



ECONOMIC OUTLOOK

CENTRAL BANK OF THE REPUBLIC OF TURKEY

December 2004

Past

Present

Future

Chronic
Inflation



Disinflation



Price
Stability

Unsustainable ?
Public Debt



**Decreasing
Public
Debt**



Sustainable
Budget
Finance

Boom-bust
Growth Cycles

Crises



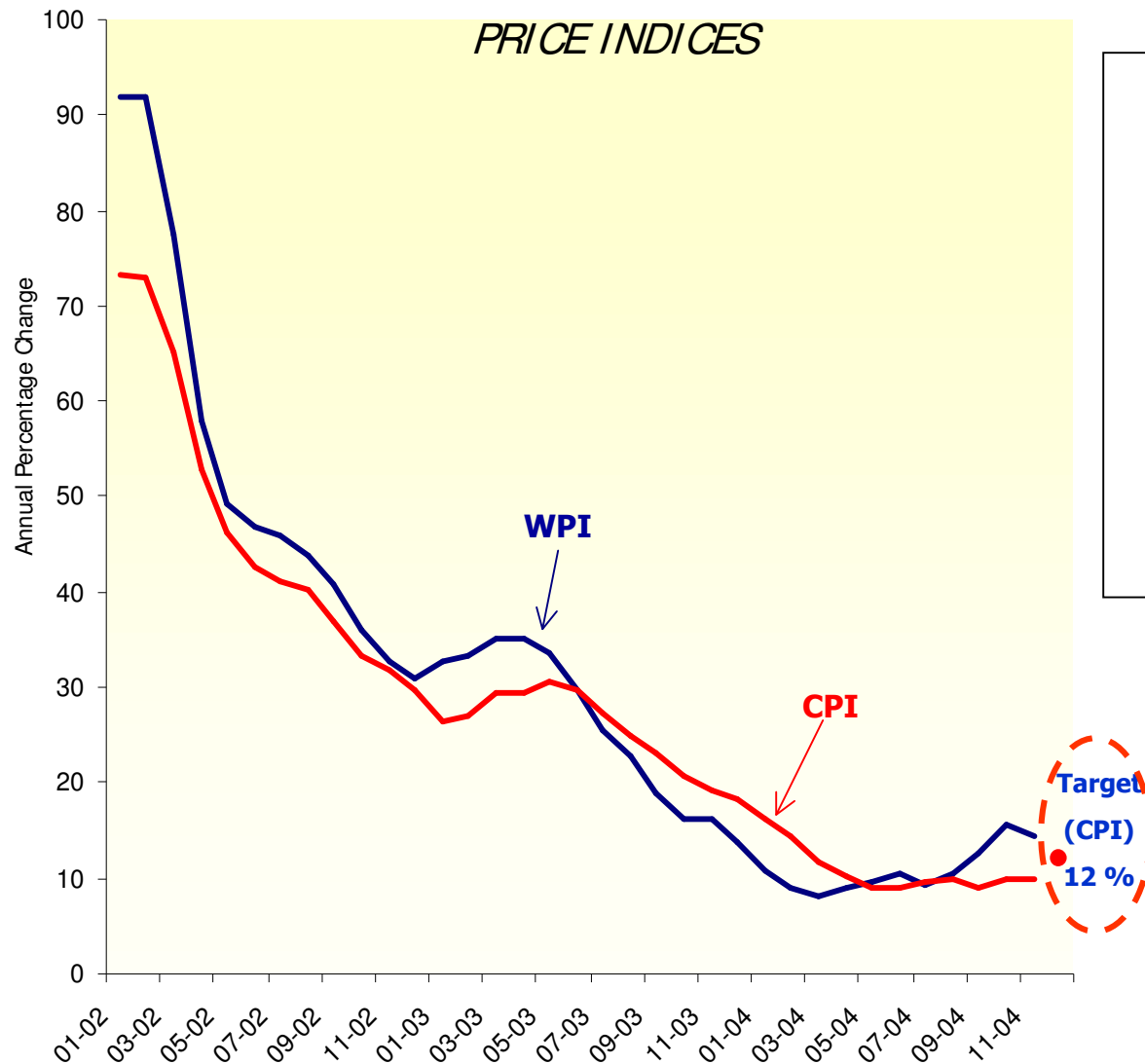
**Positive
Growth
Rates**



Sustainable
Growth

INFLATION

Disinflation



Source: SIS

2001-2004 CPI:

2001 \Rightarrow 68.5 %

November 2004 \Rightarrow 9.79 %

Target for 2004 \Rightarrow 12 %

Too good to be true?

Disinflation

What Caused Lower Inflation?

- ✓ **The CBT independence,**
- ✓ **Inflationary inertia fades away,**
- ✓ **Tight monetary and fiscal policies** ⇨ **Domestic demand under control,**
- ✓ **Productivity increase; level of real wages,**
- ✓ **Incomes policy, more or less consistent with the target,**
- ✓ **Changes in consumer and producer behavior,**
- ✓ **Weakened pass-through effect,**
- ✓ **Increasing competitiveness.**

Year-end targets for CPI:

