

SECTION I MACROECONOMIC DEVELOPMENTS

I.1.Introduction

The primary goal of central banks is to achieve and sustain price stability. To be complementary to this primary goal, central banks should take measures to ensure financial stability by monitoring the financial markets in cooperation and coordination with other related authorities. Within this framework, macroeconomic developments have the utmost importance for monitoring and analyzing financial stability.

In this section, developments in public finance, households, the corporate sector and the external sector, which are the main fundamentals of financial stability, and the interaction among these sectors, will be analyzed.

I.2.Public Finance

In the analysis of interaction between public finance and other sectors, the main factor is the structure of the public budget and public debt.

Table I.2.1.
Central Government Budget Performance

Billion YTL	January- October 2005	January- October 2006	Change (%)	Realization / Budget Target (%)	2006 Budget Target
Expenditures	116.0	144.3	24.4	82.8	174.3
Non-Interest Expenditures	77.2	103.5	34.1	80.8	128.1
Revenues	106.6	140.6	31.9	87.7	160.3
The coverage ratio of revenues to expenditures (%)	91.9	97.4	-	-	92

Source: Ministry of Finance

As of October 2006, the primary surplus reached 88 percent of the year-end-target, due to tax revenues—primarily, the Value Added Tax (VAT) on imports and taxes on domestic goods and services—and non-tax revenues.

During the January – October 2006 period, although some expenditure items had already exceeded the year-end budget target, the coverage ratio of revenues to expenditures increased by 5.5 points, to 97.4 percent compared to the same period of the previous year (Table I.2.1).

Table I.2.2.
Consolidated Government Sector Primary Surplus Targets and Realizations

(Billion YTL)	2004	2005	Mar.06	Jun.06
Primary Surplus Target (Including SEEs)	26.2	30.5	7.6	17.3
Primary Surplus Realization (Including SEEs)	27.8	28.3	10.6	25.0
Realization / Target (%)	106	93	140	145

Source: Treasury

In 2006, since revenues have grown faster than expenditures, the primary surplus was realized well above the year-end target. These developments have strengthened the expectations regarding the achievement of the 2006-year-end target (Table I.2.2).

Table I.2.3.
Public Sector Borrowing Requirement / GNP

(%)	2003	2004	2005	2006 ¹	2007 ²
Public Sector Borrowing Requirement / GNP	9.3	4.7	-0.4	-3.1	0.2

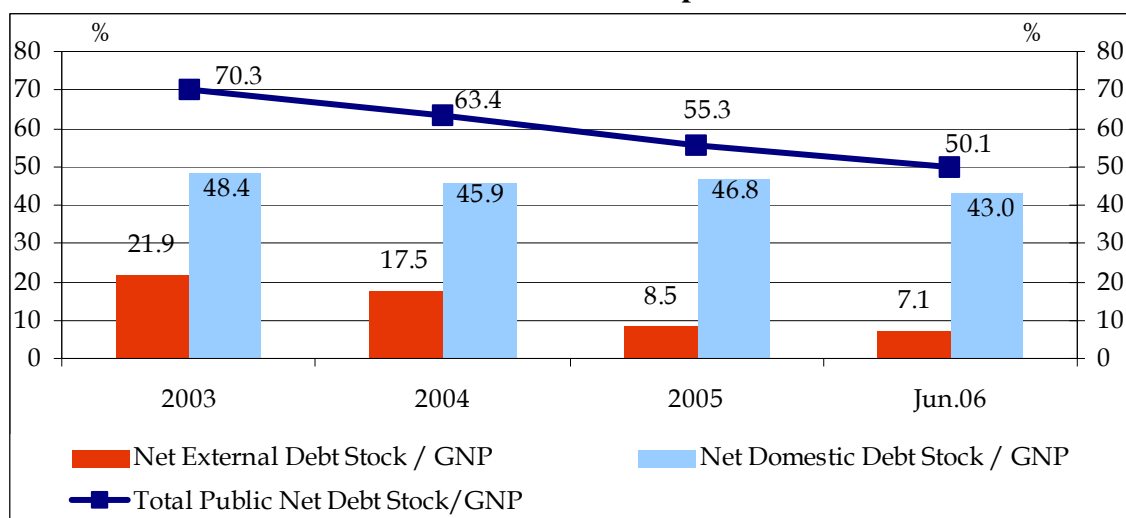
Source: 2007 Program

¹ Provisional

² Program

In relation to positive developments in public finance, the public sector balance calculated according to the definition by the State Planning Organization (SPO) was in surplus in 2005. In the 2007 program, although the expectation regarding the 2006 public sector balance indicates a surplus, the estimation for the public sector balance in 2007 reveals a deficit (Table I.2.3).

Chart I.2.1
Total Public Sector Net Debt Stock and Its Decomposition¹



Source: Treasury

¹ Public sector net debt stock is calculated by subtracting central bank net assets, public deposits and unemployment insurance fund net assets from public gross debt stock.

The total public sector net debt stock to GNP ratio decreased by 5.2 points compared to 2005 and was realized as 50.1 percent as of June 2006. As a result of the increase in central bank net assets, public deposits and unemployment insurance fund net assets, the decline in net public debt stock to GNP ratio has continued (Chart I.2.1).

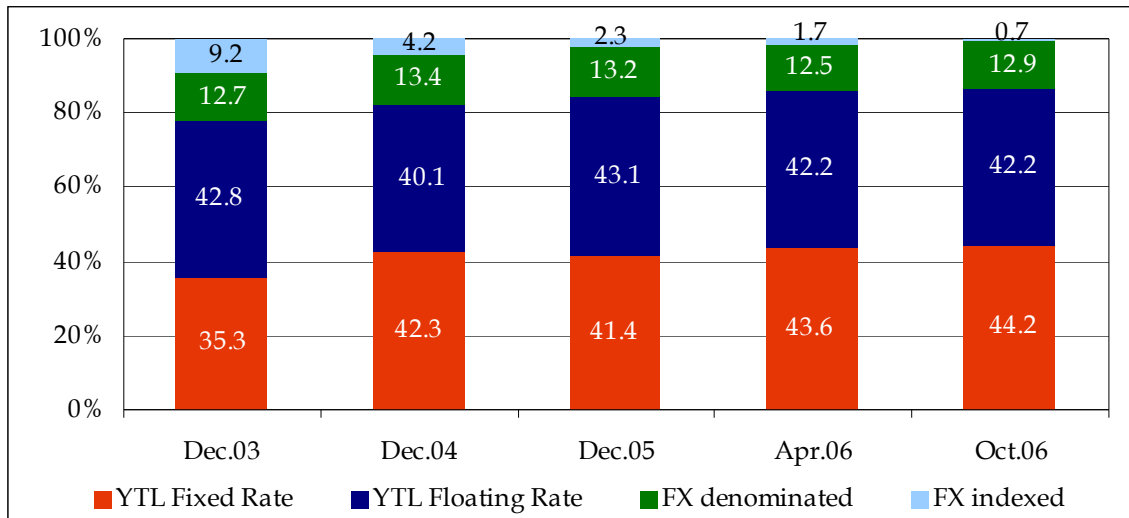
Box I.2.1 Eurobond Swap Transaction

As of September 6, 2006, the Treasury initiated a swap transaction of US dollar denominated Eurobonds issued in international markets with the maturity dated between 2006 and 2010 with the new issuance of a US dollar denominated Eurobond with a maturity of 2016, and a swap transaction of 1.5 billion USD was realized. This swap transaction through which bonds with an average maturity of 2-years were exchanged for bonds with an average maturity of 10-years, was the first effective debt management action regarding bonds issued in international markets, and the average maturity was extended by eight years.

Despite pressure on economic activities due to fluctuations experienced in the May-June 2006 period, the realization of the Eurobond swap transaction with a maturity of 2016, whose return was 7.12 percent to investors, indicates that the impact of these negative developments on the Treasury's borrowing cost has been kept to a minimum level.

Source: Treasury

Chart I.2.2
Composition of Domestic Debt Stock

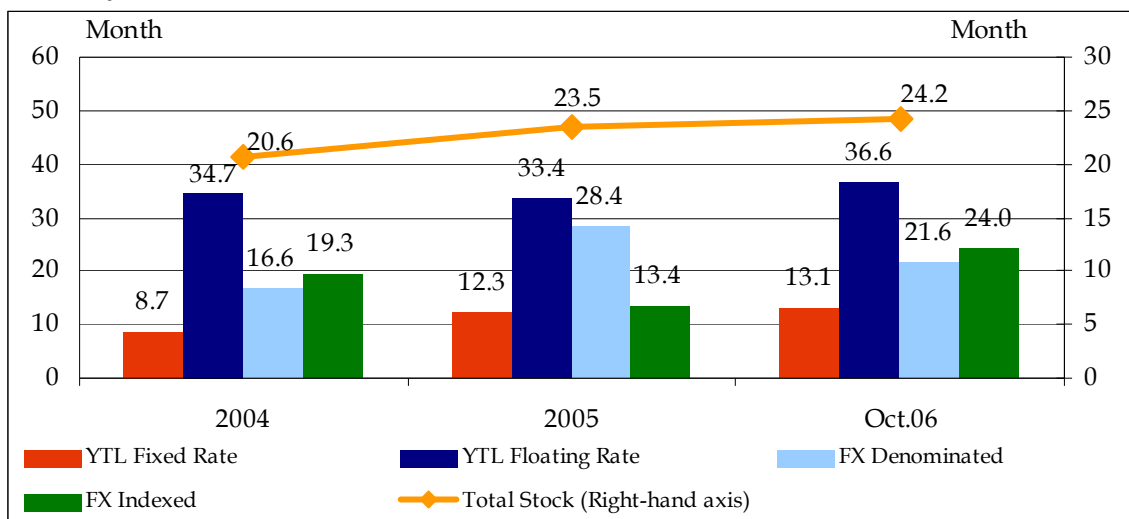


Source: Treasury

As a result of the redemption of the majority of the FX-indexed instruments, which were issued on June 2001 by the Treasury with the goal of exchanging the Turkish Lira denominated debt stock instruments, the share of FX-indexed instruments in the total domestic debt stock declined to a very low level. On the other hand, the share of FX-denominated instruments in the total domestic debt stock has not changed considerably since 2004 (Chart I.2.2).

The downward trend in the share of YTL floating rate and FX-indexed government bonds in the composition of debt stock reveals that the Treasury's sensitivity to interest rate risk and exchange rate risk declined as of October 2006, compared to the end of 2005.

Chart I.2.3
Maturity Structure of Government Debt Securities (Month)¹

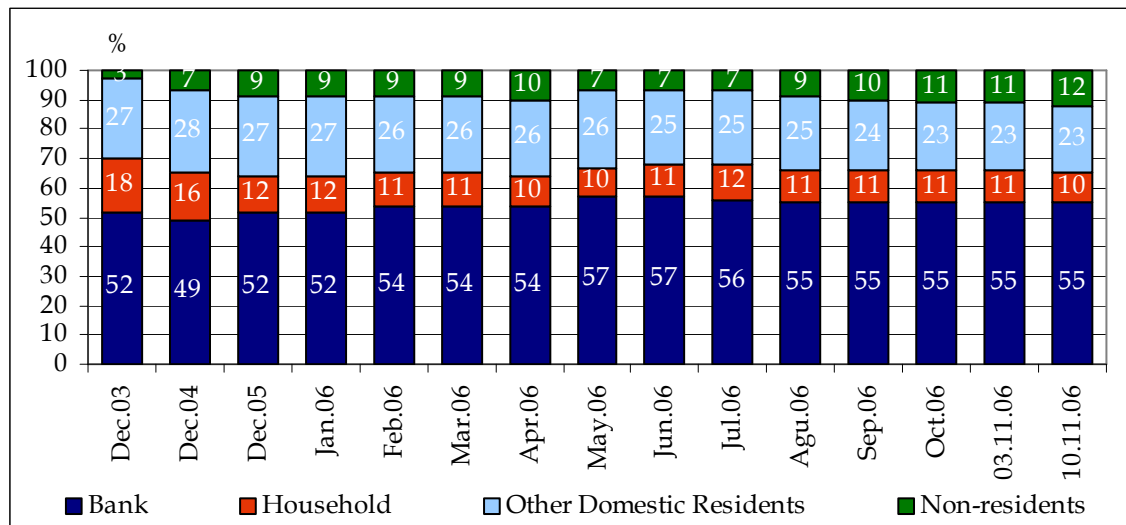


Source: Treasury

¹ Calculation is based on term to maturity.

The average maturity of total government securities stock increased to approximately two years, as of October 2006. The average maturity of YTL-denominated floating rate instruments, which has the highest share in total domestic debt stock, increased, while the maturity structure of YTL denominated fixed income government securities maintained a steady trend. On the other hand, the average maturity of FX-denominated government securities declined (Chart I.2.3). The extension of the average maturity of government securities has facilitated the Treasury's domestic debt service.

Chart I.2.4
The Distribution of Government Debt Securities by Holders^{1,2,3}



Source: BRSA-CBRT

¹ Based on nominal amounts.

² "Bank" includes government domestic debt securities owned by banks operating in Turkey; "Household" contains real persons' government domestic debt securities preserved at domestic banks; "Other domestic residents" covers government domestic debt securities of domestic residents except banks and households preserved at banks and mutual funds' government domestic debt securities preserved at domestic banks; "Non-residents" involves nonresident real and legal persons' government domestic debt securities held at domestic banks.

³ Government domestic debt securities owned by the Central Bank are excluded.

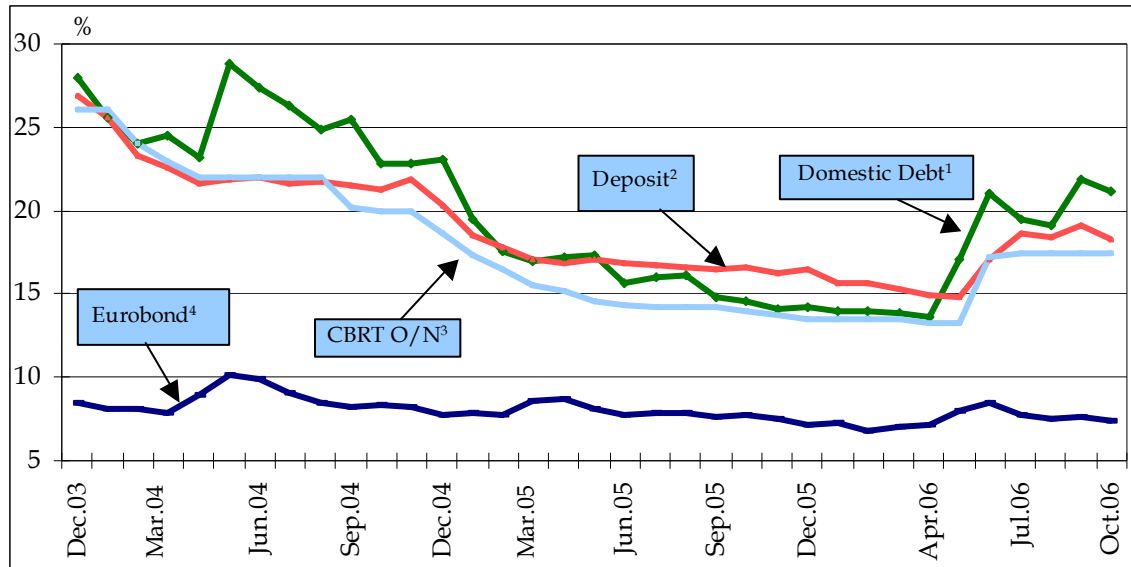
Most of the government domestic debt securities are owned by the banks operating in Turkey and these securities constitute an important part of the balance sheet of the banking sector. After the fluctuations experienced in domestic and international markets in May 2006, the share of the households' portfolio in government domestic debt securities decreased slightly, while the share of other domestic residents' portfolio declined. The share of nonresidents' portfolio declined in the May-June period and then followed an upward trend with the "0" withholding tax rate on certain capital market instruments and reached 12.4 percent as of November 10, 2006 (Chart I.2.4).

