CENTRAL BANK OF THE REPUBLIC OF TURKEY

MONETARY POLICY REPORT 2004-II

CONTENTS

1. GENERAL ASSESSMENT: Recent economic developments

Within the framework of the program being implemented, the high growth and declining inflation trend , which gained ground over the past two years, will continue in the second half of 2004 as well. This trend is based on the evidence suggested by the growth, production and inflation data since the start of this year. Despite the adverse developments in cost factors caused by the depreciation of the Turkish lira and the increase in public sector prices thereby emerged during the second quarter, pressure on costs remained constrained as a result of the continuing rise in productivity.

Indeed, the increasing rate of capacity utilization during the last three quarters has given rise to a need for new investments and subsequent to the increase in investment expenditures, labor-capital ratio has grown both of which resulted in a drop in unit-labor costs and a rise in productivity. The disproportionate distribution of growth in personal consumption expenditures (PCE) among the consumption groups as well as the implementation of the incomes policy, in line with the tight fiscal policy framework, constraining the demand on necessities prevented the kind of demand pressure from acting upon consumer prices that would otherwise manifest itself as the outcome of the revival of domestic demand. As a consequence of these developments, consumer price inflation continued to decline in the second quarter of 2004 and was 8.9 percent at the end of June. According to the CBRT Expectations Survey, average end-year inflation expectation decreased to 10.9 percent.

It is predicted that the accelerating price increases in manufacturing industry due to the increase in production costs in the first half of the year will tend to slow down during the rest of the year. In addition, the pass-through from exchange rates to inflation has weakened owing to the adoption of floating exchange rates regime. Thus, the reflection of the exchange rate movements on prices has slowed down and become impeded. In view of this occurrence, it is unlikely that the observed cost increase should endanger the 2004 inflation target. However, the risk of the possible influence of the delayed effects of the above mentioned cost increases, the tendency of a possible revival of domestic demand, the continuity of the rigidity in the service sector and the difficulty of predicting agricultural products and food prices due to their vulnerability to seasonal conditions necessitate a careful follow-up of price increase in 2005, in which one-digit inflation is targeted.

As a consequence of the application of the present economic program, primary surplus proved to be in line with the targets in the first half of the year. Within the framework of the program being carried out with the IMF, the targets for net international reserves and net domestic assets remained within the predetermined limits for April. Yet, base money realised slightly above this level. This occurrence, as has been explained in detail in the previous reports, is the outcome of the recovery in inflationary expectations and the increase in money demand due to the decrease in inflation, exchange rates and interest rates. This situation does in no way contradict the primary target of price stability nor does it threaten the attainment of end-year inflation, target. It is worth mentioning that the interest rates establish the main policy instrument and that the monetary aggregates within the framework of the economic programme is determined endogenously. The fact that similar tendencies are likely to continue in future leads us to the conclusion that the monetary targets may have to be re-examined within this framework.

The encouraging developments that enabled the improvement in production costs during the first quarter of 2004 showed a relatively reverse tendency in the second quarter. During this period, the depreciation of the Turkish lira and the public sector prices, mainly the fuel-oil price increases, had been the main determinants of inflation. Turkish lira started to depreciate by the end of April and by the second quarter reached a rate of 7 percent deprecation on average against the exchange rate basket of US$1 and €0.77. The inflationary effects of this situation were most distinctly observed on wholesale prices.

The upward tendency of the exchange rates and the increase in international crude oil prices led to an increase in the raw material import prices of oil products. Under these circumstances, price adjustments had become imperative to avoid any tax loss. Fuel oil prices became effective primarily on the WPI. Moreover, parallel with the developments in foreign markets, the already mounting prices in metal and chemical industries gained further impetus by the increase in exchange rates which in turn played a major role on the relative increase in public sector related inflation. Following these developments inflationary tendencies in WPI, excluding agriculture, rose starting from April 2004.

The stable course of the food prices helped maintain the CPI below the level implied by the end-year target in the first six months. Therefore, non-food CPI increase remained in accordance with the inflation target despite the rigid prices of the service sector and the surging public sector prices.

In spite of the high increase in private consumption expenditures, no pressure as regards demand on consumer prices has been observed during the second quarter of 2004. This was primarily due to the public inclination to buy durables and the lack of an even distribution of the increase observed in private consumption expenditures among the consumption groups. The price of consumer durables remained relatively low as a result of the powerful course of the Turkish lira and high productivity increase in these sectors. The incomes policy implemented within the framework of tight fiscal policy and the low employment level restricted the expenditures of those 125 consumer goods which are especially sensitive to the level of income. Consequently, the first half of 2004 has been a period of high growth occurring simultaneously with the decrease in inflation.

2. INFLATION DEVELOPMENTS

Compared with the first quarter of the year, in those sectors excluding agriculture and food, price increases have accelerated and such factors as the depreciation of the TL and rise in public prices resulted in a relatively faster increase specifically in wholesale prices during the second quarter. Yet, the effects of cost pressures upon consumer prices have remained considerably limited. Furthermore, agricultural goods and food prices have been effective in pulling the inflation trend downward in the same period. In the period from January to June, seasonally adjusted inflation actualised as 7.2 percent in WPI (excluding agriculture) and as 5.2 percent in CPI (excluding food). In the light of this data, reaching the end-of-year CPI target of 12 percent is considered as a high probability outcome. The following are some of those factors, which are thought to be the main determinants of inflation in the period from March to June:

(1) depreciation of the TL,

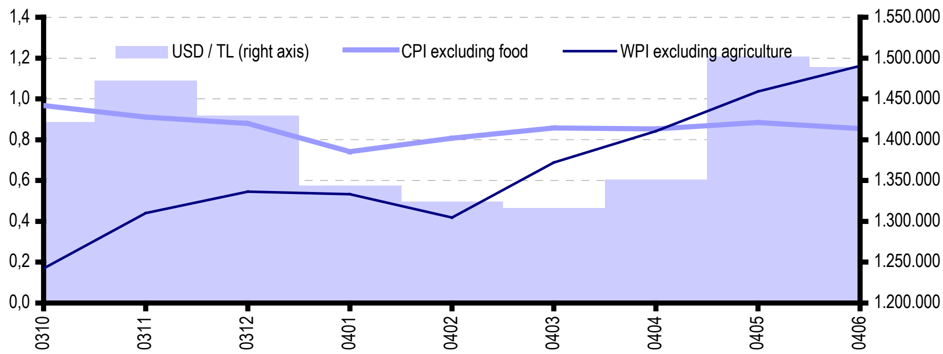
(2) price increases in the public sector, specifically in the fuel-oil group,

(3) course of agricultural goods and food prices,

(4) weakness of domestic demand pressure.

Exchange rates developments, which had a positive impact upon costs during the first quarter of the year, relatively reversed in the second quarter. By the end of April, depreciation of the Turkish lira against foreign currencies and the impact of this upon inflation have more significantly been observed on wholesale prices. From the beginning of April with the upsurge in exchange rates, inflation trend in WPI excluding agriculture increased while CPI excluding food followed a horizontal course (Graph 2.1). On the other hand, increase in WPI excluding agriculture remained limited when compared with the depreciation of the TL.

Graph 2.1 Seasonally adjusted six- month moving averages

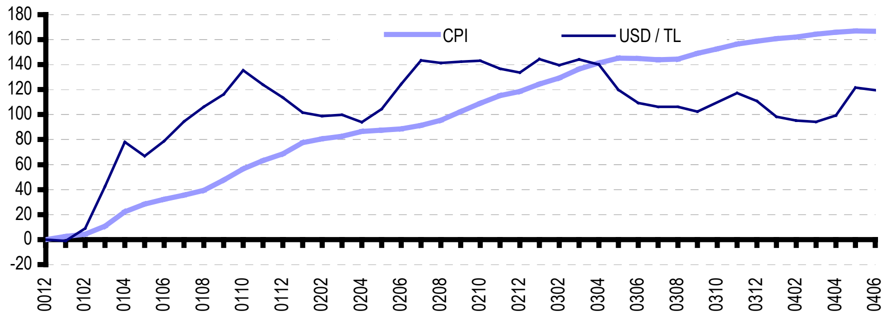


It is believed that there are mainly two reasons behind the decrease in exchange rate pass-through in both WPI and CPI. The first of these is the structural change in the relation between exchange rate and inflation, which was emphasised in the previous monetary policy reports. The upward/downward movements in the exchange rates due to the floating exchange rate regime, have weakened the mechanism whereby changes in exchange rates are reflected on the prices via short-term indexation. The second reason that prevents the rise in exchange rates from reflecting upon inflation appears when increases in prices and exchange rates in the aftermath of the crisis are contrasted. Graph 2.2 displays the accumulated increases in the exchange rate and consumer prices since December 2000. In the period after the crisis, price increases had at the outset lagged behind the high rise in exchange rates and cost increases had not been reflected on the prices. Hence, a decrease in profit margins (mark-up) was observed. Later on, however, it was seen that the fall in exchange rates had not influenced a fall in prices by the same ratio and that profit margins had begun to increase. In retrospect, compared with the end of 2000, prices had increased more rapidly than exchange rates. Taking into consideration the decrease in unit-labour costs at the same period, it becomes apparent that the firms, especially for the past one and a half years, have not had to tackle the problem of not being able to reflect cost increases upon prices. Conceivably, it is not essential that the rise in exchange rates necessitate price increases but that they can be met via restricting profit margins, which have already expanded considerably.

Another determining factor of inflation in the second quarter has been the public sector prices, namely fuel oil price increases.

Graph 2.2 Contrasting exchange rate and price increases with respect to the period before 2001 Crisis

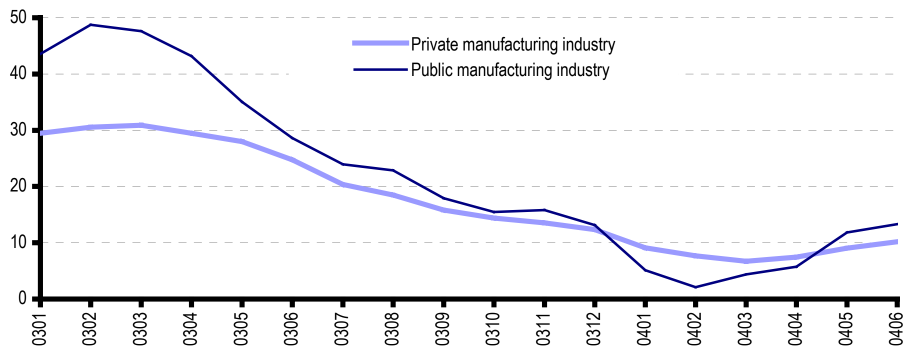
(percent)



It was virtually possible in 2003, in which Turkish currency substantially appreciated, to reduce fuel oil prices and increase the taxes on oil products at the same time. Recently, however, the upward trend in exchange rates and the rise in international oil prices have led to an increase in crude oil import prices. Under these circumstances, increasing retail prices has become inevitable so as to prevent tax losses.

The increase in fuel oil prices have especially been influential on WPI. Apart from this, basic metal industry prices, which displayed extremely high increases in response to the developments in foreign markets, and the prices of chemical products, which accelerated parallel to the rise in exchange rates, have been influential on the relative upsurge in public sector inflation. Public manufacturing industry price increase in the period between January and June reached 11 percent along with the contribution of the rise in the prices of TEKEL* products in the first quarter of the year. The annual price increase in public manufacturing industry is 13.3 percent which is 3.1 percentage points above private manufacturing industry (Graph 2.3).

Graph 2.3 Annual price increases in private and public manufacturing industrries
(percent)

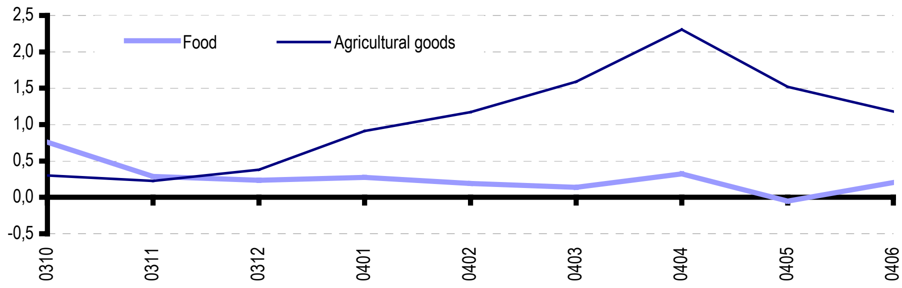


It is observed that the price increases, particularly in TEKEL and fuel oil products are related to Special Consumption Tax (SCT) increases. These increases posed no risk of exceeding the end year target; especially for CPI, the reason being the relatively low level of the general inflation trend. Yet, indirect tax increases to attain fiscal discipline may put greater strain in future in which one-digit inflation levels will be targeted. At this point, the importance of increasing the quality of fiscal discipline is well worth mentioning.

The stable course of food prices enabled the CPI inflation to remain below the expected level in the first half of the year. In this period, food prices reduced by 0.9 percent cumulatively and the annual inflation rates remained within the limits of 2.6 percent. Seasonally adjusted food prices realized far below the target level with a monthly average of 0.2 percentage points increase. The high increase in agricultural goods prices in the first quarter started to correct itself as anticipated and entered a process of rapid decline (Graph 2.4).

* Tobacco and alcoholic beverages company.