2005 ⇨ **8 %**

Expectations for 2005: 8.7 %; credibility gap: 0.7

2006 ⇨ **5 %**

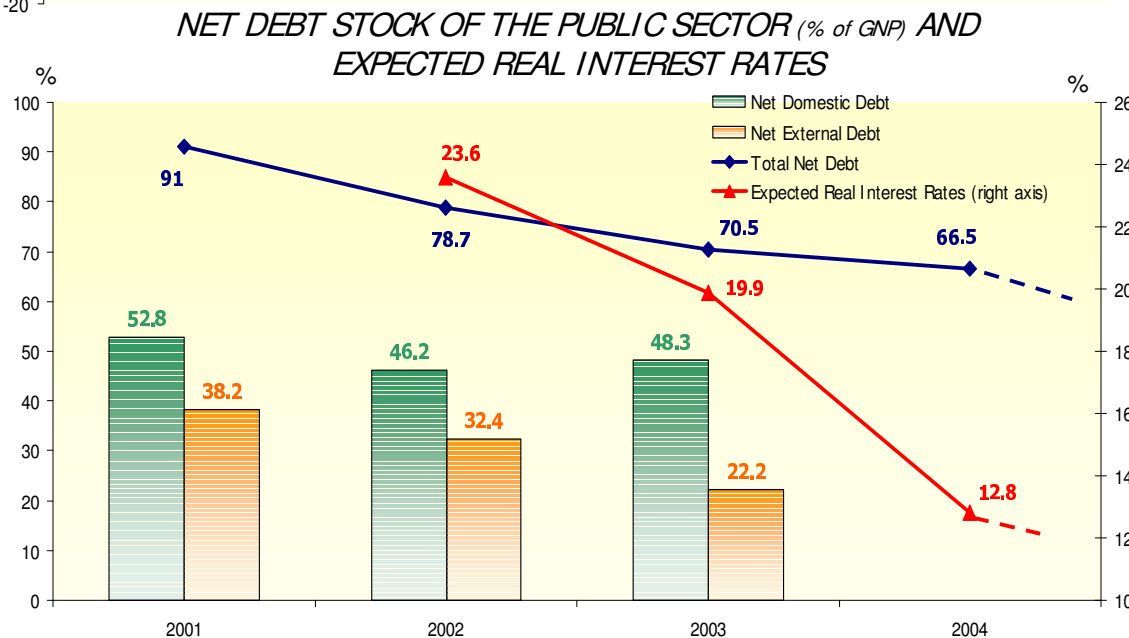
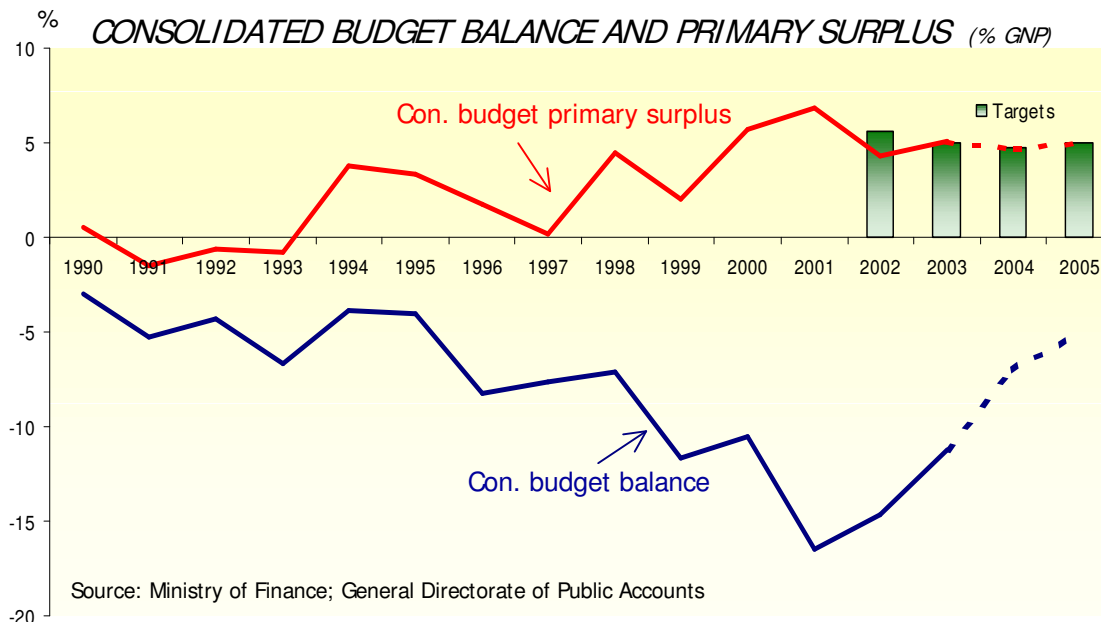
2007 ⇨ **4 %**



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 November for the year 2004.

