



THE CENTRAL BANK OF
THE REPUBLIC OF TURKEY

inflation report

2006-III



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1. Overview

1.1. Developments in Inflation and Monetary Policy

In June 2006, annual inflation rate exceeded the upper bound of the uncertainty band established around the path consistent with the target inflation rate and became 10.12 percent. In order to fully comprehend the main factors that were influential for overshooting the target, it is important to analyze the inflation developments of the first half of the year in two separate periods, namely the January-April period and May-June period. In the January-April period, the rise in inflation stemmed from the high increases in prices of oil, gold and unprocessed food products. Despite the fact that the supply shocks has led to an interruption in the downward trend in annual inflation, they did not lead to any changes in the medium term outlook, allowing the Monetary Policy Committee (the Committee) to act in line with the policy perspective outlined in the January Inflation Report by cutting policy rates by 25 basis points in its April meeting.

The inflation in May and June was driven by exchange rate developments as well as other supply-side factors. From May onwards, risk perceptions began to change due to the deterioration in liquidity conditions in global financial markets. In other words, an important risk factor, which had been pointed out in previous Inflation Reports, materialized. The fact that these developments coincided with changes in regional risk perceptions and a higher level of short-term New Turkish lira (YTL) assets in the portfolios of non-residents exacerbated fluctuations in financial markets. Consequently, the risk premium increased rapidly and the YTL depreciated vis-à-vis the USD by more than 20 percent in a short span of time. Exchange rate movements soon started to affect consumer prices via imported commodities (first round effects). The effect of exchange rate developments on inflation reached as much as 1.5 percentage points in two months' time.

The rapid depreciation of the national currency at the time of an unfavorable supply-side has also deteriorated the medium and long-term inflation expectations and brought about the risk of materialization of second round effects. The Central Bank of the Republic of Turkey (CBRT) responded to these developments with a strong monetary tightening. In June, policy rates were raised by a total of 400 basis points. The CBRT not only increased

borrowing interest rates during this process but also gradually sterilized the excess liquidity in the overnight market via YTL deposit auctions and by selling foreign exchange. Moreover, CBRT increased its effectiveness and flexibility in the management of the excess liquidity by increasing its lending rates by 600 basis points.

These measures have made it clear that the CBRT acts entirely in line with its medium-term commitments. This, in turn, has contributed to the easing of volatilities in the financial markets. These measures will alleviate the pressure on inflation in the upcoming period. In its meeting held on 20 July 2006, the Monetary Policy Committee has concluded that there is still a need for remaining precautionary for the inflation outlook, as a result of observing the further increases in oil prices and commodity prices as well as the inflation expectations which are not yet in line with CBRT's medium-term targets. Taking all these factors into account, the Committee decided to move toward a measured policy tightening in order to achieve the 2007 end-year inflation target.

1.2. Outlook

The effect of recent exchange rate movements on inflation is predicted to be in the form of changing relative prices between tradable and non-tradable goods. Therefore, the calculations for the exchange rate pass-through in 2006 mainly include first round effects. In this framework, in addition to the increases in inflation observed so far, the recent exchange rate movements are expected to lead to an additional increase of approximately 2 percentage points in the inflation for the rest of 2006. Even in the case that the price adjustments due to exchange rate movements are completed in six months and the secondary effects do not materialize, it may take as late as the end of 2007 for the effects of recent exchange rate movements on annual inflation figures to disappear.

Indicators of economic activity point a re-acceleration of growth in the second quarter of the year after the slowdown observed in the last quarter of 2005 and the first quarter of 2006. However, it is anticipated that this outlook will change in the near future following the recent fluctuations in financial markets. The uncertainty caused by the fluctuations in financial markets since mid-May is expected to affect domestic demand negatively, and disrupt the

tendency for higher output growth in the second half of the year. As a matter of fact, the indicators related to new orders and sales in the domestic goods market for the next quarter, collected as part of the CBRT Business Tendency Survey (BTS), have shown sharp declines in May. The rapid decline in the new automobiles sales observed in June complements the possible picture suggested by the other indicators. Above all, there was a decline in the Consumer Confidence Index.

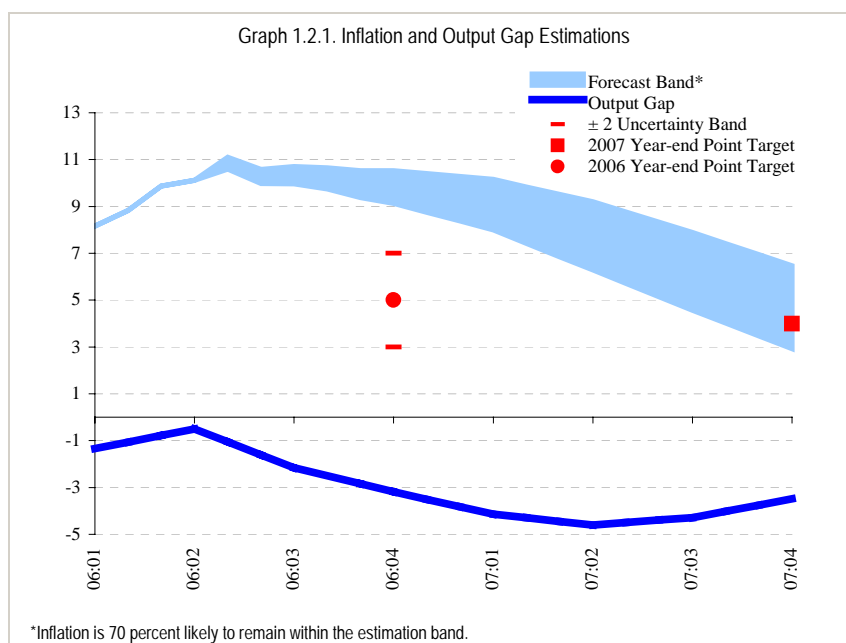
Meanwhile, due to the depreciation of the YTL, it is expected that net foreign demand will remain buoyant, which will affect especially the production in the export-oriented private manufacturing industry positively. The absence of a significant decline in Real Sector Confidence Index in June also supports this expectation. Nonetheless, considering the aggregate picture in the real economy after considering the demand sensitive sectors such as the services sector, a decrease in domestic demand is more likely. As a result, it is expected that the contribution of the demand-side factors to the disinflation process will continue at an increasing rate in the second half of the year. In summary, it should not be perceived as a surprise to observe a deceleration in growth rate of output in the second half of 2006 and the first half of 2007.

In 2006, the continuation in the increase in labor productivity supported the downward trend in unit labor costs. The absence of a decline in the investment tendencies despite the recent developments can be perceived as development supporting the increases in the labor productivity in medium term. However, low levels of productivity increases in the services sector moderate the decrease in unit labor costs in the related sectors. Considering the fact that oil and other commodity prices are still increasing, there is still a need to remain cautious regarding inflation in the upcoming period.

The secondary effects of the movements in exchange rates and commodity prices should rather be evaluated from a medium-term perspective. It is expected that the measures taken by the CBRT in June will restrain the second round effects and ease the pressures likely to appear on inflation figures in 2007. However, the continuation of fiscal discipline and structural reforms is as important as the monetary policy practice for keeping the second round effects under control. In particular, in order to attain medium-term targets, it is of critical importance that the income policy should be implemented in line with medium-term inflation targets, and that the government expenditures should be

made considering the budgetary expenditure limits in order to prevent out-of-program public price adjustments.

In light of available information and the above mentioned evaluations, it is estimated with 70 percent probability that annual inflation rate at the end of 2006 will be contained in the interval between 9.1 percent and 10.5 percent. According to estimations – based on the assumption that, in addition to the measures of June, the Central Bank will implement measured monetary tightening in the rest of 2006 and cut policy rates gradually in 2007; inflation will display a significant decline from the second quarter of 2007 onwards, and there is a 70 percent probability that it will stand somewhere between 3 percent and 6.5 percent in end-2007 (Graph 1.2.1).



1.3. Risks

The possibility of further increases in crude oil prices continues to be an important risk factor for inflation. As before, the Central Bank will not respond to the primary effects of increases in oil prices. However, in line with the recent deterioration of expectations, it became necessary to be more cautious about the second round effects of oil prices. Should the developments in oil prices affect medium-term inflation expectations adversely or start to disrupt pricing behavior, necessary policy measures will be taken.

The main development that marked the economic conjuncture in the recent period is the fluctuations in financial markets, which arose due to the changes in international liquidity conditions. Central banks in developed countries continue to tighten their monetary policies due to arising concerns about inflation. However, their hesitance to make clear statements regarding the extent of the tightening increases uncertainty in the emerging markets. CBRT's forecasts have been made under the assumption that the current uncertainties regarding these factors continue in the upcoming period. Rapid changes in global risk appetite and potential fluctuations continue to be among the major risk factors for inflation. In case such a risk materializes, the Central Bank will act with a medium-term perspective: It will not respond to the temporary increase in inflation induced by changes in relative prices; however, it will closely monitor medium-term inflation expectations, as it did recently.

Under current conditions, it is of great importance for both price stability and macroeconomic stability to avoid any policy implementation that would affect the risk perceptions and expectations negatively. Any step towards limiting the risk perception would reduce the cost of attaining and sustaining stability. It should be borne in mind that the main determinant of the continuation of non-inflationary growth is the confidence in the permanence of macroeconomic stability. Besides determination for structural reforms that would increase the quality of fiscal discipline even further, the uninterrupted implementation of structural reforms that would bring about long-term productivity growth by promoting competition in real sector and improving the investment environment are of critical importance. In this context, the continuation of the accession process to European Union and uninterrupted implementation of structural reforms in the economic reform program are still crucial. Continuation of the determined steps taken in recent years in this context will increase the strength of Turkish economy in coping with the changes in the international conjuncture at the lowest cost.

2. International Economic Developments

The world economy has grown significantly in recent years. In 2004, global economic growth reached its highest level of the last 30 years. High growth rates were accompanied by low inflation figures and low interest rates. During this period, technological developments boosted productivity, restrained unit labor costs and contributed to keeping inflation under control. Another global contribution to keeping inflation under control has been provided by the limited increases in unit labor costs due to participation of skilled labor force to the world economy in the aftermath of the integration of the Chinese, Indian and former Socialist bloc economies into the world trade system. As a result of worldwide low inflation and strong growth trend, inflation expectations declined and also with the contribution of the increased risk appetite, risk premiums decreased globally. Consequently, global liquidity significantly switched to emerging markets.

However, the recent increase in energy prices stands out as the most significant factor leading inflationary pressures around the world, and concerns are mainly focused on the emergence of “secondary” effects via the impact of this pressure on inflation expectations, wage contracts and pricing behaviors. Besides, it is still unclear for how long the cost increases and global inflation can be controlled via balancing effect of unit labor costs. In case of a reversal in the current trend of low inflation and low interest rates, it is believed that not only developed economies will slow down but also the world economies will be affected adversely due to the change in global liquidity.

The general approach of the international institutions like the International Monetary Fund (IMF) and the World Bank as well as central banks is to seek ways for a smoother transition to relatively high inflation, high interest rate and low growth, rather than an abrupt transition in the aftermath of a global crisis. The most significant impact of this transition on emerging market economies is the distorting impact it could create via capital outflow. However, these countries will be able to adapt to new conditions without experiencing a crisis as long as the transition is smooth.

2.1. Economic Performance and Monetary Policy Developments

The US economy maintained its rapid growth performance of 2004 in 2005 despite the adverse effects of last year's hurricanes and the increase in crude oil prices, and the growth rate reached 3.5 percent. Although a high growth rate of 1.4 percent was registered in the first quarter of 2006, growth is expected to slow down in the rest of the year and realized as approximately 3.5 percent for the whole year (Table 2.1.1). Meanwhile, the US current account deficit, which reached 6.4 percent of the Gross Domestic Product (GDP) in 2005 due to strong domestic demand, is expected to increase at a rate that is likely to create a risk in terms of the global economic equilibrium and exceed 7 percent in 2006.

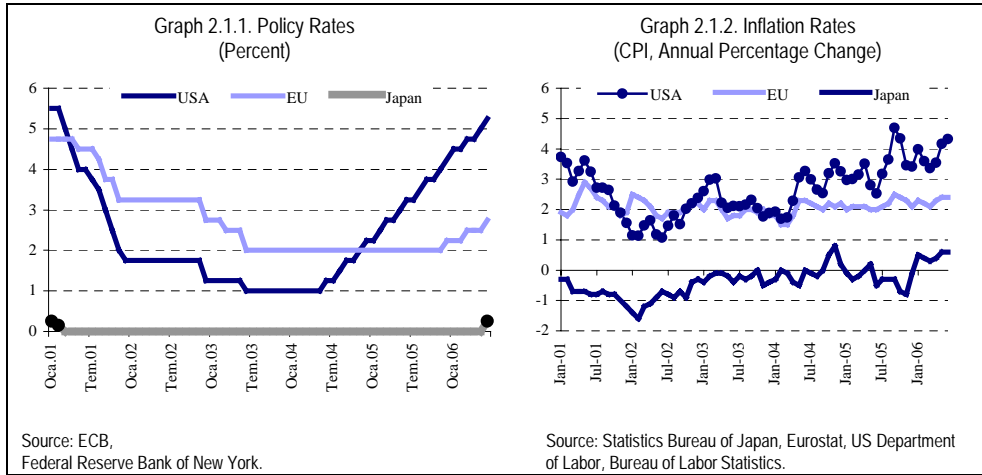
	2005	2006**	y-o-y Growth Rate*				2006-I
			2005-I	2005-II	2005-III	2005-IV	
<i>World</i>	4.8	4.9	-	-	-	-	-
<i>USA</i>	3.5	3.6	0.9	0.8	1.0	0.4	1.4
<i>Japan</i>	2.7	2.8	1.4	1.3	0.2	1.1	0.5
<i>Euro Zone</i>	1.4	2.2	0.4	0.4	0.7	0.3	0.6
<i>Germany</i>	1.1	1.8	0.6	0.4	0.6	0.0	0.4
<i>France</i>	1.4	2.1	0.1	0.0	0.6	0.3	0.5
<i>Italy</i>	0.1	1.4	-0.4	0.6	0.3	0.0	0.6
<i>UK</i>	1.8	2.4	0.2	0.5	0.5	0.6	0.6
<i>China</i>	9.9	9.7	9.9	10.1	9.8	9.9	10.3

* The figures for China are annual percentage rate.
** Expected de-seasonalized values for 2006.
Source: Eurostat, OECD, IMF.

In the US economy, core inflation rate has been increasing in recent months. The increasing energy and commodity prices are still foreseen to exert pressure on inflation and inflation risks will continue. The Federal Reserve (FED) has increased the interest rates by 25 basis points for the seventeenth consecutive times since June 2004 and interest rates have been raised to 5.25 percent (Graph 2.1.1). Ben Bernanke, in his testimony of July 19, 2006, stated that likely increases in oil and commodity prices continue to be the risk factors for inflation, but core inflation is expected to decrease in the upcoming period. Bernanke also stated that future interest rate decisions would be shaped according to developments in inflation and growth indicators.

The Euro zone, which grew by 1.4 percent in 2005 due to increase in exports, is expected to grow at 2-2.5 percent rate in 2006 driven by domestic demand. However, continuing increases in oil prices and the change in global capital movement stand out as the risk factors that would impede the growth process. The ratio of current account deficit to GDP is expected to reach 0.5

percent in 2006 due to higher cost of imports, which has increased in line with the increase in oil prices since the beginning of 2005.



In the Euro zone, the annual rate of increase in the Harmonized Index of Consumer Prices (HICP), which was 2.5 percent in June 2006, is expected to be above 2 percent in the second half of 2006 and throughout 2007 on annual basis. Monetary expansion and credit expansion observed due to low levels of interest rates in the Euro zone also increases the upward pressures on inflation in the medium and long term. A gradual monetary tightening is envisaged in order to remove all these risks against price stability. The European Central Bank (ECB) has raised interest rates to 2.75 percent with an increase by 25 basis points for the third times since December 2005 (Graph 2.1.1).

As a result of strong domestic demand, which has been accompanied by increases in exports since mid-2005, the Japanese economy grew by 2.7 percent in 2005 (Table 2.1.1). In line with the continuing strong domestic demand driven by increases in employment and wages in 2006, the Japanese economy is expected to grow by approximately 3 percent this year as well. The current account surplus, which was 3.6 percent of the GDP in 2005, is expected to increase depending on the export performance, and exceed 4 percent in 2006. The positive figures for annual rates of increase in consumer prices are expected to continue in the upcoming period as long as the output gap values continue to be positive. The Bank of Japan (BoJ), in its March meeting, ended its excess liquidity policy, which had been followed for the last five years and decided to keep its policy rate, for which an official target has not been set, at zero level. However, in line with the recent developments and owing to concerns over likely fluctuations in economic activity and prices in the

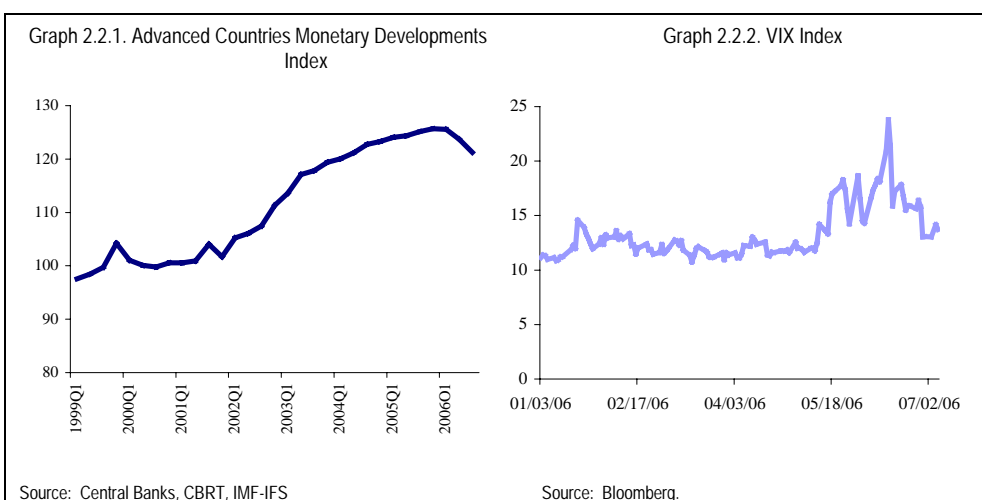
upcoming period due to keeping interest rates at zero, the BoJ raised interest rates by 25 basis points in its meeting held on 13-14 July 2006.

The Chinese economy, which grew by approximately 10 percent in 2005 due to the increase in exports and investments triggered by the strong increase in company profits, is expected to grow by 10 percent due to the same trends in 2006 as well (Table 2.1.1). In 2005, due to rapid growth in exports, the ratio of China's current account surplus to its GDP doubled that of 2004 and reached 6.3 percent. However, the appreciating Chinese Yuan, Renminbi, against USD since the second half of 2005 and continuing appreciation with faster rate since the first quarter of 2006 lead to the expectation that the current account surplus will decrease in 2006.

2.2. International Markets

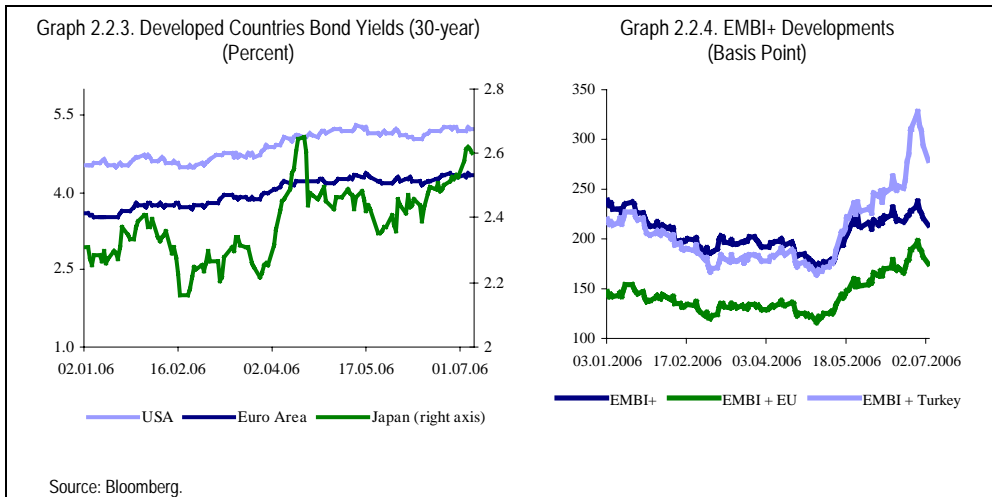
2.2.a. Financial Markets

The favorable conditions in the global markets since 2003 have been disrupted in May 2006. Central banks of developed countries raised policy rates in the face of increasing inflationary pressures and the BoJ started to withdraw the excess liquidity in the world markets as part of its decision to tighten monetary policy taken at the March meeting. These developments thus brought about an increase in risk perception and interrupted the ongoing upward trend in global markets.



Monetary base, which expanded at a higher rate than nominal GDP growth in the USA, the Euro zone and Japan, has been weighted with the GDPs of the mentioned countries in order to derive “Advanced Countries Monetary Developments Index” with base year 1999=100 (Graph 2.2.1).^{1,2} The index, following the slowdown in the rate of growth in 2005, reached a peak in the first quarter of 2006 and then started to decline according to provisional data of April-May 2006.³ The BoJ, whose March decisions became the most influential factor in the aforementioned development, continued to tighten its base money in June, albeit at a significantly slower rate.

The Chicago Board of Options Exchange Volatility Index (VIX), which is closely monitored by international investors as it reflects global risk appetite, maintained its historically low levels until May 2006. The high level of risk appetite enabled commercial banks to further expand global liquidity in accordance with the central bank policies on one hand, and increased their demand for riskier assets on the other. However, in line with the financial market fluctuation in mid-May, there was a rapid rise in VIX reflecting a decline in risk appetite (Graph 2.2.2).



¹ Seasonally adjusted data are used.

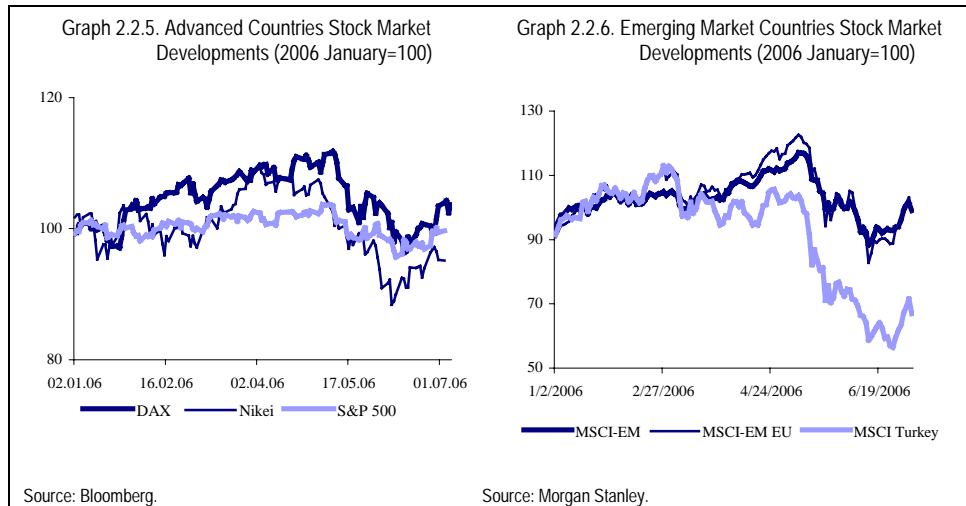
² See Baks K., Kramer C. (1999): “Global Liquidity and Asset Prices: Measurement, Implications and Spillovers”, IMF WP/99/168, and Global Financial Stability Report (2005, April) pp. 13-15.

³ When the 1999 average is taken as 100, the USA component of the index has been calculated as 103.5, the Euro zone component as 127.5 and the Japan component as 175 for the end of the first quarter of 2006.

