ECONOMIC OUTLOOK

CENTRAL BANK OF TURKEY

October 2005

General Framework

Why is the fight against inflation crucial?

1- The primary objective of economic policies is to increase economic prosperity.

Prosperity increases only if;

2- Sustainable growth and Sustainable employment *are achieved.*

For sustainability:

3- Economic stability is a must. ⇨

The pre-condition of economic stability is;

Price Stability.

The Turkish Economy

Strictly implemented economic policies

- Single-digit inflation after 35 years, currency reform.
- Considerable economic growth largely higher than expectations.
- Fall in the ratio of public debt to national income.

- Decreasing economic uncertainties, increasing predictability.
- Strengthening macroeconomic fundamentals, increasing resistance to shocks.
- Changing dynamics of the economy: the private sector in the foreground, productivity increase, behavioral changes, increasing competitiveness.

The Turkish economy is undergoing a structural transformation.

Inflation

Inflation

CPI; January – September 2005:

First 9 months cumulative : 3.93 %

Annual : 7.99 %

- **Services sector rigidities;**
  - ✓ Still continuing backward indexation.
  - ✓ Closed to foreign competition; oligopolistic structure.
- **Oil and Fuel-oil;**
  - ✓ Effective on transportation and housing.
  - ✓ Indirect effects are not yet visible.
- **Restaurants and hotels;** affected by tourism.
- **Tobacco;** affceted by special consumption tax.

PPI; January – September 2005:

First 9 months cumulative : 2.98 %

Annual : 4.38 %

- **More sensitive to exchange rate and raw material prices:** Simultaneous movements of them are important.
- **Agriculture** may follow a more stable course compared to the past, **due to the change in calculation methods.**
- **PPI is not the target.**

September CPI – Annual percentage change of some groups

CPI General	**7.99**
Health	**0.34**
Clothing and Footwear	**1.77**
Food and Nonalcoholic Beverages	**4.38**
Education	**7.36**
Housing	**10.11**
Restaurants and Hotels	**14.13**
Transportation	**18.17**
Alcoholic Beverages and Tobacco	**22.36**

September PPI– annual percentage change

PPI General	**4.38**
Agriculture	**1.58**
Industry	**5.14**
- Mining	**11.82**
- Manufacturing	**6.15**
- Energy	**-11.53**

Inflation

- Specified CPI Coverages:

Indices excluding:

✓ Seasonal products whose prices display regular fluctuations according to periods,

✓ Energy prices determined in international markets,

✓ Tax regulations that are not directly related to supply-demand balance but influence prices, and goods with administered prices,

are critical in identifying the main trends in the economy.

Annual percentage change

A	**9.10**
F	**6.73**
G	**6.86**

The trend is downward.

The end-year target can be achieved, however;

- Monetary policy has lagged effect; decisions are meant for 2006 and later.

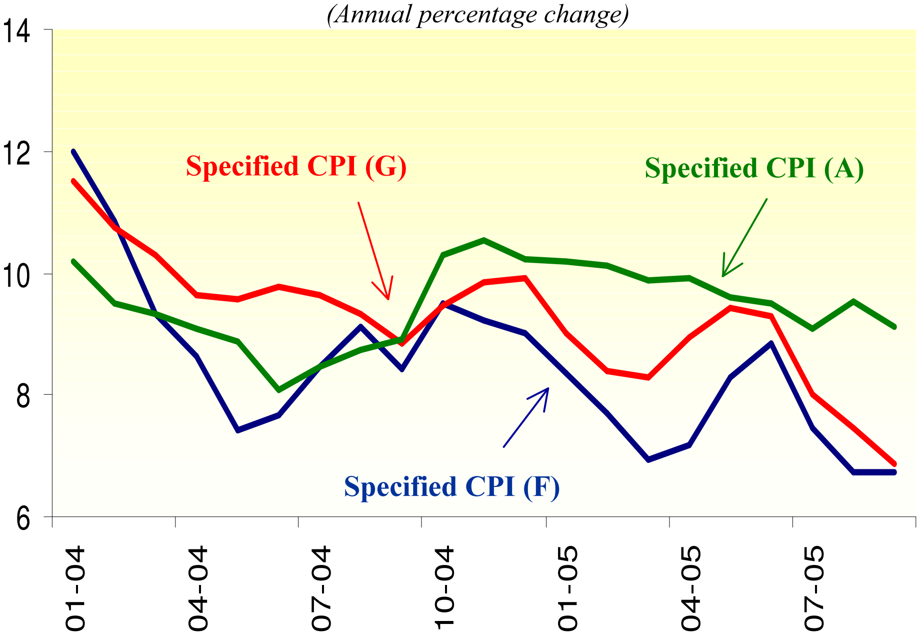
Program targets:

2006	2007	2008
5 %	4 %	4 %

Specified CPI (A): Excluding seasonal products
Specified CPI (F): Excluding energy, alcoholic beverages, tobacco products, other goods with administered prices and indirect taxes
Specified CPI (G): Excluding F and unprocessed food products

SPECIFIED CPI COVERAGES

(Annual percentage change)



Source: SIS

Inflation - Outlook

What is the Outlook?

In the normalization process of the economy;

- ✓ **Demand** developments,
- ✓ **Productivity**,
- ✓ **Employment** indicators

have increasing impact on decisions.

Domestic demand developments are closely monitored.

✓ The upward trend in sales of **white goods** and total sales of **vehicles** continues, following the relative slowdown in the beginning of 2005.

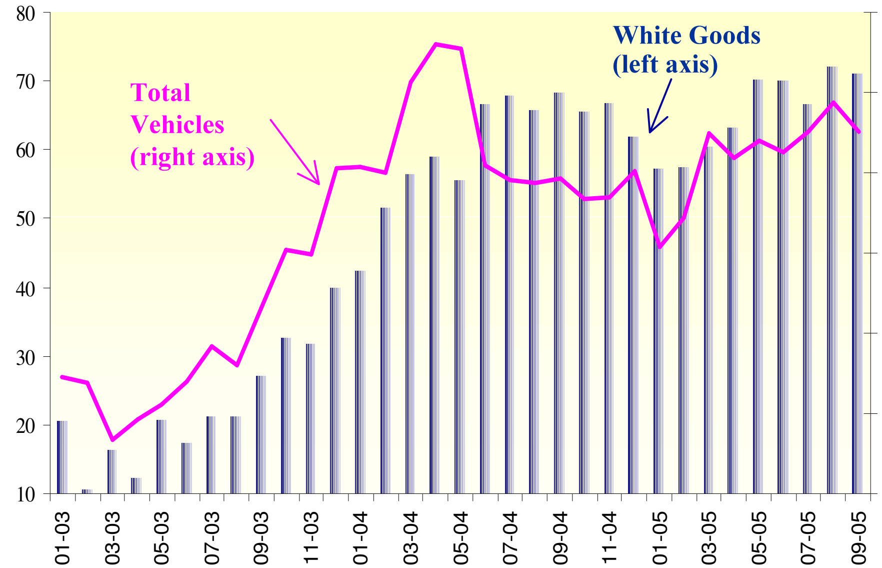
✓ **Decreases in consumer confidence indices** and deteriorations in domestic sales expectations show that domestic demand will be under control during the rest of 2005.

✓ **The capacity utilization rate** is below that of last year.

✓ The persistent **output gap** restrains the demand pressure on prices. However, it may converge to its potential level at the end of 2005.

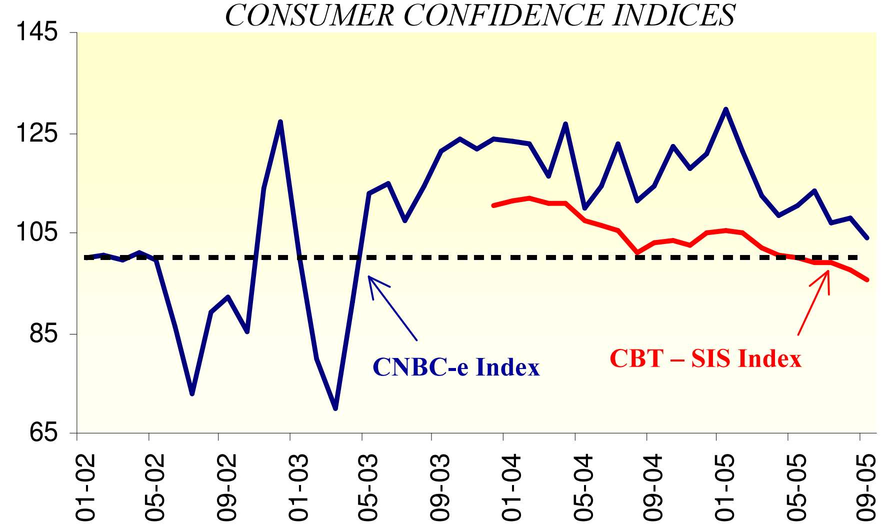
DOMESTIC WHITE GOODS AND TOTAL VEHICLE SALES

(Seasonally adjusted, a thousand pieces)



Source:AMA, BESD, CBRT

CONSUMER CONFIDENCE INDICES



Source: SIS, CBT, CNBC-e

Inflation – Outlook

What is the Outlook?

- **Foreign demand developments** are important since they make up an element of total demand. **Moderating the growth expectations for the EU** may reduce total demand.
- **Employment developments;**

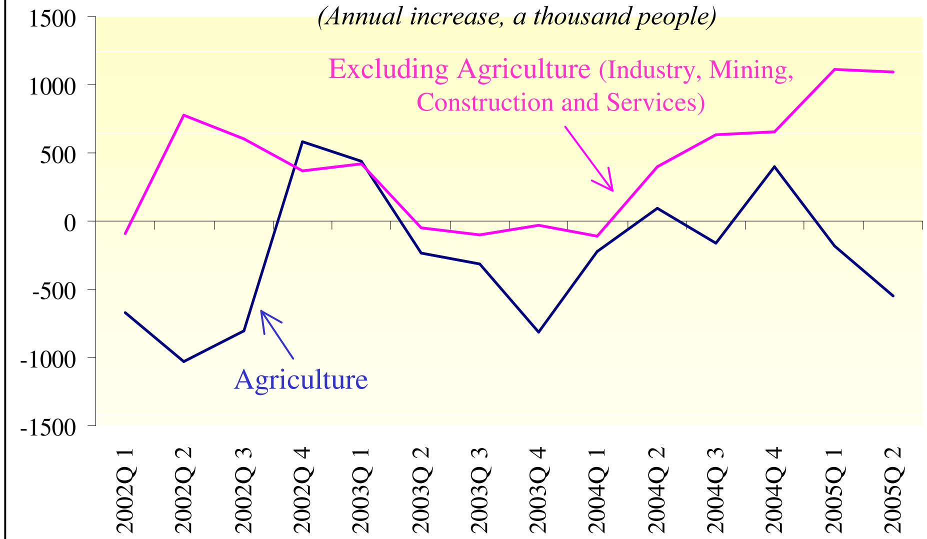
✓ Improvement continues. In the first half of 2005, the number of employed people increased by 3.5 percent compared to the same period of 2004.

✓ Strong increase in employment in sectors excluding agriculture:
21.2 percent increase in construction, 7.7 percent increase in services, 5.3 percent increase in industry sectors; 5.2 percent decrease in agricultural sector.

✓ Data of the CBT Business Tendency Survey show that the upward trend in employment may continue.

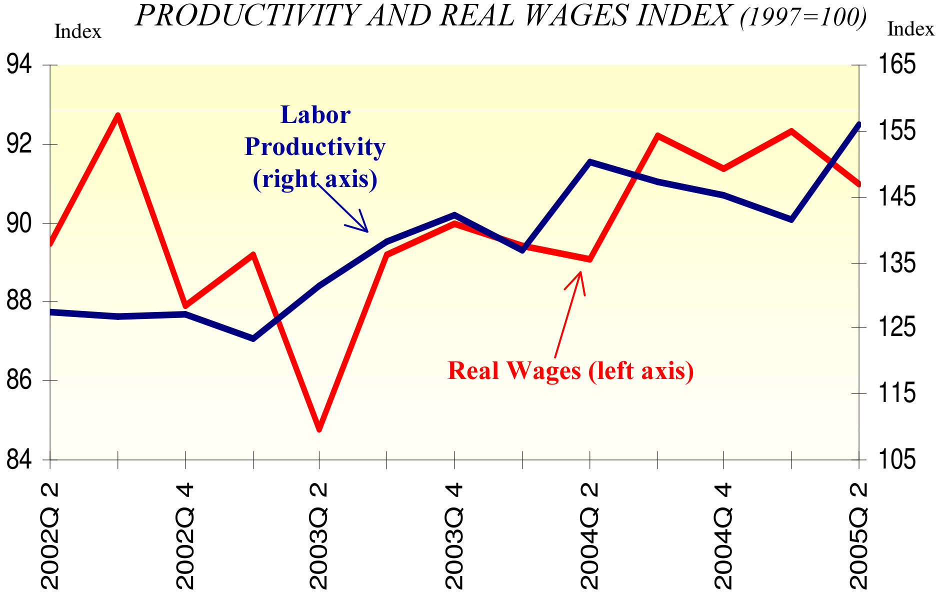
This trend may create pressure on **real wages.** However, the continuing rise in productivity, increasing investments and high rates of labor force participation may restrain the pressure.

ANNUAL EMPLOYMENT INCREASES
(Annual increase, a thousand people)



Note: Total employment is 23.3 million people as of July.

PRODUCTIVITY AND REAL WAGES INDEX (1997=100)



Source: SIS

Inflation – Outlook

What is the Outlook?

- There is a rapid increase in consumer loans.

✓ The rate of annual increase in **credit cards** slightly decelerated in the recent period.

✓ The highest increase is observed in **housing credits.** The rate of increase accelerated in the last three months.

- Share of housing credits in consumer credits:

2002; 20.3 percent ⇨ September 2005; 36.8 percent

⇨Fall in credit interest rates,

⇨Extended maturities; maturities up to 20 years,

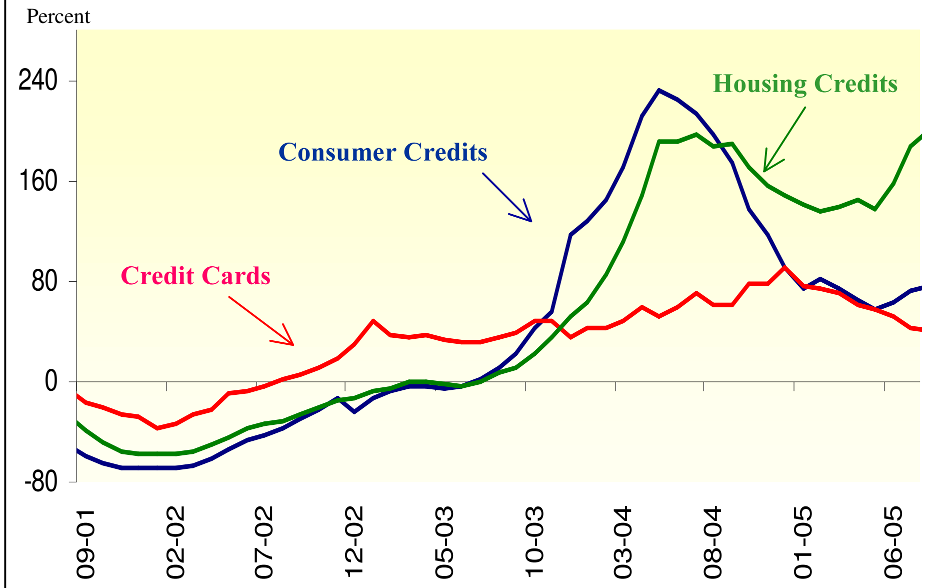
⇨Widespread preference of house purchase as investment.

-The **volume of housing credits in Turkey is very low compared to other countries** in terms of the ratio to GNP.

- New financing instruments (mortgages), current demand and the EU process indicate that the increase will continue in the upcoming periods.

The demand for houses exerts pressure on house **prices** and **rents.** The medium-term effect on demand is being closely monitored. There is **a serious risk of maturity mismatch** since the average maturity of deposits in banks is three months.

REAL CONSUMER CREDITS, HOUSING CREDITS AND CREDIT CARDS INDEX (Annual percentage change, CPI, 1994=100)



Source: CBT

HOUSING CREDITS / GNP RATIOS (percent)

Latin American Countries	4 – 12
Middle East Countries	1 – 22
East and South East Asian Countries	2 – 59
USA	53
EU (Average)	43
Turkey (September 2005)	1.3

Source: Capital Markets Board of Turkey

Inflation – Outlook

What is the Outlook?

- Services sector rigidities;

✓ Have effected the **slowdown of the downward trend in inflation** since last year.

