MONETARY POLICY REPORT

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CENTRAL BANK OF THE
REPUBLIC OF TURKEY

CONTENTS

GENERAL ASSESSMENT

With respect to monetary policy implementations and economic developments, 2000 and 2001 differ notably from previous years. "Exchange Rate-Based Disinflation Program" introduced in December 1999 was the key element that shaped the framework of monetary policy and economic developments in 2000. The program aimed at increasing primary surplus via tight fiscal policy, realizing structural reforms, accelerating privatization and implementing an incomes policy consistent with the inflation target. However, the basic policy instruments of the program have been the exchange rate and monetary policy. In the beginning of 2000, exchange rate for the basket composed of 1 US$+0.77 Euro was announced by the Central Bank on a daily basis for a one-year period. In order to sustain the exchange rate regime, the Central Bank set net domestic assets, and the growth of balance sheet was determined by the increase in net foreign assets. This quasi currency board policy framework ruled out the possibility of sterilization, the liquidity expansion was linked to reserve build-up and restricted the flexibility of the Central Bank on short-term interest rates.

Though the inflation targets set forth in the program were not achieved in 2000, considerable progress was made against inflation. Inflation recessed to the lowest level of the past 14 years. Moreover, public finance was improved and significant structural reforms were realized.

Along with the decline in the exchange rate risk and the increased possibilities for the economic agents towards perfect foresight, interest rates fell sharply in 2000. The decrease in interest rates led to a burst in consumption and investment expenditures that were suspended due to rapid contraction in 1999, and allowed the economy to enter into a growth process. Thanks to the control of public expenditures and increase in the tax revenues owing to extra tax regulations, considerable improvement was observed in primary public balance. Consequently, domestic borrowing cost of the Treasury decreased and the growth in domestic debt stock was brought under control.

The November Crisis

However, recovery in domestic demand and increase in energy prices, mainly in crude oil, as well as the depreciation of the Turkish lira against Euro in real terms, which resulted in rapid increase in imports, led to deterioration of current account. While the rapid increase in current account deficit persisted, delays in privatization and structural reforms in the second half of the year increased the uncertainty in domestic and external markets. These developments triggered an increase in short-term interest rates, affecting both capital inflows and liquidity adversely. Owing to the delays in structural reforms and reluctance to take additional financial measures, the third tranche of the IMF credit that should be released in October was postponed, having a negative impact on prospects of international markets. Rise in interest rates deteriorated the financial positions of some banks, which hold large amounts of Treasury Bills and fund these bills via short-term resources and increased distrust in financial markets in the second half of November. Loss of confidence in these banks, where maturity mismatch was at high levels, caused rapid increase in their liquidity requirements, which caused short-term interest rates to rise above 100 percent in the November 17-22, 2000 period.

This enormous increase in short-term interest rates resulted in a sharp decline in government securities and stock prices. As a result, foreign investors tended to reduce their portfolios in Turkey. Though Net Domestic Assets and Net International Reserves targets were achieved until the mid-November, intense liquidity needs that arose in the financial system in November necessitated the Central Bank funding. Mainly Open Market Operations in the November 22 and 30, 2000 period provided the total of TL 3.9 quadrillion. Consequently, Net Domestic Assets target was exceeded. Additionally, due to the rise in foreign currency demand of domestic and foreign investor, the Central Bank should sell foreign currencies amounting to US$ 6 billion. Because of these developments, Net Domestic Assets and Net International Reserves targets were revised. Supplemental Reserve Facility extended by the IMF in December, short-term syndicated loan provided to the Treasury by international markets and additional structural and fiscal measures strengthening the program eased the financial *markets to some extent, and the revised targets were achieved at the end of the year.*

Monetary and exchange rate policies for 2001 were announced at the end of 2000. Accordingly, the exchange rate policy would be carried out within the same framework of pre-crisis. The predetermined daily exchange rate path announced for the January-June period as well as the "progressively widening band" around the central exchange rate path would remain the same. While the main principles of monetary policy for 2000 were maintained, new targets were set for Net Domestic Assets and Net International Reserves. Moreover, the +/- 5 corridor related to Net Domestic Assets was abandoned. Additionally, it was announced that the Central Bank would show certain flexibility in its interest rate policy and the monetary policy would be implemented more actively and efficiently.

Due to rapid rise in the Central Bank reserves in January, Net Domestic Assets decreased, taking once more negative values. Money market interest rates were declined, fluctuating within a narrow band. The Central Bank, in the light of these developments, reduced the Net Domestic Assets target, while raising the Net International Reserves target.

The February Crisis

Despite favorable developments in the Central Bank balance sheet, interest rates in primary and secondary markets maintained their high levels due to sharp increase in risk premium. Even though a relative recovery was observed in capital inflows, the damage caused by the November crisis on the banking sector, mainly on the state banks, increased the fragility of the system. During this period, the maturity of both domestic and foreign funds shortened. Interest rates remained high relative to the depreciation rate, which raised serious doubts on the sustainability of current exchange rate regime.

Towards the end of February, the unfavorable political developments preceding the Treasury auction caused panic in the markets that were already in a restless mood. Confidence in the markets was completely shaken and the Turkish lira faced a serious attack on February 19, 2001. The Central Bank tightened the liquidity in order to avoid the realization of the demand for US$ 7.6 billion registered for the next day. However, this development resulted in complete malfunctioning of payments system due to excessive daily liquidity needs of state banks. Parallel to these developments, due to potential negative impact of defense of the existing exchange rate policy on the economy, the exchange rate regime was abandoned in favor of a floating exchange rate regime on February 22, 2001.

The unfavorable developments of November and February have compelled the Central Bank to follow policies that have been formulated to re-establish stability in financial markets after the crisis. After the announcement of floating exchange rate regime, the Central Bank gave priority to re-establish a healthy payments system meeting the liquidity needs of the market. In this context, the Central Bank reduced buying and selling quotations in interbank money market and provided liquidity to the system, mainly the state banks and fund banks, via open market transactions. Moreover, the Central Bank provided necessary sources to the banking system to meet its foreign liabilities through the use of FX depos and FX sales. About US$ 2 billion was sold, the banks were provided with FX depo of approximately US$ 1 billion between February 22 and March 28. At the end of March, the Central Bank started multi-priced auctions in FX purchases and sales, in order to allow markets to fix exchange rates and to prevent excessive fluctuations as well.

Post-Crisis Macroeconomic Policies

In mid-March, general strategy of "Transition to Strong Economy Program" was announced. With this strategy, general framework of regulations in public finance, incomes policy, privatization, structural reforms and the banking sector was determined. In accordance with this strategy, priority would be given to reduce uncertainty in the markets and to restructure the banking system in order to withdraw from the crisis atmosphere. One of the main priorities was the resolution of overnight borrowing problems of state and fund banks that resulted in increase in interest rates and malfunctioning of markets during the February crisis. In this framework, the reduction in overnight borrowing needs with high inflation rates of state and fund banks from private banking and non-banking sector would be minimized and these borrowing needs would be met by the Central Bank.

The Treasury provided floating rate notes to state and fund banks against their capital requirements and claims arising from duty losses. The Central Bank directly purchased a portion of TL 14 quadrillion of these Treasury bonds and for the remaining part, repo facility was allowed. Accordingly, while 41 percent of overnight borrowing needs of state and fund banks amounting to TL 21.7 quadrillion was met by the Central Bank on March 16, 2001- the date on which the operation started - the share of the Central Bank rose to 96.8 percent as of May 31, 2001. This operation relieved the pressure of state and fund banks on the markets, led to decline in interest rates, lengthened the maturities, and caused a reduction in balance sheets of these banks. In order to eliminate the liquidity-increasing impact of the operation amounting to total TL 21.7 quadrillion, the Central Bank withdrew the excess liquidity via reverse-repo and FX sale. Additionally, the Treasury gave support to liquidity controls through its borrowings above its redemption. As a consequence, the impact of this excess increase in net domestic assets to the base money was prevented, and thus its inflationary impact was restricted.

In mid-April, "Transition to Strong Economy Program" was announced together with its measures and legal regulations. The program has emphasized on structural reforms and legal regulations rather than conjunctural policies. In this context, 15 regulations have been set forth for re-structuring of financial sector, increasing the transparency in state and strengthening of public finance, improving competitiveness and efficiency in economy and strengthening of social solidarity. These regulations involve Amendment to the Banking Act, the Central Bank Law, regulation on Closing of Extrabudgetary Funds, Expropriation Act, Telecom-Sugar-Tobacco-Natural Gas Laws and Law on Economic and Social Council. Upon the completion of preparatory studies and introduction of majority of these regulations, a new letter of intent was signed with the IMF on May 3, 2001 and was announced to the public.

Among the structural reforms, it is noteworthy that Central Bank Law was also approved. Pursuant to the Law, price stability was determined as the main goal of the Central Bank, and the Central Bank is to set the monetary policy autonomously. Moreover, Monetary Policy Committee was established. The Committee will set the inflation target in cooperation with the Government. Transparency and accountability are the main issues in the new law. In this context, the Central Bank will issue periodical reports on targets and implementations of monetary policy to be submitted to the public and the Government. Maastrich criterion has been adopted, prohibiting the Central Bank from extending credit to the Treasury and other public institutions. However, for so doing, six months were given as a transition period.

As a result of the "Transition to Strong Economy Program" and approval of the program policies by the IMF, an additional foreign financing of US$ 15.7 billion was extended by the IMF and the World Bank for the May-December 2001 period. It was adopted that the portion of US$ 9.6 billion of US$ 13.3 billion extended by the IMF would be extended to the Treasury through the Central Bank. Along with this supplementary foreign financing, it was set forth that the support of foreign private sector banks via increasing the credit lines to Turkey was essential. Thus, stability in exchange rate and interest rates would urgently be re-established so that the crisis would easily be overcome.

Post-Crisis Monetary Policy

The Central Bank announced the general framework of the monetary policy on May 15, 2001. Abandonment of the existing exchange rate regime necessitated changing of the monetary policy strategy. For this purpose, within the framework banking system restructuring and restricting the inflationary impact of rapid devaluation of the Turkish lira, a more active monetary policy has been designed. In this framework, a ceiling value for Net Domestic Assets and a floor value for the changes in Net International Reserves have been set. These values have been taken as performance criterion. Since the exchange rate anchor was abandoned, Base Money has been determined both as an intermediate target and a nominal anchor to provide a criterion to the economic agents to form their inflationary expectations. Since the crisis environment and rapid structural changes in financial markets led to uncertainties in the money demand and base money estimations, periodic base money ceilings would be indicative rather than performance criteria. The targeted rate of increase in base money would be consistent with inflation and growth projection, which indicated that *there would not be monetization and that the inflationary effects of devaluation would be restricted. Also, it was adopted that the short-term interest rates would be used actively to curb the inflationary pressures. It was also announced that once the preconditions are met, inflation targeting would be put into practice.*

As for exchange rate regime, the Central Bank announced that exchange rates would be determined in the market by supply and demand conditions, but would intervene in the markets only in the event of any sudden and temporary fluctuations. It has also been pointed out that these interventions would aim at preventing sudden and temporary shocks without affecting the long-term equilibrium value of exchange rate. Additionally, the programmed FX auctions have been initiated in order to eliminate the liquidity-increasing impact of utilization of the part of the IMF credit used by the Treasury for domestic financing.

In the second half of April, the Turkish lira began to appreciate and this tendency strengthened in May with the announcement of monetary program and favorable expectations stemmed from additional foreign financing. The Central Bank, considering the decrease of inflationary pressures reduced the interest rates rapidly in the ISE Repo-Reverse Repo and Interbank Money Markets in the second half of May. Simple annual overnight interest rates that were 77 percent on May 14, 2001 decreased to 63 percent at the end of May.

In this period, Treasury borrowing rates as well as secondary market rates tended to drop until the end of May. However, towards the end of May, amount of bids for Treasury auctions declined, while interest rates rose due to the Treasury's attempt to extend the maturity of borrowing. Discussions on a potential domestic debt swap and lowered borrowing of the Treasury that aimed at preventing the rise of interest rates increased concerns in the markets. In such an environment, among other reasons, since the reverse repo interest rates of the Central Bank were higher from that of Treasury domestic borrowing bills, banks preferred to lend to the Central Bank via reverse repos.

Higher level of the existing interest rates compared to program rates and resulting intensified concerns regarding the sustainability of public debts led to domestic debt swap in mid-June. Bills amounting to nominal TL 9.8 quadrillion that were due in about 6 months were swapped by T-bills with the average maturity 37.5 months; consequently, total of TL 6.4 quadrillion were saved from domestic debt services in 2001. FX-indexed bills significantly covered open foreign exchange position of the banking system, while the maturity of domestic debt stock was extended. Contrary to the expectations, Treasury borrowing rates and exchange rates rose after the swap operation due to political developments. Nonetheless, the Central Bank intervened directly in the foreign exchange markets without making any change in short-term interest rates.

Serious fluctuations were observed in money and foreign exchange markets in July. Due to the discussions on the management of Turk Telecom and delays in some structural regulations, the IMF meeting of July 3, 2001 regarding the credit tranche of US$ 1.6 billion to be extended to Turkey was suspended. This event led to an increase in interest rates in the secondary market for government securities creating uncertainty in the markets. The increased concerns about the Argentinean economy in the international markets, negative opinion of the S&P on Turkey's credit outlook resulted in the decline of prices of Turkish bills and capital outflows. While the compounded interest rates rose to 107.6 percent from 76.9 percent in the secondary market government securities between June 15 and July 12, the Turkish lira depreciated by 12.2 percent despite the FX sales of about TL 1.4 billion by the Central Bank. Nevertheless, a downward tendency was observed in interest rates soon after the IMF and the World Bank approved to extend the credit.

The Central Bank increased the overnight interest rate by 4 percent to 67 percent on July 16, 2000 to eliminate the excess liquidity and to reduce the inflationary impact of the increase in the foreign exchange rate caused by the developments in the Argentinean economy as well as the domestic political developments. Unsatisfactory bids to the Treasury auction that was held the day after and the rise of compounded interest rate to 105.5 percent increased doubts on the sustainability of domestic debts. Despite the rise in short-term interest rates, the said increase in the risk premium led to an increase in the exchange rates and massive FX sales by the Central Bank. Moreover, foreign loan repayments of the *banks in large amounts and securities sales by foreigners assumed significant roles in fluctuations in interest rates and exchange rates in July.*

At the end of July, government securities of TL 13.8 quadrillion with one-year maturity, interest payable on a 3-month basis held by the Central Bank, were swapped by the bonds with 2-6 year maturity, interest payable on one-year basis. Consequently, the Treasury made significant savings in domestic debt services for 2001 and 2002, but an important assumption in the Program related to the Central Bank was revised. The program that was announced in the early May has adopted that the interest payments of these bills that were held in the Central Bank portfolio would be made in cash on a 3-month basis, thus ensuring the liquidity control. Since higher interest rates compared to their targeted level in June and July, and the Treasury's borrowing that is below its redemption increased the doubts on the fulfillment of domestic debt service in the remainder of the year, it has been inevitable to swap the securities in the Central Bank's portfolio.

Net Domestic Assets and Net International Reserves aggregates realized within the program targets in July while the upward trend of base money observed in June continued also in July. At the end of July, in the framework of annexed letter of intent, annual CPI inflation was revised from 52.5 percent to 58 percent while the GNP contraction estimation was revised from 3 percent to 5.5 percent. The Central Bank, considering current trends, revised the ceilings for base money and Net Domestic Assets upward. Targets related to change of Net International Reserves remained the same.

The Central Bank dropped short-term interest rates as of the beginning of August and started to hold FX sales auctions of US$ 20 million on a daily basis in September, which was twice a week previously. Prior to the terrorist attacks towards the USA on September 11, 2001, money and foreign exchange markets were stable, compared to the previous months. However, after the terrorist attacks of September 11, both the rate of depreciation of the Turkish lira and interest rates rose. The Central Bank announced that it would meet the liquidity requirements of the markets when necessary, and dropped the upper quotation on interest rates. This increase in interest rates and exchange rates in addition to the USA operation to Afghanistan contracted foreign and domestic financing facilities of the economy, thus increasing the need for an additional external support. Particularly, the negative developments in international markets that led a contraction in both Treasury's foreign borrowing and privatization potential as well as high levels of foreign and domestic debt services caused markets focus on the additional foreign support. Concerns arisen in mid-September continued until mid-October because of the delay in the IMF credit of US$ 3.2 billion committed in the framework of the 10th Review. Nevertheless, the announcement of the new macroeconomic targets and budget aggregates and the international support to Turkey increased the possibility of additional external financing by the IMF which re-established the stability in the markets. The Government concluded the measures that ensure that the primary surplus would be 6.5 percent of GNP for 2002. Meanwhile, the IMF announced that an additional external financing support of US$ 10 billion would be provided in 2002, apart from US$ 3.2 billion committed in the framework of the 10th Review. These two respective incidents led interest rates to decrease to 70 percent and exchange rates to drop to the levels of the early September.

The provision of the new Central Bank Law that would prohibit the Central Bank from extending loan to the Treasury and other public enterprises become operative on November 5, 2001. In order to extend external financing support amounting to US$ 3.2 billion to the Treasury to be supplied by the IMF in the framework of the 10th Review, the Central Bank extended advances to the Treasury with the same terms and conditions as of November 5. Moreover, the Central Bank extended the maturity of the government securities of TL 15.8 quadrillion in its portfolio and indexed their interest rates to CPI. Consequently, a more suitable environment was set to sustain domestic debts as well as to lead monetary policy more efficiently.

Developments in Other Macro Aggregates in 2001

The annual inflation rate measured on a basis of consumer price indices dropped to 33.4 percent in February 2001, the lowest level of the last 14 years. Due to the sharp depreciation of the Turkish lira at the end of February and *the increase in the prices of public goods and services, the consumer prices started to rise again. Consequently, the inflation rate realized at 66.5 percent in October 2001 on an annual basis. Another development observed in that period was that the increase in consumer prices remained below that of wholesale prices owing to the sharp contraction in domestic demand. Also, the rate of price increase in the services sector that was less than that of the exchange rate contributed to this development. As of October, annual increase in the sub-groups of consumer price indices was 77 percent for commodities while it was 49.2 percent for services. In this period, wholesale prices rose by 81.4 percent. CPI inflation is estimated to exceed 65 percent by the year-end.*

The slowdown in the economy that started with the November crisis turned into recession with the February crisis. GDP that decreased by 2.1 percent in the first quarter of the year dropped by 8.9 percent in the second quarter and by 7.1 percent in the third quarter of the year. Sharp depreciation of the Turkish lira, rise in real interest rates and shrinkage of credit supply by the banking sector had unfavorable effects particularly on expenditures for durable consumer goods and fixed capital expenditures. Consequently, GDP was contracted by 6.4 percent in the first nine months of the year. Yet net exports of goods and services had positive effect on the growth due to both rapid decline in imports and the increase in exports of goods and tourism revenues. During this period, rise in interest payments and decline in workers' remittances resulted in a decrease of net factor income from abroad, and GNP dropped by 8.3 percent. It is expected that GNP will decrease by around 8.5 percent in 2001 as a result of the persistence of contraction in the domestic demand and the decline in agricultural production.

In the second quarter of the year, overall employment declined by 1 percent, while unemployment rate that was 6.2 percent in the corresponding period of the previous year rose to 6.9 percent. Yet, unemployment rate in urban areas rose from 8.9 percent to 10.4 percent. The employment of wage and salary earners declined by 5.6 percent in the same period. Real wages and salaries decreased and real wages per hour in manufacturing industry recessed by 9.2 percent in 2001 compared to the same period of the previous year.

The sharp contraction in the economy and the depreciation of the Turkish lira in real terms led trade balance to decline and current account to register surplus. The recovery in both balances stemmed, in general, from declining in imports. Current account that gave a deficit of US$ 6.9 billion in the January-September 2000 period yielded a surplus of US$ 2.5 billion in the same period of this year. Despite the improvement in the current account balance, a serious deterioration was observed in capital accounts. Although a capital inflow of US$ 10.9 billion was realized in the first nine months of last year, a capital outflow of US$ 10.6 billion was observed in the same period of this year. Capital outflows were realized in portfolio investments and short-term credits of the banking sector. In this period, the IMF credit of US$ 8.3 billion was utilized and official reserves decreased by US$ 3 billion.

The November and February crises had substantial on financial sector's source and utilization structure. Increase in funding cost of banks, contraction of funding, increase in non-performing loans and preference for banks on liquidity had unfavorable effects on credit supply. In addition, high credit interest rates, and rapid contraction both in domestic demand and production led the demand for credit to decline. Additionally, state and fund banks reduced their credit within the context of the program. Hence, total credit volume, mainly consumer credit, recessed in real terms. On the other hand, the credit/deposit ratio that was 47 percent at the end of last year declined to 33.3 percent at the end of October 2001. Due to the loss of confidence in the Turkish lira after the February crisis and sharp depreciation of the Turkish lira, the share of foreign currency deposits in overall deposits increased rapidly. The share of foreign currency deposits in overall deposits which was 49.2 percent in February rose to 60.2 percent at the end of September.

Fiscal policy has been carried out in line with the program and significant improvement has been achieved in primary budget balance as a result of the increase in non-tax revenues and real decline in primary expenditures. With the effect of contraction in the economy and due to the fact that a large part of additional taxes of 2000 were not collected in 2001, tax revenues dropped in real terms. Moreover, contraction of the economy led the tax collection/assessment ratio decline. In financing the budget deficit, short-term *borrowing instruments were generally employed. Average borrowing term was 139 days while average compounded interest rate was realized at 107.2 percent in the January-October period. Short maturity of domestic borrowing, high level of interest rates and cost of restructuring the banking system are among factors that have increased in domestic debt stock. The increase in domestic debt stock was mainly stemmed from the rise in non-cash debt stock. While the ratio of total domestic debt stock to M2X rose to 104.4 percent as of October 2001, the ratio of cash domestic borrowing stock was realized at 46.7 percent.*

Fundamental Factors that have affected Macroeconomic Developments and Monetary Policy

Fundamental factors that have affected macroeconomic developments and markets after the February crisis are sustainability of domestic debt, functioning of floating exchange rate regime and problems in financial structure of the banking system, and the related expectations. Apart from developments in international conjuncture, domestic political developments caused excess fluctuations in the markets, having favorable or unfavorable impacts on expectations on these problems. As in 2001, political measures for resolving these problems and expectations of economic enterprises will profile the developments in 2002. Therefore, it will helpful to make a brief evaluation of these three fundamental problems and policies to be adopted for 2002.

Sustainability of Domestic Debt

Sustainability of domestic debt was the key element of the program implemented in 2001. In this context, the Program has adopted increase in primary surplus, external support of international organizations, and restructuring of the banking system. Despite downward tendency observed in interest rates and exchange rates in May, interest rates remained at a high level in the following months because of lack of confidence in the Turkish lira as an outcome of political developments. Severe damage of the February crisis on the economy, confidence crisis and the preference of private banks towards liquidity and to decrease their high cost liabilities and capital outflows are the main reasons for this adverse development.

In order to dispel doubts about domestic debt sustainability in the short term, domestic debt swap was realized with private banks in June. However, the problem preserved its gravity even after domestic debt swap, owing to deep recession in the economy and persistent increase in dollarization due to loss of confidence in the Turkish lira. With the purpose of minimizing domestic debt service, interest payment terms of the bills kept in the Central Bank portfolio were changed and their maturities were extended. In August, the maturity of some T-bills given to public banks has been extended. The Treasury started FX-indexed and foreign currency denominated borrowings as of September. Thanks to these measures, the problem of domestic debt service for 2001 was mainly resolved by decreasing the borrowing needs from the market.

The decrease in borrowing rates and exchange rates in the last months of 2001 brought hopeful expectations for domestic debt service and borrowing in 2002. Apart from the improvements in expectations, in 2002;

- *Maintaining tight fiscal policy and increasing the primary surplus/GNP ratio to 6.5 percent in overall public sector,*

- *Reducing the amount of borrowing from the domestic markets and maintaining the decline in the interest rates through the IMF additional external financing support of US$ 10 billion,*

- *Reducing the domestic debt service, by adjusting the maturity and interest rates of debts to the Central Bank and to the state banks that take place in the non-cash debt stock,*

- *Starting off the economy's growth process and the consecutive increase in loanable funds*

will be the fundamental elements that provide the sustainability of domestic debts. Moreover, the discipline to be introduced through the borrowing law, new borrowing instruments and tax regulations that improve the borrowing facilities from non-banking system will contribute to this purpose. Consequently, relieving the pressures on the financial markets will lead to a decline in interest rates and *an increase in maturities. Accordingly, the ratio of net public debt stock to GNP will fall from around 90 percent to around 80 percent.*

Floating Exchange Rate Regime

Transition to floating exchange rate regime after the exchange rate based program of 2000 brought about severe problems in the economy. During the exchange rate based program, a significant increase was observed in FX open positions of banks, companies and households. Since this development caused heavy losses on economic agents that suffered FX open positions after the February crisis, the floating exchange rate regime was often under discussion.

Although the Central Bank announced that exchange rates would be determined according to the supply and demand conditions in the markets within the framework of floating exchange rate regime and that it would intervene in the foreign exchange markets in the event of excess fluctuations, expectations of the markets for intervention could not be avoided. During the times that adverse developments in the international markets and domestic political problems were prevailing, the Central Bank had to intervene in foreign exchange markets. Insufficient foreign currency supply due to the capital outflows and loss of intensity in the markets created difficulties in establishing stability.

Starting from August, the Central Bank stopped non-program FX interventions and started to hold FX sale auctions on a daily basis in line with the pre-announced calendar as of September. The clear attitude of the Central Bank had favorable impact on the markets and weakened the discussions on the floating exchange rate regime significantly. Furthermore, slowdown in capital outflows, the recovery in external credit facilities of banks and positive expectations for additional external support have restored stability in the exchange rates.

It is expected that exchange rates will show a steady course in line with the floating exchange rate regime and economic agents will take more rational decisions in 2002. Increase in capital inflows with the help of additional external resources, decrease in uncertainties aroused by the crisis environment and reduction in inflation rate will relieve the exchange rate fluctuations. Moreover, measures for more efficient operation of foreign exchange markets, eliminating the drawbacks facing forward foreign exchange markets, and a healthier banking structure will contribute to the more efficient functioning of floating exchange rate regime.

Problems in the Banking Sector

The banking system has suffered severe losses because of liquidity and interest rate risks in the November crisis and exchange rate risk in the February crisis. Relations between the real sector and the banking sector began to deteriorate which affected the assets quality of the banking sector adversely. Weakened capital base of the banking sector are both limiting credit to the real sector and putting restrictions on implementation of the monetary policy.

In 2001, significant steps were taken towards the restructuring of the banking system. State banks have acquired profitable nature with the strengthening of their financial structures. By the year-end, the deposits and similar liabilities of the SDIF banks will either be sold to other banks or be liquidated. Hence, these banks that have become a burden on the economy with their losses will be withdrawn from the system in order to reinforce the general structure of the system. Additionally, preparations are moving ahead for reinforcement of the financial structures of the existing banks via merging, foreign partners or new capital transfers. In order to overcome the problems between real sector and the banking sector, both parties have initiated a joint attempt. Supply of necessary sources and legal regulations for reinforcing the capital base of the banks are under preparation.

Macroeconomic Targets and Monetary Policy for 2002

In 2001, a considerable progress has been made in eliminating the adverse outcomes of the crisis and implementation of structural reforms. Nevertheless, unsatisfactory efforts to restore the confidence in policies hindered the favorable effects that were expected from the measures and structural reforms. Sustainability of domestic debt, more efficient functioning of the floating exchange rate *regime and implementation of policies towards the strengthening of the banking system with full determination will contribute to both recovery of confidence and increase in growth and employment potentials of the economy in 2002.*

Within the framework of this approach, the main purpose of the 2002 Program and Budget Draft is to decrease inflation that tended to rise after the February crisis, to reduce the domestic debt to a sustainable level and to put the economy once more into growth path.

In 2002, the rate of growth of GNP is expected to be 4 percent due to the expected increase in domestic demand. Apart from the expected increase in agricultural production, improvement in relations between the banking sector and real sector, re-establishing of consumer confidence and a mild real appreciation of the Turkish lira following its severe depreciation in 2001 will assume important role in this development.

Rate of increase of the GNP deflator is expected to fall to 46 percent in 2002. Moreover, it is projected that the annual consumer inflation will reduce to 35 percent. The fact that prices of public goods and services and incomes policy will be set according to the inflation target, the real appreciation of the Turkish lira and control of increase in domestic demand via fiscal and monetary policies will contribute to the achievement of the inflation target.

The current account that has been expected to yield a surplus of 1.8 percent of GNP in 2001 will likely register a deficit of 1 percent of GNP in 2002 due to the adverse impact of the terrorist attacks against the USA on September 11 on the tourism revenues. For 2002, capital account, which is predicted to record a deficit of US$ 17 billion in 2001, is expected to produce surplus thanks to the additional external financing of US$ 10 billion and the increase in capital inflows. This recovery in capital account will have a favorable effect on exchange rates and interest rates, and contribute to the achievement of the inflation target.

Priority will be given to the regulations to be adopted to avoid excess employment in public sector, to boost efficiency and productivity in public management, to review the administrative structure and to improve transparency and accountability and to control of primary expenditures. The ratio of primary surplus in the overall public sector to GNP has been set as 6.5 percent for 2002. In order to achieve this target, in addition to a reduction in primary expenditures, additional increases should be made in revenues.

The Central Bank had formerly announced that inflation targeting regime would be implemented starting from the beginning of 2002. However, the conduct of inflation targeting was postponed because of the disturbances in money and foreign exchange markets arising from terrorist attacks of September 11, uncertainty atmosphere created by external financing needs, and high inflation level and rigid inflationary expectations. During this period, which will be a transition stage to inflation targeting system, the Central Bank will formulate the monetary policy towards re-establishing the price stability in the economy. In this framework, base money aggregate consistent with growth and inflation targets has been fixed as a performance criterion as of 2001. Similar to 2001, the aggregates related to net domestic assets and net international reserves will closely be monitored and short-term interest rates will effectively be used towards the inflation target. Moreover, priority will be given to enlightening of public and transparency issues.

