CENTRAL BANK OF THE REPUBLIC OF TURKEY

MONETARY POLICY REPORT 2004-IV

CONTENTS

INDEX of GRAPHS and TABLES

1. Introduction*

The ongoing disinflation process of the last three years continued throughout 2004 and CPI inflation, at 9.3 percent, was below the targeted level for the third consecutive year. The rising commodity prices in international markets in 2004 and the fluctuations in financial markets in April and May did not have a lasting impact on inflation. Besides, as of end-2004, inflation expectations for end-2005 converged to the targeted level of 8 percent. These developments mainly stemmed from pursuing consistent fiscal and monetary disciplines as well as ongoing structural arrangements.

In line with the forecasts emphasized in the previous report, economic growth and domestic demand slowed down in the third quarter of 2004. Data for the last quarter for consumer credit utilization, industrial production and motor vehicles sales to the domestic market show that relative sluggishness in domestic demand continued in the last quarter of the year. Meanwhile, demand composition, which is another factor contributing to the disinflation process, also maintained its immediate structure during this period. Within this framework, increases in private consumption expenditures remained limited to certain goods groups and they were not reflected to a wider range of consumers in a balanced manner. The ongoing low level of non-durable expenditures point to the demand gap in the economy. Besides, the upsurge in investment expenditures, which supports productivity increases and pushes up the level of potential output, has continued. In addition to the domestic demand conditions, with the contribution of the favorable course of cost factors such as the energy prices, the real exchange rate and unit wages, no pressure was observed on prices in 2004.

Furthermore, uncertainties about adherence to the basic principles of the economic program in 2005 and after, which have been strictly implemented during the last three years, have eased to a large extent. A decision was made on 17 December 2004 for the start of the negotiation process with the European Union (EU) for full membership. This is believed to have had a favorable impact on the reform process implemented within the framework of the economic program. As a result of all these developments, risk factors with regard to inflation diminished and the Central Bank cut overnight borrowing interest rate to 18 percent from 20 percent on 20 December 2004 and to 17 percent on 11 January 2005.

The insignificant impact of cost factors on inflation and the effectiveness of 2005 inflation target on expectations are important developments with respect to the inflation targeting regime, which will be introduced in 2006. 2005 will be the year of transition to the new regime, during which the process and timing of interest rate decisions will be rendered more transparent and foreseeable, and thus consistent with formal inflation targeting.

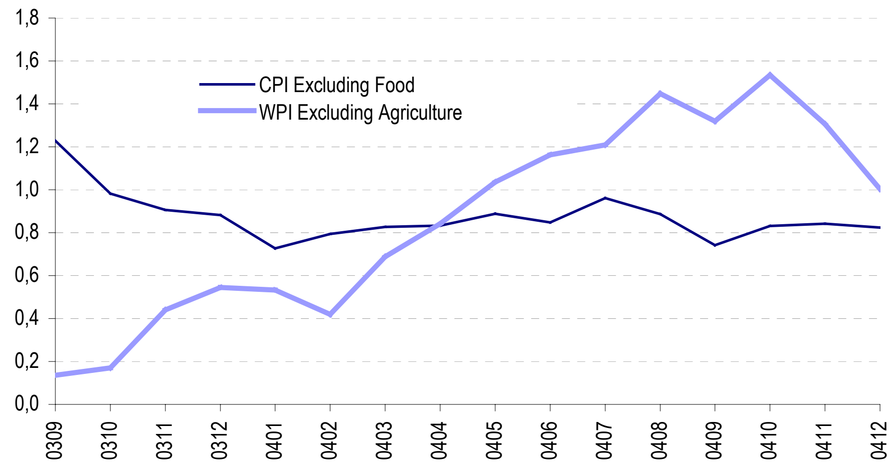
* This report is prepared by using the data covering the period till 4 February 2005 and the WPI-CPI data for December with 1994=100 as the base.

2. Inflation Developments

As of the end of the year, CPI inflation dropped to 9.32 percent, remaining below the 12 percent inflation target set for 2004. Annual WPI inflation was realized at 13.84 percent. Due to delayed seasonal increases and increases in petroleum prices, the decline in inflation stagnated during October and November. Nevertheless, the downward trend in inflation re-gained pace in December, owing to the transitory nature of the shocks and the ceasing cost pressures. When analyzed in seasonally adjusted terms, it can be seen that increases in prices, excluding food and agriculture regressed as of November (Graph 2.1).

Due to delayed seasonal increases and increases in petroleum prices, the decline in inflation stagnated during October and November. Nevertheless, the downward trend in inflation re-gained pace in December.

Graph 2.1 Seasonally Adjusted Price Increases in CPI and WPI
(Six-month Moving Averages, Percent)

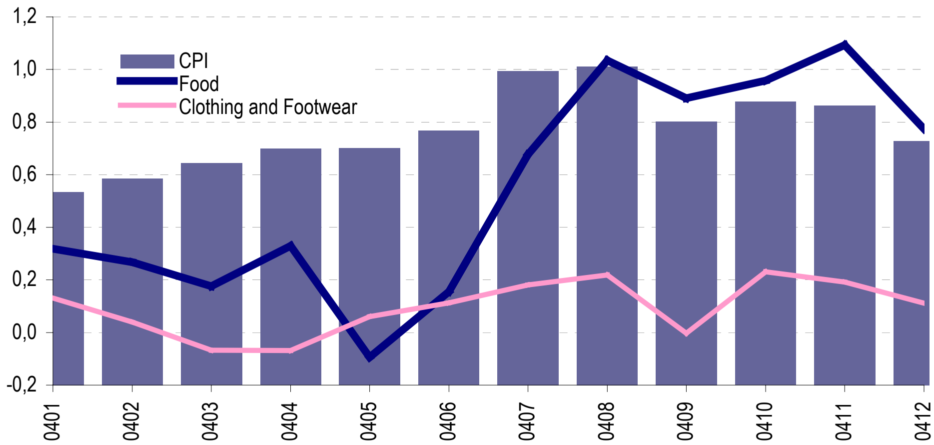


Source: SIS, CBRT

The outstanding factors with respect to inflation in the October-December period can be summarized as follows: (i) acceleration of food and clothing price increases due to seasonality, (ii) appreciation of the Turkish lira vis-a-vis the US dollar, (iii) start of a decline in international crude oil prices, (iv) ongoing price rigidity in the services group, (v) controlled revival of domestic demand.

Seasonally adjusted price increases in food and clothing sub-groups rose in October and November (Graph 2.2). This led to stagnation in the downward course of annual inflation in the same period. However, as of the end of the year, the annual rates of increase in food and agriculture prices remained quite below the general CPI inflation (Graph 2.3).

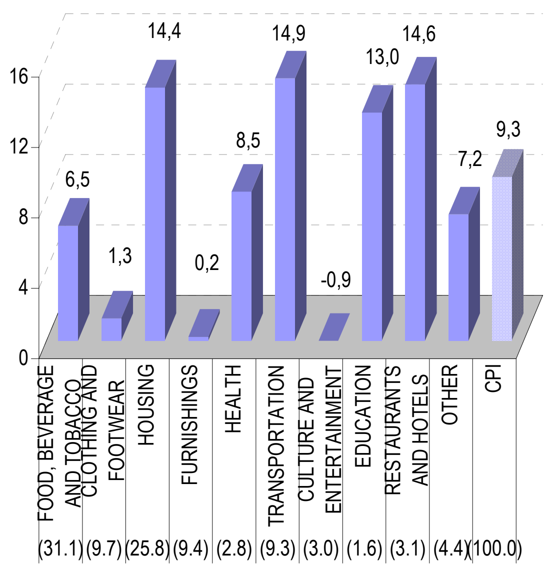
Graph 2.2 Seasonally Adjusted Price Increases ın CPI, Food and Clothing
(Six-Month Moving Averages, Percent)



Source: SIS, CBRT

Meanwhile, the transportation group, which is mostly comprised of goods, recorded the highest rate of increase among CPI sub-items (Graph II.3). In line with the 32.6 percent annual increase in international crude oil prices, petroleum prices in the transportation group of the CPI rose by 30.7 percent and the prices of oil products in the WPI public manufacturing industry increased by 31.4 percent (Graph 2.4). The downward trend in crude oil prices that has started as of October is highly significant due to its favorable impact in limiting the lagged effects of recent increases in oil prices and cost pressures.

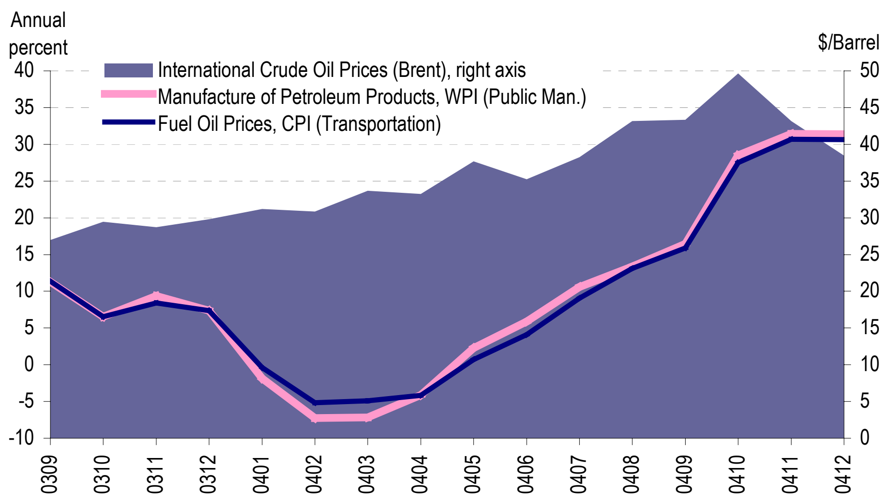
Graph 2.3 CPI and Major Subgroups, Annual Rates of Increase in 2004



Source: SIS, CBRT

Another important point about inflation in the last quarter of 2004 is the ongoing price rigidity in the services sector. As of December 2004, the annual rate of increase in the prices of the services group realized as 15.3 percent, staying quite above the 6.1 percent increase in the goods prices. This significant difference between the rates of increase in the prices of the goods and services groups can also be clearly observed when increases in the main sub groups of the CPI are compared. Apart from the transportation group, prices of restaurants-hotels, housing and education groups displayed increases above overall CPI inflation and the annual target of 2004. These groups have a significant share of the services sector (Graph 2.3).

Graph 2.4 International Crude Oil and Fuel Oil Prices

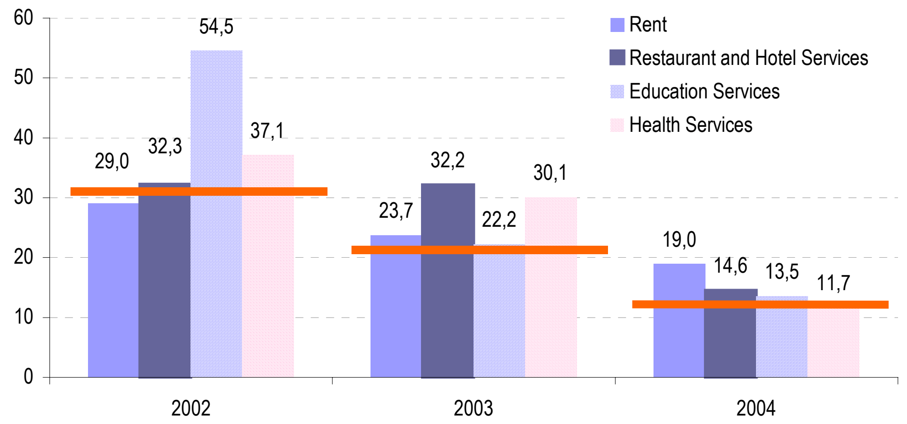


Source: SIS, CBRT

Since the start of the disinflation process in 2002, the annual rates of increase in the prices of the services sector sub-groups continuously declined. However, due to the price rigidity in the services group, they remained above the general inflation trend and the year-end inflation target Graph 2.5). Nevertheless, prices of services such as restaurant and hotels, education and health, that did not accompany the disinflation trend in 2002 and 2003, displayed a more rapid decline in 2004, coming closer to the inflation target. This is considered to be positive, since it indicates that the rigidity of services prices is diminishing, albeit slowly. Meanwhile, increases in rents, which comprise a remarkable portion of the services group, diverged from the inflation target to a greater extent in 2004 compared to the previous years. While the rate of increase in prices of restaurant and hotel services declined to a year-end value of 14.6 percent in 2004 from the 32.2 percent of 2003, the increase in rents declined to 19 percent from 23.7 percent (Graph 2. 5).

