I. MACROECONOMIC DEVELOPMENTS

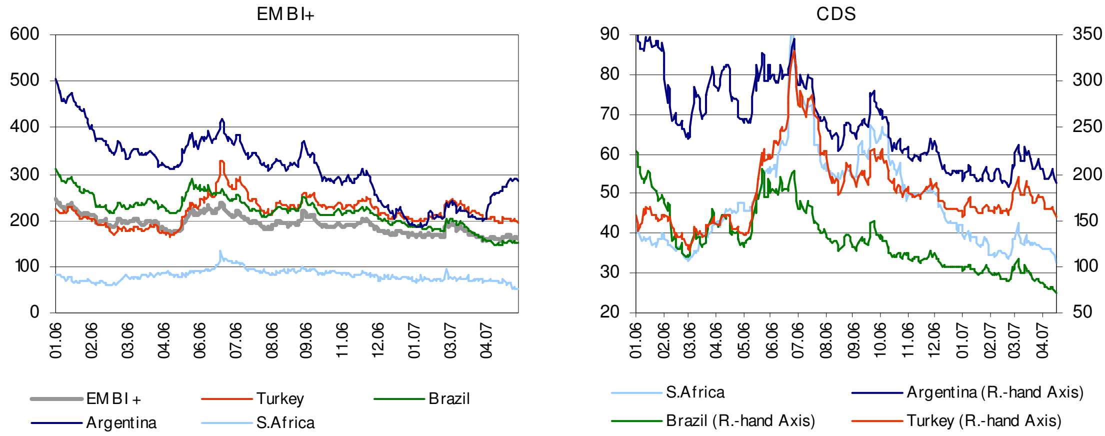
Complementary to its primary goal of maintaining price stability, the Central Bank, in cooperation with other related authorities, is responsible for monitoring financial markets and taking the necessary measures in order to safeguard financial stability. Considering the importance of macroeconomic developments for financial stability, both international and domestic developments are analyzed in this chapter.

I.1. External Sector

I.1.1. International Developments

Previous issues of this report emphasized the importance of sudden changes in global liquidity conditions and risk appetites of investors on financial stability. A shift in international capital flows parallel to changes in investor expectations may have unfavorable effects on developing countries, depending on the liquidity and depth of national financial markets.

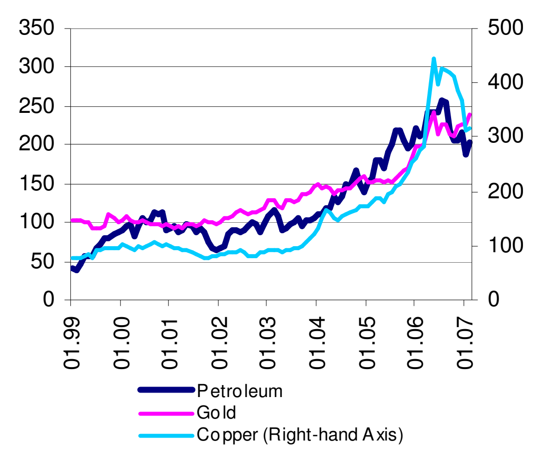
Chart I.1.1.1. Risk Premia[1,2] of Selected Countries and Turkey and Development of Credit Default Spreads[3] (Basis Point)



Source: Bloomberg
(1) Country risk premium is the difference between the relevant country's EMBI+ index and returns of US Treasury instruments.
(2) EMBI+ index includes Eurobonds of 18 developing countries, Brady bonds and traded loans. The weight of each country in the index is different. For instance, Brazil's weight is 22.5, Turkey's weight is 10, Argentina's weight is 2.6 and South Africa's weight is 1.8 percent in the EMBI+ index as of April 19, 2006. Also the index is calculated for each country individually.
(3) 5 year CDS contracts in USD are taken as benchmark.

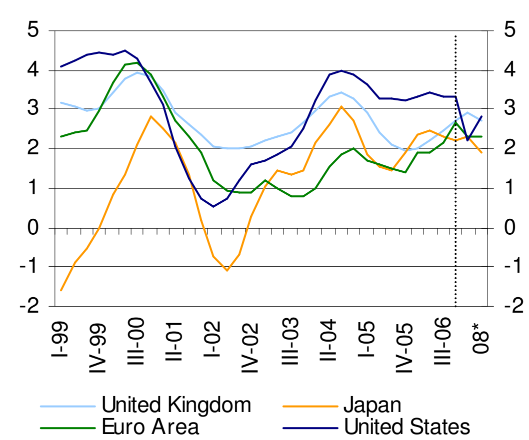
Indeed, the drop in the Shangai stock exchange in February 2007, concerns about the sluggishness of growth in the United States, announcements by the IMF of possible threats to the global economy posed by low interest rates in Japan, expectations that the European Central Bank would raise key interest rates, the tension arising from Iran's nuclear projects and the increase in oil prices consequently disturbed the global economy, and led to a fall in asset prices and a hike in the volatility of interest and exchange rates. The efforts of carry-traders, who borrow funds at a lower cost from financial markets in Japan and invest these funds in high-yield financial instruments in other countries, to close their positions rapidly with the expectation of an appreciation of the Japanese Yen, adversely affected developing countries, including Turkey, and increased the risk premium on these countries (Chart I.1.1.1).

