



CENTRAL BANK OF THE REPUBLIC OF TURKEY

Durmuş YILMAZ
Governor

27 March 2008



Presentation Plan

- I. International Developments and the Turkish Economy
 - i. Financial Stability
 - ii. Price Stability
 - iii. Economic Growth
- II. Overall Assessment



Main Policy Targets

- ✓ Broadly speaking, decision makers take into account three fundamental issues while setting economic policies:



- ✓ Though these three main targets seem to contradict with each other from time to time, they are not alternatives to one another in long term.
- ✓ On the contrary, they stand out as the three “sine qua non” of a sound economy.



1. Financial Stability

→ a. International Developments

→ b. Turkish Economy



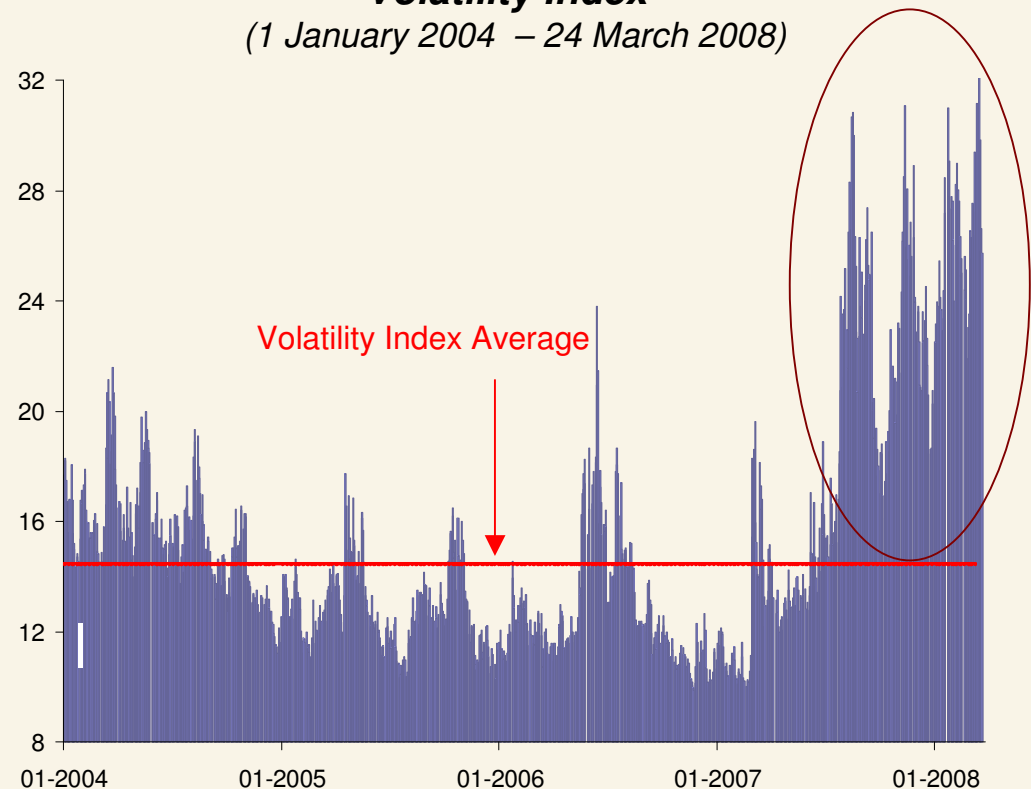
Financial Stability

✓ The global financial turbulence, which started in mid-2007, has not subsided yet.

✓ The magnitude of the turbulence is larger than that of the turbulence in 2006.

✓ In the face of rising uncertainties, international banks have focused more on the default risk and become reluctant to lend, which in turn has led to liquidity squeeze in the financial markets.

Volatility Index*
(1 January 2004 – 24 March 2008)



•VIX measures the volatility of the options prices of the S&P 500 stock index by using the interpolation method.

•Source: Bloomberg



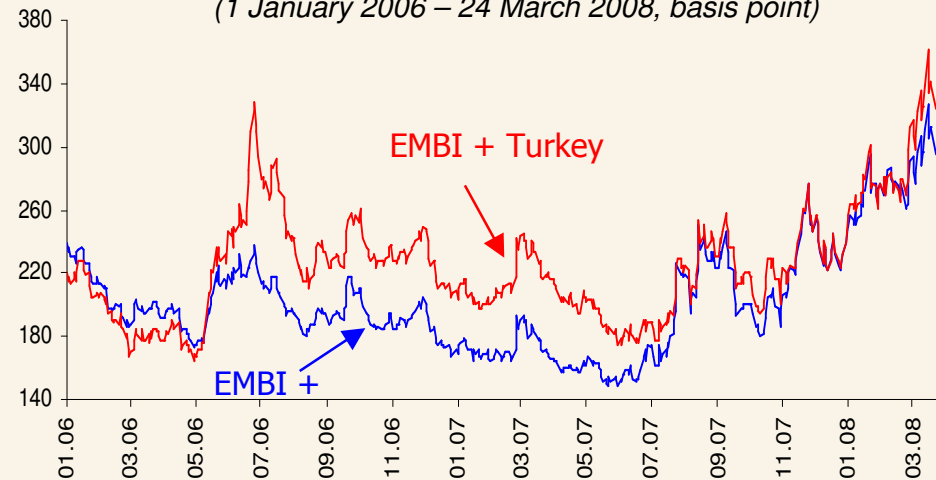
Financial Stability

✓ Financial institutions incurring big losses coupled with concerns over recession in the US economy led to significant deterioration in risk perceptions and increased the risk premium of developing countries.

✓ Turkey's risk premium has increased in parallel to those of other developing countries.

Risk Indicators

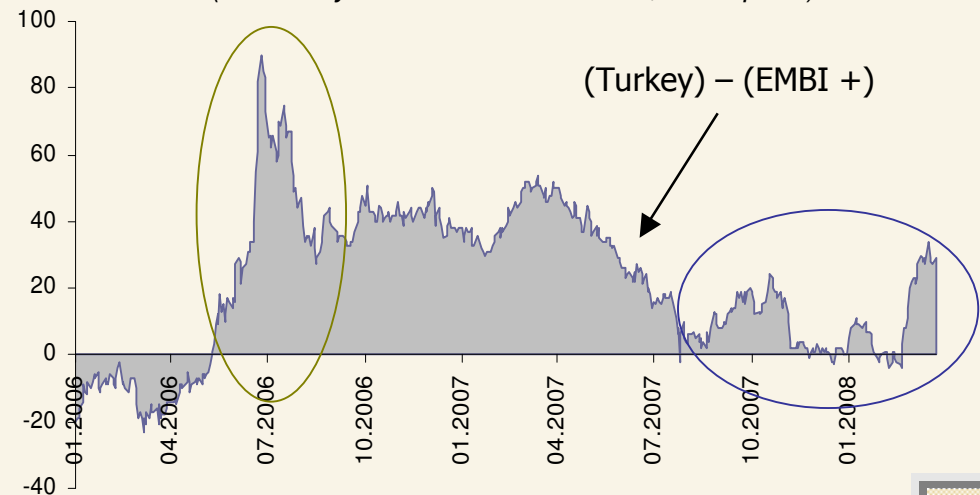
(1 January 2006 – 24 March 2008, basis point)



Source: JP Morgan

Risk Indicators

(1 January 2006 – 24 March 2008, basis point)



Source: JP Morgan

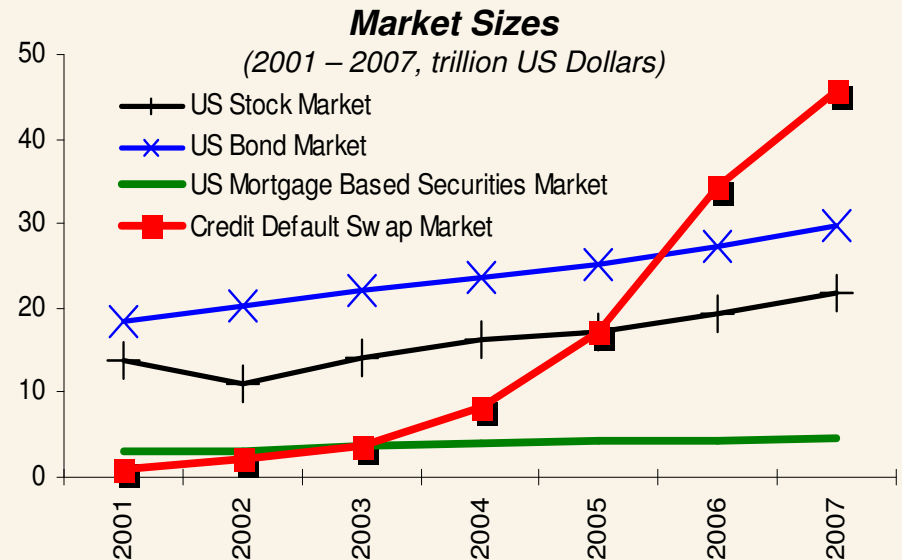


Financial Stability

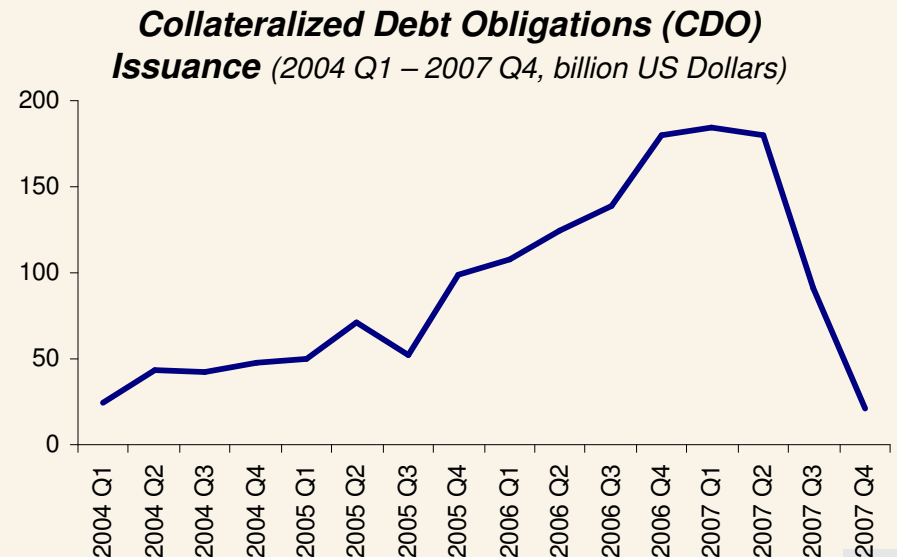
How Did We End Up Here?

