ECONOMIC OUTLOOK

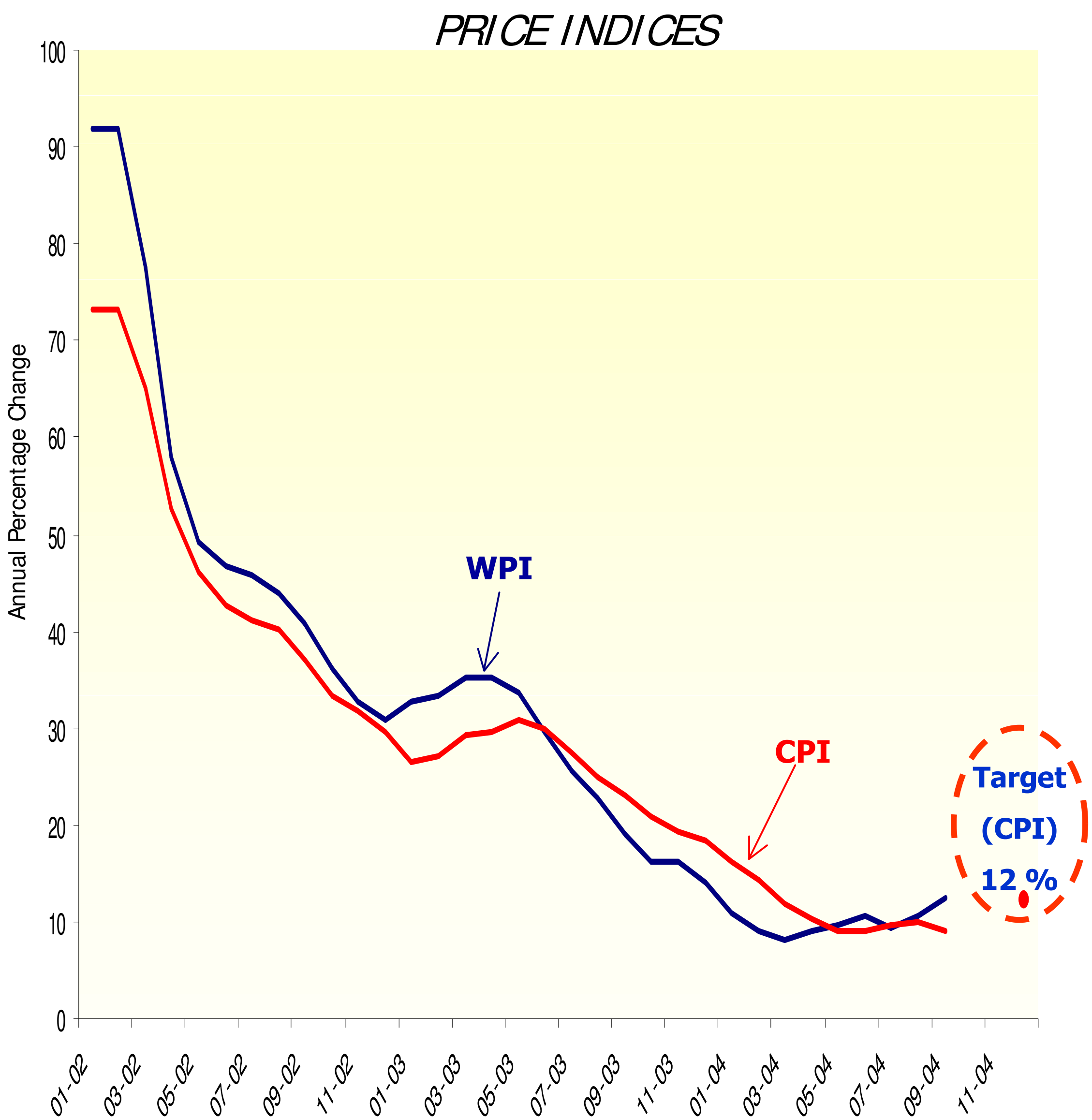
CENTRAL BANK OF THE REPUBLIC OF TURKEY

October 2004

Past	Present	Future
Chronic Inflation	**Disinflation**	Price Stability
Unsustainable ? Public Debt	**Decreasing Public Debt**	Sustainable Budget Finance
Boom-bust Growth Cycles ⇩ Crises	**Positive Growth Rates**	Sustainable Growth

INFLATION

Disinflation



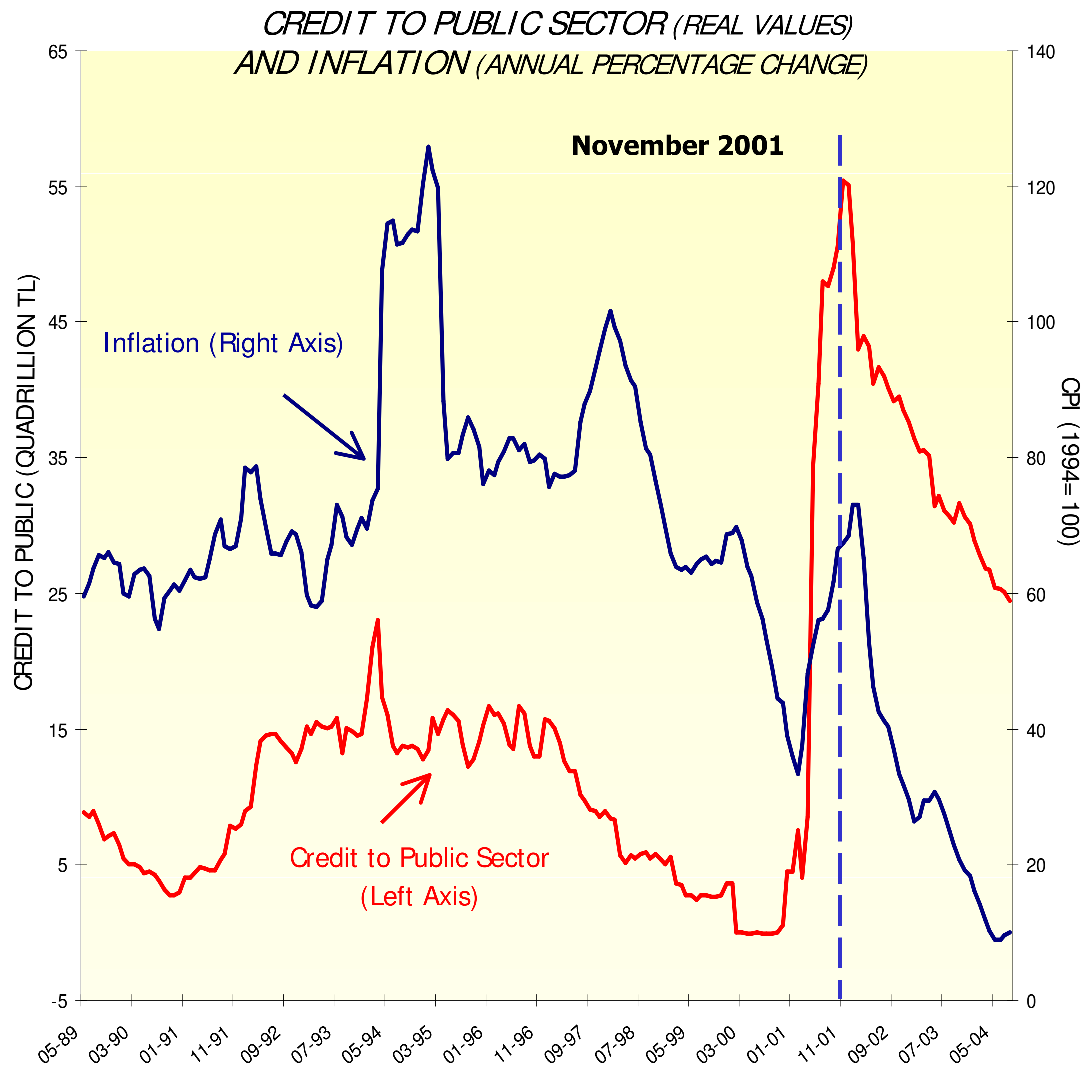
CPI: January – September 2004

- ✓ **First nine months** cumulative 4.85 %;
- ✓ **Annual** 9.0 %
- ✓ **Target** 12 %

What Caused Lower CPI?

What Caused Lower Inflation ?

1- The Central Bank Independence



Two turning points:

✓ **<u>May 2001</u>: New Central Bank Law**;

- Clearly defined target: price stability

- Target: Government + CBT

- Operational independence:

The CBT formulates policy and sets instruments

✓ **<u>November 2001</u>: No more credit to public sector.**

What Caused Lower Inflation ?

2. Weakened Exchange Rate Pass through Effect

✓ Today, together with changing dynamics of the Turkish economy, the exchange rate pass-through is;

- Lower compared to high inflation periods,
- More lagged.

✓ As evident from the experiences of other countries:

Lower and lower inflation

⇩

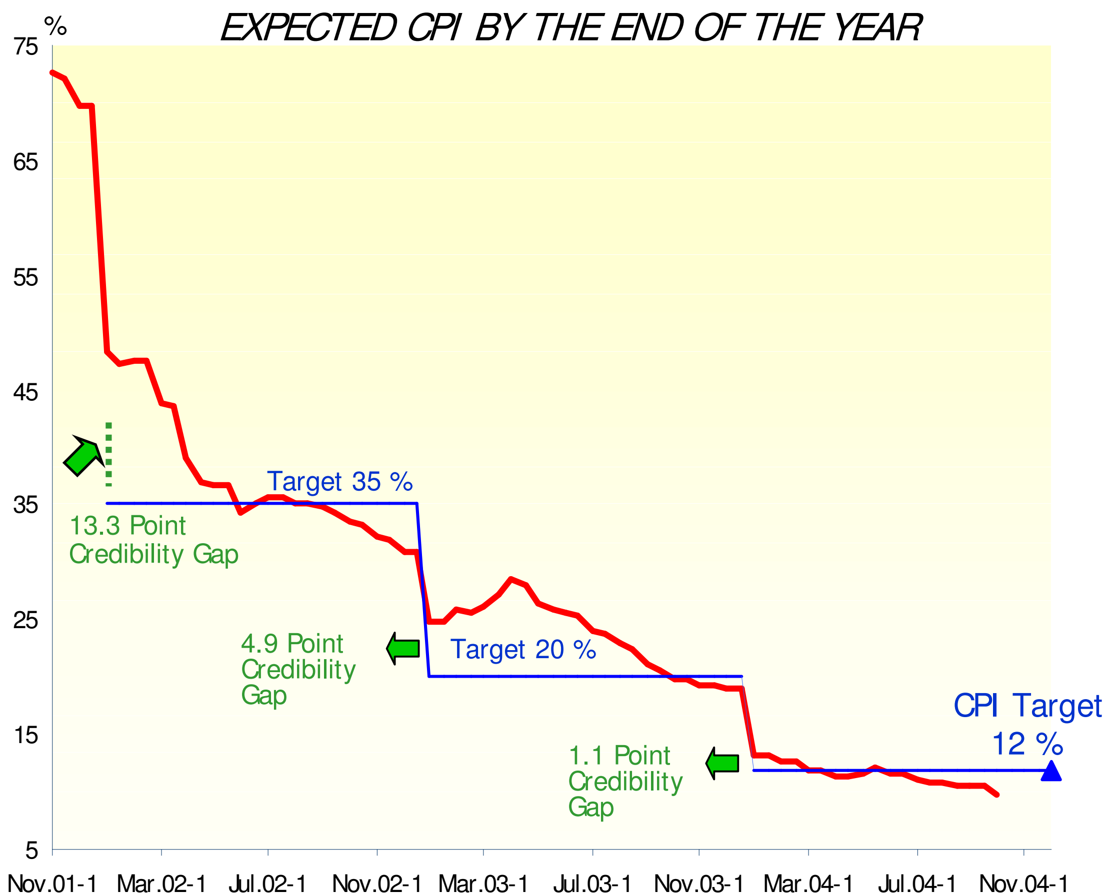
higher and higher monetary policy credibility

- More common use of pricing in terms of domestic currency,
- Perception of depreciation in domestic currency as transitory, due to low and more stable inflation environment,
- Less frequent price adjustments by firms,

Exchange rate pass-through has been weakening.

What Caused Lower Inflation?

3- Decreasing Inflation Inertia



The CBT put managing expectations and effective communications policy at center of its policies: Transparency and accountability.

