



# AN OVERVIEW OF TURKISH ECONOMY

**June 2003**

**CENTRAL BANK OF THE REPUBLIC OF TURKEY**

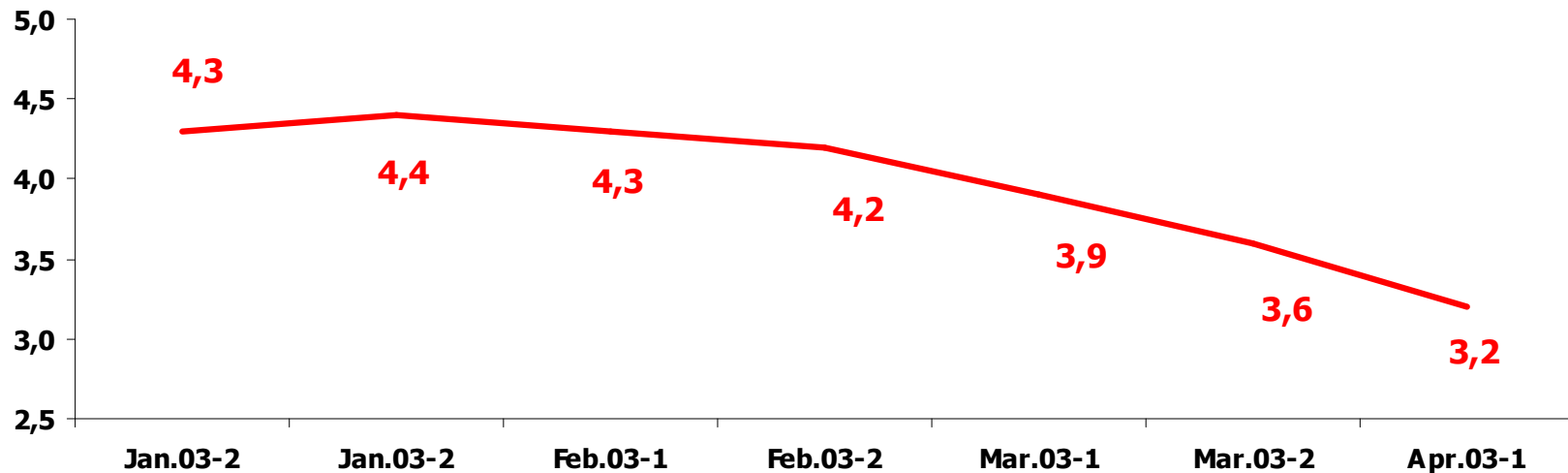


# GROWTH

# Growth

**2003**  
**Estimate: 5 %**

- Growth expectations declined in the January - April 2003 period, from 4.4 percent to 3.2 percent.



## ● Why?

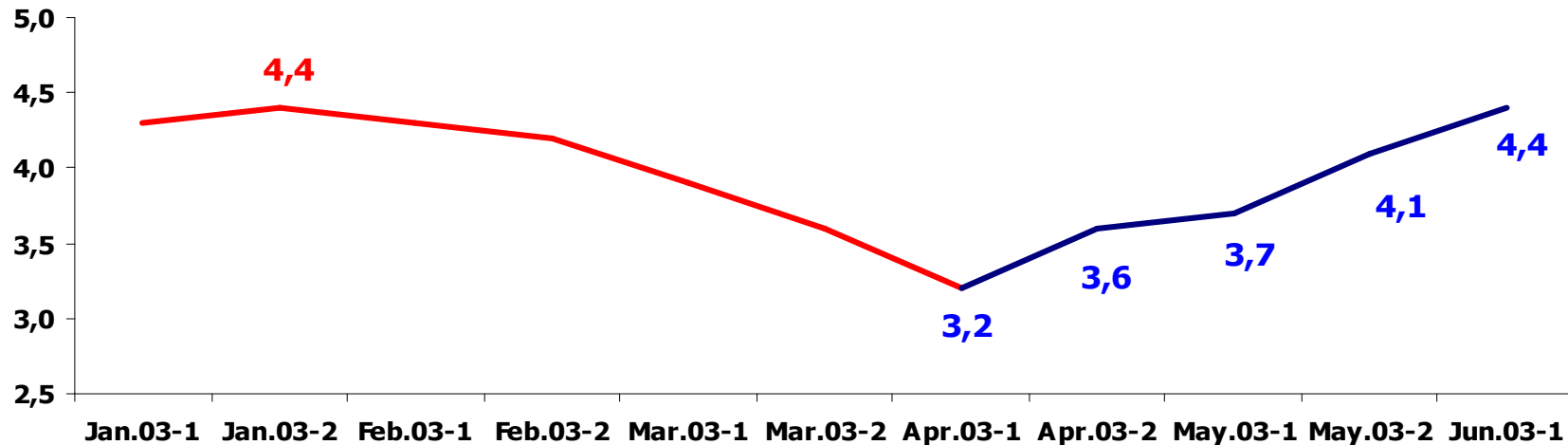
- ✓ Iraq Crisis
- ✓ IMF review delayed



- ✓ Real Sector Confidence Index ↘
- ✓ Real interest rates ↗

# Growth

Expectations increased to 4.4 as of June.



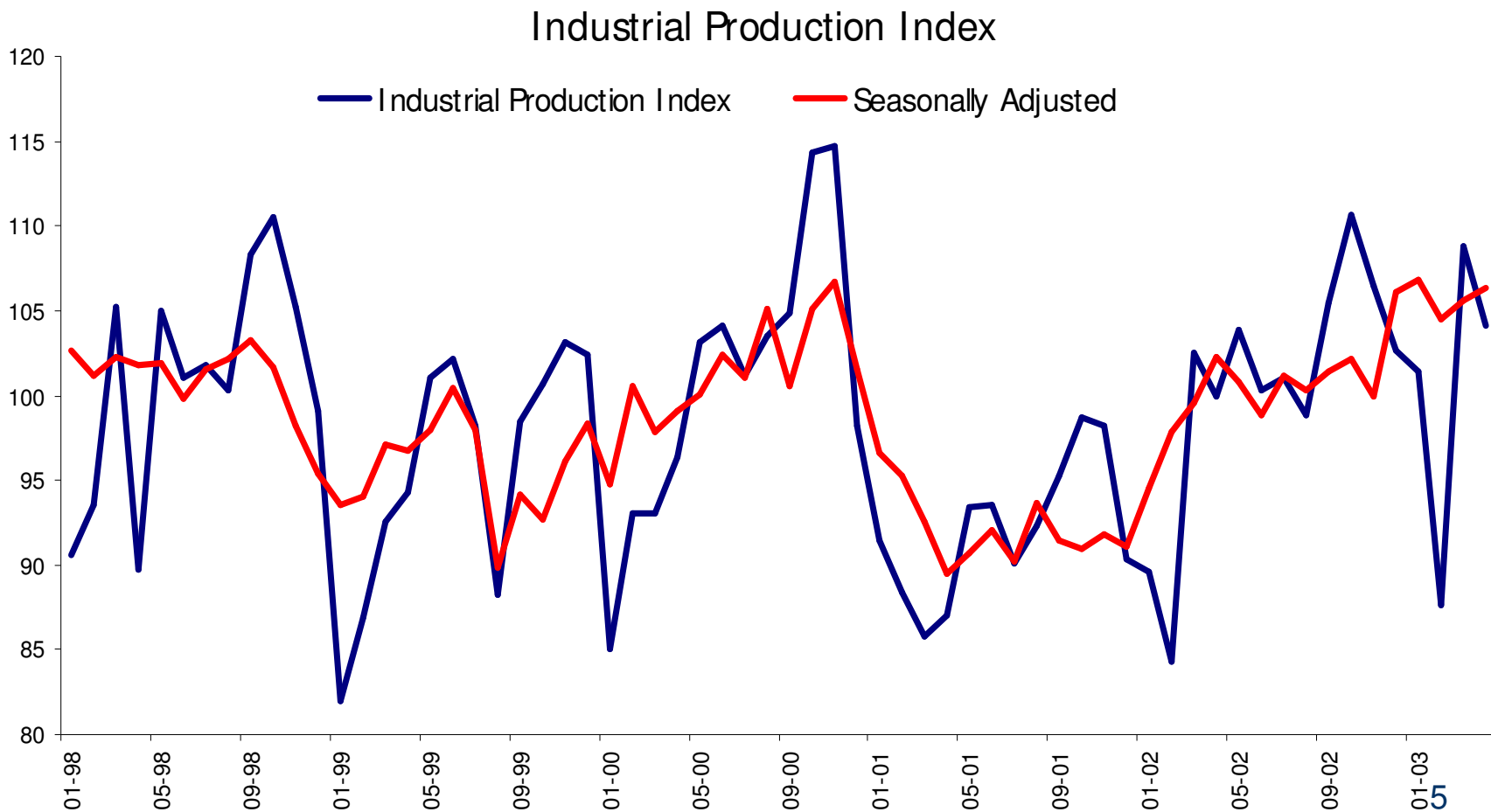
- ✓ Stability in TL and FX markets
- ✓ Favorable developments in expectations  
 ↓  
 Further increase in private fixed investment and consumption expected
- ✓ Increase in productivity resulting from structural reforms
- ✓ Acceleration in exports  
 30.3 % yoy increase in April  
 30.6 % yoy increase in first four months
- ✓ Increase in production  
 4.2 % yoy increase in April,  
 6.8 % yoy increase in first four months in IPI
- ✓ Revival in consumer credits and credit cards

