



ECONOMIC OUTLOOK

CENTRAL BANK OF THE REPUBLIC OF TURKEY

April 2005

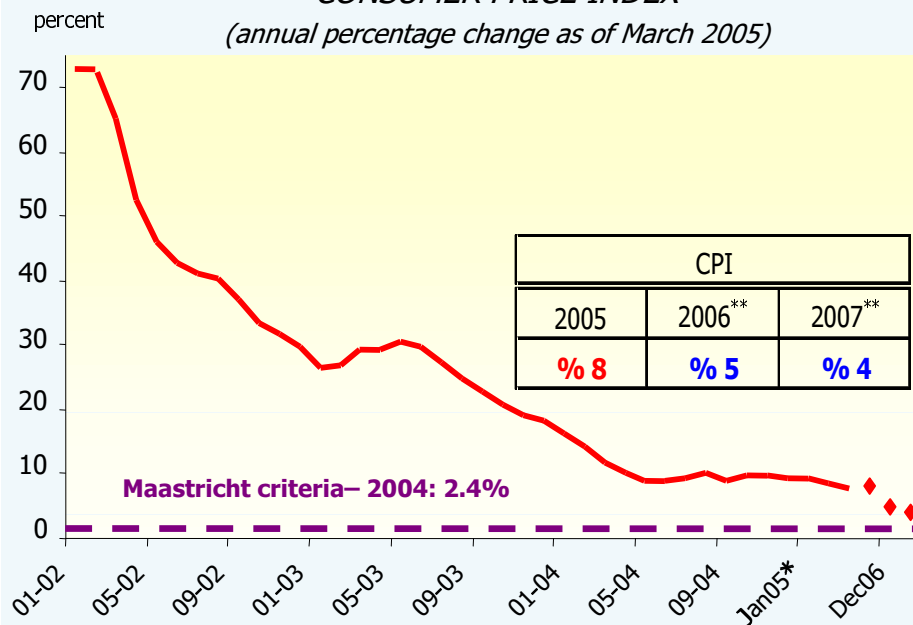


PROGRESS MADE TOWARDS STABILITY

Inflation

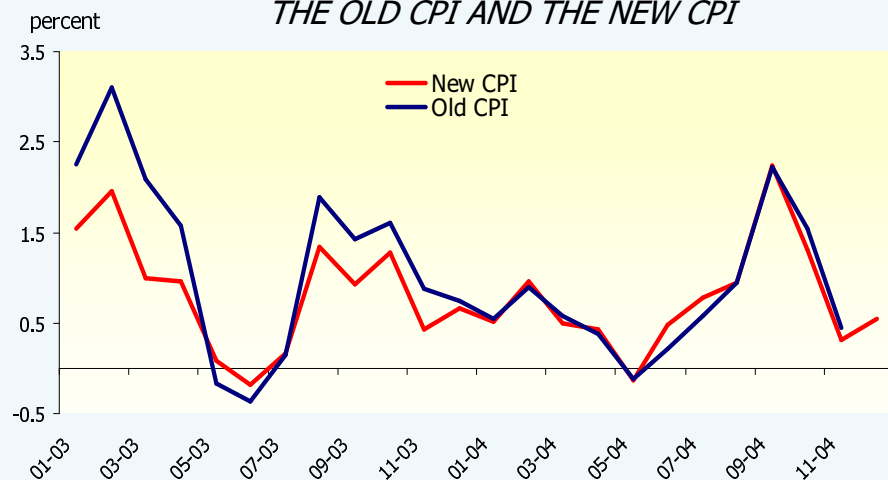
Progress Made Towards Stability

CONSUMER PRICE INDEX
(annual percentage change as of March 2005)



* Inflation data for the year 2005 was calculated by using the index as 2003=100.
** 2006 and 2007: Program targets

THE OLD CPI AND THE NEW CPI



Source: SIS

Considerable progress has been made in the fight against inflation.

CPI; 2005 March; the lowest inflation in **35 years**

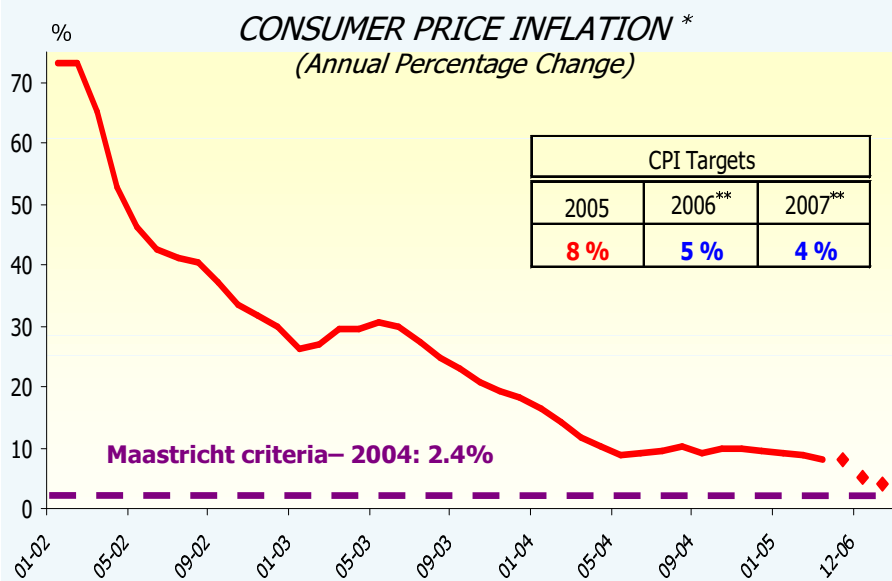
2001: 68.5 % ⇔ 2005 March: 7.94 %

	2002	2003	2004	2005
Target	35	20	12	8
Realization	29.7	18.4	9.32	March 7.94

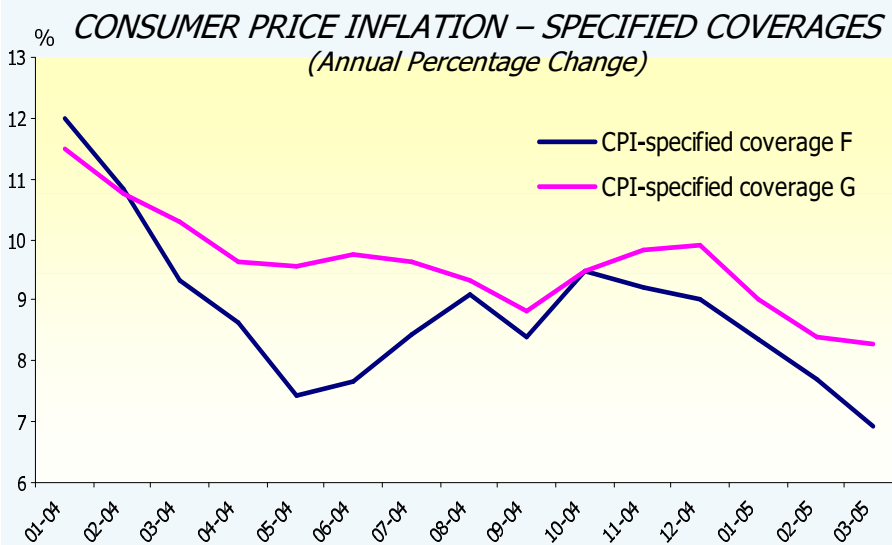
The new CPI index for 2005 with the base year 2003:

- ✓ The old / new CPI for 2004 display no apparent measurement difference.
- ✓ The new index covers a wider basket of goods and services.
- ✓ The number of workplaces and residences used in the compilation of prices was raised.
- ✓ Current consumption was reflected in the new index, weights of certain items such as rents were changed. (25.8 % ⇔ 16.9 %)
- ✓ **Core inflation?** Seasonally adjusted CPI's having specified coverages began to be announced, in order to help to observe the basic trends of inflation (7 coverages).

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* 2005 inflation has been calculated with the 2003=100 index.
** 2006 and 2007: Program targets



CPI-specified coverage F excludes: energy, administered prices and indirect taxes
CPI-specified coverage G excludes: F and unprocessed food products

Source: State Institute of Statistics

CPI; January - March 2005:

**First 3 months cumulative: 0.83 %; lowest figure ever,
March: 0.26 %, Annual: 7.94 %**

- ✓ Food and clothing prices;
 - Below the CPI increase for the first three months
 - Slight rise possible in April due to seasonality.
- ✓ Relative increase in demand persists, but in a controlled fashion;
 - This controlled nature limits the upward pressure on prices.
- ✓ Lagged effect of the appreciation in the TRY;
 - Favorably affected the prices of durable consumption goods.
- ✓ High level of oil, natural gas and heating oil prices worldwide;
 - Affected the prices of housing and transportation in the first three months; now they stand above the CPI.
 - May have a stronger effect on inflation in April.
- ✓ The continued price rigidities in the services sector, although having eased;
 - The housing, restaurants and hotels group display an increase above the CPI.

- ✓ In the coming months, the CPI may rise above the levels recorded in the first three months.
- ✓ CPI's having specified coverage indices declined considerably.
- ✓ No apparent problem with the 8 percent target.

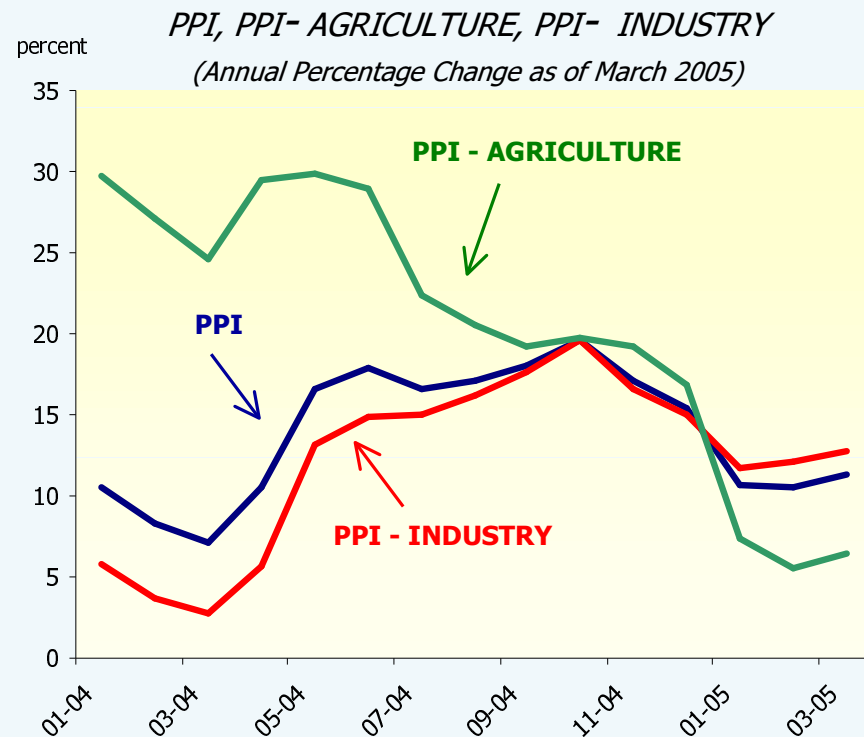


CPI shows a downward trend.

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In 2005, the new index with the base year 2003 began to be publicized instead of the WPI, i.e. the PPI – Producer Price Index.

- ✓ No more differentiation between the public and the private.
- ✓ Value added tax is not covered.
- ✓ Weights of the agricultural and mining sectors were decreased, while the weights of the manufacturing industry and energy sectors were increased.



Source: SIS

PPI; January - March 2005:

**First 3 months cumulative: 0.83,
March: 1.26 %, Annual: 11.33 %**

- ✓ Industrial sector prices push the PPI up.
 - Manufacturing industry prices rose above the PPI.
 - Oil price increases were instrumental. Higher pressure is likely if the high level of oil prices persists.
 - The increase in energy prices remained limited. Yet, oil price increase in the coming periods may be reflected on the electricity and natural gas prices.
 - Although having risen around the world, domestic basic metal prices declined, also due to the appreciation of the TRY. This is a risk factor.
- ✓ Agricultural price increases remained below the PPI.
 - Owing to the calculation method of the new index, volatility in agricultural prices diminished.

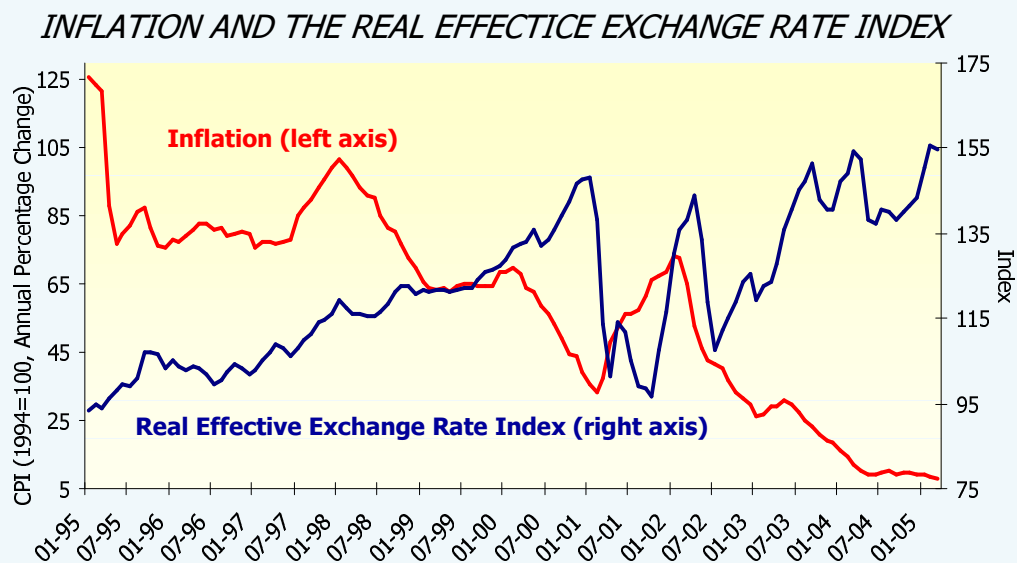
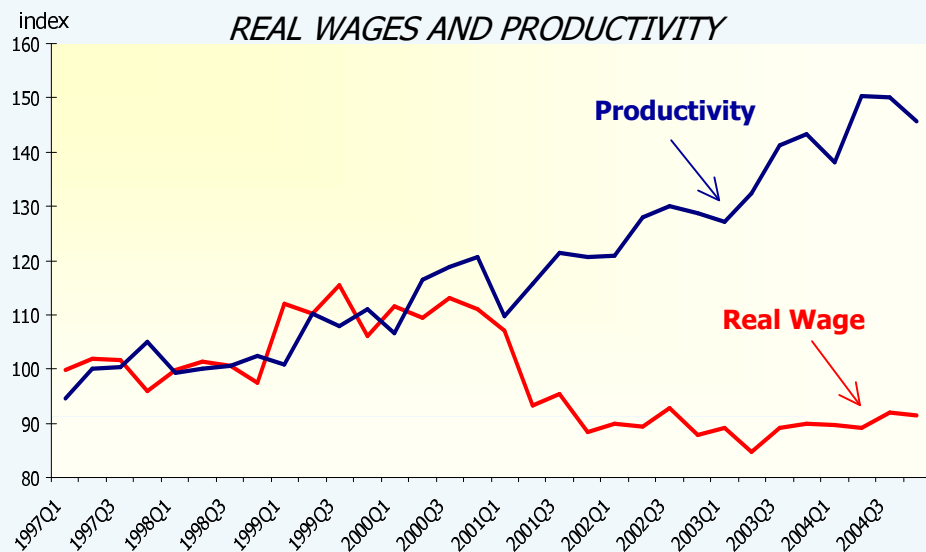
The new index, i.e. PPI became more susceptible to raw material prices and exchange rates.

It is likely that it will display a more volatile trend.

The PPI is not a target.

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The Factors that Ensured the Fall in Inflation



Source: SIS, CBRT

1- Central Bank independence;

The concept and the practice are becoming settled; a credible history is being formed. This should be preserved and safeguarded. EU criteria set an example.

2- Tight monetary and fiscal policies;

Controlled increase in domestic demand

3- Incomes policy largely coherent with the target

4- Reliable, transparent and consistent communication policy;

A wide source of information and anticipation was shared with the public, managing expectations became top priority.

5- Productivity increase, the course of real wages;

Contributed significantly in the last three years. However, with the slowdown in productivity as of the second half of 2004 and the upward trend in real wages,

Its contribution to disinflation has been in decline.

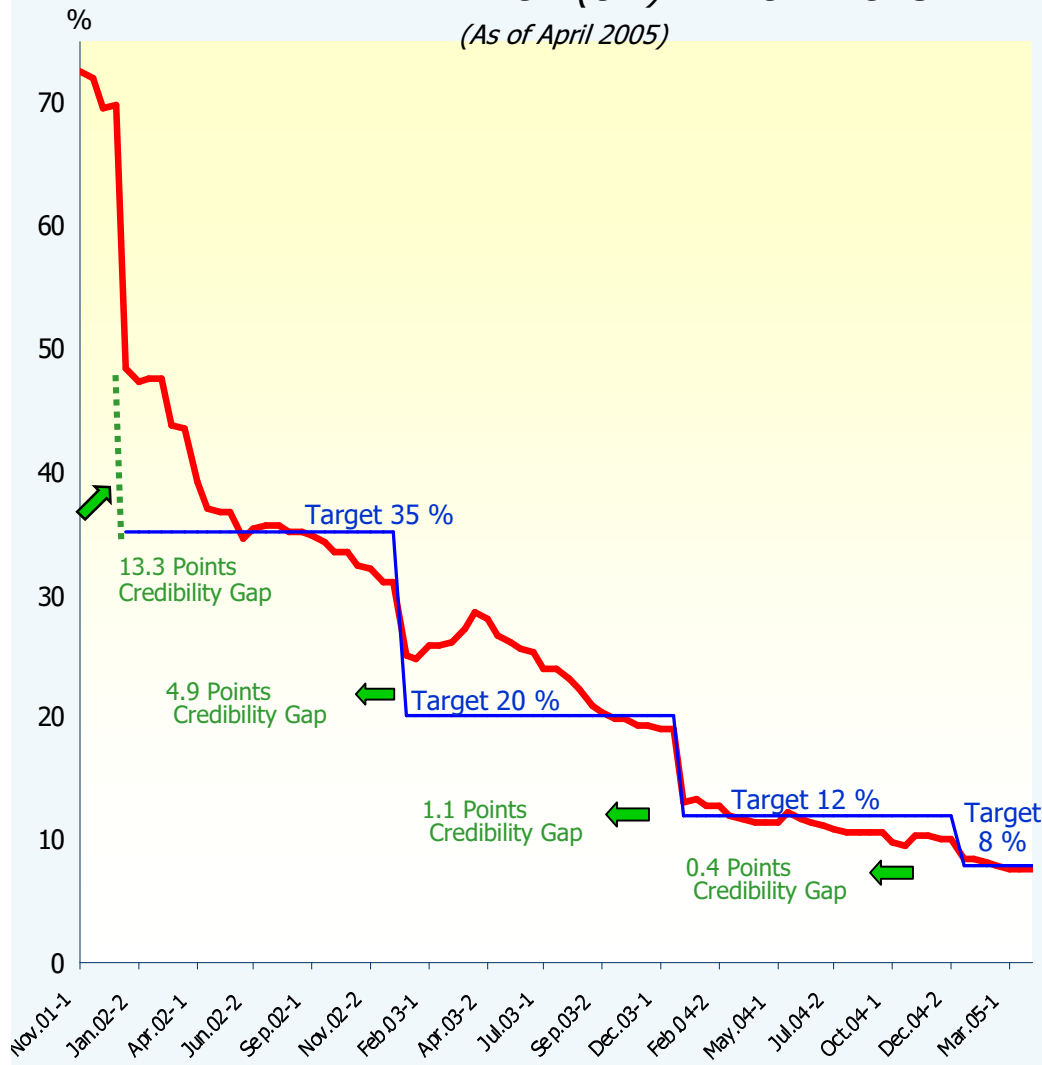
6- How helpful was the course of exchange rates?

- Never in the past when exchange rates had risen in real terms, has inflation been this low.

- It is not possible to explain with exchange rates alone.

Progress Made Towards Stability

YEAR END INFLATION (CPI) EXPECTATIONS
(As of April 2005)



Source: CBRT

During this process, there were significant changes in inflation dynamics, thus these changes enabled inflation to retreat **in a stable manner**.

Changing Dynamics

1- Inflation inertia diminished.

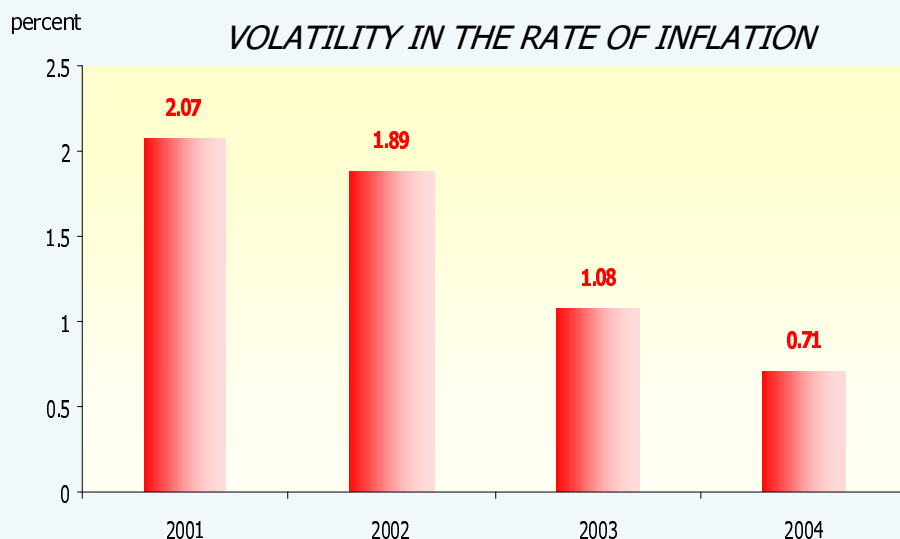
✓ Owing to an effective communication policy and rising confidence that **the fall in inflation is a permanent one**, the inflation target gradually became a more credible anchor, and there were remarkable breaks in inflation **inertia**.

