



CHANGING STRUCTURE OF THE TURKISH ECONOMY

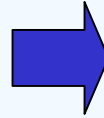
CENTRAL BANK OF TURKEY

June 2005

General Framework

In the last four years,

- Prudent macroeconomic policies,
- Structural reforms



- Falling inflation,
- Robust output growth,
- More competitive and efficient real sector,
- More stable financial markets; lower interest rates, less volatile exchange rates,
- Stronger institutions.

Change in the structure of the Turkish economy is now on an irreversible path.

Changing Dynamics

Falling Inflation:

The inflation is down to single digits.

- In 2002, 2003 and 2004, inflation targets were attained.
- Not only inflation fell, but also dynamics of inflation have changed significantly.



Irreversibility of disinflation.

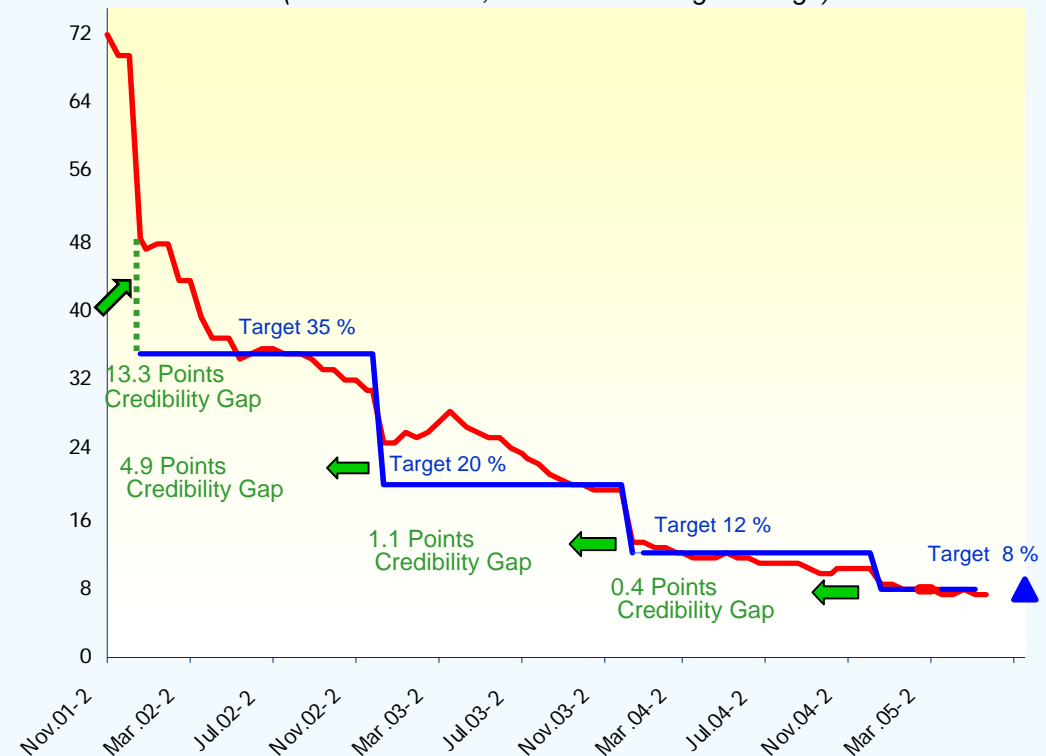
- ✓ *The Central Bank has been granted independence.*
 - *Policies gained credibility.*
 - *Inflation inertia has decreased.* →
 - *The volatility of inflation has declined.*
 - *Inflation target is now a more credible anchor.*
- ✓ *Fiscal discipline has been restored.*
- ✓ *Consumer and producer behavior are changing.*

INFLATION TARGETS AND REALIZATIONS (2002-2007)

	2002	2003	2004	2005	2006*	2007*
Target	35 %	20 %	12 %	8 %	5 %	4 %
Realization	29.7 %	18.4 %	9.32 %	May 8.70 %	-	-

YEAR END INFLATION (CPI) EXPECTATIONS

(As of June 2005, Annual Percentage Change)

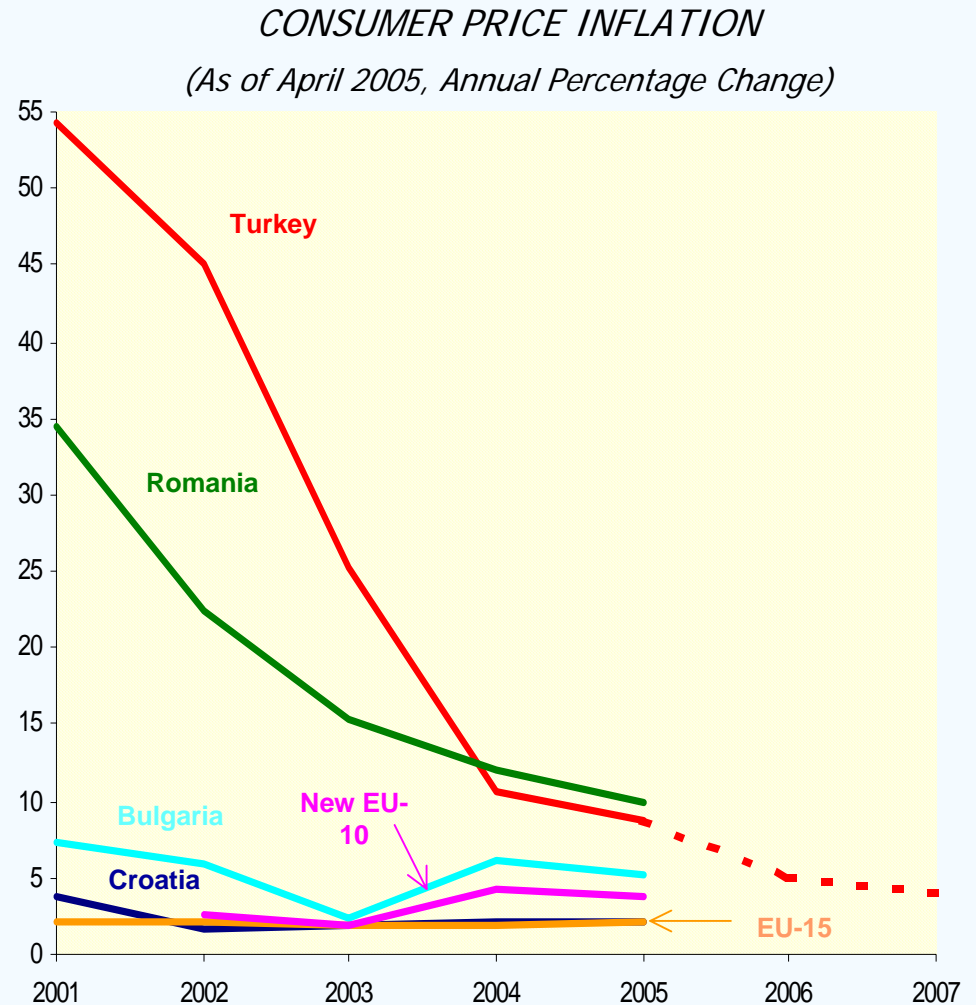


* 2006 and 2007: Program targets
Source: State Institute of Statistics (SIS), CBRT

Changing Dynamics

Falling Inflation:

- Turkey appears to be catching up with the Maastricht criterion on inflation. →
- Central Bank moves toward full-fledged inflation targeting: January 2006.
 - ✓ *Stronger and institutional commitment to targets*
 - ✓ *More institutionalized decision making process*
 - ✓ *More transparency in monetary policy*



Turkish data is as of May 2005.
Source: SIS, European Commission

Changing Dynamics

Robust Output Growth:

As inflation falls, the Turkish economy has been experiencing high growth rates since 2002.

