CENTRAL BANK OF THE REPUBLIC OF TURKEY

MONETARY POLICY REPORT 2004-III

CONTENTS

1. Introduction

Inflation maintained its downward trend in the third quarter of 2004 and dropped to 9 percent by the end of September. Besides, October results of Central Bank of the Republic of Turkey (CBRT) Expectations Survey revealed that average end-year expectation declined to 9.5 percent. Year-to-date price increases by merely 4.8 percent point out that the inflation rate will unlikely exceed the end-year inflation target, despite probable public price adjustments in the rest of the year.

Economic policies to be implemented in the coming years started to take shape in the third quarter of 2004. Stronger expectations that a date will be set at the end of the year regarding the Turkey's membership negotiations with the European Union (EU), and a new stand-by agreement will be signed with the International Monetary Fund (IMF) also strengthened expectations for the deepening of macroeconomic stability. This favorable course continued in the second half of 2004 as well. Besides, owing to tight fiscal policies, the sustainability of the budget discipline was ensured and primary budget surplus displayed a strong performance. Moreover, cost-push pressures of the second half of the year had only a limited impact on inflation. Hence, CBRT cut O/N interest rates down to 20 percent as of September 8.

The growth trend in the Turkish economy, which has started in 2002, continued in the second quarter of 2004 as well. While increases in the productivity and export performance continued during this period due to the low level of unit wages, the contribution of domestic demand components to the growth process strengthened as well. Contrary to the previous periods, the recovery in domestic demand is to reflected on a wider consumer group in this period. Meanwhile, the revival in private expenditures on investments in durable consumption goods and machinery-equipment was accompanied by the upsurge in expenditures on semi-durable and non-durable consumption goods. Yet, non-durables expenditures still maintain their moderate level. Despite ongoing rise in capacity utilization rates, high course of investment expenditures ensures the maintenance of the increases in productivity. At the same time, real unit wages maintain their relatively low level despite the increase in employment and wages. This is of great importance with respect to sustainable non-inflationary growth and prevents a likely pressure to be exerted on consumer prices.

The volatility in exchange rates slowed down in the third quarter compared to the second quarter. In line with the transition to floating exchange rate regime, automatic indexation of prices to exchange rates has started to be abandoned gradually. At the same time, the tendency of exchange rate movements to reflect on prices has become more sensitive to whether the nature of exchangrate movements are permanent or temporary. In this context, the re-stability in Turkish lira following the fluctuations in the second quarter limited the reflections of such fluctuations on price increases. Nevertheless, ongoing rise of crude oil and iron-steel prices in international markets is a factor increasing production costs. As a matter of fact, the rise in oil prices was not reflected on the domestic market for some time with the partial waiver of tax revenues firstly. However, persistent price increases in international markets led to upward adjustments in petroleum and natural gas prices.

Throughout the summer, agricultural prices declined much beyond the general tendency, contributing to the declining trend in inflation. However, agricultural prices may often take a course completely different from general price tendency, creating quite impacts on prices both in upward and downward directions depending on the seasonal factors. As a matter of fact, with the end of summer, the upsurge in agricultural prices started to push up wholesale prices. Furthermore, ongoing rigidity in the prices of services sector stood as another unfavorable factor.

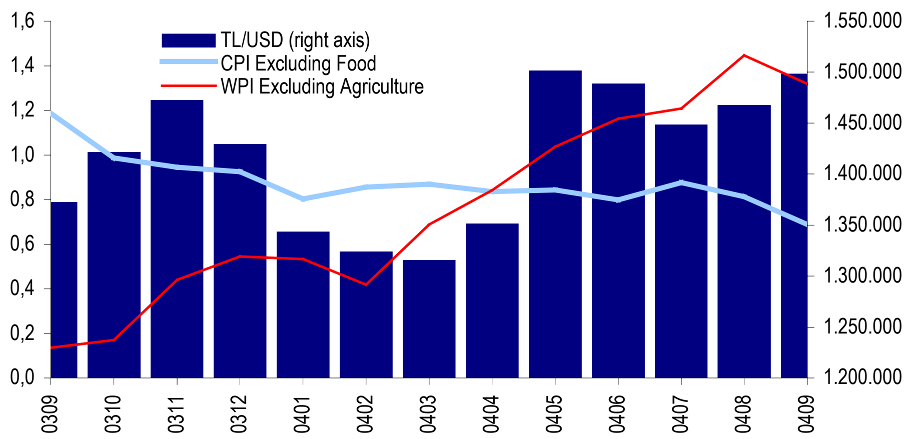
Despite the fact that developments in oil prices, public price adjustments and agricultural-food prices will likely to be the determining factors of inflation in the short-run in the coming period as well, the basic inflation trend excluding temporary/external factors is expected to be downward-oriented.

2.Inflation Developments

In the January-September period, seasonally adjusted inflation realized as 10.8 percent in WPI excluding agriculture and 6.7 percent in CPI excluding food. In the third quarter of 2004, due to the relative stability in FX rates, price increases in sectors excluding food and agriculture lost pace compared to the second quarter during which TL/US dollar exchange rate rose by 13.1 percent. In this period, the delayed effects of the depreciation of Turkish lira and the hike in crude oil prices were the determining factors on WPI inflation excluding agriculture, while the impact of the said cost elements on CPI inflation excluding food remained somewhat limited (Graph 2.1). The fact that domestic demand has not reached to a level to exert pressure on price level by pushing manufacturing capacity was effective on this development.

In the third quarter of 2004, due to the relative stability in FX rates, price increases in sectors excluding food and agriculture lost pace compared to the second quarter.

Graph 2.1 Seasonally Adjusted Six- Month Moving Averages

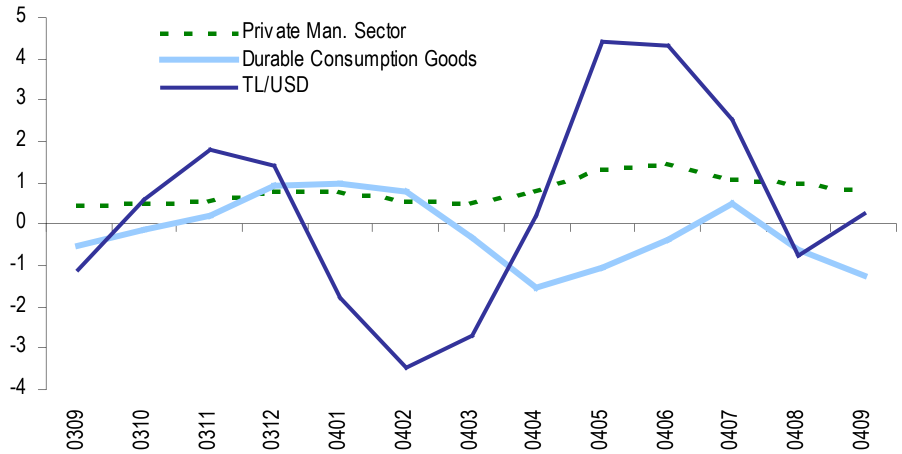


Source: SIS,CBRT

The factors that are considered to be the main determinants of inflation in the July-September are: (i) the limiting impact of the relative stability in FX rates on inflation rates, (ii) accelerating petroleum prices in line with international crude oil prices, (iii) rigidity in the prices of the services group, (iv) controlled recovery in domestic demand, (v) the course of agricultural goods and food prices.

As underlined in the previous reports, with the transition to the floating exchange rate regime, there is a slowdown as well as a weakening in the pass-through effect. The fact that short-term upward and downward movements at variable rates are likely to be witnessed in exchange rates in a floating exchange rate regime hinder price makers from adjusting prices, unless they are sure of the duration and extent of the movements in FX rates. Hence, the effects of exchange rate changes on inflation come out with a delay. In this framework, the relative slowdown in the depreciation rate starting from June, limited the impact of the likely delayed effects of this increase on consumer prices (particularly durable goods). Meanwhile, the upsurge in international commodity prices, chiefly in oil prices, created a cost pressure, leading to ongoing acceleration of the WPI inflation (particularly manufacturing industry) (Graph.2.2).

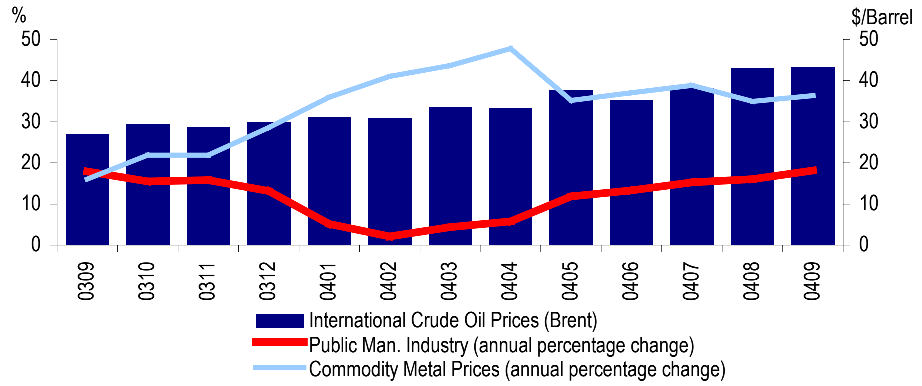
Graph 2.2 Exchange Rate Movements and Seasonally Adjusted Price Increases in Some CPI and WPI Subgroups (3 Months Moving Average, %)



Source: SIS, CBRT

Due to the uncertainty in production conditions, hikes in international crude oil prices continued in the third quarter of the year as well. Despite the partial reflection of the said increase on domestic prices, petroleum prices under CPI rose by 8 percent, while prices in petroleum goods manufacturing industry under WPI increased by 9.4 percent in the third quarter of 2004 through waiving some of tax revenues. Since the strategy of not reflecting all rises in international oil prices on domestic prices is unlikely to be sustainable in the medium-term, the persistence of this rise poses a risk for inflation and growth as seen in other countries. In the third quarter of 2004, while the public price increases under CPI excluding petroleum and natural gas were rather limited, ongoing rise in international iron-steel prices had a boosting effect on WPI price increases in public manufacturing industry. World iron and steel prices that rose in line with demand based on rapid economic growth in developing economies, particularly in China, displayed a slighly lower rate of increase in the third quarter compared to the first two quarters of the year. However, price increases in industries (especially in public sector) that manufacture iron and steel and that use iron-steel products as basic inputs, still realized above the general WPI inflation trend (Graph.2.3).

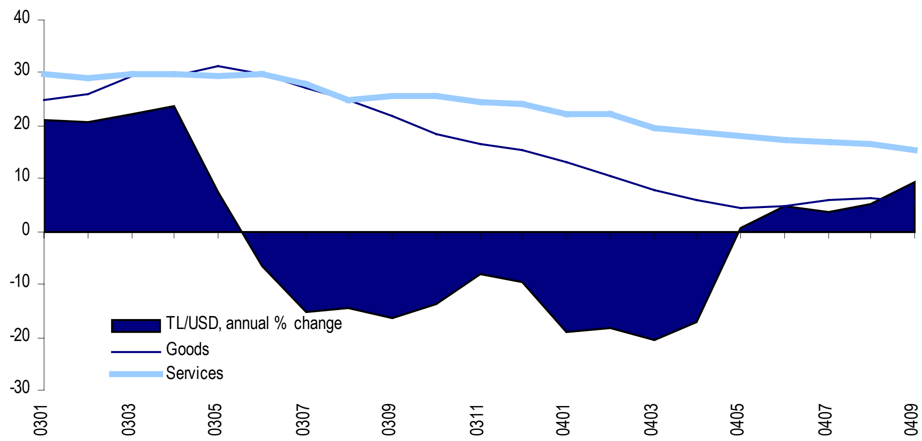
Graph 2.3 International Commodity and Public Manufacturing Industry Prices



Source: SIS, IMF, Energy Information Administration

Another notable point with respect to CPI sub-groups is the differentiation between the rates of increase in goods and services prices. The gap between the rates of increase in goods and services prices has been widening since August 2003. Annual inflation rates, which were around 25 percent rates in August 2003 in both groups, dropped to 5.6 percent in goods group and 15.3 percent in services group as of September 2004 (Graph2.4).*

Graph 2.4 Annual Rates of Increase in Goods and Services Prices (%)



Source: SIS, CBRT

The rigidity in the services group prices enhances the importance of a controlled revival in domestic demand. Goods prices, which had not faced any significant cost and demand pressures until now, displayed a rapid decline, offsetting the rigidity of services prices in CPI in general. However, in the event of a likely increase in cost and

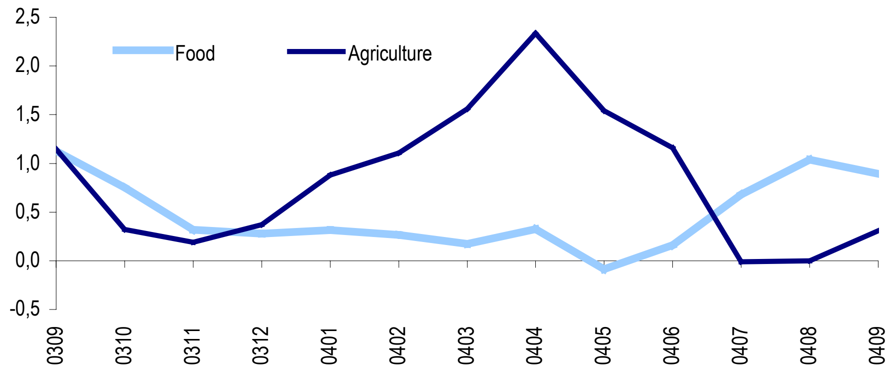
* The factors that lead to the differentiation are analyzed in detail in Box .

demand-oriented pressures on goods prices, the rigidity in services prices will pose greater risks to inflation.