Chart I.1.1.2. Petroleum and Other Primary Commodities' Price Index (2000=100)



Source: IMF- IFS

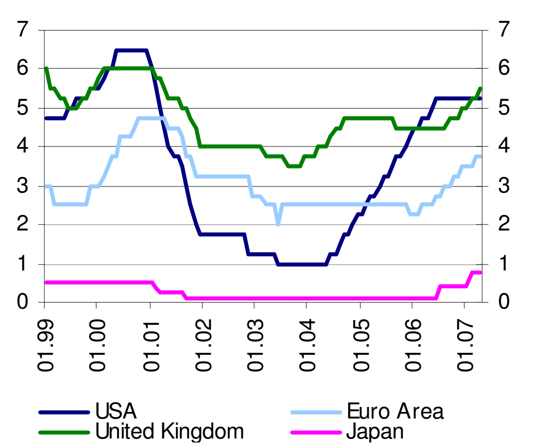
Chart I.1.1.3. Growth Rates of Selected Developing Countries (annualized quarterly, %)



Source: IMF IFS, IMF WEO, EU European Economy
* Forecast (IMF)

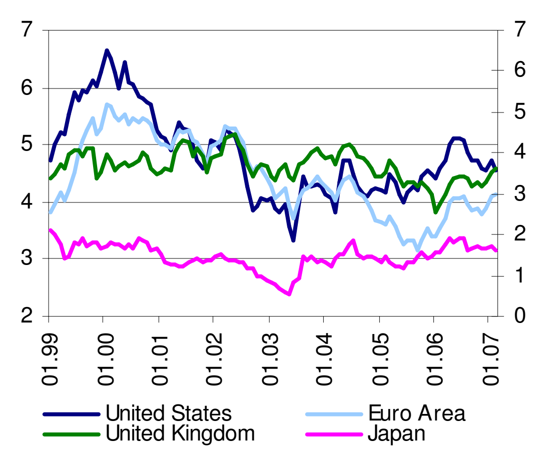
Rapid growth in China, deterioration in growth performance and tensions following defaults in the sub-prime mortgage market in the United States, along with high oil and other primary commodity prices have all contributed to the increase in global risks. The rise in energy prices might both deteriorate growth and inflation performances and widen the current account deficits of energy importing countries. However, as in 2006, strong global growth performance is expected to continue in 2007. Therefore, the expected slowdown in growth rates in the United States, the Euro Area and Japan is anticipated to be rather limited in 2007 and 2008 (Chart I.1.1.3).

Chart I.1.1.4. Selected Countries' Policy Interest Rates (%)



Source: ECB, Federal Reserve, BoJ

Chart I.1.1.5. Average Government Bond Yields (10 year) (%)

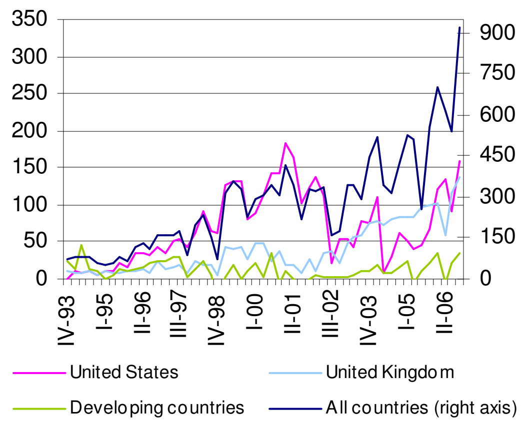


Source IMF IFS, ECB

Strong growth and increasing primary commodity prices, especially oil prices, ample liquidity and high asset prices force developed countries to either maintain or tighten their current monetary policy stances. As a matter of fact, in the first quarter of 2007, policy interest rates increased in Japan, the Euro Area and the United Kingdom (Chart I.1.1.4).

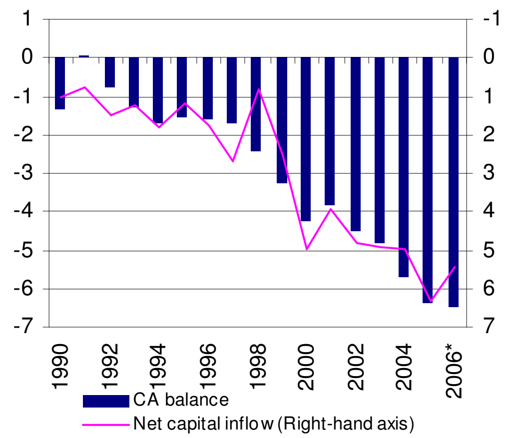
Despite the recent increases in key policy rates of developed countries, long-term interest rates have not increased at the same pace (Chart I.1.1.5). This might be the result of high credibility of central banks in developed countries regarding price stability, which in turn positively impacts the medium and long-term inflationary expectations. Besides, investment in bonds by private equity, hedge funds and pension funds also play a role in curbing the increase in the long-term interest rates.

Chart I.1.1.6. International Debt Securities (Net issues, in USD, quarterly)



Source: BIS

Chart I.1.1.7. Current Account Balance and Capital Inflow in United States (as a percentage of GDP, %)



Source: Bureau of Economic Analysis, US Department of Commerce
* Forecast.

Due to strong global loan supply, net bill and bond issues in international markets have increased. Parallel to the movement of global debt markets, debt securities issued by developing countries also rapidly increased in the second half of 2006 (Chart I.1.1.6).

On the other hand, imbalances in the global economy prevail. The United States continues to finance its increasing current account deficit with the savings surplus supplied by developing and oil exporting countries (Chart I.1.1.7). Accordingly, the stability of the flow of funds to the United States and the share of USD denominated assets in the foreign reserves of developing countries are important for the sustainability of the current account deficit in the United States.

There is an increase in the volume of transactions, which aim to earn profits by directing funds borrowed at low interest rates such as Japanese Yen or Swiss Francs to developing countries. Such profits, to some extent, shape the hedge fund activities[1]. These transactions result in increasing global risks. Due to the low interest rates in Japan, international investors have borrowed in Japanese Yen and transferred these funds to high yield financial instrument markets, these developments have led to a depreciation of the Japanese Yen and a rise in asset prices in almost all markets. It should be noted that the decline in the value of the Japanese Yen could move towards an equilibrium point, and this process could have an impact on all global markets, especially emerging markets.

[1] BIS Quarterly Review, March 2007 and ECB Financial Stability Review, December 2006.

To conclude, global risk factors for Turkey depend mainly on the monetary policy decisions of central banks of developed countries and the direction of international capital flows. Besides, possible price increases in primary commodities due to the current conjuncture in global politics might have direct and indirect adverse effects on the Turkish economy.

