CENTRAL BANK OF THE REPUBLIC OF TURKEY

MONETARY POLICY REPORT 2005-III

CONTENTS

1. Introduction[1]

The downward trend of inflation persisted in the third quarter of 2005. The price movements in food and clothing groups continue to contribute to this process. Meanwhile, it is also observed that the adjustments made in public prices and tax regulations, especially the prices of petroleum products and tobacco products, had a negative impact on inflation. In addition to the direct impacts of oil prices, some of the sub-items of the transportation and housing groups have had indirect impacts. Moreover, due to the economic revival and some structural factors, significant increases occurred in services items, such as rents, restaurants and hotels. In other words, it is observed that the rigidity in service prices still continues, even when the effects of oil prices on the services sector are removed. Meanwhile, special CPI aggregates continue their downward trend.

The Turkish economy continued to grow in the second quarter of 2005. In this period, the revival of economic activities gained momentum. The contribution of consumption expenditures to growth did not change compared to the previous period, meanwhile that of investment expenditures increased remarkably. Investment expenditures came to the forefront due to the ongoing increase in the private sector' s investments on machinery and equipment despite a strong base effect as well as the contribution of construction investments to the strong growth trend. Analyzing the production of the manufacturing industry on a sectoral basis, the trend of investment expenditures is also predicted to continue in the third quarter of the year. Furthermore, public expenditures continued their positive contribution to growth in this period. Though the total final domestic demand maintains its upward trend, the development of its composition in favor of investment expenditures is of great importance with respect to the continuation of high growth rates without causing any inflationary pressure.

The decline process in unit real wages persisted in this period despite a slowdown compared to previous periods. Moreover, public wage policies follow a course consistent with the inflation target. However, the unfavorable trend displayed by raw material prices in international markets causes increasing effects on costs. Although, the particularly

[1] This report is based on the data gathered until 24 October 2005.

high-rated annual increases in crude oil prices have a limited effect due to the strong position of the Turkish lira, such rises still continue to pose a cost-originated risk to inflation.

Towards the second half of the year, the Central Bank maintained its " cautious stance " due to mixed signals concerning domestic demand and inflation in the upcoming period. Hence, the Bank did not make any changes in short-term interest rates and kept them at 14.25 percent in July, August and September. Nevertheless, the Bank cut short-term interest rates by 25 basis points consecutively in October and November taking into consideration the facts that in spite of an ongoing increase, the composition of the final domestic demand displayed a trend in favor of investment expenditures, the predictions for restricted inflationary pressure improved and uncertainties about the negotiations with the EU eased. Hence, short-term interest rates came to 13.75 percent.

In the last period, significant steps were taken in structural reforms aimed at enhancing the quality of fiscal discipline. The multiyear central budget system, which will be put into effect as of 2006 in order to increase transparency, will support the establishment of monetary policy with a medium-term perspective. In a period where significant steps towards price stability were taken, the continuity of reforms that will sustain fiscal discipline is of great importance.

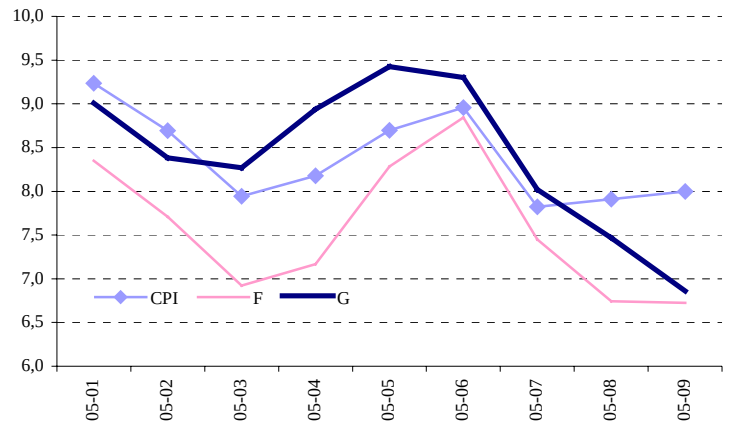
2. Inflation Developments

In the first nine months of 2005, the CPI increased by 3.93 percent. CPI inflation became 1.74 percent in Q2 and 1.30 percent in Q3.

CPI increased by 3.93 percent in the first nine months of the year.

Following the rise in the April-June period, inflation headed downwards in July again and fell behind the end-year target. Meanwhile, the decline in annual inflation of the Special CPI Aggregates F and G, which are the CPI aggregates with the narrowest scope, is still continuing (Graph 2.1).

Graph 2.1. CPI and Special CPI Aggregates (F and G)
(Annual, Percentage Change)



F: CPI excluding energy, alcoholic beverages and tobacco products, other administered prices and indirect taxes.
G: CPI excluding energy, alcoholic beverages, tobacco products, other administered prices, indirect taxes and unprocessed food.
Source: SIS.

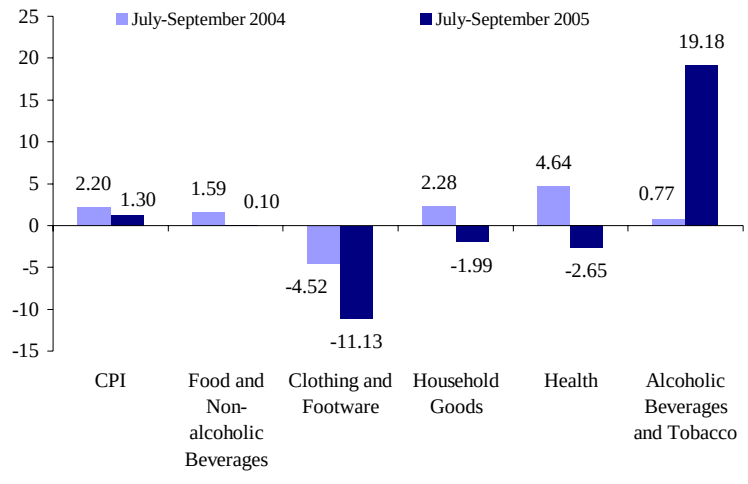
Price developments in seasonal products, direct and indirect effects of oil products and price increments in alcoholic beverages and tobacco group became the factors that affected inflation in the second quarter of the year.

Price developments in the food and clothing groups, which contain seasonal products in the consumption basket, made a positive contribution to CPI inflation in Q3. Clothing and footwear prices decreased by 11.13 percent in the July-September period (Graph 2.2). An evaluation of this development together with the developments in the same period last year and in the first half of the year suggests that the pricing behavior in the clothing and footwear group may differ from the past. However, whether this difference is permanent or not will be

Price increments in tobacco products and seasonal products became the factors that influenced inflation in Q3.

clear in the upcoming period. In the third quarter, price increments in the food and non-alcoholic beverages group were quite limited. Meanwhile, due to the adjustment made in the scope of the special consumption tax levied on tobacco products in July, prices of alcoholic beverages and tobacco group displayed a rapid rise in August. It should be emphasized that this increase, which stemmed from a structural change, will not affect the inflation trend in the medium-term since this change is a one-off measure.

Graph 2.2. CPI and Selected CPI Sub-groups
(Percentage Change)



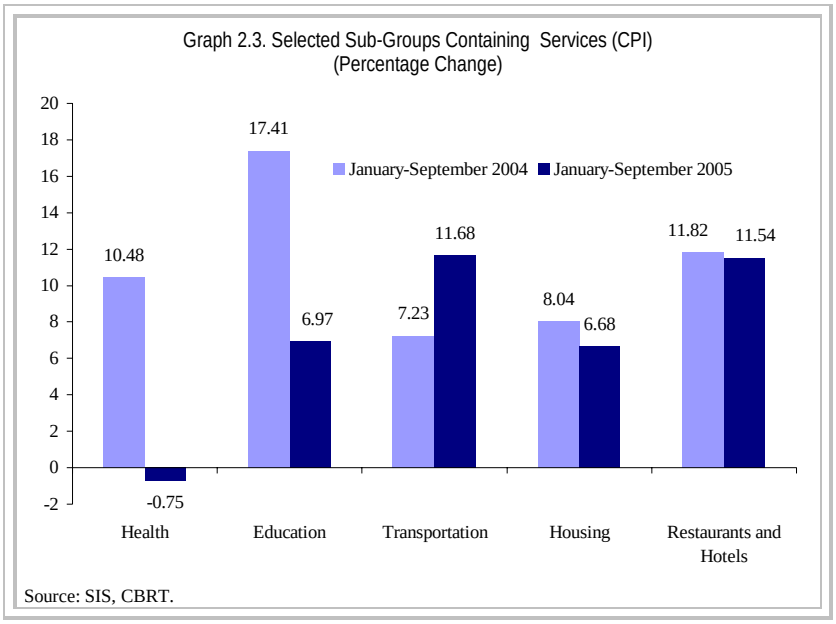
Source: SIS, CBRT.

While prices in the health and household goods groups decreased in the third quarter of 2005, prices in transportation and education group increased. The decrease in health prices mainly resulted from the decline in prices of medicines. In the household goods group, prices of both furniture and electrical and non-electrical appliances sub-groups dropped. Movements in the health and household goods groups can be basically attributed to the stable course of New Turkish lira (YTL). While there have been seasonal price increments in the education group, the rise in transportation prices mainly reflects the increase in oil prices.

The prices in health and household goods groups decreased while prices in transportation and education group increased in Q3.

A comparison between the nine-month cumulative rates of increase in sub-groups that fall in the scope of services group under the CPI pertaining to 2005 and 2004 gives a general idea of the sustained rigidity in the services prices. While cumulative price increments in housing and restaurants and hotels groups are close to the price

increments of last year, the nine-month cumulative price increment in transportation groups has exceeded the rise recorded last year (Graph 2.3). Meanwhile, it is observed that the rate of increase of prices in education has remained under that of last year. Within this framework, it can be asserted that the rise in the prices of education group is concurrent with the end-year target. However, rigidity in the other groups referred to is continuing. Even though there is a decline in health prices, price increments in health services groups are continuing, since this decline mainly stems from the decline in the price of medicines. The rise in rents, which is an important component of the rigidity in the housing group, reached 15.80 percent in the first nine months of the year with the effect of high increases in the last two months.



Oil prices is one of the influential factors that affect consumer prices inflation. A rise in oil prices directly and indirectly affects prices of services and goods within the consumption basket. While the prices of oil products in the CPI increased by 7.12 percent in Q3, the prices of non-oil products rose only by 0.38 percent (Table 2.1). The prices of services, which are indirectly affected by oil prices, increased by 14.33 percent in the January-September period. Within this framework, it is observed that the rigidity in the prices of services still persists, even if the indirect impact of oil prices on the services sector is adjusted.

A rise in oil prices directly and indirectly affects the prices of goods and services within the consumption basket.

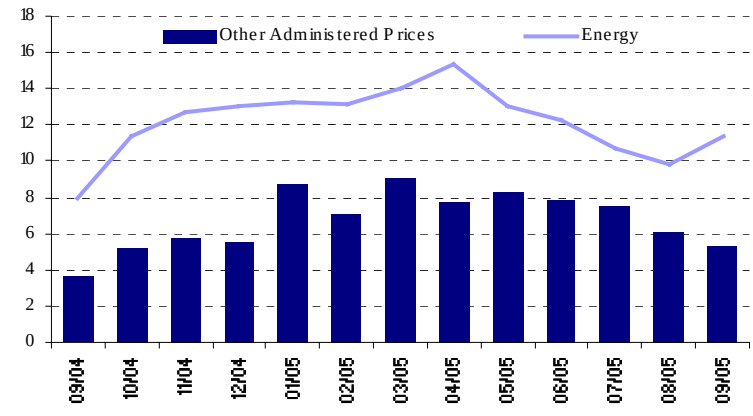
Table 2.1. Effects of Oil Prices on Goods and Services
(Percentage Change)

	January-September 2005	July-September 2005
Goods Group		
Petroleum Products	16.21	7.12
Non-Petroleum Goods	0.83	0.38
Services Group		
Services Susceptible to Oil Prices	14.33	4.31
Services not Susceptible to Oil Prices	9.80	3.50

Source: CBRT.

Public price adjustments and tax arrangements especially influenced the prices of petroleum products, tobacco products and the education group in the third quarter. The price increments of university tuition and dormitory rates in the education group are adjusted on an annual basis. Energy prices, which make up the main part of the administered goods prices, increased by 6.12 percent in the first nine months of the year. Additionally, other administered prices rose by 4.56 percent in the same period. Annual price increases of the mentioned groups are projected to move upwards in the last quarter due to seasonal factors (Graph 2.4). Within this framework, it is vital to keep public price adjustments and tax policies in conformity with the end-year inflation target in order to achieve the targeted rate of inflation.

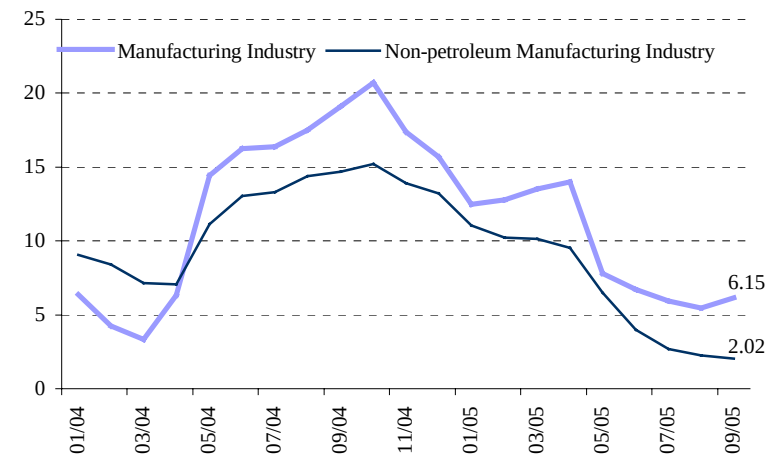
Graph 2.4. Energy and Other Administered Prices
(Annual Percentage Change)



Source SIS, CBRT.

Since the PPI with the base year of 2003 is compiled with producer prices excluding taxes, it has become more susceptible to costs and exchange rate developments compared to the Wholesale Price Index with the base year of 1994. Accordingly, developments in oil prices, which come to the fore among other cost factors, has become a leading factor affecting the trend of the PPI. Meanwhile, it is observed that the annual rise in non-petroleum manufacturing industry (excluding coke, coal and refined petroleum products) prices is lower than that of manufacturing industry prices (Graph 2.5). This data points to the fact that when the effect of oil prices is adjusted, manufacturing industry prices pursue a favorable course and make a positive contribution to consumer prices inflation.

Graph 2.5. Manufacturing Industry and Non-Oil Manufacturing Industry Prices
(Annual Percentage Change)



Source:SIS, CBRT.

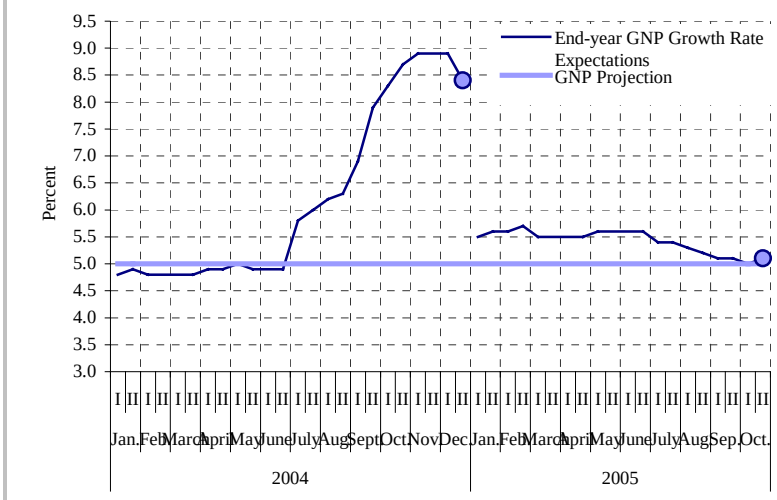
3. Demand and Supply Developments

3.1. Supply-Demand Balance

Economic growth continued in the second quarter of 2005 and the GNP grew by 3.4 percent compared to the same period last year.