Prices of services such as restaurant and hotels, education and health, that did not accompany the disinflation trend in 2002 and 2003, displayed a more rapid decline in 2004, coming closer to the inflation target.

Graph 2.5 Annual Price Increases in Selected Services Groups and Inflation Target



Source: SIS, CBRT

Though, as mentioned in the previous Monetary Policy Report, the improvement in the income level compared to the post-crisis[1] period is considered to have a slight effect on the relative price adjustments in services sub-items, mainly rents, the rather limited increases in durable goods, clothing and food prices point to a controlled revival in domestic demand. However, according to GNP data, which follows the price data with a lag, the recovery in domestic demand observed in the second half of 2004 lost pace in the third quarter of the year. As confirmed by the rate of increase in CPI sub-items, expenditures on goods excluding durables, "necessity goods", displayed a slight increase and maintained its low levels during this period.

The controlled recovery in domestic demand is of high importance in limiting the price increases in services along with curbing the negative effects of annual WPI inflation on CPI inflation, which rose up to 15.5 percent as of October, on CPI inflation. Although, there is a weakening in the pass-through effect of exchange rates to prices both in the WPI and in the CPI with the adoption of the floating exchange rate regime, the degree of pass-through to the WPI being twice that of the CPI, contributed to the acceleration of the WPI compared to the CPI in the August–October period when exchange rate developments were relatively unfavorable.[2] Along with the controlled recovery of domestic demand, the slow-down in the rate of increase in the WPI in November and December due to favorable cost conditions have sent positive signals that the influence of this increase will probably be limited.

[1] Check see BOX II.1, CBRT Monetary Policy Report, 2004-III, pg. 8-9.
[2] The pass through effect in floating exchange rate regime is examined in detail in BOX II.1.

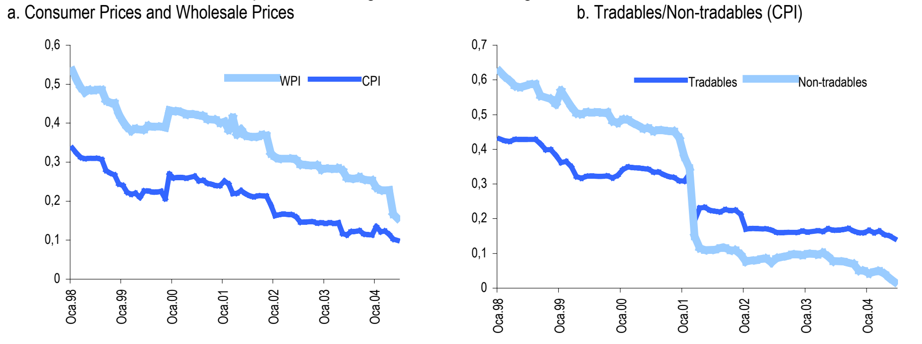
BOX 2.1 EXCHANGE RATE PASS-THROUGH IN TURKEY: DO BEHAVIORAL PATTERNS OF PRICE-SETTERS CHANGE?

The determination of Central Bank independence as the main premise of the stability program in April 2001 and the amendments made to the CBRT Law enhancing its independence signify a transformation in the historical structure. Another significant change in the period following the 2001 crisis was the transition to a floating exchange rate regime and the adoption of price stability as the primary objective. Due to these developments, along with fiscal discipline and ongoing structural reforms, inflation figures have pursued a downward trend consistent with the target for the last three years. The leading question concerning structural transformation in inflation dynamics and pricing behavior during this process is related to the relationship between exchange rates and inflation, as the foreseeability of the exchange rate in a floating exchange rate regime is rather limited. Therefore, reliable inflation forecasts can only be made provided that the impact of exchange rate volatility on inflation is limited.

Econometric Findings

When the pass-through effect of the exchange rate on prices is analyzed by 'time-varying parameter' models, it can be seen that the exchange rate pass-through effect has weakened in the post-2001 period and backward-looking indexation has diminished. Considering the trend of the coefficients of the pass-through effect of exchange rates to prices for the CPI and WPI in Panel (a) in Figure 1, the coefficient for the WPI fell to an average of 0.30 from 0.50 and the coefficient for the CPI to an average of 0.15 from 0.30 as of the year 2004. Panel (b) shows that the pass-through effect of exchange rates to prices in non-tradable goods under the CPI has declined to a third of its historical path since May 2001. More importantly, although this coefficient was historically higher than the estimated coefficient of the pass-through of the exchange rate to prices for tradable goods (high indexation), it fell below the latter after 2001. Consequently, a weakening in backward-looking indexation behavior can be concluded.

Graph 2.A Exchange Rate Pass-Through to Domestic Prices *



*In the 'time-varying parameter models', the seasonally adjusted monthly inflation rate is explained by using its own lags and the monthly depreciation rate of the Turkish lira. At each observation in the sample of the model, a coefficient is estimated for each explanatory variable. The state-space of these coefficients is based on the assumption of 'random walk'.

Sources: Kara, H., Küçük-Tuğer, H., Özlale, Ü., Tuğer.B., Yavuz, D and Yücel, E.M. (2005) "Exchange Rate Pass-Through in Turkey: Has it changed and to What Extent?', the CBRT, Research Paper

In the light of these findings, it can be said that the monetary policy strategy adopted after 2001 succeeded in weakening the pass-through of exchange rates to prices. A more striking point is that the exchange rate pass-through effect in non-tradable goods that historically used to pursue a high course weakened. In a sense, this weakening in indexation behavior manifests the efficiency of the framework of current monetary policy in directing inflation expectations.

Within the econometric framework defined above, the analysis of CPI and WPI sub-items yields the following results: (1) The pass-through effect has weakened historically both in CPI and WPI. The level of weakening is higher in WPI. (2) Apart from its assessment within CPI or WPI, the pass-through effects of exchange rates to energy prices is higher than of all the other items. (3) The second highest pass-through is seen in the item "Public sector manufacturing industry (WPI)".

Determinants of Pass-Through Effect

Table 1 analyzes the cases where the pass-through effect is higher. The findings in the table have been obtained by calculating the averages of the coefficients of pass-through effect of exchange rates to prices estimated by Kara et al. (2005) for sub-sample periods that reflect four different cases. These situations are defined by combining two cases in which the exchange rate appreciates/depreciates and the output gap is positive/negative.

Table 2.A Pass-Through Effect of Exchange Rates to Prices (sub-sampling period averages)*

		Output gap>0	Output gap <0	
CPI	*Appreciation of TL*	**0,21**	**0,13**	0,14 (b)
	Depreciation of TL	**0,30**	**0,23**	0,26 (b)
		0,29 (a)	0,20 (a)	0,24 (c)
		Output gap >0	*Output gap <0*	
WPI	*Appreciation of TL*	**0,31**	**0,23**	0,24 (b)
	Depreciation of TL	**0,48**	**0,37**	0,42 (b)
		0,46 (a)	0,32 (a)	0,38 (c)

*In the sample, there are four periods where the exchange rate appreciates and the output gap is positive. In 20 periods, the exchange rate appreciates, whereas the output gap is negative. There are 41 periods during which the exchange rate depreciates, while the output gap is positive. In 42 periods of a total of 107 periods, the exchange rate depreciates and the output gap is negative. (a), (b) and (c) show the (weighted) averages of column, line and table, respectively.

The Table shows that in the periods where the Turkish lira depreciates - without taking the output gap into consideration – the pass-through effect of exchange rates to prices is weaker compared to the periods where the Turkish lira depreciates. Similarly, in the periods where the output gap is negative – regardless of the change in exchange rate - the pass-through effect coefficient is lower compared to the periods where the output gap is positive. In other words, the pass-through effect of exchange rates to prices reaches its highest (lowest) average level during periods where both the output gap is positive (negative) and the Turkish lira depreciates (appreciates).

Intuitively, the pass-through-effect of exchange rates to prices is always expected to be positive. In other words, in periods of depreciation prices will increase, while prices will fall in periods of appreciation. However, pricing behavior will be more sensitive to exchange rates in periods of depreciation compared to periods of appreciation. This assumption is consistent with the opinion that prices are more elastic upwards. The impact of the output gap can be explained by the sensitivity of price-setters against cost factors in cases where they face a demand beyond the production potential of the economy. In such cases, the demand-reducing effect of price increases will be relatively limited or in other words, prices will be flexible upwards.

The Cost of Success – or – Homework for the Upcoming Period

In the light of these findings, it can be concluded that the floating exchange rate regime and recent stabilization program have proved to be successful in weakening the exchange rate-inflation relationship. These findings, at the same time, point out that other cost factors have come to the foreground with respect to inflation dynamics in the recent period. In this context, producing policies towards increasing productivity both in the public and private sectors is a 'must' in order to maintain the downward trend in inflation.

Has the Pass-Through Effect in the New Indices Changed?

The above analysis indicates that there is a structural break in the exchange rate-inflation relationship in pre and post 2001(according to 1994 base year indices). The SIS started to publish a new index with a 2003 base year last month. Though it is still early, it is possible to develop the following judgments for the index and the exchange rate-inflation relationship:

- In the new CPI, the pass-through effect seems to weaken, albeit slightly, due to the reduced share of housing rents (the sensitivity of this group against exchange rates is low) and the increased share of tradable goods.
- In the new PPI with base year 2003, non-tax prices are compiled. This has led to a significant increase in the sensitivity of the index to exchange rates.
- All the above assessments of pass-through are not only valid for exchange rates, but for imported raw material prices as well.

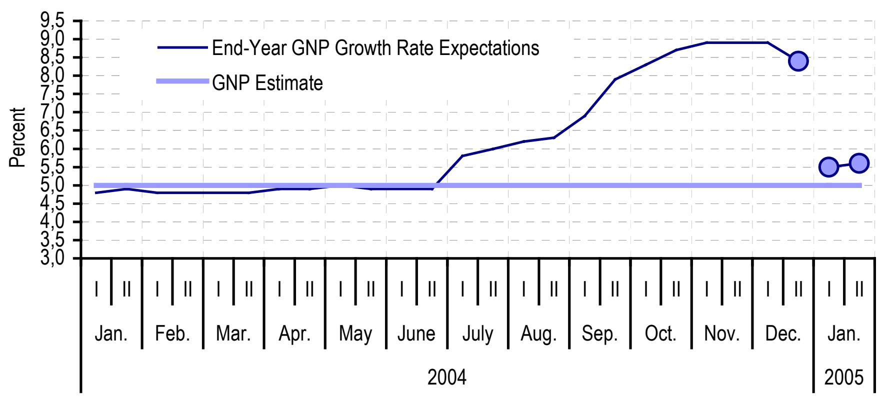
All in all, the new PPI seems to be more sensitive to exchange rates compared to the WPI. Meanwhile, the increase in sensitivity in the CPI is deemed limited.

3. Supply and Demand Developments

3.1 Supply and Demand Balance

The rapid growth tendency in the Turkish economy that started in the first half of 2004 lost pace in the third quarter of the year. During this period, the GNP increased by 4.7 percent compared to the same period of the previous year. Due to a relative slowdown in domestic demand along with the base effect caused by the high level of production during the same period of the previous year, economic growth was realized below expectations. Moreover, the unexpected fall of the value added in the agriculture sector compared to the same period of the previous year had a negative impact on growth at this period. Despite the slowdown in the third quarter of 2004, in the first nine months high growth figures were achieved. In line with these developments, during the second survey period of December, growth expectations reached 8.4 percent rate, which was rather above the program estimate of 5 percent.. The success of the economic program in achieving macroeconomic goals had a positive effect on expectations for 2005. Within this framework, in the second survey period of January, the end-2005 GNP growth expectation was 5.6 percent, above the figure forecasted by the program (Graph 3.1).