✓ With tight fiscal policy

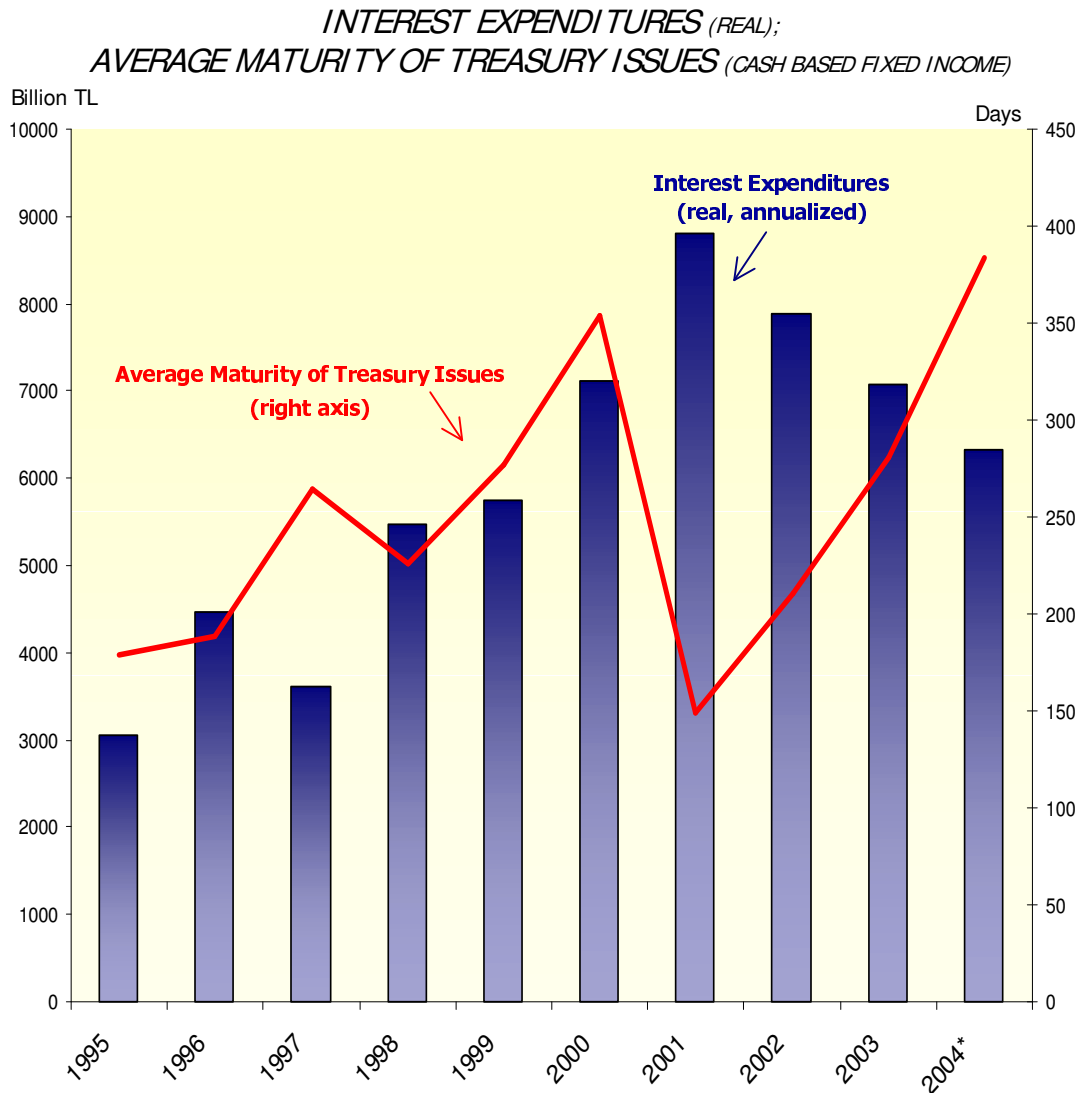
- Very **high primary surpluses** obtained in 2002-2004.
- Consolidated **budget deficit decreases** considerably.



✓ 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



✓ 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.



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

✓ Measures to cut expenditures:

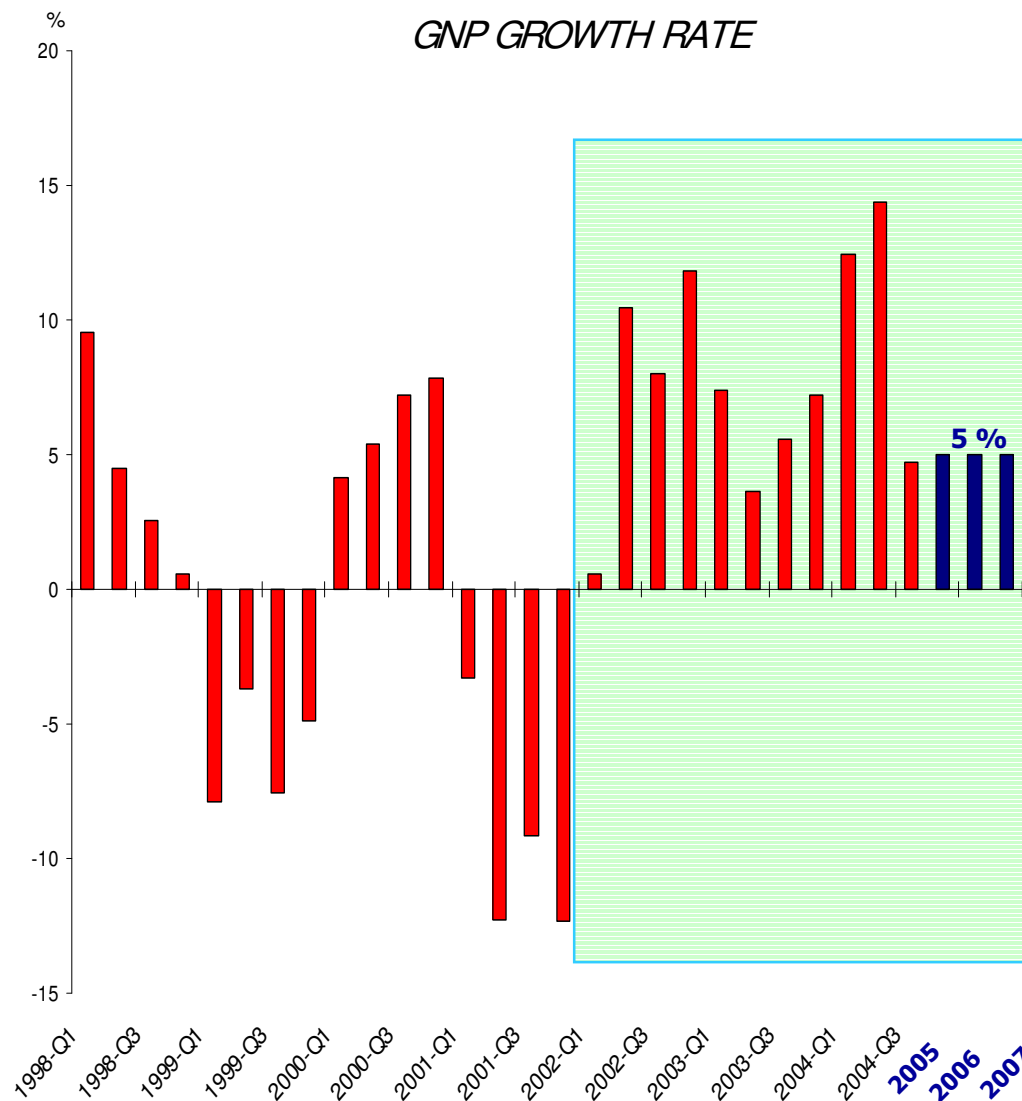
- Decreasing transfer payments
- Preventing idle employment

✓ Strategy to increase revenues:

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

GROWTH

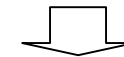
Positive Growth Rates



Source: SIS

Together with the current economic program, the Turkish economy has been experiencing

high growth rates since 2002.