Announcements will regularly be made on the implementation of the monetary policy. With the signs of favorable progress in preconditions, transition to the inflation targeting system will come into effect.

I. DEVELOPMENTS IN PRICES

The most important factor behind the price increases in 2001 is the high deprecation of the Turkish lira after the crisis, which occurred in February. Another important development that was observed about the price indices is the Consumer Price Index (CPI) staying well behind the Wholesale Price Index (WPI). In the January-October period, the WPI rose by 73.8 percent, while this rate was 56.6 percent for CPI, which was 17.2 percentage points below the increase of WPI (Table I.1 and Figure I.1). Despite a dense pressure of costs resulting from the increasing exchange rates in the economy, a significant decline in domestic demand limited the reflection of increasing WPI to retail prices. A similar case was also observed in 1994, when domestic demand had seriously contracted.

Other important development that has been observed about the price indices for 2001 was that the CPI stayed well behind the WPI.

Increasing exchange rates caused prices of tradables to rise more than prices of non-tradables, which is in line with the expectations. When the prices are analyzed according to other type of classification, it has been observed that prices of services increased less than prices of goods. Prices of education, health and transportation increased significantly despite contracting domestic demand. However, due to low increases in rents with the effect of Rent Law that was adopted in 2000, the price increase in services sector was below the price increase of goods sector (Figure I.2).

On the other hand, due to direct pricing, taxes and especially price increases in fuel products, controlled prices rose faster than uncontrolled prices. Prices of consumer durables also inclined faster than CPI. The prices of these sub sectors have been affected from increasing exchange rates due to intense usage of imported inputs. Despite this fact, for the January-October period, prices of agricultural products and food prices increased slowly especially due to the

Table I.1. Annual and Periodical Inflation Rates

		DEC-DEC			JAN-OCT		OCT-OCT	
	Weighted (%)	1998	1999	2000	2000	2001	2000	2001
WPI	100.00	54.3	62.9	32.7	27.1	73.8	41.4	81.4
WPI (Public)	23.17	35.6	117.7	24.7	20.6	93.7	46.4	100.4
WPI (Private)	76.83	60.1	48.4	35.7	29.7	66.7	39.6	74.5
WPI (Excluding Agriculture)	77.78	47.8	76.9	30.4	26.2	86.6	43.6	92.9
CPI	100.00	69.7	68.8	39.0	30.8	56.6	44.4	66.5
CPI (Tradables)	58.16	62.9	55.3	34.6	27.5	62.7	41.5	71.8
CPI (Non-tradables)	41.84	78.6	85.1	43.4	34.2	50.9	47. 3	61.3
CPI (Goods)	70.69	61.6	61.3	34.6	26.5	66.4	41.0	77.0
CPI (Services)	29.31	89.0	83.9	47.0	38.6	40.7	50.4	49.2
CPI (Pub controlled)	20.72	53.8	94.2	32.9	26.4	83.2	46.1	92.6
CPI (Not pub controlled)	79.28	74.0	62.6	40.7	31.9	49.2	43.8	59.1
CPI (Durables)	11.05	64.8	57.4	38.9	32.4	67.5	44.1	75.9
CPI (Excluding Food)	68.91	73.9	74.7	41.3	33.4	56.9	45.1	66.3
CPI (Excluding Housing)	74.20	63.9	60.9	35.7	28.7	59.0	42.4	67.7
Export Price Index	-	-3.5	-8.9	-1.0	-2.0*	-4.7*	-3.7*	-3.7*
Import Price Index	-	-6.2	3.1	0.2	0.5*	-3.4*	4.7*	-3.8*

*January-August, August-August

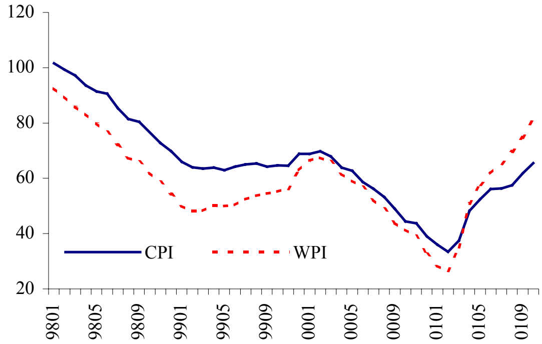
Source: SIS, CBRT

Table I.2. Monthly Inflation Rates

	2001									
	Jan.	Feb.	March	April	May	June	July	Aug	Sept.	Oct.
CPI	2.3	2.6	10.1	14.4	6.3	2.9	3.3	3.5	5.4	6.7
WPI (Public)	1.4	1.8	12.3	21.5	6.9	5.8	4.4	5.0	5.3	5.3
WPI (Private)	2.7	2.9	9.3	11.8	6.1	1.7	2.8	2.9	5.4	7.3
WPI (Excluding Agriculture)	1.6	2.3	11.3	17.2	7.0	4.7	4.1	4.9	5.4	6.8
CPI	2.5	1.8	6.1	10.3	5.1	3.1	2.4	2.9	5.9	6.1
CPI (Tradables)	1.1	1.4	7.7	13.1	6.5	2.8	1.5	1.6	7.4	7.6
CPI (Non-tradables)	3.8	2.2	4.5	7.7	3.7	3.5	3.3	4.3	4.4	4.6
CPI (Goods)	1.8	1.3	7.7	13.9	6.0	3.3	1.9	2.1	7.2	7.7
CPI (Services)	3.7	2.6	3.4	4.5	3.3	2.8	3.2	4.6	3.6	3.1
CPI (Pub. Controlled)	5.3	1.5	12.1	16.0	4.6	5.1	4.0	5.4	4.9	4.2
CPI (Not controlled)	1.7	1.9	4.3	8.6	5.4	2.4	1.8	2.2	6.2	6.7
CPI (Durables)	3.2	2.3	5.8	10.4	6.0	6.8	3.3	5.3	6.0	4.0
CPI (Excluding Food)	2.9	1.8	5.8	10.2	5.1	3.7	3.1	4.0	5.7	4.2
CPI (Excluding Housing)	2.1	1.4	6.0	11.7	5.7	3.1	1.8	2.5	6.3	7.3
Export Price Index	3.8	-1.9	-1.0	-1.5	-1.6	-1.9	4.5	-5.0	-	-
Import Price Index	2.2	1.2	0.9	-2.9	-0.9	-3.3	0.9	-1.4	-	-

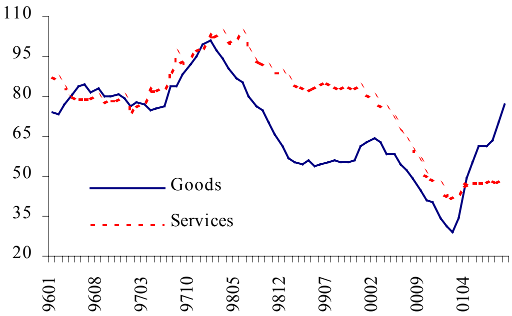
Source: SIS, CBRT

Figure I.1. WPI and CPI; 1994=100
(Annual Percentage Change)



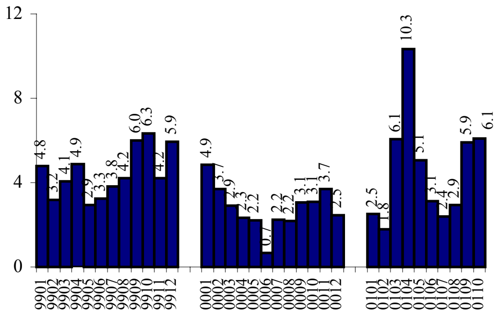
Source: SIS

Figure I.2. CPI Goods and Services; 1994=100
(Annual Percentage Change)



Source: SIS, CBRT

Figure I.1.1. CPI; 1994=100
(Monthly Percentage Change)



Source: SIS

contribution of seasonality during the summer, compared to the general index. Within the considered period, increase in WPI excluding agriculture was realized as 86.6 percent, which was 12.8 percentage points above the general index. It was observed that prices of the public sector that has a share of 23.17 percent in total wholesale prices increased by 93.7 percent, which is significantly higher that the price increases of 66.7 percent of the private sector that has a share of 76.83 percent in the total index.

The ending of the previously arranged export agreements and contracts will enable the effect of exchange rate increase on declining export prices to be observed more effectively in the coming future.

It has been observed that prices of exports and imports declined significantly in US $ terms. As of August, export and import prices declined by 3.7 percent and 3.8 percent respectively on an annual basis. Despite the devaluation of the domestic currency, the decline in the export prices remained restricted. Cost pressure due to exchange rate increase with increasing public prices and imported inputs caused exporting firms not to decrease their prices on the basis of foreign currencies. In addition to this, the ending of the previously arranged export agreements and contracts will enable the effect of exchange rate increase on declining export prices to be observed more effectively in the coming future.

I.1. Developments in Consumer Prices

The consumer price increase that occurred in 2001 was the common result of the two opposite effects. The first effect is the increasing wholesale prices due to a surge in costs and the second effect is related to insufficient domestic and foreign demand.

After leaving exchange rates for floating, the Turkish lira has depreciated by a cumulative 55.5 percent against the US dollar in February and March. CPI increased by 6.1 percent in March, 10.3 percent in

April, and the increase in the January-October period reached 56.6 percent (Table I.1.1).

With the floating exchange rates and the abandoning of the exchange rate based stabilization program that has been implemented since the beginning of 2000, publicly controlled prices in CPI increased in March and April by 12.1 percent and 16 percent respectively. Consequently, CPI after reaching a 14-year low level of 33.4 percent in February jumped to 48.3 percent level in April 2001.

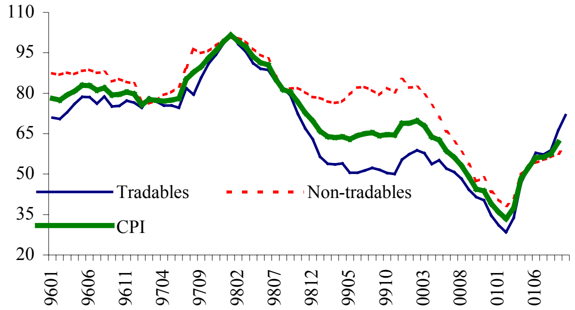
The consumer price increase that occurred in 2001 was the common result of the two opposite effects. The first effect is the increasing wholesale prices due to a surge in costs and the second effect is related to insufficient domestic and foreign demand.

In addition to this, prices of the tradables increased, partially figuring out the effects of high jump in exchange rates, and the difference between the prices of tradables and nontradables, which amount to 10 percentage points, disappeared in May. At the end of October, price increase changed in favor of tradables and the increase was realized as 71.8 percent and 61.3,percent, respectively (Figure I.1.2).

In October, it was observed that many sectors of the economy were not able to reflect the change in exchange rate to their prices although the average depreciation of the Turkish lira was 136.2 percent against the US dollar. It is considered that there are two reasons behind this fact; the first one is the contracting domestic demand after the crisis. The second reason is related with the firms supplying goods from their inventories for both domestic and foreign demand. Along with the contracting domestic demand, as the foreign demand is low due to a general slowdown in the world economy, the reflection of the depreciation of the Turkish lira to CPI remained limited.

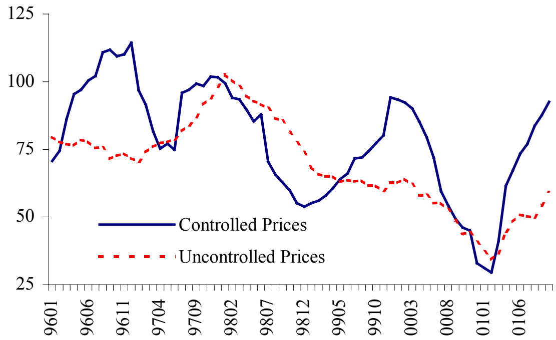
The difference between the controlled and uncontrolled prices within the first 10 months of the year is of great importance. Within this period, the prices in the public sector increased by 34 percentage points above the

Figure I.1.2. CPI, Tradables and Non-tradables; 1994=100 (Annual Percentage Change)



Source: SIS, CBRT

Figure I.1.3. CPI. Controlled and Uncontrolled Prices 1994=100 (Annual Percentage Change)



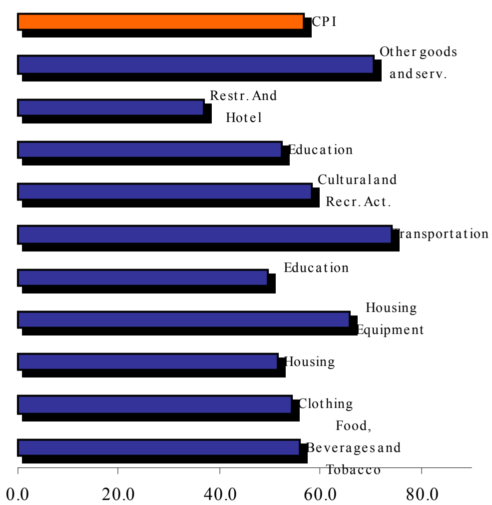
Source: SIS, CBRT

Table I.1.1. CPI and Sub Items; 1994=100

	OCTOBER		JAN-OCT		OCT-OCT	
	2000	2001	2000	2001	2000	2001
CPI	3.1	6.1	30.8	56.6	44.4	66.5
Food	3.9	11.8	24.2	55.9	42.4	67.0
Clothing	8.0	11.1	27.4	54.5	38.6	64.6
Housing	2.7	3..5	35.5	51.7	48.9	63.9
Housing Equipment	1.5	4.2	36.2	65.7	45.7	74.6
Health	0.6	0.6	47.2	49.7	50.8	53.5
Transportation	1.0	3.4	24.5	74.2	40.9	78.7
Culture and Recr.	4.9	2.4	28.2	58.4	32.5	68.8
Education	1..3	0..3	27..5	52..3	27.7	52..3
Restaurant and Hotel	2..3	2.7	40.4	37.0	48.6	42.4
Other goods and Serv.	2.4	5.3	40..5	70.5	53.2	79..9

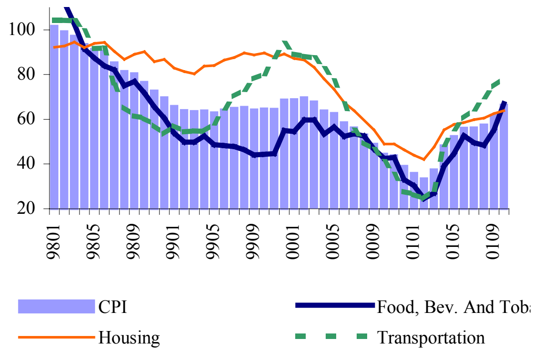
Source: SIS

Figure I.1.4. CPI and Sub-Items :1994=100 (2001 Cumulative Percentage Change)



Source: SIS

Figure I.1.5. CPI, Food Housing and Transportation Prices; 1994=100 (Annual Percentage Change)



Souwere under rce: SIS

private sector. The high price increase for the public prices came afterwards the stabilization program that was implemented in 2000 during which the public prices were under control. The reason why the public prices are well above the private prices are related with the delayed price adjustments in public prices during 2000 and cost increases (these are sometimes realized indirectly and sometimes as indexation) related to high devaluation of the Turkish lira.

In the first 10 months of the year the prices in the public sector were 34 percentage points above the prices of the private sector.

When the sub-items of CPI are examined in detail, it has been observed that transportation prices, prices of housing equipment and prices of other goods and services are the three sub-items that experienced high increase in the January-October 2001 period. The prices of the transportation sector has been affected from the increasing exchange rates, rising prices of the imported motor vehicles and increasing prices of transportation services due to a surge in fuel prices. Housing equipment sector is the one that is the most affected sector form the increasing costs as the goods in the sector are imported goods or import substitutes.

Lower than expected increases in rents and the difference between wholesale and retail prices especially for the food and clothing sector constitute a risk for the CPI inflation for the coming period.

In food, beverages and the tobacco sector that is one of the two important sub-items of CPI, the prices increased by 39.4 percent for the January-September period, which is 8.3 percentage points below the general index. Seasonal factors also contributed positively to this increase. However, a price increase of 11.3 percent at the end of October, the prices surged to 55.9 percent. The other important sub-item of CPI is housing prices that increased by 51.7 percent, which is near to the increase in general index. The reason of it is related with the fact that the rents increased by 31.9 percent due to the legal restriction, decline in real wages and contraction in economic activities, while one of the most important sub-items of housing, electricity, and oil and gas prices increased by 115.4 percent. Lower than expected increases in rents and the difference between wholesale and retail prices especially for the food and clothing sectors constitute a risk for the CPI inflation for the coming period.

Table I.2.1.WPI and Sub-Items ; 1994=100

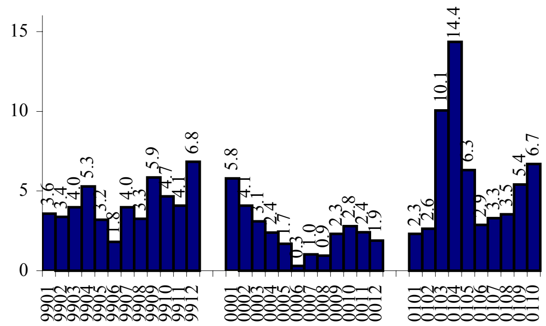
	OCTOBER		JAN-OCT		OCT-OCT	
	2000	2001	2000	2001	2000	2001
WPI	2.8	6.7	27.1	73.8	41.4	81.4
Agriculture	4.6	6.6	30.3	35.9	34.8	45.8
Mining	7.1	6.4	43.2	85.1	60.6	89.0
Manufacturing	2.0	7.0	25.4	85.7	43.2	91.7
Public	0.8	5.6	16.8	93.1	45.6	98.8
Private	2.5	7.6	29.4	82.7	42.2	88.7
Energy	1.9	3.6	28.4	101.1	41.2	115.3

Source: SIS

I.2. Developments in Wholesale Prices

The volatility in the financial markets in November 2000 and a crisis in 2001 February, which resulted in a floating exchange rate regime, determined the price movements of 2001. Wholesale prices increased fast in the first 10 months of the year due to the depreciation of the Turkish lira, increasing credit costs and high public sector price adjustments.

Figure I.2.1. WPI; 1994=100
(Monthly Percentage Change)

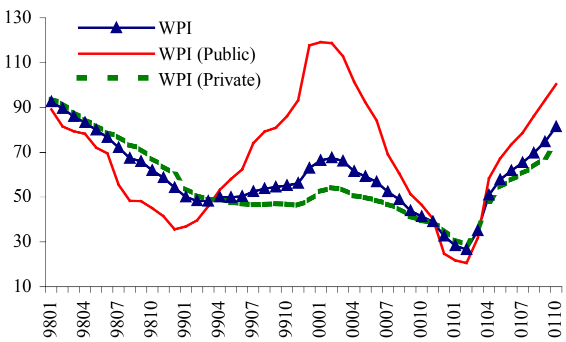


Source: SIS

The prices increased above 10 percent following the two months after the crisis, March and April (Figure I.2.1). At the end of October, annual increase in WPI was realized as 81.4 percent (Table I.2.1).

The volatility in the financial markets in November 2000 and a crisis that happened afterwards in 2001 February, which ended with a floating exchange rate regime, determined the increasing prices of 2001.

Figure I.2.2. WPI. Public and Private Sector Prices; 1994=100
(Annual Percentage Change)



Source: SIS

Increasing exchange rates after the crisis and the pressure created by rising credit interest rates affected wholesale prices negatively. Besides, jump in the public prices within the three months after the crisis caused additional costs for the firms. In short, high public price adjustments with a surge in costs due to the high depreciation of the Turkish lira, is responsible for high increases in WPI after February (Figure I.2.1). Contracting economy was not able to limit the increasing WPI. Expectations related to WPI deteriorated after January 2001, which is another reason behind the high jump in wholesale prices (Figures I.3.1, I.3.2).

In May, with a deceleration in the rate of increase of public prices and exchange rates, and a new stand-by agreement with the IMF, the inflation expectations were affected positively; that is, the expectations followed a smooth path after May (Figures I.3.1, I.3.2). WPI started to slow down after May and with the seasonal factors that affected agricultural prices positively average increase in WPI remained as 3.2 percent for the period June-August.

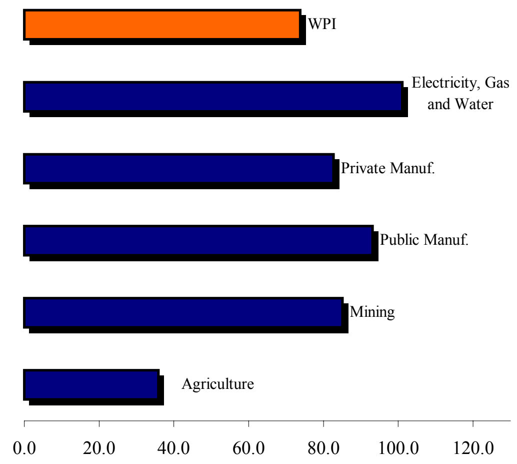
In September, increase in WPI started to rise again with the effect of exchange rates, seasonal movements and public prices and was realized as 5.4 percent. In October also, accelerating agricultural prices and a surge in the private manufacturing prices are responsible for high increases in WPI.

In the first two months of 2001, it was observed that the increase in agricultural prices was limited when compared with the previous years. However, in March, April and May, the agricultural prices started to increase higher than before with the effects of the crisis that occurred in February 2001. In June, the agricultural prices decelerated significantly, but in July the prices increased by 0.3 percent, which was the first time after the crisis of 1994. However, this increase did not continue in August. In September, it was observed that a 5.1 percent increase in the agricultural prices remained well below the seven-year averages. In October, the agriculture prices rose at an average of 6.6 percent, which is equal to the seasonal average. It is expected that the agriculture prices will rise when compared with the previous years during the rest of the year due to decline in production and seasonal factors.

Private manufacturing prices are the most responsive to changes in the exchange rates following the public manufacturing prices.

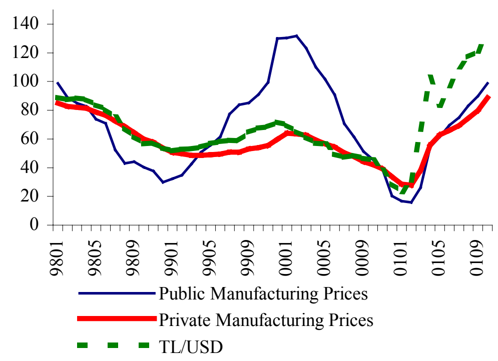
Due to that reason, the prices are negatively affected from the depreciation following the February crisis. In the first two months of the year the public prices were under control and the WPI was mostly affected by the

Figure I.2.3. WPI and Sub-Items; 1994=100 (Year 2001- Cumulative Change)



Source: SIS

Figure I.2.4. Exchange Rates, Prices of Public and Private Manufacturing; 1994=100 (Annual Percentage Change)



Source: SIS, CBRT

adjustments in the private manufacturing prices. However, after the February crisis, high price adjustments in public prices and energy prices were highly effective on the WPI. Especially, price increases in fuel and fuel products and the depreciation of the Turkish lira resulted in a surge in the prices of some sub-items of private manufacturing sector prices and sectors that utilize imported goods. Conclusively, within the January-October period, the private manufacturing prices increased by 82.7 percent and the public manufacturing prices increased by 93.1 percent that is 10.4 percentage points above the private manufacturing prices. On the first 10 months of the year, the cumulative increase in the energy prices were realized as 101.1 percent.

In the January-October period, the private manufacturing prices increased by 82.7 percent and the public manufacturing prices increased by 93.1 percent that is 10.4 percentage points above the private manufacturing prices.

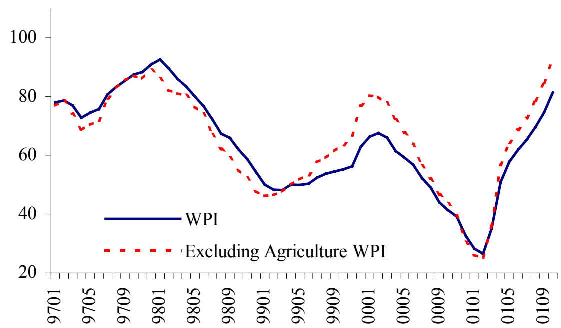
In the coming months, it is expected that the WPI will slow down due to a slowdown in exchange rates and the cost pressure related to public prices.

I.3. Inflation Expectations

Besides the inflation forecasts, inflation expectations have a great importance for the monetary policy of the Central Bank, as the changes in the monetary policy affect macroeconomic fundamentals with a lag.

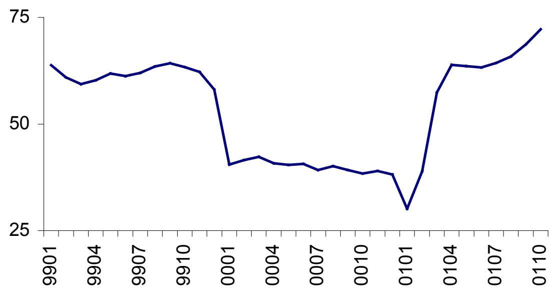
In an economy where a reliable yield curve and long-term inflation indexed assets do not exist, surveys have a special importance to gather inflation expectations. In this framework, the Central Bank of the Republic of Turkey carries out two different surveys for the determination of inflation expectations. The first survey, which is the Business Tendency Survey, has been carried out since 1987 by the CBRT, covering 500 private and manufacturing firms. Although this survey includes both private and public firms, the results are interpreted with respect to private firms only.

Figure I.2.5. WPI and WPI excluding Agriculture: 1994=100 (Annual Percentage Change)



Source: SIS, CBRT

Figure I.3.1. Year-End Inflation Expectations



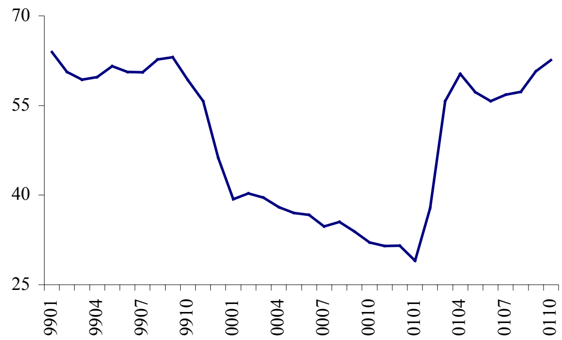
Source: CBRT

Accordingly, the Business Tendency Survey has been utilized for the inflation expectations of private manufacturing industry firms. The CBRT Business Tendency Survey represents 49 percent of the private manufacturing industry according to the number of employees and total sales. The second survey is the Inflation Expectations Survey, which is still at the stage of targeting to obtain the inflation, interest rate and exchange rate expectations of the financial sector twice a month. Inflation Expectations Survey aims obtaining expectations are related to CPI and it has been implemented since August 2001. This survey has been implemented only for eight periods and the rate of response is 65 percent for this survey.

In an economy where a reliable yield curve and long-term inflation indexed assets do not exist, surveys have a special importance to gather inflation expectations.

According to the Business Tendency Survey of the CBRT, the WPI expectations for the next 12 months and the year-end inflation expectations declined gradually until January 2001, but after January, with increasing exchange rates the expectations jumped until May. With the implementation of a new monetary program for 2001 and contracting domestic demand, expectations followed a smooth path after May. Although a slowdown was observed for inflation in the summer, the rates were above the seasonal averages that caused a deterioration of the expectations again in August (Figures I.3.1, I.3.2).

Figure I.3.2. Inflation Expectations for the next 12 Months



Source: CBRT

For the second period of November, according to the Inflation Expectations Survey, the CPI increased by 72 percent.

The year-end and for the following 12 month inflation expectations in January 2001 were realized as 30.1 percent and 29 percent, respectively. These expectations were 72.2 percent and 62.6 percent for the year-end and the following 12-months respectively in October. The higher than expected inflation rates for September and October influenced the inflation expectations negatively. After the second half of

October, the stability that has been observed in exchange rates is thought to push down the inflation expectations in the coming month.

For the second period of November, the results of the Inflation Expectations Survey showed a slowdown for the first time. According to the first period and the second period results of the November survey, the inflation expectations for the end of 2001 declined from 73.1 percent to 72 percent, and the next 12 month expectations declined from 53 percent to 51.5 percent.

II. MONETARY AND EXCHANGE RATE POLICY

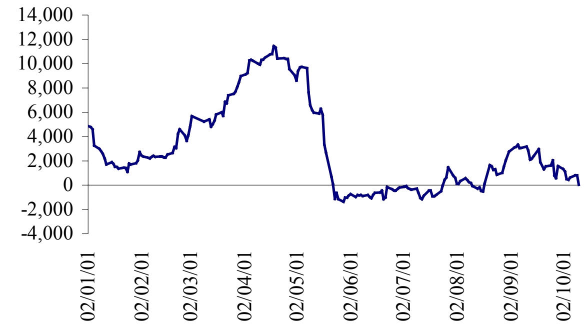
II.1. Monetary and Exchange Rate Policy

In the aftermath of the November 2000 crisis, despite the relative increase in capital inflow and the decline in interest rates by the Supplementary Reserve Facility of the IMF, fragility of the financial structure in the banking system mainly state banks increased, and the maturity of the internal and external funds provided shortened. The political events before the Treasury auction in late February caused a panic in the already discontent markets, and the Turkish lira was exposed with a serious attack on February 19, 2001. On February 22, 2001, considering the potential damages to the economy of the decreased credibility of the sustainability of the existing exchange rate, the Turkish lira was let to float against foreign exchange.

On February 22, 2001, considering the potential damages to the economy of the decreased credibility of the sustainability of the existing exchange rate, the Turkish lira was let to float against foreign exchange.

