THE TURKISH ECONOMY

CENTRAL BANK OF TURKEY

June 2005

General Framework

In the last four years,

– Prudent macroeconomic policies,

– Structural reforms

– Falling inflation,

– Robust output growth,

– More competitive and efficient real sector,

– More stable financial markets; lower interest rates, less volatile exchange rates,

– Stronger institutions.

Change in the structure of the Turkish economy is now on an irreversible path.

Inflation

Falling Inflation:

The inflation is down to single digits.

–In 2002, 2003 and 2004, the inflation targets were attained.

2002 January: 73.2 % ⇨ *2005 May:* 8.70 %

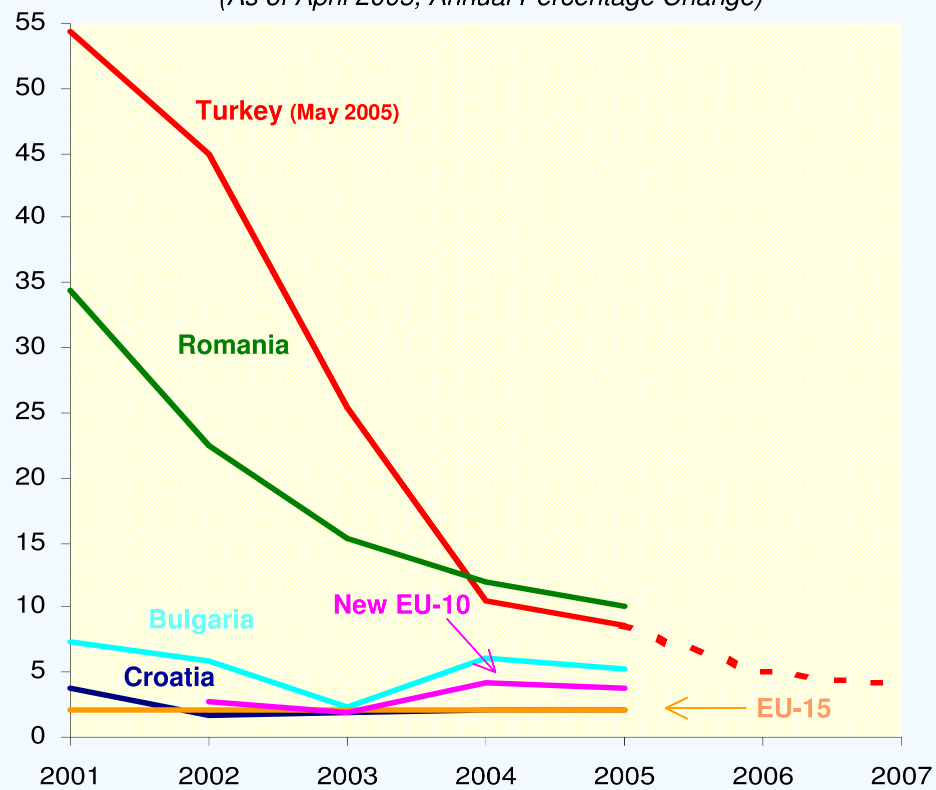
–Turkey appears to be catching up with the Maastricht criterion on inflation.

INFLATION TARGETS AND REALIZATIONS (2002-2007)

	2002	2003	2004	2005	2006*	2007*
Target	35 %	20 %	12 %	8 %	5 %	4 %
Realization	29.7 %	18.4 %	9.32 %	May 8.70 %	-	-

CONSUMER PRICE INFLATION

(As of April 2005, Annual Percentage Change)



* 2006 and 2007: Program targets.

2005 inflation for Turkey has been calculated with the 2003=100 index.

Source: SIS, European Commission

Inflation

Falling Inflation:

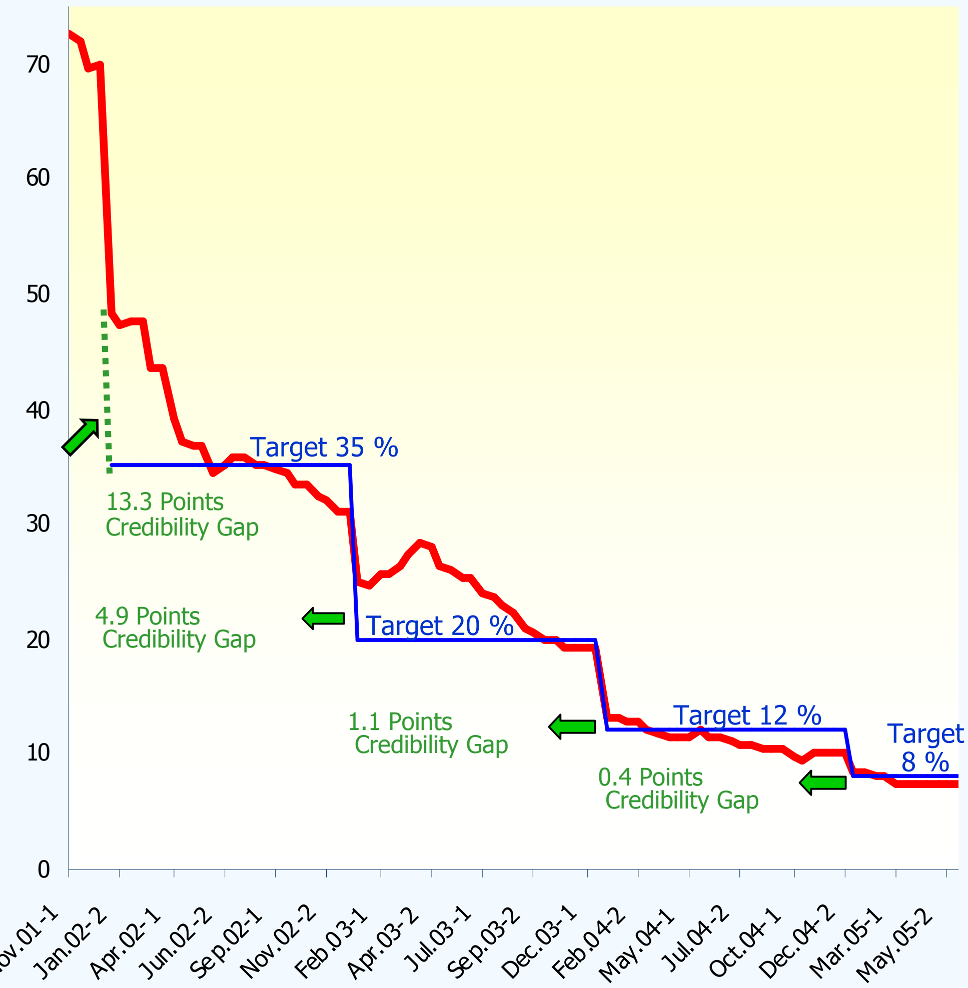
Not only inflation fell, but also dynamics of inflation have changed significantly.

Irreversibility of disinflation.

- ✓ *The Central Bank has been granted independence.*
  - *Effective communication policy is at the center of the CBT's policies. Successful management of expectations*
  - *Policies gained credibility.*
  - *Inflation inertia has decreased.*
  - *The volatility of inflation has declined.*
  - *Inflation target is now a more credible anchor.*
- ✓ *Fiscal discipline has been restored.*
- ✓ *Productivity increased, level of real wages helped.*
- ✓ *Exchange rate pass-through effect is weaker.*
  - *The pass-through effect is weaker and more lagged compared to the high inflation period.*
  - ***New CPI basket:** The weight of tradable goods is higher, the pass-through effect became stronger, but its trend continues to be downward.*
- ✓ *Consumer and producer behavior are changing.*
  - *Consumers check out prices and quality; hence competition increases; producers control their costs and put efforts to increase productivity.*

YEAR END INFLATION (CPI) EXPECTATIONS

(As of June 2005, Annual Percentage Change)



Source: CBT

A Detailed Analysis of Inflation

Inflation

<u>CPI; January – May 2005:</u>

First 5 months cumulative: 2.49 %;

Annual: 8.70 %

✓ **Clothing-footwear prices:**

- *Lower than the CPI in the first quarter*
- *Higher increase than expected in April and May due to seasonality*

✓ **Recreation - cultural prices and furnishing - household equipment:**

- *Increase above the CPI*
- *Show seasonality as well*

✓ **Though diminishing, continuing price rigidities in the services sector;**

- *Hotel / restaurant prices and rents; above the CPI*

✓ **Developments in oil, natural gas and gasoline prices in the world;**

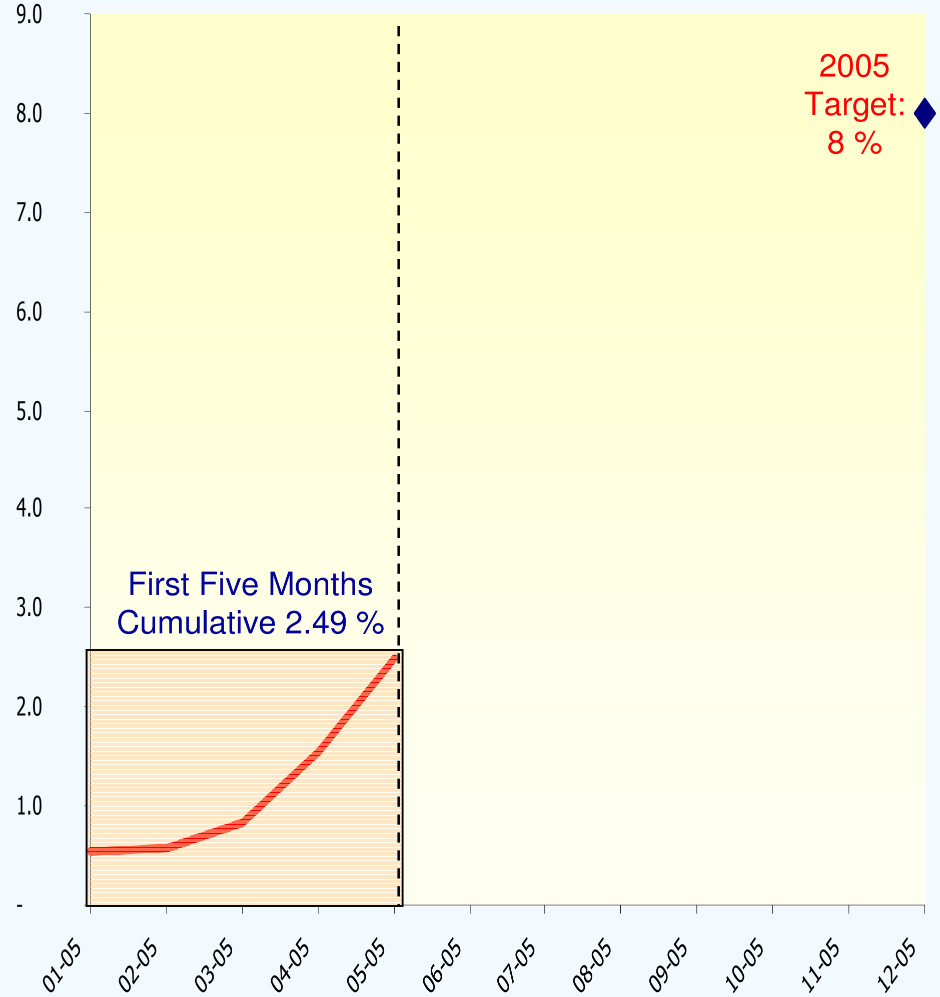
- *Housing / transport prices; above the CPI in the first four months*
- *Limited increase in May*

✓ **Food prices:**

- *Well below the CPI*

CONSUMER PRICE INFLATION

(Cumulative Percentage Change from December 2004 and The Year-end Target)



Source: SIS

Inflation Outlook

Inflation – Outlook

- ✓ **New index makes seasonality less predictable.**
  - ➢ *When seasonality is high, CPI excluding seasonal products may give better information: In May, 0.92 % increase in CPI vs.*
    - ❖ *CPI excluding clothing and footwear 0.28 %,*
    - ❖ *Specified coverage A; excluding seasonal goods 0.43 %.*
- ✓ **The CPIs having specified coverages are important.**
  - ➢ *They may contain seasonal effects. So, they should be examined on an annual and cumulative basis.*
  - ➢ *Due to revision in the data for April, slight increases observed in April and May figures: Specified coverages F and G.*
  - ➢ *Closely monitored by the CBT.*

