



# **CHANGING STRUCTURE OF THE TURKISH ECONOMY**

**April 2005**

**CENTRAL BANK OF THE REPUBLIC OF TURKEY**

# Turkish Economy

Since the crisis in 2001, economic policies have

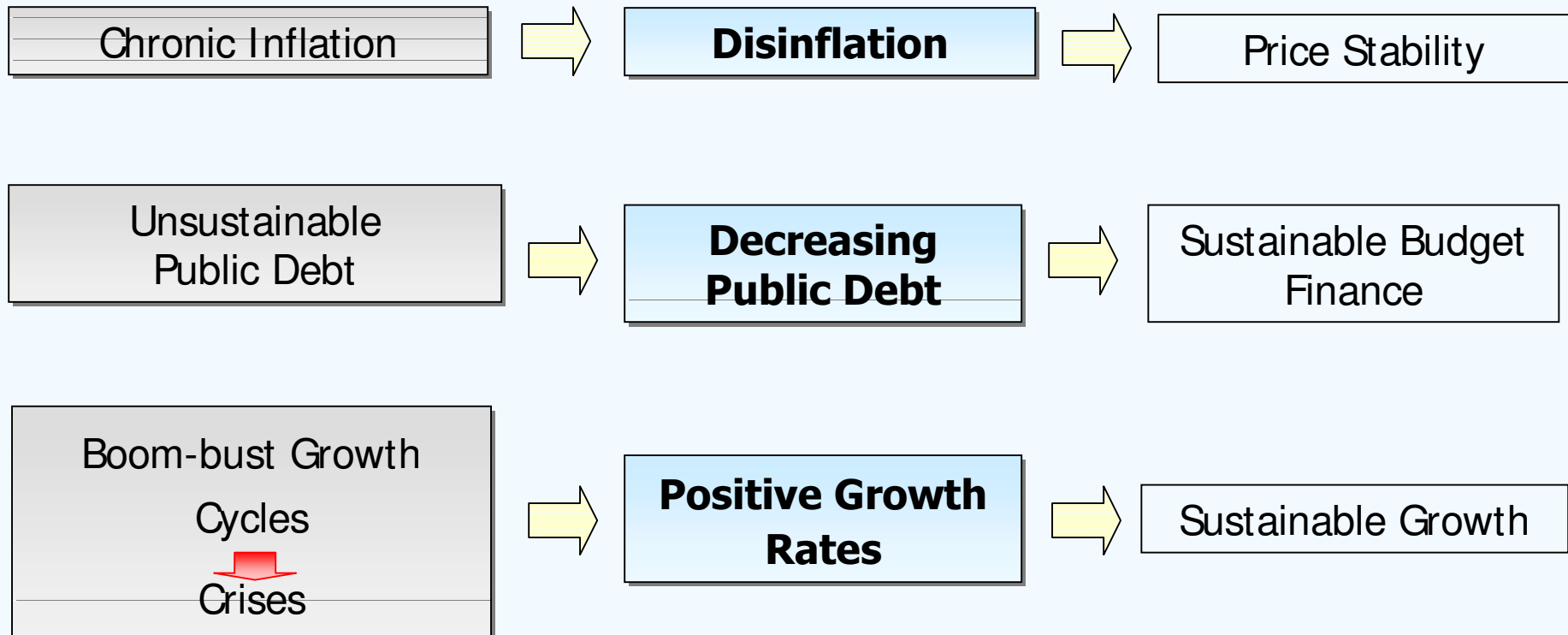
- brought macroeconomic stability;
- changed the dynamics of the economy:

**The Turkish economy is far from the weaknesses of the past.**

Past

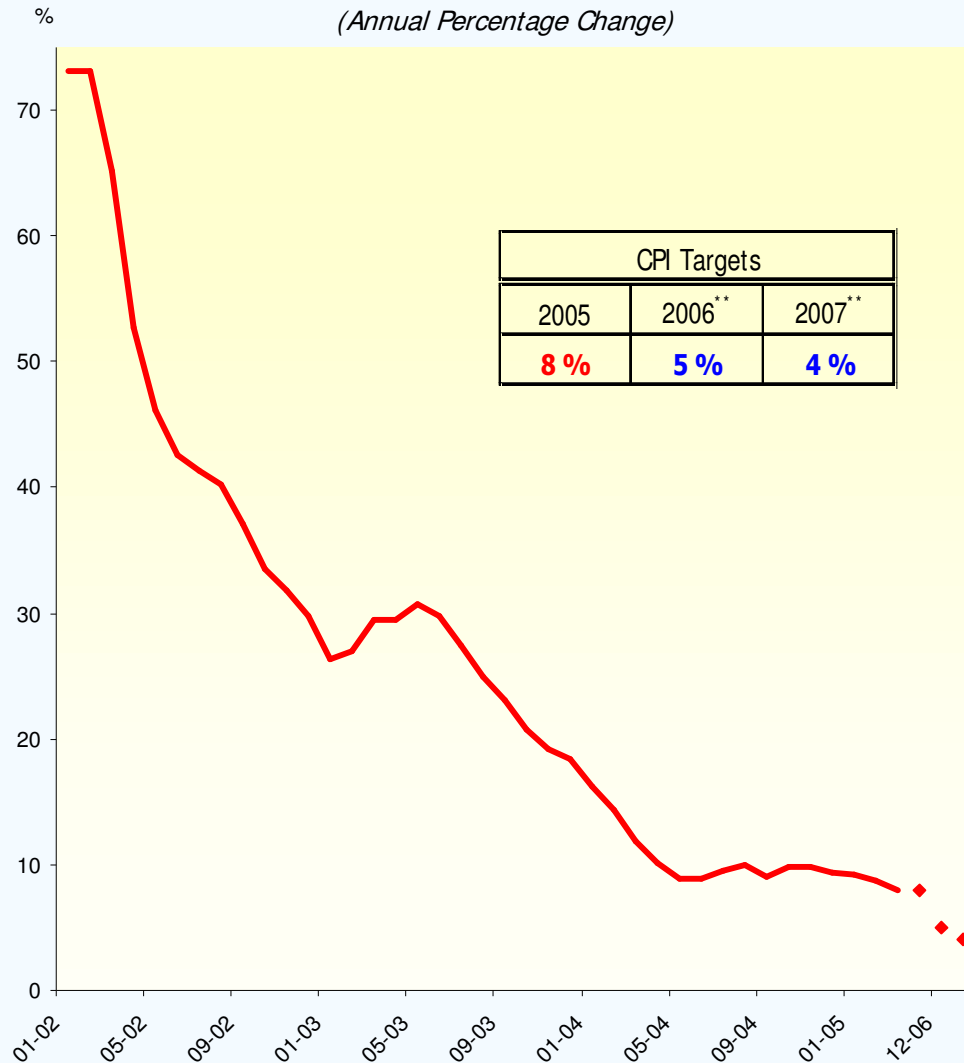
**Present: Towards  
Stability**

Future



# Inflation

*CONSUMER PRICE INFLATION\**  
(Annual Percentage Change)



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

**Significant progress has been achieved in the disinflation process.**

As of March 2005; lowest annual CPI figure for the last **35 years**

2002 January:

2005 March:

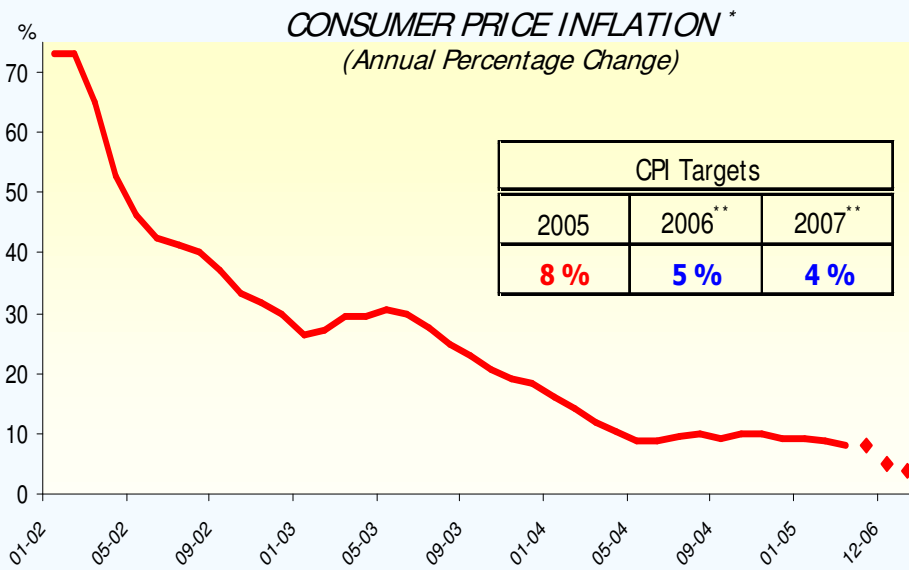
73.2 %



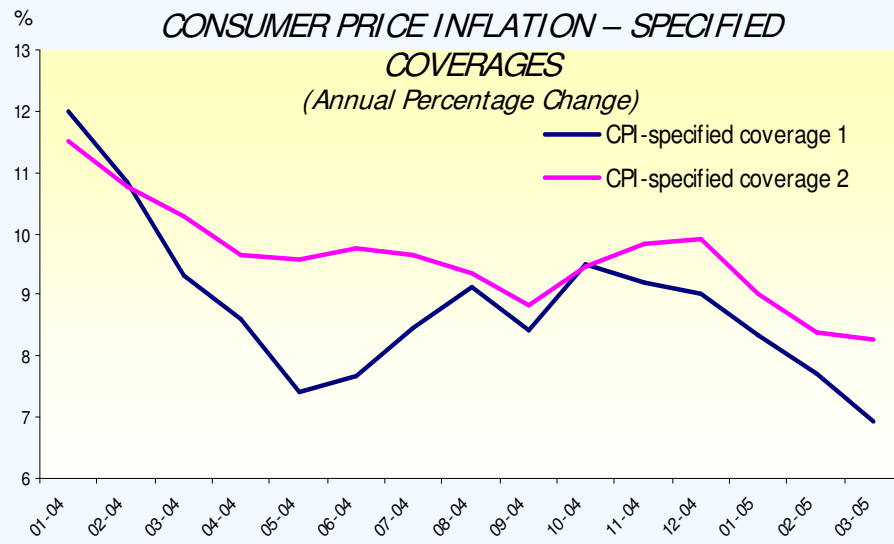
7.94 %

	2002	2003	2004	2005
<b>Target</b>	35 %	20 %	12 %	8 %
<b>Realization</b>	29.7 %	18.4 %	9.32 %	March 7.94 %

# Inflation



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



CPI-specified coverage 1 excludes: Energy, administered prices and indirect taxes  
CPI-specified coverage 2 excludes: 1 and unprocessed food products

