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What matters most is the IMF and we have seen evidence to that effect time and often in the last four months. The moment an IMF stand-by appears on the horizon the USD/TL exchange rate slides below 1.5 and secondary bond market interest rates ease below 9%. That is, in an environment of rating increase, which was long overdue in the opinion of many, the risk premium falls, and a sustainable single-digit interest rate path becomes viable. The main obstacle to achieving this goal is the borrowing requirement of the Treasury. The IMF loan should be deposited by the Treasury to the CBT (Central Bank of Turkey), and this transaction scores two points simultaneously: the CBT's FX reserves rise and the TL liquidity provided by the CBT to the Treasury in exchange helps the Treasury to roll its domestic TL-denominated debt more easily. The current account deficit is not to be financed directly through the IMF money, but the amount going into the CBT reserves would provide a cushion nonetheless. Even so, the rate of interest in the secondary bond market could go up on the backdrop of economic recovery and a CPI reading that is now expected to be in the vicinity of 7% year-on-year even by the CBT. Turkish CPI would exceed 8% like in April-May 2010, and might fall a bit in the second half of the year. Nonetheless, non-processed food inflation and the administrative price hikes combined with the end of incentivised tax cuts in the last quarter of 2009 have already eaten into inflation, causing the 2009 inflation to exceed the October 2009 CBT estimate by one percentage point. Our main problem is to contain the interest rate and lock it in the 8-10% disciplinary box in the secondary bond market going forward. That is not an easy goal to achieve.

In addition to the IMF enters the medium term fiscal rule proposed by the Government. Although details are not yet disclosed and the model is being scrutinized upon currently, the rule will be one of countercyclical policy-induced one. Deviations from a budget deficit target would cause fiscal tightening, whereas deviations from the trend growth rate would lead to fiscal innovation and easing. Now, what would happen in a two period overlapping generations model with endogenous growth and with a public sector aiming at convergence for public debt to GDP and primary balance to GDP ratios? In order to ensure convergence towards the target values of fiscal variables, a fiscal policy rule ought to be fed in. According to this rule, the primary balance ratio could be adjusted as a function of the distance between the current and the target public debt stock to GDP and the primary surplus to GDP ratios. It has been shown in the literature that the fiscal rule displaying *time invariant parameters* might induce non-linear adjustment dynamics of the fiscal ratios as well as endogenous fluctuations in the rate of GDP growth. Moreover, the transitional dynamics towards fiscal targets would critically depend on the adjustment tool chosen by the fiscal authorities to implement the rule.

As we look at the Chilean experience, however, we do see a clear-cut counter-cyclicality in the fiscal rule. As Michael Kumhoff states in an IMF working paper, "*The structural surplus rule implies a counter-cyclical behavior of ex-ante government surpluses. It states that the central government's overall structural balance should in every year equal a surplus of 1% (0.5% effective 2008) of actual GDP. The structural balance equals structural revenues plus interest on net government assets (which are positive in Chile) minus actual expenditures on goods and services. Structural revenue is determined by two independent panels of experts and reflects what tax revenue would have been if the economy had operated at potential rather than actual output, and what copper revenue would have been at a* *long-term reference world copper price rather than the actual price. The rule therefore specifies permissible annual expenditures on goods and services as a residual, given the values of the target, structural revenues, the level of government assets, interest rates, and GDP. The resulting counter-cyclicality of government deficits isolates government expenditures on goods and services from the cycle and keeps them growing with trend output. No distinction is made between government consumption and investment expenditures, because this is difficult to do in practice.*" Now, the question for Turkey's fiscal rule is the flexibility of responses to deviations of GDP from trend. The difference from the Chilean experience would obviously be the absence of exogenous revenues as are generated by copper exports in the case of Chile, and therefore as the low likelihood of considering the upper tail of fiscality, i.e. the case of excess fiscal revenues. Instead, Turkey would have a rather one-tailed fiscal (deficit) rule combined with a two-tailed GDP target rule, of which more on next week.