THE CENTRAL BANK OF
THE REPUBLIC OF TURKEY

inflation report
2007-I

CONTENTS

1. Overview

1.1. Developments in Inflation and Monetary Policy

After a gradual fall in the last quarter of 2006, inflation declined to 9.65 percent at the end of the year, in line with the projections made in the Inflation Reports of July and October. In the last quarter of 2006, the year-on-year downward trend in unprocessed food prices that had been on the rise since mid-2005 and the moderated lagged effects of the exchange rates were the main determinants of the course of the inflation.

The cumulative exchange rate pass-through since May has added around 3.5 percentage points to the headline inflation, in line with our projections laid out in July Inflation Report. This effect, coupled with the impact of former supply-side shocks, kept the inflation rate at high levels. Although the inflation in energy and unprocessed food prices decelerated in the second half of the year, annual inflation rates remained high for this group. Thereafter, the end-year inflation for 2006 was realized well above the target.

The recent downward trend in commodity prices, the slowdown in the rate of increase in unprocessed food prices and international liquidity conditions in favor of developing countries can all be cited among positive developments regarding inflation outlook. Nevertheless, the Monetary Policy Committee (the Committee) has noted that uncertainties relating to energy and unprocessed food prices and global liquidity conditions continue.

The growth figures for the third quarter of 2006 had revealed a marked slowdown in private consumption demand. However, as foreseen in the October Inflation Report, the slowdown in total demand was rather limited due to the ongoing strong external demand and the increases in public expenditures. In other words, the upward trend in public expenditures and external demand alleviated the impact of tight monetary policy on total demand and inflation. Considering that the inflation was well above the medium-term targets and the lagged effects of monetary tightening implemented since June were still vague, the Committee decided to keep policy rates unchanged in the last quarter of the year. Besides, the factors such as the high course of medium-term inflation expectations, risks relating to the services prices and uncertainties in the global economy necessitate keeping the tight policy stance.

1.2. Outlook

At the turn of 2007, it is observed that global growth has gained a more stable structure and the U.S. economy relatively slowed down while growth in other regions remained strong. As stated in the October Inflation Report, the persistent strong course of the domestic demand in Euro zone continues to support Turkey's exports.

In the recent period, although the Central Bank of Turkey (CBRT) decided to keep policy rates unchanged, monetary policy remained tightened as the risk premium did not change noticeably and inflation expectations continued to slow down. Longer-term interest rates such as the interest rates on government securities and consumer loans stayed at high levels, thereby restraining the consumption demand.

In this framework, although it is estimated that external demand conditions will contribute to economic growth in the first half of 2007, current projections show that the decline in private consumption will keep growth at lower levels compared to the previous years. It is anticipated that the slowdown in economic activity and the cautious stance of monetary policy will limit the secondary effects of supply-side shocks that emerged in 2006. In sum, the demand conditions are expected to continue to support the disinflation process in the upcoming period.

The removal of the high base effect caused by these supply-side shocks stands as another development that might accelerate the disinflation process in 2007. The moderation of energy and other commodity prices and the return of food prices to their usual trend along with the removal of the base effect of the exchange rate pass-through may trigger a remarkable decline in annual inflation starting from the second quarter of 2007.

In light of the current estimations that are based on this framework, and under the scenario that the Central Bank keeps the policy interest rates constant in the first three quarters of 2007 and eases afterwards, the annual inflation rate is forecasted with 70 percent probability to be within the 3.6-to-6.6 percent range (midpoint 5.1) at the end of 2007 and within the 1.6-to-5.2 percent range (midpoint 3.4) at the end of 2008 (Graph 1.2.1). The downward trend in inflation is expected to be more prominent in the second and third quarters of

2007. Projections emphasize that the current tight policy stance should be preserved in order for the inflation to converge to the medium-term target of 4 percent. At this point, it should be underlined that the mentioned interest rate path represents a policy framework that is based on the current data set, and does not necessarily imply a commitment by the CBRT. This path is subject to revisions whenever any change in economic conditions or assumptions occur.

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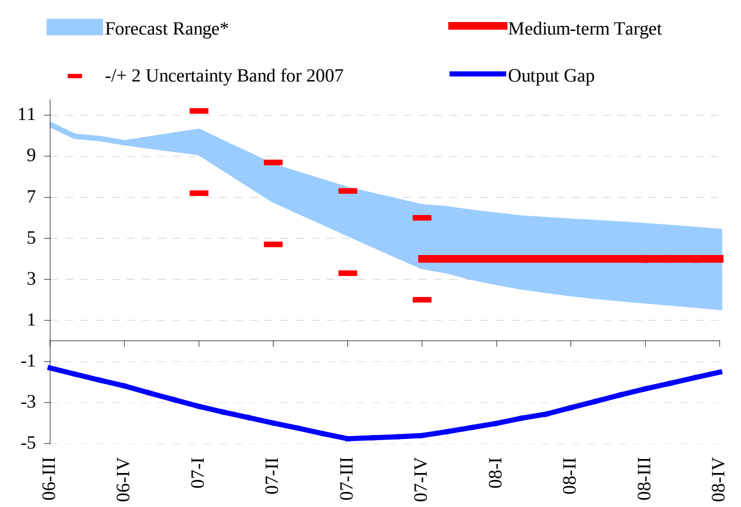
Graph 1.2.1. Inflation and Output Gap Forecasts



*The probability of inflation lying within the forecast range is 70 percent.

In sum, since recent macroeconomic developments have been consistent with the framework outlined in the October Inflation Report, there has been no need to make any significant adjustments to medium-term projections and to the monetary policy perspective. Detailed information regarding assumptions and analyses underlying the projections can be found in the last chapter of this Report.

1.3. Risks

The main risk for the medium-term inflation outlook is the possibility of higher-than-expected inflation inertia, which already manifests itself in inflation expectations and services inflation. Services inflation displayed a very slight improvement throughout 2006 compared to the previous years. The annual rate of increase in services prices is anticipated to decelerate in the upcoming period due to the expected slowdown in domestic demand. However, given the low relative productivity growth in the services sector, backward-looking price setting behaviour and the sensitivity of services prices to wage hikes, developments in services inflation should continue to be closely monitored. The recent wage adjustments have increased risks related to the services prices. In this framework, considering the fact that we aim at bringing inflation down to 4 percent in a very short period of time, the possibility of the persistence of high increases in services prices over the medium-term stands as a major risk. Materialization of such a risk would require keeping the tight policy stance for an extended period of time.

Another risk for the inflation outlook is the uncertainty related to the lagged effects of monetary policy on aggregate demand. Lags in monetary policy transmission are time variant across countries, and the Turkish economy is no exception. The sizeable slowdown of economic activity in the third quarter of 2006 was a result of lower consumer and producer confidence due to financial market volatility in May-June period, rather than an outcome of the tightened monetary policy. Although the tightening exercised since June 2006 started to be effective on private demand recently, the extent and duration of the slowdown in overall economic activity remains to be seen. Moreover, the ongoing uncertainties related to the behaviour of government spending constitute an upside risk to aggregate demand, and therefore inflation in 2007. In this respect, the Central Bank has been closely monitoring the macroeconomic impact of the developments in incomes policy as well as public sector non-interest expenditures.

Another risk factor that may delay attaining the medium-term targets is the possibility of a sudden change in the global financial market sentiment. Global liquidity is still the major factor in shaping risk appetite and volatility in financial markets. Currently, the concerns over high inflation and thus higher interest rates in the United States seem to have diminished. However, a faster – than envisaged slowdown in world economy or disorderly developments owing to global imbalances still remain as possible scenarios that may lead to another wave of portfolio shock in emerging markets. The Committee will revise the policy rates should these shocks turn out to have lasting effects on the medium-term inflation outlook.

There are favourable scenarios regarding the inflation outlook as well as unfavourable ones. Turkey is a net commodity importer. Although a slowdown in the global economic growth or a further easing in commodity prices could have an immediate adverse impact on domestic inflation through its impact on the global risk appetite, it will also lead to a positive terms of trade shock and thus to a more favorable outlook in the medium term.

Above all, developments related to structural reforms that would enhance the quality of fiscal discipline in the medium and long run are closely monitored from the perspective of both macroeconomic stability and price stability. The continuation of the European Union accession process and the sustained implementation of the structural reforms envisaged in the economic program are still crucial. Continued determination in implementing the decisive steps taken in these areas in recent years will strengthen the resilience of the economy against possible changes in the global conjuncture.

2. International Economic Developments

2.1. Economic Performance and Monetary Policy Developments

Since the second quarter of 2006, the annual rate of growth of the U.S. economy, which had been 3.7 percent in the first quarter, has decelerated, owing to the continued high level of the Federal Reserve's (Fed) interest rates, the slowdown in housing and automobile markets and the surge in energy prices, particularly crude oil prices. The annual growth rates of 3.5 percent and 3 percent observed in the second and third quarters respectively were perceived as an evidence to the above-mentioned trend of the U.S. economy. Nevertheless, the fact that the recently announced increase in employment of December 2006 surpassed expectations provides a more favorable outlook for the future. In December, increase in non-farm payroll employment was 67 percent higher than expected. Moreover, the fact that the deceleration in the housing market was not as sharp as expected and energy prices started to decline reinforced the expectations that the deceleration in the U.S. economy will be moderate. However, tight labor market conditions and firms' need for qualified workers lead to a surge in unit labor costs, causing inflationary pressures. It will be less likely to have a loose monetary policy in the near future, especially due to the high level of core inflation in 2006.

Table 2.1.1. Growth Rates
(Annual Percentage Change)

	2005	2006*	2007*	2006-I	2006-II	2006-III	2006-IV*
World	4.9	**5.1**	**4.9**	-	-	-	-
USA	3.2	**3.3**	**2.4**	3.7	3.5	3.0	**3.0**
UK	1.9	**2.7**	**2.5**	2.3	2.6	2.7	**2.7**
Asia-Pacific	4.8	**5.0**	**4.6**	-	-	-	-
Japan	2.7	**2.4**	**1.8**	2.9	2.1	1.6	**2.0**
China	10.2	**10.6**	**10.3**	10.2	10.9	10.7	**9.6**
E. Europe	6.0	**6.3**	**5.6**	-	-	-	-
Latin America	4.3	**4.9**	**4.3**	-	-	-	-
Euro Zone	1.4	**2.7**	**2.0**	2.2	2.8	2.7	**3.0**
Germany	0.9	**2.5**	**1.5**	1.9	2.7	2.8	**3.2**
France	1.2	**2.0**	**1.9**	1.4	2.6	1.8	**2.4**
Italy	0.1	**1.8**	**1.3**	1.7	1.7	1.7	**1.9**

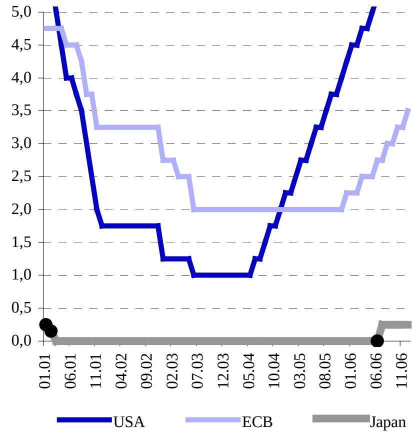
* Predicted values.
Source: Consensus Forecasts, OECD, World Economic Outlook.

In the third quarter of 2006, the U.S. current account deficit continued to widen, parallel to the first two quarters, and reached 6.8 percent of the Gross Domestic Product (GDP). It is expected to reach 6.9 percent in 2007, continuing to pose a risk to the global economic balance.

The fact that core inflation failed to decline to a moderate level as desired, albeit the slowdown in the second and third quarters of 2006, made Fed decide to keep interest rates at 5.25 percent at the Federal Open Markets Committee (FOMC) meeting of December 12, 2006. It is anticipated that future interest rate decisions will be shaped on the basis of the developments in core inflation and growth.

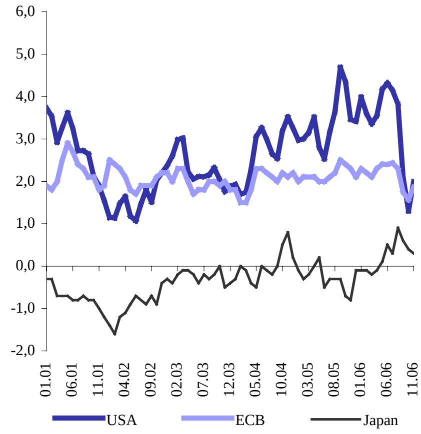
Eurozone grew by 2.6 percent in the first three quarters of 2006 compared to the same period of the previous year. It is estimated that Eurozone, which grew by 2.1 percent on average in the last eight-year period, reached a growth rate above the all time average in 2006 (Table 2.1.1). Domestic demand was the main determinant of this growth. Investments, boosted by the increase in profit margins and credit expansion, stood as the most prominent component of domestic-demand-driven growth, outpacing the contribution of the moderate rise in private consumption. Decreased unemployment, positive expectations about employment and increased credit volume together indicate that investments and consumption will also increase in forthcoming periods. In addition, given the fact that global growth rates became relatively balanced and that stagnation in the U.S. economy is less probable in light of the recent data, it is expected that the demand for exports will continue to increase in the following periods and will not have any negative impact on growth. However, the increase in the Value Added Tax (VAT) rate in Germany, effective as of January 2007, suggests that quarterly growth rates may follow a volatile course in 2007. In light of these evaluations, in 2007, the Eurozone is expected to display a growth performance that is close to its historical averages. The volatile course of oil prices, in spite of the recent downward trend, stands out as the most significant risk factor that would reduce the pace of Eurozone growth.

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..

Eurozone Harmonized Index of Consumer Prices (HICP) inflation, which had been realized above 2 percent on average until August 2006 on an annual basis, fell below 2 percent from then on, due to the base effect and the decline in crude oil prices (Graph 2.1.2). Uncertainties regarding global energy prices in 2007 and increase in VAT in Germany are considered as unfavorable developments for Eurozone inflation. However, assuming that the ongoing increase in investment expenditures will boost the level of potential growth and tight monetary policy will be prolonged, it is believed that the negative impact of the aforementioned factors on inflation may be offset.

The European Central Bank (ECB) perceived the excess liquidity resulted from ongoing money and credit expansion as a risk factor to price stability in the medium and long-term, and continued its gradual tight monetary policy. In this framework, the ECB Governing Council raised its interest rates to 3.5 percent by 25 basis points at six meetings held from December 2005 to December 7, 2006 (Graph 2.1.1). Jean Claude Trichet, president of the ECB, signaled further monetary tightening by emphasizing that loose monetary policy would not be effective in boosting productivity and the potential output level, and would lead to high inflation.

The Japanese economic growth, triggered by exports and company profits, is expected to be realized around 2.4 percent in 2006 (Table 2.1.1). In the coming period, it is expected that the high level of company profits which contribute to household incomes will keep its level and consequently, private domestic demand will continue to increase, furthermore, the upward trend of exports, which has not been negatively influenced by the signals of slowdown in the U.S. economy so far, will be maintained. In this respect, the growth rate for 2007 is estimated to be around 1.8 percent. The annual rate of increase of consumer prices, which follow a positive trend at a moderate rate, is expected to persist in the upcoming period as well, as long as the output gap continues to be positive (Graph 2.1.2).

The Bank of Japan (BoJ), ended its five-year excess liquidity policy at its March meeting in 2006 and on the basis of developments in the following period, decided to raise its policy rate by 25 basis points at the meeting held on 13-14 July 2006. In the subsequent meetings, the BoJ decided to keep policy rates unchanged (Graph 2.1.1). These developments are deemed positive in terms of global liquidity in the short-term. Moreover, the BoJ is expected to adjust the level of interest rates gradually in light of developments in economic growth and prices.

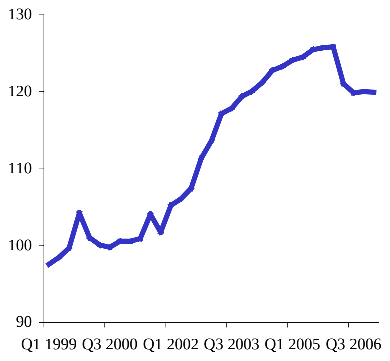
The Chinese economy, which had grown by 10 percent in 2005 owing to the increases in company profits, exports and investments, grew by 10.2, 10.9 and 10.7 percent in the first three quarters of 2006 respectively, albeit a relatively low investment rate. The Chinese economy is expected to grow by around 10.6 percent in 2006 (Table 2.1.1). It is anticipated that the slowdown in the U.S. economy will have a limited impact on the Chinese economy. Likewise, exports increased by 27 percent annually in 2006, pushing China's foreign trade surplus to a record high level of USD 177.5 billion with an increase of 74 percent compared to the previous year. However, growth rate is expected to be around 10 percent in 2007, due to a relative slowdown in exports, domestic investment and consumption demand.

2.2.International Markets

2.2.1. Financial Markets

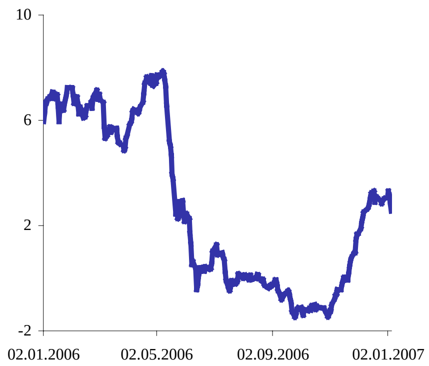
Uncertainties in economic activities and inflation rates of industrialized countries, producing ambiguities regarding the potential course of their policy rates, leads to fluctuations in international markets. However, the ongoing strong course of growth against expectations and the increase in global risk appetite restrained the impact of uncertainties. In light of these developments, it is observed that the markets of both developed and developing countries demonstrated good performance in the last quarter of the year.

Graph 2.2.1. The Index of Monetary Developments in Industrialized Countries (1999=100)



Source: Central Banks, CBRT and IMF-IFS.

Graph 2.2.2. Credit Suisse Global Risk Appetite Index



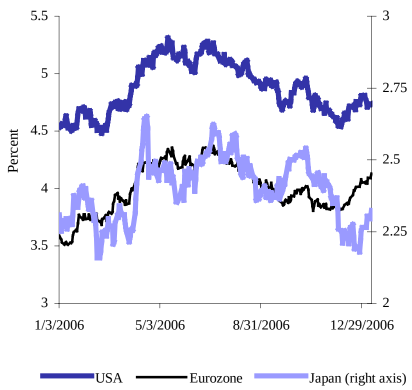
Source: Credit Suisse.