1st APPROACH : NON-TRANSPARENT OPERATIONS

- ✓ Complex instruments due to increased financial engineering practices
- ✓ Business model based on packaging and marketing
- ✓ Deficiency in surveillance and supervision
- ✓ Arbitrage opportunities arising out of this deficiency



Source: ISDA, WFE, SIFMA



Source: SIFMA



Financial Stability

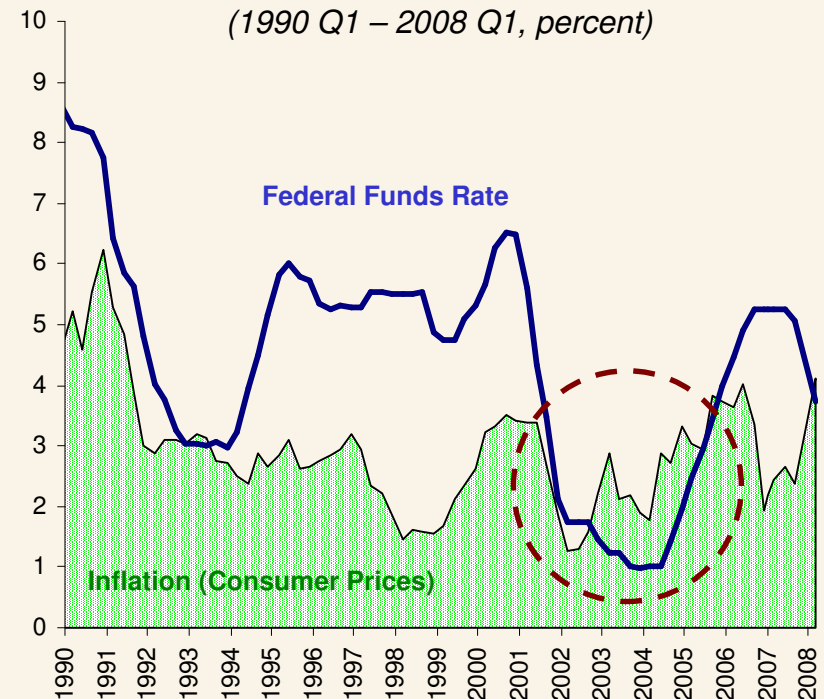
How Did We Ed Up Here?



2nd APPROACH: GLOBAL LIQUIDITY CONDITIONS

- ✓ Abundant credit facilities supported by accommodative monetary policies
- ✓ Surge in leveraged transactions
- ✓ Excessive risk appetite and search for high yields.

US Inflation and Federal Funds Rates
(1990 Q1 – 2008 Q1, percent)



Source FED, BLS

- ✓ The two approaches should not be perceived as alternatives to one another.
- ✓ They, in fact, complement each other and explain two different aspects of the turbulence.



1. Financial Stability

→ a. International Developments

→ **b. Turkish Economy**



Financial Stability in Turkey

General Outlook of the Banking Sector

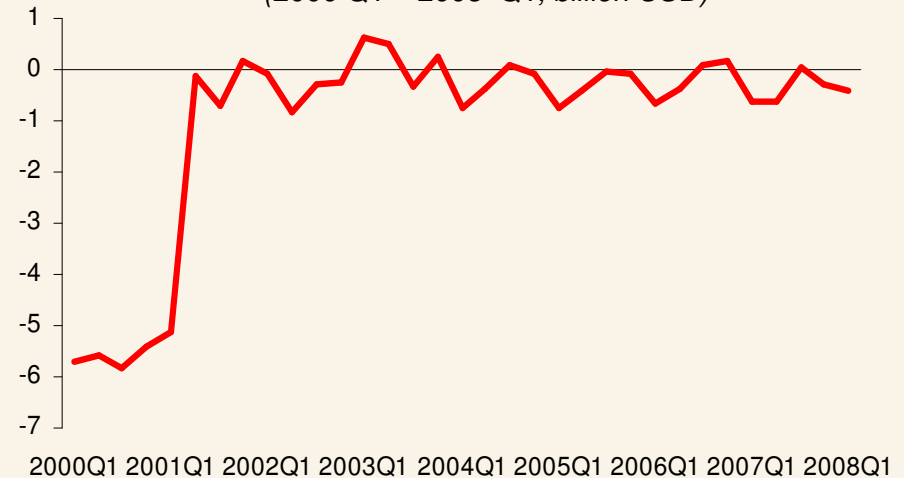


✓ The sector does not hold a noteworthy FX short position. Net FX positions of the banks are at a low level compared to their equity capital.

✓ The capital adequacy ratio is well above the legal limit and the EU average of 12.1%.

✓ Still, it should be kept in mind that the FX short position of the real sector poses an indirect credit risk on the banking sector.

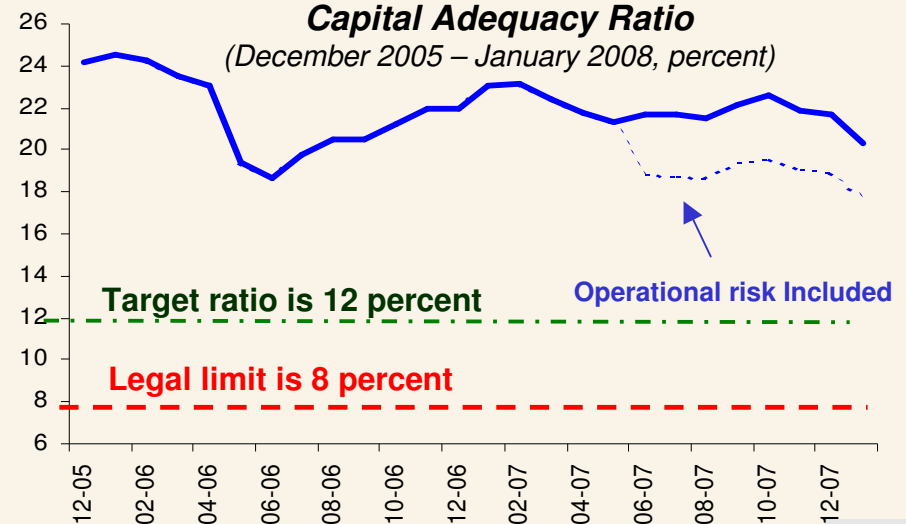
Net FX Position of the Banking Sector
(2000 Q1 – 2008 Q1, billion USD)



Source: BRSA, CBRT

Capital Adequacy Ratio

(December 2005 – January 2008, percent)



Source: BRSA, CBRT



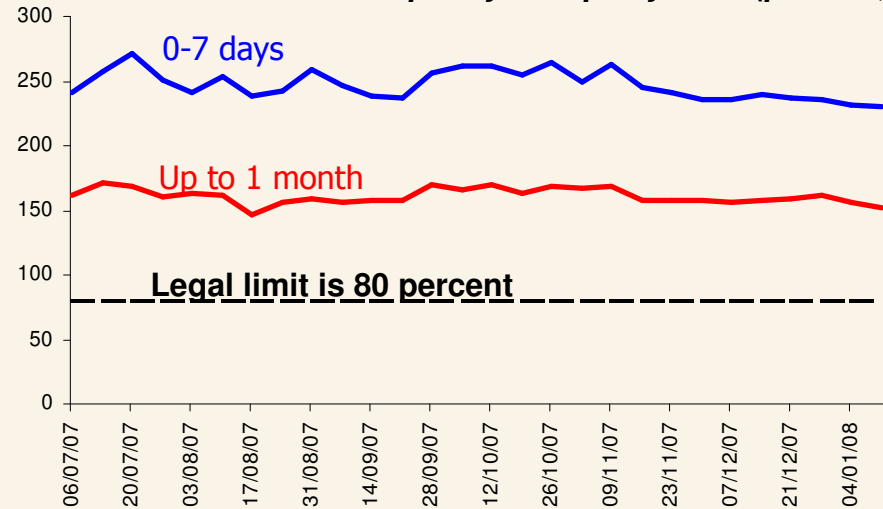
Financial Stability in Turkey

✓ Banks' short-term FX liquidity adequacy ratios are well above the legal limit of 80%

✓ Total short-term liquidity adequacy ratios stay at high levels, as well.

