



# **CENTRAL BANK OF THE REPUBLIC OF TURKEY**

## **PRESENTATION BEFORE THE COUNCIL OF MINISTERS**

**Durmuş YILMAZ**  
Governor

**12 November 2007**



# Outline

## Goals:

### ✓ Sustainable and High Growth

#### Prerequisites

- *Macroeconomic Stability*
  - Price Stability
  - Low Public Debt
- *Structural Reforms*
- *Good Governance*

### ✓ Single-digit Nominal Interest Rate

#### Prerequisite

- *Price Stability*

## Turkey- Economic Outlook:

- ✓ Inflation Developments
- ✓ Interest Rate and Exchange Rate Policies, Markets
- ✓ Growth and Employment
- ✓ Balance of Payments Developments

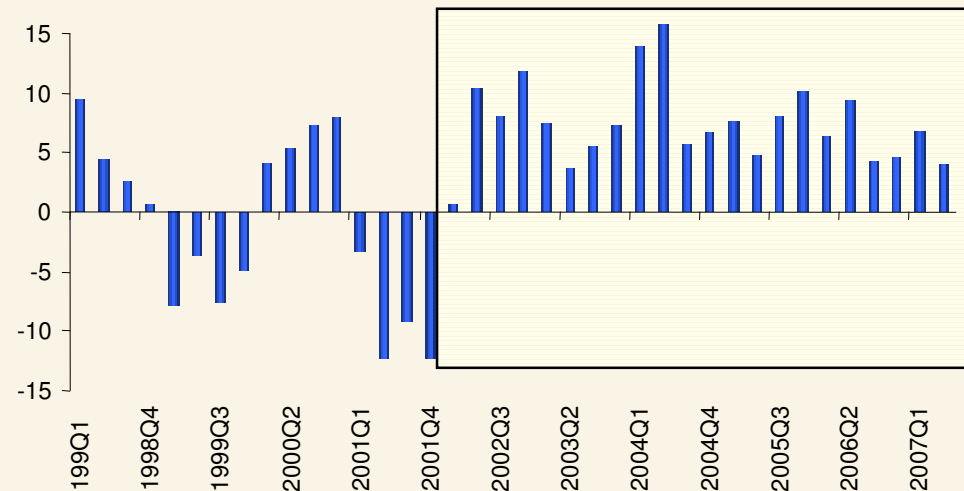


# Sustainable and High Growth

- ✓ The Turkish economy has been growing for 22 successive quarters.
- ✓ Between 2001 and the first half of 2007, the real GNP growth rate was:
  - 46.6 percent on a cumulative basis,
  - 7.2 percent on average.
- ✓ The industrial sector has made the largest contribution to growth from 2002 onwards.
- ✓ The commerce sector has also supported the high growth rate.
- ✓ The contribution of exports to growth is increasing along with the integration into the global economy and increased competitiveness.

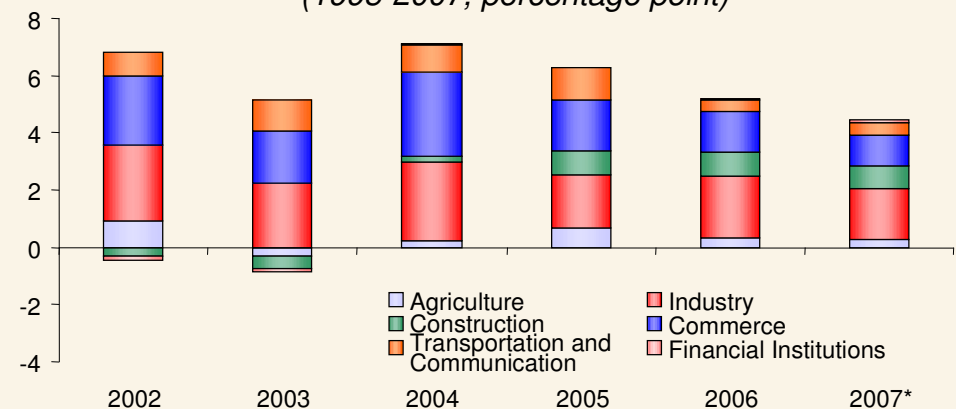
## Growth

(GNP, percentage change, 1998-2007 Q2)



## Contribution to GDP Growth

(1998-2007, percentage point)



\* 2007Q2

Source: TURKSTAT



# Sustainable and High Growth

✓ The private sector has been the engine of growth since 2001.

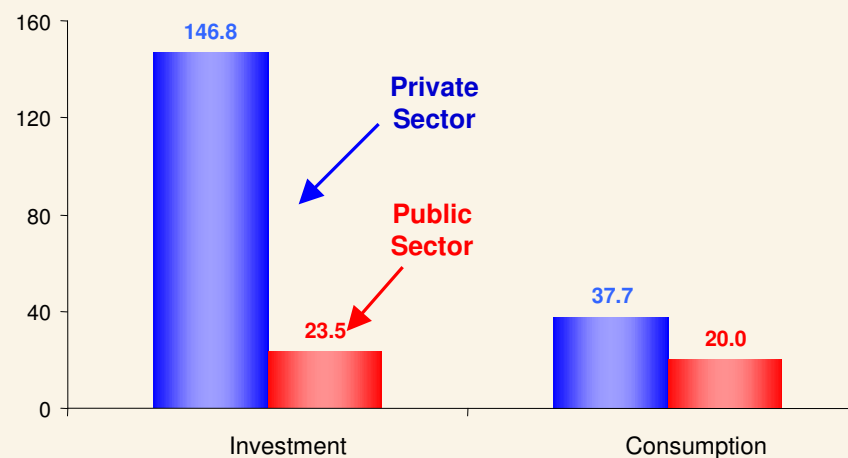
- Between 2001 and the second quarter of 2007, investment and consumption expenditures of the private sector rose by 146.8 percent and 37.7 percent, respectively, in real terms.

✓ Productivity gains have underpinned the economic growth and enhanced its quality.

- From 2001 onwards, the cumulative increase in productivity has reached 42.8 percent.

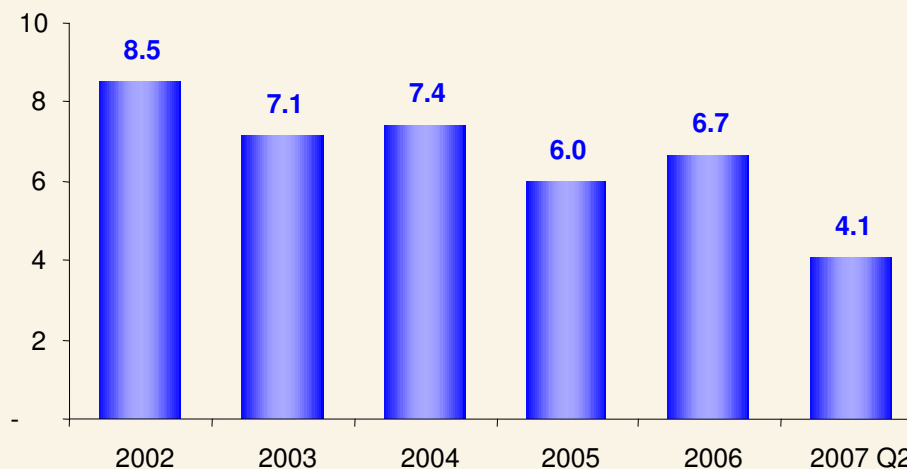
## Investment and Consumption Expenditures

(real percentage change, 2001 – 2007 Q2)



## Productivity in Manufacturing Industry

(per hour worked, annual average growth, percent)



Source: TURKSTAT



# Sustainable and High Growth

- ✓ Raising productivity is crucial for high and sustainable growth.
- ✓ Productivity increases play a significant role in the strong growth performance.
- The contribution of total factor productivity to growth, which was 24.5 % on average in the 1996-2000 period, rose to 42 percent in the 2001-2005 period.
- In the upcoming period, the upsurge in total factor productivity is expected to result chiefly from industrial and services sectors.
- ✓ Productivity-boosting measures should be taken not only in public but also private sectors.

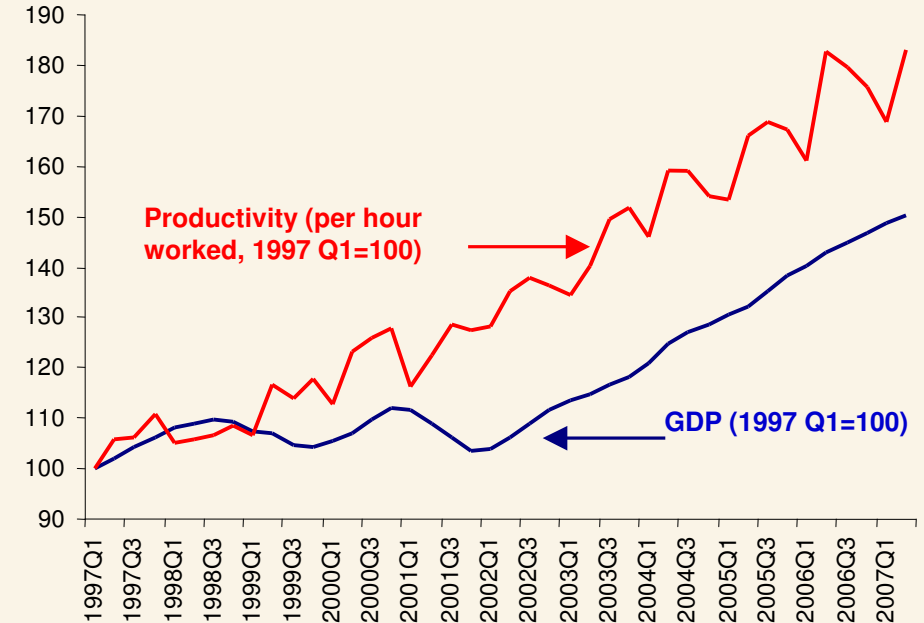
## Contribution of Total Factor Productivity to Growth (annual average, percent)

1996-2000	2001-2005	2006	2007-2013*
% 24.5	% 42.0	% 38.2	% 37.0

\* Forecast

Source: SPO Ninth Development Plan

## GDP and Manufacturing Industry Productivity (1997Q1—2007Q2, per hour worked)

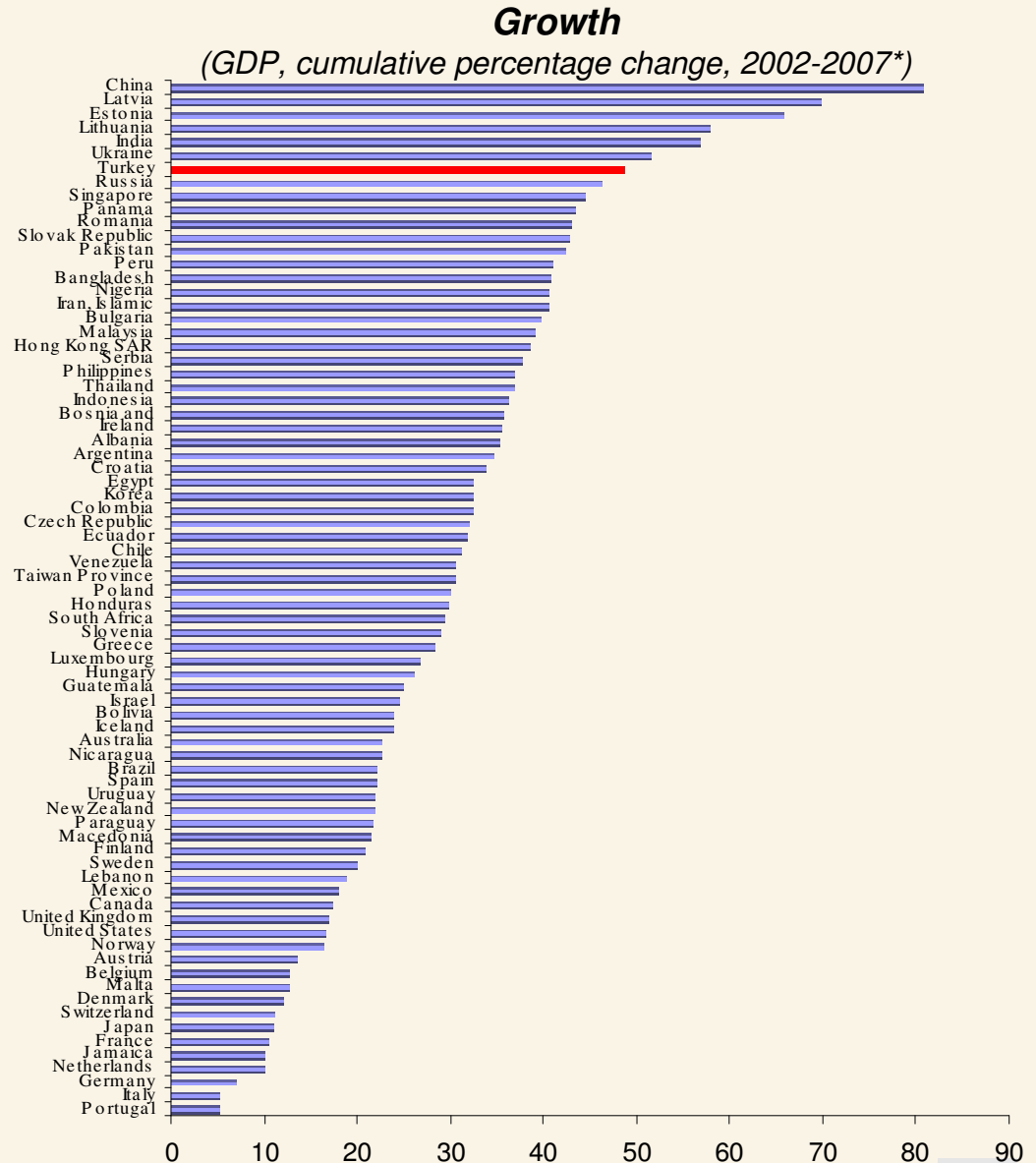


Source: TURKSTAT



# Sustainable and High Growth

- ✓ In the 2002-2007 period, the Turkish economy has been one of the fastest-growing economies in the world.
- ✓ In this period, the cumulative growth rate of GDP was 48.7 percent and Turkey ranked 7th in growth rate among 76 developed/developing countries (among 180 countries Turkey ranked 32nd)
- ✓ What Turkey needs is to maintain the achievements made after 2001 and ensure the sustainability of growth.



\* Forecast for 2007

Source: IMF World Economic Outlook



# How to Achieve Sustainable and High Growth

- ✓ Sustainable growth refers to an economic growth involving an environment price stability, the consistency between economic indicators and macroeconomic balances as well as stable growth rates that are close to the potential growth level.

## How to achieve high sustainable growth



### ✓ **Macroeconomic stability**

- Price stability
- Sustainable public finances

### ✓ **Structural reforms**

- Social security reform
- Tax reform
- Regulations on the labor market
- Education reforms
- Regulations on the energy market
- Competitive environment

### ✓ **Good Governance**

- Political stability
- Rule of law
- Voice and accountability
- Regulatory quality
- Government effectiveness
- Control corruption



- ✓ Some of these reforms require legal and administrative regulations, while others need to find a place in the budget.
- ✓ These measures should be taken by maintaining fiscal discipline and be implemented via the enlargement of the tax base or prioritization or savings in public expenditures rather than raising current tax rates.





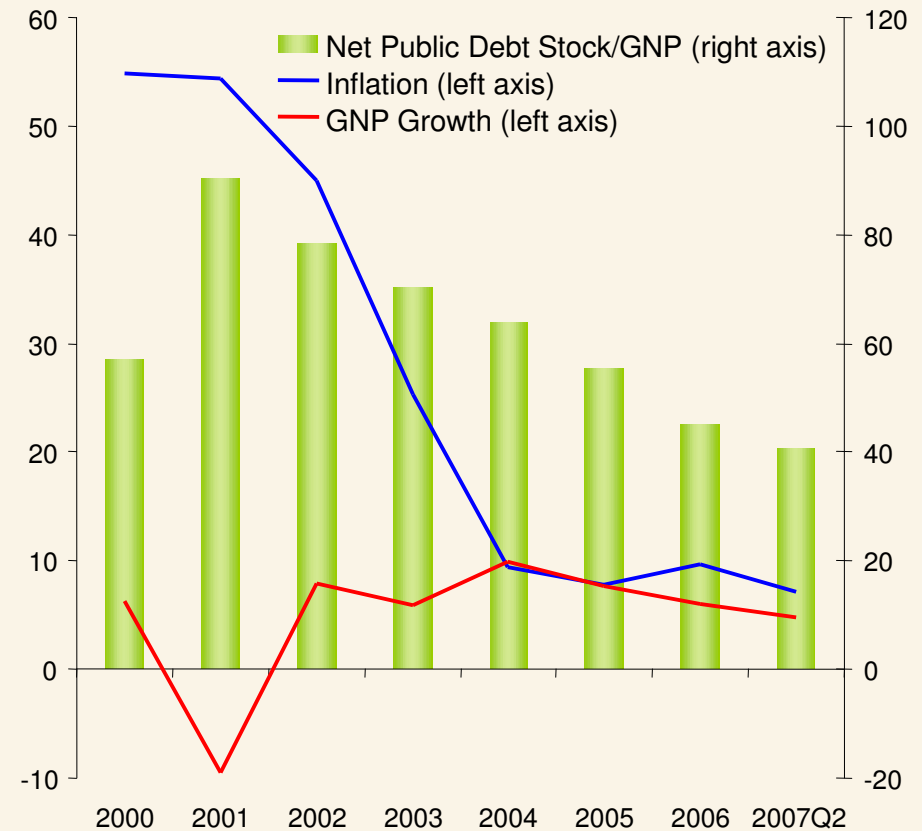
# How to Achieve Sustainable and High Growth

## Macroeconomic Stability



- ✓ Macroeconomic stability is a prerequisite for high sustainable growth.
- ✓ Although important achievements have been made in the disinflation process in the last five years, price stability has not been achieved yet.
- ✓ The fiscal discipline to reduce public debt stock is an important determinant of the inflation and growth dynamics.

**Net Public Debt Stock / GNP,**  
**Inflation** (CPI, annual percentage change, as of September 2007), **GNP** (annual percentage change)



Source: TURKSTAT, Undersecretariat of Treasury





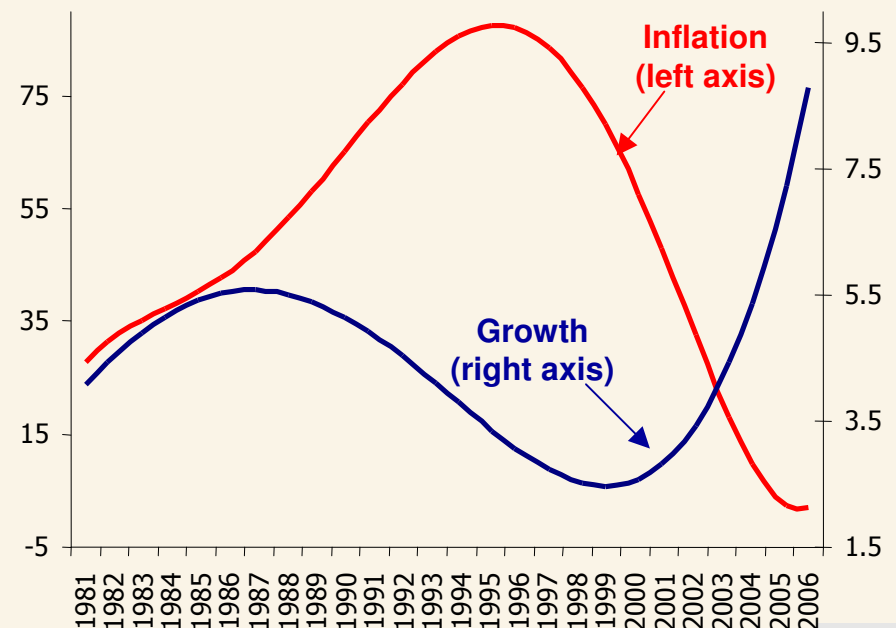
# How To Achieve Macroeconomic Stability

## Price Stability

- ✓ **Economic growth that compromises price stability can not be permanent.** The rise of economic prosperity solely hinges on the achievement of sustainable growth.
- ✓ The high growth rates attained in the 1980s along with high inflation could not be sustained and was replaced by higher inflation and economic stagnation.
- ✓ During the 2002-2007 period, high growth rates were accompanied by falling inflation.

	Average Inflation	Average Growth
1981-1989	43.4 %	4.8 %
1990-2001	74.0 %	3.0 %
2002-2006	14.9 %	7.5 %

***Inflation and Growth Trends in Turkey***  
(1981-2006, percent)



Source: TURKSTAT



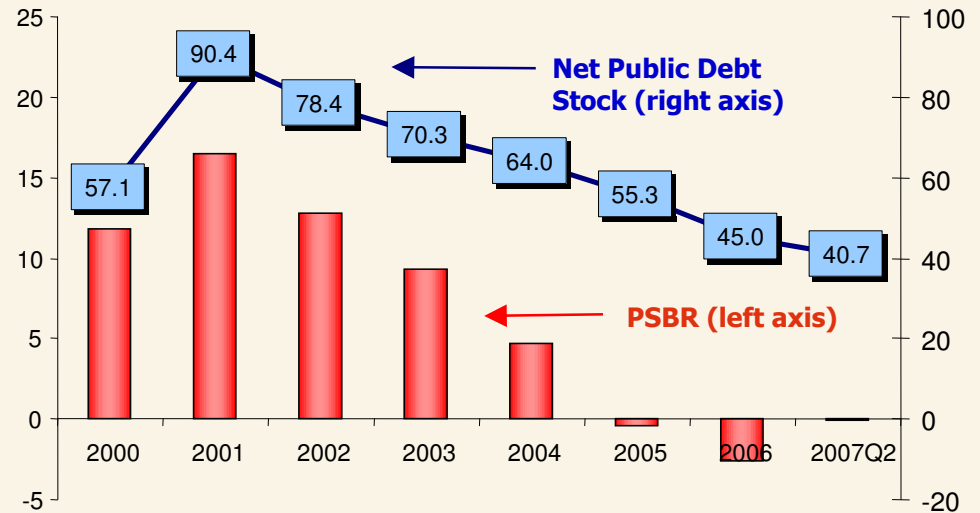
# How To Achieve Macroeconomic Stability

## Fiscal Discipline

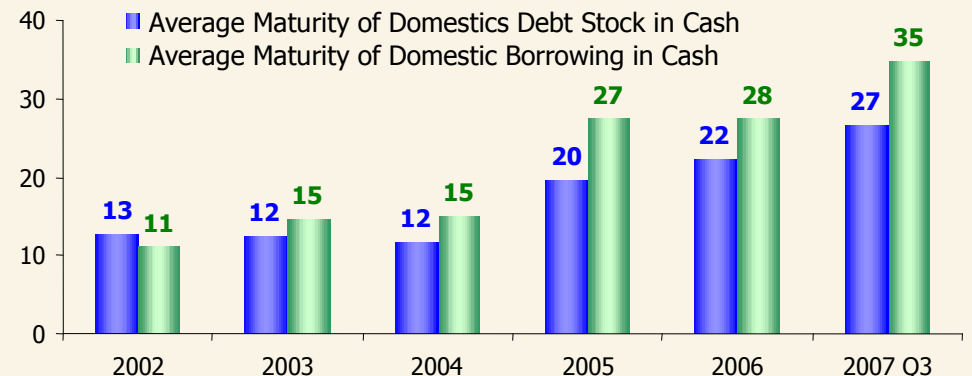
- ✓ Chronic public deficits ranked first among the factors that led to high interest rates in Turkey for long years.
- ✓ As a result of substantial restoration of fiscal discipline after 2001,
  - Borrowing requirement of the public sector has diminished,
  - Roll-over ratio of the debt stock has been reduced and the domestic borrowing maturity has increased.
  - Public debt burden was eased.

Hence, interest rates has dropped significantly.