It is important to analyse base money expansion of the central banks of the United States, Japan and Eurozone, which will provide insight for global liquidity conditions. To this aim, using seasonally adjusted data, base money expansion that exceeds nominal GDP growth has been indexed by GDP weights of the above-mentioned countries. It is observed that the index started to decline sharply in the second quarter of 2006, following the monetary policy tightening decision of BoJ. In the third and fourth quarters of the year, as a result of a balance between limited downward movement in Japan and USA and increases in Eurozone, the index, following a sluggish trend, prevented monetary developments from producing any kind of impact –positive or negative– on global liquidity conditions (Graph 2.2.1).

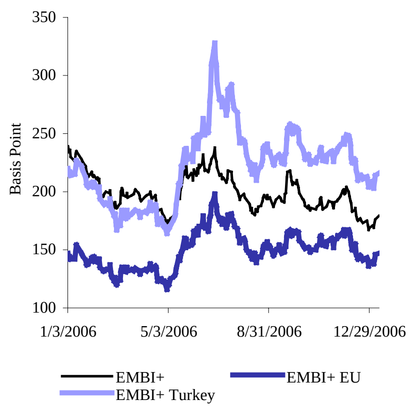
The Credit Suisse Global Risk Appetite Index (CSRA), which is closely monitored for the information it provides about the risk behaviour of international investors and the extent they take risk, entered into declining trend sharply in the face of the financial turbulence in May and June. Taking into account the confidence interval, obtained by adding and subtracting the 1.5 standard deviation from the average, it is observed that the index had fallen close to the lower limit by the end of October. Later, however, the index rebounded thanks to the favourable data announced in developed countries. The improvement in risk appetite, as can be observed from the index, helped the financial assets of developing countries to perform better (Graph 2.2.2).

The analysis of interest rate developments in developed countries demonstrates that increases in policy rates in Eurozone and expectations of new interest rate hikes due to ECB's emphasis on inflation pushed yields higher. Despite unchanged Fed policy rates, yields have been on the rise in the United States, due to signals released by the data that slowdown in growth rate would not be as sharp as expected and the fact that Fed still perceives inflation as a threat under current circumstances. While the decline in inflation in the second half of 2006 and the less-than-expected growth of the third quarter led to a decrease in yields in Japan, positive remarks made by BoJ for the short-term outlook and statements of probable new interest rate hikes under these circumstances reboosted the yields (Graph 2.2.3).

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



Graph 2.2.4. EMBI+ Developments

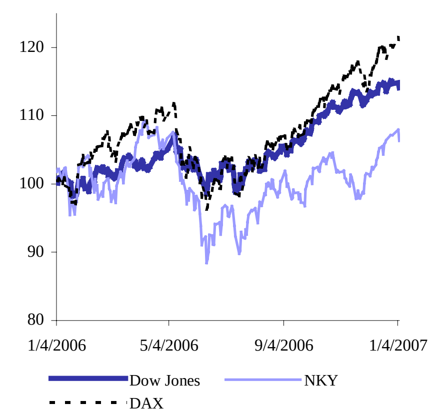


Source: Bloomberg.

The level of yields in developing countries in the second half of 2006 presented a stable path, though being higher compared to the pre-turbulence period. In the last quarter of the year, yield spreads started to decline again due to growing risk appetite and converged to pre-turbulence values. Emerging Markets Bond Index (EMBI+) and its sub-indices of developing European countries and Turkey continued to follow a similar trend. EMBI+ Turkey sub-index has recorded values above the EMBI+ in May since two years, and the difference between the two indices became 41.5 basis points on average in the last quarter (Graph 2.2.4).

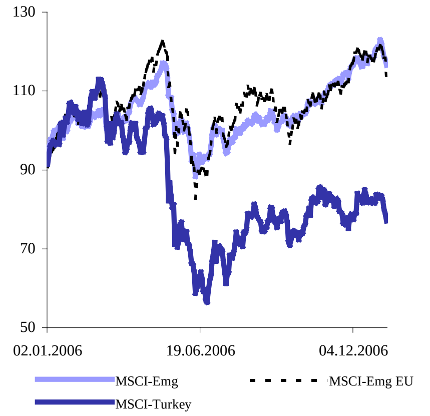
The equity markets of developed countries pursued a remarkably strong course in the second half of the year. The DAX Index displayed a more apparent upsurge thanks to the high growth performance of Eurozone and Germany (Graph 2.2.5). As regards developing countries, Morgan Stanley Capital Index (MSCI) Developing Countries and Developing European Countries sub-indices showed a strong upward trend in the last quarter of the year and reverted to pre-turbulence figures, while the increase in Turkey sub-index remained rather limited (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)



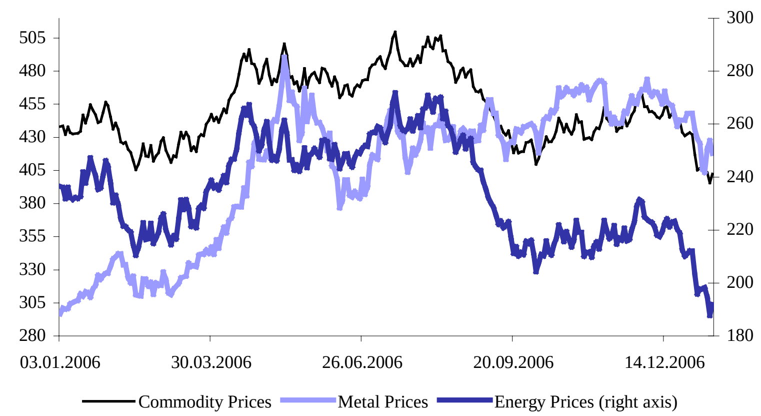
Source: Morgan Stanley.

Uncertainties regarding inflation and growth in industrialized countries, which led to sharp fluctuations in international relative prices throughout the last quarter of 2006, continue to stand out as the most significant risk factor in the first quarter of 2007. Convenient global liquidity conditions, high level of risk appetite and a moderate slowdown in global growth rate generate the belief that international conditions will be more favorable than expected in the first quarter of 2007. Despite this positive outlook, an increase in the interest rates of developed countries may have a negative impact on the financial assets of emerging market countries.

2.2.2. Commodity Markets

Recent price increases observed in commodity markets were particularly replaced by energy-price driven decreases starting from the third quarter of 2006. The Goldman Sachs (GS) Energy Prices Index, which had been stagnant in the last quarter of 2006, started to decrease rapidly in December and finally declined by 16.8 percent on January 12, 2007 as compared to December 1, 2006. Similarly, the GS Metal Prices sub-index, which had also followed an upward course in the last quarter of the year, recorded a decrease of 10.3 percent on January 12, 2007 as compared to early December, due to the impact of sharp drops observed in basic metals in December. As a result of the above-mentioned developments in energy and metal prices, the GS Commodity Prices Index also fell by 13.0 percent during the same period (Graph 2.2.7).

Graph 2.2.7. Commodity Prices



Source: Goldman-Sachs.

The simple average price of six basic metals traded in the London Metal Exchange (LME) increased by 15.6 percent in the last quarter of 2006 compared to the third quarter. On annual basis, in the last quarter of 2006, rapid increases continued in prices of six basic metals, while as compared to the third quarter, increasing trend continued in all base metals except copper (Table 2.2.1).

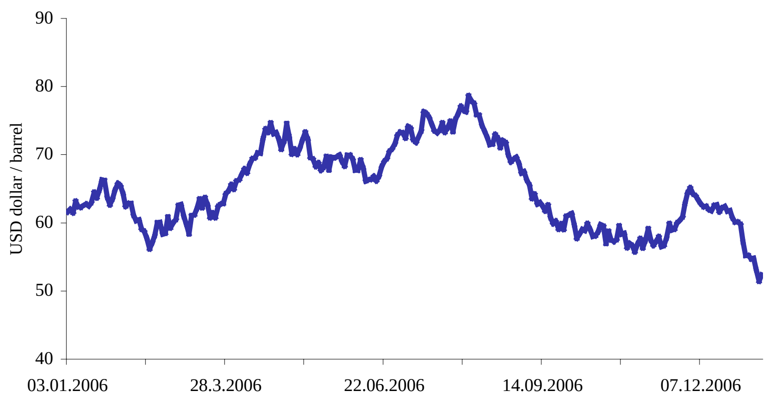
Table 2.2.1. London Metal Exchange Developments

USD	2006 Q3	2006 Q4	2006 *December*	2006 *12 January*	Percentage Change 06Q4 / 05Q4	Percentage Change 06Q4 / 06Q3	Percentage Change 13 Jan 07/Dec 06
Aluminum	2530.9	2530.9	*2461.6*	*2695.0*	*31.7*	*7.9*	*9.5*
Copper	7627.1	7627.1	*7690.3*	*5750.0*	*71.2*	*-7.2*	*-25.2*
Lead	1194.5	1194.5	*1179.3*	*1610.0*	*57.2*	*33.2*	*36.5*
Nickel	26505.9	26505.9	*30468.9*	*32445.0*	*149.3*	*20.0*	*6.5*
Tin	8623.7	8623.7	*8436.7*	*10550.0*	*59.0*	*18.8*	*25.0*
Zinc	3358.7	3358.7	*3340.0*	*3770.0*	*152.1*	*23.5*	*12.9*

Source: London Metal Exchange.

Favorable weather conditions and rapid growth of inventories have led to a marked slowdown in oil prices starting from the early January 2007. In international markets, average Brent oil price was about USD 62.3 per barrel in December 2006, with a surge of 6.6 percent over November. On the contrary, international crude oil prices had plummeted to USD 52.4 per barrel by January 12, 2007 (Graph 2.2.8). The February 2007 contract traded on the futures market, also descended to USD 52.97 per barrel due to recent declines.

Graph 2.2.8. Oil Prices



Source: Bloomberg.

The strong trend of global growth in recent years has exerted pressure on crude oil prices. However, prices have fallen in the recent period as a result of the outflow from futures markets due to expected decline in oil consumption in parallel to slowdown in global growth rates, favorable weather conditions, and especially the record high levels of crude oil reserves of the last two years. Moreover, the relatively stable outlook in the Middle East and recent increases in production are the other important factors that support the decline in crude oil prices. However, the recent second quota reduction, effective as of 1

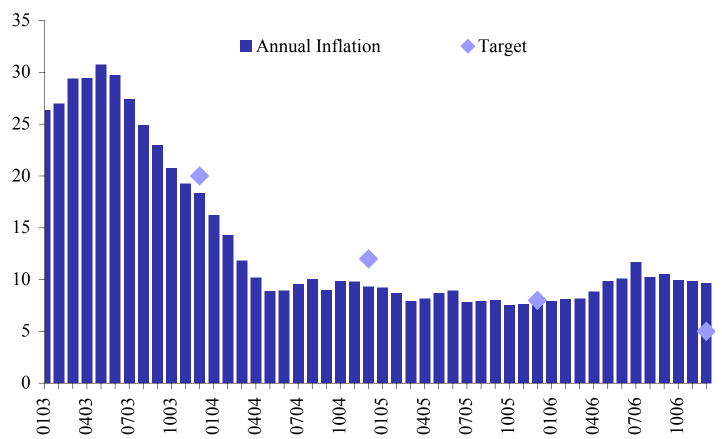
February 2007, emphasized by the Organization of the Petroleum Exporting Countries (OPEC) and the possibility of a further quota reduction are viewed as risk factors that might reverse the downward trend of crude oil prices in the future.

3. Inflation Developments

3.1. Inflation

Year-on-year consumer inflation was 9.65 percent in 2006 (Graph 3.1.1). By the end of June, with the depreciation of the New Turkish lira (YTL) in the second quarter driven by international liquidity conditions, consumer prices remained outside the uncertainty band set around the path consistent with the target. In the third quarter, despite of YTL's regaining strength and the favorable course of oil prices, annual inflation continued its high course above the upper limit of the uncertainty band, by September, led by the accumulation from the second quarter and the lagged effects of exchange rates. The fourth quarter involved a slight improvement in the inflation outlook. This was mainly due to the apparent decline in the annual rate of increase of unprocessed food prices which have been lifting up since mid-2005 and the moderating lagged effects of exchange rates.

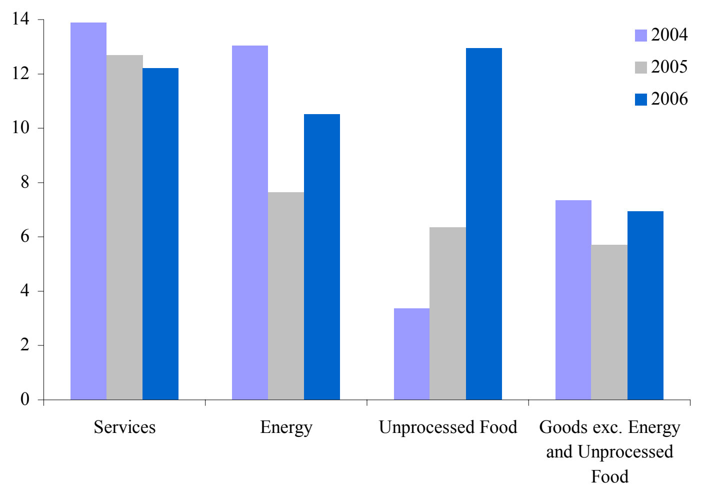
Graph 3.1.1. End-Year Inflation Target and Annual CPI Inflation



Source: TURKSTAT.

2006 consumer price developments indicate that the services inflation displayed a very limited improvement compared to previous years, whereas the goods inflation was above last year's figures (Graph 3.1.2). Unprocessed food prices increased at a rapid pace, with 12.94 percent, above the previous years, while goods excluding unprocessed food were mainly subject to the depreciation of New Turkish lira. Continued oil price rises in the first half of the year and the depreciation of New Turkish lira made energy prices adversely affect inflation. Analysing the contributions of these groups to annual inflation, it is observed that the contribution of services did not change and that goods, mainly unprocessed food, inflation was effective on the rise of consumer inflation compared to 2005 (Graph 3.1.2, Table 3.1.1).

Graph 3.1.2. Consumer Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

Table 3.1.1. Contribution to Annual CPI Inflation

	Services	Energy	Unprocessed Food	Goods excl. Energy nad Unprocessed Food
2004	3.58	1.94	0.44	3.40
2005	3.22	1.10	0.79	2.60
2006	3.33	1.51	1.65	3.16

Source: TURKSTAT, CBRT.

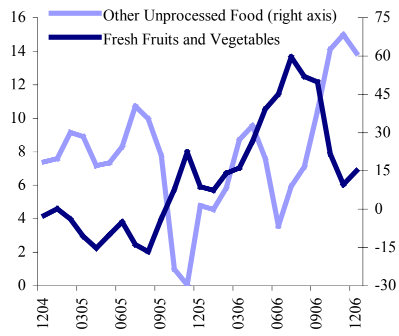
Unprocessed food products were influential on consumer inflation particularly in the first three quarters of the year, primarily due to high course of fresh fruit and vegetable prices as a result of supply-side factors throughout the year. In the last quarter of the year, unprocessed food prices underwent a “correction” driven by the remarkably high levels of increase of the same period in 2005 and recorded the lowest fourth quarter inflation, 5.81 percent, of the last four years (Table 3.1.2). On the other hand, annual inflation of unprocessed food excluding fresh fruit and vegetables, meat in particular, increased significantly in the last quarter of 2006 as a result of the base effect of the avian influenza-rooted sharp decline in the last quarter of 2005 (Graph 3.1.3).

Table 3.1.2. Unprocessed Food Prices
(Quarterly Percentage Change)

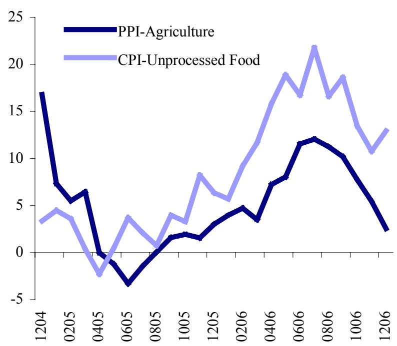
	I	II	III	IV	Annual
2004	6.70	-10.84	-0.01	8.66	3.36
2005	3.61	-7.87	0.25	11.12	6.34
2006	8.81	-3.67	1.83	5.81	12.94

Source: TURKSTAT, CBRT.

Graph 3.1.3. Unprocessed Food Prices
(Annual Percentage Change)



Graph 3.1.4. Agriculture and Unprocessed Food Prices
(Annual Percentage Change)

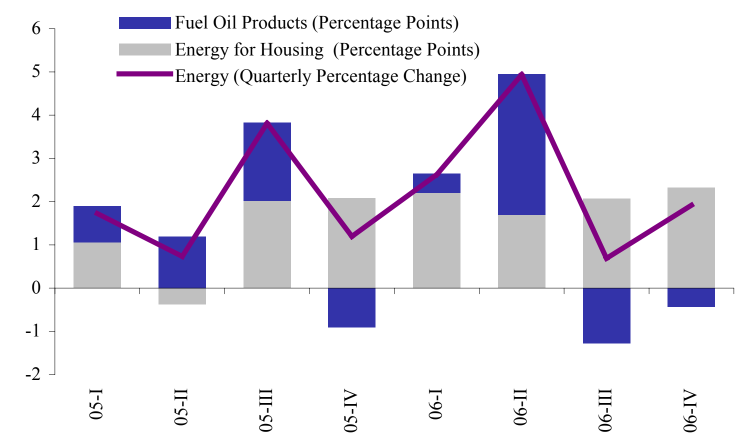


Source: TURKSTAT, CBRT.

A concurrent evaluation of favorable unprocessed food prices in the last quarter and agricultural price developments would be rather helpful. The apparent decline in agricultural production prices in the last quarter of 2006, which used to display seasonal increases in the last quarter of the year, is remarkable (Graph 3.1.4). This might have a positive effect on unprocessed food prices, but it must be borne in mind that the recent adverse weather conditions pose a risk to the group prices.

The stable course of New Turkish lira along with the decline in oil prices led to a yearly downward trend as of August 2006 in energy prices which have high exchange rate pass-through. This favorable course of energy prices was particularly driven by the 10.18 percent decline in fuel oil prices in August–November period. However, housing energy prices, contributing to energy inflation by about 2 percentage points every quarter since the third quarter of 2005, rose by 3.19 percent due to natural gas and solid fuel price hikes, causing energy inflation to surge in the last two months of 2006 (Graph 3.1.5).

Graph 3.1.5. Domestic Energy Prices



Source: TURKSTAT, CBRT.

Among the consumer expenditure groups, the group with the highest exchange rate pass-through, other than the energy group, is the "goods excluding energy and unprocessed food" group that mostly comprises tradable goods. The inflation in this group accelerated significantly in second quarter of 2006 with the impact of the high depreciation of New Turkish lira in May and June. The lagged effects of the turbulence on the group prices also continued in the third quarter, albeit at a slower pace, while the group prices increased in the last quarter at a relatively low rate compared to the same period of 2005. This was particularly due to the marked decline in durable goods prices and the disappearance of the impact of price hikes in tobacco products in the last quarter of 2005.