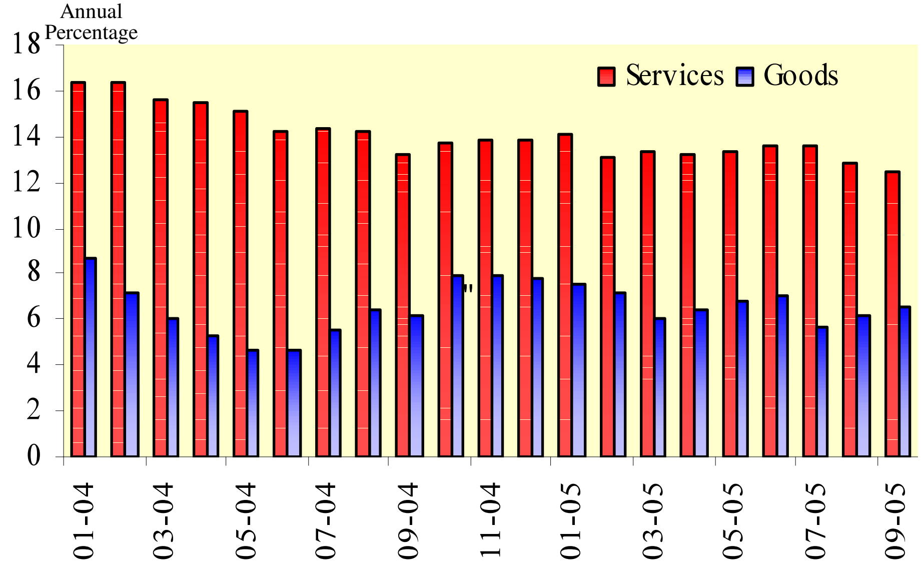
- Despite the slight decrease observed in the last two months, the rate of increase in the prices of services sector is still very high compared with the goods group.

✓ **Are considerably effected by oil price increases.** There is considerable difference between the oil-based and oil-free groups of the sector.

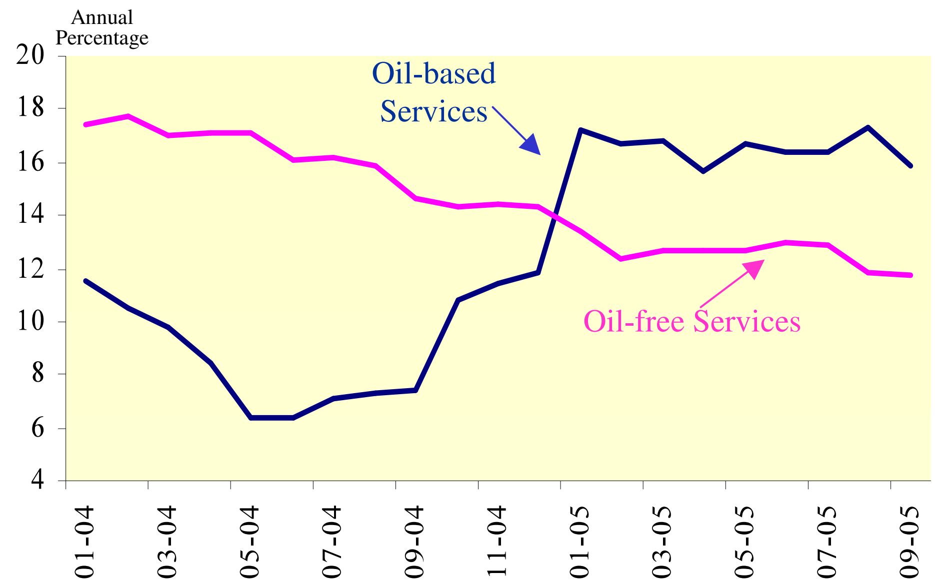
✓ Rent increases have been above those of last year for the last two months.

If these trends continue, **the negative impact of the services sector on 2006 inflation will be felt very strongly.**

GOODS AND SERVICES GROUP INFLATION



OIL-BASED AND OIL-FREE SERVICES INFLATION



Source: SIS

Inflation – Outlook

What is the Outlook?

- **High level of prices in energy and metal prices continue throughout the world.**

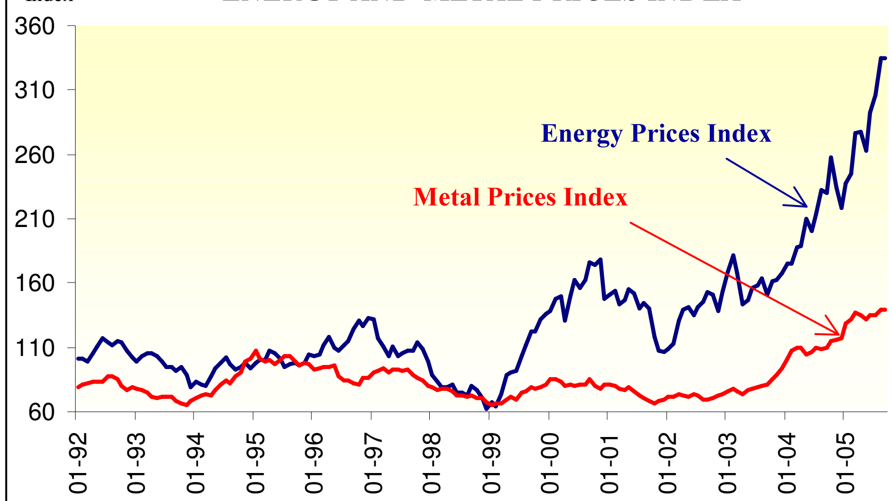
✓ **The primary effect of oil price increases on the CPI** reached **1.5 points** during the previous year. Part of this primary effect is expected to appear with a time lag in 2006.

✓ **Monetary policy can in no way react to external direct and primary indirect effects.**

✓ Monetary policy only reacts if such effects create permanent **secondary indirect effects** on expectations and pricing behaviors.

- Meanwhile, twelve-month inflation expectations converge to the 2006 target.

ENERGY AND METAL PRICES INDEX



Source: IMF

In 2006, the "explicit inflation targeting regime" will be adopted in order to strengthen the institutional framework in the fight against inflation.

- Preparations for this regime have been underway since 2000.

- Significant distances have been covered in fulfilling the pre-conditions.

- Technical studies continue within the CBT.

- The main goal is to further institutionalize decision-making processes and increase transparency.

Risks

- **Tight fiscal policy, target-consistent revenues and pricing policy** should be maintained.

- It is crucial that the **reform process does not lose pace**.

- The EU and IMF are important anchors that are not alternatives to each other.

- It is essential that the **expectations are not distorted**.

- **Where to spend the privatization revenues** has high importance.

- **Increase in domestic demand** should be monitored, recovery in consumption should develop in a controlled manner.

- **Did international developments contribute?**

✓ Positive: Global liquidity

✓ Negative: Low growth in the EU,
Increase in oil / energy prices,
EUR / USD parity,
US interest rates.

- **Agriculture and raw material prices**

Risk factors at all times.

Growth

Growth

Growth

- **Real growth rate since 2002 is 27.9 percent.**

✓ This is the highest growth rate, excluding that of China and some small countries.

- Our economy has never grown this rapidly in a four-year period since **1953**.

- Growth is driven by **the private sector,** the highest contribution came from **the productivity increase.** Exports played a critical role; **trade openness** increased.

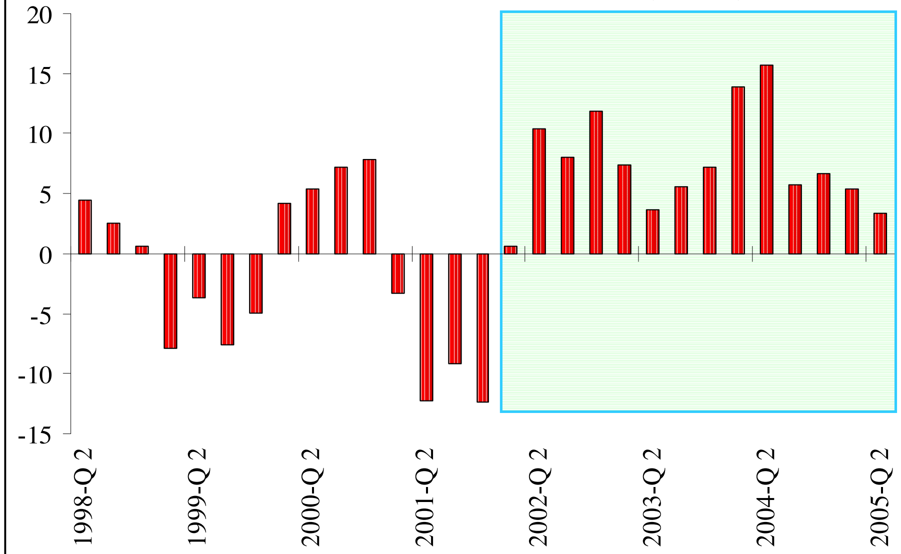
- The growth process also continued in the first half of 2005, at 4.3 percent.

✓ **On the supply side,** growth in trade (5%) and industrial sectors (4.6%) lost pace, while rapid growth in the construction sector (19.7%) continued.

✓ **On the demand side,** the high course of private consumption expenditures (4.2%) continued, while public expenditures also increased (4.2%).

✓ Despite the high base effect, investment expenditures rapidly increased (13.1%) due to the impact of the construction sector. The investment base of economic growth is expanding.

RATE OF GNP GROWTH (Percent)



Source: SIS

SOURCES OF GROWTH (Percent)

	1990-2000	2002-2004
GDP Increase	4.1	7.5
Contribution of Employment Increase	23.5	2.4
Contribution of Increase in Capital Stock	73.2	46.2
Contribution of Total Factor Productivity	3.3	51.3

Source: SPO

Growth

The sectors that grew most rapidly and increased their exports are those which increased their productivity the most.

2001Q4-2005Q2 PERIOD % CHANGE (Ranked according to productivity. Sectors with a share of more than 2.5 percent in total exports have been selected.)

SECTORS	PRODUCTIVITY (According to the Index of Working Hour Partial Productivity)	GROWTH	EXPORTS (Annualized 12-month Cumulative)	SHARE IN TOTAL EXPORTS (As of August 2005)
MANUFACTURING	**30.0**	**36.3**	**126.6**	**94.1**
Motor Vehicles	106.0	203.1	283.9	14.5
Metal Products Industry	56.7	35.1	233.3	3.6
Chemical Mat. and Products	54.6	48.0	85.2	3.9
Plastic and Rubber Products	50.9	59.5	137.2	3.3
Radio,TV, Communications Equipments	46.3	142.0	200.0	4.3
Electrical Mach. and Devices	41.4	20.7	70.2	2.6
Machinery and Equipment	31.9	93.2	176.0	6.4
Non-Metalic Mineral Products	28.0	41.6	104.7	3.7
Basic Metal Industry	17.5	40.4	147.3	10.1
Food Products and Drinks	14.1	12.7	90.7	5.6
Coke Coal, Refined Petroleum Products and Nuclear Fuels	11.6	4.3	341.0	2.8
Textile Products	5.6	6.4	70.1	12.1
Clothing	-5.3	4.1	81.0	14.0
Furniture	-37.9	-10.6	182.1	3.0

Growth

Growth

Two important factors to be considered in growth analyses:

- 1) Base effect;

✓ Rapid growth in the first half of 2004 caused the base effect to be felt strongly in the first half of 2005.

- **2) Seasonality;** in seasonal adjusted terms, the growth tendency is strong.

In the first half of 2005;

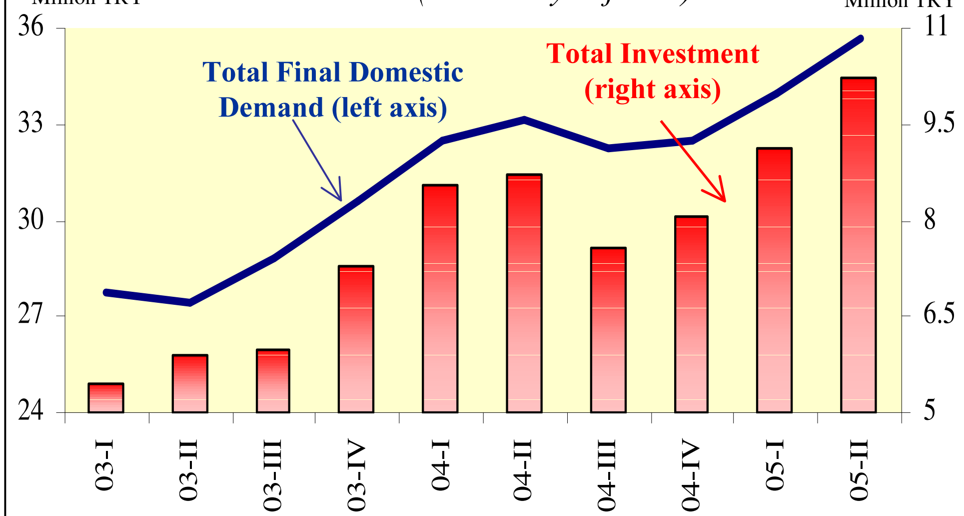
✓ Private final consumption and private sector investment expenditures increased compared to the previous period,

✓ Investment expenditures of the state increased at an accelerating pace,

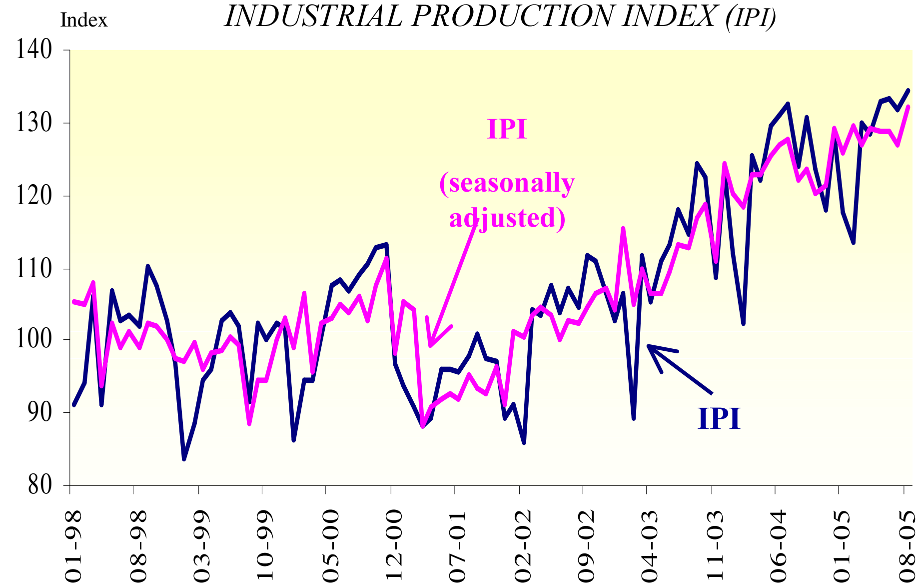
✓ Mach. equip. manufacturing increased compared to the previous quarter. Employment-generating building and housing investments – particularly industrial construction permits – increased as well.

- **As of August 2005,** the upward trend in industrial production continues at an accelerating pace, strongly felt in sectors manufacturing intermediary and investment goods.

TOTAL INVESTMENT AND TOTAL FINAL DOMESTIC DEMAND (Seasonally adjusted)



INDUSTRIAL PRODUCTION INDEX (IPI)



Source: CBT, SIS

Growth

Growth – Outlook

- With the removal of the base effect, **annual growth rates will maintain their strong course in the third quarter of 2005.** However;

✓ The significant contribution of the post-crisis process to growth started to come to a close towards the end of 2004.

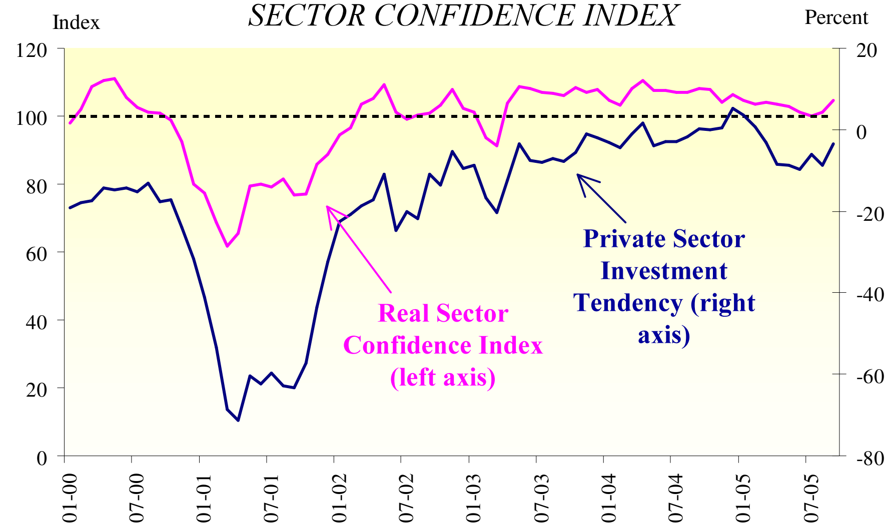
- As of 2005, the rate of growth is expected to be close to program estimations: **5 %**

Potential Growth:

- The potential growth rate changes in time in line with the results of reforms and the prevailing economic conditions.