Thus, GNP growth in the first half of 2005 became 4.3 percent compared to the same period last year. While the contribution of private consumption expenditures to growth remained the same in the second quarter compared to the previous quarter, the contribution of private investment expenditures increased significantly. In the same period, public expenditures positively contributed to growth, while net exports and change in inventories had a negative impact on growth. With respect to production, it is observed that value added in all sub-items increased in Q2-2005 compared to the same period of the previous year. As in Q1-2005, the services sector became the sub-group that contributed the most to growth in Q2-2005. The rapid growth trend in the value added of the construction sector, the leading engine of growth in 2005, has continued.

Graph 3.1.1. Annual GNP Growth Rate Expectations in the CBRT Expectations Survey



Source: CBRT.

Seasonally adjusted data point to an increased momentum in the GDP in the second quarter compared to the first quarter, which can be translated as an acceleration in economic activity. As the base effect created by high growth rates in the first quarter of 2004 would weaken, it is foreseen that annual growth rates will be relatively higher in the second half of the year provided that the current trend in the economy

Seasonally adjusted data point to an acceleration in economic activity in Q2-2005.

is maintained. In this respect, the end-year growth rate projection of 5 percent is expected to be achievable. In the CBRT Expectations Survey, the projected end-year growth rate realized as 5.1 percent in the in the second survey period of October (Graph 3.1.1).

According to the SIS Monthly Industrial Production Index results, total industrial production increased by 3.8 percent in the July-August 2005 period compared to the same period in 2004. Seasonally adjusted data indicate that there was an upward trend in industrial production in July and August compared to the previous months. Meanwhile, production expectations for September improved compared to the previous month. These developments indicate that the growth in industrial production also continued in the third quarter as well. Moreover, the fact that the base effect created by brisk production in the first half of 2004 will weaken in some sectors as of August will have a favorable effect on annual growth rates in the second half of the year. Hence, machinery-equipment manufacturing, which has been decreasing on an annual basis since March, recorded a positive growth rate in August.

Analyzing developments in the manufacturing industry by sectors, it is seen that the tendency observed in the first half of the year in the composition of sectors driving production growth is also maintained in July and August. In this way, metallic goods, plastic-rubber, non-metallic minerals and motor vehicles stood out as the sectors that contributed the most to growth. Other sectors that made a significant contribution to growth were the food, chemicals and electrical machinery sectors. The increase in the production of metallic goods and non-metallic minerals, and the manufacturing of electrical machinery signal an acceleration in construction investments and machinery-equipment investments, respectively. Thus, the developments in the sectoral composition of manufacturing industry production confirm the current trend in investment expenditures.

The developments in the sectoral composition of the manufacturing industry production confirm the current trend in investment expenditures.

According to data released by the SIS, the capacity utilization rate of the manufacturing industry became 80.5 percent in the July-August period, 2.2 percentage points lower compared to the same period last year. Hence, it can be asserted that the capacity utilization rate of the manufacturing industry is not at a level to exert any kind of pressure on prices. The ongoing increase in manufacturing industry production, despite lower capacity utilization rates, manifest the importance of

investment expenditures for achieving sustainable growth without jeopardizing the disinflation process.

Table 3.1.1. GDP Developments by Expenditure Side
(Annual Percentage Change)

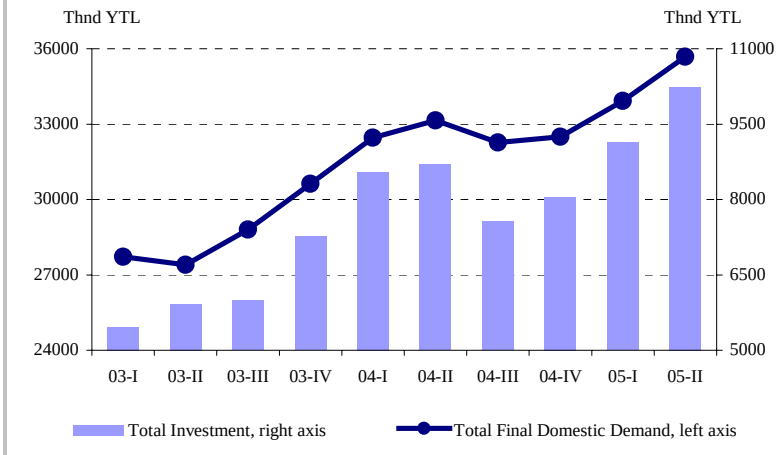
	2003	2004				2005			
	Annual	I	II	III	IV	Annual	I	II	Six-MonthAlı Aylık
1-Consumption Expenditures	5.6	11.6	15.4	5.9	4.7	9.0	4.0	4.4	4.2
Public	-2.4	2.6	-7.8	-7.0	11.1	0.5	4.3	4.0	4.2
Private	6.6	12.4	18.4	7.3	3.6	10.1	4.0	4.4	4.2
Durable Goods	24.0	48.0	61.4	28.9	-5.7	29.7	1.5	2.6	2.1
Food and Beverages	4.1	5.3	2.6	0.0	5.4	2.8	4.6	8.8	6.7
Semi-dur and Non-dur. Goods	2.1	8.2	36.8	18.3	16.3	18.8	12.0	4.2	8.2
2-Fixed Capital Formation	10.0	57.6	47.4	26.1	11.2	32.4	6.9	17.9	13.1
Public	-11.5	-5.9	-8.7	-10.8	0.9	-4.7	36.6	31.1	32.6
Private	20.3	65.5	63.1	38.9	17.7	45.5	4.8	15.8	10.8
3- Stock Change*	3.0	2.5	1.4	-1.2	2.5	1.1	0.1	-0.9	-0.4
4-Exports of Goods and Services	16.0	10.9	17.2	8.2	14.4	12.5	11.3	4.7	7.7
5-Imports of Goods and Services	27.1	31.3	32.7	16.1	19.6	24.7	9.3	9.2	9.2
6-Total Domestic Demand	9.3	20.6	21.4	8.1	8.5	14.1	4.4	6.4	5.4
7-Total Final Domestic Demand	6.5	19.8	22.9	9.9	6.3	14.1	4.7	8.2	6.5
8-GDP (Expenditure Side)	5.8	11.8	14.4	5.3	6.3	9.0	4.8	4.2	4.4

*Contribution to GDP growth, percent.
Source: SIS.

When GDP developments are analyzed by expenditures, it is observed that growth in total final domestic demand, which displayed an increase in Q1-2005 compared to the previous period, maintained its upward trend in Q2. In seasonally adjusted terms, total final domestic demand rose at an increasing rate compared to the previous period (Graph 3.1.2). Meanwhile, total final domestic demand, which was realized at the same rate as GDP growth in annual terms in Q1, significantly exceeded GDP growth in Q2.

According to seasonally adjusted data, total final domestic demand displayed an accelerated rise in Q2 compared to Q1.

Graph 3.1.2. Total Investment and Total Final Domestic Demand
(Seasonally Adjusted)



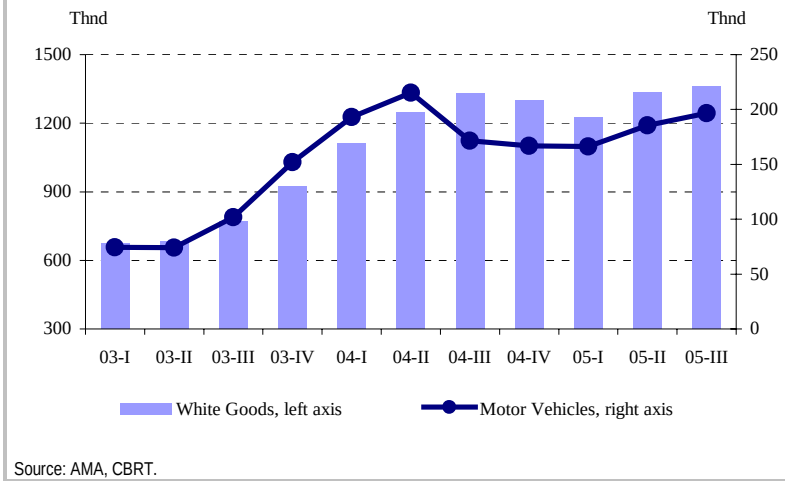
Source: SIS, CBRT.

Domestic demand composition in Q2-2005 seems to be relatively more favorable compared to the previous period in terms of medium-term growth-inflation relationship.

While this development is evaluated with respect to its link inflation, the composition of domestic demand should be carefully analyzed. The reason is that as it was emphasized in previous reports, when economic growth is investment-driven, inflationary pressures are limited via productivity and thus unit costs. In this context, the data on the second quarter of 2005 displays a relatively more favorable picture compared to the first quarter, in terms of medium-term growth-inflation relationship.

In seasonally adjusted terms, demand for consumer durables showed a high-rated rise in the second quarter compared to the previous quarter, as was the case in Q1. Meanwhile, the increase in food, semi-durable and non-durable goods expenditures also continued in the second quarter. In the July-September period, sales of automobiles and white goods increased by 13.4 percent and 2.3 percent, respectively, compared to the same period last year. When the mentioned data are seasonally adjusted, it is observed that there is a rising demand for durable goods in the third quarter (Graph 3.1.3). In addition, the latest data provided by the CBRT Private Consumption Index (CBRTPCI) indicate that the upward trend in consumption expenditures continues in the third quarter (Graph 3.1.4).

Graph 3.1.3. Domestic Sales of White Goods and Motor Vehicles
(Seasonally Adjusted)



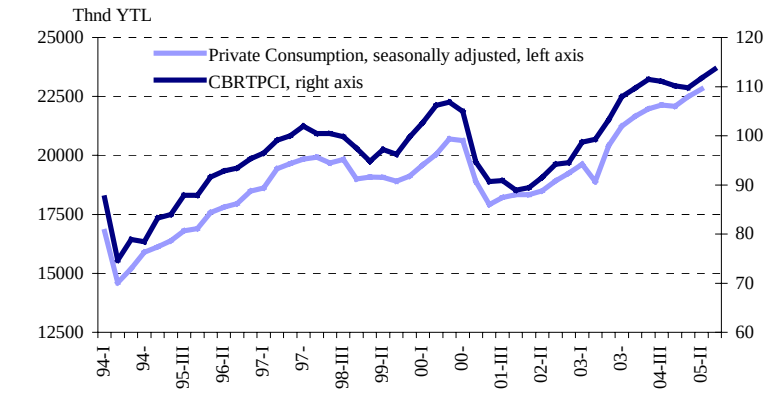
Source: AMA, CBRT.

However, the growth in private consumption expenditures does not represent a revival that may impose a perceptible pressure on inflation in the short run. Meanwhile, the increase in the importance of medium-term tendencies rather than the projections for 2005 manifests the need

to evaluate demand developments within this context. In this respect, growth in the labor supply along with the public incomes policy consistent with the inflation target is expected to ease the pressure on wages and thus to contribute to the ongoing stable growth in demand.

When demand developments are analyzed in terms of medium-term trends, growth in labor supply along with the public incomes policy consistent with inflation target is expected to ease the pressure on wages and thus help stable growth in demand continue.

Graph 3.1.4 . Private Consumption and CBRTPCI



Source: SIS, CBRT.

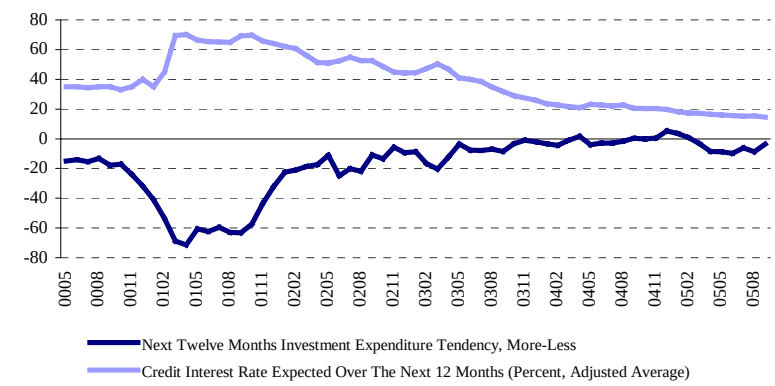
In the second quarter, the recovery in investment expenditures was more significant compared to the rise in consumption expenditures. Hence, the contribution of investment expenditures to GDP growth in Q2-2005 was rather higher than that of total consumption expenditures. As was the case in to Q1, total consumption expenditures contributed to growth by 3 percent in Q2. Meanwhile, the contribution of total investment expenditures to GDP growth, which was 1.6 percent in Q1, became 4.8 percent in Q2-2005. The rapid growth trend in investment demand is also confirmed by seasonally adjusted data.

Private sector machinery-equipment investments, which had recorded a limited rise in annual terms in Q1-2005, displayed an annual increase of 13.6 percent in Q2, despite the strong base effect in the same period last year. This rapid rise underpinned the strong growth trend in investments, making total investment expenditures the main driving factor with respect to growth.

Indicators pertaining to Q3-2005 indicate that machinery-equipment production decreased by 7.3 percent in the July-August period compared to the same period last year. However, if the current trend in machinery-equipment production continues, the sector is expected to display positive growth rates in the rest of the year with the removal of

the base effect in August. Meanwhile, the 23.1 percent rise in electrical machinery production and 23.5 percent rise in imports of capital goods compared to the same period last year point to the fact that machinery-equipment investment demand also continued in the third quarter. The 13.7 percent rise in the domestic sales of commercial vehicles in Q3 confirms the robust investment growth. The level reached by the investment tendency of the CBRT Business Tendency Survey as of September, following the reversal of the downward trend since the start of the year, is favorable regarding investor confidence. (Graph 3.1.5).

Graph 3.1.5. CBRT BTS Expectation of TL Credit Interest Rate and Investment Expenditure Tendency



Source: CBRT BTS.

Besides machinery-equipment investments, when the latest developments in sectors providing intermediate inputs to the construction sector are analyzed, it is observed that the production of other non-metallic minerals and metallic goods increased by 8.0 percent and 80.7 percent, respectively, in the July-August period, compared to the same period last year. Therefore, the upward trend in construction investments is believed to continue.[1] The high-rated increases in the number of construction permits as of the second quarter compared to the same period of the previous year verify this belief. Therefore, current data indicate that total investment expenditures will continue to increase in the third quarter as well.

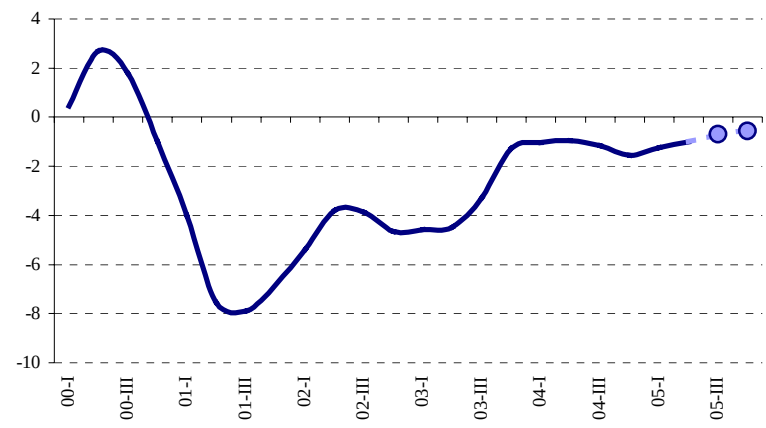
Current data indicate that total investment expenditures will continue to increase in the third quarter as well.