According to GNP data, which are announced with a lag compared to the price data, expenditures on semi-durables and non-durables as well as durable goods as of the second quarter of 2004. In other words, the revival in domestic demand has started to involve a wider range of consumers. Meanwhile, no demand pressure is observed on the prices of the CPI sub-sectors in this period. The lack of a significant rise in FX rates avoided the reviving demand to exert a pressure on durable goods prices. On the other hand, the fact that the price increases in the furniture sector, which makes use of less imported inputs compared to other durable goods such as white goods and thus is less sensitive to exchange rate, realized over the CPI inflation (a similar case is also observed in the furniture manufacturing sector under the private manufacturing industry) points at a likely demand pressure in this sector. Moreover, price increases in goods group, chiefly in the food and clothing prices, remained well below the seasonal tendencies in September despite the unfavorable seasonal factors. This proves the lack of a significant demand pressure in general.

As of the second quarter of 2004, the revival in domestic demand has started to involve a wider range of consumers. Meanwhile, no demand pressure is observed on the prices of the CPI sub-sectors in this period.

Graph 2.5 Seasonally Adjusted Rates of Increase in Food and Agriculture Prices
(6 months moving average, %)



Source: SIS, CBRT

Apart from the factors mentioned above, another factor that was determinant in the inflation developments in the third quarter of 2004 was the course of agriculture and food prices. While agricultural prices displayed excessive volatility in both upward and downward directions due to various structural and seasonal conditions, manufacturing industry prices changed at less significant rates thanks to the general downward trend in inflation as well as the weakening in pass-through effect of exchange rate to prices. Hence, major contribution to WPI came from agricultural prices. The most important outcome of this development is the substantial increase in the variability of the WPI. The impact of high volatility in agriculture prices on WPI can be observed in both directions. In the summer months, agricultural goods prices declined by large amounts and offsetted the acceleration in the manufacturing industry prices due to exogenous cost factors. However, with the end of the summer, agriculture prices started to pull the

WPI inflation up (Graph.2.5). Therefore, in terms of future inflation, it will be more helpful to monitor the WPI excluding agriculture, which is more informative compared to the general WPI.

Moreover, food prices played a supportive role in the downward trend in the CPI inflation in the first quarter of 2004. As seen in Graph II.5, the rates of increase in food prices under CPI and agriculture prices under WPI may substantially differ. Food prices, though being one of the items with the highest volatility, do not display large diversions from the general inflation trend like agriculture prices. This mainly stems from the fact that two price groups are different in terms of definition and content.

In summary, the January-September 2004 developments prove that end year inflation target will be achieved. As of September 2004, CPI inflation dropped to 9 percent. Though public prices, chiefly petroleum prices, are expected to increase in the last quarter of the year due to the price raises announced in September, these raises will unlikely pose a threat in achieving inflation target when the margin created by the 4.8 percent cumulative inflation in the first 9 months of the year is considered.

BOX 2.1 RECENT DIFFERENTIATION BETWEEN GOODS AND SERVICES PRICES

The following three factors are considered to be particularly influential on the recent differentiation between goods and services prices:

- (i) Higher exchange rate pass-through in goods group compared to services group;
- (ii) Rigidity in services prices;
- (iii) Higher competitiveness and productivity increases in goods group compared to services group.

Substantial drops in exchange rate starting from May 2003 led to rapid declines in price increases in goods, which are sensitive to the developments in exchange rate, as of the second half of 2003. Meanwhile, the fall in inflation has been slower in the services group in which the exchange rate pass-through is rather limited (Figure II. 4).

Varying exchange rate pass-through between goods and services groups is a structural phenomenon consistent with economic theory. Therefore, in every case changes in exchange rate become more effective on inflation dynamics, price increases in goods and services groups are expected to differentiate to some extent. As a matter of fact, the discrepancy between goods and services prices had grown in favor of goods prices– unlike the present situation – when high increases were recorded in exchange rate during the 2001 crisis (Table 2.A).

However, it will not be right to attribute the discrepancy between goods and services prices in the last year completely to the differentiation in the exchange rate pass-through. In fact, the view that the price rigidity in the services group also plays an important role in the discrepancy between goods and services prices is supported by the fact that annual increase in rents realized as 19.7 percent (while annual price increase in services group became 15.3 percent) in the September of 2004 when the end-year inflation target was 12 percent.

Table.2.A Annual and Cumulative Rates of Increase in CPI, Goods, Services and Services Subgroups

	ANNUAL % CHANGE December-December				CUMULATIVE % CHANGE January-September			
	2001	**2002**	**2003**	**2004 ***	**2001**	**2002**	**2003**	**2004**
CPI	68.5	29.7	18.4	9.0	47.7	20.1	13.8	4.8
Goods	80.9	29.7	15.5	5.6	54.5	18.2	10.9	1.3
Services	49.2	29.8	24.0	15.3	36.5	23.9	19.8	11.4
House Rent	39.7	29.0	23.7	19.7	27.7	21.5	17.8	13.9
Transportation services	68.6	22.5	25.3	4.8	59.3	19.5	25.4	4.9
Dining	47.2	32.3	32.6	16.9	34.0	24.6	25.2	10.4
Housekeeping and services	85.7	9.8	4.0	-1.9	64.0	8.6	4.5	-1.4
Communication	82.0	27.7	14.8	0.1	55.6	20.0	14.8	0.1
Hospital and medical services	43.8	37.1	30.1	11.7	39.8	36.1	28.9	10.7
Education services.	56.9	54.5	22.2	13.6	56.4	54.4	22.1	13.5
Entertainment and culture services	54.9	30.1	24.8	12.6	44.1	22.3	19.2	7.5
Hotel services	34.8	32.1	26.3	25.3	25.6	23.1	14.0	13.1
Financial services	71.7	73.0	47.0	27.9	71.7	73.0	47.0	27.9
Other services	61.8	53.1	23.8	22.3	60.2	53.1	23.7	22.3

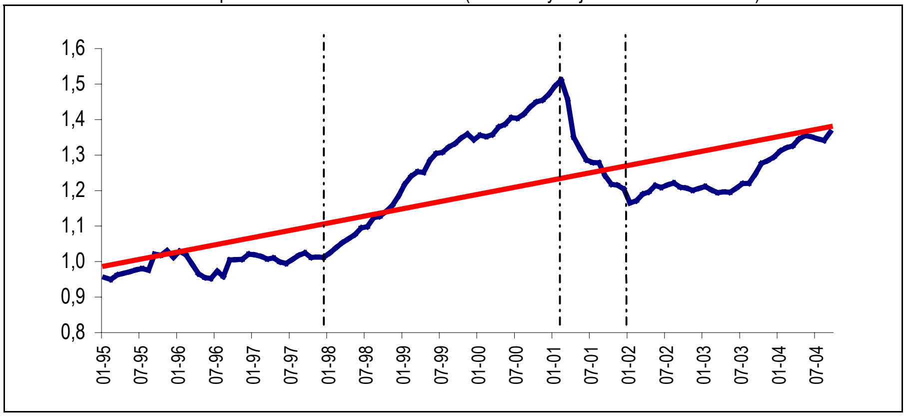
*Annual price increase in the September 2003-September 2004 period has been used.

What causes rigidity in service prices is that the bulk of service prices is based on contracts. Though there is a continuous downward trend in inflation, prices in the services sector groups such as rent, health, and education services subject to contracts and periodic price adjustments do not decrease in line with the decline in inflation, as prices do not change until the contract-renewing period. Contract rigidity might arise even if the seasonal price increases are determined according to the inflation target since inflation is steadily falling. For example, should there be an increase of 12 percent, compatible with this year’s target, in the education services in September 2004 for the coming year, the annual price increase in this sector would be around 12 percent until September 2005, and would most probably remain above inflation which would be declining towards 8 percent in line with the 2005 end year target.

Contract rigidity becomes even more important when it there is backward looking pricing behavior. In an economy with declining inflation, if the rate of increase in rents is determined according to last year’s inflation figures, it is bound to remain above inflation. However, recently, compensating for the decline of the relative price of services in the post-2001 crisis period has also been a determinant of the high rates of increase in the services prices along with backward looking pricing behavior.

In the period following the 2001 crisis, services prices increasing only modestly in response to goods prices gaining momentum, resulted in a dramatic decline in relative services prices (Table 1). After 2002, though high increases in services prices somewhat compensated for the deterioration in relative prices, relative services prices are still low compared to the pre-crisis period. In case price makers in the services sector set take the relative prices in the pre-February 2001 period as a reference point, this correction is expected to go on for some time more. On the other hand, when the long-run is analyzed, it can be seen that services prices have been higher than goods prices since 1998 and consequently it is not possible to talk about a correction of any kind in the services prices. In other words, whether there is a correction or not, and how long it will last depends on which point is taken as a reference.

Graph A Relative Price of Services (Seasonally adjusted Services/Goods)



Looking at Graph 1, which shows the variation of relative price of services over time, it is observed that another factor is standing along with the error correction after the crisis: Relative price of services do not fluctuate around the constant 1 but around a positive trend and deviations from this trend are not corrected in the short term. (1) Relative price of services, which have moved around the constant 1 as a result of the parallel course of goods and services prices until 1998, has constantly increased since then, until the February crisis of the year 2001. In the period following the 2001-crisis, the ongoing upward trend in the relative price of services is reversed and for the first time after three years relative price of services fell below its trend. But, it did not take long for the relative price of services to start rising again.

The structural upward trend in the relative price of services can be explained by the fact that the increase in competitiveness and productivity in tradable goods is higher compared to that in non-tradable services in the Turkish economy, which has gradually become more open. As services sector is generally nontradable, it less affected by foreign competition than goods sector which is mostly composed of tradable goods. On the other hand, in the goods sector which is subject to international competition, companies have to increase productivity in order to maintain their competitive power.

In the goods sector, when there is a certain rate of increase in productivity, manufacturers can boost wages in line with the productivity increase without raising their prices. On the other hand, since social services like health and education and personal services like hair cut are not subject to technological improvement, most of the time there is not a parallel increase in the productivity, and therefore wages, in the services sector. However, lower wages in the services sector compared to the goods sector cannot be sustained in the long-run since this would cause excess demand for labor in this sector. That is why, wage increases in the services sector might be close to those in the goods sector even if not supported with productivity increases(2) . This might lead to a faster increase in prices of the services than goods .(3)

In sum, the discrepancy between the prices of goods and services is partly due to factors that are structural and hard to change in the short-term like the increase in competitiveness and productivity along with the strong pass-through in tradable goods sector, and partly due to the backward looking pricing behavior in the services sector. The largest area of maneuver to reduce the rigidity in the prices of services is in the backward lookingness issue. E rror correction in the post-crisis period, which is a part of the backward pricing behaviour is expected to disappear in the medium term. However, pricing according to past inflation is a factor that may cause higher price increases in services than in goods until permanent price stability is attained. Within this framework, it is considered that to firmly break the backward lookingness in services prices, building of confidence in the continuation of disinflation and enhancing transparency through providing a more efficient way of managing inflation expectations by announcing mid-targets or forecasts will be more effective than legal adjustments.

Nevertheless, it should always be kept in mind that even if backward pricing behaviour is broken and/or permanent price stability is achieved, there may any time be a difference between the price increases in services and goods in favor of services sector owing to the above-mentioned structural factors. The important point is that this difference should not be at an extent and persistence to have an unfavorable impact on general inflation trend.

(1) Hypothesis of a unit-root in the relative price of services could not be rejected since the absolute value of the ADF statistics obtained from the test equation with constant and trend have been -1.52 which is under the critical value of 3.15 at 10 percent significance level.

