	2003 January-June
Revenues	35821	44689
Expenditures	53696	69448
Budget Balance	-17875	-24759
Primary Budget Balance	10590	10094

Source: Ministry of Finance.

Figure IV. 1. Consolidated Budget Balance and Primary Balance (Monthly, TL Trillion)



Source: Ministry of Finance

IV.1. Revenues

In the January-June 2003 period, budget revenues increased by 24.8 percent compared to the same period of the previous year and realized as Turkish lira 44.7 quadrillion while the tax revenues rose by 45.6 percent and realized as Turkish lira 37.1 quadrillion (Table IV.1.1).

In the January-June 2003 period, compared to the overall increase in tax revenues corporation tax, motor vehicles tax and VAT on imports showed a more substantial increase with respect to the same period of the previous year. Special

consumption tax was another significant revenue item, which favorably affected the performance of tax revenues. Collection proceeds from the special consumption tax in the first half of 2003 amounts to Turkish lira 9.8 quadrillion. The largest part of this amount came from the special consumption tax on petroleum and natural gas products.

Table IV. 1.1. Consolidated Budget Revenues (TL Trillion)

	2002 January-June	2003 January-June	Rate of Increase (percent)
REVENUES	35821	44689	24,8
Tax Revenues	25485	37111	45,6
Income Tax	6010	7452	24,0
Corporate Tax	2203	3554	61,4
Motor Vehicles Tax	339	596	76,0
Domestic VAT	4969	6719	35,2
Special Consumption Tax	-	9750	-
Bank.& Insuran. Trans. Tax	505	582	15,1
VAT on Imports	3690	5381	45,8
Non-Tax Revenues	6985	4091	-41,4
Special Revenues and Funds	2785	2414	-13,3
Annexed Budget Revenues	566	1073	89,7

Source : Ministry of Finance.

The share of indirect taxes in tax revenues, which was 66.2 percent in the January-June period of 2002, rose to 67.6 percent in the same period of 2003.

For the January-June period of 2003, the share of indirect taxes in total tax revenues stood at 67.6 percent.

With an increase of only 24 percent, the increase in income tax revenues in January-June 2003 from the same period of the previous year, realized lower than the increase in total tax revenues. This development mainly stemmed from the limited increase in the income tax withholding. The fact that the rise in the civil servants' salaries in the beginning of 2003 was kept to be limited, and also the fact that the interest rates realized lower during the first half of the year in relative terms compared to the same period of the previous year, played a significant role in this limited increase in the income tax withholding.

When the tax revenues are analyzed in terms of collection assessment ratios, it is observed that the ratio which was at 77.3 percent in January-June 2002 period, affected also by te

Tax Justice Project, dropped to 75.8 percent in the same period of 2003.

In the January-June period of 2003, both non-tax revenues and the special revenues and funds item contracted, compared to the same period of the previous year, by 41.4 percent and 13.3 percent, respectively. This high rate of deterioration in the non-tax revenues is mainly attributable to the sum of Turkish lira 3 quadrillion, transferred from the Central Bank's term profit to the budget, in May 2002.

IV.2. Expenditures

In the January-June period of 2003, expenditures increased by 29.3 percent compared to the same period of the previous year (Table IV.2.1). In this period, non-interest expenditures grew by 37.1 percent compared to the same period of the previous year.

Table.IV. 2.1. Consolidated Budget Expenditures (TL Trillion)

	2002	2003	Rate of Increase
	January-June	January-June	(percent)
EXPENDITURES	53696	69448	29,3
NON-INTEREST EXP.	25231	34596	37,1
Personnel	10793	14329	32,8
Wages	1444	1654	14,6
Other Personnel Expenditures	9349	12675	35,6
Other Current	1996	2099	5,2
Investment	1553	1356	-12,6
Non-interest Transfer Expenditures	10890	16811	54,4
Transfers to SEE's	811	403	-50,4
Tax Rebates	2237	4230	89,1
Social Security Institutions	5448	8363	53,5
Payments to Retirement Fund	2635	3272	24,2
Payments to SSK	1354	2723	101,1
Payments to Bag-Kur	1331	2256	69,5
Unemployment Insurance Fund	128	113	-12,1
Agricultural Support	870	1525	75,3
Other Transfers	1524	2290	50,3
INTEREST PAYMENTS	28465	34853	22,4
Domestic Debt Interest Pay.	26191	31634	20,8
Foreign Debt Interest Pay.	2274	3218	41,5

Source : Ministry of Finance.

The personnel expenditures rose by 32.8 percent, in January-June 2003. Civil servants' salaries were increased by 5 percent in January 2003. Moreover, the additional amount arising out of the increase made in the salaries in October 2002 was paid to the civil servants in

January 2003 as well. The salaries of civil servants were raised at equal amounts for the second half of 2003. This raise corresponds to an average increase of 9 percent.

The investment expenditures are observed to have retreated by 12.6 in the January-June period of 2003, compared to the same period of the previous year.

Transfers made from the budget, to the social security institutions in connection with their financial structure, increased by 53.5 percent in the first half of 2003, compared to the same period of the previous year. The sum of such transfers in the mentioned period amounts to Turkish lira 8.4 quadrillion. The largest part of this sum was transferred to the Retirement Fund. Nevertheless, when the growth rates of the transfers from the budget are analyzed, the transfers made to Social Security Institution (SSK) and Bağ-Kur display higher rates of growth.

Another expenditure item among the non-interest budget expenditures, which displayed a high rate of growth in the January-June period of 2003, was the tax rebates. Influential in this development was the increase in the VAT rebates on exports.

IV.3. Consolidated Budget Deficit and Financing

In January-May 2003 period, consolidated budget cash deficit realized as Turkish lira 24 quadrillion. During this period, the Treasury was a net borrower in domestic borrowing. Analyzing the structure of domestic borrowing, the Treasury appears to be a net borrower both in government bonds and also in Treasury bills. During this period, net borrowing in government bonds amounted to Turkish lira 23.7 quadrillion, while net borrowing in Treasury bills was Turkish lira 2.3 quadrillion (Table IV.3.1.).

As for net foreign borrowing, it amounted to Turkish lira 0.4 quadrillion, in the January-May period of 2003.

In the January-May 2003 period, net domestic borrowing realized as Turkish lira 25.9 quadrillion.

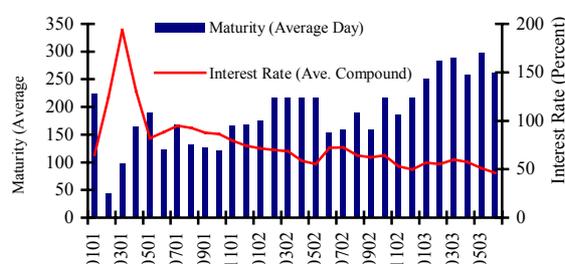
Table IV. 3.1. Consolidated Budget Balance and Financing (TL Trillion)

	2002	2003
	January-May	January-May
Primary Budget Balance	8932	9349
Budget Balance	-15699	-21807
Cash Balance	-14125	-24025
Financing	14125	24025
Net Domestic Borrowing	-529	25931
Government Bonds	-6699	23677
Treasury Bills	6170	2254
Guaranteed Debt Returns	0	0
Net Foreign Borrowing	13221	355
Other	1432	-2262

Source : Treasury.

The average compound Treasury Auction interest rates, which were 49.8 percent at the end of 2002, resumed an upward trend in early-2003 and realized as 59.9 percent in March (Figure IV.3.1). From then onwards, Treasury Auction interest rates started decline and eased to 46 percent in June.

Figure IV.3.1. The Treasury Auction Interest Rates and Maturity



Source: Treasury

IV.4. Domestic Debt Stock

Domestic debt stock, which was Turkish lira 149.9 quadrillion at the end of 2002, stood at Turkish lira 162.6 quadrillion in March 2003. It reached Turkish lira 175.3 quadrillion as of June 2003, having increased by 16.9 percent from its end-2002 level and by 7.8 percent from March 2003 level (Table IV.4.1). While the cash domestic debt stock went up by 30.7 percent compared to December 2002, non-cash domestic debt stock declined by 3.3 percent. This increase in cash domestic debt stock stemmed mainly from the increase in the fixed income and interest rate-indexed debt stock. The major part of the increase in the flexible rate domestic debt stock took place in the months of January and April. Liquidation of

Compulsory Savings Account in April and the restructuring and early redemption of the securities in this account, caused the cash domestic debt stock to rise as much as the accrued interest. During this period, the decline in non-cash domestic debt stock stemmed from the incident of January 2003 when securities in the portfolio of the banks under SDIF, worth of US dollar 735 mio nominally were returned to the Treasury, causing the foreign exchange debt stock to go down. In April 2003, both domestic debt stock to the market and overall domestic debt stock increased from the previous month, by 5.4 percent and 4.6 percent, respectively. Monthly increases in domestic debt stock to the market and overall domestic debt stock realized as 5.7 percent and 2.3 percent respectively, in May 2003. The increase observed in the domestic debt stock to the market, in the months of April and May, was mainly attributable to the borrowing made to meet principle payments of the Compulsory Savings Account (ÇTTH), as well as the coupon payments of the securities in the Central Bank portfolio, in May. In June 2003, both domestic debt stock to the market and overall domestic debt stock increased from the previous month, by only 0.7 percent and 0.8 percent, respectively. This points to a significant slowdown in the growth rate of the debt stock in the month of June.

Table IV. 4.1. Domestic Debt Stock and Its Structure (Amounts are in TL Quadrillion and Shares are in Percent)

	2002		2003*	
	Amount	Share in Total	Amount	Share in Total
CASH	89.3	59.6	116.7	66.6
Fixed Income	37.6	25.1	57.3	32.7
Flexible-rate	17.4	11.6	24.4	13.9
FX Denominated	16.5	11.0	17.6	10.0
FX Linked	17.8	11.9	17.4	10.0
IMF Credit	9.7	6.5	9.3	5.3
Swap/Tap	7.6	5.1	7.6	4.4
Public Sales	0.5	0.3	0.5	0.3
NON-CASH	60.6	40.4	58.6	33.4
Fixed Income	0.0	0.0	0.0	0.0
Flexible-rate	46.7	31.2	46.8	26.7
Interest Linked	28.3	12.3	28.4	16.2
CPI-Indexed**	18.4	7.9	18.4	10.5
FX Denominated	11.9	7.9	9.8	5.6
FX Linked	2.0	1.3	2.0	1.1
TOTAL STOCK	149.9	100.0	175.3	100.0
Fixed Income	37.6	25.1	57.3	32.7
Flexible-rate	64.1	42.8	71.2	40.6
Interest Linked	45.7	30.5	52.8	30.1
CPI-Indexed**	18.4	12.3	18.4	10.5
FX Denominated	28.4	19.0	27.4	15.6
FX Linked	19.8	13.2	19.4	11.1

* As of June 2003

** Indicates the CPI-Indexed part of the non-cash securities that take place in the portfolio of the Central Bank.

Source : Treasury

The share of domestic debt to the market within the overall domestic debt stock increased by 13.2 points from its level in 2001 and reached 47.2 percent in 2002. Having increased as much as Turkish lira 17.6 quadrillion from its end-2002 level, the share of the market in the overall domestic debt stock advanced by a further 3.6 points and reached 50.8 percent in May 2003 (Table IV.4.2). This figure remained unchanged in the month of June.

The structure of domestic debt in terms of debt instruments changed in January-June 2003. The share of fixed income instruments increased while the share of other instruments showed a decline.

Table IV.4.2. The Distribution of Domestic Debt Stock According to Buyers (TL Quadrillion)

	2001	Pay	2002	Pay	2003	Pay
	Dec.	(Per.Dec.)	Dec.	(Per.)	June	(Per.)
1. PUBLIC SECTOR	80.6	66.0	79.1	52.8	86.3	49.2
a. CBRT	32.5	26.6	28.1	18.8	27.8	15.9
IMF Credit	13.8	11.3	9.7	6.5	9.4	5.4
Other	18.7	15.3	18.4	12.3	18.4	10.5
b. State Banks (*)	22.7	18.6	24.3	16.2	27.0	15.4
c. SDIF Banks	15.1	12.4	11.0	7.4	9.4	5.4
d. Other Public	10.2	8.3	15.7	10.5	22.1	12.6
2. MARKET	41.6	34.0	70.8	47.2	89.0	50.8
TOTAL (1+2)	122.2	100.0	149.9	100.0	175.3	100.0

(*) As of end of 2000, unsecured duty loss accruals amounts to TL 15.1 quadrillion.

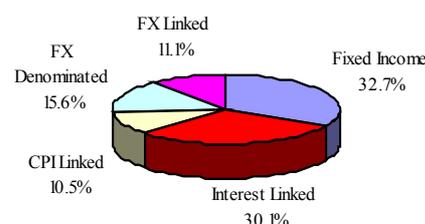
Source : Treasury

In June 2003, the share of interest-linked government securities within the overall domestic debt stock decreased by 0.4 points from its end-2002 level. The share of CPI-indexed government securities, dropped by 1.8 points and fell to 10.5 percent. Similarly, the share of FX-denominated and FX-linked government securities went down to 26.7 percent, having declined by 5.4 points. The share of fixed income government securities in the overall domestic debt stock increased by 7.6 points from its end-2002 level and reached 32.7 percent (Figure IV.4.1.). As the uncertainties stemming from the war eased, prevailing high interest rates boosted demand for long-term discount TL-denominated borrowing instruments. This caused the share of fixed income debt instruments within the total debt stock to go up. However, long-term borrowing with substantially high

interest rates causes interest payments to mount in the coming terms. This increases the importance of fiscal discipline and primary budget surplus, to secure a stable path for the debt stock in the future.

High interest rates adopted a downward trend, with the end of war and ease of uncertainties from April 2003 onwards.

Figure IV.4.1. The Distribution of Domestic Debt Stock as of June 2003 (Percent)



Source: Treasury.

Roll-over ratio in TL realized above 100 percent in the first half of 2003, except for the months of January and March. The ratio showed a decline in January and March 2003, as Treasury reduced borrowing in terms of TL, due to its high cost. During this period, Treasury financed some of the TL-denominated redemption via borrowing in terms of FX, though it did not have a significant amount of payment in FX to the market.

The roll-over ratio for borrowing in TL realized as 126.7 percent, 117.3 percent and 124.8 percent respectively, in the months of April, May and June (Figure IV.4.2.). Prevailing high interest rates, despite the ease of uncertainties in the mentioned period, increased demand for TL-denominated domestic debt instruments. In April and May, Treasury did not borrow in terms of FX, from the market. Whereas in June, there was inadequate demand for FX-denominated debt instruments, and the roll-over ratio in FX realized as 74 percent.

Figure IV.4.2. Roll-over Ratio

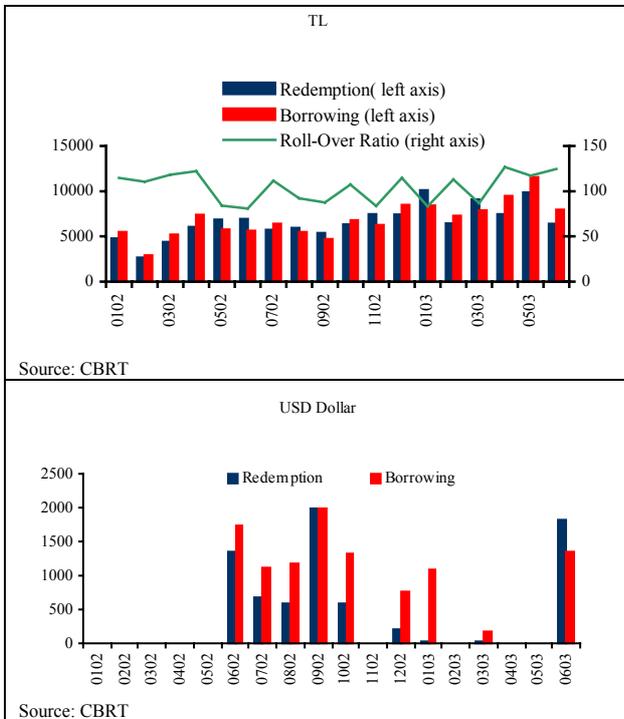


Figure IV.4.3. The Ratio of Domestic Debt Stock to M2X



The ratio of total domestic debt stock to M2X, an indicator of pressure exerted by domestic debt stock on the financial markets, rose by around 22 points in June 2003 from its end-2002 level, and reached 134.3 percent. The ratio of cash domestic debt stock to M2X, another indicator of this pressure, increased by around 22.5 points, and went up to 89.4 percent, on account of the fact that total borrowing from the market exceeded that of redemption (Figure IV.4.3). The ratio of domestic debt stock to M2X showed an increase, especially in April and May. The developments influential in this were, upsurge in cash domestic debt stock and decline in the TL equivalent of the FX deposit accounts, as a result of appreciation of TL in the said months.