Price increases in durable goods that mostly involve imported goods or goods with a high level of imported input and have a relatively rapid exchange rate pass-through accelerated in the second quarter of the year due to the depreciation of New Turkish lira and pursued a high course in the third quarter, albeit at a slower pace. In the last quarter, the loss of pace was replaced by a decline, driven by both the slowdown in consumer demand for durable goods and the recent appreciation of New Turkish lira. Within this framework, prices of almost all sub-items declined in the last quarter and durable goods prices dropped by 2.2 percent (Table 3.1.3).

Table 3.1.3. Prices of Durable Goods
(Quarterly Percentage Change)

	2005					2006				
	I	II	III	IV	Annual	I	II	III	IV	Annual
Durable Goods (excl. gold)	**1.86**	**3.66**	**-1.86**	**2.23**	**5.94**	**-3.04**	**5.40**	**2.84**	**-2.20**	**2.78**
Furniture	3.10	5.26	-2.74	7.64	13.62	-7.81	7.45	9.21	-3.17	4.74
Electric and Non-Electric Appl.	2.62	4.24	-1.97	0.39	5.28	-5.55	4.51	-0.54	-2.25	-4.03
Automobile	-0.12	3.07	-1.32	-0.17	1.42	2.93	7.09	2.57	-2.28	10.48
Other Durable Goods	4.15	-0.21	-1.03	0.44	3.32	-1.17	-1.86	1.43	0.91	-0.73

Source: TURKSTAT, CBRT.

Lagged effects of change in exchange rates on the inflation of goods excluding energy and unprocessed food persisted in the fourth quarter especially in clothing-footwear and processed food group and seasonal price hikes in clothing-footwear group were above the levels of previous years. But, the 1.91 percent rate of the current annual inflation in clothing-footwear involves no negative outlook. The limited annual inflation in this group draws attention to the impact of global competition and domestic demand conditions on group prices. Besides, monthly price hikes of processed food accelerated remarkably in the third quarter, which continued in the fourth quarter, albeit at a slower pace. This tendency of processed food prices was influenced by the lagged effects of exchange rates, together with the impact of elevated flour and flour product prices stemming from the decline in grain production in the third quarter.

Table 3.1.4. Goods and Services Group Prices
(Quarterly Percentage Change)

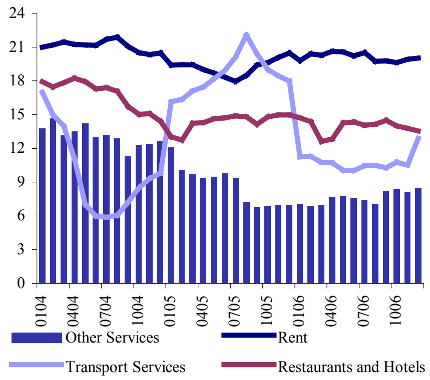
	2005					2006				
	I	II	III	IV	Annual	I	II	III	IV	Annual
CPI	**0.83**	**1.74**	**1.30**	**3.65**	**7.72**	**1.25**	**3.58**	**1.69**	**2.81**	**9.65**
1. Goods	**-0.24**	**1.16**	**0.80**	**4.42**	**6.21**	**0.80**	**3.67**	**0.88**	**3.10**	**8.69**
Energy	1.73	0.73	3.81	1.20	7.65	2.63	4.94	0.69	1.92	10.52
Unprocessed Food	3.61	-7.87	0.25	11.12	6.34	8.81	-3.67	1.83	5.81	12.94
Goods excl. Energy and Unprocessed Food	-1.94	3.91	-0.05	3.79	5.71	-2.01	5.54	0.67	2.70	6.93
Durable Goods	-0.37	3.61	-0.80	4.41	6.91	-1.66	8.69	1.34	-1.58	6.61
Durable Goods (excl. Gold)	1.86	3.66	-1.86	2.23	5.94	-3.04	5.40	2.84	-2.20	2.78
Semi-Durable Goods	-3.38	5.75	-1.10	3.76	4.85	-3.65	9.14	-2.14	4.75	7.81
Non-Durable Goods	2.11	-2.58	2.60	4.91	7.07	4.64	-1.12	3.01	3.04	9.82
2. Services	**3.85**	**2.77**	**3.65**	**1.87**	**12.68**	**2.41**	**3.36**	**3.83**	**2.09**	**12.21**
Rent	4.26	3.74	7.06	4.04	20.48	4.08	3.69	6.67	4.25	20.01
Restaurant and Hotels	5.19	2.65	3.29	3.09	14.98	3.02	4.25	3.40	2.24	13.54
Transport Services	7.87	2.04	6.00	1.11	17.97	1.27	1.36	6.26	3.50	12.89
Other Services	1.75	2.73	1.72	0.56	6.92	1.80	3.32	2.32	0.76	8.45

Source: TURKSTAT, CBRT.

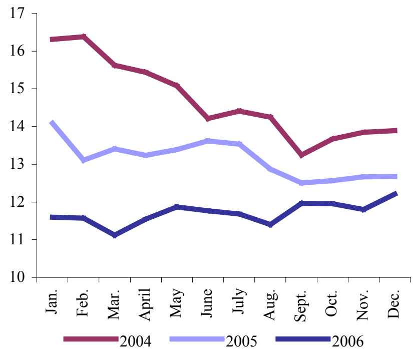
In sum, goods prices increased at lower rate of 3.10 percent in the last quarter compared to the same period of the previous year. Services inflation of the same period, 2.09 percent, prevailed over the previous year largely due to the increases in rents and transport services (Table 3.1.4).

Although slowed down compared to the previous year, annual services inflation remained stable throughout 2006 (Graph 3.1.6). The most obvious decline as opposed to 2005 was observed in the transport services group, which was considerably affected by the developments in oil prices. 2006 inflation in rents and restaurants-hotels groups maintained their high levels, following a course close to that of the previous year (Graph 3.1.6). As regards the restaurants-hotels group, catering services inflation displayed a limited decline, while accommodation services prices maintained its tendency of rapid increase, on which foreign demand through tourism is also effective.

Graph 3.1.6. Services Prices
(Annual Percentage Change)



Graph 3.1.7. Services Prices with Respect to Years
(Annual Percentage Change)



Source: TURKSTAT.

While the drop-off of services inflation in 2005 was 1.2 percent, that of 2006 was 0.5 percent (Graph 3.1.7). This was mainly due to the fact that the domestic demand conditions' support to disinflation was rather limited compared to previous years and that the overall inflation displayed a short-term upward tendency during and after the exchange rate turbulence of May 2006.

Special aggregates are analysed primarily because they are guidelines to define various shocks in the Consumer Price Index (CPI). Here, the fact that the annual inflation of indicators excluding energy and unprocessed food was below the CPI increase suggests that the excluded groups were effective in the increase of consumer inflation in 2006 (Table 3.1.5).

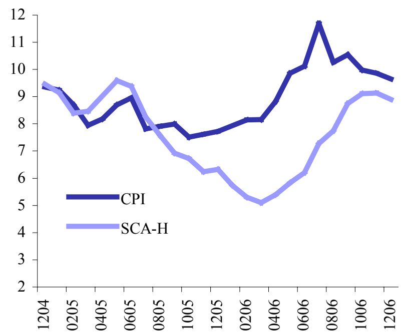
Table 3.1.5. Special CPI Aggregates (2003=100)
(Quarterly Percentage Change)

	2005					2006				
	I	II	III	IV	Annual	I	II	III	IV	Annual
CPI	**0.83**	**1.74**	**1.30**	**3.65**	**7.72**	**1.25**	**3.58**	**1.69**	**2.81**	**9.65**
A. CPI Excluding Seasonal Products	2.06	1.84	2.75	1.48	8.39	2.31	2.79	3.23	1.36	10.04
B. CPI Excluding Unprocessed Food	0.37	2.95	1.58	2.68	7.78	0.12	4.79	1.67	2.38	9.21
C. CPI Excluding Energy	0.67	1.94	0.89	4.07	7.75	1.01	3.38	1.86	2.96	9.51
D. CPI Excluding Unprocessed Food Products and Energy	0.09	3.44	1.14	2.98	7.84	-0.38	4.77	1.86	2.47	8.95
E. CPI Excluding Energy, Alcoholic Beverages and Tobacco Products	0.59	2.05	-0.16	4.00	6.58	0.74	3.62	1.98	3.16	9.82
F. CPI Excluding Energy, Alcoholic Beverages, Tobacco Products, Other Goods with Administered Prices and Indirect taxes	0.30	2.23	-0.33	4.45	6.75	1.75	3.82	1.86	3.39	11.25
G. CPI Excluding Energy, Alcoholic Beverages, Tobacco Products, Other Goods with Administered Prices, Indirect Taxes and Unprocessed Food	-0.38	3.98	-0.32	3.25	6.61	0.26	5.59	1.88	2.91	10.99
H. CPI Excluding Energy, Unprocessed Food, Alcoholic Beverages, Tobacco Products and Gold	0.17	3.70	-0.28	2.56	6.23	-0.96	4.76	2.19	2.70	8.89

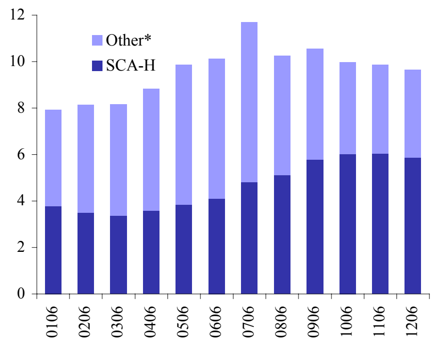
Source: TURKSTAT.

The special CPI aggregate (SCA-H), excluding energy, unprocessed food, alcoholic beverages, and tobacco products and gold, can provide important information on the main trend of inflation by leaving exogenous factors out. In the first quarter, the index rose at a rate below that of the previous year and the disinflation trend continued. However, with the exchange rate depreciation in May, this trend backtracked. Due to its content, the SCA-H is more susceptible to exchange rate movements than the general index. Accordingly, following May-June developments, end-year headline inflation increased by 0.8 percentage points compared to April, while the annual SCA-H inflation rose by 3.5 percentage points (Graph 3.1.8). Thus, the increase in consumer inflation during the second half of the year was mostly shaped by the price increases in the goods and services groups within the SCA-H (Graph 3.1.9). On the other hand, with the lagged effects' tendency to be complete in the last quarter of the year, the rise in the said index decelerated remarkably and the upward tendency was replaced by a downward one. Even though the content of information is concealed in times of particularly upside exchange rate shocks, it should be underlined that the SCA-H index is crucial in following the main trend of consumer inflation when exchange rates are stabile.

Graph 3.1.8. CPI and SCA-H
(Annual Percentage Change)



Graph 3.1.9. Contribution to Annual Inflation
(Percentage Points)



Other: Energy, unprocessed food, alcoholic beverages and tobacco products and gold
Source: TURKSTAT. CBRT.

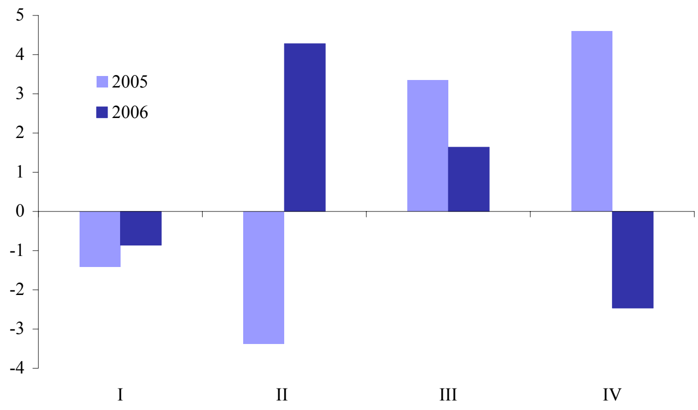
With the impact of the May-June fluctuations in exchange rates, Producer Price Index (PPI) increased by 8.98 percent in the second quarter. Therefore, the annual inflation, which gained pace in second quarter, entered a slowdown trend in the second half of the year and became 11.58 percent (Table 3.1.6). Declines in oil and agricultural prices were instrumental in the deceleration of PPI inflation in the second half of the year. Agricultural prices, which used to push producer prices up seasonally in the fourth quarter of the previous years, deviated from this tendency and declined by 1.57 percent in the last quarter of 2006. This was one of the factors that restricted the increase in producer prices (Graph 3.1.10).

Table 3.1.6. PPI and Sub-Items
(Quarterly Percentage Change)

	2005					2006				
	I	II	III	IV	Yıllık	I	II	III	IV	Yıllık
PPI	0.96	0.92	1.07	-0.31	2.66	2.48	8.98	-0.12	0.04	11.58
Agriculture	1.65	-2.74	-1.50	5.80	3.03	2.12	4.81	-2.67	-1.57	2.53
Industry	0.76	1.97	1.75	-1.89	2.57	2.57	10.00	0.47	0.40	13.81
Mining and Stone Quarrying	-2.28	7.16	8.28	-3.32	9.63	3.20	9.52	3.57	-2.98	13.57
Manufacturing Industry	0.61	1.95	2.68	-2.05	3.15	1.55	10.66	0.33	-0.37	12.33
Electricity, Gas and Water	3.98	0.68	-13.72	1.44	-8.38	18.18	1.29	1.66	12.49	36.90

Source: TURKSTAT.

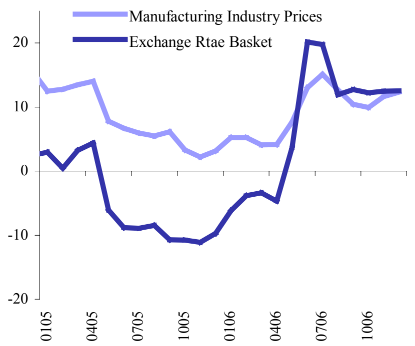
Graph 3.1.10. Agriculture Prices (PPI)
(Seasonally Adjusted, Quarterly Percentage Change)



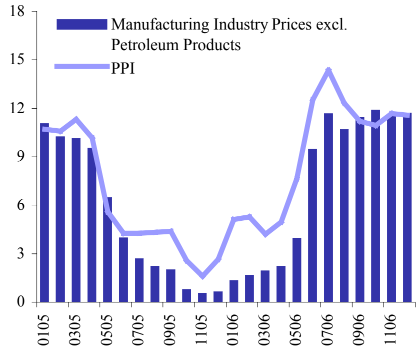
Source: TURKSTAT, CBRT.

In line with the favorable course of international crude oil prices in the fourth quarter, prices of coke and refined petroleum products declined compared to the previous quarter. In the last quarter, prices of the manufacturing industry decreased by 0.37 percent, while, excluding the effect of oil products, the annual rate of increase remained close to its third quarter level (Graph 3.1.12).

Graph 3.1.11. Manufacturing Industry Prices and Exchange Rate Basket (0.5 USD+0.5 Euro)
(Annual Percentage Change)



Graph 3.1.12. PPI and Manufacturing Industry Prices Excluding Petroleum Products Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

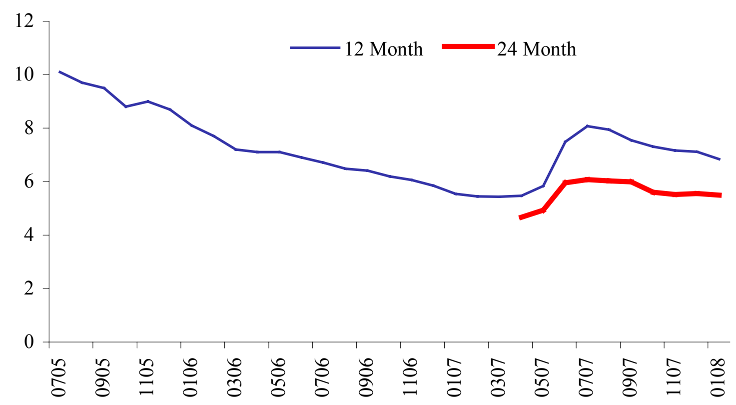
Natural gas and electricity price hikes were influential in the electricity-gas-water item which rose by 12.5 percent in the last quarter of 2006. Natural gas inflation persisted in the fourth quarter due to the lagged effects of the upsurge in oil prices and the 2006 rate of increase reached 29.0 percent.

CPI housing electricity prices including VAT and consumption tax are compiled from electricity distributors while PPI electricity prices are compiled based on the rates the Turkish Electricity Trade Company (TETAŞ) applies to distributors. The 15.9 percent annual increase in PPI electricity prices stems from the 23.9 percent rise in the rates applied to distributors by TETAŞ between September 1-December 31 2006. On the other hand, this increase in electricity prices was not reflected upon the consumer prices and CPI electricity prices remained the same in the fourth quarter. Besides, the 8.3 percent reduction in wholesale rates of TETAŞ, effective from January 1, 2007, points to a decline in PPI electricity prices in the first quarter.

3.2. Expectations

Medium-term inflation expectations that had deteriorated because of the fluctuations in the financial markets in May entered a recovery process as of August due to the determined stance of the Central Bank (Graph 3.2.1).

Graph 3.2.1. CPI Inflation Expectations Regarding the Next 12 and 24-Month Periods*
(Annual Percentage Change)



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

The "credibility gap[1]" which is defined as the difference between the targeted inflation and the expected end-year inflation had reached in early 2007 its highest level of the last four years (3 points for 2007). The analysis of the developments in the coefficient of variation[2], an indicator of uncertainty in inflation expectations, reveals that the decline of the coefficient regarding

[1] Credibility gap can be defined as the difference between end-year inflation target and the end-year expectation specified in the Expectation Survey of the second term of January.
[2] The coefficient of variation, which indicates the deviation among participants' expectations, is the ratio of the standard deviation to the mean in a data set where appropriate means are chosen.

inflation expectations of the next 12-months in the last quarter points to the ease of uncertainty in inflation expectations (Table 3.2.1.). It should be kept in mind that, despite an improvement in the uncertainty of expectations, medium term expectations continue to be clearly above the 4 percent target.