(2) Baumol, W. 1967. "The Macroeconomics of Unbalanced Growth: The Anatomy of Urban Prices" , The American Economic Review 57(3): 415-26

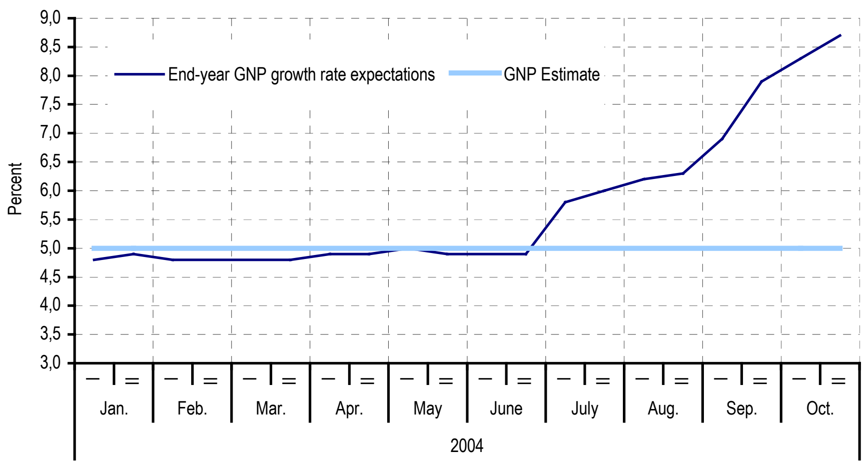
(3) It is found that Baulmol's hypothesis is valid for most of the developed countries. See Gagnon, E., Sabourin, P., Lavoie, S.. 2003. "The Comparative Growth of Goods and Services", Bank of Canada Review, Winter 2003-2004..

3.Supply and Demand Developments

3.1.Supply-Demand Equilibrium

Growth trend in Turkish economy persisting since 2002 extended to the second quarter of 2004 as well. In this period, GNP recorded a high rate of increase by 14.4 percent over the same period of the previous year. Higher-than-expected rates of growth in the first half of 2004 and quite low levels of inflation in the first nine months of the year had a positive effect on the end-year expectations of economic agents and boosted confidence about the economic program. Within this framework, expectations on GNP growth swiftly approximated the target since the beginning of 2004 and remained constantly above the target as of July. In the second survey period of October, GNP growth well exceeded the target and became 8.7 percent (Graph 3.1).

Graph 3.1 Annual GNP growth rate expectations in the CBRT Expectations Survey

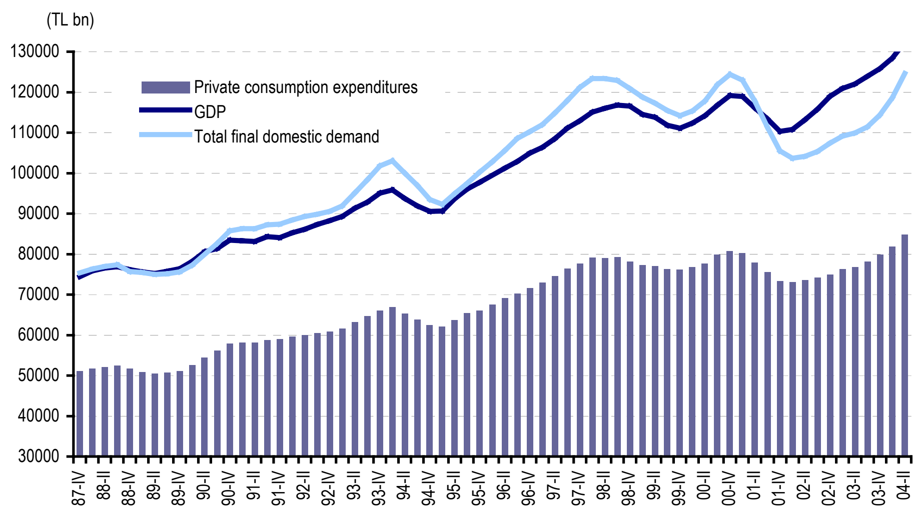


Source: CBRT

Due to the optimistic expectations about the course of economy, capacity utilization rates maintained their high levels and industrial production continued to grow rapidly in the third quarter of the year as well. Results of the State Institute of Statistics (SIS) Monthly Industrial Production Index reveal that total industrial production increased by 12.6 percent in January-August period compared to the same period of the previous year. During the same period, manufacturing industrial production made a major contribution to industrial production growth with a rise by 13.8 percent. In line with the rapid rises in production during January-September 2004, capacity utilization rates in manufacturing industry retained their high levels. According to data announced by the SIS, capacity utilization rate in total manufacturing industry sector hit an extremely high level by reaching 80.9 percent in the first nine months of 2004.

Domestic demand conditions contributed to the rapid growth process at a greater extent, while the high performance in exports continued as a result of the boosts in productivity and the promising levels of unit wages. On balance, revival in domestic demand accelerated in the second quarter of 2004. During this period, rapid growth in the economy was fueled by the upsurge in private spending (Table 3.A). Growth in total final domestic demand, which exceeded GDP growth by the last quarter of 2003, kept its upward trend in the second quarter of 2004 as well. As a matter of fact, annualized data indicate that the revival in domestic demand became much more evident during this period. However, total final domestic demand remaining still below the level of GDP, points out the persistence of demand gap in the economy (Graph 3.2).

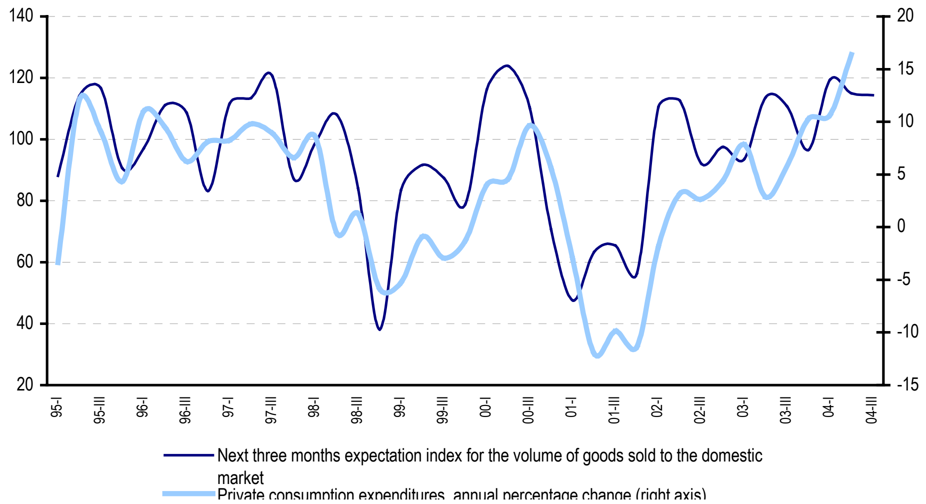
Graph 3.2 Annualized GDP, total final domestic demand and private consumption expenditures (1987 prices)



Source: SIS

An analysis of the components of total final domestic demand highlights the fact that the greatest contribution to GDP growth came from private spending in the second quarter of 2004. During this period, public spending diminished due to the tight fiscal policy implementation. Resurgence in private spending mainly encompassed durable goods sector and machinery-equipment investments. Meanwhile, spending for semi-durable and non-durable goods boosted at a high rate by 31.2 percent (Table 3.A). This fact indicates that, contrary to previous periods, private spending was more evenly dispersed and the revival in domestic demand affected a wider range of consumers. As stated in the CBRT Business Tendency Survey (BTS) for the next three months, the high level of volume of goods sold to domestic market evinces that the revival in domestic demand continues in the second half of the year as well (Graph 3.3).

Graph 3.3 Private consumption expenditures and expected sales



Source: SIS, CBRT BTS

Private consumption expenditures grew rapidly, particularly on durable goods. The main factors leading to this increase can be listed as the strong position of Turkish lira against foreign currencies, very limited price increases and enhanced consumer confidence as well as the revival in the credit channel as a result of the improvement in borrowing facilities such as low levels of interest rates on credits and longer-term installments. As a matter of fact, consumer credits and credit card use swiftly climbed up in the second quarter of 2004. The Consumer Confidence Indices of the CBRT and CNBC-e, and the tendency of new orders from domestic market, one of the indicators from CBRT BTS, displayed a favorable course in the second quarter of 2004 as an indication of a further boost in consumer confidence during this period. Along with these developments, positive reflections of the rapid growth on the labor market are considered to contribute to the revival process in domestic demand due to the rises in employment and real wages observed in the second quarter of 2004.

Table 3.A GDP developments by expenditure side (annual percentage change)

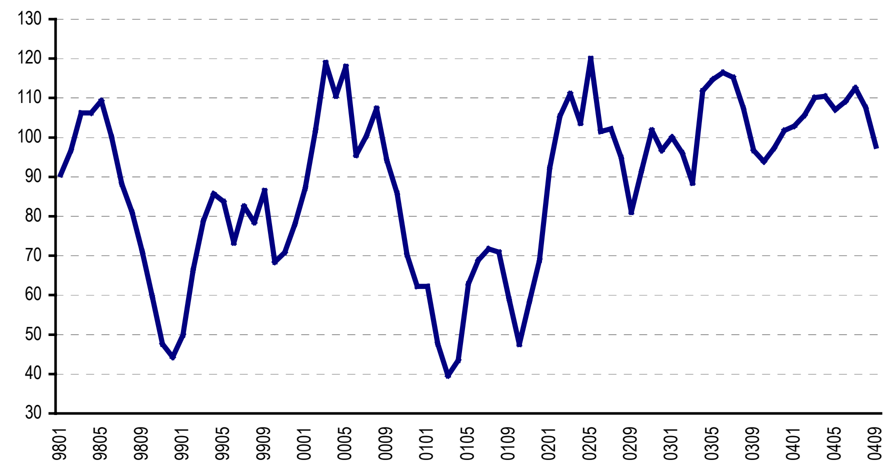
	2003					2004		
	I	II	III	IV	Annual	I	II	First Half
1- Consumption expenditures	6.9	2.3	5.2	8.0	5.6	9.9	13.6	11.8
Public	-2.3	-2.0	-0.7	-4.2	-2.4	2.4	-7.9	-3.5
Private	7.8	2.9	5.8	10.3	6.6	10.6	16.4	13.5
Durable goods	24.7	10.6	11.4	49.5	24.0	49.7	61.7	55.3
Services	9.6	5.1	7.6	7.9	7.5	10.1	14.3	12.4
Food and beverages	4.4	4.1	5.7	1.0	4.1	0.9	0.3	0.6
Semi-dur.& non-dur. cons. exp.	4.7	-4.5	3.7	3.8	2.1	4.9	31.2	16.0
2- Fixed capital formation	11.7	6.4	3.0	19.2	10.0	52.6	51.7	52.1
Public	-34.8	-14.6	-22.7	5.0	-11.5	-11.3	-9.1	-9.6
Private	22.5	14.2	16.4	30.1	20.3	60.6	68.7	65.1
3- Stock change*	3.6	5.5	2.2	1.2	3.0	3.1	1.4	2.2
4- Exports of goods and services	14.5	12.3	19.4	16.9	16.0	10.3	15.7	13.1
5- Imports of goods and services	22.0	24.7	28.3	33.0	27.1	31.2	32.7	32.0
6- Total domestic demand	10.9	8.5	7.0	11.3	9.3	19.1	21.1	20.2
7- Total final domestic demand	7.7	3.2	4.7	10.6	6.5	17.5	22.5	20.1
8- GDP (expenditure side)	8.1	3.9	5.5	6.1	5.8	10.1	13.4	11.8

*Contribution to GDP growth, percent
Source: SIS

However, the slow down in consumer credit use observed in June-September period points out that the demand for durable goods in the third quarter of the year might not catch up to the pace in the first half. In fact, domestic car sales lost momentum since June due to the restrictions imposed by public banks on credit limits, the raise in interest rates on consumer credits and the reduction in junk discount on cars. Meanwhile, according to data of the Automotive Manufacturers Association (AMA), sales of commercial vehicles and agricultural tractors to domestic market dropped significantly as well. Particularly in August, the contribution to industrial production growth made by machinery-equipment and transportation vehicles sectors declined markedly compared to previous months. In this context, a relative deceleration was observed in both total and manufacturing industrial production growth in July and August over the previous months. Moreover, production tendency index for the next three months constructed with CBRT BTS indicators started to decline as of July and fell to the lowest level of 2004 in September (Graph 3.4).

Added to these developments is the high base effect brought about by the economic recovery in the last quarter of 2003. Taking this effect into account, it is expected that the high-rated increases in spending on machinery-equipment investments as well as on durable goods would continue with a slower pace in the second half of the year.

Graph 3.4 Production tendency index for the next three- month period *



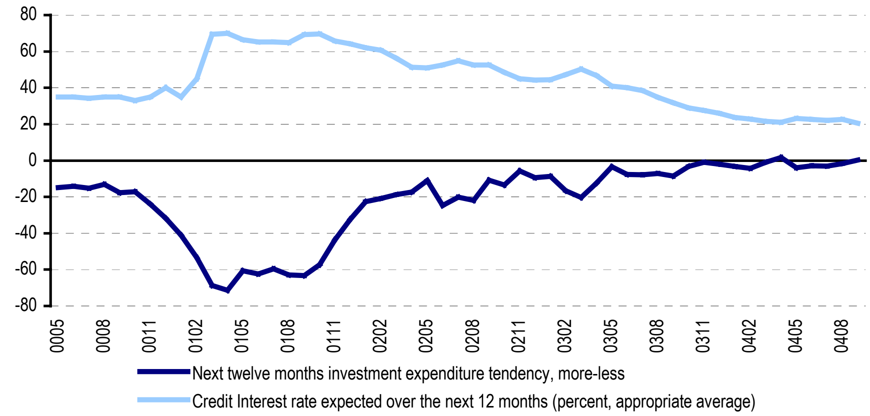
*The index comprises CBRT BTS next three months indicators of volume of raw material, volume of output and total employment.
Source: CBRT

The steadfast implementation of macroeconomic program has enabled a decline in interest rates by easing the uncertainties in the economy and reducing the risk premium. In this context, private investment expenditures recorded a high rate of increase by 68.7 percent in the second quarter of 2004 as a result of the rapid rise in machinery-equipment investments. The greatest contribution to the economic growth during this period came from private investment expenditures. Effectuation of private sector investments, whose importance was emphasized in previous reports as well, is a favorable development in terms of a non-inflationary sustainable growth.