The increase in government securities portfolio of non-bank sector and mutual funds, by Turkish lira 17.6 quadrillion in the January-June period, also played a role in this development. Excluding the government securities portfolio of non-bank sector and mutual funds, ratio of total domestic debt stock to M2X dropped to 92 percent, while ratio of cash domestic debt stock to M2X fell to 47.1 percent, as of end-June.

V. MONETARY AND EXCHANGE RATE POLICY AND DEVELOPMENTS IN FINANCIAL MARKETS

V.1 General Framework of Monetary and Exchange Rate Policy

In the second quarter of 2003, implicit inflation targeting strategy was pursued in monetary policy implementation. Within this framework, short-term interest rates have been used as the main policy instrument and monetary targets specified in the economic program implemented with the IMF have been achieved.

Taking into account the main determinants of future inflation, the CBRT cut down interest rates applicable to overnight and one-week borrowing on April 25, June 4 and July 16 by three points each. Meanwhile, late liquidity window lending interest rates were cut down by 3 points on April 25 and June 4 and by 4 points on July 16. Late liquidity window borrowing interest rate was left intact. The main reasons underlying the interest rate cuts were; ease of cost-push inflationary pressure, optimism observed in inflation expectations with recovery of confidence and the decisions about the structural reforms specified in the economic program. After the latest interest rate cut-down operation dated July 16, 2003, overnight and one-week borrowing rate became 35 percent and lending rate became 41 percent. Late liquidity window lending interest rate came down to 46 percent. The interest rates on overnight and one-week maturity borrowing facilities that the primary dealer banks can use via repo transactions within the framework of open market operations were cut down to 37 percent.

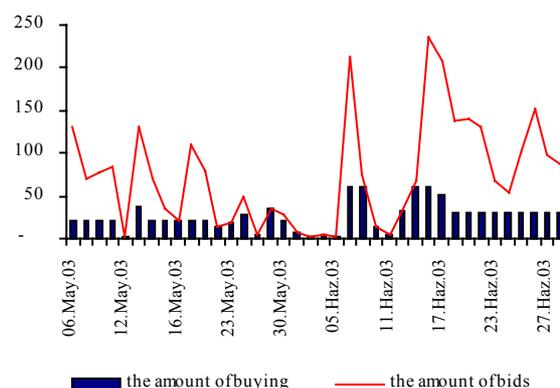
Table V.1.1. CBRT Interest rates (Simple, compound)

	Agu. 2002	Nov. 2002	Mar. 2003	Apr. 2003	Jun. 2003	Jul. 2003
O/N	46	44	44	41	38	35
Borrowing						
O/N Lending	53	51	51	48	45	41
1 week Borrowing	46	44	44	41	38	35
Late Liquidity Window						
Borrowing	5	5	5	5	5	5
Late Liquidity Window Lending	63	61	56	53	50	46

Upon seeing the excess foreign exchange supply, the Central Bank started to hold foreign exchange buying

auctions on May 6, 2003 in order to increase its foreign exchange reserves. Initially, the total amount of foreign exchange purchased per day was US dollar 20 million, however, this amount was incremented to 30 million as of June. As of June 16, 2003, the practice that provided for determining the maximum price that could be bid in the auctions was terminated. With the announcements made on June 30 and July 16, the amount to be auctioned was first incremented to US dollars 40 million and than to 50 million.

Figure V.1.1. Foreign Exchange Buying Auctions and the Amounts Purchased (million US dollars)



V.2. Developments in Financial Markets

V.2.1 CBRT Balance Sheet Developments and Monetary Targets

The monetary targets for end-June and end-July specified in the Letter of Intent dated April 5, 2003, have been achieved. Base Money item remained well below the value specified as the performance criteria and the target was achieved as of the end of June. In April and June, the Net Domestic Assets item remained well below the indicative ceiling value. Meanwhile, Net International Reserves item recorded a level quite above the indicative floor value.

Table V.2.1.1. Performance Criteria and Indicative Targets for Base Money and Net Domestic Assets (Trillion TL)

	Base Money		Net Domestic Assets	
	Ceiling ⁽¹⁾	Realization	Ceiling ⁽¹⁾	Realization
December 31 2002	10,850 ^P	10,720	33,100 ^I	28,600
April 30 2003	12,800 ^P	11,883	32,800 ^I	30,951
June 30 2003	13,200 ^P	13,039	34,100 ^I	29,395
September 30 2003	14,100 ^I		33,800 ^I	
December 31 2003	14,300 ^I		34,200 ^I	

(1) The ceilings are calculated based on the averages of the values at the aforementioned dates and the values at the following 5-working day period.
(P): Performance criterion, (I): Indicative Value

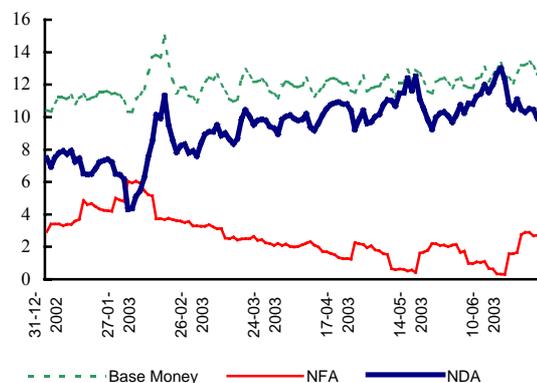
Table V.2.1.2. Criteria Pertaining to the Level of Net International Reserves (Million US dollars)

	Floor	Realization
December 31 2002	-9,700 ^P	-4,600
April 30 2003	-6,500 ^P	-5,996
June 30 2003	-7,000 ^P	-3,865
September 30 2003	-6,000 ^I	
December 31 2003	-6,000 ^I	

(P): Performance criterion, (I): Indicative Value

When developments about Base Money in the second quarter of 2003 are analyzed, a significant increase is observed as of the end of May. When the effect of the subject increase on the liabilities side of the balance sheet as specified in the Stand-by Agreement is studied, it is observed that the effect of TL Required Reserves and Free Deposits has remained relatively limited and the determinant movement has happened in currency issued item. Currency issued item exhibited a significant increase in June during the wage-payment period and as of the beginning of the second half, the contraction recorded in previous months remained limited. This is of evidence that there has been a sizable increase in the demand for cash, which had been quite stable except for the cyclic fluctuations since the beginning of 2003. As a consequence of these developments, in the rest of June 2003, the currency issued exceeded Turkish lira 9 trillion.

Figure V.2.1.1. Base Money, NDA and NFA(Quadrillion TL)



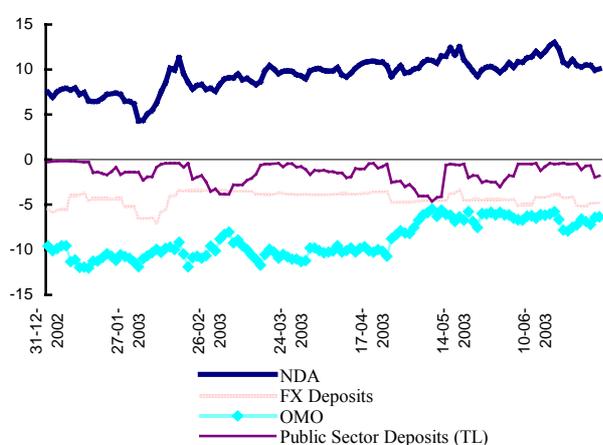
The breakdown of sources in the assets side of the balance sheet that corresponds to the increase in Base Money exhibited a change in the second half of 2003. Within this framework, while NDA increased until mid-June and started a downward trend in the second half of June, NFA increased substantially.

Table V.2.1.3. Contribution of Main Balance Sheet Items to the Rise in Base Money

	Monthly Average (Trillion TL)			Contribution to the Rise in Base Money (Percentage)	
	2002	2003	2003	12/2002-	03/2003-
	Dec.	Mar.	Jun.	06/2003	06/2003
Base Money	11,490	11,960	12,632	100.0	100.0
Currency Issued	8,074	8,370	8,859	68.7	72.7
TL Required Reserve	1,664	1,786	1,867	17.8	12.1
Free Deposits	1,752	1,804	1,906	13.5	15.2
NFA	2,423	2,577	1,541	-77.2	-154.1
NDA	9,067	9,382	11,092	177.2	254.1
• Treasury Debt	30,496	31,942	29,122	-120.3	-419.2
• Public Sector Deposits TL	-1,357	-1,527	-841	45.1	102.0
• FX Deposits.	-5,267	-3,732	-4,571	61.0	-124.6
• Open Market Operation (net)	-7,964	-10,203	-6,643	115.7	529.1
• Revaluation Account	-985	-903	687	146.3	236.3

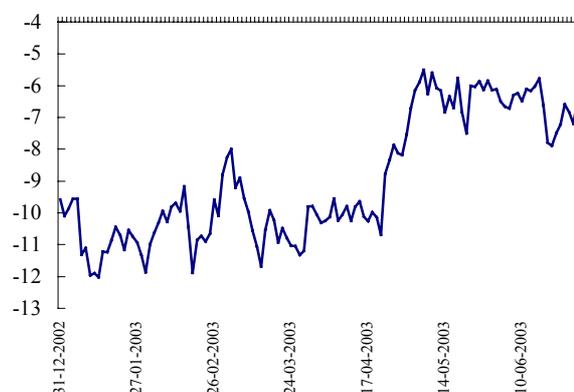
The contribution of developments in main balance sheet items to Base Money is as follows: the average Base Money value increased by 5.6 percent in June compared to that of March. This increase corresponds to 8.7 percent increase in Net Foreign Assets and 14.3 percent increase in Net Domestic Assets in the assets side of the balance sheet.

Figure V.2.1.2. NDA and Selected Sub-items (Quadrillion TL)



Important developments were observed in the sub-items of NDA in the second quarter of 2003. As the coupon payments totaling Turkish lira 3 quadrillion of the WPI-indexed government papers under CBRT's portfolio was affected by the Treasury on May 12, 2003, Treasury Debts item decreased substantially. Parallel to this development, a decline was observed public sector TL deposits. The liquidity mopped up by the Central Bank, which is registered under Open Market Operations (Net) sub-item of the Net Domestic Assets item, exhibited a sizeable increase as of the end of April. The said item, which was TL 10 quadrillion as of the beginning of April, rolled back to TL 6.5 quadrillion by the end of June and this development became the principle reason of the rise in NDA. Consequently, in the period in question, the rise in NDA compensated the decline in Net Foreign Assets (NDA) and increase in base money was counterbalanced by the Net Domestic Assets.

Figure V.2.1.3 Open Market Operations (net-TL quadrillion)



V.2.2 Developments in Monetary Aggregates

Compared to end-March figures, the M1 and M2 monetary aggregates increased by 11.4 percent and 3.5 percent, respectively, in the second quarter of 2003. In March 2003, sight deposits, which decreased due to the uncertainties caused by the Iraq war, started to increase again in April-June period because of the payments within the scope of the tax peace project and this became the main factor underlying the significant rise in M1 money supply (Table V.2.2.3.).

Table V.2.2.1. Monetary Aggregates (TL trillion)

	2002 JUN.	2002 DEC.	2003 MAR.	2003 APR.	2003 MAY.	2003 JUN.
M1	12.871	14.259	14.622	15.511	15.370	16.869
Currency in Circulation	5.922	7.209	7.881	7.838	7.712	8.562
Sight Deposits	6.950	7.050	6.741	7.673	7.658	8.308
M2	53.345	61.195	63.412	63.675	65.037	67.916
Time Deposits	40.473	46.936	48.791	48.165	49.667	51.046
M2X	117.240	133.450	132.878	129.764	126.942	130.509
FX Deposits	63.896	72.255	69.465	66.089	61.906	62.593
M2XR	120.947	136.213	136.802	132.999	129.603	132.949
Repo	3.707	2.763	3.925	3.235	2.660	2.440
CPI (1994=100)	6.445	7.469	8.078	8.247	8.377	8362.6
US Dollar	1.602.733	1.633.732	1.705.559	1.591.090	1.434.663	1.426.927

Source: CBRT "Weekly Press Bulletin", the provisional data were used for the last Friday of each month

In the period in question, M2X monetary aggregate contracted by 5.1 percent in real terms. The decline in M2X stemmed from the decrease in TL value of the Foreign Exchange Deposits accounts of the residents. In the second quarter of the year, the volume of FX deposit accounts decreased by 13 percent in real terms due to the appreciation of TL. The FX deposit accounts decreased from TL 65.9 quadrillion in March to TL 62.6 quadrillion in June. The share of FX deposit accounts in M2X monetary aggregate declined from 52.3 percent in March to 48.0 percent in June. Meanwhile, in the mentioned period TL deposit accounts increased by 6.9 percent in real terms.

Table V.2.2.2. Monetary Aggregates, Real Percentage Change)

ANNUAL	CUMULATIVE			ANNUAL		
	2002			2003		
	APR.	MAY.	JUN.	APR.	MAY.	JUN.
M1	8.9	-2.2	1.0	-1.5	-3.9	5.7
Currency in Circulation	14.8	12.5	11.4	-1.5	-4.6	6.1
Sight Deposits	3.5	-13.6	-7.9	-1.4	-3.2	5.2
M2	-3.1	-4.6	-1.9	-5.8	-5.2	-0.9
Time Deposits	-6.4	-5.3	-2.8	-7.1	-5.7	-2.9
M2X	-4.4	-11.6	-14.2	-11.9	-15.2	-12.7
FX Deposits	-5.6	-18.0	-24.5	-17.2	-23.6	-22.6
M2XR	-5.0	-12.7	-15.3	-11.6	-15.2	-12.8
Repo	-23.0	-44.4	-49.3	6.0	-14.2	-21.1

Source: CBRT "Weekly Press Bulletin", the provisional data were used for the last Friday of each month.

Table V.2.2.3. Monetary Aggregates, Real Percentage Change

MONTHLY	COMPARED TO MARCH		
	2003		
	APR.	MAY.	JUN.
M1	3.9	-2.5	9.9
Currency in Circulation	-2.6	-3.1	11.2
Sight Deposits	11.5	-1.7	8.7
M2	-1.6	0.5	4.6
Time Deposits	-3.3	1.5	3.0
M2X	-4.3	-3.7	3.0
FX Deposits	-6.8	-7.8	1.3
M2XR	-4.8	-4.1	2.8
Repo	-19.3	-19.1	-8.1

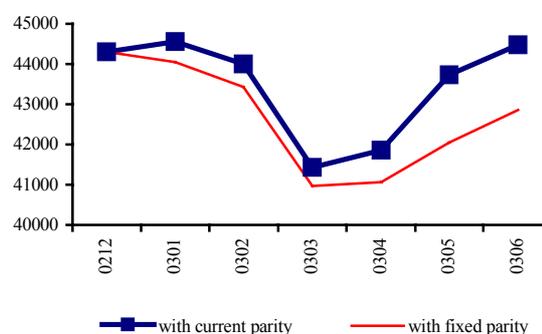
Source: CBRT "Weekly Press Bulletin", the provisional data were used for the last Friday of each month.

With the increasing uncertainties brought on by the war in Iraq in the first quarter of 2003, as a consequence of the rise in the yield of foreign exchange and other

alternative TL denominated investment instruments, the volume of FX deposit accounts decreased to USD 41.4 billion from 44.3 billion and meanwhile, demand for TL, government papers and mutual funds boosted. However, FX deposit account started to increase again upon the termination of the war in Iraq and recovered from USD 41.4 billion to reach 44.5 billion. In this development played an important role the rise in the USD equivalent of Euro-denominated FX deposits (Figure V.2.2.1).

M2XR monetary aggregate, which is calculated by adding the repo transaction that the banks conduct with their customers, contracted by 6.1 percent in real terms in the second quarter of 2003. The decreased in the volume of repo transactions, which had relatively increased prior to the war, and decline in TL equivalent of FX deposit accounts are the main reasons for the decrease in M2XR.

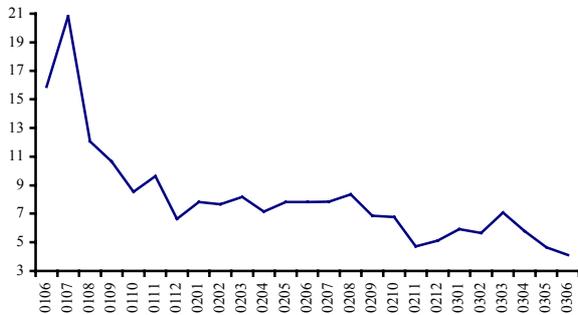
Figure V.2.2.1. Developments in FX Deposits Portfolio (million US Dollar)



When the breakdown of TL-denominated deposits by maturity composition is analyzed, it is observed that compared to the March figures, the share of sight TL deposits in total TL deposits increased by 2 percentage points in June and reached 14.0 percent. Thus, the share of time deposits in all deposits came down to 86 percent.