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Inflation inertia is disappearing:

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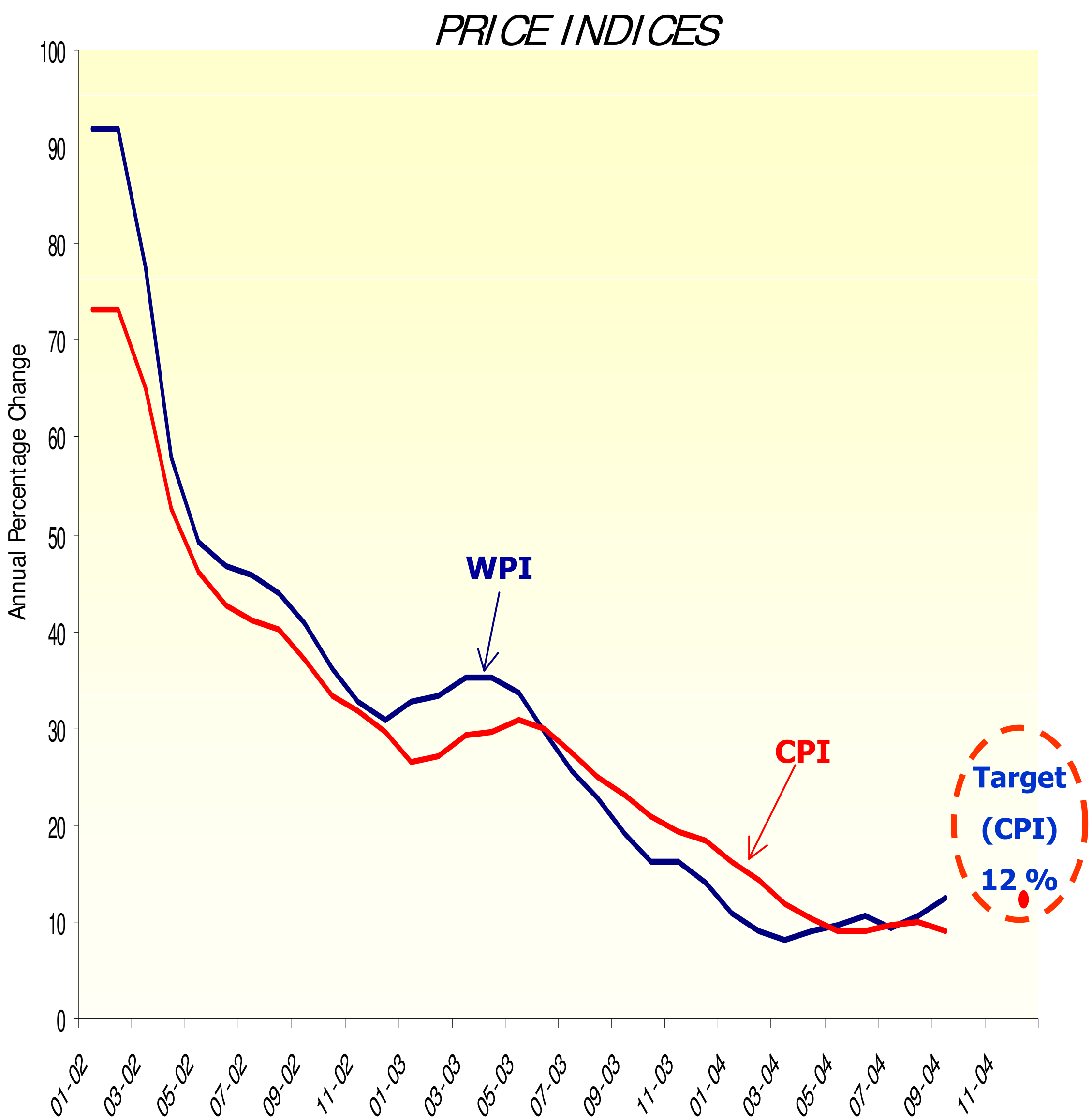
Credibility Gap:
(Expectations – Target)

2002: 13.3 Points
2003: 4.9 Points
2004: 1.1 Points

At present, October 2004: **- 2.3 Points**

Disinflation



CPI: January – September 2004

- ✓ **First nine months** cumulative 4.85 %;
- ✓ **Annual** 9.0 %. **Target** 12 %.
- ✓ **What caused lower CPI?**
  - The CBT independence,
  - Weakened pass-through effect,
  - Decreasing inflationary inertia,
  - Changes in consumer and producer behavior,
  - Tight monetary and fiscal policies,
  - Domestic demand under control,
  - Increasing competitiveness,
  - Incomes policy, more or less consistent with the target,
  - Productivity increase,
  - Level of real wages.

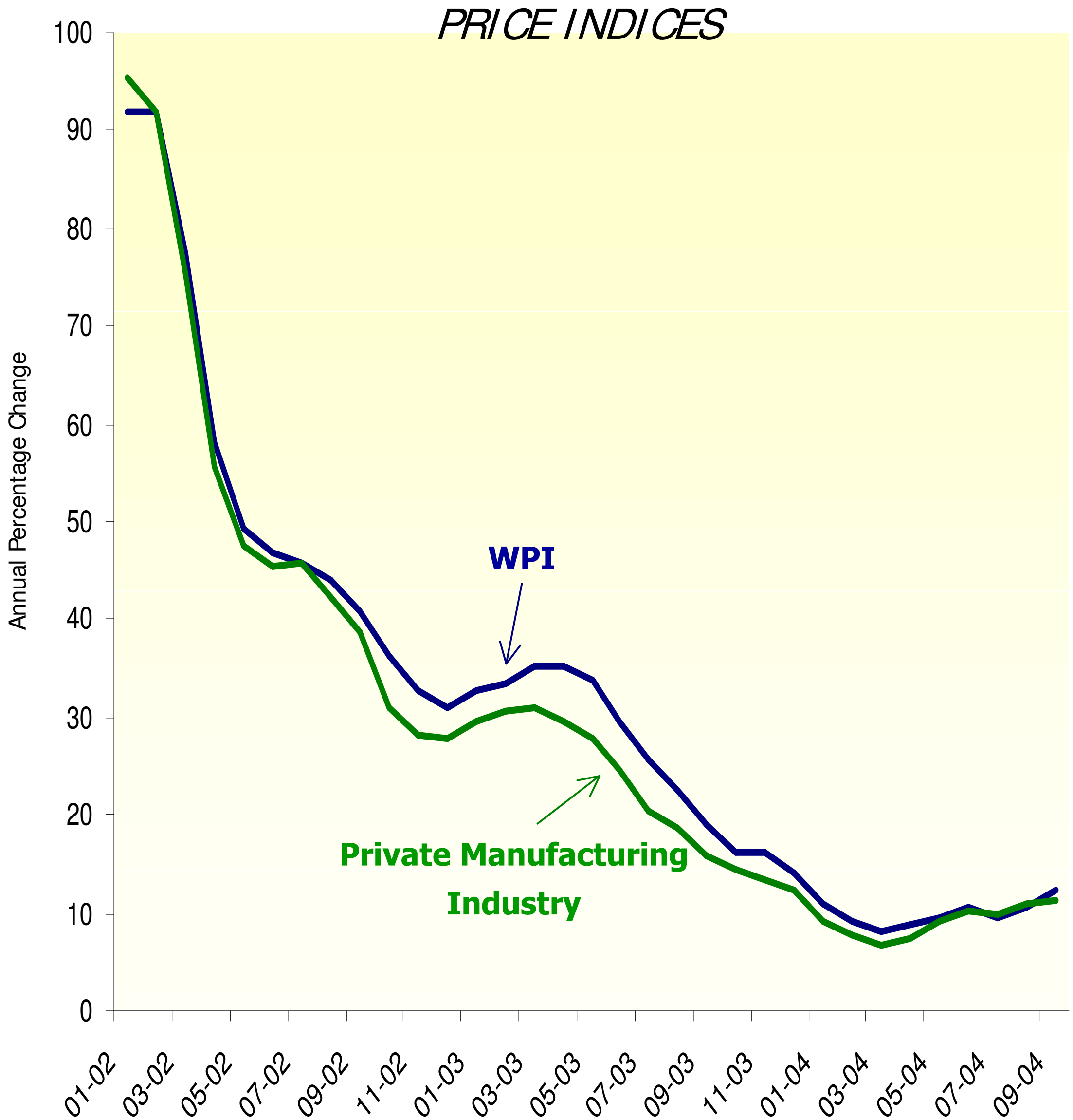
✓ **The recovery in demand** and the increase in consumer credits were **limited** to certain sectors; this constrained the upward pressure on prices.

✓ The **effect of** the increase in **WPI on CPI** was **limited.**

	Monthly	Annual
Food	0.1	6.5
Clothing	1.0	-0.4
Rent	2.5	19.7
Hospital Services	0.4	16.3
Education	3.3	13.1

✓ **Price rigidities in the services** group especially in rents, despite having diminished, still **persist**.

Disinflation



WPI: January - September 2004

✓ **First nine months** cumulative 9.31 %; **Annual** 12.5 %

	Monthly	Annual
Agriculture	5.5	11.8
Public Sec. Manuf.	1.1	18.1
Private Sec. Manuf.	0.6	11.2

✓ **Public sector prices** are **driving WPI up** since June 2004.

✓ The developments in **oil and basic metal prices** exert pressure.

✓ The contribution of

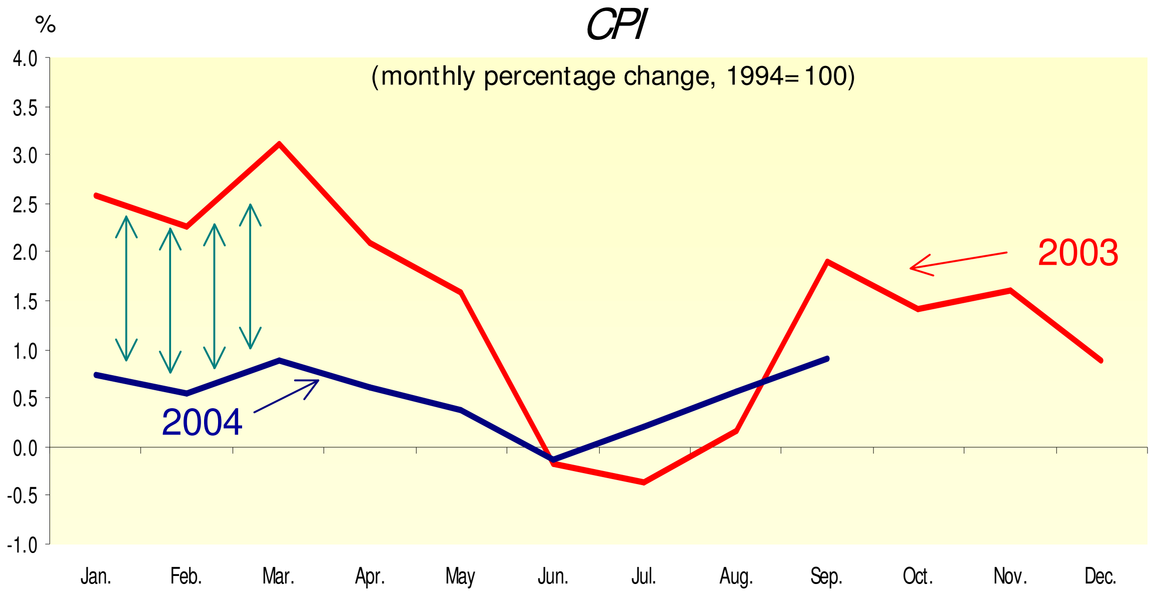
i) Productivity increase and,

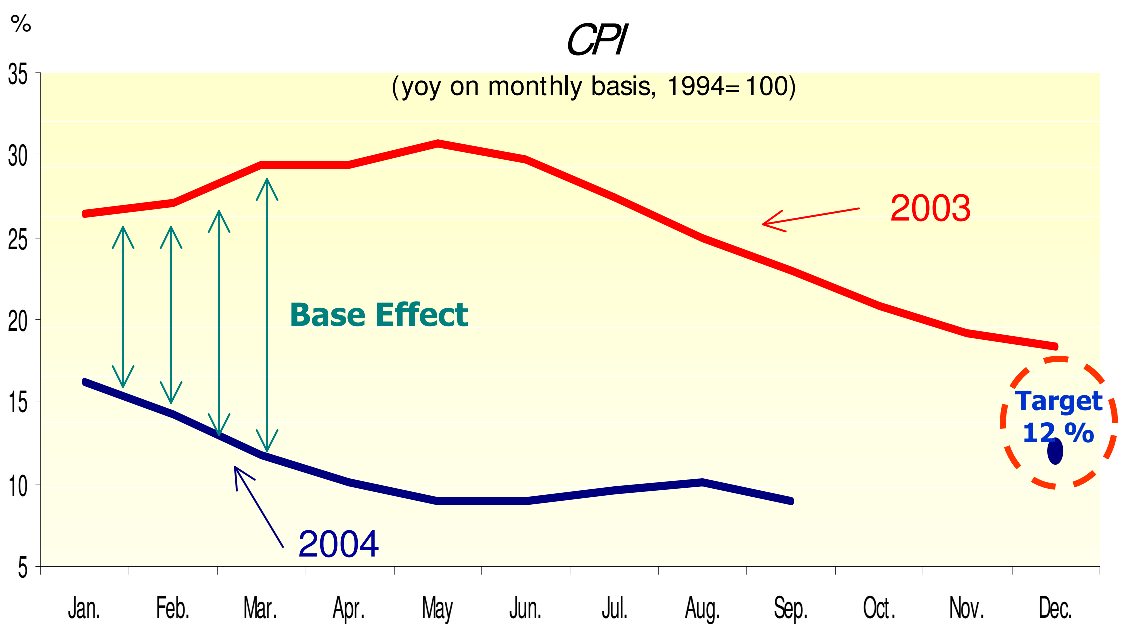
ii) Real wages,

may be limited in the future.

WPI is not a target.

Disinflation - Outlook





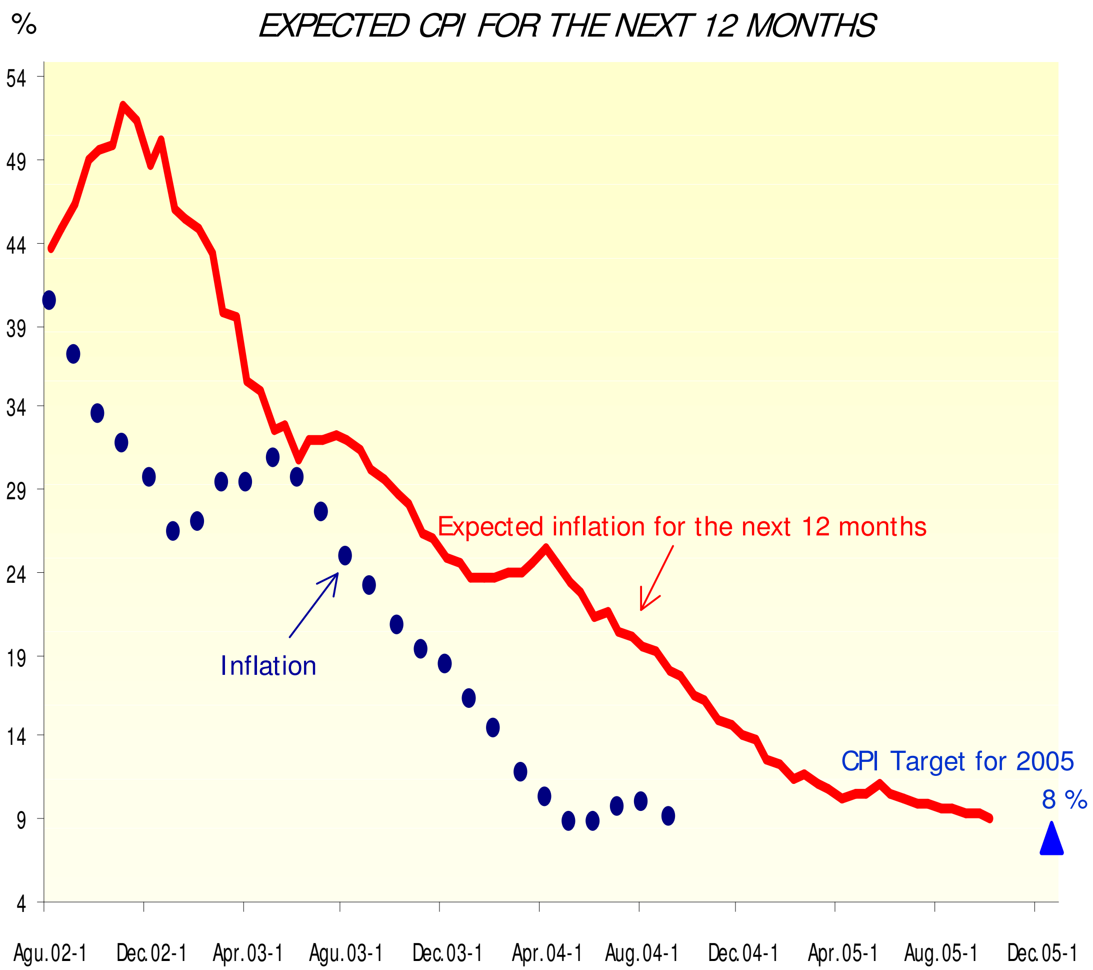
✓ Annualized inflation figures for 2004 are affected by the **base effect**.

