



**CENTRAL BANK OF THE REPUBLIC OF TURKEY**

**PRESENTATION MADE BEFORE THE COUNCIL**

**OF MINISTERS**

*October 2006*

# Outline

- ✓ Inflation

- 2006 January – July

- 2006 August – September

- Inflation and Response of the Monetary Policy

- Outlook

- ✓ Developments in Financial Markets

- Exchange Rate Regime – Exchange Rate Policy

- ✓ Growth

- ✓ Employment

- ✓ Current Account Deficit



# Inflation

# Inflation

✓ Considerable progress has been achieved in fight against the inflation in the last four years.

→ Inflation dropped to single-digit figures from figures of 70 percent - observed at the start of 2002.

→ In 2005, end-year inflation reached its lowest level in the last 35 years.

✓ However, price stability has not yet been fully achieved.

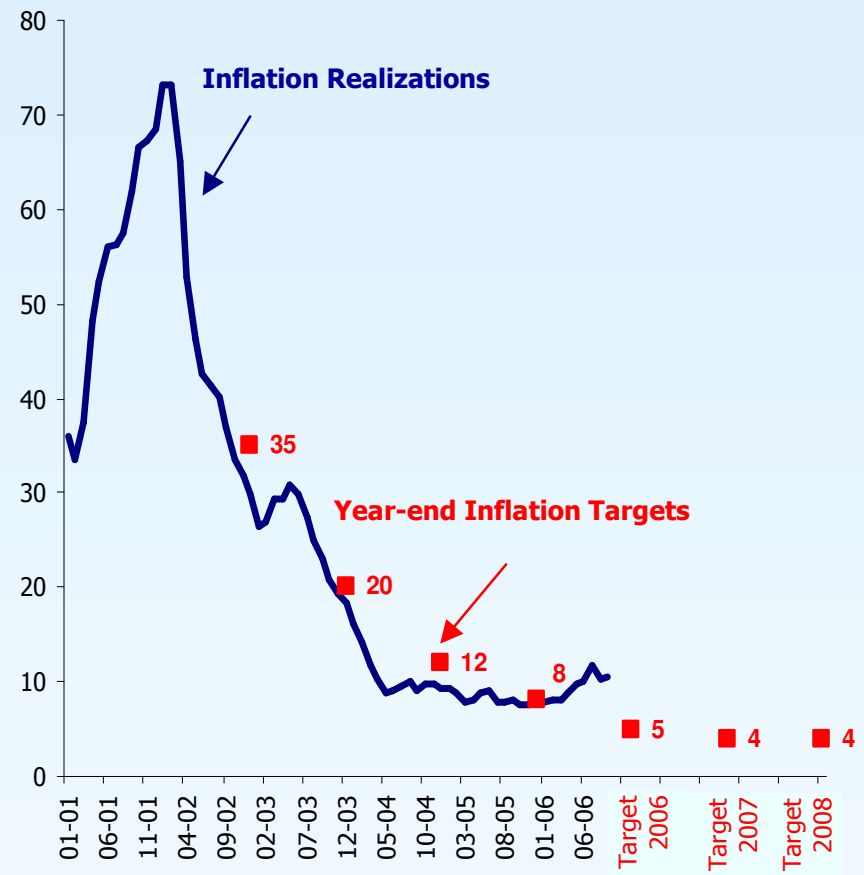
→ The duty to achieve and maintain price stability presents a historical mission and high degree of responsibility to the Central Bank.

→ The determined fight against inflation continues and will continue in the future.

→ It should be borne in mind that the disinflation process is a long and tough one.

➤ *Inflation developments of 2006 confirm this view.*

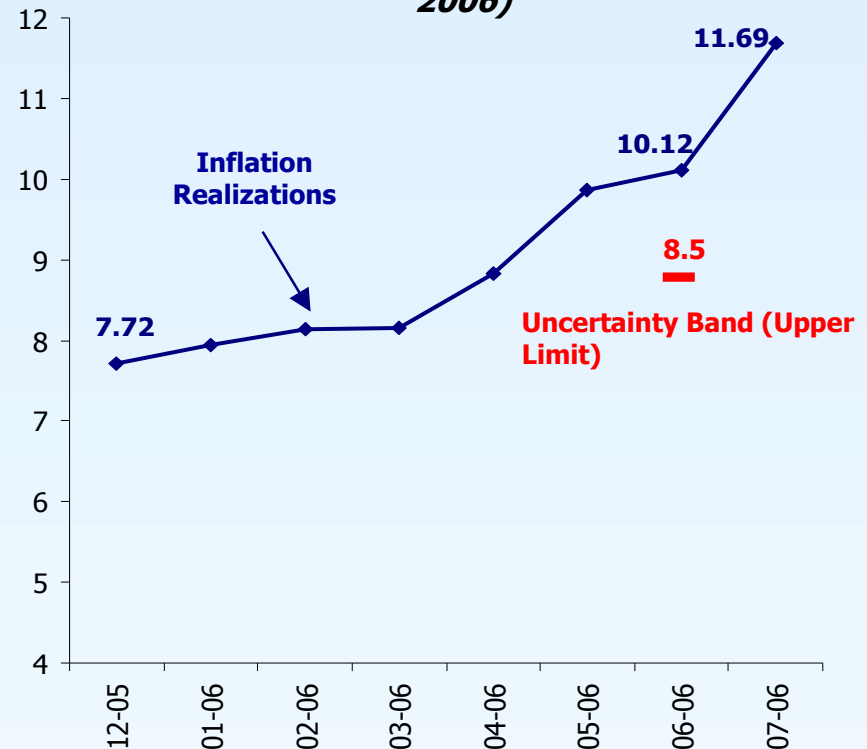
***Inflation and Year-end Targets– CPI  
(Percent, January 2001 – September 2006)***



# Inflation; January-July 2006

- ✓ Inflation followed an upward course in the first seven months of 2006.
  - By June 2006, annual inflation was realized as 10.12 percent and exceeded the upper limit (8.5 percent) of the uncertainty band of the path consistent with the end-year target.
  - By July 2006, annual inflation increased to 11.69 percent.

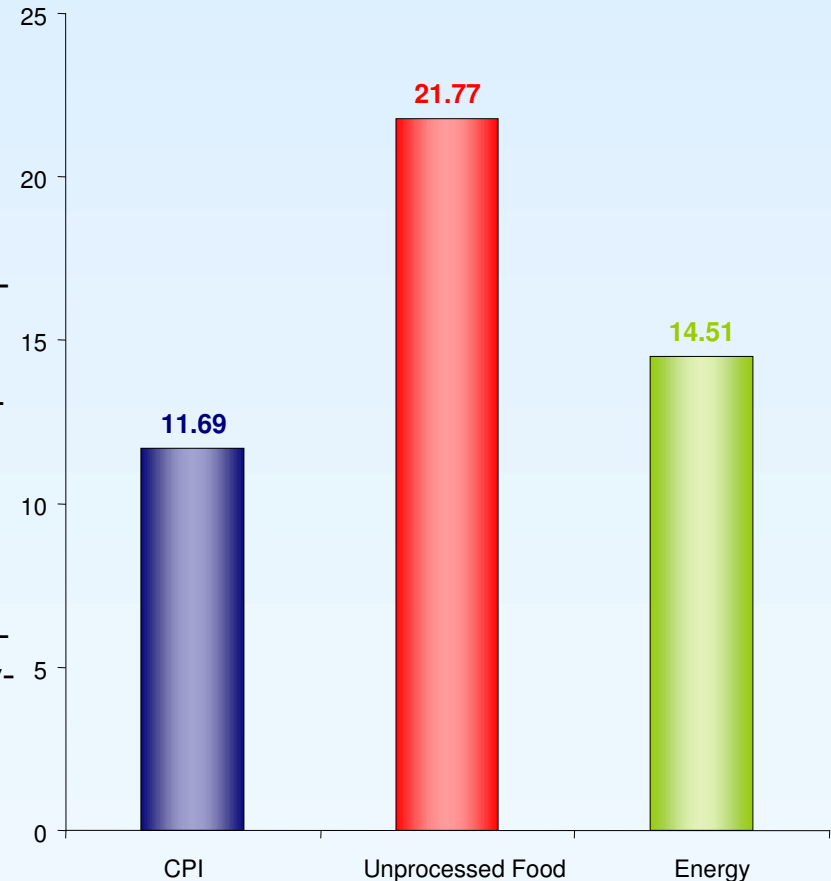
**2006 CPI Realizations and the Path Consistent with the End-year Target**  
(Annual Percentage Change, December 2005-July 2006)



# Inflation; January-July 2006

- ✓ The upward trend observed in the first seven months of 2006 mainly stemmed from seasonal conditions and external factors.
- ✓ From the last quarter of 2005 onwards, prices of unprocessed food started to rise due to adverse weather conditions and the annual rate of increase became 21.77 percent by July 2006.
- ✓ As a result of the fluctuation observed in the May-June period, where the developments in international markets were mainly effective, the YTL depreciated and led to rises in prices of both the goods priced in terms of foreign exchange and imported goods.
  - The increasing effect of the depreciation of the YTL on inflation reached 1.5 percentage points in the May-June period.
- ✓ Energy prices increased along with the rise in crude oil prices and the depreciation of the YTL and the annual rate of increase in/of this item was realized as 14.51 percent at the end of June.

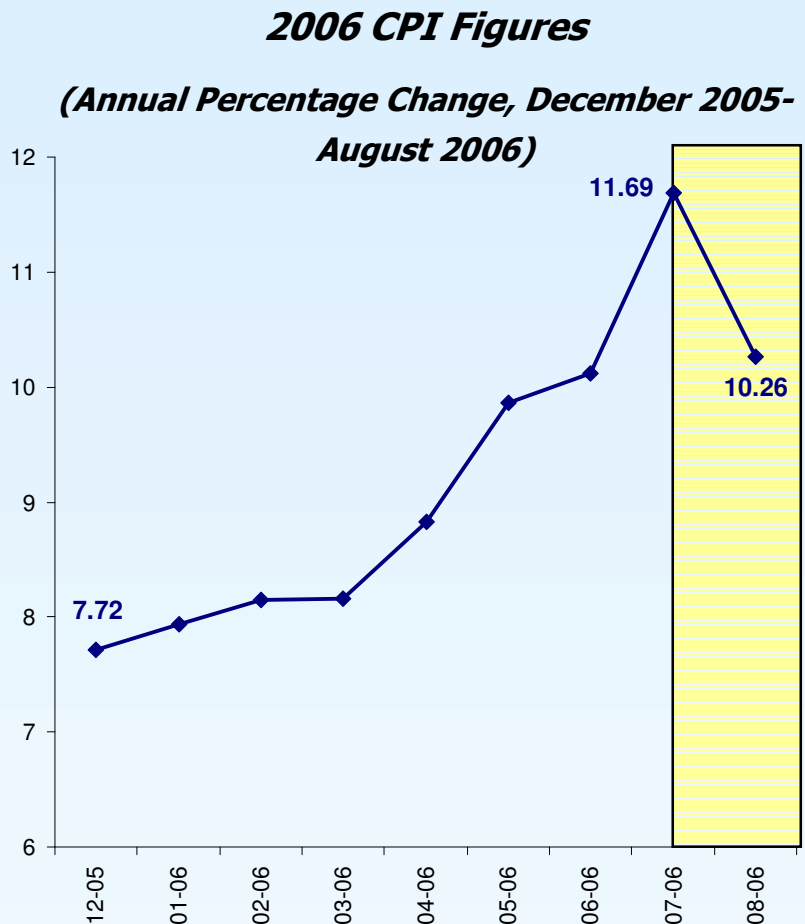
***CPI, Unprocessed Food and Energy Prices  
(Annual Percentage Change, July 2006)***



# Inflation; August 2006

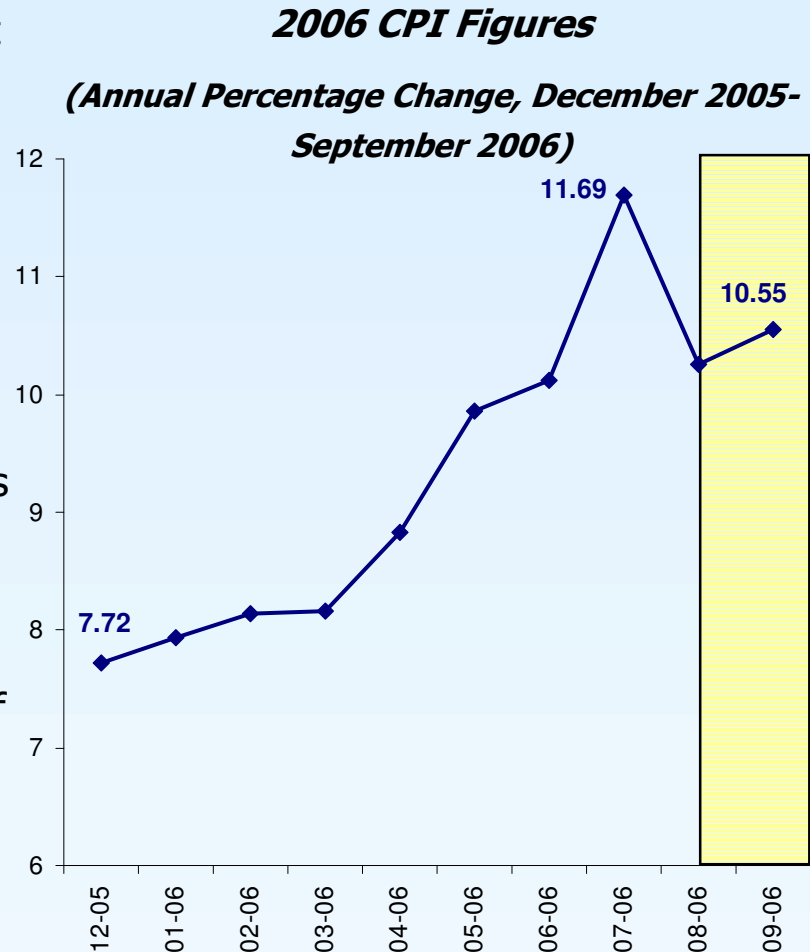
✓ In August, inflation dropped by 0.44 percent on a monthly basis and was realized as 10.26 percent in annual terms.

✓ Main determinants of the drop were seasonal declines in food and non-alcoholic beverages and clothing and footwear groups and removal of the base effect in the alcoholic beverages and tobacco group.



# Inflation; September 2006

- ✓ In September, inflation rose by 1.29 percent and was realized as 10.55 percent in annual terms.
- ✓ Cumulative price increases reached 6.65 percent in the first nine months/three quarters of the year.
- ✓ High increases in prices of seasonal products were influential in the rise observed in September.
- ✓ The religious month of Ramadan, opening of schools and lagged impacts of exchange rates had an unfavourable effect on September inflation, while the decline in energy and gold prices had the opposite effect.

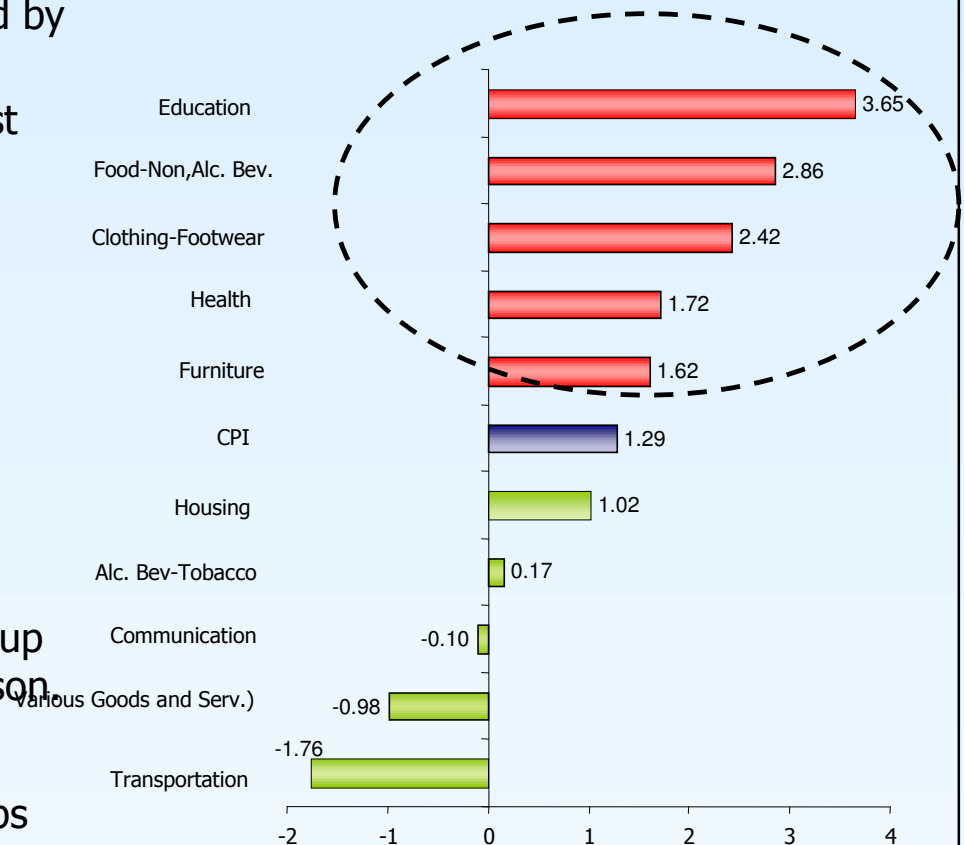




# Inflation; September 2006

- ✓ The religious month of Ramadan had an increasing effect of 0.2 percentage point to September inflation.
- ✓ Prices of the education group increased by 3.65 percent on a monthly basis due to seasonal factors and displayed the highest increase among sub-items.
- ✓ The 2.86 percent-monthly increase in prices of the food and non-alcoholic beverages group is the highest increase observed in September in the last four years.
  - The monthly increase in unprocessed food prices reached 4.92 percent.
- ✓ Prices of the clothing and footwear group rose by 2.42 percent due to the new season.
- ✓ Due to the lagged effects of exchange rates, prices of health and furniture groups increased by 1.72 percent and 1.62 percent, respectively in annual terms.

