

2006-I

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1. Overview¹

The Central Bank of the Republic of Turkey (CBRT) adopted an inflation targeting regime starting in January 2006. The Inflation Report is one of the main communication tools of the Monetary Policy Committee (MPC) under the new regime. The Report evaluates the recent macroeconomic developments so as to shed light on the trend of inflation in the medium-term and presents inflation forecasts. This chapter summarizes the macroeconomic outlook which is discussed in detail throughout the rest of the report.

1.1. An Overview of 2005

The downward trend in inflation continued in 2005, albeit at a lower pace compared with the preceding four years. However, inflation expectations maintained their favorable course under the cautious stance of monetary policy and budget discipline. The fact that inflation outturns were in line with the targets also helped contain inflation expectations. Moreover, progress in structural reforms, the adoption of three-year planning of the budget, adherence to the medium-term program, the start of accession talks in the process of full membership towards the European Union, money reform achievements and enhanced financial stability contributed to the reduction in the risk premium and increased the demand for New Turkish lira denominated instruments. Following these developments, average maturities started to lengthen, the gradual decline in medium and long-term real interest rates continued and the New Turkish lira maintained its strong position. Meanwhile, sustained fiscal discipline and lower interest rates reduced the Treasury's need for borrowing, boosting the supply of credit.

Lower interest rates, longer maturities, a wider array of borrowing facilities, favorable relative price movements and increased confidence led to a rapid rise in durable goods consumption and investment expenditures. Unlike the previous year, the revival in economic activity broadened to a wider base during this period. The recovery in non-interest public expenditures and in the construction sector confirm this observation.

¹ This Report has been prepared using data covering the period up to 23 January 2006.

As a result of the consumption and investment demand boosted by these developments and due to the relatively low prices of imported goods, rapid increases in imports of investment and consumption goods continued. Imports of intermediary goods also increased at high rates due to the recovery in economic activity and significant increases in international raw material prices. The continuing trend of strong growth in the world economy, increased openness to foreign markets and productivity increases supported export growth. However, due to reasons mentioned above, imports increased at higher rates and the current account deficit widened. The performance achieved in foreign direct investments, the rising trend in long-term credit utilization and the continuity of fiscal discipline prevented a deterioration of expectations that could have arisen from concerns associated with the rising current account deficit.

The revival in consumption demand, the rapidly increasing trend in non-agricultural labor demand and the rigidity in services inflation stood as the main factors leading to the slowdown in the disinflation process throughout 2005. Besides these factors, adverse effects of imported raw material prices on inflation continued during the same period. Specifically, unpredicted increases in oil prices caused the disinflation to falter at times. However, the ongoing strength of the New Turkish lira restrained the costs pressure of oil prices, while continuing productivity increases enabled the favorable contribution of unit labor costs to the reduction in inflation, albeit in a declining manner.

All these developments provided an opportunity for the Central Bank to gradually reduce short-term interest rates – its policy instrument – in the first half of 2005. Meanwhile, the Central Bank, which started to focus on 2006 end-year inflation as of the second half of 2005, increased its cautious stance by drawing attention to the factors impeding the downward trend in inflation.

1.2. 2006 Outlook

Demand, production and credit indicators for the last quarter of 2005 indicate that economic activity maintains its momentum, without further acceleration. On the other hand, the high rate of increase in household borrowing in last year has the potential to restrain disposable incomes, especially through reimbursements of housing credits. This may in turn curb the rate of increase in private consumption and domestic demand in the future.

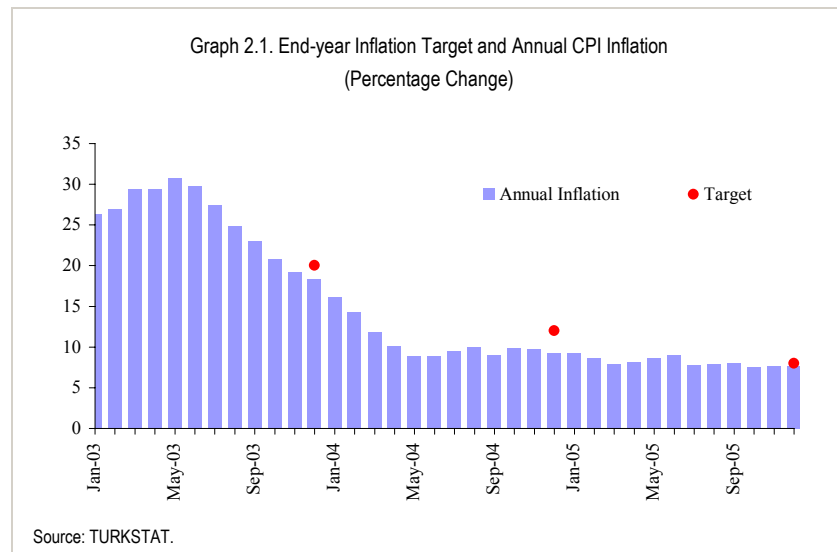
Moreover, competition in the labor market, continuity of productivity increases and sustained fiscal discipline is also expected to contribute to the downward trend in inflation in the upcoming period.

The gradual decline in core inflation indicators in the second half of 2005 confirms that the downward movement in the underlying trend of inflation continued. In line with this development, inflation expectations also continued to improve in the last quarter of 2005. As of January 2006, end-year inflation expectations are approximately 0.7 points above the 2006 target. Despite high rates of increases in oil prices, inflation expectations continued to decline throughout 2005, which indicates that the second round effects of oil prices will be restricted. Accordingly, our short-term projections indicate that inflation will follow a stable course in the first quarter of 2006 and resume its downward trend thereafter.

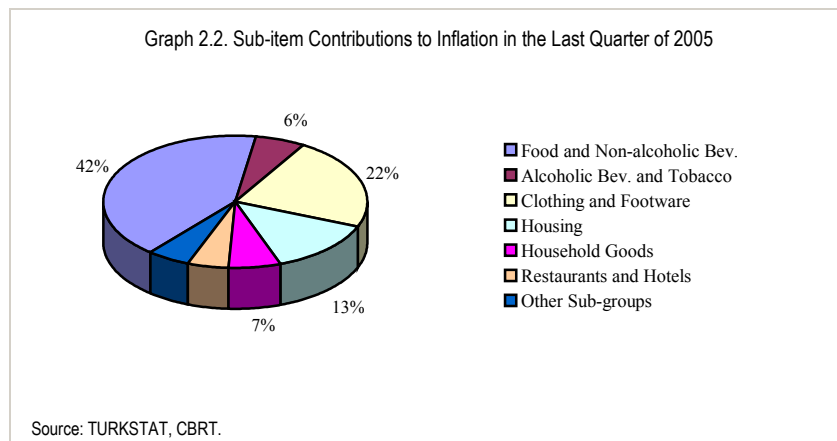
In sum, baseline forecasts indicate that the downward trend in inflation will continue. The important question for the period ahead is what all these developments imply in terms of the speed of the downward trend in inflation and attainability of the targets. To answer this question, the last chapter of this report presents medium-term inflation forecasts based on the outlook displayed throughout the report. These forecasts will be updated every quarter contingent on new data announcements and the realization of exogenous shocks. As a requirement of the inflation targeting regime, changes in forecasts will be explained to the public through inflation reports .

2. Inflation Developments

As of end-2005, CPI inflation reached 7.72 percent and remained under the 8-percent target set for 2005 (Graph 2.1). In the last quarter of 2005, Special CPI Aggregates (SCA) continue their downward trend on an annual basis and indicate that the main trend of the consumer inflation is downward.



The factors that stand out in the course of consumer prices, which increased by 3.65 percentage points in the fourth quarter of 2005, are: (i) seasonal effects, (ii) effects of international crude oil prices, (iii) reflections of the rigidity of pricing in the services sector and (iv) the price developments in tobacco products (Graph 2.2). In addition, the strong position of the New Turkish lira is observed to contribute to the favorable course of inflation.

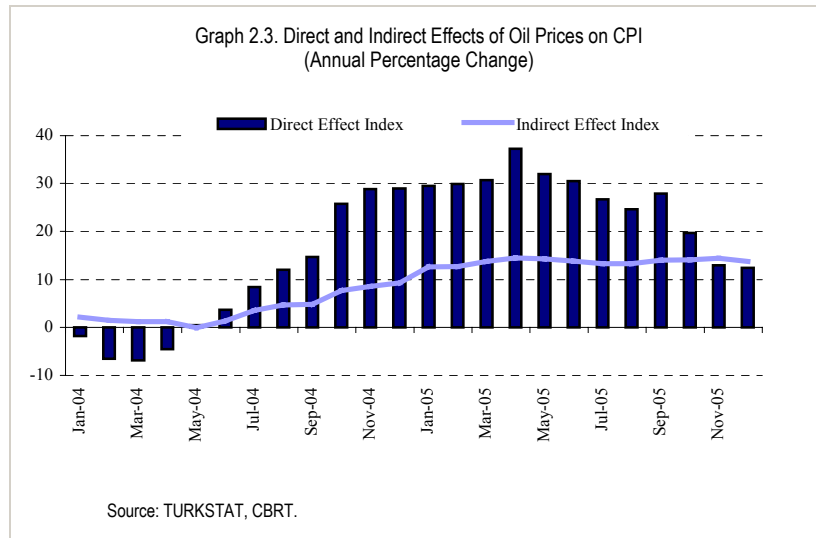


In the last quarter of the year, seasonal price movements were the main factors that determined the course of inflation. The price increases in food and non-alcoholic beverages, clothing and footwear groups had an unfavorable effect on consumer prices inflation. In the October-December period, prices of food and non-alcoholic beverages accelerated and displayed an increase of 5.31 percentage points. The determining factors of this development are the increases in the prices of fresh fruits and vegetables that occurred considerably higher than seasonal trends, especially in November. Similar seasonal increases are also observed in clothing prices. When the seasonal products (various food and clothing products that have changing weights in the index) are excluded (SCA-A), it is observed that consumer inflation remained limited at 1.48 percent in the last quarter of the year.

Although the developments in international crude oil prices generally had an unfavorable effect on the consumer inflation in the first three quarters of the year, the said effects weakened in the fourth quarter (Table 2.1).

Table 2.1. Petroleum Product Prices in the CPI *	
(Percentage Change)	
January-September 2005	16.21
October-December 2005	-3.24
*Liquid Fuels, fuel and oils of private motor vehicles.	
Source: CBRT, TURKSTAT.	

In order to better understand the impact of the increase in oil prices on the CPI, it will be useful to decompose and then analyze direct and indirect effects, which are called primary effects (Graph 2.3). The direct effects comprising liquid fuels in the housing group and fuel products in the transportation group, decreased significantly parallel to the developments observed in international oil prices in the last quarter of the year. This sharp decline stemmed from the fact that prices of petroleum products were realized at much lower levels compared to the last quarter of 2004. Meanwhile, the indirect effects, which include the effects of oil prices on sub-sectors such as transportation, are observed to occur in a delayed manner compared to the direct effects. The annual inflation of the prices of goods and services groups, which are indirectly affected by oil prices, were between 13 and 14 percent throughout 2005.

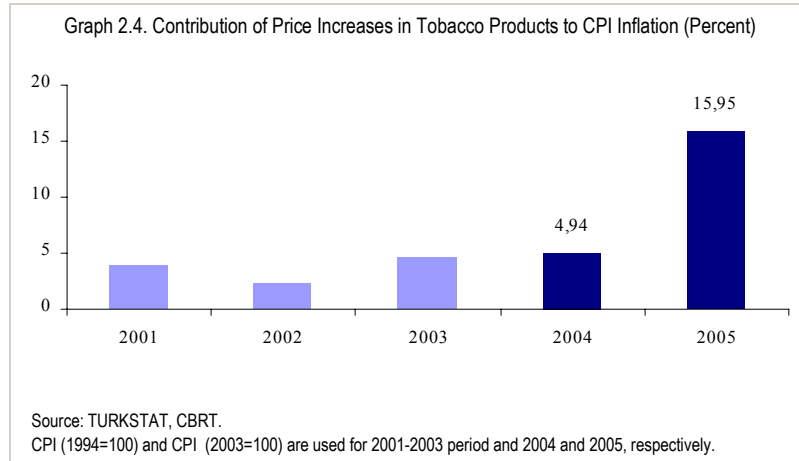


Despite the fact that the negative impact of oil prices on consumer prices weakened in the last quarter of the year, rapid price increases continue in services items such as rents, restaurants and hotels due to the relative economic revival and structural factors. The inertia of the price increases in rents is derived from the fact that rents are mainly determined with pricing behavior based mainly on past inflation. The increases in rents did not lose momentum in the last period, albeit the decline in past inflation. Nevertheless, this accounts for the fact that the housing supply could not respond to the increasing housing demand in the short term. The main determinants of restaurant and hotel groups are considered to be the increases in both demand and costs. As for the service prices of the transportation sector, they are mainly affected by the developments in fuel oil prices.

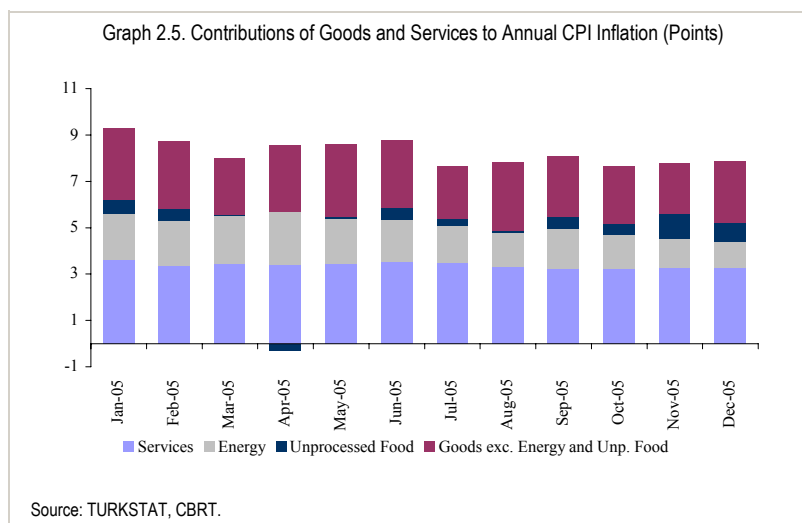
Considering that the main determinants of the services group are rents, restaurants-hotels and transportation services, the high price increases in this group are expected to maintain their trend above the target in the upcoming period, albeit being in decline. The “labor intense services” index, which includes labor-intense services items (maintenance and repair services, barber and hairdresser services, etc.) from the CPI, increased by 14 percent in 2005. The prices in this index are not affected directly by energy prices and are not administered directly.

Other important factors that affected the fourth-quarter inflation, are the price increases observed in tobacco products. In 2005, the prices of tobacco

products increased remarkably and reached 28.33 percent mainly due to tax adjustments. Their contribution to consumer inflation was 1.23 points. It is remarkable that the impact of the tobacco product prices, which carry more weight in the new consumer prices index with a base year 2003, was considerably high in 2005 (Graph 2.4).

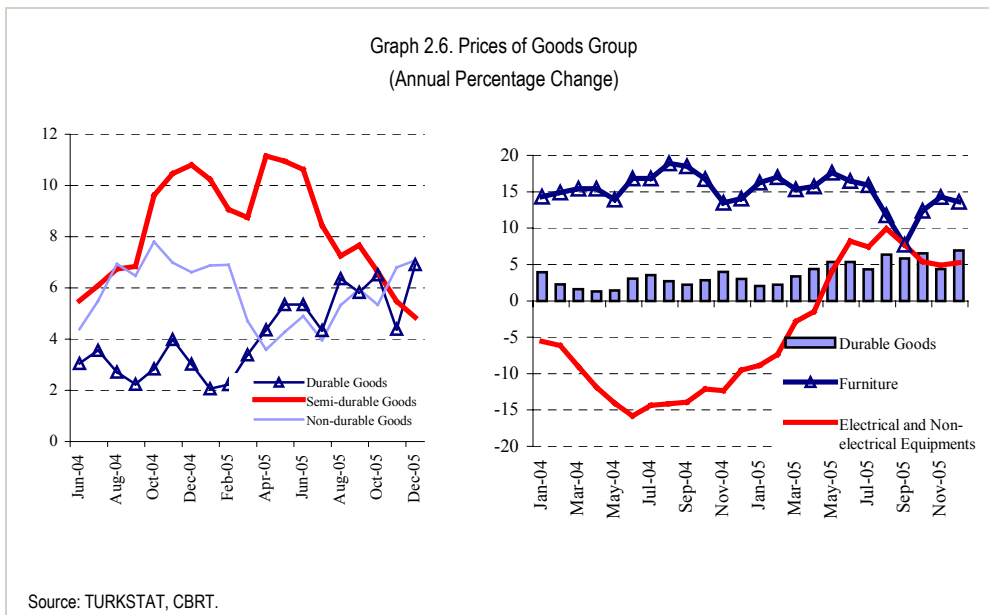


Analyzing the impacts of the goods and services groups to annual inflation, it is seen that the contribution of the services group has not changed much in 2005 (Graph 2.5). In the scope of the goods group, it is observed that the contribution of energy prices to annual inflation reduced gradually in 2005, whereas that of unprocessed food products increased significantly in the last quarter.