Graph 3.1 Annual GNP Growth Rate Expectations in the CBRT Expectations Survey



Source: CBRT

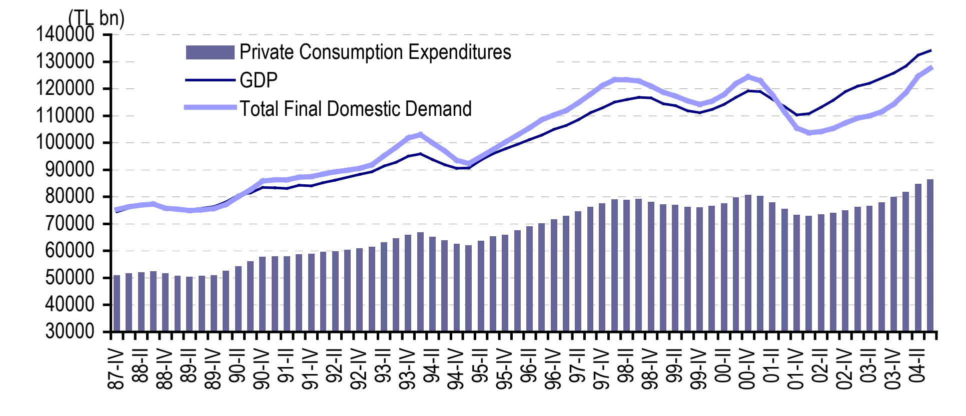
When the production developments during the last quarter of 2004 are examined, it can be seen that the increase in industrial production, although sluggish, continued. The data of the State Institute of Statistics (SIS) Monthly Industrial Production Index revealed that during the January-November period, total industrial and manufacturing industry production increased by 10.4 percent and 11.1 percent, respectively compared to the same period of the previous year. Accordingly, capacity utilization rates in the manufacturing industry maintained their high levels in 2004. According to the data announced by the SIS, the capacity utilization rate in the total manufacturing industry sector hit an extremely high level, reaching 81.5 percent in 2004.

Table 3.A GDP Developments by Expenditure Side (Annual Percentage Change)

	2003					2004			
	I	II	III	IV	Annual	I	II	III	Nine Months
1- Consumption Expenditures	6.9	2.3	5.2	8.0	5.6	9.9	13.6	5.4	9.3
Public	-2.3	-2.0	-0.7	-4.2	-2.4	2.4	-7.9	-7.1	-4.8
Private	7.8	2.9	5.8	10.3	6.6	10.6	16.4	6.7	10.8
Durable Goods	24.7	10.6	11.4	49.5	24.0	49.7	61.7	29.3	46.1
Services	9.6	5.1	7.6	7.9	7.5	10.1	14.3	5.5	9.4
Food and beverages	4.4	4.1	5.7	1.0	4.1	0.9	0.3	-1.2	-0.2
Semi-Dur.& Non-Dur. Cons. Exp.	4.7	-4.5	3.7	3.8	2.1	4.9	31.2	18.3	16.8
2- Fixed Capital Formation	11.7	6.4	3.0	19.2	10.0	52.6	51.7	23.5	41.1
Public	-34.8	-14.6	-22.7	5.0	-11.5	-11.3	-9.1	-11.8	-10.7
Private	22.5	14.2	16.4	30.1	20.3	60.6	68.7	35.8	54.6
3- Stock Change*	3.6	5.5	2.2	1.2	3.0	3.1	1.4	-1.1	0.9
4- Exports of Goods and Services	14.5	12.3	19.4	16.9	16.0	10.3	15.7	7.8	11.0
5- Imports of Goods and Services	22.0	24.7	28.3	33.0	27.1	31.2	32.7	16.0	26.5
6- Total Domestic Demand	10.9	8.5	7.0	11.3	9.3	19.1	21.1	7.3	15.3
7- Total Final Domestic Demand	7.7	3.2	4.7	10.6	6.5	17.5	22.5	9.0	15.7
8- GDP (Expenditure Side)	8.1	3.9	5.5	6.1	5.8	10.1	13.4	4.5	8.7

*Contribution to GDP growth, percent
Source: SIS

Graph 3.2 Annualized GDP, Total Final Domestic Demand and Private Consumption Expenditures (1987 Prices)



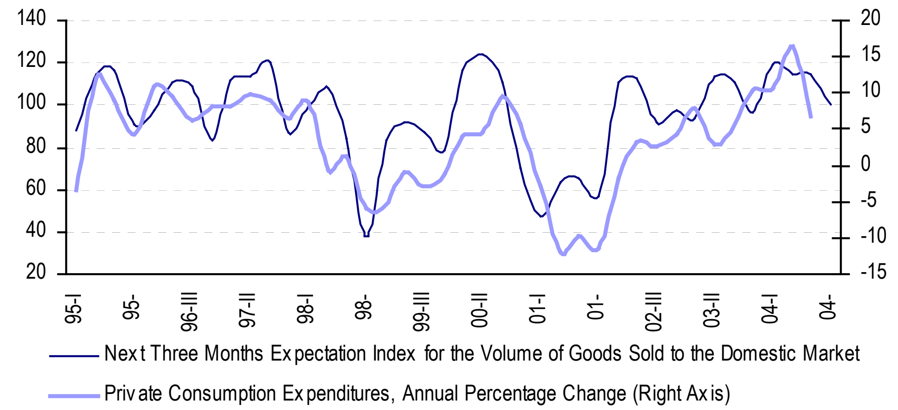
Source: SIS

The revival of domestic demand that had accelerated in the fist half of 2004, slowed down significantly in the third quarter. On the other hand, domestic demand conditions have still contributed to the growth process to a great extent. However, the high rate of increase in private expenditures in this period was a major determining factor for growth (Table 3.A). Growth in total final domestic demand, which by the last quarter of 2003 had exceeded GNP growth, maintained this trend in the third quarter of 2004 as well.

This shows that domestic demand conditions will not be as instrumental in the disinflation process as they used to be in former periods. Nevertheless, the current level of the total final domestic demand, which is still below GNP, shows the persistence of demand gap in the economy (Graph 3.2).

Compared to the first half of the year, the contribution of private expenditures to growth declined, while public expenditures continued to decrease in this period as well due to tight fiscal policy implementation. When private expenditures, the demand component, which made the major contribution to GNP growth, are examined in terms of sub-groups, durable, semi/non-durable goods and machinery-equipment investments are the expenditure groups that led the economic growth (Table 3.A). On the other hand, the decline in food expenditures compared to the same period of the previous year and the low level of expenditures on necessities show that the increase in domestic demand is not balanced among consumer groups.[1] As stated in the CBRT Business Tendency Survey (BTS) for the next three months, the level of volume of goods sold to domestic market indicates that the slowdown in domestic demand also continued in the last quarter of the year (Graph 3.3).

Graph 3.3 Private Consumption Expenditures and Expected Sales



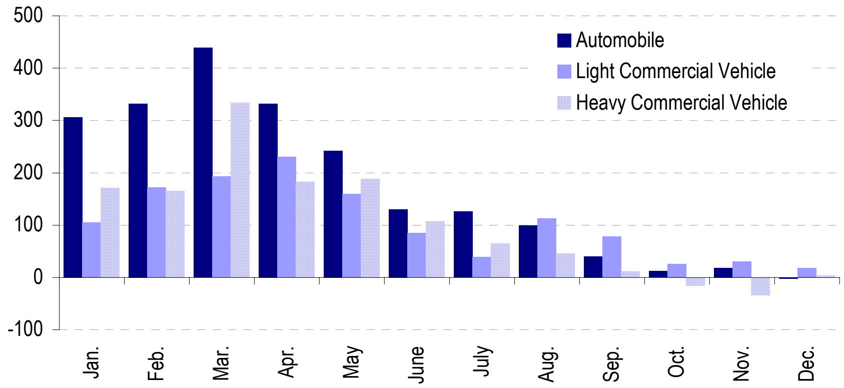
Source: SIS, CBRT BTS

In the first half of 2004, the strong position of the Turkish lira against foreign currencies led to a decrease in the relative prices of tradable goods. The improvement in borrowing facilities, such as the decline of interest rates on consumer credits and longer-term installments, enhanced the revival of the credit channel. These two factors were instrumental in the rapid growth of private consumption expenditures. However, in the third quarter of the year, along with the precautions to curb domestic demand, — limiting of consumer credits by public banks, the increase of the Resource Utilization Support Fund by the government, the decrease in scrap discount by 50 percent — the uncertainty brought by the rise in crude oil prices in international markets negatively

[1] The expenditures on necessities consist of the private consumption expenditures on goods and services excluding consumer durables.

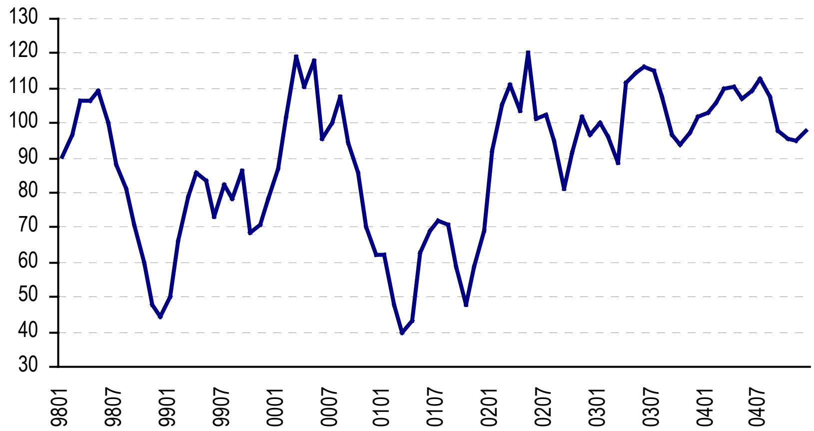
influenced consumption demand and caused a slowdown in credit use. Moreover, loss of pace in the domestic automobile sales arising from the increase in the Private Consumption Tax (PCT) in November and recent industrial developments, show that the slowdown in consumption demand has continued in the last quarter of 2004 (Graph 3.4).

Graph 3.4 Domestic Sales of Motor Vehicles (Annual Percentage Change)



Source: AMA

Graph 3.5 Production Tendency Index for the Next Three-Month Period *



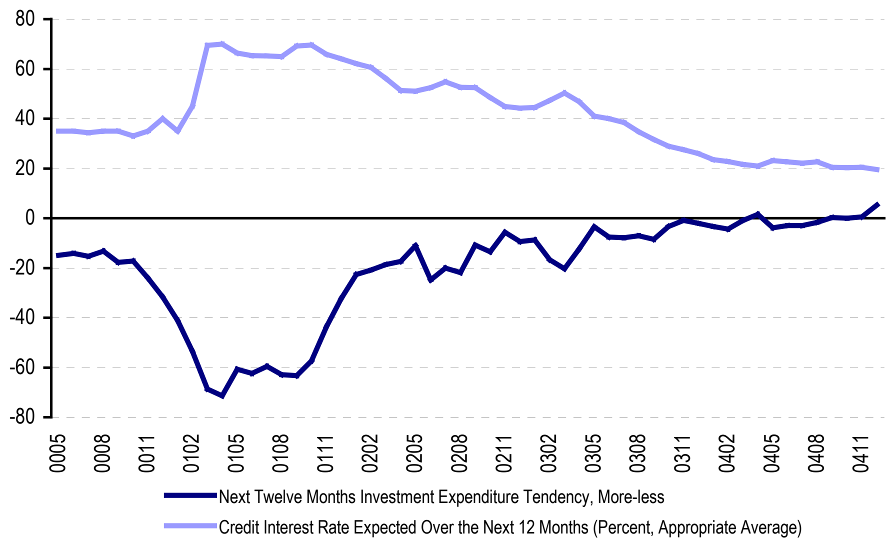
*The index comprises CBRT BTS next three months indicators of volume of raw material, volume of output and total employment.
Source: CBRT

In line with the slowdown in domestic demand, the rate of increase in industrial production dropped in the third quarter of the year. During this period, the volume of industrial production grew by 7.6 percent compared to the same period of the previous year. Along with this, the slowdown in industrial production continued in October and November and was realized as 1.5 percent and 9.6 percent, respectively. Moreover, the production tendency index for the next quarter compiled on the basis of CBRT BTS indicators maintained its downward trend observed since July and dropped to 2004's lowest level in November. However, a slight increase was observed in the index in

December (Graph 3.5). The high base effect brought about by the economic recovery in the last quarter of 2003 is expected to stimulate the downward trend in economic growth in the last quarter of the year as well.