I.1.2. Balance of Payments

The high current account deficit, which has arisen due to increased private sector investments of recent years, rapid economic growth, increase in prices of primary commodities and decline in private sector savings, was mainly financed by long-term investments in 2006. Considering the possibility of a change in global liquidity conditions against developing countries, it is necessary to monitor the current account deficit closely.

Table I.1.2.1. Balance of Payments (Billion USD)

	2004	2005	2006	03.07[1]
CURRENT ACCOUNT	-15.6	-22.6	-31.8	-32.1
Foreign Trade Balance	-23.9	-33.2	-39.8	-39.7
Exports (f.o.b) (Including gold)	67.0	76.9	91.8	96.7
Imports (f.o.b) (Including gold)	-90.9	-110.1	-131.6	-136.4
Coverage Ratio (%)	73.7	69.9	69.8	70.9
Balance of Services	12.8	15.3	13.4	13.4
Balance of Investment Income	-5.6	-5.8	-6.6	-7.0
Current Transfers	1.1	1.5	1.7	1.7
CAPITAL & FINANCIAL ACCOUNT	13.4	20.5	34.9	32.9
Direct Investments	2.0	8.7	19.2	25.8
Portfolio Investments	8.0	13.4	7.4	8.0
Other Investments	4.2	16.2	14.5	4.5
Reserve Assets	-0.8	-17.8	-6.1	-5.4
NET ERRORS & OMISSIONS	2.2	2.1	-3.2	-0.8

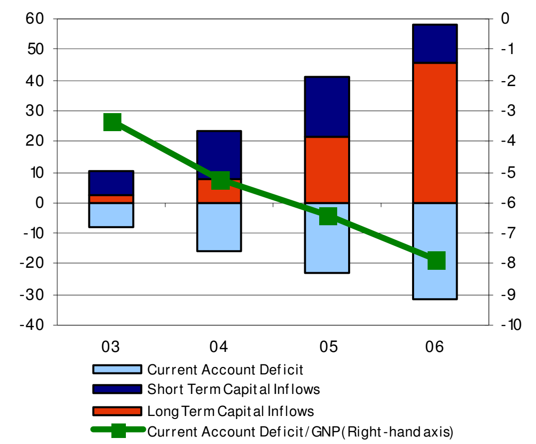
Source: CBRT
(1) April 2006 – March 2007 period is covered.

The current account deficit rose to 32.4 billion USD in January 2007, from 31.8 billion USD as of end of 2006. However, in February 2007, the 12-month current account deficit started to decrease and reached 32.1 billion USD as of March 2007 (Table I.1.2.1).

Exports (including gold) on an annual basis reached a record level of 96.7 billion USD as of March 2007. On the other hand, due to the strong YTL, the dependence of increased industrial production on the import of intermediate goods and the recent rise in energy prices, imports have continued to rise. However, the ratio of exports to imports rose to 70.9 percent as of March 2007, as exports grew faster than imports (Table I.1.2.1).

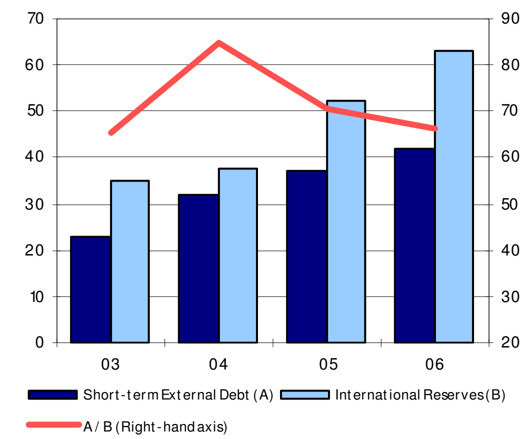
As of March 2007, the share of foreign direct investments in capital and finance account increased, while other items in this account have lost their share due to the decrease in short-term loans that banks received from abroad and the increase in banks' FX foreign assets (Table I.1.2 .1).

Chart I.1.2.1. Current Account Deficit and Capital Inflows[1,2] (Billion USD, %)



Source: CBRT
(1) Long-term capital inflows consist of foreign direct investment, debt securities of general government and banks, long-term cash loans, long-term trade loans and long-term deposits at CBRT.
(2) Short-term capital inflows consist of portfolio investments including equities and government bonds, short-term cash loans, short-term trade loans, short-term deposits at CBRT and banks and other short-term liabilities.

Chart I.1.2.2. Short-Term External Debt[1] and International Reserves[2] (Billion USD, %)



Source: Treasury, CBRT
(1) Short-Term External Debt = General Government + CBRT + commercial banks + other sectors
(2) International Reserves = CBRT gross foreign exchange reserves (including gold)

Short-term portfolio investments, which had an important role in the financing of the current account deficit in previous years decreased in 2006, while foreign direct investments and long-term loans received by banks and firms increased. Long-term capital inflows equivalent to one and a half fold of annual current account deficit were realized by the end of 2006 (Chart I.1.2.1).

The ratio of short-term debt to international reserves, one of the indicators of the external debt service, decreased from 70.8 percent as of end of 2005 to 66.4 percent in 2006, due to the greater increase in the Central Bank's international reserves (Chart I.1.2.2).