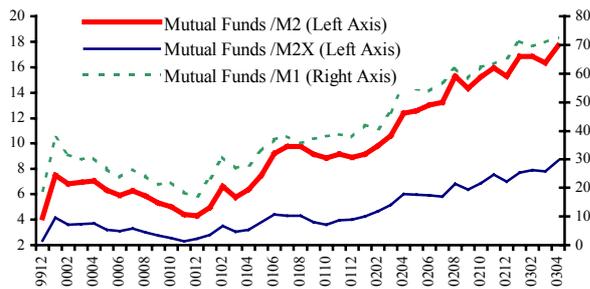
Meanwhile, the share of TL deposits in all deposits increased from 44.4 percent in March to 48.7 percent in June. The ratio of repo transactions to TL deposits, meanwhile, declined from 7.1 percent down to 4.1 percent in the same period (Figure V.2.2.2.).

Figure V.2.2.2. Ratio of Repo Transactions to TL deposits (Percentage)



Source: CBRT “Weekly Press Bulletin”, the provisional data were used for the last Friday of each month.

Figure V.2.2.3. Ratio of Mutual Funds to M1, M2 and M2X Monetary Aggregates

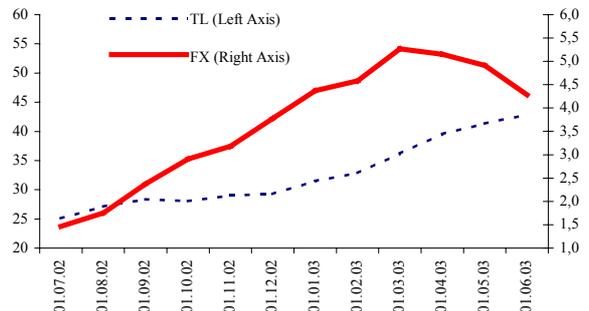


Source: CBRT “Weekly Press Bulletin”, the provisional data were used for the last Friday of each month.

It is observed that the economic agents have been investing overwhelmingly in mutual funds in the last few years and 98 percent of the mentioned funds are comprised of government securities and repo transactions. These investment instruments, the yield ratios of which follow a parallel course to that of time deposits, are deemed as a substitute for M1 due to their high liquidity. Therefore, changes in mutual funds affect developments in money supply. The upward trend in the ratio of A and B type mutual funds to money supply observed since 2001 prevails (Figure V.2.2.3). Ratio of mutual funds to M1 monetary aggregate, which was 65.5 percent by the end of 2002 increased to 70.9 percent in March 2003 and 72.7 percent in April. Meanwhile, the ratio of mutual funds to M2 monetary aggregate increased to reach 17.7 percent and to M2X monetary aggregate to 8.7 percent.

An analysis of the government papers portfolio of residents for the second quarter of 2003 shows that as of the beginning of April, residents have been decreasing the share of FX-denominated investment instruments and increasing that of TL-denominated investment instruments in their entire portfolios due to appreciation of TL. In the mentioned period, the TL-denominated government papers portfolio increased from TL 36.2 quadrillion to TL 42.8 quadrillion. Meanwhile, FX-denominated government papers portfolio decreased from TL 5.3 quadrillion to TL 4.3 quadrillion. Thus, the total government papers portfolio of the non-banking sector increased from TL 41.5 quadrillion to 47.1 quadrillion.

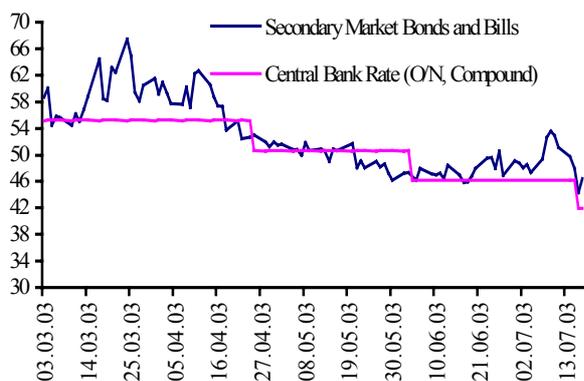
Figure V.2.2.4. Developments in Government Securities Portfolio of the Non-Banking Sector (TL quadrillion)



V.2.3. Developments in Interest Rates

With the termination of the war in Iraq and parallel to the depreciation in exchange rates as of mid-April, interest rates at the secondary market started a downward trend with the additional effect of Central Bank’s interest rate cut-down operation of 25th April. The subject downward trend persisted until mid-June. Meanwhile, it is observed that the interest rate cut-down operation carried out by the Central Bank on June 4 made only a negligible impact on the secondary market interest rates. However, similar to the one carried on the interest rate cut dated 25th April, the interest rate cut dated 16th July brought along a cut-down in secondary market interest rates as well.

Figure V.2.3.1. Interest Rates at ISE Bonds and Bills Outright Purchases and Sales Markets (Weighted Average, compound, percentage)



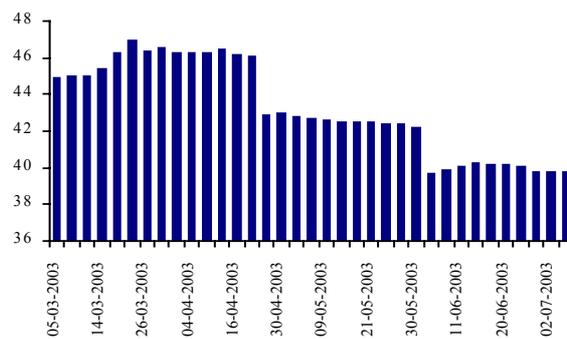
Source: ISE

The compound interest rate at the secondary market declined from 62.9 percent on 11th April to 45.8 percent on 17th June, however, contrary to the trend in exchange rates, started an upward trend as of mid-June. The point to be highlighted here is that transactions at the secondary market were highly concentrated on government papers and average interest rates were affected by the rise in interest rates on government papers. Average interest rates at the secondary market pursued an upward trend from the second half of June until 16th July.

The interest rates at the 4-week maturity TL deposit buying auctions held by the Central Bank is of evidence that the interest rate cut-down operations carried out by the Central Bank made a significant impact on the short-term investment instruments during April-June period. While the simple interest rate at the 4-week maturity TL deposit buying auctions fluctuated within a narrow range between 46 percent and 46.3 percent until the interest rate cut-down operation on 25th April, the interest rates at the mentioned auctions decreased by 3.1 percentage points down to 42.9 percent on 25th April. Simple interest rate at the 4-week maturity TL deposit buying auctions, which gradually marked down to 42.3 percent until 4th June decreased by 2.5 percentage points with the cut-down operation on 4th June. The subject interest rate fluctuated between 39.8-40.3 percent band

during the period from the rest of June until the beginning of July.

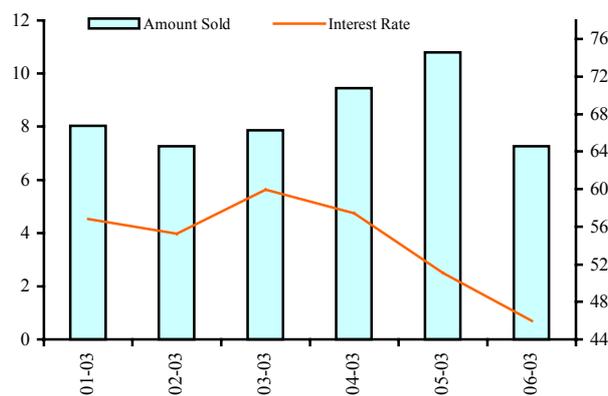
Figure V.2.3.2. Interest Rates at 4-week maturity Deposit Buying Auctions (Simple, percentage)



Source: CBRT

Parallel to the secondary market interest rates, the average compound interest rates at the Treasury auctions displayed a downward trend in April-June period. This trend became more apparent in May and June. However, interest rates at the auctions held in the second half of the month was recorded to be higher than those held in the first half. This trend persisted at the auctions held at the beginning of July and especially interest rate at the long-term government paper auctions increased.

Figure V.2.3.3 Interest Rates at Treasury Auctions (Percentage) and Borrowing Volume (Net, TL quadrillion)*



* Auction rates are the average interest rates of the discounted bond auctions. The borrowing volume includes the discounted bond auctions only.
Source: CBRT

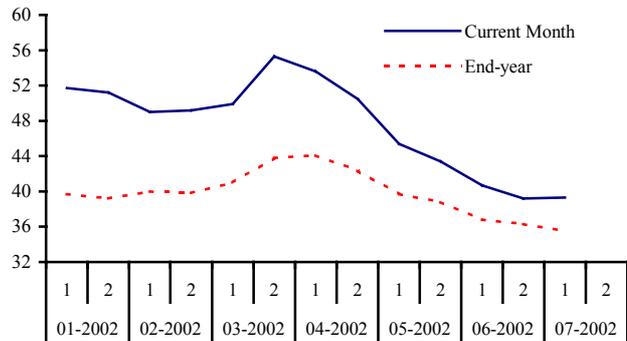
Expected compound interest rates at the three-month Treasury auctions decreased substantially in April-June period. It was observed that this trend became more obvious in May and it was more evidently reflected on the current month's expectations. Consequently, the gap between the expectations for the current month and end-year, which was 9.5 percentage points in the first half of April, came down to 3.8 percentage points in the second half of June. The decline in interest rates in the mentioned period can mostly be attributed to the ease of uncertainties after the termination of war in Iraq. The climb observed in interest rates as of mid-June was reflected on the expectations about current interest rates in the first half of July and made a limited push-up impact on rates. In contrast, the end-year three-month compound interest rate at the Treasury auction declined by 0.8 percent in the first half of July 2003.

Figure V.2.3.4. Developments in Real Interest rates in Treasury Auctions (According to Annual CPI Inflation Expectations, percentage)



When the actual monthly compound rate of interest and developments pertaining to real interest rates calculated by using "CPI expectation over the next 12 months" serial in the CBT Survey of Expectations are analyzed, it is observed that following the ease of uncertainties pertaining to the war in Iraq, the real interest rates have decreased substantially. Within this framework, the real interest rate, which was 30 percent in March dropped down until 20 percent in June (Figure V.2.3.4).

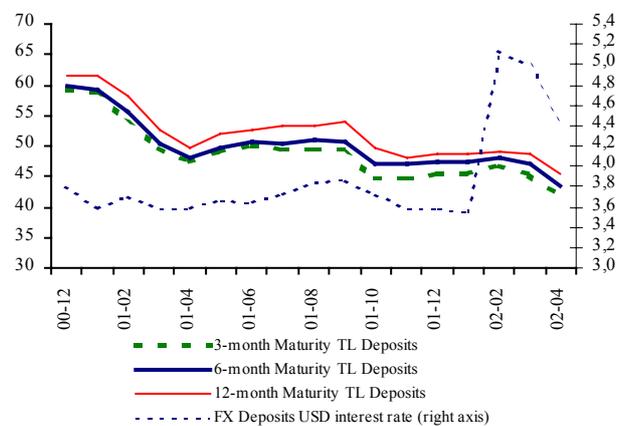
Figure V.2.3.5. Three-month Treasury Auction Interest Rates Expectations (percentage, compound)



Source: CBRT Survey of Expectations

Following the climb in March, the deposit interest rates displayed a decline in April and June. The drop that took place in May right after the interest rate cut-down operation dated April 25, 2003 was quite obvious. In May again, interest rates for TL deposits with 3 and 6-month maturity decreased faster than those with 1 and 12 month maturity. Consequently, interest rate for deposits with three-month maturity decreased from 46.9 percent in March to 41.8 percent in May and interest rate for deposits with 6-month maturity from 48.1 percent to 43.3 percent. Meanwhile, in April-May period, interest rate for FX deposits with 3-month maturity decreased by 0.7 percentage points down to 4.4 percent after the hike in March.

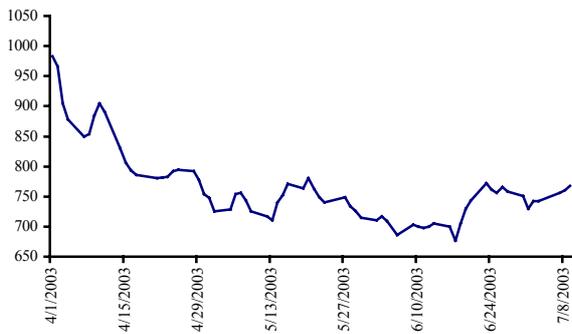
Figure V.2.3.6. Interest Rates for TL and FX deposits (percentage)



Source: CBRT

The difference between the interest rates applicable to Eurobonds and the benchmark securities having the same maturity started to decrease from the beginning of April till mid-June due to the ease of uncertainties pertaining to Iraq war and favorable developments about the economic program and declined from 976 basis points by end-March to 676 basis points on June 17, 2003. However, the yield spread between these two increased towards the end of June and sustained until the beginning of July and finally came down to 768 basis points on 9th July.

Figure V.2.3.7. Yield Spread (basis points, JP Morgan indices)



Source: JP Morgan

V.3. Developments in Exchange Rates

The uncertainties created by the war in Iraq led to high volatility in exchange rates in the first quarter of 2003. With the end of the war and ease of uncertainties, TL started to appreciate rapidly as of the beginning of April and this trend persisted until the end of June. Compared with the end of the first quarter, USD and euro had depreciated against TL by 16.8 percent and 11.4 percent, respectively by the end of the second quarter. In terms of monthly averages, by June USD had depreciated by 6.7 percent compared to the same period last year and euro had appreciated by 14.5 percent against TL. In Q2 2003, expectations for the current month's exchange rates sustained above the actual rates. This is of evidence that the downward trend in exchange rates is faster than expected by the economic agents. Another point to be highlighted here is that the economic agents expect that

the monthly increase in exchange rates would be faster than the first half of the year.

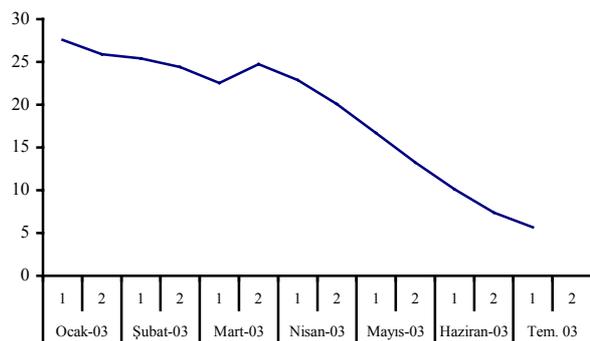
Figure V.3.1. Exchange Rate (TL/USD, Average of buying/selling rates, TL thousand)



Source: CBRT

The faster-than-expected slump in exchange rates mainly stemmed from the increasing demand for TL-denominated investment instruments. The balance of payments data of May indicates that goods and services movements and capital movements in the second quarter have not caused a foreign exchange demand that would affect exchange rates.

Figure V.3.2. Expected Annual Increase in Exchange Rates for 2003 (percentage)*

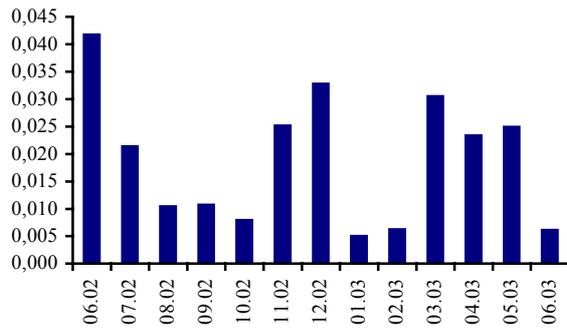


End-year USD-TL parity expectations for each month have been transformed into yearly percentage change figures using the USD-TL parity at end of 2002.
Source: CBRT

The Central Bank intervened in the exchange rates through buying foreign exchange from the markets twice in May and once in June with the aim of dampening excessive volatility stemming not from fundamental economic variables but from temporary conditions. The 1

amount of foreign exchange mopped up through these interventions adds up to USD 1.145 million.

Figure V.3.3. Monthly Exchange Rate Volatility (*)



*The ratio of the monthly standard deviation of the exchange rate to the monthly average exchange rate is used to measure volatility.
Source: CBRT

VI. BALANCE OF PAYMENTS

VI.1. Developments in Foreign Trade

During the first five months of 2003, compared to the same period of the previous year exports increased by 30.1 percent whereas imports grew by 31.3 percent. Consequently, the foreign trade deficit expanded by 34.6 percent, thus, exports to imports declined to 71.7 percent.