On the basis of interest rate developments in the developed countries, yields of long-term bonds increased moderately, although with a lag, in response to increases in policy rates of the USA and the Euro zone. Meanwhile, yield in Japan increased rapidly and shifted to a higher plateau following the decision to tighten monetary policy (Graph 2.2.3).

Interest rates in emerging market countries fell to the lowest level by March 2006 in line with the downward trend that started at the end of 2002. However, this trend was reversed following the financial fluctuation that started in mid-May. It is notable that the Emerging Markets Bond Index (EMBI+) and the sub-indices of “Emerging Europe” and Turkey follow similar patterns with same turning points, while movements in the Turkey’s sub-index are of a larger scale (Graph 2.2.4).

Similarly, it is observed that the upward trend in the stock markets of developed countries, which has been going on since the beginning of 2003, has been reversed as of May 2006 (Graph 2.2.5). Although Turkey’s sub-index displays sharper declines in line with EMBI+ developments, dates of the turning points coincide with those of the Morgan Stanley Capital Index (MSCI) of emerging market countries (Graph 2.2.6).



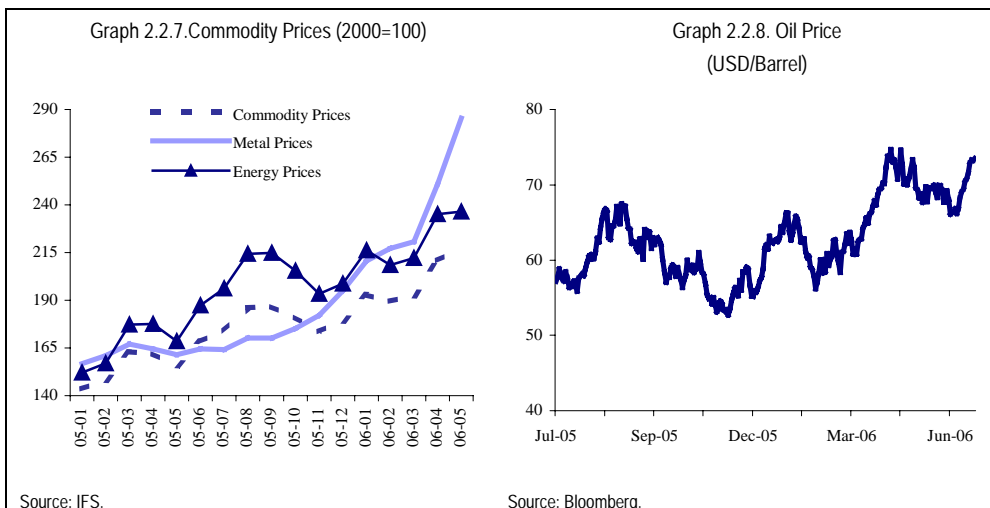
In summary, while May 2006 stands out as the turning point in the ongoing trends in international capital movements, indices of emerging market countries, though at different magnitudes, follow similar patterns. Hence, even though the country-specific main economic indicators are crucial, the main triggering factors may originate from the global conditions.

Meanwhile, the fact that Japan, which played a significant role in the liquidity expansion observed in recent years, still experiences deflation excluding energy prices, contrary to expectations, increases the uncertainties regarding at which frequency the policy rates will be increased and the liquidity withdrawal process will continue. Furthermore, large current account deficit of the USA and the likely potential problems in its financing constitute another factor of uncertainty as they might lead to sharp movements in international markets and relative prices.

In light of these developments, it is not quite probable that international conditions in the upcoming period will be as convenient as they had been in recent years. Hence, monitoring the decisions of central banks of developed countries - especially that of Japan- as well as international investor sentiment are of utmost importance.

2.2.b. Commodity Markets

The strong growth trend in the world economy in recent years led to rapid increases in demand and prices in the commodity markets. The IMF Commodity Price Index increased by 2.8 percent in May 2006 compared to the previous month, while the Metal Price Index increased by 0.5 percent (Graph 2.2.7). Annual increases in the aforementioned indices have been 39 percent and 40 percent, respectively.



According to the London Metal Exchange (LME) figures, the rate of increase in prices of the six traded basic metals decelerated in May, and prices fell by the end of June. Despite the decrease in prices of basic metals in June,

prices of five metals are still higher compared to the previous quarter (Table 2.2.1).

USD	2006				Percentage Change		
	I	II	May	June	06-II / 05-II	06-II / 06-I	May/June
Aluminum	2443.5	2681.1	2881.4	2520.6	49.3	9.7	-12.5
Copper	4855.7	7142.3	7905.2	7097.3	122.2	47.1	-10.2
Lead	1222.3	1121.0	1195.5	993.5	17.9	-8.3	-16.9
Nickel	14915.9	19625.5	20685.0	19991.4	23.3	31.6	-3.4
Tin	7623.4	8551.9	8892.4	7945.0	8.2	12.2	-10.7
Zinc	2260.5	3248.2	3490.7	3182.2	152.3	43.7	-8.8

Source: LME.

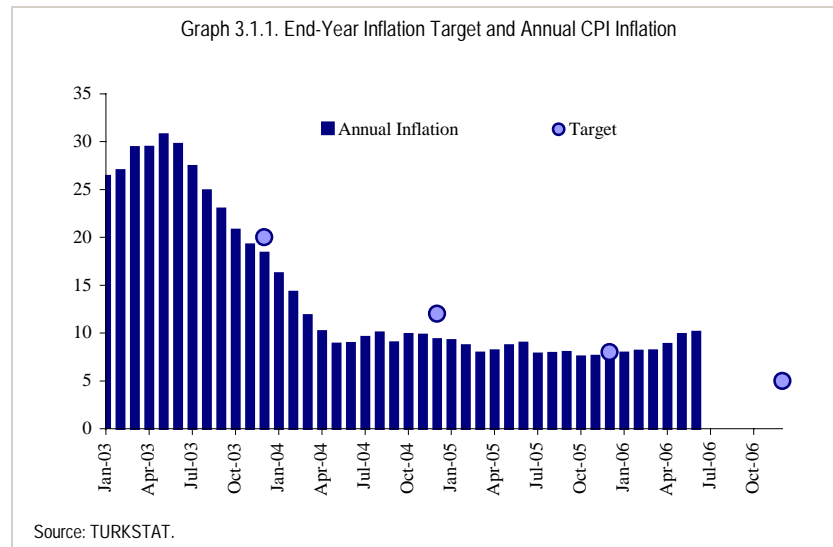
Sharp increases also continue in the Energy Price Index of the IMF. This index increased by 13.9 percent in May compared to April and by 76.8 percent compared to May 2005. In international markets, the average price of Brent oil has been USD 68.9/barrel in June with a decline by 1.9 percent compared to last May (Graph 2.2.8). Following the recent tension in the Middle East, oil prices reached historically high levels. The futures contract maturing in November 2006 has recorded USD 75.99/barrel in the aftermath of the fluctuations at the end of June.

The strong global growth trend exerts pressure on prices in the crude oil markets, where the idle capacity is limited. Geopolitical uncertainties, as well as the indirect effects of the investment companies trading in the futures markets intensify this pressure. Moreover, seasonally stronger demand during summer months stands out as another determining factor in the recent price increases. On the other hand, deterioration of global growth and liquidity conditions as in other commodity markets, expected new capacity facilities to be in operation soon, high level of available stocks and the continued above-quota production by the Organization of the Petroleum Exporting Countries (OPEC) are all seen as factors mitigating the pressure on prices.

3. Inflation Developments

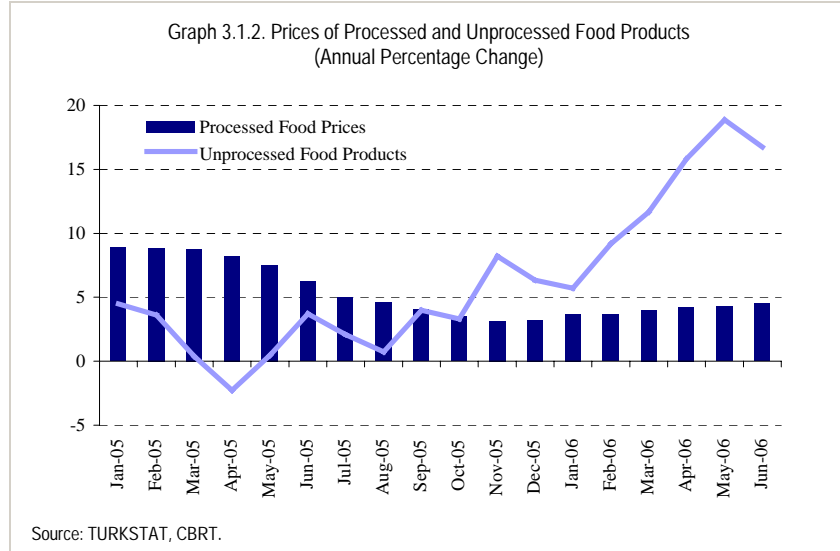
3.1. Inflation

By the end of the second quarter of 2006, the annual rate of increase in consumer prices became 10.12 percent (Graph 3.1.1). Hence, by the second quarter, annual inflation realized outside the uncertainty band set around the path consistent with the target. The main domestic factor leading to the rise in annual inflation in the second quarter was the supply-oriented developments in prices of unprocessed food, while the course of energy and gold prices stood among the international factors. Moreover, the depreciation of the New Turkish lira, which basically resulted from the deterioration in global liquidity conditions, also played a significant role in the said rise.



Prices in the food and non-alcoholic beverages group, which entered an upward trend in the last quarter of 2005, became influential in the course of consumer inflation during the first half of 2006. It would be more appropriate to evaluate the said expenditures group in light of the distinction between processed and unprocessed food, in order to be able to determine the source of the increase. As seen in Graph 3.1.2, behavior of prices in these two sub-groups differs fundamentally from each other. Prices in the unprocessed food group did not change significantly in the first five months of 2005, while they increased by 11.4 percent in the same period of 2006. Contrary to this upward trend in prices of unprocessed food that started in the last months of 2005, price

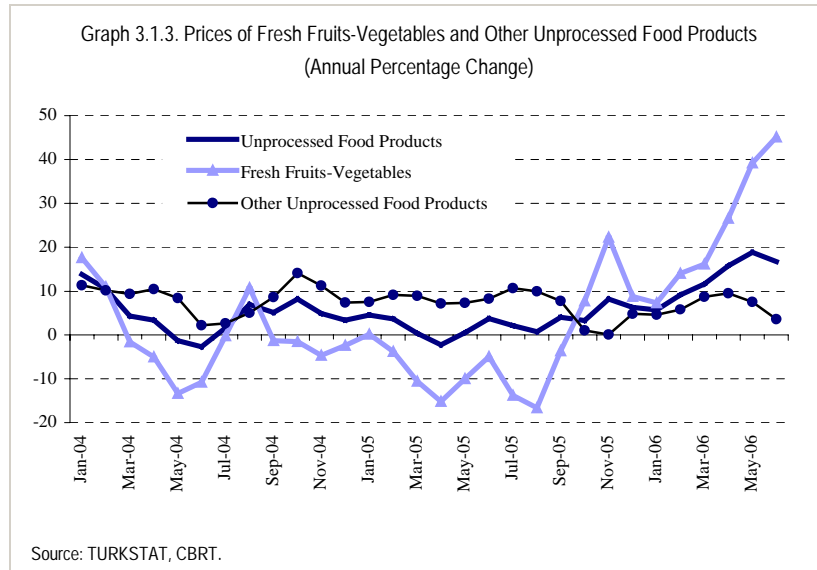
increases in the processed food group, that is expected to be more sensitive to demand developments, remained limited (Graph 3.1.2).



It is believed that the upward trend in prices of unprocessed food mainly resulted from the harvest being affected by weather conditions, and consequently from high rated increases in prices of fresh fruits and vegetables exceeding seasonal averages. It is observed that the increase in prices of other unprocessed food products excluding fresh fruits and vegetables was rather limited (Graph 3.1.3). This fact indicates that increases in food prices basically originate from supply factors. The high rated increase in fresh fruit and vegetable prices started in the last quarter of 2005, and the decrease in prices, which occurred in the second quarter of 2006, was very limited when compared with seasonal averages (Table 3.1.1). Meanwhile, changes in prices of other unprocessed food products excluding fresh fruits and vegetables in the last one-year period were mainly triggered by price movements resulting from avian influenza observed in poultry and poultry products.

	I	II	III	IV
2004	13.7	-29.41	-4.41	27.18
2005	4.2	-24.98	-3.13	43.67
2006	11.23	-6.25		

Source: TURKSTAT.

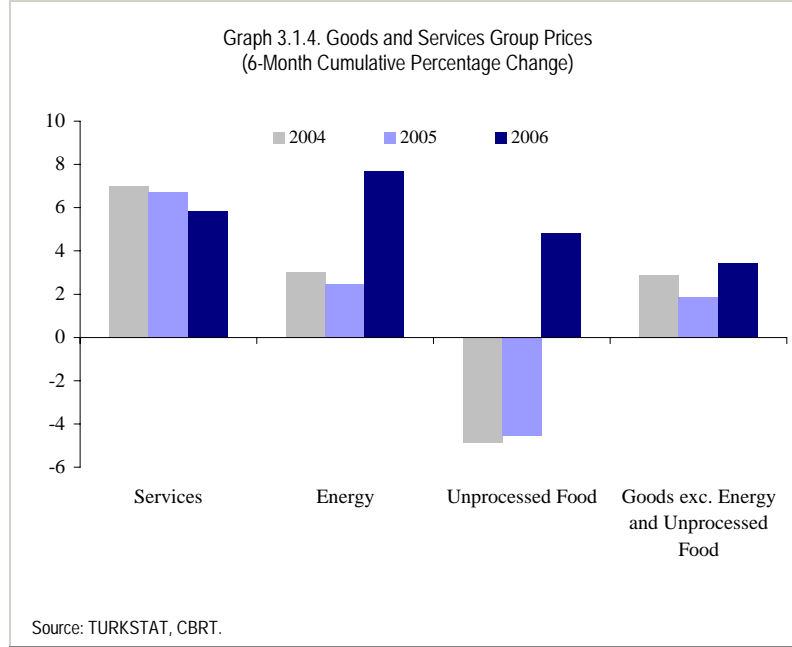


High rated increases observed in international energy prices in the second quarter of 2006 adversely affected consumer prices via increases in fuel oil and natural gas prices. The said prices showed high increases after March due to the impact of crude oil prices that have been on the rise in foreign markets, while the increase observed since May resulted mainly from exchange rate developments. International oil prices, which rose again at the end of June, are likely to affect consumer prices negatively in the upcoming period. Meanwhile, the fact that electricity prices, which have a significant share in the energy group, not increasing in recent years stands as a factor contributing favorably to consumer inflation both directly and through the cost channel.

In line with the rise in international markets and the increase in exchange rates, gold prices affected consumer inflation unfavorably in the second quarter of the year, too. It is noticeable that gold prices, which have a significant share in consumer prices, increased by approximately 60 percent in the last one-year period. Prices of the clothing and footwear group registered high increases by similar rates in the second quarter of the year, following the significant discounts in the first quarter. The cumulative price increase of the said group for the first six months remained limited with an increase of 1.97 percent.

A comparison of energy and unprocessed food prices with prices of previous years more clearly demonstrates the adverse affects of these prices on consumer inflation this year (Graph 3.1.4). Prices of goods excluding

unprocessed food and energy increased less in the first quarter than previous years, while the increase in the second quarter exceeded that of previous years due to the depreciation of the YTL.

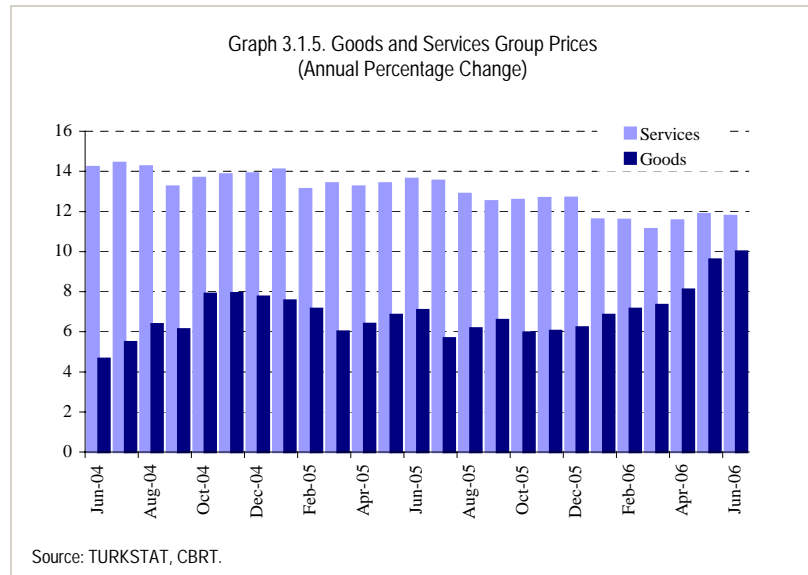


Prices in the services group increased by 3.36 percent in the second quarter of the year. The annual rate of increase in the prices of the said group maintained its high level despite remaining below the rate recorded in the same period of the previous year (Table 3.1.2, Graph 3.1.5).

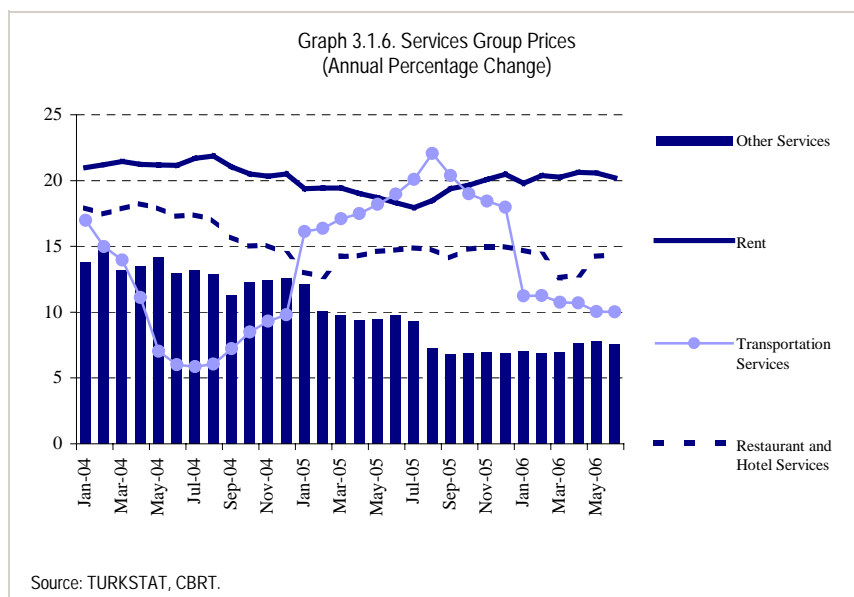
Table 3.1.2. Goods and Services Group Prices
(Quarterly Percentage Change)

	2005					2006	
	I	II	III	IV	Yıllık	I	II
CPI	0.83	1.74	1.30	3.65	7.72	1.25	3.58
1. Goods	-0.24	1.16	0.80	4.42	6.21	0.80	3.67
Energy	1.73	0.73	3.81	1.20	7.65	2.63	4.94
Unprocessed Food	3.61	-7.87	0.25	11.12	6.34	8.81	-3.67
Goods excl. Energy and Unprocessed Food	-1.94	3.91	-0.05	3.79	5.71	-2.01	5.54
Durable Goods	-0.37	3.61	-0.80	4.41	6.91	-1.66	8.69
Durable Goods excl. Gold	1.86	3.66	-1.86	2.23	5.94	-3.04	5.40
Semi-Durable Goods	-3.38	5.75	-1.10	3.76	4.85	-3.65	9.14
Non-Durable Goods	2.11	-2.58	2.60	4.91	7.07	4.64	-1.12
2. Services	3.85	2.77	3.65	1.87	12.68	2.41	3.36
Rent	4.26	3.74	7.06	4.04	20.48	4.08	3.69
Restaurants and Hotels	5.19	2.65	3.29	3.09	14.98	3.02	4.25
Transportation Services	7.87	2.04	6.00	1.11	17.97	1.27	1.36
Other Services	1.75	2.73	1.72	0.56	6.92	1.80	3.32

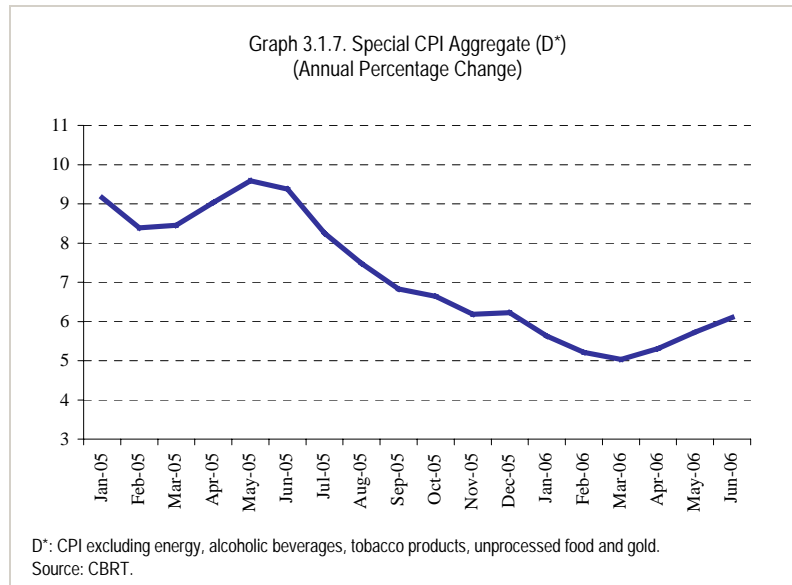
Source: TURKSTAT, CBRT.



High rated increases observed in services sector inflation continued in the second quarter of the year, particularly through the channel of rents and restaurant-hotel group prices that registered high annual increases. High annual growth rates prevail in the case of rents. Inflation in the food services under restaurant-hotel group decreased compared to the previous year, while the rate of increase in prices of accommodation services for the first six months was above that of the last two years. Meanwhile, the annual rate of increase in transportation services prices remained below that of the previous year. However, prices in this group are likely to increase in the upcoming period since they are highly sensitive to developments in fuel oil prices (Graph 3.1.6).



It is observed that the depreciation of the YTL due to the fluctuations in financial markets in the last two months was reflected on consumer prices in May and June. The first impacts are visible on the goods priced in terms of foreign exchange within the index and on imported goods. As a matter of fact, high increases were observed in prices of fuel oil, durables such as electrical devices and automobiles as well as in gold prices in the recent period. The said direct effects, which added to consumer inflation by approximately 1.5 points in the said two months' time, are expected to continue with a loss of pace in the short run. In the framework of these developments, the rate of increase in prices of the goods group accelerated significantly in the second quarter of the year compared to the same period of the previous year, and reached 3.67 percent (Table 3.1.2). Meanwhile, the extent of the indirect effects of exchange rate movements will be determined by the course of domestic demand.



Since unprocessed food, energy and gold prices became influential on consumer inflation in the second quarter of the year; accelerations were observed in the annual growth rates of special aggregates containing the said items. Meanwhile, the Special CPI Aggregate D* (SCA-D*), which was formulated by the Central Bank and excludes the above mentioned effects, as well as the alcoholic beverages and tobacco group, has registered increases on an annual basis since April. These increases were triggered by price increases in new season products observed in the clothing and footwear group in April and May. When price realizations of the last two years are analyzed in the clothing and footwear group, it is observed that seasonal price increases and

decreases were at higher rates compared to the previous year. Prices in the said group, which increased at higher rates in April and May compared to the previous year, led to a temporary acceleration in the annual rates of increase in special aggregates. In this context, it should be stated that before the exchange rate movements observed in May, the annual increase in the SCA-D* index remained at a limited level, except for the temporary increase triggered by price developments in the clothing and footwear group. Hence, no upward movement was observed in the main trend of inflation (Graph 3.1.7). Meanwhile, the rate of increase in special aggregates has accelerated in line with the price increases observed in the framework of recent exchange rate developments.