Table 3.2.1. CPI Inflation Expectations

Current Period	Survey Period	End-Year*	Next 12 Months Average Expectation*	Next 12 Months Coefficient of Variation	Next 24 Months Average Expectation*	Next 24 Months Coefficient of Variation
January-06	1	5.68	5.49	0.10		
	2	5.67	5.54	0.11		
February-06	1	5.75	5.45	0.10		
	2	5.81	5.45	0.11		
March-06	1	5.8	5.46	0.10		
	2	5.78	5.44	0.09		
April-06	1	5.76	5.41	0.10	4.64	0.11
	2	5.79	5.47	0.10	4.67	0.09
May-06	1	6.27	5.57	0.11	4.79	0.13
	2	6.75	5.83	0.15	4.93	0.16
June-06	1	8.82	6.66	0.15	5.37	0.15
	2	9.78	7.48	0.16	5.95	0.20
July-06	1	10.17	7.89	0.16	6.13	0.19
	2	10.28	8.07	0.16	6.07	0.16
August-06	1	10.59	7.98	0.13	6.06	0.17
	2	10.46	7.94	0.13	6.02	0.15
September-06	1	9.77	7.62	0.13	5.91	0.18
	2	9.63	7.54	0.10	5.99	0.16
October-06	1	9.96	7.38	0.11	5.80	0.17
	2	9.88	7.31	0.11	5.60	0.15
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

* 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.

BOX 3.1. THE COURSE OF DURABLE GOODS PRICES AFTER MAY

The increases in durable goods prices, which apparently accelerated after May due to exchange rate movements, entered a slowdown tendency by November. While New Turkish lira depreciated about 12 percent against the nominal FX rate basket in the last 8-month period, durable goods prices rose by 5.45 percent during the same period. However, the response rate and the course of the response in time to FX movements vary between sub-groups that compose durable goods group (Box 3.1, Table 1). Scrutinizing the sectoral pricing behavior might be the key to understanding these differences.

The most rapid response to fluctuations that had started with the 8.7 percent depreciation of New Turkish lira against the FX basket in May came from the electrical and non-electrical household appliances group. This response is considered to stem from the fact that (i) import input utilization of companies in this sub-group is higher compared to other sub-groups, (ii) “state dependent” policies are adopted to act as price adjustment polices, and (iii) indexation behavior is common among these companies. In line with the course of depreciation of New Turkish lira in June-July, the accumulated increase in the prices of this group reached 7.65 percent in July compared to April; then, the prices started to decrease with the decline in the depreciation of New Turkish lira. Although New Turkish lira was stable against the FX basket after August, the decline in prices of this group continued steadily until December and ended the year with a 4 percent fall, which might have stemmed from the contraction in demand and the competition within the sector. Thus, the lowest FX rate pass-through among sub-groups, along with other durable goods (bicycle, carpet, eyewear, etc.), was realized in the expenditure group of electrical and non-electrical household appliances. Moreover, the 4-percent decrease in prices of electrical and non-electrical household appliances supports the view that this group’s degree of susceptibility to demand and competition conditions is higher than that of other durable consumption goods groups.

Box 3.1. Table 1. Durable Goods Prices

	(Cumulative Percentage Change With Respect to April, 2006)								Annual Percentage Change
	May 2006	June 2006	July 2006	August 2006	September 2006	October 2006	November 2006	December 2006	
Foreign Exchange Basket (0,5Euro+0,5Dollar)	8.70	21.99	18.86	12.68	13.12	12.83	12.08	11.86	12.54
Durable Goods (Exluding Gold)	1.82	4.85	7.20	7.70	7.82	8.08	6.90	5.45	2.78
Electrical and Non-electrical Household Appliances	4.51	5.88	7.65	6.57	5.30	4.48	3.89	2.94	-4.03
Domestically Produced or Imported Goods	4.17	3.24	5.52	6.39	4.80	4.26	4.10	3.59	-2.46
Highly Imported Goods	5.26	11.81	12.44	6.98	6.43	4.99	3.41	1.46	-7.46
Otomobile	1.50	6.60	10.05	10.56	9.33	11.15	10.71	6.85	10.48
Furniture	-0.53	2.49	4.65	7.55	11.93	11.95	8.38	8.38	4.74
Other Durable Goods	-1.53	0.45	1.61	2.25	1.89	1.30	1.14	2.82	-0.73

Source: TURKSTAT, CBRT.

[1] According to this policy, there are no specific periods when price adjustments are made, rather they are determined according to big shocks that might necessitate to revise the price adjustments.

[2] For detailed information please see Karadas, E., Mutluer, D., Barlas Ozer, Y., Aysoy, C., (2006) “Pricing Behavior of Turkish Private Manufacturing Firms”, in Turkish, CBRT, Working Paper, No: 06/02.

It would be helpful to analyse the electrical and non-electrical household appliances group as to the sub-groups of (i) highly imported technological products (mobile phones, computers, cameras etc.) and (ii) both imported and domestically manufactured products (dishwashers, washing machines, televisions etc.). The initial response of highly imported products to volatility was high as expected, but later, prices notably declined due to the higher demand elasticity of this group's products compared to that of other groups. Between May and December, despite the 12 percent depreciation of YTL, prices of technological devices, which are mostly imported, increased by 1.5 percent. Prices of this group fell by 7.5 percent throughout the year. In the other group, in which domestic production is predominant, the initial response of May was maintained until the end of the year, albeit with some differences during the period.

In the May-July period during which a high rate of depreciation was experienced, the imported automobiles group gave the highest response. In general, the FX pass-through effect is high in the automobile group. Even though automobile sales to the domestic market declined remarkably by June and this trend continued until the end of the year, the 10 percent inflation of July was maintained until November. Hence, with the 10.5 percent increase, the automobile group became the expenditure group of durable goods that recorded the highest rate of increase.

As it is known, in the furniture sector, prices are revised either monthly or less frequently and imported input utilization and indexation behavior is rather low. In parallel to these properties of the sector, the initial post-fluctuation response was weak. As the furniture sector tends to work with the desired mark-up, the depreciation in TRY is considered to have created an appropriate environment for the said industry, which could not raise prices in early 2006, to achieve the desired mark-up. As a matter of fact, even after August during which depreciation of TRY noticeably slowed down, prices of this group continued to increase until October.

Finally, when compared to other expenditure groups, the "other durable goods" group comprising various durable goods does not display an obvious pass-through effect.

To sum up, it is observed that the pass-through effect of post-May YTL depreciation on durable goods group was high as expected, yet a closer analysis of the sub-groups comprising the durable goods group reveals that the effects are more varied than expected. For example, while the FX pass-through effect remained limited in the electrical and non-electrical household appliances sub-group, comprising directly imported goods or domestic goods with high rate of imported input, price increases were quite high in sectors with low susceptibility to FX rates, such as furniture, which indicates that, even in the event of a big shock, demand and competitiveness conditions along with sectoral pricing policies are influential in determining the degree of the FX pass-through effect.

BOX 3.2. CHINESE EFFECT ON DOMESTIC PRICES

China's impact as a growing economy is being felt all over the world as well as in Turkey. Since 2000, China's share in Turkey's total imports has constantly been increasing. Analyzing the imports given in Table 1 according to the end-use, it is noticeable that shares of the items imported by Turkey from China have increased remarkably since 2000.

Box 3.2. Table 1. China's Share in the Total Imports According to End Use (Percent)

	2000	2001	2002	2003	2004	2005	2006*
TOTAL	2.5	2.2	2.7	3.8	4.6	5.9	8.5
Investment Goods	2.9	2.7	3.6	6.7	7.5	10.2	13.6
Intermediate Goods	1.9	1.6	2.0	2.4	3.0	3.6	5.2
Consumption Goods	4.6	6.1	6.7	7.8	9.5	13.0	18.4
Other	1.3	5.4	0.1	5.6	3.6	1.4	0.1

*Comprises the January-July period.
Source: TURKSTAT, CBRT.

Considering the fact that the booming sectors of China, which holds third place in Turkey's imports after Russia and Germany, are machinery industry, electronics industry, computer and information technologies and construction equipment, China's share in Turkey's total imports is expected to increase in the upcoming period. In the past, Turkey's trade with China was determined by the tendency of small-sized enterprises to import cheap goods, especially textiles. However, today this tendency is shifting gradually to such sectors as construction, machinery, metal, non-metallic minerals, data processing, electrical appliances, communication, furniture and other transportation vehicles. Detailed analysis of sectors that are dominated by China reveals that in 2006, 93 percent of games and toys, 96 percent of motorcycles and 94 percent of the non-iron metal ores are imported from China (Box 3.2. Table 2).

Box 3.2. Table 2. China's Share in Total Imports According to Items (Percent)

	2000	2001	2002	2003	2004	2005	2006*
Motorcycles	59	2	1	8	22	64	96
Non-iron metal ores	44	11	15	20	11	14	94
Games and toys	29	60	73	78	43	85	93
Luggage, handbags, other articles of leather	34	44	45	55	36	76	89
Bicycles and vehicles for the disabled	26	32	43	58	34	74	89
Non-fireproof ceramics excl. construction materials	23	8	7	10	8	36	83
Light bulb-lamps and lighting appliances	23	20	22	28	18	40	78
Sports equipment	15	26	24	33	18	44	78
Clay and ceramic building materials	21	0	4	12	24	64	78
Stone	2	13	12	31	21	60	76
Watch	46	17	23	24	13	31	76
Musical instruments	15	28	30	34	17	41	74

* Comrpises the January-July period.
Source: TURKSTAT, CBRT.

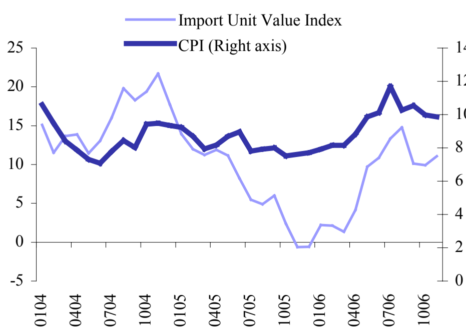
Though few in number, there are new studies on globalization and inflation (or the impacts of countries with low-cost production on other countries) in economic literature. The findings presented in one of this recent studies (Globalization and Inflation in the OECD Economies, Working Party No.1 on Macroeconomic and Structural Policy Analysis, OECD, 26-Sept-2006) conducted by the OECD can be summarized as follows:

- The impact of import prices on domestic consumer prices became more apparent from the mid-1990s onwards.
- The trade that increased due to low cost economies such as China and India is considered to have been effective in controlling inflation in the last decade. Domestic producers had to decrease their profit margins in order to compete with low import prices. Hence, the trade growth driven by low cost economies caused a limited decline in domestic prices.

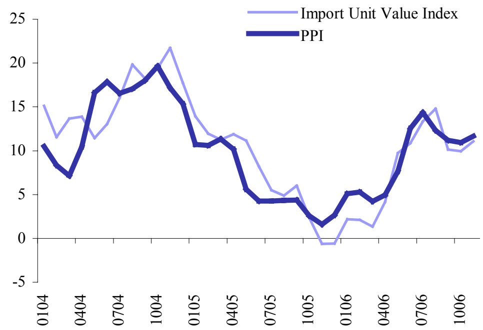
- Inflation became less vulnerable to domestic cyclical economic developments, but more vulnerable to developments in foreign markets due to import prices.

These findings that apply to OECD economies in general are also valid for the Turkish economy. The graphs below show the import unit value index with the CPI and the PPI (Box 3.2. Graph 1, Box 3.2. Graph 2). Especially the producer prices are extremely vulnerable to import prices. The relationship between consumer inflation and import prices is less apparent but still worth noting.

Box 3.2. Graph 1. Import Unit Value Index and CPI
(Annual Percentage Change)



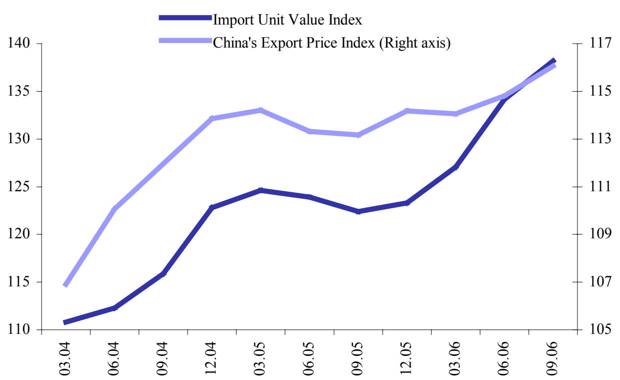
Box 3.2. Graph 2. Import Unit Value Index and PPI
(Annual Percentage Change)



Source: TURKSTAT.

The similarity between the import unit value index and the export price index of China is remarkable (Box 3.2 Graph 3). In other words, an upward trend in China's export prices and/or any development that might increase the prices of goods imported from China would adversely affect the prices of goods we import. Considering the fact that the weight of goods imported from China has increasingly been growing in Turkey's imports, it is believed that the Chinese economy, and especially the appreciation trend of Renminbi will gain more importance in the upcoming period with regard to inflation dynamics.

Box 3.2. Graph 3. Import Unit Value Index and Export Price Index of China (Quarterly)



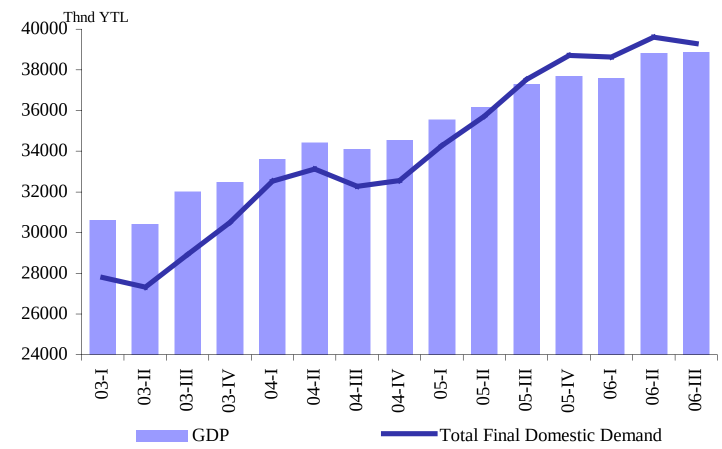
Source: TURKSTAT, OECD Outlook Database.

4. Supply and Demand Developments

4.1. Supply-Demand Balance

In the third quarter of 2006, the GDP increased by 3.4 percent compared to the same period of 2005. The demand for durable goods, which is more sensitive to exchange rate and interest rate movements, decreased following the fluctuations observed in the financial markets in May and June. The rate of increase of the private sector investments in machinery and equipment decelerated. These two developments have been main factors behind the slowdown in growth. In the third quarter of the year, the total final domestic demand increased by 4.2 percent over the same period of the previous year, while, in terms of seasonally adjusted figures, it decreased by 0.8 percent compared to the previous quarter (Graph 4.1.1).

Graph 4.1.1. GDP and Total Final Domestic Demand
(Seasonally Adjusted)



Source: TURKSTAT,CBRT.

As regards production, the agricultural value added decreased by 2 percent. The unfavorable impact of agricultural sector on growth was high due to its seasonally large share in the third quarter. The contribution of the agricultural sector to growth, which was 1.5 percentage points in the third quarter of 2005, was realized as –0.4 percentage points in the same period of 2006. On the other hand, the value added of the industrial and services sectors continued to increase, albeit at a slow pace. The value added of the construction sector continued to rise at a higher rate, whereas import duties increased relatively at a lower rate in annual terms. The deceleration of imports and the shrinkage in the agricultural value added caused the value added of commercial and transportation sectors to grow at a lower pace.

In terms of demand components, the rate of increase of total consumption expenditures declined due to slowdown in private consumption expenditures (Table 4.1.1). Parallel to the projections presented in the October Inflation Report, the slowdown in private consumption expenditures was driven by the ebbing demand for durable goods. While the demand for semi-durable and non-durable goods increased as anticipated, food consumption fell unexpectedly. Public consumption expenditures continued to increase rapidly in the third quarter parallel to the second quarter.

As regards the sub-items of private investment expenditures, in the third quarter of the year, the rate of increase of machinery-equipment expenditures decelerated significantly as expected, while construction investments continued to grow. Public investments declined further in this period, adversely affecting investment expenditures.

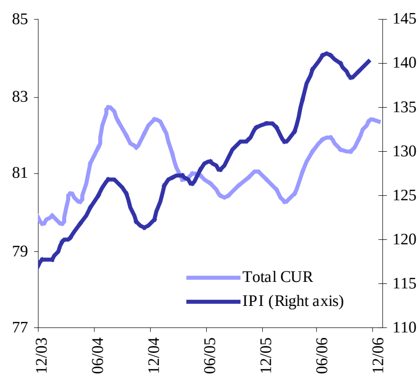
Table 4.1.1. GDP Developments by Expenditures
(Constant Prices, Annual Percentage Change)

	2004	2005					2006			
	Annual	I	II	III	IV	Annual	I	II	III	First Nine Months
1-Consumption Expenditures	9.0	4.1	3.9	9.8	14.1	8.1	8.4	11.1	2.3	6.9
Public	0.5	4.4	4.0	3.2	0.0	2.4	8.1	18.0	15.4	14,2
Private	10.1	4.1	3.9	10.4	16.7	8.8	8.4	10.4	1.3	6,2
Durable Goods	29.7	3.2	2.9	26.0	31.3	15.0	13.4	16.5	-8.9	6,3
Food and Beverages	2.8	3.3	8.6	10.8	8.7	8.2	6.7	5.6	-1.1	2,9
Semi-dur and Non-dur. Goods	18.8	9.0	3.0	3.7	39.6	12.9	12.7	22.4	20.9	18,5
2-Fixed Capital Formation	32.4	10.3	20.0	30.6	33.0	24.0	30.8	11.5	9.4	15.7
Public	-4.7	30.7	30.2	38.2	17.1	25.9	34.5	-11.4	-5.6	-2,2
Private	45.5	8.8	18.4	29.0	41.6	23.6	30.4	15.4	13.0	18,8
Machinery-Equipment	60.3	5.1	15.4	26.8	43.5	21.4	32.7	11.5	4.8	15,5
Construction	15.3	20.8	28.8	33.2	35.9	29.9	24.1	27.7	28.7	27,2
4-Exports of Goods and Services	12.5	14.0	6.7	3.9	10.9	8.5	2.9	3.4	5.7	4.1
5-Imports of Goods and Services	24.7	10.6	9.1	11.2	15.3	11.5	8.2	9.5	1.7	6.6
6-Total Domestic Demand	14.1	5.6	6.8	10.9	11.6	8.8	8.8	10.4	1.7	6.8
7-Total Final Domestic Demand	14.1	5.5	8.4	14.5	19.1	12.1	13.8	11.2	4.2	9.3
7-GDP	9.0	6.6	5.5	7.7	9.5	7.4	6.5	7.8	3.4	5.6

Source: TURKSTAT.