Box I.2.2 The Amendment in the Income Tax Law Related to Withholding Tax

To prevent double taxation affecting foreign investors' demand unfavourably, the Income Tax Law No:5527 Section 1/a was amended. The amendment regarding withholding tax rates became effective from July 7, 2006.

Within this context, the withholding tax rate for the revenues generated from the difference between the purchase and sale prices of securities and other capital market instruments, for the revenues generated from the difference between the purchase and redemption prices of securities and other capital market instruments, the revenues generated from the difference between periodical returns and revenues from repo transaction of securities and other capital market instruments, which had been implemented as 15 percent since January 1, 2006, has been rearranged as 0 percent for a foreign-based taxpayer and the withholding tax rate for the fully-fledged taxpayer was reduced to 10 percent, effective as of July 23, 2006, according to the decision of the Council of Ministers, No: 2006/10731.

Chart I.2.5
Interest Rates



Source: ISE, CBRT, Bloomberg

¹ The compound interest rate of the government debt security, which has the highest turnover in the secondary bond market.

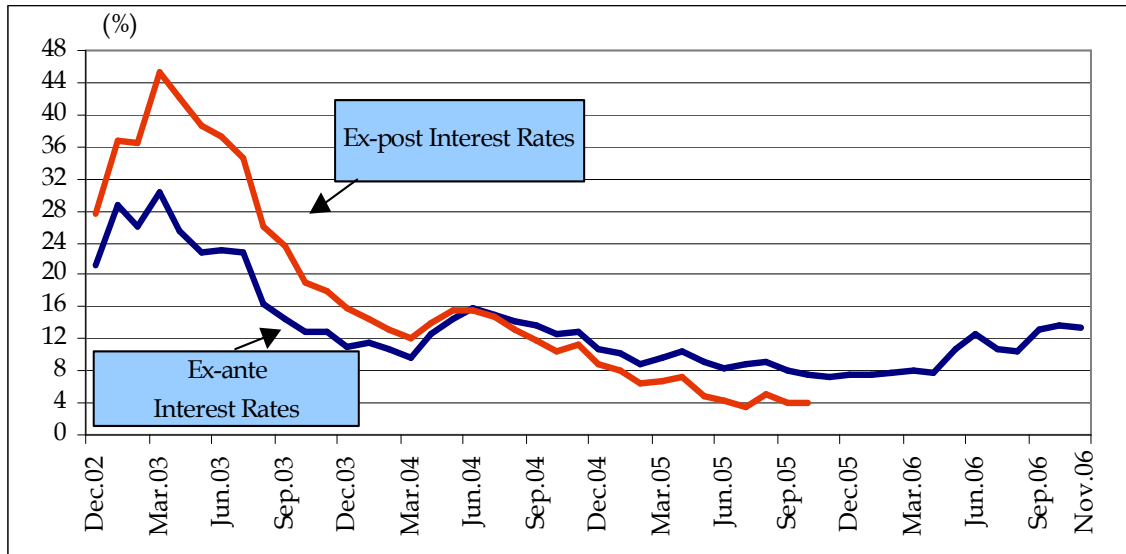
² Banking sector 3-month weighted "flow YTL deposit" interest rate.

³ CBRT overnight (O/N) borrowing rate.

⁴ Interest rate of US-dollar denominated Eurobond with the maturity date 2030 is taken as a basis.

Interest rates went up due to the fluctuations experienced in May-June 2006 period (Chart I.2.5). It is expected that the persistence of the high level of interest rates of government securities in the second half of the year will affect the Treasury's borrowing cost unfavourably and will generate an additional burden on public finance.

Chart I.2.6
Exante¹ and Expost² Real Interest Rates of Government Domestic Debt Securities



Source: Calculated by using the data of CBRT, ISE and TURKSTAT.

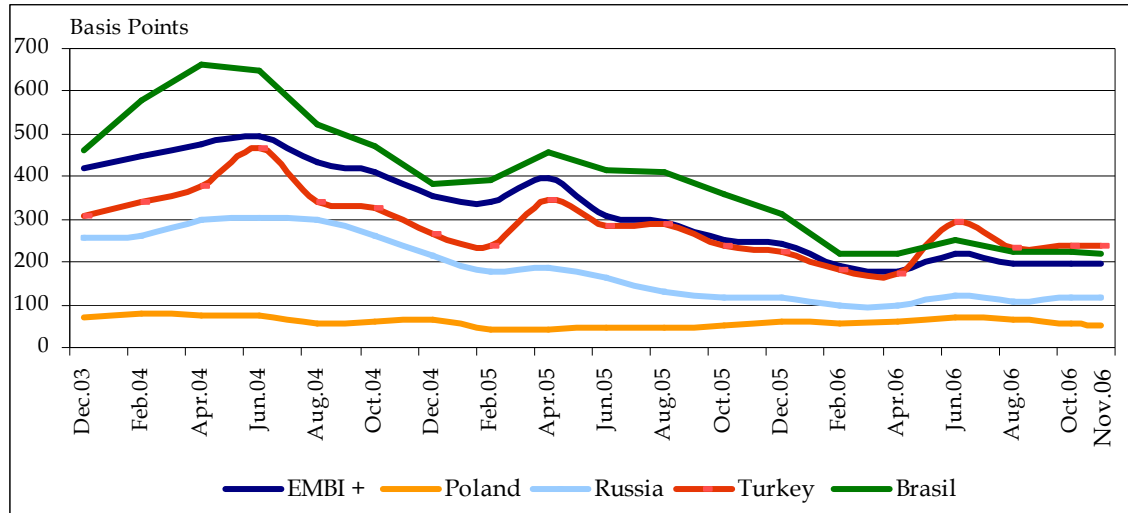
¹ Ex-ante interest rate= $\frac{(1 + \text{nominal interest rate})}{(1 + \text{expected inflation rate})} - 1$ * 100

² Ex-post interest rate= $\frac{(1 + \text{last year's nominal interest rate})}{(1 + \text{realized inflation rate})} - 1$ * 100

As expected inflation rate, yearly ex-ante CPI figures in the bi-weekly Survey of Expectations published by the CBRT are used.

In the second quarter of 2006, the contraction in global liquidity, the downward trend in the risk appetite of foreign investors for developing countries and upward trend in inflation deteriorated the expectations of market participants and the ex-ante real interest rates increased to 12.6 percent as of June 2006. As a response to these developments, the Central Bank of Turkey (CBRT) tightened monetary policy to show its commitment to the inflation target. Besides this policy response, the preservation of the primary surplus target and the return of funds, which had gone out of developing countries, led to a decline in the ex-ante real interest rate to 10.3 percent as of August 2006. However, the ex-ante real interest rate started to increase again, reaching 13.4 percent as of November 2006 due to the continuation of uncertainty in the global economy (Chart I.2.6).

Chart I.2.7
Country Risk Premiums in Selected Developing Countries^{1,2}



Source: Bloomberg

¹ Country risk premium is the difference between the relevant country's EMBI+ index and the returns of US Treasury instruments.

² EMBI+ index includes Eurobonds, Brady bonds and traded loans of the 18 developing countries. The weight of each country in the index is different. For instance; Brazil's weight is 23.2, Mexico's weight is 18.8, Russia's weight is 17.3 and Turkey's weight is 9.4 in the EMBI+ index. Also, the EMBI+ index is calculated for each country.

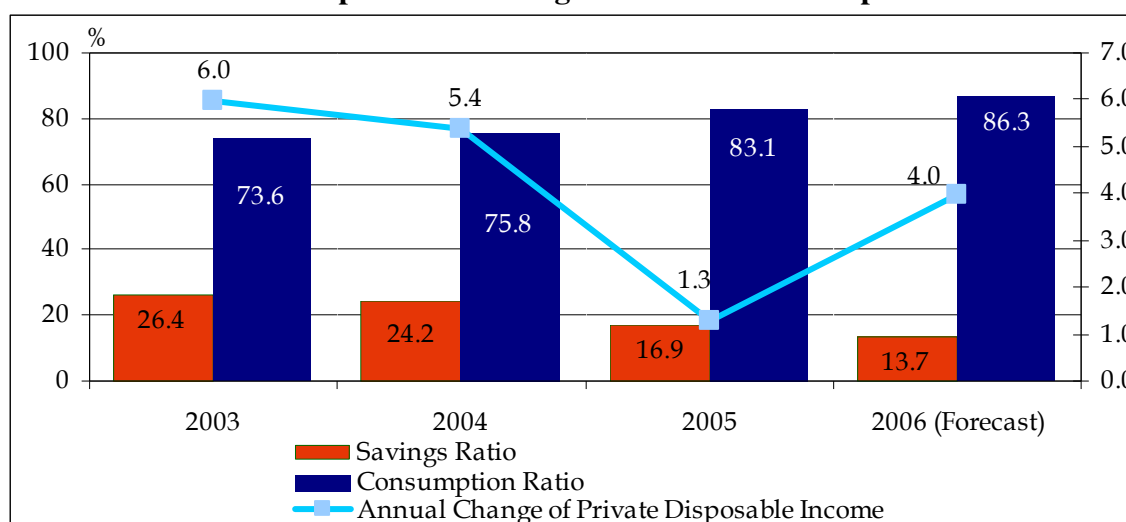
As of April 2006, Turkey's country risk was realized as 171 basis points, the lowest level during the period. Following the fluctuations that started in May 2006, the country risk level climbed to 294 basis points in June 2006, then declined to 238 basis points by November, parallel to the improvement of expectations (Chart I.2.7).

The possibility of a change in the global liquidity conditions and the uncertainty related to the elections could create adverse effects on public finance. On the other hand, a strong commitment to the budget targets indicated by appropriate policies and the extension of the maturity structure of the Treasury's domestic debt stock improved the expectations of public finance.

I.3. Households

In harmony with the favorable economic developments in Turkey in recent years, it is observed that there is rapid growth in private consumption expenditures, which also include household expenditures. The continued growth of consumption expenditures in the second quarter despite the May-June fluctuations shows that in spite of the fact that the propensity to consume slows down, it relatively keeps its dynamism in relative terms.

Chart I.3.1
Private Sector's Consumption and Savings Ratios and Real Disposable Income^{1,2,3}



Source: SPO

¹ Private sector's disposable income is converted to real terms by the GNP deflator of the relevant year.

² Savings Ratio = Total Private Savings / Total Disposable Income.

³ Consumption Ratio = Total Private Consumption / Total Disposable Income.

The share of private consumption expenditures, which also include household expenditures, in disposable income has been increasing since 2003. Disposable income increased by 1.3 percent and consumption increased by 11 percent in real terms in 2005. According to the 2007 Programme, the aforementioned growth rate of private disposable income is 4 percent, and a growth rate of 7.6 percent in private consumption expenditures. Accordingly, it is estimated that the savings ratio, which has displayed a decreasing trend for years, will decrease to 13.7 percent at the end of 2006 (Chart I.3.1).

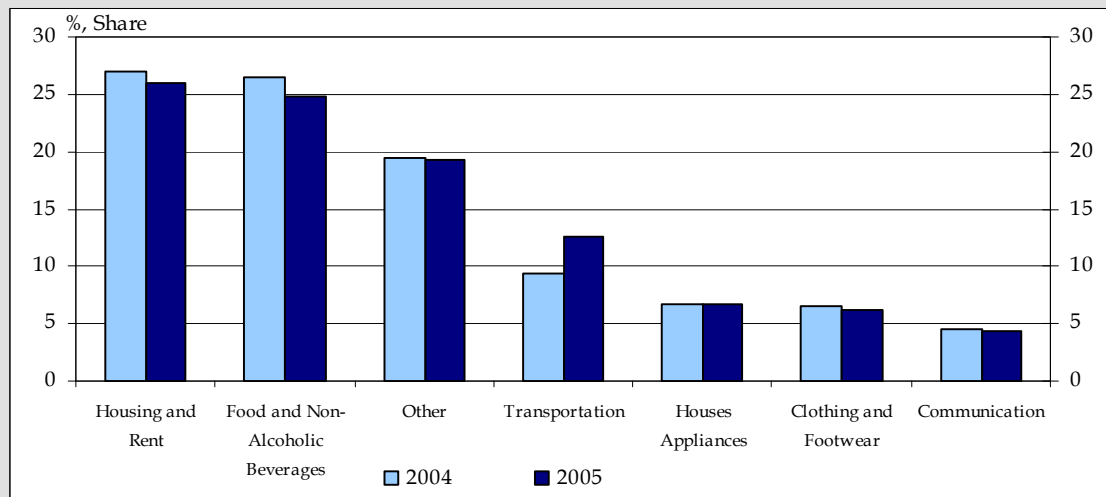
Table I.3.1.
Private Consumption Expenditures

(Yearly Change, %)	2001	2002	2003	2004	2005	January -June 2006
Private Consumption Expenditures	-9.2	2.1	6.6	10.1	8.8	9.4
Durable Goods	-30.4	2.1	24.0	29.7	15.0	14.6
Services	-9.3	8.5	7.5	9.3	7.8	5.6
Food and Beverages	-3.6	1.1	4.1	2.8	8.2	6.8
Semi-Durable and Non-Durable Goods	-9.0	3.0	2.1	18.8	12.9	16.8

Source: TURKSTAT

As of June 2006, although the growth rate of food and services expenditures slowed down, the rapid growth of semi-durable and non-durable goods and durable goods in consumption expenditures continues (Table I.3.1). On the other hand, it is expected that the unfavorable effects of financial fluctuations of May and June, which ended up in increased exchange and interest rates, will cause a decrease in the domestic demand for goods and services which are financed by retail loans, particularly for durable consumption goods.

Box I.3.1. Distribution of Household Expenditures (2005)



Source: TURKSTAT, 2005 Household Budget Survey

Household expenditures include the monthly purchases of households, consumption from its own production, consumption from stocks, earnings in kind and consumption by way of transfers and the monthly average of consumption expenditures for durable consumption goods purchased in the last year.

In 2005, the share of expenditures for housing and rent (except for housing purchase investments) in total expenditures were realized as 26 percent, while expenditures for food and non-alcoholic beverages were 24.9 percent. In 2005, there was not a significant change in the distribution of household expenditures with respect to 2004, but the increase in the share of transportation expenditures in total expenditures from 9.5 percent to 12.6 percent has resulted mostly from new vehicle purchases and is also a reflection of the considerable increase in oil prices on household's transportation expenditures. The decrease in the share of food and non-alcoholic beverages from 26.4 percent to 24.9 percent resulted from the relatively limited levels of price increases of these products in 2005. In 2005, the share of expenditures for housing and rent, which had the biggest share in total expenditures, decreased by 1 point.