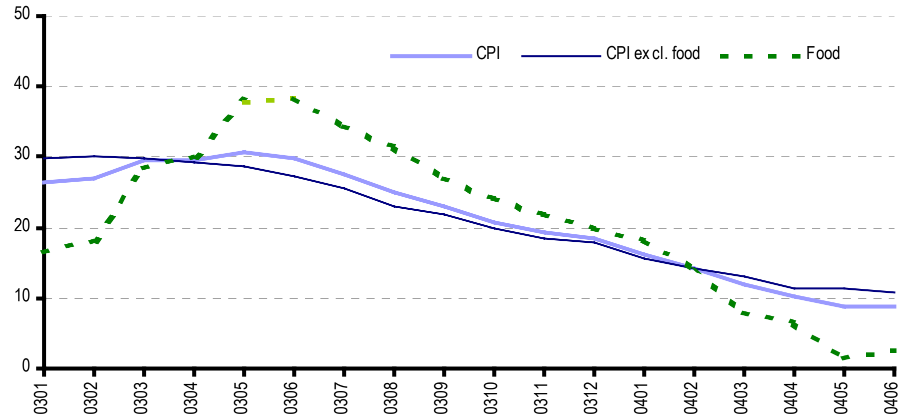
Graph 2.4 Seasonally adjusted price increases in food and agricultural goods
(6-month moving average)



No significant demand pressure was observed in the second quarter. Although there has been a certain recovery in domestic demand, this was observed in some sectors such as durables. Besides, this recovery was not an all-encompassing one. Cost advantages, which arose in these sectors, prevented the demand pressure from reflecting on the prices. Hence, it would not be possible to talk about a revival in demand, which is not in line with the production increase and which would cause an excess demand in the first half of the year.

In brief, there are not many risks involved with respect to inflation target of 2004. Despite the price rigidity in the service sector and the increase in public prices, the rise in CPI (excluding food) has been consistent with the inflation target. With the positive contribution of food prices, the annual CPI inflation realized as 8.9 percent at the end of six months (Graph 2.5). This ratio is expected to show a slight rise due to the base effect. However, it is unlikely that this ratio will exceed the end year target of 12 percent.

Graph 2.5 Food, CPI excluding food and CPI
(annual percentage change)



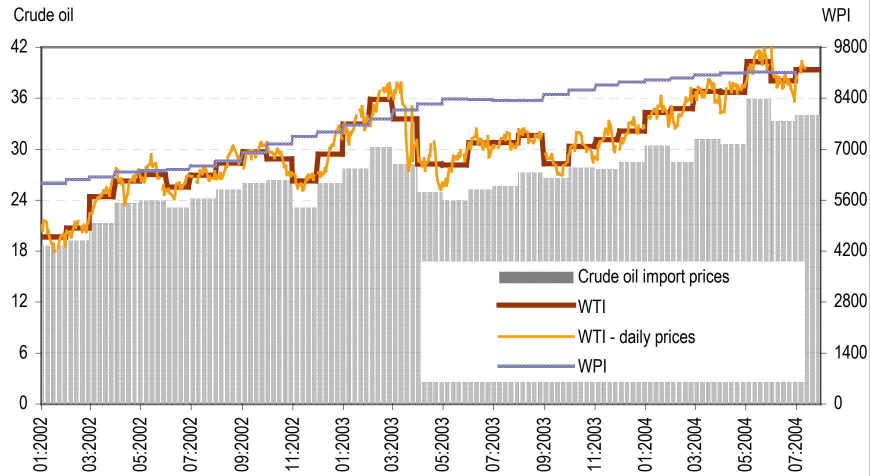
Crude Oil Prices and Monetary Policy Decisions

Energy, as the primary input of most of the economic activities is of vital importance as a cost item. Furthermore, its role in the formation of prices is more than obvious. From the point of view of those central banks that carry out price stability focused policies, developments in energy prices constitute a very important risk factor. Indeed, this exogenous character of the risk factor renders a critical question to be answered by the policy makers: What stand should the central banks take against the inverse supply shocks and the general price increases due especially to world oil price increases?[(1)] We shall treat this issue by first dwelling upon the course of crude oil price developments in the past two years and move on to explaining how various central banks handled this situation. Finally, we shall conclude by giving a brief account of how the CBRT positioned itself against these negative developments.

The Evolution of Crude Oil Prices (2002-2004)

Oil prices show dramatic fluctuations with respect to supply-demand conditions. Both changes in demand and oscillations in the amount of supply as well as expectations are being effective on crude oil prices. The graph below shows how oil prices fluctuate daily; even on the basis of monthly averages there are serious changes in both directions.

Graph A Crude Oil Prices (monthly average, $/barrel) and WPI (1994=100)



Oil prices rose sharply during the Iraqi war and then reverted to their pre-war level as the war lasted shorter than anticipated. Yet, uncertainties surrounding the circumstances in the area provoked concerns as to supply and so price increase tendency has continued, accompanied by significant fluctuations.

Vulnerability of Interest Rate Policies: when and how?

It is especially important to distinguish between short-term developments and medium-term tendencies while discussing the formation of monetary policy with respect to price volatilities. Whereas short-term, temporary shocks do not pose any risks, the prevalence of the shocks in medium-term will bring about a deviation from price stability. In this connection, forward-looking policy formation as such will only react to price shocks, which are expected to continue in the medium-term. Besides, any reaction against the fluctuations of temporary crude oil price increases will lead to a further decrease in economic activities, which are already slowing down. This, in turn, might have negative influence upon the overall welfare level, as recently suggested by the European Central Bank [(2)].

(1) For more information refer to "Energy: the economy and monetary policy," Federal Reserve Bank of Dallas, available at: http://dallasfed.org/educate/everyday/ev2.html.

(2) "Press conference: introductory statement," European Central Bank, 1 July 2004. Similar specifications were pronounced in the press conferences dated 21 June 2001 and 7 March 2002.

A similar strategy of monetary policies adopted by Canada and Australia shows that temporary fluctuations in consumer prices are relatively well tolerated and that such temporary factors as crude oil prices are merely kept under surveillance in this respect(3). The question as to which price index development should be considered more appropriate arises when the observations are analysed within the framework of inflation targeting. Although answering this question necessitates some highly complicated technical analyses, the underlying principle behind the answer is consistent with the observations mentioned above. In other words, the most representative price index of medium-term inflationary tendencies ought to be considered and temporary shocks should be accounted for as long as they can nourish the medium-term tendencies. Notably, core inflation definitions that capture overall tendencies for prices take precedence at this stage. Bank of Canada and European Central Bank, for instance, are attentively following consumer price indices excluding food, energy and indirect prices for this purpose(4). Another related study on this subject proposes that it would not be an advisable strategy to aim at overall price indices when there exist petroleum price shocks(5). Moving from here onwards, it can be asserted that those banks, which follow forward looking monetary policy strategies, mainly place emphasis upon overall price tendencies. It should be noted that the above-mentioned sources also suggest a close follow-up of exogenous and temporary price shocks.

Crude oil prices and inflation in Turkey

Although crude-oil import prices in Turkey are generally lower than WTI and Brent crude-oil prices in Turkey, price changes follow a parallel course in time. Hence, fluctuations in the international arena reflect on Turkey's crude oil import prices. However, bearing in mind the high and fluctuating course of inflation in the past 30 years and the role of taxation as regards the relation between prices of fuel oil products and crude oil prices, the impact of petroleum shocks on CPI inflation has been observed as relatively limited(6). In recent years, on the other hand, in the aftermath of the decrease in inflation, the impact of the changes in crude oil and petroleum prices on overall domestic price indices especially on WPI is becoming more significant. Apart from this, it is equally important to pay attention to taxation policy in addition to changes in petroleum price movements for a true assessment of the short-term impact of petroleum price shocks on inflation. In other words, the interaction between petroleum prices and energy prices within the CPI may not be mutually reciprocal depending upon the taxation policy in the short term while there exists an overall uniformity in the long-term: As fuel oil products are primarily composed of taxes, the impact of petroleum price shocks on domestic prices is relatively constrained.

As a consequence of the firm implementation of the stabilization programme after the 2001 crisis, the figures of inflation have considerably declined and this tendency is still being preserved. It was stated in the CBRT announcement of May 2004 *Inflation Outlook* that the fuel oil price adjustments, which were made on the basis of petroleum prices and developments in exchange rates, reflected on wholesale prices. It was also stated that the reflection of these developments on consumer prices was to remain in a relatively narrow domain(7). As shown on the Graph A, the recent course of CPI seems to support this observation. In the light of these data and the experiences so far, there seems to be no strong reason why a change in monetary policy be made against the recent fluctuations in crude oil and energy prices. Nevertheless, of course, these price developments will have to be followed very closely. Monetary Policy will react in due course in case the petroleum price increases continue to rise and affect the general pricing behaviour and long-term inflationary expectations.

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(3)Monetary policy," *Reserve Bank of Australia*, available at: http://www.rba.gov.au/Education/monetary-policy.html
See also releases about *infilation targeting:* Czech National Bank (27 May 2004), Tha Bangko Sentral ng Pilipinas (April 15, May 6, June 3, July 1, 2004), The South African Reserve Bank (10 June 2004), Bank of Korea (8 July 2004), The Sweden Riksbank (June ll, July 8, 2004), Central Reserve Bank of Peru (June 3, July 1 2004), National Bank of Poland (April 27, June 30 2004), The Central Bank of Chile (May 13, June 10 2004), Bank of Thailand (April 21, June 9 2004)

(4) Please note that FOMC excludes food and energy prices, while Federal Reserve Bank of Thailand excludes unprocessed food prices and energy consumer prices while examining their effects on overall trend. See Cutter, Joanne (2001). "Core inflation in the UK," *External MPC Unit Discussion Paper, no. 3.*

(5) See Kamps and Pierdzioch (2002). "Monetary policy rules and oil price shocks," *Kiel Working Paper*, no. 1090, Kiel Institute of World Economics.

(6) During the computation process of retail petroleum prices; first, the refinery prices (ceiling prices) are determined on the basis of world crude oil prices and developments in exchange rates, and then delivery/transportation and SCT costs are added to assess the VAT basis. A ratio of 18 percent VAT is finally added to this VAT basis to obtain the retail price of gasoline per litre.

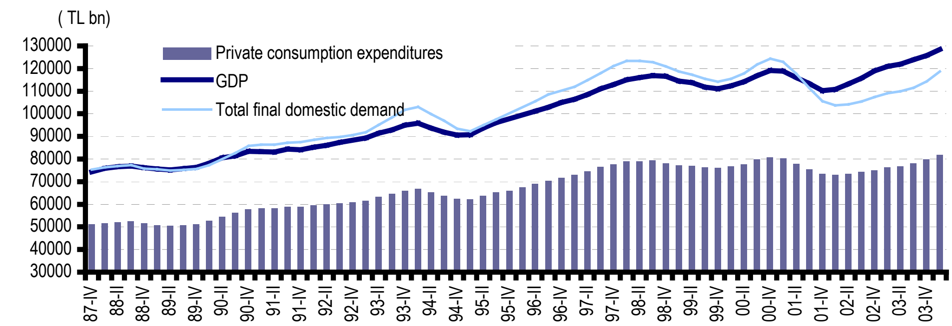
(7) "May 2004 Inflation Outlook," *The Central Bank of the Republic of Turkey*, June *2004*.

3. SUPPLY and DEMAND DEVELOPMENTS

Domestic demand

Revival of domestic demand, which started to accelerate in the second half of 2003 continued to increase its pace in the first quarter of 2004. Hence, not only the positive export performance but also accompanying ever-expanding domestic demand became the components of the high growth actualized in the first quarter (Table 3.A). In the last quarter of 2003, and in the first quarter of 2004, total final domestic demand growth actualized well above the GDP growth. Indeed, annualized data show that the limited revival of domestic demand as of 2002 gained further acceleration since the last quarter of 2003. However, the level of total final domestic demand still being below GDP clearly indicates a demand gap in the economy (Graph 3.1).

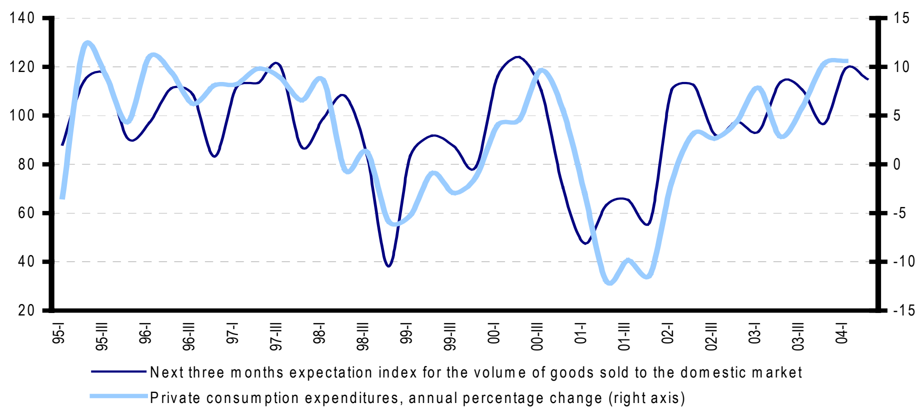
Graph 3.1 Annualized GDP, total final domestic demand and private consumption expenditures (1987 prices)



Source: SIS

The production and the demand indicators show that the tendency of rapid revival of domestic demand continued in the second quarter of 2004 as well. Hence, the volume of goods sold to the domestic market, one of the indicators of the CBRT *Business Tendency Survey(BTS)*, reveals that the rise in private consumption expenditures will also continue in the second quarter (Graph 3.2).

Graph 3.2 Private consumption expenditures and expected sales



Source: SIS, CBRT, BTS

When the components of total final domestic demand are examined, it is seen that private spending was the main determinant of economic growth in the first quarter of 2004. These increases in expenditures mainly comprised durables and machinery-equipment investments (Table 3.A). Consumer durables spending showed as high an increase as 49.7 percent. This was the result of the decline in the cost of borrowing due to the decline in interest rates on credits as well as to the limited price increases brought about by the appreciation of the TL against foreign currencies, and the upsurge in consumer confidence. Another factor, which improved the borrowing facilities and hence manifested the confidence felt in the economy, was the expansion of credit opportunities with the realization of long-term repayment schedules, which eased deferred consumer spending. Indeed as consumer credits and credit card use showed a rapid acceleration in the first quarter of 2004, the CBRT and CNBC-e consumer confidence indices maintained their favorable levels.