- The goal of the structural transformation process is to enable our economy to enter a sustainable growth process with rates close to high potential growth rates.

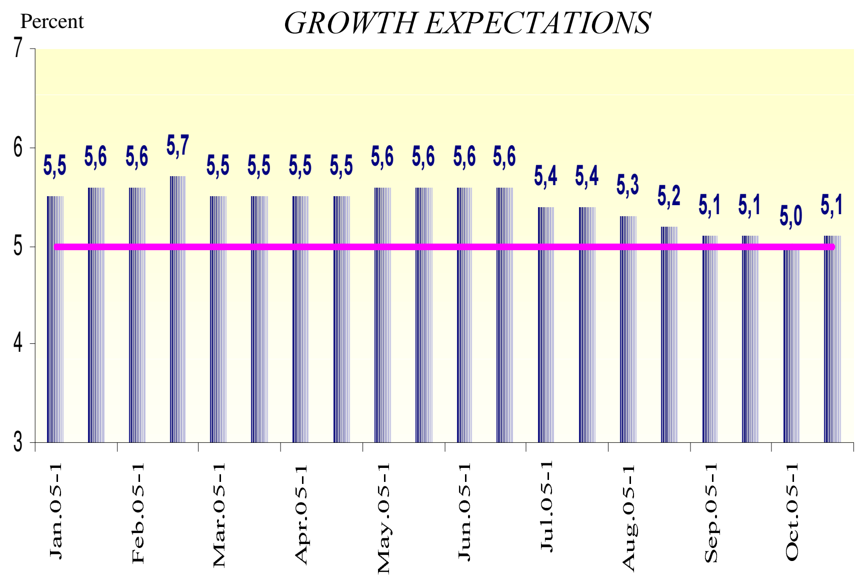
PRIVATE SECTOR INVESTMENT TENDENCY AND REAL SECTOR CONFIDENCE INDEX



Source: CBT

Figures above 100 indicates increase in confidence.

GROWTH EXPECTATIONS

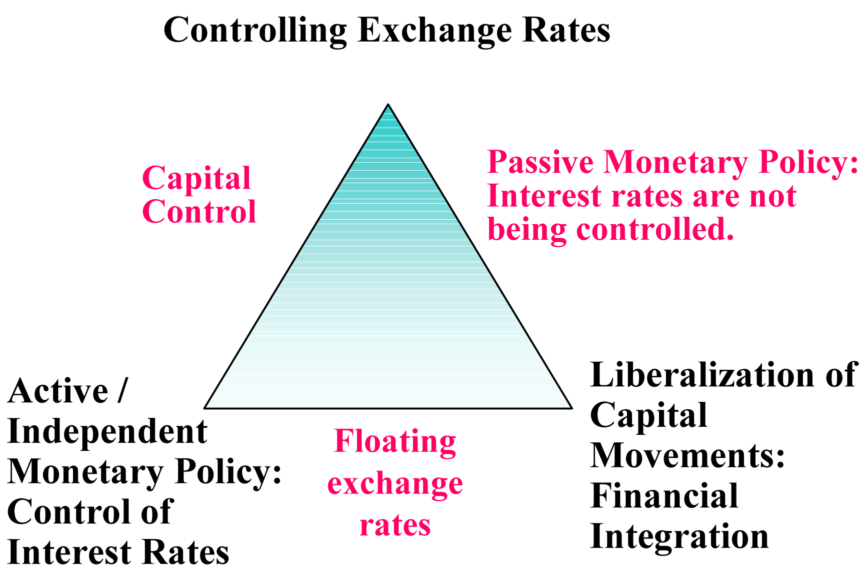


Source: CBT

Monetary Policy Strategies

Monetary Policy Strategies

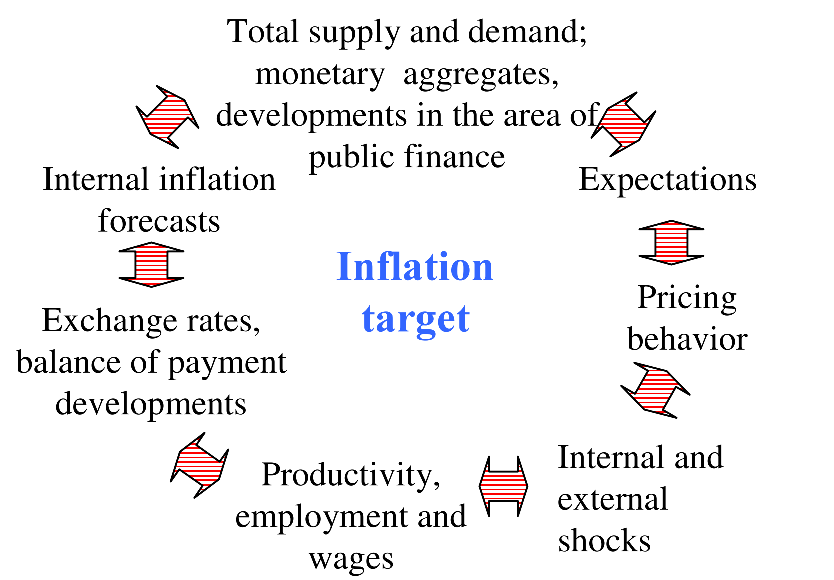
Main constraint in the design of monetary policy: Impossible trinity



Result: When capital movements are free, interest rates and exchange rates cannot be concurrently controlled in the long run.

Today, the Central Bank pursues an active monetary policy strategy with implicit inflation targeting.

- ✓ *Policy tool* ⇨ *Short-term interest rates*
- ✓ *How decisions are taken?* ⇨ ***Only the future course of inflation***
- ✓ *Which factors are considered?*



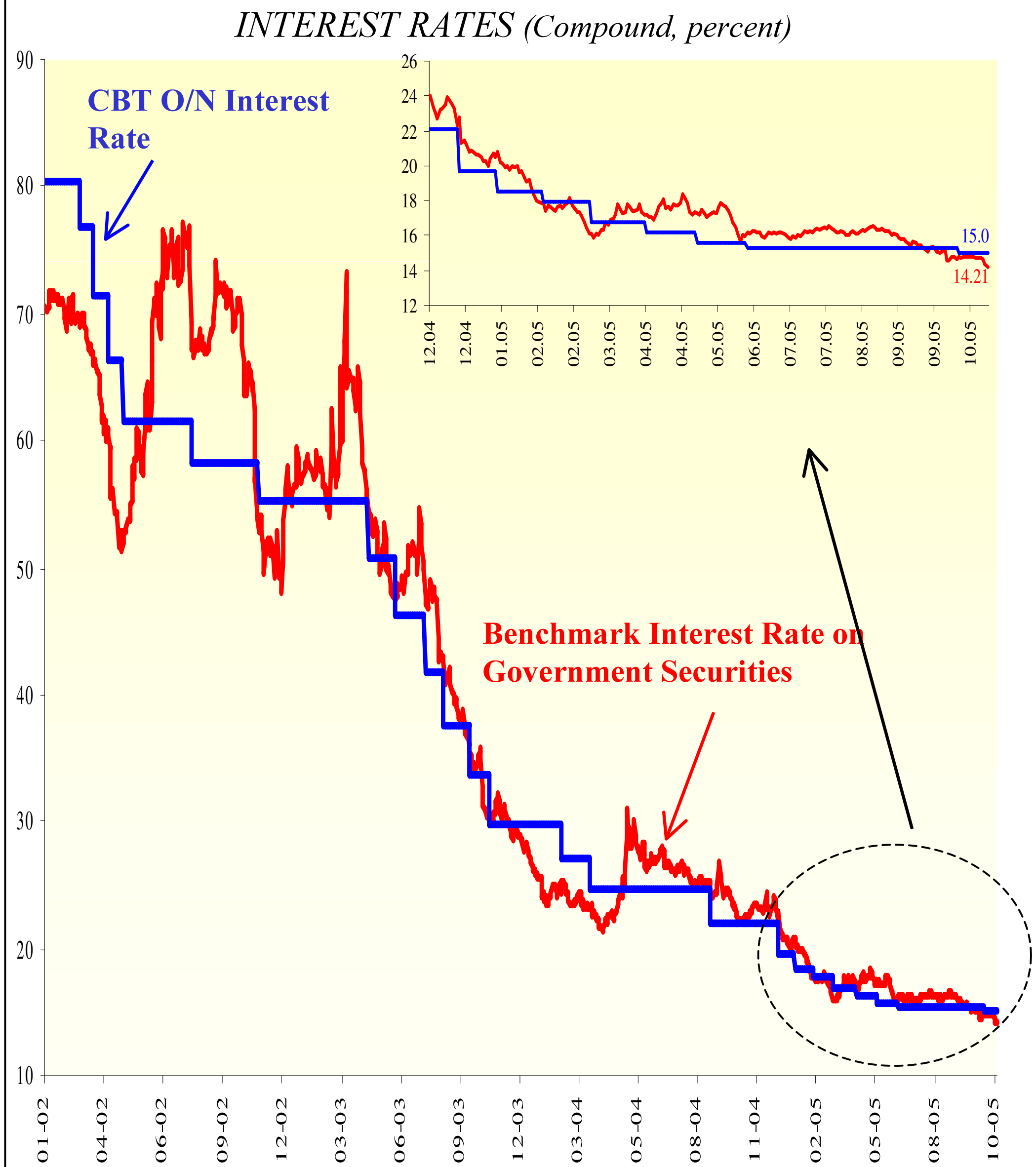
Short-Term Interest Rates

Two significant assessments:

1- The effect of interest rate decisions on inflation is observed through various channels and with a lag of time:

A- Expectations: The signals given by interest rate decisions pertaining to the course of the economy affect investment and consumption decisions, and determine pricing behavior. **This has been the most effective channel up to now.** Though interest rates have not reached the desired level yet, expectations management/ favorable expectations enabled private sector production-investment and consumption to record historic high levels in the last 3 years.

B- General Level of Interest Rates: Though strengthening in time, the relation between short and long-term interest rates has not yet been as strong and permanent as desired. The direction and strength of this relation may alter according to risk perceptions.



Source: CBT

Short-Term Interest Rates

1- The effect of interest rate decisions on inflation is observed through various channels and with a lag of time :

C- Asset Prices: Today, it is not the short-term interest rates, but international liquidity conditions, as well as the expectations pertaining to the economic and political course that dominate asset prices such as exchange rates and equities.

D- Credit Channel: Gains strength together with the normalization tendency of the economy. Expected to be one of the most effective channels in the future.

2- The transmission mechanism is getting more clear together with the progress made towards stability:

A- Interest rate decisions have a lagged effect on the economic activity and inflation as should be the case.

B- Today, this period is estimated to be 3-9 months for economic activity and 9-18 months for inflation (This may be as high as 24 months in the case of developed countries).

Hence, interest rates decisions of today are taken towards next year's inflation and are directed to the medium-term.

CBT O/N INTEREST RATE AND ASSET PRICES

Source:ISE, CBT

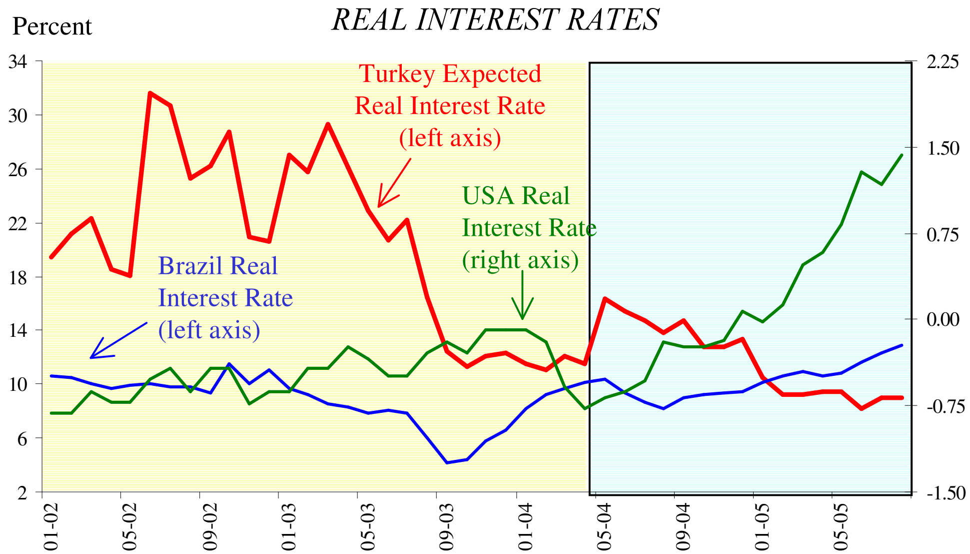
Where The Short-Term Interest Rates Are Heading

Together with the progress made towards stability during the last three years, nominal and real interest rates declined significantly.

	June 2002	October 2005
Nominal Interest Rates	**72.2%**	**14.6%**
Expected Real Interest Rates[1]	**31.6%**	**7.9%**

– Especially the recent decline in nominal and real interest rates coincided with a period when;

✓ Nominal and real interest rates were constantly rising **in the USA** (*has the power to influence global interest rates directly)* and **in Brazil** (*implements a stability program just as Turkey).*



TURKEY - BRAZIL BASIC ECONOMIC INDICATORS		
	Brazil	Turkey
Inflation*	6,1	8,0
Current Account Balance / GDP (%)**	1,9	-5,2
Government Gross debt Stock / GDP (%)**	51,8	77,1
Central Bank Short-term Interest Rates (Compound)*	**19,5**	**15,3**
Real Interest Rates*	**12,7**	**7,9**

[1] Expectations survey, 12-month CPI expectation and Treasury auction average interest rate are used.

* As of September 2005

** End-year 2004

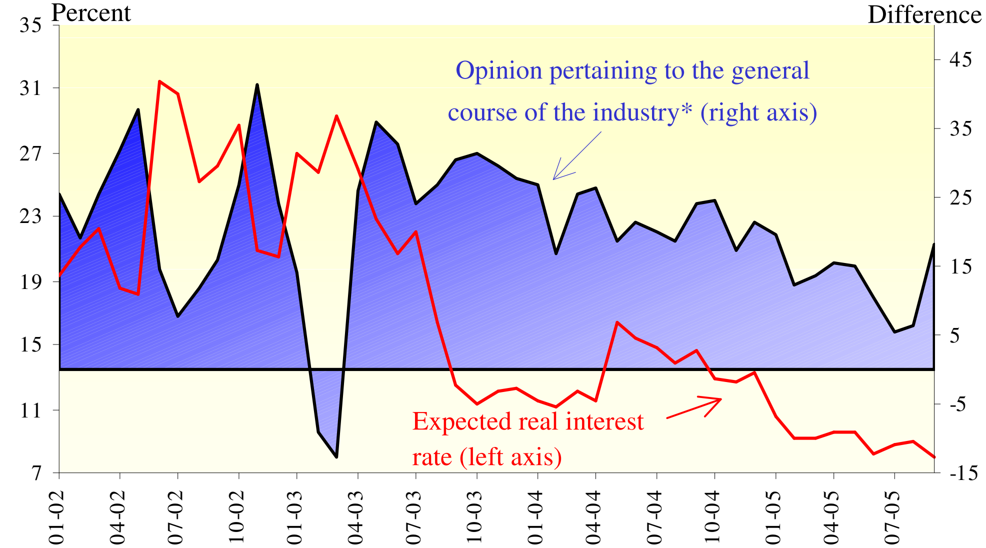
Short-Term Interest Rates

– **However, the general level of interest rates are not at the desired level yet.**

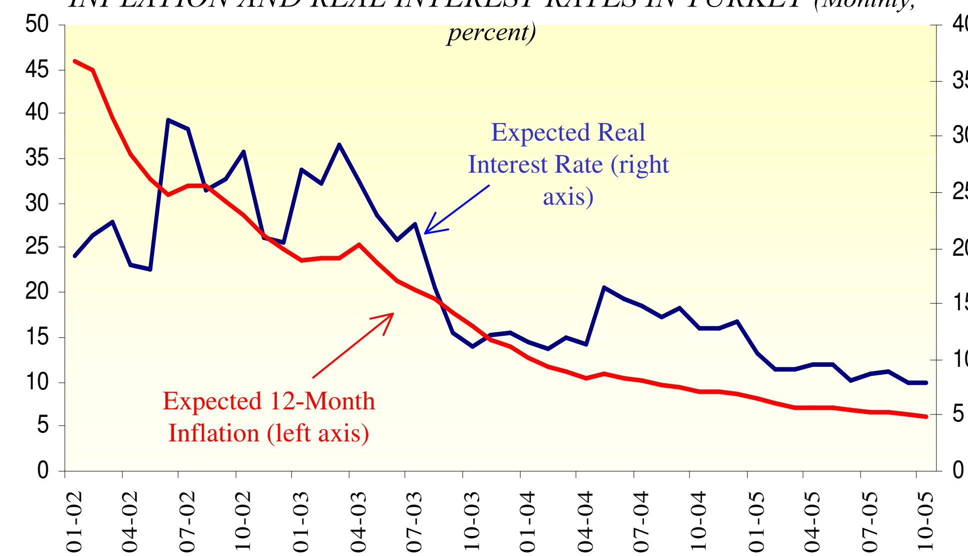
– What is necessary for the nominal and real interest rates to decline further and in a permanent manner is not **CBT reducing the short-term interest rate artificially** - as shown clearly by past experience -, **but by;**

- ✓ Turkish economy getting more resilient to internal and external shocks by the help of **structural reforms**,
- ✓ **Macroeconomic balances** being established in a more solid fashion,
- ✓ The improvement of **expectations**, enhancement of confidence,
- ✓ Diminishing worries regarding the **public debt stock**, and its financing getting more sustainable.