✓ Turkish economy grew by

22.6 % in real terms **since 2001.**

✓ In the first two quarters of 2004, growth rates were particularly high.

2004

	I. Quarter	II. Quarter	III. Quarter	9 Months
GNP	12.4	14.4	4.7	9.7
GDP	10.1	13.4	4.5	8.7

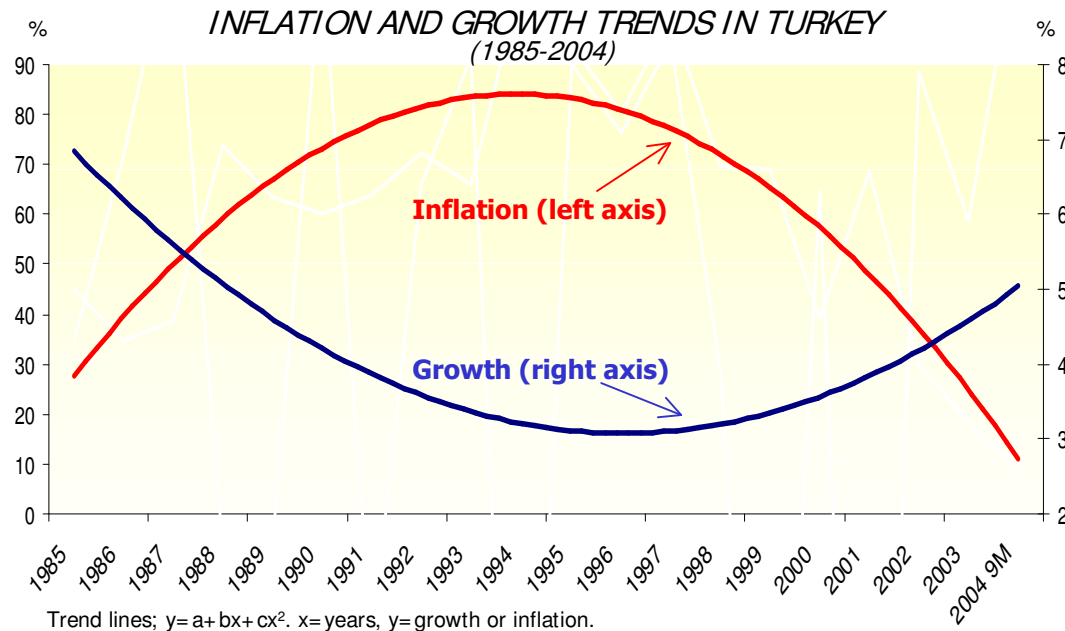
Growth estimates:

2005 → **5 %**

2006 → **5 %**

2007 → **5 %**

Sustainable Growth – Changing Dynamics



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



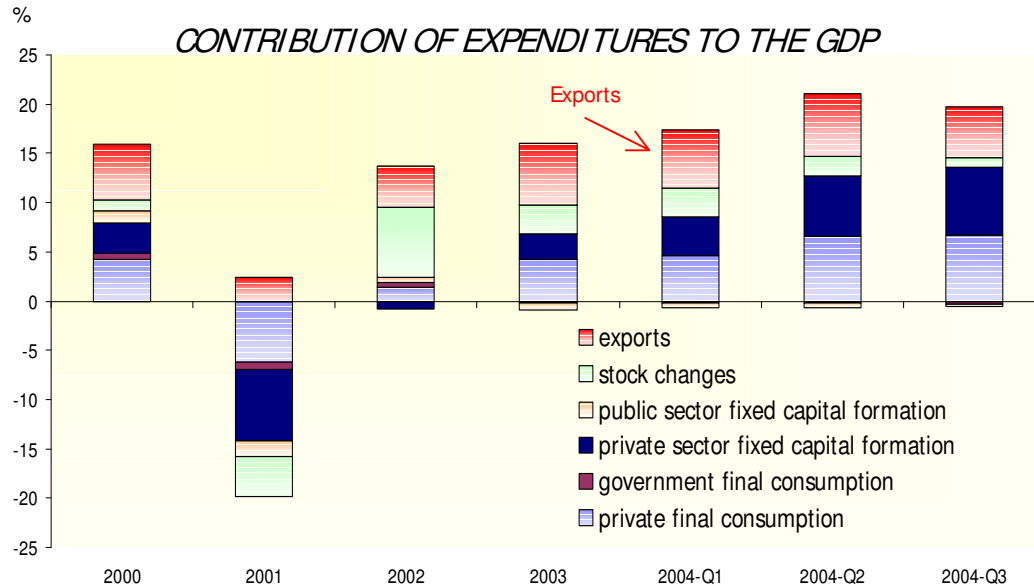
1. High growth rates have been attained while inflation is falling.

