CENTRAL BANK OF
THE REPUBLIC OF TURKEY

inflation report
2007-IV

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1. Overview

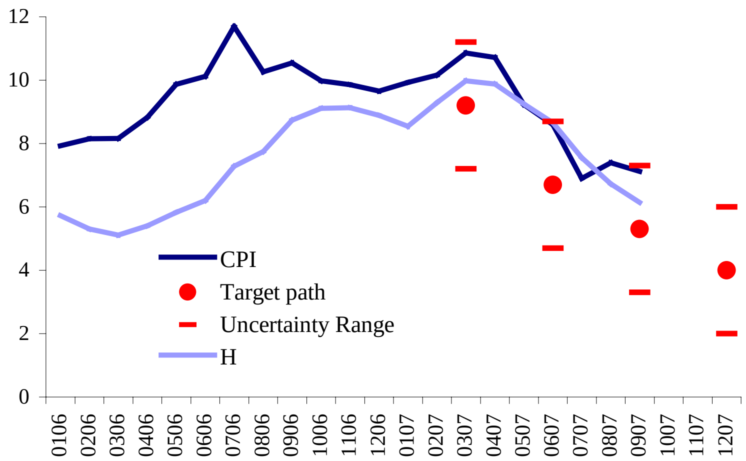
1.1. Inflation Developments

Disinflationary impact of the monetary tightening exercised since June 2006 has continued at an increasing pace in the third quarter of 2007. In this period, both inflation and economic activity were in line with the predictions of Central Bank of the Republic of Turkey (CBRT). Notwithstanding rising government expenditures and signs of recovery in domestic demand, aggregate demand conditions continued to support disinflation, owing to accumulated past impact of monetary tightening on private demand. Accordingly, deceleration of inflation in demand sensitive items, such as services and durable goods, was more significant.

Deterioration in credit markets and subsequent concerns that it would have broader effects on the economy have triggered fluctuations in financial markets. The reaction by central banks of developed countries, in the form of liquidity injection and easier monetary policy stance, has somewhat alleviated these concerns, leading to a rebound in global risk appetite and international liquidity conditions. YTL remained strong over the course of the third quarter, offsetting the impact of rising commodity prices on domestic production costs.

Food prices continue to increase owing to the adverse weather conditions and global developments. The rise in food prices has been the main factor to slow down the disinflation process. As of the end of third quarter, the contribution of food component to the overall CPI inflation exceeded 3 percentage points. Despite the elevated course of food prices, inflation, owing to the lagged effects of monetary tightening, continued to decelerate and remained within the uncertainty band (Graph 1.1.1). The disinflation in widely cited core indicator, H-index (CPI excluding energy, unprocessed food, alcohol, tobacco and gold), became more visible in the third quarter.

Graph 1.1.1. Annual Inflation (CPI and H)



H: CPI excluding energy, unprocessed food, alcohol, tobacco and gold.
Source: TURKSTAT, CBRT.

As the developments in inflation and aggregate demand have evolved in parallel with the expectations of the CBRT, monetary policy was conducted broadly in line with the outlook envisioned in the previous inflation reports. In this regard, the Monetary Policy Committee (The Committee), after keeping the policy rates constant for an extended period, initiated the measured rate cuts in September. The Committee lowered the policy rates by a total of 75 basis points in September and October meetings. The rate cuts, which started slightly earlier than market expectations, was well perceived by the economic agents, lowering the inflation expectations and inflation uncertainty, and consequently, leading to a reduction in medium and long term interest rates.

1.2. The Outlook

Short Term

As explained below, we revised the short term forecasts upwards compared to the previous Report, mainly due to developments in energy and food prices, which cannot be influenced by the monetary policy:

- Underlying assumption on oil prices in the July Report was 65 USD per barrel. However, after having witnessed an average price of 75 USD in this period, we revised our assumption on oil prices up to 70 USD per barrel. Moreover, unlike the previous

Report, we assumed a sizeable increase in electricity prices in the last quarter of 2007. The revision in energy prices by itself increased the end-2007 forecast by 0.8 percentage points.

- In the previous Report, we envisaged a gradual correction in food prices. However, food prices both in Turkey and other countries continued to display sharp increases since then. This development in turn led to a further upward revision in our short term inflation forecasts.
- Besides these revisions for end-2007, we assumed that some fiscal measures in the form of tax and/or administered price adjustments wil take place in the first quarter of 2008 for items such as fuel and tobacco. These adjustments will have a one year impact on annual inflation.

To sum up, despite the favorable developments in core inflation indicators, short term forecasts were revised upwards due to factors beyond the control of the CBRT, such as tax adjustments and hikes in energy, food, and administered prices. Accordingly, we forecast inflation to be between 6.7 and 7.9 percent (midpoint 7.3) at the end of 2007.

Medium Term

Recent turmoil in credit markets of developed countries had adverse effects on global risk appetite. However, the impact on many emerging economies, including Turkey, has so far been quite limited, possibly due to significant measures these countries have taken in recent years towards achieving macroeconomic stability. Easing domestic uncertainties with the completion of general elections and benign expectations on inflation have not only reduced market interest rates but also supported the strength of the domestic currency. Furthermore, downward revision of expectations on global growth indicates a possible slowdown in external demand.

These developments suggest that the composition of growth in the upcoming period may be different than past year, during when economic growth was driven by net exports and government expenditures. We expect that, the contribution of domestic demand conditions to the disinflation process will gradually decline starting from the last quarter of 2007, as private consumption and investment become the main engines of growth. However, cautious stance of monetary policy, coupled with tighter financing conditions and higher credit spreads, is expected to keep the domestic demand under control. Accordingly, our medium term projections envision a continued support from demand conditions to the disinflation process.

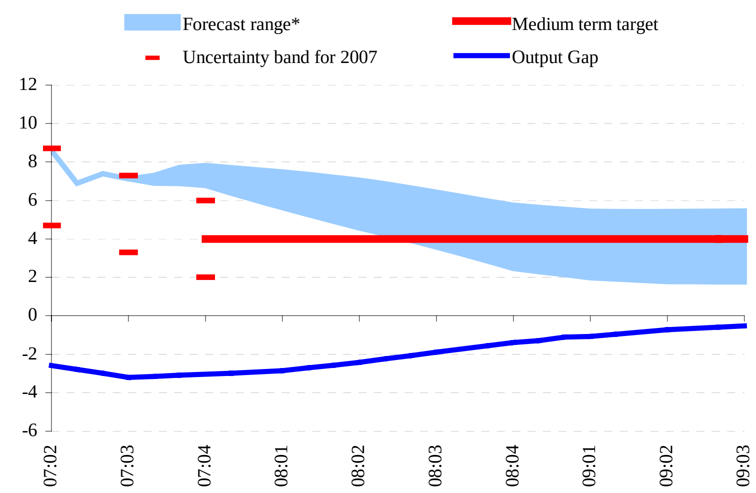
Observing that developments in services inflation were more favorable than expected in the third quarter, we have reduced the degree of inflation inertia embedded in previous forecasts.

As already indicated above, our assumption on oil prices was revised upwards from 65 USD to 70 USD per barrel. Besides, underlying the medium term forecasts are the assumptions that recently announced 2008 budgetary targets will be met and the slowdown in global growth will be gradual, and hence there will be no significant shift in Turkey's risk premium.

The impact of tax increases and administered price hikes on annual inflation will dissappear in about one year. On the other hand, we assumed that food price inflation will gradually correct in the medium run, moving close to the headline inflation. To sum up, we expect the inflationary impacts of factors such as administered prices and tax adjustments to be short lived. Year on year percentage change in CPI excluding exogenous factors such as food, energy, alcohol and tobacco is expected to be close to the 4 percent target starting from the end of the first quarter of 2008.

Considering the outlook presented above and assuming measured rate cuts for the rest of the year and for the first couple of months of 2008 followed by a flat course for some time; inflation is forecast to be between 2.5 percent and 5.7 percent (midpoint 4.1) at the end of 2008, and between 1.7 and 5.5 (midpoint 3.6) at the end of the third quarter of 2009 (Graph 1.2.1).

Graph 1.2.1. Inflation and Output Gap Forecasts



*Forecast range corresponds to the 70 percent confidence interval.

Therefore, the revision in inflation forecasts compared to the previous Report can largely be explained by administered price hikes, tax adjustments, and initiation of the measured rate cut cycle earlier than expected. September rate cut decision led to a significant decline in both the medium and long-term interest rates. The fall in interest rates is expected to provide some stimulus to the domestic demand reducing downward risks on medium term inflation posed by global economic developments. Accordingly, inflation is expected to stay close to the 4 percent target in one to two year's horizon.

1.3. Risks and Monetary Policy

The term "monetary policy stance" refers not only to the current level of the short term interest rates but also to the possible future path of policy rates. The policy path assumption underlying the medium term projection is based on the current data set and thus it should be subject to revision as new information arrives. In other words, unexpected developments on the inflation outlook will lead to a change in the monetary policy stance. Therefore, the assumption about the policy path should by no means be perceived as a commitment of the CBRT. A deviation of actual interest rate developments from the assumed path must be perceived as the norm rather than the exception. In this respect, the policy path underlying the above forecast should not be perceived as a commitment for uninterrupted rate cuts in the following months. Depending on the incoming information, the policy rate may follow different paths: For example, it may remain constant in the near term, or it may decline faster or for a longer period time than indicated above.

September rate cut is a case in point. Recall that underlying the forecasts in July Inflation Report was an assumption which envisaged measured rate cuts starting from the beginning of the last quarter. The following statement in the July Report made clear that this assumption on policy path is not a commitment: "*... rate cuts can be considered earlier as well as later depending on the flow of incoming information regarding external demand, public expenditures and other determinants of medium term inflation outlook*". Indeed, the Committee—citing the downside risks on domestic as well as external demand conditions posed by recent developments in credit markets of developed countries, and pointing to better than expected developments in services inflation—decided to initiate the measured rates cuts one month before the last quarter.

Main risks to the inflation and monetary policy outlook can be summarized as follows:

The CBRT closely monitors the developments in international liquidity conditions and credit markets. As of today, a sharp slowdown on global economic growth is not perceived as the most likely scenario, leading to continued capital flows to emerging markets. However, that the risks in the financial markets have not yet been adequately priced necessitates caution. The CBRT, in case of a heightened risk aversion and a decline in risk appetite towards emerging financial markets, will aim at limiting the effects of possible market fluctuations on inflation outlook by pursuing an active liquidity management strategy as well as by utilizing other policy instruments if needed.

Recent volatility in credit markets has partially offset the upside risks to the aggregate demand outlook mentioned in the previous Report. However, there are some remaining risks to the demand outlook. On one side, the extent to which the recent decline in longer term rates will stimulate the domestic demand is yet to be observed. On the other side, a sharper-than-envisaged slowdown in global growth will ease both the external demand and, through the tighter credit conditions, the domestic demand. The CBRT will monitor the financing conditions and credit developments closely in the face of upside and downside risks. If credit conditions turn out to be more favorable than expected and the domestic demand accelerates, this may lead to a more cautious policy stance than implied by the baseline scenario, as well as the use of policy tools other than short term interest rates, such as required reserves and alike. Likewise, materialization of downside risks would lead to an adjustment in the policy stance so as to contain the downside risks on inflation.

The medium term projections are based on the assumption that the government expenditure targets will be met in 2008. Any deviation from this assumption may have an effect on inflation outlook and monetary policy stance. The fact that government incomes policy will be set in line with inflation targets will facilitate the management of demand and inflation expectations. On the other hand, the fact that efforts to readjust the primary budget balance are more focused on increases in indirect taxes as opposed to expenditure cuts poses a risk to the predictability of inflation.

The sustained rise in food prices is considered as an important risk to the inflation outlook. Our medium term projection envisages a gradual correction in which food inflation converges to headline inflation in the medium term. However, low crop yields in 2007 and recent global trends have increased upside risks to the food inflation. On the other hand, past cumulative hikes have created a high base in food prices, increasing the possibility of a downward adjustment. Potential volatility in food prices continue to pose risks to the inflation outlook on both sides, since food prices constitute a large fraction of the CPI index. The CBRT will not react to the developments in food prices as long as the second round effects are contained.

There are some uncertainties over the medium term impact of the recent developments in energy prices. It is likely that there will be a sizeable increase in electricity prices in the near term. The price of water, classified as an energy item in the CPI, may also display a significant rise in the last quarter of 2007, although the rate of increase may differ across regions. Moreover, international crude oil prices have continued its upward course. Medium term impact of the rise in energy prices on inflation will be limited, as long as the inflation expectations and the price setting behavior remains intact. However, since the energy price is an important factor of production, it should also be added that recent developments in energy prices have compelled the CBRT to be relatively more cautious. On the other hand, switching to a cost-based automatic pricing mechanism in electricity would reduce the risks on shortage of supply as well as on price stability.

Turkey has taken significant steps towards price stability in recent years. However, it is not yet possible to define the current state as price stability. The CBRT will continue to exercise its policy instruments to attain price stability and thus to improve welfare of the society in the medium term. During this process, it is particularly important not to sacrifice long term permanent gains in favor of temporary benefits.

The support of fiscal policy and structural reforms are also critical in achieving price stability. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be important. Particularly, advances in structural reforms that would enhance the quality of fiscal discipline are monitored closely with regard to their implications on macroeconomic and price stability.

2. International Economic Developments

2.1. Economic Performance and Monetary Policy Developments

The US economy grew at an annual rate of 1.9 percent in the second quarter of 2007 up from 1.5 percent in the first quarter (Table 2.1.1). The Federal Reserve (Fed) decided to lower the federal funds rate by 50 basis points at its meeting on September 18 considering the negative impact of the financial contraction due to the developments in the subprime loan market on growth performance. The Fed also noted that although readings on core inflation have improved modestly this year, there still remains some risk, and domestic demand conditions are relatively benign, therefore future policy adjustments would depend on the outlook for both inflation and economic growth.

Table 2.1.1. Growth Rates
(Annual Percentage Change)

	2006	**2007***	2006-III	2006-IV	2007-I	2007-II	**2007-III***
World	5.4	**4.9**	-	-	-	-	
USA	3.3	**2.0**	2.4	2.6	1.5	1.9	**2.2**
UK	2.8	**2.9**	3.0	3.1	3.0	3.0	**2.8**
Asia-Pacific							
Japan	2.2	**2.0**	1.5	2.4	2.6	1.7	**2.5**
China	10.7	**10.0**	10.7	10.7	11.1	11.5	
E. Europe	6.0	**5.5**	-	-	-		
Latin America	5.5	**4.9**	-	-	-		
Eurozone	2.9	**2.6**	2.8	3.3	3.2	2.5	**2.6**
Germany	2.9	**2.6**	3.2	3.9	3.6	2.5	**2.5**
France	2.2	**1.8**	2.1	2.1	1.9	1.3	**1.9**
Italy	1.9	**1.8**	1.6	2.8	2.3	1.8	**1.9**

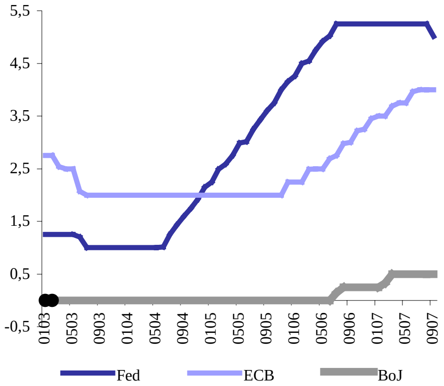
* Forecast.
Source: Consensus Forecasts, Eurostat, World Economic Outlook.

The US current account deficit narrowed in the second quarter of 2007 as compared to the first quarter, being 5.5 percent of the Gross Domestic Product (GDP). A relatively robust global demand and the weaker US dollar signify to the declining trend of the current account deficit, which is perceived as a favorable development in terms of global economic balances.

In the second quarter, Euro area grew by 2.5 percent compared to the same quarter of 2006 and by 0.3 percent with respect to the previous quarter, largely on the back of investments. Although consumer and business confidence indicators dropped in the face of financial market volatility in August, the fact that these indicators remain above their historical averages points to ongoing sustained growth during the second half of 2007. Moreover, loans to households and non-financial corporate sectors continue to grow strongly despite tight financing conditions. On the other hand, increased corporate profits and lower unemployment rates support the expectations for continued domestic demand-led GDP growth. However, the relatively increased uncertainty in world financial markets adds to the downside risk to euro area growth.

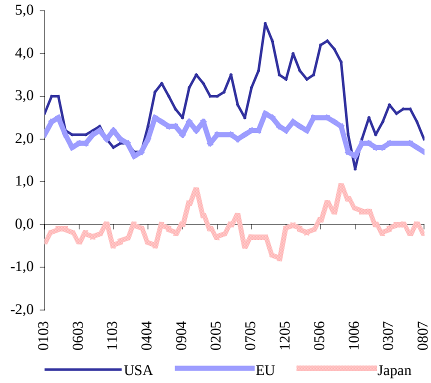
Euro area Harmonized Index of Consumer Prices (HICP) inflation has been moderate since early 2007 thanks to the base effect from last year's high oil prices, but it may pick up again over the remainder of the year and into 2008 due to the recent surges in oil prices (Graph 2.1.2). Forecasts suggest that euro area inflation will be more than 2 percent on average in 2008 due to limitations on capacity utilization and tight labor market conditions. Moreover, unanticipated increases in indirect taxes and administered prices, probable rises in food and oil prices, higher-than-expected wage increases and possible price hikes in non-competitive markets exert an upward pressure on euro area inflation.