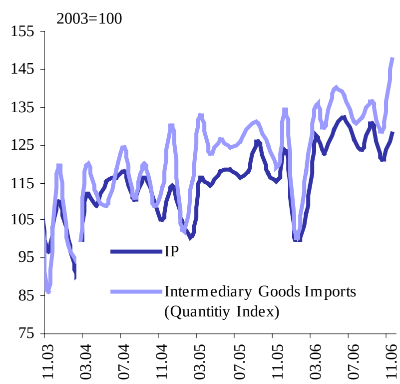
The annual growth rate of exports and industrial production, which declined in October due to the Ramadan holiday that fell upon business days, increased noticeably in November. According to seasonally adjusted data, the industrial production index average relating to the October-November period surpassed its third quarter figures (Graph 4.1.2). The high level of capacity utilization and the companies' optimistic December expectations for production suggest that industrial production will increase over the third quarter in terms of seasonally adjusted data. Sustained upward trend of exports according to data released by the Turkish Exporters' Assembly (TEA) suggests that strong exports had supported industrial growth in December. The annual increase of intermediate goods' imports in October-November period reinforces the expectation that industrial production will increase in the last quarter compared to the third quarter (Graph 4.1.3). On the other hand, it is projected that decline in the agricultural value added in the third quarter may persist in the fourth quarter due to adverse weather conditions and this decline will affect the services value added, primarily commerce and transportation. However, as the agricultural share in GDP shrinks seasonally in the fourth quarters, it is anticipated that any decline in the agricultural value added will have a less adverse effect on GDP growth than the third quarter.

Graph 4.1.2. Industrial Production Index – Capacity Utilization Rate (Seasonally Adjusted, Quarterly Moving Average)



Source: TURKSTAT, CBRT.

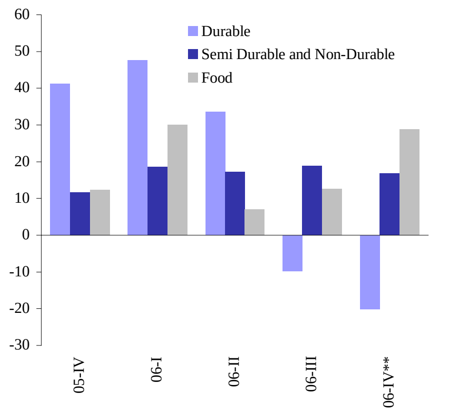
Graph 4.1.3. Industrial Production Index – Intermediate Goods Imports Quantity Index



Source: TURKSTAT.

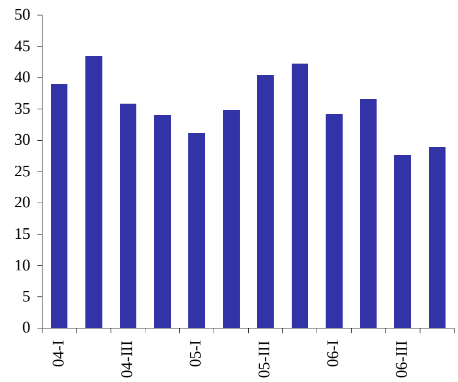
Similar to the third quarter of the year, the average annual change of the imports of consumer goods in October-November period indicates a decline in the imports of durable goods and a rise in the imports of semi-durable and non-durable goods and food (Graph 4.1.4). However, the seasonally adjusted data regarding the fourth quarter do not suggest a further decrease in the demand for durable goods. Accordingly, automobile sales of the last quarter prevailed over the figures of the third quarter according to seasonally adjusted data (Graph 4.1.5). White goods' sales maintained their stable course in the last quarter, and the seasonally adjusted October-November average increased compared to the third quarter. On the other hand, following its halt in the third quarter, credit expansion remained stable in the last quarter of the year (Graph 4.1.6). The slowdown in the rate of increase of credits was mainly spurred by housing and vehicle loans. In contrast, 'other' consumer loans are still continuing to increase. This tendency continues to restrain the demand for durable goods. While the ongoing rise in clothing and household goods expenditures, items of the CNBC-e consumption indices, indicates that the upsurge of semi-durable and non-durable goods' expenditures will continue, the food expenditures index falls (Graph 4.1.7). As regards Business Tendency Survey (BTS) indicators, the next quarter expectations for the volume of domestically sold goods and for the amount of new domestic orders do not suggest a further slowdown in private consumption demand in the fourth quarter.

Graph 4.1.4. Imports of Consumer Goods According to Items*
(Annual Percentage Change)



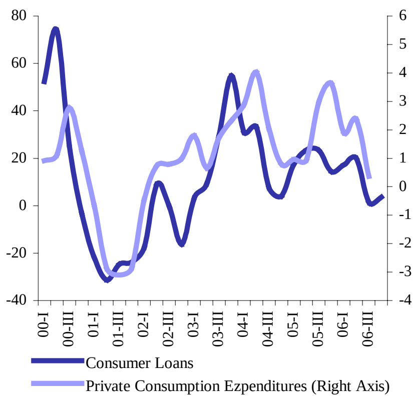
Source: TURKSTAT.
* The imports of durable goods data derives from the total import of automobiles and durable goods covered by BEC (Classification of Broad Economic Categories). The food imports data derives from the total import of processed and unprocessed products of food and beverages.
** The last data include the October-November period.

Graph 4.1.5. Domestic Sales of Automobiles
(Seasonally Adjusted, Monthly Average, Thousand)



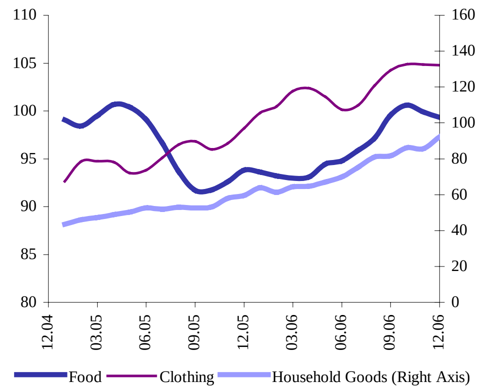
Source: AMA, CBRT.

Graph 4.1.6. Consumer Loans and Consumption Expenditures
Quarterly Real Percentage Changes*



*Private consumption expenditures are annualized.
Source: CBRT.

Graph 4.1.7. CNBC-E Expenditure Indices
(Seasonally Adjusted, Quarterly Moving Average)

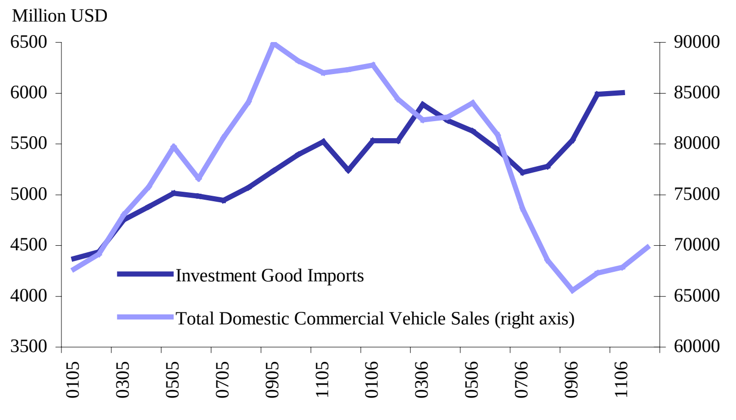


Source: CNBC-e.

The ongoing increase in construction permits and in the production and import of other non-metallic minerals sector, which is considered to be closely related to construction investments show that construction investments will maintain their strength in 2007. In the October-November period, production and imports of machinery-equipment, office machinery and electrical machinery and electronics sectors that are considered to be leading indicators for machinery-equipment investments increased over the previous quarter. In seasonally adjusted terms, imports of capital goods increased in the October-November period, while domestic sales of commercial vehicles increased in the fourth quarter compared to the third quarter of the year (Graph 4.1.8).

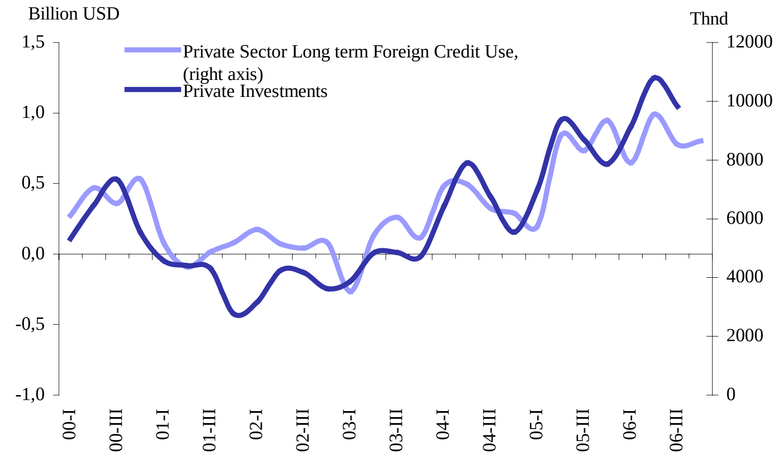
In summary, though a recovery is expected in private sector machinery-equipment investments in seasonally adjusted terms in the last quarter, the base effect created by the high-rated increase in the last quarter of 2005 is predicted to restrain the annual growth rate of investments. The investor confidence according to the investment expenditure tendency, a Business Tendency Survey (BTS) indicator, implies the continuation of momentum in investments in the medium term, yet, low expectations regarding financing conditions continue to restrain investments. The susceptibility of private sector investments to global financing conditions should also be taken into consideration (Graph 4.1.9). The rise in foreign credit utilization in the October-November period indicates that investments will remain strong despite pessimistic anticipations about domestic financing conditions.

Graph 4.1.8. Intermediate Goods Imports and Domestic Sales of Commercial Vehicles
(Seasonally Adjusted, Quarterly Moving Total)



Source: TURKSTAT, OSD.

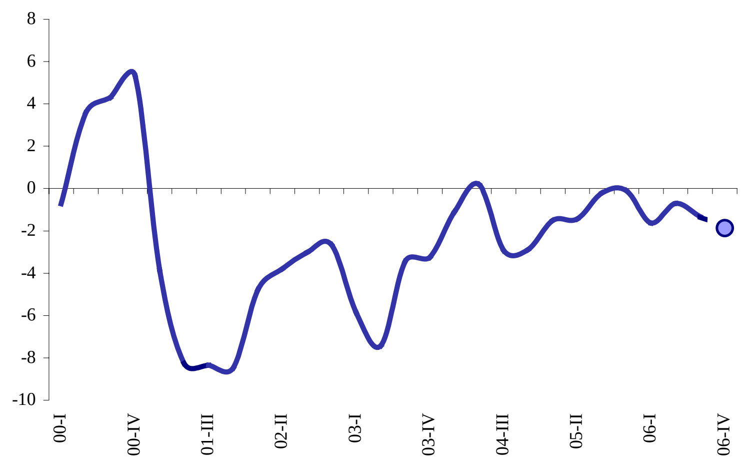
Graph 4.1.9. Investment Expenditures and Long-term Net Credit Utilization from Abroad *



*Quarterly average, last data include the October-November period.
Source: TCMB, TURKSTAT.

In sum, recently available data on demand conditions do not suggest a decline beyond the figures of the third quarter in the last quarter of 2006. Although the impacts of the loss of confidence in economic activities, caused by financial fluctuations in May and June, diminished, the tight monetary policy is expected to continue to restrain the revival in domestic demand. As for foreign demand, it is considered that it will make a positive contribution to growth owing to the strong export performance. In other words, it is anticipated that the favorable course of foreign demand will limit the slowdown in total demand and that growth will primarily be foreign demand oriented in the last quarter of the year. The output gap forecasts made in the light of the above evaluations indicate that the demand conditions' support for disinflation will continue in the first quarter of 2007 as well (Graph 4.1.10). In addition, the probability of the upward course of public consumption expenditures to continue in the upcoming period stands as a risk for total demand and inflation. Furthermore, the persistency of the unfavorable agricultural outlook may add supply-side pressure on food prices.

Graph 4.1.10. Output Gap (Percent)

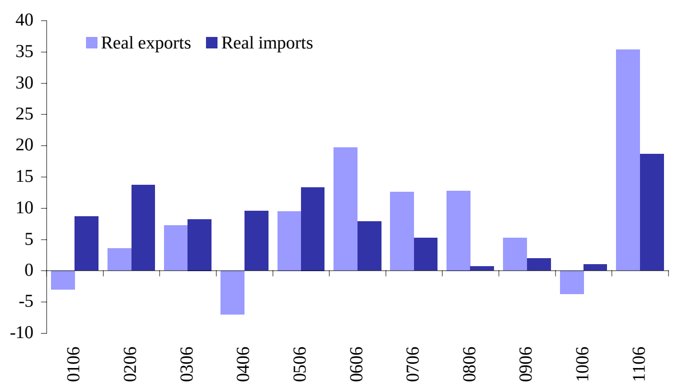


Source: CBRT.

4.2. Foreign Demand

The annual growth rates of exports and imports in the January-November period of 2006 were realized as 15.6 percent and 19.2 percent, respectively. In the same period, the growth rates of exports and imports in real terms, excluding the price effect, were 8.4 percent and 7.9 percent, respectively (Graph 4.2.1). Especially by June, the export quantity index grew larger than the import quantity index. In fact, in the third quarter of 2006, while the foreign trade deficit widened at current prices, the net exports of goods and services provided a surplus on the basis of national income statistics at constant prices and contributed to growth positively.

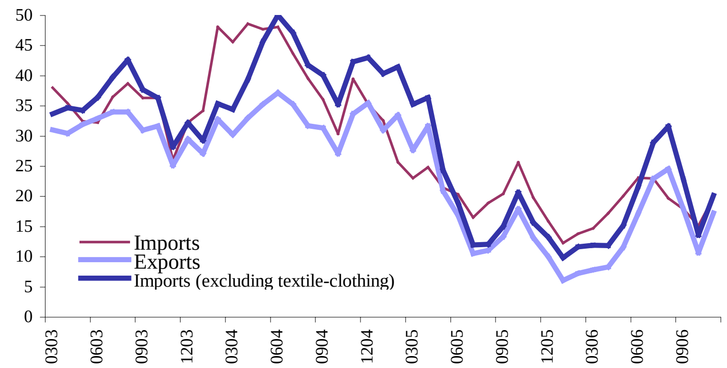
Graph 4.2.1. Real Exports and Imports*
(Annual Percentage Change)



* Export and Import quantity indices.
Source: TURKSTAT.

The improvement observed in export performance since May derived mainly from the capital-intensive sectors such as motor vehicles, electrical machinery and electronics, machinery and equipment and basic metal industry. On the other hand, the export growth of textile and clothing lagged behind the acceleration of total exports. The improvement in export performance observed in the second half of the year becomes more apparent by excluding the above sectors (Graph 4.2.2).

Graph 4.2.2. Imports and Exports
(Billion USD, Annual Percentage Change)

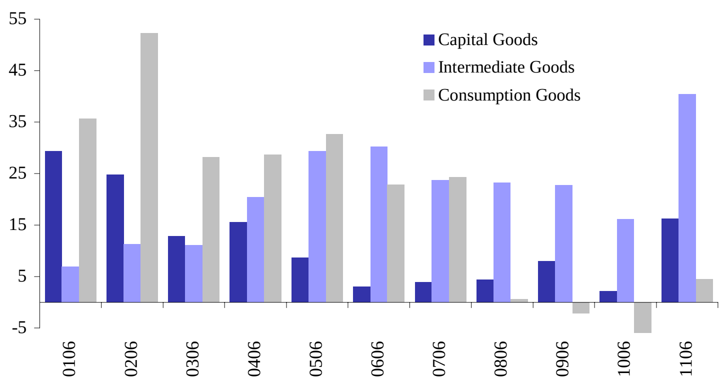


* Quarterly moving averages.
Source: TURKSTAT.

Regarding the sub-sectors of imports, it is observed that the imports of intermediate goods continued its upward course throughout the year. Oil prices, which still remain above the 2005 level despite the slowdown trend and strong industrial production since September, induced the imports of intermediate goods to increase sharply. In the upcoming period, if oil prices maintain their current level, the imports of intermediate goods might decelerate along with the weakening economic activity. However, considering jointly the negative change in stocks in the third quarter of 2006 and the slowdown in imports, with the upturn of expectations for the general course of the economy, the imports of intermediate goods aimed for stocks accumulation may increase and thus, restrict the said slowdown.

Imports of capital goods, which entered a sluggish trend from April 2006 onwards, showed signs of revival in the last quarter of the year compared to the previous quarter (Graph 4.2.3). Imports of consumption goods, which displayed sharp rises in annual terms during the January-July period, decreased as of August due to the decline in automobile imports and the slowdown in the imports of durable goods. Considering the slowdown in domestic demand and the high base effect observed at the beginning of 2006, the imports of consumption and investment goods is expected to grow at a subdued rate in annual terms in the same period of 2007.

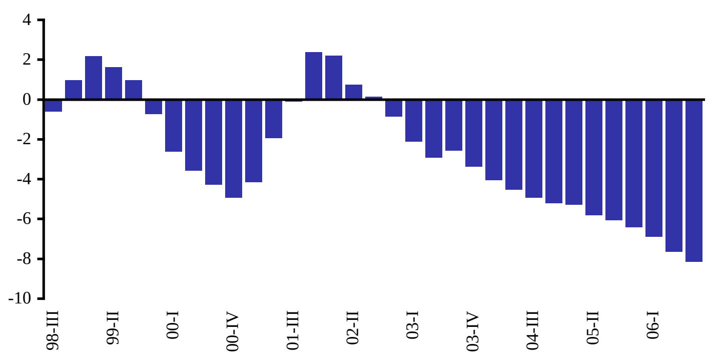
Graph 4.2.3. Sub-items of Imports
(Billion USD, Annual Percentage Change)



Source: TURKSTAT.

In conclusion, in the second half of 2006, the expansion of foreign trade deficit lost momentum compared to the first half of the year owing to the slowdown in domestic demand, the decline in oil prices and the strong trend of foreign demand. However, the current account deficit was affected adversely by the drop in services revenues as a result of the reduced tourism revenues and the widening investment revenues deficit, in the January-November period. In this respect, the current account deficit increased to USD 29.9 billion in the first eleven months of 2006 (Graph 4.2.4).

Graph 4.2.4. Current Account Balance/ GNP*
(Percentage)



* Annualized figures.
Source: CBRT.

In the upcoming period, it is expected that the increasing foreign demand, partial productivity rises, the slowdown in domestic demand and the stable course of energy prices will underpin the slowdown in foreign trade deficit. The revival in economic activities of the EU and the appreciation of the Euro against the US dollar reinforce this expectation. Furthermore, expectations for the upcoming quarter regarding Business Tendency Survey (BTS) indicators such as the amount of new orders from the export market and the volume of goods sold to the foreign market indicate that the revival in foreign demand will continue.