Private investment expenditures recorded a high rate of increase by 35.8 percent in the third quarter of 2004 as a result of the rapid rise in machinery-equipment investments. Thus, in the third quarter of the year, private investment expenditures continued to be the demand factor that made the greatest contribution to economic growth. The fact that machinery-equipment investments have still increased at high rates despite the slowdown compared to the first half of the year is an indication of favorable expectations reflecting the "confidence" about the course of economy.

Graph 3.6 CBRT BTS Expectation of Credit Interest Rate and Investment Expenditure Tendency

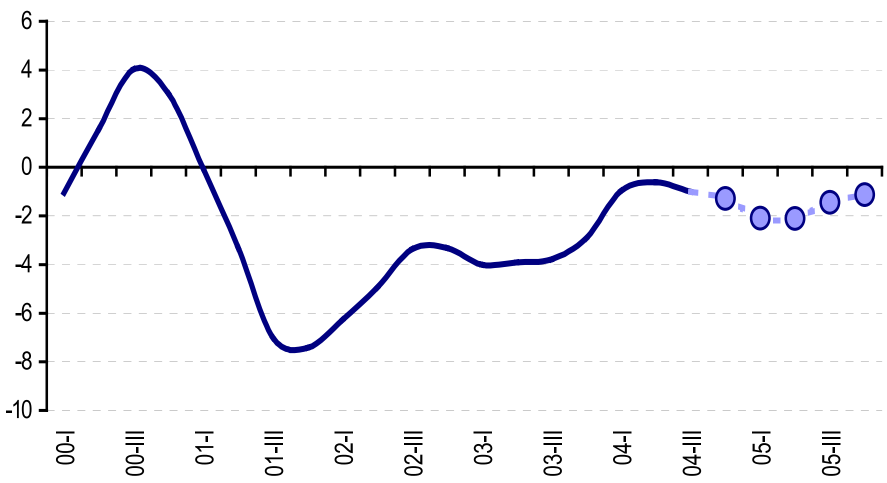


Source: CBRT BTS

Compared to the same month of the previous year, machinery-equipment production decreased slightly in October 2004, but re-accelerated rapidly in November. In October and November, domestic sales of heavy commercial vehicles (trucks, buses, midibuses) decreased compared to the same months of the previous year, but increased slightly in December. In the same period, the rate of increase in sales of light commercial vehicles dropped compared to the same period of the previous year (Graph 3.4). However, developments in imports of capital goods in December and high capacity utilization rates in machinery-equipment sector indicate that the increases in investment expenditures are still continuing. Meanwhile, in the framework of the favorable expectations about financing costs, the CBRT BTS expectations for credit interest rates and investment expenditure tendency are other indicators that show the increases in investment expenditures (Graph 3.6). In light of this information, it is anticipated that the rate of increase in investment expenditures will lose pace in the last quarter of the year due to the high base effect observed in the same period of 2003. However, these increases are expected to continue in line with the current investment tendency.

The boost in productivity still continues, albeit slower, compared to the first half of the year and the investment expenditure tendency keeps its high level, limiting the pressure on prices. In addition, no demand pressure is expected on prices in the short run due to the structure of the current consumption composition and the relative slowdown in domestic demand that is also expected to continue in the last quarter of the year. Moreover, forecasts about the output gap show that the production level in the Turkish economy in 2005 will not threaten the disinflation process (Graph 3.7). However, in the current demand climate, likely increases in unit labor costs, which may emerge in line with the increases in employment and real wages as well as the slowing trend in productivity, may pose a risk for price developments in the upcoming period.

Graph 3.7 Output Gap / Potential GDP (Percent)



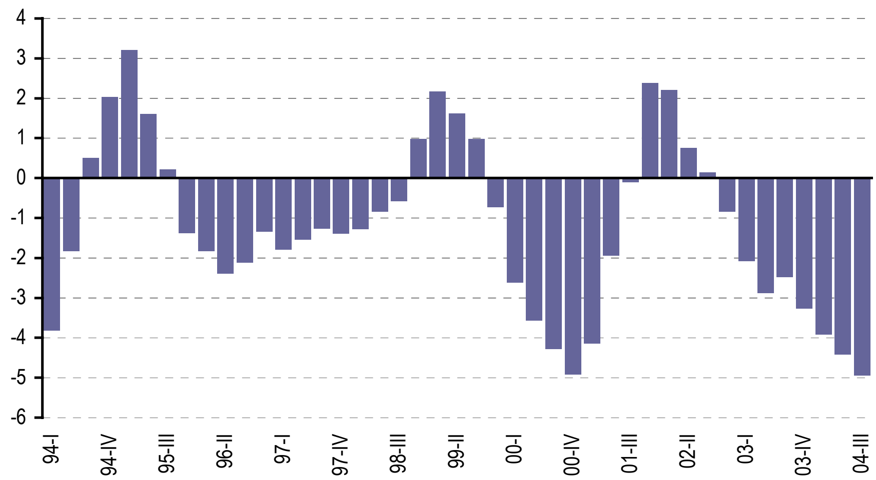
Source: CBRT

In this respect, investment expenditures and productivity gains, which has significantly contributed to the downward trend in inflation, will continue to play a critical role in the growth-price relationship in 2005. Developments about the accession process to the European Union are considered to act as a catalyst for investment expenditures that bear importance in terms of "non-inflationary sustainable growth". The most important point is to put into effect structural reforms that will attract direct foreign investments and help to improve the investment environment. Only in this way will it be possible to sustain economic growth on solid ground and maintain price stability.

3.2 Foreign Demand

In 2004, the current account balance produced a deficit of USD 15.6 billion (Graph 3.8). During this period, although service revenues were boosted as a result of the rapid rise in tourism revenues, the current account balance was mainly determined by the rapidly increased foreign trade deficit.

Graph 3.8 Current Account Balance / GNP*
(Percent)



* Annualized data
Source:CBRT

According to data announced by the SIS, exports increased rapidly by 32.8 percent in 2004. The boost in productivity exceeded increases in real wages, leading to a continuation of the decrease in unit real wages. This, in turn, helped firms to maintain their competitiveness in foreign markets and paved the way for an increase in exports.

Throughout 2004, high performance in exports and increase in domestic demand supported the rise in industrial production and, accordingly, imports increased rapidly. In 2004, total imports expanded by 40.1 percent. The greatest contribution to the rise in imports came from imports of intermediary goods in line with the increases in production and exports. The rate of increase in imports of consumption goods decelerated in the second half of the year compared to the first half. In this framework, the rate of increase in private consumption expenditures is assumed to have lost pace in the second half of 2004 compared to the first half.

In the light of current data, the current account deficit is expected to become 5 percent of the GDP by the end of 2004 and 3.7 percent of the GDP in 2005. An analysis of the current account deficit-inflation relationship highlights the effect of two main factors. The first one is the likelihood that concerns about the financing of the current account deficit may affect inflation through expectations and the exchange rate. However, an improvement is expected in financing conditions in the framework of the gains achieved in economic stability under the current program and the decision to initiate the screening process ahead of full membership negotiations with the European Union. In addition, the fact that the three-year economic program, prepared in cooperation with the International Monetary Fund (IMF), emphasizes a reform-oriented process will reinforce the economic foundations and reduce the sensitivity of the economy to external shocks. In this context, the effect of exchange rate shocks on inflation, which may emerge due to global liquidity preferences, will be temporary. Secondly, the current account deficit may come to indicate a recovery in domestic demand in the whole economy. However, it is anticipated that the level of potential production will keep rising in line with the growth in investment expenditures and consumption will rise in a controlled manner in the upcoming period. As a matter of fact, the high increases in imports of capital goods and the forecasts for the output gap support this view. In conclusion, the current account deficit is not expected to pose a risk to the inflation target.

3.3 Costs

In the third quarter of 2004, employment in the manufacturing industry increased by 1.8 percent over the same period of the previous year. In the meantime, the index of real wages per working hour in production climbed by 3 percent compared to the same period of 2003 while productivity per working hour increased by 5.9 percent (Table 3.B).

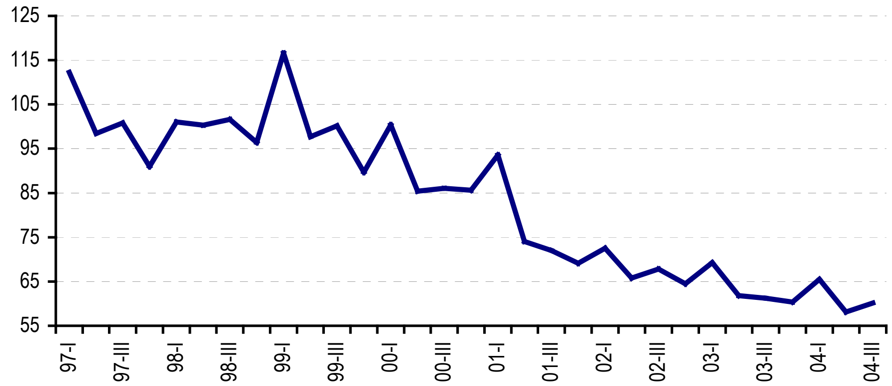
Table 3.B Employment, Real Wage and Productivity Developments in Manufacturing Industry
(Percentage Change Compared to the Corresponding Period of the Year Before)

	2002	2003					2004		
	Annual	I	II	III	IV	Annual	I	II	III
Employment[(1)]	0,6	5,1	1,8	1,4	-0,5	1,8	0,7	2,7	1,8
Public	-9,1	-4,1	-6,5	-5,3	-10,7	-6,8	-13,6	-11,0	-9,6
Private	2,3	6,3	3,1	2,4	0,9	3,1	2,6	4,5	3,2
Wages[(2)]	-5,4	-0,9	-5,3	-3,8	2,4	-1,9	0,4	5,2	3,0
Public	1,4	-2,5	-8,9	-8,5	-1,1	-5,3	2,9	7,7	5,5
Private	-4,2	0,9	-2,7	-1,1	5,1	0,6	2,8	7,7	4,8
Productivity[(3)]	8,6	5,1	3,5	8,6	11,4	7,2	8,8	13,0	5,9
Public	16,4	4,8	8,2	8,4	11,3	8,1	14,8	13,1	6,1
Private	7,8	6,0	3,5	9,4	12,4	7,9	9,3	14,3	6,9
Earnings[(4)]	-8,0	-5,4	-10,6	-8,2	-0,9	-6,3	1,8	3,7	0,9
Public	-2,1	-3,5	-12,2	-11,0	4,1	-5,6	0,6	9,2	0,9
Private	-6,8	-4,2	-8,4	-5,8	-0,1	-4,7	5,5	5,8	3,9

(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

The index of unit real wages in the private manufacturing industry, defined as the ratio of real wages to partial labor productivity, decreased by 1.8 percent over the same period of the previous year (Graph 3.9). The current state of unit real wages did not only prevent capacity-oriented pressures, which may be exerted on prices by the rises in production, but was also the main contributory factor to the upward surge in exports.

