CENTRAL BANK OF THE REPUBLIC OF TURKEY

Presentation Before the Planning and Budget Commission of the Grand National Assembly of Turkey

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27 December 2007

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Outline

Goals:

✓ **Sustainable and High Growth**

Prerequisites
> ➢ *Macroeconomic Stability*
>   • Price Stability
>   • Low Public Debt
> ➢ *Structural Reforms*
> ➢ *Good Governance*

✓ **Single-Digit Nominal Interest Rate**

Prerequisite ➢ *Price Stability*

Turkey – Economic Outlook:

✓ Inflation Developments

✓ Interest Rate and Exchange Rate Policies, Markets

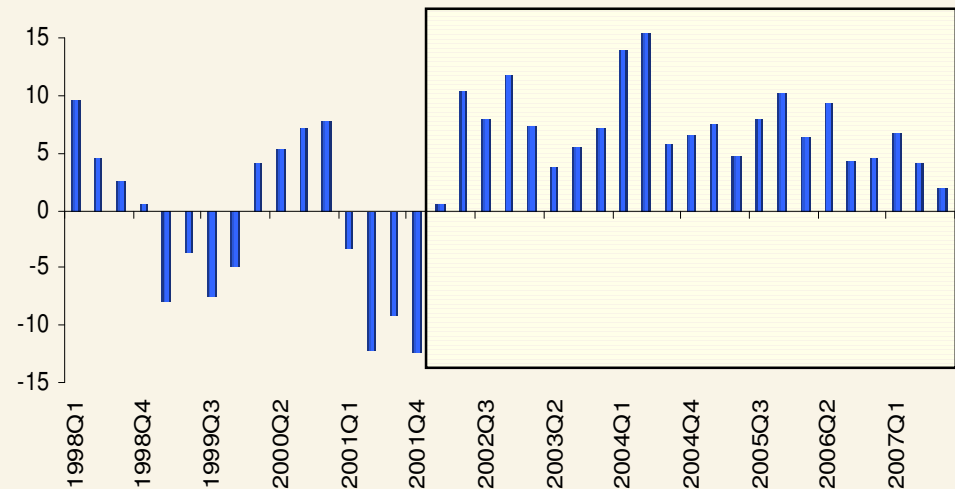✓ Growth and Employment

✓ Balance of Payments Developments

Sustainable and High Growth

✓ The Turkish economy has been growing for 23 successive quarters.

✓ Between 2001 and the third quarter of 2007, the real GNP growth rate was:

- 47.5 % on a cumulative basis,

- 7.0 % on average.

✓ The industrial sector has made the largest contribution to growth from 2002 onwards.

✓ The commerce sector has also supported the high growth rate.

✓ The contribution of exports to growth is increasing along with the integration into the global economy and increased competitiveness.
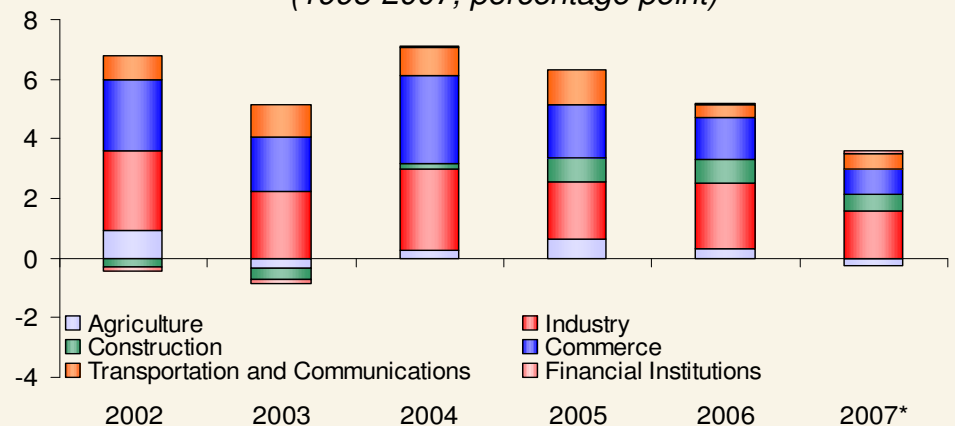
Growth
(GNP, percentage change, 1998-2007 Q3)

Contribution to GDP Growth
(1998-2007, percentage point)

- Agriculture
- Construction
- Transportation and Communications
- Industry
- Commerce
- Financial Institutions

* As of 2007 Q3
Source: TURKSTAT

Sustainable and High Growth

✓ The private sector has been the engine of growth since 2001.

- Between 2001 and the third quarter of 2007, investment and consumption expenditures of the private sector increased by 149.3 % and 38.9 %, respectively, in real terms.

✓ Productivity gains have underpinned the economic growth and enhanced its quality.

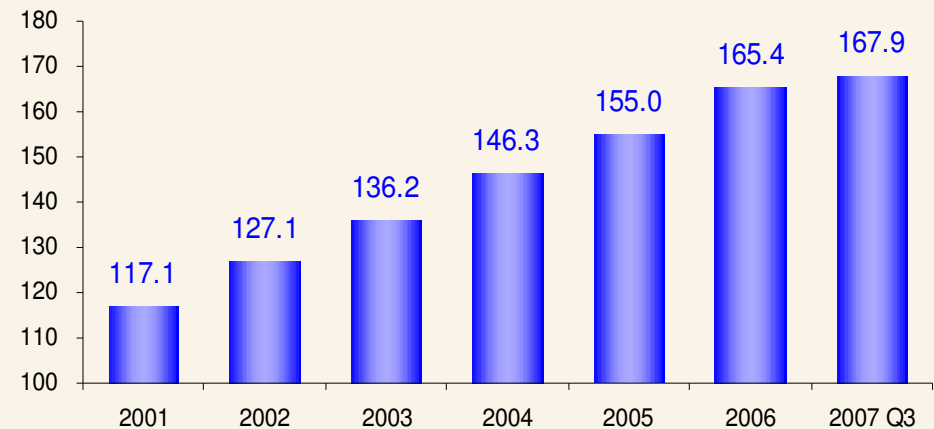- From 2001 onwards, the cumulative increase in productivity has reached 43.4 %.

Investment and Consumption Expenditures
(real percentage change, 2001 – 2007 Q3)

Private Sector
Public Sector

Investment: 149.3, 26.8
Consumption: 38.9, 21.8
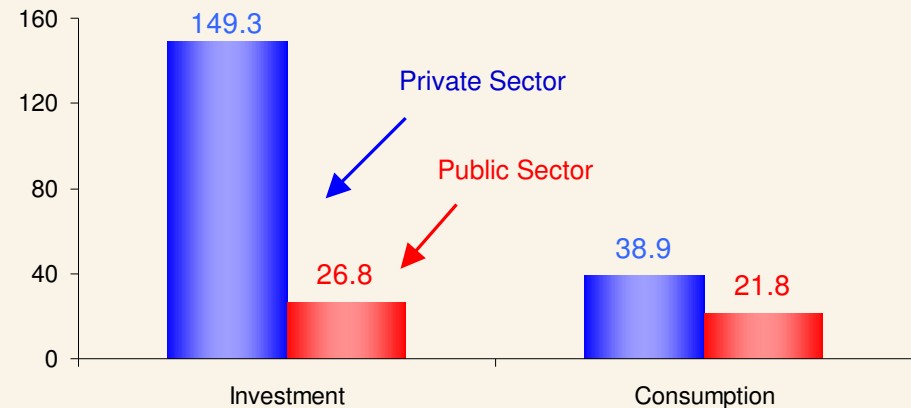
Productivity in Manufacturing Industry
(per hour worked, annual average)

2001	2002	2003	2004	2005	2006	2007 Q3
117.1	127.1	136.2	146.3	155.0	165.4	167.9

Source: TURKSTAT

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Sustainable and High Growth

✓ Raising productivity is crucial for high and sustainable growth.

✓ Productivity increases play a significant role in the strong growth performance.

  - The contribution of total factor productivity to growth, which was 11.4 % on average in the 1988-2000 period, rose to 44.2 % in the 2002-2006 period.

  - In the upcoming period, the upsurge in total factor productivity is expected to result chiefly from industrial and services sectors.

✓ Productivity-boosting measures should be taken not only in the private, but also in the public sector.

Contribution of Total Factor Productivity to Growth
(annual average, percent)

1988-2000	2002-2006	2007-2013*
11.4 %	44.2 %	37.0 %

* Forecast
Source: State Planning Organization Ninth Development Plan

GDP and Manufacturing Industry Productivity
(1997Q1–2007Q3, annual moving average, per hour worked)

Productivity (1997 Q1 = 100)
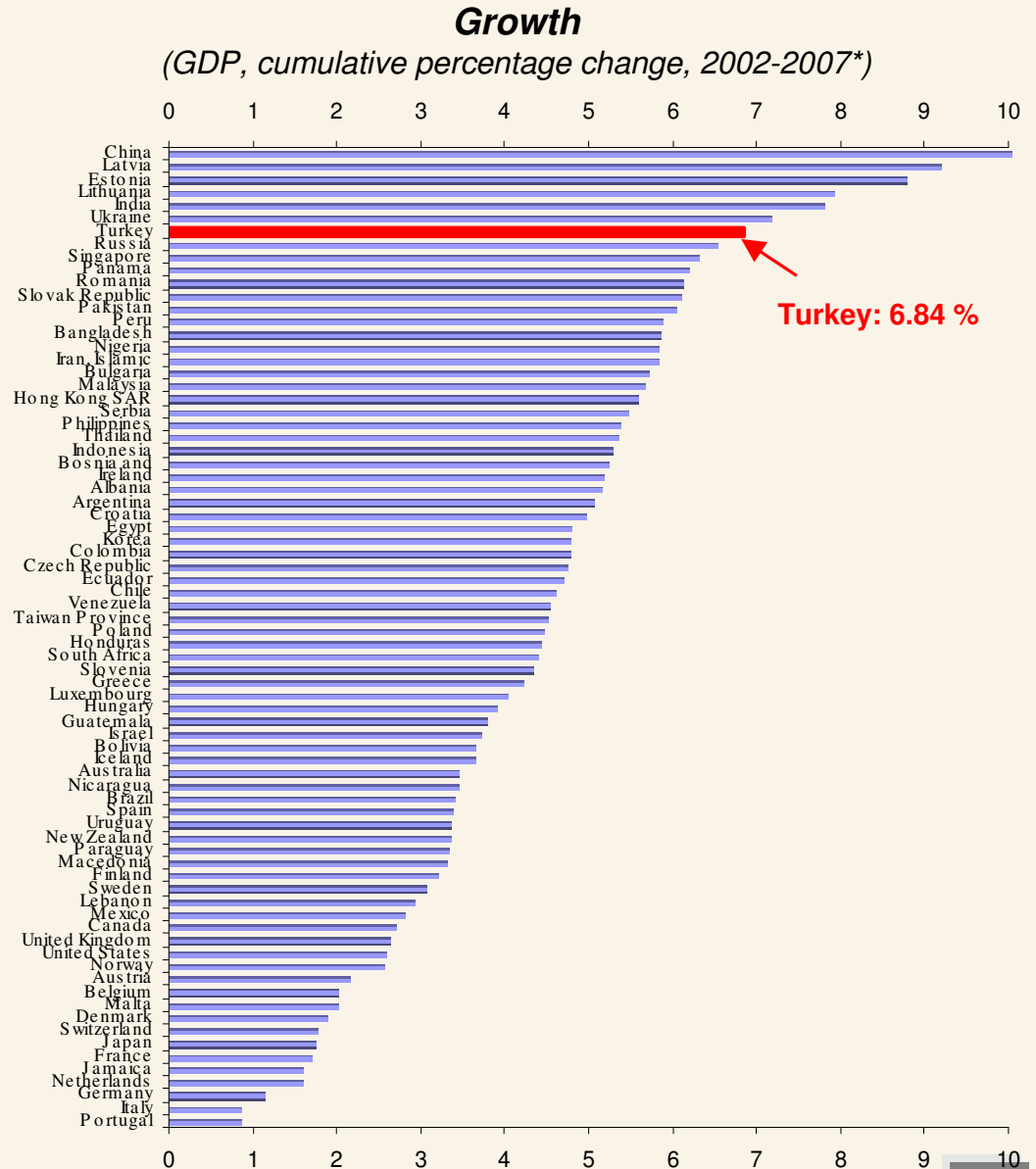
GDP (1997 Q1 =100)
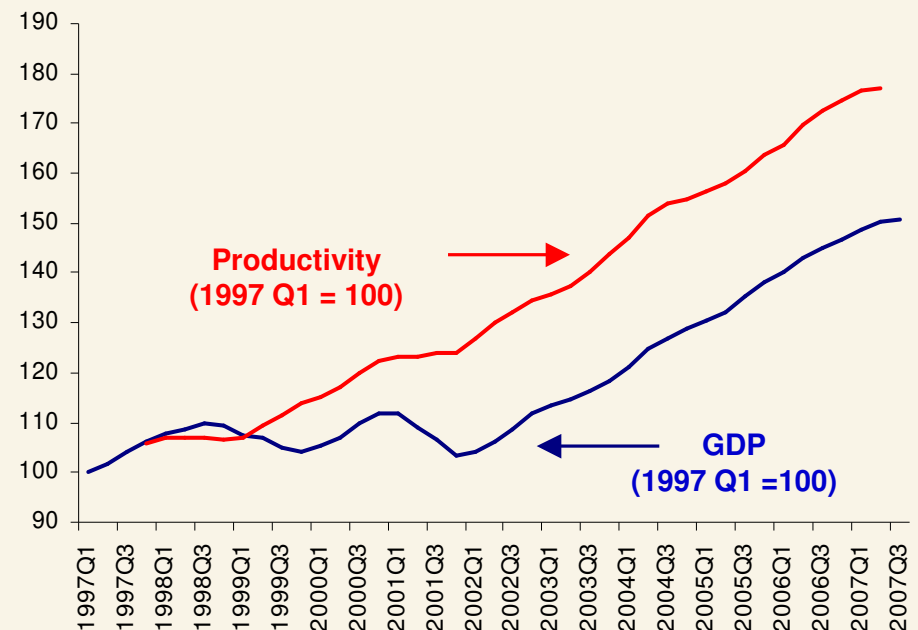
Source: TURKSTAT

Sustainable and High Growth

✓ In the 2002-2007 period, the Turkish economy has been one of the fastest-growing economies in the world.

✓ In this period, the cumulative growth rate of GDP was 48.7 %. (annual average rate**:** 6.84 %)

✓ Turkey ranked 7th in growth rate among 76 developed/developing countries (Among 180 countries Turkey ranked 32nd)

✓ What Turkey needs is to maintain the achievements made after 2001 and ensure the sustainability of growth.

Growth
(GDP, cumulative percentage change, 2002-2007)*

Turkey: 6.84 %

China
Latvia
Estonia
Lithuania
India
Ukraine
Turkey
Russia
Singapore
Panama
Romania
Slovak Republic
Pakistan
Peru
Bangladesh
Nigeria
Iran, Islamic
Bulgaria
Malaysia
Hong Kong SAR
Serbia
Philippines
Thailand
Indonesia
Bosnia and
Ireland
Albania
Argentina
Croatia
Egypt
Korea
Colombia
Czech Republic
Ecuador
Chile
Venezuela
Taiwan Province
Poland
Honduras
South Africa
Slovenia
Greece
Luxembourg
Hungary
Guatemala
Israel
Bolivia
Iceland
Australia
Nicaragua
Brazil
Spain
Uruguay
New Zealand
Paraguay
Macedonia
Finland
Sweden
Lebanon
Mexico
Canada
United Kingdom
United States
Norway
Austria
Belgium
Malta
Denmark
Switzerland
Japan
France
Jamaica
Netherlands
Germany
Italy
Portugal

*Forecast for 2007
Source: IMF World Economic Outlook

How To Achieve Sustainable and High Growth

✓ Sustainable growth refers to an economic growth involving an environment of price stability, the consistency between economic indicators and macroeconomic balances as well as stable growth rates that are close to the potential growth level.

How to achieve high sustainable growth

✓ **Macroeconomic stability**
- Price stability
- Sustainable public finance

✓ **Structural reforms**
- Social security reform
- Tax reform
- Regulations on the labor market
- Education reforms
- Regulations on the energy market
- Competitive environment

✓ **Good Governance**
- Political stability
- Rule of law
- Voice and accountability
- Regulatory quality
- Government effectiveness
- Control of corruption

✓ Some of these reforms require legal and administrative regulations, while others need to find a place in the budget.

✓ These measures should be taken by maintaining fiscal discipline and be implemented via the enlargement of the tax base or prioritization or savings in public expenditures rather than raising current tax rates.

How To Achieve Sustainable and High Growth

Macroeconomic Stability

✓ Macroeconomic stability is a prerequisite for high sustainable growth.

✓ Although important achievements have been made in the disinflation process in the last five years, price stability has not been achieved yet.

✓ The fiscal discipline to reduce public debt stock is an important determinant of the inflation and growth dynamics.

Net Public Debt Stock / GNP,
Inflation (CPI, annual percentage change),
GNP (annual percentage change)

Inflation (left axis)

Net Public Debt Stock / GNP (right axis)

GNP Growth (left axis)
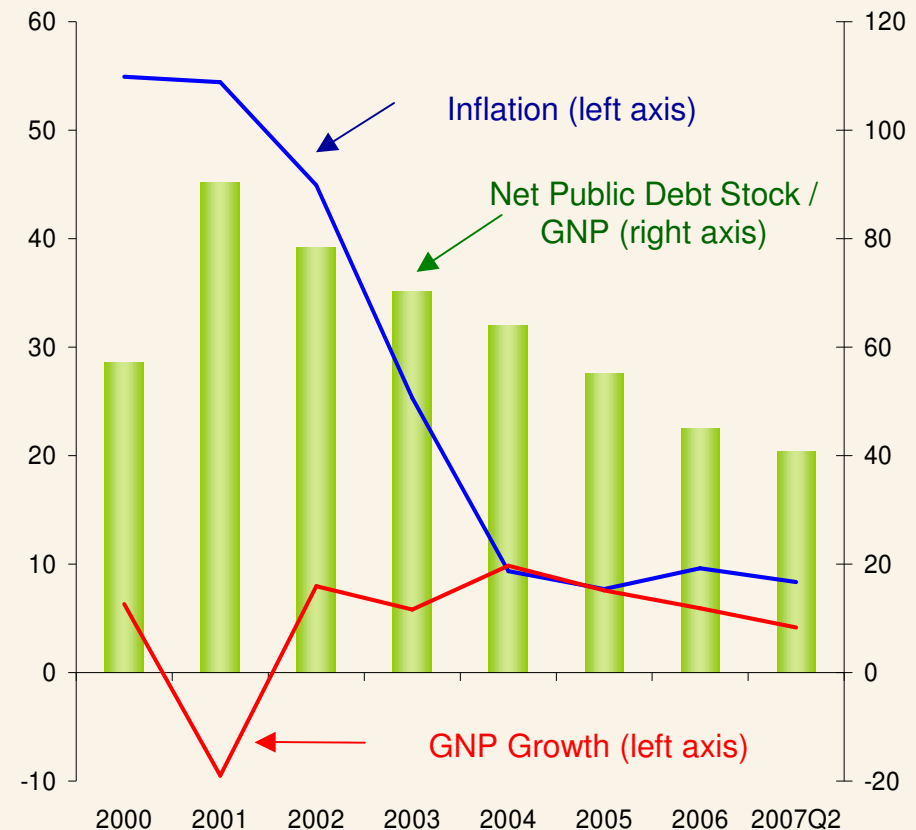
Source: TURKSTAT, Undersecretariat of Treasury

How To Achieve Macroeconomic Stability

## Price Stability

✓ **Economic growth that compromises price stability can not be permanent.** The rise of economic prosperity solely hinges on the achievement of sustainable growth.

✓ The high growth rates attained in the 1980s along with high inflation could not be sustained and was replaced by higher inflation and economic stagnation.

✓ During the 2002-2007 period, high growth rates were accompanied by falling inflation.

	Average Inflation	Average Growth
1981-1989	43.4 %	4.8 %
1990-2001	74.0 %	3.0 %
2002-2006	14.9 %	7.5 %

Inflation and Growth Trends in Turkey
(1981-2006, percent)
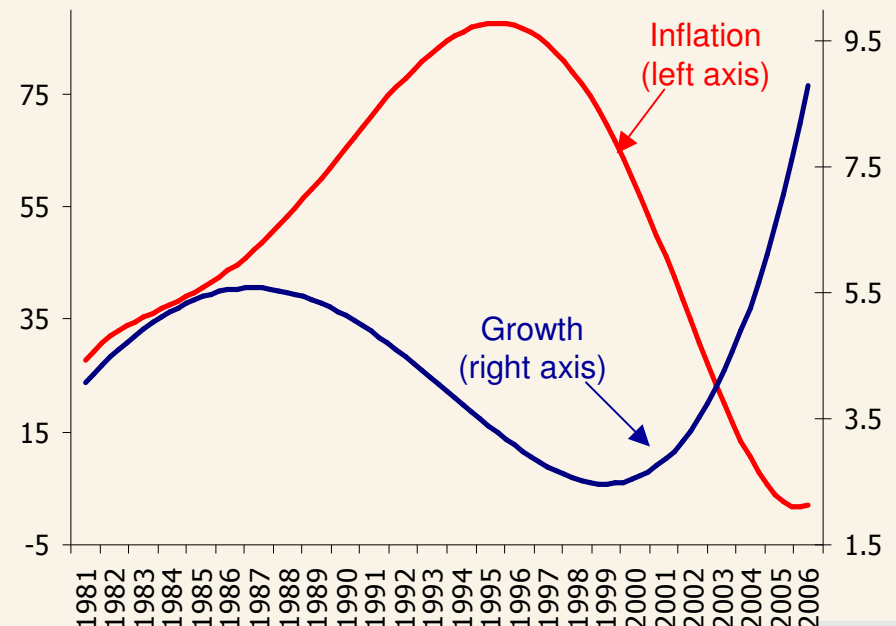

Source: TURKSTAT

How To Achieve Macroeconomic Stability

Fiscal Discipline

✓ Chronic public deficit ranks first among the factors that led to high interest rates in Turkey for long years.

✓ As a result of substantial restoration of fiscal discipline after 2001,

- Borrowing requirement of the public sector diminished.

- Roll-over ratio of the debt stock has been reduced and the domestic borrowing maturity has increased.

-Public debt burden was eased.

Hence, interest rates have dropped significantly.

Net Public Debt Stock and Public Sector Borrowing Requirement *(Ratio to GNP, percent)*
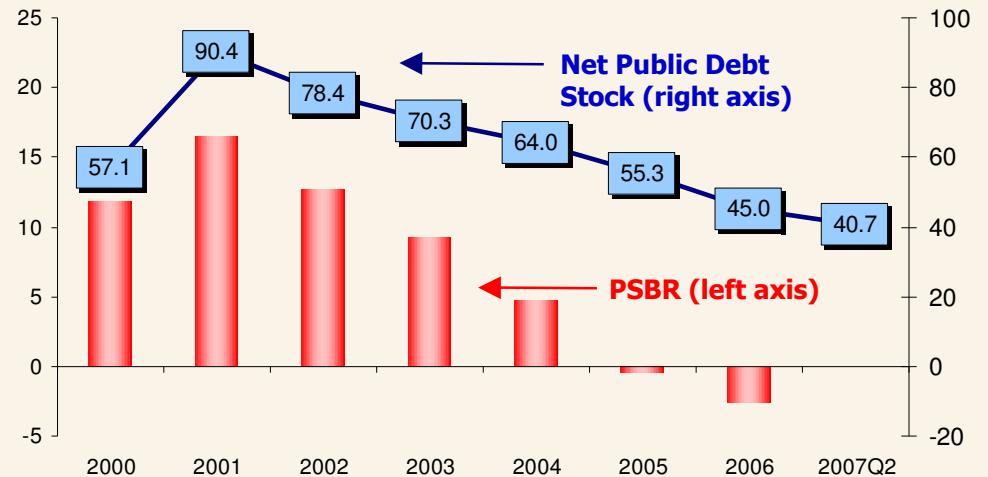
Average Maturity of Domestic Debt Stock in Cash and Average Maturity of Domestic Borrowing in Cash*(month)*


Source: TURKSTAT, Undersecretariat of Treasury

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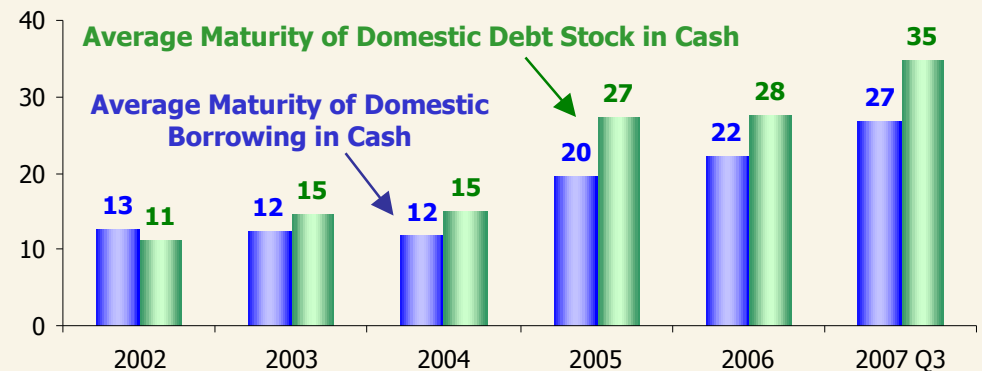
How To Achieve Macroeconomic Stability

Fiscal Discipline

✓ Current fiscal practices are among the main determinants of interest rates.

✓ Tight fiscal policy is not only essential for demand control but also for displaying our determination in implementing the program.

✓ It is also influential in shaping expectations.

✓ Budget balance has improved significantly since 2002. In 2006, the ratio of budget deficit to national income dropped to its lowest level in the last three decades.

✓ In 2007, the level of fiscal discipline lagged behind the level of 2006.

✓ Public sector balance may display volatilities from year to year depending on the pace of economic activities.