In the medium term

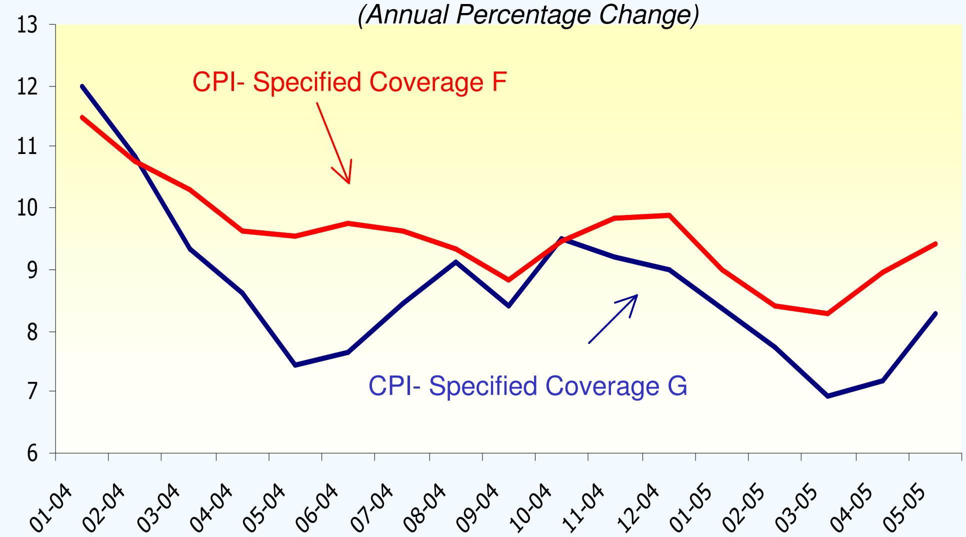
- ✓ **On the supply side, there is still room to reach potential.**
  - ➢ *High investment expenditures in 2004, created new capacity.*
  - ➢ *Ongoing production increase.*
  - ➢ *Investment expenditures continue to increase.*
- ✓ **On the demand side, continued recovery is under control.**
  - ➢ *Constrained upward pressure on prices;*
  - ➢ *Change in the first four months compared to the same period of 2004; automobiles sales 25.4 % decrease, white goods sales only 1.3 % increase.*

In the near future, supply-demand gap is not expected to close.

Unit Labour Costs

CONSUMER PRICE INFLATION – SPECIFIED COVERAGES

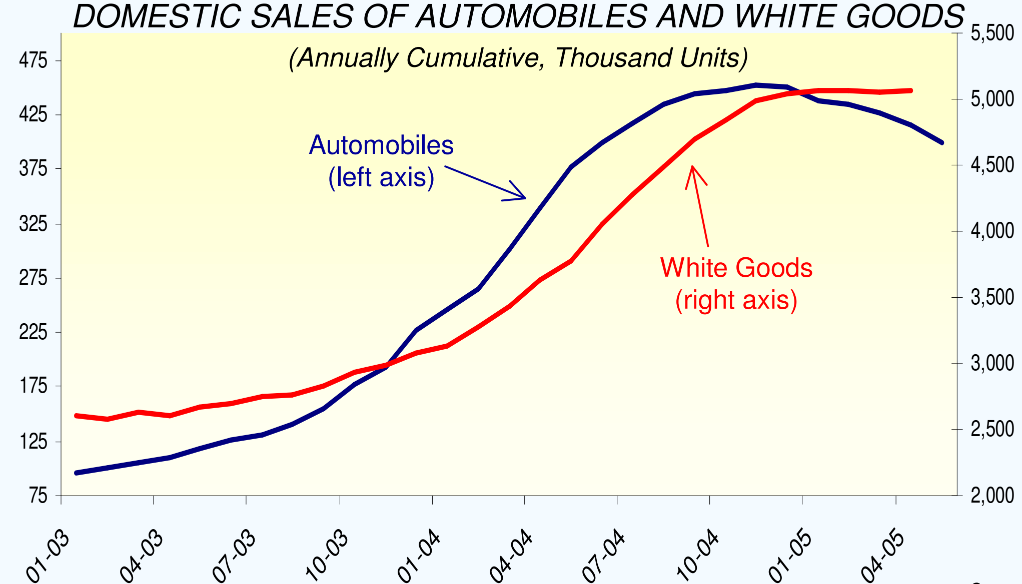
(Annual Percentage Change)



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

DOMESTIC SALES OF AUTOMOBILES AND WHITE GOODS

(Annually Cumulative, Thousand Units)



Source: SIS

Inflation – Outlook

However,

- ✓ **Unit labor costs are increasing;**
  - ➢ *Employment has started to recover.*
  - ➢ *Productivity increase may not help in 2005 as much as it did before.*
- ✓ **Increase in the volume of credits should be monitored.**
  - ➢ *Ongoing increase especially in housing credits.*
  - ➢ *Excess liquidity in the markets signals continuity in credit expansion.*
- ✓ **External developments;**
  - ➢ *International liquidity conditions.*
  - ➢ *Energy and raw material prices.*

Expectations;

- ✓ **For the year-end inflation, are below the target;**
- ✓ **For the next 12 months, are converging to the target.**

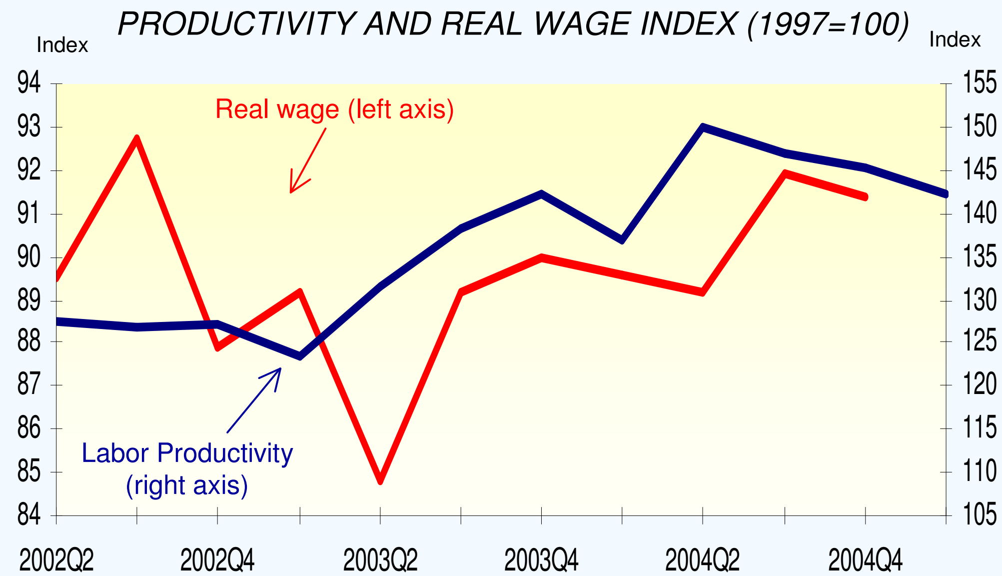
Long-term inflation expectations are becoming more important for 2006 and afterwards.

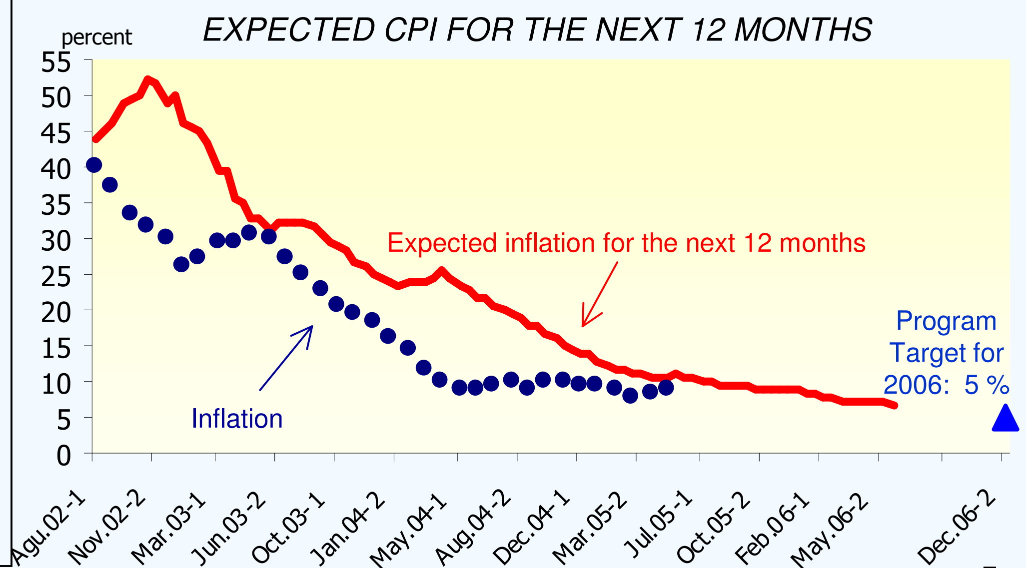
No difficulty attaining the 2005 target;

Policies now concentrate on the 2006 target.

Cautiously optimistic

PPI





Source: CBT

Inflation

PPI; January - May 2005:

First 5 months cumulative: 2.38 %;
Annual: 5.59 %

✓ **Despite high increase in May, annual agricultural prices inflation is negative: -1.23 %.**

- *Volatility in agriculture prices decreased due to the calculation method in the new index*.*

✓ **Industrial sector prices;**

First five months: 2.40 %

Annual: 7.67 %

- *The developments in oil, raw material and energy prices in the world are the main determinants in industrial sector prices.*
- ***On the other hand,** relative stability in the foreign exchange rates constrains upward pressure on PPI.*
- *First five months' increase in wearing apparel and dressing of leather prices may indicate a cost pressure on clothing prices in CPI.*

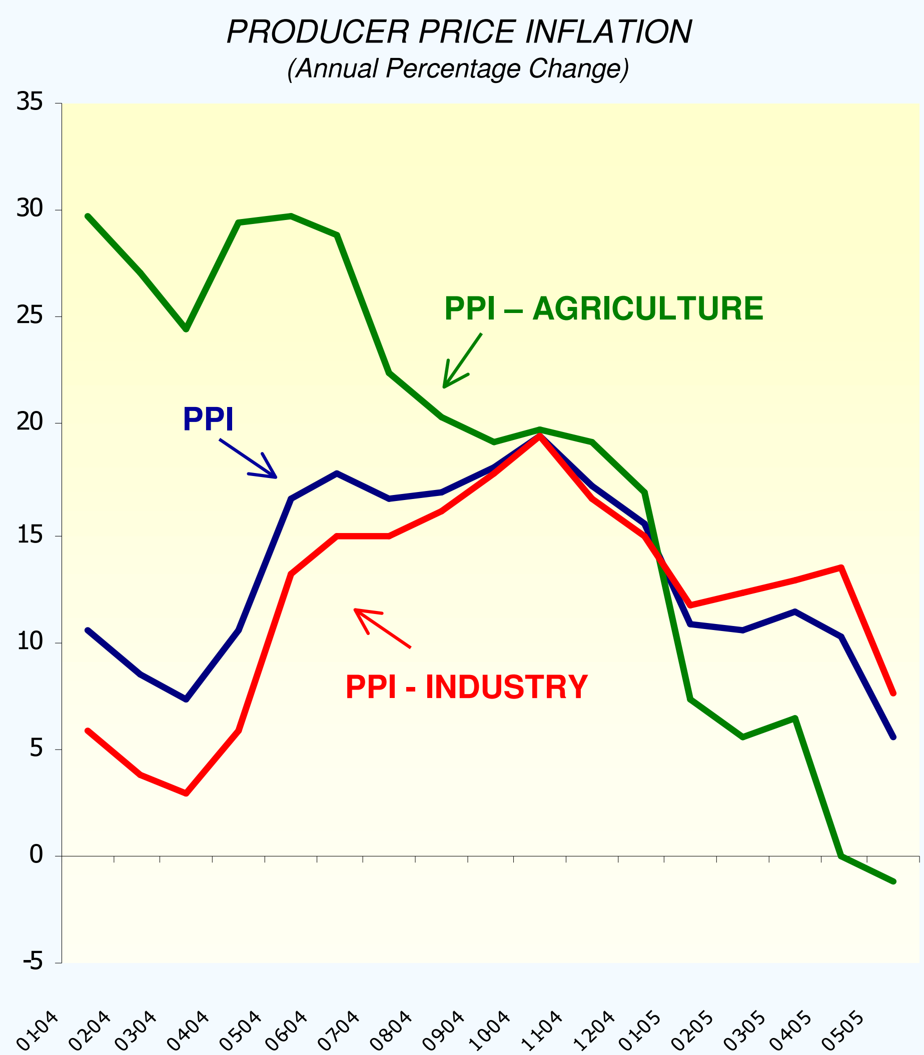
✓ **The effects of PPI on CPI is limited because of:**

- *Domestic demand being under control,*
- *PPI's new calculation method which excludes tax.*

✓ PPI is more sensitive to exchange rates and raw material prices ⇨ Volatility in PPI is possible.