Credibility Gap (Expectations - Target)

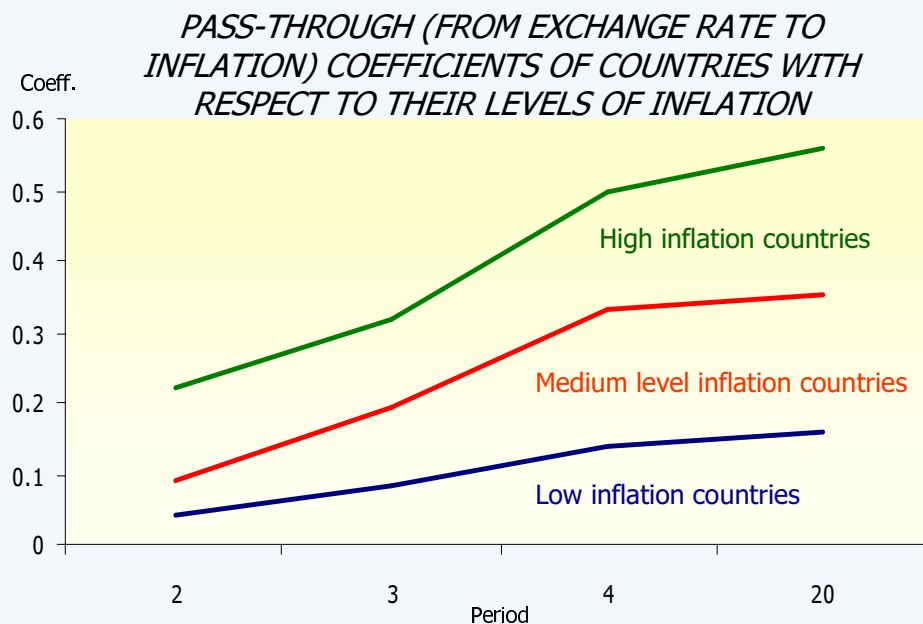
2002	2003	2004	2005
13.3 pts.	4.9 pts.	1.1 pts.	0.4 pts.

April 2005: Expectations are below the target

Progress Made Towards Stability



Volatility: 12-month moving averages of the standard deviations of monthly CPI changes



Source: Report on Currency and Finance 2003-04, Reserve Bank of India

Changing Dynamics

2- Volatility in inflation diminished.

✓ There was a remarkable decline in inflation volatility, which constituted a serious obstacle to the predictability and forecast of inflation.

2001: 2.07 %

2004: 0.71 %

3- The inflation - exchange rate pass-through weakened.

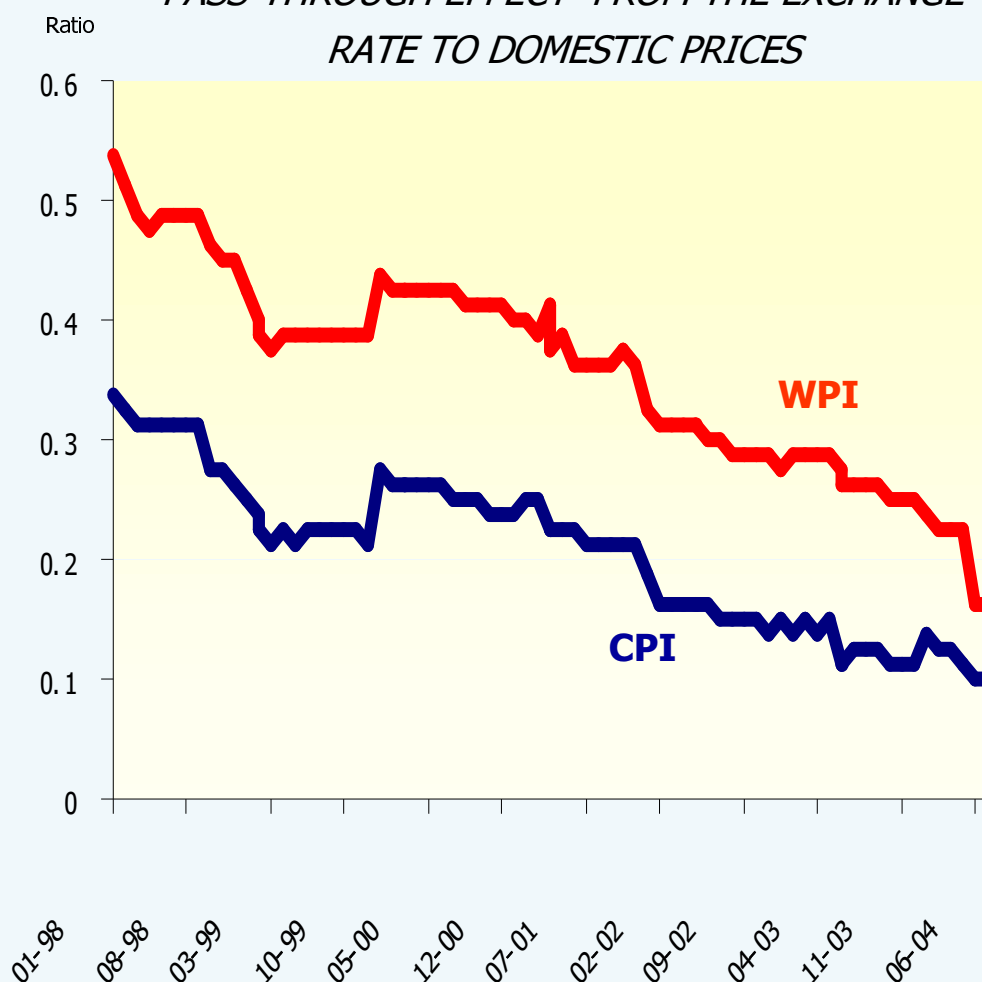
✓ In those country examples with a low and stable inflation environment achieved as a result of highly credible economic policies, the fact that;

- Pricing in the domestic currency is widespread.
- Depreciation of the currency is perceived as temporary,
- Firms make price adjustments less frequently,

resulted in a **weaker and lagged pass-through effect from the exchange rates to prices.**

Progress Made Towards Stability

PASS-THROUGH EFFECT FROM THE EXCHANGE RATE TO DOMESTIC PRICES



Source: CBRT

Changing Dynamics

3- The inflation - exchange rate pass-through weakened.

✓ Also, in Turkey, under the changing dynamics of the Turkish economy, the pass-through effect of the exchange rates on prices is decreasing;

- Lower compared to the high inflation periods,
- Weaker than expected,
- More lagged.

In the new inflation basket;

- The effect of tradable goods is higher; the pass-through is stronger compared to the old basket, yet the tendency is still downward.

4- Producer and consumer behavior changed.

✓ In the chronic inflation environment of the past, while consumers made no price control, producers made no cost control, and goods or services could be sold at any price.

✓ Whereas today, together with disinflation, consumers began price controls and producers began cost controls, competition increased, productivity came to the forefront.

The inflation problem solved?

RATES OF YEAR-END ANNUAL INFLATION
AS OF MARCH 2005 (CPI) (percent)

1. Singapore**	0.00
2. Israel	0.80
3. Czech Rep.	1.50
4. Peru	1.88
5. Chili	2.40
5. China*	2.40
5. Malaysia**	2.40
8. Slovak Rep.	2.45
9. Slovenia**	2.60
9. South Africa**	2.60
11. Korea	2.80
12. Thailand	3.20
13. Hungary	3.50
14. Poland	3.60
15. India***	4.00
16. Mexico	4.39
17. Bulgaria	4.40
18. Colombia	5.02
19. Uruguay	5.48
20. Brazil	7.54
21. TURKEY	7.94
22. Philippines	8.50
23. Romania	8.70
24. Indonesia	8.80
25. Argentina	9.14
26. Russia*	11.70
27. Belarus	11.93
28. Ukraine*	12.30
29. Venezuela	15.70

*December 2004, ** February 2005, ***November 2004

✓ In spite of the distance covered in terms of the change in inflation and inflation dynamics, **price stability has not been achieved yet.**

✓ Though targets are met, Turkey is still **one of the countries with the highest rate of inflation.**

✓ **Is it a problem to remain below the exact target?**

No. *It is natural to undershoot the target in the fight against high inflation and during the process of acquiring credibility.*

- For 2004; Brazil: 5.5 % ± 2.5; the UK: 2 % ± 1;

Mexico: 3 % ± 1; Hungary: 4 % ± 1 point;

-In many countries, symmetric upward and downward bands are given around the target .

✓ Is there a threshold in inflation; does it prevent it from declining further? No. *The threshold is the level where expectations are formed.*

✓ **Deflation? No.** *Deflation is a constant decline in the general level of prices. It is risky if there is idle capacity, a contraction in the money supply or a serious decline in aggregate demand.*

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*December 2004, ** February 2005, ***November 2004

✓ Is it possible to comment on the trend of inflation for the whole year by looking at one monthly figure alone?

No. Such a conclusion suffers from myopic vision.

- The monthly figure is much below the market expectation



- Inflation will be much below the target; better revise it downward.

- The monthly figure is well above the market expectation



- The target will not be met.

Turkey is still in an environment of disinflation.

✓ In 2006, **full-fledged inflation targeting** will be adopted.

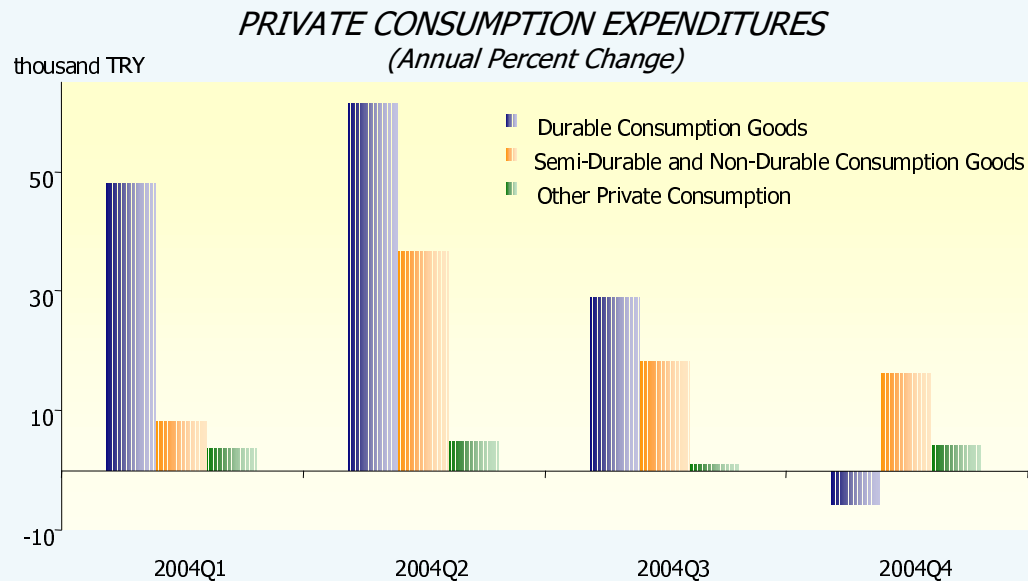
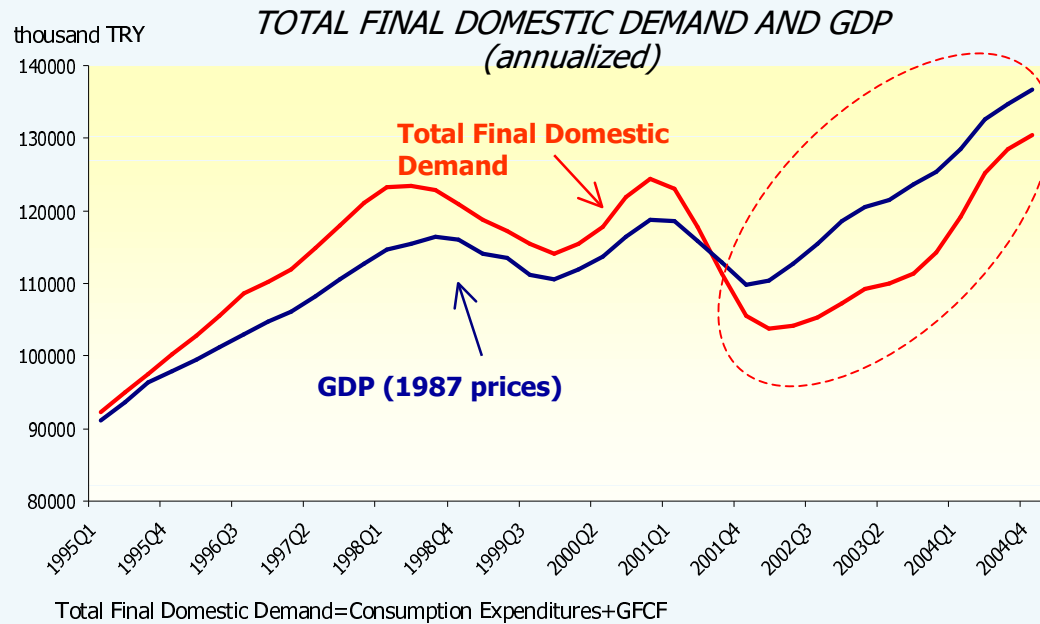
- Studies in the CBRT have been carried out since the year 2000.

- Significant progress was made in securing the pre-conditions.

- The aim is to clarify decision-making processes, as well as enhance the institutional commitment.

✓ For inflation targets to be met from now on within the framework of these policies, **there are certain risks to be cautious about:**

Risks



Source: SIS

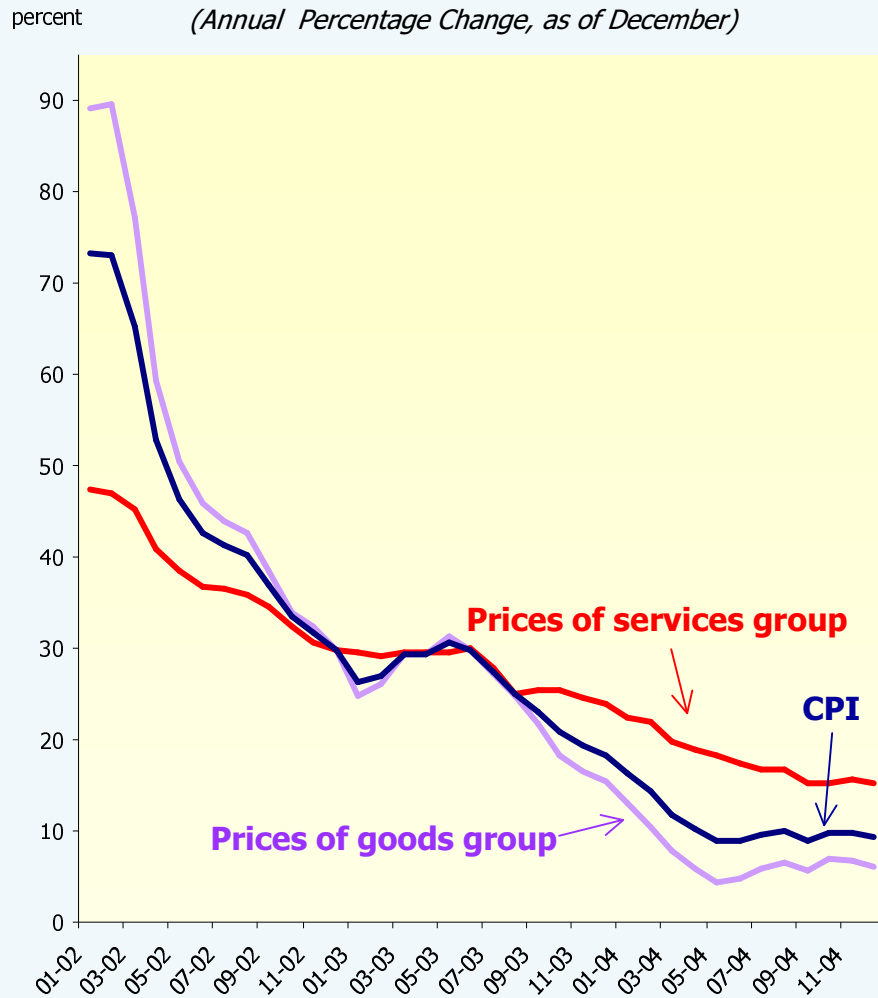
1- Increase in domestic demand requires caution, the revival in consumption needs to be controlled.

At present:

- ✓ Despite the high rate of growth in 2004, **total final domestic demand is below the GDP; the demand gap persists.**
- ✓ In 2004, certain sectors recorded a rapid increase in demand: Automobiles, white goods; led by **postponed or advanced demand.**
- ✓ A relative slowdown in the second half of 2004. Signals of the slowdown from the summer onwards: **Credit growth, decline in money demand, lowering of excess liquidity**; as a matter of fact, the consumption of durable goods eased in late-2004.
- ✓ Some recovery in the first quarter of 2005, compared to the last quarter of 2004. Yet, when compared with the first half of 2004, the recovery points to a controlled increase in demand, and is coherent with the program forecasts.
- ✓ No strong **domestic demand pressure** at the moment.

Risks

CPI, PRICES OF GOODS AND SERVICES
(Annual Percentage Change, as of December)



Source: SIS

2- Price rigidities on certain sectors, especially the services sector, should be emphasized.

✓ The differentiation between the rate of price increase in the foods and services sectors is still high.

2005 Last two months	%
Goods Group	-0.5
Services Group	1.4

✓ To eliminate the rigidity in the services sector;
- *Measures for increasing competitiveness and supply in this sector should be devised.*

3- Developments in agriculture and energy prices always pose risk.

4- It is essential that public price adjustments are in line with the target.

5- Income policies compatible with the target and tight fiscal policies should be carried out.

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

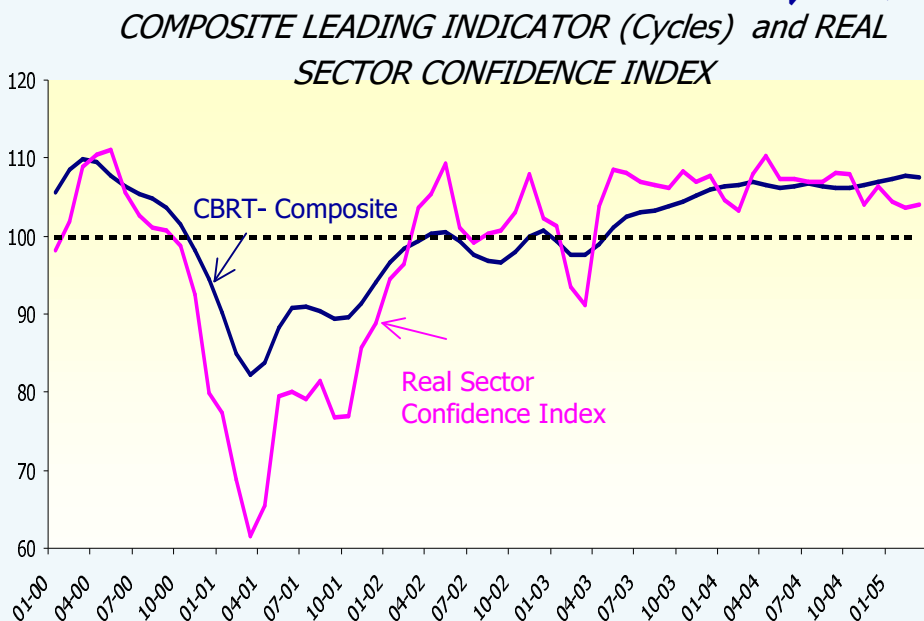
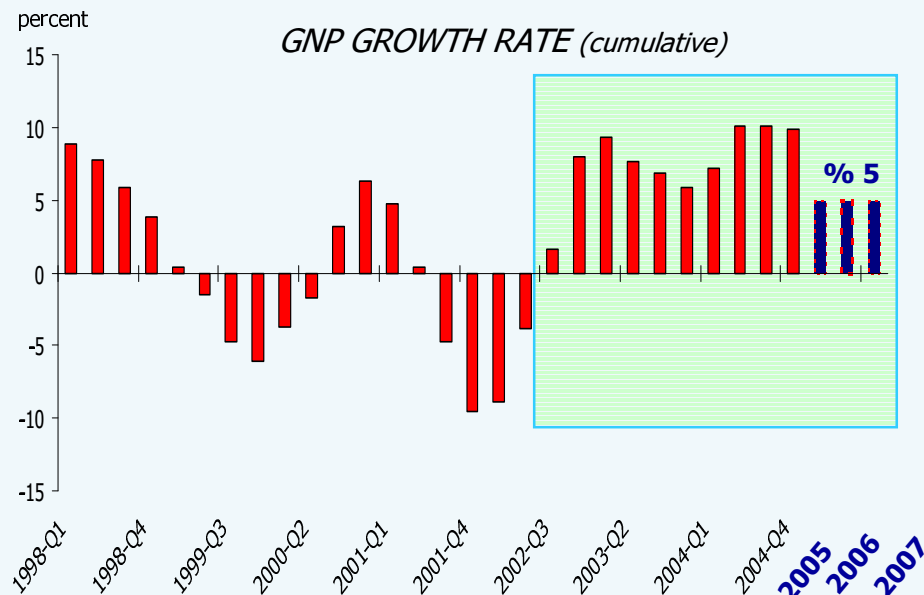
7- Exogenous shocks may have temporary effects. With the strengthening of economic fundamentals, these effects will be felt less.

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



**PROGRESS MADE TOWARDS
STABILITY
Real Economy**

Progress Made towards Stability



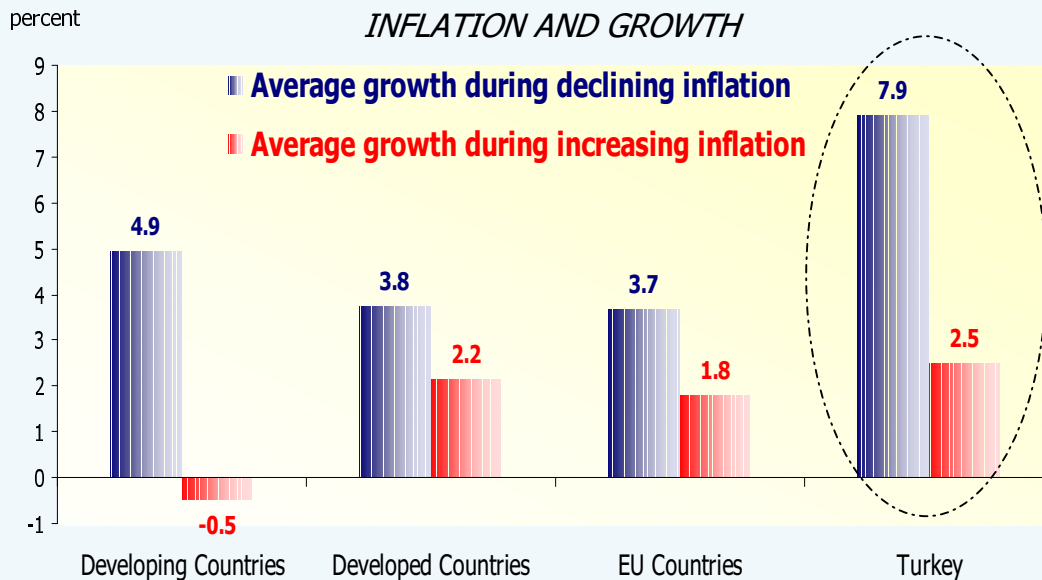
Source: CBRT
Above 100 shows the increase in confidence.