**Growth estimate is feasible.**

Furthermore, we have to focus on productivity increase and FDI to achieve high and sustainable growth.

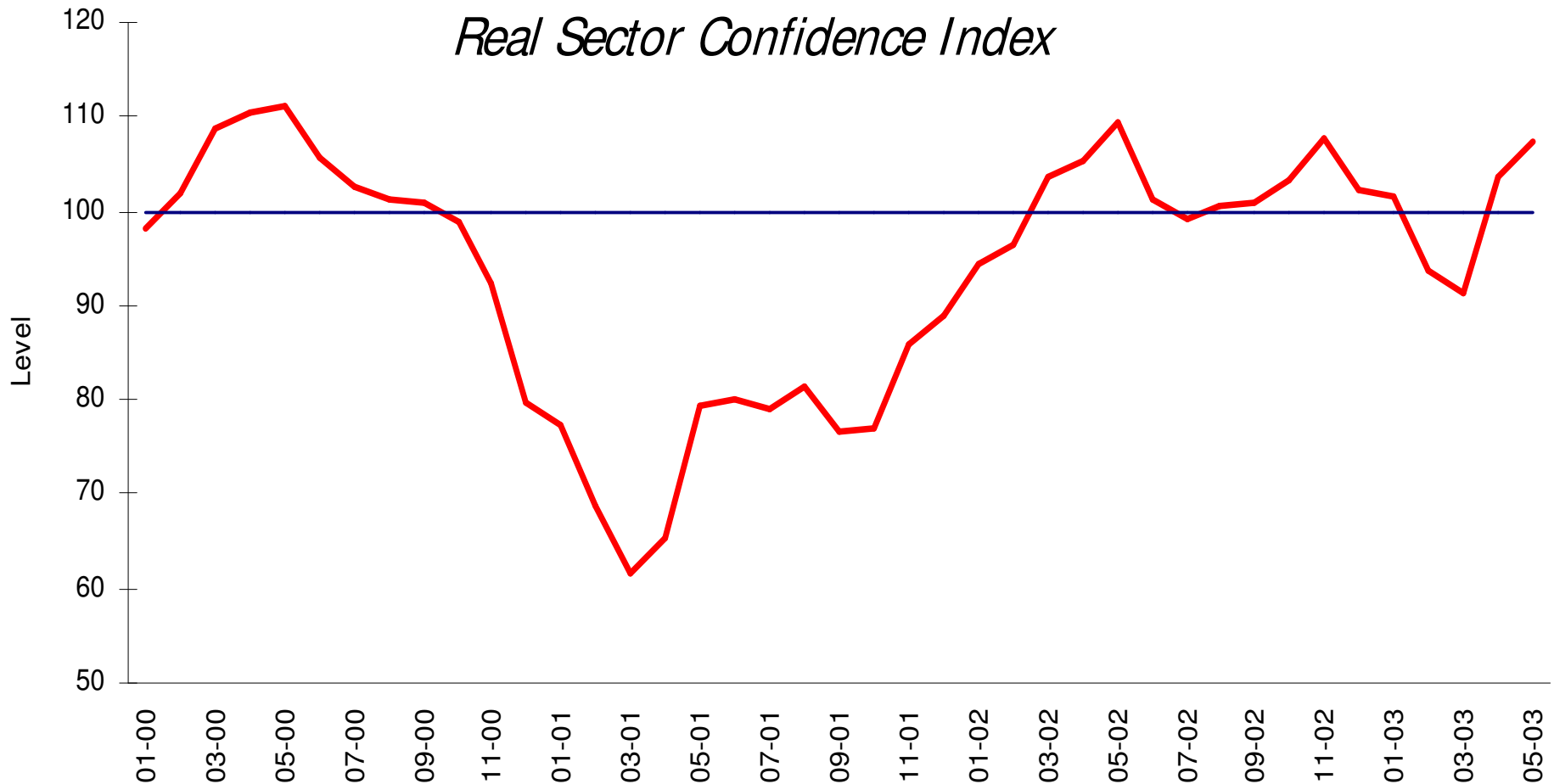
# Growth

- The industrial production index attained a robust 4.2 percent yoy growth in April 2003, albeit at a slower pace due to the strong base year effect.
- Also, seasonally adjusted industrial production index continued its increasing trend this year.



# Growth

- Real Sector Confidence Index indicates a substantial hike starting from March 2003 and reaches the highest value for the last six months in May.



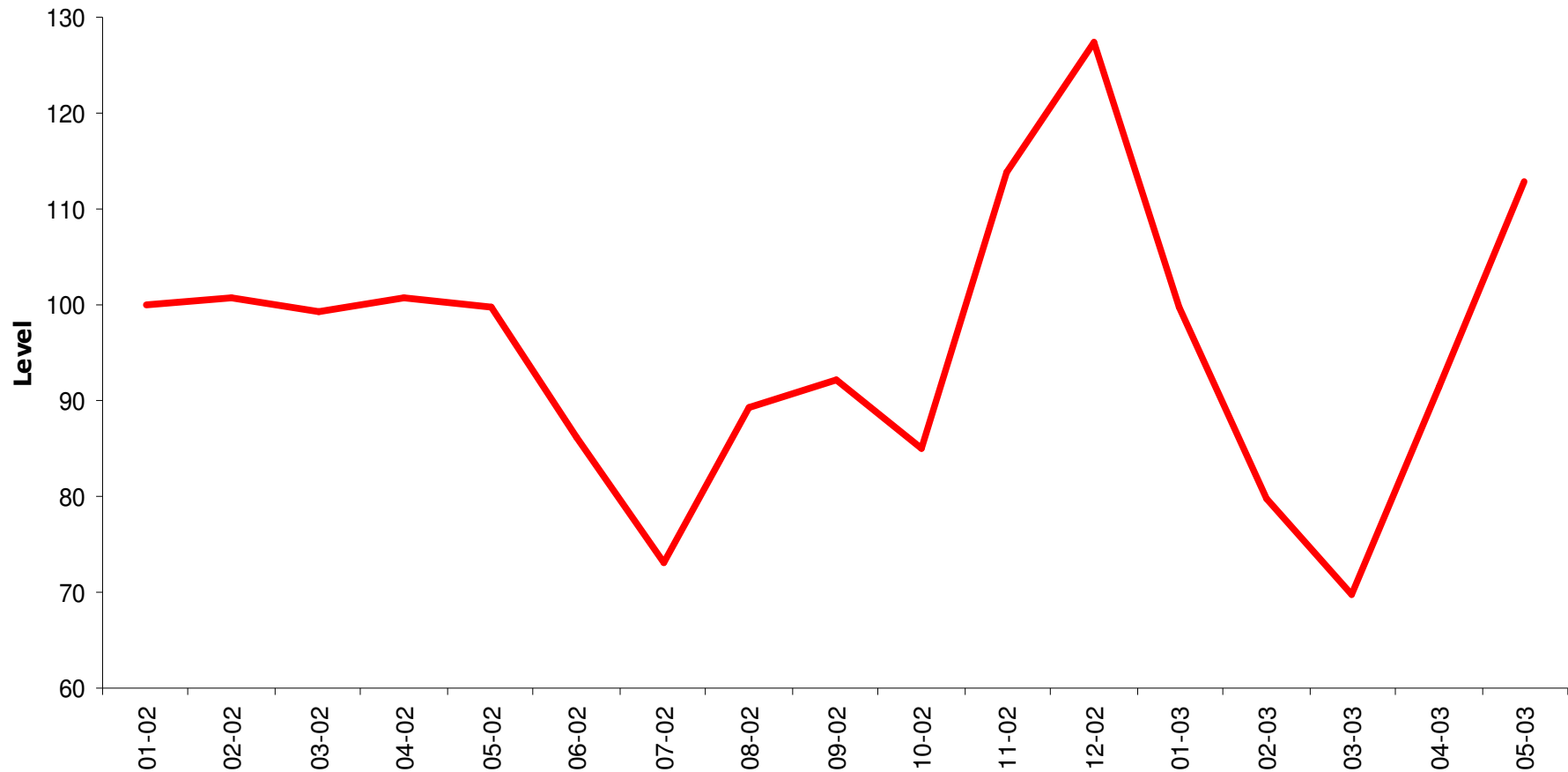
Real Sector Confidence Index = Expectations on (Business climate + export facilities + investment spending + total orders + inventory of finished goods + total employment + production volume + volume of goods sold to domestic market + raw materials inventory tendency).