Source: SIS

## **CPI; January – March 2005:**

**First 3 months cumulative: 0.83 %; historical low**

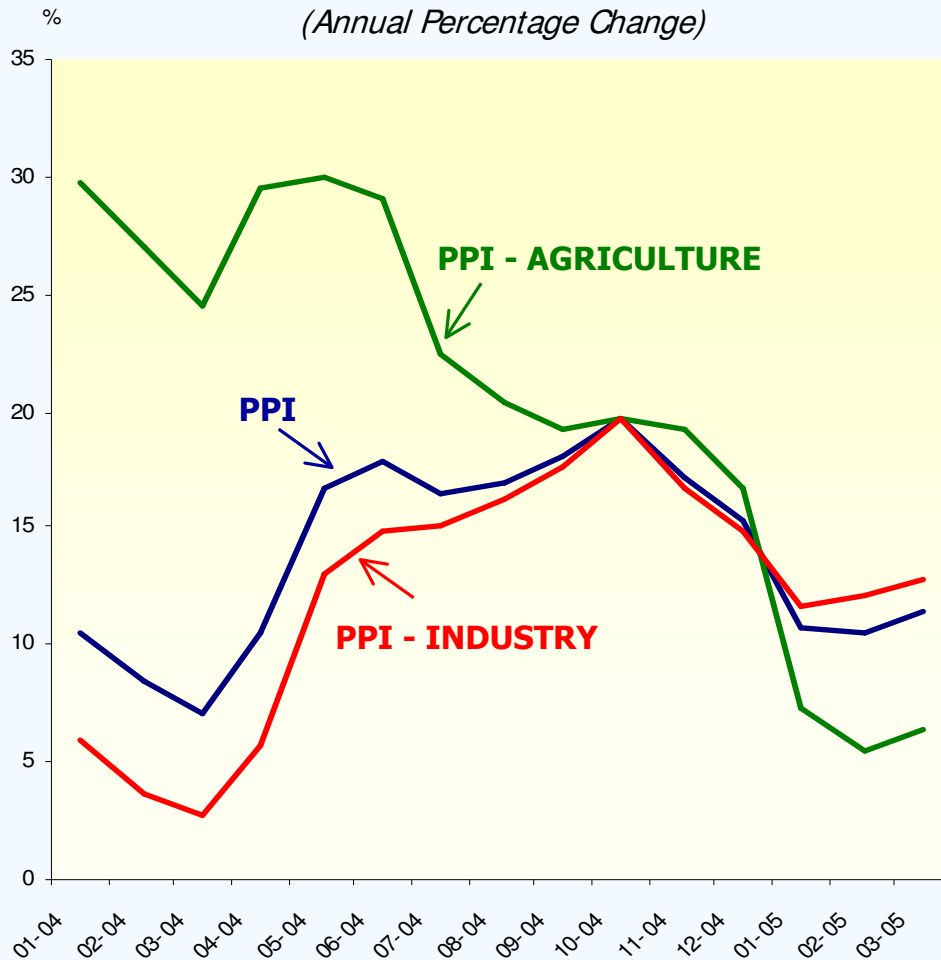
Annual: 7.94 %

- ✓ **Delayed effects of appreciation of TRY;**
  - Positive effects on durable goods prices.
- ✓ **Food and clothing prices;**
  - Lower than the CPI in last three months;
  - A slight increase expected in April due to seasonality.
- ✓ **Continued recovery in demand; under control**
  - Constrained the upward pressure on prices.
- ✓ **Supply-demand gap is not expected to close in the near future.**
- ✓ **High oil, natural gas and gasoline prices in the world;**
  - Housing / transport prices; above the CPI.
  - May have further effects in April.
- ✓ **Though diminishing, continuing price rigidities in the services sector;**
  - Above the CPI; hotel / restaurant prices.
- ✓ **The CPIs having specified coverages declined considerably.**
- ✓ **Figures in Q2 may be higher than Q1.**

***CPI shows a downward trend.***

# Inflation

*PRODUCER PRICE INFLATION  
(Annual Percentage Change)*



Source: SIS

\* It is calculated by geometric mean.

## PPI; January - March 2005:

**First 3 months cumulative: 0.96 %;**

Annual: 11.3 %

### ✓ **Industrial sector prices are driving PPI up.**

- High increase in manufacturing sector prices.
- The developments in oil prices exert pressure; expected to continue to have pressure as oil prices stay high in the world market.
- Increase in energy prices is limited, but; sensitivity of natural gas and electricity prices to oil prices should be taken into account.
- **On the other hand**, contrary to increase in the world market; basic metal prices declined in the domestic market thanks to appreciation of TRY.

### ✓ **Increase in agricultural prices were below PPI.**

- Volatility in agriculture prices decreased due to calculations in the new index\*.

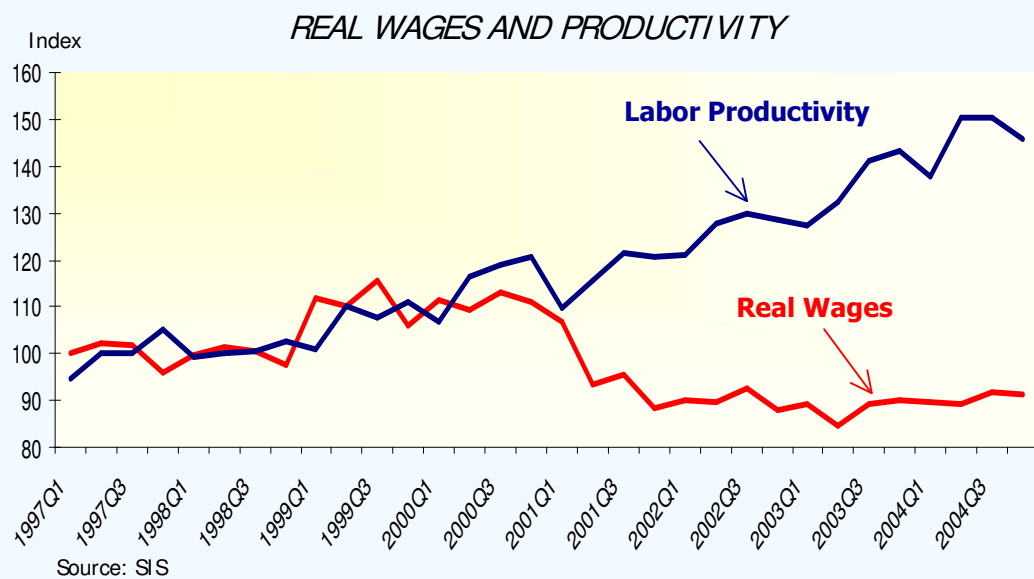
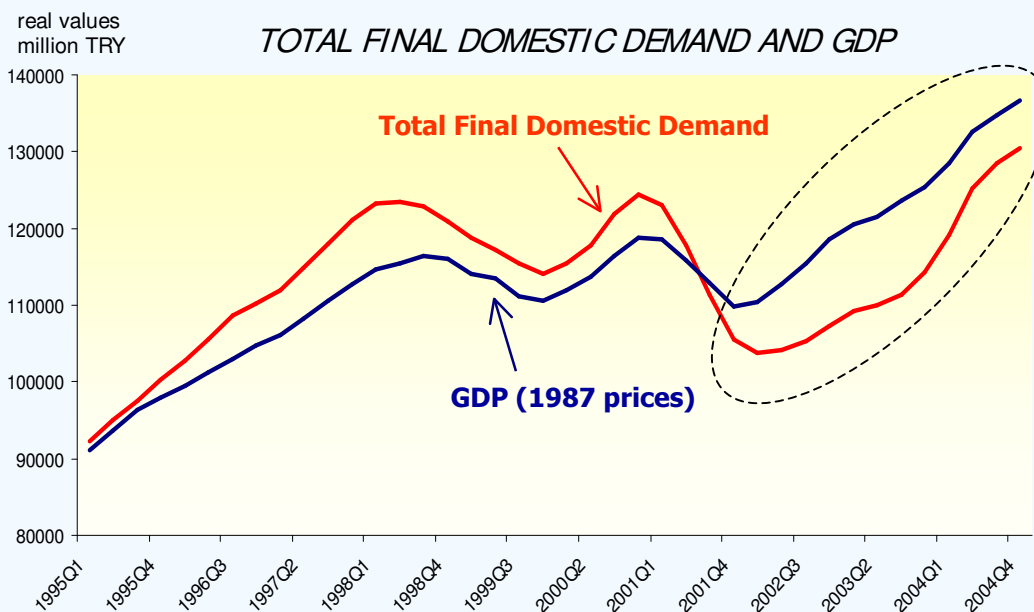
PPI is more sensitive to exchange rates and raw material prices



Volatility in PPI is possible.

***PPI is not a target.***

# What Caused Lower Inflation?



**1- Central Bank independence**

**2- Effective communication policy  
at the center of the CBT's policies**

*Successful management of expectations*

**3- Tight monetary and fiscal  
policies**

**4- Productivity increase, level of  
real wages;**

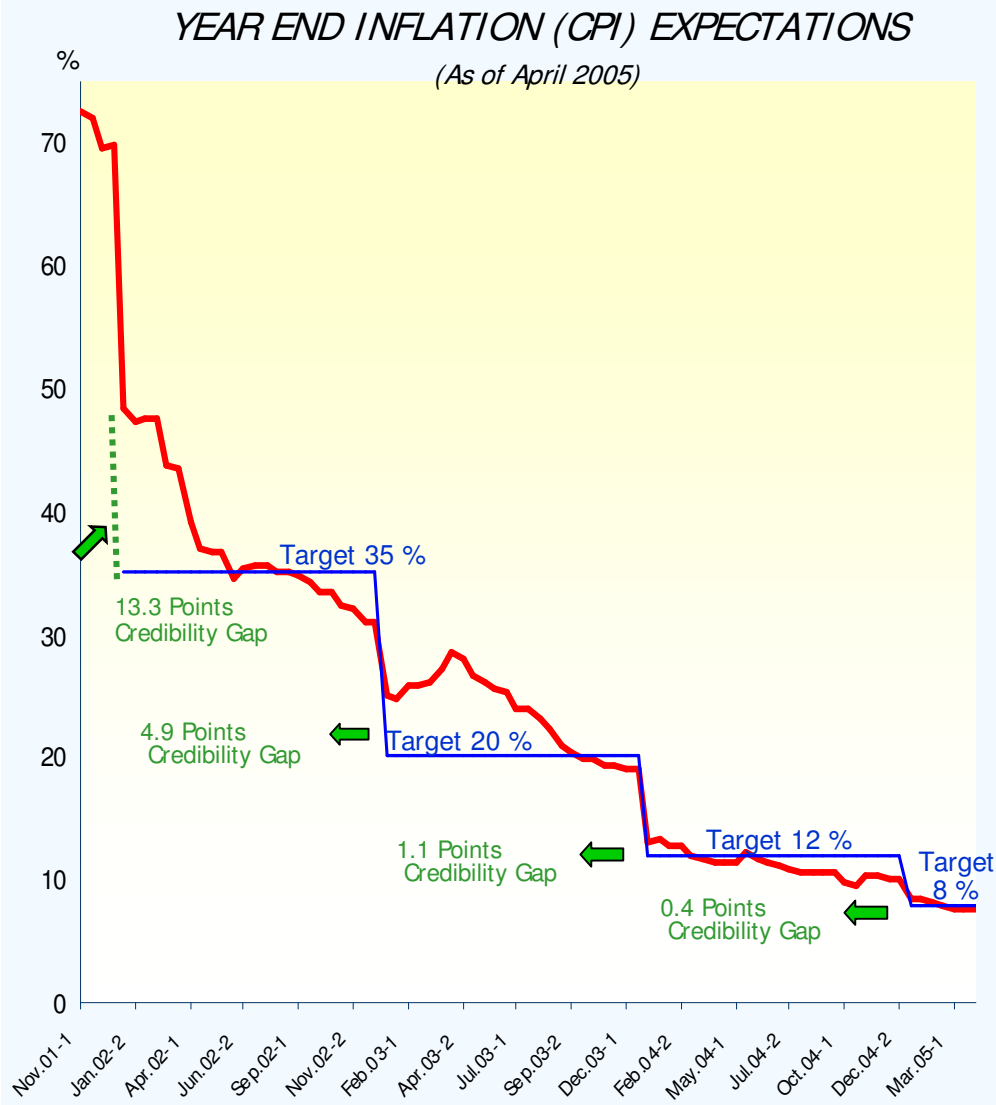
*May not help in 2005 as much as they did before*

**5- Incomes policy, more or less  
consistent with the target**

**6- Appreciation of the lira**

*To what extent?*

# Changing Dynamics of Inflation



Inflation dynamics have changed significantly and ensured **steady decline** in inflation.

