THE CENTRAL BANK OF
THE REPUBLIC OF TURKEY

inflation report
2006-II

CONTENTS

1. Overview [1]

The Central Bank of the Republic of Turkey (CBRT) adopted the inflation targeting regime starting from January 2006. The Inflation Report is the main communication tool under the new regime. In this Report, the CBRT presents its views about the factors affecting inflation as well as its evaluations pertaining to the inflation outlook. Within the framework of transparency and accountability principles, inflation forecasts and policies to be implemented for achieving the target are also shared with the public.

1.1. Developments in the Last Quarter

The downward trend in inflation displayed a slowdown tendency in the first quarter and annual inflation was 8.16 percent by the end of March, slightly exceeding the path consistent with the end year inflation target. As stated in the previous Inflation Report, the slowdown in disinflation can mainly be attributed to base effect due to historically low inflation in the first months of 2005. However, the abovementioned base effect is not the sole reason for inflation exceeding the path consistent with the end year inflation target. The rapid rise in prices of alcoholic drinks - tobacco, energy and unprocessed food is another factor that has played a role in this development. The rate of increase of the index excluding these sub-items suggest that the main trend of inflation is downward sloping and the underlying inflation trend in the first three months of this year is lower than the same period of the previous year. In other words, disinflation process continues.

In the first Inflation Report released in January, the projections predicted that inflation would slightly edge up in the first quarter but the disinflation process would resume again starting from the second quarter provided there were no exogenous shocks. The decrease in Value Added Tax (VAT) imposed on the textile, ready-wear and leather sectors from 18 percent down to 8 percent affected in March has been a supporting factor, while the current rapid rises in oil prices necessitates caution on this projection.

[1] This report has been prepared by using the data collected until April 13, 2006.

Besides price developments, the data on economic activity in the last three months also support the outlook presented in the previous Report. Seasonally adjusted Gross Domestic Product (GDP) figures pertaining to the last quarter of 2005 indicate that growth continues on a stable path. Sales and production data released on the first quarter of 2006 support this outlook as well.

In 2005, the rise in total final domestic demand reached very high levels, however, the negative contribution of the net foreign demand was a factor that restricted growth. Meanwhile, growth rate was well above the historical averages. The main reason why high growth rates do not exert a significant pressure on inflation is that growth is mainly investment driven and it hinges on a rise in productivity. Underlying this development was the high investment appetite sustained by the overall confidence established by fiscal and monetary discipline and sustained macroeconomic stability.

To conclude, data on inflation and economic activity released since the publication of the first Inflation Report have been consistent with the Central Bank's projections. As no unpredictable development has occurred in the last three months, it has been possible to act in line with the policy perspective announced in the January Report and thus policy interest rates were not changed in the first quarter.

1.2. Forecasts

Under the current perspective of monetary policy, it is projected that domestic demand would retain its stable trend with no further acceleration. The stable outlook in investments and productivity also imply that production capacity will continue to expand. Recently, there has been a significant rise in employment in non-agricultural sectors. The labor shifting from the agricultural sector to other sectors creates a higher demand potential, which in turn supports the total final domestic demand. However, as the participation rate of the labor force increases at the same pace with the increasing demand for labor in non-agricultural sectors, the pressure to be exerted on prices via unit labor costs by the rise in the demand for labor is contained. Accordingly, although the contribution of supply-demand conditions to the disinflation process has decreased compared to previous years, it is projected that no significant pressure would come from this channel to inflation.

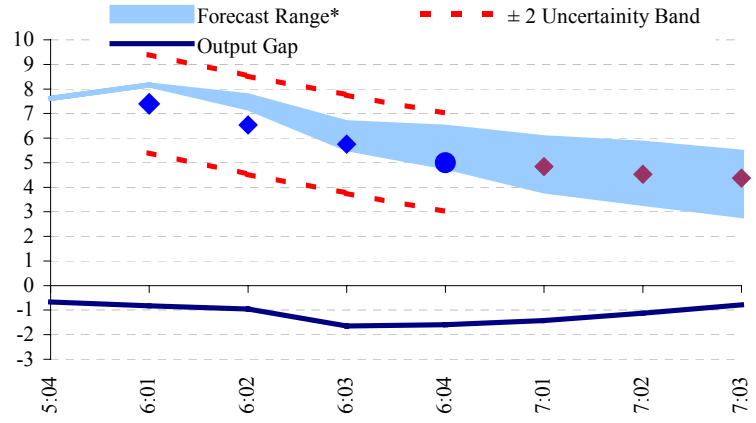
The strong New Turkish lira supports the downward trend in inflation. Certainly, besides macroeconomic stability and structural transformation, the favorable trend in international liquidity conditions underlie this development. The strong domestic currency has been a factor that has limited the adverse effect of the increase in commodity prices on domestic prices. The strong position of the New Turkish lira also helps domestic production to shift to a more capital intensive form, and thus, further contributes to the rise in productivity.

In the medium term, another factor that would contribute to the downward trend in inflation would be the low labor costs in countries like China and India. These low labor costs and high international competition would continue to curb the rise in prices of tradable goods. Meanwhile, the high growth rates in these countries would push up world commodity prices and thus have an adverse impact on inflation through input costs. Still, when the impacts of these two opposite factors on inflation are examined, it is projected that the net impact would be positive.

The developments in international liquidity conditions and risk premium in the first two months of the year progressed in favor of developing countries. In March, in spite of the fact that the global risk appetite has a tendency to deteriorate and the uncertainty perceptions about interest rates of the Bank of Japan (BOJ) increased, the forecasts presented in the Report are based on the assumption that the change in global liquidity would be smooth and international liquidity conditions would not change suddenly.

Taking into account the macroeconomic outlook and the stance of the monetary policy presented above, it is projected that the inflation trend would be downwards in the period ahead. The detailed forecasts presented at the end of the Report suggest that, under the perspective where policy rates are cut gradually, inflation would be very close to the target in 2006 and would conform with the medium-term targets by mid-2007 (Graph 1.2.1). Under the same perspective, it is projected that the contribution of total demand and capacity conditions to the disinflation trend would continue, albeit to a lesser degree. In other words, it is forecasted that the output gap would be negative but close to zero.

Graph 1.2.1. Inflation and Output Gap Forecasts



*The probability of inflation staying within the forecast range is 70 percent.
♦ The path "consistent with the target", which is announced in 5 December 2005 "General Framework of Inflation Targeting Regime and Monetary and Exchange Rate Policy" and constitutes the base for the principle of "accountability".
• 2006 end-year point target.
♦ The path consistent with the 2007 end-year target, under contemporary data set.

1.3. Risks and Policy Reaction

Uncertainty about oil prices is one of the leading risk to attainability of the inflation target. The forecasts in the January Report assumed constant oil prices throughout the forecast horizon. However, in the meantime, oil prices continued to rise and have recently reached quite high levels. The negative impact of oil prices on annual inflation became one of the factors that slowed down the decrease in inflation expectations in the first quarter of 2006. In case the rise in oil prices continues in the next few months, the unfavorable impact of oil prices on end-2006 inflation would become more apparent. Up to this point, the unfavorable impact of the rise in oil prices has merely been a relative price change and has not led to a change in price setting behavior in sectors that do not use petroleum products as a direct input. In other words, the second round effects have remained limited. However, inflation expectations should be monitored more closely compared to the last three months. At this point, it should be restated that monetary policy would react if the secondary effects become more evident.

Another important factor that has slowed down the downward trend in inflation is the extraordinary rise in rents stemming from the sustained excess demand in the housing sector. It is projected that the rise in the prices of the

services sector, especially in rents, would be well above the general inflation trend. The high increase in housing prices can be mainly attributed to structural factors and to the transition of the economy, and thus would continue for a while. However, no policy reaction is necessary for the time being as it is projected that this situation would gradually fade away through time with the increase in housing supply.

The contribution of the rise in service prices to the headline inflation in 2006 is projected to be around 2.5-3 percentage points. Therefore, to attain the 2006 target, the rise in goods sector prices is required to be around 3 percent. However, the current rapid rise observed in the prices of goods that are beyond the control of monetary policy, such as fresh fruits and vegetables, oil, main metal and gold, decreases this possibility. At this point, it should be emphasized that the rise in these prices is mostly temporary and that monetary policy would not react aggressively provided the secondary effects remain limited.

Another risk factor for the upcoming period is the difficulty in predictability of the course of global risk appetite and international liquidity conditions. The recent improvement in the quality of financing of the current account deficit and favorable developments in public finance are believed to increase the resistance of the economy to potential shocks. However, it is a fact that any shock arising from the mentioned factors still has the potential to adversely affect our economy. In case such a risk realizes, the primary objective would be to keep inflation in line with the medium-term targets. Accordingly, the policy reaction would be smoothed over time and thus, the effects of the exogenous shocks on the economy will be alleviated while preserving price stability.

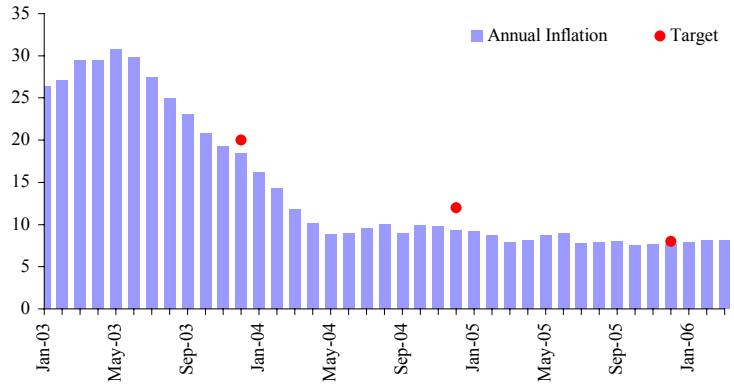
Price stability is a *sine qua non* for macroeconomic stability and sustainable growth. Important steps have been taken towards price stability in the last few years. The CBRT will continue to fulfill its tasks to build on the achievements made so far. It should be borne in mind that in the recent years the main factor for the achievement of non-inflationary growth has been the confidence regarding the sustainability of macroeconomic stability. Within this framework, the ongoing determination regarding structural arrangements that will further improve the quality of fiscal discipline should continue. Also, the continuity of reforms that will improve competition and investment environment, which in return contribute to the rise in productivity in the long term, are crucial for the achievement of price stability.

2. Inflation Developments

2.1. Realizations

By the end of the first quarter of 2006, annual Consumer Price Index (CPI) inflation became 8.16 percent. The basis effect created by the VAT reduction on the food, education and health sectors introduced at the beginning of 2005, played an important role in this increase of the annual CPI inflation, which was recorded as 7.72 at the end of 2005. While the downward trend in special CPI aggregates in annual terms was interrupted in the first quarter of 2006, the interruption is anticipated to be temporary and the CPI inflation would resume its downward trend in the second quarter provided there is no unfavorable exogenous developments.

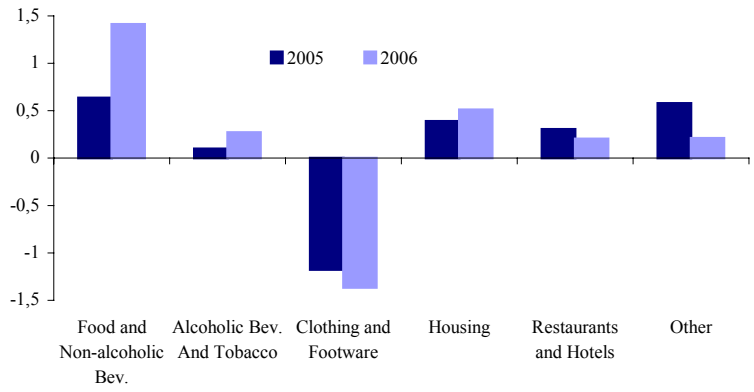
Graph 2.1.1. End-year Inflation Target and Annual CPI Inflation
(Percentage Change)



Source: TURKSTAT.

The factors that contributed to the 1.25 percent-rise in consumer prices in the first quarter of 2006 were: (i) above-expectations increase in the prices of unprocessed foods, (ii) considerable decrease in clothing prices resulting from demand conditions and competition, (iii) rises in the prices of tobacco products, and (iv) the course of services sector prices.

Graph 2.1.2. Sub-Item Contributions to Inflation in the First Quarter of 2006 (Percentage Points)



Source: TURKSTAT, CBRT.

Seasonal price movements became a factor affecting the CPI in the first quarter and the negative impact of the rapid price increments in food prices on consumer prices was constrained by the high season sales in clothing prices. The 5.10 percent rise in food prices in the first quarter was mainly due to the seasonal price hikes in fresh vegetables, as well as price increments in food products other than vegetables, like meat and bread. The rate of discount in clothing and footwear prices, which was higher than that of the last year, reveals that the contribution of demand and competition to clothing inflation is increasing. Meanwhile, the reduction of VAT from 18 to 8 percent in the prêt-a-porter and leather sectors is believed to have a favorable influence in consumer prices in the upcoming period.

The elevation of prices of the tobacco products is another factor that had a negative impact on consumer prices. It is observed that the effects of high price increments made in tobacco products in December continued in January, as well. Last year, tobacco prices were increased in August due to the rise in Special Consumption Tax (SCT). It is expected that the negative -yet temporary- impact of this rise on the CPI would disappear by the third quarter of 2006 and annual CPI inflation would drop by 1 percent.

When the contributions coming from the prices of goods and services to consumer prices are analyzed separately, it is observed that the contribution of services prices has decreased, while that of goods has accelerated. In the first quarter, the rate of increase in services prices, except for the housing rents, decelerated in annual terms and its unfavorable impact on consumer prices

diminished (Table 2.1.1). Meanwhile, the rates of increase in the prices of especially restaurant and hotel services, as well as transportation services remained significantly lower than the rates of increase of the last year. Meanwhile, the annual inflation rate of labor-intensive services, the prices of which are neither administered nor influenced by energy prices, has stayed at a constant level for about a year after the downward trend in 2004. Meanwhile, as housing supply is short of meeting the demand, the rise in rents became very close to the figures of last year and this signals a negative impact on consumer prices (Table 2.1.1). In the light of these, developments pertaining to services demand, as well as the productivity developments in services, are closely monitored and the cautious stance toward them is retained.

When goods price developments are analyzed, it is observed that the rate of increase in prices of energy and unprocessed food products was higher in the first quarter of 2006 compared to the previous year. In the energy group, fuel oil prices (transportation-oriented energy prices) increased in a limited manner compared to the previous year, due to developments in crude oil prices. Meanwhile, housing-oriented energy prices, such as prices of natural gas and water, registered higher rates of increase. Although the deceleration of the rate of increase in fuel oil prices compared to the first quarter of 2005 is a favorable development, the current high levels of prices resulting from the re-start of the upward trend in oil prices as of end-March are being carefully monitored regarding the future course of inflation.

Unprocessed food products, which markedly contributed to annual inflation as of the last quarter of 2005, became the main determinant of the rapid increase in goods prices in the first quarter of 2006. The rate of increase in prices of the said groups surpassed that of the previous year by 5.2 points, and became 8.81 percent. Excluding the prices of unprocessed food products determined by the agricultural performance and energy prices determined by developments in international markets, goods prices decreased by 2.01 percent signifying a lower rate of inflation compared to the same period of the previous year (Table 2.1.1).