When the index goes up above 100, we understand that expectations have turned positive, when it goes down below 100, it means that expectations have turned negative. Source: CBT

# Growth

- Consumer Confidence Index shows a similar trend, pointing to a sharp rise in the last two months. The value of the index in May is the second highest since the elections.

*Consumer Confidence Index*



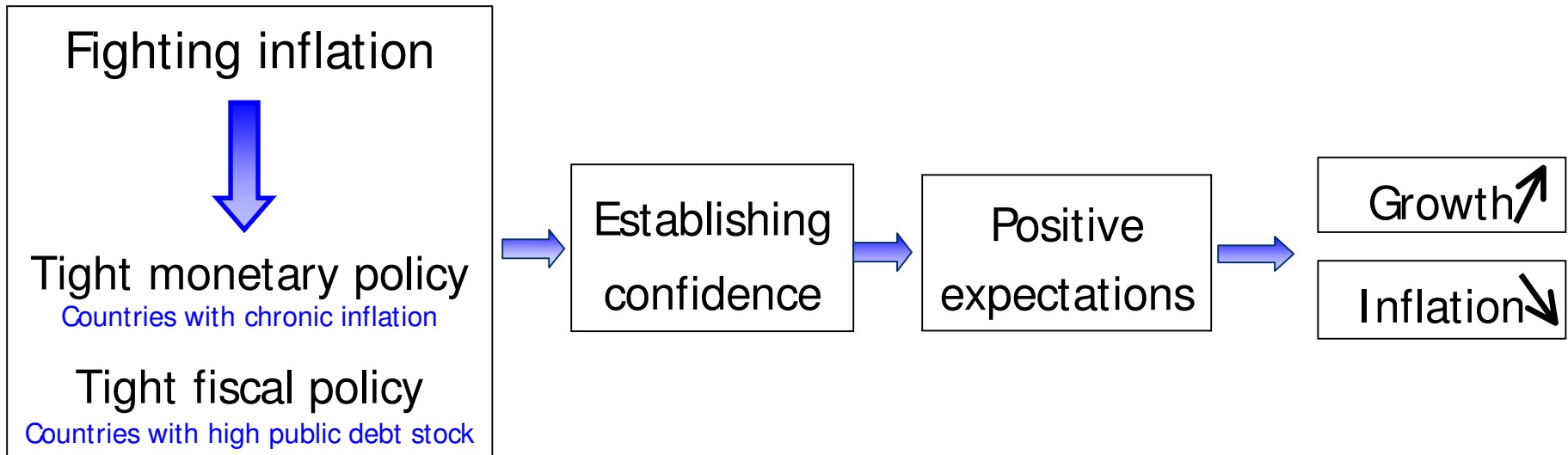
Source: CNBC-E



# INFLATION



# Inflation



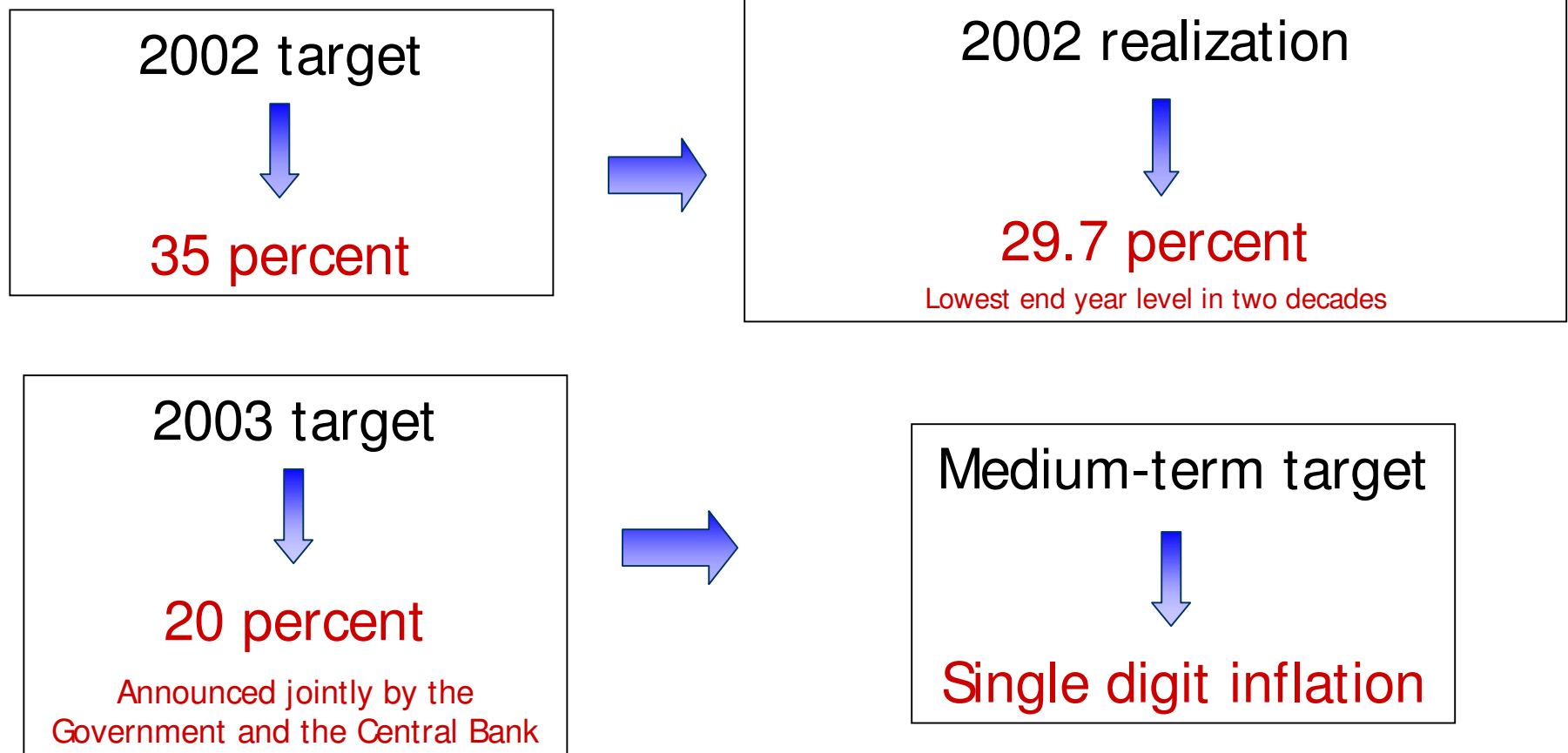
- **Although 3 % growth was not seen possible in the beginning of 2002, 7.8 % was achieved.**

- **Today, it is generally accepted that price stability is a sine qua non of Turkey's economic stability.**

# Inflation

- The **primary objective** of the Central Bank is to achieve and maintain **price stability**.
- **Financial stability** is our **auxiliary objective** due to its effect on inflation.