In the post-crisis period, the CBRT (Central Bank of the Republic of Turkey) designed its monetary policy in order to cease the problems in the payments system and maintain stability in the financial markets. Within this framework, the Central Bank provided the required liquidity through quotations and Open Market Operations in the form of direct purchases, and supplying the Turkish lira at the Interbank Money Market (Graph II.1.1). In order to bring functionality to the banking system and to end the bottleneck at the payments system, the Central Bank actively intervened in the markets, lowered the short-term interest rates, and implemented policies to provide the efficient allocation of the liquidity in the system. The maturity of the overdue repos of the state banks and the banks under the Savings Deposit Insurance Fund (SDIF) was renewed so that the pressure of these banks to the system was depressed. Furthermore, these banks were granted FX lending for them to be able to fulfill their external liabilities (Graph II.1.2).

Figure II.1.1. Open Market Operations (Net-TL Trillion)



*(+) values indicate liquidity injected to the market.

Figure II.1.2.FX Facility provided by the CBRT (US$ Million)

Table II.1.1. Developments in Base Money and Net Domestic Assets (TL Trillion)

	Base Money (Ceiling)			Net Domestic Assets (Ceiling)		
	Target (1)	Target (2)	Realization	Target (1)	Target (2)	Realization
April 30. 2001	-	-	5.850	-	-	6.739
May 31. 2001	5.900		5.815	9.750		7.942
June 30. 2001	6.050		6.247	13.250		12.943
August 31. 2001	6.300	7.175(I)	6.748	15.850	17.250(P)	16.437
October 31. 2001	6.800	7.550(I)	7.140	19.500	21.150(P)	17.933
Dec. 31. 2001	7.300	7.750(I)		21.000	22.400(G)	

P: Performance Criteria, I: Indicative Target
*: Last 5 work day average
(1) Letter of Intent dated May 2001
(2) Letter of Intent dated July 2001

In the post-crisis period, in order to bring functionality to the banking system and to end the bottleneck at the payments system, the Central Bank actively intervened in the markets, lowered down the short-term interest rates, and implemented policies to provide the efficient allocation of the liquidity in the system.

The Central Bank announced in the Monetary Program of May 15, 2001 that the base money aggregate would be used as the nominal anchor.

Table II.1.2. Floor Values of Changes in Net International Reserves (US$ Million)

	Target [1]	Target [2]	Realization
April 30, 2001 (Stock)	-	-	3.860
May 31, 2001	-1.500	-1.500	-837
June 30, 2001	-2.900	-3.562	-3.059
August 31, 2001	-2.000	-2.500	-1.370
October 31, 2001	-2.600	-3.250	-304
December 31, 2001	-600	-3.546	

*Floor values of change after October will be raised by the unused portion of the previous period or 25 percent of the floor value of the current period (whichever is less).
(1) Letter of Intent dated May 2001
(2) Will be raised by the unused portion of the previous period or 25 percent of the floor value of the current period (whichever is less).

The aforementioned program brought ceiling values to the Net Domestic Assets (NDA), and Base Money items of the CBRT balance sheet, and floor values to the changes that can periodically be realized in the Net International Reserves (NIR). Different than the limits set to the NDA and NIR, the restriction on the base money is not a performance criterion but an indicative ceiling value (Table II.1.1).

The program's outline is determined by

- The limits on the NDA item of the CBRT balance sheet brought by the rehabilitary operations of state banks and fund banks;

- The amount and the timing of the external financing provided from the International Monetary Fund (IMF) and the World Bank, as well as the allocation of this financing between Central Bank reserves and budget financing.

In order to rehabilitate the financial structure of state banks and fund banks, the Treasury gave new T-bills to these banks, of which TL 14 quadrillion was purchased directly by the CBRT, and TL 7 quadrillion was subjected to repo transactions with the CBRT in return for notes. This liquidity enabled state banks and fund banks to close their overnight borrowing to other banks and to their customers. The excess liquidity due to this transaction was withdrawn by the CBRT through FX sales, reverse repo and Interbank transactions. The Treasury, through, the CBRT, used the external financing provided from the IMF. The liquidity expansion due to use of this external financing provided from the IMF in the domestic financing was withdrawn through FX sales. The effect of domestic credit expansion on monetization as a result of these operations was controlled by the CBRT, maintaining the level of the base money as predicted by the program, and thus limiting its inflationary consequences.

II.2. Developments in Monetary Aggregates

As of late October, broad (M1) and narrow (M2) defined money supplies decreased by 23.1 percent and 17.2 percent in real terms compared with the end of the year. There was a decrease in currency in circulation, which is a sub-item of M1 money supply, by 14.7 percent and in sight deposits by 28.6 percent in real terms in the same period. Decline in time deposits, which is a sub-item of M2 money supply, was realized as an amount of 15.2 percent. According to the contribution of sub-items to developments in money supplies, it can be observed that contribution of currency in circulation to decline in M1 is 64.6 percent and contribution of sight deposits is 35.4 percent. The contribution of time deposits to the decline in M2 happens as 82.8 percent. The reason of the decline in sub-items of M1 and M2 money supplies is that, by the crisis, deposits in the banking system either were preferred to hold in foreign currency deposits or to be withdrawn (Graph II.2.1).

As of late October, broad (M1) and narrow (M2) defined money supplies decreased by 23.1 percent and 17.2 percent in real terms compared with the end of the year.

The problem of confidence, which emerged after the crisis, caused a negative effect on expectations and as a result, TL deposits shifted to foreign currency deposits. So, it is observed that while foreign currency deposits are increasing, deposits on Turkish lira decreases in real terms (Graph II.2.2). If we look at the changes in composition of deposits according to types of money they are held, total amount of the deposits on

Figure II.2.1. Monetary Aggregates
(Annual Percentage Change in Real Terms)

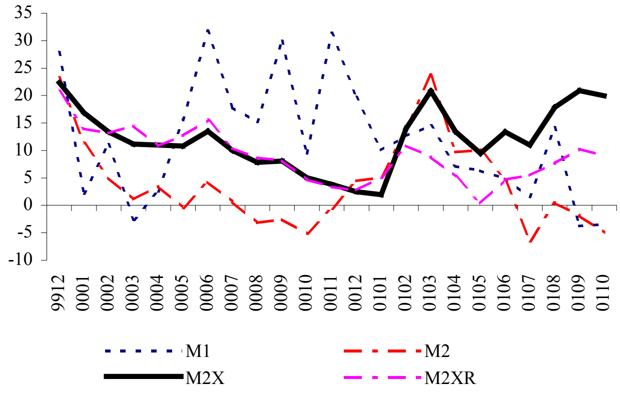
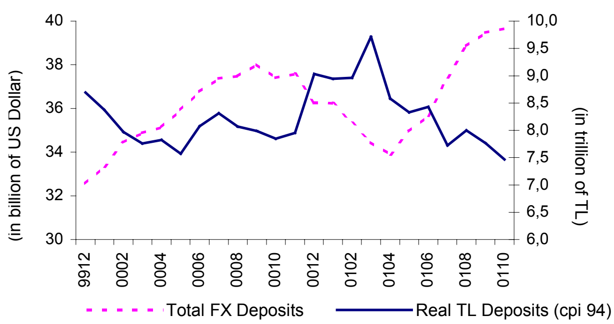


Table II.2.1. Monetary Aggregates (TL Trillion)

	2000		2001	Percentage Change	
	OCT.	DEC.	OCT.	ANNUAL	CUM.
	1	2	3	(3/1)	(3/2)
M1	6.151	8.210	9.886	60.7	20.4
Currency in Circulation	2.746	3.215	4.297	56.5	33.7
Sight Deposits	3.405	4.995	5.589	64.1	11.9
M2	26.886	32.813	42.554	58.3	29.7
Time Deposits	20.734	24.603	32.669	57.6	32.8
M2X	52.618	57.167	105.089	99.7	83.8
FX Deposits	25.732	24.355	62.534	143.0	156.8
M2XR	59.669	63.145	108.357	81.6	71.6
Repo	7.051	5.977	3.268	-53.6	-45.3
CPI (1994=100)	3.214	3.416	5.350	66.5	56.6
US Dollar	682.686	671.765	1.587.404	132.5	136.3
EURO	577.347	618.561	1.433.743	148.3	131.8

*Last Friday of month data have been used in money supplies

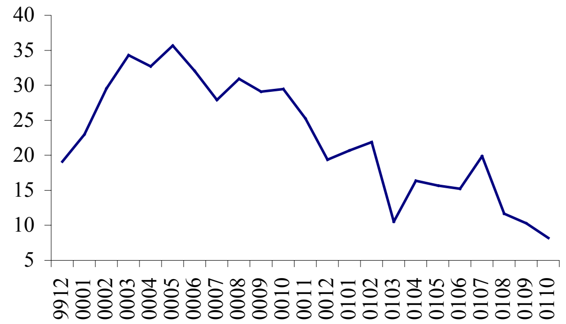
Figure II.2.2. Real TL Deposits and FX Deposits



The Turkish lira shrunk by 17.3 percent in real terms compared with the end of year and foreign currency deposits increased by 63.9 percent in the US dollar basis. With these changes, the share of foreign currency deposits on total increased to 61 percent by the late October while this amount happened to be 44.1 percent by the end of 2000.

The problem of confidence, which emerged after the crisis, caused a negative effect on expectations and fluctuations in foreign currency as a result, TL deposits shifted to foreign currency deposits.

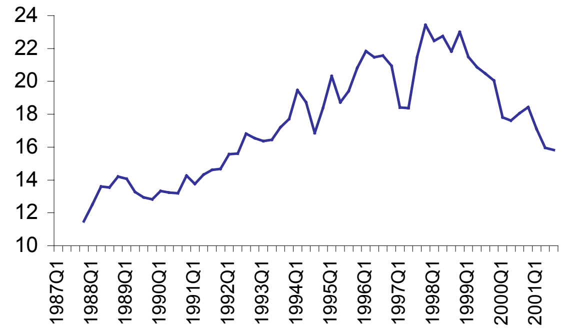
Figure II.2.3.Repo Transactions/ TL Deposits (Percentage)



As a result of increase in foreign currency deposits, M2X money supply increased by 17.4 percent compared to the end of the year in real terms. In order to encourage Turkish Lira deposits, the withholding tax rate on interest income were lowered in Turkish Lira deposits while the rate on foreign currency deposits' were raised. It is expected that this practice will slow down the increase in foreign currency deposits.

In order to encourage Turkish Lira deposits, the withholding tax rate on interest are lowered in Turkish Lira deposits while the rate on foreign currency deposits were raised. It is expected that this practice will slow down the increase in foreign currency deposits.

Figure II.2.4.Velocity of Money (GDP/M1)



*Average of last Friday of month data in money supplies and GDP annual cumulative values in GDP were used.

M2XR money supply, which is a sum of M2X and repo transactions between banks and their customers, increased by 9.5 percent. This stemmed from a 65.1 percent decline in repo operations compared to the end of the year. Along with the decline in balance sheets of banks after the February 2001 crisis, within the framework of restructuring of the banking system, reducing of overnight borrowing needs of public banks and increasing in the withholding tax rate on repo incomes caused a decrease in repo transactions (Graph II.2.3).

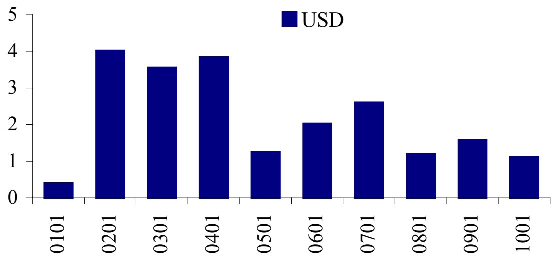
It is observed that the declining trend in Velocity of Money has been ongoing since 1998.

If the ratio of GNP to M1 money supply as an indicator of velocity of money is taken into account, it is seen that a declining trend is observed in velocity of money since 1998. This decline is due not only from the decline in GNP but also the problems in banking and payment systems and uncertainties in markets, which is a fact to limit decline of money demand.

II.3.Developments in Foreign Exchange Markets

A high volatility was observed in the first months following the switch to floating rate regime (Graph II.3.1). One of the main reasons of this volatility was high open position of the banking sector before the February 2001 crisis (Graph II.3.2). In order to remove the fragility that was caused by banks' open positions, government securities were given to the state banks and SDIF banks in May and debt swap was conducted with private banks in June. In spite of these efforts, both domestic and foreign banks were reluctant in terms of providing new credit as a result of the contraction in real sector in 2001, weakening financial structures and risk averse behavior of banking sector. Therefore, banks became net foreign debt payers and that situation emerged as an additional pressure on exchange rate. While the January – September 2000 period showed a US$ 10.936 million capital inflow, the January- September 2001 period showed a US$ 10.636 million capital outflow. This US$ 21.572 million worsening in capital balance was the main reason behind the instability in exchange rate (Table II.3.1). Other reasons behind the volatility in exchange rate are domestic political developments, uncertainties about the emerging markets and suspects about the domestic debt sustainability. Presence of backward indexation and the rise in inflationary expectations were other factors behind the increase in the exchange rate.

FigureII.3.1. Monthly Exchange Rate Volatility



*In the calculation of the volatility, daily percentage changes are taken followed by the calculation of the 5-day moving average of these changes. The monthly average of these moving averages is used as the volatility measure.

Figure II.3.2. Net FX Position of the Banking Sector and Exchange Rate

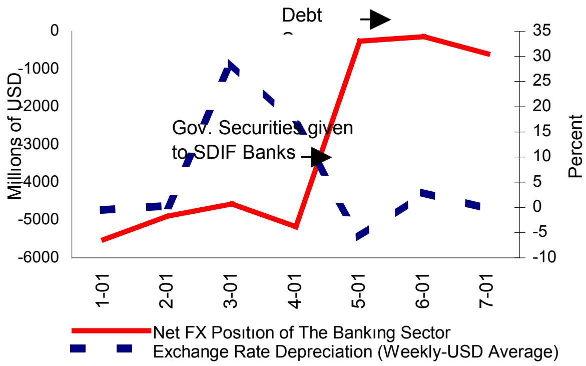
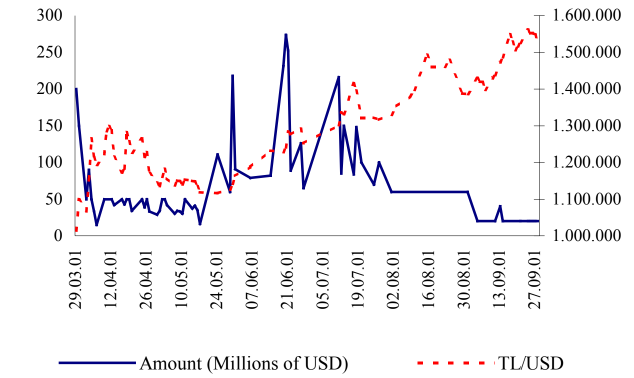


Table II.3.1. Some Items of Balance of Payments (US$ Million) (January-September 2001)*

	2000 Jan-Sep	2001 Jan-Sep
• Current Account Balance	-6894	2514
• Capital Flows	10936	-10636
Securities	682	-3717
Security Purchases of Non-Residents in	2469	2745
Turkey	-1787	-6462
Security Sales of Non-Residents in Turkey	3270	-4948
Banks (Short-Run Capital Flows)	151368	97636
Loans Received	-148098	-102584
Repayments	-1645	-3142
• Net Errors and Omissions	-2397	11264
• Total Changes in Reserves	499	8258
Use of Fund Credit Official Reserves	-2896	3006
* A (+) in reserves indicates loss of reserves.		

The CBRT conducted regular auctions of sale of foreign exchange in order to smooth the effects of short-run temporary exchange rate fluctuations without affecting the long run equilibrium level of the exchange rate. On the other side, sale of foreign exchange was conducted in order to sterilize the excess liquidity in the market caused by the use of external financing, which is provided by the IMF, for Treasury's domestic debt payments. The CBRT provided foreign exchange deposit facility to the banks having external liabilities until May and started to conduct foreign exchange sale auctions in late March. Regular foreign exchange sale auctions were performed in the following period (Graph II.3.4). After September, the foreign exchange auctions, which were previously conducted in two days in a week, were conducted in daily in US$ 20 million. This strategy was pursued in order to prevent liquidity to increase in excessive amounts on certain days and smoothing the excess fluctuations in exchange rate.

Figure II.3.4. FX Sales Auctions



The CBRT conducted regular auctions for sale of foreign exchange in order to smooth the effects of short-run temporary exchange rate fluctuations.

Fluctuations in exchange rate were diminished as a result of these policies (Graph II.3.1). However, fluctuations in exchange rate increased as a result of the adverse developments in the Argentinean economy and the possibility of the delay of the IMF credit owing to the TELEKOM crisis in July and the effects of the terrorist attacks to the USA in September.

Table II.4.1.Open Market Operations ISE Repo and Interbank Rates (Simple, Annually)

	OMO		ISE REPO		INTERBANK	
	O/N	7 Days	O/N	7Days	O/N	7Days
February 21-23	700-1000	-	-	-	-	-
February 26-March 29	112.01-139.21	-	80-100	80	-	-
March 12-22	80.11-89.39	90	80	-	80	85
March 23- April 13	-	87	80-83	80-87	78.7-83	85-87
April 16-26	-	83	79	83	79	83-87
April 27-May 01	-	81	77	81	77	81
May 02-04	-	79	77-79	79-82	77-79	79
May 07-14	-	77	77	77	77	77
May 15	-	76	75	-	75	-
May 16	-	75	67	73	70	73
May 17-23	-	71	67	71	67	71
May 24-28	-	69	65-68	69	65	69
May 29- July 15	-	69	63	69	63	69
July 16-August 7	-	71	67	71	67	71
August 8-August 26	-	71	67	71	62	68
August 27-August 30	-	65	60	65	60	65
August 31-September 02	-	65	60	60	60	65
September 03	-	65	60	65	60	65
September 04	-	62	59	62	59	62

II.4. Developments in Interest Rates

Aftermath of the February 2001 crisis, short-term interest rates has been used to provide price stability and determined considering the domestic and foreign developments. In this framework, interest rates increased (TELEKOM crisis and the developments in the Argentinean economy) or decreased (as in August) conditional to the developments. However, concerns about the sustainability of the domestic debt were an important factor in restricting the effectiveness of short-term interest rates.

Aftermath of the February 2001 crisis, short-term interest rates as one of the monetary policy tools has been determined considering the domestic and foreign developments.

The operation concerned diminishing the O/N borrowing requirements of state banks and SDIF banks shaped main lines of interest rate policy of the Central Bank. The securities issued for that purpose and given to the aforementioned banks were purchased by the Central Bank and the substantial borrowing requirements have been reduced which was exerting upward pressure on the short-term interest rates. An additional measure to avoid such a development in the future was taken by an amendment, which compels these banks, back to relatively plausible levels (Graph II.4.1).

The operation concerned diminishing the O/N borrowing requirements of state banks and SDIF banks shaped main lines of interest rate policy of the Central Bank.

The ISE bonds and bills market has closely followed the movements in short-term interest rates in terms of interest rate level. By the February crisis, interest rates bounded up 250 percent where the volume of transactions declined drastically compared before the crisis level. Until the mid March, interest rates in that market floated within the 150 –250 percent band. Following the announcement of main policies of the new program, the interest rate in Treasury auction, which succeeded to be bided albeit with small amounts, decreased to the 125-140 percent band. With the help of the constructive developments about foreign financing facilities, as of the end of March, interest rates in the ISE bonds and bills market came about 90–100 percent levels. By the help of above developments, the volatility in interest rates fell, too. After the announcement of the new economic program in May and the strengthening confidence to economic management, interest rates declined to the 70’s percent levels. Until the beginning of October, interest rates floated in the 80- 95 percentage band in line with the economic and political developments (Graph II.4.5).

Figure II.4.1. Short Term Interest Rates (Compounded)

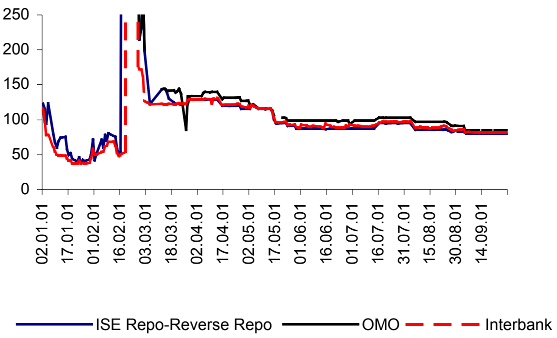


Figure II.4.2. OMO Interest Rates (Simple Percentage)

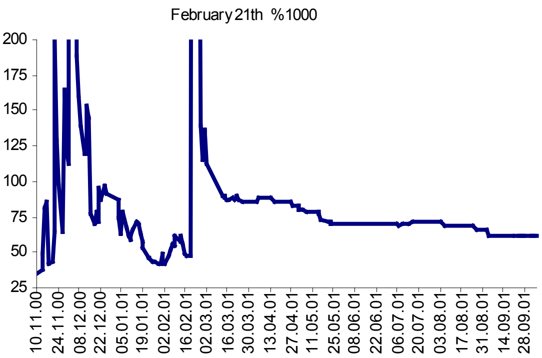


Figure II.4.3. Treasury Auction Interest Rates (Compounded)

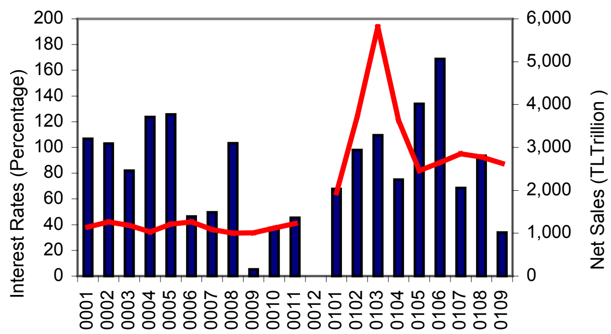
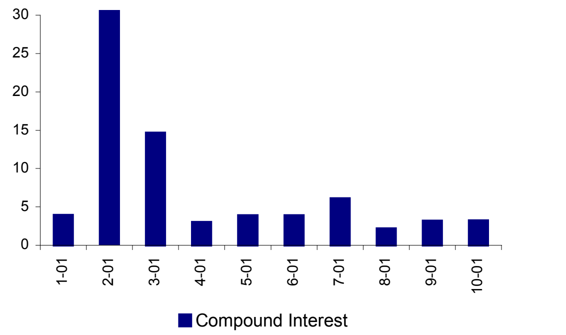
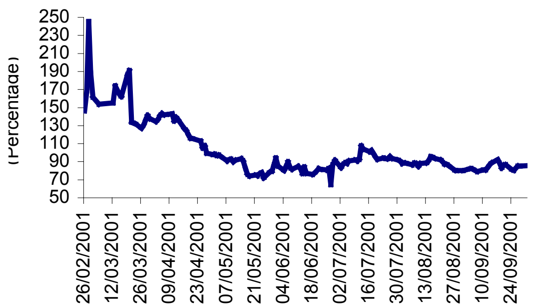


Figure II.4.4. ISE Bonds and Bills Market Monthly Interest Rate Volatility (*)



*In the calculation of the volatility, daily percentage changes are taken followed by the calculation of the 5-day moving average of these changes. The monthly average of these moving averages is used as the volatility measure.

Figure II.4.5 Second Market Treasury Bills and Bonds Interest Rates (Annually, Compounded)



The upper limit of that band was exceeded and the interest rates reached 107 percent in the middle of July due to the Telecom crisis and delays of the committed reforms. With positive developments realized aftermath of that rise, interest rates again fell in the previous level.

Interest rates in treasury auctions, which historically shows similar patterns with secondary markets were affected in same manner form the aforementioned developments.

With the help of the constructive developments about the foreign financing facilities, as of the end of March, interest rates in the ISE bonds and bills market came down about the 90–100 percent level.

In the October expectations about the treasury auction interest rates (the CBRT inflation expectations survey), arise compared with September. However, positive developments in exchange rates and additional external support provided by the IMF made expectations on inflation and interest rates be more optimistic.

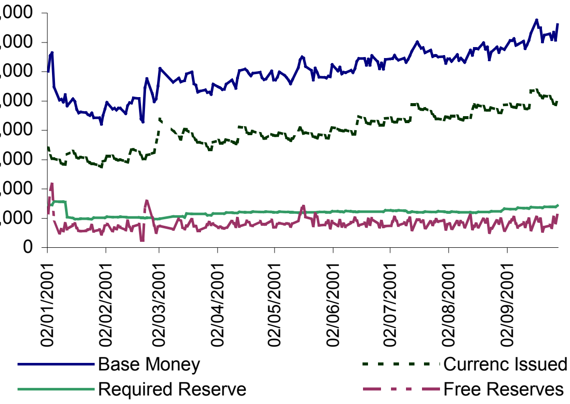
In current situation, interest rates at the ISE bills and bonds market seem to be high compared with the realized inflation rates. After the terrorist attack occurred in September, interest rates increased from 80 percent to 90 percent. Possibilities concerning additional external supports, and recent stability of exchange markets are expected to decrease interest rates to more plausible levels. Worries about sustainability of domestic debt are also expected to vanish by the contribution of external support. A possible decrease in short-term interest rates can easily be adjustable in the sense that the liability side of the banks has short maturities.

II.5. Developments on the Central Bank Balance Sheet

Following the February 2001 crisis, two main developments shaped the Central Bank Balance Sheet in 2001. One of the developments affecting the CBRT's Balance Sheet in this term is the rehabilitation of state banks and SDIF Banks. An important factor having impact on the magnitude and the content of the NDA item is the given t-bill through this operation and the direct purchase of the t-bill by the CBRT. Another important development having impact on the CBRT Balance Sheet is the use of IMF financing by the Treasury through the CBRT. The timing and usage of the financing is another important factor shaping the CBRT Balance Sheet in year 2001.

Following the February 2001 Crisis, two main developments shaped the Central Bank Balance Sheet in 2001. One of the developments affecting the CBRT's Balance Sheet in this term is the rehabilitation of state and SDIF Banks.

Figure II.5.1. Base Money and Its Sub-items (TL Trillion)

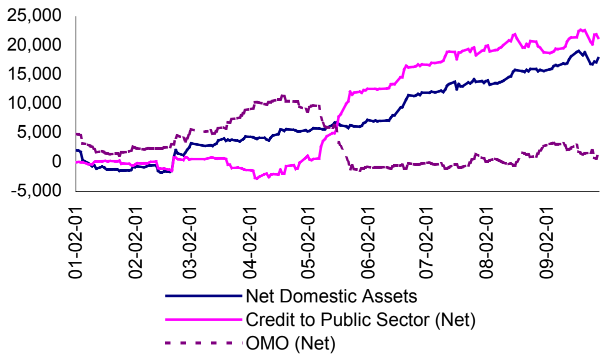


As a result of these developments, the share of NFA accounts on the CBRT Balance Sheet declined and that of NDA increased. At the beginning of 2001, the NDA item was accounting of 34 percent of total Balance Sheet aggregates, whereas it increased to 247 percent at the end of October, and at the same time the share of NFA in the total balance sheet declined.

As a result of these developments, the share of NFA accounts on the CBRT Balance Sheet declined and that of NDA increased.

The CBRT's Balance Sheet aggregates which was formed in accordance with these developments, exhibited following developments in 2001: NDA item which takes place on the assets side of the CBRT's Balance Sheet presented a decline. The reason behind this decline is the decrease in the OMO item in the early 2001 as a result of withdrawn liquidity, which had been injected at the end of 2000. Following the February 2001 crisis, NDA item displayed an increase as a result of the liquidity injection to the market and increased by 617 percent compared with the early 2001 figures. While this increase may be attributed to the increase in the OMO item until May 2001, the source of this increase changed later.

Figure II.5.2. NDA and Important Sub-items (TL Trillion)



One of the factors behind this structure change is the rehabilitation of the state and SDIF Banks. The direct purchase of the government papers by the CBRT was resulted in the removal of the overnight borrowing

Table II.5.1. Selected Balance Sheet Items (Current, TL Trillion)

	Dec.26,2000	Feb.28,2001	Oct.30,2001
	Current	Current	Current
BASE MONEY (a + b + c)	5.788	5.071	7179
a-Currency Issued	3.772	3.586	4628
b-Bank Deposits	1.404	977	1469
c-Bank Free Deposits	611	508	1082
NET FOREIGN ASSETS	3.310	2.915	-1.0574
A-Net International Reserves	7.672	7.935	-1734
1-Gross International Reserves	13.601	19.975	3.0681
2-Gross International Reserve Liabilities	-290	-11.838	-3.2415
3-Net Forward Position	0	-202	0
B-Medium-term FX Credit	-5	1.263	2255
C-Other (**)	-4.917	-6.283	-1.1095
NET DOMESTIC ASSETS	2.477	2.156	1.7753
II-Credit to the Public Sector (Net)	43	777	2.5342
A-Credit to the Public Sector	1.499	2.623	2.9057
-Government Papers	1.515	2.642	1.8770
CBRT's Portfolio	6.489	7.653	2.1756
2-Public Sector Deposit (TL)	-249	-416	-669
3-Public Sector Deposit (FX)	-1.208	-1.430	-3045
B- Funds	-116	-120	-102
C- Deposits of Nonbank Sector	-45	-34	-41
D- Credit to the Banking Sector	500	750	750
E- Open Market Operations (Net)	5.219	4.109	-201
F- Other	-2.445	-3.110	-8411
G- Devaluation Account	-869	-1.741	226
H- IMF Emergency Assistance (Treasury)	191	191	191
I- Bank's FX Lending (TCMB)	0	1.335	0
NET DOMESTIC ASSETS (1)		2.156	1.7753
Devaluation Account (2)		-1.741	226
Year 2000 Allotment to Treasury from Rev. Acc. (3)			-275
NET DOMESTIC ASSETS (Program Definition) ((1-2-3)		3.897	1.7803

decline in the OMO item and in an increase in the requirements of the mentioned banks, in a sharp Credit to the Public Sector (Net) item. In the succeeding term, OMO item had negative values as a result of the withdrawn liquidity through reverse repo operation and declined by 104 percent compared with the early 2001 figures. The increase in the Credit to the Public Sector (Net) item may be seen as the main source of the increase in the NDA item after the rehabilitation operation of these banks. Another important development having influence on the NDA item is the usage of the IMF financing by the Treasury through the CBRT. The part of foreign financing used for the domestic financing results in the increase in the NDA item, and the increase in NDA, which is not removed through the foreign exchange sales causes an increase in the Base Money item, which is the liability aggregate of the CBRT Balance Sheet.