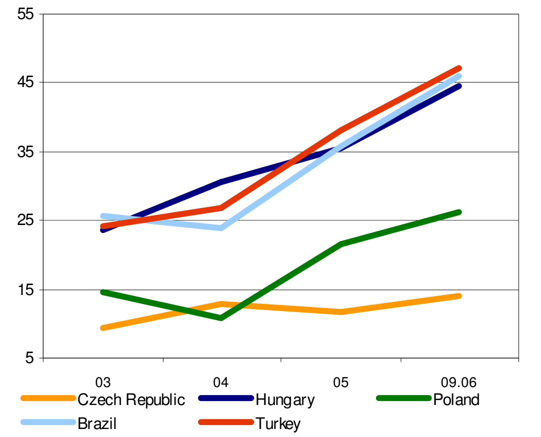
Table I.1.2.2. Parties Financing The Current Account Deficit (Billion USD)[1]

	2004	2005	2006	03.07
Current Account	-15.6	-22.6	-31.8	-32.1
Financial Account	13.4	20.5	34.9	32.9
General Government (Including CBRT and CBRT reserves)	2.4	-16.5	-2.9	0.1
Private Sector (Including Banks)	11.0	37.0	37.8	32.8
Net Errors and Omissions	2.2	2.1	-3.2	-0.8

Source: CBRT
(1) Annualized data is used.

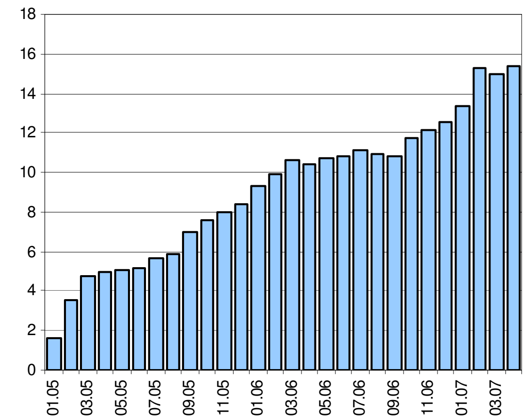
The current account deficit has, to a large extent, been financed by long-term funds from the private sector, including banks (Table I.1.2.2).

Chart I.1.2.3. Net Receivables of International Banks from Selected Countries (Billion USD) [1]



Source: BIS
(1) Figures for September 2006 are provisional.

Chart I.1.2.4. Net YTL-Denominated Bonds Issued by Foreigners (Billion YTL)



Source: CBRT

Despite the recent global turbulence, funds that were provided by banks reporting to the Bank for International Settlement (BIS) to developing countries also continued to increase in 2006. The net receivables of international banks from Turkey rose to 47.1 billion USD as of September 2006 (Chart I.1.2.3).

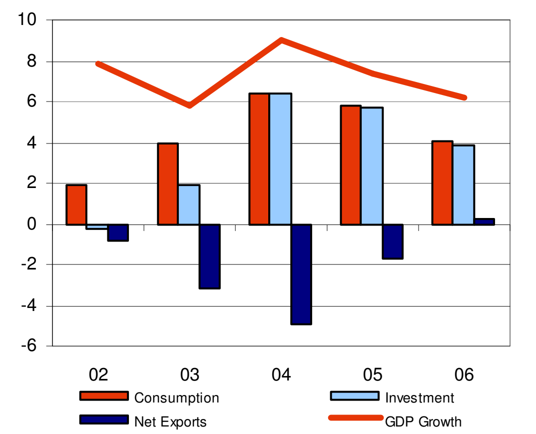
The net volume of YTL denominated bonds issued by foreigners increased from 8.4 billion USD as of end-2005 to 12.6 billion USD as of end-2006, and to 15.4 billion USD by April 2007 (Chart I.1.2.4). This indicates that the positive expectations of foreigners keep increasing towards Turkey.

I.2. Growth and Inflation

I.2.1. Growth

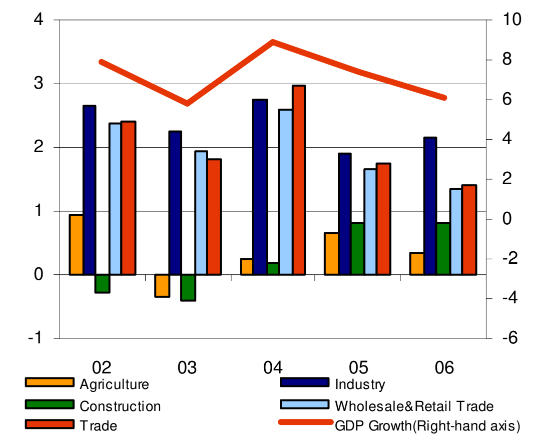
The growth rate slowed down in the second half of 2006 as a result of the May-June fluctuations.

Chart I.2.1.1. Growth Rate and Its Composition (%) [1]



Source: TURKSTAT
(1) Net Exports = Exports - Imports

Chart I.2.1.2. Contribution of Sectors to Growth (%)



Source: TURKSTAT

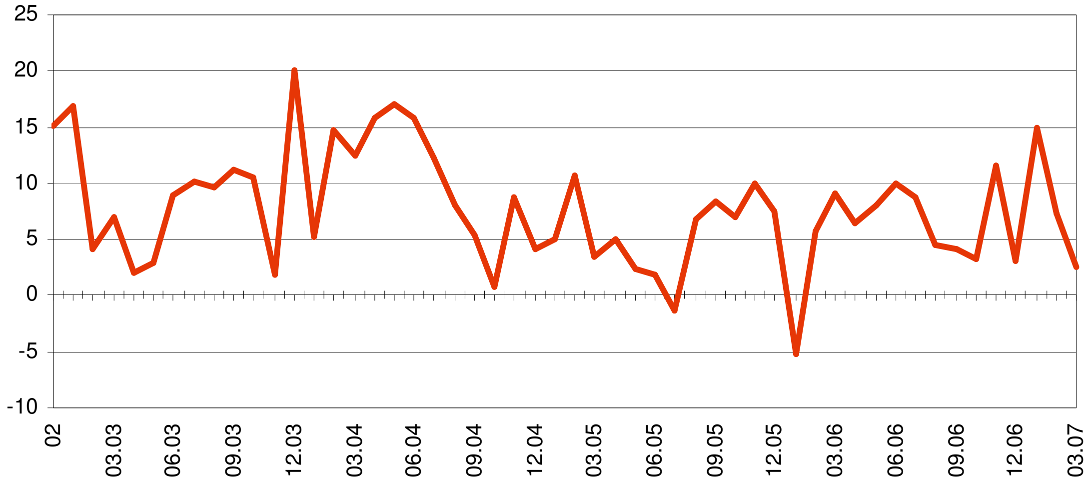
In second half of 2006, the gross domestic product (GDP) grew by 6.1 percent, which is above the expectations, as foreign demand continued to be strong - contrary to the sluggishness in consumption and investment expenditures. In addition, the contribution of exports to GDP became positive for the first time in five years (Chart I.2.1.1).