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

	2002	2003					2004
	Annual	I	II	III	IV	Annual	I
1- Consumption expenditures	2.5	6.9	2.3	5.2	8.0	5.6	9.9
Public	5.4	-2.3	-2.0	-0.7	-4.2	-2.4	2.4
Private	2.1	7.8	2.9	5.8	10.3	6.6	10.6
Durable goods	2.1	24.7	10.6	11.4	49.5	24.0	49.7
Services	8.5	9.6	5.1	7.6	7.9	7.5	10.1
Food and beverages	1.1	4.4	4.1	5.7	1.0	4.1	0.9
Semi-dur.& non-dur. cons. exp.	3.0	4.7	-4.5	3.7	3.8	2.1	4.9
2- Fixed capital formation	-0.9	11.7	6.3	3.0	19.2	10.0	52.6
Public	8.8	-34.8	-14.6	-22.7	5.0	-11.5	-11.3
Private	-5.3	22.6	14.2	16.4	30.1	20.3	60.6
3- Stock change*	7.1	3.6	5.5	2.2	1.2	3.0	3.1
4- Exports of goods and services	11.1	14.5	12.3	19.4	16.9	16.0	10.3
5- Imports of goods and services	15.8	22.0	24.7	28.3	33.0	27.1	31.2
6- Total domestic demand	9.3	10.9	8.5	7.0	11.3	9.3	19.1
7- Total final domestic demand	1.8	7.7	3.2	4.7	10.6	6.5	17.5
8- GDP (expenditure side)	7.8	8.1	3.9	5.5	6.1	5.8	10.1

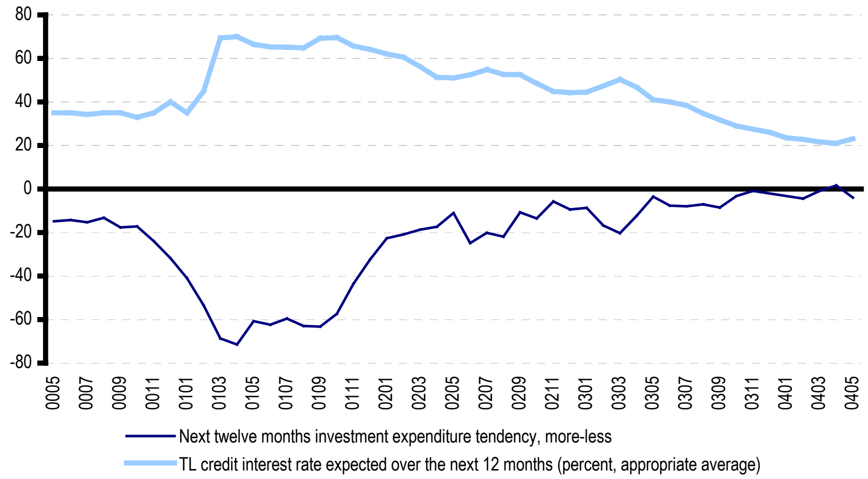
*Contribution to GDP growth, percent
Source: SIS

In May, interest rates and exchange rates increased, public banks tightened the supply of credits and increased their interest rates. In addition, the amount of the tax incentive granted for brand new car purchases against scrapped cars reduced by half, as a result, a slowdown in the use of consumer credits was observed by the second half of June. Evidently, the pace of increase in car sales declined in June, as suggested by the Automotive Industry Association (AIA) data. In the light of these developments, it is believed that this upsurge in demand for consumer durables and machinery-equipment investments will dampen in the third quarter.

Investment expenditures are considered to be one of the most important components of economic growth in 2004 estimates. Indeed, the improvement in gross capital formation in the first quarter seems to verify these forecasts. In this same period, private investment expenditures had a very high growth rate of 60.6 percent stemming from the increase in machinery-equipment investments. The reason behind this rapid increase in private investment expenditures can be summarised as follows: the lower level of interest rates compared to previous years as a result of the decline in the risk premium of the economy, the decline in borrowing costs, the expansion of external finance opportunities, the optimistic expectations regarding the course of the economy, and the rise in investor confidence. Admittedly, in April 2004 investment expenditure tendency of the firms turned out to be in favour of the optimists for the first time since April 1997 (Graph 3.3). Besides the high rate of increase observed in machinery-equipment production and import of capital goods, expectations about the interest rates on credits and investment expenditure tendencies outlined in the *Business Tendency Survey* all point to the fact that investment expenditures will continue to increase rapidly owing to the optimistic expectations with respect to finance costs.

The lack of a demand pressure on consumer prices in the first half of 2004 was due to the upsurge in the level of potential production brought about by the rapid acceleration of private investment expenditures, which are of primary significance in terms of non-inflationary sustainable growth.

Graph 3.3 CBRT *BTS* expectation of TL credit interest rate and investment expenditure tendency



Source: CBRT, BTS

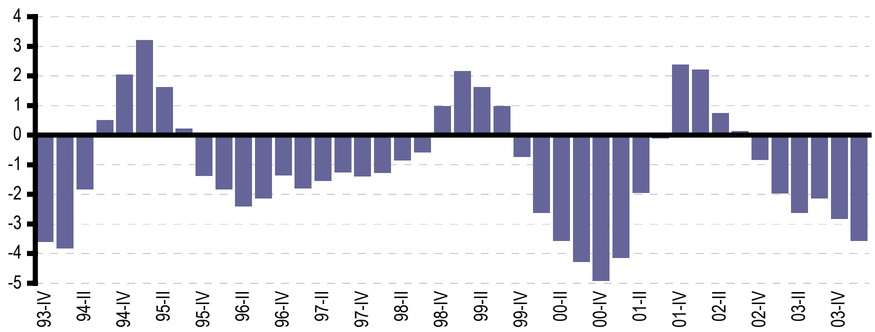
The importance of the increase in investment expenditures —from the point of view of growth/inflation relation— was duly emphasized in the previous reports. The underlying reason for this is that it provides an increase in capital-labor ratio, which in turn enables the sustainability of productivity increase and the maintenance of cost conditions at favorable levels. Moreover, when the growth of investment continues, potential output level increases thereby limiting the probable demand pressure on costs. Conceivably, from this perspective, rapid increase in private investment expenditures proves to be a positive development with respect to the sustainability of "non-inflationary growth". The investments required for the medium-term sustainable growth and price stability could only be made possible when confidence in the economy is permanently established subsequent to the actualization of structural reforms.

Despite the revival of domestic demand, no demand pressure was observed in the first half of 2004. Two factors were primarily influential on this development: In the first place, the fact that increase in private consumption expenditures was mainly due to expenditures on durables in effect shows that there had been a rather disproportionate reflection of domestic demand among consumer groups. Incomes policy being implemented within the framework of tight fiscal policy and the adverse developments in the labor-market —by constricting expenditures on necessities which are fairly income-elastic— further support this situation. Secondly, the increase in private investment expenditures enabled a rise in the level of production by expanding production capacity. This situation, admittedly, opens up the possibility for production to grow rapidly without letting inflationary pressures penetrate.

Foreign demand

Between January and April 2004, current account balance indicated a deficit of US $ 6.9 billion (Graph 3.4). During this period, service sector revenues rose as a result of high rate of increase in tourism revenues. However, foreign trade deficit, which also showed a high rate of increase, had become the determinant factor in current account balance. The tendency of the TL to appreciate, high rate of increase in industrial production and revival of domestic demand were effective in the rise of imports compared to the increase in 2003.

Graph 3.4 Current account balance / GNP* (percent)



* Annualized data
Source: SIS

According to the data announced by the State Institute of Statistics (SIS), the 29.8 percent increase in foreign trade in this period compared to the data of the same period the year before was the result of manufacturing industry products which comprised 93.8 percent of total exports. The recovery in supply and cost conditions observed in 2003 having continued in 2004 was also effective in the rise in exports. Especially, the low level of labor and energy costs and the increase in productivity have provided the firms with a competitive power despite the appreciation of the TL. Furthermore, the recovery in finance opportunities, the market opportunities created as a result of the tendency of the global economy to expand and the increasing export prices all supported the aforementioned increase.

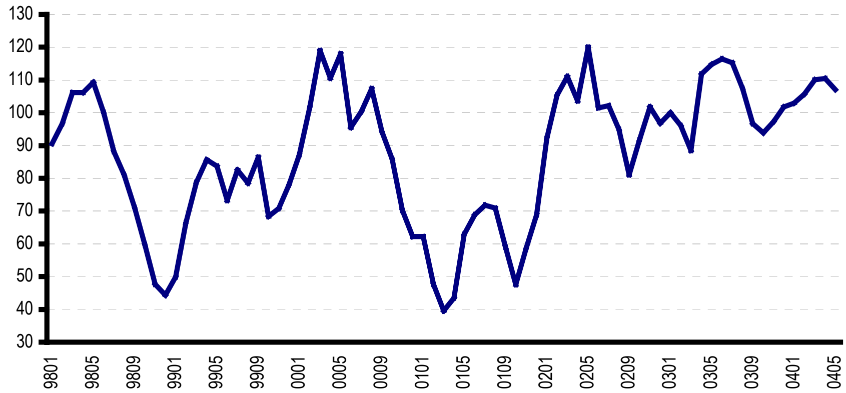
In this very same period, the 46.2 percent increase in total imports stemmed from the increase in intermediate goods and capital goods imports. The fact that rising capacity utilization rates required new investments to sustain production increase, has caused the import of capital goods to continue its upward trend. Meanwhile, the high rate of increases observed in industrial production has accelerated the import of intermediate goods. With the appreciation of the TL, the high rate of increase in demand for durables, motor vehicles, in particular has become the main determinant of the rise in consumer goods imports. Indeed, demand being met as such reduces inflationary pressure.

Data announced by SIS and TEA (Turkish Exporters Assembly) show that increase in exports of industrial products continued in the first half of 2004. Moreover, according to the June 2004 data announced by the Ministry of Finance, the upward trend of VAT on imports confirms that the rise in imports has continued. In case of the persistence of the current trend in foreign trade data, the increase in imports is expected to be met via high export performance and tourism revenues and, as a consequence, the current account balance is expected to give a deficit within the range of 3.5-4.0 percent of GDP at the end of 2004.

Supply side developments

Following 2003, Turkish economy continued to grow in the first quarter of 2004. In this period, GNP increased by 12.4 percent compared to the previous year realizing a very high rate of increase. The apparent high level of *Production Tendency Index* for the next three months based on the CBRT *Business Tendency Survey* indicators point out that firms have optimistic expectations with respect to production (Graph 3.5).

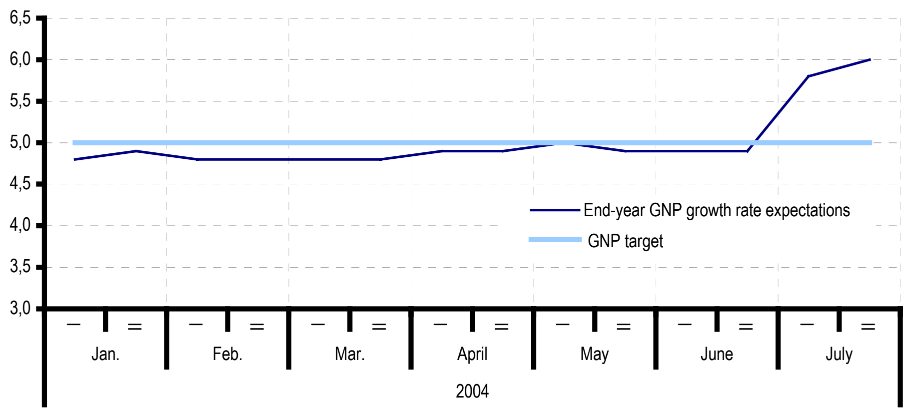
Graph 3.5 Production tendency index for the next three- month period *



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

The fact that the growth rates were realized far above the expectations in the first quarter of 2004 and that the rate of inflation remained quite low in the first half of the year had a positive influence upon the economic agents and raised their confidence in the economic program. In this context, GNP growth expectations have become much closer to the target since the beginning of 2004 and realized as 6 percent in the second half of July, exceeding the program target (Graph 3.6).

Graph 3.6 Annual GNP growth rate expectations in the CBRT *Expectations Survey*



Source: CBRT

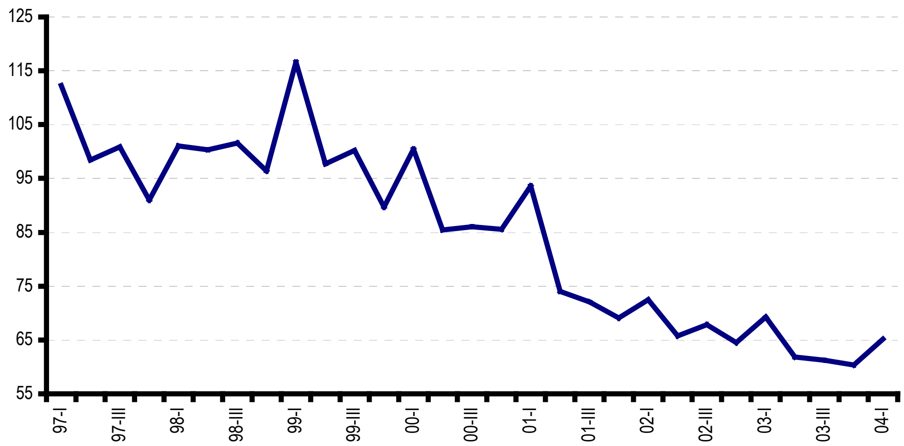
SIS *Monthly Industrial Production Index* indicates that total industrial production rose by 13.2 percent in January-May period compared to the same period of the year before. Manufacturing industry production contributed significantly to the growth of industrial production by increasing 14.6 percent in the same period. High export performance achieved as the outcome of productivity increase and the favorable level of unit wages continued to be the main determinants of the rise in industrial production in the first half of the year. Furthermore, the revival of domestic demand for durables supported production increase.

