



CENTRAL BANK OF THE REPUBLIC OF TURKEY

MONETARY POLICY REPORT 2005-II

CONTENTS

1. INTRODUCTION	1
2. INFLATION DEVELOPMENTS	3
3. SUPPLY and DEMAND DEVELOPMENTS	11
3.1. Supply and Demand Balance	11
3.2. External Demand	18
3.3. Costs	20
4. DEVELOPMENTS in FINANCIAL MARKETS and MONETARY POLICY	23
4.1. Developments in Financial Markets	23
4.2. Monetary Policy	27
5. PUBLIC FINANCE	31
5.1. Developments in Debt Stock	33
6. OUTLOOK	42
6.1. Supply and Demand Factors	42
6.2. Cost Factors	43
6.3. Monetary and Fiscal Discipline	45
GRAPHS	47
TABLES	48
ABBREVIATIONS	49

1.Introduction¹

In the second quarter of 2005, there was a stagnation in the disinflation process. The rigidity in the services sector prices continued. While the increase in the prices of oil and petroleum products stimulated the rise of the general price index, seasonal price developments and the stability of the Turkish lira were the main factors limiting the increase in prices. The Special CPI Aggregates (SCAs), which are special price aggregates announced within the scope of the consumer price index with a base year 2003, maintained their general downward trend. Yet, the ongoing volatile course of these aggregates for some time signals a slowdown in the disinflation process.

In the first quarter of 2005, there was a significant slowdown in the annual growth rate of the Gross National Product (GNP). However, this slowdown is not because of a decline in the economic activity and/or demand, but more due to the base effect created by the acceleration of the economic revival in the first half of 2004. Analyzing the seasonally adjusted expenditure items, domestic demand, which had lost pace in the third quarter of 2004 following the implementation of restrictive measures, is seen to have resumed its increase. In the first quarter of 2005, total final domestic demand rapidly increased compared to the previous period. In the first half of the year, the upward trend in the credit volume of banks and cash demand of households also supported the recovery of economic activities. During this period, semi-durable and non-durable consumption and construction investments were the leading expenditure groups in terms of growth. Meanwhile, the share of private consumption expenditures in growth decreased, while that of public expenditures increased (especially those of investment-led expenditures). This development points to a change in the domestic demand composition. Hence, analyzing the decline in annual growth rates within the framework of domestic demand components, no sign of a marked slowdown in domestic demand is observed.

In the aforementioned period, costs continued to support the downward trend in inflation. Despite the high rates of increase displayed by oil and metal prices in international markets, the Turkish lira maintained its strong position and limited the impact of these developments on

¹ This report was prepared with the data available as of July 25, 2005.

inflation. Besides, employment and real wages per hour displayed an increase in the first quarter of 2005. However, the rate of increase in productivity per hour was even higher. In other words, unit labor costs maintained their low level due to the fact that the real unit wage index, the ratio of real wages to partial labor productivity, declined in the same period.

In the framework of real economic activities and the downward trend of inflation and in line with the developments mentioned above, the Central Bank of the Republic of Turkey (CBRT) maintained its “cautious” stance regarding interest rate decisions and held overnight interest rates at the level of 14.25 percent. Furthermore, in the first seven months of the year, the Central Bank directly intervened in the foreign exchange market a total of four times to buy foreign currency due to the excessive volatility that occurred from time to time in exchange rates. Foreign exchange buying auctions held with the aim of building up reserves also continue. Thereby, the FX reserves of the Central Bank reached almost USD 40 billion.

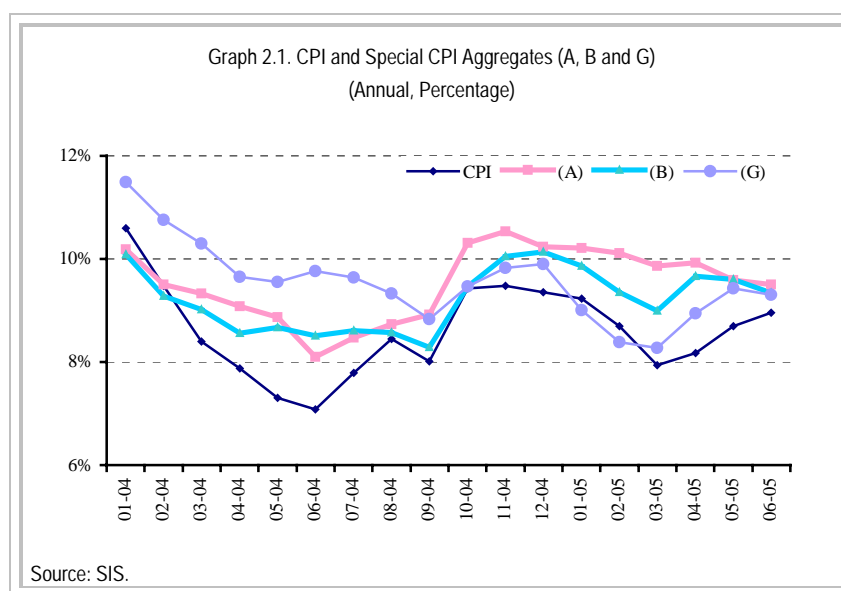
The downward trend in interest rates and the ongoing strong position of the Turkish lira – enabled by the decline in the structural risk premium as a consequence of the success of the current economic program – continue to positively contribute to the debt stock. In this content fiscal dominance continues to weaken. However, the current maturity structure and level of debt stock still necessitate a high level of primary surplus.

Achieving high growth rates in the disinflation process of the post-2001 period was made possible through structural arrangements and high productivity increases. During this process, significant progress was made towards price stability. Yet, absolute price stability can only be achieved if the economic program is carried out with the same determination as that of recent years, a budget and incomes policy that is consistent with the inflation target is pursued, no concessions are made in fiscal discipline, and structural reforms that will ensure the quality of fiscal discipline in the long-run are continued.

2. Inflation Developments

As of the first half of 2005, Consumer Price Index (CPI) inflation is realized at 2.59 percent, a figure quite low compared to those of previous years. However, it is observed that the downward trend in inflation halted in the second quarter. CPI inflation, which was recorded as 0.83 percent in the first quarter, became 1.74 percent in the second quarter with the impact of price developments in seasonal products. Meanwhile, the annual inflation of special CPI aggregate (G), which displayed an upward trend in March and April, dropped again in June (Graph 2.1).

CPI inflation is realized at 2.59 percent in the first half of 2005.

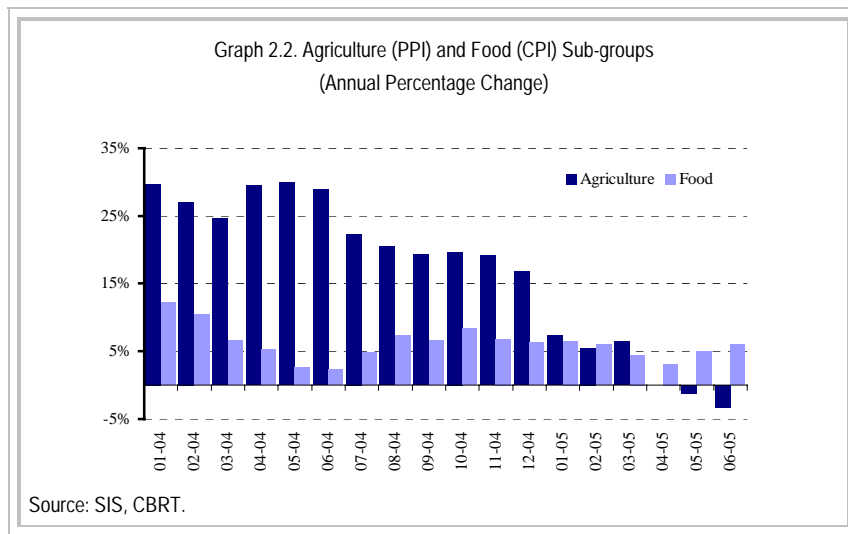


Outstanding factors that have influenced inflation developments in the second quarter have been: (i) price developments in seasonal products, (ii) sustained price rigidity in service prices (iii) the upward trend in oil prices (iv) the stable course of Turkish lira.

The impact of seasonal products became more visible in the second quarter. Price increases in the clothing and footwear group in April and May, and the decrease in the prices of food and agricultural products in June are indicators of the said seasonal impact. Even if the 19.1 percentage point-rise in clothing and footwear prices in the April-June period can basically be attributed to seasonal price adjustments, it is still a high-rated rise compared to the previous years (the same increment was 9 percent last year, according to the index with base

The effect of seasonal products was more clearly observed in the second quarter.

year 2003). However, the rapid decline observed in the prices of this group in the first quarter should not be ignored. Meanwhile, the decrease in the food group in May and June helped to limit the CPI inflation. Actually, the CPI excluding unprocessed food products, which is a special CPI aggregate, increased by 2.95 percentage points in the second quarter. The year-on-year increase in agricultural prices became negative in this quarter for the first time since 1994 (according to the indices with base years 1994 and 2003) (Graph 2.2).

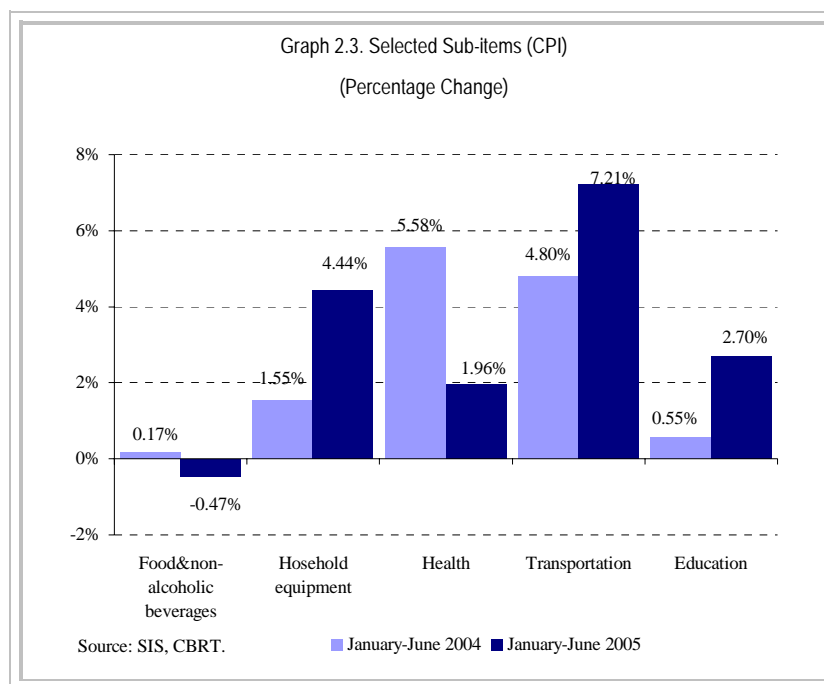


Additionally, the rigidity in prices of services continued in the second quarter.

Rates of annual price increases in services groups such as education, health, and especially transportation and housing, are realized above the target. Besides this, the rates of rent increases are still very high. Thus, it can be noted that the rigidity in prices of services continued in the April-June period too. When transportation and housing groups are analyzed, it is observed that these CPI sub-groups are those that are most susceptible to energy prices. Price increases in these sub-groups are mostly due to the rise in oil and natural gas prices, as well as the price increments of items which are related to oil and gas (Table 2.1). Impacts of the international crude oil prices on CPI and Producer Price Index (PPI) in 2004 and 2005 will be analyzed later in this section (Box 2.1).

	June-2004-June 2005			December 2004 – June 2005		
	Gasoline	Diesel	Heating Fuel	Gasoline	Diesel	Heating Fuel
Oil related products	33,71 %	32,01 %	38,69 %	10,29 %	9,14 %	15,03 %
Gas related products	Natural gas	LPG (housing)	LPG	Natural gas	LPG (housing)	LPG
	34,93 %	19,87 %	21,83 %	5,33 %	14,64 %	5,73 %
	Source SIS, CBRT.					

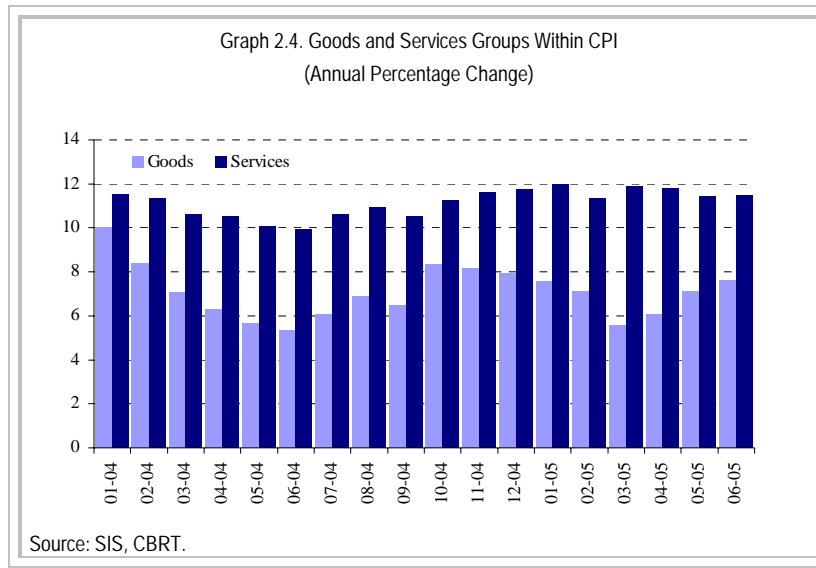
The high annual rise observed in the education sector as of June can mainly be attributed to advanced price adjustments as private educational courses and private primary/secondary schools made their price adjustments for the coming educational year in May and June. Therefore, it is expected that the annual rate of increase in the education sector would decline at the end of the year (Graph 2.3).



The high rates of increase in the CPI sub groups of entertainment-cultural activities and restaurant-hotel groups continue. Price increments in these sectors as well as in the household furniture group stem from the relative recovery in domestic demand. Even if price the developments pertaining to other CPI sub-groups do not point to an apparent recovery in demand, this will become important with respect to the inflation trend in the near future in these sectors.

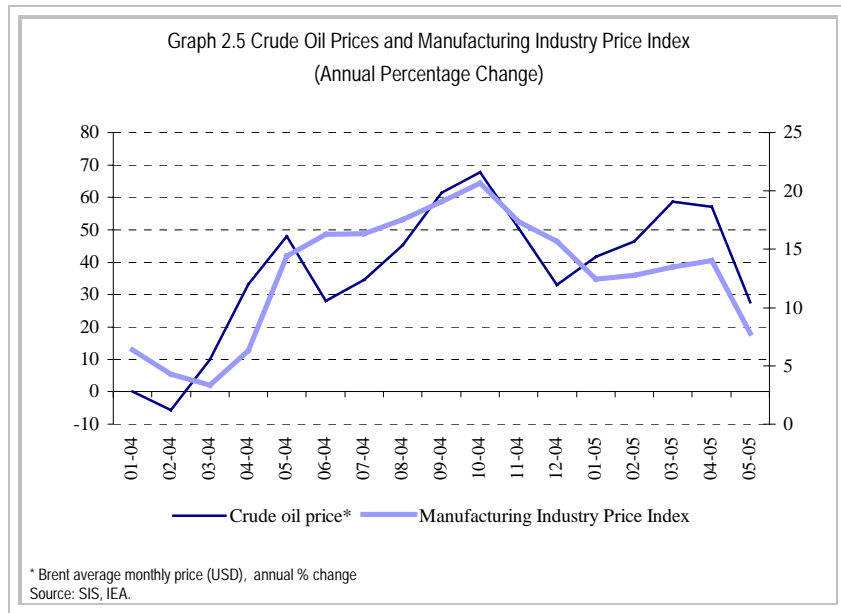
The analysis of the annual rates of increase in the goods and services groups show that the spread between goods inflation and services inflation has diminished in the second quarter, compared to the first quarter. While the tendency of the annual price increase in the services group has remained unchanged, the annual rate of increase in the goods group, which can be attributed to demand recovery, is believed to be the underlying factor of the aforementioned development (Graph 2.4).