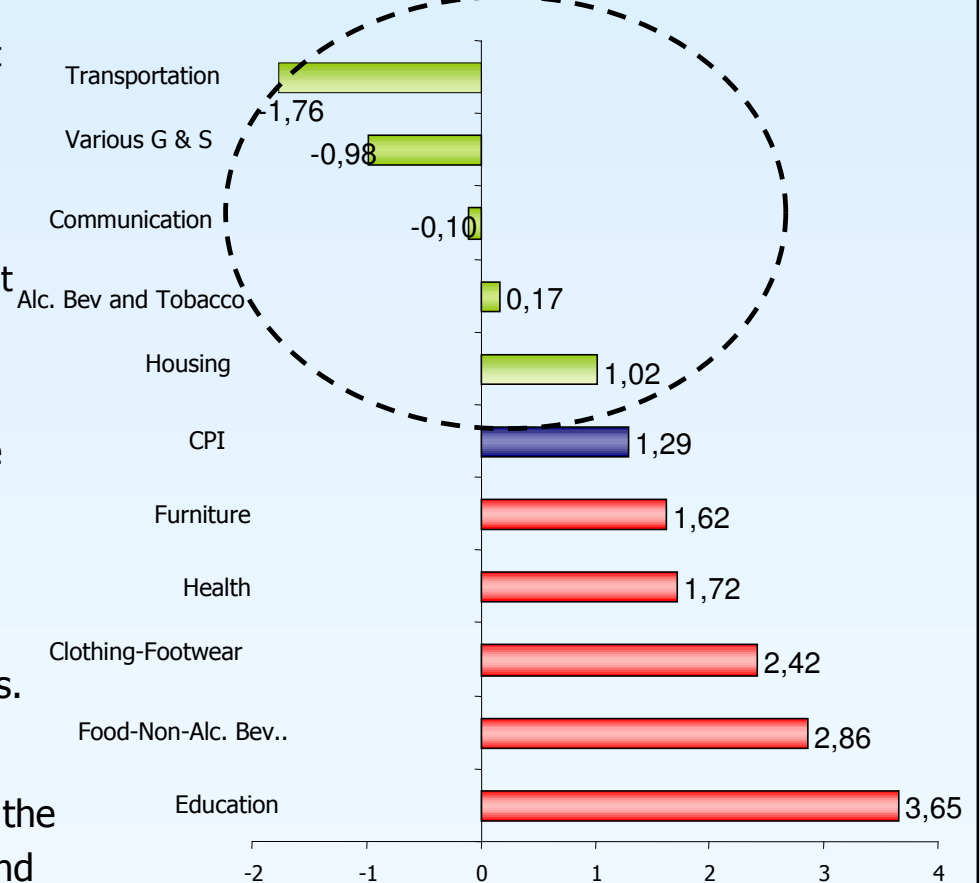
***Chosen Sub-items Affecting the September Inflation (Monthly Percentage Change, September 2006)***



# Inflation; September 2006

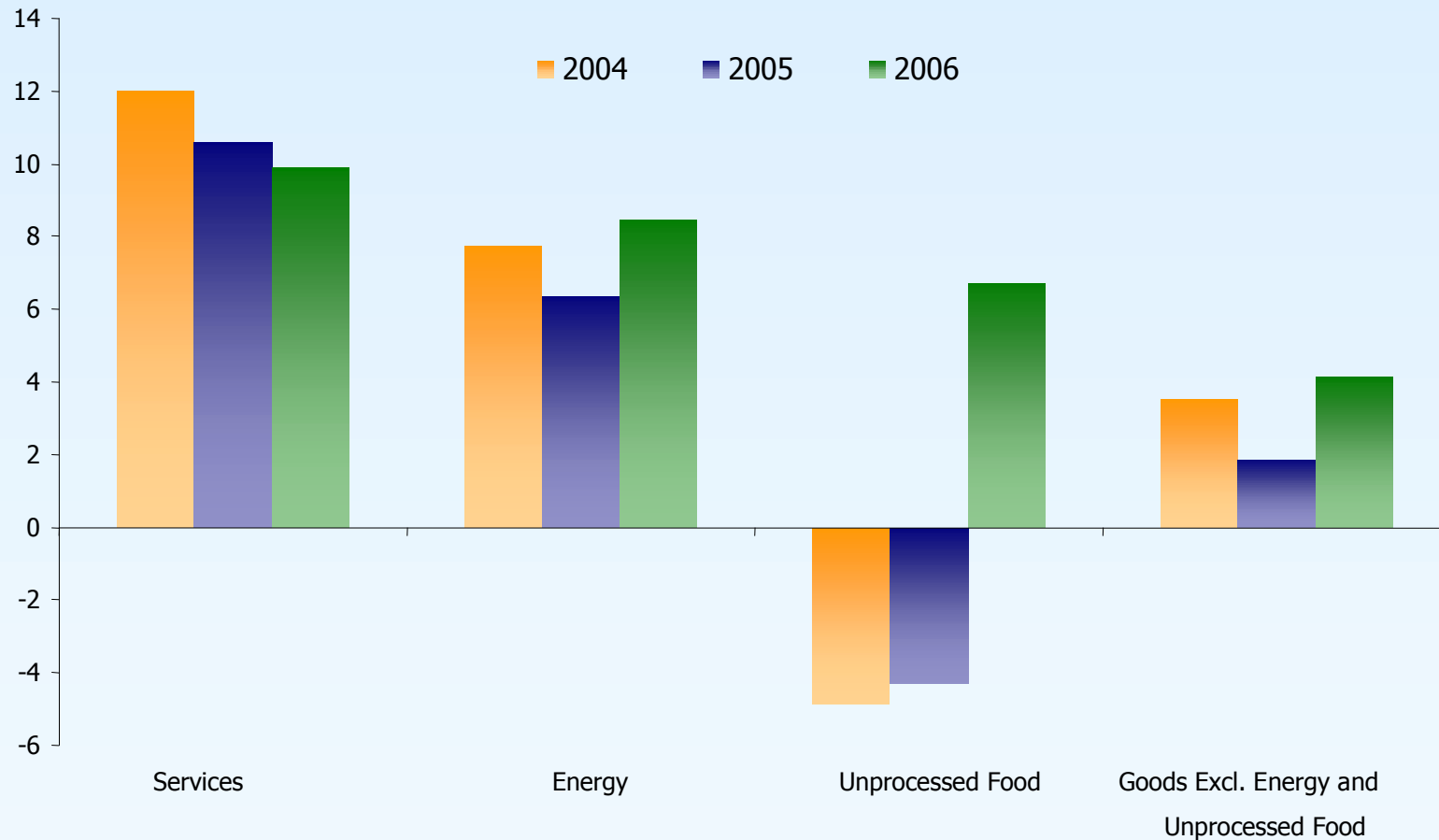
- ✓ Prices of the housing group rose by 1.02 percent on a monthly basis. The hikes in rents were the determinants of this rise.
  - As a result of the monthly increase of 2.38 percent in rents, the annual increase remained at 20 percent.
- ✓ Prices of the transportation group declined by 1.76 percent on a monthly basis.
  - The recent drop in oil prices played an important role in the said decline.
- ✓ Prices of the various goods and services group declined by 0.98 percent on a monthly basis. The drop in gold prices was influential in the said decline.
- ✓ Prices of the transportation group displayed a limited decline of 0.10 percent on a monthly basis.
- ✓ The slight monthly increase of 0.17 percent observed in this group along with the removal of the base effect in prices of the alcoholic beverages and tobacco group made a relatively positive contribution to the increase in the CPI relating to September.

***Chosen Sub-items Affecting the September Inflation (Monthly Percentage Change, September 2006)***



# Inflation

***Inflation in the First Nine Months According to Sub-groups  
(Cumulative Percentage Change)***



Source: TURKSTAT, CBRT



# Inflation and Monetary Policy Response

# Inflation and Monetary Policy Response

✓ Short-term interest rates are the main policy instruments of the Central Bank.

→ Interest rate decisions are made solely by taking inflation targets into account.

→ All developments are evaluated in a medium-term perspective and the main tendencies that are likely to affect inflation along with the permanent effects are taken into consideration.

## Interest rate decisions made in 2006, reasons and impacts.

Inflation expectations deteriorated in the April-July period and inflation deviated from targets due to the factors below:

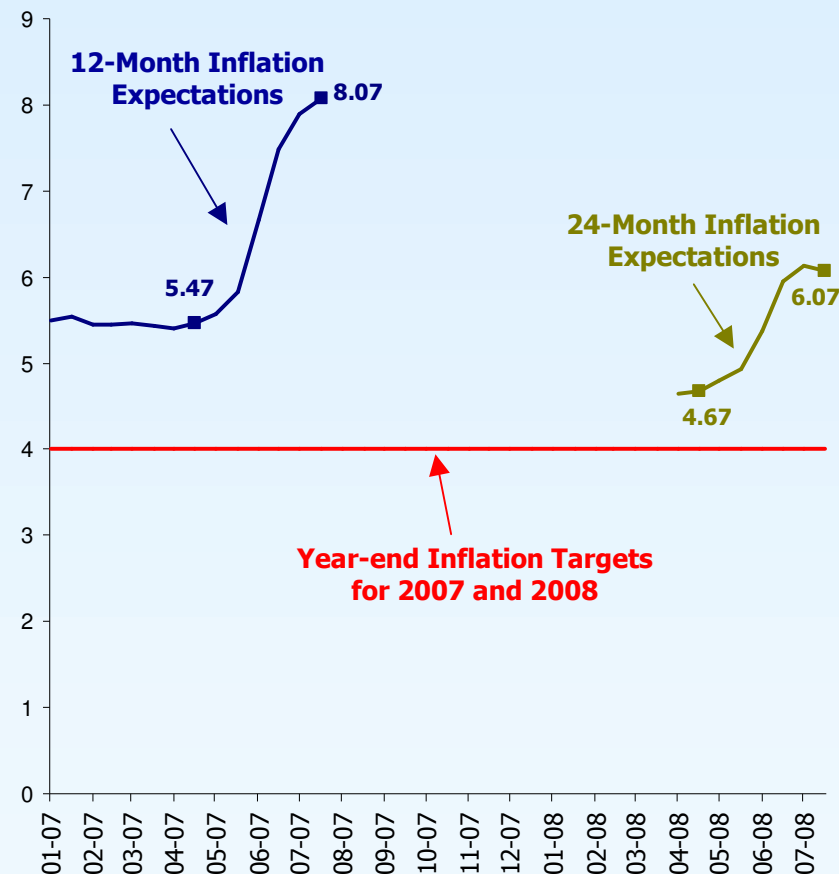
✓ Inflation increased in the January-July period,

→ Especially in April and May, inflation realized far above expectations.

✓ Volatility occurred in financial markets,

✓ Uncertainty perceptions created by internal and external developments

**Year-end Inflation Targets and  
12 and 24 –Month Inflation Expectations  
(Percent, January 2007-July 2008)**



# Inflation and Monetary Policy Response

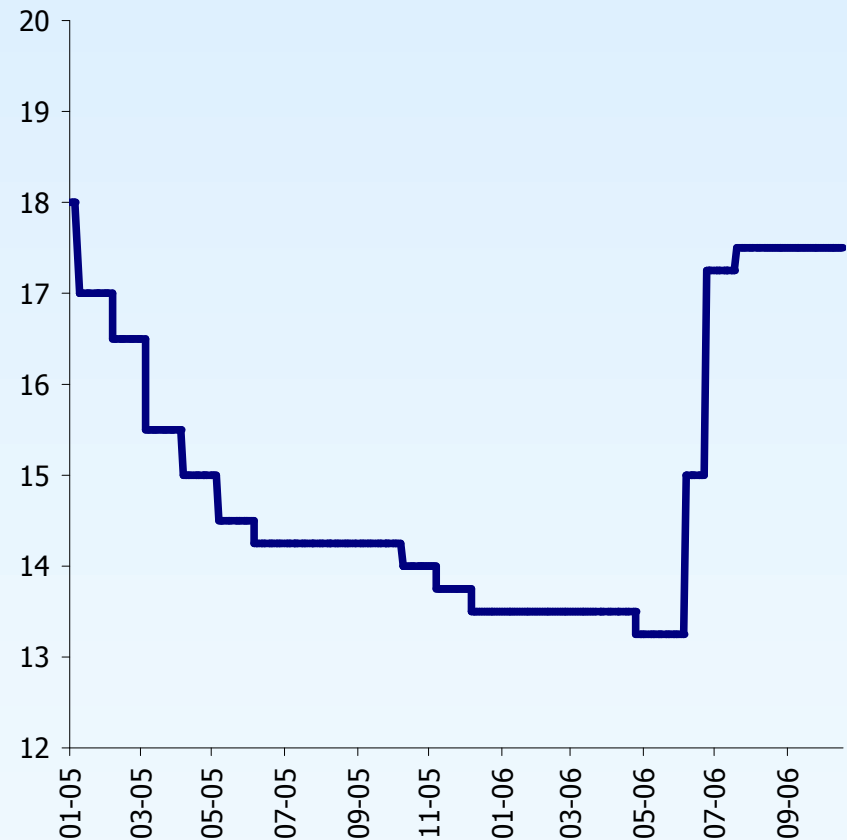
✓ As this deterioration had the potential to affect inflation and become permanent, at its ordinary and extraordinary meetings the Monetary Policy Committee decided to implement strong monetary tightening, by using short-term interest rates - the main policy instruments, with the aim of:

→ Curbing the deterioration in both inflation and medium and long-term inflation expectations,

→ Ensuring the achievability of medium-term targets.

✓ In the June-July period, short-term interest rates were raised to 17.50 percent with an increase of 425 base points.

**CBRT Overnight Borrowing Interest Rates**  
(Simple, Percent, January 2005-October 2006)

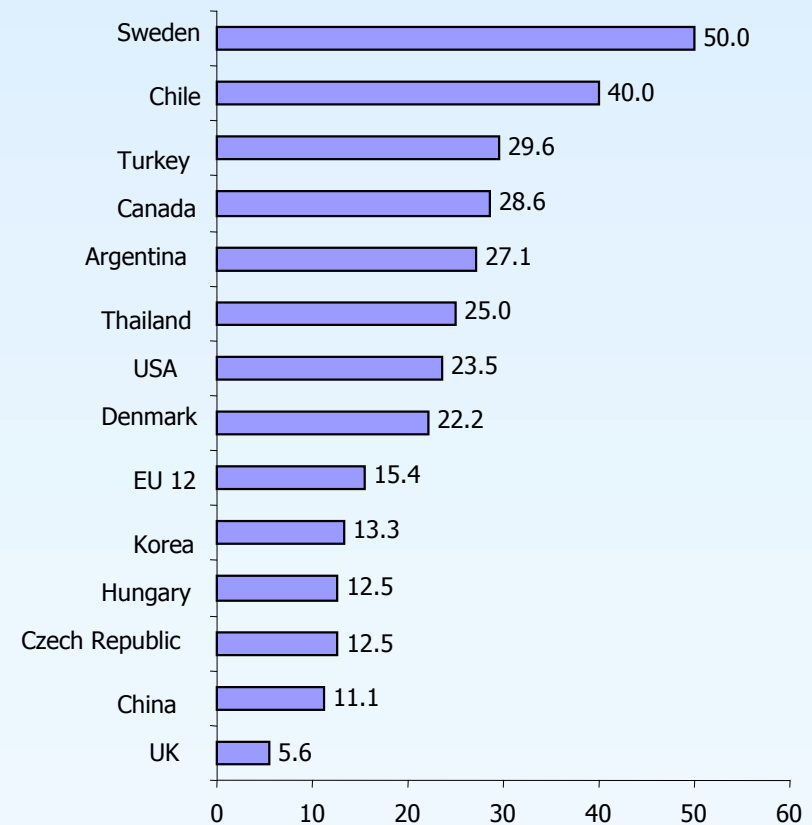


# Inflation and Response of the Monetary Policy

✓ Similarly, in cases where inflationary risks increase and excessive volatilities are observed in financial markets, all central banks respond to the medium-term impacts of these developments on inflation by severely raising policy rates.

→ From 2004 onwards, when global inflationary trends started, central banks raised short-term interest rates significantly in order to avoid these trends.

**Changes in Central Bank Policy Rates—  
Selected Countries**  
(Percentage Change, December 2005-July 2006)



# Inflation and Response of the Monetary Policy

- ✓ As a result of the strong monetary tightening,
  - Volatilities in financial markets eased gradually.
  - Medium and long-term inflation expectations improved to a certain extent.
- ✓ Moreover, in the August-October period, the Monetary Policy Board decided to keep policy rates unchanged at 17.50 percent, as a result of the following developments:
  - International liquidity conditions followed a moderate course.
  - Inflation displayed a more favorable outlook compared to previous months.
- ✓ The impact of monetary policy decisions on overall economic activity and inflation will manifest itself more clearly in the upcoming periods.