✓ Due to this effect, annual inflation recorded a rapid decline in the first half of 2004, whereas it rose slightly in the summer months.

The course of inflation in 2004 is consistent with the inflation target and the 12 % year-end CPI target will be met.

Also, in the first few months of 2005, a slight increase is expected in annual figures due again to the base effect.

Price Stability - Expectations



✓ As a sign of the significant progress achieved, **the lowest inflation figure** for the **last 30 years** has been attained.

✓ However, **price stability has not been achieved yet.**

✓ **When will inflation stabilize at single digit levels?**

2005 Q1: Base effect still exists;

2005 Q2: Probable.

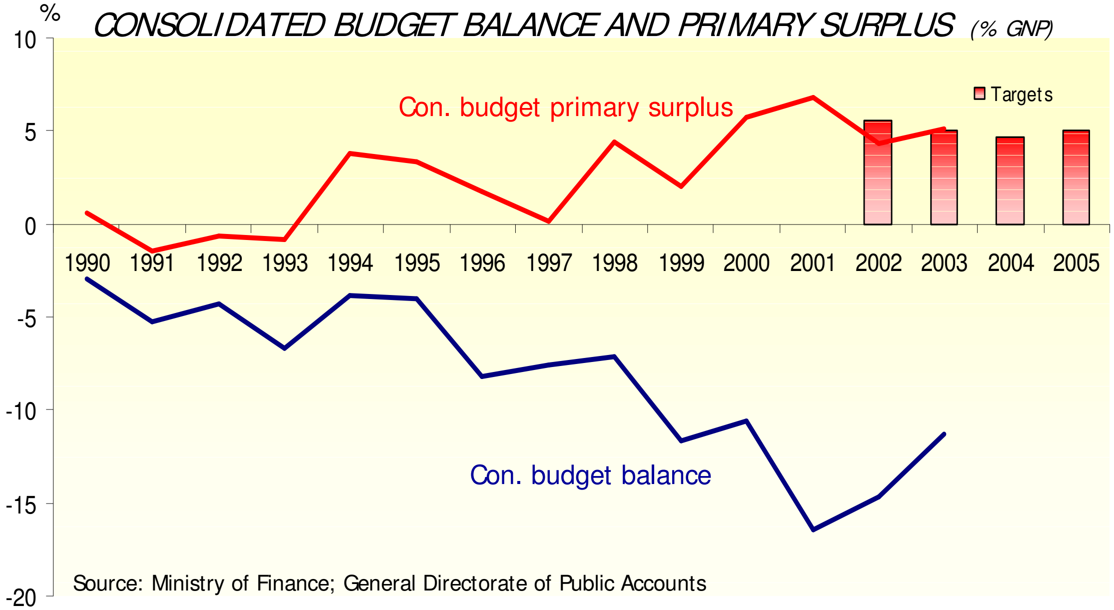
2005 Year–end target: 8 %

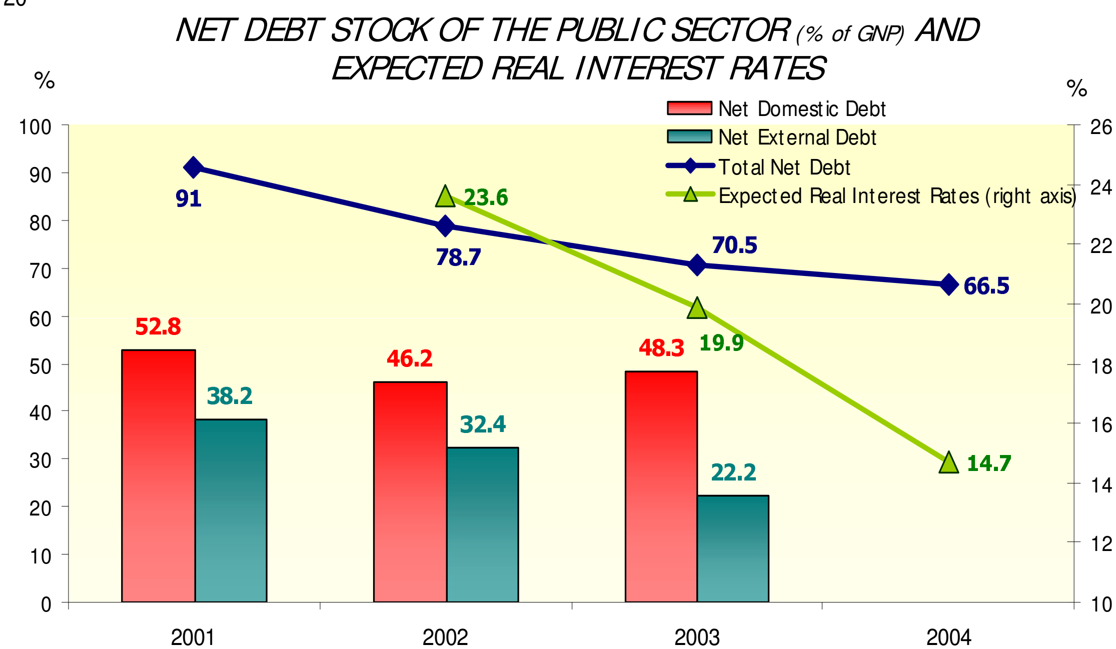
✓ Long-term inflation expectations are also consistent with the downward trend of inflation achieved as a result of our policies.

The inflation target is becoming a reliable nominal anchor.

PUBLIC DEBT

Decreasing Public Debt





Source: Treasury, IMF Country Report (Total Net Debt 2004 projection); Expected real interest rate is of September for the year 2004.

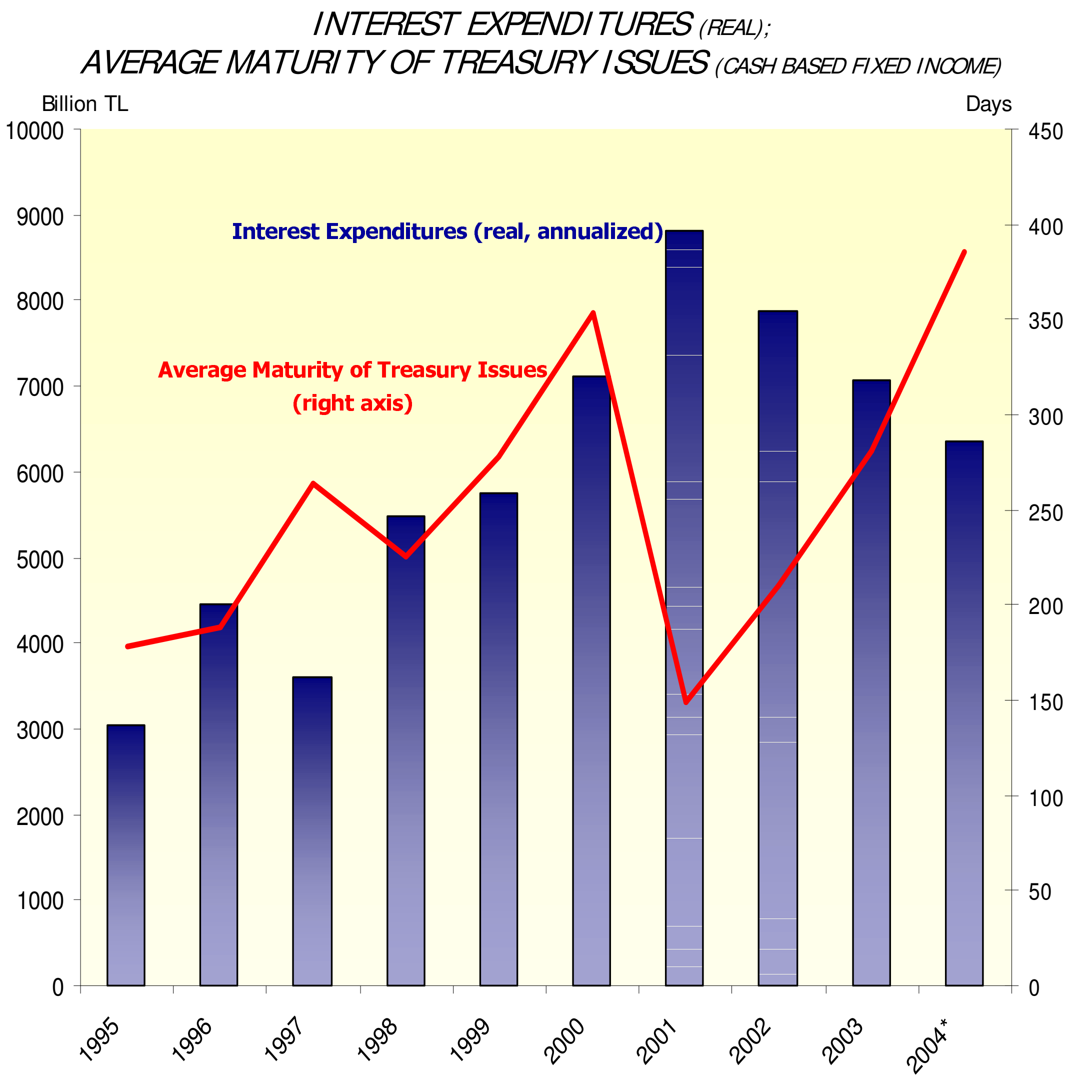
✓ **With tight fiscal policy**

- Very **high primary surpluses** obtained in 2002-2004.
- Consolidated **budget deficit decreases** considerably.

✓ The **net debt stock** of the public sector is on a **downward** path.

✓ Together with decreasing fragility of the economy, expected **real interest rates** are coming **down**.

Decreasing Public Debt



* 2004 data includes first nine month figures.

✓ Strict implementation of the program brings a **reduction in the debt service burden; interest expenditures down** in real terms,

✓ A significant **increase** is observed **in the average maturity** of treasury issues.

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For further improvement, **budget financing should be sustainable**:

✓ Measures to cut expenditures:

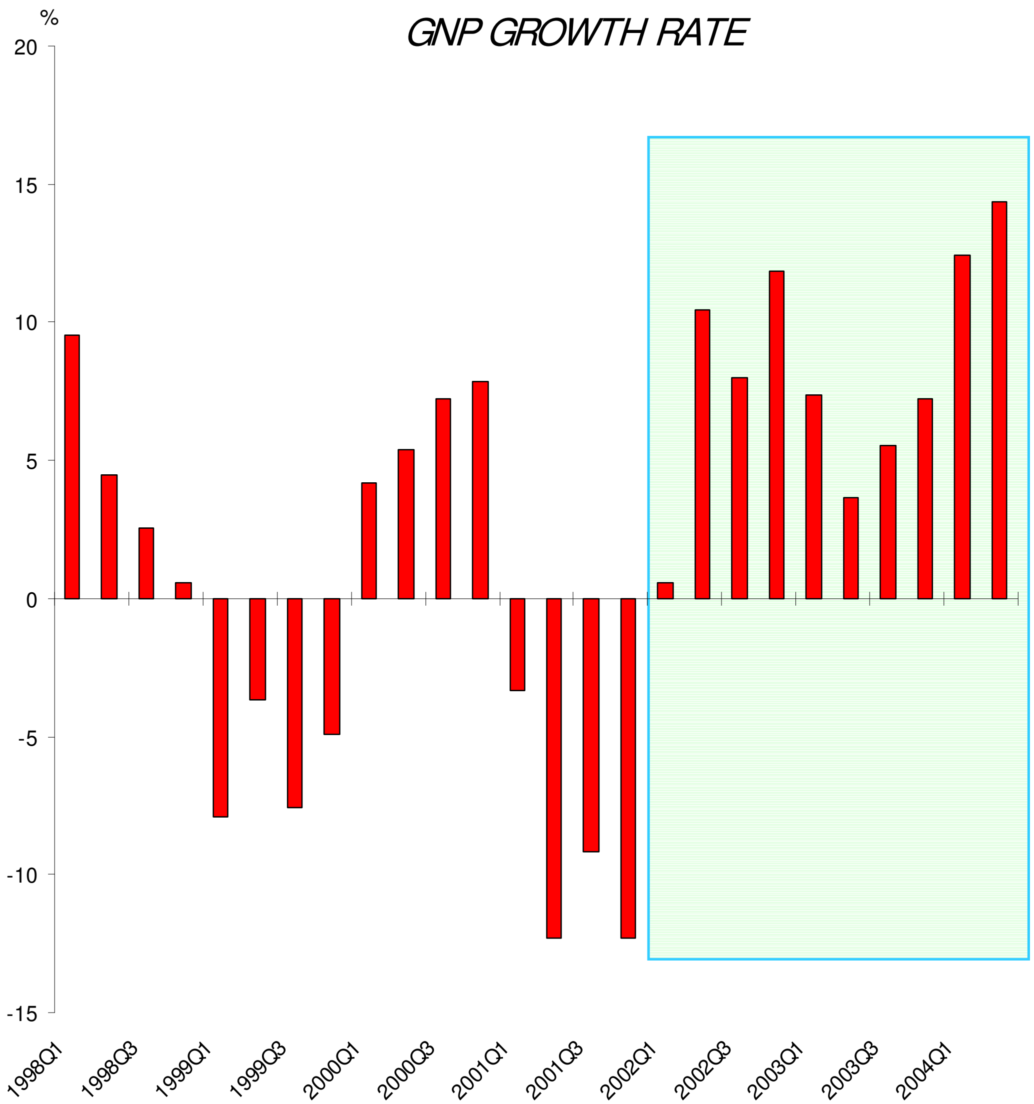
- Decreasing transfer payments
- Preventing idle employment

