

MONETARY POLICY REPORT

APRIL 2003



***CENTRAL BANK OF THE
REPUBLIC OF TURKEY***

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GENERAL ASSESSMENT*

Implicit inflation targeting strategy has been maintained and base money has been used as a supplementary anchor. The targets for CBRT balance sheet components for April-December 2003 period were set down in the letter of intent dated April 5, 2003. Short-term interest rates were used as the basic policy instruments within the framework of the implicit inflation targeting strategy. Worries regarding a military operation in Iraq and developments about the design of future fiscal policy brought along uncertainties in the first three months of the year. The rise in costs triggered by the increase in international crude oil prices and exchange rate developments due to uncertainties coupled with increase in agricultural and food prices halted the downward trend in inflation in the first quarter of the year. However, the sustained deficient domestic demand curtailed the effect of increase in costs on consumer prices. Consequently, CPI and WPI, which were 29.7 percent and 30.8 percent by the end of 2002, became 29.4 percent and 35.2 percent by the end of March 2003. Termination of the military operation in Iraq in April; the foresight that the adverse effects of the exogenous shock on the downward trend in inflation would be limited, the promising budget performance in the recent months and the conclusion of the 4th IMF review eased the uncertainties in the market to a great extent. Within this framework, the short-term interest rates -except for the late liquidity window facility borrowing interest rate- were dropped down by 3 percent on 25 April 2003, taking into account the variables affecting future inflation trends.

The CBRT has continued with the implementations intended for enhancing financial stability and established the Securities Lending Market within the framework of the primary dealer system. Moreover, some additional measures have been taken in the Turkish lira and foreign exchange markets with the sole aim of curbing the adverse effects of Iraq operation on financial markets. Accordingly, on March 20, 2003, the CBRT

announced that it would provide funding at the ISE Repo-Reverse Repo Market with an overnight interest rate of 51 percent, in case necessary. On the same day, the interest rate applicable to late liquidity window facility lending interest rate was decreased by 5 points to come down to 56 points. The interest rate applicable to foreign exchange deposit accounts with one week maturity were decreased by 4 points on March 20, 2002 to be followed by a further 2-point-decrease on March 24, 2002.

An analysis of the money supply developments reveals that M1 and M2 money supplies contracted by 5.2 percent and 4.2 percent, respectively, in the first quarter of 2003. Contraction in M1 money supply despite the increase in the volume of money in circulation, stemmed from the decline in sight deposits. M2X money supply also contracted by 7.9 percent in real terms in the same period. The comparably higher rate of real decline in M2X money supply can be attributed to the 11.1 percent contraction in FX accounts.

The monthly average of compound interest rates in the Treasury auctions significantly increased in January. The said interest rates then exhibited a limited decline in February to be followed by an upward trend in March due to uncertainties incited by the military operation in Iraq. Thus, the compound interest rates in Treasury auctions reached the highest level in March after the elections. The interest rates in the secondary market also fluctuated in the referred period. As of the beginning of March, interest rates at the secondary market started a rapid climb. In April, however, interest rates at the Treasury auctions as well as at the secondary market dropped significantly parallel to the ease of uncertainties.

In the first three months of 2003, exchange rates were -to a large extent- determined by external developments and worries about the degree of success in accomplishing the requirements of the program, which is the main determinant of the course of economic fundamentals. While US dollars exhibited a limited decline until the end of March compared to the level by the end of December, Euro appreciated vis-à-vis both TL and US dollars in the

* Data until 25 April 2003 have been used in this report.

same period. Exchange rate basket started to depreciate towards the January level as of the end of March again.

Credit volume in banking sector displayed an increasing trend in December 2002 and January 2003. Total credit volume, which contracted in February due to uncertainties incited by the Iraq crisis displayed no change in real terms in March. An overall evaluation of the first quarter of 2003 reveals that when the transfers between accounts totaling TL 3.3 quadrillion is subtracted, the total credit volume increased by 1 percent compared to the end-year figures.

In January-March 2003 period, budget surplus excluding interests and privatization increased by 25.5 percent compared to the same period last year and reached TL 4.9 quadrillion. The budget deficit became TL 10.9 quadrillion in the same period. In January-February 2003 period, in which the Treasury was the net borrower, consolidated budget cash deficit was TL 9 quadrillion. The Treasury borrowed TL 10.7 quadrillion from domestic markets as a net borrower and external borrowing recorded 422 trillion Turkish liras.

Domestic debt stock increased from TL 149.9 quadrillion at the end of 2002 to TL 162.6 quadrillion with 8.5 percent increase as of the end of March 2003. In response to the worries about the exact time of the military operation in Iraq, the Treasury borrowed from the markets more than it paid back in order to accumulate reserves for the forthcoming period. The primary surplus in the first two months of the year contributed to the deceleration in the rise of domestic debt stock.

In 2002, Turkish economy started to recover after a serious contraction in 2001. Compared to the figures of the same period previous year, GDP and GNP increased by 11.4 percent and 11.5 percent in the last three months of 2002. Thus, overall increase in GDP and GNP in 2002 became 7.8 percent.

When contribution of demand components to economic growth are analyzed, it is observed that stock change has contributed the most to growth in 2002. While the

contribution of private expenditure has been limited, that of public expenditure in growth has been significant in the second half of the year. Meanwhile, contribution of net exports component has been negative due to sharp rise in imports and decline in invisible earnings. Total final domestic demand inched by a mere 1.7 points in 2002 compared to the figures of the last year. The low level of domestic demand prevented a demand-pull pressure on consumer prices. Meanwhile, rapid increase achieved in exports enabled a significant rise in manufacturing sector despite the sluggish demand. Base effect of the last year's serious contraction played an important role in this rapid growth.

Despite the growth trend in economy in 2002, adverse developments in labor market accelerated. Unemployment rate, which was 6.6 percent in 2000 became 8.5 percent in 2001 and finally reached 10.6 percent in 2002. Real wages continue to decline especially in private manufacturing sector in 2002.

Compared to the same period last year, exports increased by 12 percent and reached USD 35.1 billion while imports increased by 28.8 percent to reach USD 50.8 billion in January-December 2002 period. In the same period, proportion of imports covered by exports dropped down to 69 percent. According to the temporary foreign trade data released by SIS for January-February 2003 period, exports and imports increased by 21.1 percent and 27.3 percent, respectively. Foreign trade deficit increasing parallel to the economic growth became an important determinant of current account in 2002. Thus, current account balance started to run deficit in annual basis in the last quarter of the year. Current account ran a deficit of USD 1.8 billion in the entire 2002 while it stayed at USD 224 million in January 2003. The total amount of net capital inflow was USD 2.2 billion in 2002 and USD 1.2 billion in January 2003.

In 2002, global economy exhibited an unexpectedly slow and vulnerable recovery after the 2.2 percent growth in 2001 and reached only 3 percent in 2003. While growth rate of developed countries remained below the global average rate of growth, economic performance of

developing countries varied between regions and countries. In the last quarter of 2002 and first quarter of 2003, the global economic trends were mainly drawn up by the increasing uncertainties due to the tension in Middle East and rising oil prices. Uncertainties stemming from the tension in Middle East eased down as of April. The Asian economies, which had recorded high rates of growth in 2002, started to be affected by the slow down in United States. Meanwhile, Latin American countries are expected to achieve positive rates of growth in 2003 after the contraction in 2002.

Consequently, developments regarding the design of future fiscal policy as well as the operation in Iraq led to fluctuations in the market in the first quarter of 2003. Moreover, rise in agricultural and food prices fed into unexpected increase in monthly inflation figures. Taking into account the relative ease of political tension in Middle East, the current monetary policy, which focuses on price stability, is believed to bring back downward trend in inflation provided the economic program is implemented without concessions.

I. PRICE DEVELOPMENTS

The rise in costs due to developments in international crude oil prices and exchange rates coupled with rapid increase in agricultural and food prices led to a halt in the downward trend of inflation in the first quarter of 2003. However, continued sluggish domestic demand restricted the effect of the rise in costs on consumer prices. Consequently, annual rate of increase in CPI and WPI, which were 29.7 percent and 30.8 percent at the end of 2002, were recorded as 29.4 and 35.2 percent at the end of the first quarter of 2003 (Table I.1).

The rise in inflation in the above-mentioned period can mainly be attributed to the external developments. Uncertainties sparked by the war in Iraq led to fluctuations both in exchange rates and oil prices. The foreign exchange rate basket which followed a really unstable course during the period of January through March, had increased by 7.3 percent by March 2003 compared with December 2002 (Box I.1).

Triggered by the developments in Iraq, rise in oil prices and exchange rates pushed up domestic oil prices which in return played an important role in the increase of WPI. Increase in the prices of petroleum products item under WPI became 20.2 percent in January-March period.

The rise in costs due to developments in international crude oil prices and exchange rates coupled with the rapid increase in agricultural and food prices led to a halt in the downward trend of inflation in the first quarter of 2003.

Not only the external developments but also the public price adjustments played an important role in the increase in inflation in the first quarter. While public price adjustments mainly stemmed from the developments in fuel prices, public prices other than fuel products were also adjusted. These adjustments have been carried out in compliance with the tight fiscal policy and the fiscal targets to be attained.

Table I.1. Annual and Cumulative Inflation

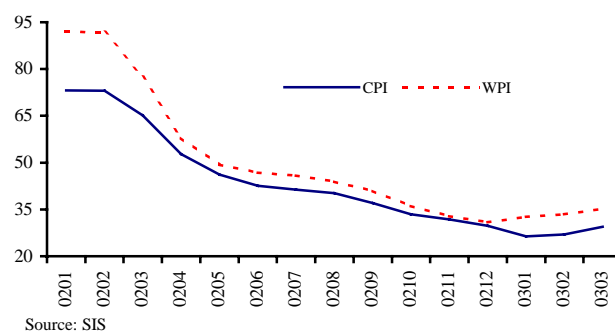
| | Weight (%) | ANNUAL INFLATION | | | JAN - MAR | |
|------------------------------|------------|------------------|----------|---------------------|-----------|------|
| | | 2001 Dec | 2002 Dec | 2003 Mar | 2002 | 2003 |
| WPI | 100,00 | 88,6 | 30,8 | 35,2 | 8,8 | 12,4 |
| WPI (Public) | 23,17 | 99,7 | 32,4 | 42,7 | 5,2 | 13,4 |
| WPI (Private) | 76,83 | 84,6 | 30,3 | 32,4 | 10,2 | 12,0 |
| WPI (Exc. Agriculture) | 77,78 | 96,3 | 29,6 | 35,6 | 4,6 | 9,4 |
| WPI (Agriculture) | 22,22 | 65,5 | 35,2 | 33,9 | 23,8 | 22,6 |
| CPI | 100,00 | 68,5 | 29,7 | 29,4 | 8,4 | 8,2 |
| CPI (Tradable) | 58,16 | 78,1 | 30,1 | 27,4 | 9,9 | 7,6 |
| CPI (Non-tradable) | 41,84 | 59,4 | 29,4 | 31,6 | 6,8 | 8,7 |
| CPI (Goods) | 70,69 | 80,9 | 29,7 | 29,3 | 8,7 | 8,4 |
| CPI (Services) | 29,31 | 48,2 | 29,8 | 29,6 | 7,9 | 7,8 |
| CPI (Administered) | 20,72 | 92,0 | 31,3 | 34,9 | 7,5 | 10,5 |
| CPI (Non-administered) | 79,28 | 62,1 | 29,2 | 27,6 | 8,5 | 7,1 |
| CPI (Food) | 28,50 | 78,4 | 24,1 | 28,5 | 12,7 | 16,8 |
| CPI (Durable Goods) | 7,33 | 65,6 | 45,0 | 20,0 | 24,7 | 3,1 |
| CPI (Exc. Food) | 68,91 | 65,6 | 31,5 | 29,7 | 7,1 | 5,6 |
| CPI (Exc. Housing) | 74,2 | 72,9 | 30,1 | 30,0 | 9,3 | 9,2 |
| ER Basket (average) | - | 113,6 | 15,8 | 33,8 | -7,2 | 7,3 |
| Export Prices ⁽¹⁾ | - | -5,0 | 4,9 | 7,5 ⁽¹⁾ | | |
| Import Prices ⁽¹⁾ | - | -5,8 | 9,6 | 13,7 ⁽¹⁾ | | |

Source: SIS, CBRT

(1) 2003 January

It is observed that the upward trend in agricultural prices in the last quarter of 2002 continued during the period of January through March 2003. The rapid increase in agricultural prices fed into CPI food prices and seasonally adjusted increase in food prices became 11.1 percent in the first quarter, while seasonally adjusted increase in CPI excluding food remained at 7.0 percent in the same period.

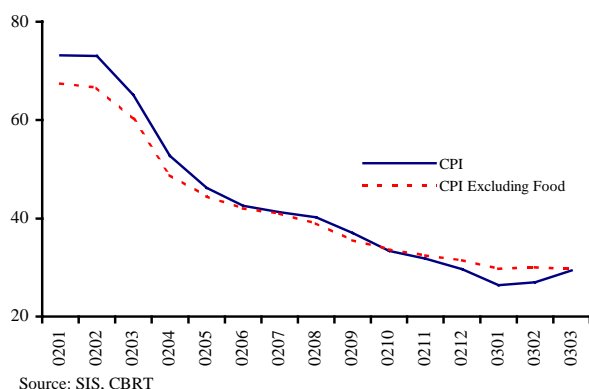
Figure I.1. WPI and CPI; 1994=100 (Annual Percentage Change)



Source: SIS

As appreciation of exchange rates, increase in fuel prices and public prices other than fuel prices are more influential on WPI while demand conditions have a more dominant effect on CPI, increase in WPI became more significant in the first quarter of 2003.

Figure I.2. CPI and CPI Excluding Food; 1994=100 (Annual Percentage Change)



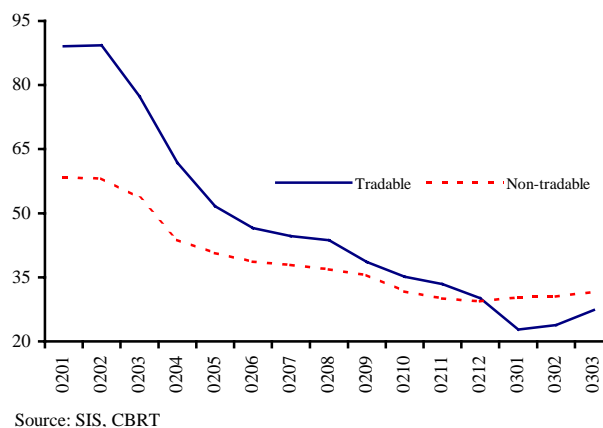
I.1. Developments in Consumer Prices

In the first quarter of 2003, consumer price inflation was adversely affected by the rise in food, transportation and health prices due to seasonal factors while the relatively low increase in consumer durables and house rents became a strong factor that curtailed further increase in CPI inflation.

Developments in Tradables

Prices of non-tradable goods exhibited a relatively faster course in January-March 2003, however this was the result of seasonal factors. While the decline in clothing prices due to seasonal factors decelerated inflation for tradables, acceleration observed in services prices again due to seasonal reasons made a negative impact on the prices of non-tradable goods. Consequently, prices of tradables and non-tradables increased by 7.6 and 8.7 percent, respectively, in the first quarter of 2003. (Figure I.1.1).

Figure I.1.1. CPI Tradable and Non-tradable; 1994=100; (Annual Percentage Change)

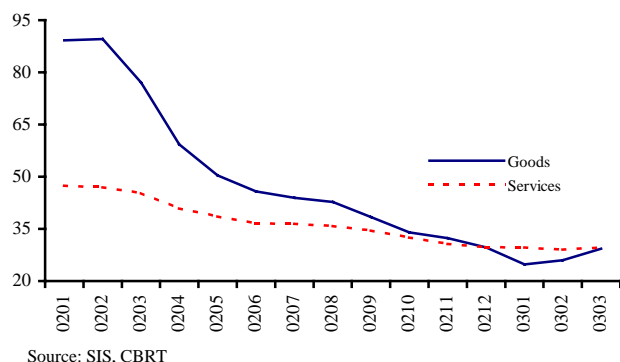


Developments in the Prices of Goods and Services

Despite the decline in the prices of clothing group, rate of increase in the prices of goods became 8.4 percent in January-March period. However, that the increase mainly stems from the rise in food and oil prices means that the increase is originally based on exogenous factors. When food prices are excluded, rate of increase in the prices of goods remains only at 3.9 percent. Despite the rate of increase in house rents increased by a mere 5.5 percent in the first quarter, the overall increase in the prices of services reached 7.8 percent. Seasonal increase in the prices of health and financial services and rise in transportation services due to oil prices became the main factors that triggered increase in services prices. That the annual rate of increase, in which seasonal developments is not a factor, sustains its horizontal course, shows that increase in the prices of services mainly stems from seasonal factors (Figure I.1.2). It is estimated that inflation in services sector will return to a downward trend with the ease of the effects of war and slowdown in seasonal increases.

When food prices are excluded, rate of increase in the prices of goods remains only at 3.9 percent.

Figure I.1.2. CPI Goods and Services Prices; 1994=100
(Annual Percentage Change)



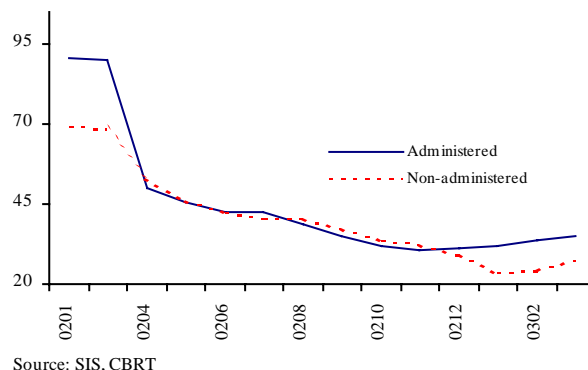
Developments in Administered Prices

Increase in the prices of administered goods in the first quarter of 2003 was higher compared with the figures of 2002. While the highest quarterly rate of increase for administered prices in 2002 was 9.2 percent, prices of the same group increased by 10.5 percent in the first quarter of 2003. Underlie this high rate of increase, the overall effect of the rise in fuel prices stemming from external factors, seasonal price adjustments made in some public services and increase in the prices of certain public goods such as TEKEL (State Monopoly Agency) with the aim of harmonizing public financial position with the program targets. The upward trend in public prices is projected to be reversed with deceleration in fuel prices, provided the economic program is strictly adhered to. In the same period, rate of increase in non-administered goods stayed only at 7.1 percent. An analysis of the annual price increases reveals that rate of increase in administered goods was more significant and that of non-administered goods remained below the end-2002 level (Figure I.1.3).

CPI Sub-items

In the first quarter of 2003, the highest rates of increase in CPI were recorded in food, beverage and tobacco group and health group while relatively low rate of increase in housing and furniture groups became a factor that curtailed CPI inflation.

Figure I.1.3. CPI Administered and Non-Administered Prices; 1994=100
(Annual Percentage Change)



Food Prices

The upward trend in food prices, which started in the last quarter of 2002 persisted and even accelerated through the first quarter of 2003. Despite the rise in prices partially stemmed from seasonal factors, agricultural prices exhibited a continued upward trend in the last six months because of the unfavorable weather conditions, which led to an increase above seasonal expectations in food prices. Actually, rate of increase in food prices, which was 16.8 percent in January-March period, was 11.1 percent when seasonally adjusted. Rate of increase of prices in most of the groups other than the food group remained below the level recorded in the same period last year (Table I.1.1).

Figure I.1.4. CPI and Sub-items :1994=100
(January-March Cumulative Inflation)

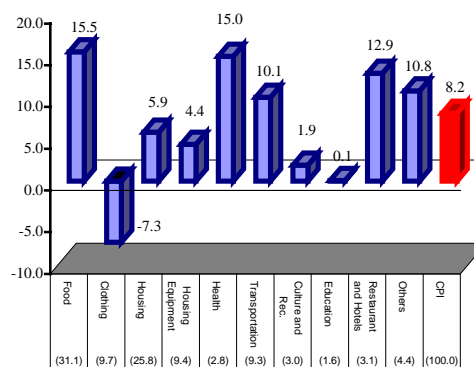


Table I.1.1. CPI and Sub-items; 1994=100

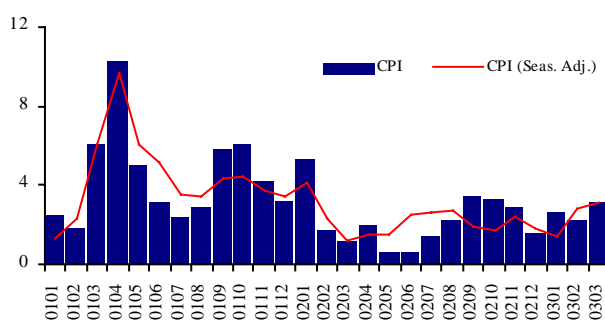
| | ANNUAL | | | JAN – MAR | |
|--------------------------|-------------|-------------|-------------|-----------|------|
| | 2001 Dec | 2002 Dec | 2003 Mar | 2002 | 2003 |
| CPI | 68,5 | 29,7 | 29,4 | 8,4 | 8,2 |
| Food, Beverages, Tobacco | 80,2 | 24,7 | 29,7 | 11,1 | 15,5 |
| Food | 78,4 | 24,1 | 28,5 | 12,7 | 16,8 |
| Clothing and Shoes | 65,2 | 40,1 | 33,8 | -2,9 | -7,3 |
| Housing | 59,6 | 28,9 | 28,0 | 6,6 | 5,9 |
| Rent | 39,7 | 29,0 | 27,0 | 7,2 | 5,5 |
| Housing Equipment | 72,7 | 25,9 | 19,7 | 9,9 | 4,4 |
| Health | 58,4 | 27,5 | 33,5 | 9,9 | 15,0 |
| Transportation | 77,5 | 36,8 | 31,4 | 14,6 | 10,1 |
| Culture and Recreation. | 61,7 | 24,5 | 18,8 | 6,8 | 1,9 |
| Education | 52,4 | 53,8 | 53,6 | 0,3 | 0,1 |
| Restaurant and Hotels | 46,2 | 32,3 | 36,6 | 9,4 | 12,9 |
| Others. | 81,2 | 30,5 | 29,6 | 11,6 | 10,8 |
| Goods | 80,9 | 29,7 | 29,3 | 8,7 | 8,4 |
| Goods Exc. Food. | 82,4 | 32,9 | 29,8 | 6,4 | 3,9 |
| Services | 48,2 | 29,8 | 29,6 | 7,9 | 7,8 |

Source: SIS, CBRT

Price Developments in Housing Group

The low level of increase in house rents became the main factor that curtailed price increases in housing group in January-March period. Despite the increases in fuel prices, there was no rise in electricity prices, which limited heating and other costs of dwellings. Consequently, rate of increase in housing group, which realized at 5.9 percent remained well below the general CPI increase in the first quarter of the year.

Figure I.1.5. CPI and Seasonally Adjusted CPI; 1994=100 (Monthly Percentage Change)



Source: SIS, CBRT

Price Developments in Furnishings

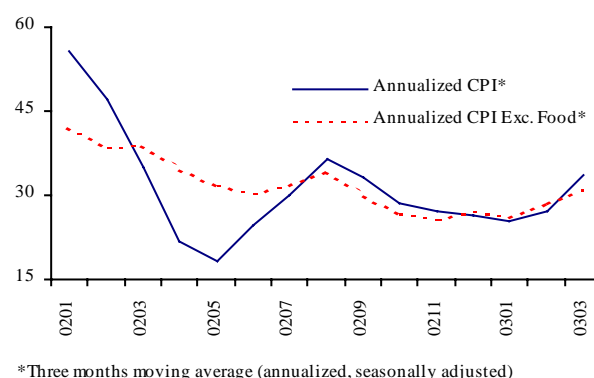
The 4.4 percent increase in the furnishings groups is a historically low level compared with the figures of the same period in the previous years. The fact that there was no significant increase in the prices of consumer durables, which are adjusted at the turn of the year each year, indicates sluggish consumption demand.

Price Developments in Transportation and Health Groups

Prices in health and transportation groups increased by 15.0 and 10.1 percent, respectively. Seasonal price adjustments in medical services distributed among the first three months of 2003 were quite high. Meanwhile, rise in fuel prices as well as the 11.3 percent increase in transportation services prices constituted the main factors that pushed up transportation group prices.

Within the framework of the above-mentioned data, annual inflation calculated by using quarterly moving averages of the seasonally adjusted consumer price index increased in the first quarter of 2003. Seasonally adjusted annualized inflation became 33.6 percent for CPI and 31.0 percent in CPI excluding food as of March (Figure I.1.6).

Figure I.1.6. Annualized Inflation CPI (Annual Percentage Change)



*Three months moving average (annualized, seasonally adjusted)

Consequently, it can be asserted that the interruption in the downward trend in inflation is stemming from exogenous shocks and domestic food prices.

Consequently, it can be asserted that the interruption in the downward trend in inflation is stemming from exogenous shocks and domestic food prices. In other words, it is not possible to declare that inflation has indulged in a permanent upward trend with the data available. Therefore, it is evident that disinflation efforts can not be renounced.

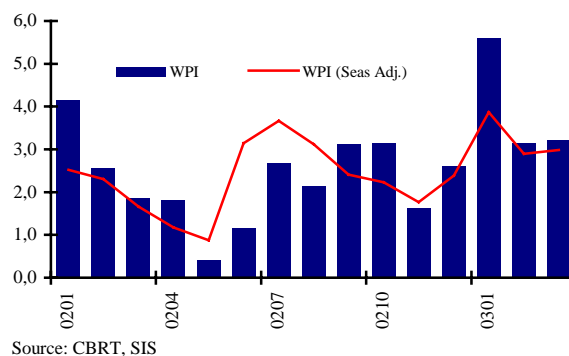
Consistent and steadfast implementation of economic program as well as affecting expectations in a positive way by enhancing confidence become more important for persevering what has been achieved in disinflation efforts so far.

In view of the fact that the end-year inflation target is 20 percent, the January-March inflation figures is not consistent with the target. However, most of the factors that led to high inflation in this period are believed not to persist in the forthcoming period. Departing from the projection that domestic demand would preserve its current position, exchange rates would not make a sharp upward move, and no out-of-the-program- price adjustments would be made, it is estimated that annual CPI increase would follow a course that is parallel to the inflation target. At this point, consistent and steadfast implementation of economic program as well as affecting expectations in a positive way by enhancing confidence become more important for persevering what has been achieved in disinflation efforts so far.

1.2. Developments in Wholesale Prices

The upward trend in WPI inflation continued in the first half of 2003 and WPI increased by 35.2 percent in March, compared with the figures of the same period last year. High rates of increase in manufacturing industry and agriculture prices have been important contributors to the upward trend in WPI. The average rate of increase in seasonally adjusted WPI became 3.3 percent in the first quarter of 2003 (Figure I.2.1)

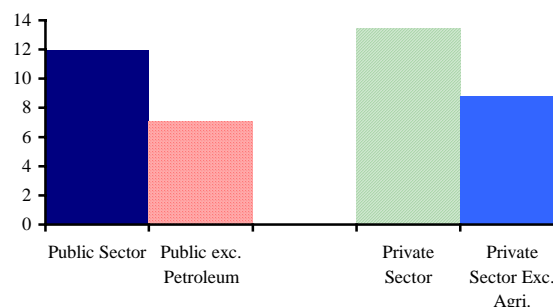
Figure I.2.1. WPI and Seasonally Adjusted WPI; 1994=100 (Monthly Percentage Change)



The upward trend observed in WPI inflation in the first three months of 2003 is stemmed from manufacturing industry and agriculture sectors.

When the breakdown of WPI inflation by public and private sectors is studied, it is observed that private sector prices increased by 12 percent while public sector prices increased by 13.4 percent in the first three months of 2003. When agriculture prices are excluded, rate of increase in private sector goes down to 7 percent while that in public sector comes down to 8.8 percent when the prices of petroleum products are excluded (Figure I.2.2). Thus, it can be asserted that WPI inflation in the first quarter of 2003 mainly stemmed from the increase in agriculture and petroleum products sectors.

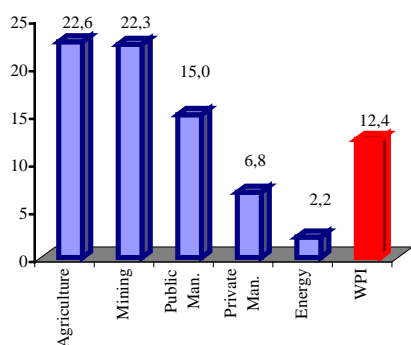
Figure I.2.2. Rates of Increase in the Prices of WPI Public, Private Sector and Subgroups in the First Quarter of 2003 (Percentage Change)



Agriculture Prices

The flood that struck greenhouses in and around Antalya coupled with the unfavorable winter conditions led to a cumulative increase of 22.6 percent in agriculture prices during the period from January 2003 through March 2003. The subject rate is well above the 12.4 percent cumulative increase in WPI (Figure I.2.3). When seasonally adjusted data is analyzed, it is observed that agriculture prices increased by an average of 3.3 percent in the first quarter of 2003. In case the upward trend in agriculture prices persists in the forthcoming period, food prices under CPI would also be adversely affected.

Figure I.2.3. WPI and Sub-items in the First Quarter of 2003 ; 1994=100 (Rate of Change)

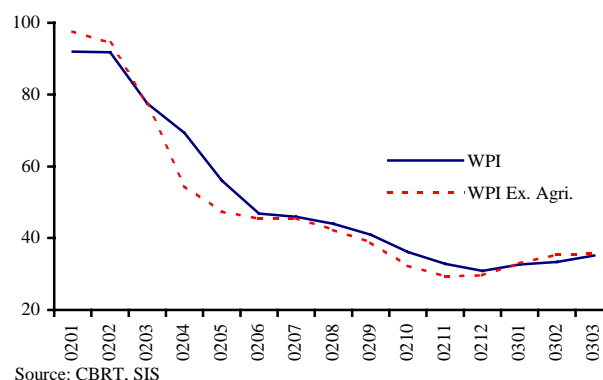


Source: SIS

Cumulative increase in WPI comes down to 9.4 percent when agriculture prices are excluded. Besides, monthly rate of increase in WPI excluding agriculture has been declining since January. However, as the mentioned rates are above the 2002 figures, both WPI and WPI excluding agriculture have been increasing in annual basis (Figure I.2.4). As of March 2003, annual increase is 35.2 percent in WPI and 35.6 percent in WPI excluding agriculture.

