



THE CENTRAL BANK OF  
THE REPUBLIC OF TURKEY

# inflation report 2006-IV



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# 1. Overview

## *1.1. Developments in Inflation and Monetary Policy*

As of third quarter of 2006, annual consumer price inflation reached 10.55 percent. As stated in the previous Inflation Report, the rise in inflation stemmed from the unfavorable course of international oil and gold prices as well as the supply shocks such as the rapid increase in prices of tobacco and unprocessed food and the capital outflows originated from the deterioration of global liquidity conditions. The cumulative effects of these shocks keep the annual inflation rate at high levels.

The exchange rate pass-through ranks first among the factors that have pushed the annual inflation rate upwards. Since the financial turmoil in the second quarter of the year, the nominal depreciation in New Turkish lira (YTL) has been around 15 percent against the currency basket. The first round effects of this episode on annual inflation is expected to reach 3.5 points by end-2006, while the second round effects are being monitored carefully.

Following the policy tightening of 400 basis points in June, the Monetary Policy Committee (Committee) continued to act in accordance with the *measured monetary tightening* as foreseen in the previous report for the rest of the year. Accordingly, the Committee raised policy interest rates by 25 basis points in July. In recent months, medium term inflation expectations have started to improve relatively as a result of policy measures and the favorable impact of international developments on domestic markets.

Latest economic developments have led to some improvement in the inflation outlook: Although the rapid acceleration in unprocessed food prices, standing as one of the key determinants of the rise in inflation, persisted; the prices of oil, gold and other commodities maintained a more favorable course compared to the assumptions that constituted the main scenario in the July Inflation Report. Moreover, the appreciation trend of the New Turkish lira further improved the short-term inflation outlook and signals of a slowdown in the private domestic demand became more apparent. In the light of these developments, the Committee kept policy interest rates constant in August and September, stating the prevailing possibility of further policy tightening.

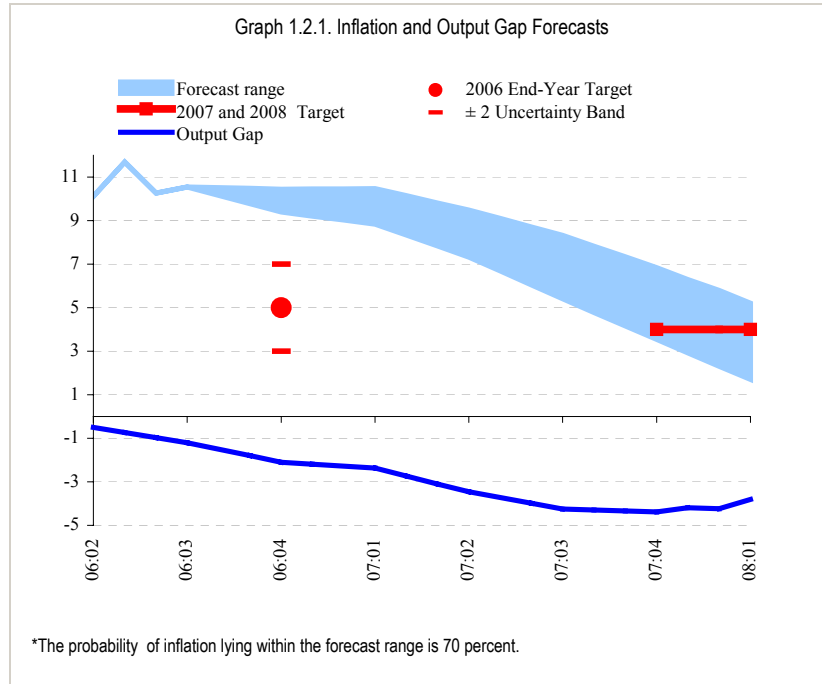
Conversely, the upward trend in public expenditures and the inconsistency of the incomes policy with the inflation target might have an unfavorable impact on the medium-term inflation outlook. Moreover, the fact that there will be some lagged effects of the past increases in oil prices on natural gas and electricity prices indicates that energy prices will continue to affect the disinflation process unfavorably in the upcoming period. In this framework, despite the relative improvement in medium-term inflation expectations, the Committee decided to keep interest rates constant in October as well and maintained the tight stance of monetary policy. The Committee assessed that factors such as the continued existence of a gap between the medium-term inflation expectations and the targets, the emergence of new risks related to services prices and the continuation of uncertainties in the global economy necessitate the monetary policy to remain cautious in the medium term.

### ***1.2. Outlook***

The impact of policy measures taken in June is expected to manifest itself on inflation as of the first quarter of 2007. The current indicators point to a significant slowdown in domestic demand for the goods groups that are sensitive to interest rate changes, particularly durable goods and housing. However, due to the facts that there are no signals for a remarkable slowdown in demand for semi-durable and non-durable goods and that net foreign demand follows a relatively stronger course compared to the first half of 2006, the slowdown in total demand is expected to remain limited. Although industrial production in July and August and seasonally adjusted data on capacity utilization rates of the July-September period are at lower levels compared to the second quarter of the year, they do not point to a significant slowdown in economic activities.

Current estimations that are based on this framework indicate that there is 70 percent probability that the annual inflation rate at the end of 2006 will be realized in the interval between 9.2 percent and 10.6 percent. Under the scenario that the Central Bank maintains its tight stance until the last quarter of 2007 and cuts policy interest rates gradually afterwards, it is expected that inflation will stand somewhere between 1.7 percent and 5.2 percent at the end of the first quarter of 2008. Therefore, inflation is expected to converge to the

target path in a period of one and a half years (Graph 1.2.1).<sup>1</sup> It should be borne in mind that the mentioned interest rate path represents a policy framework that is drawn up according to the available set of data and that any new data may change this path.



### 1.3. Risks

The likely changes in the global risk appetite and the related fluctuations that might emerge in financial markets continue to be one of the main risk factors that might deteriorate the inflation outlook. Recently, concerns in the developed economies regarding the inflation outlook have seemed to be replaced by the concerns about the economic slowdown. Both of these concerns might lead to an increase in global risk perception and have an unfavorable effect on inflation in the short term by causing fluctuations in emerging economies. In case the medium-term expectations are affected adversely, the Central Bank of the Republic of Turkey (CBRT) will not hesitate to further tighten monetary policy. Nevertheless, it should be taken into account that a global slowdown might have a favorable effect on the medium-term inflation outlook via a decline in prices of oil and other commodities.

<sup>1</sup> The 2007 year-end figure is foreseen to be between 3.5 and 6.8 percent.

Risks that may arise from the high course of medium-term inflation expectations and the persistence of backward-looking pricing behavior in the services group stand as other factors leading to uncertainties in terms of inflation outlook. Services inflation, which is currently around 12 percent, is anticipated to decrease further to a certain extent next year in line with the expected slowdown in domestic demand. However, the possibility of higher-than-expected stickiness in services inflation emerges as a risk element due to the continuation of backward-looking pricing behavior, the inconsistency of the 2007 incomes policy with the inflation target and other structural factors. Considering the fact that the contribution of the incomes policy set for 2007 to the disinflation process will be limited, the risks regarding the inflation inertia become more evident.

The facts that the effects of the increase in primary public expenditures, especially relating to personnel and health items, on inflation in the future period are not clear and that there exist other uncertainties relating to the monetary transmission mechanism, are considered as the risk factors that might change the framework of the overall inflation outlook. The CBRT will continue to closely monitor the effects of monetary tightening that has been carried out in the previous period, on the economy. In case the medium-term inflation outlook improves at a slower pace than anticipated due to the materialization of the aforementioned risks, there will be further tightening of monetary policy.

The continuation of the European Union (EU) accession process and the implementation of the structural reforms as envisaged in the economic program are still crucial in terms of both the medium and long-term outlook. Continued determination in implementing the decisive steps taken in these areas will help the economy to overcome the adverse changes in the international conjuncture at minimum cost.

## 2. International Economic Developments

### 2.1. Economic Performance and Monetary Policy Developments

The US economy has been exposed to the adverse effects stemming from various hurricanes, geopolitical tensions and increases in crude oil prices as of summer 2005. Nevertheless, the high growth performance of 2004 continued in 2005 and the US economy grew at 3.5 percent. The US economy that had grown at 1.4 percent in the first quarter of 2006 has relatively slowed down and grew at 0.6 percent in the second quarter of 2006. The decline in the aforementioned growth rate has been attributed to the lagged effects of 17 consecutive hikes in Fed interest rates as of 2004 and increase in energy prices. The lagged effects of interest rate increases are mostly prevalent in the housing market. The decline in the growth rate is expected to persist for the remainder of year 2006 and the growth rate of 2006 is expected to be 3.6 percent (Table 2.1.1). On the other hand, the US current account deficit reached 6.6 percent of the gross domestic product (GDP) in the second quarter of 2006. The abovementioned deficit is expected to reach 6.9 percent in 2007 continuing to pose a risk factor for the global economic balance.

Table 2.1.1. Growth Rates

	2005	2006**	q-q Percentage Change*					
			2005-I	2005-II	2005-III	2005-IV	2006-I	2006-II
<i>World</i>	4.8	5.2	-	-	-	-	-	-
<i>USA</i>	3.5	3.6	0.9	0.8	1.0	0.4	1.4	0.6
<i>Japan</i>	2.7	2.8	1.4	1.3	0.2	1.1	0.7	0.2
<i>Euro Zone</i>	1.4	2.2	0.4	0.4	0.6	0.3	0.6	0.9
<i>Germany</i>	1.1	1.8	0.6	0.4	0.5	0.3	0.7	0.9
<i>France</i>	1.4	2.1	0.1	0.0	0.7	0.2	0.5	1.2
<i>Italy</i>	0.1	1.4	-0.4	0.6	0.3	0.0	0.7	0.5
<i>UK</i>	1.8	2.4	0.2	0.5	0.4	0.7	0.7	0.8
<i>China</i>	9.9	9.7	9.9	10.1	9.8	9.9	10.2	10.9

\* The figures for China are annual percentage rate.

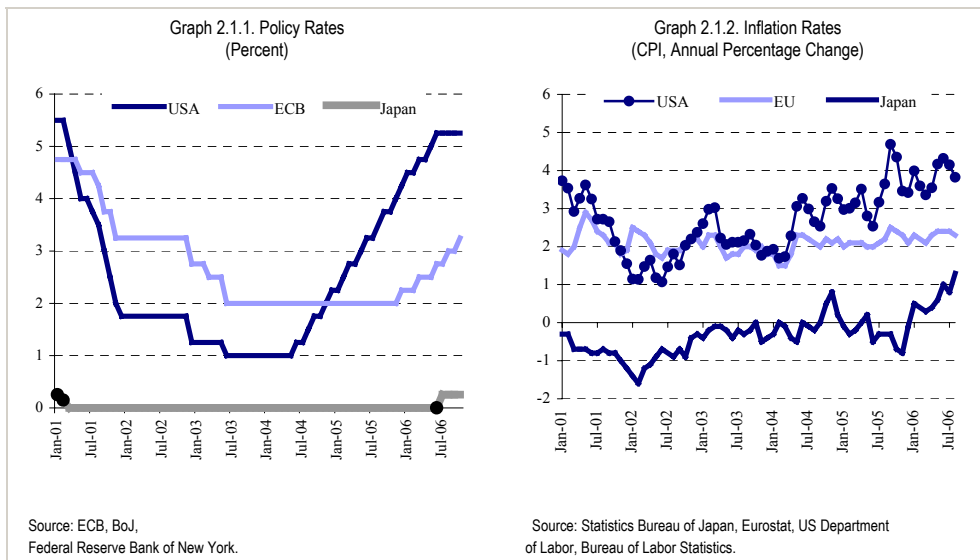
\*\* Predicted values for 2006.

Source: Eurostat, OECD, World Economic Outlook.

The US economy has experienced an increase in consumer price inflation due to recent increase in energy and other commodity prices. On the other hand, in view of the relatively moderate course of growth and the reduced inflationary pressure of energy price increases, Fed funds rate was decided to be kept at 5.25 percent at the Federal Open Market Committee (FOMC) meetings of August 8, September 20, and October 25 of 2006. (Graph 2.1.1, 2.1.2). FOMC which will hold the last meeting of the this year at December 12, 2006 is not expected to change interest rates. Nevertheless,

it is often emphasized by FOMC that the future interest rate decisions will be shaped according to the new inflation and growth figures.

The Eurozone which grew at 0.6 percent in the first quarter of 2006 recorded a growth rate of 0.9 percent in the second quarter. In this context, the average growth rate of the last four quarters has been approximately 0.6 percent in the Eurozone (Table 2.1.1). In the Eurozone which has domestic demand-driven-growth, positive expectations about employment, rising company profits and decreasing unemployment also supports the expectations of rising investment and consumption expenditures. In view of the relatively more balanced global economic activities across regions, the strong Eurozone exports are expected to provide ongoing support for growth. Thus, growth rate in Eurozone is expected to exceed 2 percent in 2006, while the aforementioned rate was realized as 1.4 percent in 2005. In the coming period, while the growth rate is predicted to accelerate due to declining oil prices, protective pressures, global imbalances and the likelihood of an oil price increase stand out as the risk factors against growth.



The Eurozone Harmonized Index of Consumer Price (HICP) inflation, which has been below 2 percent in September 2006 on annual basis, is expected to be over 2 percent in the rest of the year and during 2007 (Graph 2.1.2). Oil price decline has been influential on the decrease in HICP inflation in September 2006, while HICP inflation registered 2.3 percent annual increase on average until August 2006. On the other hand, high quotations at the futures

market signal an increase in energy prices, thus, energy prices continue to constitute a pressure on inflation. Furthermore, the ongoing money and credit expansion that has been prevalent due to prolonged settling of interest rates at low levels constitutes an inflationary pressure in medium to long term. As a consequence, the European Central Bank (ECB) Governing Council raised interest rates to 3.25 percent with an increase of 25 basis points at five meetings held since December 2005, the last two of which were held on August 3, 2006 and October 5, 2006 (Graph 2.1.1). Jean-Claude Trichet, the President of the ECB, at his speech before the European Parliament on October 10, 2006, signaled further monetary tightening by ECB with the objective of maintaining price stability and sustainable growth compatible with job creation.

The Japanese economy grew by 2.7 percent in 2005 due to strong domestic demand and high export performance (Table 2.1.1). As a result of sustained revival in domestic demand owing to increases in employment and disposable income, the Japanese economy is expected to grow by approximately 2.8 percent in 2006. The current account surplus, which was 3.6 percent of the GDP in 2005, is expected to increase in 2006 owing to increases in exports and to exceed 4 percent. As a matter of fact, exports revenue increased by almost 16 percent in September 2006 compared to the same period of the last year. Unlike previous periods, the annual rate of increase in consumer prices followed a positive trend in 2006 due to strong domestic demand (Graph 2.1.2).

In its March meeting, the Bank of Japan (BoJ) ended its excess liquidity policy that has been conducted for five years and decided to keep its policy rate, for which it has not set an official target, effectively at zero. However, in view of the recent developments, the BoJ raised interest rates by 25 basis points in its meeting held on July 13-14, 2006 due to rising concerns about sharp fluctuations in economic activity and prices in the upcoming period that might be caused by zero-rate policy. At the subsequent meetings, interest rates have been kept unchanged (Graph 2.1.1).

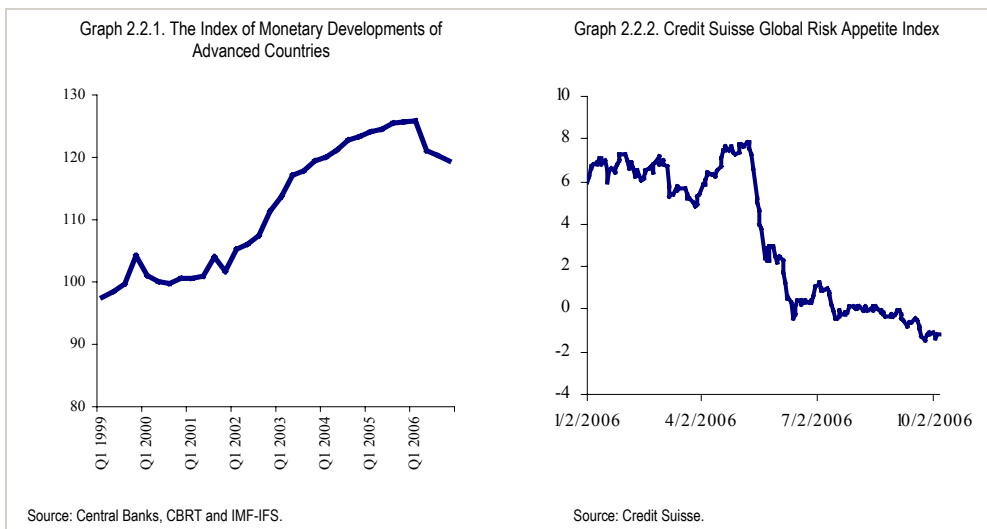
The Chinese economy grew by approximately 10 percent in 2005 owing to the increases in exports, investments and company profits. The Chinese economy is expected to grow by about 10 percent in the current year following a similar trend (Table 2.1.1). Within this framework, the Chinese economy which grew by 10.2 percent in the first quarter of 2006

has recorded a growth rate of 10.9 percent in the second quarter of the same year. Exports, as the most significant factor contributing to growth, surged in 2005, and consequently, China's current account surplus relative to its GDP reached 6.3 percent in 2005 by doubling from the previous year. However, the fact that the Chinese yuan started to appreciate against the USD as of the second half of 2005 and this appreciation gained further momentum starting from the first quarter of 2006, led to the expectation that the current account surplus would decrease in 2007.

## 2.2. International Markets

### 2.2.a. Financial Markets

The favorable conditions prevalent in global markets since 2003 were disrupted as a result of the turbulences in May and June 2006. While financial markets have re-stabilized as of July, unlike the pre-turbulence period, developed countries assets have demonstrated a better performance. Along with the decline in the global risk appetite, international investors switched to relatively stable instruments in the developed countries, which have lower market and liquidity risks.

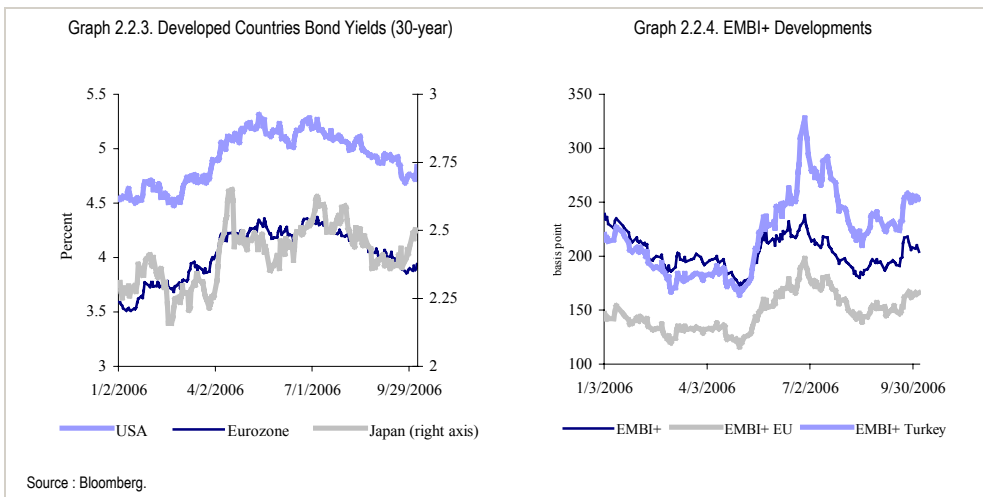


The “Index of Monetary Developments in Developed Countries”, which is derived as an index where base money expansion exceeding nominal GDP growth rate in the USA, the Eurozone and Japan has been weighted with the GDPs of the mentioned countries with the base year 1999=100, peaked in the first quarter of 2006. However, it has been

observed that the index has been declining in the aftermath of the monetary tightening decision taken at the March meeting of BoJ. The BoJ, severely narrowing its base money in April and May, continued its policy, albeit at a slower pace, in the subsequent months (Graph 2.2.1).