The spread between goods inflation and services inflation has diminished in the second quarter, compared to the first quarter.



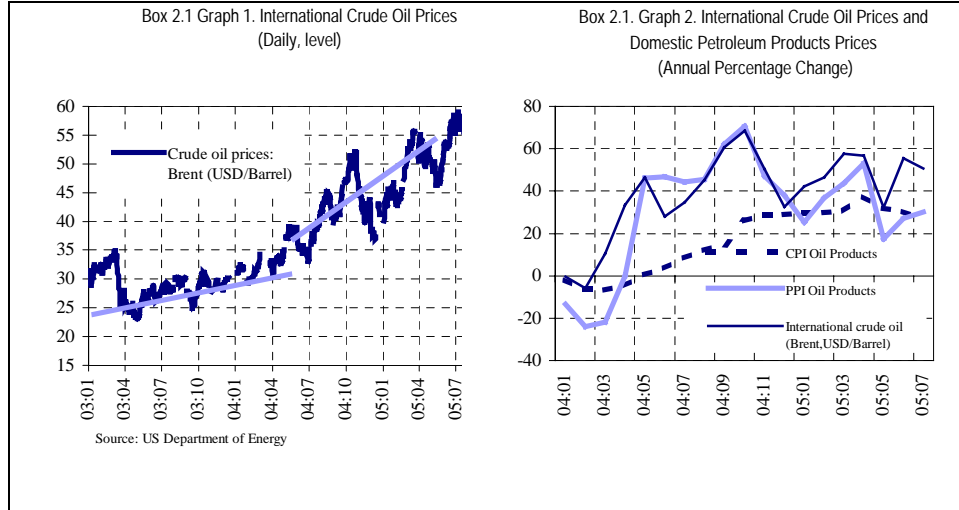
In this period, public price adjustments were mainly concentrated on oil, natural gas and their derivatives. The impacts of Value Added Tax (VAT) reduction on education, health and food products that was introduced at the turn of the year were mostly observed in the first couple of months. The 8.3 percent discount in medicine prices, which is realized in July, is expected to help reduce price increases in health sector. Meanwhile, it should be borne in mind that price rigidity in the health sector stem from medical examination and hospital services prices rather than medicine prices.

The PPI, which excludes taxes, moves basically in line with the course of international energy and commodity prices, as well as that of the Turkish lira. Among these indicators, the movements in crude oil prices have an especially significant impact on manufacturing industry prices and thus on producer prices (Graph 2.5). Therefore, any movements in the PPI should be evaluated in the light of such data. The Producer Prices Index declined in June. Despite the sustained rise in crude oil prices, the stable course of Turkish lira along with the decline in agricultural prices, were the determinants of the favorable course of the PPI. Thus, as of June, the annual rate of increase in the PPI became 4.25 percent.



BOX 2.1 IMPACTS OF CRUDE OIL PRICES ON CPI AND PPI IN 2004 AND 2005

International crude oil prices have been surging since the second half of 2004 (Box 2.1. Graph 1). This exerts pressure on domestic prices. This box explains the direct and indirect effects of the rise in international crude oil prices on the CPI and PPI inflation in 2004 and 2005.



The direct effects can clearly be observed in the prices of petroleum products that are directly influenced by international crude oil prices. As illustrated in Graph 2, there is a significant relation between international crude oil prices and the rise in the prices of domestic petroleum products. This relationship is even stronger in case of the PPI that is comprised of prices excluding taxes, as taxes are the main determinants in forming petroleum prices in Turkey. While determining the pump price of oil, the first step is to calculate the ex-refinery price of oil parallel to international crude oil prices and exchange rates. Then, the distribution margin, inland freight and specific Special Consumption Tax are added to the ex-refinery price and when 18 percent VAT is added to this sum, the pump price of oil is reached. Thus, the share of taxes in the pump price of petroleum, namely the Special Consumption Tax plus VAT, is approximately 65-70 percent. The second biggest determinant of the pump price of petroleum after that of taxes is the ex-refinery price which is approximately 25 percent.

While petroleum products within the CPI fall into two main sub-groups as housing and transportation, petroleum products within the PPI come under refined petroleum products of the manufacturing industry. Table 1 shows petroleum products under the CPI and PPI. It is observed that the rise in the prices of petroleum products under the CPI, which stayed close to the rate of increase in international crude oil prices in the January-December 2004 period, remained significantly below the latter in the first seven months of 2005. This development was mostly shaped by the fact that, unlike 2004, the Special Consumption Tax, which is the main determinant of the pump price of petroleum, was raised only moderately in 2005. In fact, the rate of increase in petroleum products prices under the tax-excluded PPI became 26.75 percent in the first seven months of 2005, which is well above the 10.33 percent rise in petroleum products in the CPI. However, undoubtedly, the 10.33 percent rise in petroleum products in CPI in the first seven months is quite high compared to the general CPI trend for the same period and the expected trend required by the end-year target.

Box 2.1. Table 1. Price Increments in Petroleum Products Under CPI and PPI (Percentage Change)

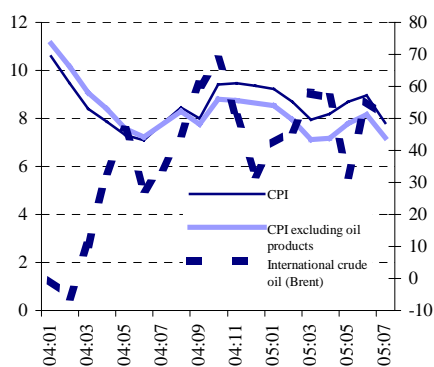
	2004 Jan-Dec	2005 Jan-Jul
CPI	9,35	2,00
Petroleum Products under CPI (Direct Effects)	28,94	10,33
Fuel oil	26,93	18,00
Gasoline	31,02	12,02
Liquid petroleum gas	19,95	6,60
Diesel	32,04	11,37
Motor oils	10,82	3,91
PPI	15,35	1,14
Petroleum Products under PPI (Indirect Effects)	37,98	26,75
Unleaded gasoline	26,05	35,51
Super gasoline	26,49	35,12
Diesel fuel	53,82	19,04
Fuel oil no.6	5,47	68,21
Heating fuel	31,84	29,56
Motor oils	12,77	3,03
Brent (USD/Barrel)	32,65	45,59
USD (Buying Rate)	-2,50	-4,35
Special Consumption Tax (Unleaded Gasoline)	34,54	4,27

Note: Rate of increase of the petroleum products are calculated from prices.

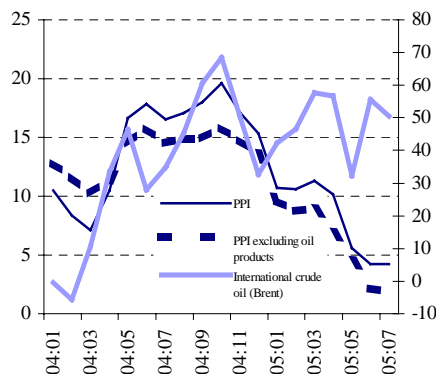
Source: SIS, USA Department of Energy

When we strip the CPI and PPI of the direct effects of crude oil prices, in other words, when we exclude petroleum products from these indices, we come up with a rather lower rate of increase in both indices, especially as of the second half of 2004 which was marked with the acceleration of crude oil prices (Box 2.1. Graph 3.4). Having said that, the trend of the annual rate of increase in the CPI is seen to be unrelated to crude oil prices.

Box 2.1. Graph 3. CPI and CPI Excluding Direct Effects (Annual Percentage Change)



Box 2.1. Graph 4. PPI and PPI Excluding Direct Effects (Annual Percentage Change)



Direct effects constitute only a small part of the overall effects of international crude oil prices on inflation. Most of the effects are indirect. Indirect effects emerge as international crude oil prices affect input costs and expectations, and through this channel, also the prices of goods other than petroleum products are affected. The indirect effects are expected to appear first in the sectors in which petroleum products are intensely used as input and then gradually spread to other sectors that use petroleum products at a lower rate, as input. Finally, the indirect effects lead to a rise in the general inflation level, which in turn spreads to all sectors through expectations.

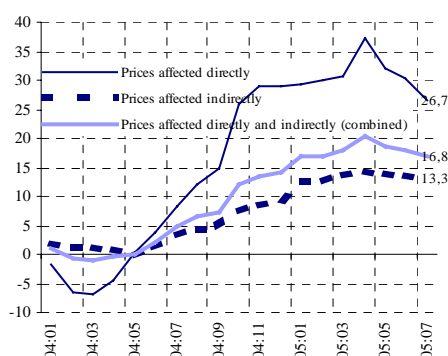
With the aim of gaining a rough idea about the primary indirect effects, a method has been employed which excludes the prices of sectors that used petroleum products most intensely from the general indices. However, it was then realized that this exclusion method would not be suitable for calculating the primary indirect effects on the PPI. This is due to the fact that petrochemical products, which are directly affected by petroleum prices and widely used as a major input for the whole manufacturing industry, are spread over several sub-sectors of the industry. The CPI groups, in which the primary indirect effects can be traced, have been selected by using the data provided by the input-output table of 1996 and judgement. The subject items are shown in Table 2.

Box 2.1. Table 2. Sectors Using Petroleum Products Most Intensely as Input Under the CPI(Percentage Change)

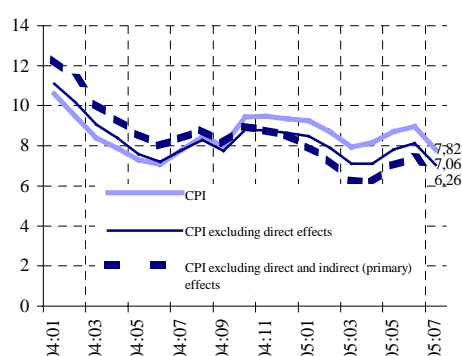
	2004 Jan-Dec	2005 Jan-Jul
CPI, Indirect Effects (Primary)	9,26	9,25
Electricity	0,19	0,13
Gas	15,26	13,21
Passenger transportation via railway	12,29	14,79
Passenger transportation via overland	10,59	12,31
Passenger transportation via airway	-13,90	7,78
Passenger transportation via sea	-14,02	-0,86
Fright services	22,44	12,70
Postal services	14,29	-4,73
Package tours	19,23	12,85

We have obtained an index by merging the items in Table 2 to see the prices that are the first to be indirectly affected from the international crude oil prices. It is observed that the annual rate of increase for the index has been rising regularly since January 2004, however it is also observed that this rise is below that of the directly affected prices (Box 2.1. Graph 5).

Box 2.1 Graph 5. Prices Affected Directly and Indirectly (Primary) by Crude Oil Prices (Annual Percentage Change)



Box 2.1 Graph 6. CPI and CPI Excluding Direct and Indirect Effects (Annual Percentage Change)



According to these calculations, the direct and primary indirect effects of international crude oil prices on annual CPI inflation were 0.81 percentage points in 2004. As of July 2005, the mentioned effects are seen to have pushed annual inflation up by 1.56 percentage points (Table 3). When input costs in other sectors and the effect of expectations are taken into account, the effect of international crude oil prices on inflation is projected to become even stronger. However, it is believed that the effect of expectations was not at a level that could affect the pricing behaviour in all sectors, for the past year.

Box 2.1. Table 3: The Influence of Direct and Primary Indirect Effects on CPI Inflation Last Year

	2004 July- 2005 July	
	Percentage Change	Contribution to Inflation
Direct effects	24,60	0,76
Indirect effects (primary)	13,27	0,67
Direct and Indirect effects (primary)	16,24	1,56

NOTE: The reported contributions are calculated by subtracting the rate of increase in indices excluding direct/indirect effects from the CPI inflation, ie, for direct effects, the contribution to inflation is 7,82-7,06=0,76 points.

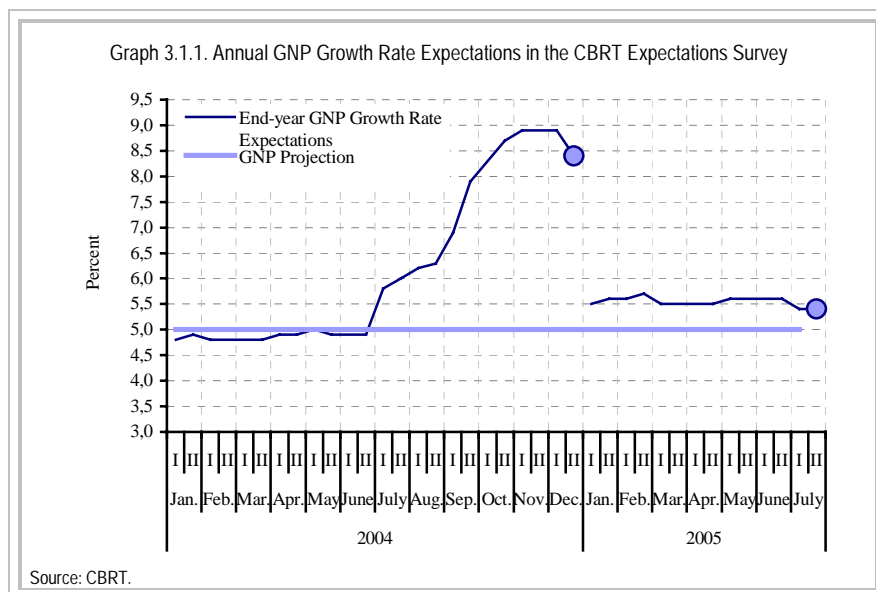
3. Supply and Demand Developments

3.1. Supply and Demand Balance

In the first quarter of 2005, the Turkish economy continued to grow and the GNP increased by 5.3 percent compared to the same period last year. In the first quarter, private expenditures became the main determinant of economic growth, while the positive contribution of public expenditures continued, as it did in the last quarter of 2004. During this period, the composition of demand and production changed compared to the previous year, and developments in the construction sector became preeminent in terms of both expenditures and production sides. Among the subgroups of the services sector, the construction sector was the one whose value added increased at the highest rate. Along with this, both private and public investment expenditures on construction increased.

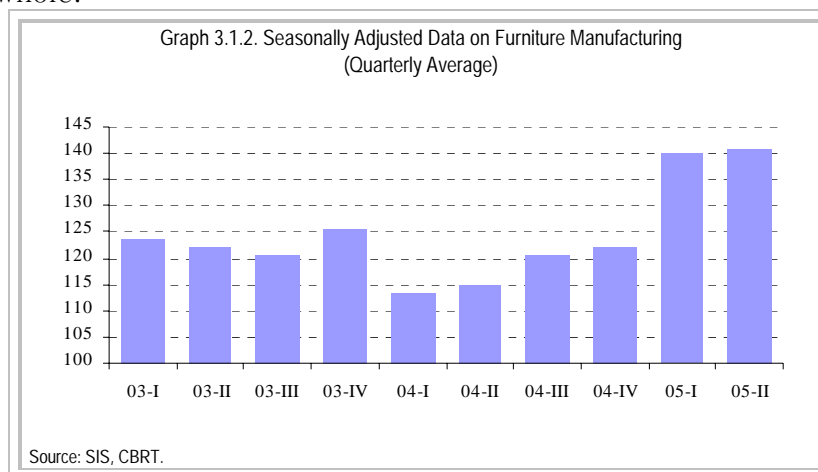
In the first quarter of 2005, the GNP increased at a slower pace compared to the same period of the previous year. However, this does not indicate a parallel slowdown in domestic demand and economic activity. This development stemmed from the high base effect created by the recovery in domestic demand that gained pace in the first half of 2004. The base effect is expected to be even more powerful in the second quarter and thus to limit annual growth rates. It is anticipated that in line with the decline of interest rates in the first half of 2005, domestic demand may gain pace in the second half and removal of the base effect in the second half may allow relatively higher rates of growth. In this respect, the end-year growth projection of 5 percent seems achievable. In the Expectations Survey of the CBRT, the end-year GNP growth expectation for 2005 became 5.4 percent in the second survey period of July (Graph 3.1.1).