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

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

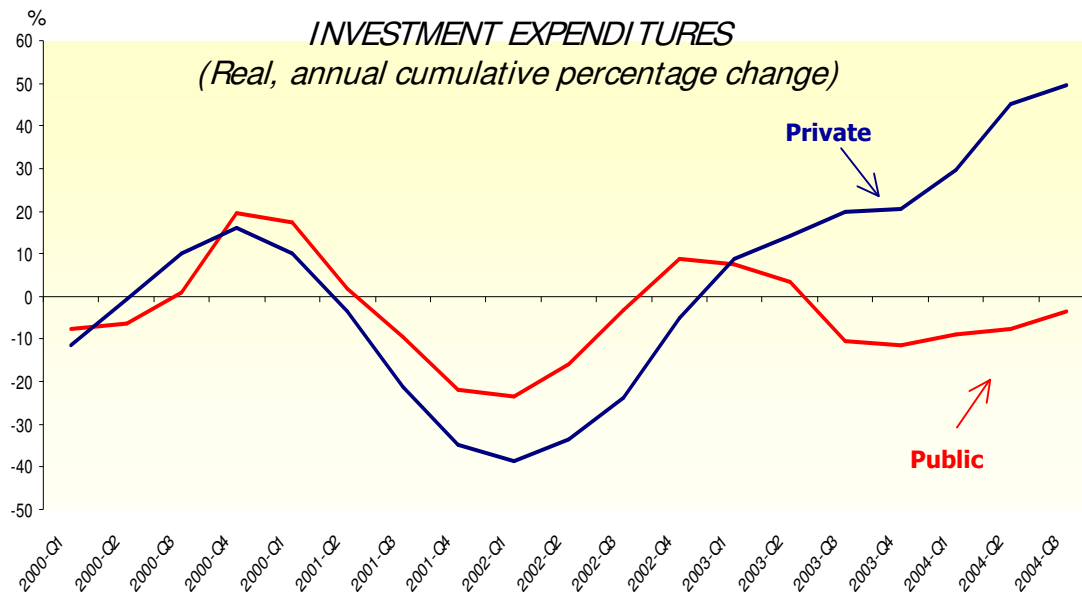
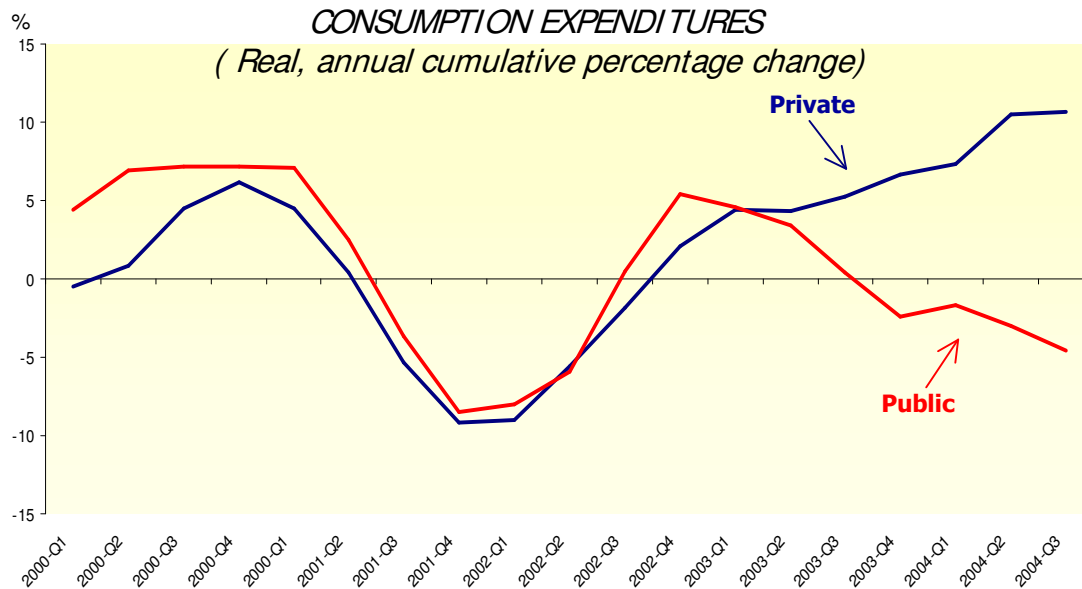


✓ The Turkish economy has become more integrated with the world economy, giving rise to a more competitive environment.



Source: SIS

Sustainable Growth – Changing Dynamics



Source: SIS

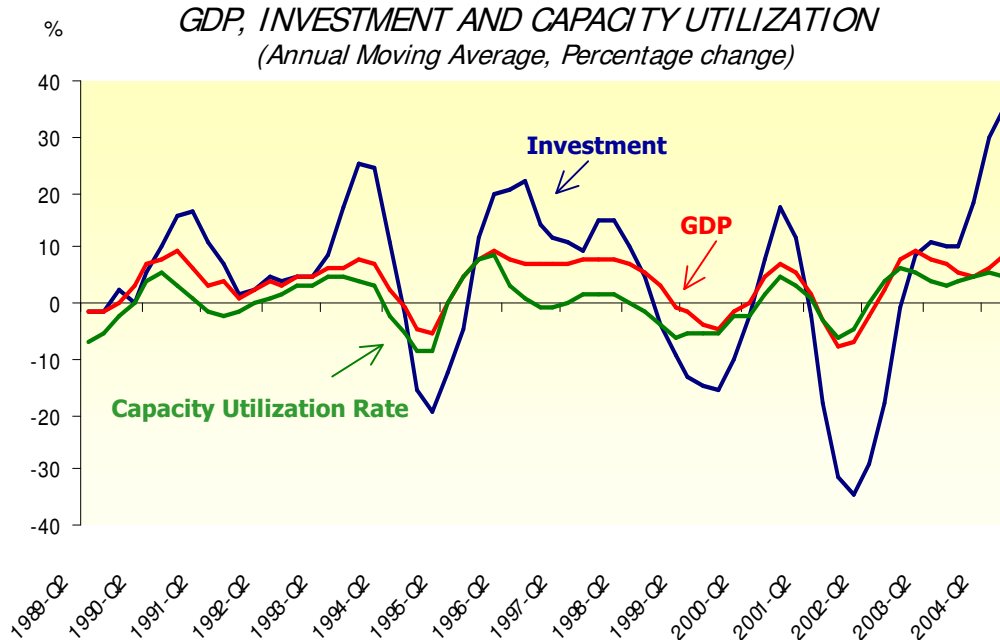
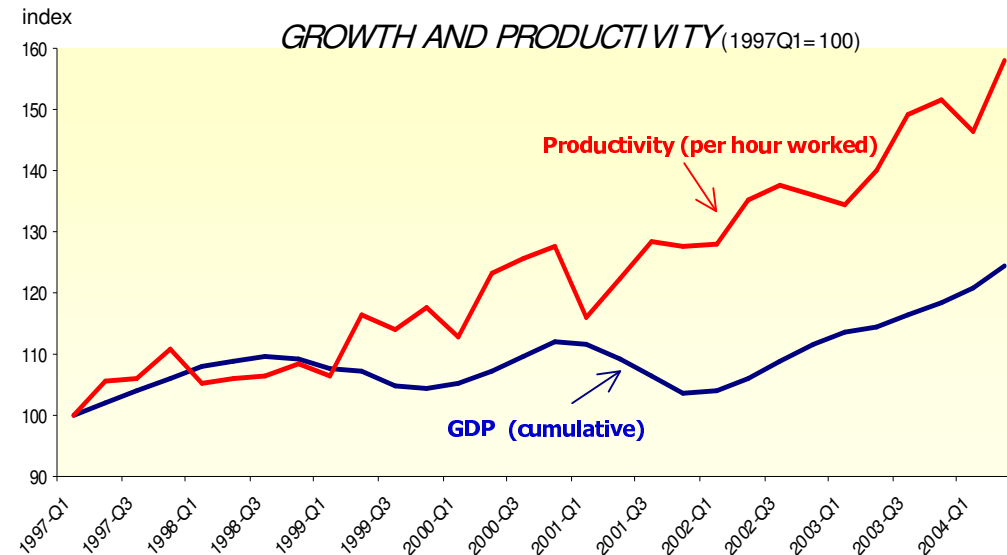
3. Tight fiscal policy affects expectations favorably; stimulates growth.