Table I.3.2**Household Disposable Income, Indebtedness and Interest Payments^{1,2,3}**

(Billion YTL)	2003	2004	2005	June 06	Sept. 06
Household Interest Payments	3,851	6,982	9,747	10,794	11,071
Household Debt	13,442	28,259	48,760	65,386	67,592
Household Disposable Income	180,305	218,752	233,368	264,500	264,500
Interest Payments / Disposable Income (%)	2.1	3.2	4.2	4.1	4.2
Debt / Disposable Income (%)	7.5	12.9	20.9	24.7	25.6

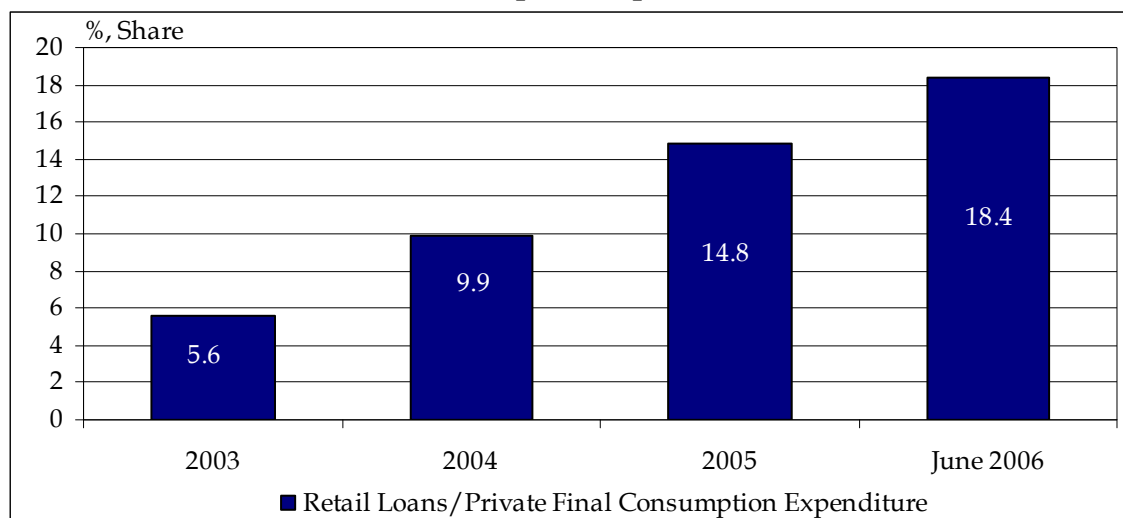
Source: BRSA-CBRT, TURKSTAT

¹ June and September 2006 household interest payments are calculated on a yearly base.

² Household debt consists of gross consumer credits and credit card balances extended by banks and consumer finance companies.

³ Household disposable income for 2005 and 2006 is calculated by using, private sector disposable income for 2005 and private sector disposable income estimation for 2006, under the assumption that the 2004 ratio of household disposable income to private sector disposable income has not changed.

Although the ratio of household liability to disposable income increased rapidly until June 2006, after that period the growth rate decreased. Interest payments to disposable income kept its 2005 level as of September 2006, despite the increase in household liabilities (Table I.3.2). It is thought that this is due to the fixed nature of the interest rates on consumer credits, which also continued to decrease until May 2006, and the decreased growth of retail loans after this month.

Chart I.3.2**Retail Loans to Private Final Consumption Expenditures^{1,2}**

Source: CBRT-TURKSTAT

¹ Retail loans are composed of gross consumer credits and credit card balances extended by banks and consumer finance companies to real persons.

² Private final consumption expenditures are calculated on a yearly base.

Private consumption expenditures financed by retail loans increased to 18.4 percent at the end of the first half of 2006 from 14.8 percent in 2005 (Chart I.3.2). It is observed that financing private consumption expenditures with retail loans slowed down after the upsurge in interest rates in May and June 2006 (Chart III.1.1.1.8). It is expected that this trend will result in the retail loans to private final consumption expenditures ratio remaining steady.

Table I.3.3
Number of Non-Performing Consumer Loans and Credit Card Holders¹

	2002	2003	2004	2005	Sept.2006
Non-Performing Credit Card Holders	32,911	30,845	49,611	159,808	182,076
Non-Performing Consumer Loans	5,627	4,157	9,863	16,767	21,660

Source: CBRT

¹ It indicates the number of credit card and consumer credit debtors in the NPL accounts of banks. According to the implementation initiated by the Bank effective from 2000, the records whose "paid notice" is sent by banks are erased from the Registry of non-performing loans after three calendar years and those whose "paid notice" is not sent are removed after five calendar years. Therefore the number of records for previous periods may vary due to removal of three or five year old records.

The upsurge in household indebtedness is also reflected in the number of non-performing consumer loans and credit card holders. The number of credit card holders who did not pay their credit card debt was 159,808 at the end of 2005; increasing to 182,076 in the nine month period of 2006, while the number of non-performing consumer loans increased from 16,767 to 21,660 in the same period (Table I.3.3).

Table I.3.4
Composition of Household Financial Assets¹

(Billion YTL)	2003	2004	2005	Apr. 2006	May 2006	June 2006	July 2006	Aug. 2006	Sept. 2006
YTL Deposits	45.9	63.5	90.4	102.2	106.5	108.7	107.6	107.5	111.0
FX Deposits	55.4	61.3	59.8	59.1	65.6	67.8	66.8	68.3	71.0
FX Deposits (Billion USD)	39.4	45.3	44.5	44.8	43.1	42.0	44.6	46.6	47.4
Currency in Circulation Domestic	10.1	12.4	18.3	20.2	21.6	21.7	21.8	22.4	22.0
Debt+Eurobond	35.3	39.1	32.6	29.4	28.9	32.1	33.3	32.9	31.9
Stocks	8.0	12.3	15.7	16.9	15.9	14.7	14.7	15.2	15.2
Repos	2.8	1.6	1.5	2.2	2.3	2.4	2.8	2.3	2.0
Private Pension Funds	0.0	0.3	1.2	1.7	1.8	1.9	2.0	2.2	2.4
Total Assets	157.6	190.5	219.5	231.7	242.5	249.2	249.0	250.8	255.4

Source: CBRT, SPO

¹ YTL and FX deposits include participation funds.

Household financial assets increased by 16.4 percent as of September 2006, compared to the end of 2005, and reached 255 billion New Turkish Liras. As of September 2006, 71.2 and 12.5 percent of household financial assets are composed of deposits and government debt securities and Eurobond respectively (Table I.3.4).

As of September 2006, an increase is realized in both YTL and FX deposits with respect to the end of 2005. Thus, as of 2006, YTL savings deposits reached 111 billion New Turkish Liras with a 22.7 percent increase, and FX deposits reached 71 billion New Turkish Liras with a 19 percent increase with respect to the end of 2005. In USD terms, FX deposits stood at 44.5 billion USD at the end of 2005, reaching 44.7 billion USD as of April 2006. In this period, the limited increase in FX deposits mostly resulted from the stability of exchange rates and the credible YTL.

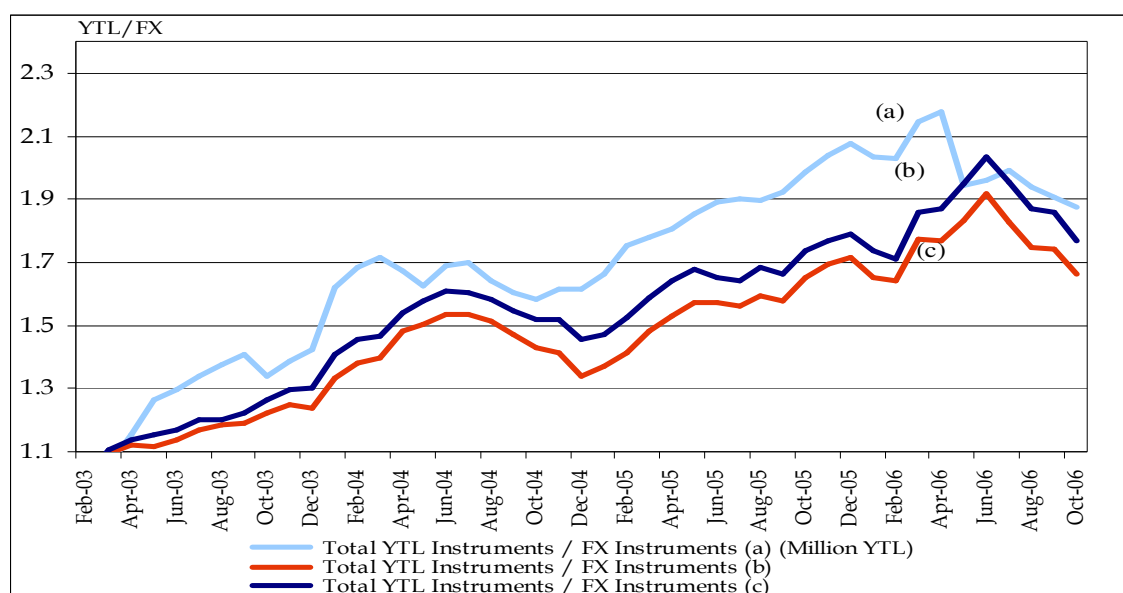
As of June 2006, FX deposits decreased to 42 billion USD with a 6.1 percent decrease with respect to April 2006. This decrease was due to the shift of households from FX deposits to YTL deposits due to the depreciation of YTL. The increase in FX

deposits in YTL terms, despite the decrease of FX deposits in USD terms, resulted mainly from exchange rate movements in May-June 2006.

Despite the decrease in FX rates since July, households slightly increased their FX deposits partly because of seasonal effects and to some extent because of the change in their risk perception.

Although it has a small share in total assets of households, pension funds have presented a considerable increase. The total amount of pension funds, which was 1.2 billion New Turkish Liras at the end of 2005, reached 2.36 billion New Turkish Liras with nearly a hundred percent increase as of September 2006. This trend will create a positive impact on the economy in the long run.

Chart I.3.3
Ratio of YTL-FX Denominated Investment Instruments¹



Source: CBRT

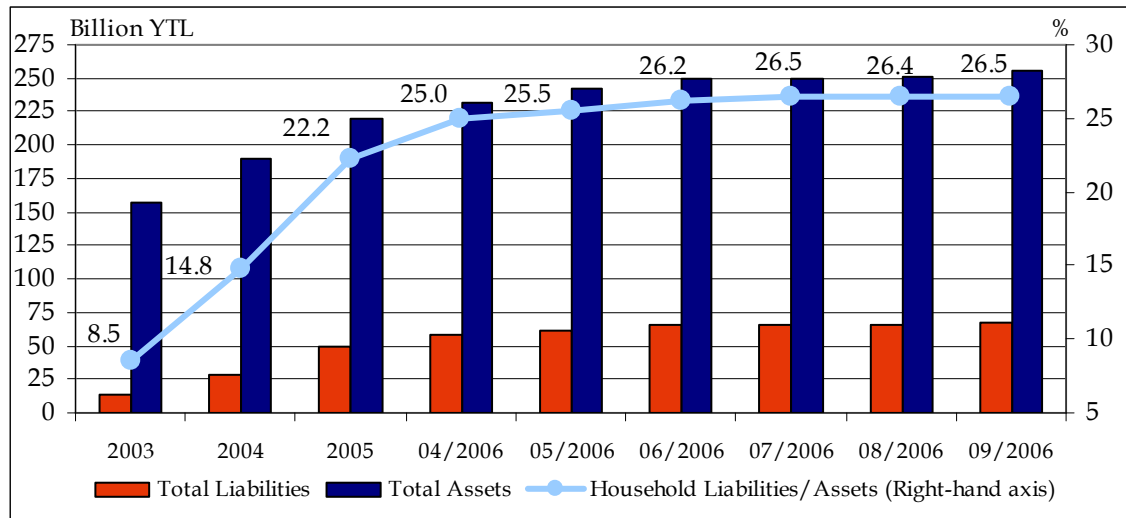
¹ YTL Instruments = Deposits + Repos + Gov. Dom. Debt Sec. (real person) + Participation Funds (YTL);

FX Instruments = FX Deposits + Gov. Dom. Debt Sec. (real person) + Eurobond (real person) + Participation Funds (FX), (a) current YTL value of FX deposits, (b) for FX deposits, exchange rate prevailing on 31.12.2002 is used and the parity effect is eliminated.

The volume of total domestic currency denominated instruments became twice that of foreign currency denominated instruments calculated by the prevailing exchange rates at end-2005. In May 2006, along with the depreciation in the New Turkish Lira, the mentioned ratio was realized as 1.94 and in October it stood at 1.87 (Chart I.3.3).

Strengthening of domestic currency from 2002 to mid 2006, except for some periods, caused households holding foreign exchange denominated savings to face serious income losses in comparison to other investment tools. Thus, it is worth mentioning that upward and downward movements of exchange rate are equally likely under the floating exchange rate system, and investment preferences should be determined bearing this point in mind.

Chart I.3.4
Household Financial Assets and Liabilities¹



Source: CBRT, SPK

¹ Household Assets= Savings Deposit+FX Deposit+Money in Circulation+ Gov. Dom. Debt Sec. + Eurobond + Repos +Stocks +Pension Funds

² Household liabilities consist of gross consumer credits and credit card balances extended by banks and consumer finance companies.

The ratio of household liabilities to financial assets has increased rapidly in recent years due to the increase in retail loans. This ratio, which was 22.2 percent at end-2005, rose to 26.2 percent as of June 2006 and remained steady after July (Chart I.3.4).

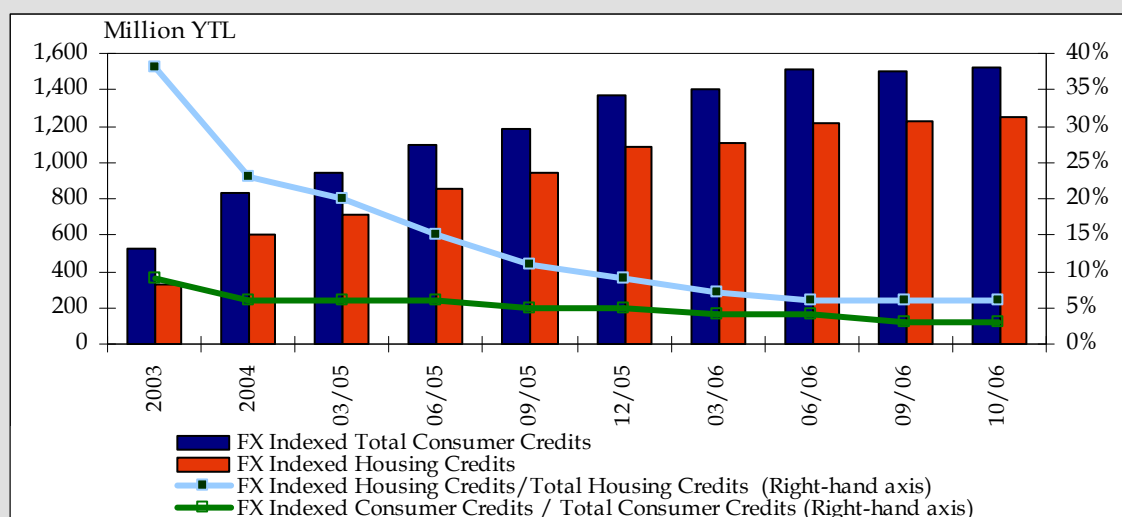
Table I.3.5
Household Liabilities in Selected Countries

	Household Liabilities/GDP (%)		Household Liabilities excluding Housing Loans/GDP (%)	
	2004	2005	2004	2005
Lithuania	8	13	2	4
Slovakia	10	13	3	4
Czech Republic	12	15	4	5
Estonia	21	30	4	5
Hungary	15	17	6	7
Latvia	17	27	5	8
Malta	40	43	10	9
Poland	14	15	10	10
Slovenia	12	16	10	11
Italy	25	28	12	12
Greece	31	36	11	12
Portugal	64	68	14	14
Spain	58	69	18	19
Eurozone	49	52	16	16
EU-25	57	61	17	17
Turkey	6	10	6	7

Source: ECB, CBRT

At the end of 2005, the household liabilities to GDP ratio was 10 percent in Turkey and 52 percent in the Eurozone. The household liabilities excluding housing loans to GDP ratio was 7 percent in Turkey and 16 percent in the Eurozone. Accordingly, despite the rapid increase of household liabilities in Turkey, the household liabilities to GDP ratio is still well below the Eurozone average (Table I.3.5).

Box I.3.2. FX Indexed Gross Consumer Credits and Housing Credits



Source: CBRT

FX borrowings of households, who do not have FX income, may increase the household debt burden because of possible increases in exchange rates under the floating exchange rate system.

While FX indexed gross consumer loans stood at 1,369 million New Turkish Liras at the end of 2005, it reached 1,519 million New Turkish Liras with an 11 percent increase as of October 2006 and 1,249 million New Turkish Liras of this consisted of FX indexed housing credits.