PPI is not a target.

*It is calculated by geometric mean.



Source: SIS

Growth ⇨

Growth

Robust Output Growth:

As inflation falls, the Turkish economy has been experiencing high growth rates since 2002.

	2002	2003	2004
Growth Figures	7.9 %	5.9 %	9.9 %

– Growth in 2002-2004: **25.5 %** in real terms

– **Growth in 2004: 9.9 %**; one of the highest growth rates in the world

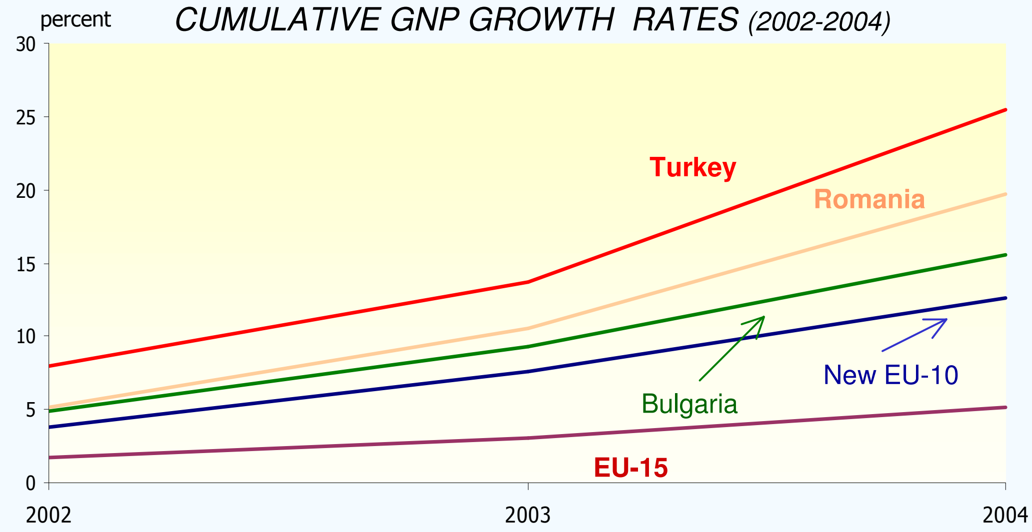
✓ ***In the first half***, *durable goods consumption increased considerably; led by pent- up demand.*

✓ ***Second half;*** *relative slowdown;*

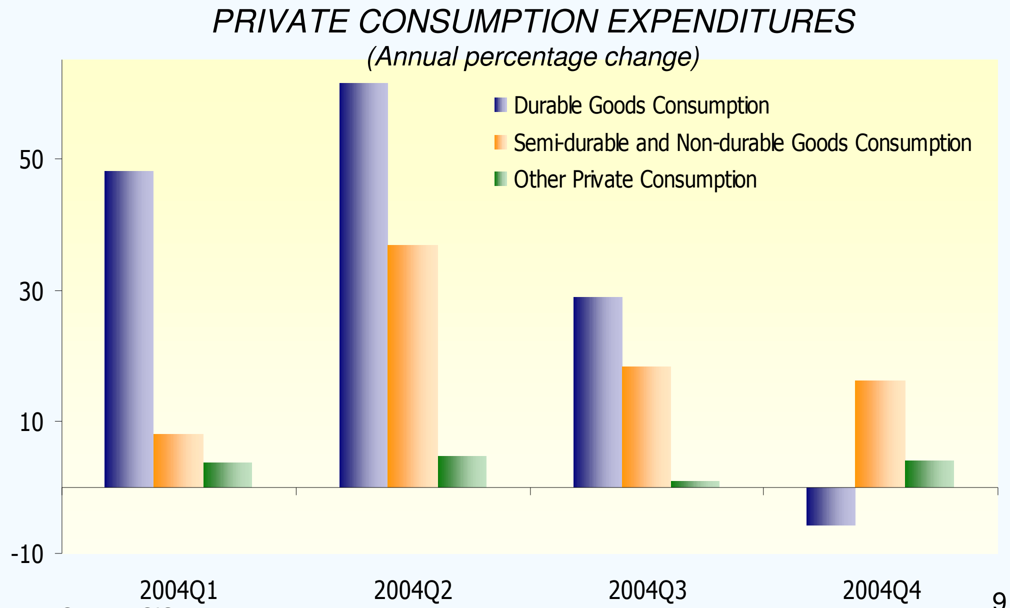
➢ *Q4; seasonally adjusted private consumption and total domestic demand decreased.*

❖ *Durable goods consumption declined substantially.*

❖ *Semi-durable and non-durable goods consumption relatively increased.*



Source: World Economic Outlook and National Statistics Offices



Source: SIS

Growth - Outlook

Robust Output Growth:

In 2005;

- Increase in domestic demand slower compared to the first half of the last year.

- Buoyant industrial production

- Investment expenditures continue to increase.

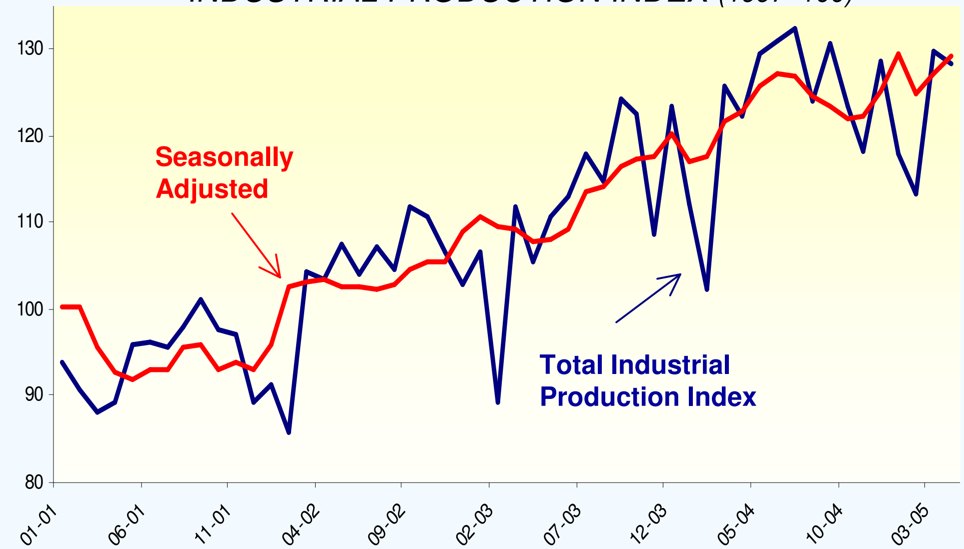
- Exports continue to increase.

- Growth expectations are above the forecast of 5 %.

- Consumer confidence indices and other demand indicators show rise in economic activity as well.

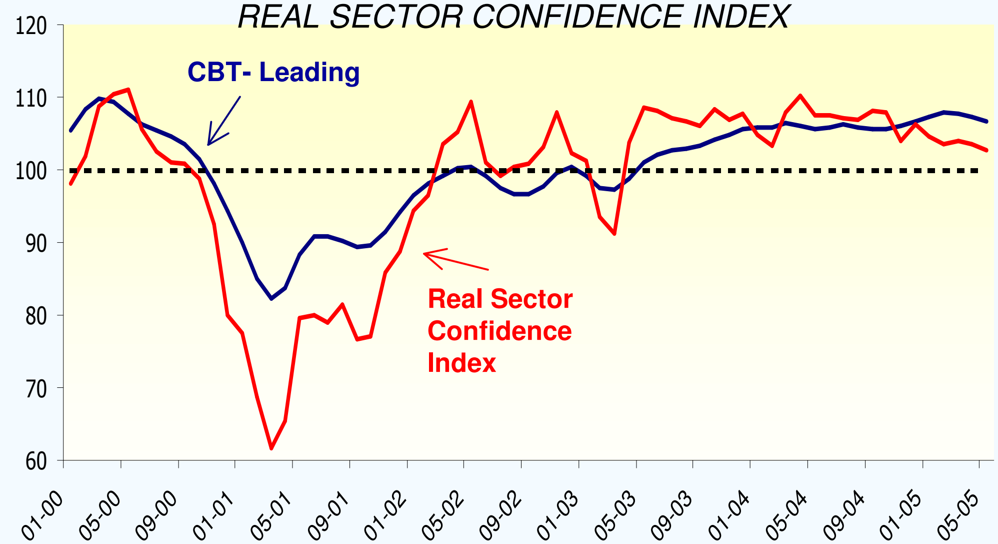
Changing Dynamics

INDUSTRIAL PRODUCTION INDEX (1997=100)



Source: SIS, CBT

CBT-COMPOSITE LEADING INDICATOR (Cycles) AND REAL SECTOR CONFIDENCE INDEX



Source: CBT
Above 100 indicates increase in confidence

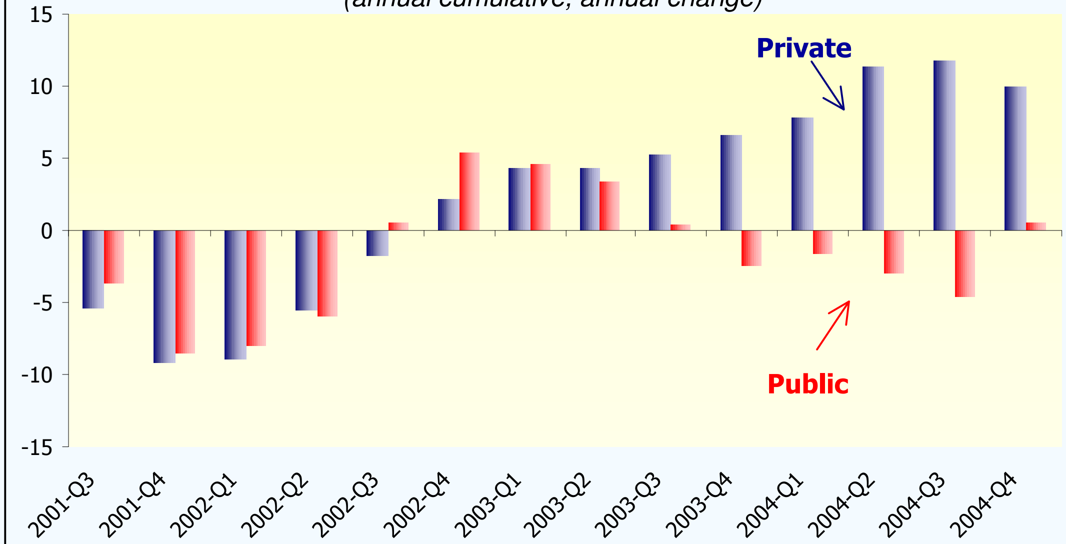
Changing Dynamics

Changing Dynamics of Growth:

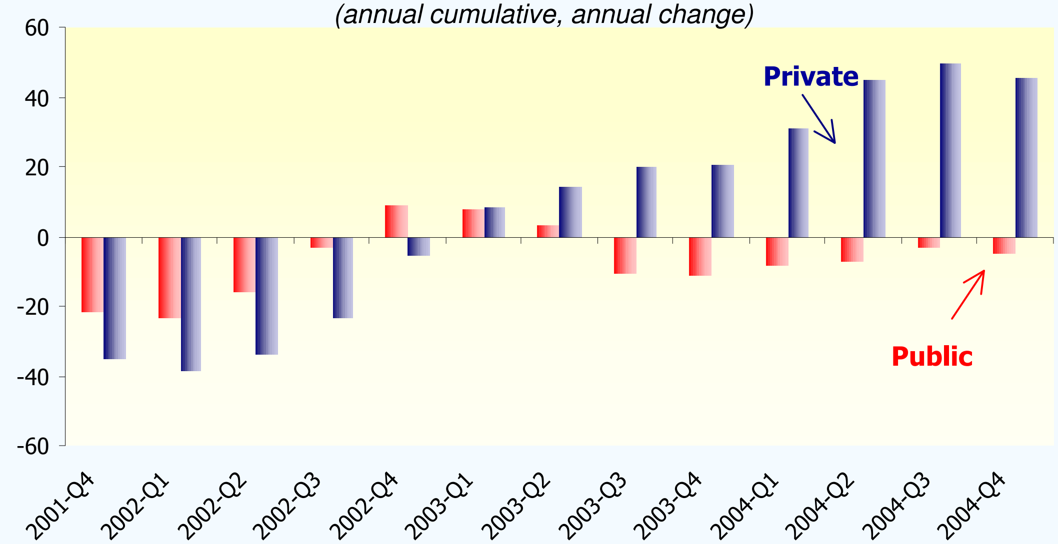
– Sources of high growth rates:

✓ *The private sector is the engine.*

CONSUMPTION EXPENDITURES
(annual cumulative, annual change)



INVESTMENT EXPENDITURES
(annual cumulative, annual change)



Source: SIS

Changing Dynamics

Changing Dynamics of Growth:

– Sources of high growth rates:

- ✓ *The private sector is the engine.*
- ✓ *The highest contribution to growth came from the productivity increase.* ⇒
- ✓ *Exports contributed to growth with an increasing share.* ⇒

- These changing dynamics indicate a considerable economic growth potential.