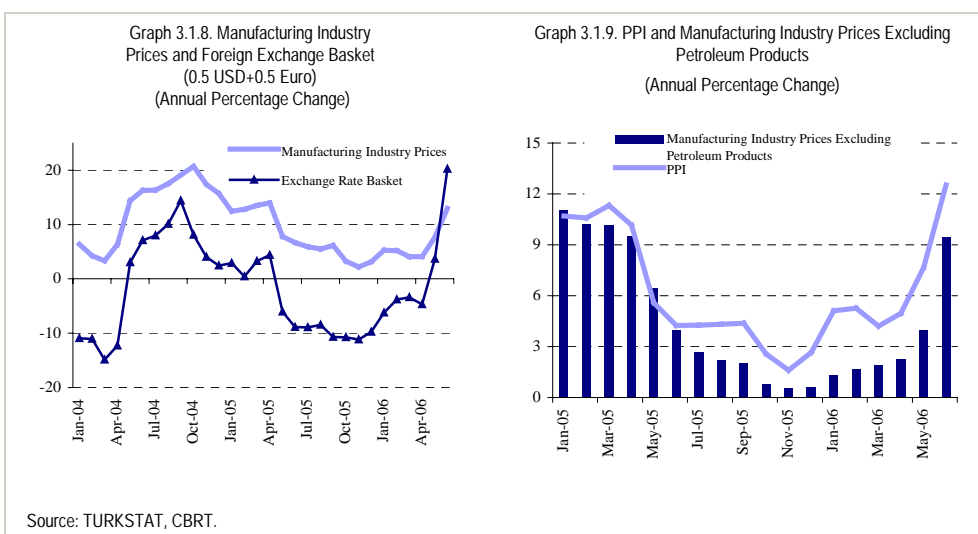
Table 3.1.3. Special CPI Aggregates (2003=100)

	2005					2006	
	I	II	III	IV	Yıllık	I	II
CPI	0.83	1.74	1.30	3.65	7.72	1.25	3.58
A. CPI excluding seasonal products	2.06	1.84	2.75	1.48	8.39	2.31	2.79
B. CPI excluding unprocessed food	0.37	2.95	1.58	2.68	7.78	0.12	4.79
C. CPI excluding energy	0.67	1.94	0.89	4.07	7.75	1.01	3.38
D. CPI excluding unprocessed food products and energy	0.09	3.44	1.14	2.98	7.84	-0.38	4.77
E. CPI excluding energy, alcoholic beverages and tobacco products	0.59	2.05	-0.16	4.00	6.58	0.74	3.62
F. CPI excluding energy, alcoholic beverages, tobacco products, other goods with administered prices and indirect taxes.	0.30	2.23	-0.33	4.45	6.75	1.75	3.82
G. CPI excluding energy, alcoholic beverages, tobacco products, other goods with administered prices, indirect taxes and unprocessed food.	-0.38	3.98	-0.32	3.25	6.61	0.26	5.59
D*. CPI excluding energy, unprocessed food, alcoholic beverages, tobacco products and gold.	0.17	3.70	-0.28	2.56	6.23	-0.96	4.76

Source: TURKSTAT.

Exchange rate developments affect producer prices more rapidly and at higher levels than consumer prices. As a matter of fact, prices in the manufacturing industry responded quickly to the increases in exchange rates in May and June and showed a rapid rise on annual inflation in line with the 8.98-percent rise observed in producer prices in the second quarter of the year (Graph 3.1.8). The increase in oil and commodity prices, coupled with exchange rate developments, has led to the rapid rise in manufacturing industry prices. For instance, manufacturing of basic metal industry prices within the Producer Prices Index (PPI) increased by 41 percent in the second quarter of 2006, in line with the rapid increases in international metal prices and exchange rate movements. The upward trend in international metal prices at the beginning of July observed in metals excluding aluminum signals that the increases in prices of the basic metal industry might continue in the third quarter, too.

Moreover, it should be taken into account that the 12-percent increase observed in natural gas prices in the second quarter of 2006 may also exert significant pressure on costs in the industrial sector. Following all these developments, even if the effect of oil products is excluded, it is still observed that the annual rate of increase in prices of the manufacturing industry has accelerated (Graph 3.1.9). It should be emphasized that the impact of this development on consumer inflation will depend on demand conditions and the future course of services sector inflation.

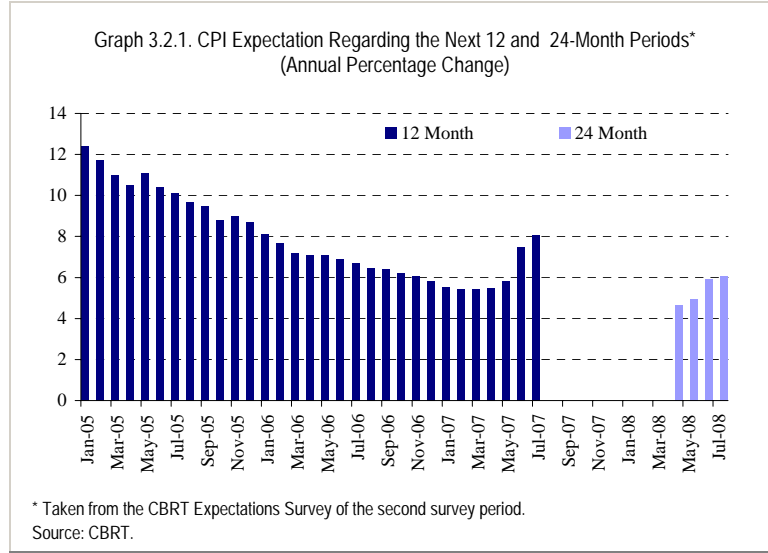


Cost increases affect producer prices more than they affect consumer prices, because producer prices are compiled excluding taxes. In PPI, untaxed refinery prices are compiled for petroleum products. Since the refinery price makes up approximately 25-35 percent of the pump price, increases in prices of petroleum products do not affect the PPI and CPI in the same way. For example, in the first half of 2006, gasoline prices increased by 62.2 percent in the PPI while they increased by only 15.9 percent in the CPI. In this context, the increase in terms of gasoline costs for consumers is confined to 15.9 percent, rather than 62.2 percent. Hence, this factor should also be taken into account while evaluating costs in terms of producer prices.

3.2. Expectations

Developments observed in the global as well as the Turkish economy in the second quarter of 2006 have affected inflation expectations unfavorably. The deterioration in expectations coincided with the release of April CPI inflation, which was realized above the expected level. However, since

exogenous factors were the main determinant of inflation realizations in April, the deterioration in expectations remained limited.



On the other hand, parallel to the fluctuations observed in financial markets in May, the main source of the deterioration in expectations was the depreciation of the YTL. Inflation expectations for the next 12 and 24 months are significantly above the medium-term targets as of July. Moreover, the fact that the increase of the ratio of the standard deviation of expectations to average expectations stands as another indicator of the deterioration in inflation expectations (Table 3.2.1). It is of critical importance that inflation expectations stay in line with medium-term targets for the convergence of inflation realizations to target inflation figures. For this reason, the course of expectations is being carefully monitored and analyzed.

Current Period	Survey	End-Year	Next 12 Months		Next 24 Months	
			Average Expectation	Standard Deviation/Average Expectation	Average Expectation	Standard Deviation/Average Expectation
January-06	1	5.68	5.49	0.10		
	2	5.67	5.54	0.11		
February-06	1	5.75	5.45	0.10		
	2	5.81	5.45	0.11		
March-06	1	5.8	5.46	0.10		
	2	5.78	5.44	0.09		
April-06	1	5.76	5.41	0.10	4.64	0.11
	2	5.79	5.47	0.10	4.67	0.09
May-06	1	6.27	5.57	0.11	4.79	0.13
	2	6.75	5.83	0.15	4.93	0.16
June-06	1	8.82	6.66	0.15	5.37	0.15
	2	9.78	7.48	0.16	5.95	0.20
July-06	1	10.17	7.89	0.16	6.13	0.19
	2	10.28	8.07	0.16	6.07	0.16

Source: CBRT.

BOX 3.1. BEHAVIOR OF PRICE LEVEL AND INFLATION IN CASE OF LIKELY SHOCKS

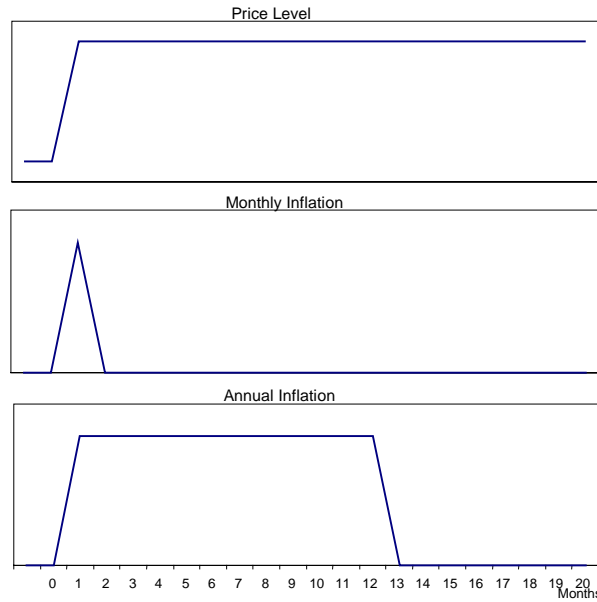
In the period of inflation targeting regime, the Central Bank of Turkey shares with the public its analyses and evaluations on inflation developments via various publications, as it did previously. In the said evaluations, analyses are made from time to time as to the general price level and inflation behavior in case of actual or likely shocks, and these evaluations include remarks especially on for how long the impacts of these shocks on inflation will last. In this context, this box has been prepared in order to inform the public about the impacts of various shocks likely to emerge in the economy on price level as well as on monthly and annual inflation via two simple examples. The first example discusses the effect of a one-off increase in the rate of Special Consumption Tax (SCT) on tobacco products on price level and inflation, while the second example focuses on the primary effects of a depreciation in the YTL on price level and inflation, and assumes that the secondary effects are negligible. At this point, it would be useful to explain primary and secondary effects.

Primary effects cover mostly price adjustments in prices of goods with a high imported component. These effects, which are observed as the relative price discrepancy between tradable goods and non-tradable goods, can lead to a temporary rise in inflation. However, such effects do not change the medium-term inflation trend, as they do not disrupt the general pricing behavior. Therefore, central banks that act on medium term perspective do not give policy responses to these primary effects. The secondary effects emerge when the rising tendency of prices is not limited to goods with high imported components, but is spread to the entire economy. Such an effect, which might lead to an uninterrupted rise in the general price level, may mean that the rise in inflation is permanent and in such a case reducing inflation again would be too costly. Therefore, while evaluating the effects of exchange rates or oil prices on inflation, central banks attach great importance to the secondary effects.

Example 1: One-off Increase in SCT on Tobacco Products

Box 3.1. Graph 1 shows the likely route of price level and inflation rates in case of a one-off increase in the special consumption tax on tobacco products. Here, the most important point is that the said tax increase in this example affects prices prevailing in the month of tax increase only, and will not lead to any impact on monthly inflation in other months. For the sake of simplifying the presentation, the value of long-term equilibrium inflation has been assumed zero.

Box 3.1. Graph 1. Behavior of Price Level and Inflation In Case of a One-Off Increase in SCT on Tobacco Products

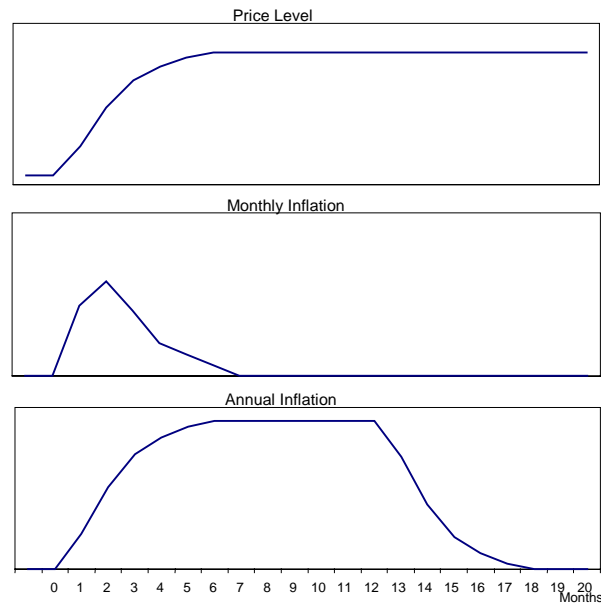


As seen in the Graph, the increase affects price level only once in the month of increase and monthly inflation shows a significant rise in the first month in line with the increase in prices. Meanwhile, annual inflation stays above the long-term equilibrium value for twelve months due to the tax-based increase in tobacco products. In the thirteenth month, in which annual inflation falls to the long-term equilibrium value again, a downward base effect is observed in annual inflation for only once a year. This simple example clearly demonstrates how annual inflation has been affected for one year, from the date of the tax increase on tobacco products made at the end of July 2005 until the end of August 2006.

Example 2: One-Off Depreciation in the YTL

Box 3.1. Graph 2 summarizes the effects of a one-off depreciation in the YTL. In this example, under the assumption that the secondary effects will be limited, it is assumed that the primary effects on inflation will extend to a 6-month period within the framework of the staggered price setting in the economy. This simple exercise leads us to two basic arguments: (i) If the secondary effects are at a negligible level, the effect of a one-off depreciation in the YTL on inflation will be temporary. (ii) Considering that an effect on price level will gradually decrease and eventually disappear in T months' time (6 months in this example), monthly inflation will be affected for a period of T months, while annual inflation will stay above the long-term equilibrium value for $T+12$ months (18 months in this example) and only then fall to the equilibrium value. Thus, *ceteris paribus*, it takes 18 months for annual inflation to return to the target path. This simple exercise clarifies why it takes annual inflation more than one year to come close to the target again in the aftermath of a significant depreciation in the YTL. It should be emphasized that the effects of any significant increase in commodity or oil prices on price level and inflation may also lead to similar outcomes, but the effects of the said shocks on prices will probably last for a much shorter period of time.

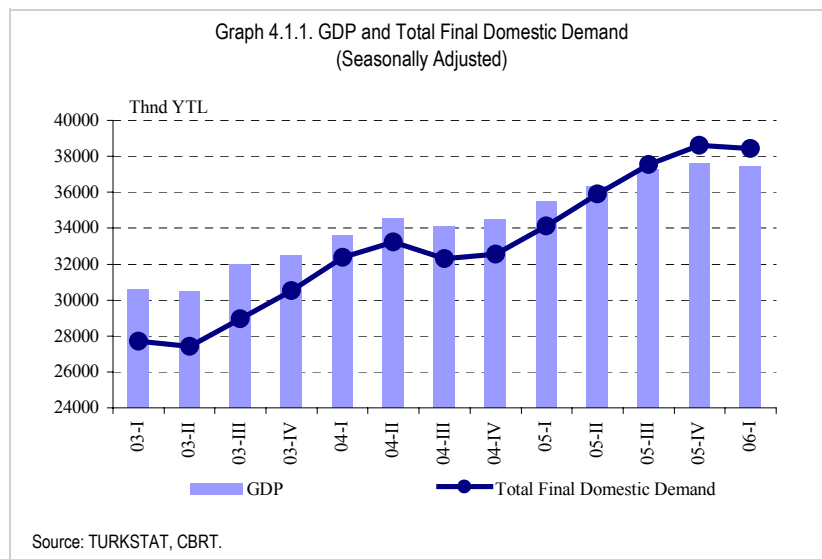
Box 3.1. Graph 2. Behavior of Price Level and Inflation in Case of a One-Off Depreciation in the YTL



4. Supply and Demand Developments

4.1. Supply-Demand Balance

In the first quarter of 2006, the GDP increased by 6.4 percent compared to the same period last year. According to seasonally adjusted figures, the GDP declined by 0.4 percent compared to the previous period. Thus, the slowdown in economic activities observed in the last quarter of 2005 also continued in the first quarter of 2006 (Graph 4.1.1).



When economic growth is analyzed in terms of production side, it is observed that the value added from the industrial sector has increased only slightly due to the negative performance in January. While the rise in the value added of the agricultural sector remained limited, that of the services sector increased by 6.7 percent. The construction sector continued to be one of the leading contributors to the growth of the service sector by growing 25.9 percent.

Analyzed in terms of demand components, it is observed that the biggest contribution to GDP growth in the first quarter of 2006 came from private investment expenditures by 6.7 percentage points, 5.3 percent of which was generated by machinery-equipment and the rest by construction investments. In this period, public investments displayed a high rated increase and continued to contribute to growth.

Despite the 8.4 percent-annual growth, when adjusted seasonally it is observed that private consumption expenditures decreased slightly compared to the previous period, mainly stemming from the decline in demand for durable, semi durable and non-durable goods.

Table 4.1.1. GDP Developments by Expenditure Side
(Constant Prices, Annual Percentage Change)

	2004					2005					2006
	I	II	III	IV	Annual	I	II	III	IV	Annual	I
1-Consumption Expenditures	11.6	15.4	5.9	4.7	9.0	4.1	3.9	9.8	14.1	8.1	8.4
Public	2.6	-7.8	-7.0	11.1	0.5	4.4	4.0	3.2	0.0	2.4	8.1
Private	12.4	18.4	7.3	3.6	10.1	4.1	3.9	10.4	16.7	8.8	8.4
Durable Goods	48.0	61.4	28.9	-5.7	29.7	3.2	2.9	26.0	31.3	15.0	13.5
Food and Beverages	5.3	2.6	0.0	5.4	2.8	3.3	8.6	10.8	8.7	8.2	6.5
Semi-dur. and Non-dur. Goods	8.2	36.8	18.3	16.3	18.8	9.0	3.0	3.7	39.6	12.9	12.8
2-Fixed Capital Formation	57.6	47.4	26.1	11.2	32.4	10.3	20.0	30.6	33.0	24.0	30.5
Public	-5.9	-8.7	-10.8	0.9	-4.7	30.7	30.2	38.2	17.1	25.9	34.6
Private	65.5	63.1	38.9	17.7	45.5	8.8	18.4	29.0	41.6	23.6	30.2
3- Stock Change*	2.5	1.4	-1.2	2.5	1.1	0.6	-0.7	-3.0	-6.3	-2.5	-4.4
4-Exports of Goods and Services	10.9	17.2	8.2	14.4	12.5	14.0	6.7	3.9	10.9	8.5	3.5
5-Imports of Goods and Service	31.3	32.7	16.1	19.6	24.7	10.6	9.1	11.2	15.3	11.5	8.2
6-Total Domestic Demand	20.6	21.4	8.1	8.5	14.1	5.6	6.8	10.9	11.6	8.8	8.5
7-Total Final Domestic Demand	19.8	22.9	9.9	6.3	14.1	5.5	8.4	14.5	19.1	12.1	13.8
8-GDP (Expenditure Side)	11.8	14.4	5.3	6.3	9.0	6.6	5.5	7.7	9.5	7.4	6.4

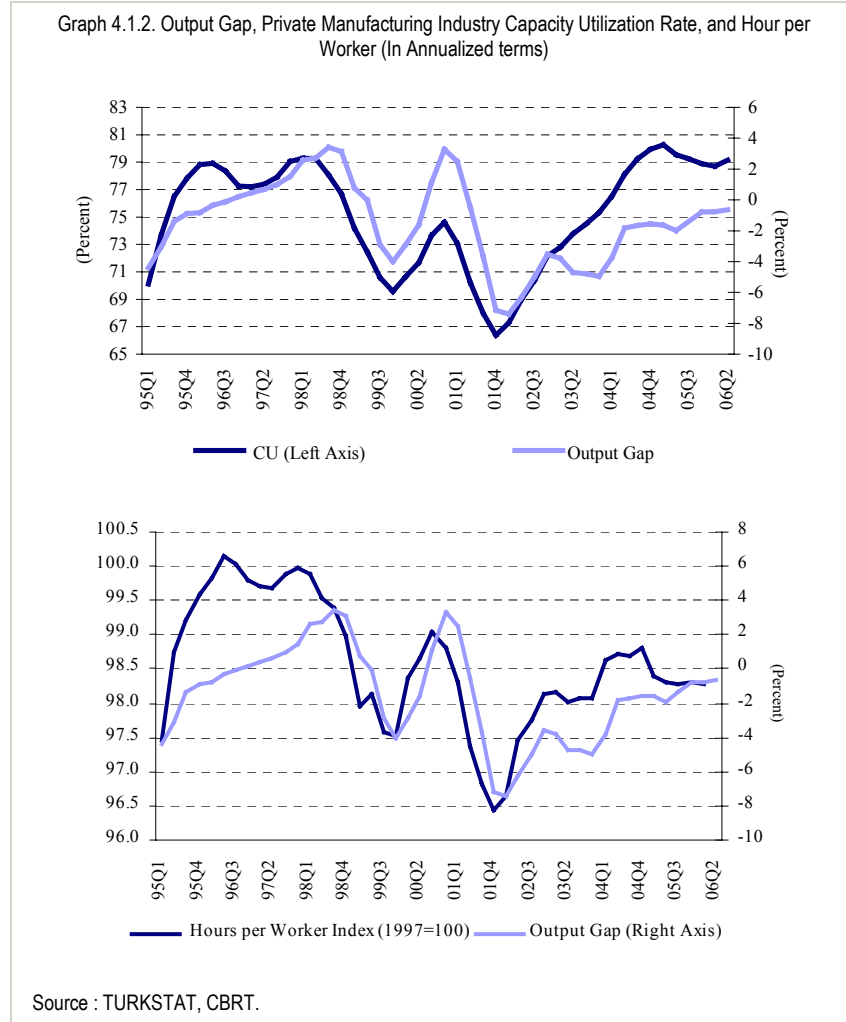
*Contribution to GDP growth, percent.

Source: TURKSTAT.

As a result of rapid growth in the demand for both consumption and investment, total final domestic demand increased by 13.8 percent compared to the same period last year (Table 4.1.1). Analyzed quarterly, despite the strong growth trend in investment expenditures, the decline in consumption expenditures has led to a decrease in total final domestic demand compared to the previous period (Graph 4.1.1).

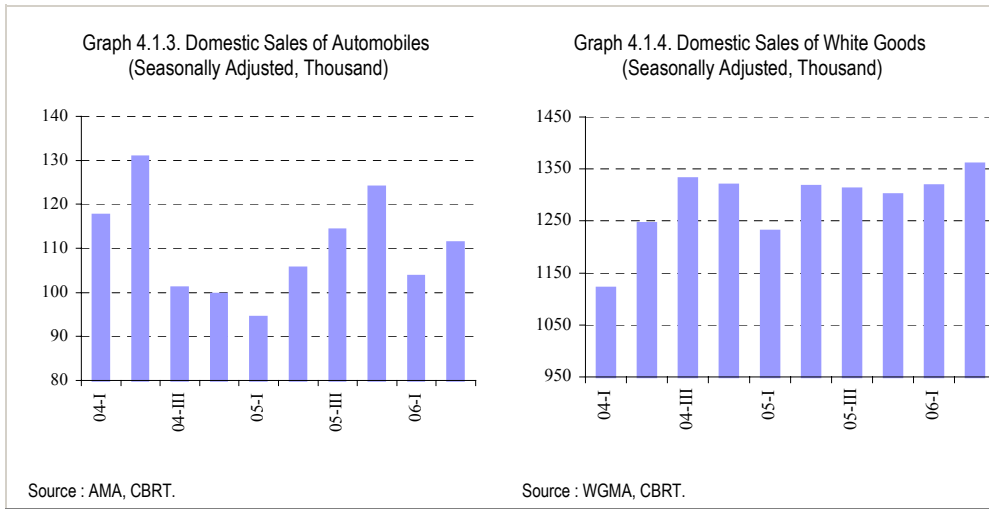
In light of this information, before analyzing the supply-demand developments of the first half of 2006, it would be useful to emphasize few points that had formed the basis of our past analysis. In the previous report, it was stated that despite rapid growth in total final domestic demand and the GDP, the current production trend did not cause any pressure on prices. In fact, in the period in question, neither output gap nor manufacturing sector capacity utilization rate and hours per worker pointed to overheating (Graph 4.1.2). It was also emphasized that the contribution of the output gap to the disinflation process had declined compared to the previous periods. Moreover, it was stated in the Inflation Report published in April that rapid economic growth did not pose any risk with respect to inflation due to two primary factors. The first factor is productivity gains supported by the structural transformation of the economy and the rapid increase in investment, and the second one is the strong position of the New Turkish lira vis-à-vis other foreign currencies. However, the financial turbulences observed as of mid-May have necessitated a revision

of this assessment. Therefore, it is beneficial to evaluate the aforementioned factors to identify to what extent they have changed since the last report.