Graph 2.1.1. Policy Rates
(Percent)



Source: ECB, BoJ, Federal Reserve Bank of New York

Graph 2.1.2. Inflation Rates
(CPI, Annual Percentage Change)



Source: Statistics Bureau of Japan, Eurostat, US Department of Labor, Bureau of Labor Statistics.

In October, the European Central Bank (ECB) emphasized the risks to the outlook for growth and decided not to change the key interest rates, but also noted that the risks to inflation over the medium-term remained on the upside. The ECB also added the importance of new data for upcoming monetary policy decisions given the uncertainty resulting from financial market volatility.

Japan's economy grew at an annual rate of 1.7 percent in the second quarter of 2007, down by 0.3 percent from the preceding quarter (Table 2.1.1). The uncertainty over Japan's economic outlook driven by declining housing investments and industrial production might intensify the turmoil in the world financial markets.

Against this background, the Bank of Japan (BoJ) left its overnight rate unchanged at 0.5 percent in the first half of 2007 to have more effectively operating money market (Graph 2.1.1), but raised its lending rate to 0.75 percent, widening the spread between these two rates to 0.25 points.

Consumer prices in Japan went down by 0.1 percent in the first and the second quarters of 2007. Falling prices of furniture and household utensils might further reduce consumer prices by 0.2 percent in the third quarter. On the other hand, both the continued weakness in industrial production and the expected bounce back in consumer spending driven by the falling unemployment rate put upward pressure on consumer prices (Graph 2.1.2).

After China's annual inflation rate hit 6.5 percent in August, the People's Bank of China raised its interest rate by 0.27 percent in September. China's inflation hit a 10-year high on the back of surging prices of food, which accounts for 37 percent of the consumption basket, and crude oil. Yet, thanks to the rate hike, China's yield curve continued to have a relative advantage over other countries. Therefore, it is quite likely that larger amounts of capital will flow into the country despite capital controls, and the remninbi will appreciate against other currencies. Moreover, both the price competition in the domestic market and the labor surplus are expected to stabilize price increases.

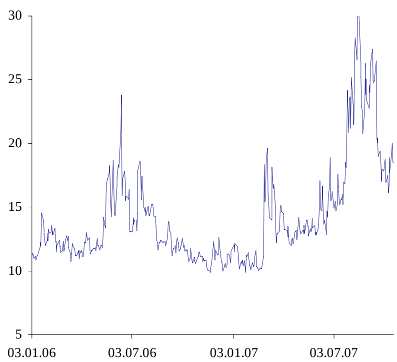
The Chinese economy continued to expand at a robust rate during the second quarter (11.5 percent). The main source of this rapid growth in recent years has been the strong performance of investments and exports. Investments will continue to grow in upcoming years as long as low-cost credits are available and the government fails to control investment demand. However, appreciation of the remninbi, increasing labor and land prices, reduced foreign demand, and abolitions and reductions to the export Value Added Tax (VAT) refund rate for certain items will possibly lower the export, reducing the growth rate to 10.0 percent and 9.2 percent in 2008 and 2009, respectively.

2.2. International Markets

2.2.1. Financial Markets

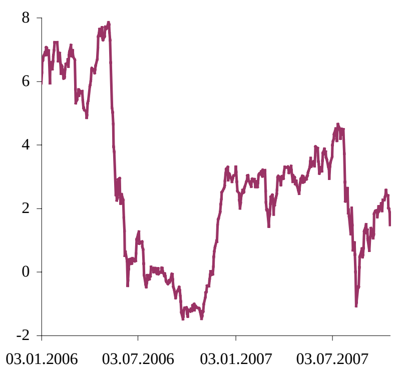
Global financial markets have been volatile due to the weakness in the US housing market and the resulting tight credit and liquidity conditions. The volatility has deepened due to the factors that the European institutions hold significant shares in these markets, credit derivatives trades between banks and hedge funds are not disclosed to investors, and a spate of bad news piled up. Yet, Fed's and ECB's decisive approach through liquidity pump and interest rate decisions have provided relative stability in the financial markets and restored some risk appetite.

Graph 2.2.1. VIX Index



Source: Bloomberg.

Graph 2.2.2. Credit Suisse Global Risk Appetite Index

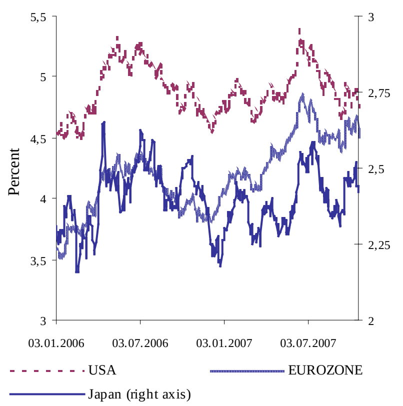


Source: Credit Suisse.

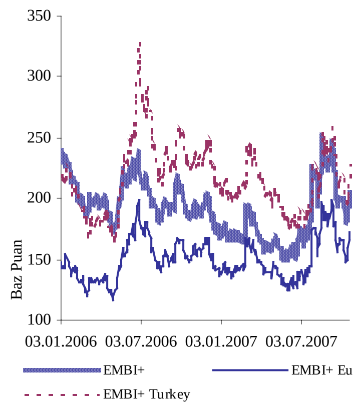
Ultimately, the risk appetite, as measured by the Credit Suisse Global Risk Appetite index (CSRA) and the VIX index, fell dramatically, but Fed's larger-than-expected rate cut at its September 18th meeting gave a boost to the risk appetite. Nevertheless, both indices reached only their historical means, indicating a greater risk perception compared to the first half of the year (Graph 2.2.1, Graph 2.2.2).

As regards the interest rate movements in developed economies, the first thing to note is the increased volatility in money market rates. Interest rates were up in August although the ECB and the Fed injected liquidity to the markets, and the three-month Libor rates for USD and EUR rose by around 40 and 50 basis points, respectively. Bond yields, on the other hand, have fallen significantly as investors sought a safe haven. 30-year US Treasury bond yields declined by 80 basis points from June to September. In the face of increasing concerns over inflation due to the Fed rate cut and the unchanged ECB rate as well as rising risk appetite, there has been some capital outflow in the bond market since late September (Graph 2.2.3).

Graph 2.2.3. Developed Countries Bond Yields (30-year)



Graph 2.2.4. EMBI+ Developments

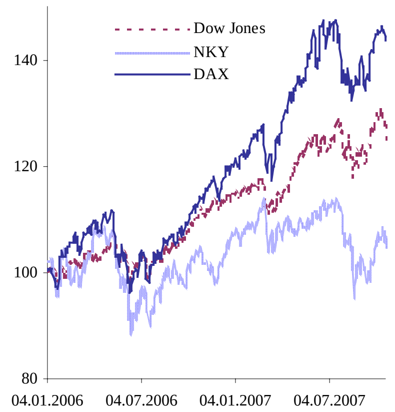


Source: Bloomberg.

While the financial market volatility weakened the demand for investment assets in the emerging markets, decline in the US bond yields due to investors' seek for safe heaven further widened the yield spreads between emerging market bonds and the US notes. The Emerging Markets Bond Index (EMBI+) widened to as much as 251 basis points in mid-August from a historic low of 149 basis points on June 1, 2007. The spread between EMBI+ Turkey sub-index and EMBI+ Index has barely changed for the past three months, moving to 24 basis points on October 19th (Graph 2.2.4).

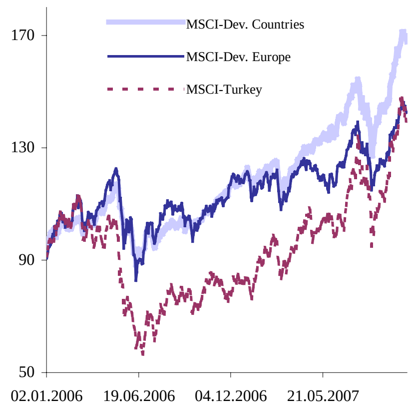
The first-half upsurge in stock markets has also reversed. The Nikkei stock index plunged the most due to Japan's trade relations with the USA. The recovery in investor risk appetite bolstered stock markets, with Dow Jones and DAX being the most remarkable, which resumed their pre-volatility levels (Graph 2.2.5). Emerging Markets, Emerging Europe and Turkey sub-indices of the Morgan Stanley Capital Index (MSCI) displayed a similar pattern and exceeded their pre-volatility levels in October. These indices, however, yielded lower returns in local currency terms. Accordingly, from August 16 to October 19, the increase in MSCI Emerging Markets index was 32 percent in US dollar terms and 26 percent in local currency terms (Graph 2.2.6).

Graph 2.2.5. Developed Countries Stock Market Developments (2006 January=100)



Source: Bloomberg.

Graph: 2.2.6. Emerging Market Countries Stock Market Developments (2006 January=100)

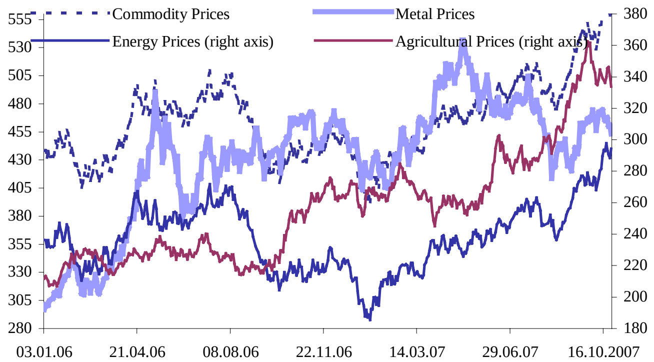


Source: Morgan Stanley.

2.2.2. Commodity Markets

The third-quarter average for the Goldman Sachs (GS) Commodity Index increased by 6.6 percent over the second quarter average and by 7.6 percent compared to the third quarter of 2006, mainly on the back of changes in the GS Energy and GS Agriculture sub-prices (Graph 2.2.7).

Graph 2.2.7. Commodity Prices



Source: Goldman-Sachs.

The third-quarter average price of six basic metals traded on the London Metal Exchange (LME) was up 3.6 percent compared to a year earlier, but down 18.5 percent from the second quarter (Table 2.2.1). Recently, the surplus in aluminum and nickel supply resulting from a marked production growth has helped increasing their inventories at a rapid pace. Moreover, although copper production has also recently grown significantly, trend of the soared copper prices in the upcoming period has become dependent on the developments in global financial markets, growth rate of US and foreign trade data from China, world's second largest copper consumer. Similarly, LME inventories also give a clear picture of the direction of basic metal prices (Table 2.2.2).

Table 2.2.1. London Metal Exchange (LME)

Tons / USD	Value				Percentage (change)		
	2006*	2007-Q2*	2007-Q3*	October 19th	07-Q3/07-Q2	2007-Q3 / 2006-Q3	October 19th / 2007-Q2
Aluminum	2.595,2	2.801,87	2.610,00	2.557	*-6,8*	*3,1*	*-8,7*
Copper	6.678,8	7.578,23	7.624,23	7.780,00	*0,6*	*0*	*2,7*
Lead	1.281,8	2.104,58	3.093,94	3.705,00	*47*	*159*	*76,0*
Nickel	23.223,3	45.701,15	30.324,92	32.250,00	*-33,6*	*14,3*	*-29,4*
Tin	8.747,4	13.980,08	14.975,23	16.300,00	*7,1*	*73,7*	*16,6*
Zinc	3.248,0	3.679,44	3.221,03	3.955,00	*-12,5*	*-4,1*	*-7,5*

* Period averages.
Source: Bloomberg.

International crude oil prices that have been on the rise since early 2007 hit a historic peak of 85.8 US dollar per barrel on October 18 (Graph 2.2.8). While concerns over an ongoing turmoil in US credit markets persist, falling US crude oil supplies (Table 2.2.2), expectations for a continued global growth on the background of strong macroeconomic indicators from US and a forecast of a more intense hurricane season than last year have all driven crude oil prices to all-time highs lately. Furthermore, according to the International Energy Agency (IEA), last year's winter and hurricane season had been quite mild, and production cuts may put an upward pressure on crude oil prices if temperatures return to long-term averages in the coming months.

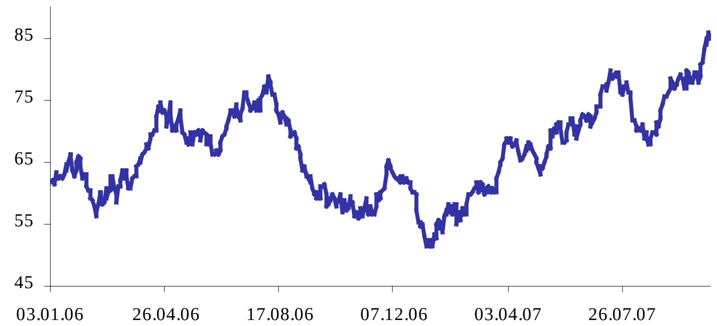
Table 2.2.2. Basic Metals and Crude Oil Stock Values*

	2004-2005	2006				2007			
	Average	January	Nov.	Dec.	Average	January	July	Sept.	Oct.**
Copper	106.004	100.517	151.014	170.626	118.951	211.825	101.705	130.775	148.950
Aluminum	781.241	672.505	680.381	680.645	723.079	736.875	838.800	938.625	932.650
Nickel	13.477	36.412	7.012	6.560	17.368	3.972	13.980	32.442	36.534
Tin	6.984	16.674	12.411	13.232	13.187	11.400	13.665	14.155	12.865
Zinc	636.348	383.176	93.666	86.967	219.489	97.675	65.875	61.350	60.275
Lead	50.162	50.781	45.630	41.076	76.151	39.050	22.275	22.150	33.450
Crude Oil	1.644,50	1.701,70	1.743,64	1.720,14	1.726,62	1.727,48	1.724,65	1.714,22	1.709,58

* Thousand tons for basic metals from LME, thousand barrels for crude oil from US stock levels.
** Basic metal and crude oil stock values as of 19 October.
Source: Bloomberg.

Although the Organization of the Petroleum Exporting Countries (OPEC) decided to raise production quotas by 0.5 million barrels effective by November 1, at its meeting on September 11, international crude oil prices have surged in response to recently falling US crude oil supplies. In other words, despite the global housing crisis, the fact that global growth has not slowed down contrary to expectations leaves crude oil markets vulnerable to supply shocks. In the upcoming period, the main sources of risk to oil prices would be a possible increase in the demand for crude oil depending on global growth and a more severe winter and hurricane season.

Graph 2.2.8. Crude Oil Prices
(US Dollars/Barrel)



Source: Bloomberg.

Bloomberg provides data on future commodity prices by gathering forecasts from 21 investment agencies. The consensus forecasts suggest that average prices for aluminum and crude oil will follow a steady course, while those of copper and nickel will rise in the last quarter of 2007 and the first quarter of 2008. Forecasts for fourth-quarter crude oil prices remain well below spot prices, but the “Consensus Forecasts” for October 2007 suggest that end-January 2008 crude oil prices will be around 72.3 US dollar per barrel.

Table 2.2.3. Consensus Forecasts for Main Commodity Prices

	2007-III			2008-IV			2008-I			2008-II		
	Average	**Min.**	**Max.**	**Average**	**Min.**	**Max.**	**Average**	**Min.**	**Max.**	**Average**	**Min.**	**Max.**
Gold	705	630	750	700	615	780	687	600	770	683	575	780
Aluminum	2550	2150	2850	2533	2094	2925	2573	2275	2950	2575	2200	2975
Copper	7262	5350	8500	7473	6500	9250	7258	5960	9500	7021	5675	9750
Nickel	32006	16000	39000	33053	29600	37000	32802	28000	38000	30427	25000	38500
Zinc	3298	2450	3810	3160	2550	3850	3086	2225	3900	2930	1925	3950
Wheat	664.87	860.00	500.00	-	-	-	-	-	-	-	-	-
Corn	374.32	354.00	415.00	-	-	-	-	-	-	-	-	-
Crude Oil	68.45	55.00	77.90	67.16	55.00	85.00	67.24	51.50	80.00	68.26	51.50	90.00

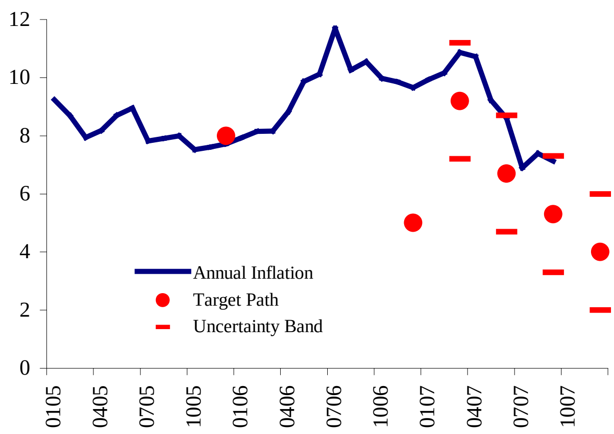
Source: Bloomberg.