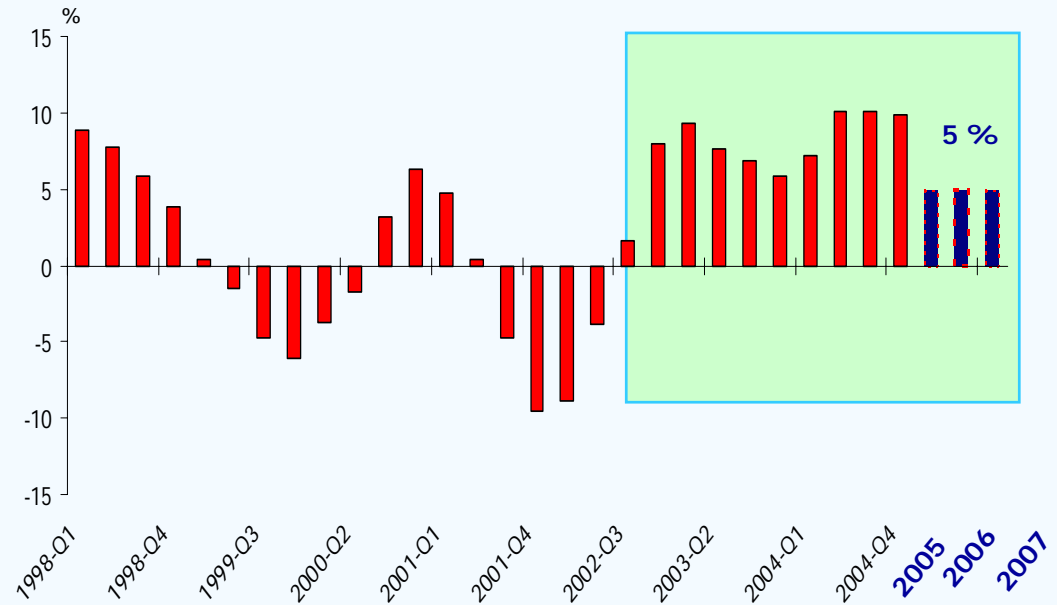
	2002	2003	2004	2005*	2006*	2007*
Growth Figures	7.9 %	5.9 %	9.9 %	5 %	5 %	5 %

- Growth in 2004: 9.9 %; one of the highest growth rates in the world. →

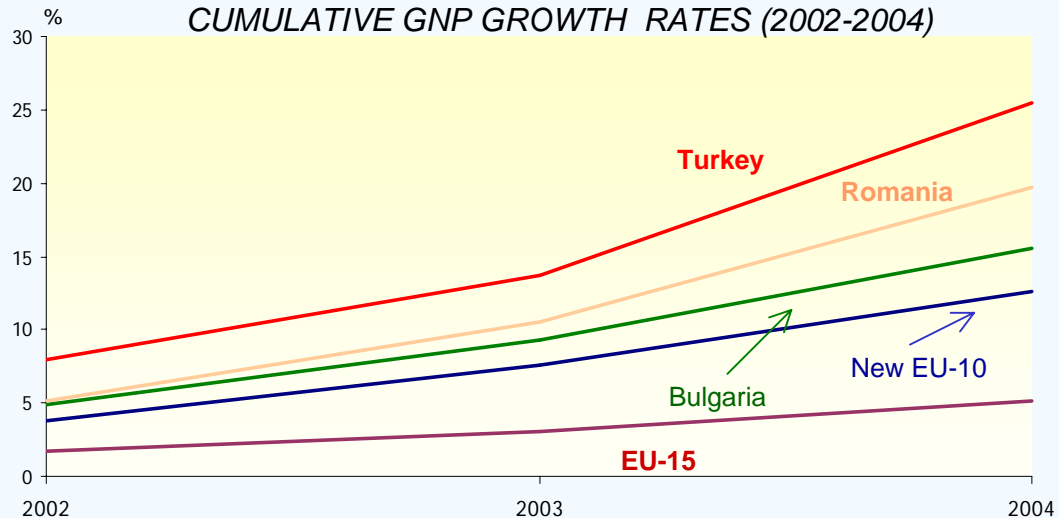
- Growth in 2002-2004: 25.5 % in real terms.

* Forecasts

GNP GROWTH RATE



CUMULATIVE GNP GROWTH RATES (2002-2004)



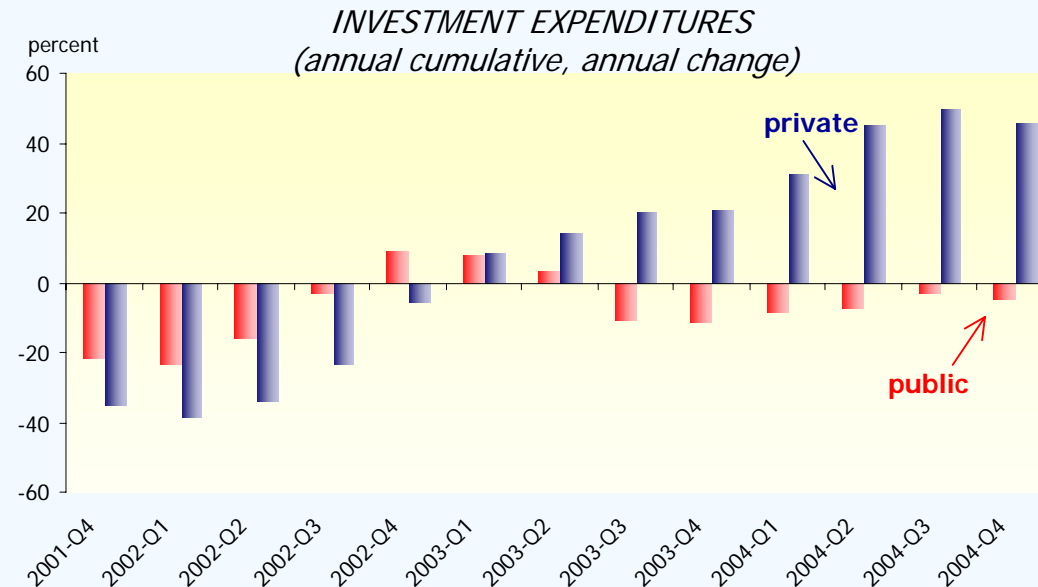
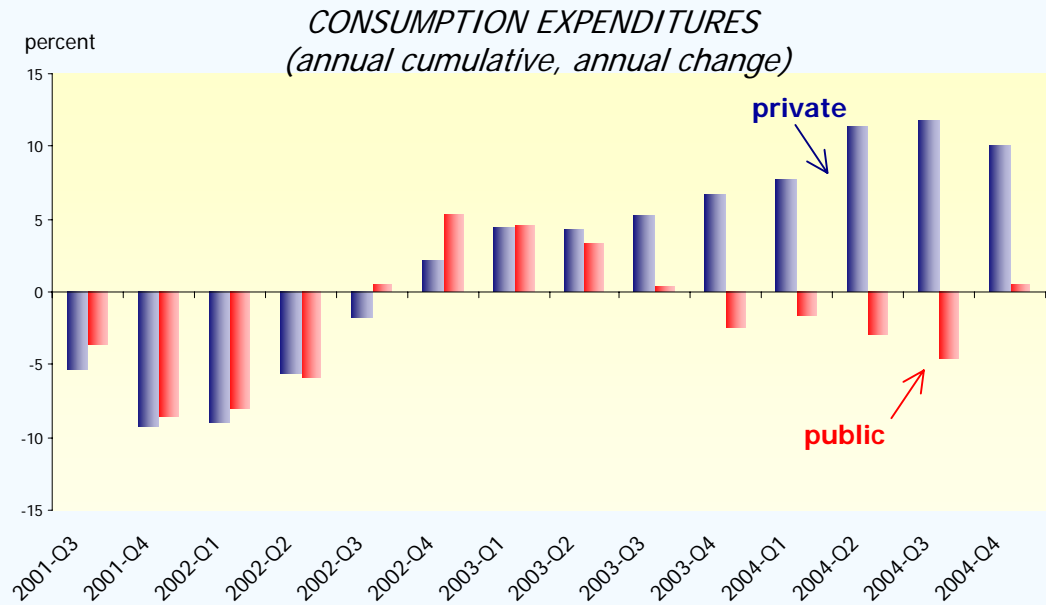
Source: World Economic Outlook and National Statistics Offices

Changing Dynamics

Changing Dynamics of Growth:

– Sources of high growth rates:

