74th SHAREHOLDERS' ORDINARY GENERAL MEETING OF THE CENTRAL BANK OF THE REPUBLIC OF TURKEY

OPENING SPEECH

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CENTRAL BANK OF THE REPUBLIC OF TURKEY
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1. Esteemed Shareholders, Distinguished Guests and Dear Members of the Press; Welcome to the 74th Shareholders' Ordinary General Meeting of the Central Bank of the Republic of Turkey.

2. I would like to begin my speech by giving a brief evaluation of the Turkish economy and assessing what we have achieved so far in the fight against inflation. This assessment will be composed of two parts; implicit inflation targeting and formal inflation targeting.

I- THE PERIOD OF IMPLICIT INFLATION TARGETING –

A GENERAL ASSESSMENT

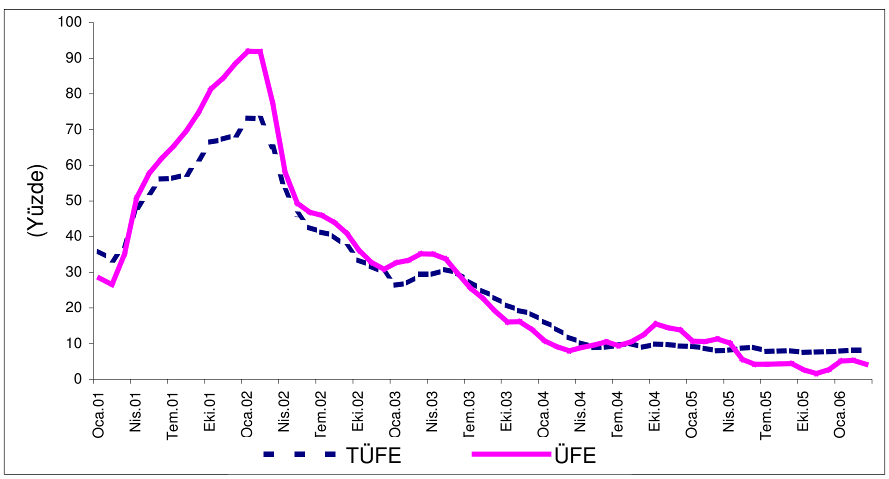
The fight against inflation has been successful

3. As you all know, Turkey had suffered from a problem of high and chronic inflation for some thirty years. This long period of chronic inflation took its toll on Turkey's economic and social life. However, with the effective implementation of the economic program – launched in the aftermath of the deep economic crisis of 2001 – based on the pillars of fiscal discipline and determined monetary policies, the period of chronic inflation was able to come to an end, leading to a lasting and marked improvement in inflation dynamics.

4. When we look at the distance we have covered in the fight against inflation, we can see that consumer price inflation (CPI), which used to be above 70 percent in early2002, recorded single digit-figures throughout last year and declined to 7.7 percent by end2005. Thereby, the rate of inflation was realized below the year-end target of 8 percent.

5. The moderate demand in 2005 was instrumental in keeping the CPI below the inflation target. Other influential factors were the ongoing rise in labor productivity, the favorable course of cost factors such as the real exchange rate and unit wages, and the low level of the growth rate of agricultural prices. On the other hand, the increase in oil prices and the persistent rigidity in the services sector prices affected inflation adversely.