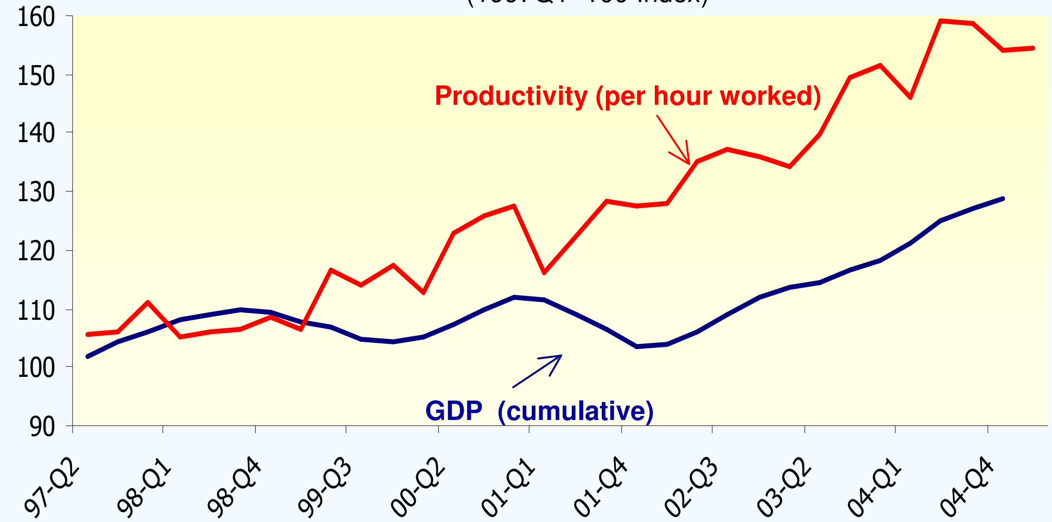
- In 2005 and onwards, the Turkish economy is expected to grow at least 5 %.

	2005	2006	2007
Growth Estimates	5 %	5 %	5 %

- Long-run sustainable growth rate?

GROWTH AND LABOR PRODUCTIVITY

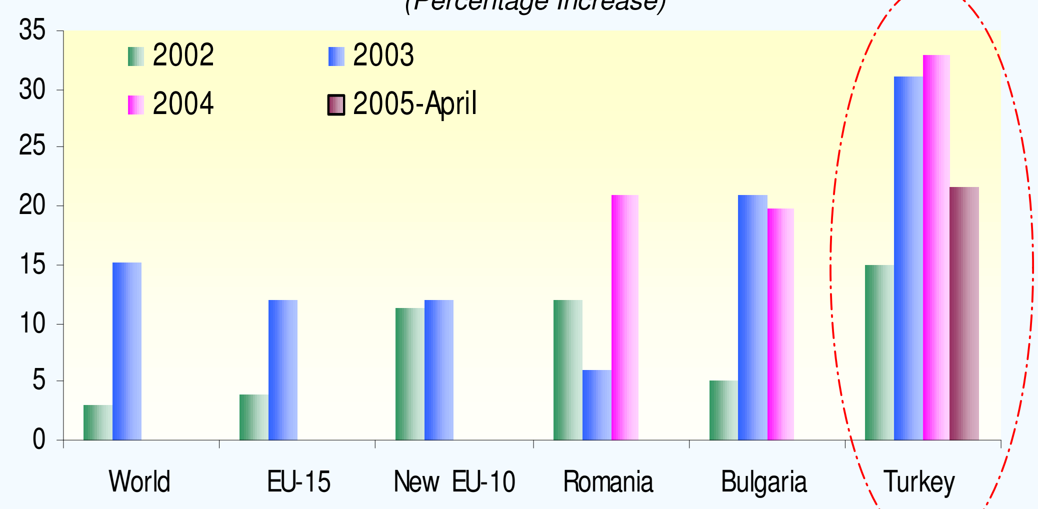
(1997Q1=100 Index)



Source: SIS

EXPORTS' GROWTH RATES

(Percentage Increase)



Source: WB; SIS

Integration with World and Foreign Trade ⇒

Changing Dynamics

The Turkish economy is now more integrated with the world economy, giving rise to a more competitive environment in the real sector:

– Since 2001, Turkey's total foreign trade volume has increased by 120 % and reached USD 160 bio in 2004.

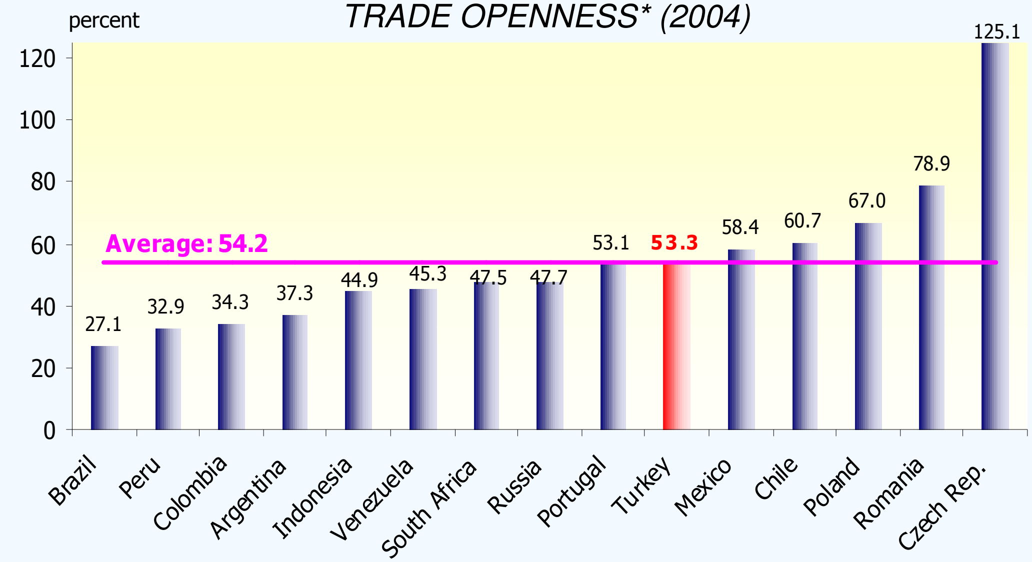
✓ *The total volume of foreign trade is expected to be USD 180 bio in 2005.*

– **Imports** of intermediate and capital goods have the largest share in total imports.

✓ *Imports are directed to production and exports.*

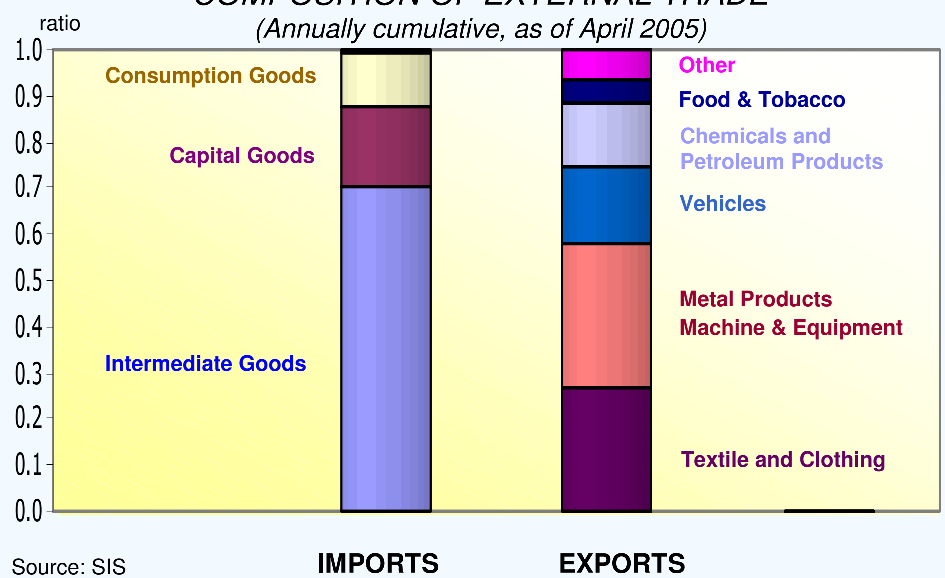
– **Exports** are well diversified and are made up mainly of finished and semi-finished industrial goods.

TRADE OPENNESS (2004)*



* Trade openness: The share of the sum of exports and imports in the GDP
Source: IMF, WTO

COMPOSITION OF EXTERNAL TRADE
(Annually cumulative, as of April 2005)



Source: SIS

Employment ⇨

Changing Dynamics

Employment:

- Turkey's employment **performance is better than most of the new EU members and candidates.**

- However, it doesn't totally reflect the high growth rates, because;

  ✓ ***Jobless recovery:*** *Productivity driven growth*

  ✓ *The **public sector** is **no longer** creating new jobs.*

  ✓ *And there are **structural difficulties:***

    ➢ *Demographic transition period: Increase in the share of working age group in whole population.*

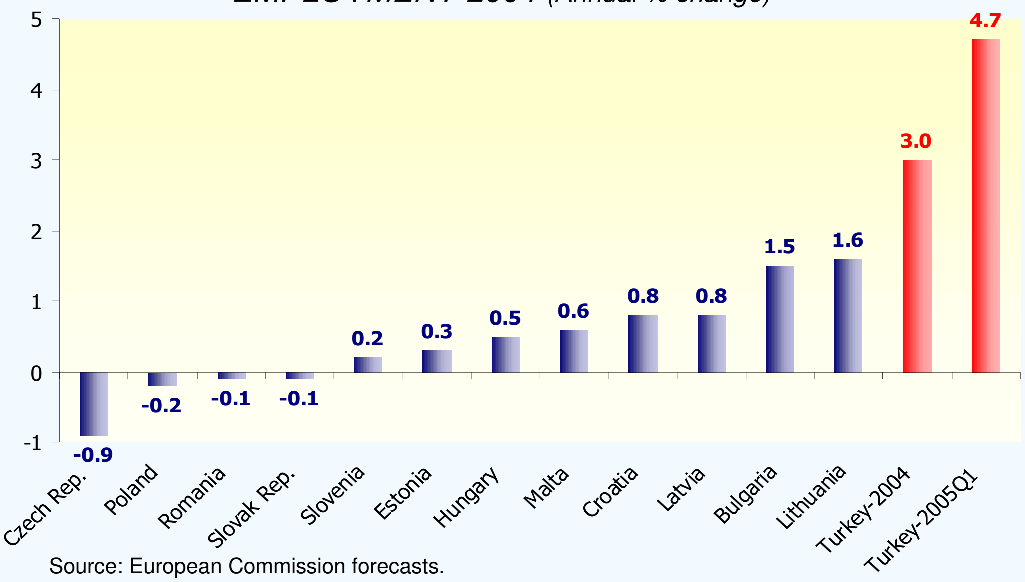
    ➢ *Lower participation rates, especially for women.*

    ➢ *Sectoral composition is changing: Transition from agricultural sector to industrial and services sectors.*

- Turkey's young and dynamic demographic figure supports **easier transfer between sectors** and improvement in sectoral dispersion of employment.