## Changing Dynamics

### 1- Decreasing Inflation Inertia

- Ongoing decline in inflation
  - Effective communication policy
  - Increasing credibility
- Structural breakdown in inflation inertia

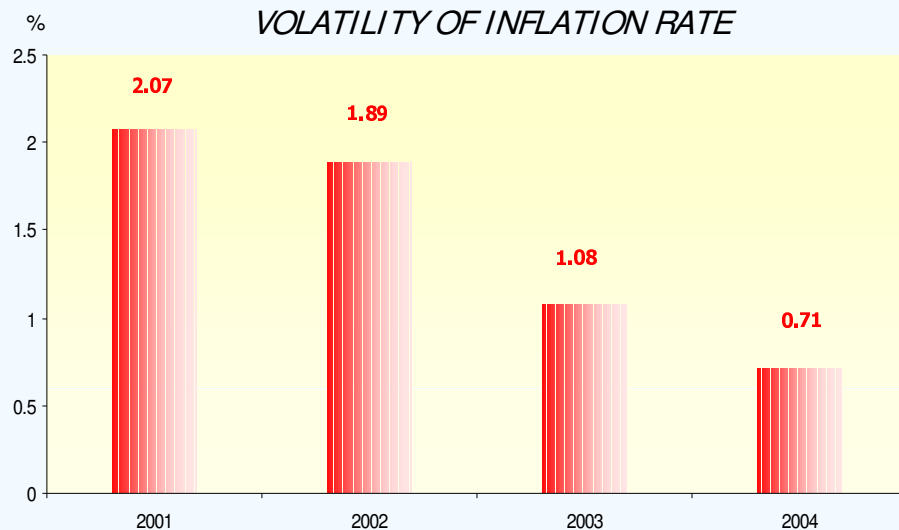
#### Credibility Gap (Expectations - Target)

2002	2003	2004	2005
13.3	4.9	1.1	0.4

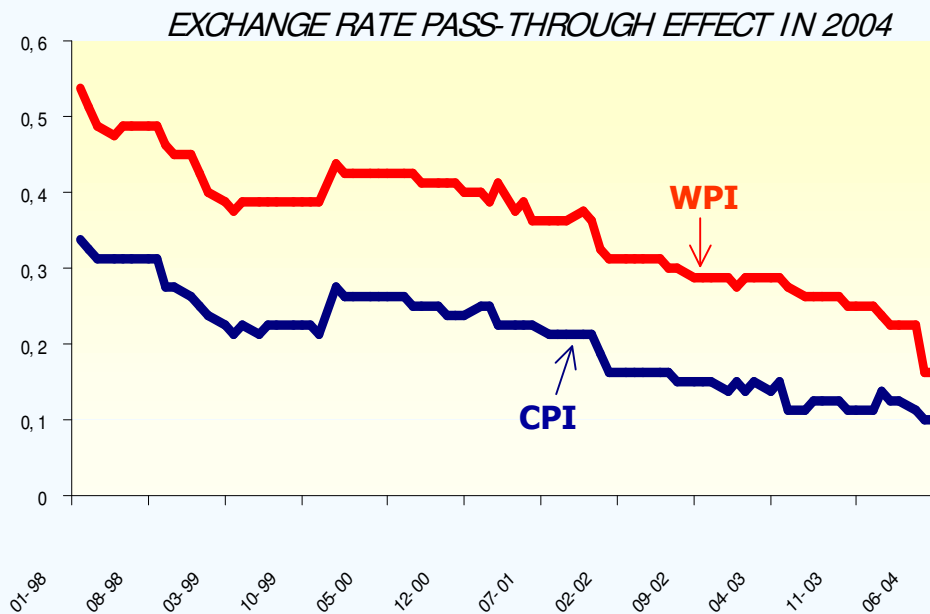
April 2005: Expectations are below the target.

**Inflation target is now a more credible anchor.**

# Changing Dynamics of Inflation



Volatility: 12 month moving standard deviation of the annualized percentage change.



Source: CBRT

## 2- The volatility of inflation has declined.

✓ Inflation volatility, an obvious obstacle to the predictability of inflation, decreased remarkably.

2001: 2.07 %      2004: 0.71 %

## 3- 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.

## 4- Changing consumer and producer behavior

✓ Consumers check out prices and quality; hence competition increases.

✓ Producers control their costs and put efforts to increase productivity.



# Risks

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- 1- Steady recovery in domestic demand**
- 2- Reform fatigue**
- 3- Tight fiscal and monetary policy**
- 4- Incomes policy more or less consistent with the target**
- 5- External shocks;** e.g. EU, liquidity conditions in international capital markets
- 6- Managing expectations**
- 7- Agricultural, energy and raw material prices**
- 8- Public price adjustments not in line with targeted inflation**



# **REAL ECONOMY AND FINANCIAL SECTOR**

# Growth

Turkish economy has been experiencing **high growth rates since 2002.**

✓ Economy grew by **25.5 %** in real terms **compared to 2001.**

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

- **In the first half**, durable goods consumption increased considerably.

- **Second half**; relative slowdown;

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

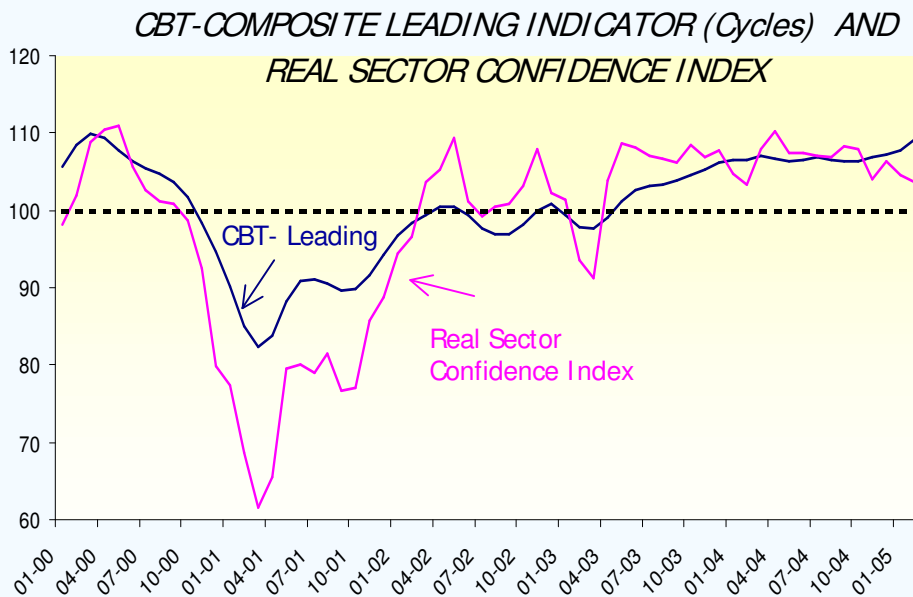
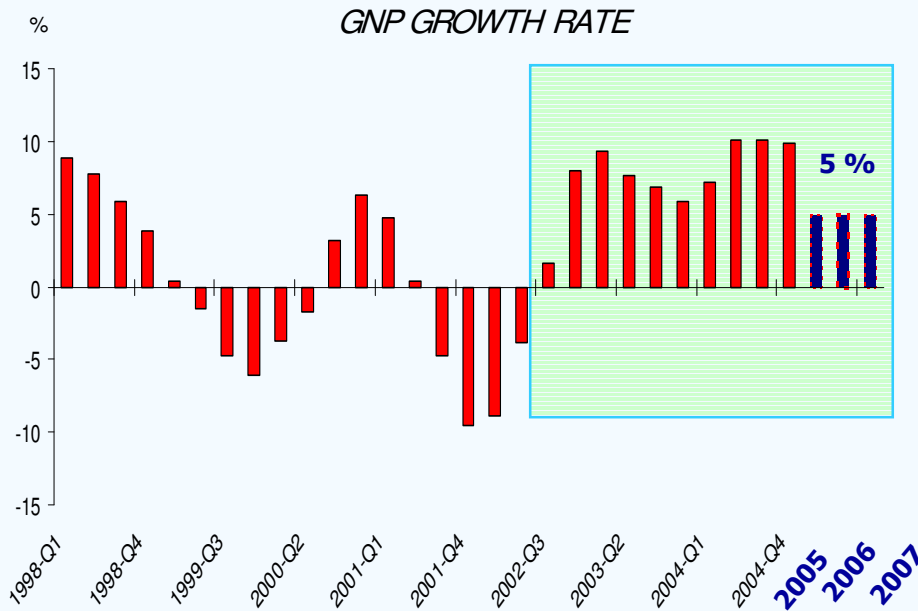
❖ Durable goods consumption declined.

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

✓ **In 2005**, domestic demand will follow a rather smooth and limited rise compared to the first half of the last year.

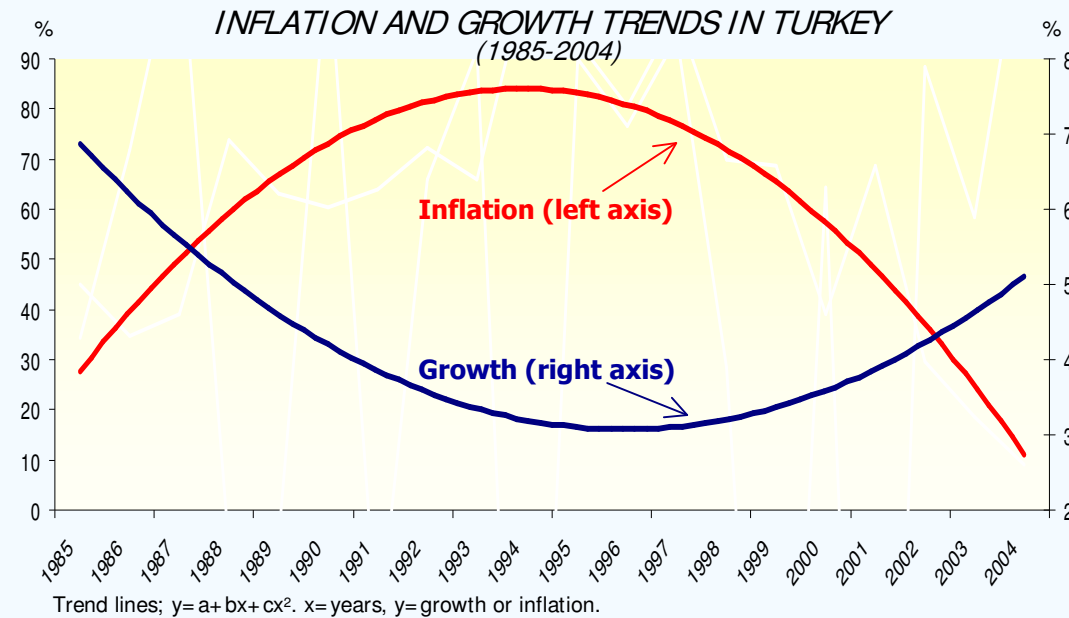
✓ Consumer confidence indices and other demand indicators show smooth rise in economic activity as well. *Not a recession.*

2005	} Growth forecasts: 5 %
2006	
2007	



Source: CBRT  
Above 100 indicates increase in confidence

# Changing Dynamics of Growth



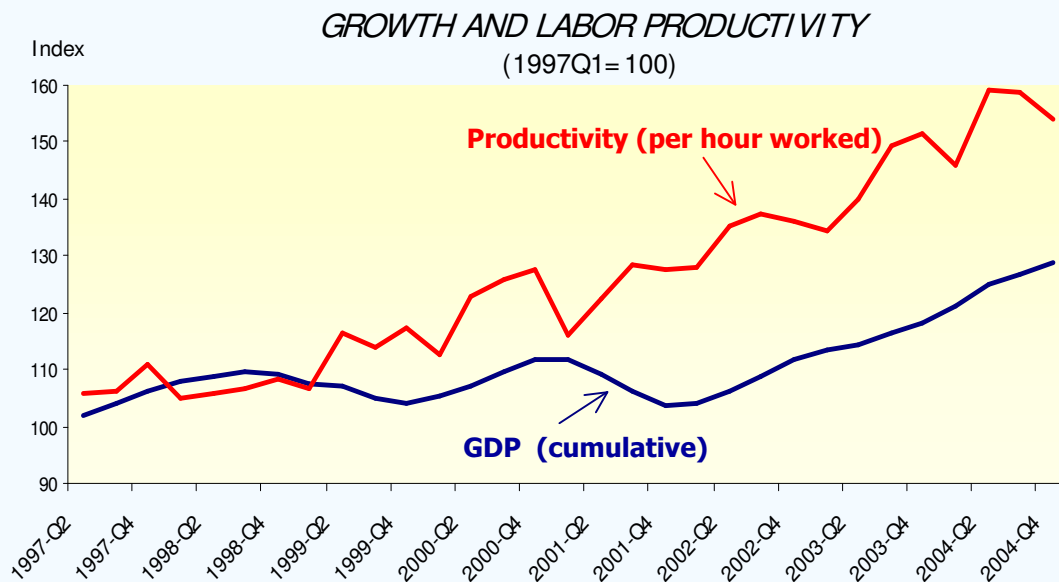
Today's growth dynamics are different from the past:



**1. High growth rates were attained while inflation is falling.**

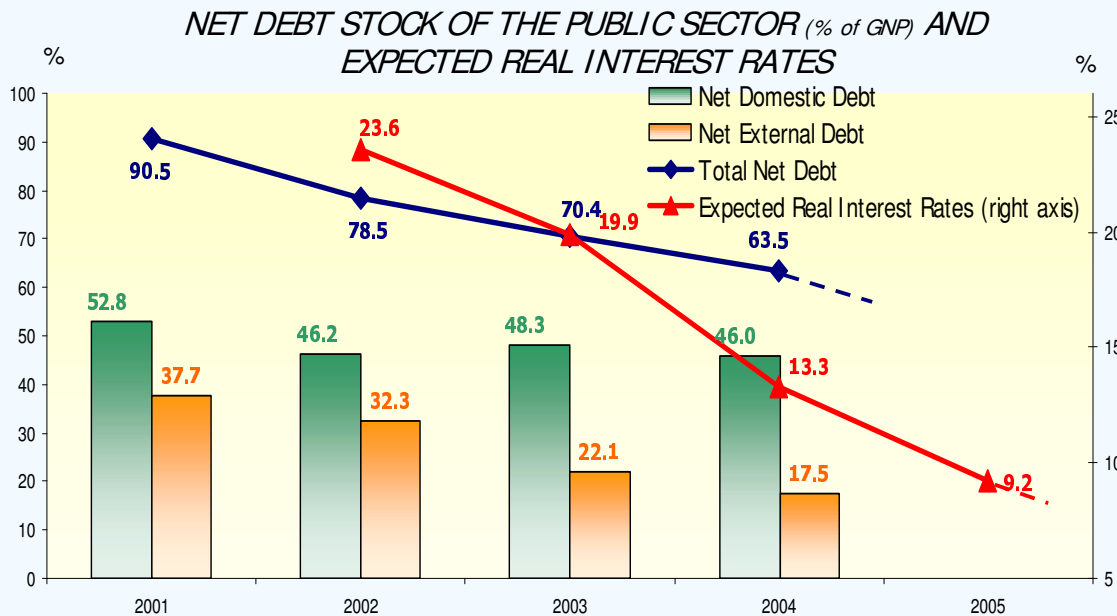
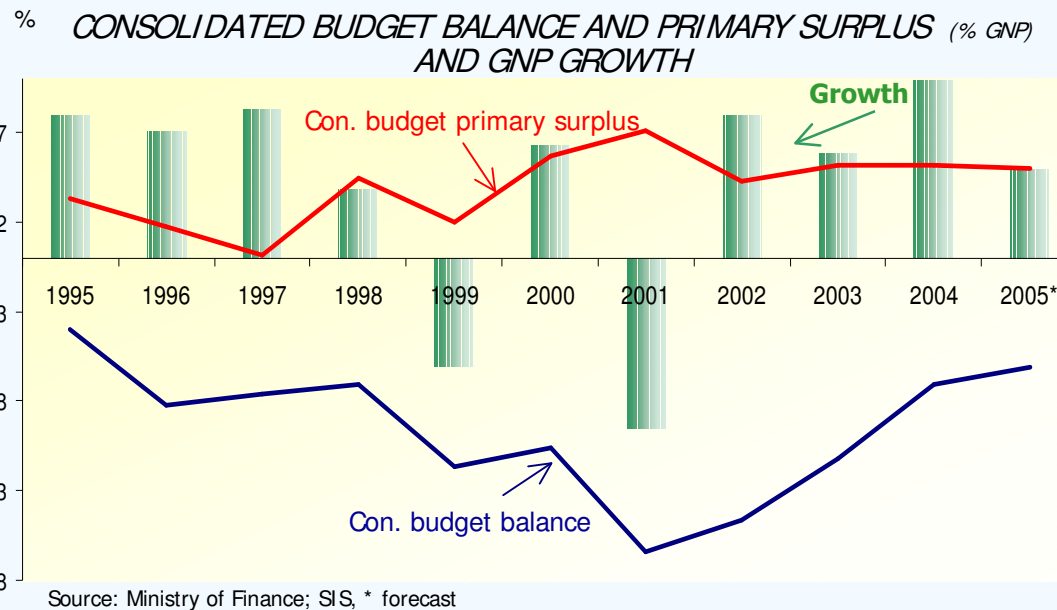
**2. Productivity is the main source of economic growth.**

- ✓ Highest contribution to growth came from the increase in productivity.
- ✓ Cumulative productivity increase has been around 26 % since 2001.
- ✓ Structural reforms can further boost productivity growth and help it spread to all sectors.



Source: SIS

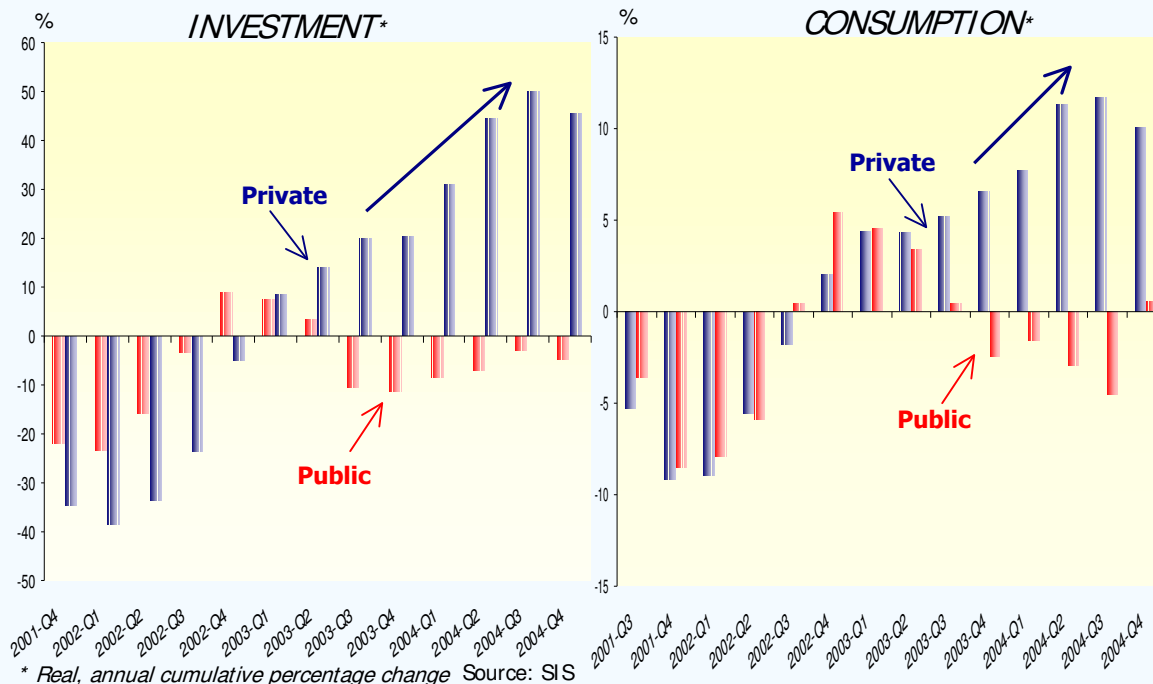
# Changing Dynamics of Growth



## 3. Tight fiscal policy affects expectations favorably; stimulates growth.

- ✓ With tight fiscal policy;
  - Very high levels of primary surplus were attained in the 2002-2004 period. Target for 2005; 6.5 % to be continued.
  - Consolidated budget deficit decreases considerably.
- ✓ The **net debt stock** of the public sector is on a **downward** path.
- ✓ Together with decreasing fragility of the economy, expected **real interest rates** are coming **down**.
- ✓ This process played a major role in changing the public sector-led growth model, via reducing the weight of the public sector in the economy.
- ✓ The **main source** of growth is **no longer the public sector**.

# Changing Dynamics of Growth



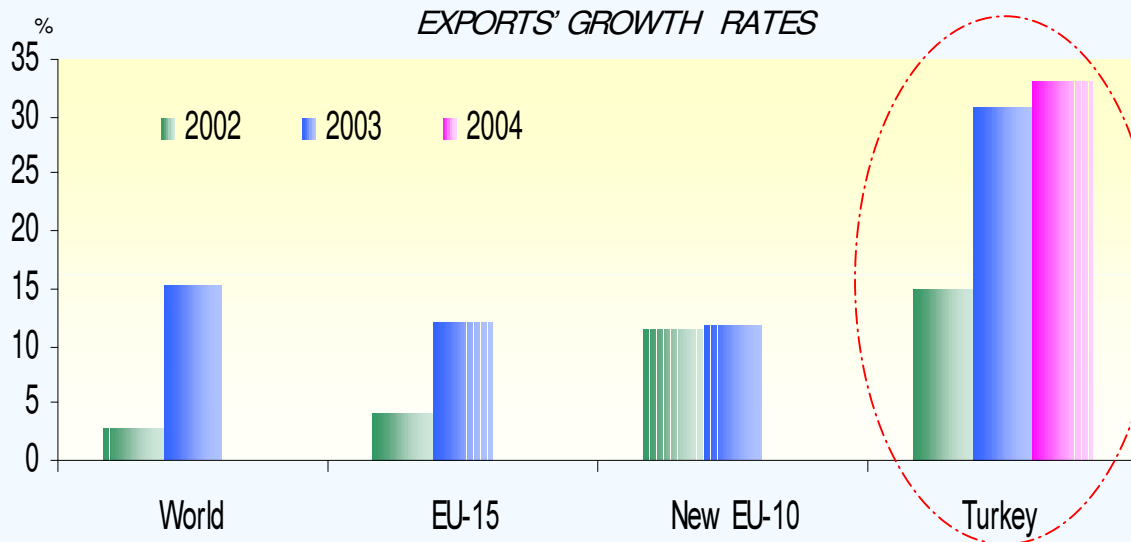
## 4. Growth is now driven by the private sector.

✓ While the private sector consumption and investment expenditures increase at high rates, consumption and investment expenditures of the public sector are decreasing.

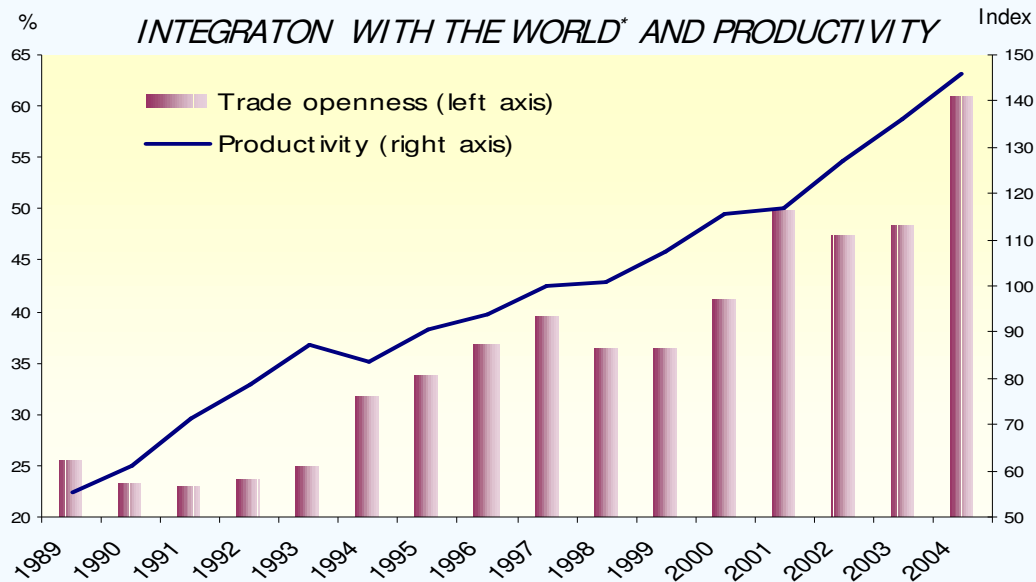
## 5. Exports contribute to economic growth with an increasing share.

✓ Very high growth rates in exports were attained in the last three years.