In the first quarter of 2006, the composition of the domestic demand developed in favor of investment expenditures. The rise in partial labor productivity in manufacturing industry continued in the same period. Therefore, it can be asserted that the favorable trend in productivity, which is one of the factors contributing to the disinflation process, continues. However, due to rapid depreciation of the New Turkish lira, the cost conditions have changed significantly. In other words, the *direct* support to the disinflation process coming from the strong position of the New Turkish lira vis-à-vis foreign currencies ceased to exist and despite the rise in real interest rates, the monetary conditions started to affect inflation negatively. While the continued rise in partial labor productivity in the manufacturing industry in the first

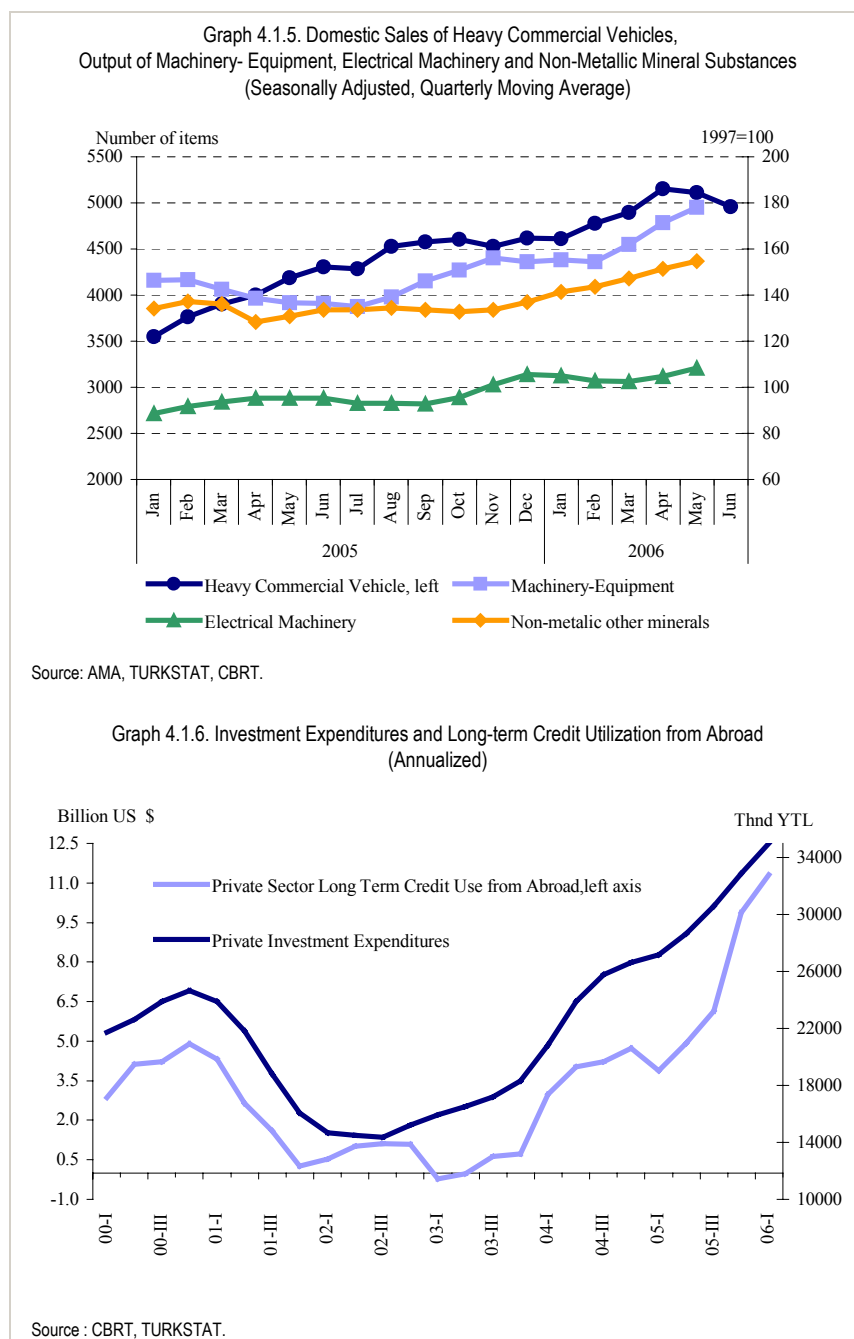
quarter helped to sustain the downward trend in unit labor costs, this downward trend will not be enough to compensate the rapid rise in imported input costs. In fact, the tendency for the next three months of the average unit cost indicator in the CBRT Business Tendency Survey (BTS) showed a sharp rise in May and June. The deterioration observed in cost conditions is not believed to generate an inflationary impact in the medium term as the rise in interest rates and the depreciation of the New Turkish lira are expected to curb demand.



In the second quarter of 2006, the high rate of increase in real consumer credits continued both monthly and annually. The seasonally adjusted domestic sales of automobiles and white goods have exceeded previous quarter's levels (Graph 4.1.3, Graph 4.1.4). Moreover, the imports data provide signals that point to a relative increase in the consumption demand in the second quarter. When all indicators are analyzed collectively, it can be asserted that consumption expenditures picked up in the second quarter following the slowdown in the first quarter.

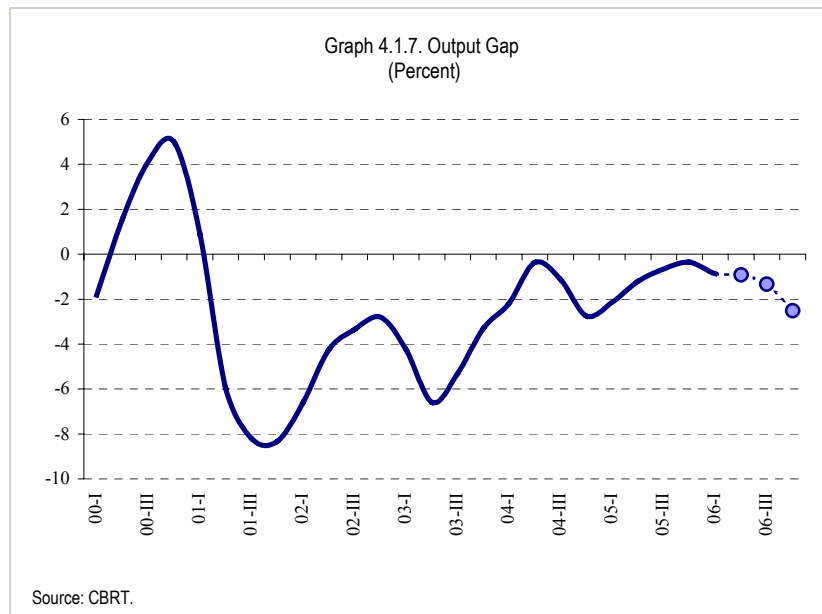
Indicators pertaining to investment demand maintained their strong trend in the second quarter as well. While the upward trend in imports of capital goods continued, output growth in manufacturing industry sub-groups such as machinery-equipment, electrical machinery and office equipment was quite high in April and May (Graph 4.1.5). Despite the rapid decline in June, domestic sales of heavy commercial vehicles increased in the second quarter compared to the previous quarter (Graph 4.1.5). Moreover, long-term credit use from abroad supports the strong investment tendency (Graph 4.1.6). In addition to the indicators related with machinery and equipment investment, output

developments in non-metallic other mineral substances sector, which provides intermediate inputs to the construction sector, signal the prevailing high level of activity in the construction sector (Graph 4.1.5).



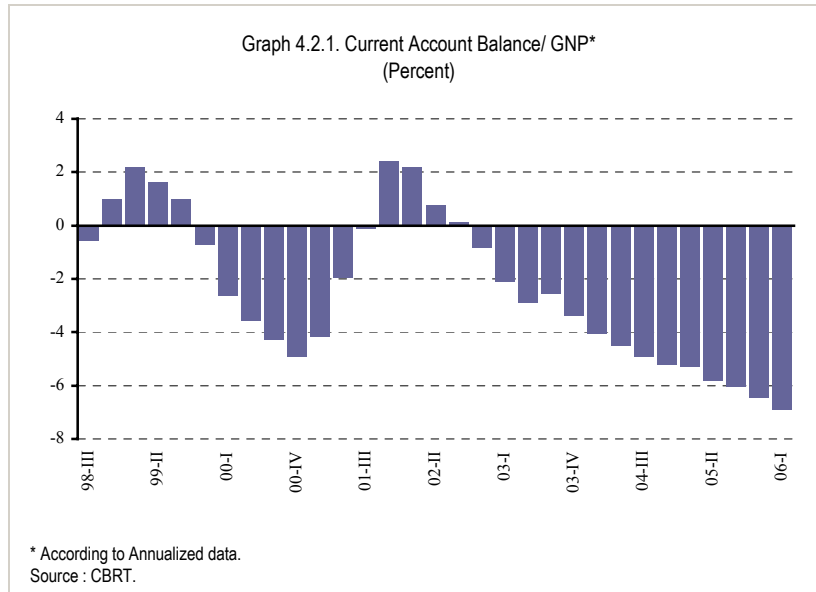
To sum up, it can be asserted that current data pertaining to consumption and investment expenditures, contain signals that following the slowdown in the last quarter of 2005 and first quarter of 2006, economic growth started to

pick up again by the second quarter of 2006. However, as had been stated in the previous reports, the strong investment-originated growth is an important factor preventing domestic demand from posing inflationary risk. Besides, increased uncertainty created by financial turbulences since May is expected to have an adverse impact on domestic demand and slow down economic growth in the second half of the year. Actually, according to the CBRT BTS, the tendency of domestic orders and sales for the next three months showed sharp declines in May and June. The rapid drop in the domestic sales of automobiles in June compared to the previous month also confirms these indicators. In this framework, it is anticipated that the medium-term tendency in demand conditions will continue to support the disinflation process. As demonstrated by output gap forecasts, the contribution of demand conditions to inflation is expected to increase in the second half of the year (Graph 4.1.7).



4.2. Foreign Demand

The current account deficit, which realized USD 16.6 billion in the January-May 2006 period, reached 6.9 percent of the GNP by the first quarter in annual terms (Graph 4.2.1). The increased trade deficit due to faster growing imports than exports, has led to rise in the current account deficit. In the January-May period, tourism revenues decreased by 3.1 percent and tourism expenditures by 11.7 percent, compared to the same period last year and thus, net tourism revenues decreased by 0.1 percent.



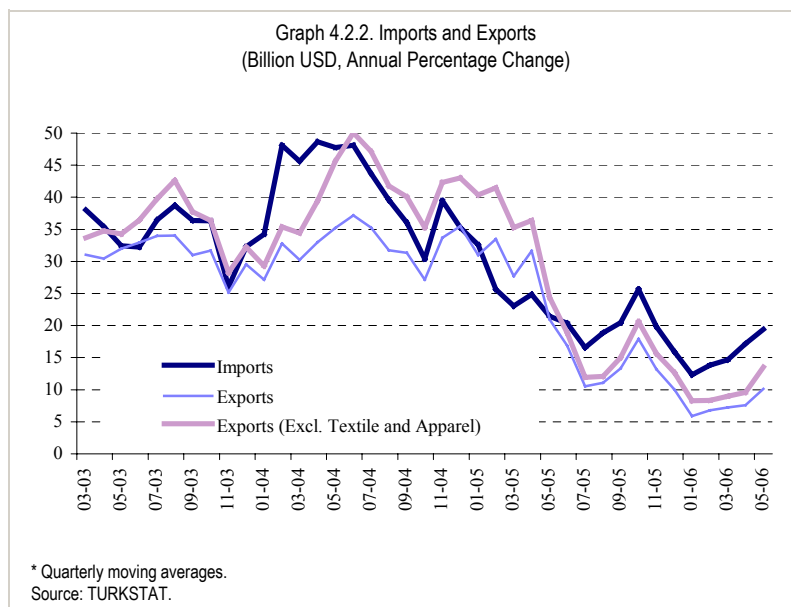
Rates of increase of imports and exports, which had started to slow down in the second half of 2005, have picked up recently (Graph 4.2.2). After a decline in the first four months of the year, the export performance of textile and apparels, which comprise a large share in total exports, increased in May again though still below the overall export performance. The rise in the exports of capital-intensive sectors such as motor vehicles, machinery-equipment, electrical machinery-appliances and communication tools in May played an important role in the general export performance. The data released by the Turkish Exporters Assembly (TEA) pertaining to June show an acceleration in total export growth, without a significant change in the export composition by sectors since May.

It is expected that depreciation in the New Turkish lira due to the financial turmoil in May would boost export performance in the second half and the end-year export target would be exceeded. Meanwhile, according to the results of a study conducted by CBRT's Research and Monetary Policy Department,¹ imported raw material expenses has the largest share in total expenses in the manufacturing industry with 36.1 percent (Box 4.1).² As imported input/materials have an important share in output especially in

¹ Karadaş, E., Mutluer, D., Barlas Özer, Y., Aysoy, C., (2006), "Pricing Behavior of Firms in Manufacturing Industry in Turkey", in Turkish, CBRT Working Paper, No: 06/02.

² The study deals with manufacturing firms that trade overwhelmingly in the domestic market. It has been assumed that the imported input ratio of exporter companies is close to that of firms trading in domestic market.

sectors like transportation vehicles, main metal industry and processed metallic goods, electrical and optical equipment, it is expected that the effect of depreciation in the New Turkish lira on exports would be limited in the medium-term as substitution of imported raw materials with domestic ones will be limited. In the long-run, focusing on productivity gains and concentrating on technology and capital-intensive sectors that bring higher value added, instead of relying on advantages brought by exchange rate movements, would be very important for the sustainability of the rise in exports.



When the imports composition is analyzed, it is observed that following the low rate of increase in the first quarter, imports of intermediary goods excluding petroleum products increased by 9.5 percent and 25.1 percent in April and May, respectively, parallel to the increased activity in manufacturing output. The boosting effect of petroleum products on imports of intermediary goods continued in this period. Imports of consumption and investment goods, which displayed a rapid rise in the first quarter, decreased according to seasonally adjusted data in the April-May period compared to the previous period, however growth in annual terms continued. The base effect observed in imports of consumption goods due to last year's low performance, led to a significant rise in imports of these goods in annual terms.

The effect of the depreciation in the New Turkish lira on imports is expected to become more apparent in the second half of the year. However,

imports of intermediary goods are not expected to show a significant slowdown due to the increase in exports, output and oil prices. Meanwhile, imports of capital goods and especially consumption goods is expected to decline due to contraction in domestic demand and the fact that the relative price advantage is no longer in place.

In the light of currently available data, it is forecasted that the current account deficit as a ratio of the GNP would decrease in 2006 and 2007 compared to 2005. Meanwhile, foreign direct investment revenues, which reached USD 8.6 billion in 2005, is expected to increase further in 2006 due to accelerated privatization activities, corporate mergers and acquisitions. As a result, the boosting effect of the current account deficit on vulnerabilities in the economy is believed to have diminished (Box 4.2).

4.3. Labor Costs

According to the results of the “Manufacturing Industry Workers, Working Hours in Production and Partial Productivity Index” prepared by TURKSTAT, employment in the manufacturing industry decreased by 1.7 percent in the first quarter of 2006 compared to the same period last year (Table 4.3.1). The decline in employment in both public and private manufacturing sectors continued in this period.

Table 4.3.1. Employment, Real Wage and Productivity Developments
(Percentage change compared to the same period of the previous year)

	2004	2005				2006	
	Annual	I	II	III	IV	Annual	I
Employment⁽¹⁾	2.0	1.9	-1.7	-1.8	-1.1	-0.7	-1.7
Public	-11.0	-10.2	-7.1	-8.6	-7.2	-8.3	-3.7
Private	3.6	3.2	-1.2	-1.1	-0.4	0.1	-1.5
Wages⁽²⁾	2.5	3.2	2.1	1.6	0.7	1.9	0.1
Public	4.7	8.7	5.4	9.0	8.4	7.9	-4.2
Private	4.8	3.5	2.0	1.0	-0.1	1.6	1.1
Productivity⁽³⁾	7.3	5.1	4.3	6.1	8.4	6.0	4.8
Public	10.5	7.0	11.8	15.5	9.8	10.9	-1.6
Private	8.0	6.1	3.5	5.2	8.8	5.9	5.9
Earning⁽⁴⁾	1.3	2.8	2.7	2.5	0.8	2.2	-0.6
Public	3.2	10.6	3.5	8.8	3.0	6.3	-3.7
Private	4.3	2.9	3.2	2.0	1.3	2.4	0.4

Source: TURKSTAT

(1) The Index of Manufacturing Industry Production Workers, 1997=100.

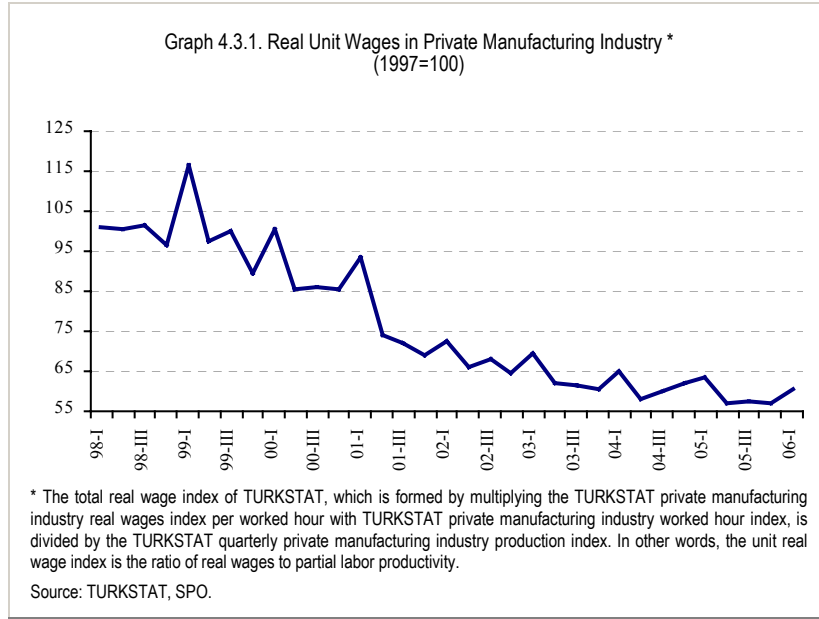
(2) The Index of Real Wages Per Working Hour in Production, 1997=100.

(3) The Index of Partial Productivity Per Working Hour in Production, 1997=100.

(4) The Index of Real Earnings Per Production Worker, 1997=100.

The partial productivity per working hour index increased by 4.8 percent in the first quarter of 2006 compared to the same period last year. In this period, productivity in the public sector has declined while it has increased in the private sector. In the first quarter, the real wages per working hour index

increased by 0.1 percent in total manufacturing industry and by 1.1 percent in private manufacturing industry while it decreased by 4.2 percent in the public manufacturing industry. In the private manufacturing industry, as a result of the continued rise in productivity coupled with a limited increase in wages, the decline in real unit wages continued and declined by 4.6 percent compared to the same period last year (Graph 4.3.1).



According to the national income statistics issued by TURKSTAT, gross fixed capital formation continued to increase rapidly in the first quarter of 2006. With the contribution of the rapid rise in investments observed for a long time, the increase in productivity is expected to continue. Therefore, under the assumption that there would not be high rates of increase in real wages, it is expected that the contribution of real unit wages to the disinflation process would continue in the upcoming period. Moreover, it is expected that low level of unit wages in terms of foreign currencies due to depreciation of the New Turkish lira, would contribute to the competitiveness of firms in export markets, which would in return make a positive contribution to exports.

In this framework, wage arrangements for 2007 are of utmost importance. In 2006, average civil servant salary increased by 12.7 percent³ and the minimum wage increased by 8.7 percent. According to the collective labor agreement signed in July 2005, it was decided that public workers' wages

³ Increase in average civil servant's salary due to 2.5 increments for the first and second halves of 2006 and compensation of 40 YTL in the first and second halves of 2006 to the civil servants who do not have any additional payment other than salary.

would be increased by 3 percent in the first and second halves of the year. However, it was stated that in case the CPI inflation exceeded the increment level, 80 percent of the difference in the first half and 100 percent of the difference in the second half would be compensated.⁴ Therefore, public officers' salaries are expected to increase in real terms and public workers' wages are expected to decrease slightly in 2006. Keeping salaries and wages that are determined by the public sector consistent with the inflation target in 2007 is very important for the convergence of inflation expectations with the target.

⁴ In accordance with the mentioned collective labor agreement, public workers' wages were incremented by 4.5 percent in July 2006.

BOX 4.1. RESULTS OF THE SURVEY ON PRICING BEHAVIOUR OF FIRMS¹

After the Central Bank of the Republic of Turkey adopted the explicit inflation targeting regime, conducting studies with the aim of strengthening the available data set and making the transmission mechanism more comprehensible have become even more crucial than before. In this framework, the CBRT conducted a "Survey to Analyze the Pricing Behaviors of the Firms" in 2005. The aim of the study was to analyze how firms made their pricing decisions and how they reacted to various changes that could affect product prices, and to test price rigidity under various theories.

Sampling

The Balance Sheets By Sectors database of the CBRT prepared for 2003 has been used in order to draw the framework of the study. From this data base, 3,606 firms operating in the manufacturing industry, which were established in year 2000 or before and which were not under the scope of cooperatives, foundations or public institutions, were selected. The cut-off method has been employed for sampling. The survey was conducted face to face with the 628 firms having 70 percent of total net sales in each sector and via mail with the remaining 2,978 firms. Response rates have been 52.7 percent for the firms interviewed face-to-face and 22.4 percent for those conducted via mail. The responses have been weighted with the firms' net sales.

Composition of Expenses and Indexation

It is very important to know the composition of total expenses of a firm to be able to understand better the firm's pricing policy and the prospective responses that it could give to various shocks. To this aim, when the composition of firms' expenses is analyzed, it is observed that the imported raw materials and supplies expenses (those that have been bought from domestic firms are included) have the largest share with 36.1 percent (Box 4.1 Table 1). Meanwhile expenditures on domestic raw materials and supplies constitute 32.6 percent of the entire main operating expenses. Total labor costs (including social security premium, etc.) have an 11.6 percent share while electricity, gas and water expenses have a 6.6 percent share while other expenses constitute 13.1 percent of all expenses. The sectors using mostly imported raw materials are the electrical and optical equipment industry, rubber and plastic products industry and main metal industry while the sectors using mostly local raw materials are food and furniture sectors, other manufacturing industry sectors that have not been classified under a specific heading, and also wood and wood products sector.

In order to find out how widespread the utilization of the indexation method is in different sectors and to see the variables that prices are indexed to, a special question was posed. For the purposes of this survey, indexation is defined as a rigid link between the price of a certain product and a variable where any change in this variable is entirely reflected at once, on the New Turkish lira value of the product in question.

¹The results presented here are a short summary of the result in Karadaş et al. (2006). For further information please see the mentioned survey.

In Box 4.1. Table 1, the far right column displays the ratio of firms whose products are somehow indexed to a certain variable and it is observed that 36.4 percent of the firms use indexation. When the firms interviewed face-to-face are analyzed by sectors, it is observed that the sectors using the indexation method most intensively are those of the main metal industry, electrical and optical equipment, rubber and plastic products, and textile and textile products industry. In all sectors using the indexation method, prices are indexed either to USD or EUR. Meanwhile, the implementation of indexation is very widespread in sectors using mostly imported raw materials.