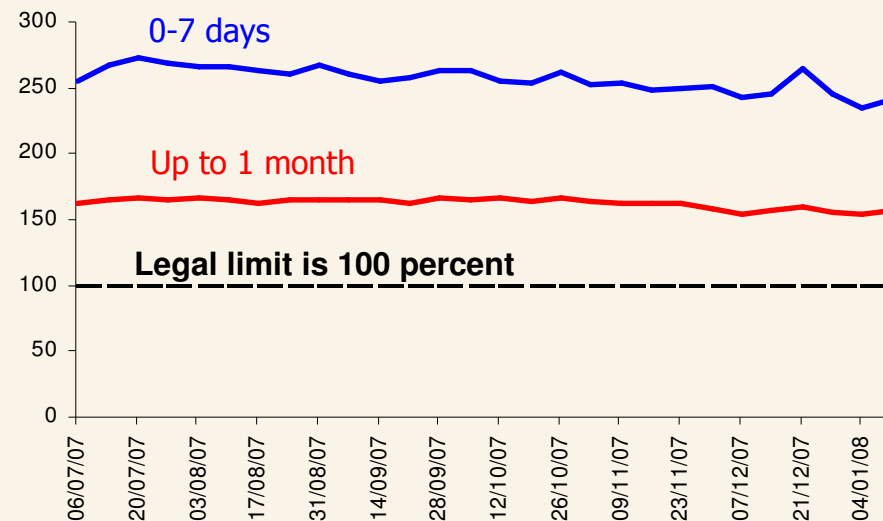
✓ Recent fluctuations in global financial markets once again highlighted the importance of liquidity risk management. In this juncture, it is important for banks to be cautious in liquidity management.

Short- Term FX Liquidity Adequacy Ratio(percent)



Source: BRSA, CBRT

Total Short-Term Liquidity Adequacy Ratio (percent)



Source: BRSA, CBRT



Financial Stability in Turkey

General Outlook of the Real Sector

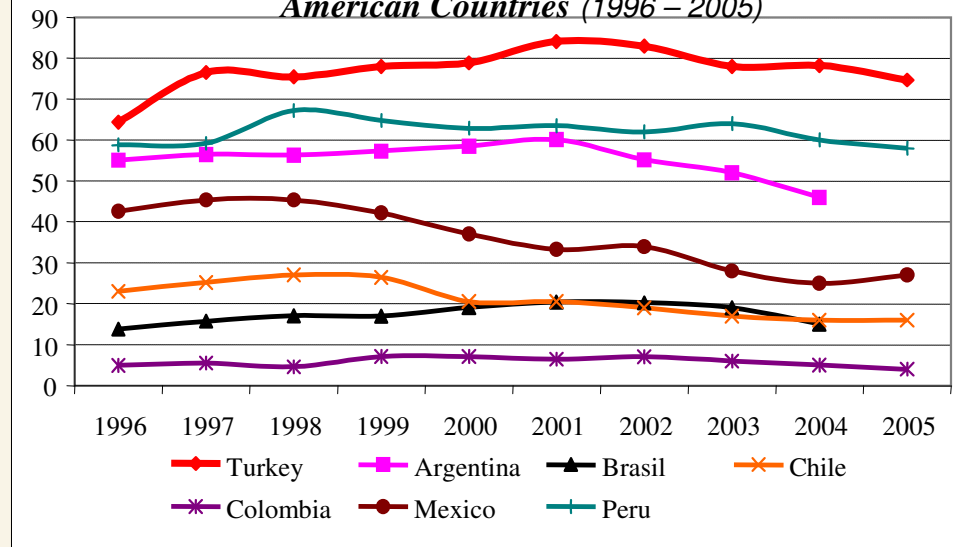


✓ In Turkey, real sector's debt is made of mainly short-term and FX borrowings compared to other developing countries. Yet, the borrowing maturity and dollarization rate has improved moderately in recent years.

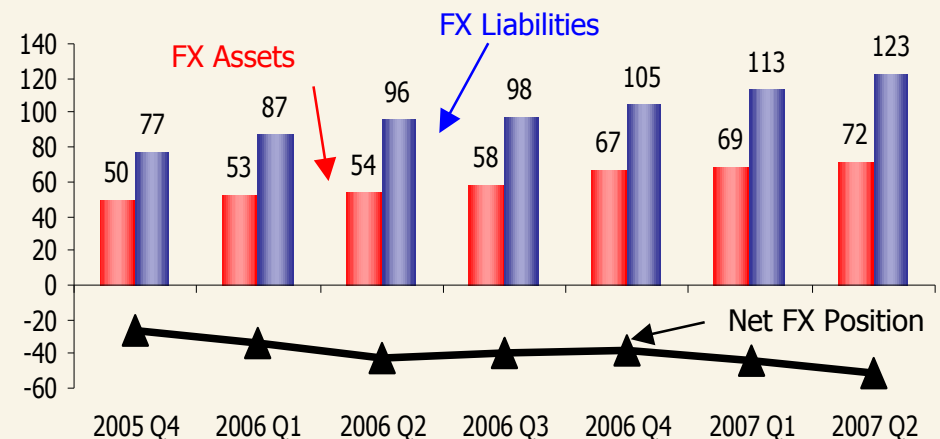
✓ The FX short position of the non-banking sector was USD 51 billion as of the second quarter of 2007.

✓ Companies should hedge exchange rate risk via various financial instruments.

Debt Dollarization of the Real Sector in Turkey and Latin American Countries (1996 – 2005)



FX Position of the Non-Banking Sector (2005 Q1 – 2007 Q2, billion USD)



Source: CBRT

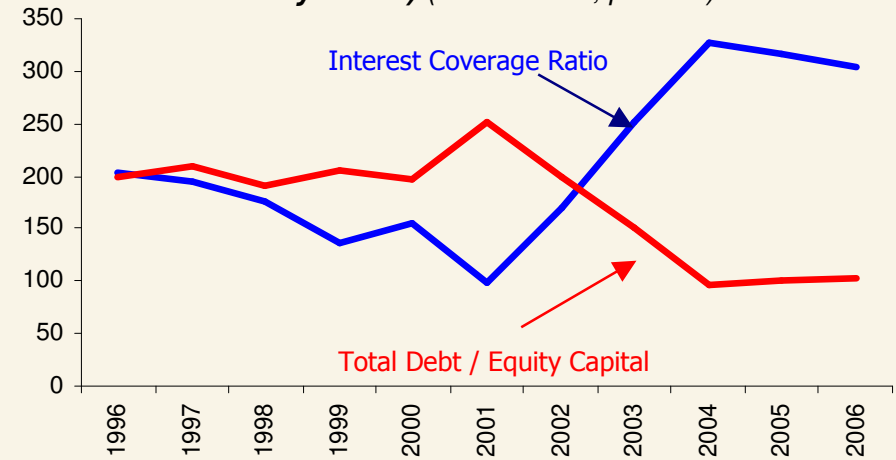


Financial Stability in Turkey

General Outlook of the Real Sector

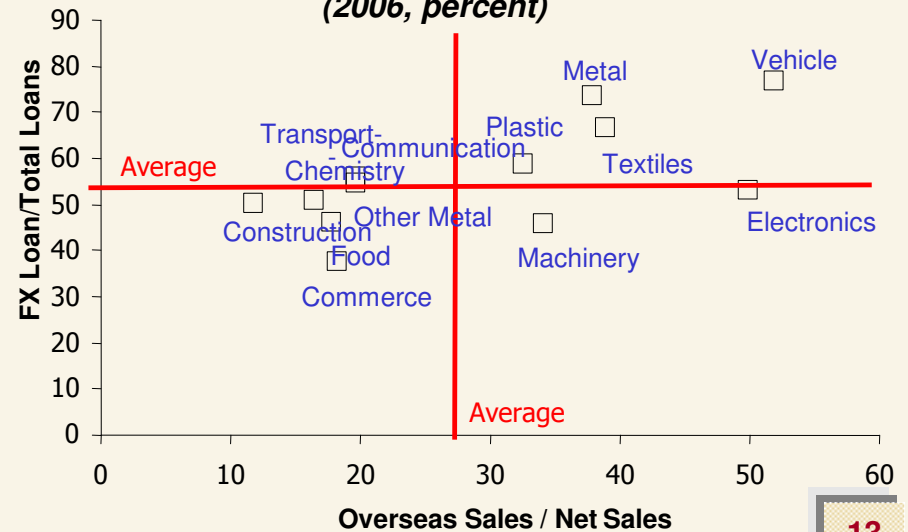
- ✓ Companies with FX-denominated revenues (exports, tourism, etc.) are assumed to have a natural hedge against the exchange rate risk.
- ✓ Sectoral analyses point to such a natural hedging tendency. FX loan utilization is below the average in sectors that are mainly focused on the domestic market.
- ✓ Companies with YTL-denominated revenue should manage exchange rate risk very carefully.
- ✓ The financial structure of the companies improved in the 1996-2006 period.
- ✓ While the ratio of total debt to equity capital declined; the interest coverage ratio recovered.
- ✓ This provides significant assurance for creditors.

Ratio of Companies' Total Debt to Equity Capital and Interest Coverage Ratio (Operating Profit / Interest Payments) (1996 - 2006, percent)



Source: CBRT Sectoral Balance Sheets

Overseas Sales and FX-denominated Loans (2006, percent)



Source: CBRT Sectoral Balance Sheets



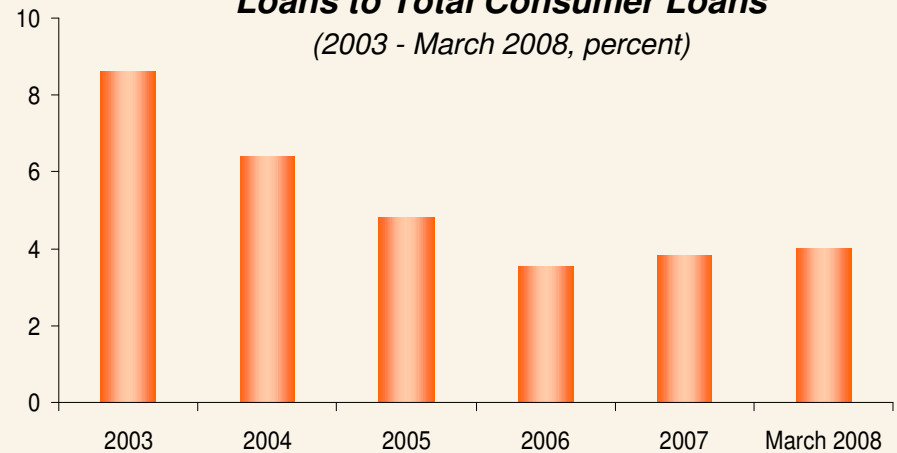
Financial Stability in Turkey

Exchange Rate and Interest Risks of Households

- ✓ In Turkey, the practice of variable rate consumer loans is rather limited.
- ✓ Entities with no FX income are not allowed to use FX denominated loans.
- ✓ FX-indexed consumer loans make up merely 4% of total consumer loans.