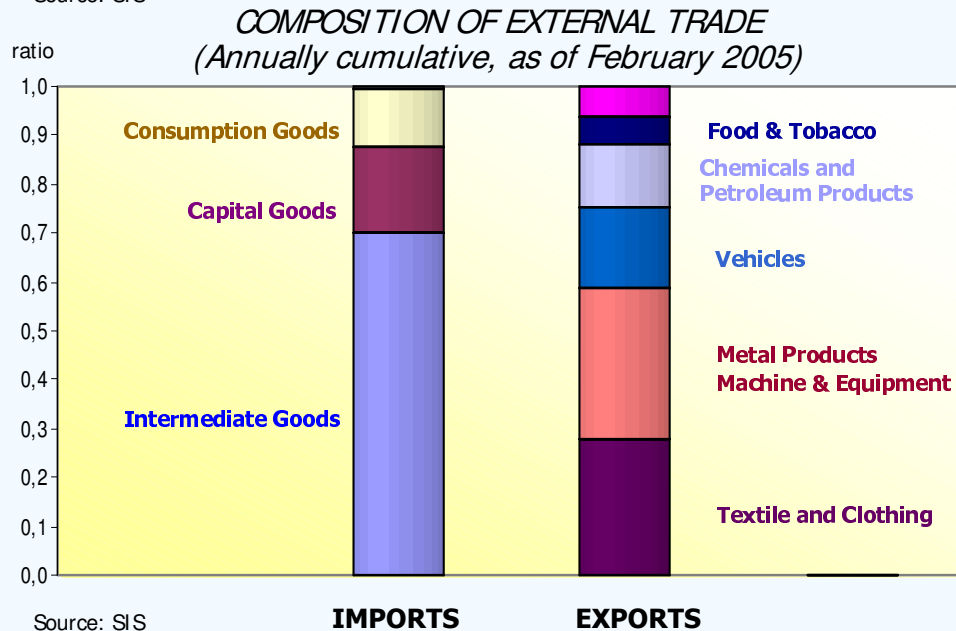
✓ Average growth rate for the last two years: 30 %.



# Changing Dynamics of Growth



\* Integration with the world: The share of the sum of exports and imports in the GDP  
Source: SIS



Source: SIS

The Turkish economy is now **more integrated** with the world economy, giving rise to a **more competitive** environment in the economy.

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



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

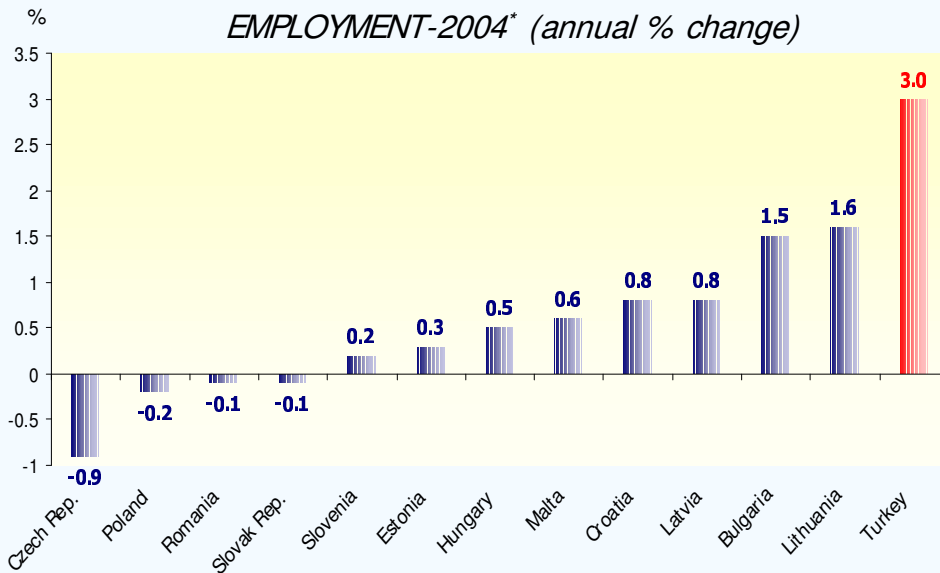
✓ **Imports** of intermediate and capital goods have the largest share in total imports.



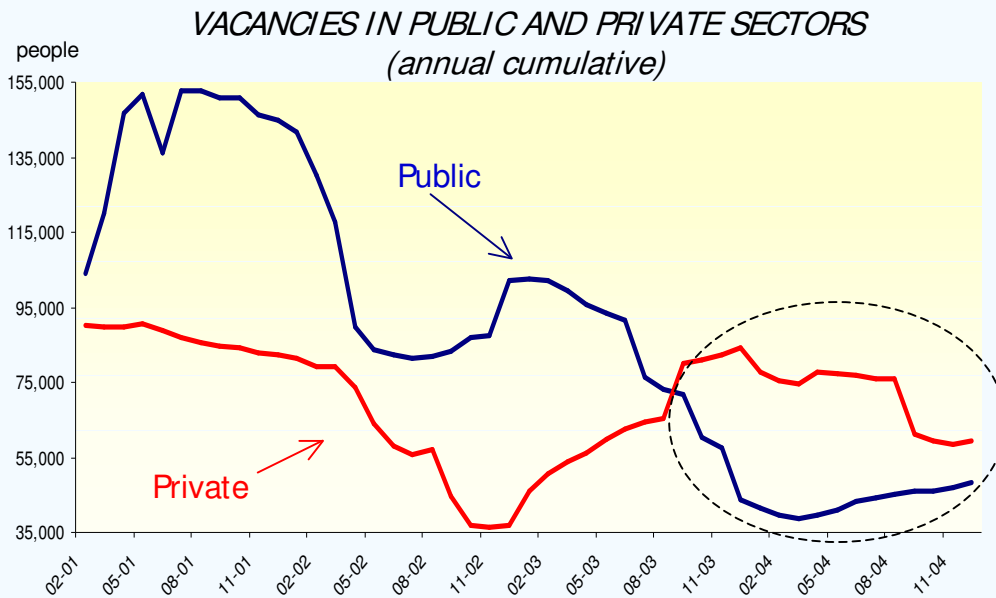
Imports are directed to production and exports.

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

# Changing Dynamics of Growth



Source: European Commission forecasts. \* Except Turkey



Source: ISKUR

## Unemployment

✓ Despite high growth rates since 2002, **jobless recovery**: Why?

- transition to a capital intensive structure
- productivity-driven growth
- increasing labor force participation rate

✓ However, Turkey's employment **performance** is **better** than the new EU members and candidates.

✓ Also the **structure** of labor market has **undergone transformation**;

- Sectoral composition of employment has changed.

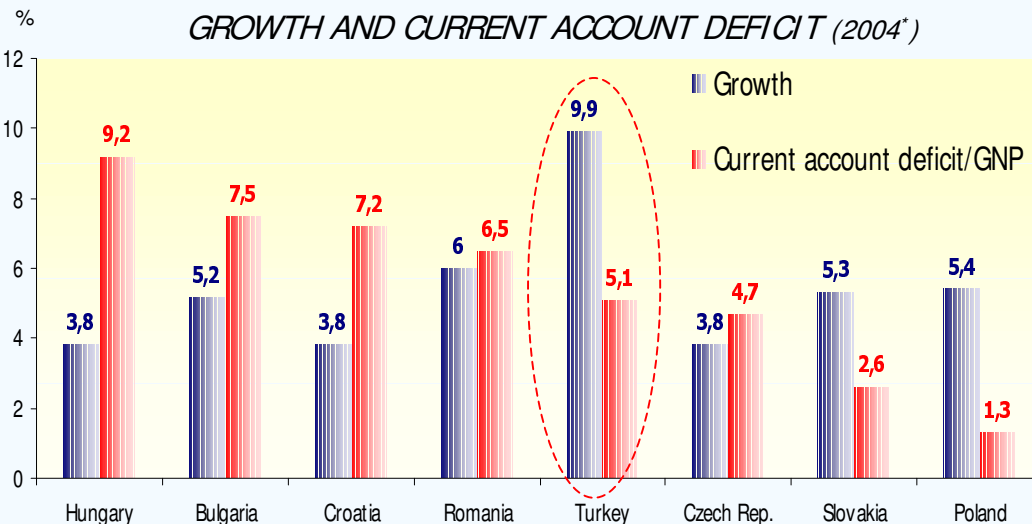
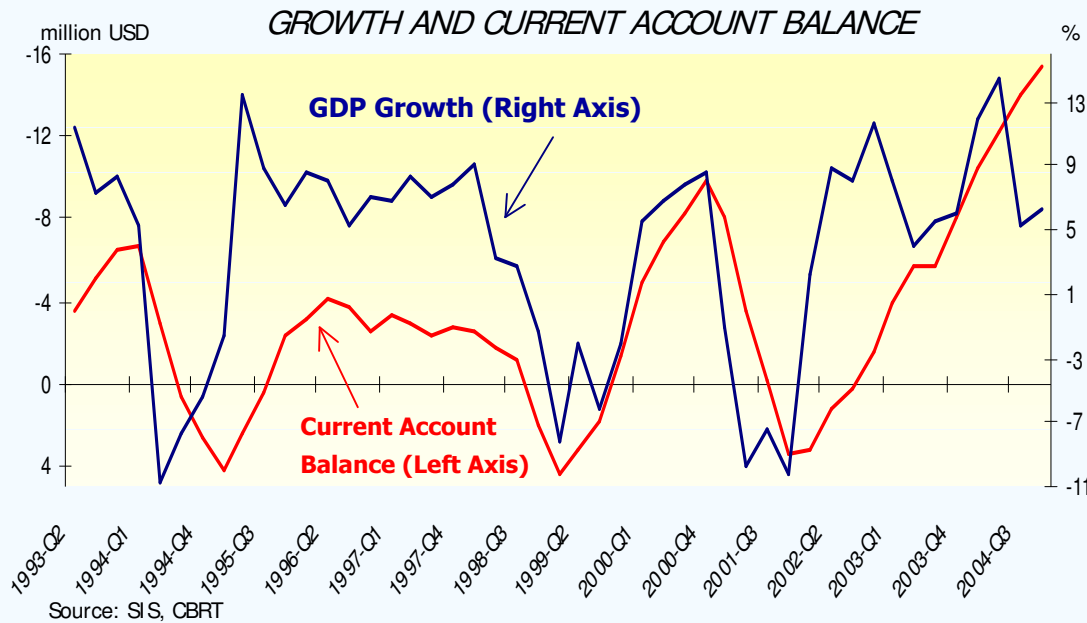
Distribution of Employment Among Sectors				
	Industry	Service	Agriculture	Construction
1989-1999 Ave.	16.3	33.5	44.0	5.8
2000-2004 Ave.	18.0	41.6	35.3	5.1

- The capacity of the private sector in creating new jobs is now higher than that of the public sector.

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



# Changing Dynamics; Current Account



## Current Account

✓ In 2004, economic **growth** has been **above** the program **forecast** of 5 %.



Higher than estimated current account deficit.

✓ But, deeper commercial and financial integration into the world facilitates the sustainability of higher -compared to the past- current account deficits in countries that achieved macroeconomic stability.

### Current Account/GDP forecasts\*\*:

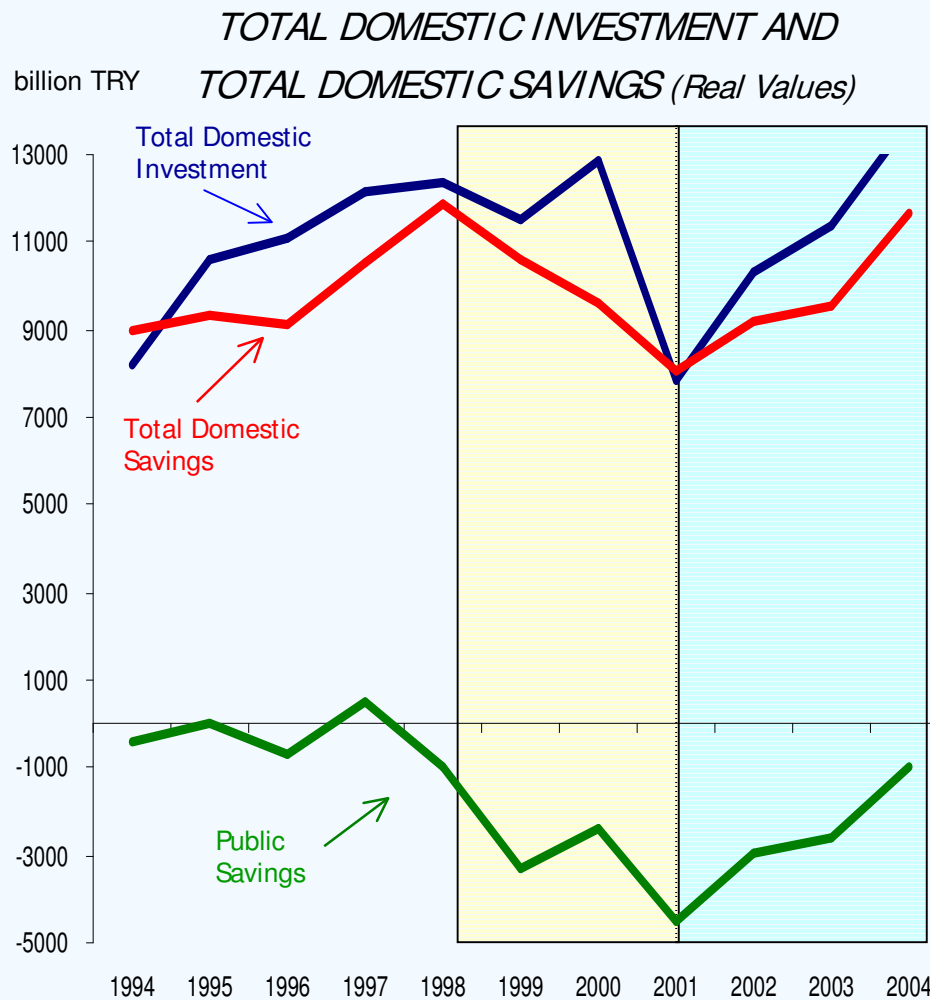
2005	⇒	-3.7 %
2006	⇒	-3.4 %
2007	⇒	-3.0 %

\* Forecast except Turkey  
Source: Citigroup Global Markets

\*\* Pre-Accession Economic Program

# Changing Dynamics; Current Account

## Past and present: What is different now?



Source: SİS, CBRT

### 1. Causes of current account deficits:

$$\text{Current Account} = T. \text{ Domestic Savings} - T. \text{ Domestic Investment}$$

In Turkey: Total domestic investment higher than total domestic savings

✓ **Before the 2001 crisis**, trends of both total domestic investment and savings were declining.