✓ The budget deficits that may be observed during economic slowdowns should be matched by the budget surplus during high growth periods, thus keeping the budget in balance on average in the long-term.

Budget Balance / GNP
(1975 – 2007*, percent)
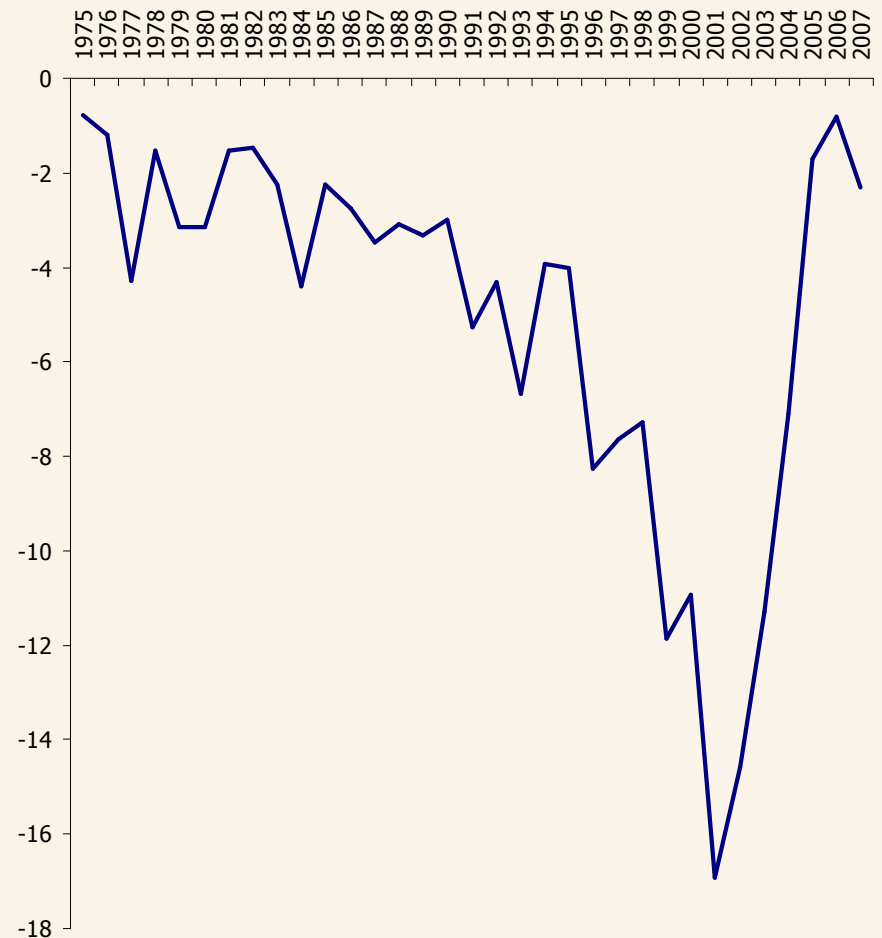
* Forecast for 2007

Source: Ministry of Finance, State Planning Organization

Fiscal Discipline

✓ Fiscal discipline is not all about primary surplus.

✓ The quality of fiscal adjustment is of vital importance with respect to both disinflation and sustainable and high growth rate.

✓ In the last two decades, both non-interest expenditures and tax revenues displayed substantial increases.

✓ Increased share of the public sector in the economy reduces the amount of funds available for the private sector investments and exerts pressure on investment-oriented resources.

✓ In order to ensure the sustainability of a private sector-oriented growth in the upcoming period, the quality of public revenues and public expenditures should be improved.

✓ For this purpose, the productivity of the public sector should be boosted and the effects of the current tax policies on the private sector should be taken into account.

✓ Local administrations comprise the other leg of public finance. The reporting of their expenditures should be conducted in a transparent manner.

Tax Revenues and Primary Balance Expenditures*

*(1990 – 2007**, Ratio to GDP, percent)*

Non-interest expenditures

Tax Revenues
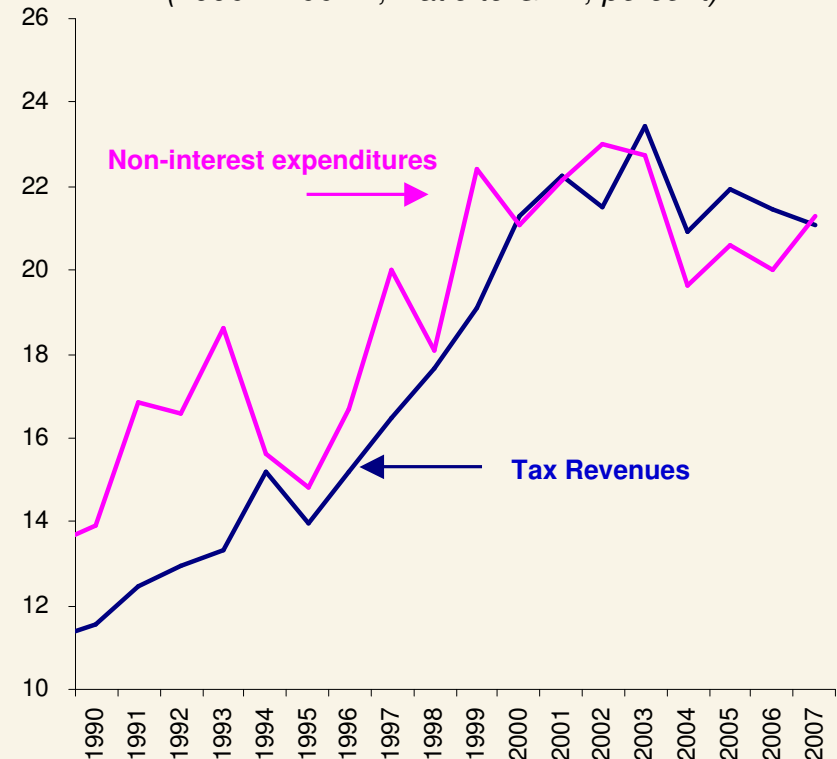
* In order to ensure the comparability of budget data in terms of years, the shares allocated to local administrations is excluded from revenue and expenditure figures pertaining to 2006 and 2007.

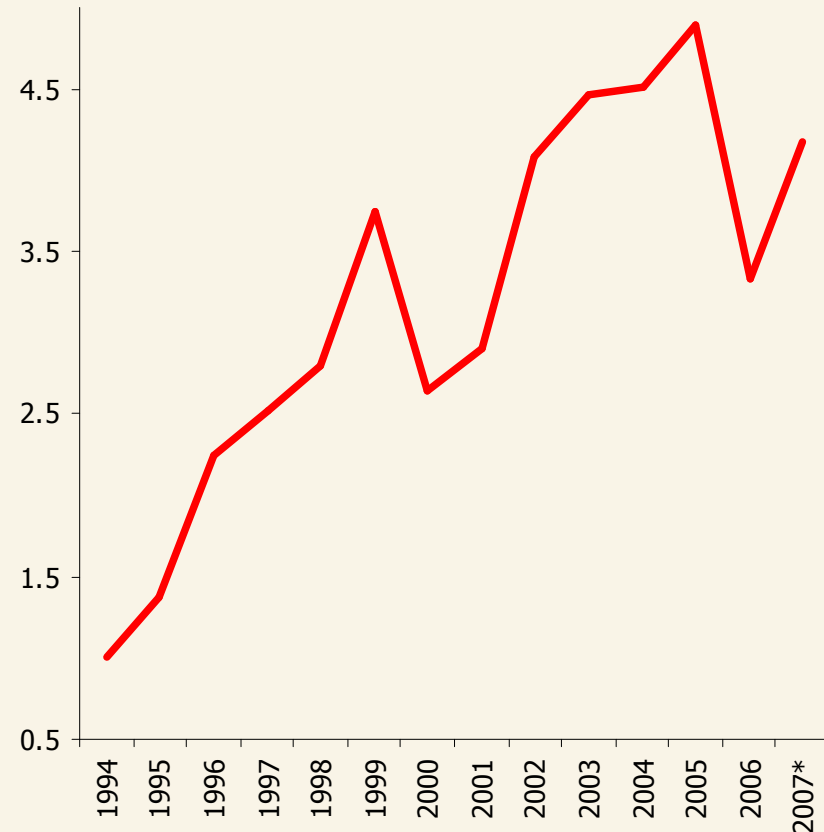** Forecast for 2007

Source: Ministry of Finance, SPO.

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Structural Reforms – Social Security System

✓ Structural reforms will ensure sustainable and high growth rates.

✓ In this framework, it is essential to establish an efficiently functioning and financially sustainable social security system.

- The deficits of the social security system have reached high levels.

- Significant steps have been taken in recent years. Nevertheless, positive results of these measures will appear in the long-run.

The Ratio of Transfers from Budget to Social Security Institutions to GNP *(percent)*

*Forecast for 2007

Source: Undersecretariat of Treasury, Ministry of Finance

Structural Reforms – Tax System and Labor Market

✓ It is of crucial importance to expand tax base and reduce the size of informal economy within the framework of a sound tax system.

✓ The labor market reforms will contribute to sustainable growth and permanent increases in employment.

✓ In this framework,

- Economic polices should be conducive to job creation.

- The business environment should be raised to a level on par with international competition and employment taxes should be cut.

- The education system should be consistent with labor demand and positioned to raise the quality of labor force.

Employment Taxes
*(as a percentage of labor cost, 2006)*
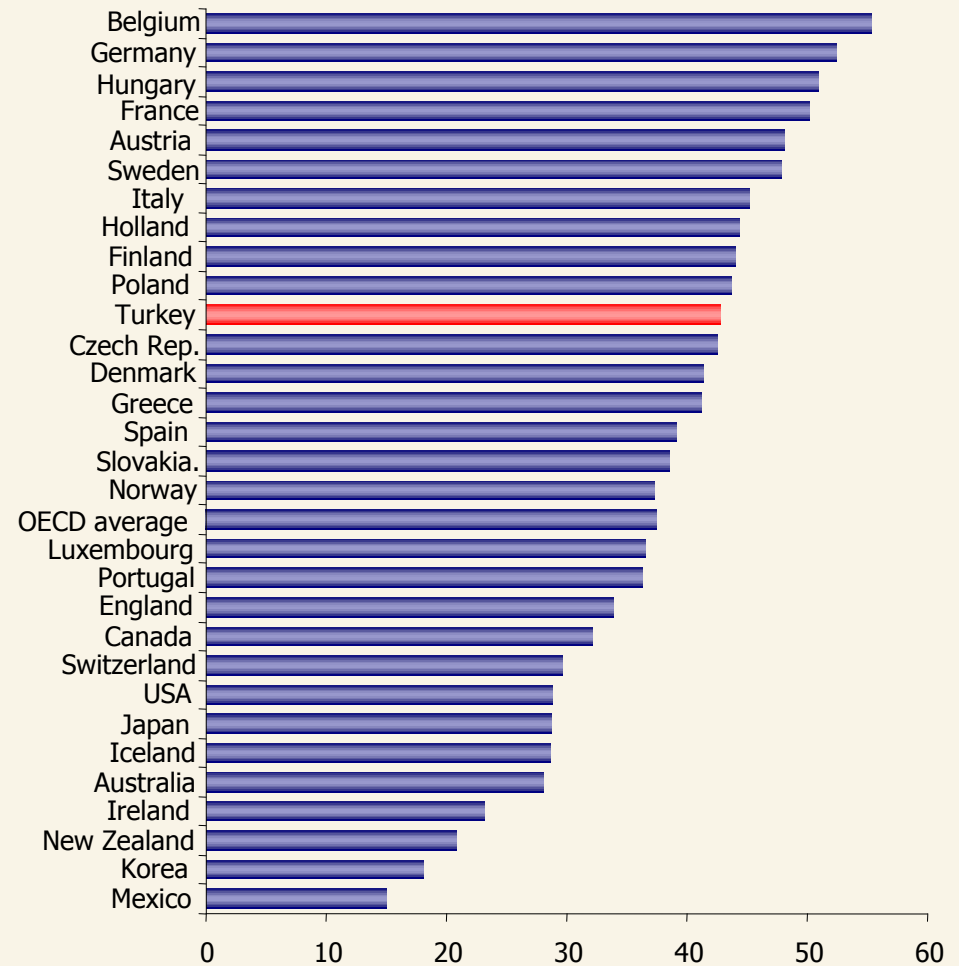
Source: OECD

**Structural Reforms-
Education System**

✓ Drafting an education reform, to meet economic needs, will have a positive impact on sustainable growth in the long-run.

- According to the results of PISA 2006 conducted by the OECD, Turkey ranks 37th, 43rd and 44th among 57 countries in reading, mathematical and scientific literacy, respectively.

- It is imperative to establish consistency between human resources developed by the Turkish education system and the needs of the Turkish economy for qualified labor force.

Breakdown of Students According to the Results of the Programme for International Student Assessment (PISA) (2006)

Source: OECD
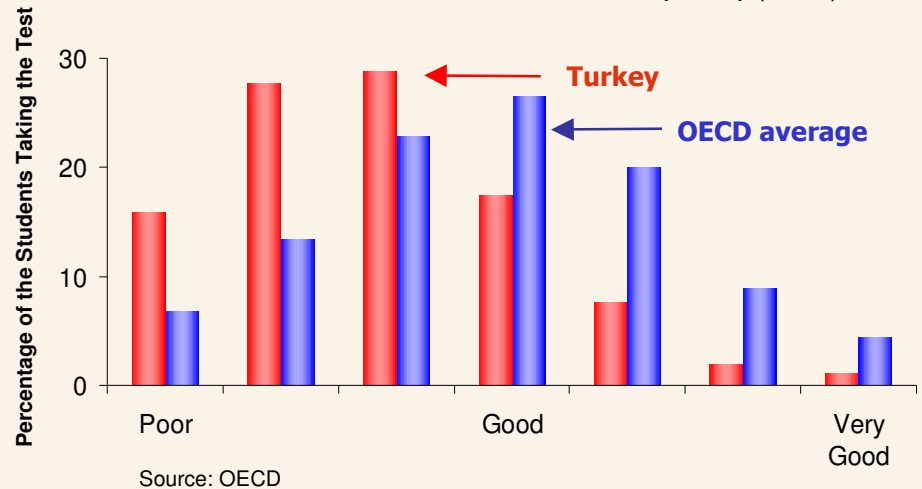
Average Hourly Wage Index by Education Level
(2002, Urban, wage-earners, average = 100)

	Male	Female
Illiterates	56	35
Primary-Middle School Graduates	78	50
High School Graduates	111	84
Vocational High School Graduates	113	82
University Graduates	211	165
AVERAGE	100	100

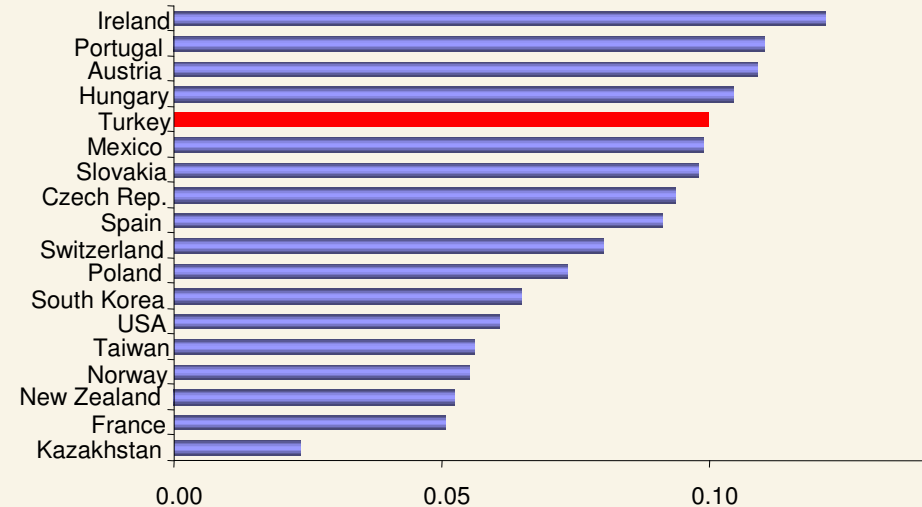Source: TURKSTAT Survey for Household Revenue and Consumption, 2002

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**Structural Reforms-
Energy Market**

✓ Privatizating the energy market, diversifying supply sources and ensuring supply security are of vital importance for achieving sustainable and high growth rate.

✓ The electricity prices for the industrial sector are higher than electricity prices for households in Turkey compared to other countries.

✓ Transition to cost-based automatic pricing system will diminish risks relating to supply security and price stability.

✓ Projected increases in electricity and natural gas prices in the upcoming period are forecasted to boost inflation in 2008 by about 0.5 percentage points.
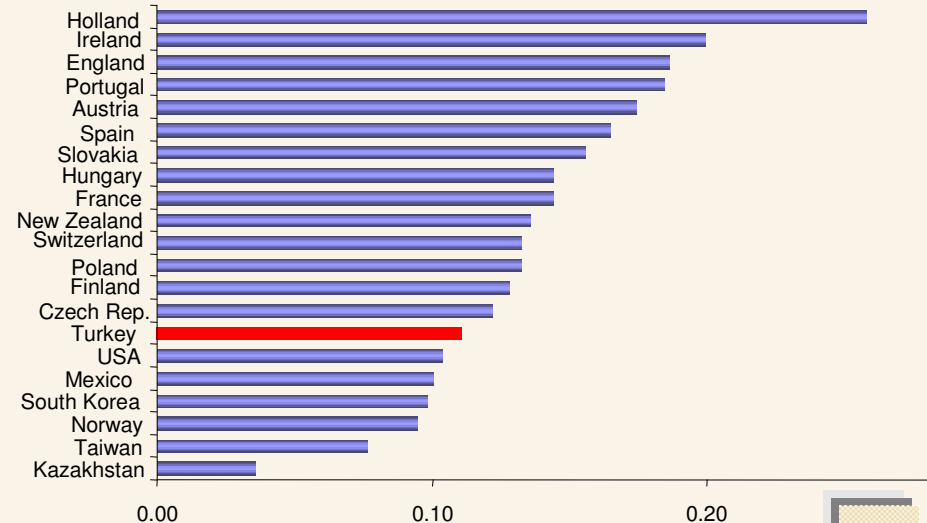
Electricity Prices for Industry
(US dollars per kilowatt-hour, including taxes, 2006)

Ireland
Portugal
Austria
Hungary
Turkey
Mexico
Slovakia
Czech Rep.
Spain
Switzerland
Poland
South Korea
USA
Taiwan
Norway
New Zealand
France
Kazakhstan

0.00   0.05   0.10

Electricity Prices for Households
(US dollars per kilowatt-hour, including taxes, 2006)

Holland
Ireland
England
Portugal
Austria
Spain
Slovakia
Hungary
France
New Zealand
Switzerland
Poland
Finland
Czech Rep.
Turkey
USA
Mexico
South Korea
Norway
Taiwan
Kazakhstan

0.00   0.10   0.20

Source: Energy Information Administration

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Structural Reforms – Business Environment and Competitiveness

✓ Achieving the results from these reforms depends not only on the reinforcement of reforms, but also on the continuance and further development of the process.
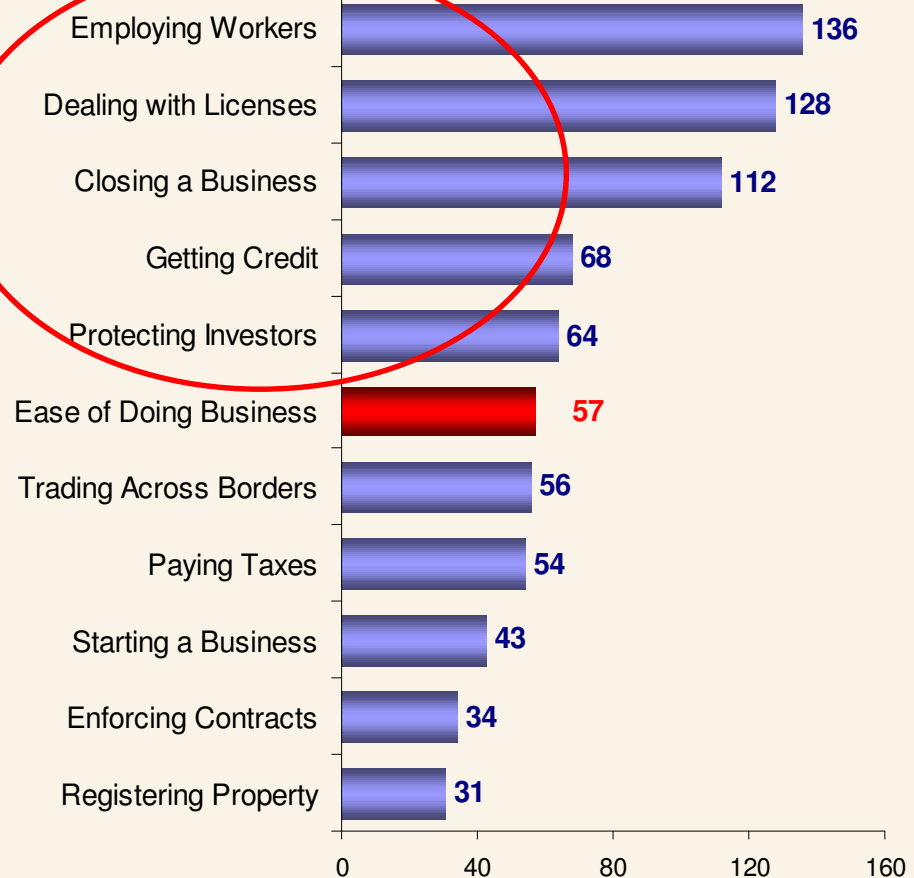
✓ In this context, structural reforms should be supported by micro reforms that enhance competitiveness and productivity.

✓ Turkey ranks 57th among 175 countries on the ease of doing business provided in the World Bank's "Doing Business Report".

- The most problematic areas in the Turkish economy are listed as the ease of employing workers, dealing with licenses, closing a business, getting credit and protecting investors.

Problematic Areas

Ease of Doing Business
(Turkey's Ranking, 2007)

Employing Workers	136
Dealing with Licenses	128
Closing a Business	112
Getting Credit	68
Protecting Investors	64
Ease of Doing Business	57
Trading Across Borders	56
Paying Taxes	54
Starting a Business	43
Enforcing Contracts	34
Registering Property	31

Lowest = Easiest

Source: World Bank, Doing Business 2008
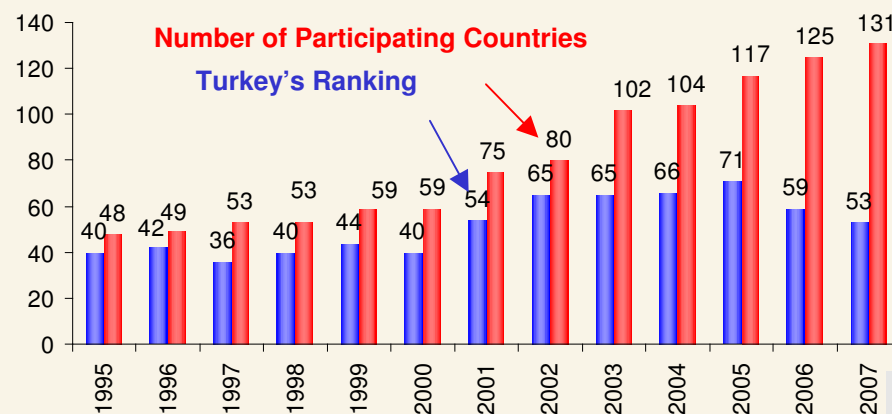
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Structural Reforms – Competitiveness of the Economy

✓ By fighting against inflation, the monetary policy enhances the competitiveness of the overall economy and the export sector in a permanent manner.

✓ Turkey should make progress in other factors affecting on competitiveness such as efficiency of bureaucracy, tax structure, quality of infrastructure, price competition and governance as well as in qualitative and structural factors.

✓ According to the Global Competitiveness Index, Turkey stepped up 18 places in the last two years.

✓ This structure confirms the importance of macroeconomic stability in general, price stability in particular.

Main Factors Affecting Competition

	2003	2007
1	Inflation	Inefficient Government Bureaucracy
2	Political Instability	Tax Regulations
3	Policy Instability	Policy Instability
4	Access to Financing	Tax Rates
5	Inefficient Government Bureaucracy	Access to Financing
6	Tax Rates	Inadequate supply of Infrastructure
7	Corruption	Inadequately-educated Workforce
8	Tax Regulations	Corruption
9	Inadequate supply of Infrastructure	Inflation
10	Restrictive Labor Regulations	Restrictive Labor Regulations
11	Poor Work Ethics	Government Instability
12	Inadequately-educated Workforce	Foreign Currency Regulations
13	Foreign Currency Regulations	Poor Work Ethics
14	Crime and Theft	Crime and Theft

Turkey's Place in Global Competition

Number of Participating Countries

Turkey's Ranking

Year	Turkey's Ranking	Number of Participating Countries
1995	40	48
1996	42	49
1997	36	53
1998	40	53
1999	44	59
2000	40	59
2001	54	75
2002	65	80
2003	65	102
2004	66	104
2005	71	117
2006	59	125
2007	53	131

Source: World Economic Forum, The Global Competitiveness Report 2007-2008

Good Governance

✓ Improvement in governance indicators is of great importance for reaching sustainable growth rates.

✓ There is a strong positive correlation between good governance and national income per capita.

✓ Turkey, standing at lower levels in 2002, made a significant progress in 2006.