EXPECTED REAL INTEREST RATE AND COURSE OF INDUSRTY



INFLATION AND REAL INTEREST RATES IN TURKEY (Monthly, percent)



Source: CBT

* CBT Business Tendency Survey, opinion on the general tendency of the course of the economy: Optimistic - Pessimistic

Expected Real Interest Rate and Hot Money

Real Interest Rate – Hot Money Relationship

1- There is a negative relationship between real interest rates and hot money.

- *Hot money inflow increases as the real interest rates decline,*

- *Hot money inflow decreases as the real interest rates rise.*

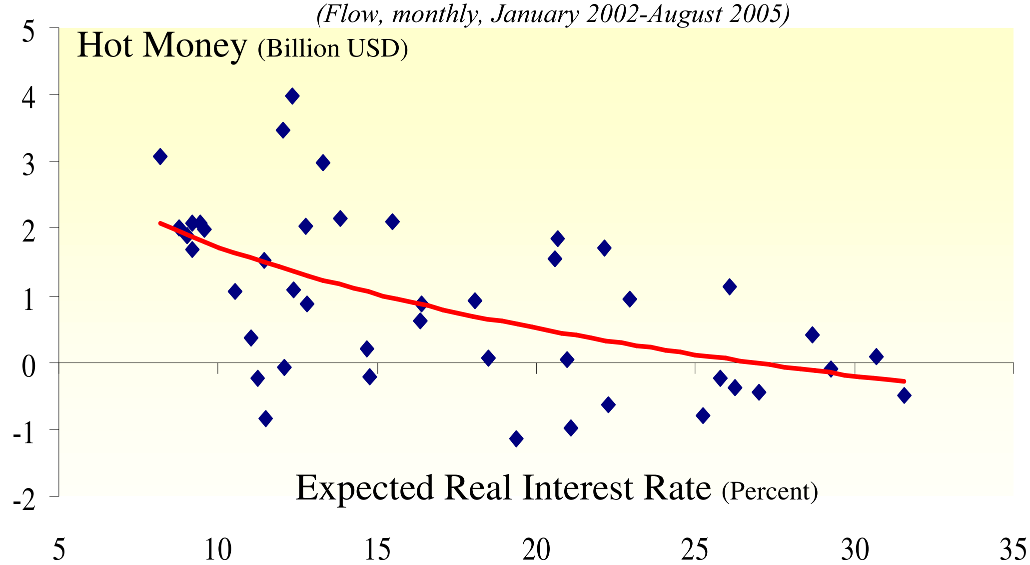
2- There is a positive relationship between expectations and hot money.

- *Hot money inflow increases as expectations improve,*

- *Hot money inflow decreases as expectations deteriorate.*

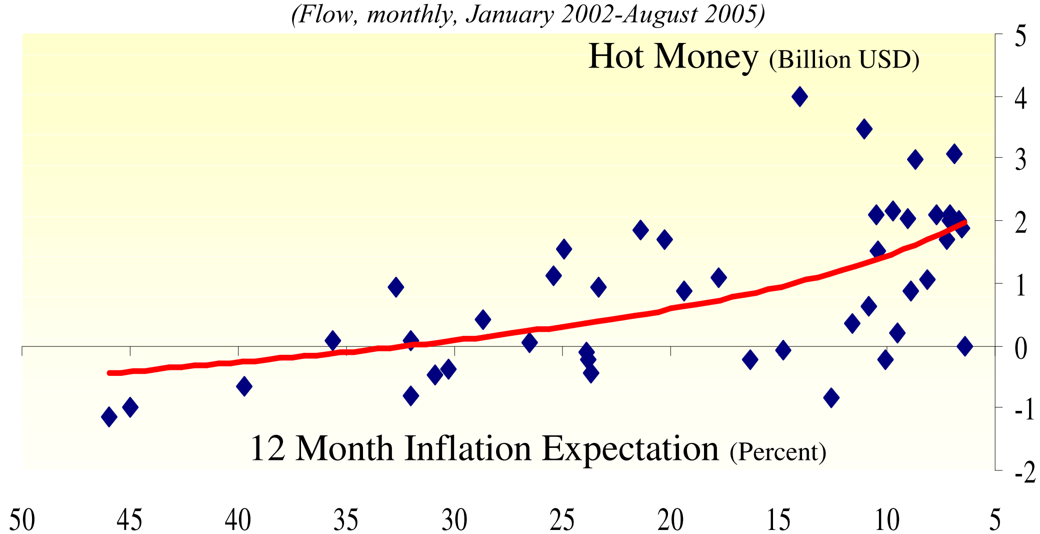
HOT MONEY – EXPECTED REAL INTEREST RATE

(Flow, monthly, January 2002-August 2005)



HOT MONEY – 12 MONTH INFLATION EXPECTATION

(Flow, monthly, January 2002-August 2005)



Source: CBT

Expected Real Interest Rate and Hot Money

1- Vicious Cycle

Expectations
Regarding the Future
Deteriorate.

Capital Inflow Decreases, Capital Outflow is Began to be Recorded.

Nominal and Real Interest Rates Rise.

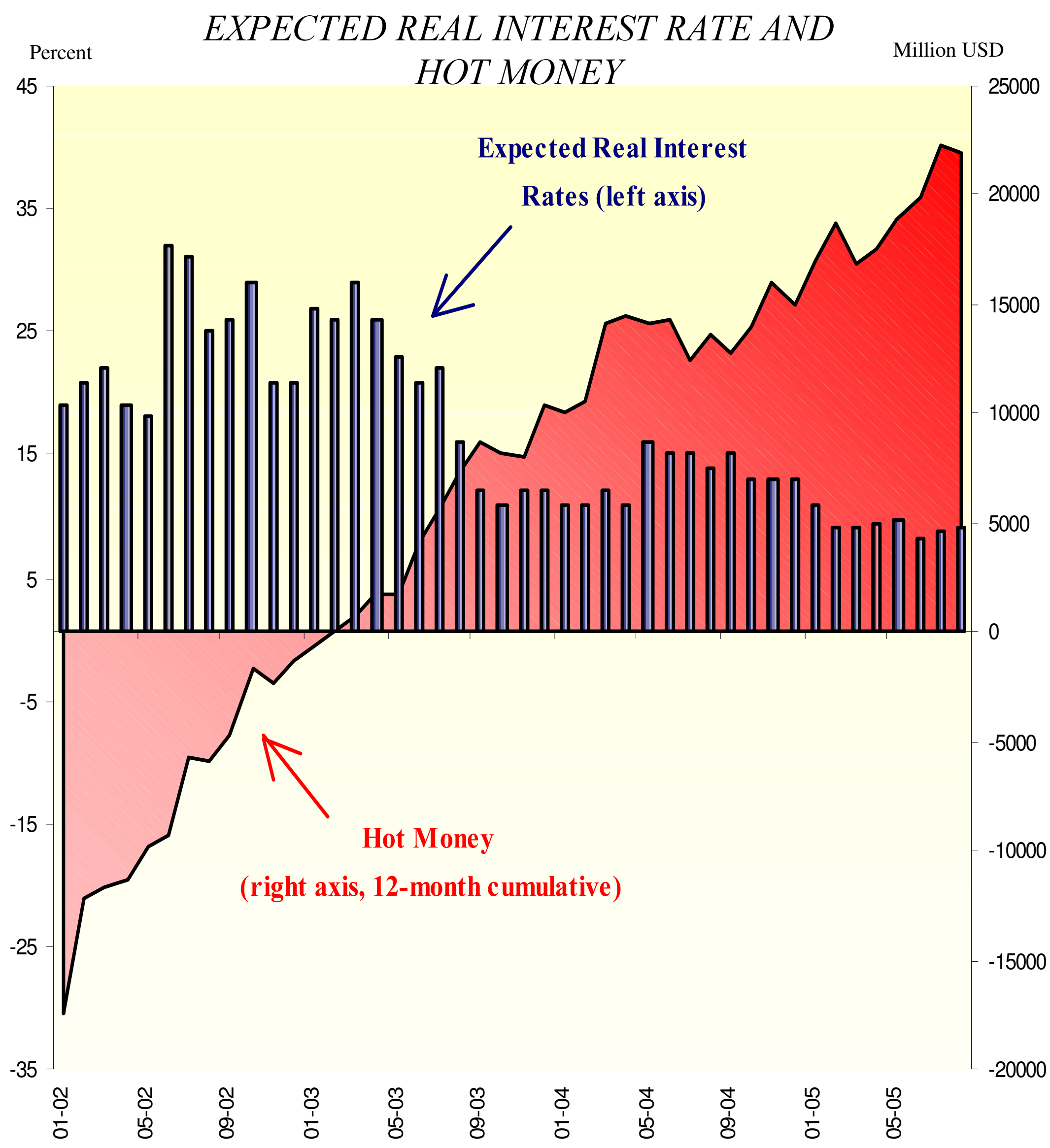
2- Virtuous Cycle

Expectations
Regarding the Future
Improve.

Capital Inflow is Recorded.

Nominal and Real Interest Rates Decline.

The direction and the volume of the hot money are determined by expectations, rather than the level of interest rates.



Source: CBT

Floating Exchange Rate Regime – Exchange Rate Policy

Floating Exchange Rate Regime – Exc.Rate Policy

Floating Exchange Rate Regime – Exchange Rate Policy

- In the floating exchange rate regime, the value of the national currency vis-a-vis foreign currencies is shaped under market conditions, by **supply and demand developments**. Under this regime, neither the Government nor the Central Bank has any target regarding the level of the exchange rate.

- **Yet**, the floating exchange rate regime does not mean that the exchange rate moves up and down in an uncontrolled way, **independent from the economic indicators**.

- As **a component of financial stability,** the exchange rate is a significant variable, and is always closely monitored by the Central Bank.

Within the scope of the floating exchange rate regime, CBT conducts two types of transactions in the markets.

1. Intervening Against Excessive Volatility:

- In either direction,

- Considering the reasons, as well as potential developments,

- Directly or via announcements and warnings.

2. Foreign Exchange Buying For Reserve Build-Up:

- As of 21 October 2005, the foreign exchange reserves of the CBT are at a level of USD 44.2 billion.

Floating Exchange Rate Regime – Exc.Rate Policy

However, with the purposes of:

- **External debt repayments of the public sector:**

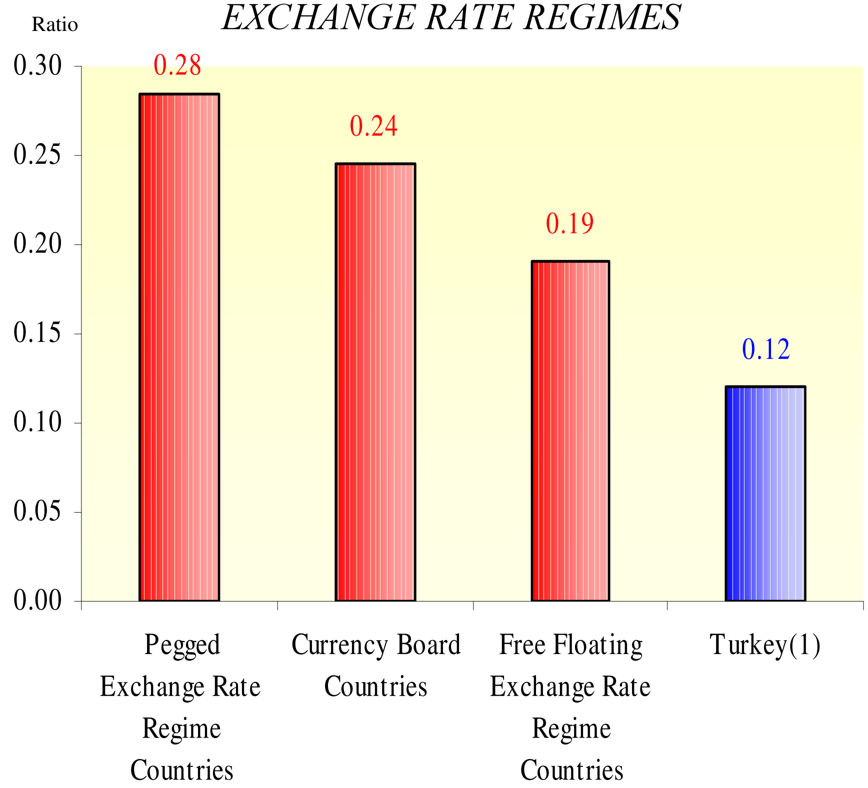
✓ *In the 2005Q3-2008 period, USD 51.1 billion worth of external debt repayment,*

- Gradually reducing **high-cost foreign exchange liabilities in CBT balance sheet**,
- **Establishment of confidence,**

foreign exchange purchase **is being made and will continue to be made** within the framework of a pre-announced, transparent program designed to strengthen the international reserve position.

- Examples from the world show that, even under floating exchange rate regimes, **countries prefer to have high foreign exchange reserves.**

AVERAGE RESERVES / GNP RATIOS FOR COUNTRIES ACCORDING TO THEIR EXCHANGE RATE REGIMES



Source: IMF
(1) As of the second quarter of 2005

Floating Exchange Rate Regime – Exc.Rate Policy

What Determines the Level and the Real Value of the Exchange Rate?