- Main factors that led to decrease in domestic savings were loose fiscal policies and rising budget deficits.

✓ **However, today** both total domestic investment and total domestic savings are increasing.

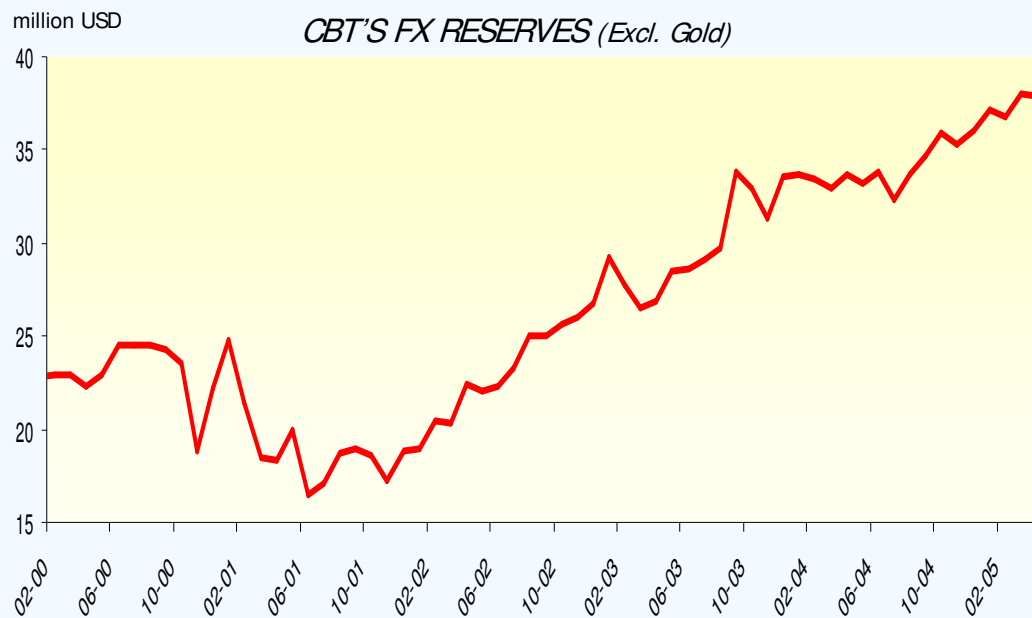
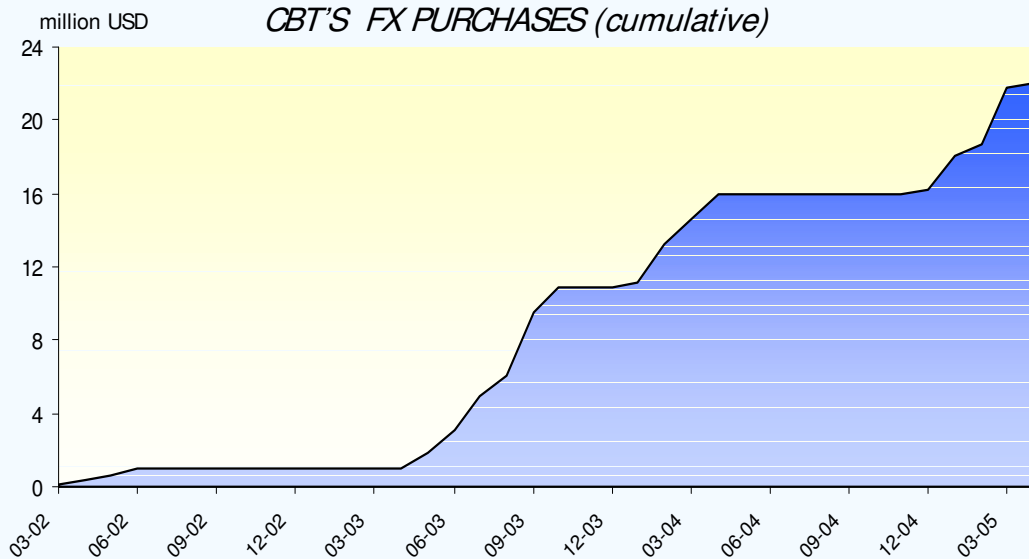
- Tight fiscal policy → Increase in public savings → Increase in total domestic savings

✓ **Current account deficit** now due to domestic investment increasing more rapidly than domestic savings.



**The driving forces of the current account deficit are different from the past.**

# Changing Dynamics; Current Account



Source: CBRT

## Past and present: What is different now?

### 2. Floating exchange rate regime.

- Shock-absorbing characteristic.

### 3. Stronger banking system.

- The system has less open positions.

### 4. TRY is not kept overvalued.

- CBT has purchased USD 22 billion since 2002.

### 5. Short-term capital inflows are not encouraged.

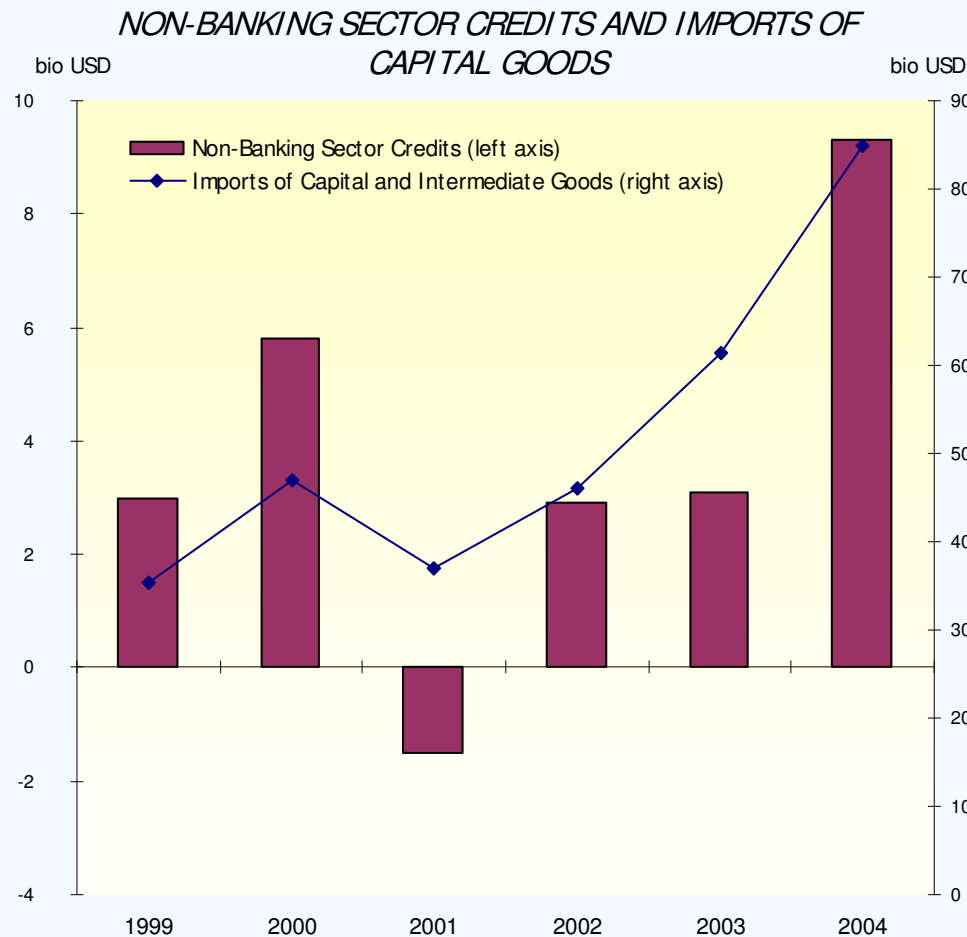
- Exchange rate risk is on the market.

### 6. Foreign exchange reserves are at record high levels.

### 7. Tight monetary and fiscal policies are put into practice.

### 8. Lower inflation environment.

# Changing Dynamics; Current Account



Source: SIS, CBRT

## Past and present: What is different now?

### 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 **credit utilization of the non-banking sector**; 40 % of total inflow:

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

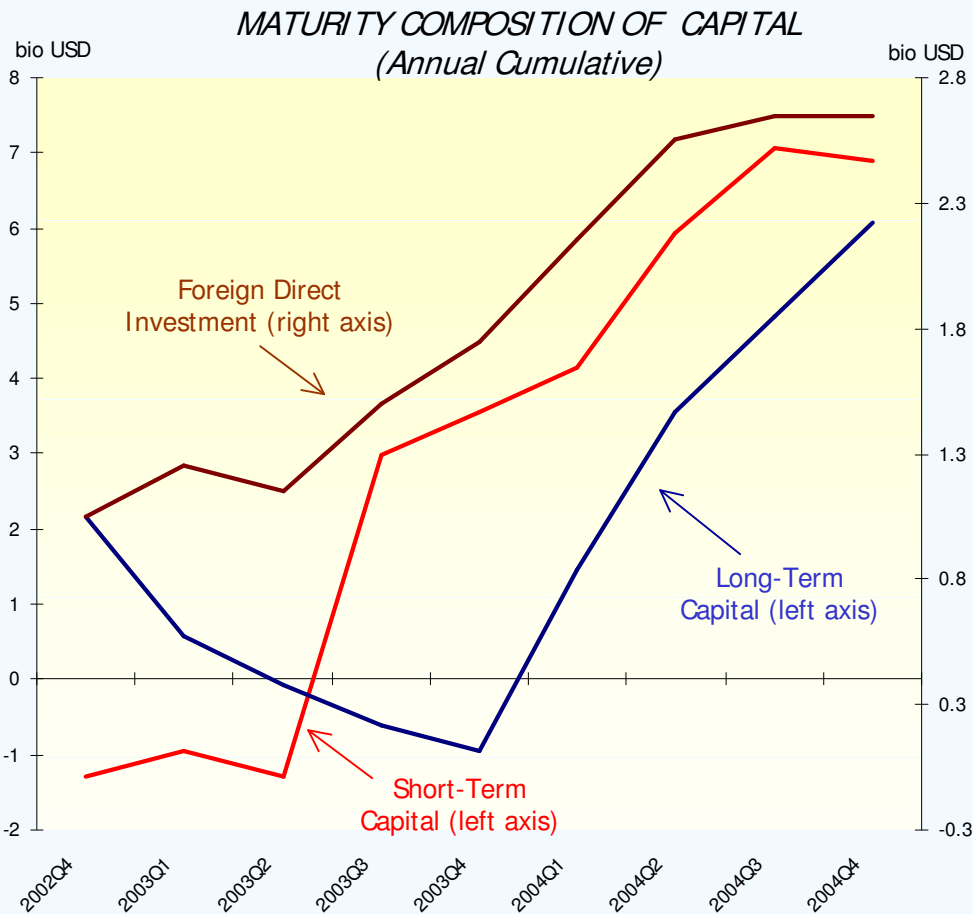


Credits are directed to imports of capital and intermediate goods.