✓ 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.**

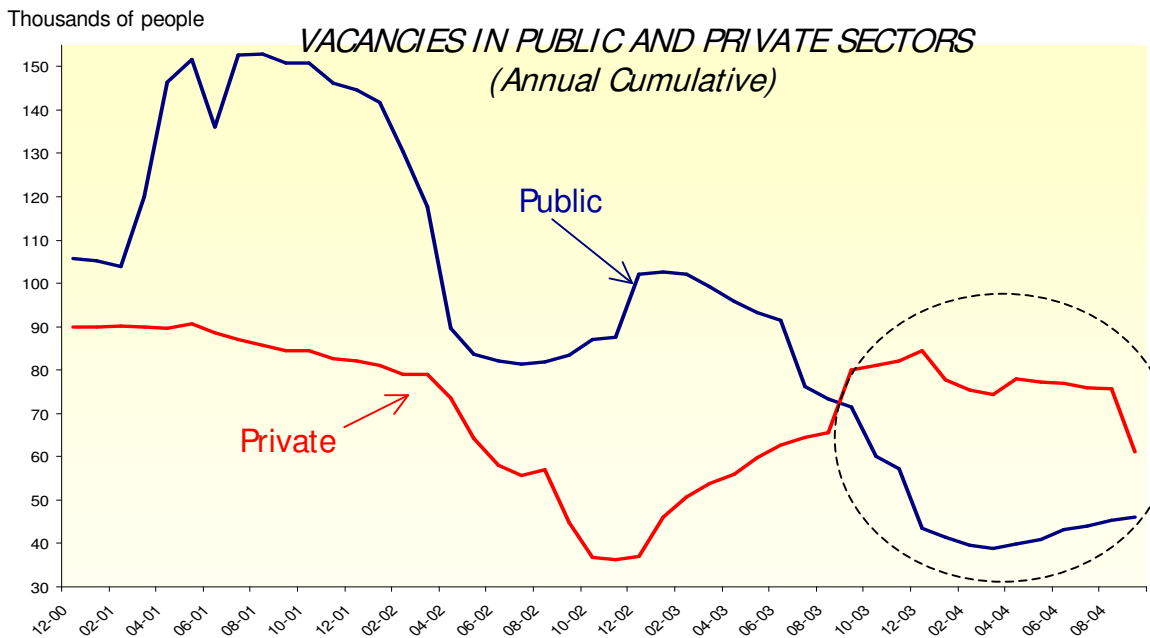
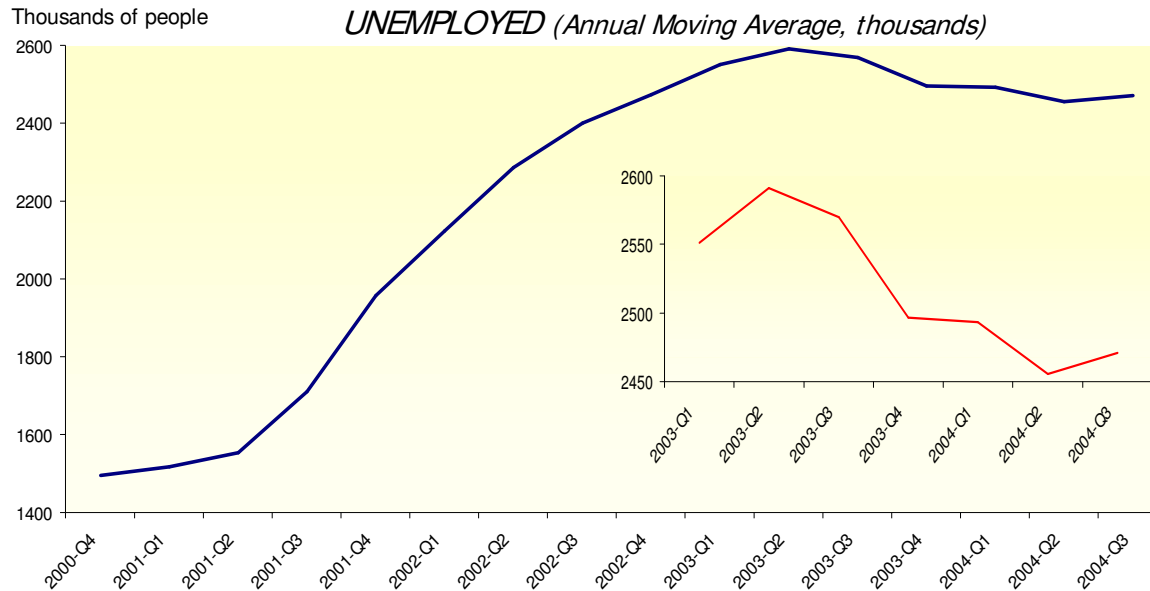
✓ In other words, at the initial stage, growth does not follow investment, **investment follows growth**.

