CENTRAL BANK OF THE REPUBLIC OF TURKEY

MONETARY POLICY REPORT

2004-I

CONTENTS

I. Introduction *

I.1. General Assessment

The substantial economic achievements, obtained due to the current economic program that has been implemented for the last three years, became more apparent by the first quarter of 2004. Undoubtedly, breaking the long-lasting chronic inflationary process and paving the way to price stability are the leading achievements. Attaining the inflation targets and achieving high growth rates successively in 2002-2003, as well as with the high possibility of achieving targets in the current year suggested by the first quarter indicators led to an increase in demand for instruments denominated in Turkish lira, thereby an appreciation of Turkish lira. In line with these developments, expectations displayed a gradual improvement. Accordingly, the change in pricing behaviour and strengthening of Turkish lira made the break in inflationary trend more visible. During this process, in which the economic relationships have been transforming, high productivity increases were recorded and real unit production costs declined significantly. As a result of all these developments, the most exceptional downward trend of inflation in the last three decades was experienced along with high growth rates.

The hike in minimum wages in the first quarter of 2004 and the deviation in 2004 public revenue projections resulting from revenue realizations in 2003 caused concerns over the sustainability of fiscal discipline and the inflationary impacts of these developments before municipal elections held at the end of March. Nevertheless, concerns about inflation and fiscal discipline eased following the measures taken towards achieving budget targets that have mainly involved expenditure-cutting measures. Hence, inflation expectations pursued a downward trend consistent with end-year target. Along with these developments, the Central Bank continued to change short-term interest rates in the first quarter of 2004 based on its analysis made in view of all variables that might affect the course of future inflation. Overnight borrowing interest rate, which was 44 percent in 25 April 2003, was reduced to 22 percent as of 17 March 2004.

Though a significant success has been attained in the fight against inflation up to now, there be no doubt that there is a long way ahead for achieving price stability. Especially starting from 2005, in which one-digit inflation will be targeted, Turkey will enter a period where fiscal and monetary discipline by itself will not be solely adequate in dropping inflation and achieving sustainable growth simultaneously. Bringing inflation down to one-digit figures and ensuring a sustainable growth along with price stability in the long run will only be possible via an uninterrupted structural reform process. In other words, accomplishment of ongoing structural reforms in many fields in the coming years by enhancing their quality should be among the main goals

*Data until 15 April have been used in this report.

in order to achieve high growth rates without any compromise from price stability in the medium and long term. In this framework, giving pace to structural reforms, mainly banking, tax and social security reforms, is of great importance as well as maintaining fiscal and monetary discipline with determination in 2004.

I.2. Recent Economic Developments

Consolidated budget primary surplus pursued a favourable course in the first quarter of 2004. Moreover, the targets set for Net International Reserves, which has been specified as the performance criterion under the stand-by agreement with International Monetary Fund (IMF), and Net Domestic Assets, which has been specified as an indicator, were achieved by end of March. Nevertheless, a Money Base realization, another performance criterion, was above the target. This reflects both a behavioral change in money demand that stems from the restoration of confidence in Turkish lira and the effects produced by the payments of Imar Bankası deposits. When evaluated with respect to the inflation target, the increase in money demand does not point at an extreme revival in consumption demand or a loosening of monetary policy.

In an atmosphere of confidence that has been much more reinforced by the strengthening of macroeconomic fundamentals, the improvement in cost conditions continued in the first quarter of 2004 as well. In January-March period, Turkish Lira appreciated by 6.2 percent in nominal terms vis-à-vis exchange rate basket, which comprises of USD 1 + 0,77 euro. Moreover, unit production costs, one of the indicators of the CBRT Business Tendency Survey, which is deemed to reflect the developments in other cost factors along with the exchange rate, maintains its low level, albeit showing slight increase in the first quarter.

The impact of declining costs on prices manifests itself evidently in private manufacturing industry prices. The increases in private manufacturing industry prices maintained their downward trend of the second half of last year and remained at a monthly average of 0.5 percent in the first quarter of 2004. With respect to consumer prices, durable consumption goods, medicine and energy prices -the most affected consumer goods by the exchange rate movements- either dropped or displayed a slight increase. On the other hand, along with the compensating measures taken towards achieving the budget target, the rise in some of international commodity prices, which are particularly used in basic metal and oil products manufacturing industries as key inputs, accelerated especially the increase in public manufacturing industry prices in March.

It was observed that despite the stable decline in inflation expectations, the rigidity of prices, mainly in services sector, continued and the pricing decisions were not consistent with the targeted inflation yet. Housing rents, the dominant sector in services basket, increased by a high rate of 4.4 percent in the first quarter. The rigidity in prices in health services sector still persisted as well.

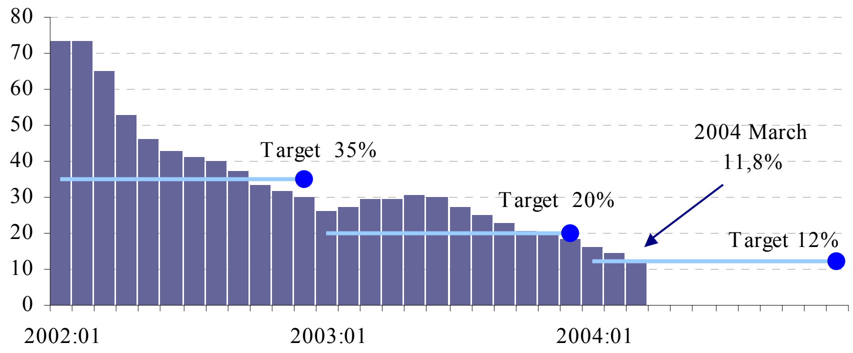
Annual consumer prices inflation declined rapidly in the first quarter of 2004 and realized as 11.8 percent in March dropping below the end-year target. According to the first period results of CBRT Expectations Survey in April, average annual year-end inflation expectations decreased to 11.4 percent. At this point, the accurate perception of the twelve-month cumulative inflation figures, which is consistent with target in 2004, is of great importance with respect to the formation of expectations in the right manner. In the first five months of 2003, inflation rates climbed owing to the cost factors due to Iraq war as well as excessive rises in agriculture and food prices stemming from unfavourable weather conditions. However, they pursued a rather sluggish course in the rest of 2003 with the removal of these unfavourable conditions. These developments led to an apparent difference in the trend of inflation between the first and second halves of 2003. As a natural outcome of these developments, the decline in annual inflation in the first 5 months of 2004 will be more evident than of the general inflation trend. Hence, it was observed that the above-mentioned factors had an effect on the drop in annual inflation figures in the first quarter of the year. On the other hand, even though the downward process will continue for the rest of the year due the same reason, annual inflation rates may stagnate or move upward. Nonetheless, such a trend will be consistent with the inflation target.

While the downward trend in inflation continues, there is a revival of domestic demand in the first quarter of 2004. In this period, the upsurge in consumer credits and domestic demand indicators in Business Tendency Survey (BTS) confirms the relative revival in domestic demand. Due to the increase in export demand as well as the recovery in domestic demand in the first quarter, the rapid increase in industrial production continued. According to BTS, investment expenditures also rose in the same period. The rise in investment expenditures accompanying the revival in consumption is expected to ease the inflationary pressures to some extent. Though the supply-demand balance and capacity utilization rates are not expected to contribute to the decline in inflation in the coming period as much as they did in 2003, the favourable outlook in inflation expectations and low levels of unit production costs will still continue to keep inflation under control. Undoubtedly, these predictions are made under the assumption that fiscal discipline will be maintained and there will not be an unexpected deviation from income policy.

II. Inflation Developments

Achieving the inflation targets in both 2002 and 2003 demonstrates the success of the economic program and disinflation efforts. In the first quarter of 2004, favorable cost conditions persisted, the level of domestic demand did not put pressure on prices by forcing production capacity and the inflation expectations were consistent with the year-end target. The rise in consumer prices remained consistent with the year-end target in this period as well. For the wholesale prices, while high rates of increase were observed in agricultural prices, the rate of increase in prices excluding agriculture was consistent with the year-end WPI forecast.

Figure II.1. CPI, Annual Inflation (1994=100)



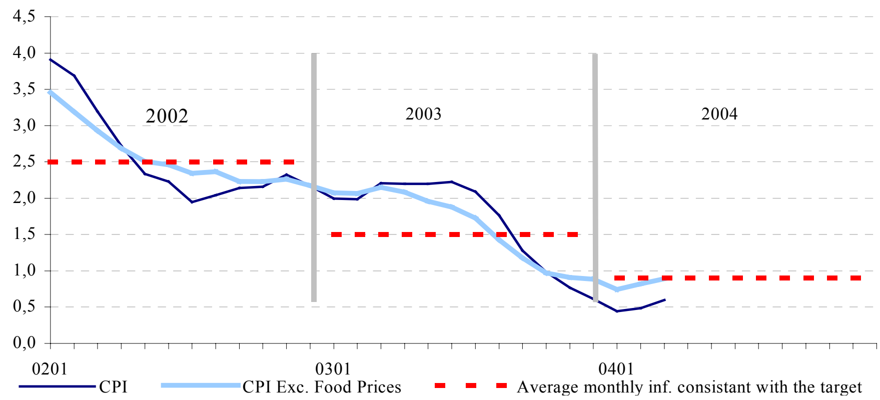
Annual inflation in consumer prices maintained its downward trend in the first quarter of 2004 and became 11,8 percent, realizing below year-end target by the end of March. However, it is of great importance to evaluate this downward trend accurately. A significant discrepancy was noted between the first and second halves of 2003 in terms of inflation trend. This situation, also called the base effect, played an important role on the sharp decline in the annual inflation rates experienced in the first quarter of 2004. Yet, due to the same effect, even if the downward process in the general inflation trend continues after May as well, annual inflation rates may display a standstill or an increase. Therefore, such an upward trend should not be construed as to lead to a deviation in inflation target.

Moreover, regardless of the annual inflation, seasonally adjusted price increases in the first quarter of 2004 strengthen the belief that the inflation target will be achieved. Consumer inflation (seasonally adjusted) increased only by 1,8 percent in January-March period.

Seasonally adjusted price increases in the first quarter of 2004 support the belief that the inflation target will be achieved.

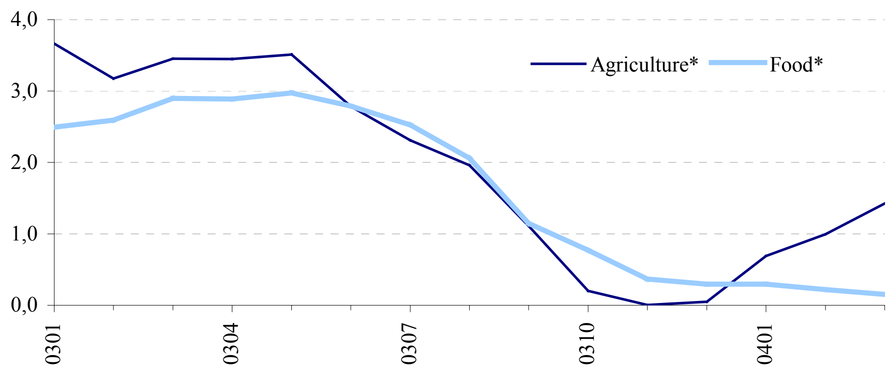
It was observed that food prices supported the low trend in consumer inflation in the first quarter of the year; the price increases in groups excluding food were also consistent with the inflation target. As shown in Figure II.2, the average inflation rate in the last six months were at the level consistent with the inflation target in CPI excluding food, whereas it realized even below that level in CPI.

Figure II.2. Seasonally Adjusted CPI and CPI Excluding Food Inflation (6 Months Moving Average)



While food prices supported the downward trend in CPI inflation, agricultural prices increased at a rate above the general inflation trend in wholesale prices in the first three months of 2004. The remarkable discrepancy between the increases in agriculture and food prices during this period stems from the fact that items such as fresh vegetable-fruit, which are affected considerably by supply conditions, are more dominant in agriculture prices as well as from the fact that demand conditions play an important role in determining the prices of processed products within the food group (Figure II.3).

Figure II.3. Seasonally Adjusted CPI and CPI Excluding Food Inflation (6 Months Moving Average)



*Seasonaly adjusted inflation, 6-months moving average (deseasonalized by using Tramo/Seats)

When price increases in groups excluding food are examined, it is observed that no significant changes occurred in the general macroeconomic conditions compared to 2003. However, three basic factors are remarkable in terms of January-March 2004 inflation, which can be listed as:

Three basic factors are remarkable in terms of January-March 2004 inflation.

i. The constraining effect of the relative stability in exchange rates on inflation rates,

ii. The importance of price-setting behavior in line with the inflation target, and the rigidity in prices of services group within this framework,

iii. The effects of mostly one-off public price adjustments and indirect tax increases which led to a slight increase in inflation trend in March, and the significance of energy prices

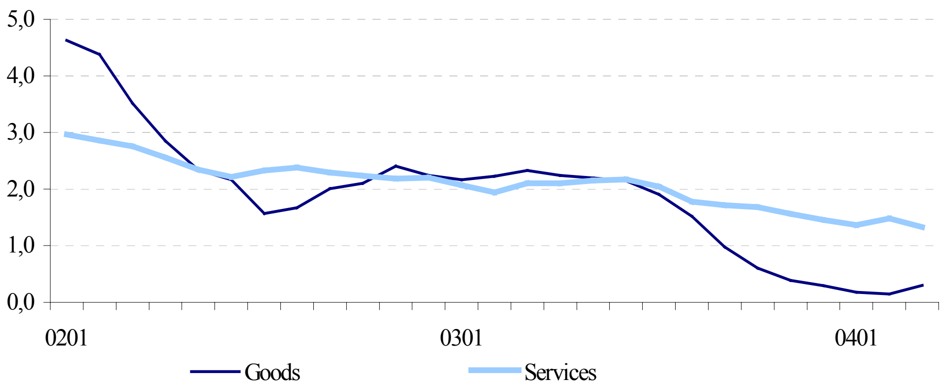
The sub-groups with the lowest price increases in both wholesale and consumer prices were those most affected by the exchange rate.

It was underlined several times in our previous reports that the appreciation of Turkish lira made a significant contribution to the downward trend in inflation as of the second half of 2003. In the period of January – March 2004, Turkish Lira appreciated nominally by 7.9 percent against US Dollar and by 6.2 percent against exchange rate basket. The sub-groups with the lowest price increases in both wholesale and consumer prices were those most affected by the exchange rate. Price increases in private manufacturing industry maintained their low trend in the second half of 2003, realizing as 0.5 percent in monthly average terms. Similarly, durable goods, pharmaceuticals[1] and energy prices, which are directly affected by the exchange rate, declined or only slightly increased in consumer prices. As a result, the relative price structures of the sub-groups reveal the effect of appreciation in Turkish Lira on inflation.

Another important point concerning consumer inflation is the requirement to shape pricing behavior in line with forward-looking targets (Box II.1). Inflation expectations indicate that economic units have confidence in the current economic program. Nevertheless, especially the prices in the services group have been displaying rigidity since 2003 (Figure II.4). Prices in services group, which increased at a rate above the target, level last year, failed to comply with the 2004 end year target of 12 percent as well. The discrepancy between the prices of goods and services groups is significant in terms of two points. Firstly, in monetary policy frameworks such as inflation targeting, in which the expectations are of greatest importance, inflation target can be achieved only if all agents in the economy make their pricing decisions according to the inflation target. However, due to history of chronic inflation in Turkey, the former pricing behavior cannot be abandoned easily and the process of making forward-looking decisions especially in services group has not been adopted yet (Figure II.4). Institutional and structural factors are deemed to have an impact on price rigidities in this sector as well. Among these factors are the inadequate competitive environment and the impact of private agencies and the public sector on prices. It is anticipated that price rigidities can be reduced via shaping the pricing behavior in line with the market conditions and establishing a wider competitive environment in the sector.

[1] VAT rebate along with the exchange rate was also influential on the decline in prices.

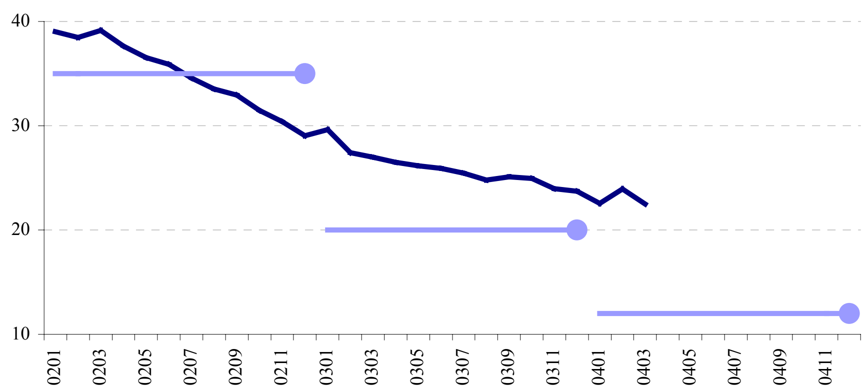
Figure II. 4. Goods and Services seasonally adjusted price increases (6 months moving average)



Secondly, price rigidity in services group enhances the importance of a controlled recovery in domestic demand. Price rigidity in services group may pose risks in the future if the favorable effects of the exchange rate disappear and a noticeable recovery is observed in domestic demand.