Rate of increase in agriculture prices was 22.6 percent and that in WPI excluding agriculture was 9.4 percent in the first quarter of 2003.

Figure I.2.4. WPI and WPI Excluding Agriculture: 1994=100 (Annual Percentage Change)



Source: CBRT, SIS

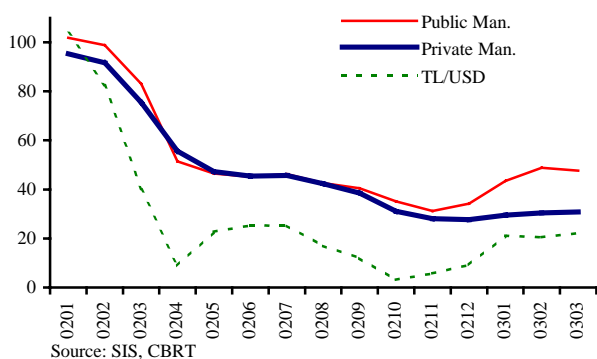
Manufacturing Sector Prices

Manufacturing sector prices, which constitute 71.1 percent of WPI, is the group that is most severely affected by the production costs and developments in expectations. In January, international crude oil prices and exchange rates destabilized by the developments regarding the military operation in Iraq exerted a cost-push pressure on manufacturing prices. In February and March, however, manufacturing industry price increases remained within the expected range.

Fluctuations in exchange rate market and international crude oil prices due to the military operation in Iraq affected the rate of increase in manufacturing industry prices.

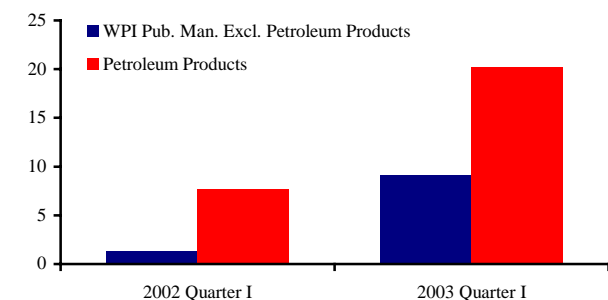
Private manufacturing sector price increases have also been affected by the rise in international crude oil prices. Moreover, depreciation of Turkish lira vis-à-vis exchange rate basket by 7.3 percent in the first three months of 2003 adversely affected the prices in sectors that are vulnerable to exchange rate changes, especially the petroleum and main metal productsng sectors. Thus, annual rate of increase in private manufacturing sector increased from 27.7 percent at the end of 2002 to 30.9 percent in March 2003 (Figure I.2.5).

Figure I.2.5. Exchange Rate, Public and Private Manufacturing Sector Prices;1994=100 (Annual Percentage Change)



Affected by the price increments in TEKEL (State Monopoly Agency) and the cost-push pressures, rate of increase in public manufacturing industry prices became 8.5 percent in January but the increase decelerated in February and March thanks to restoration of relative stability in the financial markets. Thus, public manufacturing industry prices increased by 15 percent in the first three months of 2003, in which 20.2 percent increase in oil products manufacturing sector played a significant role (Figure I.2.6). In annual terms, rate of increase in public manufacturing industry prices increased from the end-2002 value of 34.3 percent to 47.6 percent as of March (Figure I.2.5).

Figure I.2.6. Quarterly Rate of Increases in Prices of WPI Public Sector Petroleum Products Manufacturing (Percentage Change)



As a result, manufacturing industry prices increased by 9.3 percent in the first three months of 2003. In annual terms, rate of increase of total manufacturing sector prices increased from 29.7 in December 2002 to 35.9 percent. However, sustenance of stability in international

crude oil prices and exchange rates in the period ahead would restrict rate of increase in manufacturing sector prices.

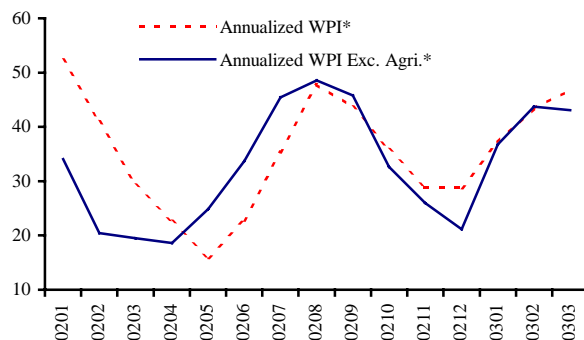
Energy Prices

Rate of increase of the prices in energy group remained quite low in the first quarter of 2003. While energy prices increased by 8.3 percent in 2002 Q1, they increased by a mere 2.2 percent in 2003 Q1. This was mainly due to the 0.5 percent increase in the prices of electricity and gas sub-item that compensated for the 9.5 percent increase in the prices of water sub-item.

The Energy Market Regulatory Authority and reduction of special allowances limited increase in electricity prices. Thus, in annual terms, rate of increase in energy prices decreased from 24.3 percent in December to 17.3 percent.

To sum up, WPI inflation started an upward trend in 2003 Q1. The significant rise in agriculture prices-which stemmed from unfavorable weather conditions in winter and flood that destroyed produce in the greenhouses played an important role in this development. Moreover, fluctuations in the financial markets and rise in oil prices adversely affected the rate of increase in manufacturing industry prices. As of March, annual WPI increase reached 35.2 percent, which is 5 percentage above the end-2002 figure.

Figure I.2.7. Annual Inflation Trend, WPI (Annual Percentage Change)



*Three Months Moving Average (Annualized, Seasonally Adjusted)
Source: CBRT, SIS

Annual inflation calculated by using quarterly moving averages of seasonally adjusted wholesale prices increased compared with the end-2002 figures and reached 46.8 percent in March. Annual inflation calculated likewise for prices excluding agriculture increased in March compared with the end of 2002, however decreased compared with February and realized at 43.1 percent (Figure I.2.7).

Thus, it can be asserted that rise in WPI inflation remained quite limited in the first quarter of 2003, when effects of exogenous factors like agriculture prices and international crude oil prices are excluded.

1.3. Inflation Expectations

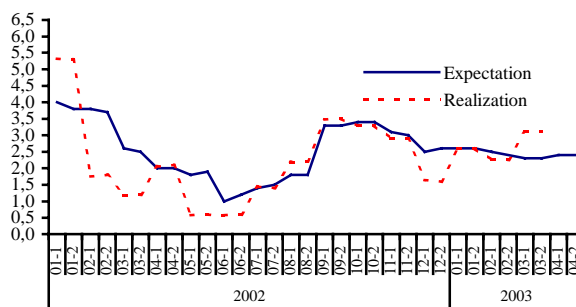
Concerns over debt-sustainability and upward trend in inflation incited by the military operation in Iraq affected expectations negatively in the first quarter of 2003.

Expectations for Consumer Prices Inflation

The CBRT uses the CBRT Survey of Expectations to analyze the expectations for consumer inflation¹. The bimonthly survey furnishes the opportunity to monitor the effects of political and economic developments on expectations, as most of the participants are selected from financial sector and the results of the survey are quantitative.

Expectations for monthly CPI increase had exceeded the actual figures in January and February. However, expected inflation for the current month in March remained below the actual inflation because of the significant increase in food prices.

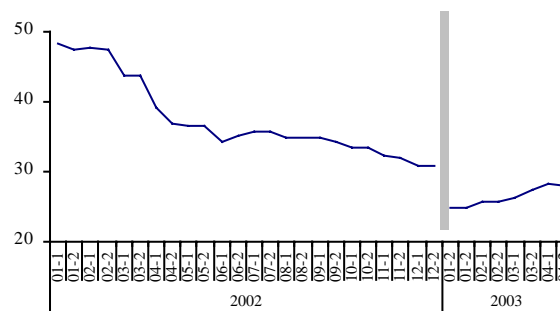
Figure I.3.1. Inflation Expectation and Realization of the Current Month (Monthly, Percent)



Source: CBRT Expectations Survey

Expected end-year inflation increased in the first quarter of 2003 and stayed 8 points higher than the end-year target of 20 percent in the second half of April. Actual inflation exceeding the expected inflation rate due to rise in agriculture and food prices as well as in international crude oil prices led to increase in end-year expected inflation rates.

Figure I.3.2. Expectations for the Year-End CPI Inflation (Percent)

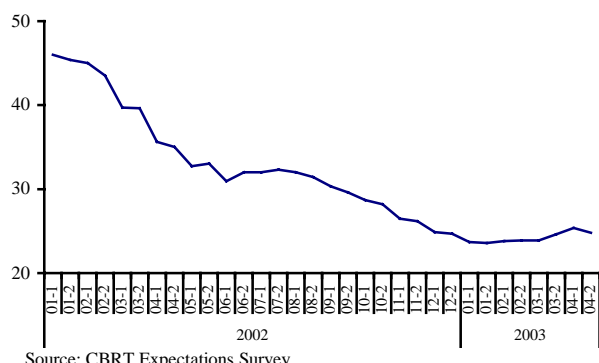


Source: CBRT Expectations Survey

Expected CPI inflation for the next 12 months followed a flat course in the first 3 months of 2003. A similar tendency had been observed just in the May-July 2002 period marked by uncertainties; however, inflation expectations had started to decelerate in the following period after ease of uncertainties with the announcement of the election date. Keeping in mind the developments in 2002, pursuing the economic program to restrict the adverse impact of inflation on expectations is crucial to return to downward trend in inflation expectations.

¹ The Survey was first conducted on August 3, 2001. Participants from the real sector and financial sector state their expectations and estimations about inflation and other macroeconomic developments. The data gathered in the CBRT Survey of expectations data are compiled by SIS twice a month, in the first and third week of every month, following the issue of inflation figures. The participants are asked to state their one-month, two-month, end-year and twelve-month expectations for consumer inflation for.

Figure I.3.3 CPI Inflation Expectations for the Next 12 Months (Percent)

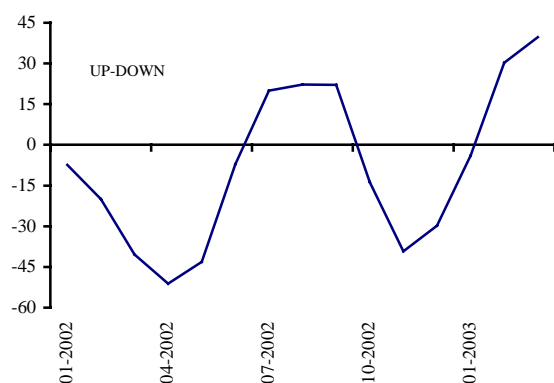


Source: CBRT Expectations Survey

Expectations for Wholesale Prices

The CBRT Business Tendency Survey is used for analyzing the expectations for wholesale prices.ⁱⁱ According to the qualitative expectations compiled in CBRT Business Tendency Survey, the ratio of participants that expect an upward trend in inflation in the next three months to the total number of participants is increasing. The optimistic-pessimistic difference, which was 30.2 percent in February reached 39.7 percent in March.

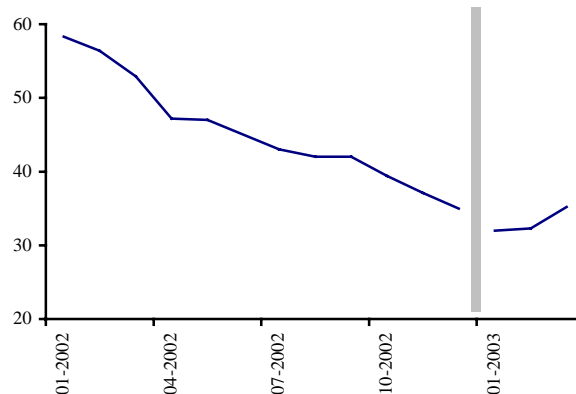
Figure I.3.4. Next 3-Month Inflation Expectations (Percent)



Source: CBRT Business Tendency Survey

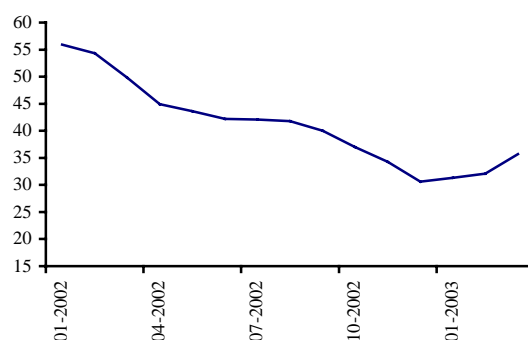
ⁱⁱ The Survey, in which public and private sector companies participate, was first conducted in 1987. The qualitative question asking for the expected WPI for the next three-month period was annexed to the Survey in 1997. The answers of the private sector representatives are used in the analysis

Figure I.3.5. Year-End WPI Inflation Expectation



Source: CBRT Business Tendency Survey

Figure I.3.6. Next 12 Month WPI Inflation Expectations (Percent)



Source: CBRT Business Tendency Survey

According to the results of the CBRT Business Survey of March, expected rates of WPI inflation for the next twelve months and end-year continue to increase compared with the previous month's expectations. The expectations had followed a similar course in February as well. Expected rate of WPI inflation became 35.2 percent for end-year and 35.7 percent for the next twelve months in March Survey.

Expectations for Manufacturing Sector Prices

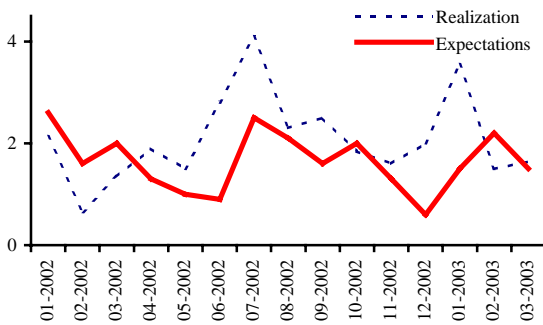
SIS Monthly Manufacturing Sector Tendency Survey is used to analyze the expectations for manufacturing sector prices.ⁱⁱⁱ According to the results of the survey conducted in February 2002, general manufacturing industry prices were expected to increase by 1.7; public manufacturing

ⁱⁱⁱ The Survey is prepared to provide information to the public and it reflects the expectations for production, sales and sales prices of the firms representing 70 percent of the total manufacturing production.

sector prices by 1.9 and private manufacturing sector prices by 1.5 percent. The actual rates of increase in general manufacturing sector prices became 1.7 percent while increase in public manufacturing sector prices and private manufacturing prices became 1.8 and 1.6 percent, respectively. Consequently, the actual rates were close to the expectations.

In January, expected increase in manufacturing sector prices had increased due to cost-push pressures, however, with the relative stability in exchange rates and oil prices, expectations started a downward trend in the following period. It is expected that the decline in international crude oil prices after the termination of military operation in Iraq would make a positive effect on the expectations for manufacturing sector prices.

Figure I.3.7. Realizations and Expectations for the Private Sector Manufacturing Industry Prices (Monthly, Percentage Change)



Source: SIS Monthly Manufacturing Tendency Survey

BOX I.1. HAS THE EXCHANGE RATE PASS-THROUGH CHANGED AFTER THE ADOPTION OF THE FLOATING EXCHANGE RATE REGIME?

In an open economy, the domestic level of prices is affected by the international prices and changes in exchange rates through the prices of tradable goods and services. An increase in exchange rates leads to increase in input costs and the prices of imported goods in TL, thus pushes up the import costs and then the prices of imported goods in domestic markets. The effect of the changes in exchange rates on domestic inflation is called the “pass-through effect”. The aim of this study is to find out whether any changes have occurred in the exchange rate pass-through to inflation after adoption of floating exchange rate regime¹. The change in exchange rate pass-through will be analyzed in the context of slowdown and decline concepts.

Decline in pass-through is defined as decrease in the cumulative effect of any changes in exchange rates on prices. Slowdown in pass-through effect is defined as the lagged effect of exchange rates on prices (for instance, the increase in exchange rates this month starts affecting prices after three months). Even if these two pass-through concepts are not completely independent from each other, such a distinction is believed to help understand the changes (if any) in the decision-making process of economic agents and distinguish the behavioral drives.

Before making price adjustments after observing changes in exchange rates, the economic agents look if the increase in exchange rate is permanent or not. A look into the Turkish experience shows that during 1989-200 period, when the managed float regime was implemented, the firms tended to reflect any upward movement in exchange rates (even the very minor ones) on their prices as they perceived all of them as permanent. In floating exchange rate regime, however, it is expected that firms would consider the probability that the increase in exchange rates is temporary and the rates could depreciate in a short while. This, in return, could bring a change in the exchange rate pass-through to inflation.

Table 1: Did Pass Through From Exchange Rate to Inflation Slow Down After Floating Exchange Rate Regime?: 1987-2003 , Cross Correlation between k period Lagged Rate Of Change Of Exchange Rate And Inflation

| Rate Of Change of Exchange Rate (k-period lagged) | 1987:01-1995:01 | | 1995:01-2001:02 | | 2001:2-2003:03 | | 2001:6-2003:03 | |
|---|-----------------|------------------|-----------------|------------------|----------------|------------------|----------------|------------------|
| | Monthly Change | 3 Monthly Change | Monthly Change | 3 Monthly Change | Monthly Change | 3 Monthly Change | Monthly Change | 3 Monthly Change |
| 0 | 0,65 | 0,63 | 0,33 | 0,57 | 0,42 | 0,48 | -0,13 | 0,07 |
| 1 | 0,27 | 0,54 | 0,42 | 0,52 | 0,60 | 0,70 | 0,10 | 0,23 |
| 2 | 0,06 | 0,29 | 0,28 | 0,39 | 0,37 | 0,61 | 0,38 | 0,46 |
| 3 | -0,02 | 0,02 | 0,21 | 0,26 | 0,26 | 0,39 | 0,72 | 0,63 |
| 4 | -0,10 | -0,06 | 0,06 | 0,14 | 0,10 | 0,29 | 0,54 | 0,63 |
| 5 | 0,01 | 0,01 | 0,05 | 0,08 | 0,16 | 0,36 | | |

Note: For Computations, nominal USD Exchange Rate is used.

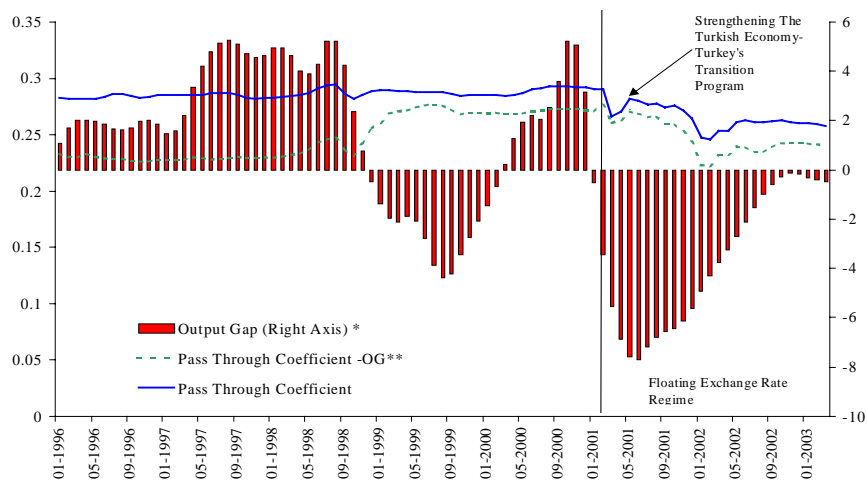
Dynamic correlation coefficients have been calculated in order to appraise the slowdown in the pass-through effect of exchange rates on inflation. (Table 1). When the period between 1987-1995 is analyzed, it is observed that there is a kind of simultaneous indexation mechanism between inflation and devaluation. In the period between 1995-2001, inflation reacted to changes in exchange rates with one month delay. However, as of May 2001, the longest correlation period between exchange rate and inflation became 3 months. In other words, there is a strong correlation between any change in exchange rate that happened at time t and the inflation at $t+3$.

There is a point to be drawn attention here. First of all, no significant change was observed in the dynamic correlation structure in exchange rate-inflation relationship in the first few months following the adoption of floating exchange rate regime. However, a significant change is observed as of May 2001. In other words, the refraction did not happen just after the adoption of floating exchange rate regime but after the adoption of “Transition Program for Strengthening the Turkish Economy. This means that it took time for the economic units to perceive the floating exchange rate regime and reflect their perception on their behavior. In other words, it can be asserted that worries about the sustainability of floating exchange rate regime were consequently calmed down only after seeing the adoption of a highly credible economic program and announcement of strong forward-looking commitments and exchange rate-inflation pass-through became lagged after June 2001.

(1 In Monetary Policy Report July 2002, the subject correlation was examined with country experiences.

It would be wrong to draw clear-cut conclusions about the decline of pass-through from exchange rates to inflation by only looking at Table 1 because while correlation within the same month decreases, correlation with three months of delay increases. Taking this point as our departure, a method that takes into account the lagged effects has been employed in order to reach more concrete results about overall effect. Within this framework, for the period between 1988 and 2003, a regression that explains CPI inflation with exchange rate changes and exchange rate changes in the current month and the last four months², last month's output gap and lagged CPI inflation, was recursively estimated by using monthly data³.

Figure 1 : Had Pass-Through Decreased After The Floating Exchange Rate Regime? Recursive Pass Through Coefficient And The Output Gap



Notes: The Pass-Through coefficient is the sum of the coefficients of lags of exchange rate from the corresponding regressions.

(*) For the values of the output gap, assumptions were made about the last quarter of 2002 and first quarter of 2003.

(**) Corresponding coefficient results from the regression in which Output Gap is also included as an explanatory variable.

Figure 1 shows the total of exchange rate coefficients calculated by rolling sample method since 1995 in order to see whether pass-through from exchange rates to inflation has declined or not. In the period following February 2001, a decline was observed in exchange rate-inflation correlation. However, this decline is well below the figures indicated by simultaneous correlation coefficients. Actually, starting from February 2001, pass-through effect has been following a parallel course to that of the output gap.

Consequently, there is enough evidence that confirms the hypothesis that automatic and immediate pricing behavior that was prevalent during managed float has changed recently (2001-2003). However, when periodic fluctuations in economic activities are taken into account, it is observed that decline in the pass-through is not very clear-cut and it may not be permanent. Moreover, it does not seem possible to make a meaningful statistical distinction in the probable change in exchange rate pass-through in a period where the sample size is limited and many structural changes (like floating rate regime and independence of Central Bank) coincide. A more detailed econometric analysis can only be made after macroeconomic dynamics are stabilized and a satisfactory sample size is available.

References:

- Garcia, C. and E. Restrepo (2001) "Price Inflation and Exchange Rate Pass-Through in Chile", Central Bank of Chile Working Paper 1 28.
 Leigh, Daniel and Marco Rossi (2002) "Exchange Rate Pass-Through in Turkey", IMF Working Paper.

² In a recent study on exchange rate pass-through on inflation in Turkey (Leigh and Rossi 2002), it was found out that most of the pass-through was completed in the first 4 months.

³ See Garcia and Restrepo (2000) for a similar method applied to Chilean economy

II. MONETARY AND EXCHANGE RATE POLICY

II.1. General Framework of Monetary and Exchange Rate Policy

In the first four months of 2003, Base Money continued to be the basic nominal anchor of monetary policy and implicit inflation targeting strategy was pursued. Within this framework, short-term interest rates continued to be the main policy instrument in disinflation process. On April 25, 2003, the CBRT cut down the short-term interest rates by 3 percentage points except for the overnight borrowing interest rate of late liquidity window facility. Moreover, late liquidity window facility lending interest rate was dropped down by 5 percentage points on March 20, 2003, with the aim of enhancing financial stability.

In the mentioned period, CBRT continued to exert control over the monetary aggregates through transactions in Open Market Operations and Interbank Money Market within the framework of the price stability objective. CBRT's balance sheet item targets for April-December 2003 were specified in the letter of intent dated April 5, 2003 (Table II.1.1-2).

CBRT continued to carry out certain implementations to strengthen financial stability that it deems a supportive target in the first quarter of 2003. In this regard, Securities Lending Market was established with the CBRT within the framework of the Primary Dealership system. In this market, the primary dealer banks can be parties in government securities lending as well as borrowing transactions, while those banks which are not primary dealers can only participate in government securities lending transactions. Lending/borrowing rates are determined under competitive price mechanisms. CBRT's basic role in this market is to intermediate between borrowing and lending banks. However, this intermediation is different from the role that it assumed in Turkish lira and foreign exchange markets and after the new arrangements adopted, the CBRT does not bear any kind of operational risks any more.

In March 2003, the CBRT took some additional measures in Turkish lira and foreign exchange markets in order to minimize the adverse effects of the military operation in Iraq on financial markets. Accordingly, the CBRT announced in its press release dated March 20, 2003 that there still existed access liquidity in Turkish lira markets and it would provide funding at ISE Repo-Reverse Repo Market with an overnight interest rate of 51 percent in case an additional liquidity demand emerged. In the same press release, it was also announced that overnight lending interest rate within the framework of late liquidity window facility was cut by 5 percentage points and dropped down to 56 percent. On the same day, interest rate applicable to one-week maturity foreign exchange deposit accounts provided for the banks in Foreign Exchange and Banknotes Market was cut from 12 percent down to 8 percent. This rate was decreased once more on March 24 by 2 percentage down to 6 percent.

In the first quarter of 2003, the CBRT carried out reverse repo transactions at ISE Repo-Reverse Repo Market and purchasing transactions at the Interbank Money Market at the pre-announced interest rates in order to mop up excess liquidity. Meanwhile, 4-week maturity Turkish lira deposit purchasing auctions that started in April 2002 were also utilized to sterilize excess Turkish lira liquidity in the market.

Table II.1.1. Performance Criteria and Indicative Targets for Base Money and Net Domestic Assets (Trillion TL)

| | Base Money | | Net Domestic Assets | |
|-------------------|------------------------|-------------|------------------------|-------------|
| | Ceiling ⁽¹⁾ | Realization | Ceiling ⁽¹⁾ | Realization |
| December 31 2002 | 10,850 ^(P) | 10,720 | 33,100 ^(I) | 28,603 |
| April 30 2003 | 12,800 ^(P) | | 32,800 ^(I) | |
| June 30 2003 | 13,200 ^(P) | | 34,100 ^(I) | |
| September 30 2003 | 14,100 ^(I) | | 33,800 ^(I) | |
| December 31 2003 | 14,300 ^(I) | | 34,200 ^(I) | |

⁽¹⁾ The ceilings are calculated based on the averages of the values at the aforementioned dates and the values at the following 5-working day period.

(P): Performance criterion, (I): Indicative Value

Table II.1.2. Performance Criteria and Indicative Targets for International Reserves (USD, Million)

| | Floor | Realization |
|-------------------|-----------------------|-------------|
| December 31 2002 | -9,700 ^(P) | -4,614 |
| April 30 2003 | -6,500 ^(P) | |
| June 30 2003 | -7,000 ^(P) | |
| September 30 2003 | -6,000 ^(I) | |
| December 31 2003 | -6,000 ^(I) | |

II.2. CBRT Balance Sheet Developments

In the first three months of 2003, the most significant change occurred during the religious holiday in February in the Base Money that constitutes the liabilities side of the balance sheet specified in the Stand-by Agreement. In January, when Base Money fluctuated less intensely compared with the following periods and stayed more or less in the same level, Net Domestic Assets displayed a declining trend while Net Foreign Assets displayed an upward one. These trends were reversed as of February, and Net Domestic Assets increased until the end of March while Net Foreign Assets decreased.

Table II.2.1 CBRT Balance Sheet Items (Trillion TL)

| | 12/31 2002 | 03/31 2003 | 03/31 2003 |
|---|---------------|---------------|---------------|
| | CONSTANT | CONSTANT | CURRENT |
| I- BASE MONEY (a+b+c) | 10,427 | 12,208 | 12,208 |
| a-Currency Issued | 7,636 | 8,303 | 8,303 |
| b. TL Required Reserves | 1,672 | 1,828 | 1,828 |
| c. Free Deposits | 1,120 | 2,077 | 2,077 |
| II-NET FOREIGN ASSETS (A+B+C) | 3,931 | 3,285 | 2,164 |
| A-Net International Reserves (1+2+3) | 14,456 | 13,592 | 17,857 |
| 1-Gross Foreign Reserves | 37,128 | 36,103 | 46,868 |
| 2-Gross International Reserve Liabilities | -22,672 | -22,511 | -29,011 |
| - FX Deposits of Banking Sector | -9,064 | -8,970 | -11,321 |
| - IMF | -10,962 | -10,812 | -13,932 |
| 3-Net Forward Position | 0 | 0 | 0 |
| B- Medium Term FX Credits (net) | 2,020 | 2,001 | 2,373 |
| C-Other | -12,546 | -12,308 | -18,067 |
| III-NET DOMESTIC ASSETS | 6,497 | 8,923 | 10,044 |
| Treasury Debt | 29,388 | 30,342 | 32,633 |
| a-CBRT's Portfolio | 29,448 | 30,407 | 32,700 |
| b-Other | -60 | -65 | -66 |
| Public Sector Deposits (TL) | -272 | -1,212 | -1,212 |
| FX Deposits of Non-bank Sector | -4,694 | -3,177 | -3,926 |
| Open Market Operations (net) | -9,579 | -9,789 | -9,789 |
| Other | -7,256 | -6,745 | -6,745 |
| Revaluation Account | -1,109 | -695 | -1,166 |
| NDA (1) | 6,497 | 8,923 | |
| Treasury Liabilities to the IMF (2) | 18,591 | 18,509 | |
| Treasury FX denominated borrowing with an original maturity of less than 1 year (3) | 2,508 | 2,762 | |
| NET DOMESTIC ASSETS (Prog. def) (1+2+3) | 27,596 | 30,194 | |

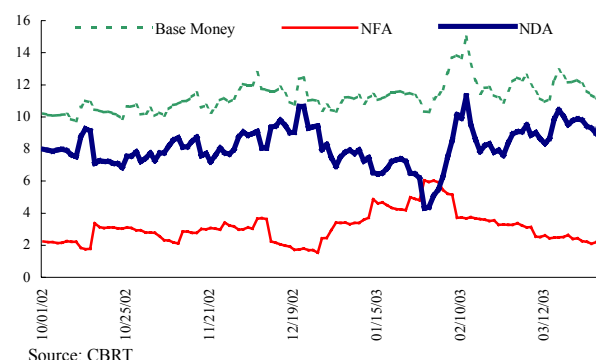
Source: CBRT

As of the beginning of February, significant increase was observed in Base Money item due to rise in money demand before the religious holiday. The total amount of increase in Base Money in the period until mid-February was TL 4.5 quadrillion. High rate of increase can be attributed to the long religious holiday as well as the earlier-than-scheduled payment of wages. Base Money

item decreased following the contraction in the volume of currency issued after the religious holiday. Base Money item followed a considerably high level and fluctuated more intensely in the rest of the first quarter.