**Net Public Debt Stock and Public Sector Borrowing Requirement** (Ratio to GNP, percent)



**Average Maturity of Domestic Debt Stock in Cash and Average Maturity of Domestic Borrowing in Cash**(month)



Source: TURKSTAT, Undersecretariat of Treasury

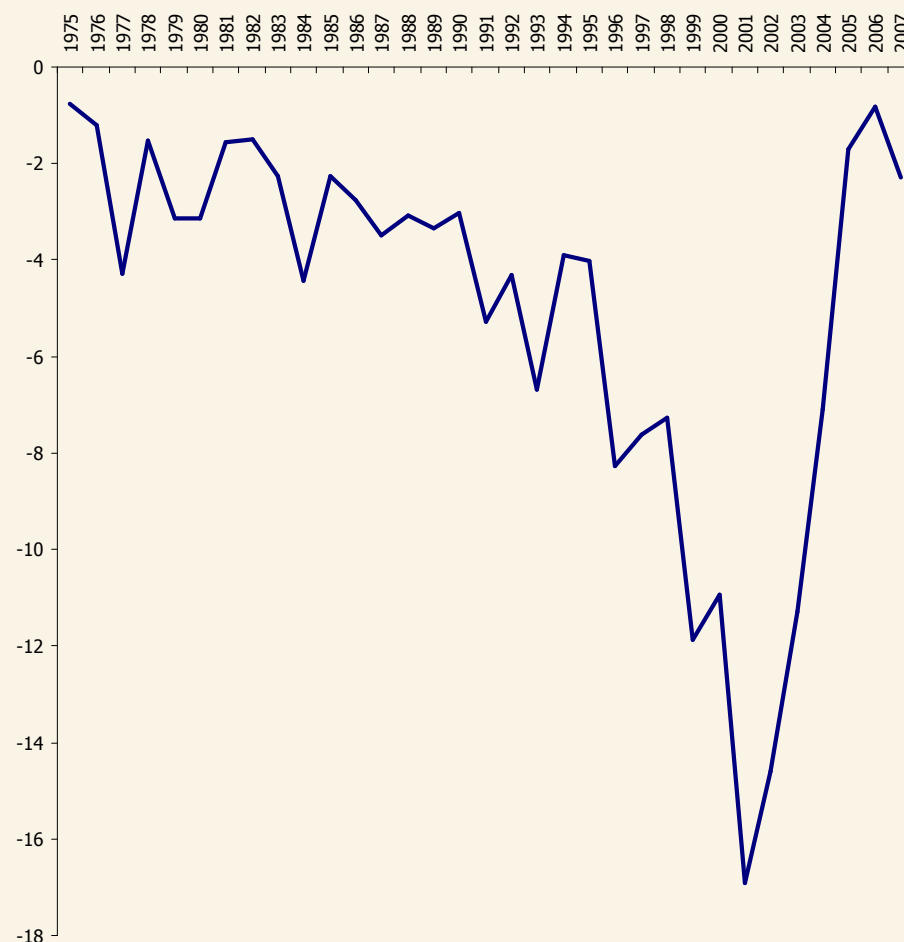


# How To Achieve Macroeconomic Stability

## Fiscal Discipline

**Budget Balance / GNP**  
(1975 – 2007\*, percent)

- ✓ Current fiscal practices are among the main determinants of interest rates.
- ✓ Tight fiscal policy is essential not only for demand control but also for displaying our determination in implementing the economic program.
- ✓ It is also influential in shaping expectations.
- ✓ Budget balance has improved significantly since 2002. In 2006, the ratio of budget deficit to national income dropped to its lowest level in the last three decades.
- ✓ In 2007, the level of fiscal discipline lagged behind the level of 2006.
- ✓ Public sector balance may display volatilities from year to year depending on the pace of economic activities.
- ✓ The budget deficits that may be observed during economic slowdowns should be matched by the budget surplus during high growth periods, thus keeping the budget in balance on average in the long-term.



\* Forecast for 2007 realizations

Source: Ministry of Finance, State Planning Organization



# How To Achieve Macroeconomic Stability

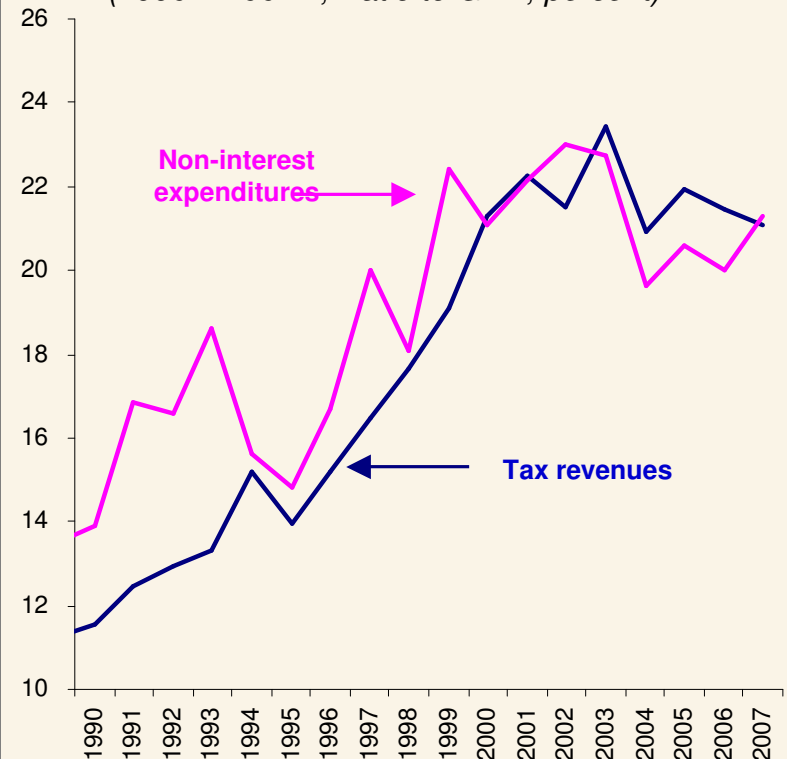
## Fiscal Discipline



- ✓ Fiscal discipline is not all about primary surplus.
- ✓ The quality of fiscal adjustment is of vital importance with respect to both disinflation and sustainable and high growth rate.
- ✓ In the last two decades, both non-interest expenditures and tax revenues displayed substantial increases.
- ✓ Increased share of the public sector in the economy reduces the amount of funds available for private sector investments.
- ✓ In order to ensure the sustainability of a private sector-oriented growth in the upcoming period, the quality of public revenues and public expenditures should be improved.
- ✓ For this purpose, the productivity of the public sector should be boosted and the effects of the current tax policies on the private sector should be taken into account.
- ✓ Local administrations comprise the other leg of public finances. The reporting of their expenditures should be conducted in a transparent manner.

### Tax Revenues and Primary Balance Expenditures \*

(1990 – 2007\*\*, Ratio to GDP, percent)



In order to ensure the comparability of budget data in terms of years, the share allocated to local administrations is excluded from revenue and expenditure figures pertaining to 2006.

\*\* Forecast for 2007 realizations

Source: Ministry of Finance, State Planning Organization

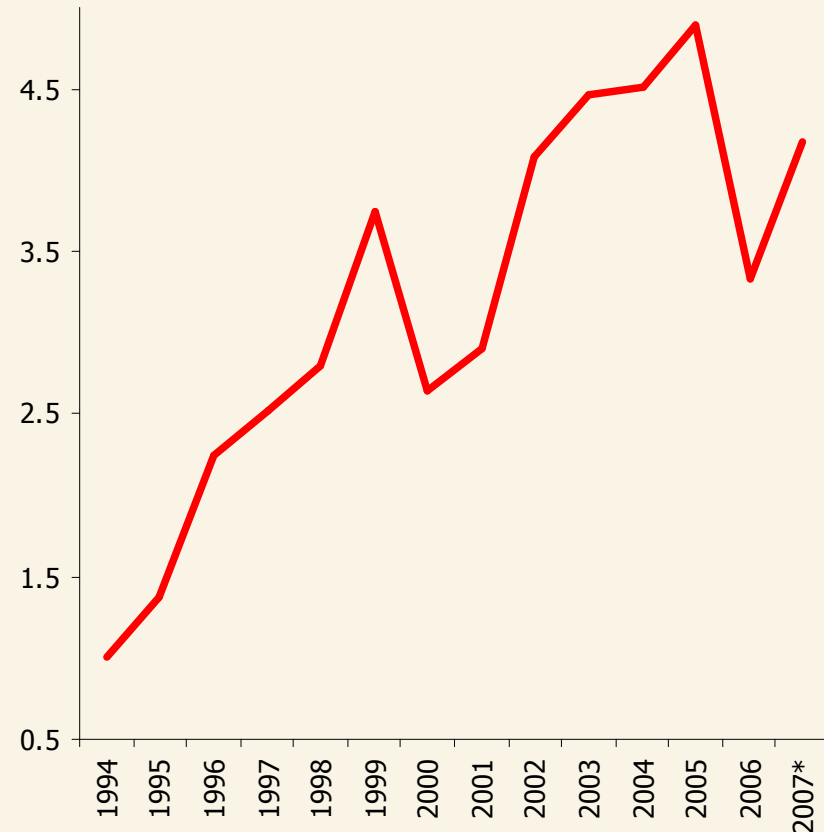


# How to Achieve Sustainable and High Growth

## Structural Reforms – Social Security System

- ✓ Structural reforms will ensure sustainable and high growth rates.
- ✓ In this framework, it is essential to establish an efficient and financially sustainable social security system.
  - The deficits of the social security system have reached high levels.
  - Significant steps have been taken in recent years. Nevertheless, positive results of these measures will appear in the long run.

*The Ratio of Transfers from Budget to Social Security Institutions to GNP (percent)*



\* Forecast for 2007

Source: Undersecretariat of the Treasury, Ministry of Finance

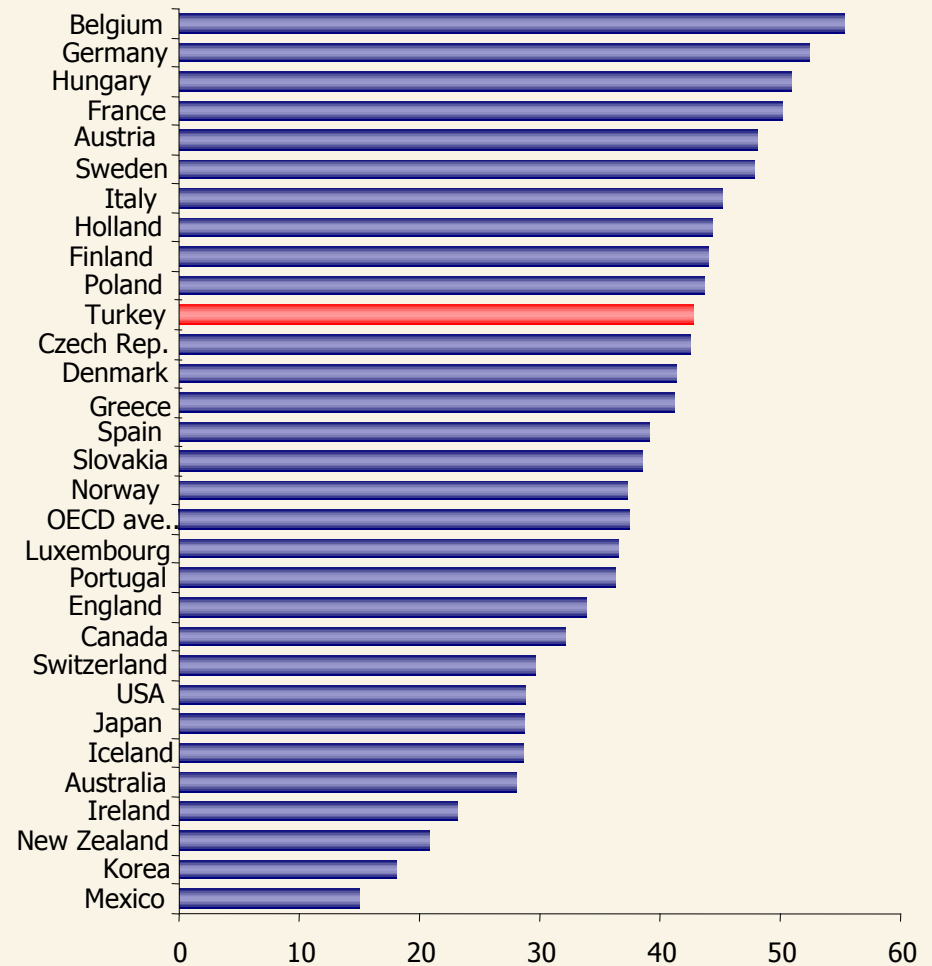


# How to Achieve Sustainable and High Growth

## Structural Reforms – Tax System and Labor Market

- ✓ It is of crucial importance to expand tax base and reduce the size of informal economy within the framework of a sound tax system.
- ✓ The labor market reforms will contribute to sustainable growth and permanent increases in employment.
  - Economic policies should be conducive to job creation.
  - The business environment should be raised to a level in par with international competition.
  - The education system should be consistent with labor demand and positioned to raise the quality of labor force.

**Employment Taxes** (as a percentage of labor cost, 2006)



Source: OECD





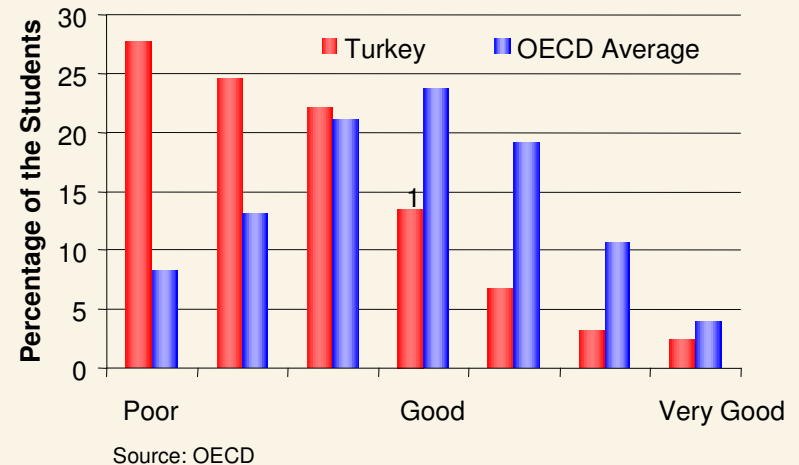
# How to Achieve Sustainable and High Growth

## Structural Reforms- Education System

✓ Drafting an education reform to meet economic needs will have a positive impact on sustainable growth in the long run.

- According to the results of PISA conducted by the OECD, Turkey ranks 33rd, 34th and 35th among 40 countries in reading, mathematics and sciences, respectively.
- It is imperative to establish consistency between human resources developed by the Turkish education system and the needs of the Turkish economy for qualified labor force.

**Breakdown of Students According to the Results of the Programme for International Student Assessment (PISA) (2003)**



**Average Hourly Wage Index by Education Level (2002, Urban, wage-earners, average = 100)**

	Male	Female
Illiterates	56	35
Primary-Middle School Graduates	78	50
High School Graduates	111	84
Vocational High School Graduates	113	82
University Graduates	211	165
AVERAGE	100	100

Source: TURKSTAT Survey for Household Revenue and Consumption, 2002





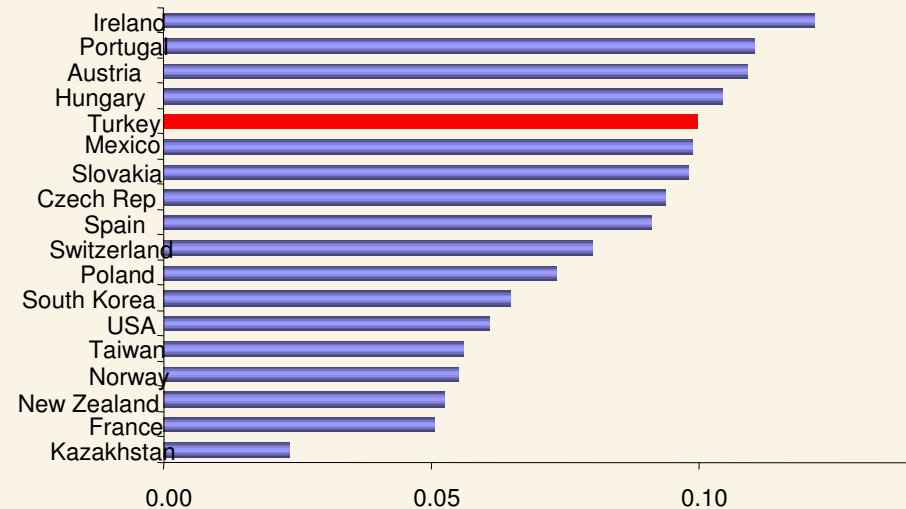
# How to Achieve Sustainable and High Growth

## Structural Reforms- Energy Market

- ✓ Privatizing the energy market, diversifying supply sources and ensuring supply security assume vital importance for achieving sustainable and high growth rate.
- ✓ The electricity prices for the industry are higher than electricity prices for households in Turkey compared to other countries.
- ✓ Transition to cost-based automatic pricing system will diminish risks relating to supply security and price stability.

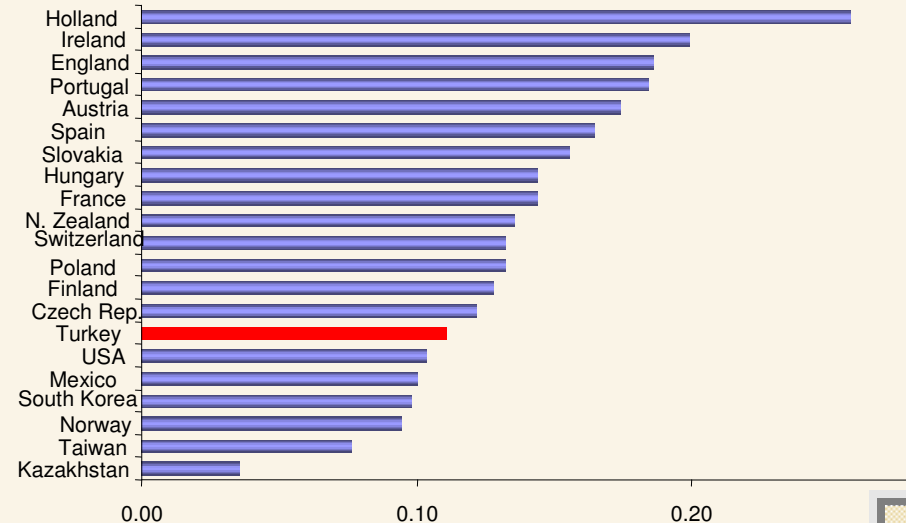
### Electricity Prices for Industry

(US dollars per kilowatt-hour including taxes, 2006)



### Electricity Prices for Households

(US dollars per kilowatt-hour including taxes, 2006)



Source: Energy Information Administration



# How to Achieve Sustainable and High Growth

## Structural Reforms – Business Environment and Competitiveness



- ✓ Achieving the results from these reforms depends not only on their initial implementation, but also on the continuance and further development of these reform.
- ✓ In this context, structural reforms should be supported by micro reforms that enhance competitiveness and productivity.
- ✓ Turkey ranks 57th among 175 countries on the ease of doing business provided in the World Bank's "Doing Business Report".
  - The most problematic areas in the Turkish economy are listed as the ease of employing workers, dealing with licenses, closing a business, getting credit and protecting investors.





# How to Achieve Sustainable and High Growth

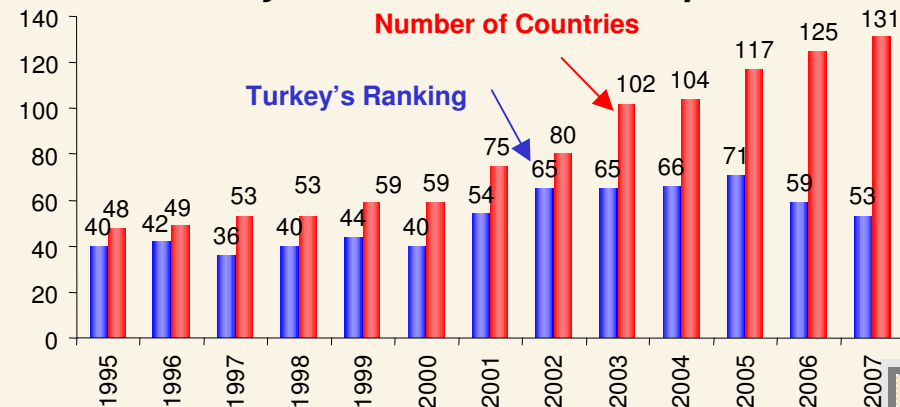
## Structural Reforms – Competitiveness of the Economy

- ✓ By fighting against inflation, the monetary policy enhances the competitiveness of the overall economy and the export sector in a permanent manner.
- ✓ Turkey should make progress in other factors affecting competitiveness such as efficiency of bureaucracy, tax structure, infrastructure, price competition and quality of labor force and governance.
- ✓ According to the Global Competitiveness Index, Turkey stepped up 18 places in the last two years.
- ✓ This structure confirms the importance of macroeconomic stability in general, price stability in particular.

### Main Factors Affecting Competition

	2003	2007
1	<b>Inflation</b>	Inefficient Government Bureaucracy
2	Political Instability	Tax Regulations
3	Policy Instability	Policy Instability
4	Access to Financing	Tax Rates
5	Inefficient Government Bureaucracy	Access to Financing
6	Tax Rates	Inadequate supply of Infrastructure
7	Corruption	Inadequately-educated Workforce
8	Tax Regulations	Corruption
9	Inadequate supply of Infrastructure	<b>Inflation</b>
10	Restrictive Labor Regulations	Restrictive Labor Regulations
11	Poor Work Ethics	Government Instability
12	Inadequately-educated Workforce	Foreign Currency Regulations
13	Foreign Currency Regulations	Poor Work Ethics
14	Crime and Theft	Crime and Theft

### Turkey's Place in Global Competition



Source: World Economic Forum, The Global Competitiveness Report 2007-2008



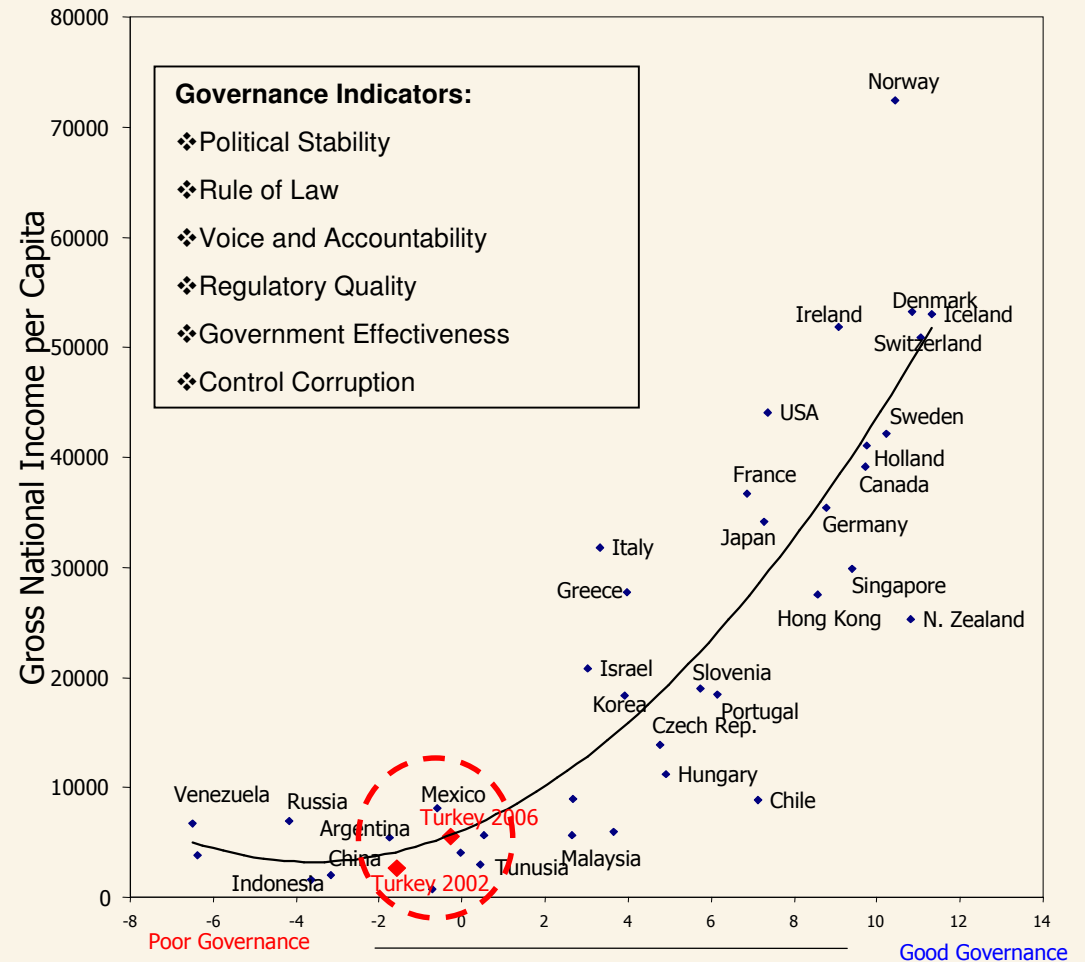
# How to Achieve Sustainable and High Growth

## Good Governance



- ✓ Improvement in governance indicators is of great importance for reaching sustainable growth rates.
- ✓ There is a strong positive correlation between good governance and national income per capita.
- ✓ Turkey, standing at lower levels in 2002, made a significant progress in 2006.