The data summarized herein point to a significant change in favor of investments in terms of the composition of total final domestic demand in Q2 compared to Q1 and also provide signals for the continuance of this trend in Q3. Productivity increases will be supported to the extent

[1] For a detailed evaluation of the developments in the construction sector, please see Box 3.1.

that the investment-originated base of economic growth expands and the likely pressure imposed by growth in domestic demand on inflation will remain limited. The sustained rise in investment expenditures provides signals that the low level of unit wages will be maintained via productivity gains. Nevertheless, while evaluating the demand-supply balance, indicators pertaining to the output gap, capacity utilization rates and the current stance in the labor market should also be taken into account.

Graph 3.1.6. Output Gap/ Potential GDP (Percent)



Source: CBRT.

The estimates for the output gap indicate that the production level in the Turkish economy by Q2 is not at a level that could generate inflationary pressure. It is forecasted that the output gap will shrink, though slightly, towards the second half of the year, but will remain at negative levels (Graph 3.1.6). It is considered that current demand conditions are not at a level that may lead to a pressure on prices thanks to the negative output gap, the low level of capacity utilization rates and the depressing effect of the unemployment rate of 9.2 percent as of Q-2 2005 on wages. However, it is a fact that the contribution of demand conditions to the disinflation process has weakened compared to the last three years.

Although it is believed that current demand conditions are not at a level that may exert a pressure on prices, it is a fact that their contribution to the disinflation process has weakened compared to the last three years.

Meanwhile, the importance of the developments in the credit growth on inflation is still continuing. High-rated increases in credit use lead to increased demand for certain types of goods in certain periods. The demand revival in the first half of 2004 is a very good example of it. However, in an environment where incomes increase in a controlled manner, rapid credit expansion may curb consumption in the upcoming

period. Otherwise, the rise in the level of household debt can pose risk on the banking sector. Therefore, sustained fiscal discipline and controlled monetary policy are of great importance with respect to both financial stability and price stability.

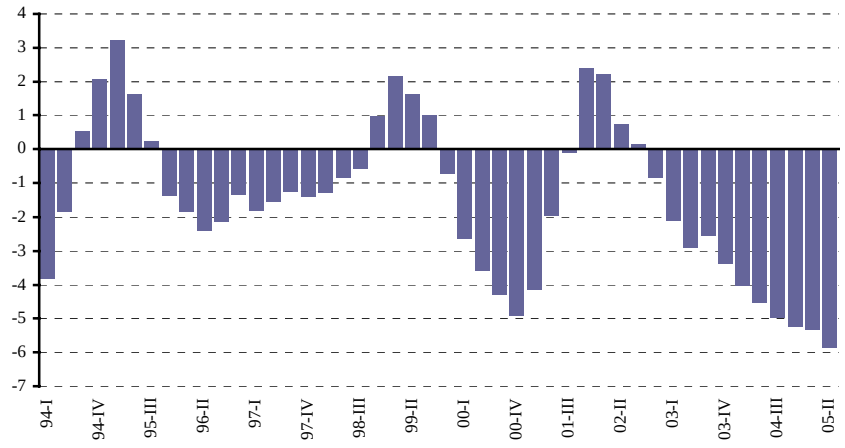
A likely deterioration in expectations that may stem from the rise in oil prices –if it persists too long to become permanent - still poses risk on the 2006 inflation target.

Regarding the inflation target for 2006, another important development is the rise in international crude oil prices. Along with its direct effects, the rise in oil prices also has indirect effects on inflation through input costs and expectations. Considering the fact that the direct effects of international crude oil prices on inflation comprise only a small portion of the total effects, it becomes important to be able to foresee the indirect effects. As it was previously defined in past reports, the indirect effects of international oil prices through input costs are deemed as " primary" indirect effects whereas expectations channel represents the " secondary" indirect effects. The estimates pertaining to direct and primary indirect effects, considering the sectors that use fuel-oil products most intensively, do not pose risk on the 2005 inflation target. However what is more important with respect to the medium-run inflation trend, is the possible emergence of " secondary" indirect effects that could change the pricing behavior due to a deterioration in expectations. Viewed accordingly, the sustained downward trend in inflation expectations over the next 12 months, one of the indicators of the CBRT Business Tendency Survey, shows that the oil price shock is perceived to be rather " temporary" and the mentioned expectation effect has not been materialized. However, the possibility that the expectations might deteriorate if the rise in oil prices prevails for a long time and turns out to be " permanent" , still poses risk on the 2006 inflation target.

3.2.Foreign Demand

The current accounts balance yielded a deficit of US dollar 13.3 billion in the first half of 2005. When analyzed on an annual basis, the current account deficit realized as 5.9 percent of the GNP in the period covering the second half of 2004 and the first half of 2005 (Graph III.2.1). In the July-August period, the current account deficit became US dollar 2.5 billion and total current account deficit in the first eight months of the year was realized as US dollar 15.8 billion. In this period, tourism revenues expanded and the increased foreign trade deficit became the determinant of the current account deficit.

Graph 3.2.1. Current Account Balance / GNP*
(Percent)



* Annualized data.
Source: CBRT.

According to data released by the SIS, in the first eight months of the year, exports increased by 17.4 percent compared to the same period last year. According to TEA (Turkish Exporters Assembly) data, exports grew by 20.3 percent in September. Even the rate of growth in exports remains under the figures of 2004, the upward trend continues.

In the first eight months of 2005, rise in imports was led mostly by imports of intermediary goods. The rise in oil prices made significant contribution to the rise in imports.

Imports grew by 20.7 percent in the first eight months of the year. The increase in imports of intermediary goods became the primary determinant in import growth. While the rate of increase in imports of intermediary goods was 24.8, it became 14.8 percent in capital goods and 7.5 percent in consumption goods. The rise in imports is mainly attributed to the increase in imports of crude oil, natural gas and refined petroleum products due to the rise in oil prices. When these items are excluded, the rate of increase in imports in the first eight months of the year was 16.5 percent. The import tax figures announced by the Ministry of Finance confirm that imports also continued to increase in September as.

The relatively low rate of increase in imports of consumption goods indicates that increased current account deficit is not a reflection of excessive demand. When finance items are analyzed, the tendency

towards an increase in direct foreign capital investments and long-term credit utilization is remarkable.

3.3.Costs

Developments in productivity and real wages in the first half indicate that the favorable trend in costs continues.

In the second quarter of 2005, employment in the manufacturing industry decreased by 1.6 percent compared to the same period last year. The rapid decline in employment in the public manufacturing industry continued in this period too. In the private manufacturing industry sector, employment increased in 14 sub-groups out of 22. However, the high-rated decline in employment in textile, clothing and leather sectors that constitutes approximately one-third of employment, has led to the drop in employment in the manufacturing industry sector. In this period, the real wage per hour in production and productivity per hour indices rose by 2.1 percent and 4.3 percent, respectively (Table III.3.1).

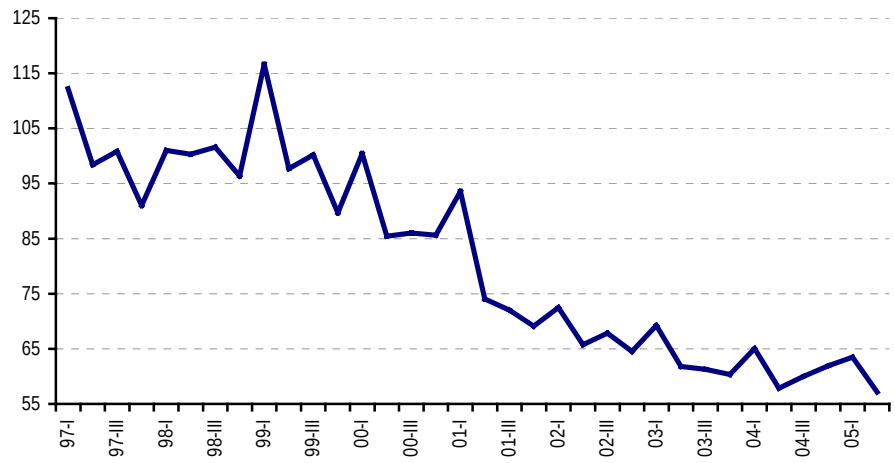
Table 3.3.1. Employment, Real Wage and Productivity Developments in Manufacturing Industry
(Percentage Change Compared to the same period last year)

	2003	2004				2005		
	Annual	I	II	III	IV	Annual	I	II
Employment [(1)]	1.8	0.7	2.7	2.2	2.2	2.0	1.9	-1.6
Public	-6.8	-13.6	-11.0	-9.6	-9.7	-11.0	-10.2	-7.8
Private	3.1	2.4	4.5	3.7	3.6	3.6	3.1	-1.1
Wages[(2)]	-1.9	0.2	5.1	3.4	1.6	2.5	3.2	2.1
Public	-5.3	2.9	7.7	5.6	2.9	4.7	8.7	5.4
Private	0.6	2.5	7.5	5.3	3.9	4.8	3.5	2.0
Productivity[(3)]	7.2	8.5	13.6	6.4	1.6	7.3	5.1	4.3
Public	8.1	14.8	13.1	5.6	8.5	10.5	7.0	12.6
Private	7.9	9.0	15.0	7.6	1.2	8.0	6.1	3.3
Earnings[(4)]	-6.3	-0.6	3.7	1.5	-0.5	1.3	3.1	2.6
Public	-5.6	-0.6	9.2	1.2	2.5	3.2	10.6	3.3
Private	-4.7	2.6	5.8	4.6	2.3	4.3	3.2	3.0

(1) SIS, Manufacturing Industry Production Worker Index, 1997=100.
(2) SIS, Manufacturing Industry Real Wages Index per Production Hours Worked, 1997=100.
(3) SIS, Manufacturing Industry Partial Productivity Index per Production Hours Worked, 1997=100.
(4) SIS, Manufacturing Industry Real Earnings Index per Production Worker,1997=100.

The unit real wage index in the private manufacturing industry, which is defined as the ratio of real wages to partial labor productivity, inched down by 0.7 percent compared to the same period last year (Graph 3.3.1). Although the downward trend in unit real wages has slowed down compared to the previous year, it still continues.

Graph 3.3.1. Private Manufacturing Industry Unit Real Wage Index *
(1997=100)



* The total real wage index of the SIS, which is formed by multiplying SIS private manufacturing industry real wages index per production hours worked by SIS private manufacturing industry production hours, is divided by the SIS quarterly private manufacturing industry production index. In other words, the unit real wage index is the ratio of real wages to partial labor productivity.

Source: SIS, SPO, CBRT.

Production data pertaining to July and August coupled with expectations for September indicate that the annual rise in manufacturing industry production will move upwards in Q3 compared to Q2. The increase in productivity is expected to continue due to the increase in employment lagging behind the increase in production.

Analyzing the public wages policy for 2006, it is observed that the wage increments of workers are close to the inflation target.[2] Meanwhile, it is planned to increase civil service salaries by 2.5 percent in the first and the second halves of 2006, each, and to add a bonus of YTL 40 to the salaries of low-income groups in January and July. The Ministry of Finance announced that the average civil servant salary would increase by 12.7 percent in 2006.[3] The increase in the average civil servant salary is projected to have limited impact on domestic demand. Provided salary increases in the private sector remain close to the increases in public workers' salaries, no cost pressure is expected to be generated by wages and salaries.

Provided the salary increases in private sector stays close to the increases in public workers' salaries, no cost pressure is expected to generate from wages and salaries

[2] According to the protocol signed in July 2005, public workers' salaries will be increased by 3 percent each in the first and second halves of the second year of the protocol. However, in case the CPI exceed the increment ratio, 80 percent of the difference will be added to salaries in the first half and 100 percent of the difference will be added to the salaries in the second half.
[3] Ministry of Finance, "Presentation of the Budget for 2006" (TGNA Plan and Budget Commission), 28 October 2005, p 44.

Though the unfavorable course of raw material prices, another factor affecting costs, has slowed down, it still continues on an annual basis (Table 3.3.2). In particular, the annual rise in crude oil prices has reached 50 percent. The strong Turkish lira has prevented the effects of the rise in oil prices being thoroughly reflected on the domestic market. Nevertheless, the direct and primary indirect effects of oil prices have started to appear. The high level of oil prices still poses risk on the inflation target for the upcoming period. In conclusion, wages, one of the components of costs, maintain their favorable course with respect to inflation, whereas the high level of raw materials, especially of oil prices, pose risk on inflation.

The high level of raw material prices, especially of oil prices, poses risk to inflation.

Table 3.3.2. Indicators of Production Costs

	2003	2004				2005			
	Annual	I	II	III	IV	Annual	I	II	III
Imports Unit Price Index	100.0	111.4	112.7	116.6	123.3	116.0	125.3	123.6(1)	122.0(1)
Crude Oil Prices ($/Barrel)	27.0	30.0	32.0	36.7	39.6	34.6	41.7	47.6	55.3(2)
Metal Prices Index	98.2	130.0	130.2	133.8	141.9	134.0	161.5	163.5	167.2(1)

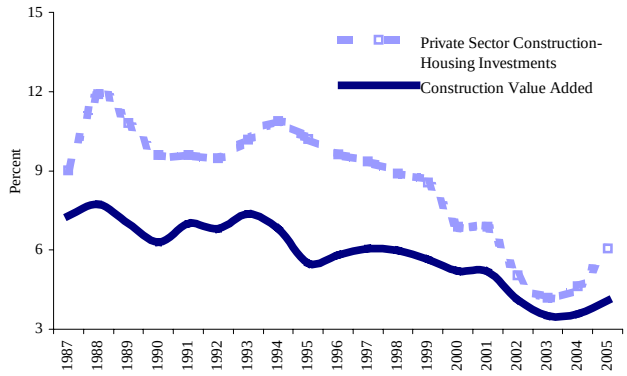
(1) The data pertaining to Q3-2005 covers July-August period.
(2) August and September values are estimated values.
Source: SIS, SPO, IFS.

BOX 3.1. PRODUCTION IN CONSTRUCTION SECTOR AND HOUSE SUPPLY

Construction sector has started to recover as of the end of 2003 after a long period of stagnation. Private investments on buildings and houses that had tended to shrink by 1996 have started to grow since the last quarter of 2003, thus increasing their share in GNP. (Box 3.1.Graph 1). Increased loan opportunities and the decline in interest rates as well as recovery in deferred demand stimulated by economic stability became the factors that helped recovery. Value added in construction started to increase parallel to the revival in investments in buildings and houses. Demand has stimulated recovery in the sector and housing prices started to climb. The developments in the last few years helped recovery in deferred demand for houses and brought housing to the fore as an important investment instrument. These developments supported the process that increases the supply of houses. The formation of the necessary legal infrastructure that enables the borrower to buy residential property by using a mortgage to pledge real property to the lender as security against the debt is believed to rest demand process on a more sound ground.

In Turkey, the periods of shrinkage in construction sector have always coincided with the periods of decline in GDP. The value added of construction sector rapidly decreased in 1994, 1999 and 2001, when economy underwent serious contraction. However, recovery in construction sector was rather delayed compared to the GDP. For instance, value added of construction sector started to decrease due to the economic crisis in 2001 and did not recover until the end of 2003, although the economy entered upward trend in 2002 and 2003. The growth in the value added in construction sector was quite high in the first half of 2005. Therefore, the share of the value added in construction sector in GDP started to increase.