Graph 1: Inflation Developments

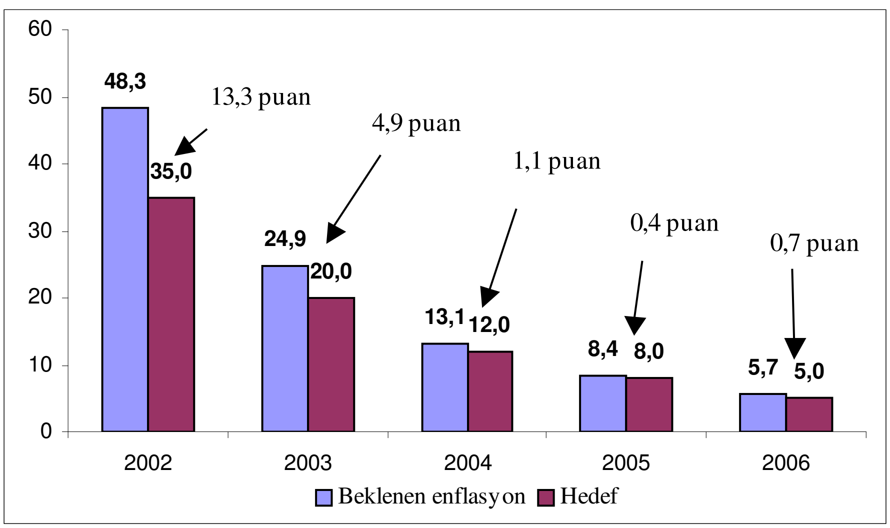


Note: Index with base year 2003 has been used from January 2005 onwards.
Source: TURKSTAT.

Distinguished Guests,

6. I would also like to draw your attention to the marked improvement in inflation expectations that occurred hand-in-hand with the disinflation process. The credibility gap, expressed as the difference between targeted inflation and inflation expectations, narrowed from 13.3 points in early2002, to 0.7 points in early2006. Results of the Expectations Survey conducted by the Central Bank reveal that, the year-end inflation expectation has been realized as 5.8 percent as of the first half of April 2006, and has come considerably closer to the formal inflation target of 5 percent for 2006.

Graph 2: Credibility Gap
(Expected and Targeted Rates of Inflation as of the Start of the Year)

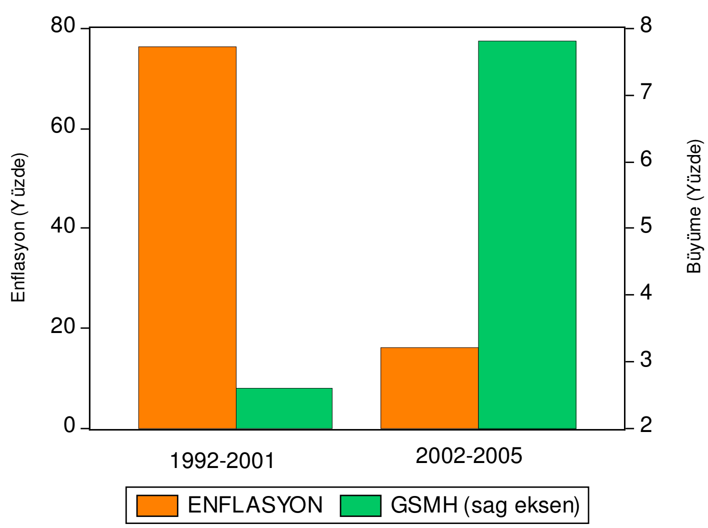


Source: TURKSTAT, CBRT.

High growth figures were attained

7. In this part of my speech, I would like to touch on certain issues related to Turkey's economic growth performance. As you all know, alongside falling inflation, Turkey has attained consecutive high rates of growth during the past four years. The real cumulative growth rate was realized as 35.1 percent for the period from 2002 up to the present date. The rate of growth was realized as 7.6 percent in 2005, basically due to the rising investment and consumption expenditures and a buoyant construction sector. Thereby, the 5 percent growth rate for 2005, which was set within the macroeconomic program, was exceeded as well. These results clearly demonstrate the extent of the damage inflicted on the Turkish economy by high and chronic inflation over the years.