✓ Strategy to increase revenues:

- Broadening tax base: Tax reform
- Unregistered economy ⇨ Registered economy

GROWTH

Positive Growth Rates



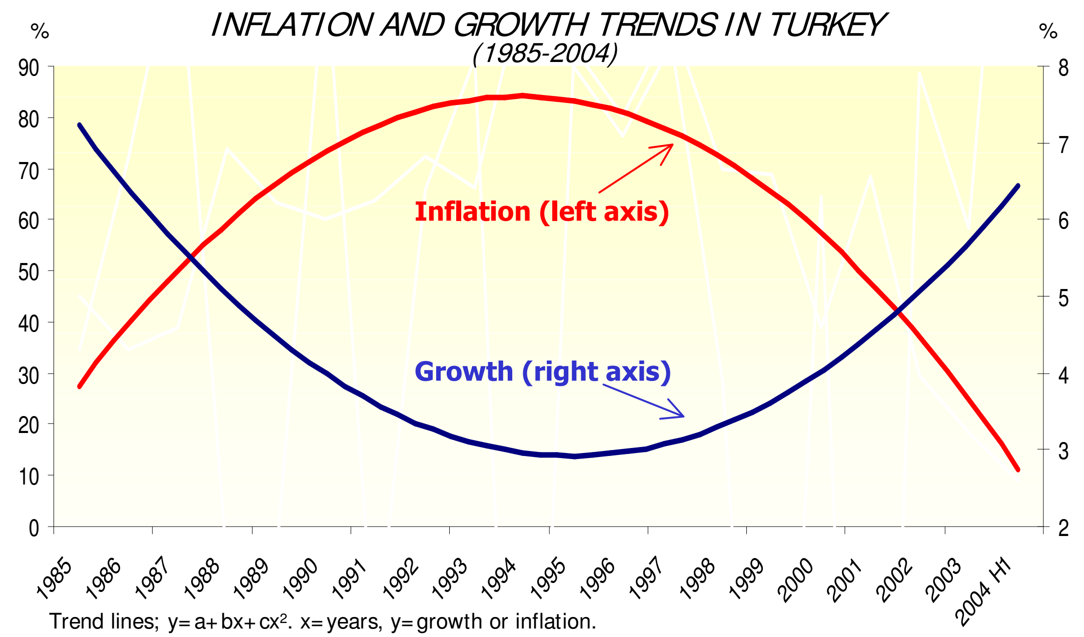
Together with the current economic program, the Turkish economy has been experiencing **high growth rates since 2002.**

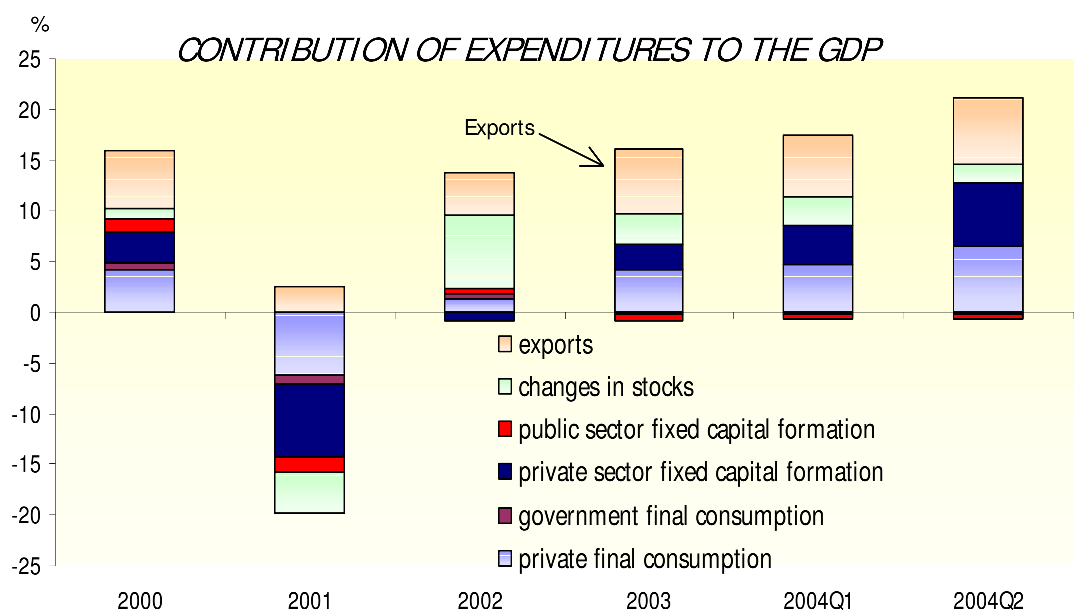
✓ Turkish economy grew by **20.8 %** in real terms **since 2001**.

2004

	II. Quarter	I. Half
GNP	14.4	13.5
GDP	13.4	11.9

Sustainable Growth – Changing Dynamics





Today's growth dynamics are different from yesterday's;

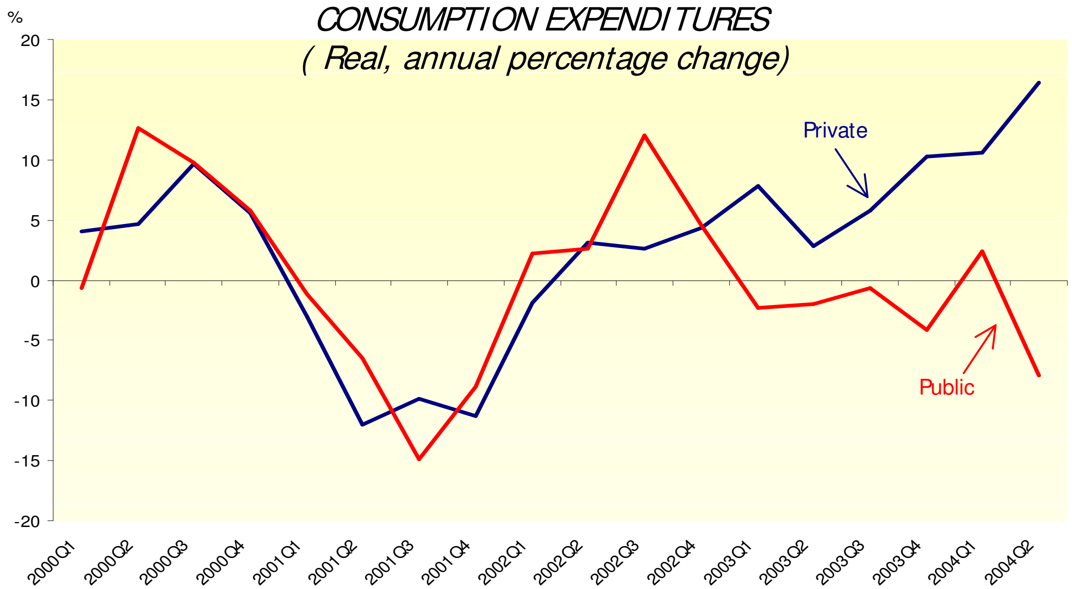
1. High growth rates have been attained while inflation is falling.

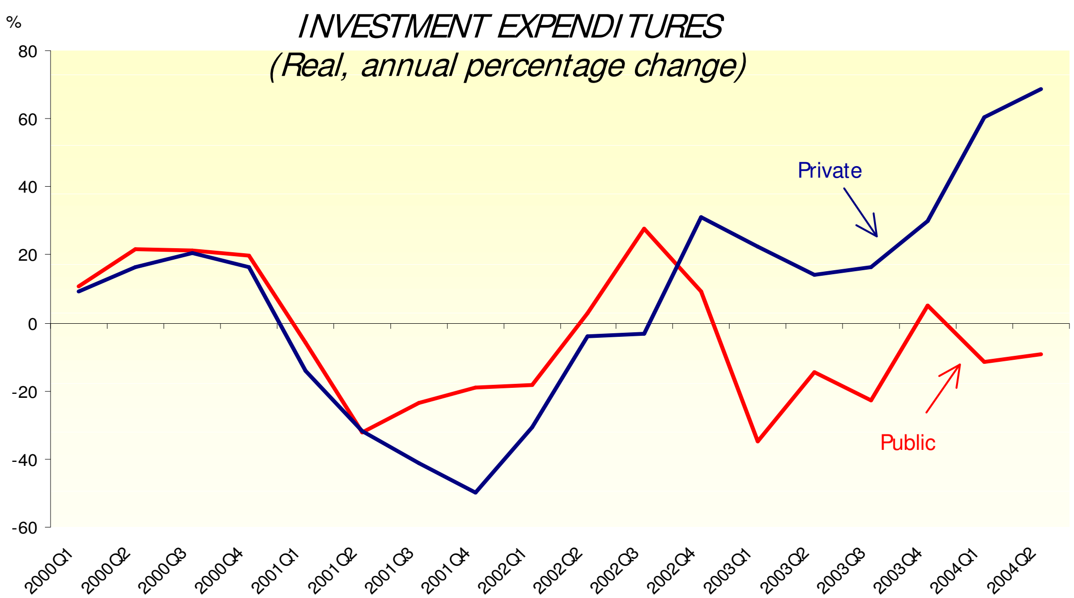
2. Exports contribute to economic growth with an increasing share.

✓ Turkey's total foreign trade volume is expected to reach 150 billion US dollar by the end of 2004.

✓ The Turkish economy has become more integrated with the world economy, giving rise to a more competitive environment.

Sustainable Growth – Changing Dynamics





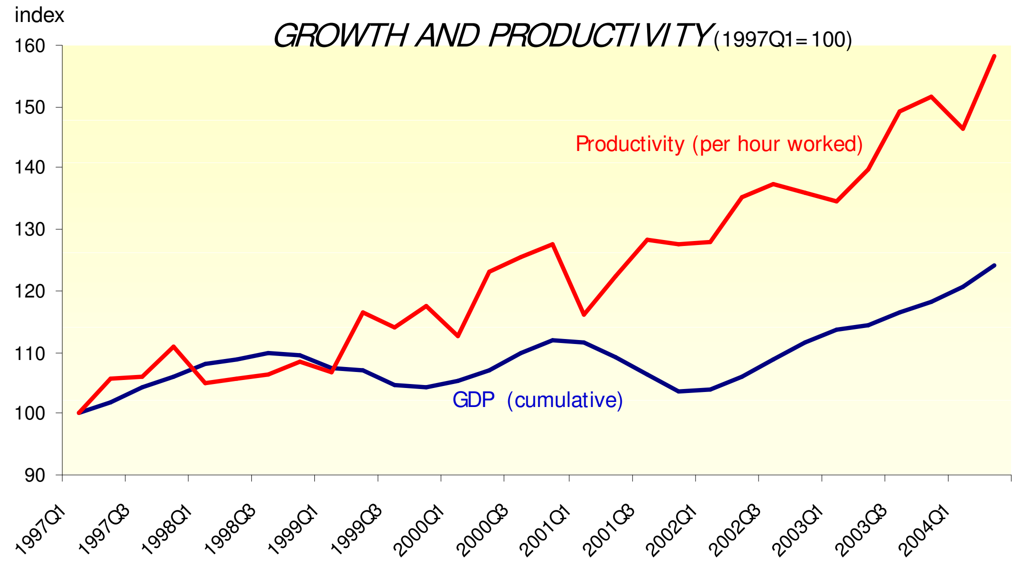
3. Tight fiscal policy affects expectations favorably; stimulates growth.

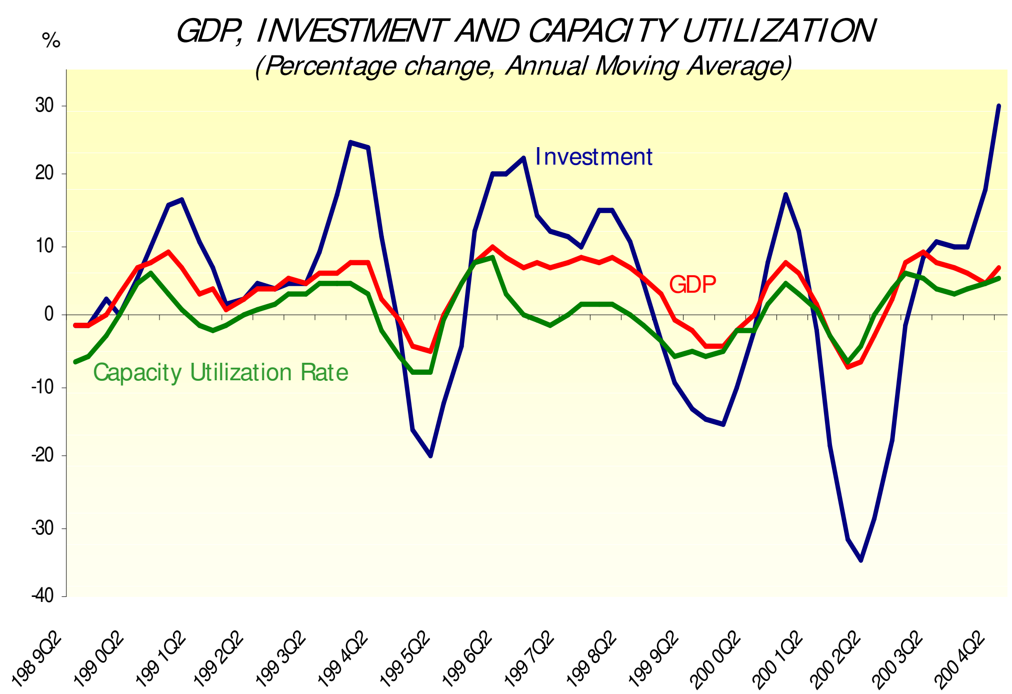
✓ The main source of growth is no longer the public sector.

4. Growth is now driven by the private sector.

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

Sustainable Growth – Changing Dynamics





5. Productivity – Investment - Employment

✓ Just like several countries achieving strong growth performances in post-crisis periods, the highest contribution to growth at the initial stage comes from the **productivity increase**.

✓ **The increase in investment comes afterwards**.