Table VI.1.1. Foreign Trade (USD Million)

	May			January - May		
	2002	2003	% Change	2002	2003	% Change
EXPORTS	2984	3827	28.2	13666	17778	30.1
Agriculture	100	124	23.9	739	861	16.5
Fishing	3	1	-65.0	15	20	33.2
Mining	30	39	27.1	141	170	20.4
Manufacturing	2846	3652	28.3	12754	16685	30.8
Other	4	11	182.3	16	42	154.7
IMPORTS	4298	5506	28.1	18869	24784	31.3
Consumption goods	711	914	28.6	2837	3509	23.7
Capital goods	462	613	32.9	1766	2494	41.2
Intermediate goods	3108	3946	27.0	14158	18627	31.6
Crude oil	329	341	3.7	1484	1935	30.4
Other	18	32	77.8	107	153	42.6

Source: SIS

The realizations and the leading indicators during the first five months of 2003 indicate that the recovery in the US and European economies will not begin before the final quarter of the year. Nonetheless, the Turkish lira which appreciated since August 2002 in real terms, depreciated 6.2 percent in average according to the WPI based index in the first quarter of 2003 compared to the same period of the previous year. By the cease of the Iraq operation in the second quarter of the year, Turkish lira appreciated by 3.5 percent compared to the second quarter of 2002. Compared to the previous period, strengthening trend of the Turkish lira accelerated due to declining domestic prices as well as the deteriorating nominal exchange rates in June.

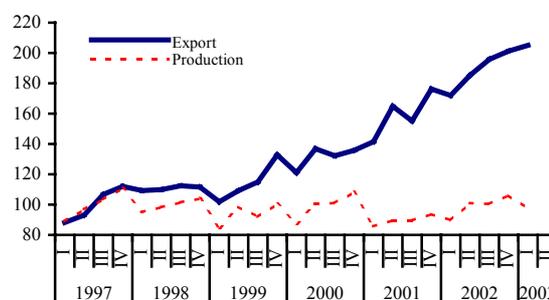
Despite, unit price index has maintained its low level during the first three months of 2003 and real wages of employees per hour at domestic private manufacturing industry increased merely by 0.9 percent. It is thought

that the said developments supported the competitive power abroad.

Besides, domestic demand showed restricted increase according to the growth figures of the first quarter of 2003. Thereby, with the help of flexible and efficient marketing techniques towards increasing the market share, excess production is directed abroad.

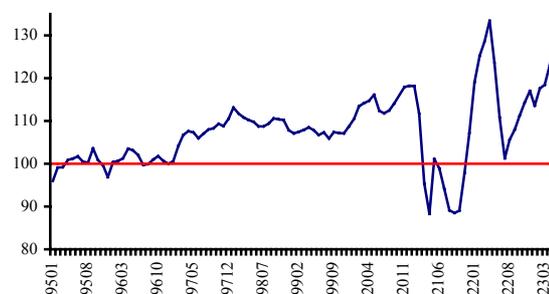
The euro/dollar parity which started to increase since the beginning of 2002 followed the same trend during the second quarter of 2003. In the second quarter of 2003, in average, euro appreciated 5.8 percent against the US dollar compared to the previous quarter. The appreciating trend continued in the second quarter of the year and in June the appreciation rate of euro compared to end 2002 is realized as 14.7 percent in average. As a result, US dollar equivalent of euro denominated exports has increased.

Figure VI.1.1. Manufacturing Export Volume and Production Indices (1997=100)



Source: SIS

Figure VI.1.2. Real Effective Exchange Rate (1995=100)

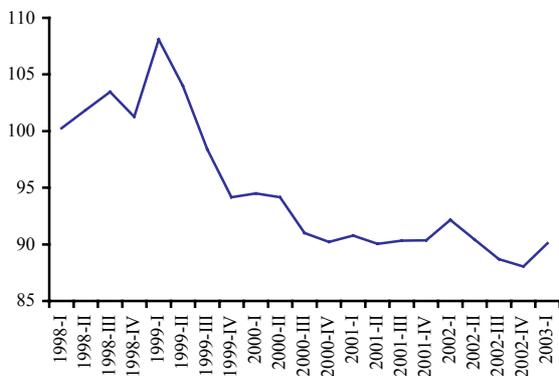


WPI based real effective exchange rates calculated by using IMF weights based on the trade flows of 17 countries from 1988-1990. An increase in index denotes an appreciation of Turkish lira.

Source: CBRT.

In the first quarter of 2003 exports increased by 30.7 percent compared to the same period of the previous year and rose by 29.2 percent during the period of April-May. Exports of agriculture and forestry rose by 16.5 percent in January-May 2003 compared to the same period of the previous year. Exports of manufacturing industry constituted 93.9 percent of total exports during the first five months of 2003 and maintained its upward trend which started since the second half of 2002.

Figure VI.1.3. Terms of Trade (Export Prices/Import Prices)



Source: SIS

Motor vehicles and their parts, knitted articles of apparel and clothing, iron and steel were the highest contributing items to export growth in the period of January-May.

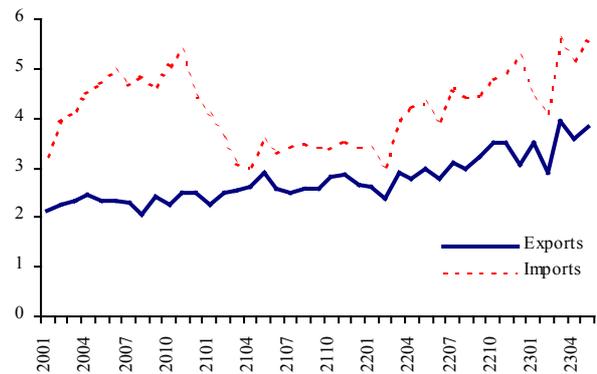
Export prices, which have been in a rising trend since August 2002, decelerated in March and April. Despite, during the first four months of the year export prices increased by 10.7 percent in average compared to the same period of the previous year.

According to the outcome of June 2003 Business Tendency Survey, an increase is observed in the export orders of April-June. However, in May and June trend of export prospects for the next three months turned pessimistic significantly. Similarly, export orders for the next three months also declined considerably.

The records of Exporters Board of Turkey (EBT) indicate that exports increased by 39.1 percent in June compared to the same period of the previous year and reached US dollar 3.8 billion. Exports of vehicles and

subsidiary industries have the highest increase in total exports in June and grew by 72.9 percent compared to the same period of the previous year. Besides, exports of iron and metals other than iron, machinery and equipment also recorded high increase rates.

Figure VII.4. Monthly Exports and Imports (USD Billion)



Source: SIS

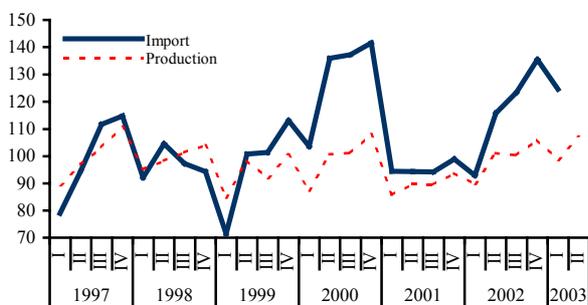
Figure VI.1.5. Export Expectations for the Next Three Months (Percentage) (Optimists minus Pessimists)



Source: CBRT

The real appreciation of the Turkish lira since the second quarter of 2003 is the determining factor on imports in this period. With the effect of recovering private consumption expenditure, the consumption goods imports was the most reactive one to the strengthening process of the Turkish lira.

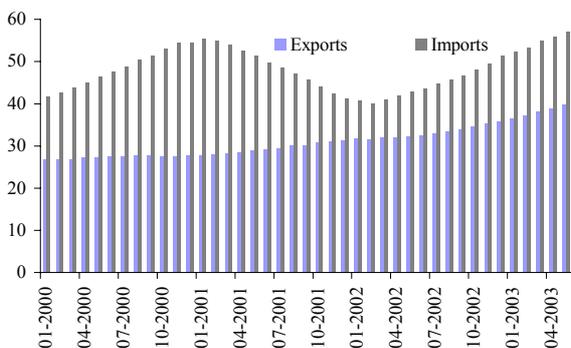
Figure VI.1.6. Manufacturing Industry Import Volume and Production Indices (1997=100)



Source: SIS

The increase in domestic production in the said period led to an upsurge in the imports of intermediary goods (Box VI.1). However, high rate of capacity utilization and the relative slow recovery of domestic demand led to a diminishing rate of increase in production compared to the previous year. Therefore, a similar development is also observed in the growth rate of imports of intermediary goods, however, this effect was weakened by the strengthening trend of the Turkish lira.

Figure VI.1.7. Exports and Import (Annual, USD Billion)

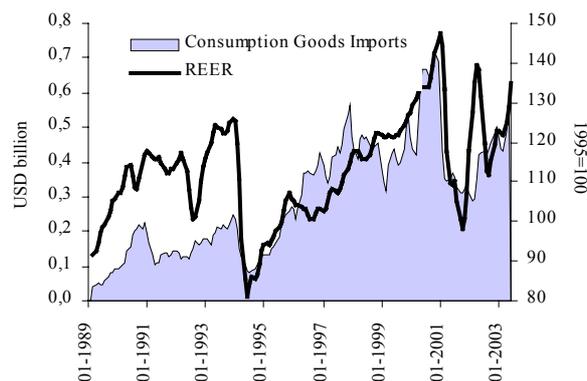


Source: SIS

A similar trend is observed in the imports of capital goods due to the increase in the investment of private sector during the first quarter of the year. According to the figures of Business Tendency Survey of the CBRT, domestic investment expenditure started to increase following the cease of the Iraq operation. The figures regarding imports of capital goods in May also recorded rates of increase supporting the survey results.

Total imports which increased by 36.4 percent in the first quarter of 2003 compared to same period of the previous year, rose by 25.2 percent during April-May.

Figure VI.1.8. Consumption Goods Imports and Real Effective Exchange Rate (3-Month Moving Average)



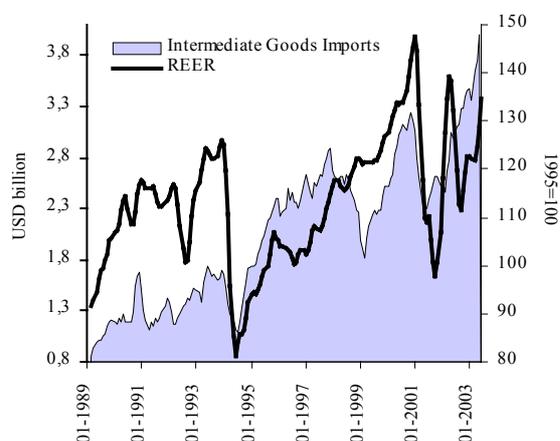
Source: SIS, CBRT

During the January-May period, iron and steel, mineral fuel and oil, boilers, machines, mechanical appliances, motor vehicles and their parts plastics and likes had the most contribution to import growth.

Import prices have, been rising since the beginning of 2002. In the first quarter of 2003 import prices increased by 13.6 percent compared to the same period of the previous year. Increase in import prices of crude oil and natural gas by 40.3 percent significantly contributed to the increase of the general index. Decline in the import prices of crude oil and natural gas by 7.4 percent in April compared to the previous month also led to the fall of general import price index. On the other hand, during the period of January-April, rate of increase in the manufacturing industry import prices is realized as 9.2 percent.

The improvements in investment expenditure and increase in production due to exports as well as the revival of domestic demand indicate that imports will accelerate in the forthcoming period.

Figure VI.1.9. Intermediate Goods Imports and Real Effective Exchange Rate (3-Month Moving Average)



Source: SIS, CBRT

Crude oil prices which rapidly decelerated following the cease of Iraq operation increased by 3.2 percent in average in May compared to the previous month and accelerated by 7.2 percent in June. The unfavorable political situation in the Middle East and uncertainties regarding the exports of crude oil from Iraq in full capacity are considered as the factors which restrict the fall of crude oil prices. Therefore, a significant recovery in the import expenditure of crude oil is not expected in the second half of the year.

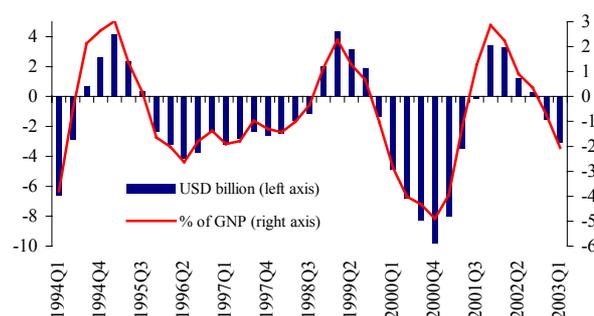
VI.2. Current Account Balance

In line with the accelerating foreign trade deficit, current account has recorded deficit on annual basis since the last quarter of 2002. In the first quarter of 2003, ratio of current account deficit to GNP increased to 2.1 percent on annual basis.

In the first five months of 2003 shuttle trade decreased by 12.3 percent as to the same month of the previous year and realized as US dollar 1.4 billion. On the other hand, tourism revenues decelerated by 16 percent and realized as US dollar 1.8 billion for the mentioned period. During the period of March-May 19.5 percent decline is observed in the number of tourists compared to the same period of the previous year due to Iraq operation. In June, partial recovery of unfavourable effects of Iraq war is

observed and number of tourists increased by 1.9 percent compared to the same month of the previous year. On the other hand, the average expenditure level of tourists maintained its downward trend in the first five months of 2003.

Figure VI.2.1. Current Account Balance (Annual)



Source: CBRT, SIS

During January-May 2003 foreign trade balance recorded a deficit of US dollar 4.2 billion whereas investment income balance had a deficit of US dollar 2.4 billion. Surplus of US dollar 1.8 billion and current transfers of US dollar 1.3 billion led to current account deficit of US dollar 3.5 billion in the mentioned period.

Table VI.2.1. Current Account Balance (USD million)

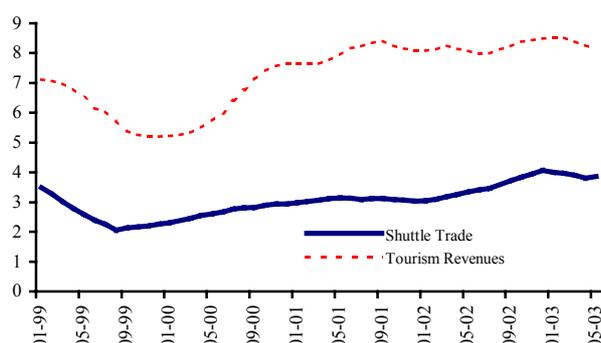
	May		January-May	
	2002	2003	2002	2003
CURRENT ACCOUNT	-293	-578	-1513	-3467
Trade Balance	-759	-1000	-2470	-4171
Exports (fob)	2984	3827	13666	17778
Shuttle Trade	297	359	1600	1403
Imports (cif)	-4298	-5506	-18869	-24784
Services Balance	701	654	1657	1789
Tourism Revenues	759	637	2106	1769
Investment Income Balance	-515	-524	-2069	-2415
Direct Investment Income(net)	-38	-44	-154	-69
Portfolio Investment Income (net)	-63	-85	-389	-651
Other Investment Income (net)	-414	-395	-1526	-1695
Interest Expenditures	-488	-487	-1891	-1972
Current Transfers	280	292	1369	1330
Workers' Remittances	187	202	812	794
Imports with Waiver	72	83	362	379

Source: CBRT.

Due to the declining trend of interest rates abroad, interest income decreased in the first five months of the year compared to the average of the previous year. The portfolio investment expenditure, which is mainly constituted by the interest payments of bond issues of Treasury abroad, increased in the same period due to

increasing bond stocks. On the other hand, total interest payments, more than half of which constitutes of interest payments of general government and Central Bank did not exhibit significant changes in the mentioned period.

Figure VI.2.2. Shuttle Trade and Tourism Revenues (Annual, USD billion)



Source: CBRT

Workers' remittances, which is the largest item of the current transfers, is decelerating since the beginning of 2001. During the first five months of 2003, workers' remittances decreased by 2.2 percent as to the same month of the previous year and realized as US dollar 794 million.

VI.3. Capital and Financial Account

The net capital inflow of US dollar 4.1 billion is observed in the first quarter of 2003. The trend reversed in the period of April-June and net capital outflow of US dollar 921 million is realized.

As of the first quarter of the year, capital inflow is mainly due to increase of FX assets of banks', which is recorded under the item of other investment. FX assets of banks, which show the movements of FX holdings of banks' held in the correspondent banks abroad increased US dollar 4.1 billion in the first quarter of the year. Significant portion of this increase was due to the revised accounts of a private bank's winding up a branch abroad.