Turkey has experienced **high rates of growth since 2002.**

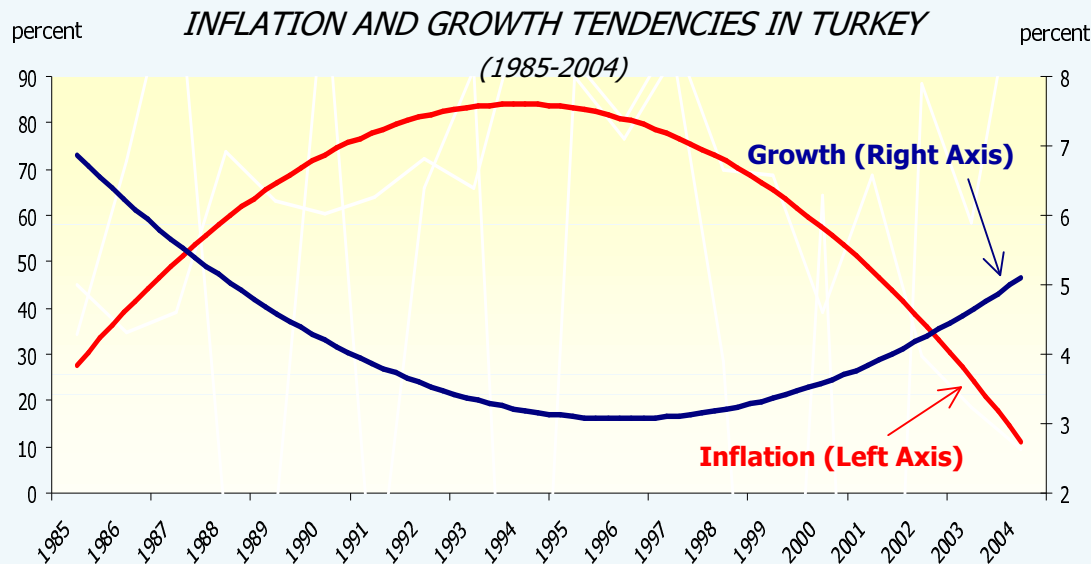
- ✓ Real growth is **25.5 %** compared to 2001.
- ✓ **Growth in 2004: 9.9 %**; among the highest rates in the world.
 - **In the first half of the year**, expenditures on durable goods have increased significantly.
 - **In the second half of the year**; a relative slowdown,
 - **Q4**; seasonally adjusted private consumption expenditures and total final domestic demand decreased.
 - ❖ Durable goods expenditures declined.
 - ❖ Semi and non durable goods expenditures increased relatively,
- ✓ **In 2005**, total demand is expected to follow a controlled course parallel to program predictions.
- ✓ Consumer confidence index and other indicators related to demand point to a slower increase in activity. *This should not be interpreted as stagnation.*

2005	} Growth Forecast: 5 %
2006	
2007	

Progress Made towards Stability



Source: IFS, WEO, CBRT



Tendency lines are, $y=a+bx+cx^2$ curves. x =years, y =growth and inflation.

The dynamics of growth is unlike the past.

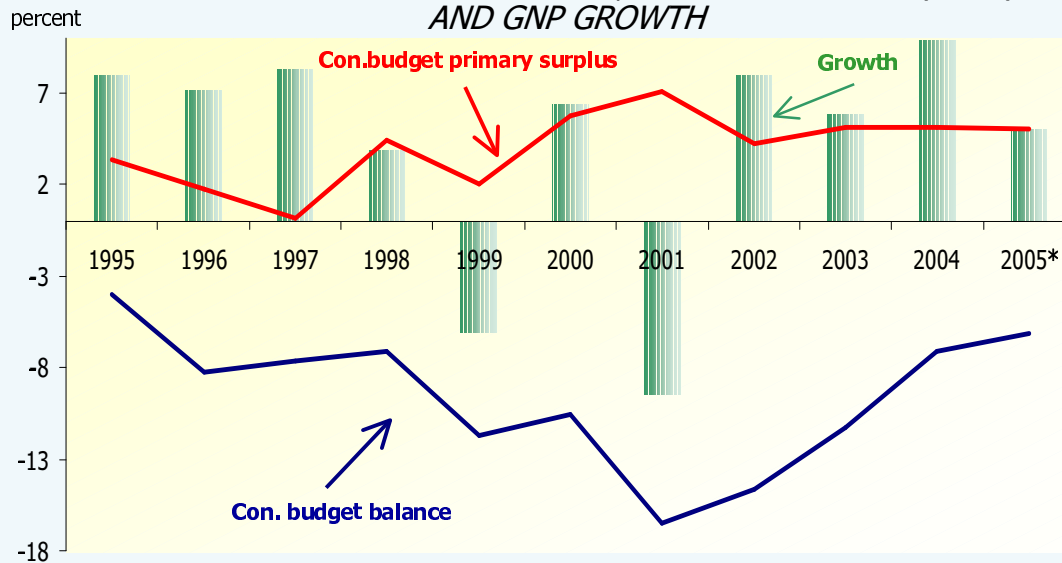


1. While inflation has declined, high rates of growth have been attained.

- ✓ There is a strong and reverse relation between inflation and growth:
 - Both in developed and developing countries, when inflation falls average growth rates rise, when inflation rises average growth rates fall.
 - High-sustainable growth and an increase in employment can only be achieved through price stability.
- ✓ The declining process of inflation and the concurrent high growth period experienced recently in our country confirms this argument.

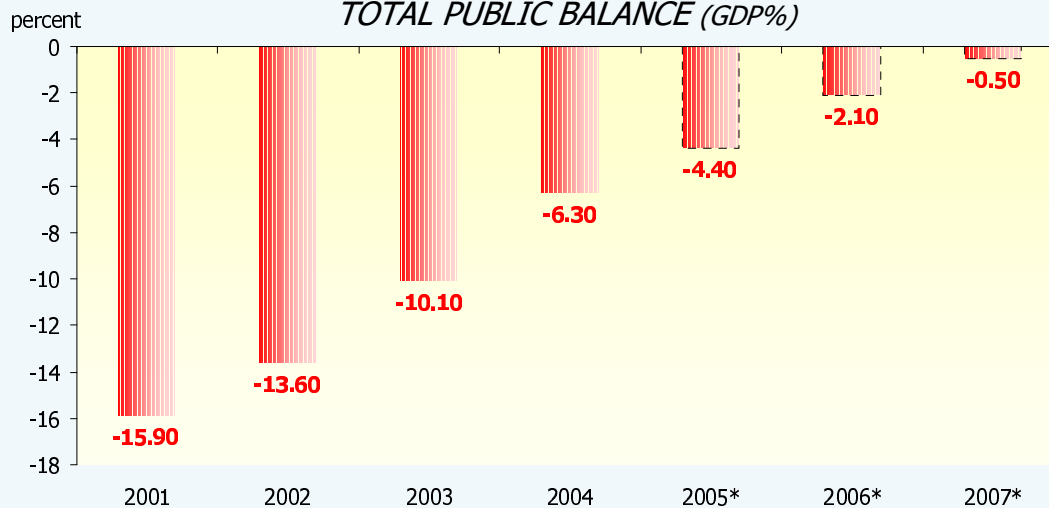
Progress Made towards Stability

CONSOLIDATED BUDGET BALANCE, PRIMARY SURPLUS (GNP%) AND GNP GROWTH



Source: Ministry of Finance, SIS
* prediction

TOTAL PUBLIC BALANCE (GDP%)



Source: Pre-Accession Economic Program, *2004 9 months; target of primary surplus, others predictions.

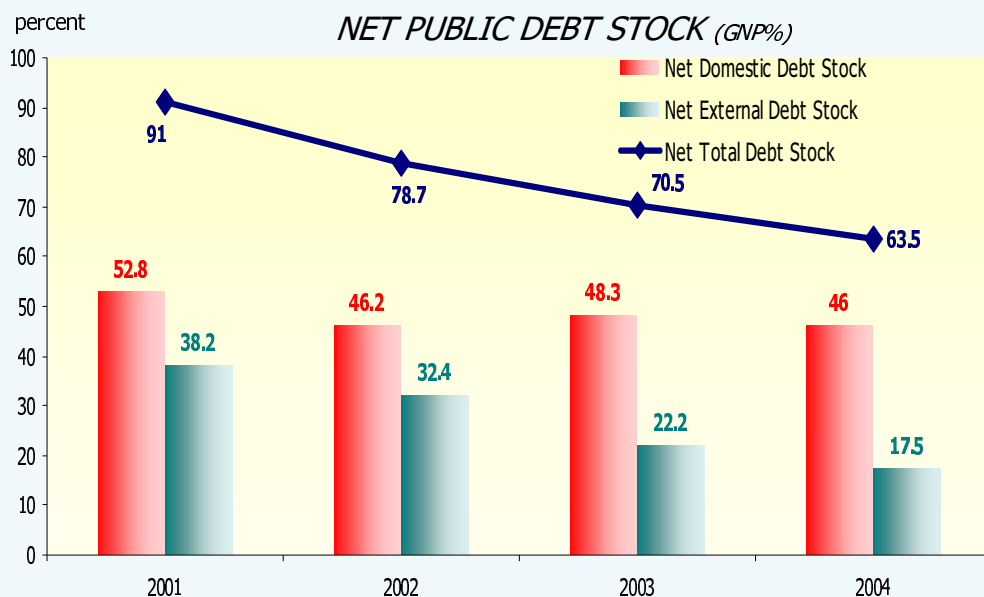
The dynamics of growth is unlike the past.



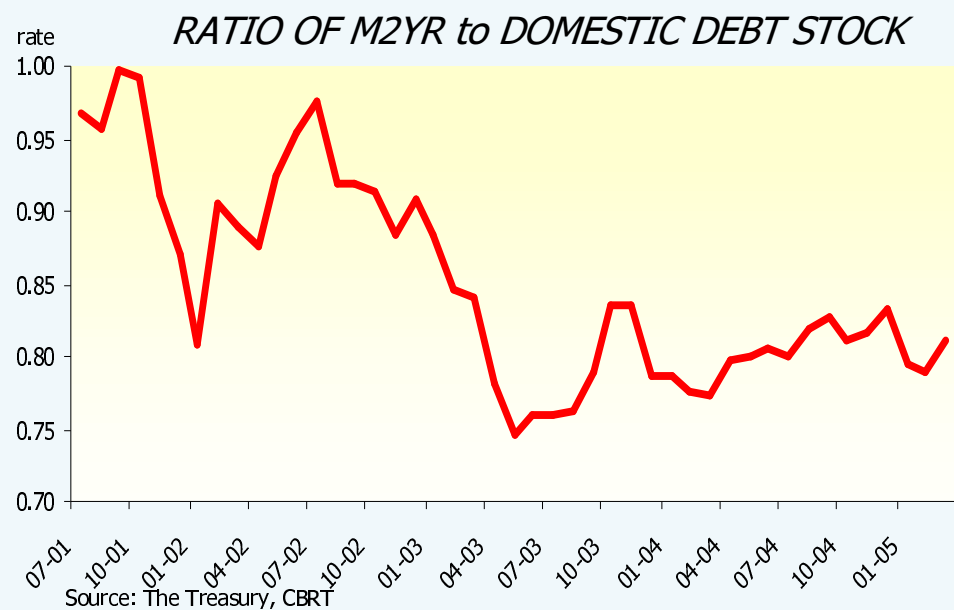
2. The implemented tight fiscal policy supported growth and the fight against inflation.

- ✓ By diminishing the weight of the public sector on the economy, it played an important role in the change of public sector-based growth process.
- ✓ It contributed to growth through its positive impact on expectations.
- ✓ Within this framework, the **primary surplus** is the most important **variable** of the tight fiscal policy.

Progress Made towards Stability



Source: The Treasury



Due to the tight fiscal policy fiscal dominance is weakening, markets are becoming deeper and more varied.

✓ With the implemented policies, the rate of debt stock to national income is falling, the pressure of domestic debt stock on markets is becoming less.

- *The rates of net and gross public debt to national income, which are the main indicators for evaluating debt statistics, have constantly been in decline since the 2001 crisis. By maintaining fiscal discipline, the Maastricht criteria will also be attained.*

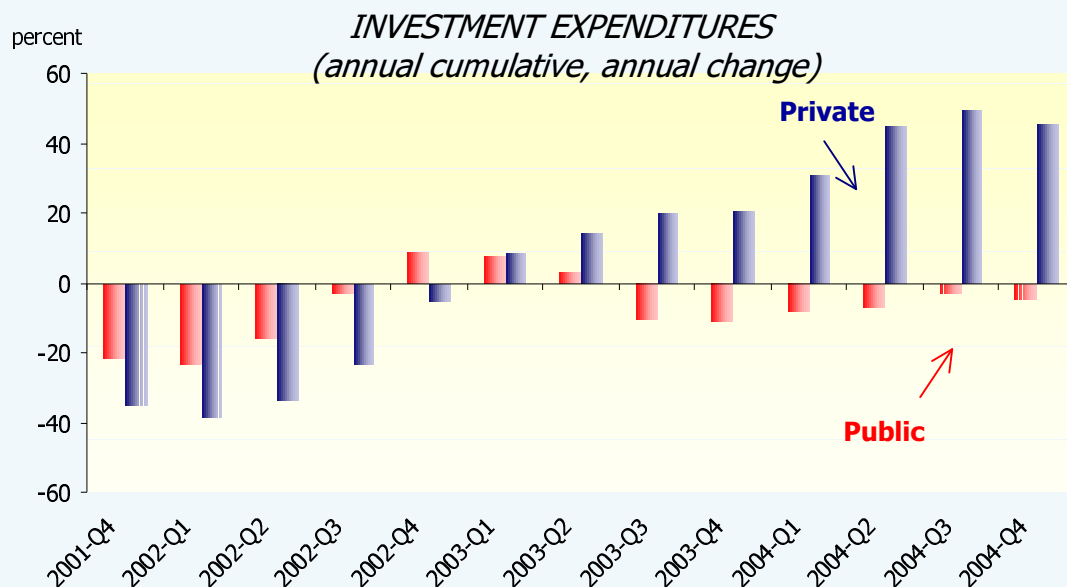
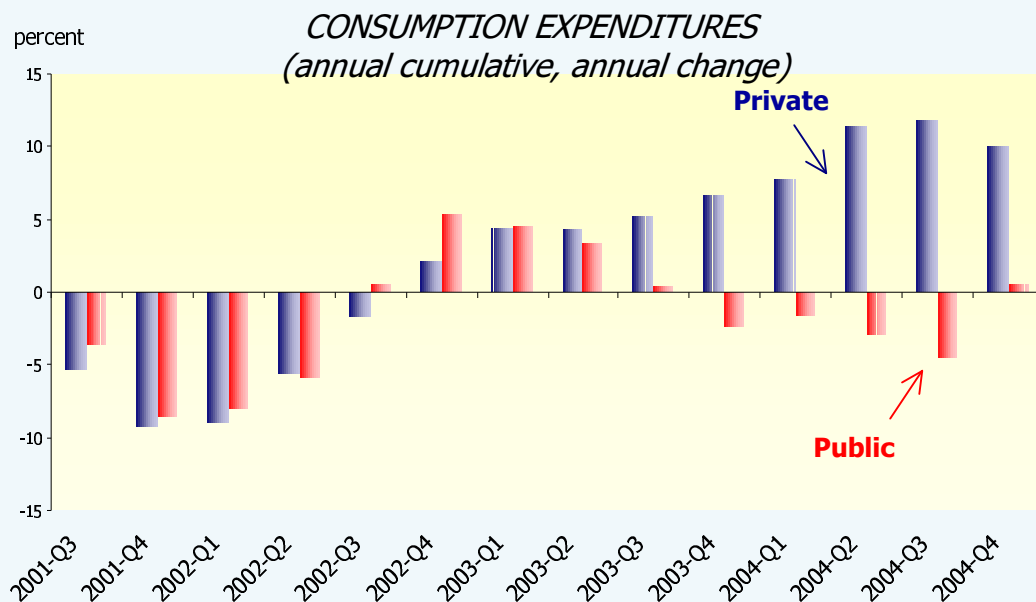
✓ Maturities are longer. For the first time in its history, the Treasury is borrowing from the domestic market with a 5-year maturity.

✓ Foreign banks are issuing New Turkish lira denominated instruments with 10-year maturity.

- *TRY denominated total amount of issues reached almost **USD 3.6 billion**.*

✓ TRY is now included in the operations of the international clearance and custody systems.

Progress Made towards Stability



Source: SIS

The dynamics of growth is unlike the past.



3. Growth is based on the private sector.

✓ While the contribution of the government's final consumption and investment expenditures to GDP decreases as of the fourth quarter of 2002, the contribution of the private sector increases.

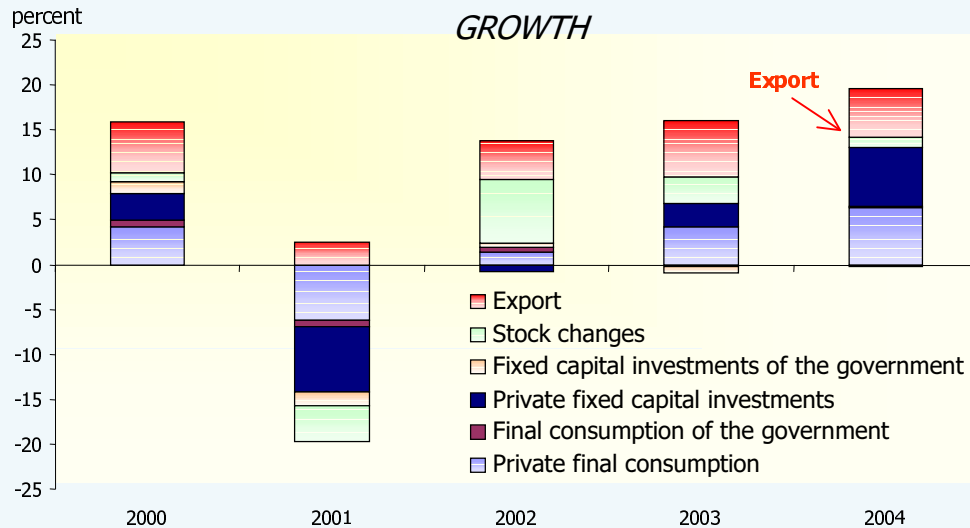
2004 GNP (%)					
Public	Final	Private	Final	GFCF*-	GFCF*-
Consumption	Consumption	Consumption	Consumption	Private	Public
0.5		10.1		45.5	-4.7

* Gross Fixed Capital Formation

✓ **During this process what the public should do as investor and regulator has to be in areas that will increase the growth potential of the country, in line with good governance principles.**

Progress Made towards Stability

CONTRIBUTIONS of EXPENDITURE GROUPS to GDP



The dynamics of growth is unlike the past.

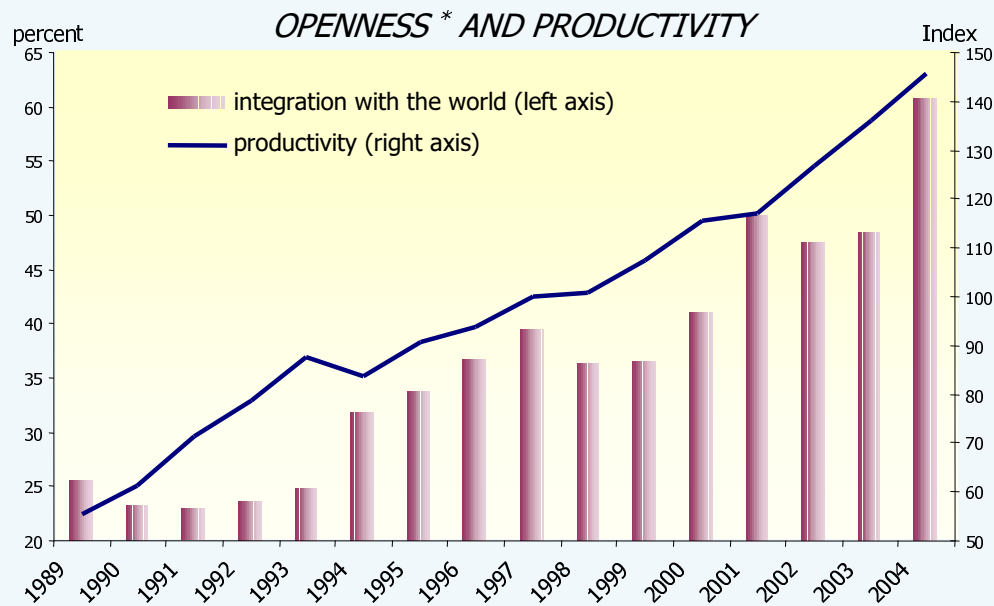


4. Exports have increasing contributions to growth.

- ✓ Foreign trade has risen by 120% since 2001, reaching USD 160 billion as of 2004.
- ✓ It is expected to increase more and become USD 180 billion in 2005.

Integration with the world is increasing.

- ✓ With the progress towards stability, the changing dynamics of the economy enhanced integration with the world; the Turkish economy started to integrate with world markets, became stronger and sounder, plus productivity increased and competitiveness became more significant.