In the first quarter of 2005, the GNP increased at a slower pace compared to the same period of the previous year. However, this slowdown does not indicate a parallel slowdown in domestic demand and economic activity.



Industrial production developments in the April–May 2005 period and expectations for June show that increases in production continued in the second quarter of the year. However, the strengthening base effect exerted pressure on annual growth rates during this period. Seasonally adjusted data show that industrial production nevertheless increased at a limited rate in the second quarter of the year compared to the previous period. Therefore, economic activity did not record any slowdown during this period. According to the data in the Monthly Industrial Production Index of the State Institute of Statistics (SIS), total industrial production increased by 5.0 percent in the January–May period compared to the same period of 2004. An analysis of sectoral developments shows that production increases generally stemmed from the activities of sectors producing intermediate and capital goods. In this framework, the main sectors fueling the growth of industrial production were those related to the production of chemicals, plastic–rubber, other non–metallic mineral substances, basic metal, metal goods, motor vehicles and furniture. As emphasized in previous reports, the increase in the production of investment goods is a favorable development in terms of both confidence in the economy and the relationship between production and inflation. Meanwhile, the recovery in the furniture–manufacturing sector observed since the beginning of 2005, which is considered to be an indicator of movements in consumption demand, is outstanding in terms of demand developments (Graph 3.1.2). However, the deceleration in the rate of increase in the production in this sector during the second quarter of 2005 compared to the first quarter stands as a factor that alleviates concerns about demand. In addition, developments in other sectors producing final

goods signal that the growth in demand continues but does not necessarily point to an excessive recovery in demand in the economy as a whole.



The revival in the construction sector significantly contributed to the increase in industrial production in the first five months of the year through the sectors that provide input to this sector, particularly the other non-metallic mineral substances sector. Hence, imports of iron, steel and cement increased rapidly during this period. However, the contraction in the sectors that manufacture final goods such as clothing, textile and leather articles restrained growth in industrial production. In the meantime, according to data released by the SIS, the capacity utilization rate in the manufacturing industry was recorded as 79.5 percent in the January–June 2005 period. It is observed that the level of the capacity utilization rates does not impose any pressure on prices in the manufacturing industry as a whole as well as in its subgroups.

Table 3.1.1. GDP Developments by Expenditure Side
(Annual percentage change)

	2004				2005	
	Annual	I	II	III	IV	Annual
1- Consumption Expenditures	5.6	11.6	15.4	5.9	4.7	9.0
Public	-2.4	2.6	-7.8	-7.0	11.1	0.5
Private	6.6	12.4	18.4	7.3	3.6	10.1
Durable Goods	24.0	48.0	61.4	28.9	-5.7	29.7
Services	7.5	11.6	15.3	6.1	6.6	9.3
Food and beverages	4.1	5.3	2.6	0.0	5.4	2.8
Semi-dur.& Non-dur. Cons. Exp.	2.1	8.2	36.8	18.3	16.3	18.8
2- Fixed Capital Formation	10.0	57.6	47.4	26.1	11.2	32.4
Public	-11.5	-5.9	-8.7	-10.8	0.9	-4.7
Private	20.3	65.5	63.1	38.9	17.7	45.5
3- Stock Change*	3.0	2.5	1.4	-1.2	2.5	1.1
4- Exports of Goods and Services	16.0	10.9	17.2	8.2	14.4	12.5
5- Imports of Goods and Services	27.1	31.3	32.7	16.1	19.6	24.7
6- Total Domestic Demand	9.3	20.6	21.4	8.1	8.5	14.1
7- Total Final Domestic Demand	6.5	19.8	22.9	9.9	6.3	14.1
8- GDP (Expenditure Side)	5.8	11.8	14.4	5.3	6.3	9.0

*Contribution to GDP growth, percent

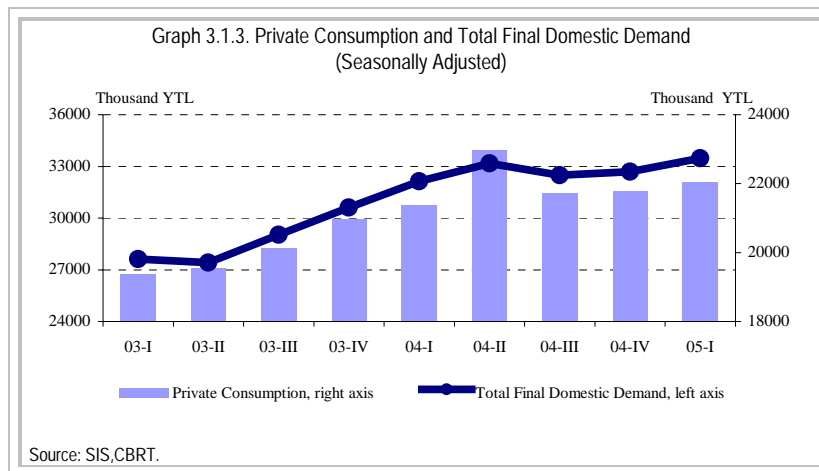
Source: SIS.

Analyzing the economic growth from the demand side, it is observed that durable goods expenditures and private machinery–equipment investment expenditures, which were among the leading sectors in

growth during the first nine months of 2004, displayed a slight increase in the first quarter of 2005. Meanwhile, expenditures on semi-durables and non-durables as well as investment expenditures on construction became the leading expenditure groups in domestic demand (Table 3.1.1). Moreover, the contribution to growth by public expenditures points to a change in the composition of domestic demand in this period.

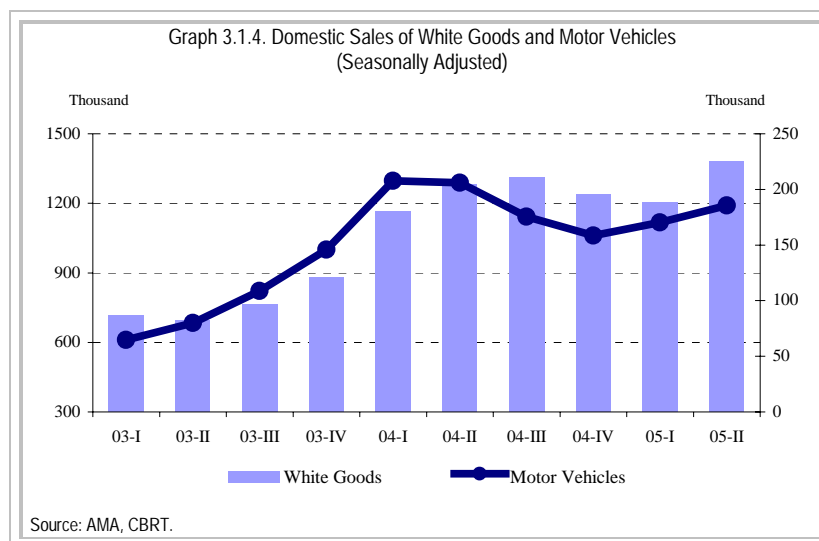
While seasonally adjusted data do not point to any slowdown in domestic demand, they reveal that the decreases in annual growth rates resulted from the high base effect observed in the same period of the previous year.

According to data for the first quarter of 2005, annual growth rates of domestic demand were lower than those of 2004. Nevertheless, the seasonally adjusted series should be carefully analyzed in interpreting the latest developments in domestic demand. As a matter of fact, while the said data do not point to any slowdown in domestic demand, they reveal that the decreases in annual growth rates resulted from the high base effect observed in the same period of the previous year. Analyzing the seasonally adjusted data of selected expenditure groups, it is observed that domestic demand, which decreased in the third quarter of 2004 due to restrictive measures, started to reincrease following the specified period. According to quarter-on-quarter growth rates, private consumption expenditures and total final domestic demand grew rapidly in the first quarter of 2005 compared to the previous period (Graph 3.1.3). Demand for durable goods also increased rapidly during the same period. Similarly, seasonally adjusted data on private investment, private machinery-equipment investment and total investment expenditures also indicate that investment demand gained momentum in the first quarter of 2005 compared to the previous period. Hence, these data reveal that the decrease in annual growth rates of domestic demand components creates the illusion of a slowdown in domestic demand.



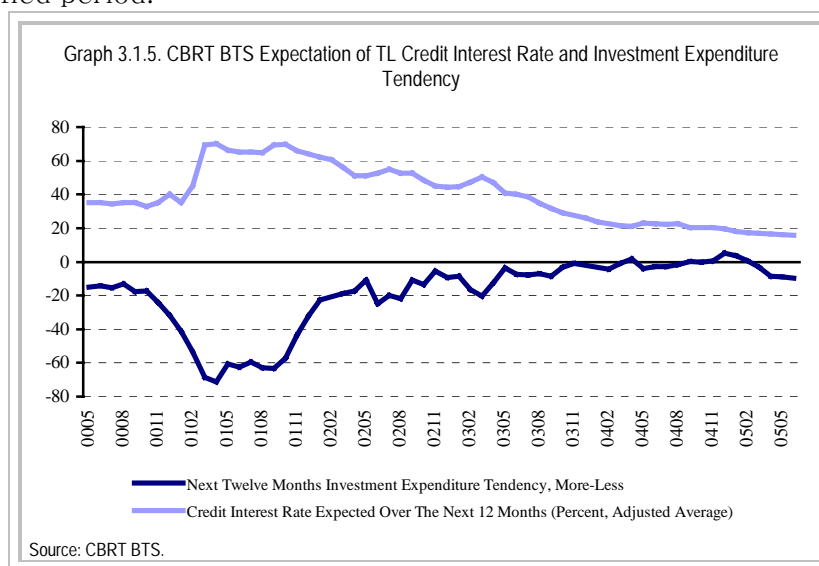
Information indicating that domestic demand increased in the first quarter of 2005 compared to the previous period reinforces the significance of the data for the second quarter. According to data announced by the Automotive Manufacturers Association (AMA), domestic sales of motor vehicles decreased by 13.6 percent in the April–June 2005 period compared to the same period of the previous year. During the same period, domestic sales of white goods rose by 8 percent compared to the same period of 2004. Seasonally adjusted domestic sales of motor vehicles continued to increase rapidly in the second quarter of the year. Following the abatement of scrap discount in the first quarter, automobile sales rapidly increased again in the second quarter of the year. Similarly, domestic sales of white goods also accelerated in the second quarter (Graph 3.1.4). All these data indicate that demand for durable goods increased in the second quarter of 2005 compared to the previous period. Yet, it would not be surprising if annual growth rates remained limited in this period due to the high base effect observed in the same period of last year.

In the second quarter of 2005, the demand for durable goods increased compared to the previous period. However, the high base effect observed in the same period of 2004 will limit annual growth rates during this period.



The increases in investment expenditures, which enable concurrent sustainability of the downward trend in inflation and rapid economic growth, continued in the first quarter of 2005. However, in contrast to last year, construction sector investments became the main determinant of gross fixed capital formation in this period. Private sector and public sector construction investments contributed to the 6.9 percent–growth in the total gross fixed capital formation– by 3.6 and 1.8 points, respectively. Meanwhile, the year–on–year growth rate of machinery–equipment investments in the private sector was quite low in the first

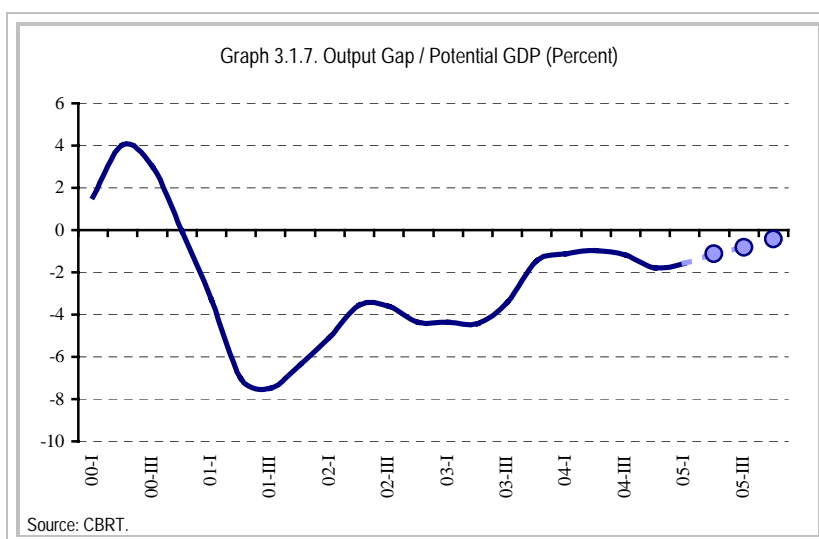
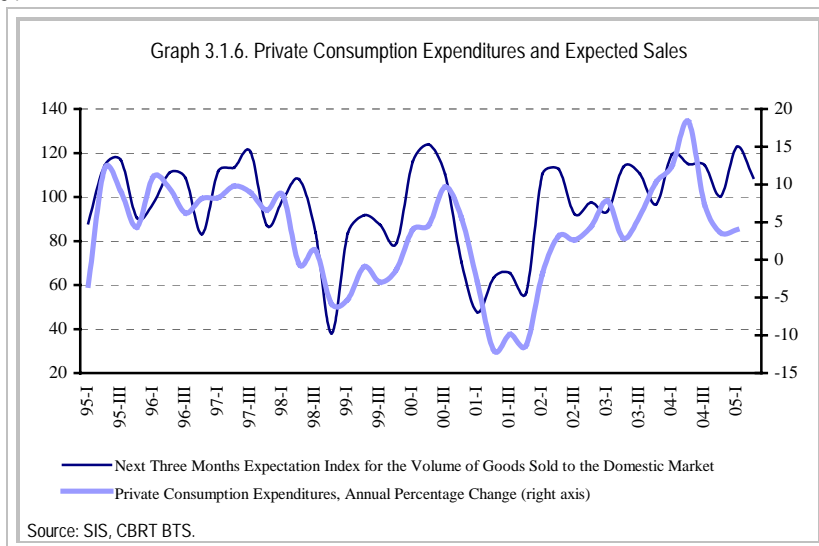
quarter of the year. However, seasonally adjusted data show that machinery–equipment investments, which decreased in the second half of 2004, started to increase in the first quarter of 2005. Seasonally adjusted data on private sector and total fixed capital formation covering both machinery–equipment and construction investments point out that these expenditures display a recovery process following the downward trend observed in the third quarter of 2004. The rapid increase in these expenditures observed during the first quarter of 2005 manifests the fact that investment demand did not decelerate in the specified period.



The situation is more or less the same for seasonally adjusted data on domestic sales of commercial vehicles, one of the indicators for the second quarter of 2005. In this context, it is observed that domestic demand for the afore–mentioned goods has been going up since the last quarter of 2004. The increase in domestic sales of commercial vehicles observed in the second half of 2005 is a positive indicator of investment expenditures. Developments in imports of capital goods pertaining to the April–May period also support this trend. During the same period, however, imports of machinery–equipment decreased compared to the first quarter of the year. Meanwhile, production increases in sectors providing intermediate input to the construction sector indicate that construction investments continued in the second quarter of the year. On the other hand, despite the recently observed decline, the investment tendency, one of the indicators in the CBRT BTS, maintains its historically high level, which can be considered as a favorable development in terms of investor confidence (Graph 3.1.5). An overall evaluation of current indicators shows that investment demand also

An overall evaluation of current indicators shows that investment demand also accelerated in the second quarter of the year compared to the previous period.

accelerated in the second quarter of the year compared to the previous period.