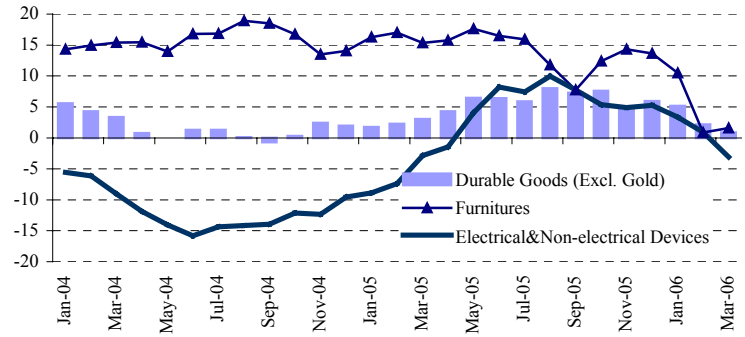
Table 2.1.1. Goods and Services Group Prices (Quarterly Percentage Change)

	2005					2006
	I	II	III	IV	Annual	I
CPI	**0.83**	**1.74**	**1.30**	**3.65**	**7.72**	**1.25**
1. Goods	**-0.24**	**1.16**	**0.80**	**4.42**	**6.21**	**0.80**
Energy	1.73	0.73	3.81	1.20	7.65	2.63
Unprocessed Food	3.61	-7.87	0.25	11.12	6.34	8.81
Goods Excluding Energy and Unprocessed Food	-1.94	3.91	-0.05	3.79	5.71	-2.01
Durable Goods	-0.37	3.61	-0.80	4.41	6.91	-1.66
Durable Goods (Excluding Gold)	1.86	3.66	-1.86	2.23	5.94	-3.04
Semi-durable Goods	-3.38	5.75	-1.10	3.76	4.85	-3.65
Non-durable Goods	2.11	-2.58	2.60	4.91	7.07	4.64
2. Services	**3.85**	**2.77**	**3.65**	**1.87**	**12.68**	**2.41**
Rents	4.26	3.74	7.06	4.04	20.48	4.08
Restaurants and Hotels	5.19	2.65	3.29	3.09	14.98	3.02
Transportation Services	7.87	2.04	6.00	1.11	17.97	1.27
Other Services	1.75	2.73	1.72	0.56	6.92	1.80

Source: TURKSTAT, CBRT.

Excluding gold prices, which continue to increase rapidly in line with the developments in the international markets (Box 2.1), the annual rate of increase in durable goods prices decreased starting from August 2005, following the increase observed in the first half of 2005 (Graph 2.1.3). In the first quarter of 2006, the said downward trend accelerated and prices of this group decreased by 3.04 percent. This marked decrease was mainly determined by (i) the 7.81-percent decrease in furniture prices that can be utilized as an indicator of consumption demand, and (ii) the 5.55-percent decrease in the prices of the electrical and non-electrical devices group, which generally includes technology-intensive goods, are open to competition and susceptible to developments in the exchange rate (Graph 2.1.3). An overall evaluation indicates that, price developments in durable goods suggest a favorable outlook as of the first quarter of 2006, owing to the reversal of the trends in the furniture and electrical/non-electrical household devices groups.

Graph 2.1.3. Prices of Durable Goods (Excluding Gold)
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

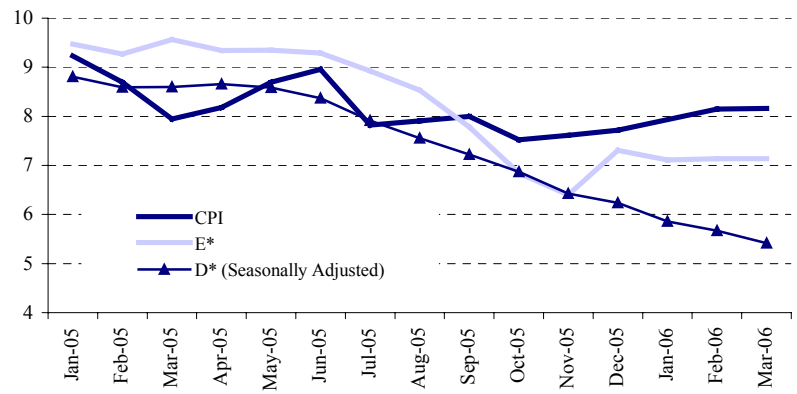
Considering the fact that consumer prices were mainly affected by seasonal price movements in the first quarter, it would be useful to analyze the Special CPI Aggregates excluding seasonal products, regarding the course of inflation. In the Special CPI Aggregate E*, which is obtained by excluding seasonal products from the Special CPI Aggregate E, (calculated by excluding energy, alcoholic beverages and tobacco products) the deceleration in the annual rates of increase observed since the start of 2005 came to a halt in the first quarter of the year. When the Special CPI Aggregate D* (obtained by excluding energy, unprocessed food, alcoholic beverages, tobacco products and gold) is seasonally adjusted, it is revealed that the downward trend of inflation continued in the third quarter of the year (Graph 2.1.4). Significant increases observed in March in the least comprehensive Special CPI Aggregates, F and G, which exclude indirect taxes, signify that the VAT cuts on clothing were shared by both retailers and consumers.

Table 2.1.2. Special CPI Aggregates (2003=100)

	2005					2006
	I	II	III	IV	Annual	I
CPI	**0.83**	**1.74**	**1.30**	**3.65**	**7.72**	**1.25**
A. CPI excluding seasonal products	2.06	1.84	2.75	1.48	8.39	2.31
B. CPI excluding unprocessed food	0.37	2.95	1.58	2.68	7.78	0.12
C. CPI excluding energy	0.67	1.94	0.89	4.07	7.75	1.01
D. CPI excluding unprocessed food products and energy	0.09	3.44	1.14	2.98	7.84	-0.38
E. CPI excluding energy, alcoholic beverages and tobacco products	0.59	2.05	-0.16	4.00	6.58	0.74
F. CPI excluding energy, alcoholic beverages and tobacco products, other goods with administered prices and indirect taxes	0.30	2.23	-0.33	4.45	6.75	1.75
G. CPI excluding energy, alcoholic beverages and tobacco products, other goods with administered prices, indirect taxes and unprocessed food	-0.38	3.98	-0.32	3.25	6.61	0.26

Source: TURKSTAT.

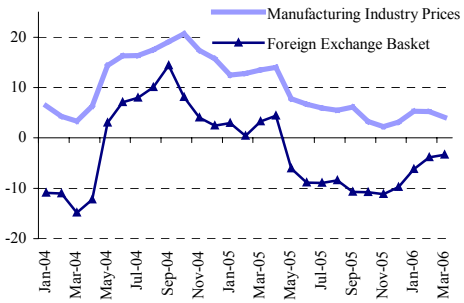
Graph 2.1.4. CPI and Special CPI Aggregates (E* and D*)
(Annual Percentage Change)



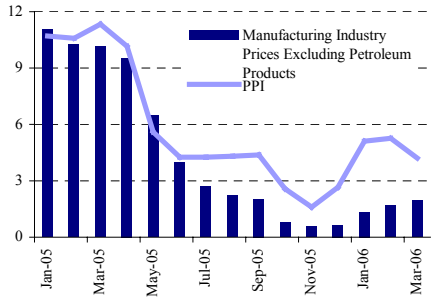
E*: CPI excluding energy, alcoholic beverages, tobacco products and seasonal products.
D*: CPI excluding energy, alcoholic beverages, tobacco products, unprocessed food and gold.
Source: TURKSTAT, CBRT.

In the first quarter of 2006, producer prices increased by 2.48 percent. As also stated in previous reports, manufacturing industry prices, which constitute a significant part of the Producer Prices Index (PPI), became even more sensitive to raw material prices and exchange rate developments compared to the past, due to the fact that the PPI is a compilation of before-tax prices (Graph 2.1.5). In the manufacturing industry, the said effect was most strongly felt in the refined petroleum products sector that is subject to high taxes. In the first quarter of the year, the strong position of the New Turkish lira partially reduced the negative effects deriving from oil prices, whereas the sales prices at the refinery level continued to influence the headline PPI. Therefore, it would be more sensible to evaluate the producer prices by excluding the items that are directly affected by petroleum products. When the effects of these items are excluded, the annual rise in manufacturing industry prices continue to be at low levels, albeit with a slightly upward trend compared to the last quarter of 2005 (Graph 2.1.6).

Graph 2.1.5. Manufacturing Industry Prices and Foreign Exchange Basket (0.5 USD + 0.5 EUR) (Annual Percentage Change)



Graph 2.1.6. PPI and Manufacturing Industry Prices Excluding Petroleum Products (Annual Percentage Change)



Source: TURKSTAT, CBRT.

In the first quarter of 2006, there have been high increases in international metal prices, while the prices of the main metal industry included in the PPI increased by 2.31 percentage points. At the beginning of April, the high rates of increase observed in international metal prices enhance the probability that price increases in the main metal industry will continue in the second quarter of the year, as well.

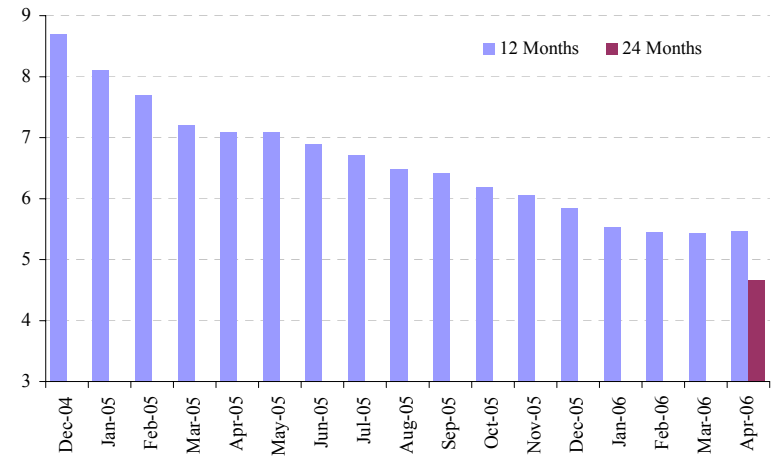
2.2. Expectations

CBRT Expectations Survey is the main information source that can be used to measure expectations. The survey is conducted among the decision makers and experts working in the financial and real sectors. Financial sector experts constitute the majority among these professional participants.

Inflation expectations have a determining effect on inflation realizations as they provide a basis for both price developments and wage adjustments. In this framework, the developments in expectations have an important place in the analyses and assessments made by the CBRT. The expectations are affected by various factors, but mainly from the medium-term signals given by the CBRT and the general outlook of the economy. As monetary policy focuses on the medium term and inflation targets are announced as to comprise a three-year period, it has become necessary to obtain information about the expectations in the long run and analyze the changes in these expectations. In this respect, in April 2006, the data set pertaining to the medium term is extended by adding the "consumer inflation expectation" regarding the next 24-month period to the CBRT Expectations Survey.

Inflation expectations for 2005 indicate that economic agents set their inflation expectations in line with the inflation target and therefore, the permanence of the shocks that affect the economy were limited, such as the increases in oil prices. When expectations regarding consumer inflation in 2006 are analyzed, as of the second survey period of April it is seen that inflation expectations remained 0.79 percentage points above the end-year target, where this difference maintained itself in the last quarter. Meanwhile, it was observed that the consumer inflation expectations regarding the next 12-month period deteriorated in the first quarter of the year, whereas the deterioration rate slowed down and maintained a relatively stable course in February (Graph 2.2.1).

Graph 2.2.1. CPI Expectation Regarding Next 12- and 24-Month Periods
(Annual Percentage Change)



Source: CBRT.

As of the last survey period, the consumer inflation expectation regarding the next 24-month period point to an annual inflation rate of 4.67 percent for April 2008 (Table 2.2.1). As the expectations regarding long-term consumer inflation in the next 12 and 24 months are slightly above the corresponding targets, they should be monitored carefully as to the decline in inflation. However, lower levels of the longer term expectations can be considered as salutary for the performance of inflation targeting.

Table 2.2.1. CPI Inflation Expectation

Current Period	Survey	End-year CPI Inflation Expectation	CPI Inflation Expectation Regarding Next 12 Months	CPI Inflation Expectation Regarding Next 24 Months
January-06	1	5.68	5.49	
	2	5.67	5.54	
February-06	1	5.75	5.45	
	2	5.81	5.45	
March-06	1	5.80	5.46	
	2	5.78	5.44	
April-06	1	5.76	5.41	4.64
	2	5.79	5.47	4.67

Source: CBRT.

BOX 2.1. INTERNATIONAL GOLD PRICE DEVELOPMENTS AND THEIR EFFECTS ON THE CPI

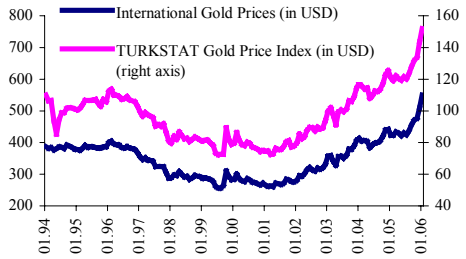
International Developments

International gold prices adopted a sharp upward trend with the second half of 2005 (Box 2.1. Graph 1). As the Turkish economy is one of the economies with a high level of household demand for gold, gold has a relatively significant weight within the CPI. Within this context, it will prove useful to analyze the effect of gold prices on inflation, for a better grasp of consumer price dynamics.

The Effect of Gold Prices on the CPI

The gold price index, which is contained under the 'various goods and services' group within the CPI, follows a course almost parallel to that of international markets. When said prices are quoted in USD terms, annual rates of increase are seen as closely mimicking the prices abroad (Box 2.1.Table 1).

Box 2.1. Graph 1. Gold Prices at Home and Abroad



Source: IMF-IFS, TURKSTAT.

Box 2.1. Table 1. Gold Prices at Home and Abroad

Annual Percentage Change

	International Prices	TURKSTAT Prices* (US Dollar)
2002	20.4	20.3
2003	22.6	22.3
2004	8.6	9.6
2005	15.4	14.5

* CPI (1994=100) is used for the 2002-2004 period while CPI (2003=100) is used for year 2005.

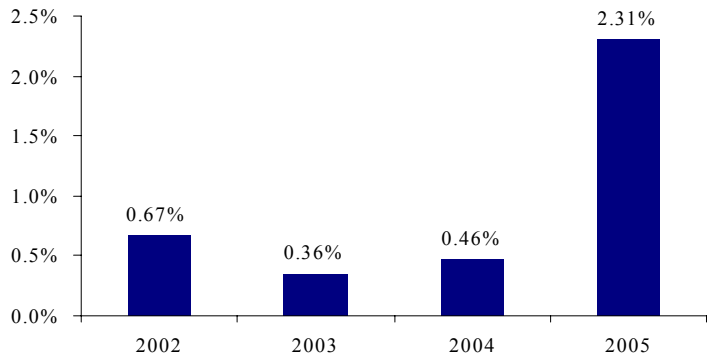
Source: IMF-IFS, TURKSTAT.

In 2005, gold prices increased by 15.4 percent in foreign markets, while the rate of increase calculated by Turkish Statistical Institute (TURKSTAT) is 14.5 percent in US dollar terms. Almost 0.18 points, 2.31 percent – of the 7.72 percent CPI inflation recorded the same year resulted from the increase in gold prices. From this perspective, in 2005, the contribution to the CPI of the increase in gold prices may well be said to be much above previous years (Box 2.1. Graph 2). The importance of this development is further highlighted when the low inflation targets for 2006 and 2007 – at 5 and 4 percent, respectively – are taken into account.