The Credit Suisse Risk Appetite Index (CSRA), one of the most major risk appetite indicators, decreased remarkably following the developments experienced in May 2006 and remained below its 25-year average of 0.97. When the 1.5 standard deviation confidence interval of index averages are taken into account, it is observed that the index had been above the upper bound since November 2005, thus indicating "euphoria"; while it declined remarkably after the developments in May 2006. The low level of the index indicates that international investors give more weight to safe assets of the developed countries in their portfolios (Graph 2.2.2).

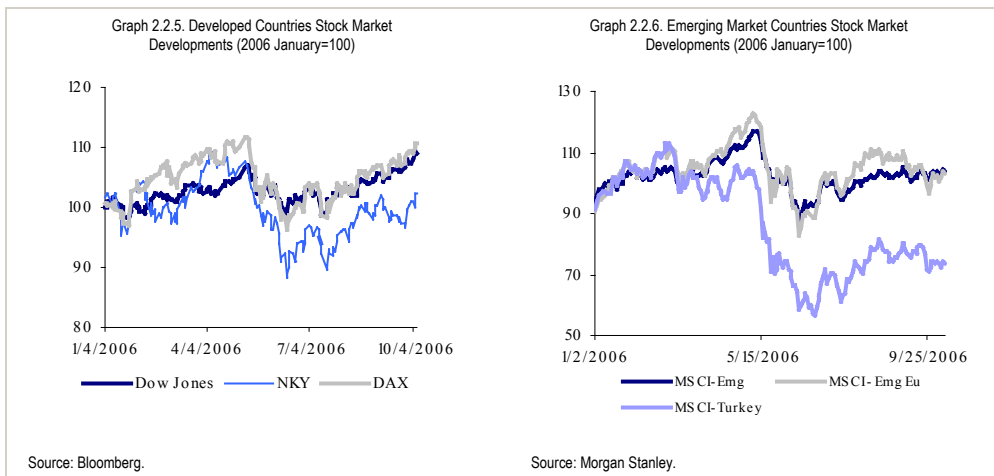
The analysis of interest rate developments in advanced countries demonstrates that the yields on long-term bonds slightly declined as international investors increased their demand towards more secure assets as well as due to prevalent view about policy rate increases having come to an end in view of the mitigating inflationary pressures in the USA and the Eurozone. In Japan, following the August CPI developments, the downward trend of the yields backtracked and yields surged (Graph 2.2.3).



Yields in developing countries reached their historically low levels as of March 2006 and then showed a tendency to move upward as a result of the financial turbulence that started in mid-May, while this trend continued

until end-June. Despite the decline in yields as of this date, stability has been achieved at a higher level compared to the pre-turbulence period. It is notable that the Emerging Markets Bond Index (EMBI+) and the developing Europe and Turkey sub-indices of this index follow similar pattern and feature the same turning points. The Turkey sub-index took values above the EMBI+ after a two-year period and in the following months the difference between the two series remained positive (Graph 2.2.4).

The upward trend in the equity markets of the developed countries, which was interrupted in May has been reinforced since mid-June; where Dow Jones has particularly recorded a high performance (Graph 2.2.5). When developing countries are analyzed, it is seen that the Morgan Stanley Capital Index (MSCI) and its Developing Countries and Turkey sub-indices declined remarkably after the financial turbulence and despite having risen slightly since July, the indices have yet to reach the pre-turbulence values (Graph 2.2.6).



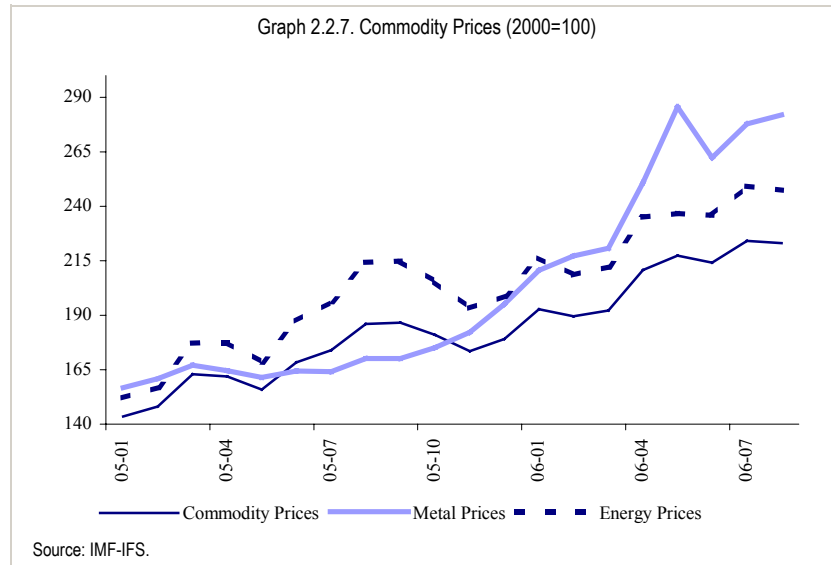
Even though the international markets present a relatively stable picture beginning from July, important risk factors continue to exist. The fact that contraction in the US real estate market makes the country's growth decline abruptly and which, in turn, hampers global growth, may lead to further deterioration in the risk appetite. International institutions draw attention to global imbalances and evaluate this as a risk factor for the upcoming period. On the other hand, significant changes in the value of developed countries' currencies might cause international investors to re-adjust their portfolios. The likely revaluation of Chinese yuan in accordance with the counsel of international institutions or adopting new practices in

reserve accumulation policy in China which is experiencing more and more difficulties in implementing reserve management and monetary policy, stands out as another risk factor.

Considering the negative impact of the announcement of Philadelphia Fed's survey on September 21, 2006 which reinforces the expectations that the US economy could enter recession, it should be kept in mind that in an environment where risk appetite is low, each new data can affect the portfolio decisions of investors. In light of these developments, the probability that international conditions in the upcoming period will be as convenient as they had been until May 2006 seems to be weak.

### 2.2.b. Commodity Markets

The strong growth trend observed in the world economy in recent years led to rapid demand and price increases in commodity markets (Box 2.2). However, the increase in commodity prices has slowed down in recent months and the annual growth rate in August 2006, contrary to June 2006, decreased compared to the same period of the previous year. The monthly growth rates of the IMF Commodity Prices and Energy Prices Indices declined by 0.4 percent and 0.7 percent respectively, in August 2006 (Graph 2.2.7). Meanwhile, contrary to the other two indices, monthly growth rate in the IMF Metal Prices Index continues to increase at a decelerating rate.



The average price of the six basic metals traded in the London Metal Exchange (LME) increased in the third quarter of 2006, compared to the

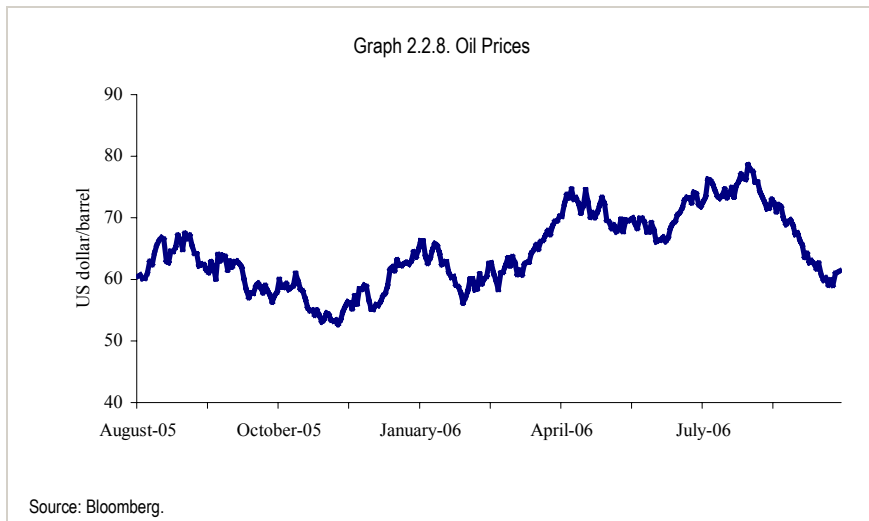
second quarter. In September 2006, the annual growth rate of the average price of the six basic metals traded in LME has registered higher increases compared to the corresponding period in 2005 (Table 2.2.1). The quarterly growth rate in the third quarter of 2006 indicates an increase in all metals in LME excluding aluminum.

Table 2.2.1. London Metal Exchange Developments

USD	2006		Percentage Change				
	II	III	August	September	06-II / 05-III	06-III / 06-II	August/September
Aluminum	2,81.1	2.481.7	2.461.6	2.471.8	36.9	-8.0	0.4
Copper	7.42.3	7.672.1	7.690.3	7.599.3	115.4	6.9	-1.2
Lead	1.21.0	1.191.1	1.179.3	1.340.6	37.6	5.9	12.0
Nickel	19.625.5	28.919.6	30.468.9	30.104.1	84.7	32.1	-1.2
Tin	8.551.9	8.605.3	8.436.7	9.022.9	23.4	0.6	6.5
Zinc	3.248.2	3.354.1	3.340.0	3.401.5	155.4	3.2	1.8

Source : LME.

The annual growth rates of IMF Energy Prices and Commodity Prices, in contrast to the annual rate of increases in June, almost fell by half in September and were realized as 19.9 and 15.5, respectively. The annual growth rate of the IMF Metal Prices Index fell from the rate of 76.8 percent in June 2006 to 65.6 percent in September 2006 (Graph 2.2.7). In international markets, the average price of Brent oil was realized as USD 62.8/barrel in September, indicating 14.7 percent decline in the monthly growth rate of crude oil compared to July 2006 (Graph 2.2.8). The December 2006 contract traded at the futures market fell to USD 60.08/barrel due to the latest declines in crude oil market.



The strong trend of global growth in recent years exerts pressure on prices in the crude oil markets. However, as of September, the increase in crude oil production and the decline in crude oil consumption growth, pushed the prices down. On the other hand, the outflows in the crude oil futures market in September are viewed as another important source of the decline in crude oil prices in this period. Moreover, higher than expected crude oil reserves of USA and the relatively stable conditions in the Middle East are the factors contributing to decline in crude oil prices. However, the seasonally higher demand during winter and the possibility of a quota reduction underlined by the Organization of the Petroleum Exporting Countries (OPEC) in its last two announcements are viewed as the risk factors that might reverse the downward trend of crude oil prices in the future.

BOX 2.1. RESULTS FROM A STRUCTURAL VAR ANALYSIS OF THE DETERMINANTS OF CAPITAL FLOWS INTO TURKEY

Capital inflows to developing countries and emerging market economies have surged considerably since the beginning of the 1990s. Large amounts of capital inflows tend to create significant effects on the economic performance of recipient countries. Capital inflows contribute to economic growth by increasing consumption and investment expenditures. However, it may also give rise to inflationary pressures in the economy and raise the current account deficit led by the boost in the total aggregate domestic demand.

International capital, in a rapidly globalizing world where restrictions on capital mobility are almost removed, may leave a country as swift as it arrives. The impact of capital inflows on inflation, exchange rates, credit volume and current account balance can lead to accumulation of vulnerabilities, and thus to instability in a country's financial system, if the firms and especially the banking system lack sufficient regulatory and supervisory framework. The experiences in Mexico and Turkey in 1994, in East Asia in 1997, in Russia in 1998 and finally in Argentina and Turkey in 2001 all demonstrate the potential problems that can follow sudden reversals of capital inflows. Therefore, it is crucial to examine the determinants of the capital flows in order to increase our understanding of how to avoid or minimize such costs.

The determinants of capital flows have been extensively analyzed in the relevant literature. This subject is mostly examined in the context of push and pull factors in economic literature. Push factors refer to external determinants of capital flows from developed countries to emerging economies such as interest rates and economic activity in industrial countries. Pull factors; on the other hand, refer to domestic determinants of capital inflows in a particular emerging market economy such as domestic interest rates, stock market prices, macroeconomic stability, exchange rate regime, inflation, domestic credit levels, and industrial production. Determining the relative roles of push and pull factors in driving capital flows is a crucial issue regarding the actions of the policymakers in capital recipient countries. If capital flows are determined by push factors, domestic policymakers will have little to do to control the capital flows. On the other hand, to the extent that capital flows are determined by pull factors, domestic policymakers will have more control on capital flows by introducing sound macroeconomic policies.

To examine the determinants of capital flows into Turkey, a structural vector autoregression (SVAR) model has been employed in the framework of traditional 'push-pull' factors approach and impulse-response and variance decomposition functions have been produced.<sup>1</sup> The analysis covers the whole sample period (1992:01-2005:12) and the two sub-periods before and after the 2001 economic crisis (1992:01-2001:12 and 2002:01-2005:12). In the model, the push factors are defined as interest rates on 3-month US Treasury bills and the US industrial production index. The pull factors are defined as real interest rate on Turkish Treasury bills, Istanbul Stock Exchange price index, budget balance, and current account balance. The capital movements have been measured as the sum of portfolio and other short-term capital flows from the balance of payments statistics.

The findings produced with impulse-response functions from the structural VAR model can be summarized in terms of push-pull factors as follows:

### **Push Factors**

The results from the impulse-response analysis covering the period of 1992:01-2005:12 indicate an unexpected relationship between capital inflows to Turkey and US interest rates. According to the results, a positive shock to US interest rates leads to an increase in capital inflows to Turkey. This finding, rather than a causal relationship, can largely be attributed to the concurrence of the crisis periods (or contagion effects of financial crisis elsewhere, e.g. in East Asia and Russia) in Turkey, when there were also massive capital outflows, with the decline in US interest rates. When the same analysis is carried out over the two sub-periods 1992:01-2001:12 and 2002:01-2005:12, a different picture emerges. Over the first sub-period (1992:01-2001:12) an increase in US interest rates initially leads to an increase in capital flows to Turkey, as the case in the whole sample period. However, beginning from the fifth month, a slight amount of capital outflow occurs. In the second sub-period (2002:01-2005:12) an increase in the US interest rates causes capital outflow from Turkey, consistent with the theory. Basically, this can be attributed to the so-called 'normalization'<sup>2</sup> of the Turkish economy after the deep crisis in 2001.

According to the analysis for the whole sample period (1992:01-2005:12), an increase in the US industrial production index initially leads to capital outflows from Turkey. This fact can be attributed to the inflationary pressure due to accelerated economic activity along with the increase in the US industrial production index, leading to the expectation of a rise in interest rates. This development, in turn, leads the international capital to flow to the US. The analysis for the two sub-periods shows that the relationship between capital inflows to Turkey and the increase in the US industrial production index is positive. Thus, it is possible to make the deduction that; in general, the acceleration of economic activity in developed countries increases capital inflows to Turkey.

<sup>1</sup> ÇULHA, Ali (2006), "A Structural VAR Analysis of the Determinants of Capital Flows into Turkey", CBRT Working Paper, No: 06/05.

<sup>2</sup> The Turkish economy has been characterized by persistent fiscal imbalances, chronic and high inflation, volatile growth rates and macroeconomic instability during 1990s. However, the economy has undergone a fundamental restructuring in the post-crisis period mainly driven by prudent monetary and fiscal policies accompanied by various comprehensive structural reforms. The term 'normalization' here is used to characterize the stable macroeconomic environment during the period after the 2001 economic crisis, in which inflation rate came down to single digits along with high growth rates averaging 7,8 percent over the last four years.

### **Pull Factors**

According to the impulse-response analysis for the whole sample period and the first sub-period, a positive shock to real interest rates leads to capital outflow from Turkey. The main reason behind this unexpected relation is the risk premium inherent in the real interest rates in Turkey. The increasing risk premium in periods of economic and political instabilities is rapidly reflected on interest rates and this is accompanied with high levels of capital outflows. However, the analysis covering the second sub-period shows that the rise in real interest rates in Turkey increases capital inflow. This conclusion, consistent with the theory, once again points to the 'normalization' process of the Turkish economy after the economic crisis in 2001.

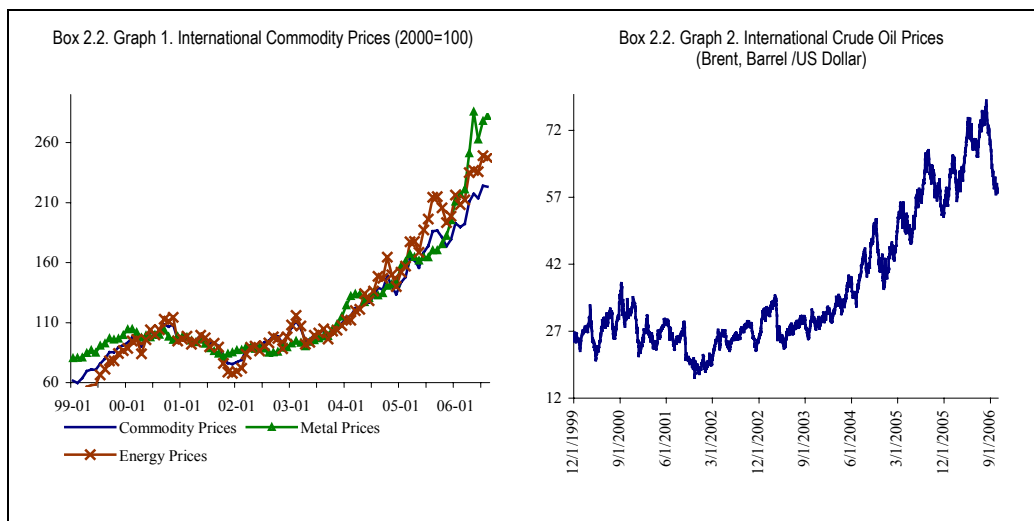
A rise in the stock exchange index reflects the increased returns on investment as well as the improved economic fundamentals, mostly particular to Turkey. The analysis, consistent with the theory, suggests that there is a positive correlation between the increase in stock exchange price index and capital flows into Turkey. Similar results were obtained from the analysis for the two sub-periods. In regards to Turkey, this finding demonstrates that, besides the returns on investments, the improvement in economic fundamentals is an important factor in attracting capital flows.

Impulse-response analysis shows that an increase in both budget deficit and current account deficit leads to capital outflows from Turkey. This finding is supportive of the argument that foreign investors perceive the budget balance and current account balance as indicators of fiscal and external fragility, respectively. Thus, deteriorating budget and current account balances increase the risk perception regarding the economic fundamentals and this leads to capital outflows.

The results of the variance decomposition analysis aimed at finding the relative importance of the push and pull factors in determining capital flows to Turkey can be summarized as follows: In terms of the effects on capital flows, both in the whole sample period (1992:01-2005:12) and in the two sub-periods (1992:01-2001:12 and 2002:01-2005:12), pull factors tend to have more weight than push factors. In the whole sample period, US interest rate seems to have the highest importance as a push factor, whereas domestic real interest rate appears to have a higher importance among the pull factors in determining capital flows. In the first sub-period, domestic real interest rate has the largest weight, while in the second sub-period, stock exchange price index turns out to have the largest weight. This particular development in the second sub-period basically reflects the positive impact of the improvement in economic fundamentals on capital flows. This finding mainly points to the 'normalization' process of the Turkish economy after the 2001 economic crisis. One of the other important findings as regards the second sub-period is that the relative importance of the current account balance in determining capital flows as a pull factor has increased considerably with respect to the first sub-period.