In light of this information, the increase in the total final domestic demand is believed to have continued in the second quarter of 2005. The level of domestic sales expectations of manufacturing industry firms for the next quarter, as registered in the first quarter of 2005, also supports this belief (Graph 3.1.6). However, the course of the said indicator in the second quarter of the year signals that domestic demand is not at such an alarming level in the third quarter of the year. Moreover, projections indicate that the output gap will continue to narrow and production will converge to its potential level towards the end of 2005 (Graph 3.1.7).

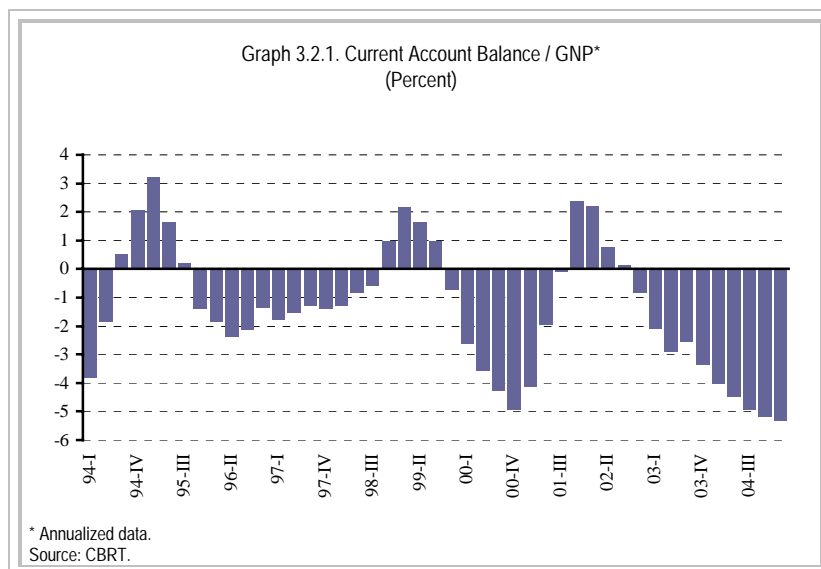
While evaluating these developments, it should be kept in mind that demand growth is inevitable in a growing economy and it is the supply and demand balance that is crucial for inflation developments. Current information also signals that domestic demand continues to increase, but in a controlled manner. In other words, there is no “excessive” recovery in domestic demand that would threaten the disinflation process. Meanwhile, developments about external demand, the other component of total demand, show that the slowdown of the growth in industrial exports, which has been persistent since the start of 2005, became evident in June. Therefore, it is believed that current demand conditions will not exert any pressure on prices “in the short run”. However, demand developments are being carefully monitored with a “medium-term” perspective that takes the 2006 inflation target into account. The continuance of current trends in domestic and external demand in the following period as well will indicate that concerns leading to the cautious stance of the Central Bank regarding demand will ease.

Analyzing national accounts pertaining to the first quarter of 2005, another development closely related to the disinflation process is the positive contribution of public expenditures to economic growth. It is important to avoid making concessions in matters of fiscal discipline, the main pillar of the current macroeconomic program, while supporting economic growth with significant increases in public expenditures. Recent consolidated budget and total public budget figures show that everything is on track concerning the budget targets for 2005. However, considering that a considerable proportion of planned expenditures will be realized towards the end of the year, favorable developments in the first half of the year do not guarantee a parallel development in the upcoming period. It should be kept in mind that undisciplined increases in public expenditures that are inconsistent with budget targets would hinder the efforts to ease fiscal dominance. Otherwise, the effectiveness of monetary policy will diminish and it will become inadequate in the fight against inflation.

3.2. External Demand

In the first quarter of 2005, the current account balance produced a deficit of US dollar 6.3 billion. Analyzing in terms of annualized data, the ratio of the current account deficit to GNP was realized as 5.3 percent in the period between March 2004 and March 2005 (Graph 3.2.1). At the

same time, adding the current account deficit of US dollar 4.8 billion in April and May, brought the current account deficit to US dollar 11.1 billion by the end of the first five months of 2005.



According to data released by the SIS, exports increased by 22.1 percent in the first five months of 2005 compared to the same period of 2004. Data from the Turkish Exporters' Assembly (TEA) indicate that exports increased by 11.7 percent in June. The low level of real unit wages is influential in the continuance of increases in exports.

However, recent data signal a slowdown in external demand. This development is attributed to the low rate of growth in the Euro area that has an important share in our exports, and the adverse effects of the rise in oil prices in the international markets on global growth as well as increased competition in international markets caused by the increased opening of the Chinese economy. If this trend in external demand continues in the upcoming period, inflationary pressures due to the total demand for domestic goods will decrease.

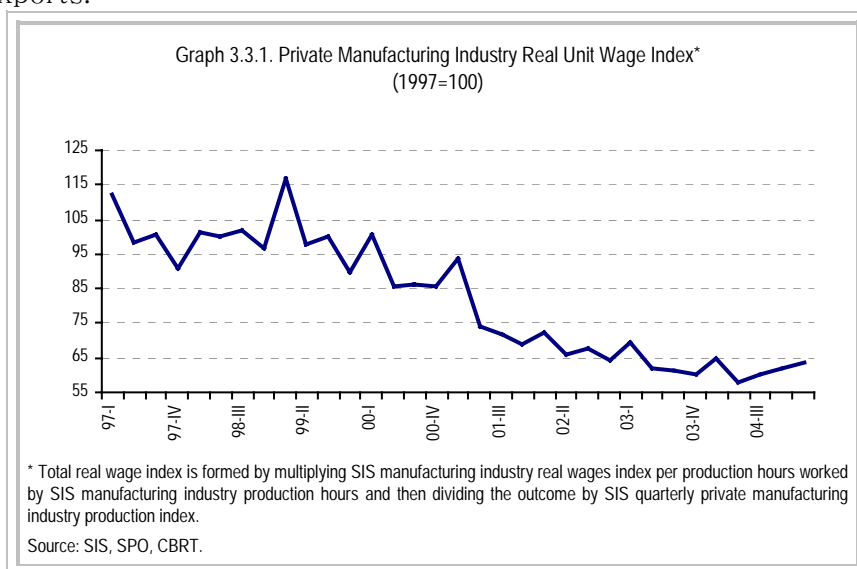
In the first five months of 2005, imports increased by 22.3 percent. This increase mainly stemmed from imports of intermediary goods. The rate of increase in imports of intermediary goods was 28.9 percent, while imports of capital goods and consumption goods grew by 13.9 percent and 2.2 percent, respectively. Data announced by the Ministry of Finance pertaining to VAT on imports show that the increase in imports also continued in June. Analyzing balance of payments developments in terms of financing, the upward trend in direct foreign capital

investments and long-term credit utilization not only points to an improvement in the quality of financing current account deficit, but also eases concerns about the sustainability of the current account deficit.

3.3. Costs

In the first quarter of 2005, employment in the manufacturing sector increased by 1.4 percent compared to the same period of the previous year, stemming from employment in the private sector. As a result of the efforts to boost productivity in the public sector, employment in the public manufacturing industry decreased considerably compared to the same period of the previous year. During the same period, indices of real wage per working hour and productivity per working hour increased by 3.8 percent and 5.8 percent, respectively (Table 3.3.1).

The real unit wage index, expressed as the ratio of real wages in the private manufacturing industry to partial labor productivity, dropped by 1.5 points compared to the same period of the previous year (Graph 3.3.1). This favorable development in real unit wages not only reduced cost pressures on prices, but also enabled the continuity of performance in exports.



Data for April and May indicate that the annual rate of growth in manufacturing industry production will quite be low in the second quarter of 2005. As long as the rises in employment continue, there will not be high productivity increases in the manufacturing industry. In the meantime, the rise in employment leads to an increase in domestic demand by increasing the disposable income. Under these

circumstances, it is very important that wage increases are determined in the light of the inflation target in order to prevent cost and demand pressures on prices.

Public wage policy is of a signal nature to the public about fiscal discipline and directly influences expectations about the continuity of the economic program. Besides, it also affects price expectations and may form a reference for the wage policy of the private sector. Hence, public wage policy is an important factor that should be taken seriously in terms of medium-term inflation. Throughout 2005, civil servants' and workers' wages in the public sector increased by an average of 11 percent and 13.8 percent, respectively. In the upcoming period, the consistency of public wage increases with the inflation target will be of great significance. The collective bargaining framework agreement protocol signed in July shows that future rises in the wages of public sector workers in 2006 will be consistent with the inflation target.¹

Table 3.3.1. Employment, Real Wage and Productivity Developments in the Manufacturing Industry
(Percentage change over the same period of the previous year)

	2003		2004				2005	
	Annual	I	II	III	IV	Annual	I	
Employment⁽¹⁾	1,8	0,7	2,7	2,2	2,2	2,0	1,4	
Public	-6,8	-13,6	-11,0	-9,6	-9,7	-11,0	-12,2	
Private	3,1	2,4	4,5	3,7	3,6	3,6	2,7	
Wages⁽²⁾	-1,9	0,2	5,1	3,4	1,6	2,5	3,8	
Public	-5,3	2,9	7,7	5,6	2,9	4,7	13,2	
Private	0,6	2,5	7,5	5,3	3,9	4,8	3,9	
Productivity⁽³⁾	7,2	8,5	13,6	6,4	1,6	7,3	5,8	
Public	8,1	14,8	13,1	5,6	8,5	10,5	13,3	
Private	7,9	9,0	15,0	7,6	1,2	8,0	6,4	
Earnings⁽⁴⁾	-6,3	-0,6	3,7	1,5	-0,5	1,3	3,2	
Public	-5,6	-0,6	9,2	1,2	2,5	3,2	10,9	
Private	-4,7	2,6	5,8	4,6	2,3	4,3	3,4	

(1) SIS, Manufacturing industry production worker index, 1997=100
(2) SIS, Manufacturing industry real wages index per production hours worked, 1997=100
(3) SIS, Manufacturing industry partial productivity index per production hours worked, 1997=100
(4) SIS, Manufacturing industry real earnings index per production worker, 1997=100

Another cost factor that may pose a risk to prices is that of basic input prices, such as oil and metal prices that maintain their upward trend in international markets (Table 3.3.2). The strong position of the Turkish lira vis-à-vis foreign currencies alleviates the influence of the increases in input prices in domestic markets. Meanwhile, the increase in oil prices was partially reflected in the domestic markets in June. The significant share of taxes in prices of petroleum products shows that fiscal discipline is also influential on prices at this point. As a matter of fact, structural reforms to be effected on public revenues and expenditures will prevent the reflection of fluctuations in oil prices on

¹ According to the protocol signed in July 2005, wages of the public sector workers will be increased by 3 percent in the first and second halves of the second Agreement Year. However, if the CPI exceeds the increase rates in the said periods, 80 percent of the difference in increase will be reflected on wages in the first half while the whole difference will be paid in the second half.

prices in domestic markets via changes in tax rates, without leading to any deviation from the primary surplus target. However, in all conditions, exogenous shocks, such as an increase in oil prices, will continue to pose risks to inflation.

Table 3.3.2. Selected Indicators of Production Costs

	2003		2004				2005	
	Annual	I	II	III	IV	Annual	I	II
Import Price Index	100,0	111,4	112,7	116,6	123,3	116,0	125,4	125,7 ⁽¹⁾
Crude Oil Prices (\$/Barrel)	27,0	30,0	32,0	36,7	39,6	34,6	41,7	48,0 ⁽²⁾
Metal Prices Index	98,2	130,0	130,2	133,8	141,9	134,0	153,2	163,0 ⁽¹⁾

(1) April-May.

(2) May and June figures are forecasted figures.

Source: SIS, SPO, IFS.

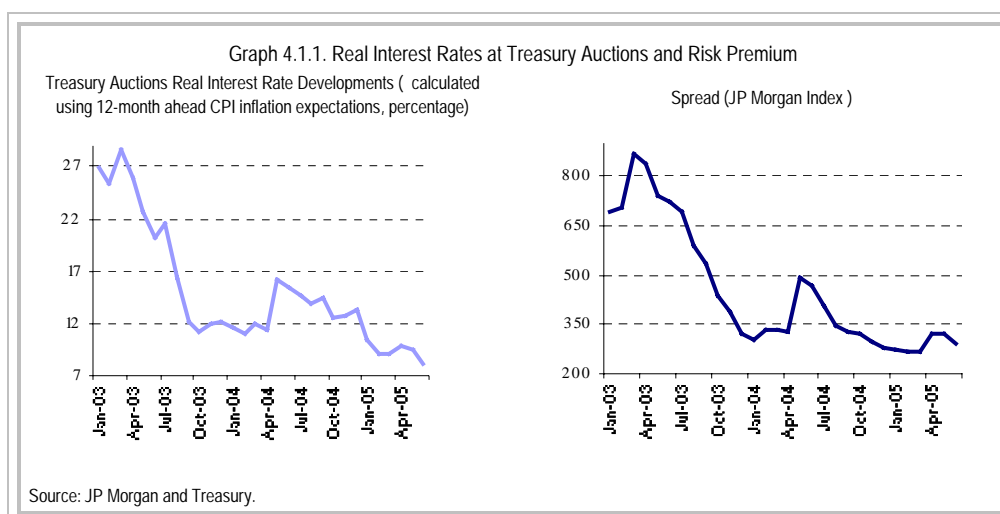
4. Developments in Financial Markets and Monetary Policy

4.1. Developments in Financial Markets

As it is the case in many developing countries, developments in money, capital and foreign exchange markets in Turkey are mainly influenced by expectations. As for expectations, they are shaped in line with the national economic and political agenda and policies as well as relations with international institutions, and developments in international markets. More specifically, the factors currently influencing expectations are: developments pertaining to Turkey's accession to the European Union (EU), the implementation of macroeconomic policy and maintaining fiscal discipline and carrying out the structural reforms that altogether form the focal point of the reviews with the International Monetary Fund (IMF), monetary policy decisions of the USA and the EU, the course of international liquidity conditions and oil prices.

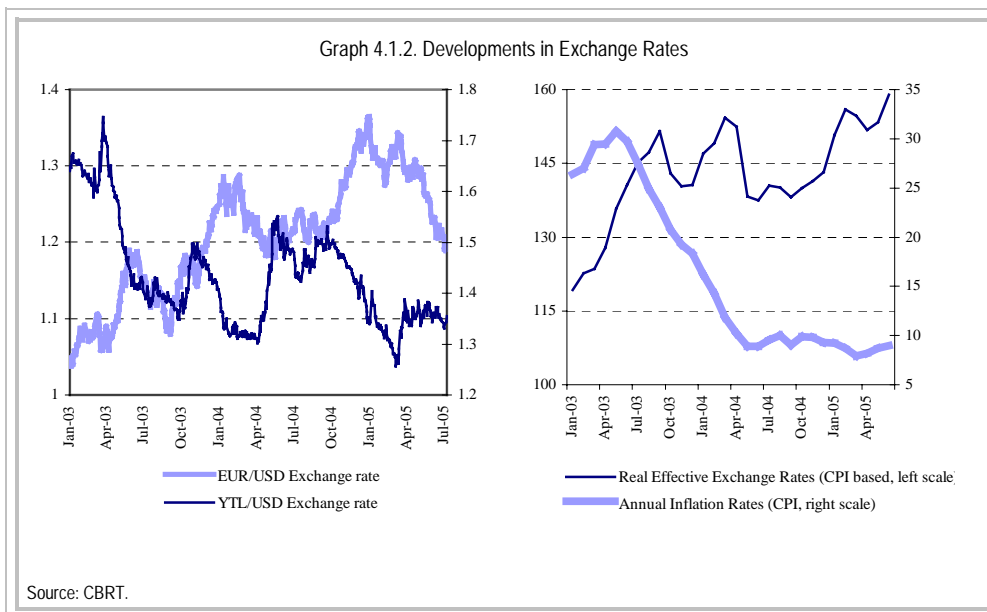
The Turkish economy has made a considerable progress towards financial stability thanks to the policies implemented and structural reforms put in place within the framework of restructuring efforts, especially in the banking sector. The initial result of these steps has been a downward trend in nominal and real interest rates, although they still remain high. Moreover, the yield spread calculated as the difference between the interest rates applicable to government securities issued abroad and benchmark US bonds with the same maturity, which is also the risk premium indicator for the country, has narrowed (Graph 4.1.1).