When the goods group is analyzed in terms of durable, semi-durable and non-durable goods, it is seen that prices of semi-durable goods, which

increased remarkably in 2004, decreased in 2005, especially due to the slowdown in the rate of increase in energy prices. Meanwhile, the rate of increase in the prices of durable goods that displayed a favorable trend in the previous year rose in 2005 (Graph 2.6). Determinants of the acceleration in the inflation rate of durable goods are the price increases observed in the furniture and electrical and non-electrical household equipments groups. Furniture production that can be considered as an indicator of the demand for consumer goods had displayed high-rated increases since the beginning of 2005. Parallel to these developments, it is observed that prices of the furniture sector maintained their upward trend in 2005 as well as in the previous year. Furthermore, it is also noted that the favorable impact of the electrical and non-electrical household equipments group, which includes technology intensive goods that are open to competition and susceptible to developments in foreign exchange, reversed in 2005 (Graph 2.6).



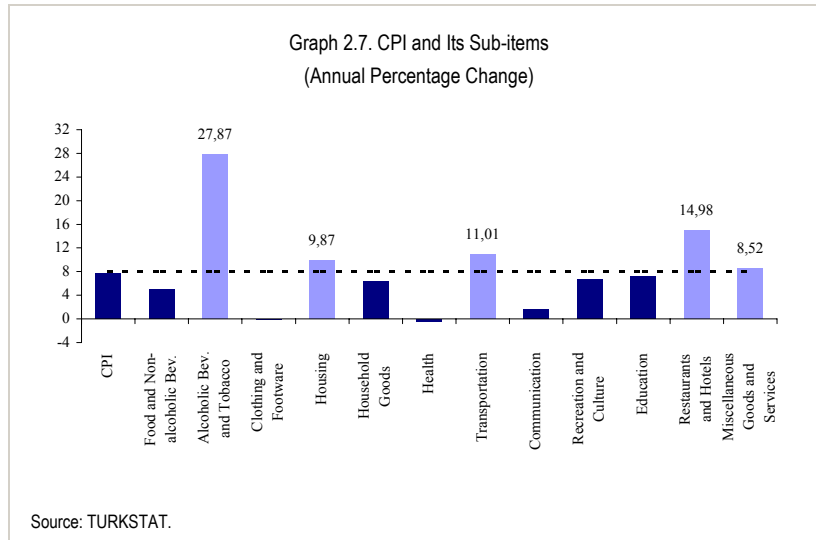
In the framework of the inflation developments in the fourth quarter of 2005, it is seen that the gap between services price inflation and goods price inflation is safeguarded (Table 2.2). In other words, relative prices continue to display a trend in favor of the services sector.

Table 2.2. Goods and Services Group Prices (Percentage Change)

	2005				
	Q1	Q2	Q3	Q4	Annual
CPI	0.83	1.74	1.30	3.65	7.72
1. Goods	-0.24	1.16	0.80	4.42	6.21
Energy	1.73	0.73	3.81	1.20	7.65
Unprocessed Food	3.61	-7.87	0.25	11.12	6.34
Goods Excluding Energy and Unprocessed Food	-1.94	3.91	-0.05	3.79	5.71
Durable Goods	-0.37	3.61	-0.80	4.41	6.91
Semi-durable Goods	-3.38	5.75	-1.10	3.76	4.85
Non-durable Goods	2.11	-2.58	2.60	4.91	7.07
2. Services	3.85	2.77	3.65	1.87	12.68
Rents	4.26	3.74	7.06	4.04	20.48
Restaurants and Hotels	5.19	2.65	3.29	3.09	14.98
Transportation Services	7.87	2.04	6.00	1.11	17.97
Other Services	1.75	2.73	1.72	0.56	6.92

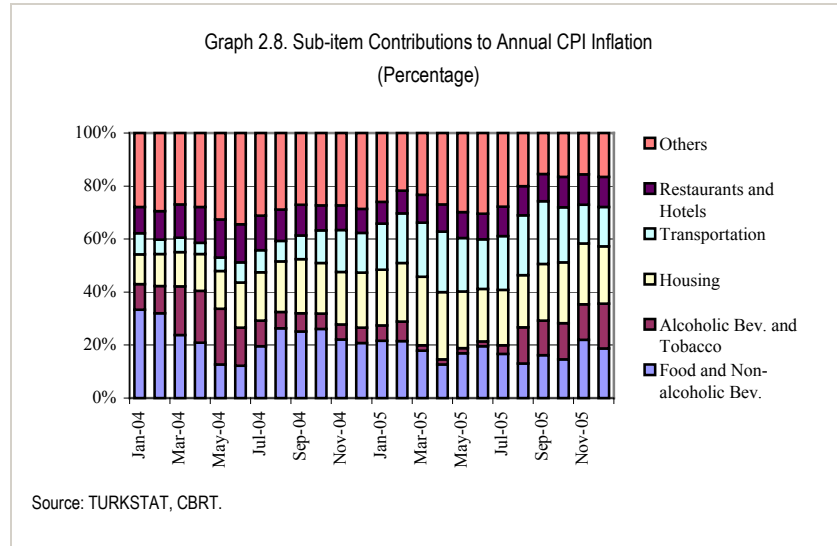
Source: CBRT.

When the sub-items are analyzed as of end-2005, it is seen that the annual inflation rates of the five groups were realized above the end-year inflation target (Graph 2.7). The increases in alcoholic beverages and tobacco, and transportation groups basically occurred as a result of the tax adjustments and the increases in international crude oil prices, which are out of control of the monetary policy. Meanwhile, it is observed that the annual price increases in the housing, restaurants and hotels groups, which are among the groups where service prices are effective, were realized above the target, as well.



When annual inflation is analyzed in terms of sub-groups, it is seen that the total contribution of the transportation and housing groups, where the direct effects of oil prices are generally observed, had started to grow as of the second quarter of 2004 (Graph 2.8). In the last quarter of 2005, the contribution of the transportation group declined due to the slowdown in the upward trend of crude

oil prices. Meanwhile, the mentioned trend of oil prices did not have the same impact on the housing group where rents make up a large share.

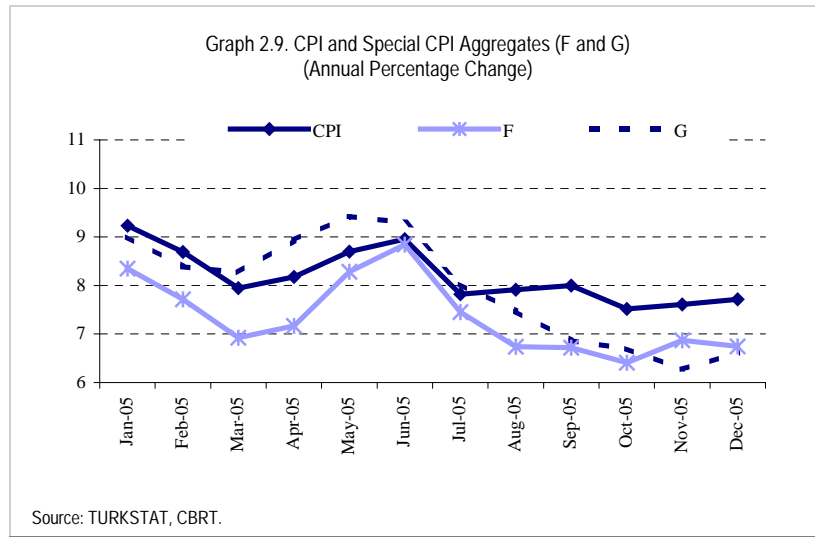


When Special CPI Aggregates are evaluated, it is seen that the annual rates of increase of the indices of special CPI aggregate F, which excludes energy, alcoholic beverages, tobacco products, other goods with administered prices and indirect taxes, and CPI aggregate G, obtained by excluding unprocessed food from CPI aggregate F, were realized between 6 and 7 percent as of the last quarter of the year (Graph 2.9). Therefore, the SCA series that are calculated by excluding the groups whose prices are determined by factors other than monetary policy, point to the downward trend of inflation (Box 2.1).

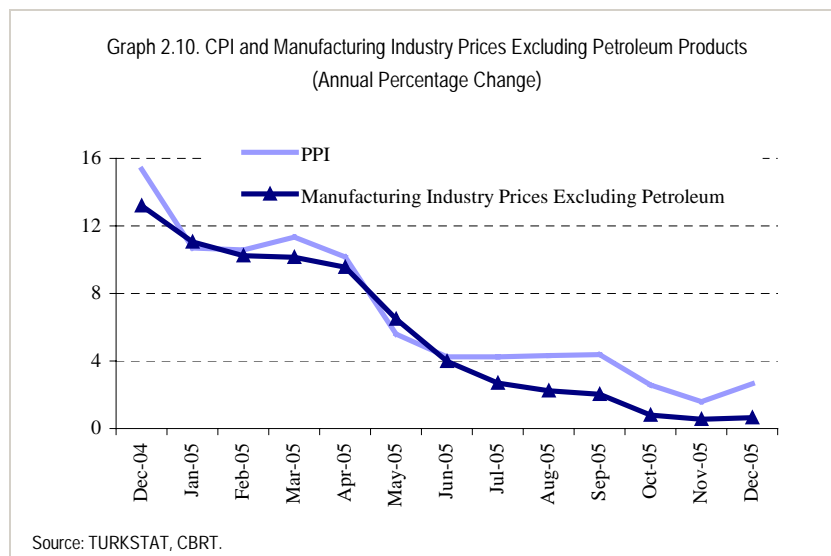
Table 2.3. Special CPI Aggregates (2003=100)

	2005				
	Q1	Q2	Q3	Q4	Annual
CPI	0.83	1.74	1.30	3.65	7.72
A. CPI excluding seasonal products	2.06	1.84	2.75	1.48	8.39
B. CPI excluding unprocessed food	0.37	2.95	1.58	2.68	7.78
C. CPI excluding energy	0.67	1.94	0.89	4.07	7.75
D. CPI excluding unprocessed food products and energy	0.09	3.44	1.14	2.98	7.84
E. CPI excluding energy, alcoholic beverages and tobacco products	0.59	2.05	-0.16	4.00	6.58
F. CPI excluding energy, alcoholic beverages, tobacco products, other goods with administered prices and indirect taxes.	0.30	2.23	-0.33	4.45	6.75
G. CPI excluding energy, alcoholic beverages, tobacco products, other goods with administered prices, indirect taxes and unprocessed food.	-0.38	3.98	-0.32	3.25	6.61

Source: TURKSTAT, CBRT.

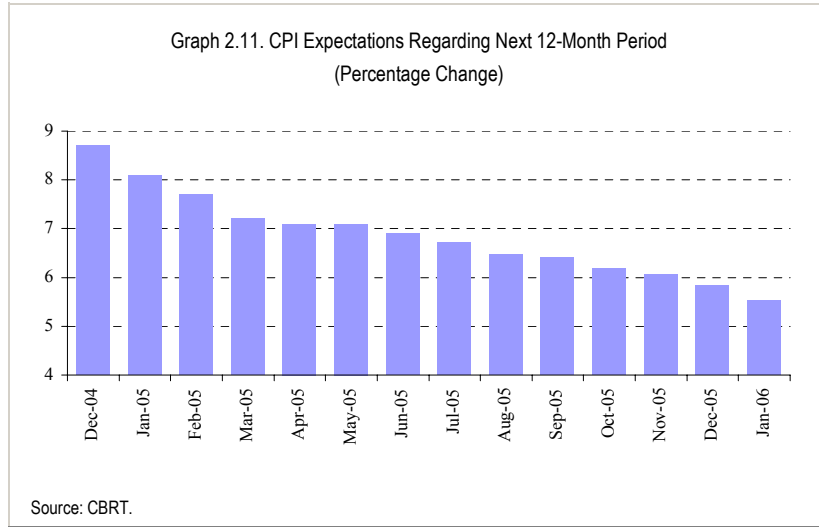


Producer prices rose by 2.66 percent in 2005. As producer prices have impacts on the retail sector in terms of costs, they include information for inflation in the upcoming period. It is observed that especially the price changes in petroleum products are determinant in producer price inflation. Excluding the items that are directly affected by petroleum products, prices of the manufacturing industry are at historically low levels (Graph 2.10). This development provides positive signals about future inflation and unfavorable developments are not foreseen in the short term regarding the pass-through from producer prices to consumer prices.



The CBRT Expectations Survey indicates that inflation expectations regarding the next 12-month period continued to decrease in the last quarter of

the year, as well (Graph 2.11). According to the second survey period of January 2006, the expectation for end-year consumer inflation exceeds the end-2006 target by 0.67 percentage points. When the continuity of the decline in the expectations is evaluated together with the trend of Special CPI Aggregates in the fourth quarter, the outlook regarding 2006 seems positive.



BOX 2.1. THE USE OF SPECIAL CPI AGGREGATES IN THE MEASUREMENT OF CORE INFLATION

In the inflation targeting regime, annual consumer price inflation is generally used as the target variable. The targeting of CPI inflation constitutes the necessary ground for communication between the CBRT and the public to be as smooth as possible. On the other hand, being a comprehensive index, the CPI may also reflect certain temporary effects. Such temporary price movements which are beyond the sphere of monetary policy are not expected to influence the CBRT's policy decisions. This is so, because in the inflation targeting regime the outlook of inflation in the future and the expectations underlying the outlook should be the basis of policy decisions, rather than current inflation. Within this context, the special CPI aggregates (SCAs) published by the Turkish Statistical Institute (TURKSTAT) since February 2005 are of paramount importance. With the effective use of the SCA series, not only is the likelihood of temporary price movements to be reflected on policy decisions reduced, but the attainment of clear perception with regard to inflation is also possible while communicating with the public. In other words, the SCA series are also significant tools in terms of rhetoric, in addition to their analytical significance.

The percentage change of the SCA series corresponds to "core inflation" in the economics literature. However, as temporary price movements may occur at different times and stem from different sources, for the Turkish economy it was preferred that core inflation would be measured by more than one indicator.¹ There exist seven different special aggregates in practice, and thus there are seven different core inflation measures.

In spite of their brief history, special price indices have begun to play a crucial role, in explaining the source of changes observed in prices to the public. For instance; the effect on consumer prices of a potential change - stemming from weather conditions - in unprocessed food production can be examined by using the price index which excludes the prices of unprocessed food products. Similarly, price fluctuations caused by international oil prices can be studied by utilizing the indicator excluding the energy items. Likewise, it is easier to grasp the effects of tax arrangements on consumer prices, through the use of the indicator excluding the items with administered prices. The fact that special aggregates are calculated and announced by the Turkish Statistical Institute and not by the monetary authority points to the transparency of the framework of monetary policy.

The most important factor regarding SCAs that should not be disregarded is that they are designed both to facilitate the formation of monetary policy, as well as to evaluate its performance. In other words, the aggregates are not alternatives to the CPI; on the contrary, the CPI and the SCA information sets complement each other. The aggregates are not separated from each other by strict lines; but they achieve meaningful integrity when used together with each other and with the CPI. That is why the adopted approach is to use special aggregates as a whole and in a continuous manner, while making the inflation analysis.

1. A similar approach is seen in other country examples too. For details: Special CPI Aggregates for Turkey, Core Inflation Working Paper, February 3, 2005, <http://www.tcmb.gov.tr/yeni/evds/yayin/kitaplar/oktg.pdf> [in Turkish].

Box 2.1. Table 1. Special CPI Aggregates

Indicator	% (in CPI)
CPI	100.0
-Excluding seasonal products [A]	87.2
- Excluding unprocessed food products [B]	85.8
- Excluding unprocessed food products and energy [D]	70.9
-Excluding energy [C]	85.1
- Excluding energy, alcoholic beverages and tobacco products [E]	80.4
- Excluding energy, alcoholic beverages, tobacco products, other products with administered prices and indirect taxes [F]	70.3
- Excluding energy, alcoholic beverages, tobacco products, other products with administered prices, indirect taxes, and unprocessed food products [G]	56.1

Basic Indicators

CPI Excluding Seasonal Products (A): Indicator A, formed by excluding from the CPI items whose production quantities and prices are determined by seasonal conditions, although does not entirely remove the seasonal effects in the CPI, does filter them to a large extent. Seasonal products include those unprocessed food and clothing products, the weights of which vary in the CPI within the year.

CPI Excluding Unprocessed Food Products (B): Indicator B is calculated by excluding the prices of unprocessed food from the CPI. Hence, the CPI is adjusted for price shocks originating from agricultural production. Taking into account the susceptibility of Turkey's agricultural production performance to seasonal conditions, it is not possible to underestimate the significance of the information this aggregate contains.

CPI Excluding Unprocessed Food Products and Energy (D): With indicator D, the CPI is adjusted for shocks that could arise from the prices of not only unprocessed food products, but also energy.

The basic function of the C, E, F and G aggregates can be summed up as adjusting the CPI for price volatilities originating from administered prices or tax arrangements. In this framework, the main items of which the prices are administered can be considered as energy, and alcoholic beverages-tobacco products. Nevertheless, although their prices are subject to public regulation, it cannot be disregarded that there is a possibility for the said items to enjoy gradually increasing market freedom, depending on the success of the current privatization process. Therefore, energy, and alcoholic beverages-tobacco groups are handled as separate items while other items with administered prices are collected under the heading of "Other Products with Administered Prices". Another reason for the energy item to be dealt with as a separate item is its sensitivity to international price shocks. The handling of the said goods groups as such limits possible future breaks in the time series characteristics of the SCAs.