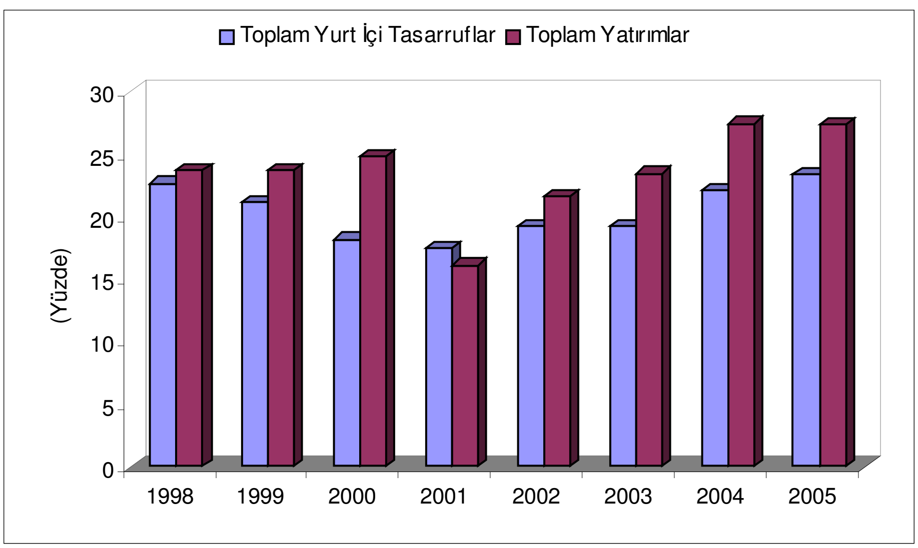
Graph 3: Rates of Growth and Inflation



Source: TURKSTAT, CBRT.

8. The decline in interest rates in recent years and the appreciation of the Turkish lira engineered capital-intensive quality of private sector production, thus leading to high-rated increases in productivity. On one hand, productivity increases raised capital yield and on the other encouraged investments. The public sector's tendency towards economic and social infrastructure activities and privatizations realized during recent periods also became key factors that enhanced the efficiency of the private sector in the economy. These favorable developments observed in the growth dynamics of the Turkish economy are raising the potential production level as well.

Graph 4: Investments and Savings
(Ratios to GNP)

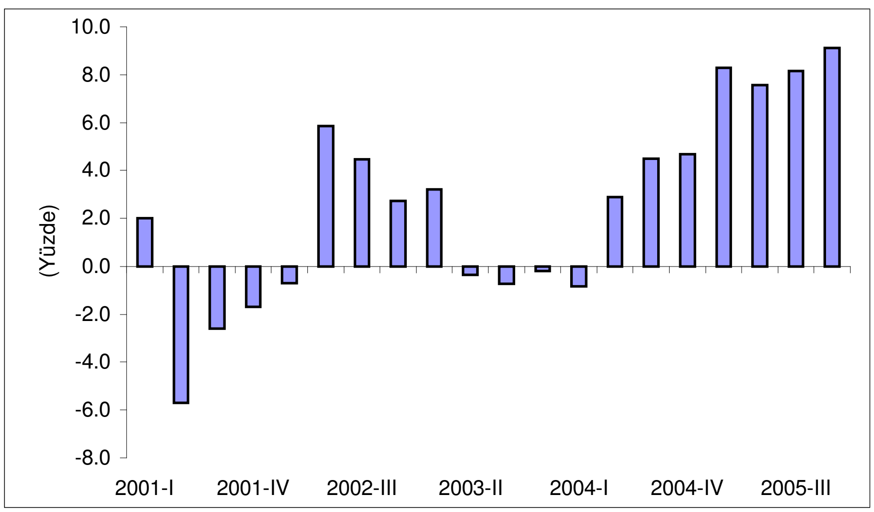


Source: SPO, CBRT.

Private sector employment is boosting

9. The impact of high growth performance observed in the last four years in Turkey is especially felt on non-agriculture employment. The constant accelerating increase in non-agriculture employment since the second quarter of 2004 points to a gradual increase, particularly in the employment-creating potential of the services sector.

Graph 5: Non-Agriculture Employment (Annual Percentage Increase)



Source: TURKSTAT.

10. Nevertheless, we have difficulties in reducing the unemployment rate below a certain level because of structural problems in the employment area. The process of demographic change in Turkey leads to an increase in the share of the working population in the overall population. Moreover, there is an intense flow of labor force from the agricultural sector to the industrial and services sector. Though this rapid flow of labor force from low value added sectors to high value added sectors restricts the decline in unemployment rates, at the same time it accelerates the productivity-based growth.

Price stability: Precondition for Sustainable Growth

11. A permanent increase in employment depends on the achievement of sustainable growth. Sustainable growth can be defined as a permanent growth process that pursues a course close to the potential growth level due to constant price stability and the utilization of economic resources with maximum efficiency. The achievement of high-rated growth rates for the last four consecutive years is an encouraging development on the way to sustainable growth.