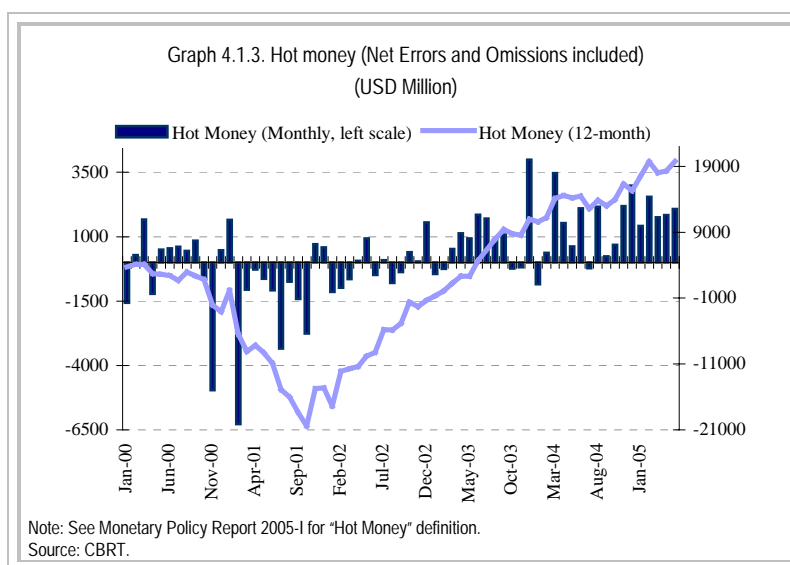
The Turkish economy has made a considerable progress towards financial stability.



As for developments in the foreign exchange markets, it is observed that the appreciation of New Turkish lira, which started in the last quarter in 2004, continues (Graph 4.1.2). Short-term capital inflows and residents' portfolio preferences changing in favor of New Turkish lira played an important role in determining the value of New Turkish lira in the short run (Graph 4.1.3). Capital inflows and portfolio preferences are influenced in the short-run, by a decline in the risk premium due to determined implementation of the economic program and positive expectations about debt sustainability, expectations about the sustainability of the current account deficit, developments in international markets and the actions of market players. Within this framework, economic improvement thanks to the favorable developments in inflation and growth performance and international liquidity conditions favoring developing countries have played an important role in the appreciation of New Turkish lira in the first half of 2005. Moreover, relations with the IMF and unfavorable political and economic developments within the EU were not considered negative by the market players as per their effects on Turkey's accession to the EU. These factors, coupled with the belief that the quality of the financing of the current account deficit has been increasing, helped sustain the positive expectations and thus, supported the appreciation of the New Turkish lira.

The appreciation of Turkish lira, which started in the last quarter of 2004, continues.



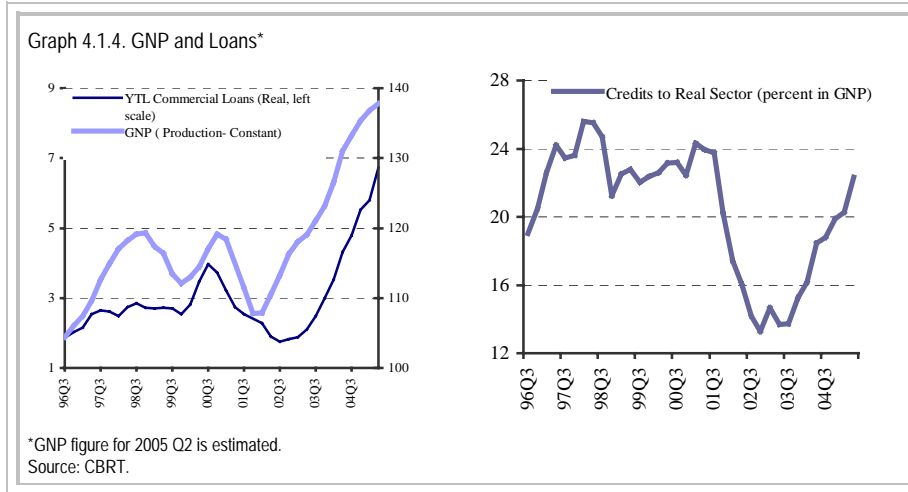


The factors affecting the value of New Turkish lira in the medium and long-run are: the continuity of structural reforms and the effect of this on productivity, the net foreign debt position of the country, the business cycles of the economy, developments in fundamental economic variables such as inflation and growth, long-term capital movements and direct foreign investments influenced by improved investment environment and sustained economic stability.

The CBT closely monitors any volatility or developments that might lead to volatility in exchange rates. Thereby, the Central Bank directly intervened in the foreign exchange market through FX purchases four times between January-July 2005. The FX buying auctions aiming at building up reserves are regularly held as outlined in the Press Release on Monetary and Exchange Rate Policy for 2005. According to the data released in mid-July, the FX reserves of the Central Bank have reached almost USD 40 billion.

The banking sector and credit developments provide important information on the continuity of financial stability and the future trend of inflation. In the first half of 2005, banks' credit volumes continued to increase, in particular for housing credits. As the public sector borrowed less from the banking sector and interest margins narrowed due to the successful maintenance of budgetary discipline, banks increased consumer loans in order to protect their profitability (Graph 4.1.4). By doing so, banks aim to increase their operational incomes by

expanding their customer bases. The increase in the amount of credit, which is mainly granted by private and foreign banks, affects private investments on one hand and private consumption on the other.



In upcoming periods, further increases are expected in the credit volume as a result of the continuity of excess liquidity in the markets, which especially stems from FX purchases of the Central Bank and the decline in real interest rates. From a medium-term perspective, the Central Bank closely monitors the growth rate of overall credits granted by the banking sector as a whole, especially the housing credits (Table 4.1.1, Table 4.1.2).

The Central Bank closely monitors the growth rate of overall credits granted by the banking sector as a whole, especially the housing credits.

	2004Q2	2004Q3	2004Q4	2005Q1	2005Q2
Consumer Loans	33.1	7.7	4.0	17.6	23.4
Housing Loans	51.1	12.4	9.1	33.7	61.9
Automobile Loans	34.3	4.5	0.7	-0.7	11.7
Other Loans	26.2	8.3	4.4	23.8	11.7
Credit Cards	21.6	14.6	25.5	-2.4	8.4

Source: CBRT.

Table 4.1.2. Developments of Consumer Loans (in Banking Groups)
(Monthly Nominal Percentage Change)

	Consumer Loans	Public Banks	Private Banks	Foreign Banks
December 2004	4.1	2.1	4.6	7.8
January 2005	1.0	-0.9	1.7	3.3
February 2005	10.9	26.3	3.3	6.5
March 2005	5.8	2.0	7.8	9.7
April 2005	9.5	5.7	11.6	11.2
May 2005	6.8	3.9	8.7	5.7
June 2005	7.4	3.6	9.1	9.7

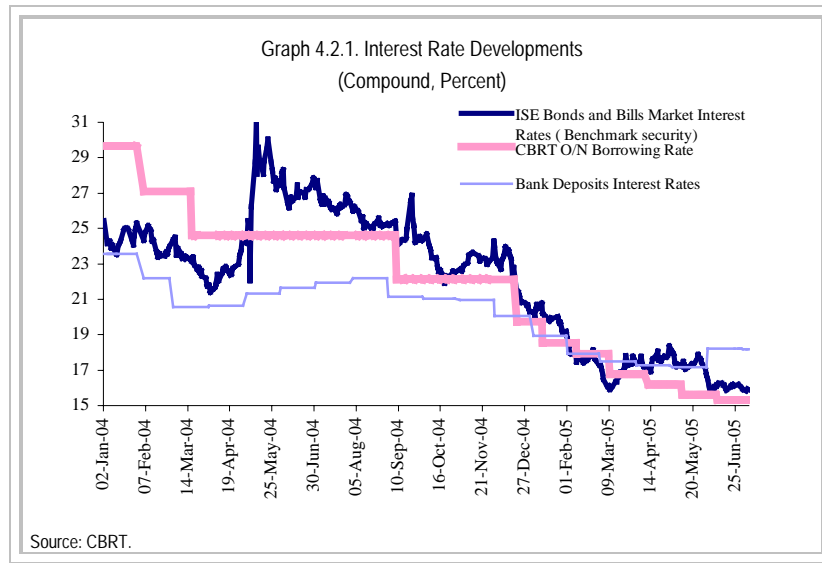
Source: CBRT.

As required by the current economic program, monetary indicators, as well as credit aggregates, are closely monitored by the Central Bank. In the first half of 2005, the increase in cash demand seems to support the recovery tendency in economic activities. Yet, the realization for Base Money, which became a performance criterion for end-June 2005, with the Letter of Intent dated 26 April 2005, remained below the set ceiling.

4.2. Monetary Policy

The Central Bank conducted its monetary policy with a medium-term perspective, in accordance with its primary objective of price stability also in the second quarter of 2005. While making monetary policy decisions, the CBRT analyses developments in capital, money and FX markets, as well as macroeconomic data on inflation, total supply-demand equilibrium and productivity-employment-wage-unit cost, public and private sector pricing behavior, fiscal discipline indicators, inflation expectations and risk factors that might be encountered as a result of potential exogenous shocks to be caused by developments in international markets. The stance of monetary policy is shaped by the information on the future course of inflation, included in the data set used in such analysis. In this framework, the Central Bank underlined the factors, which may pose a risk to inflation in the medium term, in its April-May-June “Inflation and Outlook” reports and adopted an “optimistic - cautious” approach in its interest rate decisions. Nevertheless, the data that became available as of end-June pointed to a slow-down in the disinflation process and necessitated the adoption of a “cautious” stance towards the inflation figures of 2006. In this context, and in light of the evaluations made at the Monetary Policy Committee in July, the Central Bank did not make any changes in interest rates and held overnight borrowing rates unchanged at 14.25 percent (Graph 4.2.1).

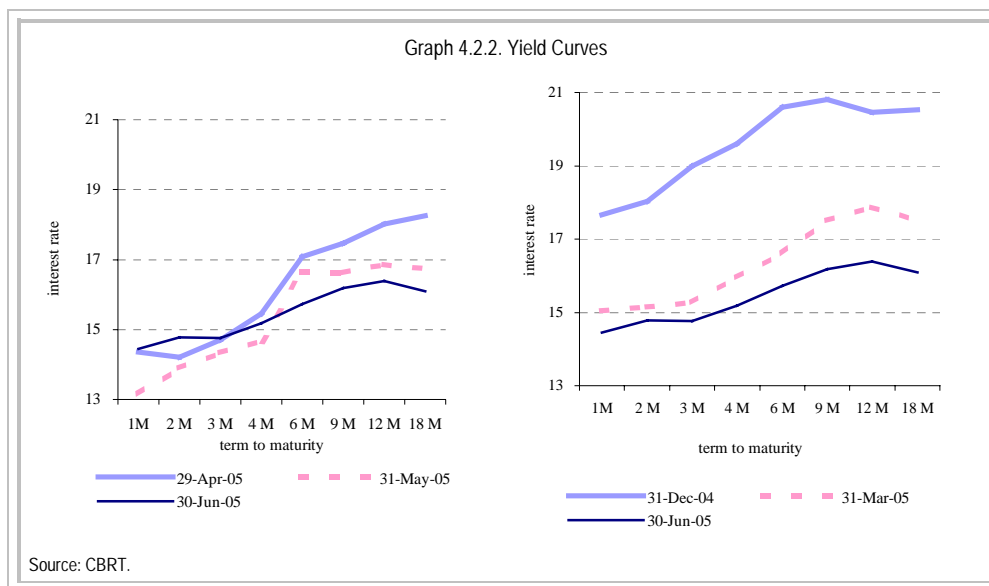
The Central Bank conducted its monetary policy with a medium-term perspective, in accordance with its primary objective of price stability.



The effect of monetary policy on inflation depends on the power of the Central Bank to influence medium and long-term interest rates by using short-term interest rates. This, in turn, is closely related to macroeconomic stability and the credibility of monetary policy implementations. This process may become even more complex in economies where fiscal dominance exists. In this framework, when the relationship between market interest rates and Central Bank interest rates are analyzed, it is observed that benchmark government securities yields and average interest rates on deposits move in the same direction with the Central Bank interest rate owing to the atmosphere of confidence. To be more precise, under the assumption that there would be no uncertainties or instabilities to prevent the Central Bank from achieving the inflation target, market interest rates are also observed to decline following the decision of the Central Bank to cut interest rates. Yet, the relatively high and volatile risk premium in Turkey may lead to upward deviations from the Central Bank interest rates even with developments of temporary nature, which would normally hinder neither the implementation of the economic program, nor the achievement of the inflation target. In this context, it is clear that the general level of interest rates in the economy is not determined merely by the interest rate decisions of the Central Bank. This argument is especially supported by the fact that the average interest rates on deposits have been higher than Central Bank interest rates since the first quarter of 2005 (Graph 4.2.1).

A closer look at the yield curves in the second quarter of 2005 would clearly show the impact of national and international factors on risk perceptions. Although interest rates in the short, medium and long-term shifted downwards following the interest rate cuts of the Central Bank in April and May, yield curves became more vertical compared to March due to the increase in risk premium. During this period, concerns regarding the membership process of Turkey, which increased due to political developments in the EU, played a significant role in the increase in risk premium. Perception of such developments as temporary enabled a decline in the risk premium as of end-June, as well as a fall in the longer-term interest rates and the yield curves to take a relatively horizontal shape. However, persisting uncertainties in the short run caused short-term market interest rates to be higher compared to previous months as of end-June, despite the interest rate cuts of the Central Bank. This development is significant in that it shows Central Bank interest rate cuts alone are not sufficient to reduce market interest rates (Graph 4.2.2).

Perceiving national and international developments influential in risk perceptions as temporary enabled end-June yield curves to take a relatively horizontal shape.



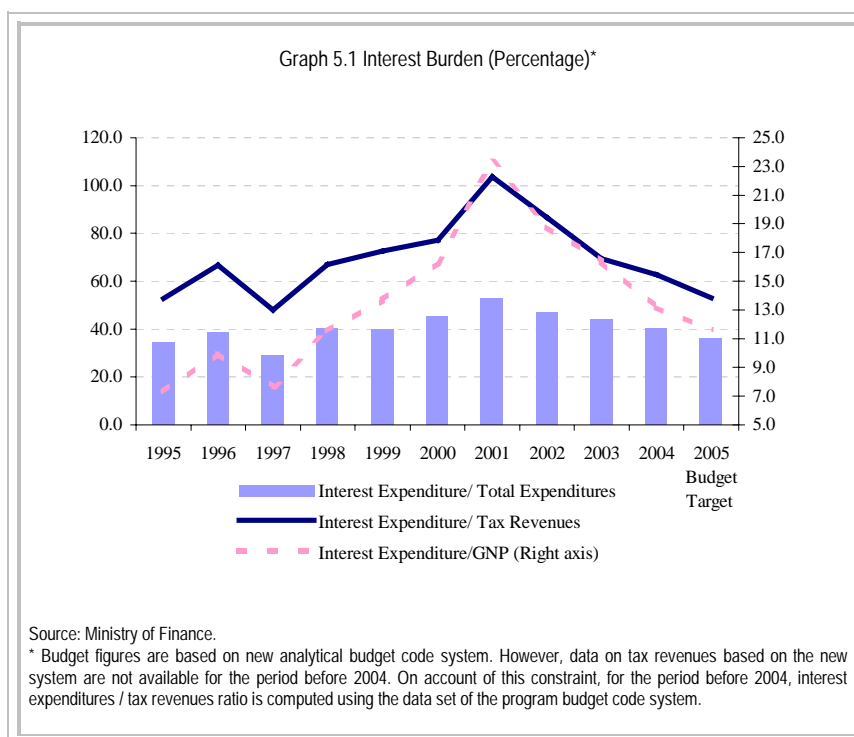
Analyzed over a longer time span, yield curves provide signals for a change in the relationship between overnight interest rates and medium/long-term interest rates. Examining yield curves from end-2004 through the first half of 2005, the curve is seen to have shifted downwards in the short, medium and long term and become more horizontal. The yield curves, particularly the long-term edge, which continue to have a positive slope, but became more horizontal, signify

favorable expectations for the upcoming period. In line with the gradual cuts in the first half of the year in short-term interest rates, the policy instrument of the Central Bank, market interest rates for short, medium and long terms also displayed a steady downward trend. This development can be seen as an indicator of the fact that the required relationship between short-term interest rates and longer-term interest rates started to crystallize. The Treasury started to borrow from domestic markets with long maturities, the average maturity for domestic borrowing was extended and fiscal discipline, supported by structural reforms, was sustained. These developments strengthened the belief that fiscal dominance decreased and became the main determinant of the downward trend in the risk premium that was described as high and volatile in previous years. This points to the critical significance of uninterrupted, long-lasting and steady implementation of macroeconomic policies and structural reforms in reducing long-term interest rates (Graph 4.2.2).