At this point, it would be useful to dwell briefly upon the upward trend in rents since the course of house rents, which comprise the half of services group, has a key role in price rigidities in services group. In the aftermath of the economic crisis, the decline observed especially in real wages led to a demand-oriented pressure on rent increases and consequently rent increases during this period realized at low levels. As a matter of fact, rent increases were consistent with the target in 2002 and remained below the inflation target at the end of the year. However in 2003, the rate of rent increases realized 3.7 points above the inflation target in the year-end. In the first three months of 2004 rent increases followed the same course with that of 2003, leading to an inconsistency with the target of 12 percent (Figure II.5).

Figure II.5. House Rent Increases and Inflation Target (Annual Percentage Change)



Another important point to be emphasized regarding inflation realizations in January – March period is the relation between fiscal adjustment, budget targets and inflation. We have underlined several times in our previous announcements and reports that fiscal discipline is a sine qua non for the success economic program and disinflation. Yet, for the sake of inflation target, the quality of fiscal prudence gains as much importance as the fiscal discipline itself, especially in the short run.

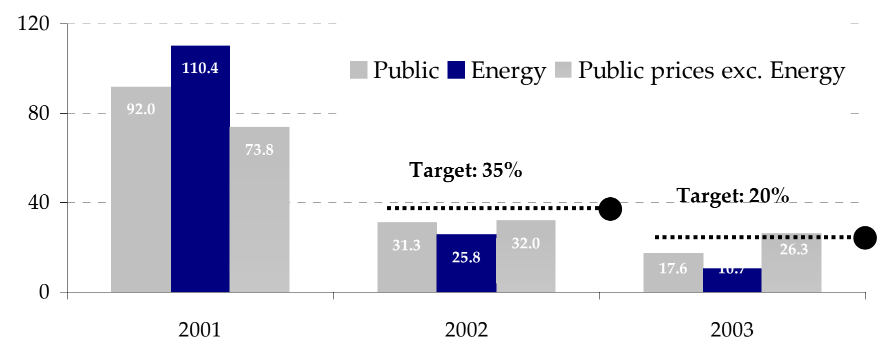
A supplementary budget was drawn up in the end-February in order to meet the financing requirement in the budget. Indirect tax increases stipulated in the supplementary budget had an unfavorable effect on March inflation. Yet, these mostly one-off increases are deemed to exert only a limited amount of pressure on inflation in the future. Moreover, financing methods had a limited effect on production costs since the energy prices such as electricity-natural gas prices were kept unchanged despite the increases in fuel oil prices and since tax increases were made mostly on tobacco products.

At this point, increases in energy prices are especially crucial. Even when we do not take their indirect effects (that is, when only their share within the CPI is considered) into account, energy prices still bear a significance in terms of inflation. Furthermore, when the production costs and the indexation behavior in some sectors are taken into account, the indirect effects of price increases in this group may be as important as their direct effects.

The course of energy prices in recent years highlights their obvious contribution to the downward trend in inflation.

The course of energy prices in recent years highlights their obvious contribution to the downward trend in inflation. In the period of 2001 crisis, energy prices increased at a rate well above the general consumer inflation. This rate of increase slowed down in 2002 and 2003, which played an important role in achieving the year-end targets. Moreover, thanks to the low rate of increase in energy prices in 2003, price increases in public sector became consistent with the inflation target. As shown in Figure II.6, price increases in public sector excluding energy prices realized 6.3 points above the inflation target. In other words, one of the most important reasons why public price increases did not exceed the inflation target was that price increases in energy group which remained 9.3 percent below the target. Therefore, the course of energy prices in 2004 will be of critical importance in terms of inflation target as well.

Figure II. 6. Year-end increases in energy prices and public prices excluding energy



In the short run, the probability of the contradiction between budget target and the inflation target is a structural problem that may be faced also in the coming period in which we will aim at achieving single digit inflation, since increasing the quality of fiscal discipline will gain more importance as inflation comes closer to single digits (Box V.1). Turkish Economy, which has been producing a considerable amount of primary surplus for the last two years in the framework of the program, has attained a remarkable financial success. Yet, as the program goes on, the sustainability of fiscal discipline can only be attained through structural arrangements that would increase the quality of primary surplus.

BOX II.1. CHANGES IN INFLATION DYNAMICS

Turkish economy has entered a different process starting from the mid-2001. The big economic crisis and the conditions stipulated by the economic program, which was put into implementation following the crisis, led to a transformation in the macroeconomic structure that had caused high inflation in Turkey for over twenty years. The scale of the crisis called for a restructuring in both real and financial sectors, which is supported by fundamental changes included in the economic program. All these developments, when combined with the adoption of floating exchange rate regime in 2001, the independence of the Central Bank and the monetary and fiscal discipline have paved the way for the breakdown in inflation dynamics.

The inflationary process in Turkey has emerged as a consequence of a macroeconomic structure built up of many interdependent factors rather than as a result of one single factor. The basic elements of this macroeconomic structure can be listed as the exchange rate, the role of the public sector and the general pricing behavior. The role of these three basic elements on inflation dynamics has undergone changes in the process of disinflation and consequently inflation has witnessed a breakdown unprecedented for the last 30 years:

Exchange Rate

Starting from the 1980s, exchange rate has increasingly become a dominant factor on inflation as a consequence of a swift and uncontrolled capital account liberalization process. The weight of imported and import substitute goods on the CPI basket were noticeable and a great amount of total imports was composed of intermediate and capital goods. As a result, exchange rate became an important determinant in prices directly and indirectly by affecting the costs.

Moreover, economic units, which are used to living with inflation for long years, develop some indexation mechanisms while making their forward-looking decisions. Under the inflationary uncertainty, supposing that exchange rate is a good indicator for future inflation, price-setters may prefer to adjust their prices according to the exchange rate in order to protect themselves from inflation. Managed exchange rate regime adopted after the fiscal liberalization has led to a "predictable" exchange rate "under the guarantee of the Central Bank" and strengthened the relation between exchange rate and inflation by encouraging currency substitution and financial dollarization.

With the economic program adopted following the 2001 crisis, floating exchange rate regime was adopted. Exchange rate is deemed to maintain its impact on prices through putting pressure on prices of import goods and on production costs also in the post-crisis period. However, since the policy of making the exchange rate predictable through superficial methods was abandoned and both an upward and a downward movement were observed in the exchange rate in the short-term, foreign exchange lost its characteristic of being a secure investment instrument and thus an important step were taken on the way of breaking the indexation behavior. In this context, floating exchange rate regime is believed to have led to a structural transformation in the relation between exchange rate and inflation.

Public Sector

Another important factor in the economic structure reinforcing the inflationary process is the dominant role of the public sector balances. Debt dynamics have been the most important factor shaping the expectations about inflation and other macroeconomic variables for over ten years. In addition, public prices and indirect taxes, which are directly related to the financial structure of public sector, are also effective in inflation. Two basic channels can be considered in this regard. Firstly, the unhealthy fiscal structure of public sector leads to increases in revenue-boosting adjustments in public prices and indirect taxes, which consequently exert a direct pressure on inflation. The second channel emerges as a result of the fact that these price and tax increases may occur in sectors closely related with input costs such as the energy sector within the public monopoly, making the impact of this channel much greater.

On the other hand, during the downward trend in inflation, risk premium has decreased and public sector pressure on inflation expectations has considerably weakened thanks to the improvement in debt dynamics. Public prices and indirect tax increases have been kept at levels consistent with inflation targets throughout the implementation of economic program. However, considering the fact that the heavy burden of public debts on financial system still persists, debt dynamics continue to be one of the most important determinants of inflation expectations. Besides, indirect taxes and public price increases maintain their importance as regards inflation dynamics. Therefore, the weakening pressure of public sector on inflation in the recent period is not deemed to be a structural transformation yet. The said transformation can only be achieved through a more efficient production process, social security and tax reforms and an economy free from public sector burden; that is to say, through structural reforms.

General Pricing Behavior

Considering the high inflation experienced in Turkey for over twenty years, it is natural that some indexation mechanisms have been established. The exchange rate indexation mentioned above is one of the most outstanding mechanisms. Like all high inflation examples, rigidity in prices caused by such mechanisms reinforces the inflationary process in Turkey and disrupts the disinflation efforts. Therefore, shaping the expectations in line with the forward-looking inflation target by breaking this rigidity becomes one of the most important objectives of the economic program. This objective can only be realized through establishing credible economic policies and price-setting behaviors under free a competition environment.

Proper management of inflation expectations is an indispensable factor in disinflation. In a way, the ability of the Central Bank to keep inflation under control depends on its ability to keep expectations under control. Thus, a transparent, credible and inflation-focused monetary policy is the most significant determinant factor of expectations. In order to implement such a monetary policy, the Central Bank should have an institutional structure that is based on operational independence that would provide more efficiency in policy actions. As a matter of fact, one of the most significant structural innovations made in the post-crisis period has been the new Central Bank Law. With the Law, the objective of the Central Bank was set as to achieve price stability, and the Bank was provided with operational autonomy. This reform is a remarkable step taken for the sake of shaping forward-looking expectations.

The most important outcome of this step has been the success in achieving the inflation targets of the last two years. As of March 2004, inflation expectations are consistent with the year-end target as well. The empirical studies point out that past inflation is still a suggestive parameter in determining inflation expectations but yet the impact of inflation target on expectations has considerably strengthened in recent months.[1]

Another noteworthy factor in general pricing behavior is the outstanding role of "output gap" or "demand gap" on inflation dynamics in an environment where price-setters are forced to be more rational in making forward-looking decisions. Economic policies adopted before the 2001 crisis in Turkey had not aimed at keeping total demand under control in an inflation-focused manner. In other words, a "loose" or "demand-stimulating" fiscal and monetary policies were adopted from time to time. Therefore, indexation and exchange rate movements were dominant in inflation, and the elasticity of domestic demand against price increases was at a low level. As a result, price-setters were faced with such demand conditions that let them reflect cost increases immediately on their prices.

However, the economic crisis led to an unprecedented contraction in demand for long years, and the floating exchange rate regime and tight monetary policy adopted just thereafter has made the relation between supply-demand equilibrium and inflation evident. Besides, due to the decline in inflation consumers were able to recognize the relative price changes more easily, which consequently increased the price elasticity of demand. This, in turn, forces the firms to take the future cost and supply-demand conditions into consideration in setting prices. Especially, as backward-indexation behavior and the public sector pressure on inflation as well as the exchange rate-inflation relation weaken, the relationship of supply-demand equilibrium with inflation is expected to become statistically more evident in the future.

Conclusion

In conclusion, the transformation process in inflation dynamics experienced in Turkey can be summarized as follows:

- With the changing of exchange rate regime, exchange rate indexation behavior weakened. However, exchange rate continues to affect inflation through costs and import prices,
- Debt sustainability concerns eased and public prices were increased at a rate consistent with inflation targets, which consequently weakened the pressure caused by public sector on inflation. Yet, structural arrangements that would maintain this course have not yet been fully realized,
- Thanks to the historical achievement in disinflation, the decision making behavior shaped according to past inflation has started to change and inflation target has become effective in shaping expectations,
- Price-setting behavior has become more rational, and especially the role of domestic demand in determining inflation started to increase compared to past.

It should be kept in mind that economic units still have a strong inflation memory and they can be possibly tempted to return to their previous behavior patterns in case of any unfavorable development. Therefore, the current stability environment should be carried out in the medium and long term in order to maintain the positive changes in inflation dynamics, and this, in turn, necessitates the permanent structural reforms[2] as has always been underlined.

[1] See CBRT Monetary Policy Report, October 2003, Box II.1 Inflation Target and Expectations

[2] See Box III.1 and Box VI.1.

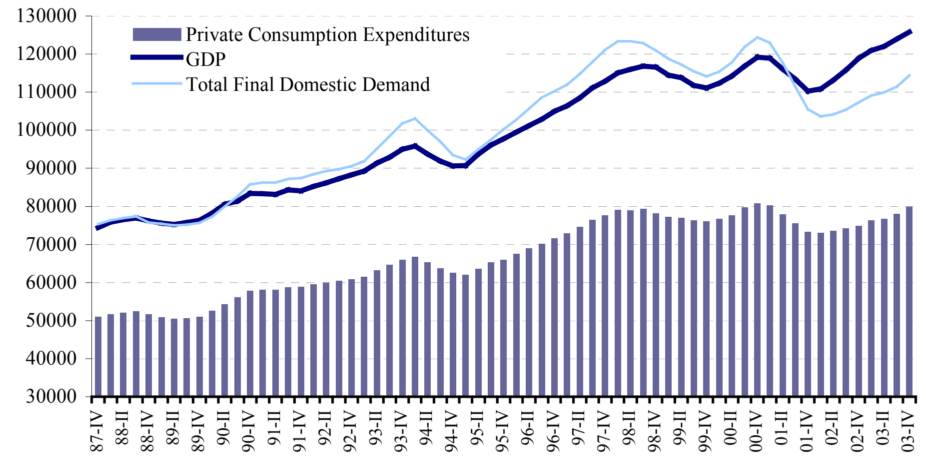
III. Supply and Demand Developments

III.1. Domestic Demand

The ongoing economic growth in 2003 was based on the high performance in exports and the revival of domestic demand in the second half of the year (Table III.1.1). Contrary to the previous three years, the growth in total final domestic demand realized above the GDP growth in the last quarter of 2003. Hence, total final domestic demand level was still below the GDP, though the annualized data pointed out the acceleration of the limited recovery of domestic demand, which began to recover in 2002. Meanwhile, the implementation of tight fiscal policy in 2003, on one hand restricted the private consumption expenditures indirectly via income policy, on the other hand, it was the fundamental factor that limited domestic demand directly by reducing public expenditures. These developments avoided any demand pressure on consumer prices in 2003 (Figure III.1.1).

The annualized data indicated that the revival in domestic demand accelerated in the last quarter of 2003. The level of total final domestic demand below the GDP avoided the demand pressure on consumer prices in 2003.

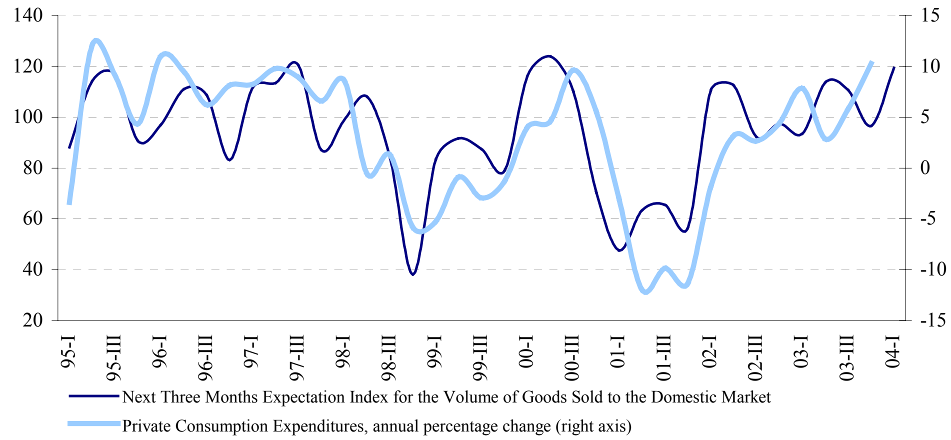
Figure III.1. 1. Annualized GDP, Total Final Domestic Demand and Private Consumption Expenditures (1987 prices)



Source: SIS

When consumption expenditures, one of the components of total final domestic demand, are analyzed by sub-groups, it is observed that expenditures for durable goods and services increased by 24 percent and 7.5 percent in 2003, respectively, compared to the previous year (Table III.1.1). The high rate of increase in expenditures for durable goods stemmed from the facts that the relative price increases in this sector remained rather limited due to the appreciation of Turkish lira against foreign currencies, interest rates on credits declined to lower levels, the improvement in borrowing facilities such as longer term repayment schedules and the realization of postponed consumption expenditures. Hence, consumer credits and credit card use accelerated in the second half of 2003. Besides, CBRT and CNBC-e Consumer Confidence Indices, which reflect consumer confidence, indicated that consumer confidence had improved in this period. Furthermore, the favorable course of tendency of volume of goods sold to the domestic market for the next three months, an indicator in the CBRT Business Tendency Survey, reflects the positive expectations of producers on domestic demand. The high level of the tendency of the volume of goods sold to the domestic market, announced in the first months of 2004, indicates the acceleration in the private consumption expenditure growth in the first quarter of the year (Figure III.1.2).