Fiscal discipline has been applied without compromise

Distinguished Guests,

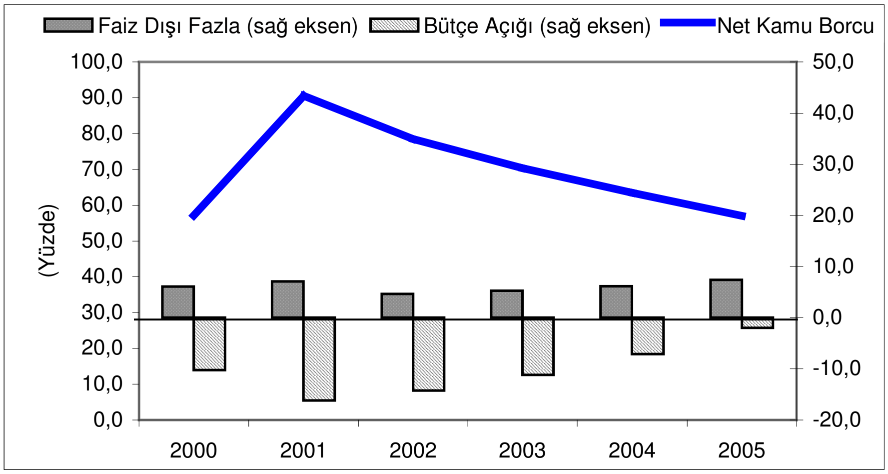
12. After summarizing employment and sustainable growth, let me now outline public finances developments.

13. As it is known, a satisfactory fiscal discipline could not be established as a whole in Turkey, especially towards the end of 1990s, and the financing of high-rated public deficits were mostly realized via borrowing. As a result, public debt stock expanded rapidly. Due to the financing of domestic borrowing primarily from the banking sector, interest rates rose sharply and borrowing maturities were shortened.

With the high costs of the restructuring of the banking sector to the public sector following the 2001 crisis, the ratio of net public debt stock to national income reached a record level of 91 percent. As an outcome of all these developments, the issue of sustainability of debt came to the top the agenda and the developments in debt stock became one of the fundamental factors that affected exchange rate and inflation developments due to its impact especially on risk premium risk.

14. With the implementation of the stability program after the economic crisis, fiscal discipline was established to a great extent and budget deficits dropped rapidly in subsequent years. Under this program, the target for the ratio of primary surplus to national income was set as 6.5 percent and this target was to a considerable degree achieved, especially in the last three years. The same target has been maintained for 2006 and 2007. Hence, the commitment to maintain tight monetary policy was sustained. As a result of all these steps, the ratio of net public debt to national income declined to 63.5 percent by 2004. This ratio is expected to realize as 57 percent, dropping further starting from the end of 2005.

Graph 6: Progress in Budget Deficit, Primary Surplus and Net Public Debt Stock (Ratios to GNP)*



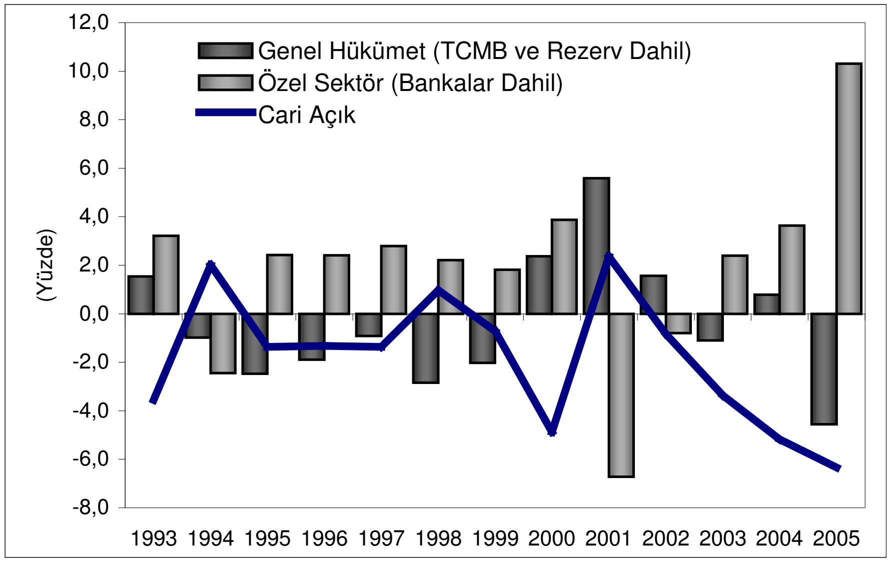
* Net Public Debt Stock forecast for 2005.
Source: Undersecretariat of Treasury.