Box 3.1.Graph 1. The Share of Private Sector Construction-Housing Investments and Value Added of Construction in GDP



One of the most important indicators of demand for housing is the statistics pertaining to construction permits. After 1994, and especially after the 1999 earthquake and the 2001 economic crisis, there has not been a significant increase in the number of construction permits for houses despite the rise in population. The number of construction permits granted for apartments started to increase rapidly after years of decline. Meanwhile, the construction permits show that recovery in housing production started to be manifested in housing supply only in a limited manner in 2005. (Box 3.1.Table.1). Therefore, despite the revival in housing production, housing supply has not yet reached a level that is adequate to meet the deferred demand. The rise in investment expenditures with the ease of uncertainties led to an increase in the construction of industrial and commercial buildings -though not as much as housing- and contributed to the value added in construction sector.

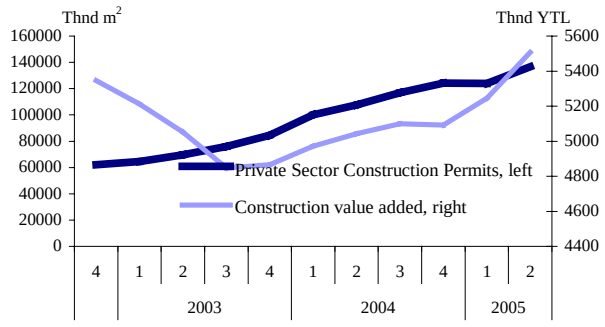
Box 3.1. Table 1. Housing Production by Years (According to Construction Permits Received and Residence Permits)

	Construction Permits		Residence Permit	
	No. Of Apartments	Annual % Change	No. Of Apartments	Annual % Change
1990	381,408	-7.7	232,018	-7.4
1991	392,943	3.0	227,471	-2.0
1992	467,024	18.9	268,804	18.2
1993	548,129	17.4	269,695	0.3
1994	523,791	-4.4	245,610	-8.9
1995	518,236	-1.1	248,946	1.4
1996	454,295	-12.3	267,306	7.4
1997	464,117	2.2	277,056	3.6
1998	414,573	-10.7	219,737	-20.7
1999	339,446	-18.1	215,613	-1.9
2000	315,162	-7.2	245,155	13.7
2001	279,616	-11.3	243,464	-0.7
2002	145,397	-48.0	166,318	-31.7
2003	202,237	39.1	162,776	-2.1
2004	323,927	60.2	160,116	-1.6
2005*	204,094	57.4	86,593	18.6

* For the first 6 months
Source: SPO.

While SIS calculates the value added in private construction sector, a building that has been granted construction permit is deemed to be completed within 5 years at the latest. According to the SIS method, the value added calculated for any given year contains the total area of buildings that have received construction permits in the last two years as well.[1] Therefore, the rise in the number of construction permits received in 2003 and 2004 precedes the increase in the value added in construction sector in 2005. In other words, movements in construction permits are reflected on the national construction statistics with delays (Box 3.1.Graph 2). Within this framework, the ongoing rise in the number of permits received in the first half of 2005 hints that growth in the value added in construction sector will continue to increase in the upcoming period too.

Box 3.1. Graph 2. Construction Permits of Private Sector and Value Added of Construction (Annualized)

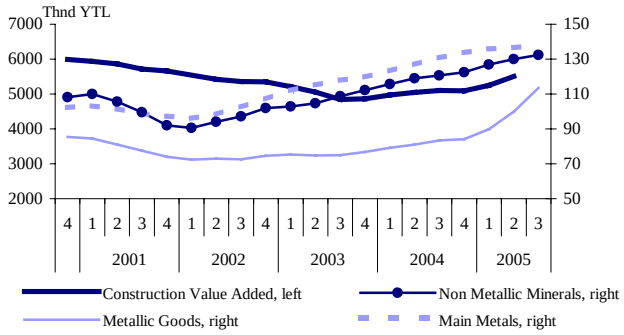


Source: CBRT.

In the mean time, the vigorous activity in construction sector boosts production in many sub-sectors of manufacturing industry, such as metallic goods, main metals and especially non-metallic minerals. The strong relationship between the developments in sectors providing intermediate input to construction sector and the value added in the construction sector is illustrated in Box 3.1 Graph 3. Therefore, it can be asserted that construction sector, within respect to the relations between sectors, will continue to contribute to growth substantially in the upcoming period.

[1] For details see, "Gross National Product: Concept, Methodology and Sources" (in Turkish), SIS, Nov. 1994, Pub. No. 1710.

Box 3.1. Graph 3. Developments in Sectors Providing Intermediate Input to Construction Sector
(Annualised)



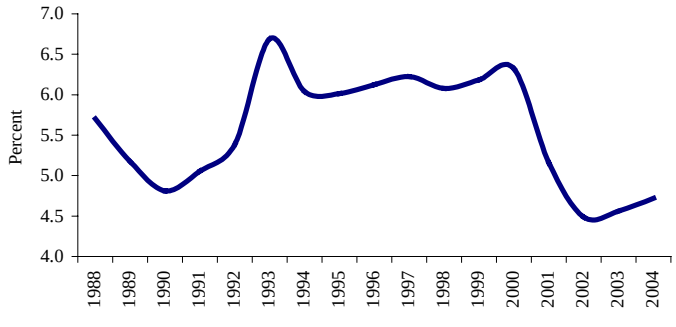
With the achievement of lasting economic stability and the decline in interest rates, buying a house has become more attractive. Within this framework, the housing financing system based on mortgage, which is planned to be implemented in 2006, is expected to boost the activity in construction sector. Therefore, it is projected that the building and housing investments will continue to boost in order to meet the deferred demand and rapid urbanization. Thus, the share of value added in construction sector in economic activities will continue to rise. As was emphasized above, Turkish economy involves the necessary conditions for going beyond the level reached in 1990s.

DEVELOPMENTS IN CONSTRUCTION SECTOR AND LABOR MARKET

The reflections of the developments in housing sector on labor market shall be evaluated by taking account of the fact that the convergence of Turkish economy with the European Union countries will be accelerated in the accession period. In this period, labor force will gradually shift from agricultural sector to industrial and services sectors. Demand for houses will grow parallel to the rise in population and the need for urbanization, and accordingly, investments in buildings and housing will increase, which, in turn, will support growth and employment.

Parallel to the rise in the share of value added in construction sector, employment in the sector has increased substantially. The share of construction sector in total employment became approximately 5 percent in 2004 (Box 3.1.Graph 4). Therefore, the contribution of construction sector to the employment problem alone remains quite limited. However, as it is expected that activities in construction sector will accelerate and the share of agricultural sector in total employment will continue to decrease, it is believed that construction sector will play a very important role in the process marked by shift from agricultural sector to industrial and services sectors and the share of construction sector in total employment will expand.

Box 3.1. Graph.4. The Share of Construction Sector in Total Employment



4. Developments in Financial Markets and Monetary Policy

As a result of the determined implementation of the economic program, which was put into practice after the February 2001 crisis, it is possible to talk about an economic environment where macroeconomic stability has been largely achieved and uncertainties have been reduced. High growth performance based on the private sector, rises in productivity and employment and the change in inflation dynamics and pricing behavior in a way to equip the disinflation process with a lasting nature point to a structural transformation process in which Turkey' s fragility against internal and external shocks is in decline. In this process, as an independent institution responsible for the implementation of monetary and exchange rate policies, the Central Bank has strived to use short-term interest rates in the most effective manner as its main policy instrument, in order to achieve its primary target; i.e. price stability. With its resolute attitude, the Central Bank succeeded in keeping the rates of inflation within the set targets. To put it more clearly, in a period of large capital inflows stemming from the above-mentioned transformation, the Central Bank tried to avoid implementations that would contradict with the floating exchange rate regime and carried out an interest rate policy consistent with the inflation target. At present, with the belief that the preconditions have, in general, been met, the Central Bank is preparing to adopt full-fledged inflation targeting as of early-2006.[1]

With the belief that the preconditions are met in general, the Central Bank is in preparation to adopt the full fledged inflation targeting regime as of the beginning of 2006.

As stated in the Central Bank announcement entitled " Monetary and Exchange Rate Policy in 2005" dated 20 December 2004, the principal medium of communication, which used to be the quarterly-published " Monetary Policy Report", will become the " Inflation Report", in the formal inflation targeting period. Therefore, this issue of the Monetary Policy Report, in the light of the main issues of previous periods, will outline the framework of monetary and exchange rate policies pursued until today, along with current developments in monetary policy.

4.1. CBRT Monetary Policy

In 2001, with law No. 4651 that amended Central Bank Law No. 1211, the primary objective of the Central Bank was set as achieving price

[1] The operational framework of the new regime and the details of its decision-making mechanism will be made public in December.

stability and in order to achieve this goal the Bank became independent in its monetary policy implementation. The Central Bank used short-term interest rates as the main monetary policy instrument, within the scope of the current implicit inflation targeting strategy, while also monitoring monetary performance criteria along with the indicative targets, within the framework of the program with the IMF. As it is known, the monetary component of the arrangements pertaining to the conditionality of the program carried out with the IMF, is composed of the performance criteria and indicative targets that are set as the floor for the amount of net international reserves and the ceiling for the amount of base money and net domestic assets.

In an environment where inflation is in decline and financial deepening is increasing, the prediction of money demand becomes more difficult and monetary aggregates may increase faster than the amounts that are foreseen in connection with the standard money demand relation. As also stated in the letters of intent, occasionally there emerges a need to revise and change monetary indicators and targets. Finally, the 2005 targets regarding base money, net international reserves and net domestic assets were set with the letter of intent dated 26 April 2005. According to the letter of intent, the ceiling values pre-set for base money and the floor values pre-set for net international reserves, were changed to indicative targets for 31 December 2005. All the targets set for May and June were achieved. As the increase in base money continued at a rapid pace in 2005 as well, due to the developments mentioned above, it has become a necessity that the targets regarding the second half of 2005 are revised as of June. However, it was not possible to revise the monetary targets because the IMF review had not been completed. In conclusion, the base money calculated for end-September was realized as YTL 26.8 billion and remained above the YTL 24.7 billion upper limit (Table 4.1.1).

Table 4.1.1. Performance Criteria, Indicative Values and Their Realizations

	Base Money Upper Limit (Billion YTL)		Net Domestic Assets Upper Limit (Billion YTL)		Net International Reserve Level (Billion Dollars)	
	Target	Realization	Target	Realization	Target	Realization
31 December 2004	20.9 (P)	19.19	35.0(G)	30.12	-2.0(P)	1.29
31 May 2005	23.6(P)	22.98	37.7(G)	31.32	2.0(P)	5.84
30 June 2005	23.6(P)	22.6	37.7(G)	23.99	2.0(P)	10.46
30 September 2005	24.7(P)	26.8	37.8(G)	23.7	2.75(P)	13.2
31 December 2005	25.0(G)	-	36.4(G)	-	3.8(G)	-

Source: CBRT.
(1) Upper limits are calculated on the average of the stocks on the mentioned dates and the last five working days preceding these dates and up to this date.
(P): Performance criterion; (I): Indicative target

Meanwhile, rather than assessing them in terms of a definite target, the Central Bank evaluates the developments in money demand with regard to what they imply for future inflation. At this point, it is useful to emphasize the reasons and impacts of the expansion in base money: increased market confidence occurred, expectations improved considerably and risk premium decreased, due to the facts that economic uncertainties were largely diminished and the current economic program and fiscal discipline were carried on with determination. As a natural consequence of this process, which led to the decline in interest rates and the appreciation of YTL, money demand displayed an increase. Other factors that led to the expansion of money demand were increasing financial deepening and the fact that savings shifted mostly to YTL-denominated investment instruments. Thus, these developments observed in money demand, especially from the first quarter of 2003 onwards, point to a permanent behavioral change.

In the economies where inflation targeting is implemented, interest rates are used as monetary policy instruments while monetary aggregates are endogenously determined by money demand. Hence, the central bank may be obliged to meet the increase in money demand in a way not to contradict the inflation target. Otherwise, an increase (decrease) in money demand would reduce the efficiency of the central bank's interest rate policy by exerting upward (downward) pressure on interest rates. In this framework, the recent monetary expansion in Turkey is believed to be non-inflationary and is considered to be a healthy development that stemmed from the increase in economic stability.

The monetary expansion in Turkey is considered to be a non-inflationary and healthy development that stemmed from the increase in economic stability.

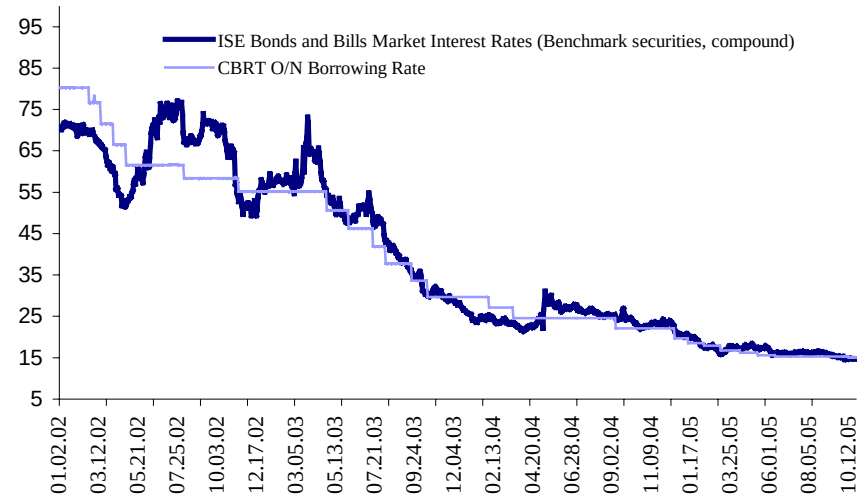
These points, which are mentioned as to monetary aggregates, imply that money demand cannot be used as a leading indicator for inflation. For this reason, setting targets for net domestic assets or base money may reduce the efficiency of monetary policy in the inflation targeting regime. For instance, in periods of increased money demand, interest rates may be raised independent of the inflation target. Accordingly, instead of the criteria regarding the ceiling/floor values of net domestic assets or base money, inflation performance indicators are used in the reviews under the inflation targeting regime, to achieve harmonization with the monetary conditionality principle of IMF-supported programs. Within this context, also in Turkey's case, base money and net

domestic assets targets will be replaced by the indicators pertaining to the inflation target, from 2006 onwards.

In the light of the assessments made above, during the period of implicit inflation targeting, instead of using base money as an anchor, the Central Bank safeguarded its basic objective of price stability and took into account probable developments in future inflation, while making its decisions pertaining to the basic policy tool of short-term interest rates. The indicators that are taken into consideration in the decision-making process include the aggregate supply and demand equilibrium, indicators pertaining to the fiscal policy, developments in wages-employment-unit cost-productivity, pricing behaviors of the public and private sectors, inflation expectations, analysis of probable exogenous shocks and all of the in-house inflation forecasts.

In this framework, during the period between early-2002 (when implicit inflation targeting was adopted) and July 2005, the Central Bank acted in line with the decisions to bring interest rates down gradually. The main determinants of these decisions were favorable developments in relations with the EU and the IMF, and the gradual decline in both the risk premium and inflation expectations, stemming from the belief that the economic program would be implemented without making any concessions in fiscal discipline and structural reforms. Moreover, the Central Bank emphasized its cautious stance as data announced towards the second half of 2005 gave mixed signals about domestic demand and future inflation. In this framework, the Central Bank did not make any changes in interest rates in July, August and September and kept overnight borrowing interest rates unchanged at 14.25 percent. Short-term interest rates were reduced in October and November, by 25 percentage points each time. Thus, rates were set as 13.75 percent as of November, as data announced at that time indicated there was increased probability that inflationary pressure stemming from demand developments would remain limited, and since the uncertainties regarding the start of the negotiations with the EU had eased (Graph 4.1.1).