## Economic Performance and Governance (2006)



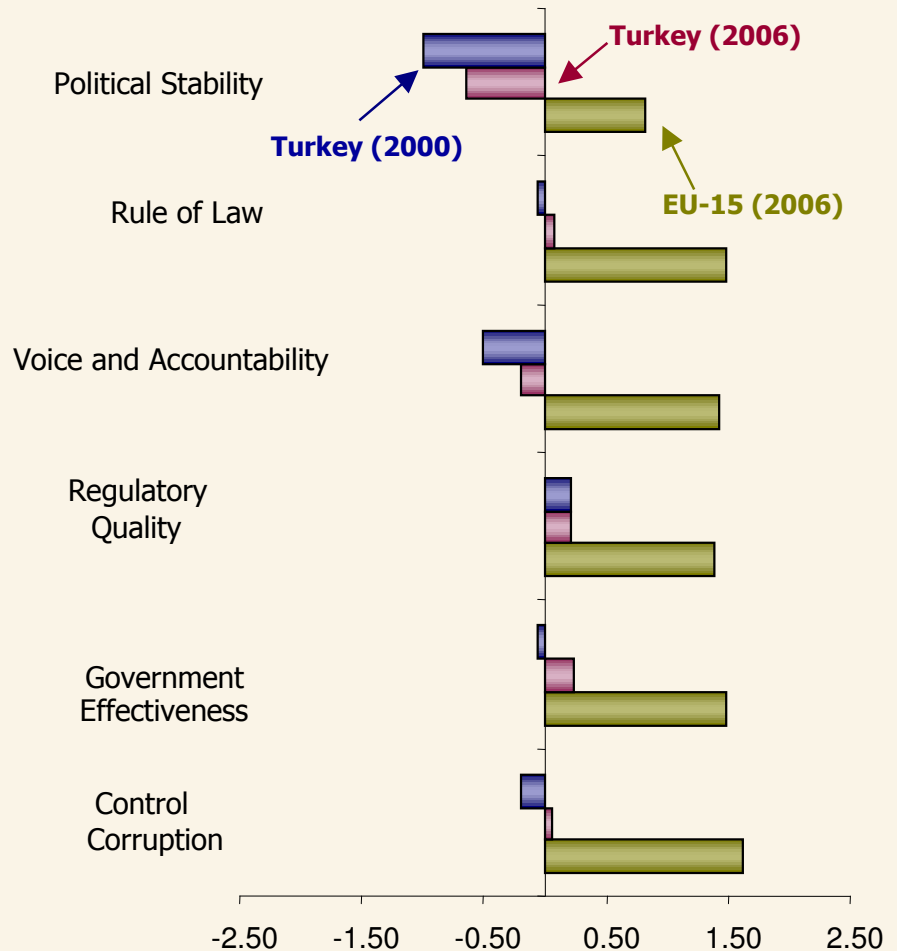


# How to Achieve Sustainable and High Growth

## Good Governance

- ✓ All indicators of good governance improved compared to 2000.
- ✓ Nevertheless, there is still much to be done to reach a level compatible with the EU-15 countries.

**Governance Indicators of Turkey and EU-15\***  
(2000 and 2006)



\*Governance indicators; governance forecasts are between -2.5 ile +2.5. Higher forecast figures indicate better governance.

Source: World Bank



# **How To Achieve Single-Digit Nominal Interest Rate**





# How to Achieve Single-Digit Nominal Interest Rate?

## Level of Interest Rates

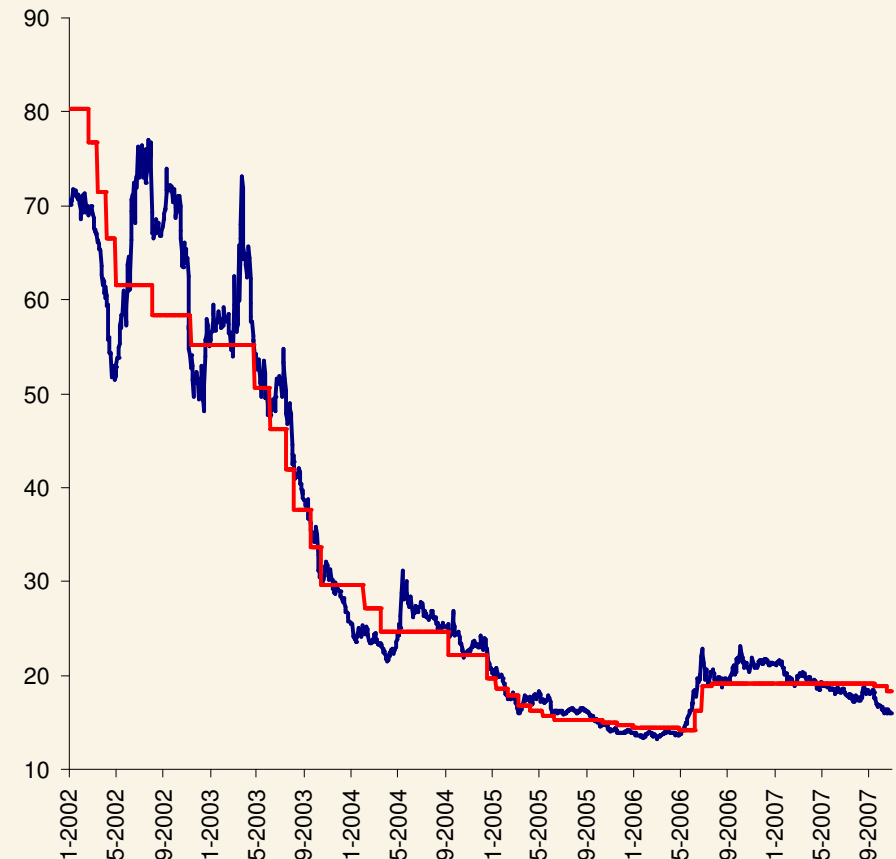
✓ Nominal interest rate is determined by three variables:

$$\text{Nominal Int.} = \text{Real Int.} + \text{Risk Premium} + \text{Inflation Expectation}$$

- Real interest rate is determined by real variables such as the marginal efficiency of capital and the savings rate.
  - The level of inflation compensation, which is the sum of inflation expectations and the inflation risk premium, is directly related to price stability.
  - A fall in both inflation expectations and the risk premium leads to a decline in nominal interest rates.
- ✓ It is not possible to bring interest rates down by artificial policy rate cuts below the level required to sustain the disinflation process.
- ✓ On the contrary, such a move would lead to higher medium and long-term interest rates since it would deteriorate inflation expectations and risk perceptions.

### **CBRT Short-Term Interest Rates and Benchmark Interest Rate on Government Securities**

(2 January 2002 – 9 November 2007, compound, percent)



Source: CBRT





# How to Achieve Single-Digit Nominal Interest Rate?

## Level of Interest Rates

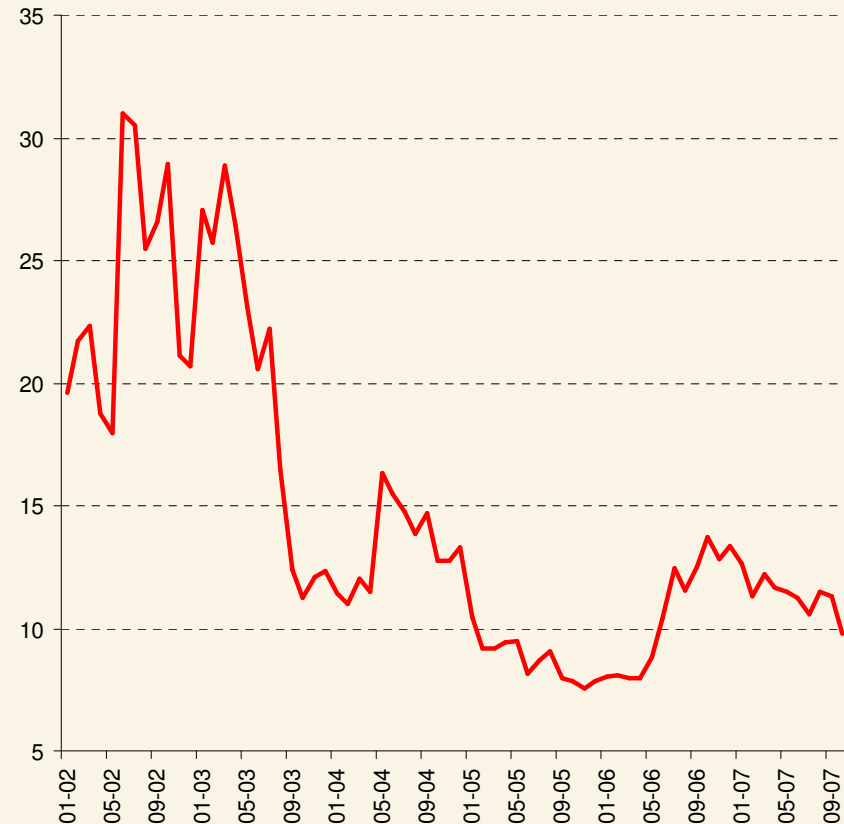


✓ Interest rates have declined in recent years, both in nominal and real terms, owing to the achievements on the road to stability.

- While nominal interest rates have declined to 15-16 % from 70 % since the start of 2002, real rates also fell below 10 % from 20 – 30 %. As of October 2007, real interest rates stand at 9.81 %.

### Real Interest Rates

(January 2002 – October 2007, compound, percent)



\* Based on borrowing interest rates accepted in government domestic borrowing auctions and 12-month inflation expectations.

Source: CBRT, Treasury



# How to Achieve Single-Digit Nominal Interest Rate?

**How to achieve further decline in nominal and real interest rates?**

**Nominal and real interest rates will fall to and remain at desired levels as long as:**

- ✓ There are less uncertainties in macroeconomic variables, particularly in inflation,
- ✓ Public debt stock is reduced and public financing becomes sustainable,
- ✓ The economy is bolstered against internal and external shocks through structural reforms,
- ✓ Decisive steps are taken for permanently established macro balances and an environment of confidence,
- ✓ Inflation expectations of the private sector improve and confidence on the economy increases.

**Our determination in the implementation of monetary policy contributes to the decline in short and long-term real interest rates via demand control and expectations management.**

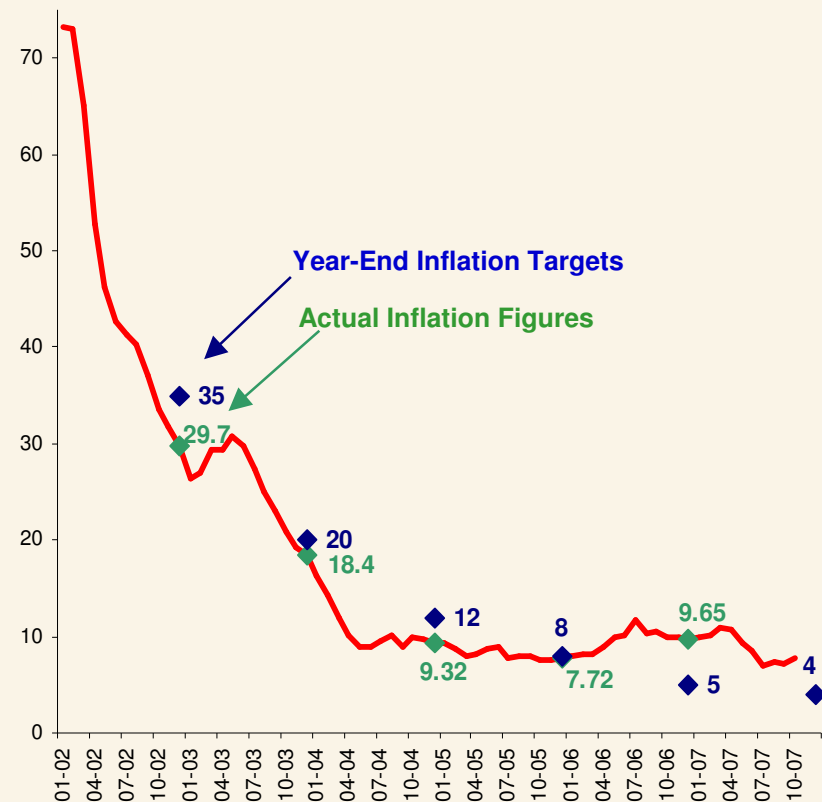


## For Further Decline in Nominal and Real Interest Rates...

### Price Stability

- ✓ Price stability refers to an inflation at rates low enough not to affect economic agents' decisions on investment, consumption and savings.
- ✓ Central Bank has been decisively fighting against inflation for the last seven years.
  - Inflation targets were achieved and inflation was lowered by more than 60 percentage points between the years 2001 and 2005.
  - Inflation exceeded the target in 2006.
- ✓ Hence, disinflation process is a dynamic and ongoing process.

**Inflation Realizations and Year-End Inflation Targets** (January 2002 – October 2007, annual percentage change)



Source: TURKSTAT, CBRT



## How to Reduce Further Nominal and Real Interest Rates

**Central Bank independence is a cornerstone in the disinflation process.**



- ✓ Monetary policies of the past, which mainly focused on short-term political goals, have resulted in high inflation, low and unstable growth rates, economic crises and high unemployment rates.
- ✓ An independent central bank with a medium and long-term perspective would resist such short-term behaviors and thus, fight against inflation more effectively.
- ✓ Therefore, central bank independence is critical for the achievement of price stability.



## For Further Decline in Nominal and Real Interest Rates...

### Central Bank of Turkey and Independence



- ✓ The Central Bank of Turkey was granted independence by the Grand National Assembly of Turkey with an amendment to the Law in 2001.
- ✓ The primary objective of the Bank is to achieve and maintain price stability.
  - Inflation target is set jointly with the Government.
  - The monetary policy to be implemented and monetary policy instruments to be used to achieve and maintain price stability are determined by the Central Bank on its discretion.
- ✓ The Central Bank implements its policies decisively within the framework of inflation targeting regime with a view to achieving the goal of price stability.
- ✓ The Central Bank supports the growth and employment policies of the Government, provided that these policies are not in conflict with the objective of achieving and maintaining price stability.



## For Further Decline in Nominal and Real Interest Rates...

Historical successes have been achieved in the disinflation process with the inflation targeting regime, which was implemented implicitly between 2002-2005 and has been implemented explicitly since 2006.



- ✓ Inflation targeting is a regime that has proved successful around the world, and requires continuity.
- ✓ Inflation targeting regime is not only a numerical target setting.
- ✓ It applies to a wide range of areas in terms of design, implementation, communication and institutional structure.
- ✓ It has been worked on for a long time and a strong technical infrastructure has been established.
- ✓ It has a strong direct or indirect interaction with other policies.



## For Further Decline in Nominal and Real Interest Rates...

Working principles and worldwide implementations of inflation targeting regime are clear-cut.

- ✓ The regime reflects a medium-term perspective.
- ✓ It is essential that the targets remain intact, except for extraordinary conditions.
- ✓ Periodical deviations from targets have been observed in many countries implementing this regime. However, no country has abandoned the regime.
- ✓ In cases of deviations from the target, a certain period of time is needed before resuming the process of converging to the target.
- ✓ Abandoning the inflation targeting regime or adopting different principles in its conduct would impede the disinflation process and price stability, and put past achievements at risk.





# **Economic Outlook “Inflation Developments”**

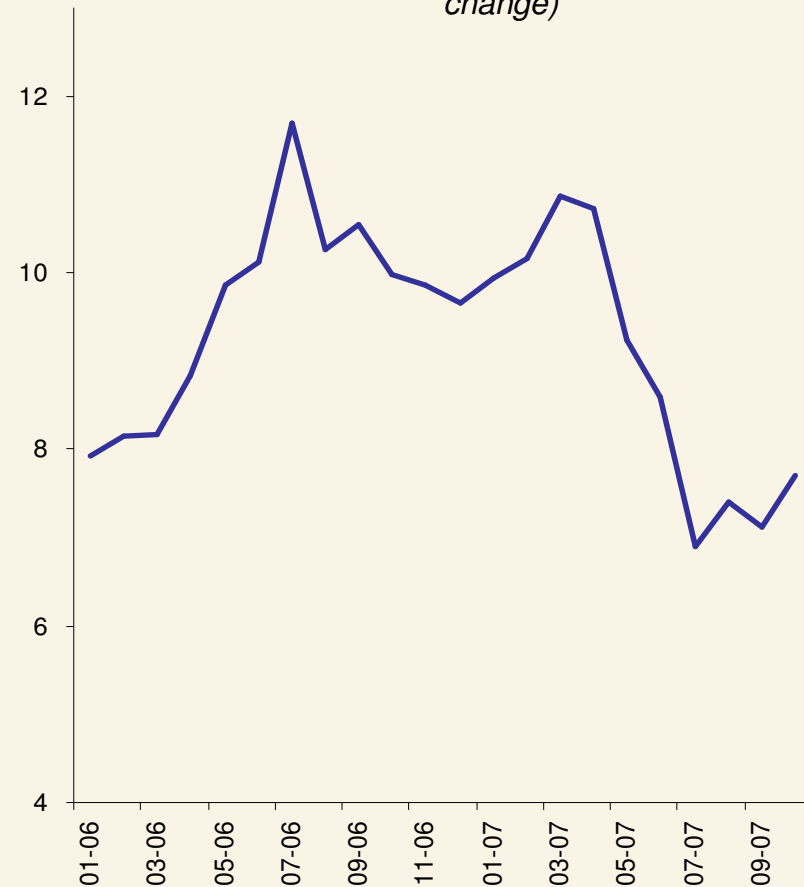


# Inflation Developments

- ✓ The May – June 2006 volatility and the deterioration in expectations disrupted the medium-term disinflation process.
- ✓ However, lagged effects of strong monetary tightening have subdued the rise in inflation and brought it back to a path consistent with the target.
- ✓ The strong disinflation process of the second quarter of 2007 came to a halt in the last quarter.
- ✓ Inflation, which was 7.12 % as of the third quarter of 2007, remained below the upper limit of the uncertainty band (7.3 %) formed around the path consistent with the target.
- ✓ As of October 2007, inflation stands at 7.70 %.

## Consumer Price Inflation

(January 2006 – October 2007, annual percentage change)



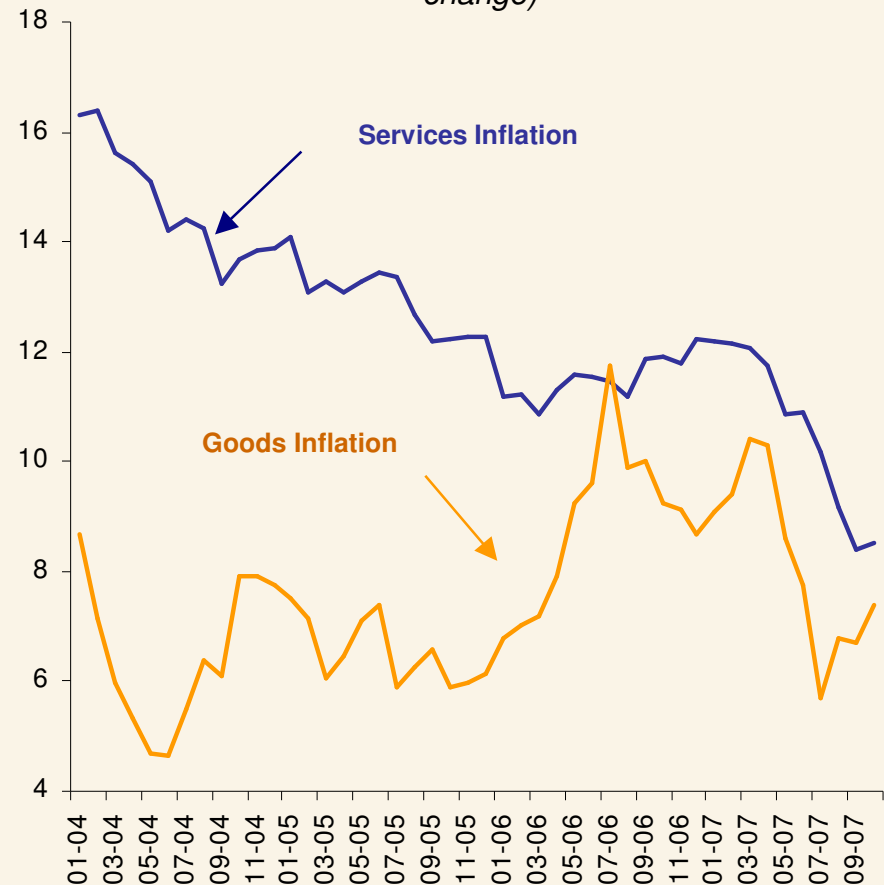
Source: TURKSTAT



# Inflation Developments

- ✓ The downward trend observable particularly in services inflation is encouraging, since it points to a gradual break of long-term inflation rigidity in this group.
- ✓ Better-than-expected inflation figures in the services sector in the third quarter of the year was a positive development with regard to inflation outlook.
- ✓ Although prices of goods follow a more volatile course due to external and supply-side factors, the inflation rate in goods continues to decelerate.

**Services and Goods Inflation**  
(January 2004 – October 2007, annual percentage change)



Source: TURKSTAT, CBRT



# Inflation Developments

✓ Food prices stand as the main factor that has impeded the disinflation process in 2007.

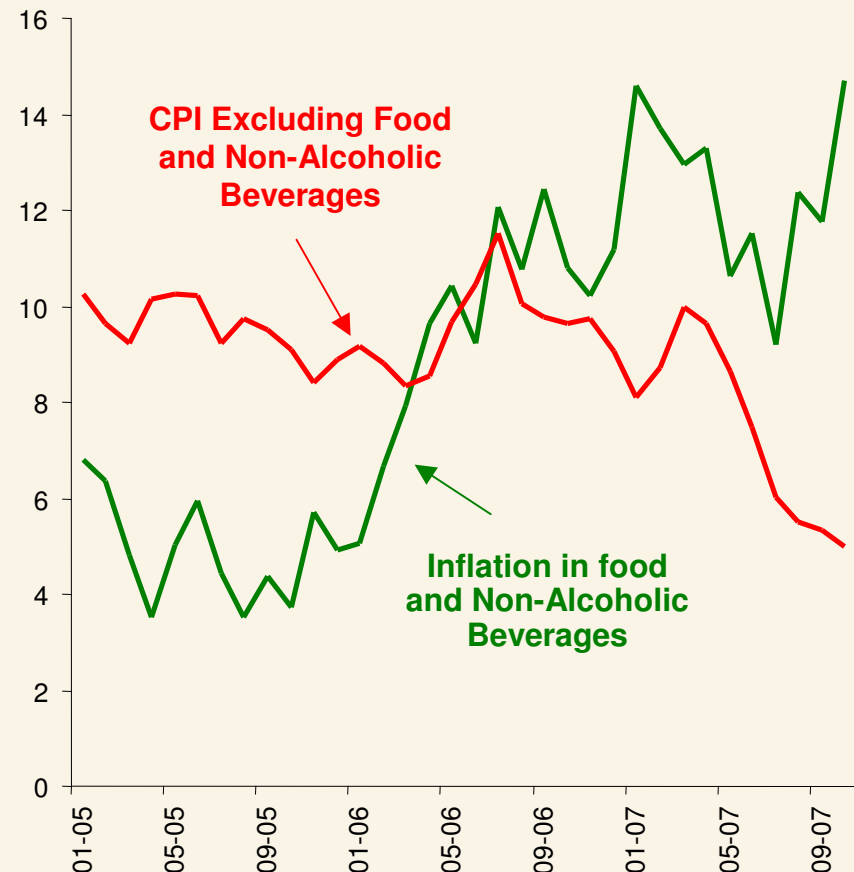
- As of October 2007, food group has added 4.19 percentage points to annual inflation.

✓ For more than a year, non-food inflation has displayed a downward trend, except for the temporary rise in February and March 2007.

- As of October, food inflation stands at 14.71 %, while non-food inflation is 4.99 %.

✓ Temperatures above seasonal averages in the recent period and changing supply conditions are obstacles to the predictability of food prices.

**Food and Non-Food CPI**  
(January 2005 – October 2007, annual percentage change)



Source: TURKSTAT, CBRT



# Inflation Developments

✓ The ongoing volatility and spikes in unprocessed food prices have accelerated in the recent period.

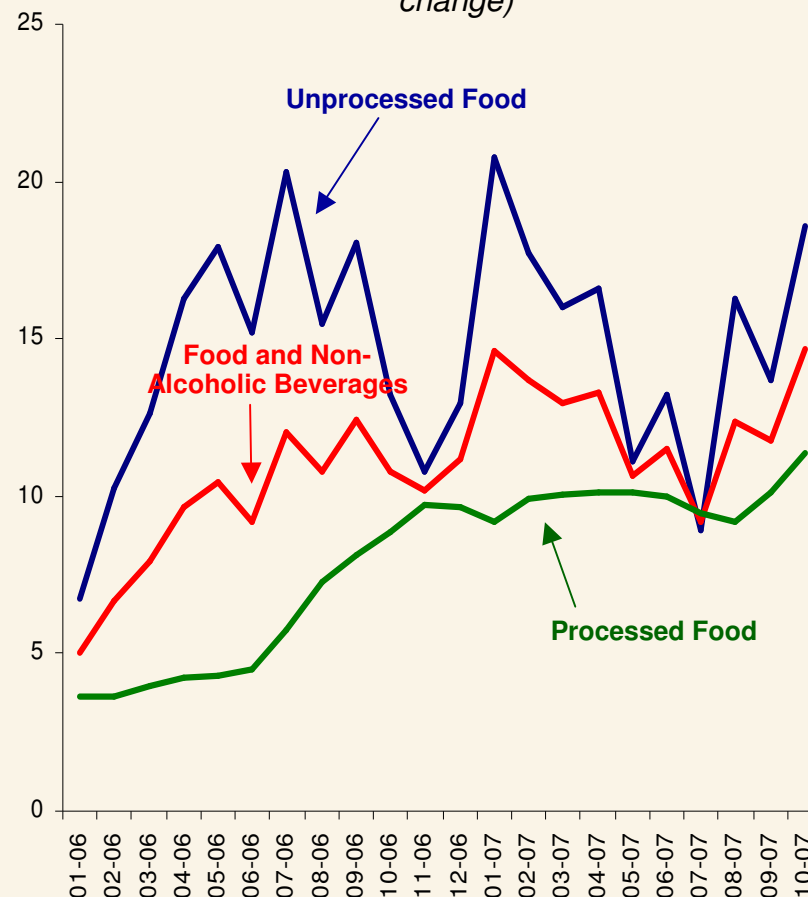
- As of October, annual inflation in the unprocessed food group is 18.59 %.
- This increase was triggered by the rise in fresh vegetable prices. The year-on-year inflation rate in fresh vegetable prices, which was 7.72 % on average in the previous three years, reached 30.00 % in October 2007.