3. Inflation Developments

3.1. Inflation

Annual consumer inflation slowed to 7.12 percent in the third quarter. As we noted in our previous reports, the second-quarter downtrend in inflation spilled over into the third quarter. Consumer prices rose by 0.31 percent, the lowest quarterly rate in the 2003 based CPI. Although food prices have been rising at a higher rate than previous years, inflation continued to trend downward as strong monetary tightening put pressure on services and durable goods, and annual inflation remained within the uncertainty band (Graph 3.1.1).

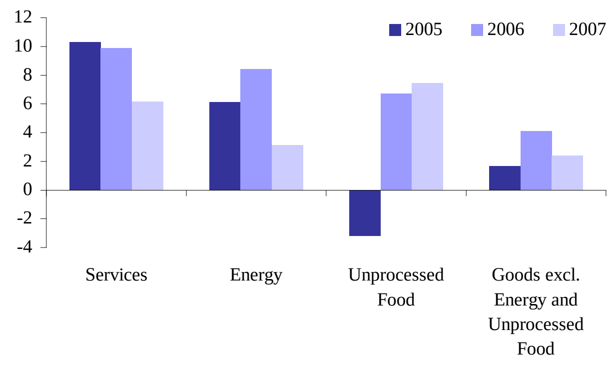
Graph 3.1.1. Target Path and Annual CPI Inflation
(Annual Percentage Change)



Source: TURKSTAT.

Over the first nine months of the year, services inflation rate was considerably lower than previous years (Graph 3.1.2). Similarly, energy prices increased at a lower rate than previous years during the same period, but the run-up in unprocessed food prices gained momentum. The nine-month increase in prices of goods excluding energy and unprocessed food lagged behind its year-ago level, despite the rapid rise in processed food prices.

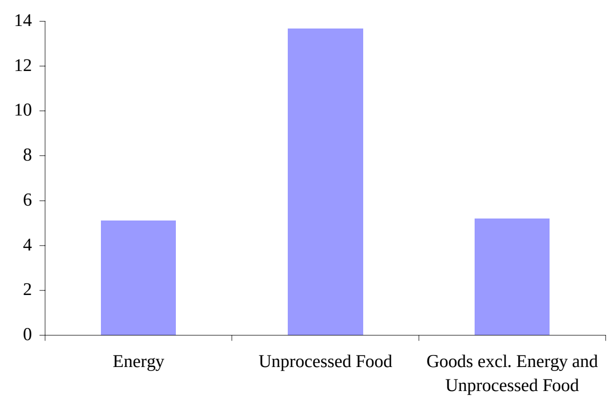
Graph 3.1.2. Consumer Prices
(Nine Months Cumulative Percentage Change)



Source: TURKSTAT, CBRT.

Unprocessed food prices rose 13.69 percent on an annual basis in the third quarter, surpassing other items of goods (Graph 3.1.3). After a sharp first-quarter increase and a partial second-quarter correction, unprocessed food prices started to soar again in the third quarter, recording the highest third-quarter rise in 2003 based index mainly on the back of surging fresh fruit and vegetable prices. The third-quarter increase in fresh vegetable prices that averaged 13.55 percent for the past three years was 27.43 percent in 2007. Recently, warmer temperatures and changing supply conditions have hindered the predictability of the group's prices. Given the fact that food prices will climb in the fourth quarter as part of a typical seasonal pattern, the food component might continue to have a strong influence on consumer price index in the short run.

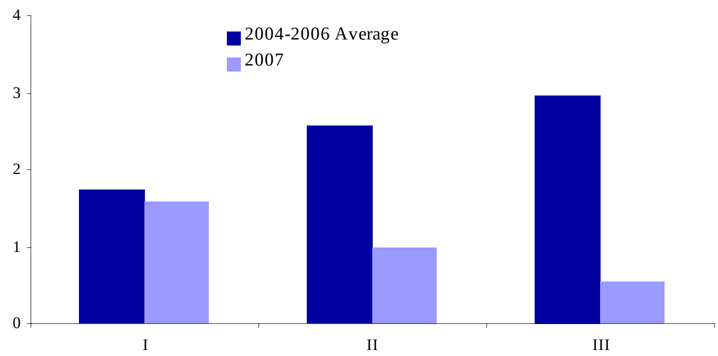
Graph 3.1.3. Goods Prices
(Annual Percentage Change, September 2007)



Source: TURKSTAT, CBRT.

Energy prices continued to follow the positive trend that prevailed throughout 2007 in the third quarter (Graph 3.1.4). The group's prices rose by a cumulative 3.16 percent over the first three quarters of the year, pushing the consumer inflation rate lower (Graph 3.1.2). The strengthening of the Turkish lira in the third quarter eased the impact of soaring world oil prices on domestic fuel prices. Yet, high and volatile oil prices still remain a risk to the outlook for the upcoming periods.

Graph 3.1.4. Energy Prices
(Quarterly Percentage Change)



Source: TURKSTAT, CBRT.

Table 3.1.1. Goods and Services Prices
(Quarterly Percentage Change)

	2006				2007		
	II	III	IV	Annual	I	II	III
CPI	**3.58**	**1.69**	**2.81**	**9.65**	**2.36**	**1.47**	**0.31**
1. Goods	**3.67**	**0.88**	**3.10**	**8.69**	**2.39**	**1.18**	**-0.11**
Energy	4.94	0.69	1.92	10.52	1.58	1.00	0.55
Unprocessed Food	-3.67	1.83	5.81	12.94	11.74	-5.93	2.23
Goods excl. Energy and Unprocessed Food	5.54	0.67	2.70	6.93	-0.10	3.56	-1.01
Durable Goods	8.69	1.34	-1.58	6.61	1.23	-1.73	-1.15
Durable Goods (excl. Gold)	5.40	2.84	-2.20	2.78	1.13	-1.36	-1.60
Semi-Durable Goods	9.14	-2.14	4.75	7.81	-3.37	7.43	-3.50
Non-Durable Goods	-1.12	3.01	3.04	9.82	6.75	-2.07	2.52
2. Services	**3.36**	**3.83**	**2.09**	**12.21**	**2.29**	**2.28**	**1.50**
Rent	3.69	6.67	4.25	20.01	3.94	3.33	4.56
Restaurant and Hotels	4.25	3.40	2.24	13.54	2.60	1.94	2.27
Transport Services	1.36	6.26	3.50	12.89	0.10	1.70	2.10
Other Services	3.32	2.32	0.76	8.45	2.10	2.19	-0.36

Source: TURKSTAT, CBRT.

Prices of goods excluding energy and unprocessed food fell 1.01 percent in the third quarter, reporting an improved outlook compared to the same period in previous years (Table 3.1.1). Favorable prices of durable goods, clothing and footwear were the main source of downward pressure on the group's inflation rate, but prices of processed food went up as high as they did last year.

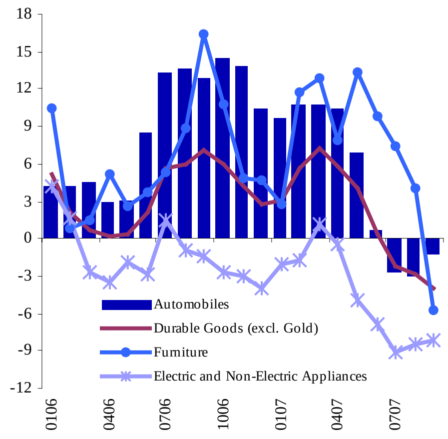
Table 3.1.2. Durable Goods Prices
(Quarterly Percentage Change)

	2006				2007		
	II	III	IV	Annual	I	II	III
Durable Goods (excl. Gold)	**5.40**	**2.84**	**-2.20**	**2.78**	**1.13**	**-1.36**	**-1.60**
Furniture	7.45	9.21	-3.17	4.74	-0.60	4.50	-6.34
Electric and Non-Electric Appliances	4.51	-0.54	-2.25	-4.03	-0.52	-3.75	-1.80
Automobiles	7.09	2.57	-2.28	10.48	3.22	-2.74	0.71
Other Durable Goods	-1.86	1.43	0.91	-0.73	0.82	1.09	-0.52

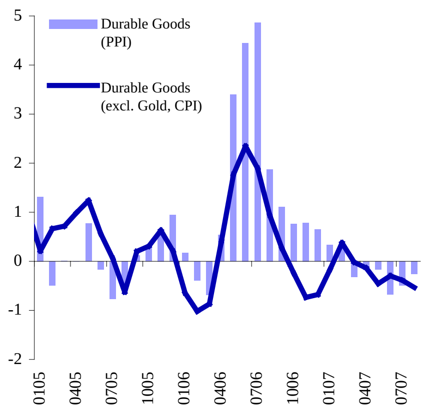
Source: TURKSTAT, CBRT.

The lagged effects of monetary tightening continue to put pressure on prices of durable goods. Annual inflation in prices of durable goods (excluding gold) stood at –4 percent at the end of the third quarter (Graph 3.1.5). Except for automobiles, prices of all sub-items went down and helped brighten the outlook as a whole (Table 3.1.2). Particularly, prices of electric and non-electric appliances have been on a steady decline since the third quarter of 2006. The third-quarter 2007 data on sales of white goods and automobiles suggest some recovery in the demand for consumer durables, while producer prices remain in check thanks to the continued strengthening of the New Turkish lira (Graph 3.1.6).

Graph 3.1.5. Durable Goods Prices
(Annual Percentage Change)



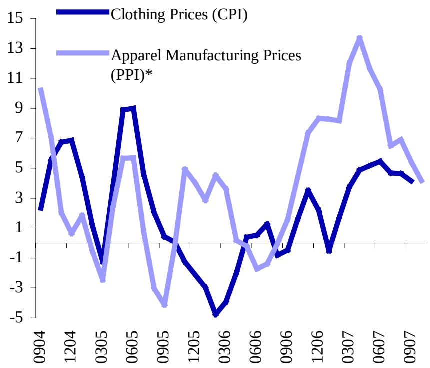
Graph 3.1.6. Durable Goods Consumer and Producer Prices
(Monthly Percentage Change, Three Months Moving Average)



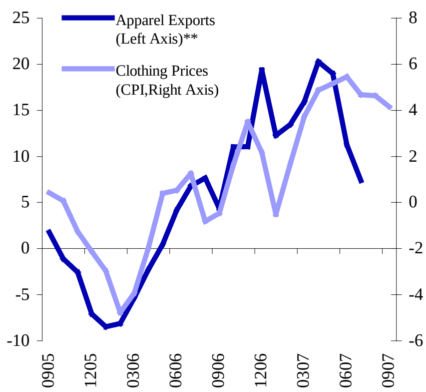
Source: TURKSTAT, CBRT.

After a gradual increase in the first half of the year, the annual inflation in clothing and footwear slowed in the third quarter. The annual rate of increase in group's prices fell to 5.19 percent in September. Hikes in apparel manufacturing prices have recently moderated (Graph 3.1.7). Moreover, the strong performance of apparel exports reversed in the third quarter, thereby further lowering the inflation rate for clothing (Graph 3.1.8).

Graph 3.1.7. Clothing and Apparel Manufacturing Prices
(Annual Percentage Change)



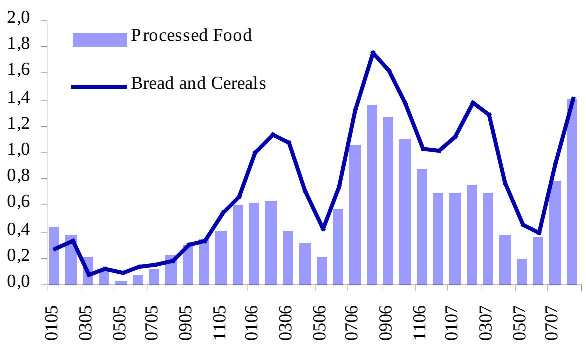
Graph 3.1.8. Clothing Prices and Apparel Exports
(Annual Percentage Change)



* Moved forward by 2 months after taking two months moving average of apparel manufacturing annual inflation.
** Three months moving average of annual rate of increase in apparel exports.
Source: TURKSTAT

Processed food prices rose as high as 4.26 percent in the third quarter, but the annual price growth remained flat at 10 percent due to the high base from a year earlier. It is well-known that rising bread and grain prices significantly drove up processed food prices over the past eighteen months (Graph 3.1.9). During the first nine months, bread and grain prices increased by 10.11 percent, while the rest of the processed food group saw a price increase of 5.31 percent. This was mainly due to low crop yields resulting from unusually high temperatures and lack of rainfall. In parallel with these developments, food production and agricultural prices remained elevated, and cost pressures continued to be a challenge for food prices in the third quarter.

Graph 3.1.9. Processed Food and Bread-Cereals Prices
(Monthly Percentage Changes, Three Months Moving Average)



Source: TURKSTAT, CBRT.

In sum, as frequently referred to in our previous reports, temperatures above seasonal norms have adversely affected food prices over the past eighteen months. The prospects for 2007 that suggest more losses in crop production (Table 3.1.3) strengthen the belief that risks to food prices remain of great concern.

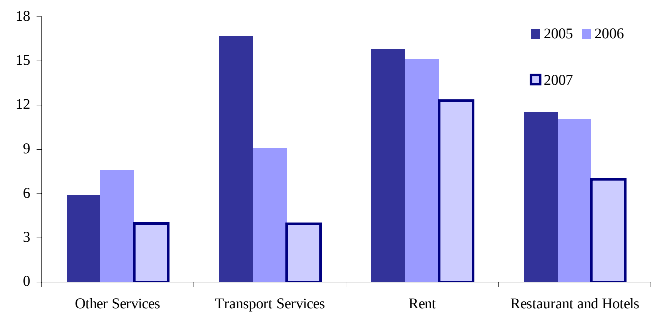
Table 3.1.3. 2007 Plant Production Forecasts and Agricultural Sector Value Added
(Percentage Change Compared to the Same Period Last Year)

	2007 Plant production Forecasts	2007 Agricultural Sector Gross Value Added 1. Quarter	2. Quarter
Cereals	-12.8	0.0	-14.5
Pulses	-6.5	0.0	-6.7
Vegetable	-2.9	-0.1	-1.1
Fruit	0.1	-1.4	10.8

Source: TURKSTAT.

Services inflation continued to slow down at a fast pace in the third quarter, which was not limited to certain sub-items but the entire services group. When compared to the previous years, services prices have clearly moderated in the first nine months (Graph 3.1.10). The third-quarter trend is of particular significance. The average third-quarter increase, which was 4.0 percent during the 2004-2006 period, reduced to 1.5 percent in 2007 (Table 3.1.1). As a result, annual services inflation decreased by 2.5 basis points in this quarter.

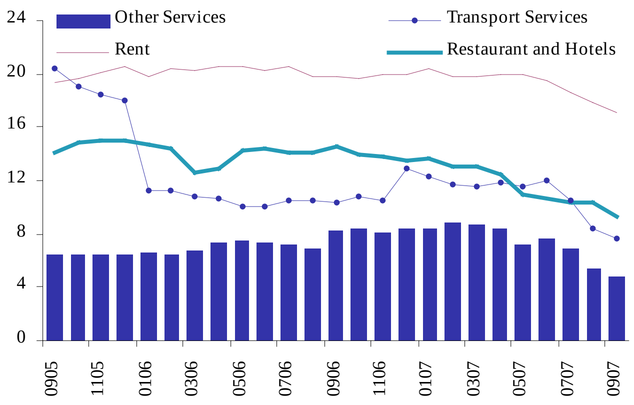
Graph 3.1.10. Services Prices
(Nine Months Cumulative Percentage Change)



Source: TURKSTAT, CBRT.

The most remarkable price development in the third quarter was the downturn in rents. The annual rent increase dropped to 17 percent in September, from 20 percent in the last two years (Graph 3.1.11). This downtrend is very affirmative though the annual rate of increase still appears to be on a high level considering the contribution of rents to overall inflation.

Graph 3.1.11. Services Prices
(Annual Percentage Change)



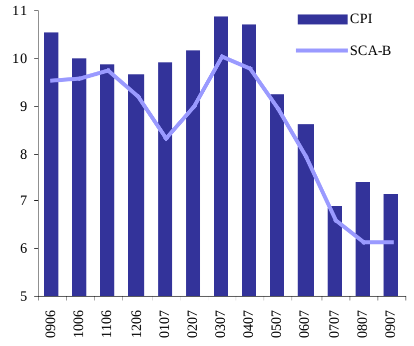
Source: TURKSTAT, CBRT.

Annual inflation in restaurants and hotels fell by 5.1 percentage points from a year earlier. Similarly, recreation-culture, health care and education services also declined in annual terms. Transport services saw a more marked slowdown in the third quarter. Moreover, reduced landline call rates brought communication prices down during the same period.