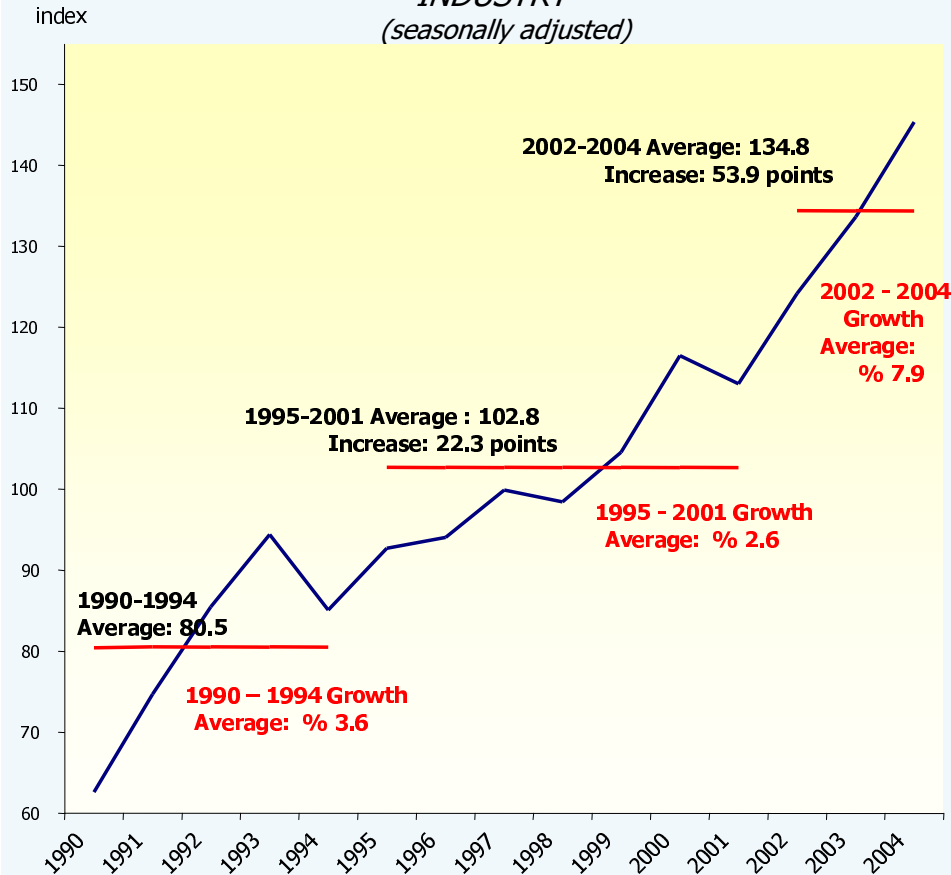


Source: SIS

* Openness: The share of total export and import in GDP.

Progress Made towards Stability

*PRODUCTIVITY in PRIVATE MANUFACTURING INDUSTRY **
(seasonally adjusted)



Source: SPO

* SIS Private manufacturing industry production index / SIS Private manufacturing industry employment index

Increases are computed according to the average of 1990-1994.

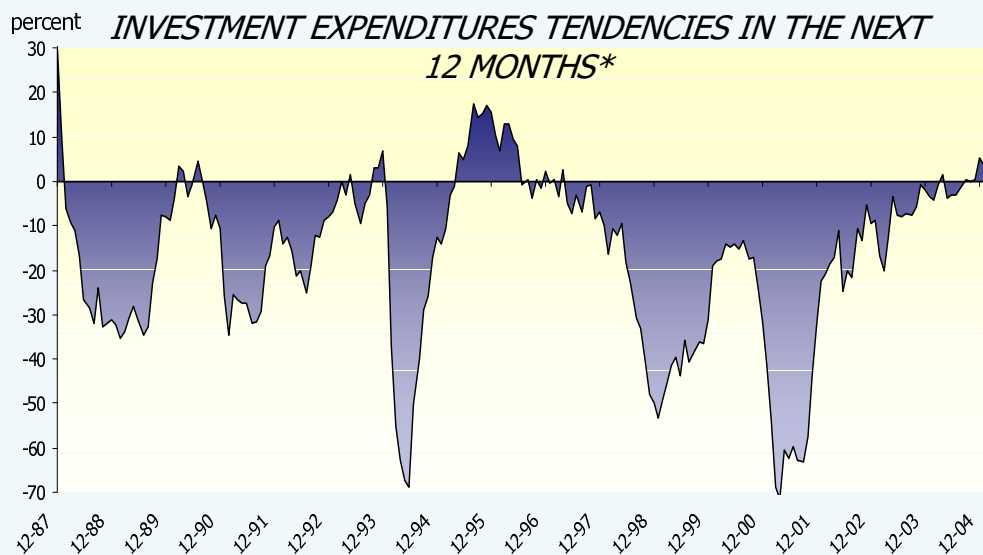
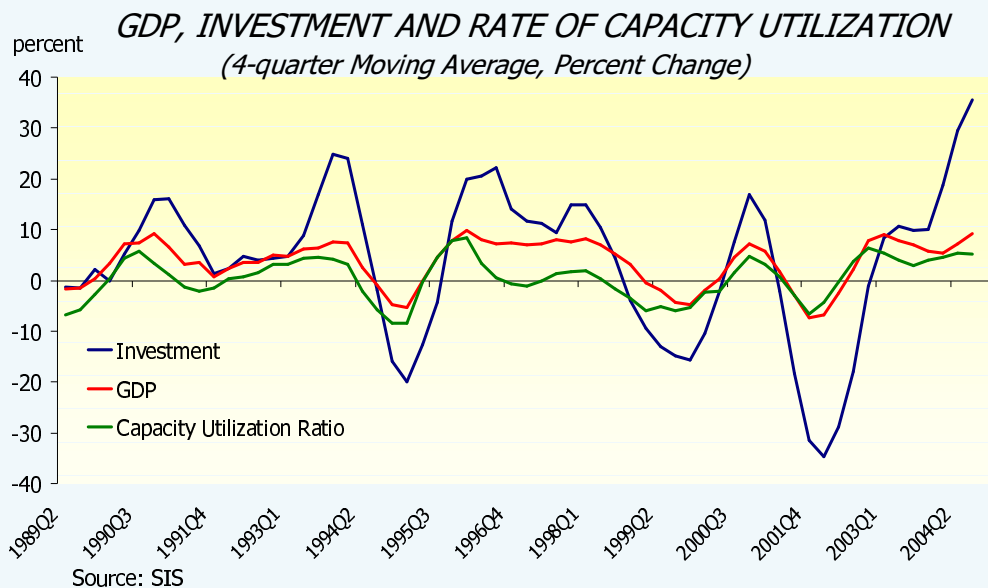
The dynamics of growth is unlike the past.



5. Productivity is one of the factors that contribute most to growth.

- ✓ In countries like ours, with high growth performances following a crisis, the most significant contribution comes from the rise in productivity. In the last three years the cumulative increase in productivity is 25%.
- ✓ The increased productivity in this process, increases the input of capital and encourages investment as well.
- ✓ However, the process is dynamic, the increase in productivity needs to continue. It has to spread to all sectors; both in terms of firms and on a macroeconomic level progress also has to be made. **The key factor is structural reforms.**

Progress Made towards Stability



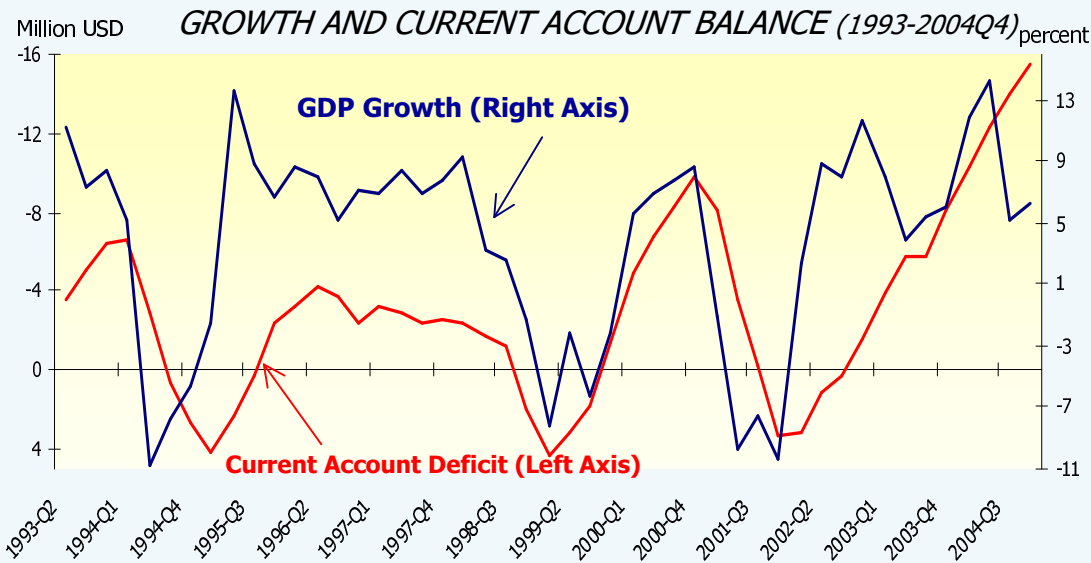
Investment

- ✓ In countries with strong growth performances following a crisis;

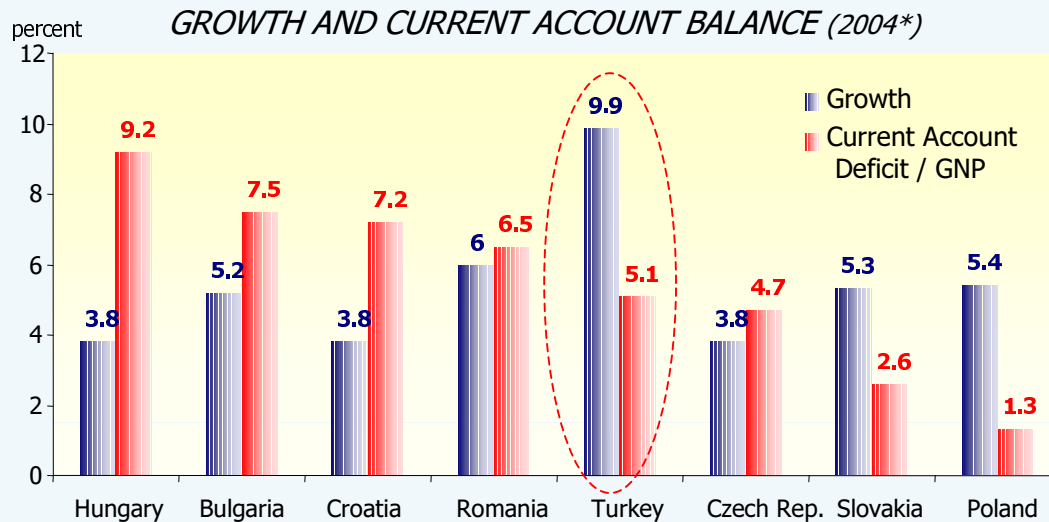
Investment follows growth, growth does not follow investment.

- ✓ The reason is that investors want to see whether the progress made towards stability is permanent or not.
- ✓ Recently, in Turkey, there has been a remarkable increase in investment in the private sector.
- ✓ The survey results indicate an increase in the investment expenditure trend during the next 12 months.
- ✓ In the upcoming periods, **investments will increase depending on the persistence of the increase in confidence and the development of the current gains.**

Is Current Account Balance a Problem?



Source: SIS, CBRT



Source: Citigroup Global Markets

* Data excluding Turkey indicate predictions.

Current Account Balance

✓ **Growth realized above expectations is bound to increase the current account deficit.**

✓ An increase in current account deficit is not expected to result in a balance of payments crises as was the case in the past.

✓ Deepening commercial and financial integration throughout the world ensures higher current account deficits in countries with macroeconomic stability compared to previous periods.

Current account deficit / GDP predictions*:

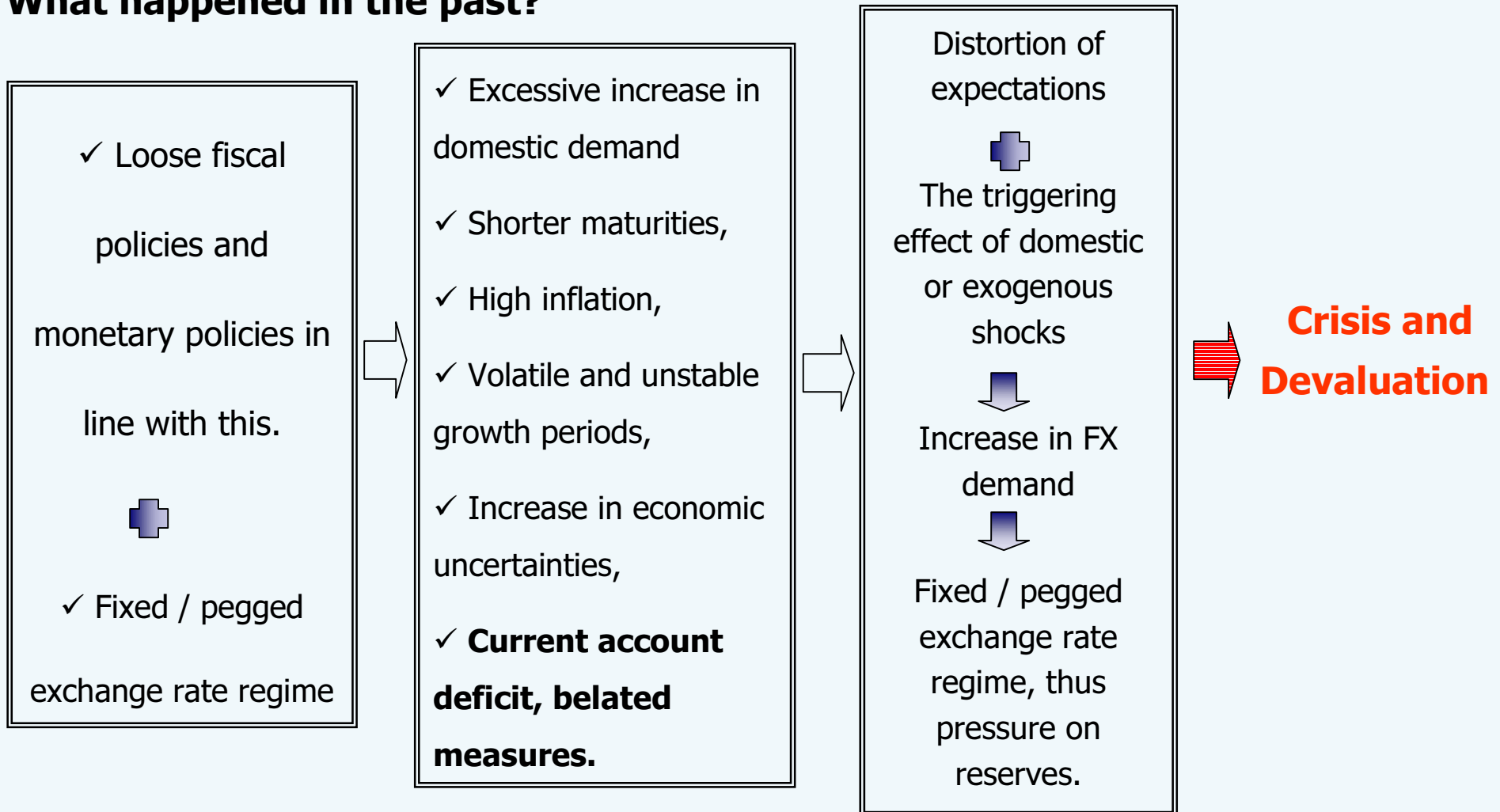
2005	⇒	% -3.7
2006	⇒	% -3.4
2007	⇒	% -3.0

* Pre-accession economic program

Is Current Account Balance a Problem?

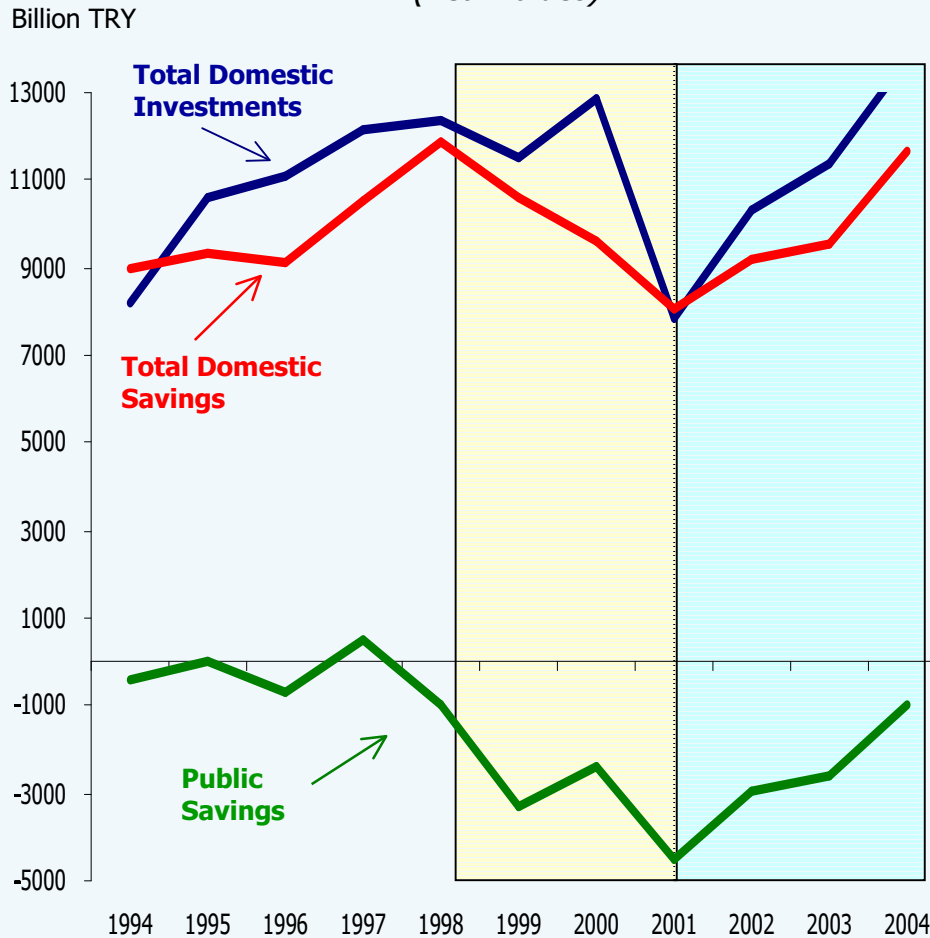
Could Current Account Balance Lead to Crisis?

What happened in the past?



Changing Dynamics: Current Account Balance

TOTAL DOMESTIC INVESTMENTS AND
TOTAL DOMESTIC SAVINGS
(Real Values)



Source: SIS, CBRT

Today, conditions are much different from those of the past.

1. Causes of the current account deficit

$$\text{Current Account Balance} = \text{Total Domestic Savings} - \text{Total Domestic Investment}$$

In Turkey, total domestic investments have generally been higher than total domestic savings.

- ✓ **Before the 2001 crisis**, both total domestic investments and total domestic savings maintained a downward trend.
 - Decline in domestic savings; loose fiscal policies and growing budgetary deficits.
- ✓ **However, today** both total domestic investments and total domestic savings display an upward trend.

Tight fiscal policies → *Increase in public savings* → *Increase in total domestic savings*

- ✓ **Current account deficit** emerged due to the fact that domestic investments grow more rapidly than domestic savings.



Factors that contribute to the increase in current account deficit differ from those of the past.

Current account balance, a problem?

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



Crises under the
Managed Exchange
Rate Regime = 51

Crises under the
Floating Exchange Rate
Regime; Argentina = 1



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

After the crises occurred under the managed exchange rate regime, 12 of these countries **changed their exchange rate regimes.**



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

Today, conditions are much different than those of the past.



2. The floating exchange rate regime is adopted. The floating exchange rate has a shock absorbing characteristic.

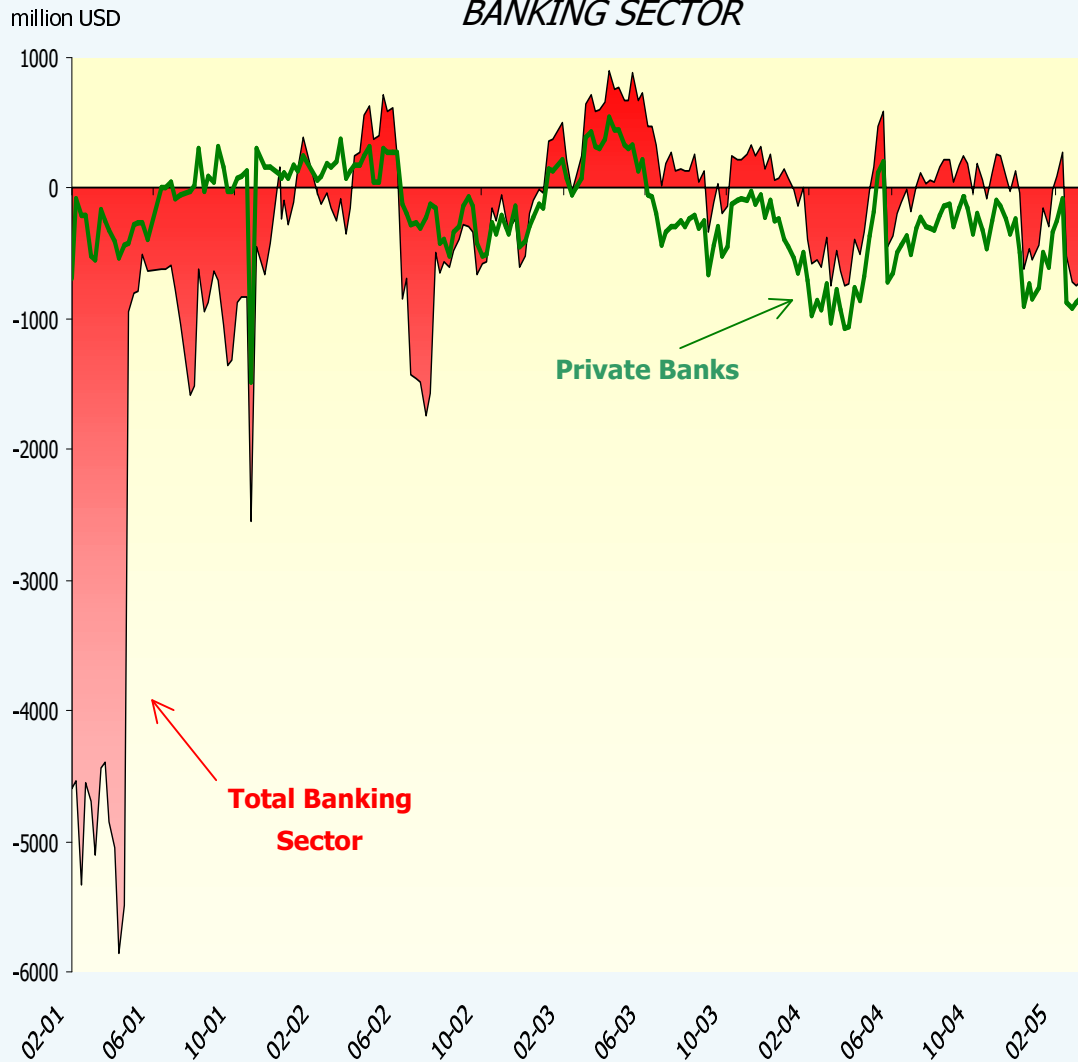
Almost all these countries had adopted fixed or foreseeable exchange rate regimes before experiencing a balance of payments crisis.