The course of monetary policy in the upcoming periods is more predictable now. This is especially important in the management of expectations, for increased confidence in policies implemented and ultimately, for achieving lasting price stability. In this respect, new arrangements were made from early 2005 onwards, to institutionalize the monetary policy decision-making mechanism (see, Press Release entitled “Monetary and Exchange Rate Policy for 2005” dated December 20, 2004). Thus, the decision-making process and timing of interest rate decisions were rendered more transparent and predictable. The institutionalization process of the decision-making mechanism will be completed with transition to inflation targeting at the beginning of 2006. In the new period, increased predictability and decreased fiscal dominance will further enhance the efficiency of the monetary transmission mechanism.

5. Public Finance

The decline in fiscal dominance is one of the main elements of the economic transformation that has started after the 2001 crisis. In the said period, the decreasing interest rates eased the interest burden significantly. Hence, the budget deficit shrunk and debt dynamics bettered (Figure 5.1). Furthermore, the structure of debt stock has improved since 2002 owing to the extension of the maturity of borrowing, appreciation of the Turkish lira and the intense borrowing in terms of TL (Box 5.1).



The consistency between inflation expectations and targets and the maintenance of fiscal discipline in the medium term can only be attained through a permanent decline in the expenditures that structurally remain at high levels. As it is known, such expenditures cannot be controlled via policy instruments. They require reforms. In case of the absence of reforms, expenditures become uncontrollable and affect the expectations negatively by increasing the need for finance. For this reason, fiscal dominance should not only be considered in the framework of fragile debt dynamics. It should also be defined on account of the structural budget reforms that determine the quality of the primary surplus, which, along with the interest payments, is a

source of the improvement observed in the debt dynamics. In this framework, fiscal dominance eased after 2001 due to decreasing debt burden (Debt stock/GNP), the improvement observed in the structure of the debt stock and the expectation for the maintenance of the budgetary discipline accompanied by reforms in the medium term. Fiscal dominance is expected to reduce in the upcoming periods owing to the improvement in debt stock dynamics and the implementation of the reforms, which will bring solutions to the structural problems of the budget, especially to the social security issue. Key role of the sustainability of fiscal discipline and the implementation of reforms, for the maintenance of the said favorable environment and the effective conduct of monetary policy under formal inflation targeting to be adopted as of 2006, should not be underestimated.

Table 5.1. Consolidated Central Government Budget Figures

	Ratio of Realizations to Budget Targets (Percentage)		
	2004		2005
	Jan-Jun-	Jan-Dec	Jan-Jun
Revenues	47.8	104.6	48.6
Taxes	44.8	101.4	45.6
Direct Taxes	48.3	105.5	52.1
Indirect Taxes	43.3	99.6	43.3
Expenditures	42.9	93.5	42.0
Interest	44.9	85.5	41.5
Non-interest	41.4	99.8	42.3
Personnel	51.1	101.4	49.3
Goods and Services Procurement	23.9	104.2	28.6
Current Transfers	48.6	100.7	50.4
Social Security Institutions	47.9	99.3	52.9
Capital Expenditures	19.6	124.4	24.1
Budget Balance	31.8	66.1	13.3
Primary Balance	74.4	129.5	71.6

Source: Ministry of Finance.

Primary budget surplus, an indicator of fiscal discipline, displayed a favorable trend in the January–June 2005 period and consolidated central government primary balance provided a surplus of YTL 19.5 billion (Table V.1). This amount also constitutes 71.6 percent of the budget target for 2005. In the January–June 2005 period, another signal for the good performance of the budget is that the budget deficit was only 13.3 percent of the budget target for 2005. Nonetheless, analyzing the shares of the sub-items of the budget expenditures in the budget target for 2005, the increases in goods–services procurement and capital expenditures are significant. The rate of increase in capital expenditures is a reflection of the budget target in 2005. A high rate of increase was foreseen for the said expenditure item in the budget allowance in 2005, contrary to the limited increase in capital expenditures in 2003 and 2004. The increases, which were observed in

Primary budget surplus displayed a good performance in January–June 2005 period.

capital expenditures and goods-services purchases in the first half of 2005, contributed to the GNP growth in the same period (Table 3.1.1). Another item, realization of which has a large share in the budget target compared to 2004, is the transfers to social security institutions. As it has been emphasized before, the high amount of transfers to social security institutions hinders the continuity of the fiscal discipline and prevents the public sector from providing its fundamental services in an efficient manner. In case a similar trend to that of 2004 continues in the second half of 2005, the said items may exceed the budget target. However, we do not expect a deviation from the overall budget targets.

Despite the favorable developments on the way towards fiscal discipline in compliance with the current economic program, it is highly crucial that the structural reforms on various fields, such as social security, public expenditures and taxes, are put into implementation without delay in order to sustain fiscal discipline. In addition to these reforms, measures against informal economy, motivated to enhance the quality of fiscal adjustment, will have a positive impact on the budget performance and increase the effectiveness of the monetary policy in terms of establishing and sustaining price stability.

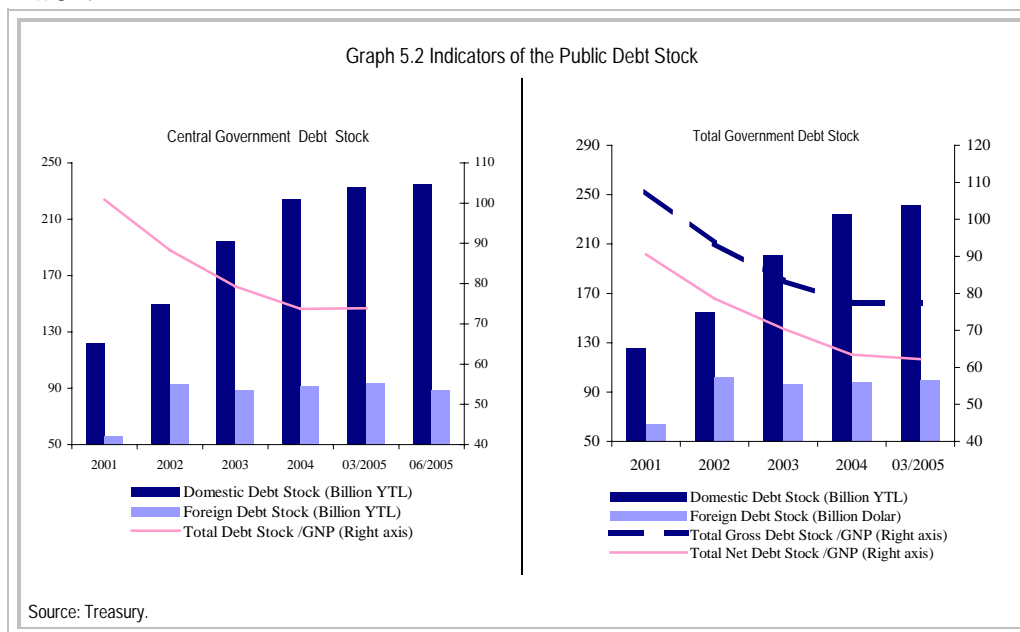
5.1. Developments in Debt Stock

One of the favorable outcomes of the current economic program has been the significant decline in the ratio of debt stock to GNP. The share of consolidated central government gross debt stock in the GNP, which was 100.9 percent in 2001, dropped to 73.7 percent in 2004 and maintained this level in the first quarter of 2005 (Graph 5.2). The same trend was also observed in total gross and net debt stock of the public sector. Consolidated budget debt is expected to decrease to around 70 percent at the end of 2005.¹ Along with the tight fiscal policy, the decline in interest rates starting from 2001 and the appreciation of the Turkish lira as of early 2003 had a significant effect on easing the debt burden. The international liquidity, which headed to emerging markets from 2003 onwards, affected the Turkish economy as well and the capital inflow contributed to the decline in interest rates and the appreciation of the New Turkish lira. High primary surplus, which is the only controllable variable for the time being, is expected to assume a

Important achievements were made regarding the debt stock but the fragile structure of the debt stock persists.

¹ Debt stock projections for end-2005 are consistent with the 5-percent GNP growth rate and the 8-percent GNP deflator assumption.

key role in determining the debt dynamics in the upcoming period as well.



Despite its significant decline, the ratio of debt stock to GNP is still high. In addition to the size of the debt stock, its short average maturity also indicates the fact that fiscal pressure prevails, although it has eased compared to previous periods (Graph 5.2, Box 5.1). Moreover, although there are significant improvements in the debt structure in terms of borrowing instruments, its sensitivity to exchange rates and interest rates is still continuing. In fact, as of June 2005, some 45 percent of the consolidated domestic debt stock is composed of FX-linked or floating rate borrowing instruments (Graph 5.3). Such a structure has an adverse impact on not only exchange rates and interest rates, but also on the shaping of inflation expectations, thus undermining the effectiveness of the monetary policy.

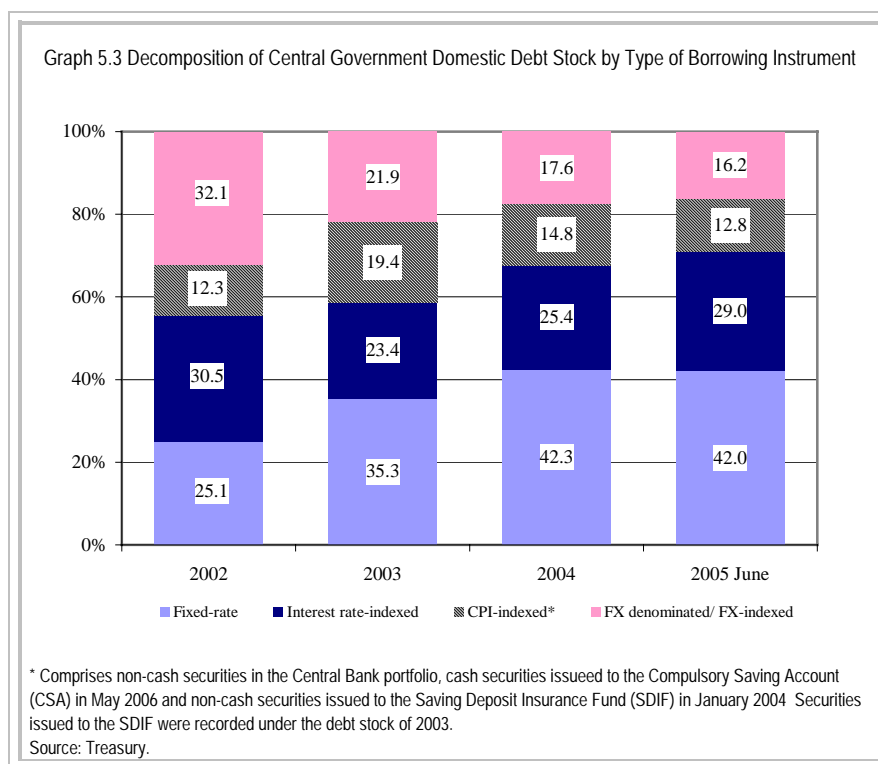


Table 5.2. Maturity Structure of the Domestic Debt Stock

	2003		2004		2005 Haziran	
	Term to Maturity (Months)	Share	Term to Maturity (Months)	Share	Term to Maturity (Months)	Share
Total borrowing	18.1	100.0	17.3	100.0	25.9	100.0
Cash	14.7	90.5	15.0	96.1	25.9	100.0
T-bill	6.2	35.2	6.2	37.6	6.3	31.9
Bond	20.1	55.3	20.6	58.5	35.1	68.1
Non-Cash	50.4	9.5	73.9	3.9	0.0	0.0
Total Stock	25.1	100.0	20.6	100.0	21.4	100.0
Cash	12.4	67.1	11.8	73.8	15.2	76.3
Non-Cash	51.2	32.9	45.5	26.2	41.2	23.7

Source: Treasury.

Average borrowing maturity, which was 17.3 months in 2004, displayed a significant increase and became 25.9 months as of June 2005. The determinant of this development was the extension of the maturity of cash borrowing (Table 5.2). As it was emphasized many times, in the 2001-2004 period, important steps were taken towards achieving economic stability and this period enabled improvement in terms of effective execution of the borrowing policy. In this framework, this improvement did not have a one-to-one effect on the average maturity of cash borrowing due to the changes in the borrowing composition,

In 2005, average maturity of cash borrowing increased remarkably.

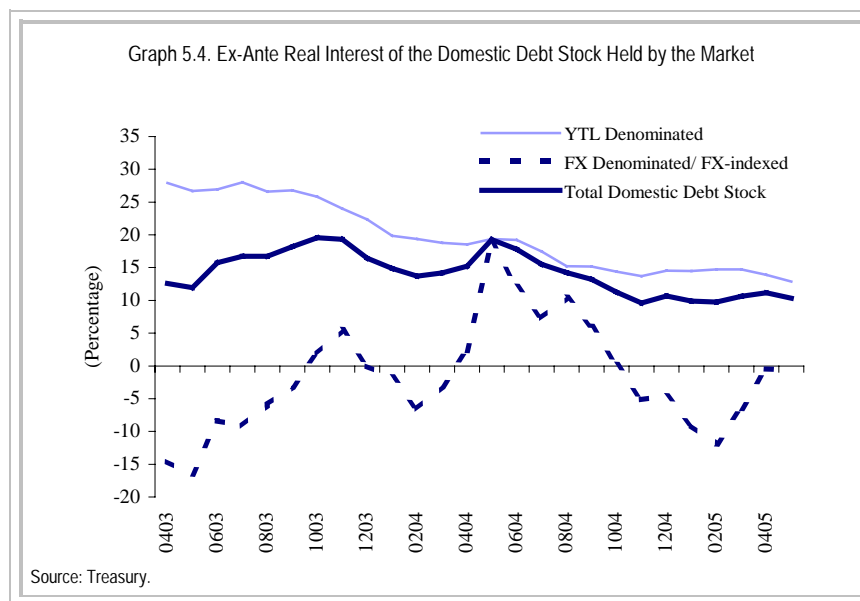
whereas the maturity in discounted auctions, which constitute an important part of cash borrowing, followed an upward trend. Average maturity of the borrowing made through discounted auctions, which was approximately 5 months in 2001, became 11 months in 2004. In 2005, there is a more significant transformation in the borrowing strategy. Along with the extension of the maturity to 20 months in discounted auctions, a start has been given to the issue of the YTL-denominated bonds with 5-year maturity and semiannual coupon payments. In 2005, maturity of cash borrowing extended significantly as a result of this implementation. The issue of the said bonds did not only extend the borrowing maturity, but also gave the opportunity to benefit from the environment of decreasing interest rates, because of their floating rate characteristic.