Figure III.1.2 Private Consumption Expenditures and Expected Sales



Source: SIS, CBRT BTS

Table III.1.1. GDP Developments by Expenditure Side (Annual Percentage Change)

	2002					2003				
	I	II	III	IV	Annual	I	II	III	IV	Annual
1- Consumption Expenditures	-1.5	3.1	3.5	4.4	2.5	6.9	2.3	5.2	8.0	5.6
Public	2.2	2.6	12.0	4.5	5.4	-2.3	-2.0	-0.7	-4.2	-2.4
Private	-1.9	3.2	2.7	4.4	2.1	7.8	2.9	5.8	10.3	6.6
Durable Goods	-7.0	8.7	1.8	6.1	2.1	24.7	10.6	11.4	49.5	24.0
Services	2.0	10.0	8.8	11.5	8.5	9.6	5.1	7.6	7.9	7.5
Food and Beverages	-0.7	-0.3	2.7	1.8	1.1	4.4	4.1	5.7	1.0	4.1
Semi-dur.&Non-dur. Cons. Exp.	-2.1	4.3	1.6	10.5	3.0	4.7	-4.5	3.7	3.8	2.1
2- Fixed Capital Formation	-28.4	-1.8	5.9	20.7	-0.9	11.7	6.3	3.0	19.2	10.0
Public	-18.4	3.0	27.9	9.2	8.8	-34.8	-14.6	-22.7	5.0	-11.5
Private	-30.6	-3.8	-3.2	31.0	-5.3	22.6	14.2	16.4	30.1	20.3
3- Stock Change*	6.9	12.0	3.9	6.4	7.1	3.6	5.5	2.2	1.2	3.0
4- Exports of Goods and Services	10.6	5.1	15.9	12.5	11.1	14.5	12.3	19.4	16.9	16.0
5- Imports of Goods and Services	2.5	20.4	19.2	22.1	15.8	22.0	24.7	28.3	33.0	27.1
6- Total Domestic Demand	-0.7	14.9	8.3	14.9	9.3	10.9	8.5	7.0	11.3	9.3
7- Total Final Domestic Demand	-7.4	2.0	4.0	7.8	1.8	7.7	3.2	4.7	10.6	6.5
8- GDP (Expenditure Side)	2.3	8.9	8.0	11.6	7.8	8.1	3.9	5.5	6.1	5.8

*Contribution to GDP growth, percent
Source: SIS

When investment expenditure, one of the determinants of total final domestic demand, is analyzed, increase of total fixed capital investment expenditure was based on the private sector in 2003. Private investment expenditures rose by 20.3 percent compared to the previous year thanks to the sharp increase in machinery-equipment sector in 2003.

The growth rate of public expenditures is expected to be significantly low in 2004, provided that the implementation of measures, taken to maintain fiscal discipline and a well-structured and efficient public sector, continue to be in effect. On the other hand, the continuity of fiscal discipline will ensure the maintenance of stability in real interest rates and exchange rates through expectations channel and thus, will stimulate private consumption and investment expenditures by improving both consumer and investor confidence.

The signal effect of fiscal discipline continuity will stabilize the real interest rates and exchange rates and stimulate the private consumption and investment expenditures by improving both consumer and investor confidence.

The simultaneous recovery of investment and private consumption expenditures is of great importance in two aspects with respect to their possible effects on growth and inflation in 2004. Firstly, investment expenditures and productivity developments, due to high levels of capacity utilization rates, are expected to determine the continuation of the production increase in 2004. High rates of production growth in machinery-equipment and office accounting and computing machinery sectors in January and February pointed out that investment expenditures are accelerating. Given the limited wage increments, this development will provide the continuation of the increase in productivity and lead to a favorable impact on exports and production by ensuring low levels of real unit wages. Secondly, acceleration in investment expenditures and productivity will contribute to the achievement of the end-year inflation target to the extent of their favorable effects on production costs and consequently on prices. As a result, investments will become more important to have a sustainable and non-inflationary growth in 2004.

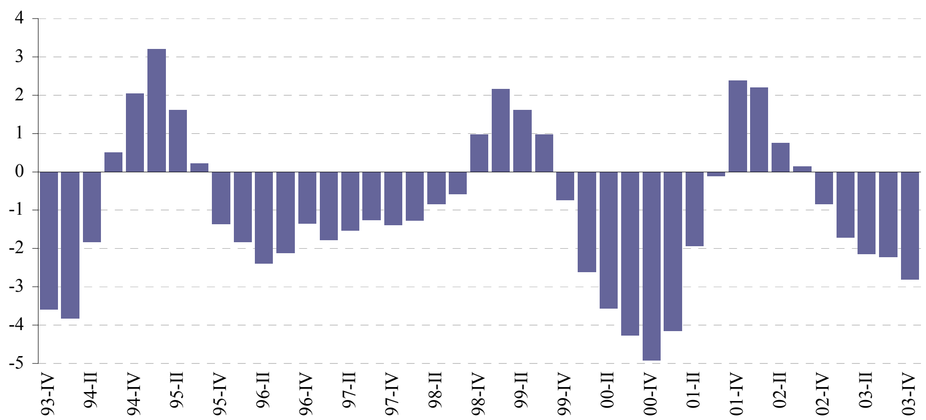
III.2. Foreign Demand

In 2003, current account deficit was US dollar 6.8 billion (Figure III.2.1). The deficit mainly resulted from the expansion in foreign trade deficit and the increase in the interest and dividend payments. In this period, current account deficit realization below the program target can be attributed to favorable developments in exports and tourism sector.

According to the data announced by SIS, the 30.5 percent increase in exports in this period compared to the previous year mainly resulted from the manufacturing industry products that constitute nearly 94 percent of total exports. Main determinants of the increase in exports were the low labor and energy costs, the decline in financing costs, the increase in productivity and the upward trend in export prices. The 33.5 percent increase in imports primarily based on the increase in imports of intermediate and capital goods. While, high growth rate of industrial production increased intermediate goods import, improved market confidence and favorable expectations in line with macroeconomic stability led the import of capital goods to accelerate. Meanwhile, the upward trend in the real exchange rate also supported the rise in imports during this period. Moreover, the parity effect arising from the depreciation of US dollar against other foreign currencies had a significant effect on the performance of imports and exports in 2003. Export and import growth net of the parity effect realized as 23.1 percent and 27.4 percent, respectively, in 2003.

A substantial increase was observed in consumption good imports in 2003. Recently, there are concerns about the fact that this increase is expected to exert pressure on exchange rate by deteriorating current account balance and thereby to affect the inflation via costs adversely. It is considered that consumption goods import, which constitute nearly 10 percent of total imports are not at a level that verify such concerns, despite its rapid increase. Moreover, when other components of imports are analyzed, it is observed that intermediate and capital good imports supported the export-oriented production increase. It is thought that recent composition of imports is not a danger for the current account provided that other conditions remain the same.

Figure II.2.1. Current Account Balance / GNP* (percent)



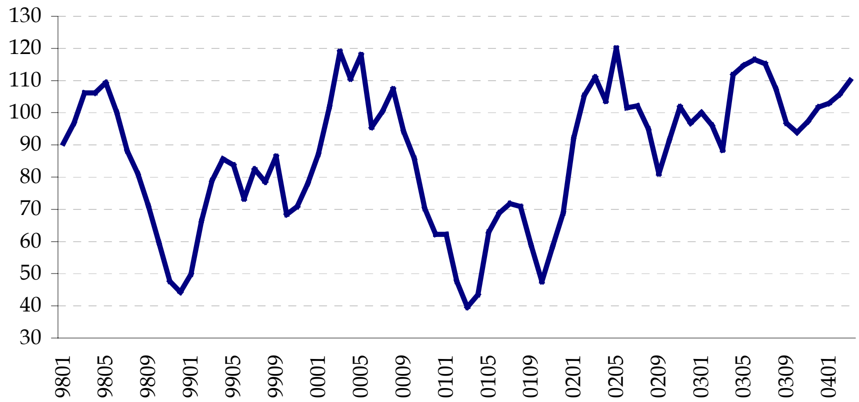
* Annualized data.
Source: SIS

Data announced by SIS and TEA (Turkish Exporters' Assembly) show that increase in exports, based on industrial products, is continuing in the first quarter of 2004 as well. Besides, the upward trend of the February 2004 data of VAT on imports, announced by the Ministry of Finance, pointed out the acceleration in imports. In case of the perpetuation of the current trend in foreign trade data tendency, current account balance is expected to give a deficit within the range 3-3.5 percent of GDP at the end of 2004.

III.3. Supply Side Developments

Following 2002, Turkish Economy continued to grow in 2003 as well. In this period, GNP increased by 5.9 percent compared to the previous year and realized above the program target of 5 percent. The apparent high and accelerated level of production tendency index for the next three months based on the CBRT Business Tendency Survey indicators points out that firms have favorable expectations for the production (Figure III.3.1).

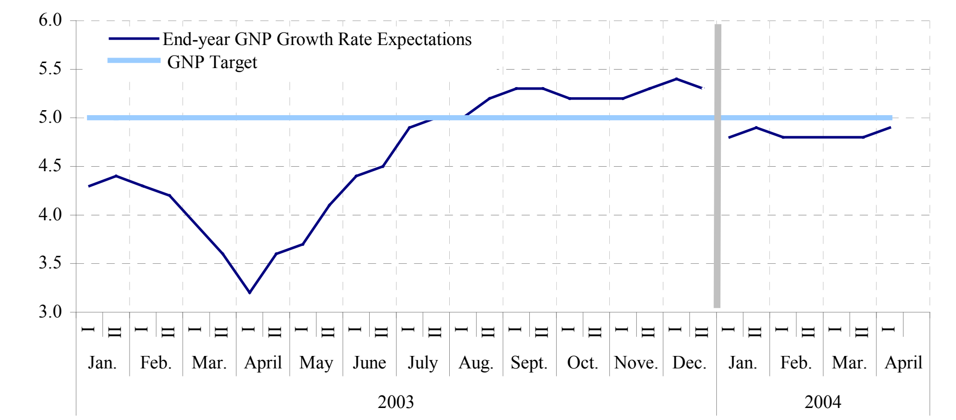
Figure III.3.1. Production Tendency Indices for the Next Three Months Periods *



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

The realization of both inflation and growth rates in line with the targets had a favorable effect on the expectations of economic agents for the end-year, and enhanced the confidence in the economic program. In this context, although the GNP growth rate forecasts, which were delayed converging to the 2003 end-year target, converged rapidly to the 2004 end-year target starting from early-2004 and realized as 4.9 percent in the first survey period of April (Figure III.3.2).

Figure III.3.2. Annual GNP Growth Rate Expectations in the CBRT Survey of Expectations



Source: CBRT

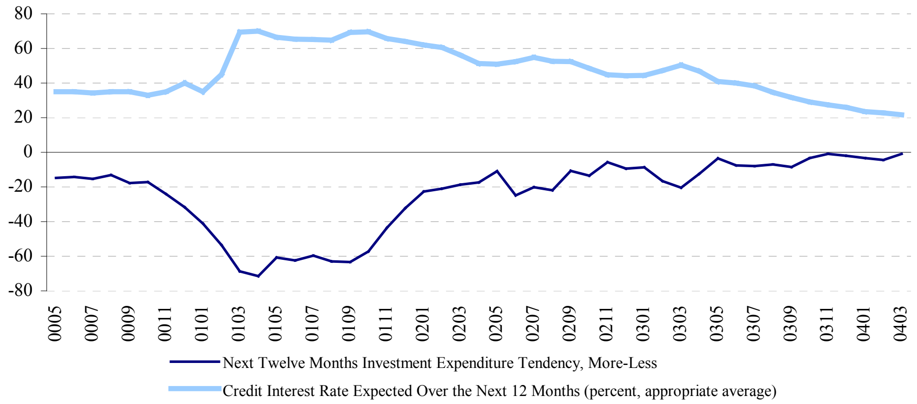
SIS Monthly Industrial Production Index indicates that total industrial production rose by 11.1 percent in January-February period compared to the same period of the previous year. Manufacturing industry production, significantly contributed to the growth of industrial production and grew by 12.4 percent in this period.

Parallel to the sharp production rise in 2003, manufacturing industry capacity utilization rates maintained their high levels in January-February period. According to the data announced by SIS, average capacity utilization rate in total manufacturing industry realized as 75.3 percent in the first two months of 2003. In this period, while capacity utilization rates decreased in the public sector, they increased in the private sector compared to the same period of the previous year. The high level of capacity utilization rates in key sectors such as basic metal and machinery-equipment sectors is a positive signal for the investment expenditures. Furthermore, motor vehicles manufacturing industry, which had been a locomotive sector driving the growth in 2003 and is expected to be one of the key sectors for the growth in 2004, still maintains its high capacity utilization rates as a result of the sector's high export performance and the recovery of the domestic demand. However, motor vehicles sector's production increase can be sustained in the short run without exerting any pressure on prices as the demand for the motor vehicles, especially for automobiles, mainly stems from low relative prices in the sector and the sector's capacity utilization rates have not yet reached to the level that force the production capacity .

High export performance due to productivity improvements and the favorable level of unit wages are still the main determinants of the rise in industrial production. Moreover, the recovery in the domestic demand, especially for the durable goods, supports the production expansion. High growth rates of durable goods, mainly motor vehicles, as well as the sectors that produce capital goods, such as machinery-equipment, office accounting and computing machinery and radio-TV communication equipment, show that investment expenditures are accelerating.

Favorable expectations for the course of the economy and the decline in the risk premium revealed a suitable investment environment. Furthermore, the realization of inflation rates in the first quarter of 2004 in line with the expectations, enhanced the optimistic expectations as well. Besides, the low level of interest rate expectations on credits points out the firms' favorable expectations on the cost of investment financing. Hence, the level of investment expenditure tendency, one of the indicators for the investor confidence, indicates that investment expenditures keep rising which is a vital fact for the sustainability of the rise in production (Figure III.3.3). The expansion in the potential production arising from the increase in investment expenditures is expected to ease inflationary pressures.

Figure III.3.3. CBRT BTS Expectation of TL Credit Interest Rate and Investment Expenditure Tendency



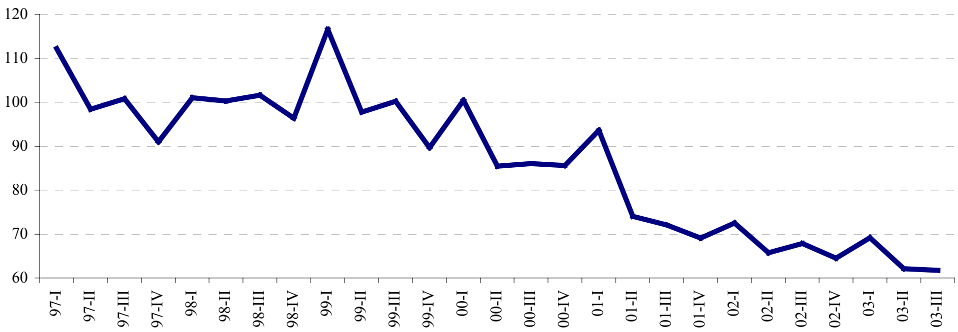
Source: CBRT BTS

However, it should be kept in mind that both domestic and foreign investment decisions are very sensitive to the confidence factor. The establishment of a permanent confidence environment for both domestic and foreign direct investments to increase is the pre-requisite for the maintenance of the economic stability. In addition to the success achieved as a result of the strictly implemented economic policies, structural reforms that put into effect with momentum will maintain the economic stability. In other words, investments, which are essential for sustainable growth and price stability in the medium-term, can only be realized in a permanent confidence environment that can be ensured by the structural reforms that must be urgently put into practice.

III.4. Cost Pressure

Index for Real Wages per Hour declined by 3.3 percent in the first nine months of 2003 compared to the same period of the previous year, whereas productivity per working hour rose by 5.2 percent in the same period (Table III.4.1). Private Manufacturing Industry Unit Real Wages Index maintained its low level in the third quarter of the year as well (Figure III.4.1).

Figure III.4.1. Private Manufacturing Industry Real Unit Wage Index* (1997=100)



*** Total real wage index, which is calculated by multiplying SIS manufacturing industry real wages index per production hours worked and SIS manufacturing industry production hours, is divided by SIS quarterly private manufacturing industry production index to come up with the real unit wage index.**

Source: SIS, SPO, CBRT

In 2004, the rise in the salaries of public sector civil servants and workers' wages were determined in line with the inflation target. Public workers wages were raised by 5 percent for the first half of 2004, while the wage increase set as 5 percent for the second half of the year.[1] As for the civil servants, salaries were increased by 6 percent for the first half of 2004 whereas a one-time lump sum payment of 160 million Turkish lira was given in January. Salaries of civil servants is projected to increase by 6 percent for the second half of the year. Moreover, minimum wages were raised by 38.2 percent in 2004. Since the increase in private sector wages is based on the public sector income policy, wage increments in 2004 are not expected to create a cost-oriented pressure.