Box 4.1. Table 1. The Shares of Components in the Main Operation Area Expenses in 2004
(Weighted According to Net Sales, Average, Percent)

Sectors	Imported Raw Materials and Supplies	Domestic Raw Materials and Supplies	Total Labor Expenses	Electricity, Gas and Water Expenses	Other Expenses	Ratio of Firms Using Indexation
Elect. And Optical Eq.	64.7	14.4	8.8	2.6	9.5	50.2
Rubber and Plastic	53.9	17.9	9.9	5.2	13.1	50.0
Main Metal	50.4	24.2	7.8	8.7	8.9	71.0
Chemistry	46.9	17.0	14.0	5.9	16.3	37.4
Transportation Vehicles	46.8	31.6	7.8	1.7	12.1	21.8
Leather	45.9	19.7	17.0	6.1	11.3	41.3
Machinery	36.1	33.6	11.3	5.3	13.8	13.2
Paper	34.0	26.5	13.0	7.3	19.3	22.6
Textiles	27.0	35.1	15.8	8.6	13.6	49.4
Wood	24.7	51.3	9.9	9.7	4.5	34.3
Furniture and UMI	22.8	52.7	13.6	3.4	7.4	27.2
Food	18.5	54.8	9.8	4.6	12.4	8.6
Non-Metallic Materials	8.1	33.5	17.7	19.2	21.5	29.1
Total	36.1	32.6	11.6	6.6	13.1	36.4

Competition in the Market and the Position of the Firm

The primary factors affecting the pricing policies of the firms are; the level of competition in the market, the market share of the firm and its position in the market. In the manufacturing industry in general, firms have stated that they were competing with 6 firms in the country and their market share was 22.5 percent (Box 4.1 Table 2). Meanwhile, 46.9 percent of the firms stated that they were the biggest firm in the market; 35.7 percent stated that they were among the first four, 10.8 percent said they were among the first eight and 6.7 percent said they were not among the first eight. The firms, which claimed that they were the biggest firm in the market, said they were competing with 5 firms domestically and as expected, the lower a firm ranked the higher the number of competitors was. While the market share of the main products of the firms that stated that they were the leading company in the domestic market was 35.0 percent; similar to the number of competitors, the lower a firm ranked, the lower the main product's market share was.

Box 4.1. Table 2. The Number of Competitors and Market Shares of Main Products According to the Firms' Position in the Domestic Market (Median*)

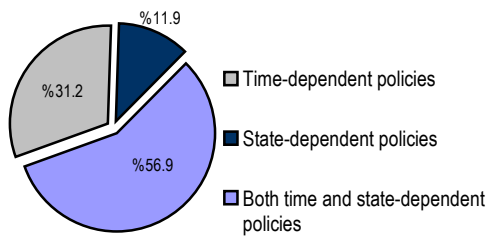
Firm's Position with Respect to Market Share	Number of Competitors	Market Share of Main Product (%)	All the Firms
Biggest Firm	5.0	35.0	46.9
Among the First Four	6.0	17.5	35.7
Among the First Eight	12.0	8.0	10.8
Not Among the First Eight	20.0	2.3	6.7
All the Firms	6.0	22.5	

*Median is used due to skewed distribution.

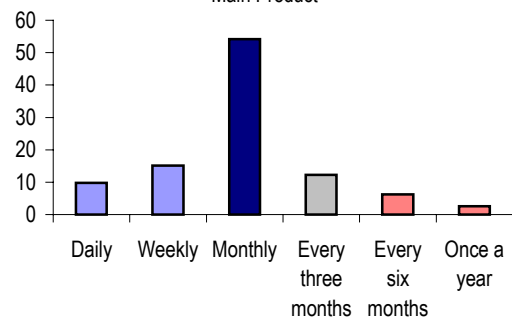
Frequency of Price Reviews and Price Changes

It is believed that price adjustment is a two-stage process. In the first stage, the prices are reviewed to see if they are compatible with the existing demand and cost conditions and during the second stage, prices are actually changed if needed. Currently, there are two different approaches to price adjustment in economics literature, one depending on time and the other on circumstances. In time-dependent policies, the prices are reviewed in pre-planned intervals without giving responses to changes in the economy. In this policy, the time interval between two succeeding reviews is determined according to the price erosion vis-à-vis inflation and thus according to the inflation rate. In state-dependent policies, however, there are no pre-planned price review intervals, but the time of price reviews are determined by big shocks that necessitate a revision in prices. According to the survey results, 31.2 percent of the firms adopt time-dependent price reviews, 11.9 percent adopt state-dependent and 56.9 percent opt for both time-dependent and state-dependent policies. (Box 4.1. Graph 1). In other words, while 88.1 percent of the firms prefer time-dependent policies and 11.9 percent normally prefer state-dependent policies, in the case of a shock emerging in the economy, the mentioned ratios change and become 31.2 and 68.8 percent, respectively. The firms that opt for time-dependent policies under normal circumstances were asked how frequently they reviewed their prices. As illustrated in Box 4.1 Graph 2, 78.9 percent of the firms review their prices every month or more frequently. Consistent with these results, the firms have stated that they had reviewed their prices 12 times in the last 12 months and 4 of these reviews ended up in price adjustments.

Box 4.1. Graph 1. Price Review Policy



Box 4.1. Graph 2. Time Interval for Reviewing the Price of Main Product



Pricing Policy

The firms participating in the survey were asked to evaluate the choices presented related with the pricing policy they implemented for determining their main product's price. The results show that firms mostly implement variable profit margins and they follow the leading firms in the sector to determine their prices (Box 4.1. Table 3). The firms have not rated these choices as highly significant, which means that none of the choices presented was adequate in reflecting the pricing policy of the firms alone and that firms prefer to implement more than one policy at a time instead of opting for one type of policy.

While determining their prices, firms may employ policies based on costs or policies focusing on market conditions. The results of the survey suggest that firms generally adopt policies based on costs, however they follow market conditions closely while deciding on the profit margin. The relation between the firms' position with respect to their main products' market share and their pricing policies are shown in Box 4.1 Table 3. Accordingly, it is observed that fixed profit margin implementation is most common in firms that stated that they are not among the eight biggest firms in the market. This shows that instead of incurring the cost of monitoring prices of competitors and the demand conditions, which are necessary for determining prices, smaller firms prefer to determine their prices by adding a fixed profit margin to their average unit cost. Meanwhile, while a flexible profit margin is implemented in all of the four groups, it is more common in firms that define themselves as the biggest firm in the market or state that they are among the first four firms.

Box 4.1. Table 3. Level of Importance Pertaining to the Position in the Market and the Price Policy Implemented*

Position of the Firm on the Market with Respect to Market Share	Oligopolistic Pricing	Variable Profit Margin Implementation	Fixed Profit Margin Implementation	Perfect Competition Pricing	Customer-Oriented Pricing	Pricing by A Regulatory Agency
Biggest Firm	48,3	51,3	24,5	13,3	10,3	4,7
Among the First Four Firms	52,1	48,3	31,3	29,7	19,5	2,9
Among the First Eight Firms	48,0	37,9	29,1	33,0	13,3	12,7
Not Among the First Eight Firms	38,5	43,2	41,6	37,9	19,3	13,2
All firms	48,9	48,4	28,5	22,7	14,5	5,7

* Level of importance is rated between 0 and 100. The closer the value is to 0, the less important the factor is for the participant and the closer the value is to 100, the more important the factor is for the participant.

Price Adjustments

In the survey, prospective factors that may necessitate price adjustments have been presented and the participants have been asked to rank them according to their importance. As was expected, a rise in costs was the most important factor that led to an increase in prices. Besides a rise in costs, an increase in exchange rates, in competitors' prices and in demand were the other factors that necessitated a price adjustment. The factors, which encouraged the firms to lower their prices, were a decrease in costs, a decline in demand or a decrease in competitors' prices.

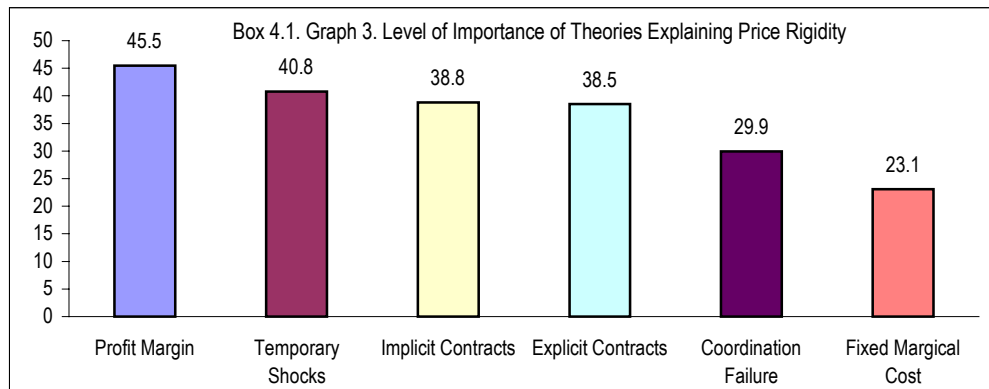
One of the most important issues judged in pricing surveys is whether there is an asymmetry between the upward or downward cost or demand shocks and the responses given by the firms. According to the survey results, a change in costs is more effective in increasing prices than lowering them. For demand, just the opposite is observed, which means the firms are not as responsive to an increase in demand as they are to a decrease in demand. It is observed that in case there emerges a significant rise or fall in costs, firms reflect this change on their prices in approximately a month's time.

Similarly, the time interval between a decrease or increase in demand and the firms' price change is 30 days, which is the same with the firms' response to cost changes.

The widely accepted policy in case of an exchange rate push-increase in costs is that firms prefer not to change prices unless the increase in exchange rates exceed a certain level after the last price adjustment. The participants, who declared that their main product's price is sensitive to exchange rates were asked questions about their process of reflecting exchange rate changes on their prices to find out whether there was any asymmetry in the reflection process. Even if there are differences between sectors, participants stated that they considered a 7.5 percent increase (or 7.0 percent decrease) in exchange rates enough to review their prices and declared that they would increase their prices by 5 percent (or decrease them by 4 percent) if exchange rates stayed at that level for a month.

Price Rigidities

In the last part of the survey, theories that try to explain the prospective reasons of price rigidities -a state where firms are not able to change their prices even if they want to- were analyzed. In the literature, there are many theories on this issue from the menu cost theory to the theory of coordination failure. As the answers of these theories to price rigidities and their macroeconomic impacts differ, it is very important to understand which theory is more explicative.



When the levels of significance of theories explaining price rigidities are analyzed, it is observed that the profit margin theory has the highest value (Box 4.1 Graph 3). According to this theory, if a firm has determined a price considering the inflation level and the upward trend in costs, even if an increase in costs arises, the firm does not reflect this increase on its prices at once and waits for the erosion in the profit margin to reach a certain level. This can be interpreted as that firms want to operate with a profit margin that does not force them to change prices immediately, following a rise in costs, but with one that allows them to move within a certain maneuver area.

Moreover, general acceptance of this theory means that firms prefer less frequent and bigger price changes instead of more frequent but smaller price changes.

The theory, which suggests that if there is a possibility of raising prices again, prices may not go down even if demand and costs increase, became the second in the ranking. This result shows that in an inflationary environment, firms will not decrease their prices even under circumstances that necessitate a fall in prices and would prefer to wait for inflation to eradicate these reasons. It is not surprising to see the theory of temporal shocks as the second ranked theory in an environment where inflation is clearly felt. In the first place, even if a shock that might necessitate a decrease in prices emerges, keeping prices constant is a more desirable state. What is important here is to judge if a mechanism that would urge firms to decrease their prices operates or not. As the operation of such a mechanism weakens in an inflationary environment, firms may not decrease their prices thinking that the shock is temporary.

The third and fourth theories were the explicit and implicit contracts theories. As the difference between these two theories is not statistically significant, it is not possible to make a clear classification. It is observed that the lower the firm ranks in the market with respect to market share, the more important the explicit contracts became. This can be interpreted that as a firm becomes bigger, it prefers to develop more institutional policies instead of conducting one-to-one relations with customers.

Neither at the level of firms nor by sectors, have the coordination failure theory and fixed marginal cost theory been rated much in explaining price rigidities. Meanwhile, it is observed that the coordination failure theory becomes more important as the firm's position in the market decreases, the number of competitors increase and market share declines. This suggests that compared to other firms, firms having a lower rank and a lower market share follow competitors more closely in determining their prices.

Generally speaking, the profit margin theory, which ranked first among the six theories in explaining price rigidities, had only 45.5 points importance level and this suggests that participants do not attribute much importance even to the explanation of the highest ranking-theory. This can be interpreted that either the theories chosen are not suitable to explain price rigidities or price rigidities are not as yet so important for participants. When the fact that firms have been operating in an inflationary environment for a long time is considered, it can be asserted that compared to the benefit from not changing prices due to the reasons listed in rigidity theories, the firms' losses have been greater with respect to the reasons that urge firms to change their prices.

Source:

Karadaş, E., Mutluer, D., Barlas Özer, Y., Aysoy, C., (2006), "Pricing Behavior of Firms in Manufacturing Industry in Turkey", in Turkish, CBRT Working Paper, No: 06/02.

BOX 4.2. RISE IN INTERNATIONAL ENERGY PRICES AND ITS EFFECTS ON CURRENT ACCOUNT DEFICIT

After 2005, the upward trend in the current account deficit continued also in the first five months of 2006 and reached USD 28.7 billion on annualized basis in May 2006. However, it is believed that domestic demand would be negatively affected in the rest of the year due to depreciation of New Turkish lira and higher interest rates stemming from fluctuations in the financial markets that started in May. Accordingly, trade and current account deficits are expected to narrow in the second half of the year. Especially, imports of capital and consumption goods that are thought to be relatively more sensitive to interest rate and exchange rate movements, are expected to decelerate in the same period of 2006 after showing high rates of increase in the second half of 2005. However, in the same period again, imports of intermediate goods are expected to continue to increase because of high energy prices. In this Box, the effects of the rise in energy prices that played an important role in the widening of current account deficit will be analyzed.

Higher demand in international markets due to rapid global growth, limited spare capacity and interruptions in oil production in countries like Iran, Nigeria and Venezuela led to rapid increases in crude oil prices in the last few years. The price of Brent oil, which was on average USD 28.8 per barrel in 2003, reached USD 77 in July 2006 with the political tension in the Middle East. These developments triggered increases not only in oil prices, but also in natural gas and other energy prices.

Being a net energy importer, the rapid climb in energy prices in international markets boosted Turkey's energy bill, and in turn, led to a deterioration in foreign trade balance and the widening of current account deficit. Due to several reasons such as the contracts signed with oil producers, the type of crude oil imported and geographical proximity to Middle East, Turkey is able to import oil at a price lower than world prices. Actually, in the first five months of the year, the price of crude oil per barrel imported by Turkey was USD 61.2 on average, which is lower than market price, however, the rates of increase have been very close to each other (Box 4.2 Table 1).

Box 4.2. Table 1. Crude Oil Prices (USD/Barrel)				
	2003	2004	2005	2006*
World Price of Brent oil	28.8	38.3	54.5	65.1
Imported crude oil price in Turkey	26.9	34.5	50.1	61.2

*January-May period.
Source: TURKSTAT and EIA (Energy Information Administration).

The extra cost of the rise in energy prices on current account deficit in the last three years was calculated based on the energy prices in 2003. The difference between the value obtained by increasing the total energy bill by the rise in volume with respect to 2003 prices and the actual bill is the extra cost stemming from the rise in prices. The rise in volume has been calculated by using foreign trade volume indices based on 2003 figures (2003=100) published by TURKSTAT. According to ISIC Rev.3 classification, the energy sub-items are crude oil, natural gas, mining of coal, peat, lignite in mining and quarrying sector, and coke, refined oil products and nuclear fuels in manufacturing industry. Meanwhile, in order to be able to measure the net effect on current account deficit, energy exports in these sectors were included as well.

According to the calculations in Box 4.2. Table 2, it is observed that the rise in energy prices has pushed up imports by USD 2.8 billion and exports by USD 0.4 billion in 2004. This in turn led to an expansion of USD 2.4 billion in current account deficit in the same year. The acceleration in the rise in energy prices further enhanced this effect in 2005.

In fact, although the volume of imports of crude oil decreased by 2.7 percent in 2005 compared to 2003, the crude oil import bill increased by 81.1 percent due to the 86.2 percent-rise in the price per barrel. As natural gas and other energy costs increased parallel to the rise in crude oil prices, Turkey's bill for imported energy reached USD 21.2 billion in 2005. When the rise in exports are taken into account, the extra cost stemming from the increase in prices became USD 7.8 billion and reached 2.1 percent of GDP in 2005 (Box 4.2. Table 2).

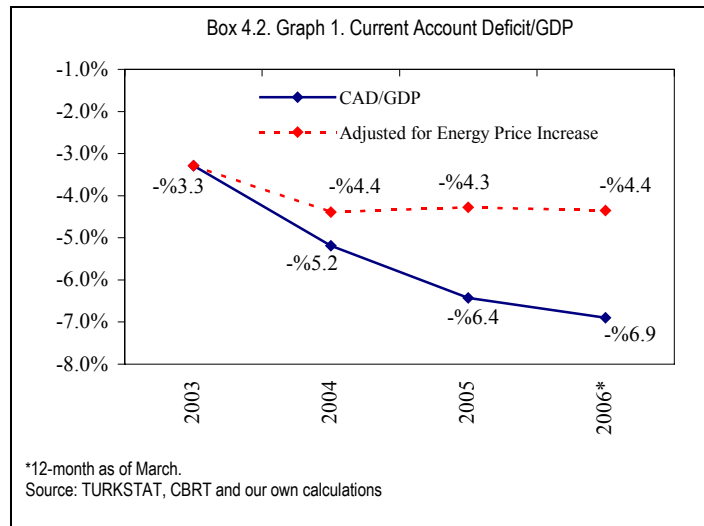
In the first five months of 2006, due to rapid increase in energy prices, Turkey's imports bill swelled by USD 7.7 billion. Meanwhile, as the price effect contributed to exports by USD 0.9 billion, the net effect of the rise in energy prices to current account deficit was limited to USD 6.8 billion. In other words, the current account deficit, which was 16.6 billion in the first five months of 2006, becomes USD 9.8 billion when the figures are adjusted for the 2003 energy prices. According to the annualized figures as of March, the net effect of the rise in energy prices on current account deficit that constitutes 6.9 percent of GDP, is USD 9.4 billion (2.5 percent of GDP) (Box 4.2. Graph 1).

Box 4.2. Table 2. The Effect of the Rise in Energy prices on Current Account Deficit

	2003	2004	2005	2006*
Total Imports (USD billion)	69.3	97.5	116.8	120.6
Imports of Energy	11.5	14.4	21.2	23.2
Imports of Crude Oil	4.8	6.1	8.6	9.0
Extra Cost Stemming from the Rise in Energy Prices		2.8	8.8	10.6
Total Exports (USD billion)	47.3	63.2	73.5	74.7
Exports of Energy	1.0	1.4	2.5	2.6
Extra Income from the Rise in Energy Prices		0.4	1.0	1.2
Current Account Deficit (CAD)				
Current Account (USD billion)	-8.0	-15.6	-23.2	-25.5
CAD/GDP (percent)	-3.3	-5.2	-6.4	-6.9
CAD Adjusted for the Rise in Energy Prices				
Current Account (USD billion)	-8.0	-13.2	-15.5	-16.1
CAD/GDP (percent)	-3.3	-4.4	-4.3	-4.4

*12-month as of March.

Source: TURKSTAT, CBRT and our own calculations.



Financing of Current Account Deficit and Direct Investment Inflows

The quality of the financing of the current account deficit has improved remarkably since 2005. Apart from the increase in long-term credit utilization, the rise in direct investments in Turkey by non-residents, which is a non-debt creating capital item, has reached historically high levels. Net foreign direct investment reached USD 8.6 billion (2.4 percent of GDP) in 2005. In the first five months of 2006, capital inflow through foreign direct investments became USD 8.1 billion. Therefore, the ratio of direct investments to the current account deficit of USD 16.6 billion was around 50 percent in the same period (Box 4.2. Table 3).

Direct capital inflows through company mergers and acquisitions, the contracts of which have been already signed, are expected to continue in the upcoming period. It is forecasted that the direct investments would reach at least USD 14.4 billion in 2006. The forecast in question depends on the assumption that the payments pertaining to the privatization and sales would be effected in 2006.

Box 4.2. Table 3. External Financing Sources (USD billion)				
	2003	2004	2005	2006 ⁽¹⁾
Capital Flows (net) ⁽²⁾	6.5	23.6	44.3	25.2
Capital and Financial Account	3.1	13.3	20.8	15.6
Direct Investment	1.2	2.0	8.6	8.1
Portfolio Investment	2.5	8.0	13.4	-0.1
Other Investment	3.4	4.2	16.6	13.8
Banks	2.0	5.7	9.2	4.1
Long-term	0.0	2.4	6.5	3.1
Short-term	2.0	3.3	2.7	1.0
Other Sectors	3.2	9.3	13.8	12.7
Long-term	0.7	4.7	9.9	10.9
Short-term	0.3	0.3	0.4	0.1
Trade Credits	2.2	4.2	3.6	1.7
Other	-1.8	-10.8	-6.4	-3.0
Change in Official Reserves ⁽³⁾	-4.0	-0.8	-17.8	-6.2

(1) January-May period.

(2) Excluding IMF credits and reserves change.

(3) Negative sign indicates increases.

Source: CBRT.

The above given analysis suggests that the extra cost created on current account deficit in recent years by the rise in energy prices continues to increase. However, when it is adjusted for the price increase, it is observed that the ratio of current account deficit to GDP is stagnant. Meanwhile, stronger financing structure due to the higher share of non-debt creating items, the depreciation of the New Turkish lira in May and June, and the foreseen slowdown in demand is expected to curb the current account deficit-related risk perceptions. However, new shocks beyond expectations in international markets and the continuation of the increases in energy prices might impede the expected improvement in the foreign trade, and hence, the current account balance.

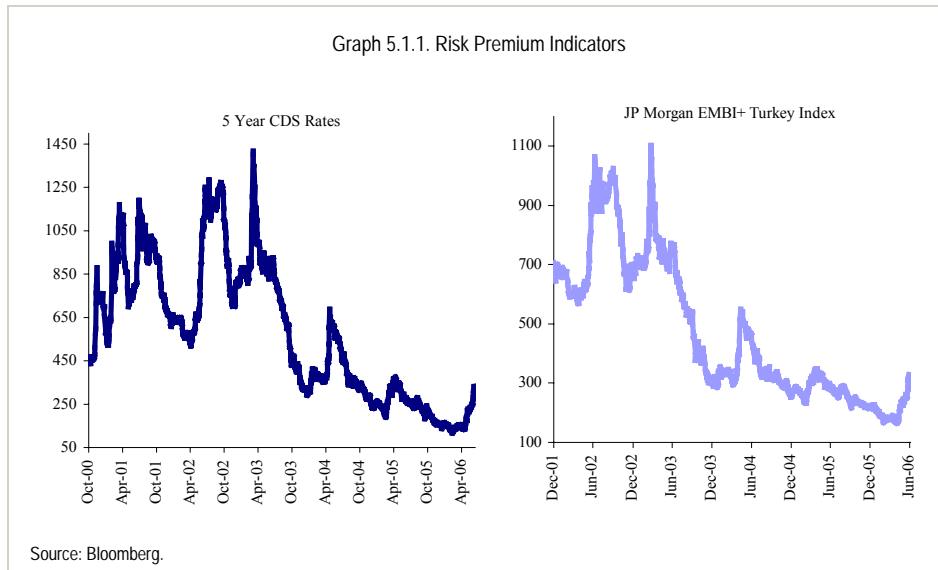
5. Financial Markets and Financial Intermediation

5.1. Financial Markets

By June 2006, annual inflation became 10.12 percent by exceeding the upper limit of the uncertainty band that was set around the path consistent with the target. In order to better understand the main factors that led to this increase, it will be useful to analyze the inflation developments that occurred in the first half of the year in two separate periods, as January-April and May-June. In the January-April period, high increases in the prices of oil, gold and unprocessed foods were effective in the upsurge in inflation. Although the mentioned supply shocks interrupted the downward trend of annual inflation, they did not change the favorable course in the medium term. In this framework, the Committee acted in line with the policy perspective mentioned in the Inflation Report of January and cut policy interest rates by 0.25 percentage points at its April meeting.