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

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

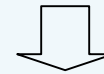
Current account balance, a problem?

DEVELOPMENT OF FOREIGN CURRENCY NET POSITION OF THE BANKING SECTOR



Resource: SIS, CBRT, BRSA

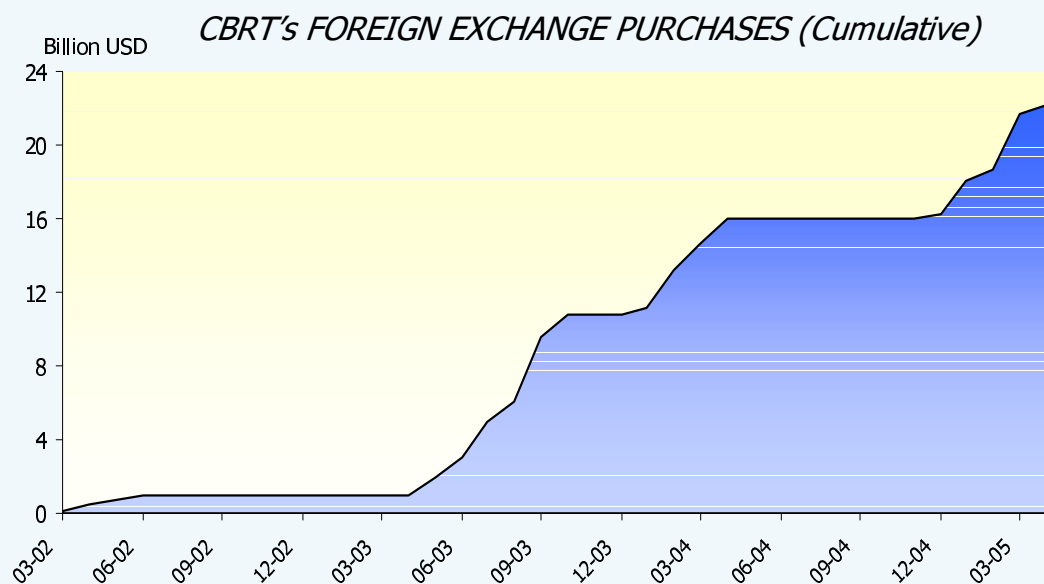
Today, conditions are very different to those of the past.



3. The banking sector has less open positions.

- ✓ However, attention should be paid to open positions in the real sector.
- ✓ The adoption of former tendencies poses a risk.

Changing Dynamics: Current Account Balance



Today, conditions are very different to those of the past.

4. TL is not kept overvalued.

- Since 2002, the CBRT has purchased USD 22.2 billion.

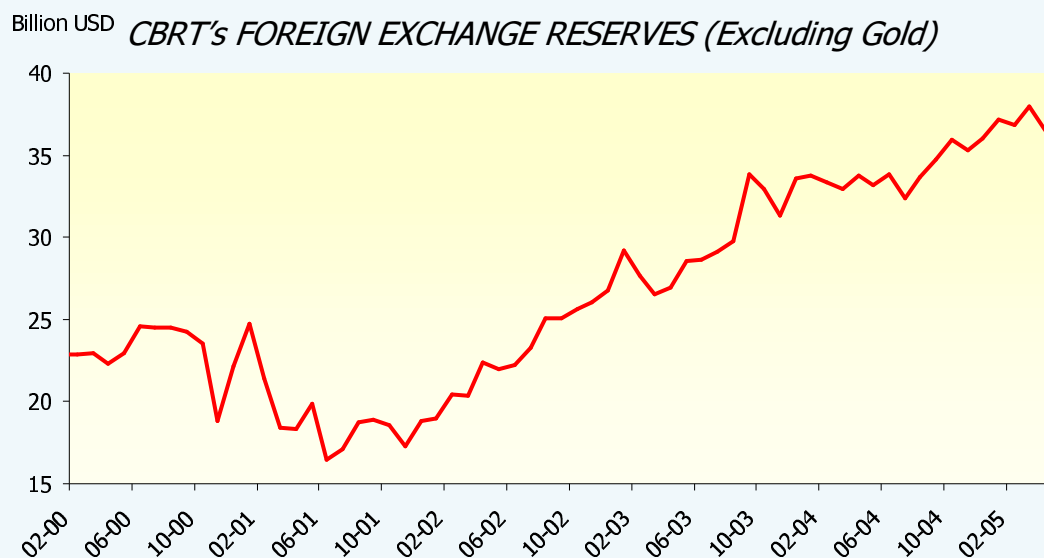
5. Hot money is not encouraged.

- The exchange rate risk is in the markets.

6. Foreign reserves hit a record high.

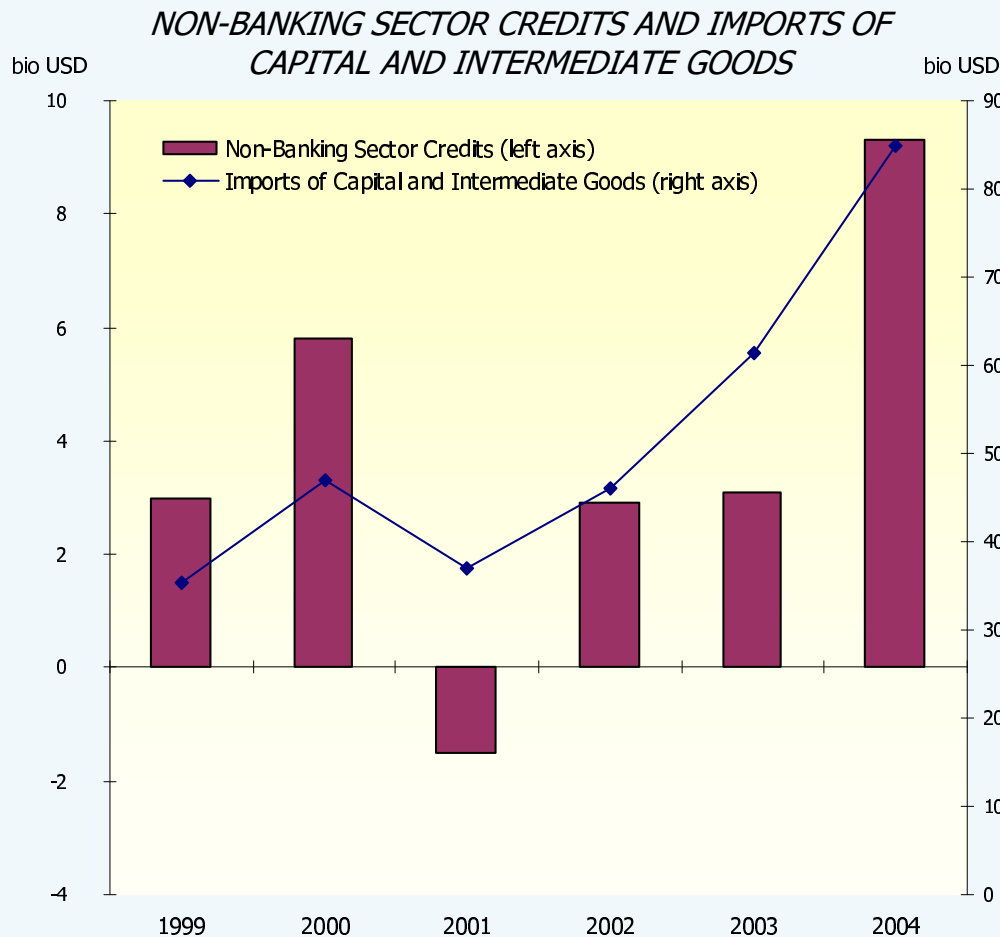
7. Tight fiscal and monetary policies are in implementation.

8. Inflation is much lower and drastic steps have been taken towards macroeconomic stability.



Changing Dynamics: Current Account Balance

Today, conditions are very different to those of the past.



Source: SIS, CBRT

* It includes short-term, long-term and commercial type of credits of other sectors in the balance of payments.

9. Changing structure of the capital account:

In 2004, except the IMF credit and the changes in reserves, USD 22.8 billion net capital inflow.

✓ The main factor is the substantial increase in **total credit utilization of the non-banking private sector***; 40 % of total inflow:

- Share of commercial credits; 44 %
- Share of long term credits; 51 %



Credits are directed to imports of capital and intermediate goods.

✓ Furthermore, improved domestic fundamentals, EU accession prospects brought about increase in portfolio investments.

Changing Dynamics: Current Account Balance

Today, conditions are very different to those of the past.

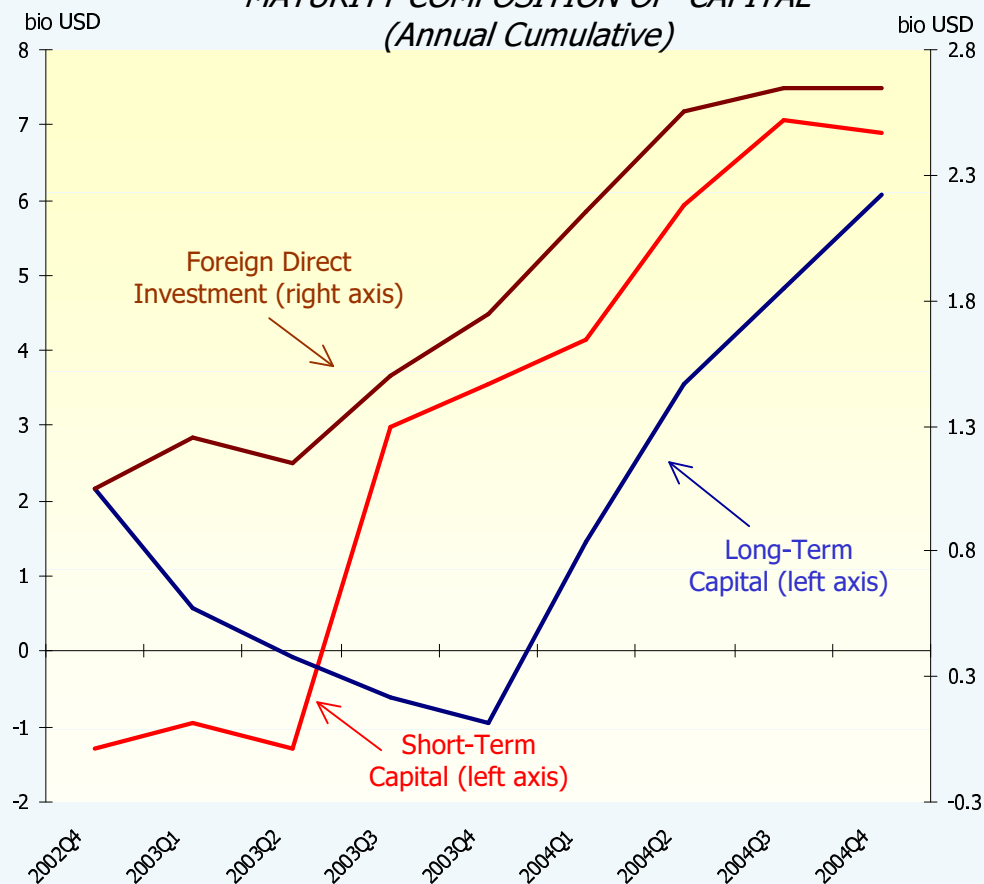
9. The changing structure of capital movements

The share of long-term capital in total capital movements increases.



- ✓ **Long-term capital*** hits record high.
- ✓ **Foreign direct investment** has started to improve. This tendency is much stronger in 2005 and is **expected to continue upward** as long as;
 - *Structural reforms are continued to be implemented,*
 - *Negotiations between Turkey and the EU continue.*
- ✓ The main determinant of the rise in **short-term capital** inflow** is the increase in the short-term credits used by banks. The risk posed by the short-term capital inflow is reduced by easing the fragilities in the banking sector.

*MATURITY COMPOSITION OF CAPITAL
(Annual Cumulative)*

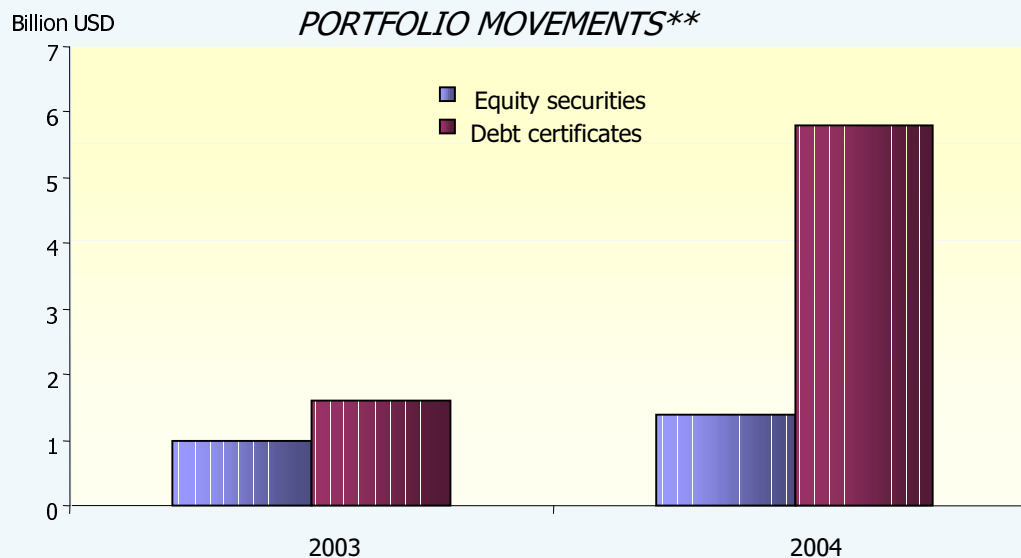
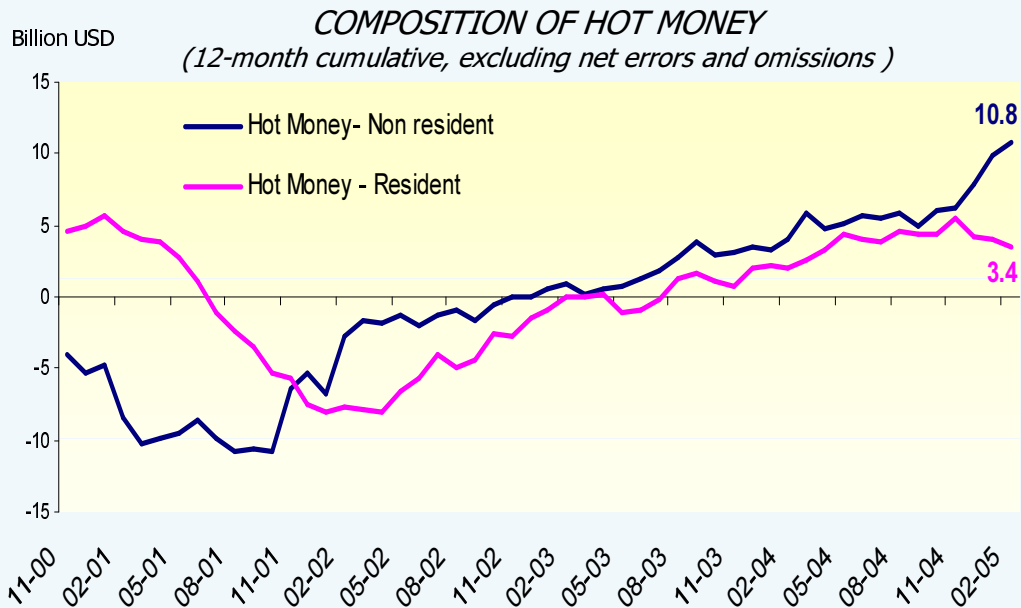


* Long term commercial credits, banking and other sectors' long term credits.

** Short term commercial credits, short term banking and other sectors' credits, banking sector deposits.

Source: SIS,CBRT

Hot Money



*The change in the short-term credits offered by banks abroad, short-term credits used from abroad and the non-banking private sector and the short-term deposits kept by foreigners in local banks.

**Only equity securities and debt certificates are shown.

Hot Money

✓ Has many definitions but in its general meaning, it is composed of:

- Foreign purchase of securities; portfolio investments
- +
- Short-term capital flow*
- +
- Net errors and omissions

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

Hot Money - Nonresident	10.8
- Foreign purchase of equity securities in the country	2.4
- Foreign purchase of government papers in the country	8.0
- Bank deposits of foreigners	0.5
Hot Money - Resident	3.4
- Short-term credits offered to foreigners by banks	0.2
- Short-term credits used by banks	3.0
- Short-term credits used by the non-banking private sector	0.3
Total Hot Money (Excluding net errors and omissions)	14.2

Note: Figures are in terms of billion USD as of February 2005.

✓ Rapid movements of hot money are more important than the amount.

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

- The floating exchange rate regime, extension of the maturities of government papers and the strengthening of economic foundations reduce its negative effects.

Progress Made towards Stability

THE MAIN DETERMINANTS OF COMPETITIVENESS

(In alphabetical order)

Infrastructure
Exchange Rates
Legal System
Domestic Economic Stability
Quality and Trademarking
Cost:
Tax, Social Security Contributions
Capital Cost (exchange rate, interest rate), Labor Cost
Organizational and Administrative Structure
Market Structure
Productivity
Innovation

Is Turkey losing its competitiveness?

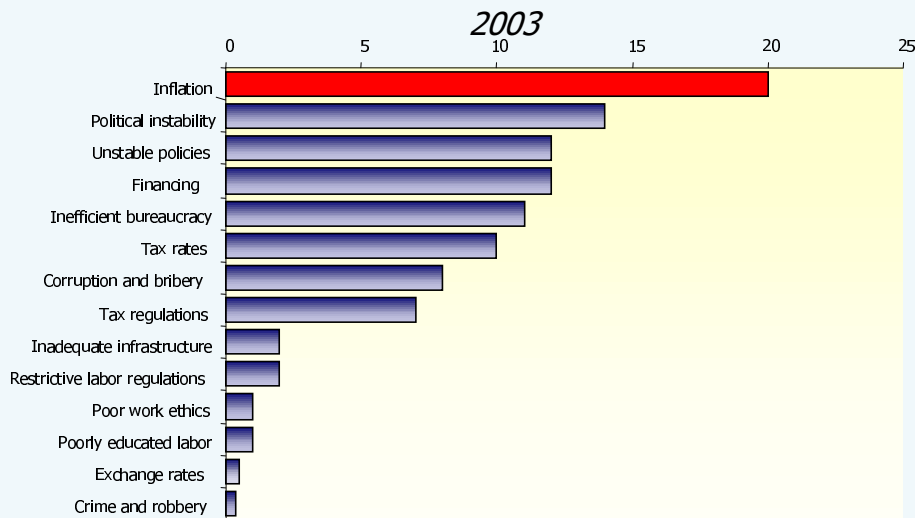
Competitiveness is defined as ;

- ✓ A country's ability to sell goods and services that meet global quality and standards, in more favorable conditions compared to its rivals, **by increasing productivity and the capacity to produce and develop technology** without **lowering living standards** through some factors such as devaluation, pollution, social dumping and protectionism.
- ✓ Many factors affect competitiveness: The number of influential factors reached 106 in the studies carried out.

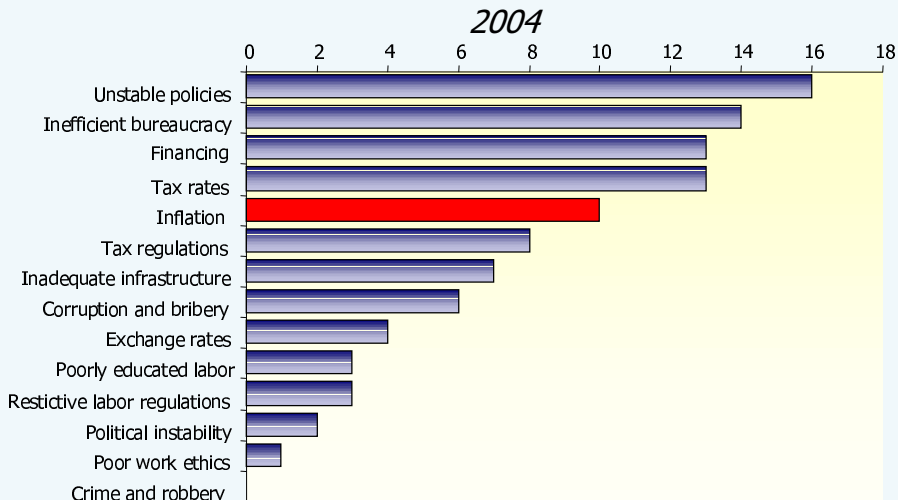
* Source: Aktan, C., Vural, İ. (December 2004). Competitiveness Series.