***CBRT Overnight Borrowing Interest Rates in 2006 (Simple, Percent)***

<b>23 January 2006</b>	<b>13,50</b>
<b>23 February 2006</b>	<b>13,50</b>
<b>23 March 2006</b>	<b>13,50</b>
<b>27 April 2006</b>	<b>13,25</b>
<b>25 May 2006</b>	<b>13,25</b>
<b>7 June 2006</b>	<b>15,00</b>
<b>20 June 2006</b>	<b>15,00</b>
<b>25 June 2006</b>	<b>17,25</b>
<b>20 July 2006</b>	<b>17,50</b>
<b>24 August 2006</b>	<b>17,50</b>
<b>26 September 2006</b>	<b>17,50</b>
<b>19 October 2006</b>	<b>17,50</b>





# Inflation - Outlook

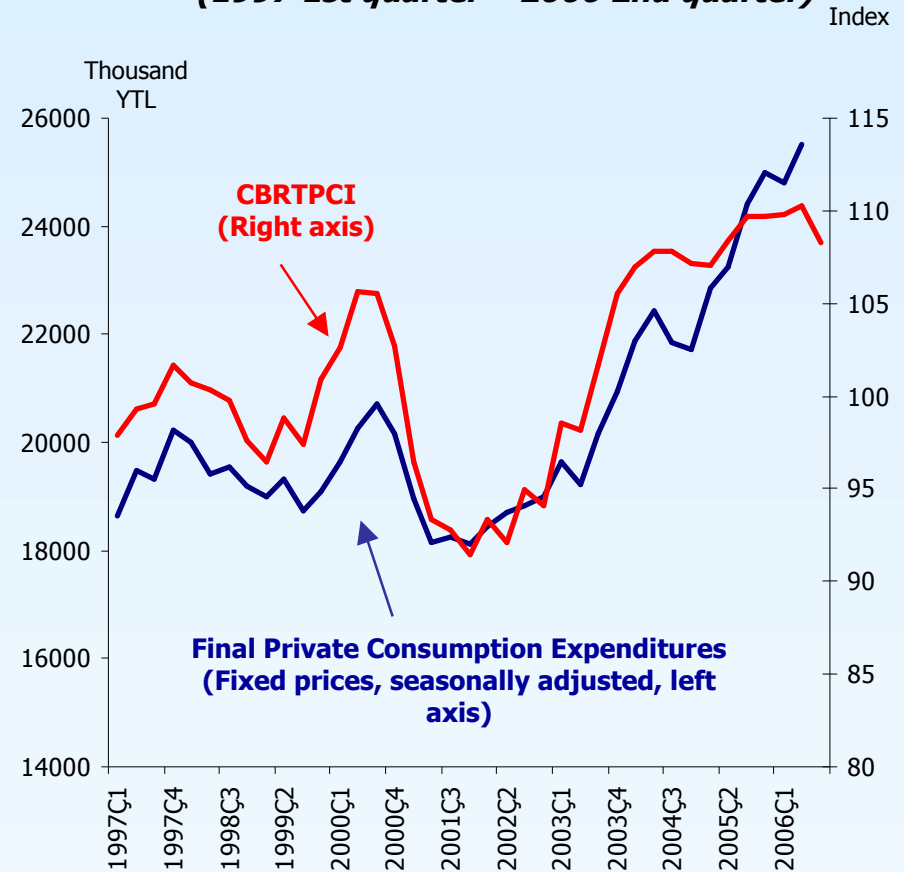
# Inflation – Outlook

✓ Total final domestic demand remained strong in the second quarter of 2006, and grew by 10.8 percent in annual terms.

→ Seasonally adjusted final private consumption expenditures soared in the second quarter of 2006, in the aftermath of the slowdown in the first quarter.

✓ However, the CBRT Private Consumption Index (CBRTPCI), which is a significant indicator of the likely course of private consumption expenditures, indicates that the share of seasonally adjusted final private consumption expenditures in the GNP will decrease in the third quarter of 2006 compared to the second quarter.

**CBRTPCI (1997 1st quarter – 2006 3rd quarter)  
and Final Private Consumption  
Expenditures  
(1997 1st quarter – 2006 2nd quarter)**

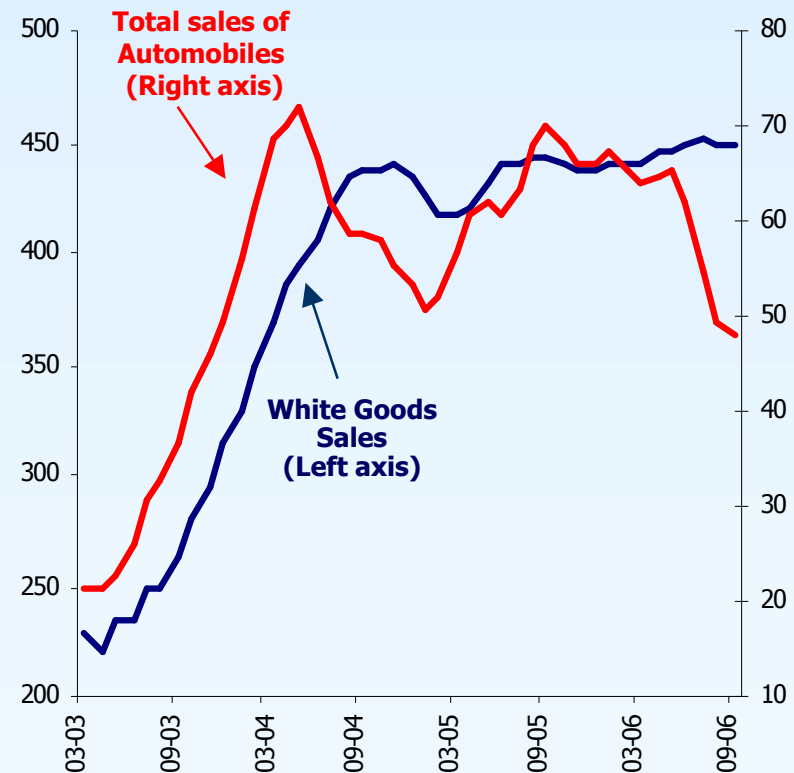


Series making up the CBRTPCI: Seasonally adjusted imports of consumer goods, seasonally adjusted real domestic taxes on goods and services, seasonally adjusted total domestic sales of white goods, seasonally adjusted domestic sales of automobiles.

# Inflation – Outlook

- ✓ Interest rates, which increased due to the financial turbulence in markets and the monetary tightening of the CBRT, led to a fall in demand in those sectors sensitive to financing conditions.
- ✓ Total sales of automobiles decreased by 33 percent in the third quarter of 2006 in annual terms, while seasonally adjusted sales fell by 23.1 percent compared to the second quarter of 2006.
- ✓ White goods sales decreased by 4.4 percent in the third quarter of 2006 in annual terms, while seasonally adjusted sales declined by 0.3 percent compared to the second quarter.

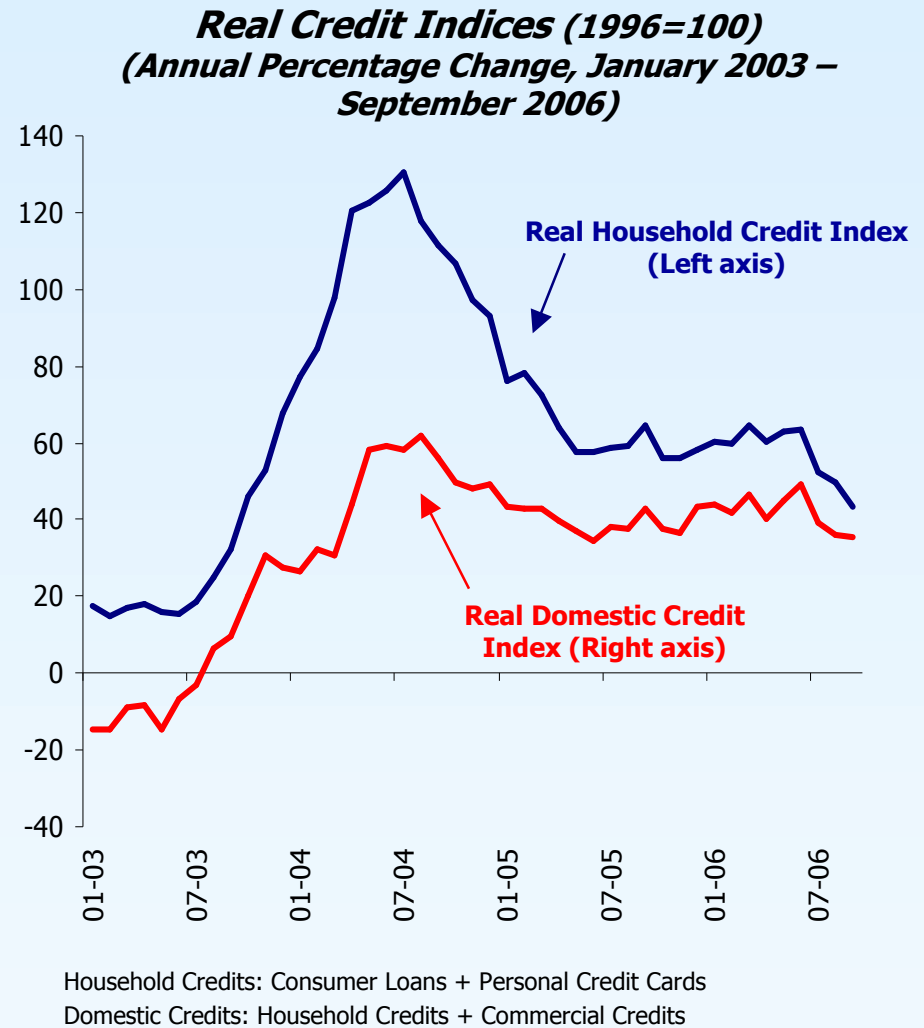
**Domestic Sales of White Goods and Total Sales of Automobiles**  
(By September 2006, Seasonally Adjusted, Quarterly Moving Average, Thousand Pieces)



# Inflation – Outlook

✓ Annual rate of increase in real household and real domestic credit indices lost pace significantly in the July-September period.

→ Annual rate of real increase in housing loans and automobile credits continued to decelerate in September, and annual rate of real increase in consumer loans fell to the lowest level of the last 15-month-period with a decline of 63.3 percent in September.



# Inflation – Outlook

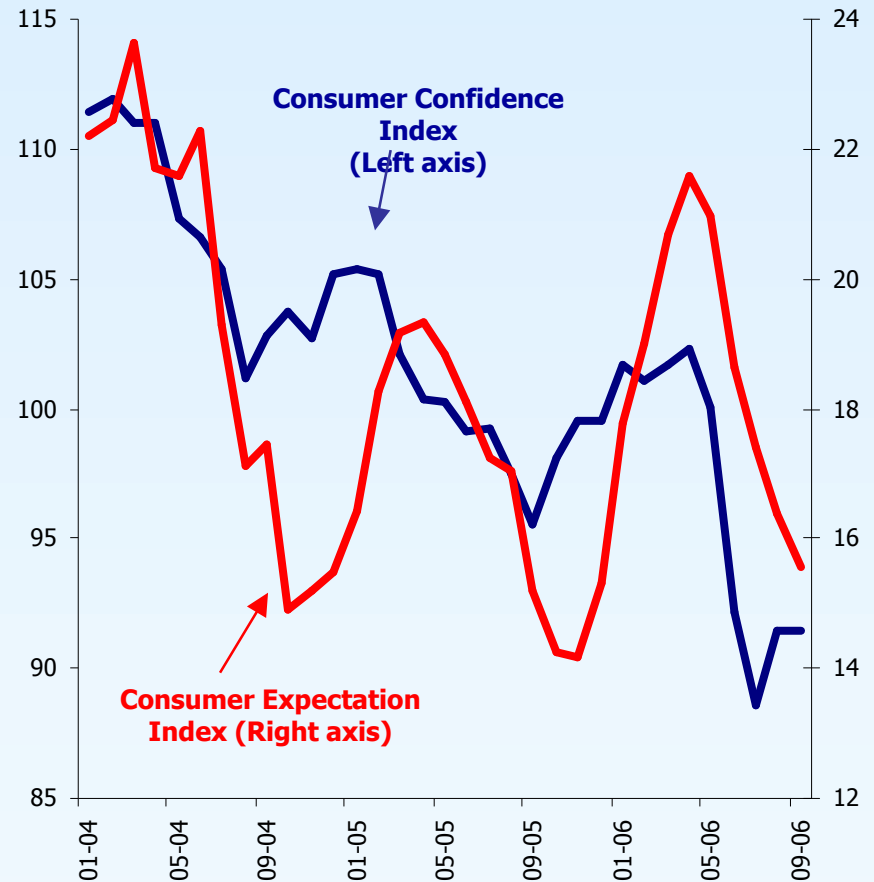
✓ The Consumer Expectation Index, which is a compilation of questions in the Consumer Tendency Survey regarding future purchases of durable goods and automobiles and spending on housing repairs, has been declining since May.

→ The index declined in August and September because the possibility of spendings on housing repairs decreased, even though the possibility of future purchases of durable goods and automobiles increased.

✓ The Consumer Confidence Index, comprising questions about the current and future conditions, rebounded slightly in August after falling to its lowest level in July 2006. The index remained at its August level in September.

✓ Developments in indices point to a slowdown in consumption demand, but also denote that this slowdown may be of a limited nature.

**Consumer Confidence and Consumer Expectation Indices (January 2004 – September 2006, Index)**



# Inflation – Outlook

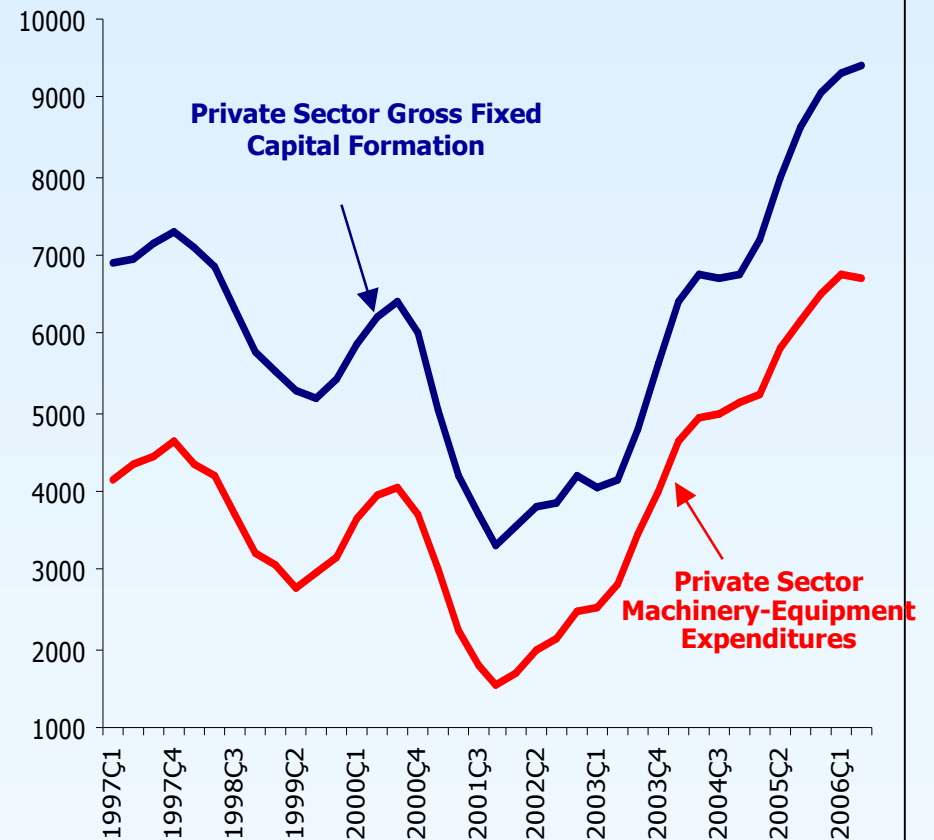
✓ The annual rate of increase in total fixed capital investments was recorded as 10.9 percent in the second quarter of 2006.

→ While fixed capital investments of the private sector increased by 14.8 percent, those of the public sector decreased by 11.3 percent.

✓ The annual rate of increase in machinery-equipment investments of the private sector decelerated in the second quarter of 2006, and seasonally adjusted investments decreased compared to the first quarter of the year.

→ It is anticipated that the decline in machinery-equipment investments may lead to a parallel decline in fixed capital investments of the private sector in the second half of 2006.