National currencies may appreciate or depreciate in the short and long-run in connection with:

- Selected exchange rate regimes and exchange rate policies that are being implemented,

- The extent of liberalization for the capital movements,

- Business cycles, growth and productivity increase,

- Current economic policies and their level of success,

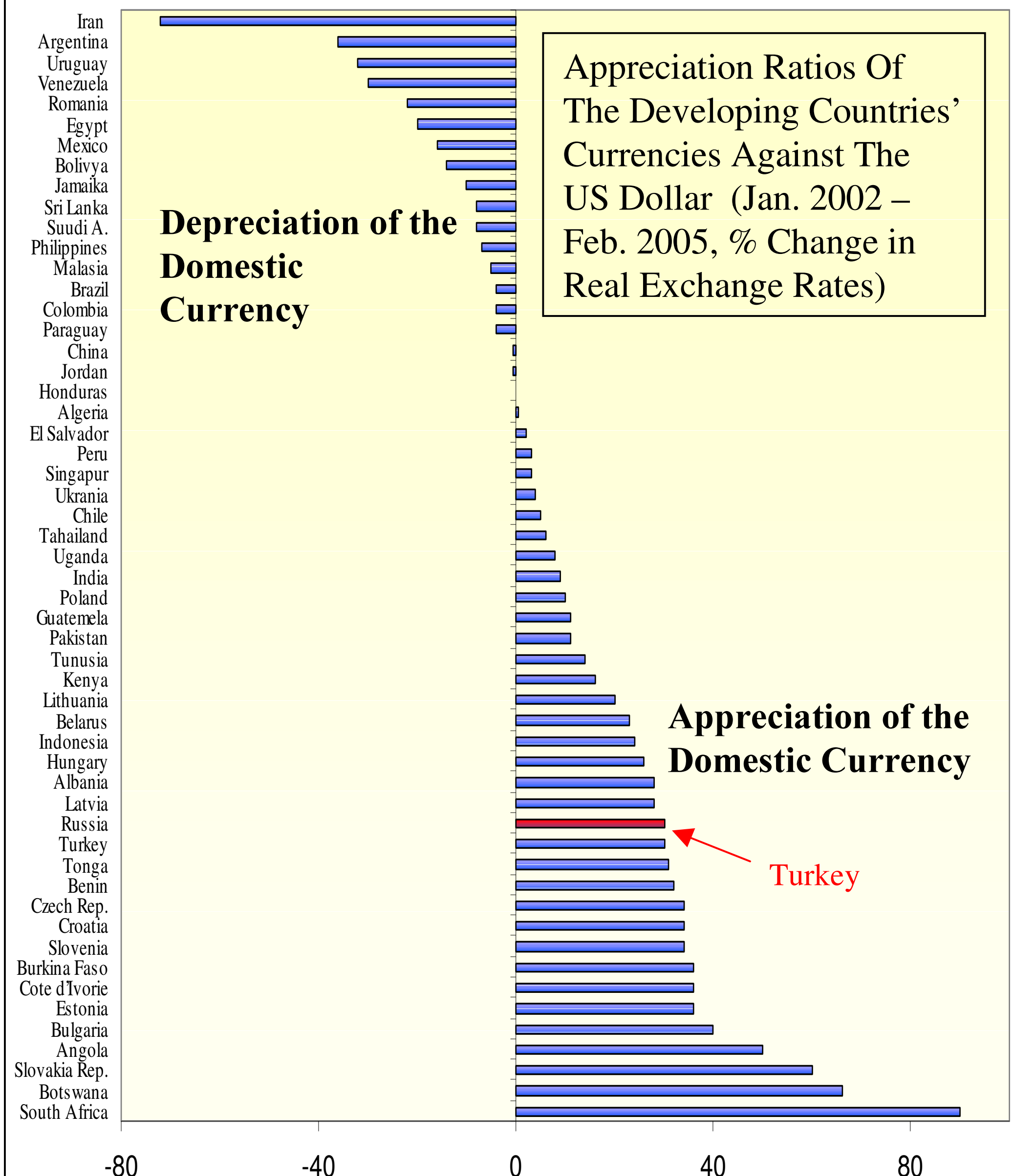
- Improvement in the economic fundamentals,

- Progress made towards stability, expectations and the encountered risk premium,

- Confidence and perspective given to internal and external economic units,

and also with the effect of the international liquidity conditions.

In the January 2002 – February 2005 period, Turkish currency is not the only national currency that appreciated; it is accompanied by the national currencies of several developing countries.



Source: World Development Finance

Floating Exchange Rate Regime – Exc.Rate Policy

Why is the Turkish Currency Appreciating?

- Success of the current economic policies: Growth without inflation,

- Improvement in economic fundamentals,

- Progress made towards stability.

- Confidence and perspective given to the domestic and external economic units,

- Improvement in the expectations,

- Decline in the risk premium.

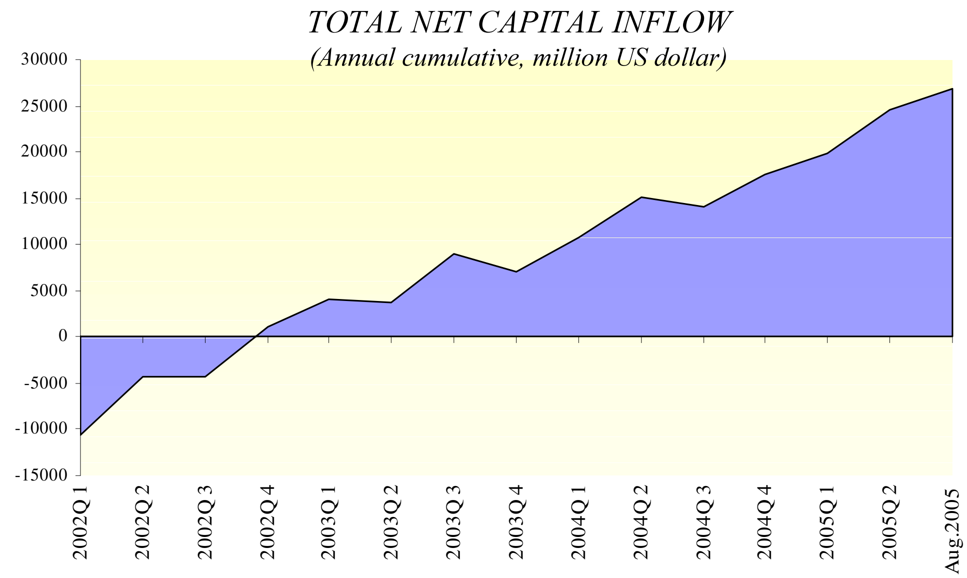
Credibility of the Turkish Currency Increases:

- Volume of currency in circulation / GDP

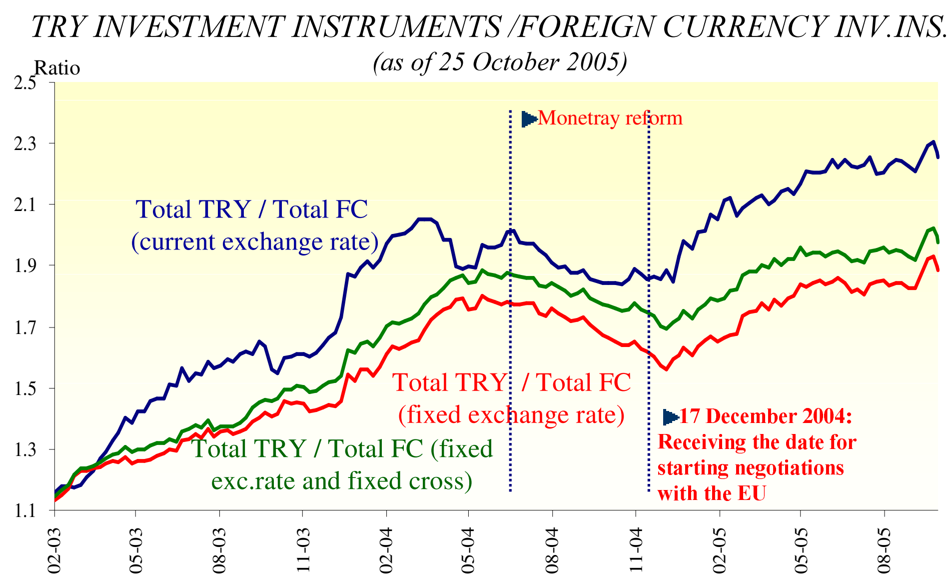
- Cycles per year

- Per capita amount of banknotes

- Foreigners issue TRY-denominated debt instruments.



Source: CBT



Foreign Currency Portfolio = Deposits + Government Securities + Eurobond+ Other

TRY Portfolio = Deposits + Government Securities + REPO + Mutual Funds + Other

Source: CBT

Floating Exchange Rate Regime – Exc.Rate Policy

Central Bank does not have any policy of keeping TRY overvalued.

- Transition to floating exchange rates, Telekom crisis, September 11 incident, summer 2002 political tension, Iraqi War, October 2003, April-May 2004 period, **Turkish lira suffered 7 sharp depreciations. If economic fundamentals deteriorate; the stability program is interrupted or delayed; expectations worsen; there may very well be another one.**
- Except 11 May 2004, **there has been no foreign exchange sales to the market since the start of 2003.**

- In the 2002 – 2005 period, USD **33.9 billion**, and since 22 December 2004, USD **17.9 billion** worth of foreign exchange has been bought. Purchases continue.
- **As, under the floating exchange rate regime, the level of exchange rates is a 'consequence',** it should be kept in mind that CBT intervenes directed to **volatility and not to the level**.

FOREIGN EXCHANGE RATES

(CBT benchmark daily exchange rates, US dollar BD doları satış)

Note: The dates written in red are the dates of CBT intervening in the foreign exchange marketby buying foreign exchange.
Source: CBT

Current Account Deficit

Current Account Deficit

Current Account Deficit - Crisis

- Paralel to the liberalization and rise of capital movements in the world after the 1980s;

✓ Balance of payments crises were observed to occur more frequently, current account deficit / GNP ratios began to be monitored closely.

✓ Turkey's past experiences also confirm this assesment.

What happened in the past?

Loose fiscal polices and accommodating monetary policies

Fixed / foreseeable exchange rate regime

✓ Excessive increase in domestic demand,

✓ Shortening of maturities,

✓ High inflation,

✓ Periods of volatile and unbalanced growth,

✓ Rising economic uncertainties,

✓ Current account deficit, delayed measures

Deterioration of expectations

Triggering effect of internal or external shocks

Rising demand for foreign exchange

Pressure on reserves

Crisis and Devaluation

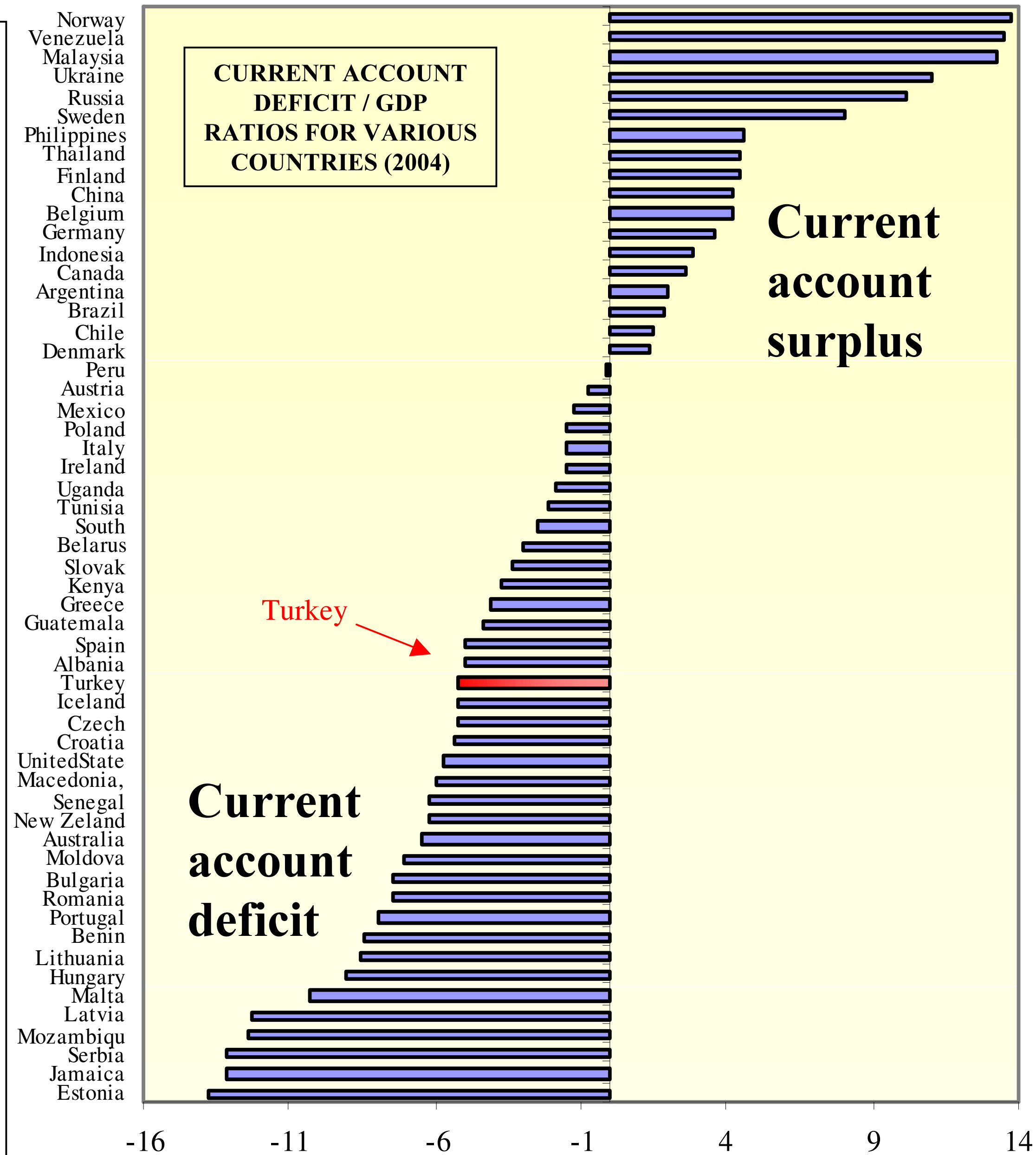
Current Account Deficit

Current Account Deficit - Crisis

- However, in recent years, higher level of financial and economic integration enable countries with strengthening macroeconomic stability **to sustain larger deficits.**

- Moreover, current account deficit alone is not an indicator of a crisis: Asian countries that suffered crises in 1997 were giving **current account surpluses at the time.**

- Today, circumstances of the **Turkish economy are significantly different from the past;** therefore, in these circumstances and under the current economic program, the rise in the current account deficit should not be expected to result in a crisis.



Source: World Bank

Current Account Deficit – Changing Conditions

What conditions differ from those in the past?

1. Causes of the current account deficit are different.

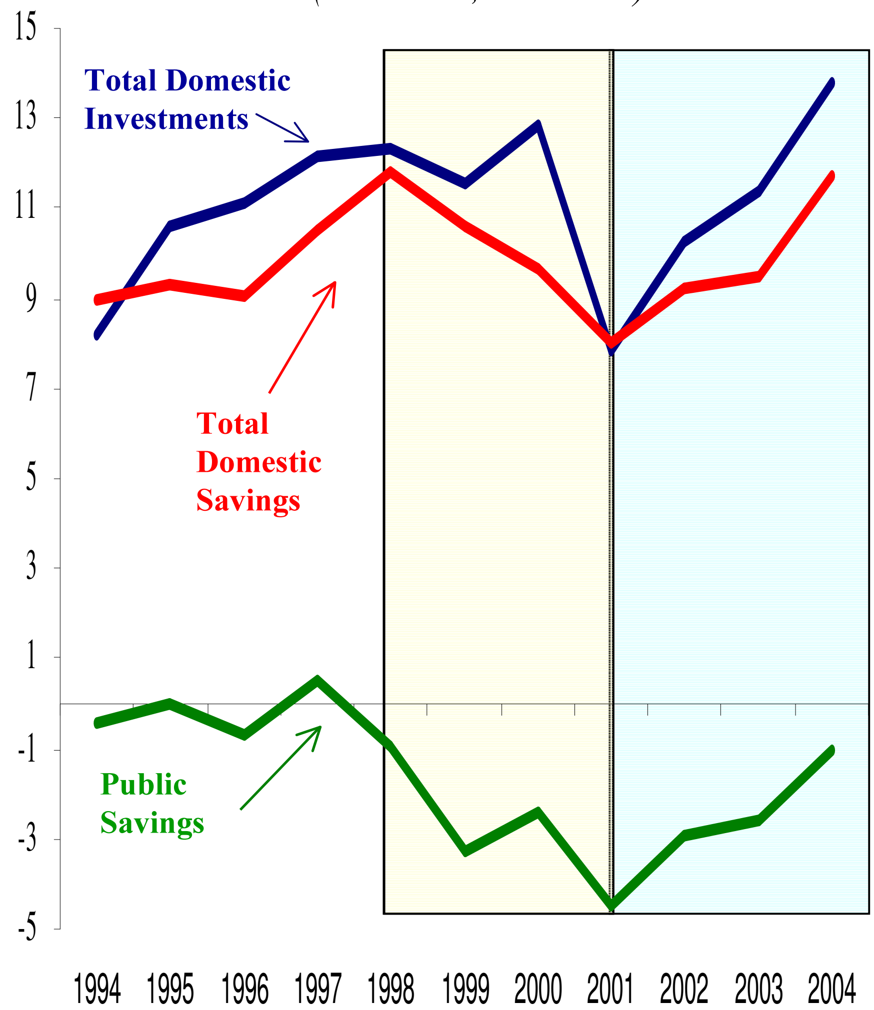
A- ***Current Account Balance = Total Domestic Savings – Total Domestic Investment.***

- Before the 2001 crisis, both investments and domestic savings declined, as a result of loose fiscal policy and increasing budgetary deficit.

- However, today both total domestic investments and public savings display an upward trend due to tight fiscal policy.

- Therefore, unlike the past, the current account deficit emerged due to the fact that investments grow more rapidly than savings.

TOTAL DOMESTIC INVESTMENTS AND TOTAL DOMESTIC SAVINGS
(Real values, billion TRY)



Source: SPO

Current Account Deficit – Changing Conditions

B- Oil prices, which have continuously increased since 2000, had a negative impact on the current account deficit.

✓ This negative impact became increasingly stronger and exceeded 1 percent of the GNP.

- A part of the current account deficit, which is caused by oil prices, created rigidity in the current account deficit.