In the same spirit, the course of the gold prices in 2006– which have been rising significantly in international markets from the second half of 2005 onwards – will be of key importance in terms of annual consumer inflation. As a matter of fact, even under the assumption that the immediate level of USD 640 is sustained, an elevation of almost 0.31 points is anticipated on annual consumer price inflation due to international gold prices (Box 2.1. Table 2).

In the same spirit, the course of the gold prices in 2006– which have been rising significantly in international markets from the second half of 2005 onwards – will be of key importance in terms of annual consumer inflation. As a matter of fact, even under the assumption that the immediate level of USD 640 is sustained, an elevation of almost 0.31 points is anticipated on annual consumer price inflation due to international gold prices (Box 2.1. Table 2).

Box 2.1. Graph 2. Contribution of Gold Prices to Annual CPI Inflation (Percent)



Source: TURKSTAT.

In Box 2.1.Table 2, the possible effects – under alternative scenarios – of gold prices on the CPI are presented. It should be pointed out that if international gold prices reach US dollar 800 as of end-2006, this will be reflected on the annual CPI as much as 0.69 points. However, it should be borne in mind that fluctuations in exchange rates might cause variations in the net contribution figures presented in the table. Within this context, assessments related to the course of gold prices in the upcoming period gain a rising significance.

Box 2.1. Table 2. Different Scenarios for Gold Prices

International Gold Prices as of End-2006 (USD)	Net Contribution to Annual Increase in CPI (in points)
640	0.31
660	0.36
680	0.40
700	0.45
750	0.57
800	0.69

Source: CBRT.

The Course of International Gold Prices in the Upcoming Period

During periods when global inflation accelerates or is expected to accelerate and factors of uncertainty reduce the predictability of exchange rates; gold comes to the forefront – as an alternative investment instrument– to facilitate risk diversification. In 2005, the gold demand for jewelry, which has a 72.9 percent share in the global demand for gold, increased by 4.5 percent. The high increases in income in China, India and the Middle East, where gold is intensely and traditionally used as jewelry, have been the determinant of the soaring demand for gold. Although its share in the total gold demand is not high, the 25.9 percent increase in the investment-oriented gold demand coming from international investment institutions also attracts attention (Box 2.1.Table.3).

Box 2.1. Table 3. Sub-Items of Gold Demand*

	2004		2005		2005 / 2004 Change
	Tons	*% Share*	Tons	*% Share*	%
Jewelry	2,618.1	*74.7*	2,736.2	*72.9*	4.5
Industrial	409.8	*11.7*	418.5	*11.1*	2.1
Investment	476.1	*13.6*	599.6	*16.0*	25.9
Total	3,504.0	-	3,754.3	-	7.1

* Data is taken from the website of World Gold Council (www.gold.org).

Despite the non-availability of demand data in 2006, the steepening of the upward tendency in gold prices from end-March onwards makes us consider it as being investment-oriented again. A number of factors signal that gold prices will maintain their high level and even their upward trend. These are, the heightening of inflationary pressures in developed countries, avoiding the implementation of measures that would remedy global imbalances, and continuous upward revisions in the gold price forecasts by international investment institutions.

Conclusion

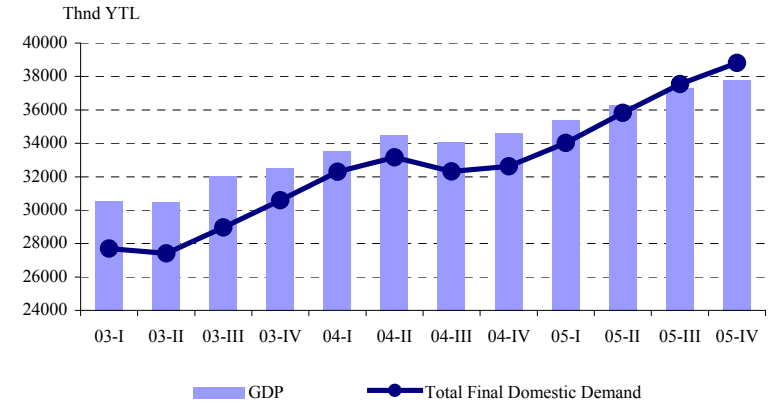
It began to be increasingly anticipated that the increase in gold prices would continue in the upcoming period. In such a case, the effect of gold prices on inflation may be at a level difficult to disregard. Certainly, if gold prices continue recording remarkable increases, this may affect short-term inflation expectations. However, it should be kept in mind that gold – by its very nature – is not used as input by other sectors. Consequently, the secondary effects of gold prices on inflation are far more limited compared to other commodity prices such as oil and basic metals. Under the assumption that the increases in gold prices will resume reasonable levels after some time, it is believed that the effect of gold prices on inflation will be quite limited in the medium-term while the secondary effects will follow a modest course. All in all, within the inflation targeting framework the CBRT will not be reacting at this stage to the changes in inflation stemming from the increases in gold prices.

3. Supply and Demand Developments

3.1. Supply-Demand Balance

GDP increased by 9.5 percent in the last quarter of 2005, compared to the same period of the previous year. Hence, over the whole year, the GDP growth rate totaled 7.4 percent. The flawless implementation of structural reforms carried out hand in hand with tight monetary and fiscal policies strengthen economic fundamentals, while a corresponding decline in the risk premium, the fall in real interest rates and maintenance of the strong position of the New Turkish lira vis-à-vis foreign currencies became the main determinants of the rapid growth in the total domestic demand in 2005.

Graph 3.1.1. GDP and Total Final Domestic Demand
(Seasonally Adjusted)



Source: TURKSTAT, CBRT.

The data revision covering the first three quarters of the year led to an upward movement in GDP growth by 0.9 points in 2005. Excluding this revision, economic growth was in line with our expectations, providing the basis for the Inflation Report of January 2006. In the last quarter of the year, the slowdown in the pace of seasonally adjusted GDP growth compared to the first three quarters enabled economic activity to maintain its supporting course for the disinflation process (Graph 3.1.1, Graph 3.1.2).

Analyzed by the production side, it is observed that the value added of all sub-groups other than agricultural sector and financial institutions sector, increased in the last quarter of the year. During this period and throughout the year, the services sector made the largest contribution to economic growth. Particularly in the last quarter of the year, the contribution of trade and

transportation-communication sectors to growth increased due to rapid growth in the value added of the industrial sector. Besides, rapid growth in the construction sector also continued.

Table 3.1.1. GDP Developments by Expenditure Side
(Constant Prices, Annual Percentage Change)

	2003	2004					2005				
	Annual	I	II	III	IV	Annual	I	II	III	IV	Annual
1-Consumption Expenditures	5.6	11.6	15.4	5.9	4.7	9.0	4.1	3.9	9.8	14.1	8.1
Public	-2.4	2.6	-7.8	-7.0	11.1	0.5	4.4	4.0	3.2	0.0	2.4
Private	6.6	12.4	18.4	7.3	3.6	10.1	4.1	3.9	10.4	16.7	8.8
Durable Goods	24.0	48.0	61.4	28.9	-5.7	29.7	3.2	2.9	26.0	31.3	15.0
Food and Beverages	4.1	5.3	2.6	0.0	5.4	2.8	3.3	8.6	10.8	8.7	8.2
Semi-dur. and Non-durable Goods	2.1	8.2	36.8	18.3	16.3	18.8	9.0	3.0	3.7	39.6	12.9
2-Fixed Capital Formation	10.0	57.6	47.4	26.1	11.2	32.4	10.3	20.0	30.6	33.0	24.0
Public	-11.5	-5.9	-8.7	-10.8	0.9	-4.7	30.7	30.2	38.2	17.1	25.9
Private	20.3	65.5	63.1	38.9	17.7	45.5	8.8	18.4	29.0	41.6	23.6
3- Stock Change*	3.0	2.5	1.4	-1.2	2.5	1.1	0.6	-0.7	-3.0	-6.3	-2.5
4-Exports of Goods and Services	16.0	10.9	17.2	8.2	14.4	12.5	14.0	6.7	3.9	10.9	8.5
5-Imports of Goods and Services	27.1	31.3	32.7	16.1	19.6	24.7	10.6	9.1	11.2	15.3	11.5
6-Total Domestic Demand	9.3	20.6	21.4	8.1	8.5	14.1	5.6	6.8	10.9	11.6	8.8
7-Total Final Domestic Demand	6.5	19.8	22.9	9.9	6.3	14.1	5.5	8.4	14.5	19.1	11.5
8-GDP (Expenditure Side)	5.8	11.8	14.4	5.3	6.3	9.0	6.6	5.5	7.7	9.5	7.4

*Contribution to GDP growth, percent.
Source: TURKSTAT.

Analyzed in terms of demand components, it is observed that the largest contribution to GDP growth came from private consumption expenditures in the last quarter of 2005. The rapid increase of expenditures on semi-durable and non-durable goods stands as the most significant factor in demand developments during this period. Expenditures on semi-durable and non-durable goods, which increased by 5.3 percent in the first three quarters of the year compared to the same period of the previous year, rose by 39.6 percent annually in the last quarter. These expenditures became one of the two components of private consumption expenditures that made the largest contribution to GDP growth together with durable goods consumption. Meanwhile, private investment expenditures, the other component of domestic demand, maintained their strong growth trend characterized by both machinery-equipment and construction investments in the last quarter. Public expenditures also supported economic growth in an investment-based manner during the same period.

Consequently, total final domestic demand increased by 19.1 percent in the last quarter of 2005 compared to the same period of 2004 (Table 3.1.1). Seasonally adjusted data for quarterly periods reveal that the rapid growth in the total final domestic demand maintained its trend in the last quarter of the year as well (Graph 3.1.1).

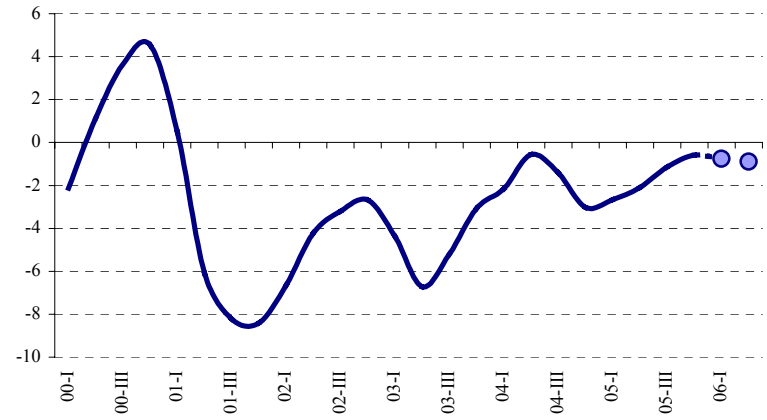
The factors that explain why the current production trend does not lead to any pressure on prices despite the rapid growth in the total final domestic demand and GDP can be listed as follows: First of all, on the supply-side of growth, the continuance of productivity gains, which is a significant factor determining the growth-inflation relationship, drives unit labor costs down and restrains the impact of increases in other costs. Secondly, on the demand-side of growth, the share of investment expenditures in the GDP continues to rise. The ongoing strong course of growth in investment expenditures restrains inflationary pressures through supporting the partial labor productivity growth by capital deepening. Therefore, the composition of the domestic demand supports a sustainable rapid growth and continuation of the disinflation process in a simultaneous way. Thirdly, it is thought that the growth of certain non-tradable goods expenditures of (durables, machinery-equipment) signifies an increase determined by the relative price advantage rather than a shift in demand at a given price level. In fact, increases in real wages are not at such a level that would exert any additional demand pressures on inflation. Both the strong position of the New Turkish lira vis-à-vis foreign currencies and the relative price effect resulting from the downward trend in import prices of consumption and capital goods prevent the rapid demand growth to be a risk factor for inflation. In other words, although the strong position of the New Turkish lira vis-à-vis foreign currencies provides support to the growth in domestic demand, it also restrains the impact of rapid growth on prices through contributing to productivity gains by stimulating investment demand as well as through its direct impact on prices.

In short, the current "monetary conditions", which can be defined as a combination of real interest rate and real exchange rate, enables a non-inflationary rapid growth. Putting aside the short-term movements created by interest rate differentials and global liquidity conditions, there is no doubt that the trend of the real exchange rate for the "medium-term" is determined by economic fundamentals and expectations. In other words, expectations for the continuance of economic and political stability as well as the favorable outlook of structural factors such as productivity and reforms are closely related to the sustainability of the strong position of the New Turkish lira vis-à-vis foreign currencies.[1] Besides the mentioned structural factors and expectations, in case of the continuance of current trends in global liquidity conditions, the

[1] The impacts of the productivity differentials in tradable and non-tradable sectors relative to the Euro area during the convergence process to the European Union on relative prices and real exchange rate behavior are touched upon in Box 3.1.

maintenance of the strong position of the New Turkish lira in 2006 will not be a surprising outcome. However, the "non-inflationary rapid growth" evaluation based on the monetary conditions does not change the fact that the contribution of supply-demand conditions to the disinflation process has narrowed (Graph 3.1.2).

Graph 3.1.2. Output Gap (Percent)

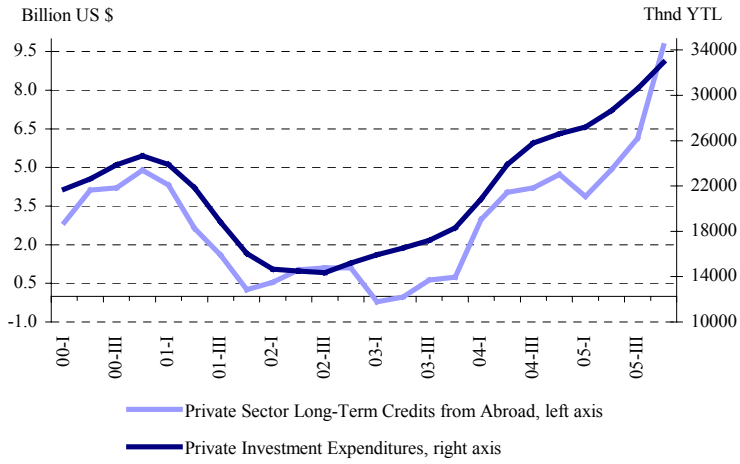


Source: CBRT.

Recent data show that the seasonally adjusted private consumption expenditures, which increased at a lower pace in the last quarter of 2005, continued to grow in a non-accelerating manner in the first quarter of 2006 compared to the previous period. During this period, real consumer credits provided by banks accelerated on a monthly basis, while seasonally adjusted domestic sales of white goods rose compared to the previous quarter. Although the seasonally adjusted data pertaining to the first quarter of 2006 do not signify any increases in the domestic sales of automobiles compared to the last quarter of 2005, annual growth rates show that the demand for automobiles maintains its strong course. The CNBC-e seasonally adjusted consumption index is below the previous quarter's average, as of the first quarter of 2006. Seasonally adjusted consumption goods imports increased in January and February, signaling that it would exceed the imports of the previous quarter. In an overall evaluation of all these indicators, the deterioration observed in indicators such as industrial production and domestic sales of automobiles in January-February 2006 are not thought to signify a permanent slowdown in consumption expenditures. The favorable course of indicators related to volume of production, orders and sales from domestic market and work in progress included in the Business Tendency Survey (BTS) of March reinforces this

belief. In sum, according to data pertaining to the recent period, although the growth in private consumption expenditures continues, the rate of increase is not so high to exert pressure on prices.