Economic Performance and Governance (2006)

Governance Indicators:
- ❖ Political Stability
- ❖ Rule of Law
- ❖ Voice and Accountability
- ❖ Regulatory Quality
- ❖ Government Effectiveness
- ❖ Control Corruption
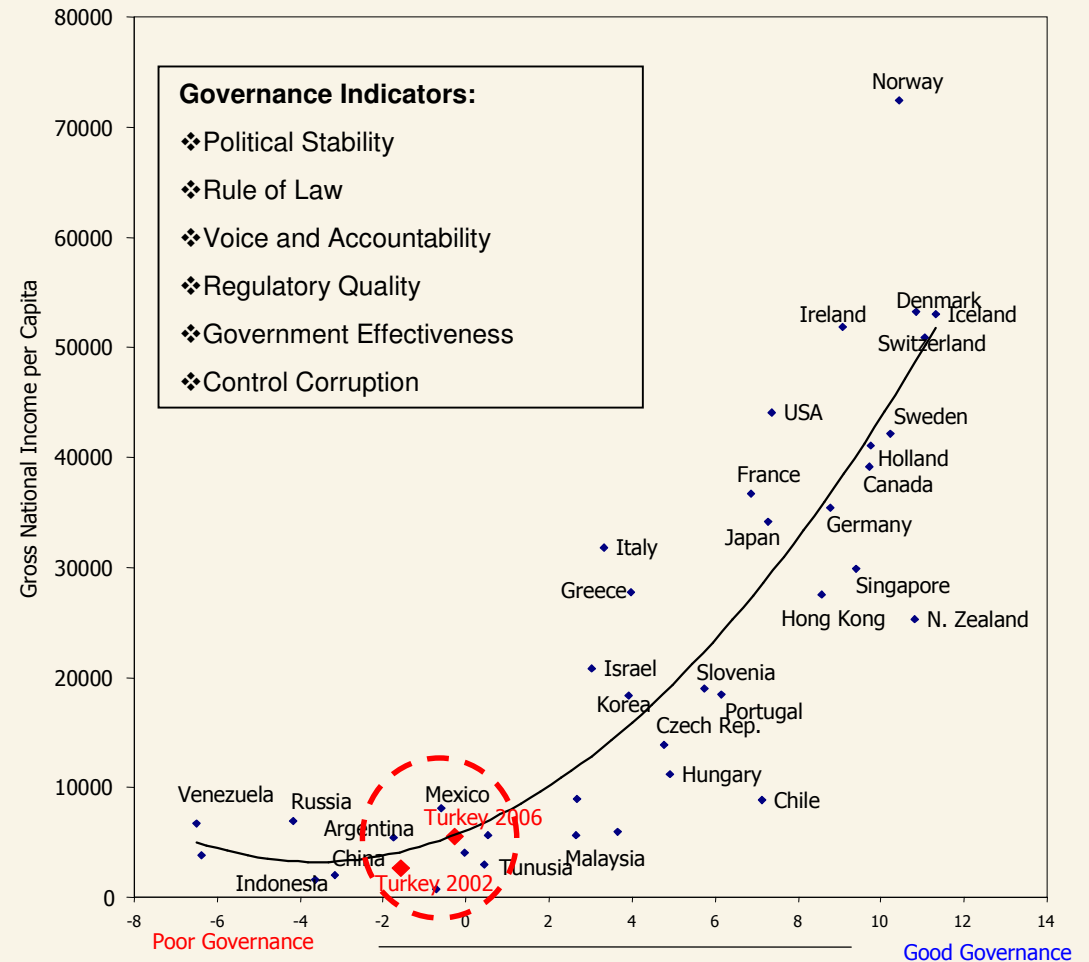
Trend line is $y=a+bx+cx^2$ curve; y=GDP per capita and x=governance index.

Source: World Bank, CBRT

How to Achieve Sustainable and High Growth

Good Governance

✓ All indicators of good governance improved compared to 2000.

✓ Nevertheless, there is still much to be done to reach a level compatible with the EU-15 countries.

Governance Indicators of Turkey and EU-15*
(2000 and 2006)

Turkey (2006)

Turkey (2000)

EU-15 (2006)

- Political Stability
- Rule of Law
- Voice and Accountability
- Regulatory Quality
- Government Effectiveness
- Control Corruption

-2.50 -1.50 -0.50 0.50 1.50 2.50
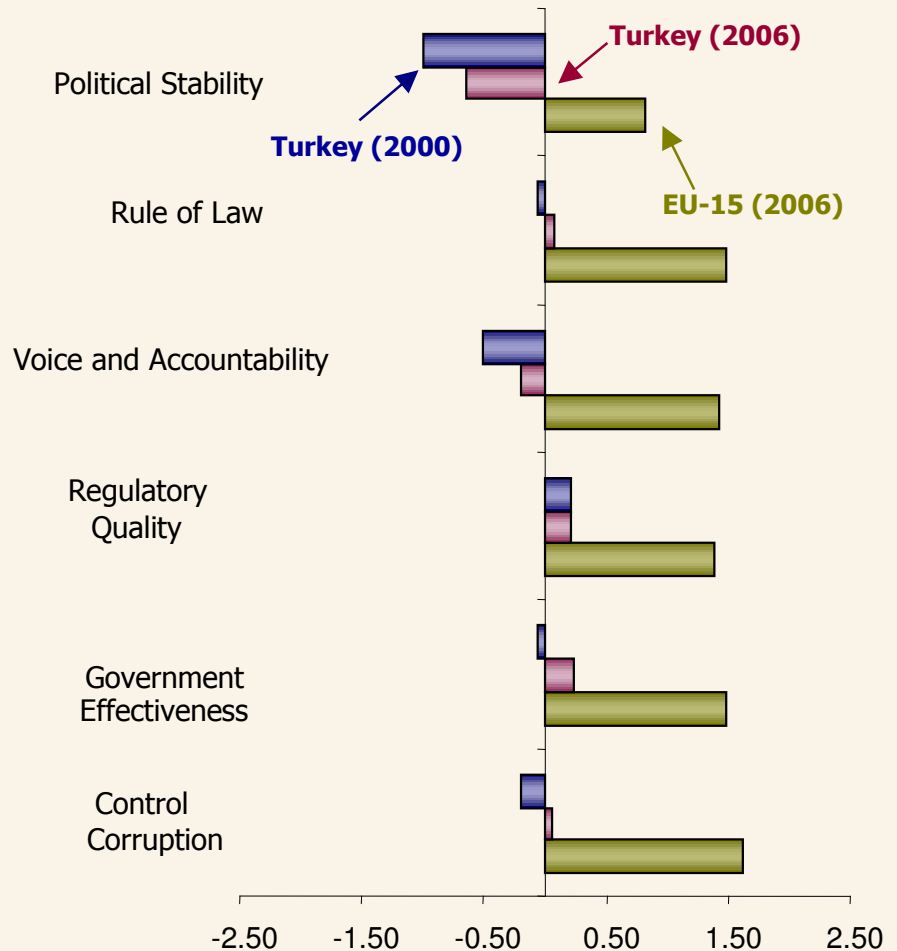
*Governance indicators; governance forecasts are between –2.5 and +2.5. Higher forecast figures indicate better governance.

Source: World Bank

How To Achieve Single-Digit Nominal Interest Rate

Level of Interest Rates

✓ Nominal interest rate is determined by three variables:

Nominal Int. = Real Int. + Risk Premium + Inflation Expectation

- Real interest rate is determined by real variables such as the marginal efficiency of capital and the savings rate.

- The level of inflation compensation, which is the sum of inflation expectations and the inflation risk premium, is directly related to price stability.

- A fall in both inflation expectations and the risk premium leads to a decline in nominal interest rates.

✓ It is not possible to bring interest rates down by artificial policy rate cuts below the level required to sustain the disinflation process.

✓ On the contrary, such a move would lead to higher medium and long-term interest rates since it would deteriorate inflation expectations and risk perceptions.

CBRT Short-Term Interest Rates and Benchmark Interest Rate on Government Securities

(2 January 2002 – 26 December 2007, compound, percent)

Short-Term Interest Rate

**Benchmark Interest Rate on Government Securities**

Source: CBRT

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Level of Interest Rates

✓ Interest rates have declined in recent years, both in nominal and real terms, owing to the achievements on the road to stability.

- While nominal interest rates have slumped to 16 % from 70 % since the beginning of 2002, real rates also fell below 10 % from 20 – 30 %. As of December 2007, real interest rates stand at 9.81.

Real Interest Rates*
(January 2002 – December 2007, compound, percent)
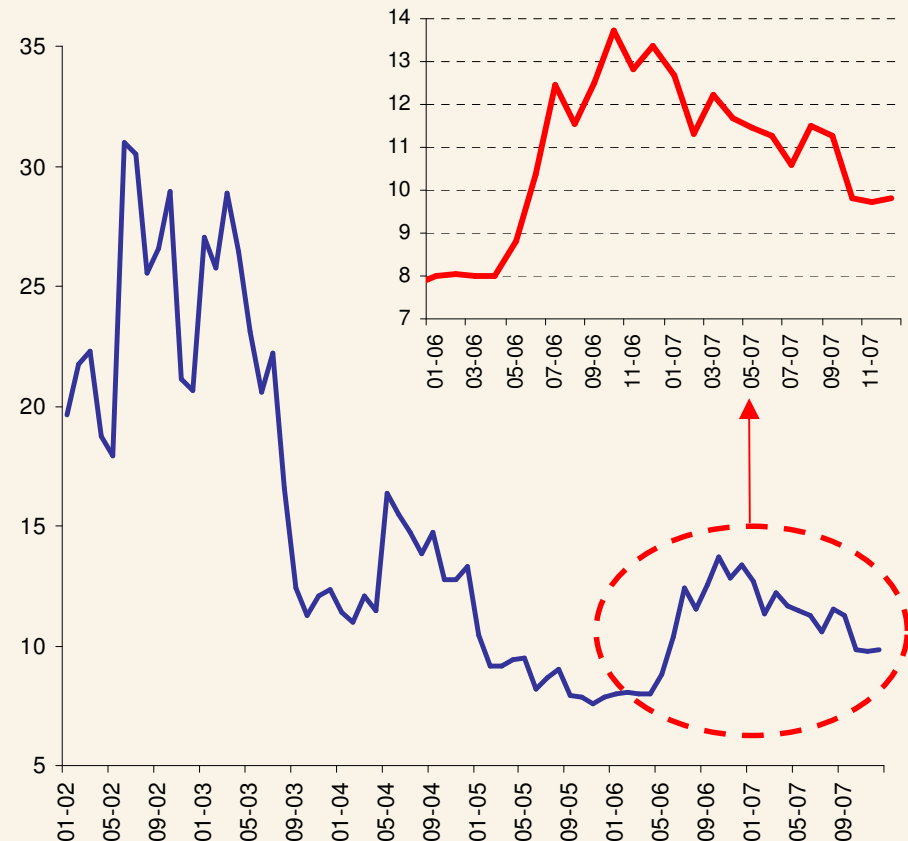
* Based on borrowing interest rates applicable in government domestic borrowing auctions and 12-month inflation expectations.

Source: CBRT, Undersecretariat of Treasury

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How to Achieve Single-Digit Nominal Interest Rate?

How to achieve further decline in nominal and real interest rates?

Nominal and real interest rates will fall to and remain at desired levels as long as:

✓ There are less uncertainties in macroeconomic variables, particularly in inflation,

✓ Public debt stock is reduced and public financing is sustainable,

✓ The economy is bolstered against internal and external shocks through structural reforms,

✓ Decisive steps are taken for permanently established macro balances and an environment of confidence,

✓ Inflation expectations of the private sector improve and confidence on the economy increases.

Our determination in the implementation of monetary policy contributes to the decline in short and long-term real interest rates via demand control and expectations management.

Price Stability

✓ Price stability refers to an inflation at rates low enough not to affect economic agents' decisions on investment, consumption and savings.

✓ Central Bank has been decisively fighting against inflation for the last seven years.

- Inflation targets were achieved and inflation was lowered by more than 60 percentage points between the years 2001 and 2005.

- Inflation exceeded the target in 2006 and is expected to remain outside the uncertainty band by the end of 2007 as well.

✓ Hence, disinflation process is a dynamic and ongoing process.

Actual Inflation Figures and Year-End Inflation Targets

(January 2002 – November 2007, annual percentage change)
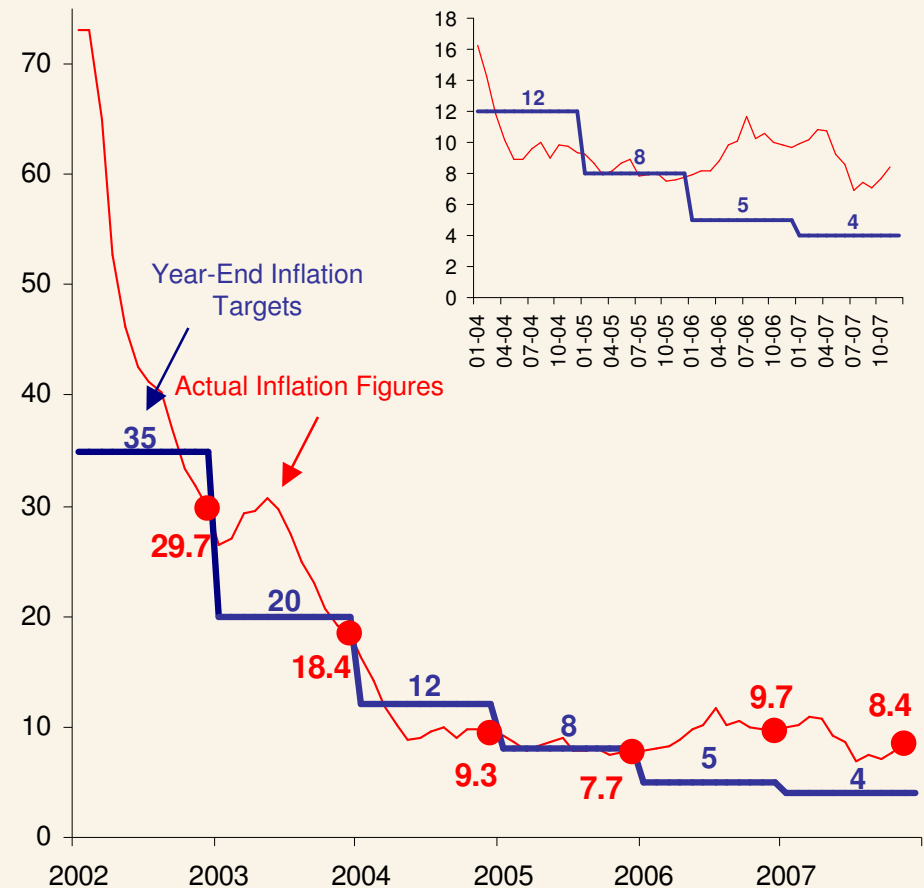
Source: TURKSTAT, CBRT

**Central Bank independence is a cornerstone
in the disinflation process.**

✓ Monetary policies of the past, which mainly focused on short-term political goals, have resulted in high inflation, low and unstable growth rates, crises and high unemployment rates.

✓ An independent central bank with a medium and long-term perspective would resist such short-term behaviors and thus, fight against inflation more effectively.

✓ Therefore, central bank independence is critical for the achievement of price stability.

Central Bank of Turkey and Independence

✓ The Central Bank of Turkey was granted independence by the Grand National Assembly of Turkey with an amendment to the Law in 2001.

✓ The primary objective of the Bank is to achieve and maintain price stability.

   - Inflation target is set jointly with the Government.

   - The monetary policy to be implemented and monetary policy instruments to be used to achieve and maintain price stability are determined by the Central Bank on its discretion.

✓ The Central Bank implements its policies decisively within the framework of inflation targeting regime with a view to achieving the goal of price stability.

✓ The Central Bank supports the growth and employment policies of the Government, provided that these policies are not in conflict with the objective of achieving and maintaining price stability.

For Further Decline in Nominal and Real Interest Rates...

Historical successes have been achieved in the disinflation process with the inflation targeting regime, which was implemented implicitly between 2002-2005 and has been implemented explicitly since 2006.

✓ Inflation targeting is a regime that has proved successful around the world, and requires continuity.

✓ Inflation targeting regime is not only a numerical target setting.

✓ It applies to a wide range of areas in terms of design, implementation, communication and institutional structure.

✓ It has been worked on for a long time and a strong technical infrastructure has been established.

✓ It has a strong direct or indirect interaction with other policies.

Working principles and worldwide implementations of inflation targeting regime are clear-cut.

✓ The regime reflects a medium-term perspective.

✓ It is essential that the targets remain intact, except for extraordinary conditions.

✓ Periodical deviations from targets have been observed in many countries implementing this regime. However, no country has abandoned the regime.

✓ In cases of deviations from the target, a certain period of time is needed before resuming the process of converging to the target.

✓ Abandoning the inflation targeting regime or adopting different principles in its conduct would impede the disinflation process and price stability, and put past achievements at risk.

Economic Outlook
"Inflation Developments"

✓ The May – June 2006 volatility and the deterioration in expectations disrupted the medium-term disinflation process.

✓ However, lagged effects of strong monetary tightening have subdued the rise in inflation and brought it back to a path consistent with the target.

✓ In the first three quarters of 2007, inflation, as projected, remained within the uncertainty band set around the path consistent with the target.

✓ In the last quarter of the year, supply-side shocks such as drought and hikes in energy prices as well as adjustments in administered prices led to stagnation in the downward tendency of inflation.

✓ As of November 2007, inflation stood at 8.40 %.

Consumer Price Inflation
*(January 2006 – November 2007, annual percentage change)*
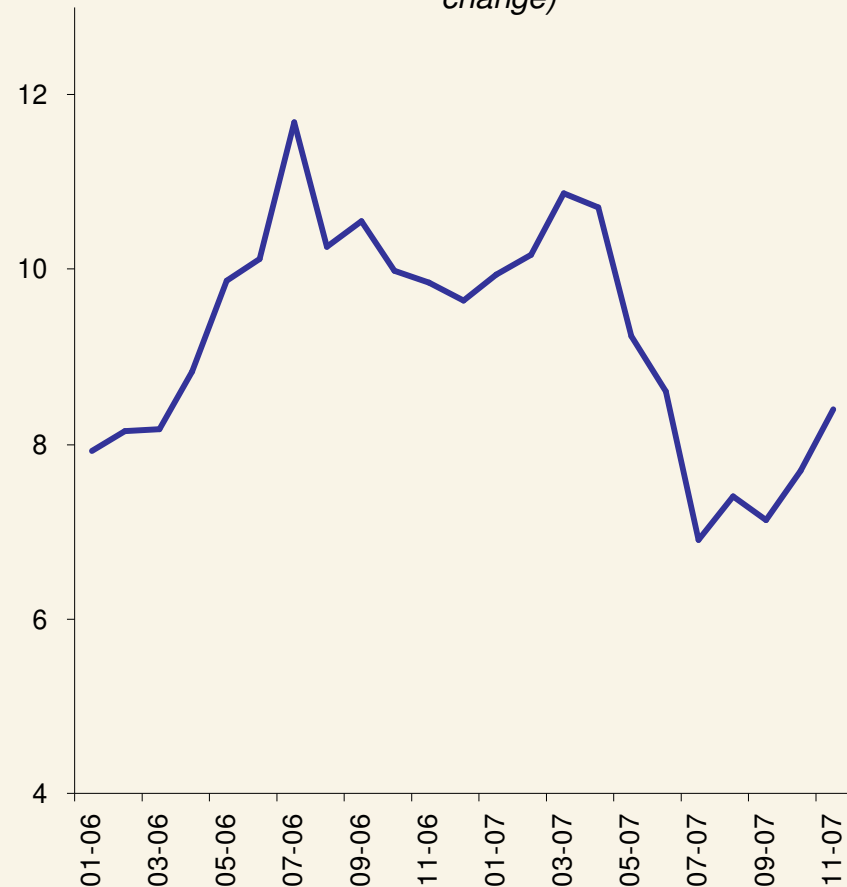
Source: TURKSTAT

Inflation Developments

✓ The downward trend observable particularly in services inflation is encouraging, since it points to a gradual break of long-term inflation rigidity in this group.

✓ Better-than-expected inflation figures in the services sector in the second and third quarters of the year gave a positive signal for inflation outlook.

✓ Goods inflation has followed a more volatile course due to external and supply-side factors.

Services and Goods Inflation
(January 2004 – November 2007, annual percentage change)
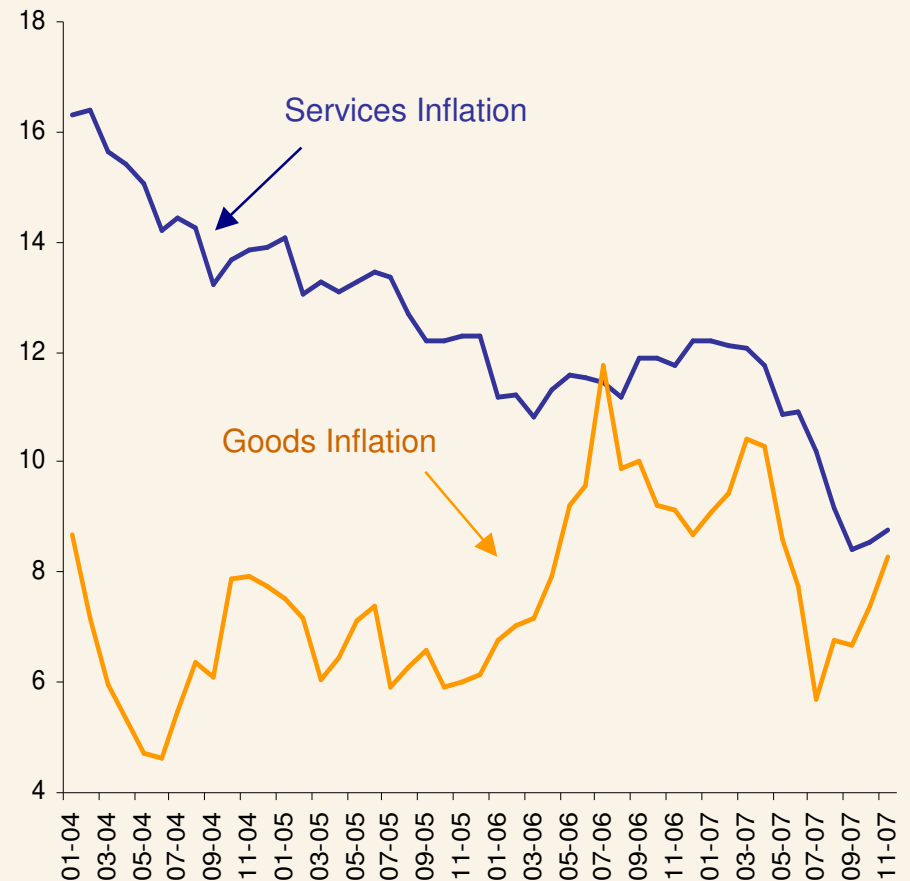
Source: TURKSTAT, CBRT

✓ Food prices stand as the main factor that has impeded the disinflation process in 2007.

- As of November 2007, food group has added 3.5 percentage points to annual inflation.

✓ Non-food inflation showed a significant deceleration in 2007 compared to 2006.

- Non-food inflation, which was 9.8 % in November 2006, declined to 6.9 % over the same month of 2007.

- Adjustments to administered prices in November resulted in stagnation in the downward tendency of non-food inflation.

Food and Non-Food CPI
(January 2004 – November 2007, annual percentage change)

Food and Non-Alcoholic Beverages

CPI Excluding Food and Non-Alcoholic Beverages

Source: TURKSTAT, CBRT

33
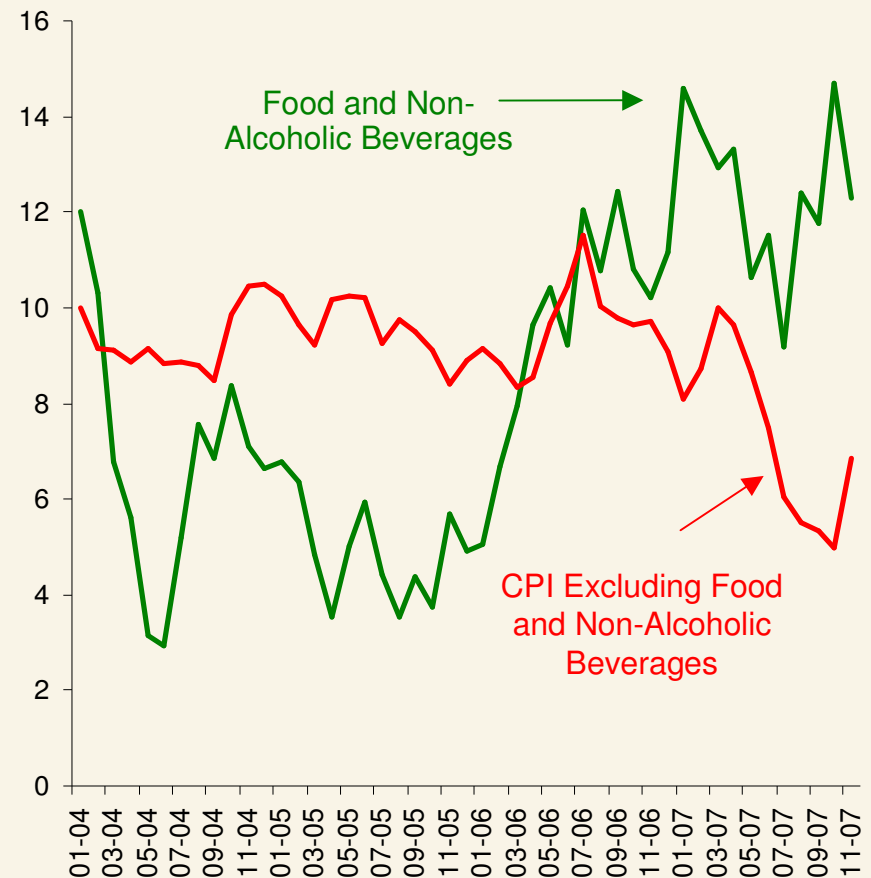
Inflation Developments

✓ Temperatures above seasonal averages in the recent period and changing supply conditions exert upward pressure on food prices.

✓ As of November 2007, year-on-year inflation in the unprocessed food group is 12.5 %. This increase was triggered by the rise in fresh vegetable prices.

- The year-on-year inflation in fresh vegetable prices, which was 8.2 % on average in the previous three years, reached 16.7 % in November 2007.

✓ The 12.1 % year-on-year increase in processed food prices in November is the highest increase ever in the index with 2003 base year.

- This increase mainly stemmed from bread and cereal group prices, which climbed by 13.8 % in the first eleven months of the year.