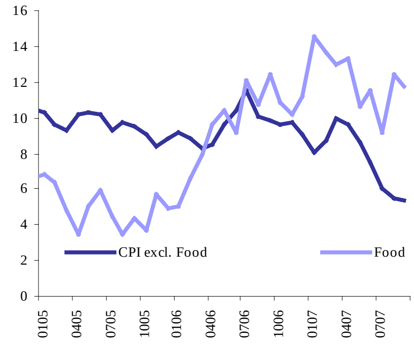
In sum, the pressure on prices of services items, caused by weaker domestic demand associated with strong monetary tightening, became more evident in the third quarter. Services inflation is expected to decline further in the upcoming period.

Ultimately, the annual inflation rate for all special CPI aggregates fell in the third quarter. The indicators excluding unprocessed food saw a marked slowdown, suggesting that the group has an adverse effect on consumer prices (Graph 3.1.12). Recently, both unprocessed and processed food prices have been fluctuating on supply concerns. It is therefore of greater importance that non-food consumer prices are closely monitored to better identify the basic trend of inflation (Graph 3.1.13). Non-food inflation has been on a downward trend for over a year, except the temporary rise between February and March 2007. Food inflation ended at 11.76 percent, in September while non-food inflation dropped to 5.32 percent. Projections for end-2007 suggest that non-food inflation will be consistent with the medium-term target range.

Graph 3.1.12. CPI and CPI excl. Unprocessed Food (SCA-B)
(Annual Percentage Change)



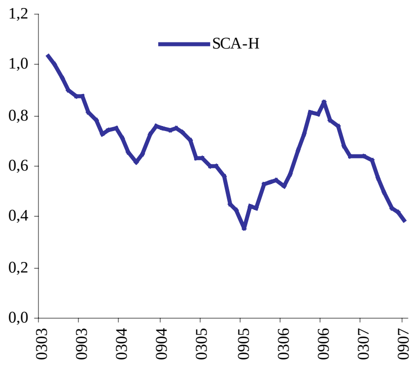
Graph 3.1.13. Food and CPI excl. Food
(Annual Percentage Change)



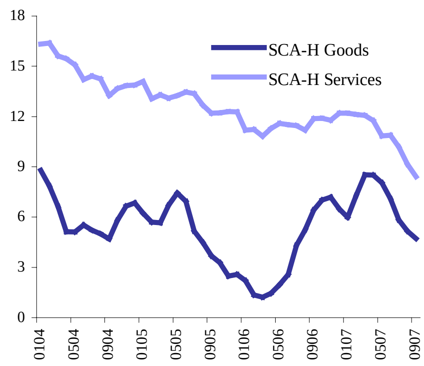
Source: TURKSTAT, CBRT.

The annual inflation in the SCA-H index (special CPI aggregate excluding energy, unprocessed food, alcoholic beverages, tobacco products and gold) has recently displayed a remarkable slowdown, with a total decline of 2.75 percentage points at end-September. The seasonally adjusted monthly increase in the SCA-H index decelerated quite markedly in the third quarter (Graph 3.1.14). According to the current data from the index, the basic trend of inflation is on the downside. Moreover, both goods and services components of the SCA-H index have been falling in annual terms (Graph 3.1.15).

Graph 3.1.14. Seasonally Adjusted SCA-H
(Monthly Percentage Change, Three Months Moving Average)



Graph 3.1.15. SCA-H Goods and Services
(Annual Percentage Change)



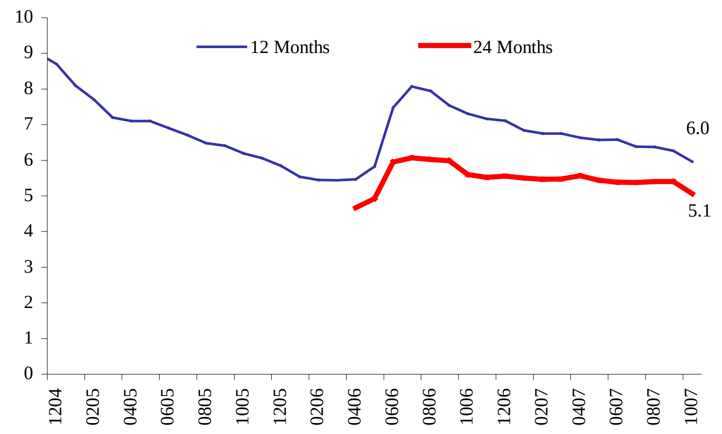
Source: TURKSTAT, CBRT.

3.2. Expectations

The recent downtrend in annual inflation had a limited impact on medium-term inflation expectations. The 12-month-ahead inflation expectations fell to 5.96 percent in October, from 6.84 percent in early 2007, whereas 24-month-ahead expectations have barely improved.

However, as long as inflation remains low, expectations will continue to gradually improve in the upcoming period (Table 3.2.1).

Graph 3.2.1. 12 and 24 Months Ahead Inflation Expectations*
(Annual Percentage Change)



* CBRT Expectation Survey, second survey period expectations.
Source: CBRT.

Medium-term inflation expectations remained nearly unchanged, as measured by their coefficient of variation[1] (Table 3.2.1).

Table 3.2.1. CPI Inflation Expectations

Current Period	Survey period	End-Year*	12 Months Ahead		24 Months Ahead	
			Average Expectation*	Coefficient of Variation	Average Expectation*	Coefficient of Variation
October-06	1	9.96	7.38	0.11	5.80	0.17
	2	9.88	7.31	0.11	5.60	0.15
November-06	1	9.84	7.13	0.08	5.55	0.13
	2	9.85	7.16	0.09	5.52	0.14
December-06	1	9.93	7.23	0.11	5.58	0.13
	2	9.96	7.11	0.07	5.56	0.12
January-07	1	6.98	6.84	0.08	5.43	0.14
	2	7.04	6.84	0.07	5.50	0.13
February-07	1	7.16	6.77	0.08	5.43	0.13
	2	7.13	6.75	0.07	5.47	0.13
March-07	1	7.26	6.83	0.13	5.48	0.12
	2	7.28	6.75	0.10	5.48	0.11
April-07	1	7.44	6.64	0.11	5.54	0.15
	2	7.48	6.63	0.11	5.57	0.14
May-07	1	7.78	6.63	0.14	5.52	0.15
	2	7.84	6.57	0.11	5.44	0.12
June-07	1	7.66	6.47	0.11	5.40	0.14
	2	7.67	6.58	0.13	5.39	0.12
July-07	1	7.44	6.25	0.11	5.30	0.13
	2	7.49	6.38	0.09	5.38	0.11
August-07	1	7.15	6.31	0.12	5.35	0.14
	2	7.16	6.37	0.12	5.40	0.12
September-07	1	7.13	6.27	0.12	5.44	0.13
	2	7.18	6.27	0.10	5.40	0.13
October-07	1	6.97	6.04	0.11	5.25	0.13
	2	6.94	5.96	0.12	5.06	0.11

* 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.

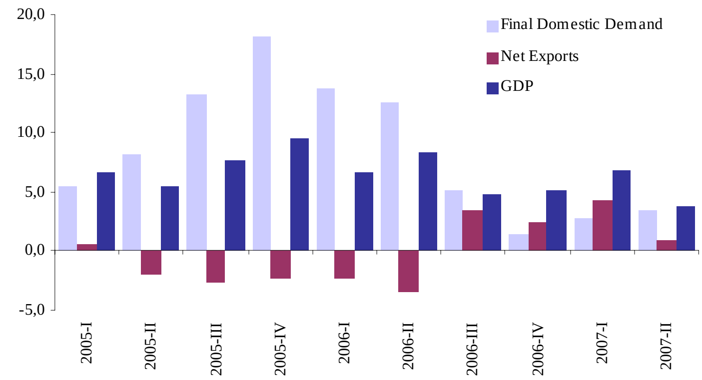
[1] The coefficient of variation, which indicates the deviation of participants' expectations, is the ratio of standard deviation to the mean in a data set with the appropriate mean.

4. Supply and Demand Developments

4.1. Supply-Demand Balance

In the second quarter of 2007, Gross Domestic Product (GDP) expanded by 3.9 percent compared to the same period of the last year. Net foreign demand continued to support growth, albeit at a slower rate than preceding quarters, while the contribution of domestic demand to GDP growth increased (Graph 4.1.1). During this period, public and private investment spending gained momentum and became the main driver of domestic demand growth. Private consumption expenditures, however, decreased on an annual basis, as foreseen in July Inflation Report. The lagged effects of monetary tightening were also observed during this period, particularly in consumer durables, which has been the main component limiting private consumption spending.

Graph 4.1.1. Contributions to Annual GDP Growth
(Percentage Point)



Source: TURKSTAT, CBRT.

An analysis over expenditure items on a seasonally adjusted basis is of critical importance for giving a clear indication of whether domestic demand is on the rebound. Second-quarter GDP data show a decline in the annual growth rate compared to the first quarter, but in seasonally adjusted terms, they clearly point to an upturn in economic activity in the second quarter after a slow-down period that started in mid-2006. In fact, the seasonally adjusted GDP increased by 1.9 percent from the previous quarter. However, excluding the temporarily large contribution of public spending, the quarterly GDP growth data imply a moderate upturn in economic activity. In addition to public investment spending, the most significant change in the first quarter was the accelerating private investment demand for machinery and equipment. Private consumption spending, on the other hand, grew at a modest pace on a quarter-on-quarter basis, the same as in the first quarter. As the recovery in private demand was confined to investment spending, total domestic demand continued to expand moderately in the second quarter.

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

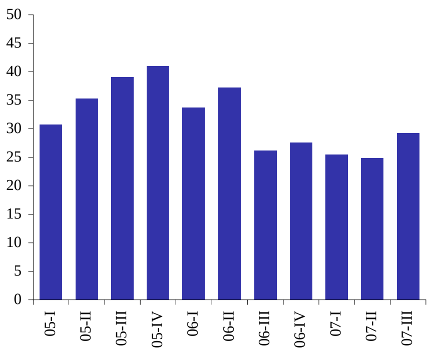
	2005	2006					2007		
	Annual	I	II	III	IV	Annual	I	II	First Half
1- Consumption Expenditures	8.1	8.3	12.2	3.3	0.2	5.6	2.6	0.4	1.5
Public	2.4	10.1	18.3	14.8	0.7	9.6	9.0	7.4	8.1
Private	8.8	8.1	11.5	2.3	0.1	5.2	2.0	-0.3	0.8
Durable Goods.	15.0	12.7	15.9	-8.3	-6.3	2.9	-1.1	-9.3	-5.2
Semi-dur and Non-dur. Goods	12.9	11.8	30.3	19.8	4.2	15.8	1.0	-2.1	-0.6
Food	8.2	6.6	5.5	1.2	0.2	3.1	3.8	3.9	3.9
2- Fixed Capital Formation	24.0	32.1	14.0	11.3	4.4	14.0	3.0	10.0	6.9
Public	25.9	32.8	-11.9	-4.1	1.8	-0.2	9.1	33.9	25.1
Private	23.6	32.1	18.4	15.0	5.6	17.4	2.5	6.9	4.9
Machinery-Equipment	21.4	34.9	15.4	7.2	0.3	13.9	-2.7	5.1	1.5
Construction	29.9	24.1	27.9	29.8	21.6	26.4	18.0	11.9	14.6
3- Changes in Stocks*	-2.5	-4.9	-0.9	-3.8	1.3	-2.1	-0.2	-0.5	-0.4
4-Exports of Goods and Services	8.5	6.8	9.1	11.5	6.2	8.5	14.7	12.7	13.6
5- Imports of Goods and Services	11.5	10.0	13.7	3.6	1.0	7.1	4.3	8.4	6.5
Net Exports*	-1.7	-2.2	-3.5	3.4	2.4	0.3	4.3	0.9	2.5
6- Total Domestic Demand	8.8	8.2	10.6	1.4	2.7	5.6	2.4	2.6	2.5
7- Total Final Domestic Demand	12.1	14.1	12.7	5.3	1.4	8.0	2.7	3.4	3.1
8-GDP (Expenditure Side)	7.4	6.7	8.3	4.8	5.2	6.1	6.9	3.9	5.3

*Contribution to GDP, percent.
Source: TURKSTAT.

Leading indicators for the third quarter signal that the aggregate demand composition shifts toward domestic demand. Current indicators suggest a revival in private consumption demand compared to the previous quarter. According to seasonally adjusted figures, domestic sales of white goods and imports of consumer goods for the July-August period and domestic sales of automobiles for the third quarter grew significantly over the preceding quarter. The third-quarter average of the CNBC-e consumption index exceeds its second-quarter level, and consumer confidence indices confirm the modest recovery in private consumption demand. All these developments are believed to be driven by the relative price effect resulting from the strengthening of the Turkish lira against foreign currencies.

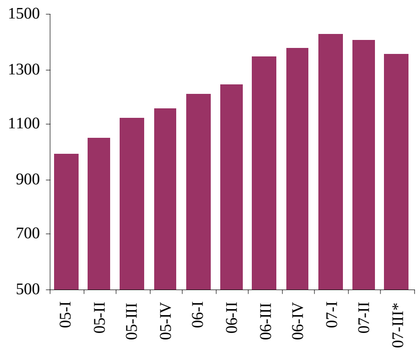
It should be borne in mind that these developments indicate a relative recovery in domestic demand compared to the period of steady slowdown that began in the second half of 2006, and that the restrictive effects of the strong monetary tightening still prevail. In fact, although the quarterly growth rate of real consumer loans have been on the rise compared to previous quarters, it still remains below the period in which domestic demand was more robust. Likewise, domestic sales of automobiles remain below the 2005 level despite the recovery in the third quarter (Graph 4.1.2). Domestic sales of white goods also rebounded but total sales lag behind the recent quarterly levels due to weaker exports (Graph 4.1.3).

Graph 4.1.2. Domestic Sales of Automobiles
(Seasonally Adjusted, Monthly Average, Thousand)



Source: AMA, CBRT.

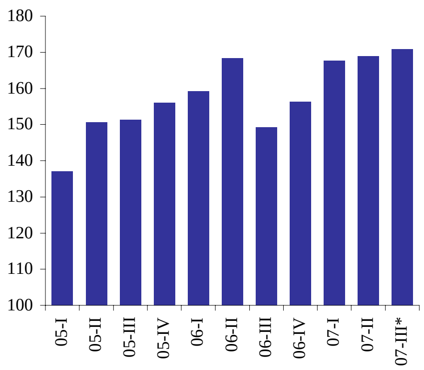
Graph 4.1.3. Domestic Sales and Exports of White Goods
(Seasonally Adjusted, Monthly Average, Thousand)



* July-August period is included.
Source: WGSA,CBRT.

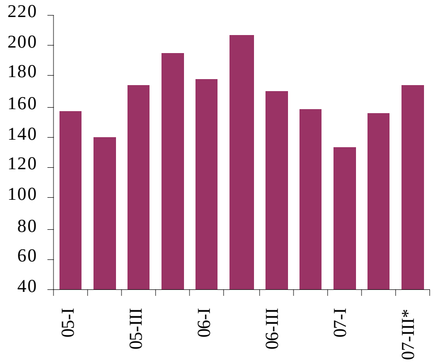
Industrial production figures in August and forecasts for September confirm the moderate growth in domestic production. Indeed, industrial production for the July-August period increased by 5 percent compared to the same period last year, while seasonally adjusted figures based on forecasts for September indicate a slight increase of 1.2 percent over the preceding quarter. As regards sub-sectors which are believed to reflect consumption-related demand conditions, manufacturing of chemicals continues to grow at a reasonable rate, but despite the recent revival, furniture manufacturing remains below the level it reached during the first half of 2006 (Graph 4.1.4 and Graph 4.1.5).

Graph 4.1.4. Chemicals Manufacturing
(Seasonally Adjusted, Quarterly Average, 1997=100)



* July-August period is included.
Source: TURKSTAT, CBRT.

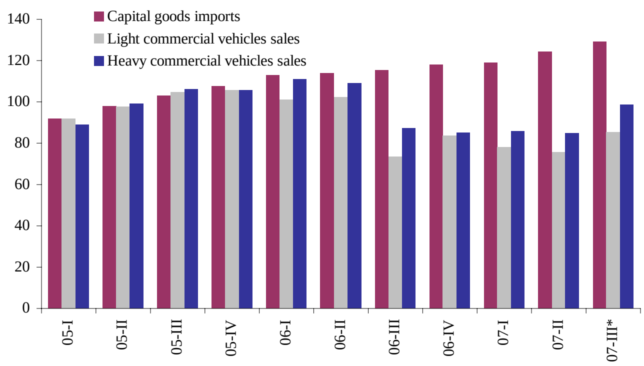
Graph 4.1.5. Furniture Manufacturing
(Seasonally Adjusted, Quarterly Average, 1997=100)



* July-August period is included.
Source: TURKSTAT, CBRT.

Turning to investment demand indicators, the second-quarter acceleration in private investment spending was better represented by imports of capital goods (Graph 4.1.6). Import figures suggest that the upsurge in investments continues in the third quarter. Similarly, domestic sales of commercial vehicles recorded high growth rates during this quarter after a sharp slowdown that began in the second half of 2006.