## BOX 2.2. COMMODITY MARKETS

The upward trend that has been observed in commodity prices since January 1999, continued and gained momentum especially in the first months of 2002. In the period from January 2002 to August 2006, the Metal Prices, the Energy Prices and the Commodity Prices Indices of the IMF increased by 224.3 percent, 256.7 percent and 190.1 percent, respectively. (Box 2.2. Graph 1). International crude oil prices, which constitute the most important sub-item of the Energy Price Index, increased by 241 percent over the same period (Box 2.2. Graph 2). During the 2000-2004 period, the price increases observed in the commodity markets, which constitute 22 percent of the world trade, led to a deterioration in current account balances of the countries that import these commodities as well as increases in their inflation rates (IMF World Economic Outlook, September 2006). In this context, this Box aims to provide an outlook of the recent developments in the international commodity markets and evaluate the reasons behind the aforementioned upward trend in commodity prices.



Two views stand out among the various opinions that were put forward to explain the rapid upward trend observed lately in commodity prices: According to the first view, high increases in commodity prices in effect point to a break in the long-term price trends. In other words, the increase in demand caused by the integration of developing countries, especially of China, to the world economy created a significant surge in world commodity demand (Box 2.2. Table 1). While the rate of increase of China's main metal consumption share was already high during the 1993-2002 period, it surpassed 80 percent in the 2002-2005 period especially in lead, nickel, tin and zinc. In the aftermath of 2002, the demand from developed countries, particularly of the USA caused a break in prices (Box 2.2. Table 1).

On the other hand, some economists view the increasing domination of hedge funds and investment banks especially in the futures and forward markets as the reason behind the increases in prices of both energy and non-energy commodities. In this context, the second important reason behind the increase in commodity prices is the increasing domination of investment funds in commodity markets in recent years. The most important reason for investment banks and hedge funds to include commodities in their portfolios is the drive to minimize risk by diversifying their portfolios. Idzorek (2006)<sup>3</sup> and Greer (2000)<sup>4</sup> showed that, a portfolio provides higher return per unit risk when various commodities are included in investor portfolios. Another reason for commodities to be included in the portfolios of stocks and bonds is that, they have generally provided more positive returns than the stocks provided in the last 10 years.<sup>5</sup> For instance, while global crises such as earthquakes and geopolitical uncertainties raise metal and energy prices in particular, causes losses in stock values. Finally, due to the negative correlation between commodity prices and unanticipated inflation, commodities are expected to display better performance in the investor portfolio compared to stocks and bonds<sup>6</sup>; and therefore to limit the likely losses in the portfolio.

**Box 2.2. Table 1. Oil and Main Metal Consumptions<sup>1</sup>**

	1993-2002			2002-2005		
	World metal consumption	Shares in increase		World metal consumption	Shares in increase	
		China	Other Developing countries <sup>2</sup>		China	Other Developing countries <sup>2</sup>
<b>Metal</b>						
Aluminum	3.8	38	9	7.6	48	9
Copper	3.5	43	15	3.8	51	41
Lead	3	42	15	4.3	110	-7
Nickel	4.4	12	-11	3.6	87	-11
Iron	3.4	38	11	9.2	54	8
Tin	1.3	34	16	8.1	86	2
Zinc	3.4	42	10	3.8	113	7
<b>Oil</b>	1.5	21	18	2.2	30	7

Source: IMF World Economic Outlook, September 2006.

In conclusion, the most important demand-driven factors that increase commodity prices is the rapid economic growth particularly led by China, the USA and other developed countries and the speculative hedge fund investments. The high probability of the continuation of the above-mentioned developments signals sustained price increases in the future. In addition, it stands as an important risk factor concerning both inflation rates in the world economies and the current account balances of the importing countries.

<sup>1</sup> Consumption levels are shown with real annual percentage changes, while shares in the increase in consumption are given as a percentage-point contribution to growth.

<sup>2</sup> Brazil, India, Mexico and Russia. However, due to the lack of data regarding 2005, Russia was not included in the part headed "oil".

<sup>3</sup> Idzorek T. (2006), "Strategic Asset Allocation and Commodities", May 2006, Chicago: Ibbotson Associates, (Available via the internet: <http://www.pimco.com/LeftNav/Viewpoints/2006/Ibbotson+Commodity+Study.htm>).

<sup>4</sup> Greer, Robert J. (2000), "The Nature of Commodity Index Returns." Journal of Alternative Investments, Summer 2000, 45-53.

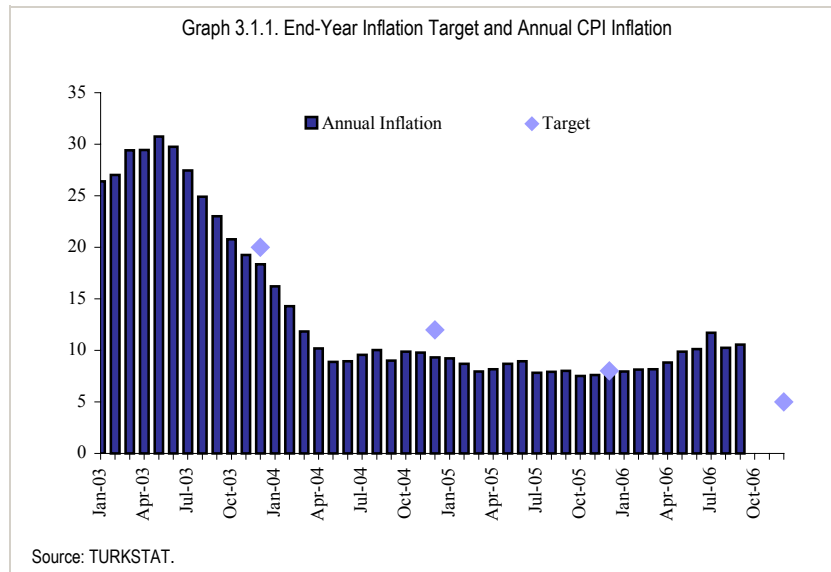
<sup>5</sup> International Monetary Fund (2006), Global Financial Stability Report, Market Reforms and Issues, September 2006, Washington.

<sup>6</sup> Froot K. (1995), "Hedging Portfolios with Real Assets", Journal of Portfolio Management, Vol.21 No.4 (Summer), pp.60-77.

## 3. Inflation Developments

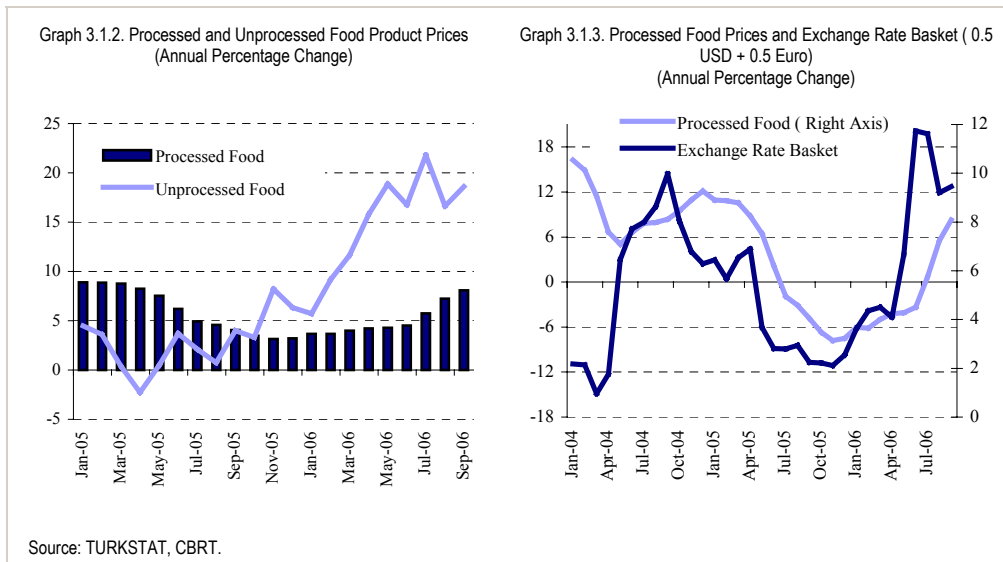
### 3.1. Inflation

The annual rate of increase in consumer prices became 10.55 percent by the end of the third quarter of 2006 (Graph 3.1.1). The acceleration in annual CPI inflation, which started in the second quarter, also continued in the third quarter and thus, annual CPI inflation realized outside the uncertainty band set around the path consistent with the target by the end of September. The primary factors leading to the rise in inflation were the lagged effects of the depreciation of the New Turkish lira stemming from adverse international liquidity conditions in the second quarter of 2006 and the rapid increase in unprocessed food prices. Besides, the ongoing high annual increase in services prices became another factor affecting inflation figures negatively. Meanwhile, the declines in oil and gold prices in international markets can be noted as favorable developments in the same period.



The food and non-alcoholic beverages has been the main group in the rise of consumer inflation in the last one-year period. When this expenditure group is analyzed according to the unprocessed and processed food, it is observed that the upward trend in the prices of unprocessed food products continued in the third quarter, albeit slower, and that the annual rate of increase in this group maintained its high level. Meanwhile, the rate of increase in the processed food

that displayed a relatively limited rise in the first half accelerated significantly in the third quarter (Graph 3.1.2).

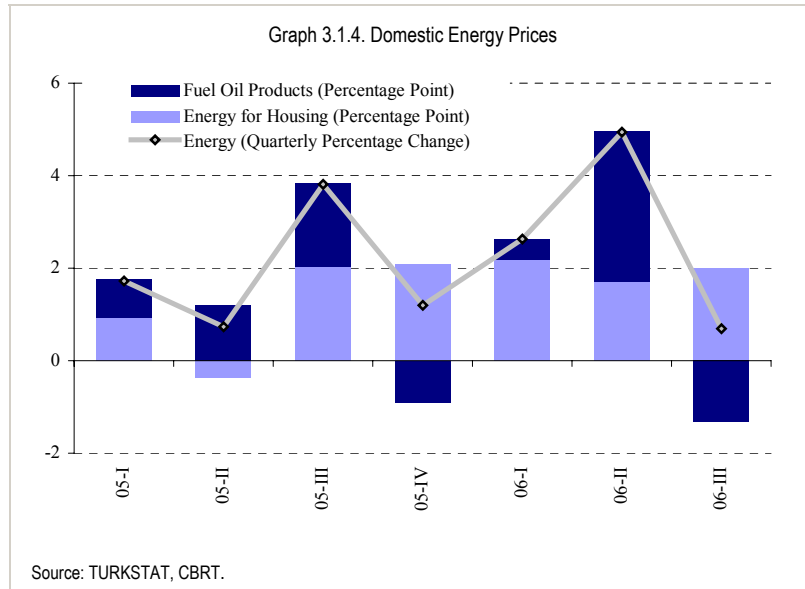


In our previous reports it was stated that high rated increases in unprocessed food prices stemmed from supply-side factors due to price developments in the fresh fruits and vegetables. When compared to 12.9 percent cumulative decrease recorded in the first nine months of 2005, the 35.2 percent upsurge in the same period of 2006 in fresh fruit prices is a note-worthy development. Although the rate of increase in the prices of unprocessed food excluding fresh fruits and vegetables showed a slight acceleration in the third quarter, the current level of annual inflation in this group does not seem to be unfavorable. On the other hand, the price movements due to avian influenza had been observed in this group in the last quarter of 2005. Therefore, it should be noted that there might be some temporary fluctuations in the annual rate of increase in this group in the following months.

The significant acceleration in prices of processed food products in the third quarter can mainly be attributed to the lagged effects of exchange rate developments (Graph 3.1.3). The analysis indicate that the exchange rate developments affect processed food prices with a time lag of 2-3 months. In addition, the increased demand for processed food products due to month of Ramadan was thought to have upward pressure on prices in this group.

While energy prices displayed a higher rate of increase in the first six months of 2006 compared to the same period of last year, the rise in the third

quarter of 2006 was relatively lower than the same period in 2005 (Table 3.1.1). Developments in international energy prices affect consumer prices directly via fuel oil and natural gas prices. Oil prices, which are reflected on natural gas prices with a certain time lag, displayed an upward trend in July and then decreased significantly in August of 2006. The said development in oil prices and the appreciation of the New Turkish lira caused fuel oil prices fell in August - September period and thus, prices of energy items under the transportation group decreased by 4.7 percent in the third quarter of 2006 (Graph 3.1.4). Moreover, the energy for housing group prices increased by 2.9 percent due to the increases in natural gas and tap water prices.



To sum up, as for developments in the prices of goods in the third quarter, the rate of increase in energy prices decelerated compared to the same period last year while the rate of increase in the prices of unprocessed food products increased by 1.5 percentage points compared to the previous year's figures. The increase in the prices of goods excluding unprocessed food products and energy accelerated in the second quarter due to the real depreciation of the New Turkish lira and displayed a slowdown in the third quarter with the completion of the major part of the relative price adjustments (Table 3.1.1).

Table 3.1.1. Goods and Service Sector Prices  
(Quarterly Percentage Change)

	2005					2006		
	I	II	III	IV	Annual	I	II	III
<b>CPI</b>	<b>0.83</b>	<b>1.74</b>	<b>1.30</b>	<b>3.65</b>	<b>7.72</b>	<b>1.25</b>	<b>3.58</b>	<b>1.69</b>
<b>1. Goods</b>	<b>-0.24</b>	<b>1.16</b>	<b>0.80</b>	<b>4.42</b>	<b>6.21</b>	<b>0.80</b>	<b>3.67</b>	<b>0.88</b>
Energy	1.73	0.73	3.81	1.20	7.65	2.63	4.94	0.69
Unprocessed Food	3.61	-7.87	0.25	11.12	6.34	8.81	-3.67	1.83
Goods excl. Energy and Unprocessed Food	-1.94	3.91	-0.05	3.79	5.71	-2.01	5.54	0.67
<b>2. Services</b>	<b>3.85</b>	<b>2.77</b>	<b>3.65</b>	<b>1.87</b>	<b>12.68</b>	<b>2.41</b>	<b>3.36</b>	<b>3.83</b>
Rent	4.26	3.74	7.06	4.04	20.48	4.08	3.69	6.67
Restaurants and Hotels	5.19	2.65	3.29	3.09	14.98	3.02	4.25	3.40
Transportation Services	7.87	2.04	6.00	1.11	17.97	1.27	1.36	6.26
Other Services	1.75	2.73	1.72	0.56	6.92	1.80	3.32	2.32

Source: TURKSTAT, CBRT.

The direct effects of the depreciation of YTL on CPI are generally observed through fuel oil, gold and imported consumer durables or consumer durables having a high import content. In this framework, following the depreciation of YTL in May and June, prices of durable goods displayed very high rates of increase in the second quarter. It is observed that the lagged effects of the depreciation on durable goods differed in terms of sub-groups and continued albeit at a slower pace in the third quarter. A similar trend is also observed in producer prices of durable goods. An analysis of the sub-group reveals that the upward pressure on electrical and non-electrical appliances as well as on automobile prices exerted by exchange rates has almost been completed by the third quarter and prices started to drop upon the appreciation of YTL<sup>1</sup> while the rapid rise in furniture prices continued and further accelerated compared to the previous quarter (Table 3.1.2). It is predicted that following the slow down of demand, there will be a deceleration in furniture prices.

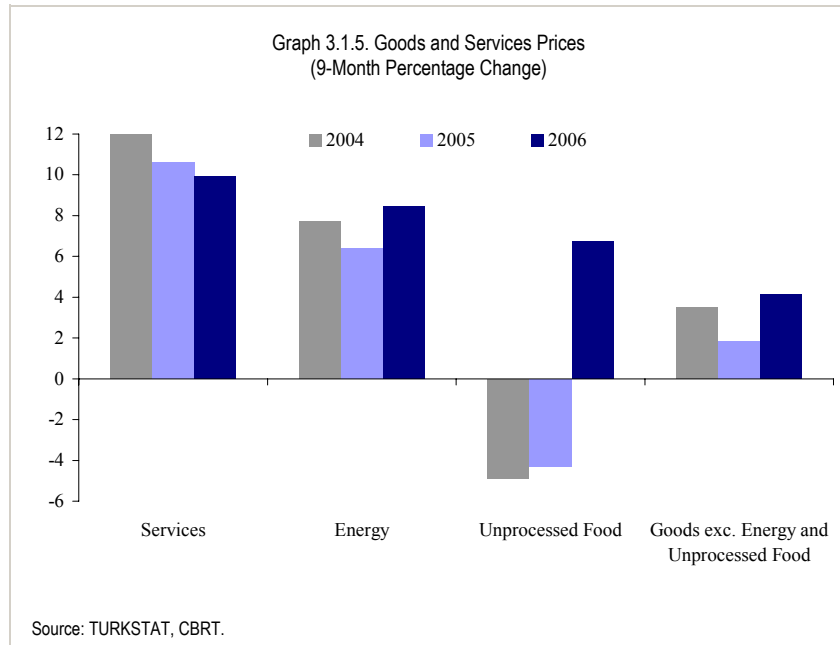
Table 3.1.2. Durable Goods Prices  
(Quarterly Percentage Change)

	2005					2006		
	I	II	III	IV	Annual	I	II	III
<b>Durable Goods excl. Gold</b>	<b>1.86</b>	<b>3.66</b>	<b>-1.86</b>	<b>2.23</b>	<b>5.94</b>	<b>-3.04</b>	<b>5.40</b>	<b>2.84</b>
Furniture	3.10	5.26	-2.74	7.64	13.62	-7.81	7.45	9.21
Electrical and Non-Electrical Appliances	2.62	4.24	-1.97	0.39	5.28	-5.55	4.51	-0.54
Automobile	-0.12	3.07	-1.32	-0.17	1.42	2.93	7.09	2.57
Other Durable Goods	4.15	-0.21	-1.03	0.44	3.32	-1.17	-1.86	1.43

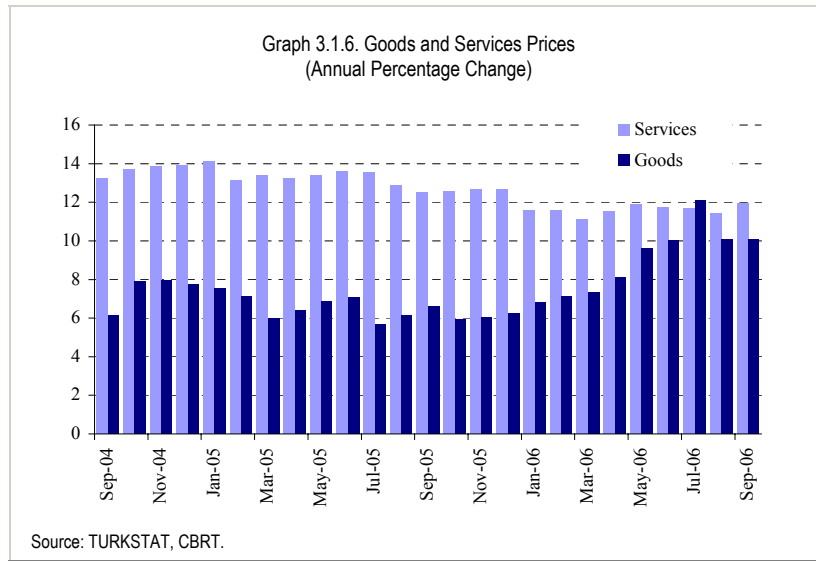
Source: TURKSTAT, CBRT.

<sup>1</sup> Prices of electrical and non-electrical appliances displayed a monthly decline in August and September while those of automobiles displayed a monthly decline in September.