Following the crisis, another development affecting the NDA account is the CBRT's foreign exchange lending to the banks in order to fulfill their liabilities in terms of foreign exchange and its monitoring as FX Deposit item under NDA account. However, FX lending to the banks came to an end on May 2, 2001.

In the new term initiating following the February 2001 crisis, the CBRT decreased its interventions in the FX market and it declined to a minimum level in August, and the interventions had only the aim of decreasing the extreme and transitory volatilities in the exchange rates, as it is mentioned above. Since these transactions were generally made against the extreme increase in the foreign exchange, it was realized as foreign exchange sales and therefore caused declines in the NFA and NIR items. In this term, some of the transactions of the CBRT in the FX market aimed at withdrawing excess liquidity which was created as a result of the IMF financing used by the Treasury for domestic debt services through the CBRT. The utilization of the IMF credit for this aim is another factor resulted in a decline in NFA and NIR account. The utilization of the IMF credit for foreign debt service directly decreased these items in the mentioned term. These two items were also affected by the FX lending of the banks between themselves through interbank money market. Since these transactions take place under the CBRT's guarantees, they took place on the liability side of the CBRT's Balance Sheet.

On the other side, base money, on the liability side, contracted in the beginning of 2001 due to the sterilization of the liquidity injected during the November crisis, the following Religious Holidays, and the New Year holiday. On the days following the February crisis base money demonstrated an upward slope and as of the end of October it increased by 24 percent compared with the previous year-end. The most important item of the base money, currency issued displayed an upward trend in the middle of months due to the salaries beside the rapid expansion occurred aftermath of the February crisis. As of the end of October, the currency issued item increased by 23 percent compared with the previous year-end. Another item of the base money, TL reserve requirements item decreased by 5 percent in the aforementioned period due to both the cut in reserve requirements ratio (came into affect as of December 1, 2001) and the limited increase of the TL deposits during the period. Lastly, the Free Deposits item fluctuated due to their weekly average responsibility.

Targets, declared on May 15, 2001 in the Stand-by agreement, concerning the base money, Net Domestic Assets and Net International Reserves were achieved as of the end of October.

Figure II.5.3. Credit to Public Sector (Net) and Some of its Sub-items (TL Trillion)

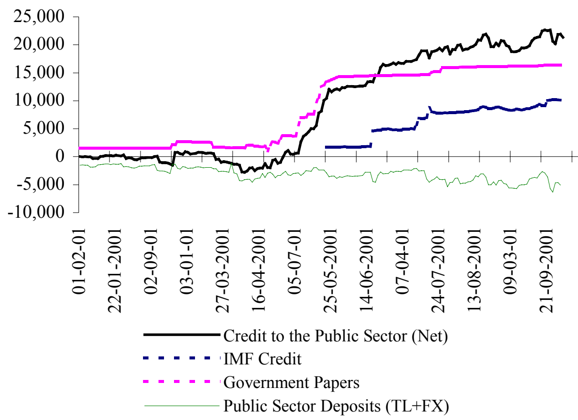


Figure II.5.4 Base Money (TL Trillion)

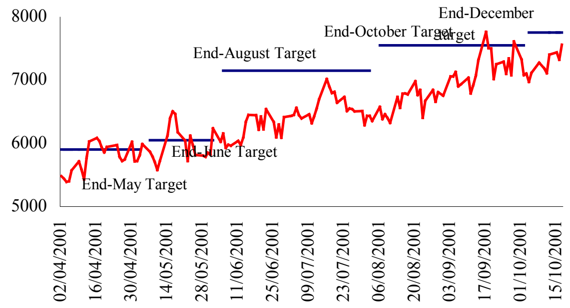


Figure II.5.5. Net Domestic Assets (TL Trillion)

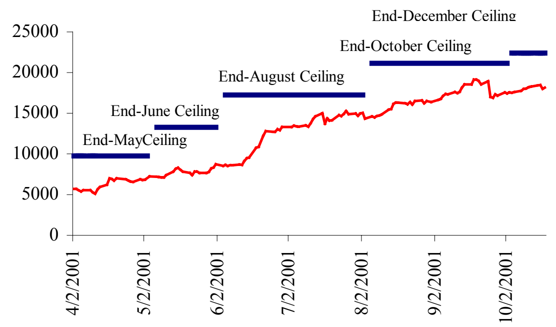


Figure II.5.6. Net International Reserve (US$ Million)

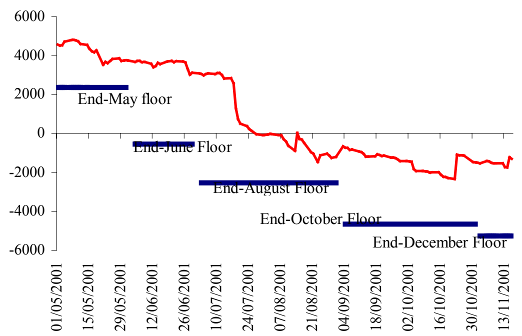
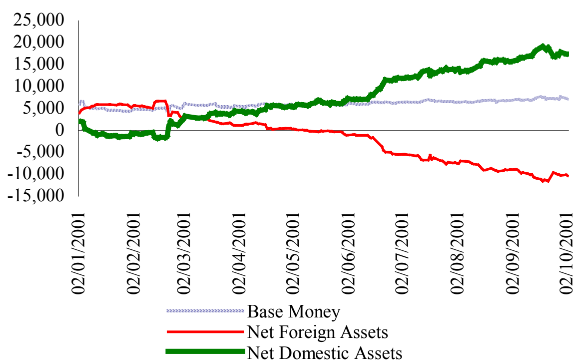


Figure II.5.7. Base Money, NDA and NFA (TL Trillion)



REDUCING THE OVERNIGHT BORROWING REQUIREMENTS OF THE STATE BANKS AND SDIF BANKS IN THE AFTERMATH OF THE CRISIS

The banking sector became more fragile to the liquidity, interest rate and exchange rate risks with the structural change of their assets in 2000. The rise in interest rate due to the November 2000 and February 2001 crises, adversely affected the financial structures of the state banks and SDIF banks that have high overnight borrowing requirements. In order to overcome these problems, Banking Sector Restructuring Program was introduced in May 2001. This program aims at

1- Providing stability in financial markets with restructuring of state banks,

2- Solving problems of SDIF banks in order to prevent their adverse effects on the stability of financial markets and pressure on fiscal sector,

3- Providing a healthy structure for private banks which are adversely affected from the crisis.

In the context of this program:

The Treasury extended floating rate notes to the state banks for their duty losses in order to reduce their short-run borrowing requirements. This policy aimed at eliminating the duty losses and interests arising from these losses, reducing balance sheets of these banks and providing efficient functioning of these banks.

- State banks provided liquidity by repo or sales from the Central Bank with these notes in the context of a program. They reduced their overnight liabilities to other banks and non-banking sector with this liquidity.

-The rise in the borrowing requirement of the Treasury as a result of the issuing of bonds in order to eliminate the duty losses of state banks did not result in a proliferation in total funding source used by public sector from the markets. This operation had positive effects on reducing the short- run borrowing requirement of state banks and extending the maturity of borrowing.

- A similar program is implemented in order to reduce the overnight borrowing requirements of SDIF banks.

Within this framework, after March 16, 2001, overnight borrowings of the state banks and SDIF banks excluding the ones conducted with the Central Bank are to be eliminated as of the end of May 2001. Within these measures, the overnight borrowing requirements of the SDIF banks are eliminated at the end of May 2001; the overnight borrowing requirements of the state banks are eliminated at the end of June 2001. The excess liquidity in the market was sterilized through reverse repo and sales of foreign exchange.

Overnight Borrowings of State and SDIF Banks

	TL Trillion		Percentage Distribution	
	March 16	May 31	March 16	May 31
Central Bank	8.900	19.620	41.0	96.8
Other (Priv. Banks and Customers)	12.799	643	59.0	3.2
Total	**21.699**	**20.263**	**100.0**	**100.0**

Source: CBRT

After the restructuring of securities in July and August non-cash stock data of September 2001 indicate that state banks and the Central Bank hold a big portion of the TL part of the non-cash stock whereas SDIF banks hold greater part of the foreign exchange denominated non-cash stock. The bigger share of the SDIF banks in foreign exchange denominated assets points out their foreign exchange open positions.

Non-Cash Domestic Debt Stock for Year 2001(*)

	TL Trillion	US$ Million	EURO Million	Percentage Distribution		
				TL	US$	EURO
State Banks	20.233.70	1.171.10	349.8	43.6	16.8	13.6
Savings Deposit Insurance Fund	7.502.40	5.819.70	2.229.10	16.2	83.2	86.4
CBRT	15.830.40	0	0	34.1	0.0	0.0
Other	2.823.20	0	0	6.1	0.0	0.0
TOTAL	**46.389.70**	**6.990.80**	**2.578.90**	**100.0**	**100.0**	**100.0**

(*) September. Provisionary

The New CBRT Law

Price Stability

Coordination with the Government

Independence

Accountability and Transparency

Instrument and Policy Independence

Setting the Inflation Target together with the government

Supporting the growth and employment policies of the government in line with the price stability objective

The attendance of undersecretary or deputy undersecretary of the Treasury to the Monetary Policy Committee meetings with no right of vote

Independent conduct of duties and power

To take precautions to provide stability in the financial system

Bank's being the sole competent and responsible authority in the conduct of monetary policy

Authorization of the bank to directly set and implement monetary policy instruments other than the ones in the law, which are in line with the price stability objective

No granting of cash advances to the Treasury and credit lines to the public institutitions

No purchase of T-bills in the primary market

The Announcement of the Monetary Policy Committee minutes

Openness to Independent Audit

The issue of periodic reports on monetary policy targets and implementation

The public notification as well as the briefing of the government on the causes and measures to be taken in case of a failure or a potential failure to reach targets

III. DEVELOPMENTS IN FINANCIAL MARKETS

III.1. The Banking Sector

In the Turkish banking sector, there were 79 banks at the end of 2000, as 61 of the total was deposit banks and 18 of the total were development and investment banks, the amount of deposit banks decreased to 51 whereas the amount of the development and investment banks decreased to 16 in November 2001. Total amount of banks decreased to 67 in November 2001.

In the Turkish banking sector, the number of the total banks was 79 at the end of 2000, and it decreased to 67 in October 2001.

Total balance sheet of the banking system increased by 1 percent in real terms and reached TL 151.9 quadrillion as of June 2001 compared to the end of 2000. In this period, in US$ dollar terms, total balance sheet decreased to US $120 billion from US$ 155 billion. In June 2001, while the share of the balance sheet of the private banks and SDIF banks in overall banking system increased compared to the end of the previous year, the share of the public and foreign banks decreased. While the share of the private banks increased to 51 percent from 50 percent, the share of SDIF banks increased to 16 percent from 8 percent because of the government securities given to the SDIF banks for enhancing their financial conditions by the Treasury and new banks covered by the SDIF. While the share of the state banks decreased to 26 percent from 34 percent because of the decreasing short term liabilities with selling government securities given by the Treasury to the Central Bank to end the special duty losses with banking sector restructuring program, the share of foreign banks decreased to 2.6 percent from 3.4 percent. In June, the share of the development and investments banks was also realized as 4.4 percent.

Table III.1. Selected Consolidated Balance Sheet Banking Sector Items (TL Trillion)

	2000 December			
	Public	**Private**	**SDIF**	**Total**
TOTAL ASSET	**35.707**	**48.255**	**8.862**	**104.257**
TL	**29.095**	**26.654**	**5.835**	**67.471**
FX	**6.612**	**21.601**	**3.028**	**36.786**
1. Claims on Banks	2.103	9.062	686	15.840
2. Securities Portfolio (Net)	2.197	4.774	3.751	11.995
TL	996	2.568	2.733	7.231
FX	1.202	2.206	1.018	4.764
3. Credit	8.757	17.815	2.138	31.845
TL	6.839	9.316	1.414	18.945
FX	1.918	8.499	724	12.900
4. Past-Due Loans (Brut)	1.153	1.157	1.570	3.960
6. Interest &Income Accruals	899	2.464	345	4.195
7. Participations and Subsidiaries (Net)	523	3.326	185	4.188
8. Securities in Non-Trading Portfolio (Net)	994	3.885	819	6.468
TL	742	2.729	256	4.297
FX	252	1.156	563	2.171
9. Other Assets	15.798	847	150	16.895
TOTAL LIABILITIES	**35.707**	**48.255**	**8.862**	**104.257**
TL	**28.657**	**19.297**	**3.174**	**55.576**
FX	**7.049**	**28.958**	**5.688**	**48.682**
1. Deposit	23.483	26.059	7.896	58.900
TL	18.152	8.561	3.739	30.837
FX	5.331	17.498	4.157	28.063
2. Due to Banks	5.321	11.430	1.227	23.907
3. Interest &Expense Accruals	1.396	1.106	257	3.017
4. Owners Equity	1.093	6.628	-2.052	7.504
Paid Up Capital	697	3.019	689	5.579
Legal &Provisional Reserves	214	810	3.406	4.623
Profit (Loss) for the Period	-185	371	-3.310	-2.848
Profit (Loss) for Previous Years	0	-16	-3.006	-2.982
Selected Off-Balance Sheet Items				
1.Repos and Reverse Repos	4.949	4.476	4.423	14.830
2.FX and Interest Rate Contracts	1.469	44.448	2.083	60.079

				2001 June
	Public	**Private**	**SDIF**	**Total**
TOTAL ASSET	**39.916**	**72.815**	**23.372**	**151.894**
TL	**29.085**	**34.954**	**15.802**	**86.185**
FX	**10.831**	**37.860**	**7.571**	**65.709**
1. Claims on Banks	2.936	11.310	1.342	21.363
2. Securities Portfolio (Net)	17.065	4.261	10.746	32.533
TL	14.273	2.824	8.300	25.707
FX	2.792	1.437	2.446	6.826
3. Credit	8.137	24.776	1.706	39.184
TL	5.643	9.811	926	18.001
FX	2.494	14.965	780	21.184
4. Past-Due Loans (Brut)	2.058	1.235	2.798	6.277
6. Interest &Income Accruals	3.890	5.916	2.406	13.200
7. Participations and Subsidiaries (Net)	726	3.529	257	4.720
8. Securities in Non-Trading Portfolio (Net)	1.326	8.700	5.593	16.930
TL	625	6.619	3.170	11.557
FX	701	2.081	2.423	5.373
9. Other Assets	932	1.040	185	2.464
TOTAL LIABILITIES	**39.916**	**72.815**	**23.372**	**151.894**
TL	**28.550**	**25.410**	**10.885**	**70.361**
FX	**11.366**	**47.405**	**12.488**	**81.533**
1. Deposit	28.193	44.645	11.672	87.894
TL	19.431	13.432	4.941	38.365
FX	8.762	31.213	6.731	49.189
2. Due to Banks	2.514	15.891	2.603	27.688
3. Interest &Expense Accruals	1.047	1.501	539	3.522
4. Owners Equity	2.263	7.577	4.231	16.352
Paid Up Capital	2.719	3.854	723	8.767
Legal &Provisional Reserves	312	1.530	15.473	17.545
Profit (Loss) for the Period	-955	114	-4.493	-4.970
Profit (Loss) for Previous Years	-305	-111	-7.715	-8.086
Selected Off-Balance Sheet Items				
1.Repos and Reverse Repos	8.067	3.399	2.299	14.395
2.FX and Interest Rate Contracts	735	46.580	528	58.750

Source: BRSA

The banking sector made a loss as a result of high expenses from capital market transaction and foreign exchange transactions in the first half of 2001. Due to the November 2000 and the February 2001 crises, the banking sector funded relatively long term and fixed investments with short-term liabilities and high foreign exchange open position. Banking system made a loss of TL 4.9 quadrillion (US$ 3.9 billion) in the first half of 2001. While state and SDIF banks made a loss, private and foreign banks slightly made a profit in the first half of 2001. In that period, public and SDIF banks had TL 1 quadrillion and TL 4.5 quadrillion losses, respectively.

The number of the branch and personnel of the banking system were observed to decrease with applied policies aimed to decrease personnel and operating expenses with banking sector restructuring program. While total number of the branches was 7,840 at the end of 2000, it was decreased to 7,576 in June 2001, especially with the decrease in the number of the branch of the public and the SDIF banks. The number of the personnel of public and SDIF banks also decreased from 171,705 to 155,867.

Table III.2. Financial Markets-Main Indicators (TL Trillion)

	Dec.30,1999	Oct.27,2000	Dec.26,2000	Oct.26,2001
Deposit (Residents)	39.751	50.962	55.209	102.492
TL	21.357	25.229	30.854	39.958
FX	18.394	25.732	24.355	62.534
Credit To Non-Financial Sector by Deposit Banks	16.243	24.843	25.689	33.981
TL	8.964	16.585	17.264	16.709
FX	7.278	8.258	8.425	17.272
Consumer Loans	982	4.501	4.619	2.554
Repos (Savings Holders)	4.080	7.051	5.977	3.268
Past Due Loans/Tot. Credit (%)	9.8	10.1	10.3	20.1
Past Due Loans/Tot. Credit (%)-Excluding SDIF	-	5.9	5.7	12.6
Securities Portfolio/Tot. Deposit (%)	30.5	23.4	21.8	4.1.1
Securities in Non-Trading Port. /Total Deposit (%)	-	7.1	8.5	16.8
Credit/Deposit (%)	40.9	48.7	46.5	33.2
Public Bank Dep./Tot.TL.Deposits (%)	66.6	65.8	58.9	53.0
Public Bank credit/Tot.TL Credit (%)	29.8	30.8	32.8	23.5

Source: CBRT Weekly Press Bulletin, Last Friday data of each month.

III.1.a.Credit

The credit volume, which had significantly increased in 2000, decreased in real terms due to the developments occurred with the November 2000 and the February 2001 crises. The fact that banks preferred to stay liquid negatively affected the credit volume due to the increasing interest expenses of the banks, the shrinking financing possibility, and difficulties to use in past due loans. The demand of the credit was also shrunk because of high credit interest rates, weak domestic demand and contraction in the economy.

The fact that banks preferred to stay liquid negatively affected the credit volume due to the increasing interest expenses of the banks, the shrinking financing possibility, and difficulties to use in past due loans.

Total credit extended by the deposit banks to the non-financial credit, decreased by 16.4 percent in real terms and dropped to TL 34 quadrillion in November 2001 compared to the end of the previous year. It was mainly resulted from the decrease of the commercial loans denominated in the Turkish lira and specialized loans of the state banks. In this period, commercial loans denominated in the Turkish lira and specialized loans of the state banks decreased by 34.9 percent and 47.7 percent in real terms, respectively, compared to the end of the previous year. On the other hand, as of June 2001 export credit and export guaranteed credit increased by 7.6 percent and 26.8 percent in real terms, respectively, compared to the end of the previous year. The strengthening of owners' equity of the banking sector and improvement of the growth rate is expected to stop the shrinking of the total credit volume in the future period.

While the credit extended by the public, SDIF and private banks decreased in real terms, the credit extended by foreign banks increased in the first eight months of 2001 compared to the end of the previous year. In this period, credit extended by the state, SDIF and private banks decreased by 39 percent, 42 percent and 7 percent in real terms, respectively, the credit extended by foreign banks increased by 48 percent in real terms. The decrease of the public bank loans resulted from the limitation of the specialized loans to be extended by the state banks as well as interest rates applied to these loans indexed to the yearly average compounded interest rates on government securities in accordance with the banking system restructuring program.

The share of Turkish lira equivalent of the loans denominated in foreign currency over total loans increased to 47.6 percent in October 2001 from 32.5 percent at the end of 2000 because of the high increase of the exchange rates. But, US dollar equivalent of loans denominated in foreign currency decreased by US$ 2.4 billion and dropped to US$ 10.2 billion in October compared to the end of year 2000.

Figure III.1.1. Loans to Non-Financial Sector (Discounted with CPI 94=100 Index. TL Billion)

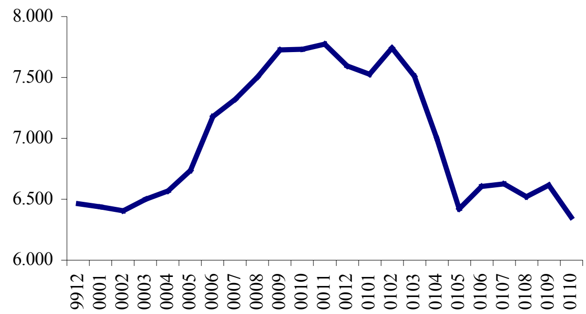


Table III.3. Deposit Banks Credit (TL Trillion)

	Public	Private*	Foreign	Total
December 30, 1999	**4.676**	**10.464**	**551**	**15.692**
TL	3.571	5.172	217	8.961
FX	1.105	5.292	334	6.731
October 27, 2000	**7.581**	**16.137**	**855**	**24.572**
TL	5.995	10.184	395	16.573
FX	1.586	5.953	460	7.999
December 26, 2000	**8.423**	**16.405**	**861**	**25.689**
TL	6.767	10.116	381	17.264
FX	1.656	6.290	479	8.425
October 26, 2001	**7.995**	**23.221**	**1.658**	**32.875**
TL	5.525	10.679	484	16.688
FX	2.470	12.542	1.174	16.187

* Including SDIF banks

Source: CBRT Weekly Press Bulletin

Figure III.1.2. FX loans

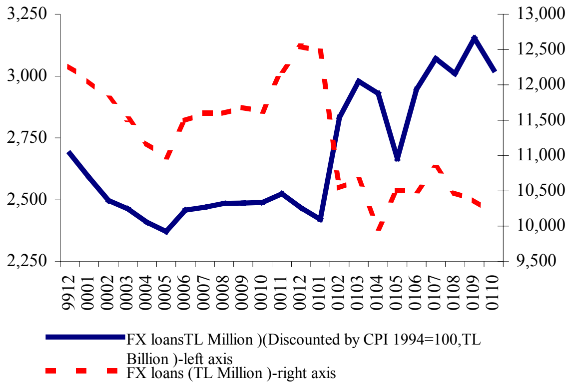
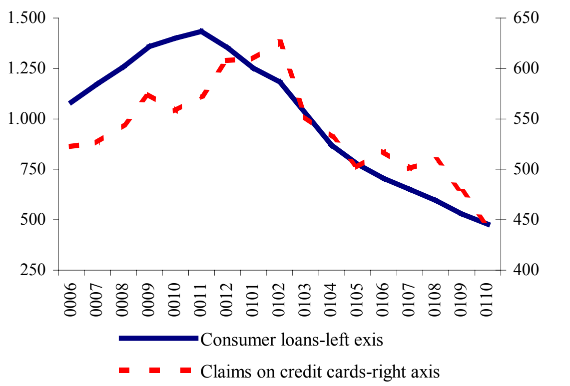


Figure III.1.3. Developments in Consumer Loans and Claims on Credit Cards
(Discounted by CPI 1994=100, TL Billion)



Due to increasing financing costs and uncertainties banks cut down the supply of consumer loans, and due to increased cost of borrowing and decreasing real income of individuals, the demand for consumer loans also decreased substantially. The share of consumer loans in total loans, which had been 17.8 percent at the end of 2000, declined to 7.5 percent at the end of October 2001. During the same period, claims on credit cards also showed a decreasing trend.

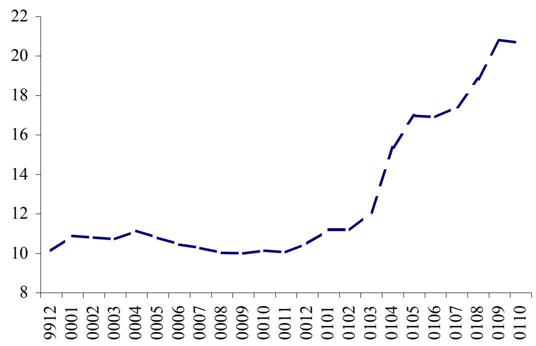
It is observed that the share of consumer loans in total loans shows a substantial decreasing trend in 2001compared to 2000.

After February 2001, the banking sector's past due loans jumped, and at the end of October, the share of past due loans in total loans rose to 20.7 percent according to provisional figures. Although the majority of the increase in past due loans is caused by the SDIF banks and state banks, in the same period past due loans of other banks also increased. Share of past due loans of banks in SDIF in total past due loans was 39.2 percent in October 2001 whereas for state banks and private banks it was 41.3 percent and 16.7 percent in October respectively. High credit rates, weak domestic demand and the fact that banks call for their credit back disturbed financial structures and transactions of firms, and caused firms fail to repay their loans on time.

The majority of the increase in past due loans was caused by the banks governed by the Savings Deposit Insurance Fund and the state banks.

The largest share in past due loans is the textile sector, which is export oriented and which was severely affected by the distortion in the balance of payments structure of the economy in 2000. The share of textile sector past due loans in total past due loans decreased by a small amount in 2001 due to the increase in exports. The share of past due loans of textile and textile products industry in total past due loans, which had been 30.2 percent in August 2000, declined to 25.4 percent in August 20001. When Turkey became a member of the Customs Union, the textile sector made a large amount of investment. But after the 1997 Asian and 1998 Russian crises, the sector faced with the decline in external demand and lost in competitiveness. This is the reason for persistent high level of past due loans of the sector, and this also negatively affected the banking sector indirectly. The construction sector made up the second biggest share among the loans extended, and in August 2001, the share of past due loans of this sector amounted 11 percent of the total.

Figure III.1.4. The Share of Past Due Loans in Total Loans (Percent)



III.1.b. Developments in the Securities Portfolio and the Securities in Non-Trading Portfolio of the Banks

Securities portfolio and the securities in the non-trading portfolio of the banks increased fast in 2001 in real terms. Main reason of this increase is the government securities given to state banks to compensate their special duty losses and to SDIF banks in order to strengthen their financial structure and to obtain the desired capital level. The target was to obtain the stability in financial markets and to strengthen the banking system.

The substantial increase in securities portfolio and the securities in non-trading portfolio of the banking sector in real terms in 2001 was mainly caused by the domestic government securities given to the state banks to compensate their special duty losses and to SDIF banks in order to strengthen the financial structure and to obtain the desired capital level.

Figure III.1.5. The Sum of Securities Portfolio and Securities in Non-Trading Portfolio (Discounted by CPI 1994=100, TL Billion)

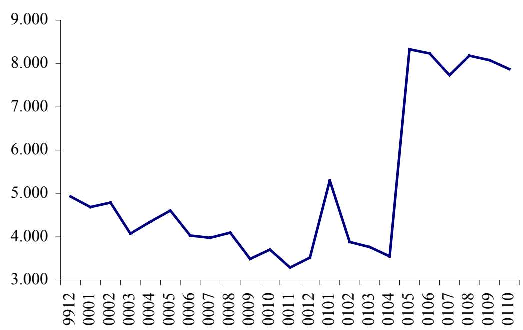


Figure III.1.6. Developments in Deposit Items (Discounted by CPI 1994=100, TL Billion)

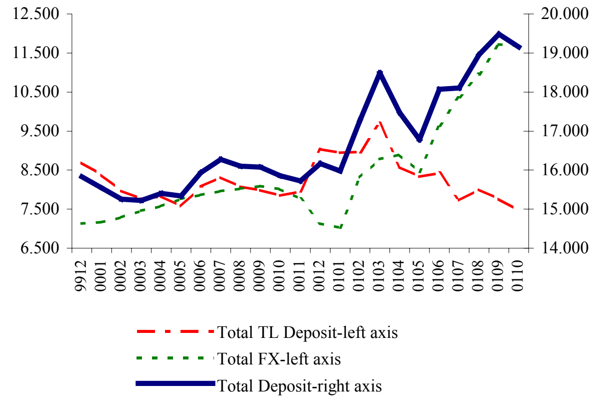


Table III. 4. Developments in Securities Portfolio and the Securities in Non-Trading Portfolio (TL Trillion)

	Public	Private	SDIF	Total
December 2000				
Securities Portfolio	**2.197**	**5.212**	**3.751**	**11.995**
TL	996	2.767	2.733	7.231
FX	1.202	2.444	1.018	4.764
Sec. in Non-Trad. Porfolio	**994**	**4.261**	**819**	**6.428**
TL	742	2.940	256	4.297
FX	252	1.321	5.63	2.171
June 2001				
Securities Portfolio	**17.065**	**4.187**	**10.837**	**32.533**
TL	14.273	2.744	8.390	25.707
FX	2.792	1.443	2.446	6.828
Sec. in Non-Trad. Porfolio	**1.326**	**9.631**	**5.603**	**16.931**
TL	626	7.451	3.175	11.557
FX	701	2.180	2.427	5.374

Source: BRSA

In 2001, government securities given to the SDIF banks by Treasury in order to put their financial structures in order, amounted to TL 16.3 quad trillion In addition, in 2001, government securities given to state banks by the Treasury to compensate their special duty losses amounted to TL 23 quad trillion, and as of May 2001, the special duty losses of these banks came to an end.

While the government securities carried by the state and the SDIF banks went up because of the securities given by the Treasury, the securities carried by the private and foreign banks shrunk. The reason was that they limited their investments on government securities due to high losses they had encountered in the November 2000 crisis. In the first half of 2001, while securities carried by the state and SDIF banks increased by 437 percent and 100 percent respectively in real terms, the securities carried by private and foreign banks decreased by 44 percent and 64 percent respectively in real terms. In October 2001, total securities carried by banking sector increased by 123.7 percent in the first 10 months.