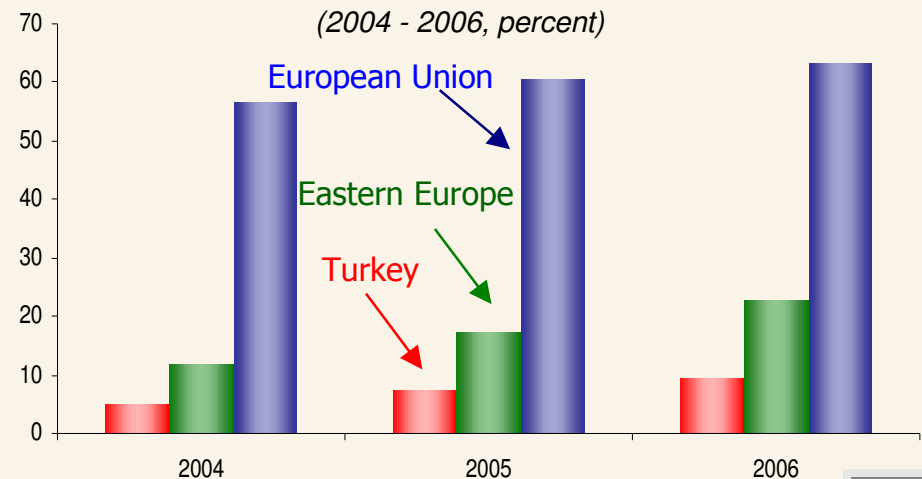
- ✓ Non-performing loan ratio for consumer loans is 1.5%.
- ✓ Household indebtedness ratio is at a low level compared to European Union and Eastern European countries.

Ratio of the FX-Indexed Consumer Loans to Total Consumer Loans
(2003 - March 2008, percent)



Source: CBRT

Ratio of the Household Liabilities to GDP
(2004 - 2006, percent)



Source: European Central Bank, CBRT



Financial Stability in Turkey

Public Finance



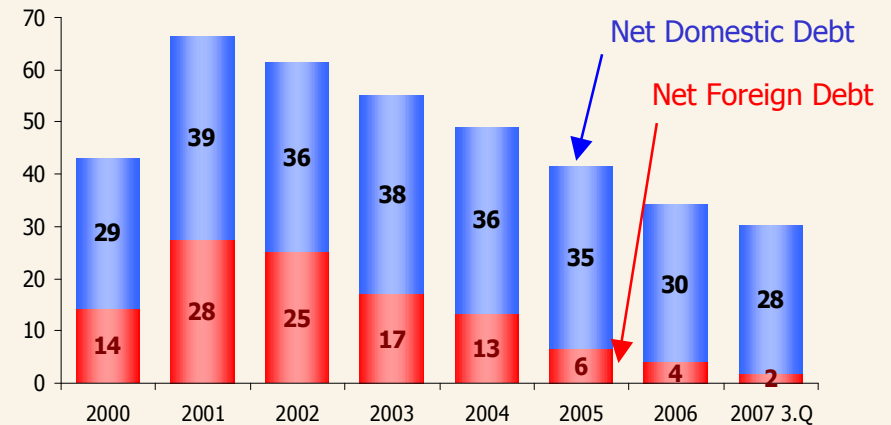
✓ With the support of fiscal discipline implemented since 2001, public sector has become more resilient against external shocks.

✓ The ratio of FX-denominated and FX-indexed debt to the total central government debt stock stood at 31% as of 2007. Ratio of net foreign debt stock to GDP declined to 2% in the third quarter of 2007.

✓ The Treasury maintains its policy of holding a high level of FX reserves to minimize any liquidity risk that might arise in cash and debt management.

Public Net Debt Stock / GDP

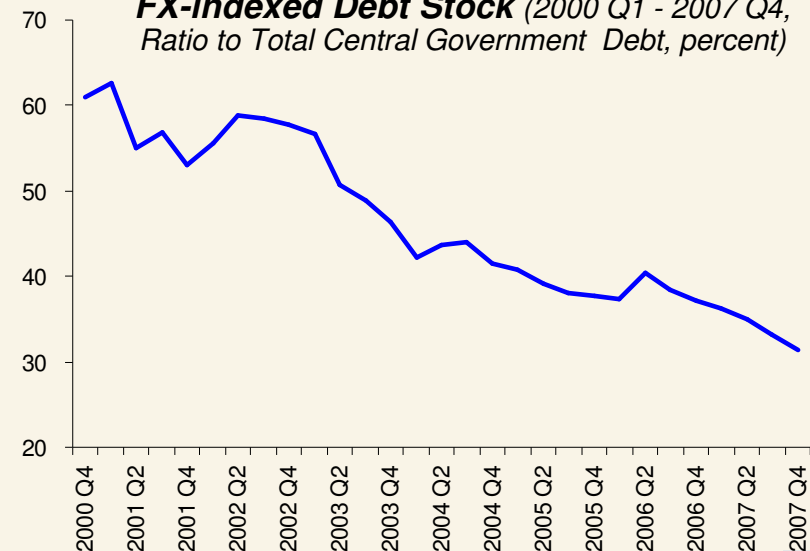
(2000 - 2007 Q3, percent)



Source: Treasury, CBRT

Central Government FX-denominated and

FX-indexed Debt Stock (2000 Q1 - 2007 Q4, Ratio to Total Central Government Debt, percent)



Source: Treasury, CBRT



Financial Stability in Turkey

Balance of Payments



✓ Factors such as inadequate domestic savings, increasing investment expenditures and high energy prices lead to current account deficit in the Turkish economy.

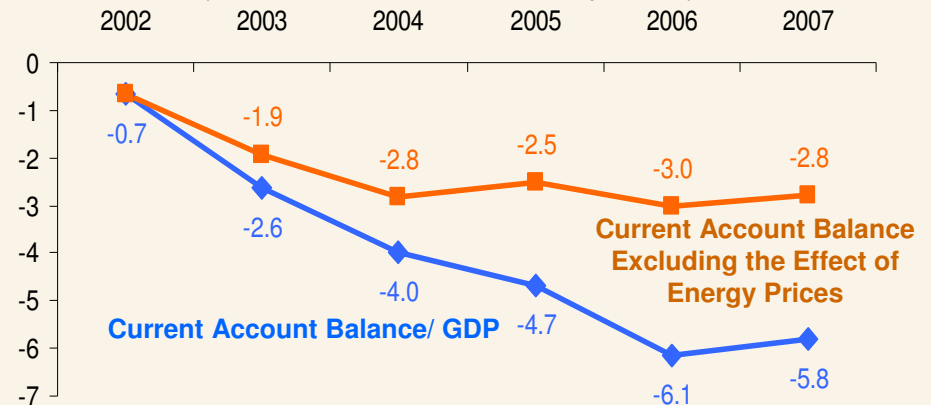
✓ Along with foreign direct investments, long-term credits assume great importance for financing quality of current account deficit and diminishes fragility.

✓ Portfolio and short-term capital inflows have substantially decreased for the last 12 months.

✓ Financing of current account deficit was accomplished by long-term loans and direct investment inflows in this period.

Current Account Balance and the Effect of Energy Prices on Current Account Deficit*

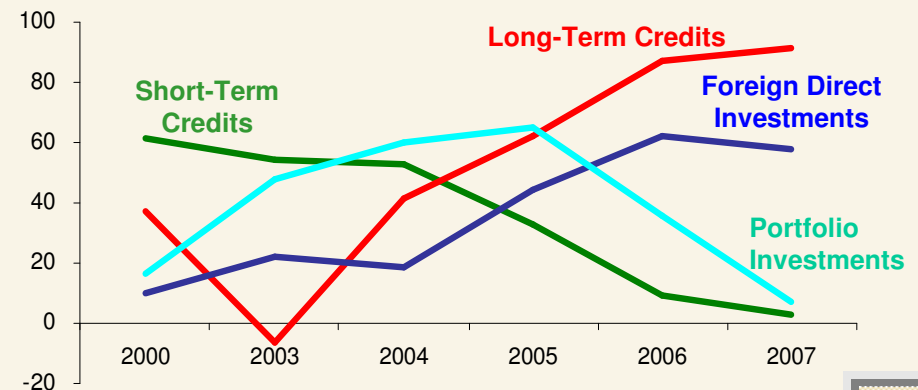
(2002 – 2007**, ratio to GDP, percent)



* The effect of energy price increases on the current account in the 2003-2007 period was calculated by keeping the prices of 2002 constant. Energy Sub-items: Stone coal and lignite, crude oil and natural gas under the mining and quarrying sector, and coke coal, coal, refined petroleum products and nuclear fuels under the manufacturing industry.