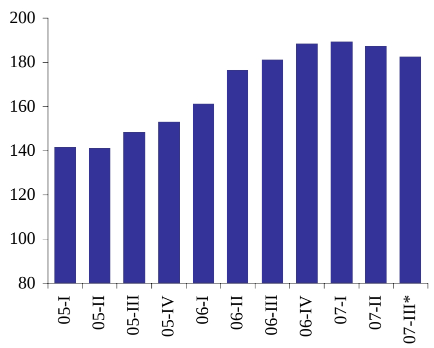
Graph 4.1.6. Imports of Capital Goods and Domestic Sales of Commercial Vehicles
(Seasonally Adjusted, Quarterly Average, 2005=100)



* Imports of capital goods include the July-August period.
Source: TURKSTAT, AMA and CBRT.

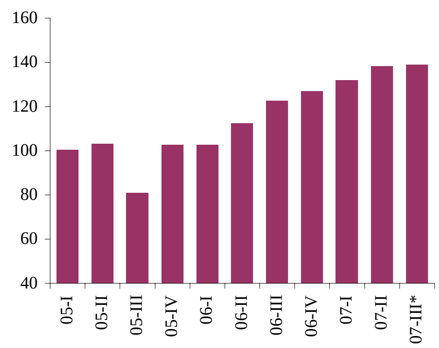
As to other indicators of investment demand, machinery-equipment production ended the July-August period below its second-quarter level, while electrical machinery production continued to grow in the same period, albeit at a slower pace (Graph 4.1.7 and Graph 4.1.8). On the other hand, import figures for these sectors yield an increase over the second quarter. In sum, initial readings show a strong recovery in the third-quarter investment demand, which, however, is largely for imported goods.

Graph 4.1.7. Machinery-Equipment Manufacturing
(Seasonally Adjusted, Quarterly Average, 1997=100)



* July-August period is included.
Source: TURKSTAT, CBRT.

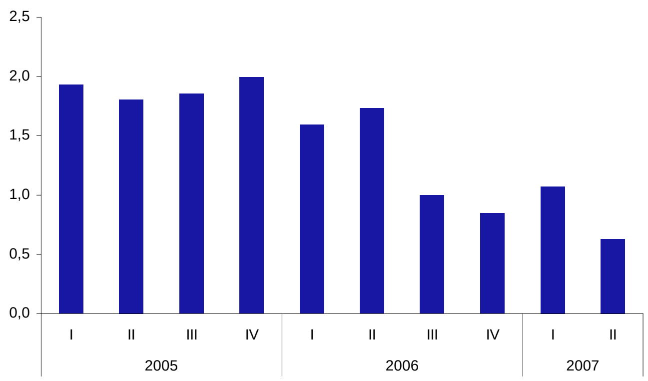
Graph 4.1.8. Electrical Machinery Manufacturing
(Seasonally Adjusted, Quarterly Average, 1997=100)



* July-August period is included.
Source: TURKSTAT, CBRT.

Hence, the monetary policy continues to put pressure on economic activity. Due to strong monetary tightening, the growth rate of services employment, in particular, has been on the downside since mid-2006 (Graph 4.1.9). This downward trend is more pronounced in wholesale/retail trade and in hotels/restaurants, items which are believed to better reflect domestic demand conditions. In this context, the non-farm unemployment rate that stopped declining in the first half of 2007 avoids any labor market-induced wage change. Moreover, manufacturing industry employment registered a strong growth rate mainly due to the robust export performance in the first half of the year.

Graph 4.1.9. Employment in Services
(Seasonally Adjusted, Quarterly Percent Change, Annualized)



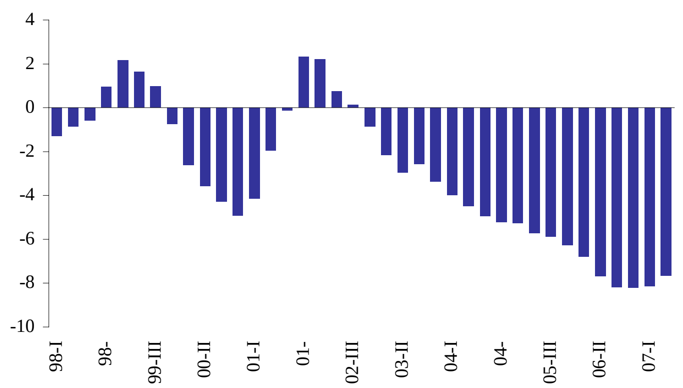
Source: TURKSTAT, CBRT.

In terms of supply conditions, the value-added of the agricultural sector is expected to decrease for the remainder of 2007 due to drought-related supply shortfalls particularly in crops and vegetables. The reduced value-added in agriculture is of great importance with regard to the GDP growth in 2007 as it accounts for a large share of national income in the second half of the year. On the other hand, the valued-added in industry is expected to grow in the second-half thanks to the recovery in domestic demand and the robust export performance. Strengthening of domestic demand, strong performance of construction sector, though with a declining rate and the favorable outlook in tourism are expected to increase the value-added of services sector.

4.2. Foreign Demand

The real depreciation of the new Turkish lira and the weakening domestic demand, driven by fluctuations in May-June 2006, slowed down the imports of capital and consumer goods, a trend which continued up to the second quarter of 2007. The rapid decline in oil prices from August 2006 onwards also curbed the nominal import growth in the subsequent period. Moreover, these developments boosted export growth on the back of strong foreign demand and productivity gains. As a result, exports grew faster than imports and the contribution of net foreign demand to GDP growth became positive. Against this background, the current account deficit over Gross National Product (GNP) ratio fell to 7.6 percent in the first half of 2007, from 8.2 percent at end-2006 (Graph 4.2.1).

Graph 4.2.1. Current Account Balance / GNP
(Annualized, Percent)

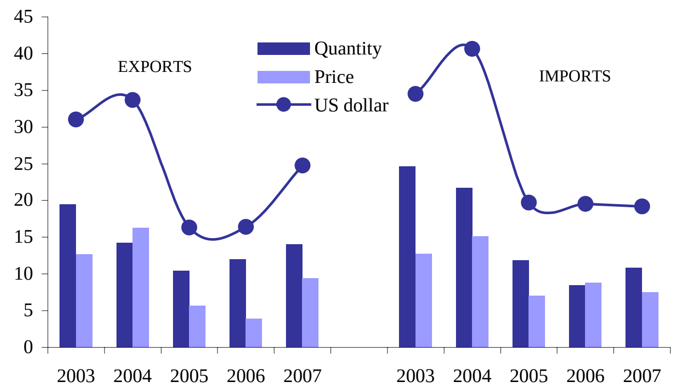


Source: CBRT.

Import growth during the July-August period accelerated as a result of buoyant capital and consumption goods imports. The current account deficit began to widen again, although tourism revenues retraced their earlier run-up in 2007 after a sluggish 2006 and exports continued to perform well.

Almost half of the growth rates in nominal imports since 2004 was attributed to (mostly crude oil-driven) import price hikes, whereas export growth rates were mainly derived from quantity increases (Graph 4.2.2). This suggests that the deterioration in the terms of trade accounts for a large proportion of the sharp increase in the current account deficit that has been observed in recent years. Nevertheless, starting from the last quarter of 2006, the terms of trade have shifted in favor of exports, contributing to the slowdown in the current account deficit.

Graph 4.2.2. Export and Import Growth Rates *
(Annual Percentage Change)



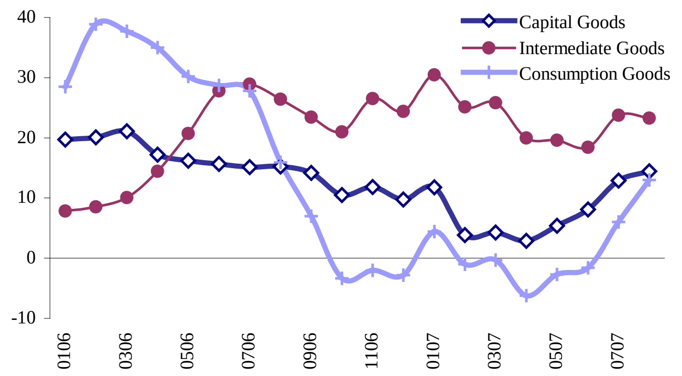
*January-August period for 2007.
Source: TURKSTAT.

Exports grew by 24.8 percent during the January-August period compared to the same period of previous year. Even though the main drivers of the strong export growth were motor vehicles, basic metals and machinery-equipment, textiles and clothing have also seen a recovery since mid-2006. Labor productivity gains from these industries are, *inter alia*, believed to have added to the allegedly high growth rate of textiles and clothing in the first half of 2007. Furthermore, soaring metal prices on global markets have boosted exports of basic metals.

Since over half of exports are done in euros, the recent strengthening of the euro against the US dollar has helped exports grow in dollar terms. The low growth rates of exports particularly in the first four months of 2006 paved base for a steep rise in the same period of 2007. The initial data released by the Turkish Exporters' Assembly (TEA) suggest that exports continued to grow in the third quarter.

During the January-August 2007 period, imports grew as high as 19.2 percent compared to the same period of previous year. Although the main source of import growth was the imports of intermediate goods, imports of capital and consumption goods held an increased share in total import growth during July and August. Imports of intermediate goods grew by 23.1 percent during January-August from the previous year, while imports of capital and consumption goods increased by 8.7 and 4.2 percent, respectively (Graph 4.2.3). Considering the slowdown in domestic demand from mid-2006 onwards, the export-related industrial production should be the main factor behind the growth of imports of intermediate goods during this period. Despite the recent pick-up, oil prices remained low in the first half compared to a year earlier, which helped imports grow at lower rates. The strengthening of the euro against the US dollar raised the dollar value of imports, albeit at a lower rate than exports. Given the relative revival in domestic demand in the third quarter and the price effect caused by the appreciation of the new Turkish lira, imports of capital and consumption goods are expected to trend upward, and imports of intermediate goods will continue to grow at a high rate in response to growing exports and soaring oil prices.

Graph 4.2.3. Sub-items of Imports
(Annual growth rate of 3-months moving averages)



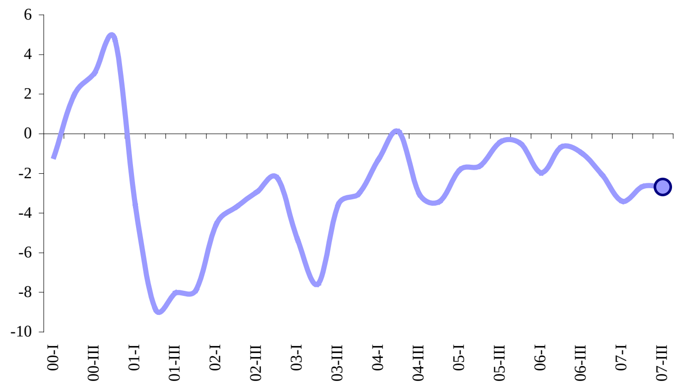
Source: TURKSTAT.

To sum up, exports continued to grow strongly, while imports outpaced exports during the June-August period thanks to the recovery in domestic demand and the appreciation of the new Turkish lira. Forecasts for the remainder of the year indicate that foreign demand will remain strong, but religious holidays and the strong base effect from the last year will restrain its growth in annual terms. As imports resumed its rapid growth in response to increased domestic demand, the contribution of net exports to GDP growth shall be negative in the second half of the year.

The US housing turmoil in August has the potential to weaken foreign demand in the medium term. In fact, the downward revision to the GDP forecast for 2008 in the EU, Turkey’s biggest trading partner, is of critical concern for foreign demand.

Hence, the growth composition for the upcoming period is expected to shift in favor of domestic demand, which, however, is likely to gain less from public spending. Current data suggest that the recovery in domestic demand will be partially offset by net foreign demand in the second half, and that aggregate demand conditions will continue to support the disinflation process (Graph 4.2.4).

Graph 4.2.4. Output Gap
(Percent)



Source: CBRT.

4.3. Unit Labor Costs

According to the indices of “Production Workers and Hours Worked in Production in Manufacturing Industry” released by the Turkish Statistical Institute (TURKSTAT), employment in the manufacturing industry rose by 1.7 percent in the second quarter of 2007 over a year earlier (Table 4.3.1). As in the past two quarters, public sector employment fell, but private sector employment increased. Productivity in the manufacturing industry grew at a subdued rate of 0.3 percent in the second quarter. Real wages went down in the public sector, but remained unchanged in the private sector. Since productivity gains surpassed the growth of real wages, real unit wages in manufacturing industry fell by 0.9 percent in the second quarter compared to the same period last year, as foreseen in our July Inflation Report (Graph 4.3.1). Given the industrial production growth, real unit wages are expected to keep falling in the third quarter.

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

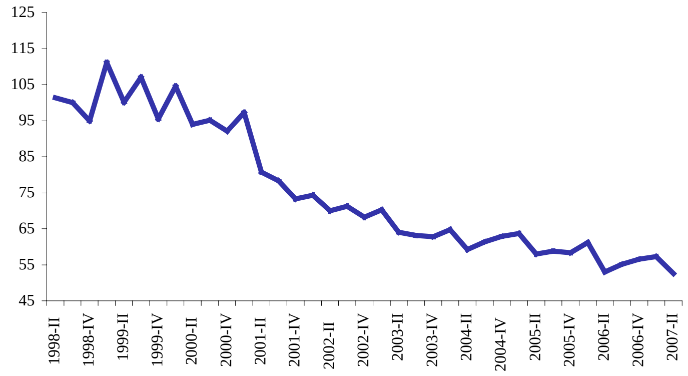
	2005	2006					2007	
	Annual	I	II	III	IV	Annual	I	II
Employment(1)	-0.7	-1.9	-1.4	-0.7	1.2	-0.7	2.3	1.7
Public	-8.1	-3.3	-3.8	-5.7	-2.9	-4.1	-3.2	-3.6
Private	0.1	-1.9	-1.2	-0.2	1.6	-0.4	2.7	2.0
Wage(2)	2.0	1.0	0.5	0.0	2.1	0.9	-2.0	-0.6
Public	8.0	-3.9	-2.7	-4.0	-1.5	-3.0	0.4	-2.2
Private	1.7	1.9	1.3	1.2	3.1	1.9	-1.8	0.0
Earnings (3)	1.8	0.3	0.4	0.0	2.8	0.9	-1.1	-0.3
Public	6.1	-3.3	-2.4	-0.4	0.0	-1.5	1.1	0.4
Private	1.9	1.3	1.2	0.7	4.0	1.9	-0.8	0.2
Productivity(4)	6.0	5.0	9.9	6.5	5.2	6.7	4.8	0.3

(1) Manufacturing Industry Employment Index, 1997=100.
(2) The Index of Real Wage per Working Hour as Per Period, 1997=100.
(3) The Index of Real Earning Per Worker as Per Period, 1997=100.
(4) The Index of Partial Productivity Per Working Hour as Per Period, 1997=100.
Source: TURKSTAT, CBRT.

In sum, the increase in partial productivity and the decline in real unit wages paused in the second quarter of 2007. The increase in industrial production is accompanied by decrease in hours worked in 2005 and 2006, resulting high productivity gains and hence real unit wages declined substantially. However, during January-June 2007, both industrial production and hours worked increased, which limited productivity gains.

As a result of increased capital deepening and more efficient utilization of labor force by manufacturing firms due to increased competition, labor productivity increased substantially in recent years. Close monitoring is needed on the marked second-quarter slowdown in the declining trend of real unit wages in recent years, which has contributed significantly to disinflation process and export growth. To prevent the slowdown of the fall in real unit wages from becoming permanent, a substantial amount of productivity gains and therefore investment growth is needed in the medium term. Moreover, it is still of great importance that wages are set according to the inflation target, so as to support the disinflation process.

Graph 4.3.1 Real Unit Wages Index in the Manufacturing Industry
(1997=100)



Source: TURKSTAT, CBRT.

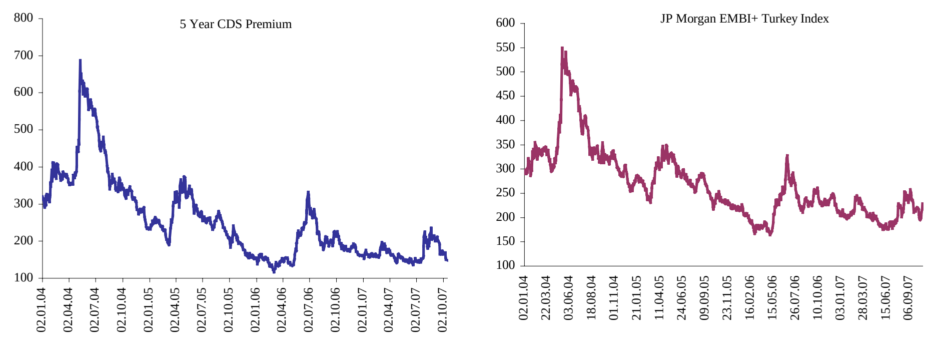
5. Financial Markets and Financial Intermediation

5.1. Financial Markets

Perceptions of risk in global credit markets deteriorated in the third quarter of 2007, resulting in a liquidity squeeze in the US, UK and euro area banking sector, all of which was driven by the US mortgage crisis. Economic and financial data released within the quarter implied that the credit market and banking turmoil might spill over into the wider economy (Graph 2.2.2). Thereafter, central banks of the developed world injected liquidity into troubled markets and loosened monetary policy conditions, replacing the fears of a global downturn with measures to rebuild confidence in financial markets. Consequently, global liquidity conditions and global risk appetite have been on the rebound since mid-September.