III.1.c. Developments in the Source Structure of Banking Sector

Although the total deposit volume decreased in real terms since the February crisis, the tendency of the total deposit volume inclined to increase as a result of real increase in the volume of foreign currency denominated deposits since May. As a result of uncertainties related to financial structure of the banking sector, the volume of total deposits decreased and some of the saving volume leaked out of the banking system.

Although the total deposit volume decreased in real base since the February crisis, the tendency of the total deposit volume inclined to increase as a result of real increase in volume of foreign currency denominated deposits since May.

The volume of TL denominated deposits continued to decrease in the following months. As of October, volume of demand deposits and time deposits decreased by 4.1 percent and 21.6 percent in real terms respectively, compared with deposit volumes of the end of previous year.

Although foreign currency denominated deposits in US dollars decreased as a result of uncertainties in the economy, it inclined to increase as of May and switching from TL deposits to foreign currency denominated deposits was observed.

While the share of foreign currency deposit in total deposit was 48.1 percent in February, it increased to 61 percent in October. To increase attractiveness of TL deposits, the withholding tax rate for foreign currency denominate deposits having maturity shorter than one year increased in August, and interest payment application for TL deposits required reserves started. The expected effect of these measures on TL deposit was limited by continuing uncertainties related to exchange rate.

Although deposit and credit interest rates that inclined to increase a result of the economic crisis have started to decrease as of May, the interest rates are still high. The state and SDIF banks interest rates have become almost the same, and interest rates started to decrease as of April as a result of decreasing short term financing needs of state and SDIF banks by government bonds and bills, and common market interest rate policy; that is, their deposit interest rates are determined by a common and politically independent board which eliminated higher deposit interest rates than prevailing market interest rates. However, continuing uncertainties related to exchange rate and world economy and high risk factor that circumvent capital inflow have limited decrease in interest rates.

The volume of repo that consists of off-balance sheet transactions of banking sector to TL deposits was 29.5 percent in October 2000. That ratio inclined to decrease in 2001, as a result of restructuring of state and SDIF banks that ensured decreasing short term financing needs of those banks. In August 2001, the withholding

Figure III.1.7. Developments in TL Deposits and FX Deposits

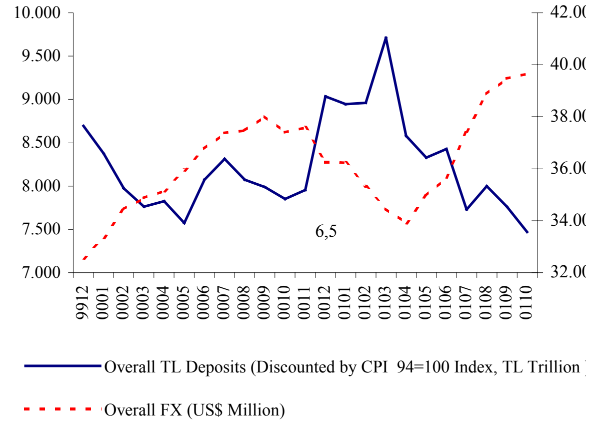


Figure III.1.8. The Ratio of FX Deposits to Overall Deposits (Percentage)

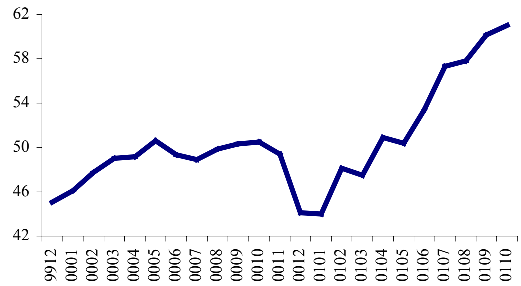


Figure III.1.9. Interest Rates of Commercial Credit, TL Deposits and Repos (Compound)

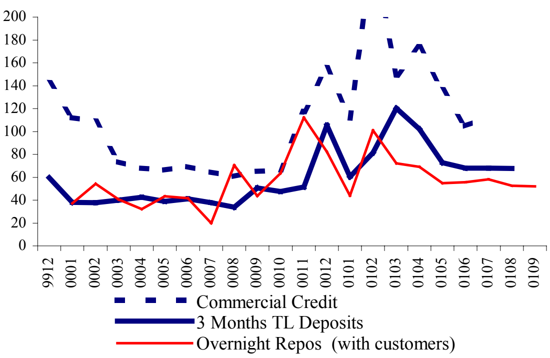


Figure III.1.10. The Ratio of Repo Transactions to TL Deposits (Percentage)

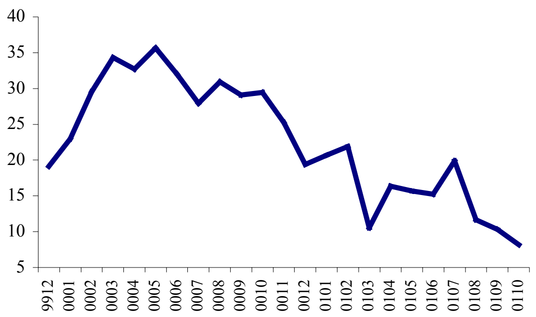


Figure III.1.11. Foreign Credit used by the Banking System (US$ Billion)

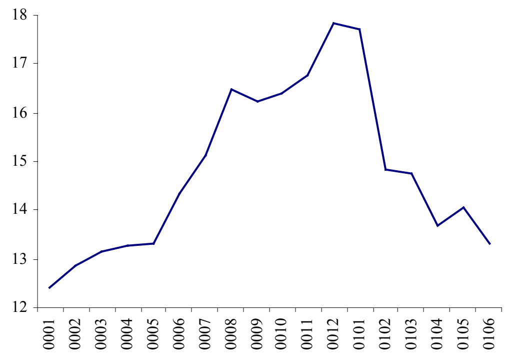
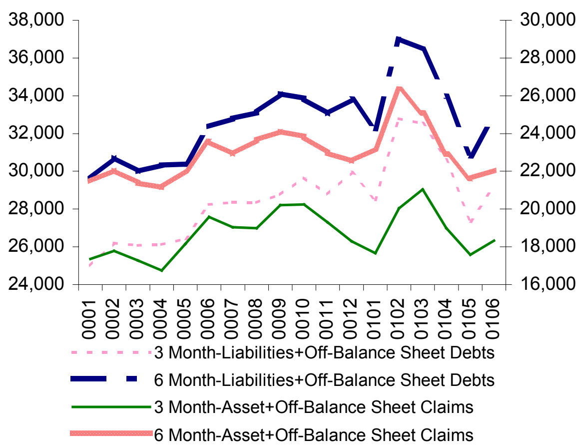


Figure III.1.12. Three and Six Month Assets+Off-Balance Sheet Claims and Liabilities+Off-Balance Sheet Debts (Discounted by CPI 1994=100, TL Billion)



tax rate that consider repo income as a tax base, increased from 16 percent to 20 percent and increment of tax rate accelerated downward trend in repo transactions and the ratio of repo to deposit decreased to 8.2 percentage in October.

The decrease in the foreign credit of banking system dampens the funding source of banking system. The facts that the crises of November 2000 and February 2001 changing exchange rate regime from predetermined to floating exchange rate and decline in economic activity caused a decrease in used foreign credit volume of banking system from both of demand and supply sides. Capital inflow to Turkey is expected to improve as a result of exchange rate, stability following new Stand-By agreement with the IMF and the elimination of SDIF bank problem until the end of 2001 and decreasing uncertainties related to terrorist attack to the US in September. That case will positively affect banking system liquidity and the banking system's borrowing rate from international capital markets may decrease.

III.1.d. Average Maturities of Assets and Liabilities

Considering both in balance and off balance sheet items, the analysis of maturity structure of the banking sector indicates that the maturity mismatch still prevails. The shortening in the average maturity of liabilities resulted the maturity mismatch, due mainly to the shortening in the average maturity of deposits.

The shares of short-term TL deposits in total TL deposits, and short-term FX deposits in total FX deposits were observed to be 93 percent and 86.3 percent, respectively in October 2001. The fact that uncertainties prevailed in 2001 caused maturity preferences of both banks and depositors to change in favor of short-term deposits. On the other hand, no significant change was observed in the average maturity of assets, due to a large increase in the medium term loans extended in previous year. Therefore, while the average maturity of assets remains unchanged, shortening in the average maturity of liabilities caused the existing maturity mismatch between the assets and liabilities to continue.

The fact that the uncertainties prevailed in 2001 caused maturity preferences of both banks and depositors to change in favor of short-term deposits.

We expect that changes in the withholding tax rate on interest incomes in favor of long-term deposits, which was introduced with a new regulation in August 2001, may change depositors' preferences in favor of longer-term deposits, and hence, the average maturity of deposits gets longer. Furthermore, the decrease in the volume of repo transactions may also lead to an increase in the average maturity of liabilities.

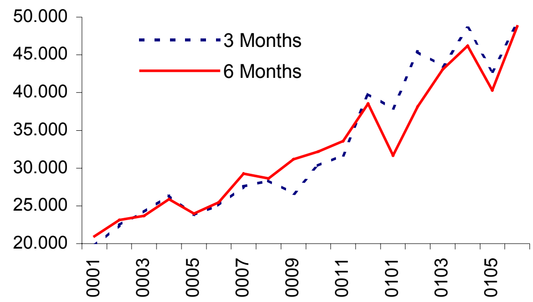
III.1.e. Developments in the Open Foreign Currency Position of the Banking Sector

Net Open Foreign Currency Position (NOFCP) of the banking sector started to shrink after the financial crisis in November 2000, and declined to US$ 612 million by September 2001. In September 2001, that of the banks taken over by the Savings Deposit Insurance Fund (SDIF), and that of foreign banks declined to US$ 1.091 million, and US$ 15 million respectively. During the same period, Net Foreign Currency Position of state banks, and private banks resulted in an excess of US$ 116 million, and US$ 321 million, respectively.

III.2. The Securities Market

The ISE National 100 index continued to decrease because of capital outflow, high interest rates and declining economic activity in 2001. The ISE 100 national index decreased by 40 percent in real terms in October compared to the index of previous year. In same period, the service index decreased by 48.8 percent in real terms that is the highest decrease among indices, and financial and industrial indices decreased by 44.9 percent and 24.4 percent respectively. In the aforementioned period, trading volume continued to decline.

Figure III.1.13. Maturity Mismatch (TL Trillion)



Maturity Mismatch=(Short-Term Liabilities+Off-Balance Sheet Debts)-(Short-Term Asset+Off-Balance Sheet Claims)

Figure III.1.14. The Shares of Short Term TL and FX Denominated Deposits in Total Deposits (in percent)

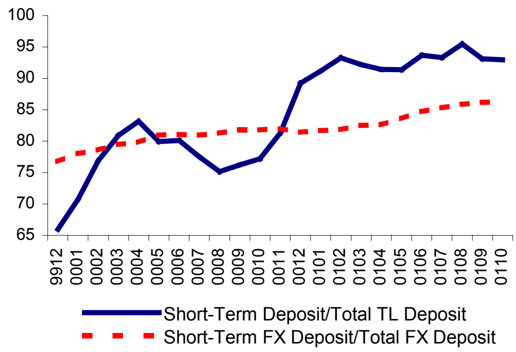


Figure III.1.15. Open Foreign Currency Position of the Banking Sector-Net Open Foreign Currency Position (US$ Million)

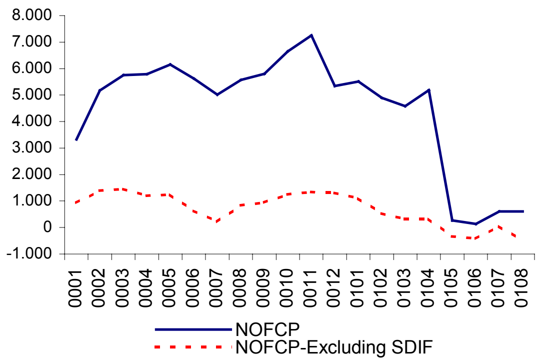
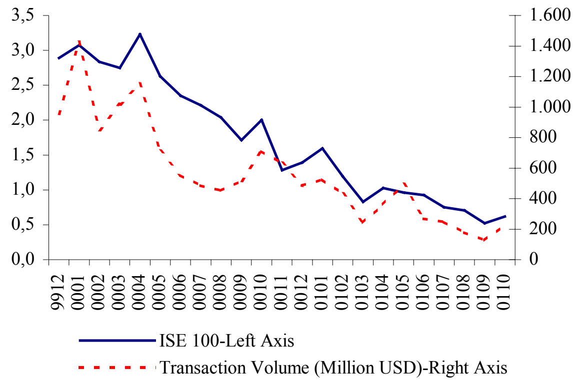


Figure III.2.1. ISE National 100 Index and Transaction Volume (US$)



The ISE National 100 index continued to decrease because of capital outflow, high interest rates and declining economic activity.

Although the ISE 100 index was US$ 1.4 in December 2000, it decreased to US$ 0.6 in October 2001. In the same period, service, financial, industrial indices decreased from US$ 1.1 to US$ 0.4 from US$ 1.9 to US$ 0.8 and from US$ 1 to US$ 0.6, respectively. While the daily trading volume was US$ 632 million in December 2000, it decreased to US$ 227 million in October 2001.

RESTRUCTURING OF THE BANKING SECTOR

“The Restructuring Program of the Banking Sector” was declared to the public on May 16, 2001.The Program aimed to rehabilitate state banks, to resolve the banks taken over by the SDIF to reduce their cost to the public and their threat to the financial sector stabilization, and to strengthen the net-worth of other private sector banks, which were substantially eroded by the crisis. Following improvements were achieved during the restructuring process.

The state and SDIF Banks: Excluding overnight liabilities to the Central Bank, all of the overnight liabilities of both state and SDIF banks were removed in June 2001 and May 2001, respectively. By the end of May 2001, outstanding repo balances of the state and SDIF banks were limited to TL 7 quadrillion. As of May 2, 2001, the outstanding balance of duty losses in the state banks was completely removed, and further duty losses was prevented. A ceiling was set for the deposit interest rates offered by the state banks and SDIF banks to depositors. A capital injection of TL 325.6 trillion in the form of cash, and TL 1.524 quadrillion in the form of government securities were made to strengthen the capital of the state banks. Emlak Bankasi was transferred to Ziraat Bankasi on July 9, 2001. In order to strengthen the financial position of the SDIF banks, the Undersecretariat of the Treasury issued securities, amounting to TL 19.7 quadrillion. Furthermore, to strengthen their capitals, the SDIF made deposit with these banks, and fresh capital was injected. The total amount of capital injection was TL 2.2 quadrillion. Three of the SDIF banks were sold, and other banks were stated to resolve by the end of 2001. Furthermore, the number of branch and personnel in state banks also decreased, as envisaged in the Program. In line with the Program targets, the number of personnel decreased to 60.444 in June 2001, from 70.329 in December 2000. During the same period, the number of branch of these banks was reduced from 2915 to 2747. The number of personnel of the SDIF banks was reduced from 20.044 to 17.087, and the number of branch was also reduced from 1071 to 910.

The Private Sector Banks: Financially weakened private sector banks were obliged to give written commitment to the BRSA, regarding additional capital injection by the end of 2001, up to the level, which is regarded as sufficient by the international standards. The methods regarding the inclusion of the market risk, that is the interest rate risk, FX risk, and market risk, in the calculation of capital requirement were determined. The related Communiqué was introduced in February 2001, and will be applied in 2002. Inclusion of the market risks in the calculation of the capital requirement on a consolidated basis will be started to apply by July 2002. Meanwhile, various regulations encouraging bank mergers were introduced. Furthermore, works to remove legal and bureaucratic barriers preventing the merger with foreign banks are in progress. Regulations regarding the inclusion of the repo transactions in the balance sheet items were completed.

By the end of 2000, there were 61 commercial banks, and 18 investment and development banks. Of these banks, 4 banks were state owned, 28 were private sector banks, 18 foreign banks, 11 SDIF banks, and 18 banks were investment and development banks. By August 2001, the number of banks in the sector declined to 67. Of these banks, 3 are state owned, 22 are privately owned, 8 are SDIF banks, and 16 are investment and development banks. During the first eight months of 2001, Emlak Bank was taken over by Ziraat Bankasi, 7 SDIF banks (Egebank, Yurtbank, Yaşarbak, Bank Kapital, and Ulusalbank were combined in a bridge bank (Sümerbank), 2 SDIF banks (İnterbank and Esbank) were combined in another bridge bank (Etibank). 2 SDIF banks were sold (Bank Ekspres was sold to Tekfen Group on June 30, 2001, Sumerbank was sold to Oyak Group), 2 investment and development banks were liquidated (Okan Yatırım Bank and Atlas Yatırım Bank), 7 banks (Ulusalbank, İktisat Bankası, Bayındırbank, EGS Bankasi, Kentbank, Milli Aydın Bankasi (Tarişbank), and Sitebank) were taken over by the SDIF, and the banking license of an SDIF bank (Türk Ticaret Bankasi) was cancelled.

The private sector banks are on the way to merge with other banks and/or foreign banks. For example, Körfezbank and Osmanli Bankasi were merged in Osmanli Bankasi on July 30, 2001. Currently, merger of Osmanli Bankasi with Garanti Bankasi is underway. Terrorist attacks on September 11, 2001 in the United States have adversely affected the endeavors of the banks to find a foreign partner.

IV. PUBLIC FINANCE AND DOMESTIC DEBT STOCK

Due to the tight fiscal policy and measures to provide fiscal discipline, consolidated budget primary balance performed well and gave TL 12.1 quadrillion surplus in the January-October 2001 period (Table IV.1) The improvement in the primary balance resulted especially from the contraction in the non-interest expenditures and non-tax revenues which performed well. However, the budget deficit reached TL 24 quadrillion in this period due to the domestic interest payments, which increased rapidly as of May.

Consolidated budget primary balance performed well in the first ten months of 2001.

IV.1. Revenues

Budget revenues were realized as TL 41.2 quadrillion in the January-October 2001 period, increasing by 47.7 percent with respect to the same period of the last year.

While the increase in tax revenues remained at a limited level, non-tax revenues increased at a very high rate. In addition to the sales of Telecom License, net proceeds of the Central Bank and the revenues, which transferred from Central Bank's revaluation account to the Treasury, affected the non-tax revenues positively (Table IV.2).

While the increase in the tax revenues remained at limited level the non-tax revenues increased at a very high rate in 2001.

Tax revenues were realized at TL 31.2 quadrillion increasing by 41.2 percent in the January-October 2001 period. The ending of application period of some of the temporary supplementary taxes introduced in the last period of 1999 as well as economic contraction was effective in the limited increase in the tax revenues. Due to the economic contraction, which negatively affected the tax paying ability, the

Table IV.1. Consolidated Budget Balances (TL Trillion)

	2000 Jan-Oct	2001 Jan-Oct
Revenues	27908	41217
Expenditures	38918	65208
Budget Balance	-11010	-23991
Primary Budget Balance	7996	12101
Primary Budget Balance Exc. Privatization	7943	10568

Source: Ministry of Finance

Table IV. 2. Consolidated Budget Revenues (TL Trillion)

	2000 Jan-Oct	2001 Jan-Oct	Increase Rate (percent)
REVENUES	27908	41217	47.7
General Budget Revenues	27457	40650	48.0
Tax Revenues	22058	31155	41.2
Tax Revenues Exc. Supplementary Taxes	19575	30022	53.4
Taxes on Income	8737	12228	39.9
Income Tax	5029	9440	87.7
Corporate Tax	1854	2405	29.7
Taxes on Wealth	326	403	23.8
Taxes on goods and services	9501	14134	48.8
Domestic VAT	3675	5629	53.2
Petroleum Consumption Tax	2882	4273	48.3
Banking and Insurance Trans. Tax	744	1361	83.0
Taxes on Foreign Trade	3493	4390	25.7
VAT on Imports	3164	4073	28.7
Non-tax Revenues	2695	6398	137.4
Special Revenues and Funds	2704	3097	14.5
Annexed Budget Revenues	451	567	25.6

Source: Ministry of Finance

collection/assessment ratio was realized at 85.8 percent in this year whereas it was realized at 89.1 percent in the January-October 2000 period.

The increase in the income tax revenues resulted especially from withholding tax. The increase in the deposit and repo interest rates since February 2001 and 2 percentage point increase in the withholding tax rate on repo interest income and 1 percent increase in the withholding tax rate on deposit interest income since January 2001 positively affected withholding tax, which obtained from interest income.

Due to the increase in the economic uncertainty and high interest rates, the decrease in the consumption demand negatively affected indirect tax revenues, especially domestic VAT. In order to increase the domestic VAT revenues, domestic VAT rate on some goods and services was increased by 1 percentage point as of May 15, 2001. Due to the increase in the consumer credit interest rate and economic contraction the demand for durable consumption goods, especially automobile, decreased; consequently, it negatively affected motor vehicle purchasing tax and VAT revenues. However, the VAT revenues have increased in the last months.

The increase in the petroleum consumption tax revenues remained a limited level due to the decline in the consumption. However, the petroleum consumption tax revenues increased rapidly in the last months due to the high increase in the lump sum tax.

Another tax, which very little increased, is VAT on imports. Due to the economic contraction and the depreciation of the Turkish lira, imports declined and this negatively affected the VAT on imports.

IV.2. Expenditures

In order to reflect the effects of the February 2001 crisis and the costs of the banking system-restructuring program to the budget, the Supplementary Budget Law allowing an additional appropriation of the amount of TL 30.6 quadrillion was enacted in July 2001. An amount of TL 24.6 quadrillion of the additional appropriation is related to the interest payments.

The Supplementary Budget Law enacted in July 2001 allowed an additional appropriation of the amount of TL 30.6 quadrillion.

In the January-October 2001 period, the total and primary budgetary expenditures exhibited an increase by 67.6 percent and 46.2 percent, respectively.

The increase in the personnel and other current expenditures remained limited with respect to general rate of increase in expenditures. The salaries of civil servants were raised by 10 percent and 5 percent in first and second halves of the year, respectively. However, since the increase fell below the CPI inflation rate, the difference between inflation and the initial salary rise has been reflected to salaries with an additional welfare premium of 2 percent. The collective wage bargaining in the public sector was contracted with an increase of 15 percent in both halves of 2001 and 10 percent in both halves of 2002. Yet, if the CPI inflation rate exceeds these wage increases, the 80 percent of the difference will be added to wages in the first three 6-month periods. The additional increase will cover all the difference between inflation and 10 percent wage increase for the last half year. The additional wage increase for the first 6 months of 2001 will be paid in February 2002.

The increase in investment expenditures was due to the inclusion of the expenditures of abolished Public Participation Fund within the consolidated budget in 2000.

Due to the increasing uncertainty from February 2001 onwards, the interest rates raised and the maturity of borrowing shortened. Furthermore, due to interest payments accrued on the public securities given to state banks and to the Savings Deposit Insurance Fund and replacement of these securities with new ones [with higher interest rates], resulted in an increase in domestic interest payments from May 2001 on. These

Table IV. 3. Consolidated Budget Expenditures (TL Trillion)

	2000 Jan-Oct	2001 Jan-Oct	Increase Rate (percent)
EXPENDITURES	38918	65208	67.6
NON-INTEREST EXPENDITURES	19913	29115	46.2
Personnel	8109	11927	47.1
Wages	1351	1922	42.3
Other Personnel Expenditures	6757	10004	48.0
Other Current	2156	2975	38.0
Investment	1627	2537	55.9
Transfer Expenditures	27026	47769	76.7
Interest Payments	19006	36092	89.9
Domestic Debt Interest Payments	17773	33467	88.3
Foreign Debt Interest Payments	1233	2625	113.0
Transfers to the SEE's	652	923	41.5
Tax Rebates	1286	2074	61.3
Social Securities	2916	5248	80.0
Payments to Retirement Fund	1680	2530	50.6
Payments to SSK	400	841	110.3
Payments to Bağ-Kur	836	1630	95.0
Agricultural Support	305	359	17.8
Payments to Funds	1496	839	-43.9
Other Transfers	1367	2233	63.4

Source: Ministry of Finance

Figure IV.1. Consolidated Budget Balance and Primary Balance (Monthly, TL Trillion)

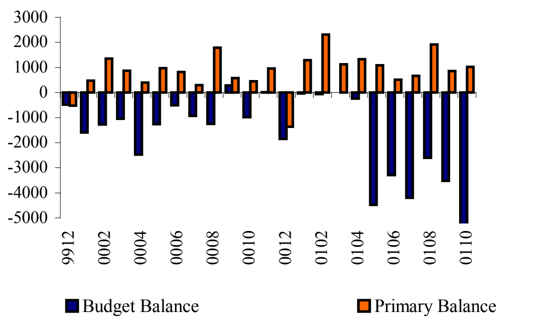
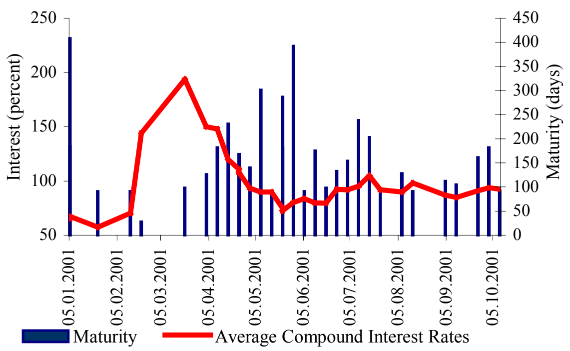


Figure IV.2. 2001 Treasury Auction Interest Rates and Maturity Structure



events caused the share of interest payments in budget expenditures to rise. Especially, the high increase in the domestic interest payments after May is the primary source of the deterioration of the budget balance (Figure IV.1).

The high increase in the domestic interest payments is the main reason of the deterioration of the budget balance.

Another item affecting the budget balance negatively is the transfers to social security institutions. Main sources of the increase in this item are the increase in the transfers to Bag-Kur and SSK. The increase of the financial deficit of SSK raised from increasing unemployment, decreasing real wages, indexing the retirement benefits to the CPI inflation, the low increase of the social security premium floor, and the declining rate of the premium collections due to recession (Table IV.3).

IV.3. Consolidated Budget Deficit and Its Financing

The withdrawal of two banks holding large amounts of public securities after their transfer to the SDIF following the November 2000 crisis triggered an increasing uncertainty that caused a decline in demand for government securities. Another reason for the decline in government securities demand is the unwillingness of foreigners for buying Turkish treasury bills after the crash of the former exchange rate regime. The foreign capital outflow after February 2001 and the increasing country risk made foreign borrowing difficult and external debts were replaced with domestic debts. The uncertainty caused by the financial turmoil after February 2001 caused both shortening borrowing maturities and increasing interest rates (Figure IV.2).

After the announcement of a new economic program and the new stand-by arrangement with the IMF, one observed a serious decline in interest rates, however as of June interest rates increased again due to political instability, negative events in Argentina and the postponement of the credit to Turkey agreed previously upon by the IMF executive board.

In this framework, short-term domestic borrowing became the most important means of the deficit financing in the January-September 2001 period (Table IV.4).

The consolidated budget was financed through short-term domestic borrowing during the January-September 2001 period.

An inspection of the structure of the domestic borrowing reveals that the Treasury was a net borrower in both Government Bonds and Treasury Bills. However, in July, the Treasury financed through public sales as well. Within this framework, FX denominated and FX linked papers were used as a means of borrowing due to the short maturity, high interest rates, and insufficient demand to TL denominated borrowing instruments. Therefore, the share of the FX denominated and FX linked securities in the domestic debt stock started to increase.

In the January-September 2001 period, the Treasury realized a domestic debt service of TL 48.4 quadrillion whereas borrowed TL 44.9 quadrillion from the domestic market. The average borrowing maturity of the Treasury which had been 359 days in the January-October 2000 period turned out to be 139 days while the weighted average compound interest rate which had been realized at 35.9 percent was 107,2 percent in the same period of 2001. Hence, the borrowing maturity decreased while the borrowing cost increased considerably with respect to the previous year.

Table IV. 4. Consolidated Budget Balance and Financing (TL Trillion)

	2000 Jan-Sep	2001 Jan-Sep
Primary Budget Balance	7553	11081
Budget Balance	-10034	-18434
Cash Balance	-10613	-19155
Financing	10613	19155
Net Domestic Borrowing	8316	15523
Government Bonds	8751	1114
Treasury Bills	-978	14408
Guarantied Debt Returns	543	0
Net Foreign Borrowing	2111	-3143
Other	187	6775

Source: Treasury

Table IV. 5. Domestic Debt Stock and Its Structure (Amounts are in TL Quadrillion and Shares are in Percent)

	2000		2001	
	Amount	Share In Total	Amount	Share In Total
Total Stock	36.4	100.0	109.3	100.0
Cash**	29.6	81.3	49.6	45.4
Discounted	19.4	53.3	15.8	14.5
Flexible-rate	9.0	24.7	9.6	8.8
FX Denominated and FX linked	1.2	3.3	24.2	22.1
Non-Cash	6.8	18.7	59.7	54.6
Discounted	1.0	2.7	0.0	0.0
Flexible-rate	0.0	0.0	27.7	25.3
3 month coupon payment	0.0	0.0	23.5	21.5
Treasury Auction Linked	0.0	0.0	17.3	15.8
Repo Interest Linked	0.0	0.0	6.2	5.7
6 month coupon payment	0.0	0.0	4.2	3.8
CPI Indexed	4.0	11.0	21.4	19.6
FX Denominated and FX linked	1.8	4.9	10.6	9.7

*: As of October 2001.
**: Cash debt stock also includes the CBRT's TL 8.1 quadrillion FX linked portfolio obtained as IMF credit.
Source: Treasury

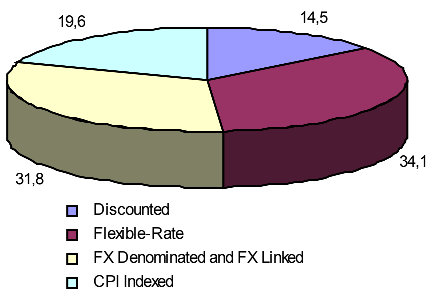
IV.4. Domestic Debt Stock

The domestic debt stock increased from TL 36.4 quadrillion in October 2001 to TL 109.3 quadrillion at of the end of 2000**.** The increasing amount of the government domestic borrowing securities, which were issued in response to the duty losses of the state banks accumulated in the previous years, was the main source of the rise in the domestic debt stock. As a result of the issuance of these securities which aimed at strengthening the financial structure of the state and SDIF banks and took place as a sub-item of the non-cash debt stock, the domestic debt stock increased by TL 52.9 quadrillion and constituted 72.6 percent of the rise in the debt stock. The increase in the cash domestic debt stock, which is the indicator of the domestic debt liabilities of the Treasury to the market, remained at a limited level. (Table IV.5, Table IV.6).