✓ This is also the case in Turkey.

✓ The cumulative **productivity increase** is **36 % since 2001**.

✓ **Investment** will continue to increase.

Sustainable Growth – Changing Dynamics



Source: ISKUR, SIS

✓ With the negative impact of the crisis and contraction in the economy, the **number of unemployed people** increased considerably.

✓ But, it has been indicating a **decreasing trend** since 2003-Q2, and thus the unemployment rate decreased to 9.5 % in 2004-Q3.

✓ During the recovery period, in line with the changing structure of the Turkish economy, the capacity of the **private sector** in **creating new jobs** is higher than that of the public sector.

✓ 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.
...But is it sustainable?

FOR SUSTAINABLE GROWTH

For Sustainable Growth

What needs to be done to attain a sound macroeconomic environment for price stability, high and sustainable growth ?

1- Banking Sector Reform

The Turkish banking sector in 90's could not perform its intermediary function efficiently. Why?

Instead of a relationship between

Real Sector



Banking Sector

A relationship between

Public Sector



Banking Sector

had developed.

How to strengthen real sector – banking sector relationship?

- ✓ Maintaining price stability
- ✓ Decreasing public debt stock
- ✓ **Banking sector reform**

For Sustainable Growth

Banking Sector Reform:

Important steps have been taken already.

What is on the agenda now?



Preparation of **a new Law on Credit Institutions** including review of the Banking Act and to bring the legal framework more closely in line with the EU standards.



Privatization of state banks as soon as their restructuring is completed and whenever market conditions are favorable.



Transfer of **regulation and supervision of non-bank financial institutions** from the Treasury to the BRSA.



Modern credit risk management methods to be applied.

Banking sector-real sector relationship should not be limited to credit lending only, but should involve active risk management as well.



Financial structure of firms will be healthier.

Firms having modern management techniques and preparing more transparent financial accounts will contribute to this process.

For Sustainable Growth

2. Tax Reform- Formalizing Unregistered Economy



The tax system is not working effectively;
both direct and indirect effective tax rates* are quite low.



The tax burden on the registered economy is quite heavy.



**Therefore, the tax reform is given priority.
In 2005, new measures will be put into effect.**

- ✓ More effective tax controls
- ✓ Restructuring of the Revenues Administration
- ✓ Simplification of tax legislation
- ✓ Broadening the tax base
- ✓ Formalizing unregistered economy
- ✓ Simultaneous implementation of public and private sector reforms

3. Good Governance



Having progress in governance indicators is the key issue to
increase investment via improving the investment environment.



Major steps have been taken so far.
But further and comprehensive steps are also needed.

* **Effective Direct Tax Rates** = The ratio of total tax and nontax revenue net of domestic taxes on goods and services divided by the sum of compensation to employees and total operating surplus.
Effective Indirect Tax Rates = The rate of all domestic taxes on goods and services divided by private consumption.

ON THE CONDUCT OF MONETARY POLICY

Short-term Interest Rates

From **implicit** to **formal inflation targeting**

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

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

Which factors are observed while forecasting future inflation?



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

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

Floating Exchange Rate Regime

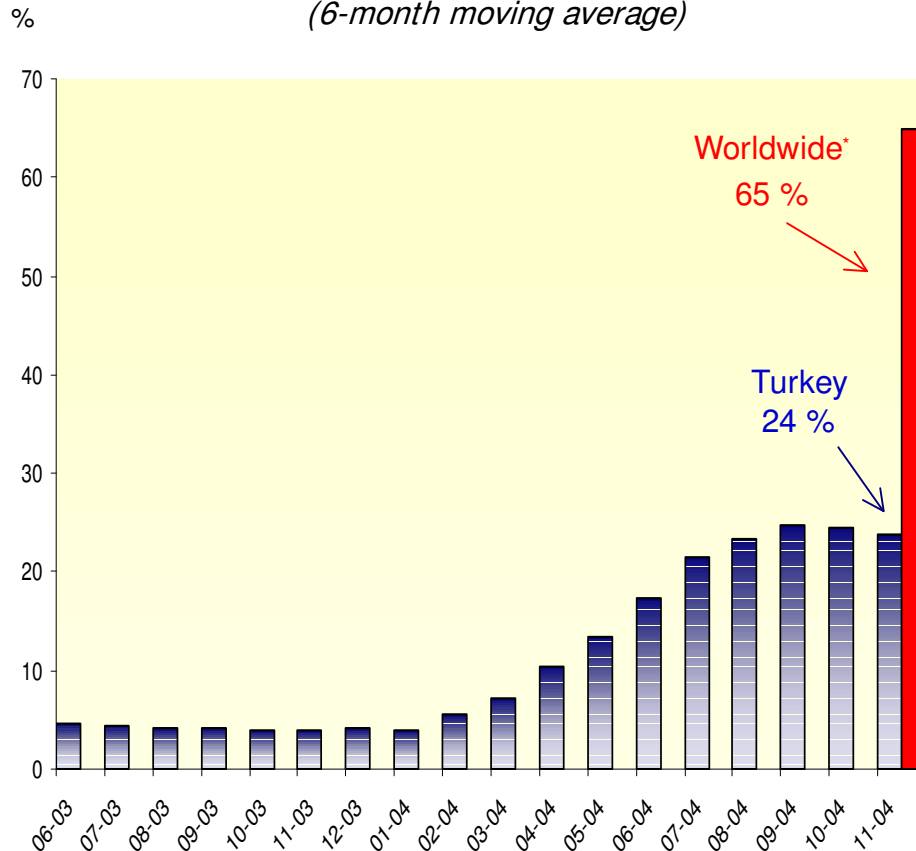
The volatility in the exchange rates are gradually decreasing.