Unprocessed and Processed Food Prices

(January 2006 – November 2007, annual percentage change)

Unprocessed Food

Processed Food

CPI Excluding Food and Non-Alcoholic Beverages
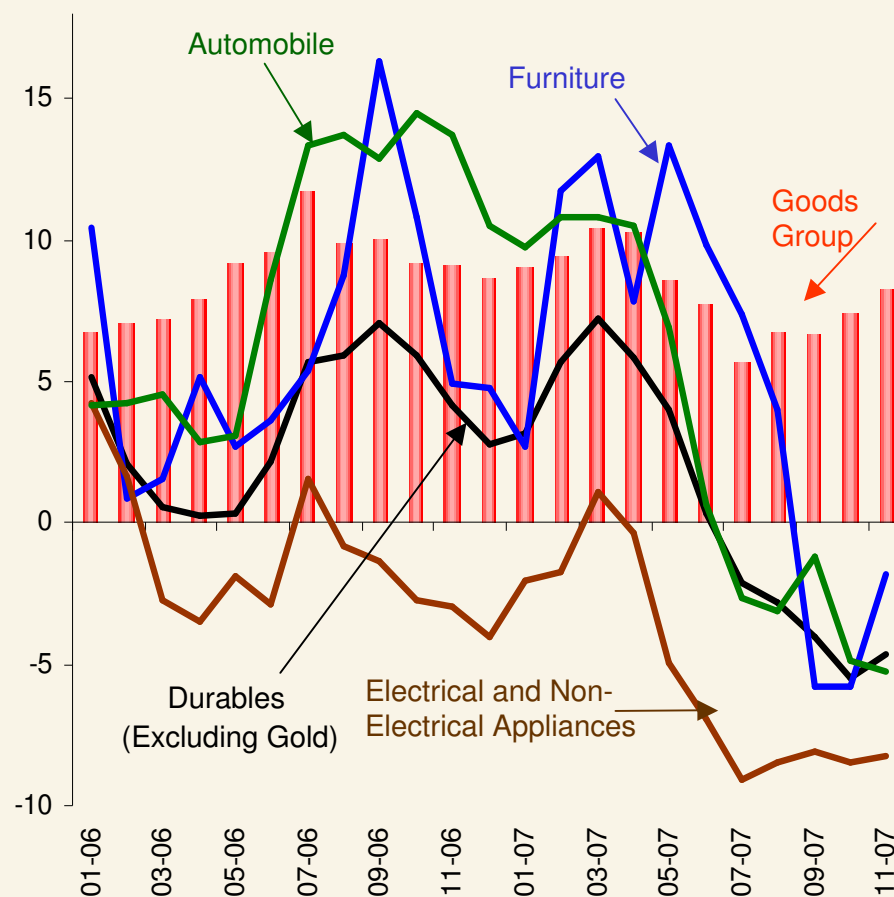
Source: TURKSTAT, CBRT

34
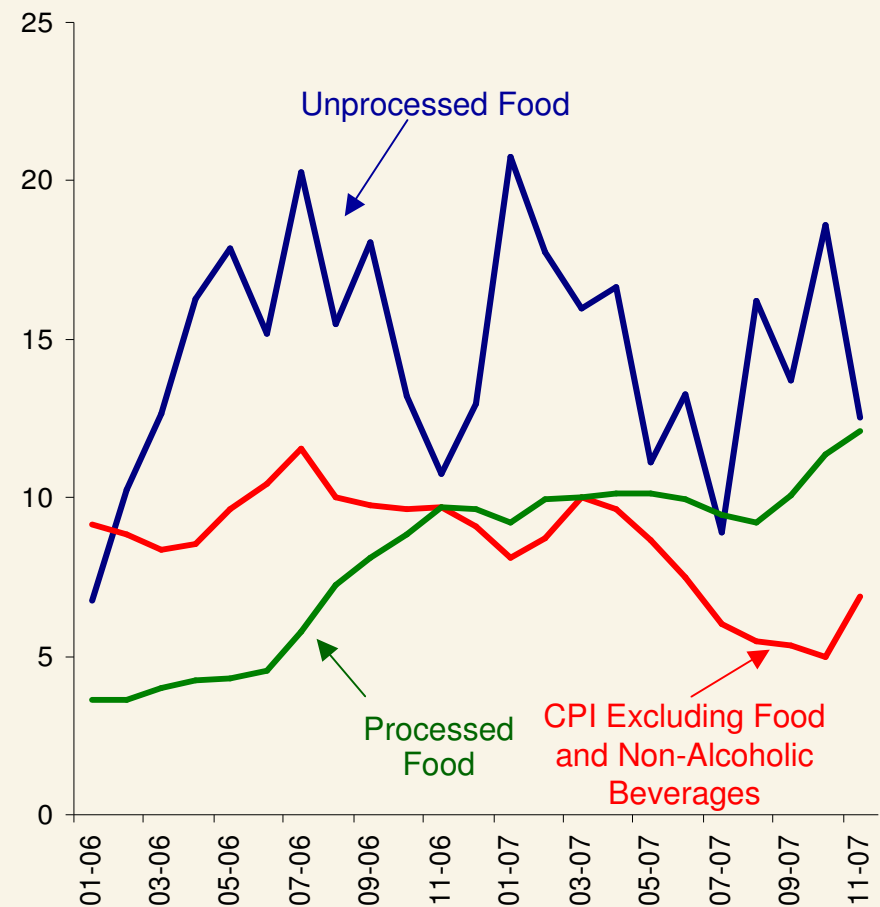
Inflation Developments

✓ Monetary tightening continues to exert pressure on prices of goods, particularly on durables.

✓ The year-on-year goods inflation, which started to decelerate in April 2007, declined to 5.7 % in July, but rebounded to 8.3 % in November due to increased food and energy prices along with adjustments to administered prices.

- Prices of durable goods excluding gold posted a 4.6 % year-on-year decrease in November 2007.
Prices in all sub-groups also followed a downward trend.

Goods Group and Selected Sub-Items Prices
(January 2006 – November 2007, annual percentage change)
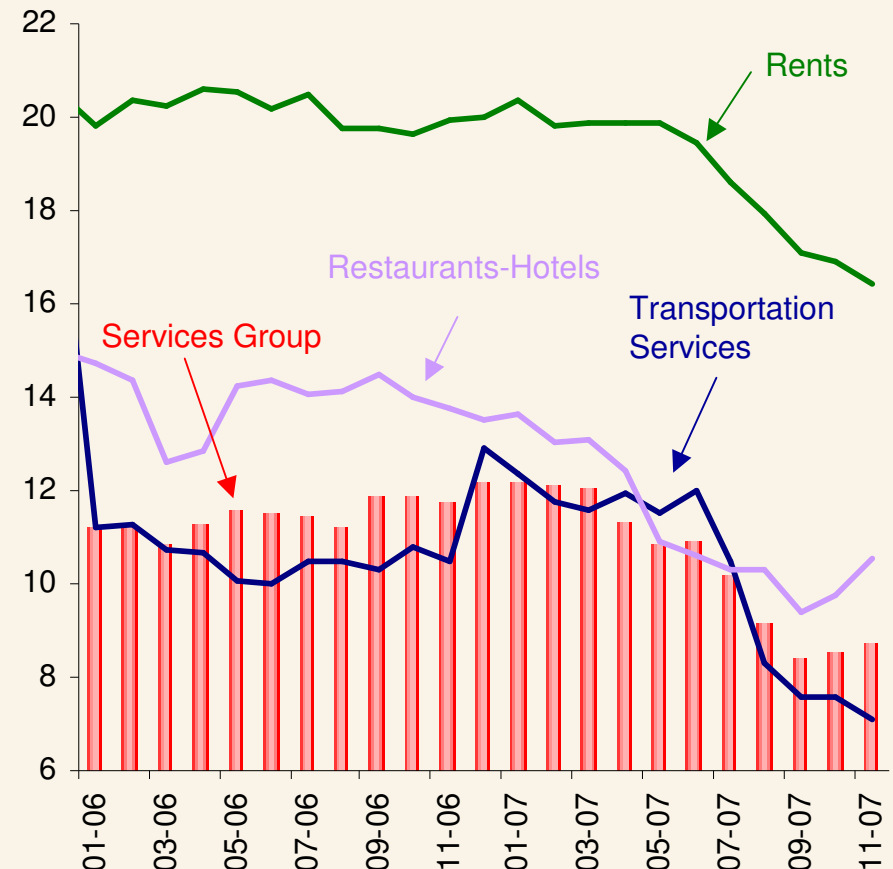

Source: TURKSTAT, CBRT

✓ The slowdown in services inflation, on which the monetary policy has a relatively stronger impact, has become more significant after April, and is more favorable than envisaged.

- Year-on year services inflation declined to 8.8 % in November 2007 from 12.2 % in end-2006.

- The rates of increases in all sub-groups of the services sector are slowing down, except for the restaurants-hotels.

- The deceleration in annual inflation in the restaurants-hotels group was interrupted in October and November due to lagged effects of food prices.

- The deceleration in rent inflation is noteworthy. Annual rate of increase, which was 20 % in December 2006, fell to 16.4 % in November 2007.

✓ Downward trend in services inflation is expected to continue in the upcoming period.

Services and Selected Sub-Items

(January 2006 – November 2007, annual percentage change)
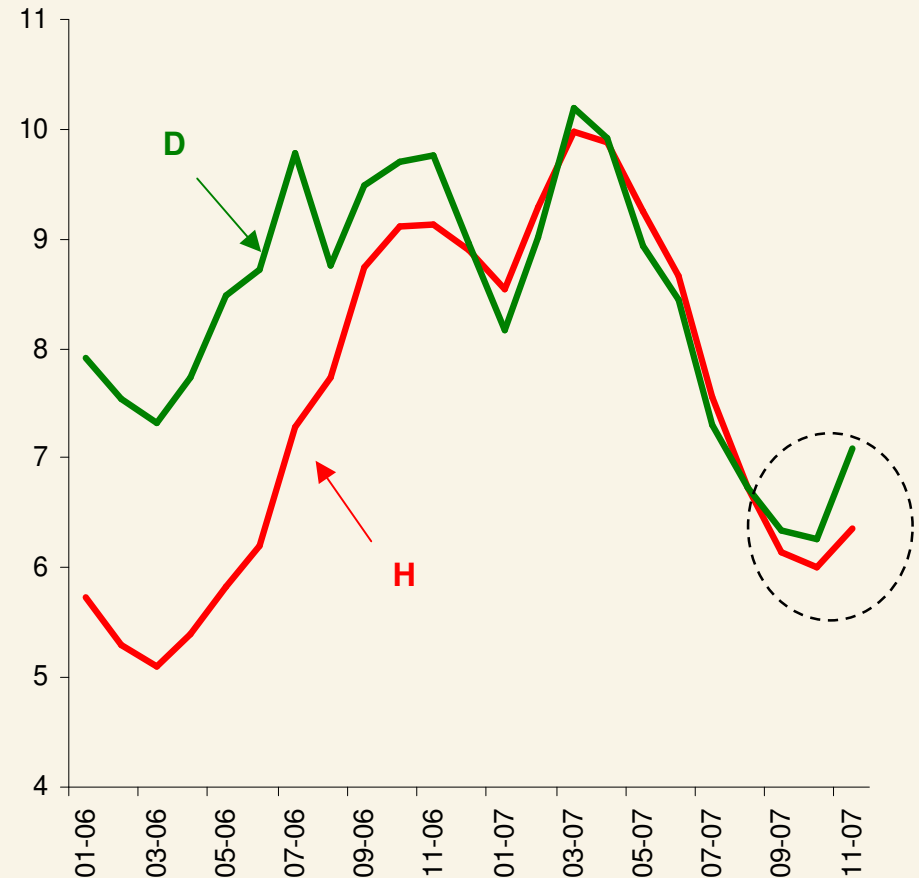

Source: TURKSTAT, CBRT

✓ As of November, the year-on-year increases in all special CPI aggregates lost pace compared to the same period of the last year.

✓ The slowdown in the annual rate of increase in the widely cited core indicator, H index, was disrupted in November.

✓ As of November 2007, the annual rate of increase in the H index declined by 2.8 percentage points to 6.4 % compared to the same period of the last year

Special CPI Aggregates

(January 2006 – November 2007, annual percentage change)

D: CPI excluding unprocessed food products and energy
H: CPI excl. energy, alcoholic beverages, tobacco products, other products with administered prices, indirect taxes, unprocessed food prices and gold
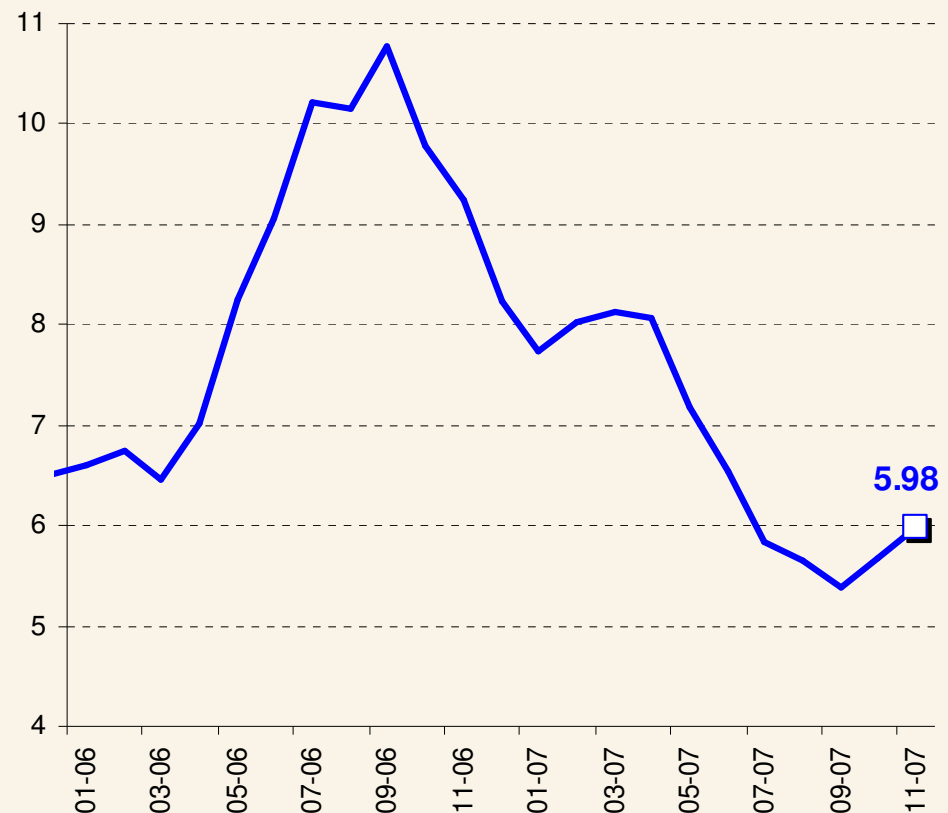Source: TURKSTAT

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Inflation Developments

✓ Annualized figures based on seasonally adjusted core indicator SCA-H point that the disinflation process observed since 2006 Q3 was interrupted in October and November.

✓ This interruption was mainly driven by the rapid price increments in processed food that constitutes an important place in the SCA-H index.

Annualized monthly change in seasonally adjusted SCA-H
(Quarterly moving average, January 2006 – November 2007, percent)

Source: TURKSTAT, CBRT

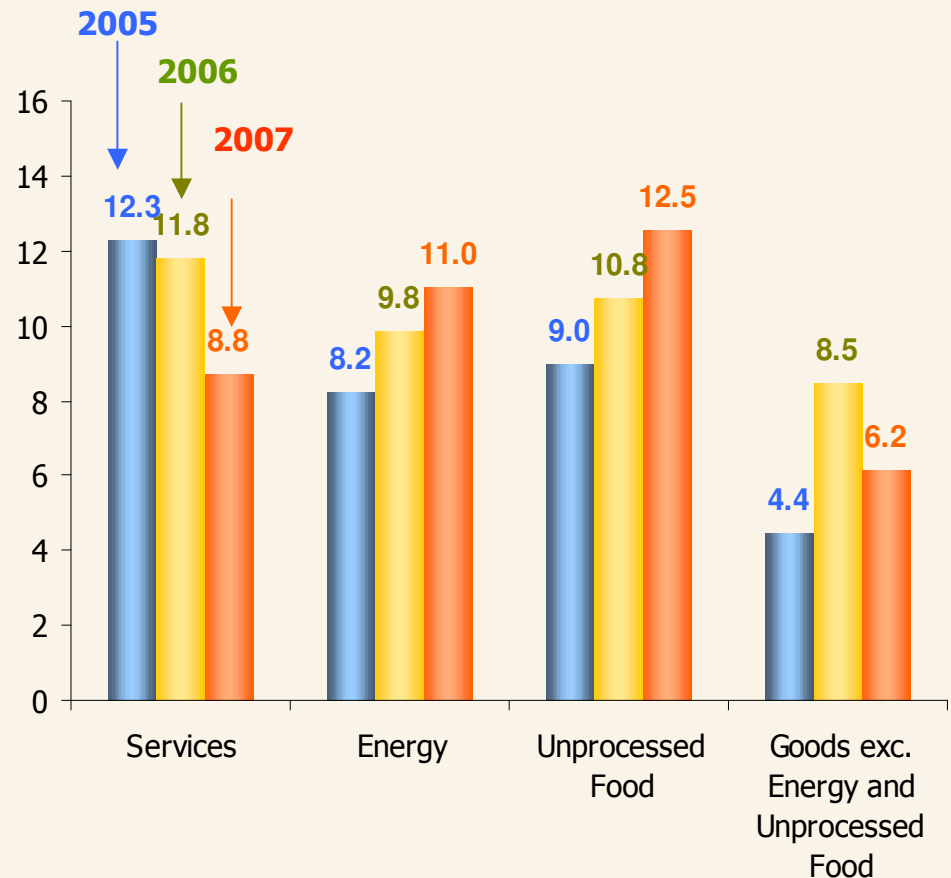# Inflation Developments

✓ Services inflation has slowed down significantly compared to the previous years and stood at 8.8 % as of November 2007.

✓ Annual inflation in energy and unprocessed food are higher compared to 2005 and 2006 figures due to supply-side shocks.

✓ Prices of goods excluding energy and unprocessed food posted a 6.2 % year-on-year increase in November 2007. This was mainly driven by the significant rise in the prices of processed food, tobacco products and gold in November.

Inflation by Groups

(2005-2007, annual percentage change as of November)

Source: TURKSTAT, CBRT

Inflation Outlook:
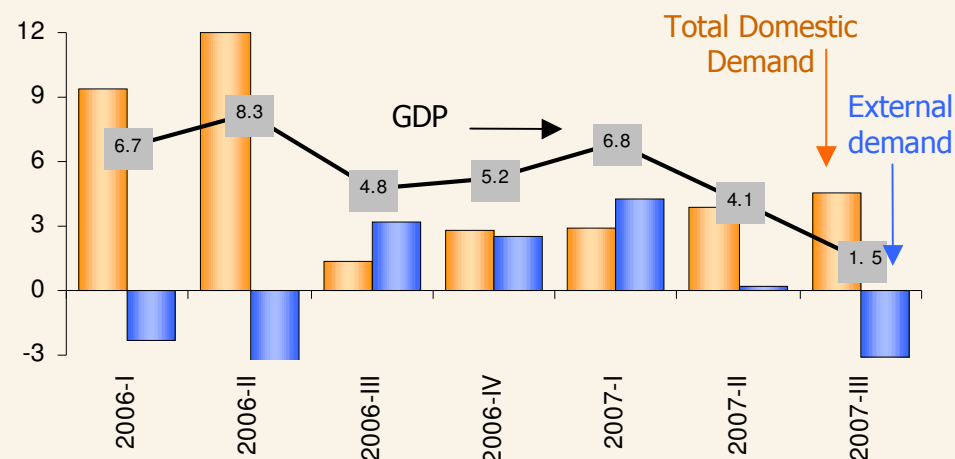# "Domestic Demand Indicators, Wages, International Prices"

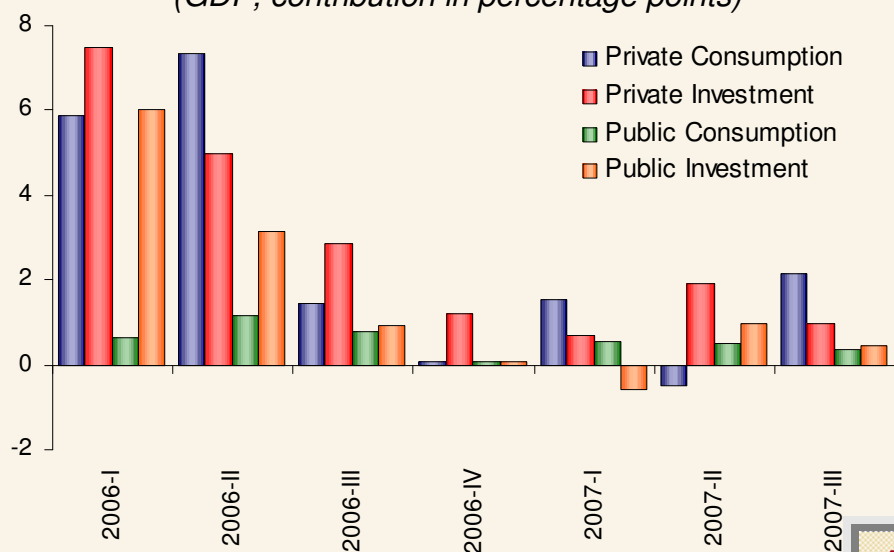# Inflation – Outlook

Outlook: Domestic Demand Developments

✓ The monetary policy that has been implemented since mid-2006 has been effective in bringing domestic demand under control.

✓ Data pertaining to 2007 Q3 point to a slowdown in economic activity due to the lagged effects of the monetary tightening as well as to the supply-side factors in agricultural sectors.

✓ Moderate growth in domestic demand continues.

Quarterly Growth
(GDP, percentage change)

Total Domestic Demand

External demand

GDP

6.7   8.3   4.8   5.2   6.8   4.1   1.5

2006-I, 2006-II, 2006-III, 2006-IV, 2007-I, 2007-II, 2007-III

Components of Growth
(GDP, contribution in percentage points)

- Private Consumption
- Private Investment
- Public Consumption
- Public Investment

2006-I, 2006-II, 2006-III, 2006-IV, 2007-I, 2007-II, 2007-III

Source: TURKSTAT

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Domestic Demand Indicators:

Private Consumption

✓ Private consumption index of the Central Bank points to a moderate pick-up in private final consumption expenditures and domestic demand in the second half of 2007.

Private Consumption Index *(2005 Q1– 2007 Q4, index)*
and Private Final Consumption Expenditures
(2005 Q1 – 2007 Q3, fixed prices, seasonally adjusted, thousand YTL)

Private Consumption Index (right axis)

Private Final Consumption Expenditures (left axis)
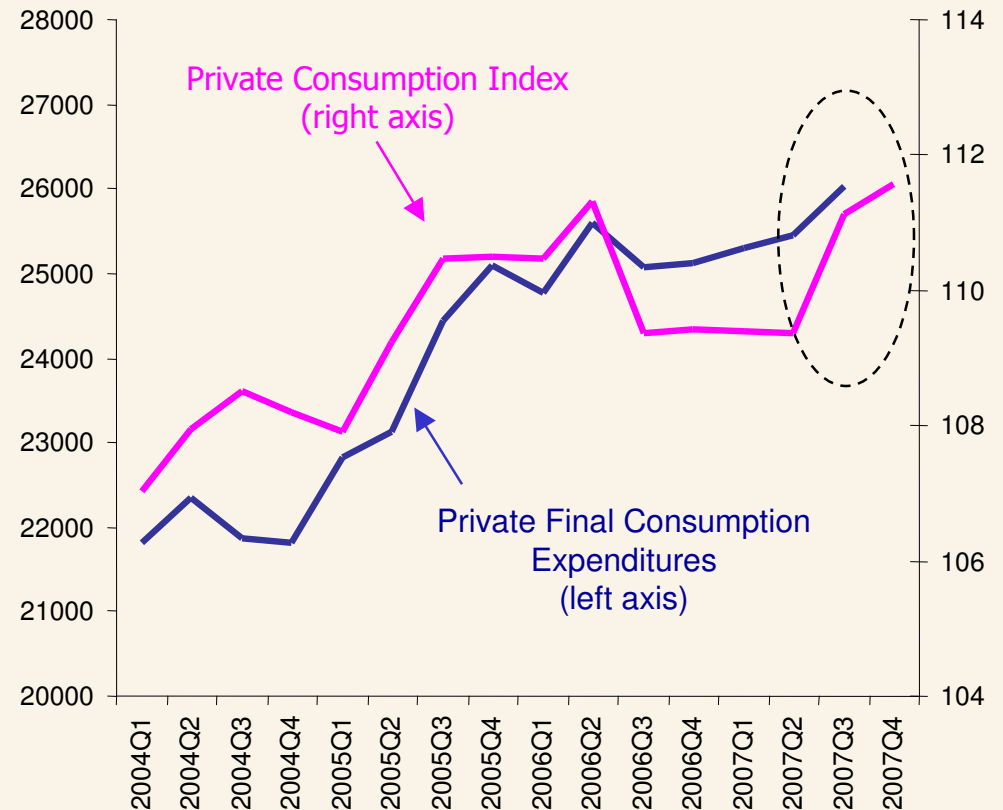
Series making up Private Consumption Index: Seasonally adjusted imports of consumption goods, seasonally adjusted real domestic taxes on goods and services, seasonally adjusted total domestic sales of white goods, seasonally adjusted domestic sales of automobiles.

Source: CBRT, TURKSTAT

Inflation – Outlook

Consumer Loans

✓ The increase in consumer loans, though still continuing, does not hint at an acceleration in private consumption expenditures.

✓ Real consumer loan utilization continues to increase at relatively low rates compared to the first half of 2006, when domestic demand was strong.

    - Annual rate of increase in November was 31.3 % in real terms.