The high rate of increase in Base Money item in the first quarter of 2003 mainly stemmed from the increase in currency issued item and partly from the rise in TL required Reserves. Similar to the previous periods, developments in free deposits item again became influential on fluctuations of Base Money in the referred period. The effect of Free Deposits on the average level of Base Money remained quite restricted compared with the other two sub-items.

Figure II.2.1. Base Money, NDA and NFA (TL, quadrillion)



Source: CBRT

Net Domestic Assets, which is one of the two main items on the assets side of the CBRT balance sheet, decreased approximately by TL 3 quadrillion in January 2003. In the subject period, when Net Foreign Assets increased by an almost equal amount, the underlying reason of the Net Domestic Assets was mainly the increase in the Treasury's TL denominated deposits and foreign exchange deposits with the CBRT. In January, the Treasury borrowed from foreign markets more than it redeemed and borrowed foreign exchange from domestic market through US dollar denominated securities. These two brought along a substantial increase in the Treasury's foreign exchange deposit accounts registered under FX deposit accounts sub-item of Net Domestic Assets. In the same period, as the Treasury borrowed more than its cash

deficit, TL deposit accounts registered under Government's TL Deposits sub-item.

The high rates of increase in Base Money item from the beginning of February until mid-February corresponded to the increase in Net Domestic Assets. In the referred period, Net Domestic Assets registered an increase of TL 7 quadrillion with the decline in Net Foreign Assets. As money demand increased in the period just before the religious holiday, the liquidity mopped up from the market by Central Bank, which is registered under Net Domestic Assets sub-item, decreased by TL 2.5 quadrillion. In the same period again, mainly due to foreign debt redemption, the Treasury's foreign exchange deposit accounts with the CBRT declined substantially. Within this framework, not only Open Market Operations, but also Foreign Exchange Deposit Accounts and Government's TL Deposits displayed such a course to increase Net Domestic Assets. With the decline in money demand after the end of religious holiday, the amount of Turkish lira liquidity sterilized by the CBRT started to increase again and Net Domestic Assets declined by TL 3.5 quadrillion until 20 February.

Net Domestic Assets generally increased from the end of February until the end of March. the Treasury's Turkish lira deposit account recorded the highest level of the first quarter of 2003 in the first few business days of March. But the amount of TL deposits declined substantially in March after the amount of borrowing was decreased following the increase in interest rates and the amount of Turkish lira liquidity mopped up rose.

Figure II.2.2. NDA and Selected Sub-items (TL, quadrillion)

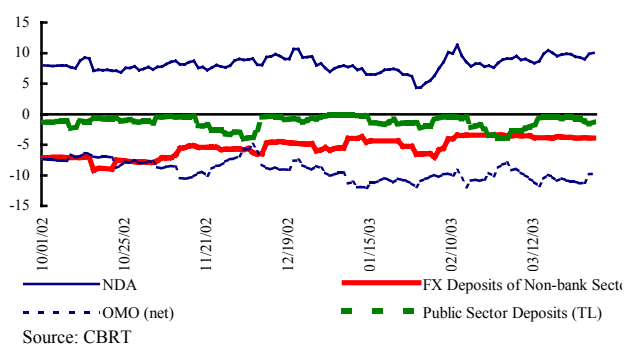
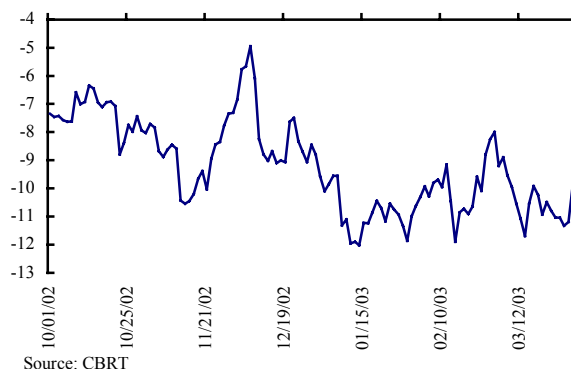


Figure II.2.3 Open Market Operations (Net) (TL, quadrillion)



CBRT portfolio, which constitutes almost the entire Treasury Debts sub-item under Net Domestic Assets, displayed a movement parallel to the revaluation as a consequence of developments in exchange rates and interest rates in the first quarter of 2003. The subject item increased from TL 31 quadrillion in December 2001 to TL 32.5 quadrillion by the end of March 2003.

Another main item under assets side of the stand-by balance sheet, the Net Foreign Assets, increased by USD 3 billion in January 2003. The main reason of this rise was that the Treasury borrowed from foreign markets more than it redeemed and borrowed from domestic markets in foreign exchange. In February and March, the Treasury was the net foreign debt payer and no credit was used from international institutions, together which led to a decline in Net Foreign Assets. In the mentioned period, Net Foreign Assets dropped down to USD 1.3 billion.

The effect of developments in main balance sheet items on Base Money changes is as follows: In March 2003, the average value of Base Money increased by 4.1 percent compared with the figures of December 2002. In the assets side of the balance sheet, Net Foreign Assets' contribution to Base Money increase was 1.3 percent while Net Domestic Assets' contribution was 2.8 percent.

Table II.2.2. Contribution of Main Balance Sheet Items to Increase in Base Money

| | Monthly Average (Trillion TL) | | | Contribution to Base Money Growth (Percentage) | |
|-------------------------------|----------------------------------|--------------|---------------|--|--------------------------|
| | 2002 March | 2002 Dec. | 2003 March | March 2002- March 2003 | Dec. 2002- March 2003 |
| Base Money | 8,317 | 11,490 | 11,960 | 100.0 | 100.0 |
| Currency Issued | 5,550 | 8,074 | 8,370 | 77.4 | 63.0 |
| TL Required Reserves | 1,761 | 1,664 | 1,786 | 0.7 | 26.0 |
| Free Deposits | 1,005 | 1,752 | 1,804 | 21.9 | 11.0 |
| NFA | -1,745 | 2,423 | 2,577 | 118.7 | 32.8 |
| NDA | 10,062 | 9,067 | 9,382 | -18.7 | 67.2 |
| • Treasury Debt | 28,507 | 30,496 | 31,942 | 94.3 | 308.0 |
| • Public Sector Deposits (TL) | -1,218 | -1,357 | -1,527 | -8.5 | -36.4 |
| • FX Deposits of Non-bank | | | | | |
| Sector | -2,670 | -5,267 | -3,732 | -29.2 | 326.8 |
| • OMO (net) | -6,155 | -7,964 | -10,203 | -111.1 | -476.6 |

Source : CBRT

II.3. Developments in Monetary Aggregates

As of March 2003, M1 and M2 monetary aggregates contracted by 5.2 percent and 4.2 percent compared with the figures of December. Contraction in M1 monetary aggregate despite the increase in money in circulation in real terms stems from the decline in sight deposits (Table II.3.2). M2X monetary aggregate decreased by 7.9 percent in the mentioned period. The real decline in M2X is relatively higher because FX deposit accounts contracted by a 11.1 percent in real terms.

As of March 2003, M1 and M2 money supplies contracted by 5.2 percent and 4.2 percent compared with the figures of December.

Turkish lira deposit accounts increased by 4.9 percent as of March 2003 compared with December 2002 figures. In terms of TL, foreign exchange deposit accounts, however, decreased by 11.1 percent despite appreciation of exchange rates. With the increase in uncertainties incited by the operation in Iraq, the yield of TL-denominated investments increased and FX deposit accounts came down from USD 44.3 billion to USD 41.4 billion. The share of FX deposit accounts in M2X monetary aggregate decreased from 54.1 percent in end-December 2002 to 52.3 percent in March 2003.

Table II.3.1. Monetary Aggregates (Trillion TL)

| | 2002 | 2002 | 2003 | 2003 | 2003 |
|-------------------------|-----------|-----------|-----------|-----------|-----------|
| | MAR. | DEC. | JAN. | FEB. | MAR. |
| M1 | 11,486 | 14,259 | 14,521 | 15,043 | 14,622 |
| Currency in Circulation | 4,915 | 7,209 | 6,901 | 7,463 | 7,881 |
| Sight Deposits | 6,571 | 7,050 | 7,619 | 7,580 | 6,741 |
| M2 | 50,104 | 61,195 | 61,366 | 62,132 | 63,412 |
| Time Deposits | 38,618 | 46,936 | 46,845 | 47,089 | 48,791 |
| M2X | 103,335 | 133,450 | 134,149 | 131,967 | 132,878 |
| FX Deposits | 53,230 | 72,255 | 72,783 | 69,835 | 69,465 |
| M2XR | 107,024 | 136,213 | 137,368 | 135,057 | 136,802 |
| Repo | 3,690 | 2,763 | 3,219 | 3,090 | 3,925 |
| CPI | 6,242 | 7,469 | 7,662 | 7,835 | 8,078 |
| (1994=100) | | | | | |
| US Dollar | 1,332,489 | 1,622,282 | 1,642,218 | 1,602,796 | 1,708,213 |

Source: CBRT "Weekly Press Bulletin", the provisional data were used for the last Friday of each month..

The share of FX deposit accounts in M2X came down to 52.3 percent in March 2003.

When TL deposit accounts are analyzed by maturity structures, it is observed that the share of TL sight deposits in total TL deposits came down to 12.1 percent by the end of March 2003 with a 1 percentage point decline compared with the figures of December 2002. Meanwhile, the share of repo transactions in total TL deposits increased from 5.1 percent in December 2002 to 7.1 percent in March, due to shortening of maturities affected by the uncertainties created by the war in Iraq.

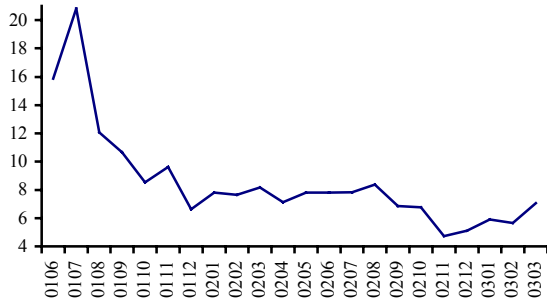
Table II.3.2. Monetary Aggregates, Real Percentage Change

| | ANNUAL | | | COMPARET TO DECEMBER | | |
|-------------------------|--------|-------|-------|-------------------------|------|-------|
| | 2002 | | | 2003 | | |
| | OCA. | ŞUB. | MAR. | OCA. | ŞUB. | MAR. |
| M1 | 12.7 | 0.5 | -1.6 | -0.7 | 0.6 | -5.2 |
| Currency in Circulation | 21.2 | -2.3 | 23.9 | -6.7 | -1.3 | 1.1 |
| Sight Deposits | 6.0 | 3.4 | -20.7 | 5.4 | 2.5 | -11.6 |
| M2 | 3.7 | 0.0 | -2.2 | -2.3 | -3.2 | -4.2 |
| Time Deposits | 1.2 | -0.2 | -2.4 | -2.7 | -4.4 | -3.9 |
| M2X | 5.7 | 0.4 | -0.6 | -2.0 | -5.7 | -7.9 |
| FX Deposits | 7.5 | 0.7 | 0.8 | -1.8 | -7.9 | -11.1 |
| M2XR | 4.8 | -0.4 | -1.2 | -1.7 | -5.5 | -7.1 |
| Repo | -22.9 | -25.9 | -17.8 | 13.6 | 6.6 | 31.3 |

Source: CBRT "Weekly Press Bulletin", the provisional data were used for the last Friday of each month.

M2XR monetary aggregate calculated by adding the repo transactions carried out by the banks with their customers to M2X contracted by 7.1 percent in real terms in the first quarter of 2003. Parallel to shortening of maturities due to uncertainties incited by the war in Iraq, the amount of repo transactions increased by 31.3 percent compared with December 2002 (Figure II.3.1).

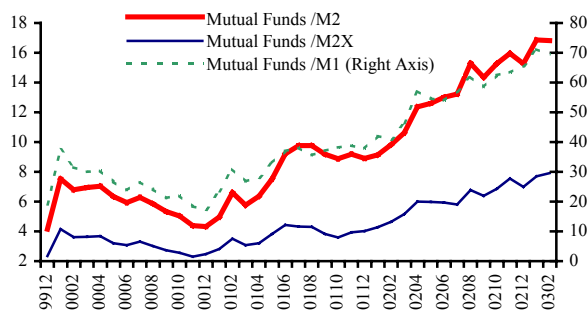
Figure II.3.1. The Ratio of Repo Transactions to TL Deposits (Percentage)



Source: CBRT "Weekly Press Bulletin", the provisional data were used for the last Friday of each month.

It is observed that the economic units tend to invest in mutual funds more gradually for a couple of years. 97 percent of these mutual funds is comprised of government papers and reverse repo transactions. The yield of these instruments follow a parallel course to that of time deposits and as they have high liquidity, they can be a substitute for M1. That is why developments in mutual funds are effective on money supplies. the ratio of mutual funds to money supply continues the upward trend since the beginning of 2001 (Figure II.3.2). The ratio of mutual funds to M1 monetary aggregate, which was 65.5 percent by the end of 2002, reached 69.5 percent by the end of February 2003. In the same period, the ratio of mutual funds to M2 monetary aggregate increased from 15.3 to 16.8 percent and to M2X monetary aggregate from 7.0 percent to 79 percent (Figure II.3.2).

Figure II.3.2. The Ratio of Mutual Funds to M1, M2 and M2X (Percentage)



Source: CBRT "Weekly Press Bulletin" and CMB "Monthly Bulletin"

II.4. Developments in Interest Rates

With the aim of enhancing stability and curbing the adverse effects of the Iraq operation on the financial markets, the CBRT cut down the lending interest rate in late liquidity window facility by 5 points down to 56 percent on 20 March. Meanwhile, taking into account the inflation expectations that would affect future inflation, other interest rates at the market, exchange rates and demand developments, the CBRT cut down short-term interest rates -except the late liquidity window borrowing interest rate- by 3 percentage points on April 25, 2003 (Table II.4.1).

Table II.4.1. CBRT Interest Rates (Simple, percentage)

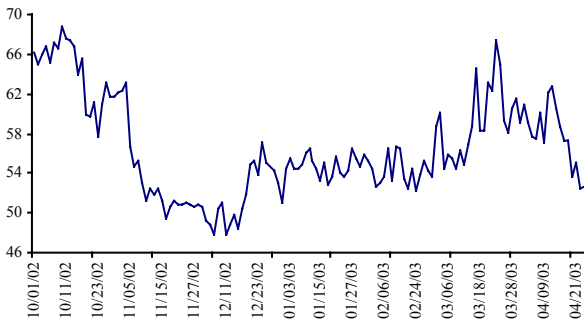
| | April 30 2002 | August 5 2002 | Nov. 11 2002 | March 20 2003 | April 25 2003 |
|--|------------------|------------------|-----------------|------------------|------------------|
| O/N Borrowing | 48 | 46 | 44 | 44 | 41 |
| O/N Lending | 55 | 53 | 51 | 51 | 48 |
| 1 week Borrowing | 49 | 46 | 44 | 44 | 41 |
| Late Liquidity Window Borrowing* | - | 5 | 5 | 5 | 5 |
| Late Liquidity Window Lending* | - | 63 | 61 | 56 | 53 |

* As of June 1, 2002 the CBRT initiated the implementation of "late liquidity window" in the Interbank Money Market between 16:00-16:30 as a new TL liquidity facility from 1st July 2002. The interest rates within this facility were determined as 5 percent for borrowing and 65 percent for lending on June 1, 2002.
Source: CBRT

In the first quarter of 2003, interest rates at the secondary market and interest rates at the Treasury auctions were influenced by the worries pertaining to debt sustainability, to the uncertainties sparked by the operation in Iraq and future fiscal policy. Therefore, compound interest rates at the secondary market were quite volatile in 2003 Q1 (Figure II.4.1). As of the beginning of March, fluctuations in interest rates became more severe and interest rates displayed a significant increase because of the operation in Iraq and developments pertaining to the role of Turkey in this operation. The 9.2 point increase in the first three business days following the launch of the military operation in Iraq was the consequence of the market's reaction to uncertainties. Average rate of interest rates at the secondary market declined in March to be followed by a rise due to increase in the average days to maturity of traded securities in April and a sharp decline just after April. On 24th April, secondary market interest rates

became 52.7 percent, which is 2.5 points below the end-January value.

Figure II.4.1 Interest Rates at ISE Bonds and Bills Outright Purchases and Sales Markets (Weighted average, compound, percentage)

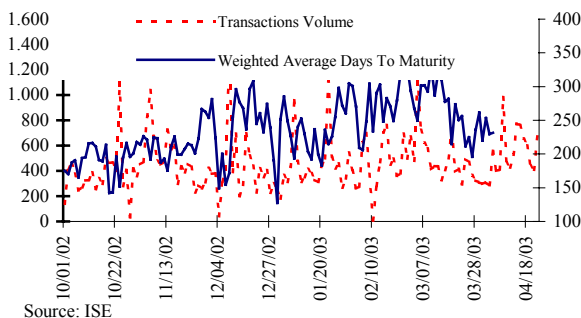


Source: ISE

The Treasury bills with maturity dated December 3, 2003 reflected the developments in secondary market interest rates in January-April 2003 period. The interest rate of this bill displayed a mild volatility and declined in January-February period to be followed by a sharp rise in March. On March 25, 2003, the interest rate of this bill reached the highest level of this period with 72.5 percent. With the ease of uncertainties towards the end of March,

the interest rate on these bills declined and this decline continued in April with gradual acceleration. Interest rate on this bill, which was 56.4 percent at the beginning of January, became 53.3 percent on April 24. The transaction volume and days to maturity at ISE Bonds and Bills Outright Purchases and Sales Market changed according to the uncertainties and developments in interest rates (Figure II.4.2).

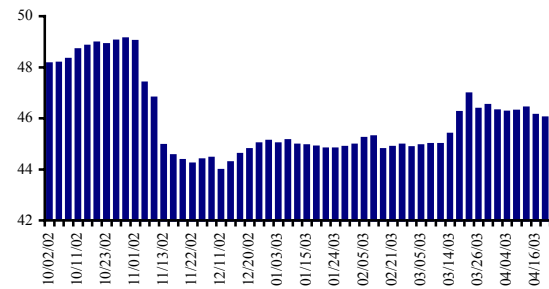
Figure II.4.2. ISE Bonds and Bills Outright Purchases and Sales Trading Volume (Trillion TL) and Weighted Average Days to Maturity



Source: ISE

Simple interest rates at 4-week maturity TL deposit purchase auctions stayed within 44.5-45.5 percent band from January until mid-March (Figure II.4.3). From 14th March until the end of March, a limited rise was observed in the said interest rates. In the auctions held on 19th March and 21st March, the total amount of bids was short of the maximum amount that could have been borrowed and this may be attributed to the impact of uncertainties pertaining to the Iraq operation on investment preferences. However, in other auctions held in March and April, the maximum amount of borrowing was reached. Consequently, simple interest rate at 4-week TL deposit purchase auctions, which was 44.96 percent by the end of January, reached 46.02 percent on April 18, 2003.

Figure II.4.3 Interest Rates at 4-Week Turkish Lira Deposit Purchase Auctions (Simple, Percentage)

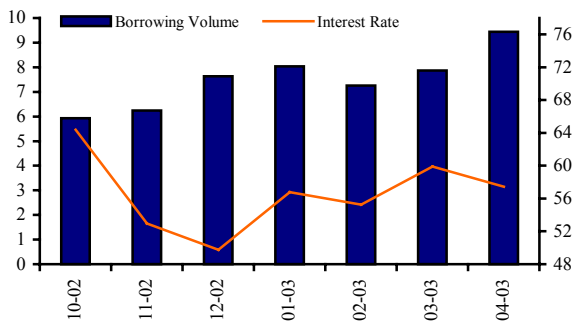


Source: CBRT

An analysis of the interest rates at the Treasury auctions reveals that the significant increase in monthly average rate of compound interest in January was followed by a limited decline in February and a steady rise in March due to escalating uncertainties pertaining to the operation in Iraq (Figure II.4.4). Therefore, the monthly average of compound interest rate at Treasury auctions reached the highest level after the elections in March. While interest rates of short-term Treasury Bills at Treasury auctions held in March recorded a significant rise, increase in interest rates applicable to long-term bills remained limited. This fact reveals that the risk factors are more likely to be reflected on the short-term pricing mechanism rather than on the long-term. Parallel to the downward trend in interest rates in the second half of the month, the average rate of interest at the auctions decreased by 2.5 percent in April. Another important

observation is that with the ease of short-term uncertainties like the military operation in Iraq, the decline in interest rates was much more reflected on auctions for short-term bills.

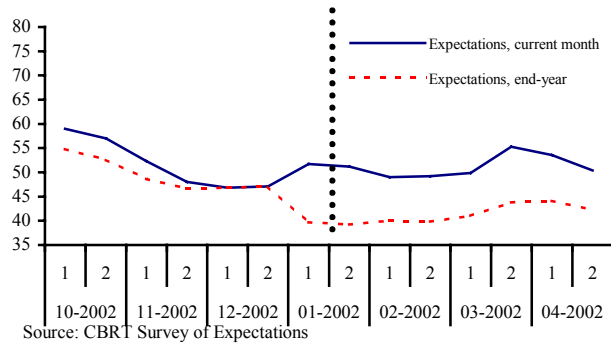
Figure II.4.4. Interest Rates at the Treasury Auctions (percentage) and Borrowing Volume(TL quadrillion, net)*



*Auction interest rates are the average interest rates of the discounted bond auctions. The borrowing volume includes only the volume of the discounted bond auctions. Source : CBRT

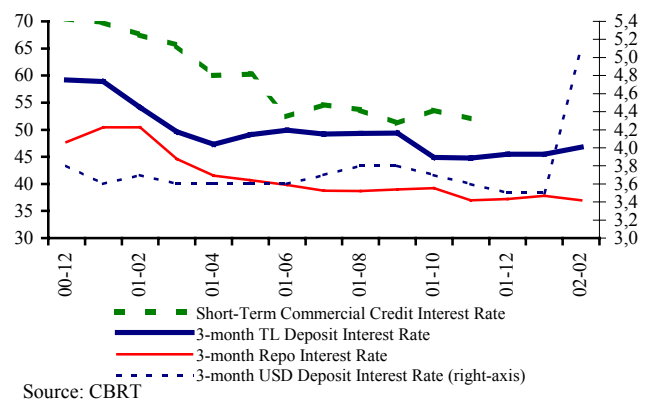
The three-month Treasury auction interest rate expectations in CBRT Survey of Expectations verify these two observations. The three-month Treasury auction interest rate expectations for the current month highly deteriorated in January increasing by 4.1 percent and declined by 2 percent in January (Figure II.4.5). Auction interest rate expectations for the current month, which showed a limited increase in the first survey of the month, rose by 5.4 percent in the second period and reached 55.3 percent. This rate is 6.3 points above the expectations in the first period of February, the lowest level in 2003. In April, interest rate expectations for the current month fell sharply and became 50.4 percent in the second period of the month. Auction interest rate expectations for the end-year realized at 43.8 percent in the second period of March, remaining above the January observation, the lowest level of 2003, by 4.6 percent. In April, interest rate expectations for the end-year dropped, albeit slightly compared to the expectations for the current month and realized at 42.3 percent in the second period of the month. However, Treasury auction interest rate expectations for the current year and Treasury auction expectations for the end-year in the second period of April were above 1.4 percent and 3.1 percent, respectively, among the lowest levels throughout the year.

Figure II.4.5. Three-Month Treasury Auction Interest Rate expectations (percentage, compound)



The three-month TL deposit interest rates showed a limited drop December 2002 and then rose in the first quarter of 2003. These interest rates realized at 46.8 percent in March, remaining 1.9 percentage points above its level in November 2002 (Figure II.4.6). On the other hand, FX deposit interest rates recorded a gradual drop in December-February period, but significantly increased in March. As a consequence of these developments, the three-month US dollar deposit interest rates increased by 1.4 points and became 5.1 percent at the end of March. Repo interest rates became 37 percent in December-March period, dropping by 2.2 points. Interest rates on short-term commercial credits declined in August-December period and realized at 52 percent.

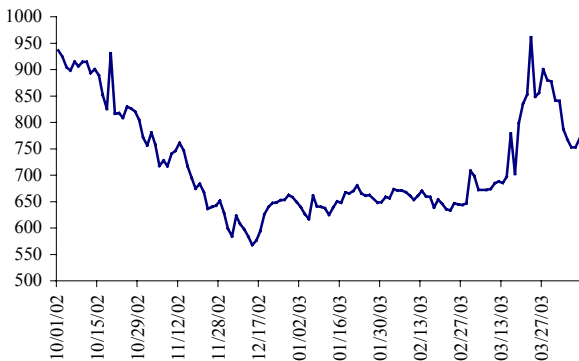
Figure II.4.6. Interest Rates on Commercial Credit, TL, FX Deposits and Repo (percentage)



Source: CBRT

When the yields of Eurobond due in 2030 issued by the Treasury are compared to the benchmark securities having the same maturity, it is observed that the yield spread of the Treasury securities moved within the range of 616-646 basis points until March (Figure II.4.7). However, the yield spread leaped in the beginning of March in line with domestic and foreign developments on Iraqi operation. This upward trend continued in the following period of the month and rose to 961 basis points at the end of the first three days following the start of Iraq war. Although the yield spread entered in a downward trend towards the end of March, it realized as 770 basis points on 9 April. This level is approximately 110 basis points above the January level.

Figure II.4.7. Yield Spread (basis points, Turkey 01/15/2030- US Treasury 30-year Generic Bond)

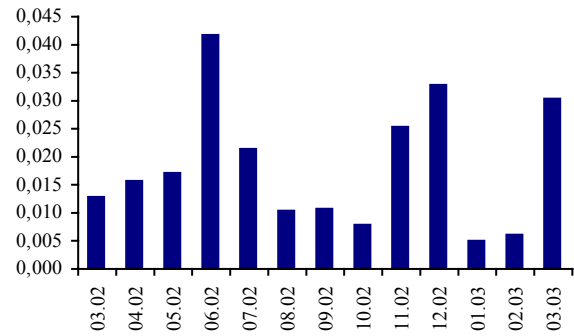


Source: Bloomberg

II.5. Developments in Foreign Exchange Market

Exchange rates displayed a downward trend until mid-December following the general elections held in early-November. Exchange rates had risen sharply owing to the developments in the process of membership to EU and US operation against Iraq. Fluctuations in the markets had eased with the Central Bank's FX intervention in the markets towards the end of December. It was observed that in the first quarter of 2003, the course of exchange rates was mainly determined by the developments on Iraqi operation. The impact of other political economic developments on the exchange rates were temporary and limited (Figure II.5.1).

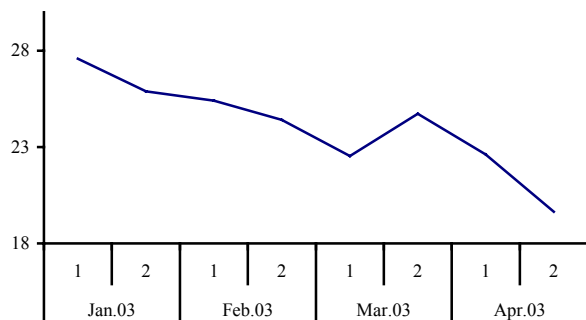
Figure II.5.1. Monthly Exchange Rate Volatility (*)



*The ratio of the monthly standard deviation of the exchange rate to the monthly average of exchange rate is used to measure volatility.

While US dollar recorded a limited drop until March 2003 compared with the end-December, euro, which appreciated against US dollar during the same period, increased against Turkish lira as well. Developments on Iraqi operation and Turkey's role in the operation throughout March led to a considerable volatile course in exchange rates. However, starting from the end-March, exchange rates regressed to their January level. Considering the possible impact of Iraqi operation on exchange rates, the Central Bank took a number of measures. As explained above, these measures can be listed as the cut of borrowing interest rates in Foreign Exchange and Effective Markets and the necessary preparations in order to meet any effective foreign exchange demand.

Figure II.5.2. Expected Annual Appreciation of US Dollars in 2002*



* Year-end US dollar-TL parity expectations has been transformed into yearly percentage change expectations by using end of 2001 US dollar-TL value.
Source: CBRT

Foreign exchange rate expectations for the year-end pursue a course in line with the exchange rate movements in the current period. US dollar expectations for the end-year, which was TL 2.085.000 in early-January dropped until the second half of March. These expectations rose at the end of March in line with the expectations for the current period, but fell again in the beginning of April. It is considered that the parallel course of foreign exchange rate expectations for the end-year parallel with the foreign exchange rate expectations for the current period proves that exchange rates were affected by the changes in risk perceptions rather than short-term supply-demand conditions in the market.