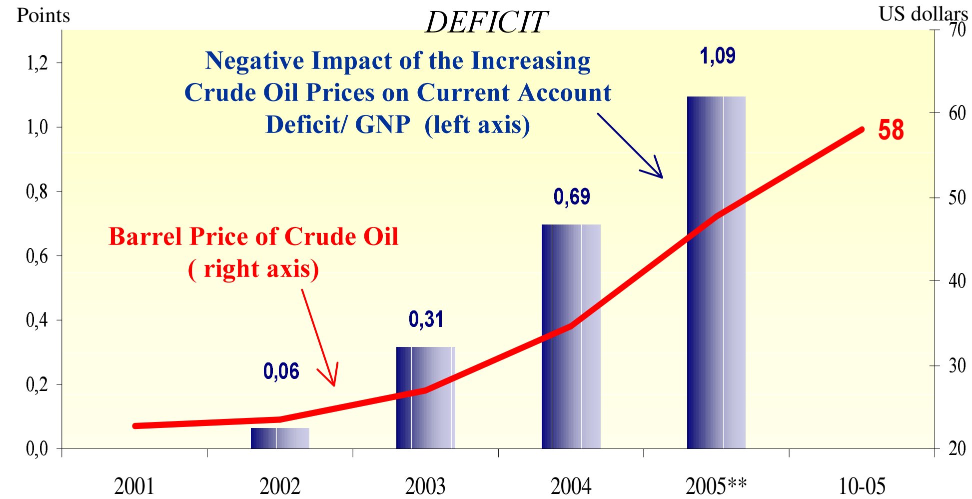
-Why do crude oil prices increase?

✓ Insufficient investment in the world petroleum sector led to low supply flexibility.

✓ Along with the downward trend of global interests, investors entered petroleum markets in order to protect themselves, with expectations that the decline in the US dollar would continue in the medium term and oil prices would increase.

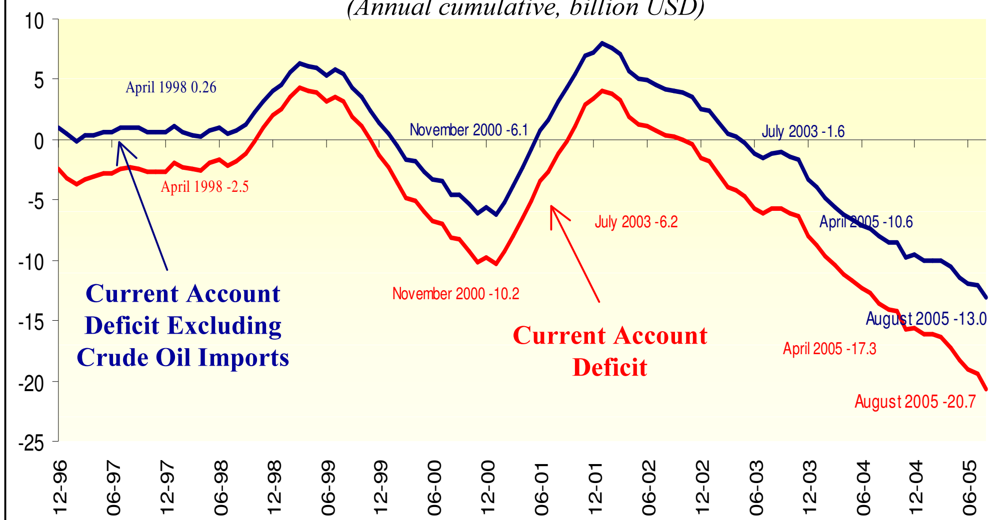
✓ Oil demand increased due to high growth rates.

CRUDE OIL PRICES AND ITS IMPACT ON CURRENT ACCOUNT DEFICIT



* The average, which is used herein, is compiled in 2001 and is 22.7.
** Crude oil imports are 12-month cumulative as of July, whereas the GNP is annually cumulative as of Q2. Brent oil price dated 10-05, 28 October 2005.

CURRENT ACCOUNT DEFICIT
(Annual cumulative, billion USD)



Source: SIS, SPO, CBT

Current Account Deficit – Changing Conditions

Which conditions differ from those in the past?

2. The structure of capital movements, which finance the deficit, have changed:

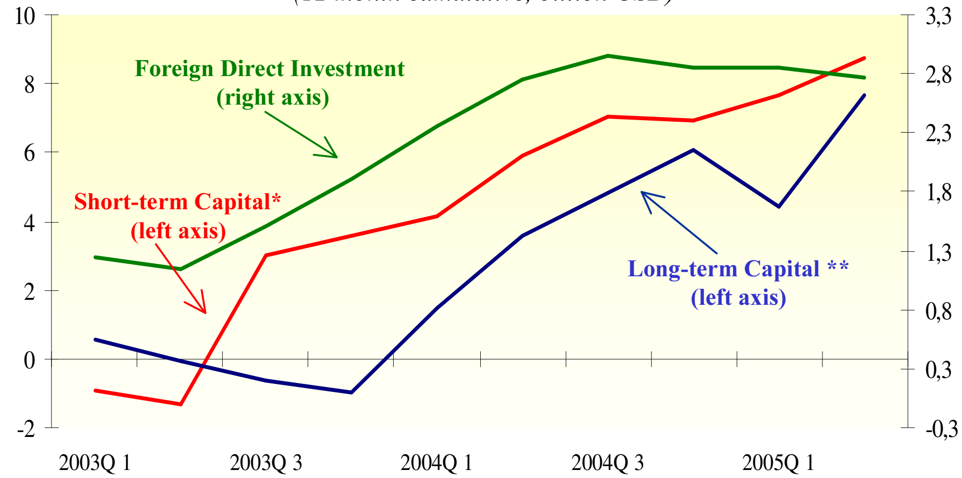
As of August 2005, except for IMF credits and FX reserves, net (**annual** cumulative) **capital inflow became USD 26.9 billion**.

A- The main factor of capital inflow is the substantial increase in the credit utilization of the non-banking private sector. It constitutes 33 percent of the total inflow:

- *Share of commercial credits,36 percent*
- *Share of long-term credits, 62 percent*

- These credits are production- oriented and are used in the imports of capital and intermediate goods.

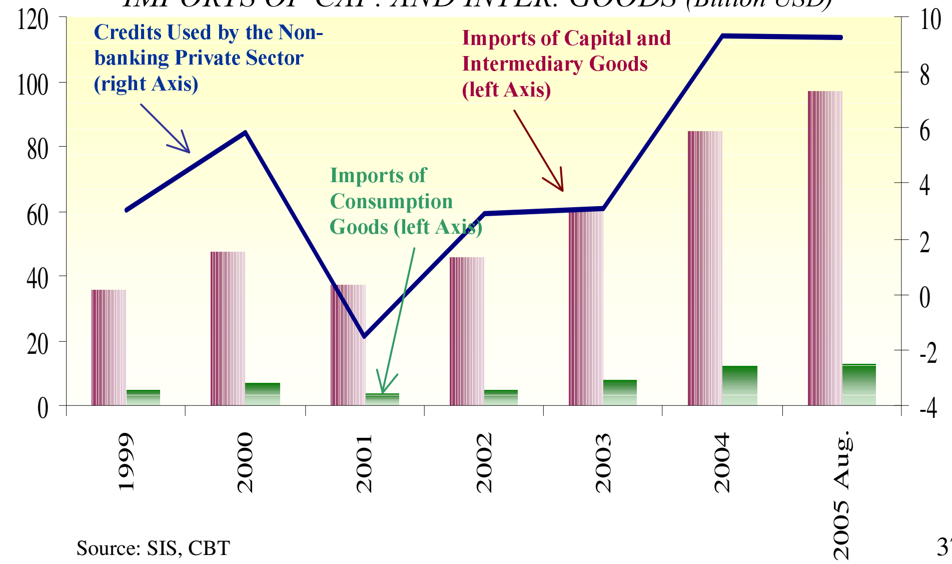
MATURITY COMPOSITION OF CAPITAL
(12 month cumulative, billion USD)



* Short-term commercial credits, short-term credits belonging to banks and other sectors and banking sector deposits.

** Long-term commercial credits, long-term credits belonging to banks and other sectors.

CREDIT UTILIZATION OF NON-BANKING PRI. SECTOR AND IMPORTS OF CAP. AND INTER. GOODS (Billion USD)



Source: SIS, CBT

Current Account Deficit – Changing Conditions

B- **Shares of long-term capital** and **foreign direct investment grow** increasingly in total capital movements.They will continue to grow as long as structural reforms are carried out and stability is maintained.

- **Despite its gradual increase** in a period of 20 years (1980-2000), foreign direct investment inflow **was realized as** USD 500 million **on average**.

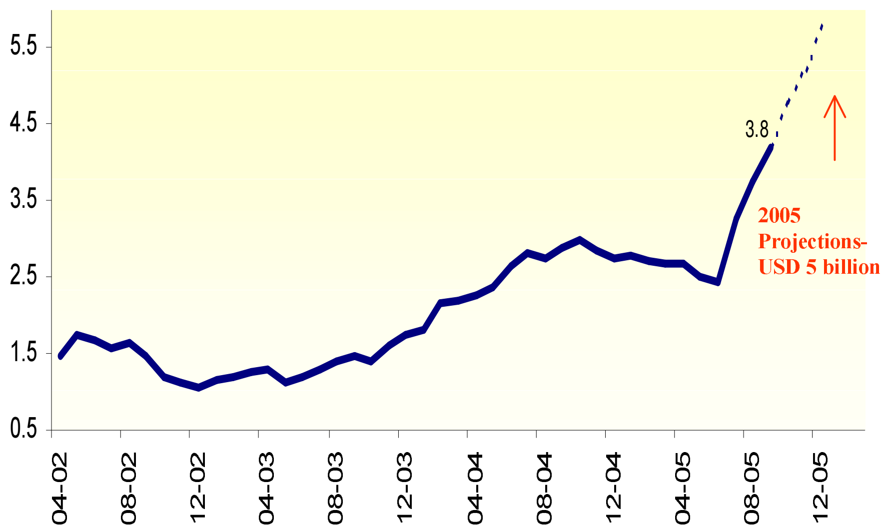
-The foreign direct investment inflow reached **USD 2 billion** in **the last five years** (2000-2004).

- Foreign investments displayed a substantial increase in 2005 and this trend is expected to continue in the upcoming years. Privatisation has an important impact on the said performance.

- In 2005, the subscribed amount reached USD 20 billion in the scope of privatisation and other activities. This figure is twice as big as the income that Turkey had earned via privatisation in the last 20 years.**

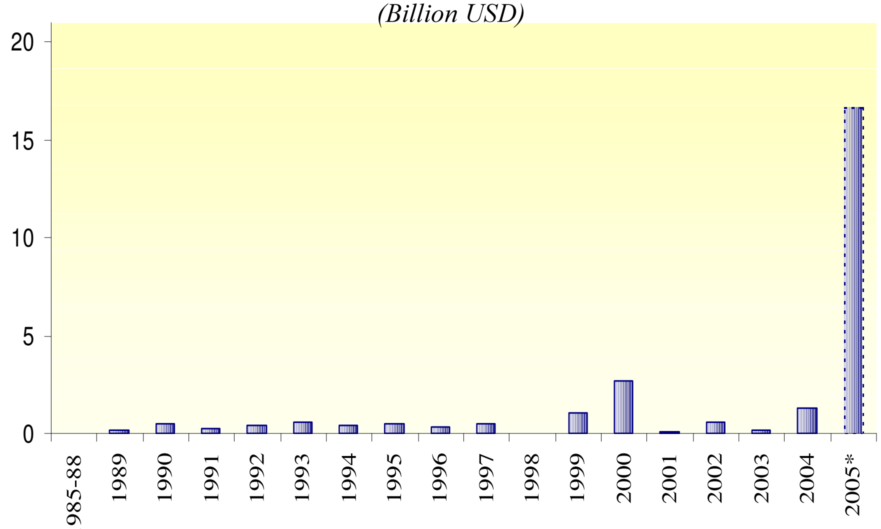
C- Share of the short-term capital in total is 53 percent. Main factor of the increase in short-term capital inflow is the increase in the short-term credits used by banks. Risk decreases as the fragilities in the banking sector ease.

FOREIGN DIRECT INVESTMENT
(12 month cumulative, billion USD)



Source: CBT

PRIVATISATION REVENUE
(Billion USD)



* Source:PA (Privatisation Administration) as of October 2005.
** Galataport is included.

Current Account Deficit – Changing Conditions

D- Hot money is composed of part of the short- term capital flows, portfolio investments and net errors and omissions.

- It is not only non-resident-oriented, in fact there is a **significant amount of resident's hot money** in Turkey.

- The most important item of hot money is portfolio investments, which are composed of equity securities and government papers.

Is hot money a problem?

✓ Floating exchange rate regime, shock- absorbing, risk is in the market.

➢ Under the fixed/managed exchange rate regimes there were exchange rate commitments; so when hot money was exiting the market the CBT had to sell them in terms of the said exchange rate. As long as the regime prevails, no risk or yield is guaranteed.

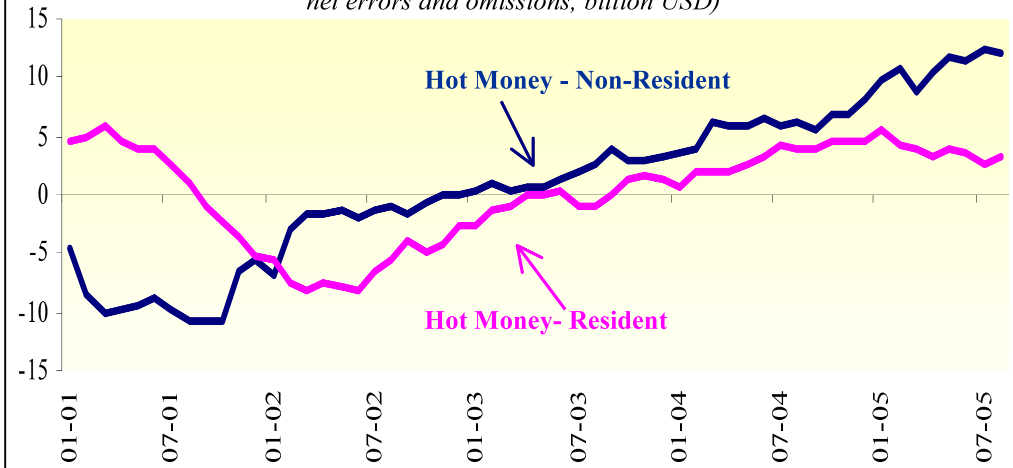
➢ Today there are no exchange rate commitments. Thus,when hot money wants to exit, the CBT has to conduct transactions in terms of market exchange rates. There is exchange rate risk, the yield is not guaranteed, leading to probable loss.

✓ Extension of the maturity of government papers,

✓ Stronger economic foundations,

Slow down the sudden movements of hot money and weaken its negative impacts.

COMPOSITION OF HOT MONEY (12 month cumulative , excluding net errors and omissions, billion USD)



Source: CBT.

Hot Money (As of August 2005 annual cumulative, billion USD)

	Aug. 2005
Non-resident	**12.2**
Government papers	**5.9**
Equity securities	**4.8**
(TRY+ FX+Repo)	**1.5**
Resident	**2.6**
Banking sector short-term credits extended abroad	**0.2**
Banking sector short –term external debt	**2.3**
Private sector short-term external debt	**0.1**

Net Errors and Omissions (cumulative)	**7.3**

Current Account Deficit – Changing Conditions

E- There has been a significant rise in the net errors and omission item (NEO) in recent years.

- **Factors leading to net errors and omissions:**

✓ Foreign exchange assets of the non-banking sector can not be monitored completely.

✓ Movements of goods and payments may fall into different balance sheets in imports and exports.

✓ False statements on customs operations.

✓ Errors made while conducting surveys on tourism and shuttle trade.