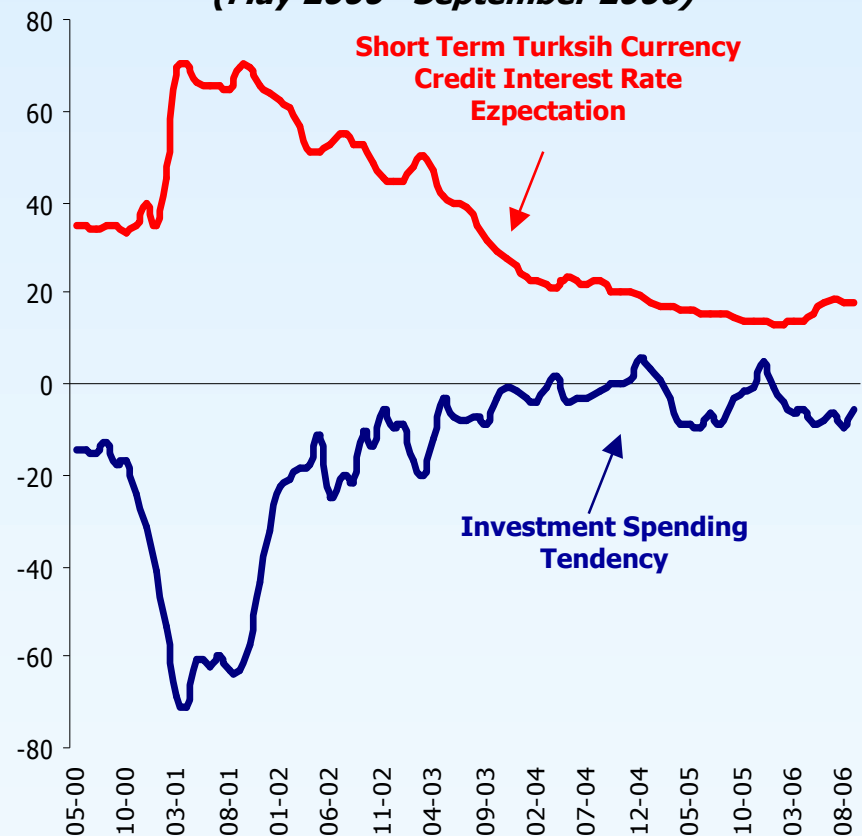
**Private Sector Investment Expenditures**  
(Seasonally Adjusted, Fixed Prices, Thousand YTL, 1997 1st quarter - 2006 2nd quarter)



# Inflation – Outlook

- ✓ The investment expenditures tendency for the next twelve-month period, which has been decreasing since the start of 2006 according to the results of the Business Tendency Survey, continued to decline by 2.8 percentage points in August compared to July, but displayed a moderate increase in September.
- ✓ Expected costs of credit, which increased in the March-July period due to financial turbulence in the markets, decreased slightly in August and remained stable in September.
- ✓ The deterioration in investment tendency is expected to be moderate.

**Credit Interest Rate Expectation for the Next 12-Month Period (Percent, Appropriate Average) and Investment Expenditures Tendency (Percent, Up-Down) (May 2000 –September 2006)**

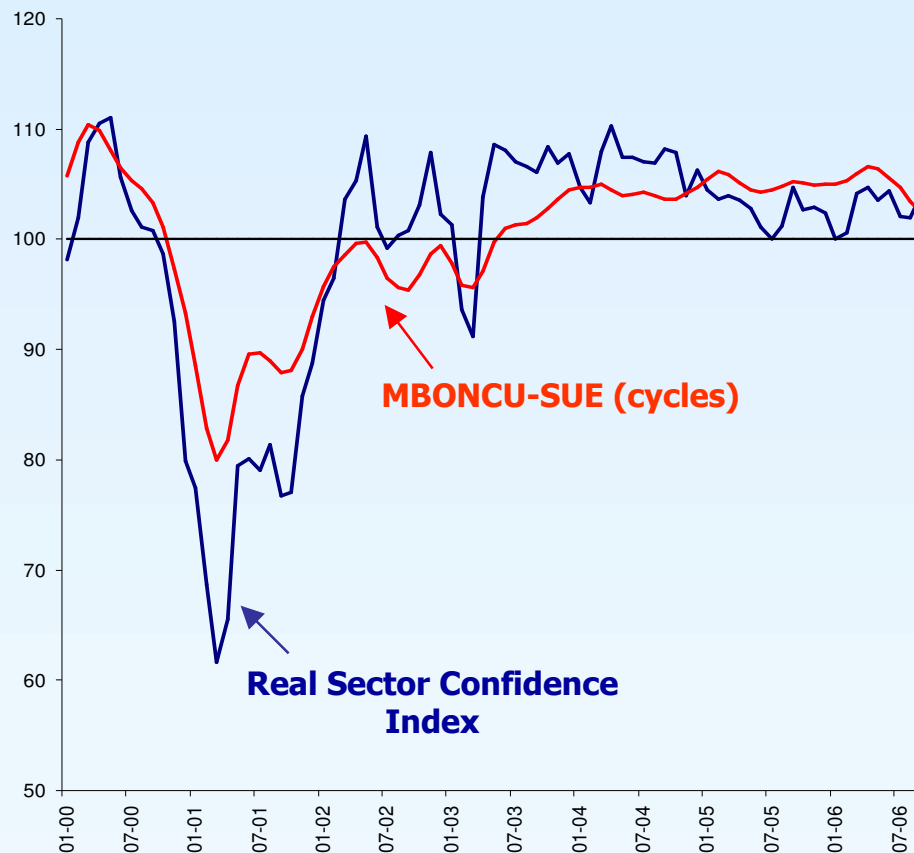


Source: CBRT

# Inflation – Outlook

- ✓ The Real Sector Confidence Index slightly increased in September, following the declines in July and August.
- ✓ The MBONCU-SUE has been in decline since May.

**Real Sector Confidence Index and MBONCU-SUE\*  
(Index, by September 2006)**



\* Composite Leading Indicators Index for Economic Activity: Data from industrial production index and business tendency survey were used.



# Inflation – Outlook

✓ Productivity in the private manufacturing industry continues to increase.

→ The annual rate of increase in productivity is 10.4 percent for the second quarter of 2006.

✓ Real wages in the private manufacturing sector do not display any significant changes.

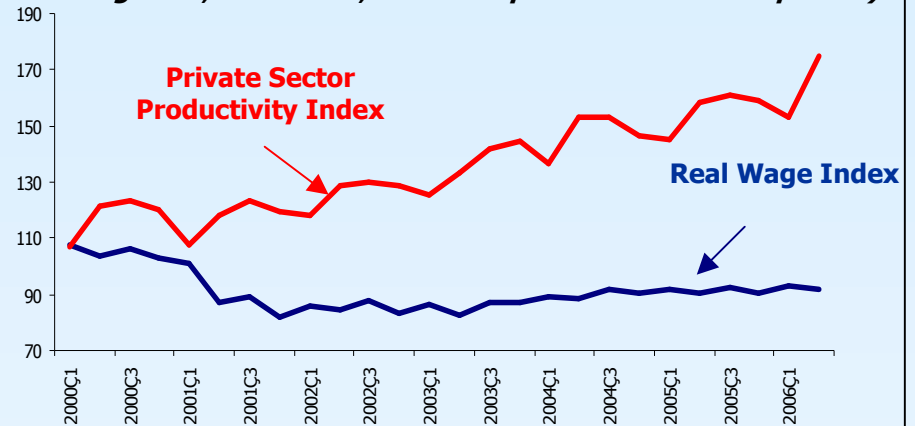
→ The annual rate of increase in the real wage index was recorded as 1.3 percent in the second quarter of 2006.

✓ Cost pressure on inflation is limited, since productivity is higher than real wages.

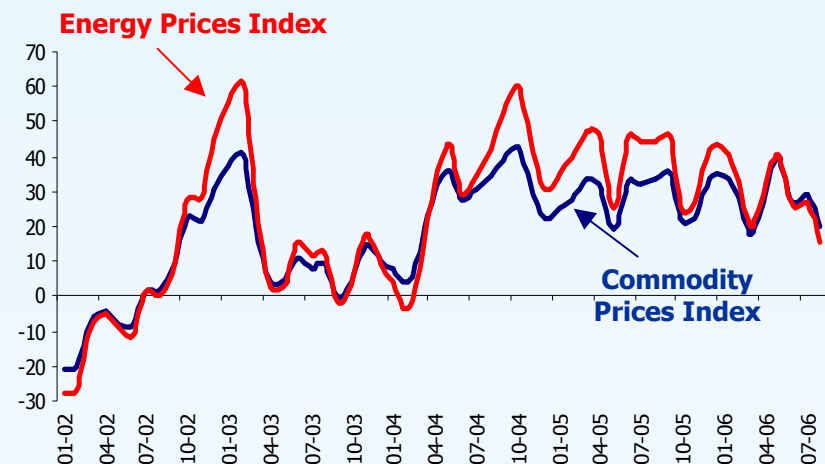
✓ The moderate decline in energy and commodity prices in the international markets stands as a positive development.

→ Especially, the decline in oil prices is significant in terms of restraining the second round effects of energy costs that have been on the rise for a long time.

**Real Wage and Productivity Indices in the Private Manufacturing Industry**  
(Per Working Hour, 1997=100, 2000 1st quarter – 2006 2nd quarter)



**International Price Indices**  
(Annual Percentage Change, 2000=100, January 2002 - August 2006)



# Inflation – Outlook

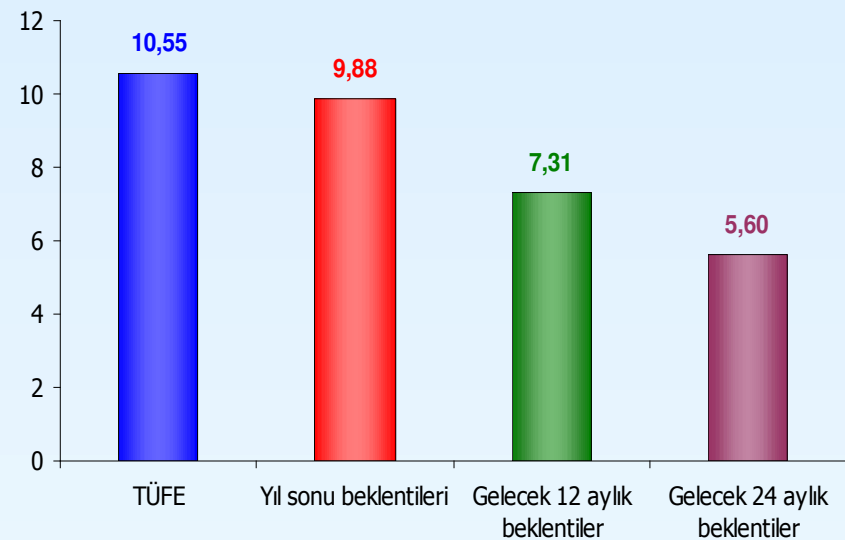
✓ The deterioration observed in inflation expectations in the April-July period ceased in the August-October period, and expectations for the next 12- and 24 month-period improved slightly.

→ While end-year expectations rapidly deteriorated during the financial turbulence period, the deterioration in medium-term expectations was rather mild.

In sum;

- ✓ There will be a significant deviation from the end-year target of 5 percent.
- ✓ Inflation will resume its downward trend, as the impacts of decisions will strengthen over time.
- ✓ The inflation target of 4 percent for 2007 and 2008 are achievable.
- ✓ All our policies are implemented with a view to achieving these targets.

***CPI (Annual Percentage Change, September) and End-Year, Next 12-Month, Next 24-Month Inflation Expectations (Percent, October 2006)***



***Year-end Inflation Targets***

2006	2007	2008
5 %	4 %	4 %

# Inflation – Risk Factors

**However, there are some risks that could ruin the expected course of the disinflation process in the medium-term.**

- ✓ Medium-term inflation expectations that are above the targets pose risk in terms of wage and price setting.
  - It is critical that economic agents take inflation targets into account while making plans for the future.
- ✓ It is not clear whether the recent decline in oil prices will be permanent or temporary.
  - There is always a risk that oil prices may increase, especially depending on foreign policy developments.
- ✓ Sudden changes in global risk perceptions and international liquidity conditions owing to monetary policies of developed countries stand as another risk factor.
  - In such cases, the Bank will not react to temporary increases in inflation, complying with its medium-term stance. However, it will continue to monitor medium-term inflation expectations closely.
- ✓ Policies that would boost the supply and competitiveness of the services sector must be implemented in the face of price rigidities.

# Inflation – Risk Factors

✓ Political processes are carefully monitored by the Bank.

→ In case these processes affect our inflation targets, the Central Bank will not hesitate to respond via its policy rate decisions.

✓ Strong implementation of tight monetary policy is critical. It has provided the strongest support to the disinflation process so far.

→ Possible impacts of incomes policy adjustments and non-interest expenditures of the public sector on 2007 inflation are carefully followed.

➤ *Wage hikes planned for 2007 will not be assist the disinflation process.*

→ Shaping pricing policies in view of inflation targets and avoiding any need of unprogrammed public price adjustments within budgetary expenditure limits are important issues.

→ Expenditures of local administrations require particular attention.

✓ Uninterrupted and timely implementation of structural reforms is also critical. Interruptions and delays negatively affect expectations and lead to high costs.

→ These reforms will further improve the quality of fiscal discipline, and will enhance productivity in the long run by cultivating a better environment of competition and investment.

# Inflation – Risk Factors

✓ It is highly critical that any implementations, initiatives and remarks that would ruin risk perceptions and expectations are avoided.

→ In Turkey, expectations may significantly change in a very short time. In a country with thirty-year experience of high inflation, a five-year period is a fairly short period for structural gains to permanently offset the fragility of expectations. In this case expectations management is a significant pillar of the current program. Making up for losses takes a long time and the costs affect the whole society.

→ In this respect, relations with the IMF and EU are two critical anchors with regard to expectations in the medium and long term.

✓ It should be underlined that any remarks, discussions and implementations that would question the Central Bank's independency will impair the reliability of our policies and targets, and such outcomes will be destructive.

→ The Central Bank's independency is one of the most significant gains of Turkey. It is for the good of all. The current success is evidence of this fact.



# **Developments in Financial Markets**

## **Exchange Rate Regime – Exchange Rate Policy**

# CBRT Exchange Rate Policy

✓ The floating exchange rate regime is the core element of the currently implemented formal inflation targeting regime in the disinflation process.

✓ In the floating exchange rate regime, exchange rates are determined by supply and demand conditions in the markets.

→ In this framework, the value of the Turkish currency changes depending on;

➤ *Short-term expectations, foreign currency supply and demand developments and behaviours of market players in the short run,*

➤ *Economic fundamentals, the course of structural reforms, and medium- and long-term expectations in the medium and long run.*

✓ In the floating exchange rate regime, the Central Bank operates in FX markets for two main reasons:

1- To build up reserves (via daily FX buying auctions).

2- To prevent excessive volatility (via FX interventions). These interventions are neither mechanical nor of a symmetrical nature, and each case is evaluated on its own merits.

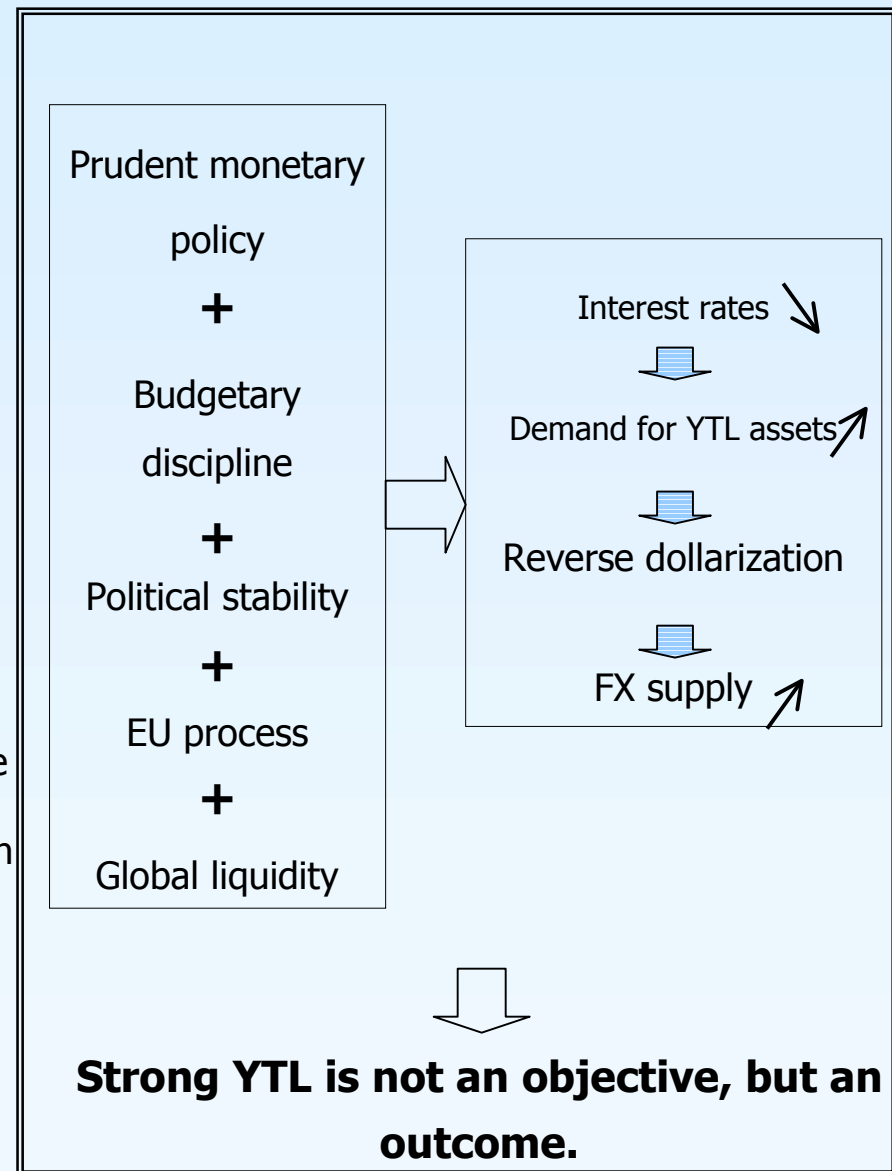
# CBRT Exchange Rate Policy

✓ A net amount of USD 43.7 billion foreign currency has been withdrawn from markets via auctions and interventions since 2002. By 13 October 2006, Central Bank reserves are USD 56 billion.