The increase in the domestic debt stock in the first ten months of 2001 was mainly due to the government securities issued to strengthen the financial structure of the SDIF banks and to meet the duty losses of the state banks accumulated in previous years.

The structure of the debt stock shows that 34.1 percent of the securities is linked to the interest rate whereas 31.8 percent is linked to the exchange rate (Figure IV.3). That kind of a debt structure simply implies that the public finance has become too sensitive to interest and exchange rate shocks. However, restoring stability in the financial markets and rebuilding positive expectations about the markets should lead to a reduced interest rate premium and relieve the concerns about the domestic debt stock. Additionally, indexation to interest rate should provide an advantage to the budget balance due to a fall in the inflation rate, since the real interest rate would be lower compared to the fixed interest rate. The securities in the Central Bank portfolio were restructured as of October 30, 2001 and indexed to CPI. Consequently, the share of the CPI indexed securities in the domestic debt stock increased to 19.6 percent at the end of October 2001.

Figure IV.3. The Distribution of Domestic Debt Stock as of October 2001 (Percent)



In the January-October 2001 period, interest and FX linked securities constituted the majority in the debt stock.

Measures to improve the primary budget balance seem necessary since the interest payments of the discounted and indexed papers will be realized in 2002.

IV.4.a. Cash Debt Stock

High interest rates prevailing also in June and the fall in the maturity of borrowing increased the short-term liquidity need of the Treasury. On the other hand, a domestic debt swap operation was realized on June 15, 2001, mainly due to the open position of the banking sector. With this swap operation, 3 and 5 year maturity 3 month coupon payment FX linked, and 1 and 2 year maturity flexible interest rate 3 month coupon payment TL denominated securities were handed to the banking sector which in turn led to an increase in the borrowing maturity and a significant reduction of the open positions of the banking sector. The structure of the domestic debt stock changed significantly as a result of this operation. The share of the discounted papers decreased to 31.9 percent in October 2001 from its 65.6 percent in 2000 while in the same period, the share of the FX and FX linked borrowing securities, including the Central Bank's TL 8.1 quadrillion IMF credit, increased from 4 percent to 48.8 percent (Figure IV.4).

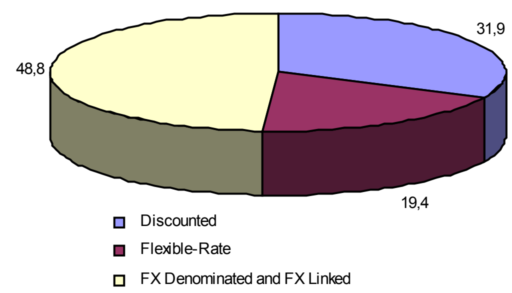
With the swap operation realized in June, the Treasury managed to increase the maturity of the domestic debt and meet the short-term liquidity need. With this operation, the open position of the banking sector was significantly reduced.

Table IV.6. The Distribution of the Domestic Debt Stock According to Buyers (TL Quadrillion)

	2000 December	2001 September
1. PUBLIC SECTOR	12.2	71.7
a. CBRT	1.5	24.5
IMF Credit	-	8.7
Other	1.5	15.8
b. State Banks (*)	2.9	21.5
c. SDIF Banks	3.9	16.5
d. Other Public	4	9.2
2. MARKET	24.2	34.1
TOTAL (1+2)	36.4	105.8

(*) The duty loss accruals, which are not linked to paper amounts TL 15.1 quadrillion as of the end of 2000.

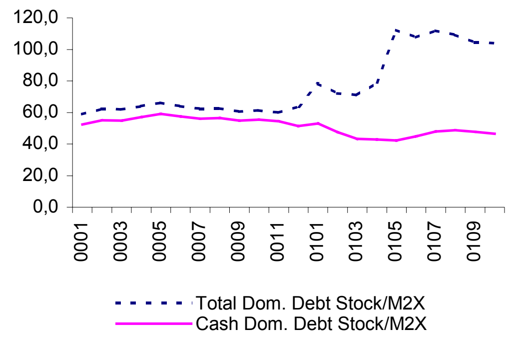
Graph IV.4. The Share of Cash Domestic Debt Stock In Its Own as of October 2001 (Percent)



With the swap operation, which amounted to a nominal TL 9.8 quadrillion of which average maturity was approximately 6 months were changed with the bonds of which average maturity was 37.5 months. Hence, the average maturity of the domestic debt was prolonged and a total of TL 7.9 quadrillion was saved from the domestic debt service in 2001 of which TL 2.8 quadrillion was interest payments. This swap operation also contributed to the extension of the maturity of the banking sector's assets. In addition, the fact that the issued papers are coupon payment and flexible-rate securities reduced the interest and exchange rate risk of the banking sector and helped to provide short-term liquidity.

Volatile financial markets, political instability, negative developments in the foreign markets, high level of the domestic debt stock and interest rate risk averse banking sector were the main factors behind high levels of interest rate. This situation, with the unfavorable structure of the domestic debt stock, adversely affects the future expectations.

Figure IV.5. The Ratio of Domestic Debt Stock to M2X



The share of the debt stock in M2X, an indicator of the pressure of the debt stock in the financial markets, increased whereas the pressure of the cash debt stock in the financial markets decreased (Figure IV.5).

IV.4.b. Non-Cash Debt Stock

Non-cash debt stock consists of the securities issued by the Treasury due to the liabilities of the public institutions. In other words, by the issuance of these papers, the Treasury does not acquire any cash inflows, but aims at strengthening the financial structure of the state and SDIF banks. Especially during the February and November economic crises, state banks demanded a great deal of fund with high interest rates from the markets to meet the liquidity need stemmed from their duty losses, which in turn led to an excess interest burden on these banks. In addition to this, the effectiveness of the monetary policy implementation was limited due to the adverse effects of the high level of duty losses on short-term interest rates.

In order to offset these negative effects, the Treasury provided these banks with flexible-rate securities. With these securities, the state banks reduced their daily liabilities to the banking and non-banking sector via repo operations and direct sales to the Central Bank within a predetermined program. Within this frame, the Central Bank purchased a part of these securities from these banks, which amounted to TL 14 quadrillion and had these banks leave the short-term funding markets. These securities, which take place in the Central Bank's portfolio, were changed with CPI indexed and one-year coupon payment bonds as of October 30, 2001. These securities amounted to TL 18.8 quadrillion with the incurred interest. As a result of these operations, the Central Bank's portfolio had also gone up. (Table IV.7).

Table IV. 7. Non-Cash Debt Stock(*)

	Quadrillion TL	Million USD	Million EURO
State Banks	20.2	1171.1	349.8
SDIF Banks	7.5	5769.7	2229.1
CBRT	18.8		
Other Public	2.8		
Total	49.3	6940.8	2578.9

*: As of October 2001.

V. DEVELOPMENTS IN THE REAL ECONOMY

V.1. Demand and Production

The Turkish economy entered into a deep recession period in the first half of 2001 stemming from the February crisis. GDP decreased by 6.4 percent in the first nine-month period of the year, whereas GNP declined by 8.3 percent due to the decrease of net factor income from abroad. The contraction of domestic demand by 17.5 percent in the first nine-month period of the year was effective on the reduction of GDP.

In this period, the floating of the Turkish lira led exports of goods and services continued its increasing trend in the first nine-month compared to previous year's same period. On the other hand, imports of goods and services decreased by 24.5 percent as a result of domestic demand contraction and noticeable depreciation of the Turkish lira. In the following period, the adverse consequences of terrorist attacks to the U.S.A. in September to the world economy are expected to affect the exports of goods and services, tourism and the growth rate negatively.

The contraction of domestic demand by 17.5 percent in the first nine-month period of the year was effective on the GDP reduction of 6.4 percent.

Domestic demand contraction caused the recession of the economy continued in the third quarter of the year. Besides, the contraction of the domestic demand decreased the pressure on the consumer prices relatively.

V.1.1. Domestic Demand Developments

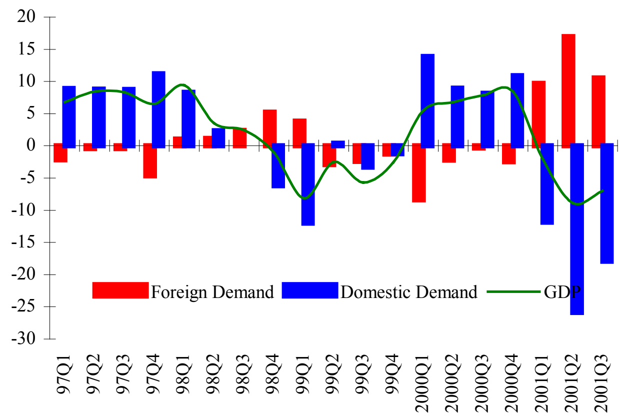
The uncertainties in the financial markets adversely affected the consumers and firms' expectations. Furthermore, the rise of inflation as a result of the depreciation of the Turkish lira caused real incomes of consumers and private firms to decline. These circumstances caused domesti c demand contraction

Table V.1.1. Main Expenditure Items (Annual Percentage Change)

	2000	2001			
	Annual	I	II	III	First nine months
Consumption Expenditures	6.3	-2.8	-11.0	-9.9	-8.2
Private Consumption Expenditures	6.2	-3.0	-11.6	-9.4	-8.2
Public Consumption Expenditures	7.1	-0.6	-6.0	-14.3	-7.8
Gross Fixed Capital Investment	16.9	-11.5	-31.8	-35.8	-28.2
Public Investment Expenditures	19.6	-6.5	-32.1	-20.8	-23.0
Private Investment Expenditures	16.0	-12.4	-31.7	-40.3	-29.7
Machinery and Equipment	37.2	-18.3	-44.4	-61.9	-43.5
Construction	-9.7	-1.8	-7.9	-6.1	-5.5
Total Investment Expenditures	19.7	-32.1	-49.2	-37.4	-40.5
Total Domestic Demand	9.8	-10.7	-23.3	-17.5	-17.5
Final Domestic Demand	8.9	-4.9	-17.0	-17.0	-13.6
Exports of Goods & Services	19.2	9.7	8.7	5.0	7.6
Imports of Goods & Services	25.4	-14.4	-30.7	-27.0	-24.5
GDP	7.4	-2.1	-8.9	-7.1	-6.4

Source: SIS

Figure V.1.1. Contributions of Demand Components to Growth Rate



Source: SIS

based on private consumption and investment expenditures.

Domestic demand contraction is due to the reduction in the private consumption and investment expenditures.

Table V.1.2. Public Expenditures (Annual Percentage Change)

	2000	2001			
	Annual	Q1	Q2	Q3	First nine months
Public Consumption	7.1	-0.6	-6.0	-14.3	-7.8
Compensation of Employees	2.0	3.3	3.2	2.3	2.9
Purchases of Goods & Services	12.4	-9.6	-15.4	-29.8	-20.7
Public Investment	19.6	-6.5	-32.1	-20.8	-23.0
Machinery and Equipment	20.3	-5.6	-65.7	-25.5	-42.1
Building Construction	31.6	-13.1	-2.2	-21.2	-13.5
Other Construction	12.2	-3.6	-8.0	-18.8	-12.8

Source: SIS

Additionally, public expenditures substantially decreased based on machinery and equipment, since the first nine months of the year compared to previous year's same period (Table V.1.2). Within the public expenditures, only compensation of employees item increased limitedly. In the last quarter of the year, public expenditures are expected to continue its decreasing trend because of the existing tight fiscal policy.

V.1.1.a. Private Consumption Expenditures

The private consumption expenditures decreased by 8.2 percent in the first nine months of the year compared to previous year's same period. All expenditures groups except the ownership of dwelling and energy, transportation and communication expenditures declined in this period. In this trend, the reduction in the real incomes, rise in the real interest rates and decline in the employment had an important impact. Besides, uncertainties in the financial sector affected consumer confidence negatively and increased the contraction in the economy.

Table V.1.3. Private Consumption Expenditures (Annual Percentage Change)

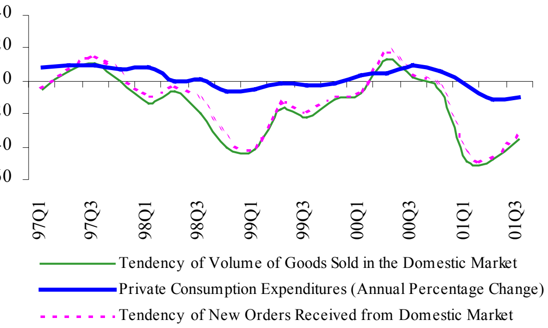
	2000	2001			
	Annual	Q1	Q2	Q3	First nine months
Private Consumption	6.2	-3.0	-11.6	-9.4	-8.2
Food. Beverages	3.2	0.9	-4.5	-4.3	-3.0
Durable Goods	27.4	-20.4	-36.1	-31.1	-29.5
Semi-durable & non- Durables	0.9	3.7	-12.5	-9.9	-6.0
Energy-Transportation-Communication	-2.1	1.4	-1.1	0.5	0.3
Services	7.6	-3.4	-11.5	-9.0	-8.4
Ownership of Dwelling	0.0	2.2	2.1	2.1	2.1

Source: SIS

Expenditures for the durable goods decreased considerably by 29.5 percent in the first nine months of 2001 compared to previous year's same period (Table V.1.3). One of the reasons of this development was that substantial amount of the expenditures for these products were realized in 2000. The real consumer credit increased and interest rates declined sharply during the Exchange Rate based Stabilization Program in 2000. Hence, the demand for the durable goods was brought forward and was realized in 2000.

The real contraction of the consumer credit due to the shortage of resources and instability in the financial market and the high interest rates negatively affected the demand for the durable goods. Furthermore, the instability of the exchange rates led the economic agents, who had shifted their returns to foreign exchange, postponed their consumption expenditures. Besides, continuation of the reduction in the employment of wage earners and real wages in the last year had adverse results on private consumption expenditures. The continuation of the unfavorable developments mentioned above, the private consumption expenditures are expected to contract in the last quarter of 2001. The domestic demand indicators of the CBRT Business Survey support this expectation, as well. (Figure V.1.2).

Figure V.1 2. Domestic Demand Indicators in Business Survey



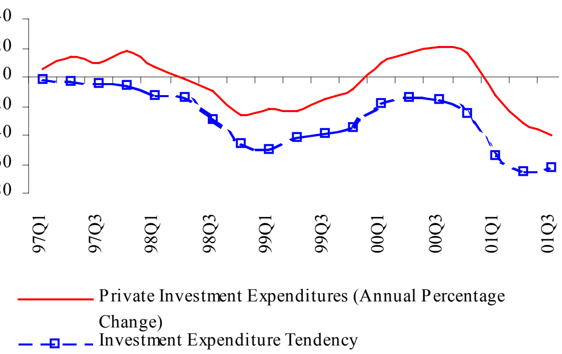
Source: CBRT, SIS

V.1.1.b. Private Investment Expenditures

Private investment expenditures decreased by 29.7 percent due to machinery and equipment investment in the first nine months of the year compared to previous year (Table V.1.1). As the economy is in a recession period, the industrial production and accordingly the capacity utilization rates of the private firms declined. Moreover, the increase of the interest rates compared to previous year raised alternative costs of investment.

The increase of interest rates and the volatility of exchange rates led the expenditures for the private consumption and investment expenditures to decline.

Figure V.1. 3. Tendency of Investment Expenditures in Business Survey



Source: CBRT, SIS

Additionally, the contraction of availability of foreign and domestic credit, the volatility of the exchange rates badly affected the expectations of the private firms and resulted in postponed investment expenditures. Thus, the private investment expenditures are expected to contract in the last quarter of 2001. The investment expenditure tendency of the CBRT Business Survey supports this expectation (Figure V.1.3).

It is important to have stable growth pattern of private investment expenditures in order to have a normal and long-standing growth rates in the economy. A stable growth rate for private investment expenditures can be attained by a recovery in the domestic demand, especially in the private consumption expenditures, fulfillment of stability in the financial markets and altering the expectations from pessimistic to optimistic. In this respect, credit to be obtained from the new stand-by agreement with the IMF is expected to positively affect the domestic demand and bring about stability for the financial market and the exchange rates. Mainly, the reduction of the volatility in the exchange rates will be fundamental for the realization of the postponed consumption expenditures. These developments will reverse the expectations to positive and stimulate the investment in the medium term.

Table V.1.4. GNP and Added Values by Sectors (Annual Percentage Change)

	2000	2001			
	Annual	Q1	Q2	Q3	First nine months
Agriculture	3.9	6.7	-3.2	-4.5	-3.2
Industry	6.0	-1.3	-8.5	-9.2	-6.7
Manufacturing Industry	6.4	-0.9	-9.2	-10.1	-7.1
Services	7.2	-2.5	-7.5	-5.3	-5.3
Construction	4.4	-5.2	-7.7	-8.8	-7.5
Trade	12.0	-4.0	-11.3	-7.3	-7.8
Transportation-Communication	5.5	-3.7	-8.2	-4.5	-5.5
Financial Institutions	0.9	-5.3	-10.0	-9.2	-8.2
Ownership of Dwelling	0.0	2.2	2.1	2.1	2.1
Business and Personnel Services	6.1	-1.9	-8.9	-7.6	-6.5
Government Services	2.0	3.3	3.2	2.3	2.9
Import Tax	28.1	-10.1	-32.1	-27.9	-23.9
GDP	7.4	-2.1	-8.9	-7.1	-6.4
GNP	6.3	-4.4	-11.4	-8.5	-8.3

Source: SIS

V.1.2. Imports and Exports of Goods and Services

The contraction in the domestic demand and the real depreciation of the Turkish lira led imports of goods and services declined by 24.5 percent in the first nine months of 2001 compared to previous year's same period (Table V.1.1). The base effect due to increase of imports in 2000 at a very high rate is crucial for this development. Imports are expected to continue its decline in the last quarter of the year.

Exports of goods and services increased by 7.6 percent in the first nine months of the year compared to previous year's same period. Thus, raise of the competitiveness by floating exchange rate regime, recovery in the tourism sector and deep contraction of the domestic demand led the private firms to shift to foreign markets. Exports are expected to continue its increasing trend in the last quarter of the year. However, scarcity of financial sources for exporters and slowdown of the foreign demand negatively affected the exports.

V.1.3. Growth and Production Developments

The economic slowdown, which began in December 2000, turned into a recession due to high real interest rates and the reduction in the availability of credit in the first quarter of 2001. The floating of the Turkish lira as a result of the crisis at the end of the February increased the uncertainties in the economy. As a result, the Turkish lira depreciated noticeably and the inflation rose. This development negatively affected the confidence of producers and consumers and caused domestic demand, through GDP, to shrink substantially in the second quarter of 2001. In the third quarter of 2001, GDP continued its contraction and fell by 7.1 percent compared to previous year's same period. Therefore, GDP decreased by 6.4 percent and GNP, due to the contraction in the net factors from abroad, fell by 8.3 percent respectively in the first nine months of 2001.

V.1.3.a. Agriculture

The value added of agricultural sector decreased by 3.2 percent in the first nine months compared to previous year's same period. The agricultural production, especially grains production, is expected to decline in 2001 because of the drought. The reduction in the agricultural sector is negatively affecting the growth of GDP, trade, transportation and industry production.

V.1.3.b. Industry

The value added of the industrial sector decreased by 6.7 percent in the first nine months compared to previous year's same period (Table V.1.4). In addition, the total manufacturing sector capacity utilization rate declined from 75.9 percent on average in the January-October period of 2000 to 71.5 percent on average for the same period of 2001. The private manufacturing sector capacity utilization rate, which had been 75.2 percent for the same period in 2000, was diminished to a very low level, 65 percent, in 2001.

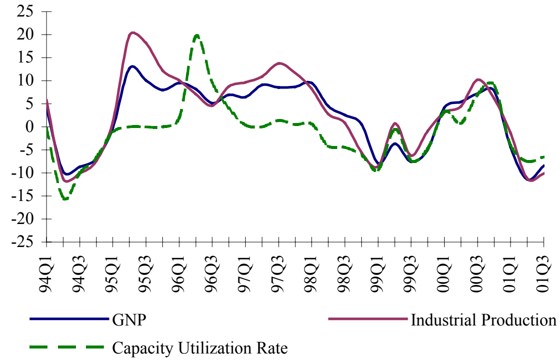
The high interest rates, the noticeable depreciation of the Turkish lira, and the shortage of availability of domestic and foreign finance led industrial production decrease substantially. The credit extended to real sector fell due to problems in the banking sector and the contraction in the domestic demand.

Table V.1.5. Industrial Production (Annual Percentage Change)

	September		January- September	
	2000	2001	2000	2001
Total Industry	6.5	-9.2	4.8	-7.5
Mining	-6.8	-16.7	-5.9	-4.6
Manufacturing	7.2	-9.6	5.1	-8.3
Energy	9.6	-2.1	8.7	-2.1
Non-Petroleum Industry Production	8.2	-13.7	8.6	-10.1

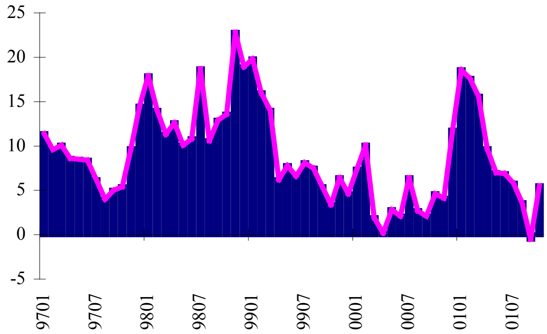
Source: SIS Monthly Industrial Production Index

Figure V.1.4.GNP. Industrial Production and Capacity Utilization Rate (Annual Percentage Change)



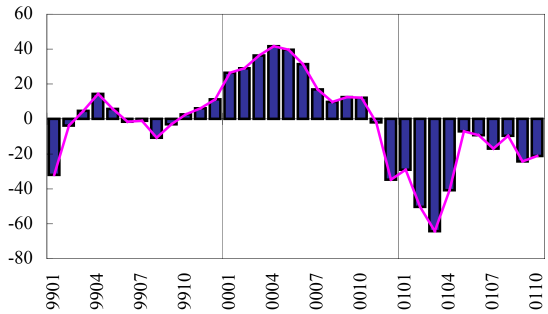
Source: SIS

Figure V.1.5. Tendency of Finished Goods Stock in Business Survey



Source: CBRT

Figure V.1.6. Business Sentiment in Business Survey



Source: CBRT

Table V.1.6. Services Sector Developments (Annual Percentage Change)

	2000	2001			
	Annual	Q1	Q2	Q3	First nine months
Services	7.2	-2.5	-7.5	-5.3	-5.3
Construction	4.4	-5.2	-7.7	-8.8	-7.5
Trade	12.0	-4.0	-11.3	-7.3	-7.8
Wholesale and Retail Trade	11.1	-4.1	-15.5	-12.5	-11.3
Hotels. Restaurants Services	17.3	-3.3	13.8	20.3	12.9
Transportation-Communication	5.5	-3.7	-8.2	-4.5	-5.5
Financial Institutions	0.9	-5.3	-10.0	-9.2	-8.2
Ownership of Dwelling	0.0	2.2	2.1	2.1	2.1
Business and Personnel Services	6.1	-1.9	-8.9	-7.6	-6.5

Source: SIS

The interest rates were persisted its high level as a result of lack of confidence in the financial market and the real credit volume expanded to real sector continued in the financial market, and the real credit volume expanded to real sector continued its falling trend in the third quarter of 2001. Moreover, it is expected that contraction in the domestic demand will lead the decline of industrial sector production to continue in the last quarter of 2001 (Table V.1.4). In the January-September period, industrial production decreased by 7.5 percent. In contrast to previous year, the increase in the production of petroleum products restricted the contraction in the industrial sector. When the petroleum production is excluded from the total industrial production index, it is observed that the industrial production has decreased by 10.1 percent.

The contraction of the domestic demand caused the stocks of private firms rise to high levels (Figure V.1.5). For this reason, private firms, mainly the automobile and the durable goods sectors slowed down their production and tried to lessen their stocks by exporting or by low sales campaigns.

It is expected that contraction in the domestic demand leading the decline of industrial sector production will continue in the last quarter of 2001.

Industrial sector's private firm's expectations about the business sentiment turned in favor of the pessimistics in the first quarter of 2001 due to the crisis in the economy in February (Figure V.1.6). Expectations in the second quarter showed limited improvement. In addition, the expectations about the third quarter were in favor of the pessimistics indicated that industrial sector's contraction is expected to continue with a little slowdown.

V.1.3.c. Services

The value added of the services sector decreased by 5.3 percent in the first nine months of 2001 (Table V.1.6). In addition to the contraction in the agricultural and industrial sectors, substantial decrease in the imports negatively affected services sector, especially the trade sector. The recovery in the tourism sector restricted the reduction in trade sector in the third quarter of 2001. The decelerating trend of value added contraction of services sector restricted the shrinkage of the GDP. However, the contractions in the domestic demand and on the producer side imply that the decline in the services sector is expected to continue in the last quarter of 2001.

Among the services sector, contraction is more severe in the construction and trade sectors (Table V.1.6). The continuation of the value added fall of the financial institutions persisted in the third quarter of 2001 due to negative effects of the crises in November 2000 and February 2001. In the first nine months, trade sector's, especially wholesale and retail trade sector's, value added decreased due to reduction of imports and decline of industrial production as a result of the contraction in the domestic demand. The recovery in the tourism sector assisted the increase of the value added of the sub-sector of the trade, hotels, restaurants services, in the second and third quarters. However, the continuing trend of contraction of industrial production and imports pointed out that the decline of the value added of the services sector is expected to continue.

The reduction of real incomes, high interest rates, and the shortage of the availability of credit negatively affected the investment demand, especially ownership of dwelling, and led the value added of the construction sector to decrease by 7.5 percent in the first nine months. This tendency is expected to continue in the following period.

Table V.2.1. Developments in the Labor Markets

	2000					2001	
	I	II	III	IV	Total	I	II
Employment*							
Total	19.006	21.312	21.727	20.182	20.578	19.222	21.127
Wage and Salary Earners	9.404	10.375	10.345	10.363	10.127	9.682	9.791
Urban	10.461	11.293	11.529	11.198	11.128	10.872	11.037
Wage and Salary Earners	7.490	8.000	8.151	8.176	7.962	7.904	7.882
Rural	8.545	10.019	10.198	8.984	9.450	8.350	10.090
Employment by Sectors**							
Agriculture (Percent)	33.1	35.8	37.6	32.8	34.9	32.6	38.9
Industry (Percent)	18.1	17.9	17.7	18.9	18.1	18.9	17.0
Construction (Percent)	5.1	7.1	6.6	6.9	6.5	5.4	5.6
Services (Percent)	43.7	39.3	38.1	41.3	40.5	43.2	38.5
Unemployed*	1.720	1.415	1.295	1.366	1.451	1.809	1.567
Unemployment Rate**							
Total (Percent)	8.3	6.2	5.6	6.3	6.6	8.6	6.9
Urban (Percent)	10.4	8.9	8.0	8.2	8.9	10.8	10.4
Rural (Percent)	5.5	3.0	2.8	4.0	3.7	5.6	2.7

*(aged 15+.male+female, thousand person)

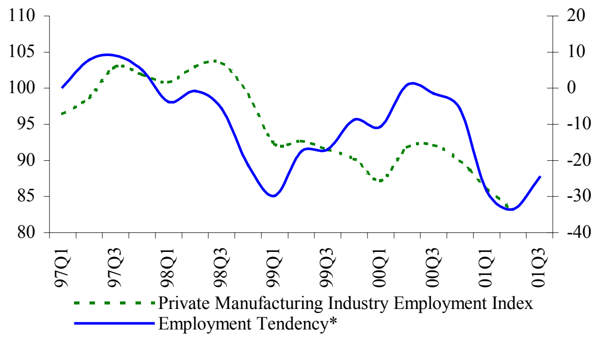
**(aged 15+.male+female, percent)

Source: SIS, Household Labor Survey.

V.2. Developments in the Labor Markets

According to the provisional results of the SIS Household Labor Survey, the unemployment rate was realized as 6.9 percent in the second quarter of 2001. Employment, which was based on agricultural sector, increased compared to previous period, while it decreased nearly 1 percent as a result of the contraction in the economy compared to previous year's same period. Nonetheless, the number of wage and salary

Figure V.2.1. Employment in Private Manufacturing Industry



*Employment Tendency is figured on the right axes.
Source: CBRT. SIS.