✓ The 2.17 % monthly increase in processed food prices in October is the highest increase ever in the index with 2003 base year.

- This increase mainly stemmed from bread and cereal group prices, which climbed by 11.61 % in the first three quarters of the year.

## ***Food and Non-Alcoholic Beverages, Unprocessed Food, Processed Food Prices***

*(January 2006 – October 2007, annual percentage change)*



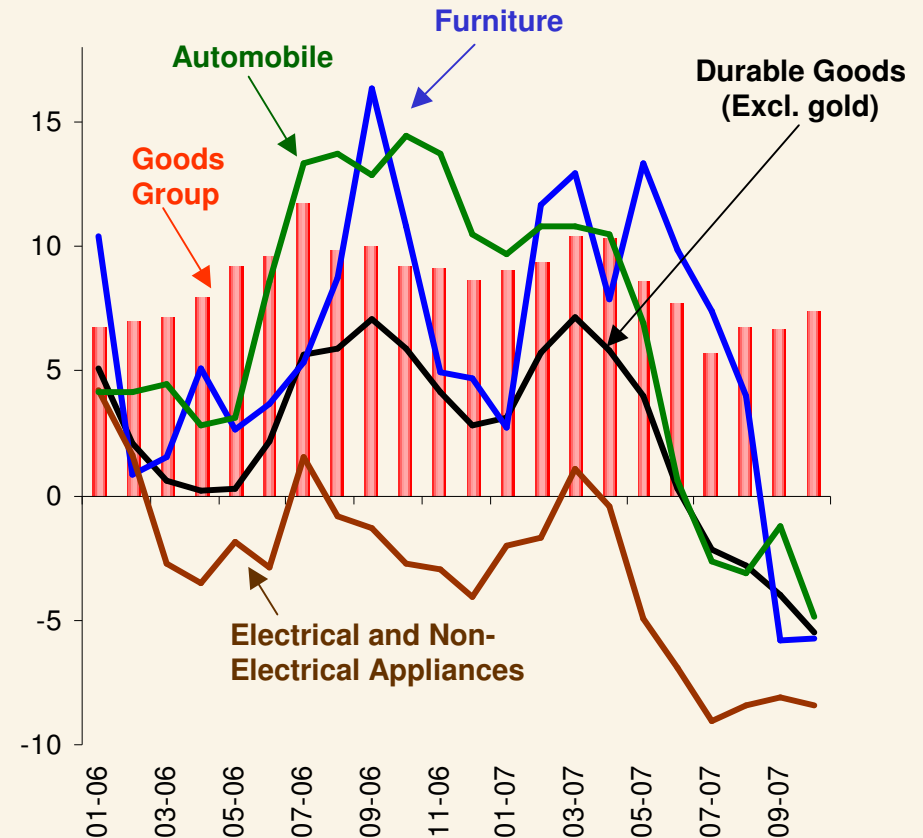
Source: TURKSTAT, CBRT



# Inflation Developments

- ✓ Monetary tightening continues to exert pressure on prices of goods, particularly on durables.
- ✓ The year-on-year goods inflation, which started to slow down in April 2007, declined to 5.71 % in July, but rebounded to 7.41 % in October due to increased food prices.
- Annual inflation in durable goods excluding gold declined to -5.47 %.
- Prices in all sub-groups followed a downward trend and created a favorable outlook.

**Goods Group and Selected Sub-Items Prices**  
(January 2006 – October 2007, annual percentage change)



Source: TURKSTAT, CBRT



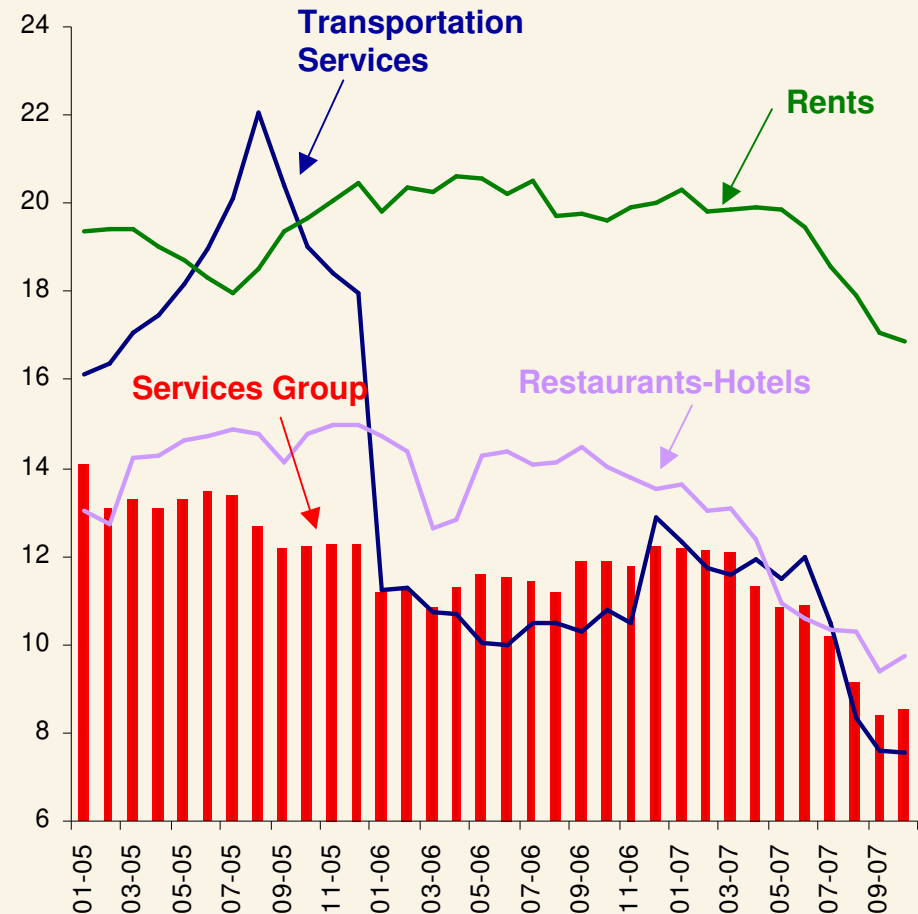
# Inflation Developments

✓ The slowdown in services inflation, on which the monetary policy has a relatively stronger impact, has become more significant after April, and is more favorable than envisaged.

- Cumulative decline in services inflation has reached 3.7 percentage points since early-2007.
- While the average annual October inflation in services prices was 12.60 % in the 2004-2006 period, it was realized as 8.53 % in October 2007.
- Annual inflation in the restaurants-hotels group fell by 4.3 percentage points compared to the same period of the previous year.
- The deceleration in rent inflation is noteworthy. Annual rate of increase, which used to be around 20 % in the last two years, decreased to 16.7 % in October.

✓ Downward trend in services inflation is expected to continue in the upcoming period.

**Services Group and Selected Sub-Items**  
(January 2005 – October 2007, annual percentage change)



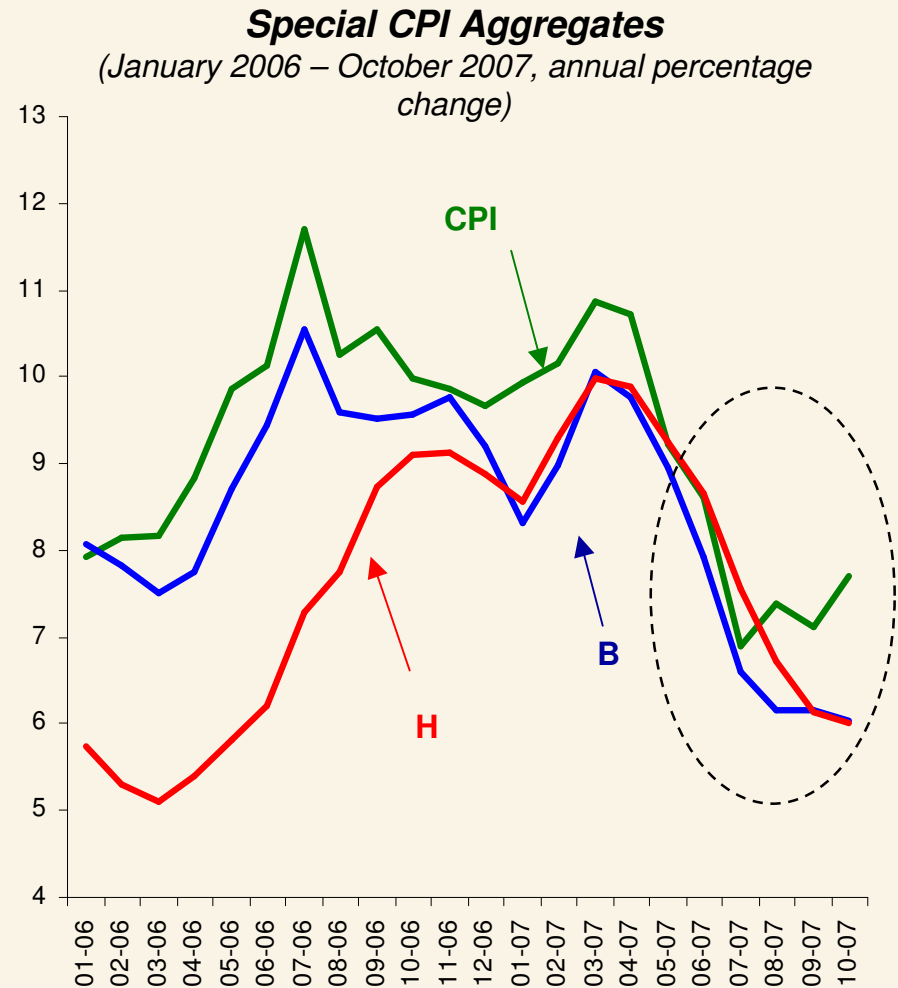
Source: TURKSTAT, CBRT





# Inflation Developments

- ✓ The year-on-year increases in all special CPI aggregates lost pace in October, compared to same period last year.
- ✓ The slowdown is especially apparent in the CPI excluding unprocessed food (SCA-B).
- ✓ The slowdown in the annual rate of increase in the widely cited core indicator, H index, became evident in May, and total decline on the year to October reached 2.90 percentage points.



B: CPI excl. unprocessed food products  
H: CPI excl. energy, unprocessed food, alcoholic beverages, tobacco products and gold

Source: TURKSTAT

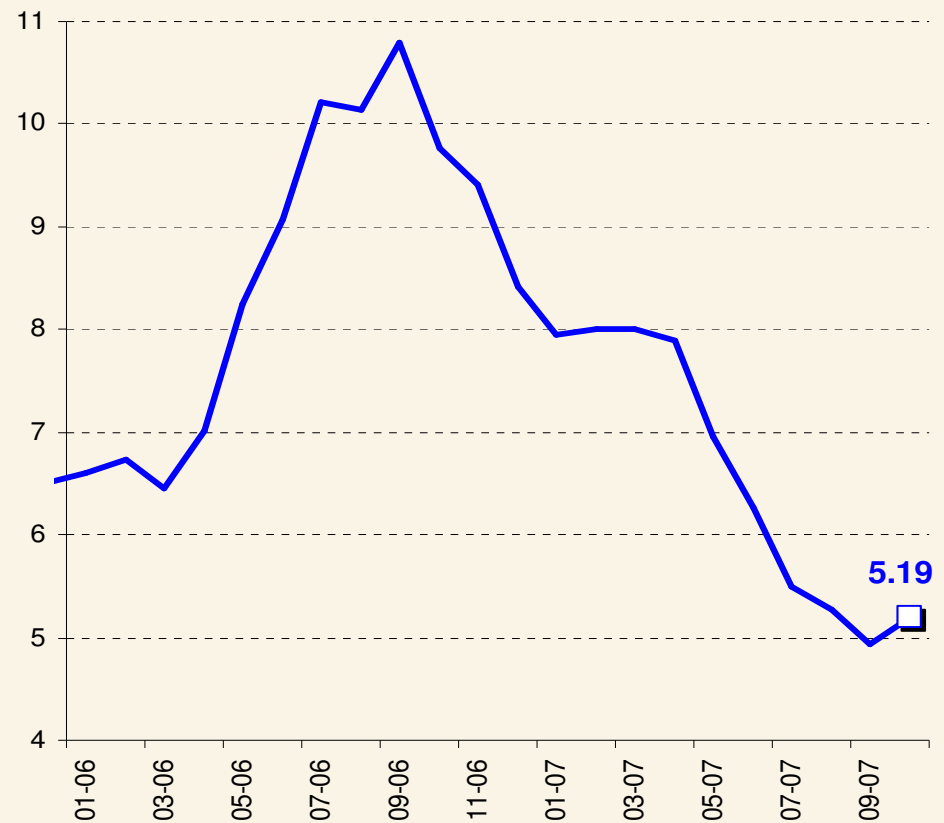


# Inflation Developments

✓ Annualized figures based on seasonally adjusted core indicator SCA-H point to an ongoing disinflation process.

## **Annualized monthly change in seasonally adjusted SCA-H**

(Quarterly moving average, January 2006 – October 2007, percent)



Source: TURKSTAT, CBRT



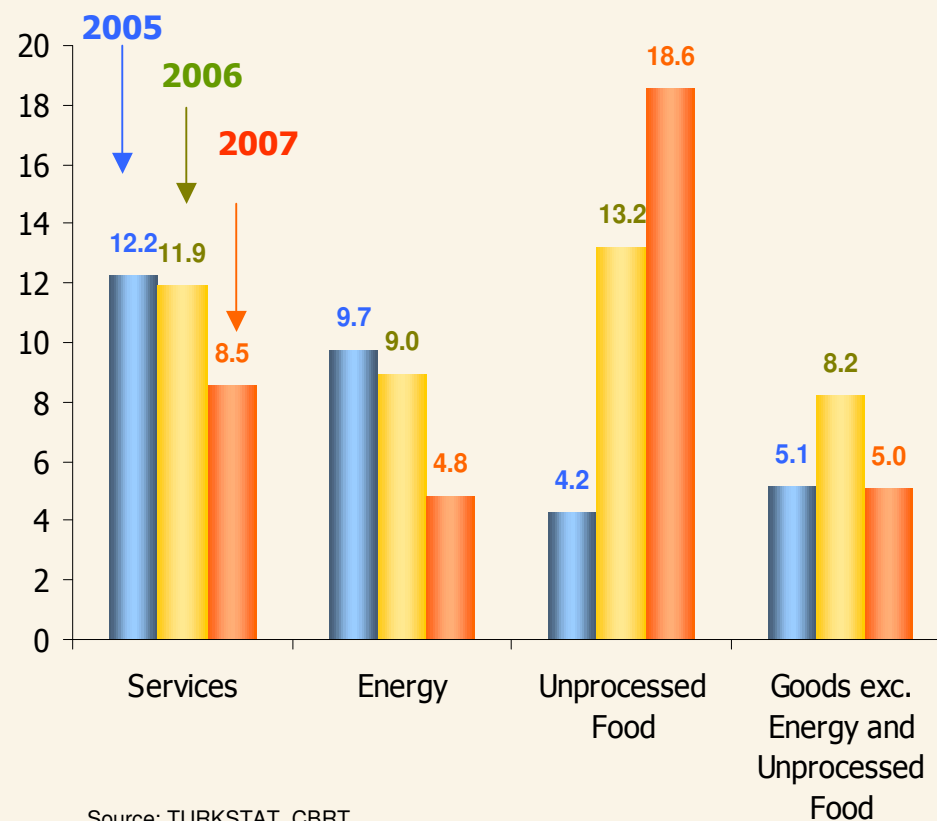
# Inflation Developments

**In the last three years,**

- ✓ Services inflation has slowed down significantly compared to previous years.
- ✓ The increase in energy prices has also remained subdued compared to previous years, whereas unprocessed food prices maintain the upward and volatile course.
- ✓ Annual inflation excluding energy and unprocessed food has declined to 5.0 % by October 2007.

## ***Inflation by Groups***

*(2005-2007, annual percentage change as of October)*



Source: TURKSTAT, CBRT

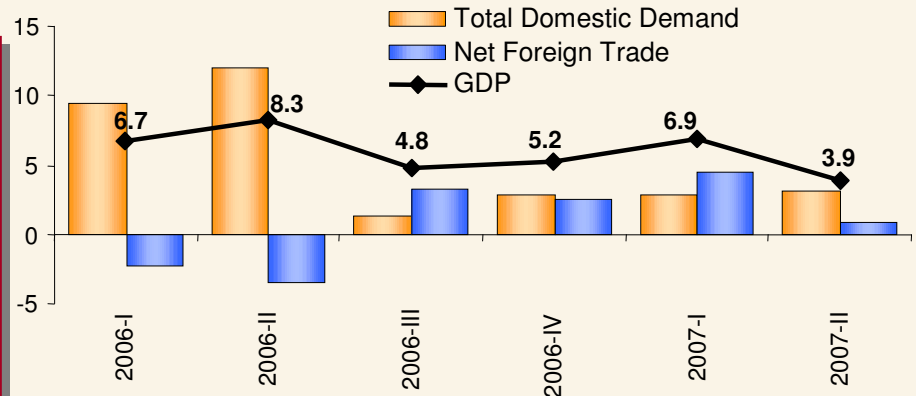


# Inflation-Outlook

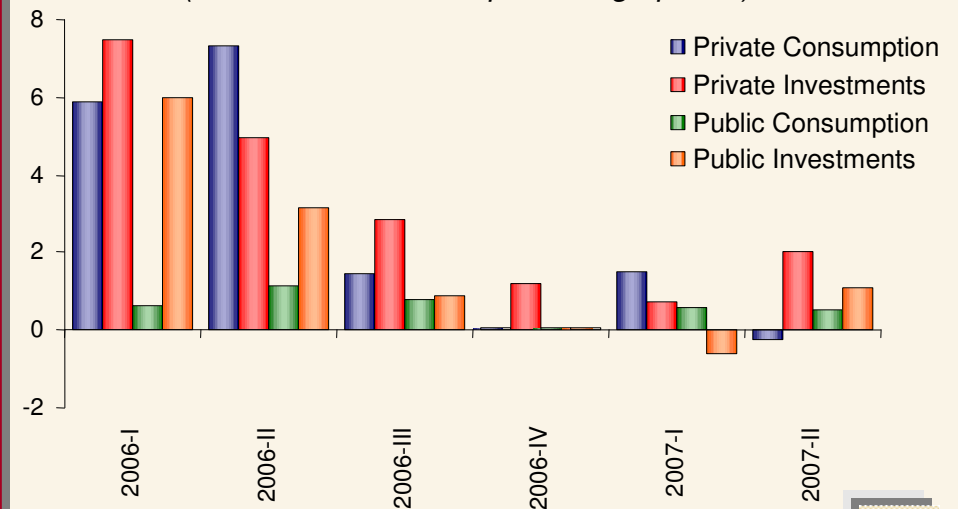
## Outlook

- ✓ The monetary policy implemented since mid-2006 has been effective in bringing domestic demand under control.
- ✓ Data for the second quarter of 2007 indicate a moderate growth in domestic demand and economic activity.
  - Private and public sector investments became the main determinants of the growth in domestic demand during this period, and the increase in private consumption expenditures remained subdued.
- ✓ Domestic demand points to a relative recovery rather than an overheating in the economy compared to the second half of 2006, when it steadily weakened. Strong monetary tightening continues to be effective in restricting domestic demand.

**Quarterly Growth**  
(GDP, percentage change)



**Components of Growth**  
(GDP, contribution in percentage points)



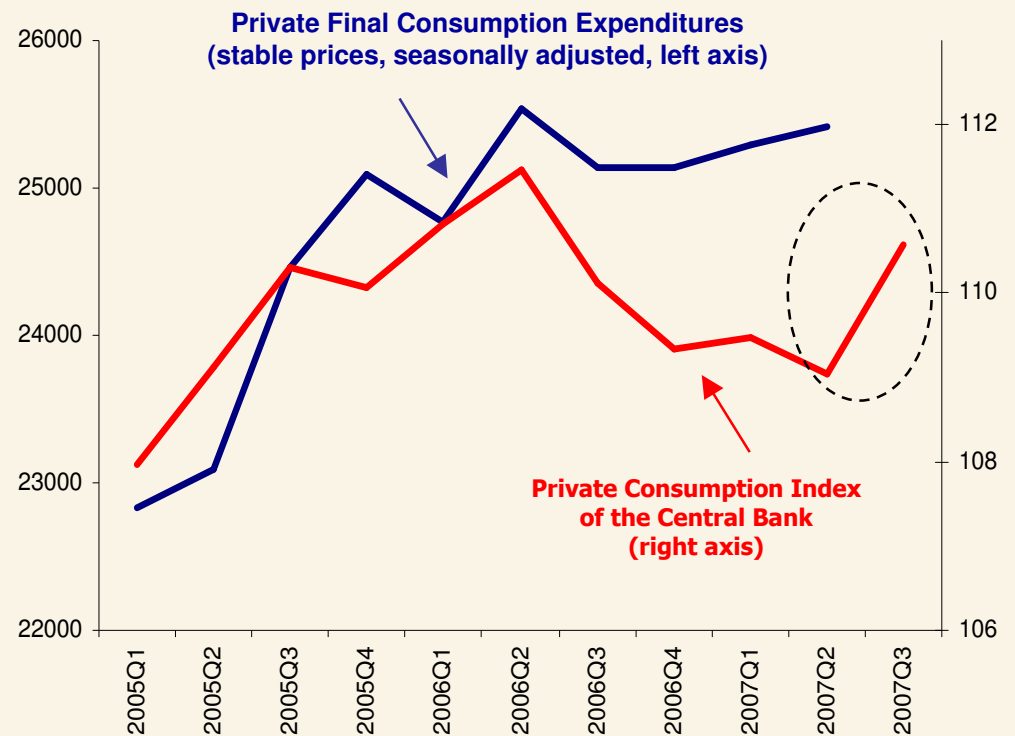
Source: TURKSTAT



# Inflation-Outlook

✓ Private consumption index of the Central Bank points to a moderate pick-up in private final consumption expenditures and domestic demand.

**Private Consumption Index** (2005 Q1– 2007 Q3, index)  
**and Private Final Consumption Expenditures**  
(2005 Q1 – 2007 Q2, thousand YTL)



Series making up Private Consumption Index : Seasonally adjusted imports of consumption goods, seasonally adjusted real domestic taxes on goods and services, seasonally adjusted total domestic sales of white goods, seasonally adjusted domestic sales of automobiles.

Source: CBRT, TURKSTAT

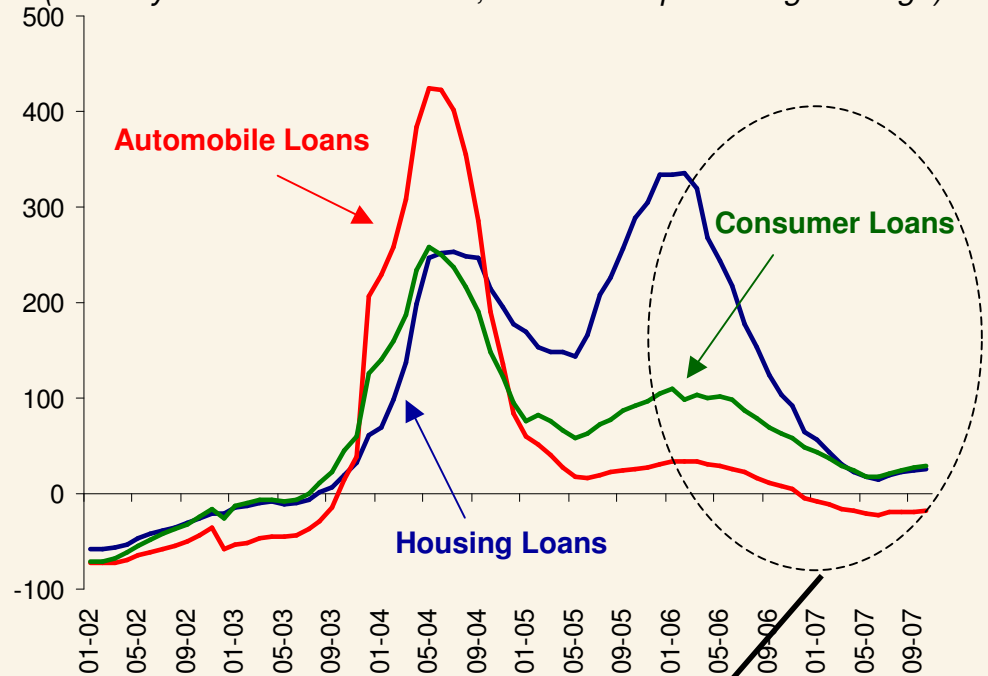


# Inflation-Outlook

- ✓ Consumer loan utilization does not signal a substantial increase in private consumption expenditures.
- ✓ Real consumer loan utilization continues to increase at relatively low rates compared to the first half of 2006, when domestic demand was strong.
  - The year-on-year increase in real terms was 26.8 % in September.