The upsurge in private investment expenditures, which are critical for noninflationary sustainable growth, pushed up the potential production level in the economy. Thanks to this development, no demand-push pressure was observed on consumer prices in the first half of 2004.

The rapid rise in the share of private sector investment expenditures in GDP in the first half of 2004 indicates that the economic growth is sound and sustainable. Investment expenditure tendency, one of the investor confidence indicators in CBRT BTS, took an upward course in September again while the expectation on credit interest rate declined (Graph 3.5). In addition, the share of those advocating the view that “no investment expenditure is planned” continued to fall due to the firms’ favorable expectations about financing costs. Meanwhile, high capacity utilization rates observed in basic metal and machinery-equipment sectors in September as well as the developments as of August in machinery-equipment production and the imports of capital goods point at the continuation of high-rated increases in investment expenditures.

Graph 3.5 CBRT BTS expectation of TL credit interest rate and investment expenditure tendency



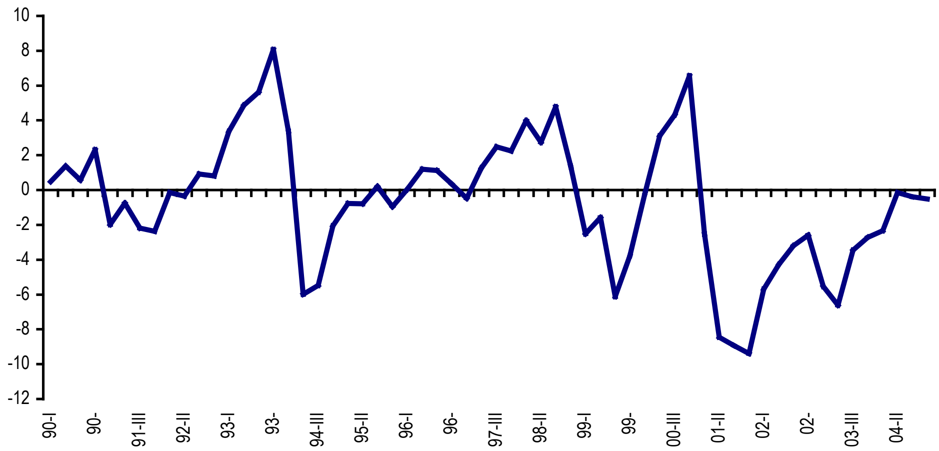
Source: CBRT BTS

High-rated growth in the economy is not exerting any upward pressure on prices despite the high levels of capacity utilization rates and the narrowing output gap in the recent period. This can be attributed to the favorable course of such cost factors as energy prices and real exchange rate as well as to rapid rises in productivity that kept unit wages at low levels, and the relatively low level of domestic demand still prevailing in many sectors. For instance, as of the second quarter of 2004, spending on consumption goods and services excluding durable goods remained at a low level yet. Meanwhile, rapid growth in investment expenditures is contributing to the disinflation process by sustaining the rises in productivity and pushing up the potential production level in the economy. In this respect, domestic demand is not deemed to be at a level that would cause a pressure on prices in the short run. However, it is obvious that the contribution of demand conditions to the downward trend in inflation will not be as strong as in past periods. Although a slowdown is expected in domestic demand in the second half of the year, the main factor to mark the effects of demand on prices would be the developments in productivity.

Taking all these factors into account, continuation of the rises in investment expenditures becomes important for sustaining productivity improvements as well as for maintaining the disinflation process and sustainable growth simultaneously. Therefore, the continuity of structural reforms for permanently establishing the confidence in the economy and for improving the investment environment is critical in terms of maintaining the current trend in domestic investments as well as attracting foreign direct investments in the following period.

Output gap, one of the indicators of the resource utilization in the economy and production capacity-oriented pressures on inflation, is defined as the difference between current and potential production. Forecasts concerning the output gap indicate that the Turkish economy remained well below its potential production level in the second quarter of 2004. In this period, the output gap is expected to maintain its current track concurrently with the slow down in growth in the second half of the year (Graph 3.6). To sum up, evaluating the output gap along with productivity improvements and favorable course in cost factors such as the exchange rate and energy prices, the current production level in the economy is not anticipated to exert pressure on prices.

Graph 3.6 Output Gap / Potential GDP* (Percent)



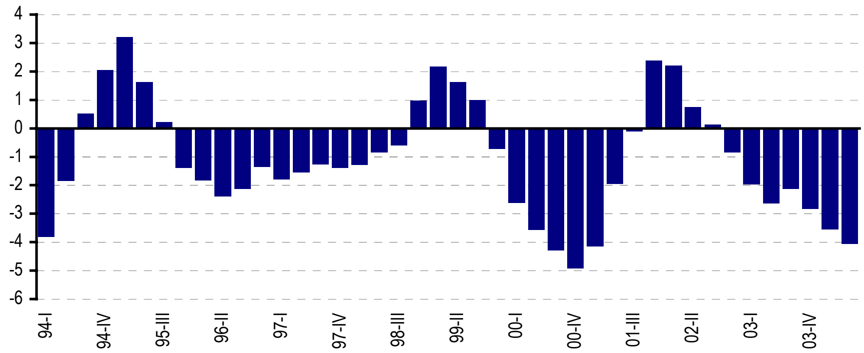
Source: CBRT

3.2.Foreign Demand

Current account balance indicated a deficit of US dollar 10.6 billion in January-September 2004 (Graph 3.7). In this period, although services revenues climbed due to the spurt in tourism revenues, foreign trade deficit, which has largely expanded, became the main determinant of the current account balance.

According to the data announced by SIS, exports expanded by 32.3 percent in this period compared to the same period of the previous year. The favorable levels of unit costs, achieved through productivity gains accompanied by energy prices and developments in real exchange rate provided an impetus to firms' competitiveness in international markets resulting continuation of exports.

Graph 3.7 Current account balance / GNP* (percent)



* Annualized data
Source: SIS

The upsurge observed in industrial production along with the uptrend in exports and the acceleration in domestic demand, provided a further lift to imports. In this period, the 42.4 percent increase in total imports mainly derived from the hike in imports of intermediary goods. The revival in domestic demand stimulated both imports of consumption goods and intermediary goods, whereas the present high capacity utilization rates necessitated imports of capital goods. During this period, strong position of TL against foreign currencies contributed to the decline in the relative prices of motor vehicles and durable goods, while it had a favorable effect on firms' production and investment costs

Data compiled by SIS and Turkish Exporters Assembly (TEA) indicates that the rise in exports, which is stimulated by industrial products, maintained its upward trend in the third quarter of 2004. Meanwhile, the upward trend in VAT on imports published by the Ministry of Finance for September 2004, points out to the upsurge in imports.

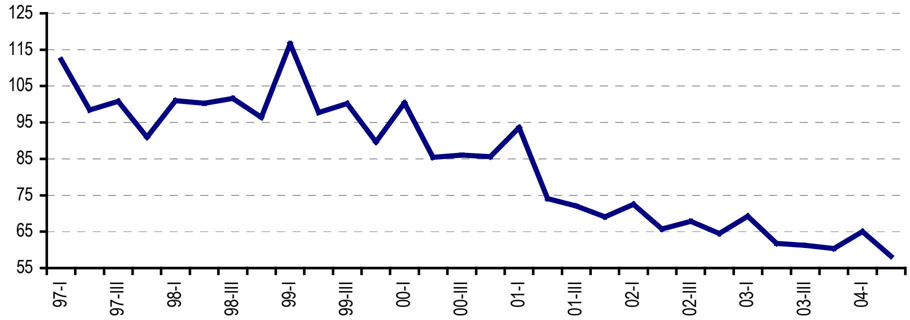
In the event that data regarding foreign trade continue to indicate its current trend, the expanding imports are expected to be compensated partially by high exports and tourism revenues, and therefore current account balance is predicted to produce a deficit of 4.9 percent of GNP in end-2004

3.3.Costs

In the second quarter of 2004, employment in the manufacturing industry increased by 2.4 percent compared to the same period of the previous year. In the same period, index of real wages per working hour in production rose by 5.2 percent compared to the same period of the previous year, while productivity per working hour in production increased by 13 percent (Table 3.B).

Index of unit real wages in the private manufacturing industry, defined as the ratio of real wages to partial labor productivity, declined by 5.7 percent compared to the same period of the previous year and reached its lowest level since 1997 (Graph 3.8). Current state of the unit real wages did not only prevent the capacity-oriented pressures, which may be exerted on prices by the rapid rises in production, but also mainly contributed to the upsurge in exports.

Graph 3.8 Private manufacturing industry real unit wage index* (1997=100)



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

Source: SIS, SPO, CBRT

The rising tendency of real wages starting from the last quarter of 2003 has been narrowing the gap between the productivity and real wages, and hence slowing down the erosion in real unit wages. For this reason, parallel to the high growth rates in the economy, developments in wages are not expected to contribute to the cost advantage of firms as much as they did in the past two years. However, productivity gains, which are predicted to realize above the increases in real wages, are anticipated to prevent the cost-oriented pressures on prices and contribute to the upsurge in exports in the upcoming periods.

An average of 10.7 percent-raise, which remains above the inflation target of 8 percent, will be paid to civil servants in 2005. In the event that wage rises in the private sector realize parallel to the incomes policy of the public sector, real wages of the manufacturing industry will maintain their upward trend in 2005. However, productivity gains brought by investment expenditures, which will likely remain above the upsurge in real wages, will limit the cost-oriented pressures on prices.

Table 3.B Employment, real wages and productivity developments in the manufacturing industry
(percentage change compared to the corresponding period of the year before)

	2002	2003					2004	
	Annual	I	II	III	IV	Annual	I	II
Employment(1)	0.6	5.1	1.8	1.4	-0.5	1.8	0.7	2.4
Public	-9.1	-4.1	-6.5	-5.3	-10.7	-6.8	-13.6	-11.0
Private	2.3	6.3	3.1	2.4	0.9	3.1	2.6	4.1
Real Wages(2)	-5.4	-0.9	-5.3	-3.8	2.4	-1.9	0.4	5.2
Public	1.4	-2.5	-8.9	-8.5	-1.1	-5.3	2.9	7.7
Private	-4.2	0.9	-2.7	-1.1	5.1	0.6	2.8	7.7
Productivity(3)	8.6	5.1	3.5	8.6	11.4	7.2	8.8	13.0
Public	16.4	4.8	8.2	8.4	11.3	8.1	14.8	13.1
Private	7.8	6.0	3.5	9.4	12.4	7.9	9.3	14.3
Earnings(4)	-8.0	-5.4	-10.6	-8.2	-0.9	-6.3	1.8	3.7
Public	-2.1	-3.5	-12.2	-11.0	4.1	-5.6	0.6	9.2
Private	-6.8	-4.2	-8.4	-5.8	-0.1	-4.7	5.5	5.8

(1) SIS, Manufacturing industry production worker index, 1997=100
(2) SIS, Manufacturing industry real wages index per production hours worked, 1997=100
(3) SIS, Manufacturing industry partial productivity index per production hours worked, 1997=100
(4) SIS, Manufacturing industry real earnings index per production worker, 1997=100

Strong position of TL against foreign currencies, pulled down the prices of imported raw materials and investment goods in terms of national currency and eased the cost-oriented pressures on prices. However, the hike observed in international prices of the raw materials used as the main input in basic metal and petroleum products sectors, point out to cost-oriented pressures, which may be exerted on inflation in the upcoming months. Considering the cumulative increases observed as of the beginning of 2004, import prices mounted by 11.2 percent while crude oil and basic metal prices inched up by 33.4 percent and 22.1 percent, respectively in the third quarter of 2004 (Table 3.C). Thus, the upsurge of oil prices in international markets, partially affected the internal market in July, August and October. This situation indicates that exogenous shocks, which are independent from the internal balances of the economy, may induce a surge in production costs and hence push up inflation to higher levels. Parallel to the external developments, continuation of these shocks constitutes a risk for price developments.