Parallel to the rapid production rise in the January-June period of 2004, manufacturing industry capacity utilization rates maintained their high levels. In view of the data announced by SIS, average capacity utilization rate in total manufacturing realized as 79.7 percent in the first half of 2004. The high level of capacity utilization rates in such key sectors as basic metal and machinery equipment, continue to give positive signals from the point of view of investment expenditures. In addition, as one of the leading sectors, motor vehicles manufacturing industry utilization rates have continued to increase in line with the revival of domestic demand and high export performance. It should be noted, however, that since demand for motor vehicles, especially for automobiles stems mainly from the relatively low prices and since capacity utilization rates are below the level that would force production capacity, production increase in this sector can be sustained in the short run without exerting any pressure on prices.

Cost pressure

Manufacturing industry index of real wages per working hour rose by 0.6 percent in the first quarter of 2004 while the productivity per working hour rose by 8.6 percent in the same period (Table 3.B). Private manufacturing industry index of unit real wages maintained its low level in this period as well (Graph 3.7). Production data of the second quarter of 2004 indicate that productivity increases and the low level of real unit wages will continue. This situation reduces any capacity oriented pressure on prices that would otherwise exert itself as the outcome of rapid increase in production (see the box on pages17-19).

Graph 3.7 Private manufacturing industry real unit wage index* (1997=100)



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

Source: SIS, SPO, CBRT

In 2004, the rise in the salaries of civil servants and public workers' wages were determined in line with the inflation target. Public workers' wages were raised by 5 percent for the second half of 2004, the same as that of the first half (on condition that annual CPI inflation rate exceeded 5 percent, the corresponding amount would be added to the salaries on 31.12.2004). As for the civil servants, their salaries were increased by 6 percent for the first half of 2004 with a lump sum payment of TL 160 million given in January. A 6 percent increase was given for the second half of 2004. Moreover, minimum wages were raised by 5 percent for the second half of the year following the 38.2 percent increase in the first half. It is unlikely that 2004 wage increments should create a cost pressure as the increases in the private sector are based on the public sector incomes policy.

High productivity performance in the recent period contributed to the decline in the production costs of firms. It is expected that unit labor costs will not exert any pressure on prices as the productivity increase will remain above the rise in real wages in the period ahead and so firms will be able to maintain their competitiveness in export markets. Accordingly, the low level of real unit wages will not only limit the rise in prices in the domestic market, but will also continue to become the main driving force of the rise in exports in the second half of 2004.

Meanwhile, when considered with respect to intermediate and capital goods, which constitute a substantial portion of total imports, the strong position of the TL against foreign currencies has been observed as having a positive impact on imported input costs. Nevertheless, the increase in the international price of raw materials used as the primary input in basic metal and petroleum products sectors are indicative as probable cost pressures on inflation in the months ahead. Indeed, the rise in petroleum prices in the international market was partially reflected on the domestic market in May and June.

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

	2002	2003					2004
	Annual	I	II	III	IV	Annual	I
Employment(1)	0.6	5.1	1.8	1.4	-0.5	1.8	0.6
Public	-9.1	-4.1	-6.5	-5.3	-10.7	-6.8	-13.7
Private	2.3	6.3	3.1	2.4	0.9	3.1	2.4
Real Wages(2)	-5.4	-0.9	-5.3	-3.8	2.4	-1.9	0.6
Public	1.4	-2.5	-8.9	-8.5	-1.1	-5.3	2.9
Private	-4.2	0.9	-2.7	-1.1	5.1	0.6	2.9
Productivity(3)	8.6	5.1	3.5	8.6	11.4	7.2	8.6
Public	16.4	4.8	8.2	8.4	11.3	8.1	15.0
Private	7.8	6.0	3.5	9.4	12.4	7.9	9.1
Earnings(4)	-8.0	-5.4	-10.6	-8.2	-0.9	-6.3	2.1
Public	-2.1	-3.5	-12.2	-11.0	4.1	-5.6	0.6
Private	-6.8	-4.2	-8.4	-5.8	-0.1	-4.7	5.8

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

Measuring the output gap for Turkey

The competence of central banks to foresee upward and downward pressures on prices bears major significance for the shaping up of policy decisions. In this context, central banks implement price stability focused monetary policies with a forward-looking vision and follow each and every datum that offers information on the future course of the prices and design various indicators related to inflationary pressures.

Part of the information on inflation in the period ahead consists of the variables related to supply-demand balance of the economy. For instance, the possibility that a pressure may be imposed on prices in the periods in which total output increases rapidly for long periods has directed the central banks to go deep into the relation between level of production and inflation. As a consequence "output gap", the difference between actual output and the level of production that does not exert inflationary pressure has become one of the regularly derived indicators. In this context, there are significant differences between "potential production" used in the literature of economics of growth and the "potential production" used in inflation dynamics. The level of potential production describes the maximum output level which can be attained by the given amount of labor-capital and the level of technology and which does not cause an increase in inflation. According to this definition, in cases where present production level surpasses potential production, the capacity of production is coerced thereby exerting pressure on input costs and increase in prices. Similarly, in cases where current production level remains below potential production, there can be no mention of an increase in inflation caused by pressure on capacity. From this point of view, output gap is an important indicator that reflects the utilization of resources and the production-capacity directed pressures on inflation. In the process of transition to inflation targeting regime to be adopted as the ultimate objective of monetary policy in the coming period, taking into consideration those dynamics intrinsic to Turkish economy, the derivation of a meaningful output gap series is being worked on.

Neither the potential output nor the output gap is directly observable variables. Therefore, the case necessitates the use of various filtering techniques of time series to be able to estimate these variables. Depending on the technique used, it is possible to attain different series of output gap. For this purpose, besides economic approaches like the production function approach, such statistical approaches as univariate or multivariate filters are being used. Hodrick Prescott (HP) Filter, for instance, is one of the most widely employed methods used to decompose the cyclical and trend components of the time series. However, this filter is criticized for its being primarily a statistical method and thus for its inadequacy in conveying any economic information. For this purpose, in the series generated by the CBRT, the statistical methods are being supported by macroeconomic relations.

The method used in the calculation of output gap is based on Extended Kalman Filter estimations of a Time Varying Parameter/Unobserved Components Model. This method provides numerous advantages over other methods by modeling the interaction of the unobservable variables of potential output and output gap with inflation, exchange rate dynamics and expectations considering the peculiarities specific to Turkey. Besides the employment of the Philips Curve, this model provides additional advantages, namely, the output gap series is explained by a model defining its own dynamics. Thus the output gap is derived in the context of its interplay with such variables as exchange rates, real interest rates, expectations and inflation. In brief, the advantage of this model over pure statistical ones is that it basically offers the opportunity to designate a Turkey specific model.

Another improvement offered by the method over previous studies is that the model parameters change over time. It is not unusual that macro-economic dynamics often change in time in countries like Turkey as a result of political instability, economic crises and subsequent structural transformations. It is with this idea that the employment of the Extended Kalman Filter within the framework of a Time Varying Parameter Model is found most appropriate for the estimation of output gap. Furthermore, recursive estimation of the parameters offered by this method enables the examination of the dynamic effects of macroeconomic variables on capacity pressures in the context of the structural change, which Turkey has been undergoing since the beginning of 1990's. In the light of all these considerations, with respect to the dynamics specific to Turkey, three alternative models of the same category are being employed, the results of which to be followed up separately. The general form of the model used for the estimation of the output gap is as follows:

(1) Inflation/Output Gap Dynamics:

$$\pi_t = \alpha_{1,t}\pi_{t-1} + \alpha_{2,t}\pi_{t-2} + \alpha_{3,t}GAP_{t-1} + \alpha_{4,t}\pi_t^{\ M} + \nu_t$$

(2) Actual Output Decomposition:

$$y_t = y^*{}_t + GAP_t$$

(3) Potential Output Equation:

$$y^*{}_t = y^*{}_{t-1} + \mu_{t-1} + \eta_t$$

(4) Potential Growth Rate Equation:

$$\mu_t = (1-\rho_t)\mu_0 + \rho_t\mu_{t-1} + \varepsilon_t$$

(5) Output Gap Dynamics

$$GAP_t = \gamma_{1,t}GAP_{t-1} + \gamma_{2,t}r_t + \gamma_{3,t}DI_t + \gamma_{4,t}TRQ_t + \zeta_t$$

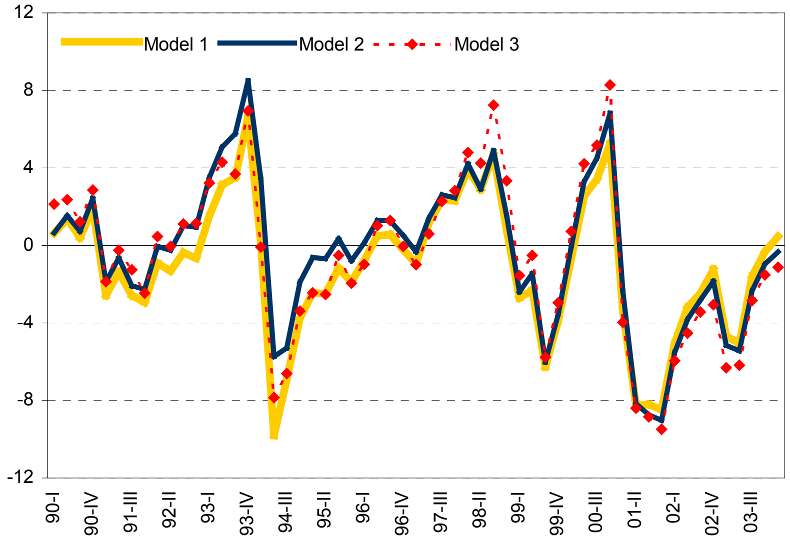
In this unrestricted model π represents seasonally adjusted consumer price inflation; GAP is the output gap; π^M is the import price inflation in TL; *y* is the seasonally adjusted GDP; *y** is the unobserved potential output; μ is the potential output growth; *r* is the real interest rate; ***TRQ*** is the short term component of nominal exchange rate; *DI* is the demand index, which is constructed on the basis of demand anticipations of producers based on the information from the CBRT *Business Tendency Survey.*

Macroeconomic stability programs which proved unsuccessful in the previous periods, the dominance of backward indexation of wages, and the exchange rate adjustment in line with inflation in the context of fixed exchange rate regimes not only caused an inflationary inertia but also made the exchange rate, historically one of the most important determinants of inflation. The first equation is a kind of ‘Philips Curve’ equation, which shows the relation between output gap and inflation. Lagged values of the inflation rate reflect the inflationary inertia whereas the import price inflation reflects the exchange rate pass-through over prices. The second equation is an identity, which decomposes output into its cyclical and potential components. The third equation is the potential output equation in which the shocks to the level of potential production are permanent and the rate of potential output growth shows variations in time. The fourth equation expresses a stochastic process in which the rate of long–run potential growth is defined as μ_0 . Admittedly, in developing countries like Turkey, frequently changing macroeconomic policies and the recurrent economic crises expose potential production to considerably intense shocks. Hence, this model reflects the fact that the rate of potential output growth is prone to vary in time. Furthermore, modeling the potential output growth as time-varying also allows for taking the shocks to technology and productivity into account. In the last equation, in addition to the real interest rate, the variables such as temporary exchange rate movements and expectations considering the Turkey-specific dynamics at interplay are also included so as to explain the output gap. By this way, expectations channel—a significant determinant of production dynamics in Turkey— and the exchange rate movements have been included in the model with the underlying idea that when the exchange rate diverges from its long-run equilibrium value, supply-demand balance may also change.

It is observed that the estimated output gap series for the Turkish economy is both historically consistent and harmonious with the macroeconomic developments. As a result of the economic crises in 1994, 1999 and 2001 respectively, production activities had receded and output dropped below its potential level. It was observed that in 2000 the level of production, which could exert pressure on inflation, was exceeded by the implementation of exchange rate-based stability program. This revival in economic activities had been curtailed as a result of the February 2001 crisis which could rightly be called as the most severe crisis ever. The crisis caused domestic demand to contract rapidly. Closing of many production units along with banks and firms getting into enormous difficulties and experiencing great deterioration of their balance sheets was the obvious outcome. Fortunately, the destructive effects of the crisis are diminishing, however slowly and the economy is returning back to its potential production capacity.

What needs be accentuated at this point is the fact that there is a high degree of uncertainty about the output gap series as they are unobservable. Indeed, the series derived from three different models show similar inclinations in terms of the turning points but show differences regarding the levels. Based on the recent estimations, Model 1 indicates a higher capacity pressure than the other models. On the other hand, other output gap series indicate that the level of production is still below its potential level as of the first quarter of 2004 (Graph A).

Graph A Output gap series obtained from alternative models(i)



The facts that the Turkish economy is undergoing a period of transition and that macroeconomic relations has been subject to change increase the uncertainties about the state of current dynamics. In this context, it is believed that applying different models will be helpful for a more accurate evaluation of the output gap, which is an unobserved variable.

The sluggish recuperation of output gap had a major impact on the decline in inflation following the February 2001 economic crisis. However, output gap estimations reveal that the contribution of the level of production to the disinflation process in the past three years will not be of the same size in the periods ahead. Nevertheless, in the present state of affairs, considering the fact that the favorable level of unit costs and productivity improvements are being maintained, it is unlikely that the present level of production will exert a severe pressure on prices.

It is worth mentioning that output gap is merely one of the indicators that serves to explain the extent to which current resource utilization is to exert pressure on production capacity. For this purpose manufacturing industry capacity utilization rates, unemployment gap—defined as the difference between non-accelerating inflation rate of unemployment (NAIRU) and actual unemployment rate—and labor market developments have also been included in the information set. Moreover, apart from cost factors like wages, exchange rates and energy prices, productivity improvements are also considered together with other leading indicators.