✓ The growth in consumer loan utilization is believed to be curbed by the lagged effects of monetary tightening coupled with the turmoil in international credit markets.
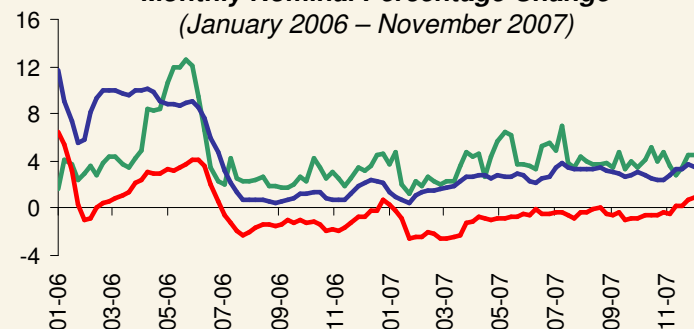
Consumer, Automobile and Housing Loans
(January 2002 – November 2007, annual real percentage change)

Automobile Loans

Housing Loans

Consumer Loans
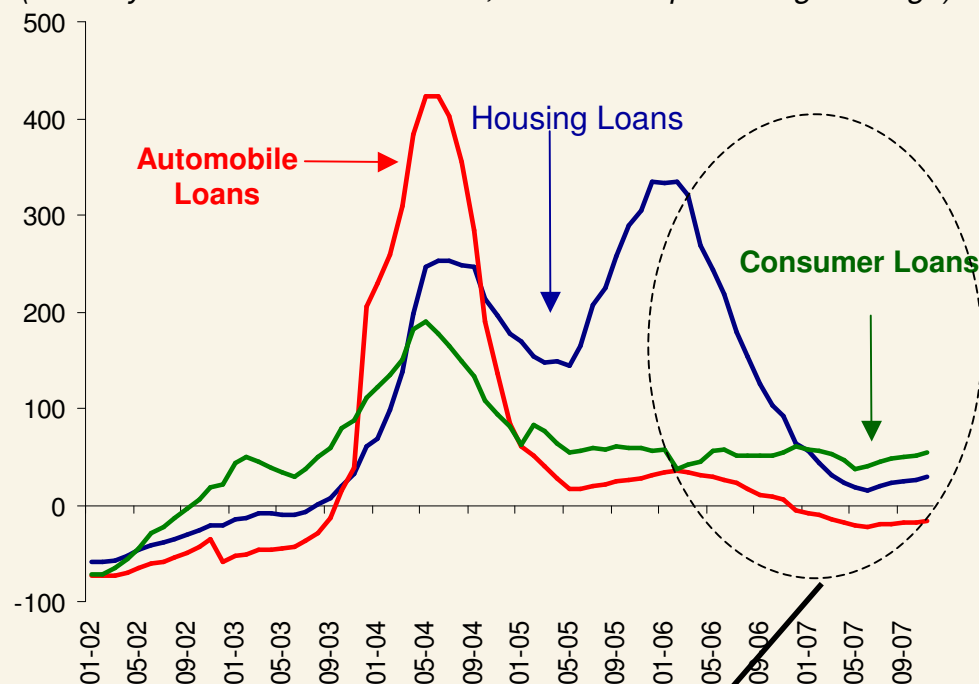
Monthly Nominal Percentage Change
(January 2006 – November 2007)

Source: CBRT

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Domestic Sales of Automobiles and White Goods

✓ Indicators such as sales of automobiles and white goods give signals for an ongoing moderate recovery in private consumption in the last quarter of 2007 as well.

- Following a period of contraction in the second half of 2006 and first half of 2007, domestic demand for white goods has displayed a moderate pick-up since the third quarter of 2007.

- Automobile sales have displayed a significant rise in the second half of 2007, compared to the average of the first two quarters of 2007.
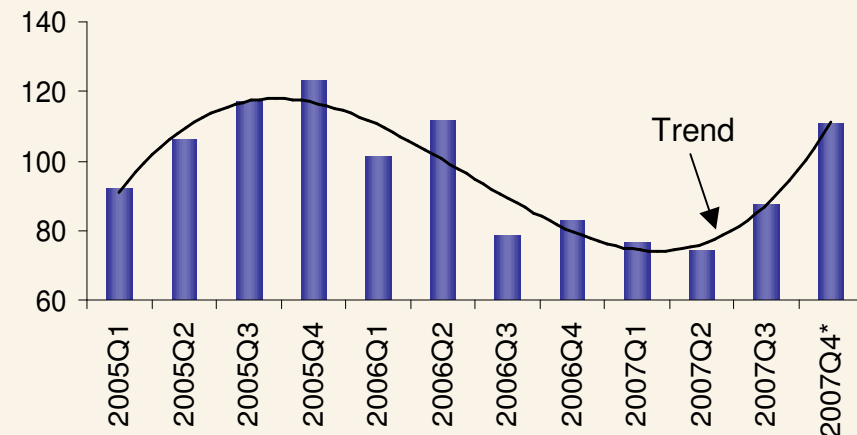
Domestic White Good Sales
(2005 Q1- 2007 Q3, seasonally-adjusted, 3-month rolling, thousand)
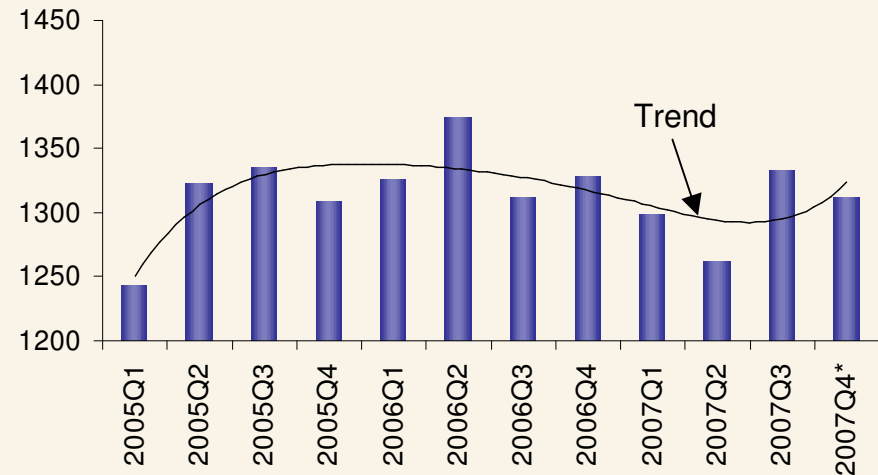
* Data of October 2007.

Domestic Auto Sales
(2005 Q1 – 2007 Q3, seasonally-adjusted, 3-month rolling, thousand)

* Data pertaining to October-November.
Source: Automotive Manufacturers Association (AMA), White Goods Manufacturers Association (WGMA), CBRT

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Consumer Indices

✓ Consumer Confidence Index, which was rising since July 2006, peaked in August 2007. Since then it has been following a downward trend.

✓ The upward trend in Consumer Expectation Index halted in May 2007 and replaced by a decline since May.

Consumer Confidence Index and Consumer Expectation Index
(January 2004 – November 2007)

Consumer Expectation Index (right axis)

Consumer Confidence Index (left axis)
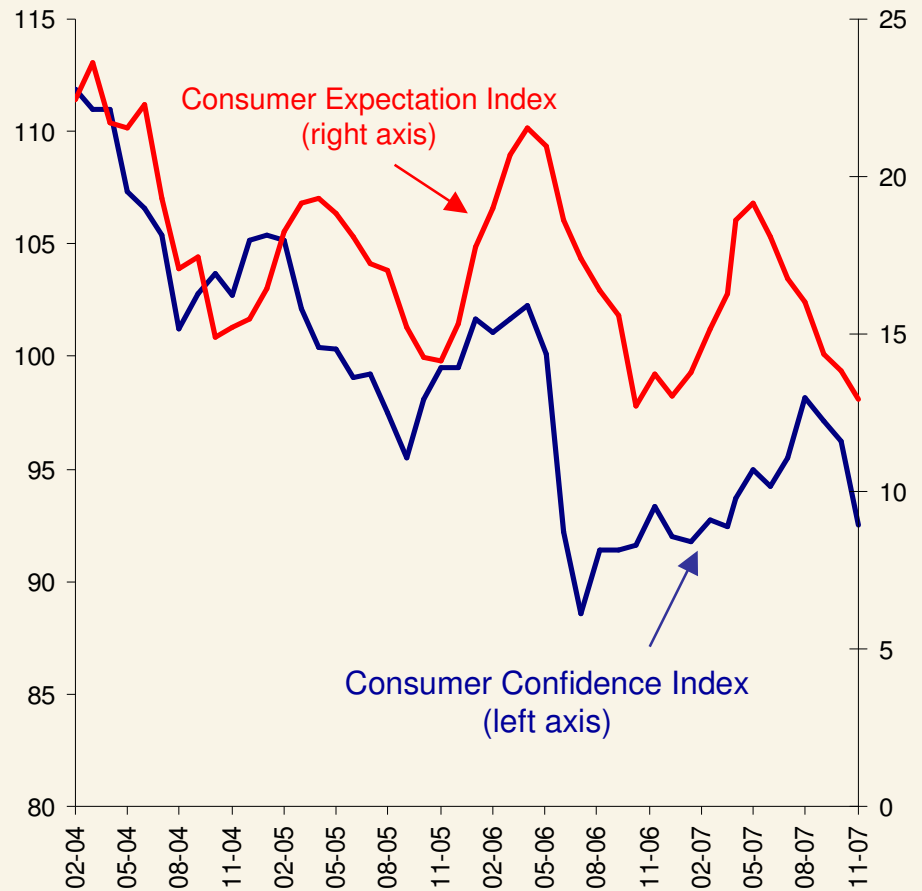
Source: CBRT, TURKSTAT

Inflation – Outlook
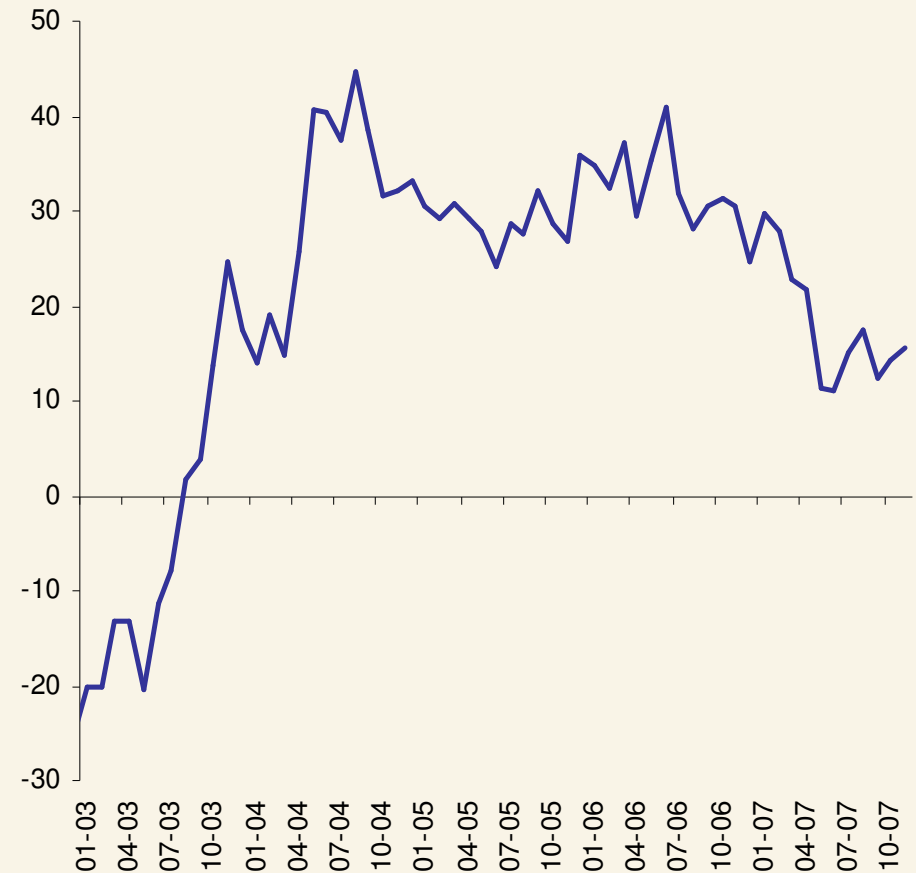
Commercial Loans

✓ The deceleration in the real growth rate of commercial loans, which had started in February, ceased in July 2007.

✓ Commercial loans posted a 15.6 % year-on-year increase in real terms in November 2007.

Real Commercial Loan Index*

(January 2003 – November 2007, annual percentage change)

* Commercial Loan: Corporate loans+ specialized loans

Source: CBRT

Inflation – Outlook

Production Costs

✓ The favorable developments in production costs have continued to support disinflation process.

✓ In manufacturing industry;

- The productivity growth maintains its high level, albeit a slowdown in 2007 Q2.

- After the rapid decrease in the aftermath of 2001 crisis, real wages have been displaying a moderate growth since mid-2003.

- Since the productivity gains have surpassed growth in real wages, real unit wage index calculated by dividing real wages by productivity index continues to decline.

Productivity in Manufacturing Industry, Real Wages and Real Unit Wage Index
(1998 Q4 – 2007 Q2, per hour worked, annual moving averages)

Productivity Index (left axis)

Real Wages Index (right axis)

Real Unit Wage Index (right axis)
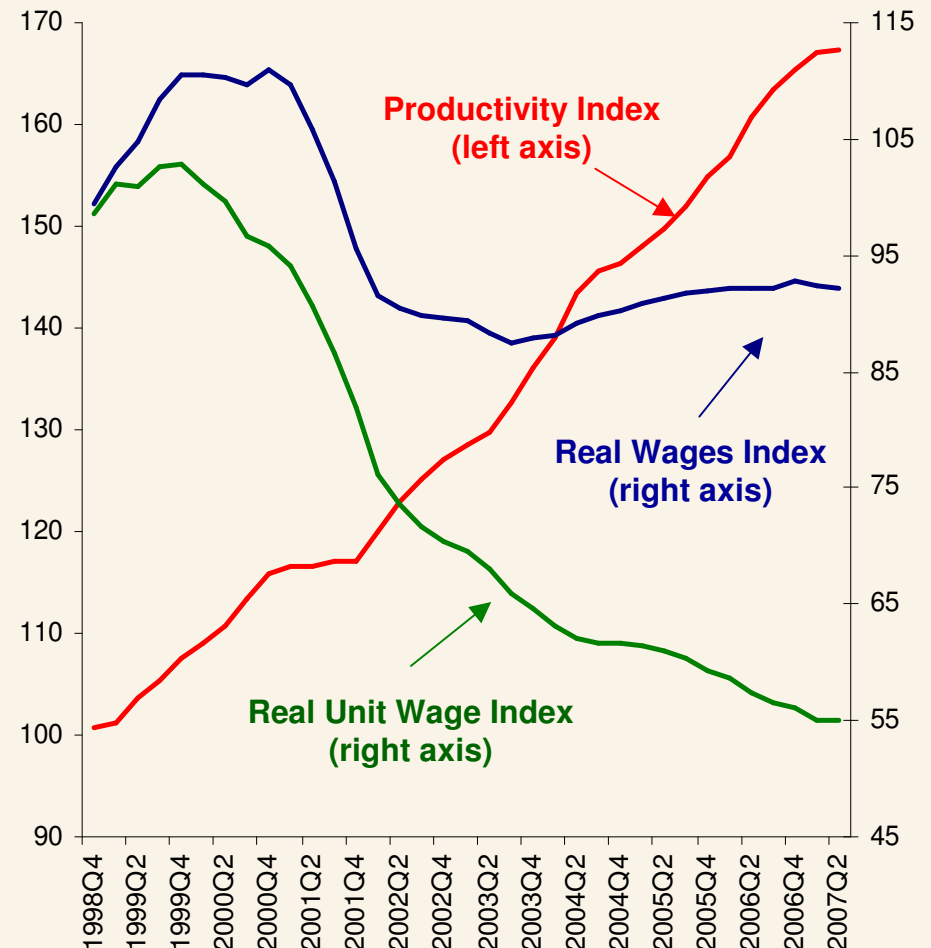
Source: TURKSTAT, CBRT

Inflation – Outlook

International Prices

✓ Prices in international markets and their impact on inflation are closely monitored.

✓ While the rapid rise in energy and commodity prices in the last couple of months has continued, there has been a slowdown in metal prices compared to June.

✓ The upward trend in international crude oil prices since early 2007 still continues.

International Price Indices for Selected Goods
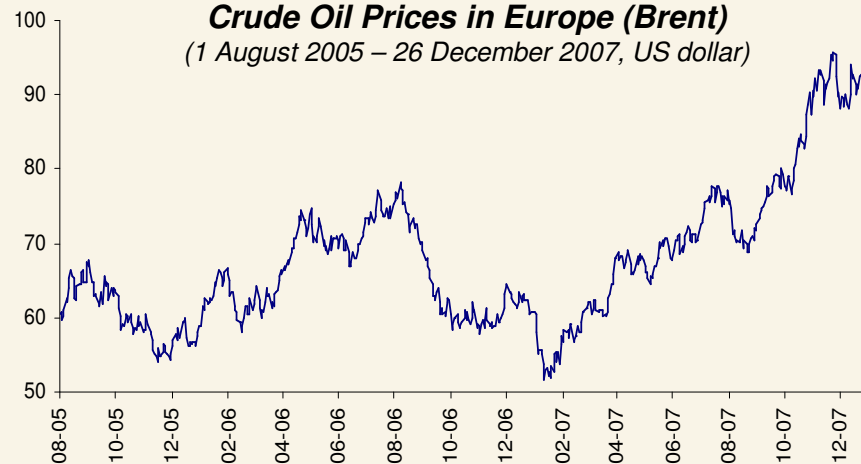*(January 2002 – October 2007, 2000=100)*

Metal

Enegy

Commodity
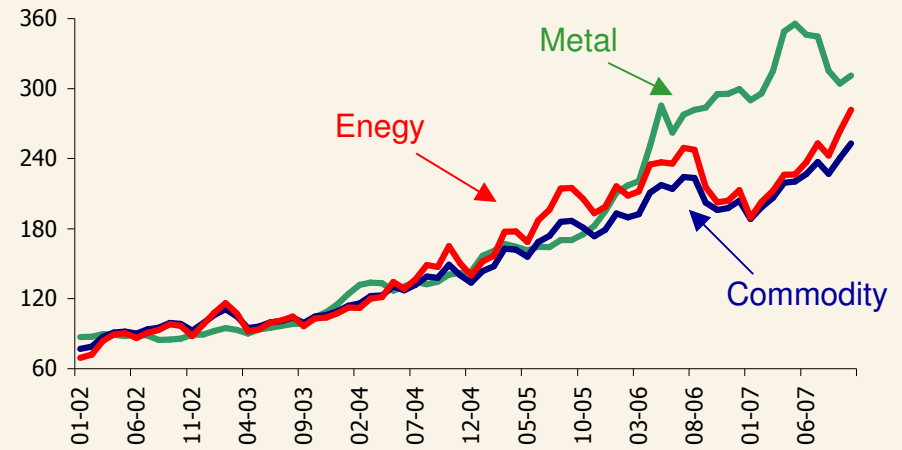
Source: IFS

Crude Oil Prices in Europe (Brent)
(1 August 2005 – 26 December 2007, US dollar)

Source: Bloomberg

Inflation:
"Risks, Expectations, Targets"

Inflation – Primary Risk Factors

Primary Risk Factors

✓ In case of a heightened risk aversion and deterioration in international liquidity conditions, the CBRT will aim at limiting the effects of possible market fluctuations on inflation outlook by pursuing an active liquidity strategy as well as utilizing other policy instruments.

✓ The risks on total demand conditions are two-sided:

- The upside risks arise from the uncertainties pertaining to the magnitude of the impact of the downward trend of long-term interest rates on demand for credits.

- As for the downside risks: a faster-than-expected slowdown in global economy, prospective contraction both in foreign demand and financing conditions could lead to lower-than expected domestic demand.

✓ Resorting to hikes in indirect taxes to partially compensate for deviations in primary budget balance poses a risk to the predictability of inflation.

Inflation – Primary Risk Factors

Primary Risk Factors

✓ Since food prices account for 28 % of the CPI basket and volatility in this sector continues, increases in food prices pose risk in either direction.

✓ There are uncertainties over the impact of energy prices on medium-term inflation outlook.

- A high level of increase in electricity prices is expected soon.

- The upsurge in international oil prices continues.

✓ The support of fiscal policies and structural reforms play a crucial role in the disinflation process.

- The European Union accession and harmonization process and structural reforms that would reinforce the quality of fiscal discipline are closely monitored with respect to their implications on macroeconomic stability and price stability.

Inflation – Expectations

Expectations

✓ Despite recent signs of improvement, inflation expectations are still below the target.

✓ Inflation expectations for the next 12 months, which was 6.84 % at the turn of the year, came down to 6.14 % in December, while inflation expectations for the next 24 months stood at 5.24 %.

✓ The inflation expectations are expected to improve as long as the disinflation process continues.

Inflation and Inflation Expectations
(As of December 2007, annual percentage change)

Inflation

12-Month forward

24-Month forward

8.40

6.14

5.24

Target for 2007-2008-2009: 4 %

Source: CBRT, TUKSTAT
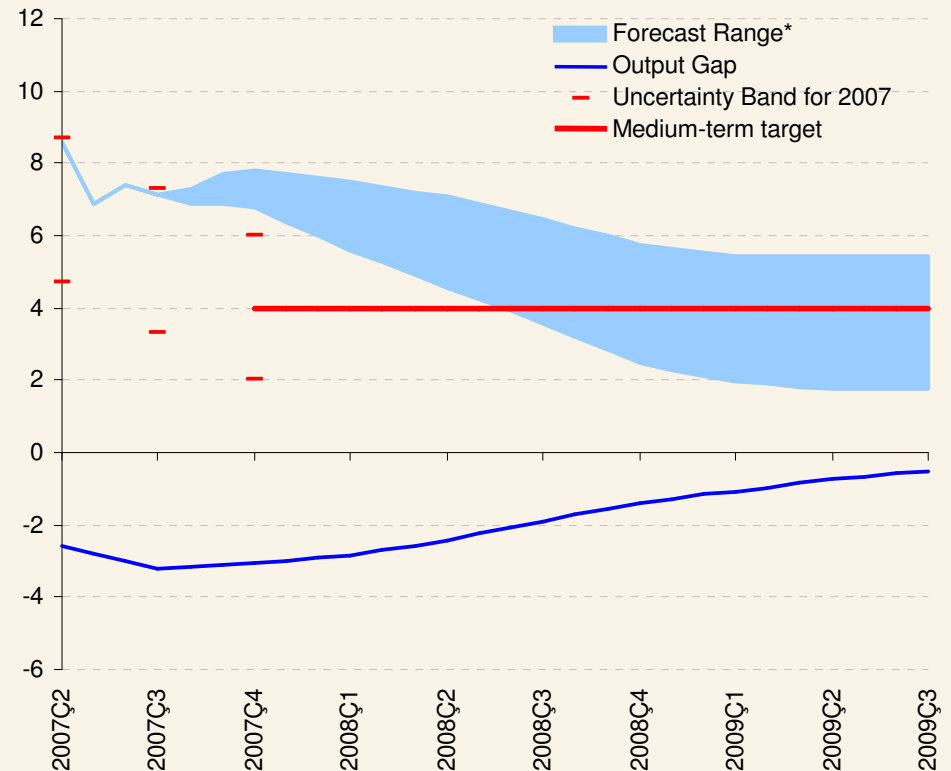
Inflation – Forecasts

Inflation target for end-2008 is 4 %.

✓ As presented in the Inflation Report of October 26, 2007, under the assumption that policy rate cuts will continue in the rest of 2007 and the first few months of 2008 and then be kept constant for a while, with 70 % probability, inflation is predicted to be:

- between 2.5 % and 5.7 %
  (mid-point _4.1 %_) at the end of 2008;

- between 1.7 % and 5.5 % in the third quarter of 2009
  (mid-point _3.6 %_)

Inflation and Output Gap Forecasts

Legend:
- Forecast Range*
- Output Gap
- Uncertainty Band for 2007
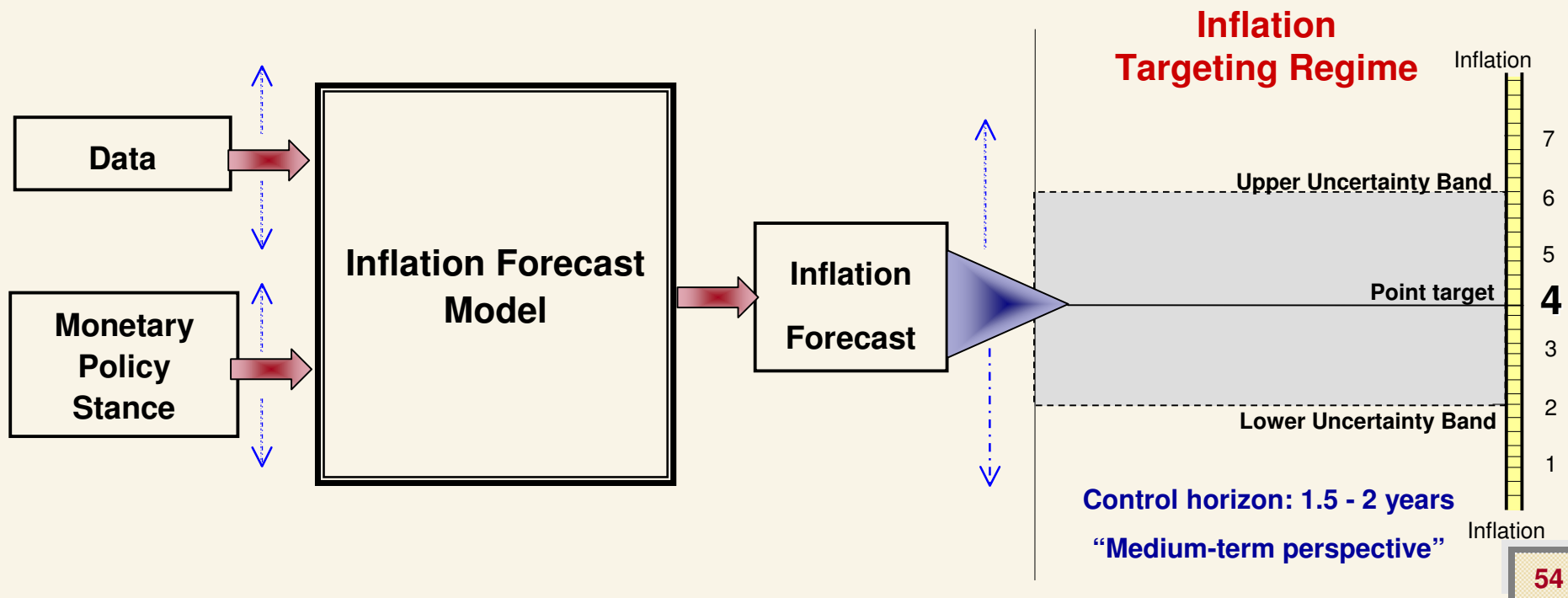- Medium-term target

* Probability of inflation remaining within the forecast range is 70 percent.