Role of floating exchange rate regime?



# Inflation - 2003

## ● What happened in the first three months?

- ✓ Food prices ↗
- ✓ Public sector prices ↗
- ✓ Oil prices ↗
- ✓ Cost-push effects of exchange rate ↗



Inflation expectations deteriorated. Monthly inflation rates were above program estimates and market expectations.

## ● April inflation

- ✓ Cost pressures ↘



Inflation rate was **quite below the expectations.**

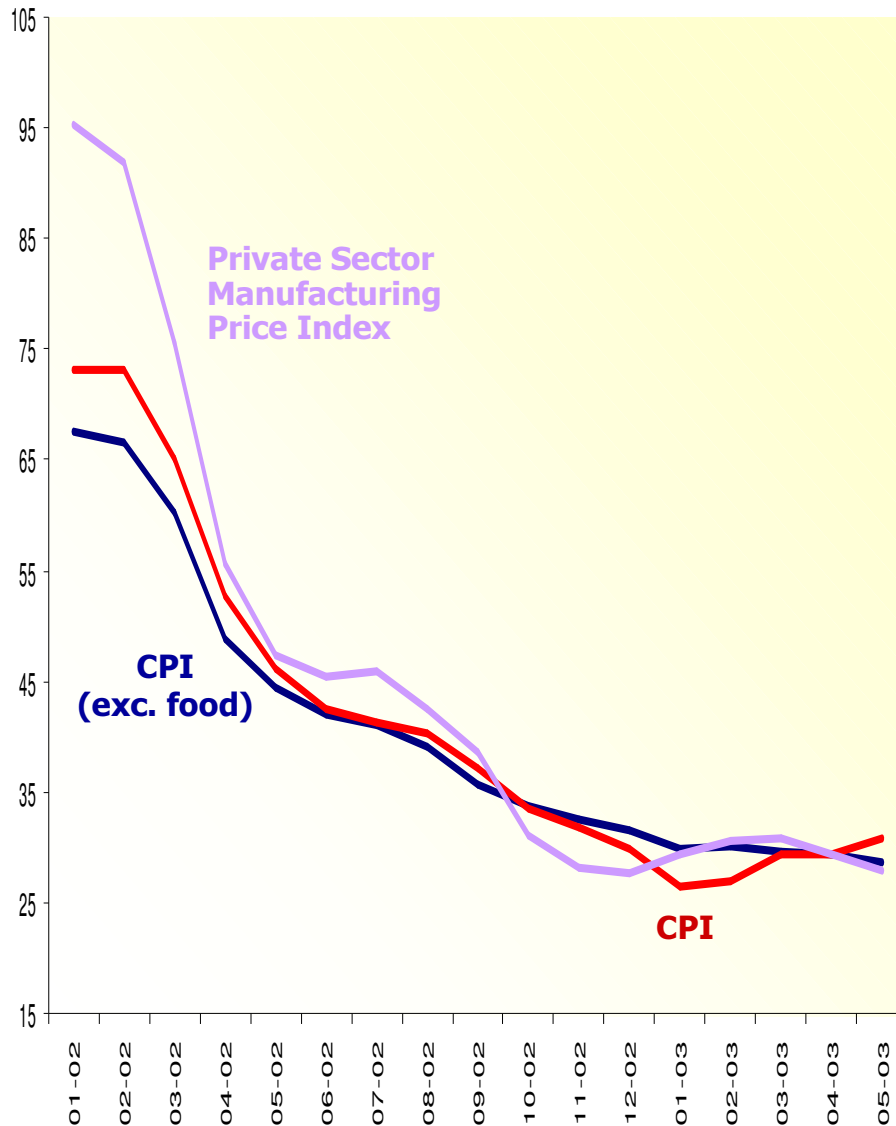
## ● May inflation

- ✓ Cost pressures are still low
- ✓ Confidence and positive expectations ↗



Inflation rate was **in line with the expectations.**

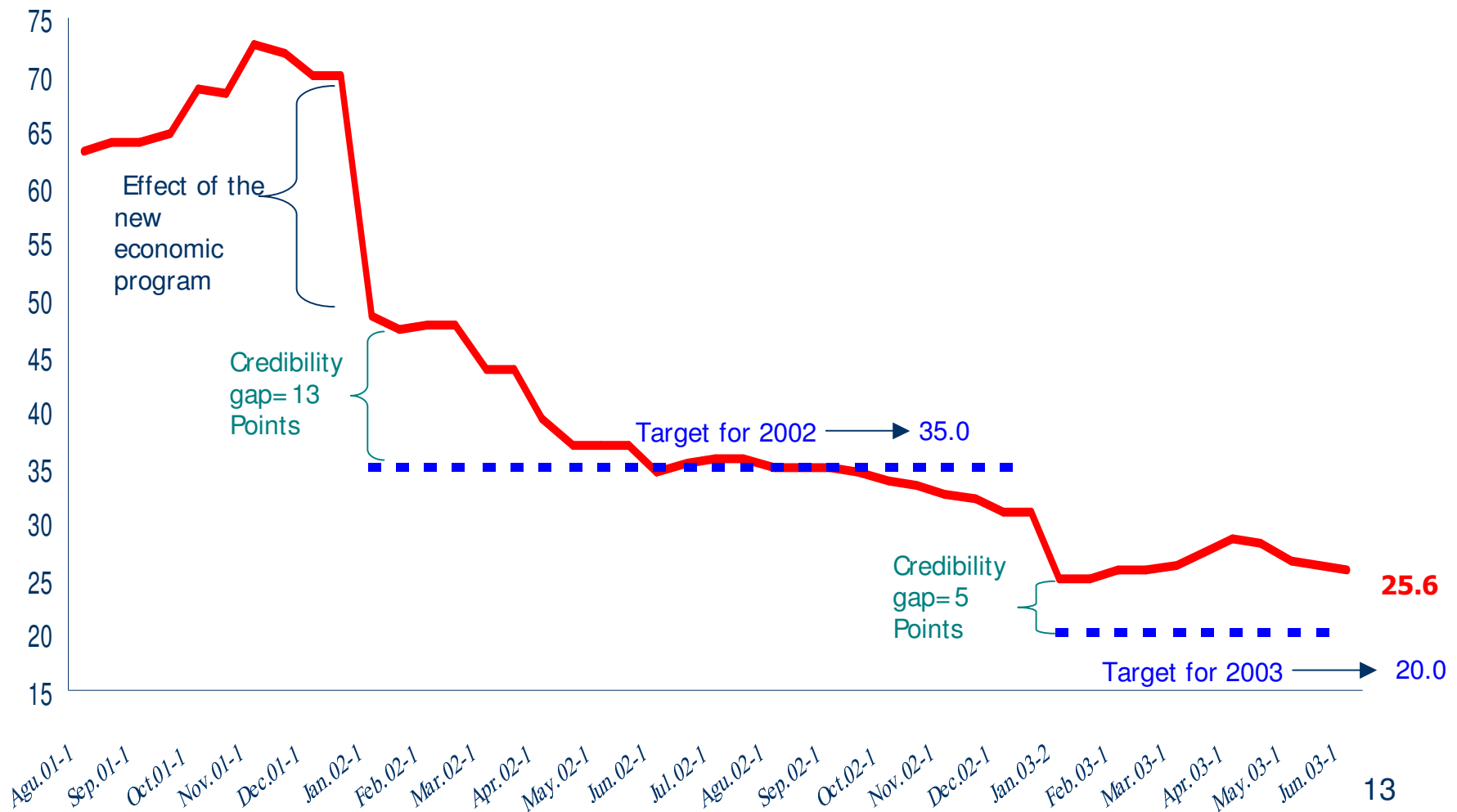
# Inflation - 2003



- ✓ The CPI showed a **limited increase** of 1.6 percent in May due to the rise in food and clothing prices. This was quite in line with the expectations.
- ✓ The CPI excluding food prices indicates a continuing decline, largely consistent with the program.
- ✓ The CPI registered a cumulative increase of 12.2 percent in the first five months of the year, whereas the **CPI excluding food prices rose by 9.4 percent.**
- ✓ Private sector manufacturing price inflation also shows a continuing deceleration in the underlying inflation rate.
- ✓ The increase in private sector manufacturing prices is only **0.3 percent**, which is **the lowest since 1994.**
- ✓ **The WPI** recorded a **decline of 0.6 percent**, which is a deflationary reading for the first time **since June 1987.**

# Year-End Inflation Expectations (Consumer Prices)

- The credibility gap, was 13 points when the inflation target was 35 percent.
- It declined to 5 percent with an inflation target of 20 percent.
- It is observed that the inflation expectations gradually converge towards the inflation target.