CPI Excluding Energy (C): C aggregate is obtained by excluding energy prices from the CPI. "Energy", which does not exist as a main group within the CPI, corresponds to the sum of energy items used directly or indirectly, within and outside of houses. Within this framework, the energy item is made up of the sources of energy used within the houses for heating and cooking purposes; expenses of tap water and out-of-house petroleum; and similar factors.

CPI Excluding Energy, Alcoholic Beverages and Tobacco Products (E): Indicator E is obtained by excluding alcoholic beverages and tobacco products from indicator C.

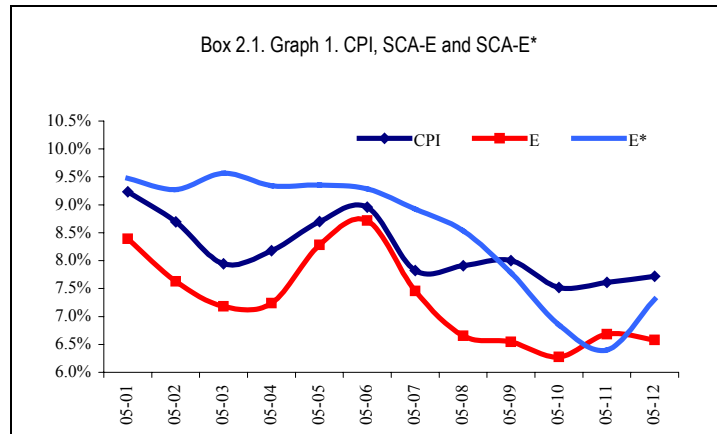
CPI Excluding Energy, Alcoholic Beverages, Tobacco Products, Other Products with Administered Prices and Indirect Taxes (F): Indicator F excludes all items with administered prices from the CPI. Furthermore, the taxes included in the prices of other items that are not excluded from the index are also excluded by indicator F. Indirect taxes cover value added tax, special consumption and private communication taxes. Indicator F largely filters the primary effects of the public sector to the general price level.

CPI Excluding Energy, Alcoholic Beverages, Tobacco Products, Other Products with Administered Prices, Indirect Taxes and Unprocessed Food Products (G): Indicator G is calculated with the exclusion of unprocessed food products from indicator F.

As shown by the above given order of the indicators, Special CPI Aggregates can be considered as 3 main indicators and their derivatives. The main indicators of A, B and C are derived from the CPI, while D is derived from B; E is derived from C; F is derived from E; and G is derived from F.

Derived Indicators

As they have been derived by the method of exclusion, special indicators display a dynamic structure. Moving from this point on, it is possible to derive new indicators that have different contents from those of the immediate indicators. For example; indicator E*, derived - by the CBRT - by excluding seasonal products from indicator E, has manifested quite successful performance in measuring core inflation. Annual percentage changes of the E* series point to the fact that the disinflation trend in the Turkish economy retains its strength. Also, when compared with the original indicators, the E* series follow a less volatile course (Box 2.1. Graph 1).



How Did the Core Inflation Approach of Pre-2005 Lose its Validity?

Before the official use of the consumer and producer price indices with base year 2003, the annual percentage change of Private Manufacturing Industry Prices – one of the sub-items of the Wholesale Price Index with base year 1994 – was widely used as “core inflation”. However, with the replacement of the WPI by the PPI as of February 2005, this approach is no longer applicable. The foremost important reason underlying this is that the Producer Price Index with base year 2003 removed the private-public differentiation. The second reason is the compilation, in the case of the PPI, of the prices excluding tax, which is a different approach from that of the WPI. Compiling the prices by excluding taxes may be misleading in case the producers react to changes in taxes by changing their profit margins. For example; if producers keep their sales prices unchanged and sacrifice their profit margins in case of an increase in the tax rates, this will result in the prices excluding taxes to be measured lower than they really are. This in turn, will inevitably lead to concluding that prices are lower, though there is no change in producer prices. Due to these reasons, the measurement of core inflation on the basis of producer prices gives rise to inaccurate results. Besides, in an environment where the monetary authority targets annual CPI inflation, it is clear that the measurement of core inflation on the basis of CPI as well - rather than the producer prices - is much more reasonable.

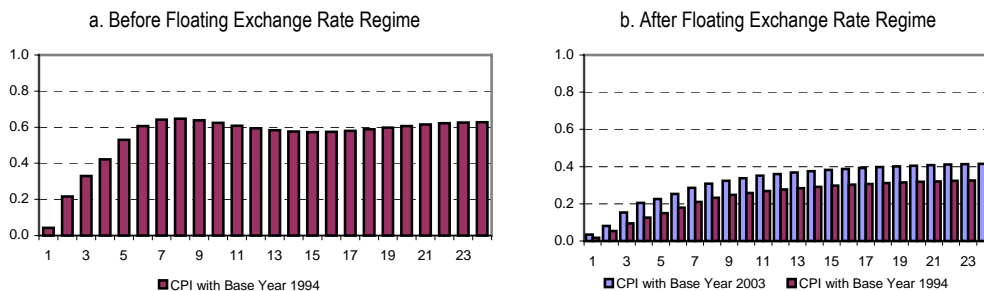
**BOX 2.2. THE EXCHANGE RATE PASS-THROUGH IN TURKEY:
HAS THE PASS-THROUGH CHANGED WITH THE NEW CPI INDEX?**

One of the main challenges for the inflation targeting countries is the evaluation of the impacts of both import price and exchange rate shocks on domestic prices. Especially in small, open and emerging economies, where exchange rates are sensitive to capital flows, such shocks often constitute an obstacle against the achievement of inflation target. For this reason, it is important to understand and quantify the exchange rate pass-through for any monetary authority with the goal of price stability.

After the 2001 crisis, floating exchange rate regime was adopted in the Turkish economy. In this period, inflation dynamics went through a transformation due to the achievement of the independence of the central bank and the emphasis given on price stability as its primary objective. In this framework, along with the transition to floating exchange rate regime, which is a policy implementation for Turkey, it is important to determine to what extent the pass-through from exchange rates to prices has changed. Moreover, due to the changes made in price indices as of 2005, the consumer price index with base year 1994 has replaced the one with base year 2003. An important point to be emphasized in this context is the impact of the change in index on the pass-through from exchange rate to consumer inflation.

When the pass-through from exchange rates to consumer inflation is analyzed in the framework of McCarthy's (1999) vector auto regression (VAR) model, it is observed that a large amount of the exchange rate pass-through to consumer inflation was completed within 4-5 months in the period before the floating exchange rate regime (Box 2.2.Graph 1). It is noted that the completion of the pass-through takes longer (approximately 1 year) after the adoption of the floating exchange rate regime. A striking point is that in the period after the floating exchange rate regime, the exchange rate pass-through to inflation has weakened, however, the extent of weakening is more limited in the consumer inflation index with a base year 2003 compared to the previous index (index with a base year 1994) (Box 2.2.Table 1). Despite the weakening of the pass-through observed after 2001, the results indicate that exchange rate and import prices still maintain their importance in the scope of the new consumer index.

Box 2.2.Graph 1. Cumulative Exchange Rate Pass-through to Consumer Inflation⁽¹⁾



⁽¹⁾ Monthly VAR model is used for the analysis of the exchange rate pass-through. The model is composed of four variables and displays a triangular-causal system. In the order of identifying the shocks, the variables that are used in the model are as follows: output gap, import prices denominated in YTL, private manufacturing prices and consumer prices. In this study, external shocks are identified from import prices denominated in YTL by taking into account the joint effect of exchange rate (USD) and import prices. For this reason, the definition of pass-through in this box is a broad concept and it comprises all cost pressures arising from import prices and exchange rate. For more detailed information on the subject and the methodological explanations see: Kara and Ögünç (2005).

Box 2.2. Table 1. Exchange Rate Pass-through to Consumer Prices-Summary Table

	SPEED: How long does it take to complete 80 percent of the total long-run exchange rate pass-through? (Month)		EXTENT: What percent of the exchange rate changes are reflected into the inflation by the end of 24 months? (%)	
	Before Floating Exchange Rate Regime	After Floating Exchange Rate Regime	Before Floating Exchange Rate Regime	After Floating Exchange Rate Regime
CPI with Base Year 1994	4-5	10-11	63	33
CPI with Base Year 2003		9-10		42

The argument that the exchange rate pass-through to consumer inflation could be higher in the new consumer price index compared to the index with a base year 1994 were set forth in our previous reports.⁽²⁾ The main reason for the relatively high degree of pass-through in the new CPI index can be attributed to the increase in the share of tradable goods that are more susceptible to exchange rate changes, which occurred especially due to the decreasing share of the rents item in the basket. Furthermore, it is considered that some products, which were not included in the previous consumer basket but newly entered to the new price index and priced over foreign exchange as various technological products (computers, etc.), combi boilers and package tours to abroad, might be effective in this development.

In conclusion, the findings put forward that there is a noticeable decline in the long run exchange rate pass-through after the adoption of the floating exchange rate regime and the new consumer price index is more sensitive to exchange rate developments compared to the index with base year 1994.

Sources:

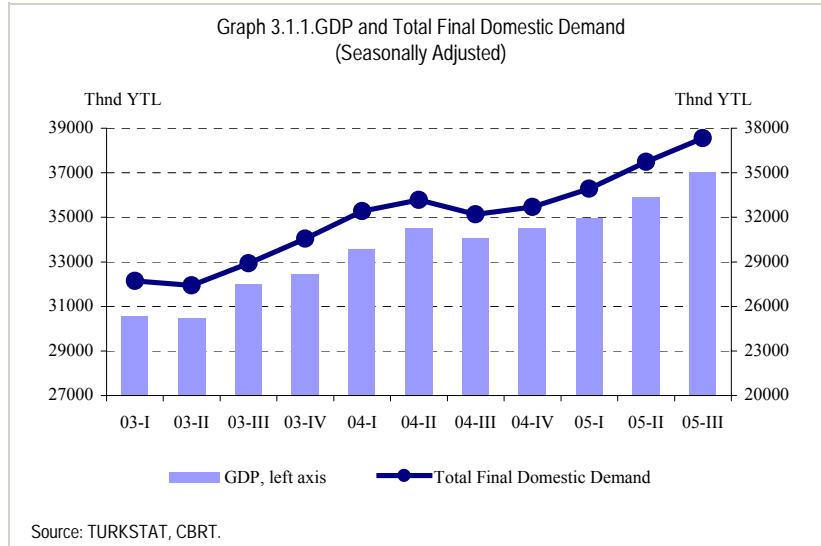
Kara, H. and Ögünç, F. (2005) "Exchange Rate Pass-Through in Turkey: It is Slow, but is it Really Low?", CBRT Working Paper, No:05/10.
 McCarthy J. (1999) "Pass-Through of Exchange Rates and Import Prices to Domestic Inflation in Some Industrialized Economies", BIS Working Papers, No.79.

⁽²⁾ See Monetary Policy Report, 2004-IV, Box 2.1 "Exchange rate Pass-Through in Turkey: Do Behavioral Patterns of Price-Setters Change?"

3. Supply and Demand Developments

3.1. Supply-Demand Balance

The Gross Domestic Product (GDP) maintained its upward trend in the third quarter of 2005, with a growth rate of 7 percent compared to the same period of the previous year. Hence, in the first three quarters of the year, GDP growth rate summed up to 5.5 percent compared to the same period of 2004. The mitigation of the strong base effect inherited from the first half of the previous year was effective in reaching a relatively higher annual growth rate in the third quarter of 2005, though it is not the only contributing factor. In fact, seasonally adjusted data indicate that economic activity gained further momentum in this period (Graph 3.1.1). In addition, considering the current data related to the last quarter of the year, the end-year growth rate projection, which was set as 5 percent in the scope of the macroeconomic program, is expected to be surpassed. In fact, in the second survey period of December, GNP growth expectations for end-2005 were indicated as 5.5 percent in the CBRT Expectations Survey.



In the third quarter of 2005, the agricultural value added increased significantly compared to the first half of the year and made a contribution of 1.3 points to GDP growth. Furthermore, the stable growth of the value added of the construction and industrial sectors continued, while the services sector made a larger contribution to growth, stemming from trade, transportation and communications sectors, compared to the first half of the year.

On the expenditures side, the greatest contribution to GDP growth came from private consumption expenditures with 7.3 points in this period. This development can be attributed to the fact that consumer durables, which increased slightly in the first half of the year, increased by 31.2 percentage points and made a contribution of 3.5 points to GDP growth in this period. Meanwhile, the robust growth trend of private investment expenditures also prevailed in this period and public expenditures supported economic growth similar to that observed in the first half of the year. Nevertheless, contrary to imports, exports continued to slow down and net exports made a negative contribution to growth as in the second quarter of the year.

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

	2003					2004					2005					
	Annual	I	II	III	IV	Annual	I	II	III	IV	Annual	I	II	III	IV	Nine Months
1-Consumption Expenditures	5.6	11.6	15.4	5.9	4.7	9.0	4.0	4.4	10.6	6.6						
Public	-2.4	2.6	-7.8	-7.0	11.1	0.5	4.3	4.0	3.3	3.9						
Private	6.6	12.4	18.4	7.3	3.6	10.1	4.0	4.4	11.2	6.9						
Durable Goods	24.0	48.0	61.4	28.9	-5.7	29.7	1.5	2.6	31.0	11.2						
Food and Beverages	4.1	5.3	2.6	0.0	5.4	2.8	4.6	8.8	10.3	8.3						
Semi-dur. and Non-durable Goods	2.1	8.2	36.8	18.3	16.3	18.8	12.0	4.2	5.1	7.1						
2-Fixed Capital Formation	10.0	57.6	47.4	26.1	11.2	32.4	6.9	17.9	27.8	18.1						
Public	-11.5	-5.9	-8.7	-10.8	0.9	-4.7	36.6	31.1	32.8	32.7						
Private	20.3	65.5	63.1	38.9	17.7	45.5	4.8	15.8	26.7	15.9						
3- Stock Change*	3.0	2.5	1.4	-1.2	2.5	1.1	0.1	-0.9	-2.8	-1.3						
4- Exports of Goods and Services	16.0	10.9	17.2	8.2	14.4	12.5	11.3	4.7	2.7	5.8						
5- Imports of Goods and Services	27.1	31.3	32.7	16.1	19.6	24.7	9.3	9.2	11.9	10.1						
6-Total Domestic Demand	9.3	20.6	21.4	8.1	8.5	14.1	4.4	6.4	11.0	7.4						
7-Total Final Domestic Demand	6.5	19.8	22.9	9.9	6.3	14.1	4.7	8.2	14.5	9.5						
8-GDP (Expenditure Side)	5.8	11.8	14.4	5.3	6.3	9.0	4.8	4.2	7.0	5.4						

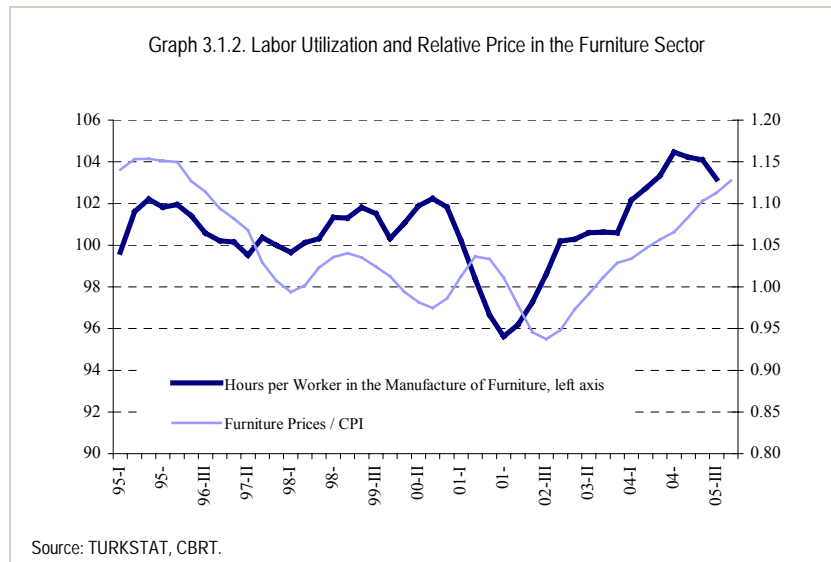
*Contribution to GDP growth, percent.

Source: TURKSTAT.

In this way, total final domestic demand, which grew at about the same rate as the GDP on annual basis in the first quarter of the year, displayed an increase significantly above the GDP growth during this period, similar to the second quarter (Table 3.1.1). Seasonally adjusted data also point to an ongoing rapid increase in total final domestic demand (Figure 3.1.1). At this point, analyzing the composition of the domestic demand is of great importance with respect to the demand-inflation relationship.