Source: CBRT

Forecast Model and Inflation Targeting

✓ The policy stance explained in the Inflation Report is established on the basis of available data.

✓ Any new data pertaining to the medium-term inflation outlook would necessitate revising the future stance of monetary policy.

✓ Monetary policy's data-dependency is a natural outcome of the inflation targeting regime.

✓ Under this regime, updating the monetary policy stance is not an exception, but a rule.

Inflation Targeting Regime

Inflation

| Data |
| Monetary Policy Stance |

Inflation Forecast Model

Inflation Forecast

Upper Uncertainty Band

Point target **4**

Lower Uncertainty Band

7
6
5
3
2
1

Control horizon: 1.5 - 2 years

"Medium-term perspective"

Inflation

Forecast Model and Inflation Targeting

Examples of data-dependency in case of:

✓ **Loosening in Fiscal Policies:** Inflation forecasts of the Central Bank would go up and exceed the target; the monetary policy stance would be reviewed in view of a probable deviation from the target; a new monetary policy stance would be set to establish consistency between the inflation forecast set forth by the model and the inflation target.

✓ **Slowdown in economic activity in Europe:** External demand would lose pace; inflation forecasts would be pushed below the target; monetary policy stance would be loosened in view of a probable deviation from the target.

✓ **Contraction in international credit markets:** The amount of foreign credits used by domestic banks would decrease and domestic demand would slow down; inflation forecasts would drop below the target; monetary policy stance would be loosened in view of a probable deviation from the target.

✓ **Supply shock in food prices:** If the first-round effects are projected to fade away in the medium-term, there would be no change in medium-term inflation forecasts, and consequently, current monetary policy stance would be maintained.

Inflation – Targets

✓ The Central Bank will continue to use "point targets" for the year end Consumer Price Index (CPI) inflation calculated by the annual percentage change of the CPI. The target horizon has been set as 3 years in line with 3-year budget implementation.

✓ Considering the structural transformation of the economy, convergence process to the developed countries and the pricing behavior that remained from high inflationary period, a target of 4 % has been considered appropriate for the medium-term as agreed with the government.

✓ Therefore, inflation targets for 2008 and 2009, which were previously announced as 4 %, have been maintained and inflation target for 2010 has also been set as 4 %.

Inflation Targets for 2008-2010

	2008	2009	2010
Inflation Target	4.0 %	4.0 %	4.0 %

✓ Due to its comprehensive context by definition, consumer price index can be exposed to temporary fluctuations.

✓ Core indicators allow the differentiation of price movements that fall outside of the control of monetary policy and thus ensure a sound assessment of the main inflation trend.

✓ A series of supply-side shocks that have occurred over the last 2 years have highlighted the importance of special CPI aggregates. The relevant indicators, which may also be called as "core" indices, have played an important role in the communication of monetary policy decisions in 2007.

✓ It is not possible to define a single core indicator for inflation that can eliminate all temporary effects observed in consumer prices .

✓ In this context, the Central Bank has compiled an index excluding all food items and has started to closely monitor this index in order to eliminate temporary effects of supply-side shocks such as recent drought.

Inflation – Targets

✓ From time to time, the Central Bank also draws attention to price movements in certain sub-groups of the CPI in order to enhance the efficiency of the communication of the monetary policy and to take sound decisions.

✓ For instance, in order to highlight the effects of the monetary policy tightening being implemented since mid-2006, the Central Bank has frequently referred to the developments in sub-groups, such as services or durable consumption goods whose prices are susceptible to monetary policy actions, in 2007.

✓ The Central Bank examines several variables including Special CPI Aggregates while assessing the main inflation trend, and can highlight different indicators at certain periods depending on the economic conjuncture.

✓ Understanding of the Central Bank's approach to core inflation by the public will allow a better assessment of the monetary policy actions.

Inflation – Targets

✓ Since a sudden reaction of monetary policy to factors that are beyond its control, such as food, energy and administered prices, will increase volatility in macroeconomic variables, inflation-targeting central banks adopt a medium-term approach and allow temporary fluctuations in inflation as long as the expectations are under control.

✓ Therefore, it has been decided to keep the width of the uncertainty band at 2 percentage points for 2008. In this context, a path consistent with the year end target has been defined for the end of each quarter of 2008.

✓ The primary objective of setting an uncertainty band is to establish a measurable criterion that will enable to determine to what extent the deviations from the point target will be tolerated with respect to the accountability principle.

Inflation Path Consistent With the End-Year Target And The Uncertainty Band for 2008

	March	June	September	December
Uncertainty Band (upper limit)	9.1 %	8.5 %	8.3 %	6.0 %
Path Consistent with the Target	7.1 %	6.5 %	6.3 %	4.0 %
Uncertainty Band (Lower Limit)	5.1 %	4.5 %	4.3 %	2.0 %

Economic Outlook
"Interest Rate and Exchange Rate Policies, Financial Markets"

✓ The Central Bank's main policy instrument is "short-term interest rates".

✓ The basis for short-term interest rates is the signal effect.

✓ It is intended to control total demand via transmission mechanism and to attain inflation targets by steering expectations with the signal effect.

✓ This effect will surface with a time lag.

✓ In general, the structural characteristics of the economy, effectiveness of financial markets and uncertainty areas determine the strength of this impact.

A Simplified Transmission Mechanism

CBRT Short-term Interest Rate

| 1. General Level of Interest Rates | 2. Credit Market | 3. Asset Prices | 4. Expectations |

Total Demand

Domestic Inflationist Pressure

Inflation
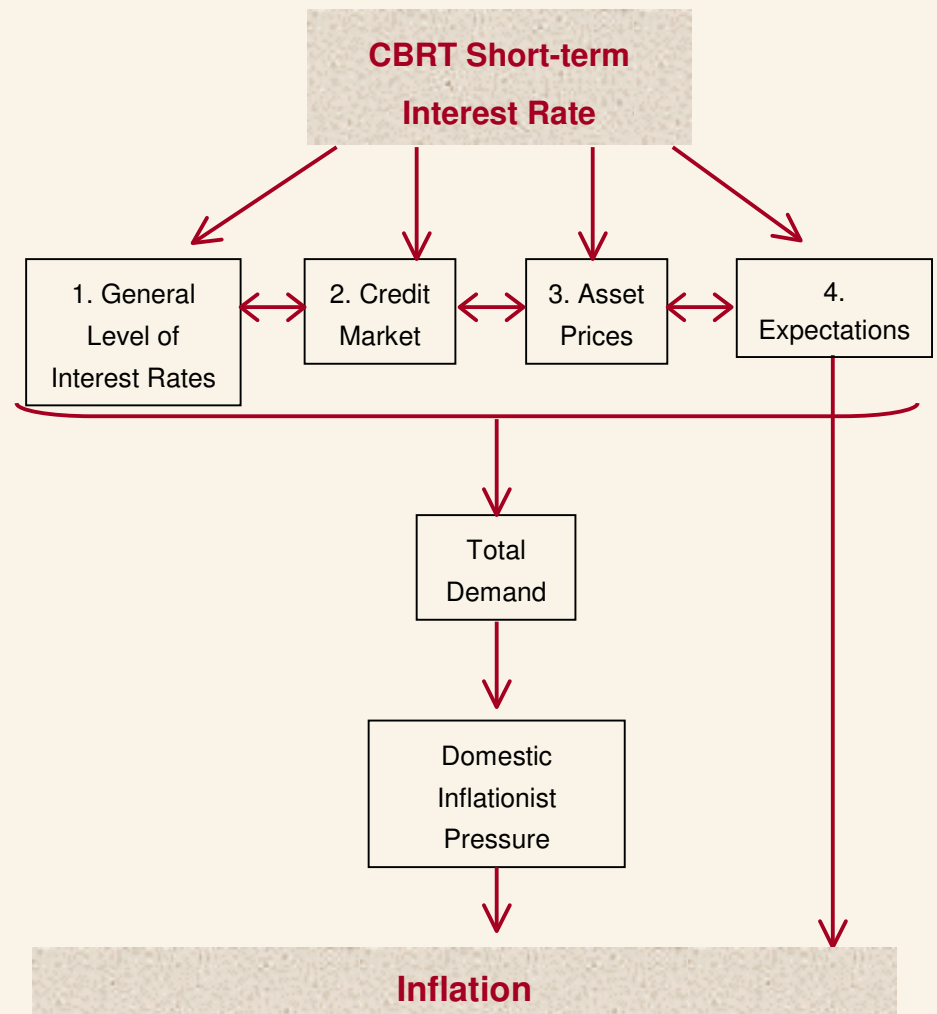
Interest Rate and Exchange Rate Policies, Markets

✓ The impact of interest rates on pricing behavior via cost channel is rather limited.

✓ The ratio of financing expenses of firms in manufacturing industry to their total costs is 1.9 %.

✓ The ratio of financing expenses to net sales continuously fell in the 2001-2005 period, dropping from 16.4 % to 1.8 %.
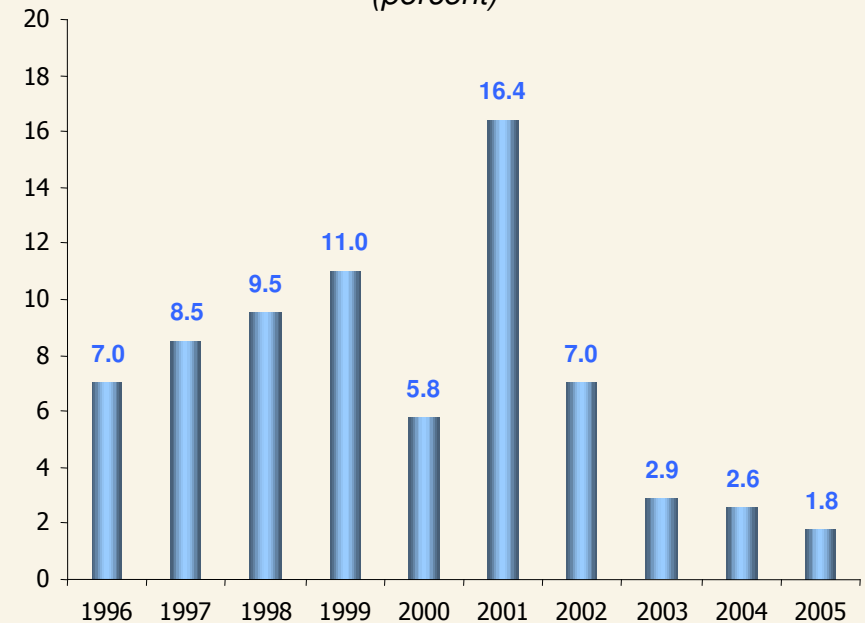
Breakdown of Total Costs of Firms in Manufacturing Industry (2005, percent)

Operation costs (9.3)

Other costs (2.8)

Financing costs (1.9)

Costs of Goods Sold (86.0)
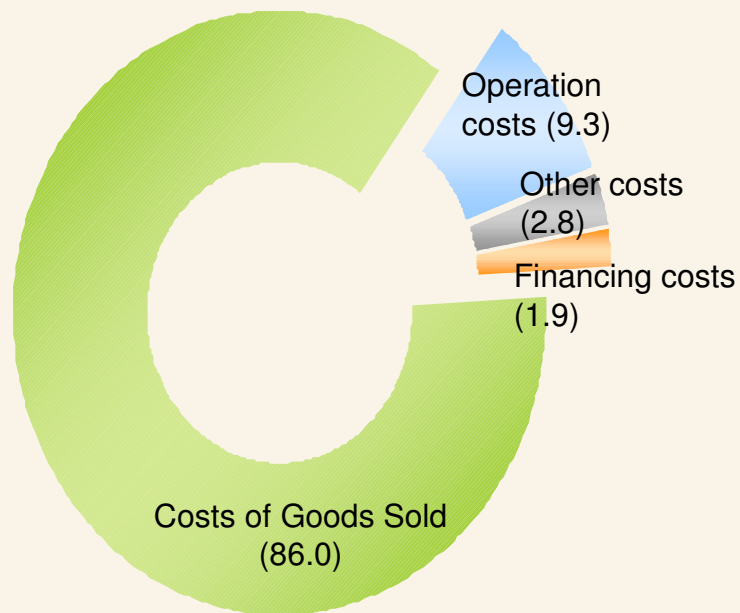
* Costs of goods sold= costs of domestic and imported raw material and other material, electricity-natural gas-water expenses, labor costs

Source: CBRT, Sectoral Balance Sheets 2004-2006

Ratio of Financing Expenses of Firms in Manufacturing Industry to Total Net Sales (percent)

Year	Value
1996	7.0
1997	8.5
1998	9.5
1999	11.0
2000	5.8
2001	16.4
2002	7.0
2003	2.9
2004	2.6
2005	1.8

Source: CBRT, Sectoral Balance Sheets

Monetary Policy Decisions

✓ Monetary Policy Committee (MPC) makes decisions with the sole aim of achieving inflation targets and keeping inflation within the path consistent with the target.

✓ After holding interest rates constant for 13 months since August 2006, short-term interest rates were cut by 25 basis points at the MPC meeting on September 13, 2007.

✓ Interest rates were cut by 50 basis points each at the MPC meetings of 16 October, 14 November, 13 December 2007.

Monetary Policy Committee Decisions
(May 2006 – December 2007)

Meeting Date	Policy Rates	Changes
25 May 2006	13.25	0
07 June 2006	**15.00**	**+ 1.75**
20 June 2006	15.00	0
25 June 2006	**17.25**	**+ 2.25**
20 July 2006	**17.50**	**+ 0.25**
24 August 2006	17.50	0
26 September 2006	17.50	0
19 October 2006	17.50	0
23 November 2006	17.50	0
21 December 2006	17.50	0
16 January 2007	17.50	0
15 February 2007	17.50	0
15 March 2007	17.50	0
18 April 2007	17.50	0
14 May 2007	17.50	0
14 June 2007	17.50	0
12 July 2007	17.50	0
14 August 2007	17.50	0
13 September 2007	**17.25**	**- 0.25**
16 October 2007	**16.75**	**- 0.50**
14 November 2007	**16.25**	**- 0.50**
13 December 2007	**15.75**	**- 0.50**

Source: CBRT

Interest Rate and Exchange Rate Policies, Markets

✓ At its last meeting of 13 December 2007, the Committee noted the modest recovery in private domestic demand, but assessed that aggregate demand conditions have continued to support the disinflation process on the back of slowdown in public expenditures and net external demand.

✓ In this framework, the Committee, judging the recent rise in inflation as temporary, maintained the policy stance presented in the October Inflation Report, and assessed that, under a measured and cautious rate cut cycle, the risks against attaining the inflation target in the medium term are balanced.

Markets' Reaction to Interest Rate Cut Decisions

✓ The earlier-than-expected rate cut decisions of the Monetary Policy Committee have accelerated the downward trend in medium and long-term interest rates.

✓ The yield curve on October 22, 2007 remained below that of June 29, 2007 in all maturities.

✓ This demonstrates that rate cut decisions have had a positive impact on expectations.

✓ Meanwhile, the negatively sloped yield curves after 12 months of maturity affirms that the economic agents still expect that the decline in inflation will continue in the medium-term.

Yield Curve
(29 June and 22 October 2007)
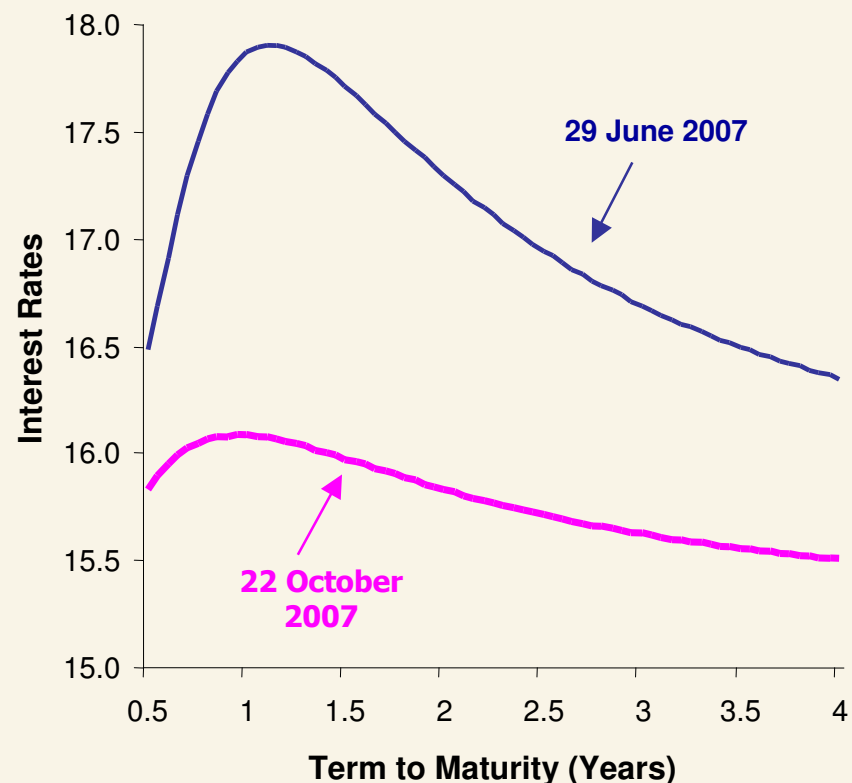
Source: CBRT

## Floating Exchange Rate Regime

✓ Floating exchange rate regime is one of the main pillars of inflation targeting regime.

✓ Exchange rate is an endogenous variable.

✓ The level of exchange rates are determined under market conditions and reflect all economic and political policy implementations as well as expectations.

✓ The value of the currency is not an objective, but a consequence.

✓ **We have no intention to implement a "high interest rate, low exchange rate" policy.**

✓ **The policy in implementation is the interest rate policy required for "low inflation".**

High interest rate ✕ **Low exchange rate**

Policy Rate (percent) ***and Exchange Rate***
(TRL/ USD, monthly average, January 2002 – December 2007)

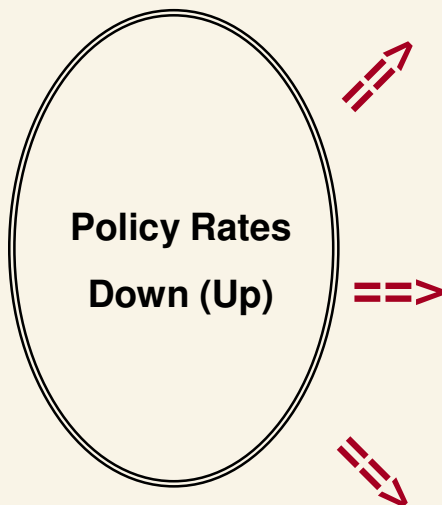TRL/USD(right axis)

Policy rate (left axis)
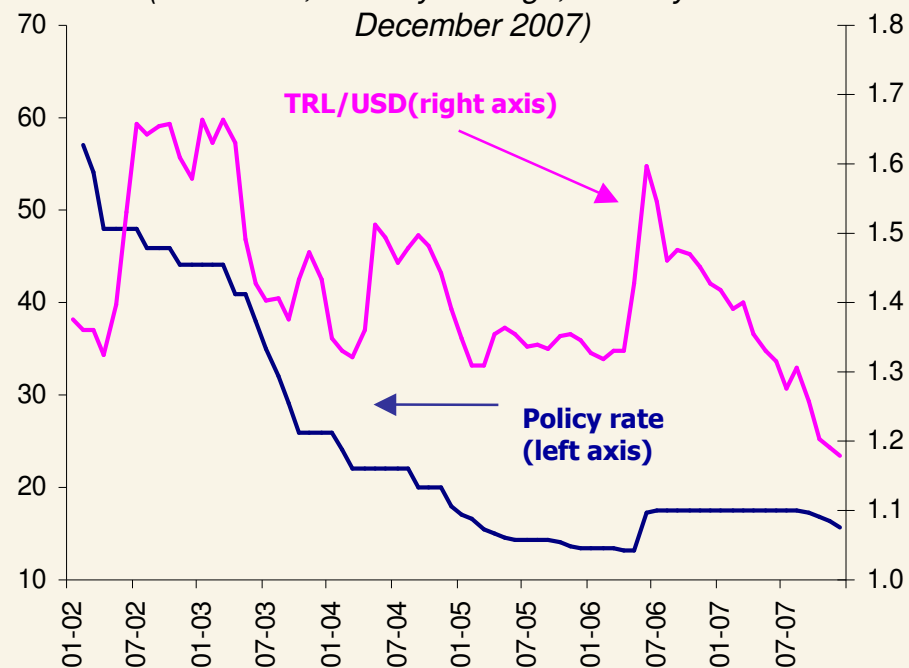
Source: CBRT

Interest Rate and Exchange Rate Policies, Markets

There is a multidimensional and complicated relationship between Central Bank policy rates and the exchange rates.

Policy Rates Down (Up)

1. Yield of the Turkish currency-denominated assets decreases (increases).

   Demand for foreign exchange increases (decreases).

   Depreciation (appreciation) pressure emerges on the Turkish currency.

2. A positive (negative) signal is emitted relating to general outlook.

   Confidence increases (decreases). Reverse currency substitution becomes stronger (weaker).

   Appreciation (depreciation) pressure emerges on the Turkish currency.

3. Exchange rates can move independently from economic fundamentals and policy rates: foreign exchange liquidity, investor behavior, expectations

Which of these three relationships will prevail to what extent is determined by the immediate conjuncture.

Central Bank FX Reserves

✓ The Central Bank has two main goals in its operations at the foreign exchange markets.

  1. Foreign exchange buying auctions with the aim of building up reserves

  2. Foreign exchange interventions to prevent excessive volatility

✓ Central Bank is a net buyer at foreign exchange market.

  -Total foreign exchange bought between April 2002 – December 26, 2007 : USD 54.8 billion

  - Foreign exchange reserves as of December 14, 2007: USD 70.6 billion

✓ Moreover, with the aim of enhancing liquidity management, the Central Bank;

  - issued liquidity bills on 19 July, 23 August, 17 October 2007 and 15 November 2007 with maturities of 32, 40, 29 and 61 days, respectively.

Central Bank FX Reserves
(2002-2007, USD billion)

Year	Value
2002	27.0
2003	33.7
2004	36.0
2005	48.3
2006	58.3
2007	70.6
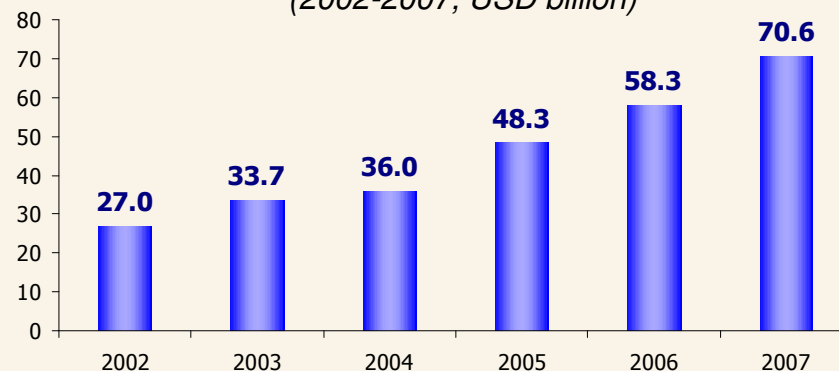
Source: CBRT

Ratio of FX Reserves to GDP in 2007 in Countries Implementing Floating Exchange Rate Regime*

	Value
Average of Countries Implementing Floating Exchange Rate Regime	18.7
Turkey	15.0
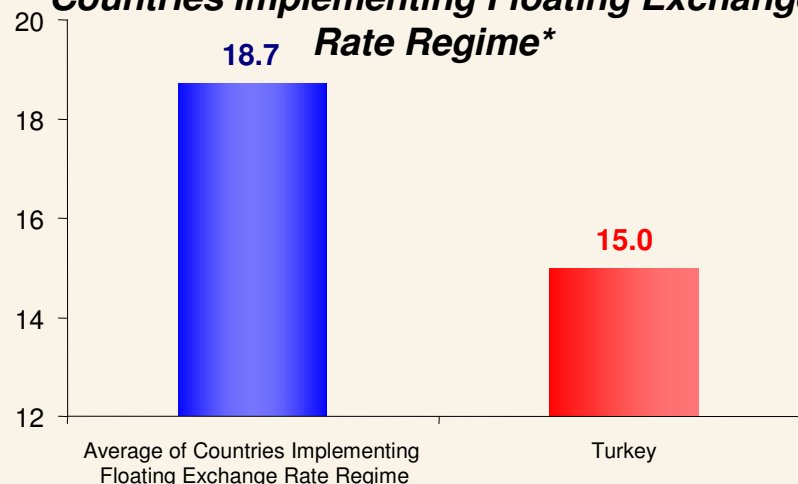
* Countries included in the calculation: Argentina, Brazil, Czech Republic, Indonesia, Philippines, South Africa, South Korea, Croatia, India, Kazakhstan, Colombia, Mexico, Paraguay, Peru, Poland, Romania, Russia, Chile, Thailand, Uruguay

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Source: CBRT, IMF World Economic Outlook October 2007, IFS

International Developments

✓ Some abrupt and rapid movements are observed in international markets.