# Inflation – Outlook

## The future course of inflation depends mainly on:

- ✓ Putting fiscal policy back on track by means of extra measures in the 2003 budget,
- ✓ **Continuing with the structural reforms** with determination,
- ✓ Ease of past **indexation** in the economy,
- ✓ **Incomes policies** and **public sector price adjustments** in accordance with the **inflation target**,
- ✓ The avoidance of private sector's **opportunistic attitude, in terms of increasing their profit margins**, which can be observed in case of a possible **increase in domestic demand**, following the ease of uncertainty and the increase in confidence.

## Inflation target of 20 % can be achieved:

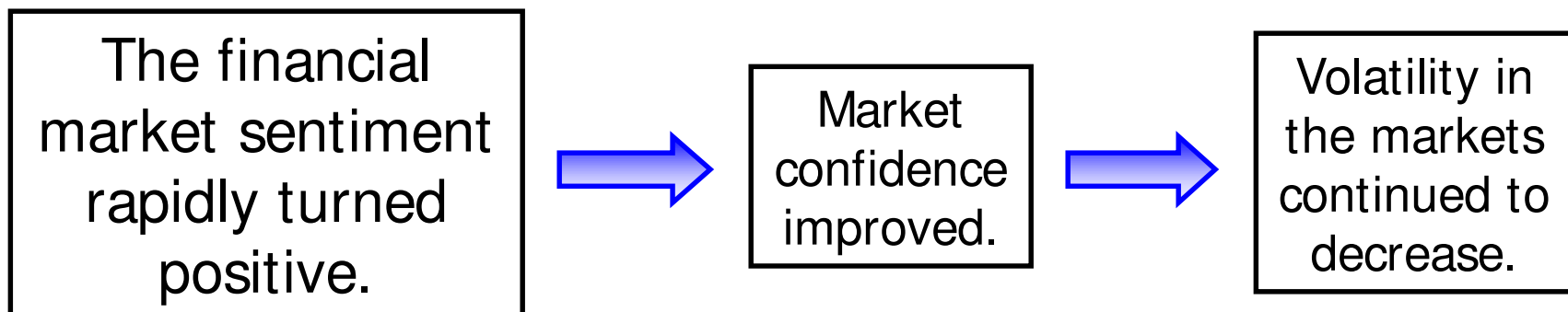
- Substantial decline will be observed in the second half of the year (base effect).
- Increase in food prices is a risk but, agricultural prices are encouraging.
- But, oil prices are always a risk factor for the target.



# MARKET OVERVIEW

# Market Overview

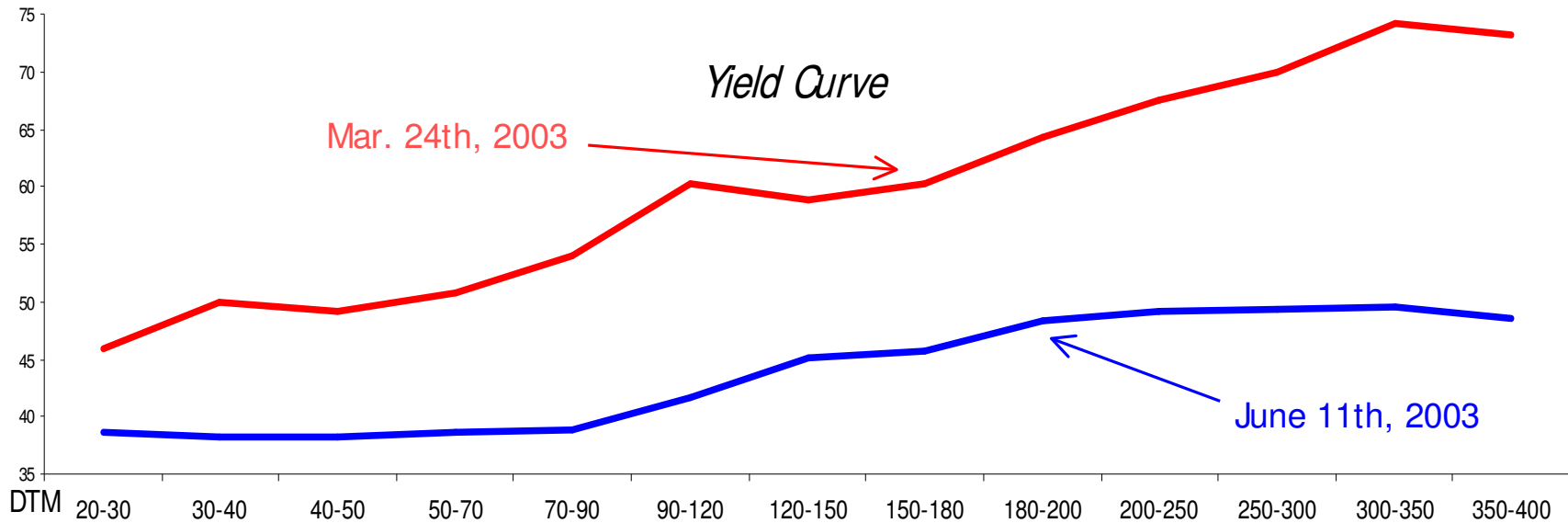
- Strict implementation of tight monetary policy,
- Efforts to put fiscal policy back on track,
- Stronger economic fundamentals; exports, IPI, CUR, inflation;
- The CBT's measures to sustain banking and financial stability,
- End of the Iraq war;



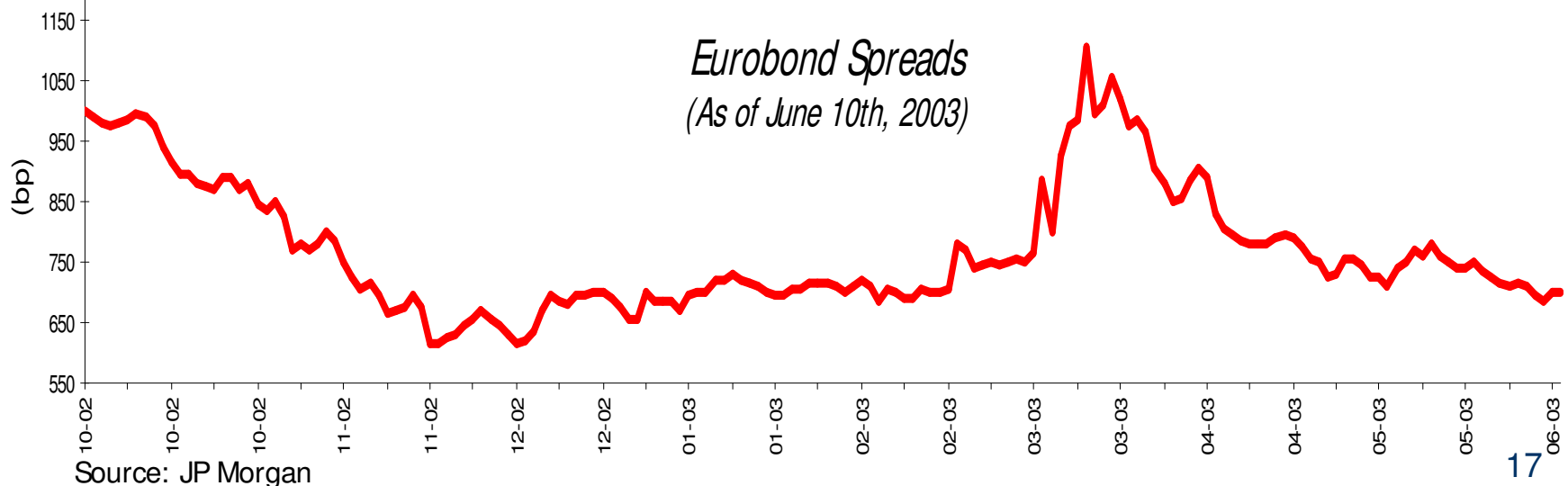


# Market Overview

- With the decline of uncertainties and the fall of inflationary expectations, the yield curve has **substantially shifted downward** and **flattened out**, which shows investors' positive expectations for the future course of the Turkish economy.