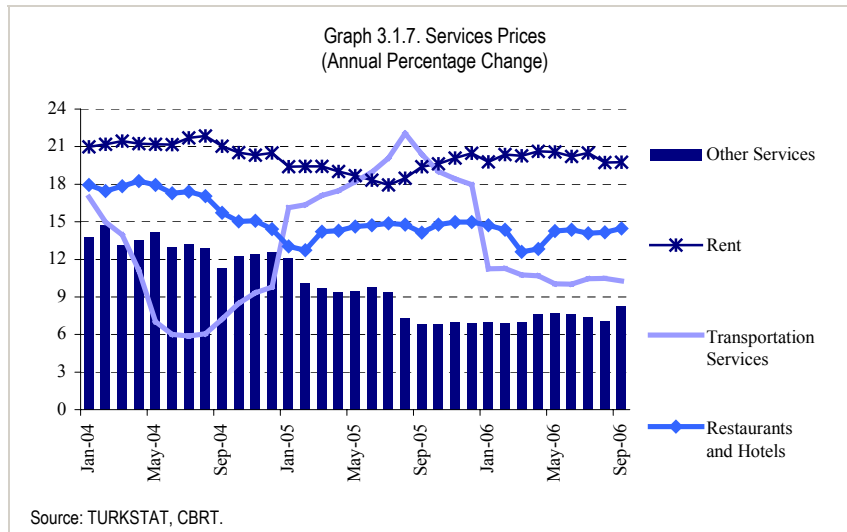
When the developments in the first nine months of 2006 are compared to those of the previous years, the factors underlying the rise in inflation become more clearly visible (Graph 3.1.5). The significantly higher rate of increase in unprocessed food products in the first three quarters of 2006 compared to previous years has made a substantial contribution to the rise in annual consumer inflation. Moreover, the nine-month-rise in goods excluding energy and unprocessed food products on which the effects of exchange rates have most clearly been observed recently, became another important contributor of the increase in inflation. In addition, although price increases in the services group decelerated compared to the previous years, they still maintain a high trend.



While prices of goods increased by 0.88 percent in the third quarter, prices of services increased by 3.83 percent in the same period (Table 3.1.1). It is observed that the rise in annual inflation in the services group displayed a modest decline while the rise in annual inflation in the goods group is well above last year's figures due to exchange rates effects (Graph 3.1.6).

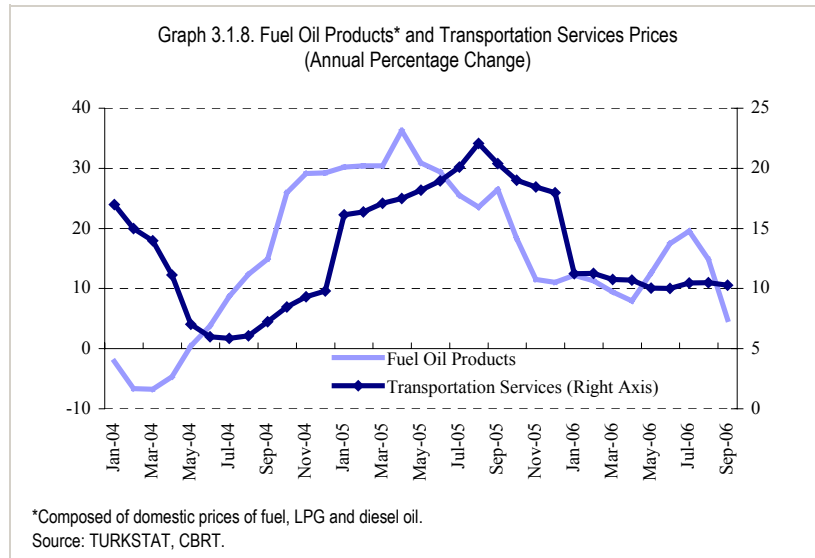


The annual inflation in the rents item under the housing group, has maintained its high level at 20 percent which is close to last year's figures (Graph 3.1.7). The price increases in the restaurants and hotels group in last two quarters are higher compared to the same period of 2005. As for the subgroups of this group, nine-month inflation of catering services decreased, albeit slightly, whereas that of accommodation services increased slightly compared to the same period of last year.



Transportation services prices became the primary determinant of the partial improvement in inflation of services group in the last 12-month period. It is observed that transportation services prices are largely sensitive to fuel oil price developments (Graph 3.1.8). Annual transportation services inflation,

which exceeded 20 percent in 2005 due to the rapid climb in oil prices, declined to 10 percent as of September 2006. Annual inflation in this group is expected to slow down further provided that the decline in oil prices in international markets becomes permanent.



Prices of services other than rents, restaurants-hotels and transportation services (other services) increased by 2.32 percent in the third quarter, exceeding the figures recorded last year (Table 3.1.1). Prices of education, house-related services and package holidays were the underlying factors in this development. Although annual inflation in services prices is expected to slow down depending on the rate of deceleration of domestic demand in the upcoming period, services prices still continue to be an important risk factor for medium-term inflation targets.

In the third quarter, unprocessed food prices and exchange rate developments played an important role in the Special CPI Aggregates. Especially, the lagged effects of the rise in exchange rates influenced the prices in related aggregates via price increases in items such as processed food products, durable goods, medicine and household furniture included in every special aggregates. Thus, the increase in all special aggregates in the third quarter surpassed the figures of last year (Table 3.1.3).

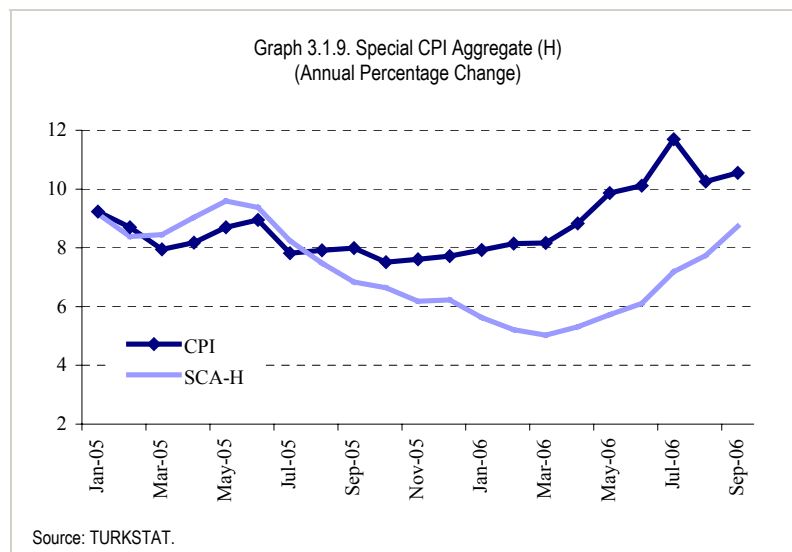
Table 3.1.3. Special CPI Aggregates (2003=100)  
(Quarterly Percentage Change)

	2005					2006		
	I	II	III	IV	Annua I	I	II	III
<b>CPI</b>	<b>0.83</b>	<b>1.74</b>	<b>1.30</b>	<b>3.65</b>	<b>7.72</b>	<b>1.25</b>	<b>3.58</b>	<b>1.69</b>
A. CPI Excluding Seasonal Products	2.06	1.84	2.75	1.48	8.39	2.31	2.79	3.23
B. CPI Excluding Unprocessed Food	0.37	2.95	1.58	2.68	7.78	0.12	4.79	1.67
C. CPI Excluding Energy	0.67	1.94	0.89	4.07	7.75	1.01	3.38	1.86
D. CPI Excluding Unprocessed Food Products and Energy	0.09	3.44	1.14	2.98	7.84	-0.38	4.77	1.86
E. CPI Excluding Energy, Alcoholic Beverages and Tobacco Products	0.59	2.05	-0.16	4.00	6.58	0.74	3.62	1.98
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	1.86
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	1.88
H. 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	2.19

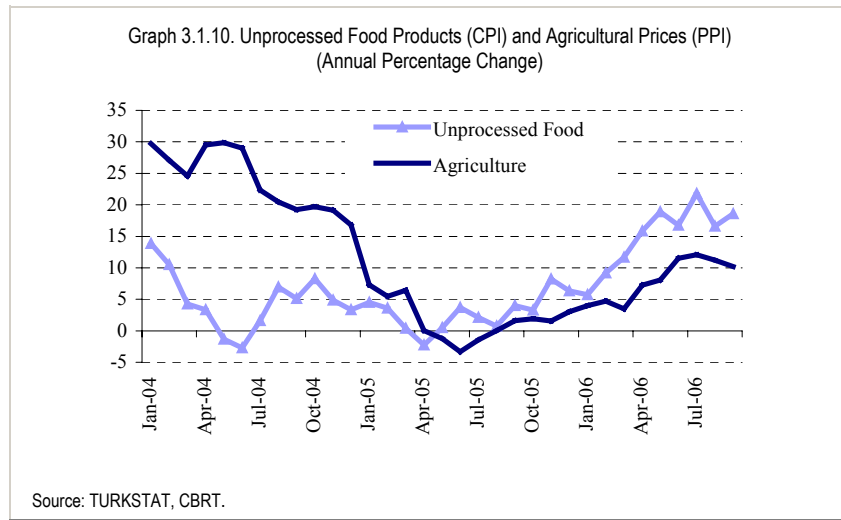
\* CPI excluding energy, unprocessed food, alcoholic beverages, tobacco products and gold\* which was formerly released by CBRT (SCA-D\*), started to be issued by TURKSTAT as SCA-H from September onwards.

Source: TURKSTAT.

The annual increase in the Special CPI Aggregate excluding energy, unprocessed food products, alcoholic beverages, tobacco and gold, which started to be issued as SCA-H by TURKSTAT from September onwards, continued to rise in the third quarter (Graph 3.1.9). The lagged effects of exchange rates developments played a significant role in the rise of the SCH-A. Parallel to the improvement in cost conditions and slow down of domestic demand, it is predicted that the monthly increase in the SCH-A indicator will decelerate in the next few months and the annual increase will continue to remain high for some time. Meanwhile, how the new season increases will affect the rates of increase in prices of the clothing and footwear group will be influential in the course of the SCA-H in October and November.



Annual Producer Prices Inflation, which started to accelerate as of May with the effect of the rise in exchange rates, climbed to 14.34 percent in July from 4.96 percent in April. Manufacturing industry prices was the primary determinant of this rise (Graph 3.1.11). Mainly due to the decline in oil prices in August and September, the rise in industry prices slowed down significantly. Annual inflation in agricultural sector, which had been rising for the last year, fell in the third quarter as well (Graph 3.1.10).



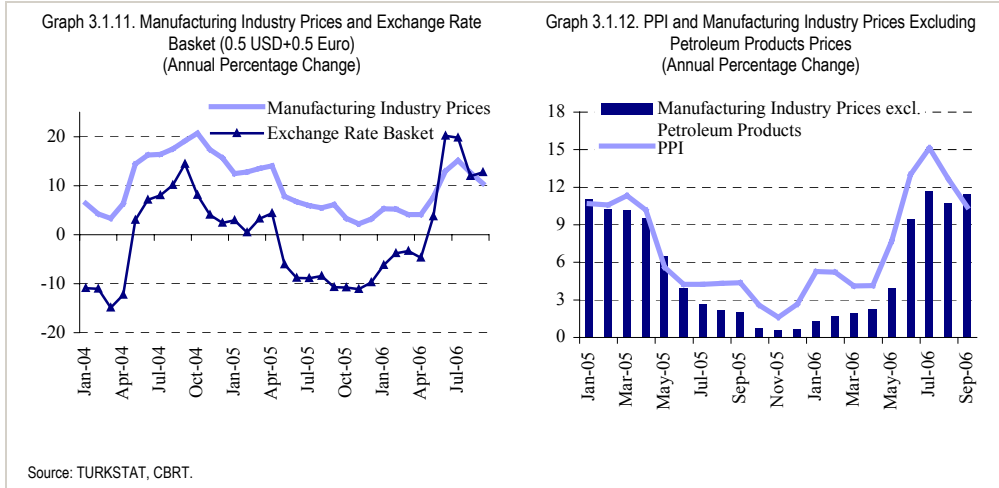
In the third quarter, the inflation rates accelerated in food, clothing, leather products and media-press sectors. The month of Ramadan, the new season in the clothing sector, the opening of schools and the lagged effects of exchange rates made a collective contribution to this acceleration.

	2005					2006		
	I	II	III	IV	Annual	I	II	III
PPI	0.96	0.92	1.07	-0.31	2.66	2.48	8.98	-0.12
Agriculture	1.65	-2.74	-1.50	5.80	3.03	2.12	4.81	-2.67
Industry	0.76	1.97	1.75	-1.89	2.57	2.57	10.00	0.47
Mining and Stone					9.63			
Quarrying	-2.28	7.16	8.28	-3.32		3.20	9.52	3.57
Manufacturing Industry	0.61	1.95	2.68	-2.05	3.15	1.55	10.66	0.33
Electricity, Gas and Water	3.98	0.68	-13.72	1.44	-8.38	18.18	1.29	1.66

Source: TURKSTAT.

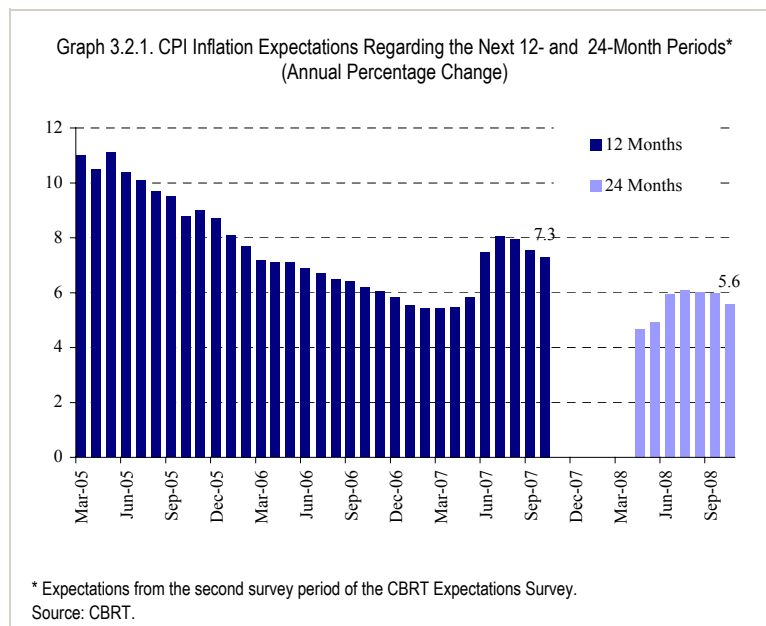
When the effect of oil products is excluded, annual inflation in manufacturing industry rose in the third quarter of 2006 compared to the previous period (Graph 3.1.12). Parallel to commodity price developments in international markets and the appreciation of YTL, prices of the basic metal industry, and coke and refined petroleum products decreased by 3.66 percent

and 13.53 percent, respectively. The favorable impact of this development on costs was limited due to the 10.26 percent rise in natural gas prices in the third quarter.



### 3.2. Expectations

Inflation expectations, which started to deteriorate in the second quarter of 2006 due to turbulences experienced in economy, started to recover as of August with the effect of the strong policy response of the Central Bank. However, medium-term inflation expectations are currently above the targets.



The end-year inflation expectations that displayed a sharp rise in June showed an improvement in August and became 9.88 percent as of last survey period. It is observed that the fluctuation increased the end-year inflation expectations by 4.1 percentage points compared to the pre-fluctuation period. Inflation expectations for the next 12- and 24-month periods, asked for longer-term, became 7.31 and 5.60 percent, respectively, as of second survey period of October. The economic units think that the downward trend in inflation will progressively continue in the medium run.

The decline in the coefficient of variation<sup>2</sup> for the next 12-month period to its level in April confirms the improvement in inflation expectations in the second period of September. No significant improvement has been observed yet in the coefficient of variation of inflation expectations regarding the next 24-month period, which decreased to 5.60 percent after significant increase in June, with the effect of the uncertainty pertaining to longer terms (Table 3.2.1).

In the inflation-targeting regime, monetary policy is designed so as to ensure that inflation expectations are consistent with the medium-term targets. In this context, though inflation expectations have started to recover, inflation expectations even for both the next 12 and 24-month periods are still remaining above the targets and emerge as a risk factor for wage and price-determination and should be monitored with caution.

Current Period	Survey	End-Year	Next 12 Months		Next 24 Months	
			Average Expectation*	Coefficient of Variation	Average Expectation*	Coefficient of Variation
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
August-06	1	10.59	7.98	0.13	6.06	0.17
	2	10.46	7.94	0.13	6.02	0.15
September-06	1	9.77	7.62	0.13	5.91	0.18
	2	9.63	7.54	0.10	5.99	0.16
October-06	1	9.96	7.38	0.11	5.80	0.17
	2	9.88	7.31	0.11	5.60	0.15

\* Average expectation figures presented in the table are specified through comparing the appropriate means designated based on the comparison of arithmetic mean median, mode, alpha-and trimmed mean and extreme value analysis.  
Source: CBRT.

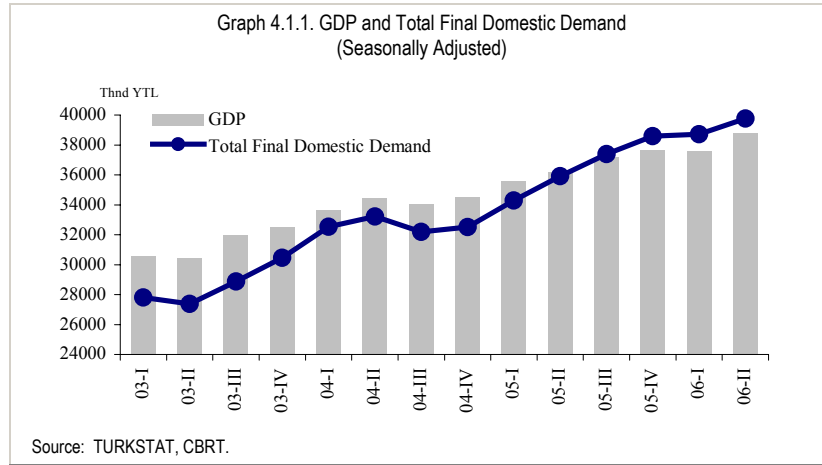
<sup>2</sup> The coefficient of variation, which indicates the deviation of participants' expectations, is the ratio of standard deviation to mean of the data set on which appropriate means are made.



## 4. Supply and Demand Developments

### 4.1. Supply-Demand Balance

In the second quarter of 2006, GDP increased by 7.5 percent compared to the same period of the previous year. According to the seasonally adjusted figures, GDP grew by 3.1 percent compared to the previous period. Thus, consistent with leading indicators presented in the July Inflation Report, economic activity gained momentum (Graph 4.1.1).



When economic growth is analyzed in terms of the production, it is observed that the value added from the industrial sector, which lost pace significantly in the first quarter of the year, increased at a high rate in the second quarter and made the greatest contribution to growth. Unlike the revival in the industrial sector, the value added from the agricultural sector fell. Meanwhile, the contribution of the services sector to growth also decreased compared to the first quarter, due to the slowdown in the construction sector. The decline in public sector construction investments was the main reason behind the fall in the value added of the construction sector.

Analyzed in terms of demand components, it is observed that while the rate of increase in consumption expenditures increased in the second quarter of 2006 compared to that of the first quarter, the rate of increase in investment expenditures declined (Table 4.1.1). Analyzed in terms of the sub-groups of consumption expenditures, both public and private consumption increased. The slowdown in the rate of increase in investment expenditures stemmed from the decrease in public sector investment as well as from the decline in the rate of increase in private sector machinery-equipment investments. While the annual

rate of increase of consumption expenditures climbed, that of investment expenditures fell rapidly. As a result of this development, the annual rate of increase of the total final domestic demand remained below that of the first quarter (Table 4.1.1). If analyzed in terms of seasonally adjusted quarterly figures, it is observed that total final domestic demand increased by 2.7 percent, slightly less than GDP growth rate, compared to the previous quarter (Graph 4.1.1).