High productivity performance in the last period is contributing to the decline in firms' production costs. It is expected that unit labor cost will not exert any pressure on prices as the productivity increase will remain above the rise in real wages in the next period and, thus, firms will maintain their competitiveness in the export markets. Accordingly, the favorable level of real unit wages is expected to limit price increases in the domestic market and will be the main driving force for the export increase as well (Box III.1).

Meanwhile, when considered with respect to intermediate and capital goods that constitute a substantial portion of total imports, strong position of Turkish lira against foreign currencies has a positive impact on imported input costs. Nevertheless, the rise in the international prices of raw materials that are used as primary inputs in basic metal and petroleum products sectors may impose cost pressures on inflation in the coming months.

Table III.4.1. Employment, Real Wages and Productivity Developments in the Manufacturing Industry
(Percentage Change Compared to Previous Year's Same Period)

	2002					2003			
	I	II	III	IV	Annual	I	II	III	Nine Months
Employment(1)	-6.9	0.1	3.4	6.0	0.6	5.0	1.8	1.3	2.7
Public	-11.4	-12.0	-8.0	-5.1	-9.1	-4.1	-6.5	-4.6	-5.1
Private	-6.1	2.3	5.5	7.8	2.3	6.2	2.9	2.2	3.7
Real Wages(2)	-15.9	-4.2	-2.7	-0.5	-5.4	-1.0	-5.1	-3.9	-3.3
Public	-12.6	5.9	4.1	6.9	1.4	-2.5	-8.9	-8.6	-6.7
Private	-15.1	-3.2	-1.1	1.1	-4.2	0.8	-2.6	-1.4	-1.0
Productivity(3)	10.3	10.4	7.0	6.6	8.6	4.6	3.3	7.7	5.2
Public	15.7	22.4	20.7	8.0	16.4	4.7	8.2	7.7	6.8
Private	9.6	9.0	5.0	7.9	7.8	5.5	3.2	8.3	5.7
Earnings(4)	-17.4	-4.5	-6.5	-2.2	-8.0	-5.5	-10.6	-8.5	-8.2
Public	-14.7	4.4	-2.3	7.0	-2.1	-3.5	-12.2	-11.4	-9.1
Private	-16.4	-3.6	-4.3	-1.6	-6.8	-4.3	-8.4	-6.2	-6.3

(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

[1] In the case CPI inflation rates announced by SIS for the first half of the year realize above 5 percent, 0.80 of the exceeding figure will be added to the rate of raise in wages set for the second half of the year. If inflation rates announced for the second half of the year realize above 5 percent, the exceeding figure will entirely be added to the wages valid on December 31, 2004.

BOX III.1. STRUCTURAL REFORMS TARGETING IMPROVEMENT IN COMPETITIVENESS AND PRODUCTIVITY INCREASE

The aim of increasing productivity and improving competitiveness is among the focus points of structural reforms, which have been carried out since May 2001. A sustainable high growth rate in medium and long term can only be achieved via productivity improvement. Whereas, expansion in the production due to cyclical fluctuations will be transitory increases. In other words, increase in productivity along with increase in production signifies a more permanent improvement for both the economy and the firms. The main target in the long term is to make production at lower costs. The productivity increase, which means more production with the same amount of input, is deemed as the most permanent way to bring down production costs. Despite the recovery in macroeconomic conditions, sectors may display price rigidity due to the peculiarities specific to them. The price rigidity may stem from structural problems such as unproductiveness or monopolization of sectors. For this reason, the improvement of competitiveness is as vital as increasing the productivity in order to achieve and maintain price stability. Improvement in competitiveness means restructuring markets so as to furnish them with mechanisms that will not allow economic agents to acquire profit margins systematically above the average market yield in the medium and long terms. The resulting gains from such structuring is that it will create an environment that will allow maintaining growth along with price stability. The success of the reforms in the long term can directly be assessed by achievement of price stability and the rise in private sector investments and potential output. The structural reforms towards the improvements in competitiveness and productivity can be analyzed under the headings given below.

Measures Towards Increasing Productivity in Public Sector

Redundant labor force in SEEs was reduced in 2002 and 2003. Further measures for reducing redundant posts in SEEs are under way in 2004 as well. In the scope of restructuring SEEs and strengthening their governance frameworks, studies on SEE Governance Law are continuing. Strengthening the structure of SEEs will allow achieving the following goals with respect to their operation: Firstly, the burden of SEEs on the public budget will be alleviated. Secondly, more efficient operation of SEEs will improve competitiveness in the markets regarding their products. Finally, employment of more productive enterprises in a more effective way under the privatization program will be possible. Hence, improvements in the governance of SEEs will contribute to increasing the role of private sector in the economy.

Increasing the role of private sector in the economy

It is observed that the target of increasing the role of private sector in the economy overlaps with privatization to a large extent at present. The main goal of privatization programs is to make productivity and cost structure in the economy reach competitive levels in international platform by providing free market conditions. Another target to be attained concurrently with or via privatization is to allow government to focus solely on its fundamental duties such as legislation, supervision and monitoring rather than being goods and services producer apart from goods considered to be public property. Within the framework of privatization, extending the private security ownership and technological advancement as well as diminishing debt stock is aimed especially by rapid privatization of SEEs.

Achievement of privatization programs in concrete terms mainly depends on the development of the policy framework of competition law. In this context, the Competition Board is making up the preparations on communiqué relating to secondary regulations. The studies on harmonization to EU legislation are being carried out as well. Easing uncertainties that may arise in the interpretation of competition laws by entrepreneurs and increasing the sanctionary power of the laws will have a significant effect on the performance of the reforms.

The legal framework relating to the management of firms' capital structures, which has been announced to the public under the heading of "The Financial Sector Reforms", is of great importance with respect to the improvement in competitiveness. The subjects on the restructuring of the financial sector are being treated under a different heading "Financial Sector Regulations".

Improvement in Investment Environment

Regulations relating to the foreigners' working or establishing company in Turkey are one of the focus points of the efforts towards the improvement in investment environment. These studies are carried out on the fields such as foreigners' work permits, their right to benefit from investment discount without an incentive certificate, simplification of a company's establishment process, accounting standards, patent and sectoral license regulations. The competition and capital regulations treated under the heading "Privatization" should be considered as a pre-requisite for the success of the reforms on foreign investments.

The regulations on SMSEs set the second focus point of the improvement in investment environment. The apparent problems concerning SMSEs arise mainly in the fields such as investment financing, working capital management and access to technological information. Especially broadening the scope of the banking sector services towards SMSEs and increasing the quality of these services should be considered as top-priority reform areas.

Efforts on public ethics, which are of a determinant nature for both foreign and domestic investors, are continuing at present under the headings "simplifying bureaucratic processes, reducing corruptions -good governance in a broader sense-" are considered under Administrative Reforms. These regulations are being put into effect progressively.

Financial Sector Regulations

Restructuring of financial sector is of great importance with respect to the following points: Firstly, an unhealthy financial sector – especially the banking sector – is not only affected from a crisis unfavorably, but also stands as one of the main reasons that leads to a financial crisis. Secondly, a banking system having weaknesses fails to perform an efficient resource allocation, its fundamental duty. Increasing the share of private entrepreneurs in real sector is not possible in case of an inefficient resource allocation. Costs of an unhealthy banking system to a country's economy can be comprehended more clearly when SMSEs, which compose the major part of the Turkish economy, is specifically considered.

The restructuring program that aims at restoring the health of the banking sector, which was affected adversely by November 2000 and February 2001 crises, and making it one of the fundamental elements of sustainable growth was put into implementation on May 2001. The focus points of the program involves the restructuring of public banks with respect to their financial and operational aspects, where privatization is the ultimate objective, the settlement of problems concerning the banks under SDIF and the accomplishment of legal and institutional framework, which will enhance the efficiency of supervision and provide the sector with more effective and more competitive structure. The program made a significant progress towards providing the sector with a healthier and more competitive structure. Restoration of banks' profitability and strengthening of their capital structures are among the concrete outcomes of the program.

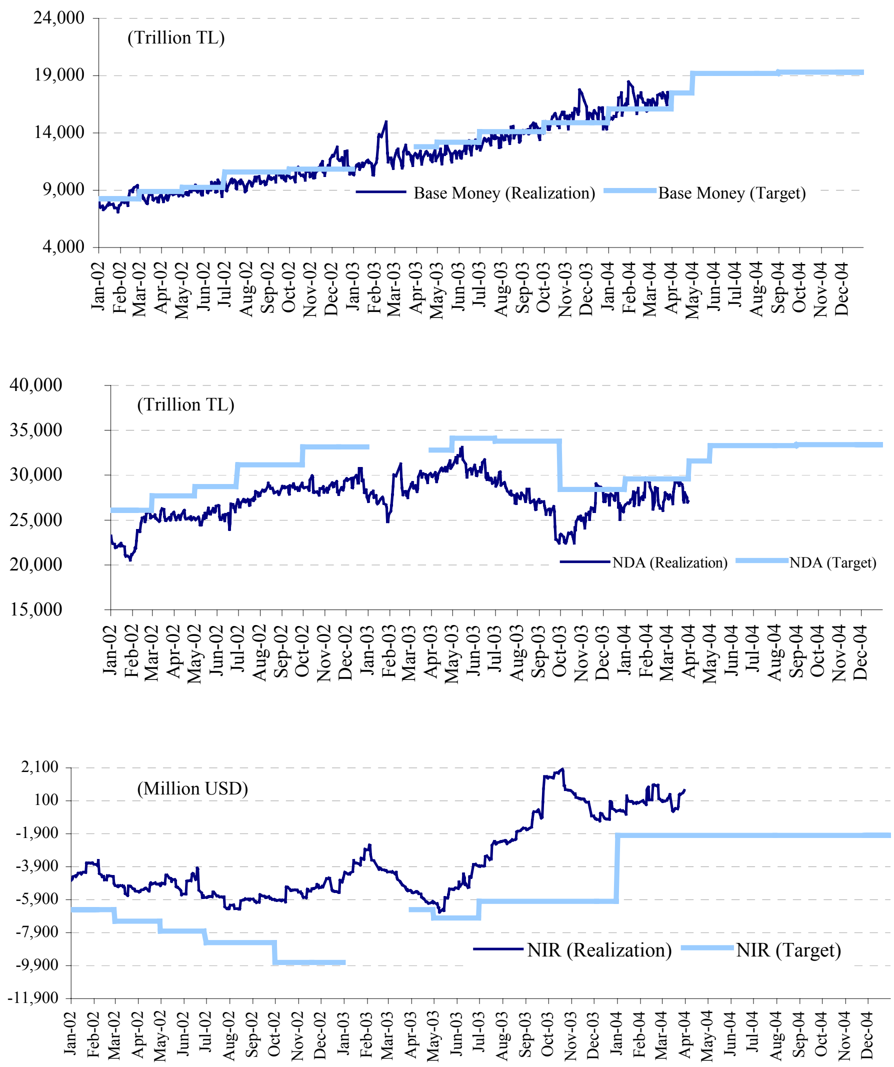
Inadequate development of capital market resulted from its utilization mainly by public sector due to high public deficits. A capital market, which could not deepen adequately, fails to make an efficient resource allocation, given the effects of public debt burden. In 2002 and 2003, a number of regulations were introduced in order to protect the investors in the capital market and to ensure the market efficiency in view of the process of harmonization to European Union. These regulations focus on counseling activities, the exercise of shareholder right and voting right, internal auditing and information systems, mergers and the principles of establishment and operation of over-the-counter markets. Moreover, a pretentious restructuring program is under way for the 2003-2006 period. Efforts on establishing a futures and option market, harmonizing Capital Market Board's accounting standards to EU legislation, stabilizing price fluctuations after initial public offering and integration of the capital market data are on the agenda until 2006.

IV. Developments in Financial Markets

IV.1. CBRT Monetary and Exchange Rate Policy Developments

As it is known, under the floating exchange rate regime the CBRT implements an "implicit inflation targeting" monetary policy that focuses on future inflation. Moreover, the CBRT takes financial stability as a supportive objective in order to implement price stability policies efficiently, and the Bank takes immediate measures to avoid the developments that could threaten the stability in the markets. In this system where short-term interest rates are the main monetary policy instrument, monetary performance criteria and indicative targets are being monitored within the framework of the economic program supported by the IMF.

Figure IV.1.1 Performance Criteria



Note: The Base Money, Net International Reserves (NIR), and Net Domestic Assets (NDA) targets for the end of April, June and September 2003 were determined in the Letter of Intent dated April 5, 2003 and for the end of December 2003 , they were determined in the Letter of Intent dated October 31, 2003. For the end of March, April, August and December 2004, they were determined in the Letter of Intent dated April 2, 2004.
Source: CBRT

Within this framework, all monetary performance criteria and indicative targets for 2003 have been achieved. As for 2004, performance criterion for Net International Reserves and indicative target for Net Domestic Assets pertaining to end-March have been achieved while another performance criterion for Base Money has been above the targeted level. (Figure IV.1.1).

At this point, it would be useful to focus on the reasons of the expansion in Base Money and on their signal effects. To start with, it is possible that monetary aggregates may grow at a higher rate than foreseen by the economic program since it has become harder to estimate money demand in an environment where inflation and interest rates follow a downward course. In monetary policy strategies – implemented in Turkey as well – in which interest rates are the main policy instrument, monetary aggregates are determined endogenously by money demand, and through interest rate policy, central banks may accommodate the increases in money demand as long as they do not contradict with the inflation target. Otherwise, increases (decreases) in money demand would exert an upward (downward) pressure on interest rates and consequently reduce the effectiveness of interest rate policies implemented by central banks. Therefore, expansions in base money should be evaluated in terms of the information about future inflation, rather than as a direct target.

The increase in Base Money indicates a behavioral change in money demand rather than a recovery in consumption demand.

As of the first quarter of 2003, confidence in the economic environment was reestablished as a result of the removal of uncertainties in the economy and the determined implementation of the program. Sharp decline in inflation and interest rates, the stability in exchange rates and the expectations about the continuation of favorable developments increased the economic agents' using of Turkish Lira. Bank deposits increased due to the enhanced confidence of the economic agents related to the future course of the economy and the shift of new reserves into Turkish lira investment instruments in the financial sector, which started to expand and deepen as a consequence of the economic program. This increase in bank deposits was another factor determining the expansion in Base Money. Furthermore, the liquidation of deposits held in Imar Bank has contributed to the process by increasing the deposit amount base subject to reserve requirement. Thus, the increase in Base Money indicates a behavioral change in money demand rather than a recovery in consumption demand. Empirical studies also point out a permanent behavioral shift in money demand in this period where a downward trend in inflation and interest rates is observed, and a stabilization in exchange rates together with the strengthening of Turkish lira is established.[i]

In other words, monetary expansion does not imply a loose, and therefore an inflationary monetary policy. In a certain period of time, the rigidity or looseness of a monetary policy should be evaluated in terms of real interest rate implied by the short-term interest rates, which is the main policy instrument of the Central Bank, rather than

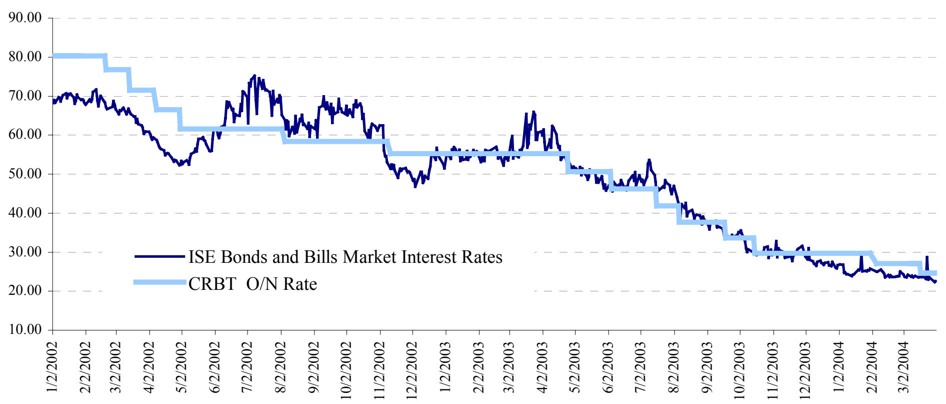
[i] See. Özge AKINCI (2004), "Modeling the Demand for Currency Issued in Turkey", *Central Bank Review*, Vol.3 (1) : 1-26.

Despite the observed downward trend, real interest rates are still at high levels; in this framework, it can be said that the Central Bank continues to implement a tight monetary policy.

any monetary aggregate. Despite the observed downward trend, real interest rates are still at high levels; in this framework, it can be said that the Central Bank continues to implement a tight monetary policy. (Figure V.1.4).