Floating rate bonds are deemed to be risky as they leave the debt stock susceptible to interest rate movements. However, issuance of these bonds is considered as a favorable development owing to the relatively longer maturity of their final and coupon payments. Meanwhile, the long-term borrowing in terms of fixed rate discounted bonds is a factor that increases the interest burden in the environment of declining interest rates. However, the ongoing fiscal dominance and nearing date of maturity of the non-cash debt stock bring the importance of reducing the risk posed by the debt stock and extending the maturity of the debt stock in this framework. The positive developments in cash borrowing are reflected on the maturity of the cash debt stock as well. If current borrowing policy is maintained, the improvement in the maturity structure of the debt stock will become more evident and effect of the nearing maturity of the non-cash debt stock will be removed.

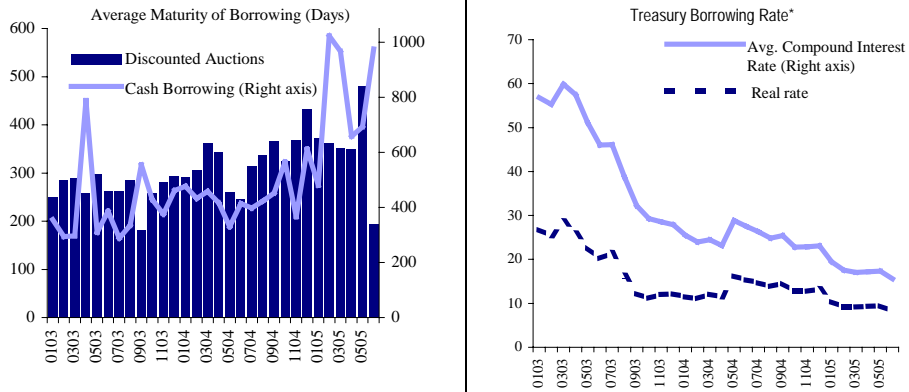
In 2005, the conditions of external borrowing, along with those of domestic borrowing, present a positive outlook. The coupon rate and average maturity of USD-denominated bond issues were 7.2 percent and 18 years, respectively. As for Euro-denominated bond issues, the said figures were 5.2 percent and 10 years, respectively. The external borrowing made via bond issues provided 5.3 billion-dollar resources. Within the framework of the 2005 financing program, the target for the resources to be created through bond issue has been achieved to a great extent.

Real interest of the domestic debt held by the market displays the current interest burden, while Treasury auction real interest rate shows the interest burden brought by new borrowing. Analyzing real interest rates of the domestic debt held by the market, substantial declines were observed. Real interest rates of the YTL-denominated bonds dropped to 13 percent in May 2005 from 28 percent of April 2003 (Graph 5.4). Meanwhile, real interest rate of the foreign currency linked debt exhibited volatility along with the changes in exchange rates. Furthermore, it is observed that the average compound interest rate of Treasury auctions, which was 28 percent for end-2003, decreased to 23 percent by the end of 2004 and was recorded as 17 percent in the second quarter of 2005 (Graph 5.5). The decline in borrowing rate, which was observed as of June, mainly stemmed from the shortening of the maturity in Turkish lira denominated discounted auctions and the borrowing that focused on FX-denominated government securities on account of FX-payments. The downward trend in the said interest rates indicates ease in interest burden in the coming periods. Nevertheless, real borrowing rates present the interest burden lower because of two reasons: there are discounted auctions in which maturity exceeds one year and inflation expectations are expected to decrease in the medium term. Considering the rate of economic growth, high levels of real interest rates, albeit their recent drops, obligate the maintenance of fiscal discipline and reforms in the upcoming periods as well, for the sake of the sustainability of debt stock. Continuance of improvement in debt dynamics and favorable course of expectations in the coming period will only be possible by the maintenance of fiscal discipline and the realization of structural reforms.

Although real interest declined significantly, they are still at high levels.



Graph 5.5. Borrowing Maturity and Compound Interest Rate



* YTL denominated discounted auctions are used in the calculations. Real interest rate is computed using the average weighted (with net sales) compound Treasury auction rate and 12-month ahead CPI expectations from the Expectations Survey published by CBRT.
Source: Treasury, CBRT.

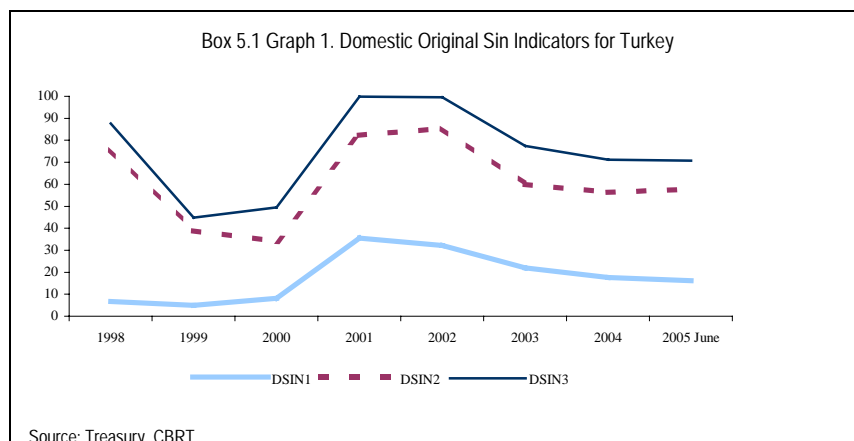
BOX 5.1. FISCAL DOMINANCE and RISK-ADJUSTED DEBT BURDEN

Sustainable public debt, in terms of both its structure and level, forms the foundation of macroeconomic stability, hand-in-hand with sound fiscal and monetary policies. Debt stock, which is composed of short-term, floating rate and FX bonds, increases the susceptibility of the debt service (principal and interest payments) to fluctuations in interest and exchange rates, and therefore, it is considered to be risky. The existence of this structure, which is also known as fiscal dominance, through its adverse impact on financial stability and expectations, limits the efficiency of monetary policy instruments, namely, short term interest rates. The poor borrowing strategy that results in the susceptibility of the debt structure can be explained with the original sin concept. "Original Sin (OS)" is defined as the inability of a country to borrow internationally long term in local currency (International component of OS) and its compulsory exercise to borrow domestically in local currency at short maturities or in terms of foreign exchange (Domestic component of OS). This issue is experienced more seriously in countries characterized with poor institutional structure and lack of confidence in policies. In this framework, the measurement and surveillance of the level of fiscal dominance stemming from the original sin become significant. As Turkey cannot borrow internationally in local currency, it is classified as a country with high international OS. In Graph 1, the domestic OS indicators, which are defined in the study by Hausmann and Panizza (2003)¹, are computed for Turkey. For this purpose, domestic debt stock is divided into components by considering the structure of borrowing instruments: i) long-term fixed rate debt stock (DLTF); (ii) short-term fixed rate debt stock (DSTF); (iii) long-term debt indexed to short-term interest rates (DLTI); (iv) long-term domestic debt indexed to inflation (DLTIP); and (v) FX denominated/FX indexed debt (FC). We compute the following three indicators by using these components:

$$DSIN1 = FC / (FC + DLTF + DSTF + DLTH + DLTIP)$$

$$DSIN2 = (FC + DSTF + DLTH) / (FC + DLTF + DSTF + DLTH + DLTIP)$$

$$DSIN3 = (FC + DLTF + DSTF + DLTIP) / (FC + DLTF + DSTF + DLTH + DLTIP)$$



The first definition (DSIN1) focuses on foreign currency domestic debt while the second definition (DSIN2) focuses on both foreign currency debt and domestic debt, which is susceptible to short-term interest rates. The third definition (DSIN3) comprises also domestic debt including bonds indexed to prices, omitting only long-term fixed-rate bonds.

These three indicators deteriorated in the 2001-2002 period owing to the increase in borrowing at short maturities and fixed rates in YTL and foreign exchange linked instruments. From 2002 onwards, long-term YTL-denominated borrowing started to increase as a result of the confidence in the Turkish Lira caused by the credibility of the program. The relative extension of domestic borrowing maturities and the change observed in the debt structure against foreign exchange linked debt stock indicate that the domestic OS level is decreasing. However, OS indicators are still at high levels. In other words, the susceptibility of domestic debt to fluctuations in short-term interest rates and the exchange rate still prevails, in spite of its recent easing.

Considering the fragile structure of debt stock, surveillance of the risk taken by the public sector as to the interest and FX movements, is crucial. The risk-adjusted public debt burden is an indicator, computed with this aim and is calculated by incorporating the volatility in interest rates and foreign exchange and the joint movements of these two variables to the debt stock. This indicator shows the highest expected value of debt, which may occur within a 95 percent confidence level in the upcoming year as a result of unfavorable developments in interest and exchange rates.²

¹ Hausmann, R. and U. Panizza (2003): "The Determinants of Original Sin: An Empirical Investigation, Journal of International Money and Finance", Vol. 22, Issue 7, p:957-990.

² Exchange rate and nominal interest rates, which are the main determinants of the debt dynamics, are selected as risk factors. The GDP growth rate, which affects the debt burden, is taken as given. Value-at-Risk (VaR) methodology is used while calculating the "risk-adjusted debt indicator". VaR, which is a measure used in the finance sector, expresses the maximum decline, with a given probability, in the market value of a portfolio over a given period.

The debt dynamic, which is taken as the basis in risk-adjusted debt calculations, is displayed in equation 1. In this framework, debt stock is divided into fixed rate YTL denominated, floating rate YTL denominated and FX-denominated components.³ Contrary to the standard debt burden equation, equation 1 points to the future value of the debt stock in the upcoming year.

$$d_{t+11} = \frac{D_{t-1}^{SF} * (1 + i_{t-1})}{Y_{t+11}} + \frac{D_{t-1}^{FX} * (1 + i_{t-1}^{FX}) * (1 + \dot{e}_t)}{Y_{t+11}} + \frac{D_{t-1}^{DF} * (1 + i_t)}{Y_{t+11}} - \frac{FDF_{t+11}}{Y_{t+11}}$$

In this equation, the following refers to:

d_t , Ratio of total domestic debt stock to GDP at time t ,

D_t^{FR} , Fixed rate domestic debt stock at time t ,

D_t^{FX} , YTL value of the foreign debt stock at time t ,

D_t^{FLR} , Floating rate domestic debt stock at time t ,

Y_t , 12 month-GDP at time t ,⁴

i_t , Annual YTL-denominated compound interest rate (Average weighted interest rate realized in the discounted Treasury auctions)

i_t^{FX} , Annual foreign interest rate (The interest rate, which is implemented for FX-denominated deposits, is used.)

\dot{e}_t , Annual change at the end of month, USD buying rate at time t ,

FDF_t , 12-month aggregate public primary surplus at time t .

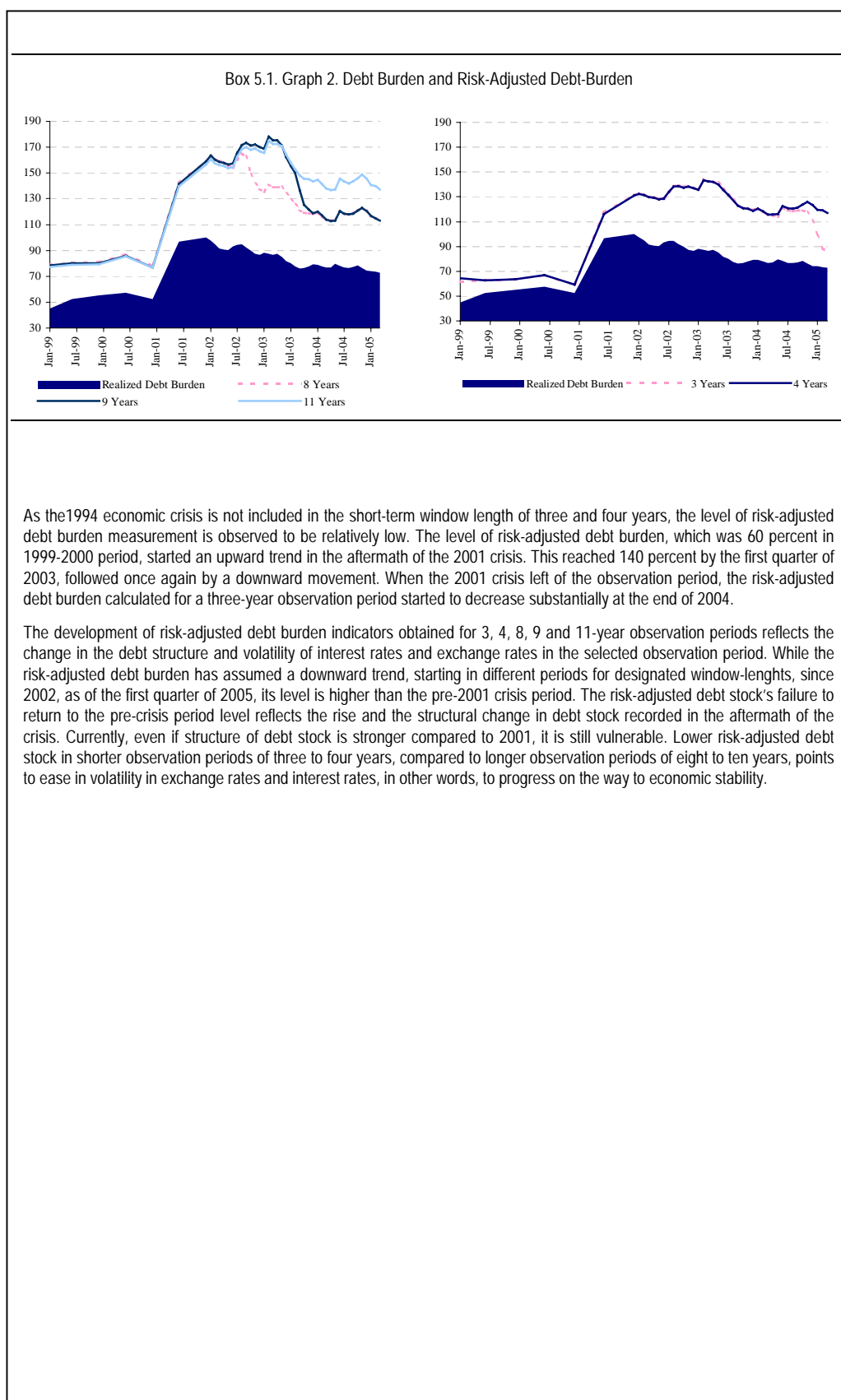
The risk-adjusted debt burden measure that was calculated at monthly intervals for the January 1999- March 2005 period is a forward-looking indicator. The risk-adjusted debt stock at time t is calculated at time $t-1$ and indicates the maximum value that debt stock/GDP ratio will take in the coming year. The aim of this calculation is to develop a measurement that would enable the assessment of the impacts of any prospective unfavorable developments in exchange rates and interest rates on debt stock over the next 12-month period. The risk-adjusted debt burden indicator is obtained by using the historical simulation method. The risk-adjusted debt burden corresponds to the 95th percentile of the historical distribution of the debt burden that is calculated by using the past values of risk factors. Under the historical simulation method, first we identify an observation period (window length) in which the historical distribution of debt burden would be based. Then, the value of the risk factors that took place over the designated observation period is collected. Next, the current values of the components of the debt burden exposed to risk are taken as given and used to simulate the hypothetical frequency distribution of debt burden we would have had if we had held the current debt structure over the observation period. In the next step, the maximum value that debt burden can take in a 95 percent confidence interval is calculated as the threshold value for which 5 percent of the simulated values remain on the right-hand side of the distribution. While calculating the risk-adjusted debt burden of the coming month, the window length is kept the same and observation period is extended by one month.