- The adjustment process to the floating exchange rate regime;
- The decisive and transparent implementation of monetary and exchange rate policy.

**Exchange rate volatility is not an uncertainty, but a risk;
so it can be avoided and managed.**

Derivatives Market

*SHARE OF DERIVATIVES MARKET TRANSACTIONS IN
SPOT + DERIVATIVES MARKETS TRANSACTIONS
(6-month moving average)*



Source: CBT, BIS

* Daily averages in April 2004

**In order to hedge exchange
rate risk, it is crucial to
improve derivatives markets.**

- ✓ In Turkey, the volume of foreign exchange derivatives transactions has increased significantly compared to past, but it is still lower than that of the world levels.
- ✓ Important steps have already been taken:
 - Turkish Derivatives Exchange (Turkdex) was granted permission in March 2004.
 - The banking sector now provides derivatives instruments.
- ✓ In this framework, the CBT supports the development of these markets.

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.

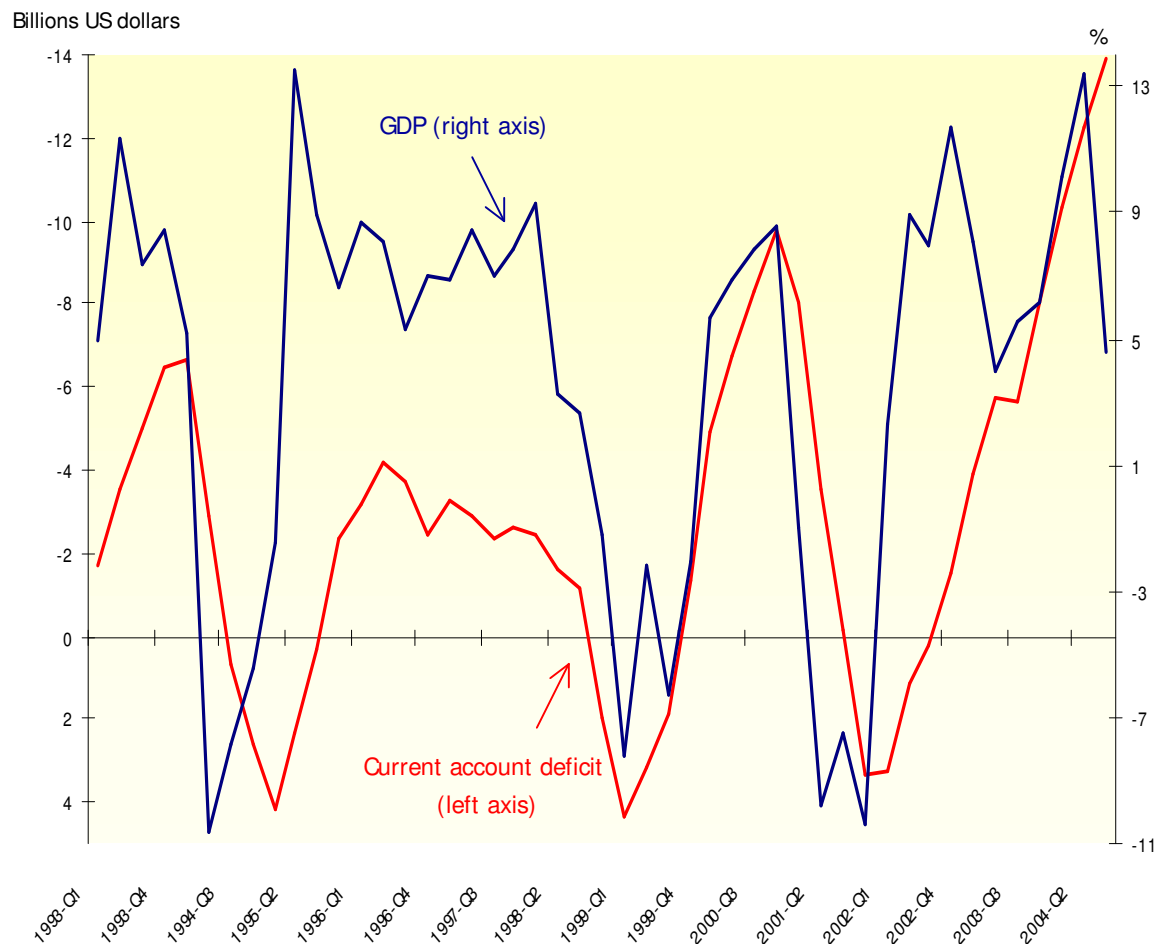
RISKS, PROBLEMS AND CHALLENGES

Risks, Problems and Challenges

- 1- Steady recovery in domestic demand, especially consumption closely monitored**
- 2- Reform fatigue**
- 3- External shocks**
- 4- Managing expectations**
- 5- Public price adjustments not in line with targeted inflation**
- 6- Agricultural and energy prices**

Growth – Current Account Deficit

GROWTH AND CURRENT ACCOUNT BALANCE



Source: SIS, CBT

- ✓ 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.

Current Account Deficit/GDP estimates:

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

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.



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