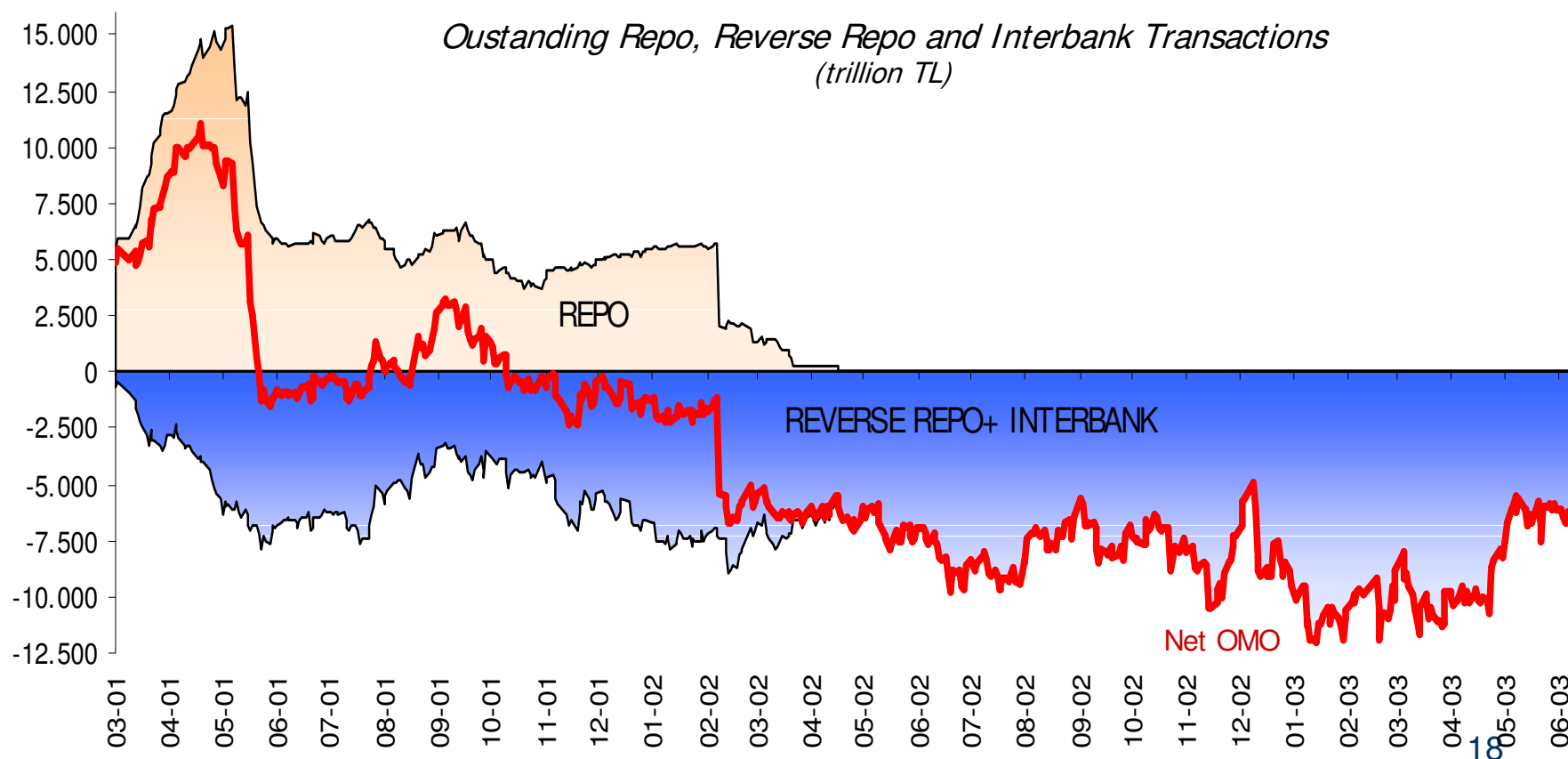


- The positive economic momentum we have seen since early April also manifests itself in the **decline in the Eurobond spreads'** to 700 bp, from a year high of 1103 bp in March.