Graph 3.9 Private Manufacturing Industry Real Unit Wage Index *
(1997=100)



* Total real wage index is formed by multiplying SIS manufacturing industry real wages index per production hours worked by SIS manufacturing industry production hours and then dividing the outcome by SIS quarterly private manufacturing industry production index.

Source: SIS, SPO, CBRT

The rate of increase in productivity is assumed to have lost pace in the second half of the year in line with the slowdown of rises in production. Thus, taking into account the continuation of rises in employment and real wages, declines in unit real wages have proved to be modest compared to previous periods.

An average of a 10.7 percent rise, which remains above the inflation target of 8 percent, will be paid to civil servants in 2005. Meanwhile, the minimum wage has been raised by 10 percent. Coherent implementation of the incomes policy with the year-end target for 2005 will yield a favorable effect on price developments in the coming period via expectations. Taking into account that the wage increases in the private sector will be realized parallel to the above-mentioned increases, real wage developments in 2005 will not pose a threat to inflation developments in terms of demand and production costs.

A collective analysis of productivity and real wage developments suggests that the contribution of unit real wages to the downward trend in inflation will fall in 2005 compared to the last two years. However, it is anticipated that the increases in real wages will continue to remain below the spurts in productivity throughout 2005. This situation will help firms to retain their competitiveness in foreign markets and limit cost pressures on prices.

The strong position of the Turkish lira against foreign currencies has pushed down prices of imported raw materials and investment goods in national currency and eased cost pressures on prices. However, the increase in international prices of petroleum and metal products used as essential raw materials in industrial production pose a risk to prices. Considering the annual averages, the price index for imports rose by 12.3 percent in 2004 while crude oil prices and metal prices climbed by 27.5 percent and 36.3 percent, respectively (Table 3.C). The likelihood that these unfavorable developments in international markets will not reverse in the upcoming period constitutes a risk for inflation in all circumstances.

Table 3.C Selected Indicators of Production Costs

	2003					2004				
	I	II	III	IV	Annual	I	II	III	IV	Annual
Import Price Index	101,6	99,7	99,9	102,3	100,9	108,5	111,6	114,0	119,0	113,3(1)
Crude Oil Prices ($/Barrel)	28,7	24,7	26,5	28,0	27,0	30,0	32,0	36,7	38,8	34,4(2)
Metal Prices Index	92,7	93,0	97,9	109,3	98,2	130,0	130,2	133,8	141,3	133,8(3)

(1) October
(2) November and December figures are forecasted values
(3) October-November
Source:SIS, SPO, IFS

4. Developments in Financial Markets

4.1 CBRT Monetary Policy

The explicit inflation targeting strategy, which will increase the reliability of the price stability target, will be effective from the beginning of 2006.

The Central Bank published its strategy on monetary and exchange rate policy for 2005 on December 20th, 2004. The said announcement, which takes an important step towards greater transparency of monetary policy, is also significant as it includes information confirming the consistency of the monetary and exchange rate policies implemented within the economic program, which was put into effect after the crisis in February 2001. At the same time, it was announced that the explicit inflation targeting strategy, which increase the reliability of the price stability target, will launch from the beginning of 2006.

The CBRT forms its interest rate policy by evaluating probable developments in inflation in the upcoming period. While determining interest rates, the CBRT takes several factors into account: the total supply-demand balance, indicators concerning fiscal policy, developments in wages-employment-unit labor cost productivity, pricing behavior of the public and private sector, inflation expectations, exchange rates and developments which may affect them, analysis of probable external shocks and the inflation expectations of the CBRT. Within this framework, the CBRT has decided to cut short-term interest rates applied on the CBRT Interbank Money Market and on the Istanbul Stock Exchange Repo-Reverse Repo Market by 2 points on 20 December 2004 and 1 point on 11 January 2005, and subsequently, lowered overnight lending rates to 17 percent. Political determination for the sustainability of fiscal discipline and structural reforms, favorable developments in the relationships with the EU and the IMF and predictions regarding the continuation of the downward trend of inflation contributed to the making of this decision.

The decision making process regarding interest rates and timing of these decisions will be transparent and predictable and it will gradually harmonize with the explicit inflation targeting system.

As clearly outlined in the announcement of the monetary policy for 2005, the decision making process regarding interest rates and the timing of these decisions will be transparent and predictable and will gradually harmonize with the explicit inflation targeting system. Accordingly, interest decisions will be announced regularly in the morning of the working day following periodic meetings of the Monetary Policy Committee. This practice will help the CBRT to manage expectations more effectively and enhance the effectiveness of the transmission mechanism, which will clarify the relationship between short-term interest rates and inflation. With the transition to explicit inflation targeting in 2006, interest rate decisions will be made according to the vote of the Monetary Policy Committee. Meanwhile, in the transition period, year 2005, Monetary Base and Net International Reserves (NIR) will continue to be monitored as performance criteria ; Net Domestic Assets (NDA) will be monitored as indicative target.

In 2005, the Treasury's duty concerning the payment of net debt in terms of foreign exchange and the increase in economic agents' money demand are expected to decrease the amount of liquidity in the market while FX buying auctions are predicted to boost liquidity in the market. Net effect of these factors are expected to lead to a decline in the

In 2005, in the event of liquidity shortage, the CBRT will assume a lender's role; hence, the short-term interest rates taken as reference by the markets will not be the CBRT's borrowing rates but its lending rates.

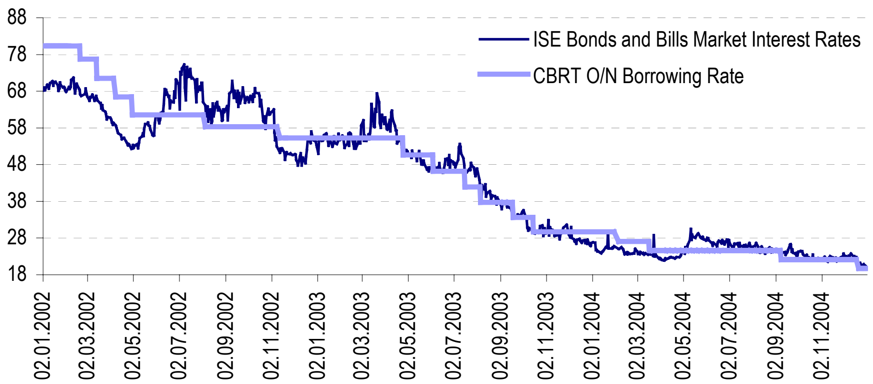
amount of liquidity in the market. In the event of liquidity shortage, the Central Bank will assume a lender's role; hence, the short-term interest rates taken as reference by markets will not be CBRT's borrowing rates but its lending rates. This also means, considering the fact that predictability of interest rate decisions will increase during the transition to inflation targeting, the effect of short-term interest rates on long-term interest rates will increase, and thus transmission mechanisms of the monetary policy will be strengthened.

In economies where monetary transmission mechanisms work effectively, central banks are supposed to fix inflation rates at moderate levels targeted in the medium term by changing interest rates and by means of total supply and total demand, which are shaped by credit amount, exchange rate, prices of financial assets and expectations. However, in economies, which have become more fragile to internal and external shocks owing to "fiscal dominance", existence of the high and volatile risk premium, which is basically determined by public debt dynamics, may damage the effectiveness of the transmission mechanism. The uncertainties arising from such fragilities, pose an obstacle to the mechanism, which affects long-term interest rates through monetary policy instruments; short-term interest rates. In addition, volatile risk premium may lead to unexpected developments in inflation by causing sudden fluctuations in exchange rates and make inflation difficult to predict. In this case, monetary policy may not fulfill its own aims.

Since the 2001 crisis, the Turkish economy has made notable achievements on the way towards price stability due to fiscal and monetary discipline, increase in the reliability of inflation expectations, implementation of a floating exchange regime, structural reforms including important steps made towards CBRT's independence.

As explained in the announcement of the monetary and exchange rate policy strategy for 2005, Turkey has been undergoing significant economic change since the 2001 crisis. During this period, notable achievements have been made on the way towards price stability due to fiscal and monetary discipline, increase in the reliability of inflation expectations, implementation of a floating exchange rate regime, structural reforms including important steps made towards the CBRT's independence. In this environment, CBRT's decisions regarding interest rates have a stronger influence in the transmission mechanism. However, although concerns about the sustainability of public debt stock have started to ease, risk factors relating to this point still exist. Therefore, high and volatile risk premium still plays an important role in determining long term interest rates, although this role has weakened in the last three years (Graph 4.1).

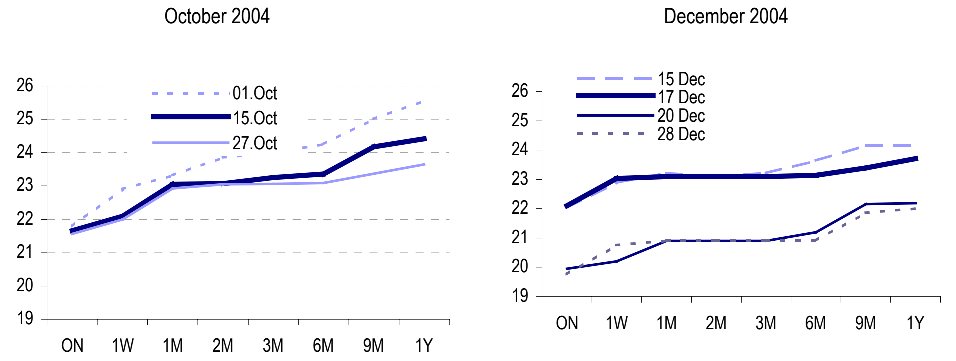
Graph 4.1 CBRT's Overnight Interest Rates and Secondary Market Interest Rates
(Weighted Average, Compound, Percentage)



Source: ISE, CBRT

The effects of risk perceptions on the secondary market interest rates can be seen in yield curves. There was no significant change in the short-term interest rates in September, while the decline in medium-term and especially in the long-term interest rates, which started mid-September and became more significant at the end of the month, is remarkable. Interest rates displayed a downward trend after the favorable effect of the Regular Report on Turkey's Progress Towards Accession, published on 6 November 2004. This downward trend came to a halt at intervals as a result of prolonged negotiations with the IMF, October inflation rates remaining above expectations and the relative shortage in TL liquidity. Moreover, the progress made towards a three-year stand-by agreement with the IMF and the EU's decision dated 17 December 2005 regarding starting negotiations with Turkey on 3 October 2005, contributed to the general downward tendency of interests. After interest rates cut dated 20 December 2004, yield curves displayed a downward trend in each maturity, however there was no significant change in the slope and curvature. At the end of the month, short end of the yield curves displayed a limited rise, whereas long end dropped parallel with the decline in risk perceptions due to the said developments (Graph 4.A).

Graph 4.A Yield Curve Analysis



*CBRT decreased policy rates to be effective from December 20, 2004.
Source: Turkish Banking Association

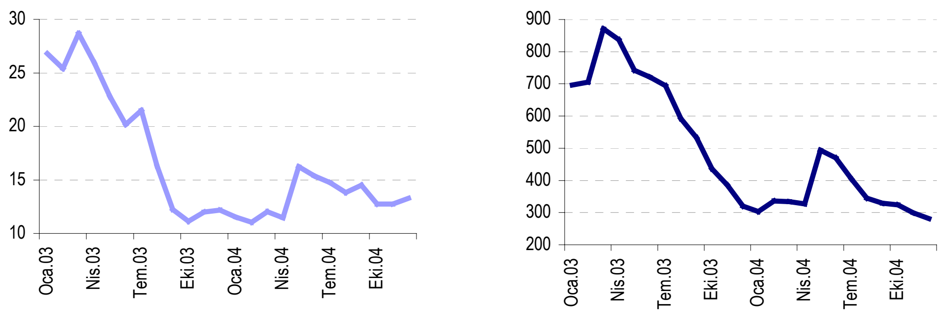
The establishment of an effective financial system and deep financial markets, sustainability of reforms that enhance the quality of fiscal discipline and reduce the fragilities in the economy and removal of concerns about the sustainability of the economic program will play important roles in bringing real interests down.