→ External debt payment of the public sector for the next 4-year period (2007-2010) is USD 43.3 billion.

✓ In the current regime, Central Bank has no explicit or implicit commitment for the exchange rate level, nor it has any specific implementation to strengthen the Turkish currency.

→ Strong YTL is not an objective, but an outcome.

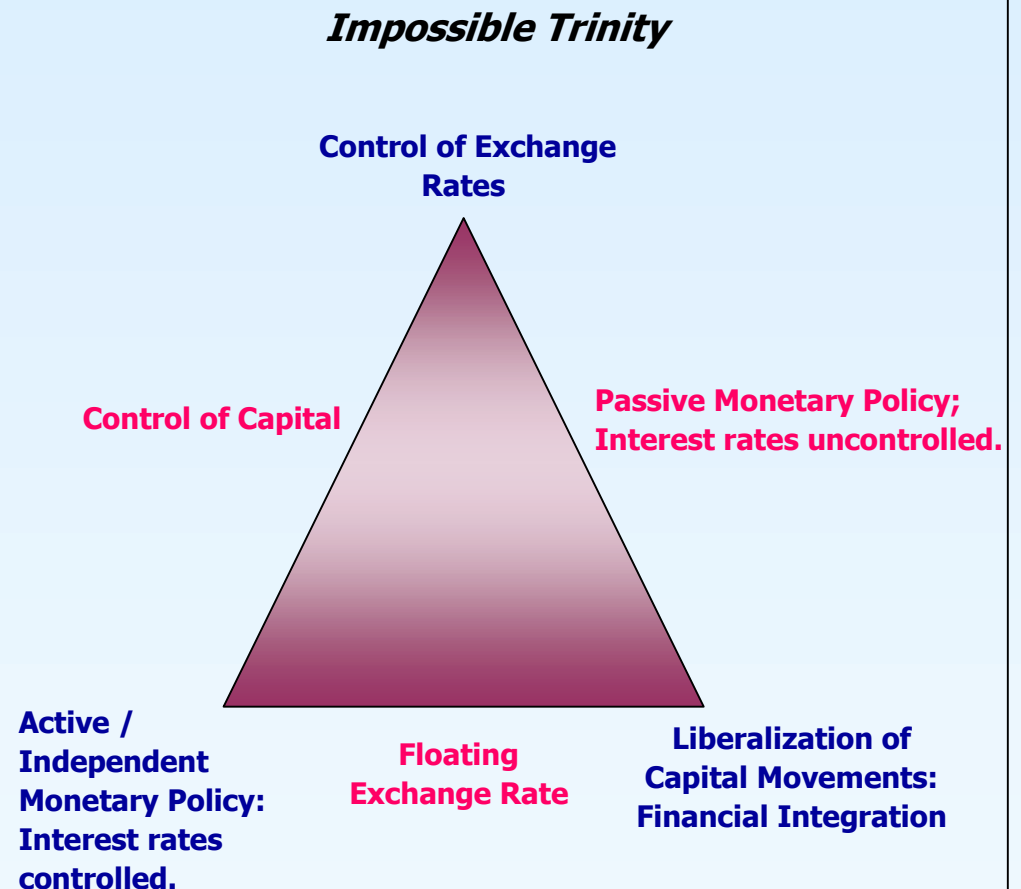




# CBRT Exchange Rate Policy

✓ In the floating exchange rate regime, exchange rates cannot be used as a policy instrument.

→ In an environment where capital movements are free and short-term interest rates are used as the policy instrument, it is not possible to control exchange rates.



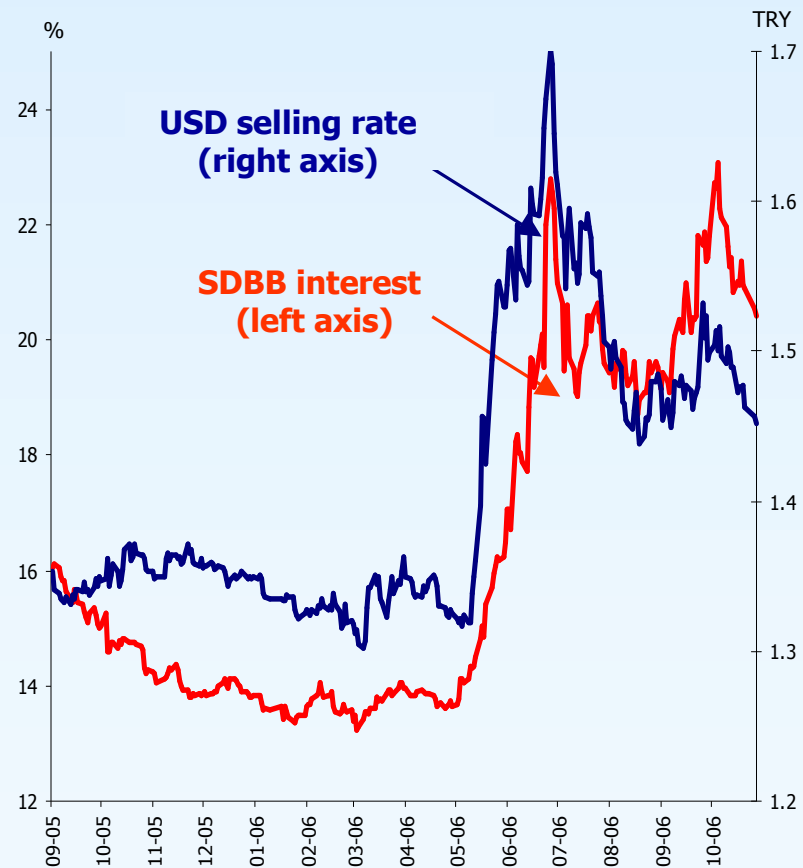
# Financial Markets

- ✓ However, due to their importance as a part of financial stability, exchange rates are variables that the Central Bank closely monitors at all times.
- ✓ Developments in financial markets are important in terms of their effects on inflation and on the economy.
- ✓ Within the framework of supportive financial stability, the Central Bank closely monitors the developments in financial markets and takes the necessary measures.
- ✓ Since 2002 many financial reforms were implemented. The Central Bank has been supportive of and/or has been implementing these reforms.
  - The on going reform process fortifies the soundness of the financial system.
- ✓ Moreover, the soundness of economies and financial systems are tested by the crises that are experienced.

# Financial Markets

- ✓ Fluctuation in the May-June period is one of the crises experienced.
- ✓ In this period, due to the forecast that the central banks of developed countries would probably tend to increase interest rates, global liquidity diverged from developing countries to developed countries and created fluctuations in global markets.
- ✓ This fluctuation strongly also affected Turkey and in the period from the beginning of May to end-June;
  - based on the capital outflow, the Turkish currency depreciated by almost 29 percent.
  - Interest rates rose by almost 7 percent.

**CBRT Indicative USD Selling Rate and Indicative Government Securities Interest Rates (Composite)**  
(1 September 2005 – 27 October 2006)

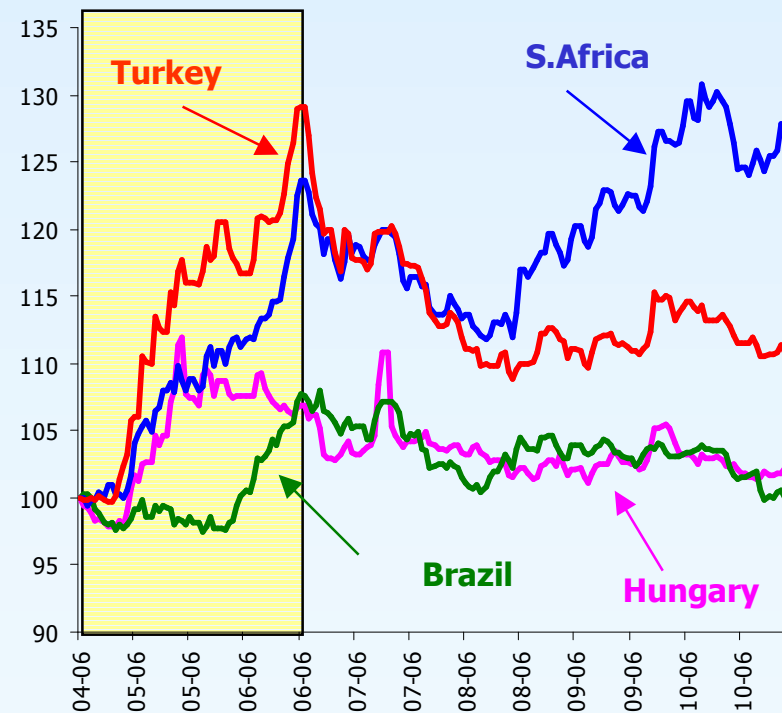


# Financial Markets

- ✓ This fluctuation in the May-June period is not specific to Turkey.
- ✓ Other developing countries were also affected by this fluctuation.
- ✓ The depreciation in currencies of developing countries, which started in the first quarter of May, continued until mid-June.
- ✓ After the second quarter of August, their currencies depreciated again..

## *Exchange rate of currencies of Turkey and Other Developing Countries in terms of USD\**

*(30 April – 27 September 2006, Index)*

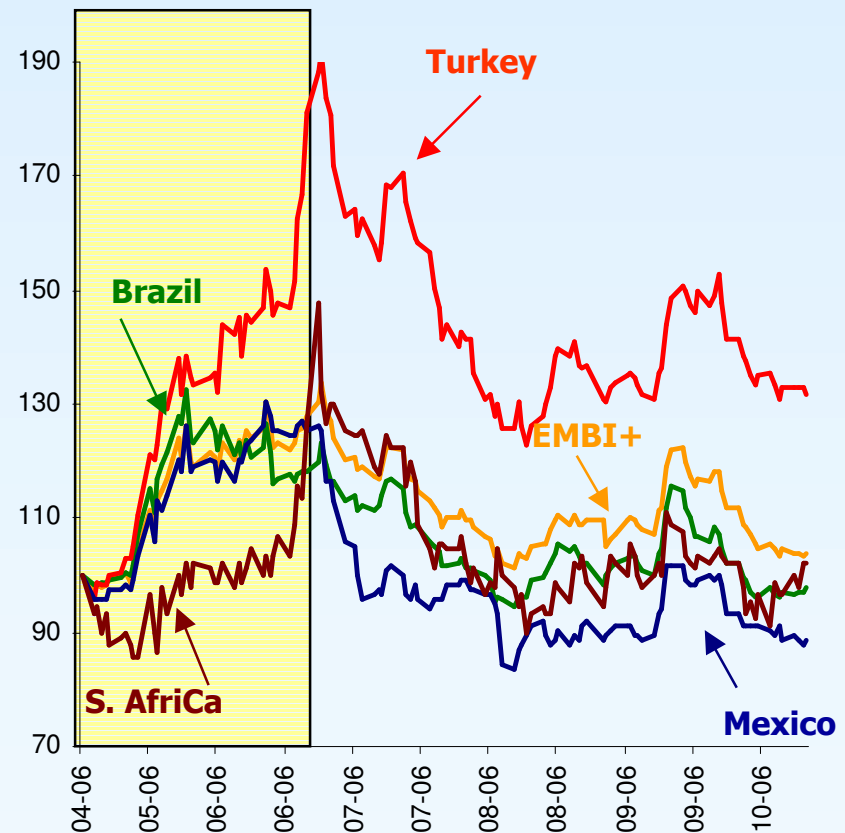


\*The increase in the index indicates that USD has appreciated in terms of currencies of the developing countries. 30 April 2006 = 100

# Financial Markets

- ✓ Turkey was more shaken by these fluctuations than other countries were.
- ✓ Though there was not any deterioration in the macroeconomic background, with the negative impact of activity in the markets due to foreign capital outflow, inflation, increased domestic risk perceptions concerning the current account deficit, and political issues, the fluctuations were felt strongly.
- ✓ In this period, the Central Bank took effective market measures to maintain financial stability..

**EMBI+Spreads\* of Turkey and Some Developing Countries**  
(28 April - 27 September 2006, Index)



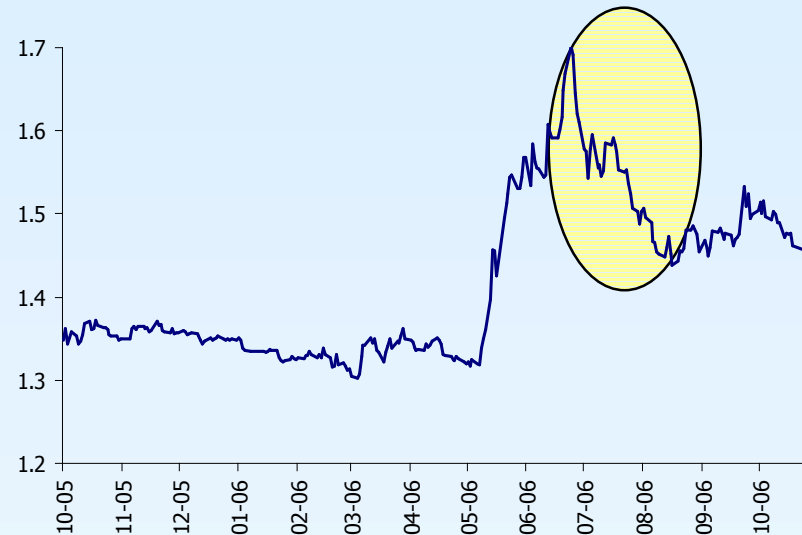
\* EMBI+: Emerging Market Bond Index, 28 April 2006 = 100

# Financial Markets

## FX Markets;

- ✓ FX buying auctions were suspended as of May 16, 2006 to prevent the declining FX liquidity from increasing the volatility in FX rates.
- ✓ On June 13, 23, and 26 direct intervention was in the markets; 2.1 billion USD sale was made..
- ✓ On June 26 and 27, FX selling auctions were held, 1 billion USD exchange was sold.
- ✓ An other important factor of this period is that a large extent of the capital outflow was compensated by the FX sales of residents.

**CBRT Indicative USD Selling rate  
(3 September 2005 - 27 October 2006)**



**June 2006 FX Sale Auctions and FX Sale  
Intervention (billion USD)**

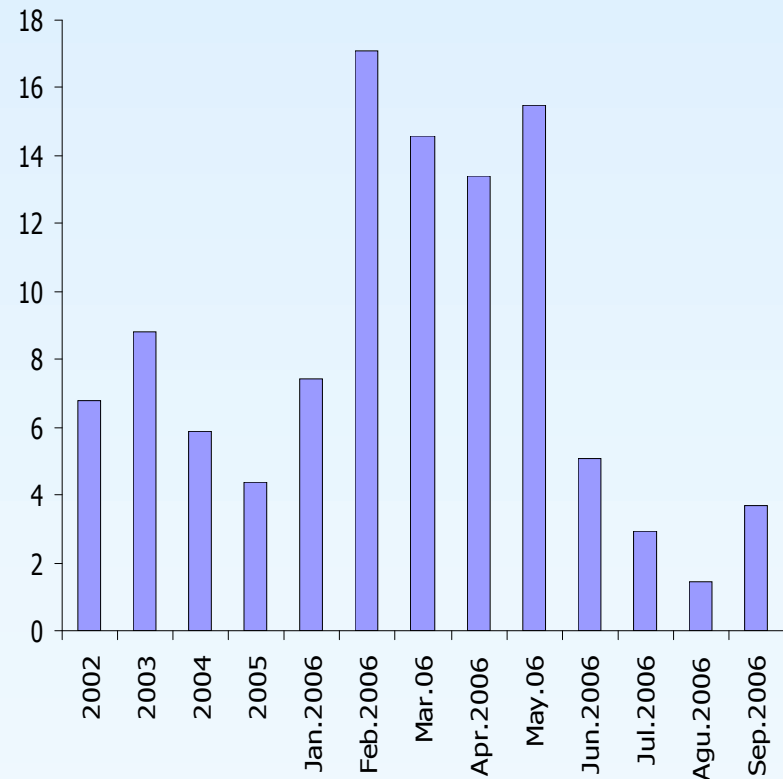
<b>FX Sale Auctions</b>	<b>FX Sale Interventions</b>
<b>1.0</b>	<b>2.1</b>

# Financial Markets

## YTL markets;

- ✓ An effective liquidity management strategy was followed. The Central Bank;
  - Between June, 26 and August, 25 2006, held New Turkish lira deposit buying auctions,
  - Difference between lending and borrowing interest rates went up from 3 to 5 points.
- ✓ As a result of the operations in FX and YTL markets, liquidity declined from its February level of 17.1 billion to 3.7 billion in September.
- ✓ After all these measures, volatility in the markets slightly declined and the fluctuation was curbed.