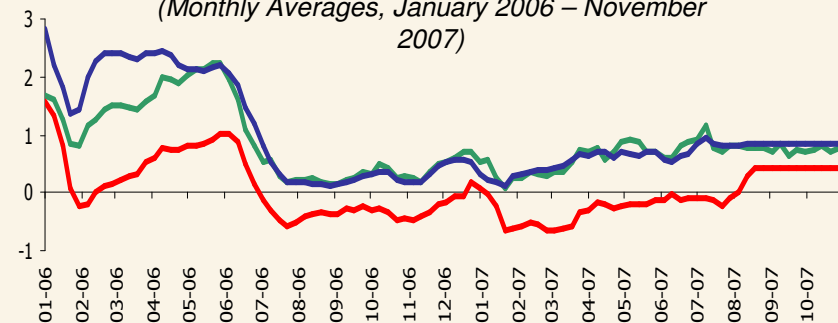
## Consumer, Automobile and Housing Loans

(January 2002 – October 2007, annual real percentage change)



## Weekly Nominal Percentage Change

(Monthly Averages, January 2006 – November 2007)



Source: CBRT

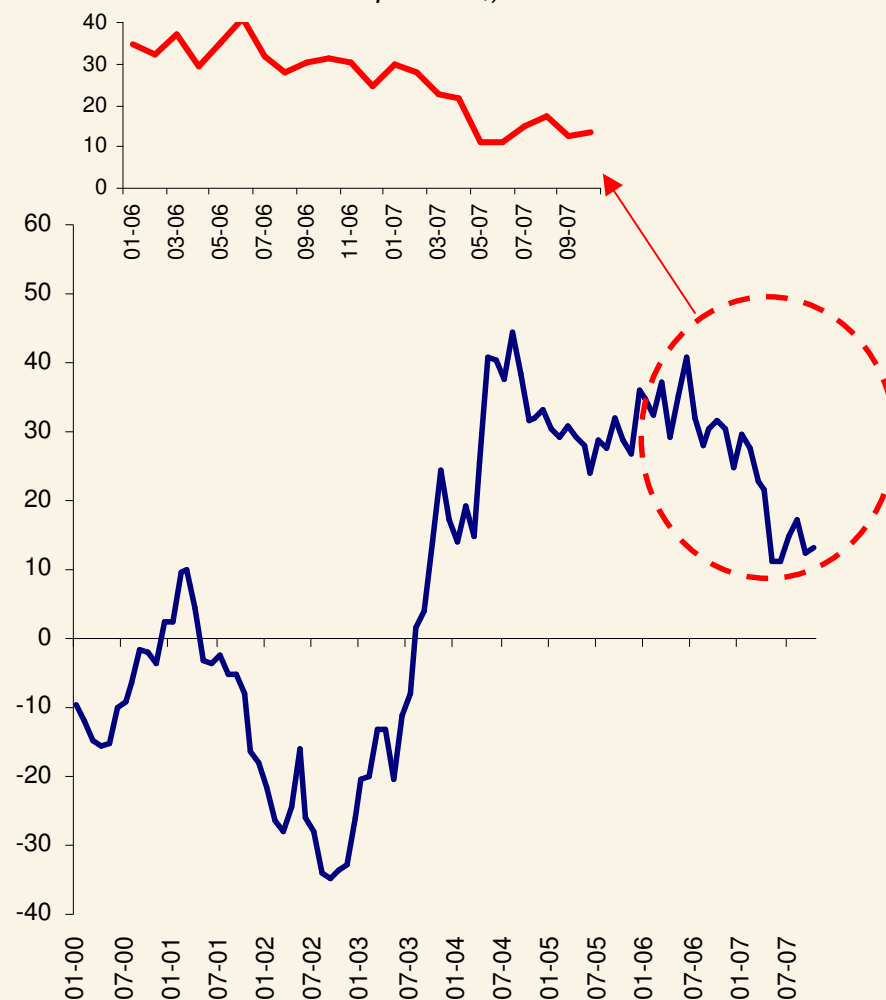


# Inflation – Outlook

- ✓ The deceleration in the growth rate of commercial loans that had started in February ceased in July.
- The annual rate of increase in corporate loans reached 13.3 percent in real terms in October 2007.

## Commercial Loan Index\*

(January 2000 – October 2007, year-on-year real change, percent,)



\* Commercial credits: Corporate loans+ specialized loans

Source: CBRT





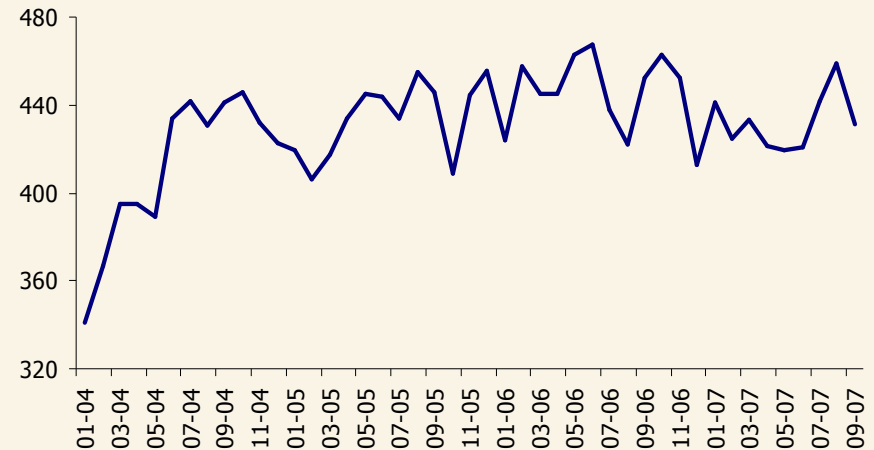
# Inflation – Outlook

✓ Seasonally-adjusted data point to a rise in the sales of white goods and automobiles.

- Despite a recovery in domestic demand for white goods in 2007 Q3, which had been shrinking since 2006 Q3; total sales are declining compared to the previous periods due to the slowdown in exports.
- The automobile sales, which had been falling since June 2006, has picked up in 2007 Q3, but are still below their 2005 levels.

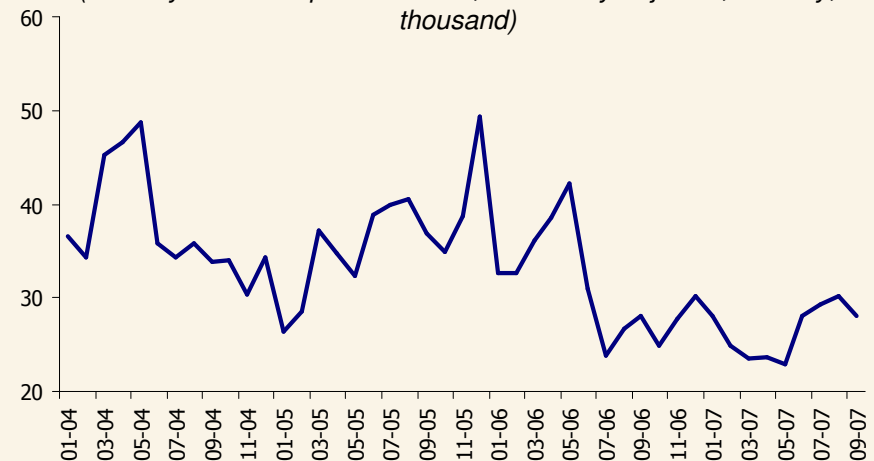
## Domestic White Good Sales

(January 2004 – September 2007, seasonally-adjusted, monthly, thousand)



## Domestic Auto Sales

(January 2004 – September 2007, seasonally-adjusted, monthly, thousand)



Source: Automotive Manufacturers Association (AMA), White Goods Manufacturers Association (WGMA), CBRT



# Inflation – Outlook

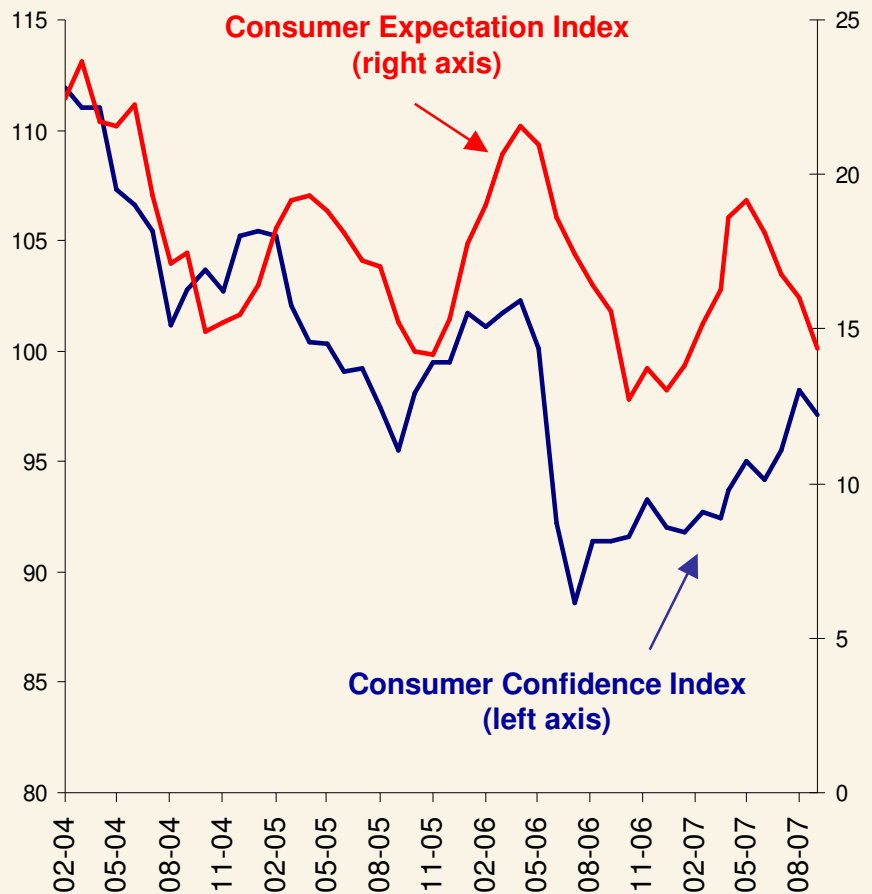
✓ Consumer Confidence Index has been rising steadily since July 2006.

- This development confirms the recovery in private consumption demand.

✓ The upward trend in Consumer Expectation Index started from early-2007 was replaced by a decline in May.

## Consumer Confidence Index and Consumer Expectation Index

(January 2004 – September 2007)



Source: CBRT, TURKSTAT

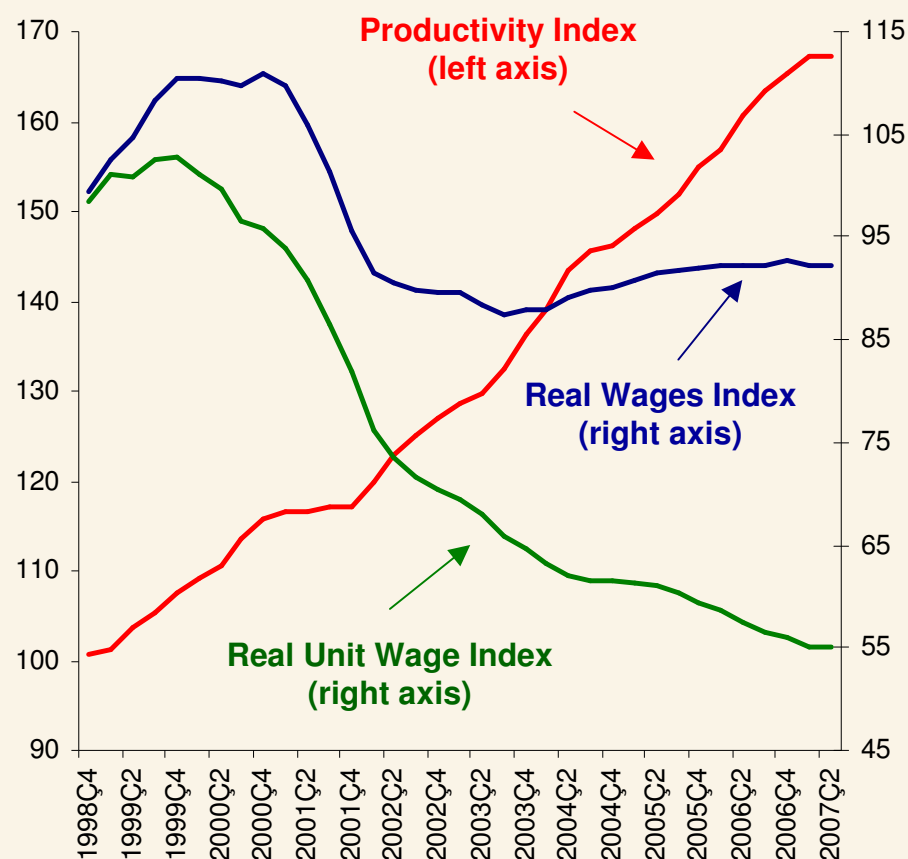


# Inflation – Outlook

- ✓ The favorable developments in production costs has continued to support disinflation process.
- ✓ In manufacturing industry;
  - The productivity growth maintains its high level, albeit a slowdown in 2007 Q2.
  - After the rapid decrease in the aftermath of 2001 crisis, real wages have been displaying a moderate growth since mid-2003.
  - Since the productivity gains have surpassed that of real wages, real unit wage index calculated by dividing real wages by productivity index continues to decline.

## ***Productivity in Manufacturing Industry, Real Wages and Real Unit Wage Index***

*(1998 Q1– 2007 Q1, per hour worked, annual moving averages)*



Source: TUKSTAT, CBRT

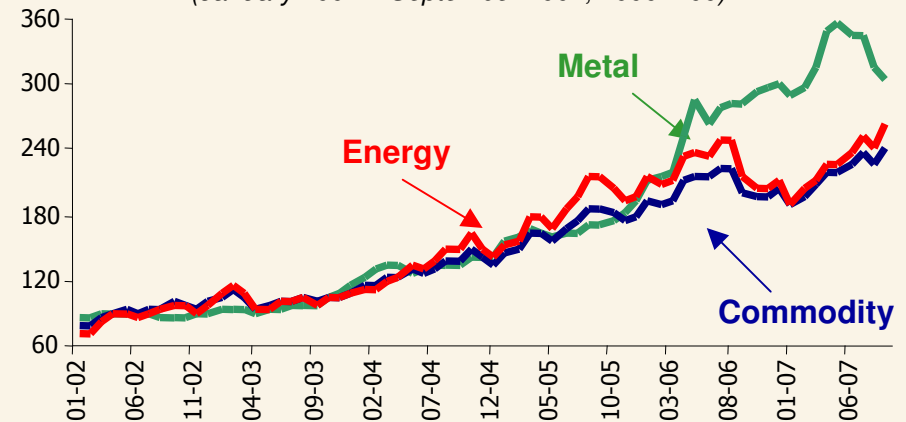


# Inflation – Outlook

- ✓ Prices in international markets and their impact on inflation are closely monitored.
- ✓ While the rapid rise in energy and commodity prices in the last couple of months has continued, there has been a slowdown in metal prices since June.
- ✓ The crude oil prices has maintained the upward trend that had started in early 2007.

## International Price Indices for Selected Goods

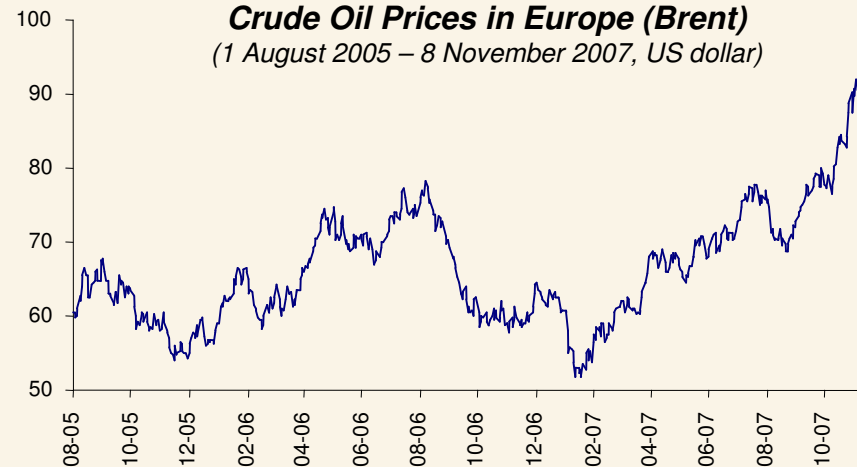
(January 2002 – September 2007, 2000=100)



Source: IFS

## Crude Oil Prices in Europe (Brent)

(1 August 2005 – 8 November 2007, US dollar)



Source: Bloomberg



# Inflation – Primary Risk Factors

## Primary Risk Factors



- ✓ In case of a heightened risk aversion and deterioration in international liquidity conditions, the CBRT will aim at limiting the effects of possible market fluctuations on inflation outlook by pursuing an active liquidity strategy as well as utilizing other policy instruments.
- ✓ The risks on total demand conditions are two-sided:
  - The upside risks arise from the uncertainties pertaining to the magnitude of the impact of the downward trend of long-term interest rates on demand for credits.
  - As for the downside risks: a faster-than-expected slowdown in global economy, prospective contraction both in foreign demand and financing conditions could lead to lower-than expected domestic demand.
- ✓ Resorting to hikes in indirect taxes to partially compensate for deviations in primary budget balance poses a risk to the predictability of inflation.



# Inflation – Primary Risk Factors

## Primary Risk Factors



- ✓ Since food prices account for 28 percent of the CPI basket and volatility in this sector continues, increases in food prices pose risk in either direction.
- ✓ There are uncertainties over the impact of energy prices on medium-term inflation outlook.
  - A high level of increase in electricity prices is expected soon.
  - The upsurge in international oil prices continues.
- ✓ The support of fiscal policies and structural reforms play a crucial role in the disinflation process.
  - The European Union accession and harmonization process and structural reforms that would reinforce the quality of fiscal discipline are closely monitored with respect to their implications on macroeconomic stability and price stability.

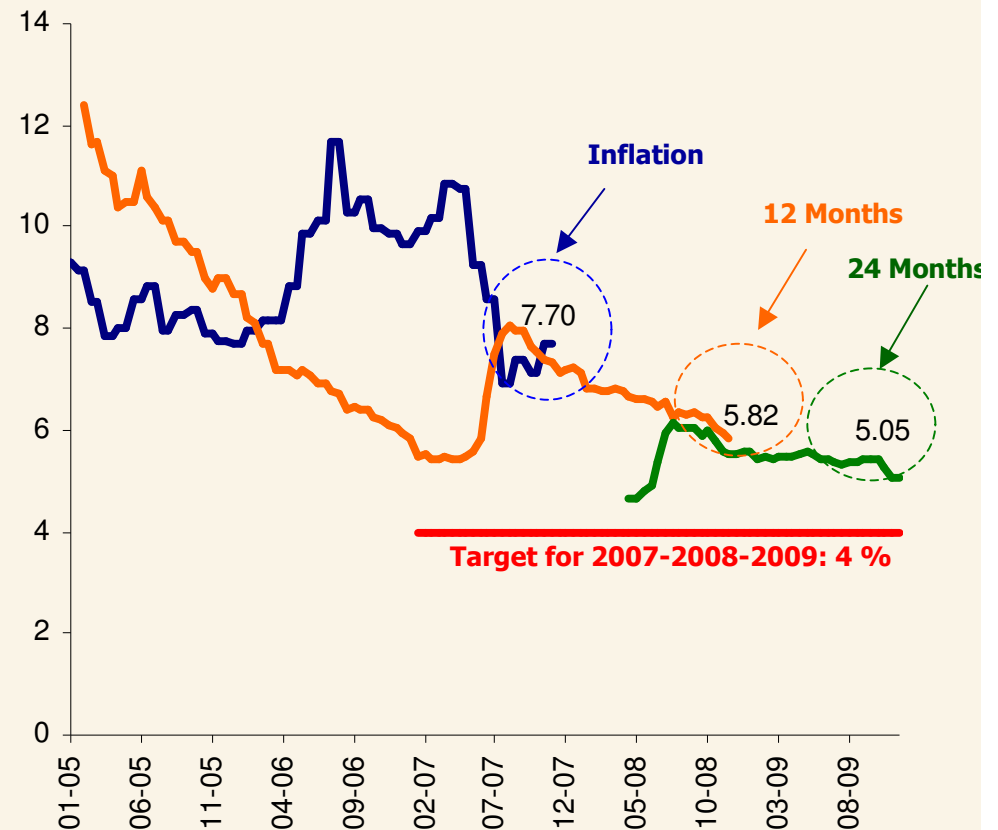


# Inflation – Expectations

## Expectations

- ✓ Despite recent improvement in inflation expectations, they are still below the target.
- ✓ Inflation expectations for the next 12 months, which was 6.84 percent at the turn of the year, came down to 5.82 percent in November, while inflation expectations for the next 24 months decreased to 5.05 percent.
- ✓ As long as the disinflation process continues, the inflation expectations is expected to improve.

**Inflation ve Inflation Expectations**  
(As of November 2007, annual percentage change)



Source: CBRT, TÜKSTAT





# Inflation –Forecasts

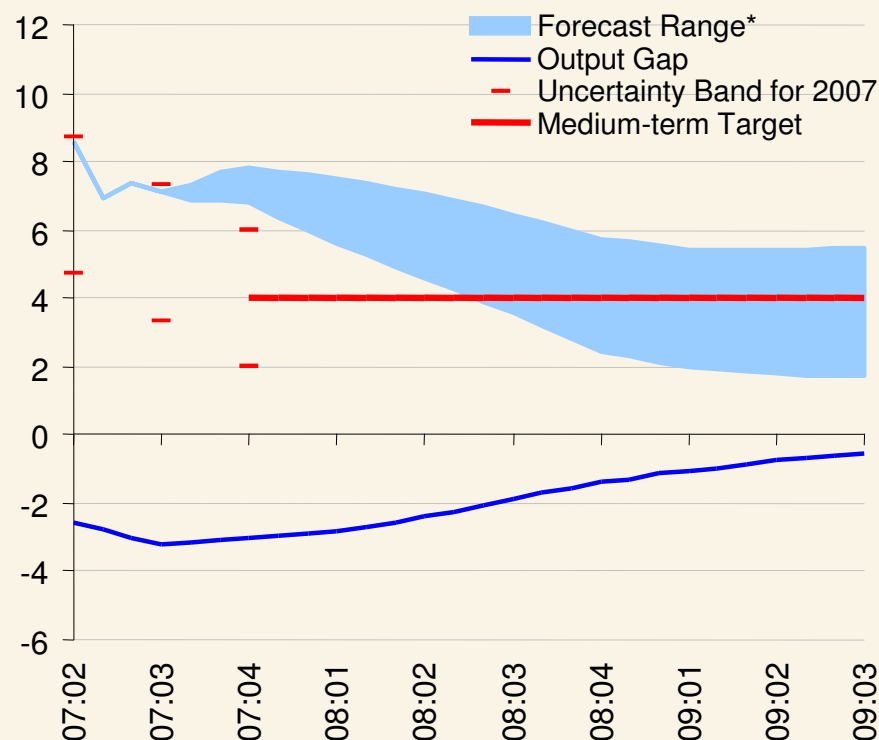
**Inflation target for 2008 is  
4 percent.**



✓ As presented in the Inflation Report of October 26, 2007, under the assumption that policy rate cuts will continue in the rest of 2007 and the first few months of 2008 and then be kept constant for a while, with 70 percent probability inflation is predicted to be:

- between 6.7 percent and 7.9 percent by the end of 2007  
(mid-point 7.3 percent)
- between 2.5 and 5.7 percent by the end of 2008  
(mid-point 4.1 percent)

## *Inflation and Output Gap Forecasts*



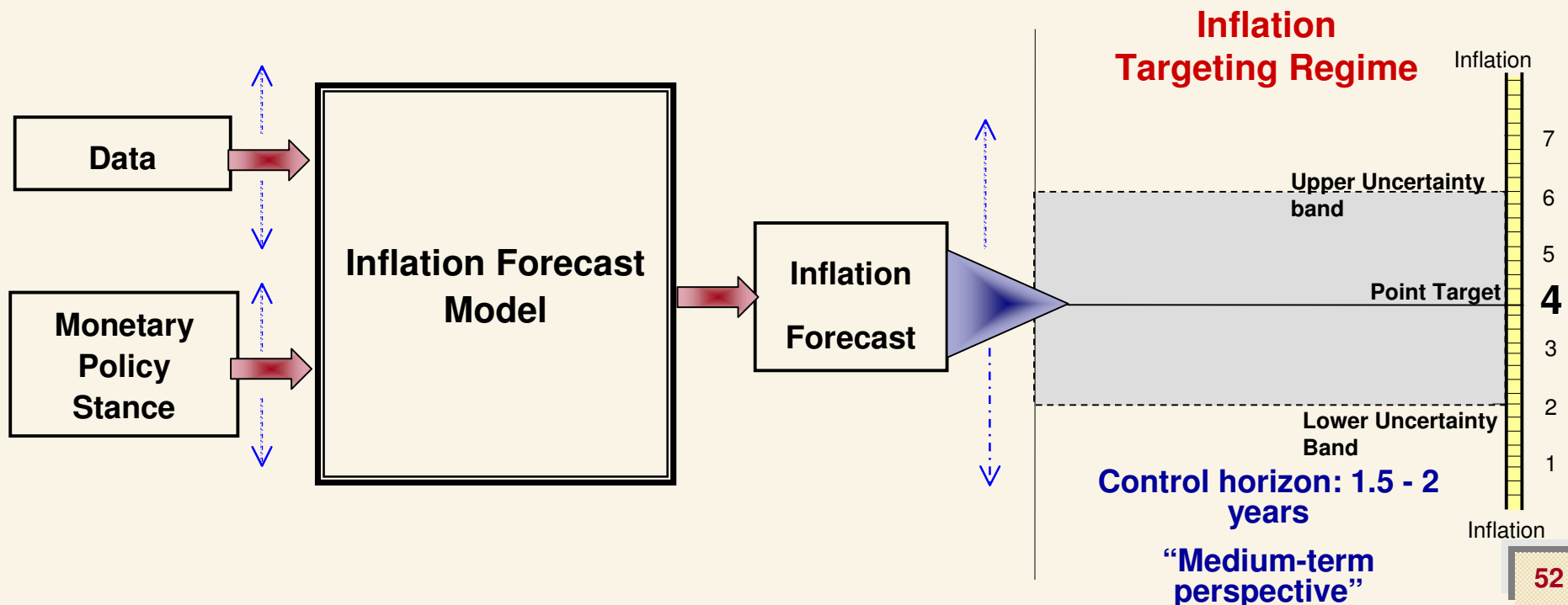
\* Probability of inflation remaining within the forecast range is 70 percent.