Being the major component of the GDP, the rate of increase in private consumption expenditures, whose contribution to the GDP declined to 3.4 percent in 2006, was 5.2 percent in spite of a severe slowdown in the second half of the year (Chart I.2.1.1). The annual rate of increase in public consumption expenditures stood at 9.6 percent, although it was realized as 0.7 percent for the last quarter, due to tight budgetary discipline. The slowdown in the economic growth rate mainly stemmed from the sluggishness in private consumption expenditures as the major component of GDP.

Regarding the composition of investment expenditures, the contribution of private investment expenditures to the GDP slowed down in the last quarter and decreased annually to 3.9 percent (Chart I.2.1.1). On the other hand, public investment expenditures declined by 0.2 percent in 2006, while it had increased by 25.9 percent in 2005.

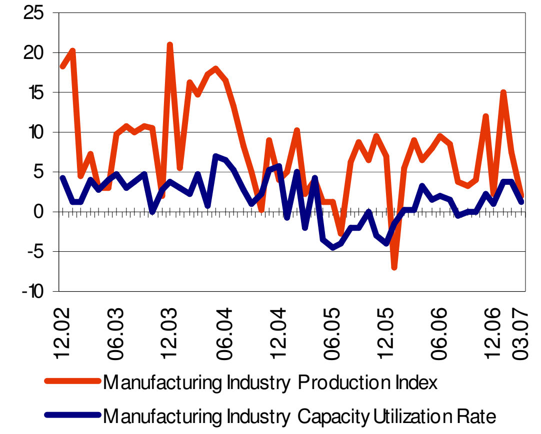
Analyzing the contribution of sectors to GDP, the growth rate of agricultural production has been noted to decrease from 5.6 percent in 2005, to 2.9 percent in 2006 due to supply side factors. As one of the driving forces behind economic growth, industrial production increased by 7.4 percent in 2006, especially due to the growth of manufacturing, and electricity, gas and water sectors. Besides, growing annually by 19.4 percent in 2006, the construction sector's strong contribution to GDP continued. The growth rate of wholesale and retail trade sectors became 6.5 percent on an annual basis due to its decline in the second half of 2006.

Chart I.2.1.3. Industrial Production Index (%) [1,2]

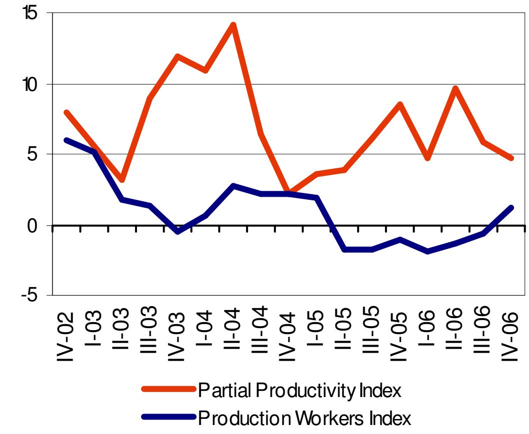


Source: TURKSTAT
(1) Percentage change compared to the same month of the previous year.
(2) Monthly industrial production index 1997=100

The industrial production growth rate was realized as 5.8 percent in 2006. Although it declined to 2.6 percent in March 2007, the industrial production growth rate was 7.8 percent in the first quarter of 2007and is expected to strengthen GDP growth in first quarter of 2007 (Chart I.2.1.3).



Source: TURKSTAT
(1) Percentage change compared to the same month of the previous year.
(2) Monthly industrial production index 1997=100

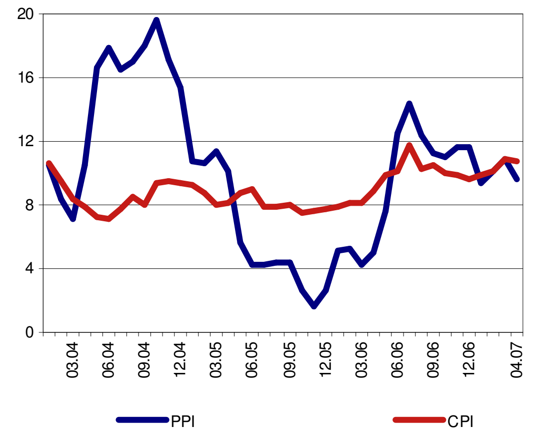


Source: TURKSTAT
(1) Percentage change compared to the same month of the previous year.
(2) 1997=100 index is used.

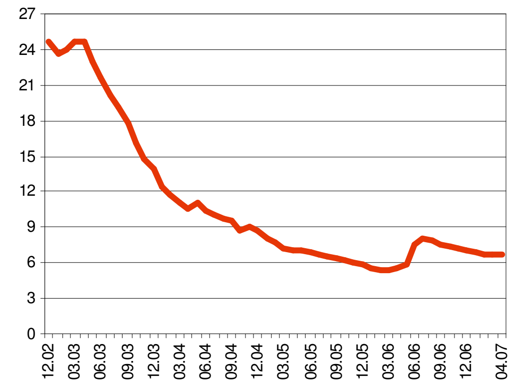
Manufacturing industry production, the share of which is 86.9 percent in the industrial production index, increased annually by 5.5 percent in 2006 and by 7.6 percent in the first quarter of 2007. Despite the limited increase of 2.1 percent in March, its high level in the first quarter was due to large increases in the months of January and February (Chart I.2.1.4). Analyzing composition of production by subsectors in March 2007, the average growth in sectors of coke, refined petroleum products, non-metallic mineral products, furniture and publishing and printing and reproduction became negative, whereas the average growth rate in sectors of machinery and equipment, fabricated metal products (except machinery and equipment), and tobacco products slowed down. In addition, contrary to the slowdown in the decline of growth of textile production, the degree of contraction in the sectors of wearing apparel and radio, TV, communication equipment has continued to increase.