- **Compared to European countries, Turkey's net errors and omissions item is not very large.**

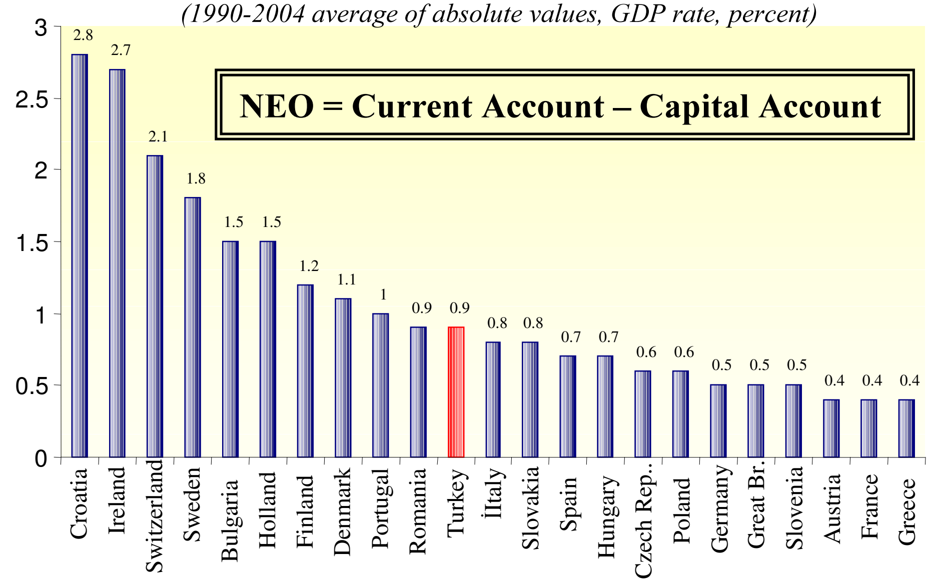
- **Currency substitution;**

-The net errors and omissions item is likely to show a positive balance in periods with relative stability where there is reversecurrency substitution.

-On the other hand, it tends to show a negative balance in times of crisis and instability where there iscurrency substitution.

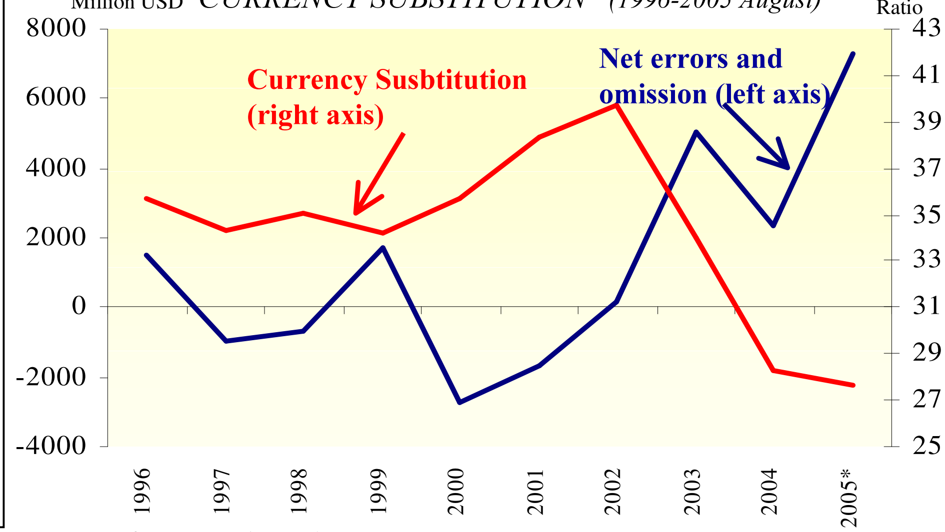
-The recent increase in the net errors and omissions item confirms the fact that, as a result of the enhanced credibility, the private sector has brought to the country the foreign assets that they kept abroad or hoarded.

NET ERRORS AND OMISSION VALUES OF EUROPEAN COUNTRIES
(1990-2004 average of absolute values, GDP rate, percent)



Source: IMF

NET ERRORS AND OMISSION AND CURRENCY SUBSTITUTION (1996-2005 August)*



* As of August 2005, annual.
Source: CBT

* Currency substitution is calculated as the ratio of the foreign currency portfolios of the residents to total portfolios.

Current Account Deficit – Changing Conditions

What conditions differ from those in the past?

3. The **Finance sector is stronger** and the amount of open position of the banking sector is much less.

✓ However, the real sector should pay attention to its open positions. A return to past tendencies is a risk.

4. FX reserves hit record highs.

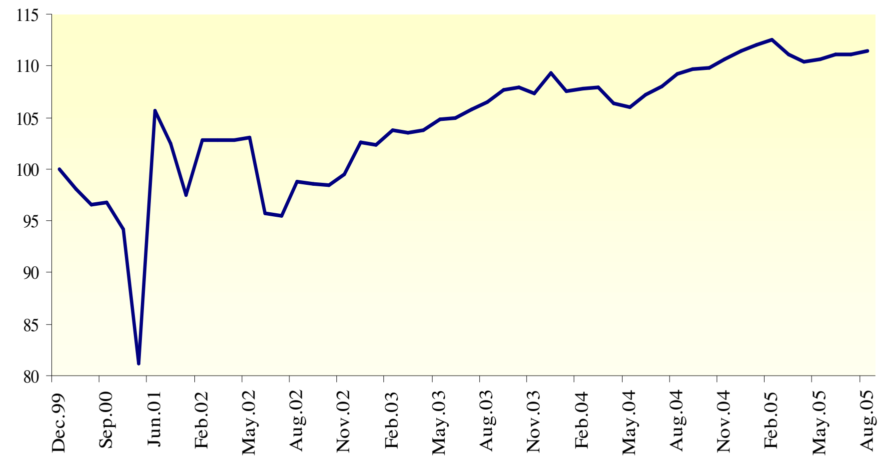
5. The value of TRY is not kept high artificially.

✓ The CBT purchased USD 33.9 billion in the 2002-2005 (27 October) period.

6. Tight fiscal and monetary policies are maintained.

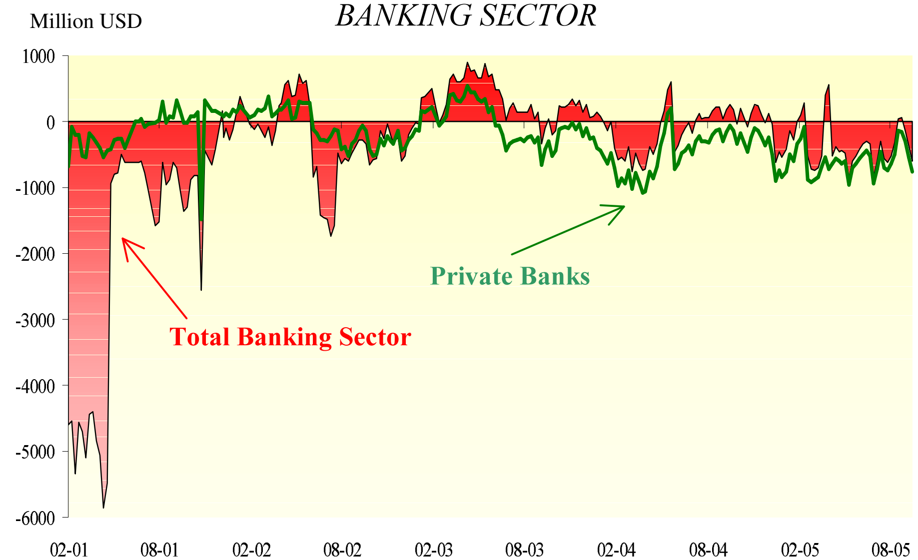
7. Inflation is much lower and significant steps have been made towards macroeconomic stability.

FINANCIAL STRENGTH INDEX



Note: A rise in the index points to an amelioration, while a decline shows a deterioration.
Source: CBT

DEVELOPMENT OF THE NET FX POSITION OF THE BANKING SECTOR



Source: SIS,CBT, BRSA

Relationship between Current Account Deficit – Interests – Exchange Rate

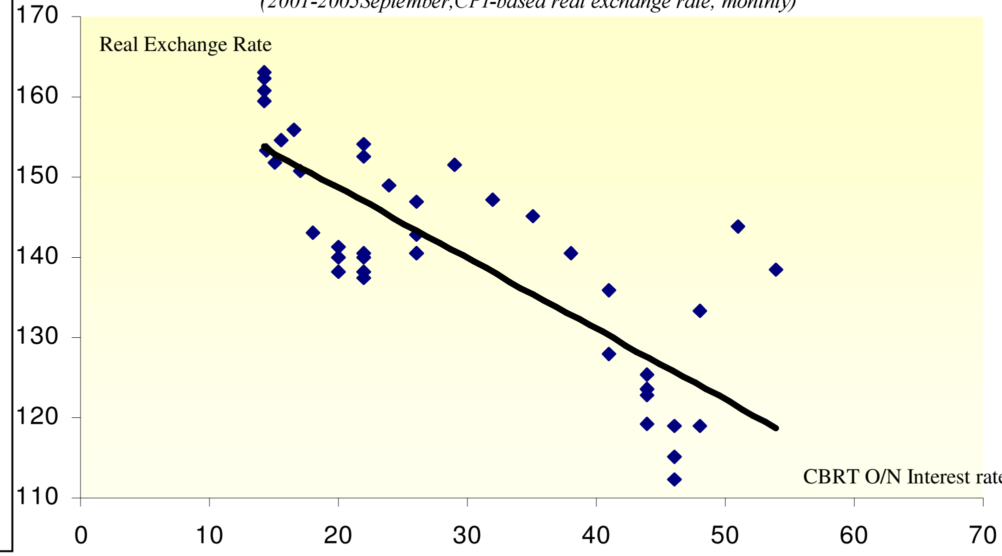
Current Account Deficit-Interest;

- As indicated in theoretical and applied economics literature, under certain assumptions, there is a negative correlation between between current account deficit and interests in most countries. The situation is the same in Turkey:

✓ A rise in interests decreases the current account deficit or puts pressure on its increase.

✓ A decline in interests increases the current account deficit.

RELATIONSHIP BETWEEN CBT ON INTEREST RATE- REAL EXCHANGE RATE
(2001-2005September,CPI-based real exchange rate, monthly)



Source: CBT

Interests- Real Exchange Rates ;

- Contrary to expectated/ projected, there is a negative correlation between policy interest rates and real exchange rates in Turkey.

- In other words, Turkish currency appreciated as interest rates decreased and depreciated as interest rates increased.

- Expectations reversed the relationship between interest rates and exchange rates; which is foreseen by the theoretical framework.

- The decline in interest rates improves positive expectations, causes capital inflow and applies selling pressure on exchange rates.

- A rise in interest rates deteriorates expectations and results in depreciation of the national currency.

-Therefore, we cannot say that decreasing interest rates will help to reduce the current account deficit via exchange rates.

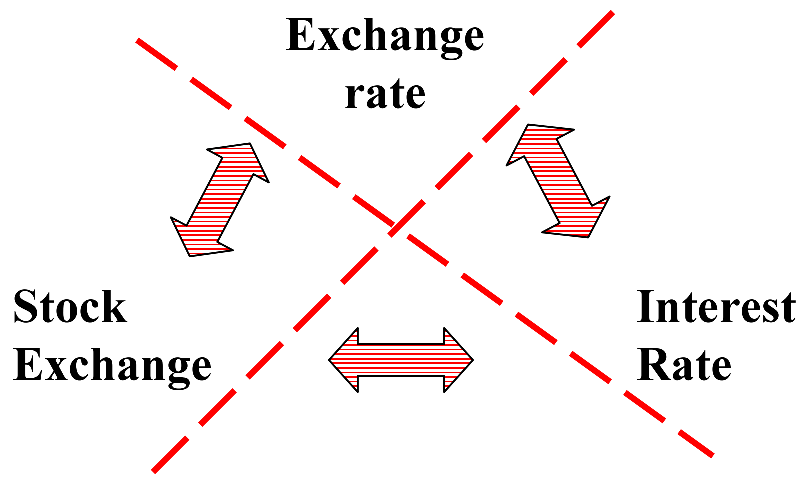
Turkish Economy – From Now On

Turkish Economy-From Now On

The future of the Turkish economy depends on **when and how it will reach its final goals** and **how comprehensive** and **swift** the structural reform process will be achieved.

Therefore,

We should discuss the **real functions** of the



triangle, which has become **a vicious circle** because of the "rise and fall" talks made with a **short-sighted perspective.**

Turkish Economy-From Now On

We should focus on what needs to be done in the framework of

Price Stability

Sustainable Increase in Employment

Sustainable Growth

with a medium and long term perspective. The EU membership process presents an important framework.

From now on:

1- Banking Sector Reform

2- Tax Reform

3- Social Security Reform

4- Quality of Fiscal Adjustment

5- Public Sector Reform

6- Application of the principles of good governance

7- Improvement of the investment environment

8- Spreading the increases in productivity to all sectors

9- Active employment policies

10- Coordination of Economic Policies

11- Institutionalization

ANNEX 1: Dolarization

Dollarization and De-dollarization

Causes of Dollarization; 1983 – 2001

- **Macroeconomic instability;**

✓ Chronic and high inflation,

✓ The volatility of inflation being relatively higher than the volatility of exchange rates.

- Poor market regulations;

✓ State guarantees for FX deposits,

✓ Undeveloped risk- protection instruments,

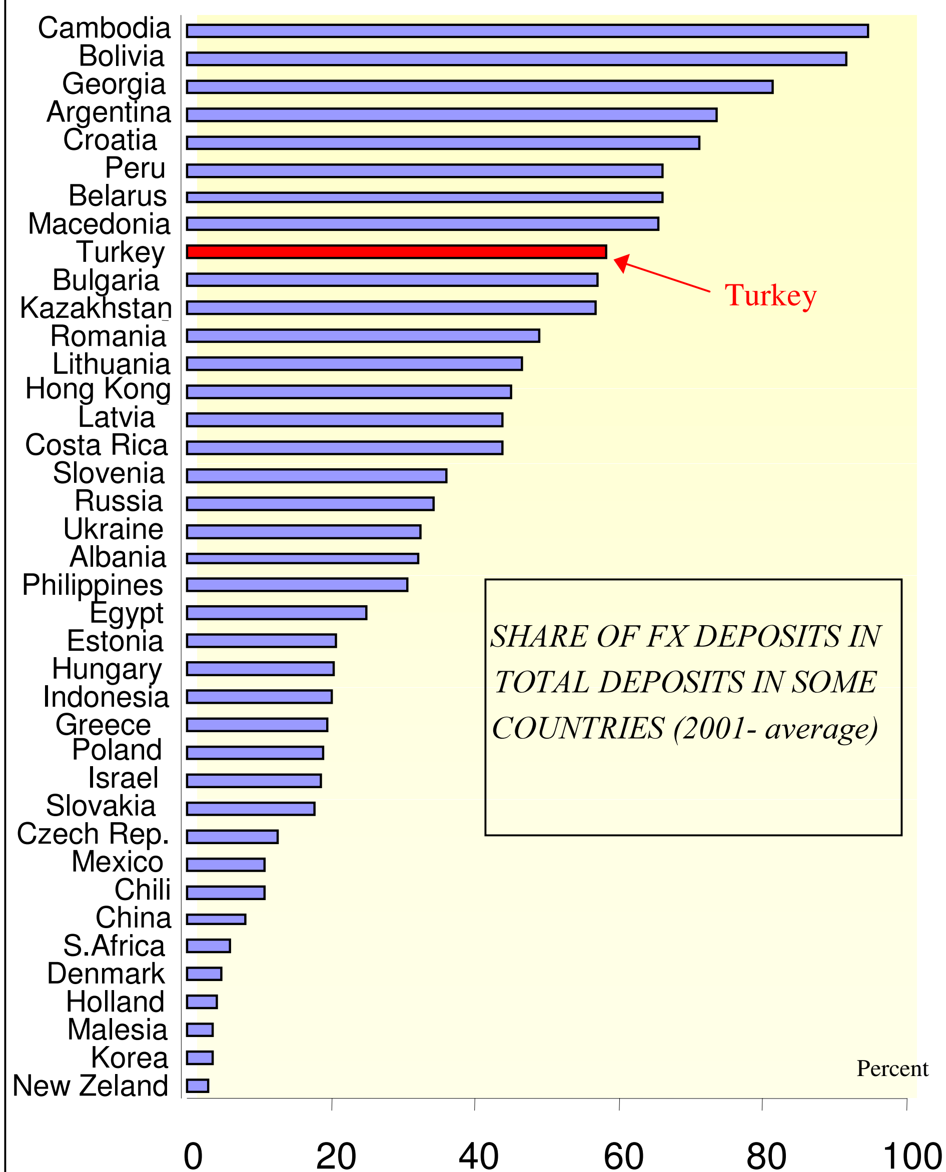
✓ Lack of supervision.

- *Lack of confidence in economic policies.*

As of 2001, Turkey became one of the countries with the highest dollarization rate among enhancing market economies.