The parallel course of foreign exchange rate expectations for the end-year parallel with the foreign exchange rate expectations for the current period proves that exchange rates were affected by the changes in risk perceptions rather than the market conditions.

It is assumed that concerns about the sustainability of debt stock are the major factor that lies behind the sharp and strong reaction of investors against risks. As observed in other financial markets, ease of concerns about the sustainability will probably diminish the volatility in foreign exchange markets as well. Favorable developments in domestic debt will also have a positive effect on the reverse currency substitution.

Figure 11.5.3. Exchange Rate (TL/USD, Average of buying selling rates)



Source: CBRT

III. DEVELOPMENTS IN FINANCIAL MARKETS

III.1. The Banking Sector

The number of banks in the banking sector, which have been restructured after the crises, reduced to 54 as of March. 40 of these banks are deposit banks and 14 of these are development and investment banks. Deposit banks comprise of 3 state-owned banks, 20 private banks, 2 banks under SDIF and 15 foreign banks. Four of the foreign banks are those that were set up in Turkey and the rest are the branches of foreign banks in Turkey.

There was no demand for Pamukbank until 28 March, which was re-taken over by SDIF on January 27, 2003 and whose sale process is still underway. The Bank was put on sale on 3 April for the second time in order to be resolved.

Table III.1.1. Financial Markets-Main Indicators (TL, Trillion)

| | 29.03 2002 | 27.12 2002 | 28.03 2003 |
|---|---------------|---------------|---------------|
| Deposit (Residents) | 100,451 | 128,549 | 128,100 |
| TL | 47,221 | 56,294 | 58,635 |
| FX | 53,230 | 72,255 | 69,465 |
| Repos (Savings Holders) | 3,690 | 2,763 | 3,925 |
| Credit to Non-Financial Sector by Deposit Banks* | 30,931 | 31,845 | 36,559 |
| TL | 18,130 | 17,409 | 19,151 |
| FX | 12,801 | 14,436 | 17,408 |
| Consumer Loans | 2,077 | 2,902 | 3,416 |
| Credit Cards | 2,551 | 4,099 | 4,481 |
| FX Position (USD, Million) | -674 | -517 | 643 |
| Past Due Loans/Tot. Credit (%) | 18.6 | 26.0 | 20.6 |
| Past Due Loans/Tot. Credit (%) - Excluding SDIF | 15.9 | 22.3 | 18.5 |
| Securities Portfolio/Tot. Deposit (%) | 20.3 | 30.4 | 31.9 |
| Securities in Non-Trading Port. /Total Deposit (%) | 46.9 | 34.6 | 36.3 |
| Credit/Deposit (%) | 31.1 | 25.1 | 30.1 |
| Public Bank Dep./Tot.TL.Deposits (%) | 56.5 | 53.9 | 55.1 |
| Public Bank credit/Tot.TL Credit (%) | 23.9 | 22.8 | 21.3 |

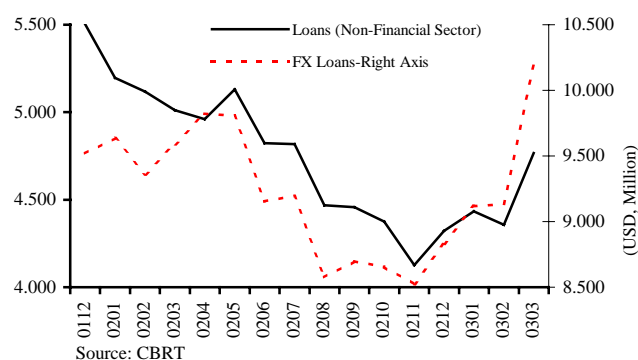
* The increase in the credit volume in March 2003 stemmed from takeover of 3.3 quadrillion TL loans extended by foreign branch of a bank by domestic branch.

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

III.1.a. Credit

Credit volume, which was in contraction trend due to the deterioration in financial structure of the banking sector, entered in upward trend in December 2002 and January 2003. However, credit volume re-shrank in February because of the uncertainties about Iraqi crisis. Total credit volume, which expanded by 3 percent in January compared to the previous month, dropped by 2 percent in real terms in February. (Figure III.1.1).

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



Credit volume expanded in December 2002 – March 2003 period, for the first time after 2000 and 2001 crises.

In March 2003, total credits increased due to the display of a foreign loan of TL 3.3 quadrillion, which was extended from a foreign branch of a bank and did not appear within the credit volume, under credit items. In March, total credits increased by 9 percent in real terms compared to the previous year. The amount of total credits remained unchanged in real terms after deducting TL 3.3 quadrillion arising from the transfer between accounts. Total credits grew by 1 percent in real terms in the first quarter of 2003, after TL 3.3 quadrillion was deducted.

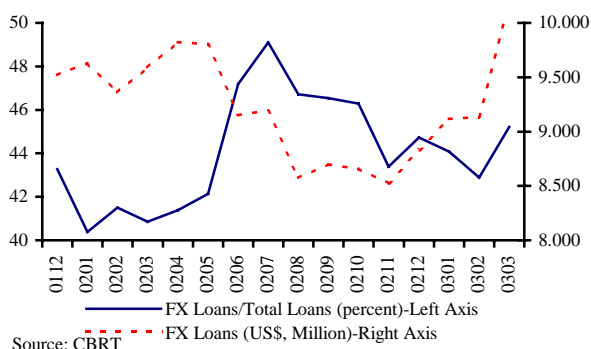
In this period, the private bank credits excluding the increase arising from the transfer between accounts rose by 1 percent in real terms compared to the end-year, while state-owned bank credits declined by 1 percent in

real terms. Meanwhile, the foreign bank credits increased by 1 percent in real terms as well.

In March 2003, TL commercial credits rose by 3 percent in real terms compared to the end-year due to the increases in January and February, whereas specialized credits reduced by 4 percent in real terms.

In March 2003, TL equivalent of FX loans excluding the increase arising from the transfer between accounts remained unchanged in real terms compared to the end-year. FX loans in terms of US dollar rose to US dollar 9.1 billion in March 2003, increasing by US dollar 300 million compared to the end-year. The share of TL equivalent of FX loans in overall credits, which was 44.7 percent at the end of 2002, increased to 45.2 percent in March. (Figure III.1.2).

Figure III.1.2. FX Loans



Source: CBRT

Table III.1.2. Deposit Banks Credit (TL, Trillion)

| | Public | Private* | Foreign | Total |
|---------------------|--------|----------|---------|--------|
| 29.03.2002 | 7,374 | 22,317 | 1,219 | 30,910 |
| TL | 5,517 | 12,091 | 522 | 18,130 |
| FX | 1,857 | 10,226 | 697 | 12,780 |
| 27.12.2002 | 7,259 | 22,430 | 2,156 | 31,845 |
| TL | 5,664 | 10,814 | 931 | 17,409 |
| YP | 1,595 | 11,616 | 1,225 | 14,436 |
| 28.03.2003** | 7,786 | 26,415 | 2,359 | 36,560 |
| TL | 6,047 | 12,074 | 1,030 | 19,151 |
| FX | 1,739 | 14,341 | 1,329 | 17,409 |

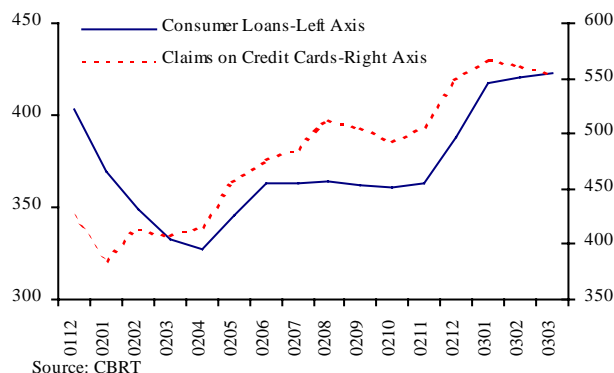
* Including SDIF.

** The increase in the credit volume in March 2003 stemmed from takeover of 3.3 quadrillion TL loans extended by foreign branch of a bank by domestic branch.

Source: CBRT Weekly Press Bulletin.

In March 2003, consumer loans and claims on credit cards rose by 8 percent and 1 percent in real terms compared to the end-year, respectively. The share of consumer loans in overall credits, which was 9 percent at the end of 2002, dropped to 8.9 percent in March (Figure III.1.3). Claims on credit cards is expected to decrease in the following period owing to the amendment made to law on protection of the consumer rights in order to facilitate the repayment of claims on credit cards that are in the process of execution proceedings or will be resulted in execution proceedings. Pursuant to this law, the principal of claims on credit cards on the date of default, for which a written application has been submitted within 30 days can be repaid in twelve equal installments with its annual default interest, which should not exceed fifty percent.

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



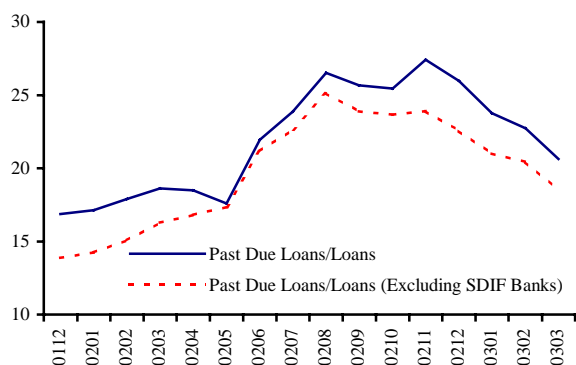
Source: CBRT

In March 2003, consumer loans and claims on credit cards rose by 8 percent and 1 percent in real terms compared to the end-year, respectively.

The share of past due loans in total credits, which was 26 percent at the end of 2002, decreased to 20.6 percent in March 2003. (Figure III.1.4.). In March, the share of past due loans of the banks taken over by SDIF in total became 12, while the share of state-owned banks and private banks were 49 percent and 37 percent, respectively.

In December 2003, 49 percent of past due loans belonged to state-owned banks.

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



III.1.b. Banks' Trading Available for Sale and Banks' Investment Securities to be Held Till Maturity

In March, total of banks' "trading securities and securities available for sale" and banks' "investment securities to be held till maturity", under which mainly banks' treasury bonds and government securities are accounted, reduced by 3 percent compared to the end-year. During this period, trading securities and securities available for sale item decreased by 4 percent in real terms, whereas investment securities to be held until maturity dropped by 3 percent in real terms.

In March 2003, securities to be held till maturity comprised a major portion of government securities of state-owned banks, whereas a substantial portion of government securities held by private banks were composed of trading securities and investment securities to be held till maturity. While the share of state-owned banks was 17 percent in deposit banks' trading securities and securities available for sale, the share of private banks realized at 81 percent in March 2003. Moreover, the shares of state-owned banks and private banks in deposit banks' investment securities to be held till maturity were 75 percent and 23 percent, respectively.

In March, total of banks' "trading securities and securities available for sale" and "investment securities to be held till maturity" reduced by 3 percent in real terms compared to the end-year.

Figure III.1.5. The Share of Total Government Securities in Total Deposit of Banking Sector (Percent)

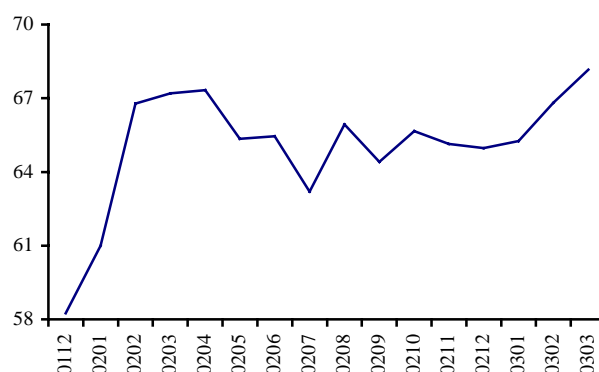


Table III.1.3. Developments in Securities Portfolio and the Securities in Non-Trading Portfolio (TL Trillion)

| | Public | SDIF | Private | Banking Sector |
|-----------------------------|---------------|--------------|---------------|----------------|
| 2002 March | | | | |
| Securities Portfolio | 3,447 | 2,007 | 16,252 | 20,200 |
| TL | 1,395 | 1,986 | 10,216 | 12,027 |
| FX | 2,052 | 21 | 6,036 | 8,173 |
| Sec. in Non-Trad. Portfolio | 30,840 | 1,494 | 15,256 | 46,854 |
| TL | 24,195 | 1,494 | 10,401 | 34,880 |
| FX | 6,645 | 0 | 4,855 | 11,974 |
| 2002 December | | | | |
| Securities Portfolio | 5,762 | 4,474 | 31,820 | 39,106 |
| TL | 1,442 | 4,442 | 17,772 | 20,037 |
| FX | 4,320 | 32 | 14,048 | 19,069 |
| Sec. in Non-Trad. Portfolio | 33,075 | 194 | 10,244 | 44,417 |
| TL | 24,483 | 188 | 7,350 | 32,251 |
| FX | 8,592 | 6 | 2,894 | 12,166 |
| 2003 March | | | | |
| Securities Portfolio | 6,799 | 4,576 | 32,770 | 40,802 |
| TL | 1,831 | 4,548 | 17,678 | 20,096 |
| FX | 4,968 | 28 | 15,092 | 20,706 |
| Sec. in Non-Trad. Portfolio | 34,876 | 197 | 10,517 | 46,516 |
| TL | 25,867 | 197 | 7,541 | 33,843 |
| FX | 9,009 | 0 | 2,976 | 12,673 |

Source: CBRT

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

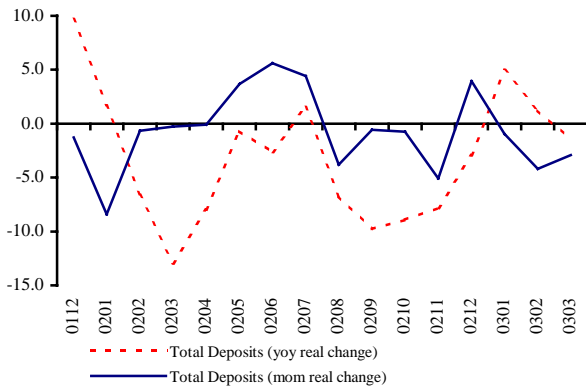
Turkish lira deposits and TL equivalent of FX deposits reduced in real terms in the first quarter of 2003. The drop stemmed from both the uneasiness caused by Iraq war and the residents' inclination towards TL instruments

such as repo, government securities and investment funds, whose yields are relatively higher (Box III.1).

In the first quarter of 2003, total deposits of residents decreased by 8 percent in real terms and realized as TL 128 quadrillion (Figure III.1.6). This drop mainly stemmed from the decline in TL equivalent of FX deposits in real terms. Appreciation of TL against US dollar in the first quarter multiplied real decline in TL equivalent of FX deposits in real terms due to the fact that more than two third of FX deposits were in terms of US dollar.

Drop in total deposits in the first quarter of 2003 mainly stemmed from real decline in TL equivalent of FX deposits.

Figure III.1.6. Developments in Total Deposits (Discounted by CPI 94=100, Percent)

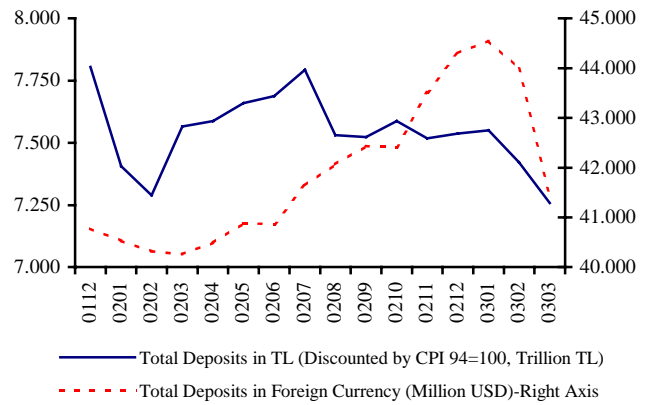


In the first quarter of 2003, TL deposits decreased by 4 percent in real terms and realized as TL 58.6 quadrillion. During this period, while the share of private and foreign banks in TL deposits fell to 44.1 percent from 45.2 percent and to 0.8 percent from 0.9 percent, respectively, the share of state-owned banks rose to 55.1 percent from 53.9 percent. It is presumed that depositors preferred state-owned banks considering these banks more reliable due to the uneasiness caused by Iraq war.

In this period, TL equivalent of FX deposits reduced by 11 percent in real terms and became TL 69.5 quadrillion.

As to the FX deposits in terms of US dollars, it is observed that this item reduced by US dollar 2.9 billion in March 2003 compared to December 2002 and realized as US dollar 41.4 (Figure III.1.7).

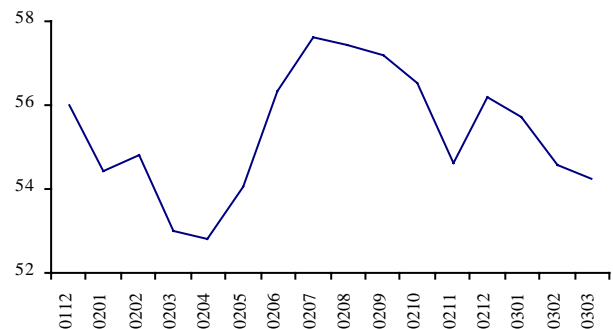
Figure III.1.7. Developments in Turkish lira and Foreign Currency Deposits



In the first quarter of 2003, the share of private and foreign banks in FX deposits declined to 73.9 from 74.3 percent and to 2.8 percent from 3.1 percent, respectively. The share of state-owned banks rose to 23.3 percent from 22.6 percent.

Due to the developments mentioned above, the share of FX deposits in total deposits dropped as well. This share, which was 56.2 percent in December 2002, regressed to 54.2 percent in March 2003 (Figure III.1.8).

Figure III.1.8. The share of FX Deposits in Total Deposits (Percent)



BOX.III.1 IRAQ CRISIS and PORTFOLIO PREFERENCES

The impact of the last Iraq war on financial system manifested itself both in similar and distinct ways compared to 1990 Iraq war. The most striking similarity is that the early impact appeared as the withdrawals from FX deposits. In both crises, the Central Bank, as a lender of last resort, enhanced its effective foreign exchange reserves and took the necessary measures to meet the requirements of the system. The second significant similarity is that in both crises, nominal domestic borrowing cost soared over 70s percent from 50s percent.

The basic difference is the implementation of a program aiming at strengthening of macro fundamentals, attributing an independent structure to the Central Bank within the framework of the program, short-term advance practice and transmission to floating exchange rate regime. Contrary to the first war, compulsory foreign exchange transfer application was no longer in force. Again contrary to the first Iraq war during which "monitored floating" regime was in effect, the current floating exchange rate regime has allowed the markets to find new balances with their own dynamics under free market conditions throughout the war. During the last war, there was no need for any direct intervention in foreign exchange markets. Foreign exchange liquidity requirement in the system arising from FX outflows were met by the cut of interest rates on foreign exchange deposits to 6 percent from 12 percent.

EFFECTS OF IRAQ CONFLICT ON PORTFOY PREFERENCES

| | FX Deposit (Resident-USD, Million) | TL Deposit (Resident-TL, Trillion) | Repos (TL, Trillion) | Government Domestic Debt Instruments of Non-Bank Sector (TL, Trillion) | Mutual Fund (TL, Trillion) | TL Investment Instruments (TL, Trillion) | Net Change (TL, Trillion) (*) |
|----------------------------|--|--|-------------------------|--|-------------------------------|--|-------------------------------------|
| 28.02.03 | 47.550 | 58.149 | 3.090 | 37.428 | 10.657 | 109.324 | |
| 07.03.03 | 47.363 | 58.424 | 3.404 | 38.185 | 10.894 | 110.907 | |
| 14.03.03 | 46.741 | 58.723 | 3.963 | 39.030 | 10.799 | 112.515 | |
| 21.03.03 | 45.314 | 59.445 | 3.660 | 39.906 | 10.987 | 113.998 | |
| 28.03.03 | 45.051 | 58.635 | 3.925 | 41.485 | 10.738 | 114.783 | |
| 04.04.03 | 44.914 | 58.809 | 3.269 | 42.106 | 10.577 | 114.761 | |
| 11.04.03 | 45.012 | 57.852 | 3.983 | 43.063 | 10.710 | 115.608 | |
| 28 February-14 March Perio | -809 | 574 | 873 | 1.602 | 142 | 3.191 | 1.878 |
| 14 March-28 March Period: | -1.690 | -88 | -38 | 2.455 | -61 | 2.268 | -614 |
| 28 March-11 April Period: | -39 | -783 | 58 | 1.578 | -28 | 825 | 760 |

(*) USD buying rate has been used to compute TL equivalent of FX Deposit .

Source: CBRT, provisional data.

After the the motion allowing the deployment of foreign troops on Turkish soil and sending the Turkish army to a cross-border operation was rejected March 1, the downward trend in the interest rates on TL investment instruments reversed. Simultaneously, fluctuation has started in foreign exchange rates. The first severe sign of crisis on savings instruments was the depletion in FX accounts after 14 March. When it became certain in mid-month that the war was inevitable and that the US foreign aid would not be due to the vagueness in Turkey's attitude towards the war, the secondary market interest rates on government securities leaped over 70s percent, while USD foreign exchange rate exceeded TL 1.750.000.

Although in the beginning, withdrawals from FX accounts appeared as resource outflows from the system because of the uncertainty created by Iaq war, the effects of floating exchange rate regime as automatic stabilizer prevailed immediately. Increasing interest rates and high exchange rates led investors to exchange their foreign exchange assets with TL instruments bearing high interest. Hence, government securities stock held by the non-banking sector increased sharply in line with withdrawals from FX accounts. This increase was met by the cutback of private banks' trading securities and securities available for sale to TL 32.4 quadrillion of April 4 from TL 34.5 quadrillion of March 21. With the ending of war, the portion of FX outflows, which was withdrawn because of war, started to be reinstated albeit partially. However, FX accounts failed to reach their pre-war level due to the transmission to TL instruments.

It was clearly seen during Iraq war how floating exchange rate regime could perform its stabilizer role in an efficient manner in times of exterior-shocked-originated crises. Floating exchange regime allowed the markets to achieve new balances by their own dynamics during and afted Iraq war 2003 without any direct intervention in foreign exchange markets and, clearly revealed that the crisis-avoiding effects of the portfolio preferences of the depositors.

In conclusion, thanks to floating exchange rates regime, an exterior shock such as Iraq war was overcome without any necessity for direct foreign exchange buying intervention, on contarry to 1991 crisis. The Central Bank provided support to financil system during short-lived foreign exchange liquidity shortage. The demand for support ceased automatically with the ending of Iraq crisis. With the decline of foreign exchange rates to their pre-crisis level, tho borrowing cost of the Treasury backed to its previous level as well.

The maturity of TL deposits became shorter again in the first quarter of 2003 (Figure III.1.9). In this period, the share of short-term deposits, which include three-month deposits and deposits having maturity up to three months in total deposits rose to 88.3 percent from 88.1 percent. The maturity of FX deposits extended during this period. The share of short-term FX accounts in total FX accounts dropped to 84.6 percent from 85.1 percent.

Figure III.1.9. The Share of Short-term Deposits in TL and FX in Total (Percent)

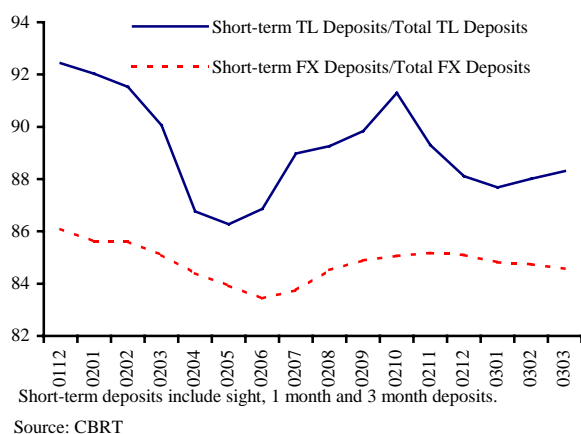
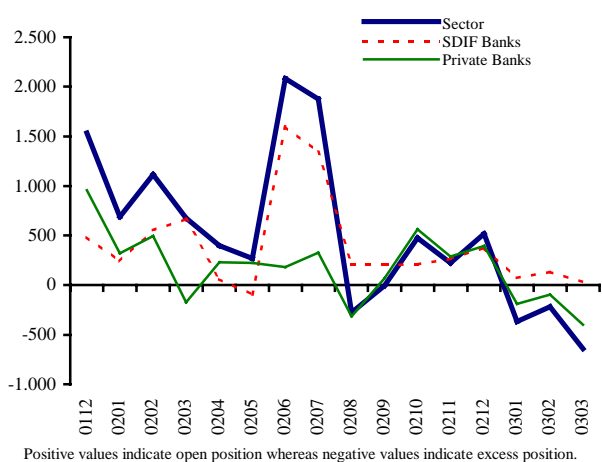


Figure III.1.10. Foreign Exchange General Open Position of the Banking Sector (Million USD)

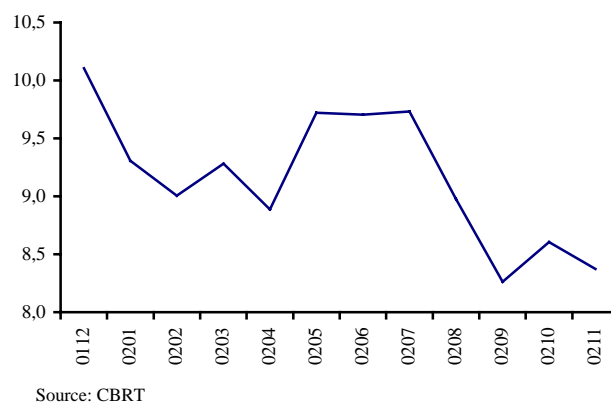


Foreign exchange net general position of the banking sector, which produced a deficit of US dollar 517 million

in December 2002, provided a surplus of US dollar 643 million in March due to the regression in open positions of all banking groups in early-2003. In this period, open position of SDIF banks declined to US dollar 29 million from US dollar 375 million. While private banks produced an open position of US dollar 395 million in December 2002, it turned out to be a surplus of US dollar 398 million in March 2002. Surplus of state-owned banks rose to US dollar 234 million from US dollar 196 million in December 2002-March 2003 period.

Foreign exchange credits from abroad, one of the funding resources of the banking system, realized as US dollar 8.3 billion in September 2002 and US dollar 8.4 billion in November 2002 (Figure III.1.11).

Figure III.1.11. Credit Used by Banking Sector from Abroad (Million USD)

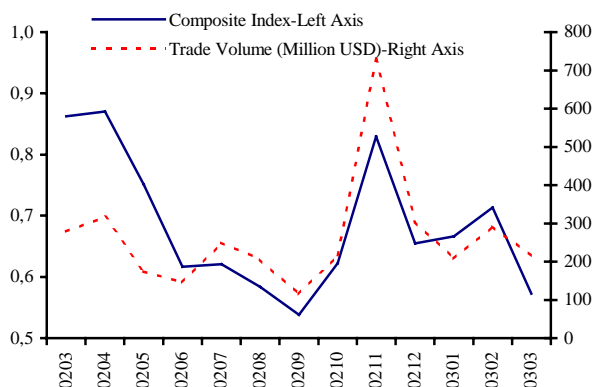


III.2. The Securities Market

ISE National 100 Index and trading volume contracted in the first quarter of 2003 due to the atmosphere of uncertainty created by Iraq war.

ISE National 100 Index dropped by 16 percent in real terms in the first quarter of 2003. In this period, services index, financial index and industrial index declined by 15 percent, 20 percent and 9 percent in real terms, respectively.

Figure III.2.1. ISE Composite Index and Trade Volume (USD)



Source: CBRT

ISE National 100 Index maintained its downward trend (Figure III.2.1). ISE National 100 Index, which was 0.7 US dollar in December 2002, fell to 0.6 US dollar at the end of March 2003. Industrial index remained unchanged. Daily average trading volume dropped to US dollar 215 million in March 2003 from US dollar 304 million of end-2002.

The worth of balances of keeping stocks owned by foreign investors, which was US dollar 3.450 million at the end of 2002, declined to US dollar 3.033 million in March 2003.

When the stock markets of some of the developing countries are analyzed, it is seen that Brazilian Bovespa Index and Russian Mos Times Index remained almost unchanged in the first quarter of 2003. Mexican Mxse IPC Gral In Index and South Korean Kospi Index dropped by 3 percent and 12 percent, respectively (Table III.2.1). Developments in developing stock markets on annual basis are given below.

Table III.2.1. Developments in the Stock Exchange Indices of Some Selected Developing Countries, December 2002-March 2003 Period (Percent)

| | In Domestic Currency | In USD |
|-----------|----------------------|--------|
| Malaysia | -2,1 | -2,1 |
| Tailand | 3,3 | 3,8 |
| Argentine | 8,3 | 25,9 |
| Brazil | -0,5 | 3,9 |
| Chile | 0,3 | -0,6 |
| Mexico | -2,9 | -5,4 |
| Israel | 5,8 | 7,1 |
| Turkey | -9,3 | -12,2 |
| Hungary | -2,9 | -5,4 |
| Poland | -2,3 | -7,9 |
| Russia | -0,3 | 1,5 |

Source: The Economist

IV. PUBLIC FINANCE AND DOMESTIC DEBT STOCK

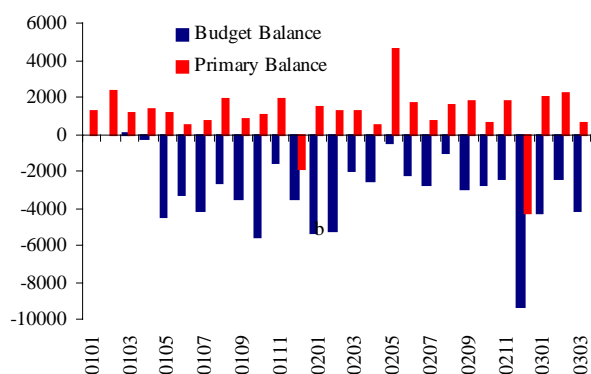
In January-March 2003 period, primary budget surplus excluding privatization realized as TL 4.9 quadrillion increasing by 25.5 percent compared to the same period of the previous year (Table IV.1). During this period, budget deficit became TL 10.9 quadrillion. Primary budget surplus was TL 638 trillion in March 2003 (Figure IV.1).