# Market Overview

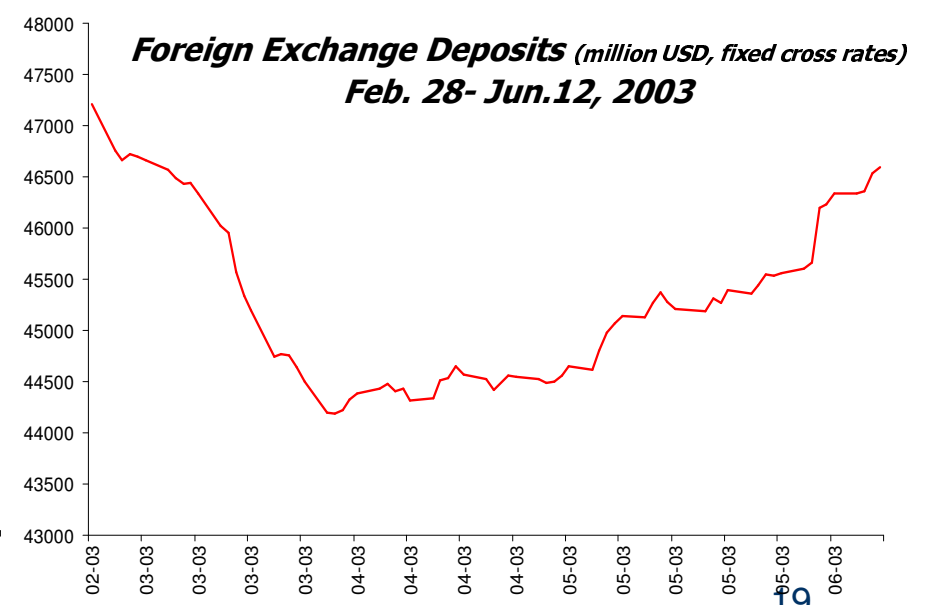
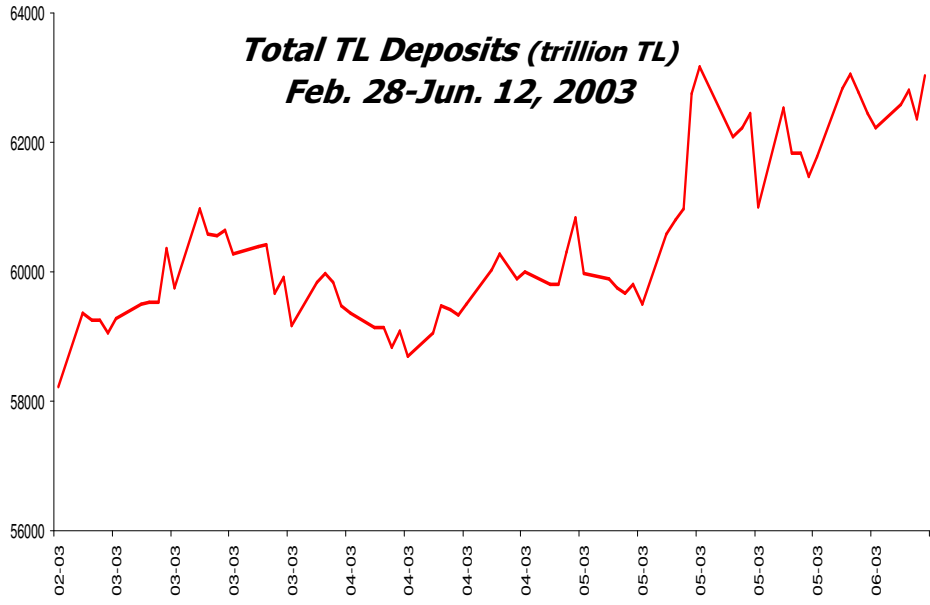
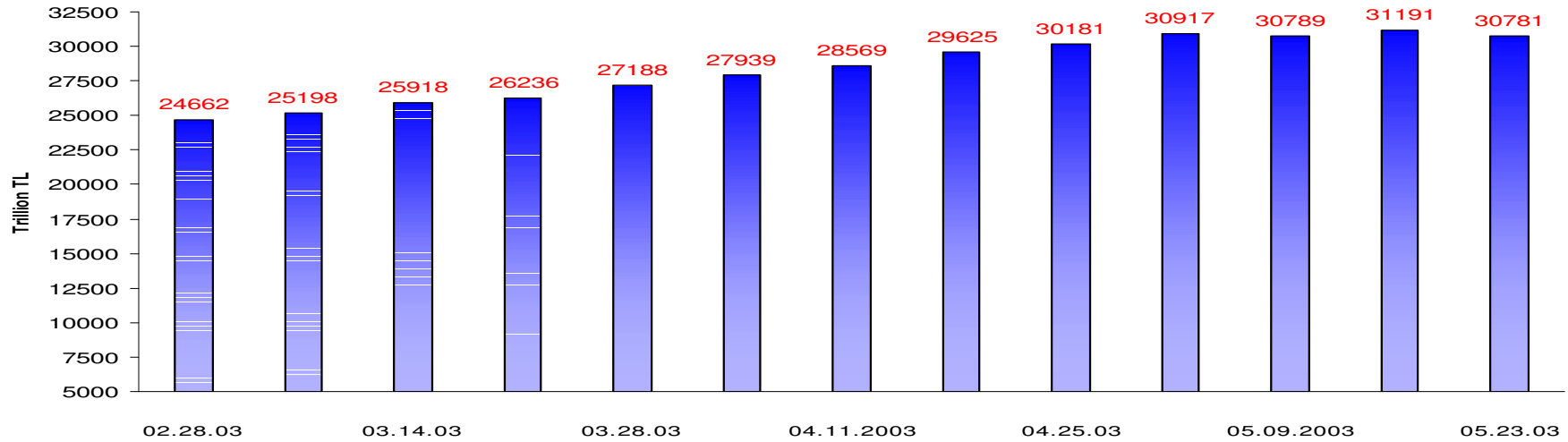
- As of the end of May, the amount of excess liquidity in TL market declined by about 32 % yoy in real terms due to Treasury's high roll-over ratio and tax payments.
- The CBT will continue to withdraw excess liquidity through TL deposit auctions in the Interbank Money Market and reverse repos at the ISE, Repo – Reverse Repo Market under the open market operations.



# Market Overview

- Individuals increased government debt securities holding in their portfolios.
- Forex banknotes that were withdrawn from the system due to Iraqi war, turned back to the system to a large extent.

*Government Securities Held by Individuals (TL+ FX)*



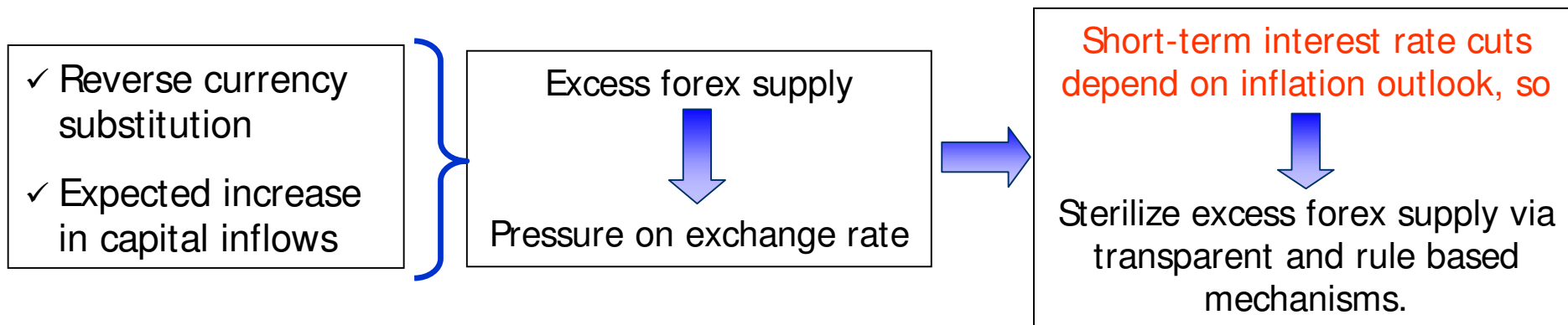
# Market Overview

## Exchange Rate Policy



### Committed to the floating exchange rate regime

- Exchange rates are determined by economic fundamentals, implementation of the program and, expectations.
- The CBT could **only intervene** in the foreign exchange market to dampen **excessive volatility** in both sides in a transparent way, if it poses danger to price stability.
- Interventions may be made also in the form of warnings, announcements and controls.

The appreciation of the Turkish lira in fact is the natural outcome of the increasing confidence in the current program implementation.



- In order to strengthen the international reserves, the CBT reintroduced foreign exchange purchase auctions on the 6th of May, taking into account the developments in the areas of balance of payments and reverse currency substitution:

✓ USD 20 million per day,  Then, USD 30 million,  No longer maximum bid price.  
USD 2.7 bio till the end of August

# Market Overview

## Exchange Rate Policy

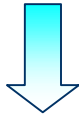
- Why doesn't the CBT declare appropriate level of the exchange rate?
- Does the CBT intentionally keep the exchange rate level high?
- Doesn't the CBT care about stability of the foreign exchange rate?