Table 3.C Selected Indicators of Production Costs

	2003					2004		
	I	II	III	IV	Annual	I	II	III
Import Price Index	101.6	99.7	99.9	102.3	100.9	108.5	111.6	113.8(1)
Crude Oil Prices ($/Barrel)	28.7	24.7	26.5	28.0	27.0	30.0	32.0	37.3(2)
Metal Prices Index	92.7	93.0	97.9	109.3	98.2	130.0	130.2	133.4(3)

(1) July-August.
(2) August and September figures are forecasted values.
(3) July-August.
Source: SIS, SPO, IFS

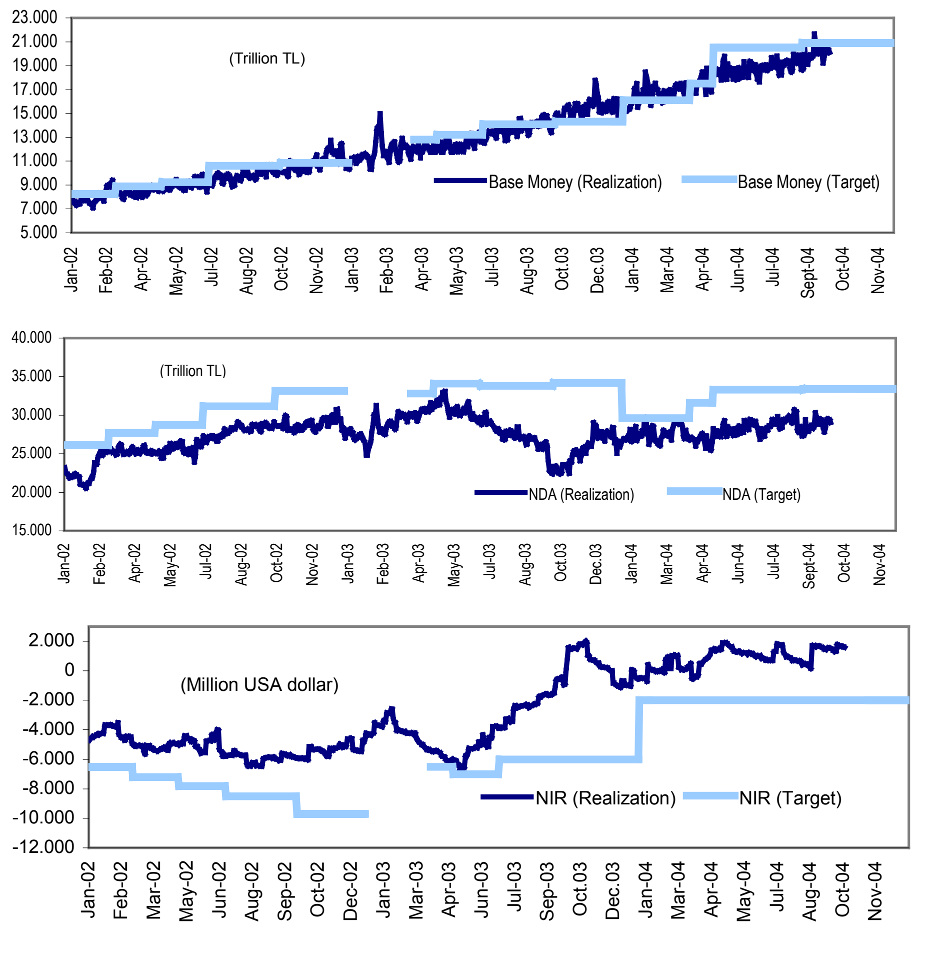
4.Developments in Financial Markets

4.1.Developments in CBRT Monetary and Exchange Rate Policies

The performance criteria for Base Money and NIR, as well as the indicative targets for NDA set for end-August have been achieved

As stipulated in its law, the aim of the monetary policy implementations of the Central Bank of the Republic of Turkey is to achieve and maintain price stability. CBRT implements a monetary policy strategy focused on price stability by utilizing short-term interest rates as the main policy instrument in line with the prospective developments in future inflation, takes all necessary measures for ensuring financial stability and monitors monetary performance criteria and indicative targets within the framework of the program drawn up with the IMF. Accordingly, the performance criteria for Base Money and Net International Reserves (NIR) as well as the indicative targets for Net Domestic Assets (NDA) set for end-August have been achieved (Graph 4.1).

Graph 4.1 Performance Criteria



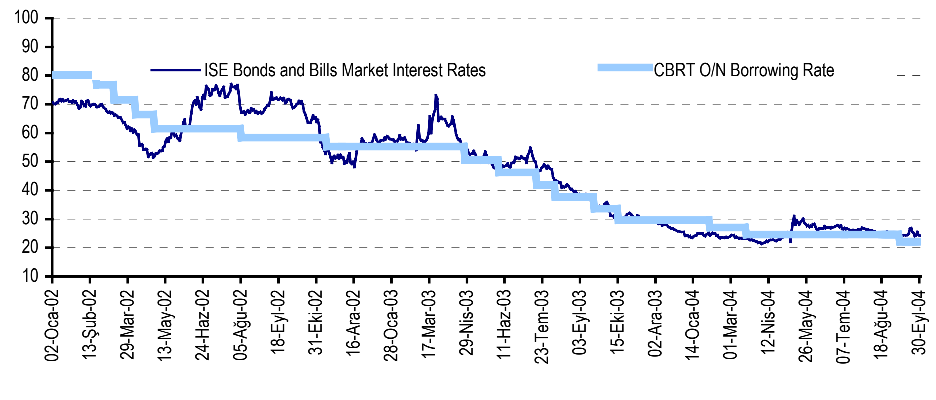
Note: The Base Money, NIR and NDA targets for the end of April, June and September 2003 were determined in the Letter of Intent dated 5 April 2003 and for the end of December 2003, they were determined in the Letter of Intent of 31 October 2003. For the end of March and April 2004 they were determined in the Letter of Intent dated 2 April 2004 and for the end of August and December 2004, they were determined in the Letter of Intent dated July 15, 2004.
Source: CBRT

While disclosing its monetary policy, although having announced the Base Money as the anchor, CBRT emphasized that the main policy instrument of monetary policy was short-term interest rates and that it could revise monetary indicators and targets when necessary in order to achieve price stability. As emphasized by this announcement, CBRT revised Base Money targets for end-August and end-December upward in the Letter of Intent dated July 15, 2004. Meanwhile, money demand increased at a slower than expected pace in August, in line with the relative slowdown in real economic activity. Real economic activity being on the forefront, the expectations about inflation, interest rates and exchange rates are projected to be the main determinants of money demand during the rest of the year.

Interest rate policy of the CBRT is focused exclusively on the main objective of achieving price stability and is determined by evaluating prospective developments in future inflation. The parameters evaluated while making interest rate decisions are: the total demand-supply balance, indicators pertaining to fiscal policy, developments regarding wages-employment-unit costs-productivity, pricing behavior of public and private sectors, inflation forecasts, exchange rates and developments that could affect these, analysis of potential external shocks and inflation projections within the Bank. It is believed that the course of the mentioned parameters is not likely to pose a serious threat to the end-year inflation target. Therefore, presuming that the main determinants of the inflation in 2005, which are budget discipline, structural reforms and current economic program would be strictly adhered to and thus optimistic expectations would prevail, CBRT decreased overnight borrowing interest rate to 20 percent to be effective from September 8, 2004 (Graph 4.2).

CBRT overnight borrowing interest rate was dropped down to 2003 percent as of September 8, 2004

Graph 4.2 CBRT overnight interest rates and secondary market interest rates
(benchmark security, compound, percentage)



Source: ISE, CBRT

As stated in the previous report, there still remain several risk factors that are beyond CBRT's range of control on the way of reaching the targeted inflation. Pricing behaviors that are not consistent with the inflation target in services sector, especially in rents, education and health sectors; supply side fluctuations in food prices and high oil prices are the factors that could exert pressure on inflation. Moreover, any liquidity shortage in international markets and a likely pressure on exchange rates that can be created by the rise in international interest rates could be added to the list of risk factors. In case these risks are realized, CBRT would effectively utilize the monetary policy instruments in order to maintain economic stability.

While the parallel course between the market interest rates and CBRT interest rates continued in the third quarter as well, market interest rates surpassed short-term interest rates in the said period.

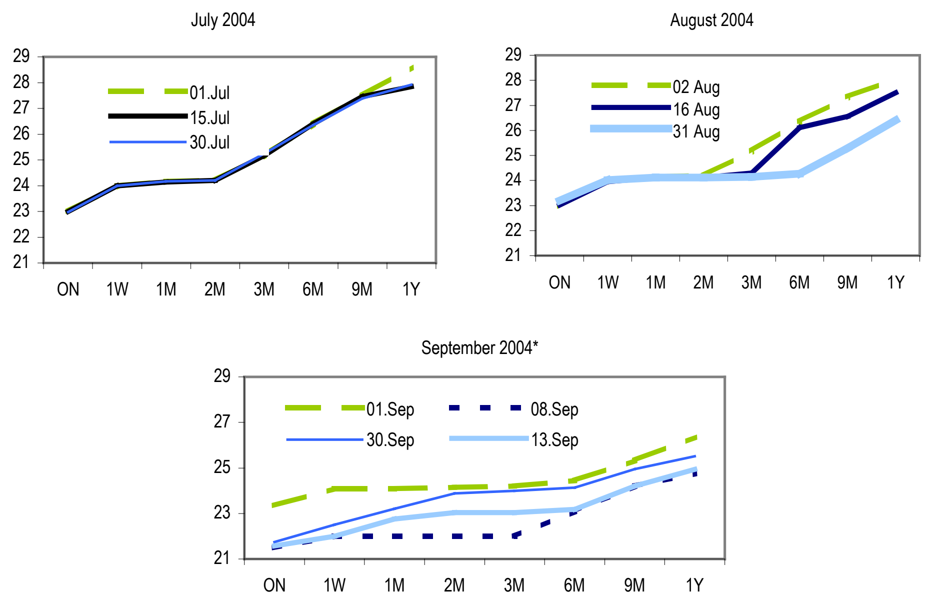
After analyzing the movement of CBRT interest rates and interest rates applicable to benchmark government securities traded in the secondary market, it can be inferred that while the parallel course between the market interest rates and CBRT interest rates continued in the third quarter as well, market interest rates surpassed short-term interest rates in the mentioned period. This provides valuable insight on how the signals given by the CBRT are perceived by market agents and draws attention to the importance of risk perceptions. In addition to the macroeconomic developments, a number of other factors considerably affecting the market risk perception determine the course of market interest rates in Turkey. These are namely the EU accession talks and relations with the IMF, the US interest rate policy as determined by the recent developments in the US economy and the historically high oil prices. Although climbed again later, market interest rates headed down in the first half of July owing to several reasons such as: i) rapid growth in the first quarter of 2004, coupled with favorable June inflation figures in tune with the end-year inflation target, ii) completion of the 8th IMF review, iii) core inflation in the US realizing lower than expected and this being perceived as a signal that Federal Reserve would not opt for fast action in raising interest rates, iv) expectations that a date would be set at the end of the year for Turkey's membership negotiations with the European Union (EU), and a new stand-by agreement would be signed with the International Monetary Fund (IMF). The bounce in interest rates was mainly due to concerns about current account deficit figures, as well as the uncertainties surrounding the US interest rate policy caused by the statements by the Chairman of the Board of Governors of the Federal Reserve.

By end-September, market interest rates came down to their lowest level in the third quarter.

After reaching a consensus with the IMF in early August about signing a new stand-by agreement, market interest rates declined more cautiously than expected. This can be attributed to the uneasiness caused by a higher than expected current account deficit. In September, market interest rates dropped by approximately 1 percentage point immediately after the reduction in short-term interest rates, but bounced back as heated discussions over Turkish Penal Code raised worries about an interruption of EU accession talks. The worries were calmed down towards the end of September when positive signals started to be received from the EU after the adoption of the Penal Code excluding the adultery close and thus the pressure on interest rates was eased to a great extent. Actually, by end-September, market interest rates came down to their lowest level in the third quarter (Graph 4.2).

The effects of the above-mentioned developments on risk perceptions and market interest rates can also be detected on the yield curves. The yield curves maintained their level throughout July. As was the case in the previous month, the breaking point realized as 2 months again. As for the yield curves of August, the downward trend in the short and medium-term interest rates, which started rather modestly in mid-August, became more evident towards the end of the month. This downward move can be attributed to the decline in risk premium after the announcement that a new stand-by agreement would be signed with the IMF. The extension in breaking points is another important development in August. The breaking point, which was 2 months in early August, reached almost 3 months by mid-August and realized as 6 months by the end of the month. This shows that investors still categorize 6 months and longer maturities as "more risky". The yield curves of September clearly show how important risk perceptions are, in addition to CBRT's interest rate policy, for the level of interest rates. Right after CBRT's interest rate cut dated September 8, 2004, interest rates on all maturities came down. In the coming days, while short and long-term interest rates retained their levels, medium-term interest rates adopted an upward trend. This upward trend observed in medium-term interest rates spread to the short as well as long-term interest rates towards the end of September and interest rates in all maturities had turned upwards by the end of the month. The breaking point, which was 6 months in early September, dropped to 3 months in the period marked by the interest rate reduction and came down to 2 months at the end of the month. The rise in interest rates, which was mostly triggered by the worries over an interruption in the accession negotiations with the EU due to the debates on the Turkish Penal Code, slowed down towards the end of September with positive signals coming from the EU and interest rates reached their lowest level in the third quarter (Graph 4.3).