April inflation figures published just after a few days following this decision were realized quite above the market expectations. Although April inflation was basically determined by the prices of unprocessed food, gold and energy, this development took place at a time when perceptions of uncertainty increased. As a result, economic agents attributed a negative meaning to inflation figures and concerns about the continuation of the upward trend of inflation increased.

In May, the outlook of international liquidity conditions, which had been in favor of developing countries, entered a period of change due to the increasing uncertainties observed in the monetary policies of developed countries. The risk appetite towards the country groups including Turkey declined (Graph 2.2.2) and the risk premium increased rapidly (Graph 5.1.1). In other words, one of the risk factors mentioned in the Inflation Reports published in January and April was realized. As a result, Turkey witnessed a sudden deterioration in the credit risk premium (measured by the EMBI spread) by almost 150 basis points and the New Turkish lira depreciated more than 20 percent against the USD in May and June.



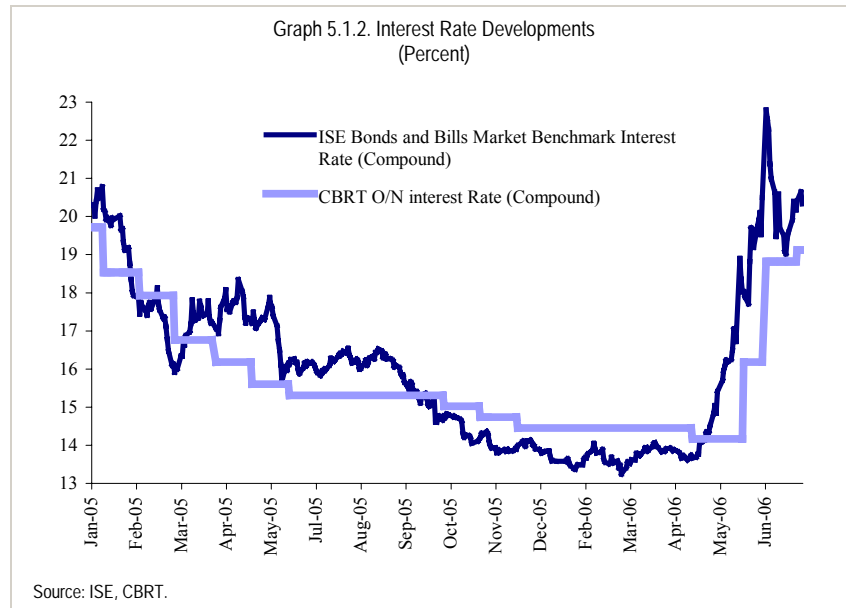
At the background of reversed international liquidity conditions, May inflation figures, which were realized above expectations due to the extraordinary increase in unprocessed food prices, heightened the volatility in financial markets. In a period where supply-oriented shocks put significant pressure on inflation, the rapid depreciation of the national currency disrupted inflation expectations. These developments indicated that the impacts of depreciation of the national currency on prices might go beyond what was required by relative price adjustment. The Committee held an extraordinary meeting on 7 June 2006 and decided on a 175-basis-point increase in policy interest rates. As the announcement was perceived as decisive, the volatility in the markets eased. In other words, the fluctuation in financial markets stopped to some extent supported by the emphasis placed on the determined fight against inflation.

Following these developments, in the ordinary meeting dated 20 June 2006, the Committee stated that the data announced on 7 and 20 June and recently acquired information did not change the outlook in the medium term and decided to keep policy rates unchanged. However, after the Committee meeting, market volatility increased again due to unfavorable developments in global liquidity and risk perception accompanied by the deterioration of inflation expectations. It became necessary for the Monetary Policy Committee to hold a second extraordinary meeting as the loss of stability in the markets was incoherent with economic fundamentals and it had the potential to threaten medium-term targets by damaging inflation expectations even further.

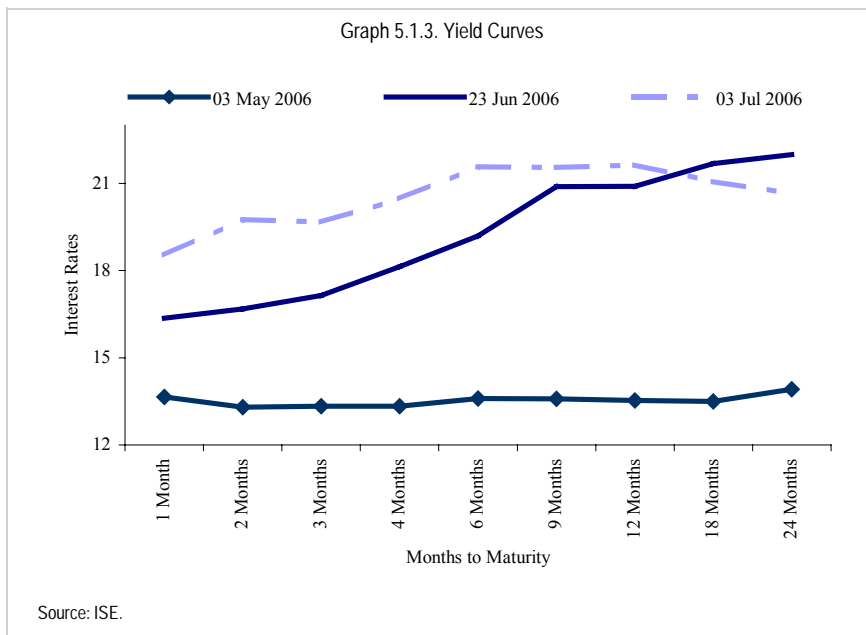
Three important decisions were made and put into effect after the meeting. Firstly, short-term interest rates were increased to 17.25 percent by rising 225 basis points. Secondly, in order to reduce the excess volatility in the FX market, the excess YTL liquidity in the financial markets was withdrawn through a combination of one and two week YTL-deposit purchase auctions. After the announcement of the purchase amount, the interest rate is determined by the auction bids. The interest rates formed in the initial days of high volatility increased rapidly up to 21.22 percent, then eased by dropping to 19 percent. Thirdly, foreign exchange sale auctions were held to prevent the liquidity squeeze in the FX market from hindering the proper functioning of the market mechanism and to render price formations in harmony with economic fundamentals. The total amount of sales of the two auctions reached USD 1 billion. This operation also contributed to the withdrawal of the excess YTL liquidity. In addition, the Central Bank had direct foreign exchange interventions in order to reduce excessive volatility.

In the week the decisions became operative, as interest rates formed in the YTL deposit auctions converged to the level of CBRT lending rates, the 3 point difference between deposit and lending rates was raised to 5 points so that the lending rate was raised to 22.25 percent. The effects of the measures, which are part of the CBRT's determined effort to meet inflation targets, began to be seen in a short period of time. Consequently, the volatility in exchange rates decreased. One and two-week deposit rates also decreased, to reflect the decline in uncertainties regarding inflation. Lastly, in the MPC meeting held on 20 July 2006, the cautious stance towards the inflation outlook was maintained and policy interest rates were increased by 0.25 points. With this decision, the CBRT's determination to reach the inflation target for 2007 was emphasized once again.

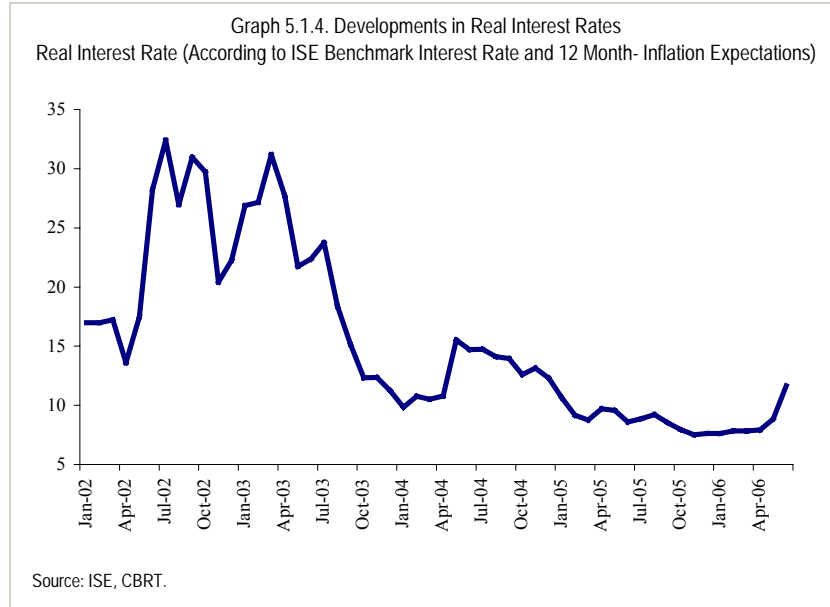
The deterioration in inflation expectations and risk perceptions that persisted in May and June brought about a rapid increase in the benchmark government securities interest rate that is formed in the Bonds and Bills Market of the Istanbul Stock Exchange (ISE). Nevertheless, the benchmark interest rate decreased in July as a result of the CBRT's responses regarding monetary policy and the decline in the deterioration of international liquidity conditions (Graph 5.1.2).



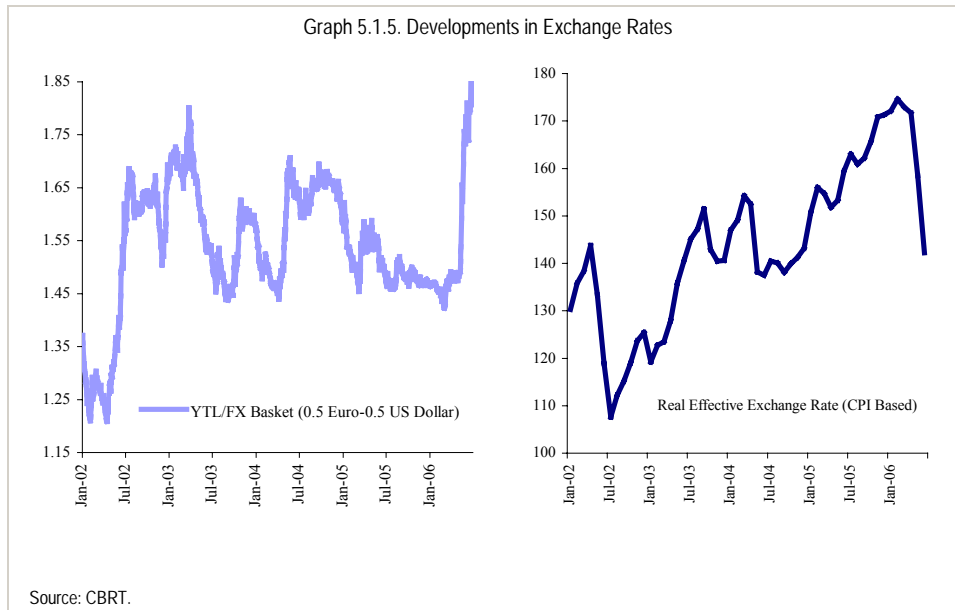
The secondary market interest rates of government securities traded in the ISE increased in all maturities as of the first week of May, where international liquidity conditions had started to deteriorate and yield curves had started to shift upwards (Graph 5.1.3). The upward trend of interest rates continued until the monetary policy decisions were made at the Monetary Policy Committee on 25 June 2006. Along with the easing of concerns about the CBRT's determination to fight inflation, a downward movement was observed at the longer maturity end of the yield curve.



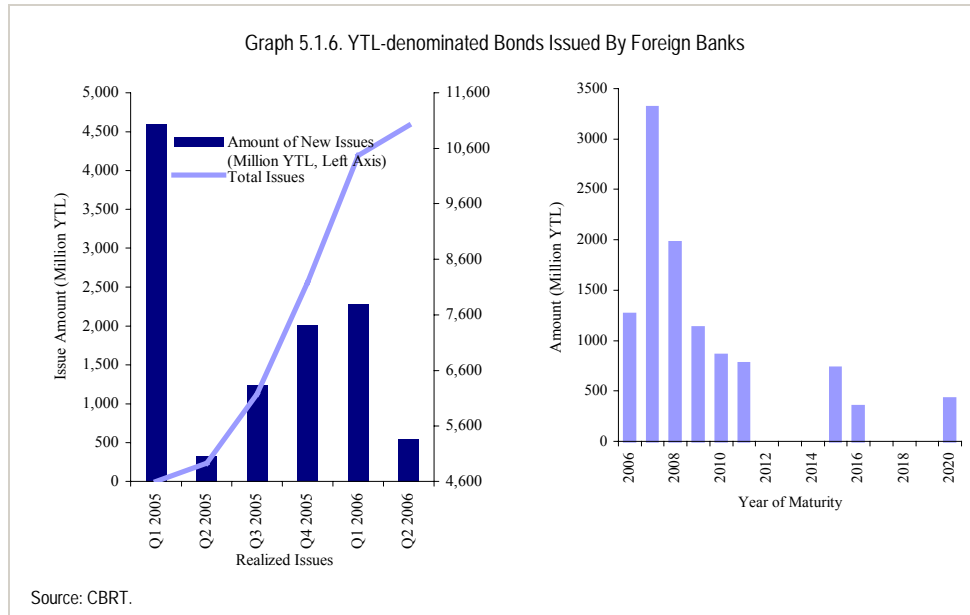
Real interest rates, which are calculated from the 12-month inflation expectations in the CBRT Expectations Survey and benchmark interest rates, displayed an upward trend as of May due to the deterioration in risk perceptions (Graph 5.1.4).



After the nominal exchange rate movements in May and June, the New Turkish lira depreciated in both nominal and real terms (Graph 5.1.5).



In the second quarter of 2006, YTL-denominated bonds issued by foreign banks, which constitute an indicator of foreign demand for the New Turkish lira, decreased compared to the previous quarter (Graph 5.1.6). This development is considered to have been derived from the increasing volatility in exchange rates, seasonal effects and the rising country risk premium.

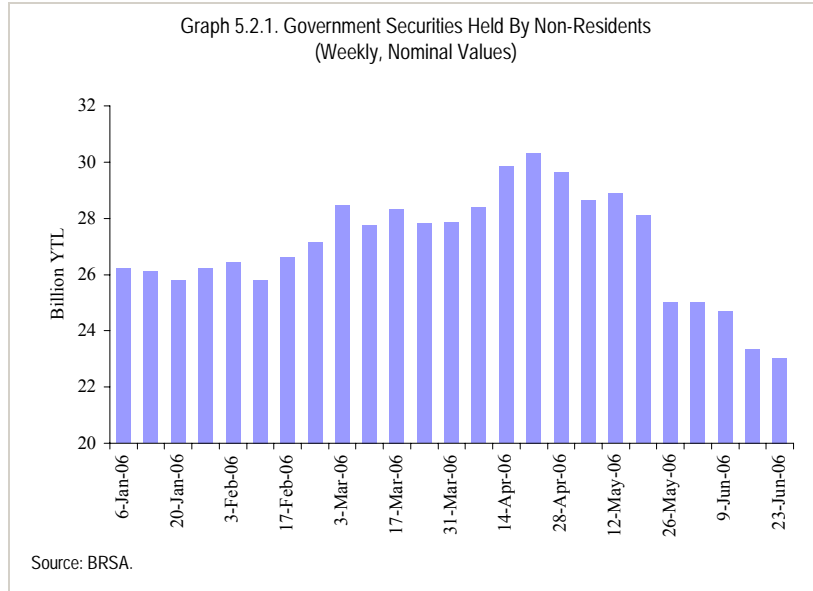


5.2. Financial Intermediation and Credits

Financial System

The volatility that started to increase in financial markets in the first week of May affected the financial system; one of the important components of the monetary transmission mechanism. The downward course of the country risk premium in recent years let banks borrow from abroad on the one hand and gave them opportunity to hedge open positions in their balance sheets via financial derivatives at lower costs on the other. However, the latest fluctuations that had started as a result of the withdrawal of non-residents from government securities market and the money market affected the risk premium negatively and led to an increase in the costs of derivative transactions conducted by banks. Furthermore, the redemption of FX-indexed government papers, which were issued mid-June 2001, increased banks' demand for foreign exchange. The fluctuation may cause a change in the composition of banks' assets and liabilities as well as having a negative impact on inflationary expectations. These developments are considered to deepen the impact of the

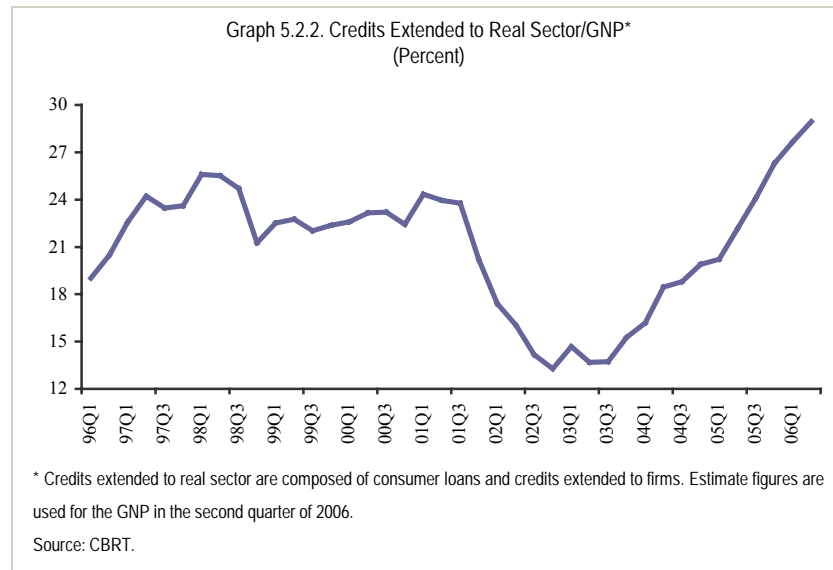
heightened risk perception on domestic markets, which had increased after the change in international liquidity conditions in May.



The exit of non-residents from the government securities market can be monitored via the entrusted securities item of the banks providing custody service (Graph 5.2.1). From early-May to end-June, the government securities held by non-residents decreased by YTL 6.9 billion on a nominal basis in the period.

Credits

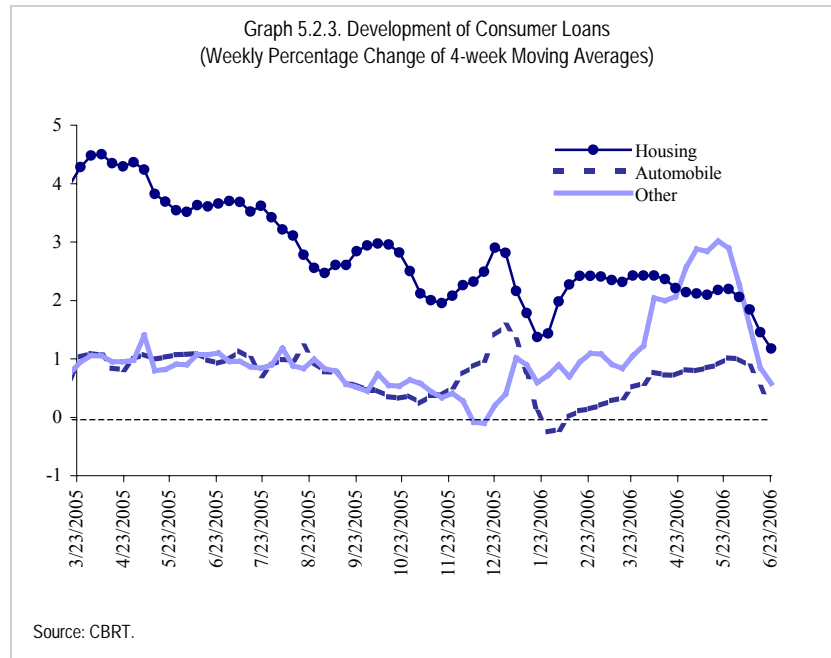
In the first half of 2006, credit expansion continued (Graph 5.2.2). Credit expansion may still be supported by factors such as the increasing foreign participation in the banking system in the medium and long-term and continuing structural change, and the sustained fiscal discipline and banks' actions to maintain or further increase their market shares.



Nevertheless, it will not be a surprise if the growth rate of credits slows down in the short term. Following recent developments, the increases in both CBRT policy interest rates and market interest rates and the upsurge in banks' credit interest rates are the factors that will slow down the rapid credit expansion.

As the latest fluctuations in financial markets increased risk aversion, it is likely that this may also reduce the banks' appetite for extending loans. For instance, credit supply might decline due to the fact that the increase in short-term interest rates raises funding costs and that the long-term housing credits extended with fixed interest rates decrease banks' profitability. Moreover, another development that is considered to reduce credit supply is the withdrawal of liquidity through a combination of both one and two week YTL-deposit purchase auctions and foreign exchange sale auctions; as this will reduce the amount of funds that can be converted to credits by banks.

Recent credit developments indicate that the growth rate of consumer loans has declined rapidly (Graph 5.2.3). The weekly volume of automobile loans has declined, albeit in a limited manner. The rigidity of financial contracts and deferred demand are the factors that delay the slowdown in credits, which is anticipated to result from the increase in interest rates. The slowdown in the rate of increase is expected to become more evident in the upcoming period.



This whole experience has shown us once again that the carrying out of sound risk management by banks, households and firms is very important in the floating exchange rate regime. In the upcoming period, the Central Bank will continue to monitor both developments in the banking sector and credits carefully, as to both financial and price stability.

BOX 5.1. DEBT STRUCTURES OF COMPANIES IN TURKEY

It is widely discussed in the public that the companies in Turkey are becoming increasingly more vulnerable to exchange rate shocks. To shed light on these discussions, Box 5.1 analyses *the level* of relative foreign currency-denominated debt (including FX-indexed debt), average borrowing *shares* of foreign currency-denominated debt and the development of the *maturity structure* of the this debt belonging to different groups in the 2000-2005 period. In this, companies' balance sheets and the information regarding the debt structure according to currency types - compiled by the CBRT - were used. As the said data do not include the information on the composition of companies' assets according to currency types, the FX open positions cannot be calculated. However, it is possible to make some assertions about the debt structures of the potential company groups that are vulnerable to exogenous shocks.¹

The data that provide a basis to this study enable the compilation of the variables such as sales, exports, employment and assets at the company level extending to 2004 (data on balance sheet and profit and loss accounts). Meanwhile, another data set that comprises the same companies and that is provided by the CBRT Risk Centralization Division, classifies the debt structure of companies, including the year 2005, according to the maturity and currency composition that is foreign currency (FX) and New Turkish lira (YTL) (data on debts). Furthermore, by using the data regarding balance sheets and profit-loss for the 2000-2004 period, companies are also classified as large, medium and small as to their real assets and as companies that are exporter of goods (EXP), companies that are not exporter of goods (DOM) and companies with foreign participation (FPC) as to their performances in exports.^{2,3}

The size-classification of companies is important as it provides information about the repayment capacity. Small companies borrowing large amounts become more vulnerable to exogenous shocks. Meanwhile, large companies that attach more importance to risk management and that have strong asset structures become more resilient. Exporter companies are stronger, while the companies, which do not have foreign currency-denominated revenues but borrow in foreign currency, become more vulnerable. Moreover, it is assumed that the companies with foreign participation are less vulnerable to exchange rate shocks. The liability structure affects companies' exposure as it reflects the level of indebtedness. In recent years, the share of owner's equity utilization increased, while that of bank loan utilization decreased in the said companies. In 2004, the significant rise in owner's equity utilization stemmed from the change in companies' funding preferences and the revaluation of capital in the framework of inflation accounting (Box 5.1 Table 1).

Box 5.1. Table 1. Percentage Distribution of Companies' Total Liabilities (*)

	2000	2001	2002	2003	2004
Trade Credit	17.0	17.7	16.2	15.9	12.9
Bank Loans	23.1	25.2	21.9	17.3	13.8
Other Liabilities	25.1	26.9	26.0	27.0	21.3
Equity	34.7	30.2	35.8	39.8	52.0
Short-term Liabilities	46.9	47.8	43.7	44.4	36.5
Long-term Liabilities	18.4	22.0	20.4	15.8	11.6

Source: CBRT Sectoral Balance Sheets.