Net capital outflow observed in April and May was due to the repayments of syndication credits of banks.

Decreasing trend of FDI continued during the period of January-May 2003. Credits obtained from the associates of foreign capital companies abroad are the determinant item of foreign direct investment in the said period.

Portfolio investment account in which the movements of securities held or issued by residents and non-residents are monitored had a fluctuating course in the first quarter of the year. Portfolio investment, which produced a positive balance in January due to the borrowings of the Treasury from the international markets recorded deficit in February and March owing to the partial removal of government securities from the portfolios of non-residents as well as the principal repayments of bonds issued by the Treasury abroad. The spreads of Turkish bonds traded in the international markets, which accelerated due to the uncertainties created in the domestic and foreign markets by the Iraq operation, were the determinant of capital outflow owing to portfolio movements. Determinant factors in inflow in May were the foreign investors' increasing demand for government securities following the cease of the operation and capital inflow due to bond issuance of the Treasury.

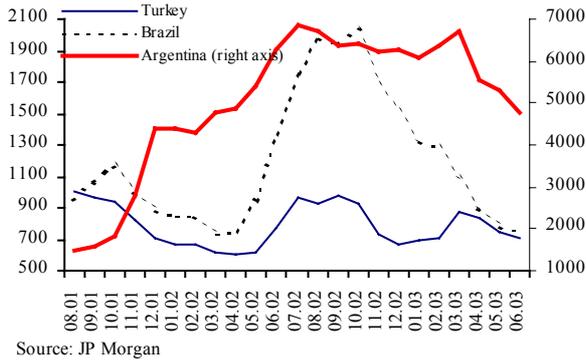
Table VI.3.1. Net Capital Flows by Sectors (USD million)

	January-May		May	
	2002	2003	2002	2003
CAPITAL AND FINANCIAL ACCOUNT	2174	3185	-140	-1010
Direct Investment	376	31	255	31
Portfolio Investment	-171	243	-714	592
Treasury's Bond Issue Abroad	2136	2388	686	750
Other Investment	4618	2963	444	-1000
Currency and Deposits	1336	3764	-1551	-55
Trade Credits	837	534	411	179
Credits	3626	-739	664	-665
Central Bank	-6138	-152	0	-39
IMF Credits	-6138	-152	0	-39
Long-Term	0	0	0	0
Short-Term	0	0	0	0
General Government	9661	-232	-59	-158
IMF Credits	10209	577	0	0
Long-Term	-548	-809	-59	-158
Short-Term	0	0	0	0
Banks	-237	-259	591	-777
Long-Term	-173	-154	11	-13
Short-Term	-64	-105	580	-764
Other Sectors	340	-96	132	309
Long-Term	851	-269	144	267
Short-Term	-511	173	-12	42
Deposits	-396	838	209	-143
Reserve Assets	-2649	-52	763	-633
NET ERRORS AND OMISSIONS	-661	282	433	1588

Source: CBRT.

In June bond issuance of the Treasury in the international markets amounted to US dollar 1.6 billion. Consequently, Treasury obtained US dollar 4 billion from the international markets during the first half of the year.

Figure VI.3.1. Secondary Market Bond Spreads (monthly average)



The high proportional rise in the volume of foreign trade during the first quarter of 2003 led to an increase in the commercial credit drawings. While the volume of foreign trade increased by 33.9 percent as to the same period of the previous year, long and short-term credits grew by 21.4 percent. It is observed that, same trend continued both in April and May. In the forthcoming months, in line with the growth of the volume of foreign trade, utilization of commercial loans abroad is expected to maintain its accelerating trend.

Banks which were the net creditors in the first quarter of 2003 due to the upward trend observed in domestic loan volume and consumer loans, turned out to be net redeemers in April and May owing to the substantial principal repayment of a short-term syndication credit borrowed by one of the commercial banks. It is expected that real increases observed in June and July in domestic credits as well as the consumer loans will rise up the utilization of foreign resources by the banking sector.

Domestic investment trend of companies were weak in the first quarter of the year, when the Iraq operation was effective on the Turkish economy and uncertainties brought by the operation were still existing. In line with these developments long-term credit drawings of the non-banking private sector deteriorated. However, due to the short duration of the operation in Iraq and the recovery of

the industrial production, long-term credit drawings of non-banking private sector amounted to US dollar 849 million. Figures of industrial production and capacity utilization rate as well as the survey results recorded with the real sector delegates indicate increases in the investment expenditures. Consequently it is anticipated that, the financial requirement for import demand of investment goods which is expected to rise will increase the long-term credit drawings of the non-banking private sector.

Figure VI.3.2. Private Sector Long-Term Credit Drawings (quarterly, USD billion)

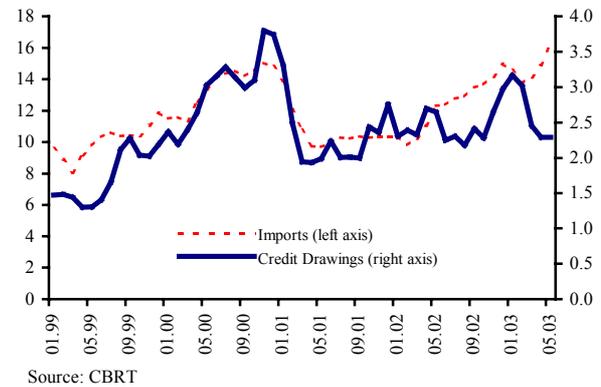
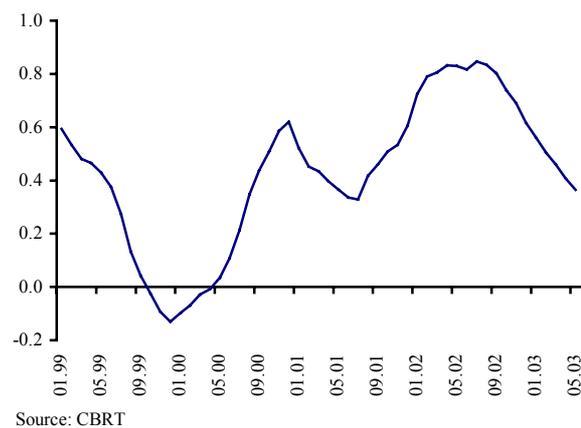


Figure VI.3.3. FX Deposits with the Central Bank (Annual Net Inflow, USD billion)



Deteriorating trend which started during the last quarter of 2002 in the foreign exchange deposit accounts opened at the Central Bank by Turkish workers living abroad as well as the super FX accounts continued in the first quarter of 2003. Moreover, a net outflow is observed in

the long-term accounts in April and May. Besides, Central Bank cut interest rates on the said accounts as of April 28,2003.

FX holdings of the non-resident banks held with the banks in Turkey, which produced a negative balance in 2002, provided positive balance during January-May 2003.

In May and June a total repayment of US dollar 2.7 billion is realized for the principal and interest payments of external debt from the accounts of the Treasury and the Central Bank. With the FX buying auctions Central Bank bought US dollar 340 million in May and US dollar 630 million in June, totaling US dollar 970 million. Moreover, US dollar 2.4 billion is reflected to the reserve accounts of the Central Bank owing to the bond issuance of the Treasury from the international markets in May and June. Due to these developments, reserves of the Central Bank which were US dollar 27 billion at the end of April reached US dollar 28.8 billion as of June 27.

When capital movements are analysed in terms of maturity, contrary to 2002, it is observed that capital inflow during the first five months of 2003 had a short-term structure. During January-May 2003 while US dollar 3.4 billion of short-term capital inflow is realized, US dollar 820 million of long-term capital outflow is observed. Considering 2002 in general, the US dollar 2.4 billion long-term capital inflow and the US dollar 1.2 billion short-term outflow is realized.

When balance of payments is analysed in terms of external financing requirement and financing resources, external financing requirement which is defined as the total of Current Account Balance and Net Errors and Omissions and which was US dollar 2.2 billion in the first five months of 2002 realized as US dollar 3.2 billion for the same period of 2003. In the said period increasing current account deficit and growth in the item of net errors and omissions are mainly covered by decreasing FX assets of banks' held in the correspondent banks abroad as well as increasing deposits. External financing surplus is realized as US dollar 1 billion in May with the contribution of an inflow of US dollar 1.6 billion

observed in the item of net errors and omissions. External financing surplus realized in the said period is basically shifted towards repayments of short-term syndication credits of the banking sector and official reserves.

Compared to end 2002 figures, debt service ratio is increased in the first quarter of 2003 due to rise in the repayments of external debt. Nonetheless, ratio of short-term debt to reserves and ratio of total of short-term debt and medium-long term debt repayments to reserves had a small increase compared to year-end figures.

Table VI.3.2. Foreign Debt Indicators

	2000	2001	2002	2003*
Foreign Debt Stock				
USD	118.7	113.9	131.6	133.2
Ratio to GNP	59.5	80.1	73.1	72.5
Short-Term Foreign Debt Stock				
USD	28.3	16.2	15.2	16.7
Ratio to Reserves	127.6	86.4	56.5	62.7
Medium Long-Term Foreign Debt Stock (USD)				
International Institutions	11.4	22.0	30.9	30.9
Private Creditors	70.3	66.9	76.1	76.5
Commercial Banks	27.3	27.4	29.7	29.0
Short-Term Debt and Medium Long-Term Repayments				
USD	43.5	32.6	30.9	34.4
Ratio to Reserves	196.2	173.5	115.1	129.1
Debt Service Ratio	36.4	41.4	37.2	52.0

Source: CBRT

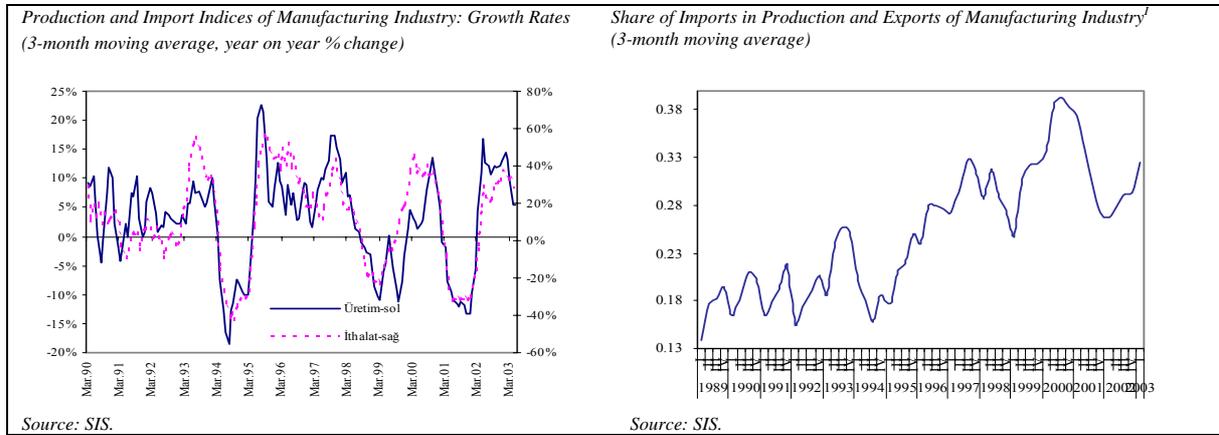
* As of first quarter.

Indicators started to show that the growth target for 2003 would be reached. Particularly growth rate, which was above the expectations in the first quarter of the year and the accelerating trend in industrial production during the first five months of the year, are giving significant signals for reaching the target. Within this framework, it is expected that for the rest of the year imports will maintain the accelerating trend of January-May. Moreover, decelerating trend of crude oil prices due to the removal of the uncertainties brought by the Iraq operation reversed in June owing to political uncertainties constituted in the Middle East. Above-mentioned factors might have unfavourable effects on current account balance in the forthcoming months. However, it is thought that, tourism revenues, which are expected to increase by the beginning of June, may partially compensate the mentioned unfavourable effect.

BOX VI 1. IMPORT DEPENDENCE OF PRODUCTION AND DEMAND

High import dependence of production has a critical role for the sustainability of economic growth. As the mentioned dependence increases, effect of foreign exchange movements on input cost grows. Initially, increase in exchange rate will increase imported input prices and will create pressure on domestic prices. Moreover, in an atmosphere where the foreign exchange rate is determined under the market conditions, difficulty in predicting the changes in exchange rates will again create uncertainty on imported input prices and will effect domestic production decisions. Increase of uncertainty will make production decisions difficult and consequently will reflect on economy negatively. This study aims at introducing the degree of import dependence of exports and production of manufacturing industry in Turkey.

In Turkish economy, there exists a strong relationship between imports of manufacturing industry products and production of manufacturing industry. On the left side of the below graph, parallel course of production of manufacturing industry and import of manufacturing industry can clearly be seen and the correlation coefficient is 0.82 for the identical period. Main reason behind the above-mentioned relation is, almost all imports other than petroleum and petroleum products consist of imports of products of manufacturing industry and approximately three-fourth of this amount is intermediary goods.



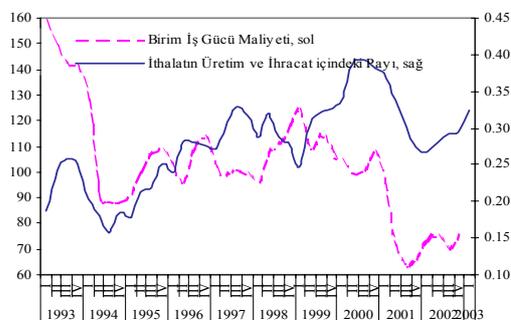
On the right hand side of the above graph, calculation of the share of imports in total production of manufacturing industry and exports is given according to three month moving averages. Accordingly, following the capital liberalization process of 1989 share of imports increased, however imports could not keep the similar accelerating trend during the period of 1990-1992. In 1993, share of imports in production and exports increased rapidly. During the crisis of 1994, imports declined to the level of 1989 and then an accelerating trend started again. Customs Union Agreement which was effective since 1996 increased the share of imports in production and exports. Until the year 2000 no considerable changes are observed in the share of imports excluding the Russian crisis of 1998 and the earthquake catastrophe of 1999. The share of imports in total production and exports which was 19.4 percent in average during the period of 1989-1993 rose to 27.6 percent in the period of 1995-1999.

The share of imports increased heavily due to the implementation of disinflation program in 2000 and the said ratio reached 37.6 percent. Following the crisis of November 2000 and February 2001 serious declines realized in the mentioned ratio and since March 2002 an accelerating trend started again.

It is observed that, excluding external shocks the share of imports in manufacturing industry is quite sensitive to cost elements. In the graph, relation between the said ratio, unit labour cost and real effective exchange rate is observed. As it can be seen on the left hand side of the above graph, in 1993 the unit labour cost inched up remarkably and as can be seen on the right hand side, Turkish lira appreciated according to the WPI. based real effective exchange rate. By the crisis of 1994, unit labour cost decreased by 37.2 percent in a year's time whereas the Turkish lira depreciated by 22.6 percent in real terms. Following the crisis a rapid revival is observed in the unit labour cost as well as the real effective exchange rates. The unit labour costs followed a high level course until the end of 1999, whereas Turkish lira protected its real value.

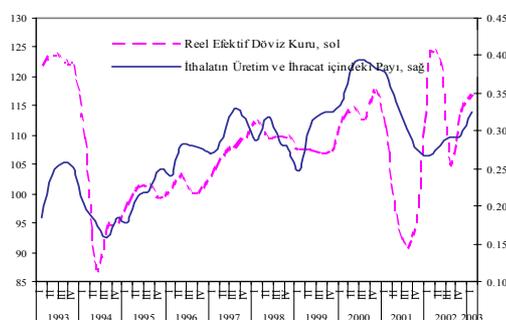
¹ Manufacturing industry is the ratio of imports quantity index to the total of production of manufacturing industry and exports quantity index. Weighted by using the shares of exports/production and imports/production of the year 1997.

Share of Imports in Production and Exports of Manufacturing Industry and Unit Labor Cost



Source: SIS, SPO.

Share of Imports in Production and Exports of Manufacturing Industry and Real Effective Exchange Rate*

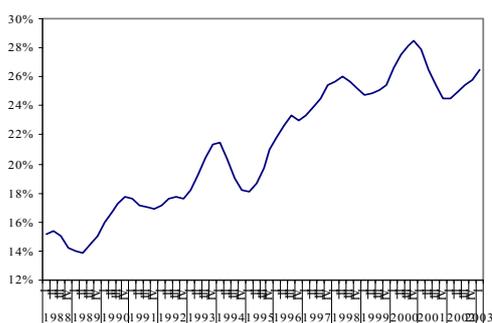


Source: SIS, CBRT.