The Central Bank sets short-term interest rates, which are the main policy instrument, by evaluating the probable developments in future inflation with regard to its primary objective; price stability. Aggregate demand-supply balance, fiscal policy indicators, developments in wages-employment-unit cost-productivity, pricing policies in public and in private sector, inflation expectations, exchange rates and developments in the factors that may affect them such as balance of payments, analysis of probable exogenous shocks and all the inflation predictions made therein, are the indicators which are taken into consideration during the decision-making process of interest rates. In this context, in 2003, under the assumptions such as; absence of an evident domestic demand pressure, continuation of the downward trend in inflation expectations, largely elimination of exogenous uncertainties, determined implementation of the economic program in long term and stability of fiscal discipline and structural reforms; the overnight loan interest of the Central Bank, which was 44 percent on April 25, 2003, was gradually decreased and it was reduced to 22 percent as of March 17, 2004. (Figure IV.1.2).

Figure IV.1.2 CBRT Overnight Interest Rates and Secondary Market Interest Rates
(Weighted Average, Compound, Percentage)



However, there certainly exist some risk factors regarding the attainment of the inflation target. The pricing behavior, which is not consistent with the inflation target in terms of rent, education and health sectors, ranks first among these factors. On the other hand, supply–oriented fluctuations in food and energy prices, which are not under the control of the Central Bank, and exogenous shocks have always constituted risks. In case of the realization of these risks, or the emergence of tendencies, which will disrupt structural reforms or deteriorate budgetary discipline, the Central Bank, whose primary objective is price stability, may increase interest rates because of the direct negative effects of such developments on inflation. (Box IV.1).

The effective functioning of the transmission mechanism which will maintain the relationship between the inflation and short term interest rates, the policy instrument of the Central Bank, bears significance in terms of the success of the implemented economic program. Sine-qua-non conditions for the functioning of the mentioned mechanism such as, high credibility of the Central Bank and the importance of not to miss signals among many different messages given by other authorities have been underlined before.

In this context, with regard to the relationship between the secondary market interest rates and the Central Bank's overnight interest rates, it is possible to note the following: the secondary market interest rates are pursuing the downward trend in line with the decline in the Central Bank interest rates. In addition, the decline of the secondary market interest rates below the short-term interest rates as of mid-November 2003 is a significant development. The main reason for these downward deviations is the confidence felt in the implementation of the current economic program. (Figure IV.1.2).

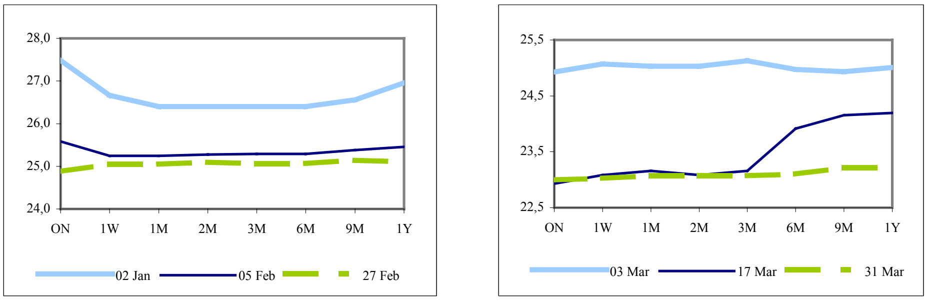
Although the relationship of the short-term interest rates, the main monetary policy instrument, with the long-term interest rates became evident in recent months, a parallel and strong correlation has not yet been established entirely due to the high-risk premium and the volatilities therein (Figure IV.1.2. and Figure IV.1.3).

Assuming that no uncertainty or instability would be observed at least in the short-term, the Central Bank cut the interest rates in the first quarter of 2004 as it did in 2003. Thus, within this framework market interest rates declined in those days, and remained at these lower levels in the following periods as well.

Before the interest rates were cut down on February 5, 2004, the yield curve was a U-shape one, denoting that risk perceptions would increase in the long run while they may decline in the medium-term. After the interest-rates cut on February 5, 2004, interest rates in all maturities declined and in the following days, a downward trend was observed especially in short-term interest rates, and consequently the yield curves became relatively horizontal. In the aftermath of the interest rate cut dated March 17, 2004, short-term interest rates declined while interest rates for longer maturities remained relatively high accentuating the importance of the level of risk perceptions in periods of interest rate cut. In periods marked by high-risk perceptions, the short-term interest rates declined while long-term interest rates remain the same. Actually, the period in question was marked by worries over the Cyprus talks. Nevertheless, a significant decline was observed in long-term interest rates at the end of March and yield curves took a horizontal form (Figure IV.1.3).

Figure IV.1.3. Effect of CBRT Interest Rate Cut on Market Interest Rates: Yield Curve Analysis

Interest Rate Cut on February 5, 2004 | Interest Rate Cut on March 17, 2004

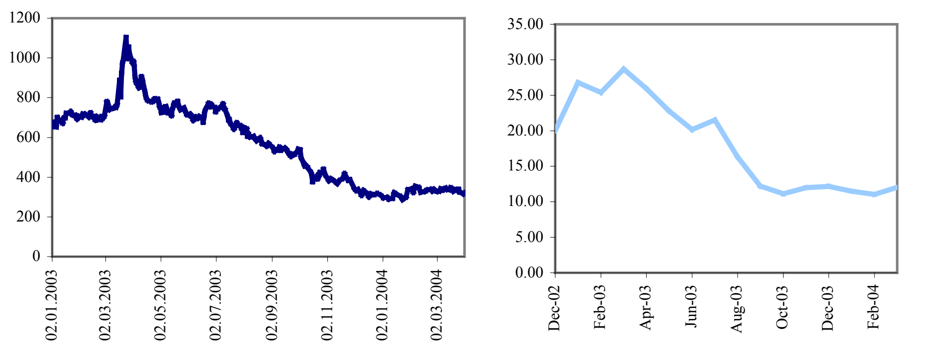


Albeit some decline, real interest rates still retain their high level. High-risk premium is one of the most important factors of the relatively high level of the real interest rates.

The downward trend in the weighted average compound interest rates at the Treasury auctions, which started to decline in parallel to the secondary market interest rates in April 2003, has continued. Albeit some decline, real interest rates still retain their high level. High-risk premium is one of the most important factors of the relatively high level of the real interest rates. The optimistic expectations about sustainability of the economic program coupled with the steps taken towards establishing fiscal discipline in 2003 helped risk perceptions diminish significantly. As is known, the sine-qua-non condition for debt sustainability is steadfast implementation of the economic program. Occasionally, some domestic as well as external developments led to worries that this sine-qua-non condition was at risk and the downward trend in real interest rates was reversed, but the general downward trend continued. The spread calculated as the difference between the long-term government securities, which are issued in international markets and generally used to evaluate the country risk premium, and the benchmark securities having the same maturity follows a lower course within the framework of the above-mentioned developments (Figure IV.1.4).

Figure IV.1.4. Risk Premium and Real Interest Rate on Treasury Auctions

Spread (JP Morgan Index)* | Treasury Auctions Real Interest Rate Developments (percent)*



(*) Calculated as the difference between the Turkish Eurobonds and USA Treasury Bills expressed in basis point

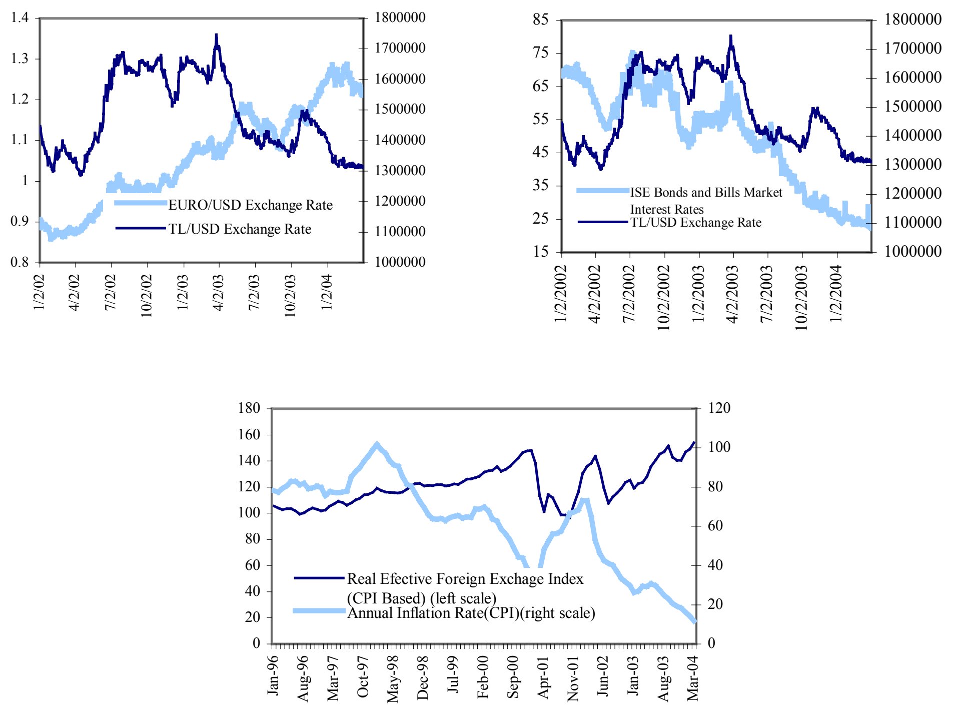
(*) Calculated using 12-month ahead CPI Inflation Expectations.

Source: JP Morgan and Treasury

Although the pass-through from exchange rate to inflation has weakened significantly under the floating exchange-rate regime that has been implemented since 2001, the exchange rate is still an important factor for inflation performance. Therefore, while using short-term interest rates as the main policy instrument within the framework of the implicit inflation-targeting policy, the CBRT still monitors the exchange rate developments closely. It should be borne in mind that the above-mentioned risk perceptions are also important for exchange rate developments and the exchange rate policy.

As illustrated in the figures below, TL has started to appreciate as of April 2003 and it has been following a stable course then. Inflation that remained even below the targeted rate in 2003 and the inflation performance observed in the first quarter of 2004 that fostered expectations that the 2004 inflation target was well within reach, played an important role in maintaining the stability in exchange rates. In the mentioned period, developments pertaining to Cyprus and Northern Iraq exerted upward pressure on exchange rates occasionally. Conclusion of the 7th Review with IMF and the favorable stance of international credit rating institutions about Turkey outlook supported optimism in inflation expectations and backed the downward trend in exchange rates (Figure IV.1.5).

Figure IV.1.5. Foreign Exchange Developments



In accordance with the exchange rate policy announced under the program and taking into account the developments in foreign exchange supply, the CBRT resumed daily foreign exchange buying auctions on January 23, 2004. As it was observed that the volatility in exchange rates was accelerating due to optimistic expectations about the Cyprus talks, the CBRT directly intervened in the foreign exchange market on February 16, 2004. Consequently, 3.8 billion US dollar -worth of foreign exchange was mopped up by way of foreign exchange buying auctions and direct buying intervention in January-March 2004 period.

When exchange rates and interest rate dynamics are studied from the inflation point of view, it can be asserted that no permanent changes are projected that might jeopardize the targeted inflation rate. Although the developments on the way to European Union membership process and the probability that the US Central Bank might raise interest rates could create volatility in the financial markets in the short run, under the assumption that the economic program would be adhered to and economic fundamentals would continue to be reinforced through steadfast implementation of structural reforms, it is projected that demand for TL-denominated investment instruments would continue and TL would preserve its strong position in the medium-run. Moreover, it was revealed in the CBRT Expectations Survey conducted in March that the expected end-year overnight annual simple interest rate was 17.5 percent and the expected annual compound interest rate at the quarterly Treasury auction was 18.4 percent. As the mentioned figures remain below the actual figures, it can be asserted that the economic agents are also convinced that the risks ahead are of temporary nature.

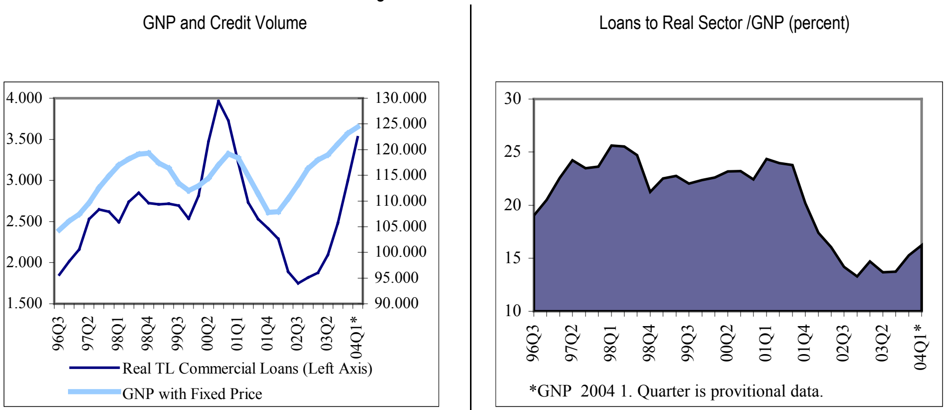
IV.2. Developments in Banking Sector and Credits

The banks should very well manage their credit and interest rate risks at times when inflation follows a downward trend and attach greater importance to exchange rate risk and maturity mismatch in transactions involving foreign exchange.

The banking sector has been strengthened via the banking sector restructuring program, and the downward trend in interest rates and exchange rates further reinforced the financial structures of the banks. However, as their interest margins have significantly narrowed and their income has decreased due to decline in interest rates and exchange rates, the banks currently tend to attach greater importance to growth in order to sustain their profitability. In order to adapt to the low-inflation environment, the banks are striving to increase the number of their clients and expand their individual credit portfolio. To this aim, they are expanding their portfolios for loans for small and medium scale enterprises (SMSEs), consumer loans and credit cards. In this period, the risks of the banks should be better monitored by their own individual risk management departments as well as by the supervision units in order to make sure that the banks can easily adapt to low-inflation environment and the financial stability can be maintained. The banks should not only employ a very good credit and interest risk management but also attach extra importance to exchange rate risk and maturity mismatch in transactions involving foreign exchange.

The volume of credits extended to the real sector by the banks has recently increased upon restoration of macroeconomic stability and decline in inflation (Figure IV.2.1).

Figure IV.2.1. GNP and Loans



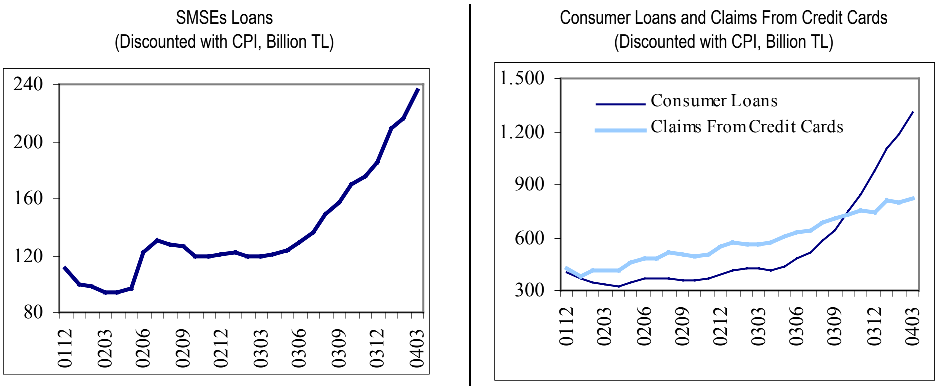
Source: CBRT

Source: CBRT

Rapid rise in credits was resulted from consumer loans and SMSEs loans.

The banks' loans for SMSEs supported investments of private sector while consumer credits backed private consumption (Figure IV.2.2). Decline in interest rates and exchange rates helped firms strengthen their financial structures and partially contributed to their credit repayment performance.

Figure IV.2.2. Consumer Loans, Claims From Credit Cards and SMSEs Loans



Source: CBRT

Source: CBRT

Compared to the commercial loans, the ratio of non-performing loans in consumer loans is generally very low. Therefore, as the share of consumer loans in the overall credit volume increases, the credit risk of the banks displays a more limited rise. However, these long-term loans with fixed interest rates increase the interest rate risk of the banks.

Individuals should act more cautiously while financing their consumption with consumer loans.

Despite the rapid decrease, compared to the previous years, the interest rates on consumer loans are still very high when the targeted inflation rates are taken into account. As was the case in the previous years, no hikes in real terms are expected in the incomes of individuals in the forthcoming period. Therefore, it is advisable for individuals to act more cautiously while financing their consumption with consumer loans. Although the consumers have a chance to swap the loans they have formerly used with new loans with lower interest rates, it is expected that consumer credit swap will be limited due to operational costs.

Even if it is not deemed as a risk for the time being for domestic demand, inflation and current account deficit, the rapid rise in consumer loans is still closely monitored.

The rise in consumer credits is not expected to follow a trend similar to that of 2000 and therefore it is expected that these would not lead to an extra swelling in domestic demand, exerting pressure on inflation and current account deficit. Actually, the ratio of primary surplus to GNP was 2.3 percent in 2000 while the primary surplus target for 2004 is 6.5 percent. Therefore, while private consumption is estimated to accelerate in 2004, the public sector demand is assumed to remain limited.