Progress Made towards Stability

MAIN NEGATIVE FACTORS INFLUENCING COMPETITIVENESS



MAIN NEGATIVE FACTORS INFLUENCING COMPETITIVENESS

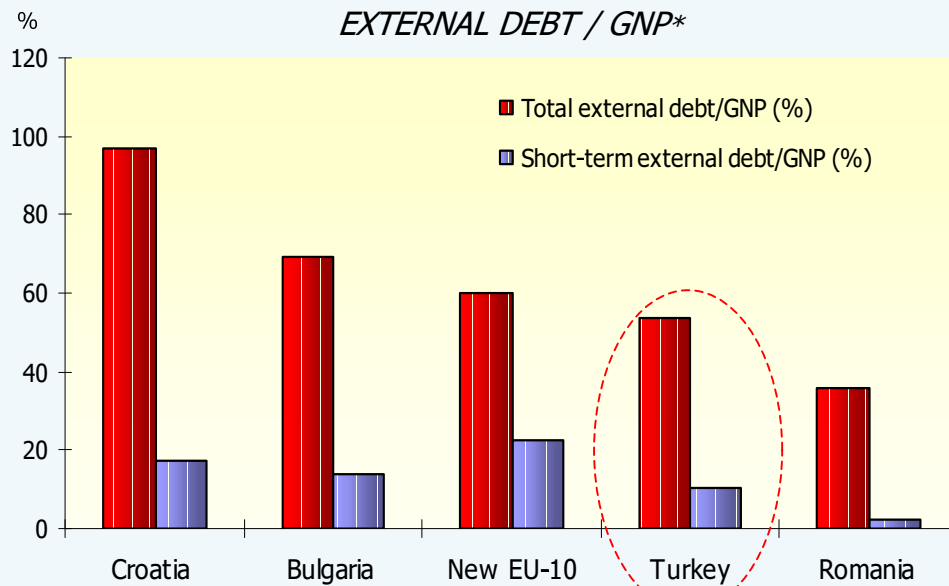


Source: The Global Competitiveness Report, 2003, 2004-2005.

Is Turkey losing its competitiveness?

- ✓ The World Economic Forum conducted a survey among Turkish firms about the Turkish economy. The survey lists the negative factors that influence competitiveness.
- ✓ In 2003, **among the 14 factors, inflation appeared at the top of the list** according to the extent of its influence.
- ✓ In 2004, inflation dropped to number five in the list due to the progress made in this period.
- ✓ In this framework, the recent **macroeconomic stability** has had **a significant effect on the competitiveness of our economy**.
- ✓ However, this process has a dynamic feature. We should at once make achievements in other sectors and provide the firms operating abroad with the same cost conditions as their rivals. This is also of the utmost importance to sustainable growth.

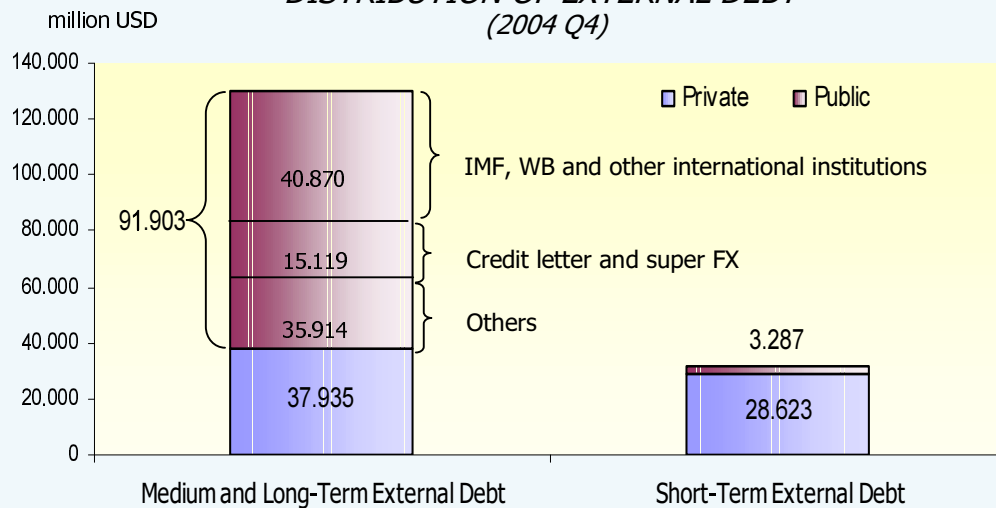
External Debt



* Turkey's external debt: As of 2004, others: As of 2003.

Source: WB, CBRT

DISTRIBUTION OF EXTERNAL DEBT (2004 Q4)



Source: CBRT

Turkey's external debt stock is USD 161.7 billion as of 2004

- ✓ The ratio of total external debt to GNP is below those of all new EU members and candidate countries except Romania.
- ✓ This difference is more significant in the ratio of short-term external debt to GNP.
- ✓ The **medium and long-term external debt constitute 80 % of the total debt stock.**

71 % of medium and long term debt → the public sector
 29 % → the private sector

- 44 % of public sector's debt is owed to international institutions such as the IMF and the World Bank.

➤ Turkey's outstanding IMF loans including interest payments is about USD 22.5 billion mainly used for strengthening the reserves and financing the government's budget.

- And, 40 % of the private sector's debt is workers' deposits kept at the CBRT.



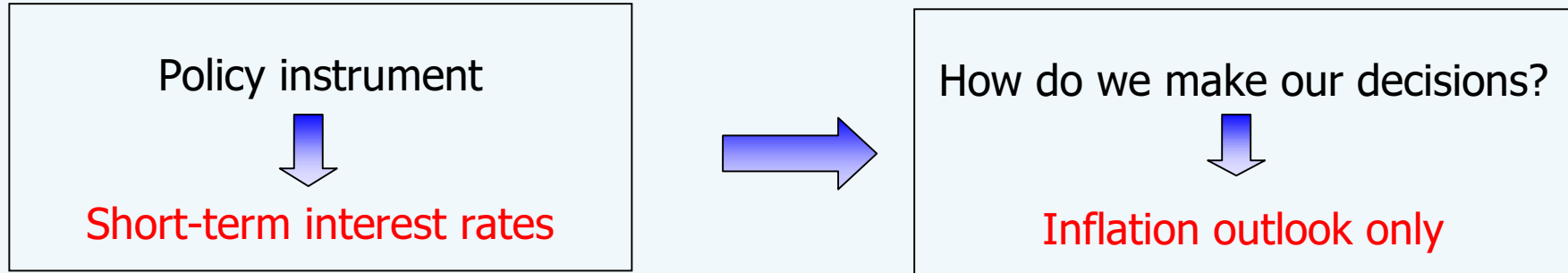
The structure of external debt stock is not fragile.



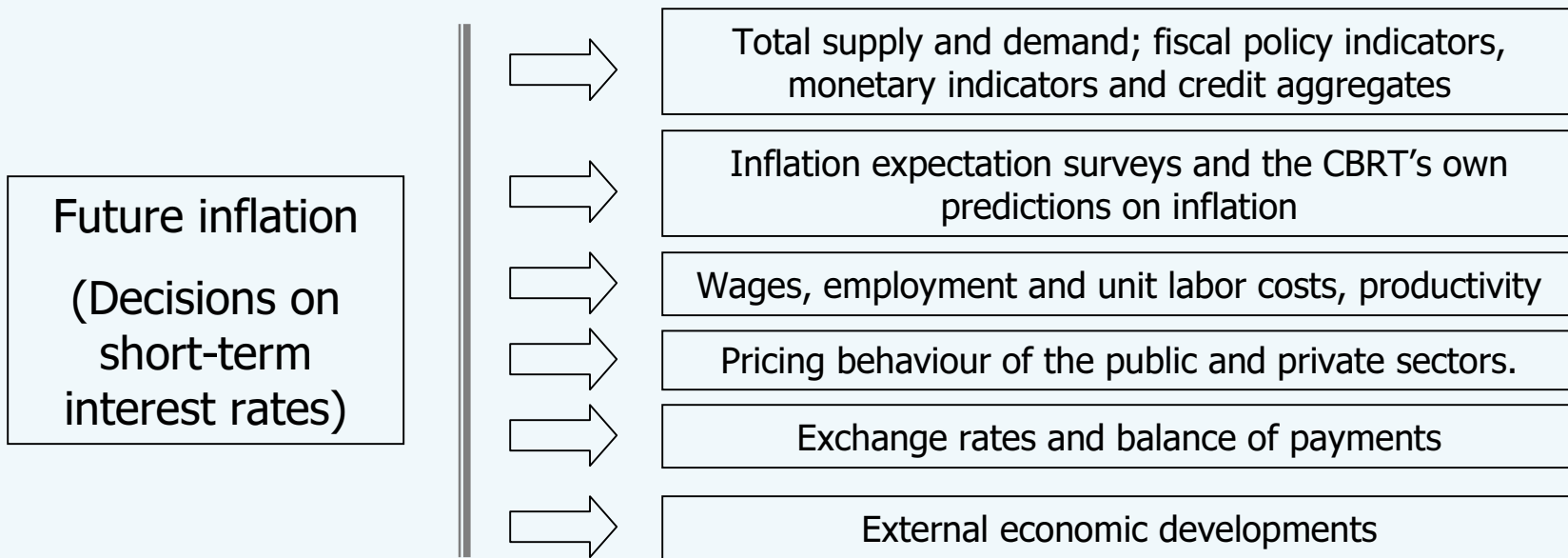
PROGRESS MADE TOWARDS STABILITY

Interest Rate Policy – Interest Rates

Interest Rate Policy



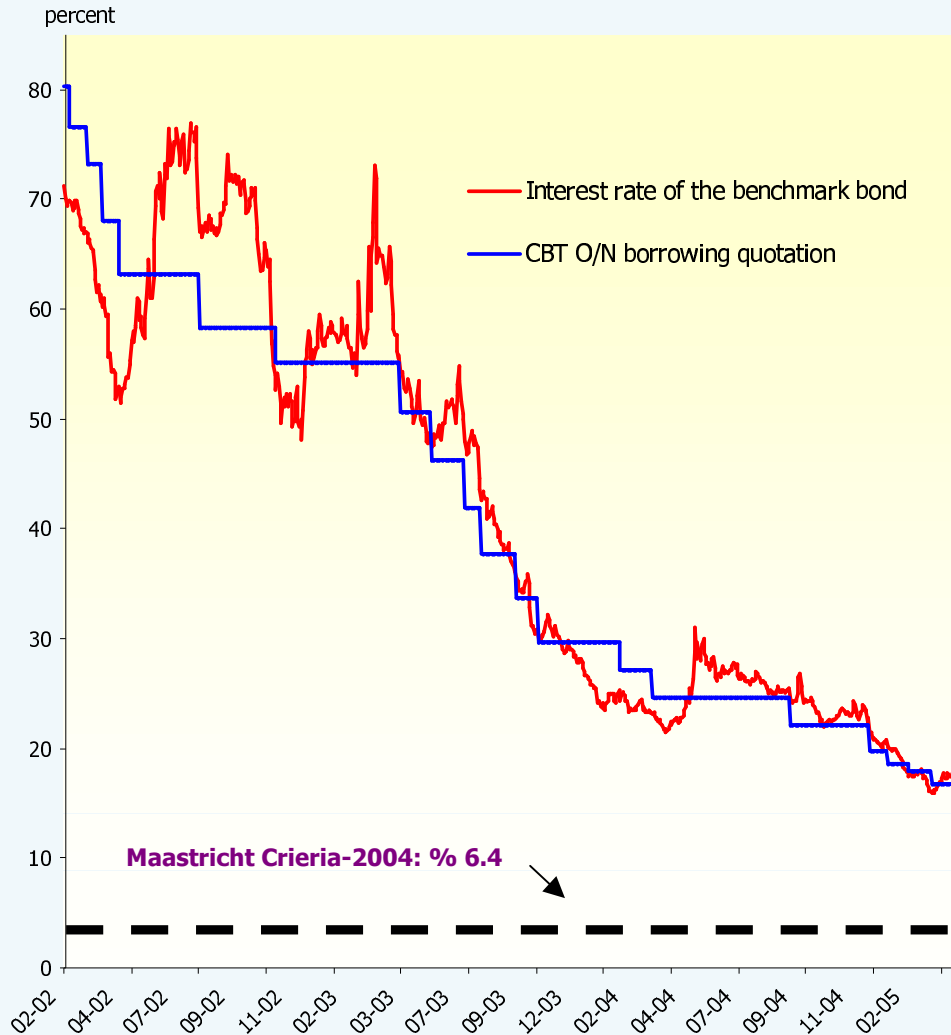
Which indicators are considered to **foresee future inflation?**



With this concept, the CBRT may **decrease** or **increase** its policy interests or may **not change** them according to the inflation target and its predictions on inflation.

Progress made Towards Stability

CBT SHORT RUN INTEREST RATE AND INTEREST RATE OF THE BENCHMARK BOND



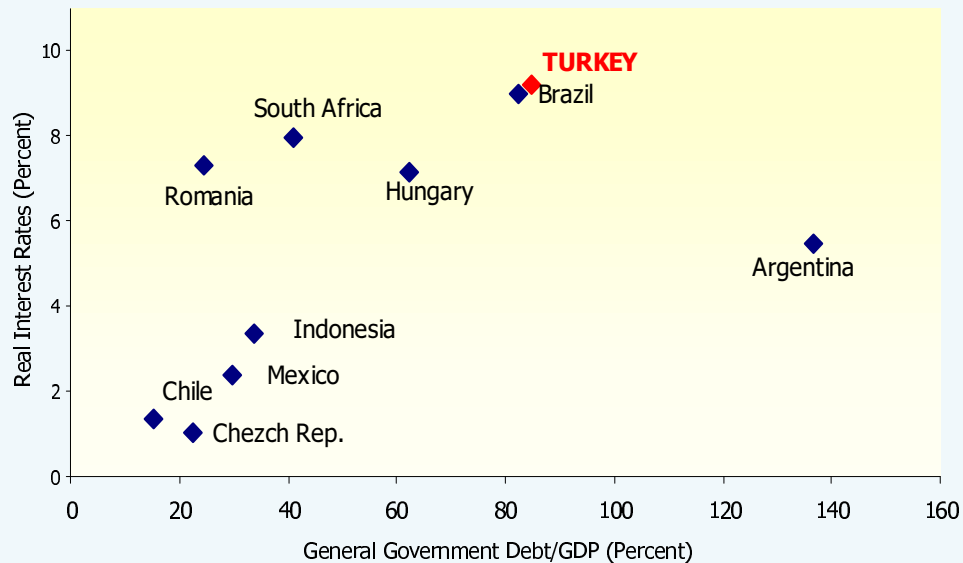
Source: CBRT

General Level of Interest Rates:
Nominal and real interest rates have decreased significantly owing to the progress made towards stability.

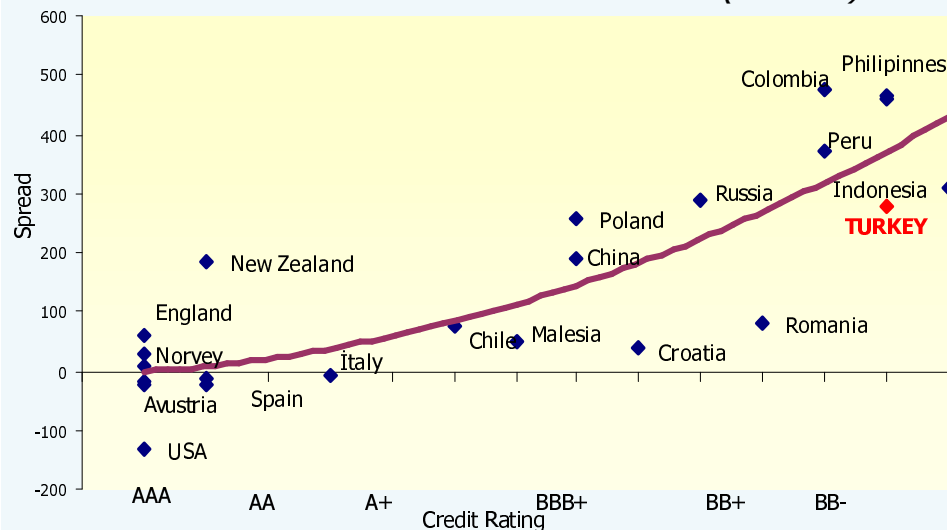
- ✓ In the last three years, real interest rates dropped by approximately 22 percent and nominal interest rates by 53 percent.
- ✓ Nevertheless, the level of interest rates is still high.
- ✓ Although getting stronger every day, the linear relationship between CBRT interest rates and the general level of interest rates is not yet at the desired level.
- ✓ Therefore, in current conditions, it is not yet possible to **permanently** decrease the general level of interest rates and real interest rates by easing CBRT interest rates.

Progress Made Towards Stability

DEBT STOCK/GDP AND REALIZED REAL INTEREST RATE



CREDIT RATING AND RISK PREMIUM (SPREAD)



Source: Bloomberg, S&P

How can we further decrease real and nominal interest rates?

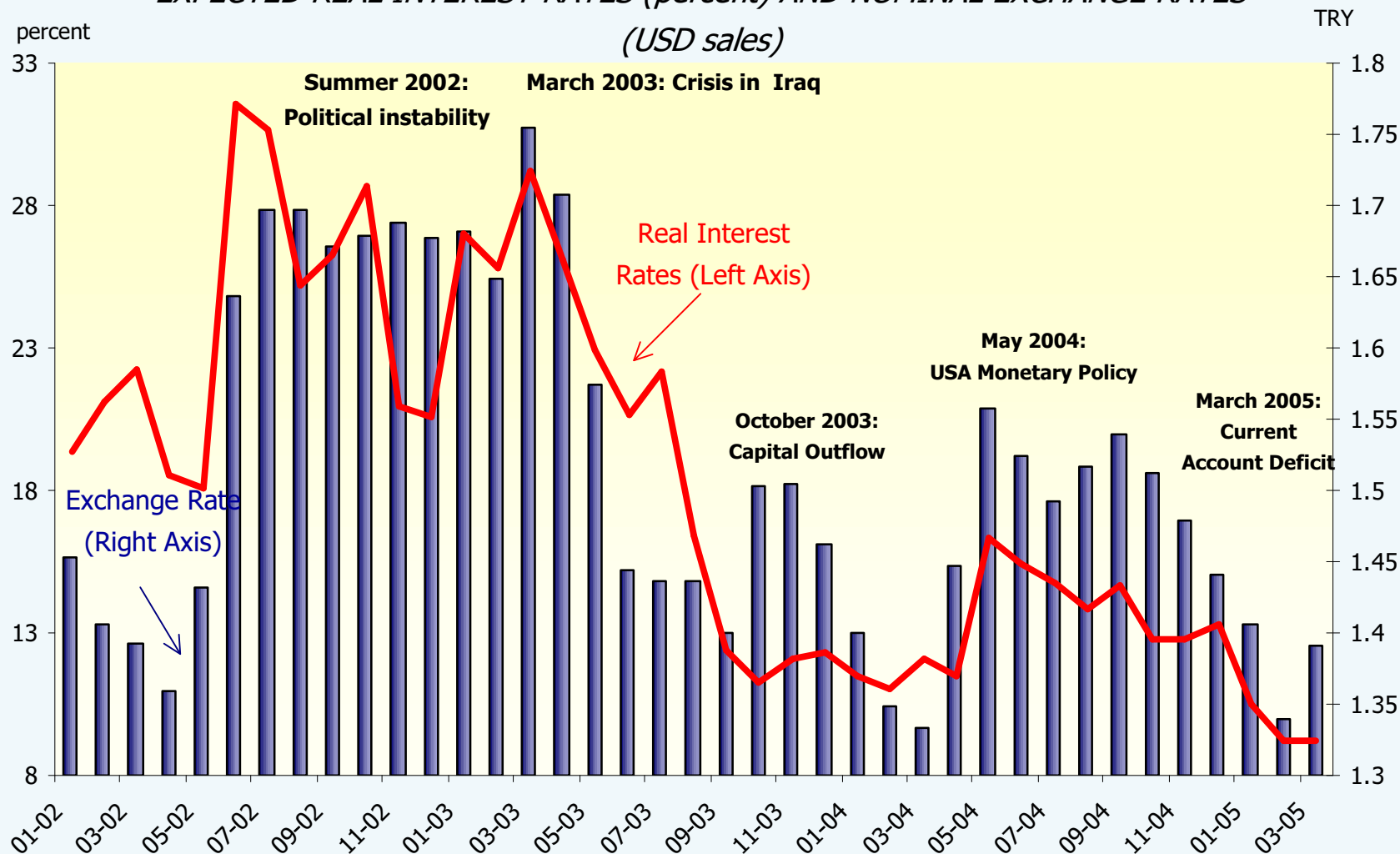
- 1- **Real interest rates** would decrease parallel to the confidence and improvement in expectations due to program implementations.
- 2- **Real interest rates** would decrease more when debt stock is decreased and a sustainable structure is achieved in public finance.
 - ✓ There is a strong linear relationship between **domestic public debt stock and real interest rates** depending on the **risk premium.**
- 3- **Real interest rates** would decrease if structural reforms are continued and a stronger macroeconomic balance is achieved.

Expected Real Interest Rates and Exchange Rates

	<u>Exchange Rate</u>	<u>Expected Interest Rate</u>
Summer 2002 : <i>Political Unrest</i>	⇒ 1.7000 31.6
March 2003 : <i>The Iraq Crisis</i>	⇒ 1.7600 29.2
October 2003 : <i>Capital Outflow</i>	⇒ 1.5000 11.3
May 2004 : <i>US Monetary Policy</i>	⇒ 1.5600 16.4
March 2005 : <i>Current Account Deficit</i>	⇒ 1.4000 10.5

Expected Real Interest Rates and Exchange Rates

*EXPECTED REAL INTEREST RATES (percent) AND NOMINAL EXCHANGE RATES
(USD sales)*



Source: CBRT



PROGRESS TOWARDS STABILITY

Floating Exchange Rate Regime

Floating Exchange Rate Regime

The foreign exchange regime
is chosen in coordination with the

Government.



**Floating Exchange
Rate Regime**

The CBRT is responsible for
the implementation of the
exchange rate regime.

Under the floating exchange rate regime;

Exchange rates are freely set according to supply-demand conditions in the market.

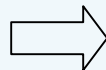
Factors affecting the level of exchange rates:

Short-term



- ✓ Developments in the economic program
- ✓ Public debt stock and risk premium
- ✓ Expectations; especially those about the balance of payments
- ✓ External developments
- ✓ Behaviour of market players

Long-term



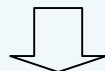
- ✓ Structural reforms and their effects on productivity
- ✓ Cyclical movements in the economy
- ✓ Economic fundamentals: inflation, growth

Floating Exchange Rate Regime

Within the framework of the floating exchange rate regime, the CBRT conducts two kinds of operations.