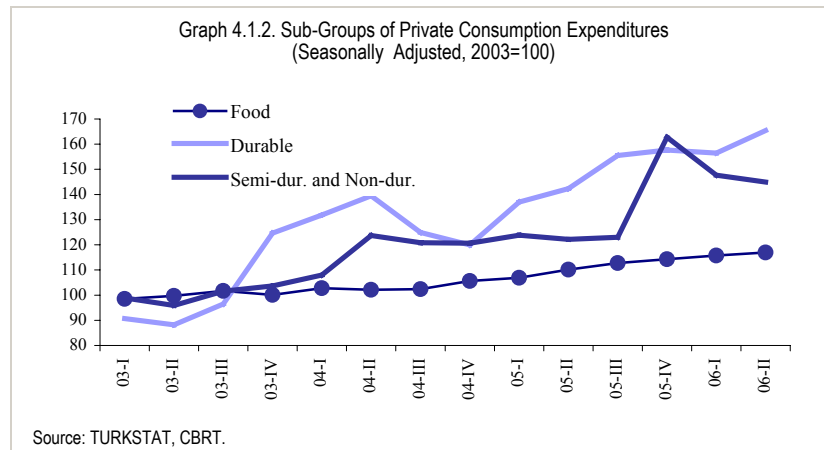
Table 4.1.1. GDP Developments by Expenditures  
(Constant Prices, Annual Percentage Change)

	2004	2005					2006		
	Annual	I	II	III	IV	Annual	I	II	Six Months
1-Consumption Expenditures	9.0	4.1	3.9	9.8	14.1	8.1	8.6	10.8	9.7
Public	0.5	4.4	4.0	3.2	0.0	2.4	8.1	18.0	13.5
Private	10.1	4.1	3.9	10.4	16.7	8.8	8.6	10.1	9.4
Durable Goods	29.7	3.2	2.9	26.0	31.3	15.0	13.4	15.9	14.6
Food and Beverages	2.8	3.3	8.6	10.8	8.7	8.2	7.5	6.2	6.8
Semi dur. and Non-dur Goods	18.8	9.0	3.0	3.7	39.6	12.9	12.7	21.6	16.8
2-Fixed Capital Formation	32.4	10.3	20.0	30.6	33.0	24.0	30.7	10.9	19.0
Public	-4.7	30.7	30.2	38.2	17.1	-25.9	34.5	-11.3	1.0
Private	45.5	8.8	18.4	29.0	41.6	23.6	30.4	14.8	21.5
Machinery-Equipment	60.3	5.1	15.4	26.8	43.5	21.4	32.7	11.0	20.2
Construction	15.3	20.8	28.8	33.2	35.9	29.9	23.8	26.3	25.2
3-Stock Change (*)	1.1	0.6	-0.7	-3.0	-6.3	-2.5	-4.4	0.3	-1.9
4-Exports of Goods and Services	12.5	14.0	6.7	3.9	10.9	8.5	3.5	4.3	3.9
5-Imports of Goods and Services	24.7	10.6	9.1	11.2	15.3	11.5	8.2	10.0	9.2
6-Total Domestic Demand	14.1	5.6	6.8	10.9	11.6	8.8	8.6	10.0	9.4
7-Total Final Domestic Demand	14.1	5.5	8.4	14.5	19.1	12.1	14.0	10.8	12.3
8-GDP (Expenditure Side)	9.0	6.6	5.5	7.7	9.5	7.4	6.5	7.5	7.0

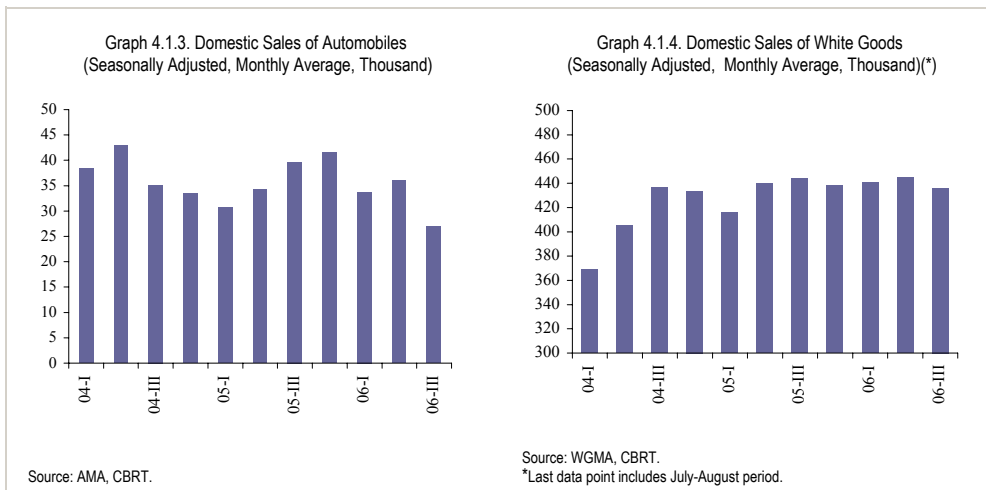
Source: TURKSTAT.

(\*) Contributions to GDP growth, percent.

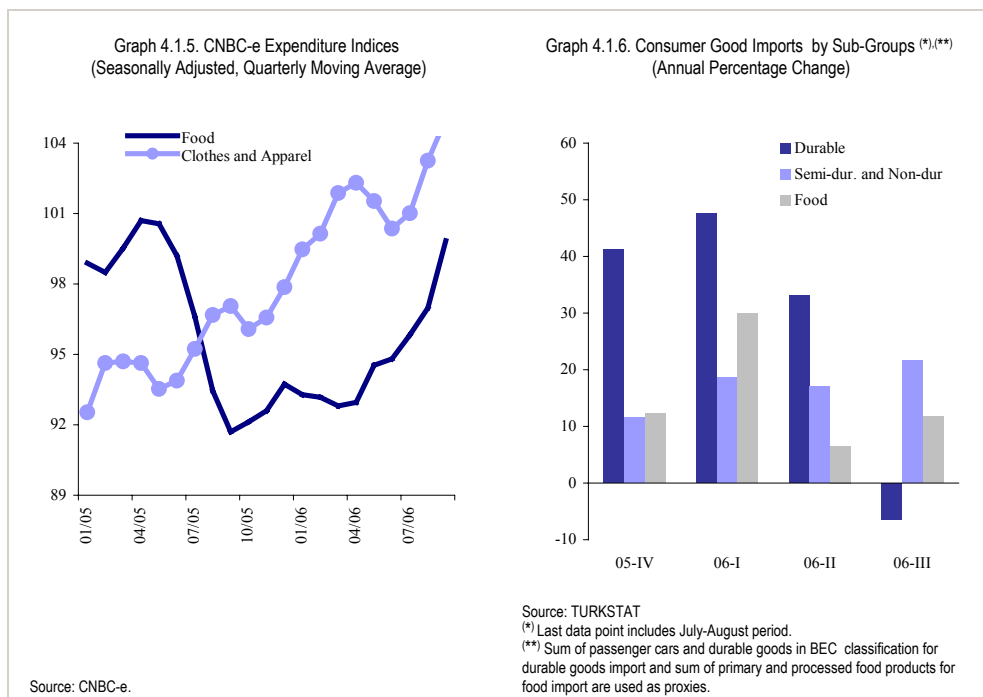
Private consumption expenditures, which had lost momentum in the first quarter of the year, started to reaccelerate in the second quarter. The said acceleration was triggered by durable goods consumption, which rose by 5.7 percent compared to the previous period according to seasonally adjusted figures. The seasonally adjusted figures also show that while the stable growth trend in food expenditures was maintained, semi-durable and non-durable goods consumption continued to decrease following the high-rated increase observed in the last quarter of 2005 (Graph 4.1.2).



The adverse impact of the financial turbulences occurred in May and June, which ultimately led to the depreciation of the YTL, will be visible on the demand for durable goods, which is most susceptible to exchange rate and credit developments, in the second half of the year. In fact, seasonally adjusted figures point to a sharp decline in domestic sales of automobiles in the third quarter (Graph 4.1.3). By the July-August period, a slight fall was also observed in white good sales (Graph 4.1.4). A persistence decline in the real automobile loans by September is a sign of the weakening in automobile sales. When the base effect of high-rated annual growth in the second half of 2005 taken into account, it is projected that durable goods consumption may come down on an annual basis throughout the rest of this year.

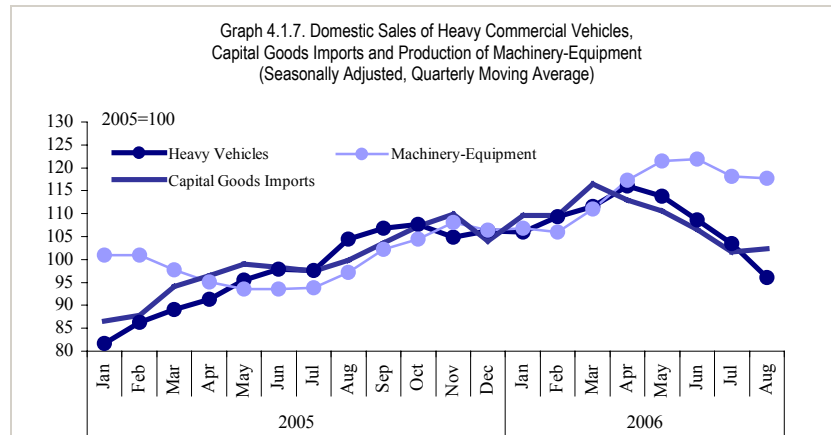


It is believed that the financial turbulence in May and June did not significantly affect the demand of consumption items, which are not very susceptible to exchange rate and credit developments. Seasonally adjusted consumption indices prepared by CNBC-e indicate that there was no decline in spending on food and clothing as of September (Graph 4.1.5). When the annual changes in imports of consumption goods is analyzed, it is observed that while imports of durable goods decreased in the July-August period, imports of semi-durable and non-durable goods and food products continued to grow (Graph 4.1.6). Therefore, although the financial turbulence in May and June is expected to lead to a deceleration in the rate of increase in private consumption in the second half of the year compared to the first half, the slowdown in consumption demand will be more apparent in durable goods than in other sub-groups.

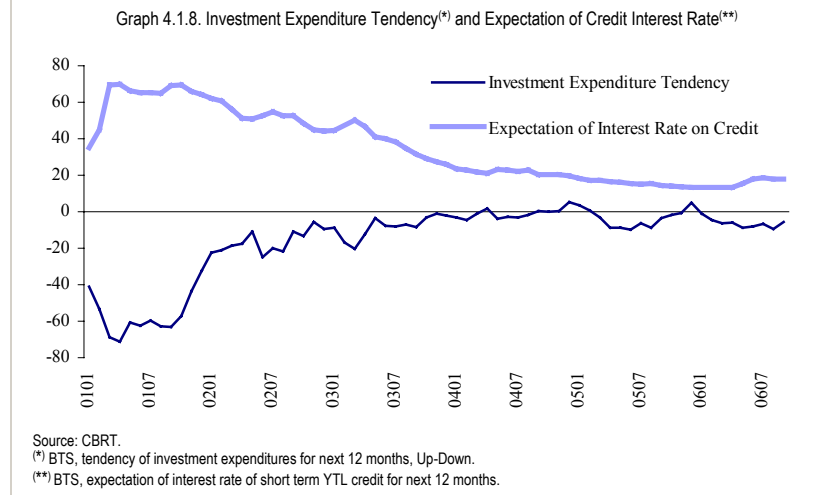


Indicators pertaining to investment demand show that the decline in machinery-equipment investments still continues due to the depreciation of the YTL and unfavorable conditions in financing. The downward trend in imports of capital goods, which had started following the historically high level in January and had been reinforced by price increases, ended in August. However, seasonally adjusted figures point to a level below that of the first two quarters of the year as of the July-August period (Graph 4.1.7). Similar to automobile sales, heavy commercial vehicles sales, a leading indicator for investment expenditure, responded sharply to the change in exchange rates. Therefore, given the base effect stemmed from high-rated increases observed in the second half of 2005, it is expected that machinery-equipment investments will exhibit a relatively low growth in the second half of the year.

Despite the above-mentioned developments, the fact that the tendency of investment expenditures for the next twelve months in the Business Tendency Survey (BTS) did not show a strong decline following the financial turbulence. This implies that investor confidence is maintained and investment expenditures will continue in the medium term (Graph 4.1.8). This situation is vital for the sustainability of productivity increases and non-inflationary high growth.



Source: AMA, TURKSTAT, CBRT.



Source: CBRT.

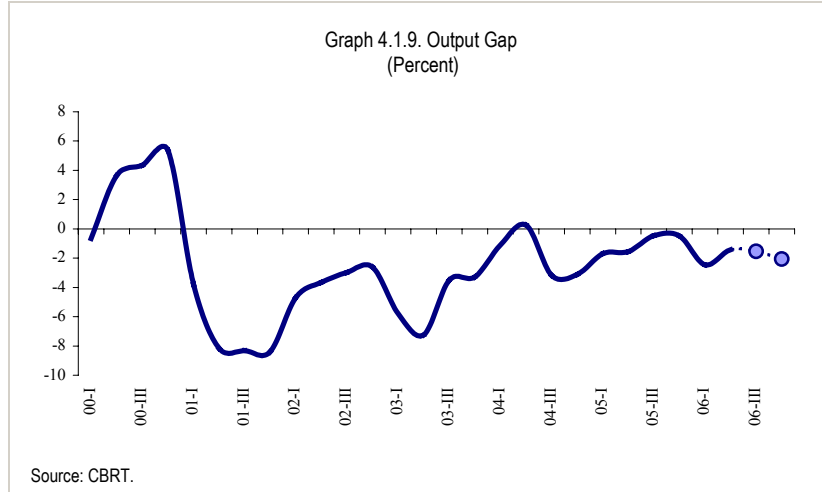
(\*) BTS, tendency of investment expenditures for next 12 months, Up-Down.

(\*\*) BTS, expectation of interest rate of short term YTL credit for next 12 months.

In conclusion, the leading indicators associated with demand show that total final domestic demand will slow down in the second half of the year due to sectors that are relatively more susceptible to financing conditions (exchange rate and credit interest rates). This expectation is reinforced by the fact that seasonally adjusted figures of total industrial and manufacturing industry production point to a downward trend in July and August, and expectations for manufacturing industry production as of September show lower annual rate of increase in the third quarter compared to the second quarter. However, the contribution of net foreign demand to growth is anticipated to be greater in the second half of the year compared to the first half and thus, is expected to restrain the domestic demand-based slowdown to a certain extent.

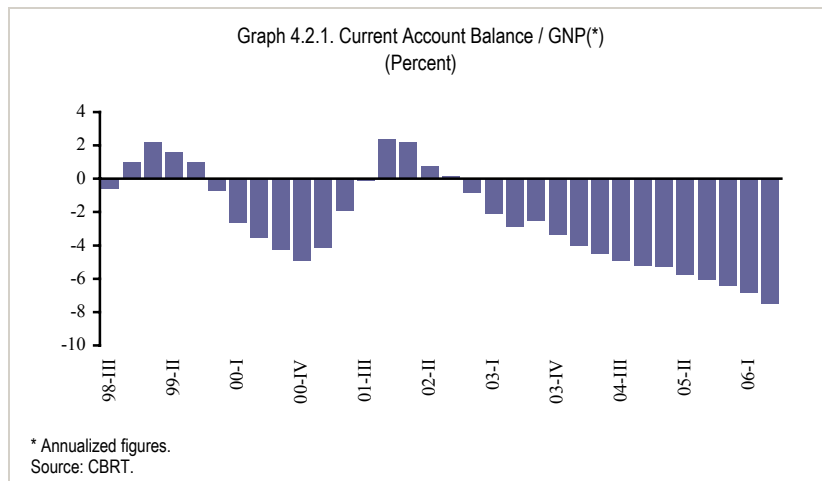
It is expected that the contribution of demand conditions to the disinflation process will increase in the upcoming period. In this respect, the output gap is estimated to widen further in the second half of the year (Graph

4.1.9). It is also projected that the increase in real interest rates and the slowdown in consumer loans stemmed from the monetary tightening in June, will have a restrictive impact on domestic demand in the upcoming period.

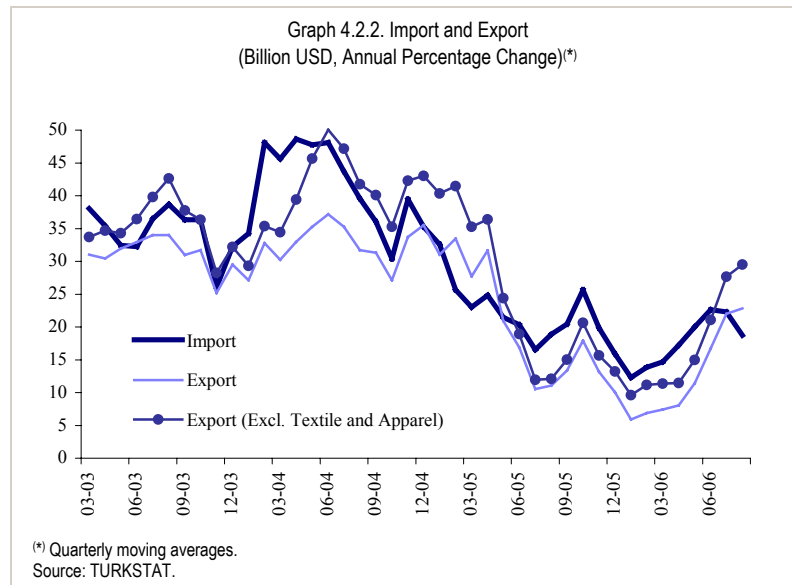


#### 4.2. Foreign Demand

Domestic and foreign demand, which followed an upward trend in the first half of 2006, provided support for the growth in exports and imports. Imports increased more rapidly than exports due to rising oil prices and vigorous domestic demand. However, the slowdown in domestic demand in the July-August period led to an annual growth rate of imports which is lower than that of exports. As a consequence, the current account deficit rose to USD 22.4 billion in the first eight months of 2006 from USD 15.5 billion in the same period of 2005. By the first half of 2006, the current account deficit reached 7.5 percent of the Gross National Product (GNP) on an annualized basis (Graph 4.2.1).



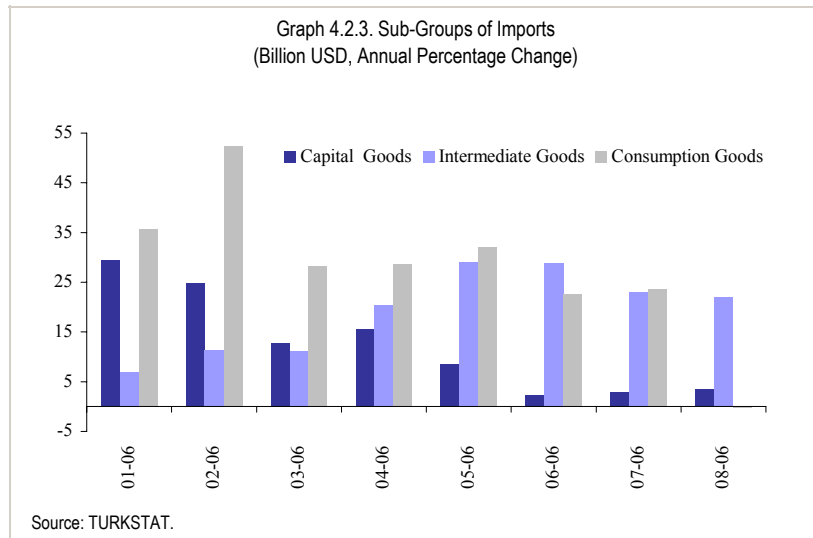
Exports and imports figures in the January-August period of 2006 grew 14.1 percent and 18.5 percent on an annual basis, respectively (Graph 4.2.2). The said growth rates are lower compared to the same period of 2005. However, the decline in the rate of increase of exports is slightly less than that of imports. The textile and apparel sectors, which have difficulties in competing far eastern countries with low labor costs and whose export performance is below the overall export performance, were favorably affected by the depreciation of the YTL in May and June, albeit moderately. Nevertheless, the export growth of these sectors remained below that of total exports in the May-August period. Excluding the textile and apparel sector, the rate of increase in exports well exceeded the rate of increase in imports in recent months. Capital-intensive sectors such as motor vehicles, machinery-equipment, electrical machinery-appliances and communication tools played an important role in general export performance.