Graph 4.3 Yield Curve Analysis



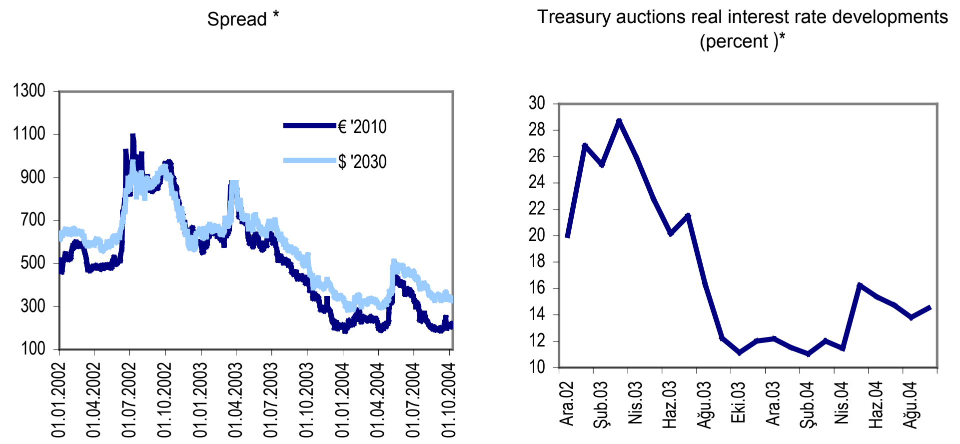
* CBRT decreased policy rates to be effective from September 8, 2004.

Source: Turkish Banking Association

Despite the presence of a downward trend, real interest rates are still high. High and volatile risk premium, which is molded by expectations about the sustainability of fiscal discipline and economic program, is still the main determinant of the level of real interest rates. Within this framework, downward trend in real interest rates at Treasury auctions that started to go down in June, maintained this downward trend in July and August, but started to climb again in September. In accordance with its favorable projections about future inflation, CBRT eased interest rates in early September. However due to the aforementioned domestic political developments that could jeopardize the EU accession process, risk perceptions increased, pulling up real interest rates in return. Therefore, it can be inferred that coping with structural problems such as establishing an effectively operating financial system and financial market, expanding the tax base, containing the underground economy and reducing the social security deficit, as well as wiping out worries on the sustainability of the economic program are crucial for pulling down real interest rates. Moreover, the decline in interest rate spread (interest rate spread is used to measure the risk premium of a country and is the difference between the interest rates applicable to US dollar denominated government bonds with 30 years maturity and EURO-denominated government bonds with 10 years maturity traded in international markets, and the reference US bonds with same maturities) which started in July continued in August and turned upwards in September (Graph 4.4).

High and volatile risk premium, which is molded by expectations about the sustainability of fiscal discipline and economic program, is still the main determinant of the level of real interest rates.

Graph 4.4 Risk premia and real interest rate on Treasury auctions



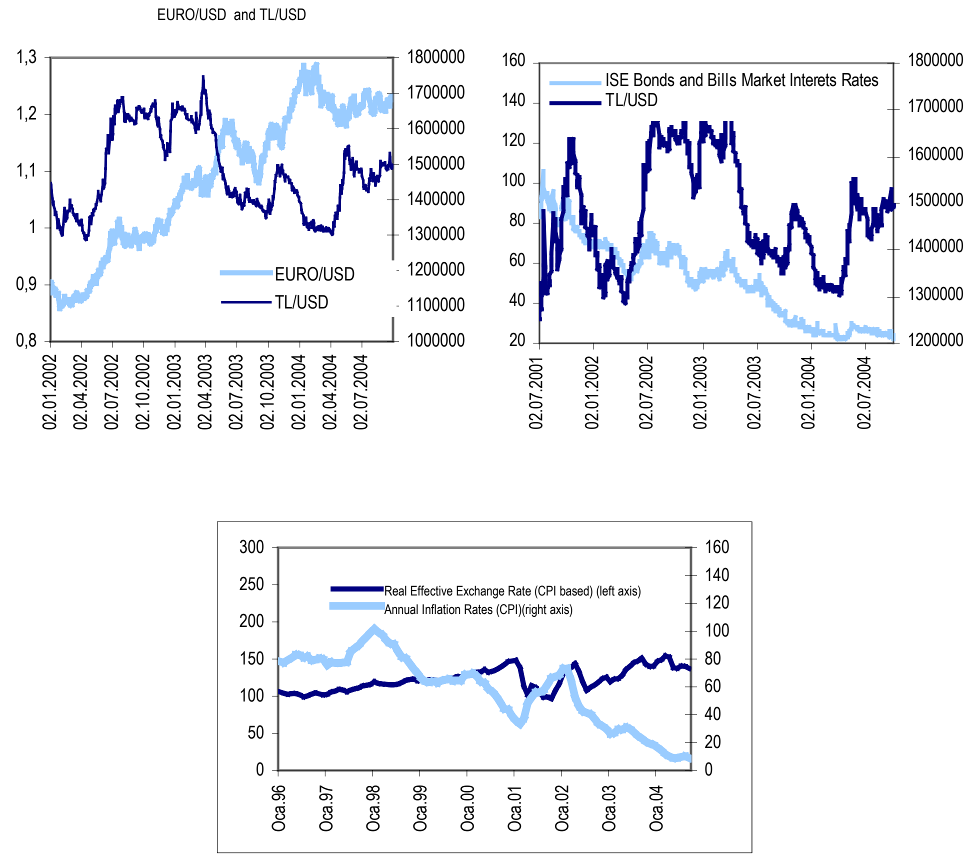
(*)Calculated as the difference between the Turkish eurobonds and USA treasury bills expressed in basis point.

(*)Calculated using 12-month ahead CPI inflation expectations .

Source: Bloomberg and Treasury

Factors determining the value of the Turkish lira in the third quarter were not only the foreign exchange inflow in the tourism season and macroeconomic developments in Turkey, but also the relations with the EU and the IMF, interest rate policy of the Federal Reserve and political and economic developments in EU via their influence on the decisions of foreign and domestic investors. In July, exchange rates declined significantly parallel to the downward trend in the market interest rates. In August, announcing that a medium-term program would be drawn up with the IMF was not enough to ease worries about the sustainability of the current account deficit. Thus, due to tendency of banks to close their open positions and due to currency substitution, exchange rates started to rise again. In September, political and economic developments on the domestic and international scene, accompanied by contraction in the foreign exchange liquidity stemming from currency substitution led to volatility in exchange rates as in the previous months. The above-mentioned developments molding risk perceptions in the markets are believed to influence exchange rates in the upcoming term as well (Graph 4.5).

Graph 4.5 Foreign exchange developments



Source :ISE, CBRT

In the coming period, exchange rate and interest rate dynamics are not likely to jeopardize the end-year inflation target. The results of the CBRT Expectations Survey of October reveal that the end-year annual simple overnight money market interest rate is expected to be 18 percent while the annual compound interest rate in the Treasury auction with three-month maturity is expected to be 19 percent. These figures remaining below the current values point to the optimism of the economic agents about the upcoming period. It is strongly believed that economic growth, favorable inflation performance, favorable developments in the relations with the IMF and the EU, as well as steps to be taken towards ensuring and maintaining fiscal discipline will continue to play important roles in the management of expectations.

4.2.Developments in Banking Sector and Credits

Although the positive atmosphere prevails for external financing opportunities for the developing countries, it is projected that due to expectations of a hike in international market interest rates, private capital inflow to emerging markets would be more limited in the upcoming period (Table 4.A).* However, capital inflow to Turkey is expected to continue as direct investments are likely to increase owing to Turkey's EU accession process. Moving on the presumption of receiving a bigger share from the direct investments to the developing countries attributable to the EU accession process, US interest rate decisions are expected to have a lesser impact on Turkey.

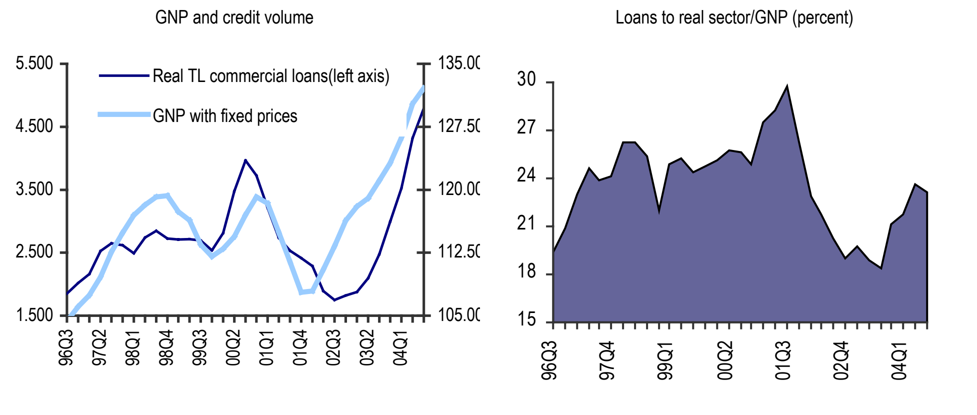
Table 4.A Net capital flows into emerging markets and developing countries
(billions us dollars)

	2000	2001	2002	2003	2004*	
Total capital flows	18,9	63,5	62,9	95,6	50,6	5,4
Private capital flows	46,6	47,8	61,2	120,4	81,6	47,5
Direct investments	177,1	191,2	143,5	147,6	166,9	175,2
Portfolio flows	16,1	-91,3	-99,6	-11,0	-21,3	-23,4
Other capital flows	-146,6	-52,0	17,3	-16,2	-64,0	-104,4
Change in reserves	-27,7	15,7	1,7	-24,8	-31,0	-42,1

Source: IMF World Economic Outlook September 2004
(*)2004 estimates

The loans extended to real sector by the banks continue to support economic growth (Graph 4.6). Stability in exchange rates and the appreciation of the Turkish lira reinforces financial structures of the real sector firms and increases their demand for loans, while also fostering the financial structures of banks and raising the level of loans they extend. The rise in the demand for and also the supply of loans has been supporting economic growth via higher investments.

Graph 4.6 GNP and Loans



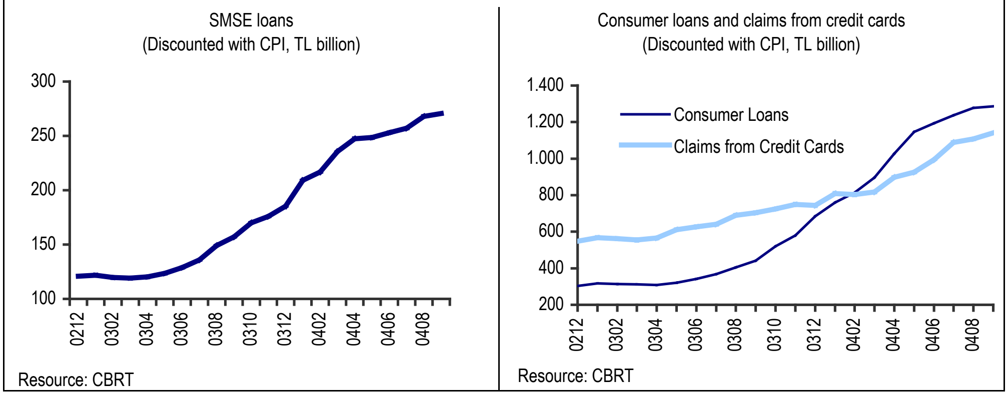
Source: CBRT Source: CBRT

* IMF World Economic Outlook (September).

Although the growth rate of consumer credits decelerated significantly as of June, it is still closely monitored for the sake of safeguarding financial stability.

Banks after having concentrated mainly on private banking activities in the first half of 2004, were observed to have switched to commercial credits in the second half of the year. Taking into account the prospective risks created by the rapid rise in commercial credits in the April-June period, the banks raised interest rates applicable to consumer credits, the public banks limited their supply of loans and the scrap discount in automobile credits was decreased by 50 percent. Moreover, the Resource Utilization Support Fund (RUSF) deduction levied on consumer credits, which was raised from 10 to 15 percent in August, limited the rate of increase in consumer credits (Graph 4.7).

Graph 4.7 Consumer loans, claims from credit cards and SMSE loans



It is expected that the growth rate of consumer credits would neither jeopardize the inflation target nor pose a risk to financial stability in the coming period. Loans provided for the private sector are believed to support investment opportunities while the potential rise in production boosted by commercial credits are believed to alleviate inflationary pressures. The growth rate of consumer credits will continue to be closely monitored with respect to domestic demand, inflation and current account deficit.

5.Public Finance

Within the framework of the current economic program, a high level of primary surplus is being targeted for 2004 as in previous years. For the first nine months of the year, consolidated budget primary surplus displayed a strong performance owing to tight fiscal policies. As a matter of fact, consolidated budget primary surplus realized as TL 24.1 quadrillion, in the January-September 2004 period. This corresponds to 119.2 percent of the year-end budget target for 2004 (Table 5.A). In the same period, consolidated budget deficit realized as TL 21.1 quadrillion.