(*) Company liabilities include equities, as well.

¹ In the survey extending to the year 2004, the Statistics Department of the CBRT calculated the open FX position of more than a 1000 companies. It is stated that the share of related companies' open FX positions in export revenues was below 30 percent on average.

² In the 2000-2004 period, the companies that provide 25 percent or more of their sales revenues from exports are classified as exporter while the companies that do not have export revenues are called non-exporter.

³ Same company can be in different groups.

Box 5.1. Table 2, shows the development of the average FX-denominated debt of the companies, which operate in the manufacturing and non-manufacturing sectors that were used in the analysis, in terms of groups and years. Accordingly, relative position of the average USD-denominated debt of companies is calculated across years, under the assumption that the average USD-denominated debt per company having a FX-denominated debt is 100 in the overall manufacturing industry in 2000. The tendency to use FX-denominated credits declined along with the crisis in 2001, but gained pace after 2003. This increase was more remarkable in the non-exporter group that has a relatively smaller amount of FX-denominated debt in the manufacturing sector. In the manufacturing industry, small and medium-sized companies and the companies that do not have export revenues have a lower amount of FX-denominated debt on average, while in the non-manufacturing sectors including that of the services, the FX-denominated debt of non-exporter companies is above the non-manufacturing average. Sectors such as energy, tourism and construction that are included in the non-manufacturing industry are classified as companies that are not exporter of goods. However, the fact that the companies in these sectors are service exporters is a factor that facilitating FX-denominated borrowing.

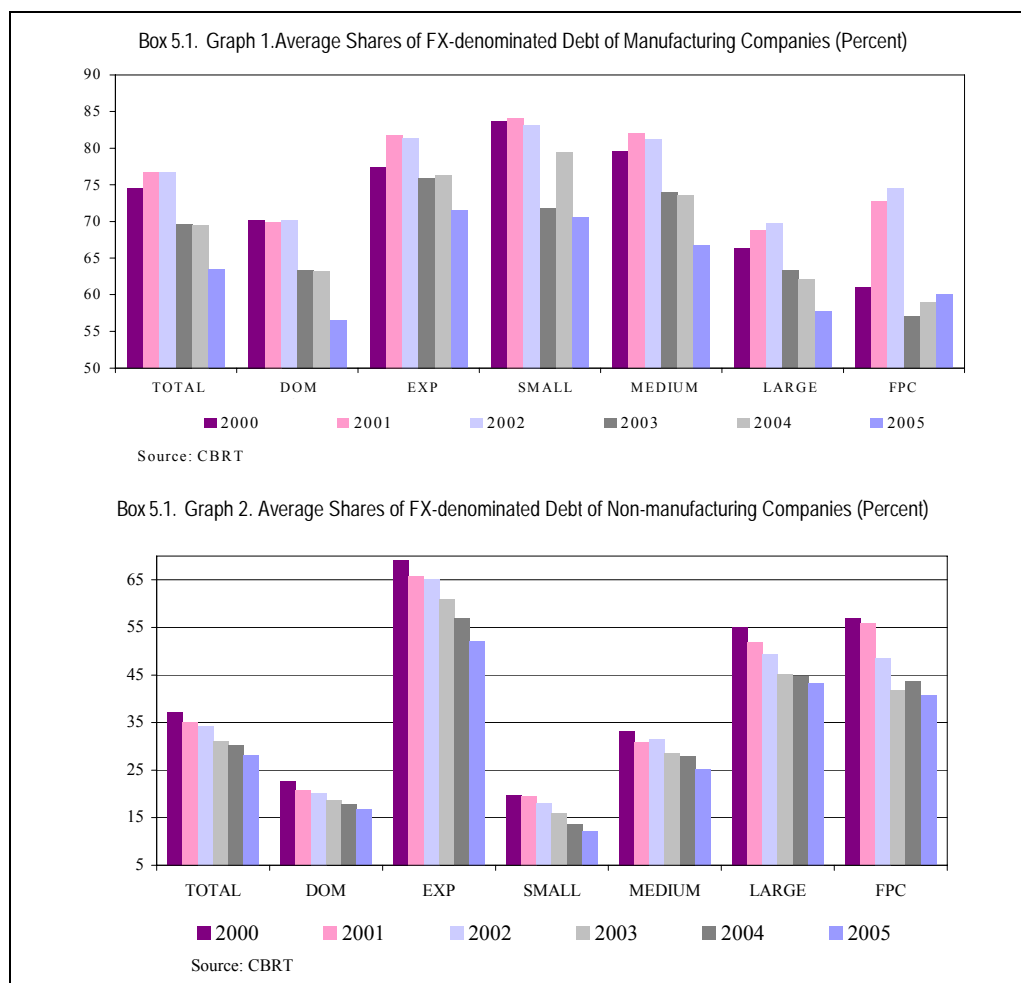
Box 5.1. Table 2. Development of FX-denominated Debt as to Groups and Years (*)							
<i>Manufacturing Sector</i>							
	Total	DOM	EXP	Small	Medium	Large	FPC
2000	100.0	22.9	118.7	3.5	17.9	191.4	173.1
2001	90.7	18.5	107.4	2.5	13.9	168.2	176.3
2002	85.8	16.6	103.4	2.6	15.5	160.5	161.9
2003	87.9	22.5	109.8	3.0	19.1	164.9	157.8
2004	118.1	45.9	144.4	3.2	24.1	228.8	213.7
2005	137.9	48.8	170.1	4.6	29.4	265.7	226.9
Average Number of Firms Using FX	1 980	99	990	53	985	943	162
Total Number of Firms	2 736	344	1 127	227	1 460	1 049	203
<i>Non-Manufacturing Sector</i>							
2000	105.2	109.2	117.2	4.4	18.7	233.8	138.0
2001	89.1	92.8	94.6	3.4	15.1	194.3	115.6
2002	82.3	101.3	84.2	3.0	15.9	181.6	110.0
2003	78.0	90.0	79.0	3.1	17.8	173.4	99.1
2004	98.8	113.6	98.7	3.8	22.6	219.8	150.5
2005	133.2	152.2	131.7	4.8	30.3	288.1	167.2
Average Number of Firms Using FX	1 215	414	329	105	618	493	68
Total Number of Firms	2 403	1269	406	418	1 286	699	100

Source: CBRT Risk Centralization Division.

(*) Total FX-denominated debt that is calculated for each group is divided to the number of the companies having FX-denominated debt. After the average debt per company is calculated in terms of USD, it is given as to years and groups after being indexed to the value of the average FX-denominated debt of manufacturing companies in 2000.

The average ratio of companies' FX-denominated debt (cash and non-cash) to their total debt (FX and YTL) is calculated for manufacturing and non-manufacturing sectors and for the 2000-2005 period (Box 5.1. Graph 1 and Box 5.1. Graph 2). FX-indexed debt takes place under FX-denominated debt. Hence, it is seen that the manufacturing companies shown in Box 5.1. Graph 1 have higher FX-denominated debt on average compared to the non-manufacturing companies shown in Graph 2. Another significant point is that in the manufacturing industry, exporter and large companies and the companies with foreign participation have higher FX-denominated debt compared to other groups, as expected. Large companies have relatively lower FX-denominated debt in the non-manufacturing sectors. In both sectors, the non-exporter and small groups, which operate in the domestic market, have less FX-denominated debt compared to other groups of companies.

The average share of FX-denominated debt of the companies included in the analysis declined in general on a yearly basis.⁴ The shares of FX-denominated debt declined due to the facts that YTL-denominated banking loans expanded, the distribution of FX-denominated debt utilization was concentrated at certain companies and that YTL appreciated. When it is considered that small and non-exporter companies in Turkey can have access to a smaller amount of FX-denominated credits, it is well expected that the FX-denominated debt belonging to these company groups be at low levels. In the said period, the average FX-denominated credits used by small and non-exporter companies were 24.5 percent and 31.8 percent, respectively, whereas the said rates were 82.2 percent and 86 percent for large and exporter companies, respectively. Meanwhile, the shares of the FX-denominated debt, which are calculated by taking into account the group's totals instead of average shares, are higher for the companies that have low FX-denominated revenues. This result indicates that the small number of companies in this group have significant share of the total FX-denominated. The fact that the companies with high FX-denominated debt are not in the small firm group limits the effect of exchange rate shocks. The small and non-exporter companies that are predicted to be vulnerable to exchange rate shocks may enhance their financial structures by holding FX-denominated assets. In Turkey, the vulnerability of households and companies to exchange rate shocks is thought to be limited to some extent, as these groups have FX-deposit accounts.

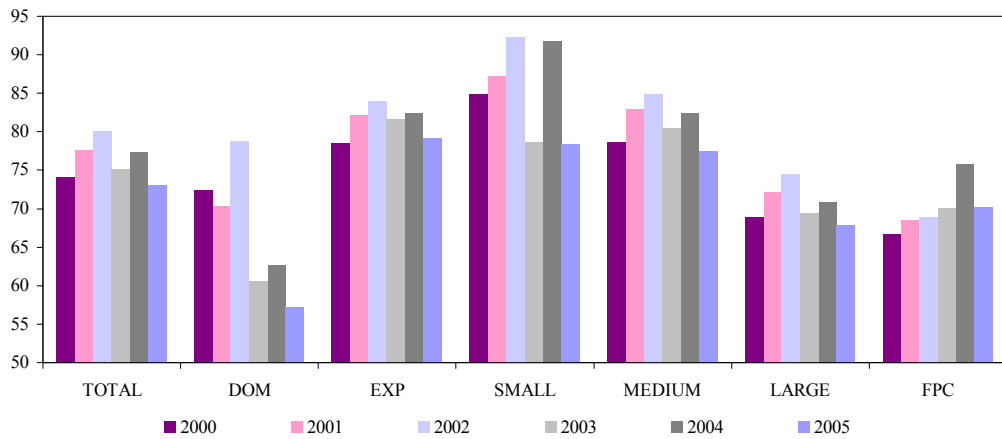


⁴ Sectoral Balance Sheets that are published regularly by the CBRT comprise the data up to 2004. The shares of FX-denominated debt that are calculated in the related publication displayed an upward trend in 2004. The main reasons behind the difference are (i) in this study, shares were calculated on average, whereas total figures were used in the said publications, and (ii) contrary to this study, the said publications included the companies, which did not report their balance sheets regularly after 2000.

The maturity structure of the FX-denominated debt also provides information on the vulnerability to exchange rate shocks. The share of short-term FX-denominated debt in total FX-denominated debt is calculated on average for manufacturing and non-manufacturing sectors by including the company groups for the period mentioned above and given in Box 5.1. Graph 3 and Box 5.1. Graph 4, respectively.⁵ In this respect, manufacturing companies borrow at shorter maturities on average compared to non-manufacturing companies. Especially after 2002, there has been a significant increase in the borrowing maturity, however that of manufacturing companies remained limited compared to non-manufacturing companies. In addition, the borrowing maturity of small and non-exporter a companies in non-manufacturing sectors has also increased considerably. This upward trend is a favorable development for the related companies as further extension of their borrowing maturities reduce their openness to exogenous shocks. Nevertheless, in the debt contracts, debt might be recalled even in the case of long maturities. Therefore, this situation should be taken into consideration while making analyses about the extension of maturity.

The calculations above are based on the total of cash and non-cash debt. Non-cash credits are composed of items such as letters of guarantee, letters of credit and the letters of guarantee that are prepared as the collateral of cash credits. Although, the calculations based on of cash credits by excluding non-cash debt, suggest similar results to the ones given above, there have been some slight differences. One of the divergence is that while the shares of FX-denominated debt decreased for all companies, the average share of FX-denominated cash debt did not display an important change for the manufacturing firms. On the contrary, the shares of FX-denominated cash debt that is acquired from group's total debt declined in time for all company groups.

Box 5.1. Graph 3. Maturity of FX-denominated Debt of Manufacturing Companies (Short-Term/Total, Percent)

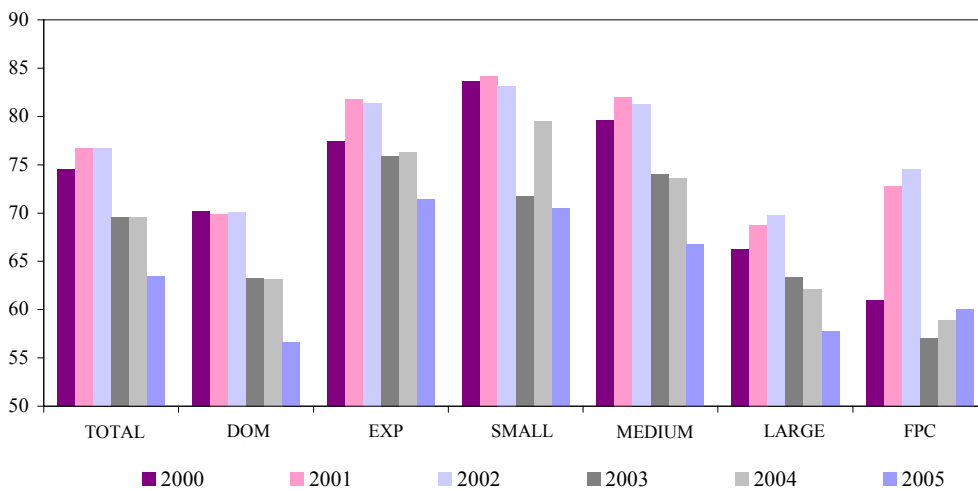


Source: CBRT

⁵ Debt with maturity up to one year is considered short-term.

To sum up, it is calculated that the sample companies borrow more, on average, in foreign currency in recent years. However, the ratio of FX-denominated debt of these companies to their total debt decreased in both manufacturing and non-manufacturing sectors. Although the FX-denominated debt of the companies with no export revenues and small companies, which are considered to be more vulnerable to exchange rate risks, were low and decreased further later on; especially the FX-denominated debt of the said companies increased rapidly in the manufacturing industry. In the non-manufacturing sector, the companies, which do not have export revenues from goods exports but generate FX-denominated revenues from the export of services and operate in sectors such as energy, tourism and construction, have high FX-denominated debt. However, there has not been a significant increase in the FX-denominated borrowing maturities of the related company groups. In recent years, companies mostly used owner's equity in order to finance their investments. Hence, this reduced the share of bank loans within total financing, although they have been rapidly increasing in absolute value, and made the debt structure of the mentioned companies less vulnerable, on average, to exogenous shocks.

Box 5.1. Graph 4. Maturity of FX-denominated Debt of Non-manufacturing Companies (Short-Term/Total, Percent)



Source: CBRT

6. Public Finance

Performance of budget practice in the first six months of 2006 and the statements indicating that total expenditures will not exceed the limit set for the end of the year, point to the continuation of the tight fiscal policy. In mid-May, global liquidity conditions started to deteriorate and the risk perception pertaining to developing countries worsened as these countries increasingly tended to implement monetary tightening. In this environment, a fiscal policy that is consistent with the targets limits risk perceptions to a great extent and eases concerns about the sustainability of the current account deficit.

As was the case in previous periods, in this period, public debt management has also been carried out in harmony with fiscal discipline, by adopting the most appropriate borrowing strategy at reasonable risk levels. However, the effective implementation of structural reforms is still important for assuring the permanence of the achievements in the field of tight fiscal policy and reducing public debt stock to lower levels. The structural reforms, which have been carried out in the public sector, provide stronger foundations for public finance. In addition, they are crucial for the furtherance of a competitive environment in the economy and the elimination of price rigidities that emerge accordingly in some sectors.

6.1. Budget Developments

The central government budget displayed favorable performance in the January-June period of 2006. By June 2006, the primary budget surplus was realized as 78.4 percent of the end-year target, as taxes and non-tax revenues were realized at high levels (Table 6.1.1). The main items that led to the high increase in non-tax revenues in the first six months of the year include the cash surplus amounting to YTL 1.365 million transferred from Turk Telecommunications Inc. in January, the share amounting to YTL 1.369 million transferred to the budget in May and obtained by the Treasury from public banks and the share amounting to YTL 1.539 million transferred to the budget in June and obtained by the Treasury from GSM operators. Another important point is that the budget provided a surplus in this period. The favorable course of budgetary performance has played a very important role in limiting the risk perceptions caused by the fluctuation in May and June.

Despite the favorable performance of the primary budget balance in the January-June period, the figures pertaining to personnel and health expenditures and social security institutions occupy a larger share in end-year budget projections. The limits of the appropriation that was especially allocated for green card (health) services were exceeded in the first six months of the year. The 2006 budget was prepared based on the projection that transfers to social security institutions will decline with respect to the GNP. In this framework, a number of measures were taken in order to curb health expenditures and to enhance premium collections.¹ The law regarding the enhancement of premium collections came into effect in March. The first impact of this implementation was that Bağ-Kur did not receive any support from the budget after the high levels of premium collection in May and June. This development was effective in the favorable course of budgetary performance in May and June. The implementation of social security reform will keep the transfers for social security at moderate levels in the medium term. However, the general health insurance that came into force with this reform may increase budgetary expenditures.

In the upcoming period, budgetary performance will be determined by tax arrangement made in the first half of the year and budgetary measures to be taken against increasing expenditures. On the revenues side, the factors that may cause revenue losses in the upcoming period are the reduction of tax rates in the framework of the new corporate tax system that became operative in May and the slow-down that might be observed in the general activity level in the second half of the year. On the expenditures side, the current level of personnel and health expenditures increases the probability of the said expenditure items to realize above the end-year target. Meanwhile, it is observed that the regulation regarding the restructuring of premium collections limits the transfers to social security institutions.

¹ 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 reestablishment 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.

Table 6.1.1. Central Government Budget Aggregates (Billion YTL)

	January- June 2006	2006 Budget Target	(Share in GNP)*	Realizations/ Budget Target (%)
Central Government Expenditures (A+B)	81.6	174.3	32.2	46.8
A) Interest Expenditures	22.9	46.3	8.5	49.5
B) Non-Interest Budget Expenditures	58.7	128.1	23.7	45.9
1. Gov. Premiums to Personnel and Social Security Agencies	20.9	41.0	7.6	51.0
2. Goods and Services Procurement	6.8	17.7	3.3	38.3
a) Defense-Security	1.8	7.8	1.4	22.5
b) Health Expenditures	2.9	4.1	0.7	72.7
General Medication	0.4	1.2	0.2	34.6
General Treatment and Health Equipment	0.7	1.3	0.2	58.6
Green Card Health Services	1.8	1.6	0.3	112.1
c) Other Goods and Services Procurement	2.0	5.7	1.1	35.4
3. Current Transfers	24.9	49.1	9.1	50.7
a) Social Security Transfers	10.3	19.5	3.6	52.7
Pension Fund	3.0	5.5	1.0	54.8
Bağ-Kur	2.5	6.8	1.2	36.6
SSK	4.5	6.7	1.2	67.4
b) Agricultural Subventions	2.5	4.0	0.7	62.6
c) Transfers Made Abroad	0.3	0.6	0.1	54.9
d) Allocations from Revenue	6.3	14.2	2.6	44.4
4. Capital Outlays	3.0	12.5	2.3	24.3
5. Capital Transfers	0.9	1.8	0.3	46.4
6. Lending	2.2	4.3	0.8	52.5
7. Reserve Appropriations	0.0	1.7	0.3	0.0
Central Government Revenues (A+B+C)	84.0	160.3	29.6	52.4
A) General Budget Revenues (I+II+III+IV)	81.8	156.2	28.8	52.3
I- Tax Revenues	66.0	132.2	24.4	49.9
1. Taxes on Income and Earning	19.1	39.0	7.2	49.1
a) Income Tax	12.7	26.1	4.8	48.5
b) Corporation Tax	6.5	12.9	2.4	50.1
2. Taxes on Property	1.5	3.1	0.6	48.3
3. Domestic Taxes on Goods and Services	29.0	59.4	11.0	48.8
a) Domestic Value Added Tax	8.1	16.3	3.0	49.6
b) Special Consumption Tax	17.7	37.3	6.9	47.5
4. Taxes on International Trade and Transactions	12.9	24.3	4.5	53.1
a) Value Added Tax on Imports	11.9	22.4	4.1	53.1
II- Non-Tax Revenues	15.3	21.4	3.9	71.4
III- Capital Revenues	0.2	2.3	0.4	7.5
IV- Special Revenues and Grants and Aids	0.4	0.4	0.1	99.2
B) Revenues from Special Budget Administrations	1.5	3.0	0.5	49.3
C) Revenues from Regulatory and Supervisory Institutions	0.8	1.1	0.2	68.8
Budget Balance	2.4	-14.0	-2.6	-17.3
Primary Balance	25.3	32.3	5.9	78.4
Budget Balance (Except Local Administrations and Fund Shares)	1.2	-14.0	-2.6	-8.6
Primary Balance (Except Local Administrations and Fund Shares)	24.0	32.3	5.9	74.4

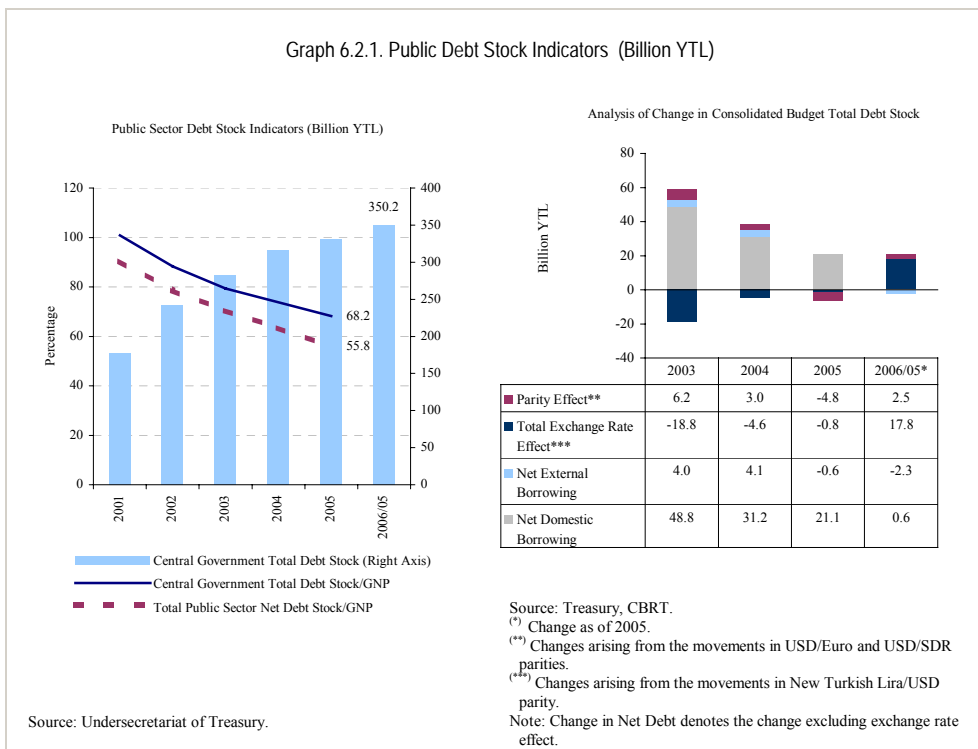
Source: Ministry of Finance.