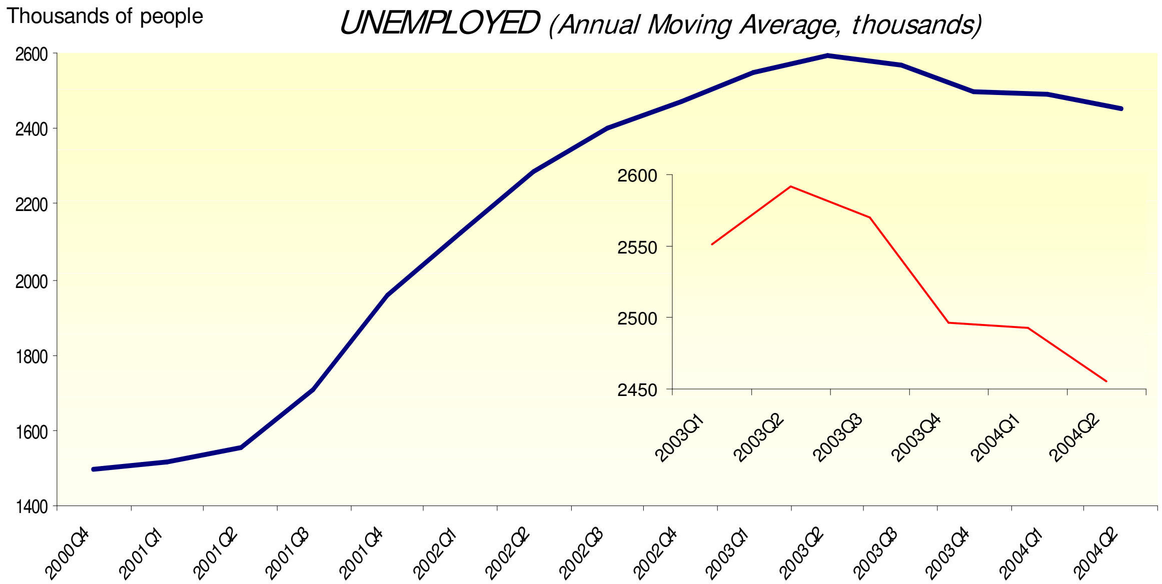
✓ In other words, at the initial stage, growth does not follow investment, **investment follows growth**.

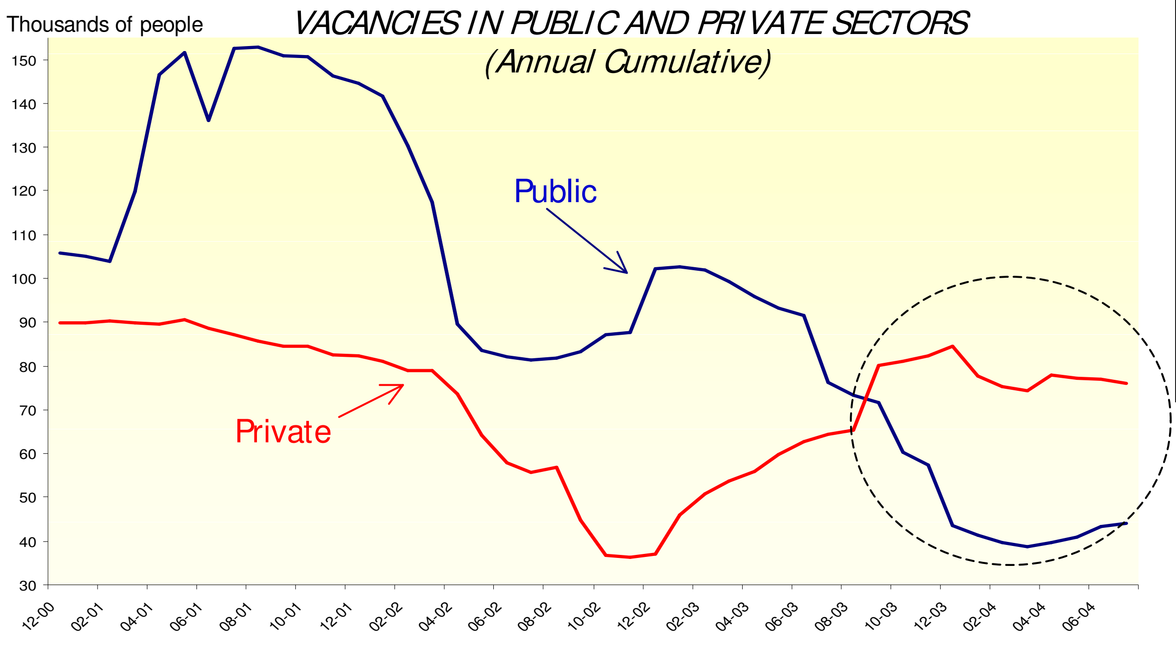
✓ This is also the case in Turkey.

✓ The cumulative **productivity increase** is around **26 %** for the **last three years**.

✓ **Investment** will continue to increase.

Sustainable Growth – Changing Dynamics





- ✓ With the negative impact of the crisis and contraction in the economy, the number of unemployed people has increased considerably since 2001.
- ✓ The **number of unemployed** people has been indicating **a decreasing trend** since 2003-Q2, and thus the unemployment rate decreased to 9.4 % in 2004-Q2.
- ✓ During the recovery period, in line with the changing structure of the Turkish economy, the capacity of the **private sector** in **creating new jobs** shows a robust expansion, while that of the public sector continues to shrink.
- ✓ The whole process of change in dynamics and increase in investment will accelerate job creation and ensure growth of employment to be **sustainable**.

All these changing dynamics indicate that growth relies on strong fundamentals.

ON THE CONDUCT OF MONETARY POLICY

Short-term Interest Rates

Basic policy tool: Short-term interest rates

How are decisions made? Based on inflation outlook only

All that matters is inflation target vs. inflation estimate

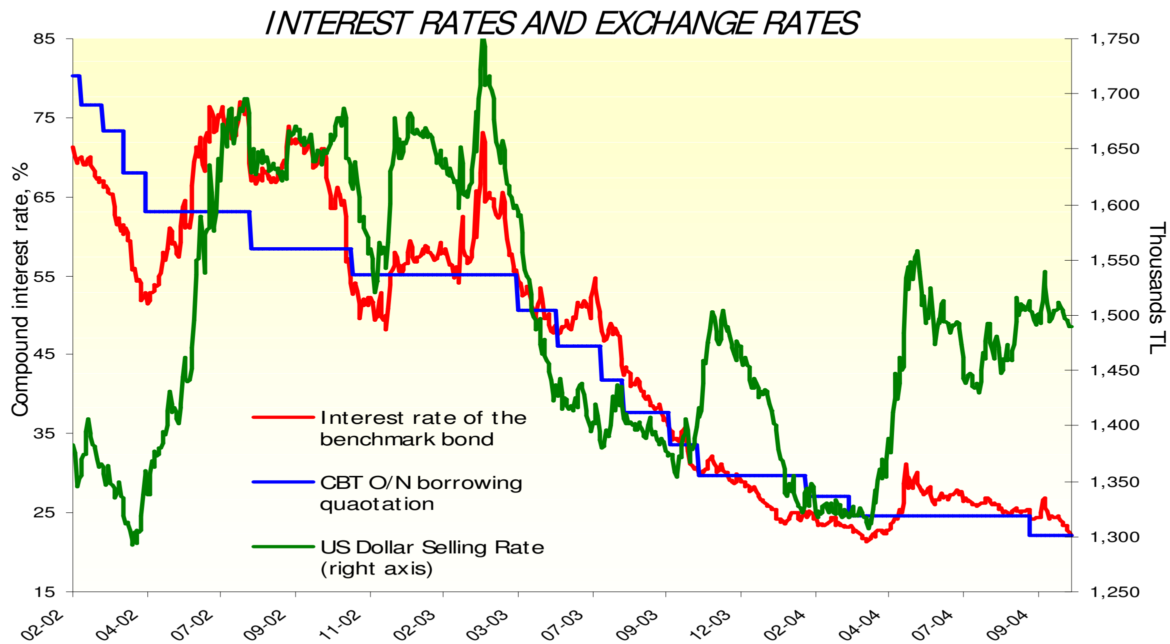
Which factors are observed while forecasting future inflation?

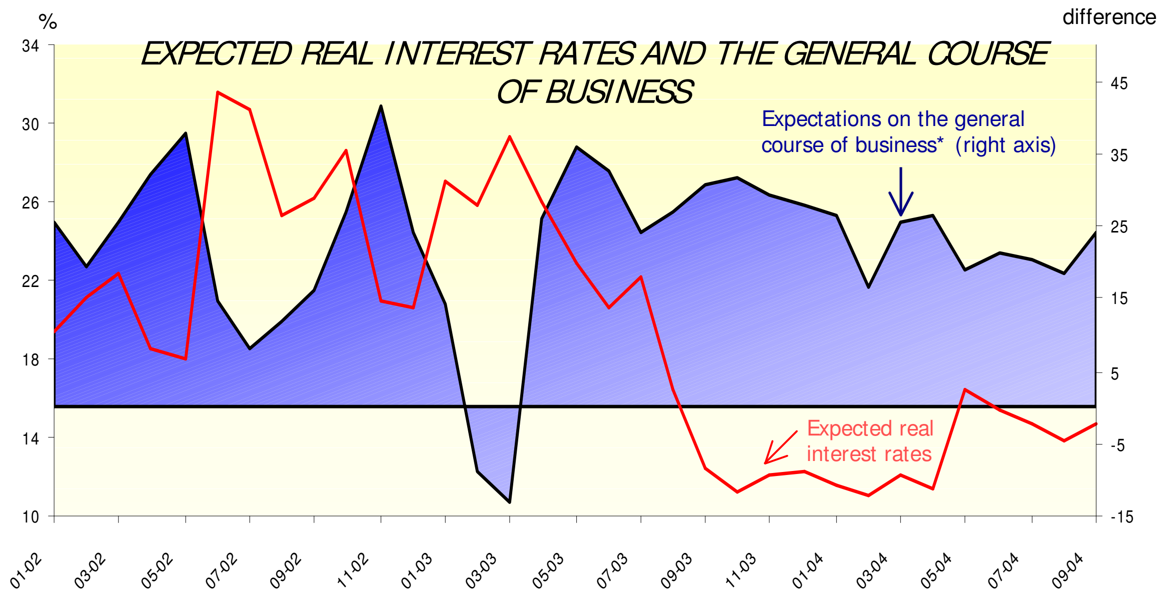
Comprehensive information set

- ✓ Aggregate supply and demand; fiscal policy indicators, monetary and credit aggregates
- ✓ Inflation expectation surveys and CBT's internal inflation forecasts
- ✓ Wages, employment and unit labor costs, productivity
- ✓ Pricing behaviour of public and private sectors
- ✓ Exchange rates and balance of payments
- ✓ External economic developments

In this framework, consistent with the inflation target and forecasts, the CBT may reduce, raise or leave the interest rates unchanged. Press releases

Short-term Interest Rates





* CBT Business Tendency Survey, expectations on the general course of business: optimistic – pessimistic

3 points on short term rates:

1- Exchange Rates

When CBT lowers its interest rates, TL may;

- Appreciate as expectations turn positive;
- Depreciate, as the return on TL assets goes down;
- Act independently of economic fundamentals due to liquidity conditions, changing expectations.

2- General Level of Interest Rates

Though getting stronger, the positive relationship between the CBT's short-term interest rates and the general level of interest rates has not yet reached desired levels.

3- Real Interest Rates

Real interest rates declined more than 15 points in the last two years.

When expectations on economic outlook are favorable, expected real interest rates decline, whereas the rates go up when expectations worsen.

Floating Exchange Rate Regime
The CBT's Exchange Rate Policy

I – Intervening against Excessive Volatility

- ✓ To prevent **excessive volatility** on either side
- ✓ Depending on the **assessment of** the volatility
- ✓ **Announcements** and **warnings**

II – Foreign Exchange Purchases with the Purpose of Reserve Build-Up

- ✓ Through **sterilizing excess foreign exchange supply** that is led by capital inflows and portfolio switch towards TL
- ✓ Aim is not affecting the level of the exchange rate; mechanism consistent with the floating exchange rate regime
- ✓ Using **transparent** methods: **Improvement** in methods

The Central Bank - Financial Stability

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

✓ When deemed necessary, measures towards securing financial stability are immediately taken, as during the Iraqi War.

When financial stability is at risk:

In the Turkish lira money market;

✓ “Late Liquidity Window” interest rates are lowered,

✓ Banks are provided with the necessary liquidity without any limit,

✓ O/N funding at the Istanbul Stock Exchange Repurchase / Reverse Repurchase Market.