The share of FX indexed consumer loans in total consumer credits, which was 4.8 percent at the end of 2005, decreased to 3.5 percent as of October 2006. The share of FX indexed housing credits in total housing credits, which has the largest share in FX indexed consumer loans, decreased from 8.8 percent to 5.9 percent during this period.

Due to the Consumer Protection Law, which prohibits changing interest rates until maturity, consumers were not affected by increases in interest rates; however, this increase limited the households' use of new credits.

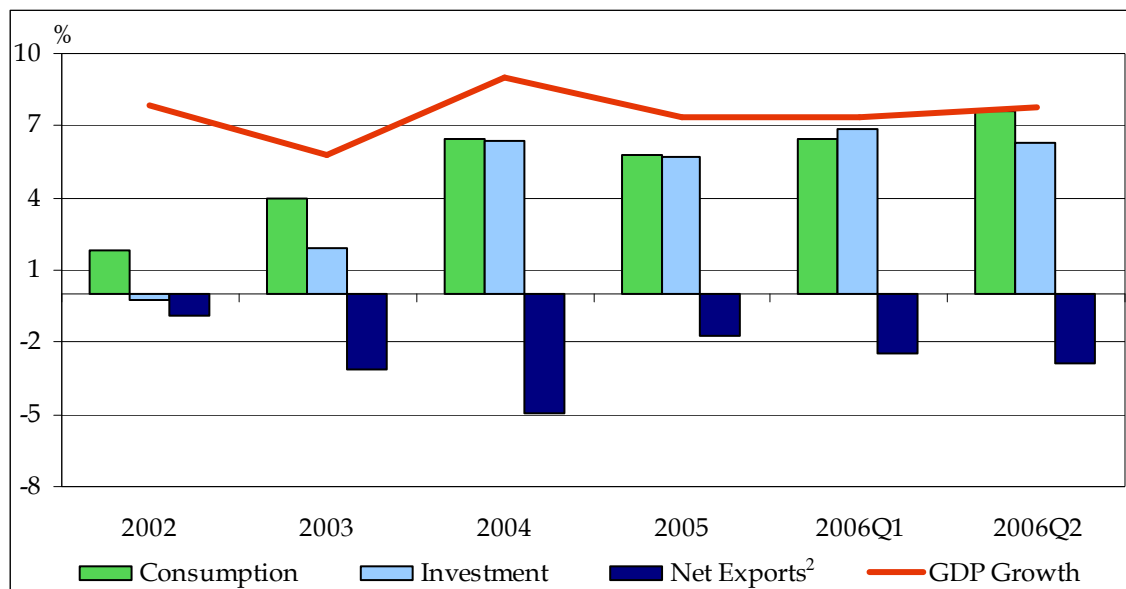
In conclusion, exchange and interest rate increases occurred as a result of financial fluctuations in the May-June period, provided households with the chance to reprice their financial assets, which are mostly short term. While households are unfavorably affected by exchange rate increases because of FX indexed loans, loans most of which are YTL denominated with fixed interest rates, limited this effect.

I.4. Corporate Sector

I.4.1. General Structure

In the first half of 2006, GDP growth exceeded expectations and the economy continued to grow for the last 18 quarters. Nonetheless, it is thought that the negative impact of the fluctuations that took place in the May-June period might be observed much more clearly on durable goods demand, which is relatively more sensitive to interest rate and foreign exchange rate changes, in the second half of the year, but increased exports might lessen the ongoing slow down related to domestic demand.

Chart I.4.1.1
Growth Rate and Its Composition ^{1,2}



Source: TURKSTAT

¹ The figures for the first two quarters of 2006 are annualized data.

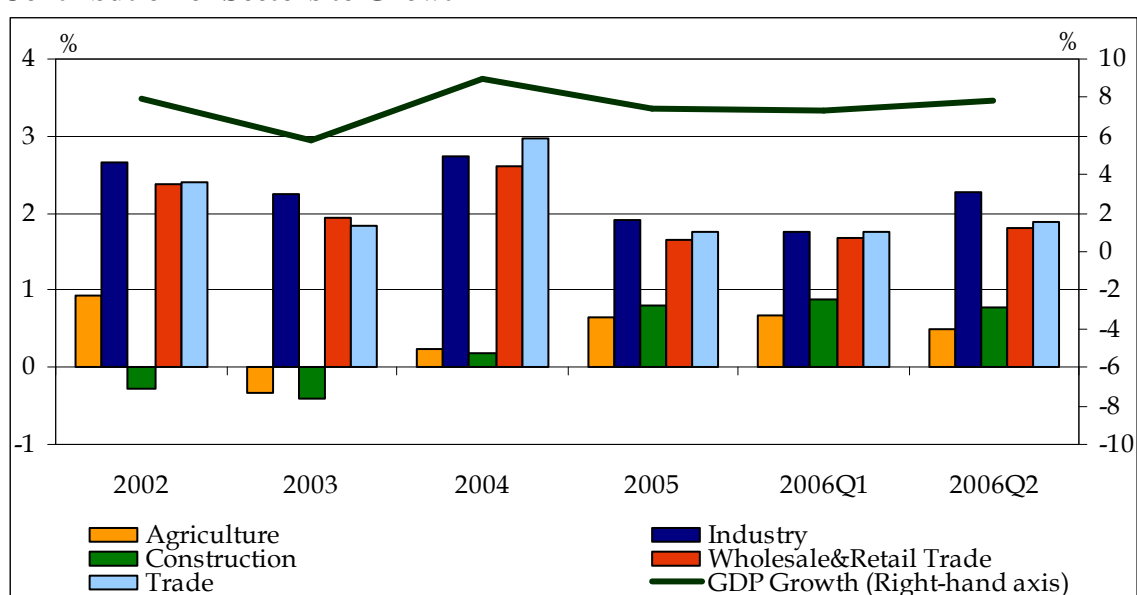
² Net Exports= Exports -Imports

The annual GDP growth rate realized as 7.8 percent, as of June 2006. Considering the demand side of this growth by components, it is remarkable that the consumption expenditures' annual growth rate increased during the second quarter of 2006 compared to 2005, whereas the annual growth rate of investment expenditures has decreased (Chart I.4.1.1).

Private consumption expenditures, the largest component of GDP according to the expenditure approach, were not influenced by the fluctuations in the first half of 2006 and it was the most significant determinant concerning the high realization of the growth rate. On the other hand, it is noteworthy that public consumption expenditures, which increased by 2.4 percent in real terms in 2005, grew by 13.5 percent for the first half of 2006 compared to the same period of the previous year.

When the composition of investment expenditures, the other component of GDP according to the expenditure approach, is analyzed, it is obvious that the soaring growth of the first quarter took a plunge in the second quarter due to fluctuations. Consequently, the growth rate of private sector investment expenditures, which was 30.4 percent in the first quarter of 2006 compared to the same period of the previous year, declined to 14.8 percent in the second quarter of the year. However, public sector investment expenditures, which increased by 34.5 in the first quarter of 2006 compared to the same period of the previous year, decreased by 11.3 percent in the second quarter. After the fluctuations, it is expected that in the second half of the year investments will increase at a lower rate than in 2005 due to adverse financial conditions.

Chart I.4.1.2
Contribution of Sectors to Growth¹



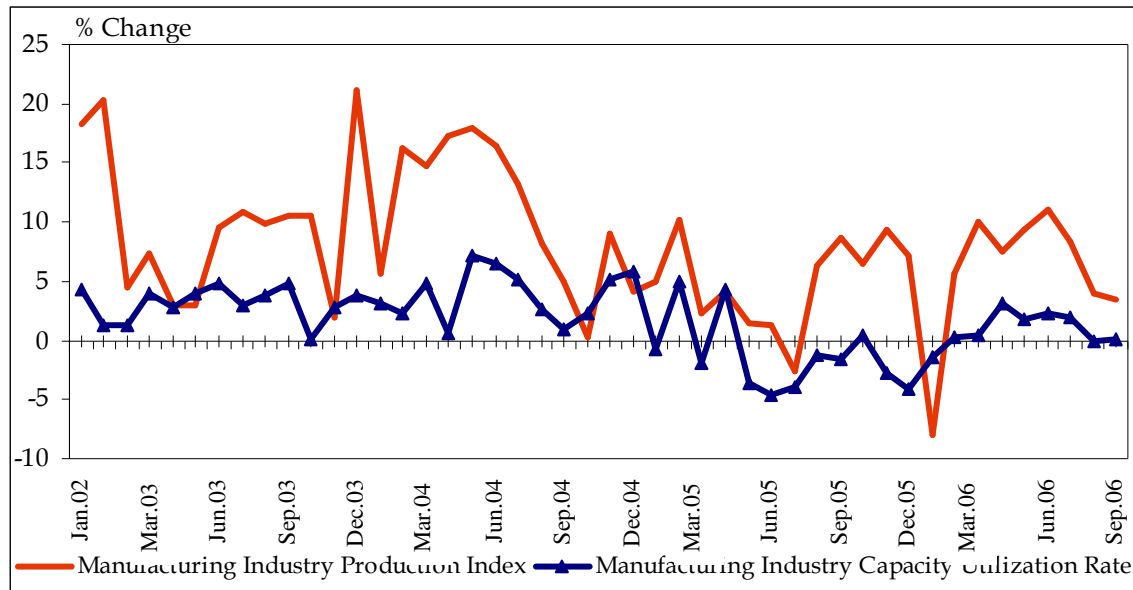
Source: TURKSTAT

¹ The figures for the first two quarters of 2006 are annual data.

When the composition of GDP is analyzed according to the production approach, it is seen that the major contribution to GDP growth came from the industry and trade sectors in the first half of 2006 (Chart I.4.1.2). Although the construction sector, which has grown by 19.3 percent in the first half of 2006 compared to the same period of the previous year, has continued to be the driving force of growth, as in 2005, there was a decline in its growth rate related with the last turbulence.

In spite of its low contribution in the first quarter of 2006, particularly due to its unfavorable performance in January, the industry sector, with its 10.5 percent growth rate in the second quarter, was the other important factor besides the construction sector that drove growth in the economy during the first half of the year. The low contribution of the agriculture sector went down even further in the second quarter of the year.

Chart I.4.1.3
Manufacturing Industry Production and Capacity Utilization Rate^{1,2}



Source: TURKSTAT

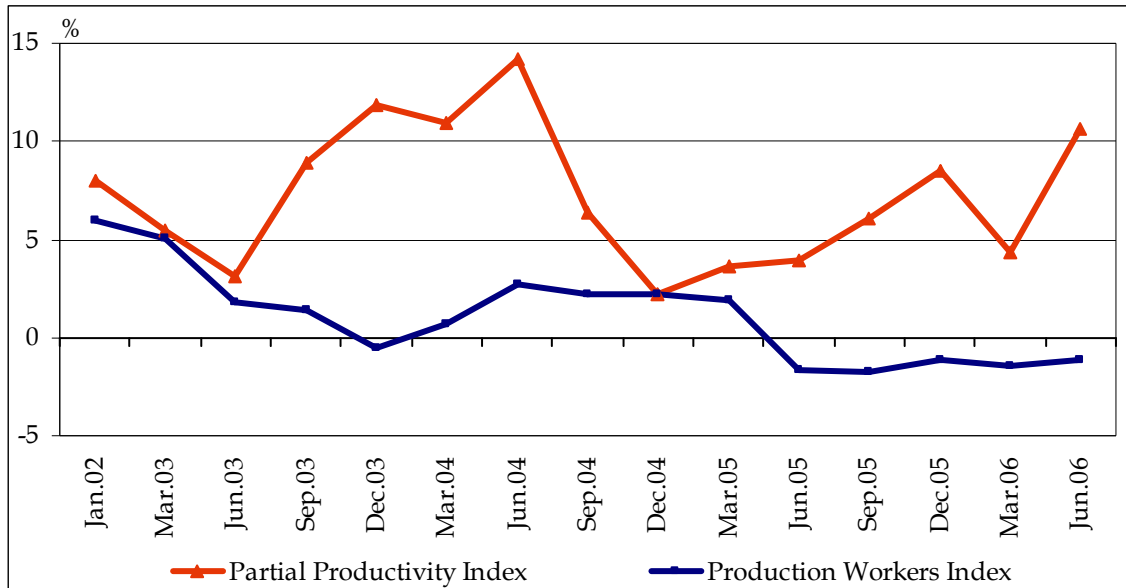
¹ Percentage change compared to the same month of the previous year.

² Monthly industrial production index 1997=100

In the beginning of 2006, the manufacturing industry production diminished compared to the same period of the previous year, whereas it rose in the following months of the year (Chart I.4.1.3). Thus, the average growth rate in the manufacturing industry production rose by 2 points to 5.9 percent for the first nine months, compared to the same period of the previous year. However, following the fluctuations in the financial markets during the May-June period, annual change in the manufacturing industry production and the manufacturing industry capacity utilization rate has started to fall since August.

While manufacturing industry production increased by 3.5 percent in September of 2006 compared to the same month of the previous year, it is thought that the reduction after June in the production of the non-metallic mineral sector, which provides intermediate goods to the construction sector, indicates a deceleration of the growth in the construction sector. Additionally, related to investment demand, the production of machinery and equipment and electric-machinery devices sectors have been shrinking, compared to June.

Chart I.4.1.4
Number of Workers and Partial Productivity per Worker for the Manufacturing Industry^{1,2}



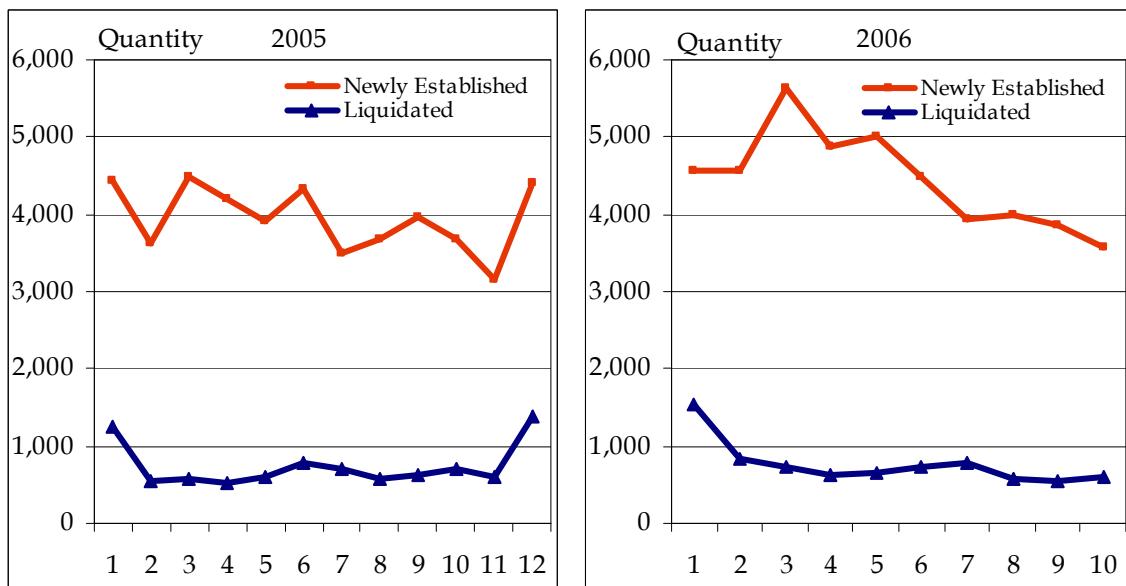
Source: TURKSTAT

¹ Percentage change compared to the same month of the previous year.

² 1997=100 index is used.

When the partial productivity per worker for the manufacturing industry and number of workers are analyzed, it is recognized that partial productivity rose by 10.6 and employment in the manufacturing sector decreased by 1.1 percent in the first half of 2006 compared to the same period of the previous year (Chart I.4.1.4).