The rise in SMSEs loans as well as in consumer loans observed recently is projected to persist for a while. However, the capacity utilization ratio in automobile sector, to which most part of the consumer loans are directed, has not yet reached a level that could strain production capacity. Moreover, part of the consumption in this sector is due to the decline in relative prices. Therefore, the probability of facing a demand-oriented inflationary pressure in the short-run is low. Meanwhile, as the loans extended to private sector are likely to support investment opportunities, the prospective production increase could reduce inflationary pressures.

The rapid rise in consumer loans will make an upward effect on imports of consumption goods as well. However, the point to be highlighted here is that credit volume grows when the economy grows, which in return necessitates new investments along with imports of intermediary goods and capital goods. Therefore, in this period, the imports of consumption goods are accompanied with the imports of intermediary goods and capital goods.[11] As these intermediary and consumption goods are imported for production or exports purposes, ceteris paribus, current account deficit shall be expected to rise slower than imports do. In other words, any bounce in consumer loans would expand current account deficit through rise in imports of consumption goods and overall imports. However, besides the rise in imports, within the framework of the above-mentioned mechanism, exports are expected to make a move as well and this would limit the current account deficit. Certainly, even if the rapid rise in consumer loans is not deemed to pose risk to domestic demand in terms of inflation and current account deficit under current conditions, it is still closely monitored.

[11] Even if we do not know how much of the imports are intended for exports exactly, imports under inward processing regime can be accepted as an indicator. As is known, the imported raw material for products to be exported on a specified date are exempt from tax and this implementation provides a cost advantage. In 2003, imports under inward processing regime constituted 23.3 percent (US dollar 16 billion) of overall imports and exports under the mentioned regime comprised 53.5 percent (US dollar 25.1 billion) of overall exports.

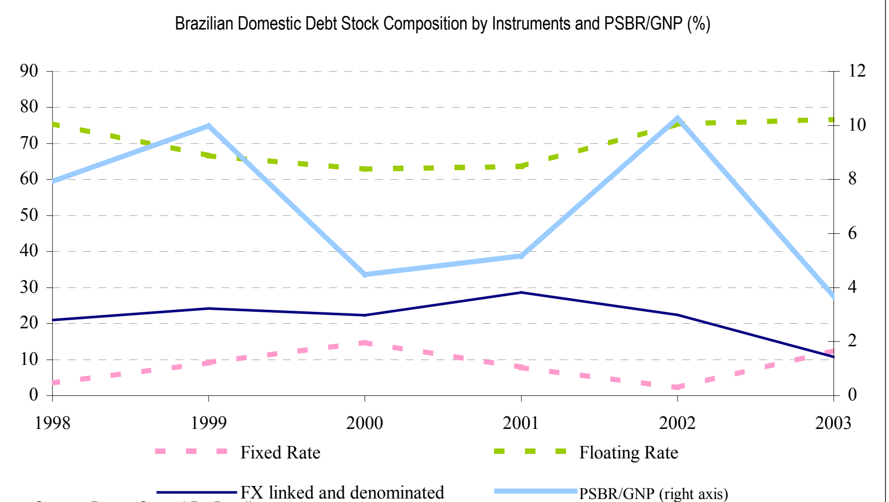
BOX IV.1. INFLATION TARGETING REGIME AND FISCAL DOMINANCE: THE EXPERIENCE OF BRAZIL

In 2002, Brazil was dragged into a crisis caused by political developments. As risk perceptions grew over the repayment of credits (credit risk), the cost of public sector borrowing increased rapidly, capital fled, the currency unit Real depreciated and led to rise in inflation. The Brazilian Central Bank, which was then implementing inflation targeting strategy, had to raise short-term interest rates that it used as the main policy instrument, in order to prevent an increase in the targeted inflation rate. Rises in exchange rates and interest rates deteriorated the public debt dynamics and risk perceptions became more intense. The exit strategy from bad equilibrium was as following: the Government of Brazil managed to persuade the lenders that a high primary surplus would be attained and a series of structural reforms would be introduced. Consequently, capital inflow was observed, interest rates declined after risk premium decreased and the domestic currency Real appreciated.

The Brazilian case has shown that in cases where debt stock is high and this debt stock is overwhelmingly comprised of short-term, floating rate, FX-linked and FX-denominated debt, the inflation-targeting regime could have many limitations. Under these limitations, which can be summarized as fiscal dominance, any upward movement in short-term interest rates to limit inflationary developments could boost debt stock. The rise in debt stock aggravates the risk perceptions over failure to debt repayment, and capital outflow coupled with depreciation of domestic currency can lead to even higher inflation rates.

In a country, which has a similar debt stock position like Brazil, interest rate raising operations to be carried out by the central bank within the framework of the inflation targeting regime might lead to different results other than the expected ones. Therefore in economies where fiscal dominance exists, the success in disinflation efforts primarily rests upon the fiscal policy, because there is little that the monetary policy can do. In economies where there are worries concerning debt repayment, the amount of primary surplus, which is the only instrument that the policy makers can use for improving debt dynamics, becomes more important and it is the main aggregate monitored by lenders.

Contrary to expectations, in economies where there is fiscal dominance, the monetary transmission mechanism can affect economy differently to what expected, making the task of the Central Bank even harder. A healthy transmission mechanism that works in the predicted way can only be achieved when fiscal pressure is relieved.



Source: Banco Central Do Brasil

V. Public Finance

Carrying out the disinflation program in a sound environment requires a tight fiscal policy along with a tight monetary policy. The primary surplus attained as a consequence of tight fiscal policy will enable debt stock to decline to a level that would not be perceived as risky by the market and facilitate the disinflation program. Within this framework, not only the size but also the quality of the fiscal adjustment is important for achieving a sustainable primary surplus. The lasting performance of primary surplus is closely related to the completion of structural reforms (Box V.1).

In 2003, the consolidated primary surplus realized as TL 18.8 quadrillion. The ratio of consolidated primary surplus to GNP was 5.3 percent. As a result of the tight fiscal policy, non-interest expenditures remained below the revised target while the performance of tax revenues fell short of the end-year target.

Consolidated primary surplus displayed a favorable course throughout 2003.

Table V.1.Consolidated Budget Figures

	2004 January-March Realizations (TL Quadrillion)	2004 Target (TL Quadrillion)	Realizations (Share in Target, percentage)
Revenues	**23.9**	**104.1**	**22.9**
Tax Revenues	18.7	88.9	21.1
Expenditures	**30.8**	**149.9**	**20.6**
Non-interest Expenditures	16.0	83.9	19.0
Personnel	7.5	28.6	26.3
Current Transfers	6.2	27.5	22.8
Interest Expenditures	14.9	66.1	22.5
Budget Balance	**-7.0**	**-45.8**	**15.2**
Primary Balance	**7.9**	**20.2**	**39.0**

Source: Ministry of Finance

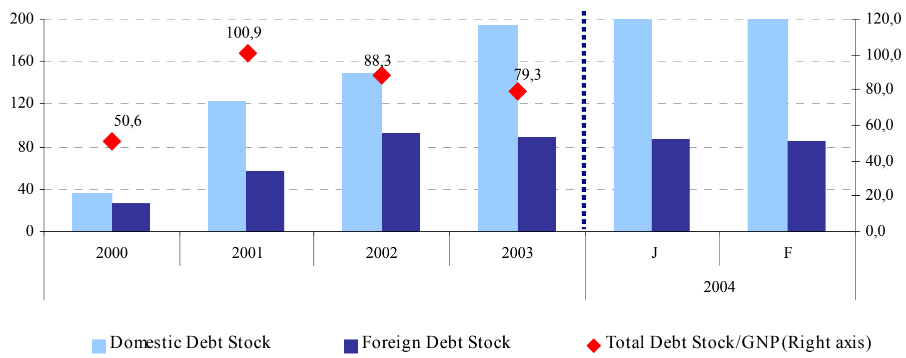
Under the tight fiscal policy framework, high level of primary surplus is targeted in 2004 as well. In the first quarter of 2004, primary surplus exhibited a good performance and realized as TL 7.9 quadrillion (Table V.1). In order to compensate the burden imposed on the 2004 budget by the increase in the minimum wages and in the pensions and because of the gap in the revenue projections of 2004 that resulted from low realization in revenues in 2003, an additional measures package composed of expenditure-reducing and revenue-increasing measures has been introduced. Accordingly, in March 2004, the Supplementary Budget Law enabling a 13 percent reduction in certain expenditure items was enacted and as for revenues, adjustments were made on the Special Consumption Taxes levied on alcoholic beverages, tobacco and fuel products. Expenditure-reducing characteristic of the significant portion of the measures is a favorable development from the disinflation point of view.

V.1. Developments in Debt Stock

In 2003, the consolidated budget total debt stock increased by 16.6 percentage points compared to end-2002 and reached TL 283 quadrillion.

In 2003, consolidated budget total debt stock increased by 16.6 percentage points compared to end-2002 and reached TL 283 quadrillion (Figure V.1). In the period in question, consolidated budget total foreign debt stock decreased in terms of TL while domestic debt stock increased by 29.7 percent and reached TL 194.4 quadrillion. The 15 percent of the rise has resulted from bonds issued to Saving and Deposit Insurance Fund (SDIF) for the payments of deposits previously held by Imar Bank. As of February 2004, domestic debt stock became TL 200.5 quadrillion. The ratio of debt stock to GNP, which is a criterion in assessing the sustainability of the debt stock, decreased in 2003 owing to the appreciation of TL, high growth in GNP, decline in interest rates and extension of maturities in domestic borrowing.

Figure V.1. Consolidated Budget Debt Stock (TL Quadrillion)

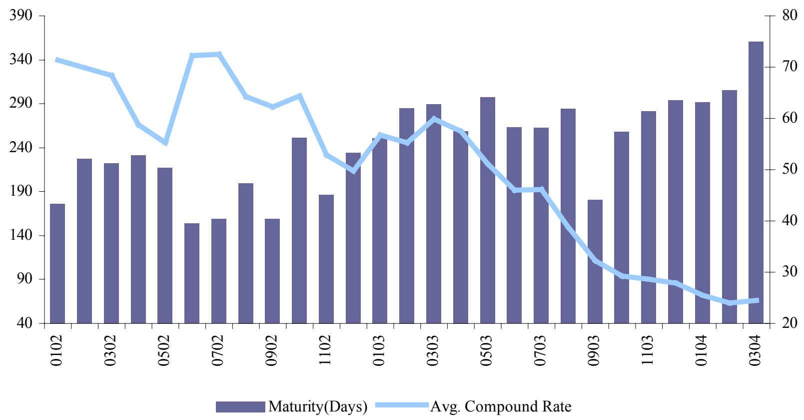


Source: Treasury.
*December FX buying rate is used in calculations.

Improvement in borrowing terms, which started in 2003, continues in 2004 as well.

Improvement in borrowing conditions, which started in 2003 due to the restored political stability and enhanced confidence regarding the sustainability of the economic program, continues in 2004 as well. This framework has enabled the Treasury to carry out active debt management. Within this framework, Treasury continues long-term borrowing in TL and foreign exchange denominated auctions in 2004 (Figure V.2). Down trend in the borrowing costs continues with a slower pace. Despite the decline in borrowing cost, long-term interest rates slightly increased at the TL-denominated discount auctions held in March 2004. The slowdown in the decline in interest rates can be attributed to the rigidity in real interest rates. Despite gradual decline, the real interest rates still keep their high level as the high debt burden persists and there are still concerns whether fiscal discipline would be sustained and exchange rates and interest rates would follow a stable course in the future. Therefore, improvement in the quality of fiscal adjustments will alleviate concerns relating to the sustainability of the debt and contribute to the decline in real interest rates.

Figure V.2. Borrowing Maturity and Compound Interest Rate*



Source: Treasury.
Note: Low realization of borrowing maturity in September 2003 is due to the existence of small amount of long-term borrowing. If the 91 day T- bill auction is left out, borrowing maturity turns out to be 371 days.
* TL denominated discounted auctions are used in calculations.

The switching auctions, which were held in October and December 2003 within the framework of active debt management, continued in the first quarter of 2004 as well. Through the switching auctions held in the last quarter of 2003, the redemptions which concentrated in the first couple of months of the year 2004 were transferred to the last quarter of 2004 and the first quarter of 2005. Thus, the amount of domestic debt service was decreased and a more balanced distribution of the debt service for 2004 was achieved. At the switching auctions held in the first quarter of 2004, TL 1 quadrillion portion of the FX-indexed securities which were due in June, were switched with TL-denominated securities with a maturity of two years. This operation, in return, reduced the debt service of 2004.

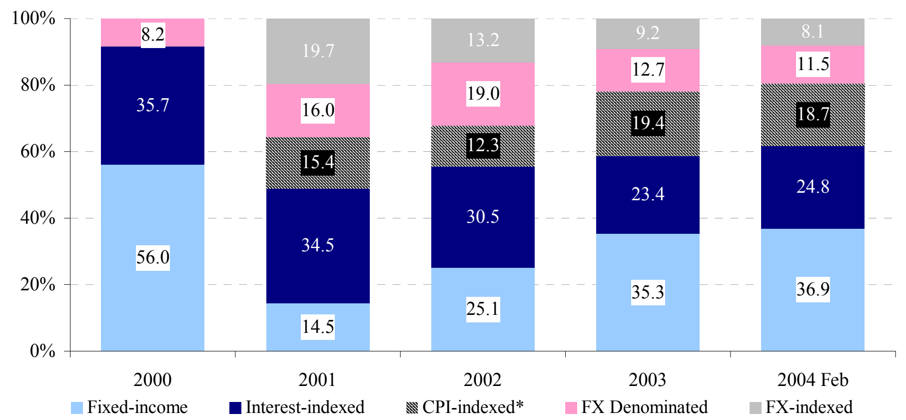
Treasury has announced its financing program for April-December 2004 period. Owing to favorable developments in exchange rates and interest rates, high borrowing maturity and the switching operations held in the first quarter of the year, the debt service specified in the new program has been reduced compared to the debt service projected in the program announced at the turn of the year. In the April-December period, TL 124.1 quadrillion-worth of domestic debt service and TL 104.7 quadrillion worth borrowing is projected. Hence, the roll-over ratio of domestic debt is projected as 84 percent.

External borrowing followed a favorable course in the first quarter of 2004.

External borrowing followed a favorable course in the first quarter of 2004, and more than half of the targeted US dollar 5 billion to be borrowed through bond issuance in international markets has already been completed.

When the composition of domestic debt stock is analyzed, it is observed that the share of fixed-income government securities continue to increase and that of FX-denominated and FX-linked securities to decrease (Figure V.3). Albeit a slight increase compared to 2003, the share of interest-linked securities has declined in the long-run. The structural change observed in domestic debt stock points out that the vulnerability of debt stock against changes in interest rates and exchange rates has declined. Despite improvement in borrowing terms and domestic debt structure, as of February, 63 percent of overall domestic debt stock is comprised of indexed or FX-denominated borrowing securities. This evidences that debt stock is still vulnerable to changes in exchange rates and interest rates.

Figure V.3. Decomposition of Consolidated Budget Domestic Debt Stock by Type of Borrowing Instruments

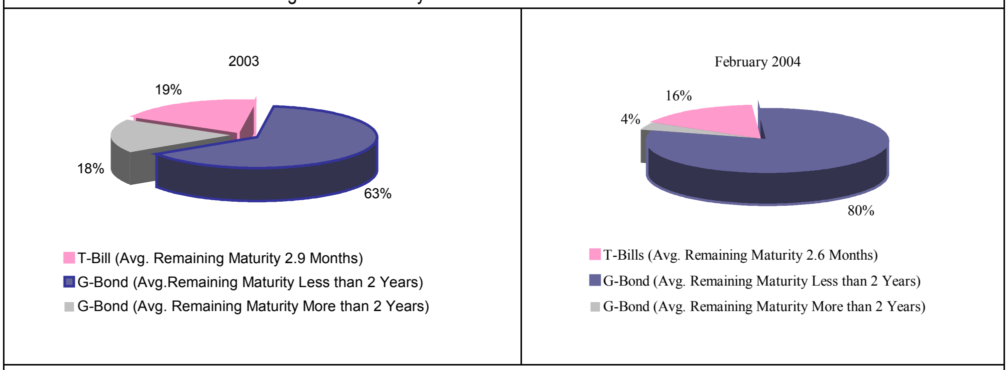


* Contains CPI-indexed non-cash securities in the Central Bank portfolio and CPI-indexed cash securities issued to CSA in May 2003.
Source: Treasury

It is observed that debt stock mainly involves government bonds with an average maturity of less than 2 years.