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

| | 2002 | 2003 |
|---|---------|---------|
| | Jan-Mar | Jan-Mar |
| Revenues | 15028 | 20364 |
| Expenditures | 27663 | 31253 |
| Budget Balance | -12636 | -10889 |
| Primary Budget Balance | 3904 | 4898 |
| Primary Budget Balance Exc. Privatization | 3904 | 4898 |

Source: Ministry of Finance.

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



Source: Ministry of Finance.

IV.1. Revenues

While budget revenues reached TL 20.4 quadrillion in January-March 2003 period increasing by 35.5 percent compared to the same period of the previous year, tax revenues rose by 42.9 percent and became TL 16.7 quadrillion (Table IV.1.1).

Table IV. 1.1. Consolidated Budget Revenues (TL Trillion)

| | 2002 | 2003 | Increase Rate |
|----------------------------|---------|---------|---------------|
| | Jan-Mar | Jan-Mar | (percent) |
| REVENUES | 15028 | 20364 | 35.5 |
| Tax Revenues | 11696 | 16711 | 42.9 |
| Income Tax | 2685 | 3240 | 20.7 |
| Corporate Tax | 846 | 1338 | 58.3 |
| Motor Vehicles Tax | 302 | 504 | 66.8 |
| Domestic VAT | 2394 | 3245 | 35.5 |
| Special Consumption Tax | - | 4288 | - |
| Petroleum Consumption Tax | 2144 | - | - |
| Bank.& Insuran. Trans. Tax | 275 | 307 | 11.6 |
| VAT on Imports | 1673 | 2547 | 52.2 |
| Non-Tax Revenues | 1534 | 1569 | 2.3 |
| Special Revenues and Funds | 1498 | 1305 | -12.9 |
| Annexed Budget Revenues | 299 | 779 | 160.2 |

Source : Ministry of Finance.

While revenues from special consumption tax, which was put into effect on August 1, 2002, was TL 6 quadrillion in 2002, this figure realized as TL 4.3 quadrillion in the first quarter of 2003. Major portion of this amount was composed of special consumption tax on petroleum and natural gas products. Hence, in the first quarter of the year, special consumption tax on petroleum and natural gas products became about TL 3 quadrillion, while special consumption tax on soft drinks, alcoholic drinks and tobacco products realized as TL 1.1 quadrillion.

During January-March 2003 period, corporation tax, motor vehicles tax and VAT on imports became the tax items that showed a substantial upsurge compared to the rise in tax revenues in the same period of the previous year. Moreover, special consumption tax stood as another significant revenue item that had a favorable effect on the performance of tax revenues.

The share of indirect taxes in tax revenues, which was 67 percent in January-March 2002, increased to 69.5 percent in the same period of 2003.

In January-March 2003 period, the share of indirect taxes in tax revenues realized at 69.5 percent.

In January-March 2003 period, the increase in income tax revenues was lower than that of total tax revenues. Income tax showed a slight increase of 20.7 percent compared to the same period of the previous year. This development mainly stemmed from the limited increase in the withholding tax. In January-March 2003 period, corporate tax rose by 58.3 percent compared to the same period of the previous year mainly due to advance tax.

In January-March 2003 period, non-tax revenues increased by 2.3 percent compared to the same period of the previous year, whereas special revenues and funds fell by 12.9 percent. In March, TL 50 trillion was obtained from the amount of WPI of Tax Justice, which is accounted under non-tax revenues.

IV.2. Expenditures

In January-March 2003 period, expenditures increased by 13 percent compared to the same period of the previous year owing to the decline in domestic debt interest payments (Table IV.2.1). In this period, non-interest expenditures rose by 39 percent compared to the same period of the previous year.

Table IV. 2.1. Consolidated Budget Expenditures (TL Trillion)

| | 2002 | 2003 | Increase Rate (percent) |
|------------------------------------|---------|---------|----------------------------|
| | Jan-Mar | Jan-Mar | |
| EXPENDITURES | 27663 | 31253 | 13.0 |
| NON-INTEREST EXP. | 11123 | 15466 | 39.0 |
| Personnel | 5221 | 7122 | 36.4 |
| Wages | 567 | 642 | 13.1 |
| Other Personnel Expenditures | 4653 | 6481 | 39.3 |
| Other Current | 470 | 558 | 18.9 |
| Investment | 281 | 127 | -54.7 |
| Non-interest Transfer Expenditures | 5152 | 7658 | 48.6 |
| Transfers to SEE's | 483 | 159 | -67.1 |
| Tax Rebates | 698 | 1432 | 105.3 |
| Social Security Institutions | 2861 | 4415 | 54.3 |
| Payments to Retirement Fund | 1365 | 1704 | 24.8 |
| Payments to SSK | 710 | 1432 | 101.7 |
| Payments to Bag-Kur | 713 | 1216 | 70.5 |
| Unemployment Insurance Fund | 73 | 64 | -12.5 |
| Agricultural Support | 545 | 852 | 56.3 |
| Other Transfers | 565 | 799 | 41.4 |
| INTEREST PAYMENTS | 16540 | 15787 | -4.6 |
| Domestic Debt Interest Pay. | 15488 | 14017 | -9.5 |
| Foreign Debt Interest Pay. | 1052 | 1770 | 68.3 |

Source : Ministry of Finance.

During January-March 2003 period, personnel expenditures increased by 36.4 percent, while other current expenditures rose by 18.9 percent. Besides the payment of additional amount in January 2003, stemming from the rise in public servants' salaries made in October 2002, public servants' salaries were increased by 5 percent in January 2003.

Sizable increases realized in non-interest transfers such as tax rebates, transfers to social security institutions and agricultural support expenditures.

Transfers to social security institutions from budget in the first quarter of 2003 amounted to TL 4.4 quadrillion. Major portion of this amount was transferred to Retirement Fund.

In January-March 2003 period, direct revenue support played a significant role in the increase in agricultural support payments. The total amount transferred from budget within this framework became TL 852 trillion.

The increase in tax rebates during January-March 2003 period mainly stemmed from VAT rebates on exports.

IV.3. Consolidated Budget Deficit and Financing

In January-February 2003 period, consolidated budget cash deficit realized as TL 9 quadrillion. In this period, the Treasury was in net borrower position regarding domestic borrowing. Analyzing the structure of domestic borrowing, it is observed that the Treasury was net borrower both in government bonds and Treasury bills. During this period, net borrowing in government bonds amounted to the TL 9.6 quadrillion, while net borrowing in Treasury bills was TL 1.1 quadrillion (Table IV.3.1). Main drivers behind high net domestic borrowing of the Treasury via government bonds were the issuance of long-term government bonds by the Treasury as of January 2003 and excessive demand for these bonds.

Net foreign borrowing was TL 422 trillion during January-February 2003 period.

In January-February 2003, net domestic borrowing realized as TL 10.7 quadrillion.

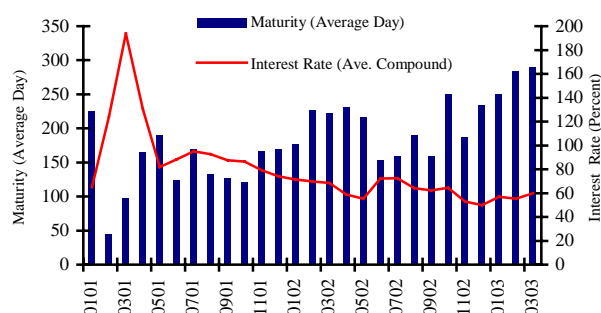
Table IV. 3.1. Consolidated Budget Balance and Financing (TL Trillion)

| | 2002 | 2003 |
|-------------------------|---------|---------|
| | Jan-Feb | Jan-Feb |
| Primary Budget Balance | 2624 | 4261 |
| Budget Balance | -10634 | -6714 |
| Cash Balance | -8707 | -8966 |
| Financing | 8707 | 8966 |
| Net Domestic Borrowing | -5048 | 10655 |
| Government Bonds | -6625 | 9598 |
| Treasury Bills | 1577 | 1057 |
| Guaranteed Debt Returns | 0 | 0 |
| Net Foreign Borrowing | 12123 | 422 |
| Other | 1632 | -2111 |

Source : Treasury.

The average Treasury Auction interest rates, which was 49.8 percent at the end of 2002, re-entered in upward trend in early-2003 and realized at 59.9 percent in March (Figure IV.3.1).

Figure IV.3.1. The Treasury Auction Interest Rates and Maturity Structure



Source: Treasury

IV.4. Domestic Debt Stock

Domestic debt stock, which was TL 149.9 quadrillion by the end of 2002, increased by 8.5 percent and reached TL 162.6 quadrillion in March 2003 (Table IV.4.1). In January 2003, due to the concerns over the timing of Iraqi operation, the Treasury borrowed from the markets considerably higher than its redemption, in order to enhance its reserves. As a result, domestic debt to the markets rose by 5.2 percent and overall domestic debt stock expanded by 3.7 percent in January 2003. In February, while the increase in domestic debt to the markets was 4.2 percent, the overall domestic debt stock

showed a limited increase of 2.6 percent compared to January. In March, domestic debt stock rose by 2 percent compared to February. Primary budget surplus of the first quarter of 2003 contributed to the slowdown in increase of rate of the domestic debt stock (Box IV.1).

Table IV. 4.1. Domestic Debt Stock and Its Structure (Amounts are in TL Quadrillion and Shares are in Percent)

| | 2001 | | 2002 | | 2003* | |
|-----------------|--------|----------------|--------|----------------|--------|----------------|
| | Amount | Share in Total | Amount | Share in Total | Amount | Share in Total |
| CASH | 58.3 | 47.8 | 89.3 | 59.6 | 101.5 | 62.4 |
| Fixed Income | 17.7 | 14.5 | 37.6 | 25.1 | 44.7 | 27.5 |
| Flexible-rate | 11.4 | 9.4 | 17.4 | 11.6 | 19.8 | 12.2 |
| FX Denominated | 7.1 | 5.8 | 16.5 | 11.0 | 19.0 | 11.7 |
| FX Linked | 22.1 | 18.0 | 17.8 | 11.9 | 17.9 | 11.0 |
| IMF Credit | 13.8 | 11.3 | 9.7 | 6.5 | 9.8 | 6.0 |
| Swap/Tap | 7.7 | 6.3 | 7.6 | 5.1 | 7.6 | 4.7 |
| Public Sales | 0.5 | 0.4 | 0.5 | 0.3 | 0.5 | 0.3 |
| NON-CASH | 63.8 | 52.2 | 60.6 | 40.4 | 61.1 | 37.6 |
| Fixed Income | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Flexible-rate | 49.5 | 40.5 | 46.7 | 31.2 | 48.2 | 29.6 |
| Interest Linked | 30.7 | 25.1 | 28.3 | 12.3 | 29.7 | 18.3 |
| CPI-Indexed** | 18.8 | 15.4 | 18.4 | 7.9 | 18.4 | 11.3 |
| FX Denominated | 12.4 | 10.1 | 11.9 | 7.9 | 11.0 | 6.7 |
| FX Linked | 1.9 | 1.6 | 2.0 | 1.3 | 2.0 | 1.2 |
| TOTAL STOCK | 122.2 | 100.0 | 149.9 | 100.0 | 162.6 | 100.0 |
| Fixed Income | 17.7 | 14.5 | 37.6 | 25.1 | 44.7 | 27.5 |
| Flexible-rate | 61.0 | 49.9 | 64.1 | 42.8 | 67.9 | 41.8 |
| Interest Linked | 42.1 | 34.5 | 45.7 | 30.5 | 49.5 | 30.5 |
| CPI-Indexed** | 18.8 | 15.4 | 18.4 | 12.3 | 18.4 | 11.3 |
| FX Denominated | 19.5 | 16.0 | 28.4 | 19.0 | 30.0 | 18.5 |
| FX Linked | 24.0 | 19.6 | 19.8 | 13.2 | 19.9 | 12.2 |

* As of March 2003

** Indicates the CPI-Indexed part of the non-cash securities that take place in the portfolio of the Central Bank.

Source : Treasury

In 2002, the share of public sector in total domestic debt stock declined by 13.2 points compared to 2001 and realized at 52.8 percent. In March 2003, this figure dropped to 51.2 percent, declining by 1.6 points (Table IV.4.2). Due to the fact that there appeared no contingent liability in 2002 other than a medium-scale bank taken over by SDIF, the increase in domestic debt stock held by public sector was rather limited. On the other hand, the share of domestic debt to the markets in overall domestic debt stock increased by 1.6 points compared to the end-2002 and reached 48,8 percent.

During January-March 2003 period, the structure of domestic debt stock changed in terms of borrowing instruments. While the share of fixed income instruments increased, the share of FX-denominated, FX-linked and CPI-indexed instruments declined.

Table IV.4.2. The Distribution of the Domestic Debt Stock According to Buyers (TL Quadrillion)

| | 2000 | Share | 2001 | Share | 2002 | Share | 2003 | Share |
|--------------------|-------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| | Dec. | (Per.Dec.) | Dec. | (Per.) | Dec. | (Per.) | Mar. | (Per.) |
| 1. PUBLIC SECTOR | 12.2 | 33.5 | 80.6 | 66.0 | 79.1 | 52.8 | 83.3 | 51.2 |
| a. CBRT | 1.5 | 4.1 | 32.5 | 26.6 | 28.1 | 18.8 | 28.2 | 17.4 |
| IMF Credit | - | 0.0 | 13.8 | 11.3 | 9.7 | 6.5 | 9.8 | 6.1 |
| Other | 1.5 | 4.1 | 18.7 | 15.3 | 18.4 | 12.3 | 18.4 | 11.3 |
| b. State Banks (*) | 2.9 | 8.0 | 22.7 | 18.6 | 24.3 | 16.2 | 25.7 | 15.8 |
| c. SDIF Banks | 3.9 | 10.7 | 15.1 | 12.4 | 11.0 | 7.4 | 10.1 | 6.2 |
| d. Other Public | 4.0 | 11.0 | 10.2 | 8.3 | 15.7 | 10.5 | 19.2 | 11.8 |
| 2. MARKET | 24.2 | 66.5 | 41.6 | 34.0 | 70.8 | 47.2 | 79.3 | 48.8 |
| TOTAL (1+2) | 36.4 | 100.0 | 122.2 | 100.0 | 149.9 | 100.0 | 162.6 | 100.0 |

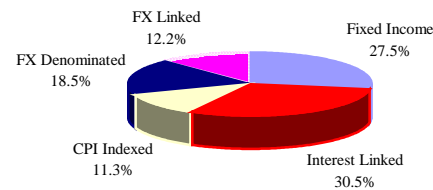
(*) As of end of 2000, unsecured duty loss accruals amounts to TL 15.1 quadrillion.

Source : Treasury

In March 2003, the share of interest-linked government securities in overall domestic debt stock remained unchanged compared to the end of 2002. On the other hand, the share of CPI-indexed government securities decreased to 11.3 percent, dropping by 0.9 point, while the share of FX-denominated and FX-linked government securities fell to 30.5 percent by a drop of 1.5 points. The share of fixed income government securities in total domestic debt stock rose by 2.4 points compared to the end of 2002 and reached 27.5 percent (Figure IV.4.1). Starting from early 2003, concerns over the timing of the Iraqi operation grew. Moreover, a number of additional measures were required in order to ensure the achievement of 6.5 percent target set for the share of total consolidated public sector primary surplus in GDP. However the delay in taking these measures led to uncertainties. This situation led to the extension of the completion process of negotiations with International Monetary Fund (IMF) and caused fluctuations in the financial markets. These unfavorable developments in financial markets led to a rise in interest rates. However, despite the upsurge in interest rates, the demand for long-term Treasury auctions were at higher levels. Non-existence of alternative high interest-yielding investment instruments and the expected decline in interest rates in the following periods were the main reasons behind the high level of demand for long-term government securities.

Delay in preparations for budget and extension of completion process of negotiations with IMF as well as the expectations for a military operation against Iraq led to rise in interest rates in the first months of 2003.

Figure IV.4.1. The Distribution of Domestic Debt Stock as of March 2003 (Percent)



Source : Treasury

While redemption to the markets amounted to TL 69.8 quadrillion in 2002, the borrowing from the markets was TL 70,3 quadrillion. In this context, roll-over ratio realized at 100.8 percent in 2002 (Figure IV.4.2). In 2002, the roll-over ratio of FX-denominated borrowing became 149.9 percent. This situation led to an increase in domestic debt stock in terms of foreign exchange. In January 2003, while the roll-over ratio of borrowing from markets in terms of TL was 83.4 percent, the roll-over ratio of borrowing in terms of foreign exchange realized at a considerably high level. Although the amount of Treasury's FX-denominated redemption was low in January 2003, its excessive borrowing led to an increase in the roll-over ratio of borrowing in terms of foreign exchange. Treasury's high FX-denominated borrowing in January stemmed from its intent to enhance its reserves for domestic debt redemption of the subsequent period. In January 2003, the roll-over ratio of overall borrowing from the markets realized at 100.8 percent. In February 2003, while the roll-over ratio of TL-denominated borrowing from the markets was 112.9 percent, no borrowing was made in terms of foreign exchange despite a limited FX-denominated redemption. In this context, total borrowing from the markets realized at 112.6 percent in February.

In March 2003, the roll-over ratio of borrowing from the market in terms of TL was 86.4 percent, whereas the roll-over ratio of FX-denominated borrowing was 543.7 percent. The roll-over ratio of overall borrowing from the markets in March 2003 realized at 89.6 percent.

Figure IV.4.2. Roll-over Ratio

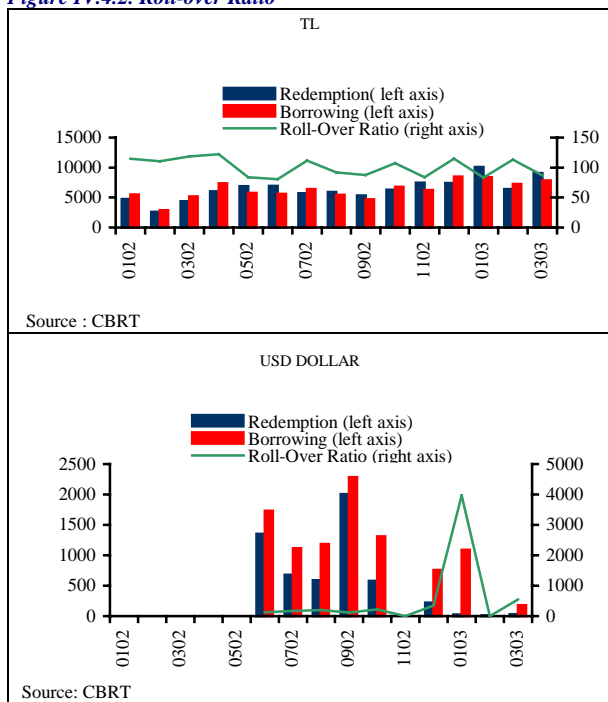
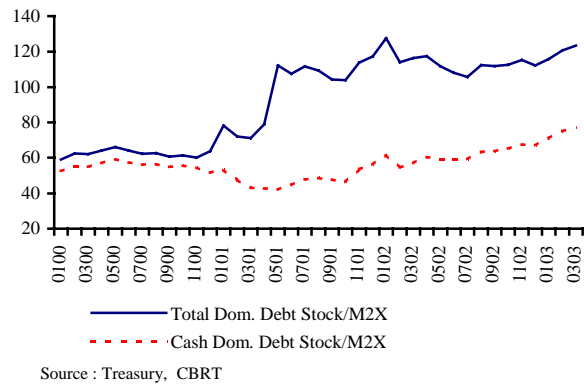


Figure IV.4.3. The Ratio of Domestic Debt Stock to M2X



The ratio of total domestic debt stock to M2X, an indicator of pressure exerted by domestic debt stock on the financial markets increased by around 11.2 points in March 2003 compared to the end of 2002. The ratio of cash domestic debt stock to M2X, another indicator of pressure, rose by 10.2 points due to higher level of total borrowing compared to redemption (Figure IV.4.3). In this context, upsurge in cash domestic debt stock played a significant role in the increase in the ratio of total domestic debt stock to M2X.

BOX IV.1. SENSITIVITY OF DOMESTIC DEBT STOCK TO MACRO VARIABLES

All economic agents in Turkey are monitoring likely course of high net public debt in medium and long-term. The forecast that the ratio of debt stock to national income will diminish and draw closer to a reasonable level in medium term eases the concerns about the sustainability of debt stock. In this context, it is of great importance to figure out the macro variables to which debt stock is sensitive in the medium and long-term.

In economic literature, the main framework of analyses on debt dynamics is mathematically expressed as follows:⁽¹⁾

$$b_t = ((1 + r^e_t) / (1 + g_t)) * b_{t-1} - PS_t \quad (1)$$

b_t refers to the ratio of net domestic debt to GNP, b_{t-1} , the ratio of the previous net domestic debt stock to GNP and r^e_t , real effective interest rate. For calculating real effective interest rate, a method specific to Turkey has been chosen and two factors have been taken into account. The first one is the maturity structure of domestic and foreign borrowing and the other factor is the weighing of real interest rates calculated in terms of TL and USD on basis of the share of the debt denominated in these currency units in total net debt stock. g_t refers to real growth rate for the current period and PS_t , the ratio of consolidated public sector budget surplus to GNP.

As seen in the equation, the future course of the ratio of net debt to national income is basically determined by three main variables, real effective interest rate, real growth rate and consolidated public sector primary budget surplus. Hence, analysis of the effects of these variables on debt stock is of great importance with respect to the future policies to be formulated in order to provide a stable debt structure.

In order to find out the relative sensitivity of debt stock to these variables, consistent projections for these variables in line with medium-term program targets were made and then various alternative scenarios were derived from a base scenario. These scenarios can be summarized as follows:

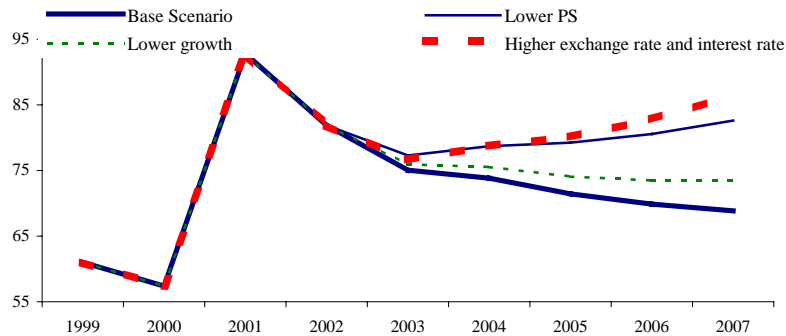
Lower PS: Realization of consolidated public sector primary budget surplus target 2.5 points below the base scenario as of 2003,.

Lower growth: Realization of real growth rate 1 point below the base scenario as of 2003,

High exchange rate and interest rate: The increase of nominal interest rate by 5 points and the increase of foreign exchange rate by 5 percent as of 2003 with respect to the base scenario.

Within the framework of these scenarios, the course of net public debt/GNP ratio in the medium term, which has been calculated by using equation (1) is shown in the following figure.⁽²⁾

Figure 1: Likely Course of Net Public Debt /GNP Ratio in Medium Term



As seen in Figure 1, in the case base scenario realizes, the ratio of debt stock to GNP is expected to decline gradually. It is observed in lower consolidated public sector primary budget surplus scenario and high interest rate and exchange rate scenario that the ratio of net public debt stock to GNP is increasing in the course of time.

In conclusion, this analysis demonstrates that a reasonable course of net domestic debt stock requires the maintenance of fiscal discipline and stability in exchange rates and interest rates. Moreover, when the unfavorable impact of divergence from fiscal discipline, on exchange rate and interest rate through expectations channel is considered, maintenance of fiscal discipline becomes more important.

⁽¹⁾ In the background of this mechanism lies the consideration that the portion of Government's total expenditures, which cannot be met by total tax revenues, are covered via borrowing. In other words, it is assumed that the amount of interest payments that cannot be met by primary budget surplus, will be covered by borrowing, thus leading to the accumulation of debt stock.

⁽²⁾ The point which should not be overlooked here is that equation (1) is based on partial equilibrium analyses and in this equation, dynamic interaction between variables has not been taken into account.

V. DEMAND AND PRODUCTION

Turkish economy re-entered in 2002 following the contraction suffered in 2001 due to crises in financial markets. In the last three months of 2002, GDP and GNP increased 11.4 percent and 11.5 percent compared to the same period of the previous year, respectively. Hence, GDP and GNP rose by 7.8 percent in 2002 compared to the previous year. The base effect of severe contraction in 2001 played an important role in rapid growth of economy as well.

Table V.1.1. Main Expenditure Groups (Annual % Change)

| | 2001 | | | | | 2002 |
|----------------------------------|--------|-------|-------|-------|-------|--------|
| | Annual | I | II | III | IV | Annual |
| Total Consumption Exp. | -9.1 | -1.5 | 3.1 | 3.4 | 4.3 | 2.4 |
| Private Consumption Exp. | -9.2 | -1.8 | 3.2 | 2.5 | 4.2 | 2.0 |
| Public Consumption Exp. | -8.5 | 2.2 | 2.6 | 12.0 | 4.5 | 5.4 |
| Gross Fixed Capital Formation | -31.5 | -28.8 | -2.3 | 5.9 | 22.2 | -0.8 |
| Public Fixed Capital Investment | -22.0 | -18.1 | 3.0 | 29.8 | 22.7 | 14.5 |
| Private Fixed Capital Investment | -34.9 | -30.9 | -4.2 | -3.7 | 21.8 | -7.2 |
| Machinery-Equipment | -49.6 | -40.8 | 6.8 | 15.2 | 71.0 | 1.4 |
| Construction | -8.0 | -15.1 | -16.7 | -16.3 | -14.7 | -15.8 |
| Total Investment Expenditures | -42.0 | 0.8 | 59.5 | 27.9 | 57.7 | 35.7 |
| Total Domestic Demand | -18.5 | -1.0 | 14.9 | 8.2 | 14.7 | 9.2 |
| Total Final Domestic Demand | -15.1 | -7.5 | 1.9 | 3.9 | 8.1 | 1.7 |
| Exports of Goods & Services | 7.4 | 10.4 | 5.0 | 15.8 | 12.3 | 11.0 |
| Imports of Goods & Services | -24.8 | 2.1 | 20.3 | 19.3 | 22.1 | 15.7 |
| GDP | -7.5 | 2.1 | 8.9 | 7.9 | 11.4 | 7.8 |

Source: SIS

The current program has restored confidence in financial markets. Easing of concerns over the sustainability of domestic debt contributed to the increase of confidence to the economy. Accordingly, interest rates dropped in 2002 compared to the previous period, Turkish lira strengthened and private firms started to utilize foreign

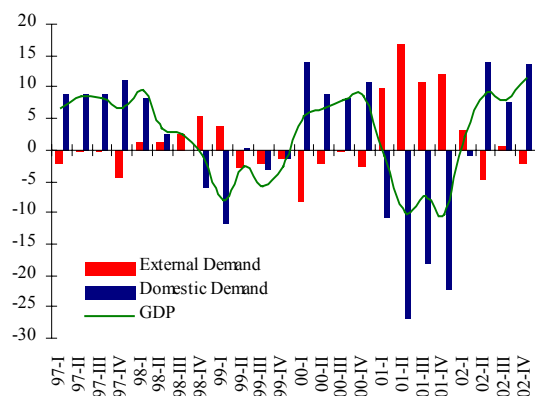
financial resources with longer maturity and under better conditions. Thanks to these favorable developments, economic agents' optimistic expectations increased rapidly and the Turkish economy entered in growth process earlier than expected.

Moreover, establishment of a single-party government after the elections held in November ensured the alleviation of political uncertainties and thus reinforcement of confidence to the economy. In this respect, the decline in interest rates accelerated and Turkish lira appreciated against foreign currencies in the last quarter of 2002. These favorable developments in financial markets contributed to the stimulation of domestic demand and total final domestic demand grew by 8.1 percent in the last quarter of the year. Hence, the growth in the economy continued in the last quarter of 2002.

V.1. Demand Developments

Despite the high rate of growth in Turkish economy in 2002, adverse developments emerged in labor market after crisis persisted progressively. Unemployment rate, which declined to 6.6 percent in 2000, rose to 10.6 percent in 2002. Besides, real wages, mainly in private manufacturing industry, continued its downward trend in 2002 as well. This situation led to a persistent low level of demand in 2002.

Figure V.1.1. The Contributions of Demand Components to GDP Growth (Percentage Points)



Source: SIS, CBRT

In 2002, total final domestic demand showed a slight increase of 1.7 percent compared to the previous year. Low level of domestic demand prevented the inflationary pressure on consumer prices. On the other hand, despite low level of domestic demand, rapid increases in exports led to substantial increases in industrial production.

When the economic growth is analyzed in terms of demand components, it is seen that stock change is the demand component that made the highest contribution to growth in 2002. While the role of private expenditures was rather limited, high increases in public expenditures as of the third quarter of the 2002 following the decision for elections contributed to the economic growth in the second half of the year. On the other hand, net exports component had a negative impact on growth due to rapid increase in imports and the decline in other invisible revenues in 2002 (Table V.1.2).