Despite the said factors that might affect budget developments negatively, the high probability of general budget revenues to exceed the end-year target and budgetary measures regarding the limitation of health expenditures and savings in the expenditure items, improve the expectations for attaining the primary surplus target. Moreover, any possible deviation from

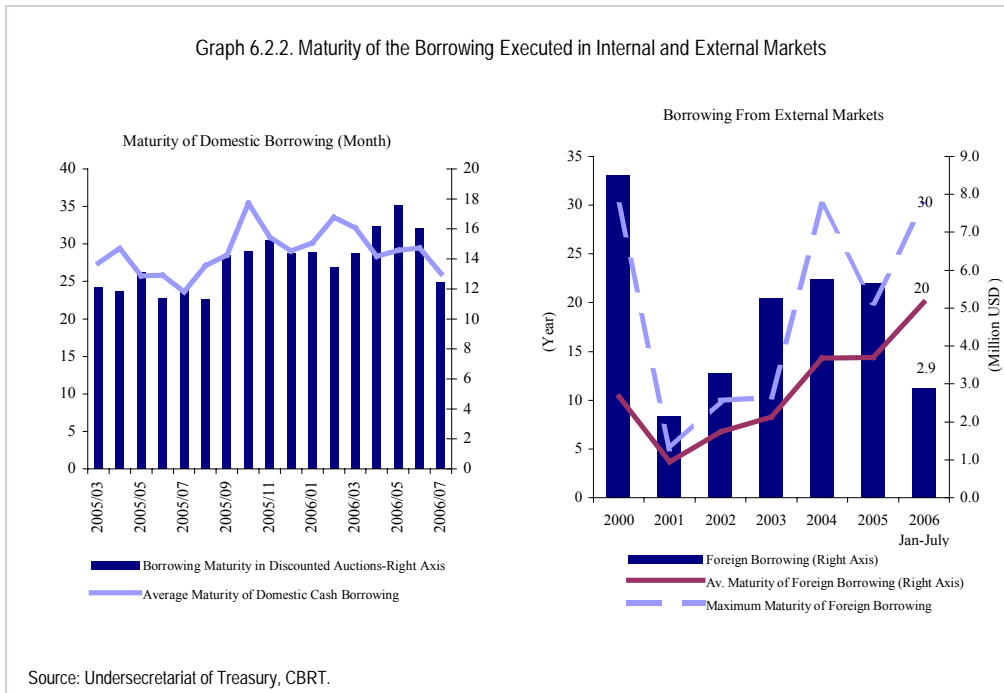
primary surplus target arise that covered via increasing indirect taxes might pose risks to the single-digit inflation rate, which is important in terms of the decline in inflation expectations.

6.2. Developments in Debt Stock

As of end-May 2006, central government debt stock, which has a large share in the total public debt stock, increased by 5.6 percent compared to end-2005 (Graph 6.2.1). High primary surplus and privatization revenues limited the growth rate of debt stock, while the depreciation of the New Turkish lira increased debt stock. In the first four months of 2006, central government debt stock displayed a limited increase in nominal terms. The depreciation observed in YTL in May, increased central government debt stock by YTL 17.8 billion. However, it should be kept in mind that the said increase, which originated from the exchange rates, was due to accounting and that the real cost would be seen along with the debt payments. Therefore, the level of exchange rates on the dates of the FX-denominated debt payments, rather than the increase observed recently, will be effective on debt stock. In addition, the relatively longer maturity of the current FX-denominated debt stock and the large amount of FX-deposits held by the Treasury, keep the risks originating from volatilities in exchange rate under control in favor of the public sector.



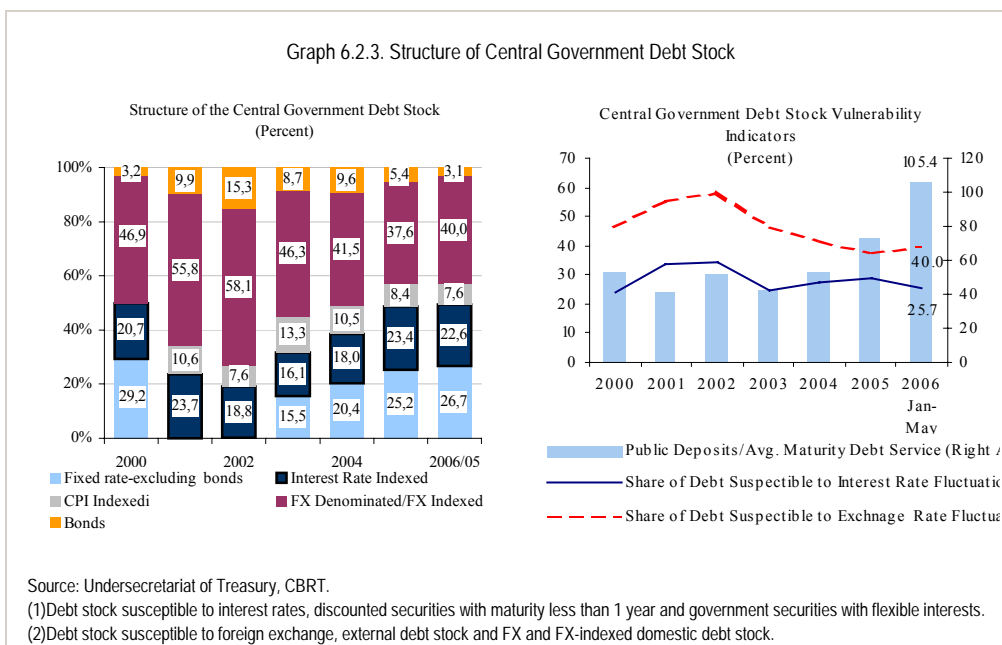
Parallel to the financing strategy that is set in line with strategic standard setting², the maturity of the cash borrowing, which affects the maturity of the debt stock, was extended significantly in the first five months of 2006. The increase that was observed in the maturity of domestic borrowing was generally obtained via the issue of coupon securities with five-year maturity. After the fluctuations in exchange rates and interest rates that started in May and continued in June, investors preferred short-term government securities with flexible rates to fixed coupon government bonds. This caused the borrowing maturity of the Treasury to decline. Despite the mentioned developments the Treasury issued discounted securities with maturities over 20 months, during this period. This is considered a positive development for public borrowing. In addition to domestic borrowing, in July, the maturity of the limited borrowing declined compared to the first half of 2006 (Graph 6.2.2.).



In May 2006, the share of long-term securities with fixed interest rates continued to grow in the debt stock. However, the share of discounted securities with a maturity of less than one year and that of CPI-indexed securities decreased in the debt stock. Moreover, due to the financing strategy

²In strategic standard setting, the aim is to keep the maturity of domestic borrowing below one year, execute domestic borrowing generally in terms of YTL-denominated securities with a fixed yield and hold a considerable amount of cash reserves in order to reduce liquidity risk.

that is applied to reduce the liquidity risk, the ratio of public deposits to the monthly average debt service exceeded 100 percent (Graph 6.2.3). High primary surplus and privatization revenues made an important contribution to this increase. Thus, although there was not sufficient demand for the auctions held on 24 May and 14 June for the Treasury's high level of payment, due to the considerable amount of reserves held by the Treasury, there was not any liquidity problem and the increase in interest rates remained limited. This experience bears importance as it indicates that fiscal discipline and privatization revenues reduce the vulnerability of the public sector to external shocks.



In the framework of the Treasury's borrowing program for 2006, it will continue to be a net payer of foreign debt, will not make any FX-indexed securities issuance and limit the FX-denominated domestic roll-over ratio to 80 percent. The mentioned actions point to the fact that the debt stock's susceptibility to FX rates will continue to decline. Although FX-denominated borrowing was reduced partially in the January-May period of 2006, the vulnerability to exchange rates increased due to the upsurge observed in exchange rates in May. As a result of the fluctuations that are observed in exchange rates and interest rates in the recent period, issues of fixed coupon bonds could not be realized from May onwards. In July, the maturity of the auctions for coupon securities with flexible interest rates declined from five

years to two years. The borrowing maturity decreased to some extent as a result of these developments. Nevertheless, there has been a high demand for securities with flexible interest rates in May, June and July. Furthermore, as announced by the Treasury earlier, it is important as to the flexibility of the borrowing policy that can change its borrowing instruments according to demand conditions in the market.

The sustainability of debt stock requires not only high primary surplus, but also the reduction of borrowing costs. While trying to find a balance between costs and risks, it will be in favor of costs to continue borrowing in terms of long-term securities with flexible interests. Meanwhile, the depreciation of the YTL and the increase in interest rates pose a risk to debt stock. The large amount of FX-deposits and YTL-denominated deposits held by the Treasury limits this risk.

7. Medium-Term Projections

In this chapter, the updated assumptions pertaining to fundamental macroeconomic variables will be summarized and the forecasts of the inflation and the output gap made in line with these assumptions will be presented. The estimations cover the last two quarters of 2006 and the whole of 2007, so as to embrace the one-and-a half years' average control horizon of monetary policy. Furthermore, emphasis is put on the probable risks, which may lead to a significant downward or upward deviation in inflation forecasts.

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

As in previous Inflation Reports, the assumptions that provide a basis for estimations regarding the medium-term are covered in two groups: Assumptions pertaining to *domestic economic activity* and assumptions pertaining to *external factors*. The above-mentioned set of assumptions has been obtained by aggregating the information and analyses given in other chapters of this Report and transforming them into figures. The assumptions that formed the basis of estimations given in the April Inflation Report were updated in the light of new data added to the data set during the last three months, and especially the reflections of the developments observed in financial markets on the economy in May.

The environment of uncertainty created by the fluctuation that started in financial markets in mid-May, the hike in interest rates, and the relative price increase in imported goods due to the depreciation of YTL affect the demand conditions as well. In this context, it is foreseen that domestic demand, which displayed a strong trend in the second quarter of the year, will lose momentum in the upcoming period and its growth will slow down in the second half of 2006. Meanwhile, the depreciation of the YTL is believed to have a positive impact on export performance while slowing down the increase in imports. In conclusion, despite the increase in net foreign demand, it is projected that domestic demand will relatively lose pace and hence total demand will slow down. In this framework, a basic outlook in which it is assumed that the downward pressure exerted on inflation by demand conditions will increase in the second half of the year is taken.

The medium-term projections for the April Inflation Report presented an outlook where the New Turkish lira maintains its strong position and continues to support the decline in inflation under the main scenario in which the current program is pursued, macroeconomic and political stability does not deteriorate, structural reforms and the resulting long-term capital inflows and increases in productivity continue. However, due to the rapid depreciation of the New Turkish lira stemming from turbulences in financial markets since May, the cost conditions have changed and thus, the support coming from the position of the New Turkish lira vis-à-vis foreign currencies to the downward trend in inflation has come to an end in the short-run.

In the previous Inflation Report, it was projected that the disinflation process would resume from the second quarter onwards, provided that there were no exogenous shocks. However, contrary to this projection, the upward trend in consumer prices that started during the last months of 2005 continued in the second quarter of 2006, as well. As of the second quarter of 2006, the annual inflation rate climbed above the upper limit of the uncertainty band. The main reasons underlying this development were the supply-oriented developments in the unprocessed food group, supply shocks such as the high levels of energy and gold prices and cost factors stemming from the depreciation of the New Turkish lira due to the deterioration in global liquidity conditions. It is projected that the direct effects of the fluctuations in exchange rates on prices would diminish starting from August; however, despite this expected decline, it is predicted that some fluctuations might be observed in inflation in the autumn due to seasonal price adjustments.

In the previous Inflation Reports, as to the attainability of the inflation target, it was emphasized that mainly cyclical price dynamics of the services group assumed critical importance. One of the reasons that came to the forefront was the pressure exerted by the rapid increase in housing prices on consumer inflation via the rent subgroup. Along with the upsurge in the interest rates of housing loans, it is foreseen that the increase in housing prices will slow down in the upcoming period and the rigidity of inflation in the related services items will gradually decline. Therefore, estimations are made within a framework where the additional pressure exerted by services group inflation on consumer prices will decrease compared to the period covered by the previous Inflation Report.

The estimations regarding external factors include the forecasts pertaining to the macroeconomic variables of the Euro zone, such as interest rates, inflation and growth, the assumptions pertaining to international commodity prices (crude oil, main metal prices, etc.), and the analysis of the probable effects of global liquidity conditions on financial markets. The forecasts pertaining to the Euro zone have been quoted from the June 2006 issue of the “Consensus Forecast” results, which is a compilation of forecasts made by numerous experts. According to these forecasts, a domestic demand-driven growth of 2-2.5 percent is expected in the Euro zone in 2006 while the Harmonized Index of Consumer Prices (HICP) inflation is expected to be over 2 percent in the second half of 2006 and throughout 2007. The low interest rates prevailing in the Euro zone create an upward pressure on inflation, signaling that the European Central Bank will continue to tighten monetary policy gradually in the medium term. As well as the monetary policies of the Euro zone, those of other developed countries are considered in our estimations in order to be able to foresee international liquidity conditions. Estimations are based on an outlook where the uncertainties regarding the aforementioned factors continue in the upcoming period.

Following the relative stability in the first couple of months in 2006, crude oil prices restarted to experience an upward trend by April. Therefore, when producing the forecasts, the assumptions pertaining to oil prices have been revised upwards. As it is difficult to make a definite forecast about oil prices, inflation forecasts are produced under the main scenario where oil prices are assumed to maintain their current level.

In the Inflation Reports published in January and April, the uncertainties in global liquidity conditions were considered as one of the risk factors that might cause a deviation in inflation forecasts. Certainly, the most important development in the international environment since the publication of the Inflation Report of April has been the change in global liquidity conditions. In this framework, the international liquidity shock, which had been listed as a main risk factor in the previous reports, did materialize. As a result, deterioration in the inflation expectations and the risk perceptions pertaining to Turkey increased substantially as of June. Turkey witnessed a sudden deterioration in the credit risk premium by around 150 basis points during May and June. The forecasts presented in this Report were produced under the assumption that expectations would be managed well in the upcoming period,

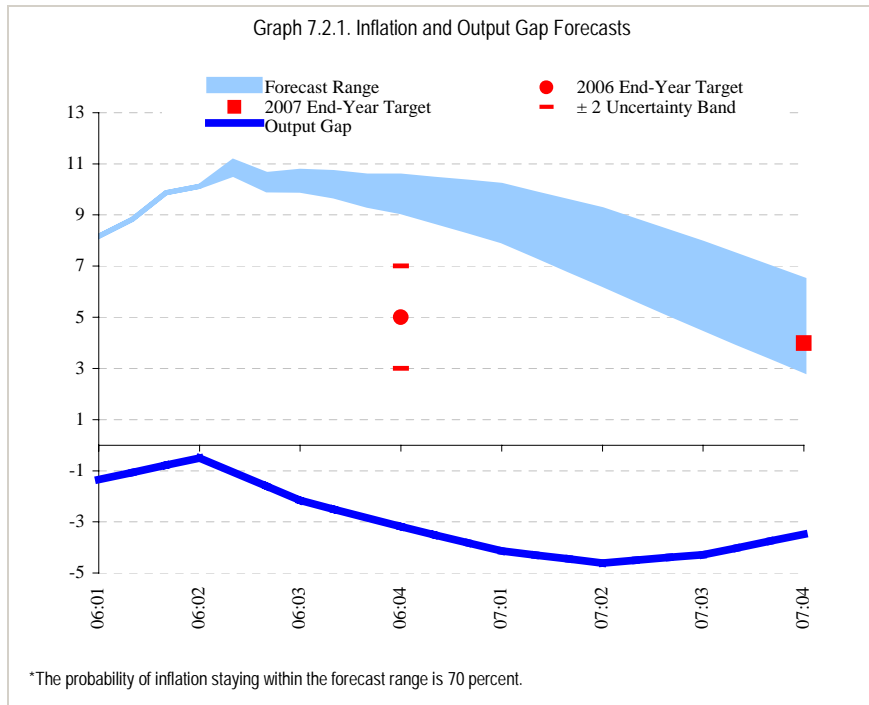
there would not be another deterioration process in international liquidity conditions similar to the recent one, and accordingly, the risk premium would not display a significant change compared to its current level.

Furthermore, the predictions that provide a basis for these forecasts are that the secondary impacts of exchange rate developments on prices will remain limited in the medium term as a result of the slow-down in domestic demand, prices of unprocessed food will come down to normal levels (as a matter of fact, the first signs of normalization are observed in June) and the one-off increases in tobacco prices will vanish.

7.2. Forecasts

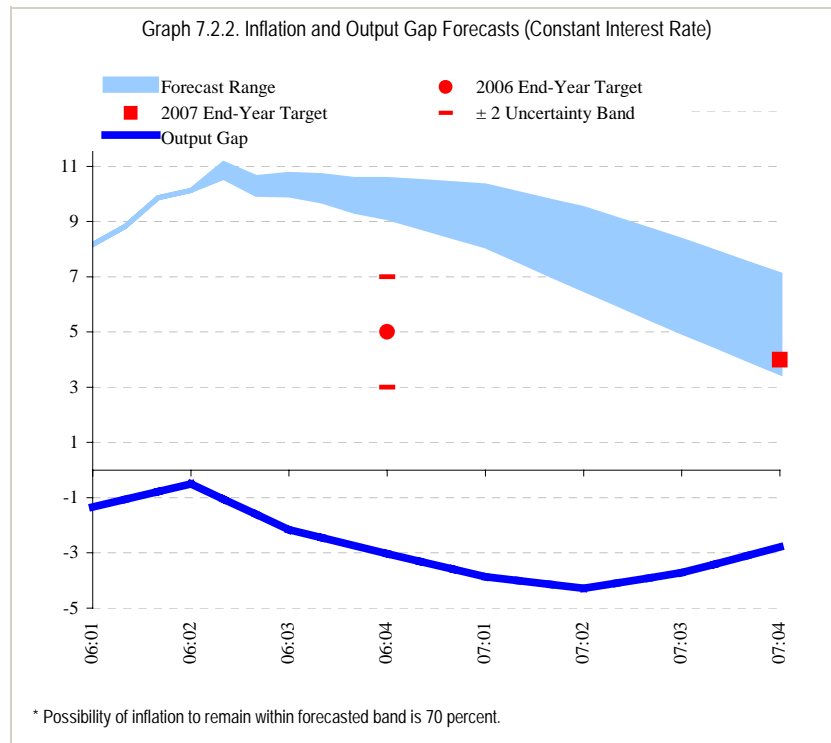
As the effects of monetary policy decisions on the economy are lagged, the evaluations pertaining to the inflation trend in the medium-term bear great importance in the policy-making process. While making evaluations pertaining to the future course of inflation, the Central Bank handles the available data set by using both numerical and judgmental methods. Numerical methods comprise structural models, simulation applications and other statistical measurement techniques while judgmental methods mostly rely on subjective analyses.

Graph 7.2.1 presents the inflation and output gap forecasts that were produced with the aggregation of the mentioned methods, to cover a one-and-a half year period including the second half of 2006 and the whole of 2007. It is estimated with 70 percent certainty that end-2006 inflation would be somewhere between 9.1 percent and 10.5 percent. According to the forecasts, which were produced under the assumption that the Central Bank would adopt a measured monetary tightening during the rest of 2006 in addition to the measures taken in June and would gradually decrease interest rates in 2007, inflation will display a significant decline as of the second quarter of 2007 and with 70 percent certainty, end-2007 inflation will be somewhere between 3 percent and 6.5 percent.



Graph 7.2.1 also presents forecasts about the output gap that underlies inflation forecasts. It is predicted that the contribution of the output gap to the decline in inflation will increase in the rest of 2006. In other words, when the forecasts pertaining to the variables, which determine 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 and that following the recent developments, this support will increase compared to the period covered in the Inflation Report of April. One important point that should be emphasized once again is that the forecasts mentioned above are produced with a medium-term perspective and in the light of the current set of data. Therefore, it should be borne in mind that all the assumptions the forecasts are based on can change in time, in which case, both the forecasts and the future stance of the monetary policy are subject to change.

Graph 7.2.2. presents the forecasts that have been produced under a scenario, in which above outlined current stance assessments, the short-term outlook, and forecasts pertaining to basic variables are preserved, and short-term interest rates are kept constant for a period of one year at the levels prior to the MPC meeting dated 20 July 2006.



According to the forecasts produced under these assumptions, it is projected that end-2006 inflation would be somewhere between 9.1 percent and 10.5 percent with 70 percent certainty and that end-2007 inflation would be somewhere between 3.5 percent and 7.0 percent. These forecasts, which are based on the assumption that the stance of monetary policy in June remains intact, point to the need for a measured monetary tightening in the rest of 2006 to be able to attain the end-2007 target. The Monetary Policy Committee decision dated July 20, 2006 should be considered as a step towards this end. Moreover, it should be emphasized once more that not only interest rates but also any new data pertaining to the factors affecting inflation might change these assessments.

In conclusion, under the cautious stance of monetary policy, the medium-term targets are believed to be attainable. Finally, it should be mentioned that these forecasts were produced in a framework where fiscal discipline is not relaxed, the incomes policy is in line with the inflation target and expectations are managed properly.

7.3. Risk Factors

The uncertainties regarding the course of oil prices, concerns about global inflation and hence likely changes in international liquidity conditions are considered as the main risk factors for the upcoming period.

As stated in the first two Inflation Reports, oil prices continue to be an important source of uncertainty when producing the inflation forecasts. A rise in oil prices leads to price increases especially in sectors that use petroleum products as direct input, such as those of energy and transportation. In case oil prices continue to increase above their current levels, no policy response will be given to the primary effects. However, in case the likely developments in oil prices affect inflation expectations negatively and hence, lead to a change in the pricing behavior in the overall economy, the Central Bank will take the necessary measures.

The ongoing concerns about inflation in developed countries and accordingly, the sustained monetary tightening process are considered as important risk factors. Recent developments manifest that oscillations in the risk appetite may continue to be one of the main risk factors with respect to inflation. In case such a risk materializes, the Central Bank will not respond to the direct effects on inflation stemming from relative price changes, nor will it allow any deterioration in the medium-term expectations or the pricing behavior.

A likely deterioration in pricing behavior is another risk factor for the upcoming period. In recent years, it was observed that along with the disinflation process, inflation targets were increasingly taken as a reference in pricing decisions. However, the significant deterioration in medium-term expectations caused by the recent developments, gave rise to the risk that a variable other than inflation of the previous period or the inflation target is taken as a reference in pricing. In case such a risk occurs, the Central Bank will not hesitate to give the necessary response and will maintain its cautious stance until the medium-term inflation expectations of economic agents converge to the targets.

Under current conditions, it is of great importance for both price stability and macroeconomic stability to avoid any policy implementation that would affect the risk perceptions and expectations negatively. Any step towards limiting the risk perception would reduce the cost of attaining and sustaining stability. It should be

borne in mind that sustaining the non-inflationary growth is possible only if the economic agents' confidence regarding the sustainability of macroeconomic stability is continued. Besides determination for structural reforms that would increase the quality of fiscal discipline even further, the uninterrupted implementation of structural reforms that would bring about long-term productivity growth by promoting competition in real sector and improving the investment environment are of critical importance. In this context, the continuation of the accession process to European Union and uninterrupted implementation of structural reforms in the economic reform program are still crucial. Enhancing the determined steps taken in recent years in this context will increase the strength of Turkish economy in coping with the changes in the international conjuncture at the lowest cost.

In the period ahead, the Central Bank will continue to announce its assessments on the inflation outlook in a transparent manner and inform the public of the monetary policies to be pursued in order to attain the medium-term inflation target.

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ABBREVIATIONS

BoJ	Bank of Japan
BRSA	Banking Regulatory and Supervisory Agency
BTS	Business Tendency Survey
CBRT	Central Bank of the Republic of Turkey
CPI	Consumer Prices Index
DC	Developing Countries
ECB	European Central Bank
EMBI	Emerging Markets Bonds Index
EU	European Union
Fed	Federal Reserve Bank of America
GDBS	Government Domestic Borrowing Securities
GDP	Gross Domestic Product
GNP	Gross National Product
HCPI	Harmonized Consumer Prices Index
IFS	International Financial Statistics
IMF	International Monetary Fund
ISE	Istanbul Stock Exchange
LME	London Metal Exchange
MPC	Monetary Policy Committee
MSCI	Morgan Stanley Capital Index
OPEC	Organization of the Petroleum Exporting Countries
PPI	Producer Prices Index
SCA	Special CPI Aggregates
SCT	Special Consumption Tax
SPO	State Planning Organization
SSI	Social Security Institution
TEA	Turkish Exporters Assembly
TURKSTAT	Turkish Statistical Institution
USA	United States of America
VIX	Chicago Board of Options Exchange Volatility Index
WGMA	White Goods Manufacturers Association
WPI	Wholesale Prices Index
YTL	New Turkish Lira