Despite the deterioration in developed credit markets, emerging markets fluctuated in narrow ranges, both because the fluctuations occurred over a short period of time and because credit derivative markets in emerging economies are shallow. As a matter of fact, Credit Default Swap (CDS) and JP Morgan EMBI+ Turkey indices have also rebounded after a slight deterioration (Graph 5.1.1). Nevertheless, with continued uncertainties over global economic prospects, global markets are likely to remain very sensitive to growth rates and financial fragility in developed economies, and thus, remain data-dependent.

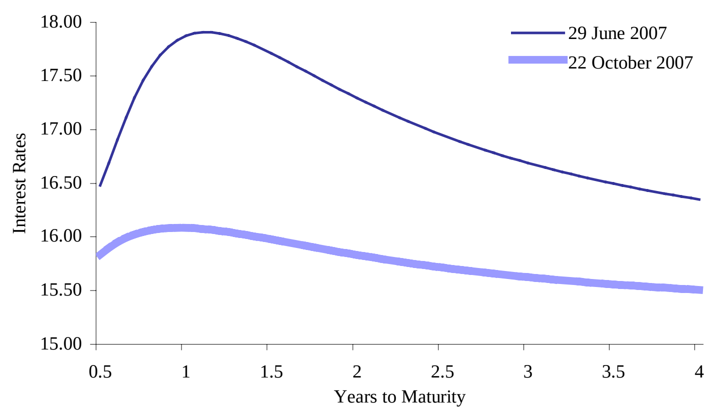
Graph 5.1.1. Risk Premium Indicators



Source: Bloomberg.

Turkey’s continued prudent monetary policy helped lower inflation expectations and inflation uncertainty in the third quarter, contributing to the reduction in long-term interest rates. The earlier-than-expected rate cuts by the Monetary Policy Committee accelerated the decline in medium and long-term rates. Yields on October 22, 2007 remained below those of June 29, 2007 on every maturity (Graph 5.1.2, Box 5.1). This implies that rate cut decisions have been positive for market expectations. Moreover, evolving yield curves started to slope downward at the 12-month maturity, which suggests that economic agents keep expecting the disinflation process to continue in the medium term.

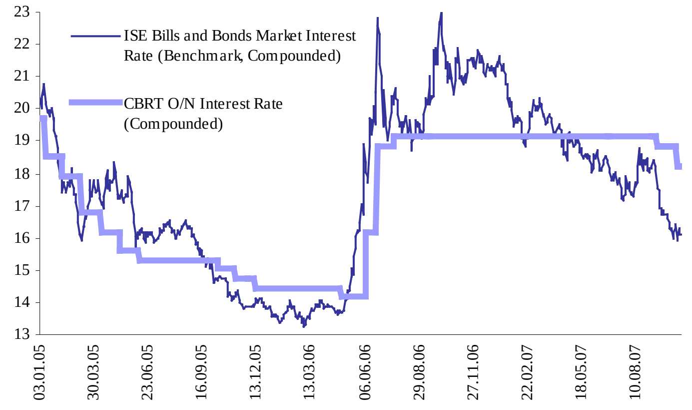
Graph 5.1.2. Yield Curves



Source: CBRT.

The steady fall in the benchmark interest rate on government securities in the Istanbul Stock Exchange (ISE) Bonds and Bills Market continued into the third quarter. Benchmark rates remained lower than CBRT policy rates even during the period in which risk perceptions deteriorated significantly, making the gap even wider in the recent quarter (Graph 5.1.3). The main sources of decrease in bond rates were the continued downtrend in inflation, as foreseen by the CBRT, and the expectations for further policy rate cuts.

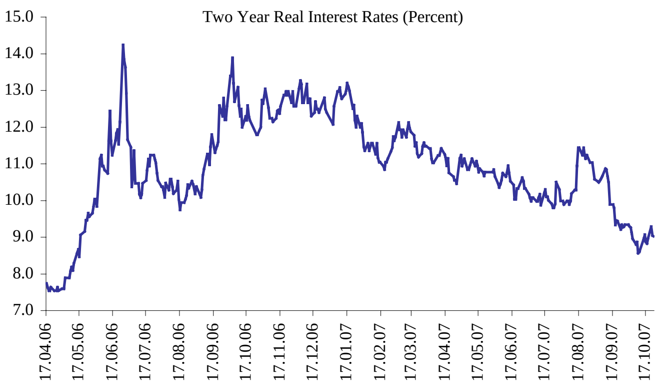
Graph 5.1.3. Interest Rate Developments
(Percent)



Source: ISE, CBRT.

The firm stance of monetary policy reduced the inflation uncertainty, leading to further reductions in real medium- and long-term interest rates. Real interest rates derived using the yield curve and 12 and 24 month inflation forecasts drawn from CBRT's Expectations Survey continued a downward trend in the third quarter, except for a period of deterioration in the risk appetite (Graph 5.1.4).

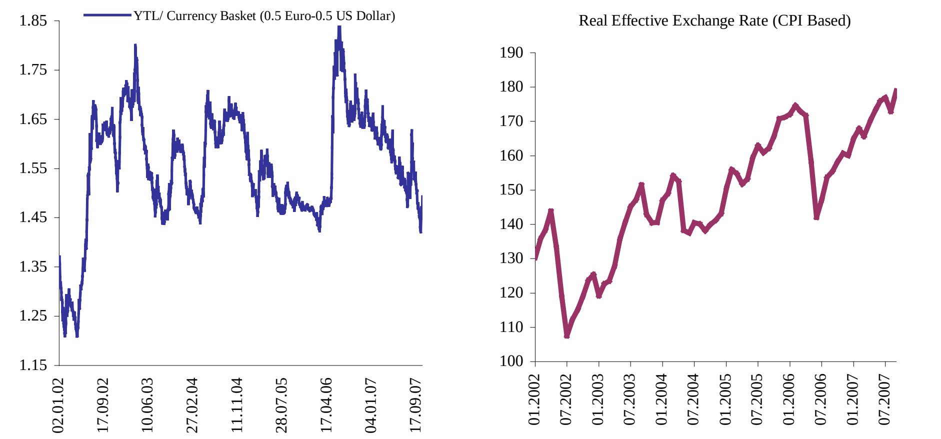
Graph 5.1.4. Real Interest Rates
(According to the Yield Curve and 12 and 24 Month Inflation Expectations)



Source: ISE, CBRT.

As direct investments grew stronger and domestic perceptions of uncertainty reduced, non-resident investors increased the share of YTL-denominated assets in their portfolios and contributed to a further strengthening of the Turkish lira (Graph 5.1.5).

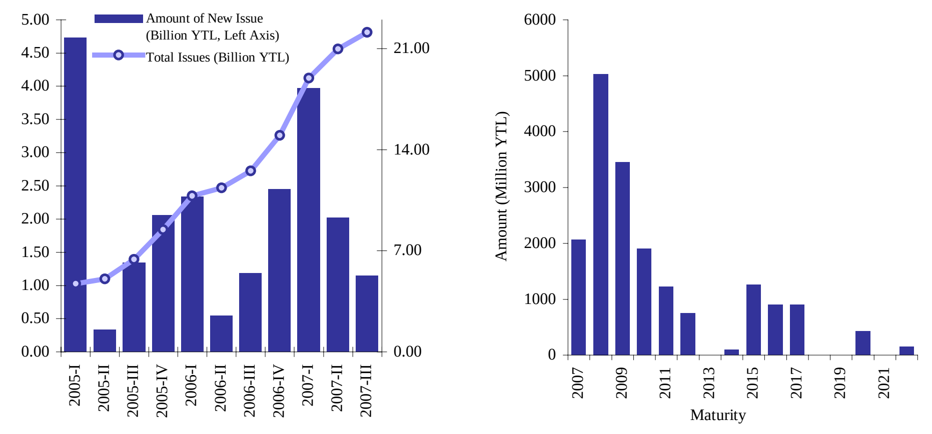
Graph 5.1.5. Developments in Exchange Rates



Source: CBRT.

YTL-denominated global bonds issued by foreign financial institutions, an indicator of foreign demand for Turkish lira assets, slightly decreased from the preceding quarter and from the same quarter of previous years (Graph 5.1.6). This was largely due to the short-term deterioration in international liquidity conditions and in the global risk appetite.

Graph 5.1.6. YTL Denominated Bonds Issued by Foreign Financial Institutions

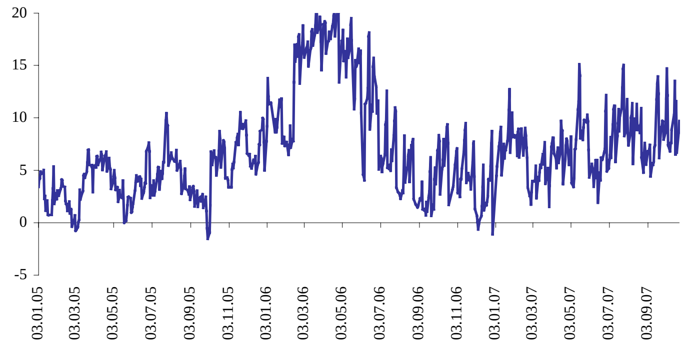


Source: CBRT.

CBRT's net foreign exchange purchase through auctions amounted to 2.75 billion US dollars in the third quarter of 2007. CBRT's foreign exchange reserves rose to 71.7 billion US dollars on September 28. The daily amount to be purchased in the auctions which has been set at USD 15 million for auction amount with USD 30 million for optional selling starting from August 15, were increased to USD 30 million and USD 60 million respectively, starting from October 9.

Excess liquidity sterilized through the overnight market increased in the third quarter over the previous one (Graph 5.1.7), which was driven by CBRT's foreign exchange purchases, despite Treasury's roll-over rate was above the target set at the start of the year. Moreover, in order to enhance the effectiveness of liquidity management, the CBRT issued bills with a 32, 40 and 30 day maturities on July 19, August 23 and October 17, respectively.

Graph 5.1.7. Excess YTL Liquidity
(Billion YTL)

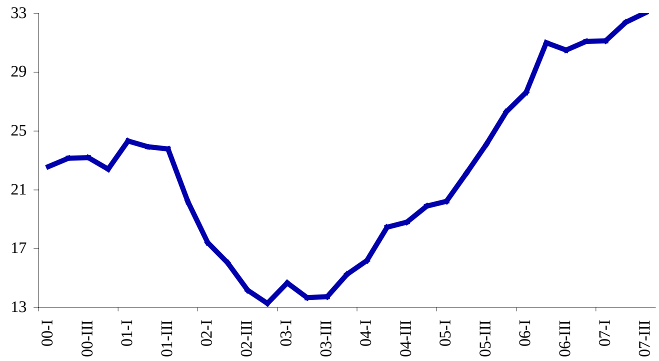


Source: CBRT.

5.2. Financial Intermediation and Loans

The moderate credit growth continued into the third quarter (Graph 5.2.1). The continued foreign capital inflow into the banking system through takeovers and mergers, on one hand, and CBRT's increased YTL supply via foreign exchange auctions, on the other, strengthened the credit supply of commercial banks, which altogether contributed to the abovementioned credit growth. However, increased perceptions of uncertainty over global credit markets may hinder the banks' accessibility to foreign sources of finance.

Graph 5.2.1. Real Sector Loans / GNP*
(Percent)



*Real sector loans are composed of consumer loans and business loans. The third quarter GNP of 2007 shows estimated figures.
Source: CBRT.

Real sector loans continued to grow in the current quarter, enlarging their share in the national income (Graph 5.2.1). Besides, the recent downturn in medium and long-term rates is expected to further improve financing conditions. In addition, the continued financial deepening stands out as another credit growth driver.

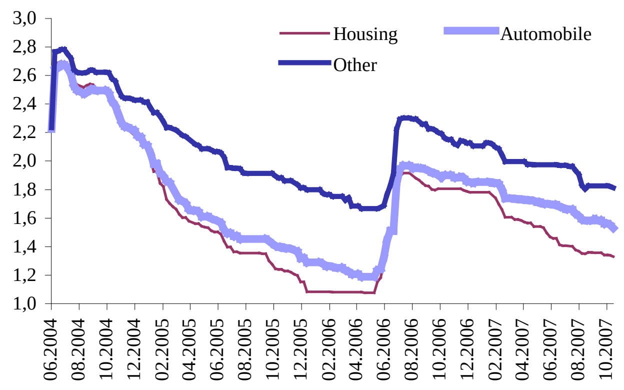
Table 5.2.1. Consumer Loans and Claims from Credit Cards
(Real Quarterly Percentage Change)

	2006			2007		
	II	III	IV	I	II	III
Consumer Loans	20.0	1.5	3.6	2.6	9.0	10.0
Housing Loans	22.8	0.9	2.2	2.7	7.5	10.2
Automobile Loans	5.1	-6.4	-5.0	-8.9	-3.4	-2.0
Other Loans	24.3	6.0	8.9	6.6	14.5	12.8
Credit Cards	6.8	2.1	2.1	-1.6	7.7	2.4

Source: CBRT.

The growth of consumer loans continued into the fourth quarter, which was, as in the past twelve months, mainly on housing loans and on “other loans” consisting mostly of short-term personal loans with relatively higher interest rates. Housing loans and use of credit cards continued to grow at a subdued rate, while automobile loans decreased in real terms (Table 5.2.1). The main sources of growth were the ad-campaigns of banks and the relatively increasing demand for credit card use.

Graph 5.2.2. Consumer Loan Rates
(Monthly, Percent)



Source: Web sites of selected banks.

Interest rates on both personal loans and automobile loans have been on the downside recently (Graph 5.2.2). Yet, the rates are still above levels in the first quarter of 2006. The increased competition among banks and the reduced inflation are expected to further lower interest rates and boost the demand for consumer loans. Nevertheless, the deterioration in the global risk appetite might affect banks' ability to grant credits, and therefore moderate their credit growth. The Central Bank will continue to carefully monitor credit developments as they related to the total final domestic demand and the soundness of the financial system.

BOX 5.1. YIELD CURVES AND MONETARY POLICY DECISIONS

The yield curve is a function that shows the structure of interest rates at various maturities. Yields in the secondary market are only derived from securities with specific maturities. Yield curve estimation facilitates the calculation of yields for maturities not actively traded, and thus gives an estimate of yields at fixed maturities. In this regard, central banks pay close attention to estimating the yield curve as it shows the expectations for future inflation and interest rates.

In a CBRT working paper titled 'Yield Curve Estimation for Turkish Treasury Debt Instruments'[1], yield curves are estimated using the data from ISE Bonds and Bills Market based on the extended Nelson-Siegel (ENS) method. Contrary to other approaches, the ENS method is barely affected by extreme fluctuations in some securities included in the data set, and therefore can provide more precise information about the level of interest rates.

The primary purpose in estimating the yield curve is to figure out fixed-maturity interest rates that are not much affected by typical fluctuations in bill rates. The changes in the benchmark interest rate on the widely used Treasury bills are often driven by the typical features of bills, and thus may obscure the general outlook of interest rates. Moreover, a long-term observance of a specific bill rate can be misleading since the maturity changes over time. For example, a change in the interest rate on a newly issued two-year bill after three months might occur either because the outlook of interest rates has altered, or because the bill has now a maturity of a year and nine months and yields an interest rate unlike the two-year maturity. Watching the yield curve for a two-year fixed interest rate removes the exposure to such an interest rate spread.

Yield curves are also used to produce fixed real interest rates. For instance, 12 and 24 month inflation forecasts drawn from the Expectations Survey and fixed nominal interest rates can be used to calculate the two-year real interest rates.

Although it has already been performed in Turkey before, CBRT's yield curve estimation is the first to employ high-frequency data and long-term fixed coupon bonds. Employing these bonds provides an anchor for the long-end of the yield curve. In order to incorporate long-term bonds, the original date of estimation was set as February 16, 2005 on which the five-year fixed coupon bond was issued.

The compounding method used at the ISE Bonds and Bills Market offers a different way to compound the yields on fixed coupon bonds and discount bonds. Yields on fixed coupon bonds are compounded semi-annually, whereas yields on discount bonds are compounded on a maturity basis. For example, the yields on a bond with a remaining maturity of 6 months to produce the annual compound rate of return are compounded twice, while those on a bond that matures in one month are compounded twelve times. As the difference restricts the comparison of yields on bonds with various maturities, unlike the ISE compounding method, all bond yields are computed on a continuous compounding basis in CBRT's study. Continuous compounding is a form of calculating the annual compound interest rate under the assumption that the interest earned on an investment is compounded at (constantly and thus infinitely) short time intervals. However, since the yield spread between continuous compounding and ISE compounding has significantly widened thereafter, in the graphs below all yields are compounded twice per year for reasons of comparability.