Table V.2.2. Labor Market Developments in Manufacturing Industry (Annual Percentage Change)

	2000					2001		
	I	II	III	IV	Total	I	II	First six months
Employment*	-3.1	-0.8	0.9	-1.7	-1.2	-3.4	-11.9	-7.8
Public	-8.0	-6.3	-5.7	-3.8	-5.9	-4.7	-7.0	-5.9
Private	-2.3	0.3	2.2	-1.3	-0.2	-3.2	-12.8	-8.1
Productivity*	5.9	5.7	10.3	8.6	7.6	3.2	-0.6	1.2
Public	-7.5	-13.0	4.2	15.5	-0.6	17.0	9.1	13.3
Private	10.2	11.0	12.0	6.9	10.0	0.1	-2.9	-1.5
Real Wages*	-0.4	-0.7	-1.9	4.7	0.5	-3.9	-14.6	-9.2
Public	24.2	12.0	10.2	17.2	15.1	4.3	-12.4	-4.1
Private	-5.2	-3.0	-3.8	2.1	-2.1	-5.7	-15.6	-10.6

*(per hour worked)
Source: SIS, Productivity of Workers, Productivity Hours Worked and Partial Productivity Indexes in Manufacturing Industry, SIS, Indexes of Wages Per Production Worked Hours & Earnings per Productivity Workers in Manufacturing Industry

earners and self-employed decreased by 5.6 percent and 0.9 percent, respectively compared to previous year's same period. The greatest employment contraction was realized in the services and the industrial sectors. The reduction in the employment of the services sector was mainly due to the banking sector's employment reduction policies as a result of the crises in the financial sector.

Employment in 2001, especially employment in the industrial sector, is expected to decline substantially, as the economy is in a recession. Employment tendency, which is among the indicators of the CBRT Business Survey, supports this expectation (Figure V.2.1).

As the economy entered into a recession, the decline of employment is expected to continue in the second half of 2001.

In the first half of the 2001, in the private manufacturing sector, real wages per hour worked, hour worked and productivity per hour worked decreased by 10.6 percent, 8.1 percent and 1.5 percent, respectively, compared to previous year's same period. The reduction of real wages in the manufacturing sector entails that the contraction of the domestic demand is expected to continue. Also, the persistence of reduction in the production in the private manufacturing industry is indicating that the continuing fall of employment is expected to persist.

VI. BALANCE OF PAYMENTS

VI.1. Developments in Foreign Trade

The real depreciation of the Turkish lira and the contraction in the economic activity following the crisis in February 2001 caused imports to decrease substantially and exports to increase. In the first nine months of 2001, imports declined by 23.3 percent while exports increased by 11.8 percent compared to the same period of last year. According to the Turkish Exporters Association figures, exports rose by 14.8 percent and reached US $25.8 billion in the January-October period.

In the first nine months of 2001 manufacturing goods exports, consisting 90 percent of total exports, increased by 11.7 percent. One of the reasons of this increase is that firms oriented their products towards foreign markets due to the contraction in domestic demand. Likewise, in the January-October period, exports of automobile sector increased by 73 percent while its production fell by 38 percent.

The contraction in domestic demand and the real depreciation of the Turkish lira positively affected exports; however, the recession in foreign markets and the financing problem limited the positive effect.

The second factor to raise exports is the increasing compatibility of Turkey with the real depreciation of the Turkish lira of 15.5 percent according to the real exchange rate index calculated by private manufacturing prices and producer prices for domestic and foreign prices, respectively. Whereas, the high volume of imported output used in the export-led production is an important factor restricting this positive effect. In addition, the increasing cost and the decreasing possibility of financing are the other factors limiting the export-led production and exports.

Table VI.1. Balance of Payments (US $ million)

	September		January-September	
	2000	2001	2000	2001
Foreign Trade	-1837	-423	-16175	-4110
Other Goods and Services	1211	764	5477	3757
Transfers	372	352	3804	2867
Current Account Balance	-254	693	-6894	2514
Capital Account	-243	381	10936	-10636
Foreign Direct Investment (Net)	210	229	-257	2110
Portfolio (Net)	270	131	6032	-3950
Long Term (Net)	-200	-173	2914	-885
Short Term (Net)	-523	194	2247	-7911
Net Errors and Omissions	445	-963	-1645	-3142
Shuttle Trade	285	280	2071	2253
Tourism Revenues	1056	1143	5885	6648
Workers' Remittances	330	220	3387	2173
Other Invisible Revenues	1014	429	8853	5592

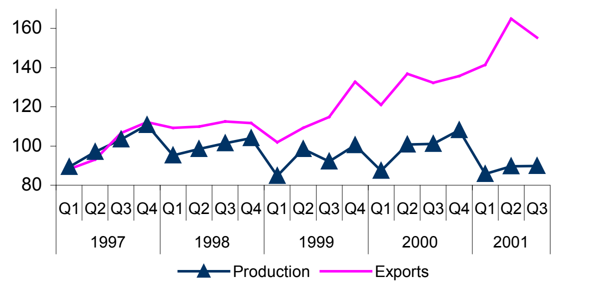
Source: CBRT

Table VI.2. Foreign Trade (US $ million)

	September			January-September		
	2000	2001	% change	2000	2001	% change
EXPORTS	2403.3	2565.3	6.7	20541.7	22974.8	11.8
Agriculture	185.6	237.4	28.0	1262.0	1539.1	22.0
Fishing	1.5	2.7	73.2	18.4	18.7	1.7
Mining	35.5	24.5	-30.8	305.0	252.9	-17.1
Manufacturing	2166.2	2299.1	6.1	18927.0	21147.2	11.7
Other	14.5	1.5	-89.9	29.4	16.9	-42.5
IMPORTS	4643.5	3310.9	-28.7	39678.7	30452.0	-23.3
Consumption	621.7	304.4	-51.0	5175.5	3076.2	-40.6
Investment	964.6	508.7	-47.3	8154.0	5294.6	-35.1
Intermediate	3042.2	2469.5	-18.8	26195.4	21806.6	-16.8
Crude Oil	305.6	413.4	35.3	2850.7	3058.3	7.3
Other	15.0	28.4	89.2	153.8	274.6	78.5

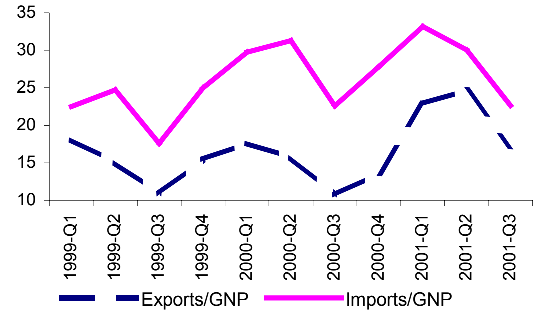
Source: CBRT

Figure VI.1. Manufacturing Export Volume and Production Indices (1997=100)



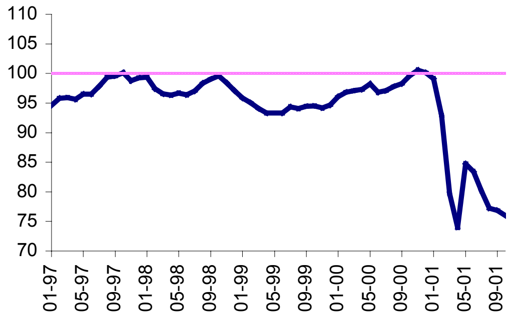
Source: SIS

Figure VI.2: Exports/GNP and Imports/GNP (Percentage)



Source: SIS

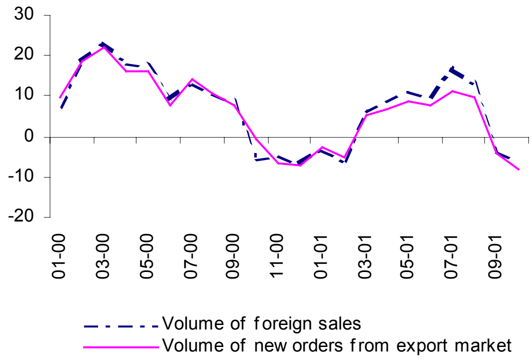
Figure VI.3. Real Effective Exchange Rate (1987=100)



The currency basket, composed of 1.5 German mark and 1 US dollar is used in the calculation of real effective exchange rate. Price index for Germany and the USA is WPI and private manufacturing price index for Turkey. The increase in the index value indicates the real appreciation of the Turkish lira against related currencies.

Source: CBRT, SIS

Figure VI.4. Exports Expectations for the Next Three Months (Optimists minus Pessimists)



Source: CBRT Business Survey

According to the CBRT October Business Survey results, a gradual decline is observed in the volume of goods sold in foreign market and new orders from the exports market in the last three months. Accordingly, the recovery in the export possibilities for the next three months will decelerate.

In the rest of the year, it is expected that unfavorable developments in the external environment will limit the improvement of exports. With the adverse impact of terrorist attack in September, the recession in the US economy starting in the second half of 2000 and augmenting in 2001 would weaken the foreign demand. According to the IMF projections, in 2001 the US economy will grow by 1.1 percent. Therefore, it is anticipated that Turkish exports to the US will decelerate. Moreover, a sign of slowdown in our major trade partner, European Union, is observed. It is expected that the deceleration of the US economy will have negative impacts on the EU economy, which is estimated to grow by 1.7 percent. As a result, the imports of these countries will decelerate. For 2001, the IMF projected the world growth as 2.4 percent and the world trade growth as 1.3, which was realized as 12.4 percent in 2000. Like other developing countries, it is expected that Turkey's foreign trade will suffer from this unfavorable situation.

The terms of trade deterioration continued in the first nine months of 2001. In that period, export prices decreased by 1.5 percent whereas import prices increased by 1.7 percent. In the rest of 2001, it is anticipated that the deterioration will continue with the low world commodity prices.

Regarding the sub-items of imports, it is observed that the turn down of the consumption goods imports accelerated since March. Also, the investment and intermediate goods imports declined by 35.1 percent and 16.8 percent, respectively. The CBRT Business Survey October results show that new orders from the domestic market will decrease in the next three months. Therefore, the decline in the domestic demand

and the imports will continue in the last quarter of 2001.

Besides, the intermediate goods imports, which constitute 70 percent of total imports, are led to the manufacturing sector production. The decrease in the manufacturing sector production will reduce the import demand. Similarly, the considerable decline in the investment goods imports signals that the production capacity of the economy will be adversely influenced.

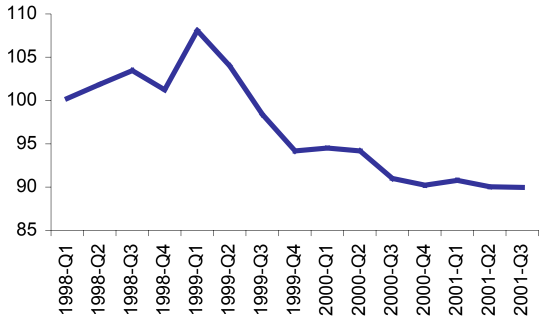
The decrease in both national income and manufacturing sector production as well as the depreciation of the Turkish lira caused imports to decline.

It is expected that the foreign trade deficit will continue to decrease in the last quarter of 2001, which narrowed by 60.9 percent and was realized as US $7.5 billion in the first nine months of 2001.

VI.2. Current Account

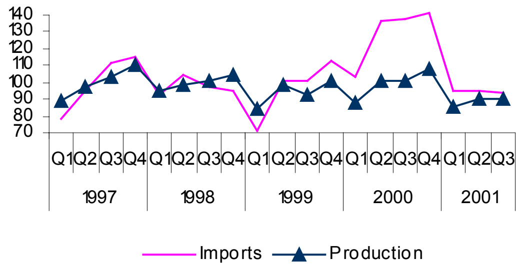
Current account surplus reached US $2.5 billion as a result of the narrowing trade deficit in the first nine months of 2001. In this period, tourism revenues increased by 13 percent. However the balance of other goods and services decreased due to the declining other official and private goods and services income. The declining trend of workers' remittances and unrequited transfers continued in 2001. The depreciation of the euro against the US dollar is the most important factor behind this trend. In addition, the rapid depreciation of the Turkish lira and the problems in the banking sector adversely influenced the workers' remittances.

Figure VI.5. Terms of Trade (Export Prices/Import Prices)



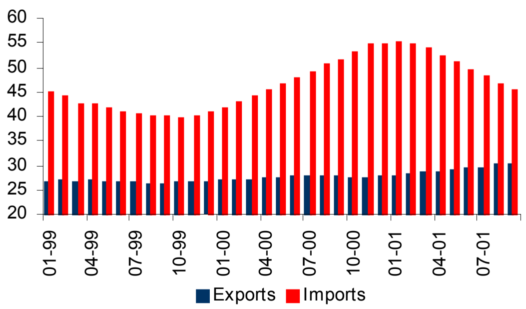
Source: CBRT, SIS

Figure VI.6.Manufacturing Import Volume and Production Indices (1987=100)



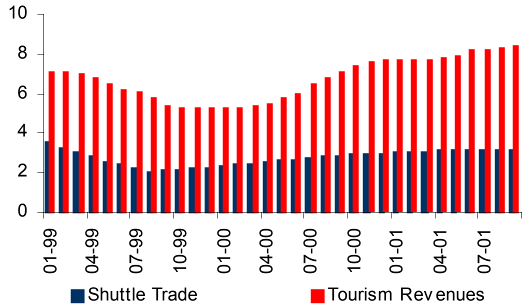
Source: SIS

Figure VI.7.Exports and Imports (Annual, US $ Billion)



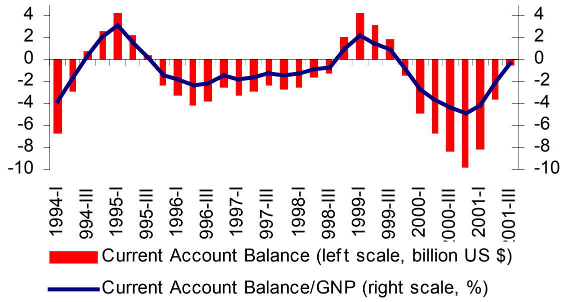
Source: SIS

Figure VI.8. Shuttle Trade and Tourism Revenues (Annual Percentage Change, US $ Billion)



Source: CBRT

Figure VI.9. Current Account Balance (Annualized)



Source: CBRT. SIS

Table VI.3. Net Capital Inflow by Sub sectors (US$ Million)

	September		January-September	
	2000	2001	2000	2001
NET CAPITAL INFLOW	-243	381	10936	-10636
GENERAL GOVERNMENT	474	-119	4918	-1271
Bond Issues	627	0	5662	-169
Medium and Long Term	-153	-119	-744	-102
Short Term	0	0	0	-1000
BANKS	-136	-1219	3432	-6750
Bond Issues	0	0	292	-3
Medium and Long Term	-393	-217	-162	-1161
Short Term	257	-1002	3302	-5586
PRIVATE SECTOR	215	332	4180	-1009
Bond Issues	0	0	0	0
Medium and Long Term	303	77	3309	25
Short Term	-88	255	871	-1034
OTHER	-796	1387	-1594	-1606
Securities	-21	37	682	-3717
Direct Investments (in Turkey)	219	253	464	2488
Other	-994	1097	-2740	-377

Source: SIS

The impact of the terrorist attack in the US on the Turkish tourism sector is to be mainly observed in 2002.

A surplus in the current account is estimated for the rest of the year as a result of narrowing trade deficit. It is expected that the terrorist attack in the US will negatively affect tourism revenues. However, it will not influence tourism revenues of 2001, which will decrease seasonally in the last quarter of the year. It is anticipated that the impact will mainly be observed next year related to lower tourism owing to safety concerns.

VI.3. Capital Account

In the first nine months of 2001, a capital outflow of US $10.6 billion was realized. Contrary to the inflow of US $10.9 billion in the same period of 2000, this high volume of outflow was an important factor preventing the stability in the exchange rates and the decrease in the interest rates.

In the January-September period of 2001, the capital outflow was mostly due to the short-term capital movements and the security transactions of non-residents.

The capital outflow was primarily due to the short-term capital movements and the security transactions of non-residents. The short-term capital outflow stemmed from the repayments of syndicated credit of banks, which were received last year with a maturity of 1 year. Moreover, the loans received by banks were less than the repayments in that period. This trend is expected to continue in the last quarter of 2001.

VII. DEVELOPMENTS IN THE WORLD ECONOMY

The world economy experienced high growth rates in 2000; world output grew by 4.7 percent and world trade volume increased by 12.4 percent annually. Following the 5.7 percent growth rate in the second quarter of 2000, the U.S.A. economy went into a gradual recession, growing by 0.3 percent in the second quarter of 2001 and contracting by 0.4 percent in the following quarter. Similarly, the growth in the Euro area began to slowdown in the second half of 2000, and could only reach 2.4 percent and 1.7 percent in the first and second quarters of 2001, respectively. Japan entered a recession after growing by 2.4 percent in the first quarter of 2000; it grew by 0.5 percent in the first quarter of 2001 and contracted by 3.2 percent in the second. Other industrialized countries and developing countries were negatively affected by the recession tendencies: low growth rates were observed in these countries especially in the second quarter of 2000 and during 2001. According to the IMF estimates, the world output is expected to grow by 2.6 percent and world trade volume by 1.3 percent in 2001, while they are projected to increase by 3.5 percent and 5.2 percent respectively in 2002. However, these estimates have been revised downward considering the negative scenario after the terrorist attacks against the U.S.A., so that the world output is now anticipated to increase by 2.4 percent in both 2001 and 2002. It is expected that the slowdown in both world output and trade volume would negatively affect the Turkish exports and tourism revenues and capital inflows to Turkey.

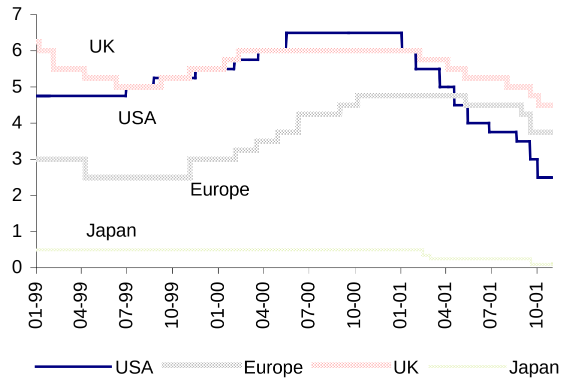
It is anticipated that while the world economy, which has been in recession since the second half of 2000, is expected to recover in 2002, the September 11 terrorist attacks against the U.S.A. would threaten the global recovery in the short term.

Table VII.1. World GDP Growth Rates (Annual Percentage Change)

	2000	2001*	2002*
World	4.7	2.6	3.5
Developed Countries	3.8	1.3	2.1
U..S.A.	4.1	1.3	2.2
Canada	4.4	2.0	2.2
Euro Area	3.5	1.8	2.2
Germany	3.0	0.8	1.8
France	3.4	2.0	2.1
Italy	2.9	1.8	2.0
U.K.	3.1	2.0	2.4
Japan	1.5	-0.5	0.2
Developing Countries	5.8	4.3	5.3
Developing Asian Countries	7.0	5.1	5.9
Newly Industrialized Asian Countries**	8.2	1.0	4.3
ASEAN-4***	5.0	2.4	4.1
China	8.0	7.5	7.1
India	6.0	4.5	5.7
Developing Countries in America	4.2	1.7	3.6
Argentina	-0.5	-1.4	2.6
Brazil	4.5	2.2	3.5
Chile	5.4	4.0	4.7
Mexico	6.9	0.8	4.0
EU members	4.9	1.1	4.7
Turkey	7.5	-4.3	5.9
Chezck Republic	2.9	3.3	3.9
Hungary	5.2	4.5	4.5
Poland	4.1	2.5	3.7
Bulgaria	5.8	4.5	5.0
Romania	1.6	4.1	4.5
CIS	7.9	4.4	4.0
Russia	8.3	4.0	4.0
Africa	2.8	3.8	4.4
Middle East	5.5	4.5	4.4

*These projections were finalized before the September 11 terrorist attack in the US and subsequent economic policy actions.
**Newly Industrialized Asian economies are Hong Kong., Korea, Singapore and Taiwan.
***ASEAN-4 includes Indonesia, Malaysia, the Philippines and Thailand.
Source: IMF, World Economic Outlook., October 2001

Figure VII.1. Main Central Bank Interest Rates (Percentage)



Source: Corresponding central banks.

Table VII.2. CPI Inflation for Selected Country Groups (Annual Percentage Change)

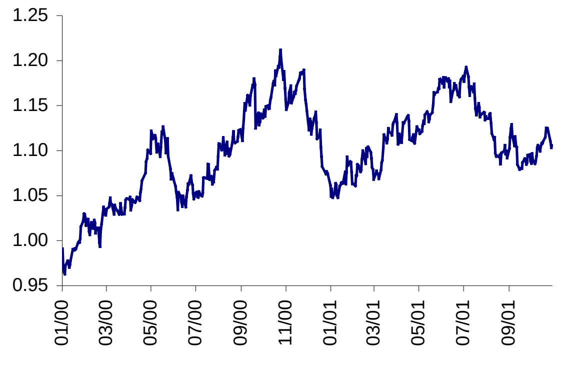
	2000	2001*	2002*
Developed Countries	2.3	2.4	1.7
U.S.A.	3.4	3.2	2.2
Canada	2.7	3.1	2.3
Euro Area	2.4	2.7	1.7
Germany	2.1	2.5	1.3
France	1.8	1.8	1.1
Italy	2.6	2.6	1.6
U.K.	2.1	2.2	2.4
Japan	-0.6	-0.7	-0.7
Developing Countries	6.0	5.9	5.1
Developing Asian Countries	1.8	2.7	3.1
Newly Industrialized Asian Countries**	1.2	2.1	2.1
ASEAN-4***	3.0	6.6	5.0
China	0.4	1.0	1.5
India	4.0	3.6	5.5
Developing Countries in America	8.1	6.2	4.9
Argentina	-0.9	-0.6	0.6
Brazil	7.0	6.2	4.8
Chile	3.8	3.4	3.3
Mexico	9.5	6.3	4.8
EU members	24.3	20.5	14.7
Turkey	54.9	51.9	32.7
Chezck Republic	4.0	3.9	3.8
Hungary	9.8	9.4	6.4
Poland	10.1	5.7	5.7
Bulgaria	10.4	6.8	3.2
Romania	45.7	33.8	26.0
CIS	25.0	21.6	13.0
Russia	20.8	22.1	12.9
Africa	13.6	12.6	8.0
Middle East	9.4	9.6	8.9

* These projections were finalized before the September 11 terrorist attack in the US and subsequent economic policy actions.
**Newly Industrialized Asian economies are Hong Kong. Korea. Singapore and Taiwan.
***ASEAN-4 includes Indonesia. Malaysia. the Philippines and Thailand.
Source: Corresponding Central Banks.

The recession in the U.S.A., which started in 2000 and continued in 2001, stemmed from the decrease in the productivity improvement, capacity utilization, industrial production, and from the slowdown in the high technology investment growth. The U.S.A. Federal Reserve cut its indicative interest rates several times in favor of investment and production, so the intended federal funds rate, which was 6.5 percent at the beginning of 2001, was decreased to 2 percent with the recent cut on November 6th. The IMF estimates imply that, with the effect of terrorist attacks and following events, the recession in the U.S.A. would persist until mid-2002. The U.S.A. output is expected to increase only by 1.1 percent in 2001, despite the 4.1 percent growth rate in the preceding year. Sectors such as airline, insurance and tourism are especially to be directly affected by the terrorist attacks. Changes in the consumer confidence and risk perception, as the changes in the consumption pattern, are more likely related to the future non-economic developments; hence, at this stage, it is not possible to come up with a definite comment on the situation.

While the decrease in the productivity improvement, capacity utilization, industrial production and the slowdown in the high technology investment growth caused the U.S.A. recession; the recession in the Euro area was a result of the contraction in the domestic and foreign demand, the fall in stock markets, and the slowdown in the technology industry.

Figure VII.2. Euro-US Dollar Parity



The growth rate in the Euro area has been slowing down since the latter half of 2000 and this tendency has been widening within the area. Weakened domestic demand due to the pressure on real income exerted by high petroleum and food prices, the declining stock markets, and worsened situation of communication and technology sectors have become main factors behind the economic deceleration. The fall in the growth rates of both exports and imports due to weakened global demand has further added to the downward pressure. Concurrently, that the European Central Bank had raised interest rates with the fear of inflationary pressures had also a negative effect on the slowdown in the first half of 2001. The gross fixed capital investment considerably decreased in Germany –where construction activity diminished significantly-, France, and Italy, the three largest economies of the Euro area. The inventory reductions in Italy, where a relatively strong growth rate was observed due to the inventory investment in the first quarter of 2001, and in Germany also put a decelerating pressure on the overall economic activity. The French economy weathered the global slowdown relatively well with the help of tax cuts and ongoing improvement in employment. However, the significant slump in the consumer and business confidence, and the recent rise in the unemployment rate point out a decline in the economic activity in the remaining part of the year and in 2002. Contrary to the Euro area, the domestic demand maintained its strength in the United Kingdom. Strong domestic demand was partially able to compensate for the weak manufacturing industry and slowing exports. Low unemployment rate and leveled off growth in earnings supported the demand growth and consumer confidence while the fiscal measures supported expenditures. As an outcome of these developments and after the terrorist attack on September 11th, the IMF projected the growth rates of both the European Union and the Euro area to be 1.8 percent and 2.2 percent in 2001 and 2002, respectively. Nevertheless, in November, the IMF revised its projections for the European Union downward to 1.7 percent and 1.4 percent in 2001 and 2002, respectively. It is anticipated that Turkey's exports would be negatively affected by the deceleration in European Union's import demand and GDP growth rate.

Despite the reforms that the new government has been implementing, the recession in Japan is expected to continue in the short run, while the reforms would contribute to growth in the long run.

Table VII.3. Curent Account Balance to GDP ratio for Selected Country Groups Percentage

	2000	2001*	2002*
Developed Countries	-1.0	-0.9	-0.8
USA	-4.5	-4.0	-3.8
Canada	2.5	1.9	0.9
Euro Area	-0.1	0.3	0.4
Germany	-1.0	-0.8	-0.5
France	1.8	2.5	2.6
Italy	-0.5	-0.1	0.1
UK	-1.7	-1.7	-2.0
Japan	2.5	2.2	2.6
Developing Countries			
Developing Asian Countries	3.0	2.1	1.6
Newly Industrialized Asian Countries**	4.9	5.0	4.8
ASEAN-4***	8.0	4.8	3.9
China	1.9	1.0	0.2
India	-0.9	-0.8	-0.9
Developing Countries in America	-2.5	-3.0	-3.0
Argentina	-3.2	-2.9	-2.8
Brazil	-4.2	-5.0	-4.5
Chile	-1.4	-2.2	-2.3
Mexico	-3.1	-2.8	-3.3
EU members	-5.1	-2.8	-3.6
Turkey	-4.9	3.0	-0.4
Chezck Republic	-4.6	-5.0	-4.9
Hungary	-3.6	-4.8	-4.8
Poland	-6.3	-5.2	-5.0
Bulgaria	-5.8	-6.0	-5.7
Romania	-3.9	-6.0	-5.5
CIS	3.5	2.5	1.7
Russia	18.0	11.5	7.9
Africa	0.5	-0.9	-1.4
Middle East	11.6	8.9	6.1

* These projections were finalized before the September 11 terrorist attack in the US and subsequent economic policy actions.
**Newly Industrialized Asian economies are Hong Kong. Korea. Singapore and Taiwan.
***ASEAN-4 includes Indonesia. Malaysia. the Philippines and Thailand.
Source: IMF. World Economic Outlook. October 2001.

By the second half of 2000, weakened foreign demand and globally diminished demand for electronic products led to a contraction phase of the Japanese economy. Despite the rise in private consumption expenditures in the second quarter of 2001, production decreased sharply as public and private investment curtailed remarkably. Ongoing negative view and speed of firm restructuring were unfavorable on securities markets. The monetary policy, which pulled overnight interest rates down to zero, was put into action in May. It was considered as a positive step towards the future of the economy. However, private consumption was excessively weak due to firm restructuring, increased unemployment rate and falling income. Decreasing business confidence and falling volume of extended credit deepened negative thoughts about the Japanese economy. While the reform package of the newly elected government is expected to have adverse short-term effects on production and employment, it is anticipated to support long-term growth. The IMF revised its growth projections for Japan to 0.9 percent and 1.3 percent contraction in 2001 and 2002, respectively. Additionally, East Asian economies, which grew by 7 percent in 2000, are estimated to grow 5.1 percent in 2001 and 5.9 percent in 2002 according to the IMF projections made before September 11th events. Those events are expected to deteriorate growth rates further.

East Asian economies are adversely affected by the recession of their most important trade partner, Japan.

Negative economic outlook of the Japanese economy has considerable effects on East Asian countries as an important trade partner. Japan consists of large portion of trade volume of the countries in consideration. Furthermore, these countries have very high exports to GDP ratio. Hence, the recession in Japan is expected to restrict the growth rates of these countries to a great extent. Moreover, there is a relatively strong interaction between the security markets of Japan and East Asian economies. Low levels of Japanese securities may cause investors to draw out of the region. Further, the Japanese banking system is the main financial source of the banks in East Asian region. These countries may encounter with problems as Japanese banking sector problems and contraction of the Japanese economy continue. Japanese foreign direct investment facilities in East Asia may be restricted as well.

Latin American economy was adversely affected from the US recession and the financial crisis in Argentina to a great extent, which led to a considerable decline in the growth rates.

Reaching 4.2 percent growth rate in 2000, the IMF projects Latin American economies to grow only by 1.7 percent in 2001. The effect of global slowdown on the region and especially Mexico and Chile troubles in the Argentinean economy spreading through other countries in the region, political uncertainties and energy crisis in Brazil can be considered as reasons for the downward revision of the growth rates. As a result of negative outlook of the regional economy, deepening crisis in Argentina in July and the uncertainty after September 11th events, investment flows in the region are restricted to a great extent. Prevailing circumstances insert pressure over the currencies of most countries in the region. High public debt is mostly financed by foreign sources. Devaluation of currencies, high interest rates and low growth rates put pressure on public finance. They are unlikely to implement accommodative monetary policy because of the devaluation of the currencies.

Crude oil prices experienced a sharp rise just after the terrorist attack to the US and then declined during the following days.

Crude oil prices rose rapidly in the 1999-2000 period; however, decreased again in 2001 due to global economic slowdown and accumulated stocks. While the price per barrel was around US $ 27 before September 11th terrorist attacks, it rose up to US $ 31 during the following days. However, expectations of low demand as a consequence of expected recession in the global economy, caused prices to fall around US $ 26 per barrel. Further, the OPEC announced that it could increase production to prevent prices from rising as war fears prevail.