Graph 3.1.3. Investment Expenditures and Long-Term Credit Use
(Annualized)



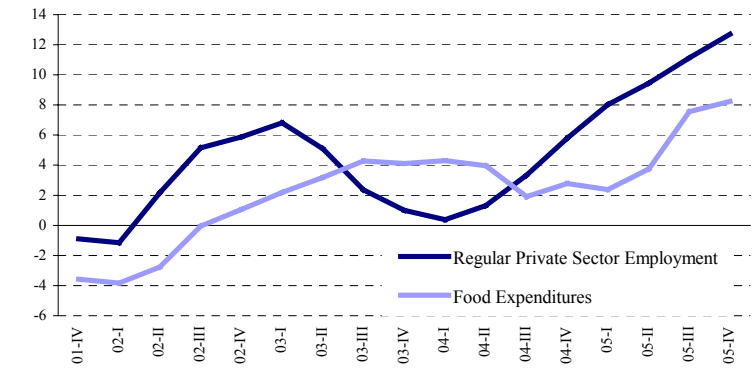
Source: TURKSTAT, CBRT.

The strong growth trend in private investment expenditures, the other component of domestic demand, continues. As with the imports of consumption goods, the imports of capital goods also register high rates of increases. Besides, according to seasonally adjusted data, domestic sales of heavy commercial vehicles displayed an upward trend in the first quarter of 2006 compared to the previous quarter. Seasonally adjusted data indicate that the deterioration observed in the production of the machinery-equipment and electrical machinery subgroups of the manufacturing industry in January reversed in February. Meanwhile, the BTS investment expenditures tendency still remains at high levels despite the deterioration in the January-March period, whereas the share of the firms not planning to undertake investment expenditures did not change dramatically. In the said period, the role of the "demand uncertainty", which is one of the factors restricting investment expenditures, continued to lessen, while the increase in the role of the "inadequate net return" factor and the interruption in the downward trend of credit interest rate expectations are outstanding. However, it should be borne in mind that private investment expenditures are also closely related to the financing conditions abroad (Graph 3.1.3). As a matter of fact, the high-rated increase observed in long-term credit use from abroad in the January-February

period compared to the same period of the previous year signifies the continuance of the strong course of investment demand in the private sector.

Meanwhile, the fact that the production of other non-metallic mineral substances, which is the leading sector providing intermediate input to the construction sector, surpassed the previous quarter's average as of the first two months of 2006, indicates that the revival in the construction sector continues. Along with the confidence in the economy, the fall in interest rates and the improvement in credit facilities, such as extended maturities, all stimulate the demand for houses that was deferred in the period of macroeconomic instability in the past. Therefore, it is anticipated that the construction sector will also maintain its current trend in the medium-term. Actually, the share of housing credits in total consumer credits increased to 47.8 percent in March 2006 from 23.8 percent in March 2005. Also, the data for construction licenses as of the last quarter of 2005 indicate that the robust growth trend especially for housing constructions continues.

Graph 3.1.4. Regular Private Sector Employment and Food Consumption Expenditures
(Annualized, Annual Percentage Change)



Source: TURKSTAT.

Along with the indicators of consumption and investment expenditures, employment developments in non-agricultural sectors stand as another important determinant of the medium-term demand-inflation relationship, as also emphasized in the Inflation Report of January. The rapid decrease in the non-agricultural unemployment rate in line with high-rated employment growth in the said sectors is outstanding. On the inflation front, the reflection of these developments may be the potential of the labor force, which has shifted from the agricultural sector to other sectors, in leading to a higher demand in urban areas due to higher average wages and a higher consumption propensities. In

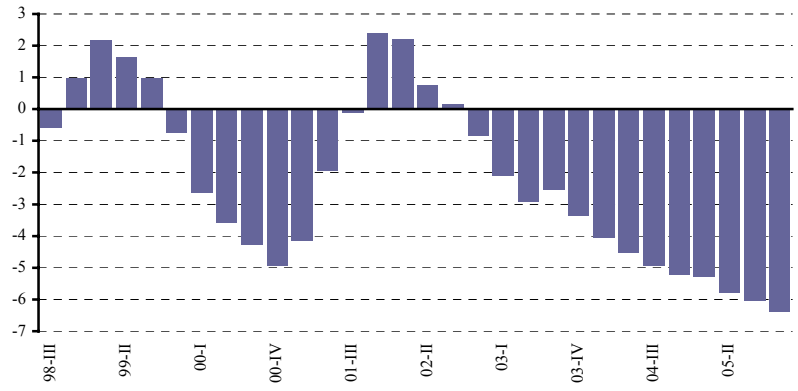
this perspective, the relationship between regular employment in the private sector, which has been accelerating since the second quarter of 2004, and food expenditures is significant (Graph 3.1.4).

To sum up, current indicators provide signals for the continuance of the strong course of domestic demand, although they do not signify an overheating for the first quarter of 2006 compared to the previous period, following the relative slowdown observed in the last quarter of 2005. Therefore, we maintain our view that the contribution of demand conditions to the disinflation process has decreased.

3.2. Foreign Demand

The current account deficit, which increased to USD 23.1 billion in 2005 from USD 15.6 billion in 2004, realized as 6.4 percent of the Gross National Product (GNP) (Graph 3.2.1). The upward trend in the current account deficit continued also in the first two months of 2006. Current account deficit was USD 5.9 billion in the first two months of 2006 while it was USD 3.7 billion in the same period of 2005.

Graph 3.2.1. Current Account Balance / GNP*
(Percent)

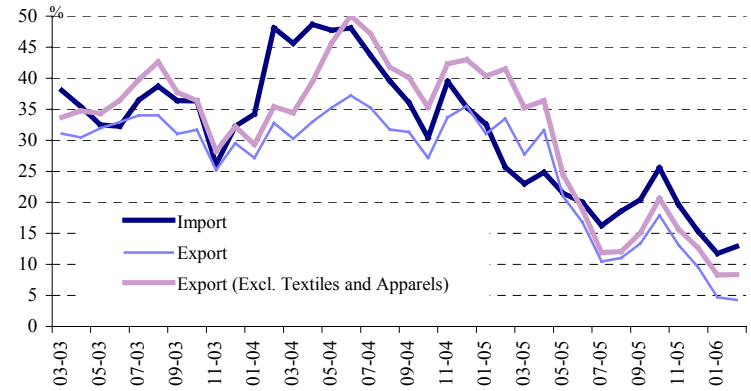


* According to annualized data.
Source: CBRT.

The rate of increase both in exports and imports lost its pace in 2005 compared to 2004, while the rate of increase in exports remained well below that of imports in the second half of the year (Graph 3.2.2). Meanwhile, the export performance of textiles and apparels sectors, which comprise a large

share in total exports, was below the overall export performance, and exports of these sectors started to decrease on an annual basis by November 2005. In the said sectors whose production is predominantly labor-intensive, price competition created by Far Eastern countries, particularly by China, whose production is based on the cheap labor force, put unfavorable pressure on export performance, production and employment, accordingly. The impact of price competition is expected to continue in the upcoming period.

Graph 3.2.2. Imports and Exports
(Billion USD, Annual Percentage Change)



* Quarterly moving averages
Source: TÜRKSTAT.

When the composition of imports is analyzed, the rate of increase in imports of intermediary goods, which makes up the largest share in total imports, exceeded that of investment and consumption goods in 2005. The increase in oil prices is believed to have played a significant role in this development. As a matter of fact, according to imports volume indices, the increase in imports of intermediary goods was considerably lower than the increase in imports of investment and consumption goods in 2005. In the second half of 2005, in terms of both current prices and volume indices, annual rates of growth in imports of investment and consumption goods increased, while the rate of growth in imports of intermediary goods slowed down. Along with the strong position of the New Turkish lira, the decrease in import prices in the said goods has been also influential in the increase in imports of investment and consumption goods. The shift observed in the composition of imports as of the second half of 2005 continued in the first two months of 2006. During this period, imports of consumption and investment goods increased by 43.9 percent and 26 percent, respectively, while the rate of increase in imports of intermediary goods remained at 8.3 percent. Seasonally adjusted data also

signify a slowdown in imports of intermediary goods.[2] The continuance of high increases in imports of investment goods is significant in terms of the sustainability of the rapid economic growth in the medium and long term. Meanwhile, the high rated increases in imports of consumption goods, resulting from relative price advantage and contribution of low base of the beginning of 2005, are closely monitored in terms of the sustainability of the current account deficit and growth, even though the increase in the consumption goods imports support the disinflation process in the short term.

When the capital and financial accounts of the balance of payments are analyzed, it is observed that foreign direct investments, which were registered as USD 2 billion in 2004, reached USD 8.6 billion – 2.4 percent of the GDP – in 2005, thanks to the increase in the pace of privatizations. In addition, the increase in the share of long-term credits in the credit composition of the banking sector and private sector helps allay concerns about the sustainability of the current account deficit. With the continuance of privatization revenues and company acquisitions, foreign direct investments are expected to prevail at their high level in 2006 as well. It is believed that the process of convergence with the European Union (EU) will maintain the interest of international capital in making investments in Turkey. In the meantime, although significant changes have been made in the regulation concerning the improvement of the investment environment in order to attract foreign direct investment, especially for the establishment of new production units, the need for improving the implementation processes remains.

The current account deficit is not expected to create any pressure in terms of economic stability and the inflation target in the short term. It is believed that the increase in imports of consumption goods results from relative price changes and thus does not lead to any demand-based inflationary pressure. Moreover, the implementation of tight fiscal policy without compromise and the ongoing process of privatization alleviate concerns about the sustainability of the current account deficit.

[2] It is believed that the slowdown in imports of intermediary goods can be attributed to the decline in industrial production due to unfavorable weather conditions in January.

3.3. Costs

According to the results of the "Manufacturing Industry Workers, Working Hours in Production and Partial Productivity Index" prepared by the TURKSTAT, employment in the manufacturing industry decreased by 1.1 percent in the last quarter of 2005 compared to the same period of the previous year (Table 3.3.1). Rapid decline in the employment of the public manufacturing industry also continued in this period. In the private manufacturing industry, the unfavorable course in the textile and apparel sectors, whose production decreased on an annual basis, also affected employment in these sectors. Excluding the above-mentioned sectors, which have a share of 34.3 percent in the manufacturing industry employment as of the last quarter of 2004, employment in the private manufacturing industry increased by 2.3 percent in the last quarter of 2005.

Table 3.3.1. Employment, Real Wage and Productivity Developments in Manufacturing Industry
(Percentage Change Compared to the Same Period of the Previous Year)

	2004					2005				
	I	II	III	IV	Annual	I	II	III	IV	Annual
Employment(1)	0,7	2,7	2,2	2,2	2,0	1,9	-1,7	-1,8	-1,1	-0,7
Public	-13,6	-11,0	-9,6	-9,7	-11,0	-10,2	-7,1	-8,6	-7,2	-8,3
Private	2,4	4,5	3,7	3,6	3,6	3,2	-1,2	-1,1	-0,4	0,1
Wage(2)	0,2	5,1	3,4	1,6	2,5	3,2	2,1	1,6	0,7	1,9
Public	2,9	7,7	5,6	2,9	4,7	8,7	5,4	9,0	8,4	7,9
Private	2,5	7,5	5,3	3,9	4,8	3,5	2,0	1,0	-0,1	1,6
Productivity(3)	8,5	13,6	6,4	1,6	7,3	5,1	4,3	6,1	8,4	6,0
Public	14,8	13,1	5,6	8,5	10,5	7,0	11,8	15,5	9,8	10,9
Private	9,0	15,0	7,6	1,2	8,0	6,1	3,5	5,2	8,8	5,9
Earning(4)	-0,6	3,7	1,5	-0,5	1,3	2,8	2,7	2,5	0,8	2,2
Public	-0,6	9,2	1,2	2,5	3,2	10,6	3,5	8,8	3,0	6,3
Private	2,6	5,9	4,6	2,3	4,3	2,9	3,2	2,0	1,3	2,4

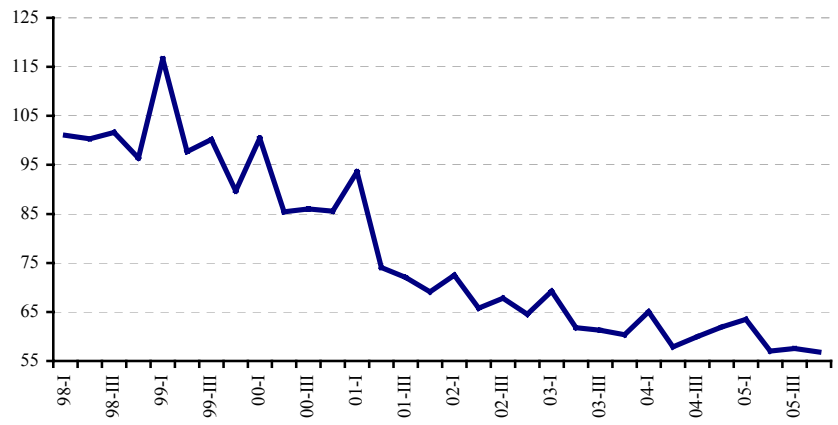
(1) The Index of Manufacturing Industry Production Workers, 1997=100.
(2) The Index of Real Wages Per Working Hour in Production , 1997=100.
(3) The Index of Partial Productivity Per Working Hour in Production, 1997=100.
(4) The Index of Real Earnings Per Production Worker, 1997=100.

Related to the continuance of the increase in manufacturing industry production, the index of the partial productivity per working hour increased by 8.4 percent in the last quarter of 2005. In the same period, real wages per working hour increased by 8.4 percent in the public manufacturing industry, while they decreased by 0.1 percent in the private manufacturing industry. While productivity in the private manufacturing industry increased at high rates, real unit wages decreased by 8.2 percent compared to the same period of the previous year, due to the slowdown in real wages (Graph 3.3.1). Real unit

wages preserved their favorable trend, and this is one of the main factors that supports the continuance of the disinflation process.

In 2006, it may be expected that productivity gains will continue as long as investments and employment in the manufacturing industry stay in line with the course of the previous period. On the other hand, as stated in the Inflation Report of January, increases planned in the salaries of civil servants and the minimum wages in 2006 indicate that wage increases may be higher than inflation rate. Therefore, it is anticipated that the contribution of real unit wages to the disinflation process will fall in 2006.

Graph 3.3.1. Real Unit Wages Index in Private Manufacturing Industry*
(1997=100)



* The total real wage index of TURKSTAT, which is formed by multiplying the TURKSTAT private manufacturing industry real wages index per production hours worked by TURKSTAT private manufacturing industry production hours, is divided by the TURKSTAT quarterly private manufacturing industry production index. In other words, the unit real wage index is the ratio of real wages to partial labor productivity.

Source: TURKSTAT, SPO and CBRT.