In conclusion, output gap is only one of the variables included in the information set, on which monetary policy decisions are based, in order to foresee inflationary pressures. The CBRT, which conducts its monetary policy focusing on future inflation will carry on developing its statistical data base and policy analysis models and if needed, will improve derivatives of output gap series derived from different models and continue to share these developments with the public.

(i) The restrictions defining alternative models are as follows:

Model 1: Unrestricted model

Model 2: $\gamma_{4,t} = 0$

Model 3: $\gamma_{3,t} = \gamma_{4,t} = 0$

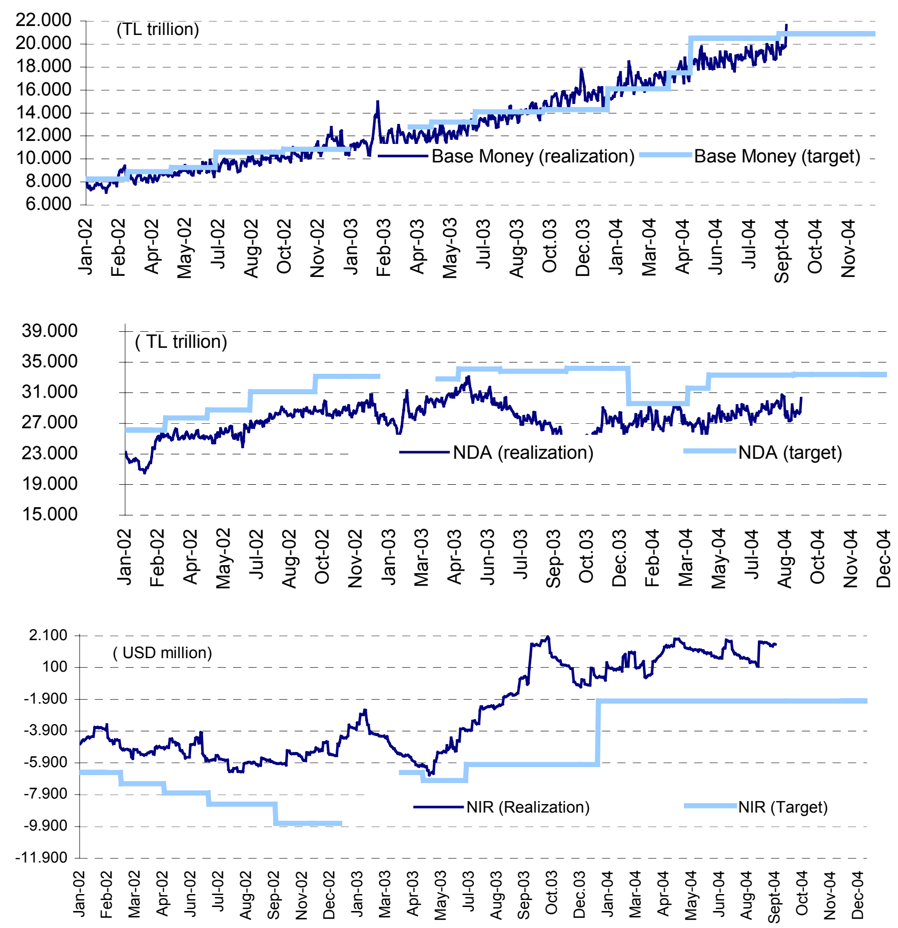
4. DEVELOPMENTS in FINANCIAL MARKETS

CBRT Monetary and Exchange Rate Policy Developments

Having directed its focus on the 12 percent end-of-year inflation target, the CBRT has been carrying out an "implicit inflation targeting" policy. In addition to this, the CBRT takes the necessary measures to maintain financial stability. In this system in which short-term interest rates comprise the main policy instrument, monetary performance criteria and indicative targets set by the IMF programme are being closely monitored. To this aim, in the Letter of Intent dated 2 April 2004, indicative targets for Net Domestic Assets (NDA) and performance criteria for Base Money and Net International Reserves (NIR) by the end of April had been proposed. While NIR and NDA remained within the designated limits, Base Money actualized slightly above the target (Graph 4.1).

The CBRT implicit inflation targeting policy has directed its focus to the attainment of the 12 per cent end-of-year inflation target without losing sight of the necessary measures to secure financial stability.

Graph 4.1 Performance criteria



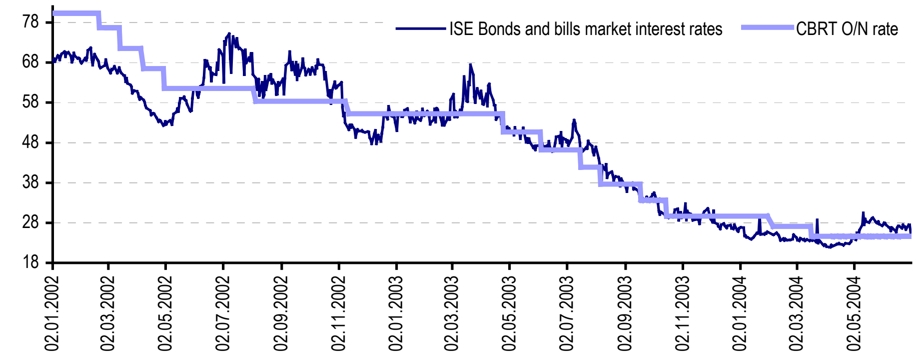
Note: The Base Money, NIR and NDA targets for the end of April, June and September 2003 were determined in the Letter of Intent dated 5 April 2003 and for the end of December 2003, they were determined in the Letter of Intent of 31 October 2003. For the end of March and April 2004 they were determined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

Reasons for this expansion in Base Money and its impact had been explained in detail in the previous reports. Especially contingent upon the decline in inflation, the exchange rates and interest rates and the improvement in inflationary expectations, this expansion – as the outcome of the increase in money demand – neither contradicts the price stability objective nor does it pose a threat pertaining to the achievement of the end-of-year inflation target. Besides, it is emphasized that tight fiscal policy is still being carried out due to the fact that the course of real interest rates is still high. Indeed, actualized inflation figures verify these assessments. As similar tendencies may continue in future, it is likely that the targets of the programme will have to be reconsidered.

The CBRT employs short-term interest rates as its primary instrument of monetary policy.

Although Base Money functions as a nominal anchor for the implementation of the monetary policy, the CBRT employs short-term interest rates as the main policy instrument. Interests rates decisions taken in accordance with the price stability objective are based on the evaluations of possible future inflationary developments. Domestic economic indicators and related expectations and analysis of probable exogenous shocks and the inflation forecasts made therein comprise the indicators in the decision-making process of interest rates. For this purpose, the CBRT overnight borrowing interest rates was determined as 22 percent as of 17 March 2004 (Graph 4.2).

Graph 4.2 CBRT overnight interest rates and secondary market interest rates
(weighted average, compound, percentage)



Source: ISE, CBRT

Despite the prevailing confidence on the presumption that the economic programme will continue and that no deviations from fiscal discipline and structural reforms will be allowed, there still remains a number of risk factors that might endanger the attainment of the inflation target beyond the control of the CBRT. In case these risks actualize, the CBRT may increase the interest rates as it considers appropriate.

The relationship between the secondary market interest rates and the overnight interest rates provides valuable insight as to how market agents perceive risks. The parallel course between the secondary market interest rates and the CBRT interest rates may be disrupted once risk perceptions change. For instance, in the first quarter of the year, the course of market interest rates was below the CBRT interest rates owing to the favorable course of the programme and to the subsequent increase in confidence in the programme. Then, in the aftermath of the referendum in Cyprus, this tendency reversed its course in April and when the expectations that the FED might raise the interest rates grew, it showed a significant upward trend.

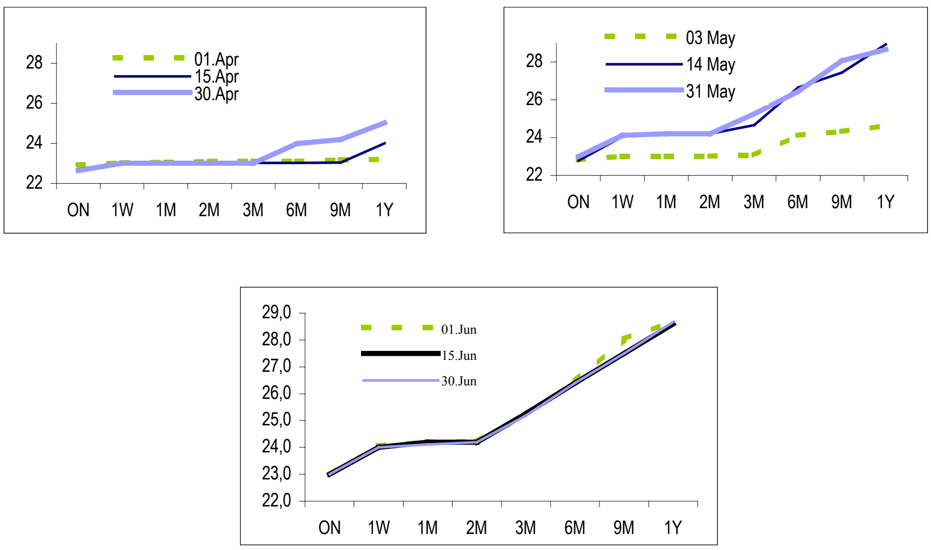
As a matter of fact, expectations and concerns about the likelihood of this increase have influenced the risk perceptions dramatically. Admittedly, as a consequence of the removal of constraints on international capital movements and the intensified integration of financial markets, emerging market economies have become much more sensitive towards economic and political developments in industrialized countries. Among those, the role of the USA is significantly different not only because the US dollar is a valid currency in most commercial transactions but it is also a means of private saving (store of value). Therefore, in case there occurred an increase in the interest rates by the FED, certain amount of capital flight from emerging market economies including Turkey would be inevitable. In that respect, the probable impact of this increase was followed closely by the CBRT and relevant information had been shared with the public in the previous report. In this context, although a certain amount of capital flight was expected due to the increase in risk premia, under the assumption that the economic programme would be strictly adhered to and that the structural reforms would be carried out with determination, it was asserted that the TL would maintain its strong position in the medium-term. Indeed, although the country risk premium indicator had sharply inclined upwards in the period mentioned, the TL was able to maintain its strong position as expected despite the increase in interest rates by 0.25 percentage points by the FED.

The empirical studies carried out by the CBRT indicate that besides domestic economic developments, the monetary policy strategies of the US have also been highly influential on the course of exchange rates (TL/USD), risk premia, interest rates and capital movements (see the box on page 28). In this context, sustainability of such indicators as fiscal balance and current account deficit are accentuated more than interest rate decisions of the FED with reference to country risk and capital inflow.

Besides, relatively low amount of excess liquidity in the banking sector due to the increase in consumer credits, pessimistic evaluations of current account deficit figures, concerns about the future course of the programme which will be ended in February 2005, internal political disputes and increase in international crude oil prices were among the factors causing the persistence of high interest rates in the secondary markets. On the other hand, the expectations about the date for a possible initiation of membership talks with the EU, favorable explanations regarding the completion of the eighth review of the economic programme which is closely followed by the markets participants, the announcement by OPEC that petroleum supply might be increased, economic growth and inflation figures exhibiting a higher performance than projections, and especially the limited increase in the interest rates by the FED at the end of June can be listed as some of the developments which relieved the tension in the markets and which caused a relatively low course of interest rates.

The effect of the change in risk perceptions can also be observed by applying the Yield Curve analysis (Graph 4.3). While the short and medium term interest rates had retained their end of March values, long-term interest rates had shown a significant slant upwards by mid-March. The shift in the breaking point is also worth mentioning. While the curve took a horizontal form at the beginning of April, it showed an upward tendency by mid-April and the breaking point realized as 9 months. As a result of the abovementioned negative developments, however, the breaking point then shifted to 3 months by the end of the month. In May, besides the shift in the breaking point to 2-months, the yield curve shifted upwards in all maturities except the overnight rates. This increase in slope, level, and curvature should be understood as an increase in risk premia in all maturities parallel to the increase in risk perceptions as the inflation expectations in the first half of the month and overnight rates remained unchanged while inflation expectations in the second half of the month slightly increased. The yield curves retained this position in June as well. In spite of the fact that the unfavorable conditions which caused fluctuations had disappeared, concerns about the adherence to the programme and to the fiscal discipline and structural reforms are thought to have created this inertia in risk premia.

Graph 4.3 Yield curve analyses

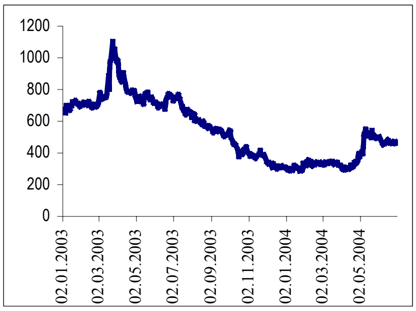


Source: Turkish banking association

The downward trend in the weighted average compound interest rates at the Treasury auctions changed its course and displayed a significant increase in May. In June, however, a declining tendency was observed. Real interest rates, on the other hand, retained their high levels. Risk premia are certainly among the most important factors in determining real interest rates. Optimistic expectations about the sustainability of the economic programme and the steps taken to maintain fiscal discipline have been influential on the downward trend in risk perceptions. Admittedly, the level of real interest rates rises when anxiety, which stems from the unfavorable domestic and external developments, dominates over optimism. In parallel to this, the spread which is generally used to evaluate the country risk and which is calculated as the difference between the long-term government securities issued in international markets and benchmark securities having the same maturity increased in May. In June, however, it started to decline (Graph 4.4).