1. Intervention against excessive volatility:

- ✓ With the aim of preventing volatility in either direction
- ✓ Taking into account the reasons for volatility and potential volatility
- ✓ Intervention can be in the form of announcements and warnings to the market



Does CBRT intervene in the level?

- ✓ CBRT intervenes in the volatility.

Volatility

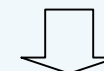


- **Daily volatility**
- **Periodic volatility**
- **Potential volatility**

- As is the case in all countries implementing a floating exchange rate regime, the CBRT does not disclose its own quantitative volatility evaluations.

2. FX Purchases with the purpose of reserve build-up:

- ✓ Mopping up excessive fx supply
- ✓ With no intention to influence the level, consistent with the floating exchange rate regime
- ✓ With transparent methods



Why does the CBRT build up reserves?

- ✓ High level of public external debt service
- ✓ Gradually decreasing **costly FX liabilities:** workers' deposits; the interest rate policy implemented for these accounts since 2002 is consistent with this aim.
- ✓ To instill confidence.

Floating Exchange Rate Regime

The Central Bank has no policy intended to keep TRY overvalued.

- ✓ TL has undergone serious devaluations 7 times: The transition to a floating exchange rate regime, the Telecom crisis, September 11 attacks, The Iraq crisis, political unrest in the summer of 2002, October 2003, April-May 2004.
 - ✓ There has been no FX sale auctions since the turn of 2003, except once on May 11, 2004.
 - ✓ USD 22.2 billion-worth of foreign exchange was purchased in the 2002-2005 period and the amount purchased since December 22, 2004 became USD 6.2 Billion.
- FX purchasing auctions continue.

Exchange Rate and Interest Rate Policy

The correlation between short-term interest rates and exchange rates is of a multidimensional and complex nature.

Under the current conditions, there might be three responses to any decrease in interest rates:

1

The yield of TRY-denominated assets decreases.
↓
The demand for foreign exchange increases.
↓
A **depreciation** pressure emerges on TRY.

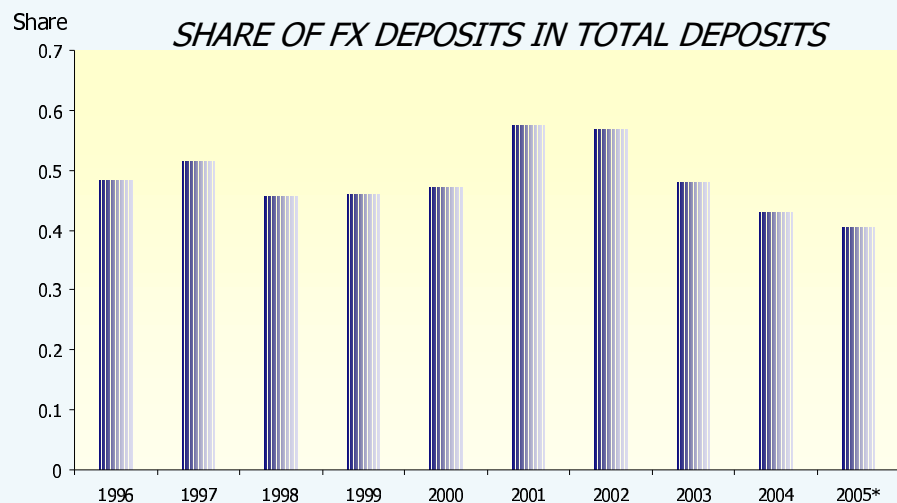
2

A positive signal pertaining to the course of events.
↓
Enhanced confidence.
Reverse currency substitution becomes stronger.
↓
An **appreciation** pressure emerges on TRY.

3

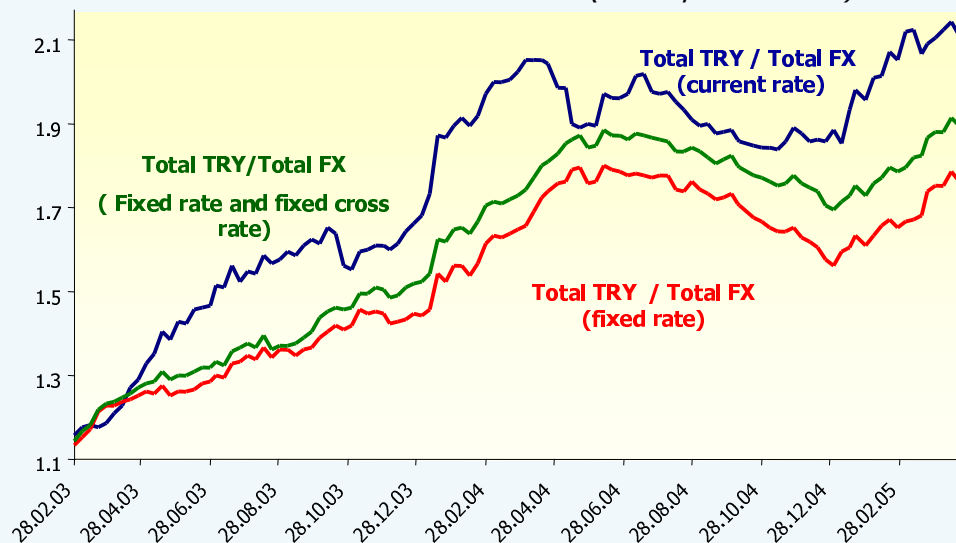
Exchange rates may move free from economic fundamentals; FX liquidity, investor behavior, different expectations.

Progress Towards Stability



*As of April, Source: CBRT

TRY-DENOMINATED INVESTMENT INSTRUMENTS/FX-DENOMINATED INVESTMENT INSTRUMENTS(As of April 21st 2005)*



Source: CBRT

Reverse Currency Substitution

- ✓ Reverse currency substitution is not a self-generated process.
- ✓ It is a side effect of the fight against inflation and economic stability attained as a result of this fight.
- ✓ The reverse currency substitution process started when the results of the economic program implemented in the last 4 years began to appear.
 - *The share of FX deposits in total deposits has gradually been decreasing since 2002.*
- ✓ The establishment of macroeconomic stability, especially price stability, and increased confidence will accelerate the reverse currency substitution process.

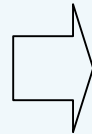


WHAT'S ON THE AGENDA?

Primary Objectives

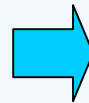
The primary objective of economic policies:

To establish
macroeconomic balances



To ensure sustainable growth
and employment in their
potential levels.

- ✓ As it is widely accepted, the desired and targeted results of economic policies can only be attained in an environment where price stability is achieved.
- ✓ Therefore, price stability is a **prerequisite** for attaining sustainable growth and a lasting increase in employment.

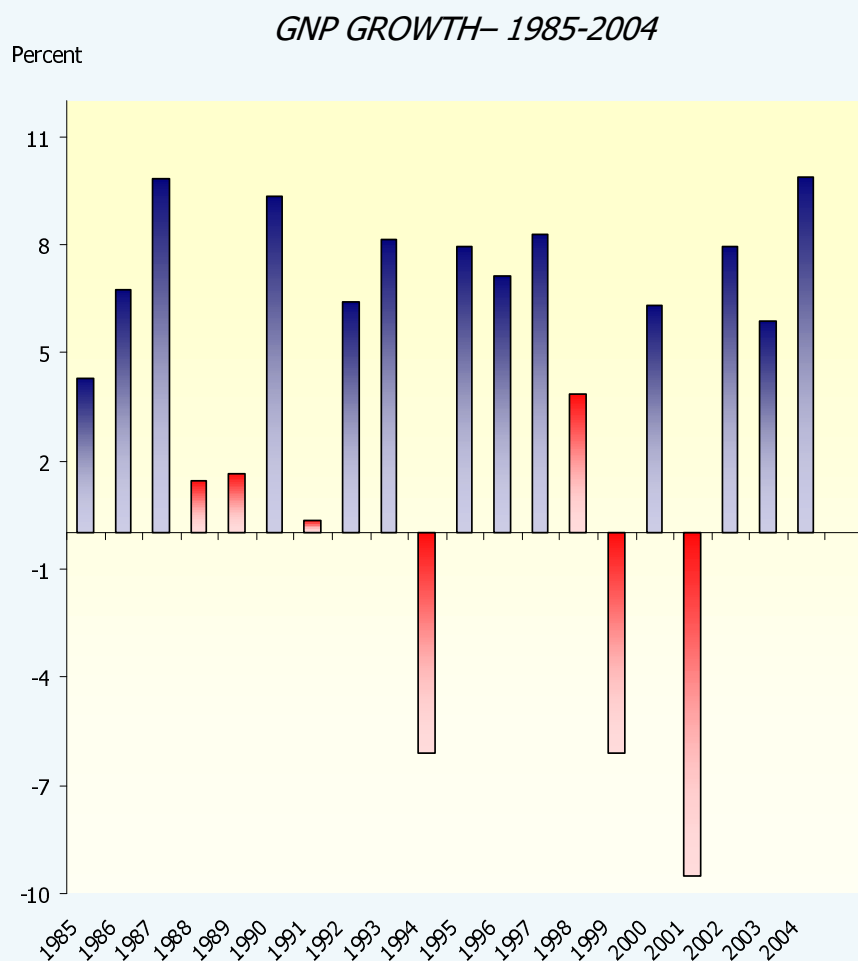


- ✓ For this reason, the aim of monetary policies, in other words, the final and prior objective of central banks is to achieve and maintain price stability.
- ✓ The greatest contribution to sustainable growth and rise in employment comes from this commitment.

(CBRT Law Article 4)

A lot has been achieved towards macroeconomic stability through economic policies. What our country needs is to make these achievements permanent and attain sustainable growth and employment.

Sustainable Growth



Source: SIS

Sustainable Growth

✓ Due to the changing growth dynamics, the boom-bust cycle in the growth trend has been broken to a great extent.

- Turkey has been growing rapidly for the last three years. Positive growth rates will also continue in the upcoming period with the help of single-digit inflation.

✓ Questions:

- What will the level of positive growth rates be?

- Will that level be satisfying?

- Where do we stand in the sustainable growth process today?

✓ **Sustainable Growth is defined as:**

Growth periods with a potential growth rate lasting for 5 or more years in an environment where

- Price stability is maintained,

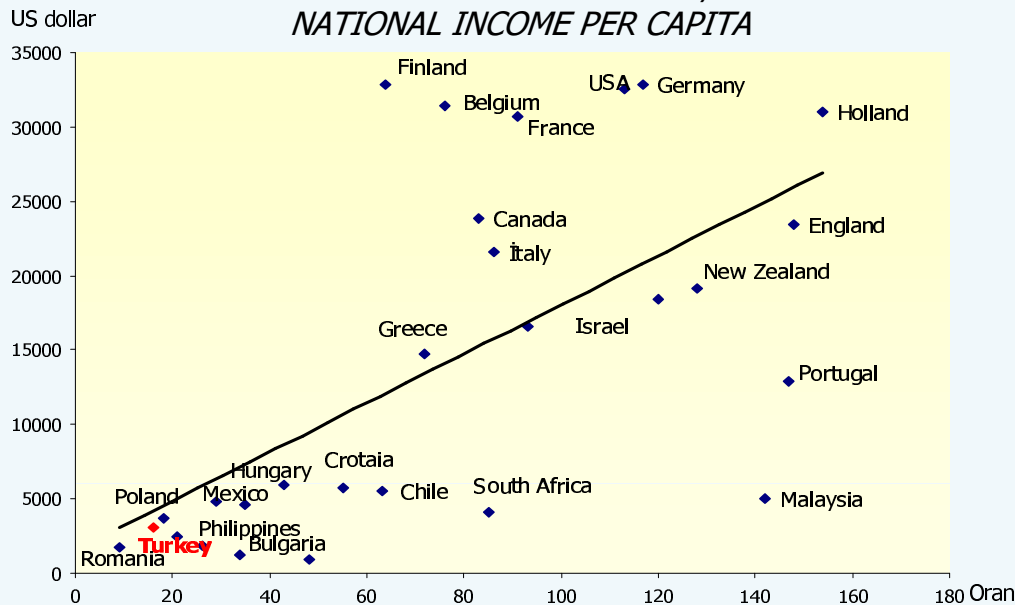
- Economic indicators including current account deficit/GNP and total demand, and macroeconomic balances are coherent.

✓ Maintaining sustainable growth requires **the continuance of comprehensive reforms.**

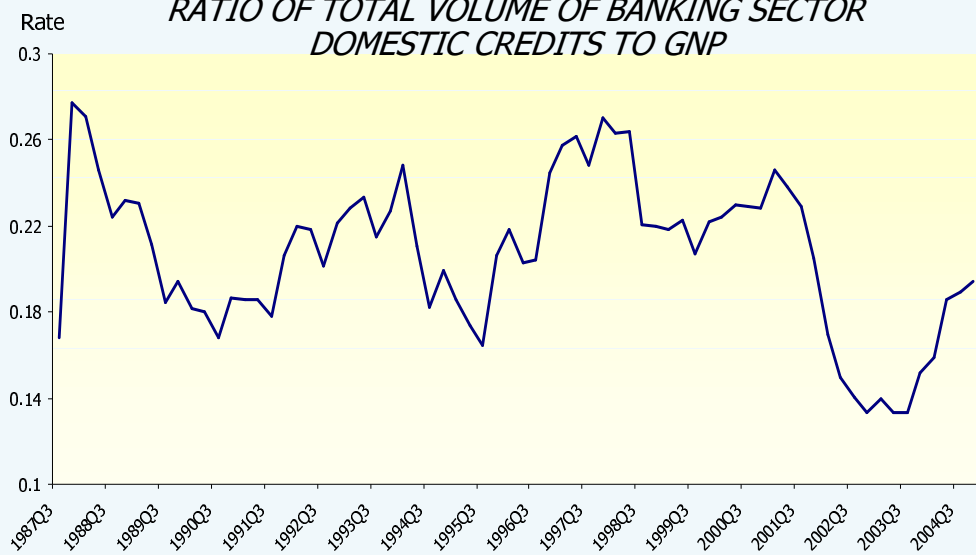
✓ At the core of these reforms lies establishing, protecting and developing a structure that will increase flexibility against internal and external shocks with productivity.

Sustainable Growth

BANKING SECTOR CREDIT VOLUME/GDP AND NATIONAL INCOME PER CAPITA



RATIO OF TOTAL VOLUME OF BANKING SECTOR DOMESTIC CREDITS TO GNP

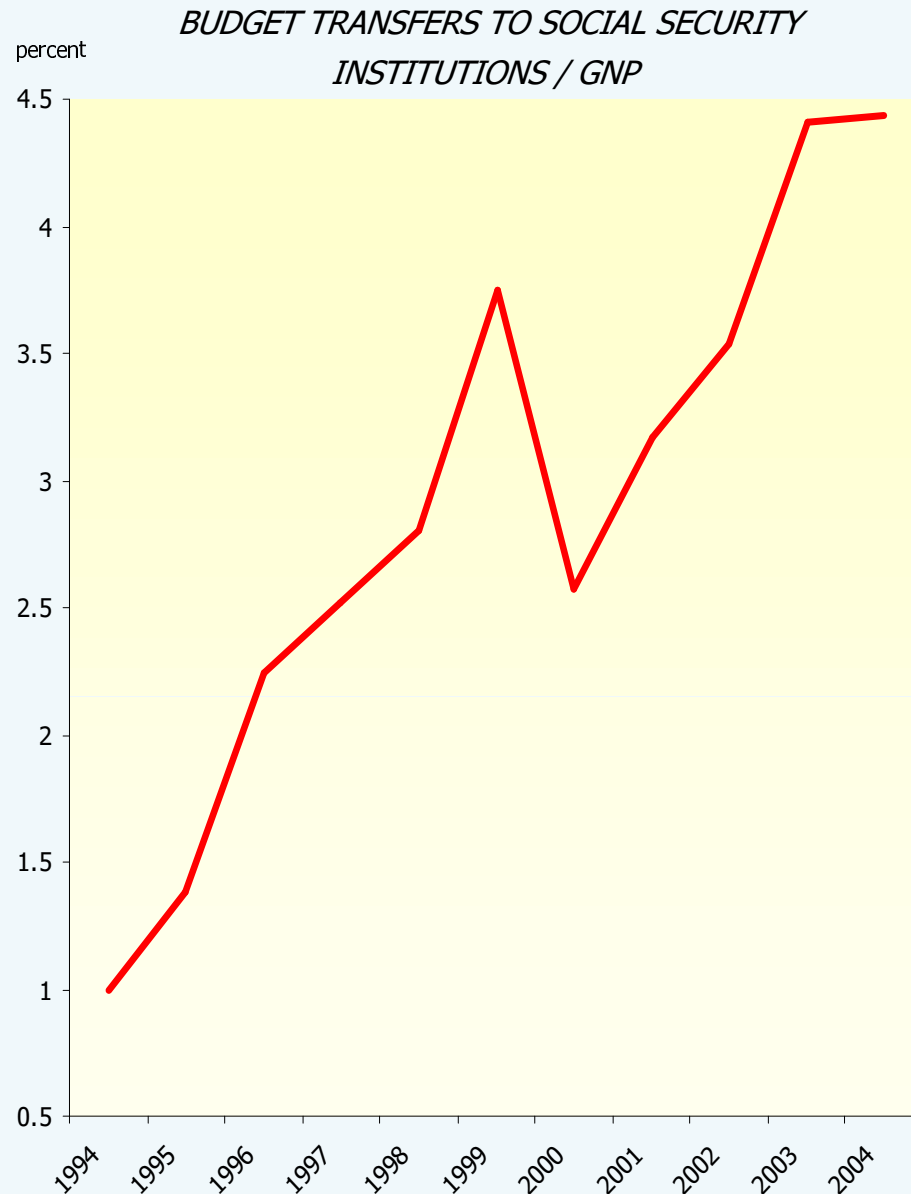


Source: CBRT, World Bank

1- Banking sector reform:

- ✓ There is a strong positive relationship between **national income per capita and the total volume of banking sector credits.**
- ✓ A strong banking sector plays a key role in **providing resources to the real sector** and achieving high growth rates.
- ✓ Credit volume in Turkey, which dropped rapidly following the 2001 crisis, **re-increased starting from end-2002.**
- ✓ However, current achievements are not sufficient; the ratio of total credit volume/national income is **below that of developed countries and many developing countries.**
- ✓ Uninterrupted implementation of banking sector reform must remain a priority in order to be able to provide resources to the real sector in a more efficient way.

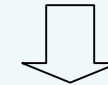
Sustainable Growth



Source: Treasury

2- Social Security Reform:

- ✓ Deficits in the social security system have reached a critical extent.
- ✓ Although the demographic structure of Turkey provides an important advantage;
 - *Small number of registered employees,*
 - *Understatement of employees' incomes,*
 - *Distortions in expenditures*



- lead to greater imbalances in the social security system.
- *It is estimated that the budget transfer to social security institutions made in 2004 corresponded to 4.4 percent of the GNP.*
 - *Important steps have been taken, and the outcomes of the measures will be observed in the long term.*

Sustainable Growth

Sustainable Growth

3- Tax Reform:

- ✓ Broadening the Tax Base
 - *In Turkey, both direct and indirect effective tax rates are quite low.*
 - *A certain amount of income is produced. However, this income cannot be taxed effectively.*
 - *Due to this taxation structure, the tax burden on the registered economy is quite heavy, whereas that on the unregistered economy is insignificant.*
 - ✓ Formalizing the Unregistered Economy
 - *In Turkey, the size of unregistered economy moves between 16 % and 50 %, conditional on assumptions. The unregistered economy causes;*
 - *A contraction in government revenues, unproductive use of country's resources, low levels of sustainable growth, only temporary increases in employment, and unfair competition.*
- Hence, restructuring of the tax system is of critical importance.

4- Improving the Investment Climate:

- ✓ This is critical in terms of encouraging both domestic and foreign direct investments (FDI).
 - *The enactment of the FDI Law and the law on the protection of property rights are important steps on the way.*
 - *In Turkey, the level of domestic savings is quite low. Encouraging foreign direct investments is very important in order to achieve high growth rates. The EU process provides significant potential. Recent developments also prove this.*

Sustainable Growth

Sustainable Growth

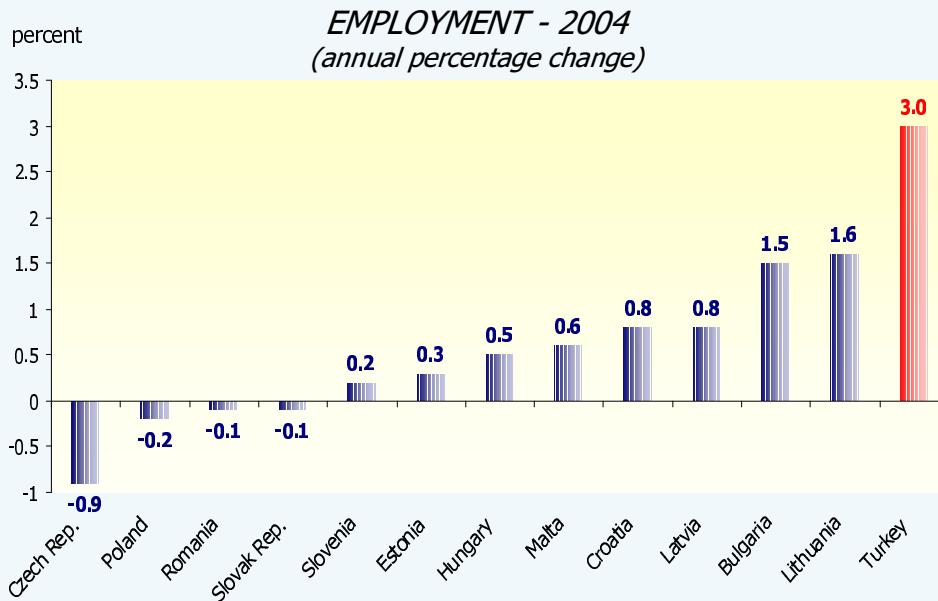
5- Sustaining productivity increases:

- ✓ Increases in total factor productivity will be one of the most important dynamics of sustainable growth in the upcoming period.
- ✓ Recent productivity increases in the manufacturing industry should be extended to all other sectors and be sustained.
- ✓ Factors needed to sustain productivity increases are;
 - *Research-development facilities that will enable technological advancement,*
 - *Labor force training,*
 - *Improvement in corporate governance.*

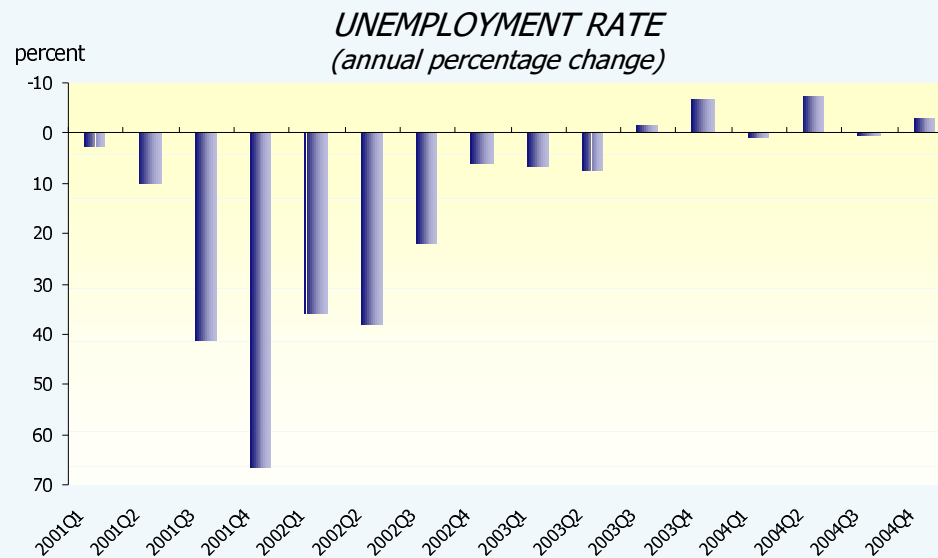
6- Implementing principles of good governance:

- ✓ In democratic countries with a dominant market economy, there is a strong positive relationship between the national income per capita and governance. Implementation of the following principles of good governance;
 - *political honesty and accountability*
 - *quality and stability of government services*
 - *effectiveness of regulations and arrangements*
 - *rule of law*
 - *prevention of corruption*
- is crucial for strong and lasting economic performance.