In the foreign exchange market;

✓ Deposit interest rates are lowered,

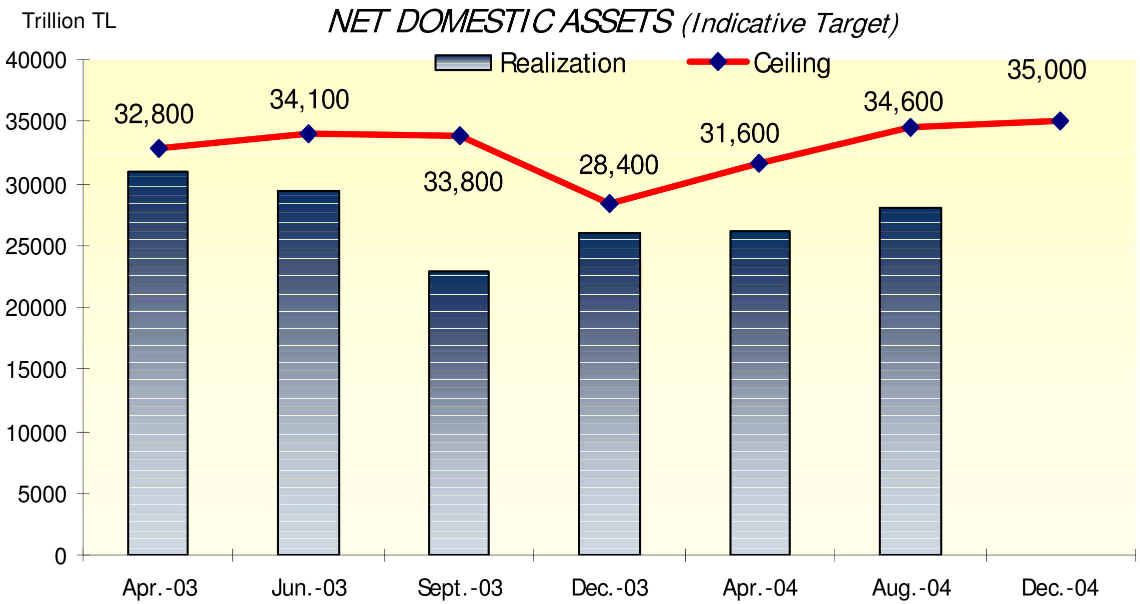
✓ FX banknote holdings are increased to meet possible demand for foreign exchange banknotes,

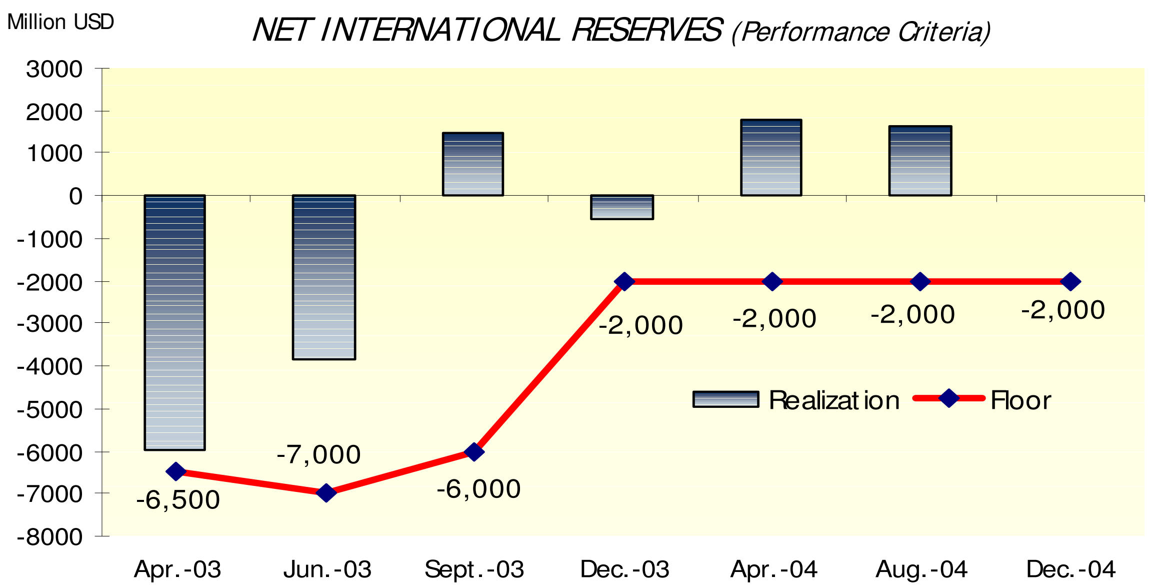
✓ Excessive volatility in FX market in either way, as a result of declining market liquidity or speculative movements damaging stability, is met with intervention.

In relation to the Payments Systems;

✓ All markets at the CBT, as well as the EFT and EST systems are left open until operations are completed.

Monetary Program Targets

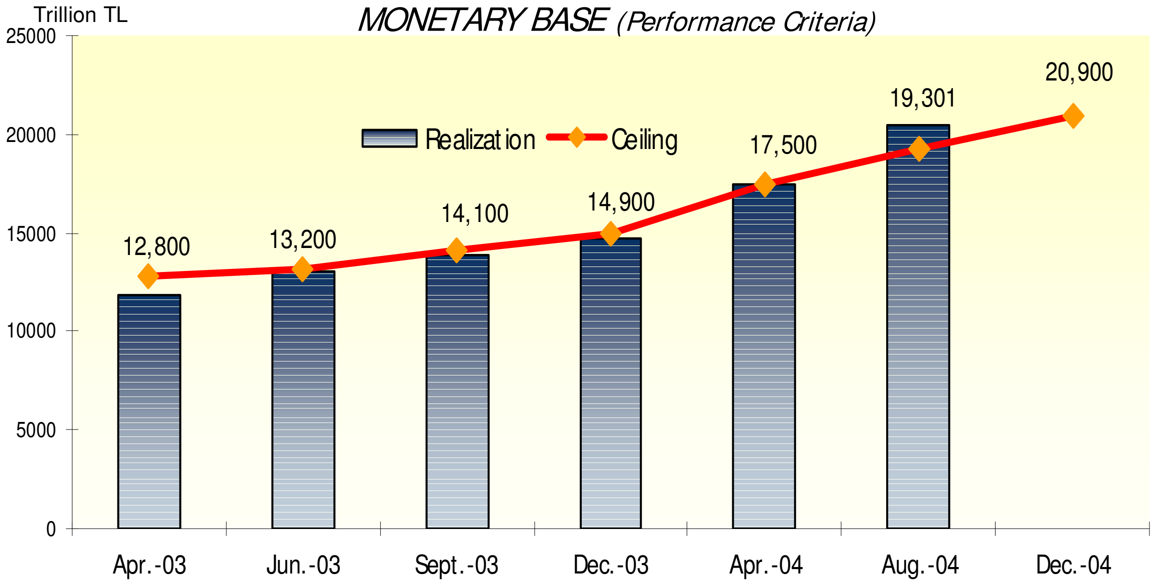


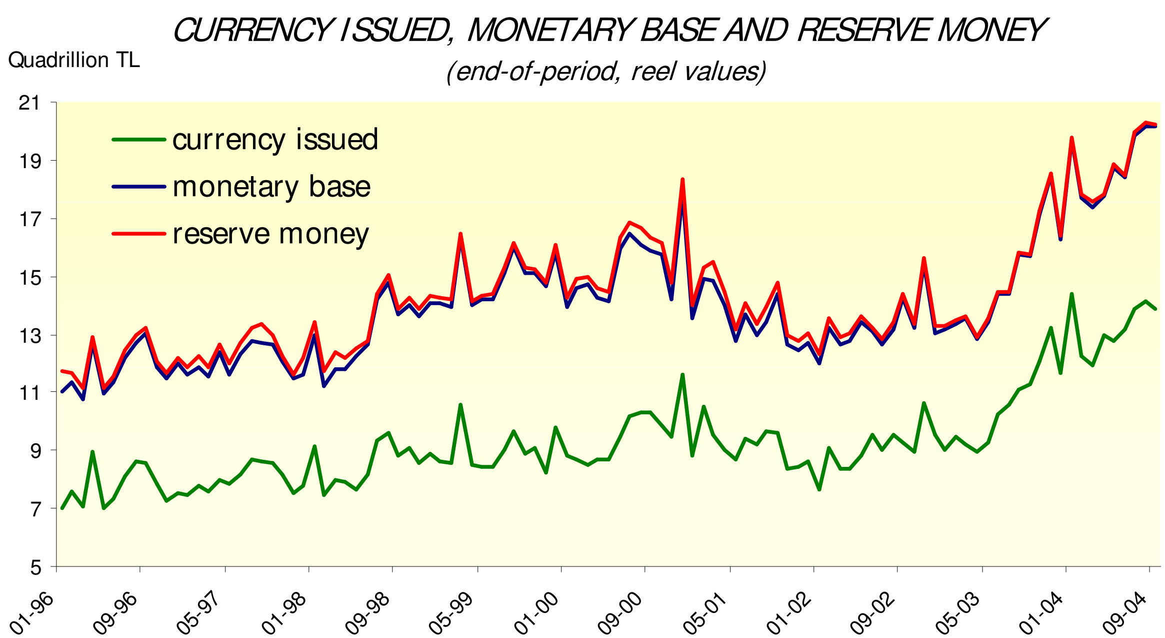


✓ Tight monetary policy continues as foreseen in the program.

✓ Net Domestic Assets targets and Net International Reserves criteria were met.

Monetary Program Targets





✓ A certain amount of deviation in the money base stems from the increase in money demand.

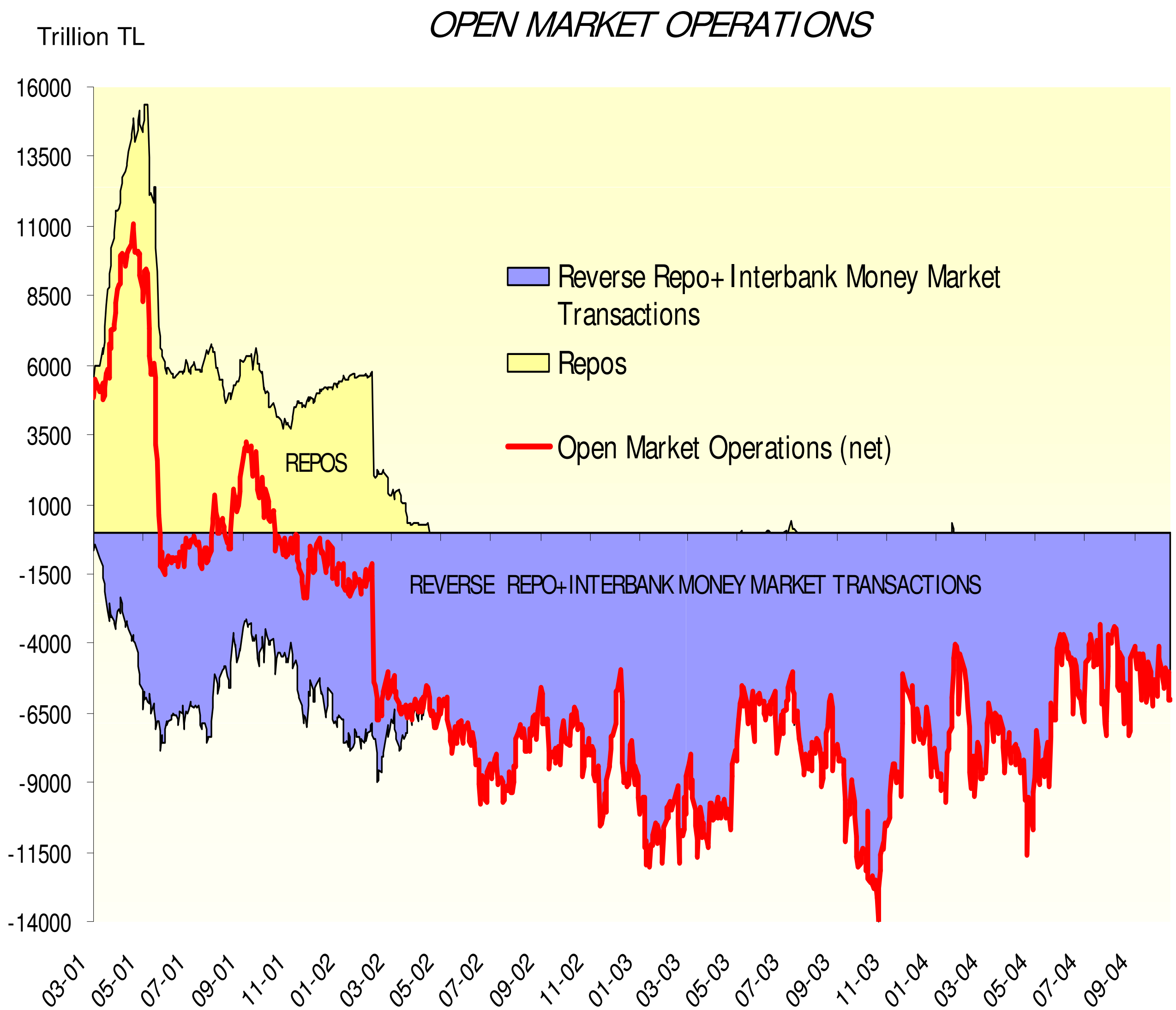
✓ **The increase in money base is not inflationary.**

Together with the fall in inflation and increase in confidence, inflation expectations and risk premium have declined.

Money demand, especially the demand for cash has increased.

Accordingly, the growth rate of currency issued is going up.

Markets



✓ Higher **demand for cash**

✓ **Suspension of** the foreign exchange buying **auctions**

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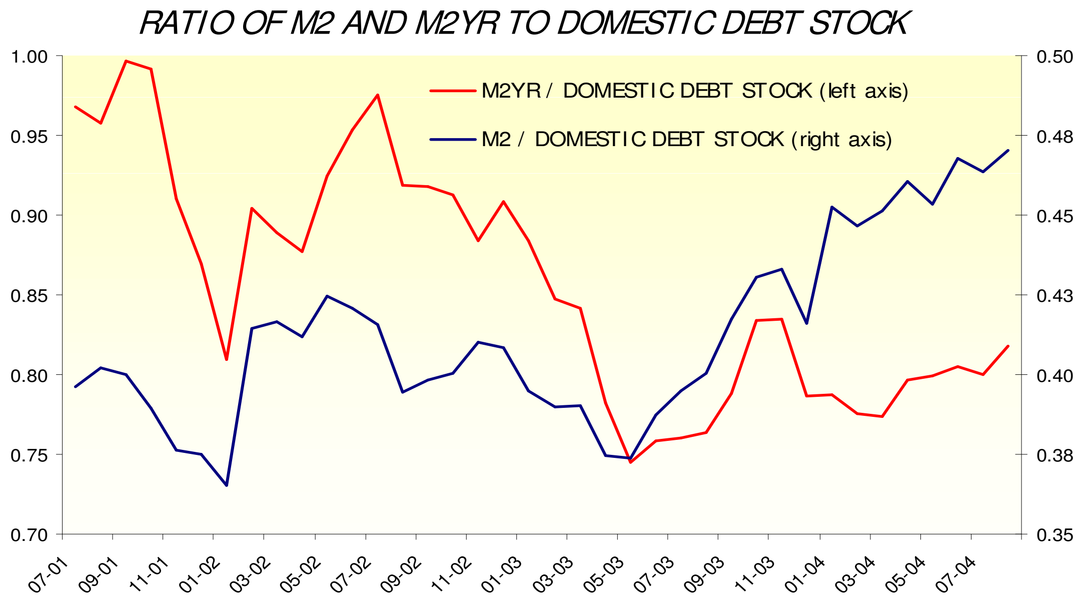
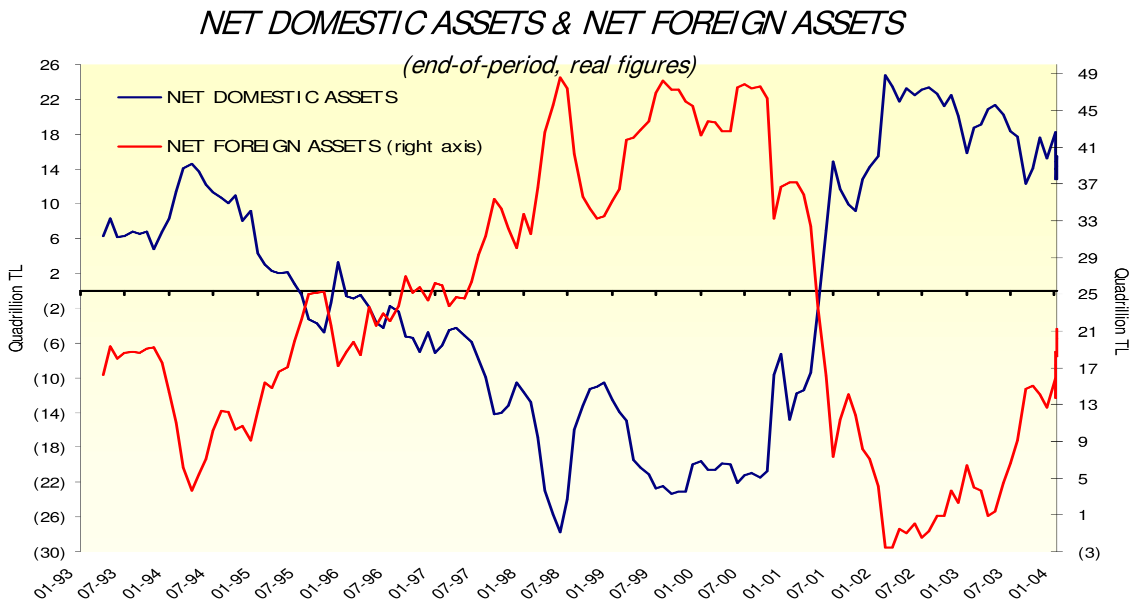
The amount of **excess liquidity** in the markets **decreases:**

Lending interest rates of the CBT were reduced at a faster pace.