# **CBT SHORT-TERM INTEREST RATES**

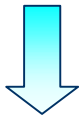
# CBT Short-Term Interest Rates

Main instrument



Short-term interest rates

Decisions are based on



Inflation outlook only

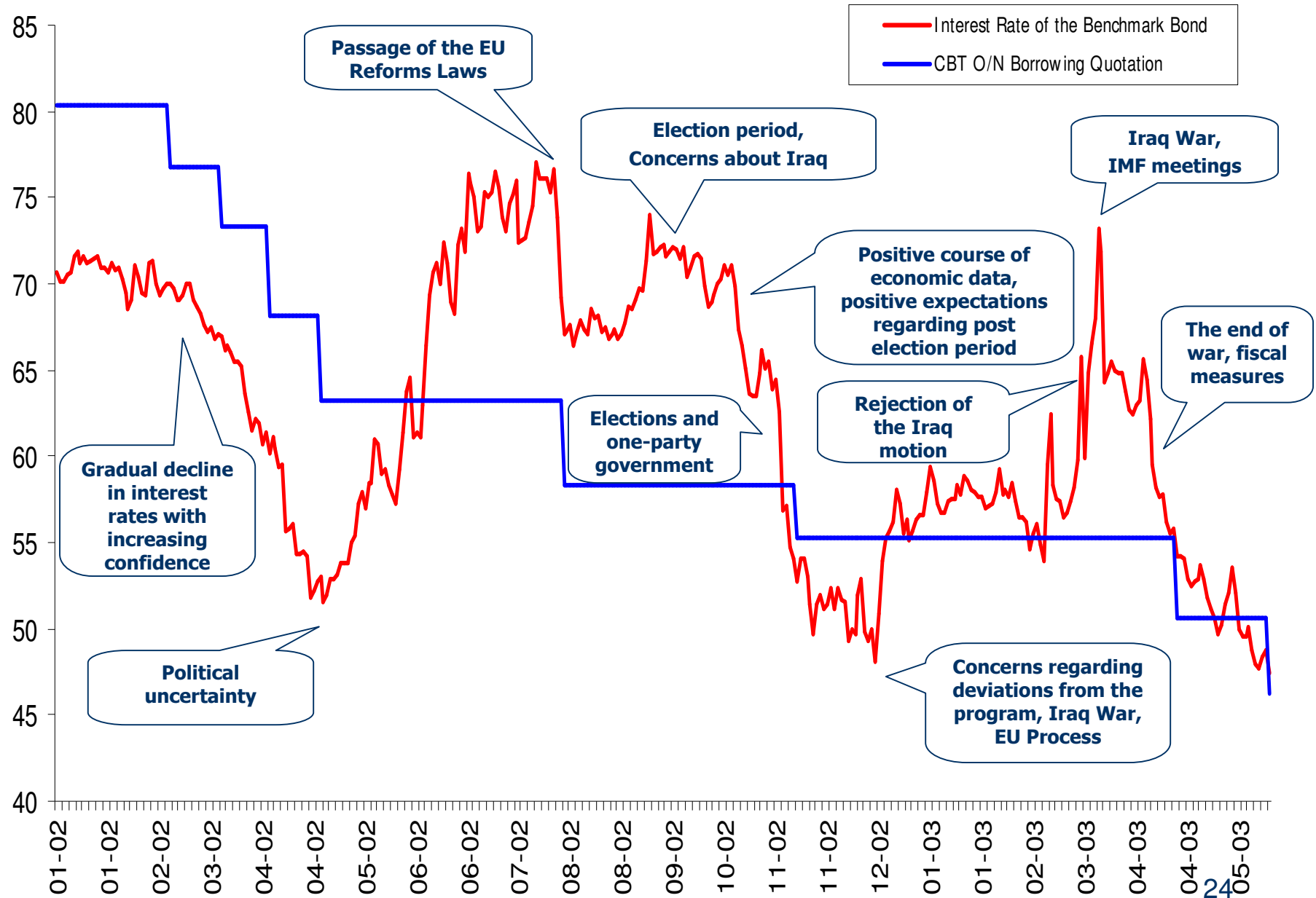
- The CBT adjusts short-term interest rates by looking at whether the future trend of inflation is compatible with the inflation target.
- Market pressures? Political pressures?

Indicators to forecast future inflation:

- ✓ Surveys on inflation expectations and CBT's internal inflation forecasts,
- ✓ Price-setting behavior of the public and private sectors,
- ✓ Exchange rates and balance of payments position,
- ✓ Wages, employment and unit labor costs,
- ✓ Aggregate demand and supply,
  - ❖ Fiscal policy indicators,
  - ❖ Monetary and credit aggregates,
- ✓ International economic and political environment.

# Inflation and Interest Rates

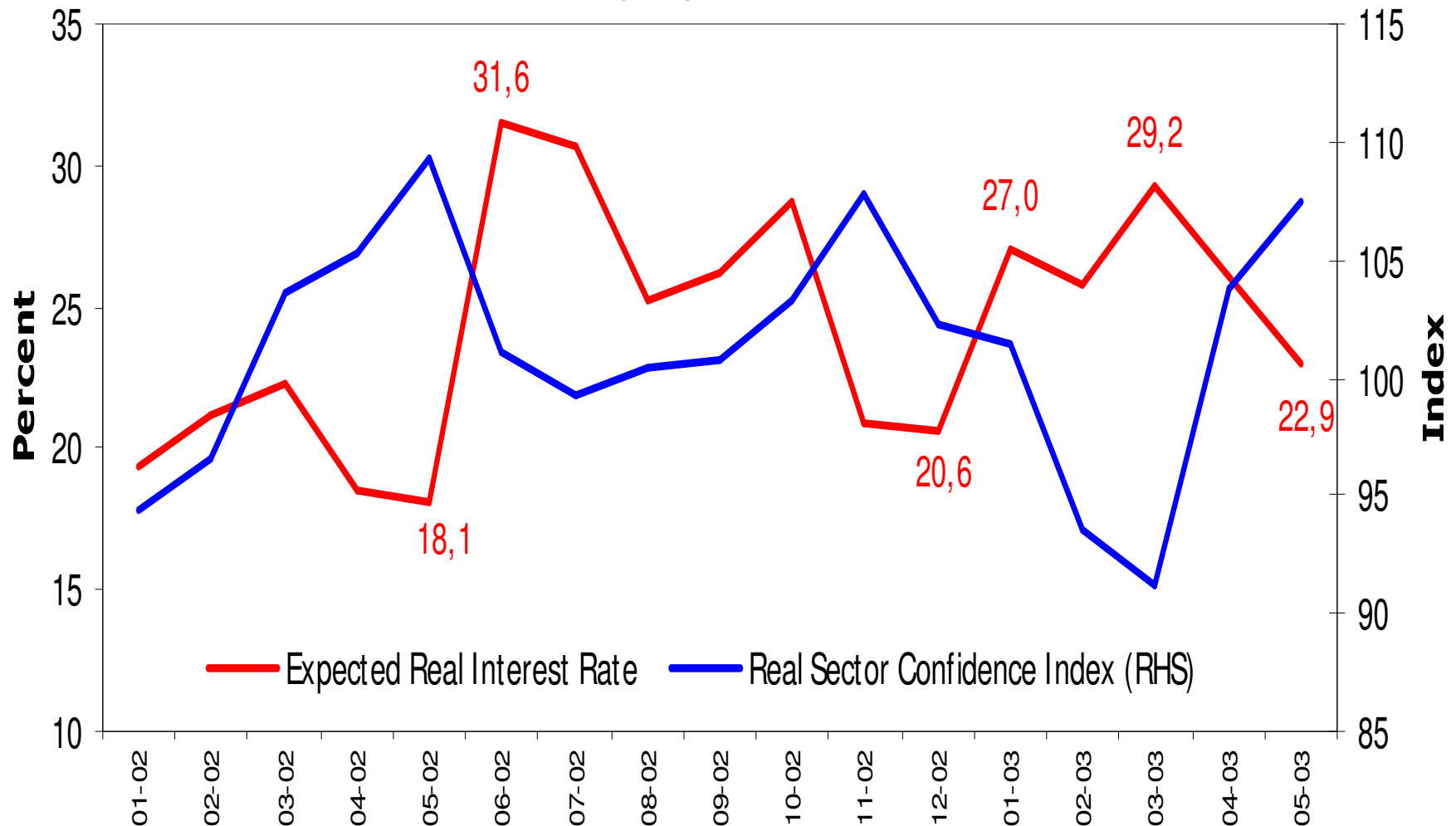
*CBT Short-term Interest Rates and Secondary Market Interest Rates of The Benchmark Bond*





# Expected Real Interest Rates and RSCI

- There is a strong negative relation between expected real interest rates and RSCI. At times when expectations of economic agents are positive, real interest rates fall, and when the confidence is lost, real interest rates go up.



$$R = \left( \frac{1+i}{1+\pi} \right) - 1$$

R = Expected real interest rate (**ex-ante**), i = Nominal monthly borrowing rate of Treasury, π = Inflation expectations for the next 12 months as stated in the CBT Expectation Survey.

# Monetary Policy in the Future

- Formal inflation targeting will be adopted when conditions allow:
  - ✓ Favorable internal environment
    - ❖ Sustained fiscal discipline
    - ❖ Reduction in backward looking indexation
    - ❖ Supportive incomes policy
  - ✓ Favorable external environment
- The Central Bank completed institutional and technical preparations for formal inflation targeting:
  - ✓ Strengthening economic databases and reporting packages
  - ✓ Development of inflation forecasting systems
  - ✓ Preparation of a core quarterly macroeconomic model
  - ✓ Publications of statistics and reports
  - ✓ Additional press releases related to Monetary Policy Council meetings also will be issued



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