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

# Changing Dynamics; Current Account

**Past and present: What is different now?**



## 9. Changing structure of the capital account:

***The share of the long-term capital in total capital inflows increased.***



- ✓ **Long-term capital\*** reached its record high level.
- ✓ **Foreign direct investment** began to increase, and it is expected to increase further;
  - As structural reforms are put into practice,
  - As the negotiation process between Turkey and the EU continues.
- ✓ **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.

\* 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

# Changing Dynamics; Banking Sector

Banking sector is much stronger now.

✓ Very **important** and **comprehensive reforms** have been carried out in the sector.

- An independent body for monitoring and supervising has been established – BRSA.
- **Public banks** have been **restructured** both financially and operationally.
- The **capital structure** of private banks have been **strengthened**.
- **Risk management** principles have been gradually put into practice.

**What is on the agenda now?**  
**Financial Sector Reform:**

## 1- A new Law on Credit Institutions

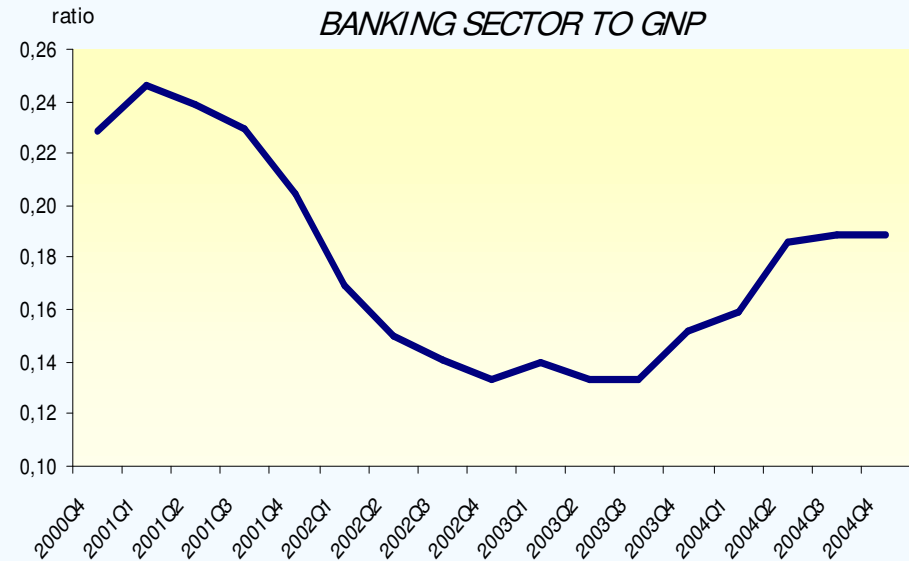
- *Harmonization of Legal Framework with the EU Acquis*

## 2- Privatization of state banks

## 3- Regulation and supervision of non-bank financial institutions

## 4- A modern risk management system for credits

*RATIO OF TOTAL CREDIT VOLUME OF THE BANKING SECTOR TO GNP*



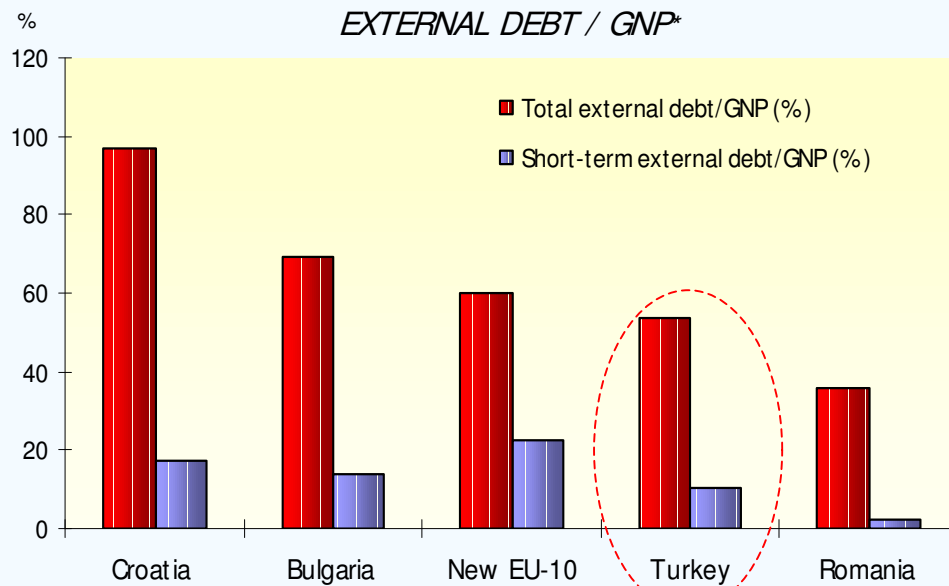
Source: CBRT

- *Total volume of credit is increasing.*
- *Non-performing loan ratio is decreasing.*
- *Deposit maturities are longer.*

✓ Foreign investors become more interested in the sector.

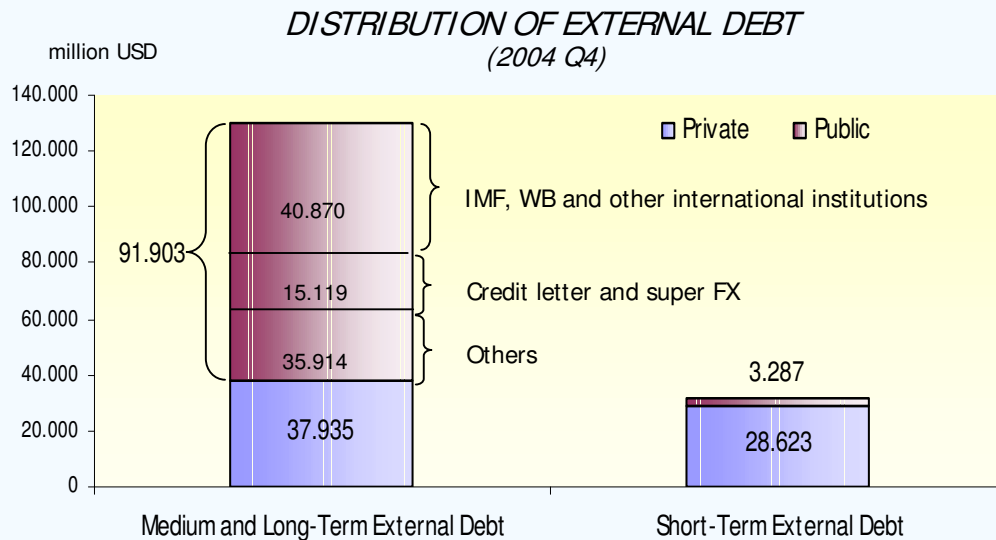
✓ **Reform process** is still under way.

# External Debt



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

Source: WB, CBRT



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.**

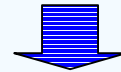


# **ON THE CONDUCT OF MONETARY POLICY AND MARKETS**



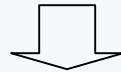
# On The Conduct Of Monetary Policy

## 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

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:**

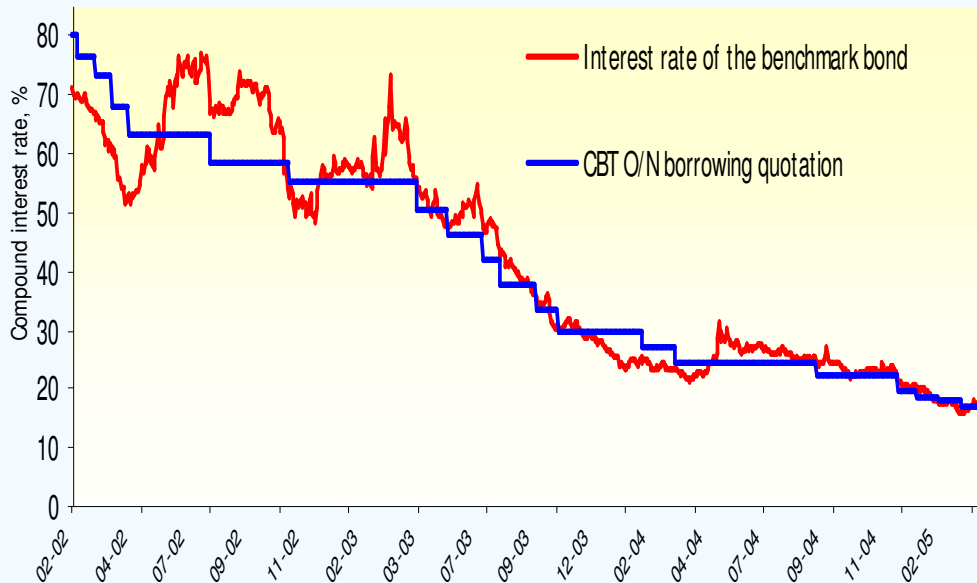
### Full-fledged IT

✓ 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.

# Towards Stability

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



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

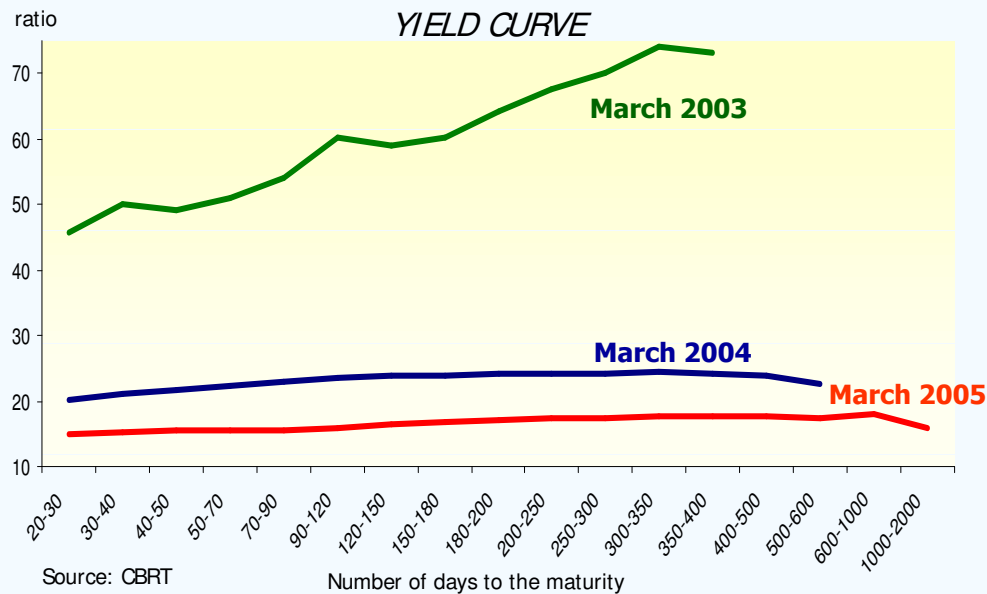


- Nominal interest rates by **53 percentage points**
- Real interest rates by **22 percentage points**

✓ 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.

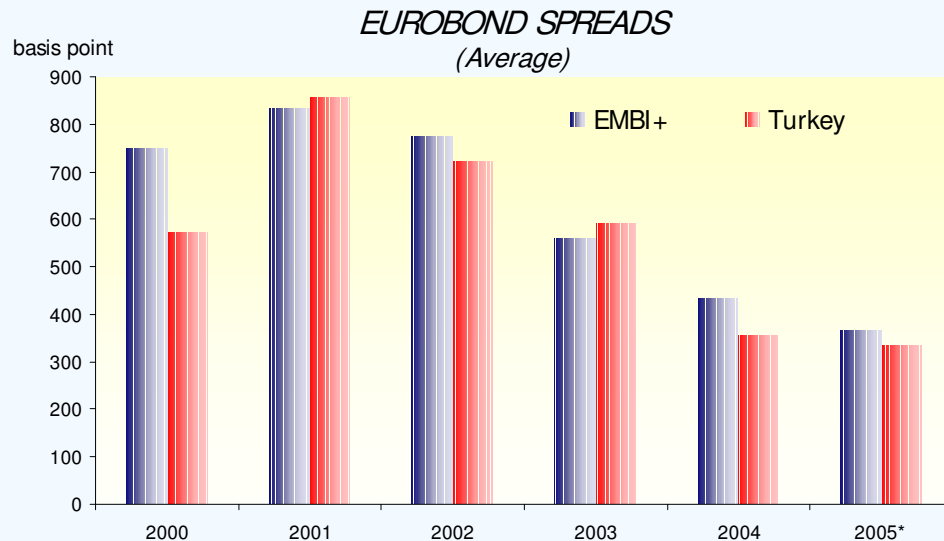
- Thanks to longer maturity of the Treasury issues, **yield curve** is getting sound. The shape of the yield curve, especially the long edge of the curve, indicates **favorable expectations**.