- The global financial turbulence, which emerged in late-July 2007 due to concerns over the "subprime mortgage" market in the USA , has not yet subsided.

- The uncertainties forced international banks to shift their focus on default risk and become reluctant to lend, which caused liquidity squeeze especially in European banks.

Volatility Index*
(3 January 2005 –24 December 2007)

Long Term Average
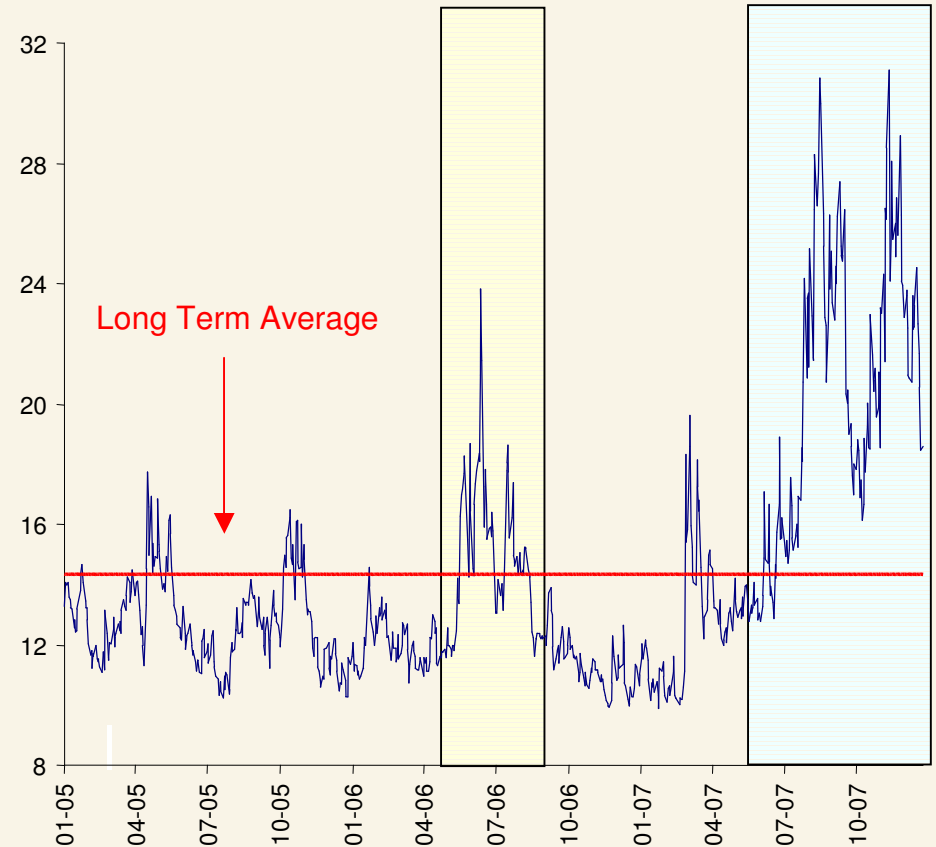
* VIX measures the market's expectation of volatility as reflected in the options prices of S&P 500 stock index by using interpolation method.

Source: Bloomberg

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Effects of International Developments on Developing Countries

✓ The recent volatilities have significant differences from the turbulence experienced in 2006.

✓ Risk premiums of developing countries initially increased due to investors' risk-averse attitude. However, since the "subprime mortgage" markets are not fully developed in these countries, they have not suffered as much as developed countries.

Risk Indicators
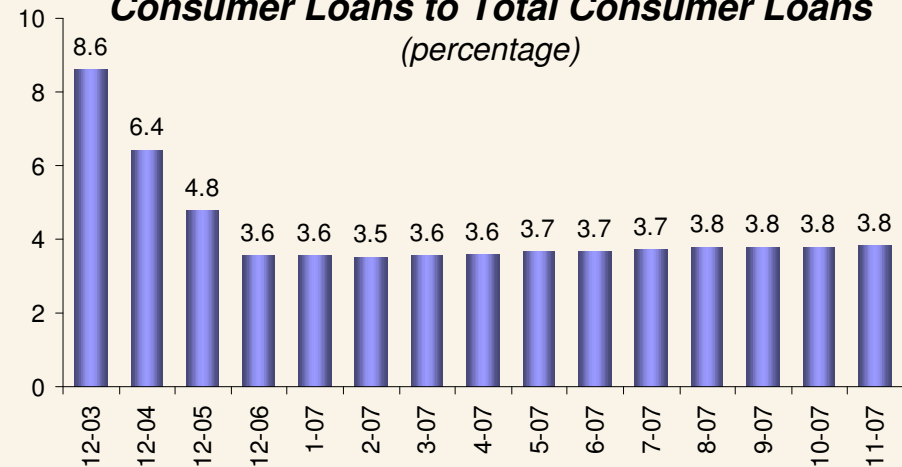*(1 April 2006 –24 December 2007, basis point)*
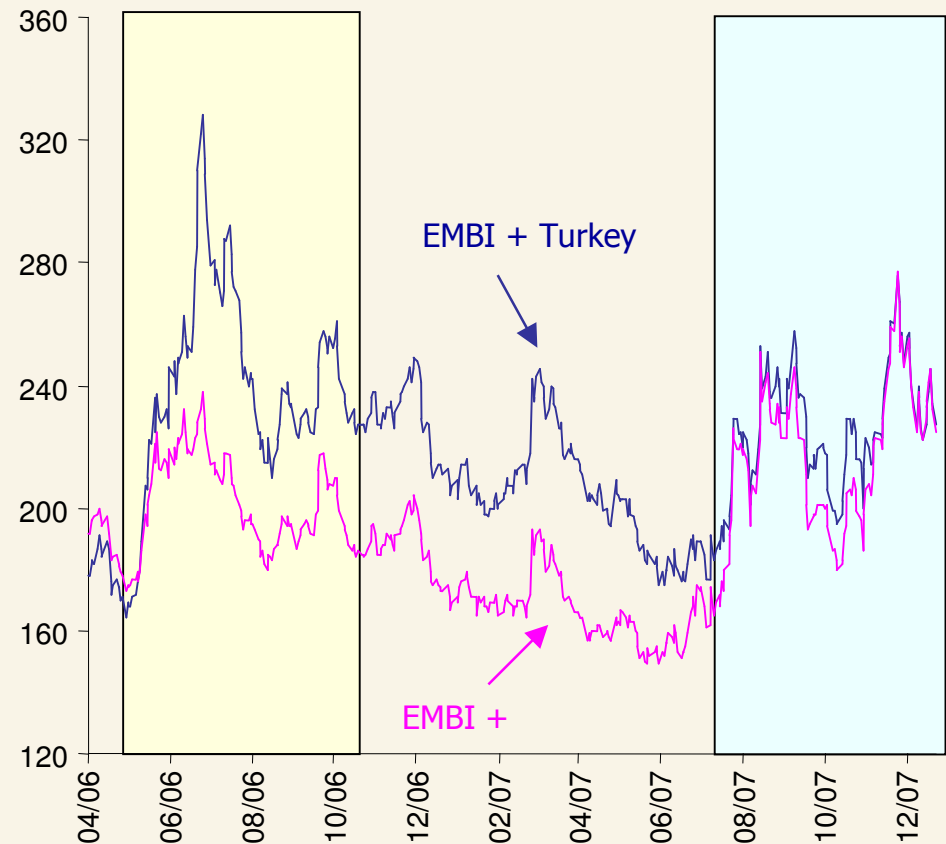
EMBI + Turkey

EMBI +

Source: JP Morgan
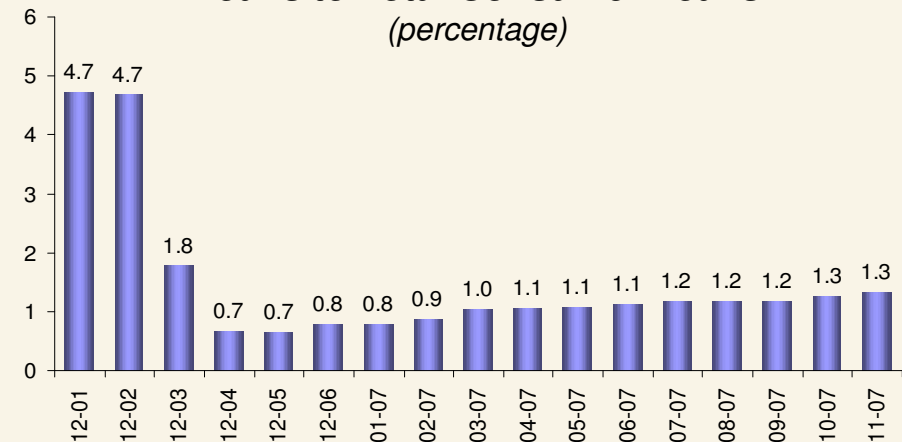
Effects of International Developments on Turkey

✓ Turkey is not exposed to unfavorable effects of international developments, either on the asset or liability side.

- Turkey does not have the practice of variable-rate loan.

- Foreign exchange-denominated consumer loan is not allowed by law.

- Non-performing loans constitute 1.3 % of consumer loans.

Ratio of Foreign Exchange-Indexed Consumer Loans to Total Consumer Loans
(percentage)

Month	Value
12-03	8.6
12-04	6.4
12-05	4.8
12-06	3.6
1-07	3.6
2-07	3.5
3-07	3.6
4-07	3.6
5-07	3.7
6-07	3.7
7-07	3.7
8-07	3.8
9-07	3.8
10-07	3.8
11-07	3.8

Ratio of Non-performing Consumer Loans to Total Consumer Loans
(percentage)

| Month	Value
12-01	4.7
12-02	4.7
12-03	1.8
12-04	0.7
12-05	0.7
12-06	0.8
01-07	0.8
02-07	0.9
03-07	1.0
04-07	1.1
05-07	1.1
06-07	1.1
07-07	1.2
08-07	1.2
09-07	1.2
10-07	1.3
11-07	1.3

Source: CBRT

Dollarization

✓ Despite recent progress, high dollarization makes the effects of turbulences on daily life more pronounced.

- According to dollarization indicators, foreign exchange deposit accounts of the residents increased following the fluctuation in May - June 2006, whereas the accounts declined during the fluctuation in July 2007.

✓ Foreign exchange deposit accounts display a decreasing trend at the times of appreciation of the Turkish currency.

Share of Foreign Exchange Deposit Accounts in Total Deposits
(2 January 2004 –23 November 2007, weekly, percentage)

Foreign Exchange Deposit Accounts
(2004 Q1 – 2007 Q4 billion USD)
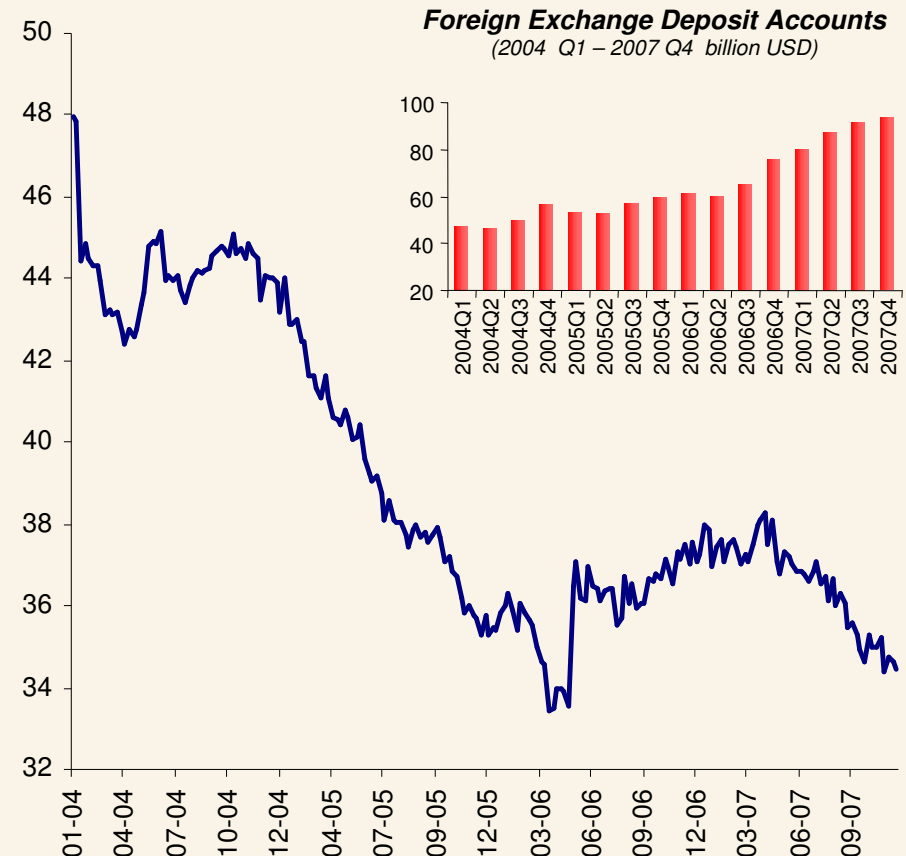
Source: CBRT

Foreign Exchange Markets

✓ The main tendency in foreign exchange markets has always been to re-establish the stability so far.

- Due to stronger macroeconomic fundamentals, the intensity and duration of fluctuations have been diminishing.

✓ Nevertheless, the costs of fluctuations are high.

- Adoption of modern risk culture and utilization of risk management tools will reduce the cost of fluctuations.

- The progress in risk management principles in real sector as well as in financial sector assumes crucial importance with respect to easing the impact of fluctuations on the economy.

RAPID CHANGES IN EXCHANGE RATES *

Beginning date	Duration of fluctuation (day)	Value at the beginning	Peak value	Change %
4/15/02	106	1.2928	1.6966	31.2
12/3/02	37	1.5200	1.6825	10.7
3/3/03	22	1.5962	1.7548	9.9
9/24/03	47	1.3545	1.5048	11.1
4/5/04	49	1.3076	1.5582	19.2
7/20/04	63	1.4293	1.5388	7.7
3/8/05	22	1.2601	1.3905	10.3
5/4/06	53	1.3167	1.7016	29.2
2/26/07	9	1.3826	1.4568	5.4
7/25/07	26	1.2421	1.3947	12.3

* USD selling rate of CBRT

Source: CBRT

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Interest Rate and Exchange Rate Policies, Markets

✓ As of today, a sharp slowdown in 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.

✓ In sum, fluctuations in external markets are expected to restrain both domestic and external demand in the Turkish economy.

1. **Slowdown in global economy**

   will restrain growth in external demand.

2. **Challenges in credit markets**

   will moderate the pick-up in domestic demand due to a deceleration in domestic loans financed via foreign credits.

Economic Outlook
"Growth and Employment"

Growth

✓ The growth rate, which was 6.8 % in the first quarter of 2007, declined to 2.0 % in the third quarter. The growth rate in the first nine months stood at 4.0 %.

✓ Looking at the growth rates for the third quarter of 2007 from the supply side;

- Substantial production losses were experienced in the agricultural sector as a result of drought. This slowdown has spread to hotel and restaurant services as well.

- Moderate growth in the industrial sector continues. Growth rate in the construction sector declined to 5.4 %.

Quarterly Growth
(Percentage change over the same period of the previous year)

	2007 Q1	2007 Q2	2007 Q3	First 3 quarters 2007	First 3 quarters 2006
GNP	6.8	4.1	2.0	4.0	6.4
GDP	6.8	4.1	1.5	3.8	6.4

Production Sub-Items
(Percentage change over the same period of the previous year)

	2007 Q1	2007 Q2	2007 Q3	First 3 quarters 2007	First 3 quarters 2006
Agriculture	2.9	-2.1	-7.8	-5.6	1.0
Industry	7.5	4.0	3.7	5.0	7.7
Construction	16.5	15.7	5.4	11.5	20.6
Trade	6.7	3.8	3.4	4.5	6.9
Hotel&Restaurant	5.5	0.4	-10.3	- 3.3	4.2
Transportation - Communication	5.8	4.1	3.6	4.4	3.8
Tax on Imports	9.9	8.2	14.5	10.9	11.2

Source: TURkSTAT

Growth

✓ Analyzing the the growth rates of 2007 from the demand side;

-Private consumption expenditures, which slowed down in the first half of 2007 due to monetary tightening, displayed a moderate recovery in the third quarter. Private investment expenditures continue to increase.

- The upward trend in public expenditures observed in the first half of 2007 lost pace in the second half.

- While the contribution of the private sector to growth was 2.3 percentage points in the third quarter of 2007, that of the public sector stood at 1.3 percentage points.

✓ Investments that will enhance the quality of expenditures and the production potential need to be brought to the forefront.

Real Consumption Expenditures
(2006 Q1 – 2007 Q3, year-on-year change)
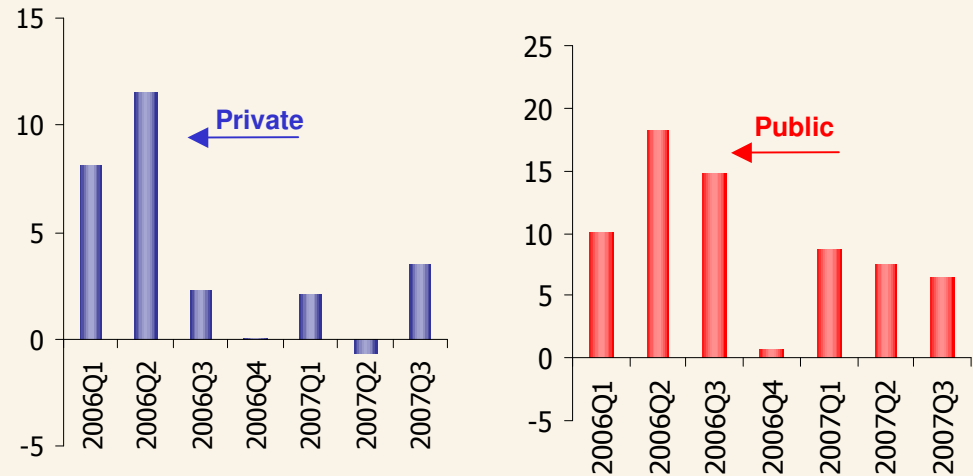
Real Investment Expenditures
*(2006 Q1 – 2007 Q3, year-on-year change)*

Source: TURKSTAT

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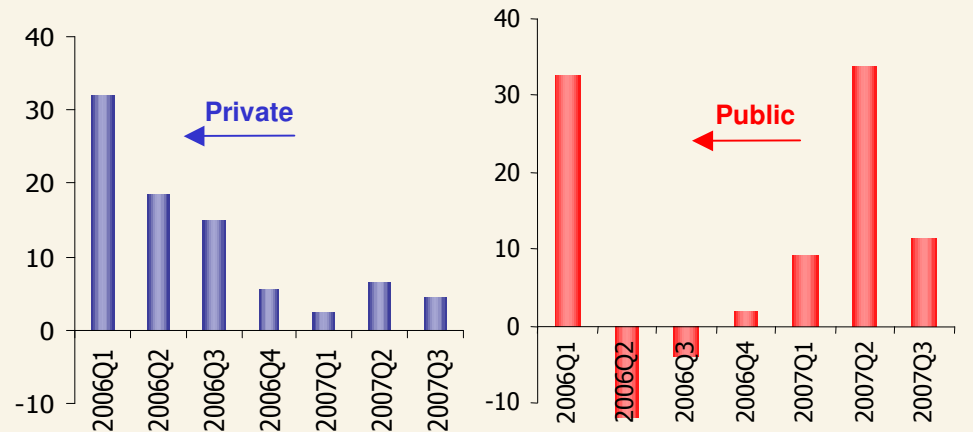
Growth - Outlook

Growth: Outlook

✓ The economic program foresees

5 % growth for 2007.

✓ October industrial production and

November capacity utilization rates

point to an ongoing modest growth in

production activities.

Year-end and 12 month-forward GNP Growth Expectations (appropriate average) and the Program Prediction

Year-end Growth Expectations

Program Forecast

12 month-forward Growth Expectations
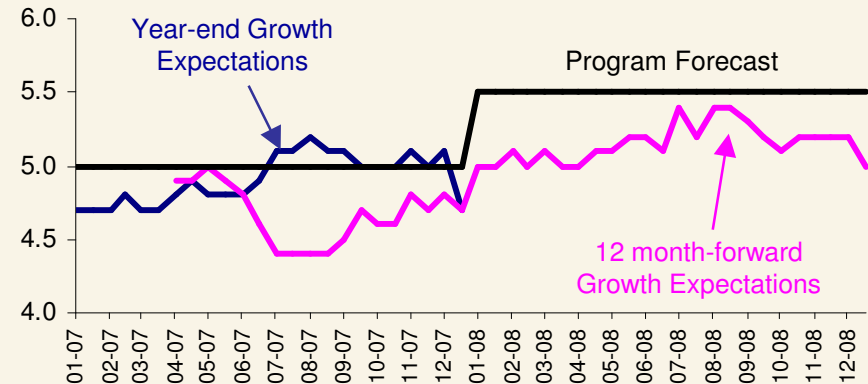
* Survey of Expectations
Source: CBRT, 2007 and 2008 Programs of the State Planning Organization

Industrial Production Index * (July 2006 - October 2007) **and Capacity Utilization Rate *** (July 2006 – November 2007, percent)

Capacity Utilization Rate (Right axis)

Industrial Production (Left axis)
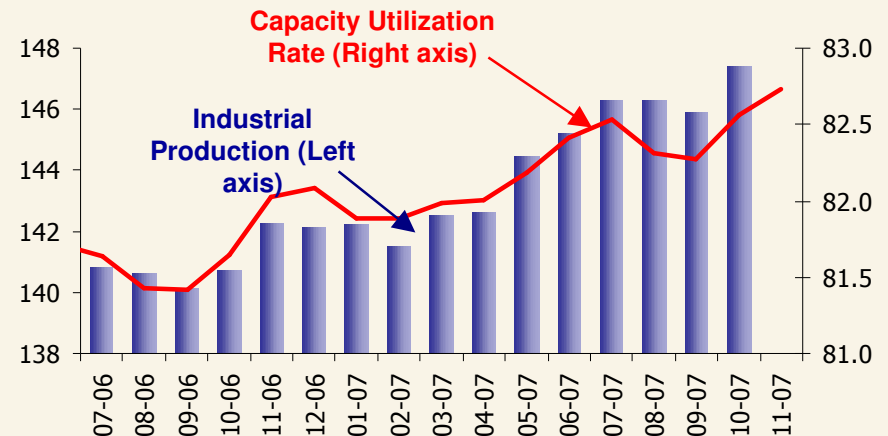
* Seasonally adjusted, quarterly moving average
Source: TURKSTAT, CBRT

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Employment

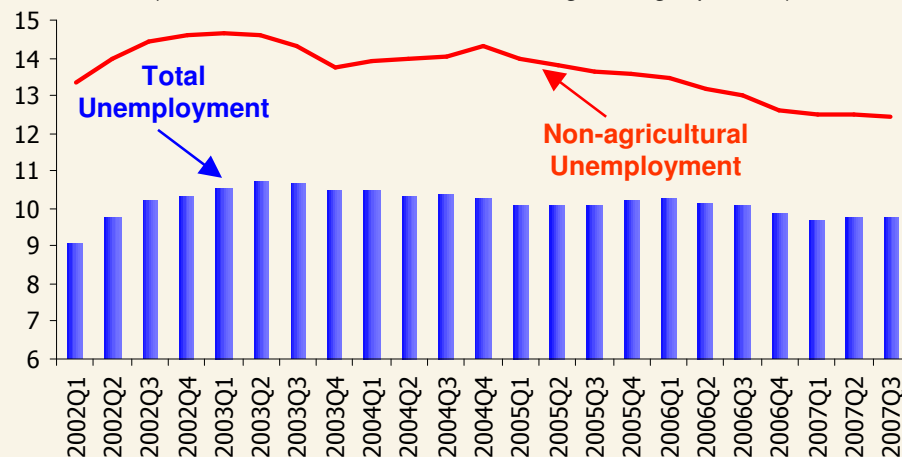## Labor Market

As of September 2007;

✓ Unemployment increased by 0.2 percentage point to 9.3 % compared to the same period last year.

✓ Non-agricultural unemployment remained unchanged at 12.0 % compared to the same period last year.

✓ 409 thousand new jobs were created in the non-agricultural sector over the last 12 months.

✓ Youth, urban and female unemployment rates stand at 19.0 %, 11.8 % and 10.7 %, respectively.

✓ Labor force participation rate is still low at 48.9 %.

Unemployment and Non-Agricultural Unemployment Rates
(2002 Q1 – 2007 Q3, annual moving average, percent)

Total Unemployment

Non-agricultural Unemployment

Unemployment Rates in Youth, Female and Urban Population *(2002 Q1 – 2007 Q3, annual moving average, percent)*

Urban Unemployment Rate (Left Axis)

Youth Unemployment Rate (Right Axis)

Female Unemployment Rate (Left Axis)
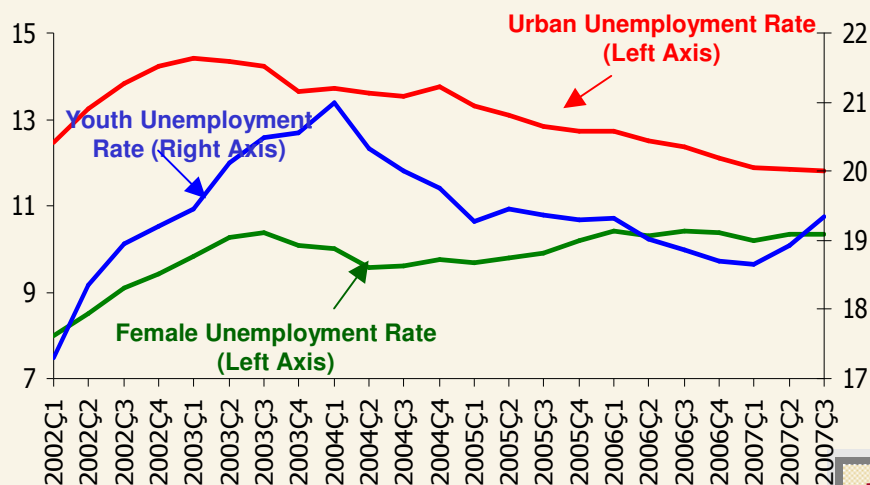
Employment

**Labor market is undergoing structural transformation**

✓ There has been a rapid shift from the agricultural sector to non-agricultural sectors since 2002.