When the imports composition is analyzed, it is observed that the increase in imports of intermediate goods made the greatest contribution to the increase of total imports. The rapid growth of industrial production coupled with rising oil prices led to a jump in the imports of intermediate goods. Fall in oil prices and slowdown in economic activity may be limiting the contribution of intermediate goods to total imports in the rest of the year.

Imports of capital goods, which generally showed rapid growth in 2005, started to lose pace in April 2006 (Graph 4.2.3). Meanwhile, the rapid growth

trend in imports of consumption goods, which continued until July, decelerated in August on an annual basis, especially due to the decline in imports of automobiles and the slowdown in imports of durable goods. Taking into account the high base effect in the last months of 2005 and parallel to the decrease in domestic demand, the rate of increase in imports of consumption and investment goods is expected to be low on an annual basis in the rest of the year.



The decline in energy prices, mainly oil prices, slowdown in domestic demand and continuation of the strong course of exports especially in capital-intensive sectors, due to the impact of vigorous external demand, implies that the growth of the foreign trade deficit will decelerate in the upcoming period. However, the ratio of current account deficit to GNP is expected to be higher in 2006 compared to 2005. Since the need for external financing is mainly met by direct investments and long-term credits, the economic fragility caused by the current account deficit is lessened in the short term. Moreover, it is expected that the high-rated increases of exports observed in the recent period will also continue in the upcoming period and surpass the increases in imports. However, likely rapid increases in oil prices may pose a risk in terms of foreign trade deficit and thus, current account deficit. As also stated in previous reports, sustainability of the current account deficit will be conditional on the strong course of exports in the medium and long terms. In this framework, structural improvements gain importance.

### 4.3. Unit 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 1.1 percent in the second quarter of 2006 compared to the same period last year (Table 4.3.1). Labor productivity per working hour index increased by 10.9 percent in the second quarter compared to the same period last year. In this period, both public and private sectors significantly contributed to the increase in labor productivity. Meanwhile, real wages per working hour increased by 0.5 percent in total manufacturing industry and by 1.3 percent in the private manufacturing industry, whereas they fell by 2.3 percent in the public manufacturing industry.

Table 4.3.1. Employment, Real Wage and Productivity Developments in Manufacturing Industry  
(Percentage Change Compared to the Same Period of the Previous Year)

	2004	2005					2006	
	Annual	I	II	III	IV	Annual	I	II
<b>Employment<sup>(1)</sup></b>								
Public	2.0	1.9	-1.7	-1.8	-1.1	-0.7	-1.4	-1.1
Private	-11.0	-10.2	-7.1	-8.6	-7.2	-8.3	-3.7	-4.4
<b>Wage<sup>(2)</sup></b>								
Public	3.6	3.2	-1.2	-1.1	-0.4	0.1	-1.2	-0.7
Private	2.5	3.2	2.1	1.6	0.7	1.9	0.3	0.5
<b>Productivity<sup>(3)</sup></b>								
Public	4.7	8.7	5.4	9.0	8.4	7.9	-4.3	-2.3
Private	4.8	3.5	2.0	1.0	-0.1	1.6	1.3	1.3
<b>Earnings<sup>(4)</sup></b>								
Public	7.3	5.1	4.3	6.1	8.4	6.0	4.6	10.9
Private	10.5	7.0	11.8	15.5	9.8	10.9	-1.8	15
Public	8.0	6.1	3.5	5.2	8.8	5.9	5.8	10.4
Private	1.3	2.8	2.7	2.5	0.8	2.2	-0.2	0.4
Public	3.2	10.6	3.5	8.8	3.0	6.3	-3.4	-1.6
Private	4.3	2.9	3.2	2.0	1.3	2.4	0.6	1.2

Source: TURKSTAT.

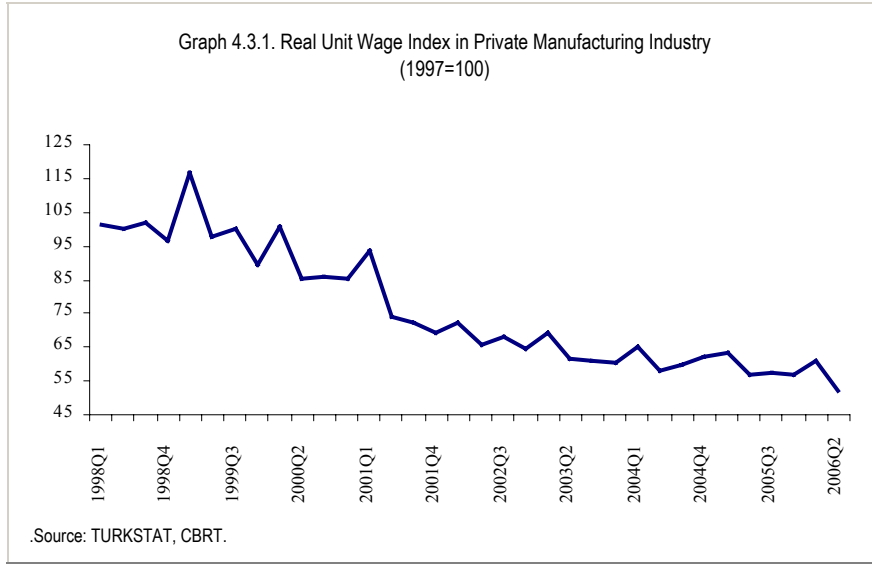
(1) The Index of Manufacturing Industry Workers, 1997=100.

(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 Workers, 1997=100.

In the private manufacturing industry, as a result of the continued rise in productivity coupled with a limited increase in real wages, the decline in real unit wages persisted and real unit wages decreased by 8.1 percent in the second quarter compared to the same period last year (Graph 4.3.1). The low level of real unit wages eases the cost pressure on prices. It also favorably contributes to export performance through supporting the competitiveness of the manufacturing industry. It is projected that the rate of increase in productivity will decline in the upcoming period parallel to the expected slowdown in economic activities and the decline in real unit wages will be milder compared to previous periods, due to likely increases in real wages.



Arrangements in civil servant salaries for 2007 cover the compensation of the difference between inflation and wage increases for the year 2006, and salary increases by 4 percent for low-paid civil servants and by 3 percent for higher-paid civil servants for each half of the year. Since real wages affect prices through both cost and demand channels, keeping wage arrangements consistent with the inflation target is critical. As a matter of fact, according to the gross national income figures based on income approach announced by TURKSTAT in current prices, almost half of labor payments come from the public sector. Besides, public wage arrangements may to affect inflation expectations and they are sometimes taken as reference in private sector wage arrangements. Therefore, it is believed that the incomes policy may impede the disinflation process especially in the services sector, given wage increases for 2007, which are above the inflation target.

## 5. Financial Markets and Financial Intermediation

### *5.1. Financial Markets*

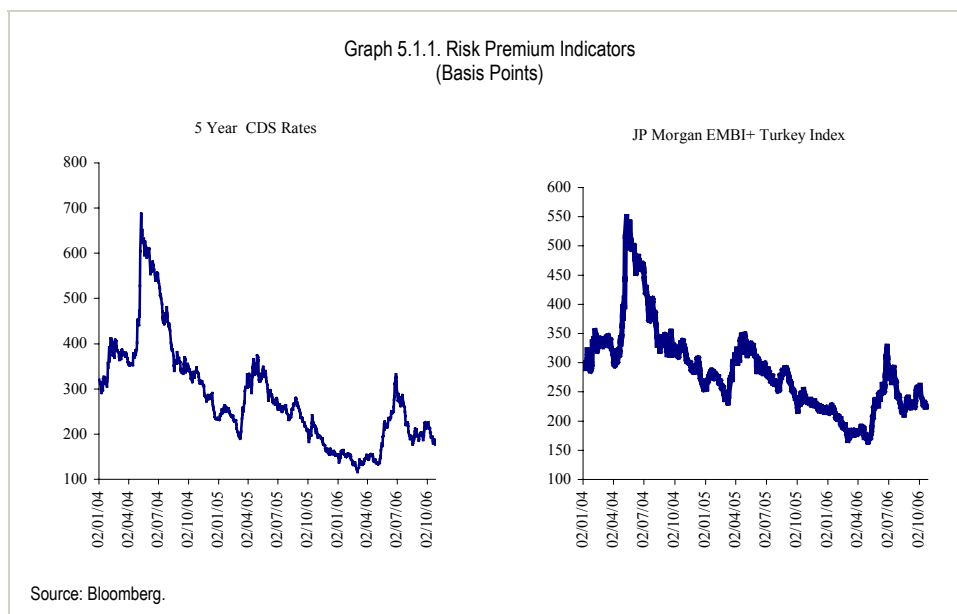
In the third quarter of 2006, the developments in financial markets contributed to the improvement in the inflation outlook. In the July-August period, the deterioration in international liquidity conditions came to a halt and the global risk appetite started to develop in favor of developing countries (Graph 2.2.2). The monetary policy measures that were taken after the fluctuations experienced in the May-June period helped the establishment of confidence in domestic markets. The amount that was withdrawn via one and two-week auctions, which served to mop up the excess liquidity in the market in the July-August period, was dropped progressively. Meanwhile, the interest rates formed in the auctions converged to overnight interest rates. As a result of the reduction in liquidity, deposit purchase auctions were terminated in August.

In the first half of July, the cautious stance towards the inflation outlook was maintained due to the high fluctuations in crude oil prices and the absence of a significant improvement in medium term inflation expectations. In this context, the Monetary Policy Committee decided to raise policy interest rates by 25 basis points in order to ensure achieving medium term targets.

In August, the deterioration in medium term inflation expectations ceased and turned into a slight improvement. Policy interest rates remained unchanged due to the signals towards a slowdown in total demand and the partial recovery in the inflation outlook. Meanwhile, high course of the energy and metal prices along with the ongoing uncertainties on international liquidity conditions led to the maintenance of the cautious stance. In September, policy interest rates were kept unchanged due to the ongoing partial improvement in the inflation outlook and the absence of a significant change in the data set.

During the days after the Committee meeting, the risk appetite towards the country groups, including Turkey, diminished due to the concerns about harsher than expected slowdown in the US economic growth and the appearance of negative political and economic shocks in some developing countries (Graph 2.2.2).

In October, favorable developments in international liquidity conditions became the main determinants of the decline in the Credit Default Swap rates and JP Morgan EMBI+ Index for Turkey (Graph 5.1.1).



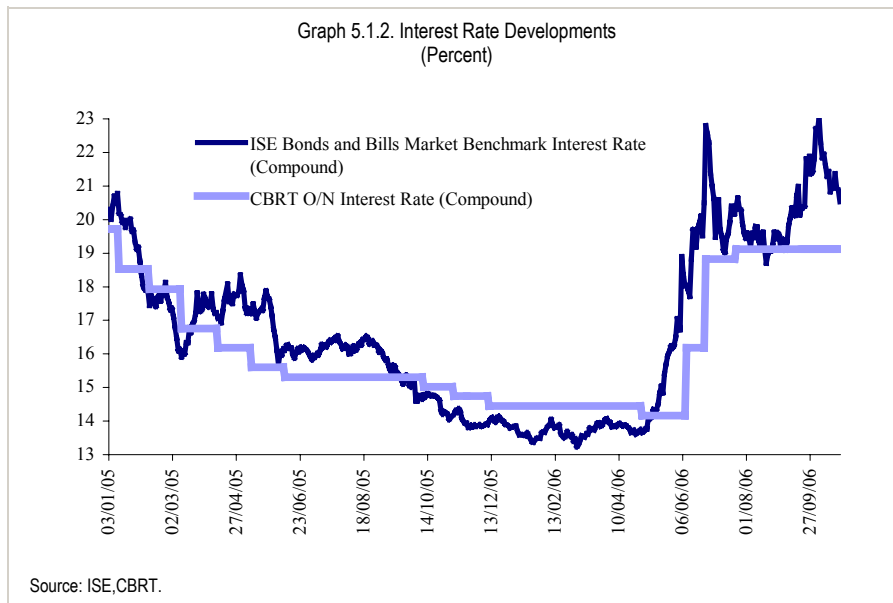
Emphasizing the potential negative effects of increases in public expenditures and the risks posed by the income policy to the inflation outlook, the Monetary Policy Committee decided to keep interest rates unchanged in October as well, thereby maintaining the tight stance of the monetary policy. The Committee also stated that; the factors such as the ongoing gap between the medium-term inflation expectations and the targets, the emergence of new risks related to service prices and the continuation of uncertainties in the global economy require the maintenance of cautious stance on monetary policy in the medium term.

Though current indicators for the US economy do not support a harsh slowdown scenario, they point to a gradual slowdown. The expectations formed around this outlook contribute to the decline of oil prices. The drop in oil prices is a favorable development for the Turkish economy, which is a net importer, especially with respect to the current account balance. Meanwhile, it should be taken into account that a harsher than expected slowdown in the US economy may lead to a temporary deterioration in the risk appetite.

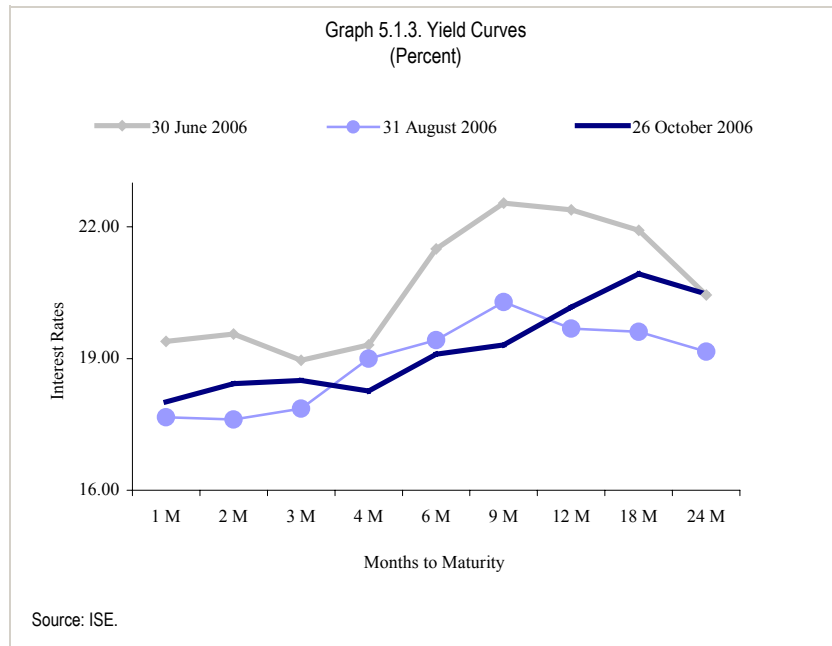
After the Committee meeting in September, in order to ease the uncertainty regarding short-term interest rates, the Central Bank announced to the public its forecast that the policy interest rate would continue to be the CBRT

borrowing interest rate in the upcoming period. Meanwhile, the mopped-up liquidity is likely to contribute to the slowdown in credit expansion rate.

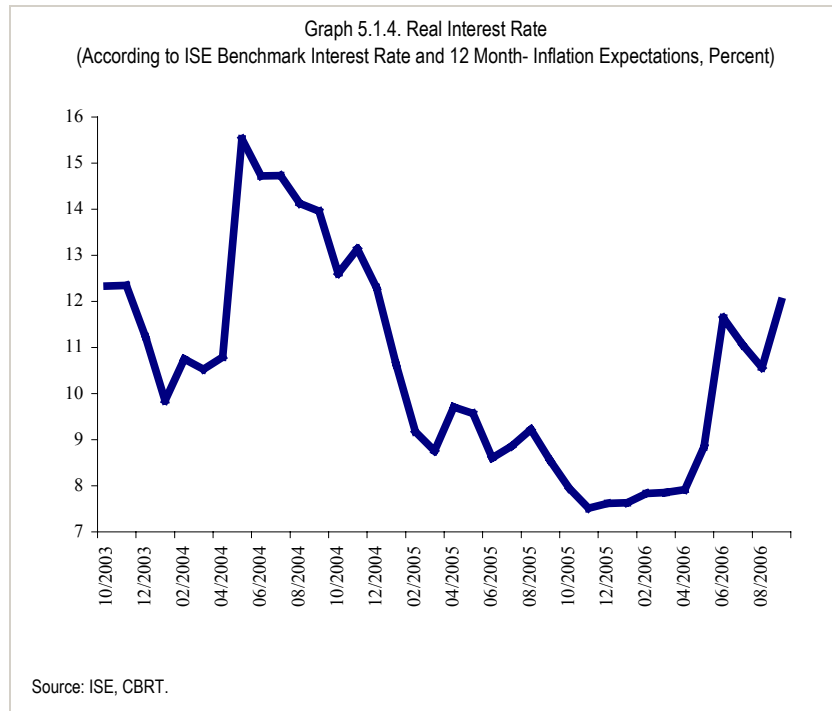
The deterioration of the risk perceptions in September and the decline in liquidity are important factors that led to the rise in the interest rate of the benchmark Government Securities that is formed in the Bonds and Bills Market of the Istanbul Stock Exchange. In October, favorable developments in risk premium indicators played an important role in the convergence of the benchmark interest rate to the CBRT borrowing interest rate (Graph 5.1.2).



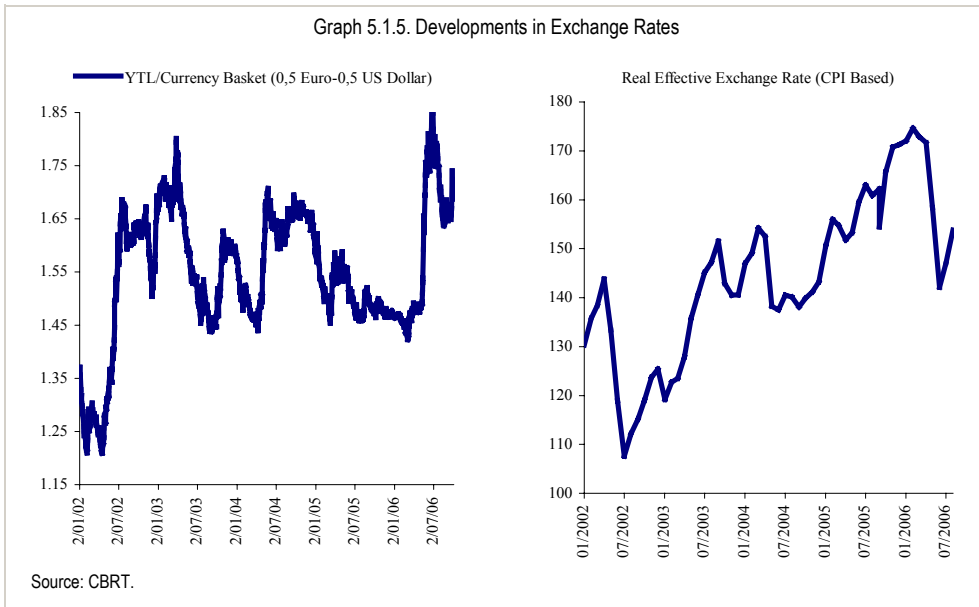
With the acknowledgement of the CBRT's determination to fight against inflation, a downward movement was observed at the longer maturity end of the yield curve at the end of June. At the end of August 2006, yields declined in each maturity compared to the end of June. Positive inflation data and the decline in risk premium were effective in this development (Graph 5.1.3). Because of the September inflation figures that were above expectations, the tendency of risk perceptions to deteriorate within the month and the liquidity squeeze led to increases in yields. Although, yields displayed a relative decline in October compared to the previous month, the yield curve of 26 October 2006 formed at higher levels in maturities longer than twelve months compared to that of 31 August 2006.