✓ *The private sector is the engine.* →



Changing Dynamics

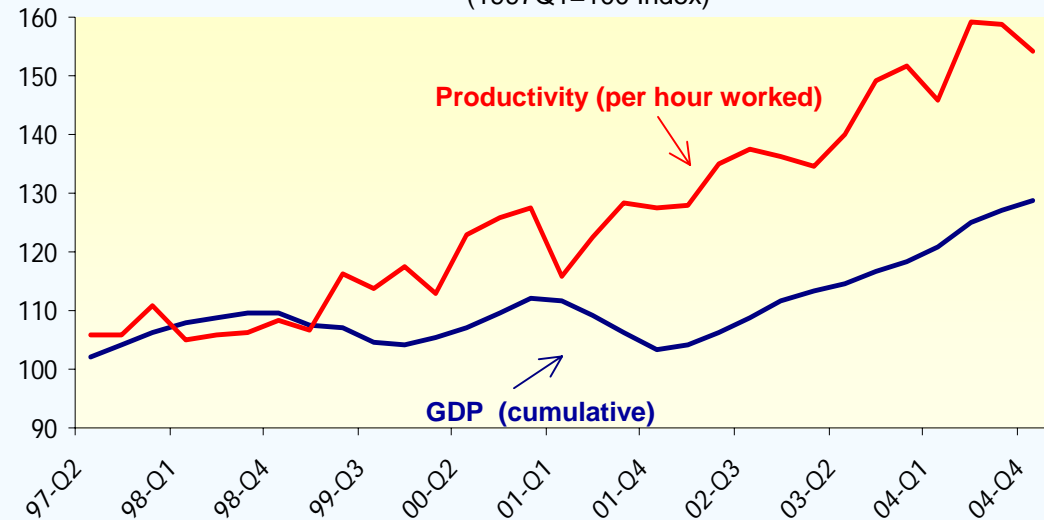
Changing Dynamics of Growth:

- Sources of high growth rates:
 - ✓ *The private sector is the engine.*
 - ✓ *The highest contribution to growth came from the productivity increase.* →
 - ✓ *Exports contributed to growth with an increasing share.* →



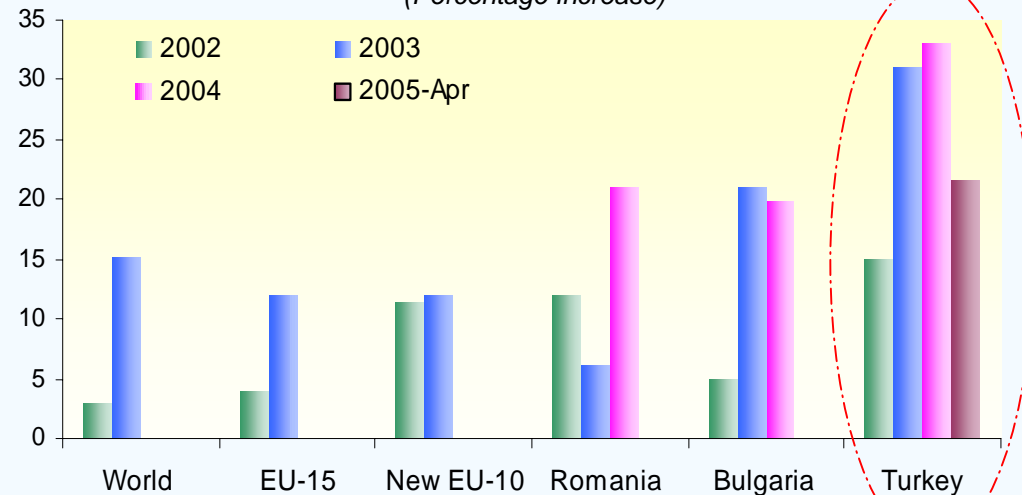
- These changing dynamics indicate a considerable economic growth potential.
- In 2005 and onwards, the Turkish economy is expected to grow at least 5 %.
- Long-run sustainable growth rate?

GROWTH AND LABOR PRODUCTIVITY
(1997Q1=100 Index)



Source: SIS

EXPORTS' GROWTH RATES
(Percentage Increase)



Source: WB; SIS

Changing Dynamics

The Turkish economy is now more integrated with the world economy, giving rise to a more competitive environment in the real sector: ➡

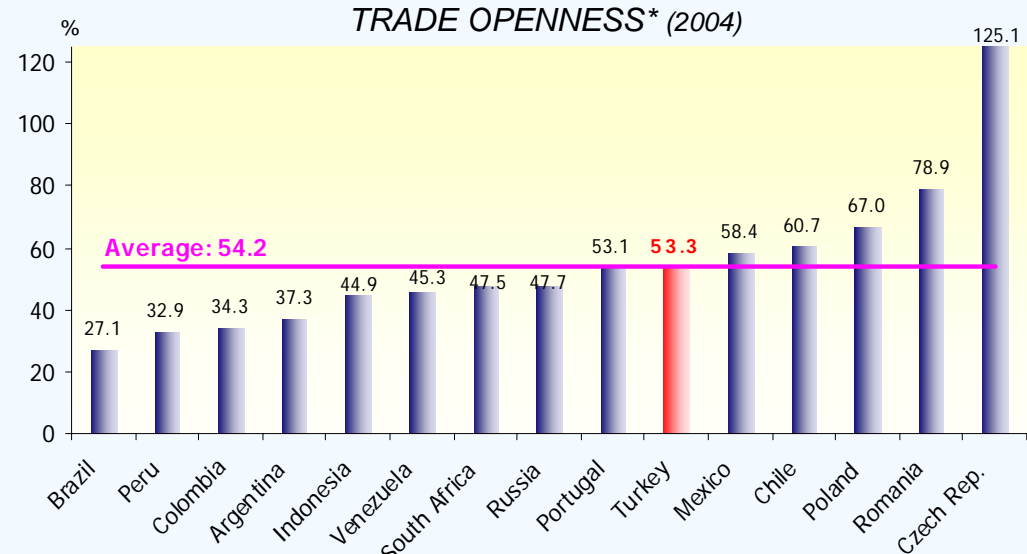
– Since 2001, Turkey's total foreign trade volume has increased by 120 % and reached USD 160 bio in 2004.

✓ *The total volume of foreign trade is expected to be USD 180 bio in 2005.*

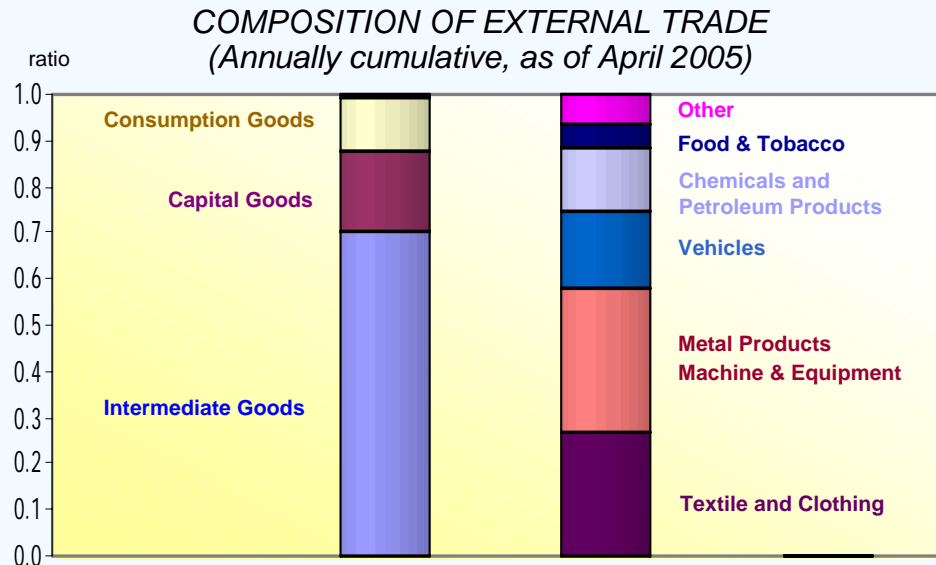
– **Imports** of intermediate and capital goods have the largest share in total imports. ➡

✓ *Imports are directed to production and exports.*

– **Exports** are well diversified and are made up mainly of finished and semi-finished industrial goods.



* Trade openness: The share of the sum of exports and imports in the GDP
Source: IMF, WTO



Source: SIS

IMPORTS

EXPORTS

Changing Dynamics

– Turkey is integrated most strongly **with the EU**, especially following the **customs union**.