As for maturity composition of the debt stock, it is observed that debt stock is concentrated on the government securities with remaining average maturity of less than 2 years (Figure V.4). As of February 2004, the remaining average maturity of these securities is 13.6 months. Moreover, 45.7 percent of the overall debt stock is composed of borrowing instruments having average days to maturity less than 1 year.

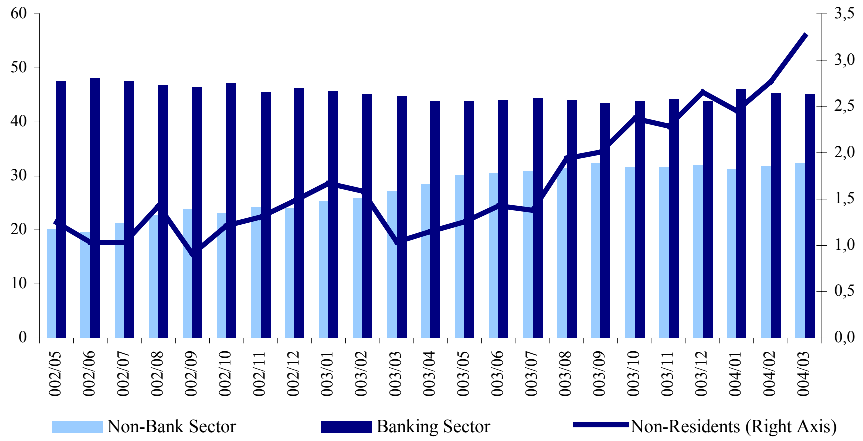
Figure V.4. Maturity Structure of Cash Domestic Debt Stock



Source: Treasury

When the decomposition of the domestic debt stock by lenders is analyzed, it is observed that the upward trend in the share of government securities held by non-residents, which started in March 2003 is still going on (Figure V.5). The total amount of government security portfolio of the non-residents reached TL 7.2 quadrillion by end-March in 2004.

Figure V.5.Composition of Domestic Debt Stock by Lenders (Share, Percentage)



Source: CBRT.
Note: Non-banking sector comprise mutual funds, real persons and legal entities excluding SDIF and CSA. Data is in terms of market values.

Consequently, albeit an improvement in 2003, the structure of the debt stock still seems to be vulnerable to movements in exchange rates and interest rates. Therefore, long-lasting instabilities, via increasing concerns regarding sustainability of the debt stock, would affect inflation expectations adversely. Sustainable fiscal adjustment, which is the prerequisite for attaining economic stability, can only be achieved by enhancing the quality of fiscal adjustment (Box V.1).

BOX V.1. STRUCTURAL REFORMS IN PUBLIC SECTOR

One of the main pillars of stability programs whose ultimate goal is to achieve price stability and ensure sustained growth is to establish the fiscal discipline. The effect of fiscal policy on growth and the sustainability of public balance in the medium and long-run depends on the quality of the fiscal adjustment. [1] As is the case in other countries, in post-crisis periods, Turkey also inevitably had to resort to urgent and temporary measures. However, ensuring sustainable fiscal adjustment in the medium-long run rests upon completion of structural reforms rather than temporary measures. Any delays in structural reforms would hamper the achievement of budget targets and increase the frequency of the need to resort to temporary measures. Such measures would adversely affect the quality of expenditures and revenues, and depending on the methods used to increase revenues, could create an inflationary impact. Enhancing the quality of fiscal adjustment necessitates efficient allocation of public resources among government spending. In other words, the budget share earmarked for education, health and infrastructure expenditures that are believed to boost productivity and growth should be increased and adequate resources must be spared for expenditures for improving the legal system and establishing public order. Meanwhile, it is essential to redesign the tax policies in such a way not to undermine the decision-making process of individuals. In a study, which compares and contrasts the quality of fiscal policies in OECD countries, it has been found out that lasting improvement in public balance was more likely to be achieved through expenditure-curbing policies rather than through revenue-boosting policies.[2] These spending cuts are composed not of investment expenditures but of spending cuts on transfers and the government wage bill.

Tax Reform

The existing tax structure in Turkey has an adverse impact on the private sector activities and investment environment. The habit of resorting to tax revenues to establish fiscal discipline in the past contributed to turning the tax system into a more complex and ambiguous one. As the rise in taxes collected has mostly stemmed from indirect taxes, the tax burden has increasingly shifted on the low-income groups leading to an unfair tax structure. It is essential to simplify the tax system and to enhance the efficiency of tax administration in order to wipe out the negative impacts of the tax system on the economy and to attain a lasting increase in revenues. The tax system should be redesigned to establish a simple, easily-comprehensible and fair system that does not allow disparities among sectors.

With the aim of ensuring efficiency in indirect taxation and simplifying the system, as of August 1, 2002, some taxes, duties, charges and funds, the number of which is 16 in total, have been abolished and replaced with special consumption tax. In April 2003, the first phase of the direct tax reform legislation was enacted. Within this framework, some implementations, which intend to simplify the tax system, such as simplifying the investment allowance system and ensuring harmonization with the international accounting standards in financial leasing, have been put into practice. In December 2003, a law was adopted which provided for inflation adjusted accounting. In February 2004, the second phase of the direct tax reform legislation was enacted.

Expanding the tax base, achieving efficiency in tax supervision, restructuring tax management and simplifying the tax regulations are the reforms that fall within the domain of the emergency action plan. The preparations are yet to be completed regarding the tax administration reform that is intended to restructure the revenue administration with the aim of registering the unrecorded economic activities, expanding the tax-base and achieving effective tax collection system. Completion of the reform would make a significant contribution to the establishment of sustainable fiscal adjustment.

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[1]For detailed information on the quality of fiscal adjustment, please see Emil and Yılmaz (2003) "The Quality of Fiscal Policies Implemented in Stability Programs: Problems and Observations on Turkish Experience"- Presented in the METU International Conference in Economics, in Turkish.

[2] Alesina and Perotti (1996) "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects", NBER Working Paper 5730.

Social Security Reform

Strengthening the financial structure of social security institutions will help decrease the amount that is transferred to the social security institutions from the consolidated budget and in turn contribute to the establishment of fiscal discipline. With the aim of achieving the long-desired improvement in social security institutions, a social security reform was introduced in 1999 and in 2000 a relative improvement was observed in the financial structures of these institutions. However, as of 2001, the financial structures of the social security institutions started to deteriorate again. In order to improve the financing balances of the social security institutions, in 2003 some measures were taken that intended to curb the rapid rise in health expenditures. Restructuring the health sector is vital to decrease expenditures on health.

Meanwhile, several laws have been enacted introducing new arrangements to administrative structures of the social security institutions. Within the framework of the law regarding SSK and Bağ-Kur, a re-installment facility has been introduced in order to facilitate the collection of Bağ-Kur premium liabilities and SSK insurance premium liabilities and surcharge for late payments. Efforts for putting all social security institutions under a single roof, separating the short- and long-term insurance programs and establishing an overall health insurance system are still under way. However, prior to introducing these reforms, some measures are foreseen in order to compensate the extra burden that would be imposed on the public finance by these reforms.

Administrative Reforms

The preparations on the public administration reform, intended to establish the necessary legal and institutional framework for providing public services in a more efficient and transparent way, are still under way. The first phase of the public administration reform is planned to involve enactment of the Public Administration Framework Law. This Law sets the principles to be adhered to in public administration and clarifies the distribution of power among the central administration and local administrations.

Along with the reforms about the central administration and local administrations, it is aimed to improve the administrative structure and enhance its effectiveness and improve the quality of public services by means of taking steps against misuse of authority and introducing state personnel regime reform.

The Public Financial Management and Control Law was enacted in December 2003. The aim of the law in question is to enable attainment and utilization of public resources in an efficient and economic way as well as to ensure accountability and fiscal transparency in public sector. This law will arrange the structure and operation of the public financial administration, the preparation and implementation of government budget; book-keeping, reporting and fiscal control of all financial operations. The Law does not only serve to extending the scope of the budget but also to transition to a 3-year budgeting system.

With the aim of ensuring transparency in public financial administration, the Law on Public Financing and Debt Management was enacted. Thus, management of domestic and external borrowing, Treasury guaranties and claims arising within this context were pooled under a single law. The subject Law has brought discipline to the borrowing . Moreover, provision of information to the public regularly on public debt management, Treasury guarantees and claims was a progress towards attaining transparency in debt management.

Introducing common accounting and reporting systems to public administration, that are in concordance with the international standards comprises another important phase of establishing fiscal discipline and transparency. Accordingly, with the aim of enabling financial statistics to be analyzed in a more orderly and reliable way and ensuring that they are eligible for international comparative studies, efforts have been launched to introduce analytical budget classification code. Within this framework, the budgets of general and annexed budget administrations for 2004 fiscal year have been established in accordance with this code system. Preparations for applying this code system in other institutions and public agencies that are not within the extent of the consolidated budget have been initiated as well. As this system enables determination of the liable persons and legal entities, it will also contribute to enhancing financial transparency and developing accountability.

VI. OUTLOOK

Probable developments and potential risks concerning inflation for the coming period can be analyzed under four main headings. These are; domestic demand and output forecasts, cost factors, monetary and fiscal discipline, and inflation expectations.

VI.1. Demand and Cost Factors

Taking into consideration the recovery process observed in domestic demand in 2003, the course of domestic demand components are of great importance in terms of the targeted inflation for 2004.

VI.1.i. Private Consumption Expenditures

There has been a recovery in the consumption expenditures, especially in the last quarter of 2003, attributable to the continuing downward trend in inflation, strengthening of the Turkish lira, as well as the decline in interest rates on credits. The developments in private consumption expenditures in the coming period are not expected to support the downward trend in inflation as much as they did in 2003. Nevertheless, the fact that private consumption expenditures, which realized at low levels following the crisis, were able to resume their level of year 2000 only in the last quarter of 2003, and the fact that the ratio of consumption expenditures to national income is at modest levels at present seem to indicate that there will be no evident demand-led inflationary pressure in 2004 either.

Besides, the relatively low level of employment, the process of structural change in the economy, and the existing incomes policy are all making a restrictive impact on consumption. The salary and wage increases of the public sector in 2004 foresee a very limited real increase. Keeping in mind that the private sector takes into consideration the wage increases in the public sector, it is believed that the increase in real incomes in 2004 will be at modest levels, and this in turn, will have a restrictive impact on the increase in consumption expenditures.

As a consequence of the ongoing structural reforms as well as the downward course of inflation, competition in the real sector is strengthening, and thus the profit margins are narrowing. Besides, easing of real interest rates and the appreciation of the Turkish lira also caused an erosion in the savings, in real terms. This fact may encourage savings in the coming periods in order to compensate for the real loss of wealth. On the other hand, the decline in real interest rates led to an increase in consumer credits. However, as the current increase in consumer credits will necessitate the increase of credit repayments in the coming periods, it will constraint incomes and thus expenditures.

VI.1.ii. Private Investment Expenditures

The acceleration in private investment expenditures in 2003 is predicted to prevail in 2004 as well, owing to the high capacity utilization ratios. According to the results of the March 2004 CBRT Business Tendency Survey, expected interest rate on loans is also at a low level, facilitating invesment expectations. As a matter of fact, the survey results also suggest that the investment expenditure tendency reached a considerably high level. The survey reveals that the planned investment expenditures are mainly intended for increasing productivity and starting new investments.

On the other hand, the same survey refers to sluggish demand as a factor restricting the increase in investment expenditures. In addition, financing and labor costs appear as other factors restricting investment expenditures. Although these unfavorable factors seem to have intensified in recent years, they have been on the agenda for long years. In this context, it is critically important for sustained growth and macroeconomic stability in the coming period that the structural reforms be carried out within the framework of the current economic program, and that the obstacles to investment and production are removed. Especially, the improvement of competition and market conditions as well as the establishment of an environment of confidence have become important factors to ensure the continuation of investment needed for price stability and sustained growth.

VI.1.iii. Public Consumption and Investment Expenditures

Tight fiscal policies that aim at a more efficient and sound structure in the public sector will continue to be pursued in 2004. Accordingly, the growth rate of public expenditures in 2004 is expected to be quite low. Consumption and investment expenditures are foreseen to increase by 2.8 and 5.9 percent, respectively, in 2004.

VI.1.iv. Production Expectations

Domestic demand developments in 2004 are not expected to jeopardize the inflation target. Nevertheless, export-oriented production increases will continue. Besides, owing to the cyclical movements, agricultural production is expected to realize at a high level in 2004, and thus agricultural prices are expected to continue supporting the downward trend in inflation. In sum, production forecasts are believed to contribute to the positive course of inflation in 2004.

VI.2. Cost Factors

VI.2.i. Exchange Rates

The implementation of fiscal and monetary policies in line with the targets and the continuation of structural reforms played an important role in shaping expectations in 2003. This has also increased the confidence in Turkish lira by reducing the perception of risk. Together with increasing confidence in the current economic program, there occurred an intense portfolio shift from foreign exchange to Turkish lira and TRL-denominated instruments. As a matter of fact, in 2003, the current account deficit, which stemmed from higher import demand, and the resulting financing need did not exert pressure on the exchange rates. Capital inflows were higher than the financing need and Central Bank's international reserves increased by US dollar 4 billion during this period, owing to the virtuous cycle discussed above. Cyclical fluctuations are foreseen to be likely for 2004, which would probably stem from external factors, such as the developments in the process of Turkey's accession in the European Union as well as the expectations concerning the Federal Reserve's probable interest rate increase. Yet, under the assumption that structural reforms will be put into practice and that the continuation of fiscal discipline in the public sector will be secured, it is believed that there will be no long-lasting or permanent pressure on the exchange rates.

VI.2.ii. Crude Oil Prices

Since the beginning of 2004, crude oil prices have shown a tendency to increase in the international markets. The average price was US dollar 31.9 per barrel for Brent oil, in the first quarter of 2004. The seasonal effects brought about by the hard winter conditions, higher demand as a result of crude oil stock accumulation, and the geopolitical uncertainties experienced in the Middle East were effective on such a trend.

Organization of Petroleum Exporting Countries (OPEC) maintained the production quotas as they are, in the first quarter of 2004, despite increased demand. Besides, at its meeting on March 31, held in Vienna, OPEC reduced its level of daily production by 1 million barrels, as a precautionary measure against the forecasts that the world crude oil demand would seasonally decline in the second quarter of the year, giving rise to an excess oil surplus, which in turn, would cause a downward pressure on prices.

On the other hand, reports issued by the International Energy Agency suggest that the global crude oil demand is expected to increase in 2004, compared to the previous year, attributable to the economic growth of China as well. Within this framework, no downward movement is foreseen in crude oil prices, in the second quarter of the year. However, the increased crude oil stock especially in February and March, caused by tough winter conditions, seems to restrict the increase in crude oil prices in the second quarter of the year. Besides, it is likely that the uncertainties ending in Iraq in the second half of the year and the crude oil production of Iraq resuming its pre-war level would exert a downward pressure on crude oil prices.

VI.2.iii. Administered Prices

The course of the administered prices are very important in terms of costs. The fact that electricity, natural gas and water prices increased modestly in 2003 supported the decline in inflation. The government announced that there would be no increase in the prices of electricity and natural gas in 2004. However, water prices increased following the local elections.

On the other hand, fuel oil prices augmented in March 2004, as a consequence of rising world crude oil prices, as well as the adjustments in the Special Consumption Tax that were made within the framework of fiscal discipline, aiming at increasing the tax revenues. Furthermore, it is observed that the decline in exchange rates was not reflected in the said prices. Similarly, in the event of a reversal of exchange rate movement, there should not be an upward adjustment in prices to a certain level. The fact that the high rate of increase in minimum wages in the first quarter of 2004 and the deviations in the revenue projections for 2004 due to the lower than expected tax revenue realizations of 2003 necessitated an increase in fuel oil prices in March in order to finance the deficit, once more highlighted the importance of the quality of fiscal adjustment for price stability. This is so, because if the price increases continue in the remaining part of 2004, cost-push pressures on inflation may emerge in the coming months.

VI.2.iv. Basic Metal Industry Prices

The significant increase in world iron and steel prices throughout 2003, as well as the first quarter of 2004, and the fact that Turkey is a net importer of iron and steel had an aggravating effect on the basic metal industry prices. The determining factor in this increase was the important share of China in the world iron and steel market, and its intense need of energy and raw material inputs during the development process.

Fortunately, due to the fact that China increased its production capacity substantially by means of the steel industry investments, the pressure on prices stemming from China is forecasted to diminish in 2004. Yet, while prices are not expected to rise further at high rates in the short-run, it is possible that they remain at high levels. Although the likelihood that world iron and steel prices to keep their high levels can exert cost-push pressure on the 2004 inflation target, the high level of productivity in the industry sector, accompanied by low labor costs are believed to offset this pressure (Box VI.1).