Chart I.4.1.5
Number of Newly Established and Liquidated Companies and Cooperatives



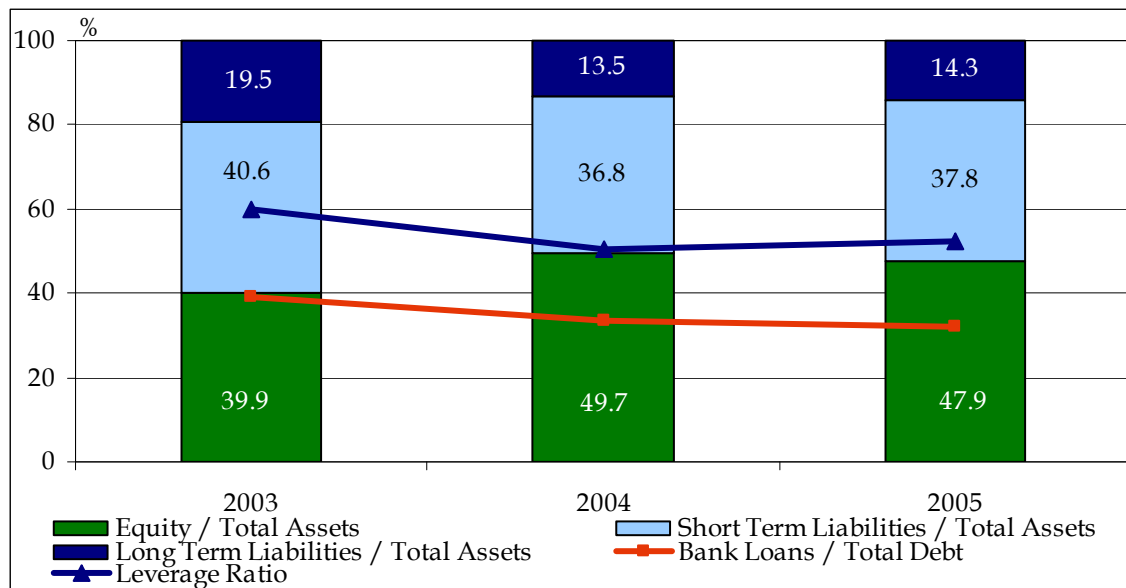
Source: TURKSTAT

The number of newly established firms, which was 39,834 for the first ten months of 2005, increased to 44,486 in the same period of 2006. The number of liquidated firms was 6,894 and 7,655, respectively (Chart I.4.1.5). The majority of newly established and liquidated firms are in the wholesale and retail trade, manufacturing industry, construction, real estate, renting and business activities, transport, storage and communication sectors.

I.4.2. Financial Analysis of Companies

The financial analysis of companies was based on balance sheets and income statements of 7,086 private sector companies contained in the Sector Balance Sheet Statistics published by the Central Bank. Since 2004 financial statements are prepared in accordance with inflation accounting principles, this fact should be taken into consideration while comparing 2004 inflation-adjusted figures with previous years' figures.

Chart I.4.2.1
Selected Financial Ratios



Source: CBRT

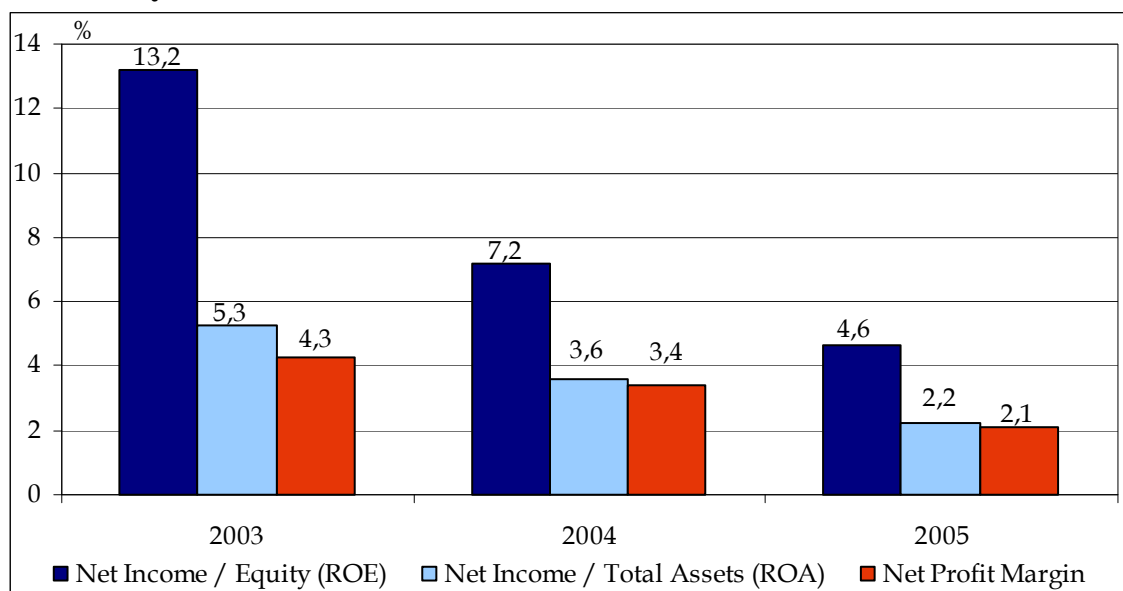
47.9 percent of assets were funded by own funds as of end-2005 (Chart I.4.2.1). Equity to the total assets ratio fell down in 2005 compared to 2004 since the rise in total assets was higher than the rise in equity. The rise in own funds financing ratios of the corporate sector, which have been very high for the last two years, is regarded as a positive development since it decreases the risk premium for firms and increases the firms' repayment capacity to the banking sector.

Nevertheless, the financial leverage ratio, the ratio of total liabilities to total assets, increased to 52.1 percent in 2005 (Chart I.4.2.1). This rise is attributable to the

fact that the increase in total liabilities, resulting from growth of both short-term bank loans and total trade debts, was proportionally larger than the increase in total assets.

The big jump in total trade debts in 2005 has caused bank loans over liabilities ratio to decline to 32.3 percent (Chart I.4.2.1).

Chart I.4.2.2
Profitability Ratios¹

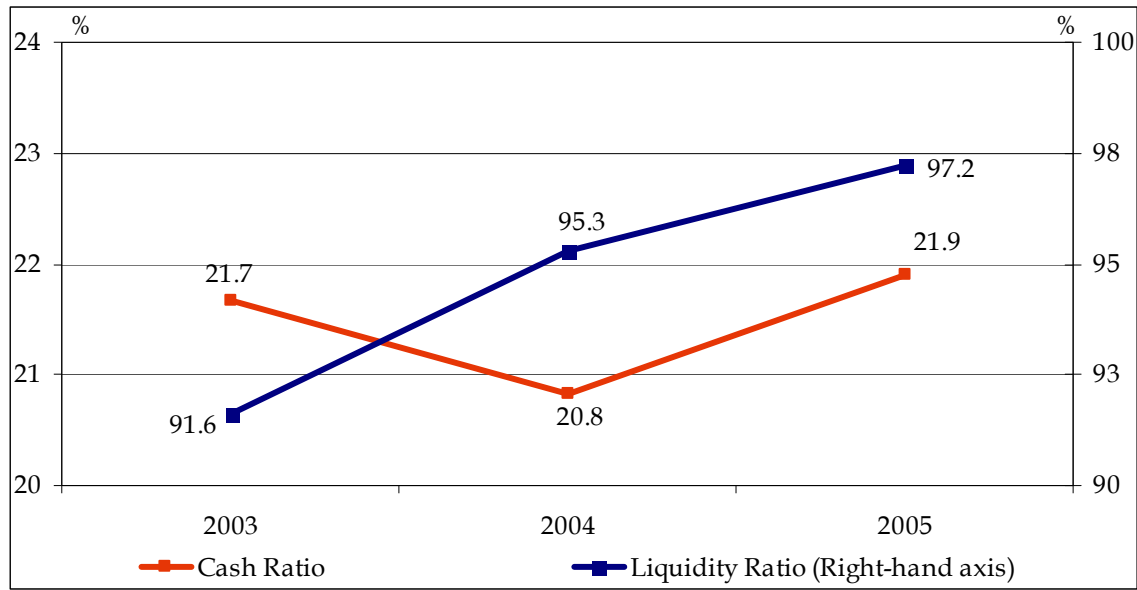


¹ Net Profit Margin = Net Profit (Loss) / Net Sales

Both net profit for the financial year and operating income of the private sector dropped in 2005. The fall in operating income resulted from the increase in cost of goods sold in spite of the increase in net sales. Albeit the growth in net sales, the reduction in corporate sector's profit can be attributable to the fact that firms could not reflect increasing costs into the prices due to the intensified competition. The reason for the fall in net profit for the financial year is the shrinkage of income from other operations in spite of the decrease in financing expenses and the increase in extraordinary expenses and losses.

In this framework, when the indicators related to profit performance were analyzed, there was a decrease in all selected profitability ratios compared to 2004 (Chart I.4.2.2). The profitability ratios for the first six months of 2006 were still in a downward trend based on the analysis of the consolidated financial statements of 88 firms listed on the ISE.

Chart I.4.2.3
Liquidity Ratios^{1, 2}



Source: CBRT

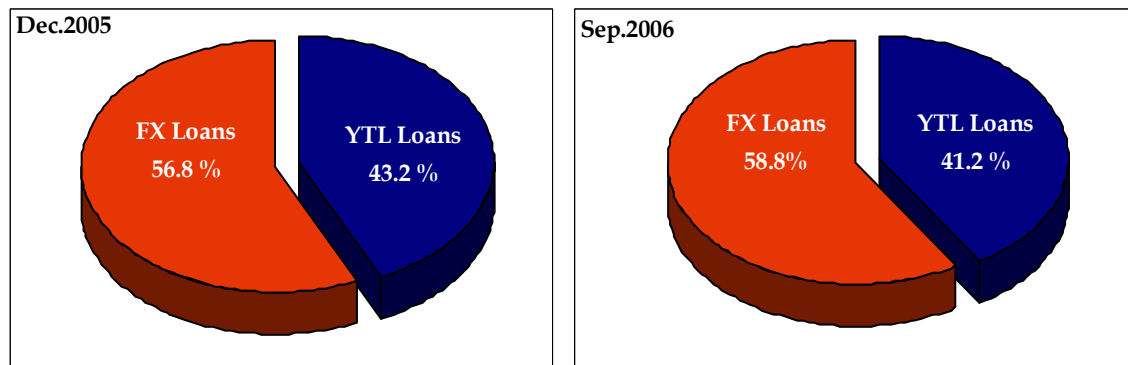
¹ Cash Ratio = (Liquid Assets + Marketable Securities) / Short-Term Liabilities

² Liquidity Ratio (Acid-Test Ratio) = [Current Assets - (Inventories + Prepayments and Accrued Income for The Next Months + Other Current Assets)] / Short-Term Liabilities

The liquidity ratio indicating the ability of firms to cover their short-term liabilities rose from 95.3 percent in 2004 to 97.2 percent in 2005. The observed increase compared with the previous year was due to the fact that the growth in current assets was bigger than the growth in short-term liabilities. The cash ratio, which shows how companies place their working capital, was lower than the liquidity ratio for 2004 and 2005 and increased to 21.9 percent in 2005 from 20.8 percent in 2004 (Chart I.4.2.3).

In spite of the recovery of cash and liquidity ratios, the corporate sector's receivables turnover, which was 57.9 days in 2004, climbed to 62.5 days in 2005. This development indicates deterioration in collection performance from short-term trade receivables from sales. When a similar analysis was carried out for inventory turnover ratio, this ratio increased from 46 days in 2004 to 49.3 days in 2005. The fall in the real interest rates could be effective in this development.

Chart I.4.2.4
Cash Loans Extended to Firms¹



Source: CBRT

¹ Foreign exchange loans include foreign exchange indexed loans.

The share of foreign currency loans including loans indexed to foreign currency in total loans extended to firms increased from 56.8 percent at the end of 2005 to 58.8 percent in September 2006 (Chart I.4.2.4).

Table I.4.2.1
Distribution of Loans Extended to Firms by Sectors ¹

SECTORS	Total Loans (Million YTL)			FX Loans / Total Loans (%)		
	Dec. 04	Dec. 05	Sep. 06	Dec. 04	Dec. 05	Sep. 06
Sources of Electricity, Gas and Water	3,912	4,272	8,886	95.6	96.0	93.9
Manufacture of Coke, Refined Petroleum and Nuclear Fuel	1,819	2,293	3,997	78.4	70.5	85.4
Public Administration and Defense, Compulsory Social Security	1,347	2,013	1,585	49.3	45.7	81.5
Hotels And Restaurants (Tourism)	2,020	3,315	5,005	81.8	77.6	78.3
Manufacture of Transport Equipment	3,264	3,898	5,094	79.3	76.4	77.0
Manufacture of Basic Metals and Fabricated Metal Products	4,011	5,916	9,057	76.5	73.9	75.7
Real Estate, Renting and Business Activities	2,507	3,502	4,737	78.5	73.6	75.3
Manufacture of Textiles and Textile Products	8,284	9,383	11,154	75.3	70.5	72.0
Financial Intermediation ²	5,359	7,406	9,322	70.7	66.2	70.0
Manufacture of Rubber and Plastic Product	1,247	1,672	2,552	67.3	64.5	62.3
Transport, Storage and Communication	4,133	6,146	11,263	79.5	68.8	59.7
Manufacture of Electrical and Optical Equipment	1,498	1,976	2,591	68.3	59.9	58.2
Manufacture of Other Non-Metallic Minerals	2,366	4,114	4,022	63.1	45.1	57.6
Construction	4,408	7,005	9,806	65.3	59.5	55.3
Manufacture of Paper and Paper Products	952	1,250	1,762	70.1	59.7	55.1
Mining and Quarrying of Energy-Producing Materials	1,081	1,383	1,386	78.8	68.0	54.6
Manufacture of Chemicals and Chemical Products	2,623	3,388	4,124	69.0	56.4	54.5
Other Community, Social and Personal Services Activities	2,269	3,917	4,399	63.3	41.1	54.2
Other Manufacturing Industry	1,219	1,987	2,855	62.9	53.7	53.4
Industry of Tobacco, Beverages and Food	5,256	7,916	8,417	51.4	47.9	51.0
Manufacture of Machinery and Equipment	2,435	3,358	5,227	66.6	60.2	50.8
Wholesale and Retail Trade, Brokerage, Repair of Motor Vehicles	11,384	20,679	36,043	43.8	38.2	42.8
Agriculture, Hunting and Forestry	3,827	5,093	6,771	22.3	19.5	14.1
Other	2,031	3,222	5,244	53.5	39.3	47.8
Total – Average	79,252	115,106	165,299	64.9	56.8	58.8

Source: CBRT

¹ Loan information was gathered utilizing the reports provided by banks in accordance with Central Bank Law no.1211 Article 44 and includes loans extended by banks (including loans obtained by firms from abroad through the intermediation of banks) to real and legal persons with a credit limit or exposure equal to or above 10 thousands YTL. The figures include interest accruals and discounts, and exclude non-performing loans and non-cash loans. Therefore, these loan figures are different from those used in analyses based on balance sheet information.

² Excluding banks.

The share of firms' foreign currency loans in total loans increased in September 2006 compared to the end of the previous year, whereas there was a reduction in the

share of foreign currency loans of the “Sources of Electricity, Gas and Water”, “Transport, Storage and Communication”, “Construction” and “Manufacture of Machinery and Equipment” sectors (Table I.4.2.1).