- Share of FX deposits in total deposits,

In 1990 - 25.9 percent ⟹ In 2001 - 58.2 percent



Source: De Nicolo, G.; P. Honohan and A. Ize; "Dollarization of the Banking System: Good or Bad?"; IMF Working Paper; WP/03/146

Dollarization and De-dollarization

Negative Impacts of Dollarization

- On Monetary Policy;

✓ Instability in money demand (makes it difficult to predict and control inflation)

- On the Finance Sector;

✓ Risks concerning solvency (balance sheet risk, credit risk),

✓ Liquidity risk

- On the Public Sector;

✓ Risk of public debt sustainability,

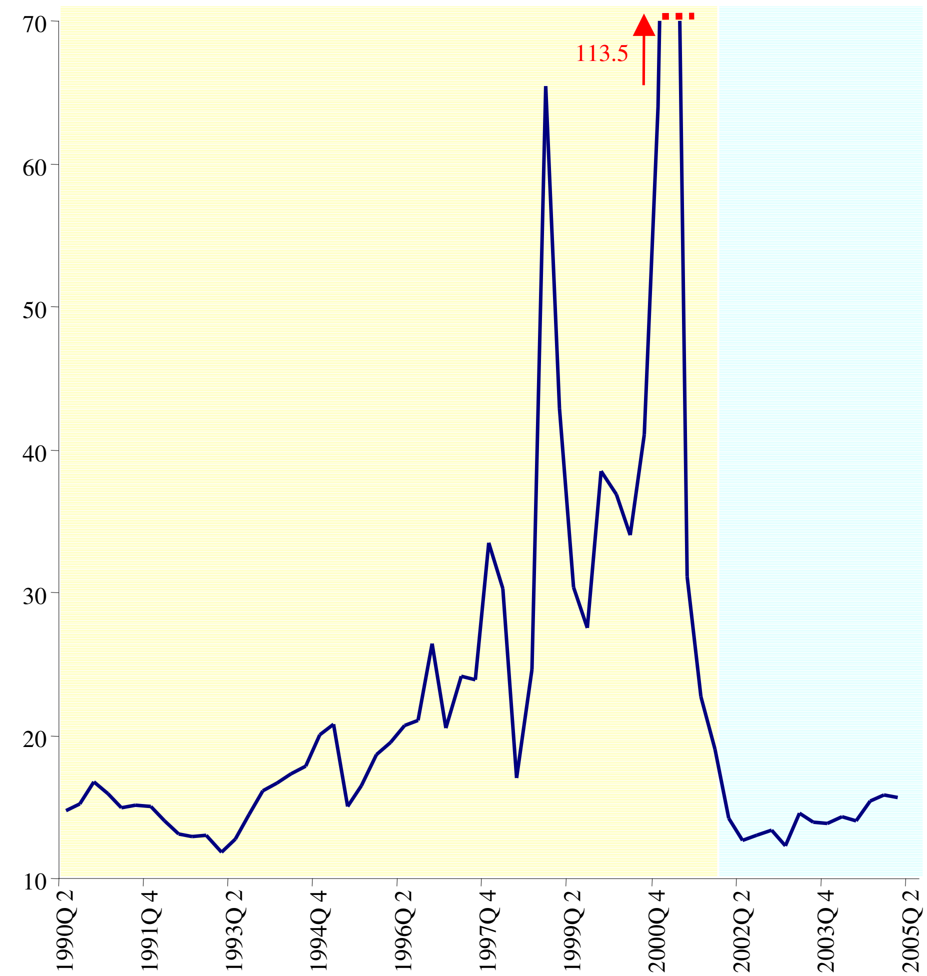
✓ Negative impact of the incoherence of the public sector on the banking system.

- On the Real Sector;

✓ Balance sheet risk,

✓ Frequent pricing behaviour.

*VELOCITY OF MONEY**



*GNP/ Central Bank Money
Stavility of the velocity of money is the indicator of the stability of money demand.
Source: CBT, SIS

Dollarization and De-dollarization

The dollarization process has reversed in the last 3 years.

- Ratio of FX Deposits to Total Deposits is 37.7 percent as of October 2005.

- Ratio of TRY-denominated investment instruments to those of foreign exchange is increasing.

Causes of the Reverse Dollarization:

- Steps towards achieving macroeconomic stability,

✓ Tight monetary and fiscal policies, structural reforms, market regulations, implicit inflation targeting, floating exchange rate regime;

Single-digit inflation figures, foreign exchange rate risk is in the market	*Inflation – Relative volatility of exchange rate decreased.*

- However, dollarization rates do not decline rapidly they are still at high levels.

✓ Past habits started to change but they still continue.

✓ The reason for opposition to the stability program and the exchange rate policy is dollarization.

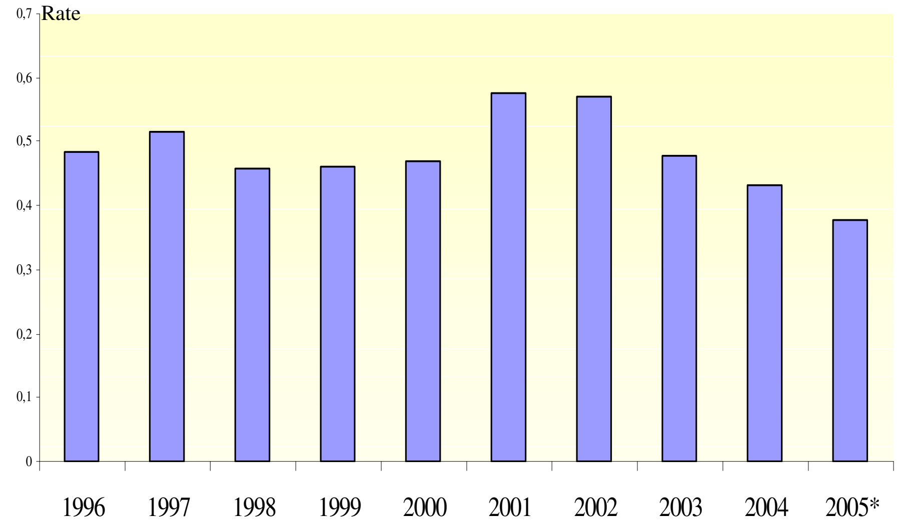
-Current policies and structural reforms should continue;

-We should implement new measures that will

✓ ***Encourage the utilization of the national currency***

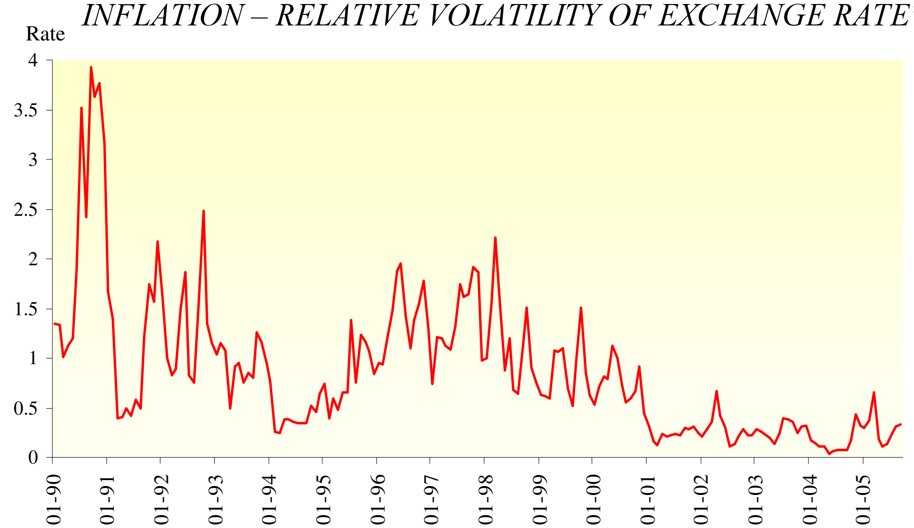
✓ ***Increase the costs of FX-denominated intermediation.***

SHARE OF FX DEPOSITS IN TOTAL DEPOSITS



* As of 7 October 2005.

*INFLATION – RELATIVE VOLATILITY OF EXCHANGE RATE**



* Volatility in inflation / Volatility in exchange rates;
Volatility is calculated with the rolling 6-month standard deviation of the percent changes.
Exchange rates, monthly average USD selling; inflation, CPI monthly percent change

Source: CBT

ANNEX 2: Domestic Debt Stock –

Interest Rates

Domestic Debt Stock- Interest Rates

Domestic Debt Stock and Interest rates

- In the framework of the domestic debt mechanism,

✓ The amount that is added to the debt stock after a new borrowing made in terms of TRY, is equal to the actual amount that is received by the Treasury.

✓ When the maturity of the debt is due, the amount to be paid is the amount received including the interest to be paid against this amount.

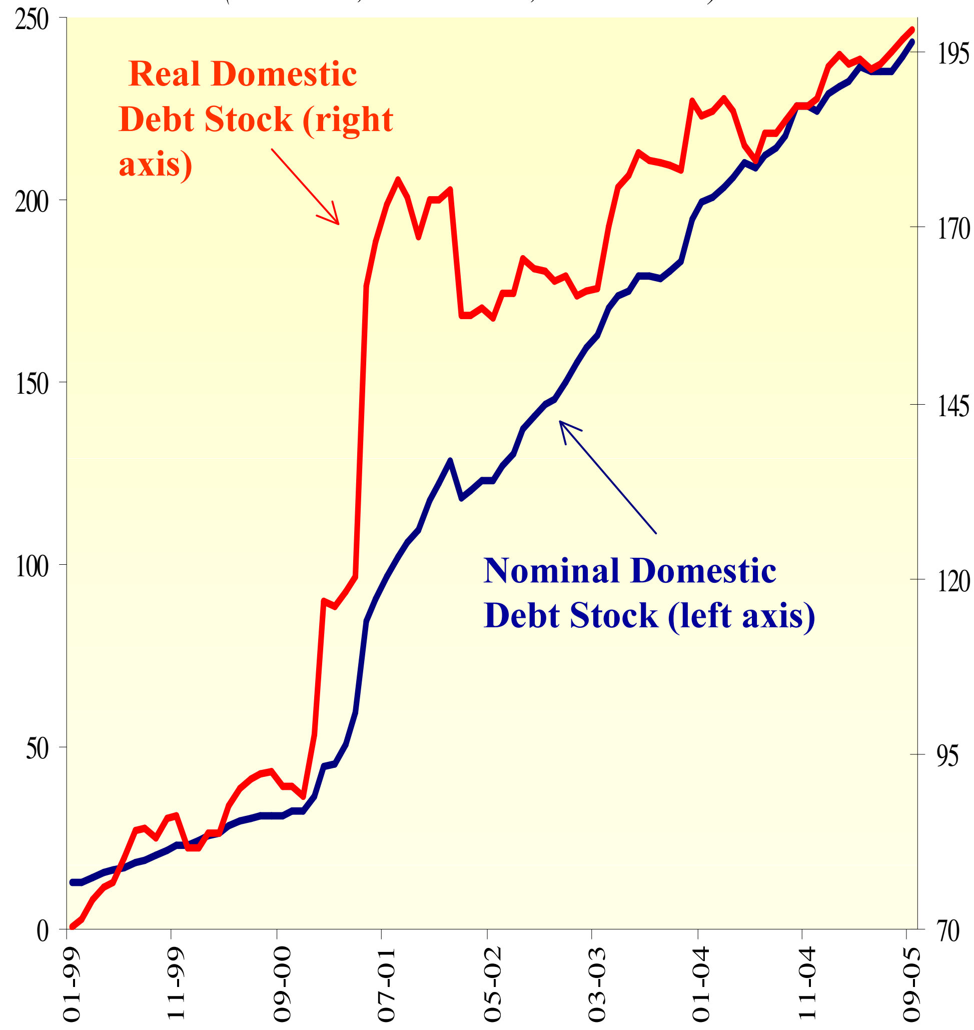
✓ As long as the Treasury did not borrow less than its redemption, it has to make a net borrowing (again) amounting to this total in order to pay the principle and interest debt.

✓ Therefore, in every redemption, debt stock decreases as much as the principle, while new debt amounting to the principle + interest payment is added to the debt stock with every old debt that exits from the stock.

In conclusion, as long as real and nominal interests are not at negative values (even if they were 1 percent, it would not change anything), TRY-denominated debt stock will increase continuously in real and nominal terms in cases where borrowing is made less than the principal. *Privatisation presents important opportunities with regard to this situation.*

DOMESTIC DEBT STOCK

(Billion TRY, PPI 2003=100, WPI 1994=100)



Source: Undersecretariat of Treasury, CBT

Domestic Debt Stock- Interest Rates

Domestic Debt Stock and Interest Rates

- Therefore, we should consider debt stock **in terms of ratios.**

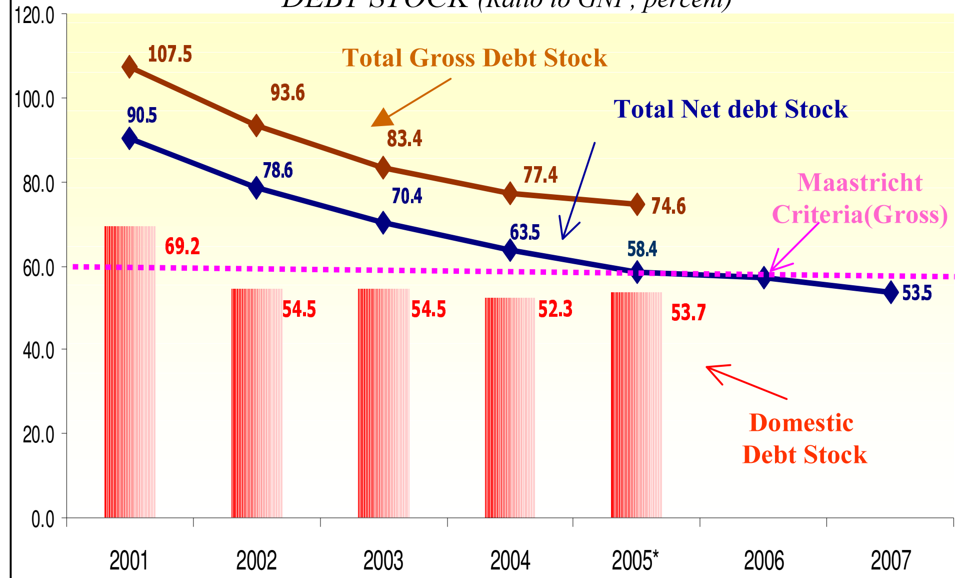
- **The ratio of debt stock to national income is decreasing.**

✓ There is a substantial decline in the ratio of stock to the paid interest amount.

- Although Turkey's debt stock/ GNP ratio is manageable for most countries, the debt structure **still has quite a short average maturity** even after its expansion in recent periods, thus it constitutes a risk. Therefore, in the framework of the National Program and the Letter of Intent, the implementation of **tight fiscal policy** and **primary surplus (application)** in accordance with the medium-term debt reducing strategy is of great importance.

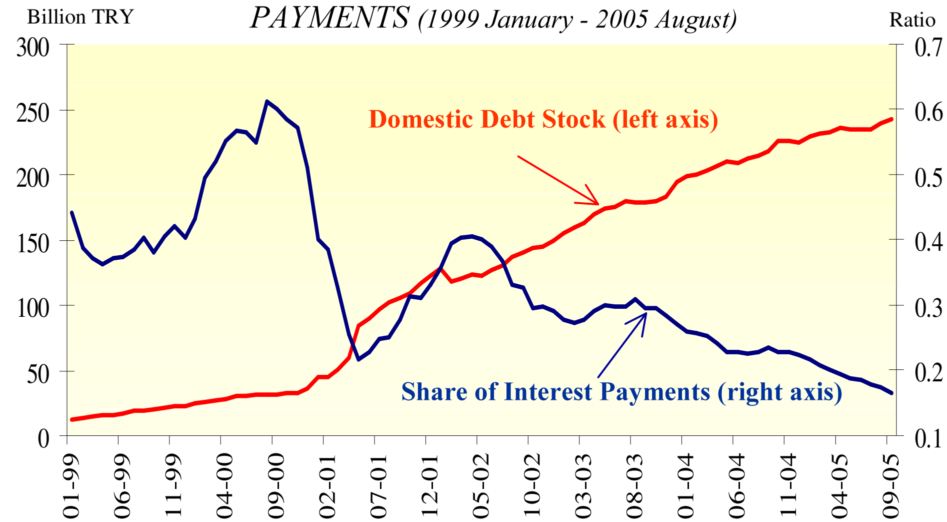
- However **the quality of fiscal adjustment**, which considers sustainability and effectiveness and aims at maximizing the impact of the fiscal policy on growth, **is as important as the policies that reduce the debt stock.**

DEBT STOCK (Ratio to GNP, percent)



* Domestic Debt Stock /GNP, as of Q2 of 2005 annual cumulative is calculated.

SHARES OF DOMESTIC DEBT STOCK (Nominal) AND INTERST PAYMENTS (1999 January - 2005 August)



Source: Undersecretariat of Treasury

ECONOMIC OUTLOOK

CENTRAL BANK OF TURKEY

October 2005