Table V.1.2. Contributions of Demand Components to GDP Growth (Percentage Points)

| | 2001 | | 2002 | | | |
|---------------------|--------|------|------|-----|------|--------|
| | Annual | I | II | III | IV | Annual |
| Private Expenditure | -13.4 | -7.2 | 1.4 | 1.2 | 4.9 | 0.3 |
| Public Expenditure | -2.3 | -0.5 | 0.4 | 2.3 | 2.7 | 1.3 |
| Net Exports | 12.3 | 3.1 | -5.0 | 0.5 | -2.2 | -0.9 |
| Stock Changes | -4.0 | 6.7 | 12.2 | 3.9 | 6.0 | 7.0 |
| GDP | -7.5 | 2.1 | 8.9 | 7.9 | 11.4 | 7.8 |

Source: SIS, CBRT

The contribution of stock change to GDP realized at 6.0 points in the last quarter of 2002 and 7.0 points in overall year. Moreover, the contribution of stock change to growth was minus 4 points in 2001. It is considered that private firms renewed their finished goods and raw material stocks in 2002, which shrank due to the contraction suffered in 2001. It is considered that the increase in optimistic expectations for demand, the decline in interest rates compared to the previous year and the upsurge in import due to the appreciation of Turkish lira against foreign currencies especially in the second and last quarters of the year played an important role in increase in private firms' stock accumulations.

Annualized data reveal that there was a limited recovery in domestic demand and domestic demand realized at a lower level compared to the previous years. Unfavorable developments in labor market are considered to be an important factor that restrict the recovery in domestic demand factor (Figure V.1.2).

Figure V.1.2. Annualized GDP and Total Final Domestic Demand (1987 Prices, Billion TL)

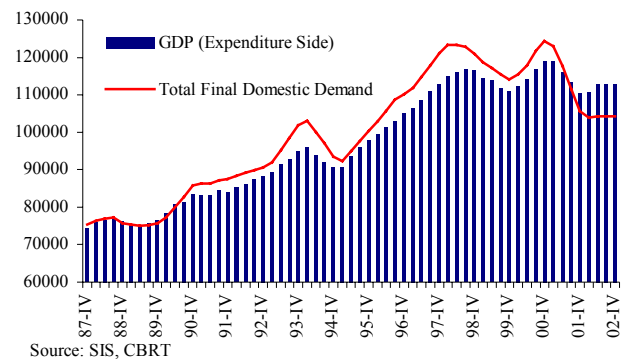


Table V.1.3. Private Consumption Expenditures (Annual % Change)

| | 2001 | | 2002 | | | |
|----------------------------|--------|------|------|------|------|--------|
| | Annual | I | II | III | IV | Annual |
| PRIVATE CONSUMPTION | -9.2 | -1.8 | 3.2 | 2.5 | 4.2 | 2.0 |
| Food | -3.6 | -1.0 | -0.5 | 2.8 | 1.5 | 0.9 |
| Durable Goods | -30.4 | -7.0 | 8.7 | 1.8 | 6.2 | 2.1 |
| Semi-durable & Non-durable | -9.0 | -1.9 | 4.4 | 1.7 | 10.8 | 3.1 |
| Energy-Transpor.-Communi. | 0.9 | -2.6 | 1.8 | -1.9 | -0.1 | -0.7 |
| Services | -9.3 | 2.4 | 11.1 | 9.1 | 10.9 | 8.7 |
| Ownership of Dwelling | 2.1 | 2.0 | 1.9 | 1.7 | 1.4 | 1.8 |

Source: SIS

On the other hand, recovery process in special consumption expenditures continued in the last quarter of 2002 as well. In the last quarter of 2002, private consumption expenditures rose by 4.2 percent compared to the same period of the previous year and by 2.0 percent in overall year. However, in 2001, private consumption expenditures had declined by 9.1 percent compared to the previous year. The limited increase in private consumption expenditures in 2002 indicates that domestic demand stood at a low level (Table V.1.3).

Table V.1.4. Public Expenditures (Annual % Change)

| | 2001 | | 2002 | | | | Annual |
|----------------------------|--------|-------|-------|------|------|------|--------|
| | Annual | I | II | III | IV | | |
| Total Public Expenditures | -14.7 | -4.8 | 2.8 | 19.8 | 12.6 | 9.2 | |
| Public Consumption | -8.5 | 2.2 | 2.6 | 12.0 | 4.5 | 5.4 | |
| Compens. of Employees | 1.6 | 1.9 | 0.2 | 0.2 | 0.6 | 0.7 | |
| Purch. of Goods & Services | -18.0 | 3.0 | 5.7 | 27.9 | 7.1 | 10.8 | |
| Public Fixed Capital Inv. | -22.0 | -18.1 | 3.0 | 29.8 | 22.7 | 14.5 | |
| Machinery-Equipment | -39.0 | -19.3 | 10.8 | 71.2 | 52.8 | 29.3 | |
| Building Construction | -20.0 | -17.8 | 27.1 | 34.1 | 25.2 | 23.9 | |
| Other Construction | -10.3 | -16.8 | -13.0 | 12.7 | 6.5 | 1.1 | |

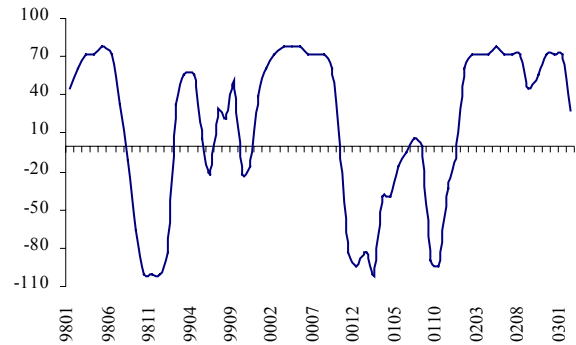
Source: SIS

In the last quarter of 2002, private investment expenditures rose by 21.8 percent compared to the same period of the previous year due to the high increase in machinery-equipment investments. In this period, machinery-equipment investments increased by 71 percent. However, private investment expenditures decreased by 7.2 percent in 2002 compared to the previous year because of the persistence of rapid decline construction investments.

In the last quarter of 2002, public consumption expenditures grew by 4.5 percent compared to the previous year. While salary and wages item, which is accounted under public consumption expenditures showed a slight increase of 0.6 percent in the last quarter of 2002 compared to the same period of the previous year, purchases of goods and services rose by 7.1 percent. In 2002, public consumption expenditures increased by 5.4 percent compared to the previous year, thus contributing to the recovery in demand (Table V.1.4).

In the last quarter of 2002, goods and services exports boosted by 12.3 percent compared to the same period of the previous year. The increase in goods exports stemmed from the fact that private firms directed their production toward foreign markets because of the inadequate domestic demand. The increase of goods and services exports in 2002 contributed to the growth of the economy.

Figure V.1.3. Expectations Index for Demand and Production (Private Industry Sector, Next Three-Months Period)



Source: CBRT Business Tendency Survey

Recovery in domestic demand and high increase in industrial production led to a rapid rise in imports in the last quarter of the year. While goods and services imports boosted by 22.1 percent in the last quarter of 2002 compared to the same period of the previous year, the increase in overall year was 15.7 percent.

Expectations Index compiled by the aggregation of quarterly expectations of Business Tendency Survey maintained its progress in the last quarter of 2002 as well. However, Expectations Index dropped significantly in the first quarter of 2003 due to the fluctuations in financial markets and the tense atmosphere created by Iraq war (Figure V.1.3).

V.1.1. Production Developments

High performance observed in the production sectors provided the rapid growth of the economy in 2002. In this period, agriculture sector value added significantly rose especially due to the cyclical increase in the production of some products and the base effect. Industrial sector value added increased at a high rate as of the second quarter of 2002. The growth in the industrial sector value added stemmed from the limited recovery in domestic demand as well as the upsurge in exports due to the fact that private firms directed their production toward foreign markets. Rapid increase in industrial production and accordingly in imports led to a rise in the import tax item. Moreover, sharp increases in

agriculture and industrial sectors value added had a favorable effect on services sector, mainly on trade, transportation and business and personal services.

In 2002, agriculture sector value added rose by 7.1 percent compared to the previous year (Table V.I.5). The high rate of increase in fruits and other farm products played a significant role in this upsurge. As a result of the base effect created by contraction in 2001 as well as the cyclical increases in production of some products such as olive and hazelnut, agriculture sector value added displayed a high increase of 15.3 percent in the last quarter of 2003. The increase in agriculture sector value added is expected to continue, albeit slower, in the first quarter of 2003. Moreover, due to the cyclical decline in the production in odd years, agriculture sector value added is forecasted to decrease in 2003 compared to the previous year.

Table V.I.5. GNP and Value Added by Sectors (Annual % Change)

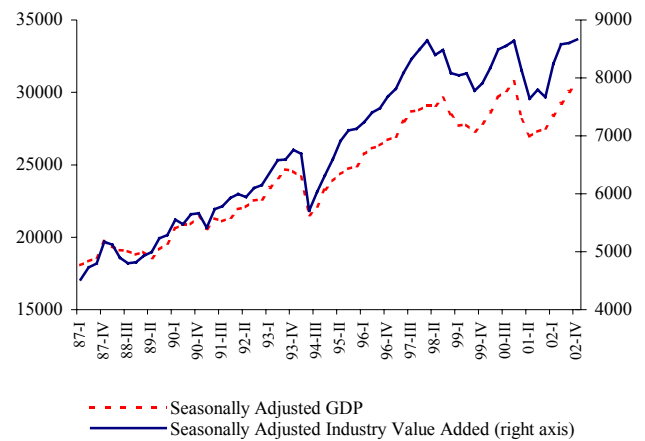
| | 2001 | | 2002 | | | | Annual |
|--------------------------------|--------|-------|------|------|------|------|--------|
| | Annual | I | II | III | IV | | |
| AGRICULTURE | -6.5 | 0.1 | 2.7 | 6.1 | 15.3 | 7.1 | |
| TOTAL INDUSTRY | -7.5 | 2.8 | 12.6 | 10.5 | 11.4 | 9.4 | |
| Manufacturing Industry | -8.1 | 2.3 | 13.7 | 11.8 | 13.5 | 10.4 | |
| SERVICES | -5.9 | 1.7 | 6.4 | 6.0 | 8.7 | 5.8 | |
| Construction | -5.5 | -11.8 | -9.6 | -3.3 | 2.7 | -4.9 | |
| Trade | -9.4 | 4.3 | 11.7 | 10.1 | 16.1 | 10.7 | |
| Wholesale and Retail | -12.8 | 3.4 | 15.5 | 12.7 | 18.7 | 12.8 | |
| Hotel & Restaurant Ser. | 9.9 | 9.7 | -5.1 | 0.0 | 3.9 | 1.1 | |
| Transportation - Communication | -5.3 | 2.1 | 8.3 | 5.4 | 5.6 | 5.4 | |
| Financial Institutions | -9.9 | -7.4 | -9.6 | -3.2 | -8.2 | -7.1 | |
| Ownership of Dwelling | 2.1 | 2.0 | 1.9 | 1.7 | 1.4 | 1.8 | |
| Business & Pers. Ser. | -7.6 | 1.7 | 8.7 | 7.6 | 10.7 | 7.4 | |
| Government Services | 1.6 | 1.9 | 0.2 | 0.2 | 0.6 | 0.7 | |
| IMPORT TAX | -25.1 | 4.0 | 27.7 | 28.9 | 33.9 | 23.0 | |
| GDP | -7.5 | 2.1 | 8.9 | 7.9 | 11.4 | 7.8 | |
| GNP | -9.5 | 0.4 | 10.4 | 7.9 | 11.5 | 7.8 | |

Source: SIS

In 2002, industrial sector value added rose by 9.4 percent compared to the previous year (Table V.I.5). When seasonally adjusted data are analyzed, it is seen that industrial sector value added and GDP increased in quarterly periods in 2002 (Figure V.1.4). Favorable

performance of exports under the limited domestic demand conditions became effective in the high-rated increase of industrial sector value added. In addition to the favorable developments in the exports markets, revival in domestic demand observed in the last quarter of 2002 contributed to the high increase of 11.4 percent in the industrial sector value added during this period, compared to the same period of the previous year. The upsurge in industrial production in 2002 led to an increase in imports as well. In this context, intermediary and capital goods imports, which have a large share in total imports, rose by 22.6 percent in 2002 compared to the previous year.

Figure V.1.4. Seasonally Adjusted GDP and Industry Sector Value Added



Source: SIS, CBRT

The slight recovery in domestic demand also played an important role in economic growth and the increase in industrial production. Thanks to the removal of political uncertainties as a result of early elections held in the last quarter of 2002, decline in interest rates and appreciation of Turkish lira against foreign currencies improved optimistic expectations of all economic agents, mainly private firms. Confidence atmosphere that appeared with respect to the course of the economy allowed partial realization of postponed consumption expenditures of households.

In 2002, industrial sector value added rose by 9.4 percent compared to the previous year.

In 2002, services sector value added increased by 5.8 percent compared to the previous year (Table V.1.5). During this period, among all services sectors, the highest growth rate was observed in trade and business and personal services sectors. Favorable developments in industry and imports had a positive effect on wholesale and retail trade value added. Beside the trade sector, transportation-communication sector was affected favorably by the vigour in exports as well. Moreover, revival in agriculture and industrial sectors became effective in the increase in services sector value added. However, rate of increase in the services sector value added remained below the growth rate of the agriculture and industrial sectors value added. This development mainly stemmed from the significant regression in construction and financial institutions sectors value added.

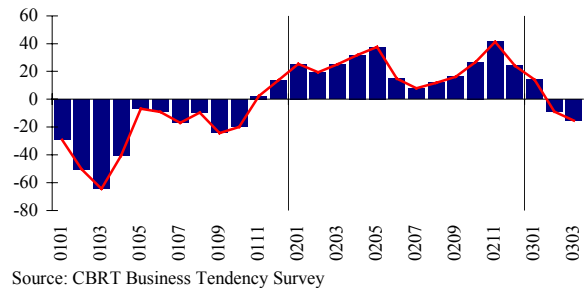
According to the data announced by SIS, the area of buildings, which were granted construction permits, recorded a high drop of 42.6 percent in 2002 compared to the previous year. On the other hand, the increase of construction sector value added by 2.7 percent in this period, which was in a persistent downward trend until the last quarter of 2002, proves that construction sector is overcoming the crisis it has been suffering since the earthquake of August 1999. Decline in real interest rates with the maintenance of stability will allow for the drop of opportunity costs and the revival of construction sector.

Despite favorable developments in the last quarter of 2002 and January 2003, political and economic uncertainties created by Iraqi operation led to an increase in volatility in financial markets and deterioration in optimistic expectations of private firms for demand and production.

The business sentiment, which reflects the expectations of private firms in industrial sector on the course of economy, reached at its highest level of the last three years after the elections held in November 2002. However, optimistic expectations of private firms deteriorated due to Iraqi operation and the increase in uncertainties about economic policies. In February

2003, business sentiment regressed sharply and changed in favor of pessimistic expectations for the first time after October 2001 and maintained this trend more severely in March 2003 as well (Figure V.1.5). Along with the Iraq war, delay in 2003 Budget and extension of negotiations with the International Monetary Fund became effective in deterioration of optimistic expectations.

Figure V.1.5. Business Sentiment in Business Tendency Survey



In January-February 2003 period, industrial production grew by 9.2 percent compared to the same period of the previous year (Table V.I.6). Excluding petroleum products, the increase in industrial production rose to 11 percent in the same period. In January-March 2003 period, manufacturing industry average capacity utilization rate increased by 1.5 points compared to the same period of the previous year and reached 74.9 percent. Rapid growth observed in industrial production in January 2003 slowed down in February. Moreover, March results of SIS Manufacturing Industry Monthly Tendency Survey reveal that slight rates of increase are expected by the firms for manufacturing industry production in March and April. Therefore, it is predicted that the growth rate of industrial sector value added will slacken in the first quarter of the year.

Table V.1.6. Industrial Production (Annual % Change)

| | Şubat | | Ocak-Şubat | |
|-------------------------------------|-------|-------|------------|-------|
| | 2002 | 2003 | 2002 | 2003 |
| Total Industry | -4.6 | 4.4 | -3.3 | 9.2 |
| Mining | -0.4 | -22.4 | -4.4 | -16.0 |
| Manufacturing | -4.9 | 5.0 | -3.6 | 10.9 |
| Energy | -5.4 | 11.9 | -0.6 | 7.0 |
| Non-petroleum Industrial Production | -7.2 | 4.7 | -7.0 | 11.0 |

Source: SIS Monthly Industrial Production Index

The growth process in the economy is expected to continue in 2003 as well. However, a limited increase is expected for industrial sector value added due to the low level of domestic demand and likely negative impact of ongoing global stagnation on exports. Moreover, high rate of economic growth in 2002 is considered as a factor that will lead to a slow down in the growth rate in 2003.

V.2. Development in Labor Market

According to the SIS Survey of Household Labor Force (HLF), labor force increased by 1.9 percent in 2002 compared to the previous year and reached 22,699 thousand people. On the other hand, employment rate declined by 0.4 percent compared to the previous year and decreased to 20,287 thousand people. Total employment rose in urban areas, while decreased in rural areas compared to the previous year. In 2002, 54.6 percent of total employment realized in urban areas, whereas 45.4 in rural areas. Hence, the unemployment rate, which was 8.5 percent in 2001, reached 10.6 percent in 2002.

The number of unemployed people rose by 510 thousand people compared to the previous year and reached 2,412 thousand people (Table V.2.1). In 2002, 20.4 percent of unemployed people in Turkey are those who lost their jobs and 20.9 percent are those who are seeking job for the first time. The prevailing rise in number of unemployed despite the recovery in the economy leads to a decrease in household income and extension of unemployment duration after 2001 crisis.

Table V.2.1. Labor Force and Employment

| | 2001 | 2002 | | | | Mid-Year |
|-------------------------------|----------|--------|--------|--------|--------|----------|
| | Mid-Year | Q1 | Q2 | Q3 | Q4 | |
| Labor Force | 22,269 | 20,929 | 23,086 | 24,064 | 23,220 | 22,699 |
| Employment | 20,367 | 18,467 | 20,869 | 21,691 | 20,584 | 20,287 |
| Urban (%) | 53.8 | 57.2 | 53.9 | 53.1 | 54.6 | 54.6 |
| Rural (%) | 46.2 | 42.8 | 46.1 | 46.9 | 45.4 | 45.4 |
| Num. of Unemployed | 1,902 | 2,462 | 2,217 | 2,373 | 2,636 | 2,412 |
| Unemployment Rate | 8.5 | 11.8 | 9.6 | 9.9 | 11.4 | 10.6 |
| Urban (%) | 11.5 | 14.7 | 13.5 | 14.0 | 14.9 | 14.3 |
| Rural (%) | 4.8 | 7.5 | 4.5 | 4.6 | 6.6 | 5.8 |
| Educ. Young Peop. Unemp. Rate | 25.8 | 29.4 | 27.2 | 31.1 | 30.0 | 29.4 |
| Underempl./ L.Force (%) | 6.0 | 5.9 | 5.8 | 5.0 | 5.1 | 5.4 |
| Inactive Labor Force (%) | 14.5 | 17.7 | 15.4 | 14.8 | 16.4 | 16.0 |

Source: SIS Household Labor Force Survey

The unemployment rate in urban areas became 14.3 percent in 2002, increasing by 2.8 points compared to the previous year. Moreover, non-agricultural employment rose by 3 percent (392 thousand people) in 2002 compared to the previous year. Despite the high rate of growth in Turkish economy in 2002, unfavorable developments can still be observed in the labor market following the crisis persisted. Besides, these unfavorable developments are considered as a factor that restricted the revival in domestic demand throughout 2002. The employment rate is expected to increase with the continuation of growth process in the coming periods.

Unemployment rate, which was 8.5 percent in 2001, reached 10.6 percent in 2002.

The unemployment rate of educated young people reached a very high level of 29.4 percent in 2002, increasing by 3.6 points. This rate realized as 31.2 percent in urban areas.

The rate of underemployed people, which is defined as people who are looking for another job though they already have a job and who are suitable to work additional hours in their current job or in another job was 5.4 percent in 2002. Thus, the rate of inactive labor force, the sum of underemployed and unemployed rate, rose by 1.5 points compared to the previous year and reached 16 percent.

Distribution of employment by sectors reveals that in 2002, the share of agricultural sector in overall employment was 33.2 percent. During the same period, the shares of industrial and services sectors were 19.2 percent and 43 percent, respectively (Table V.2.2). With the economic recovery in 2002, non-agricultural employment boosted both in urban and rural areas compared to the previous year. The increase in non-agricultural employment in urban areas mainly stemmed from services sector. Along with the economic growth in the economy in 2002, recovery in trade sector had a favorable effect on services sector employment.

Table V.2.2. Employment by Sectors

| | 2001 | | 2002 | | | |
|----------------------|----------|--------|--------|--------|--------|----------|
| | Mid-Year | Q1 | Q2 | Q3 | Q4 | Mid-Year |
| TOTAL | 20,367 | 18,467 | 20,869 | 21,691 | 20,584 | 20,287 |
| Agriculture | 7,217 | 5,624 | 7,219 | 7,908 | 6,902 | 6,745 |
| Industry | 3,734 | 3,658 | 3,907 | 3,944 | 3,896 | 3,888 |
| Services | 8,343 | 8,414 | 8,761 | 8,760 | 8,902 | 8,723 |
| Construction | 1,073 | 771 | 982 | 1,079 | 883 | 931 |
| Urban Employ. | 10,953 | 10,557 | 11,256 | 11,512 | 11,243 | 11,079 |
| Rural Employ. | 9,414 | 7,911 | 9,613 | 10,179 | 9,341 | 9,208 |

Source: SIS Household Labor Force Survey

In 2002, around 50.9 percent of total employment in Turkey was comprised of waged and daily-waged workers (Table V.2.3). In the same period, the shares of self-employed and unpaid family workers realized as 29.2 percent and 19.9 percent, respectively.

Table V.2.3. Employment by Economic Activity

| | 2001 | | 2002 | | | |
|--------------------------------|----------|--------|--------|--------|--------|----------|
| | Mid-Year | Q1 | Q2 | Q3 | Q4 | Mid-Year |
| Total | 20,367 | 18,467 | 20,869 | 21,691 | 20,584 | 20,287 |
| Workers Getting Salaries | 9,908 | 9,621 | 10,364 | 10,648 | 10,675 | 10,335 |
| Self-employed | 6,142 | 5,608 | 6,086 | 6,111 | 5,947 | 5,924 |
| Unpaid Family Worker | 4,318 | 3,238 | 4,418 | 4,932 | 3,962 | 4,028 |
| Percentage Distribution | | | | | | |
| Workers Getting Salaries | 48.6 | 52.1 | 49.7 | 49.1 | 51.9 | 50.9 |
| Self-employed | 30.2 | 30.4 | 29.2 | 28.2 | 28.9 | 29.2 |
| Unpaid Family Worker | 21.2 | 17.5 | 21.2 | 22.7 | 19.2 | 19.9 |

Source: SIS Household Labor Force Survey

In 2002, manufacturing industry employment index rose by 0.5 percent compared to the previous year. While public sector employment index dropped by 9.3 percent, private sector employment index rose by 2.3 percent (Table V.2.4). Manufacturing industry employment index displayed a private sector-originated increase in 2002. According to SIS Quarterly Industrial Production Index, while private manufacturing industry production recorded a high rate of increase by 12.3 percent in 2002, public sector production rose by 4.7 percent compared to the previous year. This points out that the increase in private manufacturing industry production contributed to the rise in employment.

Table V.2.4. Developments in Manufacturing Employment, Wages and Productivity (Annual Percentage Change)

| | 2001 | 2002 | | | | Annual |
|-----------------------------|--------|-------|-------|------|------|--------|
| | Annual | Q1 | Q2 | Q3 | Q4 | |
| Employment ⁽¹⁾ | -8.3 | -6.9 | 0.1 | 3.4 | 5.8 | 0.5 |
| Public | -6.5 | -11.4 | -12.0 | -8.0 | -5.9 | -9.3 |
| Private | -8.6 | -6.1 | 2.3 | 5.5 | 7.8 | 2.3 |
| Wage ⁽²⁾ | -14.6 | -15.9 | -4.2 | -2.7 | -0.5 | -5.5 |
| Public | -12.5 | -12.6 | 5.9 | 4.1 | 6.7 | 1.4 |
| Private | -15.2 | -15.1 | -3.2 | -1.1 | 1.1 | -4.2 |
| Productivity ⁽³⁾ | 1.0 | 10.2 | 10.3 | 7.3 | 6.5 | 8.6 |
| Public | 7.8 | 15.7 | 22.4 | 20.9 | 9.0 | 16.7 |
| Private | -0.6 | 9.5 | 8.9 | 5.3 | 7.5 | 7.7 |

(1) SIS, Index for Production Workers in the Manufacturing Industry, 1997=100

(2) SIS, Quarterly Index for Real Wages per Production Hours Worked, 1997=100

(3) SIS, Quarterly Index for Partial Productivity per Production Hours Worked, 1997=100

In 2002, the decline in real wages decreasingly continued compared to the previous year. High rate of reduction in real wages per hour observed in the first quarter of the year continued relatively slower in line with the economic recovery until the end of the year and declined by 5.5 percent in 2002 compared to the previous year. Real wages in private sector displayed a downward trend throughout the year, except the first quarter of the year, while increased in the public sector. It is expected that the private sector employment will continue to rise and real wages will increase in 2003 due to the ongoing economic growth. This will have a favorable effect on recovery in domestic demand and economic growth.

In 2002, real wages per hour in the private manufacturing industry decreased, while increased in public sector.

When productivity developments in manufacturing industry are analyzed, it is observed that productivity per working hour improved significantly both in public and private sectors in 2002 compared to the previous year. This development stemmed from the fact that while there was a slight increase in number of working hours compared to the previous year, the production in the manufacturing industry displayed a rapid rise in 2002.

VI. BALANCE OF PAYMENTS

VI.1. Developments in Foreign Trade

In January-December period of the year 2002 exports increased by 12 percent reaching US \$35.1 billion from US \$31.3 billion according to the previous year. Imports during the same period increased by 22.8 percent and reached US \$50.8 billion from US \$41.4 billion. Consequently, foreign trade deficit expanded by 56.5 percent reaching US \$15.8 billion, thus, exports to imports dropped to 69 percent.

Grow rate of exports, which were at an accelerating trend since July, showed a swift rise in the third quarter of the year as to the same period of the previous year and reached 18.9 percent. However, in the last quarter of the year, especially in November and December, with the relative slowdown impact, the growth rate of exports was 13.6 percent.

Table VI.1.1. Foreign Trade (USD million)

| | December | | | January-December | | |
|--------------------|----------|------|----------------|------------------|-------|----------------|
| | 2001 | 2002 | Percent Change | 2001 | 2002 | Percent Change |
| EXPORTS | 2660 | 2815 | 5.8 | 31334 | 35081 | 12.0 |
| Agriculture | 177 | 177 | 0.1 | 2234 | 1999 | -10.5 |
| Fishing | 4 | 4 | 16.2 | 30 | 44 | 46.4 |
| Mining | 22 | 16 | -28.1 | 349 | 348 | -0.4 |
| Manufacturing | 2454 | 2615 | 6.6 | 28695 | 32656 | 13.8 |
| Other | 4 | 2 | -37.7 | 26 | 34 | 30.7 |
| IMPORTS | 3441 | 5067 | 47.3 | 41399 | 50832 | 22.8 |
| Consumption goods | 351 | 504 | 43.4 | 4084 | 4979 | 21.9 |
| Capital goods | 700 | 1132 | 61.6 | 6964 | 8382 | 20.4 |
| Intermediate goods | 2339 | 3378 | 44.4 | 29971 | 36903 | 23.1 |
| Crude oil | 242 | 362 | 49.4 | 3878 | 4088 | 5.4 |
| Other | 50 | 54 | 7.4 | 380 | 567 | 49.3 |

Source: SIS

The insufficient revival of import acceleration in OECD countries, which have a significant amount of share in total exports of Turkey and the appreciation of the Turkish lira during the August-December 2002 period were a restrictive factor on exports. However, the said restricted factors were compensated through efficient access to international markets as a result of restricted domestic demand and appreciation of the euro against the

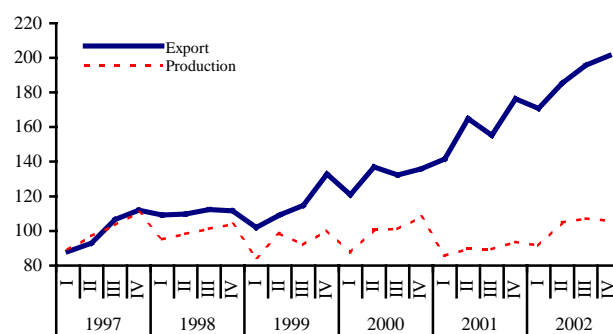
US dollar since March. In 2002 the increase in exports to countries less affected by the global recession such as England and Russia is a significant indicator of exports sectors' operating under flexible and efficient circumstances in international markets.

Real wages of employees per hour at domestic private manufacturing industry generally diminished in 2002 and at the same time the increase in productivity per hour supported the firm's competitive power abroad.

The euro/dollar rate, which increased in March, followed a flat course during the August-October period and had an accelerating tendency in the last quarter of the year. As a result US dollar equivalent of euro denominated exports has increased.