Analyzing the seasonally adjusted data for the sub-groups of private consumption expenditures for the third quarter of the year, the consumption of food, semi-durable and non-durable goods displayed an increase at a decreasing rate compared to the previous period, while the rise in demand for durable goods gained at a remarkable pace. The current growth tendency in durable consumption indicates that a period similar to the first half of 2004 is being experienced. In this context, the strong position of the New Turkish Lira, productivity gains and low levels of the relative prices of tradable goods, along

with the downward trend in financing costs, has especially pushed up the consumption of durable goods. However, considering the developments in public expenditures and the construction sector, the fact that economic growth has spread over a larger sectoral base, differentiates the current period from the previous year. Therefore, there are relatively more indicators reflecting the revival of domestic demand in the current period. In this context, furniture manufacturing, which has been displaying rapid growth since the beginning of 2005, and price developments in this sector, are striking examples (Graph 3.1.2). Hence, the outlook prior to analyzing the data for the last quarter of the year supports our view that the contribution of demand conditions to the disinflation process diminished further as of the third quarter of the year.



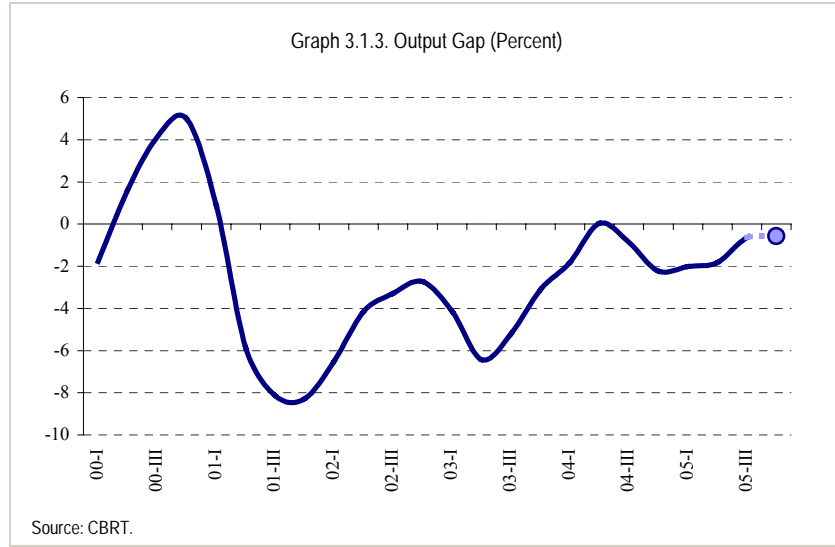
Nevertheless, demand developments in the third quarter of the year also have concern-easing aspects regarding inflation. Firstly, due to the fact that the demand for durable consumption goods is determined by the relative price advantage rather than a rise in income, such a demand growth is not expected to pose a risk for inflation. Moreover, the expenditures for these goods do not only depend on current income, but also on future income. Therefore, the decline in interest rates and the increase in confidence in the economy trigger the incentive of consumers to benefit from the relative price advantage and thus create an intertemporal substitution effect on demand for durable goods. In other words, financing of expenditures via extensive credit utilization without any rapid increase in current income means forgoing the future consumption. Undoubtedly, this situation applies not only for the consumption of durable

goods, but also for semi-durable and non-durable goods that offer installment sale opportunities with extended maturities.

Secondly, as repeatedly emphasized, though investment as an expenditure component that pushes up domestic demand in the short run, it still preserves its significance with respect to non-inflationary growth through its contribution to productivity gains and unit costs. It was stated in the October 2005 Monetary Policy Report that the contribution of investment expenditures to GDP growth was higher compared to overall consumption expenditures in the second quarter of the year, thus the composition of domestic demand should be perceived favorably regarding inflation. Even if this situation seems to have been reversed in the third quarter of the year, excluding the expenditures for consumption durables, the contribution of investment expenditures is still relatively high.

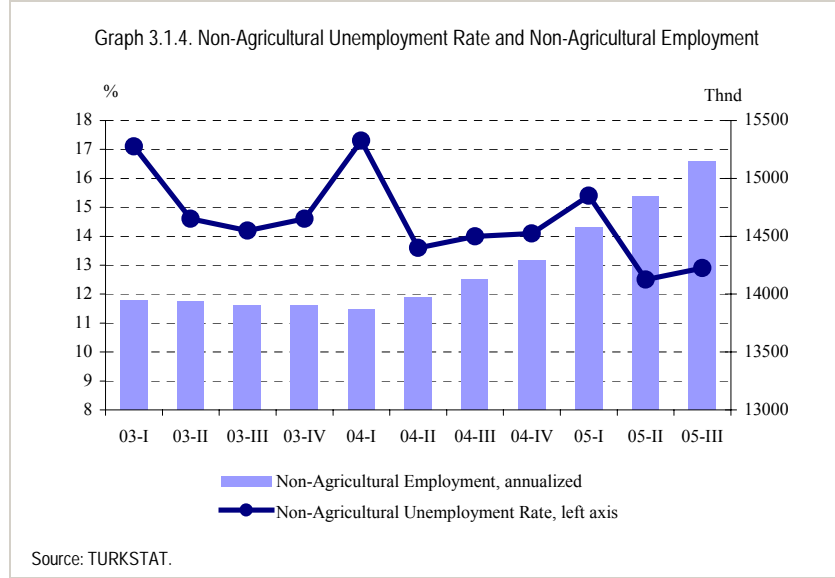
The assessment of demand developments in the third quarter of the year as well as the evaluation of the rapid growth tendency – whether or not it still continues in the last quarter – will shed light on perceptions related to the demand-inflation relationship. For this purpose, the developments in some selected indicators can be summarized as follows: According to seasonally adjusted figures, while domestic sales of white goods decreased in November as in October, the CBRT Private Consumption Index (CBRTPCI), a leading indicator for the private consumption, maintained its third quarter-level as of the October-November period. In the meantime, seasonally adjusted figures reveal that the upward trend in domestic automobile sales still continues in the last quarter. Similarly, based on seasonally adjusted figures, the average level of industrial production in the October-November period was realized higher than that of the previous quarter. Analyzing in terms of financing of expenditures, the increase in real consumer credits, which slowed down in the October-November period, re-accelerated in December. Hence, current indicators concerning demand, production and credit in the last quarter of the year imply that economic activity maintains its momentum.

Within the framework of information so far provided, it is clear that the contribution of demand conditions to the disinflation process has declined. The estimates for the output gap also provide signals in this direction (Graph 3.1.3). Another indicator that involves similar information regarding the medium-term demand-inflation relationship is the non-agricultural employment.



It has already been claimed in the earlier reports that the importance of employment developments in monetary policy decisions will be enhanced as economy enters in a stable pace in which the relationship between the pricing behavior and employment is expected to be stronger. In this respect, the analysis of recent developments in employment is of great importance. In the third quarter of 2005, total employment and private sector employment declined by 0.2 percent and 0.7 percent, respectively, compared to the same period of the previous year. Thus, the upward trend in total employment and private sector employment, which has continued since the second quarter of 2004, has come to an end. However, it must be emphasized that this development does not point to a deterioration in the employment creation of the economy. In fact, when employment data are analyzed with respect to the working place and economic activity, it is seen that agricultural employment constitutes a major part of the private sector employment. During this period, agricultural employment dropped by 15 percent compared to the same period of last year. Meanwhile, excluding the agriculture sector, the annual rates of increase in total employment and private sector employment in the same period are 8.2 percent and 9.2 percent, respectively. Therefore, ongoing extremely high-rated growth in non-agricultural employment indicates that the revival in economic activity supports employment. Although the continuous acceleration in non-agricultural employment since the second quarter of 2004 and the corresponding rapid decline in non-agricultural unemployment are favorable developments regarding the job-creating performance of the economy, these developments should be closely monitored because of their demand-expanding

potential (Graph 3.1.4). At this point, the assessment of productivity developments, whose role with respect to inflation dynamics is repeatedly underlined, is of great importance.¹

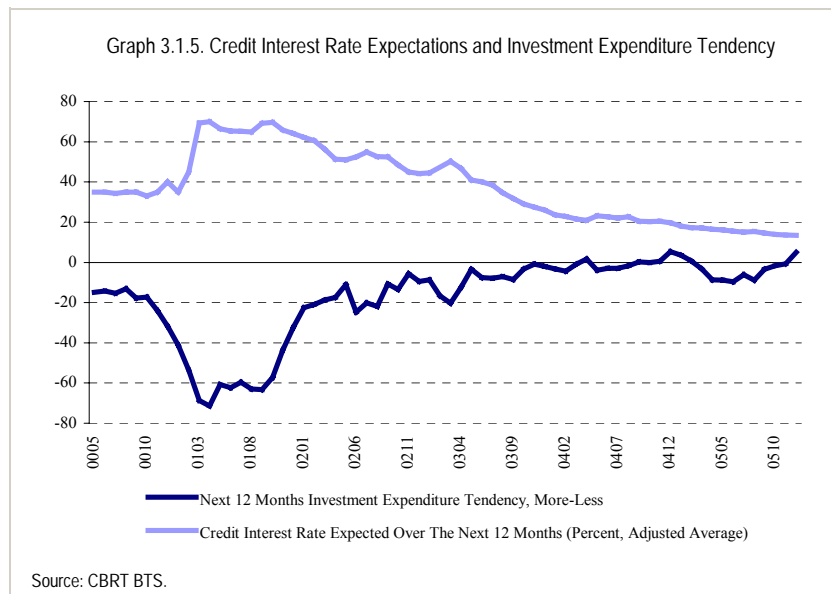


The continuation of the structural reforms is of vital importance in the sustainable improvements in total factor productivity. Efforts to reduce the role of the public sector in the economy – regarding both fiscal burden and production activity – constitute an important pillar of this process. Privatization performance achieved in 2005 will not only contribute to the financing of the current account deficit, but also encourage firms to intensify their efforts towards the improvement of productivity in a more competitive environment. In this respect, the accomplishment of the privatization of TÜPRAŞ and Türk Telekom in 2005, the leading institutions in the energy and communication sectors, is a remarkable development. Therefore, rapid productivity gains in the energy sector since 2003 as a result of the structural reform process and accordingly the sector's steady contribution to industrial production, are not surprising. Moreover, the composition of the companies in the privatization portfolio is of a nature that will ensure productivity improvements in the energy and transportation sectors in the medium-term. Undoubtedly, in addition to its direct effect, the productivity improvement in the services sector has also an indirect contribution to the aggregate productivity in the economy through its effect on sectors utilizing the services output as intermediate input, which

¹ See Box 3.1 for details.

corresponds to a dual gain.² In other words, the improvement in the competition and productivity of the nontradable sectors is important regarding their spillover effects on the tradable sectors.

Meanwhile, the indicators associated with investment expenditures maintained their favorable course, signaling that capital deepening will further support productivity gains. Analyzing the indicators for the last quarter of the year, the increases in imports of capital goods as well as the manufacturing of machinery-equipment and electrical machinery in the October-November period compared to the same period of the previous year, point to the ongoing growth in investment expenditures. Commercial vehicle sales to domestic market during the last quarter of the year give a similar signal. The investment tendency for the next twelve month-period in the CBRT Business Tendency Survey (BTS) also maintained its strong course as of December (Graph 3.1.5). Along with the favorable outlook in investment confidence, the improvement in credit conditions and the relative price advantage in capital goods are expected to reinforce further investment in machinery-equipment.



Besides machinery-equipment investment, construction investment also continued to grow rapidly in the third quarter of 2005. Construction statistics released by TURKSTAT reveal that the increase in construction licenses persisted in the third quarter of the year as well. Considering the fact that the

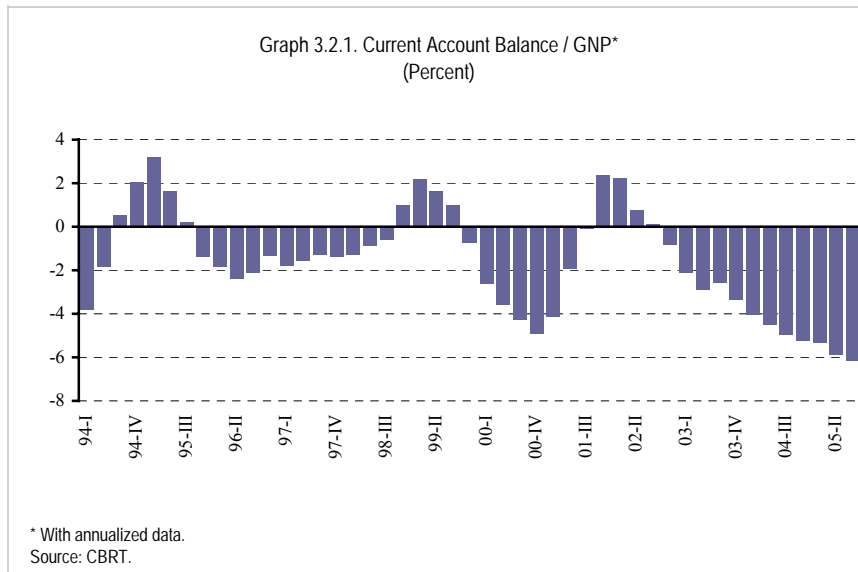
² See Giuseppe Nicoletti and Stefano Scarpetta (2005), "Regulation and Economic Performance: Product Market Reforms And Productivity In The OECD", OECD Economics Department, Working Paper Number. 460, ECO/WKP(2005)47.

construction licenses have a lagged effect on national accounts, the construction sector value added is also expected to maintain its growth trend in the upcoming period. In addition to the current tendency in housing credits, optimistic expectations for the course of borrowing conditions in the coming period provide signals that the revival in the construction sector will continue.

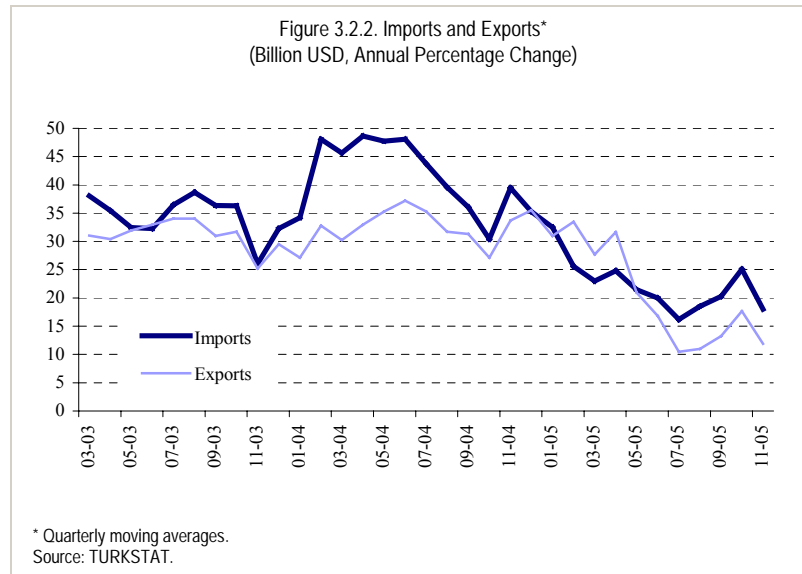
In summary, the developments in the second half of 2005 manifest that the contribution of demand conditions to the rapid disinflation process has significantly diminished compared to previous years. Capital stock expansion has accelerated due to the increased share of investment in the GDP in 2005 as in 2004, this in turn on the supply side support high GDP growth. This development is expected to sustain its contribution to the disinflation process by enabling further gains in productivity. The important point regarding the labor market development is that rapid increases in the non-agriculture employment should be closely monitored with respect to its implications for domestic demand.

3.2. Foreign Demand

Analyzing annualized data, the ratio of current account deficit to Gross National Product (GNP) was realized 6 percent as of the first nine months of 2005 (Graph 3.2.1). As of the first eleven months of 2005, the current account deficit became USD 18.7 billion.



According to data released by TURKSTAT, exports and imports rose by 16.5 percent and 20.1 percent, respectively, in the first eleven months of 2005 compared to the same period of 2004. Following rapid increase in 2004, the rate of increase in both exports and imports slowed down. However, the annual rate of increase in exports in the second half of the year realized well below the rate of increase in imports (Figure 3.2.2). Data released by the Turkish Exporters' Assembly (TEA) indicate that the annual rate of increase in exports will realize at a low rate in December as well.



When the composition of imports is analyzed, the rise in intermediary goods imports continues to make the largest contribution to the overall increase in imports. The increase in oil prices had a significant impact on the expansion of intermediary goods imports. While the rate of increase in imports of intermediary goods was 22.1 percent in the first eleven months of 2005, the said rate of increase was realized as 13.3 percent when fuel and oil are excluded. It is notable that imports of consumption goods, which increased at low rates in the first seven months of the year, have started to grow at considerably higher rates since August. A similar tendency – though not so apparent – is observed in imports of investment goods. The said revival in imports of consumption and investment goods mainly stemmed from the base effect, which weakened in the second half of 2004, and the current position of New Turkish lira as well as the general decline in non-petroleum import prices. The downward tendency in import price indices of consumption and

investment goods on an annual basis, which started in June, has persisted also in November.