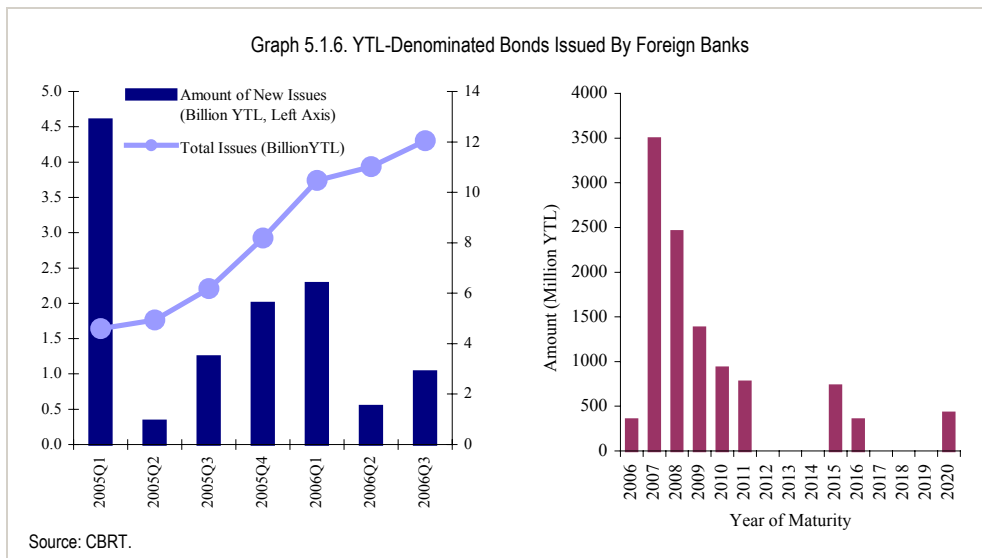
As a result of the developments mentioned above, real interest rate, which is calculated on the basis of 12-month inflation expectations contained in the CBRT Expectations Survey and benchmark interest rates displayed an upward trend in September (Graph 5.1.4).



Due to the fact that foreign investors changed their portfolio preferences in September, the appreciation observed in nominal exchange rates in July and August was replaced by a temporary depreciation (Graph 5.1.5). Exchange rates started to redisplay an appreciation trend in October.



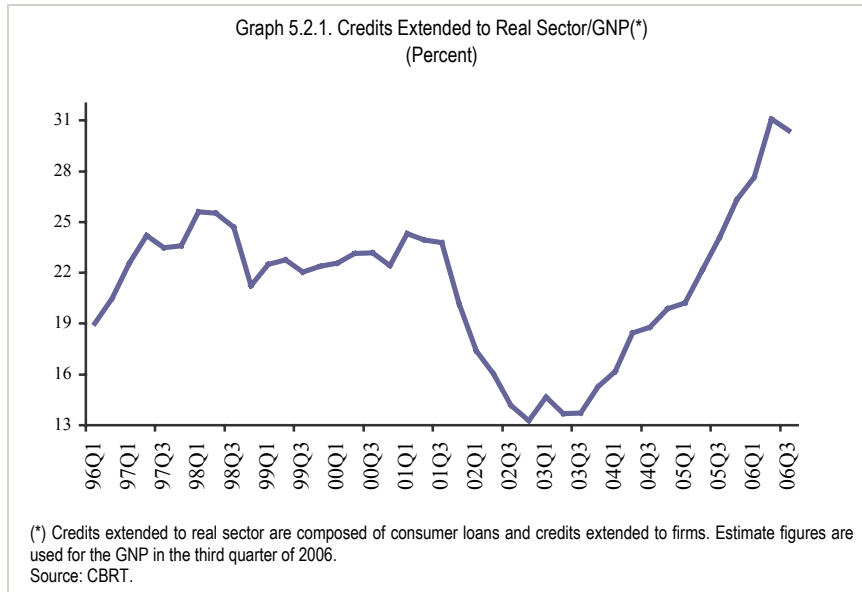
In the third quarter of 2006, YTL-denominated bonds issued by foreign banks, which constitute an indicator of foreign demand for the New Turkish lira, increased compared to the previous quarter (Graph 5.1.6). This development is considered to have been derived from seasonal effects and more favorable risk perceptions compared to the second quarter.



## 5.2. Financial Intermediation and Credits

The volatility in financial markets observed in the previous quarter, led to significant changes both in the financial system and credit developments, and caused slowdown in intermediary activities. The rapid growth phenomenon in bank credits, especially to households, significantly slowed down due to the increase in interest rates.

In the last quarter, credit aggregates continued to expand, albeit at a slower pace (Graph 5.2.1). The expansion came to a halt in some credit types. Considering the rates of increase in credits observed in previous quarters, the slowdown becomes more evident (Table 5.2.1). Especially, consumer loans that have the lead on credit expansion and that are closely related to final consumption expenditures lost momentum in the last quarter. While housing loans and credit cards increased in a limited manner, automobile loans decreased. The rise in total consumer loans mostly stemmed from the other loans, which are extended in low amounts with shorter maturity, but at higher interest rates compared to the housing and automobile loans.



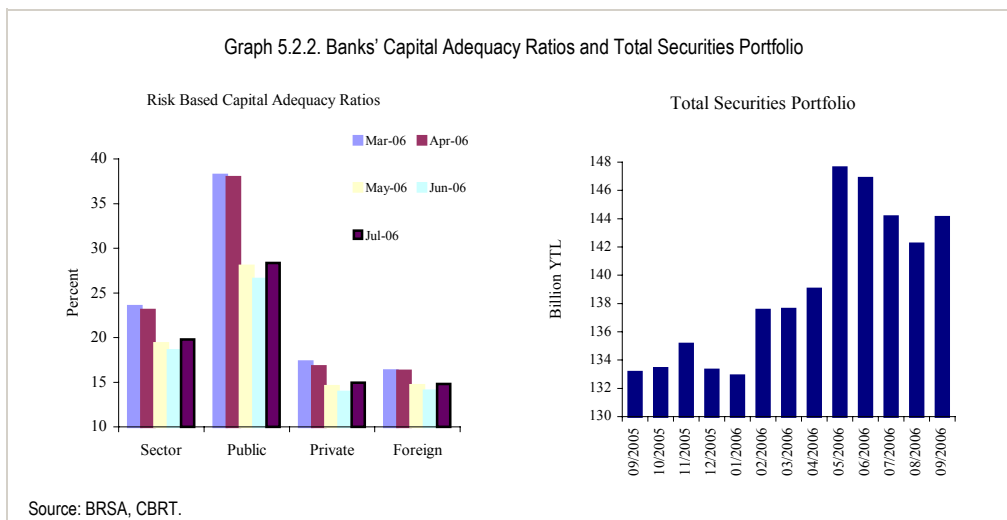
In the following process, credit developments will be determined by the credit supply, which is composed of the loanable funds of banks, on one hand, and by the credit demand, which is related to the level of interest rates and disposable income of economic agents, on the other.

Table 5.2.1. Consumer Loans and Claims from Credit Cards  
(Real Quarterly Percentage Change)

	2005Q2	2005Q3	2005Q4	2006Q1	2006Q2	2006Q3
Consumer Loans	23,4	23,3	18,6	18,7	24,3	3,2
Housing Loans	61,9	50,6	38,1	30,8	27,2	2,6
Automobile Loans	11,7	11,4	9,9	3,2	8,9	-4,8
Other Loans	11,7	11,3	5,3	13,1	28,7	7,8
Credit Cards	8,4	6,3	6,0	3,2	10,6	3,8

Source: CBRT.

Banks' credit supply is directly related to their expectations concerning the direction of the interest rate path, the amount of their liquidity, their portfolio preferences and capital structures. Especially after the fluctuations in the May-June period, banks reduced their credit facilities by rising credit interest rates. Concurrently, they increased the amount of the debt instruments in their portfolios. As a result, reserves established against the losses arising from higher interest rates, diminished banks' equities, thus leading to decline in the capital adequacy ratios of the banking system (Graph 5.2.2). Even though capital adequacy ratios improved after the fluctuations, credit supply is likely to be limited due to the facts that interest rates have not entered a downward trend yet and that liquidity is still at low levels. However, the capital adequacy ratio of the financial system is still well above 8 percent. Furthermore, the amount of the government securities that are held by banks displayed a downward trend recently, albeit in a limited manner. These developments indicate that banks have a strong capital structure that can support credit expansion in the upcoming period, as well.



In recent years, along with the financial deepening and the growth of the total credit volume, the effectiveness of credit channel in the monetary transmission mechanism is believed to improve.

Credit interest rates, which are the most important determinant of credit demand, are at higher levels compared to the first half of 2006. It is estimated that this development will continue to restrain the credit demand of individuals and firms in the upcoming period. The Central Bank will continue to closely monitor both developments in the banking sector and credits because of the information they contain with respect to total demand and the soundness of the financial system.

## 6. Public Finance

According to national income statistics issued by TURKSTAT for the first half of the year, sharp quarterly increases were observed in seasonally adjusted public sector expenditures. In the framework of budget targets for 2006, the rate of increase in public sector expenditures needs to slow down in the second half of the year. However, since figures pertaining to public sector expenditures other than the central government are issued with a significant time lag, it is impossible to make an up-to-date evaluation about developments in whole public sector. If public revenues, which are anticipated to exceed the target level, are allocated with a view to reducing the debt stock rather than directing it at new expenditures, then a permanent improvement in public finance will be achieved and the role of public finance in the disinflation process will be reinforced.

Meanwhile, the high level of the current account deficit, the expectation of a significant decline in privatization revenue in 2007 and the increase in borrowing costs induced by higher real interest rates due to the financial turbulence in May and June necessitate furtherance of the discipline in public expenditures.

Within the framework of effective public debt management strategy during January-September period, a borrowing strategy at reasonable risk levels was adopted. As a result, concerns regarding the ability to roll over debt stock in the short term and its sustainability in the medium and long term have eased to a minimum. However, the effective implementation of structural reforms primarily in the areas of social security and taxation is still crucial in assuring the permanence of achievements made in the area of tight fiscal policy and in reducing public debt stock to lower levels. The said structural reforms provide a stronger foundation for public finance. In addition, they are crucial for the furtherance of a competitive environment in the economy and thus the elimination of price rigidities occurring in some sectors.

### ***6.1. Budget Developments***

With regard to the primary budget balance, the central government budget displayed favorable performance in the January-September period of 2006. By September 2006, the primary surplus was realized above the end-year target, due to high levels of general tax revenues– primarily, the Value Added Tax (VAT) on imports and taxes on domestic goods and services – and non-tax revenues (Table 6.1.1). It should be noted that the favorable course of budgetary performance achieved during the financial turbulence in May and June has played a very important role in limiting risk perceptions.

Despite the favorable performance of the primary budget balance in the January-September period of 2006, figures pertaining to personnel expenditures, capital transfers originating from transfers to local governments, health expenditures, agricultural support and government subventions for social security institutions are very high compared to end-year projections. The appropriations allocated for green card (health) services, agricultural support and capital transfers were exceeded thresholds in the first nine months of the year. Meanwhile, the fact that green card services received a very small amount of appropriation in August and September stimulates the belief that certain payments, which needed to be made in August and September, may have been postponed to a future date.

The 2006 budget was prepared based on the projection that the ratio of transfers to social security institutions with respect to the GNP would decline. In this framework, a number of measures were taken in order to curb health expenditures and enhance premium collections.<sup>1</sup> The law on the enhancement of premium collections came into effect in March. The first impact of this implementation was that Bağ-Kur did not receive any transfers from the budget after the high levels of premium collection in the May-June period. This development has been effective in the favorable course of budgetary performance in the last four months. With the cease of premium collections in September, Bağ-Kur again started to receive transfers from the budget. The implementation of social security reform will keep transfers for social security

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<sup>1</sup> 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 the restructuring of the receivables, prevent the accumulation of new unpaid debt and enable institutions to carry out a better follow-up during the collection of their social security premium receivables.

at moderate levels in the medium term. However, the general health insurance that came into force with this reform may increase budgetary expenditures.

Table 6.1.1. Central Government Budget Aggregates (Billion YTL)

	January- September 2005	January- September 2006	Increase Rate (%)	Realizations/ Budget Target (%)	2006 Budget Target	(Share in GNP)
<b>Central Government Expenditures (A+B)</b>	<b>113.0</b>	<b>129.4</b>	<b>14.5</b>	<b>74.3</b>	<b>174.3</b>	<b>32.2</b>
A) Interest Expenditures	35.2	37.6	6.8	81.3	46.3	8.5
B) Non-Interest Budget Expenditures	77.8	91.8	18.0	71.7	128.1	23.7
1. Gov. Premiums to Personnel and Social Security Agencies	28.2	31.8	12.7	77.5	41	7.6
2. Goods and Services Procurement	7.9	11.1	40.7	62.8	17.7	3.3
a) Defense-Security	2.7	3.6	31.4	45.8	7.8	1.4
b) Health Expenditures	2.6	4.1	59.9	99.6	4.1	0.7
General Medication	0.6	0.6	-7.4	47.0	1.2	0.2
General Treatment and Health Equipment	0.8	1.1	47.8	85.9	1.3	0.2
Green Card Health Services	1.2	2.4	102.0	150.2	1.6	0.3
c) Other Goods and Services Procurement	2.6	3.4	28.9	59.4	5.7	1.1
3. Current Transfers	33.8	37.8	12.0	77.0	49.1	9.1
a) Social Security Transfers	17.7	14.2	-19.7	73.0	19.5	3.6
Pension Fund	7.1	4.4	-38.4	79.6	5.5	1.0
Bağ-Kur	4.9	2.8	-42.9	41.3	6.8	1.2
SSK	5.7	6.6	15.0	98.2	6.7	1.2
b) Agricultural Subventions	3.0	4.4	46.7	109.4	4.0	0.7
c) Transfers Made Abroad	0.3	0.5	86.8	80.7	0.6	0.1
d) Allocations from Revenue	8.4	10.2	22.5	72.2	14.2	2.6
4. Capital Outlays	5.3	6.0	13.9	48.3	12.5	2.3
5. Capital Transfers	0.8	2.0	150.8	112.1	1.8	0.3
6. Lending	1.8	3.1	65.2	71.1	4.3	0.8
7. Reserve Appropriations	0.0	0.0	-	0.0	1.7	0.3
<b>Central Government Revenues (A+B+C)</b>	<b>95.5</b>	<b>128.0</b>	<b>34.0</b>	<b>79.9</b>	<b>160.3</b>	<b>29.6</b>
A) General Budget Revenues (I+II+III+IV)	93.9	124.8	32.9	79.9	156.2	28.8
I- Tax Revenues	77.8	102.0	31.1	77.2	132.2	24.4
1. Taxes on Income and Earning	21.6	28.7	32.8	73.6	39.0	7.2
a) Income Tax	14.6	20.6	41.1	78.8	26.1	4.8
b) Corporation Tax	7.0	8.1	15.7	63.1	12.9	2.4
2. Taxes on Property	1.3	2.8	110.2	90.8	3.1	0.6
3. Domestic Taxes on Goods and Services	37.5	44.8	19.7	75.5	59.4	11.0
a) Domestic Value Added Tax	9.4	12.3	31.4	75.5	16.3	3.0
b) Special Consumption Tax	23.6	27.6	17.0	74.1	37.3	6.9
4. Taxes on International Trade and Transactions	13.8	20.3	47.6	83.7	24.3	4.5
a) Value Added Tax on Imports	12.8	18.8	47.1	83.7	22.4	4.1
II- Non-Tax Revenues	15.0	22.0	46.9	103.0	21.4	3.9
III- Capital Revenues	0.2	0.3	44.6	11.0	2.3	0.4
IV- Special Revenues and Grants and Aids	0.9	0.5	-42.1	134.9	0.4	0.1
B) Revenues from Special Budget Administrations	-	2.2	-	72.0	3.0	0.5
C) Revenues from Regulatory and Supervisory Institutions	-	1.0	-	95.2	1.1	0.2
<b>Budget Balance</b>	<b>-</b>	<b>-1.4</b>	<b>-</b>	<b>9.9</b>	<b>-14.0</b>	<b>-2.6</b>
<b>Primary Balance</b>	<b>-</b>	<b>36.2</b>	<b>-</b>	<b>112.2</b>	<b>32.3</b>	<b>5.9</b>

Source: Ministry of Finance.

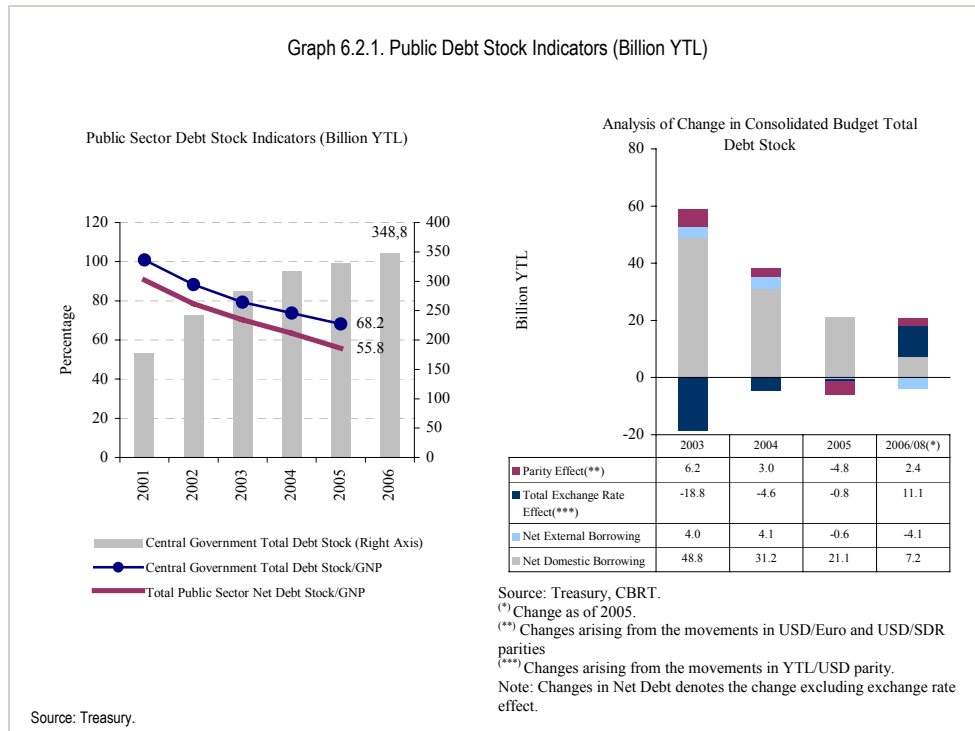
In the upcoming period, budgetary performance will be determined by tax arrangements made in the first half of the year and budgetary measures to be taken in the face of rising expenditures. On the revenues side, the factors that may cause revenue losses in the upcoming period are the lowering of tax rates in the framework of the new corporate tax system, which became operative in May, and the slowdown that might be observed in the overall economic activity in the last quarter of the year. On the expenditures side, health expenditures, agricultural support and capital transfers exceeded

budgetary targets in the first nine months. Moreover, the current level of social security and personnel expenditures increases the probability of the said expenditure items to be realized above end-year targets. Meanwhile, the fact that the inflation differential for the year 2006 and salary increases for the year 2007 reached 12.2 percent in cumulative terms stands as a development that should be carefully monitored with respect to budgetary performance and the inflation target.

Despite the afore-mentioned factors that might affect budget performance negatively, the high probability of general budget revenues, especially VAT on imports and taxes on domestic goods and services, to exceed the end-year target and budgetary measures regarding the limitation of health expenditures and the savings in certain expenditure items reinforce expectations for the attainability of the primary surplus target. Moreover, in the event that any possible deficit is covered with indirect taxes, it would be hard to achieve the single-digit inflation rate, which is important in lowering inflation expectations.