Graph 4.1.1. Interest Rates Developments



Source: CBRT.

Central Bank decisions on interest rates are expected to affect inflation via long-term interest rates and thus through investment and consumption decisions and pricing behavior that are shaped by the amount of loans, exchange rates and expectations. This is mainly related to the efficiency of the transmission mechanism and the credibility of monetary policy implementations. In fact, in economies that are more susceptible to shocks due to fiscal dominance, the presence of high and volatile risk premium reduces the efficiency of the transmission mechanism. This also constitutes an obstacle to the establishment of the positive and strong relationship that ought to be present between short-term interest rates – which are monetary policy tools – and market interest rates. Secondly, the credibility of the central bank and the strength of its signals affect the efficiency of interest rate decisions.

It is possible to say that the efficiency of Central Bank's interest rate decisions within the transmission mechanism is gradually increasing.

In this framework, considering the situation in Turkey, it is possible to say that the efficiency of the Central Bank's interest rate decisions within the transmission mechanism is gradually increasing. However, the high and volatile risk premium, which especially stemmed from concerns regarding the sustainability of the public debt stock, created by the policies pursued in the past, limits the effect of the Central Bank's short-term interest rate decisions on long-term interest rates. In other words, although market interest rates follow a course parallel to Central Bank interest rates, they may be below or above Central

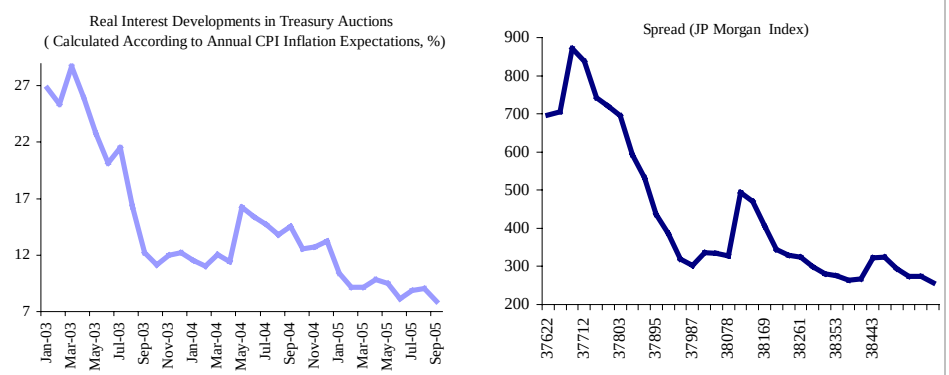
Bank interest rates when risk perceptions change. For instance, negative expectations or unfavorable news regarding internal political tension, relations with the EU or the IMF, global liquidity conditions or oil prices may lift secondary market interest rates above Central Bank interest rates. A recent example of this was the decline of secondary market interest rates below Central Bank interest rates, as a result of the positive expectations prior to 3 October 2005, for the start of negotiations with the EU, the diminishing concerns afterwards, accompanied by the enhanced confidence created by the implementation of the current program (Graph 4.1.1).

The gradual reduction made by the Central Bank in short-term interest rates, from 59 percent at the beginning of 2002, to 13.75 percent, already points to the remarkable decline.

At this point, it is necessary to address the occasionally received criticism that the level of Central Bank interest rates are too high, due to the appreciation of the YTL caused by the continuation of the FX inflow. As it is emphasized above, the Central Bank makes its decisions on interest rates mainly by considering probable developments in inflation in the upcoming period and announces the rationale behind its decisions to the public in detail. In this context, the gradual reduction made by the Central Bank in short-term interest rates, which were pushed down to 13.75 percent from 59 percent at the beginning of 2002, already points to a remarkable decline. Certainly, what lie behind this are positive expectations on the course of the economy. Furthermore, when compared to Brazil, which is going through a structural reform process similar to that of Turkey, it also indicates that the interest rate level is not that high.[2] Therefore, it is misleading to try to explain the dense FX inflows with the difference between the real interest rates alone. In conclusion, the reduction made by the Central Bank in short-term interest rates is not in itself sufficient for a decline in long-term interest rates; this can be achieved with a permanent decline in the risk premium. This kind of decline in the risk premium is mainly related to the resolute implementation of fiscal discipline and structural reforms. Turkey has made significant progress in this area. The first impacts were seen in the downward trend in nominal and real interest rates, albeit their still high levels. Moreover, the spread, which is calculated as the difference between the interest rates of the government securities issued in international markets and those of the benchmark US bonds and considered as an indicator of the risk premium for a country, decreased as well (Graph 4.1.2).

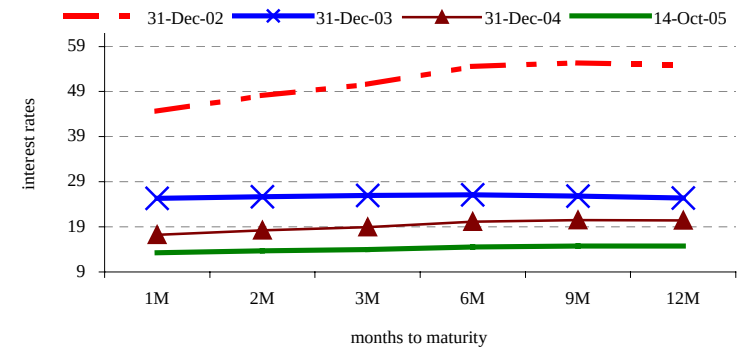
[2] As of August 2005, CBRT real interest rates were approximately 4.50 points below the real interest rates of Brazil.

Graph 4.1.2. Treasury Auctions Real Interest Rate and Risk Premium



The yield curves indicating the interest rates of the government securities in different maturities from 2002 onwards also support these developments. Yield curves shifted downwards in all maturities, while the breaking point disappeared gradually from 2002 onwards. In other words, in the periods where the program started to be implemented, economic agents assumed that even very short maturities carried with them uncertainties and kept their expectations of interest rates high. However at this point, in 2005, agents do not think that interest rates can go far beyond short-term interest rates in the long run. To be more specific, there is a significant decline in risk perceptions (Graph 4.1.3).

Graph 4.1.3. Yield Curves



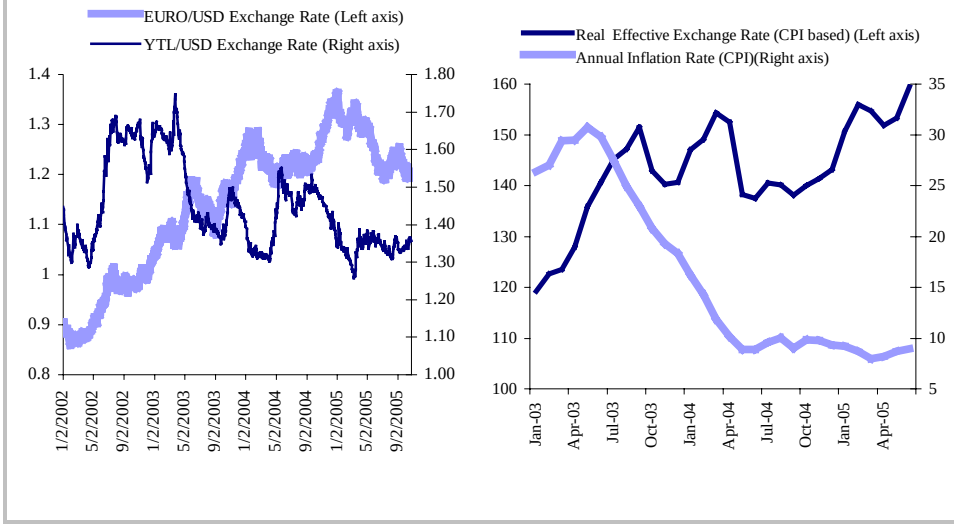
Source: CBRT.

4.2. CBRT's Exchange Rate Policy and Exchange Rate Developments

Under the floating exchange regime that has been in implementation since 2001, although the pass-through from exchange rates to inflation weakened, as the Turkish economy is an open economy, exchange rates do retain significance with regard to inflation. Furthermore, exchange rate developments are an inseparable part of financial stability. For this reason, the Central Bank monitors exchange rate developments closely. Within this framework, when exchange rate developments are analyzed, it is seen that YTL has been in a process of appreciation, which became more evident from the last quarter of 2004 onwards. The determining factors that led to the appreciation of YTL are capital inflows and the fact that residents changed their preferences in favor of domestic currency while building up their domestic portfolios. These two factors basically stemmed from the determined implementation of the economic program, which is based on the continuation of fiscal and monetary discipline and structural reforms put into practice following the 2001 crisis. Other factors that contributed to the appreciation of YTL are ongoing economic recovery stemming from inflation and growth performance, continuing optimism about relations with the IMF and EU albeit occasional uncertainties, as well as favorable international liquidity conditions for developing countries. Considering the developments from September onwards, it is seen that uncertainties regarding the start of the negotiations between Turkey and the EU, and developments in the Euro/US dollar parity had strong impacts. In the event that positive economic expectations continue and macroeconomic stability does not deteriorate in the upcoming periods, YTL will naturally maintain its strong position. Continuation of the structural reforms and completion of the necessary legal process for this will affect not only the course of relations with the IMF, but also the international investors' attitude towards Turkey and thus, will have a key role in terms of the strong position of YTL (Graph 4.2.1) (Box 4.1).

Continuation of the structural reforms and completion of the necessary legal process for this will have a key role in terms of the strong position of YTL.

Graph 4.2.1. Exchange Rate Developments



In the framework of the floating exchange rate regime, exchange rates are set according to supply-demand conditions in the FX market. However, at the beginning of 2002, the Central Bank announced that it may intervene in the FX market directly albeit in a limited manner, in the event of excess volatility that might occur in either direction. Meanwhile, the public sector' s debt repayment timetable for the external debt and the plans pertaining to the liquidation of Foreign Currency Deposit Accounts with Credit Letter in the long run, increase the significance of the level of Central Bank' s FX reserves. Furthermore, the high level of FX reserves is an important aggregate as it somewhat manifests the credibility of the Central Bank, as well as its staying power against shocks and crises. In this respect, the Central Bank announced from the start of the program that in order to strengthen its FX reserves, it might hold FX buying auctions, in connection with the strong balance of payments position and developments in reverse currency substitution, without affecting the long-term equilibrium of exchange rates. In this context, in order to minimize the effects of the FX buying auctions on the FX market, the Central Bank issued an annual program on 22 December 2004 and announced that it would be implemented as set out, unless extraordinary changes occur in FX liquidity. In this framework, the daily auction amount was set as US dollar 15 million from 22 December 2004 onwards and throughout 2005. Furthermore, the winner institutions were given an additional optional selling right over the average price

realized in the auction, as much as 200 percent of the total amount sold in the auction by the institution, and thereby the total auction amount was limited to US dollar 45 million at the most.

In this context, the Central Bank made five direct purchases in the FX market in the January-October 2005 period. The last intervention, dated 4 October 2005, was to prevent current and potential excessive volatilities stemming from the start of EU accession negotiations. The FX buying auctions held to build up reserves continued to be made on a regular basis, as laid out in the announcement on Monetary and Exchange Rate Policy for 2005. FX reserves of the Central Bank reached US dollar 44 billion as of 14 October 2005.

4.3. Banking and Credit Developments

Developments in the banking sector and credits include important information about the continuation of financial stability and the future trend of inflation. In the first half of 2005, the upward trend in the credit volume of banks continued to be observed, especially in housing loans. In the third quarter of 2005, the credit volume of banks maintains its upward course led by housing loans (Table 4.3.1).

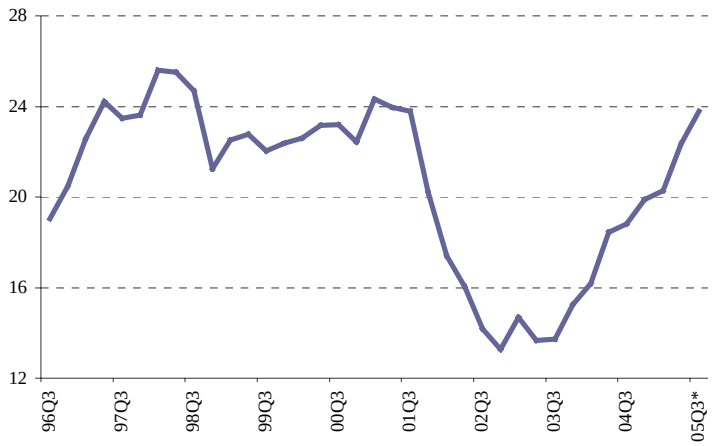
Table 4.3.1. Development of Consumer Loans and Claims from Credit Cards
(Quarterly Percentage Change in Real Terms)

	2004Q3	2004Q4	2005Q1	2005Q2	2005Q3
Consumer Loans	7,7	4.0	17.6	23.4	23.3
Housing Loans	12,4	9.1	33.7	61.9	50,6
Vehicle Loans	4,5	0.7	-0.7	11.7	11.4
Other Loans	8,3	4.4	23.8	11.7	11.3
Credit Cards	14,6	25.5	-2.4	8.4	6,3

Source: CBRT.

Credit volume maintains its rising tendency as a result of the restructuring of the financial system, positive effects on macroeconomic expectations of the converging with the EU, the eagerness of foreign banks to expand their individual loan bases in the country and the efforts of domestic banks to protect their consumer bases (Graph 4.3.1). Moreover, as a result of the successful implementation of budgetary discipline, the public sector began to borrow from the banking sector in a much more limited fashion. The growth rate of credits is supported by the factors mentioned above, as well as the banks' efforts to protect their profitability, in the face of narrowing interest rate margins.

Graph 4.3.1. Credits Extended to Real Sector/GNP (percent)



*Estimated figures are used for the GNP in the third quarter of 2005.
Source: CBRT.

The upward trend of consumer loans mainly stemmed from the loans given by private and foreign banks recently (Table 4.3.2). The acceleration of loans expands the production capacity of the economy by increasing investments on one hand, while supporting domestic demand by increasing private consumption on the other. However, the high level of credit repayments to be made by households is expected to limit the growth rates of private consumption and domestic demand in the upcoming period.

Table 4.3.2. Distribution of Consumer Loans According to Bank Groups
(Nominal Monthly Percentage Change)

	Consumer Loans	Public Banks	Private Banks	Foreign Banks*
December 2004	4.1	2.1	4.6	7.8
January 2005	1.0	-0.9	1.7	3.3
February 2005	10.9	26.3	3.3	6.5
March 2005	5.8	2.0	7.8	9.7
April 2005	9.5	5.7	11.6	11.2
May 2005	6.8	3.9	8.7	5.7
June 2005	7.4	3.6	9.1	9.7
July 2005	9.3	2.7	9.9	29.4
August 2005	6.3	3.4	8.1	6.1
September 2005	7.2	5.2	8.4	6.0

*The high increase observed in the consumer loans of foreign banks in July stemmed from the fact that Dışbank attained the status of a foreign bank.
Source: CBRT.

Due to the excess liquidity in the markets that persists because of the FX purchases of the Central Bank and the decline in loan interest rates, loans are also expected to maintain their acceleration in the upcoming periods. With a medium-term perspective, the Central Bank continues to monitor the growth rate of bank loans closely, especially housing loans.