** GDP forecast for 2007, State Planning Organization
Source: TURKSTAT, CBRT

Ratio of Financing Items to Current Account Deficit (2000 – 2007, percent)



Source: CBRT



2. Price Stability

→ a. International Developments

→ b. Turkish Economy



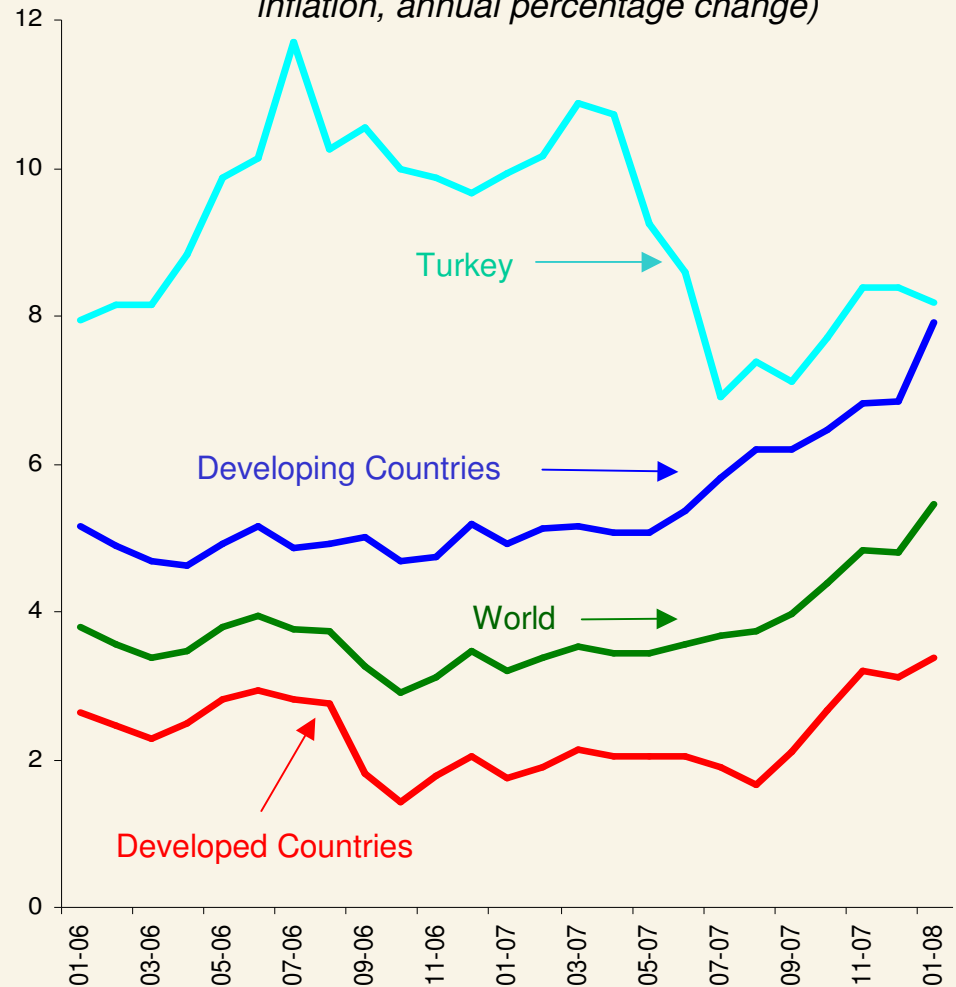
Global Inflation Developments

Global inflation trends



- ✓ Since 2007, there is an apparent upward acceleration in inflation all over the world.
- ✓ The annual inflation in developed countries' is at its highest level of the last 16 years.

Global Inflation Developments
(January 2006 - January 2008, consumer prices inflation, annual percentage change)



Source: IMF



World Commodity Prices

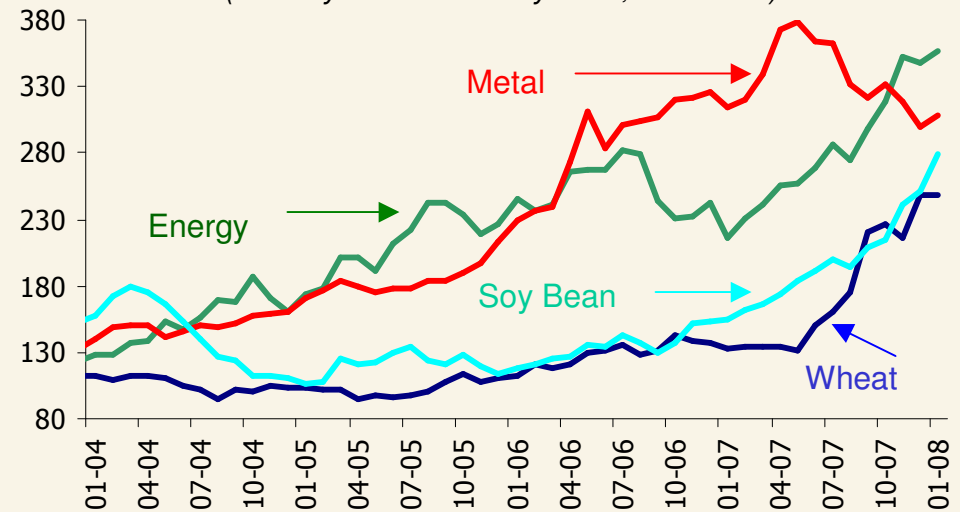
✓ Hikes, especially, in the prices of food, metal, and energy are among the main factors leading to global inflationary pressures.

✓ Rise in income levels of developing countries, mainly China and India, creates a demand pressure on commodity prices.

✓ Moreover, the utilization of food such as corn, wheat, and sugar beet in the bio-fuels production accompanied with unfavorable weather conditions have been contributed to surge in commodity prices.

International Price Indexes of Selected Products

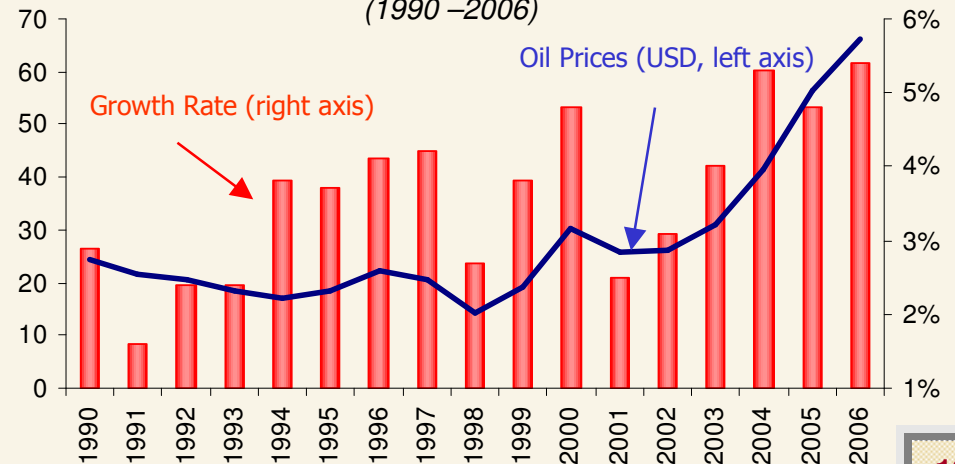
(January 2004 – January 2008, 2002=100)



Source: IFS

Crude Oil Prices and Global Growth Rate

(1990 – 2006)



Source: IFS, IMF



World Commodity Prices

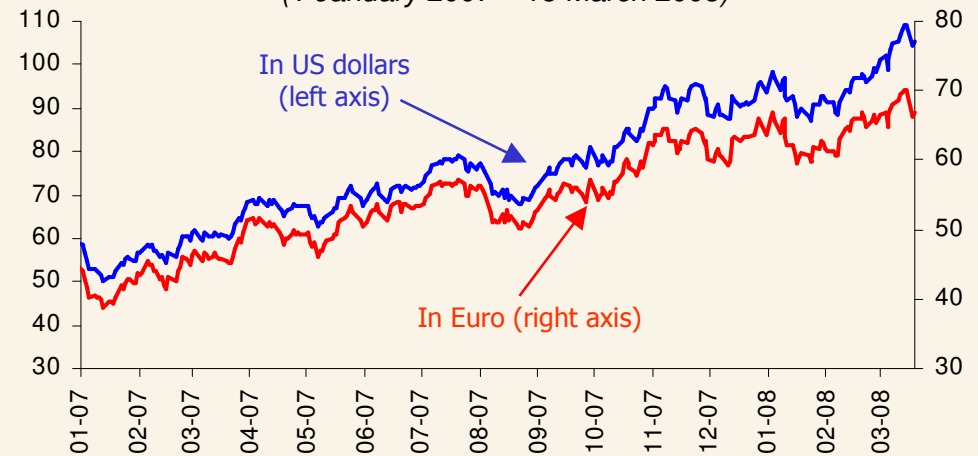
✓ Despite expectations of an economic slowdown in the developed countries, the upsurge in commodity prices has continued in 2008.

✓ Crude oil prices per barrel were over USD 105 (EUR 68) in mid-March; reaching its highest level since 1979 in real terms.

✓ In the first quarter of 2008, consecutive peaks were observed in gold prices.