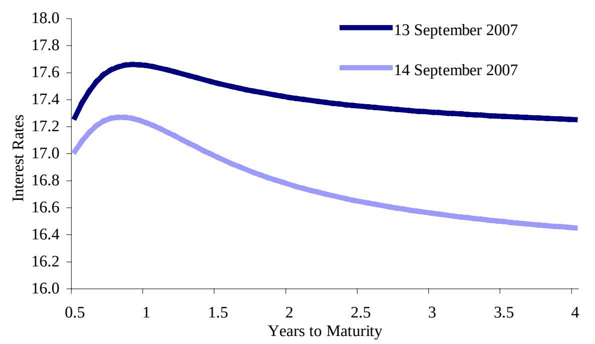
Changes in Yields Upon Monetary Policy Decisions

Yield curves are also used to measure the sensitivity of financial market expectations to macroeconomic news. As the pricing of fixed yield bonds varies according to expectations, any changes in these expectations will affect bond prices and therefore yields. Since it is quite unlikely to conduct an expectations survey both before and after any incoming data and above all, the evolving prices represent the collective expectations of individual investors, case studies that compare the yield curves drawn before and after the news hit the markets give an insight to how expectations change. For instance, if an incoming information does not affect overnight interest forecasts and risk perceptions, the yield curve is expected to remain unchanged. In this sense, the Monetary Policy Committee's 25 and 50 basis-point cuts in overnight rates on September 13 and October 16, respectively, are analyzed as follows.

[1] Özge Akıncı, Burcu Gürcihan, Refet Gürkaynak, Özgür Özel, "Yield Curve Estimation for Turkish Treasury Debt Instruments", General Directorate of Research and Monetary Policy Working Paper No:06/08, December 2006.

On September 13, 2007, the Monetary Policy Committee reduced its policy rates by 25 basis points. According to pre-decision inquiries, the markets had not expected a rate cut. The decision came as a surprise to the markets, which constitutes a striking example for the yield curve analysis. Box 5.1.Graph 1 shows how the yield curve shifted downwards following the decision and long-term interest rates declined more than did short-term interest rates. This observation implies that, after the rate cut in September, expectations for the future of inflation and monetary policy were revised in a positive direction. Thus, the September decision sent a strong signal to financial markets.

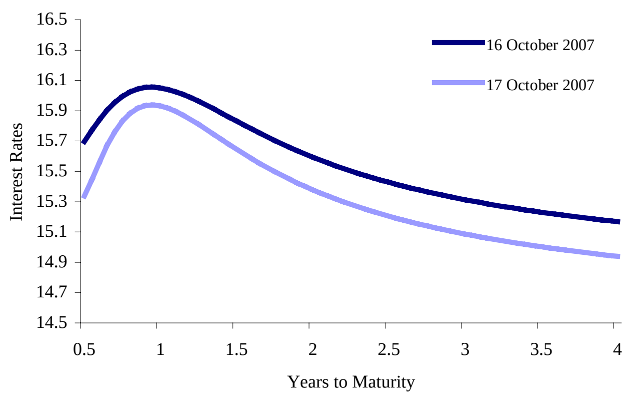
Box 5.1.Graph 1. Yield Curves



Source: CBRT.

The 50 basis point rate cut on October 16, 2007 serves as another example for the analysis. Since a majority of the markets expected a 25 basis point cut, this decision also came partly as a surprise and involved some “news” effect. Box 5.1.Graph 2 shows that the yields were even lower a day after the policy rate cut on October 16. As in the previous month, yields moved down at each maturity, but unlike September, they declined at about the same rate for each maturity. In other words, the October interest rate decision and the following press release did not notably affect the future expectations.

Box 5.1.Graph 2. Yield Curves



Source: CBRT.

Moreover, the negative slope of the yield curve for maturities more than a year demonstrates that economic agents expect the inflation rate to trend further downward in the medium term.

6. Public Finance

The central government budget balance and primary budget balance for the January-September period in 2007 deteriorated substantially compared with the same period in 2006. Yet, expenditures such as transfers for agriculture were incurred earlier in 2007. Therefore, year-end appropriations are expected not to exceed the target if expenditures are severely curtailed for the remainder of the year.

The fiscal discipline since 2002 has both encouraged the steady increase in domestic demand and helped inflation expectations become established at reasonable levels. However, the growth of public spending accelerated in the first half and contributed significantly to GDP growth, which, if continued into the second half, would limit the recent role of fiscal policy in macroeconomic stabilization. Disinflation will gain more momentum for the rest of the year and in 2008, in case fiscal adjustments concentrate on reducing government expenditures rather than increasing indirect tax revenues.

The full-fledged implementation of structural reforms in a number of areas such as social security, taxes and labor market has been of vital importance in recent years in order to assure the permanence of gains from tight fiscal policy and to reduce the public debt stock to lower levels. Structural reforms in these areas will, on one hand, enhance the stability of public finance, and on the other, help establish a competitive environment in the economy and remove inflation rigidities in some sectors and thus strengthen the efficiency of monetary policy.

6.1. Budget Developments

During January-September 2007, the central government primary balance posted a surplus of YTL 30.6 billion, while the budget balance ran a deficit of YTL 12.2 billion (Table 6.1). According to a detailed analysis of the central government budget, although revenues were up by 10.7 percent, expenditures increased by a striking 19.0 percent compared with a year earlier.

Non-tax revenues rose by 13.7 percent, whereas tax revenues increased by only 9.5 percent. Corporate tax revenues grew as high as 18.7 percent mainly on the 86.1 percent growth in August, which was, to some extent, a result of both the base effect from an unpaid tax amount allowed as a deduction in August 2006 following the corporate tax rate cut from 30 percent to 20 percent around mid-2006, and the growing corporate profits in the second quarter. Domestic VAT revenues grew at a modest pace over the same period of 2006 on the back of weakening domestic demand and the VAT rate cut from 18 percent to 8 percent on certain food items effective June 1. Import VAT revenues, on the other hand, barely increased due to the slowdown in import growth in the first half of the year.

In the first nine months of 2007, interest expenditures and primary budget expenditures rose by 13.7 and 21.1 percent, respectively, compared to the same period of 2006. As regards to non-interest expenditure items, all items except goods and services expenditures remained on course to meet year-end targets. Among items of current transfers, nearly all agricultural subsidies were used during the January-September period. Besides, transfers for agriculture were allocated earlier.

Table 6.1.1. Central Government Budget Aggregates
(Billion YTL)

	2006 January-September	2007 January-September	Rate of Increase (Percent)	Realization/Budget Target (Percent)	2007 Budget Target	2007 Budget Target/GNP[1]
Central Government Expenditures	**129.42**	**153.96**	**19.0**	**75.1**	**205.0**	**32.5**
A) Interest Expenditures	**37.63**	**42.77**	**13.7**	**80.8**	**52.9**	**8.4**
B) Non-Interest Budget Expenditures	**91.80**	**111.19**	**21.1**	**73.1**	**152.0**	**24.1**
I. Personnel Expenditures	28.20	33.04	**17.2**	**75.7**	43.7	6.9
II. Government Premiums to Social Security Agencies	3.56	4.09	**15.0**	**40.5**	10.1	1.6
III. Purchases of Goods and Services	11.12	13.63	**22.6**	**87.5**	15.6	2.5
1) Defense-Security	3.57	4.09	**14.5**	**50.1**	8.2	1.3
2) Health Expenditures	4.09	4.67	**14.4**	-	0.2	0.0
a) General Medication	0.56	0.63	**12.4**	-	0.1	0.0
b) General Treatment and Health Equipment	1.12	1.12	**0.0**	-	0.1	0.0
c) Green Card Health Services	2.40	2.92	**21.6**	-	0.0	0.0
3) Other Purchases of Goods and Services	3.39	4.82	**42.2**	**67.5**	7.1	1.1
IV. Current Transfers	37.80	47.69	**26.2**	**78.4**	60.9	9.6
1) Duty Loss	5.73	0.89	**-84.4**	**75.2**	1.2	0.2
2) Government Subventions	16.06	27.24	**69.6**	**78.9**	34.5	5.5
3) Subsidies to Households	0.53	0.70	**32.1**	**75.7**	0.9	0.1
4) Agricultural Subsidies	4.38	5.13	**17.1**	**97.6**	5.3	0.8
5) Shares from Revenues	10.25	12.45	**21.5**	**73.4**	17.0	2.7
V. Capital Expenditures	6.04	7.55	**25.0**	**62.4**	12.1	1.9
VI. Capital Transfers	2.02	2.63	**30.2**	**72.0**	3.6	0.6
VII. Lending	3.06	2.56	**-16.3**	**69.2**	3.7	0.6
VIII. Reserve Appropriations	0.00	0.00	-	**0.0**	2.4	0.4
Central Government Revenues	**128.04**	**141.79**	**10.7**	**75.4**	**188.2**	**29.8**
A) General Budget Revenues	**124.83**	**138.25**	**10.8**	**75.4**	**183.5**	**29.1**
I-Tax Revenues	102.01	111.66	**9.5**	**70.6**	158.2	25.1
1. Taxes on Income, Profits and Gains	28.70	34.22	**19.2**	**75.5**	45.3	7.2
a) Income Tax	20.57	24.56	**19.4**	**73.5**	33.4	5.3
b) Corporate Tax	8.14	9.66	**18.7**	**81.0**	11.9	1.9
2. Taxes on Property	2.82	3.19	**13.3**	**87.6**	3.6	0.6
3. Domestic Taxes on Goods and Services	44.83	46.96	**4.8**	**68.2**	68.8	10.9
a) Domestic Value Added Tax	12.31	12.53	**1.8**	**62.0**	20.2	3.2
b) Special Consumption Tax	27.64	28.75	**4.0**	**70.0**	41.1	6.5
4. Taxes on International Trade and Transactions	20.33	21.06	**3.6**	**65.7**	32.1	5.1
a) VAT on Imports	18.75	19.19	**2.3**	**64.9**	29.6	4.7
II-Non-Tax Revenues	23.39	26.60	**16.6**	**105.1**	25.3	4.7
1. Enterprise and Property Revenue	6.39	6.88	**7.8**	**88.0**	7.8	1.8
2. Interests, Shares and Penalties	15.96	12.11	**-24.1**	**83.8**	14.4	2.4
3. Special Revenues, Grants and Aids	0.22	1.60	**618.6**	**333.2**	0.5	0.1
4. Capital Revenues	0.25	6.01	**2284.9**	**234.1**	2.6	0.4
B) Revenues of Special Budget Administrations	**2.16**	**2.24**	**3.5**	**68.5**	**3.3**	**0.5**
C) Revenues of Regulatory and Supervisory Agencies	**1.05**	**1.30**	**23.7**	**90.2**	**1.4**	**0.2**
Budget Balance	**-1.38**	**-12.17**	**779.1**	**72.3**	**-16.8**	**-2.7**
Primary Balance	**36.24**	**30.60**	**-15.6**	**84.7**	**36.1**	**5.7**

[1]GNP growth rate for 2007 taken from SPO Program of 2007.

Source: Ministry of Finance

Since September, health expenditures have significantly exceeded the initial appropriation amount for 2007, which was largely due to entering the appropriations for treatment and medication services provided for public employees and green-card (health services) beneficiaries into the budget of the Social Security Institution under the assumption that the social security reform would have been implemented in 2007.

Table 6.1.2. Program-Defined Consolidated Public Sector
(Cumulative, Billion YTL)*

	2005	March 2006	June 2006	Sept. 2006	Dec. 2006	April-2007	June-2007
Realizations							
Primary Balance	**28.3**	**10.6**	**25.0**	**33.3**	**36.2**	**9.4**	**15.5**
Primary Balance (Excluding SEEs)	**23.6**	**8.4**	**22.1**	**31.4**	**34.6**	**7.3**	**12.6**
Central Government Budget	24.1	7.6	20.4	30.6	33.5	5.7	10.2
Overall Balance	**-4.2**	**1.2**	**7.1**	**2.1**	**-1.2**	**-6.6**	**-5.1**
Central Government Budget	-11.5	-2.4	1.0	-2.8	-6.9	-11.2	-11.7
Targets							
Program							
Primary Balance	30.5	7.6	17.3	29.3	34.1	12.3	-
Primary Balance (Excluding SEEs)	26.7	7.3	16.4	27.6	31.4	11.7	-
Overall Balance	-19.6	-3.7	-4.1	-5.9	-6.9	-6.6	-
Adjusted Program							
Primary Balance	30.4	7.8	17.4	29.7	34.5	12.3	-
Primary Balance (Excluding SEEs)	26.7	7.5	16.4	28.1	31.8	11.7	-
Overall Balance	-19.7	-3.4	-3.9	-5.5	-6.5	-6.6	-

* Figures for 2007 are provisional.
Note: Consolidated Public Sector = Central Government + 23 SEEs + Extra budgetary Funds (Defense Industry Support Fund, Privatization Fund and Social Assistance and Solidarity Encouragement Funds) + Social Security Institutions + Unemployment Insurance Fund.
Overall Government = Consolidated Public Sector + Local Administrations + Revolving Funds + non-CGS SEEs.
Source: Treasury.

On the other hand, factors such as the permanent employment of temporary workers, wheat and hazelnut purchase prices exceeding program targets, the opportunity for all individuals registered with the Social Security Institution to directly benefit from all of health care providers with whom the Institution has made contracts, the above-inflation target wage hike for public workers and the funds to cover drought shortfalls in 40 towns are expected to boost expenditures for the remainder of the year.

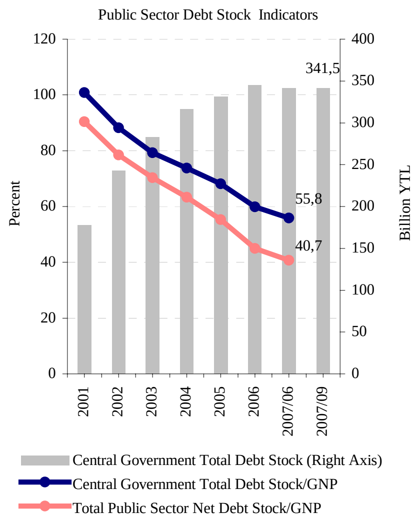
According to the draft budget for 2008 that was submitted to the Grand National Assembly of Turkey (GNAT) on October 17, central government spending for 2008 is expected to increase by 9.6 percent to YTL 222.3 billion, whereas revenues will increase by 8.8 percent to YTL 204.6 billion over the 2007 budget estimates. Moreover, the primary surplus will amount to YTL 38.2 billion, while the budget deficit will be YTL 17.8 billion.

In 2006, the primary and total balance of the program-defined consolidated government sector exceeded the program target by 5.3 billion and YTL 1.7 billion, respectively (Table 6.2). However, although the primary balance provided a surplus of YTL 9.4 billion at end-April 2007, it still remained YTL 3.0 billion below the program target and failed to meet the April target, which was treated as a performance criterion. As the program-defined central government primary balance posted only a surplus of YTL 17.4 billion at end-August 2007, it seems unable to hit YTL 32.3 billion target for the end of the year.

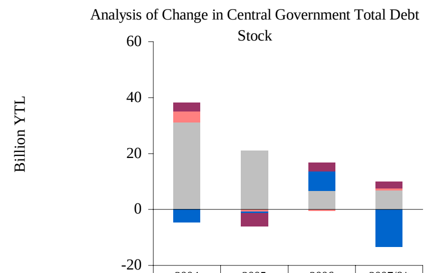
6.2. Developments in Debt Stock

During January-September 2007, the central government debt stock, which constitutes a large share of total public debt stock, decreased only by 1 percent to YTL 341.5 billion compared to end-2006, mainly owing to contributions from net domestic debt growth, parity effect and net foreign debt growth by YTL 6.8 billion, YTL 2.4 billion and YTL 0.7 billion, respectively. The overall exchange rate changes, however, boosted the decline in the central government debt stock by YTL 13.4 billion. Furthermore, the ratio of net total public debt stock to GNP was 40.7 percent at the end of the first half of 2007, maintaining the declining pattern of recent years (Graph 6.2.1).

Graph 6.2.1. Public Debt Stock Indicators



Source: Treasury.



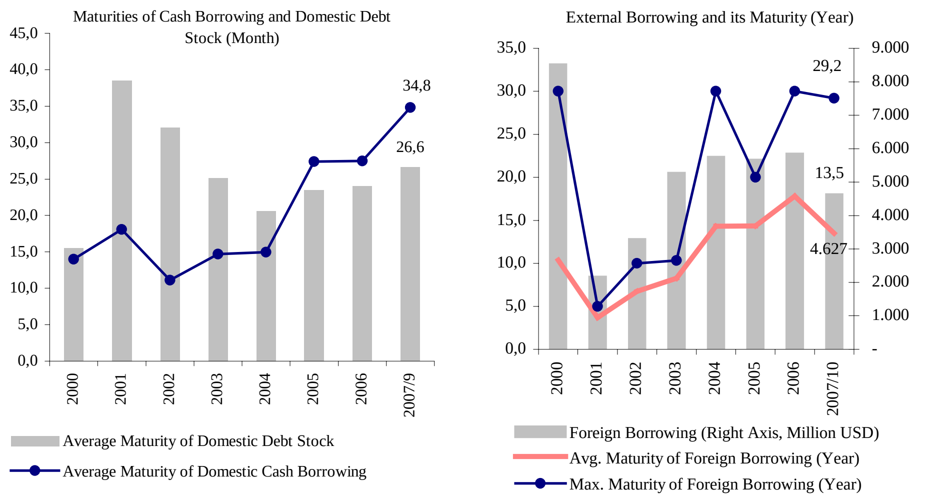
	2004	2005	2006	2007/9*
Parity Effect**	3,0	-4,8	3,1	2,4
Total Exc. Rate Effect***	-4,6	-0,8	6,9	-13,4
Net External Borrowing	4,1	-0,6	-0,4	0,7
Net Domestic Borrowing	31,2	21,1	6,7	6,8

* Changes compared to 2006.
** Changes arising from the movements in USD/EURO and USD/SDR parities.
*** Changes arising from the movements in YTL/USD parity.
Note: Changes in Net Debt denote the changes adjusted for the exchange rate and parity effect.