Although the acceleration in housing loans is under surveillance, it is not deemed to be a factor of fragility in the short-term. Having said that, for the medium-term, the uncertainties as to housing loans increase due to the facts that the banks' experience of housing loans and customer information are limited and the belief of households that housing prices will continuously increase. However, unlike other countries experiencing a rapidly increasing supply of housing loans, the amount of FX denominated-loans used by households remains limited in Turkey. This indicates that the exchange rate risk taken by households is quite limited.

The Central Bank continues to monitor the acceleration in bank loans closely, especially that of the housing loans.

Having said that, considering that the acceleration in credits has been a long-lasting trend in other countries also going through the EU process and that housing loans based on mortgages will be put into practice in the coming year, attaching particular significance and weight to policies that will increase the housing supply is important in terms of macroeconomic stability. In this framework, the Housing Development Administration of Turkey and local authorities providing infrastructure services have important responsibilities.

BOX 4.1. DE-DOLLARIZATION PROCESS AND TURKEY

In its simplest meaning, dollarization is defined as the situation in which economic agents hold foreign currency and assets denominated in foreign currency. The high inflation environment caused by macroeconomic instability leads economic agents to holding assets in foreign currency by stimulating their motivation to diversify their portfolios and to protect the value of financial assets against the depreciation of the domestic currency. Furthermore, in such an environment, firms, households and governments borrow in terms of foreign currency from both domestic and foreign sources. With all these features, dollarization is a specific characteristic of many developing countries.

There are various definitions of dollarization in economic literature. **Asset Dollarization** is defined as the situation in which a foreign currency performs one or all of the functions (unit of account, medium of exchange and store of value functions) expected from a domestic currency. Traditional dollarization literature considers the share of FX deposits in total deposits or in broad money supply (M2Y) as an indicator of the dollarization level in a country.[1] Co-utilization of foreign currency and the domestic currency as the medium of payment and the unit of account is also considered as an indicator of currency substitution.[2] Having said that, the best indicator for asset dollarization in a country is believed to be the *share of foreign currency-portfolio of households and firms (non-banking sector) in the total portfolio*. In this framework, depending on the availability of data, the degree of asset dollarization (v*) in Turkey is calculated as below: [3]

$$\text{Degree of Asset Dollarization } (v^*) = \frac{\text{FX Portfolio}}{\text{Total Portfolio}} = \frac{\text{FX Banknotes + FX Deposits+ FX and FX-indexed Government Domestic Debt Instruments + Eurobond + FX Mutual Funds + FX SFH Participation Account + Foreign Equities and Assets + Other Assets}}{\text{Currency in Circulation + Deposits + Government Domestic Debt Instruments + Mutual Funds + SFH Participation Account + Equities, Insurance and Other Assets + Repo}}$$

In addition to asset dollarization, residents' liabilities to residents and/or to non-residents in terms of foreign currency are defined as **Liability Dollarization** in literature. The "Liability Dollarization" literature, which appeared especially after the Asian crisis, together with the third generation crisis models[4] towards the end of the 1990s, suggests that the foreign exchange denominated items listed in the balance sheets of the sectors in the economy can be important indicators for the determination of the degree of dollarization in a country.[5] This new literature has been frequently discussed in recent years, especially in terms of developing countries, which are dependent on foreign deposits and especially foreign credits, due to their current account deficits. Analyzing the experiences of other countries, it is seen that the banking sector tends to create FX assets to balance the FX items in the asset and liability sections of their balance sheets, against the FX assets of the non-banking sector and the foreign assets denominated in FX. Moreover, the degree of liability dollarization becomes an important indicator in cases where the public sector borrows in terms of foreign currency from domestic sources.

Following literature on the subject, some indicators are chosen by analyzing the liability sections of the balance sheets of economic agents and the degree of liability dollarization (y*) is computed for Turkey by calculating the weighted average of these indicators:

$$\text{The Degree of Liability Dollarization } (y^*) = \frac{\text{FX Credits}}{\text{Total Credits}} + \frac{\text{Foreign Exchange and FX-indexed Domestic Debt Stock}}{\text{Total Domestic Debt Stock}} + \frac{\text{Total External Debt Stock}}{\text{GDP}}$$

Although there is no clear and generally accepted definition for the measurement of financial dollarization in a country, the "composite dollarization index" defined by Reinhart et al. (2003) is an important indicator containing information for both asset and liability dollarization.[6] In this framework, the following method of calculation is believed to be appropriate for the composite dollarization index of the Turkish economy (d*), by taking into account the indicators of both the asset and liability structures of the balance sheets of economic agents: [7]

$$\text{Composite Dollarization Index } (d^*) = w_v{}^*v^* + w_y{}^*y^*$$

[1] Primarily, the FXD/M2Y ratio indicates only one dimension of dollarization and does not comprise investment instruments other than deposits. However, due to the lack of data, other studies in the literature generally use this definition.

[2] The difficulties in predicting the amount of foreign currency held by the non-banking sector in a country pose an obstacle to determining the level of currency substitution.

[3] FX Banknotes, Foreign Equities and Assets though originally planned to be included in the calculations, ended up being omitted, due to the lack of data.

[4] These models, which analyze the effects of liability dollarization on the economy – and which can be defined as a branch of the third generation crisis models -, emphasize the roles of balance sheet imbalances arising from currency mismatch, in financial crises.

[5] Calvo (2002), Krugman (2001), Aghion et al (2000).

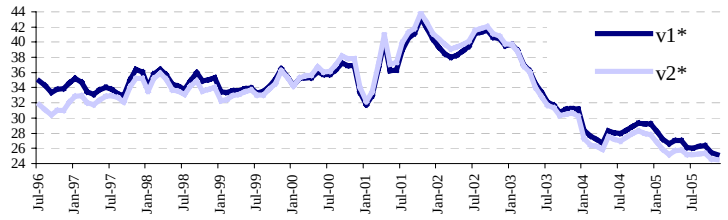
[6] In the article, an economy dominated by dollarization-is defined as an economy where part of the portfolios of the non-banking sector is composed of FX assets and/or public and private sectors borrowed in terms of foreign currency (from residents and/or non-residents). In this context, the composite dollarization index is calculated by using indicators such as the ratio of FX deposits (DTH) to broad money supply (M2Y), the ratio of total external debt stock to Gross Domestic Product (GDP) and the share of the Treasury's FX-denominated and/or FX-indexed domestic debt in the total domestic debt. The index is formed by the addition of the said ratios, after they have been normalized to a value of 10. Later on, the dollarization levels of countries are classified according to the index values, as low (0-3), medium (4-8), high (9-13) and very high (14-30). The mentioned index is the starting point for the composite dollarization index that is being attempted to be calculated for Turkey.

[7] Asset and liability dollarization levels are transformed into indices with 1997 as the base year. Later on, these indices are combined to form the composite dollarization index. Weights of the asset and liability sectors are equal in the composite dollarization index ($w_v = w_y$) and the geometric mean is used.

De-dollarization Process in Turkey

Asset dollarization displayed an upward trend in the 1990s as a result of the high inflationary periods in the history of the Turkish economy on one hand, and legal developments such as allowing residents to hold FX deposits in the Turkish banking system, in the framework of the liberalization of capital movements, on the other (Box 4.1. Graph 1). This trend increased significantly in 2001 due to financial crises as residents preferred FX-denominated investment instruments, which they considered safe. Furthermore, the stability program that has been implemented with determination since 2002 and helped reducing inflation to single-digit figures, is evidently successful in reversing the asset dollarization trend.[8] An important finding comprised by the constituted degree of the asset dollarization indicators is that the change in global liquidity perceptions observed in the Second Iraq War and in May 2004 was in the form of a halt in the de-dollarization process rather than the start of a new dollarization process.

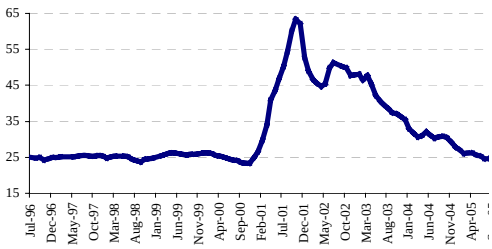
Box 4.1 Graph 1. Degree of Asset Dollarization (Jul.96-Nov.05)



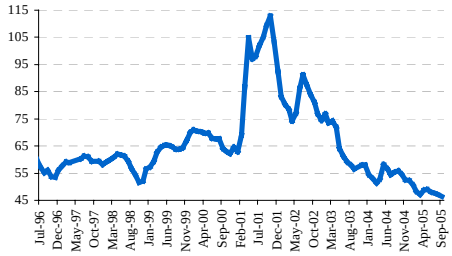
v1*: based on nominal YTL/USD exchange rate and nominal EURO/USD parity;
v2*: based nominal YTL/USD exchange rate and constant EURO/USD parity.

Liability dollarization displays a similar trend to that of asset dollarization (Box 4.1.Graph 2). Liability dollarization was 25 percent in the period from the 1990s to the 2001 financial crisis. The operation that was carried out as part of crisis management in order to strengthen the financial structure of the banking sector increased the Treasury's borrowing requirement. In this framework, The Treasury conducted a swap operation in June 2001. Moreover, degree of liability dollarization reached very high levels in 2001, also as a result of the external debt stock that increased remarkably. Having said that, as shown in Box 4.1. Graph 2, the level of liability dollarization displays a downward trend since the beginning of 2002.

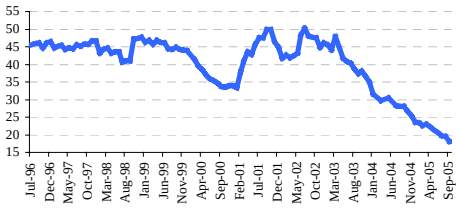
Box 4.1. Graph 2. Degree of Liability Dollarization, y* (nominal, percent)



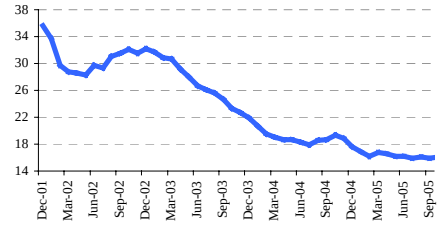
Box 4.1. Graph 3. External Debt Stock/ GDP (nominal, percent)



Box 4.1. Graph 4. FX Credits/ Total Credits (nominal, percent)



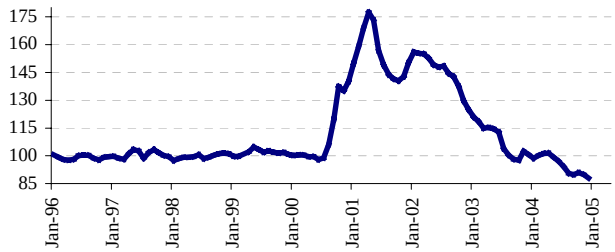
Box. 4.1. Graph 5. FX Denominated and FX Indexed Domestic Debt Stock/ Total Domestic Debt Stock



Thirdly, the composite dollarization index is calculated for Turkey and shown in Box 4.1. Graph 6.

[8] An important point that should be underlined here is that the asset dollarization indices may display a downward bias (appear lower than their actual values) as the aggregates such as the amount of foreign currency banknotes cannot be included in the analysis due to lack of data.

Box 4.1.Graph 6. Composite Dollarization Index
(Geometric average, 1997=100)



As seen in Box 4.1.Graph 6, one of the reflections of the economic program that has been implemented since the beginning of 2002 is the reversal in the dollarization trend. However, as stated by Reinhart et al. (2003) dollarization is still at high levels in the Turkish economy.

An important question is whether the de-dollarization process in Turkey will continue or not. Considering country experiences, it is seen that achieving financial stability, the independence of the central bank and the decline in inflation initially could not affect the inertia of the dollarization trend significantly. Reinhart et al. (2003), suggest that in the countries that experienced chronic inflation for years, a probable increase in inflation rates makes it difficult to break the inertia of the dollarization trend and hence, inflation rates should be kept at low and stable levels for a very long time in order to erase the memories of high inflation.

The pre-requisite of a long-lasting and comprehensive de-dollarization process is maintaining lasting monetary and financial stability in the long term. Furthermore, along with the belief that structural problems are completely solved, there is a need to diversify the instruments, which will protect the real values of the investments in domestic currency, and to build a maturity structure that ensures long-term protection as FX investments. Moreover, the formation and development of derivatives markets is very important for the countries where dollarization is at high levels. Reinhart et al. (2003) state that the two countries, which gained huge and long-lasting success with their determined economic policies in the de-dollarization process in the long run, are Israel and Poland. The experiences of the said countries are important because the negative effects of the de-dollarization process on financial intermediation and capital inflows were minimal in both cases.

Conditions for the de-dollarization process, which is expected to be healthy and long-lived in Turkey are rapidly maturing. These processes can be summarized as: i) monetary and financial stability, which have been continuing since 2002, ii) deepening of the markets for government securities and extending borrowing maturities; iii) increasing risk-averseness and the development of the Derivatives Exchange (Turkdex); iv) the new economic program that largely reduces the probability of inflation to reach high levels again, the convergence process with the EU and the ongoing reforms in this framework, vi) foreigners' YTL-denominated bond issues.

In conclusion, under the assumption that current economic and structural implementations will continue without main deviations in the upcoming periods, the Turkish economy is expected to display a similar development to that of the countries, which gained remarkable success in the de-dollarization process. Provided that steps are taken towards protecting the evident downward trend, significant success will be achieved in the fight against one of the (key) sources of fragility in the financial system; i.e. dollarization, in the medium and long term.

Source: Akıncı, Ö., Y. Barlas and B. Usta (2005), " Dollarization Indices: Indicators for the Dollarization Process in Turkey" (Dolarizasyon Endeksleri: Türkiye'deki Dolarizasyon Sürecine İlişkin Göstergeler), Central Bank of the Republic of Turkey, Working Paper No. 05/17.

5. Public Finance

In recent years, a significant distance has been covered in reducing fiscal dominance and establishing a stability environment. In the upcoming period, expectations should not deteriorate in order to maintain the achievements and to ensure the consistency between inflation realizations and targets in 2006 and afterwards. In this respect, the sustainability of fiscal discipline and structural reforms are still extremelly important.

In the January-September 2005 period, the consolidated budget primary balance produced a surplus of YTL 27 billion. This amount corresponds to a 12.1 percent increase compared to the same period of 2004. In the same period, the consolidated budget deficit decreased by 61.1 percent due to the decline in interest expenditures and was realized as 28.1 percent of the end-year target (Table 5.1). Meanwhile, high increases in primary expenditures restricted the increase in the primary budget surplus. The said adverse effect is more clearly observed in the primary surplus figures stipulated in the program. This unfavourable outcome arises from the exclusion of the dividend payments of state banks and interest revenues, which make up 6.3 percent of the revenues collected in the first nine months of 2005, from the program-defined consolidated budget revenues.

In the January-September 2005 period, consolidated budget primary balance increased by 12.1 percent compared to the same period of 2004.