The partial productivity per worker for the manufacturing industry continued to grow but its growth rate declined compared to the same period of the previous year (Chart I.2.1.5).

I.2.2. Inflation



Source: TURKSTAT



Source: CBRT

The annual change in the Consumer Price Index (CPI) rose from 7.7 percent in December 2005, to 9.7 percent in December 2006, as a result of a series of supply-side shocks and fluctuations in the financial markets. Due to the continued high pace rise in unprocessed food prices, the increase in the prices of tobacco products due to the rearrangement of taxes on these products and the fact that the impact of monetary tightening on inflation is currently unclear as well as the lagged, but also diminishing effect of the change in exchange rates, inflation expectations and realizations remained above the target. Hence, as of March 2007, the annual change in the CPI was realized as 10.9 percent (Chart I.2.2.1). On the other hand, the annual change in the CPI declined to 10.7 percent in April 2007 due to the slowdown in durable goods and services inflation in spite of the hike in wearing apparel prices.

Although the annual Producer Prices Index (PPI), which was 11.6 percent in December 2006, increased in the first quarter of 2007, due especially to increased energy prices, it decreased to 9.7 percent in April 2007 due to the decline in durable and capital goods' prices (Chart I.2.2.1).

The full-fledged inflation targeting regime was put into implementation at the beginning of 2006 and inflation targets were set as 5 percent for 2005 and 4 percent for the period of 2007-2009. In 2006, there was an upsurge in inflationary expectations since the annual inflation rate was significantly above the target. The fact that the medium-term inflation expectations are still well above the inflation target as of April 2007 represents a risk factor for the pricing behaviors in the economy (Chart I.2.2.2).

I.3. Public Finance

To reduce the share of public debt stock in national income and close the public deficit permanently in order to safeguard macroeconomic stability, a high primary surplus was also targeted in 2006.

Table I.3.1. Consolidated Government Sector Primary Surplus Targets and Realizations (Billion YTL)

	2004	2005	2006
Primary Surplus Target (Including SEEs)	26.2	30.4	34.5
Primary Surplus Realization (Including SEEs)	27.8	28.3	36.2
Realization / Target (%)	106.0	93.0	105.0

Source: Treasury

Parallel to the fact that public revenues increased at a higher pace than public expenditures, the primary surplus was realized above the Programme target (Table I.3.1). This strengthened the expectations that macroeconomic stability would gain ground and the public financing requirement would decline.

Table I.3.2. Central Government Budget Performance (Billion YTL)

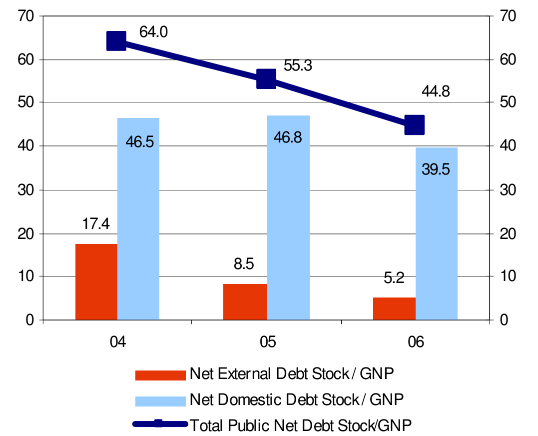
	January-April 2006	January-April 2007	Change (%)	2007 Budget Target	Realization / Budget Target (%)
Expenditures	54.5	65.8	20.7	205.0	32.1
Non-Interest Expenditures	39.1	46.8	19.7	152.0	30.8
Revenues	50.5	60.4	19.6	188.2	32.1
The coverage ratio of revenues to expenditures (%)	92.7	91.8	-	91.8	-

Source: Ministry of Finance

As of April 2007, central government revenues increased by 19.6 percent due to the sale of Turkish Telecom, amounting to 5.8 billion New Turkish liras, whereas primary expenditures increased by 19.7 percent. Besides, as a result of high interest rates, the increase in total expenditures was 20.7 percent compared to the same month of previous year (Table I.3.2).

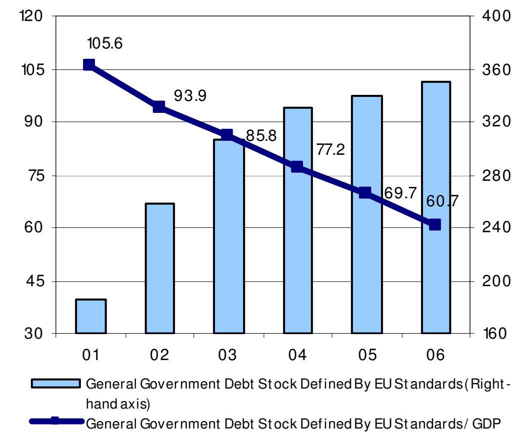
From January-April 2007, the ratio of revenues to expenditures was realized close to the level of the previous year due to the increase in the non-tax revenues that outpaced the rapid increase in expenditures (Table I.3.2). In the first fourth months of 2007, the budget deficit reached 32 percent of the year-end target.

Chart I.3.1. Composition[1] of Total Public Sector Net Debt Stock (%)



Source: Treasury
(1) Public sector net debt stock is calculated by subtracting central bank net assets, public deposits and unemployment insurance fund net assets from public gross debt stock.
(2) Figures for December 2006 are provisional.