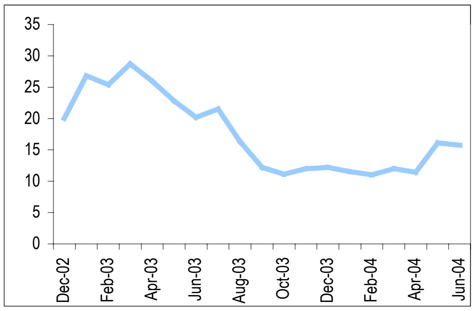
Graph 4.4 Risk premia and real interest rate on Treasury auctions

Spread (JP Morgan index)*



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

Treasury auctions real interest rate developments (percent)*

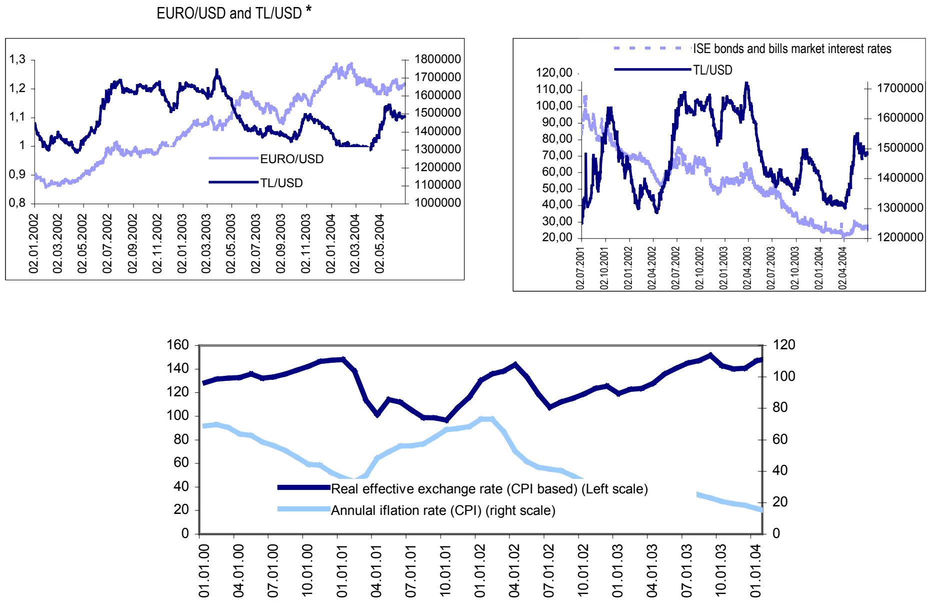


(*)Calculated using 12-month ahead CPI inflation expectations..

Source: JP Morgan and Treasury

Domestic and external developments, which have been influential on risk perceptions, have also been important for the course of foreign exchange rates. As a matter of fact, exchange rates started to increase rapidly as of April. The CBRT decreased the amount of daily foreign exchange buying auctions, which were conducted as a part of the foreign exchange policy, effective from 15 April 2004. The auctions were then suspended as of 27 April. On 11 May 2004, the CBRT directly intervened in the foreign exchange market due to the excessive volatility which was observed owing to reduced foreign exchange liquidity arising from the currency substitution process and anxiety created in the market as a result of unfavorable domestic and external developments, especially the expectations regarding the interest rate decision by the FED. In the following period, exchange rates started to move in the downward direction. Among some of the factors which supported this trend are the approaching tourism season, the FED interest rates, the explanations of EU about Turkey and the successful economic performance (Graph 4.5).

Graph 4.5 Foreign exchange developments



Source :ISE, CBRT

When exchange rate and interest rate dynamics are examined with respect to inflation, it can be asserted that no changes that might jeopardize the targeted inflation rate are anticipated in the forthcoming period. According to the CBRT Expectations Survey conducted in the first half of July, the end of year overnight annual simple interest rate is expected to be 18.16 percent and the annual compound interest rate at the quarterly Treasury Auction is expected to be 19.9 percent. As these estimations are below the actual figures, it can rightfully be claimed that the economic agents have optimistic expectations. Nevertheless the economic agents are closely following the results of the eighth review with the IMF and they are especially keen on immediate elucidation of future policy implementations in due course. It would be impossible for them to discern the effect of this positive development in case of delays.

From the point of view of exchange rate and interest rate dynamics with respect to inflation, no changes that might jeopardize the inflation target are anticipated in the period ahead.

Developments in Banking Sector and Credits

A favorable medium for external financing is created when international interest rates retain their low levels. According to the IMF *World Economic Outlook Report*, issued in April 2004, the increase in capital inflow to developing countries will continue in 2004 as was the case in 2003 (Table 4.A). Likewise, for the emerging markets to have more and more institutional investments gives rise to the positive outlook of their current economies. Yet again when these institutional investors operate by carry-trade in developing countries like Turkey, their leverage positions may be at stake. Under the circumstances, the persistence of short-term capital inflows exerting an upward pressure on the prices of non-tradable goods increases the impact of the US interest rate decisions upon developing markets.

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

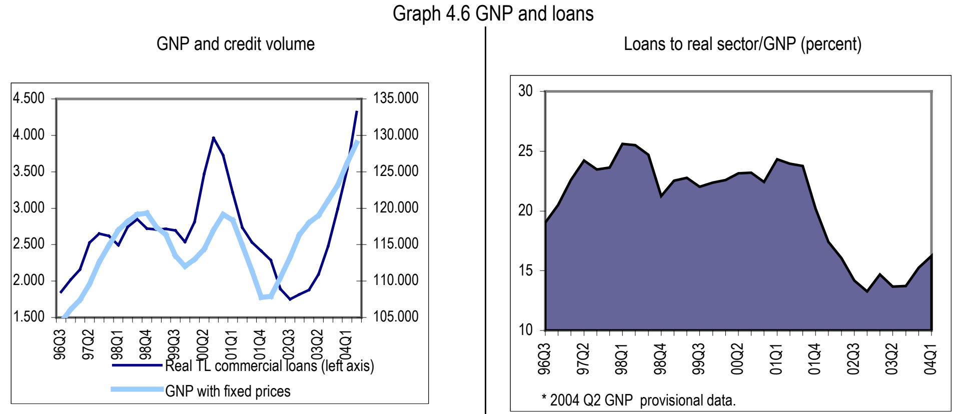
	2000	2001	2002	2003	2004*
Total capital flows	27,7	46,4	50,3	124,0	142,9
Private capital flows	42,2	20,6	47,0	131,2	162,9
Direct investments	175,0	189,1	139,3	119,3	135,5
Portfolio flows	6,1	-95,7	-98,6	-87,5	-43,9
Other capital flows	-139,0	-72,8	6,3	99,3	71,2
Change in reserves	-14,5	25,8	3,3	-7,2	-20,0

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

The possibility that the FED was to increase the interest rates came up in April created uncertainties in the markets. As a result of this uncertainty which governed the markets, there had been an increase both in the interest rates and exchange rates in all emerging markets. Moreover, the fact that the month of June is the period in which institutional investors and local banks announce their balance sheets resulted in the investors closing some of the positions they had embarked and the local banks reducing their currency risks—all of which contributed to the increase.

However, the announcement of the FED that the rise in interest rates would be limited and gradual unless there emerged inflationary pressures relieved uncertainties in the financial markets to a certain extent. Consequently, it is expected that the fluctuations in interest rates and exchange rates will be less constricted.

Graph 4.6 GNP and loans



Source: CBRT

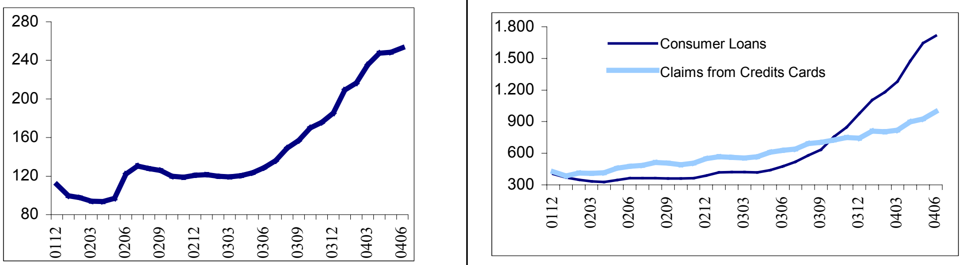
Source: CBRT

Meanwhile, in the first five months of 2004, the banks have mainly endeavored to increase the number of their clients and expand their individual credit portfolios so as to adapt to the low-inflation environment. To this aim, the portfolios of loans for small and medium scale enterprises (SMSE), consumer loans and credit cards were increased. These loans for SMSE encouraged investments of private sector while consumer loans assured private consumption. However, when the volume of consumer loans displayed a rather high amount, concerns about current account deficit arose. In June, public banks announced that they would ration consumer loans. This limitation, compounded with the increase in interest rates of consumer loans and the 50 percent restriction of tax exemption slowed down the demand for consumer loans for brand new car purchases; all of which have since led to the lessening of concerns about rapid credit extension (Graph 4.7).

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

SMSE loans (Discounted with CPI, TL billion)

Consumer loans and claims from credit cards (Discounted with CPI, TL billion)



Source: CBRT

Source: CBRT

This rate of increase in consumer loans is not expected to endanger the inflation target nor is it expected to create any risks regarding financial stability. It is anticipated that the credit offered to the private sector will enhance investment opportunities giving rise to increase in potential output, which in turn will ease the inflationary pressure. Although the rapid increase in consumer loans under present conditions is not believed to pose any risks in terms of domestic demand, inflation and current account deficit, the process is being meticulously monitored. Apart from this, the merging of Pamukbank, which is under the supervision of Saving and Deposit Insurance Fund (SDIF) with Halk Bank implies that one of the fundamental problems of the system will be solved. Furthermore, the treasury guarantee on saving deposits has been restricted to TL. 50 billion and the temporary guarantee under SDIF to the claims of all depositors and creditors from the savings banks in Turkey has been repealed as of July 5, 2004. By these improvements, part of the fundamental structural problems of the system is being worked out.

Although the rate of increase in consumer loans has slowed down since June, it is being meticulously monitored to sustain the price and financial stability.

Impact of the Changes in the US Monetary Policy on Emerging Market Economies

While the impact of the changes in the US monetary policy on emerging market economies is being discussed, certain specific areas of influence are accentuated. On the basis of the literature available, these can be grouped under the headings of: the capital movements channel, the risk premium channel and crises in the banking sector.

i. The capital movements channel: Theoretically, in the event that foreign interest rates become higher than domestic interest rates, until the international investors exhaust their opportunities of arbitrage, it is likely to occur a decline in capital inflow (or a capital outflow), an increase in interest rates and the depreciation of domestic currency against foreign currencies. Evidently, the reverse of this mechanism is also true. Apart from the negative impact of this situation on the trade balance of the country, economic policies might become unsustainable and crises may occur, depending upon whether the indexation of the foreign/domestic debt is based on foreign currencies or interest rates as these countries will be unable to maintain their economic policies. Analyses of the indicators of capital movements show that these movements are primarily determined by domestic factors and by various uncontrollable global factors. Interaction between these factors is examined by the same token. While the domestic factors represent such macro-economic indicators as growth rate, prices and public balance and institutional arrangements which influence the opportunities for investment and elements of risk, external factors comprise such indicators as international interest rates which attract funds towards emerging market economies. The empirical study, carried out by Mody, et al., on thirty-two emerging market economies including Turkey points out to the dominance of the internal factors in explaining capital movements rather than the importance of global factors— though of course, these too have influential power. (1)

ii. Risk premium channel: Although country risk is known to be determined primarily by the sustainability of the fiscal policy and level of debts, it is claimed that US monetary policy changes (decisions about changes in interest rates) also affect the risk and hence the spread which is the difference between interest rates between the two countries. The emerging market economies are believed to run higher risks of default as there may commonly exist public finance imbalances, and macro-economic ⁄ political instabilities. This situation entails that the income from government borrowing instrument of these countries should be higher than those of the risk free country's (USA) since the aim is to compensate for the probable risks the investors have undertaken. Moreover, any rise in the interest rates will adversely affect the debt burden of the countries, especially the ones having borrowing in short maturities and in US dollar, and hence the debt redemption of these countries. Finally, any such increase may diminish the incentive of the investors to take any risks. This inevitably means that the investors lose their interest in these markets. The obvious result is the debilitating effect this situation will have on the prospective financial sources of the emerging market economies.

iii. Crises in the banking sector: Most of the crises in the banking sectors of the developing countries have been related to the increase in interest rates and the strengthening of the currency in industrial countries like the US. Moreover, the impact of any change in the US monetary policy depend on the developing country's exchange rate regime. According to Whitt , the Asian Crisis of 1997 was fundamentally the result of external shocks. Among these external shocks were: the devaluation in China in 1994, the long-lasting economic stagnation in Japan and the rapid increase of the US dollar against the Japanese yen starting from 1995 to 1997. (2)

These arguments have been tested by event study approach and structural VAR for the Turkey case. Both the event study approach and the structural VAR estimates, point to the immediate impact of FED decisions about the interest rates, that is, the foreign interest rate shock on the value of TL. While the result of the structural VAR indicate an increase in risk premia and market interest rates, the result of the event study approach show that decisions about the rate of interests cannot be evaluated independently of the macro-economic/political developments prevailing in the country in the period in question. In the light of all these findings it can be asserted that such indicators as TL against the US $, risk premia, interest rates and capital movements are not only influenced by fundamental economic developments but by the FED decisions as well. It should also be noted that the sustainability of fiscal balance and current account deficit comprise the more important indicators with reference to capital movements and country risk. The course the structural reforms take with the objective of enabling the sustainability of the fiscal discipline determines the existence of high and volatile risk premia and currency and interest rate movements

[i] Mody, et al., (2001), "Modeling fundamentals for forecasting capital flows to emerging markets," *International Journal of Finance and Economics, 6, pp. 201-216.*

[2] Whitt, J., (1999), "The role of external shocks in the Asian financial crisis", *Federal Reserve Bank of Atlanta, Economic Review, Second Quarter.*

5.PUBLIC FINANCE

Between January and June 2004, the consolidated budget primary surplus showed a positive performance.