Sustainability of current account deficit

Dear Guests,

15. One of the issues that has commonly been under discussion recently is the current account deficit. I would like to share with you our observations of the current deficit, which has been widening in recent years. Firstly, the current account deficit does not result from a decrease in national savings, but from the upsurge in mainly private sector-led-investment expenditures.

Graph 7: Current Account Deficit and Financing
(Ratios to GNP)



Source: CBRT

16. Another factor that led to an increase in the current account deficit in the last two years is the increase observed in oil prices. In international markets, crude oil prices, which have been increasing since 2004, also maintained their upward trend in 2005. The average price of Brent type crude oil, which was around USD 44.4 per barrel in January, increased up to USD 64.1 in August. In 2005, the share of the increase in energy prices, which are composed of crude oil, natural gas and coal prices, in the overall current account deficit became 1.4 percentage points in terms of the ratio to the GNP.

17. In the financing of the current account deficit, it has been observed that the contribution of the public sector decreased while that of the private sector significantly increased starting from 2003. Moreover, the upward trend in direct foreign capital investments and long-term credit utilization on the one hand, and the downward trend in short-term borrowing on the other hand indicate that there will not be any major problems in the financing of the current account deficit. Besides, it is expected that structural measures such as social security reform and more effective taxation of the unregistered economy will also increase the total amount of domestic savings in the economy and lead to a decrease in the current account deficit.

Financial depth is increasing

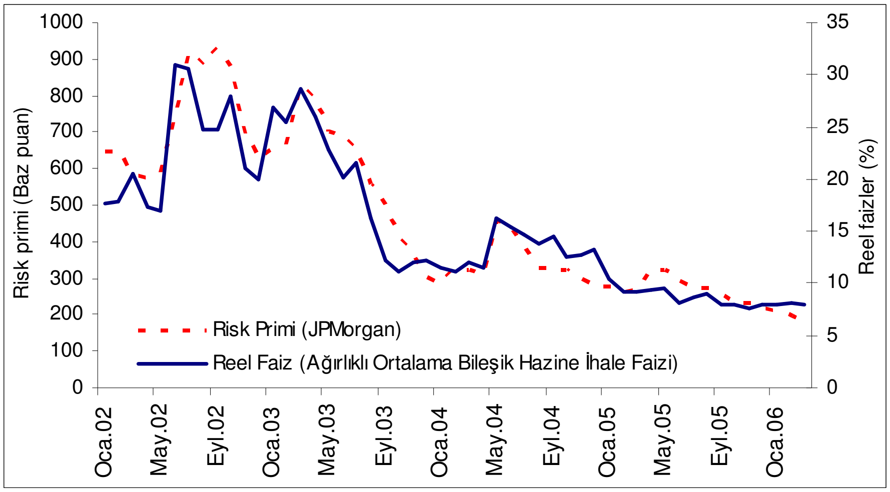
18. In this part of my speech, I would like to focus on developments in the financial markets.

19. We are happy to observe that the financial markets have started to fulfill their function as intermediary institutions. The rapid increase in credit volume, which has been observed particularly in recent years, is outstanding. This increase stems from two main factors, one being supply-based and the other demand-based. The supply-based factor is the increase of funds at the private sector's disposal in line with the decrease in public deficits and borrowing requirement. The demand-based factor is the increase in credit utilization resulting from the fall in interest rates.

20. Another favorable development is the money reform made at the start of 2005. The re-denomination of Turkish lira enabled the transaction of New Turkish lira-denominated borrowing instruments in international clearing institutions. The resolution of this technical problem and the environment of enhanced confidence drove foreign financial institutions to issue New Turkish lira-denominated bonds. This improvement in the issue of New Turkish lira-denominated bonds provided the Treasury with the opportunity to borrow with longer maturities and contributed to the increase in financial depth. All these developments harbor favorable impacts in terms of the functionality of inflation targeting. Longer maturities and reduced risk premium increase the effectiveness of monetary policy, which, in turn, enables the Central Bank to act with a medium-term perspective.