The ratio of current account deficit to GNP is predicted to be around 6.2 percent at the end of 2005. The upward trend in foreign direct investments and long-term credit utilization indicates that current account does not pose an important risk in terms of financing in the short run. In other words, the current account deficit is not expected to pose a risk as regards the inflation target through exchange rates and expectations. On the other hand, the slowdown in export increases is being closely monitored with respect to the sustainability of the current deficit and growth. Along with the improvement in the financing structure, advancing export potential with a long-term perspective is of critical importance for the sustainability of the current deficit. At this point, comprehending that the level of the real exchange rate is not the sole determinant of exports, the necessity for focusing on structural elements should be emphasized once again. Hence, taking cost-reducing measures, such as easing the tax burden on employment and reducing energy costs without contradicting fiscal discipline with the continuity of structural regulations that will encourage productivity increases such as the enhancement of competition and the improvement in investment environment are of vital importance.

3.3. Costs

In the third quarter of 2005, manufacturing sector employment declined compared to the same period of the previous year. During the same period, a rapid growth was realized in labor productivity due to the ongoing production increase. Nevertheless, the favorable developments in the productivity of the manufacturing sector should be prudentially evaluated.³ In the meantime, real wages in the manufacturing industry maintain their upward trend both in the public and the private sectors (Table 3.3.1).

³ See Box 3.1 for details.

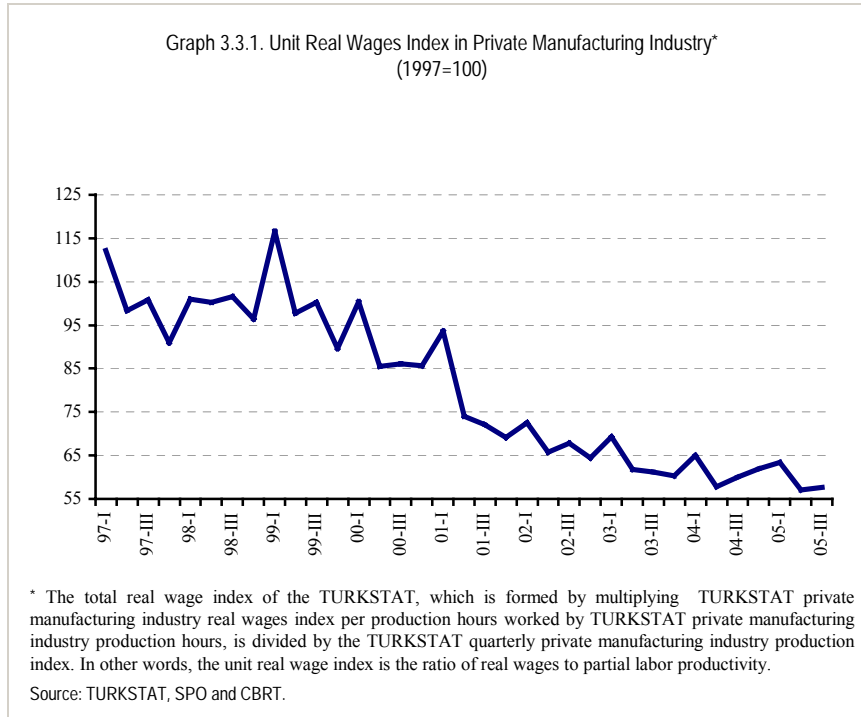
Table 3.3.1. Employment Real Wage and Productivity Developments in Manufacturing Industry, (Percentage Change Compared to the Same Period of the Previous Year)

	2003					2004			2005		
	Annual	I	II	III	IV	Annual	I	II	III		
Employment⁽¹⁾	1.8	0.7	2.7	2.2	2.2	2.0	1.9	-1.7	-1.8		
Public	-6.8	-13.6	-11.0	-9.6	-9.7	-11.0	-10.2	-7.1	-8.6		
Private	3.1	2.4	4.5	3.7	3.6	3.6	3.2	-1.2	-1.1		
Wages⁽²⁾	-1.9	0.2	5.1	3.4	1.6	2.5	3.2	2.1	1.6		
Public	-5.3	2.9	7.7	5.6	2.9	4.7	8.7	5.4	9.0		
Private	0.6	2.5	7.5	5.3	3.9	4.8	3.5	2.0	1.0		
Productivity⁽³⁾	7.2	8.5	13.6	6.4	1.6	7.3	5.1	4.3	6.1		
Public	8.1	14.8	13.1	5.6	8.5	10.5	7.0	11.8	4.3		
Private	7.9	9.0	15.0	7.6	1.2	8.0	6.1	3.4	5.2		
Earnings⁽⁴⁾	-6.3	-0.6	3.7	1.5	-0.5	1.3	2.8	2.7	2.5		
Public	-5.6	-0.6	9.2	1.2	2.5	3.2	10.6	3.5	8.8		
Private	-4.7	2.6	5.9	4.6	2.3	4.3	2.9	3.2	2.0		

Source: TURKSTAT.

- (1) The Index of Manufacturing Industry Production Workers, 1997=100.
(2) The Index of Real Wages Per Working Hour in Production, 1997=100.
(3) The Index of Partial Productivity Per Working Hour in Production, 1997=100.
(4) The Index of Real Earnings Per Production Worker, 1997=100.

In the private manufacturing industry, real unit wages dropped by 4 percent compared to the same period of the previous year, since the productivity increased faster than rise in real wages (Graph 3.3.1). Within this framework, it is believed that real unit wages preserve their favorable regarding inflation and the competitiveness of the manufacturing industry.



When incomes policy for 2006 is analyzed, it is seen that the rate of increase in workers' wages is close to the inflation target. However, the 12.7 percent increase in civil servants' average salaries is considerably higher than the inflation target. Meanwhile, minimum wages for 2006 were raised by 8.6 percent. Thus, the upward trend in real wages is expected to continue in 2006

as well. At this point, the productivity improvements will become more crucial with respect to achieving price stability.

Raw material prices, another factor that affects costs, continue to maintain their high level (Table 3.3.2). In international markets, crude oil prices started to decline after reaching record levels in September. However, the said downward reversed partly due to unfavorable weather conditions. In the meantime, it was stated at the OPEC meeting of 12 December 2005 that an increase in production is not considered due to signals of adequate supply. In conclusion, as oil demand pursues a seasonally high course in winter months, any decline in oil prices in the first quarter of 2006 compared to the previous quarter is not expected.

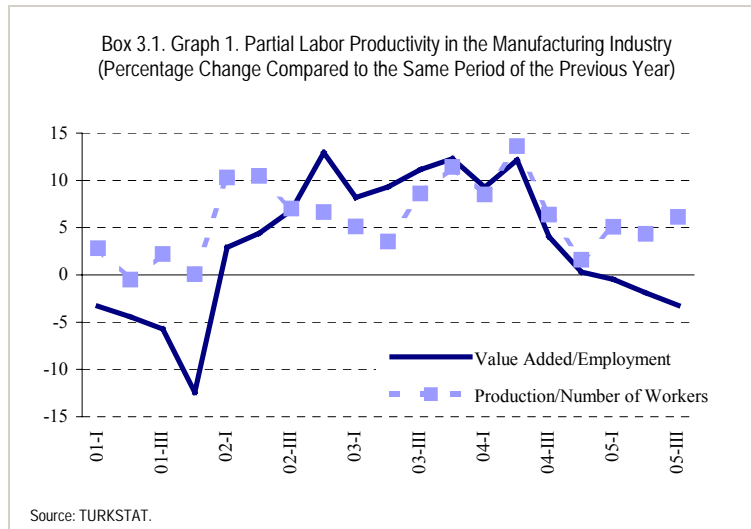
The upward trend in international metal prices also strengthened and persisted in the last quarter of the year. No decline is expected in international metal prices in the first quarter of 2006 due to the delayed response of production increases to expansion in demand. Additionally, demand increases in some metals were met by stocks and China and India-originated demand preserved its revival. Meanwhile, the declining tendency in the import unit value index released by TURKSTAT, which persisted throughout the year, reversed in October and the index rose by 2.5 points. Accordingly, raw material prices, mainly oil prices, are expected to continue to pose a risk for the 2006 inflation target.

	2004					2005			
	I	II	III	IV	Annual	I	II	III	IV
Import Unit Value Index	111.4	112.7	116.6	123.3	116.0	125.4	124.6	122.9	125.4 ⁽¹⁾
Crude Oil Prices (\$/barrel)	30.0	32.0	36.7	39.6	34.6	41.7	48.0	56.6	54.1 ⁽²⁾
Commodity Price Index	117.3	126.7	136.1	140.9	130.2	151.4	162.0	182.2	180.6 ⁽¹⁾
Metal Price Index	130.0	130.2	133.8	141.9	134.0	161.5	163.5	168.2	172.0 ⁽¹⁾

(1) Data for the last quarter of 2005 include October.
(2) Predictions have been used for November and December.
Source: SPO, IFS, TURKSTAT.

BOX 3.1. PRODUCTIVITY DEVELOPMENTS IN THE MANUFACTURING INDUSTRY

Productivity developments in the manufacturing industry are monitored through the bulletins of the 'Manufacturing Industry Workers, Working Hours in Production and Partial Productivity Index', which are published quarterly by TURKSTAT. As of the third quarter of 2005, the increases in partial labor productivity, which is obtained by dividing manufacturing industry production into production worker index, continued. On the other hand, when partial labor productivity is calculated by sector value added and employment data released in the Household Labor Survey, it is observed that the two separate productivity indicators have been giving conflicting signals since the start of 2005 and that the difference became more apparent in the third quarter of the year (Box 3.1. Graph 1). The main reason is the differentiation in employment data obtained from the two different surveys rather than value added and production figures. While the manufacturing industry production workers index fell by 1.8 percent in the third quarter of 2005 compared to the same period of the previous year, the growth in manufacturing industry employment in the Household Labor Survey realized as 8.9 percent.



At this point, the comprehension of the differences in data sources utilized in producing the two surveys related to manufacturing industry employment is of great importance as regards the evaluation of the survey results. 'The Manufacturing Industry Production Workers Index' is compiled by the 'Quarterly Industrial Production Survey' conducted in all public enterprises and in medium and large-scale enterprises that employ 10 or more workers, which constitute about 89 percent of value added of manufacturing. The 'Household Labor Survey' is compiled within the framework of sampling through face-to-face interviews conducted throughout Turkey.

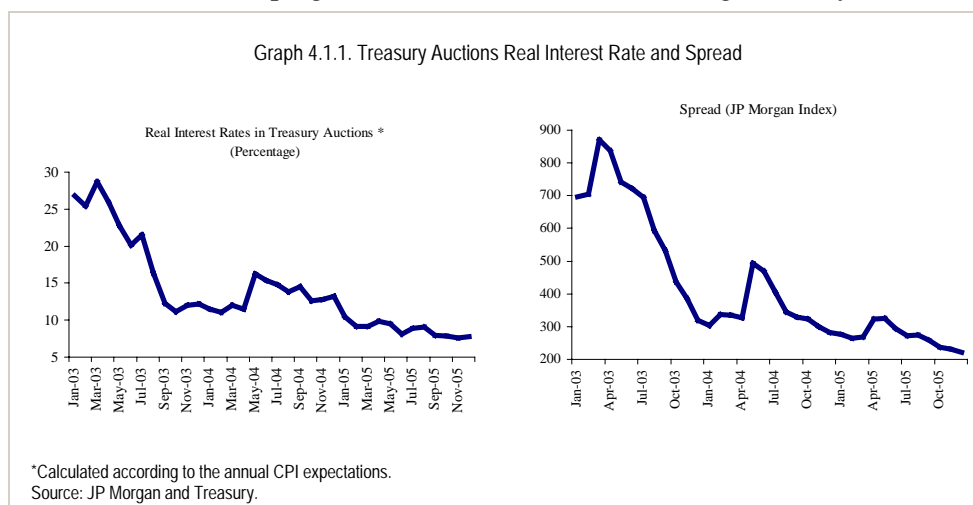
In the third quarter of 2004, the ratio of the number of production workers in the firms included in the manufacturing industry production workers index to manufacturing industry employment derived from the Household Labor Survey was 19.1 percent, while the ratio of total workers (including those employed in production and other branches) is 24.3 percent. Accordingly, the share of firms that constitute the major part of manufacturing value added in employment is quite low. Due to the fact that the survey conducted to compile the manufacturing industry workers' index is applied to the firms that constitute 89 percent of value added in terms of sectors, the survey can be expected to reflect general pricing behavior consistent with productivity and unit cost developments of a more reliable nature. On the other hand, the Household Labor Survey data should be a more reliable indicator of the total employment in the economy, thus for employment-originated demand increases. Meanwhile, the relative superiority of the Household Labor Survey in representing unrecorded employment necessitates cautious assessment of data revealing ongoing productivity increases in the manufacturing industry. Household Labor Survey data for the third quarter of 2005 show that the rate of non-registered wage earners in the non-agriculture sector rose compared to the same period of the previous year. The probability that the increase in unrecorded employment might also be realized in the sampling used to calculate the Manufacturing Industry Production Workers Index requires caution to be applied while evaluating the high-rated increase in partial labor productivity.

4. Financial Markets and Financial Intermediation

4.1. Financial Markets

Improvement in expectations and the decline in the risk premium have continued since early-2005 mainly because of the realization that the year-end inflation and budgetary targets were within reach. The one notch upgrade of Turkey's rating by Moody's, re-scheduled relations with the IMF on an achievable reform calendar, and the EU membership process were the recent significant and favorable developments for the financial markets. On the other hand, the fact that the current account deficit is well above the forecasts made in early-2005 has led some international institutions to adopt a cautious stance to the Turkish economy. Yet, the performance achieved in privatizations, as well as the primary surplus target pointing to tight fiscal policy in 2006, have kept possible deteriorations in expectations that could have emerged via this channel under control. Capital movements continued to be in favor of Turkey in the last months of 2005.

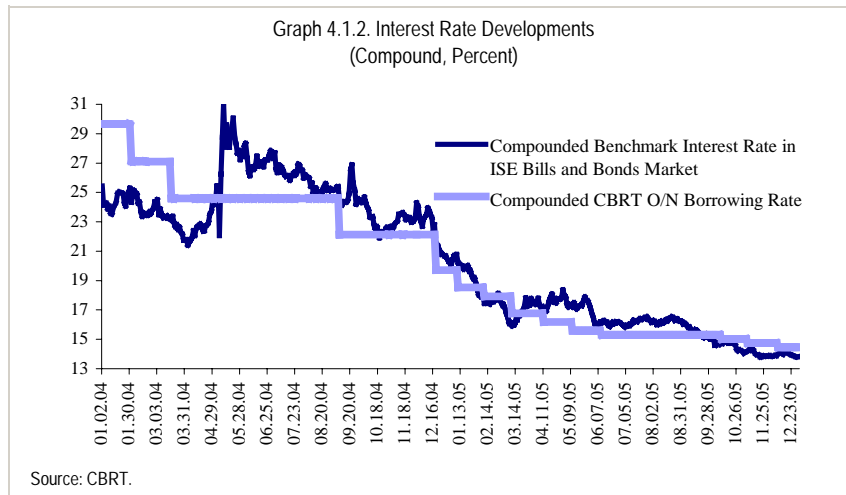
In 2005, international liquidity conditions have been in favor of developing countries. Short-term interest rate hikes would be expected to come to an end in the USA until mid-2006. The 25 basis points hike by the ECB after a period of four years will not be aggressive due to the low rate of growth in Euro area. Under these circumstances, the probability of significant capital outflows from developing countries in 2006 diminished significantly.



The real borrowing cost of the Treasury and the spread - the indicator of country risk premium - have been displaying a downward trend (Graph 4.1.1).

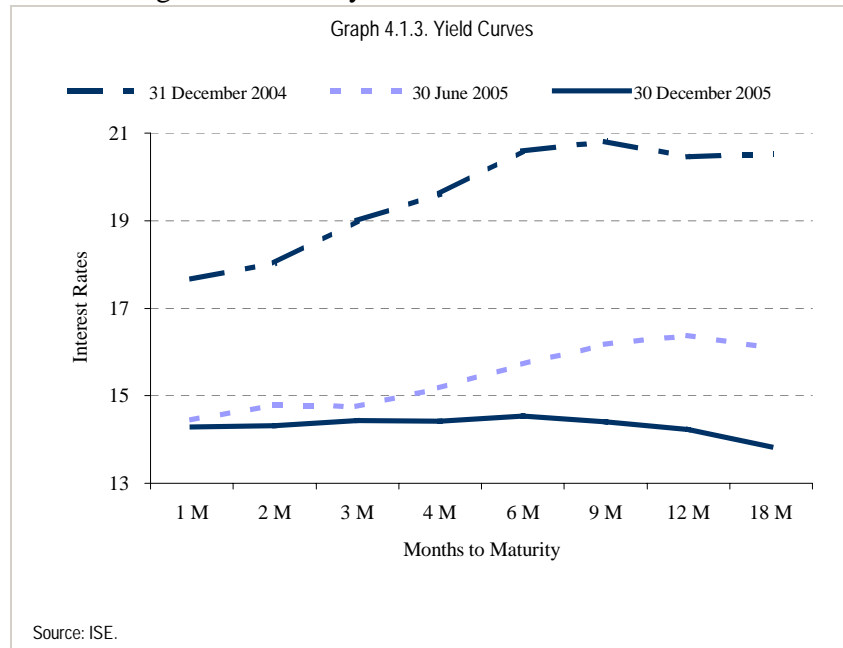
This tendency is supported by several factors, such as the ongoing decline in the public debt/national income ratio together with favorable domestic liquidity conditions; the high cash balance of the Treasury by the Central Bank of Turkey; and the expectations that the budget deficit/national income ratio would fall below the Maastricht criteria of 3 percent in 2006. The destabilizing effect of the Treasury's debt burden on the budget balance caused by the bail-out of the public and private banks after the 2001 crisis, began to alleviate in 2005. The revenues collected from the asset sales by the Savings Deposits Insurance Fund (SDIF) and privatization revenues are expected to support the reduction of public sector borrowing requirement in 2006, as well.