Rapid increases in raw material prices observed in international markets in 2005 also continued in the first quarter of 2006. The downward trend in commodity prices observed in the last quarter of 2005 due to decreases in crude oil prices was interrupted in the first quarter of 2006. In international markets, the upward trend observed in crude oil prices between December 20 – January 30 reversed to a slightly downward trend starting from this date. However, following the return of the upward trend as of March 22, crude oil prices surpassed even the record-high levels observed during Hurricane Katrina and reached USD 70.2 per barrel as of April 13. Low levels of idle capacity in the sector, increased demand due to high global growth, uncertainties about major

oil producing countries such as Nigeria and Iran, interruptions in production and unfavorable expectations thereof became the most significant factors that increased crude oil prices. In its regular meeting dated March 8, the Organization of the Petroleum Exporting Countries (OPEC) decided to keep its production quota at 28 million per barrel/day. In the announcement made by OPEC, it was stated that the markets were sufficiently supplied and a certain price level acceptable for both consumers and producers should be preserved, while it was pledged that this tendency will be maintained. The International Energy Agency (IEA) has reduced expectations of demand growth for 2006 to a certain level. Nevertheless, the fact that the expectation of the growth rate is above that of 2005 strengthens the possibility that oil prices will maintain their high levels throughout 2006, despite new capacity facilities that are expected to be implemented within this year.

The upward trend in the international metal prices continued in a strong manner in the first quarter of the year. The high global growth trend exerts upward pressure on metal prices, while the increased interest in investment funds towards the sector's investment instruments leads to an increase in metal prices beyond expectations. The imports unit value index, which increased in 2005 due to increases in oil and metal prices, maintains its upward trend in the first quarter of 2006. As a consequence, it is anticipated that the likelihood of the continuance of the unfavorable effects of oil and metal prices on inflation in 2006 increased .

Table 3.3.2. Indicators Related to Raw Material Prices

	2004	2005					2006
	Annual	I	II	III	IV	Annual	I
Import Unit Value Index	116.0	125.2	124.5	122.9	123.7	124.1	127.5
Crude Oil Prices ($/barrel, Brent)	38.4	47.6	51.6	61.6	56.9	54.4	61.9
IMF Commodity Price Index	134.6	151.5	162.1	182.2	177.9	168.4	190.4
Energy Prices Sub-Index	134.5	162.1	177.8	208.5	199.2	186.9	212.0
Metal Prices Index	135.3	161.5	163.5	168.2	184.1	169.3	208.1

*Data for the first quarter of 2006 include January and February.
Source: IFS, TURKSTAT, Bloomberg.

BOX 3.1. RELATIVE PRICE DIFFERENTIATION, PRODUCTIVITY AND THE REAL EXCHANGE RATE

According to the "purchasing power parity" approach that frequently comes up in economics literature, any deviations from the long-term equilibrium value – which expresses a constant level – of the ratio of domestic prices to prices abroad (the real exchange rate) are of a temporary nature. However, alternative approaches suggest that the long-term equilibrium value of the real exchange rate may change in time and thus, the deviations from the purchasing power parity may be permanent. Factors such as changes in the terms of trade, the economy's level of integration with the world, transportation costs, non-competitive market structure, the presence of nontradable goods and capital movements are some of the economic explanations of the said deviations. In explaining the movements of the real exchange rate in a certain direction for long periods, the experiences of developing countries in the process of convergence with the EU bring to the forefront the price differentiation between tradable and nontradable goods. In the Turkish economy, which is also in this category, the fact that the appreciation trend of the New Turkish lira in recent years and the price differentiation between tradable and nontradable goods are observed simultaneously points to the necessity of a closer analysis of the relation between the said relative price differentiation and the real exchange rate.

Balassa-Samuelson Effect

Balassa-Samuelson effect is at the top of the list of economics literature explaining the price differentiation between tradable and nontradable goods and real exchange rate behavior. This concept, introduced by Balassa (1964) and Samuelson (1964), suggests that a differentiation at international level between the relative rates of productivity of the tradables and nontradables sectors may cause structural and permanent deviations from the purchasing power parity. According to this, comparatively lower levels of productivity increases in the nontradables sectors, which have relatively more labor-intensive production processes, lead to appreciation of the real exchange rate. In other words, when relative productivity increases in the tradables sectors of a country are higher, compared to those of foreign countries subject to the real exchange rate index, the domestic currency of that country appreciates in real terms. Decomposing the real exchange rate into its basic components will allow this effect to be better understood.

According to the standard notation, the percentage change of the real exchange rate is equal to the sum of the percentage change of the nominal exchange rate and the difference between countries' rates of inflation (Equation 1).[1] In the equation, $\dot{q}$ and $\dot{e}$ (foreign currency / domestic currency) denote the growth rates of real and nominal exchange rates, while $\dot{p}$ and $\dot{p}^*$ stand for the rates of inflation at home and abroad, respectively. The real exchange rate for the tradables sector ($\dot{q}_T$) will be calculated by using the rate of inflation for that sector ($\dot{p}_T$ *ve* $\dot{p}_T^*$) (Equation 2). By calculating the difference between the two equations, changes in the real exchange rates can be defined in terms of changes in the real exchange rates of the tradables sectors and

[1] Lowercase characters, marked with a dot denote the rate of growth for the related variable. Increase in the nominal exchange rate points to tendency to appreciate. In the equations, T denotes tradables sector; N denotes nontradables sector; * denotes foreign country. In this analysis, the Euro zone is chosen as the foreign country.

changes in the relative price differentiation of the two countries (Equation 3). For the relative inflation rate in the equation to be expressed in terms of tradable and nontradable goods, the overall rates of inflation should be recorded as the weighted averages of the rates of the price increases in the tradables and nontradables sectors (Equations 4-6).[2] Finally, equation 7 is derived by placing the equalities (5) and (6) in Equation 3.[3]

(1) $\dot{q} = \dot{e} + \dot{p} - \dot{p}^*$

(2) $\dot{q}_T = \dot{e} + \dot{p}_T - \dot{p}_T^*$

(3) $\dot{q} = \dot{q}_T + \left[(\dot{p} - \dot{p}_T) - (\dot{p}^* - \dot{p}_T^*)\right]$

(4) $\dot{p} = \gamma \dot{p}_T + (1-\gamma)\dot{p}_N$

(5) $\dot{p} = \dot{p}_T + (1-\gamma)(\dot{p}_N - \dot{p}_T)$

(6) $\dot{p}^* = \dot{p}_T^* + (1-\gamma)(\dot{p}_N^* - \dot{p}_T^*)$

(7) $\dot{q} = \dot{q}_T + (1-\gamma)\left[(\dot{p}_N - \dot{p}_T) - (\dot{p}_N^* - \dot{p}_T^*)\right]$

According to this, the change in the real exchange rate stemmed from two different sources (Equation 7): The first one reflects the changes in real exchange rates for the tradables ($\dot{q}_T$)[4], whereas the other component expresses cross-country differences in relative price changes that also include the Balassa-Samuelson effect.

According to the Balassa-Samuelson effect; in developing countries that experience a structural transformation process, productivity increases in the tradables sectors tend to be faster, compared to the nontradables sectors - such as that of services. Relatively faster productivity increases in the tradables sectors cause real wages in these sectors to go up. Wage increases in the tradables sectors will take place in line with developments in productivity, and hence bring about no change in unit labor costs. The reflection on the overall economy of these wage increases also calls for wage increases in the nontradables sectors such as that of services. However, wage increases that spread to the overall economy would imply an increase beyond the gains in productivity in the case of the nontradables sectors and would cause unit labor costs and prices to go up in these sectors. This would mean an increase in the relative prices of the nontradables sectors – within the framework of Equation 7 –, resulting in the appreciation of the real exchange rate. In other words, price increases in the nontradables sectors would lead to an appreciation of the real exchange rate, by causing the general price level to go up.

[2] The coefficients γ and γ^* used in the equations represent the share of prices in the domestic and foreign tradable sectors within the general price index.

[3] $(\gamma - \gamma^*)(p_N^* - p_T^*)$, which is the last component to give rise to changes in the real exchange rate, was neither shown in Equation 7, nor included in the analysis, at this stage. In cases where there is more than one tradable good and/or there is discrepancy in the consumption basket across countries, the said component may be a determinant of the change in the real exchange rate.

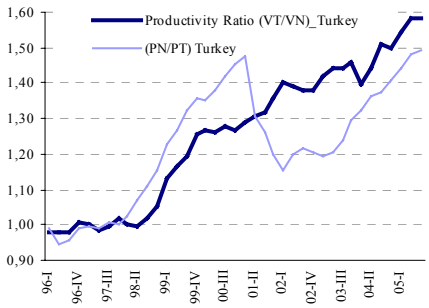
[4] This component, which is theoretically a source of the changes in the real exchange rate, realizes different from zero, due to deviations from the "Law of One Price" across countries, in the case of tradable goods. Discussing the reasons of these deviations is the subject of another analysis.

Productivity Increases in Turkey and Relative Price Differentiation

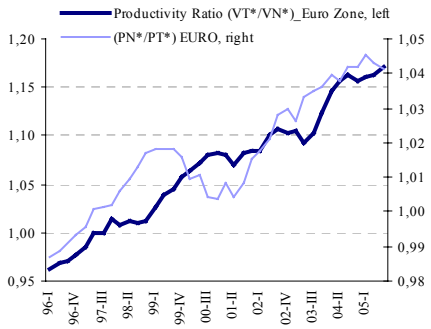
Especially in the case of other developing countries in the process of convergence with the EU, and in Turkey's economy as well, the national currency has displayed a tendency of appreciation in recent years. The mechanism explained above shows that high increases in productivity contribute to this process. As can be seen from Box 3.1. Graph 1, the role of relative productivity increases may be significant in the price differentiation between the tradables and nontradables sectors. Although this relationship seemed to have been broken off with the effect of the 2001 crisis that hit the Turkish economy, differences in productivity and relative price differences appear to have been moving together recently. In conclusion, productivity increases and the differentiation in price increases in the tradable and nontradable goods are among the factors shaping the development of the real exchange rate in Turkey in recent years.[5].

Box 3.1. Graph 1
Differences in the Productivity of Tradable and Nontradable Sectors and Relative Prices

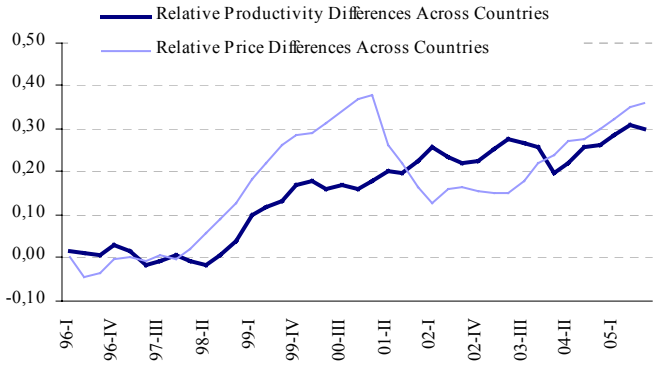
Graph 1.a: Turkey



Graph 1.b: Euro Zone



Graph 1.c: Relative Productivity and Relative Price Differences in Turkey and the Euro Zone



Source: ECB, CBRT and TURKSTAT.

[5] The classification of goods and services was used as an indicator for the tradables and nontradables sectors. A similar classification was used for the foreign country, as well.

At this point, it would be useful to explore the source of the productivity increase of recent years. Certainly, the ongoing structural reforms – being launched since the 2001 crisis – and the increasing role of the private sector in the economy reinforce productivity increases directly. Besides, the capital inflows supported by the confidence environment established as a result of the decisive implementation of the economic policies in recent years on the one hand and the international liquidity conditions on the other hand are believed to have a role in the productivity increase. Indeed, these factors also play a crucial role in the continuing strong position of the national currency. The strong course of the national currency – by reducing the relative prices of imported capital goods as compared to other input components – encourages investment expenditures and, this, in turn, brings about capital deepening and thus supports increases in partial labor productivity in tradable sectors. To conclude; within the framework of the Balassa-Samuelson effect, comparatively faster price increases occur in the nontradables sectors, and this, in turn, contributes to the real appreciation of the national currency. In other words, besides the direct effect of structural reforms, the established environment of confidence and macroeconomic stability of recent years also indirectly support the strong stance of the national currency in structural terms, via the relative price differentiation between tradable and nontradable goods.

Other Factors Leading to Relative Price Differentiation

Increases in productivity are not the only factor that explains the price differentiation in the tradables and nontradables sectors. The factors that come to the forefront in the case of Turkey are; nominal appreciation in the New Turkish lira, rigidities in the pricing behavior observed in the services sector and the higher level of international competitiveness in recent years. Increasing capital inflows of the latest period have been exerting pressure on the New Turkish lira for nominal appreciation. This has been limiting price increases in the tradables sectors while it has no significant effect on the nontradables sectors (especially, that of services). Thus, nominal appreciation facilitates relative prices to change in favor of nontradable goods. Pricing rigidities (backward indexation behavior and in some sectors, noncompetitive market structure) observed in the nontradables sectors – in a disinflation environment – are other factors that contribute to the widening of the said difference. In addition to all these factors, international competitiveness – elevated in recent years by the low costs of labor in countries like China and India – limit price increases in the tradable goods sectors and reinforce the relative price differentiation.

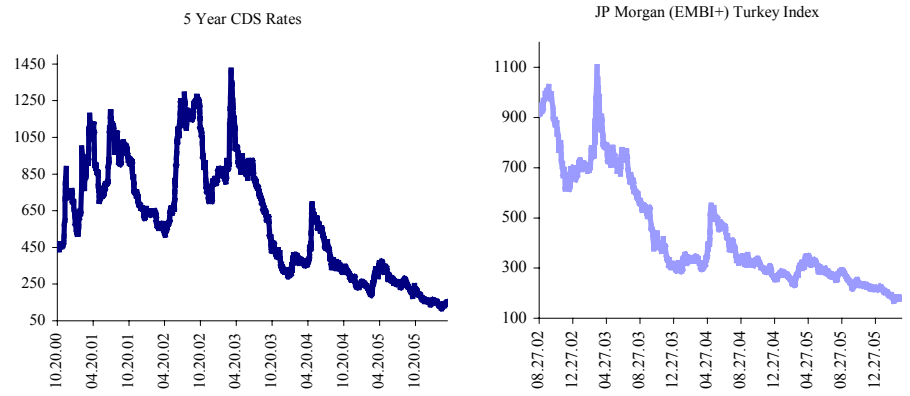
In conclusion; as foreseen in economics literature, in recent years a close relationship is being observed in the Turkish economy between the relative price differentiation in tradable and nontradable goods, and the increase in productivity. Within this context, it can be said, in the light of the analysis made above, that some part of the real appreciation of the New Turkish lira stemmed from the rapid increase in productivity in recent years. The strong stance of the New Turkish lira will continue to be supported via this channel, under the assumption that the increases in productivity would prevail in the upcoming real convergence process with the EU.

4.Financial Markets and Financial Intermediation

4.1. Financial Markets

The favorable course of the risk premium observed in the first two months of 2006 lost momentum, due to developments in March that are perceived to be unfavorable in Turkey and uncertainties in global liquidity conditions (Graph 4.1.1). Meanwhile, the fact that budget performance is sustained in a successful manner stands as the most significant development that restrained the deterioration in expectations. The unfavorable trend observed in international liquidity conditions since March results from uncertainties in the monetary policies of developed countries. BOJ announced that it planned to reduce the Japanese Yen liquidity in the markets due to the recent upward trends both in growth and inflation. While the increases in short-term interest rates in the USA were expected to remain around five percent at the start of the year, recent growth and inflation data have strengthened the perceptions that the increases in interest rates might surpass the expectations at the start of the year.