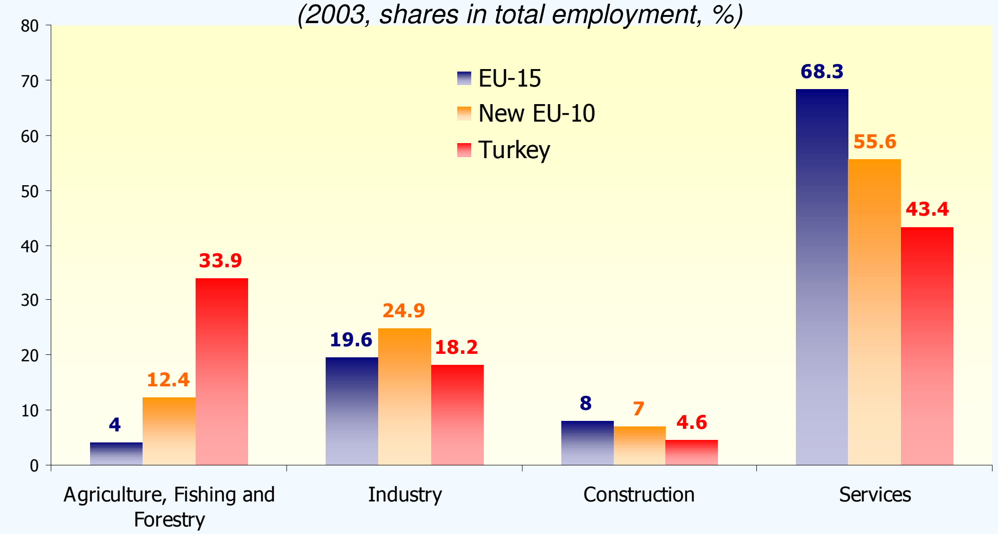
- Labor market oriented regulations intended to **reduce the size of unregistered economy**, **educational policies** and **FDI inflows** will contribute to the achievement of **sustainable increase in employment.**

EMPLOYMENT-2004 (Annual % change)



Source: European Commission forecasts.

SECTORAL EMPLOYMENT STRUCTURE
(2003, shares in total employment, %)



Source: Eurostat, Employment in Europe 2004, SIS

Current Account

Changing Dynamics

Current Account:

2004;

	Estimate	Realization
Growth	5 %	9.9 %
Current Account / GNP	Btw. – 3 % and –3.5 %	- 5.1 %

The deficit is sustainable, because:

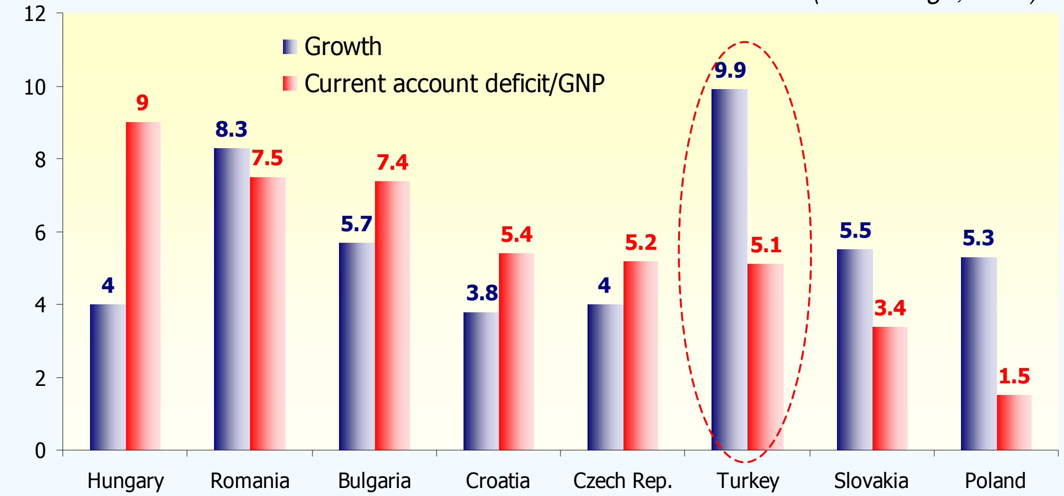
1- The driving forces of the current account have changed significantly:

*- **Before 2001,** because of loose fiscal policy and rising budget deficit, total domestic savings and investment were on a downward path;*

*- **But today**, both domestic savings and investment are increasing mainly due to tight fiscal policy, better macro indicators and good market sentiment; the cause of the current account deficit today is larger increase in investment than in savings.*

Continue

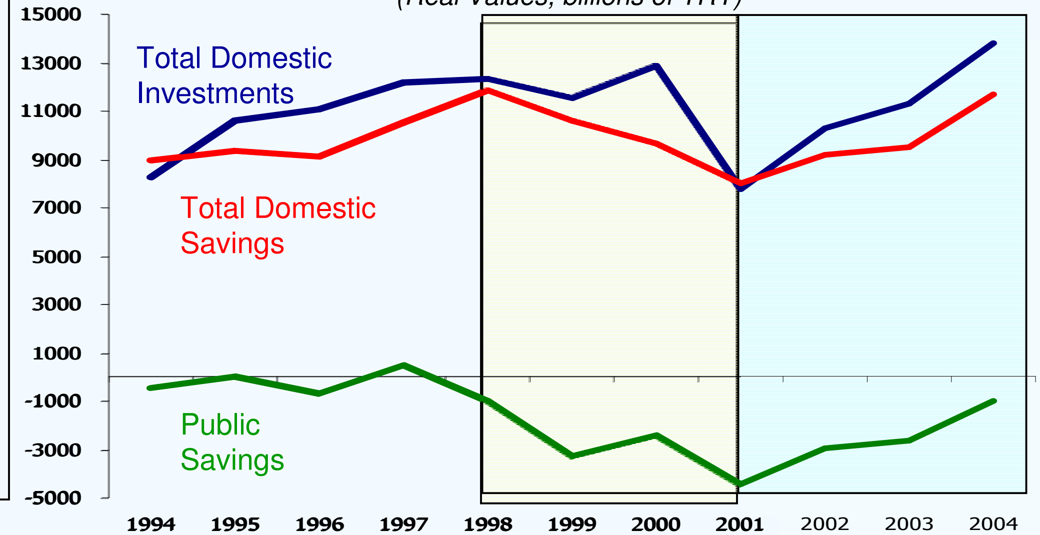
GROWTH AND CURRENT ACCOUNT DEFICIT (Percentage, 2004)



Source: IMF

TOTAL DOMESTIC INVESTMENT AND TOTAL DOMESTIC SAVINGS

(Real Values, billions of TRY)



Source: SIS, CBT

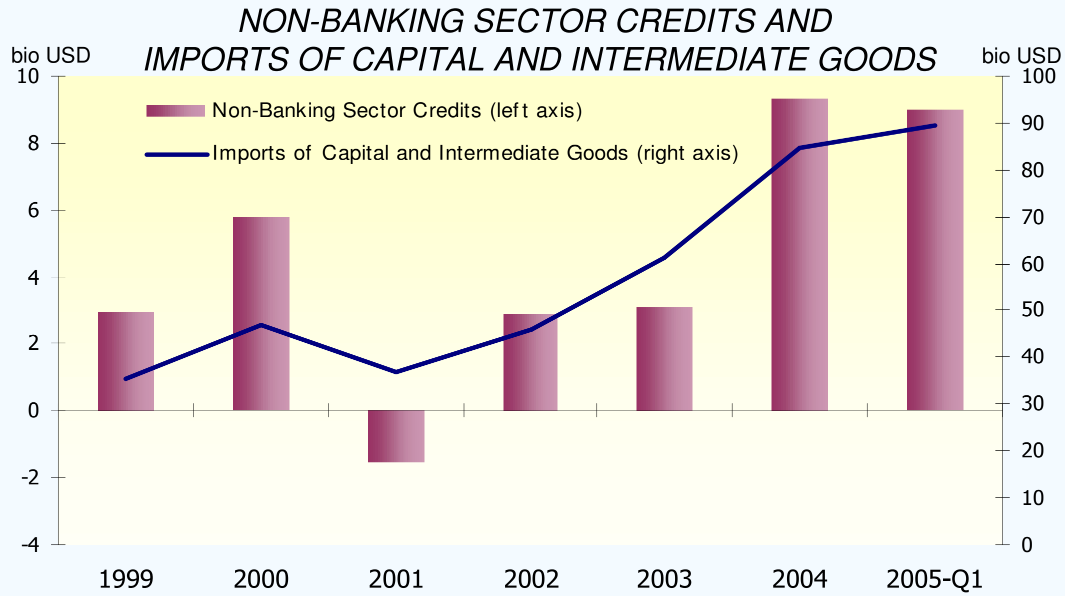
Changing Dynamics

2- Composition of the capital account is changing:

- In 2005 Q1, *except the IMF credit and the changes in reserves, USD 22.2 billion of net capital inflows.*

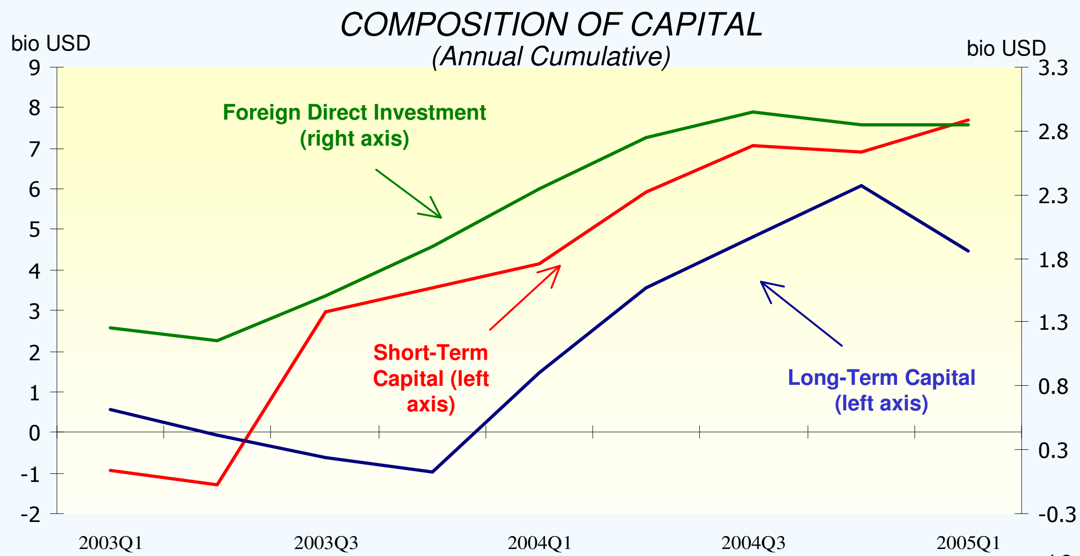
- *The main factor is the substantial increase in* ***credit utilization of the non-banking sector****; 34 % of total inflows.*
- *The share of* ***long-term capital****** *has been rising.*
- ***Foreign direct investment*** *finally begins to increase, and it is expected to increase further.*
- ***Short-term capital***** *inflows increased mainly because of the short-term banking sector credits. As the banking sector strengthens, the risk of short term capital inflows decreases.*

Continue



* 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, CBT

Changing Dynamics

3- The changing structure of the economy:

1- Floating exchange rate regime

- *Shock-absorbing characteristic.*

2- Stronger banking system

- *The system has less open positions.*

***3-** New **Turkish Lira is not kept overvalued** artificially.*

- *CBT has purchased approximately USD 25 billion since 2002.*

4- Short-term capital inflows are not encouraged.

- *Exchange rate risk is on the market.*

5- Record high level of foreign exchange reserves

6- Tight monetary and fiscal policies in force

7- Lower inflation environment

– With stable growth in the Turkish economy, the current account deficit to GNP ratio is also expected to decrease.