*Real effective exchange rate index based on the year 1995 is calculated in accordance with the definition used by the IMF. In calculating the **WPI based real effective exchange rate** IMF weights are used for the 17 countries (Germany, USA, Italy, France, UK, Japan, Netherlands, Belgium, Switzerland, Austria, Spain, Canada, Korea, Sweden, Iran, Brazil and Greece). In calculating the weights of the above mentioned countries, data related to tourism and to various goods are used in addition to the foreign trade data of 1988-1990. An increase in the index denotes real appreciation of the Turkish lira.

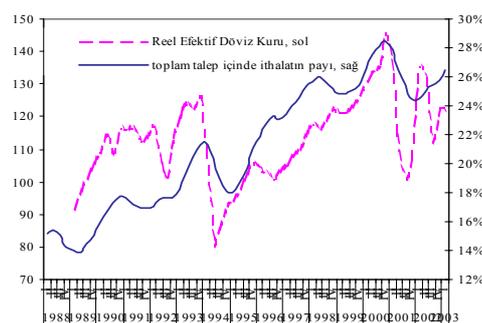
While the unit labour cost was increasing 18.4 percent in average during the period of 1995-1999, Turkish lira gained 10.3 percent strength in real terms. Within the production and exports of sector, share of imports of manufacturing industry increased to 27.6 percent compared to the period of 1989-1993 with a rise of 8.2 points, within the framework of the said trend of real exchange rates and unit prices. Turkish lira gained strength by 9 percent within the framework of the disinflation program of the year 2000. During the same period, despite the deterioration compared to the previous period, unit labour cost maintained its high level. While imports relatively cheapen due to the real appreciation of the Turkish lira as well as the high domestic costs, increase in credit volumes also contributed to the acceleration of imports. Turkish lira which depreciated substantially in nominal terms after the crisis of November 2000 and February 2001, weakened 16.5 percent in real terms in 2001. During the same period, also a decrease of 38.8 percent is observed in unit labour costs. Due to the declining labour costs and real depreciation of exchange rates after the crisis, edging towards domestic inputs is observed and the share of imports of manufacturing industry within the production and exports of manufacturing industry slowed down considerably. Unit labour cost recovered moderately at the beginning of 2002, however could not carry on with this trend. Despite, Turkish lira again started to appreciate in real terms in the same period. Thus, share of imports of manufacturing industry within exports and production of manufacturing industry tended to increase. In summary, it is observed that, the share of imports of manufacturing industry within production and exports increases while the unit labour cost increases and/or foreign exchange rates gain strength in real terms, and decreases on the contrary.

Share of Imports in Aggregate Demand² (annualized, %)



Source: SIS.

Share of Imports in Aggregate Demand and Real Effective Exchange Rate*



Source: SIS, CBRT.

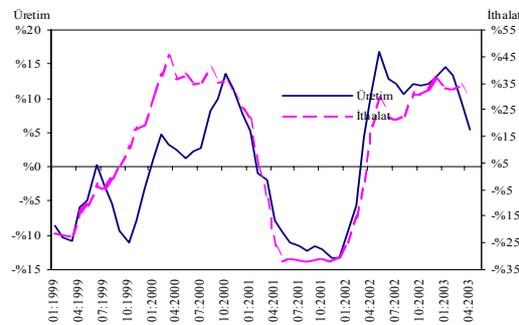
*Real effective exchange rate index based on the year 1995 is calculated in accordance with the definition used by the IMF. In calculating the **CPI based real effective exchange rate** IMF weights are used for the 17 countries (Germany, USA, Italy, France, UK, Japan, Netherlands, Belgium, Switzerland, Austria, Spain, Canada, Korea, Sweden, Iran, Brazil and Greece). In calculating the weights of the above mentioned countries, data related to tourism and to various goods are used in addition to the foreign trade data of 1988-1990. An increase in the index denotes real appreciation of the Turkish lira.

²The ratio of imports of goods and services to the total domestic demand and total exports of goods and services.

When economic activity is analysed from the demand side, it is observed that import demand has a similar structure to production. As can be seen from the left hand side of the above graph, share of imports in total demand during 1989-2002 shows an increasing trend. However, during this period crisis of 1994 and 1998 Russian crisis reversed the said trend temporarily. The share of imports in total demand which had an accelerating rate of increase in 2000, moderately deteriorated following the 2001 crisis.

Above-mentioned developments have close relationship with the real appreciation of the Turkish lira in particular periods, and consequently the relative cheapening of imports. On the right hand side of the above graph, the share of imports in total demand and the development of the CPI based real effective exchange rate are given. According to the graph, Turkish lira gained strength in real terms during 1989 and 1993. The Turkish lira which depreciated 26.5 percent compared to end-1993 as a consequence of 1994 crisis, started a rapid appreciating trend since 1995. Imports relatively cheapened during 1995-1999, owing to the strengthening of the Turkish lira around 34.5 percent in real terms. In fact, due to the accelerating real appreciation of the Turkish lira owing to the disinflation program which was put into practice in 2000, imports turned out to be more attractive and hence rate of increase in the share of imports gained momentum. However, the share of imports decelerated as a consequence of real depreciation of the Turkish lira following the 2001 crisis.

Growth Rates of Intermediate Goods Imports and GNP (annualized, %)



Source: SIS.

Economic growth periods in Turkey is in line with the high increase rate of imports of intermediary goods. In fact, the correlation coefficient between these two variables rather has a high level which is 0,72. On the other hand, according to the results of the Granger causality test it is observed that there is a bidirectional causality between the two variables. As can be seen from the above graph, when economy grew by 6-7 percent imports increased by 20-25 percent, likewise when economy contracted by 7-8 percent imports decreased by 25-30 percent. Mentioned relationship between imports and growth can be interpreted as another indicator of dependence of economy to imports.

As import dependence of economy increases, movements in exchange rates progressively effect production decisions and structure of demand. Imports hold a large place in the production of manufacturing industry of the Turkish economy and increase the external dependence of the mentioned sector. In addition, share of imports increases in total demand in time. When considered from the production side change in exchange rates alters production costs and when considered from the demand side, change in exchange rates creates substitution effect by influencing the relative price of imported good. As a result, in both ways, economy is more sensitive to exchange rate movements as the degree of import dependence increases.

VII. DEVELOPMENTS IN THE WORLD ECONOMY

World economy's gross domestic product (GDP) in the first half of 2003 maintained the level of the second half of previous year. An increase in GDP is expected in the second half of the year 2003. The rise in GDP of industrial countries is also expected to continue to be low from the long-term trend in 2003. The continuity of the perceived revival process has not gained certainty yet. Due to the depreciation of the private domestic demand the growth of the US economy lost haste. In spite of tight trade relations with industrial countries of weak economic activities in general, the performance level of the Asian countries excluding Japan have been one the most significant matters supportive of the world economy.

In relation to the outlook of the economic growth, a revival especially in the investments of the industrial countries bears significance. Depreciation of investments in the said countries or the low level of appreciation is the factor behind the weak revival tendency. Trying to overcome instabilities such as excess capacity or firm's tendency to use external sources intensively will maintain a restrictive role on investments in the short-run.

In spite of the diminishing risks created by the Iraqi war, budget and current account deficits in the US economy has increased the uncertainties in the course of the global economy.

Growth of economic activities in the US economy has been low in the first quarter 2003. Uncertainties pertaining to economic conditions and apprehension regarding the effects of the Iraqi war had a negative impact on the confidence of both the consumer and the business world. As the firms are acting rather cautious on the topic of planning investments, the consumers are reducing their expenditure levels. However, the recently announced indicators denote that the consumer confidence has recovered after the war. As a result of a significant rise lately in the household indebtedness level, interest rates might be subject to a negative shock

affecting the households and their wealth, which might be risky on consumer expenditures.

Due to a continuing budget and current account deficits and the risks of high indebtedness level of the households, contribution of the US economy to the global recovery process is expected to be restrictive in the following period.

Developments in the economic activities of Europe are below expectations. As a result of weak economic activities in most of the European countries problems of public finance origin arise. Negative economic conditions and declining stock prices have lead to the continuation of the pressures subject to the firms of the European economy.

In Japan, the short term outlook regarding the economic growth, low confidence level, unresolved structural difficulties and weak external demand are considered to be much more adverse as to the other regions.

In spite of the global recession export performances of the developing countries are still high. In South Asian countries due to the revival of intra-regional trade and exports to extraterritorial markets being in a better condition than the global economy has maintained high growth rate. However, growth performances of the Latin American countries are much better as to the previous year. Recovery of financial stability in regional countries had an affirmative impact on capital flows. In accordance to the European economies East European countries continued to grow at a much higher rate. However, public deficit and external deficit problems in the said economies continued without a concrete recovery tendency.

United States of America

The annual growth rate of the US economy was 1.4 percent in the first quarter of the year, which maintained the same rate of the previous quarter. According to the sub items, the rise of consumption expenditures as to the previous quarter was a limited increase of 2 percent. Public expenditures maintained the same level in the first

quarter as to the previous quarter while deterioration of investment expenditures is striking. One of the positive developments in the last quarter of 2002 was the high rate of increase in investments to 4.4 percent for the first time after a long period. In the first quarter of 2003 investments as to the previous year was reduced by 0.2 percent. Exports and imports in the first quarter of the year dropped by 1.3 percent and 6.2 percent, respectively. In the last quarter of 2002 exports decreased by 5.8 percent and considering the high rate of increase in imports by 7.4 percent, a recovery of the foreign trade balance is depicted for the first quarter. In relation to the US economy the announced data in the second quarter indicate that a rapid recovery of growth in the second quarter is difficult. For expansionary purposes in March, the decline in the manufacturing industry expansion index to 46.2 from the threshold value level of 50 has reached 49.8 as of June. Sectors other than the manufacturing industry seem to be relatively in a better condition. The negative progress of the manufacturing industry has been reflected on the employment data. Non-agricultural employment, in connection to the sub-items of the manufacturing industry, dropped constantly in the second quarter. In connection to these developments the unemployment rate, which was 5.8 percent at the end of the first quarter, increased to 6.4 percent by the end of the second quarter. On the other hand, consumer confidence following the termination of the Iraqi war rapidly recovered, thus had a positive impact on consumer expenditures. However, in an economy where household indebtedness increase as a result of low interest rates, strong contribution of consumer demand to the recovery process is unlikely in the following period. As the recovery process of the indicators regarding the economy was highly fragile and there were no risks in relation to inflation, in fact deflationary concerns were considered in the US economy, the FED on June 25, 2003 dropped the interest rates an extra 25 basis points and determined the rate as 1 percent. Since the interest rates have been following a low track for a long time, the effects of the recent decision of FED to decrease the rates on growth is uncertain. The current account problem in the US has been increasingly continuing in the first half of 2003. Depreciation of the dollar against the euro is expected to

have a positive impact on the problem. However, the high current account deficits in the remaining of the year are expected to restrict the potential of the US for having a positive impact on global growth.

Europe

The revival tendency in the Euro zone remained weak in 2002, which followed the recession tendency in 2001 relatively a little later than the world economy. GDP growth of the Euro zone in the last quarter of 2002 dropped 0.1 percent and increased in the same rate in the first quarter of 2003.

Table VII.1. World GDP Growth Rates (Annual Percentage Change)

	2001	2002	2003	2004
			(Forecast)	(Forecast)
World	2.3	3.0	3.2	4.1
Developed Countries	0.9	1.8	1.9	2.9
U.S.A.	0.3	2.4	2.2	3.6
Canada	1.5	3.4	2.8	3.2
Euro Area	1.4	0.8	1.1	2.3
Germany	0.6	0.2	0.5	1.9
France	1.8	1.2	1.2	2.4
Italy	1.8	0.4	1.1	2.3
U.K.	2.0	1.6	2.0	2.5
Japan	0.4	0.3	0.8	1.0
Developing Countries	3.9	4.6	5.0	5.8
Developing Asian Countries	5.7	6.3	6.0	6.3
Newly Industrialized Asian Countries*	0.8	4.6	4.1	4.5
ASEAN-4**	2.6	4.3	3.9	4.3
China	7.3	8.0	7.5	7.5
India	4.2	4.9	5.1	5.9
Developing Countries in America	0.6	-0.1	1.5	4.2
Argentina	-4.4	-11.0	3.0	4.5
Brazil	1.4	1.5	2.8	3.5
Chile	2.8	2.0	3.1	4.8
Mexico	-0.3	0.9	2.3	3.7
EU members	—	3.9	3.9	4.5
Turkey	-7.5	6.7	5.1	5.0
Czech Republic	3.1	2.0	1.9	3.3
Hungary	3.8	3.3	3.6	3.9
Poland	1.0	1.3	2.6	4.1
Bulgaria	4.0	4.0	5.0	5.5
Romania	5.7	4.9	4.9	5.0
CIS	6.4	4.8	4.4	3.9
Russia	5.0	4.3	4.0	3.5
Africa	3.6	3.4	3.9	5.2
Middle East	4.0	3.9	5.1	4.8

* Newly Industrialized Asian economies are Hong Kong, Korea, Singapore and Taiwan.

** ASEAN-4 includes Indonesia, Malaysia, the Philippines and Thailand.

Source: IMF, World Economic Outlook, April 2003. In the recovery process during the decade of the '90's (1993, 1996 and 1998), foreign demand at first has been the effective demand factor in revival, however, this wasn't point at issue in 2002. The increasing exports demand and profit

expectations during these years lead to a positive turn. Exports, which increased 1.2 percent in 2002, has been flat since the last quarter of 2002 due to the recession in the world trade balance and the appreciation of the euro against the dollar.

In spite of the low rated deterioration in the first quarter of 2002 consumer expenditures for the year in general increased by 0.6 percent and increased by 0.4 percent in the first quarter of 2003 as to the previous quarter. In general, due to the negative developments of real spendable income, low increasing rate of wages, high unemployment rate and rigidity of inflation, the decline in the purchasing power has been a restricting factor on the increase of consumption.

Furthermore, in spite of some discrepancies among countries, the rise in consumption has been less than the increase in real income. For such a conclusion it is considered that the increase in real income of other households is characterized as temporary. For example, the high rated increase of real incomes in Switzerland to a large extent is a result of reduced income tax rates and of a significant amount of decline in the paid taxes for capital gains, thus the increase in real income is considered to be temporary. The second reason would be that households, in accordance to the net results of the two different wealth effects of 2002, would be adjusting the expenditures. In countries such as Britain, Holland, Spain in 2002 according to the net results of the wealth effect created by the rise in housing prices and deterioration of real interest rates and the wealth effect created by the high rated decrease in stock prices, a net wealth effect differentiating among countries has occurred. Finally, adverse developments in consumer confidence have affected the consumption plans of France and Italy. The concerns regarding probable developments of unemployment and retirement reforms in the following period, clarifies the increased saving rates during the economic recession tendency period.

In the Euro zone contribution of stock changes on the growth of GDP till the end of 2002 was negative consecutively for seven quarters. In the first quarter of 2003 stock changes, with the revival effects of consumer

expenditures, had a positive impact on growth. Fixed capital investments till the second quarter of 2002 deteriorated for 6 consecutive quarters and risen in low rates for the remainder of the year. Weak demand, low labor force productivity, increase in input prices primarily of crude oil and low rated increase in producer prices have restricted profit margins and investment expenditures. Furthermore, negative impact of the Iraqi war over consumer and manufacturers confidence has led investments in the first quarter of 2003 to deteriorate by 1.2 percent as to the previous quarter.

Figure VII.1. Euro/Dollar Parity



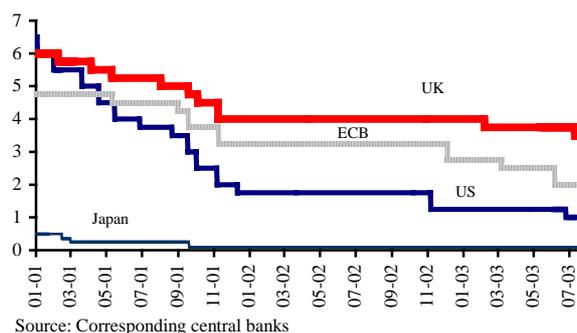
In light of these developments, the most significant contribution to growth of the economy of the Euro zone is expected from consumer expenditures in 2003. It is presumed that the contribution of net exports in 2003 will be negative. According to the estimations of the European Commission and the OECD the growth rate of GDP in the Euro zone is expected to be 1 percent in 2003.

The European Central Bank dropped the interest rates half basis points on June 6, 2003, decreasing the reference interest rate to 2 percent.