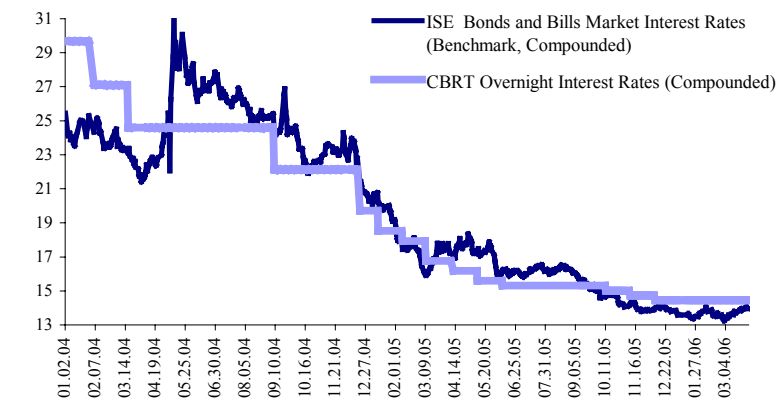
Graph 4.1.1. Indicators of Risk Premium



Source: Bloomberg.

In all its three Monetary Policy Committee (MPC) meetings held in 2006, the CBRT kept its policy interest rate at 13.5 percent. The benchmark interest rate determined in the Istanbul Stock Exchange (ISE) Bills and Bonds Market, which has been below the overnight funding rate since October 2005, increased in March due to the interruption in interest rate cuts, global liquidity conditions and uncertainties in Turkey (Graph 4.1.2).

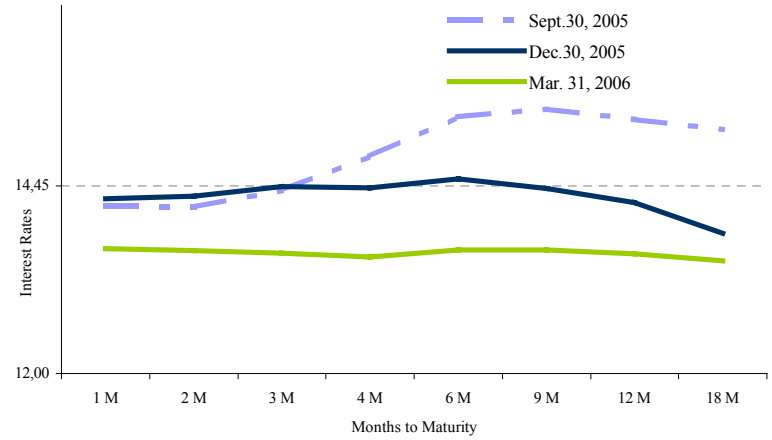
Graph 4.1.2. Interest Rate Developments
(Compound, Percent)



Source: ISE, CBRT.

Interest rates determined in the ISE were lower for all maturities by the end of the first quarter of 2006, compared to end-2005 (Graph 4.1.3). The expectation that the downward trend in inflation will continue in 2006 was influential in this development. Meanwhile, the longer-term end of yield curves followed a more horizontal course compared to previous periods, which confirms that economic units assumed a cautious stance in their forward-looking risk perceptions during this period.

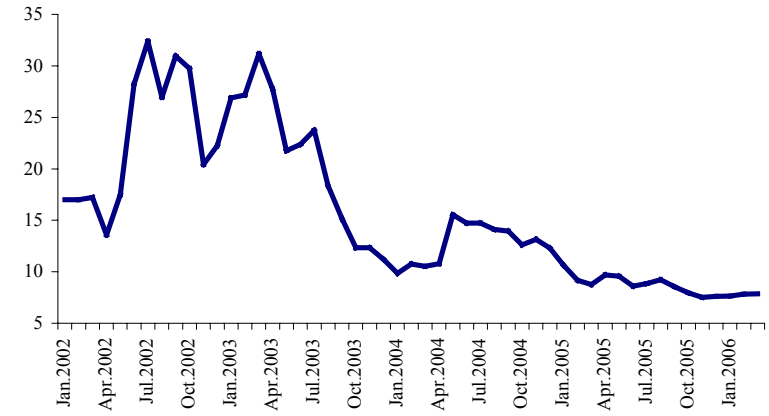
Graph 4.1.3. Yield Curves



Source: ISE.

The benchmark security interest rates and real interest rates calculated according to the twelve-month inflation expectations derived from the CBRT Expectations Survey did not increase in the first quarter of the year (Graph 4.1.4).

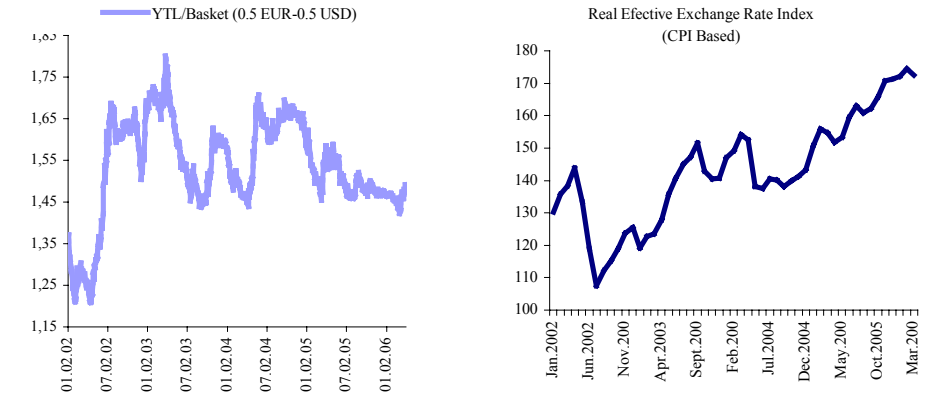
Graph 4.1.4. Real Interest Rate Developments
Real Interest (According to the ISE Benchmark Interest Rate and 12-month Inflation Expectations)



Source: ISE, CBRT.

In the first two months of 2006, the appreciation trend of the New Turkish lira continued. However, the New Turkish lira depreciated against the Euro – USD basket in March due to the increase in the risk premium (Graph 4.1.5).

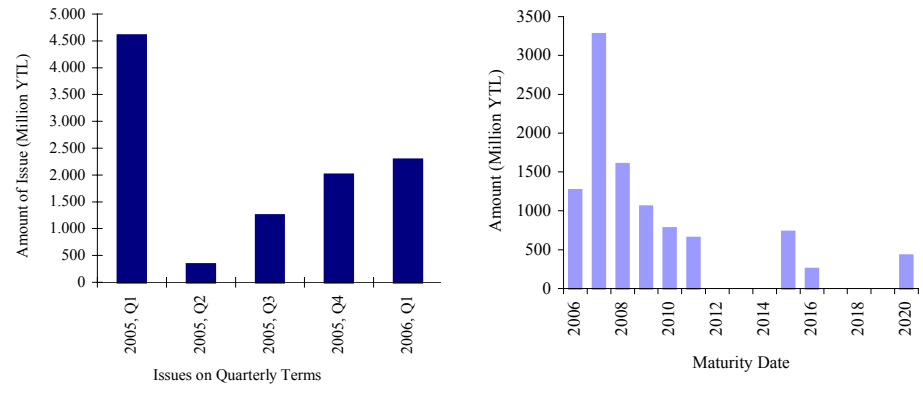
Graph 4.1.5. Exchange Rate Developments



Source: CBRT.

Meanwhile, the New Turkish lira denominated bonds issued by foreign banks, which constitute an indicator of the foreign demand for the New Turkish lira, increased in the first quarter of 2006 compared to the last quarter of 2005 (Graph 4.1.6). The issue amount was very low in the first quarter of 2006 compared to the same period of the previous year. Nevertheless, taking into account the fact that the high amount observed at the beginning of 2005 included pent up demand up to that time, it is believed that the stability in the amount of issue will continue. In the first quarter of 2006, no significant changes were observed in the maturity structure of the available securities compared to the last quarter of 2005.

Graph 4.1.6. New Turkish Lira-Denominated Bonds Issued by Foreign Banks



Source: CBRT.

4.2. Financial Intermediation and Credits

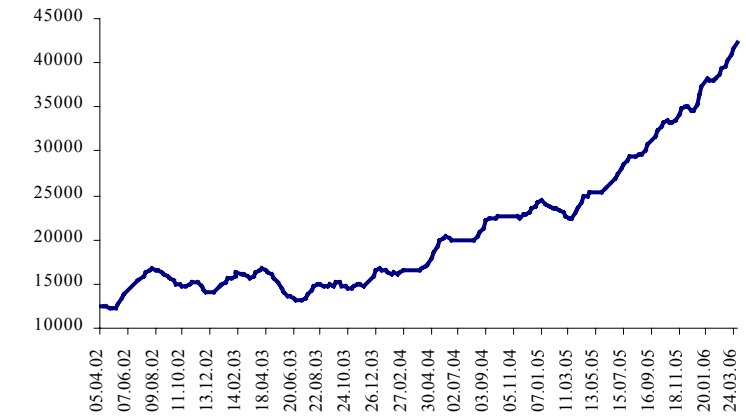
The environment of confidence formed as a result of the restructuring of the financial system and the establishment of macroeconomic stability favorably influenced the expectations of the banking system and of individuals, and led to maturity extensions in financial agreements as well as an increase in the amounts subject to the agreement. One of the impacts of this development has been the ongoing expansion in credits (Graph 4.2.1). While this process increases the risks taken on by banks and households on the one hand, it reinforces the growth potential of the country and contributes to financial deepening on the other hand. In this way, the effectiveness of the financial sector in the monetary policy transmission mechanism increases. The Central Bank evaluates these effects as a whole and closely monitors credit developments that follow a course consistent with its projections.

Graph 4.2.1. Credits Extended to the Real Sector/GNP*
(Percentage)

* Credits extended to the real sector are composed of consumer loans and credits extended to firms. Estimate figures are used for GNP 2006-Q1.
Source: CBRT.

The excess liquidity, which has emerged along with the restructuring of the financial system and has supported the credit supply until now, displayed an increase in the first quarter of 2006, as well. The main factors that led to excess liquidity include FX buying auctions and interventions, increasing foreign interest that exhibits itself in purchases and partnerships, the downward trend of the Treasury's roll-over ratio, and the fact that decreasing country risk has enhanced the foreign borrowing conditions of banks (Graph 4.2.2). On condition that these factors maintain their current trends, it is expected that excess liquidity will not change in the upcoming period, as well. Furthermore, as the Housing Finance Bill, which is pending becoming a law, enables the formation of a secondary market in favor of securities that are financed by mortgages, it is a potential source of funds for the financial system and it strengthens the expectations about the continuation of excess liquidity in the medium term. All these developments support the upward trend of credits.

Graph 4.2.2. Banks' Debt to Banks Abroad*
(Million USD)



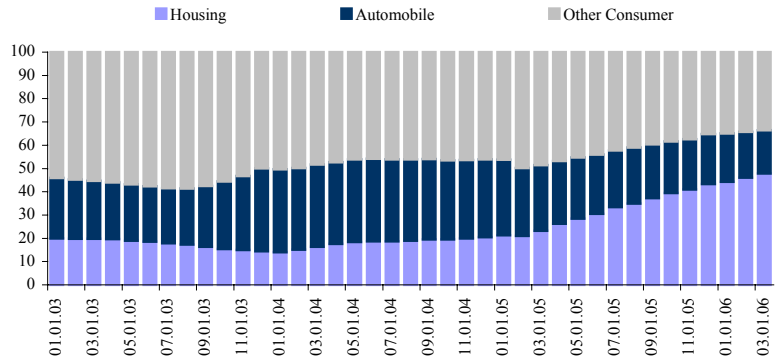
*4-week moving average is used.

Source: BRSA.

Considering recent developments in credits, it is observed that the upward trend of consumer loans continues, while the credits extended to firms are on a slower but stable track. Meanwhile, it is noted that the annual real rate of increase of automobile and other consumer loans has gained stability. In the first quarter of 2006, consumer loans increased by 17.2 percent in real terms. 12.7 percentage points of this increase stemmed from housing loans (Graph 4.2.3).

It is anticipated that housing loans will continue to increase for a while due to the Housing Finance Bill that is pending becoming a law and convergence with the EU. Hence, the housing loan/national income ratio, which is 2.5 percent at present, is expected to converge to the level of developed countries in the long-run. This assertion is especially supported by the fact that the EU process triggered the increase in housing loans in all candidate countries.

Graph 4.2.3. Distribution of Consumer Loans
(Percentage)



* Source: CBRT

Rapid credit expansion is monitored carefully in relation to affordability, financial stability and due to its impact on housing prices, as to price stability. The pressure on prices is expected to be relieved by the fact that housing supply accompanies housing demand in the country. Meanwhile, the abolishment of the Resource Utilization Support Fund (RUSF), which was used in the refinancing of credits, is expected to facilitate household repayments.

5. Public Finance

Budget figures for 2005, and those for the central government so far realized in 2006 and medium-term budget targets indicate that determination toward the sustainability of fiscal discipline is maintained. In this period, parallel to the fiscal discipline, public debt management is carried out in line with the objective of reducing borrowing costs at reasonable risk levels. Moreover, tight fiscal policy implies that public sector balance is not a factor widening the current account deficit and thus serves as a policy tool for controlling the concerns related to the current account sustainability. Nevertheless, the budget still has some structural fragilities that can be eliminated by carrying out the current reforms in public finance.

The ongoing fiscal policy contributes to the establishment of a stable environment and supports the private sector-originated growth, as stated in previous reports. The rate of increase of domestic debt stock, which slowed down and remained below that of banks' liabilities, support private consumption and investment expenditures indirectly through increasing the credit volume extended by banks to the private sector. The Treasury's borrowing strategy for 2006 indicates that the slow down observed in the rate of increase of domestic debt will continue in 2006, as well. Therefore, the support of fiscal policy on credit supply expansion is expected to continue.

5.1. Budget Developments

In 2006, the consolidated budget system was abolished and the central government budget system was put into practice. In the January-March period, the central government budget performance has been favorable. As of March, the primary budget surplus, excluding the shares of local government and funds, was realized as approximately 28.6 percent of the end-year target. The high level of non-tax revenues has contributed to this favorable outcome (Table 5.1.1).[1] The main factor behind the rapid growth in non-tax revenues was the cash surplus amounting to YTL 1.4 billion that was transferred to the budget from Turk Telecommunications Inc. (TELEKOM) in January.

[1] In the framework of budget practice and pursuant legal provisions, local governments are given a share of the general budgetary tax revenues. In the framework of the former system, general budgetary tax revenues were announced by excluding the shares reserved for local governments and funds. As of 2006, in the scope of the new reporting system, tax revenues are displayed in gross figures. However, during their transfer to local governments and funds, the shares that are separated from tax revenues are registered as expenditure to the budget. As the registration takes place during the transfer, the registration of the shares of the local government and funds as "expenditure" may shift to the following months. Therefore, the primary budget balance decreases when it is calculated by excluding the shares of local governments and funds (Table 5.1.1).

Although the overall budget performance was favorable in the January-March period, the realizations of health expenditures and transfers to social security institutions - relative to end-year appropriations - were high. The 2006 budget is prepared according to the projection that transfers to social security institutions will decline with respect to the GNP. In this framework, a number of measures were devised in order to curb health expenditures[2] and enhance premium collections.[3] The law regarding the amelioration of premium collections came into effect in March. Therefore, the mentioned law is expected to show its effect in the upcoming period. Meanwhile, the tendency in health expenditures and its reflection on the expenditures of social security institutions will be observed in the months ahead.