Consolidated budget primary surplus displayed a strong performance in the January-September 2004 period.

Table 5.A Consolidated Budget Figures

	2004 Jan-September Realization (TL Quadrillion)	2004 Target (TL Quadrillion)	The Share of Realization in the Target (percentage)
Revenues	**79.8**	**104.1**	**76.6**
Tax Revenues	64.9	88.9	73.0
Expenditures	**100.9**	**149.9**	**67.3**
Non-interest expenditures	55.7	83.9	66.4
Personnel	22.0	28.6	76.9
Current Transfers	21.0	27.5	76.4
Interest Expenditures	45.2	66.1	68.4
Budget Balance	**-21.1**	**-45.8**	**46.0**
Primary Balance	**24.1**	**20.2**	**119.2**

Source: Ministry of Finance.

Although the indicator of consolidated budget primary surplus was favorable in the first nine months of 2004, the course of budget performance in the rest of the year is of great significance. Sustainable fiscal discipline is very important for the accomplishment of current economic program.

5.1.Developments in Debt Stock *

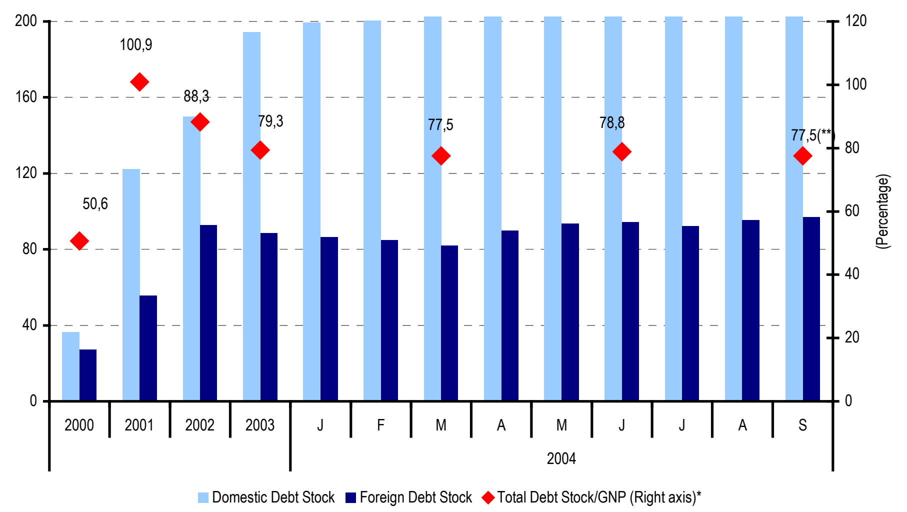
In September 2004, the consolidated budget total debt stock increased by 3.7 percent compared to June 2004 and reached TL 314.7 quadrillion. While foreign debt stock increased by US $ 1.4 billion, domestic debt stock rose by 4 percent and realized as TL 217.6 quadrillion (Graph 5.1). When compared to the year-end 2003, the increase in the total debt mainly stemmed from net domestic borrowing as well the depreciation of the Turkish lira. The drop in Treasury's borrowing costs and longer borrowing maturities as well as high primary surplus achieved within the framework of fiscal discipline had a diminishing effect on net borrowing in the first nine months of 2004 (Graph 5.2). However, volatility in the exchange rate has a significant impact on the level of total debt stock, 44 percent of which is FX-denominated/FX-indexed as of September. The depreciation of the Turkish lira in the second quarter of 2004 adversely affected the ratio of debt stock to GNP. The debt stock/GNP ratio is expected to decline in the third

In September 2004, consolidated budget total debt stock increased by 11.2 percent compared to end-2003 and reached TL 314.7 quadrillion.

* In this section, debt stock denotes consolidated budget debt stock.

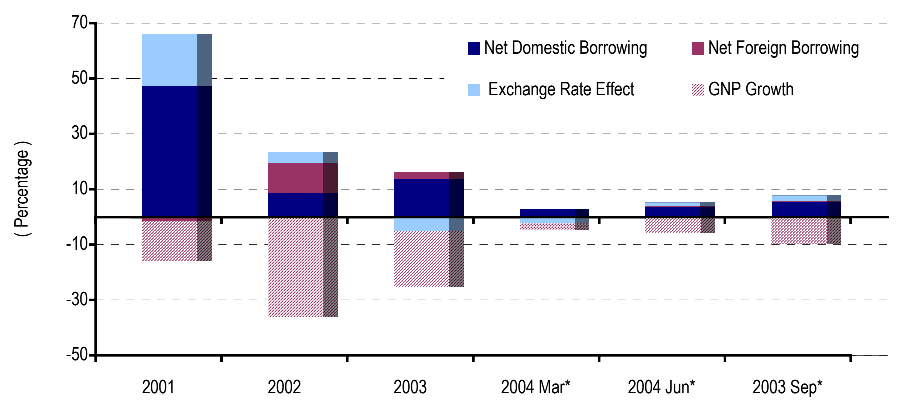
quarter of 2004 due to the favorable growth performance of 2004 as well as the low level of net borrowing.

Graph 5.1 Consolidated Budget Debt Stock (TL quadrillion)



Source: Treasury.
(*) Average monthly US $ buying rate is used in the calculations.
(**) Consistent with the 10 percent GNP growth rate forecast for the year 2004.

Graph 5.2 Decomposition of the Change in the Consolidated Budget Debt Stock/GNP Ratio



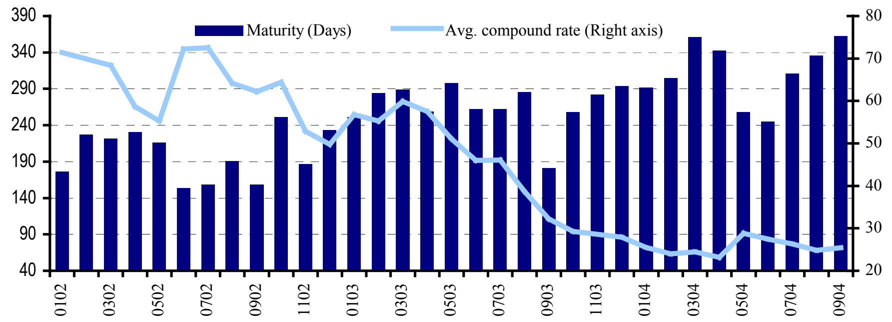
Source: Treasury.
*Change with respect to the year 2003.

Uncertainties about the political process experienced in Cyprus in April and May 2004, expectations for an interest rate increase by the Federal Reserve as well as the anticipations for a current account deficit figure above forecasts for the first quarter of the year led to interest rate hikes. Although having adopted a downward trend in June, the decline in interest rates in the June-September period remained rather limited owing to the uncertainties about the interest rate policy of the Federal Reserve as well as the

Despite the improvement in borrowing conditions of 2003 in 2004, interest rates went up in April and May.

starting date of negotiations on Turkey's membership to the European Union. Nevertheless, the interest rates re-rose in September because of the debates on the Turkish Penal Code. This development had also an unfavorable impact on the Treasury's borrowing costs. Although the average interest rate realized at the discounted auctions as of September remained below the end-2003 level, it was still above that of April (Graph 5.3).

Graph 5.3 Borrowing Maturity and Compound Interest Rate * (Percentage)



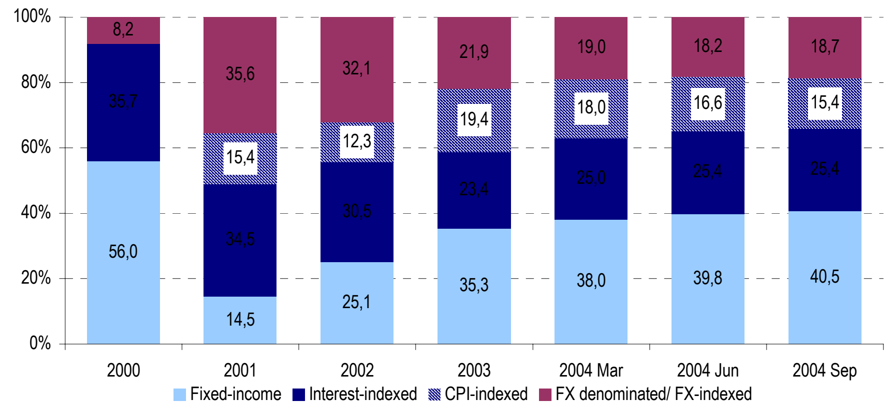
Source: Treasury.
Note: Low borrowing maturity figure in September 2003 is due to the existence of small amount of long-term borrowing. Borrowing maturity excluding 91 day T-bill auction is 371 days.
* TL denominated discounted auctions are used in the calculations.

Within the framework of the strategic benchmark implementation relating to the cost and risk analysis of the debt stock, it is foreseen that in 2004, cash domestic borrowing is to be materialized mainly in Turkish lira, and that maturities are to be kept over one year in cash borrowing. The bulk of domestic borrowing in 2004 materialized in Turkish lira discounted auctions, as foreseen. Meanwhile, average maturity of the cash domestic borrowing in the January-September 2004 period was 14.2 months. As for external borrowing, having issued US $ 5.3 billion worth of government bonds at international markets as of October 7, Treasury borrowed above the predicted figure of approximately US $ 5.0 billion worth of bond issue, which was foreseen within the framework of the financing plan for 2004.

US $ 5.3 billion worth of external borrowing was realized through bond issue in 2004.

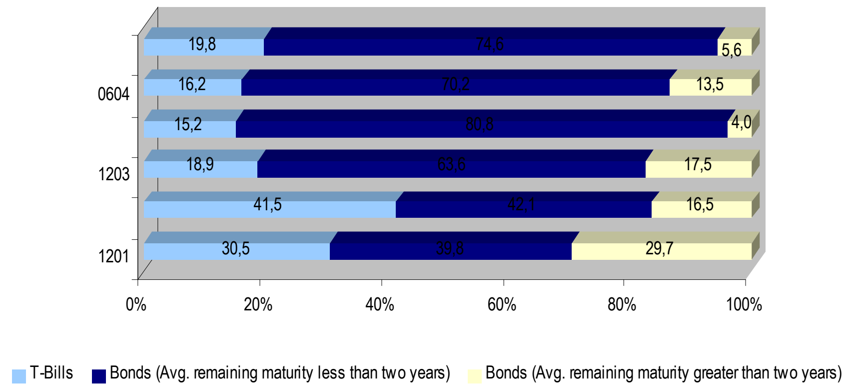
Analysis of the structure of domestic debt as of September 2004 within the framework of benchmark borrowing implementations reveals that the share of fixed income debt stock continues its rise. Despite a slight increase in the share of interest rate indexed debt stock compared to 2003, it remained unchanged compared to June. Meanwhile, the share of FX denominated and FX linked debt stock showed a limited increase compared to June. As of September, 60 percent of the domestic debt stock is composed of interest rate indexed, CPI indexed, FX denominated and FX indexed government securities. In this context, vulnerability of domestic debt stock to exchange rates and interest rates is still of great importance (Graph 5.4).

Graph 5.4 Decomposition of Domestic Debt Stock by type of Borrowing Instruments



* Comprises CPI-indexed non-cash securities in the Central Bank portfolio and CPI-indexed cash securities issued to the Compulsory Saving Account (CSA) in May 2003.
Source: Treasury.

Graph 5.5 Maturity Structure of Cash Domestic Debt Stock

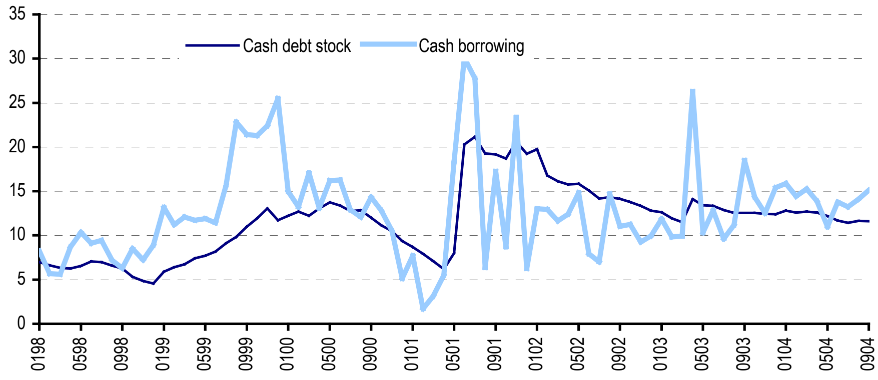


Source: Treasury.

As for the maturity structure of cash domestic debt stock, it is seen that the debt stock is mainly composed of government bonds with average maturity less than two years (Graph 5.5). The average maturity of these securities is 12.3 months. While the share of Treasury bills in cash debt stock declined owing to longer maturities for average cash borrowing, the share of bonds with maturity less than two years increased. In 2004, except May, the maturity of cash borrowing was above the average maturity of the cash debt stock (Graph 5.6).