***Liquidity by the Ends of the Months  
(2002 - September 2006, billion YTL)***



# Financial Markets

- ✓ Similar fluctuations had been experienced before.
- ✓ However, as long as the tight monetary and fiscal policies are continued, the Turkish currency returns to its course of appreciation and each time the relative stability increases more and more.
- ✓ This process is also the process of building a reputation for the Turkish currency.
- ✓ Similar fluctuations may occur in the future.
- ✓ The Turkish economy will become more robust and be less influenced by crisis if the economic program is implemented decisively and if policies are implemented without interruption.

RAPID CHANGES IN EXCHANGE RATES

Beginning Date	Duration (days)	Value at the Beginning	Peak Value	Change %
15.04.2002	106	1.2928	1.6966	31.2
03.12.2002	37	1.5200	1.6825	10.7
03.03.2003	22	1.5962	1.7548	9.9
24.09.2003	47	1.3545	1.5048	11.1
05.04.2004	49	1.3076	1.5582	19.2
20.07.2004	63	1.4293	1.5388	7.7
08.03.2005	22	1.2601	1.3905	10.3
04.05.2006	53	1.3167	1.7016	29.2

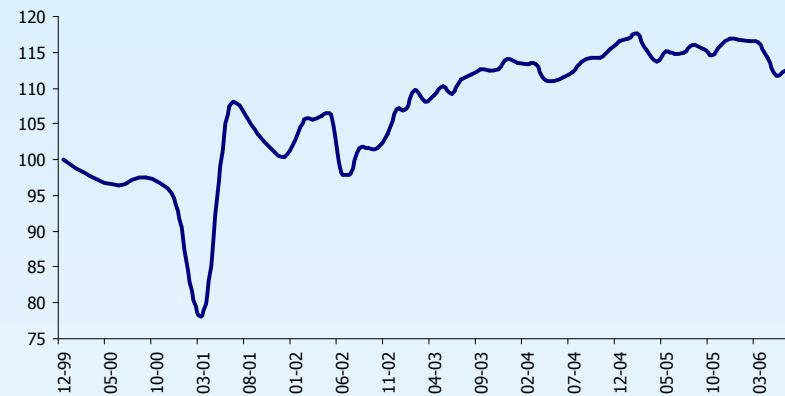
CBRT Indicative USD Selling rate



# Financial Markets

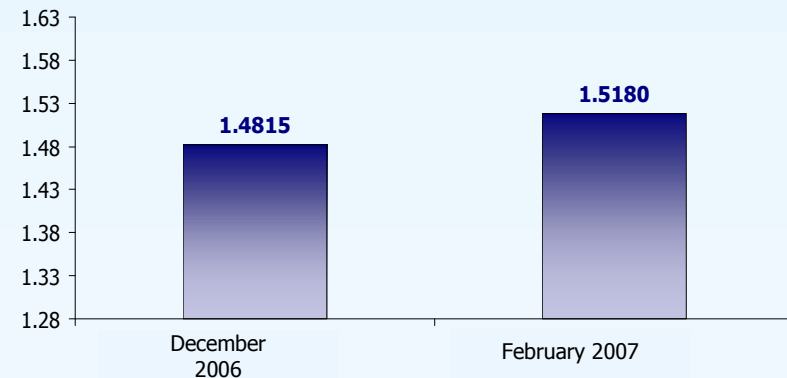
- ✓ Today, with the strong position of the financial sector, the impact of the fluctuation on financial markets was felt less strongly and the spread of the fluctuation to other fields of the economy was circumscribed.
- ✓ The May-June fluctuation once more pointed out the importance of good risk management.
- ✓ In the floating exchange rate regime, movements in exchange rates are not uncertainties but risk factors and it is possible to avoid these risks.
- ✓ As similar fluctuations may be observed in the future under the floating exchange rate regime, all economic agents should protect themselves in the framework of modern risk management principles, against interest rate or exchange rate risk on their balance sheets.
  - The İzmir Derivatives Exchange provides an important opportunity in this respect.

**Financial Stability Index\***  
(As of June 2006)



\* Increase in the index indicates improvement.

**USD / YTL Exchange Rate Forward Quotations**  
(As of 27 September 2006)

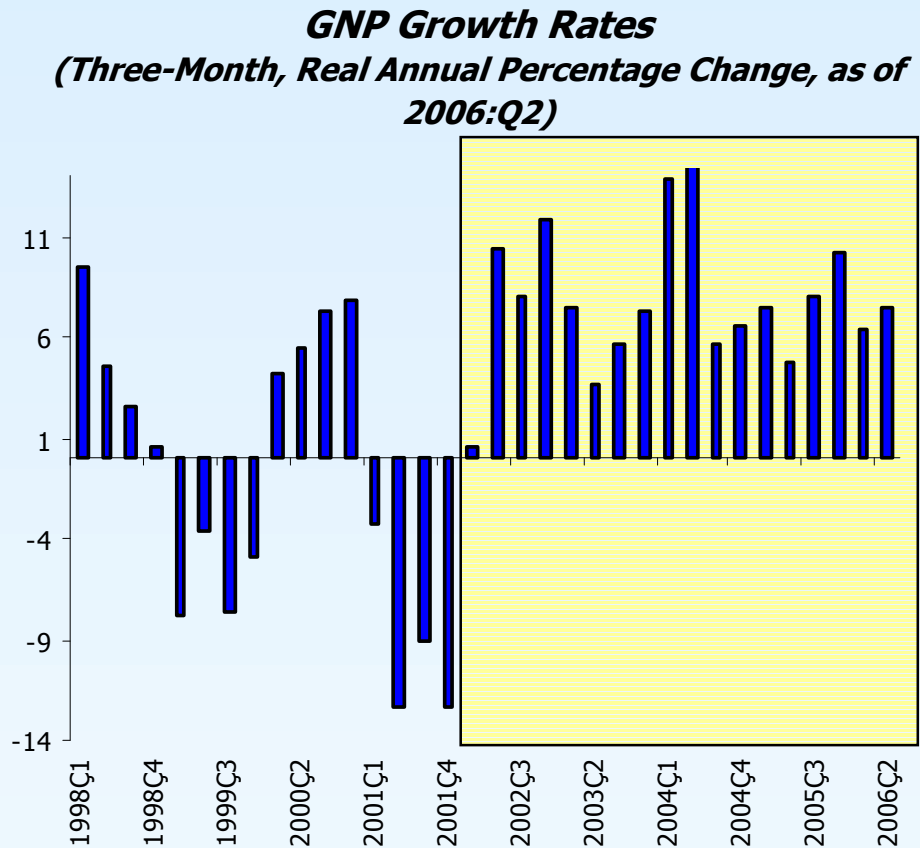




# Growth

# Growth

- ✓ The Turkish economy has been growing constantly for the last 18 quarters at high rates.
- ✓ Cumulative real growth since 2001 has reached 39,6 percent.
- ✓ The average annual growth rate between 2002 and 2006 was 7.9 percent.
- ✓ The GNP displayed 8.5 percent real growth in the second quarter of 2006.



# Growth

✓ According to the details of figures regarding the second quarter of 2006;

→ Public consumption expenditures, which have been rising since the beginning of 2006 increased by 18 percent in the second quarter.

→ The industrial sector made a remarkable contribution to growth, with 10.5 percent growth in the second quarter.

→ Construction is the fastest growing sector with a 13.7 percent growth.

➤ *This is a favorable fact in terms of the course of inflation since it will contribute to the increase in the supply of housing in the future.*

→ There was 1.1 percent shrinkage in agriculture and 1.3 percent in financial institutions.

→ Unlike the first quarter, in the second quarter of 2006, it is observed that the contribution of consumption expenditures to growth has increased whereas that of investment expenditures has declined.

**GNP According to the Method of Production  
Selected Sub-items  
(Real, Annual Percentage Change)**

	2006 Q1	2006 Q2	2006 First Half
<b>Agriculture</b>	6,2	-1,1	1,3
<b>Industry</b>	4,5	10,5	7,7
<b>Construction</b>	26,7	13,7	19,3
<b>Trade</b>	7,0	7,3	7,2
<b>Transportation &amp; Communica.</b>	3,3	4,3	3,8
<b>Financial Ins.</b>	-0,5	-1,3	-0,9
<b>Export Tax</b>	15,3	13,1	14,2

**GNP According to the Method of Expenditure  
Selected Sub-items  
(Real, Annual Percentage Change)**

	2006 Q1	2006 Q2	2006 First Half
<b>Public Consumption</b>	8,1	18	13,5
<b>Private Consumption</b>	8,6	10,1	9,4
<b>Public Inv.</b>	34,5	-11,3	1,0
<b>Private Inv.</b>	30,4	14,8	21,5

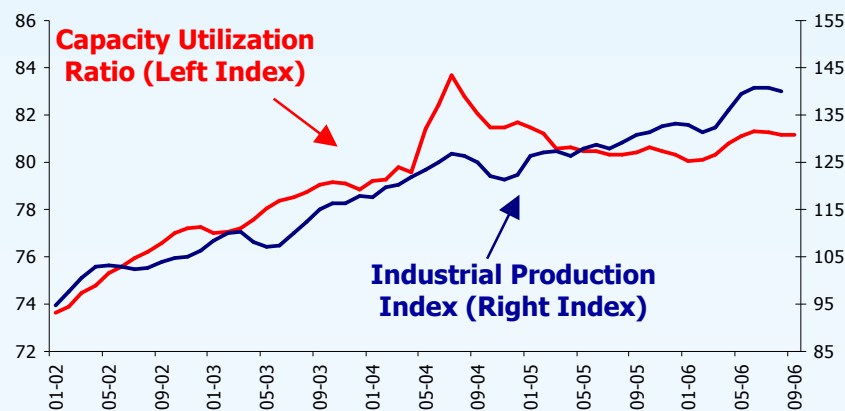
# Growth-Outlook

- ✓ The forecast of the program for 2006 growth is 5 percent.
- ✓ In the first half of 2006 growth was 7.6 percent.
- ✓ There might be some decline in the growth rate when the effects of the fluctuation of the second quarter and the monetary tightening on demand are observed.
  - There is a certain level of decline in the rate of annual increase of August industrial production and September capacity utilization figures.
- ✓ The 2006 growth rate is forecasted to comply with the program.

**End-Year GNP Growth Rate Expectations (Appropriate Average) and Realizations (Real, Annual Percentage)**



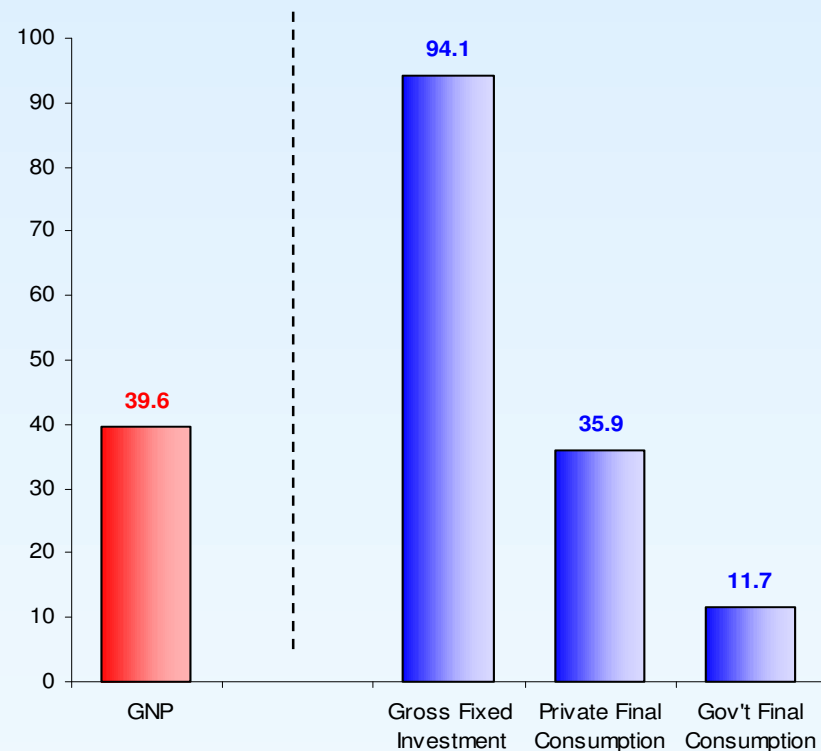
**Industrial Production Index (As of August 2006) and Capacity Utilization Ratios (As of September 2006) (Seasonally Adjusted, Three-Month Moving Average)**



# Growth

- ✓ In the last five years the economy of Turkey has come a long way in leaving behind the turbulent, on-and-off growth process.
- ✓ Today, the growth process is based on the private sector.
- ✓ The highest cumulative increase of 94.1 percent was in the item of gross fixed capital formation. The gross fixed capital formation of the private sector was 126.9 percent.
  - The investment base of the economy is expanding and the production capacity is increasing.
- ✓ Increase in productivity is the main factor in recent growth rates.
- ✓ Exports has crucial importance in growth and is escalating.

**Real Growth Rate of GNP and Sub-Items \*  
(2001=100, 2002-2006Q2 Percentage Change)**

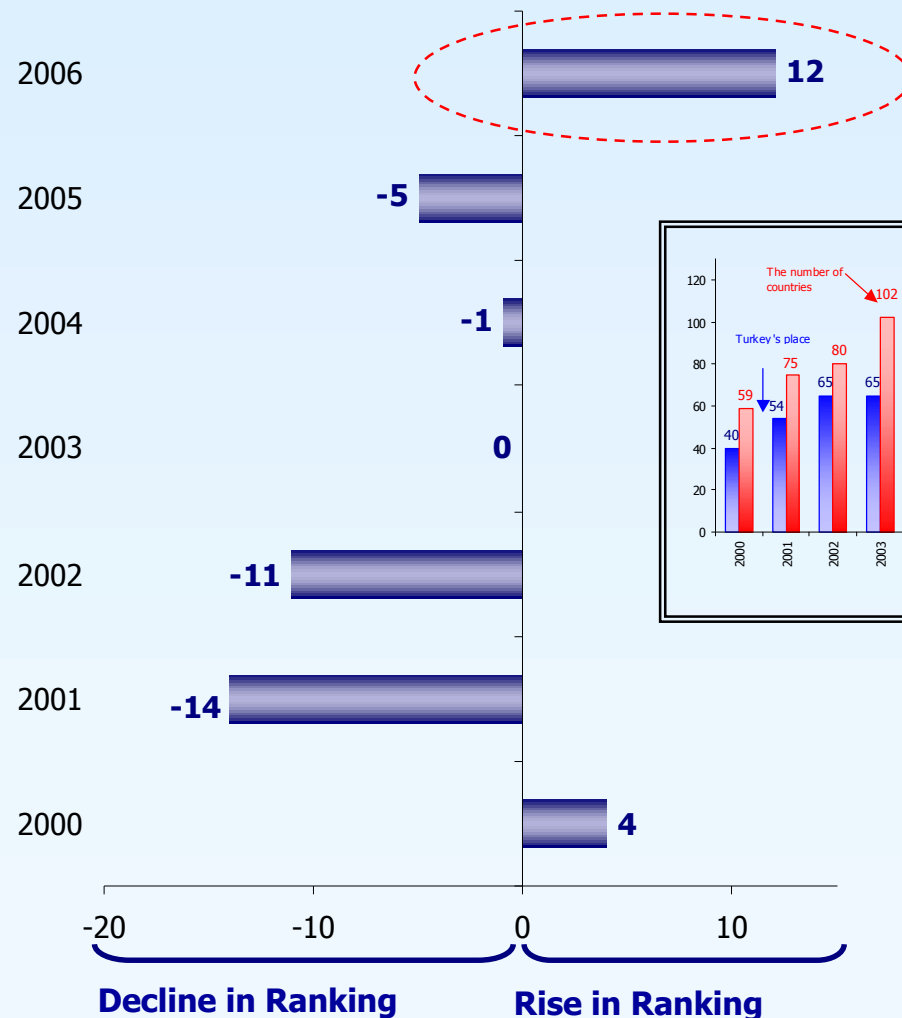


\* Net Foreign Trade: - 241 %, Stock: - 482% and Net Factor Income from the rest of the World: - 59 %.

# Growth

- ✓ All this structure is an evidence to how macroeconomic stability based on financial stability is imperative for growth and competitive capacity/strength/ power to compete.
- ✓ According to the Global Competitiveness Index Turkey was one of the countries that has increased its competitiveness most.
  - Moved up 12 places in ranking and became the 59th among 125 countries.
- ✓ Persistence of these developments and rendering growth sustainable is essential in attaining the final target of the policies; an increase in social welfare.

**Turkey's Place in the of the Global Competitiveness Index**



# Growth

- ✓ Today, Turkey should discuss the necessary measures to attain sustainable growth, not daily market volatilities.
- ✓ Analyzing the countries that completed growth and development processes successfully, it is observed that these processes involve certain phases.
- ✓ Today, the Turkish economy displays growth that is based more on productivity increases.
  - In the 2002-2004 period, the contribution of total factor productivity to growth was 51.3 percent.
- ✓ In order to achieve permanent and sustainable growth in the medium and long term, it is essential that productivity increases continue, a phase based on research, development and innovation is initiated and steps towards this phase are taken.