✓ *Turkey is the only country that completed customs union without being a member.*

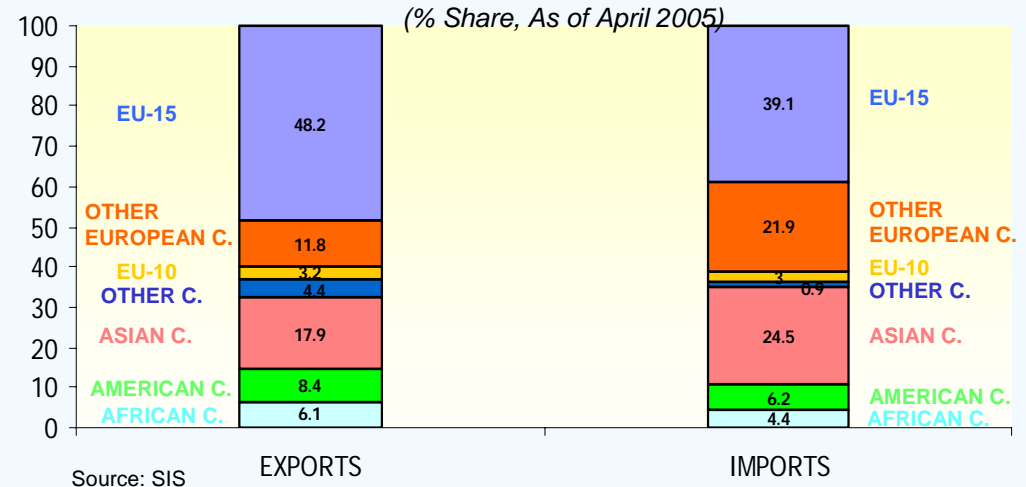
As of April 2005, Share of the EU-25 Countries in:

➤ *Total exports : 51.4 %*

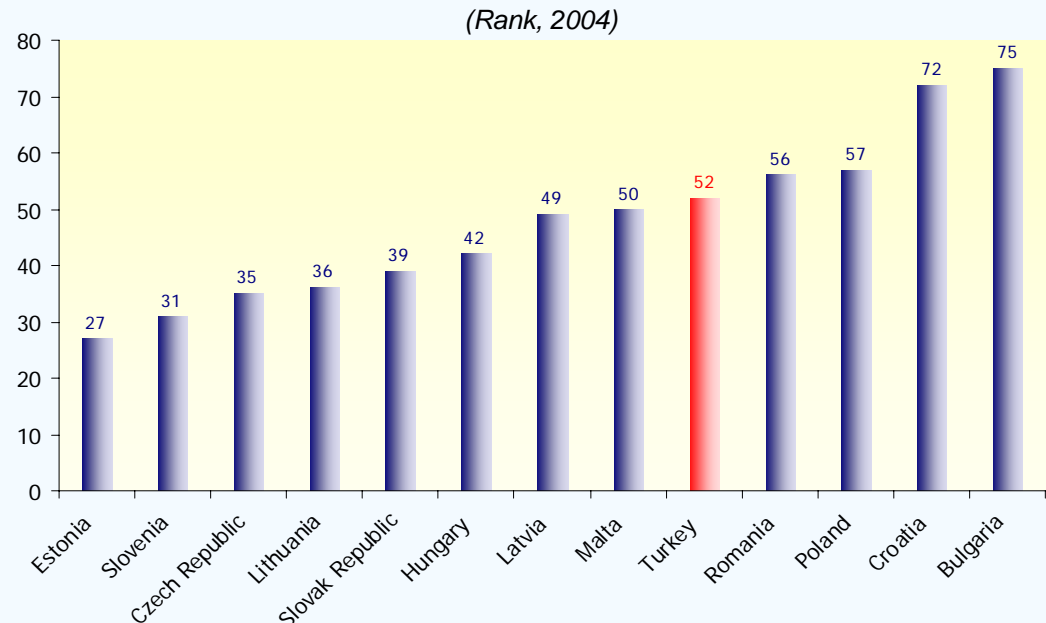
➤ *Total imports : 42.1 %*

– Thanks to high integration with the EU market, which is one of the most competitive markets, and the structural transformation process, Turkey has been improving the quality of microeconomic business environment, which is critical for national competitiveness and creation of wealth.

FOREIGN TRADE BY EUROPEAN COUNTRIES



BUSINESS COMPETITIVENESS INDEX



Changing Dynamics

Employment:

- Turkey's employment **performance is better than** most of the **new EU members and candidates.** →

- However, it doesn't totally reflect the high growth rates, because;

✓ **Jobless recovery:** *Productivity driven growth*

✓ **The public sector is no longer creating new jobs.**

✓ **And there are structural difficulties:**

➢ *Demographic transition period: Increase in the share of working age group in whole population.*

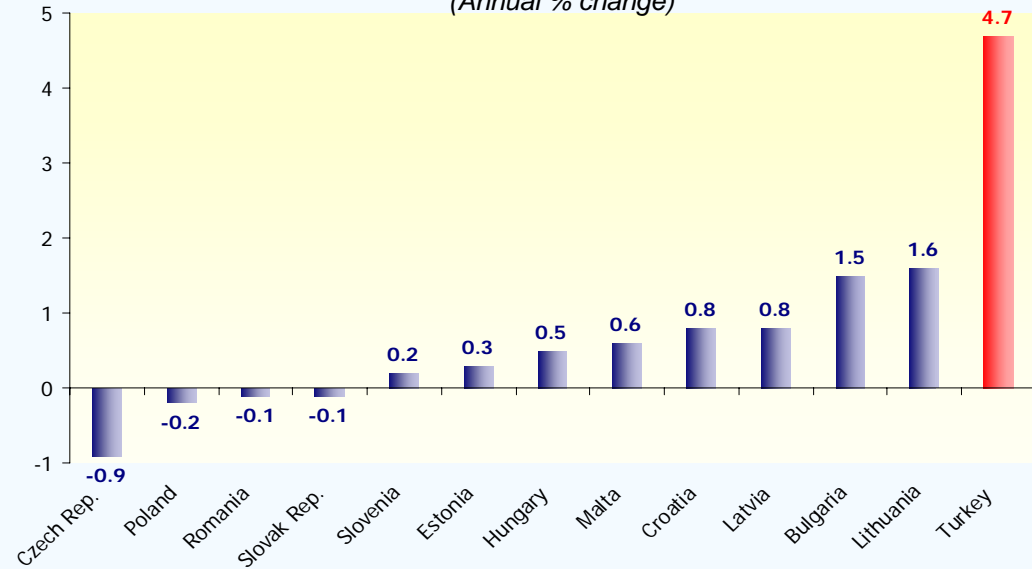
➢ *Lower participation rates, especially for women.*

➢ *Sectoral composition is changing: Transition from agricultural sector to industrial and services sectors.*

- Turkey's young and dynamic demographic structure supports **easier transfer between sectors** and improvement in sectoral dispersion of employment. →

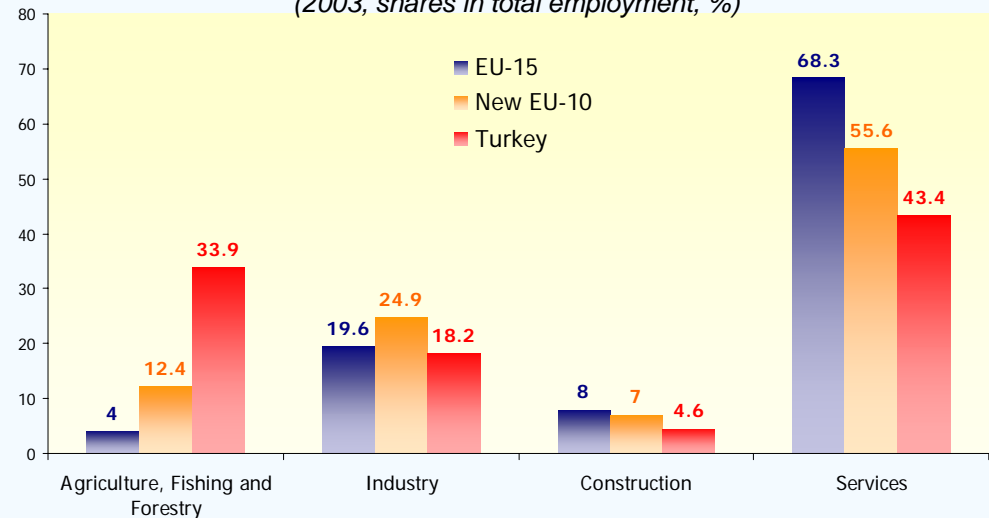
- Labor market oriented regulations intended to **reduce the size of unregistered economy, educational policies** and **FDI inflows** will contribute to the achievement of **sustainable increases in employment.**