Source: CBRT

Number of days to the maturity

# Towards Stability



Source: Bloomberg  
\* As of April 12, 2005

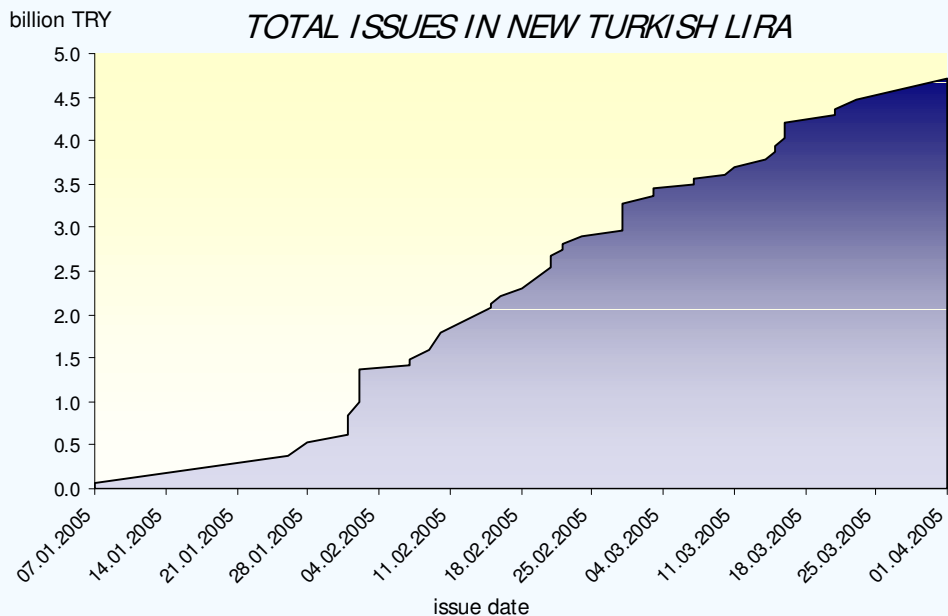
- ✓ Turkish bonds performed better than emerging markets bond index.
- ✓ Turkish **Eurobond spreads** have **dropped** by average **525 basis points** since 2001.

**Currency reform:**  
Six zeros were dropped from the currency as of January 1<sup>st</sup>, 2005.

- ✓ This is an indicator of the determination in bringing inflation to single-digit figures.
- ✓ Following the currency reform, favorable developments in markets have been observed.



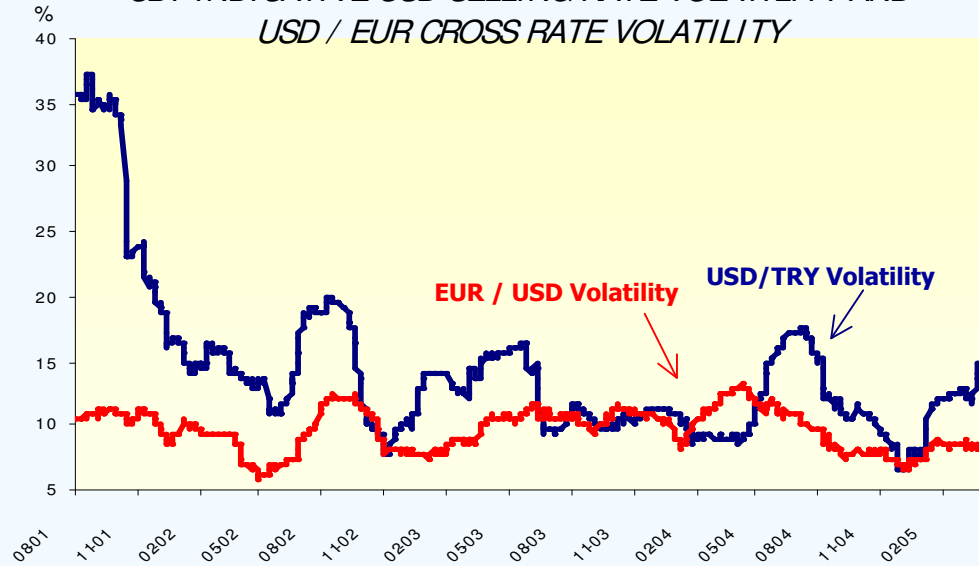
- Foreign banks started issuing **New Turkish Lira instruments** up to 10 years of maturity.
  - *Total issue in New Turkish Lira has reached about **USD 3.5 billion.***
- The New Turkish Lira is now included in operations in international clearing systems.



Source: Bloomberg

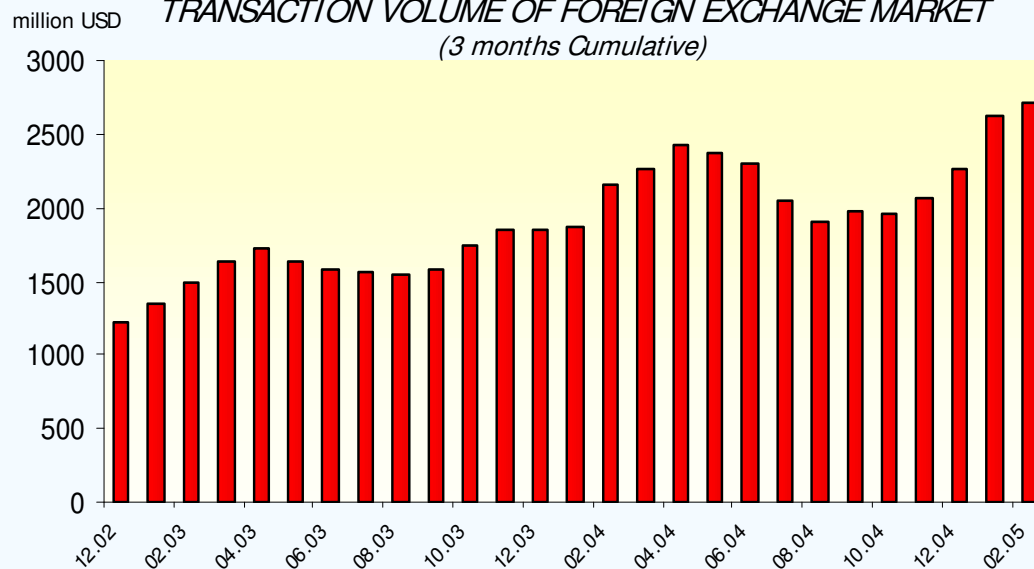
# Towards Stability

*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)*



Source: CBRT

## Floating Exchange Rate Regime

### ✓ Central Bank Interventions



**To decrease  
volatility**



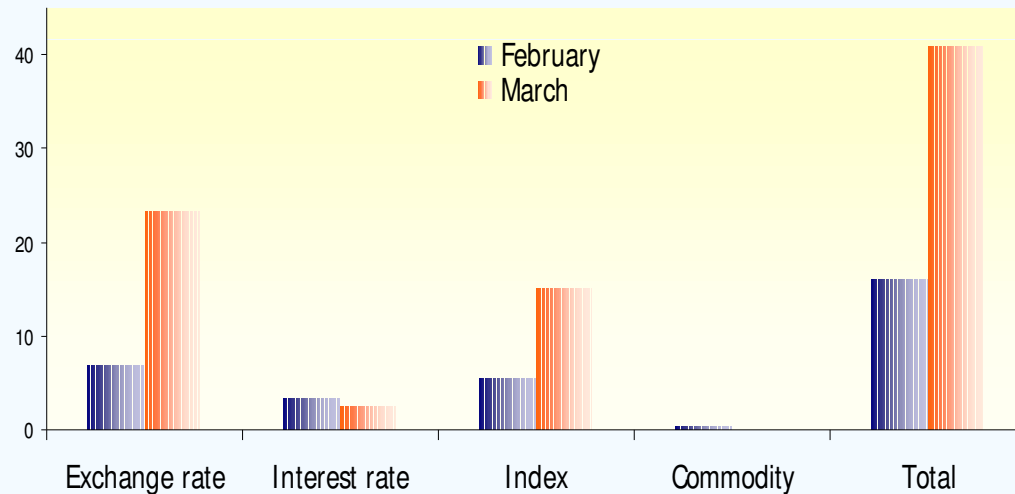
**To build up  
reserves**

✓ The volatility in the exchange rates is gradually decreasing.

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

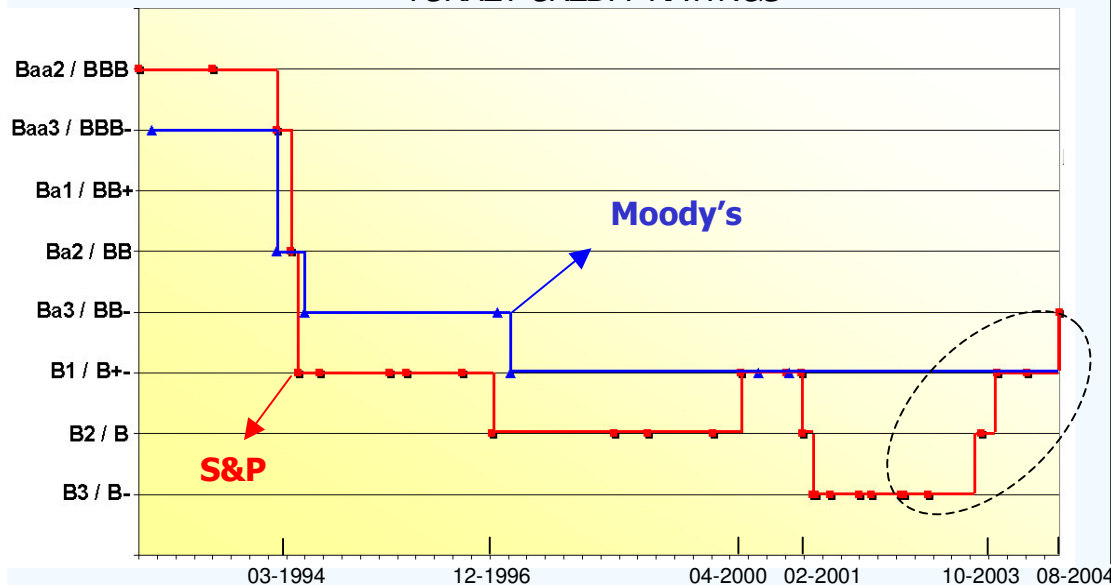
# Towards Stability

million TRY *TRANSACTION VOLUME OF TURKISH DERIVATIVES EXCHANGE*



Source: Turdex

*TURKEY CREDIT RATINGS*



Source: Bloomberg

- ✓ **Turkish Derivatives Exchange** (Turkdex) was granted permission in March 2004 and **launched in February 2005.**
- ✓ The volume of transactions in Turkdex has been increasing gradually.
- ✓ Turkdex **ensures to hedge risks** resulting not only from **exchange rate** volatility but also from volatility of **interest rate, 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.

# Challenges Ahead

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Turkey; on its way to a sound macroeconomic environment **that** would ensure **high and sustainable growth** as well as **price stability.**



## 1- Banking Sector Reform

## 2- Tax Reform:

*Unregistered Economy* ⇨ *Registered Economy*

## 3- Social Security Reform

## 4- Quality of Fiscal Adjustment

## 5- Putting the Principles of Good Governance into Practice

## 6- Steps taken to improve investment climate:

- *FDI Investment Law (enacted)*
- *Law on the Protection of Intellectual and Industrial Property Rights (enacted)*
- *Investment Promotion Agency Law (submitted)*
- *Sectorial Licences (drafted)*

## 7- Economic Policy Coordination:

- **Development of streamlined decision making**



# **CHANGING STRUCTURE OF THE TURKISH ECONOMY**

**April 2005**

**CENTRAL BANK OF THE REPUBLIC OF TURKEY**