Table I.4.2.2
Share of Exports by Sectors in Total Exports¹

S E CTORS	Exports (Million USD)			The Share of Sectors in the Total Exports (%)		
	Dec. 04	Dec. 05	Sep. 06 ²	Dec. 04	Dec. 05	Sep. 06 ²
Agriculture, Hunting and Forestry	2,542	3,329	3,484	4.0	4.5	4.3
Fishing	103	140	115	0.2	0.2	0.1
Mining and Quarrying	649	810	1,040	1.0	1.1	1.3
Manufacturing	59,579	68,813	75,564	94.3	93.7	93.7
Food products and beverages	3,349	4,272	4,329	5.3	5.8	5.4
Tobacco products	78	122	153	0.1	0.2	0.2
Textiles	7,998	8,743	8,939	12.7	11.9	11.1
Wearing apparel	9,340	9,925	9,855	14.8	13.5	12.2
Luggage, saddlery and footwear	328	370	412	0.5	0.5	0.5
Products of wood and cork	204	250	287	0.3	0.3	0.4
Paper and paper products	457	559	562	0.7	0.8	0.7
Printing and publishing	82	105	97	0.1	0.1	0.1
Coke, petroleum products and nuclear fuel	1,364	2,519	3,269	2.2	3.4	4.1
Chemicals and chemical products	2,556	2,818	3,247	4.0	3.8	4.0
Rubber and plastic products	1,959	2,486	2,783	3.1	3.4	3.4
Other non-metallic minerals	2,317	2,687	2,697	3.7	3.7	3.3
Manufacture of basic metals	6,816	6,888	8,531	10.8	9.4	10.6
Manufacture of fabricated metal products (excluding machinery)	2,200	2,685	3,053	3.5	3.7	3.8
Manufacture of machinery and equipment	3,913	4,865	5,549	6.2	6.6	6.9
Office, accounting and computing machinery	52	70	83	0.1	0.1	0.1
Electrical machinery and apparatus	1,576	1,933	2,422	2.5	2.6	3.0
Communication and apparatus	2,883	3,150	3,230	4.6	4.3	4.0
Medical, precision and optical instruments, watches	173	198	220	0.3	0.3	0.3
Motor vehicles and trailers	8,813	10,226	11,709	14.0	13.9	14.5
Other transport	1,349	1,707	2,053	2.1	2.3	2.5
Furniture	1,771	2,238	2,088	2.8	3.0	2.6
Wholesale and retail trade	231	280	352	0.4	0.4	0.4
Other	63	105	103	0.1	0.1	0.1
TOTAL EXPORTS	63,167	73,476	80,658	100.0	100.0	100.0

Source: CBRT

¹ Excluding shuttle trade.

² Covering October 2005-September 2006 period.

Although there is not any one to one match between exporting firms and firms which had FX loans extended to them by banks, the significant portion of the firms to which foreign currency loans have been extended are either exporting firms or firms which operate in foreign exchange earning sectors. Therefore, it is possible to claim that these firms can better manage foreign exchange risk. An open position might be a

significant risk for companies which cannot earn foreign currency income but use foreign currency loans (Table I.4.2.1 and I.4.2.2).

I.4.3. Corporate Sector Foreign Exchange Position

Foreign exchange positions of companies could not be calculated by using their balance sheets, since financial statements are prepared in terms of Turkish currency, without a distinction on the basis of currency.

However, in order to obtain a general idea concerning the exchange rate risk of companies, the foreign exchange position of the non-banking sector, which excludes households and banks, may be calculated approximately by using data compiled from the database of the Treasury and “Locational Banking Statistics” published by the Bank for International Settlements (BIS), Balance of Payments statistics and various statistical reports to the CBRT.

On the other hand, FX positions of companies whose stocks are traded on the ISE are calculated by using footnotes to their disclosed financial statements. Furthermore, the FX risks of these companies that constitute an important part of the sector and their credit risk stemming from cash loans are examined.

Analyses and assessments regarding the FX risk of the corporate sector are based on a macro perspective and it is a fact that some companies have a short position while others have a long position. Therefore, it should be considered that corporate sector vulnerability to exchange rate risk is required to be evaluated on a company basis.

I.4.3.1.Foreign Exchange Position of the Non-Banking Sector

Table I.4.3.1.1
FX Assets and Liabilities of the Non-Banking Sector

(Million USD)	Dec.05	Mar.06	Jun.06	Sep.06	Change Jun.06-2005 (%)	Change Sep.06-Jun.06 (%)
ASSETS	49,633	52,960	53,744	55,011	8.3	2.4
A. Deposits	34,170	37,115	37,446	38,616	9.6	3.1
- Domestic ⁽¹⁾	15,916	17,929	17,486	18,656	9.9	6.7
- Foreign	18,254	19,186	19,960	19,960	9.3	0.0
B. Securities	1,686	1,661	1,533	1,597	-9.1	4.2
- Domestic	261	268	168	207	-356	23.2
- Foreign	1,425	1,393	1,365	1,390	-4.2	1.8
C. Export Receivables	6,721	7,075	7,641	7,320	13.7	-4.2
D. Foreign Direct Invest. to Abroad	7,056	7,109	7,124	7,478	1.0	5.0
LIABILITIES	78,475	88,309	96,659	98,433	23.2	1.8
A. Cash Loans	62,168	72,774	79,161	81,464	27.3	2.9
- Domestic ^(1,2)	21,680	22,843	25,066	24,893	15.6	-0.7
- Foreign	40,488	49,931	54,095	56,571	33.6	4.6
Medium and Long Term ⁽³⁾	39,300	48,691	52,814	55,146	34.4	4.4
B. Import Payables	10,674	10,946	12,783	12,634	19.8	-1.2
C. Protocolized Receivables of SDIF	5,633	4,589	4,715	4,335	-16.3	-8.1
NET POSITION	-28,842	-35,349	-42,915	-43,422	48.8	1.2

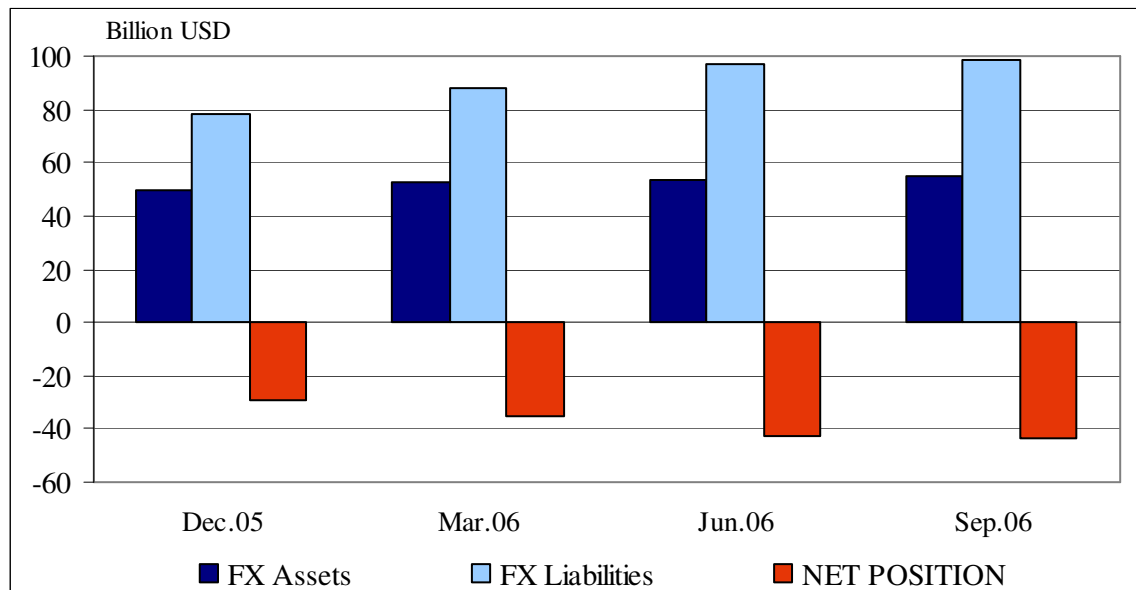
Source: BRSA-CBRT, TURKSTAT, Treasury, SDIF, BIS

¹ Participation funds and funds-extended of participation banks are included.

² FX indexed loans are included.

³ In order to obtain September 2006 data, net flow values of July, August and September 2006 are added to stock value of June 2006. Exchange rate differences are not taken into consideration.

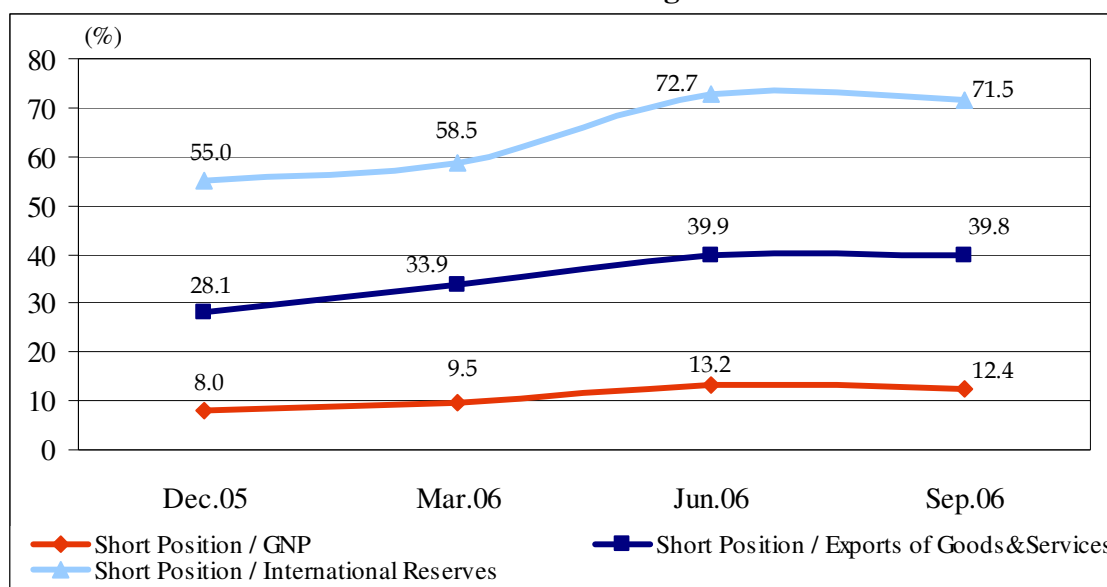
Chart I.4.3.1.1
FX Position of the Non-Banking Sector



Source: BRSA-CBRT, TURKSTAT, Treasury, SDIF, BIS

The short position of the non-banking sector increased by 49 percent and reached 43 billion USD as of June 2006, compared to the end of 2005. The determinants of this development were the increase in cash loans from abroad and import payables. The rate of increase in the short position slowed down beginning from June 2006 and became 43.4 billion USD at the end of September (Table I.4.3.1.1, Chart I.4.3.1.1).

Chart I.4.3.1.2
Ratios Related to FX Position of the Non-Banking Sector^{1,2}



Source: BRSA-CBRT, TURKSTAT, Treasury, SDIF, BIS

¹ GNP and exports of goods & services are computed on a yearly basis. International reserves are stock values at the end of period. GNP value of June is used for September.

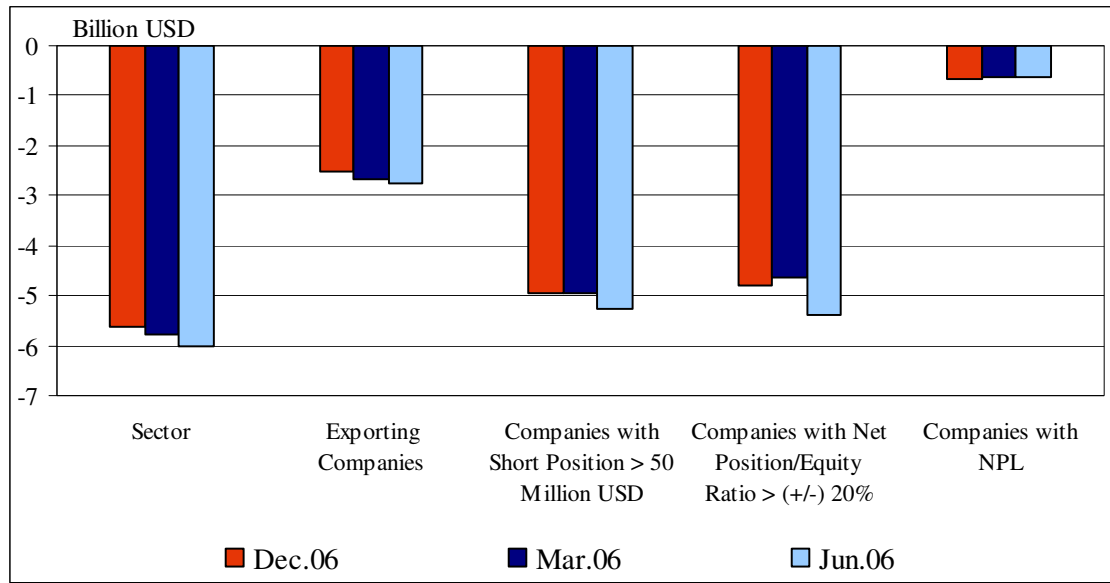
² International reserves are gross foreign exchange reserves of CBRT (including gold).

Ratios of the sector's short position to GNP, exports and international reserves increased rapidly in the first six months of 2006 and decreased slightly at the end of September (Chart I.4.3.1.2).

I.4.3.2 Foreign Exchange Positions of the Companies Listed on the Istanbul Stock Exchange

In this section, the FX positions and bank loans of companies listed on the ISE are examined. In the context of analyses, of companies whose financial statements are published by the ISE, 158 companies that disclose their FX positions in balance sheet footnotes and have no financial institution in their consolidated financial statements are taken into consideration.

Chart I.4.3.2.1
FX Position of ISE Companies¹



Source: ISE

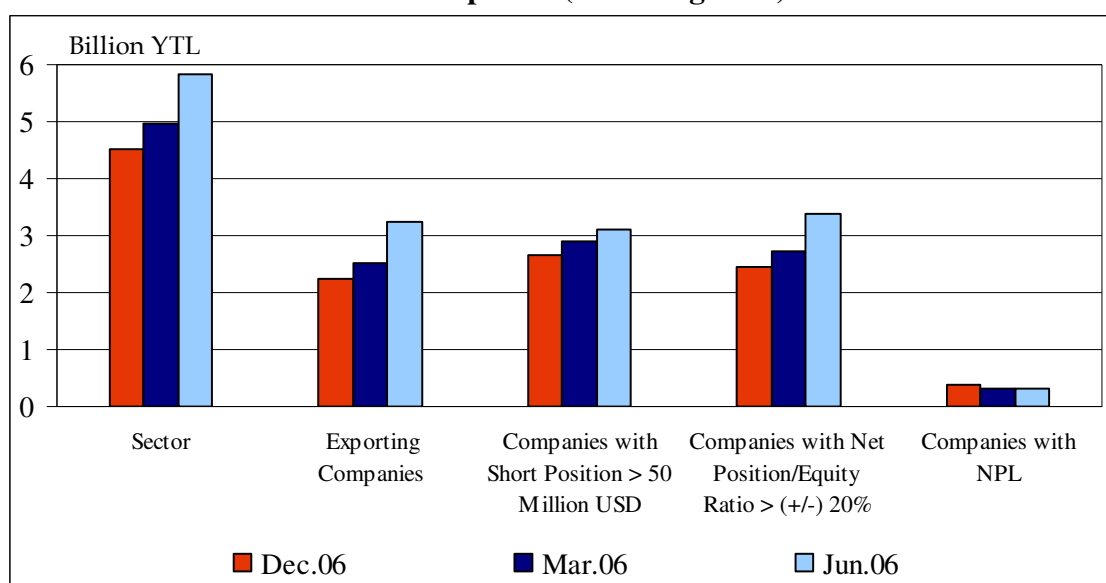
¹ Companies whose foreign sales are 30 percent or more of their gross sales are accepted as exporter companies.