The assurance of the start of the negotiation process towards full EU membership on 3 October 2005 strengthened favorable expectations and increased the demand for the Treasury's borrowing instruments. Meanwhile, the Government's decision to impose withholding tax on T-bills and bonds to be issued from 2006 onwards was another factor increasing the demand for existing securities. The partly adverse effect of withholding tax, which is likely to be observed on the gross borrowing costs, is expected to be counterbalanced by the decline in the public sector borrowing requirement.

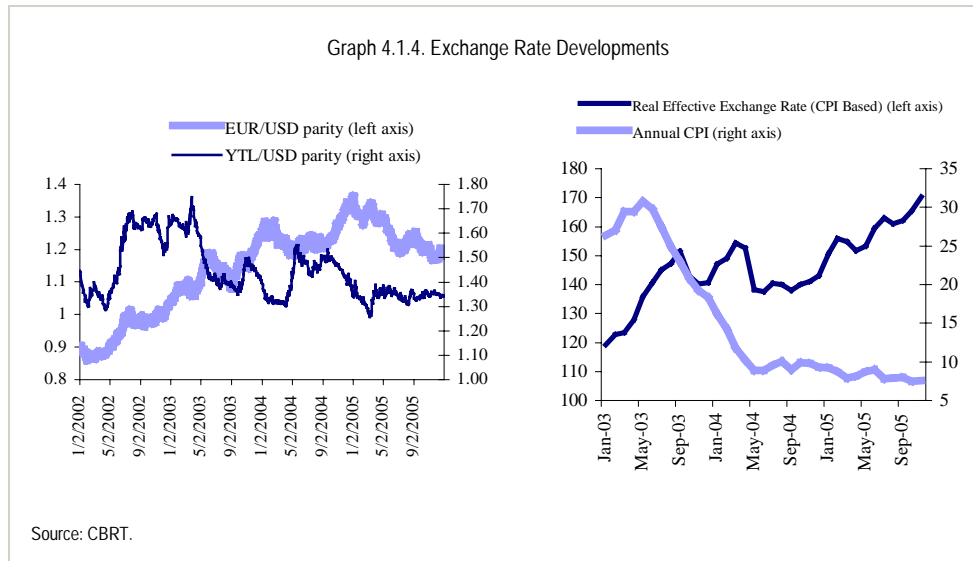


The CBRT gradually reduced the short-term borrowing rate from 18 percent in early-2005 to 13.5 percent at the end of the year. The benchmark interest rate formed in the ISE Bonds and Bills Market followed CBRT interest rate decisions (Graph 4.1.2). After October 2005, the benchmark interest rate was observed to be below the CBRT short-term borrowing interest rate indicating market's valuation of upcoming rate cuts.

Yield curves shifted downwards for all maturities in mid-2005, compared to end-2004. The factors effective in this development were; interest rate cuts by the CBRT, the favorable course of expectations and the continuing decline in the risk premium. Though lower for all maturities compared to end-June 2005, the end-year interest rates displayed a more limited decline compared to the first half of the year, due to the slowdown in interest rate cuts in the second half of the year (Graph 4.1.3). Besides, the downward sloping yield curve observed at the end of June for maturities exceeding 12 months, began to appear for maturities of 6 months and more, at the end of the year. The main factors that are likely to affect the yield curve in 2006 through the expectations channel are the stance of the monetary policy, the EU convergence process and the materialization of structural reforms. Furthermore, foreign demand for the Treasury's borrowing instruments; SDIF and privatization revenues, and the impact of the reduction in the ratio of corporate tax on total tax revenues will be the determining factors of the yield curve.

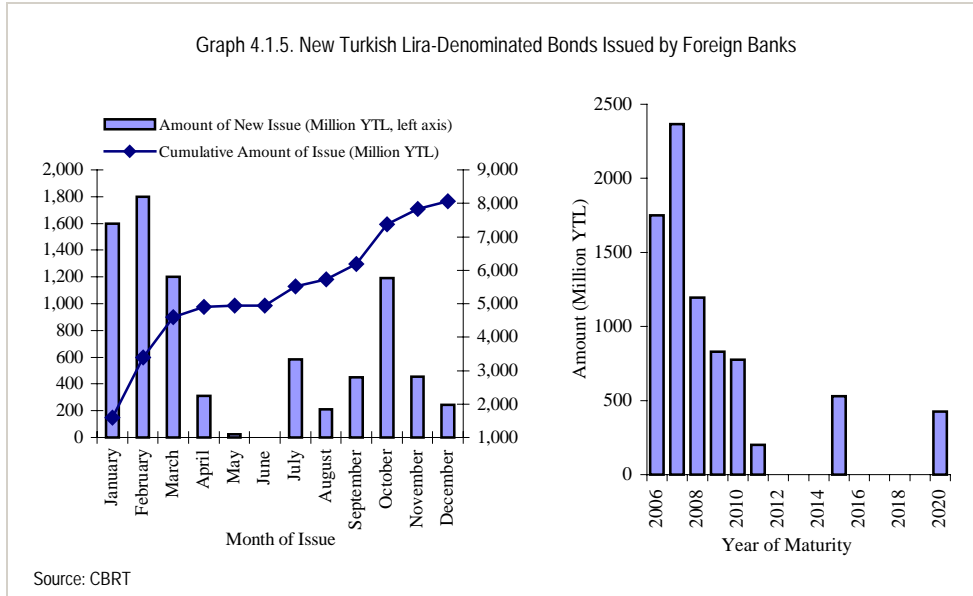


The appreciation trend of the New Turkish lira continued throughout 2005. This tendency decelerated vis-à-vis the US dollar from the second half of the year onwards because of the developments in the EUR/USD parity. Although the nominal strengthening of the New Turkish lira against foreign currencies remained low, as inflation still exceeds the levels observed in the developed countries, the real appreciation tendency of the New Turkish lira continued throughout 2005 (Graph 4.1.4).

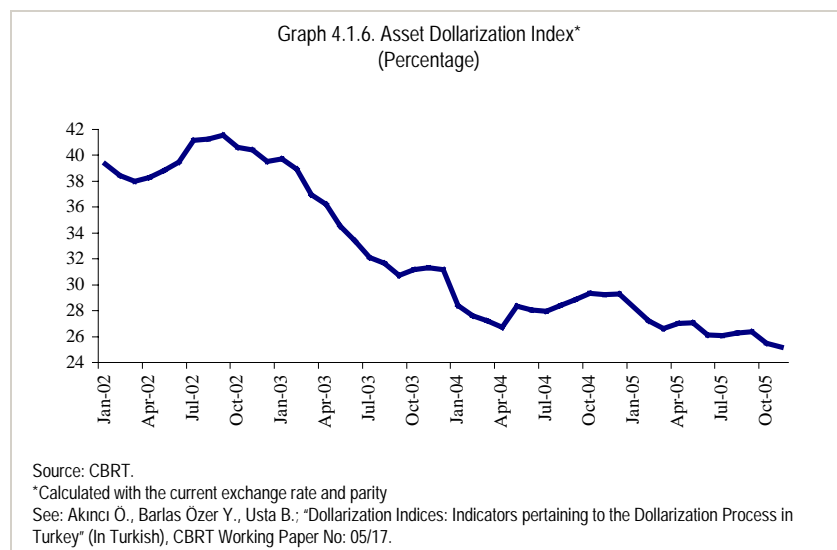


Due to the currency reform in 2005 six zeros were removed from the Turkish lira, enabling the borrowing instruments denominated in the New Turkish lira to be kept under the custody of international clearing houses. Together with the favorable economic developments, foreign finance institutions with high credit ratings began to issue bonds denominated in the New Turkish lira. These issues extended maturities and enhanced financial depth, created a potential to expand credit supply without causing maturity mismatch, as well as increased the capability of the Treasury for long-term bond issues. All these developments involve positive signals for the functionality of inflation targeting. With the extension of maturities and the decline in risk premium, the stance to be adopted by monetary policy in the upcoming period gains importance. This, in turn, enables the CBRT to act with a medium-term perspective.

Although the longest maturity in the New Turkish lira-denominated bonds issued by the foreign finance institutions is 2020, the redemption date is between 2006-2008 for the majority of the issues. The total amount of issues, which stagnated in the second and third quarters of 2005, resumed its upward trend from October onwards, with the assurance of the start of the negotiation process towards full EU membership (Graph 4.1.5). The supply of these securities is expected to increase and their average maturity is expected to extend even longer, together with ongoing gains in price stability.



The asset dollarization index, which is defined as the ratio of foreign assets of the non-banking sector to its total portfolio, declined from 29.3 percent at the end of 2004 to 25.2 percent as of end-November 2005. While this development stemmed mainly from the increase in currency in circulation and the New Turkish lira time deposits, an upward trend was observed in equities, as well. Compared to end-2004, New Turkish lira-denominated government securities held by the non-banking sector declined, whereas the total foreign currency holding of the sector did not register any significant change. Consequently, the tendency of residents (the non-banking sector) to make their new investments in New Turkish lira-denominated instruments continued in 2005 (Graph 4.1.6). On condition that macroeconomic stability continues, a similar process is foreseen for 2006.



The CBRT made a total of almost USD 22.2 billion worth of foreign exchange purchases in 2005, of which USD 14.5 billion came from interventions and USD 7.7 billion stemming from daily foreign exchange auctions. As of 30 December 2005, the gross foreign exchange reserves of the CBRT reached USD 50.5 billion.

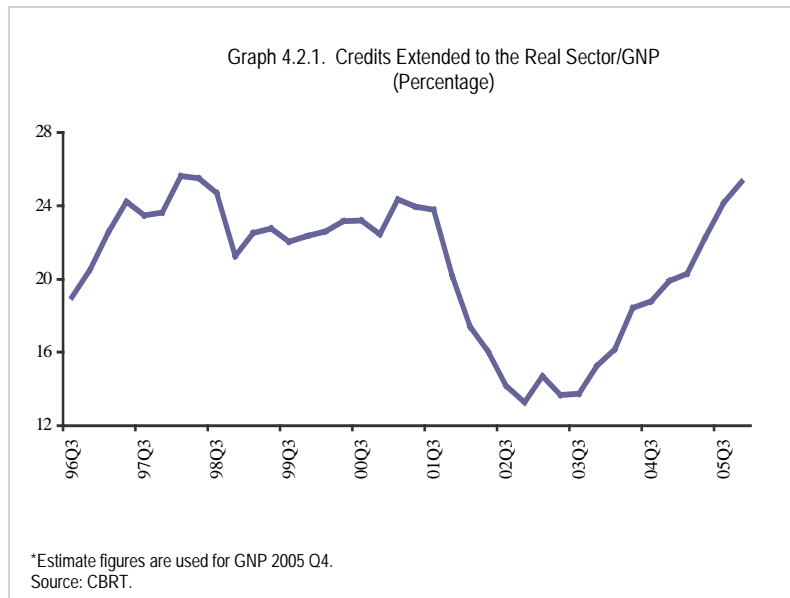
In 2006, the amount set for the daily foreign exchange buying auctions, conducted for reserve build-up purposes was raised to USD 20 million from USD 15 million, while the option to sell granted to successful bidders was raised to USD 40 million from USD 30 million. Likewise, in 2006, foreign exchange rates will continue to be determined by supply and demand conditions in the market. A number of factors or developments are likely to exert pressure for the appreciation of the domestic currency. These are the EU and IMF anchors; favorable developments in public finance; installment payments of the privatized assets; the expected high level of foreign direct investments; the enactment of the law allowing sale of real estate to foreigners; mergers and acquisitions, especially of foreign origin; the presence of those assets in the privatization portfolio, which may bring in significant revenue; the favorable course of international liquidity; and the portfolio preferences of residents. On the other hand, the risk factors that might exert pressure for the depreciation of the New Turkish lira are potential deviations in the EU negotiations process and/or the IMF program; likely changes in international liquidity conditions, and worries pertaining to the course of the current account deficit.

4.2. Financial Intermediation and Credits

The banking system has been performing its intermediation function in an increasingly more effective way. The macroeconomic factors instrumental in this healthy development are; the EU and IMF anchors retaining their power; gains from structural reforms; and the increase in the resources that are likely to be converted into credits, which is attributable to the decline in fiscal dominance. The factors unique to the sector can be listed as; strengthening of the financial structures of banks through restructuring; rising awareness of risk management and internal auditing; increasing competition due to the rising share of foreign banks in the sector; and strengthening of the system for the supervision and auditing of banks.

Gains attained in the sound functioning of the financial system in performing its intermediation function have great significance for price stability. Favorable developments in the sector affect domestic agents' perception of risk, change their portfolio attitude and reduce their inclination for foreign currencies. Besides, maturity extension of bank loans increase the weight of the financial sector in the economy. Thereby, the effectiveness of the credit channel in the monetary policy transmission mechanism, functioning through the financial system, has been increasing and making a direct contribution to price stability.

The recent expansion in the credit supply reflects a change in the portfolio preferences of the banks. The prospective shrinkage in the securities portfolio due to decreased supply of government securities as a result of the decline in fiscal dominance supports the credit supply. The marked decline in credit interest rates and the gradual extension of maturities, as a reflection of the normalization process in the economy, rendered credit utilization more attractive and gave rise to a significant increase in the demand for credits. Consequently, in 2005, consumer credits expanded rapidly and credits extended to firms sustained their steady upward trend (Graph 4.2.1, Table 4.2.1).



The process of rapid rise in consumer credits came into the picture in other loans (private consumption), automobile and housing loans, respectively, from 2003 onwards. The share of housing loans in consumer credits reached 43 percent as of December 2005, from 14 percent in early-2004, and surpassed

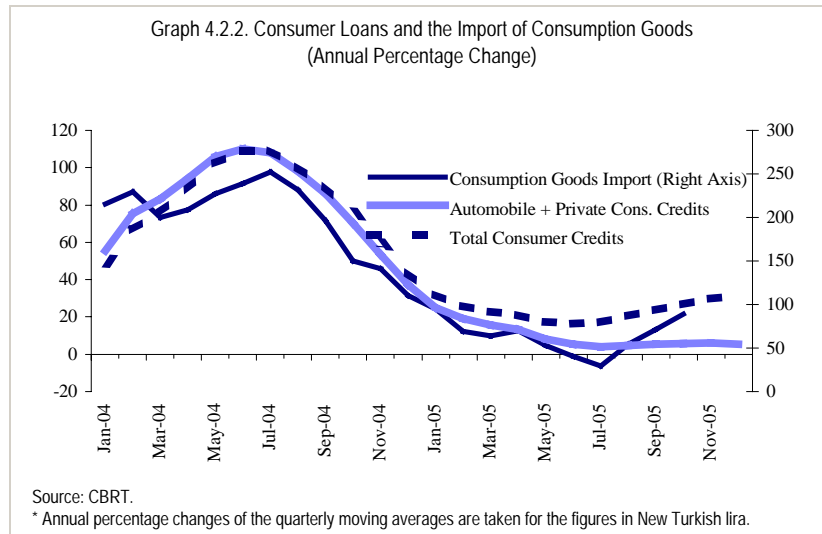
automobile and other loans. In the last quarter of 2005, there was a limited slowdown in the growth rate of housing loans, compared to the previous quarter. Yet, it is early to conclude that this is a persistent trend. (Table 4.2.1). Besides, it is foreseen that the increase in credit volume will be supported by several factors in the upcoming period, such as; Turkey’s still low level of total credits-national income ratio; the decline in credit interest rates; lengthening of average maturities; enhanced capital and profitability structure of the banking system; and continuation of the decline in the Treasury’s borrowing need. On the other hand, it is believed that, due to increased indebtedness, the growth rate of credits may reach saturation in the medium-term and begin to follow a steadier course; and experience a relative deceleration in its annual real growth rate.

Table 4.2.1. Development of Consumer Loans and Claims from Credit Cards
(Quarterly Percentage Change in Real Terms)

	2004Q3	2004Q4	2005Q1	2005Q2	2005Q3	2005Q4
Consumer Loans	7,7	4,0	17,6	23,4	23,3	14,0
Housing Loans	12,4	9,1	33,7	61,9	50,6	32,9
Automobile Loans	4,5	0,7	-0,7	11,7	11,4	5,6
Other Loans	8,3	4,4	23,8	11,7	11,3	1,2
Credit Cards	14,6	25,5	-2,4	8,4	6,3	1,9

Source: CBRT.