EMPLOYMENT-2004*
(Annual % change)



Source: European Commission forecasts. * Turkish data is for 2005 Q1

SECTORAL EMPLOYMENT STRUCTURE
(2003, shares in total employment, %)



Source: Eurostat, Employment in Europe 2004, SIS

Changing Dynamics

Current Account:

2004;

	Estimate	Realization
Growth	5 %	9.9 %
Current Account / GNP	Btw. - 3 % and -3.5 %	- 5.1 %

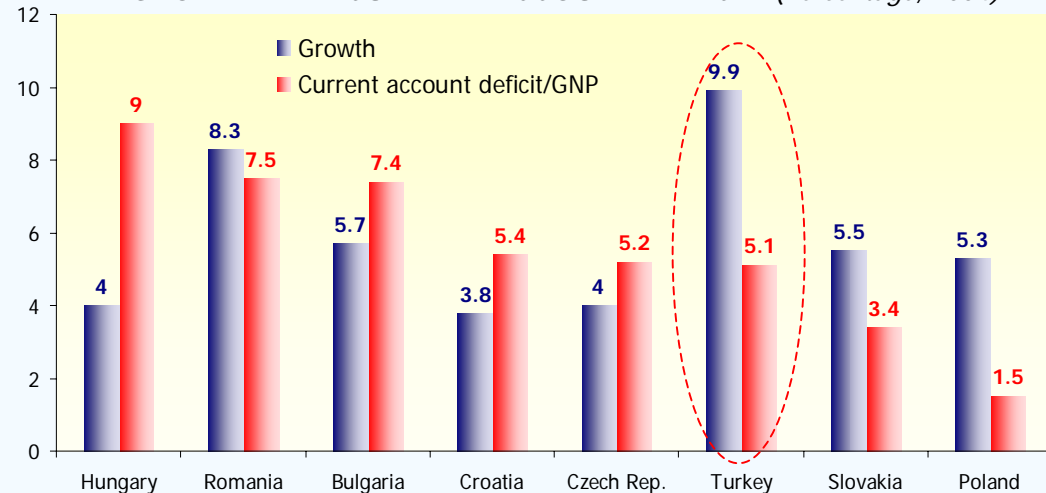
This deficit is sustainable, because:

1- The driving forces of the current account have changed significantly:

- **Before 2001**, because of loose fiscal policies and rising budget deficit, total domestic savings declined and total domestic investment fell. →

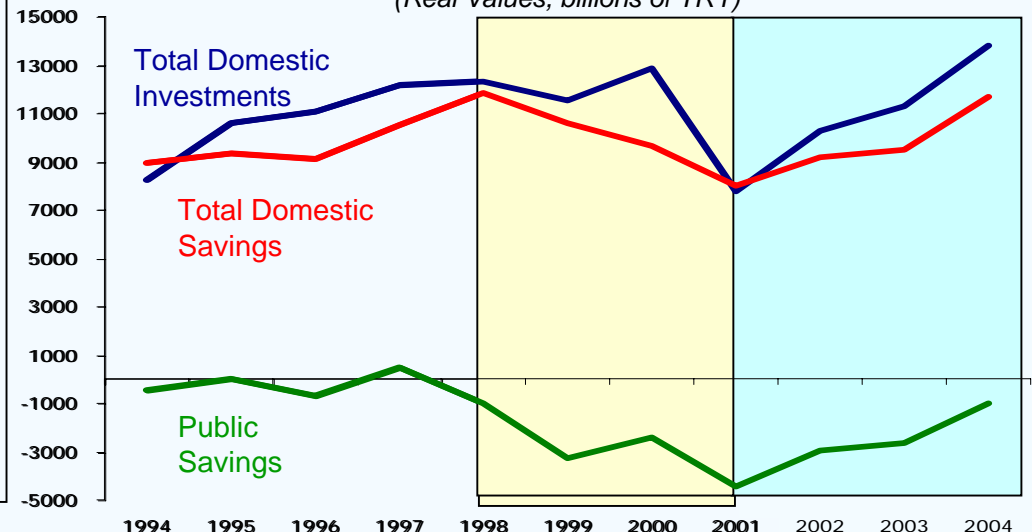
- **But today**, both domestic savings and investment are increasing mainly due to tight fiscal policy, better macro indicators and good market sentiment, the cause of the current deficit today is larger increase in investment than in savings. →

GROWTH AND CURRENT ACCOUNT DEFICIT (Percentage, 2004)



Source: IMF

TOTAL DOMESTIC INVESTMENT AND TOTAL DOMESTIC SAVINGS (Real Values, billions of TRY)



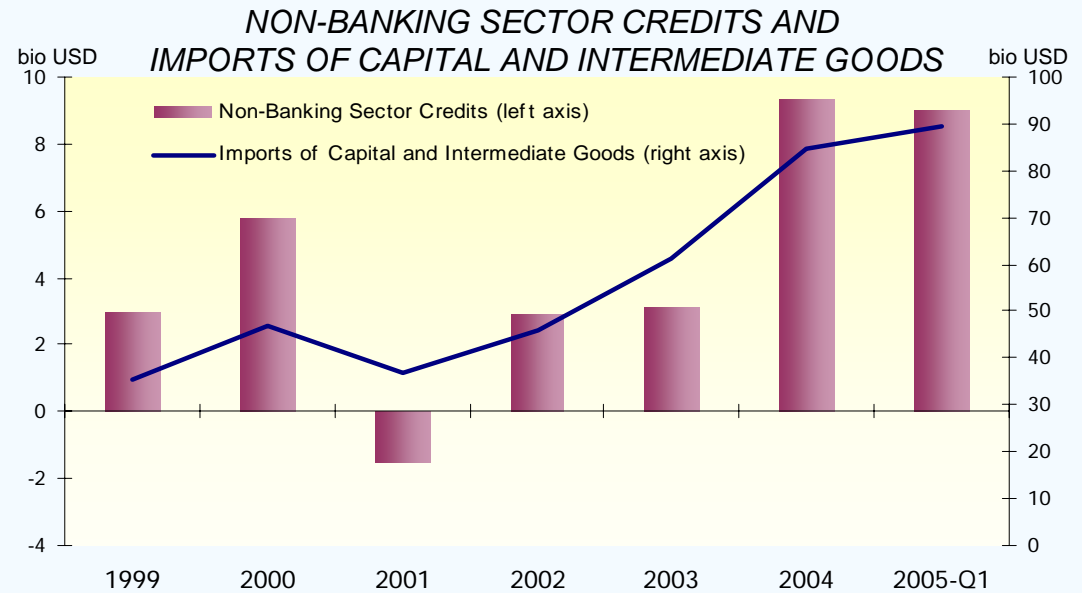
Source: SIS, CBRT

Changing Dynamics

2- Composition of the capital account is changing:

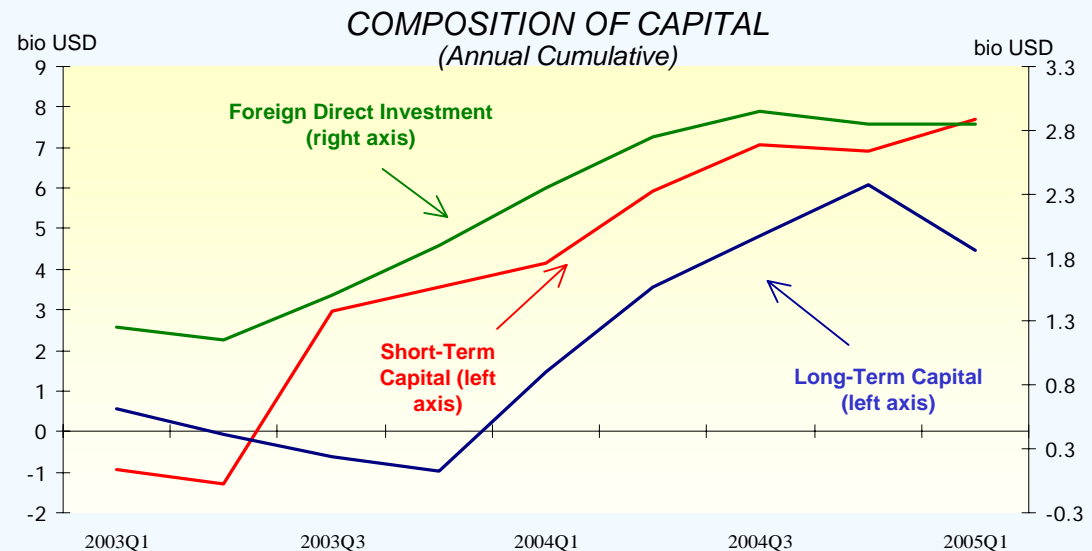
- In 2005 Q1, except the IMF credit and the changes in reserves, USD 22.2 billion of net capital inflows.