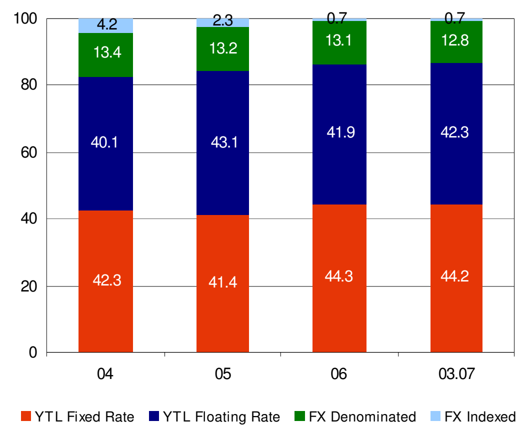
Chart I.3.2. General Government Nominal Debt Stock Defined By European Union Standards[1] (%, Billion YTL)



Source: Treasury
(1) Consolidated nominal debt stock is defined in European System of Accounts 95 (ESA 95) deficit and debt manual.

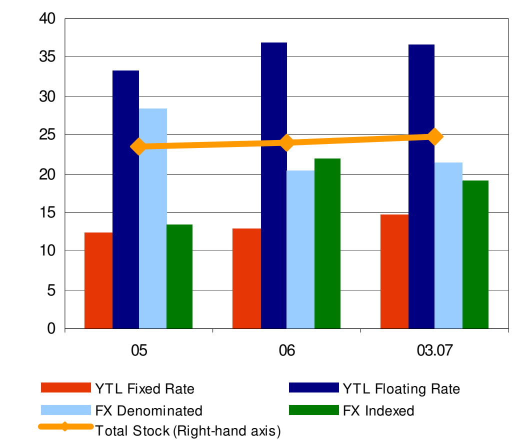
The ratio of total public sector net debt stock to GNP continued to decline (Chart I.3.1). Increases in central bank net assets, public deposits and unemployment insurance fund net assets led to the above-mentioned decline in the ratio of the total public sector net debt stock to GNP in 2006. Besides, the general government nominal debt stock to GNP, as defined by the EU, continued to decrease (Chart I.3.2).

Chart I.3.3. Composition of Domestic Debt Stock (%)



Source: Treasury

Chart I.3.4. Maturity Structure of Government Debt Securities (Month)[1]

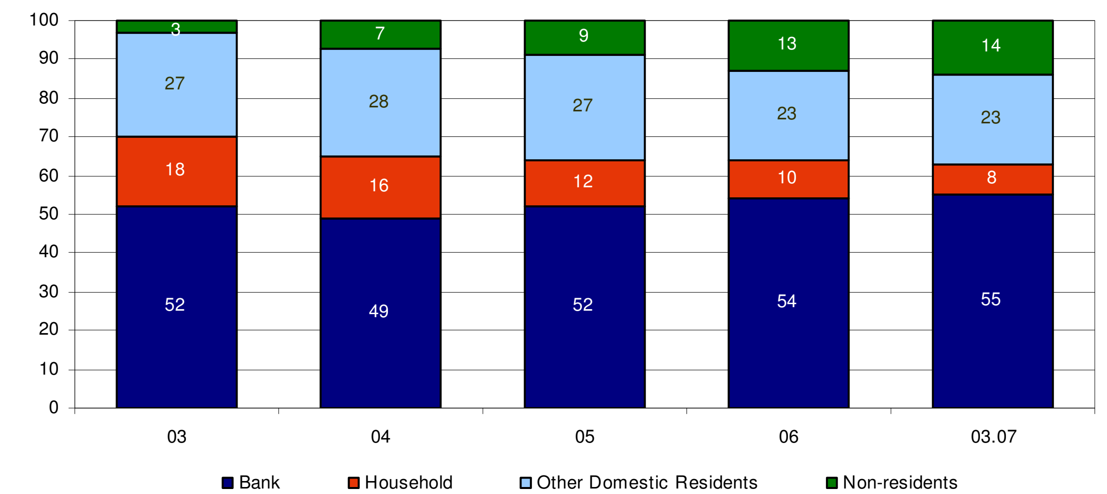


Source: Treasury
(1) Calculation is based on term to maturity.

Regarding the composition of domestic debt stock, during 2005-2006 the share of debt stock, which is sensitive to the foreign exchange rate (FX denominated and FX indexed) declined and this trend also continued in March 2007. On the other hand, the fact that the weight of floating-rate government domestic debt securities (GDDS) in domestic debt stock prevails indicates that Treasury continues to be vulnerable to interest rate risk as of March 2007 (ChartI.3.3). However, this vulnerability is expected to decline as the Treasury gives more weight to inflation-indexed bonds, which were first issued in February 2007.

The average maturity of GDDS increased to 24.9 months as of March 2007. In the period between December 2006-March 2007, the term to maturity of New Turkish Lira denominated floating rate instruments, which account for the majority of domestic debt stock, decreased, whereas the term to maturity of both New Turkish Lira denominated fixed rate instruments and FX denominated instruments increased (Chart I.3.4).

Chart I.3.5. Government Debt Securities by Holders (%)[1,2,3]