In 2006, the short position of companies examined was in an upward trend and it increased from 5.6 billion USD by year-end 2005 to 6 billion USD by June 2006 (Chart I.4.3.2.1). On the other hand, due to the fact that 3.3 billion USD of this short position belongs to non-exporting companies, the management of FX risks by these companies gains importance.

Table I.4.3.2.1
FX Position of ISE Companies

(Million USD)	Dec.05		Mar.06		Jun.06	
	Number of Companies	Net Position	Number of Companies	Net Position	Number of Companies	Net Position
Companies with Short Position	112	- 6,269	112	- 6,237	117	- 6,585
-Non-Exporting Companies	66	- 3,410	66	-3,379	68	-3,609
Companies with Long Position	46	651	46	449	41	563
-Non-Exporting Companies	31	302	31	251	29	331

As of June 2006, 117 companies out of 158 have a short position. Moreover, non-exporting companies hold 55 percent of the total short position (Table I.4.3.2.1).

Chart I.4.3.2.2**Cash Loans Extended to ISE Companies (Including NPL)¹**

Source: CBRT

¹ Based on Risk Center records, cash loans are the loans which are extended directly by domestic banks or extended by foreign banks with guarantee or intermediation of domestic banks.

The cash loans extended to the companies examined follow an upward trend. Since majority of these loans are foreign currency loans, the rise in exchange rates led to this upward trend (Chart 1.4.3.2.2).

Table I.4.3.2.2**Net FX Positions and Cash Loans Extended to ISE Companies**

	Number of Companies	Net Position (Million USD)	Net Position/Equity (%)	Bank Loans – Exc. NPL (Million YTL)
June 2006				
Total	158	-6,022	-26.49	5,751
Exporting Companies	61	-2,743	-35.16	3,196
Companies with Short Position > 50 Million USD	25	-5,277	-40.81	3,066
Companies with Net Position/Equity Ratio > (+/-) 20%	90	-5,378	-56.98	3,279
Companies with NPL	15	-619	268.91	215

Source: ISE, TCMB

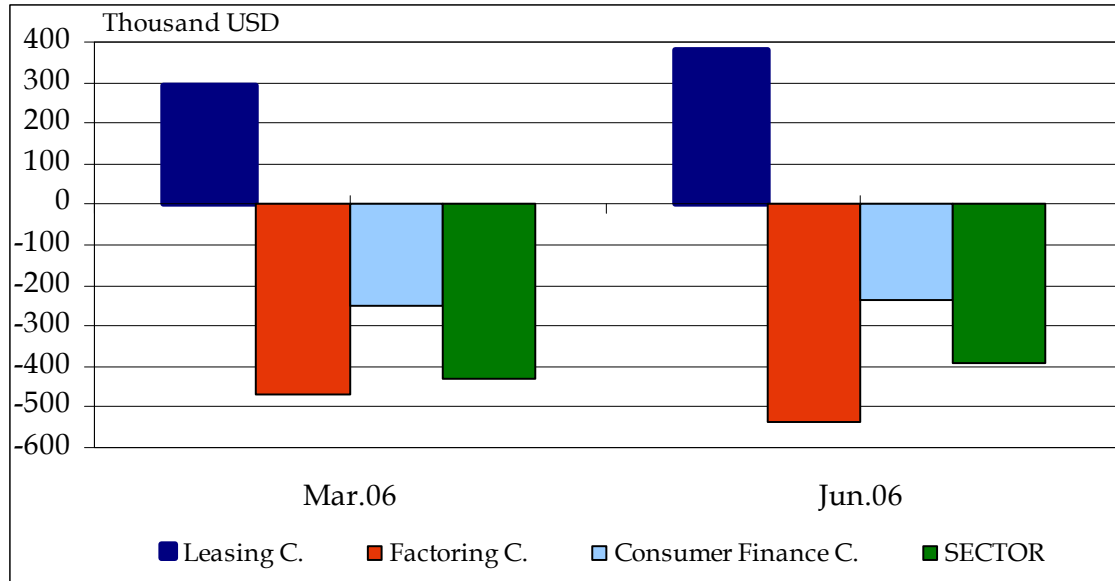
In June 2006, total loans excluding the NPL of 158 companies was 5.8 billion New Turkish Liras. The total loans of 90 companies whose Net Position / Equity ratio is greater than 20 percent was 3.3 billion New Turkish Liras (Table 1.4.3.2.2).

In order to hedge exchange rate risk resulting from the fluctuations in exchange rates, companies with a short position should use derivative instruments efficiently by taking into consideration the facilities of the Turkish Derivatives Exchange. Moreover, banks are required to adopt more prudential approaches while extending loans to companies, especially to those which have a high short position and no foreign exchange revenue.

I.4.3.3 Foreign Exchange Position of Non-Banking Financial Sector

In this section, the FX on balance sheet positions of leasing, factoring and consumer finance companies, which have a 3.2 percent share in the Turkish finance sector and have a close relationship to the corporate sector and banking sector in consideration of their activities, are examined.

Chart 1.4.3.3.1
On Balance Sheet FX Position of the Non-Banking Financial Sector



Source: BRSA

While the FX on balance sheet position of the non-banking financial sector was realized at 429 million USD in March 2006, as a result of the fluctuations in financial markets, it declined by 37 million USD and was realized at 392 million USD in June (Chart 1.4.3.3.1).

Despite the long position of leasing companies, the FX on balance sheet position of the non-banking financial sector is short due to the short positions of factoring and consumer finance companies.

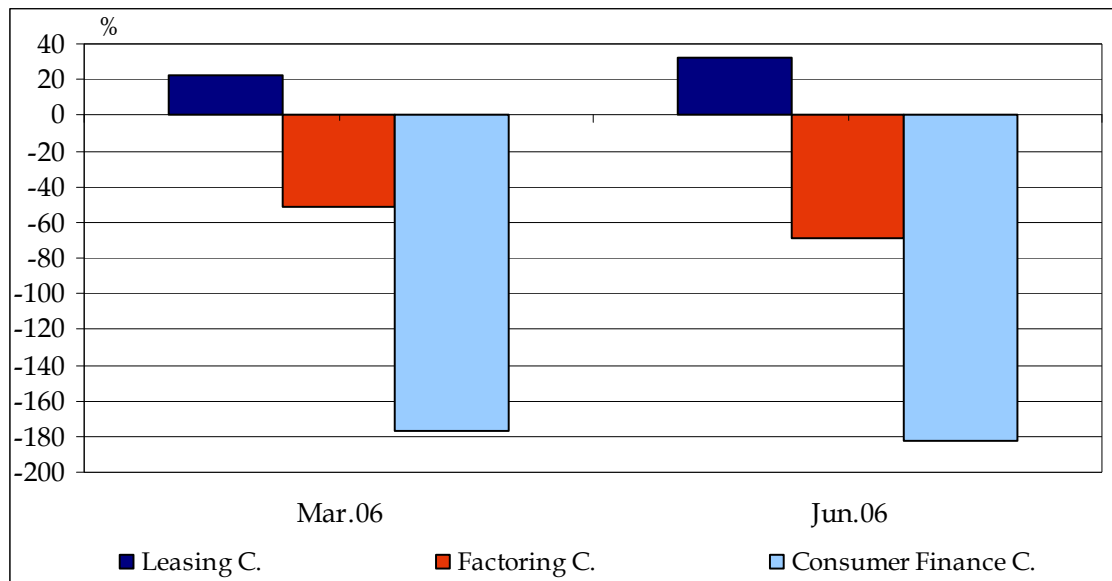
The high level of FX obligations was a determining factor on the balance sheet short position of factoring and consumer finance companies. As a matter of fact, the level of FX obligations of factoring companies is higher than the claims of import and export factoring companies. This shows that the mentioned companies financed their Turkish lira transactions with foreign currency fundings.

Similarly, on balance sheet position of consumer finance companies is short since their FX financial obligations are higher than their foreign currency loans.

The on balance sheet long position of leasing companies was 381 million USD in July 2006 due to the important part of the claims on leasing was in FX (Chart 1.4.3.3.1).

Chart 1.4.3.3.2

On Balance Sheet FX Position of the Non-Banking Financial Sector / Equity



Source: BRSA

While the ratio of factoring companies' FX on balance sheet open position to equity was 51 percent in March 2006, it reached 69 percent as of June 2006. The ratio of consumer finance companies' FX on balance sheet open position to equity was realized rather high, 183 percent in June 2006 (Chart 1.4.3.3.2).

I.5. Developments in the External Sector

Table I.5.1
Balance of Payments

(Billion USD)	2003	2004	2005	June 06 ¹	September 06 ¹
CURRENT ACCOUNT	-8.0	-15.6	-23.2	-29.1	-32.6
Foreign Trade Balance	-14.0	-23.9	-32.9	-38.6	-40.7
Exports (f.o.b) (Including gold)	51.2	67.0	76.9	81.6	84.9
Imports (f.o.b) (Including gold)	-65.2	-90.9	-109.9	-116.9	-125.6
Coverage Ratio (%)	79	74	70	70	68
Balance of Services	10.5	12.8	14.0	13.6	12.4
Balance on Investment Income	-5.6	-5.6	-5.6	-5.6	-6.0
Current Transfers	1.0	1.1	1.5	1.5	1.6
CAPITAL & FINANCIAL ACCOUNT	3.1	13.4	20.9	29.4	33.7
Direct Investments	1.3	2.0	8.7	16.8	18.1
Portfolio Investments	2.5	8.0	13.4	5.6	8.1
Other investments	3.4	4.2	16.6	22.3	21.8
Reserve Assets	-4.0	-0.8	-17.8	-15.3	-14.2
NET ERRORS & OMISSIONS	4.9	2.2	2.2	-0.3	-1.1

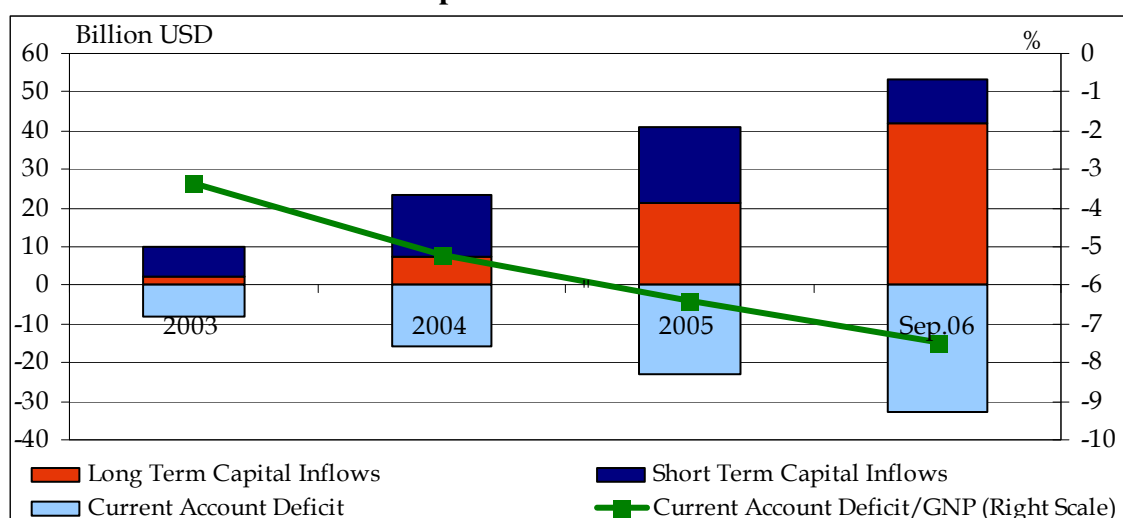
Source: CBRT

¹ June and September 2006 data are annualized.

In spite of the volatility in financial markets in the second quarter of 2006, the current account deficit continued to increase and reached 32.6 billion USD on an annual basis as of September 2006. As of the same period, exports grew by 10.4 percent compared to the end of 2005. On the other hand, imports grew by 14.3 percent annually compared to end-2005, due to the restrengthening of the New Turkish Lira following the global volatility, the dependence on intermediate goods to support industrial production as well as high energy prices albeit with a tendency to decrease. In line with these developments, the coverage ratio of exports to imports decreased to 68 percent as of September 2006.

Considering the financing structure of the current account deficit, it is seen that foreign direct investment and other investments, which include loans extended to the private sector and banks, have continued to rise (Table I.5.1).

Chart I.5.1
Current Account Deficit and Capital Inflows^{1,2,3}



Source: CBRT

¹ Annualized data is used. Current account deficit / GNP ratio is as of June 2006.

² Long-term capital inflows consist of foreign direct investment, debt securities of general government and banks, long-term cash loans, long-term trade loans and long-term deposits at CBRT.

³ Short-term capital inflows consist of portfolio investments including equities and government bonds, short-term cash loans, short-term trade loans, short-term deposits at CBRT and banks and other short-term liabilities.

The capital and financial account reveal that the share of the portfolio investments, which had an important share in the past, has been decreasing. However, the share of foreign direct investment and the loans obtained by the private and banking sectors have been increasing. As of September 2006, the size of the long-term capital flow was 1.3 times the annualized current account deficit (Chart I.5.1).

Table I.5.2
Counterparties Financing the Current Account Deficit

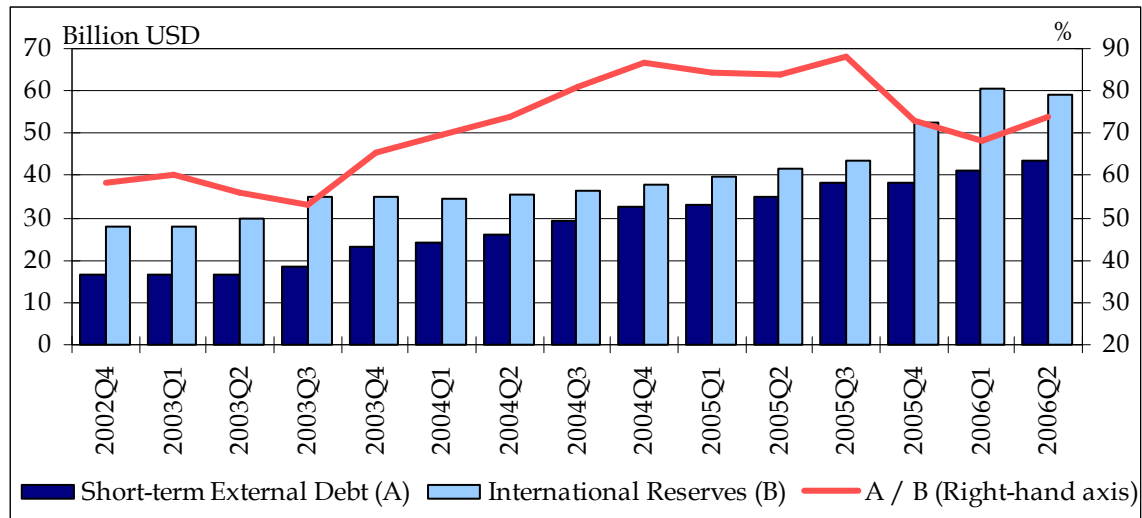
(Billion USD)	2003	2004	2005	June 06	Sep.06 ¹
Current Account	-8.0	-15.6	-23.2	-29.1	-32.6
Financial Account	3.1	13.4	21.0	29.4	33.7
General Government (including CBRT and CBRT reserves)	-2.6	2.4	-16.5	-21.6	-13.6
Private Sector (including banks)	5.7	11.0	37.5	51.0	47.3
Net Errors & Omissions	4.9	2.2	2.2	-0.3	-1.1

Source: CBRT

¹ Figures for October 2005 – September 2006 period

The current account deficit was mostly financed by the private sector rather than the public sector. The funds obtained by the private sector (including the banking sector) abroad, which have evolved towards a longer-term structure, reached 47.3 billion USD as of September 2006 (Table I.5.2). Although this positive trend is regarded crucial for funding the current account deficit, the prudent management of the rising foreign exchange risk by the private sector is becoming important.