- The main factor is the substantial increase in **credit utilization of the non-banking sector**; 34 % of total inflows. →
- The share of **long-term capital*** has been rising. →
- **Foreign direct investment** finally begins to increase, and it is expected to increase further.
- **Short-term capital**** inflows increased mainly because of the short-term banking sector credits. As the banking sector strengthens, the risk of short term capital inflows decreases.



* Long term commercial credits, banking and other sectors long term credits.

** Short term commercial credits, short term banking and other sectors credits, banking sector deposits.



Changing Dynamics

3- The structure of the economy also changed:

1- Floating exchange rate regime

➤ Shock-absorbing characteristic.

2- Stronger banking system

➤ The system has less open positions. →

3- New Turkish Lira is not kept overvalued artificially. →

➤ CBT has purchased approximately USD 25 billion since 2002.

4- Short-term capital inflows are not encouraged.

➤ Exchange rate risk is on the market.

5- Record high level of foreign exchange reserves. →

6- Tight monetary and fiscal policies in force.

7- Lower inflation environment.

– With stable growth in the Turkish economy, the current account deficit to GNP ratio is also expected to decrease.

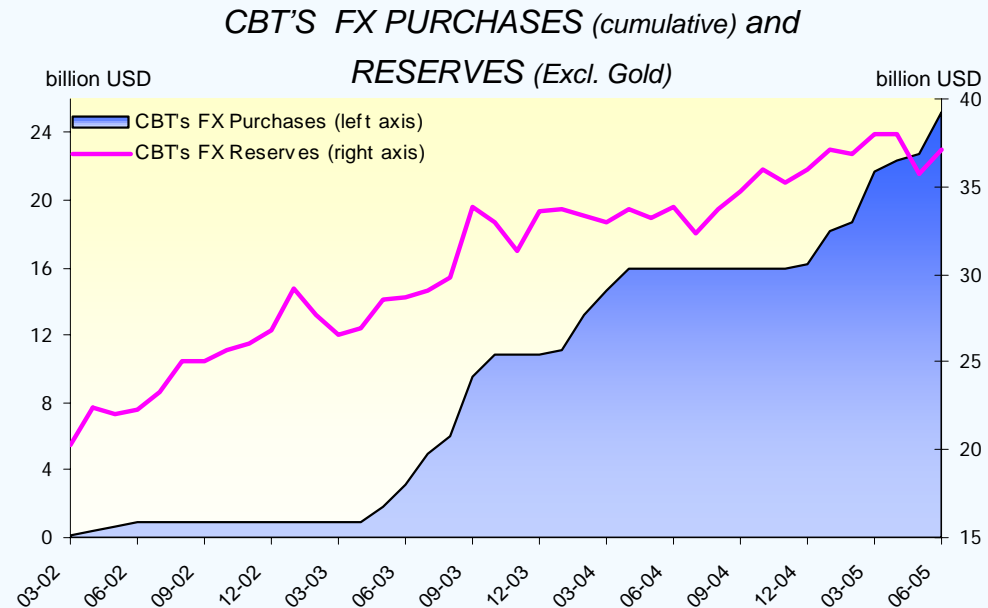
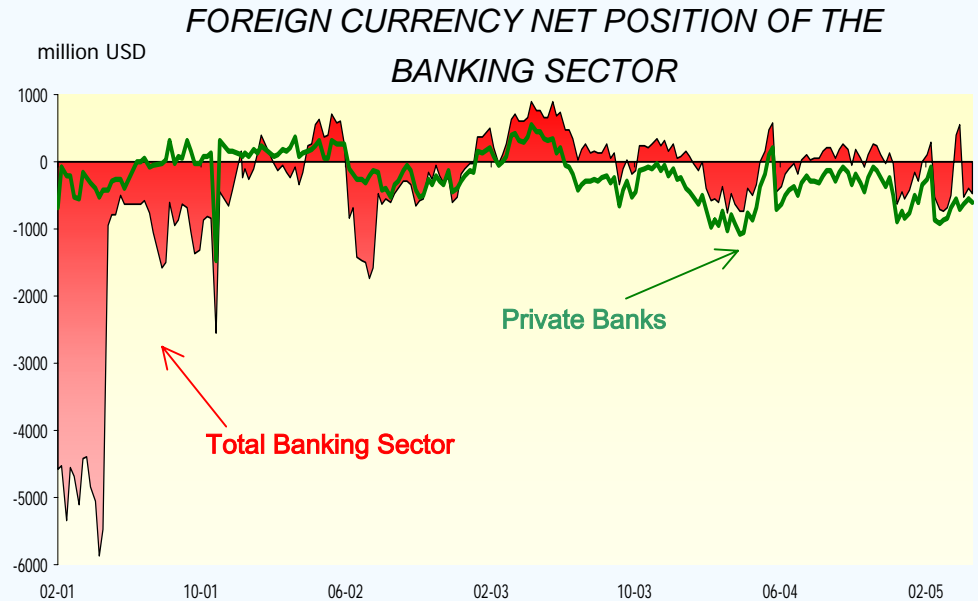
Current Account/GNP forecasts*:

2005 → -4.5 %

2006 → -3.0 %

2007 → -3.0 %

* Letter of Intent



Source: CBRT

Changing Dynamics

Public Finances:

In the last four years, disciplined and prudential fiscal policy was put into practice.

– Very high levels of primary surplus were attained to decrease the public debt stock.

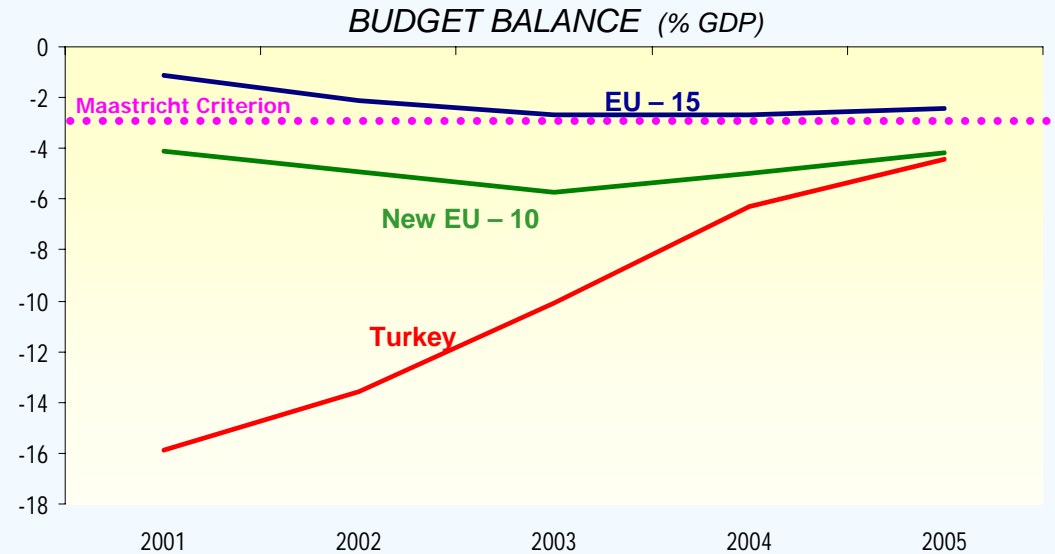
✓ The target of 6.5 % is to be continued in the next three years.