In spite of the high increasing rate of the industrial products, private consumption expenditures considered as an important indicator of domestic demand, has increased in the last quarter of the year 2002 by 4.2 percent and 2 percent for the whole year. The limited increase in the private consumption expenditures is believed to lead the producers to international markets

Figure VI.1.1. Manufacturing Export Volume and Production Indices (1997=100)



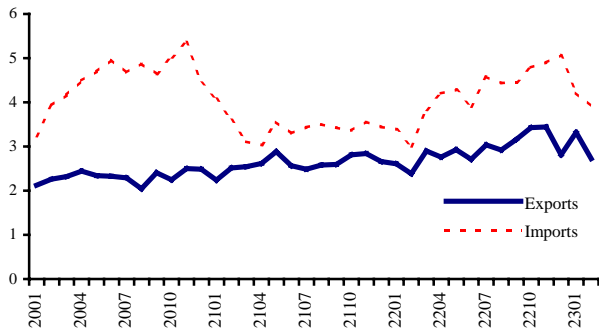
Source: SIS

Growth rate of agriculture and forestry sector exports calculated according to the three-month moving averages, which had been deteriorating since September 2001, has increased in the last quarter of 2002 in line with the increase in agricultural production.

In 2002, exports of manufactured industrial products constituting 93.1 percent of total exports and having an increasing tendency since the second half of the year, continued to soar in the last quarter of the year.

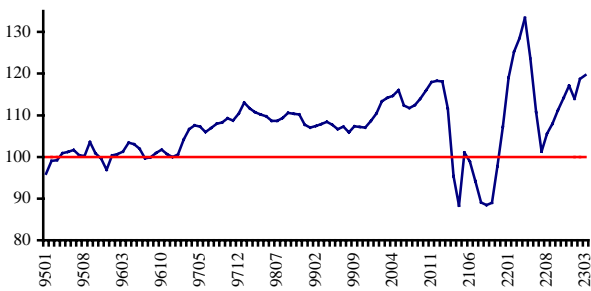
Clothing, vehicles, electrical machines and appliances, machines and mechanical appliances were the highest contributing items to export growth in January-December period of 2002. In 2002 exports of iron and steel products increased by 26.5 percent while in December dropped by 41.5 percent.

Figure VII.2. Monthly Exports and Imports (USD Billion)



Source: SIS

Figure VI.1.3. Real Effective Exchange Rate (1995=100)



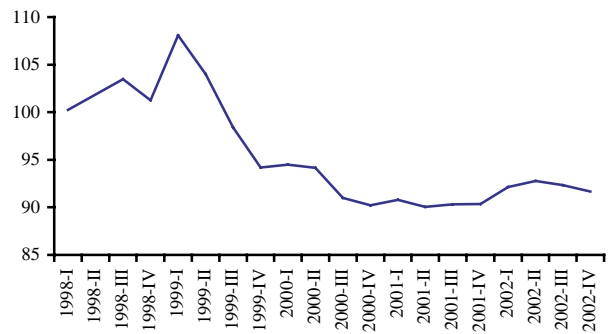
WPI based real effective exchange rates calculated by using IMF weights based on the trade flows of 17 countries from 1988-1990. An increase in index denotes an appreciation of Turkish lira.

Source: CBRT.

Export prices, which have been in a rising trend since October, increased by 2 percent in the last quarter of 2002 as to the third quarter. During the same period export prices of agricultural and forestry together with manufacturing industry sectors increased by 5.4 and 1.7 percent, respectively.

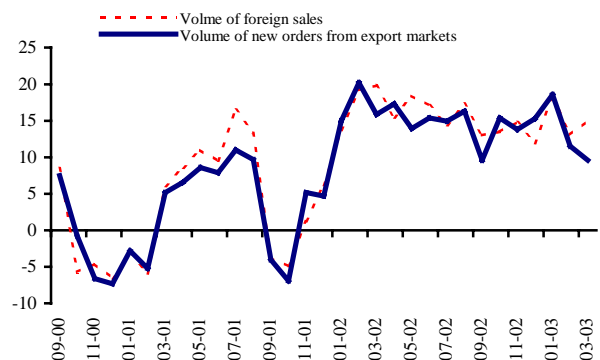
According to the results of the March 2003 CBRT Business Tendency Survey, in 2002 while export opportunity expectations were in favor of the optimists, in February and March 2003 it has turned in favor of the pessimists. According to the survey in February and March there has been a drop in export orders. In line with this the tendency of orders from the export markets for the following three months strikes a significant drop as well.

Figure VI.1.4. Terms of Trade (Export Prices/Import Prices)



Source: SIS

Figure VI.1.5. Export Expectations for the Next Three Months (Percentage) (Optimists minus Pessimists)



Source: CBRT Business Tendency Survey

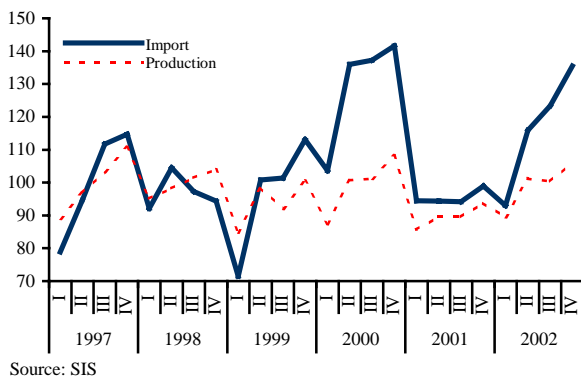
According to the outcome of the Business Tendency Survey, the impact of the global recession on export orders has been rising. In fact, the share of external cyclical developments as a restraining factor of export orders for the next three months has been increasing since October. On the contrary, the share of price competition, even though preserves its weight within the total, is in a declining tendency since September.

For the January-February 2003 period, according to the temporary foreign trade figures announced by the SIS, exports as to the same period of the previous year increased by 21.1 percent reaching US \$6 billion.

The records of Exporters Board of Turkey (EBT) indicate that in the first three months of 2003 exports increased by 33.7 percent reaching US \$10.2 billion and the sectors leading exports were vehicles and subsidiary industries. According to the EBT records, in January-March 2003 period exports of this sector as to the same period of previous year increased by 57.6 percent reaching US \$1.5 billion.

Imports increased by 22.8 percent in 2002 and 27.3 percent in January-February 2003 period. Since approximately three quarters of imports are of intermediate goods, consequently developments in the manufacturing industry productions have a significant impact on import demand (Box VI: 1). Considerable increase of manufacturing industry production since March has increased import demand as well. Manufacturing industry production increase calculated according to three-month moving averages has slowed down since July, but has once again noted high rated increase since December. However, growth of the manufacturing industry production decelerated in February 2003. In fact, the growth rate of imports volume has acted in line with manufactured industrial production.

Figure VI.1.6. Manufacturing Import Volume and Production Indices (1997=100)

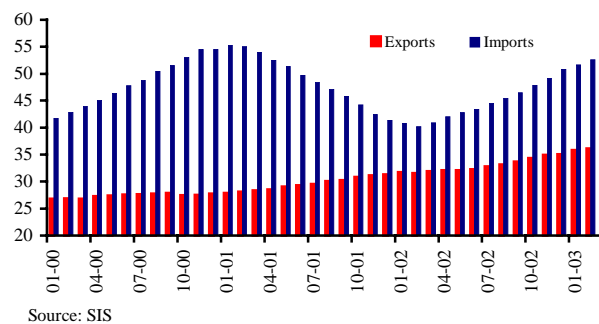


Capital goods imports began to increase considerably as of August and have increased by 20.4 percent in 2002 as to the year 2001. The increase in capital goods imports, which is calculated according to the three month moving averages, reached 63.8 percent in December and was 39.9 percent for the January-February period of 2003. The decelerated growth of capital good imports is expected to have a negative impact on domestic investment expenditures in the next period.

In 2002 together with the high growth rate of the economy, consumer expenditures resurged as well. As a matter of fact, in the second quarter of 2002 the consumer goods imports recorded a 41.5 percent growth and 48.5 percent growth in the fourth quarter. The rate of increase of the consumer good imports, calculated according to the three-month moving averages, was 50.3 percent in the January-February period of 2003. On the other hand, imports of intermediate goods in line with the increase in industrial production rose by 23.1 percent in 2002.

In 2002, imports of boilers, machines, mechanical appliances, iron and steel, plastics and like, mineral fuel and oil had the most contribution to total import growth.

Figure VI.1.7. Exports and Import (Annual, USD Billion)



Import prices increased by 2.7 percent in the last quarter of 2002 as to the previous quarter. In the same period, as the prices of capital goods imports rose by 2.5 percent, prices of intermediate goods imports and consumer goods import each increased by 0.2 percent. Import price index in 2002 as to the end of 2001 increased by 9.6 percent,

while crude oil and natural gas import prices rose by 31.6 percent.

According to the March data of the Business Tendency Survey, the data regarding the production volume and the orders expected from the domestic market in the next three months have been decreasing since the beginning of the year 2003. The planned investment expenditures for the following 12 months, with the impact of the developments in Iraq, dropped since December 2002, indicating the possibility that investment goods imports might decrease in 2003. According to the survey, in the following three months the raw material inventory volume is similarly expected to decrease similarly in 2003.

Brent oil prices per barrel increased by 55.7 percent compared to the end of 2002 and 2.2 percent as for the year-on-year average. In the first quarter of 2003 a barrel of Brent oil on the average was US \$31.5. As the war proceeded, uncertainties eased causing the prices to drop to US \$28.1 by the end of March.

VI.2. Current Account

During the economic recession process as a result of the crisis in 2001, the current account balance was in an upturn tendency and had a surplus in the last quarter of 2001. In 2002 the increasing foreign trade deficit in line with the economic growth has been distinctive on the current account. Hence, in the last quarter of 2002 the current account balance began to give a deficit in annual basis. The current account had a deficit of US \$1.8 billion in 2002 and US \$224 million in January.

Figure VI.2.1. Current Account Balance (Annual)

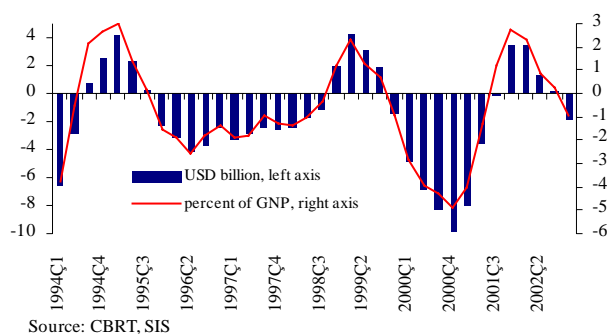


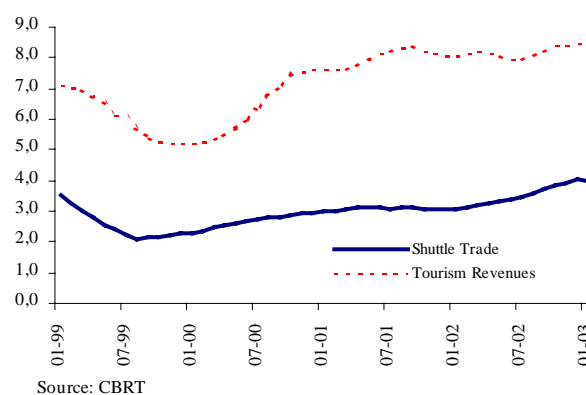
Table VI.2.1. Current Account Balance (USD million)

| | January-December | | January | |
|-----------------------------------|------------------|--------|---------|-------|
| | 2001 | 2002 | 2002 | 2003 |
| CURRENT ACCOUNT | 3390 | -1782 | 38 | -224 |
| Foreign Trade Balance | -4543 | -8635 | -348 | -688 |
| Exports (fob) | 31334 | 35082 | 2609 | 2960 |
| Shuttle Trade | 3039 | 4065 | 223 | 151 |
| Import (cif) | -41399 | -50832 | -3384 | -4041 |
| Services Balance | 9130 | 7915 | 245 | 388 |
| Tourism Revenues | 8090 | 8481 | 213 | 253 |
| Income Balance | -5000 | -4549 | -234 | -227 |
| FDI Income (net) | 52 | -86 | -69 | 7 |
| Portfolio Investment Income (net) | -694 | -830 | -30 | -66 |
| Other Investment Income (net) | -4358 | -3633 | -135 | -168 |
| Interest Expenditure | -5497 | -4417 | -266 | -209 |
| Current Transfers | 3803 | 3487 | 375 | 303 |
| Workers' Remittances | 2786 | 1936 | 164 | 163 |
| Imports with Waiver | 810 | 1045 | 66 | 49 |

Source: CBRT.

In 2002 shuttle trade, especially with the strengthening effect of the Russian economy, increased by 33.8 percent and reached US \$4.1 billion. However, in January as to the same month of the previous year decreased by 32.3 percent and was US \$151 million.

Figure VI.2.2. Shuttle Trade and Travel Revenues (Annual, USD billion)



The services balance had a surplus of US \$7.9 billion in 2002 and US \$388 million in January. Tourism revenues, the most significant item within the services balance have increased in 2002 by 4.8 percent reaching US \$8.5 billion. In spite of an increase of 14.6 percent in the number of departing foreign visitors, the decline in average expenditure has restricted tourism revenues in 2002. The average expenditure level of the tourists has dropped from US \$717 in 2001 to US \$656 in 2002. The euro appreciating 5.6 percent against the dollar in 2002 was influential within this development. However, tourism revenues in January 2003 as to the same month of the previous year increased by 18.8 percent and the number of departing foreign visitors by 39.4 percent.

Investment balance in 2002 had a deficit of US \$4.5 billion. Interest payments for loans obtained from abroad constitute a large portion of investment expenditures. Mostly long-term interest payments of the Treasury and the Central Bank were a total of US \$2.6 billion and private sector interest payments excluding banks were US \$1.3 billion in 2002. Furthermore, investment expenditures (dividend payments for stocks, interest coupon payments for bonds and equities, etc.) as a result of portfolio investments were US \$830 million in 2002. In January 2003 investment balance had a deficit of US \$227 million.

In 2002 due to a 30.5 percent decrease in workers' remittances, current transfers account dropped 8.3 percent to US \$3.5 billion. Workers' remittances in January 2003 as to the previous year did not exhibit a significant change, thus was at US \$163 million.

VI.3. Capital Account

Net capital inflows were US \$ 2.2 billion in 2002 and US \$ 1.2 billion in January 2003.

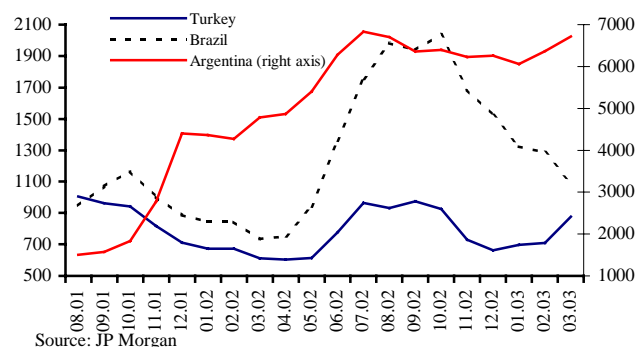
Net direct investments were US \$ 862 million in 2002. The increase in FDI since the beginning of 2002 reflects a definition change of FDI. Accordingly, long-term credits of foreign capital companies in Turkey obtained from their associates abroad have been recorded as foreign direct investment capital inflows.

Table VI.3.1. Net Capital Flows by Sectors (USD million)

| | January-December | | January | |
|--------------------------------------|------------------|-------|---------|-------|
| | 2001 | 2002 | 2002 | 2003 |
| CAPITAL AND FINANCIAL ACCOUNT | -1274 | 2204 | 501 | 1192 |
| Direct Investment | 2769 | 862 | -5 | 6 |
| Portfolio Investment | -4515 | -694 | 533 | 1108 |
| Bond Issues by Treasury | 2148 | 3286 | 600 | 1288 |
| Other Investment | -2222 | 8189 | 377 | 2087 |
| Currency and Deposits (Assets) | 927 | 611 | 1477 | 1579 |
| Trade Credit | -1930 | 2371 | -75 | -93 |
| Credits | 614 | 5213 | -565 | 271 |
| Central Bank | 10229 | -6138 | 0 | 0 |
| IMF Credit | 10230 | -6138 | 0 | 0 |
| Long Term | -1 | 0 | 0 | 0 |
| Short Term | 0 | 0 | 0 | 0 |
| General Government | -1977 | 11834 | -50 | -168 |
| IMF Credit | 0 | 12503 | 0 | -62 |
| Long Term | -977 | -669 | -50 | -106 |
| Short Term | -1000 | 0 | 0 | 0 |
| Banks | -8076 | -982 | -331 | 192 |
| Long Term | -1024 | -252 | -249 | -19 |
| Short Term | -7052 | -730 | -82 | 211 |
| Other Sectors | 438 | 499 | -184 | 247 |
| Long Term | 255 | 1226 | -108 | 360 |
| Short Term | 183 | -727 | -76 | -113 |
| Currency and Deposits (Liabilities) | -832 | 349 | -333 | 235 |
| Reserve Assets | 2694 | -6153 | -404 | -2009 |
| NET ERRORS AND OMISSIONS | -2116 | -422 | -539 | -968 |

Source: CBRT

Figure VI.3.1. Secondary Market Bond Spreads (monthly average)



The Turkish bond spreads, which have increased during May-October 2002 period, followed a downward trend in November, and displayed a stagnant phase in December and January 2003 (Figure VI.3.1). Consequently, the Treasury during the said periods had the opportunity to borrow from international markets. The Treasury issued bonds in the last two months of the year 2002 worth a total of US \$1.2 billion and in January 2003 of US \$1.3 billion. Moreover, the November 2002 bond issue has been re-opened in January 30 2003 and has been recorded in February. However, the uncertainty generated in the markets by the prospective Iraq operation

especially in February and March has raised the bond spreads.

Domestic banks purchase a portion of the Treasury bonds issued at international markets. On this account, the spread volatility mentioned above has an impact on the portfolio assets of the banks. As a result of a drop in the spreads during the November 2002-January 2003 period foreign security portfolio outflows held abroad by the residents were net US \$819 million. Considering the rising spreads after January the said portfolio purchasing is expected to slowdown.

The high proportional increase of commercial loans in 2002 is to a large extent a result of the increase in credit utilization of the private sector, excluding the banking sector, to finance imports. However, in January 2003 an outflow of US \$93 million in commercial loans has been observed, due to short-term repayments.

In 2002 while long-term capital inflow was at US \$2.4 billion, short-term capital outflow was at US \$542 million. On the other hand, despite an inflow of US \$294 million of long-term capital, short-term inflow was at US \$1.9 billion level in January.

In 2002 the banks and the general government have been net redeemers. As domestic loan utilization following the 2001 crises has tightened extensively and similar tendencies were carried on throughout 2002, this has restricted international source utilization of the banking sector. Nonetheless, a revival in real terms can be seen in the domestic loan volume and consumer loans since December. The said resurgence in the following period is expected to have an increasing impact over the utilization of foreign loans in the banking sector, as well.

In 2002, sectors other than banking are in a position of utilizing long-term loans. The most striking reason behind this is that during the said period as a result of a significant increase in industrial production and investment expenditures inclined to machinery and equipment, arising financial requirements of import demand have increased credit utilization of sectors other

than banking. The same tendency has been maintained in January 2003.

Figure VI.3.3. Private Sector Long-Term Credit Drawings (quarterly, USD billion)

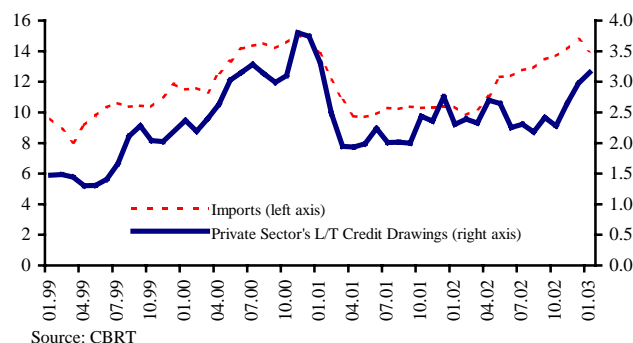
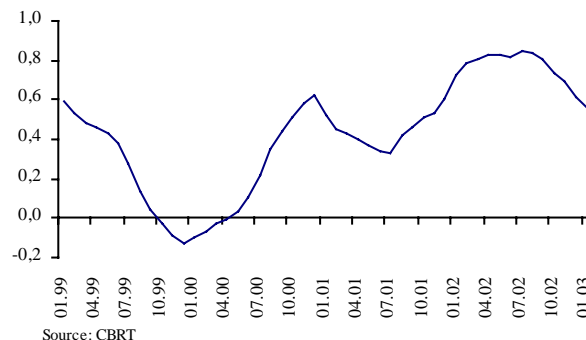


Figure VI.3.4. FX Deposits with the Central Bank (Annual, USD billion)



The declining tendency of foreign exchange deposit accounts opened at the Central Bank by Turkish workers living abroad has been reversed as the Central Bank gave permission for foreign exchange deposit accounts with one year maturity by the second half of the year 2001. Especially, in the first ten months of 2002, there has been an increase in the foreign exchange deposit accounts, which was due to the extensive growth of the short-term foreign exchange deposit accounts.

In 2002 IMF credit repayments of US \$6.1 billion were transmitted from the Central Bank accounts. During the same period the Treasury drew credit worth US \$12.5 from the IMF.

Due to the IMF credits worth net US \$6.4 billion transmitted to Central Bank accounts and foreign exchange purchase auctions in the first half of the year, gross reserves of the Central Bank increased by US \$8 billion and reached the level of US \$26.8 billion.

In January 2003, official reserves increased by US \$2 billion as a result of foreign exchange purchase auctions of US \$759 million and bond issues in international markets by the Treasury. The Central Bank gross reserves have increased to the level of US \$29.2 billion as of January 2003. During the January 1- April 16 period, US \$4.3 billion worth of debt repayment took place. On the other hand, within the framework of the credit agreement with the European Investment Bank, euro 350 million has been transmitted to the Treasury accounts in April. Consequently, the Central Bank reserves reached US \$26.4 billion by April 11.

As the uncertainties regarding the Iraqi war has demolished, it is expected that the said adverse effect on current account revenues, especially in tourism, would be temporal and restricted.

As an incentive for shuttle trade, the arrangement regarding the sales from Laleli to customs depot as exports is expected to have an increasing effect on shuttle trade. Furthermore, a limited increase in imports is expected in 2003. First of all, the expectation of low level of growth will be playing a restricting role on capital goods imports in 2003. Moreover, as uncertainties diminish, crude oil prices drop. Crude oil prices at the futures market have been deteriorating since the beginning of April. This is expected to decrease crude oil import bills and have a positive impact on the current account balance in 2003.

Table VI.3.2. Foreign Debt Indicators

| | 2000 | 2001 | 2002 |
|---|-------|-------|-------|
| Foreign Debt Stock | | | |
| USD | 118.7 | 113.9 | 131.6 |
| Ratio to GNP | 59.5 | 80.1 | 73.1 |
| Short-Term Foreign Debt Stock | | | |
| USD | 28.3 | 16.2 | 15.2 |
| Ratio to Reserves | 127.6 | 86.4 | 56.5 |
| Medium Long-Term Foreign Debt Stock (USD) | | | |
| International Institutions | 90.4 | 97.7 | 116.4 |
| Private Creditors | 11.4 | 22.0 | 30.9 |
| Commercial Banks | 70.3 | 67.2 | 76.4 |
| Commercial Banks | 27.3 | 27.8 | 30.0 |
| Short-Term Debt and Medium Long-Term Repayments | | | |
| USD | 43.5 | 32.6 | 30.9 |
| Ratio to Reserves | 196.2 | 173.5 | 115.1 |
| Debt Service Ratio | 36.4 | 41.4 | 37.2 |

Source: CBRT

Debt service ratio in the first half of 2002 exhibited a significant improvement. However, in the second half of the year the increase in the current account revenues and the deterioration of interest payments caused the debt service ratio to drop in 2002. Furthermore, a significant improvement was seen in the short-term debt to reserves ratio and the total repayments of short-term debt and medium-long term debt to reserves ratio in 2002.

VII. DEVELOPMENTS IN THE WORLD ECONOMY

In 2002 contrary to the expectations the global economy went through a fragile and a slow recovery process. Following a 2.2 percent growth in 2001, the growth rate for 2002 was 3 percent. While the growth rates of the developed countries were below the world average, the developing countries exhibited significant variations in economic performance, by regions and countries. In the last quarter of the year the increase in uncertainties depending on the tension of the Middle East and rise in the petroleum prices have been significant on the course of the global economy. As in the last quarter of 2002 the said uncertainties in the first quarter of 2003 had a negative impact on the global economy. As of April uncertainty originating from the tension in the Middle East had significantly vanished. These developments are expected to have an affirmative impact at most on the US economy and on other developed and developing country economies. On the other hand, also in 2003 the economic outcome of the financial package declared in the US economy, which has not been under implementation yet, is expected to be determinant in the global economic recovery process. It is observed that the Asian economies, which attracted attention with high growth rates in 2002, began to be affected by the slowdown in the US economy. As for the South American economies following the tightening in 2002 a positive growth is expected in 2003. Depending on the above mentioned factors if a state of recovery does not occur in developed countries, especially in the US economy, then deterioration in the Asian economies is expected to persist and the recovery in the Latin American countries to remain low.

United States of America

The growth rate of the US economy slowed down in the last quarter of the year as to the previous quarter and was 1.4 percent. According to the sub-items in the said period it is evident that the growth dynamic as to the previous quarters was different. Contrary to the previous quarters investments as to the past quarter showed a high rate of

increase of 4.4 percent, while consumption with a significant slowdown increased by 1.7 percent. As a result of the deterioration of exports by 5.8 percent and the rise of imports by 7.2 percent, foreign trade balance had a negative impact on growth. According to the data announced as of 2003 the economic stagnation is maintained in the first quarter of the year. The manufacturing industry diffusion index deteriorated in the first 3 months of 2003. The decreasing unemployment in January has increased once again in February and March. In accordance to these developments the consumer confidence level that was 80.2 percent in December 2002 dropped to 62.5 percent by March. However, in spite of all the negative developments the conclusion of the Iraqi operation in favor of the US desire is most likely to create a positive impact on consumer and investor confidence and also a development dependent on this improvement in the economy can be expected. The government continued to utilize monetary and fiscal policies in favor of growth but as a result of these policies some structural problems have aroused. Budget with a high amount of deficit in 2002 is also expected to have a significant amount of deficit this year. It is indicated that this condition might generate a negative impact on interest rates. Another significant problem with the US economy is the high current account deficits. These problems have the potential of having a negative impact on the value of the dollar.

Europe

In the euro zone the increase in GDP in the last quarter as for the previous quarter was 0.2 percent and thus was below the interval of 0.3-0.4 percent realized in the first three quarters of the year. Domestic demand in the euro zone is to a large extent a result of public expenditures and inventory changes. In spite of the increase in domestic demand, net exports had a negative contribution on GDP growth. As a result of the weak development of the global demand and the euro gaining strength, export growth decelerated. On the other hand, in spite of a recovery tendency in domestic demand, growth rate of imports has also deteriorated. However, deterioration tendency in the growth rate of imports has relatively weakened.

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

| | 2001 | 2002 | 2003 (Forecast) | 2004 (Forecast) |
|---------------------------------|------|-------|--------------------|--------------------|
| World | 2.3 | 3.0 | 3.2 | 4.1 |
| Developed Countries | 0.9 | 1.8 | 1.9 | 2.9 |
| U.S.A. | 0.3 | 2.4 | 2.2 | 3.6 |
| Canada | 1.5 | 3.4 | 2.8 | 3.2 |
| Euro Area | 1.4 | 0.8 | 1.1 | 2.3 |
| Germany | 0.6 | 0.2 | 0.5 | 1.9 |
| France | 1.8 | 1.2 | 1.2 | 2.4 |
| Italy | 1.8 | 0.4 | 1.1 | 2.3 |
| U.K. | 2.0 | 1.6 | 2.0 | 2.5 |
| Japan | 0.4 | 0.3 | 0.8 | 1.0 |
| Developing Countries | 3.9 | 4.6 | 5.0 | 5.8 |
| Developing Asian Countries | 5.7 | 6.3 | 6.0 | 6.3 |
| Newly Industrialized Asian | 0.8 | 4.6 | 4.1 | 4.5 |
| ASEAN-4** | 2.6 | 4.3 | 3.9 | 4.3 |
| China | 7.3 | 8.0 | 7.5 | 7.5 |
| India | 4.2 | 4.9 | 5.1 | 5.9 |
| Developing Countries in America | 0.6 | -0.1 | 1.5 | 4.2 |
| Argentina | -4.4 | -11.0 | 3.0 | 4.5 |
| Brazil | 1.4 | 1.5 | 2.8 | 3.5 |
| Chile | 2.8 | 2.0 | 3.1 | 4.8 |
| Mexico | -0.3 | 0.9 | 2.3 | 3.7 |
| EU members | — | 3.9 | 3.9 | 4.5 |
| Turkey | -7.5 | 6.7 | 5.1 | 5.0 |
| Czech Republic | 3.1 | 2.0 | 1.9 | 3.3 |
| Hungary | 3.8 | 3.3 | 3.6 | 3.9 |
| Poland | 1.0 | 1.3 | 2.6 | 4.1 |
| Bulgaria | 4.0 | 4.0 | 5.0 | 5.5 |
| Romania | 5.7 | 4.9 | 4.9 | 5.0 |
| CIS | 6.4 | 4.8 | 4.4 | 3.9 |
| Russia | 5.0 | 4.3 | 4.0 | 3.5 |
| Africa | 3.6 | 3.4 | 3.9 | 5.2 |
| Middle East | 4.0 | 3.9 | 5.1 | 4.8 |

* Newly Industrialized Asian economies are Hong Kong, Korea, Singapore and Taiwan.

** ASEAN-4 includes Indonesia, Malaysia, the Philippines and Thailand.

Source: IMF, World Economic Outlook, April 2003

The downward tendency of inventories in the euro zone was maintained in the last quarter of 2002. However, this tendency as to the previous periods was at a much lower rate. According to the data obtained from the survey results inventory levels of the firms as from the middle of the year 2002 proceeded at the required level. Due to weak domestic demand, negative profit expectations and rigidity in the labor market, investment expenditures deteriorated in the last quarter of 2002 as well. However, a relative slowdown was recorded in the deterioration rate. The outlook for investments as a result of high idle capacity rate, low manufacturer confidence and high indebtedness level of the firms, has preserved its uncertainty.