Meanwhile, as a result of the factors mentioned above, which lead to a relative rise in the risk premium, the drop in nominal interest rates has not caused a permanent decline in real interest rates. The restructuring for an effective financial system and deepening financial markets, sustainability of the reforms that enhance the quality of fiscal discipline and reduce the fragilities in the economy and removal of concerns about the sustainability of the economic program will play important roles in bringing real interest rates down. In addition, the spread which is generally used in measuring credit risk in emerging markets and calculated as difference between interest rates of long term government securities, which are issued in international markets, and the interest rates of benchmark US bonds with the same maturity, maintains its downward trend. This trend, which is especially supported by the good news coming from the EU front,shows that concerns about the sustainability of public debt have started to ease (Graph 4.B).

Graph 4.B Risk Premium and Real Interest Rate of Treasury Auctions

Treasury Auctions Real Interest Rate Developments
(Calculated using 12-month CPI Inflation Expectations, percent)

Spread (JP Morgan Index)



Source: JP Morgan and Treasury

Within the framework of the current economic program, the monetary performance criteria and indicative targets for December 2004, which are closely followed by the CBRT, have been achieved. The main reason for the slow down observed in the rate of increase of the Monetary Base in the last quarter of 2004, is predicted to be the drop in cash demand caused by the relative slowdown in real economic activity. In 2005, money demand is expected to be affected by economic growth (Table 4.A).

Table 4.A Performance Criteria, Indicative Targets and Realizations

	Base Money Ceiling (TL Trillion)		Net Domestic Assets Ceiling (TL Trillion)		Net International Reserves (Million US dollar)	
	Target[1]	Realization	Target[1]	Realization	Target[2]	Realization
March 31, 2004	16.100(P)	16.948	29.600(I)	27.321	-2.000(P)	748
April 30, 2004	17.500(P)	17.508	31.600(I)	26.076	-2.000(P)	1.791
August 31, 2004	20.500(P)	19.301	34.600(I)	28.015	-2.000(P)	1.629
December 31, 2004	20.900(P)	19.190	35.000(I)	30.121	-2.000(P)	229

Source: CBRT.
(1) These ceilings are based on the average of the stocks prevailing during the five working days including and immediately preceding each of these dates.
(2) Floor.
(P): Performance criteria, (I): Indicative target.

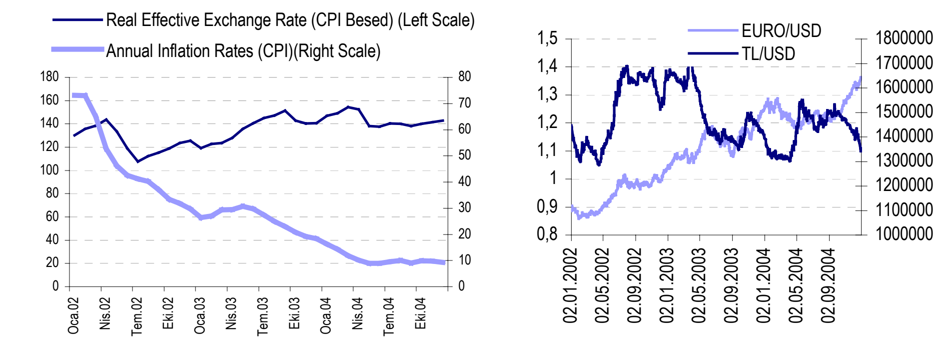
4.2 CBRT Exchange Rate Policy and Developments in Exchange Rates

The CBRT does not have any exchange rate target under the floating exchange rate regime and the exchange rate is determined by supply and demand conditions. In theory, the level of foreign currency reserves should not bear significance in this case, however, the external debt service of the public sector and the plans for the liquidation of foreign exchange deposit accounts with credit letters in the long term, stress the importance of the level of CBRT's foreign currency reserves even under the floating exchange regime. For this reason, the Central Bank holds FX buying auctions in order to collect reserves in periods when foreign exchange supply increases compared to foreign exchange demand owing to a reverse dollarization tendency, increasing capital inflow and favorable developments in the balance of payments.

In this framework, the Central Bank closely followed the developments in foreign exchange markets in the last quarter of 2004. Relations with the EU and the IMF, the US elections, developments in the euro/dollar parity and the drop in oil prices were the determining factors affecting exchange rates (Graph 4.C). In the upcoming periods, clear reverse dollarization, intensified capital inflow and favorable developments in the balance of payments will have been highly probable due to favorable developments in the accession negotiations with the EU and the fact that the negotiations on the new three-year program aimed at the continuation of the fiscal and monetary discipline and structural reforms have almost come to end. In light of these predictions, on 22 December 2004, the CBRT resumed the FX buying auctions that had been stopped on 27 April 2004, considering the fact that a strong reserve position can increase the credibility of the current program. Unlike previous periods, the CBRT started to announce an annual auction program in order to minimize the effects of FX buying auctions on the foreign exchange market. Thus, the conditions of foreign exchange supply and demand will only be slightly affected and the basic principals of the floating exchange rate regime will be preserved.

On 22 December 2004, the CBRT resumed the FX buying auctions that it had stopped on 27 April 2004.

Graph 4.C Foreign Exchange Developments



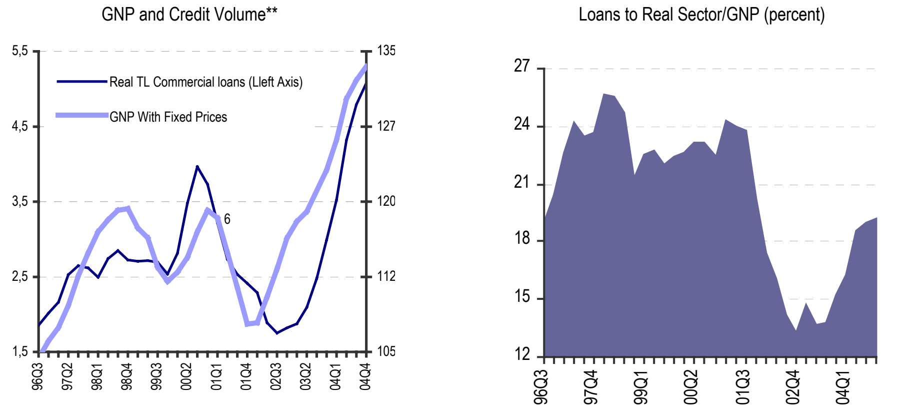
Source: ISE, CBRT

Additionally, the Central Bank considers exchange rate stability as part of price stability and therefore can directly intervene in the foreign exchange market if it detects excessive volatility in exchange rates on both sides. The Central Bank analyses the reasons for volatility in the foreign exchange market in detail, therefore bases its decision to intervene on past data combined with the possibility of future volatility. It should be underlined once more that, the Central Bank's interventions do not show concern about the level of exchange rate. There has been extreme volatility in exchange rates as a result of the increase in foreign exchange supply owing to reverse money substitution and intense capital inflow caused by the reasons mentioned above, and in this framework, the Central Bank bought USD 1.35 billion on 27 January 2005. In the upcoming periods, it is likely to happen that economic agents increase domestic currency demand as a result of the achievements made on the road to economic stability and capital inflow increase. In this case, the Central Bank may directly intervene in the markets by buying foreign currency.

4.3. Banking and Credits Developments

The credits extended to the real sector by banks in 2004-Q4 supported economic growth (Graph 4.D).

Graph 4.D GNP* and Loans

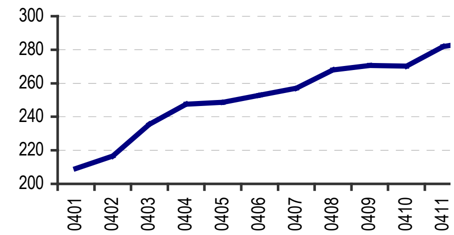


*GNP for 2004Q4 is estimate
**The mismatch in 2004Q4 stemming from combining installments of credit cards with claims from credit cards was corrected.
Source: CBRT.

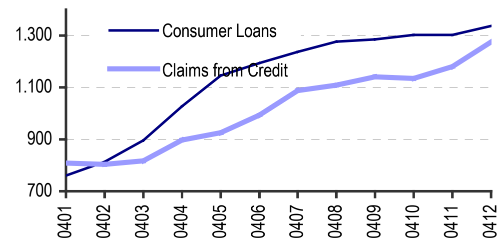
The stable course of exchange rates coupled with the appreciation of the Turkish lira has helped real sector firms that have more liabilities than assets in foreign exchange to reinforce their financial structure and increase private investments. The improvement in financial structures of the real sector firms has reduced the amount of non-performing loans, which as a chain reaction helped banks improve their own financial structures and as a consequence of general economic stability, supply of credits increased. It is projected that commercial credits extended to the real sector would push up investments and production volume, which in return would diminish inflationary pressures. Especially the rapid rise in credits extended to small and medium-size enterprises are increasing potential production(Graph 4.E).

Consumer credits and credit card movements have been monitored closely as of the first quarter for the fear that the total demand level would reach a point that could jeopardize the inflation target. A significant decline was recorded in the rate of increase in consumer credits as of the second half of the year as banks raised interest rates applicable to consumer credits, public banks limited their credit supply, scrap discount in automobile credits was decreased by half and the Resource Utilization Support Fund levied on consumer credits, was raised from 10 to 15 percent (Table 4.B, Graph 4.E). However, there has been a significant rise in the rate of increase in consumption through credit cards as installment sales with credit cards are more and more widely utilized.

Graph 4.E Consumer Loans, Claims From Credit Cards and SMSE Loans



Source: CBRT



* The mismatch in 2004Q4 stemming from combining installments of credit cards with claims from credit cards was corrected.
Source: CBRT

Table 4.B Developments on Consumer Loans and Claims from Credit Cards (Real Quarterly Change)*

	2004Q1	2004Q2	2004Q3	2004Q4
Consumer Loansi	31,0	33,1	7,7	4,0
Residential Loans	49,4	51,1	12,4	9,1
Automobile Loans	29,9	34,3	4,5	0,7
Other Loans	26,5	26,2	8,3	4,4
Claims from Credit Cards	9,9	21,6	14,7	13,5

* The mismatch in 2004Q4 stemming from combining installments of credit cards with claims from credit cards was corrected
Source: CBRT

Consumer credits and credit cards are closely monitored in order to ensure the decline in inflation and safeguard financial stability.

It is expected that the rate of increase in claims from consumer credits and credit cards will stay at a level that will not jeopardize the future inflation target and not pose a risk to financial stability. It is projected that excess Turkish lira liquidity would decline and the equity capital that the banks are required to keep in exchange for the credit card limit, which was increased in November, all of which together would help restrict the rise in credit volume. The consumer credits and the rate of increase in the number of credit cards are closely monitored in view of domestic demand, inflation and current account deficit.

Studies are pending for legal and administrative arrangements intended to settle problems that could pose risk to financial arrangements. Within this framework Pamukbank, which had been put under receivership of SDIF was merged with Halkbank in November. Meanwhile, the Banking Regulation and Supervision Agency (BRSA) and the banks carried on their efforts intended to adapt themselves to the International Convergence of Capital Measurement and Capital Standards Framework (Basel II). The BRSA firmly believes that the new arrangements introduced by the Basel II framework would have a positive impact on banking activities and the competition structure (BRSA Banking Sector Evaluation Report, October 2004). BASEL II is believed to increase effectiveness and productivity in the banking sector by reinforcing market discipline and encouraging the maintenance of reserve capital for items subject to risk. Moreover, the ratio of equity capital that banks keep in exchange for credit card limits was raised to 4 percent from 2 percent and in June 2005, this ratio will be increased to 8 percent. Meanwhile, banks have been prohibited from accepting deposits from Turkey for their off-shore banks and branches. All these arrangements are intended to prevent any occurrence that could jeopardize financial stability.