Crude Oil Prices, Europe (Brent)

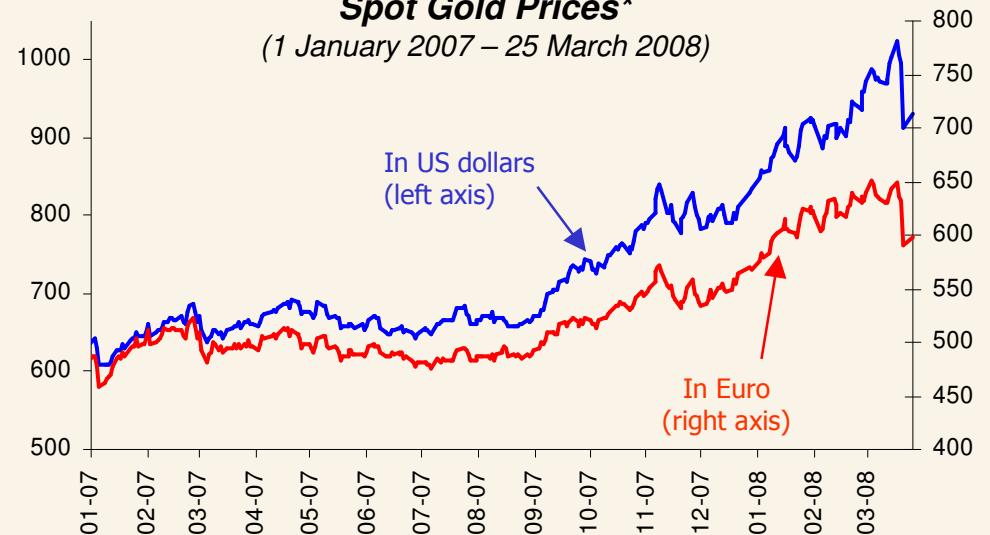
(1 January 2007 – 18 March 2008)



Source: Bloomberg

Spot Gold Prices*

(1 January 2007 – 25 March 2008)



* Price of one ounce of gold quoted on the London gold market
Source: World Gold Council



2. Price Stability

→ a. International Developments

→ b. Turkish Economy

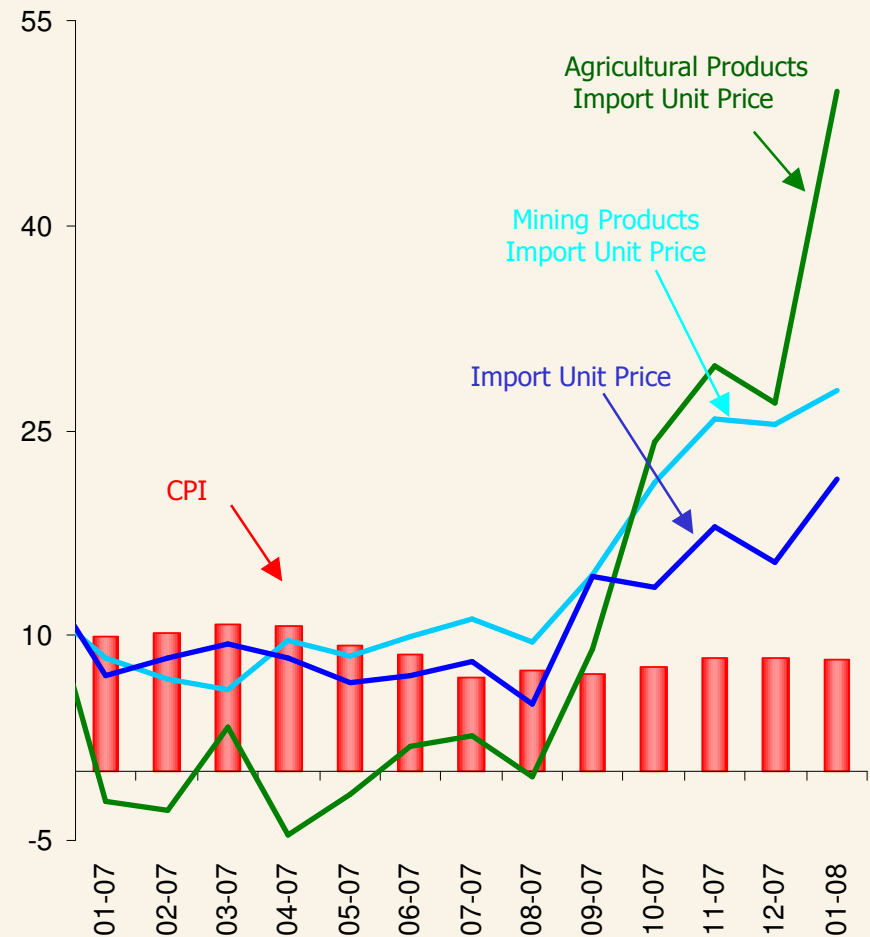


Price Stability in Turkey

✓ High increases especially in the prices of agricultural products create a significant burden for developing countries like Turkey where the share of food expenditures within household consumption is high.

✓ As Turkey is a commodity-importing country, hikes in the prices of energy and metals have unfavorable impacts on both inflation and foreign trade balance.

Inflation and Change in Import Unit Prices* in Turkey
(January 2007 – January 2008, annual percentage change)



* In US dollars
Source: TURKSTAT, CBRT



Price Stability in Turkey

Inflation shows an upward trend over the world.

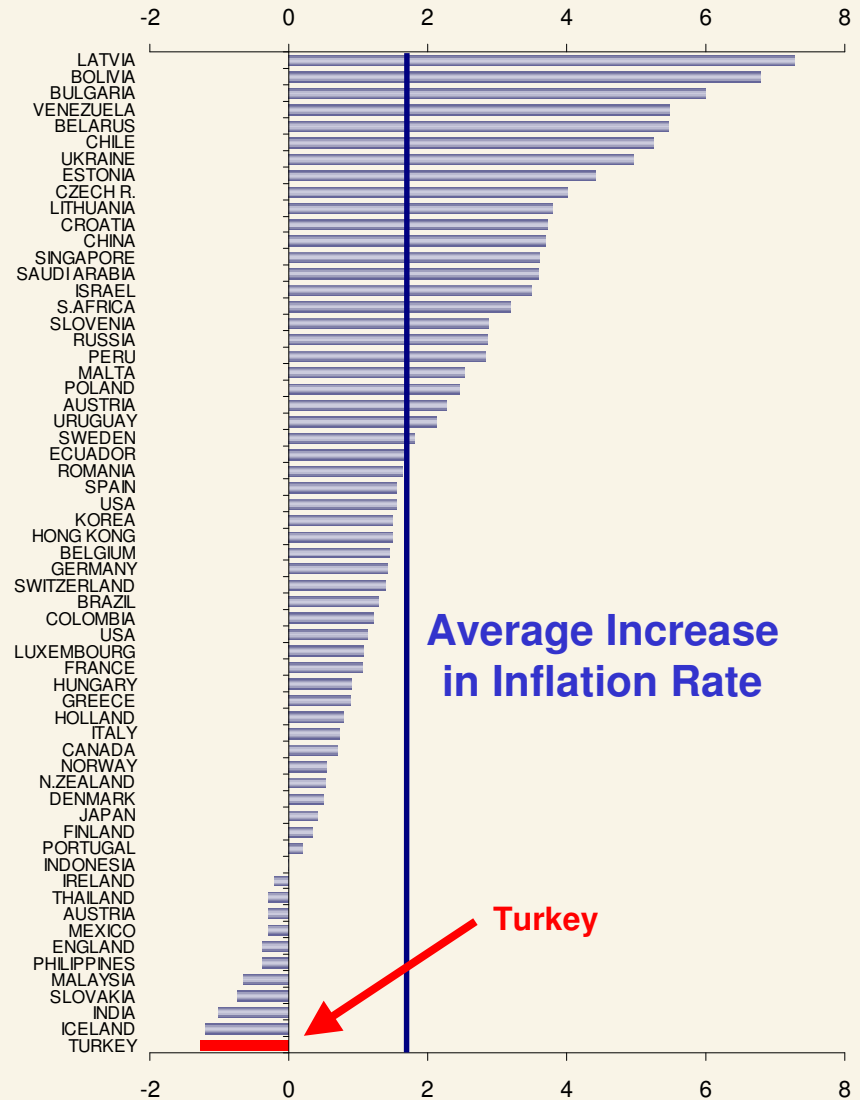


✓ Since the first quarter of 2007, inflation has accelerated significantly in most countries.

✓ Turkey is among few countries that reduced inflation rate in 2007.

✓ In 2007, inflation increased approximately by 2 percentage points in 60 major developed and developing countries, while the said rate decreased by 1.3 percentage points in Turkey.

Inflation Developments in Turkey and the World
(Change in year-end inflation rate between 2006 end 2007)



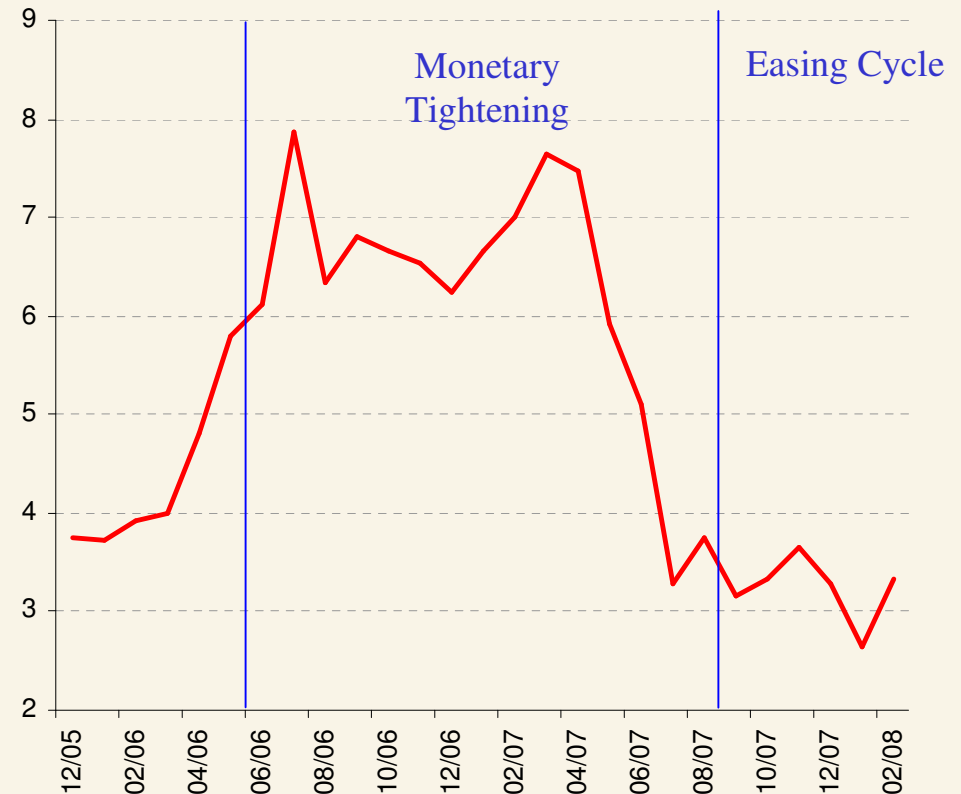
Source: IMF, TURKSTAT, CBRT



Price Stability in Turkey

- ✓ In the third quarter of 2006, the inflation in Turkey was 8 percentage points higher than the inflation rates of other developing countries that follow inflation targeting.
- ✓ The said difference began to narrow thanks to the monetary tightening and decreased to 3 percentage points by early-2008.