Sustainable Employment



Source: European Commission, projections excluding Turkey



Source: SIS

Sustainable Employment

Important points about the current employment situation:

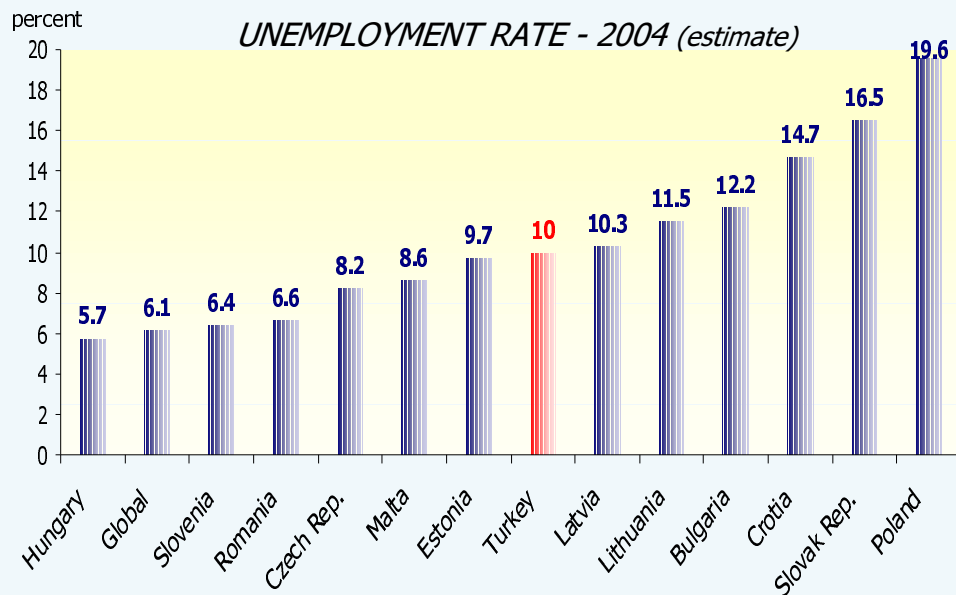
- ✓ Employment is increasing:
 - The total increase in employment in Turkey throughout **2004** is much higher than that of EU member and candidate countries: 3 %.
- ✓ Compared to the same period of 2003, the last quarter of 2004 recorded the following increases:
 - Total employment: 5.1 %
 - Construction: 9.2 %
 - Agriculture: 5.9 %
 - Services: 4.6 %
 - Industry: 3.7 %

As of the last quarter of 2004, the unemployment rate is 10 %.

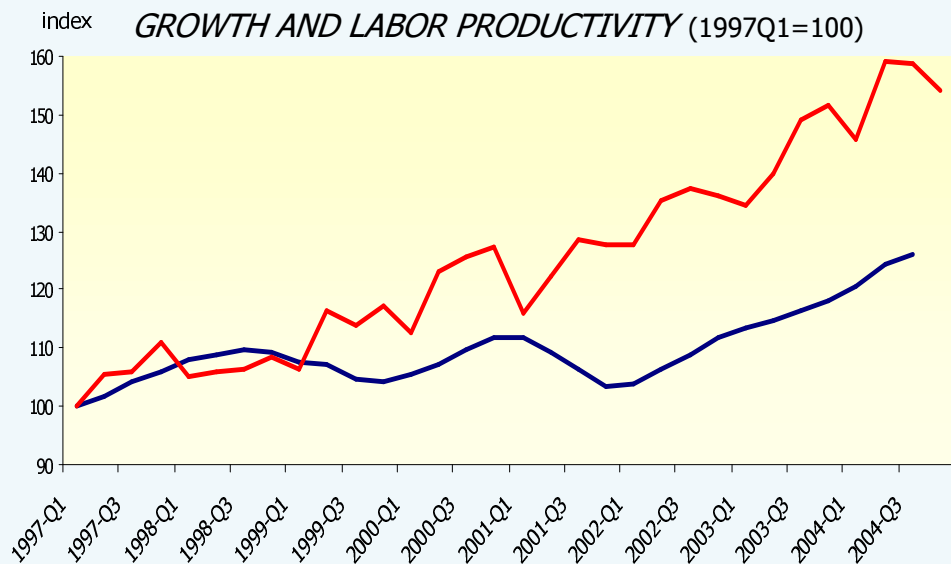
The unemployment rate in January 2005: %11.5

- Calculation method is changed to 3-month moving average and figures are revised including new parameters. Be careful when making comparisons with the old series.

Sustainable Employment



Source: SPO, * International Labor Organization



Source: SIS

However, the recovery is not at the desired level.

1. Unemployment is not peculiar to our country, it is a global problem.

- ✓ In 2004, **global unemployment** was 6.1 %, while global unemployment among the young population became 13.1 %*.
- ✓ The unemployment rate in some **EU member and candidate countries** is above 10 %.

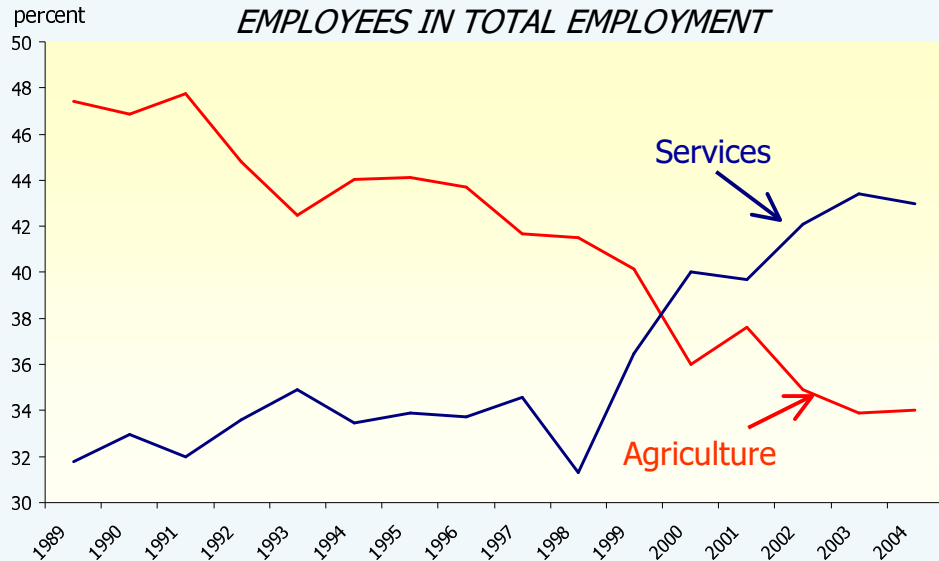
2. Productivity increases:

- ✓ In Turkey, **productivity increases have outpaced growth** for the last four years.
- ✓ Productivity increases enabled firms to boost production **without increasing their employment capacity**.
- ✓ This situation, which has recently been observed throughout the world including the USA and Europe, is referred to as **"Jobless Recovery"**.
- ✓ Although they affect the employment capacity of growth adversely in the short term, **outcomes of productivity increases are favorable in the long term**.

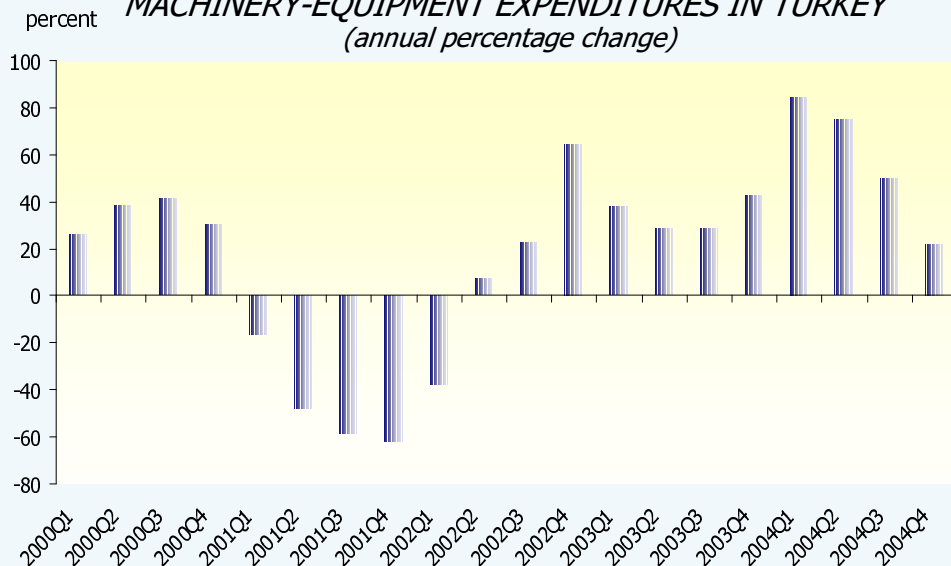
Growth without employment is a transition process.

Sustainable Employment

SHARE OF TURKEY'S AGRICULTURAL AND SERVICES SECTOR EMPLOYEES IN TOTAL EMPLOYMENT



MACHINERY-EQUIPMENT EXPENDITURES IN TURKEY (annual percentage change)



Source: SIS

3. Structural changes are also observed in the labor market within the structural transformation process in the economy.

- ✓ Some sectors are expanding while others are contracting, and the sectoral distribution of employment is changing.

- The share of the agricultural sector in total employment is falling, while that of the services sector is rising.

	Sectoral Distribution of Employment (%)			
	AGR.	INDUSTRY	CONSTR.	SERVICES
1989-1999 avrg.	44.0	16.3	5.8	33.5
2000-2004 avrg.	35.3	18.0	5.1	41.6

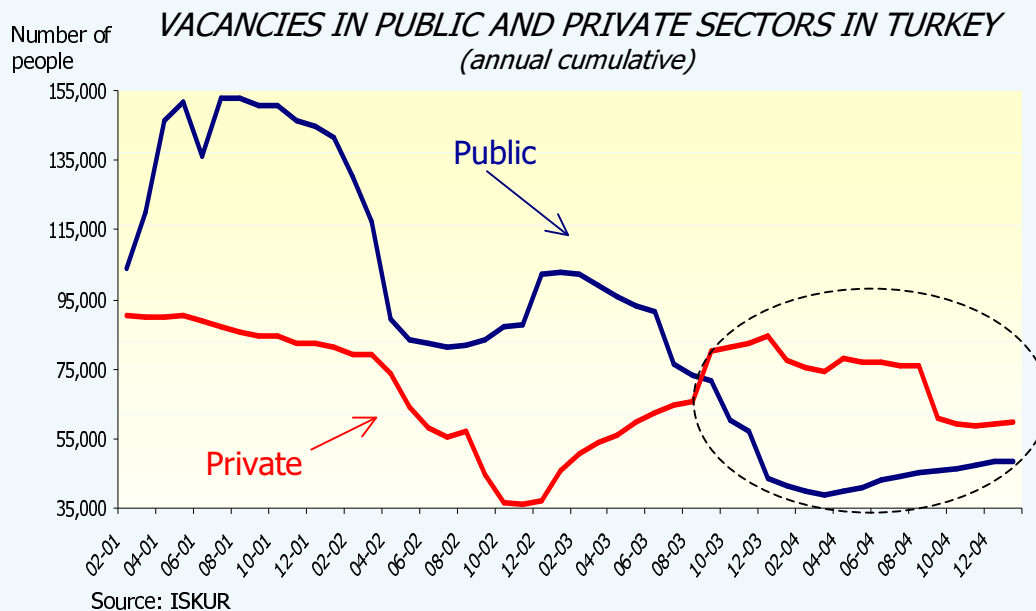
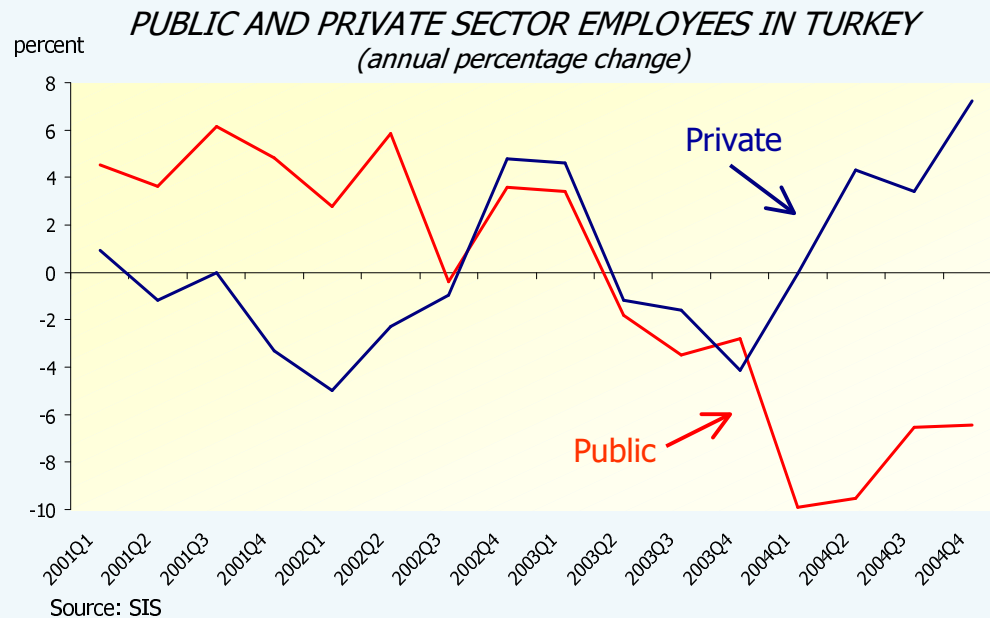
- Production factors are moving into different sectors, and more effective and competitive firms are emerging.

- ✓ Like other emerging economies, Turkey's economy is moving toward a **capital-intensive investment structure from a labor-intensive one.**

- Due to the fall in interest rates, the capital cost decreased compared to the labor cost.

- The upsurge in machinery-equipment expenditures observed since mid-2003 supports this development.

Sustainable Employment



✓ **The public sector has given up employing an excessive labor force.**

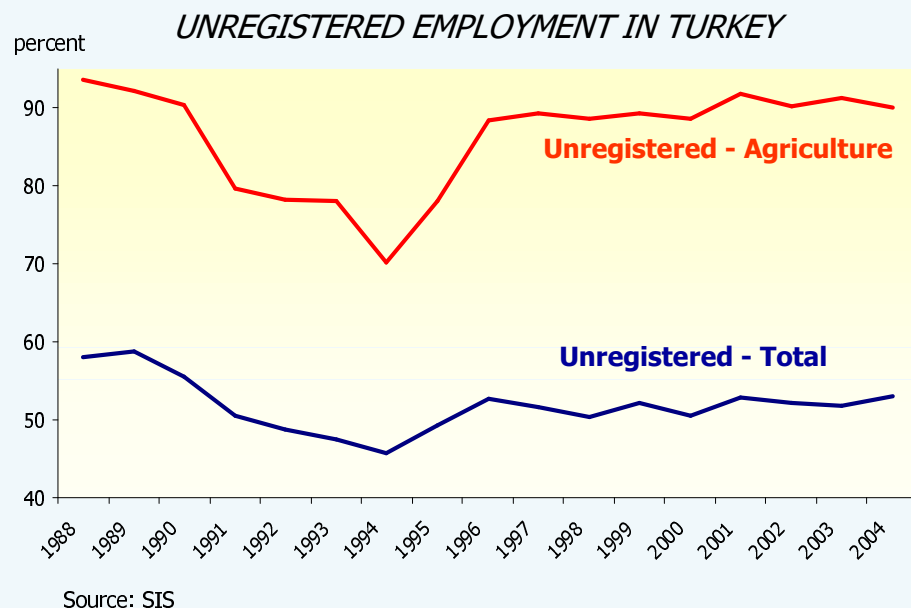
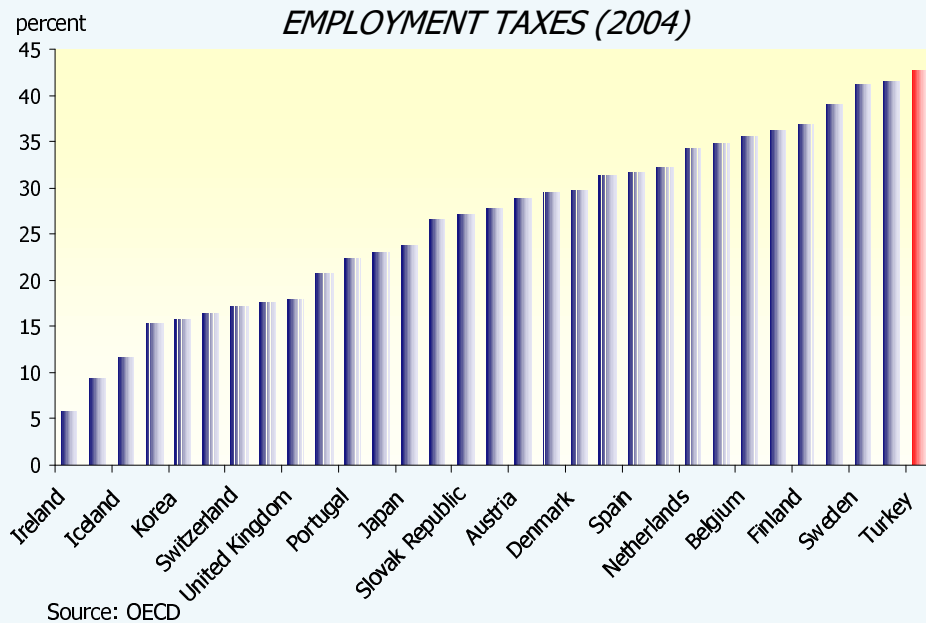
- Since the start of 2003, **employment in the public sector has noticeably been decreasing.**

- In line with the changing dynamics, the capacity of the public sector to create new jobs has decreased, whereas that of the private sector has increased considerably, especially in the recent period.

- Starting from end-2003, vacancies in the private sector have for the first time exceeded vacancies in the public sector.

- **The source of employment is the private sector now.**

Sustainable Employment



4. Structural problems of the labor market are hindering the recovery process.

- ✓ High increase in the labor force:
 - High rate of increase in population continues, albeit at a slower pace.
 - Additions to the labor force are increasing.
 - Employment in the agricultural sector is gradually falling, and the agricultural population is joining the urban labor force.
 - Female labor force participation is also increasing.
- ✓ High employment taxes:
 - Employment taxes, which were 30.3 % in 1999, reached the highest level among the OECD countries in 2004 with 42.7 %. This level is 5.9 % in Ireland, whereas the OECD average is 26.6 %.
 - As of 2003 , the share of employment taxes in labor costs is 42.1 % in Turkey. This level is also 5.6 points above the OECD average.
- ✓ Unregistered employment:
 - In particular, high employment taxes fuel unregistered employment.
 - According to SIS data, total unregistered employment as of 2004 is 53 %.
 - 90 % of it belongs to the agricultural sector.

Identifying the problem brings the solution.

Sustainable Employment

What can be done to increase sustainable employment?



Source: Eurostat, Employment in Europe 2004, SIS

1. Employment-oriented policies should be implemented;

- ✓ The real sector – financial sector relationship should be strengthened in order to provide sufficient financing to the private sector to create employment,
- ✓ The investment environment should be enhanced,
- ✓ The capacity of growth to create employment should be increased via establishing permanent macroeconomic stability.

2. Production should be increased to a level that will enable competitiveness in international markets;

- ✓ Products with high value added should be given priority,
- ✓ Regional markets should be established to address the unskilled labor force that will appear following the contraction in the agricultural sector.

3. Employment taxes should be reduced.

4. The unregistered economy should be formalized.

5. Productivity increases should be sustained.

6. Training policies are required;

- ✓ Long-term planning to increase the skilled labor force and make it suit labor demand.

7. The policies to be implemented should conform to the European Employment Strategy;

- ✓ In the framework of the Lisbon strategy, the EU set the following targets for 2010:
 - The general employment rate will be 70 %.
 - Female labor force employment will be above 60 %.
- ✓ As of 2004, in Turkey:
 - The general employment rate is 26.3 points below the Lisbon target, at 43.7 %.
 - Female labor force employment is also far below the target, at 22.9 %.



ECONOMIC OUTLOOK

**THE CENTRAL BANK OF THE REPUBLIC OF
TURKEY**

April 2005