## *Growth and Development Processes*





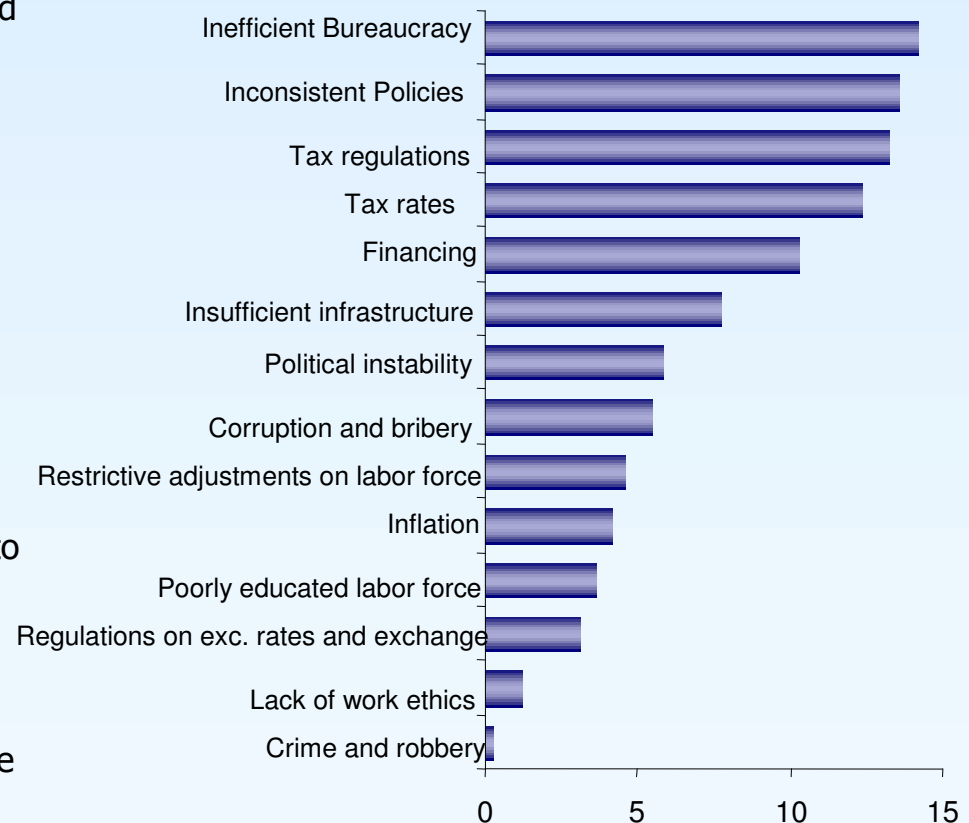
# Growth

✓ The ongoing structural transformation in the Turkish economy, increased openness to foreign markets and globalization has enhanced the competition, both in Turkey and in foreign countries.

✓ In order to be able to compete, it is essential to create medium and long-term strategies rather than focusing on short-term plans.

✓ The factors, which are listed at the top by the Global Competitiveness Index according to their negative impacts on competitiveness, are bureaucracy and adjustments on policies and taxes. Therefore, it is of great importance to avoid wrong implementations relating to these factors.

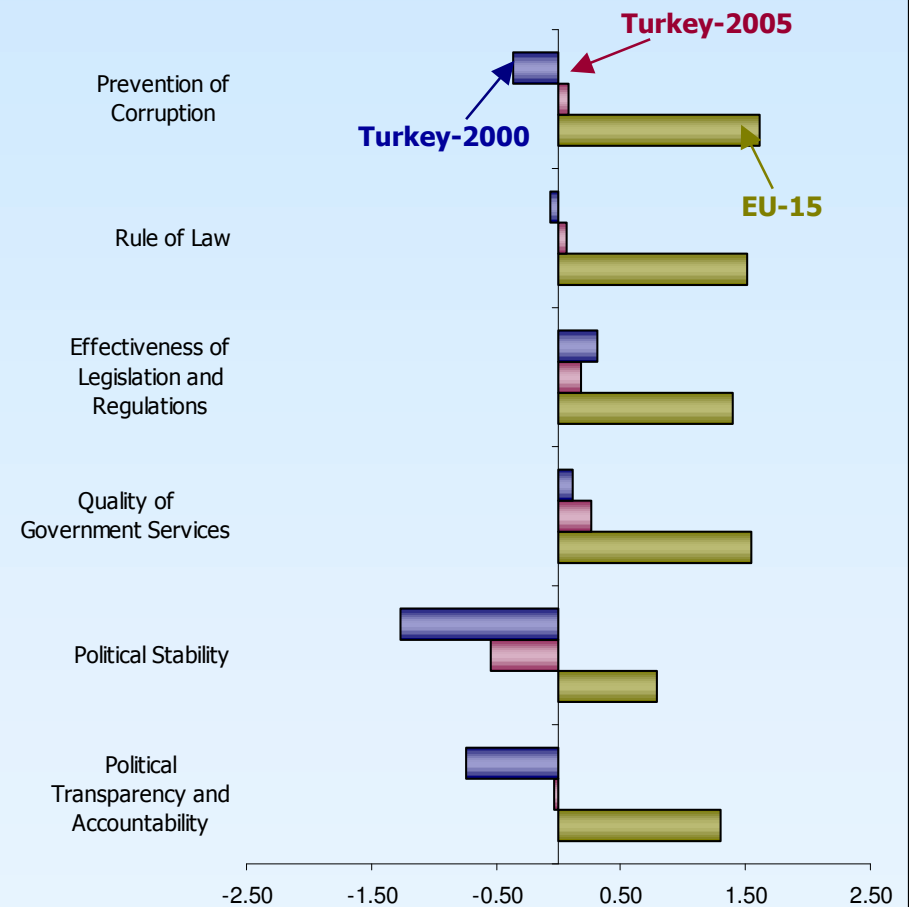
## ***Main Factors Affecting Competitiveness Negatively (2006)***



# Growth

- ✓ Implementing sound governance principles is the key element.
- ✓ Almost all of the governance indicators in Turkey have been improving since 2000.
- ✓ Simultaneous improvement in governance indicators and in macroeconomic performance is not a mere coincidence.
  - Good governance has a key role in establishing and accelerating macroeconomic stability, and it is a prerequisite for sustainability.
- ✓ Compared to EU-15, it is obvious that Turkey has got a long way to go.

**Governance Indicators of Turkey and EU-15\* (2005)**



\* Governance Indicators: Governance forecasts lie between -2.5 and +2.5. Higher the number, better the governance.

# Growth

✓ Structural reforms are very important.

These reforms should be reinforced with micro-measures and a strategic perspective should be sought according to changing needs and new structures.

✓ Accordingly, the Ninth Development Plan is an important starting point.

✓ Public and private sectors should collaborate in order to be able to put this structure into practice.

**The public sector should assume a strong supervisory and regulatory role within the framework of good governance principles and strive to create an environment enabling the private sector to be able to compete in international markets. It is necessary to register unregistered economic activity.**

**The private sector; productivity-boosting measures should continue, strong and transparent balance sheets should be prepared, companies should be able to participate in capital markets, watch risk management principles and to allocate more resources for Research & Development and innovation activities.**



# Employment

# Employment

- ✓ The ultimate aim of economic policies is to increase the welfare of the individual and of society.
- ✓ One should have a job in order to get a share of wealth.
- ✓ Unemployment is not merely an economic problem, but a multi-dimensional problem with social and individual aspects.
- ✓ Today, unemployment is one of the items at the top of the agenda in Turkey.
- ✓ There is partial improvement in unemployment rates recently, but this is not sufficient.
- ✓ Compared to last year's figures, in July 2006:
  - Total unemployment dropped by 0.3 percentage points down to 8.8 percent,
  - Non-agricultural unemployment fell by 1 percentage points down to 11.7 percent,
  - Unemployment rate in the urban young population dropped by 1.4 percentage points to 21.6 percent.

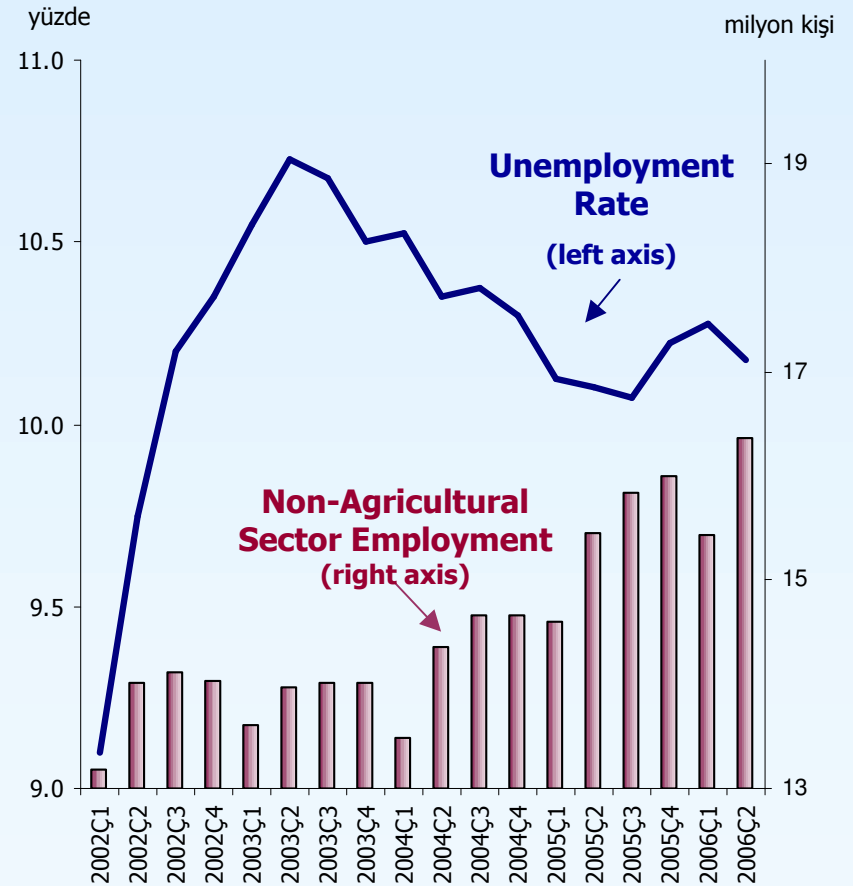
**Unemployment Rate**  
(Annual Moving Average, Percent, by 2006-Q2)



# Employment

- ✓ The non-agricultural sectors' capacity to create jobs is increasing.
- ✓ By July 2006, 866 thousand new jobs had been created by sectors other than the agricultural sector.
- ✓ The sector that created the highest number of jobs was the services sector.
  - The rate of increase in employment in the services sector became 6.7 percent in the last one-year-period.
  - The rate of increase in employment in the industrial sector became 2.8 percent.

**Unemployment Rate (Annual Moving Average) and Employment Opportunities Created by Non-Agricultural Sector (by 2006-Q2)**



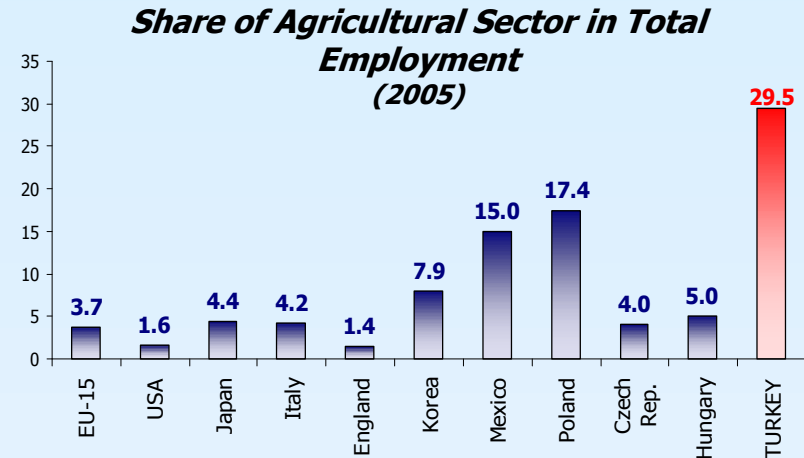
# İstihdam

- ✓ There are structural problems in the labor market, especially in the agricultural sector.
- ✓ In line with the structural transformation in the economy, there has been a rapid shift to other sectors from the agricultural sector in the last 4 years.

→ The share of the agricultural sector in total employment, which was 38 percent in 2001, became 29.5 percent in July 2006.

→ The EU-15 average was 3.7 percent in 2005.

- ✓ The shift from the agricultural sector to other sectors is expected to continue within the framework of the structural transformation process.



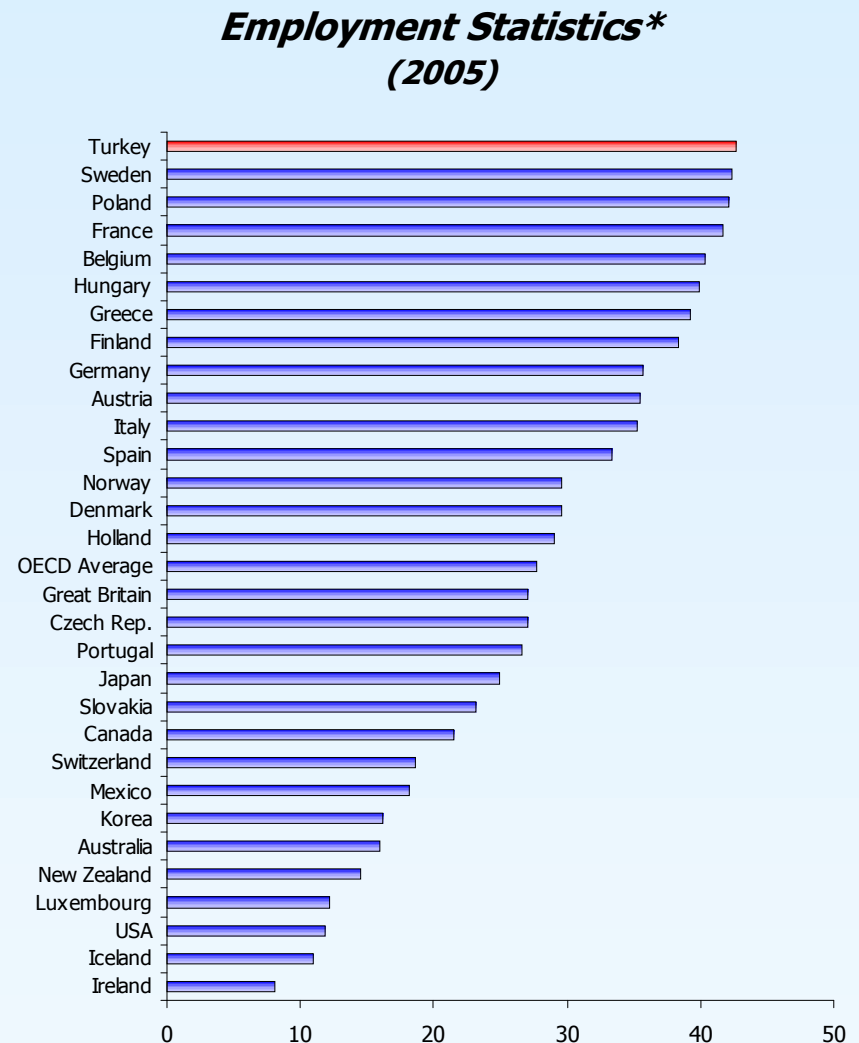
**Breakdown of Employment by Sectors (2005)**

	Agriculture	Industry	Services
EU-15	3,7	26,5	69,8
USA	1,6	19,8	78,6
Japan	4,4	27,9	67,6
Italy	4,2	31,1	64,6
Great Britain	1,4	22,1	76,5
Korea	7,9	26,9	65,2
Mexico	15,0	27,3	57,7
Poland	17,4	29,2	53,4
Czech Rep.	4,0	39,6	56,4
Hungary	5,0	32,8	62,2
<b>TURKEY*</b>	<b>29,5</b>	<b>24,7</b>	<b>45,8</b>

\* By July 2006

# Employment

- ✓ The high rate of unregistered economic activity prevents a permanent rise in employment and increases volatility.
- ✓ The labor force participation rate of women is quite low.
- ✓ The employment rate of those who have received vocational training is low. There is a scarcity of the qualified labor force required for structural transformation.
- ✓ Employment taxes are very high.
- ✓ The employable population is growing parallel to rapid population growth.



\* The tax used in this calculation includes the income tax paid by the worker, the social security deductions and the social security deductions paid by the employer (exemptions and discounts deducted) and the sum of these deductions has been rationed to the total labor cost.



# Employment

- ✓ All these structural problems call for the implementation of medium and long-term supply-oriented policies in order to find a lasting solution for the unemployment problem.
- ✓ Active/effective policies are needed to create new employment opportunities.
- ✓ The relationship between the real sector and the financial sector should be reinforced,
  - The investment environment should be improved,
  - Macroeconomic stability should be established.
- ✓ Unregistered employment should be registered and to this aim, employment taxes and other burdens on employment should be reduced gradually.
- ✓ The framework drawn in the Ninth Development Plan is a kind of road map and it should be implemented without delay.