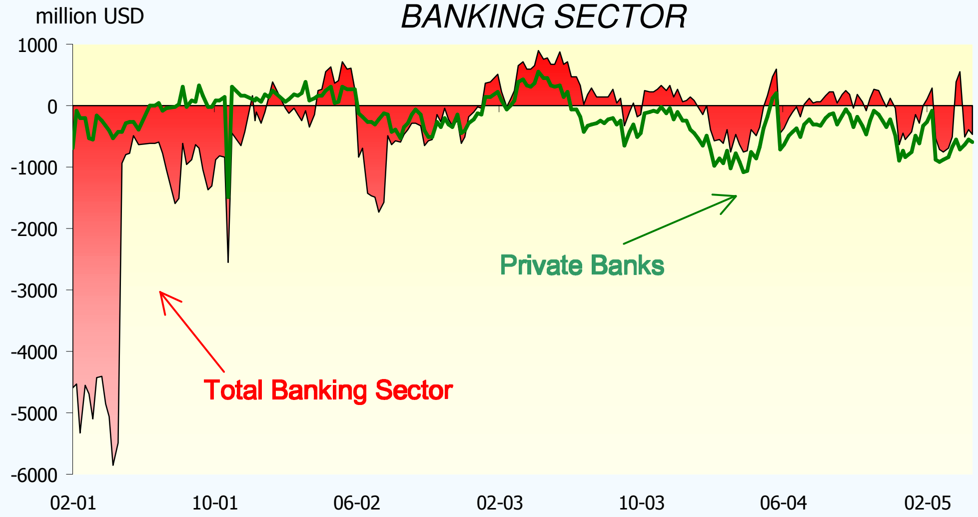
Current Account/GNP forecasts*:

2005	-4.5 %
2006	-3.0 %
2007	-3.0 %

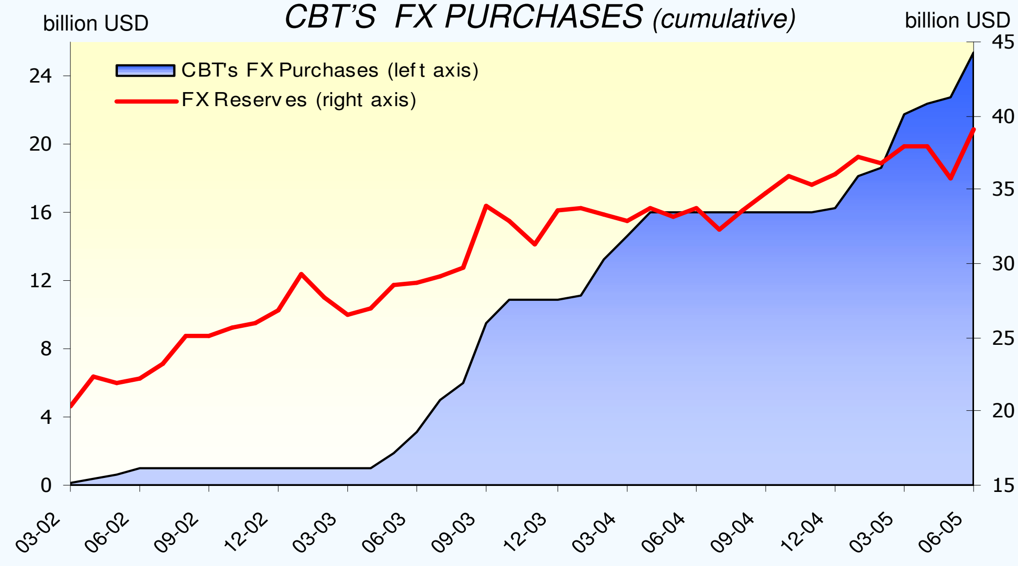
* Letter of Intent

Public Finances

FOREIGN CURRENCY NET POSITION OF THE BANKING SECTOR



FX RESERVES (Excl. Gold) and CBT'S FX PURCHASES (cumulative)



Source: CBT

Changing Dynamics

Public Finances:

In the last four years, disciplined and prudential fiscal policy was put into practice.

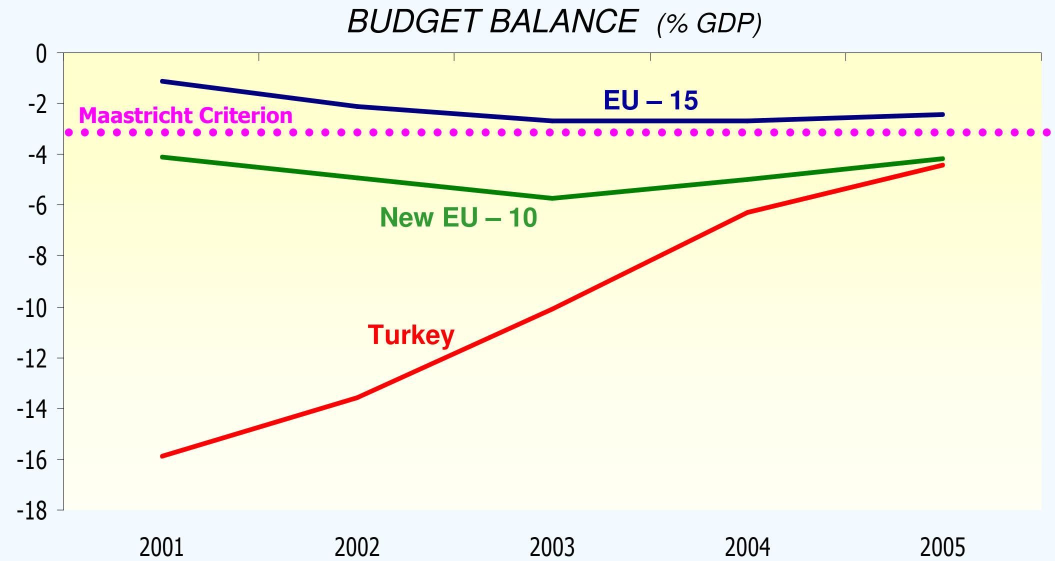
– Very high levels of primary surplus were attained to decrease the public debt stock.

✓ *The target of 6.5 % is to be continued in the next three years.*

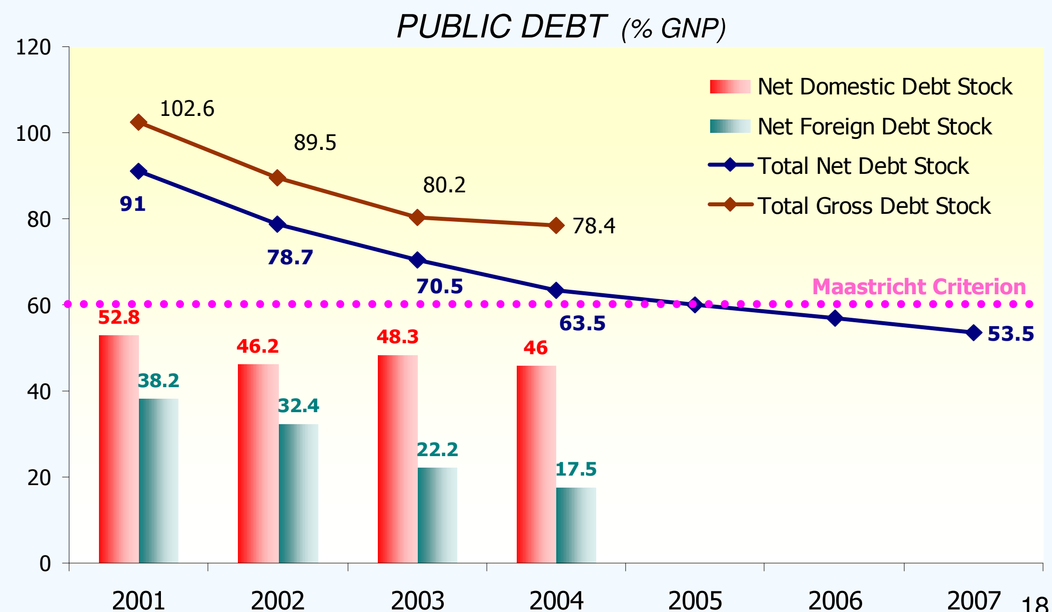
– Consolidated budget deficit decreased considerably to levels close to the Maastricht criterion.

✓ *The debt stock of the public sector is on a downward path converging toward the Maastricht criterion.*

– Continued tight fiscal policy will also keep the current account deficit under control, decrease fiscal dominance in the financial markets, and hence generate resources needed for investment and growth.



Source: European Commission, Pre-Accession Economic Program 2004



Source: Treasury, Letter of Intent

External Debt

Changing Dynamics

External Debt:

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 even 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 % of medium and long term debt ⇨ the private sector

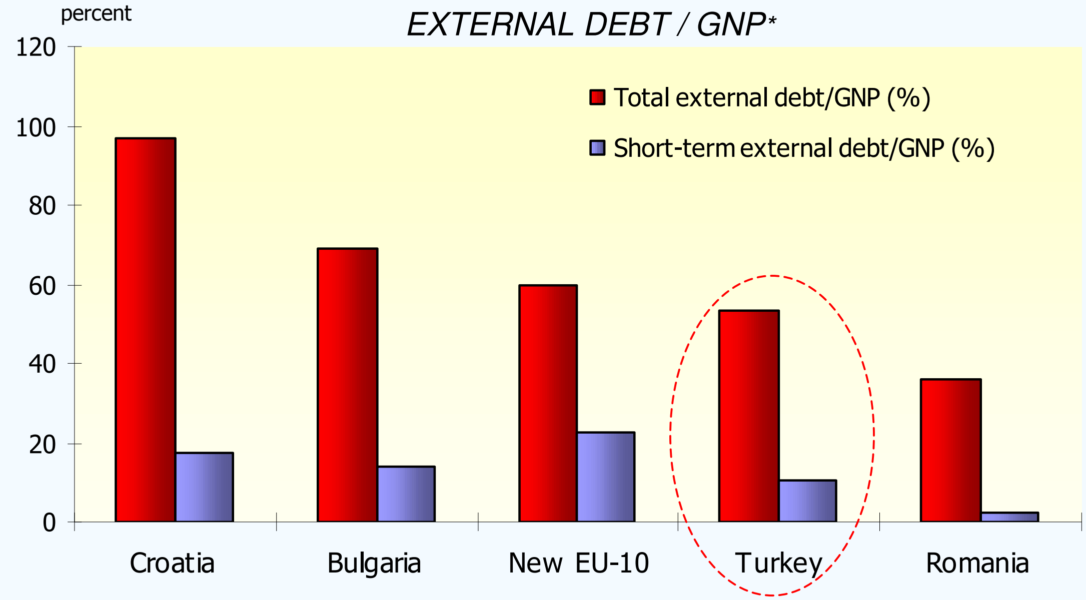
✓ *44 % of public sector's debt is owed to international institutions such as the IMF and the World Bank.*

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

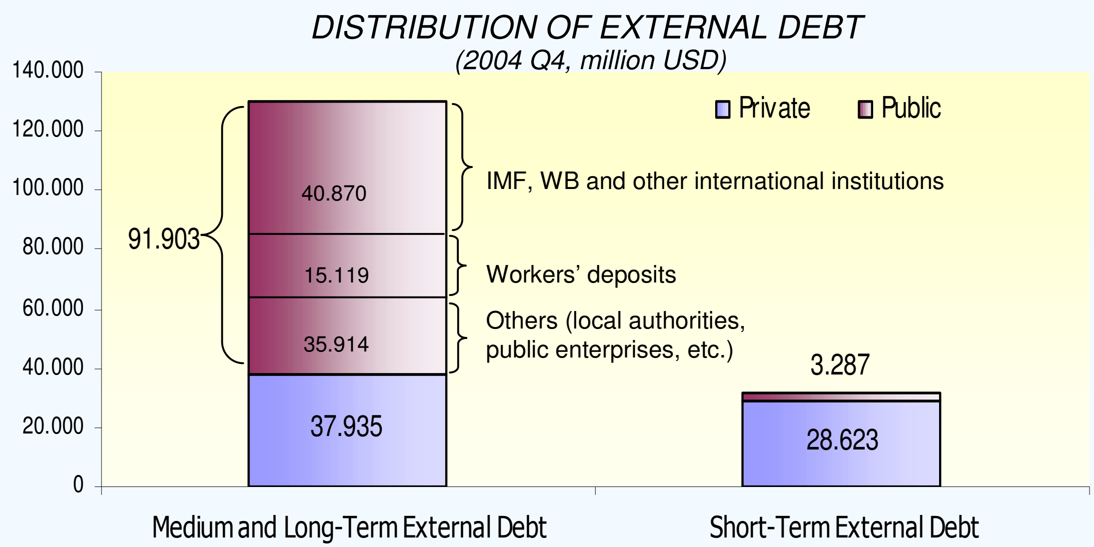
✓ *And, 17 % of the private sector's debt is workers' deposits kept at the CBT.*

The structure of external debt stock is **not fragile.**

Monetary Policy ⇨



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



Source: CBT

ON THE CONDUCT OF MONETARY POLICY AND FINANCIAL MARKETS

On The Conduct Of Monetary Policy

General Framework of Monetary Policy

Inflation target

set by the Government and the CBT

Basic policy tool:

Short term interest rates

Based on inflation outlook only

Comprehensive information set to foresee the future course of inflation

Committed to the **floating exchange rate regime**

– No exchange rate commitment, no target.