4.3. Unit Labor Costs

According to the "Manufacturing Industry Workers, Working Hours in Production and Partial Productivity Index" compiled by Turkish Statistical Institution (TURKSTAT), employment in the manufacturing industry fell by 0.2 percent in the third quarter of 2006 compared to the same period of 2005 (Table 4.3.1). In this period, public employment continued to decrease, but private employment climbed. On the other hand, the labor productivity index per working hour increased by 5.5 percent compared to the same period of 2005. Real wages per working hour fell by 0.3 percent in the total manufacturing industry and by 4 percent in the public manufacturing industry, yet, increased by 0.9 percent in the private manufacturing industry.

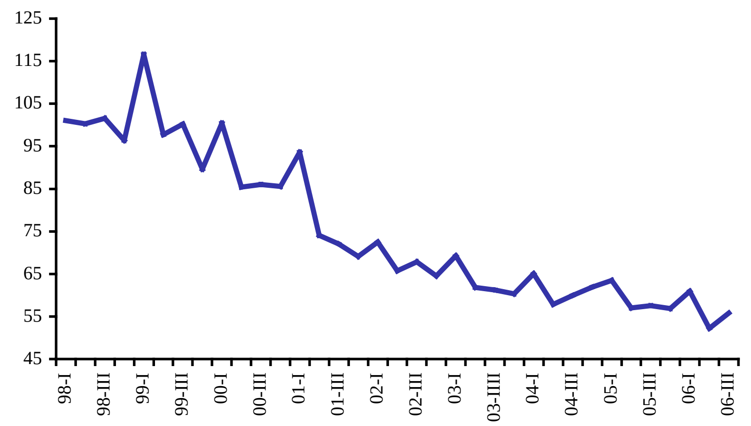
Table 4.3.1. Employment, Real Wage and Productivity Developments in the Manufacturing Industry
(Percentage Change Compared to the Same Period of the Previous Year)

	2004	2005					2006		
	Annual	I	II	III	IV	Annual	I	II	III
Employment (1)	2.0	1.9	-1.7	-1.8	-1.1	-0.7	-1.3	-1.1	-0.2
Public	-11.0	-10.2	-7.1	-8.6	-7.2	-8.3	-3.3	-3.8	-5.7
Private	3.6	3.2	-1.2	-1.1	-0.4	0.1	-1.1	-0.8	0.3
Wage(2)	2.5	3.2	2.1	1.6	0.7	1.9	0.3	0.4	-0.3
Public	4.7	8.7	5.4	9.0	8.4	7.9	-4.5	-2.6	-4.0
Private	4.8	3.5	2.0	1.0	-0.1	1.6	1.3	1.2	0.9
Productivity(3)	7.3	5.1	4.3	6.1	8.4	6.0	4.3	11.0	5.5
Public	10.5	7.0	11.8	15.5	9.8	10.9	-1.9	13.7	16.2
Private	8.0	6.1	3.5	5.2	8.8	5.9	5.5	10.6	4.0
Earnings(4)	1.3	2.8	2.7	2.5	0.8	2.2	-0.2	0.1	-0.2
Public	3.2	10.6	3.5	8.8	3.0	6.3	-3.8	-2.5	-1.2
Private	4.3	2.9	3.2	2.0	1.3	2.4	0.7	1.0	0.6

Source: TURKSTAT.
(1 The Index of Manufacturing Industry Production Workers, 1997=100.
(2) The Index of Real Wages Per Working Hour in Production, 1997=100.
(3) The Index of Partial Productivity Per Working Hour in Production, 1997=100.
(4) The Index of Real Earnings Per Production Worker, 1997=100.

Real unit wages in the private manufacturing industry dropped by 3 percent in the third quarter of 2006 compared to the same period of 2005 (Graph 4.3.1). In the last quarter of 2006, the real unit wages' support to the disinflation process, albeit at a slower pace and the productivity increases are expected to continue together with the ongoing increase in industrial production.

Graph 4.3.1. Real Unit Wages in Private Manufacturing Industry
(1997=100)



Source: TURKSTAT, CBRT.

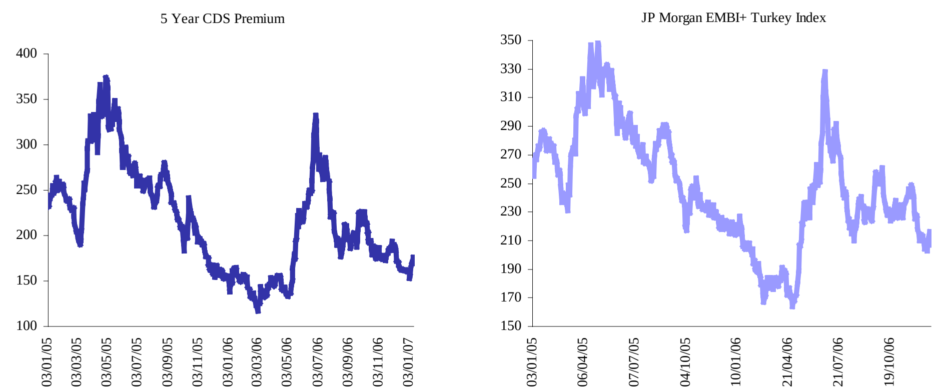
Minimum wages are raised by 6 percent and 4 percent for the first and second halves of 2007, respectively. Wage increases of public workers for the next two years will be set in the collective labor negotiations to be completed in the first half of the year. As stated in the October Inflation Report, public wage arrangements have the capacity to affect inflation expectations and private wage arrangements. Hence, as the collective labor negotiations to be made with public workers will cover the next two years, setting wages consistent with the inflation target is of great importance with respect to the convergence of long-term expectations to the target.

5. Financial Markets and Financial Intermediation

5.1. Financial Markets

In the last quarter of 2006, international liquidity conditions and the global risk appetite continued to be in favor of developing countries (Graph 2.2.2). Favorable developments in international liquidity conditions became the main determinant of the decline observed in the Credit Default Swap (CDS) rates and JP Morgan EMBI+ Index for Turkey (Graph 5.1.1).

Graph 5.1.1. Risk Premium Indicators

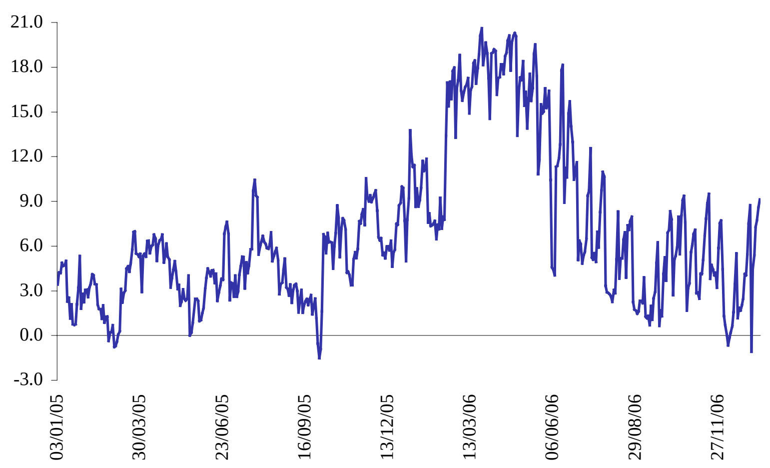


Source: Bloomberg.

Another significant development in financial markets is the growing difference in portfolio preferences of resident and non-resident investors. Foreign investors continued to strengthen their YTL positions, primarily in government securities (Graph 5.2.1), while residents increased the level of their FX deposit accounts, from USD 69.2 billion on September 29, 2006, to USD 79.9 billion by the end of 2006. This can be partially attributed to seasonal factors and to the fact that merger and acquisition revenues from non-residents are held in FX-denominated accounts. However, the gap between the risk perceptions of residents and non-residents is considered to be influential in these portfolio preference developments.

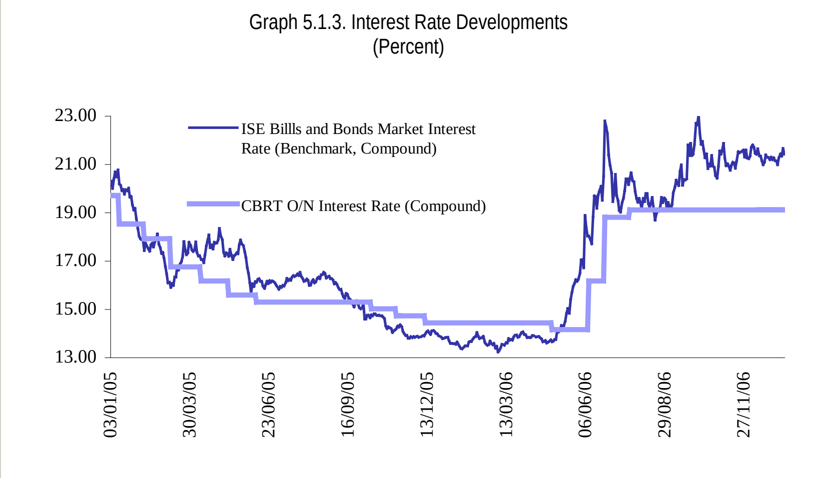
In the last quarter of the year, excess YTL liquidity in the overnight market recorded a lower level compared to the preceding three quarters (Graph 5.1.2). Influential in this development were the seasonal impact of year-end balance sheet movements of banks, CBRT's suspension of FX purchase auctions for a lengthy period and the high demand for currency in the last weeks of the year driven by the Sacrifice Feast and the New Year. In the short run, excess liquidity is basically determined by CBRT's FX purchase auctions and by Treasury's cash balance. Liquidity is expected to maintain its current course in the upcoming months. Any temporary liquidity shortages will be offset via weekly repo auctions, as done in the last quarter of 2006. In case liquidity in the market increases excessively, Central Bank liquidity bills with maturities of up to 91 days may be used.

Graph 5.1.2. Developments in Excess Liquidity
(Billion YTL)



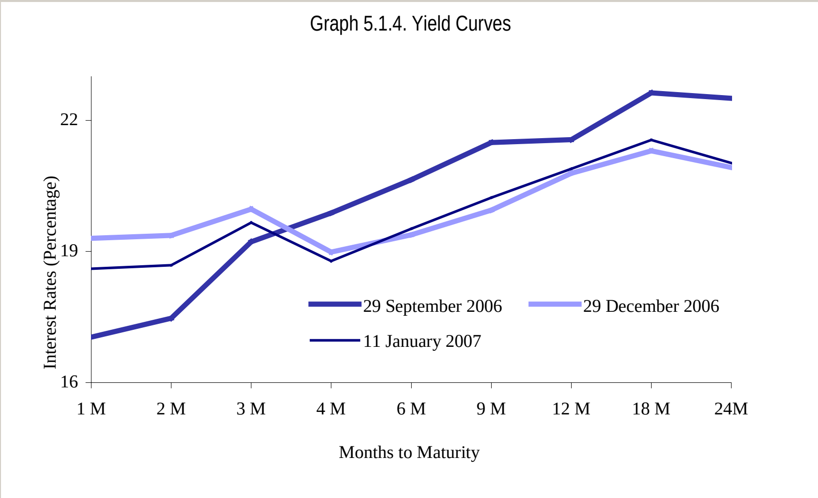
Source: CBRT.

The benchmark interest rate of government securities in the Bonds and Bills Market of the Istanbul Stock Exchange remained stable in the last quarter of the year (Graph 5.1.3). At present, the benchmark interest rate is above the CBRT borrowing interest rate. Determinants of this development are the uncertainty perceptions of 2007, the reduced YTL liquidity and the relatively lower demand for government securities in residents' portfolio preferences.



Source: ISE, CBRT.

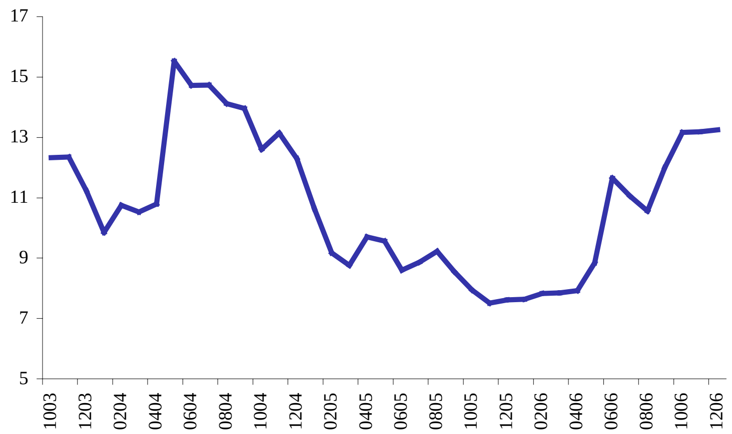
The yield curve of September 29, 2006 followed an upward course as a result of September inflation figures that were above expectations and the deterioration of risk perceptions within the month. In the last quarter of the year, thanks to the positive inflation data, the resolute stance of the CBRT and the ebbing uncertainties about inflation, the yields of December 29, 2006 and January 11, 2007 reached lower levels for all maturities over four months, compared to those of September 29, 2006 (Graph 5.1.4). The reason for the rise in maturities shorter than four months is that the interest rate in repo auctions was realized at above 18 percent after the temporary liquidity squeeze. Moreover, the fact that the yield curves of December 29 and January 11 are downwards in maturities longer than 18 months supports the downward trend observed in the inflation expectations.



Source: ISE.

Real interest rates, which are calculated on the basis of 12-month inflation expectations contained in the CBRT Expectations Survey and the benchmark security interest rates, displayed an upward trend owing to the horizontal course of nominal interest rates in the last quarter and the decline in inflation expectations (Graph 5.1.5).

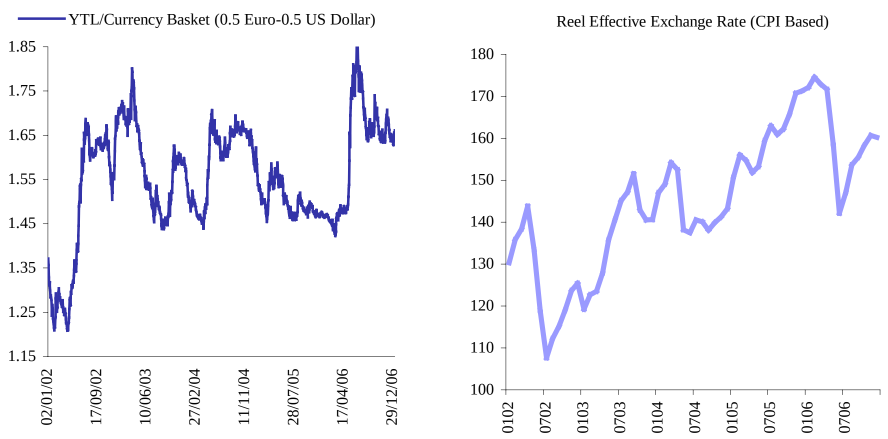
Graph 5.1.5. Real Interest Rate
(According to ISE Benchmark Interest Rate and 12-month Inflation Expectations)



Source: ISE, CBRT.

In the last quarter of the year, the appreciation of YTL continued parallel to the favorable course of the YTL-denominated portfolio preferences of non-resident investors and the high level of foreign direct capital inflow (Graph 5.1.6). The increasing amount of FX deposit accounts held by residents is believed to have slowed down the pace of a faster YTL appreciation. In addition to these developments, the FX purchase auctions that were suspended on May 16, 2006 resumed on November 10, 2006. The amount of net FX purchased by the CBRT was USD 6.6 billion in 2006. Gross FX reserves of the CBRT reached USD 60.8 billion by December 29, 2006.

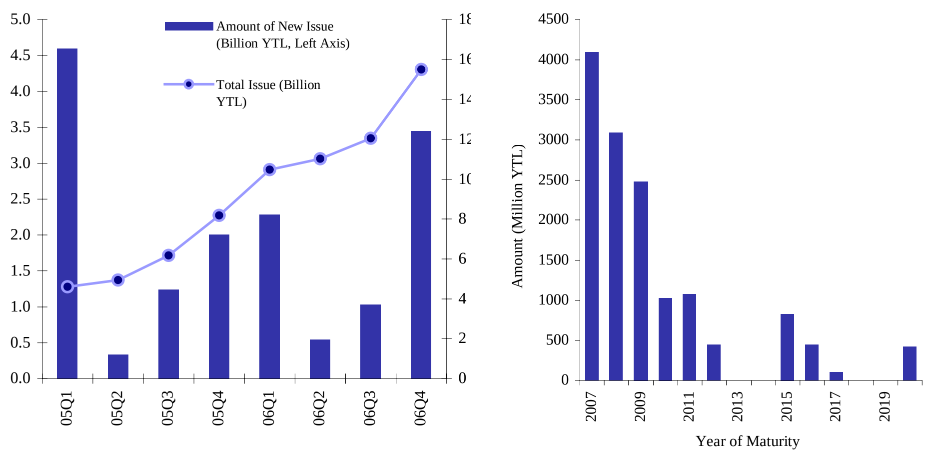
Graph 5.1.6. Developments in Exchange Rates



Source: CBRT.

In the fourth quarter of 2006, YTL-denominated global bonds issued by foreign banks, an indicator of foreign demand for YTL-denominated financial instruments, increased over the previous quarter (Graph 5.1.7), which is considered to have been due to seasonal effects and the improved risk perception of foreign investors. If the strengthening of confidence continues in the medium run, these issues will increase significantly due to the potential of rating upgrades. Such a development will not only reduce Treasury's borrowing costs, but also enhance accessibility to YTL-denominated long-term credits via structured products.

Graph 5.1.7. YTL-denominated Bonds Issued By Foreign Banks

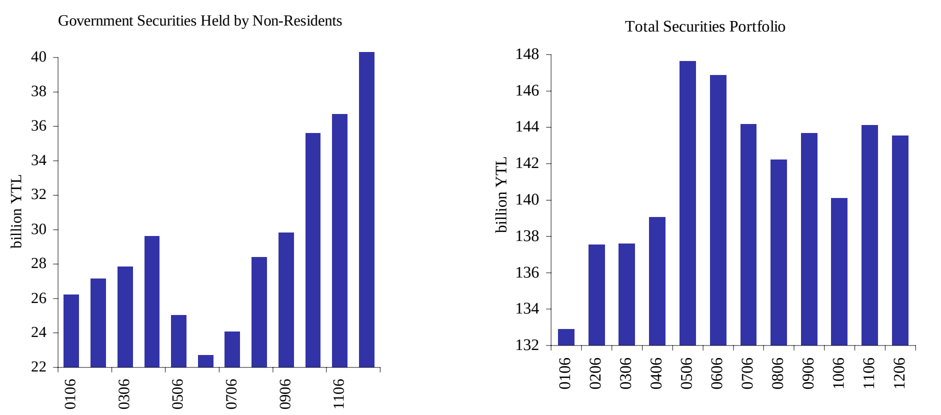


Source: CBRT.