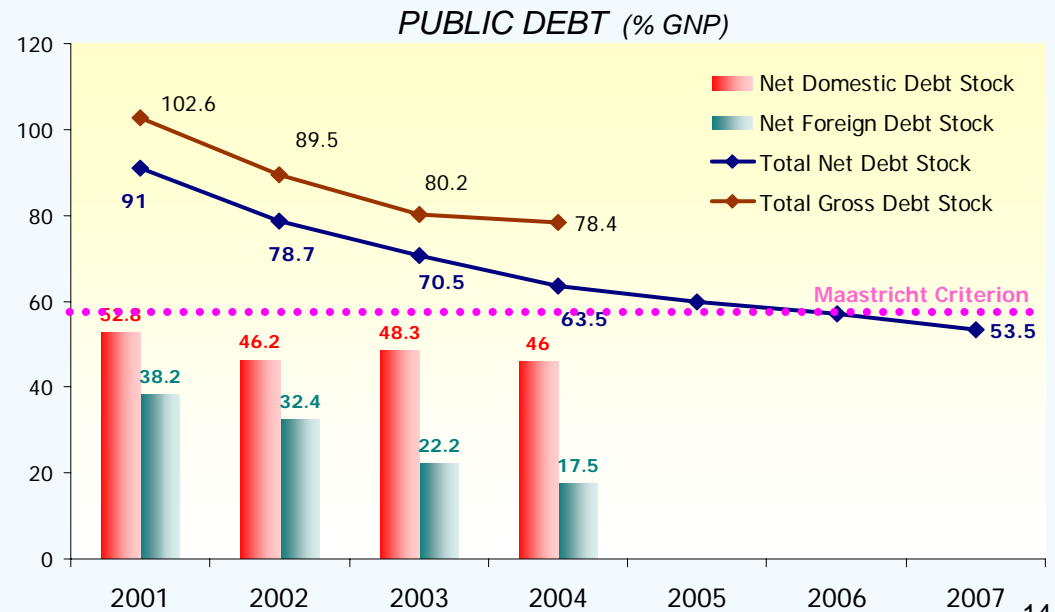
– Consolidated budget deficit decreased considerably to levels close to the Maastricht criterion. →

✓ The debt stock of the public sector is on a downward path converging toward the Maastricht criterion. →

– Continued tight fiscal policy will also keep the current account deficit under control, decrease fiscal dominance in the financial markets, and hence generate resources needed for investment and growth.



Source: European Commission, Pre-Accession Economic Program 2004



Source: Treasury, Letter of Intent

FINANCIAL MARKETS

Changing Dynamics

Financial Sector Stability:

– The Central Bank **safeguards financial stability**, as well, though it is not the supervisory authority.

– A considerable progress has been achieved toward financial stability:

✓ *Stronger macroeconomic fundamentals help it.*

➤ *Increasing credit volumes.* →

✓ *Very **important** and **comprehensive reforms** have been carried out in the sector:*

➤ *An independent body for monitoring and supervising – BRSA.*

➤ *Restructuring of public banks.*

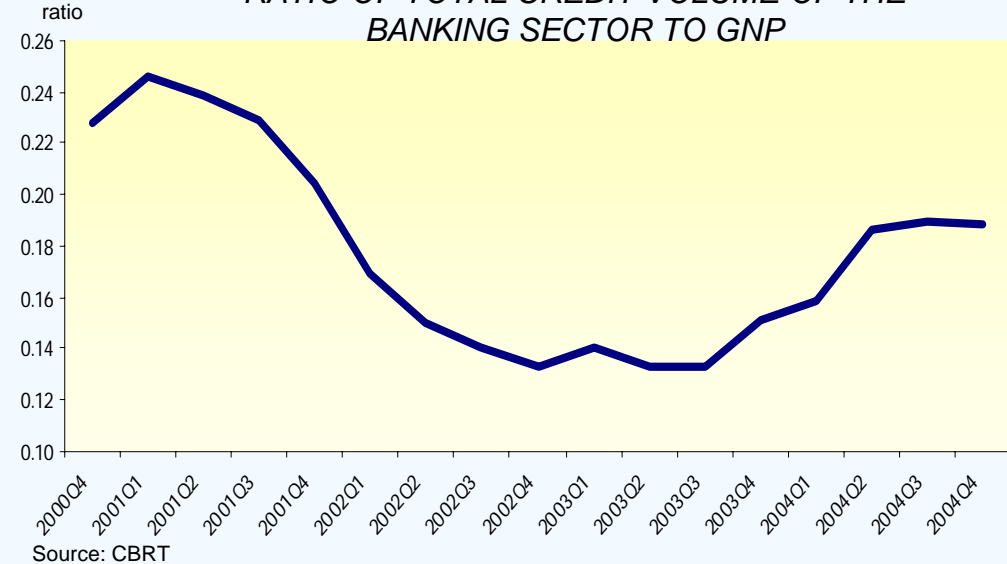
➤ *Strengthening the capital structure of private banks.*

➤ *Practice of modern risk management principles: Basel II.*

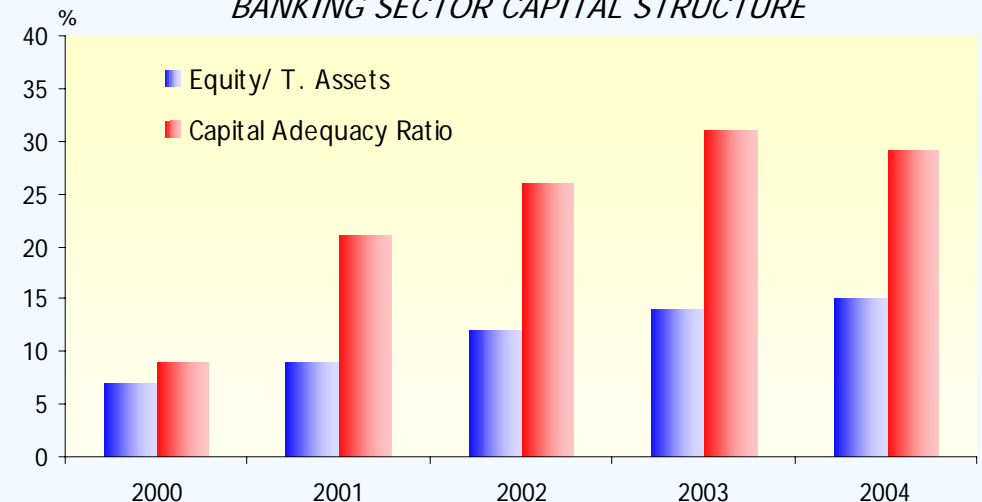
– In turbulent times, the CBT takes the necessary measures: *Iraqi War, 9/11 event.*

– Increasing foreign appetite for the sector.

RATIO OF TOTAL CREDIT VOLUME OF THE BANKING SECTOR TO GNP



BANKING SECTOR CAPITAL STRUCTURE



Capital Adequacy Ratio: Equity Capital / Total Assets

Source: BRSA

Changing Dynamics

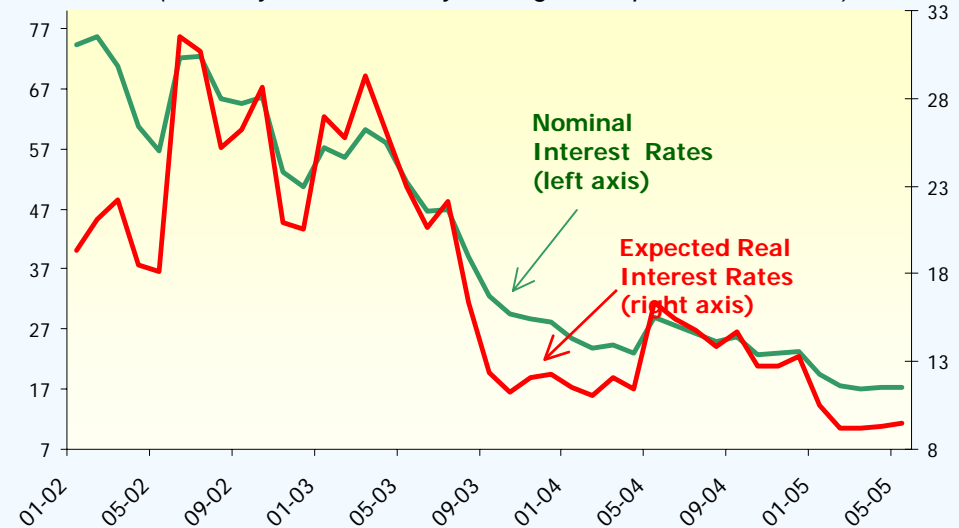
Financial Markets:

- Both **nominal** and **real interest rates** declined significantly in the last three years. →
 - ✓ *Nominal interest rates by 55 %*
 - ✓ *Real interest rates by 22 %*
- A significant increase is observed in average maturity of the Treasury issues.
 - ✓ *For the very first time, the Treasury is able to borrow at five years maturity in the domestic market.*
- Turkish bonds performed better than emerging markets bond index. →
 - ✓ *Turkish Eurobond spreads have dropped by average 525 basis points since 2001.*

Currency Reform:

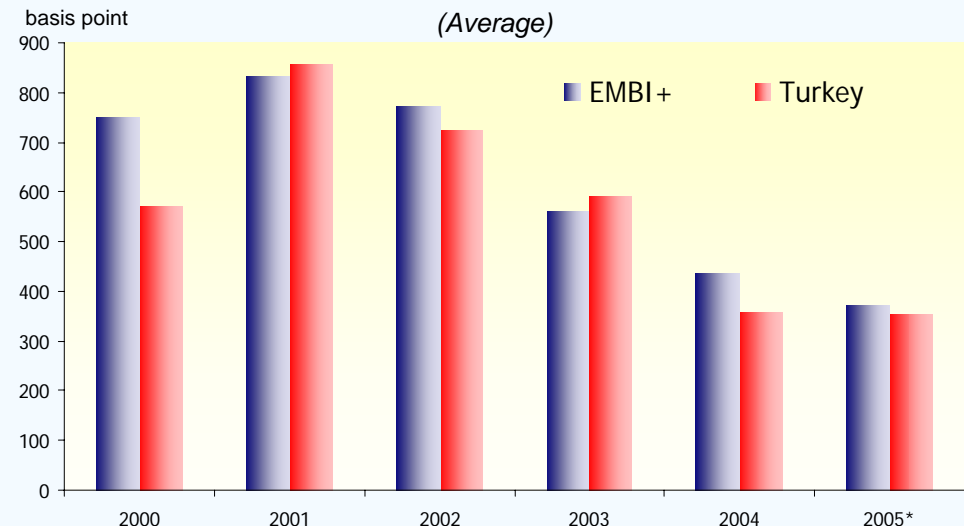
- Six zeros were dropped from the currency as of January 1st, 2005.
- Following the currency reform, favorable developments in markets have been observed.
 - ✓ *Foreign banks started issuing New Turkish Lira instruments up to 10 years of maturity.*
 - ✓ *The New Turkish Lira is now included in operations in international clearing systems.*

NOMINAL AND EXPECTED REAL INTEREST RATES
(Treasury Issues Monthly Average, Compounded, Percent)



Source: CBRT

EUROBOND SPREADS
(Average)



Source: Bloomberg
* As of June 9, 2005

Changing Dynamics

Floating Exchange Rate Regime:

No exchange rate commitment, target.
Exchange rate is not a policy tool.

Central Bank interventions



To dampen
excess volatility



To build up foreign
exchange reserves

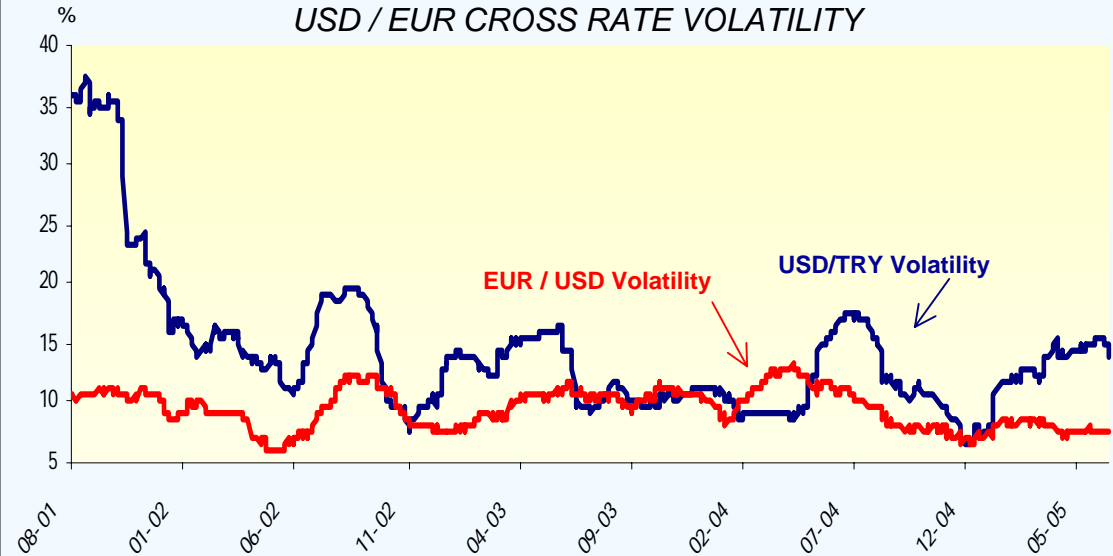
– With the help of transparent / consistent implementation of floating exchange rate regime;

✓ *The volatility in the exchange rates are gradually decreasing to the levels close to other floating currencies.* →

✓ *Turkish Derivatives Exchange (Turkdex) was launched in February 2005. The volume of transactions has been increasing gradually.* →

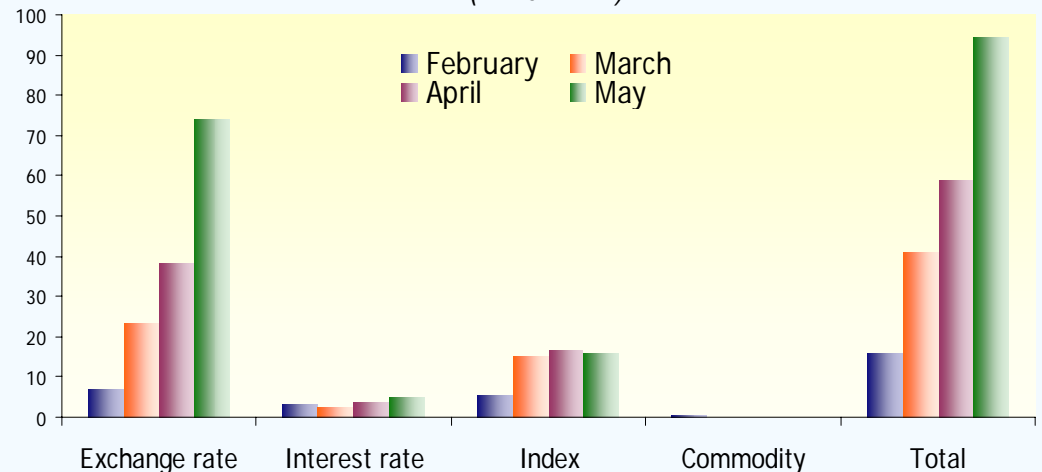
➤ *It ensures to hedge risks resulting not only from exchange rate volatility but also from volatility of interest rates, stock market index and prices of some commodities.*

CBT INDICATIVE USD SELLING RATE VOLATILITY AND USD / EUR CROSS RATE VOLATILITY



Volatility: 60 day moving standard deviation of the annualized daily percentage change


TRANSACTION VOLUME OF TURKISH DERIVATIVES EXCHANGE (Million TRY)



FROM NOW ON...

Challenges Ahead

Medium - long term goals of economic policy:

- Preserve price / financial stability
 - Continue with the reform process
- 
- Reach high levels of sustainable growth
 - Converge to the European Union economy

National Economic Program,
IMF agreement
will support the whole process.

What is on the agenda?

1- Banking Sector Reform

2- Tax Reform:

- Broadening the tax base
- Unregistered Economy ⇨ Registered Economy

3- Social Security Reform

4- Quality of Fiscal Adjustment:

- Public expenditure policy and management reform,
- Redirecting resources to more growth-enhancing public investment,
- Enhancing transparency of fiscal policy.

5- Civil Service Reform

6- Putting the Principles of **Good Governance** into Practice:

- State Economic Enterprise Governance

7- Steps to improve **investment climate**:

- FDI Investment Law (enacted)
- Law on the Protection of Intellectual and Industrial Property Rights (enacted)

8- Economic Policy Coordination:

- Development of streamlined decision making



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CENTRAL BANK OF TURKEY

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