– Exchange rate is not a policy tool.

Central Bank interventions:

To dampen excess volatility

To build up foreign exchange reserves

Within the framework of price stability, the CBT **safeguards financial stability,** as well.

On The Conduct Of Monetary Policy

From implicit to full-fledged inflation targeting

After 2001 Crisis:

✓ **Exchange rate as nominal anchor**

⇨ No credibility

✓ **Monetary targeting**

⇨ Not effective in high inflation environment

Therefore;

✓ **Inflation targeting**

⇨ Preconditions not fulfilled yet:
- Fiscal dominance
- Banking sector not strong enough
- Necessity for more credibility
- Monetary policy not effective enough

2002 - 2005

Implicit inflation targeting

2005:

Transition from implicit IT to full-fledged IT

✓ Enhancing the decision making process and institutional commitment

- Monetary Policy Committee (MPC) meetings are held on pre-set dates.

- Decisions regarding short-term interest rates are announced on the business day following the MPC meeting, including CBT's evaluations on inflation outlook follow within the next two days.

2006:

Full-fledged IT

✓ More transparent and institutionalized decision making process

- Interest rate decisions will be subject to vote in the MPC meetings.

- Summary of the MPC meetings will be published.

- Inflation forecasts will be published in quarterly Monetary Policy Report.

Financial Markets

Financial Sector Stability:

– The Central Bank **safeguards financial stability** as well, though it is not the supervisory authority.

– A considerable progress has been achieved toward financial stability:

- ✓ *Stronger macroeconomic fundamentals help it.*
  - ➢ *Increasing credit volumes.*

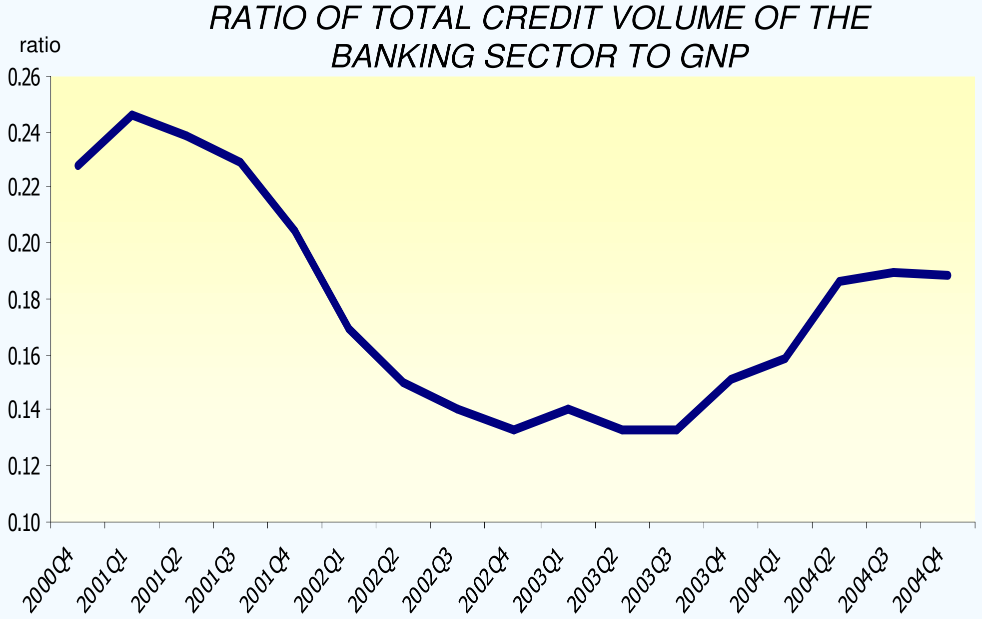
– *Very **important** and **comprehensive reforms** have been carried out in the sector:*

- ➢ *An independent body for monitoring and supervising – BRSA.*
- ➢ *Restructuring of public banks.*
- ➢ *Strengthening the capital structure of private banks.*
- ➢ *Practice of modern risk management principles: Basel II*

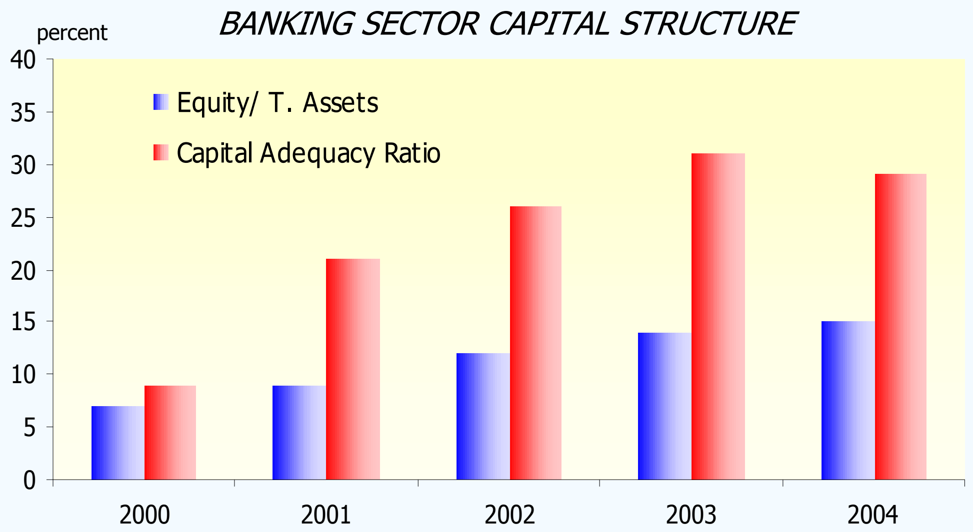
– In turbulent times, the CBT takes the necessary measures: *Iraqi War, 9/11 event.*

– Increasing foreign appetite for the sector.

Interest Rates



Source: CBT



Capital Adequacy Ratio: Equity Capital / Risk Weighted Total Assets

Source: BRSA

Financial Markets

Interest Rates:

– Parallel to achievements in stability, both **nominal** and **real interest rates** declined significantly in the last three years.

- ✓ *Nominal interest rates by **53 percentage points***
- ✓ *Real interest rates by **22 percentage points***

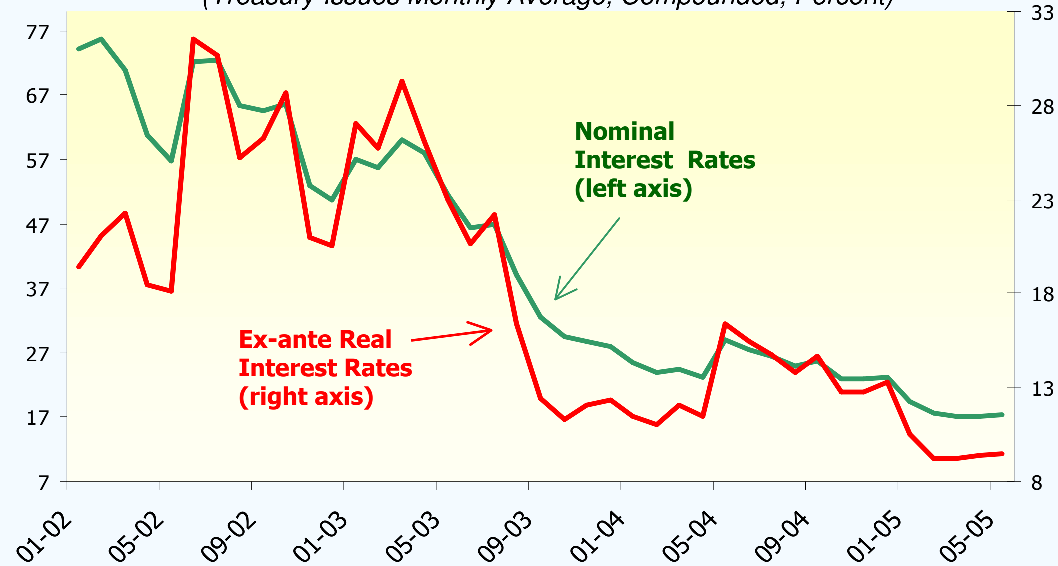
– A significant **increase** is observed **in average maturity** of the Treasury issues.

- ✓ *For the very first time, the Treasury is able to borrow at **five years** maturity in the domestic market.*
- ✓ *Thanks to longer maturity of the Treasury issues, **yield curve** is getting sound. The shape of the yield curve, especially the long edge of the curve, indicates **favorable expectations.***

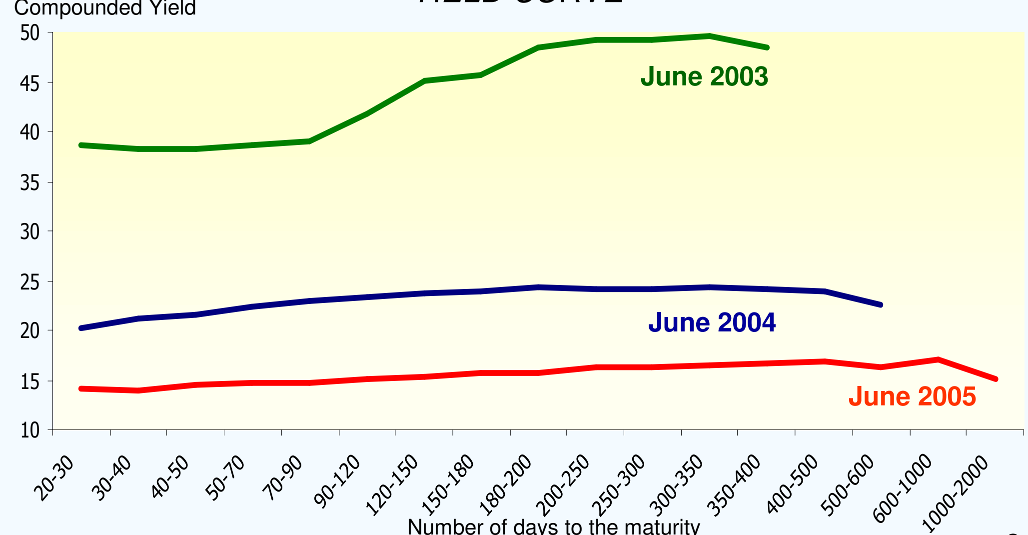
Eurobonds and Currency Reform

NOMINAL AND EX-ANTE REAL INTEREST RATES

(Treasury Issues Monthly Average, Compounded, Percent)



YIELD CURVE



Source: CBT

Financial Markets

– Turkish bonds performed better than emerging markets bond index.

– Turkish **Eurobond spreads** have **dropped** by average **500 basis points** since 2001.

Currency reform:

Six zeros were dropped from the currency as of January 1st, 2005.

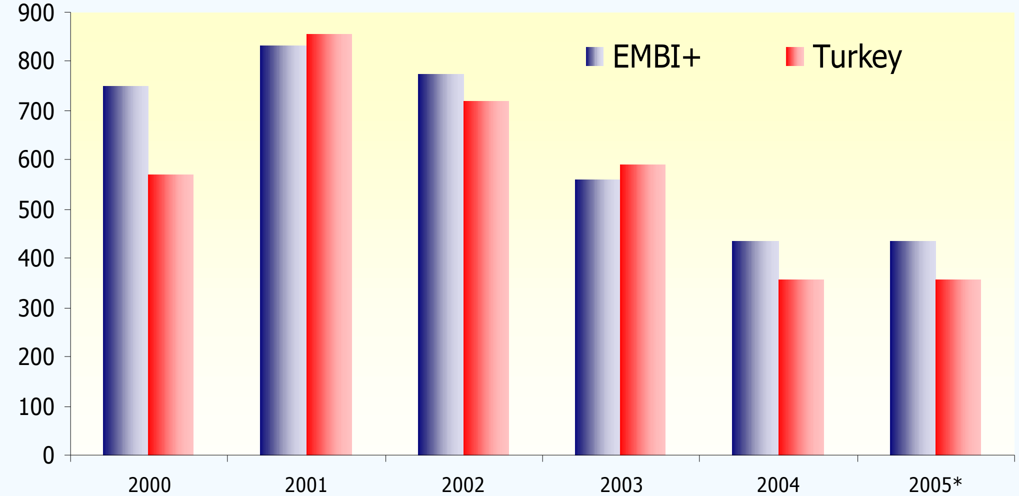
– Following the currency reform, favorable developments in markets have been observed.