Chart I.5.2
Short-Term External Debt¹ and International Reserves²



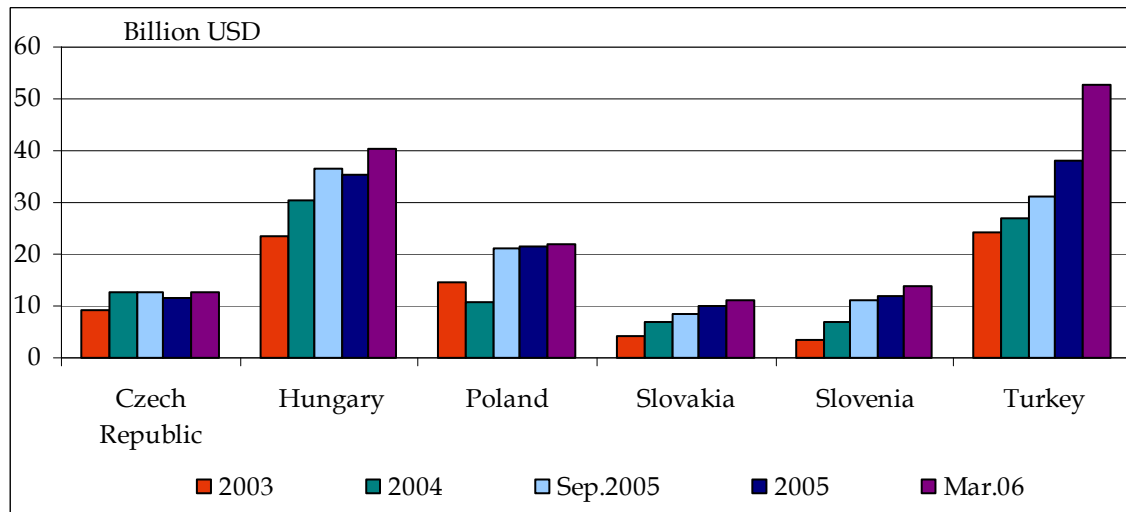
Source: Treasury, CBRT

¹ Short-Term External Debt = General Government + CBRT + commercial banks + other sectors

² International Reserves = CBRT gross foreign exchange reserves (including gold)

As an indicator of a country's external debt service capacity, the ratio of short-term external debt to international reserves, which was 72.9 percent in 2005, decreased to 68.3 percent in the first quarter of 2006 since the increase in international reserves was much larger than the increase in the short-term external debt. However, the ratio rose to 74.1 percent in the second quarter of 2006 owing to the increase in the short-term debt and the decrease in the reserves related to the turbulence in the financial markets (Chart I.5.2).

Chart I.5.3
Net Receivables of International Banks from Selected Countries¹



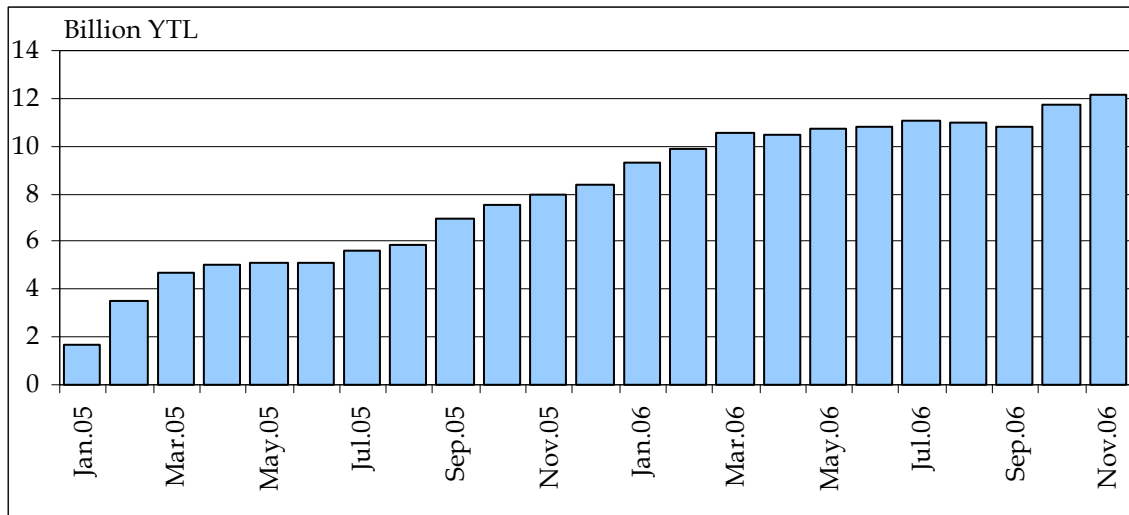
Source: BIS

¹ Figures for March 2006 are temporary.

The upward trend in the funds extended to Central and Eastern European countries by the banks reporting to the Bank for International Settlements (BIS)

continued in the first quarter of 2006. Consequently, the net receivables of international banks from Turkey have increased by 38 percent and reached to 52.5 billion USD, as of March 2006 (Chart I.5.3).

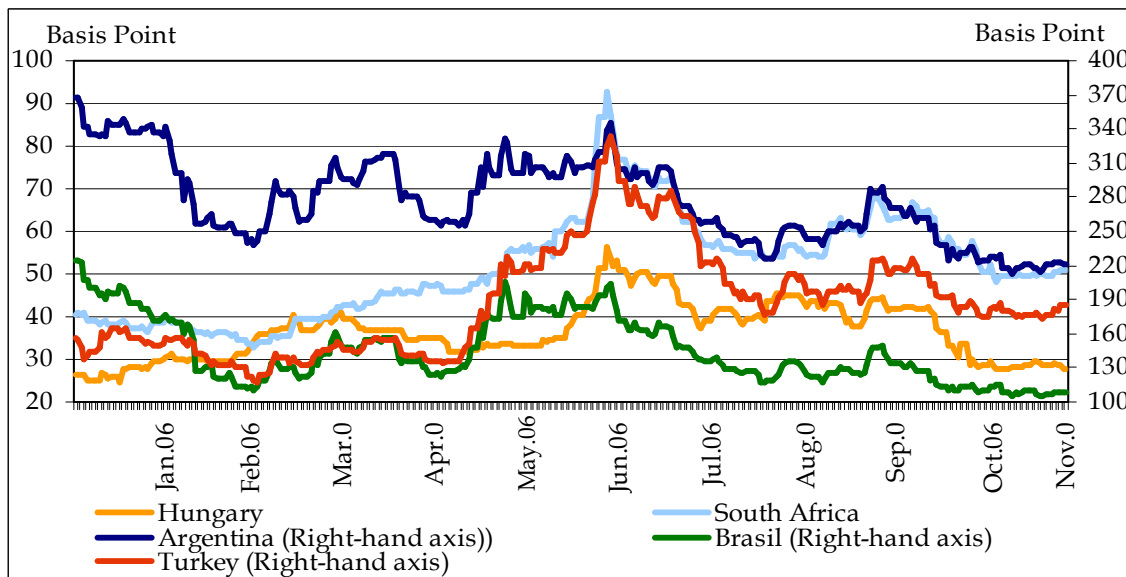
Chart I.5.4.
New Turkish Lira Bonds Issued By Foreigners



Source: CBRT

The New Turkish Lira denominated debt securities issued by foreigners rose to 12.2 billion as of November 2006 from 8.4 billion at the end of 2005 (Chart I.5.4). This indicates the continuation of positive expectations of foreign investors with regard to Turkey in spite of the financial fluctuations in May and June 2006.

Chart I.5.5
Credit Default Swap Spreads (CDS)¹ of Emerging Markets and Turkey



Source: Bloomberg

¹ 5-year CDS agreement denominated in USD is taken as reference.

Although credit default swap spreads in emerging markets were in an upward trend due to the contraction in global liquidity conditions, the steady trend in the CDS spreads of Hungary, which is a member of the European Union and has a high current account deficit, is remarkable. The CDS spreads for Turkey climbed to 218 basis points in September 2006 from 156 basis points in January 2006 and dropped to 185 basis point as of October 2006, mainly due to improvements in the global liquidity conditions (Chart I.5.5).

Box I.5.1 Credit Default Swap (CDS)

CDS is a swap agreement, which creates a payment obligation for one party to another party in case of occurrence of an “event” related with credit. It is the most liquid one among the credit derivatives. In this swap agreement, the buyer of the credit swap receives credit protection and pays a premium to other party.

Although events related to a credit can be defined exclusively by the parties, according to the definition of the International Swap and Derivatives Association, “event” related with the credit may usually arise in four ways: bankruptcy, insolvency, credit downgrade or a breakdown in the payment plan of a credit. In this regard, CDS operates like insurance. If an undesired event related to a credit occurs, insurance payments will end and the insured party will get the insured amount. Periodic payments or the premiums named as default swap premium or default swap spread are expressed as basis points for each of the value of the swap agreement. Within this context, default swap spread reflects the credit risk of the underlying asset and expressed as basis point applied on the reference rates like LIBOR and swap rate. Therefore, an increase in the basis point indicates an increase in credit risk; on the other hand, a decrease in the basis point indicates a decrease in credit risk.

Due to the insufficiency of domestic savings, the funds obtained from abroad play a crucial role in the Turkish economy, which continues its growth performance in the second quarter of 2006. However, it is also important to consider the financing structure when analysing the sustainability of the current account deficit, which is the result of the high growth performance. The rise in foreign direct investments and long-term loans extended to the private sector and the banking sector can lead to improving the production capacity of the economy, and the improved production capacity will foster domestic savings, which will ultimately cover the fund requirement of the economy. As a result of this process, the dependence on foreign funds will decrease gradually to a minimum level. Another issue, which should be covered in the analysis, is the main reason for the high current account deficit. Unlike in the past, the high current account deficit is not due to the consumption of consumer goods, but it is because of the increase in investments, which is likely to raise the production capacity of the economy in the future. This is clearly crucial for stable growth in the real economy.

In spite of the last volatility, it is regarded that balancing the capital outflow by the capital inflow indicates increasing confidence and positive expectations about the Turkish economy, where the implementation of flexible exchange rate regime can be seen as a safety factor for any likely external shocks.

Nonetheless, considering the probable negative shift of the global liquidity conditions against emerging market economies, all these positive developments do not change the reality that the current account deficit is an important risk component that should be carefully monitored.

Box I.6.1 Financial Stress Index

The Financial Stress Index is defined as uncertainty in financial markets and change in loss expectations. The increase in financial stress causes deterioration of financial stability and has adverse effect on the real economy. In this framework, to determine and monitor the stress in the financial markets, the financial stress index, as one of the most important indicators of the financial stability, is calculated for Turkey.¹

Within this context, some sub-indicators are utilized regarding foreign exchange, equity and public debt markets, and the banking sector. The selected indicators are standardized under the assumption of equal variance and normal distribution. The value of stress sub-indices for each market and the banking sector is constructed by taking March 2000 as 100, as the financial stress index is calculated by taking the arithmetic average of these indices based on their weights. The indicators, which raise financial stress, are included in the positive direction of the calculation, whereas those with a decreasing impact on financial stress, are included in the negative direction. The selected indicators and their weights for three selected markets and the banking sector are stated below:

	Financial Stress Indicators	Direction of the Impact	Weight
Banking Sector	Funds obtained from Markets/ Total Assets ¹	Positive	0.50
	Average Real Overnight Interbank Rate ²	Positive	0.50
Foreign Exchange Market	Real Effective Exchange Rate ³	Negative	0.40
	Volatility of US Dollar ⁴	Positive	0.60
Equity Market	Real ISE 100 Index ⁵	Negative	0.40
	Volatility of ISE 100 Index ⁶	Positive	0.60
Public Debt Market	JP Morgan EMBI+Turkey ⁷	Positive	0.33
	Average Interest Rates of Treasury Auctions ⁸	Positive	0.33
	Benchmark Interest Rate ⁹	Positive	0.33

¹ Funds obtained from markets by banks consist of funds generated under repurchase agreements, interbank money market takings, funds borrowed from the CBRT and payables to securities market.

² The monthly average of real overnight Interbank rate is calculated by using Fisher equation based on the yearly CPI change.

³ Real Effective Exchange Rate, which is calculated by the CBRT based on the CPI, is used.

⁴ Volatility is calculated by taking standard deviation (252-day moving average) of log return of monthly US Dollar (20 working days).

⁵ Real ISE 100 Index is calculated based on the CPI 1994=100.

⁶ Volatility is calculated by taking standard deviation (252-day moving average) of log return of monthly US Dollar (20 working days).

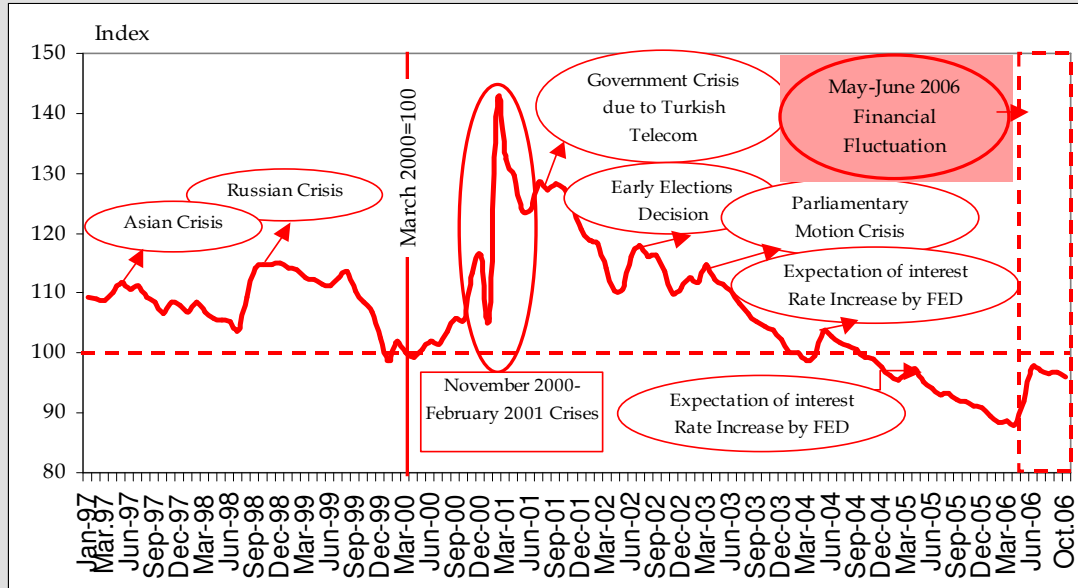
⁷ The month-end value of JP Morgan EMBI+ for Turkey is used.

⁸ The monthly data is calculated by taking the weighted average of discounted Treasury auction interest rates.

⁹ The yearly compound interest rate of government debt security, which has the highest turnover in the bonds and bills market as of the end of the month.

¹ This study is based on papers of Illing and Liu, "An Index of Financial Stress for Canada" (2003) and Das, Iossifov, Podpiera and Rozhkov, "Quality of Financial Policies and Financial System Stress", IMF Working Paper, (2005).

Financial Stress Index¹



Source: CBRT, ISE, SIS, Turkish Treasury ve Bloomberg

¹ For the calculation of the value of the stress index as of October 2006, September 2006 figure of funds obtained from markets / total assets ratio is used.

Although there were some slight jumps in the financial strength index from time to time, the index was in a downward trend after the November 2000-February 2001 crises. As a result of the reflections of global fluctuations on domestic markets during May-June 2006 period, the index went up. Although all stress indices have increased during the fluctuations, the main factors causing this rise were especially the depreciation in the real effective exchange rate and the fall of real ISE 100 Index which have raised the sub-indices related to the foreign exchange and equity market and the increase in the volatility of the US dollar and ISE 100 Index. Starting from June, the stress index indicates a declining trend.