Source: CBRT



# Forecast Model and Inflation Targeting

- ✓ The policy stance explained in the Inflation Report is established on the basis of available data.
- ✓ Any new data pertaining to the medium-term inflation outlook would necessitate revising the future stance of monetary policy.
- ✓ Monetary policy's data-dependency is a natural outcome of the inflation targeting regime.
- ✓ Under this regime, updating the monetary policy stance is not an exception, but a rule.





# Forecast Model and Inflation Targeting

## Examples of data-dependency in case of:

- ✓ **Loosening in Fiscal Policies:** Inflation forecasts of the Central Bank would go up and exceed the target, the monetary policy stance would be reviewed in view of a probable deviation from the target, a new monetary policy stance would be set to establish consistency between the inflation forecast set forth by the model and the inflation target.
- ✓ **Slowdown in economic activity in Europe:** External demand would lose pace, inflation forecasts would be pushed below the target, monetary policy stance would be loosened in view of a probable deviation from the target.
- ✓ **Contraction in international credit markets:** The amount of foreign credits used by domestic banks would decrease and domestic demand would slow down, inflation forecasts would drop below the target, monetary policy stance would be loosened in view of a probable deviation from the target.
- ✓ **Supply shock in food prices:** If the first-round effects are projected to fade away in the medium run, medium-term inflation forecasts would not be changed, current monetary policy stance would be maintained.



# **Economic Outlook**

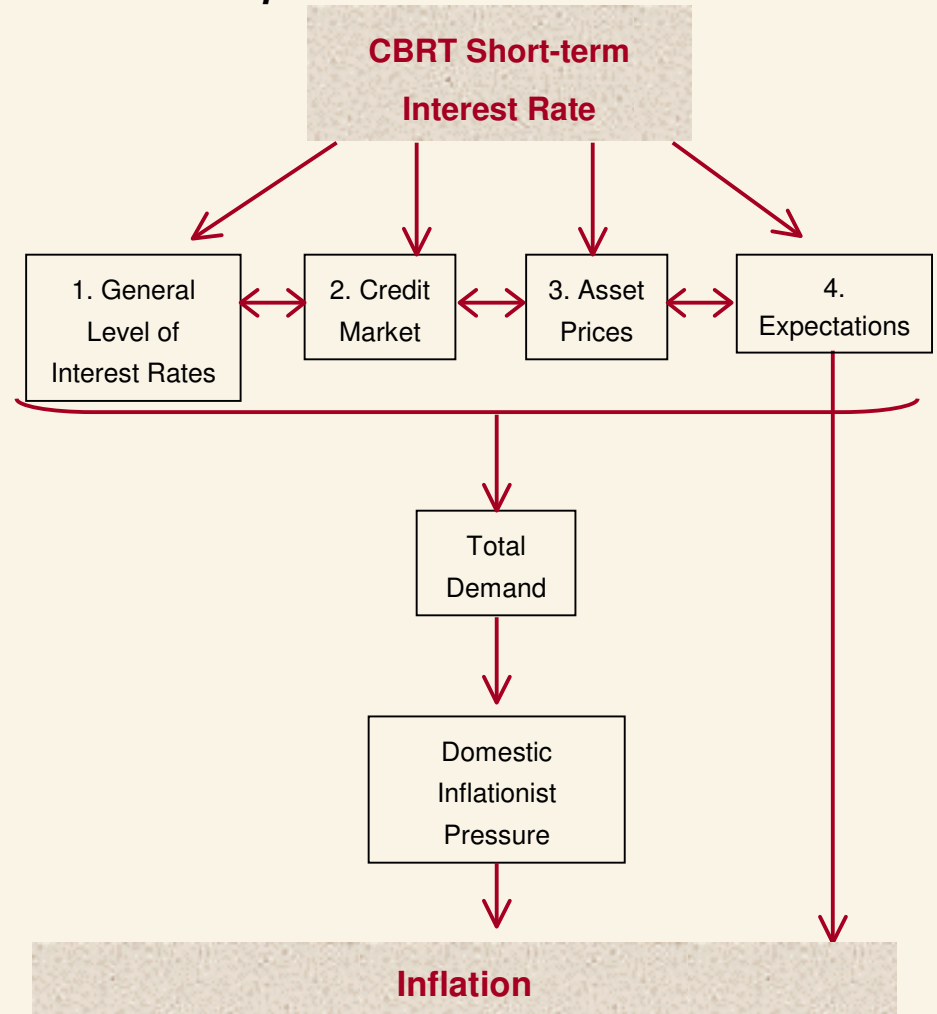
## **“Interest Rate and Exchange Rate Policies, Markets”**



# Interest Rate and Exchange Rate Policies, Markets

- ✓ Our main policy instrument is “short-term interest rates”.
- ✓ The basis for short-term interest rates is the signal effect.
- ✓ It is intended to control total demand via transmission mechanism and to attain inflation targets by steering expectations with the signal effect.
- ✓ This effect will surface with a time lag.
- ✓ In general, the structural characteristics of the economy, effectiveness of financial markets and uncertainty areas determine the strength of this impact.

## *A Simplified Transmission Mechanism*

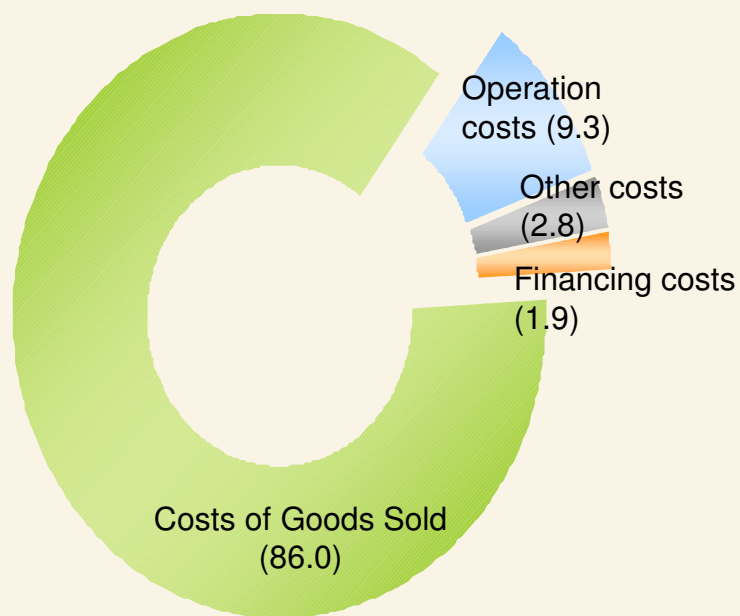




# Interest Rate and Exchange Rate Policies, Markets

- ✓ The impact of interest rates on pricing behavior via cost channel is rather limited.
- ✓ The ratio of financing expenses of firms in manufacturing industry to their total costs is 1.9 percent.
- ✓ The ratio of financing expenses to net sales continuously fell in the 2001-2005 period, dropping from 16.4 percent to 1.8 percent.

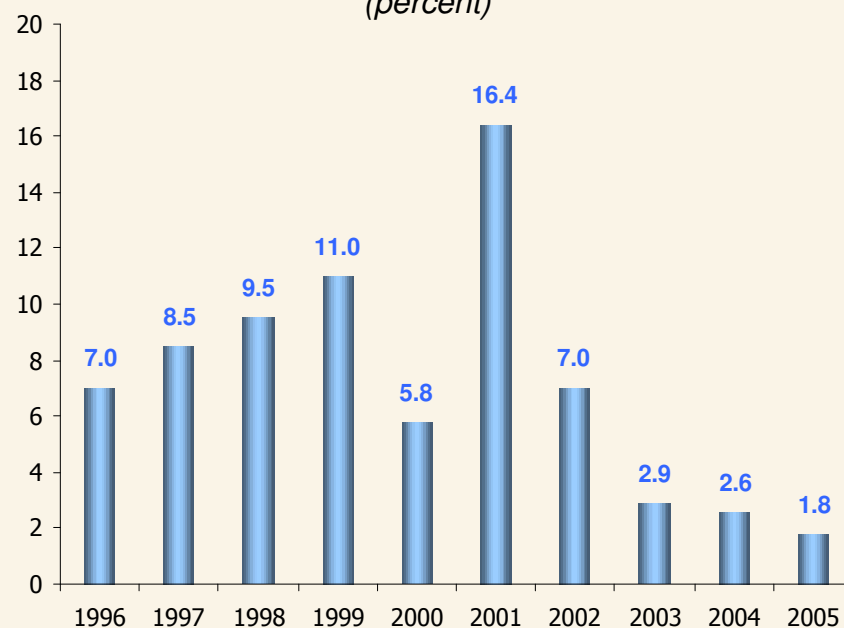
**Breakdown of Total Costs of Firms in Manufacturing Industry (2005, percent)**



\* Costs of goods sold= costs of domestic and imported raw material and other material, electricity-natural gas-water expenses, labor costs

Source: CBRT, Sectoral Balance Sheets 2004-2006

**Ratio of Financing Expenses of Firms in Manufacturing Industry to Total Net Sales (percent)**



Source: CBRT, Sectoral Balance Sheets



# Interest Rate and Exchange Rate Policies, Markets

## Monetary Policy Committee Interest rate Decisions

(January 2006 – October 2007)

Meeting Date	Policy Rates
23 January 2006	13.50
23 February 2006	13.50
23 March 2006	13.50
27 April 2006	13.25
25 May 2006	13.25
07 June 2006	15.00
20 June 2006	15.00
25 June 2006	17.25
20 July 2006	17.50
24 August 2006	17.50
26 September 2006	17.50
19 October 2006	17.50
23 November 2006	17.50
21 December 2006	17.50
16 January 2007	17.50
15 February 2007	17.50
15 March 2007	17.50
18 April 2007	17.50
14 May 2007	17.50
14 June 2007	17.50
12 July 2007	17.50
14 August 2007	17.50
13 September 2007	17.25
16 October 2007	16.75

- ✓ Monetary Policy Committee (MPC) makes decisions with the sole aim of achieving inflation targets and keeping inflation within the path consistent with the target.
- ✓ For the first time after 14 months, short-term interest rates were cut by 25 basis points in the MPC meeting dated September 13, 2007.
- ✓ Interest rates were cut by 50 basis points at the MPC meeting of 16 October 2007.

Source: CBRT





## Interest Rate and Exchange Rate Policies, Markets

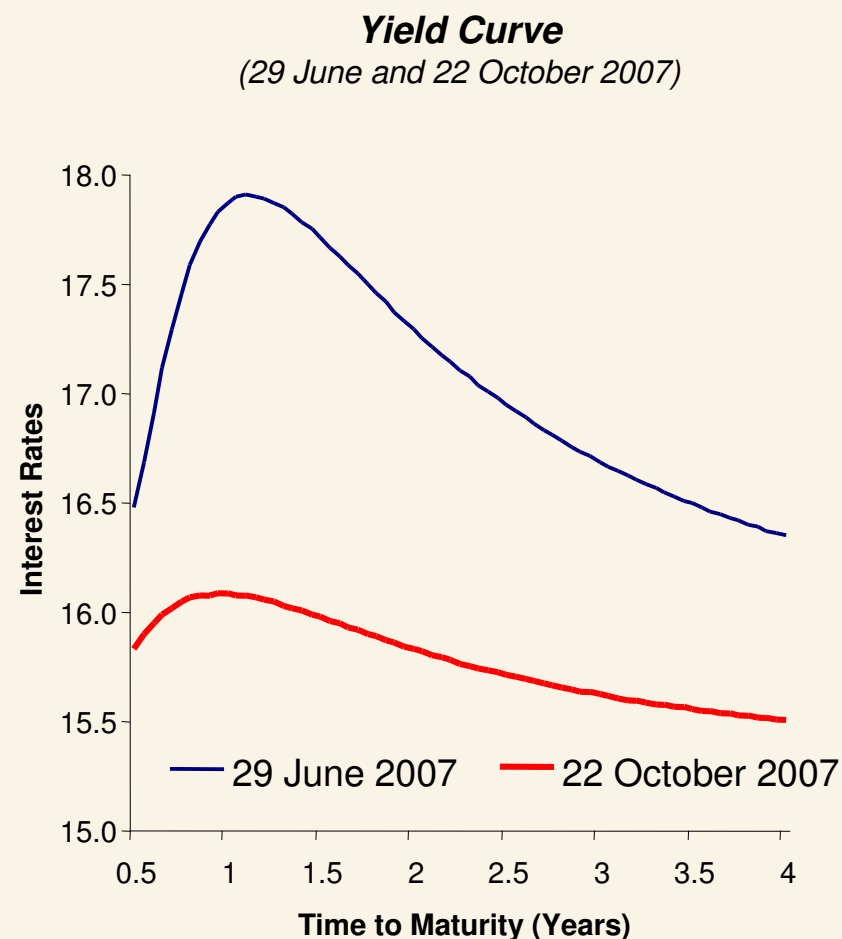
✓ At its meeting of 13 September 2007, the Committee decided that the conditions were ready for initiating the cautious rate cuts. The factors that encouraged the Committee to make this decision were:

- Favorable developments in inflation (especially in services inflation),
- The projection for a moderate recovery in domestic demand,
- The decelerating effect of international developments on domestic and foreign demand,
- At its meeting of 16 October 2007, the Committee assessed that the level of short-term interest rates continued to contribute to the disinflation process and under the current policy stance envisaging a cautious rate cut cycle, the possibility of inflation realizing close to medium term target is high.



# Interest Rate and Exchange Rate Policies, Markets

- ✓ The earlier-than-expected rate cut decisions of the Monetary Policy Committee have accelerated the downward trend in medium and long-term interest rates.
- ✓ The yield curve on 22 October 2007 remained below that of June 29, 2007 in all maturities.
- ✓ This demonstrates that rate cut decisions have had a positive impact on expectations.
- ✓ Meanwhile, the negatively sloped yield curves after 12 months of maturity affirms that economic agents still expect that the decline in inflation will continue in the medium-term.



Source: CBRT

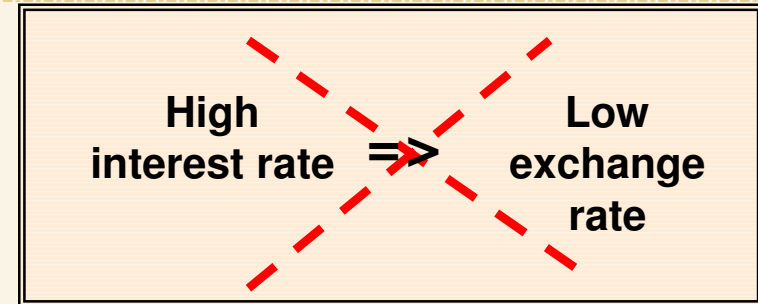


# Interest Rate and Exchange Rate Policies, Markets

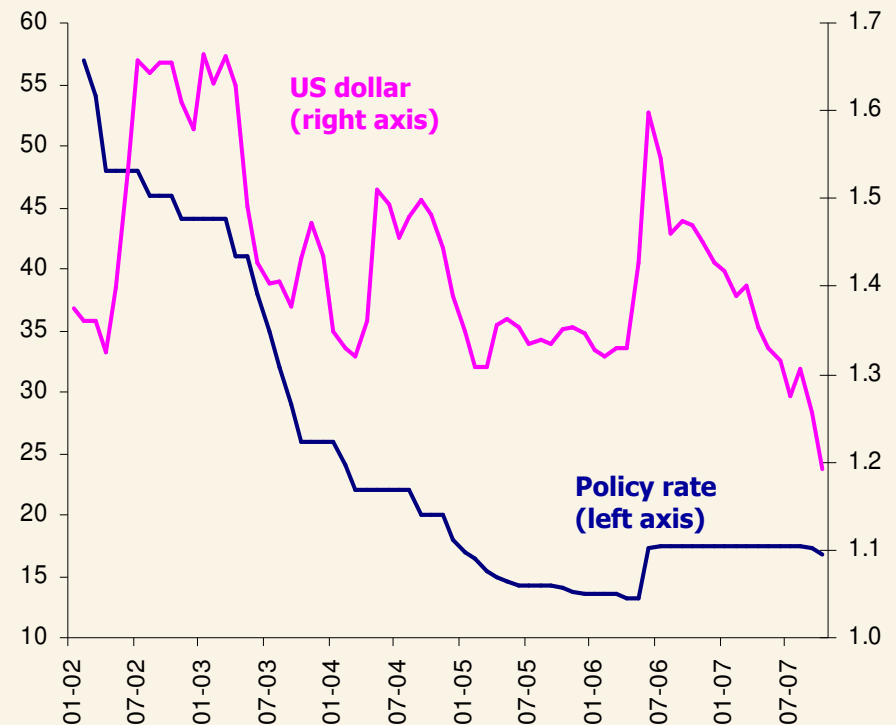
## Floating Exchange Rate Regime



- ✓ Floating exchange rate regime is one of the the main pillars of inflation targeting regime.
- ✓ Exchange rate is an endogenous variable.
- ✓ The level of exchange rates are determined under market conditions and reflect all economic and political policy implementations as well as expectations.
- ✓ The value of the currency is not an objective, but a consequence.
- ✓ **We have no intention to implement a “high interest rate, low exchange rate” policy.**
- ✓ The policy implemented is the interest rate policy required for low inflation.



**Policy Rate** (percent)  
**and Exchange Rate** (TRY/USD, monthly average)

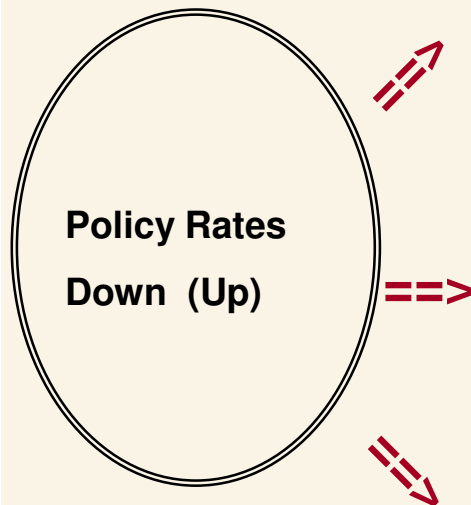


Source: CBRT



# Interest Rate and Exchange Rate Policies, Markets

There is a multidimensional and complicated relationship between Central Bank policy rates and the exchange rates.



1. Yield of the Turkish currency-denominated assets decreases (increases).  
Demand for foreign exchange increases (decreases).

**Depreciation (appreciation)** pressure emerges on the Turkish currency.

2. A positive (negative) signal is emitted relating to general outlook.  
Confidence increases (decreases). Reverse currency substitution becomes stronger (weaker).

**Appreciation (depreciation)** pressure emerges on the Turkish currency.

3. Exchange rates can move independently from economic fundamentals and policy rates: foreign exchange liquidity, investor behavior, expectations

Which of these three relationships will prevail to what extent is determined by the immediate conjuncture.



# Interest Rate and Exchange Rate Policies, Markets

✓ The Central Bank has two main goals in its operations at the foreign exchange markets.

1. Foreign exchange buying auctions with the aim of building up reserves

- Maximum daily auction amount to be purchased in daily auctions to be held as of October 9, 2007 has been increased to USD 30 million of which as auction amount and USD 60 million as optional selling amount.

2. Foreign exchange interventions to prevent excessive volatility

✓ Central Bank is a net buyer at foreign exchange market.

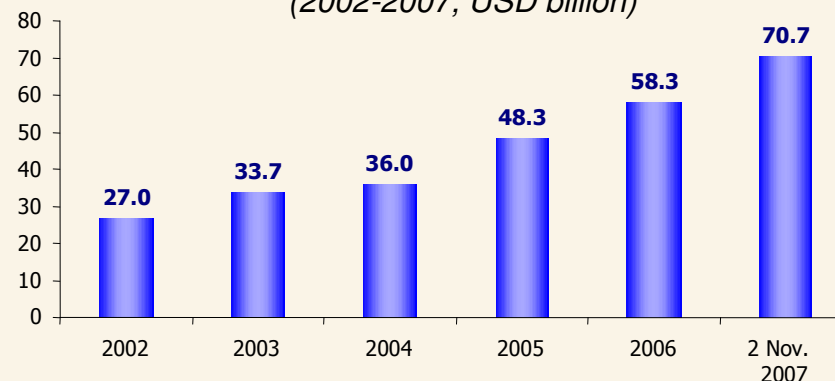
- Total foreign exchange bought between April 2002 – November 9, 2007: USD 53 billion.

- Foreign exchange reserves as of November 2, 2007: USD 70.7 billion.

✓ Moreover, with the aim of enhancing liquidity management, the Central Bank;

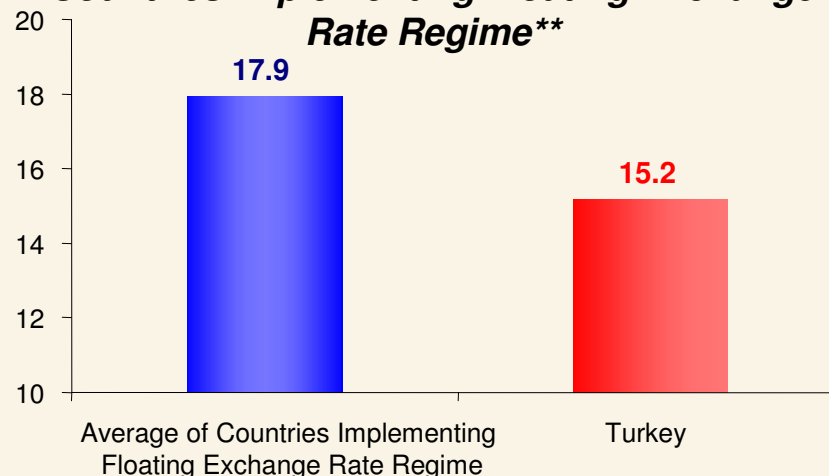
- issued liquidity bills on 19 July, 23 August and 17 October 2007 with maturities of 32, 40, and 30 days, respectively.