Source: Treasury, CBRT.

As the Treasury resumed the issue of five-year floating rate and fixed coupon bonds in September 2006, the average maturity of cash borrowing trended significantly longer and extended to 34.8 months in September 2007. Likewise, the average maturity of total domestic debt stock also extended to 26.6 months in September. Moreover, bond issues yielded a USD 4.6 billion worth of long-term foreign debt in 2007 with an average maturity of 13.5 years (Graph 6.2.2).

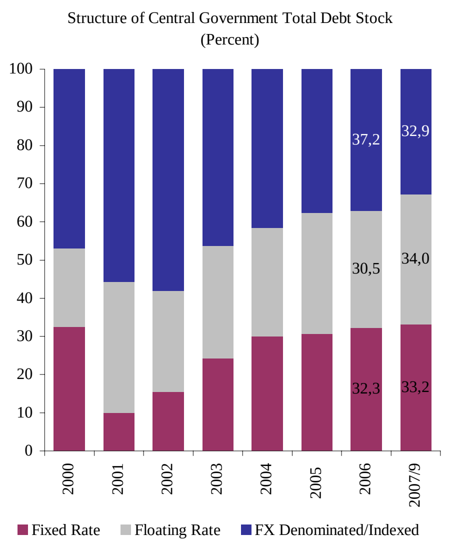
Graph 6.2.2. Maturity of Borrowing from Domestic and External Markets

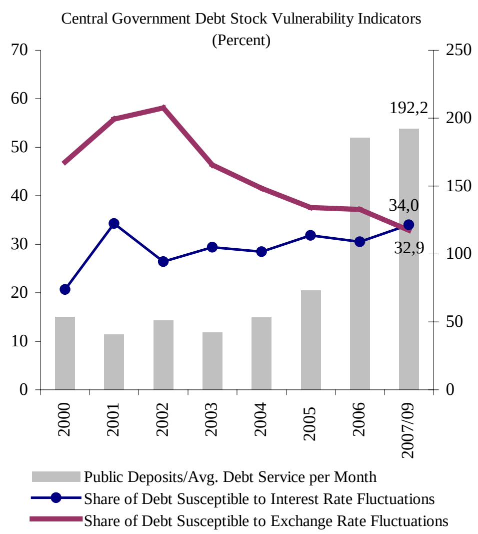


Source: Treasury, CBRT.

Between January and September 2007, the share of floating rate and fixed rate instruments in central government debt stock increased, while the share of instruments susceptible to exchange rates was low (Graph 6.2.3). Although the amount vulnerable to exchange rates (FX-denominated and FX-indexed) is still as high as 32.9 percent, the Treasury, as stated in its 2007 Borrowing Program, 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 rollover ratio to 80 percent, which altogether are a clear indication that debt sensitivity to exchange rates will continue to ease. Furthermore, as the Treasury has been issuing CPI-indexed government bonds since February 2007, the share of floating rate instruments is expected to further increase in the upcoming period. Besides, in line with the financing strategy intended for reducing the liquidity risk, the ratio of public deposits to average monthly debt service ended September at 192.2 percent.

Graph 6.2.3. Structure of Central Government Debt Stock





* Debt stock susceptible to interest rates contain discounted securities with maturity less than 1 year and government securities with flexible interest rates.
** Debt stock susceptible to exchange rates contains foreign debt stock and FX-denominated and FX-indexed domestic debt stock.
Source: Treasury, CBRT.

7. Medium Term Projections

In this chapter, updated projections and assumptions about fundamental macroeconomic variables are summarized, and the inflation and output gap forecasts produced according to these assumptions are presented. Besides, major potential risks that may change the inflation and monetary policy outlook are also analyzed. As the forecast horizon is set as two years, forecasts in this Report cover the period from the fourth quarter of 2007 to the fourth quarter of 2009.

7.1. Current Stance, Short-Term Outlook and Assumptions

The assumptions that provide a basis for the medium-term forecasts are discussed in two groups: assumptions *related to domestic economic activity* and assumptions *related to external factors*. In building this framework, the assumptions that have formed the basis for forecasts since the July Inflation Report have been updated and assembled with the data and analyses presented in previous chapters.

Assumptions related to domestic economic activity are based on assessments regarding the current economic situation and the short-term outlook, and provide the starting point of forecasts. GNP data announced for the second quarter of 2007 have broadly in line with the forecasts in the July-2007 Inflation Report. In the second quarter, net foreign demand contributed to growth at a slower rate than in previous quarters, but there was a higher-than-expected contribution from domestic demand thanks to a substantial growth in government spending. Unlike previous quarters, leading indicators for the third quarter of 2007 suggest that the aggregate demand composition shifts in favor of domestic demand, and that private consumption demand reflects a rebound from the preceding quarter. As imports resumed their rapid growth, the contribution of net exports to growth is expected to be negative in the second half of the year. However, under the assumption that government spending will remain on the course to meet end-year budget targets and increase only at a subdued rate in the second half of the year, the recovery in aggregate demand is anticipated to be very sluggish. Considering the tight monetary policy stance, the forecasts are based on the assumption that aggregate demand conditions will continue to support the disinflation process, albeit at a lower rate than the first half of the year.

The downward trend in consumer inflation that has become more pronounced since the second quarter spilled over into the third quarter as foreseen in the July Inflation Report. Food prices continued to rise rapidly owing to the abnormal weather conditions and soaring agricultural prices on global markets. Nevertheless, inflation continued to decelerate as strong monetary tightening put pressure on services and consumer durables, and annual inflation remained within the uncertainty band at the end of the third quarter.

As we have said repeatedly in all our Inflation Reports since early 2007, the slowdown in domestic demand and in the employment of services sector, driven by monetary tightening, put more evident pressure on services inflation in the third quarter. The decline in the entire services group is expected to continue in the upcoming period. Moreover, in building our forecasts, we have also taken into consideration the tax adjustments and hikes in electricity prices that might occur in the last quarter of 2007 and in administered prices that are likely to emerge in the first quarter of 2008.

The rate cuts in September and October led to a significant reduction in medium and long-term interest rates. Accordingly, it is obvious that the monetary policy stance continues to be on the accommodative side, but at a slower rate than the first three quarters.

Apart from our forecasts related to domestic economic activity, other significant variables providing input to medium term inflation forecasts are the data related to external economic activity. This data set is composed of findings pertaining to fundamental macroeconomic variables of the Eurozone such as interest rates, inflation and growth, and of projections pertaining to the course of international commodity prices and global liquidity conditions. Assumptions related to the Eurozone are derived from the October 2007 release of “Consensus Forecast” results. In this respect, Eurozone growth forecasts appear to be revised downwards most likely due to the problems in credit markets. Therefore, Eurozone growth forecast for 2007 is reduced to 2.6 percent from 2.7 percent, and forecasts for 2008 are lowered to 2 percent from 2.2 percent. CPI inflation, on the other hand, is expected to remain at 2 percent until end-2008.

The assumptions for ECB’s monetary policy are based on the notion that the bank will embark on a series of gradual rate hikes starting from the second quarter of 2008 and tighten its monetary policy due to upward pressures on inflation. Along with the Eurozone, the projections for monetary policies of other developed economies and international liquidity conditions are also closely monitored.

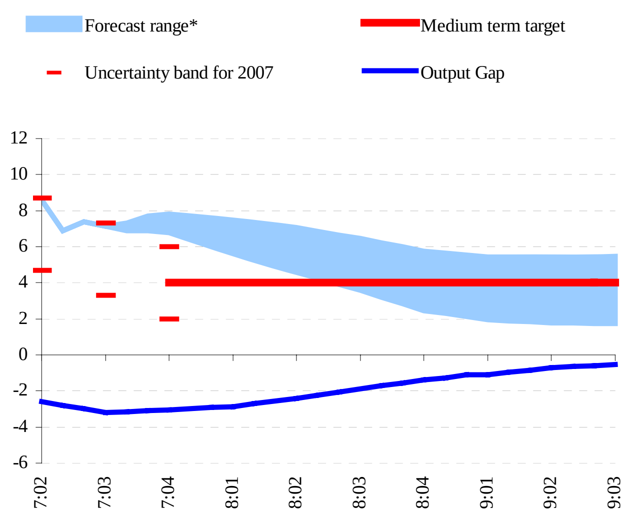
World crude oil prices that have been soaring since early 2007, run a course above our forecasts given in the July-2007 Inflation Report. Therefore, the assumption on oil prices, which was USD 65 per barrel in the July Report, is revised up to USD 70 per barrel. Due to the difficulty of making a clear projection regarding the course of crude oil prices, it was assumed that crude oil prices would follow a horizontal course at around USD 70 per barrel in producing forecasts. Besides, it is also assumed that 2008 budget targets will be met, the slowdown in global economy will be quite mild and there will be no significant shift in Turkey’s risk premium.

7.2. Medium-Term Outlook

This part presents the medium-term inflation and output gap forecasts developed within the framework of the assumptions and forecasts explained in Part 7.1.

Based on the assumption that policy rates would be gradually reduced in the rest of the year and in the first couple of months of 2008 and then remain flat, inflation is forecasted, with 70 percent probability, to be between 6.7 and 7.9 percent at the end of 2007 (midpoint 7.3), between 2.5 and 5.7 percent (midpoint 4.1) at the end of 2008, and between 1.7 and 5.5 percent (midpoint 3.6) at the end of the third quarter of 2009 (Graph 7.2.1).

Graph 7.2.1. Inflation and Output Gap Forecasts



* Forecast range corresponds to the 70 percent confidence interval.

The upward revision in the inflation forecasts for end-2008 compared to the previous report results from assumptions regarding tax adjustments and administered price hikes, and from initiation of the measured rate cut cycle earlier than expected. The September rate cut decision led to a significant decline in both the medium and long-term interest rates. The fall in interest rates is expected to give a further boost to domestic demand than predicted in the July-2007 Inflation Report. This was also reflected in the output gap estimates that underlie inflation forecasts in Graph 7.2.1. Thus, the downward risks on medium-term inflation posed by global economic developments have been reduced and inflation forecasts have come closer to the 4 percent target for 1 to 2 years ahead.

7.3. Risks and Monetary Policy

The term "monetary policy stance", which is often cited in CBRT's monetary policy releases, refers not only to the current level of the short term interest rates but also to the possible future path of policy rates. It should be emphasized again that the policy path assumption underlying the medium term projection is based on the current data set and thus it should be subject to revision as new information arrives. In other words, unexpected developments on the inflation outlook will lead to a change in the monetary policy stance. Therefore, the policy path assumption built on current data should by no means be perceived as a commitment of the CBRT. A deviation of actual interest rate developments from the assumed path must be perceived as the norm rather than the exception. In this respect, the policy path underlying the above medium-term forecasts should not be perceived as a commitment for uninterrupted rate cuts in the following months. Depending on the incoming information, the policy rate may follow different paths: For example, it may remain constant in the near term, or if conditions allow, it may decline faster or for a longer period of time than indicated above.

The rate cut decision by the Committee on September 14 is a case in point. Recall that underlying the forecasts in July-2007 Inflation Report was an assumption which envisaged measured rate cuts starting from the beginning of the last quarter. The following statement in the July Report made clear that this assumption was not a commitment: "... *rate cuts can be considered earlier as well as later depending on the flow of incoming information regarding external demand, public expenditures and other determinants of medium term inflation outlook*". Indeed, the Committee—pointing to better-than-expected developments in services inflation, and citing the downside risks on domestic as well as external demand conditions posed by recent developments in the US credit market—decided to initiate the measured rates cuts one month before the last quarter.

Main risks to the inflation and monetary policy outlook can be summarized as follows:

The CBRT closely monitors the developments in international liquidity conditions and credit markets. As of today, a sharp slowdown on global economic growth is not perceived as the most likely scenario, leading to continued capital flows to emerging markets. However, that the risks in the financial markets have not yet been adequately priced necessitates caution. The CBRT, in case of a heightened risk aversion and a decline in risk appetite towards emerging financial markets, will aim at limiting the effects of possible market fluctuations on the medium-term inflation outlook by pursuing an active liquidity management strategy as well as by utilizing other policy instruments if needed.

Recent volatility in credit markets has partially offset the upside risks to the aggregate demand outlook mentioned in the previous Report. However, there are some remaining risks to the demand outlook. On one side, the extent to which the recent decline in longer term rates will stimulate the domestic demand is yet to be observed. On the other side, a sharper-than-envisaged slowdown in global growth will curb both the external demand and, through tighter credit conditions, the domestic demand. The CBRT will keep monitoring the financing conditions and credit developments closely in the face of upside and downside risks. If credit conditions turn out to be more favorable than expected and domestic demand accelerates, this may lead to a more cautious policy stance than implied by the baseline scenario, as well as the use of policy tools other than short term interest rates, such as required reserves and alike. Likewise, materialization of downside risks on aggregate demand would lead to an adjustment in the policy stance so as to mitigate the downside risks on inflation.

The medium-term inflation and monetary policy projections are based on the assumption that the government expenditure targets will be met in 2008. Any deviation from this assumption might affect the inflation outlook and the monetary policy stance. The fact that the government incomes policy will be set in line with inflation targets in 2008 will facilitate the management of demand and inflation expectations. However, the fact that efforts to re-adjust the primary budget balance are more focused on increases in indirect taxes as opposed to expenditure cuts poses a risk to the predictability of inflation.

The sustained rise in food prices is considered as an important risk to the inflation outlook. Our medium term projection envisages a gradual correction in which food inflation converges to headline inflation in the medium term. However, low crop yields in 2007 and recent global trends have increased the upside risks to the food inflation. On the other hand, past cumulative hikes have created a high base in food prices, increasing the possibility of a downward adjustment. Potential volatility in food prices continue to pose risks to the inflation outlook on both sides, since food prices constitute a large fraction of the CPI index. The CBRT will not react to the developments in food prices as long as the second round effects are contained.

There are some uncertainties over the medium term impact of the recent developments in energy prices. It is likely that there will be a sizeable increase in electricity prices in the near term. The price of water, classified as another energy item in the CPI, may also display a significant rise in the last quarter of

2007, although the rate of increase may differ across regions. Moreover, international crude oil prices continue to trend upwards. The medium-term impact of the rise in energy prices on inflation will be limited, as long as inflation expectations and the price setting behavior remains intact. However, since the energy price is an important factor of production, it should also be added that recent developments in energy prices have compelled the CBRT to be relatively more cautious in cutting rates. On the other hand, switching to a cost-based automatic pricing mechanism in electricity would reduce the risks on shortage of supply as well as on price stability.

Turkey has taken significant steps towards price stability in recent years. However, it is not yet possible to define the current state as price stability. The CBRT will continue to use its policy instruments to attain price stability and thus to improve welfare of the society in the medium term. In order to reduce the cost of achieving macroeconomic stability, it is particularly important not to sacrifice long term permanent gains in favor of temporary benefits during this process.

The support of fiscal policy and structural reforms are also critical in achieving price stability. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be important. Particularly, advances in structural reforms that would enhance the quality of fiscal discipline are monitored closely with regard to their implications on macroeconomic and price stability.

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ABBREVIATIONS

AMA	Automotive Manufacturers Association
BoJ	Bank of Japan
CBRT	Central Bank of the Republic of Turkey
CDS	Credit Default Swap
CPI	Consumer Prices Index
CSRA	Credit Suisse Risk Appetite Index
ECB	European Central Bank
EMBI	Emerging Markets Bonds Index
EU	European Union
Fed	Federal Reserve Bank of America
GDBS	Government Domestic Borrowing Securities
GDP	Gross Domestic Product
GNP	Gross National Product
GNTA	Grand National Assembly of Turkey
GS	Goldman Sachs
HICP	Harmonized Index of Consumer Prices
ISE	Istanbul Stock Exchange
LME	London Metal Exchange
MPC	Monetary Policy Committee
MSCI	Morgan Stanley Capital Index
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers Index
SCA	Special CPI Aggregates
SCT	Special Consumption Tax
SPO	State Planning Organization
TEA	**T**urkish Exporters' Assembly
TELEKOM	Turk Telecommunications Inc.
TURKSTAT	Turkish Statistical Institution
USA	United States of America
VAT	Value Added Tax
WGMA	White Goods Manufacturers Association
YTL	New Turkish lira