Risk-adjusted debt burden indicators pertaining to different window lengths are illustrated in Graph 2. The historical development of the risk-adjusted debt burden indicator calculated in different window lengths is influenced by the changes in the debt structure and volatility of interest rates and exchange rates in the window length identified. The risk-adjusted debt burden measurement, which was approximately 80 percent for long window lengths and 65 percent for short ones between 1999-2000, displayed an upward trend after 2001 crisis due to the structural transformation in the debt structure. FX indexed securities and TL denominated floating rate securities issued in the aftermath of the 2001 economic crisis led to a rise in debt burden components exposed to interest rate and exchange rate risk. While the risk-adjusted debt burden increased in the same period in all window lengths, it decreased in different periods due to changes in volatility of the risk factors.⁵ The risk-adjusted debt stock in the eleven-year window length has been decreasing since 2003-Q1, reflecting the decrease in the share of the floating-rate TL denominated and FX-linked debt in the Gross Domestic Product (GDP). The appreciation of the TL became a major factor in the decline in the share of FX-denominated debt stock. In eight and nine-year window lengths, reduced volatility in risk factors appears as a secondary factor affecting risk-adjusted debt burden indicator besides the structural changes in debt stock. The volatility in risk factors in the mentioned period decreased as the 1994 economic crisis left the observation period. In long-term window lengths, the risk-adjusted debt burden peaked at a level of 160-170 percent under the influence of restructured debt stock after the 2001 crisis. Recently, the risk-adjusted debt burden has decreased due to the facts that the susceptibility of the debt stock structure to exchange rates and interest rates as well as volatility in exchange rates and interest rates have diminished. Nevertheless, it still remains above the pre-crisis level.

³ Floating rate YTL denominated bonds comprise the interest-indexed securities and Treasury bills. CPI-indexed securities are not included in this group. FX-denominated debt comprises foreign currency debt and domestic debt linked to foreign exchange. The bonds, which are not included in both of these groups, are considered as fixed rate YTL-denominated debt stock.

⁴ The GDP is adjusted monthly on the basis of the monthly industrial production index. The Fernandez method is used.

⁵ The course and level of exchange rates and interest rates, which correspond to the 95th percentile of debt stock distribution is determined by the window length. The effect of the window length on risk factors can be listed as: i) the movement of risk factors change when crisis periods enter and exit the observation period. ii) The shorter the window length, the more changes the risk factors display in the course of time. The shorter the observation period, the shorter the memory of risk factors becomes. In other words, past high (or low) interest rate realizations and rises in exchange rates leave the observation period in a short time. Thus, risk factors change more rapidly in short-term observation periods than they do in longer-term observation periods, iii) When the observation period is short, past unfavourable (or favourable) values fall out of the calculations, therefore the risk level in short-term observation periods appears to be relatively lower (or higher) iv) The shorter the window length, the lower the number of observations in the highest five percent of the observation period become. For instance, while the number of observations is seven in an eleven-year observation period, it becomes two in a three-year observation period. Therefore, in shorter observation periods, the 95th percentile value moves closer to the maximum value of the observation period.



6. Outlook

In this section, the inflation outlook in the upcoming period is summarized with respect to supply and demand factors, cost factors, and monetary and fiscal discipline in the light of the developments in the January–July 2005 period.

6.1. Supply and Demand Factors

By the year 2005, economic activity started to revive. When seasonally adjusted data is analyzed, it is seen that this tendency continued in the second quarter of the year. In the second quarter of 2005, a regression is expected in the production of machinery and equipment sector due to the downward trend of investment expenditures in the Business Tendency Survey as well as the high base effect resulting from the rapid increase in the same period of the previous year. On the other hand, the indicators for the construction sector show the continued increase in construction investments. Moreover, the fact that the increases in production chiefly stem from the sectors that produce intermediary and investment goods, such as chemical goods, plastic–rubber, metal goods, and other non–metallic minerals, is a positive signal of the stability in production. However, the capacity utilization rates in the said sector have not yet reached a level that might create inflationary pressures.

In the first quarter of 2005, the tendency towards the consumption of durable and semi–durable goods in the composition of private consumption, which was observed in the previous period, continued. Moreover, it was observed that durable goods expenditures persisted in the second quarter of 2005. Analyzing the seasonally adjusted data, there was an increase in the sales of white goods in May 2005 compared to April 2005, while the demand for automobiles was higher in April–May 2005 compared to the first quarter of 2005. Meanwhile, the increase in the volume of bank credits resulting from the reduction in credit interest rates continued, particularly in housing loans, in the first half of 2005. This tendency may continue in the short term due to continued excess liquidity and the decrease in real interest rates.

Current supply and demand conditions, though not posing a risk for achieving the inflation target in the short term, should be closely

monitored in the medium term. In this context, the upward trend in public expenditures as of the end of 2004 should be closely followed because of the significant role of establishing fiscal discipline in the disinflation process. However, the fact that public expenditures are investment-originated and the increase in these expenditures is mainly construction-based signals a downward tendency, which has intensified towards the end of the year. In this context, it is predicted that the increase in public expenditures will lose pace in the second half of the year and will not exceed budget targets.

6.2. Cost Factors:

6.2.a. Wages

In line with the revival in economic activity, the increase in employment and real wages also continued in the first quarter of 2005. Nevertheless, the increase in productivity was realized at a higher level due to the acceleration of production. At this point, the level of real wages and employment is still pursuing a lower course. Moreover, the industrial production developments in April and May 2005 point to a slower increase in production in the second quarter of 2005. As for the following period, it is anticipated that the increases in productivity might not support the disinflation process as much as in previous years. In addition, it is likely that expanding employment will also have an increasing effect on expendable income, bearing in mind its increasing impact on demand. Therefore, setting public salaries and wages consistent with the inflation target is of great importance.

In 2005, civil servant and worker salaries in the public sector were set above the inflation target. The said wage policy is of an indicative nature for wage policies of the private sector. In this context, public wage policies being consistent with the inflation target is crucial both for maintaining fiscal discipline and shaping expectations. Thus, the implementation of public wage increases, which are consistent with the inflation target in 2006, is considered as a favorable development

6.2.b. Commodity Prices

Oil prices are considered as exogenous shocks on the economy, which, in the long-term, have a significant, impact on costs either directly or indirectly. It is estimated that crude oil prices in the international

markets will move above USD 55 per barrel in the third quarter of 2005. The prediction that global oil demand will continue to be high in 2005–2006, though not as high as in 2004, reinforces expectations of an upward course in oil prices. Besides, factors such as the limited contribution of non-OPEC countries to production, low levels of stocks in the global sense, the persistence of political problems in Iraq, Nigeria, and Venezuela imply the continuance of high level of oil prices in the upcoming period.

From time to time the volatility of oil prices has an impact on inflation. Although the strong position of the New Turkish lira eases the effect of the increase in input prices, it is not at a level that can compensate the recent high rates of increase in oil prices. It is important to identify the effects of exogenous shocks on inflation in order to decide which shocks to respond to and when. Calculations reveal that the primary effects of oil price increases on annual inflation (via sub-items such as petroleum products, natural gas, transportation, tours) vary by between 1 and 2 percent (Box 1.1). Therefore, oil prices were the leading factor that slowed down the disinflation process starting from the second half of 2004.

The Central Bank will react to the permanent repercussions of oil prices on long-term expectations and pricing behavior, but not to the direct effects of oil prices. In this respect, the current favorable course of expectations is a significant development. Even though the downward trend in annual inflation has recently ceased, the expectations for the following period are still falling. This shows that economic agents consider the effects of cost shocks on inflation to be temporary and that when these shocks disappear, inflation will follow a course in line with the targets.

The decline in China's primary metal demand resulting from the country's efforts to cool off its economy and its attempts to limit investments and the hike in its iron-steel production led to decrease in metal prices in the last four months of 2005. However, it is foreseen that global economic growth will once again recover in the second quarter of 2005. Due to the high correlation between economic growth and metal prices, these prices will reincrease, if the said prediction is realized.

6.2.c. Exchange Rates

The US dollar appreciated against the Euro because of portfolio movements in international markets in the second quarter of 2005. Despite these developments, the New Turkish lira maintained its strong position in the domestic markets. Number of factors were instrumental in limiting the impacts of the said parity movements such as the continued economic recovery in this period, international liquidity movements directed towards developing countries and the confidence in financing of the current account deficit. Additionally, other contributory factors were relations with the IMF and issues arising in the EU accession process not creating unfavorable effects on expectations.

Even though the impact of foreign exchange developments on inflation has weakened, such developments will continue to be significant determining factors in inflation parallel to the gradual increase in the openness of the Turkish economy. Undoubtedly, the maintenance of the Turkish lira's strong position in the following period depends on increasing the resistance of the economy to exogenous shocks. In this context, maintaining fiscal discipline, improving investment conditions and reinforcing macroeconomic foundations, thus paving the way to foreign investment and direct capital inflow are of crucial importance.

6.3. Monetary and Fiscal Discipline

The Central Bank will continue to utilize its overnight interest rates as a main policy tool. However, the monetary transmission mechanism influencing economic activity is administered by longer-term interest rates, which are determined by medium-term expectations of short-term interest rates and the credibility of the Central Bank. At this stage, the effectiveness of the CBRT in future expectations, in other words, its capability to reflect its policy decisions accurately, highlights the need to conduct fiscal policies in a consistent manner.

Fiscal discipline, which is being maintained with determination, plays an important role in enhancing the efficiency of the Central Bank's policies. Within the framework of the current economic program, single digit inflation figures have been achieved, while the potential rate of economic growth is moving closer to the targeted figure. Declining interest rates have to a great extent, lightened the interest burden and improved debt dynamics via their reducing effects on the budget deficit.

The borrowing maturities of the Treasury have been extended and the costs have been reduced. After the economy emerged from the crisis process, the normalization period started. Moreover, the factors that had created problems in the functioning of the monetary transmission mechanisms have been gradually diminishing. On the one hand, this situation offered the opportunity to the Central Bank to put its monetary policy decisions into more medium-term perspective and, on the other hand, ensured the proper and clear understanding of these decisions by economic agents. However, considering the economic growth rates, the ongoing high level of real interest rates proves that there is still a long way to go towards the continuance of the structural normalization process and that there should be no compromise on fiscal discipline.

At this point, it must once more be emphasized that the recovery in debt stock should be supported by structural reforms. Otherwise, since the structural problems in the budget will persist despite the high rate of primary surplus in the current period, there will not be any structural reduction in the expectations for the borrowing requirement. Thus, the requirement for the high primary surplus will continue. Hence, the uncertainties about the monetary transmission mechanism created by fiscal dominance on the economy will not completely disappear. In other words, the permanent recovery of debt dynamics can only be achieved by high and quality primary surplus. In this context, the implementation of structural reforms in the areas of social security, financial institutions and taxes is crucial, since such reforms will help to gradually ease the uncertainties in the monetary transmission mechanism.

GRAPHS

2. INFLATION DEVELOPMENTS		_____
Graph 2.1. CPI and Special CPI Aggregates	_____	3
Graph 2.2. Agriculture (PPI) and Food (CPI) Sub-groups	_____	4
Graph 2.3. Selected Sub-items (CPI)	_____	5
Graph 2.4. Goods and Services Groups Within CPI	_____	6
Graph 2.5 Crude Oil Prices and Manufacturing Industry Price Index	_____	7
Box 2.1 Graph 1. International Crude Oil Prices	_____	8
Box 2.1. Graph 2. International Crude Oil Prices and Domestic Petroleum Products Prices	_____	8
Box 2.1. Graph 3. CPI and CPI Excluding Direct Effects	_____	9
Box 2.1. Graph 4. PPI and PPI Excluding Direct Effects	_____	9
Box 2.1 Graph 5. Prices Affected Directly and Indirectly (Primary) by Crude Oil Prices	_____	10
Box 2.1 Graph 6. CPI and CPI Excluding Direct and Indirect Effects	_____	10
3. SUPPLY AND DEMAND DEVELOPMENTS		_____
Graph 3.1.1. Annual GNP Growth Rate Expectations in the CBRT Expectations Survey	_____	12
Graph 3.1.2. Seasonally Adjusted Data on Furniture Manufacturing	_____	13
Graph 3.1.3. Private Consumption and Total Final Domestic Demand	_____	14
Graph 3.1.4. Domestic Sales of White Goods and Motor Vehicles	_____	15
Graph 3.1.5. CBRT BTS Expectation of TL Credit Interest Rate and Investment Expenditure Tendency	_____	16
Graph 3.1.6. Private Consumption Expenditures and Expected Sales	_____	17
Graph 3.1.7. Output Gap / Potential GDP	_____	17
Graph 3.2.1. Current Account Balance / GNP	_____	19
Graph 3.3.1. Private Manufacturing Industry Real Unit Wage Index	_____	20
4. DEVELOPMENTS IN FINANCIAL MARKETS and MONETARY POLICY		_____
Graph 4.1.1. Real Interest Rates at Treasury Auctions and Risk Premium	_____	23
Graph 4.1.2. Developments in Exchange Rates	_____	24
Graph 4.1.3. Hot money (Net Errors and Omissions included)	_____	25
Graph 4.1.4. GNP and Loans	_____	26
Graph 4.2.1. Interest Rate Developments	_____	28
Graph 4.2.2. Yield Curves	_____	29
5. PUBLIC FINANCE		_____
Graph 5.1 Interest Burden	_____	31
Graph 5.2 Indicators of the Public Debt Stock	_____	34
Graph 5.3 Decomposition of Central Government Domestic Debt Stock by Type of Borrowing Instrument	_____	35
Graph 5.4. Ex-Ante Real Interest of the Domestic Debt Stock Held by the Market	_____	37
Graph 5.5. Borrowing Maturity and Compound Interest Rate	_____	38
Box 5.1 Graph 1. Domestic Original Sin Indicators for Turkey	_____	39
Box 5.1. Graph 2. Debt Burden and Risk-Adjusted Debt-Burden	_____	41

TABLES

2. INFLATION DEVELOPMENTS	
Table 2.1.Oil, Natural Gas and Derivatives Prices in CPI	4
Box 2.1. Table 1. Price Increments in Petroleum Products Under CPI and PPI	9
Box 2.1. Table 2. Sectors Using Petroleum Products Most Intensely as Input Under the CPI	10
Box 2.1. Table 3: The Influence of Direct and Primary Indirect Effects on CPI Inflation Last Year	10
3. SUPPLY AND DEMAND DEVELOPMENTS	
Table 3.1.1. GDP Developments by Expenditure Side	13
Table 3.3.1. Employment, Real Wage and Productivity Developments in the Manufacturing Industry	21
Table 3.3.2. Selected Indicators of Production Costs	22
4. DEVELOPMENTS IN FINANCIAL MARKETS	
Table 4.1.1. Developments of Consumer Loans and Claims from Credit Cards	26
Table 4.1.2. Developments of Consumer Loans	27
5. PUBLIC FINANCE	
Table 5.1. Consolidated Central Government Budget Figures	32
Table 5.2. Maturity Structure of the Domestic Debt Stock	35

ABBREVIATIONS

AMA	Automotive Manufacturers Association
BTS	Business Tendency Survey
CBRT	Central Bank of the Republic of Turkey
CPI	Consumer Price Index
CSA	Compulsory Savings Account
EU	European Union
FX	Foreign Exchange
GDBS	Government Domestic Borrowing Securities
GDP	Gross Domestic Product
GNP	Gross National Product
IEA	International Energy Agency
IMF	International Monetary Fund
IFS	International Financial Statistics
OPEC	Organization of the Petroleum Exporting Countries
PCT	Private Consumption Tax
PPI	Producer Price Index
SCA	Special CPI Aggregates
SDIF	Saving Deposit Insurance Fund
SIS	State Institute of Statistics
SPO	State Planning Organization
TEA	Turkish Exporters Assembly
USA	United States of America
VAT	Value Added Tax
WPI	Wholesale Price Index
YTL	New Turkish lira