Inflation Differential Between the Economies Implementing Inflation Targeting* and Turkey
(December 2005 – February 2008, annual percentage change)



* **Countries Implementing Inflation Targeting Regime:** Brazil, Czech Rep., Colombia, Philippines, South Africa, Israel, Hungary, Mexico, Peru, Poland, Romania, Chile, Slovakia, Thailand

Source: Central Banks, TURKSTAT, CBRT



3. Economic Growth

→ a. International Developments

→ b. Turkish Economy



Global Economic Growth

✓ The recent data on the United States and European economies have signaled that the turmoil in financial markets have started to spread to the real sector.

✓ The current financial turbulence is expected to decrease economic growth worldwide.

Growth Expectations Worldwide (percent)

Regions	2007 (Forecast)	2008 (7/2007 forecasts)	2008 (10/2007 forecasts)	2008 (1/2008 forecasts)
World	4.9	4.8	4.4	4.1
USA	2.2	2.8	1.9	1.5
EU	2.6	2.5	2.1	1.6
Russia-Central Asia	8.2	7.1	7.0	7.0
Central and Eastern Europe	5.5	5.4	4.9	4.6
Middle East	6.0	5.5	6.0	5.9

Source: IMF



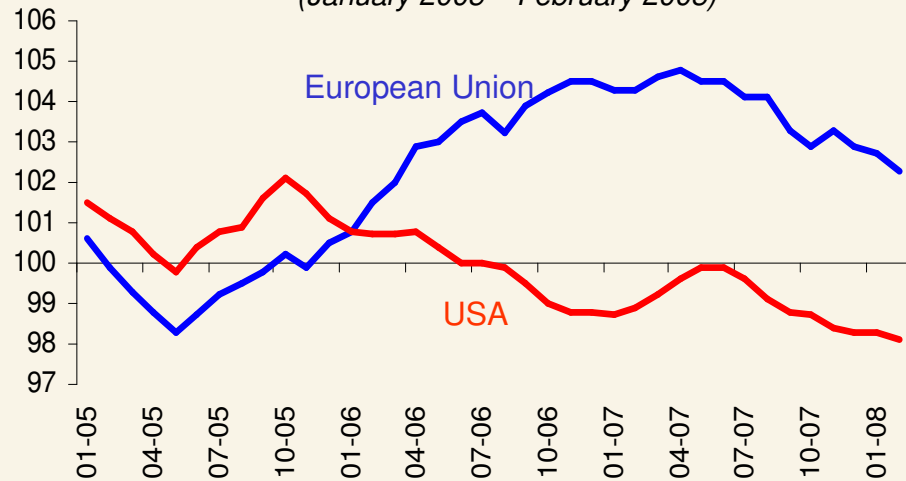
Global Economic Growth

✓ The real sector confidence index in the US, which had been falling since mid-2007, dropped to its lowest level since 2001.

✓ Although the real sector confidence in the EU index has been declining, it is still higher than that of US.

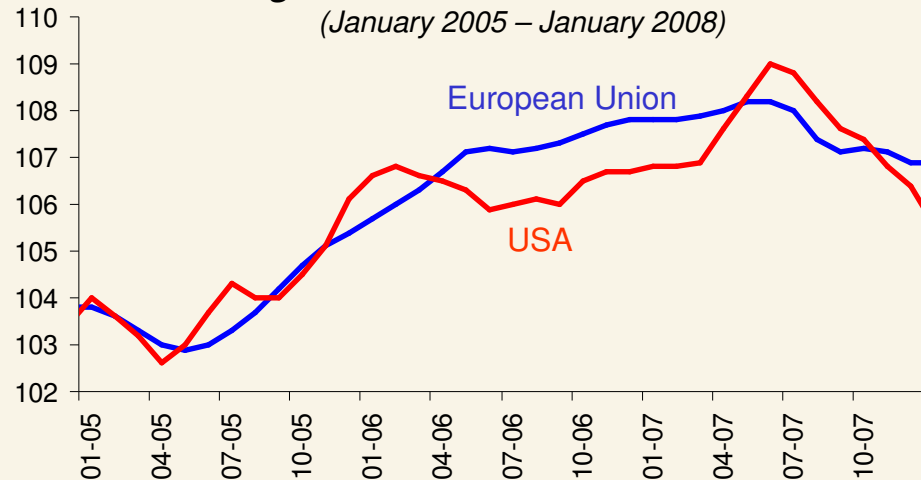
✓ The leading indicators show that the slowdown in the US economy is more severe than that in the EU.

Real Sector Confidence Index in the US and the EU
(January 2005 – February 2008)



Source: OECD

Leading Indicators in US and EU economies
(January 2005 – January 2008)



Source: OECD



Economic Growth

→ a. International Developments

→ b. Turkish Economy



Economic Growth in Turkey

- ✓ The effects of the financial turbulences on Turkish economy are expected to be observed via the trade channel (external demand) and the capital inflows (portfolio and credits).
- ✓ The main export markets of Turkey are European countries. This is likely to alleviate the first-round effects of a US-origin economic recession. However, the secondary effects of such a recession on European economies shall be monitored closely.
- ✓ Taking into account the difficulty in the pricing of risks in financial markets, it is projected that there might be a decline in the domestic banks' and real sector's credit utilization from foreign markets and this in return can restrict domestic demand.



1.Slowdown in global economy
will strain growth in external demand.



2.Problems in credit markets
will raise the cost of credits obtained by domestic banks in foreign markets and thus curb domestic demand.



Economic Growth in Turkey

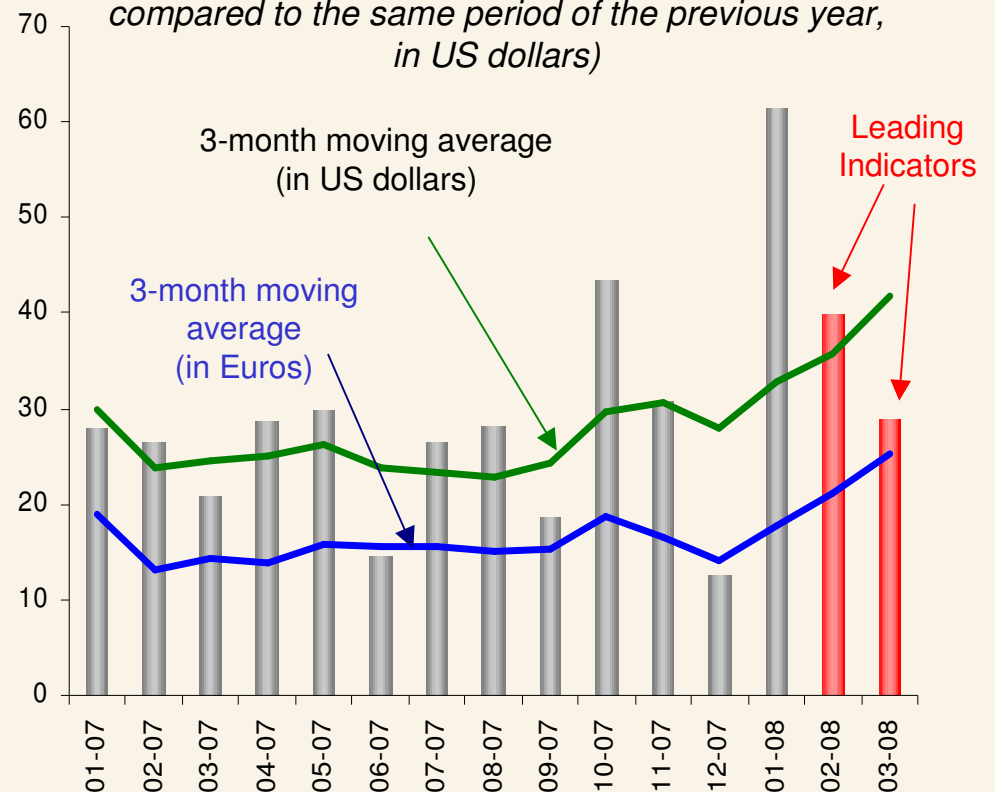
Leading Indicators for Exports

- ✓ The economic data for the quarter of 2008 suggest that the financial fluctuations have not yet had a significant decelerating effect on external demand.
- ✓ Data for January and leading indicators for February show that the high growth rate of exports continues.