**Central Bank FX Reserves**  
(2002-2007, USD billion)



Source: CBRT

**Ratio of FX Reserves to GDP\* in 2006 in Countries implementing Floating Exchange Rate Regime\*\***



\* IMF Forecast

\*\*Countries included in the calculation: Brazil, Czech Republic, Russia, Thailand, Croatia, South Africa, Argentina, Philippines, Korea, Peru, Indonesia, Chile, Poland, Mexico, Colombia

Source: CBRT, IMF World Economic Outlook October 2007, ISF

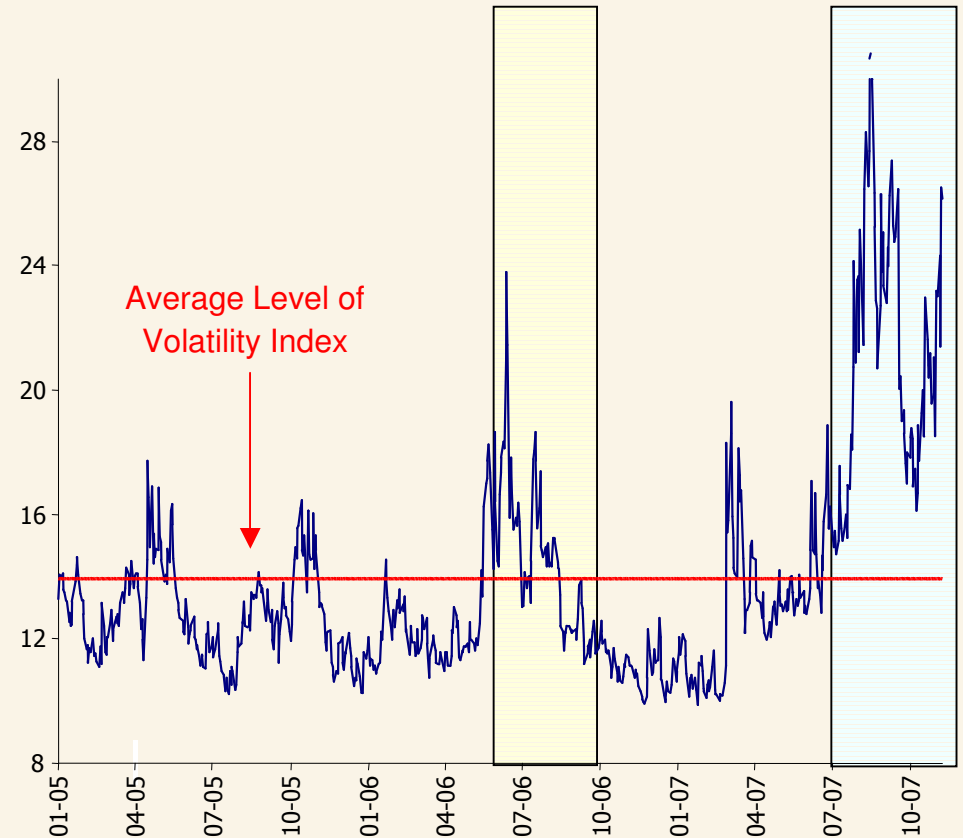


# Interest Rate and Exchange Rate Policies, Markets

## International Developments

- ✓ Some abrupt and rapid movements are observed in international markets.
  - The global financial turbulence, which emerged in late-July 2007 due to concerns over the “subprime mortgage” market in the USA , has not yet subsided.
  - The uncertainties forced international banks to shift their focus on default risk and become reluctant to lend, which caused liquidity squeeze especially in European banks.

**Volatility Index\***  
(3 January 2005 – 8 November 2007)



\* VIX measures the market's expectation of volatility as reflected in the options prices of S&P 500 stock index by using interpolation method.

Source: Bloomberg

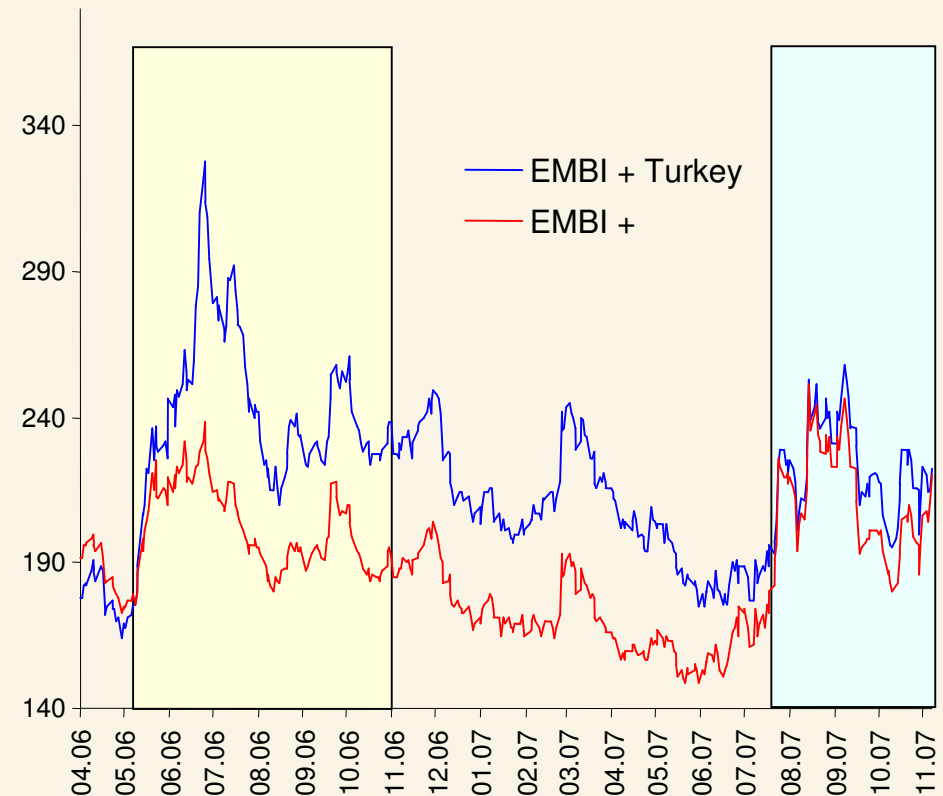


# Interest Rate and Exchange Rate Policies, Markets

- ✓ The recent volatilities have significant differences from the turbulence experienced in 2006.
- ✓ Risk premiums of developing countries initially increased due to investors' risk-averse attitude. However, since the “subprime mortgage” markets are not fully developed in these countries, they have not suffered as much as developed countries.

## **Risk Indicators**

(2 January 2007 – 8 November 2007, basis point)



Source: JP Morgan



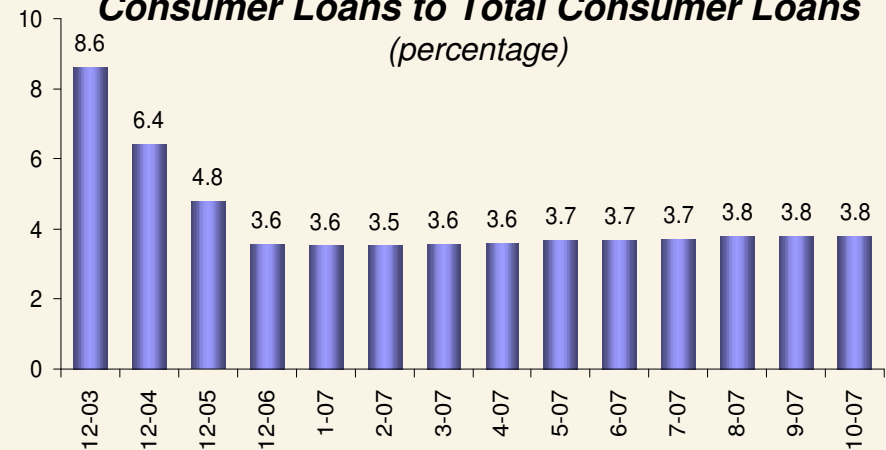


# Interest Rate and Exchange Rate Policies, Markets

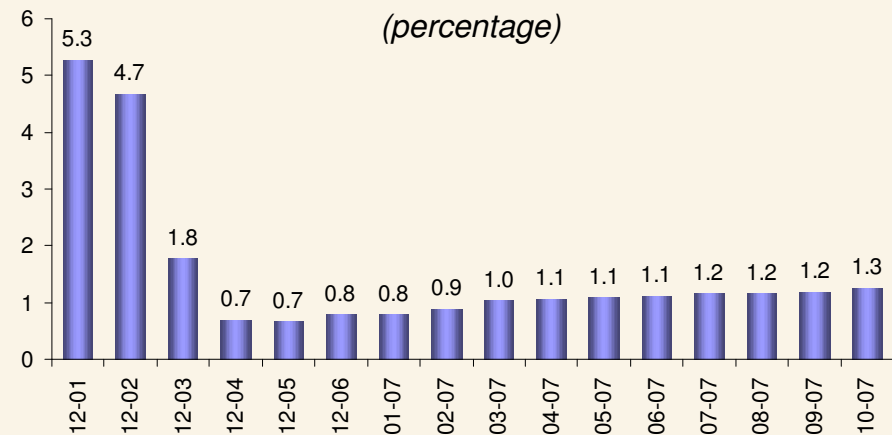
✓ Turkey is not exposed to unfavorable effects of international developments, either on the asset or liability side.

- Turkey does not have the practice of variable-rate loan.
- Foreign exchange denominated consumer loan is not allowed by the legislation.
- Non-performing loans constitute 1.3 % of consumer loans.

**Ratio of Foreign Exchange Indexed Consumer Loans to Total Consumer Loans**  
(percentage)



**Ratio of Non-performing Consumer Loans to Total Consumer Loans**  
(percentage)



Source: CBRT



# Interest Rate and Exchange Rate Policies, Markets

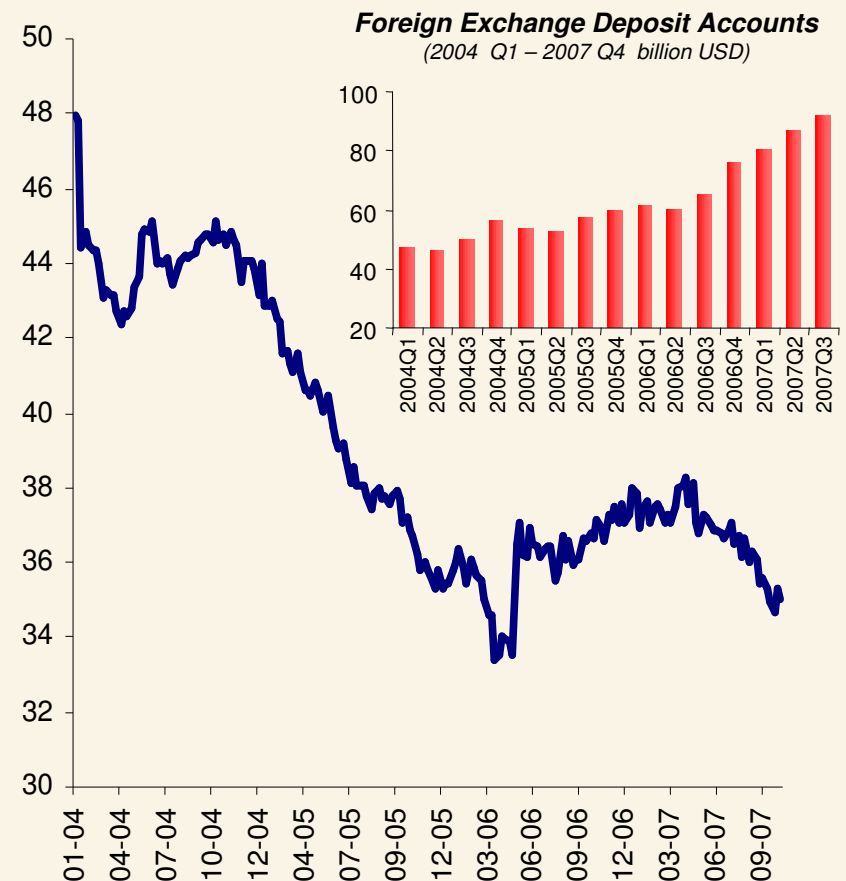
✓ Despite the recent progress, high dollarization makes the effects of turbulences on daily life more pronounced.

- According to dollarization indicators, foreign exchange deposit accounts of the residents increased following the fluctuation in May - June 2006, whereas the accounts decreased during the fluctuation in July 2007.

✓ Foreign exchange deposit accounts display a decreasing trend at the times of appreciation of the Turkish currency.

## Share of Foreign Exchange Deposit Accounts in Total Deposits

(2 January 2004 – 26 October 2007, weekly, percentage)



Source: CBRT



# Interest Rate and Exchange Rate Policies, Markets

✓ The main tendency in foreign exchange markets has always been to re-establish the stability so far.

- Due to stronger macroeconomic fundamentals, the intensity and duration of fluctuations have been diminishing.

✓ Nevertheless, the costs of fluctuations are high.

- Adoption of modern risk culture and utilization of risk management tools will reduce the cost of fluctuations.

- The progress in risk management principles in real sector as well as in financial sector assumes crucial importance with respect to easing the impact of fluctuations on the economy.

## *RAPID CHANGES IN EXCHANGE RATES\**

Beginning date	Duration of fluctuation (day)	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
26.02.2007	9	1.3826	1.4568	5.4
25.07.2007	26	1.2421	1.3947	12.3

\* USD selling rate announced by the CBRT

Source: CBRT



# Interest Rate and Exchange Rate Policies, Markets

- ✓ As of today, a sharp slowdown in global economic growth is not perceived as the most likely scenario, leading to continued capital flows to emerging markets.
- ✓ However, that the risks in the financial markets have not yet been adequately priced necessitates caution.
- ✓ In sum, fluctuations in external markets are expected to restrain both domestic and external demand in the Turkish economy.

## 1. Slowdown in global economy



Will limit growth in external demand.

## 2. Challenges in credit markets



Will moderate the pick-up in domestic demand due to a deceleration in domestic loans financed via foreign credits.



# **Economic Outlook**

## **“Growth and Employment”**



# Growth

- ✓ Growth rate, which was 6.8 % in the first quarter of 2007, declined to 3.9 % in the third quarter, while the growth in the first six months stood at 5.2 %
- ✓ Analyzing the second quarter growth rates of 2007 from the supply side;
  - Trade and industrial growth displays a relative slowdown, whereas the rapid growth in construction sector continues.

## Quarterly Growth

(Percentage change in comparison to the same period of the previous year)

	2007 Q1	2007 Q2	2007, first 6 months	2006, first 6 months
GNP	6.8	3.9	5.2	7.9
GDP	6.9	3.9	5.3	7.5

## Production Sub-items (Percentage change in comparison to the same period of the previous year)

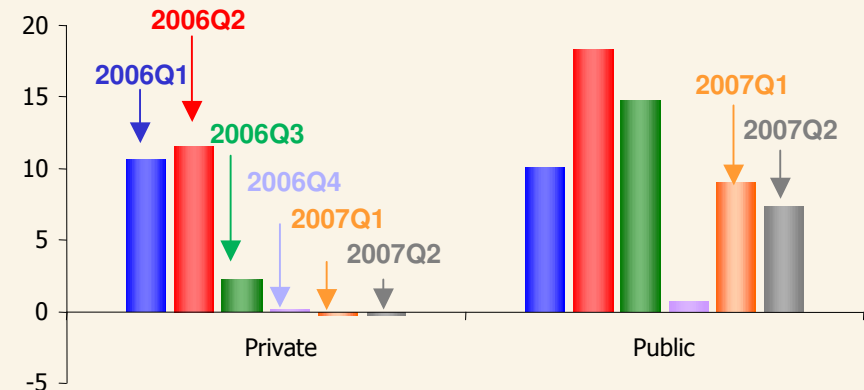
	2007 Q1	2007 Q2	2007 6 Months	2006 6 Months
Agriculture	4.4	-1.1	0.9	2.3
Industry	7.5	3.2	5.2	8.0
Construction	16.5	15.7	16.1	20.2
Trade	6.8	3.0	4.6	7.6
Transportation - Communication	5.5	4.7	5.1	4.6
Financial Institutions	8.6	6.2	7.3	0.2
Import Tax	9.8	8.6	9.2	14.8



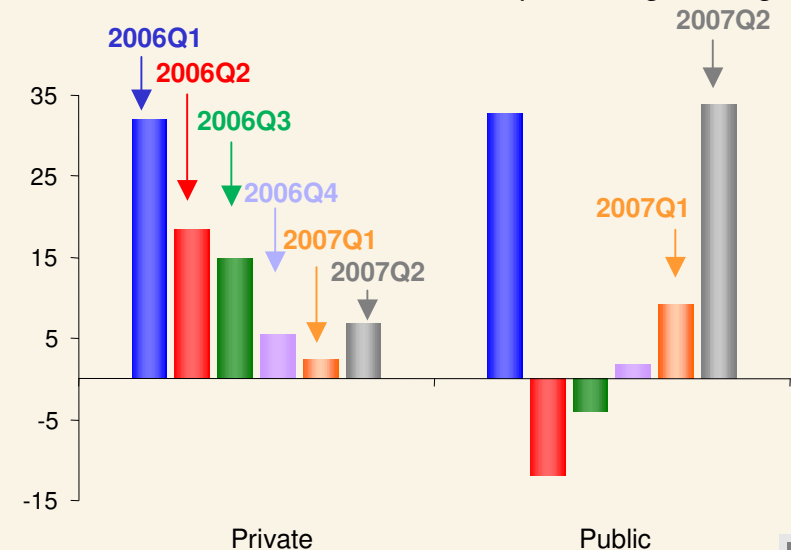
# Growth

- ✓ Analyzing the second quarter growth rates of 2007 from the demand side;
  - High growth rates in private consumption expenditures was replaced by a decline chiefly in consumer durables due to monetary tightening.
  - Public consumption expenditures rose significantly.
  - Public and private investment expenditures displayed sharp increases owing to the contribution of construction sector.
- ✓ Private sector-driven growth continues.
- ✓ Investments expanding the potential growth rate of the economy should come into foreground as well as the quality of public expenditures.

**Real Consumption Expenditures**  
(2006 Q1 – 2007 Q2, annual percentage change)



**Real Investment Expenditures**  
(2006 Q1 – 2007 Q2, annual percentage change)



Source: TURKSTAT

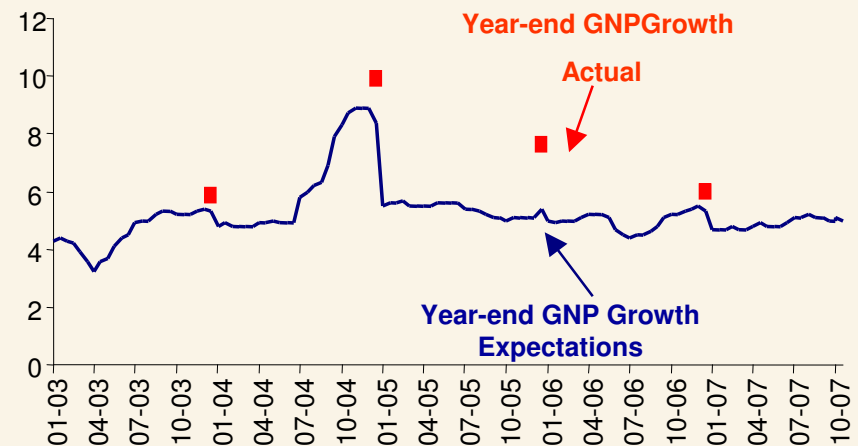




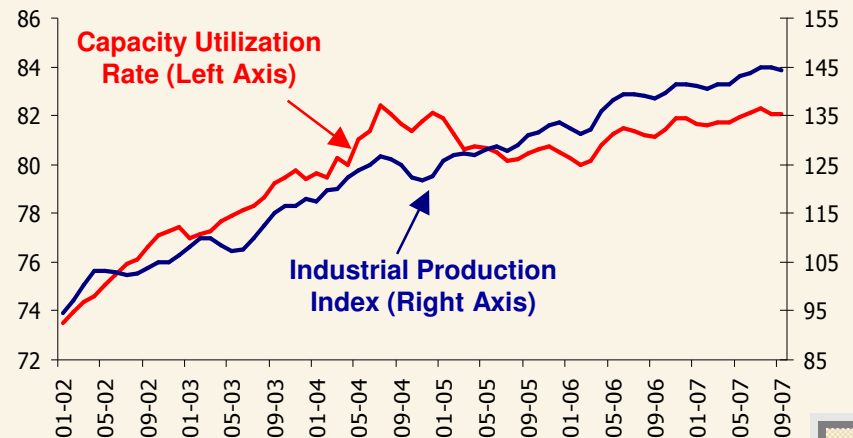
# Growth - Outlook

- ✓ Growth projection for 2007 is 5 % according to the economic program.
- ✓ September industrial production and capacity utilization rates point to an ongoing modest growth in production activities.
- ✓ Growth rate in 2007 is projected to be consistent with the program projection.

**Year-end GNP Growth Expectations (appropriate average) and Actual Growth (real, annual percentage change)**



**Industrial Production Index (as of September 2007) and Capacity Utilization Rate (as of September 2007) (seasonally adjusted, quarterly moving average)**



Source: TURKSTAT, CBRT



# Employment

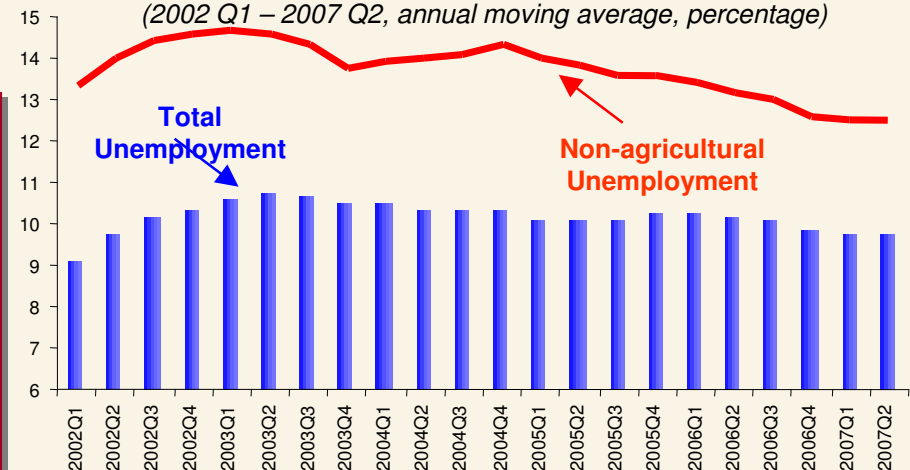
## Labor Market

As of July 2007;

- ✓ Unemployment remained unchanged at 8.8 % compared to same period of the last year.
- ✓ Non-agricultural unemployment stood at 11.6 % and declined by 0.1 points compared to same period of the last year.
- ✓ Non-agricultural employment increased by 540 thousand over the last year.
- ✓ Youth, urban and female unemployment rates, which were 18.6 %, 11.2 % and 9.5 %, respectively, are at high levels despite partial declines.
- ✓ Labor force participation rate is still low at 49.5 %.

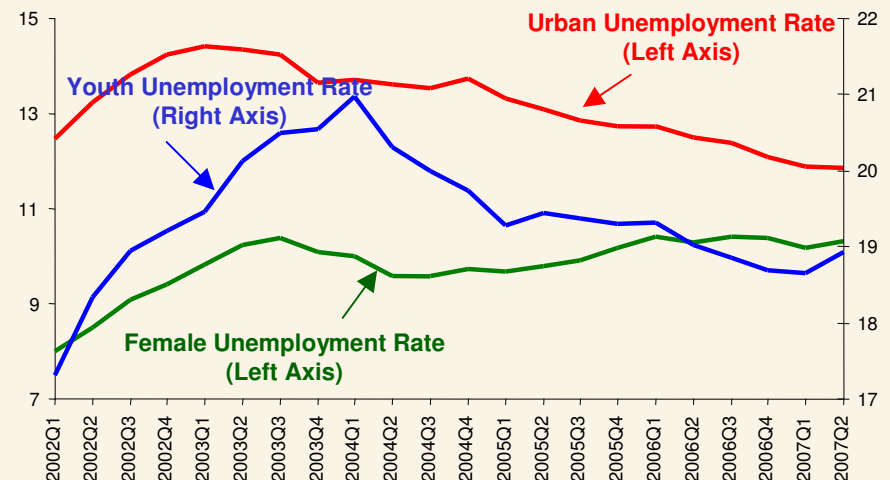
### Unemployment and Non-agricultural Unemployment Rates

(2002 Q1 – 2007 Q2, annual moving average, percentage)



### Youth, Female and Urban Unemployment Rates

(2002 1Q – 2007 2Q, annual moving average, percentage)



Source: TURKSTAT



# Employment

**Labor market is undergoing a structural transformation**

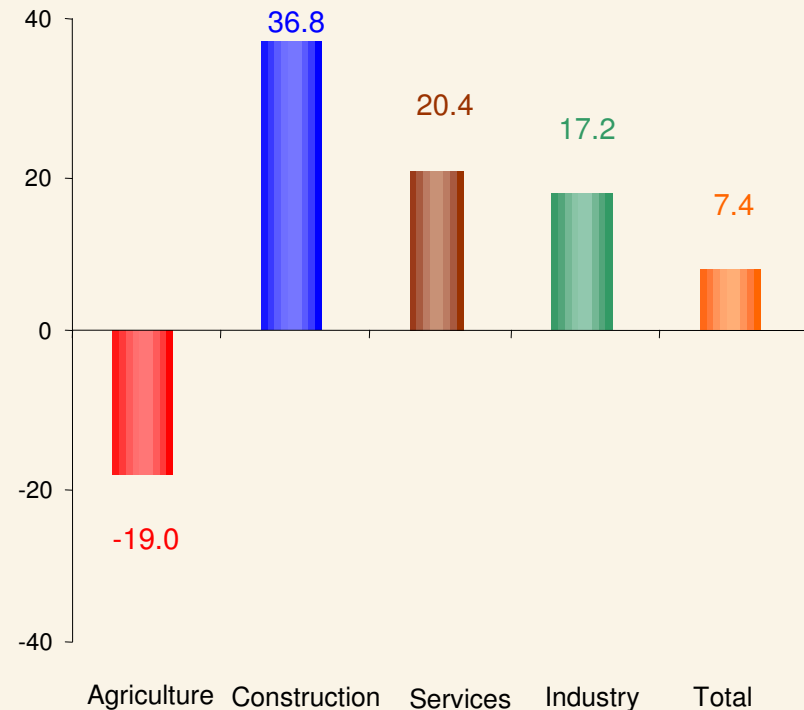


✓ There has been a rapid transition from the agricultural sector to the non-agricultural sectors since 2002.