The UK economy was less affected of the recession experienced in the world economy as to the other European countries. Due to the depreciation of the negative impact of the implemented expansionary fiscal policies and net exports on growth and in spite of the deceleration in consumption, growth is expected to

continue in 2003. In line with the revival of investments and exports, production deficit is expected to be offset by 2004 and the inflation rate to drop to the official target.

Figure VII.2. Main Central Bank Interest Rates (Percentage)



Source: Corresponding central banks

Table VII.2. CPI Inflation for Selected Country Groups (Annual Percentage Change)

	2001	2002	2003 (Forecast)	2004 (Forecast)
Developed Countries	2.2	1.5	1.9	1.7
U.S.A.	2.8	1.6	2.3	2.3
Canada	2.5	2.0	3.1	2.1
Euro Area	2.6	2.3	2.0	1.5
Germany	2.4	1.3	1.0	0.7
France	1.8	1.9	2.0	1.6
Italy	2.7	2.6	2.4	1.6
U.K.	2.1	2.2	2.8	2.7
Japan	-0.7	-0.9	-0.7	-0.6
Developing Countries	5.8	5.4	5.8	5.1
Developing Asian Countries	2.6	1.8	2.3	3.1
Newly Industrialized				
Asian Countries*	1.9	1.0	1.8	1.9
ASEAN-4**	6.6	5.9	5.3	4.9
China	0.7	-0.8	0.2	1.5
India	3.8	4.3	4.1	5.5
Developing Countries in America	6.4	8.7	11.0	6.9
Argentina	-1.1	25.9	22.3	13.0
Brazil	6.8	8.4	14.0	5.5
Chile	3.6	2.5	3.3	2.9
Mexico	6.4	5.0	4.3	3.3
EU candidates***	9.8	5.7	4.7	4.7
Turkey	54.4	45.0	24.7	14.5
Czech Republic	4.7	1.8	1.1	3.0
Hungary	9.2	5.3	5.3	4.8
Poland	5.5	1.9	1.1	2.4
Bulgaria	7.5	5.8	3.0	4.1
Romania	34.5	22.5	16.2	11.6
CIS	20.4	14.5	12.3	9.1
Russia	20.7	16.0	13.4	9.7
Africa	13.0	9.3	10.1	7.6
Middle East	8.1	9.2	9.7	9.1

* Newly Industrialized Asian economies are Hong Kong, Korea, Singapore and Taiwan.

** ASEAN-4 includes Indonesia, Malaysia, the Philippines and Thailand.

*** Excluding Turkey.

Source: IMF, World Economic Outlook, April 2003.

In the first quarter of the year the growth rate of GDP in UK was below the expected rate with 0.2 percent. Both the use of labor force and of capital in this period were below normal and the average working hour dropped. Total final demand, with the support of consumption and public expenditures, was just a little above the long term trend till the end of 2002. However, the growth rate of consumption expenditures in the first quarter of 2003 has significantly decelerated. Fixed capital investments led a flat course in 2002. The current low business world confidence sustains the probability that revival in investments can only be progressive. The growth rate of the net exports of UK in the last quarter of 2002 has significantly deteriorated and proceeded weak in the first quarter of 2003.

The inflation rate is above the targeted rate of 2.5 percent. However, the Bank of England announced that this is a result of temporary factors and expect these factors lose impact in the following months. The wage increase in general remained low in the first half of the 2003. Depreciation of the British pound since the beginning of the year is expected to support growth. However, the depreciation tendency of the pound has turned converse in the past couple of weeks, thus inflationary effect expected in the following periods has been weak. In light of these development and with the probable continuation of the decrease of economic activities in the near future, the Bank of England dropped the repo interest rate from 3.75 percent to 3.5 percent on July 10, 2003.

Japan

The revival tendency of the Japanese economy occurring in the beginning of the year 2002 has lost speed in the second half of the year with the deceleration of the growth rate of exports. Deceleration of exports has brought a similar deceleration in industrial production and unemployment has reached record high levels. However, domestic private sector demand has prevented the economy of the country to return to the recession process again. Due to the decreasing tendency of real wages households reduced the savings rates in order to maintain consumption expenditures.

Real exports of Japan have deteriorated 0.8 percent in the first quarter of 2003 as to the previous quarter and 0.3 percent in April. The deterioration in the first quarter is a result of a significant reduction of exports to a large extent to the US. Real imports increased 0.2 percent in the first quarter of the year as to the previous quarter and maintained the same level in April as to the previous quarter. Due to the uncertainties generated by the Iraqi war and the termination of crude oil imports for the purpose of stock accumulation in April, imports of intermediate goods were declining while imports of information technology goods continued to rise.

Private sector's fixed capital investments began to recover as a reflection of the increase in company profits. According to the calculations of the national income in the first quarter of 2003 investments had increased for the fourth consecutive quarters. Machine orders being the leading indicator of fixed capital investments of the private sector showed a revival tendency in the first quarter of the year. However, showed a declining tendency in April. Similarly, the company profit rates showing a high increasing rate in the last quarter of 2002, dropped in the first quarter of 2003 in line with the decelerating exports revenue.

Private consumption expenditures, on account of the negative developments of unemployment and income level, still maintain the weak development. Sales in department stores and super markets dropped in April, while sales of electrical appliances maintained the increasing trend. Consumer confidence's progression is rather weak in general in spite of a recovery in May as to the previous month.

Industrial production increased 0.4 percent in the last quarter of the past year and 0.3 percent in the first quarter of 2003 then deteriorated 1.6 percent in April as to the first quarter. However, according to the estimations of the months of May and June the increasing rate of the industrial production is expected to be 0.4 percent in the second quarter of the year. Stock level after rapidly deterioration in the first half of 2002 has continued to deteriorate at a lower rate.

Table VII.3. Current Account Balance for Selected Country Groups (Percent of GDP)

	2001	2002	2003 (Forecast)	2004 (Forecast)
Developed Countries	-0,8	-0,8	-1,0	-0,9
USA	-3,9	-4,8	-5,3	-5,1
Canada	2,8	1,5	1,6	2,0
Euro Area*	-0,2	0,9	0,9	0,9
Germany	0,2	2,5	2,6	2,6
France	1,8	2,1	2,1	1,9
Italy	—	-0,6	—	0,3
UK	-1,7	-1,9	-2,0	-2,3
Japan	2,1	2,8	2,7	3,0
Developing Countries	0,6	1,0	1,3	0,3
Developing Asian Countries	2,8	3,5	2,7	2,3
Newly Industrialized Asian Countries**	5,8	7,0	6,2	6,1
ASEAN-4***	5,0	5,3	3,1	2,7
China	1,5	1,9	1,4	1,1
India	—	0,9	0,5	0,2
Developing Countries in America	-2,8	-1,0	-1,1	-1,6
Argentina	-1,7	8,3	7,8	6,7
Brazil	-4,6	-1,7	-1,5	-2,3
Chile	-1,8	-0,9	-1,5	-1,1
Mexico	-2,9	-2,2	-2,2	-3,1
EU candidates	-2,8	-3,3	-3,6	-3,4
Turkey	2,3	-1,0	-1,8	-1,1
Czech Republic	-5,7	-5,3	-5,8	-5,3
Hungary	-3,4	-4,1	-4,8	-4,6
Poland	-3,9	-3,5	-3,7	-4,0
Bulgaria	-6,2	-3,4	-5,5	-4,6
Romania	-6,0	-3,4	-4,5	-4,5
CIS	7,7	6,9	7,6	4,4
Russia	10,5	8,8	10,1	6,3
Africa	-0,1	-1,8	-0,5	-0,9
Middle East	7,3	4,9	9,0	4,2

* Adjusted for intra-region trade.

** Newly Industrialized Asian economies are Hong Kong, Korea, Singapore and Taiwan.

*** ASEAN-4 includes Indonesia, Malaysia, the Philippines and Thailand.

Source: IMF, World Economic Outlook, April 2003.

The growth rate of GDP for Japan was 0.1 percent in the first quarter of 2003 as to the previous quarter, and according to the OECD predictions a growth rate of 1 percent is expected for the whole year of 2003. The probable strengthening of the perpetuating deflation problem, continuation of the fragility in the financial system and the increase in the public debt stocks are the primary risks that can draw down the growth prediction.

Asia

The Asian economies in the first quarter of 2003 maintained their high growth rates. Vigorous intra-regional trade is one of the significant factors behind the fact that the growth rates of the said economies proceed above the world average. As the effects of SARS on the economy are not totally reflected on the data and the

illness is shortly taken under control, thus the effects on regional economies are expected to be just as well restricted. The growth rate of the Chinese economy was 9.9 percent in the first quarter of the year. As the increase in retail sales decelerated in April and May, while exports and industrial production during the same months maintained its strength of the first quarter is an indication that there won't be a dramatic drop in the growth performance during the second quarter. The growth rate of South Korea, one of the important economies of the region, has lost a significant amount of impetus and was at 3.7 percent in the first quarter of 2003 as to the last quarter of 2002. In an economy where export increase has been 21 percent in the first quarter and 15 percent in the second quarter and depending on the deterioration of the domestic demand, the growth performance has declined.

Latin America

The tightening economies of Latin America in 2002 exhibited a more positive economic outlook in the first half of 2003 as to the previous year. Higher growth rates in the region as to the previous year and the gained stability of the national currencies had a positive impact on the inflation rates.

The growth rate of Argentina in the first quarter was 5.4 percent. The increase in industrial production by 12.6 percent and 12.2 percent in April and May, respectively, has been an indication that the growth performance has been maintained in the second quarter. The inflation rate continued to deteriorate in the second quarter as well and was 14.3 percent in May. The economic management in Argentina is expected to sign an agreement with the IMF for three-year duration in the near future. The Brazilian economy with a 2 percent growth in the first quarter of 2003 is displaying a weak revival process. The increase in exports and decrease in imports played an important role in attaining positive growth in spite of tightening of consumer and investor spending in the first quarter. The inflation rates in Brazil proceeding higher than the targeted level for end of year, lately has deteriorated depending on the national currency gaining stability. The Central Bank of Brazil, taking into consideration the

fragility in the recovery process and the declining tendency of the inflation rate, decreased overnight interests 50 basis points.

Russia

In the first quarter of 2003 the inflation rate in the Russian economy has deteriorated, goods and services production has accelerated and fixed capital investments increased. Strong balance of payments position and relative stability in the financial markets led the ruble to gain nominal strength against the US dollar.

The rising crude oil prices due to the Iraqi war, has accelerated the growth in the Russian economy in the last quarter of 2002 and in the beginning of 2003. Primarily high increasing rates in retail sales and industrial production in the first quarter of the year and other indicators as well support the rising economic activities. In spite of the consumer price-increasing rate deteriorating below 15 percent on annual basis in April, the inflation rate is above the target level for 2003.

Exports of Russia increased by 41 percent reaching US \$30.4 billion in the first quarter of the year as to the same period of the past year. The rise in the energy group of exports constitutes approximately $\frac{3}{4}$ of the increase in total exports. Increase in crude oil prices in the first quarter of the year has led to a significant amount of increase in export revenues. In the same period Russia's imports increased by 23.6 percent reaching US \$15.3 billion.

The Russian firms in line with the rise in domestic goods and services production began to increase investment spending. Consequently, fixed capital investments increased by 10.6 percent in the first quarter of the year as to the same period of the past year. Positive development in fixed capital investments has been reflected to the construction investments. In the construction sector the contractor services increased by 13.6 percent in the first quarter of the year as to the same period of the past year.

According to the OECD estimates a growth rate of 5 percent is expected for the Russian economy in 2003.

Eastern Europe

East European economies recorded a higher growth rate than the Euro zone economies in the first quarter of 2003 as well. On the other hand, public and external deficit problems in regional economies unable of providing a concrete recovery tendency carry it to year 2003.

The growth rate of the Czech Republic was 2.2 percent in the first quarter of the year. In spite of the strong koruna and the stagnation in the Euro zone, as of the first half of the year 2003, a recovery is noticed in the foreign trade balance. The appreciation of the national currency till the first half of 2002 has generated the inflation rate to drop.

The growth rate of the Hungarian economy was 2.7 percent in the first quarter of 2003. High public sector deficit being one of the most significant economic problems of 2002 will resume in 2003. Another significant problem regarding the economy is external deficits, which has not revealed a development towards recovery, despite the depreciation of the national currency since the beginning of the year 2003.

The growth rate of the Polish economy was 2.2 percent in the first quarter of 2003. The inflation rates proceed highly below the targeted level. Budget deficits and current account deficit problems of 2002 are major risks regarding the economy in 2003 as well.

International Goods Prices

International goods prices were in a rising tendency since the beginning of 2002, however a significant change was not recorded in the prices in terms of annual averages. Two of the sub-items of industrial input prices performed as follows, agricultural raw material prices increased 1.6 percent on an annual average basis in 2002, while metal prices on the average retreated 3.7 percent. In the first six month period of 2003 industrial input prices as to the same period of the past year increased by 6.4 percent on the average, while energy prices increased by 25.2 percent. The high increasing rate of the world crude oil

prices in this period has been a determining factor on energy prices.

After the Iraqi war crude oil prices began to retreat in the international markets. In April, Brent oil price per barrel on the average deteriorated by 18.3 percent as to the previous month. Crude oil prices in international markets increased in May as a result of the oil refinery activities reaching a very high level in US refineries, the maintenance process of the North Sea oil wells, the political tension in the Middle East and the depreciation of the dollar. Following a 3.2 percent increase, Brent oil per barrel reached on the average US \$25.7. The decline in OPEC production, slow crude oil production in Iraq, apprehension for the continuation of the supply deficiency due to the strike in Nigeria and the political developments in the Middle East led to rise of the crude oil prices in June as well. Brent oil increased 7.2 percent reaching US \$27.52 per barrel in June as to the previous month.

Table VII.4. International Commodity Prices (annual percentage change)

(1995=100)	2002	2003Q1	2003Q2
Industrial Inputs Index	-0.91	8.13	4.73
Agricultural Raw Materials Index	1.59	12.94	6.53
Metals Index	-2.74	4.79	3.40
Energy Index: Crude Oil, Natural Gas, Coal	-0.24	46.63	7.19
Average Crude Price	2.79	49.63	4.99
Aluminum	-6.61	0.96	1.83
Copper	-1.26	6.65	1.86
Cotton	-3.62	37.42	41.91
Lead	-5.06	-6.69	0.34
Olive Oil	8.74	21.24	28.13
Rubber	28.12	50.10	29.47

Source: IMF.

VIII. EVALUATION OF FUTURE DEVELOPMENTS

In this section, under the light of the data announced as of the second week of July and the developments during this period, expectations for the second half of 2003 are analyzed in relation to inflation target. Furthermore, risks causing diversions from the 2003 year end CPI target are evaluated.

VIII.1. External Economic Developments

The short-lived Iraq War lifted the uncertainty in international markets, oil prices decreased and a relative stability has been attained in financial markets. However, stagnation in economic activities is still prevailing.

Projections for the second half of the year points to a growth rate below long term trends in industrialized countries for the overall year of 2003. Despite the favorable outlook of the consumer and investor sentiment, the expansionary policies failed to suffice. Stagnation prevailing since the second quarter of 2002 is expected to recover only gradually by the end of 2003.

As opposed to the stagnation in developed countries, the relatively better growth performance in developing countries is expected to be maintained in the second half of the year. However, especially in Eastern European Countries public sector deficits and external deficits constitute a negative risk factor on growth performance.

VIII.2. Domestic Demand-Supply Equilibrium

GNP and GDP have grown by 7.4 percent and 8.1 percent respectively during the first quarter of 2003. Uncertainty created by the Iraq War caused domestic demand to be postponed. Nonetheless, the increasing industrial production during this period led to a rise in exports and inventories. Furthermore, the relatively low level of growth rate during the same period of 2002 created a base level effect.

The economic growth is expected to continue during the rest of 2003. However, the growth rate is expected to

slowdown. The decline of agricultural production at odd years is an important factor in this slowdown. Furthermore, the removal of the base effect as of March and the slowdown in industrial growth in the following months have been effective in this projection.

Demand recovery during the first quarter of 2003 has been limited and the increase in final domestic demand has been below GDP growth. The Expectations Survey and Business Tendency Survey, conducted and published by the Central Bank, show that upon the disappearance of uncertainties, which existed during the first half of 2003 rapidly developed positive expectations in the second quarter. In other words, the stable recovery in demand since the second quarter of 2002 is expected to continue further strengthening in this period. As a matter of fact, rapid decline in finished goods inventories in the second quarter of the year supports the domestic demand recovery.