In the last quarter of the year 2002, the increasing disposable income, as a result of increasing real wages at a stable rate, low rate of recovery in unemployment and tax arrangements for consumption incentives, had a

positive impact on private consumption expenditures. However, in the first quarter of 2003 some indicators regarding consumption denote that consumption expenditures will slowdown. In the first quarter of the year the calculated consumer confidence index for the euro zone deteriorated significantly due to the negativity in the economic developments, the increasing unemployment rate and the despair over the Iraqi war. In the first two months of the year 2003 new vehicle records have deteriorated.

Figure VII.1. Euro-US Dollar Parity



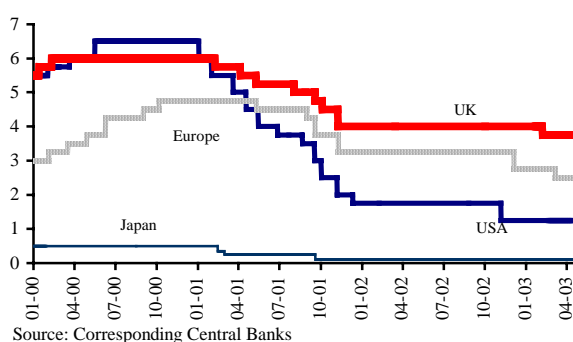
Source: CBRT

The economic condition of Germany within the euro zone hold a particular significance due to the continuance of the deterioration of the industrial production, business confidence and the retail sales and unemployment rate reaching its highest level in the past three years. Furthermore, as a result of the planned implementation of tight fiscal policies, macroeconomic policies according to the rest of the region are deemed less corroborative of economic activities. It is considered that tax increase and social security premium increases have a negative impact on consumer confidence. The negative outlook of the French economy has gained strength due to the negativities of the consumer confidence and the labor market.

Under the assumption that the crude oil prices will drop following the Iraqi war, the weak course of the GDP growth and the recent strength of the euro, supports the view that the inflation rate of the euro zone will decrease in 2003 and 2004. In accordance to these developments,

on March 7, 2003 the European Central Bank decreased the reference interest rate from 2.75 percent to 2.5 percent.

Figure VII.2. Main Central Bank Interest Rates (Percentage)



Source: Corresponding Central Banks

Strong domestic demand has provided UK with the possibility of a more sturdy growth than other European countries. In 2002 wealth effect derived from real estate ownership due to an increase in real estate prices led to an increase in consumer expenditures. However, weakening of the said effect due to the increase in the household indebtedness rate to high levels in 2002 and consumption expenditures are expected to slowdown. Continued increase in public expenditures and the limited increase in the contribution of net exports are expected to compensate for the deceleration in consumption expenditures. In February 2003, the Bank of England, in accordance to the weak domestic and external demand indicators decreased the reference interest rate from 4 percent to 3.75 percent.

Japan

The recovery in the Japanese economy, which started in the second half of 2002, began to lose impact in the last quarter. Domestic demand slowed down to a large extent, and this has been reflected as a high rate of decline in consumption expenditures and inventories. As the capacity utilization rate deteriorated in the manufacturing industry, unemployment level was at record highs.

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

| | 2001 | 2002 | 2003 (Forecast) | 2004 (Forecast) |
|---------------------------------|------|------|--------------------|--------------------|
| Developed Countries | 2.2 | 1.5 | 1.9 | 1.7 |
| U.S.A. | 2.8 | 1.6 | 2.3 | 2.3 |
| Canada | 2.5 | 2.0 | 3.1 | 2.1 |
| Euro Area | 2.6 | 2.3 | 2.0 | 1.5 |
| Germany | 2.4 | 1.3 | 1.0 | 0.7 |
| France | 1.8 | 1.9 | 2.0 | 1.6 |
| Italy | 2.7 | 2.6 | 2.4 | 1.6 |
| U.K. | 2.1 | 2.2 | 2.8 | 2.7 |
| Japan | -0.7 | -0.9 | -0.7 | -0.6 |
| Developing Countries | 5.8 | 5.4 | 5.8 | 5.1 |
| Developing Asian Countries | 2.6 | 1.8 | 2.3 | 3.1 |
| Newly Industrialized | 1.9 | 1.0 | 1.8 | 1.9 |
| Asian Countries* | | | | |
| ASEAN-4** | 6.6 | 5.9 | 5.3 | 4.9 |
| China | 0.7 | -0.8 | 0.2 | 1.5 |
| India | 3.8 | 4.3 | 4.1 | 5.5 |
| Developing Countries in America | 6.4 | 8.7 | 11.0 | 6.9 |
| Argentina | -1.1 | 25.9 | 22.3 | 13.0 |
| Brazil | 6.8 | 8.4 | 14.0 | 5.5 |
| Chile | 3.6 | 2.5 | 3.3 | 2.9 |
| Mexico | 6.4 | 5.0 | 4.3 | 3.3 |
| EU candidates*** | 9.8 | 5.7 | 4.7 | 4.7 |
| Turkey | 54.4 | 45.0 | 24.7 | 14.5 |
| Czech Republic | 4.7 | 1.8 | 1.1 | 3.0 |
| Hungary | 9.2 | 5.3 | 5.3 | 4.8 |
| Poland | 5.5 | 1.9 | 1.1 | 2.4 |
| Bulgaria | 7.5 | 5.8 | 3.0 | 4.1 |
| Romania | 34.5 | 22.5 | 16.2 | 11.6 |
| CIS | 20.4 | 14.5 | 12.3 | 9.1 |
| Russia | 20.7 | 16.0 | 13.4 | 9.7 |
| Africa | 13.0 | 9.3 | 10.1 | 7.6 |
| Middle East | 8.1 | 9.2 | 9.7 | 9.1 |

* Newly Industrialized Asian economies are Hong Kong, Korea, Singapore and Taiwan.

** ASEAN-4 includes Indonesia, Malaysia, the Philippines and Thailand.

*** Excluding Turkey.

Source: IMF, World Economic Outlook, April 2003

According to the statistics announced in January, exports show an upward tendency. However, while exports to East Asian countries are exhibiting a relatively higher growth rate, exports to US and Europe are expected to increase at a lower rate due to weak economic activities.

On the domestic demand side, real estate investments are low, while public investments show a deteriorating tendency. In spite of the improvement in the profit rate of the firms, the private sector's fixed capital investments were flat. Furthermore, in accordance to the lack of a strong recovery in western economies, the investment tendencies of the firms also do not have an indicator inclined to increase.

Table VII.3. Current Account Balance for Selected Country Groups (Percent of GDP)

| | 2001 | 2002 | 2003 | 2004 |
|--|------|------|------------|------------|
| | | | (Forecast) | (Forecast) |
| Developed Countries | -0.8 | -0.8 | -1.0 | -0.9 |
| USA | -3.9 | -4.8 | -5.3 | -5.1 |
| Canada | 2.8 | 1.5 | 1.6 | 2.0 |
| Euro Area* | -0.2 | 0.9 | 0.9 | 0.9 |
| Germany | 0.2 | 2.5 | 2.6 | 2.6 |
| France | 1.8 | 2.1 | 2.1 | 1.9 |
| Italy | — | -0.6 | — | 0.3 |
| UK | -1.7 | -1.9 | -2.0 | -2.3 |
| Japan | 2.1 | 2.8 | 2.7 | 3.0 |
| Developing Countries | 0.6 | 1.0 | 1.3 | 0.3 |
| Developing Asian Countries | 2.8 | 3.5 | 2.7 | 2.3 |
| Newly Industrialized Asian Countries** | 5.8 | 7.0 | 6.2 | 6.1 |
| ASEAN-4*** | 5.0 | 5.3 | 3.1 | 2.7 |
| China | 1.5 | 1.9 | 1.4 | 1.1 |
| India | — | 0.9 | 0.5 | 0.2 |
| Developing Countries in America | -2.8 | -1.0 | -1.1 | -1.6 |
| Argentina | -1.7 | 8.3 | 7.8 | 6.7 |
| Brazil | -4.6 | -1.7 | -1.5 | -2.3 |
| Chile | -1.8 | -0.9 | -1.5 | -1.1 |
| Mexico | -2.9 | -2.2 | -2.2 | -3.1 |
| EU candidates | -2.8 | -3.3 | -3.6 | -3.4 |
| Turkey | 2.3 | -1.0 | -1.8 | -1.1 |
| Czech Republic | -5.7 | -5.3 | -5.8 | -5.3 |
| Hungary | -3.4 | -4.1 | -4.8 | -4.6 |
| Poland | -3.9 | -3.5 | -3.7 | -4.0 |
| Bulgaria | -6.2 | -3.4 | -5.5 | -4.6 |
| Romania | -6.0 | -3.4 | -4.5 | -4.5 |
| CIS | 7.7 | 6.9 | 7.6 | 4.4 |
| Russia | 10.5 | 8.8 | 10.1 | 6.3 |
| Africa | -0.1 | -1.8 | -0.5 | -0.9 |
| Middle East | 7.3 | 4.9 | 9.0 | 4.2 |

* Adjusted for intra-area trade.

** Newly Industrialized Asian economies are Hong Kong, Korea, Singapore and Taiwan.

*** ASEAN-4 includes Indonesia, Malaysia, the Philippines and Thailand.

Source: IMF, World Economic Outlook, April 2003

Sales of electrical appliances and sales at department stores, which are indicators of consumer expenditures, have increased in January. Moreover, sales of vehicles in February have increased two consecutive months. In spite of the positive outlook, consumption expenditures in general follow a low course. On the other hand, the number of negative indicators regarding the consumer confidence has increased.

Industrial production in the Japanese economy to a large extent followed a flat course. As industrial production in the last quarter of 2002 with respect to the previous period decreased by 1 percent, it increased by 0.6 percent in January 2003 with respect to the last quarter of the previous year. Furthermore, due to the firms' cautious approach to production, inventories were at low levels.

Import prices of Japan have been increasing due to the increase in goods prices especially crude oil in international markets. The distortion in the balance of demand and supply of raw materials for steel and chemicals as a result of increase in crude oil prices has increased the prices of some domestic goods as well. Consumer prices have maintained its downward tendency over the years. Moreover, the rate of those who are expecting the prices to continue to decrease has been increasing.

The prospects for the Japanese economy to gain strength in the short-term are considered to be weak. Due to the negativities of the labor market, there is no recovery tendency of the private consumption expenditures. According to the results of the Tankan survey of March 2003, in the second quarter of 2003 there is a deteriorating tendency in the conditions of the economic activities; however, on the other hand, sales, profitability and fixed investments in the following twelve months give mixed signs.

The stock prices in the financial markets dropped to its lowest level in the last twenty years, which caused uneasiness with respect to banks and highly indebted firms, thus, threat the sustainability of the economic revival. On the other hand, the Japanese government took series of measures in order to strengthen the banking sector in October 2002 and some banks have been provided with the opportunity to utilize the funds of the private sector to raise capital. In spite of this, if unable to get over the problems in the banking sector, especially the non-performing loan problems, then both the possibility and the willingness of banks to extend loans to the private sector is expected to decrease.

Asia

The Asian economies performed highly above the world average in 2002. The increase in imports above the growth rate in the US economy and the vigorous intra-regional trade were the most important factors behind this development. The regional economies were faced with a set of negative principles in 2003. The said negative

factors can be listed as follows: deteriorating demand in the US and other large industrial countries, the effects of increasing oil prices on external balances, and the emergence of the SARS virus in some of the countries in the region. The SARS virus is expected to affect the economies of Hong Kong, Singapore and China. The illness is expected to affect the number of tourists arriving in the region and the shopping habits of the natives. Chinese economy is the least affected from the negative conditions of the region, as industrial production in the first quarter of 2003 increased by 17.2 percent, exports in the same period increased by 30 percent. South Korea, one of the strong economies of the region, during the first quarter of the year both domestic and external demand had weakened. On the other hand, the accelerating oil prices had a negative impact on the current account balance.

Latin America

In 2002 the economies of Latin American countries deteriorated by 0.5 percent. The crises in Argentina, Uruguay and Venezuela were the most significant reasons behind the said reduction. As of April 2003, positive developments have been displayed in the regional economies. National currencies, which had generally depreciated in 2002, once again began to appreciate in 2003 and the conditions in the international financial markets have developed in favor of the regional economies. However, developments in the US economy maintained to be the most significant variable for sustainability of the recovery process of the region.

According to the IMF forecasts, following an 11 percent decrease in the Argentinean economy in 2002, a 3 percent increase is expected in 2003. The announced data as of the beginning of 2003 also verifies these predictions. Industrial production of the economy in January and February, as to the same period of the previous year, increased above the 10 percent level. On the other hand, in connection to the accelerating foreign trade surplus and the diminishing capital outflows, peso began to appreciate again, which had a positive impact on the inflation rate. The Brazilian economy grew by 1.5 percent in 2002. Despite the increase in the inflation rate

and the fragile growth environment, the significant rate of depreciation of the Brazilian real last year caused the Central Bank to raise the overnight interest rates. The markets gave a positive response to several of the reforms planned to vitalize in Brazil, thus the currency real began to appreciate once again. As a result of this development the expected inflation rates drop, still prevailing above the target for 2003. Mexico, one of the important economies of the region is expected to perform above last year's growth rate of 0.9 percent in 2003. However, the slow recovery process of the US economy is considered to restrict recovery in 2003.

Russia

The Russian economy displayed a growth rate of 4.3 percent in 2002. According to the sub-items of growth, it is clear that investments have substantially slowed down in 2002 with respect to 2001. High oil prices constitute the most important factor lying underneath growth and these prices are expected to support growth positively during the first quarter of 2003. Public sector balance while in deficit when oil incomes are excluded, turn to surplus when oil incomes are included.

Eastern Europe

When global recession environment is taken into consideration, it is seen that the growth performance of the Eastern European countries is high. Region economies have offset the weakening external demand of developed European economies through vigorous domestic demand.

Polish economy recorded the lowest growth rate among Eastern European countries with 1.3 percent growth in 2002. Even though public expenditures constitute the least increasing item of the GDP by 0.3 percent during 2002, budget deficit was realized at 5 percent of GDP as of the end of 2002. High rate of unemployment, uncertainties in the recovery of investments and dependency on the German economy are the most important economic risks facing the country.

Hungarian economy displayed a growth rate of 3.2 percent in 2002. However, increasing budget deficits continued to constitute problems in the Hungarian economy. Taking this into consideration, the Government fixed a challenging financial compliance target for the year 2003. Another noticeable problem in the Hungarian economy, as is the case of other Eastern European economies, is the high current account deficit. However, in the Hungarian economy, the current account deficit is financed through foreign borrowings instead of direct investments, which are quite low with respect to other economies in the region. Financial compliance target is expected partially to affect current account problems positively.

GDP of the Czech Republic exhibited a 2 percent increase in 2002. When considered by sub-items, it is seen that growth is emanating from private consumption and public expenditures. In accordance to this development, budget gave a deficit of 3.4 percent of GDP during the year 2002. It was observed that foreign direct investment inflows to the country increased in 2002 with respect to 2001.

Crude Oil Prices

Crude oil prices increased significantly during the last months of 2002 and early months of 2003 due to vigorous expectations for the start of Iraq War and the decreasing crude oil supply generated by the strike of oil workers in Venezuela. In spite of OPEC's decision to increase the crude oil production quotas by January, crude oil prices reached US \$34 per barrel by mid March. In March, as the military operation against Iraq began, uncertainties of crude oil prices declined and crude oil prices dropped to US \$25 per barrel by early April due to the expectations that the war will not last long and will not cause a shortage in crude oil supply. The fact that prices in the futures markets are significantly in a downward tendency since May, this indicates to a large extent that the uncertainties concerned have vanished and the expectations for the effects of the Iraq war will be temporary has gained strength.

Table VII.4. Crude Oil Futures Prices (USD per barrel)

| | USD/barrel |
|--------|------------|
| Jun-03 | 25.88 |
| Jul-03 | 25.81 |
| Aug-03 | 25.64 |
| Sep-03 | 25.48 |
| Oct-03 | 25.32 |
| Nov-03 | 25.16 |
| Dec-03 | 25.00 |
| Jan-04 | 24.82 |
| Feb-04 | 24.65 |
| Mar-04 | 24.48 |
| Apr-04 | 24.32 |
| May-04 | 24.20 |

Note: Futures prices are as of April 21, 2003.
Source: www.oilnergy.com.

VIII. EVALUATION OF INFLATION PROSPECTS

In this section, probable developments for the following months of 2003 will be evaluated in the light of the data disseminated by the first week of May and future expectations through focusing on its relations with inflation targeting. The factors determining the course of inflation in the following period is going to be analyzed under the headings of costs, supply-demand and inflation expectations. Furthermore, by taking the CPI target determined for 2003 into consideration, risks that can cause deviation from this target will be evaluated.

VIII.1. Factors Affecting Inflation

It is considered that the surge in inflation during the first quarter of 2003 is caused to a large extent by external developments. Uncertainty created by the Iraqi War resulted in fluctuations both in exchange rates and oil prices. Inflation surge during the first quarter of 2003 has been affected by public sector price adjustments along with external developments. Although, the rise in public sector prices were to a large extent caused by developments in oil prices, prices of other goods produced by the public sector and used as inputs by the private sector were adjusted as well. Furthermore, during the said period, agriculture and food prices increased beyond expectations. Even though these negative developments caused stagnation in the tendency of disinflation during the first quarter of 2003, persistence of insufficient domestic demand constrained the reflections of increased costs especially on consumer prices. Consequently, CPI and WPI, which were 29.7 percent and 30.8 percent, respectively, by the end of 2002, were 29.4 percent and 35.2 percent by the end of the first quarter of 2003.

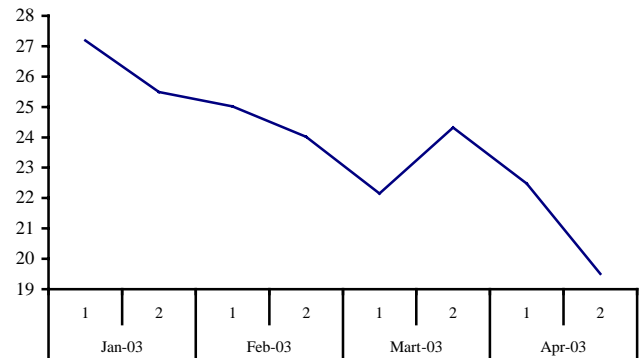
VIII.1.1. Cost Factors

Exchange Rates

The exchange rate course followed during the first quarter of 2003 was mainly determined by the developments related to Iraq operation. The effects of other political and economic events on exchange rates

were temporary and limited. While the US dollar showed a limited depreciation until March as to the end of December level, euro appreciated against the Turkish lira during the same period. Developments during March in relation to the Iraqi operation and Turkey's role in such an operation caused exchange rates to follow a significantly fluctuating course. As uncertainties by the end of March ceased and the IMF review completed, exchange rates retreated back to their levels in January. Consequently, during the first quarter of 2003, Turkish lira depreciated by 7.3 percent against the currency basket, however, appreciated by 1.2 percent in April. The depreciation of the Turkish lira in the first quarter of the year had a negative impact on prices of sectors that are sensitive to the exchange rate volatility, especially the prices of petroleum products and primary metal industry.

Figure VIII.1.1. Expected end-2003 US Dollar Exchange Rate Annual Rate of Increase (percent)*



* Monthly end of year exchange rate expectations are used to calculate the depreciation rate expectation with respect to end-2002.

Source: CBRT

According to the Expectations Survey conducted by CBRT, the rising year-end US dollar exchange rate expectation in March retreated as per the survey results for the second half of April. According to survey, the expected year-end increase in US dollar exchange is 19.6 percent.

Prices Under Public Sector Control

Prices controlled by the public sector showed a greater increase during the first quarter of 2003 as to the year 2002 in general. Increase in oil prices due to external developments, seasonal price adjustments for some of the

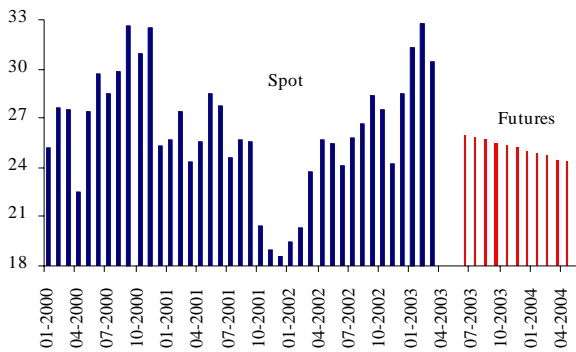
public sector services and for the purpose of bringing the financial condition of the public sector consistent with the program target, the increase in the prices of public sector products such as TEKEL were realized during the same period, which constituted the main cause for the increase in the price level.

This tendency of the public sector prices is expected to overturn during the coming period due to slowdown in oil price rise and the completion of 4th Review of the IMF.

Crude Oil Prices

Crude oil prices were significantly higher during the last months of the year 2002 and early months of 2003. In spite of OPEC's decision in January to increase production quota, crude oil prices reached the level of US \$34 per barrel by mid March. In accordance to these developments, prices of the domestic manufacturing sector for petroleum products increased by 20.2 percent during the first quarter of the year.

Figure VIII.1.2. Spot and Futures Prices of Crude Oil (USD per barrel)



Note: Spot and futures prices of Brent crude oil are used. Futures prices are as of April 21, 2003.

Source: US Department of Energy, www.oilenergy.com.

As the Iraqi operation began in March, uncertainty over the crude oil prices diminished. Expectations for the war not to last long and an uninterrupted oil supply caused crude oil prices to drop to US \$25 by early April. Significant downward tendency of the prices prevailing in the futures markets since May indicate the disappearance of the above-mentioned uncertainties and strengthening of the expectations in regard the effects of the Iraqi War will last short.

As a result, for the rest of the year the pressure of crude oil prices over inflation is expected to recede gradually.

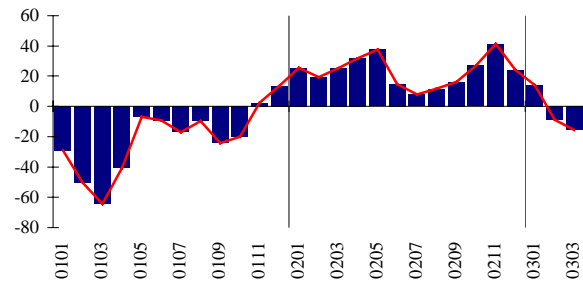
VIII.1.2. Balance of Supply and Demand

Developments in Production and Employment

In 2002, the Turkish economy recaptured the growth process. GDP and GNP increased by 7.8 percent in 2002 with respect to previous year. Growth accelerated especially during the last quarter of 2002. GDP and GNP increased by 11.4 and 11.5 percent, respectively, with respect to the same period of the previous year.

GDP figures for 2003 are not available yet. However, according to the monthly industrial production index of SIS, during January-February period of 2003, industrial production and manufacturing industries production increased by 9.2 percent and 10.9 percent, respectively, as to the same period of the previous year. Furthermore, average capacity utilization rate of manufacturing industries increased by 1.5 points during January-March period of 2003 with respect to the same period of the previous year, and reached 74.9 percent.

Figure VIII.1.3. Business Tendency Survey Business Confidence



Source: CBRT Business Tendency Survey

Despite the positive developments during the last quarter of 2002 and January 2003, political and economic uncertainties created by the Iraq war led to an increase in the fluctuations of the financial markets and deteriorations in the optimistic expectations on demand and production of the private firms. Business Tendency Survey of the CBRT, reflecting the expectations on general business outlook of private firms operating in industrial sector, retreated rapidly in February 2003,

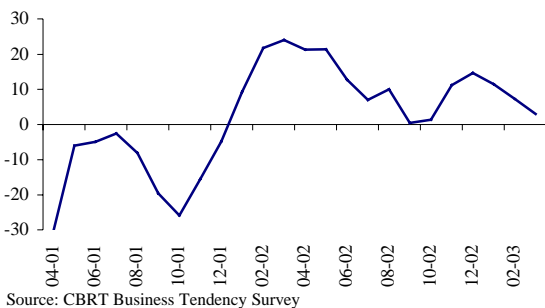
turning pessimistic expectations in favor for the first time since October 2001 and maintained the same course by further deterioration during March 2003. Along with the war context effecting the deterioration of the optimistic expectations of the private firms, incomplete public sector budget of 2003 and the delay of the necessary negotiations with the IMF were also influential.

Demand Expectations, Income and Wage Policies, Real Wage Developments

Total final domestic demand increased by 8.1 percent during the last quarter of 2002 and 1.7 percent for the whole year. Uncertainties created by the prevailing developments on economic conduct and in line with this the possibility of continuance of negative developments observed in the labor markets during the first half of 2003, point to the fact that the increase in private consumption expenditures will be limited. Furthermore, within the framework of tight fiscal policies which are planned to be implemented in 2003, consumption expenditures of public sector is expected to increase very slightly and public sector investments are expected to decline in real terms.

As was the case during the last quarter of 2002, there exists the possibility of a limited increase in the real wages of the private manufacturing industry. However, as the adjustment made in the salaries and wages in the public sector constitutes an indicator to other sectors, the developments in the wages of the economy in general is considered not to lead to a significant increase in real income.

Figure VIII.1.4. Expected Volume of Sales in the Domestic Market During Next 3 Months (Up-Down)



Although tight income and fiscal policies have direct constrictive effects on domestic demand, it is believed that the ultimate rise in credibility due to these policies will contribute positively on domestic demand. Attainment of a primary surplus in line with the economic program will ease the worries on sustainability of debt stock and result in a decrease in risk premium. The decline of uncertainties regarding the future of the economy and the optimistic views generated in the expectations of the economic units will have an increasing effect on the consumption expenditures, which has been postponed due to high real interests and uncertainties. In accordance to the positive developments in exports and the phased recovery expected in consumption expenditures, the firms are expected to maintain the rise in investment expenditures, in order to expand the production capacity.

According to the future domestic demand expectations for the next three months in the CBRT Business Tendency Survey as of March, domestic demand expectations have deteriorated in January 2003 and have been maintained in the March survey. Moreover, the planned investment expenditures for the next twelve months, due to the effects of developments in Iraq, have been retreating since December 2002. According to the survey, the volume of raw material stocks for the next three months show a decline in 2003 as well. However, according to the March results of the Business Tendency Survey, deteriorating expectations to a large extent reflect the effects of the Iraqi war. As the war has been concluded in a short period of time with a limited effect on the Turkish economy, the expectations are presumed to turn positive as of April.

The prevailing economic program foresees a 5 percent growth rate for 2003. According to the CBRT Expectation Survey annual growth rate expectation of 4.4 percent in January has been determined as very close to the rate of the program. However, due to the uncertainties in domestic policies together with the increasing tension regarding Iraq, the deteriorating growth expectation since early February has dropped as much as 3.2 percent in the first period of April. As a result of the Iraqi war lasting short together with the

completion of the 4th Review of the IMF, which has increased the confidence in the determination of implementation of the economic program, the growth expectation in the following period once again is estimated to reach the foreseen level in the economic program. As a matter of fact, according to the CBRT Expectation Survey, the growth expectation, which began to recover during the second half of April, maintained the same tendency during the first half of May and reached 3.7 percent.

Consequently, the growth process, which started in the second quarter of 2002, will continue in 2003 as well. Even though a slowdown is seen with respect to last year, it is believed that the growth rate will be closer to the long run growth potential of the economy.

VIII.1.3. Inflation Expectations

The operation process towards Iraq, together with the worries for the sustainability of domestic debt and the increasing tendency of the inflation, had a negative impact on the macroeconomic variable expectations of the economic units, primarily on inflation in the first quarter of 2003. Therefore, year-end inflation expectations began to rise during the first quarter of 2003 and it was 8.4 points above the year-end inflation target of 20 percent during the first half of April. By the end of the Iraqi war, year-end inflation expectations tended to retreat and dropped to 26.6 percent in the first half of May. While the consumer inflation expectations for the following 12 months led a flat path without a significant shift in the first quarter of the year, it slightly increased after the second half of March and following the termination of the Iraqi war began to deteriorate in the second half of April reaching 23.3 percent in the first period of May

VIII.2. Risks and Basic Assumptions

The following is the summary of the significant points regarding the course of inflation in the coming months:

i. The developments that caused the downward tendency in inflation to cease during last three months were mostly due to the external factors and it is expected not to persist effecting inflation negatively in the coming

period. Moreover, when production and demand data and measures in connection to the income policy and public finance are taken into consideration, the possibility of a pressure on inflation from the demand side is very low in the first half of the year. In other words, a permanent tendency of increase in inflation has not been generated, thus, the rise in inflation is foreseen as temporary.

ii. However, prevention of the permanency of the recent negative effects of external factors on inflation depends mostly upon the diligent implementation of the prevailing program. The relation between realized inflation and expected inflation is still significantly powerful. In other words, shocks, which are deemed to be temporary, affect the future path of inflation through the medium of inflationary expectations.

iii. Some risks exist as to the inflation in the following period. The first risk is the course of the food prices. The possible reflection of the continued acceleration of agricultural product prices on food prices is considered as a factor with a negative effect on inflation. Moreover, in case of an increase in food exports to Iraq within the framework of restructuring of Iraq, an additional pressure on domestic food prices can occur.

iv. In light of all these evaluations, in the following period under the assumptions of a limited recovery in domestic demand, absence of a sharp increase in the exchange rate and refrainment from adjusting public sector prices unforeseen in the program and under the condition that the program continue to be implemented as targeted, price increases in sectors especially other than foodstuffs will follow a course in accordance with the level of year end target.

Consequently, it is obvious that cessation in disinflation is caused by external factors such as external developments and domestic food prices. In other words, it is not possible to claim with the present data that the declining tendency of inflation is slowing down. However, the economic policies implemented with determination, and consistency, in order to protect the gains in the fight with inflation, will invigorating the confidence environment, thus, the positive effect on expectations will gain importance.