Table VII.4. World Commodity Price Developments (US $, Annual Percentage Change)

	1999	2000	2001*	2002*
Manufactured Products	-1.8	-5.1	-3.1	-0.6
Crude Oil	37.5	56.9	-5.0	-8.6
Basic Non-Oil products	-7.0	2.6	-2.6	4.5
Food	-15.6	-0.5	2.6	5.3
Beverage	-21.3	-16.6	-16.8	4.5
Agricultural Products	2.4	4.1	-1.0	2.0
Metal Products	-1.5	12.1	-7.3	7.5
World Trade Prices Deflator	-1.5	-0.8	-2.3	0.6

* These estimates exclude the September 11th terrorist attack to USA and developments afterwards.

Source: IMF, World Economic Outlook, October 2001

VIII. GENERAL ASSESSMENT: MONETARY POLICY OUTLOOK

VIII.1. Global Economic Conditions

In recent years, developments in the US economy have played an important role in shaping the world economy. The US economy grew by 4.1 percent in 2000 and benefiting from the US expansion, the world economy, especially the Southeast Asian countries, which are closely connected to the US economy, grew by 4.7 percent in 2000—the highest growth rate of the last decade. During this period, the global inflation rate remained at 2.3 percent, while world trade volume increased by 12.4 percent. Positive developments in the world economy were also reflected on the developing countries, which grew by 5.8 percent in 2000.

However, these positive developments were reversed in 2001 due to the slowdown in the US economy during the second half of 2000. The gloomy picture emerging from the noticeable slowdown in industrialized economies has worsened due to the terrorist attacks against the US on September 11, 2001. Although the adverse consequences of the terrorist attacks in the US for the world economy is widely acknowledged, it is still too early to quantify the impact of this event on the world economy.

According to the most recent forecasts, it is predicted that the world economy with the growth rate of 3.5 percent in the last decade and 4.7 percent in 2000, is going to expand by 2.4 percent in 2001.[i] The world trade volume, which increased by 6 percent on average, and by a record rate of 12.4 percent in 2000, is expected to rise only by 1.3 percent in 2001 due to the sharp economic slowdown in the world economy.

Even though there exist serious risks that may have a negative impact on the world economy in the rest of 2001 and in 2002, the world economy is less vulnerable since economic fundamentals of most countries are stronger compared to previous years. Moreover, the aggressive responses by central banks—except the European Central Bank—to these developments, through interest rate reductions are expected to alleviate the adverse impact of the September 11 events on the sentiments of consumers and firms in the upcoming months.

The recovery in the world economy is expected to start in the first half of 2002 and is envisioned to continue thereafter. It is estimated that the world economy will grow by 2.4 percent, and the world trade volume will increase by 2.6 percent in 2002.

VIII.2. Aggregate Demand and Supply Developments in the Turkish Economy

The Turkish economy entered into a severe contraction period due to the crises of November 2000 and February 2001. The increased uncertainty in the economy, the sharp devaluation of the Turkish lira, the instability in the financial markets and the persistent high levels of real interest rates resulted in a serious contraction in economic activity. Although the recovery in tourism and exports sectors in the first half of the year helped lower the economic contraction, the unfavorable developments experienced in the world economy had adverse impact on exports in the second half of the year.

Private consumption expenditures declined sharply as a result of the rising inflation and interest rates in the face of the substantial depreciation of the Turkish lira and worsening expectations. Increase in real interest rates, decline in real income, decrease in consumer credit in real terms, and fall in employment are among the factors that have accelerated the contraction in private consumption expenditures. In view of the high likelihood of the resumption of the aforementioned adverse developments, private consumption expenditures are expected to decline by 7 percent in 2001. The CBRT Business Survey's domestic demand indicators lend support to this prediction.

[i] Unless otherwise indicated, predictions on the world economy are based on figures in the study of International Monetary Fund titled "World Economic Outlook", which were revised in November.

Capital investment expenditures declined by 28.2 percent in the first nine months of 2001 due to the decrease in machinery equipment. As a result of the resumption of the high real interest rates, the volatility of the exchange rates, and, hence, the uncertainty in the financial markets in the third quarter of the year, fixed investment expenditures are estimated to decline by around 28 percent for the year as a whole. The CBRT Business Survey's investment expenditure indicators are in line with this estimation. Firms have tended to minimize their stocks in response to the contraction in domestic demand. Therefore, it is predicted that total investments will drop by more than 40 percent in 2001.

Goods and services exports increased during the first nine months of the year—an increase largely based on merchandise exports and tourism sector. The increased competitiveness due to the considerable depreciation of the Turkish lira was one of the most important contributing factors to the above-mentioned increase. It is expected that the rapid contraction in domestic demand will continue to direct firms towards foreign markets in the last quarter of the year and exports will maintain its increasing trend. The foreign demand indicators of the CBRT Business Survey support this conjecture. However, it is expected that the slowdown in foreign demand, the credit crunch, and terrorist attacks experienced in the US will have adverse effects on tourism sector and exports. In light of these factors, the rise in exports of goods and services is estimated to be 10 percent, which is less than what was expected in the beginning of 2001.

It is estimated that GDP will decline by 6.1 percent compared to the previous year. The contraction is predicted to be 6.5 percent in services sector and 5.7 percent in industrial sector. As a result of the drought, agricultural sector's value added is expected to decline by 5.8. Moreover, GNP is expected to decline by 8.5 percent as a result of the deterioration in net factor income from abroad arising from the decrease in workers' remittances and increase in foreign interest payments.

VIII.3. Year-end Inflation Expectations

The end-of-year rate of increase in CPI and WPI is estimated to be 65 percent and 80 percent, respectively. The CBRT is monitoring the expectations on consumer prices through the Survey on Expectations, which has been published since August[ii] and still on a trial period. Inflation expectations have been at around 63-64 percent starting from the first half of August until the second half of September. In the second part of September, inflation expectations rose by 0.9 percent compared to first half, reaching 64.8 percent. The rise in exchange rates in the second half of September played an important role in this development. The resumption of the depreciation of the exchange rates and the inflation rate in October above market expectations increased the expectations in November. The end-of-year inflation expectations, in turn, reached 72 percent. The CBRT closely monitors the forecasts by the private sector as well. In the second half of September, the private sector's end-of-year inflation expectation was realized at 64.6 percent. Following the announcement of the September inflation rate, the average inflation expectations of the private sector were revised upward and reached 69.2 percent. The highest inflation rate (CPI) among forecasts was 85 percent, while the lowest was 60 percent.

VIII.4. The 2002 Economic Program

VIII.4.1. Real Economy

The resumption of the recovery observed in the last months of 2001 entails improvement in the credit flow to the real sector along with the improvement in consumer confidence, which are, in turn, expected to boost the private consumption and stock accumulation. In light of these expectations, GNP and GDP are anticipated to grow by 4 percent in 2002. In the same period, growth rates of the agricultural, industrial, and services sectors are expected to be 2.5 percent, 4.1 percent and 4.3 percent, respectively.

[ii] This Questionnaire is answered by a group consisting of participants from mainly finance sector representatives as well as both real sector and consumer sector every month for two periods. The, inflationary expectations of CPI was realized as 68.5 percent according to the October first quarter data.

In light of the above assumptions, the 2002 Economic Program predicts that the Turkish economy will enter into a period of growth in 2002. GDP and GNP are expected to grow by 4 percent in 2002 compared to the previous year. It is expected that the envisioned recovery will be based largely on industrial and services sectors. Compared to the previous year, value added of the industrial and services sectors are estimated to increase by 4.1 percent and 4.3 percent, respectively. Moreover, agricultural sector's value added, which declined in 2001, is expected to rise by 2.5 percent in 2002. This, in turn, expected to have a favorable impact on industrial and services sectors as well.

On the expenditures side, it is expected that the recovery in demand will stem from private consumption and investment expenditures. Private consumption and private fixed capital investment expenditures are estimated to increase by 3.6 percent and 2 percent, respectively. Due to the contraction in domestic demand and the significant increase in production costs, private firms have reduced their production relative to the previous year. The contraction in domestic demand and increasing foreign demand were met through stocks. It is expected that firms will rebuild their inventories and increase their production during 2002. Private investment expenditures, including stock changes, are estimated to increase significantly by 23.7 percent relative to the previous year, contributing to GNP growth by 2.7 percentage points. On the other hand, it is predicted that the contribution of foreign demand to GNP growth will be negative.

Table VIII.4.1 Macroeconomic Projections

	2000	2001 Projection	2002 Projection
Growth and Expenditures			
1. GNP (TL Quadrillion)	126.0	184.8	280.6
2. GNP Rate of Growth (%)	6.1	-8.5	4.0
3. GDP Rate of Growth (%)	7.2	-6.1	4.0
Agriculture	4.1	-5.8	2.5
Industry	5.6	-5.7	4.1
Services	8.7	-6.5	4.3
4. Total Domestic Demand	8.8	-15.3	5.8
5. Fixed Capital Investment (%)	14.2	-27.8	0.6
Public	20.6	-28.1	-2.5
Private	11.5	-27.7	2.0
6. Total Investment	16.0	-40.9	18.2
7. Total Consumption	6.7	-6.9	3.2
Public	4.5	-6.6	1.0
Private	7.1	-6.9	3.6
Balance of Payments			
1. Export (FOB. US$)	27.8	30.5	32.0
2. Import (CIF. US$)	54.5	41.0	45.5
3. Curr. Acc. Balan. (US$ Billion)	-9.8	2.9	0.1
Inflation			
1. GNP Deflator (%)	51.6	60.3	46.0
2. WPI (%)			
Annual Average	51.4	60.0	45.6
Year-end	32.7	80.0	31.0
3. CPI (%)			
Annual Average	54.9	53.7	46.4
Year-end	39.0	65.0	35.0

Source: SPO, General Economic Targets and Investments for 2002, Oct.11, 2001

VIII.4.2. Fiscal Policy

The 2002 Economic Program envisions that the implementation of a tight fiscal policy will resume next year. The ratio of primary surplus to GNP in total public sector is targeted to increase to 6.5 percent. In accordance with the Economic Program, the ratio of the

Table VIII.4.2. Consolidated Budget (TL Trillion)

			Ratio to GNP	
	2001 Forecast	2002 Budget	2001 Forecast	2002 Budget
I. EXPENDITURES	**77.998**	**98.071**	**42.2**	**35.0**
1. PRIMARY EXPENDITURES	37.420	55.276	20.3	19.7
Personnel	14.900	21.891	8.1	7.8
Other Current	4.800	7.792	2.6	2.8
Investment	3.770	5.736	2.0	2.0
Primary Transfers	13.950	19.857	7.6	7.1
Social Security	5.112	7.930	2.8	2.8
Other	8.838	11.927	4.8	4.3
2. INTEREST PAYMENTS	40.578	42.795	22.0	15.3
II. INCOME	**50.151**	**71.118**	**27.1**	**25.3**
1. TAX	38.536	57.911	20.9	20.6
2. NON – TAX INCOME	11.615	13.207	6.3	4.7
III. BUDGET BALANCE	**-27.847**	**-26.953**	**-15.1**	**-9.6**
IV. PRIMARY BUDG. BALANCE	**12.731**	**15.842**	**6.9**	**5.6**

Source: 2002 Budget Rationale, Finance Department

primary budget surplus to GNP is envisaged to be 5.6 percent in 2002. The share of budget deficit in GNP is targeted to be 9.6 percent for 2002, with a decline by 6.5 percent compared to previous year. The envisaged decrease in the share of interest expenditures in GNP is an important contributing factor to the expected decline in the budget deficit in 2002. The expected decline in the budget deficit will, in turn, lower the borrowing requirement for the budget financing. In this context, the overall budget and non-interest budget balance targets will play an important role in reducing the growth rate of the debt stock.

The envisioned decrease of 0.7 percent in non-interest expenditures as a percent of GNP underlines that the tight fiscal policy stance will resume in 2002 as well. The share of total consolidated budget revenues in GNP is envisioned to decrease to 25.3 percent—a 1.8 percent decline compared to 2001. In 2002, the share of tax revenues in GNP is expected to remain roughly the same, while non-tax revenues are anticipated to fall.

VIII.4.3. Prices and Monetary Policy

The 2002 Program and the Budget Draft project an increase of 35 percent in consumer prices by the end-of-year, and an average increase of 46.4 percent on annual basis. The target on the inflation rate has been set on the basis of containing domestic demand through tight monetary and fiscal policies, setting public goods and services prices as well as the income policy in line with the predicted inflation target, appreciation of the undervalued Turkish lira in 2002, and the realization of the external financing as projected in the program. In 2002, developments in labor market are not expected to exert any significant pressure on the inflation rate, as was the case in 2001.

However, there are some risks related to the year-end inflation target. The following risk factors could jeopardize the attainment of the year-end inflation target: Realization of the year-end inflation rate for 2001 above the target, the reflection of the decline in the agricultural production on food prices in the first half of 2002, the possibility of a higher pass-through from production costs to the prices due to the decrease in inventories, and sharp increases in CPI service group prices in response to the expected recovery in domestic demand.

Since the adoption of the flexible exchange rate regime on February 22, 2001, the exchange rate lost its function as a policy tool to direct the inflation expectations towards the targeted inflation rate. As a consequence, the monetary policy has assumed the nominal anchor role in the economy and the base money, which can be easily monitored by economic agents, has become the nominal anchor. The CBRT—like most central banks in other countries where the exchange rate and interest rates are freely determined by the markets—aims to ensure that it will not generate excess or shortage of base money, consistent with its ultimate objective of price stability. To this end, an upper limit (a ceiling) on the growth of the Central Bank's net domestic assets (NDA). This limit was derived from base money demand growth forecasts and from the envisaged change in the Net Foreign Assets.

It should be noted that the above-mentioned ceiling on the growth of the Central Bank's net domestic credit is not a goal but rather a ceiling. Consequently, NDA could grow less if this helps stabilize the Turkish economy more swiftly, without creating serious complications.

The monetary policy framework, whose key aspects are summarized above, will render the base money as performance criteria in order to improve its efficiency as the nominal anchor and reinforce the monetary program. In spite of its widely acknowledged limitations such as difficulty of its estimation and lack of a tight control by the CBRT, base money is an extremely effective aggregate that can easily be monitored. The monetary program envisions an increase in base money in line with the rise in real growth and the inflation target. In this context, the targeted increase in base money, together with the strong fiscal policy and structural reform measures, will bring economic agents' inflation expectations closer to the targeted price increase in the program.

Although the key quantitative targets of the monetary policy for 2002 will be announced at the end of this year, the program is based on the maintenance of the base money as the nominal anchor in the framework of flexible exchange rate regime. The monetary program does not envision any deviation from the floating exchange rate regime and, accordingly, it does not include any pre-determined exchange rate target. The implementation of the flexible exchange rate regime will enable the real exchange rate to approach to its new equilibrium value as deemed necessary by the market forces in the face of domestic and external shocks. As economic agents adjust to flexible exchange rate regime and learn the functioning of the regime better, the pass-through of exchange rates to prices will be slower and less intense in Turkey, as was the case in other countries.

In addition to the target set for the base money, the monetary authority will monitor closely the impact of following factors on overall price trend and take the necessary policy actions to attain the inflation target: wage developments, international economic developments, inflation expectations, developments in aggregate supply and demand, evolution of the exchange rate[iii], developments in the prices of goods and services under public control, exports, imports and capital flows.

In the rest of the year and in 2002, the CBRT will continue to work on the requirements for the adoption of the inflation-targeting regime. In 2002—the transition period to inflation targeting—improving the efficiency and transparency of the monetary policy will be among the main objectives of the CBRT. In this context, in the framework of newly CBRT Law entails; (i) independent external audit of the Central Bank's balance sheet and the income statements; (ii) periodic

iii It should be reiterated that the CBRT does not have any exchange rate target. Nevertheless, the CBRT will make necessary changes in the monetary policy by both considering the nature of the shock—real or portfolio— that led changes in the in exchange rate and its impact on the inflation rate.

briefings to the Government pertaining to the implementation of the monetary policy; (iii) the announcement of the Monetary Policy Committee decisions; and (iv) informing the public and markets through periodical reports will form the basis of the monetary policy during the transition period to inflation targeting.

The announcement by the CBRT to adopt inflation targeting and that the next year would be a transition period to its introduction led to much discussion over the appropriateness of this policy under current circumstances. It should be noted that the issue at hand is not only whether the inflation-targeting regime is appropriate in the Turkish context, but also what is the most appropriate monetary policy under flexible exchange rate regime. Majority of the discussion on the inflation targeting in Turkey point to the presence of fiscal dominance and high dollarization as arguments against its adoption without proposing alternative frameworks under flexible exchange rate regime. It should be acknowledged that the presence of fiscal dominance constitutes a serious impediment not only for the implementation of inflation targeting but also for any other monetary policy framework. More specifically, addressing concerns about debt sustainability is essential both for the inflation-targeting regime and any other alternative monetary policy framework.

As is the case with other emerging market economies, high dollarization is among the salient features of the Turkish economy. The fact that the majority of the liabilities of households and firms are either denominated in foreign currency or indexed to the exchange rate and that the presence of the high pass-through from the exchange rate to prices are often posed as counter arguments against the implementation of inflation targeting regime in Turkey. In fact, it was argued that, in light of the above underlined reasons, there is a fear of floating in developing countries. [iv] In this respect, what is important is to allay the underlying problems that engender 'fear of floating' rather than institutionalizing the phenomenon by dollarizing.[v] In light of the CBRT's overriding objective of attaining price stability, addressing and eliminating these problems are among the main objectives of the Central Bank during the transition period to inflation targeting and thereafter.

[iv] 'Fear of Floating; Calvo and Reinhart, NBER Working Paper No: 7993, November 2000.

v Moreover, a recent study shows that the conventional wisdom, that flexible exchange rates are better absorbers of real foreign shocks than are fixed rates, holds in spite of potentially large balance sheet effects. ('Balance Sheets and Exchange Rate Policy' Cespedes, Chang and Velasco, NBER Working Paper No: 7840, August 2000).

ANNEX 1: DEVELOPMENTS IN STRUCTURAL REFORMS

Even though significant improvements were observed in Turkey's economic and institutional structures in the 1990s, chronic and high inflation persisted in this period, while the rate of growth followed an unstable course. Financing of high level of budget deficits through domestic borrowing led to persistence of high real interest rates and worsening of domestic debt problem. On the other hand, high real interest rates had unfavorable impact on economic activities.

It became evident that permanent reforms rather than short-term solutions could ensure the reestablishment of stability in economic activities and rate of growth as well. With this purpose, “Disinflation and Economic Stability Program” was introduced as of the beginning of 2000, which was supported by the IMF as well. In this period, despite the decisive steps taken in structural reforms and monetary & fiscal policies, both delays in privatization process of the SEEs and expansion in current account deficit due to sharp increase in energy prices stemmed from oil prices and overvaluation of the Turkish lira plus weak structure of banking sector have led to the November 2000 and February 2001 crises. In this context, efforts towards structural reforms have been intensified with the “Strengthening the Turkish Economy-Turkey’s Transition Program” that aims to reduce public deficits in the short-term and to establish permanent stability in financial structure in the long run. In the program, structural reforms are grouped under various titles, and considerable progress was made in these reforms.

1. The Banking Sector Reform

Drastic steps were made both in the resolution of problems of state and SDIF banks and in strengthening of private sector banks.

In the past, financial conditions of state banks, which provided significant resources for accomplishment of public duties, have been deteriorated due to duty losses that have accumulated as a consequence of these practices. Moreover, excess daily liquidity needs of state banks had a negative impact on overall banking system. With law No. 4603 dated November 25, 2000 as an initial resolution to this problem, charging state banks with new duties without making prior allocation in the budget was avoided. With the Council of Ministers’ decision dated April 30, 2001, the decrees on existing duty losses were annulled, and the duty losses of state banks were completely eliminated as of the end of June by extending cash and bills. Short-term liabilities of state banks amounting to TL 8.5 quadrillion on March 16, 2001, apart from those to the Central Bank, were reduced to zero by May 2001. Their short-term liabilities to the Central Bank have been significantly decreased as well. Transfer of resources that is required in the reinforcement of capital structures of state banks was made via securities and cash. On the other hand, the law that was introduced on November 25, 2000 excluded state banks from the scope of Decree No.233 on the SEEs. Hence, these banks will be subject only to the provisions of Banking Law and Commerce Law like all other banks.

With the purpose of operational restructuring, Emlak Bank was transferred to Ziraat Bank as of July 6, 2001, inefficient branches of state banks were closed and number of employees was reduced. An agreement was signed with an independent auditing firm for the external audit of state banks. Besides, outside advisors were appointed to guide operational restructuring of these banks. Rapid progress was made in both internal audit and risk management, and an internal financial control unit was established in Ziraat Bank for this duty. The State Banks' Joint Management Board that will make necessary arrangements to privatize Ziraat Bank and Halk Bank within three years has been established in April, and the newly bank management team was appointed in May.

With respect to resolution of the SDIF banks, merge and sale methods were employed. In this framework, Egebank, Yurtbank, T. Tutunculer Bank (Yasarbank), Bank Kapital and Ulusal Bank were merged with

Sümerbank while Interbank and Esbank merged with Etibank. Bank Ekspres, Sumerbank and Demirbank were sold whereas the sale process for Etibank, Sitebank and Kentbank is still ongoing. Turk Ticaret Bank was closed on July 1, 2001, via the BRSA decision published on June 15, 2001.[i] On the other hand, Toprakbank has been transferred to the Fund on November 30, 2001 in order to keep stability and confidence in financial markets. Overnight obligations of Fund banks, except those with the Central Bank, was eliminated, the short-term liabilities with the Central Bank were considerably reduced. In order to strengthen their financial structures, deposit and capital supports were provided to Fund banks from the SDIF resources. The bills that they had already purchased through auctions were replaced with the bills conforming to market conditions. Bad assets of Fund banks are still being transferred to the SDIF Collection Department. Furthermore, a joint management board was established for Fund banks with the purpose of operational restructuring as in state banks, and their branches and employees were significantly reduced.

A number of measures were taken in order to allow healthier functioning of the banking sector. The BRSA requested commitment letters from the capital deficient banks to improve their conditions. Those that failed to fulfill their capital increase commitments were transferred to the Fund. Thank to domestic debt swap performed by the Treasury on June 15, 2001, private banks whose foreign exchange positions suffered from the February crisis were extensively recovered. With the regulation published by the BRSA in February 2001, provisions related to banks' internal auditing and risk management systems were declared to the banks. The sub-arrangements pertaining to the mentioned regulation are to be completed by the year-end. Legal changes that encourage bank mergers were effected under Regulation on Bank Mergers and Transfer published in June as well as the tax advantages introduced in July. The works for improving investment environment and increasing foreign capital inflows by clearing the bureaucratic obstacles and other impediment to capital inflows of foreign banks are moving ahead. Legal changes that encourage increase in capital resources in the banking sector were made in July. Moreover, the Central Bank introduced an intensive monitoring system in May in order to obtain weekly data on deposit interest rates applied by banks. This system, by combining these data and the daily data of the banks, aims at receiving an early warning particularly about liquidity pressures and thus, taking necessary measures to prevent it. With the circular published on September 22, 2001, the Central Bank has been empowered to request and collect information on foreign exchange, gold and Turkish lira transactions directly from any and all types of finance institutions, and to make relevant examinations in these institutions. In order to reduce financial costs of banks and to encourage Turkish lira deposits, as of August 8, 2001, the Central Bank started to apply interest on required reserves allocated for Turkish lira deposits.

On the other hand, the BRSA made considerable progress with regard to the supervision of banks' branches abroad as well as offshore banks. In this context, the BRSA signed bilateral agreements with the Central Bank of the Turkish Republic of Northern Cyprus on September 17, 2001 and the Central Bank of Albania on October 19, 2001, and started negotiations with other relevant countries.

2. The Budget Reform

In the Turkish budget system, the unity of budget deteriorated as a consequence of increase in extra budgetary expenditures due to practices such as extra budgetary funds and duty losses in the past. In the course of time, the budget has lost its adequacy and efficiency. With weakening correlation between resources and expenditures, the budget system has gradually become inadequate to provide information to decision-makers and the general public. Moreover, limitations imposed on the auditing scope of the Exchequer and Audit Department (Sayistay) in the course of time reduced the efficiency of the supervision of the budget as well.

[i] The banking license of Turk Ticaret Bank was revoked as of July 1, 2001. However, the legal process is still continuing because of the Council of State's (Danistay) decision to suspend the enforcement.

With the Program, important progresses have been made in eliminating impediments and delays in the management of public expenditures, and rapid progress has been made in providing budgetary discipline. The budgetary funds except the Support Price Stabilization Fund (DFIF) that is essential for the World Bank loans, and extra budgetary funds excluding the Social Aid and Solidarity Fund, the Defense Fund, the SDIF, the Privatization Fund, and the Promotion and Publicity Fund were abolished. A decision was taken not to establish any further fund. These are radical reforms that have been made toward achieving of budget discipline and its transparency. Outstanding steps were taken toward adopting a budget code system confirming international standards in 6 pilot institutions included in the general budget. The spread of this system will allow clear and rapid pursuit of the amount and nature of expenditures of all institutions. A considerable progress has been made by the Ministry of Finance in the web based Say2000i Accountancy Automation Project that will allow monitoring daily operations of accountancies nationwide from a single center. This project aims at on-line following of account and cash movements of state institutions between main unit and the provinces on a basis of a standard accounting system. The Treasury started to systematically announce the payments related to the Treasury guarantees in order to provide transparency. To pursue the Treasury's payments within the scope of guaranteed debts and repayments to the Treasury by the related administrations, a “lending minus repayment” item was included to the Treasury's monthly reports. Additionally, regulations that will expand the range of application of tax identification number were put into force as of September.

The Draft Law on Public Financing and Debt Management, which has been formulated to improve effectiveness in debt management by gathering the provisions related to debt management that take place in various legal texts under a single law and by centralizing the debt management, has been submitted to the Parliament. This draft that brings in clear borrowing rules and limitations, aims at including the Treasury’s on-lending credit and debt guarantees into the budget coverage as well.

Amendments to Decision No.32 on the Protection of the Value of the Turkish Lira that have been adopted to ensure the pursuit of external debt records of private sector more soundly were introduced on October 1, 2001. These amendments allow the Central Bank to monitor all external borrowings of the private sector. Hence, a significant step has been taken towards efficiency in gathering data on external borrowings of private sector.

3. Reforms toward Competition and Efficiency in the Economy, and Foreign Direct Investments

Reforms aiming to increase the role of private sector in the economy and also in privatization have great importance for improving effectiveness and efficiency in the economy. In the medium-term, it is targeted to attract foreign direct investments in order to ensure financing of accumulated debt stock and sound operating of economy. Considerable progress has been made in the last period.

A strong private sector reform and increasing competition depend on amendments made within the legal framework. Principles and procedures in the production, pricing and marketing of sugar and sugar beet were re-determined by the Sugar Law introduced in April 2001. With this regulation, the state has withdrawn itself from the pricing process in order to bring competition in the market and thus paving the way for privatization of sugar factories. The Natural Gas Law that aims at offering natural gas to the market under competitive conditions, and Telecom Law that targets to increase the efficiency in telecommunication sector and prepare Turk Telecom to privatization have been published in May. The Turkish Civil Aviation Law that allows free pricing of domestic lines was introduced in April while the Electricity Market Law in July. Thanks to these legal studies, drastic steps were taken for the structural reforms about establishing competitive environment and attracting foreign direct investments to the country, and the necessary legal framework for this aim has been, to a large extent, established.

Another progress made toward attracting foreign capital is the approval of the Law on International Arbitration. With the law enacted in July, conflicts arising from specifications and contract privileges related to public services, where any foreign element is involved, shall be settled through international arbitration, paving the way of foreign-capital direct investments. On the other hand, the work is moving ahead in order to reduce administrative barriers to investments. A study and report on Project on Detecting Administrative Barriers to Investments, prepared by International Finance Corporation (IFC) of the World Bank and Foreign Investment Advisory Service (FIAS), was submitted at a conference held in September to which various international institutions and civil society organizations attended to the conference. Studies on the action plan for removing administrative barriers to investments are still continuing.

4. The Social Solidarity and Social Security Reform

Reforms that have been made in social security in order to strengthen social solidarity and to resolve existing problems at present and in medium-term were put into effect as of 1999.

At the first stage, a Law on Social Security Reform was enacted in September 1999. Accordingly, pensions were made possible to increase by the amount of paid premium. Retirement age has been progressively raised. Moreover, preserving purchasing power of pensions has been ensured by the application of inflation indexation system. Subsequently, by introducing Unemployment Insurance system, a drastic step has been taken for avoiding unemployed persons to suffer.

At the second stage of the reform aiming at the institutional restructuring, Social Security Institution was established within the structure of the Ministry on Labor and Social Security by the Council of Ministers decision dated August 24, 2000, in order to establish standardization among insurance programs implemented by the insurance companies and to monitor financial positions of these companies. Radical reforms were affected in the social security system via amendments in laws governing SSK, Bağ-Kur, Turkish-İş and Individual Retirement Savings & Investment System. On the other hand, Law on Foundation, Working Principles and Operation Methods of Economic and Social Council was introduced on April 21, 2001. The Council aims at providing reconciliation and cooperation among social groups in formulating economic and social policies. Furthermore, the studies on initiating automation project in SSK and Bağ-Kur, establishing a central database in coordination of social security institutions and forming an extensive information system, setting up a common accounting system and achieving standardization in the health services are still continuing at present.

In order to socially support the low-income group that may suffer due to the implementation of the Economic Program, the Government and the World Bank have drawn up the Social Risk Reduction Project. Under the agreement signed between the government and World Bank on August 13, 2001, the Japanese government has donated US$ 580 thousand through the World Bank. Moreover, the World Bank made a decision on providing US$ 500 million credit for this purpose on September 13, 2001.