VI.2.v. Labor Costs

The collective bargaining rounds for 2003 have been completed to a large extent and wage increases for 2004 have already been set. In addition, the rate of increase of the civil servants salaries for 2004 were announced in line with tight fiscal policy. Rises in salary and wage are not believed to be a risk factor for the 2004 inflation target due to the fact that salary and wage increases in the public sector are set in line with the inflation target and constitute a basis for that in the private sector. However, in the beginning of 2004, the minimum wages were significantly raised for the first half of the year and no clear commitment was made for the second half. It is crucial for the inflation target that the increase given in the first half of the year is not carried on to the second half.

In sum, the above mentioned facts indicate that there will not be any cost-push inflationary pressure in the coming periods. In fact, the CBRT Business Tendency Survey for March 2004 point to a decline in the tendency of average unit costs in the next quarter.

VI.3. Monetary and Fiscal Discipline

Within the framework of price stability as the primary objective, short-term interest rates will continue to be effectively used as the main policy instrument. Furthermore, monetary performance criteria and indicative targets will be monitored throughout 2004 under the program with IMF.

Floating exchange rate regime will continue in 2004 as well. To strengthen its foreign exchange reserve position, the Central Bank may hold foreign exchange auctions within the pre-announced amounts consistent with the floating exchange rate system, that is, by taking into account the developments in the foreign exchange supply and without influencing the level of exchange rates. Strong foreign exchange reserves are crucially important because they increase the effectiveness of Central Bank monetary policy as well as the market confidence and also facilitate domestic and external borrowing. This contributes to the favorable course of expectations through enhancing the success of monetary and fiscal policies. Thereby, the effectiveness of monetary policy, implemented in line with the price stability objective, also increases.

Although the pass-through from exchange rates to inflation weakened under the floating exchange rate regime, exchange rates are still an important factor on inflation in Turkey , as the Turkish economy has a high openness ratio. Indeed, exchange rates continue to be influential on the prices through the prices of imported goods as well as the production costs. Nevertheless, foreign exchange is no longer considered as a guaranteed financial instrument due to the fact that the policy to pursue predictability of the exchange rates by artificial means is abandoned and exchange rate started to move both upward and downward in the short-run. This, in turn, is a significant step taken towards changing the existing indexation behavior. Further, as a result of the fall in inflation and increase in confidence in the economic policies, price makers adopted a more rational pricing behavior for the future, which in turn, slowed down the reflection of temporary changes in exchange rates on prices. From this perspective, floating exchange rate policy is believed to have brought about a structural change in the exchange rate-inflation relationship.

The ratio of public sector primary surplus to GNP is targeted to be 6.5 percent for 2004. Running a primary surplus within the framework of the macroeconomic targets in the current economic program has been a milestone towards achieving fiscal discipline. Running a primary budget surplus helped reduce inflationary expectations and interest rates by enhancing the confidence of financial markets in the program. However, the important factor here is the quality of fiscal adjustment. It is vital to pursue expenditure-cutting policies instead of revenue-increasing policies through public sector price adjustments and additional taxes. Otherwise, the measures that are taken for securing fiscal discipline may have consequences jeopardizing the inflation target.

VI.4 Inflation Expectations and Other Risks

VI.4.i Expectations

Due to the fact that inflation targets were attained for two consecutive years, and the first quarter inflation trend is in line with the year-end target, the reliability of the 2004 inflation target strengthened. As a matter of fact, the results of the CBRT Expectations Survey for April 2004 show that inflation expectations for the next twelve months continue their downward trend and began to hit the targets. Furthermore, the decline in the year-end CPI inflation expectation to 11.4 percent, which is already below the target of 12 percent, is perceived as a favorable development.

Expectations surely play an important role in an environment where the monetary policy strategy is focused on future inflation. However, it should be noted that the inflation expectations of the private sector constitute only a part of a comprehensive information set of the Central Bank. The Central Bank, while focusing on the probable course of future inflation, considers all types of endogenous and exogenous parameters that may influence the future inflation, as well as considering the lagged effects of monetary policy decisions on the economic activity.

VI.4.ii. Risks and Results

Inflation outlook seems to be generally favorable for the remaining part of 2004, though not as good as the first quarter of the year. There are important risks in the coming period, for both the short and the medium-long run that need to be underlined as always:

- Different tendencies in international financial markets or external shocks may give rise to shifts in portfolio preferences which, in turn, may lead to unforeseeable movements in exchange rates, and thus pose a risk to inflation, on account of the reasons cited above. This is always a risk factor that needs to be taken into account. The signals given by the Federal Reserve of a possible interest rate increase in the next months can cause diversification in global liquidity trends and increase the volatility in the financial markets of developing countries. Furthermore, uncertainties with regards to the extent and the speed of the interest rate increase point at the likelihood of the persistence of such volatilities. However, what needs to be emphasized here is that such movements are normal under floating exchange rate regime and their negative effects are bound to be temporary, as long as monetary and fiscal discipline continues and the economy is strengthened by structural reforms. An experience worth remembering in this context is that the external shocks emerged in the first months of 2003 following the Iraqi operation had limited effect on the economy and the downward trend in inflation as well as the recovery in economic activity have continued as the shock disappeared.

- Revenue increasing measures taken to finance the 2004 supplementary budget negatively affected March inflation. Moreover, possible unforeseen slippages in the budget balance may raise prices in the coming period as well. Additional price increases in the public sector, no matter which sub-item they may originate from, will have a direct inflationary impact. However, among public-sector prices, energy prices deserve special attention. This is because the indirect effect of energy group prices on inflation may be high due to both input costs and indexation behavior. Increases especially in the prices of electricity and petroleum products, which are directly reflected on input costs, would be perceived negatively, because of their indirect influence on inflation.

- Although the fast downward trend in inflation has been continuing for the last 10 months, the decline in service sector prices was not that fast, despite the favorable developments in unit costs and expectations. This stems from the fact that price makers in some sectors have not yet abandoned indexation behavior and prices are not formed under free market conditions. Breaking of this rigidity in the services sector is closely related to the realization of structural transformation in the economy.

- In the first quarter, agricultural prices increased beyond the figures foreseen by seasonal trends. Although this tendency is expected to be reversed in the following months, the likelihood that the decline in agricultural prices in summer to be less than expectations, as a result of adverse weather conditions, constitutes a risk factor.

- The increases in petroleum and raw metal prices in the international markets give rise to potential cost-push pressures on domestic inflation. These pressures are felt in a limited manner at the moment, owing to the relative stability in exchange rates. Although a slowdown in the petroleum and raw metal price increases seems highly likely, the lagged effects of the past increases on domestic prices appear as a significant risk in the short-run.

- Beyond all these, the greatest risk factor at present is the relaxation of the current policies, as shown by past experiences. While the economic program and the stability in general play an important role in the recent favorable developments in the economy, it should not be disregarded that the general global economic and political environment also supports this favorable course. In order to achieve a lasting macroeconomic stability as well as price stability, it is necessary to back up the favorable developments in the economy with fundamental structural reforms and refrain from using recent positive developments as an excuse to postpone such reforms.

The most important medium-term targets of the economic stability programs implemented since the beginning of 2000 are to attain fiscal discipline, to maintain price stability after having brought inflation down to single digits, and to put into practice those structural reforms that would enhance competitiveness and thus efficiency in the economy. In this way, it will be possible to achieve sustainable and high growth rates and thus reach the final goal of elevating the general welfare of the society in the long-run. The pre-requisite for realizing this final goal is to ensure lasting price stability. In Turkey, the fiscal discipline is the pre-requisite for achieving price stability because the public debt has reached considerably high levels. However, not only the magnitude, but also the quality of fiscal adjustment determined by tight fiscal policies is of great importance in the fight against inflation, as well as in attaining sustainable high growth rates.

The realization of structural reforms, which is broadly defined as the transformation of the institutional structure comprising of the whole set of rules, sanction mechanisms and organizations in an economy with the aim of eliminating given constraints, has become a must to clear the obstacles in the way of raising the productivity of production factors in our country. Establishment of a market based and competitive production process is necessary for securing price stability as well.

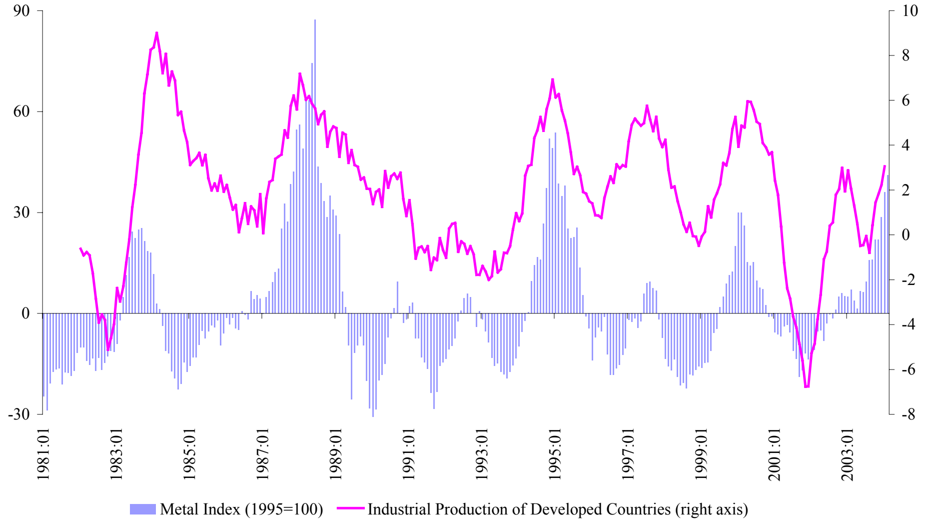
As a result of the monetary and fiscal discipline launched following the economic crisis of February 2001, a great progress was made in the fight against inflation and in the area of structural reforms. However, despite these efforts, much remains to be done to restore the economic balances and to establish price stability. Especially from next year onwards, when single digit inflation will be targeted, tight monetary and fiscal policies alone are not believed to maintain their effect on reducing inflation. Moreover, on the eve of a period of increased uncertainties in terms of external factors, it is becoming even more important to strengthen economic fundamentals and minimize fragilities. Making progress on the way to price stability along with sustainable and high growth rates will only be possible through the realization of the structural transformation process. Therefore, rapid and determined action in the area of structural reforms in 2004, especially with a view to enhance their quality, is critically important for attaining sustained macroeconomic stability in the medium-term (Box III.1 and Box V.1).

BOX.VI.1. WORLD IRON AND STEEL PRICES AND THEIR POTENTIAL EFFECT ON DOMESTIC PRICES

The increase in world basic metal prices, which started in 2003 and accelerated in the first quarter of 2004, originated mainly from iron and steel products.

Cyclical movements observed in the industrial production of developed countries are influential on the price dynamics of the world basic metal industry (Graph 1). Higher industrial production increases the demand for basic metal industry products, which in turn gives rise to an imbalance between supply and demand, causing prices to go up. On the other hand, in recent years, the movements in the industrial production of Asian countries, among which is China, with almost half of world's iron and steel consumption, began to be influential on the formation of world basic metal prices. Especially, the expansion in the Chinese demand for iron and steel, the leading steel consumer of the world, was the determining factor of the increase in world metal prices.

Figure 1: Basic Metal Industry Prices and Industrial Production of Developed Countries (Annual Growth Rate)



Having a large economy on a world scale, China needs energy and raw material inputs intensively in the development process. In addition to some large international companies shifting their production processes to China, the changing demand structure, and growing automotive, durables and construction sectors, increased the demand for the main inputs of steel and energy. China, being the leading steel producer and consumer, has a share of 20.1 percent in world steel production and 25 percent in world steel consumption.[i] Nevertheless, in order to meet domestic demand, large scale investments were made in the iron and steel industry.[2] China's 9.1 percent economic growth in 2003, led by the construction and automotive sectors, exerted an upward pressure on world metal prices.[3]

In Turkey, mainly scrap iron and iron ore are being used in the iron and steel production, and the bulk of these input materials are imported. While the ratio of imports covered by exports was 166 percent for iron and steel in 2001, this ratio realized as 73 percent and 62 percent for 2002 and 2003, respectively. In 2003, iron and steel imports were US dollar 4.7 billion, and the foreign trade deficit in the sector was US dollar 1.8 billion.

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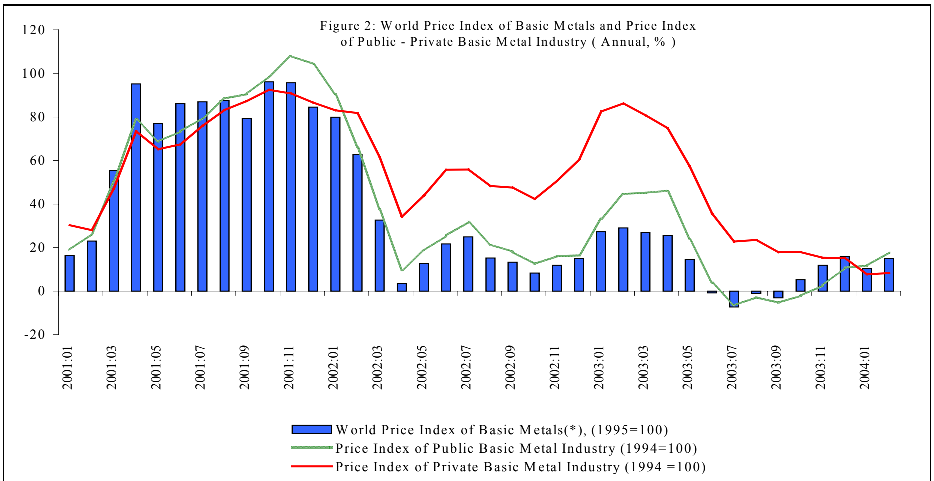
[i] *China also accounts for 7% of world daily petroleum, 30% of coal, 50% of cement and 10% of world energy consumption (Source: Central Bank of China, Monetary Policy Report),* http://www.pbc.gov.cn/english/xinwen/?id=376

[2] *Source*: "Steel, Concrete and Aluminum Sectors warned on Investment", www.china.org.cn, April 12, 2004. *Source:* People's Daily, "China becomes No.1 iron and steel importer, Why?" August 8, 2002.

[3] The Economist, "Hungry Dragon", February 21, 2004. *Source: People's Daily, "China becomes No.1 iron and steel importer, Why?" August 8, 2002.*

3 The Economist, "Hungry Dragon", February 21, 2004.

The main mechanism linking the price increases in the world iron and steel market to the domestic prices or the profit margins is as follows: In Turkey, as the bulk of raw materials (scrap iron and iron ore) used in iron and steel production are imported, the rise in international prices are directly reflected in domestic prices of iron and steel. Higher price brings about cost pressures on the basic industrial sectors where these commodities are intensely used, such as construction, automotive and white goods producing sectors. Higher costs put upward pressure on prices while dampening profit margins in these sectors. The below graph demonstrates the strong relationship between the world basic metal price index and both public and private metal industry price indices (Graph 2). As a matter of fact, in the January 1995-February 2004 period, the correlation coefficient for the relation between world metal prices, and public and private basic metal industry prices was 0.94 and 0.84, respectively.



(*)Basic metal price index has been used for the world iron and steel prices, owing to the weighted presence of iron and steel in the said index. The world basic metal price index is converted into Turkish lira by multiplying with the nominal US dollar exchange rate index.

Looking at 2002-2003 in general, it can be seen that annual changes in the world prices are not equally reflected in domestic prices, especially in the private sector. The main reason behind this is thought to be the tendency of economic units, which are in a learning process under the floating exchange rate regime, to reflect downward movements in exchange rates to prices with a time lag. This has given rise to an asymetric structure in the pass-through effect for the said period. In other words, while the nominal depreciation of Turkish lira was reflected in the prices immediately, appreciation of Turkish lira was reflected at a slower pace. However, one interesting development is the gradual decline of the annual increases in the private basic metal industry prices from the beginning of 2003 onwards, falling even below the world price increase, expressed in terms of TRL, as of the first quarter of 2004. This observation demonstrates that the producers reflected in the prices, the expectation that the stability in exchange rates will be a lasting one. Thus, in the case that the relative stability in exchange rates continue, the inflationary effects of the recent increases in world basic metal prices in the coming period will be limited.

The analysis for 2004 suggest that the increase in international iron and steel prices will not be long-lasting. The reason for this may be given as the weakening, in the long run, of the sudden demand pressure as a consequence of China's significantly increasing production capacity attributable to the investments in the steel sector. At the same time, the increase of input prices is likely to adversely affect the metal demand in China, especially that of iron and steel. Yet, while prices are not expected to continue increasing at high rates in the short-run, it is possible that they remain at high levels.[i]

Looking at the reflections of all these developments on Turkey, high productivity and low labor costs in the industrial sector are believed to constrain this pressure, although the possibility of world iron and steel prices to remain at high levels may exert a potential cost-push pressure for the 2004 inflation target

i A representative of the Chinese producer Baoshan Iron&Steel stated that especially the prices of steel, used in the automotive industry, will maintain its high level till the year-end. Source: Financial Times, April 7, 2004.