5. Public Finance

Implementing tight fiscal policy is important to ensure the decline in the ratio of debt stock to national income and to continue the fight against inflation in a sound environment. Within this framework, as was the case in previous years, a high primary surplus target was set in 2004 and the consolidated budget primary surplus performed well. As a matter of fact, the consolidated budget primary surplus realized as TL 26.2 quadrillion in 2004 (Table 5.A).

In 2004, the consolidated budget primary surplus performed well.

Table 5.A Consolidated Budget Figures

	2004 Jan-December Realization (TL Quadrillion)	2004 Target (TL Quadrillion)	The Ratio of Realization to Target (Percent)
Revenues	**109.9**	**104.1**	**105.5**
Tax Revenues	90.1	88.9	101.4
Expenditures	**140.2**	**149.9**	**93.5**
Non-Interest Expenditures	83.7	83.9	99.8
Personnel	28.9	28.6	101.4
Current Transfers	27.7	27.5	100.7
Interest Expenditures	56.5	66.1	85.5
Budget Balance	**-30.3**	**-45.8**	**66.1**
Primary Balance	**26.2**	**20.2**	**129.5**

Source: Ministry of Finance

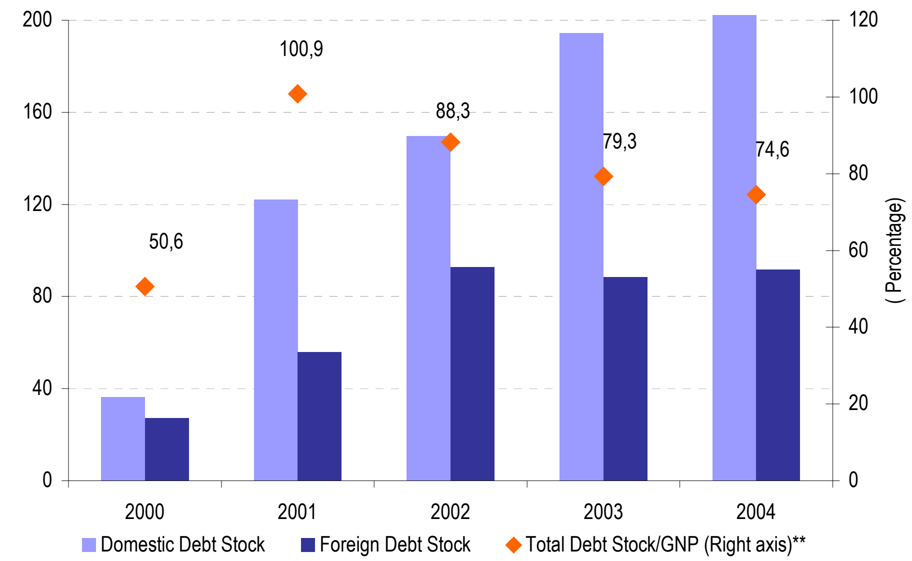
As was the case in 2004, strict adherence to fiscal discipline is also still crucial for the success of the economic program in 2005. Therefore, the target for the ratio of the primary surplus of the consolidated government sector to the GNP was set as 6.5 percent for 2005 again, as stipulated by the IMF letter of intent.[1]

5.1 Developments in Debt Stock[2]

Reducing the likelihood that developments pertaining to public debt stock will pose a risk to the economy, has a significant part in the achievement of price stability objective. Within this framework, ensuring fiscal discipline, decreasing the cost of borrowing and extending the maturity reduce concerns about debt sustainability, which in turn have a positive impact on inflation expectations. Moreover, fiscal discipline and improvement in the debt structure alleviate the vulnerability of interest rates and exchange rates to internal as well as external shocks and help with the effective implementation of policies drawn up for the purpose of achieving price stability.

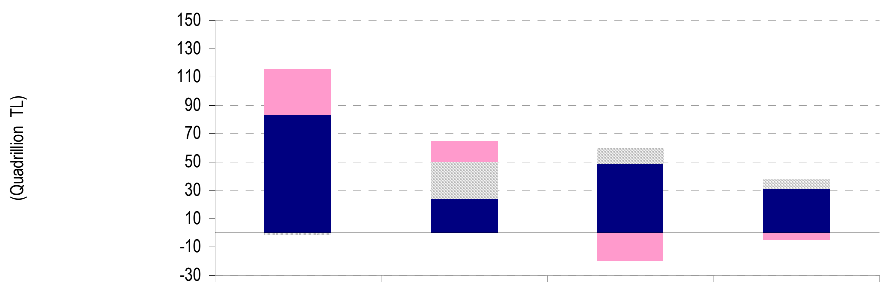
[1] In 2004, the primary balance of the consolidated government sector, as stipulated in the IMF Letter of Intent, comprised the primary balances of the consolidated central government, the 3 extra budgetary funds, the 27 state economic enterprises, the social security institutions and the unemployment insurance fund.
[2] In this section, debt stock means outstanding debt of the central government. Data issued by the Treasury on total public debt stock is comprised of the central government, extrabudgetary funds, local administrations and Public Economic Enterprises. By June 2004, consolidated debt stock comprised 96 percent of total debt stock.

Graph 5.1 Central Government Debt Stock (TL Quadrillion)*



* Average monthly USD buying rate is used in the calculations.
** Consistent with the 10 percent growth rate forecast for the year 2004.
Source: Treasury, CBRT

Graph 5.2 Decomposition of the Change in the Central Government Debt Stock



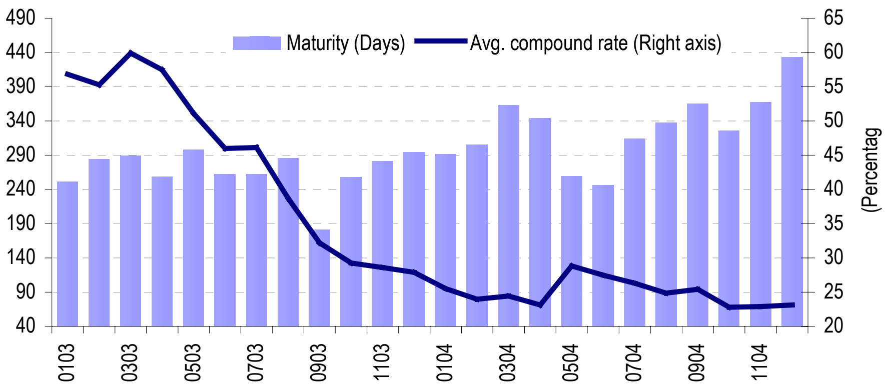
	2001	2002	2003	2004
Exchange Rate Effect*	32.1	14.9	-19.4	-4.7
Net Foreign Borrowing	-1.2	26.0	10.8	6.9
Net Domestic Borrowing	83.4	23.9	48.8	31.2

*Displays the effect of fluctuations in the value of Turkish lira against USD. Does not contain the impact of changes in the cross rates.
Note: Net borrowing figure displays the change in the debt stock disentangled from the fluctuations in the value of Turkish lira against USD.
Source: Treasury, CBRT

The share of debt stock in the GNP is expected to come down to 74,6 percent in 2004.

It is expected that the ratio of debt stock to GNP would roll back to 74.6 percent by the end of 2004 (Graph 5.1). Most of the rise in debt stock in this period has stemmed from net domestic borrowing. In 2004, decrease in the Treasury's borrowing costs, the extended borrowing maturity along with high primary surplus due to the fiscal discipline have limited net borrowing. Meanwhile, the depreciation of the USD vis-à-vis the Euro and SDR has pushed up net foreign borrowing. The depreciation observed in the Turkish lira against the USD in the second and third quarter changed in favor of the Turkish lira in September and the exchange rate impact became negative throughout 2004 (Graph 5.2). It is expected that developments in interest rates and primary surplus will play a more important role in reducing the debt stock to GNP ratio than the exchange rate impact in the upcoming period. Within the framework of the Treasury's financing program for 2005 and the growth estimates quoted in the program drawn up for 2005 the ratio of central government debt stock to the GNP is anticipated to come down to 71.5 percent in 2005.

Graph 5.3 Borrowing Maturity and Compound Interest Rate *



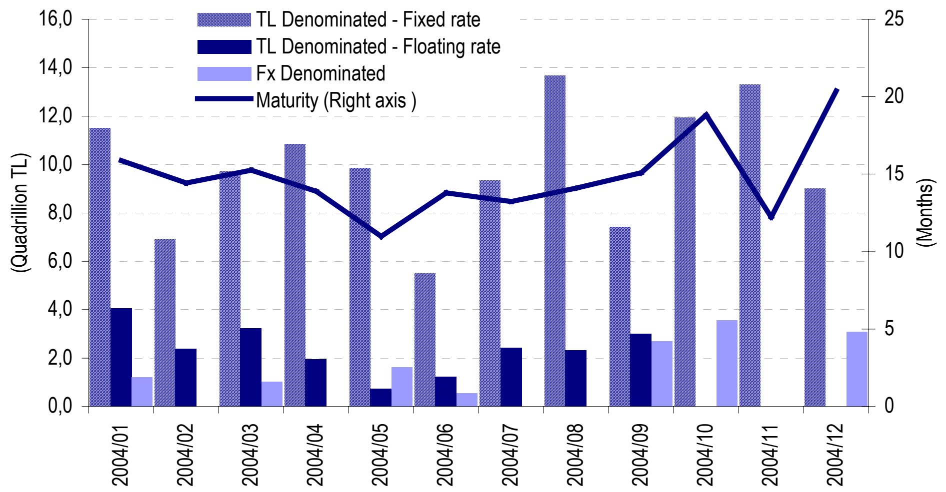
Note: Short borrowing maturity in September 2003 is due to the existence of small amount long-term borrowing. Borrowing maturity excluding 91 day T-bill auction is 371 days.
*TL denominated discounted auctions are used in the calculations.
Source: Treasury

The interest rate in Treasury auctions, which was 28 percent by end-2003, came down to 23 percent by the end of 2004. In May, the political uncertainties in Cyprus, expectations of a higher than projected current account deficit for the first quarter and expectations of an interest rate rise by the FED and in September, controversies over the Turkish Penal Code were the factors that prevented a further decrease in interest rates. Meanwhile, interest rates in the secondary market started to fall in the second half of December, on account of the EU Council decision to initiate membership talks with Turkey and the Central Bank's interest rate cut based on the anticipation that risks regarding inflation were reduced. However, the effects of the decline were not reflected in the interest rates of the Treasury auctions in December as the Treasury auctions were held in the first half of the month (Graph 5.3). The decline in interest rates is expected to continue in the upcoming period. Further decline in expected inflation rates as well as in real interest rates would be possible if confidence that economic stability will be maintained. In this context, putting in place the structural reforms that would significantly contribute to lasting economic stability is of great importance.

Active debt management contributes to decreasing the susceptibility of the economy to internal and external shocks by diminishing risks related to public debt stock.

Active debt management contributes to decreasing the susceptibility of the economy to internal and external shocks by lowering risks related to public debt stock. Significant developments have taken place in public debt management since 2002. In this context, the infrastructure for public debt risk management has been established. Within this framework, the borrowing strategy is now being planned in line with the cost and risk analysis of the debt stock. Accordingly, in 2004, domestic borrowing mainly concentrated on fixed rate TL-denominated auctions. Meanwhile, the average maturity for cash borrowing was realized at longer than one year (Graph 5.4). In the same period, non-cash borrowing, which does not generate cash inflow for the Treasury, remained limited.[3]

Graph 5.4 Composition of Cash Borrowing



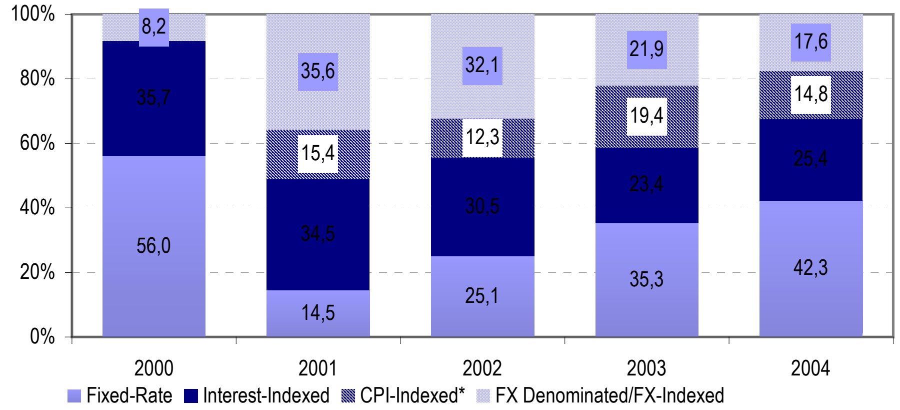
Source: Treasury, CBRT.