Exports

(January 2007 – March 2008, percentage change compared to the same period of the previous year, in US dollars)



Source: TURKSTAT, UFT, TEA(TIM)

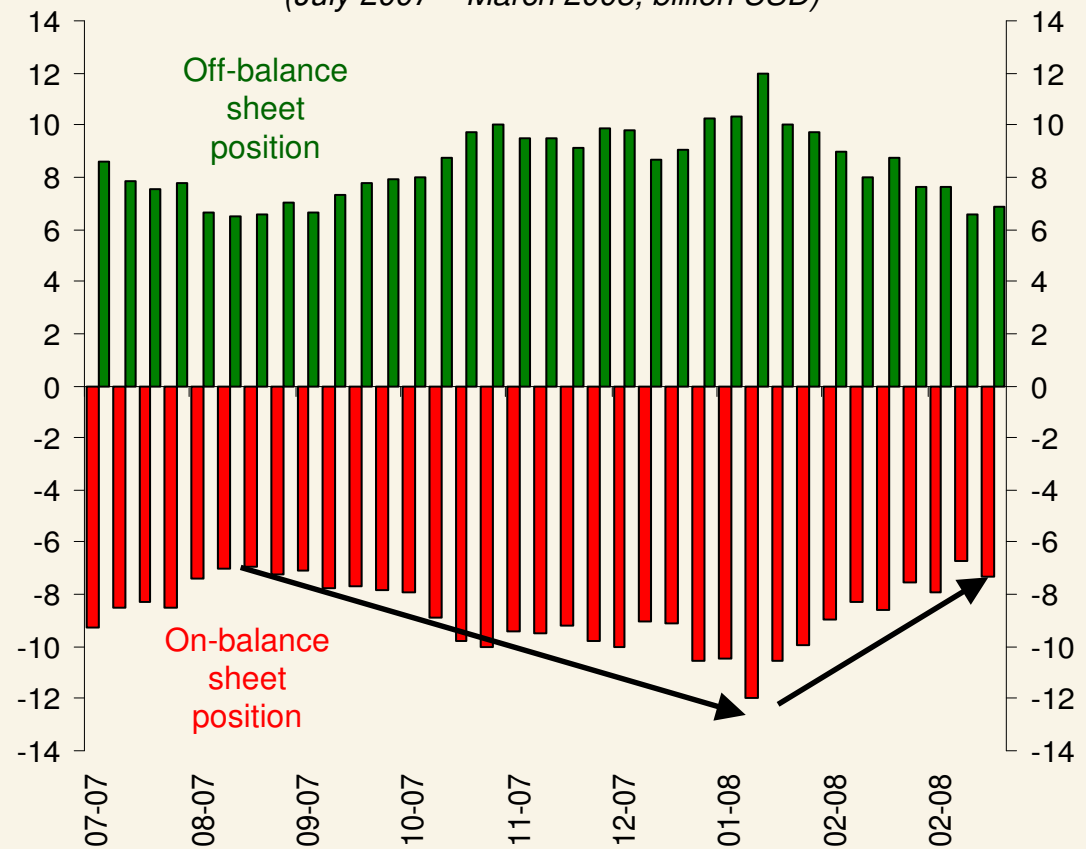


Economic Growth in Turkey

Leading Indicators of Domestic Credit Markets

✓ The recent deterioration in risk perceptions is expected to curb domestic demand by decreasing Turkish banks' tendency to borrow from abroad and lend domestically in YTL.

FX Position of the Banking Sector
(July 2007 – March 2008, billion USD)



Source: BRSA



Economic Growth in Turkey

✓ Readings on recent data indicate that the economic activity has been robust compared to the previous period and that the recovery in the economic activity has continued in the last quarter of 2007 as well as in early 2008.

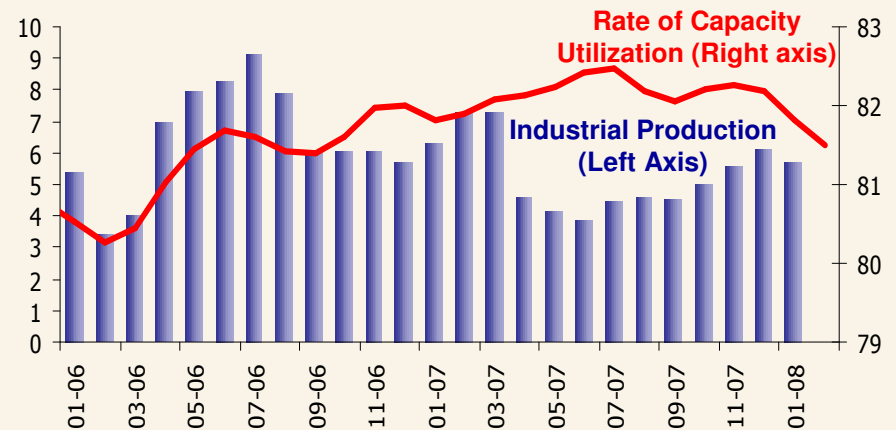
✓ Industrial production has grown moderately since the last quarter of 2007.

✓ Seasonally adjusted figures pertaining to capacity utilization maintain their high level.

✓ Despite sustained rise in credit utilization, private consumption expenditures do not exhibit a noteworthy acceleration.

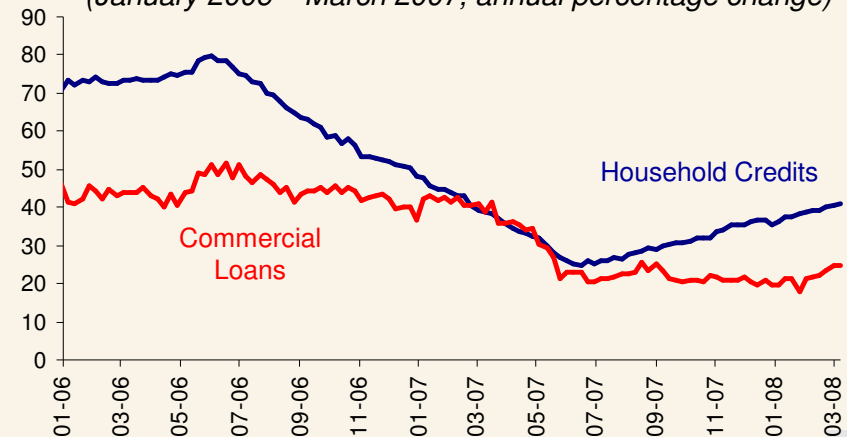
✓ It is projected that the lagged effects of the monetary tightening, along with fluctuations in international credit markets might curb growth in bank credits.

Increase in Industrial Production* (annual percentage change) **and Rate of Capacity Utilization*** (January 2006– February 2008, percent)



* Seasonally adjusted
Source: TURSTAT; CBRT

Commercial Loans and Household Credits (January 2006 – March 2007, annual percentage change)



Source: TURSTAT; CBRT



Overall Assessment



Overall Assessment

✓ Current indicators show that the Turkish economy has become more resistant to fluctuations in global markets compared to the previous years.

✓ Having said that, the decline in fragilities in comparison to the previous periods should not be interpreted as the absence of risks.



Overall Assessment

- ✓ The effects of the recession in the US economy and the fluctuations in financial markets are felt in all world economies.
- ✓ It is impossible to avoid these repercussions in today's world where trade and capital flows are free and economies are becoming more and more integrated.
- ✓ However, degree and duration of this effect will differ from country to country and will be determined by the economic policies of the countries.



Overall Assessment

- ✓ As long as the economic program is implemented decisively and no concessions are made from these policies, Turkish economy will be more resistant to shocks. Within this context, resolute implementation of the fiscal policies and keeping up with the structural reforms in an uninterrupted fashion are of crucial importance.
- ✓ Tight fiscal policy along with budget management compatible with the principles of transparency, unity, generality, and accountability has made significant contribution to the progress made since 2002 in reaching sustainable growth as well as in reducing inflation.
- ✓ It should be kept in mind that in the recent period when external risks became more pronounced, should notions indicating a possible diversion from the fiscal discipline occur, there might be a deterioration in the risk perceptions regarding the Turkish economy.
- ✓ In order to enhance the resistance of the Turkish economy against exogenous shocks, maintaining and improving the gains in public finance, as well as the reforms made in institutional infrastructure are essential.



Overall Assessment

- ✓ The baseline scenario of the Central Bank for medium-term inflation and monetary policy assumes a soft landing in developed economies, with no major portfolio shock on the Turkish financial markets. However, the probability of a sharper than expected slowdown in the global economy should not be ruled out.
- ✓ Realization of such an event may constitute an upside risk for the short-term inflation, through its potential impact on portfolio movements and the exchange rate. It also poses downside risks for the inflation and economic activity in the medium-term through a possible weakening in external demand and domestic credit.
- ✓ The potential second round impact of elevated food and energy prices on headline inflation should not be overlooked. That risk becomes more apparent in view of the fact that the medium-term inflation expectations are still above the inflation target. The Central Bank will tolerate the first-round effects resulting from food, energy and one-off adjustments in administered prices.



Overall Assessment

- ✓ In the floating exchange rate regime, the Central Bank can implement a more flexible liquidity management policy in comparison to fixed or managed exchange rate regimes. It can respond to liquidity requirements of the banking system in a more flexible and prompt manner. In addition, as long as it is in line with the inflation target, Central Bank can prevent any excessive volatility in the money market interest rates.
- ✓ However, it should be noted that the banking sector and the real sector should continue to follow cautious risk management principles, rather than relying on this relatively more flexible and effective Turkish lira liquidity management and the foreign exchange liquidity facility of the Central Bank. Taking into account the fact that they operate in an environment where the exchange rate risk lies in the market, they should establish mechanisms that will ensure the effective risk management strategies.



CENTRAL BANK OF THE REPUBLIC OF TURKEY

Durmuş YILMAZ
Governor

27 March 2008