5.2. Financial Intermediation and Loans

In the fourth quarter of 2006, interest rates maintained their high level and the slowdown in credit growth continued. In the last quarter, the financial system continued to avoid the impacts of the fluctuation that was experienced at the end of the second quarter. The downward trend of the securities portfolio, which is the major part of banks' balance sheets and is substituted for credits, continued but remained above the level that was observed before the fluctuation. In spite of this, however, the foreign investors who left the government securities market during the latest fluctuation raised their holdings of government securities in the recent period (Graph 5.2.1). These developments increase the amount of banks' loanable funds.

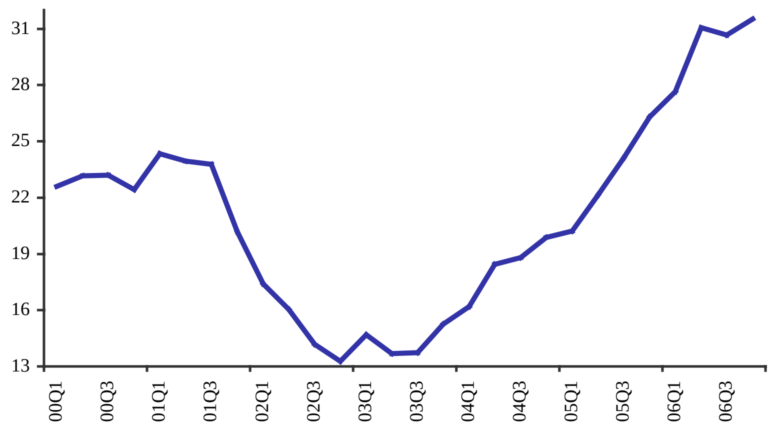
Graph 5.2.1. Government Securities Held By Non-Residents and Securities Portfolio of Banks



Source: BRSA, CBRT.

The tightening in financing conditions continued to restrain credit growth in the last quarter of the year. Although real sector loans displayed a limited increase, their growth rate slowed down significantly compared to previous years (Graph 5.2.2), which was mainly due to the fact that banks cut down their supply of loans and that rising interest rates reduced the borrowing demand of households and firms. In other words, both the supply and the demand side is considered to be influential in the sluggish trend observed in the recent period.

Graph 5.2.2. Real Sector Loans/ GNP*
(Percent)



* Real sector loans are composed of consumer loans and business loans. The fourth quarter GNP of 2006 shows estimate figures.
Source: CBRT.

Despite the sluggish trend in total credits, the slowdown in business loans was rather limited compared to that in consumer loans. The main reason for this is that the interest rate risk is undertaken by borrowers instead of banks due to the variable interest rates of business loans. Hence, the interest rate sensitivity of business loans appears to be less than that of the consumer loans.

Consumer loans increased only at a modest rate in the last quarter of 2006 compared to previous years, as was the case in the third quarter. This development is in line with the slowdown of private consumption demand observed since the second half of the year. This increase, in terms of sub-items, mainly stemmed from the "other loans" item which excludes housing and automobile loans and is generally composed of short-term consumer loans. This observation suggests that the concurrence of the New Year and the Sacrifice Feast led consumers to meet their elevated expenses by substantially using consumer loans and credit cards. On the other hand, housing loans increased slowly, whereas the real downward trend of vehicle loans continued (Table 5.2.1).

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

	2005Q3	2005Q4	2006Q1	2006Q2	2006Q3	2006Q4
Consumer Loans	23,3	14.4	17.2	20	1.5	3.3
Housing Loans	50,6	33.3	29.2	22.8	0.9	2.0
Automobile Loans	11,4	6	1.9	5.1	-6.4	-5.5
Other Loans	11,3	1.6	11.7	24.3	6	8.7
Credit Cards	6,3	2.3	2	6.8	2.1	4.4

Source: CBRT.

Loans are monitored closely as they indicate households’ consumption tendency and firms’ investment demands. Particularly as a result of the rapid credit expansion that has been observed in the last three years, the influence of the financial sector on the monetary transmission mechanism became more apparent. In this framework, the Central Bank continues to closely monitor the developments in the banking sector with respect to inflation targeting and financial stability.

6. Public Finance

2006 was a successful year with respect to achieving central government budget targets. The ratio of central government budget deficit to GNP is expected to be 0.5 percent by the end of 2006. However, this positive performance can be attributed mainly to temporary or one-off rises in tax and non-tax revenues. On the other hand, the analysis on the central government budget targets reveals that projections for the rate of increase of the revenue are consistent with the inflation target and output growth rate forecasts, but the rate of increase in expenditures exceed the inflation target. Therefore, in 2007, the contribution of fiscal policy to the disinflation process is expected to be more limited compared to previous years.

Despite the financial turbulence that has been effective by May, the public debt stock continued to improve in 2006. Besides, New Turkish lira again appreciated subsequently, whereas the increase in nominal and real interest rates became permanent. Yet, the debt burden continues to improve rapidly.

In 2006, public debt management was conducted by adopting an effective borrowing strategy at reasonable risk levels, and thus, concerns over debt rollover in the short term and its sustainability in the medium to long term were minimized. However, the effective implementation of structural reforms is still vital for assuring the permanence of the gains from tight fiscal policy and reducing public debt stock to lower levels. Already implemented structural reforms in the public sector and those planned for the future are vital not only for securing a sound basis for public finance, but also for ensuring a competitive environment in economy and thus eliminating inflation rigidities in certain sectors. Therefore, it is of great importance to pass the social security reform package which cannot be enacted as the Constitutional Court called off some of its articles.

6.1. Budget Developments

From January to November 2006, the performances of both the budget balance and the primary budget balance were well above the end-year target (Table 6.1.1). Capital revenues and non-tax revenues exceeded the end-year target partly as the sale of Turk Telecom shares added over New Turkish lira 2 billion to the budget in November. Moreover, realization rates of all tax revenue items, except the corporate tax, reached over 90 percent by November, which means that central government budget revenues will exceed the initial target of New Turkish lira 160.3 billion for end-2006. Parallel to the rise in imports, the initial target for import VAT was already exceeded by November. Despite this favorable revenue performance, health expenditures and capital transfers that contain both agricultural subsidies and transfers to local governments exceeded the initial budget appropriation for 2006 in the January-November period.

The green card health services, an item to boost health expenditures, decreased in the last four months below the average of the previous seven months, but reached 172.7 percent of its initial budget appropriation by the end of November. No budget transfer was made to Social Insurance for the Self-Employed (Bağ-Kur) in the May-August period since it collected a large amount of premium after the enactment of the law improving premium collection in March. This contributed to the favorable course of the budgetary performance and the primary budgetary performance of the second half of the year. However, this single implementation limited transfers to Bağ-Kur from the budget, while the first eleven-month figures pertaining to transfers to other two social security agencies, the Pension Fund and the SSK, reveal that budget targets have been exceeded.

In conclusion, the central government primary surplus might have been realized over the target as the end-year target for budgetary revenues will almost certainly be exceeded by a significant margin despite the revenue loss driven by the corporate tax reduction and as the budgetary measures to limit health expenditures has blocked the appropriations at 0.2 percent of GNP since October. Yet, the overspending in the areas of personnel expenditures, agricultural subsidies, capital transfers to local administrations and green card payments has been remarkable.

Table 6.1.1. Central Government Budget Aggregates (Billion YTL)

	January-November 2005	January-November 2006	Rate of Increase(%)	Realizations/ Budget Target (%)	2006 Budget Target	(Share in GNP)[1]
Central Government Expenditures (A+B)	**138.1**	**157.7**	**14.2**	**90.5**	**174.3**	**32.2**
A) Interest Expenditures	**41.4**	**44.1**	**6.4**	**95.2**	**46.3**	**8.5**
B) Non-Interest Budget Expenditures	**96.7**	**113.6**	**17.6**	**88.7**	**128.1**	**23.7**
1. Gov. Premiums to Personnel and Social Security Agencies	34.6	39.5	14.2	96.4	41	7.6
2. Purchases of Goods and Services	10.8	14.2	31.8	80.2	17.7	3.3
a) Defense-Security	4.0	4.7	18.2	60.3	7.8	1.4
b) Health Expenditures	3.3	4.9	47.4	118.7	4.1	0.7
General Medication	0.8	0.7	-9.3	58.1	1.2	0.2
General Treatment and Health Equipment	1.0	1.4	38.8	108.2	1.3	0.2
Green Card Health Services	1.5	2.8	81.8	172.7	1.6	0.3
c) Other Purchases of Goods and Services	3.5	4.6	30.3	80.0	5.7	1.1
3. Current Transfers	41.2	46.1	11.8	93.9	49.1	9.1
a) Treasury Aid to Social Security Agencies	21.8	18.3	-15.9	93.8	19.5	3.6
Pension Fund	8.7	5.5	-36.5	100.9	5.5	1.0
Bağ-Kur	6.0	3.9	-35.6	56.7	6.8	1.2
SSK	7.0	8.3	18.0	123.8	6.7	1.2
b) Agricultural Subsidy	3.3	4.6	37.6	114.0	4.0	0.7
c) Transfers Abroad	0.3	0.5	73.6	88.6	0.6	0.1
d) Shares from Revenues	10.3	12.3	19.8	86.8	14.2	2.6
4. Capital Expenditure	6.9	8.0	17.3	64.3	12.5	2.3
5. Capital Transfers	1.0	2.3	124.8	127.4	1.8	0.3
6. Lending	2.2	3.4	59.6	80.2	4.3	0.8
7. Reserve Appropriations	0.0	0.0	-	0.0	1.7	0.3
Central Government Revenues (A+B+C)[2]	**-**	**157.8**	**-**	**98.4**	**160.3**	**29.6**
A) General Budget Revenues (I+II+III+IV)	**119.2**	**153.4**	**28.7**	**98.2**	**156.2**	**28.8**
I-Tax Revenues	**96.7**	**126.0**	**30.3**	**95.3**	**132.2**	**24.4**
1. Taxes on Income, Profits and Gains	28.1	37.1	32.2	95.2	39.0	7.2
a) Income Tax	18.3	26.1	42.8	100.2	26.1	4.8
b) Corporate Tax	9.8	11.0	12.3	85.0	12.9	2.4
2. Taxes on Property	1.7	3.0	78.4	97.1	3.1	0.6
3. Domestic Taxes on Goods and Services	45.3	54.5	20.4	91.8	59.4	11.0
a) Domestic Value-Added Tax	11.2	14.8	32.8	91.0	16.3	3.0
b) Special Consumption Tax	28.9	33.6	16.4	90.2	37.3	6.9
4. Taxes on International Trade and Transactions	17.3	24.9	44.1	102.4	24.3	4.5
VAT on Imports	16.0	22.9	43.5	102.4	22.4	4.1
II-Non-Tax Revenue	20.1	24.4	21.7	114.2	21.4	3.9
III-Capital Revenue	2.0	2.4	17.9	103.2	2.3	0.4
IV-Special Revenues, Grants and Aids	0.5	0.7	46.4	166.4	0.4	0.1
B) Revenues from Private Budget Organizations	-	3.0	-	98.9	3.0	0.5
C) Revenues from Regulatory and Supervisory Agencies	-	1.4	-	123.6	1.1	0.2
Budget Balance[3]	**-**	**0.1**	**-**	**-0.5**	**-14**	**-2.6**
Primary Balance[3]	**-**	**44.1**	**-**	**136.6**	**32.3**	**5.9**

Source: Ministry of Finance.
1 GDP growth rate for 2006 taken from SPO Program of 2006.
2 Not comparable due to change of scope.
3 Budget balance and primary balance for 2005 are calculated over general budget revenues.

By September, the consolidated government sector overall balance and program-defined primary surplus exceeded program targets by New Turkish lira 7.7 billion and New Turkish lira 7.3 billion, respectively. Central government budget revenues played a major role in this favorable performance. By the end of 2006, central government budget revenues are expected to exceed the initial target of New Turkish lira 160.3 billion by New Turkish lira 12 billion. In this respect, the end-year consolidated government sector program target might well be achieved by the end of 2006 (Table 6.1.2).

Table 6.1.2. Consolidated Government Sector
(Cumulative, Billion YTL)*

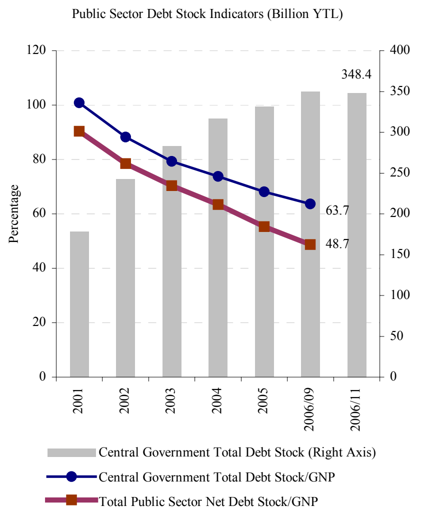
	2005	March-2006	June-2006	September-2006	October-2006
			Realizations		
Primary Balance	**28.3**	**10.6**	**25.0**	**33.4**	**-**
Primary Balance (Excluding SEE's)	**23.6**	**8.4**	**22.1**	**31.4**	**32.0**
Central Government Budget	24.1	7.6	20.4	30.6	31.0
Overall Balance	**-4.2**	**1.2**	**7.1**	**2.2**	**-**
Central Government Budget	-11.5	-2.4	1.0	-2.8	-5.2
			Targets		
Program					
Primary Balance	30.5	7.6	17.3	29.3	-
Primary Balance (Excluding SEE's)	26.7	7.3	16.4	27.6	-
Overall Balance	-19.6	-3.7	-4.1	-5.9	-
Adjusted Program					
Primary Balance	30.4	7.8	17.4	29.7	-
Primary Balance (Excluding SEE's)	26.7	7.5	16.4	28.1	-
Overall Balance	-19.7	-3.4	-3.9	-5.5	-

Source: Treasury.
*Figures for 2006 are provisional.
Note: Consolidated Government Sector = Central Government + 23 SEEs + Extra budgetary Funds (Defense Industry Support Fund, Privatization Fund and Social Aid and Solidarity Incentive Fund) + Social Security Institutions + Unemployment Insurance Fund.
Overall Government = Consolidated Government Sector + Local Administrations + Revolving Funds + non-CGS SEEs.

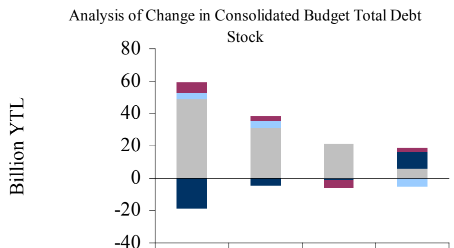
6.2. Developments in Debt Stock

By November 2006, central government debt stock, which constitutes a large share of total public debt stock, increased by 5.1 percent compared to end-2005 and reached New Turkish lira 348.4 billion. The over-target primary surplus and the New Turkish lira 10.6 billion-worth privatization revenue of the January-November period restrained the rate of increase in debt stock. Central government debt stock grew in response to New Turkish lira depreciation in May, but later followed a flat course as New Turkish lira retraced its pre-fluctuation level. Moreover, both the relatively longer maturity of current FX-denominated debt stock and the large amount of FX deposits held by the Treasury limit the risks of exchange rate volatilities, in favor of the public sector. Analyzing the change in central government debt stock over 2005, it is observed that, unlike previous years, the overall effect of exchange rate movements pushed debt stock up by New Turkish lira 9.7 billion, while the rise in net foreign debt decreased it by New Turkish lira 5.4 billion (Graph 6.2.1).

Graph 6.2.1. Public Debt Stock Indicators (Billion YTL)



Source: Treasury.



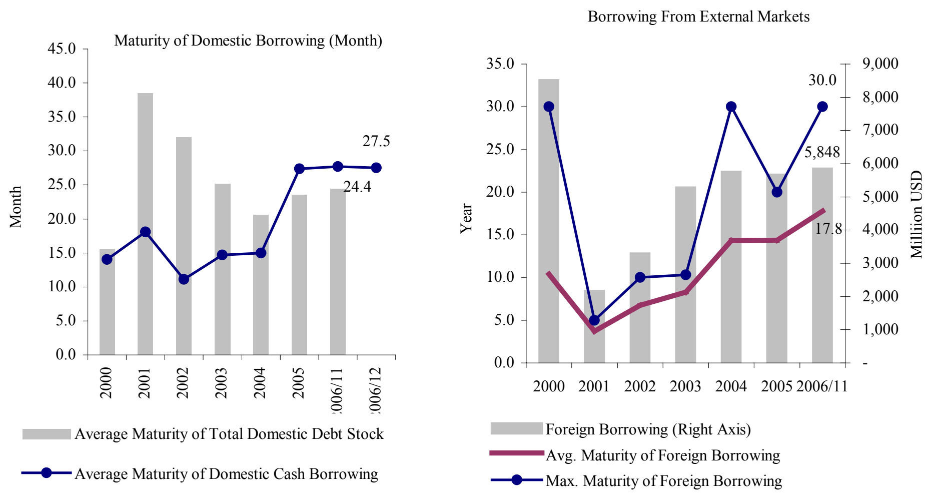
	2003	2004	2005	2006/11*
Parity Effect**	6,2	3,0	-4,8	3,1
Total Exchange Rate Effect***	-18,8	-4,6	-0,8	9,7
Net External Borrowing	4,0	4,1	-0,6	-5,4
Net Domestic Borrowing	48,8	31,2	21,1	6,2

Source: Treasury, CBRT.
*Change as of 2005.
** Changes arising from the movements in USD/EURO and USD/SDR parities.
*** Changes arising from the movements n YTL/USD parity.
Note: Changes in Net Debt denotes the change excluding exchange rate effect.

In the first 11 months of 2006, parallel to the financing strategy that is drawn in line with the strategic standard setting, the average maturity of cash borrowing, which sets the maturity of debt stock, became significantly shorter in the May-July period due to the financial turbulence. As the issuance of variable and fixed coupon securities with five-year maturity resumed as of September, debt stock maturities got extended to 27.5 months in 2006. As stipulated in the financing program, the Treasury borrowed USD 5.8 billion via Eurobonds. Despite the financial turbulence in May, the average maturity of borrowing via Eurobonds was extended compared to 2005 (Graph 6.2.2).

By November 2006, the share of fixed rate long-term securities in public debt stock had increased over end-2005, while the shares of interest rate-indexed securities and bonds decreased and the share of FX-denominated and FX-indexed debts remained unchanged. Parallel to the financing strategy intended for diminishing liquidity risk, the ratio of public deposits to average monthly debt service exceeded 188 percent in November. The high primary surplus and privatization revenues played a significant role in this increase (Graph 6.2.3).