Table 5.1. Consolidated Budget Aggregates

	Budget Figures (Million YTL)			Ratio of Figures to Initial Budget Appropriations [1] (Percentage)	
	2004	**2005**	**Percentage Increase**	**2004**	**2005**
	January-September	January-September	January-September	January-September	January-December
Revenues	79,778	95,525	19.7	72.1	75.5
Tax Revenues	64,851	77,817	20.0	72.0	73.0
Direct Taxes	19,842	22,951	15.7	70.8	82.9
Indirect Taxes	45,009	54,866	21.9	72.5	69.5
Non-Tax Revenues	12,840	14,998	16.8	73.4	87.0
Expenditures	100,858	103,718	2.8	71.5	66.6
Interest	45,176	35,235	-22.0	80.0	62.4
Non-Interest	55,683	68,483	23.0	65.9	69.0
Personnel	21,953	24,244	10.4	75.8	76.0
Goods and Services Procurement	5,244	7,393	41.0	41.3	51.2
Current Transfers	20,989	26,375	25.7	75.8	81.2
Social Security Institutions	14,800	18,050	22.0	76.6	82.1
Capital Expenditures	3,235	5,006	54.7	40.2	49.7
Budget Balance	-21,080	-8,193	-61.1	69.6	28.1
Primary Balance	24,095	27,042	12.2	92.0	99.0
Primary Balance (Program definition)	20,928	21,123	0.9	95.4	90.1

Source: Ministry of Finance.
[1] Shows the share in end-year figures for 2004.

In the first three quarters of 2005, the increase in primary expenditures exceeded the increase in revenues. The high increase in primary expenditures mainly resulted from the level of transfer expenditures to social security institutions. Meanwhile, subgroups of goods and services procurement and capital expenditures also yielded high rates of increase. However, in the budget realization forecasts for end-year 2005, announced by the Ministry of Finance in October, it is anticipated that both primary expenditures and primary expenditures excluding current transfers will not exceed the initial appropriations. Moreover, within the framework of the end-year forecasts of the Ministry of Finance, it is estimated that the consolidated budget primary surplus will exceed the end-year initial appropriation by YTL 4.5 billion and become YTL 31.8 billion. However, figures for the January-September period show that end-year figures of the program-defined consolidated budget primary surplus may remain below the expected level. Although the performance of the primary surplus stipulated by the program is below the expected level, end-year targets are not expected to deviate to such an extent that will damage expectations. This view is supported by the level of the program-defined primary surplus as of September as well as by the projection of the Ministry of Finance that end-year primary surplus expenditures will not manifest any deviation from the initial appropriation.

In the first three quarters of 2005, the increase in consolidated budget primary expenditures exceeded the increase in revenues.

It is of critical importance that the reforms to be made in areas of social security, public expenditures and taxes, which are aimed at permanently establishing fiscal discipline, should be prepared and put into effect without delay. As is known, structural adjustments in the social security system that feature on the reform agenda of the public sector are also included in the framework of structural conditionalities set out in the program undertaken with the IMF. In this framework, the Draft Law on Social Security and General Health Insurance, which includes adjustments regarding retirement reform, i.e. the performance criterion, was submitted for the approval of the Grand National Assembly of Turkey (GNAT) in April. Also, there are two more Draft Laws in the pipeline: The Draft Law on the Social Security Administrative Reform, which is a structural criterion adjusting the administrative structuring of the social security reform; and the Draft Law on Social Aid and Non-Premium Payments, which aims at the effective use of the resources allocated for social aid.

It is of critical importance that the structural reforms to be made in areas of social security, public expenditures and taxes, which are aimed to establish fiscal discipline permanently, should be prepared and implemented without any delay.

The Medium-Term Plan for the 2006-2008 period includes measures regarding public expenditures and the tax system.

The Medium-Term Plan for the 2006-2008 period involves measures regarding public expenditures and the tax system. In this respect, the reform on spending aims to increase effectiveness, transparency and accountability in public expenditures. In the framework of the Plan, strategies for an effective and simple tax system, supporting growth and employment and reducing the unregistered economy, have been put forward. In this context, it is intended to simplify income and corporation taxes and to expand the scope of income tax in the upcoming period, and also to cut the rates of corporation tax in 2006 and 2007. With the new implementation of taxes, the new withholding system will be put into effect for the taxation of securities as of January 2006. In the framework of the new system, interest income or trading proceeds of government papers issued as of January 2006 will be subject to a withholding tax of 15 percent.

Another significant issue that should be realized concurrently with tax and social security reforms in order to ensure the sustainability of fiscal discipline and resilience of fiscal policy is to record unregistered activities. Changes to be made in the tax system are aimed at reducing unregistered activities and tax evasion. In this context, the fight against the unregistered economy is the priority. In this framework, important initiatives have been undertaken to stop tax evasion on fuel oil in 2005.

With the new budget implementation to be put in to effect at the start of 2006, one of the structural reforms in public administration will be

With the new budget implementation to be put into effect at the start of 2006, one of the structural reforms in public administration will be brought into life. The multi annual central administration budget system, which has been prepared according to the Public Finance Administration and Control Law and is compatible with international standards, will be implemented. The new system aims at increasing transparency and enhancing supervision over the budget preparation and implementation process. The budget proposal for the 2006-2008 period prepared in this framework was submitted for the approval of the Grand National Assembly of Turkey on October 18, 2005. The new system includes the corporations and institutions that were previously excluded from the budget. In this framework, the central administration budget consists of budgets - in the scope of the general budget - of public authorities that carry out the principal functions of the state, institutions with a special budget, which are mainly made up of universities, and regulatory and supervisory agencies. In order to enable this implementation with increased transparency as targeted, it

is of great importance that the budget figures to be announced according to the new system and budget figures of previous periods should be provided in such a way that will allow for comparison.

5.1. Developments in Debt Stock

In the January-September 2005 period, the Treasury mainly resorted to net domestic borrowing in financing budget deficit, and was a net borrower in external borrowing. During this period, Savings Deposit Insurance Fund (SDIF) redemptions and transfers from privatization revenues contributed to the financing of the Treasury.

The public sector budget deficit can be financed via borrowing, resources other than borrowing or cash utilization. The amount and quality of borrowing determine the level of and structural change in debt stock. In the January-September 2005 period, net borrowing was realized above the financing requirement, and the strategy adopted was aimed at further increasing the cash reserves. The Treasury mainly resorted to net domestic borrowing in financing the budget deficit, and was a net payer in external borrowing. During this period, Savings Deposit Insurance Fund (SDIF) redemptions and transfers from privatization revenues contributed to the financing of the Treasury. Revenues provided from the said channels make up 23 percent of the financing requirement (Table 5.1.1). Similarly, it is anticipated that the SDIF redemptions and privatization revenues will ease public financing in the upcoming period.

Table 5.1.1. January-September 2005 Period, Consolidated Budget Financing

	Million YTL	Share %
Financing	10.334	100,0
Borrowing (Net)	17.201	166,5
External Borrowing (Net)	-2.592	-25,1
Domestic Borrowing (Net)	19.792	191,5
Privatization Revenues	1.773	17,2
Transfers from SDIF	640	6,2
Receipts from Onlending	92	0,9
Lending (-)	919	8,9
Currency/Deposit and Other Transactions*	-8.452	-81,8

Source: Treasury.
* Negative value indicates an increase.

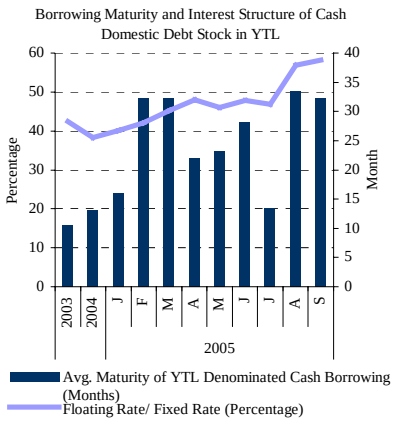
Starting from May, the Savings Deposit Insurance Fund has started to repay Treasury receivables stemming from the private placement securities issued as a loan to the SDIF in the framework of the financing of banking system restructuring. In the upcoming period, the SDIF will continue to repay its debts to the Treasury, depending on its collection performance.

Privatization implementations gained momentum in 2005.

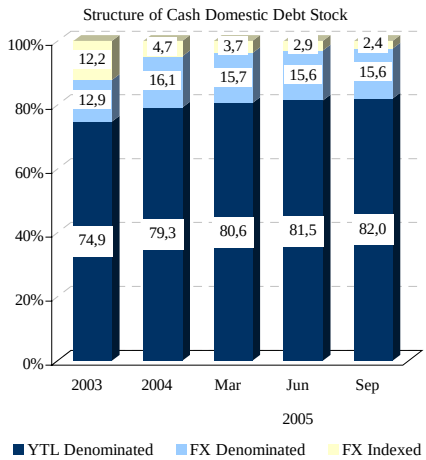
Privatization gained momentum in 2005. Including the Eregli Iron and Steel Enterprises Auction, the amount that was raised from privatization reached US dollar 17 billion by October 2005. In the upcoming period, a portion of the collected privatization revenues will be transferred to the Treasury. Pursuant to the Law No. 4568, which

was put into effect on 26 May 2000, privatization revenues are used for the expenses of the Privatization Fund in the first place, and the remaining cash amount is transferred to the Treasury for domestic and external debt payments (Box 5.1). Thus, the amount of privatization revenues to be transferred to the Treasury in the upcoming period will be determined in consideration of the expenses of the Turkish Privatization Administration. It is important that the said revenues obtained from sales of certain enterprises in public ownership are used mainly to enable a permanent improvement in the public balance. Reducing the public sector debt stock continues to be a significant issue in terms of maintaining economic stability. The level and structure of debt stock are the factors that restrict the effectiveness of monetary policy and reduce the resilience of fiscal policy. Although it has weakened since 2002, the said unfavorable effect that restricts monetary and fiscal policies is still felt to a certain extent. Under this circumstances, privatization revenues provide an opportunity to reduce debt stock and ease its sensitivity to exchange rate and interest rate movements. In the upcoming period, informing the public of the use of privatization revenues will be of great importance with respect to transparency.

Graph 5.1.1. Maturity of Cash Borrowing and Structure of Cash Domestic Debt Stock



Source: Treasury, CBRT.



Source: Treasury.

The improvement that has been observed in the structure of borrowing and debt stock since 2002 continued in 2005 in a significant manner. The increase in domestic and external borrowing maturities and the decrease in foreign debt stock were two significant developments observed in this period. The maturity of cash borrowing, which was 15

The improvement observed in the structure of borrowing and debt stock since 2002 continued in 2005 in a marked manner.

months in 2004, was extended to 27 months. Issuance of floating rate bonds with maturities of three and five years led to the increase observed in the maturity of domestic borrowing. The same process is also experienced in Turkish lira denominated cash borrowing. As a result of this process, the weight of floating rate bonds within the domestic debt stock is increasing (Graph 5.1.1, Table 5.1.2). Floating rate bonds are deemed to be risky since they leave debt stock susceptible to interest rate movements. However, issuance of these bonds is considered to be a favorable development owing to the relatively longer maturity of their capital and coupon payments. In addition, when compared to discounted fixed rate securities, floating rate bonds not only extended the borrowing maturity, but also provided the opportunity to benefit from the environment of decreasing interest rates. The ongoing fiscal dominance and approaching date of maturity of non-cash debt stock bring the importance of reducing the risk posed by debt stock and extending the maturity of debt stock into this framework. These favorable developments in cash borrowing are also reflected on the maturity of the cash debt stock (Table 5.1.2).

Table 5.1.2. Consolidated Budget Debt Stock – FX, Interest and Maturity Structure

	2002		2003		2004		2005 Eylül	
	Million YTL	%	Million YTL	%	Million YTL	%	Million YTL	%
Total Debt Stock	*242.707*	***100,0***	*282.894*	***100,0***	*316.471*	***100,0***	*329.634*	***100,0***
Domestic Debt Stock	*149.870*	***61,7***	*194.387*	***68,7***	*224.483*	***70,9***	*243.207*	***73,8***
TL	101.694	**41,9**	151.790	**53,7**	185.020	**58,5**	204.446	**62,0**
Fixed	37.576	**15,5**	68.614	**24,3**	94.930	**30,0**	97.820	**29,7**
Variable	64.118	**26,4**	83.175	**29,4**	90.090	**28,5**	106.626	**32,3**
Foreign exch./ FX-Indexed	48.176	**19,8**	42.597	**15,1**	39.463	**12,5**	38.761	**11,8**
Fixed	16.814	**6,9**	16.418	**5,8**	20.642	**6,5**	10.271	**3,1**
Variable	31.362	**12,9**	26.179	**9,3**	18.821	**5,9**	28.489	**8,6**
External Debt Stock	*92.837*	***38,3***	*88.507*	***31,3***	*91.989*	***29,1***	*86.427*	***26,2***
Fixed	54.808	**22,6**	53.244	**18,8**	54.756	**17,3**	54.048	**16,4**
Variable	38.030	**15,7**	35.263	**12,5**	37.233	**11,8**	32.379	**9,8**
	Ay	%	Ay	%	Ay	%	Ay	%
Domestic Debt Stock. Maturity	*32.1*	***100,0***	*25.1*	***100,0***	*20.6*	***100,0***	*22.5*	***100,0***
Cash	12.8	**59,6**	12.4	**67,1**	11.8	**73,8**	17.7	**77,6**
Non-cash	60.4	**40,4**	51.2	**32,9**	45.5	**26,2**	39.0	**22,4**
Domestic Borrowing Maturity	*20.6*	***100,0***	*18.1*	***100,0***	*17.3*	***100,0***	*27.0*	***100,0***
Cash	11.1	**80,4**	14.7	**90,5**	15.0	**96,1**	27.0	**100,0**
Non-cash	59.5	**19,6**	50.4	**9,5**	73.9	**3,9**	0.0	**0,0**
US Dollar Buying Rate	1,63450		1,39584		1,34210		1,34060	

Source: Treasury.

In 2005, 11.8 percent of the domestic debt stock is composed of foreign exchange denominated and foreign exchange-indexed securities.

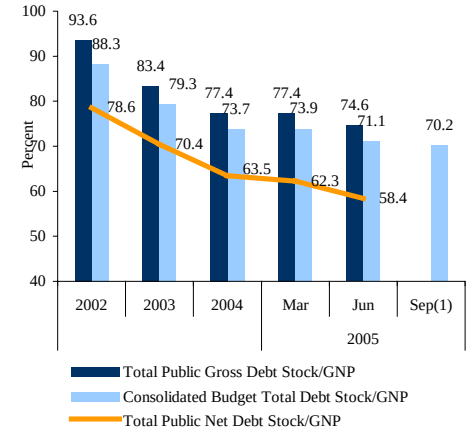
In 2005, in line with the borrowing strategy determined by the Treasury, domestic borrowing was mainly realized in New Turkish lira denominations. However restricted it may be, borrowing in foreign exchange denominations has slackened the downward movement of

shares of foreign exchange denominated and foreign exchange-indexed securities in debt stock (Graph 5.1.1). As a result of this implementation, foreign exchange denominated and foreign exchange-indexed securities reached 11.8 percent of the domestic debt stock in 2005.

As of June 2005, the ratio of total gross public debt stock and consolidated budget debt stock to GNP decreased by 2.8 and 2.7 points compared to end-2004 and became 74.6 and 71.1 percent, respectively (Graph 5.1.2). In the second quarter of 2005, it is observed that the net total public debt stock decreased at a more accelerated pace compared to gross debt stock aggregates, due to the increase in Central Bank reserves and public deposits. In the third quarter of 2005, the ratio of Consolidated Budget Debt Stock to GNP is expected to decrease to 70 percent. Consolidated budget total debt stock, which makes up approximately 95 percent of total public debt stock, increased by 4.2 percent in September compared to end-2004. During this period, the amount of net borrowing was rather low compared to previous years, due to the fall in interest rates and the high level of primary surplus. The increase in consolidated debt stock resulted from net domestic borrowing. As emphasized before, the Treasury was a net foreign debt payer in the January-September 2005 period. In this period, the impact of the exchange rate on debt stock was limited (Table 5.1.2, Graph 5.1.2).