Markets – CBT Balance Sheet





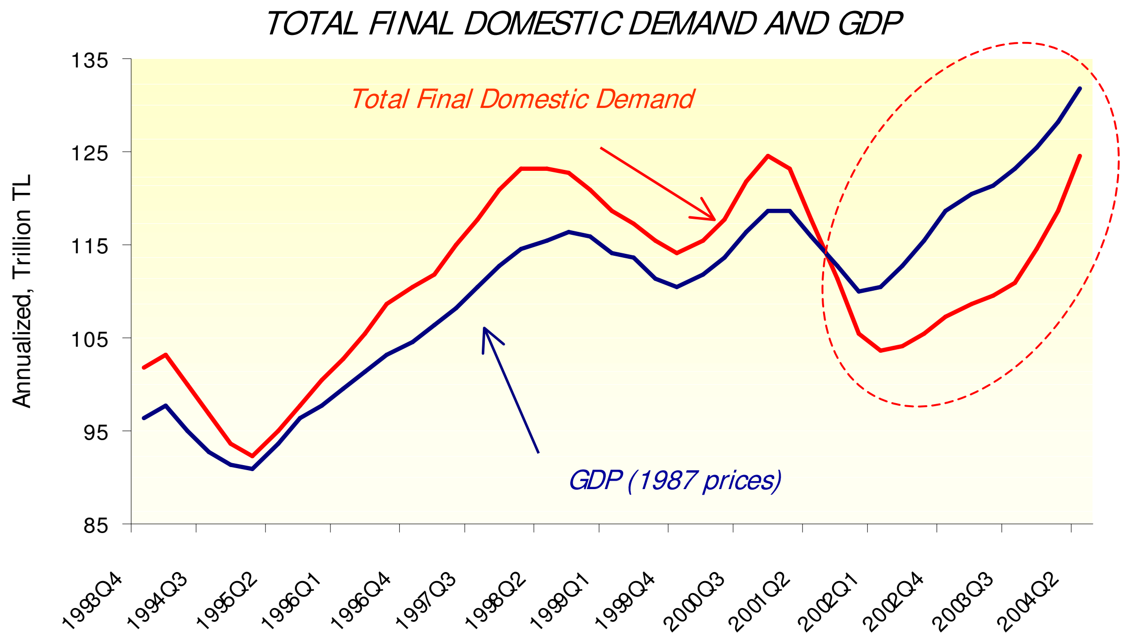
* Net Domestic Assets = Stand-by Program definition of Net Domestic Assets – Banks' TL & FX Deposits + Provisions

Financial markets are deepening.

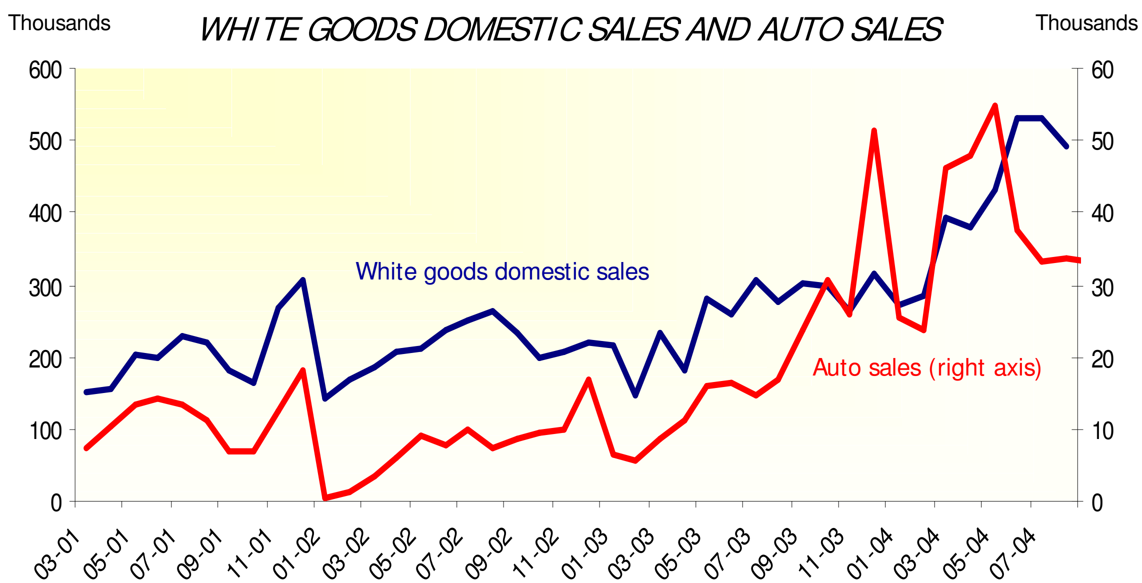
- ✓ Pressure of domestic debt stock on markets has been decreasing.
- ✓ Net domestic assets are under control in accordance with the program.
- ✓ Net foreign assets have been increasing gradually.

RISKS, PROBLEMS AND CHALLENGES

Risks, Problems and Challenges



Total Final Domestic Demand = Consumption Expenditures + Gross Fixed Capital Formation



1- Steady recovery in domestic demand, especially consumption closely monitored.

<u>At present:</u>

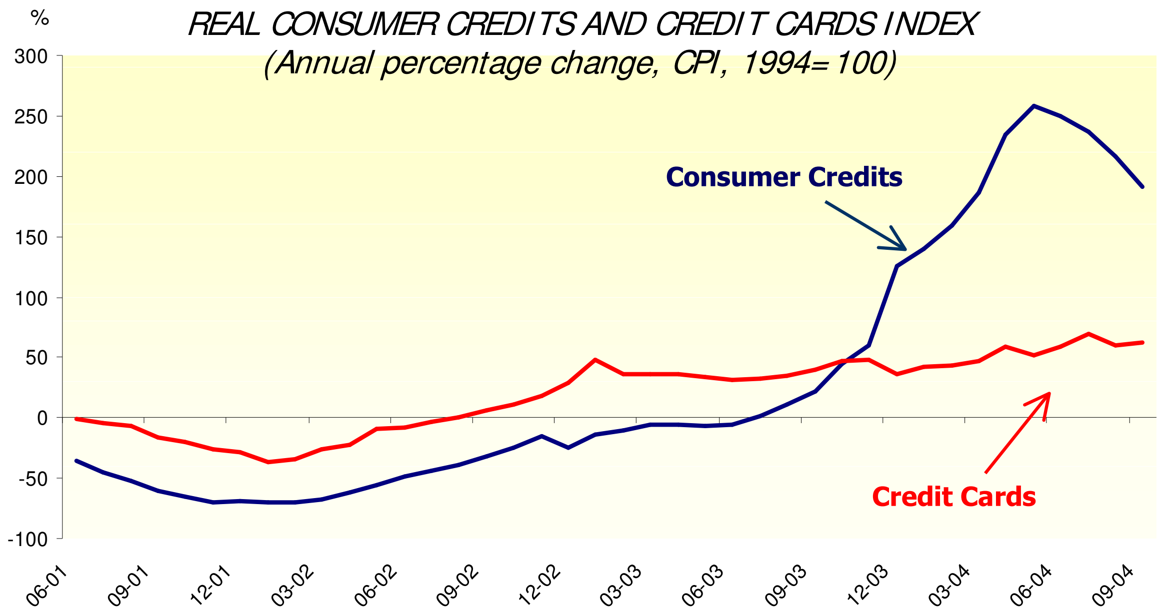
✓ Total **final domestic demand** is still **below GDP**.

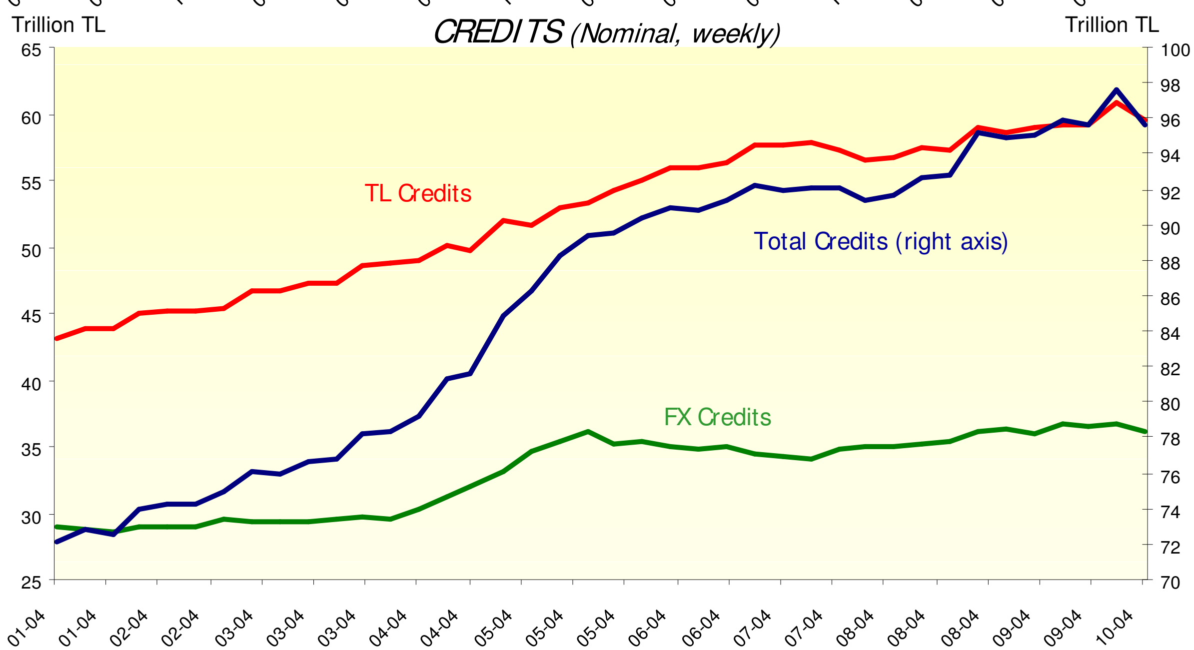
✓ The increase in consumption is observed so far only at certain sectors. The source of the recovery is **pent-up demand**.

✓ The upward trend observed in the sales of white goods and automobiles has not caused any inflationary pressure yet, thanks to the increase in productivity.

✓ Expenditures on semi-durables and non-durables are also watched.