21. In addition to these favorable developments in the financial sector, the implementation of the floating exchange rate regime in a transparent and consistent manner helped increase the effectiveness and depth of the foreign exchange market. Due to these achievements towards financial stability, significant decreases were observed in risk premium as well as in nominal and real interest rates. The fall in real interest rates coupled with the decrease in the borrowing requirement of the public sector contributed to the revival in the economy by enabling banks to offer more funds to the real sector and households.

Graph 8: Risk Premium and Real Interest Rates



Source: CBRT, JP Morgan.

22. Another significantly favorable development in the financial sector is the marked increase in reverse currency substitution in the last two years, which can be defined as the shift from the use of foreign currency to national currency as an instrument of exchange and saving. In the financial sector, the share of assets held in New Turkish lira denominations has increased noticeably. The asset dollarization index, which is described as the ratio of the non-banking sector's foreign currency portfolio to its overall portfolio, decreased from around 40 percent in 2002 to 26 percent in January 2006.[1]

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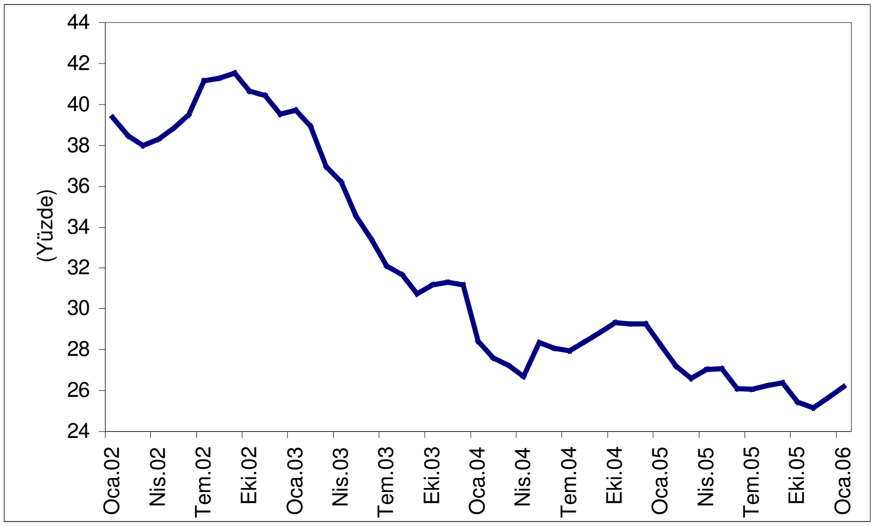
[1] Akıncı Ö., Barlas Özer Y., Usta B. "Dolarizasyon Endeksleri: Türkiye'de Dolarizasyon Sürecine İlişkin Göstergeler" ("Dollarization Indices: Indicators for the Dollarization Process in Turkey"), CBRT Working Paper No. 05/17.

Graph 9: Asset Dollarization Index*



* The ratio of non-banking sector's foreign currency portfolio to its overall portfolio.
Source: CBRT.

Factors Underlying the Success

Distinguished Guests,

23. In short, in the last four years, the Turkish economy has recovered from an environment of crisis and turned into an economy, in which today's high growth performance, single-digit inflation figures and sustainable debt dynamics as well as financial and economic stability as a whole have been achieved and accordingly, all economic agents have started to feel confident.

24. The independence of the Central Bank, implicit inflation targeting, fiscal discipline and the progress towards the full-membership of the EU stand as the factors underlying this success.

II- FORMAL INFLATION TARGETING AND THE WAY TO PRICE STABILITY

Distinguished Guests,

25. Up to now, I have tried to summarize the main determinants of the transformation process that the Turkish economy has been undergoing in recent years. In the rest of my speech, I would like to concentrate on the monetary and exchange rate policies to be implemented in 2006 and onwards. The most significant change in this new period has been the shift from implicit inflation targeting to formal inflation targeting.

Formal inflation targeting has been adopted

26. The institutional and functional details of inflation targeting have been outlined in our announcement entitled "General Framework of the Inflation Targeting Regime and Monetary and Exchange Rate Policy in 2006", on 5 December 2005. At this stage I think it would be useful to reiterate certain points, since they will also shed light on the policies to be adopted in the upcoming years.