External borrowing of USD 5.8 billion was obtained via bond issue in 2004.

In 2004, the Treasury issued USD 5.8 billion-worth of bonds in international markets, which exceeded the USD 5 billion, the amount planned within the 2004 financing program. Compared to 2003, interest rates were lower and maturities were longer in the bond issues of the year 2004. The improvement in external borrowing conditions alleviates concerns over the refinancing of the external debt, which is believed to contribute to achieving financial stability in the upcoming period. Compared to 2003, the structural change observed in domestic debt stock underlines the fact that the susceptibility of debt stock to changes in interest rates and exchange rates has decreased. In 2004, the share of fixed rate securities increased while the share of FX-denominated and FX-linked securities decreased. As no CPI-indexed securities have been issued, the share of these instruments has decreased and there has been a slight rise in the share of interest-indexed securities (Graph 5.5).

3 Most of the non-cash borrowing was accounted for Pamukbank T.A.Ş's merger with Türkiye Halk Bankası. A.Ş. Within this framework, special type government securities of TL 2.3 quadrillion were issued to Saving Deposits Insurance Fund (SDIF) by private placement (on lent) in October.

Graph 5.5 Decomposition of Domestic Debt Stock by Type of Borrowing Instruments



* Comprises non-cash securities in the Central Bank Portfolio, cash securities issued to the Cumpolsory Saving Account (CSA) in May 2003 and non-cash securities issued to the TMSF in January 2004. Securities issued to the TMSF were recorded under the debt stock of 2003.
Source: Treasury, CBRT.

In 2004, the maturity of total domestic debt stock became shorter compared to 2003. There were mainly two factors that affected the change in maturity of the debt stock. First, although the maturity of borrowing has been extended, it did not suffice to extend the maturity of cash debt stock. As cash borrowing was dominantly composed of fixed rate TL-denominated instruments, whose maturities are shorter than those with variable rate, the extension in the borrowing maturity remained rather limited. Second, the share of non-cash debt stock in the overall debt stock has decreased and its maturity has become shorter, which is a natural outcome of limited non-cash borrowing (Table 5.B). Therefore, the factor that would contribute to the extension of the debt stock would be the maturity of cash borrowing in the upcoming period.

In 2004, the maturity of total domestic debt stock became shorter compared to 2003.

Table 5.B Maturity Structure of the Domestic Debt Stock

	2003		2004	
	Maturity (Month)	Share (Percentage)	Maturity (Month)	Share (Percentage)
Total Borrowing	18.1	100.0	17.3	100.0
Cash	14.7	90.5	15.0	96.1
T-Bill	6.2	35.2	6.2	37.6
Bond	20.1	55.3	20.6	58.5
Non-Cash	50.4	9.5	73.9	3.9
Total Stock	25.1	100.0	20.6	100.0
Cash	12.4	67.1	11.8	73.8
Non-Cash	51.2	32.9	45.5	26.2

Source: Treasury.

Finally, in 2004, Treasury borrowing was exercised in line with the Treasury's borrowing strategy laid out according to the cost and risk analysis of the debt stock. Despite the improvement in the structure of the debt stock, short debt stock maturity and significant share of floating rate and FX-denominated instruments, indicates that the susceptibility of debt stock to changes in interest rates and exchange rates still continues.

6. Outlook

In this section, potential developments and risks in the coming period with regard to inflation are summarized.

6.1 Demand and Supply Factors

Domestic demand slowed down significantly in the second half of 2004 and measures such as the restrictions put on consumer credits, raising the Resource Utilization Support Fund, reduction of scrap discount, and in November, increasing the Special Consumption Tax contributed to this slow down. In addition, the fact that postponed demand was met and the base effect were other factors restricting the increase in domestic demand. The uneven distribution of expenditure items among the consumer groups and the ongoing low level of non-durables expenditures; the slowdown in the growth rates of consumer credits, industrial production and the number of motor vehicles sold to the domestic market, accompanied by the Business Tendency Survey domestic demand indicators also show that the recovery in domestic demand will continue in a controlled fashion in the coming period. However, seasonally adjusted total final domestic demand data rose significantly compared to the previous period and was above GDP growth. In other words, though it persists, the demand gap in the economy continues to shrink.

Nevertheless, seasonally adjusted private investment expenditures retreated significantly in the third quarter of the year. Furthermore, according to the data announced for the last quarter of 2004, the growth rates of capacity utilization rates, machinery-equipment imports and capital goods imports declined. When these developments are evaluated together with the increases in employment and real wages, the possibility that there would be a slow down in productivity growth and this may put pressure on the real unit labor costs, should be considered .

Though the current level of production remains below full employment, it does approach the potential output level (Graph 3.7). At this point, it is critically important that the structural reforms are continued and deepened in a resolute manner, in order to sustain non-inflationary growth performance. Thus, the increase in productivity will persist, the level of full employment will be pushed up and inflationary pressure will be contained. Consequently, steady growth and disinflation will be sustained concurrently.

6.2 Cost Factors

Despite the historical break in the exchange rate-inflation relationship, exchange rates still hold a significant place in inflation dynamics via imported input costs (Box 2.1). No development that may jeopardize the disinflation process is expected in exchange rates in the upcoming period. The reverse-dollarization process, that has already started, is expected to gain further strength following the mutual agreement on the program for the coming three years, as well as the developments towards the EU negotiation process. In fact, the Central Bank initiated foreign exchange buying auctions from 22 December 2004 onwards. Undoubtedly, the Central Bank will continue to closely monitor exchange rate movements during this period as well, in addition to the buying auctions, and will intervene in the market in case of excessive volatility on either side.

Another important factor as regards inflation dynamics is the course of international commodity prices. Crude oil prices, which have been on the rise for quite some time, started to go down from October onwards, in line with the decision of OPEC to increase the amount of supply. This development is significant in limiting the direct impact of price increases on costs, as well as their indirect impact through the channel of other energy prices. More favorable cost conditions are foreseen for 2005, owing both to the stability of exchange rates compared to the previous periods, and the slowdown in global commodity price increases.

6.3 Monetary and Fiscal Discipline

On 20 December 2004, the Central Bank announced, with regard to the 2005 monetary policy program, that it would adopt formal inflation targeting gradually. Changes announced pertaining to the upcoming period are towards a more transparent and more foreseeable monetary policy. In 2005, which is the year of transition to formal inflation targeting, the Monetary Policy Committee will function as an advisory board, and interest rate decisions will continue to be made by taking the evaluations made at the Monetary Policy Committee meetings into account as well. The practice of making interest rate decisions based on the vote of the Monetary Policy Committee will commence hand-in-hand with the transition to formal inflation targeting. In the transition period, base money and net international reserves will continue to serve as performance criteria and net domestic assets will continue to serve as indicative targets.

Within the framework of the floating exchange rate regime, which has been more clearly understood in the recent period, it is intended to have the least possible influence on the market. That is to say, there is no target level with regard to the exchange rate and the level will continue to be determined by the demand and supply conditions of the market. Foreign exchange buying auctions will continue, in order to raise international reserves moderately or to prevent them from declining. To minimize the impact on the foreign exchange market, the annual program for the foreign exchange buying auctions was announced, and it was decided they would not be subject to change unless an extraordinary change in foreign exchange liquidity was observed.

The fact that the Treasury is a net payer of foreign exchange denominated debt in 2005 has particularly a reducing impact on market liquidity. Moreover, the fact that the benchmark interest rates in this situation are Central Bank short-term lending interest rates is one of the main factors enhancing the effectiveness of the transmission mechanism of those policies towards price stability. However, care must be taken regarding the continuity of fiscal discipline and structural reforms, which is the pre-condition of the success of the selected monetary policy strategy. Although the commitment to the continuity of these policies has been made in the programs for the next three years is a favorable development, it is critically important that this commitment is put into practice rapidly.

6.4 Other Risks

- Together with the disinflation process, changes also began to be observed in the pricing behavior of the economic units. Economic units that used to make price adjustments with shorter terms, switch to longer term price adjustments in the new period. Besides, the fact that rates of inflation were quite low for the earlier months of 2004 may generate a base effect. Therefore, temporary stagnation may be possible in the disinflation process in the first months of the year. Nevertheless, the main trend in inflation is forecasted to be downward oriented throughout the year.

- The interpretation of inflation data for the earlier months of 2005 requires special attention because of a series of changes made in the economy, as well as certain innovations. First of all, VAT reductions, to be effective from early-2005 onwards, were made in sectors such as health, education and food. How much this reduction will be reflected on the prices is yet uncertain. Furthermore, the new Turkish lira (YTL) was adopted at the beginning of 2005. Although examples of other countries and research show that the effects of dropping zeros from the currency are quite minor and negligible, an uncertainty factor is present in all cases for the first months of the year.

- The most crucial uncertainty for the first months of 2005 is believed to stem from the recently published inflation index. Together with the new year, a price index with base year 2003 has been established, with a new scope, new methodology, a new goods-services basket. Certainly, the time series behavior of the prices may change together with the new index. However, it is clear that the revision in the method of the measurement of inflation should not create a change in the way the Central Bank perceives the medium-term outlook of the economy. The factors that may affect the monetary policy stance in the medium and long-term are the factors that may jeopardize price stability. It is natural that these factors will be shaped by macroeconomic and structural determinants, rather than temporary factors, such as the change in the index, or indirect taxes or oil price increases. For example, a slowdown in the productivity increase, which is not temporary, an imbalance in favor of demand that might occur in the general balance between supply and demand, or a serious halt in the structural reform process towards enhancing the quality of fiscal discipline and similar developments may alter the medium-term perception of the monetary policy.

- Looking at the indicators for production and domestic demand, the contribution of supply and demand factors to inflation is foreseen to be more limited in 2005, compared to the previous period. Yet, evaluated on a more medium-term perspective, the continuity of the disinflation process is highly likely.

Certainly, in every period, some external shocks, that are beyond the control of economic policies, might occur. For example, possible adverse developments in global liquidity conditions may cause fluctuations in exchange rates. An upsurge in energy prices in international markets may have negative effects on production costs. Supply-side shocks that may hit unprocessed food products, adverse weather conditions or adjustments in indirect taxes may jeopardize the inflation target. Such shocks were encountered several times in the recent period, however the Central Bank did not respond to them, due to the perception that such temporary shocks will not hamper the basic tendency of inflation. Monetary policy was conducted with the focus on medium-term trends and the situations that may change those trends. In the coming period, the Central Bank will go on conducting its monetary policy with the focus on medium-term trends. However, in case of an inconsistency between medium-term inflation forecasts and the targets, or a distortion in pricing behavior, the necessary response will be given.

In conclusion, in 2004, the inflation target was met for the third time in a row, and as of the first month of the year, the expectations for 2005 converged to the end-year target of 8 percent. In light of the developments in the last quarter of 2004, there is no serious risk, with the exception of large external shocks, that may jeopardize the inflation target in the coming period. However, what needs to be emphasized once again at this point, is the necessity of carrying out structural reforms with determination and sustaining fiscal discipline in the upcoming period. Consequently, the competitive environment will progress, productivity will increase and the level of non-inflationary, steady growth will be sustained.