Risks, Problems and Challenges



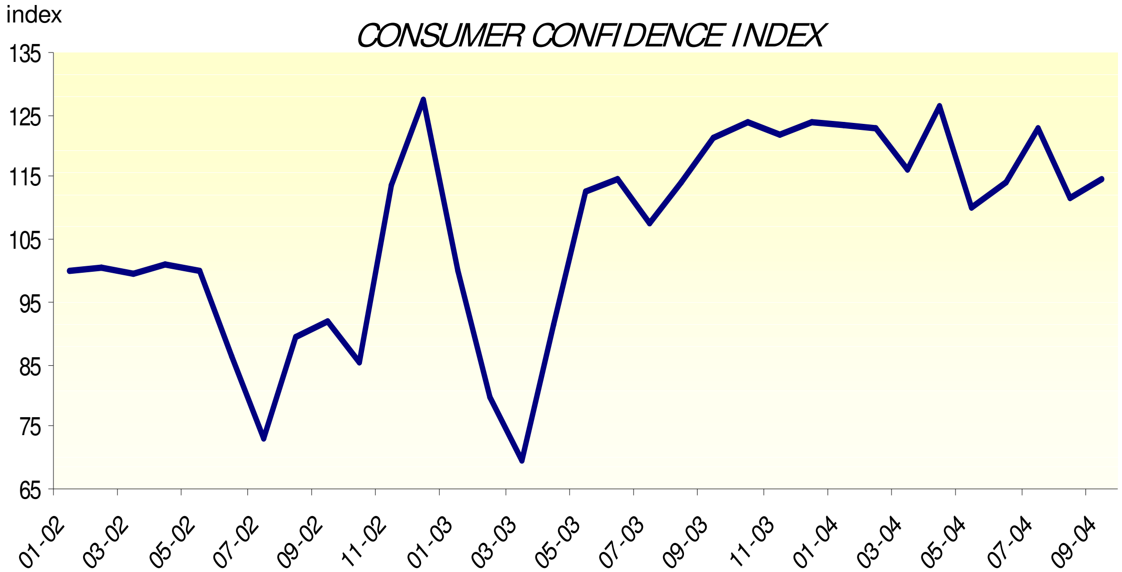


At present:

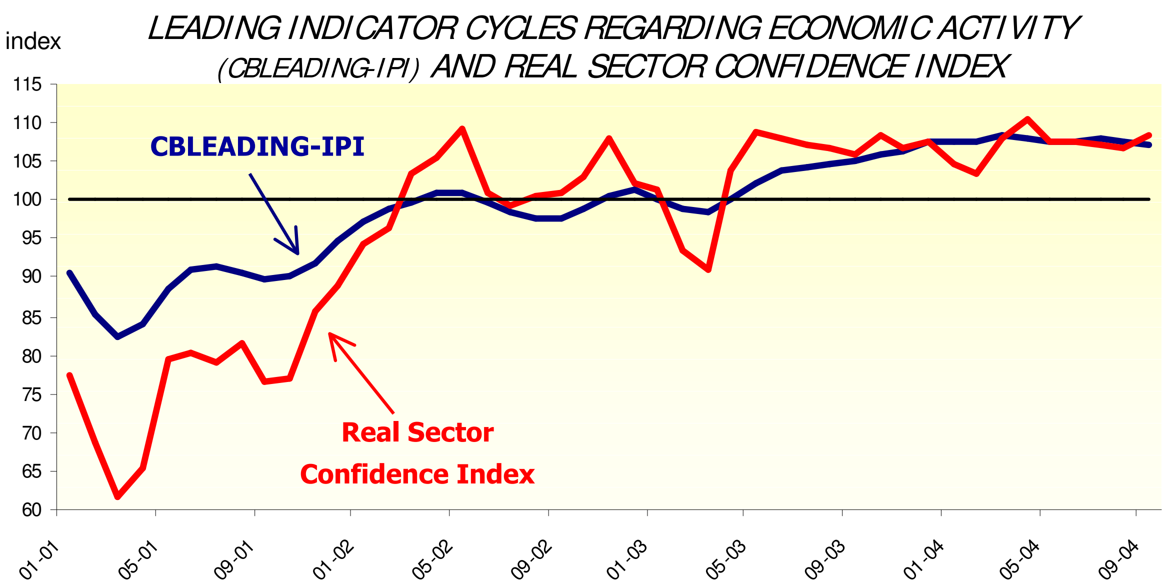
✓ A **slowing down in the real growth** rate of consumer credits and credit cards has been observed.

✓ Credits in TL have followed a **stable path** for the last three months.

Risks, Problems and Challenges



Source: CNBC-E



CBLEADING-IPI= Treasury auction simple rate, import of intermediary goods, production amount of electricity, export possibilities, stocks of finished goods, total employment expectation, amount of new orders received by domestic market.
Real Sector Confidence Index above 100 indicates increasing confidence in economic activities.

At present:

✓ Survey shows that consumer confidence has been stable.

Expectations about economic outlook are favorable as well as stable.

Leading Indicators Index

✓ Stabilized at high levels.

Real Sector Confidence Index

✓ At high levels since April 2003.

✓ Follows a more stable path compared to the past.

Risks, Problems and Challenges

1- Steady recovery in domestic demand, especially consumption closely monitored.

At present:

- ✓ Aggregate domestic demand is below GDP.
- ✓ The increase in consumption is observed only at certain sectors. The source of the recovery is pent-up demand.
- ✓ Real growth rate declines for consumer credits and credit cards. Credits in TL have followed a stable path for the last three months.
- ✓ Consumer confidence and leading indicators have been stable.

2- Reform fatigue

3- External shocks; e.g. EU, IMF

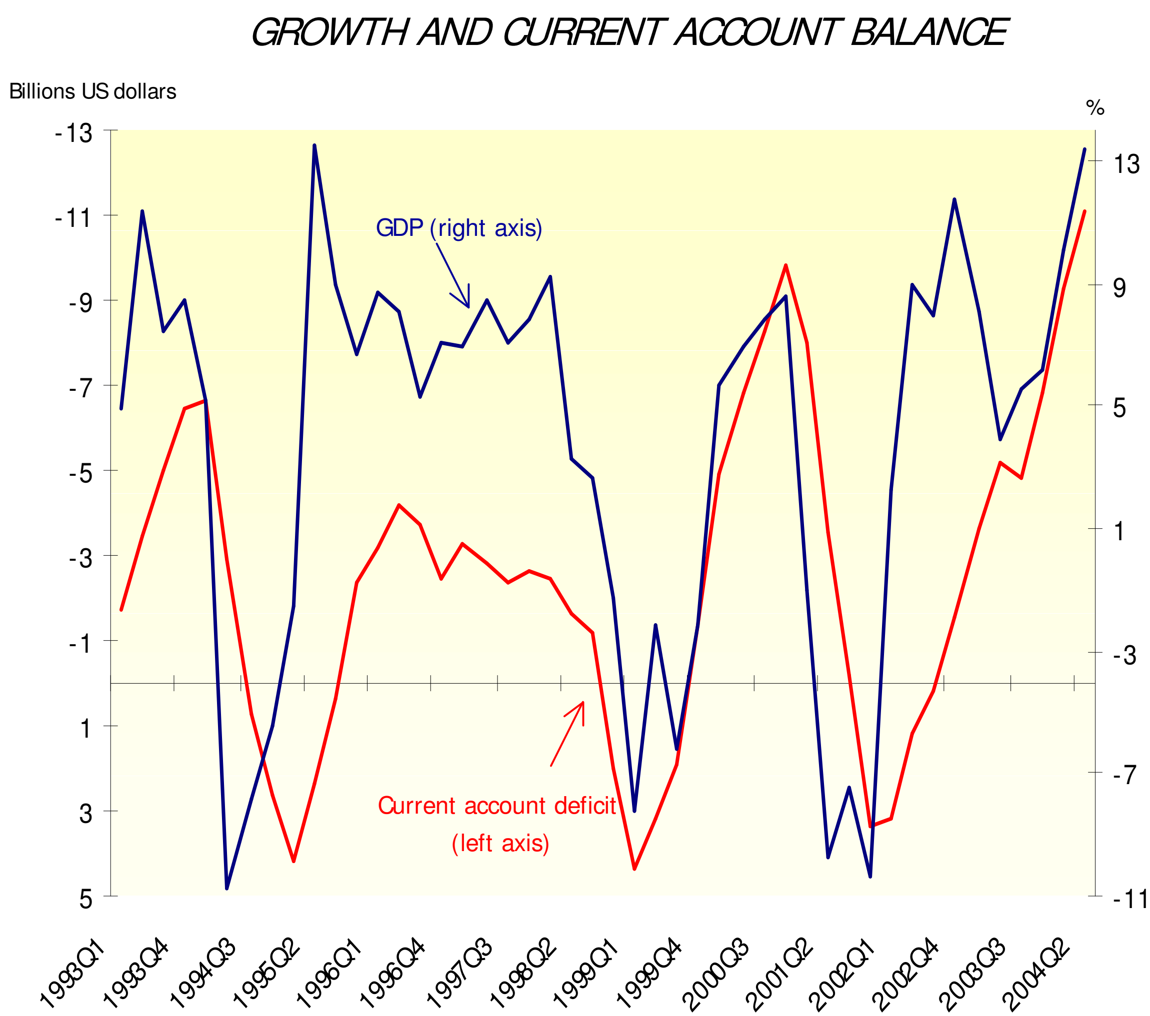
4- Managing expectations

5- Public price adjustments not in line with targeted inflation

6- Tendency to increase profit margins as the economy recovers

7- Agricultural and energy prices

Growth – Current Account Deficit



- ✓ Economic **growth** is **above** the program **forecast** of 5 %.
- ✓ This has naturally raised the current account deficit from the level determined within the economic program.

Growth – Current Account Deficit

In the past, current account deficits led to crises:

WHAT IS DIFFERENT NOW?

1. Floating exchange rate:

- 51 of the 52 balance of payments crisis in 19 countries in the 1980-2001 period were under managed exchange rate regimes*. Floating exchange rate regime has a shock-absorbing characteristic.

2. Stronger banking system:

- The system has less open positions.

3. TL is not kept overvalued.

- Does the CBT sell foreign exchange?
- Foreign exchange reserves are at high levels.

4. It should be kept in mind that the exchange rate risk is at the market.

- Short-term capital inflows are not encouraged.

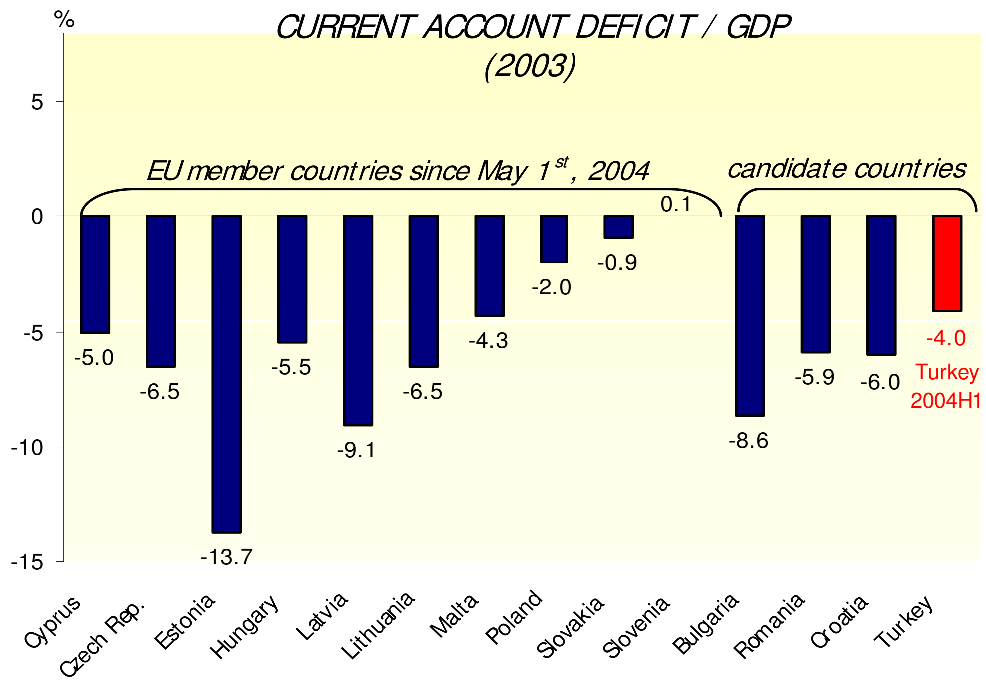
5. Tight monetary and fiscal policies are being implemented.

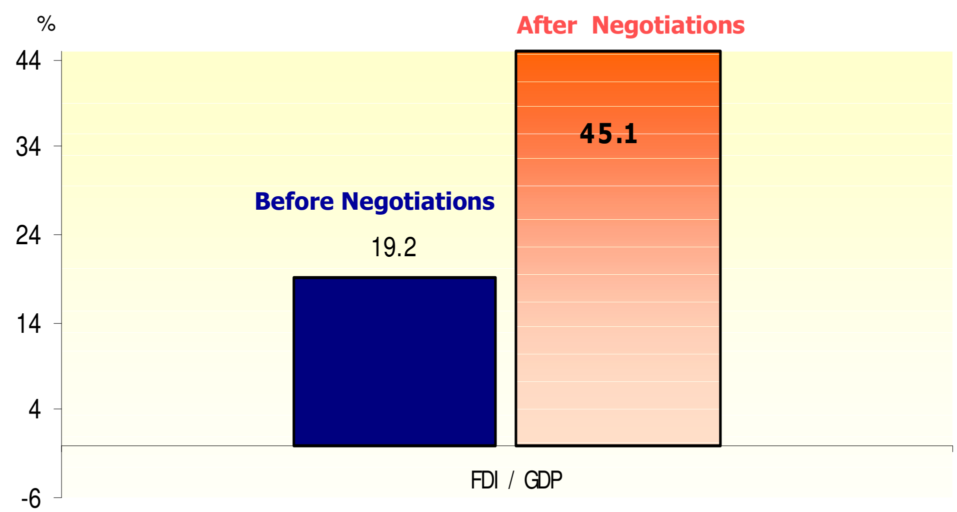
6. Low inflation:

- It is the first time for twenty years that a program is being completed. A new program will be launched. The inflation target becomes a reliable anchor for the future, as economic units are able to see longer term and confidence in policies increases.

* Sources: Kaminsky G. and C. Reinhart (1999), "The Twin Crises: The Causes of Banking and Balance of Payments Problems", The American Economic Review, Vol.89(3), pg.473-500. IMF Annual Report on Exchange Arrangements and Exchange Restrictions, 1980-2002.

Growth – Current Account Deficit





It is also observed that;

Developments in the Turkish economy in the last 3 years carried economic balances such as productivity and growth to a higher plateau together with declining inflation.

⇩

- ✓ Deeper commercial and financial integration to the world enables higher current account deficits to be sustainable.
- ✓ The ratio of Current Account Deficit / GDP is at much higher levels in some other developing countries.
- ✓ The medium-term program, the EU accession process and foreign direct capital inflows will enable these balances to be sustainable.

Countries: Hungary, Poland, Estonia, Czech Rep., Slovenia, Cyprus, Romania, Slovakia, Latvia, Lithanunia, Bulgaria, Malta.

THE NEW TURKISH LIRA

The New Turkish Lira (TRY)

The process of dropping six zeros from the Turkish lira has started. ⇨ **The New Turkish Lira will be introduced as of January 1st , 2005.**

✓ Dropping six zeros off the Turkish lira is mainly a technical operation: It is not expected to affect **variables such as exchange rates, interest rates**, nor other economic aggregates.

WILL THERE BE AN INFLATIONARY EFFECT?

✓ It is necessary to remind that prices have been and are continously **rounded-up,** due to the chronic inflation environment of the past and the consequent limited usage of coins in transactions.

✓ Small amount of rounding-up effect may occur in certain sectors, but this effect will not continue, and thus will not have any lasting effect on inflation.

✓ **Price round-ups** as a result of the dropping six zeros **are not expected to have a lasting effect** on inflation.

✓ What happened in Europe?

✓ **Banknotes and coins are being printed and minted.**

✓ **Comprehensive publicity campaign is being carried out.**

Dropping six zeros off the Turkish lira is an indicator of the determination in bringing inflation to single-digit figures.

ECONOMIC OUTLOOK

CENTRAL BANK OF THE REPUBLIC OF TURKEY

October 2004