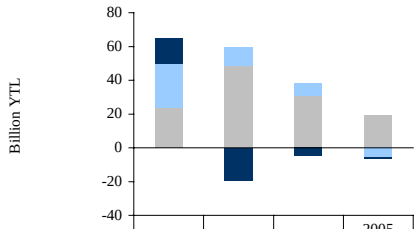
As of June 2005, the ratio of total gross public debt stock and consolidated budget debt stock to GNP became 74.6 and 71.1 percent, respectively.

Graph 5.1.2. Public Sector Debt Stock Aggregates



(1) Expectation.
Source: Treasury, CBRT.

Analysis of the Change in Consolidated Budget Total Debt Stock



	2002	2003	2004	2005 Sep(2)
Total Exchange Rate Effect(1)	14.9	-19.4	-4.7	-0.9
Net Foreign Borrowing	26.0	10.8	7.2	-5.5
Net Domestic Borrowing	23.9	48.8	31.2	19.5

(1)Does not include changes resulting from cross-rate movements.
(2) Shows the change compared to 2004.

BOX 5.1. PRIVATIZATION IMPLEMENTATIONS IN TURKEY[1]

Privatization implementations, which started in Turkey in 1980's, have been aimed to reduce the role of the state in industrial and trade activities to a minimum level. These implementations have also been planned to help reduce the financing burden of the State Economic Enterprises (SEE) on the state budget, form a market economy based on competitiveness, improve the capital market and increase effectiveness as well as productivity. Privatization has been on the agenda in Turkey since 1983, while privatization implementations started with the transfer of some unfinished facilities to the private sector in 1985. Total amount raised from the privatization implementations since 1985 has reached US dollar 17.8 billion (Box 5.1.Table 1). US dollar 8.2 billion of the said amount belongs to implementations carried out by way of sales and transfers in 2005. Including the privatizations, whose auctions have been completed but contracts are waiting for approval and signature, the amount raised from privatization in 2005 is US dollar 16.9 billion as of November. The Turkish Oil Refineries Company (TÜPRAŞ), Turk Telecommunications Inc. (Türk Telekom) and Eregli Iron and Steel Enterprises (ERDEMİR) are the main institutions privatized in 2005. Privatized large public enterprises will need a high amount of renewal investments in the coming periods. Considering the the high level of current public debt stock, keeping these enterprises in the public sector would significantly increase the public sector's need for resource. Privatization of such enterprises is expected to contribute to the continuation of productivity in the economy via allowing the private sector to make the renewal investments.

As is seen, privatization implementations gained momentum in 2005. Including the enterprises that wait for approval and signature, total amount raised from sales of privatized enterprises exceeded the privatization revenues raised in the 1986-2004 period. Privatizations belonging to the 1985-2005 period were mainly made with the block sale method (Box 5.1.Table 1).

Box 5.1.Table 1. Privatization Operations belonging to the 1986 - 2005 Period (Million dollars)(*)

	1986 - 2003		2004		2005(**)		TOTAL	
	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)
Block Sales	3,524	43.1	400	31.5	7,054	85.9	11,053	61.9
Facility/Asset Sales	863	10.6	607	47.9	399	4.9	1,.927	10.8
Public Offering	2,669	32.7	191	15.1	274	3.3	3,182	17.8
Istanbul Stock Excchange (ISE) Sales	801	9.8	0	0.0	454	5.5	1,.265	7.1
Unfinished Facility Sales	4	0.1	0	0.0	0	0.0	4	0.0
Value Transfers	308	3.8	69	5.5	27	0.3	414	2.3
TOTAL	8,170	100.0	1,267	100.0	8,208	100.0	17,845	100.0

Source: Turkish Privatization Administration.

(*) Figures shown in the tables are sales figures of the amounts raised from implementations in the related years.

(**)Figures for the amounts raised from privatization of intitutions whose sale/transfer procedure has been completed as of November.

[1] For more detailed information about privatization implementations, see Turkish Privatization Administration, 2005, Privatization Implementations in Turkey. Available on http://www.oib.gov.tr/program/turkiyede_ozellestirme.htm.

Box 5.1. Table 2 shows the resources and expenditure figures of the Turkish Privatization Administration belonging to the 1985-2004 period. In the said period, total amount of resources of the Turkish Privatization Administration was registered as US dollar 14.3 billion, US dollar 8.6 billion of which belonged to privatization collections. 74 percent of the acquired resources was used for debt payments of enterprises within the scope of privatization as well as for privatization expenditures[2], while 24.5 percent of them was transferred to the Treasury. However, privatization revenues were not transferred to the Treasury in 2003 and 2004. Including those to be raised from the enterprises waiting for approval and signature, privatization revenues have reached high levels in 2005. However, the whole of privatization revenues will not be collected in the period the sales procedure is completed, since there will be the option to pay in installments.[3] It is planned that the privatization implementations will continue in the upcoming period. In the framework of the Medium Term Program, the target amount of privatization revenues for the 2006-2008 period is set at US dollar 9 billion.

Box 5.1.Table 2. 1986-2004 Period Privatization Administration Resources-Expenditures Table (Millon dollars) (*)

	1986 - 2002	2003	2004	TOTAL	(%)
Resources	**11,199.7**	**487.2**	**2,633.6**	**14,320.5**	**100.0**
Collections Obtained from Privatization Procedures	7,225.9	255.1	1,133.7	8,614.7	60.2
Revenues from Sales of Pledged Securities	60.4	0.0	0.0	60.4	0.4
Dividend Income	2,068.1	63.1	223.3	2,354.5	16.4
Debt Principal Collections Obtained from Enterprises within the Sphere of the Privatization Administration	39.9	15.2	3.9	59.0	0.4
Interest Income from Debts/Bonds Granted to Enterprises within the Sphere of the Privatization Administration	17.7	0.7	0.0	18.3	0.1
Other Revenues	73.7	17.9	14.5	106.0	0.7
Borrowing	1,714.0	135.3	1,258.2	3,107.4	21.7
Expenditures	**10,958.8**	**494.1**	**2,428.5**	**13,881.4**	**100.0**
Payments Related to Enterprises within the Sphere of the Privatization Administration	5,276.0	385.9	464.5	6,126.3	44.1
Payments Related to Privatization Implementations	239.0	4.8	8.1	251.9	1.8
Debt Payments	1,915.6	91.2	1,930.6	3,937.5	28.4
Other Expenditures	3,528.2	12.1	25.3	3,565.7	25.7
Transfers to the Treasury	3,403.8	0.0	0.0	3,403.8	24.5

Source: Turkish Privatization Administration

(*) Figures in this table show cash amounts of inflows and outflows in the Privatization Fund Account as well as in other special accounts related to privatization implementations

[2] Payments to the institutions within the scope of privatization consist of capital equities, granted credits, compensation for damages stemming from loss of job, payments of post-privatization compensations and retirement premium.

[3] US dollar 1.3 billion of the total amount of US dollar 6.5 billion raised from the privatziation of the Turk Telecommunications Inc., whose sales procedures were completed in November 2005, was collected in cash in November. The remaining amount has been divided into installments extending up to 5 years.

6. Outlook

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

6.1. Supply and Demand Factors

The revival in investment expenditures was more evident than the upsurge in consumption expenditures in the second quarter of 2005. During this period, the contribution of investment expenditures to total domestic demand composition outpaced that of consumption expenditures despite the considerably high share of consumption expenditures within the total final expenditures. Meanwhile, high-rated increases in construction investments and in sectors providing input to the construction sector continued. Data on construction permits and manufacturing industry production show that the said trend also continued in the third quarter of the year. The rapid rise observed in domestic sales of commercial vehicles in the third quarter bolstered the momentum of the investment tendency. Moreover, CBRT BTS data show that the downward trend observed in the investment expenditure tendency since the start of the year reversed in September providing a positive signal for investor confidence.

The ongoing investment-led economic growth enables the continuance of increases in productivity and thus, the restriction of inflationary pressures through unit labor costs. Moreover, it is estimated that the current level of production is still below the potential level, while capacity utilization is at an acceptable level. Meanwhile, the unemployment rate is still high and its restrictive effect on wage increases continues.

Data in the CBRT BTS and consumer surveys show that the upward trend in consumption expenditures persists in the last period, but in a more controlled manner compared to last year. However, another factor that deserves attention in the upcoming period is the continued expansion in credits, which is a significant indicator of domestic demand. High increases in credit utilization lead especially to the acceleration of consumption demand for certain goods groups at certain

times. However, due to the current income policy, the fact that incomes have been increasing in a controlled fashion strengthen the likelihood that the rapid expansion in credits will restrict consumption in the following period.

In sum, latest developments and indicators for the next period show that the supply-demand equilibrium has not reached a level that would create inflationary pressure. Here, the main point that needs further emphasis is the necessity to maintain the upward trend in investments in order to sustain non-inflationary rapid growth. In this way, it will be possible to sustain increases in productivity and restrict the inflationary pressures created by the revival in economic activity. In the recent period, both the decline in medium and long-term interest rates and the tendencies of leading indicators indicate that the increase in investments will continue, which is deemed to be a positive signal for future inflation and growth.

6.2. Cost Factors

6.2.a. Commodity Prices

In the first three quarters of 2005, the upward trend in crude oil prices continued. Prices increased particularly due to the shortfall in supply which could not keep up with increased demand for crude oil resulting from the rapid course of global growth. Having said that, crude oil prices decreased in October and November. However, it is difficult to gauge the future course of crude oil prices, which are still at a high level. In this respect, likely increases in crude oil prices should be considered as a significant risk factor.

The primary effects on inflation arising from oil price increases during the previous year are estimated to be around 1.5 points, and do not pose any risk to the end-year target for 2005. The downward trend observed in crude oil prices in October and November helped reduce the unfavorable "primary" effects of oil prices on inflation originating from input costs. The increase observed in oil prices in 2005 was not completely reflected in the domestic market, owing to the strong position of the New Turkish lira. Nevertheless, considering the fact that high price levels could also persist also in 2006, it is obvious that the "secondary" effects likely to arise via the expectations channel constitute an important risk factor for medium term inflation.

In the prevailing period, both the CBRT Expectations Survey and CBRT BTS indicators point out to a continuation of a decline in inflation expectations for the next twelve months. In this context, it can be said that high levels of oil prices are not thought to be permanent and do not affect expectations. However, the likelihood that oil price increases may prove to be permanent stands as a significant risk factor. For this reason, the course of crude oil prices in the upcoming period is deemed to be a crucial risk factor for the 2006 inflation target, which makes the management of expectations even more important in the following period.

6.2.b. Wages

Productivity increases are also expected to continue in the third quarter of 2005. It is anticipated that productivity will continue to increase in the next period, as the increase in production outpaced the rate of increase in employment and the increase in investment expenditures continued.

Increases in the salaries of civil servants are expected to be around 12.7 percent on average in 2006. Meanwhile, increases to be made in wages of public sector employees next year have been set so as to be consistent with the inflation target. Since wage increases in the private sector are generally made in line with wage increases of public sector workers, the impact of such increases to civil servants on domestic demand is anticipated to be rather limited. Thus, wages are not expected to exert any cost pressure in 2006.

6.3. Exogenous Factors Affecting Inflation

In developed countries, long-term interest rates have declined to historically low levels in recent years, and this decline has directed global funds to developing economies that have progressed in a stable manner. However, it is expected that the Federal Reserve Bank of USA will continue to increase interest rates in 2006. The said development is likely to adversely affect global liquidity conditions. In addition, the IMF projects in its World Economic Outlook Report that global liquidity conditions will be relatively worse for developing economies in 2006 compared to previous periods, and such countries will have relatively limited access to global liquidity resources. Such a development may

trigger a reversal in capital movements and lead to fluctuations in financial markets.

In the ongoing stabilization process of the Turkish economy, similar exogenous shocks were also observed in previous periods, but the impacts of these shocks were of short-term and temporary nature. The establishment of an environment of confidence and the marked improvement in expectations observed due to the successful and determined implementation of the stabilization program explain why these shocks did not have long-lasting effects. In this context, it is very important that the policies are implemented without any compromise in the upcoming period as well. In this way, the economy will be stronger in the face of likely fluctuations created by exogenous shocks, and the impacts of the said shocks will be restricted.

6.4. Monetary and Fiscal Discipline

The Central Bank will abandon implicit inflation targeting and adopt formal inflation targeting at the start of 2006. In order to establish consistency with monetary conditionality of the IMF-supported programs, targets for base money and net domestic assets will be replaced by inflation target indicators starting from 2006.

Floating exchange rate regime implementations will continue within the framework used so far and exchange rates will also continue to be determined in light of supply and demand conditions in the foreign exchange market in the upcoming period. Although the pass-through from exchange rate to inflation is gradually weakening, exchange rates still maintain their significance in terms of inflation performance, and exchange rate developments are still an indispensable part of financial stability. Therefore, the Central Bank will continue to closely monitor exchange rate developments. In this framework, foreign exchange buying auctions aimed at strengthening foreign exchange reserves will continue. Having high level of reserves is important in terms of increasing the credibility of the Central Bank as well as increasing the resilience of the economy to exogenous shocks. In addition to this, the Central Bank may directly intervene in the foreign exchange market in case of excessive fluctuations in exchange rates.

In the framework of formal inflation targeting, the Central Bank will make decisions about its main policy instrument, the short-term interest

rates by taking into account likely developments in future inflation, in order to achieve the primary objective of price stability. Here, it should be noted that the monetary transmission mechanism must operate effectively for the monetary policy to be implemented effectively. In other words, a change in Central Bank overnight interest rates needs to be properly perceived by economic agents. This, in turn, is directly related to ensuring that the interest rate decisions made by the Central Bank provide accurate signals to economic agents. In other words, it is closely related to the credibility of the Central Bank's policy implementations. At this stage, the Central Bank has made significant progress in the last four years and become increasingly more influential in shaping the expectations of economic units. In the upcoming new period, the Central Bank will continue to implement policies in a decisive manner within the framework of the selected monetary policy.

It is critical that fiscal discipline is sustained without making any compromise in the inflation targeting period. In the previous periods, many steps were taken to improve the structure of debt stock, and the cost of borrowing decreased while borrowing maturities were extended. Moreover, important developments were recorded regarding structural reforms. However, despite the significant steps towards the normalization process of the economy, concerns about the sustainability of the budget discipline in the long run have not yet been fully eased. In a period where the monetary transmission mechanism is gradually becoming more efficient, sustaining the reform process without any compromise is critical in terms of carrying out an uninterrupted normalization process and achieving sustainable high growth in the economy.

GRAPHS

TABLES

ABBREVIATIONS

AMA	Automotive Manufacturers Association
CBRT	Central Bank of the Republic of Turkey
CBRTBTS	CBRT Business Tendency Survey
CBRTPCI	CBRT Private Consumption Index
CPI	Consumer Price Index
DOE	Derivatives and Options Exchange
ERDEMİR	Eregli Iron and Steel Enterprises
EU	European Union
FX	Foreign Exchange
FXD	FX Deposit
GDBS	Government Domestic Borrowing Securities
GDP	Gross Domestic Product
GNAT	Grand National Assembly of Turkey
GNP	Gross National Product
IFS	International Financial Statistics
IMF	International Monetary Fund
ISE	Istanbul Stock Exchange
PPI	Producer Price Index
SCA	Special CPI Aggregates
SDIF	Saving Deposit Insurance Fund
SEE	State Economic Enterprises
SFH	Special Finance Houses
SIS	State Institute of Statistics
SPO	State Planning Organization
TEA	Turkish Exporters Assembly
TL	Turkish Lira
TÜPRAŞ	Turkish Oil Refineries Company
Türk Telekom	TurkTelecommunications Inc.
USA	United States of America
YTL	New Turkish Lira