Primary surplus is an important factor for the sustainability of debt stock as well as for carrying out a successful disinflation programme. Within the framework of the economic programme, primary surplus target of 2004 has been set as high as it had been in the previous years and hence the consolidated budget primary surplus showed a positive performance in the first half of 2004. During the period between January and June, consolidated budget primary surplus realized as TL 15 quadrillion and the share of this amount in the end-year consolidated budget primary surplus target realized as 74.4 percent. Consolidated budget deficit in the same period was TL 14.6 quadrillion (Table 5.A).

Table 5.A Consolidated Budget Figures

	2004 January-June realization (TL quadrillion)	2004 target (TL quadrillion)	Realization (share in target, percentage)
Revenues	**49.8**	**104.1**	**47.8**
tax revenues	39.8	88.9	44.8
Expenditures	**64.4**	**149.9**	**42.9**
non-interest expenditures	34.8	83.9	41.4
personnel	14.6	28.6	51.1
current transfers	13.3	27.5	48.6
interest expenditures	29.6	66.1	44.9
Budget balance	**-14.6**	**-45.8**	**31.8**
Primary balance	**15.0**	**20.2**	**74.4**

Source: Ministry of Finance

In January 2004, minimum wages were increased by 38.2 percent. In order to limit the increase in the cost of minimum wage increases for employers by 20 percent, the government undertook to pay some portion of the premia. Moreover, the pensions (SSK/Bağkur) were raised by 10 percent both for the first and second halves of the year. In order to achieve the primary surplus target, 13 percent cut in some expenditure items was made and special consumption tax (SCT) on some items was increased. Without doubt, the course of the budget performance in the second half of the year is significant in that the lasting performance of the primary surplus necessitates the implementation of the structural reforms such as tax reform and social security reform.

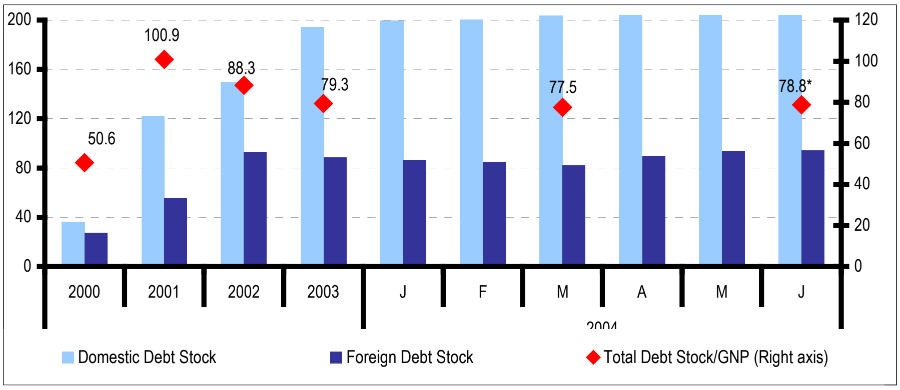
Developments in Debt Stock *

In June 2004, the consolidated budget total debt stock increased by a ratio of 7.2 per cent compared to the year 2003 and reached TL 303.4 quadrilion.

In June 2004, the consolidated budget total debt stock increased by a ratio of 7.2 percent compared to the year 2003 and reached TL 303.4 quadrillion (Graph 5.1). While the level of foreign debt stock in terms of US $ remained unchanged, domestic debt stock increased by a ratio of 7.6 pecent and reached TL 209.1 quadrillion. The ratio of debt stock to GNP, a criterion in assessing the sustainability of debt stock, is expected to show a slight increase in June as a result of the depreciation of the TL (Graph 5.1).

* In this section, debt stock refers to consolidated budget debt stock.

Graph 5.1 Consolidated Budget Debt Stock (TL quadrillion)

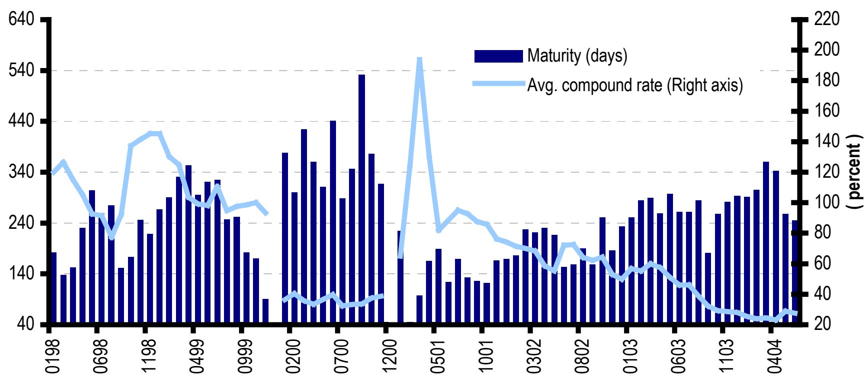


Source: Treasury
*Forecast
**Average monthly US $ buying rate is used in calculations. Annual figures are calculated using the December US $ buying rate.

Favourable borrowing conditions were interrupted by the rise in interest rates in April and May, 2004.

Favourable borrowing conditions, stemming from the environment created by the political stability and sustainable state of the economic programme, were interrupted by the rise in interest rates in April and May, 2004. Uncertainties surrounding Cyprus, the FED decision to increase the interest rates and the anticipation that the current account deficit of the first quarter was to exceed the foreseen level had been the cause of the rise in interest rates. Nevertheless, the interest rates showed a tendency to decline in June, yet remained above the level in April. In this period, in which the interest rates increased, Treasury decreased the maturity of borrowing at the TL denominated discounted auctions (Graph 5.2). In May, average interest rate in discounted auctions indicated, a 5.7 points increase. This event reveals that the risk premium effect on interest rates can be observed in cases when expectations are vitiated.

Graph 5.2 Borrowing Maturity and Compound Interest Rate*



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

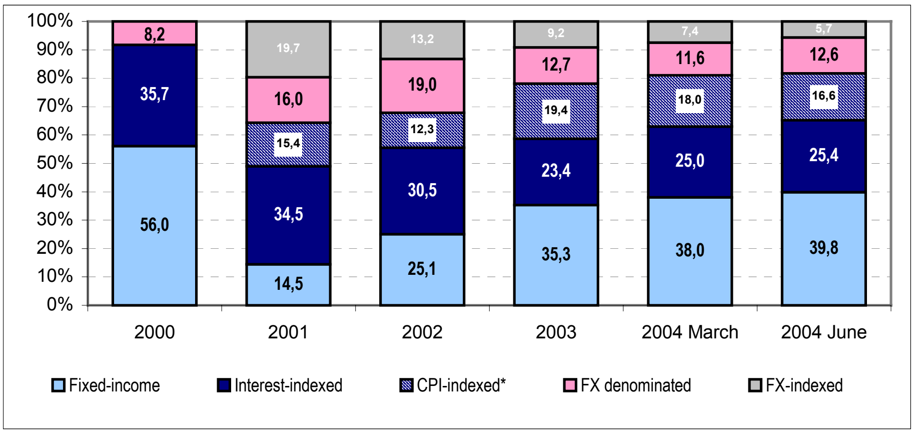
Within the framework of strategic benchmark implementation, based on the cost and risk analysis of the debt stock, the borrowing policy for 2004 foresees major portion of cash borrowing to take place in terms of TL denominated instruments and the maturity of cash borrowing to extend over a year. Domestic borrowing in the year 2004 has concentrated on TL denominated instruments in accordance with the strategic benchmark policy. Despite the reduced term of borrowing maturity in May, average cash borrowing maturity realized at 14.2 months in January-June period (Graph 5.5). In addition to the switching auctions held in the first quarter of 2004, in the switching auctions held in May, the FX indexed securities due in June were switched with 13-month FX denominated securities. By this operation, debt service of 2004 was reduced, however currency risk of the debt stock remained unchanged.

About US $ 3.5 billion of the US $ 5 billion worth of external borrowing anticipated for the year 2004 was completed via bond issuance in January, February and June. About US $ 4.6 billion worth of foreign debt redemption will be realized by the Treasury between July and December.

As of June 2004, a total amount of US $ 3.5 bn. external borrowing has been realized.

An analysis of the composition of domestic debt stock as of June 2004 shows that within the framework of the benchmak borrowing policy, the share of fixed-income government securities rose whereas the share of FX denominated and FX linked securities continued to decline (Graph 5.3). Although there has been a slight increase compared to 2003, the share of interest-linked securities has declined in the long run. The structural change observed in domestic debt stock indicates a decline in the vulnerability of debt stock against movements in interest rates and exchange rates. Despite the improvement in borrowing terms and domestic debt structure, as of June, about 60 percent of the overall debt stock is comprised of FX denominated or FX linked borrowing instruments.

Graph 5.3 Decomposition of Domestic Debt Stock by type of Borrowing Instruments

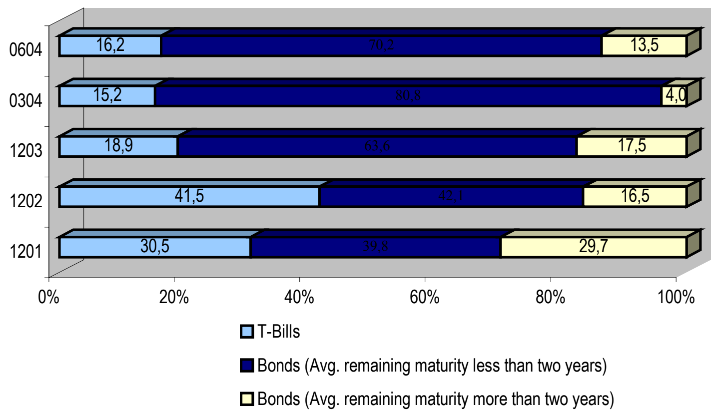


* Comprises CPI-indexed non-cash securities in the Cenral Bank Portfolio and CPI-indexed cash securities issued to Compulsory Saving Account (CSA) in May 2003.
Source: Treasury

As for the maturity structure, it is observed that cash domestic debt stock is concentrated on the government securities with remaining average maturity of less than two years (Graph 5.4). The remaining average maturity of these securities is designated as 10.5 months. Decline in the share of these securities in the cash domestic debt stock with respect to March has resulted from the redemption of maturing bonds, from a security group under the category of securities with remaining average maturity of less than two years. As maturing securities were redeemed average maturity of the remaining securities in the group extended beyond two years.

Most of the cash domestic debt stock is concentrated on the government securities with average maturity of less than two years.

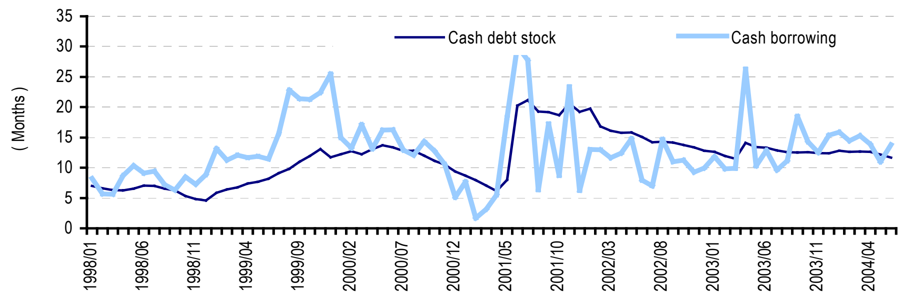
Graph 5.4 Maturity Structure of Cash Domestic Debt Stock



Source: Treasury

Graph 5.5 shows the development in the maturity of cash debt stock and cash borrowing as of January 1998. In 1999, two-year maturity floating rate notes were issued. As a result of which the maturity of the cash domestic debt stock increased. In year 2000, borrowing maturity in discounted auctions increased whereas maturity of overall cash borrowing decreased (Graph 5.2). While maturity of cash domestic debt stock decreased after the November 2000 and February 2001 crises, switching operations held in June 2001, led to an increase in the maturity of the cash domestic debt stock as maturing securities were switched with long-term securities. In the period following this operation, the maturity of cash domestic debt stock approached the borrowing maturity. There has been a stable course in the period after despite the decrease in cash domestic debt stock maturity in June 2004.

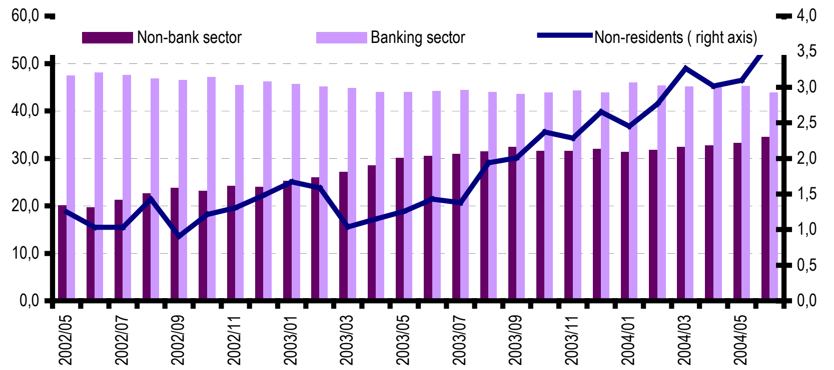
Graph 5.5 Maturity of Cash Domestic Debt Stock and Cash Borrowing



Source: Treasury

When the decomposition of the domestic debt stock by lenders is analysed, it is observed that the upward trend, which started in March 2003, in the share of government securities held by non-residents is still persisting (Graph 5.6). The total amount of government domestic debt instruments (GDDI) held by non-residents reached TL 8.5 quadrillion by the end of June, 2004.

Graph 5.6 Composition of Government Domestic Debt Instruments (GDDI) by Lenders
(Share, Percentage)



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

Consequently, no major changes pertaining to the debt dynamics have been observed with respect to the first quarter of 2004. Although the recovery in debt stock continues, the short maturity of debt stock and the considerable share of FX denominated and FX linked securities, renders it vulnerable to movements in exchange rates and interest rates.

6 Outlook

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

Demand and Cost Factors

Domestic demand entered a process of recovery in 2003 and this process continued to accelerate in the first quarter of 2004. Evidently, the course of domestic demand components are of great importance in terms of the inflation target.