## ***Ninth Development Plan Strategy Increasing Employment***

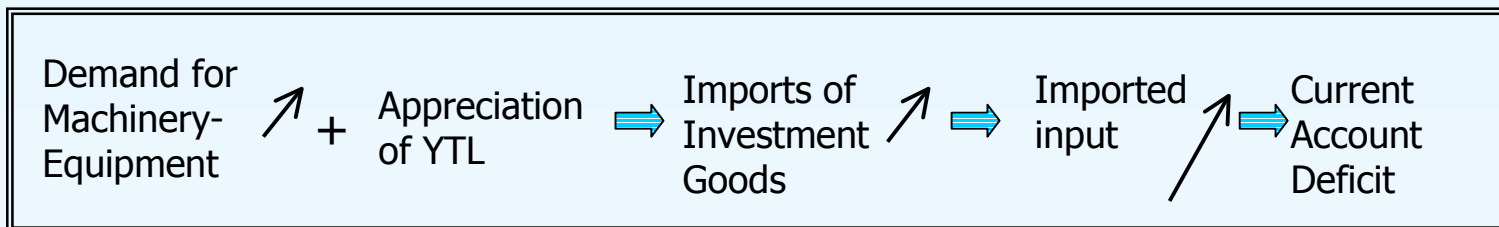
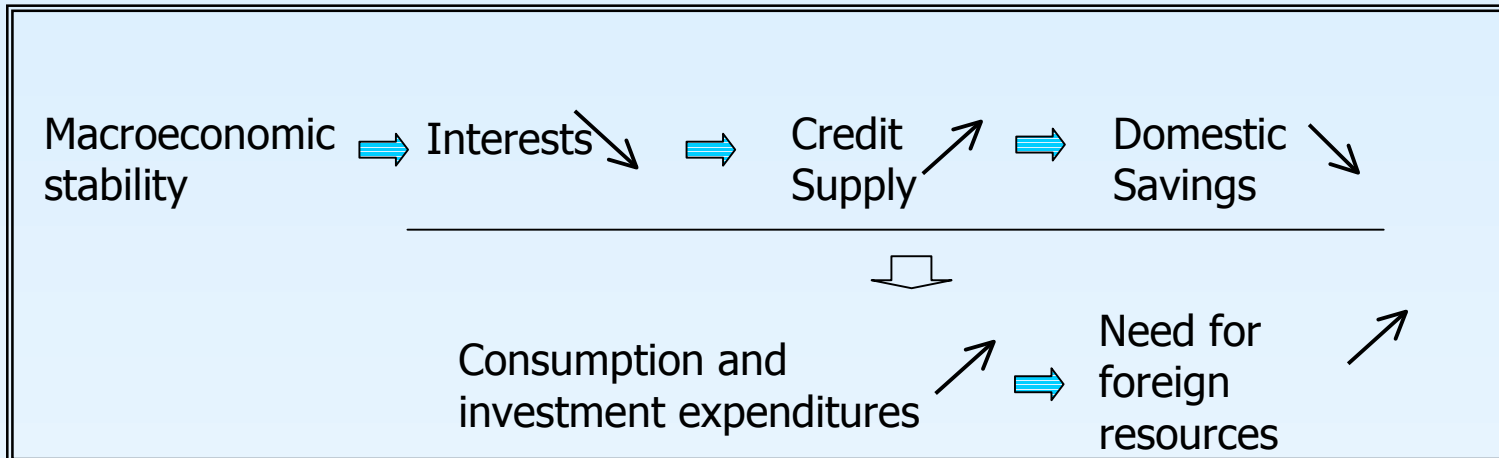
- Within the framework of improving the labor market, it is planned to establish a market in which:
  - flexibility and security are balanced,
  - burdens on employment are gradually reduced,
  - adaptability of enterprises and employees to changes is increased,
  - the wage-productivity relationship is improved.
  - Within the framework of the decreasing susceptibility of education to labor demand, it is projected to;
    - Reinforce the interaction between education and the labor market,
    - Develop active/effective labor policies in line with the qualities and needs of the unemployed, the disadvantaged portion of the labor market and of those moving from the agricultural sector,
    - Increase the quality of labor placement services.



# Current Account Deficit

# Current Account Deficit

**Turkish Economy is an economy that always runs deficit.**



**This chart shows that the current account deficit is not cyclical, but it has become a structural phenomenon.**

# Current Account Deficit

- ✓ Parallel to macroeconomic stability, high and uninterrupted growth rates were achieved in the last five years and the current account deficit has increased.
- ✓ The ratio of current account deficit to national product had reached 7.5 percent by the second quarter of 2006.
  - By August, the current account deficit had become USD 30.1 billion in annual terms.
  - By August the breakdown of annual imports were as follows:
    - *70.6 percent intermediate goods*
    - *16.7 percent capital goods*
    - *12.4 percent consumption goods*

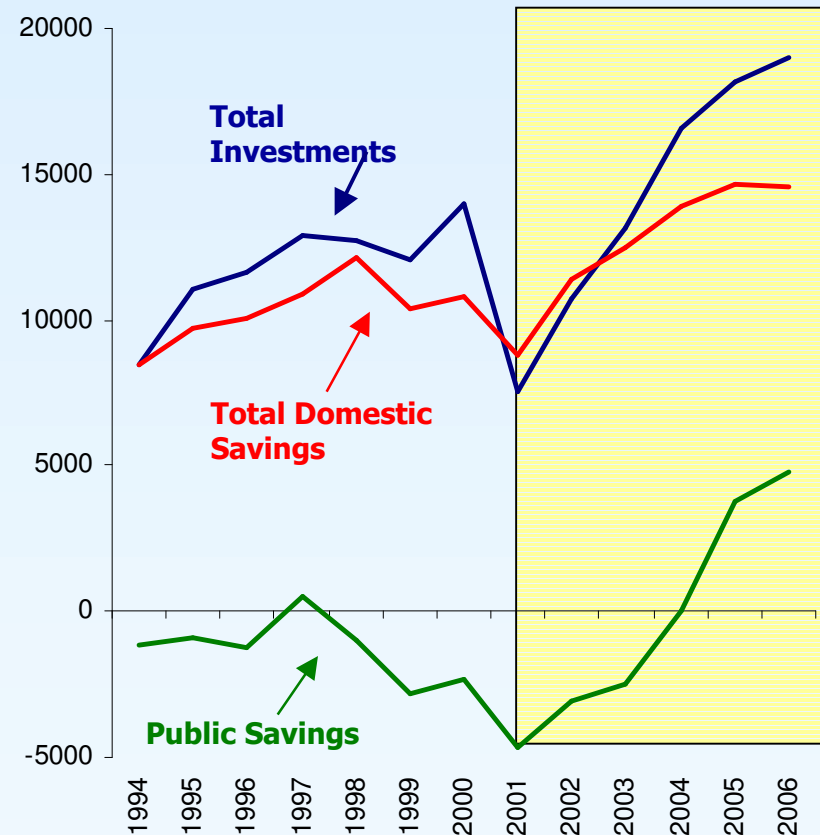


\* As of Q2-2006

# Current Account Deficit

- ✓ This structure does not allow a decline in current account deficit -without sacrificing high growth rates in the short run; under current conditions, a rapid decline in growth rates is not desirable.
- ✓ The reasons and financing method of the current account deficit is very important to determine the magnitude of risk posed by the current account deficit to macroeconomic balances.
- ✓ Today, the reasons for the current account deficit are different from the past.
  - The current account deficit is the result of investments growing at a faster rate than savings.
  - Tight monetary and fiscal policies are implemented and there is unprecedented rise in public savings.

**Total Investments and Total Domestic Savings\***  
(Real Figures, in 1998 prices, Million TL)



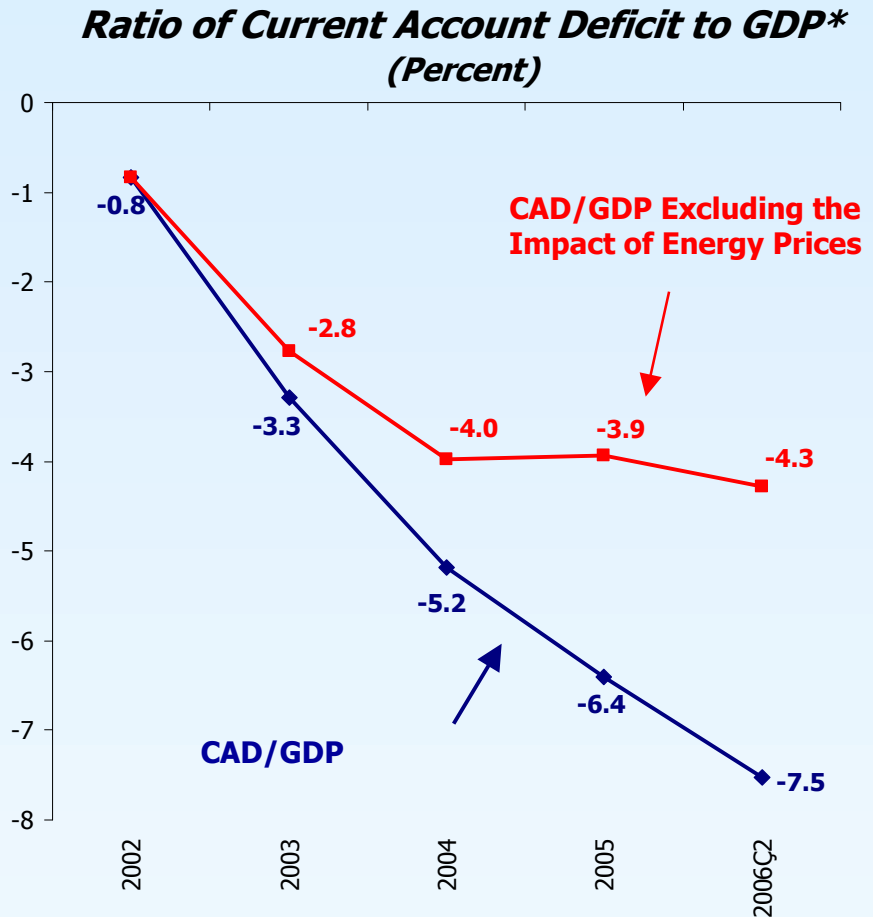
\* Figures for 2006 are projected figures.

# Current Account Deficit

✓ The meteoric rise in energy prices, especially in crude oil prices in the last four years has been an important factor affecting the rise in the current account deficit.

✓ By the second quarter of 2006;  
→ If oil prices are fixed at 2002 prices, there is a 1.6 percent fall in current account deficit.

→ If energy prices are fixed to 2002 prices, there is a 3.2 percent fall in current account deficit.



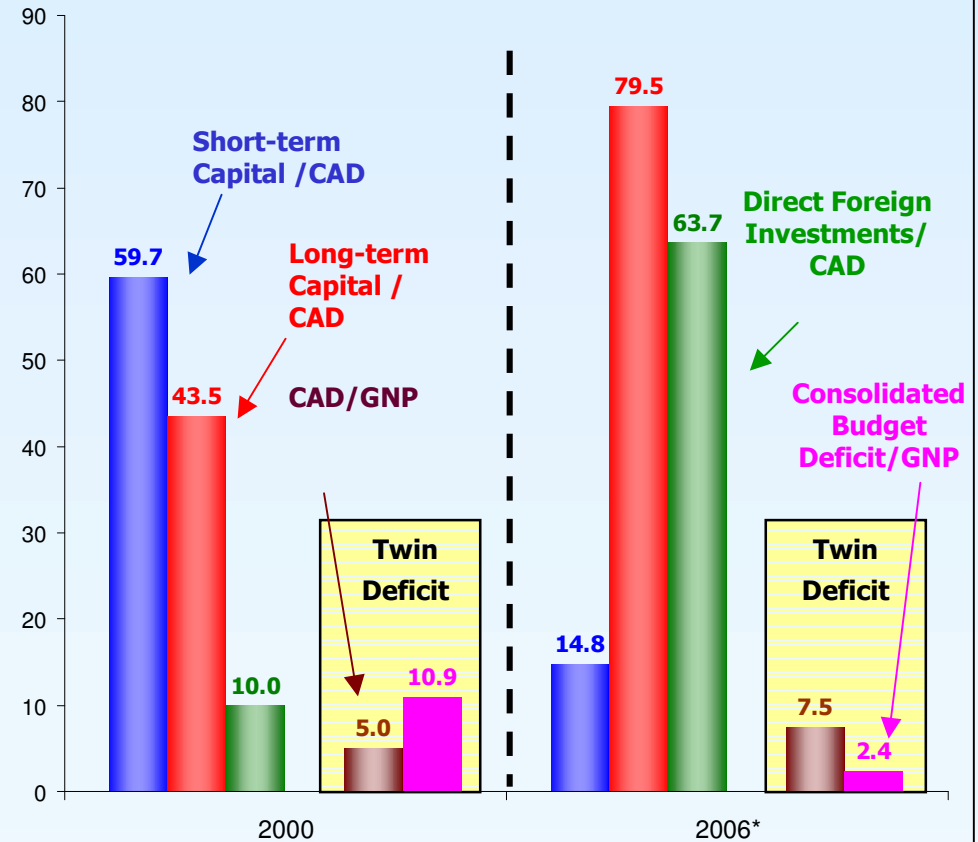
\* Energy Sub-Items: Mining and quarrying sector sub-items: black coal, lignite, crude oil, natural gas, and manufacturing industry sub-items: coke coal, refined petroleum products and nuclear fuels.

The impact of rise in energy prices for 2003-2006 has been calculated by fixing prices at 2002 level.

# Current Account Deficit

- ✓ Financing quality is very important for sustainability of the current account deficit and for not perceiving the current account deficit as a risk factor.
- ✓ Achievements in the structural transformation process as well as in economic conditions have improved the financing quality of the current account deficit.
- ✓ Long-term capital inflow, which reached USD 23.9 billion in annual terms by August 2006, became the most important resource of capital inflow.
  - Long-term capital covers 79.5 percent of the current account deficit.
  - The share of short-term capital has decreased substantially, compared to 2000.
  - Direct foreign investments of 19.2 billion in annual terms is a record-high.

**Financing of Current Account Deficit and Twin Deficit Ratios (Percent)**



\* Ratio of short-term capital, long-term capital and direct foreign investments to current account deficit (CAD) is for August 2006. Current account deficit to GNP is for Q2-2006 and budget deficit/GNP is 2006 projection.

# Current Account Deficit

✓ Turkey is among the countries that receive

the highest amount of direct foreign

investments.

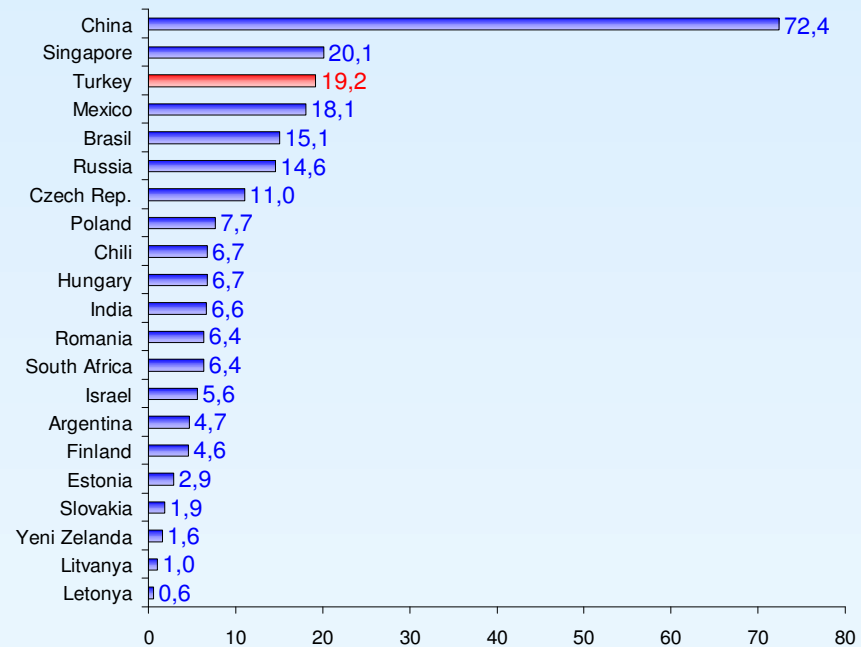
→ Steadfast implementation of the economic program and the EU perspective are believed to facilitate and maintain capital inflows.

✓ The rise in long-term capital inflow decreases the share of hot money in current account deficit financing.

✓ The non-banking private sector's credit utilization for imports of capital and intermediate goods became USD 21.1 billion in August 2006.

→ Only 14 percent of this amount is short-term.

**Direct Foreign Investments\***  
(2005, USD billion)



\* Actual figures for Turkey by August 2006.

**Ratio of Hot Money to Current Account Deficit\***  
(Net Errors-Omissions included, Annual Cumulative, Percent)

2002	2003	2004	2005	2006 Aug.
89,7	127,7	95,5	79,3	14,6

\* Hot Money: State securities, equity securities, deposits, banking sector short-term credits extended abroad, banking sector and private sector short-term foreign debt and net errors and omissions included.



# Current Account Deficit

- ✓ The floating exchange rate regime and a strong financial system mitigates the unfavorable effects of the current account deficit.
- ✓ Today, evergrowing financial integration worldwide coupled with strengthened macroeconomic fundamentals enable the sustainability of higher current account deficits.
- ✓ However, the current account deficit has always been a delicate matter for the Turkish economy.
  - It should be monitored with medium and long-term structural measures.
  - It is always a risk factor, and, as with every risk, it should be managed. Especially, the private sector should attach the utmost importance to risk management principles to handle increasing debts.
  - The economic units are working on conscientiously.



**CENTRAL BANK OF THE REPUBLIC OF TURKEY**

**PRESENTATION TO THE COUNCIL OF**

**MINISTERS**

*October 2006*