- In the last four years, agricultural employment declined by 19 %.
- Employment in industrial sector rose by 17.2 %, resulting in a 9.3 % increase in the share of industrial sector in total employment.
- Services sector has the largest share in total employment. This sector has displayed the highest increase in employment since 2002.
- Though the share of construction sector remained subdued at 4.8 % as of July 2007, it displayed rapid increases during the periods of accelerated growth.

✓ This process is expected to continue.

**Employment by Economic Activity**  
(2003 Q2 – 2007 Q2, cumulative percentage change)



Source: TURKSTAT



# **Economic Outlook “Balance of Payments Developments”**

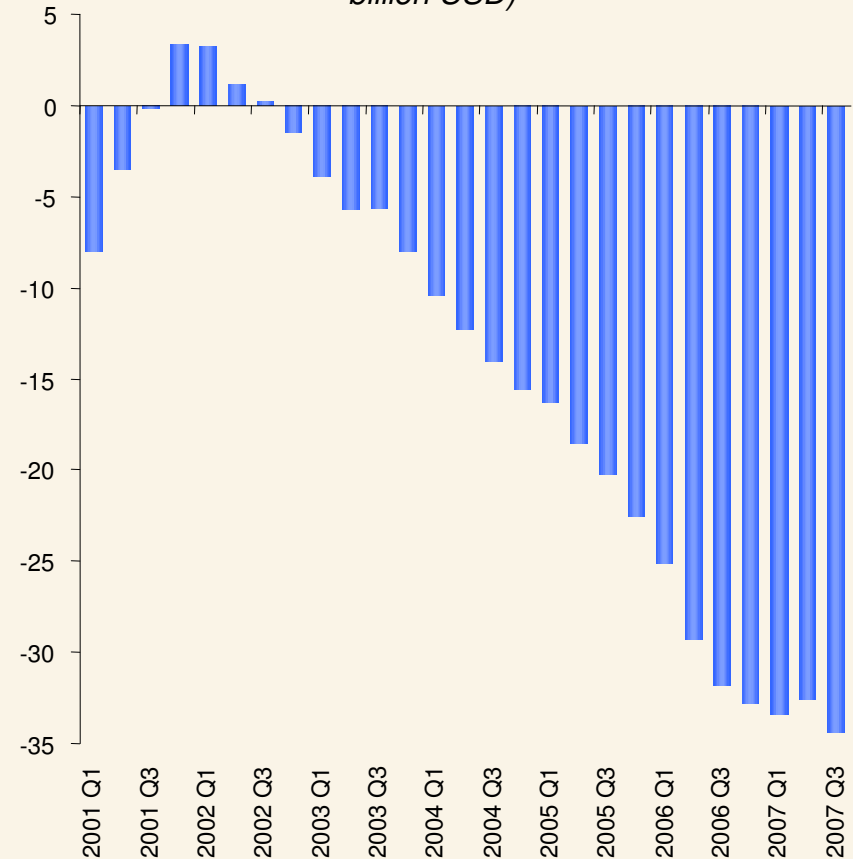


## Balance of Payments Developments – Current Account

**Current account deficit follows a stable course in 2007.**

- ✓ Throughout 2006, current account deficit displayed an upward trend compared to the previous year.
- ✓ The contribution of high energy prices to the current account deficit was 4.1 points in 2006.
- ✓ As of September 2007, the 12-month rolling current account deficit stood at USD 34.4 billion.

**Current Account Balance**  
(2001 Q1 – 2007 Q3, annualized,  
billion USD)



Source: TURKSTAT, CBRT



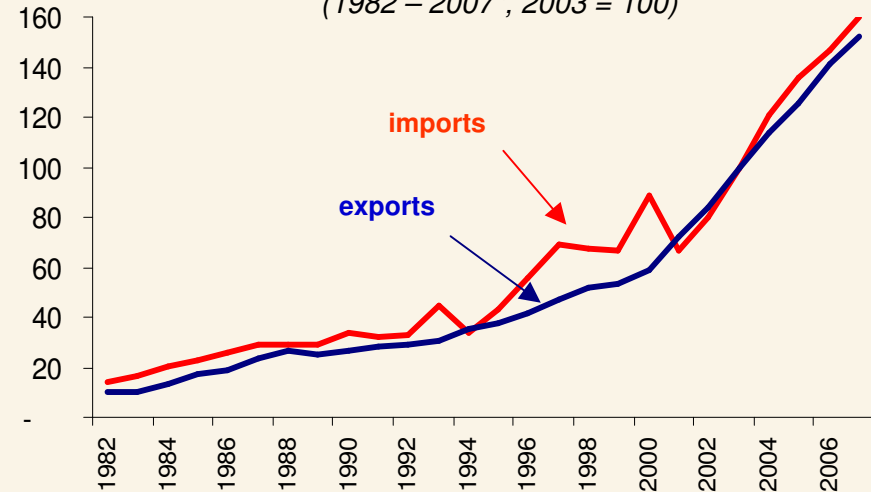
## Balance of Payments Developments – Foreign Trade

**The openness of the Turkish economy has increased since 2001 and foreign trade has posted high growth rates.**



- ✓ According to the quantity indices adjusted for exchange rate and price movements, exports and imports have expanded almost in parallel in recent years, contrary to the 1994-2000 period.
- ✓ Exports growth during the January-September 2007 period was 24.1 %.
- ✓ Annual growth rate of exports has outpaced that of imports since March 2007.

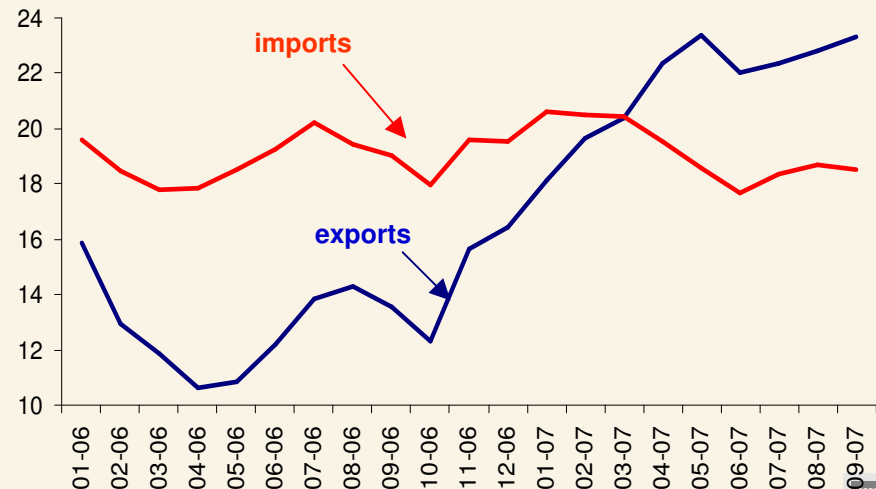
**Imports and Exports Quantity Indices**  
(1982 – 2007\*, 2003 = 100)



\* 2007 figures are average of January-September figures.

**Imports-Exports**

(January 2006 – September 2007, annual percentage change)



Source: TURKSTAT





## Balance of Payments Developments – Foreign Trade

**Worldwide favorable demand conditions in 2006 and 2007 are expected to continue, albeit at a slightly weaker rate.**



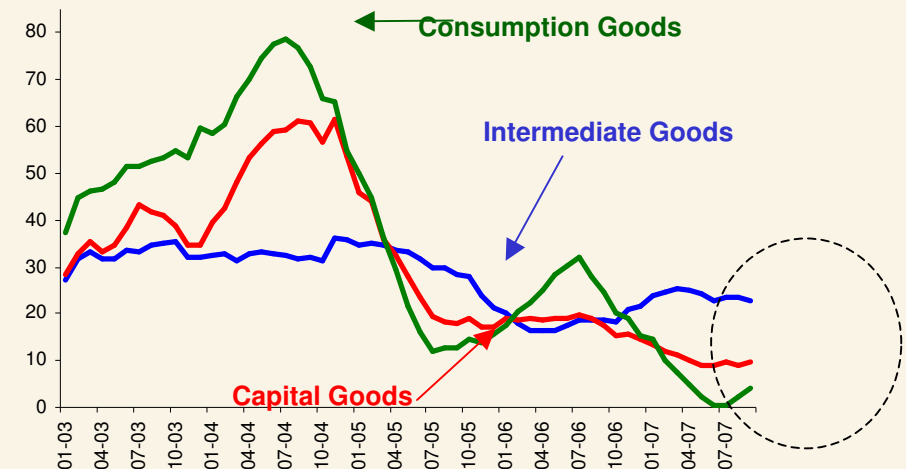
- ✓ The growth rate of imports, which had slowed down since mid-2006 in line with the weakening domestic demand, re-started to rise in July 2007.
- ✓ The largest contribution to overall import growth comes from intermediate goods.
- ✓ The growth rate of capital goods imports is below the growth rate of overall imports since May 2006.
- ✓ Imports of consumption goods have started to display a modest upward trend in September 2007.

*Growth Expectations Worldwide and Expectations in Principal Regions Where Turkey Exports (percentage)*

Regions	2006 (Actual)	2007 (Expectation)	2008 (Expectation)
World	5.4	5.2	4.8
USA	2.9	1.9	1.9
EU	2.8	2.5	2.1
Asia	9.8	9.8	8.8
Middle East	5.6	5.9	5.9

Source: IMF World Economic Outlook

*Imports Sub-items (January 2003 – September 2007, annualized, annual percentage change)*



Source: TURKSTAT

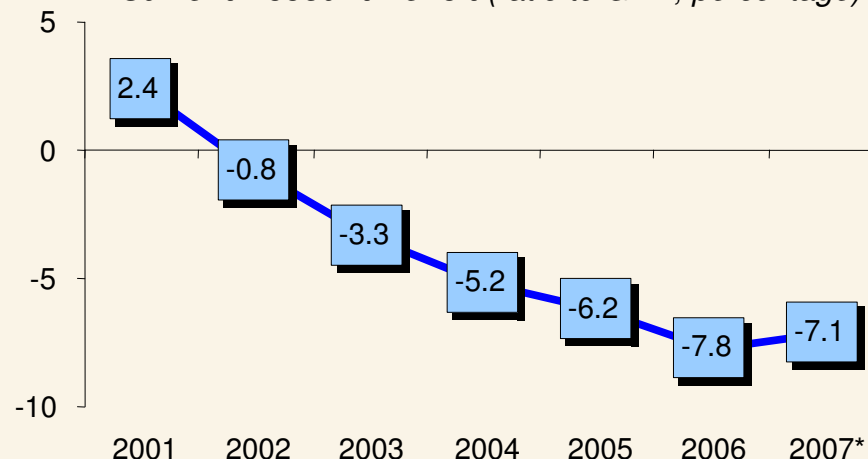




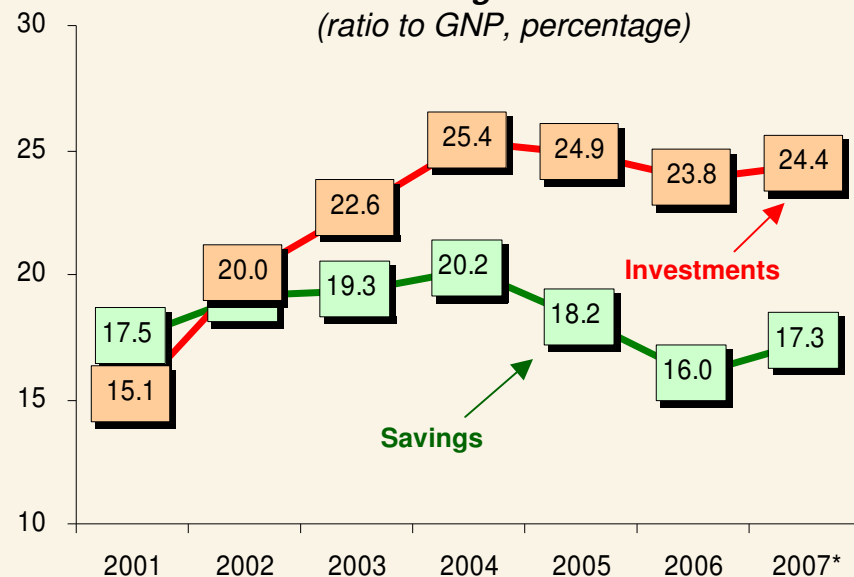
## Balance of Payments Developments – Current Account

- ✓ There is a direct and very strong relationship between current account deficit and growth rates.
- ✓ High investment increase is the primary motive of deficit.
- ✓ Current account deficit is a structural problem. The atmosphere of stability and falling interest rates lead to an increase in consumption and investment demand. Hence, the structural characteristics of economy necessitate mainly the imports of intermediate goods in order to meet increasing aggregate demand.
- ✓ A transformation in the structure of the current account deficit is essential to reduce fragility and risk perception.
- ✓ Current account deficit should be controlled via supply-oriented macro and micro policies with a medium and long-term perspective.

**Current Account Deficit** (ratio to GNP, percentage)



**Domestic Savings and Investments**  
(ratio to GNP, percentage)



\* Estimation

Source: State Planning Organization 2008 Annual Program, CBRT

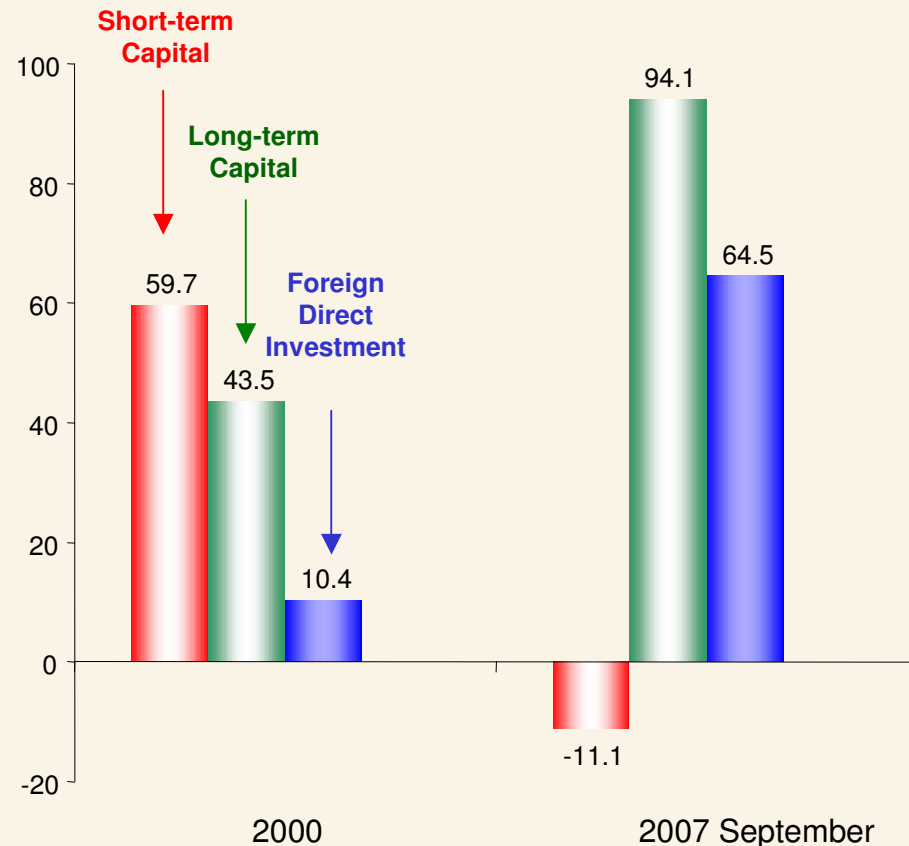


## Balance of Payments Developments – Capital Movements

- ✓ Long-term credits and capital inflows, along with foreign direct investment, assume vital importance with respect to the quality of financing in Turkey's current account deficit and diminish its fragility.
- ✓ Short-term capital inflow (net short-term foreign credits by banks, real and public sectors and deposits of non-residents) has been negative over the last 12 months.

### Ratio of Current Account Deficit Financing Items to the Current Account Deficit

(2000 – September 2007, 12 month-cumulative, percentage)



Source: CBRT



## Balance of Payments Developments – Capital Movements

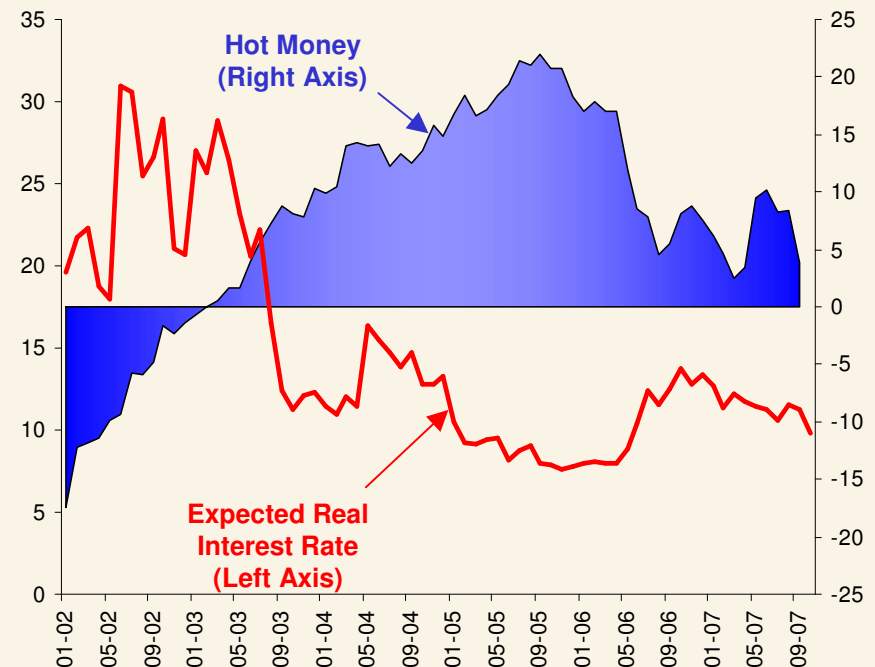
**The share of hot money in current account deficit financing is diminishing.**

- ✓ The fundamental determinant is the developments in expectations rather than the high level of real interest rates.
- ✓ Improvement in expectations accelerates fund inflows despite the fall in real interest rates, whereas deterioration in expectations fails to prevent fund outflows despite very high real interest rates.
- ✓ The extension of maturities in government securities market, the fact that the stock purchases are made not only for the purpose of capital gains, but also for company partnership, floating exchange rate regime and strengthened structure of financial markets restrain negative impacts of this item in the event of capital outflows.

**Ratio of Hot Money to Current Account Deficit**  
(annual cumulative, percentage)

2002	2003	2004	2005	2006	2007- Sept.
90.1	127.6	95.1	81.1	22.9	11.4

**Hot Money** (January 2002 – September 2007, 12 months cumulative, billion US dollars) **and the Expected Real Interest Rate** (January 2002- October 2007, percentage)



\* Hot money is composed of purchase of government securities and stocks, bank deposits of the residents abroad, short-term credits issued by banking sector to abroad, short-term foreign debt received by the banking and private sector and net errors and omissions.

Source: CBRT



## Balance of Payments Developments – Capital Movements

### Foreign Direct Investments



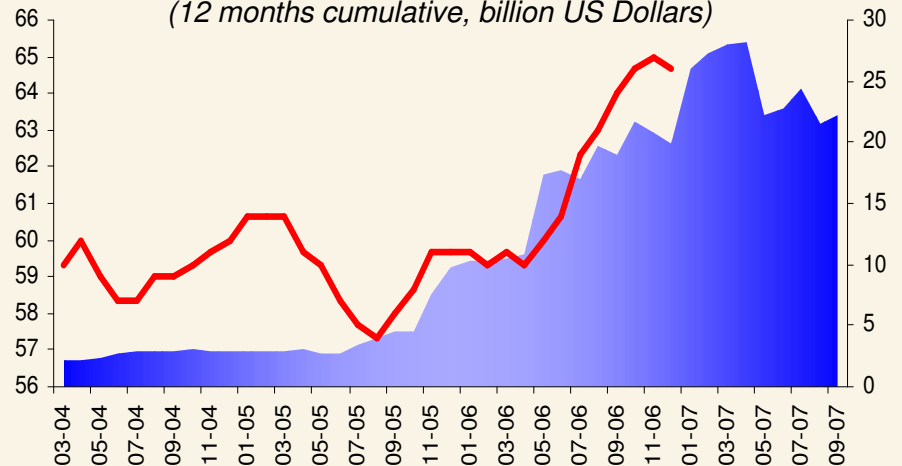
- ✓ Net inflows as of September 2007;
  - USD 19.8 billion in the last 12 months.
  - One of the items with the biggest share in financing the current account deficit in 2007.
  - According to 2006 figures, Turkey ranks 5<sup>th</sup> place on foreign direct investment among developing countries .
- ✓ Stability is the main determinant of foreign direct investments.
- ✓ It is of crucial importance with respect to the sustainability of the current account deficit.

### Foreign Direct Investments (2006, billion US Dollar)

China	69.5
Hong Kong	42.9
Russia	28.7
Singapore	24.2
<b>Turkey</b>	<b>20.1</b>
Mexico	19.0
Brasil	18.8
India	16.9
Romania	11.4
Chile	7.9

Source: UNCTAD

### Deutsche Bank Eurasia Group Stability Index (DESIX) (Quarterly averages) and Foreign Direct Investment Inflows (12 months cumulative, billion US Dollars)



Source: Deutsche Bank and Eurasia Group. The index is composed of twenty variables in four categories with equal weights (government, society, security and economy). Index values vary from 0 to 100, 100 represents the highest level of stability.



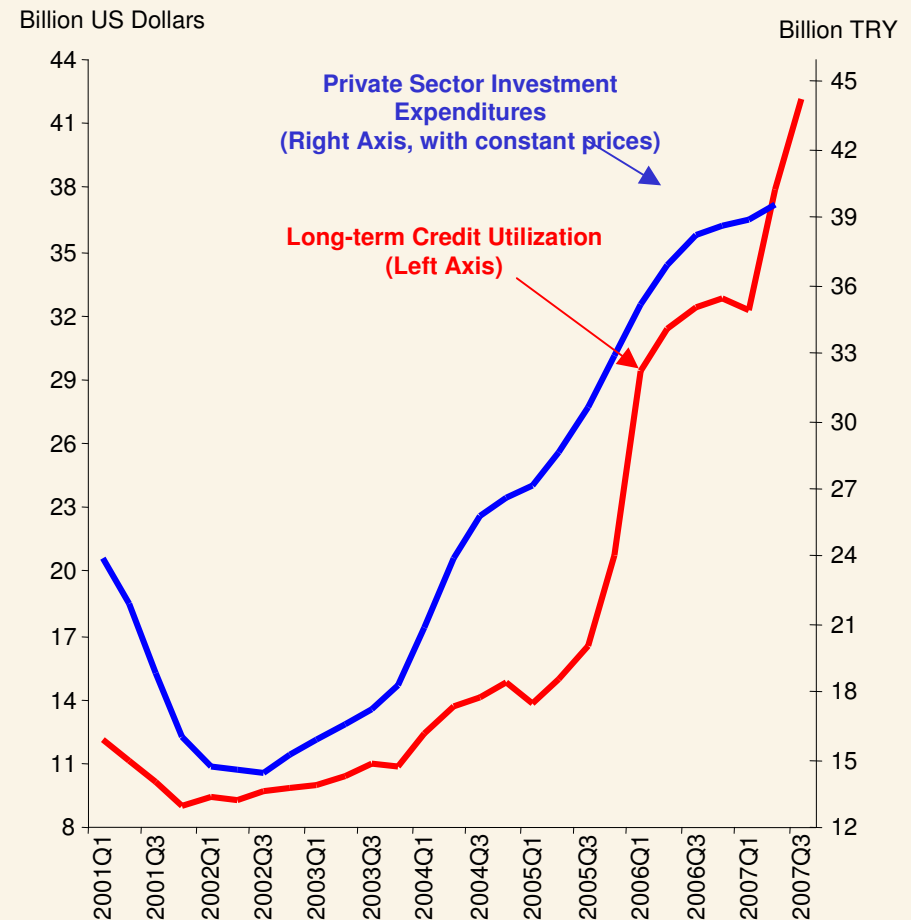
## Balance of Payments Developments – Capital Movements

**Long-term credit inflow remains strong.**



- ✓ As of September 2007;
  - Annual cumulative net inflow is USD 33.8 billion.
  - Banking sector; USD 11.6 billion
  - Private sector; USD 22.6 billion.
- ✓ Rapid increase in private sector investments plays a determining role.
- ✓ Long-term credits and capital inflows are other factors that improve the quality of finance of current account deficit and ease its fragility.

### **Long-term Credit Utilization of Non-banking Private Sector (2001 Q1 – 2007 Q3) and Private Sector Investment Expenditures (2001 Q1 – 2007 Q2, annualized)**



Source: CBRT, TURKSTAT



# **CENTRAL BANK OF THE REPUBLIC OF TURKEY**

## **PRESENTATION BEFORE THE COUNCIL OF MINISTERS**

**Durmuş YILMAZ**  
Governor

**12 November 2007**