Rapid credit expansion is a phenomenon that needs to be monitored closely in terms of not only the demand developments, but also the trade balance. The increase in the expenditures of the residents through the channel of credit utilization may exert pressure on the trade balance, in case that the expenditures edge towards import goods. As a matter of fact, in the period from 2004 until today, a close relationship is observed between consumer credits and the import of consumption goods (Graph 4.2.2).



The rapid increase in the credit volume supports domestic demand. However, the rising ratio of household indebtedness stemming especially from the housing loans and the increased likelihood that credit repayments may put pressure on disposable income might be seen as factors limiting the growth rate of private consumption and domestic demand in the upcoming periods. At this point, the course of household income level and the profitability of the financial system are of great importance in terms of potential vulnerabilities in the medium term.

In conclusion, the CBRT will continue, in a medium-term perspective, to closely monitor the growth rate of total credits, with a special emphasis on housing loans, in terms of both price stability and financial soundness.

5. Public Finance

In recent years, fiscal discipline has become one of the main factors behind the improved economic stability. In this course, inflation came down while the economy continued to grow at high rates. Fiscal discipline maintains its importance for sustaining economic stability, preserving market confidence and strengthening the effectiveness of monetary policy, thus making possible the attainment of inflation targets in the upcoming period.

In the process of economic recovery, the improvement in budget performance has strengthened the confidence in the economic program by supporting the expectations that economic stability will be permanently achieved. Improvements in the said expectations, reduced the risk premium and real interest rates accordingly, and thus contributed to the increase in private consumption and investment demand. Revenues raised from privatization and the improvement in budget performance reduced the need for public borrowing. This development together with increase in the volume of credits extended to the private sector by banks boosted consumption and investment expenditures. In short, the improvement in the performance of the public sector contributed to economic growth significantly by enabling financial institutions to operate more efficiently on the one hand, and by stimulating the activities of the private sector, on the other hand. Moreover, in addition to its above-mentioned indirect effect, fiscal policy provided direct support to economic growth through the increase in public expenditures in 2005.

In 2005, budget deficit came down due to the fall in interest rates and extended borrowing maturities as well as the achievement of high primary surplus target. The transition to the three-year medium term budget regime starting from 2006 and the announced primary surplus target as 6.5 percent of GDP for the three-year period, as well as the intensive reform agenda indicate the determination in establishing sustainable fiscal discipline in the upcoming period. Achieving the fiscal targets and thus keeping up inflation expectations in line with the target will be possible with fulfillment of the reforms for sustaining fiscal discipline without delay.

5.1. Budget Developments

In 2005, budget discipline was maintained and significant progress was made in structural reforms despite some delays. It is anticipated that the consolidated budget deficit, which stayed at low levels throughout the year due to decreased interest expenditures, will remain well below the end-year target. Concurrently, based on the January – November period figures, the primary surplus is expected to exceed the end-year target. In the budget of 2005, current transfer payments increased more than expected due to payments to social security institutions. At the same time, revenues exclusive of taxes exceeded the program target on account of dividend income from state banks, recovery from interest and reclaims and revenues raised from the privatization of Telekom. Meanwhile, since the above-mentioned revenue items are excluded from the program-defined budget, the program-defined primary surplus is expected to remain rather below the expected level and become 4.8 percent of the GNP at the end of the year (Table 5.1.1).

Table 5.1.1. Consolidated Budget Aggregates

	Ratio of Realized Figures to Budget Projections * (Percentage)		2005-2004 Annual Rate of Increase	Share in GNP (%)		Annual Rate of Increase (%)	
	2004 January- November	2005 January- November	Percentage Increase January- November	2005* End-Year Projection	2006* Program	2005* End-Year Projection	2006* Program
Revenues	89.2	95.9	22.8	27.0	26.7	18.3	10.0
1. General Budget Revenues	89.1	95.9	22.9	26.6	26.3	18.2	10.1
Tax Revenues	90.0	90.7	19.3	22.1	21.9	18.8	10.5
Other Revenues	84.8	127.4	41.1	4.5	4.4	15.3	7.9
2. Annexed Budget Revenues	94.8	93.2	19.3	0.4	0.4	21.3	5.8
Expenditures	87.3	81.4	2.9	30.1	29.1	3.5	7.8
Interest Expenditures	92.6	73.4	-20.8	9.6	8.6	-17.8	-0.3
Non-Interest Expenditures	83.8	86.0	20.4	20.5	20.6	17.7	11.5
Personnel Expenditures	92.5	93.4	11.3	6.5	6.6	9.3	12.7
Goods and Services Procurement	62.8	70.3	27.4	2.9	3.0	11.3	12.8
Current Transfers	92.9	99.0	25.1	7.4	6.9	30.2	3.7
Social Security Institutions	93.8	100.8	22.2	4.8	4.3	24.1	-0.7
Capital Expenditures	62.5	64.4	29.1	2.0	2.0	21.8	9.5
Budget Balance	80.5	18.7	-77.7	-3.1	-2.4	-52.4	-11.8
Primary Balance	106.6	131.8	29.0	6.5	6.1	20.0	5.2
Program-Defined Primary Balance	110.9	109.7	5.7	4.8	5.1	6.4	17.2

Source: Ministry of Finance, SPO.

*SPO 2006 Program.

The budget for 2006, which has been prepared in line with the public sector primary surplus target that corresponds to 6.5 percent of the GNP, indicates that the economy will approach the balanced budget target in the medium term. The 2006 budget reveals that non-tax revenues will continue to contribute to this process. Compared to 2005, it is observed that in 2006 the

weight of current transfers in budget expenditures will decline and the resources saved on this item will be transferred to the other items of non-interest expenditures.

The fiscal policy for 2006 includes adjustments not only concerning the achievement of fiscal discipline but also the improvement of its quality. In this framework, certain adjustments are envisaged in order to alleviate the tax burden and reduce expenditures on transfers to social security institutions. The corporate income tax is modified by reducing the tax rate and gradually abolishing tax abatements and exemptions. Implementations aimed at alleviating the tax burden are expected to favorably affect private sector activities and the investment environment by reducing costs and increasing the competitiveness of institutions. Besides new arrangements concerning the corporate income tax, the personal income tax system has also been amended. In this respect, legal adjustments for simplifying the personal income tax, extending the tax base and increasing its effectiveness are planned to be put into practice in 2006. Another tax reform is the strengthening of the Revenue Administration established within the Ministry of Finance following the tax administration legislation enacted in May 2005.

On the expenditures side, certain measures are to be taken, in order to reduce transfers to social security institutions. In the light of these measures, which comprise the control of health expenditures of these institutions and the improvement of premium collections, transfers to social security institutions that are expected to exceed 4.5 percent of the GNP in 2005 are aimed to be realized as 4.3 of the GNP in 2006. Current transfers are anticipated to increase by a limited amount in the 2006 budget, which reflects the expectation that measures concerning social security institutions will be effective (Table 5.1.1).¹

Lastly, keeping revenue losses that will arise from tax adjustments at a limited level and controlling transfers to social security institutions are critical for primary surplus developments to be consistent with the targets in 2006. In the framework of the new corporate income tax adjustment, it is envisaged that along with the reduction in the tax rate, investment abatements will be abolished. Therefore, it is anticipated that revenue losses arising from the cut in tax rate will be partially compensated with the abolishment of investment

¹ Details about the above-mentioned measures and reforms applied in the scope of the program, and the intended implementation schedule are given in Box 5.1.

abatements. It has been assured that resources to cover revenue losses that are likely to arise from corporate tax adjustments, will be financed through expenditure cuts. It should be noted that in case of resorting to indirect taxes to cover possible shortfall in primary surplus, which may arise from the above-mentioned implementations, might pose risks to the inflation target.

5.2. Budget Financing and Developments in Debt Stock

5.2.1. Budget Financing

In 2005, net borrowing was realized above the financing requirement, and the strategy adopted was aimed at further increasing the cash reserves. The Treasury mainly resorted to net domestic borrowing in financing the budget deficit, and was net payer in external borrowing. In the 2006 consolidated budget financing structure, there is a shift towards non-debt creating resources, while the Treasury maintains its net external debt re-payer position (Table 5.2.1).

Table 5.2.1. Financing of Consolidated Budget Cash Deficit

	2005 January-December		2006 ⁽¹⁾	
	Billion YTL	Share %	Billion YTL	Share %
Financing	13.3	100.0	12.1	100.0
Borrowing (Net)	18.9	142.3	2.0	16.5
External Borrowing (Net)	-2.5	-19.2	-0.7	-5.8
Domestic Borrowing (Net)	21.4	161.4	2.6	21.5
Other	-5.6	-42.3	10.1	83.5
Privatization Revenues	3.6	26.8	7.0	57.9
Receipts from Onlending ⁽²⁾	1.3	10.2	3.1	25.6
Lending (-)	0.9	6.9	-	-
Currency/Deposit and Other Transactions ⁽³⁾	-9.6	-72.3	0.0	0.0

Source: Treasury.

⁽¹⁾ 2006 Treasury Financing Program.

⁽²⁾ Mainly composed of transfers from SDIF.

⁽³⁾ Negative value indicates an increase.

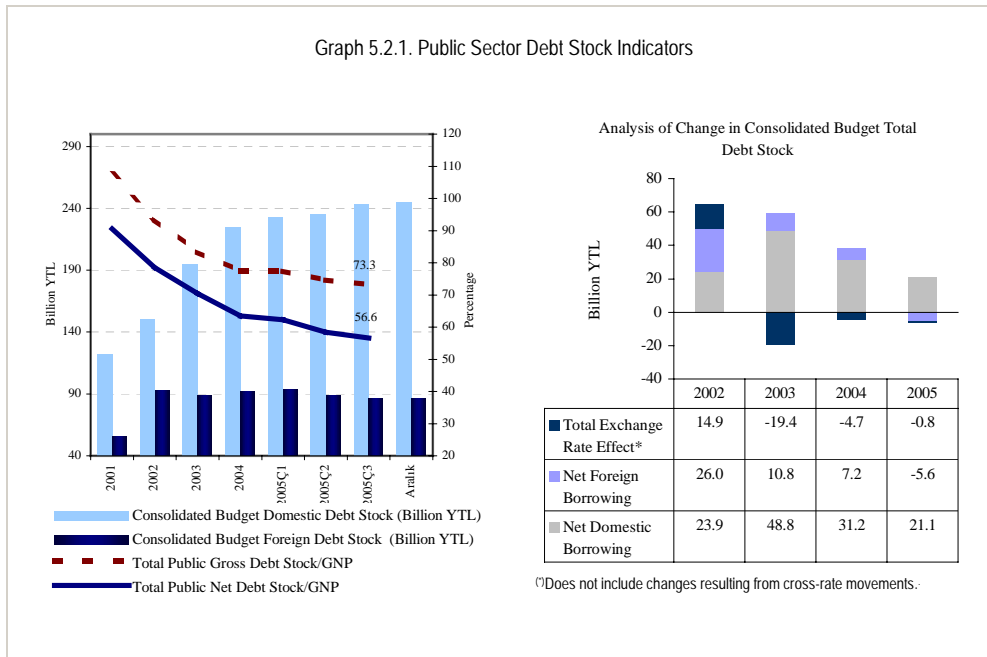
In 2005, the SDIF redemptions and transfers from privatization revenues made up approximately 35 percent of the consolidated budget financing requirement (Table 5.2.1). Contribution of the abovementioned transfers is expected to continue in 2006.² As sales transactions materialize, revenues raised from privatization activities carried out in 2005 will be collected in installments in the coming years according to the contracted payment maturities. Depending on the expenditures of the Privatization Administration, part of the collected privatization revenues will be transferred to the Treasury.³

² Starting from May, SDIF started to pay Treasury receivables arising from private placement securities issued as a loan to the SDIF, in the framework of the financing of banking system restructuring. In the upcoming period, SDIF will continue to pay back its debts to the Treasury, depending on its collection performance.

³ Pursuant to the Law No. 4568 enacted on 26 May 2000, privatization revenues are primarily used to cover the expenditures of the Privatization Fund. The excess cash amount of the Fund is transferred to the Treasury in order to be used in domestic and external debt payments.

5.2.2. Developments in Debt Stock

In 2005, decreased interest payments and the high primary surplus led to a slowdown in the rate of increase in public debt stock. Consequently, the ratio of total public debt stock to GNP continued to decrease (Graph 5.2.1).



In 2005, borrowing was mainly realized through the issue of discounted securities. Along with discounted securities, coupon bonds with maturities of three and five years, most of which had floating rates, were issued in order to extend the maturity of the debt stock. This borrowing strategy caused the share of floating rate securities in debt stock to increase. In the borrowing strategy of the Treasury for 2006, it is envisaged that fixed rate coupon securities will be issued each month along with floating rate securities. Increased borrowing in fixed rate coupon securities will reduce the sensitivity of debt stock to interest rate movements, while it will restrain the decrease in the cost of debt stock in the environment of declining interest rates (Graph 5.2.2).

It is believed that the decrease in the share of YTL denominated short-term debt stock, foreign currency-denominated and foreign exchange-indexed debt stock in the total debt stock favorably affected expectations in 2005, by reducing the sensitivity of debt stock to interest rate and exchange rate movements. Persistence of this trend in 2006 and onwards will provide an

BOX 5.1. COMMITMENTS ABOUT FISCAL POLICY

In order to increase effectiveness and efficiency in budget implementations in 2006 and onwards, a number of reforms and adjustments have been envisaged in social security, personnel management, wages, and particularly in revenues. These adjustments are extremely important in terms of strengthening the corporate structure, increasing the budget quality and achieving the budget targets. In this framework, the timely fulfillment of these adjustments, which are aimed to achieve the budget targets, are critical in terms of inflation expectations.

Box 5.1.Table.1. Commitments as Stipulated in the Program Implemented with the IMF

Commitments	Timing	Criteria
There will be no new amnesty for public sector receivables, except for those companies in the portfolio of the privatization administration	Continuous	Performance Criterion
The ratio of new recruitments in the state economic enterprises sector will not exceed 10 percent of those leaving through attrition	Continuous	Structural Benchmark
Maintaining consistency between lump-sum taxes, SEE prices and program projections	Continuous	Structural Benchmark
Approval of regulations for the implementation of the Public Finance Management and Control Law	End of December 2005 (Completed. Principles and Procedures for Internal Audit and Pre-Financial Inspection was promulgated in the Official Gazette dated 31.12.2005)	Structural Benchmark
Establishment of a tax policy unit within the Ministry of Finance	End of December 2005 (Draft law has been discussed in the GNAT Plan and Budget Committee.)	Structural Benchmark
Completion of detailed reviews on public sector employment and wage structure	End of December 2005 (Completed.)	Structural Benchmark
Approval of legal amendments concerning the improvement of tax structure through unifying the tax scales applied to wage and non-wage incomes and reducing the number of tax bracket	End of December 2005 (Being discussed in the GNAT Plan and Budget Committee.)	Structural Benchmark
Approval of the law on social security administrative reform in GNAT	End of January 2006	Performance Criterion
Approval of the draft law on pension reform in GNAT	15 February 2006	Performance Criterion
Completion of the functional restructuring of the revenues department in a way that will include re-organization of local tax offices	End of April 2006	Structural Benchmark
Submission of the legislation for personnel income tax reform to GNAT	End of May 2006	Performance Criterion
Establishment of a large-taxpayers unit within the Revenues Administration	End of June 2006	Structural Benchmark
Approval of the legislation for personal income tax reform in GNAT	End of September 2006	Performance Criterion

6. Medium-term Forecasts

In this section, assumptions regarding the fundamental macroeconomic variables are summarized, inflation forecasts are presented and the potential risks that could lead to significant deviations from these forecasts are analyzed. Considering a policy horizon of one-and-a half year, the forecasts are presented so as to cover the first half of 2007.

6.1. Current Stance, Short-term Outlook and the Assumptions

The assumption set on which the medium-term projections are based is obtained by compiling and quantifying the knowledge and analyses put forth in detail in the preceding sections of the report. There are two sets of assumptions: assumptions regarding domestic economic activity and assumptions regarding external factors. The assumptions about domestic activity are based on perceptions of the current stance and a detailed analysis of the short-term outlook; and they possess a significant importance in the forecasting process as they form the starting point of the projections.

The favorable effect of the demand conditions on the disinflation process is expected to continue in 2006, however this contribution will be more limited compared with the previous years. This observation forms the basis of the medium-term outlook. GNP figures for the third quarter of 2005 indicate that economic growth continues without any acceleration. The fast increase in consumption expenditures can be mostly attributed to the increase in the durable goods component, which is mostly due to relative price movements. By contrast, the growth rate of consumption demand excluding durables is rather modest. Accordingly, medium term forecasts are constructed under the assumption that demand-led pressures on inflation is limited. Meanwhile, the upward trend in investment expenditures continued in 2005. This has led the rise in productivity to continue despite a significant increase in non-agricultural employment. The rise in investment expenditures also increased the production capacity.