Private Consumption Expenditures

The downward trend in inflation and the appreciation of the Turkish lira as well as the increase in installments and borrowing opportunities, largely accounted for the extension of maturities as a consequence of the rise in consumer confidence, led to acceleration of consumption expenditures in the first quarter of 2004. The CBRT Business Tendency Survey suggests that the above mentioned trend will continue in the second quarter of 2004.

The evidence may suggest that domestic demand pressure may emerge in the second half of the year. However, detailed analysis shows that the consumption increase is limited to durables for the most part. While exchange rate movements and borrowing facilities triggered demand for durables, expenditures on necessities were mainly restricted implying that income and expenditure increases were mainly enjoyed by certain consumer groups only. The fact that total final domestic demand has not yet resumed the year 2000 level despite the high increase rate in the first quarter, indicates that there is no distinctive inflationary demand pressure. The existing incomes policy and the restriction of employment through labor productivity have a constricting effect on demand. Besides, in an environment in which real income increases are limited, the increase in consumer loans now will bring about an increase in pay-backs which in turn will put restraint upon income and spending in the future.

As a matter of fact, the rise in interest and exchange rates starting from the end of April, the restraint on credits by public banks and the removal of excise deduction available for new car purchase, are limiting factors restricting the conjectural increase in the first quarter of the year. It is predicted that the robust course of investment trend, the maintenance of delayed consumption, as well as the productivity level and the ratio of capacity utilization, owing to the increasing foreign demand, will follow a high and stable course of growth in the latter half of the year. Indeed, GNP growth in 2004 is foreseen to be well above the projections of the economic program. The probable risks which may occur as a consequence of these developments are discussed in the last section.

Private Investment Expenditures

Overall, the recovery in the profile for future expectations, the strong course of the Turkish lira, the decline in both internal and external financing costs and the expansion of foreign finance facilities, in particular, can be held accountable for the increase in private investment expenditures in the first quarter of 2004. Evidently, the ratio of capacity utilization of the private sector has been increasing in the second quarter as well. For this reason, firms have given priority to investments which they aim to improve their present capacity and productivity levels rather than concentrating on new investments.

The results of the CBRT Business Tendency Survey and the Real Sector Confidence Index also verify this situation. The survey reveals that the interest rate on loans will remain at a low level. In brief, investment expectations follow a favorable course and the trend of investment expenditure is continuing to rise.

Maintaining high growth rate without allowing for any inflationary pressures necessitates a continuous rise in investment expenditures and productivity increases in the rest of the year. Furthermore, the implementation of the structural reforms in conjunction with the establishment of competitive market conditions so as to ensure an environment of confidence are highly crucial contributory factors which will enable the desired increase in investments and potential output.

Public Consumption and Investment Expenditures

In the first quarter of 2004, public consumption rose by 2.4 percent, public investment expenditures declined by 11.3 percent. These developments are consistent with the public sector expenditure projections. By the same token, tight fiscal policy within the framework of fiscal discipline will continue to be implemented in the latter part of the year as well. It is therefore expected that the pace of increase in public expenditures during the latter part of the year will be rather slow and that the main source of growth will be the private sector.

Production Expectations

Neither the expenditures of the private sector nor those of the public sector are believed to pose any demand pressure that would risk the inflation target. It is also firmly believed that the export-oriented high growth rate after the 2001 crisis will continue in 2004 since industry production has been increasing at a high rate in the second quarter of the year as well. The results of the CBRT Business Tendency Survey confirms this expectation.

Cost Factors

Exchange Rates

The appreciation of the Turkish Lira, which began in 2003 continued at the start of 2004 as well. However, as a result of some negative evaluations of the current account deficit, uncertainties about whether the IMF program would continue in 2005, increase in international crude-oil prices and expectations about a probable increase in interest rates by the FOMC led to the depreciation of the Turkish Lira as of the end of April. Therefore, on May 11, 2004 The CBRT intervened in the market and sold 9 million US dollars. Though rather a small amount, by the signaling effect, along with the removal of unfavorable conditions which led to volatilities in the markets, reversed the increasing trend in exchange rates.

The floating exchange rate regime is beginning to be understood better. As a result of the changes in risk premium caused by various external shocks and/or internal political developments, exchange rates display upward or downward trends. However, these temporary fluctuations are not reflected on pricing mechanisms and so absolute increases in prices are avoided. It is likely that there will be upward/downward movements in exchange rates in the periods ahead as well. Nevertheless, only temporary and limited fluctuations in exchange rates are expected on condition that the structural reforms are put into practice and that the continuation of the fiscal discipline in the public sector is secured.

Crude Oil Prices

Crude oil prices have shown a tendency to increase in the second quarter of the year as well despite the high level of supply. Main determining factors of this increase were: the increasing demand by China and US and the fears that attacks in the middle East could spread to petroleum plants as well as the general tendencies in the futures markets. However, the signs that China's attempts to slow down growth compounded with the measures to secure peace in Iraq had an impact on the decrease in crude-oil prices. On 3 June 2004, the OPEC announcement to increase daily production by 2 million barrels as of July 1 and by 0.5 million barrels as of August 1, contributed to this decrease as well

There are no signs of an increase in crude oil prices in the near term. The present situation in Iraq, where the second largest petroleum reserves in the world lie is of crucial importance concerning the course of these prices. Once uncertainties about the Iraqi administration are settled, it is believed that daily crude-oil production would increase in which case increase in prices would not be anticipated. Moreover, the Press Release of OPEC dated July 22 gave signals of a likely intervention in case of an upward trend in petroleum prices.

Administered Prices

Public price increases, having had a positive contribution to the decline in inflation in 2003, was 3.1 percentage points above the private manufacturing industry prices in the first half of 2004 owing to the increase in crude-oil prices and metal and chemical industrial product prices, the rise in exchange rate in the second quarter of the year and the recovery in international economic activity.

The application of the SCT caused an increase in TEKEL product prices. Rising public prices as a result of the increase in taxes do not pose any risks concerning the inflation target as of the first half of the year. However, in the near term in which single digit inflation is targeted, increasing such tax revenues for the sake of maintaining the fiscal discipline may endanger inflation objectives. Therefore, the importance of the quality of fiscal discipline can not be more than emphasized.

Labor Costs

2004 public sector wage and salary increases were set in line with the inflation target which were set as the basis for the rise in wages in the private sector. The low level of unit wages and productivity increase has been going on in the first half of 2004. Unit labor costs–though not as much as had been in the past two years–, due to the productivity growth in the manufacturing sector, are expected to continue to support the decline in inflation. The extent to which productivity increase, decline in inflation and increase in growth continue depends on how successfully the necessary structural adjustments to avoid any obstacles that might harm investment and productivity opportunities are being carried out.

Monetary and Fiscal Discipline

Within the framework of price stability as the primary objective, short-term interest rates will continue to be effectively used as the main policy instrument by the CBRT. Similarly, monetary performance criteria and the indicative targets will be closely monitored under the Standby Agreement with the IMF.

The CBRT will continue to implement the floating exchange rate regime and stand ready to hold foreign exchange auctions – the amounts of which will be announced in advance. The objective will certainly be to increase the efficiency of the monetary policy without intervening in the level of exchange rates.

Securing the advancement of the fiscal discipline is of crucial importance for the effectiveness of monetary policy. Despite the relative improvements in the indicators of debt stock in the first quarter, debt dynamics still retain their fragile position and no major changes have been observed. The fact that a major portion of the debt stock is comprised of short-term, indexed and FX denominated securities creates vulnerabity with respect to volatilities in exchange rates and interest rates. Although there has been a relative decline in domestic FX denominated debt stock, the short-term maturity of TL denominated securities still continue to create risks. Indeed, the fluctuations that occurred in April and May had affected the market expectations adversely and increased the risk premium with an overall negative impact on debt stock.

Inflation Expectations Other Risks

The results of the CBRT July, Expectations Survey indicate that CPI inflation expectation at the end of year horizon had fallen below the 12 percent target and realized at 10.9 percent. The 12-month inflation expectations has also been consistent with the 8 percent inflation target of the year ahead. As of the first half of 2004, expectations of achieving year-end inflation target have been strengthened.

Risks and Results

In the light of the evidence about developments in inflation in the first half of the year, the probable risks in the next term can be listed as follows:

- With the floating exchange rate regime, a structural transformation in exchange rates and inflation link has taken place and a weakening in the pass-through from exchange rates to inflation has been observed. Among other factors acting upon this process were the increasing competitive environment, the use of inflation in fiscal policies as an endogenous parameter, and the break in inflation expectations. Indeed, the relatively slow reflection of the increase in exchange rates on inflation in May and June compared to the previous periods support this process. It is a major concern at this very stage that the lagged impact of exchange rates might appear, since evidence suggests that the cumulative effect of exchange rates in the medium term is hardly likely to be regarded as being at negligible levels.
- The unforeseen fluctuations in energy prices are always a risk factor. It is becoming more apparent than ever that the increase in crude oil prices will not display a reverse tendency in the near future. It is possible then that upward trend in crude-oil prices will exert pressure on both current account deficit and inflation. The need for budget finance that may emerge as a consequence of the continuous rise in international crude oil prices as well as the exchange rate pressure will inevitably give rise to increases in fuel-oil and petroleum product prices in the periods ahead. The reflections of these increases will be closely monitored both in the rest of 2004 and through 2005 (See Box on page 7).
- For the most part, the growth in the first half of the year was ascribed to the increase in private consumption and investment. A similar tendency in the composition of growth is likely to repeat itself in the second quarter. In response to the increasing interest rates and fluctuations in exchange rates in the previous period, there may occur a weakening in the pace of growth due to a slowdown in domestic demand. Looking forward, however, the increasing investment trend and the powerful course of foreign demand are likely to restrain this state of slowdown. In line with these developments, intermediary

and capital goods imports will follow a high course and this rising pace of expansion as a consequence of the rise in economic activity is expected to exhibit a wider current account deficit than projected despite the good performance in export and tourism revenues.

- Taking into consideration the structural dynamics inherent in Turkey, the fact that a higher rate of growth than projected also entails a wider current account deficit should not be puzzling. In the period ahead, it is imperative that the developments in the current account deficit and its components are kept under vigilant observation. It is equally important that the fiscal discipline is carried out and domestic demand kept under control. Preventing the additional tax revenues from channeling into spendings created by the cyclical movements will contribute to release the tension on current account deficit. Moreover, the stronger the perception that fiscal discipline and structural reforms are to be carried out within the framework of a medium term economic program, the more limited the potential risks the current account deficit indicate via exchange rates and output gap. Furthermore, in order to eliminate any impediments by the current account to medium-term growth, structural reforms should be accelerated and quality of finance improved.

- The acceleration in manufacturing industry prices due to cost factors over the first half of the year is anticipated as slowing down. The high possibility that electricity prices will remain unchanged for quite some time and the increase in the prices of basic metal and petroleum raw materials has been brought to a standstill will certainly ease the pressure on costs. It is estimated that these influences will not affect the CPI inflation and so they are unlikely to jeopardize the inflation target in 2004. Nevertheless, these dynamics are to be closely monitored for the inflation target of 2005.

- The risk of fluctuations in financial markets is always possible in case of any delays with respect to the continuation of the present program, not to mention the unprecedented exogenous developments like faster than expected interest rate cuts by the FOMC and the European Union talks. As long as the monetary and fiscal discipline is maintained and firmer steps are taken concerning the implementation of the structural reforms, the extent to which the above mentioned fluctuations reflect on prices will be much weaker compared to the periods preceding 2001.

- The rigidity in the service sector prices is still a fact and it seems that breaking of rigidity in sectors such as education and rent will take up some time. Consequently, monitoring the price developments in these sectors is also of great importance for the 2005 inflation target.

- Agricultural products and food prices are expected to contribute positively to the 2004 inflation. Nonetheless, the fact that these sectors are highly vulnerable to seasonal conditions, makes them render very little information about the 2005 inflation. Therefore, they do not constitute a component powerful enough concerning monetary policy decisions.

- The shaping up of inflation expectations is the outcome of the implementation of the monetary and fiscal policies in line with the inflation target for the past three years as well as the attempts of the CBRT to share with the public with openness and diligence the future course of the inflation tendency. Now, a strong point of reference for all economic units is the inflation target. In this context, despite the recent cost-push shocks, the inflation expectations have been very close to the target and they are expected to follow a similar course in the near term.
- The fact that low inflation rates are realized during the same period of the previous year is likely to bring about a slight rise in annual rates of inflation in the months ahead. Increase in foreign demand, relative recovery in domestic consumption expenditures, the upward trend in capacity utilization rates as well as the rapid increase in public prices support the fact that fall in inflation will slow down in the period ahead. Yet, the persistence of productivity increases, maintenance of tight fiscal and monetary policies and the increase in investments could be the factors that would ease the demand pressure. On account of the very low cumulative inflation through the first half of the year, exceeding the target even on the occasion of a certain external shock is a rather low probability outcome. In brief, it is expected that inflation will be realized in accordance with the target.

All these developments over the first half of 2004 reveal the present state in the fight against inflation. To establish lasting price stability, structural reforms should be put into practice. On the benchmark assumption that productivity increases will continue –though not as high as it had been in the past two years– and taking into account the present conditions in the labor market, it can be asserted that unit labor costs will contribute to the decline in inflation throughout 2004. It is nonetheless a crucial prerequisite for the progress in the fight against inflation that public wages and incomes policies be carried out in accordance with the inflation target.

Another prerequisite for the price stability is, of course, the removal of the barriers in front of the investment and production opportunities so as to attain medium and long term increase in productivity. In addition, the steps taken towards reforms in the areas of public administration, social security and fiscal sector are positive developments. It is, however, important to strengthen the mechanisms which will guarantee the persistence of these reforms. Evidently, immediate realization of the structural transformation process will help to strengthen the economic fundamentals and such will contribute to the persistence of gains.

INDEX of GRAPHS and TABLES