- In the last four years, the cumulative decline in agricultural employment reached 24.3 %.

- Employment in industrial sector rose by 12.5 %.

- Services sector has the largest share in total employment. This sector has showed the highest increase in employment since 2002.

- Though the share of the construction sector remained subdued at 6.3 % as of September 2007, the sector displayed rapid increases during the periods of accelerated growth.

✓ This process is expected to continue.

Employment by Economic Activity
(2002 Q3 – 2007 Q3, cumulative percentage change)
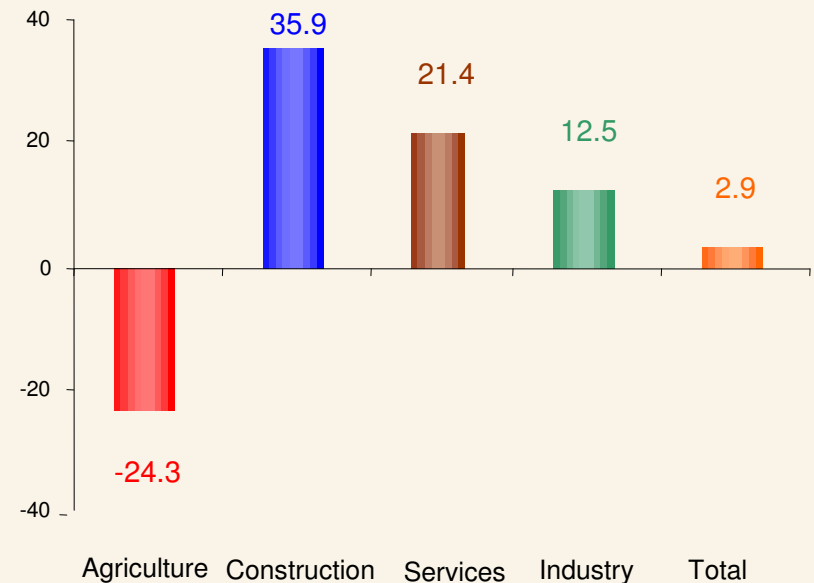
Source: TURKSTAT

Economic Outlook
"Balance of Payments Developments"

The openness of the Turkish economy has increased since 2001 and foreign trade has posted high growth rates.

✓ According to the quantity indices adjusted for exchange rate and price movements, exports and imports have expanded almost in parallel in recent years, contrary to the 1995-2000 period.

✓ Exports posted a 26.2 % increase during the January-October 2007 period, while that of imports stood at 20.2 %.

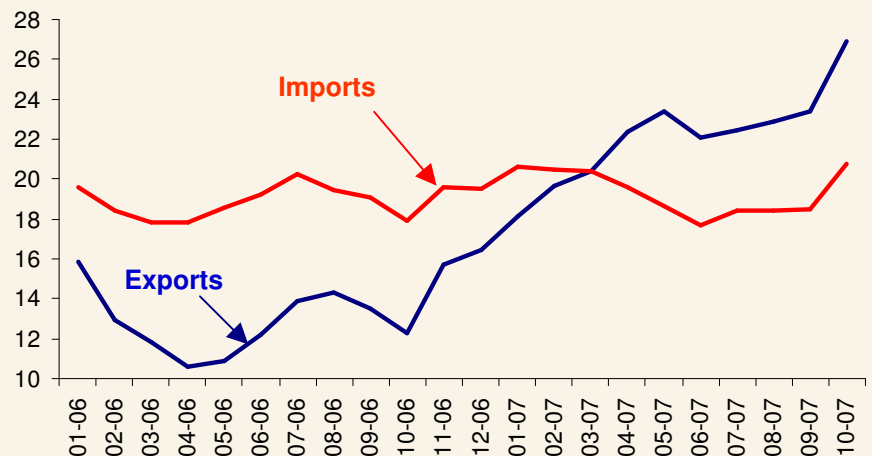✓ Annual growth rate of exports has outpaced that of imports since March 2007.

Imports and Exports Quantity Indices
(1982 – 2007*, 2003 = 100)
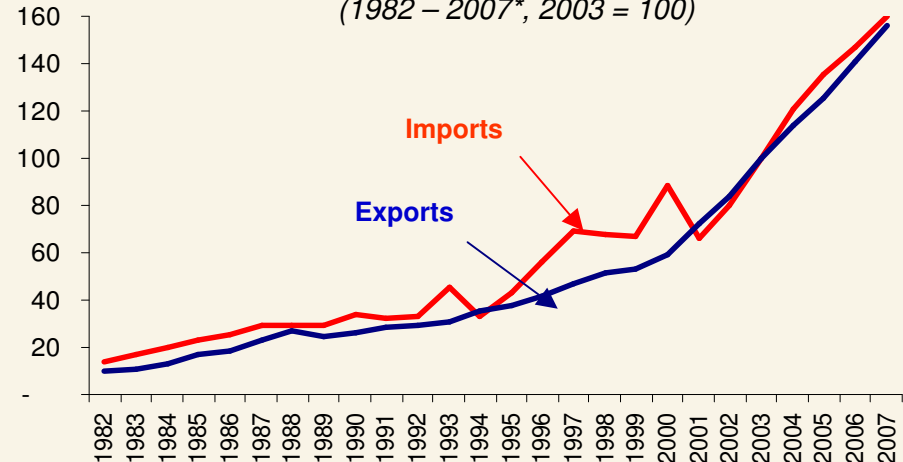
Imports

Exports

* 2007 figures are the average of January-October figures.

Imports-Exports
(January 2006 – October 2007, annual percentage change)

Imports

Exports

Source: TURKSTAT

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Compared to long-term trend, global demand conditions are expected to remain favourable in 2008, but risks are on the downside.

✓ The growth rate of imports, which had slowed down since mid-2006 in line with the weakening domestic demand, rebounded in July 2007.

✓ The largest contribution to the overall growth in imports comes from intermediate goods.

✓ The growth rate of imports of capital goods has been below the growth rate of overall imports since May 2006.

✓ There is a rebound in imports of consumption goods since July 2007.

Growth Expectations Worldwide and Expectations in Principal Regions Where Turkey Exports *(percent)*

Regions	2006 (Actual)	2007 (Expectation)	2008 (Expectation)
World	5.4	5.2	4.8
USA	2.9	1.9	1.9
EU	2.8	2.5	2.1
Asia	9.8	9.8	8.8
Middle East	5.6	5.9	5.9

Source: IMF World Economic Outlook

Sub-items of Imports *(January 2003 – October 2007, 12-month rolling, percentage change)*
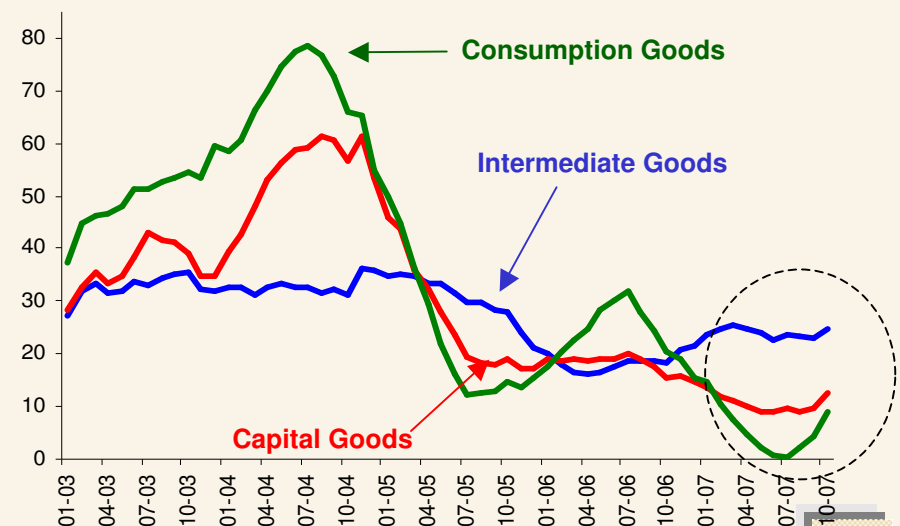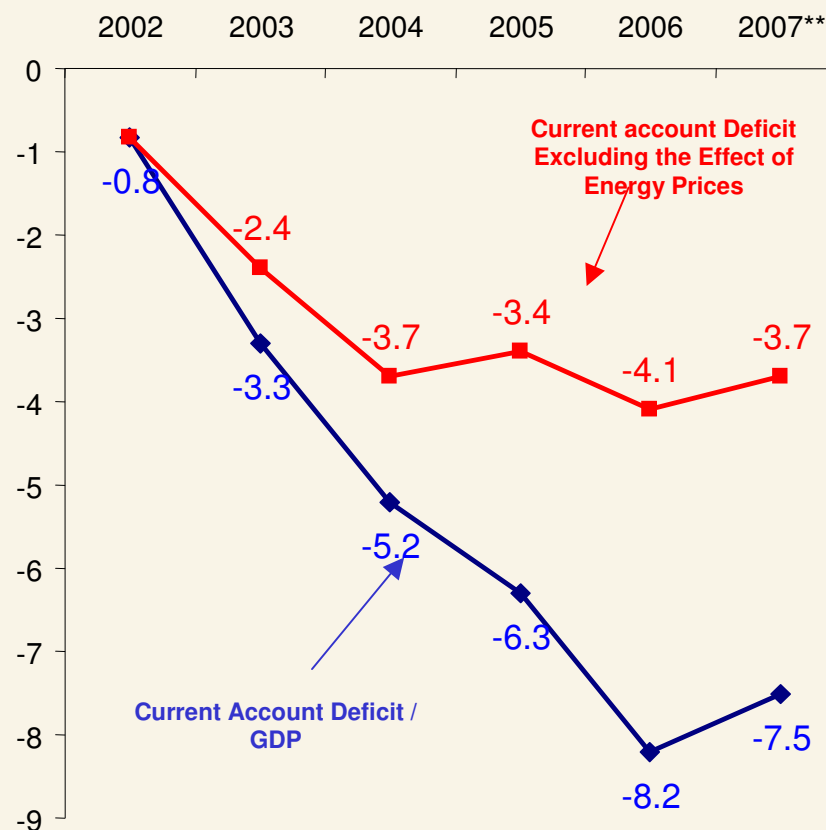

Source: TURKSTAT

Current account deficit remains stable throughout 2007.

✓ In October 2007, 12 month-rolling current account deficit rose to USD 35.2 billion with a 5.6 % increase compared to the same period in 2006.

✓ In the third quarter of 2007, the ratio of current account deficit to GDP declined by 0.7 point compared to year-end 2006 and stood at 7.5 %.

✓ High energy prices continue to have a negative impact on current account deficit.

- They added 3.8 percentage points to the current account deficit as of the third quarter of 2007.

*Current Account Balance and the Effect of Energy Prices on Current Account Deficit ***
(2002 – 2007, ratio to GDP, percent)

Current account Deficit Excluding the Effect of Energy Prices

Current Account Deficit / GDP

	2002	2003	2004	2005	2006	2007**
Excluding energy	-0.8	-2.4	-3.7	-3.4	-4.1	-3.7
CAD/GDP	-0.8	-3.3	-5.2	-6.3	-8.2	-7.5

* The effect of energy price increases on the current account in the 2003-2007 period was calculated by keeping the prices of 2002 intact. Energy Sub-Items: Stone coal and lignite, crude oil and natural gas under the mining and quarrying sector, and coke coal, refined petroleum products and nuclear fuels under the manufacturing industry.
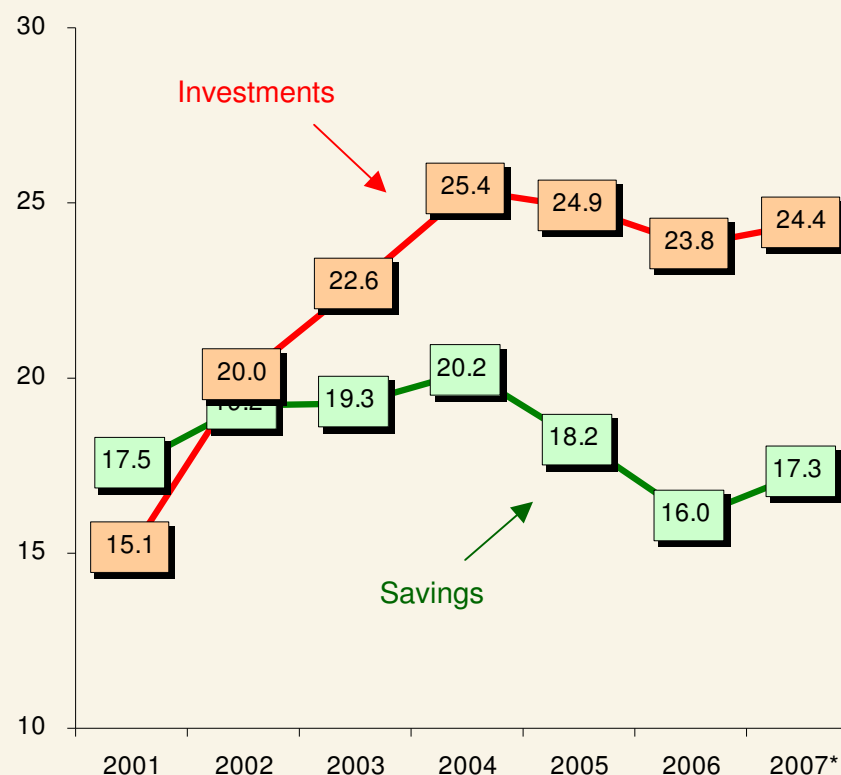** As of the third quarter of 2007

Source: TURKSTAT, CBRT

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✓ There is a direct and strong relationship between current account deficit and growth rates.

✓ The high increase in investments is the primary reason of deficit.

✓ Current account deficit is a structural problem. The atmosphere of stability and falling interest rates lead to an increase in consumption and investment demand. Hence, the structural characteristics of the economy necessitate particularly the imports of intermediate goods in order to meet increasing aggregate demand.

✓ A transformation in the structure of the current account deficit is essential to reduce fragility and risk perception.

✓ Current account deficit should be controlled via supply-oriented macro and micro policies with a medium and long-term perspective.

Domestic Savings and Investments
(Ratio to GNP, percent)

Investments

| | 15.1 | 20.0 | 22.6 | 25.4 | 24.9 | 23.8 | 24.4 |

Savings: 17.5, 19.3, 20.2, 18.2, 16.0, 17.3

2001 2002 2003 2004 2005 2006 2007*

* Forecast

Source: State Planning Organization 2008 Annual Program, CBRT

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✓ Long-term credits and capital inflows, along with direct investments, are crucial for the financing quality of current account deficit, and for reducing fragility.

✓ Short-term capital inflow has been negative in the last 12 months.

Ratio of Current Account Deficit Financing Items to the Current Account Deficit
(2000 – October 2007, 12-month rolling, percent)
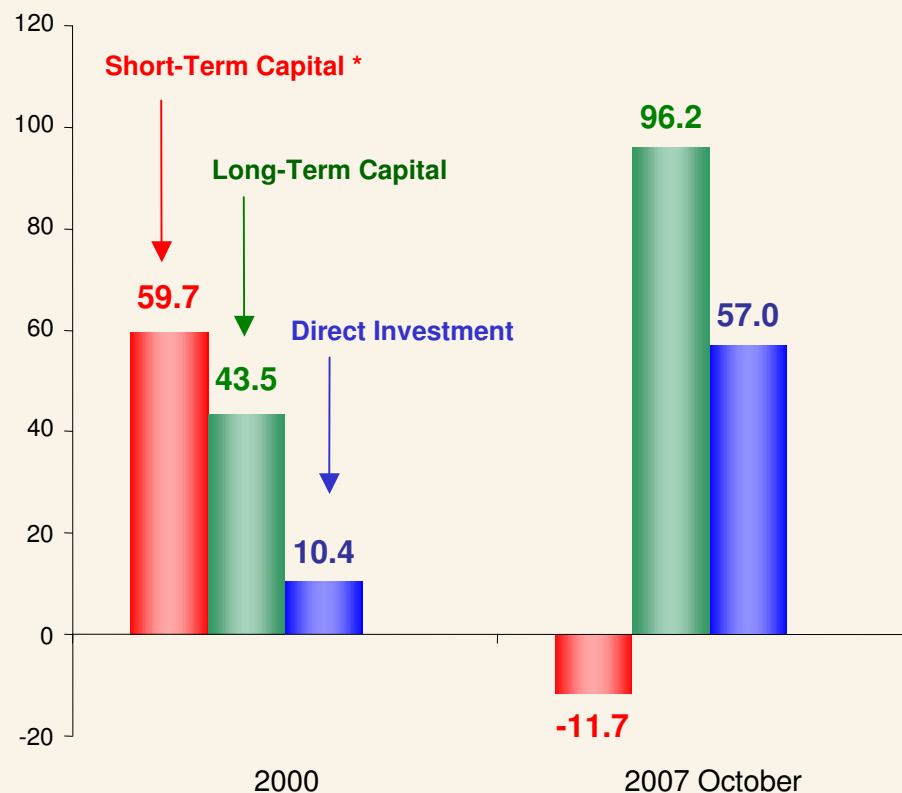
* Short-term capital inflow: net short-term credits used by foreign banks, real and public sectors, and deposits of non-residents

Source: CBRT

**The share of hot money in the financing of current account deficit is diminishing.**

✓ **The main determinant of the hot money flow are the developments in expectations rather than the high level of real interest rates.**

✓ Improvement in expectations leads to an acceleration in fund inflows despite low real interest rates, whereas deterioration in expectations leads to fund outflows despite high real interest rates.

✓ The extension of maturities in government securities market, the fact that the stock purchases are made not only for the purpose of capital gains, but also for company partnership, the floating exchange rate regime and the strengthened structure of financial markets restrain negative impacts of this item in the event of capital outflows.

Hot Money Flow (12-month rolling)

	2002	2003	2004	2005	2006	10-2007
Volume	-1.4	10.3	14.8	18.3	7.5	-0.2
Ratio to Current Account Deficit (percent)	- 90.1	127.6	95.1	81.1	22.9	- 0.6

Hot Money (January 2002 – October 2007, 12-month rolling, billion USD) **and the Expected Real Interest Rate** (January 2002- October 2007, percent)
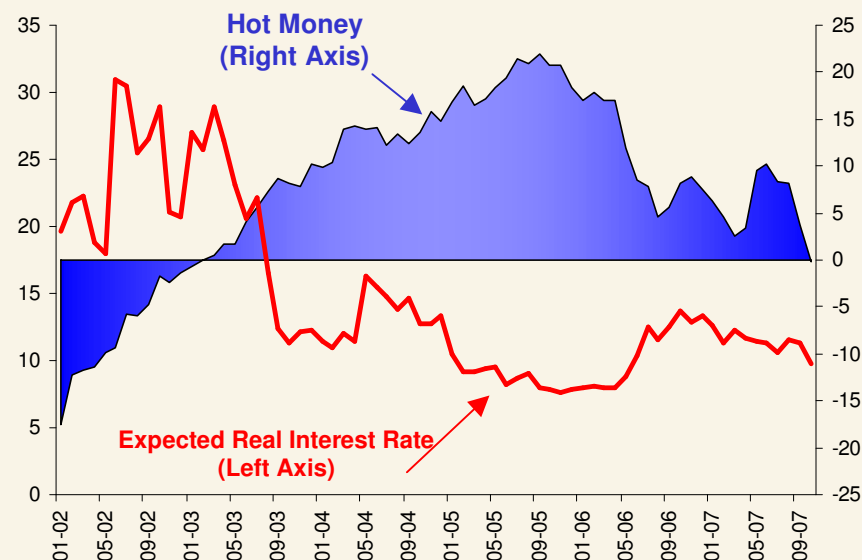
* Hot money is composed of purchases of government securities and stocks, bank deposits of the residents abroad, short-term credits extended by the banking sector to abroad, short-term foreign debt borrowed by the banking and private sectors and the net errors and omissions item.
Source: CBRT

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Foreign Direct Investments

↓

✓ **As of October 2007, net cumulative inflows for the last 12-month period reached USD 17.8 billion.**

✓ Foreign direct investment is one of the items with the biggest share in the financing of the current account deficit in 2007.

✓ According to 2006 figures, Turkey ranks 5th among developing countries in foreign direct investment.

✓ Stability is the main determinant of foreign direct investments.

✓ Foreign direct investment is crucial for the sustainability of current account deficit.

Foreign Direct Investments *(2006, billion USD)*

Country	
China	69.5
Hong Kong	42.9
Russia	28.7
Singapore	24.2
Turkey	**20.1**
Mexico	19.0
Brasil	18.8
India	16.9
Romania	11.4
Chile	7.9

Source: UNCTAD

Stability Index (DESIX) *(Quarterly averages)* **and Foreign Direct Investment Inflows** *(12-month rolling, billion USD)*
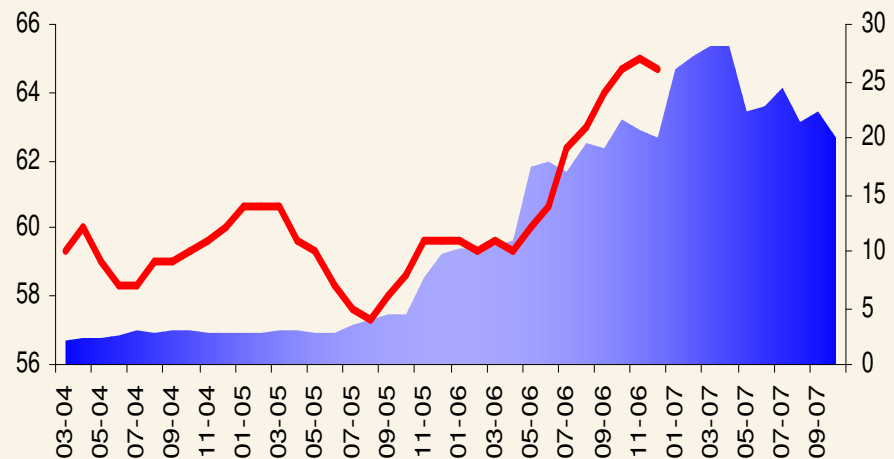
Source: Deutsche Bank and Eurasia Group. The index is composed of twenty variables in four categories with equal weights (government, society, security and economy). Index values vary from 0 to 100, 100 representing the highest level of stability.

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Long-term credit inflow remains strong.

✓ As of October 2007, net annual cumulative long-term credit inflow stood at USD 35.0 billion.

- **Banking sector**; USD 10.6 billion

- **Non-Banking Private Sector**; USD 24.6 billion.

✓ Rapid increase in private sector investments plays a determining role.

✓ Long-term credits and capital inflows are other factors that improve the financing quality of the current account deficit and ease fragility.

Long-Term Borrowing of Non-Banking Private Sector
(2001 Q1 – October 2007, 12-month rolling)
and Private Sector Investment Expenditures
(2001 Q1 – 2007 Q3, 12-month rolling)
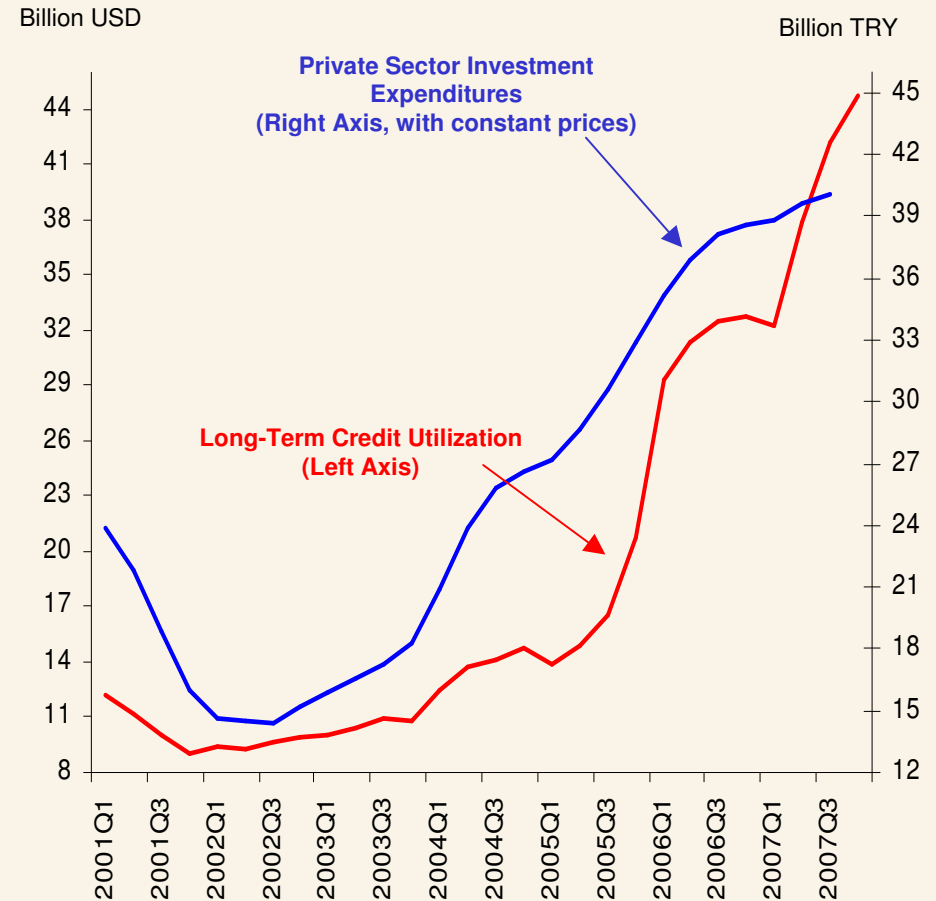
Source: CBRT, TURKSTAT

CENTRAL BANK OF THE REPUBLIC OF TURKEY

Presentation Before the Planning and Budget Commission of the Grand National Assembly of Turkey

Durmuş YILMAZ
Governor

27 December 2007