Table 5.1.1. Central Government Budget Aggregates (Million YTL)

	Jan-March	2006 Target (YTL Million))	2006 Target(As a share of GNP)*	Jan.-March Realization/ Budget Target (%)
Expenditure	39.375	174.322	32,2	22,6
Non-Interest Expenditure	28.093	128.062	23,7	21,9
Personnel	8.940	36.021	6,7	24,8
Gov. Premiums to Social Security Agen.	1.214	4.975	0,9	24,4
Goods and Services Procurements	2.639	17.721	3,3	14,9
Current transfer	13.139	49.108	9,1	26,8
Capital expenses	999	12.452	2,3	8,0
Capital transfer	320	1.834	0,3	17,4
Liability	843	4.256	0,8	19,8
Appropriation	-	1.695	0,3	0,0
Interest Payment	11.282	46.260	8,5	24,4
Revenues	38.325	160.326	29,6	23,9
General Budget Revenues	37.788	156.214	28,9	24,2
Tax Revenues	31.251	132.199	24,4	23,6
Non-Tax Revenues	6.235	21.372	3,9	29,2
Capital Revenues	95	2.269	0,4	4,2
Special Revenues and Grants and Aid	207	374	0,1	55,3
Revenues from Special Budget Institutions	475	2.963	0,5	16,0
Revenues from Regularity & Supervisory Institutions	62	1.149	0,2	5,4
Budget Balance	**(1.050)**	**(13.996)**	**-2,6**	**7,5**
Primary Balance	**10.232**	**32.264**	**6,0**	**31,7**
Budget Balance (Excl. Shares of Local Gov. and Funds)**	**(2.057)**	**(13.996)**	**-2,6**	**14,7**
Primary Balance (Excl. Shares of Local Gov. and Funds)**	**9.225**	**32.264**	**6,0**	**28,6**

Source: Ministry of Finance

*Figures related to the increase in GNP are taken from the SPO Program 2006.
**Revenues shares of local governments and funds, which were not registered as expenditures in the budget, are excluded from the primary budget balance.

[2] As stated in the letter of intent dated 24 November 2005, a global budget is prepared with the aim of curbing health expenditures. This global budget set the upper limit of total payments made by social security institutions to state hospitals.

[3] The "Law Regarding the Establishment of Social Security Premium Receivables and Related Amendments", which provides a legal framework for the implementations related to the amelioration of premium collections, was published on 4 March 2006 in the Official Gazette and came into effect on the same date. With this law, the aim is to encourage debtors to pay premiums on a regular basis and to reduce the debt to a payable level. In this framework, the aim is to collect institutions' unpaid receivables via restructuring of the receivables, prevent new unpaid debt and enable institutions to carry out a better follow-up during the collection of their social security premium receivables.

In 2006, legal regulations regarding income and value added tax are put into effect. In March, the VAT rate of textile and ready-wear sectors as well as that of leather and leather products were cut pursuant to the Council of Ministers Decree No.2006/10138. It is stated that the revenue loss, which may occur as a result of the said implementation, will be met by the decline in VAT refunds. Moreover, it is projected to modify the framework of corporate tax by reducing the tax rate and gradually abolishing the implementations of tax abatement and tax exemption. In the framework of the new corporate tax system[4] that is planned to take effect as of 1 January 2006, the revenue loss, which is to occur due to the reduction of the tax rate, is expected to be compensated partially by the abolishment of tax abatement system for investment.

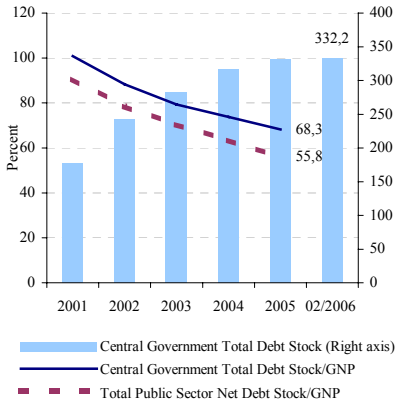
In conclusion, the tax regulations, which were not taken into consideration during the preparation of the 2006 budget, and any failure to control the transfers to social security institutions via said policies may create the need to take measures in the budget in the upcoming period. It should be noted that resorting to indirect taxes to cover shortfalls in the budget, which may arise from the above-mentioned implementations might pose risks to the end-year inflation target. In fact, unfavorable effects on inflation of the increase in special consumption tax, which has a significant share in tax revenues, were observed in the previous period.

5.2. Developments in Debt Stock

In 2005, as a result of the decline in interest payments and high primary surplus, the rate of increase of the debt stock slowed down remarkably and the public debt stock to GNP ratio maintained its downward trend. As of February 2006, the central government debt stock, which has a large share in the total public debt stock, displayed only a limited increase compared to end-2005 (Graph 5.2.1).

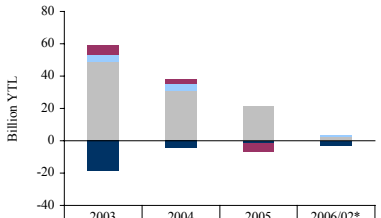
[4] The Corporate Tax Bill that was sent to the Grand National Assembly on 8 February 2006 is being evaluated by the Planning and Budget Commission and it has not been passed yet.

Graph 5.2.1.Public Debt Stock Indicators (Billion YTL)



Source: Undersecretariat of Treasury

Analysis of the Change in Central Government Total Debt Stock



	2003	2004	2005	2006/02*
Parity Effect**	6,2	3,0	-4,8	0,1
Exchange Rate Effect***	-18,8	-4,6	-0,8	-2,7
Foreign Debt Net Increase	4,0	4,1	-0,6	1,0
Domestic Debt Net Increase	48,8	31,2	21,1	2,3

Source: Undersecretariat of Treasury, CBRT

(*) Indicates change compared to 2005.

(**) Indicates changes deriving from USD/Euro and USD/SDR parities

(***) Includes changes deriving from the movements of YTL against USD

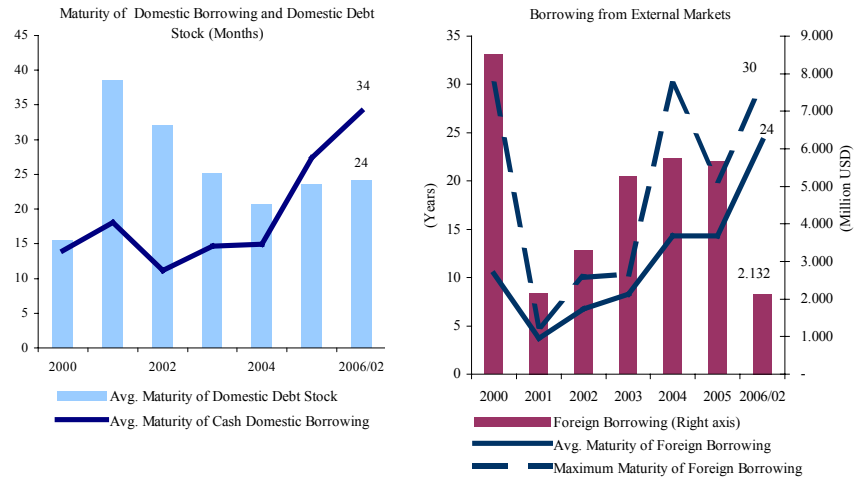
Note: Net debt exchange refers to the change that is excluded from the effects of exchange rates and parity.

Extension of the borrowing maturity and therefore, dispersion of debt service over longer time horizon reduces the roll-over risk. Parallel to the financing strategy that is set in line with strategic benchmarks[5], the maturity of the cash borrowing, which determines the maturity of the debt stock, was extended significantly in the first two months of 2006. The increase that was observed in the maturity of domestic borrowing was generally obtained via the issuance of coupon securities with five-year maturity. It is observed that this favorable development in borrowing conditions was reflected on the maturity of the cash debt stock, as well. Despite the extension of the maturity of cash debt stock, decrease in the maturity of non-cash debt stock, due to the lack of non-cash borrowing, limits the increase in the maturity of the total domestic debt stock.

In addition to domestic borrowing, long term borrowing tendency was also maintained in the external borrowing through bond issues. In the January-February 2006 period, two separate bond issues were realized in terms of US dollars and Euro (Graph 5.2.2).

[5] Strategic benchmarks are ; to keep the maturity of domestic borrowing above one year, to use fixed rate YTL denominated instruments as major source of domestic borrowing and to hold a considerable amount of cash reserves in order to reduce liquidity risk.

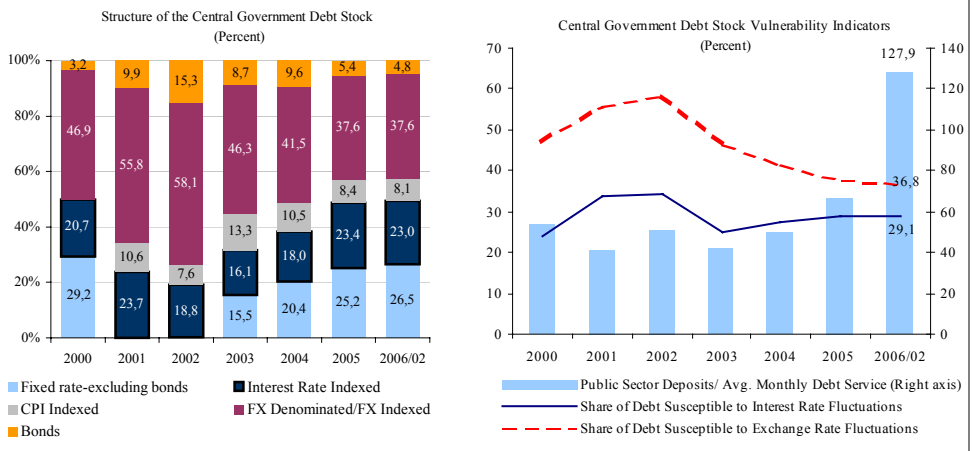
Graph 5.2.2. Maturity of the Borrowing Executed in Internal and External Markets



Source: Undersecretariat of Treasury, CBRT.

In February 2006, the share of the long-term fixed rate securities in the debt stock continued to grow. However, the share of discounted securities with a maturity of less than one year and that of CPI-indexed securities decreased. Moreover, due to the financing strategy that is applied to reduce liquidity risk, the public deposits coverage ratio of the monthly average debt service exceeded 100 percent (Graph 5.2.3).

Graph 5.2.3. Structure of the Central Government Debt Stock



Source: Undersecretariat of Treasury, CBRT.
(1) Debt stock susceptible to interest rate fluctuations comprise discounted securities with maturity less than 1 year and floating rate government securities.
(2) Debt stock susceptible to exchange rate comprise foreign debt stock and FX denominated and FX-indexed domestic debt stock.

In the framework of the financing strategy for 2006, the Treasury announced that it will continue to maintain net payer status regarding foreign debt, stop issuing FX-indexed securities in domestic markets and limit the FX-denominated domestic debt roll-over ratio to 80 percent. The mentioned strategy implies that the susceptibility of the debt stock to exchange rate movements will continue to decline. In 2006, each month, the Treasury will issue YTL-denominated government securities with both variable and fixed rates. These securities will be issued with coupon payments once in six months. The long maturity of these securities indicates that the upward trend of the maturity of the debt stock will continue. Furthermore, the fact that the issuance of long-term securities with fixed rates will continue regularly on a monthly basis indicates that the share of long-term fixed rate securities will continue to increase.

Achieving sustainability of debt stock requires curbing costs as well as reducing the risks associated with the debt stock. Therefore, the borrowing strategy of the Treasury and the structural change in the debt stock should be analyzed by considering the sensitivity of the debt stock to interest rate and exchange rate movements as well as the roll-over risk and costs. In an environment of declining interest rates, the strategy to be applied while extending the borrowing maturity entails cost and risk tradeoffs. The Treasury's focus on fixed-rate borrowing restrains the decline in borrowing costs, however reduces the sensitivity of the debt stock to interest rate movements. On the other hand, borrowing in terms of floating rate securities provides the opportunity to reduce costs but increases the interest rate sensitivity of the debt stock. Therefore, while trying to balance costs against risks, the share of floating rate securities might not display a downward trend in the upcoming period. When the borrowing strategy is evaluated in this framework, it is assumed that in 2005 the structure of the debt stock strengthened against risks.

6. Medium-term Projections

In this section, the updated assumptions regarding the fundamental macroeconomic variables will be presented in comparison with those included in the previous Inflation Report and the forecasts of inflation and output gap; which are made in line with these assumptions; will be analyzed. As the policy horizon is considered to be one-and-a half years as in the previous period, the forecasts are presented so as to cover the remaining three quarters of 2006 and the first three quarters of 2007. Furthermore, the potential risks, which may lead to a significant downward or upward deviation in the forecasts of inflation, are analyzed.

6.1. Current Stance, Short-term Outlook and the Assumptions

The set of assumptions that displays the medium-term outlook and provides a basis for the forecasts of inflation and output gap are handled in two groups: Assumptions regarding the "domestic economic activity" and the "external factors". The mentioned set of assumptions, is a compilation of the experts' opinions and the detailed analyses carried out in the other sections of this report. The assumptions that provided a basis for the forecasts of the previous Inflation Report are updated in light of the additions to the data set, most specifically the GNP figures of the last quarter of 2005.

The data related to economic activity; announced after the release of the first Inflation Report of 2006; has been consistent with the CBRT forecasts. In the last quarter of 2005, domestic final demand grew rapidly, however the aggregate demand for domestic goods remained relatively limited due to the negative impact of foreign demand. Moreover, due to the investment-originated growth and the ongoing rise in productivity, the increase in costs remained limited and the demand conditions did not exert a significant pressure on inflation. In light of these evaluations, our statements regarding the real sector variables; which provided a basis for the forecasts presented in the previous Inflation Report; are preserved in this report to a large extent.

One of the factors that led the pressure on inflation remain at low levels despite high growth rates, is the ongoing increase in the share of investment expenditures in GDP. This development has helped the demand pressure on inflation remain at low levels, by enhancing the production capacity. While

producing the forecasts, the short-term outlook of domestic supply-demand conditions is formed in light of these observations.

When the medium-term forecasts are produced, the outlook of the economy is such that, the New Turkish lira maintains its strong position and continues to support the decline in inflation under a scenario where the current program continues to be under implementation, macroeconomic and political stability does not deteriorate, structural reforms and accordingly, long-term capital inflows and productivity increases continue. On the other hand, real interests are deemed to be at a level that would not put pressure on credit rises and demand conditions. Within this context, when real interest and real exchange rate components are compiled, "monetary conditions index" is anticipated to contribute to the decline in inflation.

In the first Inflation Report of 2006, it was foreseen that the downward trend of inflation would come to a halt in the first quarter of the year but would start its downward course as of the second quarter of the year, in case no adverse external developments occur. In March, the VAT rate in the textile, clothing and leather sectors was reduced from 18 percent to 8 percent. While this development supports our anticipation that inflation would once again enter a downward trend in the second quarter, the lately observed rapid rises in oil prices necessitates a more careful consideration of the mentioned anticipation. This information is added to the scope of the short-term outlook, as well.