Targets, accountability and possible risks

27. In this framework, the first issue that I will cover is regarding inflation targets. Annual inflation targets which are calculated using the Consumer Price Index, are set as 5 percent, 4 percent and 4 percent for 2006, 2007 and 2008, respectively and have been announced accordingly. These targets can only be changed on condition that sizeable and permanent deviations occur in the targets because of factors beyond the control of monetary policy. In the event that such an extraordinary situation arises, new targets will be set with the Government.

28. The cases where inflation rate remains above or below the target will be considered as deviations that should be treated equally. In both cases, the Government and the public will be informed about the reasons for the deviation and the necessary measures that should be taken in this respect. This is also a responsibility set forth in Article 42 of Central Bank Law. The uncertainty interval, which was set for the functioning of the accountability mechanism, is calculated by adding plus and minus two percentage points to the target. Similarly, the inflation path consistent with the year-end target was announced to the public at the end of each quarter. This path was also taken into consideration in the revisions of the program that has been carried out with the IMF. In this framework, it is planned that we will contact IMF technicians in the event that there is a plus or minus deviation of one or more percentage points from the target path. As the conditionality of the program would be invalid if there was a plus or minus deviation of two or more percentage points from the target path, it is also planned that we will announce the reasons for this deviation and the measures to be taken in the framework of the principles of the program to the public, as mentioned above, and provide a written explanation to the Government and send a copy of this written explanation to the IMF. In conclusion, the obligation of accountability that is set forth by Central Bank Law has enhanced transparency along with the IMF's conditionality.

29. The Central Bank's inflation forecasts, which include a period extending to mid-2007, are announced in the first issue of the Inflation Report that is published in January. According to the forecasts that are made under various scenarios about the course of short-term interest rates being the main instrument of the monetary policy, the achievements made on price stability are expected to continue in 2006 and 2007, as well. When data regarding 2006 are examined more closely, it is foreseen that inflation rates will start to fall as of the second quarter, despite their upward but temporary trend in the first quarter of the year. It is also expected that their downward trend will become more evident in the third quarter and finally, inflation will be close to the 5 percent-target at the end of the year.

30. Meanwhile, there are exogenous risks, which may lead to a deviation from the forecasts. These risks can be listed in four categories: (i) Secondary impacts that remained ineffective throughout 2005 may emerge due to an extraordinary rise in oil prices, (ii) Developments such as changes in international liquidity conditions can lead to volatility in risk premium and exchange rates, (iii) Rigidity in services inflation, (iv) Developments that are not under the control of monetary policy such as fluctuations in agricultural products, energy and commodity prices, indirect tax adjustments and increases in the prices of public goods and services.

31. In the event that such risks occur and inflation deviates from the target, the Central Bank will inform the public of the reasons for such deviation, the next move of monetary policy and when inflation will reach the target again.

Decision-making process of the Monetary Policy Committee

32. The second issue that I would like to mention regarding the operational framework of inflation targeting, is the decision making process of monetary policy.

33. As it is known, the institutionalization process of the decision-making mechanism was completed with the adoption of inflation targeting at the start of 2006. Accordingly, the Monetary Policy Committee, which is the decision-making organ, gathers each month according to a pre-announced annual program and makes decisions on interest rates.

34. The Central Bank mainly considers the price stability target while making decisions on interests. The Central Bank supports the Government's policies on growth and employment provided that they do not contradict with the price stability target. In this respect, the Monetary Policy Committee analyzes a large set of data that includes developments relating to the real sector, balance of payments, public finance, financial markets and the external world as well as the probable risks. In light of these data, the Monetary Policy Committee evaluates probable developments in the inflation rates of the following period. One of the important components of the set of data that is used in the decision-making process along with the evaluations of specialists are the projections made by the economic forecast system that is created within the Bank. Therefore, all of the decisions on interests are made by considering the inflation targets and according to the detailed analyses based on current data.