However, as the data for the first quarter of 2003 are examined, it is denoted that the increase in private consumption expenditures is directed to durables and services, where as foodstuff and semi-durable expenditures increased slightly. Therefore, it is considered that the domestic demand recovery is not reflected to all consumer groups and is still at a low level. In the mean time, despite a slowdown, the decline in the real wages continued during the first quarter of the year. Moreover, the unemployment rate maintained at high levels. Despite the expectations of a rise in real wages and employment in line with the economic growth, the abovementioned factors are expected to limit the domestic demand during the rest of 2003.

The imports data for the first five months of the year show that the imports for consumer goods have increased by 41.2 percent compared to the same period of the previous year. Under the light of mentioned projections in addition to the disappearance of uncertainties during the first quarter of 2003, it is envisioned that the recovery in consumption expenditures will be much more significant during the rest of the year relative to the first quarter. The rapid increase in consumer credits and credit cards balances supports this trend.

Due to the rapid increase in machinery and equipment investments, private investment expenditures recorded a high increase as much as 20.4 percent during the first quarter of 2003 as to the same period of the previous year. In the mean time, the increasing trend in the capacity utilization in manufacturing industry since March 2002 accelerated during May and June 2003. In light of these developments, high growth rates in private investment expenditures are expected to continue during the following period.

As the growth in industrial production has supported the increase in exports during the first five months of the year, the growth in industrial production has led to an increase in imports of intermediate goods and capital goods. The above-mentioned trend is expected to continue during the rest of the year.

To summarize, in light of the data, expectations and the projections, it is envisaged that the economic growth of the past four quarters will continue despite some slowdown during the rest of 2003 and the current account deficit will expand significantly compared to the previous year. As the uncertainties of the first quarter of the year vanished and financial stability is restored, the limited recovery in the domestic final demand is expected to become relatively evident in the following period. It is anticipated that industrial production will continue to grow in line with the economic growth by favorably affecting employment and real wages.

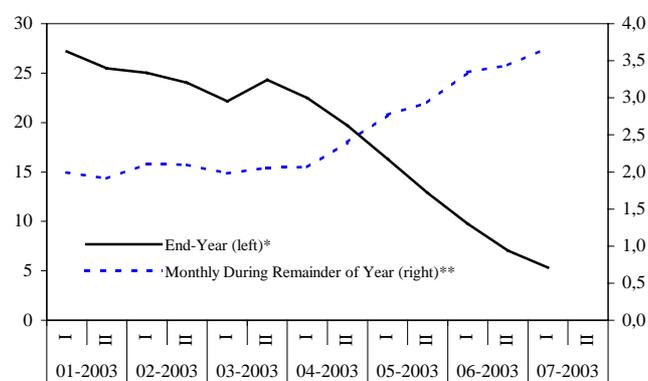
VIII.3. Cost Factors

Exchange Rates

After the end of the Iraq War, nominal exchange rates started to decline rapidly. The relatively high yields on Turkish Lira denominated investment instruments and the decreased uncertainties regarding the effects of the war on the economy have accelerated the reverse currency substitution caused exchange rates to decrease. These developments affected the exchange rate expectations and have also the year-end exchange rate expectations declined throughout the period.

Decline in exchange rates during the second quarter limited the price increases in sectors such as petroleum products, which is sensitive to the changes in the exchange rates. For example, oil prices, which are bound to exchange rate changes through automatic pricing mechanism, declined in the second quarter with respect to first quarter. Furthermore, the decline in exchange rates also limited the price increase in tradable goods.

Figure VIII.3.1. Expectations for Turkish Lira's Depreciation Rate vis-a-vis US Dollar in 2003 (percentage)



Source: CBRT.

* Calculated as the rate of change of the end-year US dollar exchange rate expectation from the CBRT Expectations Survey over the end-2002 value.

** Calculated as the monthly rate of change of the end-year US dollar exchange rate expectation from the CBRT Expectations Survey over the US dollar exchange rate on the day of the survey.

During the implementation of floating exchange rate regime, it has been observed that in the pricing process, the reactions of economic units to the decline in the exchange rates has been limited when compared to their reactions to exchange rate hikes. It is considered that this asymmetry has been a related to the exchange rate expectations of economic units for the rest of the year. Despite the retreat in the year-end exchange rate expectations hitherto the period when Turkish Lira started to appreciate in nominal terms, the participants of the CBRT Expectations Survey are expecting a gradually rising depreciation in the Turkish Lira for the rest of the year. (Figure VIII.3.1). This observation can be interpreted, as the firms' reluctance to adjust prices downward due to the expectation that the decline observed in the exchange rates during second quarter is provisional. As a matter of fact, the increase in CPI by 3.5 percent despite a declined of 14.3 percent in the average US dollar exchange rate during the April-June

period, supports this view. Therefore, assuming that the recovery in demand is not sharp, there is the possibility that the pass through from exchange rates to the private sector prices will be limited during the following period. However, it is envisaged that the pass through from a probable increase in exchange rates to the public sector prices will be much higher

Price Control by the Public Sector

The decline in exchange rates and oil prices in international markets have both caused the increase in public sector controlled prices to remain lower than the general CPI increase during the second quarter of the year. However, public sector controlled prices are higher than the general the increase in CPI, excluding petroleum products.

Price adjustments of inputs produced by the public sector are reflected gradually to the private sector prices. For example, adjustments by the public sector are observed to contribute to the price rigidity in services group through transport prices.

Price differentiations among sectors can have a negative impact on inflation in the long run. The change of the relative price structure due to factors other than market mechanism, can affect productivity of the overall economy by distorting the efficiency of the allocation of resources between sectors. Therefore, increasing public sector controlled prices in order to meet the financial needs of the State Economic Enterprises can have a negative impact on the general price index not only through directly influencing the price index and increasing input prices but also through relative price changes.

Labor Costs

Hourly real wages declined by 14.6 percent in 2001 due to the crises. In 2002, especially the increase in labor productivity offset the increase in nominal wages. However, the increase in the rate of productivity started to decelerate throughout 2002 and the same tendency was also observed during the first quarter of 2003. To

recoup the high productivity rates is considered to depend on the acceleration of domestic fixed capital investments in such away that supports productivity.

Real wages in the private manufacturing industry continued to decline gradually until the last quarter of 2002. However, there was an increase by 1.1 percent and 0.9 percent during the last quarter of 2002 and the first quarter of 2003, respectively, compared to the relevant periods of the past year. Along with the increase in the employment rate in the economy, the increase in real wages is expected to continue throughout 2003. Real wage increases, not in line with the productivity increases can potentially increase the production cost of the firms.

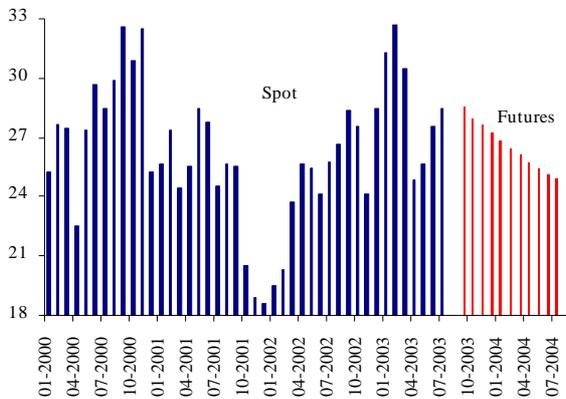
Crude Oil Prices

Crude oil prices declined in the international markets after the Iraqi war. However, crude oil prices began to increase in May and June and reached US \$29 per barrel in July (Figure VIII.3.2).

According to the data of the International Energy Agency (IEA) crude oil inventories in OECD countries are at a historically low level. On this account before the commercial inventories reach the recorded levels of the previous years once again, crude oil prices are not expected to drop distinctively in the coming periods. The negative developments in crude oil supply have been a determining factor on crude oil prices. Production of OPEC member countries and primarily of Saudi Arabia have declined in June. On the other hand, in the post-war period the uncertainties regarding Iraq to resume exporting crude oil maintain the burden. Furthermore, apprehension that the strike in Nigeria will restrict the oil supply has contributed to the rise in prices.

Even though countries exporting crude oil other than OPEC detect the probability to increase production due to the low level of the commercial stocks of OPEC countries, crude oil prices are expected to be steady till the end of 2003. Oil market experts consider that the probability for the said stock level to increase till the end of the summer of 2003 is very low.

Figure VIII.3.2. Spot and Futures Prices of Crude Oil (USD per barrel)



Note: Spot and 12-month futures prices for Brent petroleum are used. Futures prices are as of July 16, 2003.
Source: US Department of Energy, www.oilenergy.com.

Under the condition that the Iraqi exports of crude oil increase to the pre-war level, crude oil forward contract price are expected to fall to US \$26 per barrel by the end of 2004. Provided that the Iraqi exports increase faster than expected then a downward pressure on crude oil prices will be a point at issue. However, such a development can occur depending on OPEC's reaction to Iraq's reembarment exports at the previous capacity. As a response to the increasing production level, on the occasion that OPEC goes into a cutback in production then the prospects for a downward pressure on crude oil prices will be weak.

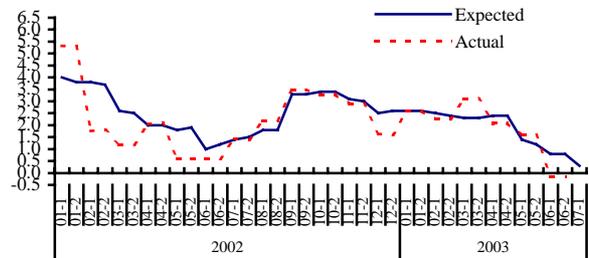
VIII.4. Inflation Expectations

The diminishing cost pressures had a positive impact on inflation expectations during the March-June period of 2003.

Consumer Price Expectations

Year-end inflation expectations, despite a decline in the second quarter of 2003 was 4 points above the 20 percent inflation target as of the first period of July. In the first quarter of 2003, inflation was in an increasing trend pertaining to the rise in agricultural and food prices in addition to the increase in international crude oil prices. However, the rising inflation expectations have returned to the level at the beginning of the year as the effects of the above factors have eased. (Figure VIII.4.2).

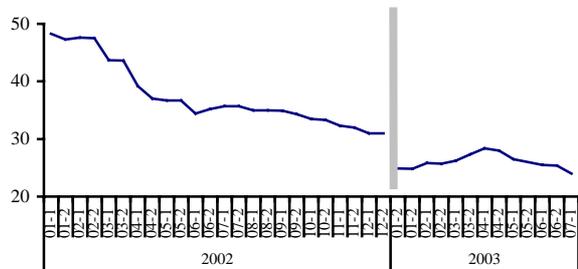
Figure VIII.4.1. Expected and Actual Monthly CPI Inflation Rate (percentage)



Source: CBRT Expectations Survey

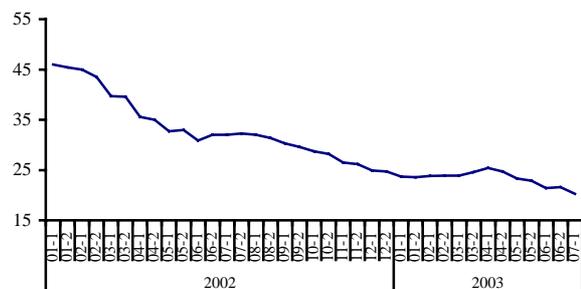
The difference between the consumer inflation expectations for the following 12-month period and the targeted inflation, which has been following a stable path in the first three months of 2003, has been falling. According to the survey results for the first period of July, for the following 12 months survey participants expect the inflation rate to be 20.1 percent. The said average rate was 24.6 percent in the survey for the second period of March (Figure VIII.4.3).

Figure VIII.4.2. Expected End-Year CPI Inflation Rate (percentage)



Source: CBRT Expectations Survey

Figure VIII.4.3. Expected 12-Month Ahead CPI Inflation Rate (percentage)



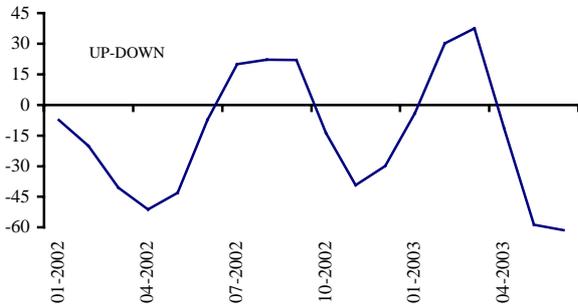
Source: CBRT Expectations Survey

Wholesale Price Expectations

CBRT Business Tendency Survey is used to analyze the expectations for wholesale inflation. According to the qualitative expectations of the Business Tendency Survey, the ratio of the expectants for the WPI to drop in the following three months will continue to rise. The inflation expectations following a fluctuating trend during the three months period can be explained with the close relation of the wholesale price expectations with the exchange rate movements. The up-down difference, which was 11.3 percent in April, increased to 61.4 percent in the June survey (Figure VIII.4.4).

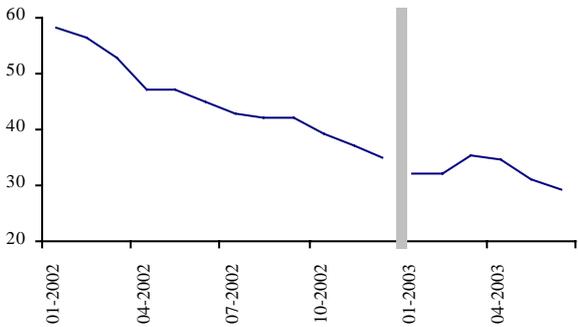
As of June, year-end WPI expectation has declined to 29.2 percent level. The relevant expectation in the March survey was at 35.5 percent level (Figure VIII.4.5).

Figure VIII.4.4. WPI Expectations for the Next Three Months (percentage)



Source: CBRT Business Tendency Survey

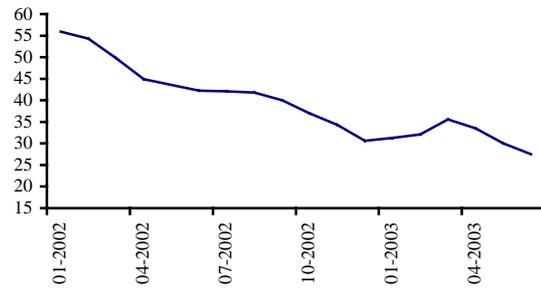
Figure VIII.4.5. Expected End-Year WPI Inflation Rate (percentage)



Source: CBRT Business Tendency Survey

WPI inflation expectations for the following 12 months have also declined. Expectations, which were at 35.6 percent level in the March survey, continuously declined in the second quarter of 2003. Average WPI expectations decreased to 30 percent in the March survey has reached 27.5 percent level as of June (Figure VIII.4.6).

Figure VIII.4.6. Expected 12-Month Ahead WPI Inflation Rate (percentage)



Source: CBRT Business Tendency Survey

VIII.5. Basic Risks and Conclusion

In light of the abovementioned analysis, the factors to be highlighted regarding the progress of inflation in the following period could be summarized as follows:

i. As the cost pressure has eased in the second quarter of the year, inflation has significantly slowed down, especially the trend of the price increases during the last two months has provided the inflation to approach towards the year-end target. In the remaining of the year in order to maintain this tendency and to reach the inflation target, the most significant pre-condition would be the keen implementation of the economic program. Even though the post-war favorable developments in inflation are expected to continue in the following period, there still exists some risks affecting the course of price increases.

ii. One of these risks would be the probable increasing trend in domestic demand in the second half of the year. Demand and production data along with the survey results point to the fact that demand will be more vigorous in the second half of the year. Nonetheless,

considering the potential output the probability that a stronger demand generating high inflation rate is low.

iii. Developments in the foreign exchange continue to be one of the main determinants of inflation. Recently the appreciation of the Turkish lira has been one of the most significant factors contributing to the slowdown in inflation. Consequently, the foreign exchange developments in the following period are critical as far as the inflation is concerned.

iv. As it is known, the economic program contain significant measures in terms of fiscal discipline and sustainability of the public debt. In the first half of the year in line with the budget realization, some supplementary measures inclined to expenditure restrictions have been determined in order to reach the fiscal target for the overall year. In the second half of the year in necessity of further supplementary measures, the probability of said income generating measures to foresee rise in public prices or indirect taxes would constitute risks in terms of inflation.

v. In light of all these evaluations and under the condition that a sharp increase in foreign exchange does not occur, public price increase not consulted other than the program and the revival of domestic demand does not create high inflation, with the basic assumption that the implementation of the program will continue with determination for reaching the year end target, as a result the positive tendency of price increases will be maintained in the following period and according to the predictions the inflation rate will approach the year end target.

In conclusion, considering that the developments causing the drop in inflation to cease in the first quarter of the year have not been permanent and inflation has captured a downward trend once again. In order to maintain this trend, the confidence environment should continue in the medium and long term and the implementation of the economic program should continue in a consistent and determined manner without any concession.