✓ *Foreign banks started issuing* ***New Turkish Lira instruments*** *up to 10 years of maturity.*

✓ *The New Turkish Lira is now included in operations in international clearing systems.*

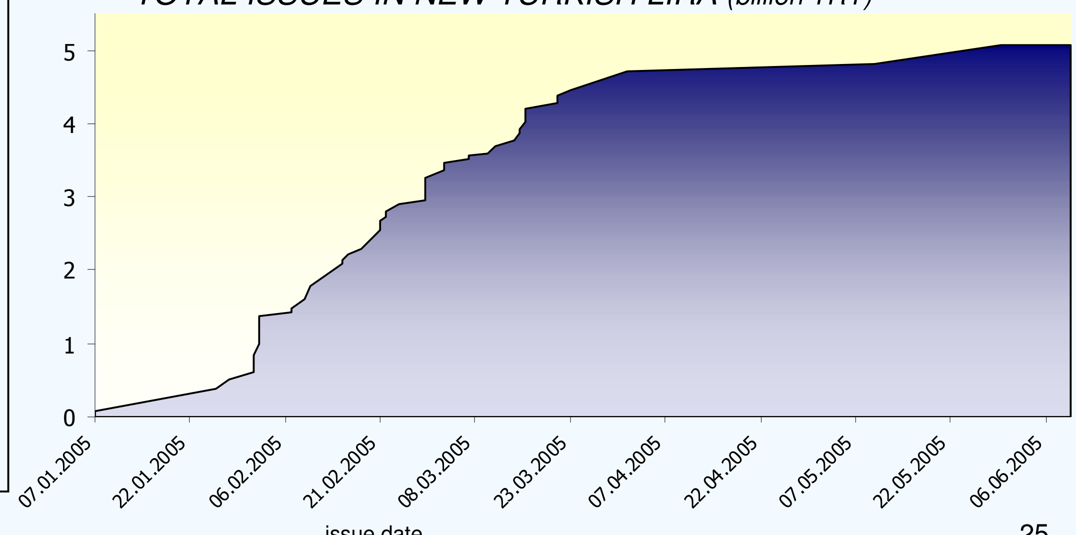
Floating Exchange Rates

*EUROBOND SPREADS**
(Average, basis point)



* As of June 15, 2005
Source: Bloomberg

TOTAL ISSUES IN NEW TURKISH LIRA (billion TRY)



Source: Bloomberg

Financial Markets

Exchange Rates:

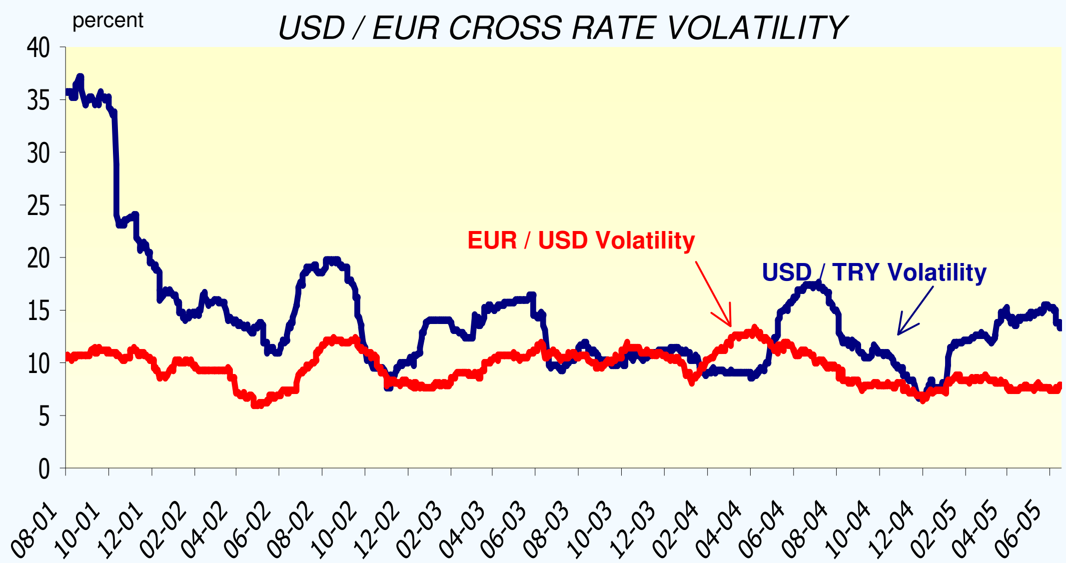
– With the help of transparent / consistent implementation of floating exchange rate regime;

✓ *The volatility in the exchange rates is gradually decreasing to the levels close to other floating currencies.*

✓ *The volume of foreign exchange transactions has increased and market has deepened significantly for 3 years now.*

Derivatives Market

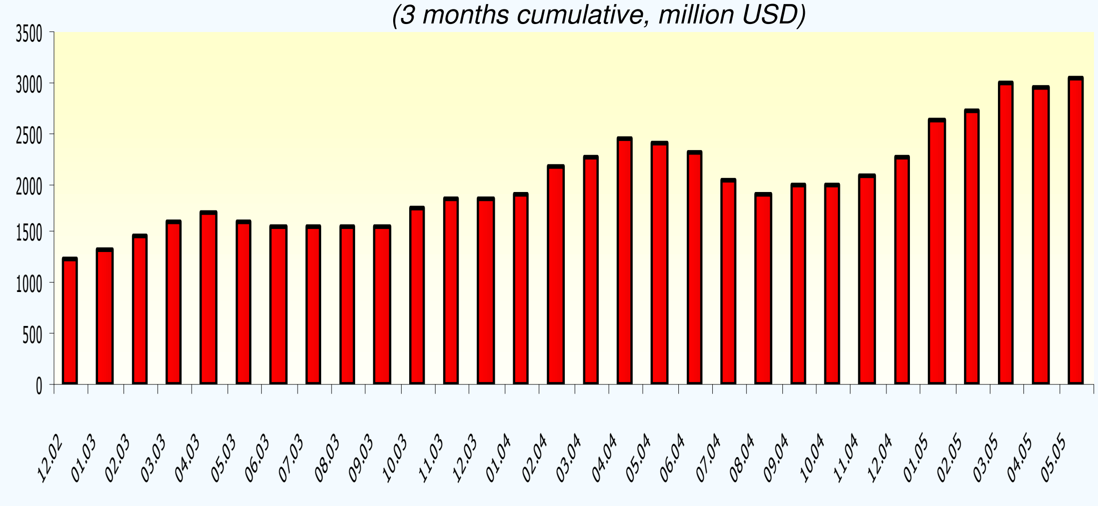
CBT INDICATIVE USD SELLING RATE VOLATILITY AND USD / EUR CROSS RATE VOLATILITY



Volatility: 60 day moving standard deviation of the annualized daily percentage change

TRANSACTION VOLUME OF FOREIGN EXCHANGE MARKET

(3 months cumulative, million USD)



Source: CBT

Financial Markets

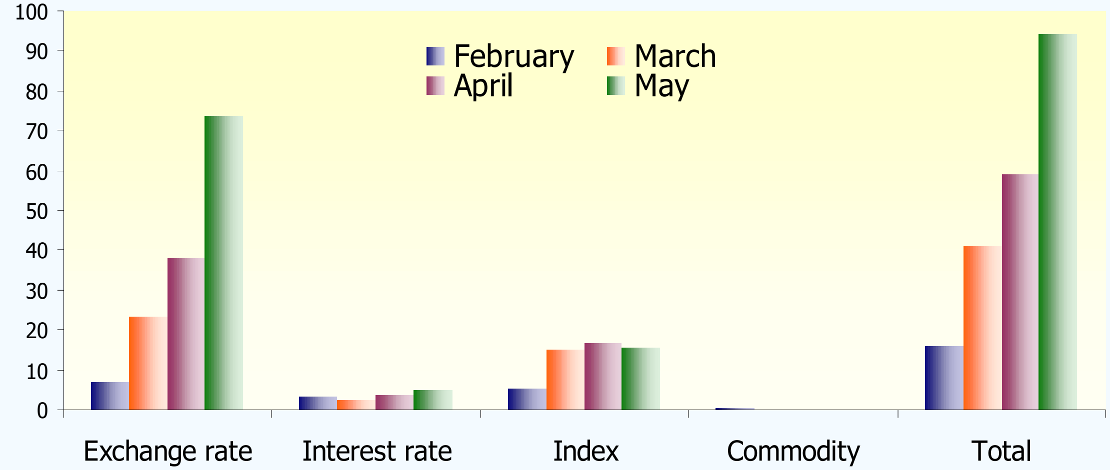
– Turkish Derivatives Exchange (Turkdex) was launched in February 2005. The volume of transactions has been increasing gradually.

✓ *It ensures to hedge risks resulting not only from exchange rate volatility but also from volatility of interest rates, stock market index and prices of some commodities.*

– The CBT gives utmost importance to development of these markets.

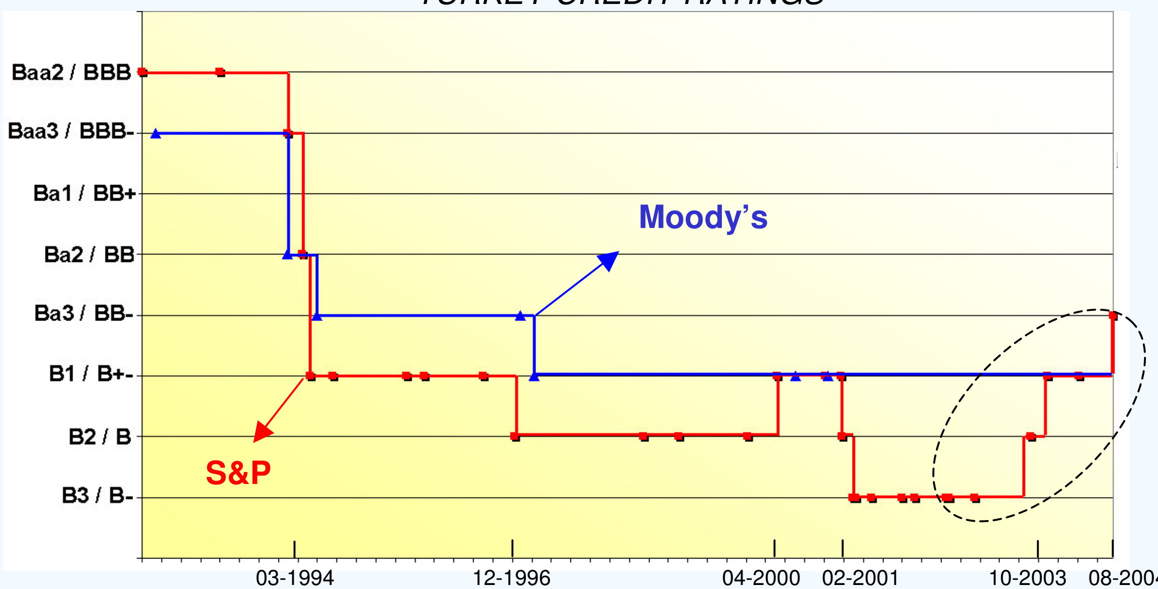
– With improvement in macroeconomic and financial stability and therefore better investment environment, Turkey's credit ratings from S&P have been gradually upgraded and Turkish ratings are expected to be upgraded further.

TRANSACTION VOLUME OF TURKISH DERIVATIVES EXCHANGE



Source: Turkdex

TURKEY CREDIT RATINGS



Source: Bloomberg

From Now On

FROM NOW ON...

Challenges Ahead

Medium - long term goals of economic policy:

– Preserve price / financial stability

– Continue with the reform process

– Reach high levels of sustainable growth

– Converge to the European Union economy

National Economic Program,

IMF agreement

will support the whole process.

What is on the agenda?

1- Banking Sector Reform

2- Tax Reform:

- *Broadening the tax base*
- *Unregistered Economy ⇨ Registered Economy*

3- Social Security Reform

4- Quality of Fiscal Adjustment

- *Public expenditure policy and management reform*
- *Redirecting resources to more growth-enhancing public investment*
- *Enhancing transparency of fiscal policy*

5- Civil Service Reform

6- Putting the Principles of **Good Governance** into Practice

- *State Economic Enterprise Governence*

7- Steps to improve **investment climate**:

- *FDI Investment Law (enacted)*
- *Law on the Protection of Intellectual and Industrial Property Rights (enacted)*

8- Economic Policy Coordination:

- *Development of streamlined decision making*

END

THE TURKISH ECONOMY

CENTRAL BANK OF TURKEY

June 2005