Debt stock is mainly composed of government bonds with average maturity less than two years.

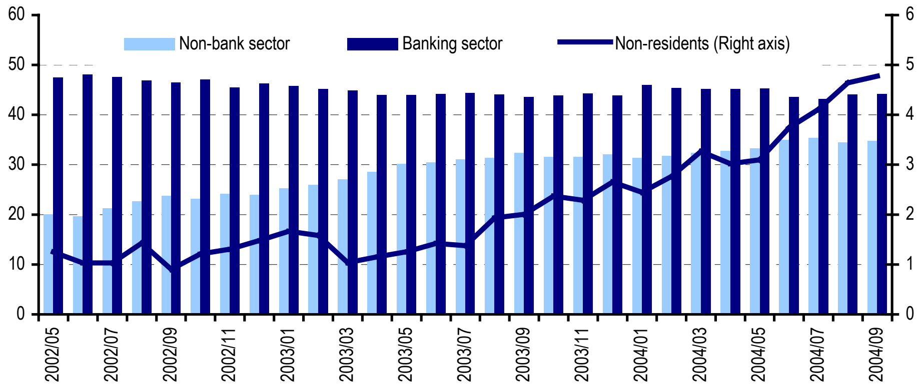
Graph 5.6 Maturity of Cash Domestic Debt Stock and Cash Domestic Borrowing



Source: Treasury.

When the decomposition of domestic debt stock by lenders is analyzed, it is seen that the upward trend in the share of non-residents in the government securities portfolio that has started in March 2003 is still continuing (Graph 5.7). Total value of government securities held by non-residents rose to TL 11 quadrillion as of end-September 2004 from TL 8.5 quadrillion of June 2004.

Graph 5.7 Composition of Government Domestic Debt Instruments(GDDI) by Lenders (Share, Percentage)



Source: Treasury.
Note: Non-bank sector comprise mutual funds, real persons and legal entities excluding Saving and Deposit Insurance Fund (SDIF) and CSA. Data is in terms of market values.

Consequently, there is not any notable change in debt dynamics compared to June 2004. Despite ongoing improvement in the structure of borrowing, the short maturity of debt stock and the considerable share of FX denominated and FX indexed securities renders it vulnerable to movements in exchange rates and interest rates.

6.OUTLOOK

Potential developments and risks regarding inflation for the next period can be classified under the following subgroups: Output and domestic demand, cost factors, and inflation expectations.

6.1.Supply and Demand Factors

Growth figures for the second quarter of 2004 reveal that the recovery in domestic demand has extended to a broader group of goods. As an indication of the persistence of recovery in domestic demand for the rest of the year, the CBRT BTS results for the next quarter show that the volume of goods traded to domestic market and the trend of receiving new orders from domestic market would stay at high levels. However, measures such as the restriction imposed on credit limits of state-owned banks in the second half of the year raised consumer interest rates and the reduction of scrap discount on cars limited the boost in spending on automobile and durable goods. Thanks to current tight fiscal and monetary policies, recovery in domestic demand is taking place in a controlled manner and is not exerting a marked pressure on prices yet. In fact, it is observed that demand for non-durable goods maintains its record-low level. Nevertheless, it is crucial that demand indicators should be closely monitored in the next period, since domestic demand has expanded to a broader subgroup.

Success of the current program in reaching the macroeconomic targets is easing uncertainties and enhancing confidence in the economy. Interest rates declined compared to past periods as a result of the reduced risk premium in the economy that, in turn, fueled private sector investments. As a matter of fact, the upward course in productivity and machinery-equipment investments continues, although the boost in consumption spending has slowed down relatively. These developments push up potential production level and help keep the pressure on prices at limited level despite high capacity utilization ratios in manufacturing industry sector and the relative rebound in domestic demand. It seems inevitable that, within a certain period of time, the rise in productivity and high output levels would lead to the opening of new fields of work, an increase in the demand for labor force and an escalation in real wages in overall economy. For this reason, it is of critical importance that public-sector wage and incomes policies should be consistent with the inflation target, so as to assure that the downward trend in inflation would continue in the next period as well. In fact, experiences in the last three years prove that one of the main factors increasing the credibility of inflation targets is the implementation of a budget policy that is consistent with the targets.

6.2.Cost Factors

Exchange Rates

Factors influencing the risk perception in the markets are of great importance for the course of exchange rates. These factors can be listed as the relations with the IMF, attitude of the EU in the membership process, interest rate policy of the USA and record-high levels of oil prices. Hence, in order to keep the risk perception of the market under control, internal and external political developments should be compatible with the EU accession process, efforts about structural problems should be carried on, an effectively operating fiscal system should be established, deficits in social security system should be diminished, and the economic program should be sustained determinedly.

Under the floating exchange rate regime, upward and downward movements might occur in exchange rates in the next period as well. However, it is anticipated that within the framework of the three-year national program the main trend will be towards macroeconomic stability and such likely movements will remain as temporary deviations from the main trend. Considering the fact that pricing behavior started to change and the effects of temporary movements in the exchange rate on prices remained limited, it is estimated that exchange rate movements are unlikely to exert pressure on prices unless substantial exogenous shocks emerge.

Crude Oil Prices

Crude oil prices, which have been on the rise since the beginning of 2004, maintained this trend in September and October as well. Supply factors became the main determinant of this rise. Supply amount increase has been constrained by the break in production because of the tension in Iraq, the partial halt in oil production in Mexico and Venezuella due to Hurricane Ivan, the confiscation of Russian oil company Yukos and the strikes in Norwegian oil manufacturing facilities. Strong increase in global demand and inelasticity of supply amount against the climbing demand are the reflections of the concerns about supply. Moreover, oncoming winter months constitute a factor leading to a seasonal rise of demand as well. This has exerted extra pressure on crude oil prices in the presence of the concerns about supply. The upsurge in oil prices persisting for a long time and the increasing pressure of supply-demand conditions on prices draw attention to the fact that they will continue to pose a risk to inflation in the upcoming period as well.

Administered Prices

Growth figures exceeded expectations in the first half of 2004. High growth rates created a marginal adjustment in the special consumption tax on petroleum products and therefore reduced the reflection of increse in the international crude oil on domestic prices was considerably less. Nevertheless, the trend observed in crude oil prices does not seem to change its track in the upcoming period. Expectations for the decline in growth rates in the upcoming term compared to the first half of 2004 and the high primary surplus target set for 2005, narrows the adjustment margin of the special consumption tax on petroleum products. Thus, prices of petroleum products were consecutively adjusted in the second half of 2004.

Meanwhile, despite a definite delay, the upsurge in oil prices will be effective in energy prices. For instance, price hikes in oil and petroleum products are influential in natural gas prices with a 3 to 6 month lag. Thus, natural gas prices were increased by 5 percent at the beginning of November. Furthermore, the price hikes in this sector are predicted to maintain their high levels in the upcoming period. Moreover, the ongoing upward trend of the said price increases may necessitate an adjustment in the prices of the electricity sector, where natural gas is intensively used input. Therefore, energy costs, which mainly supported the downward trend of inflation for the past two years, constitute an upside risk for the inflation in the next period.

Labor costs

An average of 10.7 percent-raise will be paid to civil servants in 2005. The inflation target is set as 8 percent for 2005. Price increases in the private sector are generally adjusted parallel with those of public sector and it is predicted that high increases in productivity will partially affect wages. As a result of these three developments, it is foreseen that the hikes observed lately in real wages in the manufacturing industry will continue in 2005 as well.

It is clear that the said tendency of real wages will not be as advantageous for firm costs as it was in the previous period. However, due to high investment expenditures observed recently, it is predicted that the increases in productivity will maintain their upward trend in 2005 and continue to balance cost-oriented pressures, which may be caused by the developments in real wages.

Monetary and Fiscal Discipline

It is clear that a new three-year stand-by agreement will be signed with the IMF in 2005. The new program suggests that main principles of the current program will be preserved, the continuation of the fiscal discipline, and the decline in inflation will be the primary goals. Furthermore, structural reforms are expected to deepen much more in the next three years.

In the next period, the Central Bank will continue to conduct its interest-rate policy effectively in order to reach the inflation target set for 2005. The point that should be underlined here is that the continuity of fiscal discipline is a pre-requisite for the struggle against inflation. The inflation target of 8 percent set for 2005 affects the inflation rates in terms of the probable measures regarding tax incomes. In other words, policies to be conducted to reach the primary surplus target for 2005 bear much significance. Excessive increases in the special consumption taxes put on petroleum products, natural gas, alcoholic drinks and tobacco products may jeopardize the inflation target. Therefore, maintaining the budgetary discipline of 2004 and enhancing the quality of fiscal discipline are important in 2005.

6.3.Inflation Expectations

The developments in the first ten months of the year indicate that it is highly unlikely that the end-year target will be exceeded, even if a substantial exogenous shock emerges. The Central Bank shared its cautiously optimistic attitude towards the inflation trend with the public. These two factors have had a favorable effect on expectations. According to the CBRT Expectations Survey, the end-2004 inflation expectations edged down to 9.5 percent. Inflation expectations for the next 12-month period became 8.8 percent and follow a favorable course for the end-2005 inflation target of 8 percent.

6.4.Risks

In the light of these findings, fundamental risks in terms of 2005 inflation can be summarized as such:

- Domestic demand indicators show that the recovery has spread to sectors other than durable goods, and semi/non-durable goods and expenditures of other services have gained momentum. Meanwhile, demand is expected to lose pace due to selective measures of the second half of the year. As a matter of fact, the slowdown observed in credit volume and money demand supports this expectation. Nevertheless, it is considered that the slowdown will be moderate and high output levels will be preserved with the support of foreign demand and consumer confidence that are believed to retain its strong position. The calculations of the Central Bank points out to the fact that the output level estimated to be reached by the end of 2004 would not exert an evident pressure on inflation (Graph 3.6).

- It is predicted that the relative increase in employment will reinforce the increasing tendency of the real wages. In the current situation, escalating investment expenditures boost productivity over real wage increases and averts inflationary pressures. However, the persistence of this trend in the medium and long-term may only be possible if the obstacles to investment and output are removed, productivity in public sector increase and the environment for competition is developed. At this point, it becomes evident once more that the correct implementation of the three-year national program is crucial.

- Exogenous developments appear as an important factor in terms of 2005 inflation. FED has implied that it would not act abruptly in its interest-rate policy and would not be aggressive in raising interest rates. Moreover, in the process of adaptation to the EU, any piece of information not in line with the expectations may increase risk perceptions in the markets and may cause volatility. However, what needs to be emphasized once again is that if structural reforms are carried out strictly and fiscal discipline is sustained, unfavorable exogenous developments will only be temporary diversions from the main tendency.

- The persistence of price rigidity in services sector poses a risk for future inflation. Since the second half of 2003, the difference between rate of price increases in goods and services is becoming more and more noticeable. In August 2003 annual inflation rates in both groups were around 25 percent, as of September 2004, it was recorded as 5.6 percent in goods and 15.3 percent in services. The fact that the pass-through from exchange rates to prices were faster in goods and the backward indexation was higher in services, as well as the high increase in competitiveness and productivity in sectors related to foreign trade have been effective on this discrepancy. Moreover, the fact that annual rent increase, which has a very high weight in the price index, is around 20 percent in a single digit inflation environment, is a remarkable obstacle to the disinflation process.

- It is anticipated that one of the main determining factors of inflation in 2005 would be the course of international raw material prices. At a time when single-digit inflation is targeted, the impact of relative price changes caused by exogenous shocks will be more critical. The upward trend in crude oil and basic metal prices in international markets has been continuing for a long time and the likelihood of a reversal in this trend seems rather low in the short run, which pose an important risk for 2005 inflation altogether. In the third quarter of the year, crude oil and basic metal import prices are much above the general import price increases, and their effects on inflation are being observed directly and through input costs. Albeit the mentioned developments are not instrumental in terms of inflationary expectations for the coming year, the indirect effects must be monitored closely.

- Finally, the course of agriculture and food prices in 2005 will be one of the determining factors in attaining the inflation target. However, it should be kept in mind that the course of fresh vegetable and fruit prices under the food item is mainly shaped by supply factors like weather conditions and monetary policy has only a limited effect on food prices. Therefore, the favorable course of food prices throughout 2004 contains little information about 2005 inflation. In the upcoming period, the factors to be monitored in terms of the monetary policy will be the prices determined by macroeconomic fundamentals, affecting the general inflation trend and sub-price groups that these effects are seen, rather than those affected by short-term shocks.

To sum up, there is no element that may obstruct 2004 end-year inflation target. However, it seems unlikely that the factors that have contributed to disinflation in the past three years would continue to do so in 2005. Recovery in domestic demand, relative increase in labor costs, the course of imported raw materials may exert pressure on both current account and inflation. Therefore, it is much more important that the structural adjustments foreseen in the three-year national program are immediately enforced, budgetary discipline is preserved without compromise and the quality of fiscal discipline is enhanced. In such a case, even though an exogenous shock may create short-term fluctuations, it will not be able to change the basic trends.

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