As to the attainability of the inflation target, in the upcoming period, price dynamics of the services sector will continue to assume its critical importance, which is mainly considered to be cyclical. Inflation in the services group continues to remain at high levels due to the relatively higher rates of productivity increases in the tradable sectors and the structural transformation period that the economy is going through. The forecasts are produced within a framework where as a result of the shortage of supply in the housing sector; which cannot be met in the short run; the related services items- especially the rent subgroup that already maintains a high trend- exert an additional cyclical pressure on consumer inflation throughout 2006 and this pressure continues throughout 2007, albeit with a gradual decline. The increases in the rent prices are expected to make an approximate contribution of 1 percentage point to 2006 inflation. Within this context, we keep the same stance towards services prices, which provided a basis for the forecasts provided in the Inflation Report of

January 2006. Therefore, price dynamics of the services sector continue to be one of the most critical factors regarding the attainability of the end-year inflation target.

Projections of the basic macroeconomic variables of the Euro zone, such as interest rates, inflation and growth; the assessments of international commodity prices (crude oil, main metal prices, etc.) and the detailed analysis of the potential effects of global liquidity conditions on financial markets constitute a quite important part of the forecasting period. Our assumptions about the foreign economy are updated in line with the realizations in the last quarter and the expectations regarding the upcoming period. The projections pertaining to the Euro zone have been quoted from the March 2006 "Consensus Forecast" results, which is a compilation of projections conducted by a large number of experts. In line with these projections, growth figures of the Euro zone have been revised upwards and it is assumed that EU Harmonized CPI inflation will be close to the targeted 2 percent level in 2006 and 2007.

On the other hand, with the 25-base-point-increase in March, the current level of interest rates of European Central Bank (ECB) became 2.5 percent. The fact that ECB may continue to increase its interest rates is taken into consideration while producing our inflation forecasts. In order to foresee global liquidity conditions, the monetary policies of the developed economies, besides the Euro zone, are also closely monitored while producing our forecasts.

Oil prices were assumed to be constant while producing the forecasts of the previous Inflation Report. However, after relative stability in the first two months of the year, crude oil prices re-entered an upward trend lately. As it is difficult to foresee the path that oil prices will follow, inflation forecasts are produced under the main scenario where the oil prices are assumed to maintain their current level. However, the current level of oil prices are far above its January 2006 level. For this reason, the projections of oil prices to be used in the forecasting process are revised upwards. The input costs of crude oil prices are expected to be effect inflation throughout 2006 and 2007.

Besides the assumptions that have been summarized until here, the course of the risk premium in 2006 and 2007, which is determined by domestic and external factors, is also important for the medium-term outlook. Because, the risk premium is one of the determining factors of inflation dynamics and

monetary policy via its interaction with exchange rates and long-term interest rates. In the Inflation Report of January 2006, it was foreseen that the decline in the risk premium is likely to continue under the main scenario where we do not experience any problems in the negotiations with the EU; fiscal discipline, structural reforms and privatizations continue and the global liquidity conditions favor developing countries. The global liquidity conditions and the risk premium were in favor of developing countries in the first two months. Although the global risk appetite started to decline and the uncertainty of the perceptions regarding the liquidity policy of BOJ increased in March, the forecasts presented in the last section of the Report are based on the assumption that the change in global liquidity conditions will be moderate and will not display a sudden change.

6.2. Interpreting the Forecasts

As it takes time for monetary policy decisions to influence the economy, monetary policy focuses on the consistency of future rates of inflation with targeted rates rather than the current rates. Within this framework, the Central Bank emphasized medium-term targets and announced to the public via various reports and announcements that no prompt reactions would be given to the temporary effects of exogenous shocks on inflation, which are not under the control of monetary policy, and that the policy reaction would be formed with a medium term perspective. Taking into account this medium-term perspective, forecasts have been produced for a period of one and a half years, which comprises the first three quarters of 2007.

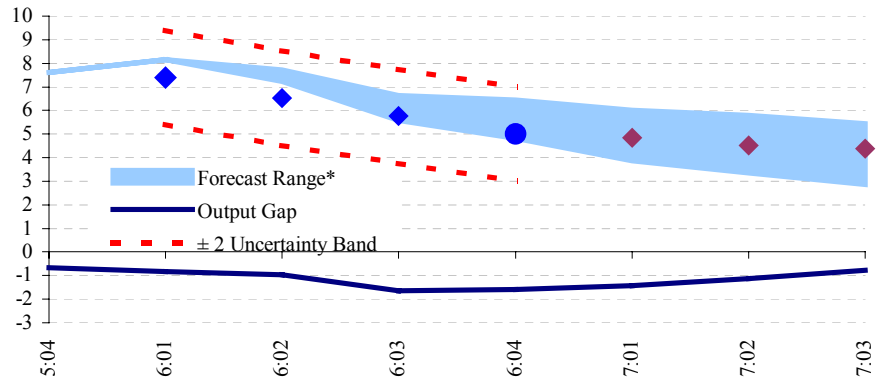
In the Inflation Report published in January 2006, it was estimated that the decline in inflation would temporarily come to a halt and float around 8 percent in the first quarter of the year. The annual rate of increase in consumer prices realized as 8.16 percent by the end of March 2006 therefore displayed an upward trend in the first quarter of the year, as it had been foreseen.

Under the baseline scenario which is formed on a basis of the assumptions presented in detail in Section 6.1 and the short-term outlook; under a monetary policy stance where the Central Bank continues to cut policy rates gradually, inflation is forecasted to be within 4.8– 6.4 percent range by the end of 2006 and within 2.9– 5.4 percent range by the end of the first nine months of 2007 (Graph 6.2.1). It should be carefully underlined here that the above

mentioned policy stance regarding the interest rates is formed in line with the current economic conditions and assumptions and the medium-term targets and it *is definitely not to be perceived as a commitment of the CBRT.* Therefore, this path is subject to change as economic conditions and assumptions that provide the basis for these forecasts change.

Under the above assessments and assumptions, it is projected that inflation will display a downward trend in the following one-and-a half year period which is defined as the average policy horizon of monetary policy. In other words, according to the forecasts made in light of the currently available information, inflation will enter a downward trend again as of the second quarter of the year, this trend will become more evident by the third quarter of the year and end-year inflation will realize very close to the target rate.

Graph 6.2.1. Inflation and Output Gap Forecasts



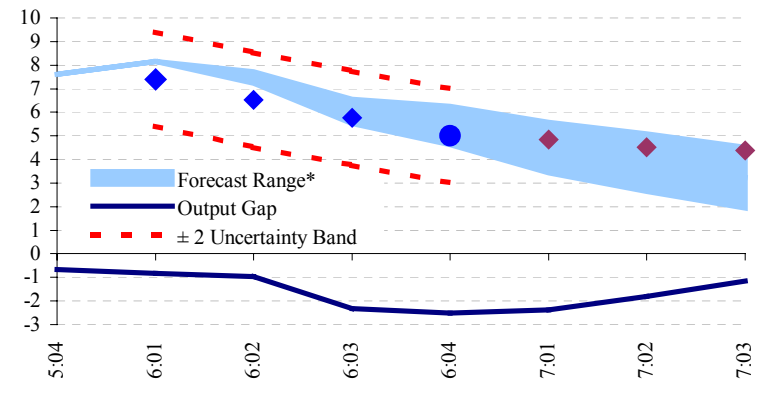
* The probability of inflation staying within the forecast range is 70 percent.
♦ The path "consistent with the target", which is announced in 5 December 2005 "General Framework of Inflation Targeting Regime and Monetary and Exchange Rate Policy" and constitutes the base for the principle of "accountability".
● 2006 end-year point target.
♦ The path consistent with the 2007 end-year target, under contemporary data set.

Graph 6.2.1 also presents output gap forecasts that lie behind the inflation forecasts. According to this, the output gap will remain negative throughout 2006. In other words, the demand and capacity conditions in the economy will continue to contribute to the downward trend in inflation in 2006, albeit at a lower level. To sum up, when the forecasts pertaining to the variables determining the demand and capacity conditions of the economy are evaluated together, it is foreseen that these conditions will support the decline in inflation in 2006, however, the support will be less compared to previous years.

In conclusion, when the analyses and forecasts in the Report are evaluated together, it can be stated that the probability of inflation staying above the target by end year 2006 is more than its probability staying below. However, it should be kept in mind that this is mainly due to high increases in oil and commodity prices and that the medium-term forecasts, which were produced under the assumption that these increases will be temporary, are in line with the target. A crucial point that should be emphasized once again is that the forecasts mentioned above are produced in light of the current data set with a medium-term perspective. Therefore, it should be borne in mind that all the assumptions that the forecasts are based on, are subject to change through time, and, in such a case, both the forecasts and the future monetary policy stance are subject to change, too.

Graph 6.2.2 presents forecasts that have been produced under a scenario where the current stance assessments, the short-term outlook and the projections of fundamental variables are preserved, but policy interests are kept constant for one year starting from today.

Graph 6.2.2. Inflation and Output Gap Forecasts (Constant Interest Rate)



* The probability of inflation staying within the forecast range is 70 percent.
♦ The path "consistent with the target", which is announced in 5 December 2005 "General Framework of Inflation Targeting Regime and Monetary and Exchange Rate Policy" and constitutes the base for the principle of "accountability".
● 2006 end-year point target.
♦ The path consistent with the 2007 end-year target, under contemporary data set.

Contrary to the previous one, in this scenario, the path of policy rates is not obtained within a medium-term perspective, but it is purely considered as an exogenous assumption. Under this assumption, the output gap gets significantly negative as of the third quarter of 2006 and the contribution of the demand conditions to the downward trend in inflation increases. According to

these forecasts, inflation declines more rapidly compared to the previous scenario; falling within the 1.9 – 4.5 percent range by the third quarter of 2007 and becomes more likely to remain significantly under the path consistent with the target.

BOX 6.1. INFLATION TARGETING REGIME, ACCOUNTABILITY AND IMF CONDITIONALITY

Within the framework of the principle of accountability, in case of inflation markedly deviating from the target, the CBRT is responsible for informing the government in writing, as well as explaining to the public, both the reasons for this situation and the measures to be taken. Despite determining the inflation targets as point targets, in its press release titled "General Framework of Inflation Targeting Regime and Monetary and Exchange Rate Policy for 2006", the CBRT defined an uncertainty band of 2 percentage points in both directions of the point target, in order to allow the accountability mechanism to be implemented. Along the same lines, an inflation path that is consistent with the end-2006 target was formed and was announced with the uncertainty bands at quarterly periods.

This path and the uncertainty band around it were also designed, in addition to serving the practice of accountability, within the framework of the program with the IMF, to form the foundation of the performance criteria to be used in quarterly reviews. Accordingly, in case the inflation realizations fall outside the band, this will mean a violation of program conditionality and will necessitate meeting with the IMF authorities. The other performance criterion in the program is the floor for Net International Reserves (NIR), as was the case in the previous periods.

Within this framework, Box 6.1.Table 1 enables the co-assessment of the accountability principle and the performance criteria. According to this, as of the first quarter of 2006, the annual inflation rate for 2006 is seen to have realized as 8.16 percent, which is above the path of 7.40 percent consistent with the target, but is within the uncertainty band. Besides, as shown by Graph 6.2.1, end-2006 inflation is also forecasted to remain within the uncertainty band, set as 3 percent and 7 percent. Regarding the NIR, it realized as USD 32.4 billion, as of 31 March 2006 and was above the floor of USD 17.2 billion. Hence, the program criteria have been met.

Box 6.1. Table 1.
IMF Program Conditionality and Realizations for the First Quarter: Inflation and NIR (31 March 2006)

	Criterion	*Realization*
Inflation	5.4 – 9.4 (1)	8.16
NIR	17.2 (2)	32.4

(1) The uncertainty band around the path that is consistent with the target; annual (percent).

(2) The floor, billion US dollars.

6.3. Risk Factors

The uncertainties regarding the course of oil prices and the likely changes in international liquidity conditions are considered as the main exogenous risks that may lead to a deviation from the inflation target.

Among these major risk factors the projections regarding oil prices change frequently depending on the conjecture, therefore, the course of these prices is considered as the most important source of uncertainty in producing forecasts. In the first Inflation Report of 2006, it was assumed that oil prices would be constant at their current level. Nevertheless, it is observed that oil prices reached very high levels in the recent period. In case the upward trend continues in the upcoming period, oil prices are expected to have more significant effects on 2006 inflation.

The increases in oil prices, up to this time, has only led to significant price increases in the sectors that use petroleum products as a direct input. However, in case the latest high-rated increases continue, inflation expectations may be affected negatively, and as a natural consequence of this, pricing behaviors of the overall economy may change. In fact, a slowdown tendency in the downward trend of inflation expectations is observed in the previous quarter, which requires a more careful monitoring of the secondary effects of oil prices. There is no doubt that the Central Bank would give the necessary policy response in case the upward trend of oil prices continues and secondary effects becomes more evident

In addition to oil prices, the uncertainties regarding global liquidity conditions and the global risk appetite have the potential to create a significant deviation from the forecasts pertaining to the upcoming period. Even though the worsening tendency in the global risk appetite and the increasing uncertainty of the perceptions regarding the liquidity policy of BOJ in March, in light of the developments afterwards, the assumptions that the change in global liquidity will be moderate and there will not be a sudden change in international liquidity conditions are maintained. However, it should be kept in mind that a shock related to global liquidity conditions may have a negative impact on the economy and hinder the attainability of the inflation target. In that case, the main objective would be to keep inflation consistent with medium-term targets. Hence, the policy reaction will be spread over time and

thus, the negative impacts of exogenous shocks on the economy will be alleviated without causing any harm to price stability.

Besides the exogenous risks mentioned above, the rigidity observed in the services sector price increases is a risk factor that hinders the attainability of the end-year inflation target. Due to the supply gap in the housing sector, which cannot be met in the short term, related services sector items, especially the rent subgroup that currently maintains a high trend, is expected to exert an additional cyclical pressure on inflation throughout 2006. It is considered that this development has resulted mainly from structural factors peculiar to the transition period and is expected to continue for a certain period of time. But it is also believed that at this stage it does not require any monetary policy response.

The Central Bank will announce its evaluations about the inflation outlook in a transparent way in the upcoming period, as well as continue to inform the public about monetary policy that would enable the attainability of the inflation target in the medium term.

GRAPHS

TABLES

ABBREVIATIONS

BOJ	Bank of Japan
BTS	Business Tendency Survey
CBRT	Central Bank of the Republic of Turkey
CPI	Consumer Prices Index
ECB	European Central Bank
EU	European Union
GDBS	Government Domestic Borrowing Securities
GDP	Gross Domestic Product
GNAT	Grand National Assembly of Turkey
GNP	Gross National Product
IEA	International Energy Agency
IFS	International Financial Statistics
IMF	International Monetary Fund
ISE	Istanbul Stock Exchange
MPC	Monetary Policy Committee
NIR	Net International Reserves
OPEC	Organization of the Petroleum Exporting Countries
PPI	Producer Prices Index
RUSF	Resource Utilization Support Fund
SCA	Special CPI Aggregates
SCT	Special Consumption Tax
SPO	State Planning Organization
TURKSTAT	Turkish Statistical Institution
TELEKOM	Turk Telecommunications Inc.
USD	United States Dollar
VAT	Value Added Tax
WPI	Wholesale Prices Index
YTL	New Turkish Lira