Inflation Report: Main Communication Tool

35. The third point that I would like to emphasize is the innovations introduced in the communication strategy of the Central Bank after the adoption of the inflation-targeting regime. As is known, the main communication tool in the new period is the quarterly Inflation Report. The first Quarterly Inflation Report was published at the end of January. The Inflation Report not only provides detailed macroeconomic analysis but also inflation forecasts of the Central Bank and some signals about the prospective policies that may be adopted in the future; therefore the report contributes to the transparency and openness principle of the Central Bank. The feedback pertaining to the first Inflation Report has been positive. The report is intended to help provide a better understanding of monetary policy and to be used as an indispensable guide for the efforts of economic units in making projections. In this respect, the second Inflation Report will be published at the end of April and a press conference will be held again in order to explain the content of the Report. Besides text reports, notes and press releases, the public will be kept informed of monetary policy through press conferences and events organized in collaboration with universities and non-governmental organizations.

Floating Exchange Rate Regime will continue

Distinguished guests,

36. In this part of my speech, I would like to highlight some important points about the floating exchange rate regime.

37. As you will recall, the floating exchange rate regime was adopted following the 2001 economic crises, which was one of the deepest economic crises experienced in Turkey. Since the adoption of the floating exchange rate regime, exchange rates have been determined in foreign exchange markets under market conditions within the framework of volatility interventions and foreign exchange buying auctions aimed at increasing reserves.

38. The steadfast implementation of policies that I mentioned previously in my speech coupled with the opening of accession talks with the EU have increased confidence in Turkey's economy. Accordingly, while on the one hand the volume of foreign capital flowing into the country is increasing, on the other hand the residents are overwhelmingly opting for local currency for their portfolio investments. Therefore, a period of appreciation has started for the Turkish Lira.

39. Developments pertaining to foreign trade are determined by the economic policies implemented in the country as well as by international economic conditions and structural factors. For instance, the current rapid rise in oil prices and international competition forced by countries having the advantage of cheap labor are international factors that have an adverse effect on the competitive power of certain sectors such as textiles and apparel. Meanwhile, in economies like Turkey, which have suffered from chronic inflation, lived under fiscal dominance for a long time and have fragile financial market structures, the relation between exchange rates and interest rates may differ from the conventional approaches. Therefore, expecting problems regarding external equilibrium to be settled by artificial adjustments in exchange rates and interest rates independent of market conditions would not solve the sectoral and structural problems, and moreover such an unfavorable approach would have unintended results such as distorting resource allocation in the medium and long run.

40. Therefore, I would like to reiterate here once more why the floating exchange rate regime should continue. According to the impossible trinity, in an environment where international capital movements are free, it is not possible to control exchange rates and interest rates at the same time. When the monetary authority chooses to directly control exchange rates, it can mitigate exchange rate risk and have a relatively reliable anchor with respect to inflation expectations. However, as the crises experienced in emerging economies in the 1990s overwhelmingly coincided with implementations of either fixed or pegged exchange rate regimes, doubts have increased about the sustainability of these exchange rate regimes in vulnerable economies struggling with a credibility problem. With increased financial integration worldwide, the floating exchange rate regime has become a deterrent factor especially against speculative attacks. Under this regime, the effects of any change in demand for or supply of foreign exchange is absorbed by adjustments in exchange rate levels immediately. Even if the exchange rate exposure borne by the economic units is higher under the floating exchange rate regime, this risk proves to be an open, measurable and manageable one. The necessary hedging mechanisms are present in Turkey and become more sophisticated every day.

41. Moreover, the floating exchange rate regime is a “sine qua non” for the inflation-targeting regime. Therefore, the floating exchange rate regime shall be retained by preserving the main framework in 2006 and thereafter.

Liquidity Management of the Central Bank

Distinguished guests,

42. I would like to emphasize that the Central Bank attaches the utmost importance to the stability of financial markets as a supportive factor of the price stability objective. The details of the Central Bank’s liquidity management were presented in the Press Release dated December 5, 2005 and the new arrangements introduced regarding required reserves and liquidity requirement with the aim of making the fluidity management of banks more effective were explained. Currently, the excess liquidity in the market is managed in line with the principles and arrangements in question.

Distinguished guests,

43. I would like to emphasize once more my belief that the Bank will, as before, take whatever steps are necessary to guarantee success on the road to achieving price stability.

Distinguished guests,

44. You can obtain a hardcopy of my presentation and the annexed press release "General Framework of Inflation Targeting Regime and Monetary and Exchange Rate Policy for 2006" at the entrance.

Thank you very much.