## ***6.2. Developments in Debt Stock***

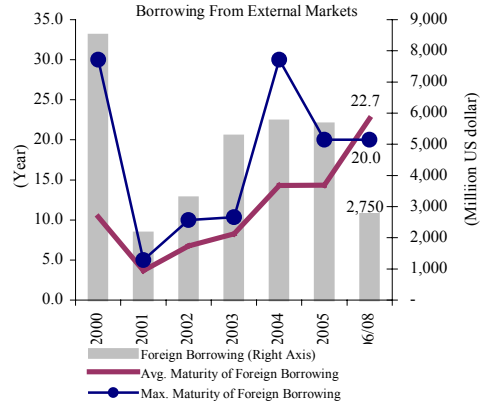
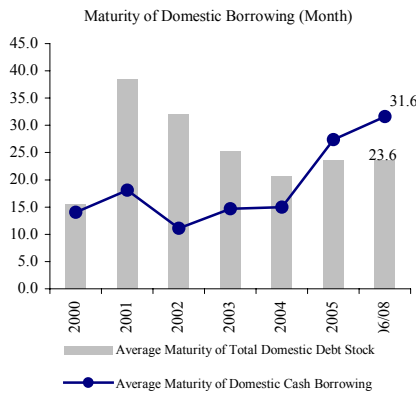
As of end-August 2006, central government debt stock, which constitutes a large share of total public debt stock, increased by 5.2 percent compared to end-2005 (Graph 6.2.1). The high primary surplus and privatization revenues has limited the growth rate of debt stock, while the depreciation of the YTL following the financial turbulence in May and June boosted it (Graph 6.2.1). However, it should be kept in mind that the said increase, which originated from exchange rates, was due to accounting and that the real cost would be seen along with debt repayments. Therefore, not the recent rise, but the level of exchange rates on the dates of the FX-denominated debt repayments, will be effective on the debt stock. As a matter of fact, central government debt stock increased in May and June due to the depreciation of the YTL. However, this increase remained limited due to the appreciation of the YTL in subsequent months. In addition, the relatively longer maturity of current FX-denominated debt stock and the large amount of FX deposits held by the Treasury keep the risks originating from volatilities in exchange rates under control in favor of the public sector.



Parallel to the financing strategy that is set in line with strategic standard setting<sup>2</sup>, the maturity of cash borrowing, which affects the maturity of debt stock, was significantly extended in the first eight months of 2006. The increase observed in the maturity of domestic borrowing was generally obtained via the issue of fixed and flexible rate coupon securities with five-year maturity. Although the borrowing maturity of discount securities remained the same following the fluctuations that started in May and continued in June, the that of long-term securities with coupon payments declined to three years from five years. However, the borrowing maturity was extended again in subsequent months, due to the resumption of the issue of fixed and flexible rate securities with five-year maturity (Graph 6.2.2).

<sup>2</sup> In strategic standard setting, the aim is to extend the maturity of domestic borrowing as much as market conditions allow, carry out domestic borrowing generally in terms of fixed income YTL-denominated securities and hold considerable amount of cash reserves in order to reduce the liquidity risk that may arise in cash and debt management.

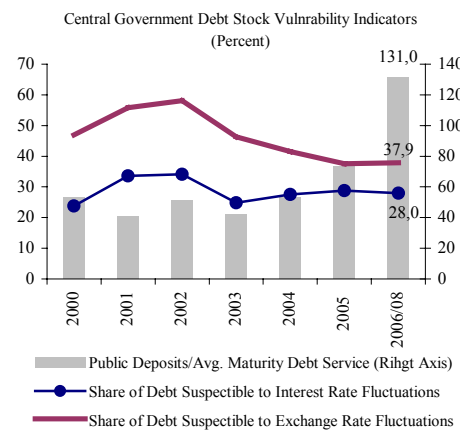
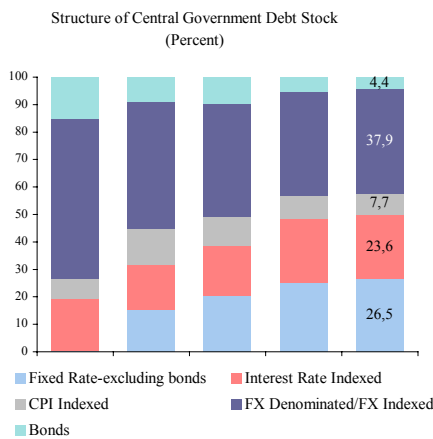
Graph 6.2.2. Maturity of the Borrowing Executed in Internal and External Markets



Source: Treasury, CBRT.

As of August 2006, the share of fixed rate long-term securities in the debt stock continued to rise. However, the shares of discount securities with a maturity of less than one year and those of CPI-indexed securities decreased in the debt stock. Moreover, due to the financing strategy applied to reduce liquidity risk, the ratio of public deposits to average monthly debt service exceeded 100 percent (Graph 6.2.3). The high primary surplus and privatization revenues played a significant role in this increase.

Graph 6.2.3. Structure of the Central Government Debt Stock



Source: Treasury, CBRT.

(1) Debt stock susceptible to interest rates, discounted securities with maturity less than 1 year and government securities with flexible interests.

(2) Debt stock susceptible to foreign exchange, external debt stock and FX and FX-indexed domestic debt stock.

In the framework of the borrowing program for 2006, the Treasury will continue to be a net payer of foreign debt, will not issue any FX-indexed securities and will limit the FX-denominated domestic debt 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-August period of 2006, FX-denominated debt stock increased due to the erosion observed in exchange rates in May.

Continuance of the decline in the debt burden requires not only financial discipline, but also an effective borrowing policy. In an environment in which borrowing costs decline while maturities are extended, it will be important to continue borrowing in terms of long-term securities with flexible rates. Meanwhile, the depreciation of the YTL and the increase in interest rates pose a risk to debt stock. However, the large amount of FX 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 inflation and output gap forecasts produced in line with these assumptions will be presented. The forecasts cover the last quarter of 2006, the whole year of 2007 and the first quarter of 2008 so as to span the average control horizon of monetary policy which is one and a half years. Furthermore, the prospective risks that could lead to a significant downward or upward deviation of inflation forecasts will be elaborated.

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

The set of assumptions that form the medium-term outlook and provide a basis for inflation and output gap forecasts are divided into two, as, assumptions *pertaining to domestic economic activity* and assumptions *pertaining to external factors*. The set of assumptions are obtained by aggregating the detailed analyses and expert opinions presented in the previous chapters of this Report. The assumptions that formed the basis for the forecasts of the July Inflation Report have been updated in light of the data released during the last three months.

In the July Inflation Report, it was anticipated that domestic demand would continue to be strong in the second quarter of the year, but that due to the fluctuations that started in mid-May, it would lose pace as of the second half of the year and growth would decelerate. The GDP data released in September point to accelerating economic activity and strong domestic demand in the second quarter of the year, thereby confirming our projections. The Central Bank retains its view that domestic demand will slow down from the second half of the year onwards. Indeed, the leading indicators of demand, which were released during the last quarter, are supportive of this view. Meanwhile, net external demand continues to increase due to the strong global growth tendency observed recently. The rapid rise in public expenditures is also a noteworthy development. Therefore, while the indicators pertaining to domestic demand point to a deceleration, the rise in net external demand emerges as a factor curbing the deceleration in total demand. However, despite the increase in net external demand, it is anticipated that the slowdown in domestic demand will be more dominant thereby leading to a lower growth rate compared to previous

periods. Accordingly, inflation forecasts are produced within a framework where the demand conditions contribute to the disinflation process.

In July Inflation Report it was pointed out that the rapid depreciation of the YTL as a result of the fluctuations in May, altered the cost conditions and therefore the contribution of the strong position of the YTL vis-à-vis foreign currencies to the disinflation process ceased to exist. In the current framework, the real exchange rates contribute more to the disinflation process compared to the previous report period. Furthermore, it is projected that the real interest rates - another component of the monetary conditions index – will curb demand as a result of the monetary tightening that started in June.

In the previous Inflation Report, it was foreseen that annual CPI inflation, which had accelerated in the second quarter, would remain at high levels in the third quarter. As a matter of fact, with the ongoing upward trend in the prices of unprocessed food products, the lagged effects of depreciation of YTL in the second quarter on prices surfaced in the third quarter. Thus, as it was foreseen, September CPI inflation realized outside the uncertainty band around the path consistent with the target. However, due to the diminishing lagged effects of the depreciation of YTL, the favorable developments observed in crude oil prices and the expectations of a more favorable course of the prices of unprocessed food products towards the end of the year, it is projected that annual CPI inflation will display a modest decline in the last quarter of the year, yet it will still fall outside the uncertainty band around the path consistent with the target.

Besides our assumptions regarding the domestic economic activity, the assumptions pertaining to external factors are also important inputs forming the basis of our medium-term inflation forecasts. This set of assumptions is comprised of data pertaining to macroeconomic variables of the Eurozone, such as interest rates, inflation and growth and the projections pertaining to the course of international commodity prices and global liquidity conditions. The projections pertaining to the Eurozone have been compiled from the September 2006 issue of the “Consensus Forecast” results. According to these projections, growth in the Eurozone will continue without accelerating; and it will take place within the 2.5 - 3 percent range by the end of 2006, and within the 1.5 - 2.0 percent range by the end of 2007 due to a gradual slowdown throughout the year. Meanwhile, the Harmonized Index of Consumer Prices (HICP) inflation

is expected to realize close to the 2 percent target. Remaining at low levels for a long time, interest rates in the Eurozone, have put an upward pressure on inflation. Therefore, the European Central Bank may gradually tighten its monetary policy in order to converge to the inflation target in the medium and long run. While producing the medium-term forecasts, the signals coming from monetary policies of not only the Eurozone but all other developed countries are assessed meticulously in order to be able to foresee the course of international liquidity conditions.

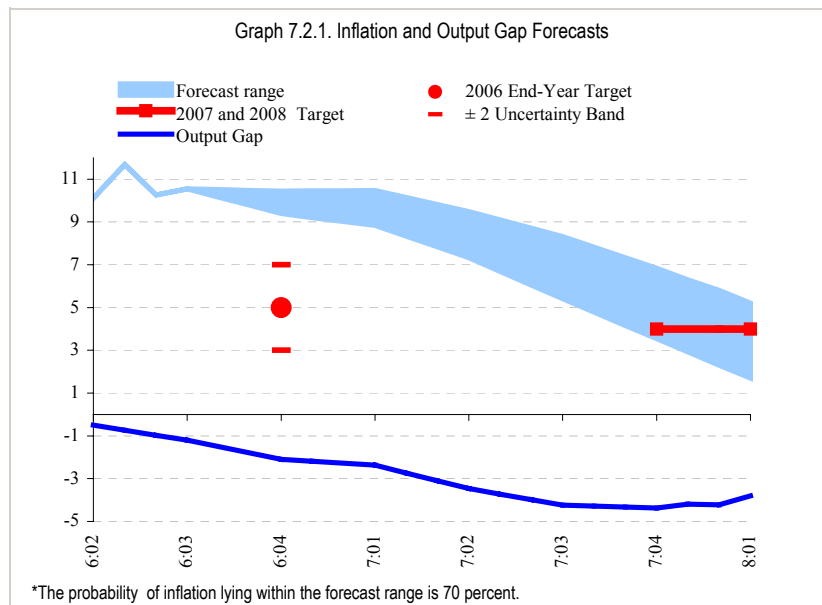
The upward pressure exerted by the recent strong global growth trend on crude oil prices is reversed as of September and crude oil prices started to exhibit a downward trend. Accordingly, our projections for international crude oil prices were revised downwards from USD 70 to USD 60. This downward trend in crude oil prices is mainly attributed to the simultaneous increase in oil production and the slowdown in crude oil consumption. Even if there seems to be several factors that can reverse this downward trend in the upcoming period, while producing the forecasts, it has been assumed that the oil prices will remain at their current levels, as it is difficult to foresee the trend in oil prices. Despite this short-term revision in the assumptions for oil prices, the fact that the lagged effects of the previously observed high level rises in oil prices will continue to affect inflation negatively, especially via increases in natural gas and electricity prices, is also taken into account.

Within the data set of the previous forecast round, it was projected that the financial turbulences in May-June period would lead to a sudden and sharp contraction in the economic activity. However, since the change in liquidity conditions lasted shorter than expected, short-term forecasts of growth have been revised upwards compared to the previous period. Meanwhile, since this development led to appreciation of the YTL and to a decline in the risk premium, it also resulted in further tightening of the monetary stance. While making forecasts, it has been assumed that there will not be a significant change in the risk premium in the upcoming period.

## 7.2. Forecasts

The Central Bank takes every possible opportunity to state that the Bank focuses on the convergence of future inflation to the target and that it takes its monetary policy decisions with a medium-term perspective. In this context, what matters for the Central Bank is not temporary fluctuations in inflation but the convergence of it to the target in the medium-term. This section of the Report presents the inflation forecasts covering the first quarter of 2008, which are produced with the mentioned medium-term perspective.

The inflation and output gap forecasts, produced in line with the assumptions and short-term projections explained in Section 7.1, are presented in Graph 7.2.1. According to these forecasts, the annual inflation rate will lie within the 9.2 - 10.6 percent range by the end of 2006 with 70 percent probability. Under a scenario in which the current tight monetary stance is maintained until the beginning of the last quarter of 2007 followed by a prudent reduction in the policy rates, it is estimated that the annual inflation rate will lie within the 1.7 - 5.2 percent range by the end of the first quarter of 2008, and thus inflation will converge to the target path in the one-and-half year horizon.<sup>1</sup> It should be borne in mind that the mentioned interest rate path reflects a policy framework based on the currently available data set and that new data could necessitate a revision of this path.



<sup>1</sup> The figure estimated for end-2007 is between 3.5 and 6.8 percent.

As a result, it is estimated that the downward trend in inflation will become more significant by the second quarter of 2007 and that inflation will converge to the medium-term targets within the one-and-half-year control horizon of the monetary policy.

As in the previous Inflation Reports, output gap forecasts that form a basis for the abovementioned inflation forecasts are also presented in Graph 7.2.1. It is forecasted that the output gap will widen further throughout 2007. In other words, demand and capacity conditions will continue to contribute to the disinflation process in the upcoming period.

### ***7.3. Risk Factors***

Prospective changes in global risk appetite and new turbulences in the financial markets that might emerge in line with these changes are still among the major risk factors regarding the inflation outlook. Recently, inflation concerns in developed countries seem to have been replaced by concerns of slowdown in economic activity. Both cases might lead to an increase in the perception of global risk and to fluctuations in emerging markets, and thus have an adverse impact on inflation. In case medium-term expectations are adversely affected, the Central Bank will not refrain from tightening the monetary policy. Meanwhile, it should be kept in mind that global cooling may lead to a more favorable inflation outlook in the medium run through a decline in the prices of oil and other commodities.

Another uncertainty regarding the inflation outlook is the risk associated with the still-high medium-term inflation expectations and backward-looking pricing behavior in services sector. Services inflation, which is currently about 12 percent, is expected to display a little bit more decline next year parallel to the expected slowdown in domestic demand. However, the ongoing backward-looking pricing behavior, lack of harmony between 2007 incomes policy and the inflation target and still-high inflation in services prices due to structural factors emerge as main risk factors. When it is considered that the support from incomes policy to disinflation process will be limited in 2007, the risk of inertia in inflation becomes more significant.

The uncertainty regarding the impact of the increases in non-interest public expenditures on 2007 inflation and other uncertainties regarding the monetary transmission mechanism are among the risk factors that could

necessitate a revision of our framework of the overall inflation outlook. The Central Bank will continue to monitor closely the effects of the recent monetary tightening on the economy. In case the abovementioned risks realize and therefore the improvement in medium-term inflation outlook comes slower than expected, the CBRT will further tighten its monetary policy.

Other than these factors, the continuation of the accession and convergence process to the European Union and the uninterrupted implementation of structural reforms regarding the economic program are still crucial for the medium and long-term outlook. The furtherance of the determined steps taken in recent years in this area will help the Turkish economy overcome the changes in the international conjuncture with the least possible turbulences.

## BOX 7.1. INFLATION TARGETING REGIME, ACCOUNTABILITY AND IMF CONDITIONALITY

Article 42 of Central Bank Law clearly defines the accountability principle. Within the framework of the accountability principle, in cases where inflation markedly deviates from the target, the CBRT is responsible for informing the government in writing, as well as explaining to the public, both the reasons for this situation and the measures to be taken. Along with the transition to inflation targeting at the beginning of 2006, the CBRT defined an uncertainty band of 2 percentage points around the point target, to allow the functioning of the accountability mechanism. Furthermore, an inflation path that is consistent with the end-2006 target was formed and was announced with the uncertainty bands at quarterly periods.

Within the framework of the program with the IMF, this path and the uncertainty bands around it form the basis of performance criteria to be used in the quarterly reviews. Accordingly, if inflation realizations fall outside the band, this means violation of program conditionality and will necessitate an announcement of the measures to be taken in the framework of program principles and consult with IMF authorities. The other performance criterion in the program carried out with the IMF is the floor for Net International Reserves (NIR), as was the case in the previous periods.

Box 7.1. Table 1 enables the co-assessment of the accountability principle and the performance criteria. The 12-month CPI inflation rates pertaining to the second and third quarters of 2006 realized as 10.12 percent and 10.55 percent, respectively and remained above the uncertainty band around the path that is consistent with the target. In this framework, the reasons for the deviation from the target in the second quarter and the time required to converge to the target was announced to the public on 14 July 2006 in an open letter to the government. The said letter was sent to the IMF authorities, as well. The letter regarding the developments in the third quarter was published on 30 October 2006. In addition, the NIR remained above the floor in both periods and the program criteria have been met.

Box 7.1. Table 1. IMF Program Conditionality and Realizations for the Second and Third Quarter:  
Inflation and NIR

	30 June 2006		29 September 2006	
	Criterion	Realization	Criterion	Realization
<i>Inflation</i>	4.5-8.5 <sup>(1)</sup>	10.12	3.8-7.8 <sup>(1)</sup>	10.55
<i>NIR</i>	19.9 <sup>(2)</sup>	31.0	20.3 <sup>(2)</sup>	31.0

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

(2) The floor, billion US dollars.



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## ABBREVIATIONS

<b>BoJ</b>	Bank of Japan
<b>BRSA</b>	Banking Regulatory and Supervisory Agency
<b>BTS</b>	Business Tendency Survey
<b>CBRT</b>	Central Bank of the Republic of Turkey
<b>CDS</b>	Credit Default Swap
<b>CPI</b>	Consumer Prices Index
<b>CSRA</b>	Credit Suisse Risk Appetite Index
<b>DC</b>	Developing Countries
<b>ECB</b>	European Central Bank
<b>EMBI</b>	Emerging Markets Bonds Index
<b>EU</b>	European Union
<b>Fed</b>	Federal Reserve Bank of America
<b>FOMC</b>	Federal Open Markets Committee
<b>GDBS</b>	Government Domestic Borrowing Securities
<b>GDP</b>	Gross Domestic Product
<b>GNP</b>	Gross National Product
<b>HICP</b>	Harmonized Index of Consumer Prices
<b>IFS</b>	International Financial Statistics
<b>IMF</b>	International Monetary Fund
<b>ISE</b>	Istanbul Stock Exchange
<b>LME</b>	London Metal Exchange
<b>MPC</b>	Monetary Policy Committee
<b>MSCI</b>	Morgan Stanley Capital Index
<b>NIR</b>	Net International Reserves
<b>OPEC</b>	Organization of the Petroleum Exporting Countries
<b>PPI</b>	Producer Prices Index
<b>SCA</b>	Special CPI Aggregates
<b>SPO</b>	State Planning Organization
<b>SSI</b>	Social Security Institution
<b>TIM</b>	Turkish Exporters Assembly
<b>TURKSTAT</b>	Turkish Statistical Institution
<b>USA</b>	United States of America
<b>VAT</b>	Value Added Tax
<b>WGMA</b>	White Goods Manufacturers Association
<b>WPI</b>	Wholesale Prices Index
<b>YTL</b>	New Turkish Lira