Under prevailing conditions, the price dynamics of services warrant a significant amount of attention. 2005 witnessed a widening of the gap between goods and services prices, in continuation of a trend that had become apparent during the recovery and structural transformation period in the aftermath of the 2001 crisis. The stickiness in services inflation is mostly due to the inelastic

demand for services and backward-looking behavior. At first sight, it may be argued that services inflation remaining well above the goods inflation is a natural development when one takes into account the rapid rise in the productivity of tradable goods and the structural transformation period that the economy is going through. However, the short supply in the housing sector and the consequent rapid rise in housing prices exert additional pressure on rents, as well as on the related services. In fact, price increases in the rent subgroup and in the food services—in which rents constitute an important input cost—are almost at the same level as those recorded in 2004 despite the downward trend in headline inflation. Therefore, the forecasts are based on an outlook in which services inflation is expected to remain high in 2006, mainly because of structural factors and habit persistence in pricing behavior that often characterizes most disinflation periods.

Furthermore, it is expected that the downward trend in inflation will come to a temporary halt in the first quarter of 2006 due to the base effect of the VAT reductions on food, health and education sectors introduced the first quarter of 2005, and also due to hikes in the prices of tobacco products.

Besides the observations regarding domestic economic activity, projections and assumptions about external factors also play a very important role in producing the medium-term inflation projections. This set of assumptions consists of the projections for international commodity prices (crude oil, metal prices, etc.), global liquidity conditions and the major macroeconomic variables of the foreign economies, such as growth, interest rates and inflation, until end-2006. The developments in our major trading partner, European Union, sits at the center of these projections.

The projections regarding the European Union (EU) have been obtained from the December 2005 issue of the “Consensus Forecasts”, which is a compilation of the projections produced by a large number of experts. According to these forecasts, the GDP growth projections for the European Union have been revised downwards and it is projected to be 1.9 percent in 2006. While the ECB has increased its policy rates by a quarter basis points for the first time after four years in December 2005, further increases in policy rates are unlikely given the prospects of low economic growth in the Euro-area. Based on the December 2005 issue of the “Consensus Forecasts”, EU-

harmonized CPI inflation is projected to remain close to the targeted 2 percent level in 2006.

Developments in crude oil prices are crucial in the assessment of the impact of import prices on inflation. Crude oil prices have increased quite rapidly in 2005, despite a slight temporary decline observed towards the end of the year. The forecasts have been based on the assumption that oil prices will stay constant throughout the forecast horizon. Even in this case, the effect of past hikes in crude oil prices on inflation is expected to continue for a while. Inflation expectations, on the other hand, are assumed to follow a benign course.

Besides the developments regarding the domestic economy and external factors; the expected course of the risk premium for 2006 is also important for medium-term forecasts, as a decline in the risk premium affects both exchange rates and long-term interest rates directly. It has been assumed that the risk premium will keep its downward trend under the baseline scenario for 2006, where there will be no breakdown in the accession talks with the EU, the current economic program will continue to be implemented, the global liquidity conditions will continue to be in favor of the emerging markets, and fiscal discipline, structural reforms and privatization will remain on track. Therefore, the forecasts are based on the assumption that the composition of capital inflows will continue to be dominated by long term maturities, and accordingly that the New Turkish lira will maintain its strength in the medium term.

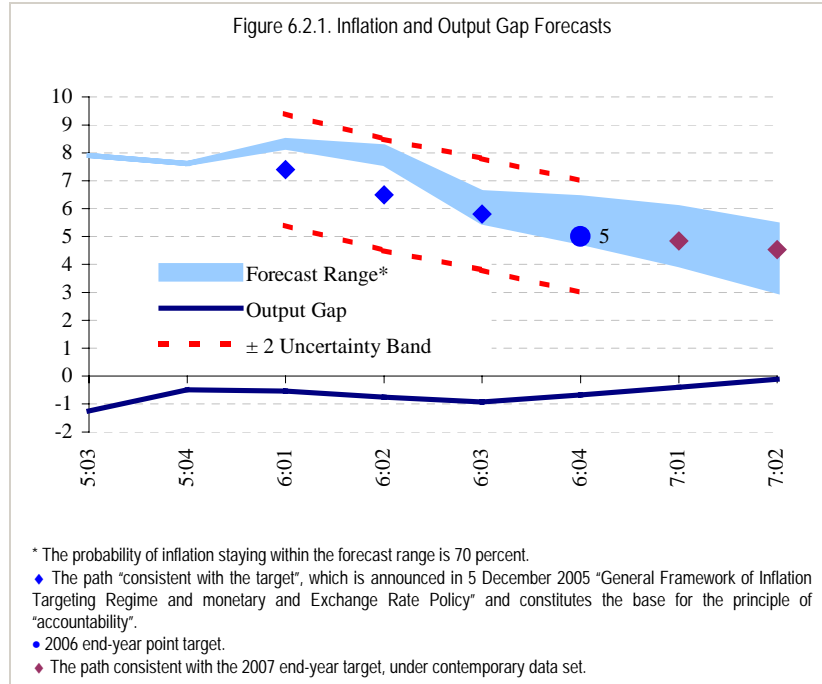
6.2. Interpreting the Forecasts

Within the framework of the implicit inflation targeting strategy during 2003-2005, end-year inflation targets were announced and realizations undershot the targets. The favorable outcome of inflation rates remaining below the targeted rates in recent years led to perceptions that the targets announced by the CBRT were the “upper limit”, which was a reasonable strategy under the disinflation period. However, from now on, the CBRT will treat any upward or downward deviations from the target symmetrically. In other words, a significant downward shift of inflation from the target will be treated as seriously as an upward deviation. As it takes time for monetary policy decisions to influence the economy, monetary policy will focus on the consistency of the future, as opposed to the current, rate of inflation with the respective targets. In this context, there would be no instantaneous reactions to temporary effects of exogenous shocks on inflation, but rather, policy reactions would be spread over time and emphasize medium-term targets. In sum, what matters for the CBRT is not temporary fluctuations in inflation but the consistency of forecasts with medium-term targets. Taking into account this medium-term perspective, forecasts are produced for the period until mid-2007.

As inflation is measured using a very comprehensive index, namely the Consumer Price Index, it may display fluctuations that may arise from factors beyond the control of monetary policy. Oil price developments, changes in international liquidity conditions and global risk perceptions, adjustments in indirect taxes and public prices, unforeseen developments in unprocessed food may sometimes lead to fluctuations in inflation. All these factors evaluated together with the uncertainties pertaining to the monetary transmission mechanism imply considerable uncertainty on the forecast. That is why forecasts are not presented as a line, but as bands.

Under the above assessments and assumptions, end-2006 inflation forecasts remain in the 4.7-6.3 percent range (Graph 6.2.1). Underlying this forecasts is a short term interest rate path remaining constant for the first couple of months in 2006 and displaying a gradual decline thereafter. It should be once more emphasized that the forecast, and thus the interest rate path, is constructed so as to attain the medium-term targets, under the contemporary information set. *This path should not, in any circumstances, be regarded as a*

commitment of the CBRT; it is subject to change as the economic conditions and assumptions change.

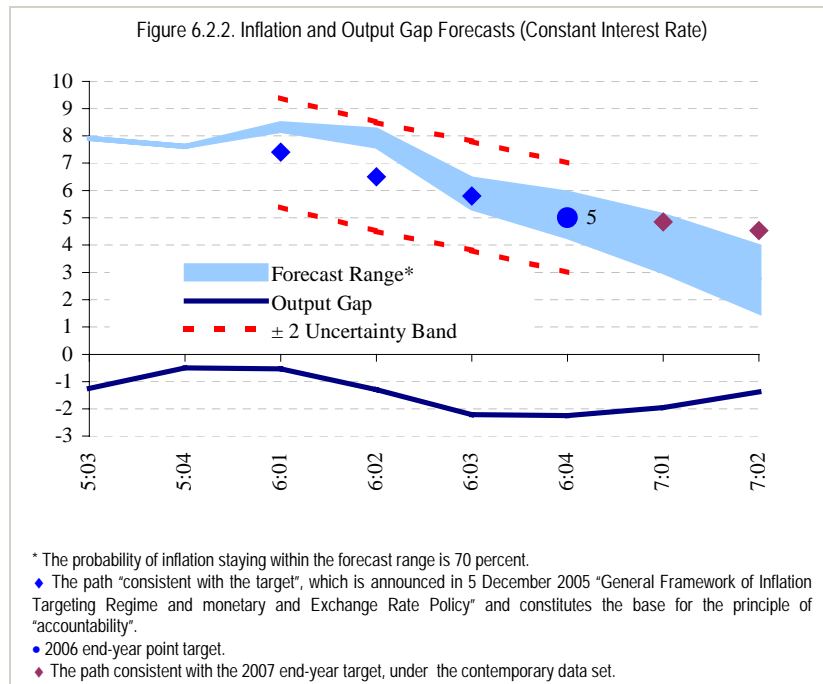


The assessments and assumptions suggest a decline in inflation forecasts over the next eighteen months. Inflation will exhibit an upward movement in the first quarter of 2006 and then decline again in the second quarter. As of the third quarter, the downward trend will become more evident and the end-year inflation will be close to the targeted rate. Under the currently available information and the assumptions mentioned above, inflation is forecasted to move to the range of 3-5.5 percent by mid-2007. It should be noted that the inflation forecast reflects implicitly the medium term approach explained above, and thus, that the interest rate path is also constructed within this approach.

Graph 6.2.1 also presents the forecasts of the output gap underlying the inflation forecasts. Under this scenario, although the output gap will be close to zero, it will remain negative throughout 2006 (negative output gap means that the level of aggregate demand does not exert upward pressure on inflation). More specifically, final domestic demand will continue to rise in a stable manner, and the contribution of net exports to the domestic value added will

remain limited. As a result, the contribution of domestic aggregate demand to the downward trend in inflation will decline.

The forecasts presented in Graph 6.2.2 have been produced under a scenario where the current stance and the assumptions underlined above are maintained, but the short-term interest rate is fixed at 13.5 percent till the end of 2006. This scenario disregards the medium-term approach and mechanically imposes the assumption of a monetary policy characterized by the fixed short term interest rate. Under this scenario, forecasts indicate that inflation will fall faster compared with the previous scenario, staying within the 4.2-5.8 percent range by the end of 2006 and moving to the 1.5-4 percent range by mid-2007. In other words, under the fixed interest rate assumption, inflation will be well below the targets in the medium term. In this case, output gap becomes significantly negative as of the second quarter of 2006, implying that aggregate demand will stay well below the potential output.



It should be stressed once more that the point forecasts are produced in the light of currently available information. Therefore, all the assumptions underlying the forecasts are subject to change, and that in such a case, both the forecasts and the future stance of the monetary policy will change. For

instance, volatility in food prices, adjustments in indirect taxes or other related developments would necessitate a revision in the forecasts.

6.3. Risk Factors

The CBRT considers the possibility of the sustained rise in oil prices as one of the main risk factors. The effects of oil prices on inflation can be decomposed as first-order and second-order effects. The first-order effects are observed in goods and services in which oil is used intensively as an input. These effects, which work mainly through the sub-components of transportation and housing groups, have pushed inflation up in 2005. While the contribution of oil-sensitive components to inflation has reached as much as 1.5 percentage points within 2005, the total effect has decreased to about 1 percentage point with the decline in oil prices towards the end of the year.

The secondary effects, on the other hand, become effective by means of relative price movements and expectations. The impact of a rise in oil prices on inflation expectations, if it alters the pricing behavior and wages, can be considered as a secondary effect. That the central banks should not react to the first-round effects of oil prices is a widely-accepted notion. Accordingly, the CBRT has not reacted to the hike in oil prices, as the second-round effects have remained limited during 2005. Despite the 1.6 percentage point fall in inflation during 2005, 12 month ahead inflation-expectations have decreased by 2.9 percentage points, suggesting that the second-round effects are likely to be contained at the beginning of 2006 as well.

Under a scenario in which oil prices move to much higher levels, the possibility of second-round effects will increase. For instance, if the oil price jumps to 100 USD per barrel in the upcoming months and maintains this level throughout 2006, the first-order effects may reach 3 to 4 percentage points. In such a case, the CBRT shall react only to potential second-round effects. In other words, in case of a huge increase in oil prices, the CBRT will tolerate some deviation from the end-2006 target, however it will react so as to prevent the second-round effects and to keep medium-term expectations under control.

Domestic or external factors that lead to sharp changes in the risk premium may also cause significant deviations in the forecasts. In 2006, the main factors that can alter the course of the risk premium are considered to be of external

origin, such as potential fluctuations in global liquidity conditions. The historically low levels of long-term interest rates in developed countries have directed global funds to developing countries, especially to ones that took important steps towards macroeconomic stabilization such as Turkey. The reversal of this trend may lead to fluctuations in the financial markets. Although the latest developments seem to signal that global liquidity will remain abundant in 2006, these kind of risks should never be ignored since they may have a significant impact on inflation under current conditions. Should such a risk realize, the CBRT will act in line with a medium-term approach and will not react if the shock is perceived as a temporary one. On the other hand, a long-lasting increase in the risk premium may put a significant pressure on inflation by leading to a permanent depreciation of the New Turkish lira. Although exchange rate pass-through has weakened under the floating exchange rate regime, the impacts of permanent upward movements have not been fully tested yet. Moreover, the new price index introduced in 2003 exhibits a slightly higher exchange rate pass-through than the old one (Box 2.1). Therefore, a permanent change in the risk premium may necessitate a reaction of the monetary policy.

One other main risk regarding the attainment of end-year inflation target, is the stickiness in services inflation. Even though the service-price inflation is expected to come down gradually, the contribution of services inflation to the CPI inflation is still predicted to reach about 2.5 percentage points in 2006. The attainment of the end-2006 inflation target, then, would require goods-price inflation to remain within the 3 to 3.5 percent range, which is only possible under favorable developments in cost factors.

Last, but not the least, agricultural prices, other energy and international commodity prices, indirect tax adjustments and the prices of administered goods and services can always be listed as risk factors for inflation. What is crucial is that, the CBRT should be able to clearly explain the sources of any significant deviation from the target, and inform the public on the monetary policy that needs to be implemented to drive inflation back to targets. As the re-adjustment period will depend on the type and size of the shocks, the estimated duration of any re-adjustment will be announced once the sources of the shocks have been identified.

BOX 6.1. INFLATION TARGETING STRATEGY AND ACCOUNTABILITY

Within an inflation targeting framework, an inflation path consistent with the 2006 end-year target of 5 percent has been published along with an uncertainty band of 2 percentage points in both directions. The inflation path consistent with the end-year inflation target and the uncertainty bands around the path are shown in Table 1. In case the inflation figures fall outside the uncertainty band, the Central Bank, in accordance with the accountability principle, shall submit a separate report to the Government explaining the reasons of the incident and the measures to be taken, and share this report with the public.

Box 6.1. Table 1. Inflation Path Consistent with the Inflation Target and the Uncertainty Band				
	March 2006	June 2006	September 2006	December 2006
Uncertainty Band (Upper Limit)	9.4	8.5	7.8	7
Path Consistent with the Target	7.4	6.5	5.8	5
Uncertainty Band (Lower Limit)	5.4	4.5	3.8	3

This path is also the basis of performance criteria to be used in the quarterly reviews to be held within the IMF-supported program. Accordingly, an inflation outcome that falls out of the band will be considered as a violation of program conditionality, in which case the necessary measures to be taken within the program shall be announced and talks with IMF staff will be organized. Therefore, any announcement made to inform the public in case of a likely violation of the program conditionality will also be presented to the IMF and thus a certain level of transparency will be attained.

At this juncture, there is a critical point that needs special emphasis: The quarterly inflation path does not mean that monetary policy will focus on quarterly periods. What matters to the Central Bank in the medium-term is that inflation declines to 5 percent by the end of 2006 and 4 percent by end-2007, displaying a gradual decline and achieving a degree of stability. The uncertainty band is a factor that will help the Central Bank to determine its monetary policy stance with a medium-term perspective. Within this framework, the monetary policy stance of the Central Bank will be shaped by the medium-term developments affecting the inflation rather than short term macroeconomic fluctuations caused by exogenous shocks.

The forecasts presented in this Report have been constructed so as to cover the period up to mid-2007. The consistency of inflation forecasts with the target in mid-2007 reflects the medium-term perspective. Under the currently available information set, inflation is forecasted to remain within the uncertainty band throughout the year, as presented in Graph 6.2.1.

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ABBREVIATIONS

BTS	Business Tendency Survey
CBRT	The Central Bank of the Republic of Turkey
CPI	Consumer Price Index
GNP	Gross National Product
GDP	Gross Domestic Product
GDBS	Government Domestic Borrowing Securities
GNAT	Grand National Assembly of Turkey
IFS	International Financial Statistics
IMF	International Monetary Fund
ISE	Istanbul Stock Exchange
MBOTE	Central Bank Special Consumption Index
OPEC	Organization of the Petroleum Exporting Countries
PPI	Producer Price Index
USA	United States of America
SIS	State Institute of Statistics
SEE	State Economic Enterprises
SCA	Special CPI Aggregates
SDIF	Saving Deposit Insurance Fund
TEA	Turkish Exporters Assembly
TURKSTAT	Turkish Statistical Institution
TÜPRAŞ	Turkish Oil Refineries Company
TÜRK TELEKOM	Turk Telecommunications Inc.
WPI	Wholesale Prices Index
YTL	New Turkish Lira
VAT	Value Added Tax