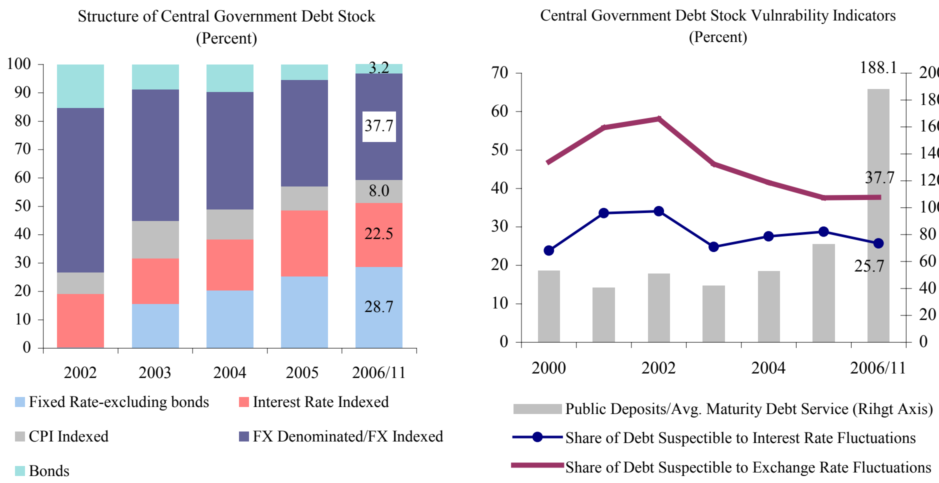
Graph 6.2.2. Maturity of Borrowing form Internal and External Markets



Source: Treasury, CBRT.

As specified in its 2007 Borrowing Program (Box 6.1.), the Treasury will continue to be a net payer of foreign debt, will not issue any FX-indexed securities and will limit the FX-denominated domestic debt roll-over ratio to 80 percent, which altogether point to the fact that the debt stock's vulnerability to FX rates will continue to decline.

Graph 6.2.3. Structure of Central Government Debt Stock



Source: Treasury, CBRT.

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

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

The maintenance of the decline in debt burden requires not only fiscal discipline, but also an effective borrowing policy. Aimed at balancing the costs and the risks, a sustained borrowing via long-term floating-rate securities would be crucial for extending maturities and reducing borrowing costs. On the other hand, any New Turkish lira depreciation or any rise in interest rates is considered a risk to debt stock. However, the large amount of FX and New Turkish lira -denominated deposits held by the Treasury limits this risk.

BOX 6.1. TREASURY'S 2007 FINANCING PROGRAM

The Treasury announced its Financing Program for 2007 on December 29, 2006. Accordingly, it is projected that the decline in overall debt service will continue in 2007, albeit at a subdued rate (Box 6.2.1. Table 1). Rises in both domestic and foreign interest rates have slowed down the pace of deceleration in total debt service. The financing of overall debt service reveals that the share of non-borrowing resources has decreased compared to 2006, due to the decline in primary surplus and in privatization revenues. As for total borrowing, there is a moderate decrease following the slump in 2006. Unlike previous years, Treasury reserves will contribute to financing in 2007. These reserves increased by YTL 15.8 billion in the last two years and a certain portion of them will be used for debt service in 2007. It is projected that the domestic debt rollover ratio will maintain its downward trend in 2007 and decline to 74.2 percent.

Box 6.1. Table 1. Treasury's Financing Program For 2007

(Billion YTL)	2005	2006 (Forecasts)	2007 (Program)
I- TOTAL DEBT SERVICE	**188.6**	**170.8**	**166.5**
Domestic Debt Service	167.4	145.4	140.3
Principal	128.2	107.2	99.6
Interest	39.2	38.2	40.7
External Debt Service	21.1	25.4	26.2
Principal	14.9	18.6	18.2
Interest	6.3	6.8	8.0
II- RESOURCES AND BORROWING	**188.6**	**170.8**	**166.5**
Non-Debt Creating Resources	36.3	49.6	41.8
Primary Surplus	32.3	38.4	34.3
Receipts from On-Lending and Guaranteed Debt	0.2	0.6	0.7
Other	3.8	10.6	6.8
Total Borrowing	162	125.9	122.0
External Borrowing	12.4	15.0	17.8
Eurobond Issue	8.6	8.2	8.2
International Institutions	3.3	6.1	6.6
Other	0.5	0.6	3.0
Domestic Borrowing	149.6	111.0	104.2
Change in Cash Balances	-9.6	-6.2	2.7
Valuation of FX Deposit	-0.1	1.4	-
TOTAL DOMESTIC ROLLOVER RATIO (%)	**89.4**	**76.3**	**74.2**

Source: Treasury, CBRT.

Treasury's borrowing strategy, with the aim to extend maturities under market conditions and restrain the risks of liquidity, exchange rate and interest rate, contains the following factors:

- New Turkish lira -denominated borrowings are to be facilitated predominantly via fixed rate long-term securities.
- FX-denominated domestic debt rollover ratio will be limited to 80 percent and Treasury will not issue FX-indexed securities.
- A USD 5.5 billion-worth borrowing is foreseen to be facilitated via bond issues in international markets.
- Despite a limited decrease compared to 2006, the Treasury will continue to hold strong reserve position in 2007.
- In order to ensure a balanced distribution of debt service among periods, repurchase and swap auctions will be used effectively.

7. Medium-Term Projections

This chapter covers inflation and output-gap forecasts that shape the medium-term outlook, summarizes the updated assumptions related to fundamental macroeconomic variables that provide a basis for these forecasts, and analyzes the main prospective risks that could lead to a significant bi-directional deviation from these forecasts. The forecasts presented in the Inflation Reports of 2006 covered an eighteen-month period. However, in order to help economic agents make better predictions and to establish a forecast horizon comparable with the results of the Expectations Survey, the CBRT decided to employ a two-year horizon as of 2007 and announced this decision in its “Monetary and Exchange Rate Policy for 2007”. Therefore, the forecasts presented in this Chapter cover a period of two years, 2007 and 2008.

7.1. Current Stance, Short-term Outlook and Assumptions

The assumptions that provide a basis for inflation and output-gap forecasts are divided into assumptions *related to domestic economic activity* and assumptions *related to exogenous factors*, as in previous Inflation Reports. This set is constructed by updating the assumptions that formed the basis of estimations presented in the October Inflation Report with the new data added during the last three months and by aggregating the detailed analyses and expert opinions introduced throughout this Report**.**

In the third quarter of 2006, the macroeconomic variables were consistent with the outlook presented in the October Inflation Report in which domestic demand was projected to decelerate by mid-2006 and the rise in net external demand driven by the strong global growth trend would continue. However, the slowdown in domestic demand was foreseen to prevail over the rise in net external demand leading to a deceleration of the total demand, thereby the growth rate would decrease in the second half of 2006 compared to previous periods. In fact, the December GDP data confirmed the slowdown in domestic demand that occurred in response to the developments in private consumption expenditures in the third quarter. On the other hand, the rise in net external demand realized in line with our projections and restrained the slowdown in overall demand along with the upward trend in public consumption expenditures. Accordingly, as projected in the preceding Report period, demand conditions continued to contribute to the disinflation process in the third quarter.

Current data on demand conditions of the last three months do not suggest a slowdown beyond the decline observed in domestic demand in the third quarter. It is estimated that brisk demand in Euro zone will help maintain the strong external demand in the last quarter and will contribute to growth. On the other hand, demand conditions are believed to continue to support the disinflation process, thanks to the tight monetary policy, in the last quarter of 2006 and in the first quarter of 2007.

Cost conditions changed due to the fluctuations in May, along with the depreciation of the YTL in the second quarter, and the support of the YTL to the disinflation process therefore disappeared. In the October Inflation Report, the assumptions were based on a framework in which real exchange rates contributed to the disinflation process more than that in July Report, but less than early 2006. In the current period, our projections as to the effect of real exchange rates on the disinflation process are kept the same as presented in October Inflation Report.

Despite unchanged policy rates, monetary policy was further tightened due to the continued decline in inflation expectations in the last quarter. Meanwhile, the real interest rates on instruments with longer maturities such as government securities and on credit remained high. Forecasts are made under a framework in which the current level of real interest rates reflects a tight monetary policy and continues to support the disinflation process by curbing demand conditions.

In the October Inflation Report, annual CPI inflation was projected to display a modest decrease in the last quarter, based on the expectation that the lagged effects of YTL depreciation would partially disappear and that crude oil and unprocessed food prices would assume a more favorable course towards the end of the year. As a matter of fact, the inflation outlook displayed some improvement in the last quarter, depending on the aforementioned factors. The downward trend in annual inflation, starting from the second quarter of 2007, is expected to be supported by the disappearance of the high base effect stemming from supply-side shocks of 2006, the easing of energy and commodity prices, the slowdown in food prices, and the weakening impact of post-May YTL depreciation on prices.

Apart from our projections on domestic economic activity, the assumptions related to exogenous factors are also important inputs that establish the basis of our medium-term inflation forecasts. This set of assumptions is comprised of: findings pertaining to macroeconomic variables of Euro zone such as interest rates, inflation and growth; as well as projections pertaining to the course of international commodity prices and global liquidity conditions. Assumptions pertaining to Euro zone are compiled from the January 2007 issue of “Consensus Forecast”. According to these assumptions, growth in the Euro zone will continue without acceleration and be around 2 percent by mid-2008. The downward trend in inflation is projected to continue and the Harmonized Index of Consumer Prices (HICP) inflation to converge to the 2 percent-target by mid-2008. The European Central Bank is expected to gradually tighten monetary policy and therefore raise interest rates slightly in order to converge to the Euro zone inflation target in the medium and long term. Along with Euro zone, the projections for the monetary policies of developing countries are examined in detail, as the course of international liquidity conditions is also critically important in the process of making medium-term forecasts.

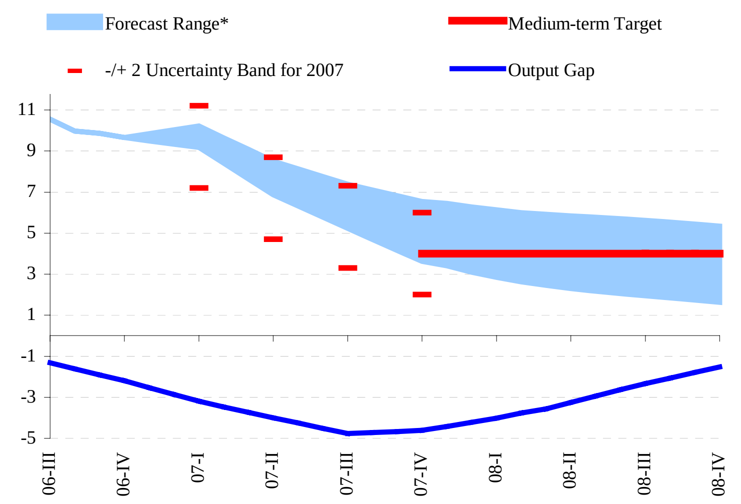
Developments in oil prices have been more favorable than our October assumptions. The deceleration in global growth, favorable weather conditions, the high level of crude oil inventories in United States, the relatively stable state in the Middle East and the rise in oil production have all together pulled oil prices down. In this respect, the international oil price per barrel, which was assumed to be US dollar 60 in the previous Inflation Report, is reduced to US dollar 55 in this Report. Even if there might be some factors to reverse this downward trend in the upcoming period, in producing forecasts it is assumed that crude oil prices will follow a flat course at around US dollar 55, due to the difficulty of making a clear projection regarding the course of oil prices. Despite this assumption update for oil prices, during the forecasting process, it was taken into consideration that the cumulative increases observed in oil prices in the recent period might lead to a price hike in items such as natural gas and electricity.

As the change in global liquidity conditions following the financial turbulences in May-June lasted for a shorter period than expected, it was assumed, in the October Report, that there would be no significant change in the risk premium. Our assumptions for the risk premium remained the same in this Inflation Report since there has been no development to cause a significant alteration in this assumption so far.

7.2. Forecasts

While formulating its policy, the Central Bank focuses on the coherence between future inflation, not current inflation, and the target, as the impacts of monetary policy on the economy can only be observed with a time lag. Within this framework, the Central Bank designs its policy response from a medium-term perspective and does not respond to the temporary effects of factors beyond the control of monetary policy on inflation. As reiterated in previous reports, while making projections about the future trend of inflation, the Central Bank assesses the available data set by employing both quantitative and qualitative methods. While the quantitative methods include structural models, simulations and other statistical measurement techniques, the qualitative methods refer more to subjective evaluations. This part of the Report involves projections designed from a medium-term perspective using the above-mentioned methods.

Graph 7.2.1. Inflation and Output Gap Forecasts



*The probability of inflation lying within the forecast range is 70 percent.

Graph 7.2.1 shows the inflation and output-gap forecasts produced to cover a 2-year period, 2007 and 2008, in line with the assumptions and projections mentioned in Part 7.1. Under the scenario that the Central Bank keeps the policy interest rates constant in the first three quarters of 2007 and eases gradually afterwards, the annual inflation rate is forecasted with 70 percent probability to be within the 3.6-to-6.6 percent range (mid-point 5.1) at the end of 2007, and within the 1.6-to-5.2 percent range (mid-point 3.4) at the end of 2008 (Graph 7.2.1). The downward trend in inflation is expected to be more prominent in the second and third quarters of 2007. Projections emphasize that the current tight policy stance should be preserved in order for the inflation to converge to the medium-term target of 4 percent. At this point, it should be underlined once more that the mentioned interest rate path represents a policy framework that is based on the current data set, and does not necessarily imply a commitment by the CBT. This path is subject to revisions whenever any change in economic conditions or assumptions occur.

Graph 7.2.1 also involves output-gap forecasts that form a basis for the above-summarized inflation forecasts. It is projected that the further widening output-gap in the first three quarters of 2007 will continue to support the disinflation process. Under the above-mentioned policy perspective, the output-gap is expected to display a narrowing tendency, starting from the fourth quarter of 2007 to the end of 2008, however demand and capacity conditions will continue to support the disinflation process.

To sum up, since the recent macroeconomic developments have been consistent with the framework outlined in the October Inflation Report, there has been no need to make any significant adjustments to the medium-term projections and to the monetary policy perspective.

7.3. Risk Factors

The main risk for the medium-term inflation outlook is the possibility of higher -than-expected inflation inertia, which already manifests itself in inflation expectations and service inflation. Services inflation displayed a very slight improvement in 2006 compared to previous years. The annual rate of increase in services prices is anticipated to decelerate in the upcoming period due to the expected slowdown in domestic demand. However, given the low relative productivity growth in the services sector, backward-looking price setting behavior and the sensitivity of services prices to wage hikes, developments in services inflation should continue to be closely monitored. In this framework, considering the fact that we aim at bringing inflation down from 10 to 4 percent in a very short period of time, the possibility of the persistence of high increases in services prices over the medium terms stands as a major risk. Recent wage adjustments have made this risk more evident. Materialization of such a risk would require keeping the tight policy stance for an extended period of time.

Another risk factor for the inflation outlook is the uncertainty related to the lagged effects of monetary policy on aggregate demand. Lags in monetary policy transmission are time variant across countries, and the Turkish economy is no exception. The sizeable slowdown in economic activity in the third quarter of 2006 was a result of lower consumer and producer confidence due to financial market volatility in May-June period, rather than an outcome of tightened monetary policy. Although the tightening exercised since June 2006 started to be effective on private demand recently, the extent and duration of the slowdown in overall economic activity remains to be seen. Moreover, ongoing uncertainties related to the behaviour of government spending constitute an upside risk to aggregate demand, and therefore inflation in 2007. In this respect, the CBT has been closely monitoring the macroeconomic impact of the developments in incomes policy as well as public sector non-interest expenditures.

Another risk factor that may delay attaining the medium-term targets is the possibility of a sudden change in the global financial market sentiment. Global liquidity is still the major factor in shaping risk appetite and volatility in financial markets. Currently, the concerns over high inflation and thus higher interest rates in the United States seem to have diminished. However, a faster-than-envisaged slowdown in the world economy or disorderly developments owing to global imbalances still remain as possible scenarios that may lead to another wave of portfolio shock in emerging markets. At this point, it would be useful to emphasize that, in the framework of the measures taken in June 2006, the Central Bank has already designed a flexible policy instrument to be used against sudden temporary fluctuations in financial markets. The current liquidity structure of the market allows a prompt upward readjustment of operational interest rates, where necessary, between two Committee meetings.

The Central Bank has announced several times that it may decide to implement such policy tightening in case of temporary and severe market fluctuations. The Committee will revise its policy rates should these shocks turn out to have lasting effects on the medium-term inflation outlook.

Finally, it should be stated that there are favorable scenarios regarding the global economy as well as unfavorable ones. Turkey is a net commodity importer. Although a slowdown in the global economic growth or a further easing in commodity prices could have an immediate adverse impact on domestic inflation through its impact on the global risk appetite, it will also lead to a positive terms of trade shock and thus to a more favorable outlook in the medium term.

Developments related to structural reforms that will enhance the quality of fiscal discipline in the medium and long run are closely monitored for the perspective of both macroeconomic and price stability. The continuation of the European Union accession process and the sustained implementation of the structural reforms envisaged in the economic program are still crucial. Continued determination in implementing the decisive steps taken in these areas in recent years will strengthen the resilience of the economy against possible changes in the global conjuncture.

GRAPHS

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TABLES

ABBREVIATIONS

AMA	Automotive Manufacturers Association
BoJ	Bank of Japan
BRSA	Banking Regulatory and Supervisory Agency
BTS	Business Tendency Survey
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
FOMC	Federal Open Markets Committee
GDBS	Government Domestic Borrowing Securities
GDP	Gross Domestic Product
GNP	Gross National Product
HICP	Harmonized Index of Consumer Prices
IFS	International Financial Statistics
IMF	International Monetary Fund
ISE	Istanbul Stock Exchange
LME	London Metal Exchange
MPC	Monetary Policy Committee
MSCI	Morgan Stanley Capital Index
OPEC	Organization of the Petroleum Exporting Countries
PPI	Producer Prices Index
SCA	Special CPI Aggregates
SEE	State Economic Enterprises
SPO	State Planning Organization
TELEKOM	Turk Telecommunications Inc.
TETAŞ	Turkish Electricity Trade Company
TİM	Turkish Exporters Assembly
TURKSTAT	Turkish Statistical Institution
USA	United States of America
VAT	Value Added Tax
WPI	Wholesale Prices Index
YTL	New Turkish lira