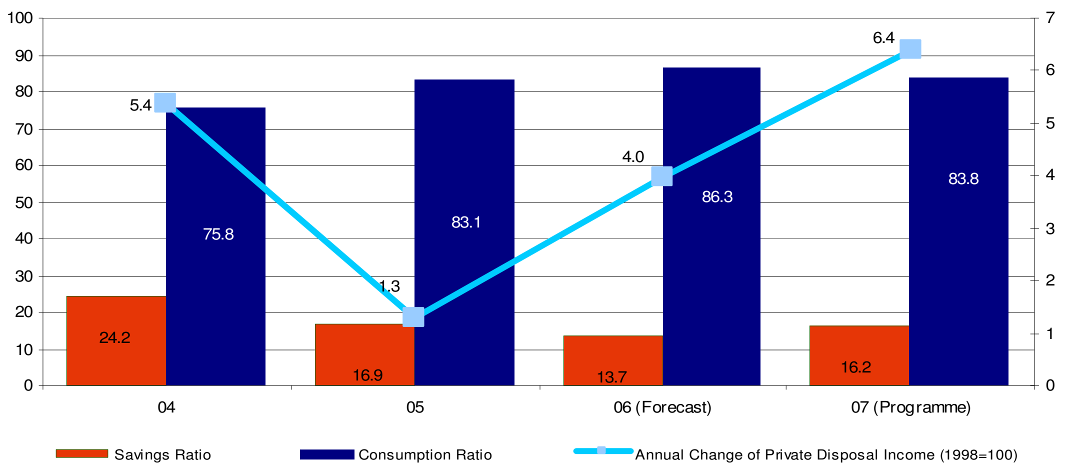
Source: BRSA-CBRT
(1) Based on nominal amounts.
(2) "Bank" includes GDDS owned by banks operating in Turkey; "Household" includes GDDS that belong to real persons kept at domestic banks; "Other domestic residents" includes GDDS of domestic legal persons except banks and households and also GDDS of mutual funds kept at banks and "Non-residents" involves non-resident real and legal persons' GDDS kept at domestic banks.
(3) GDDS owned by the Central Bank are excluded.

A large part of the total GDDS are owned by banks operating in Turkey, and thus these securities constitute a major part of the assets of the banking sector. In March 2007, the share of the government securities owned by non-residents reached to 14 percent, partially due to the exemption of foreign investors from withholding tax as of July 2006 (Chart I.3.5).

I.4. Private Sector Developments

Monetary tightening, which has been implemented to cope with the unfavorable effects of financial fluctuations experienced in financial markets in the May-June 2006 period, caused domestic demand to decrease as expected and the growth rate of private final consumption expenditures slowed down in 2006.

Chart I.4.1. Private Sector's Consumption and Savings Ratios and Real Disposable Income (%)[1,2,3]



Source: SPO
(1) Private sector's consumption and savings ratio is in current prices, private sector's disposable Income is calculated using CPI (1998=100).
(2) Savings Ratio = Total Private Savings / Total Disposable Income
(3) Consumption Ratio = Total Private Consumption/ Total Disposable Income

According to the 2007 programme, it is expected that the growth rate of disposable income, which was 4 percent in 2006 in real terms, will be 6.4 percent in 2007. The increasing share of private sector consumption in disposable income since 2004 is estimated to decrease to 83.8 percent in 2007 (Chart 1.4.1).

Table I.4.1. Private Consumption Expenditures (Annual Change, %)

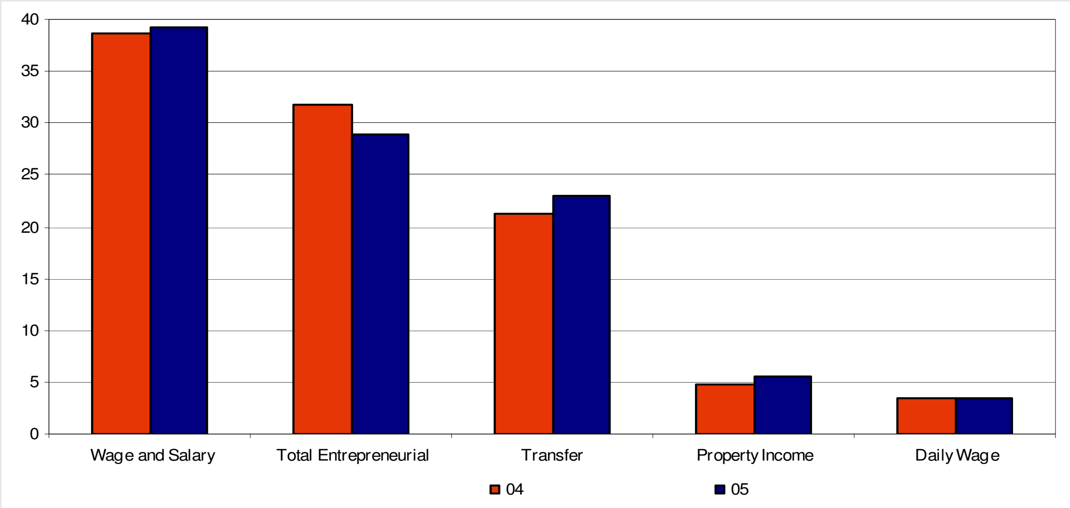
	01	02	03	04	05	06
Private Consumption Expenditures	-9.2	2.1	6.6	10.1	8.8	5.2
Durable Goods	-30.4	2.1	24.0	29.7	15.0	2.9
Services	-9.3	8.5	7.5	9.3	7.8	5.0
Food and Beverages	-3.6	1.1	4.1	2.8	8.2	3.1
Semi-Durable and Non-Durable Goods	-9.0	3.0	2.1	18.8	12.9	15.8

Source: TURSTAT

As a result of the decreased domestic demand due to the tight monetary policy implemented since June 2006, the growth rate of durable goods, services and food consumption decreased, compared to the end of the previous year. On the other hand, the growth rate of semi- durable and non-durable goods consumption increased (Table I.4.1).

I.4.1. Household

Box I.4.1.1. Distribution of the Annual Household Disposable Income (%)



Source: TURSTAT, 2005 Household Budget Survey

Household disposable income is defined as the sum of the total real payments to production factors (wage, interest, income, rent) and one-sided transfers from the Government, private entrepreneurs or the external sector (except retained earnings) minus indirect taxes and one-sided transfers of households to the Government (Pension Fund and Social Security Institution cutoff etc.).

In 2005, the share of the wage and salary and daily wage income in disposable income did not change dramatically and was realized as 42.5 percent. However, the share of entrepreneur[1] income decreased by 3 points and stood at 28.8. Furthermore, unrequited one-sided transfers from the Government, private entrepreneuers and from abroad rose by about 2 points and increased to 23 percent. Additionally, rental income from real estate and property income from securities increased by 0.8 points and was realized as 5.6 percent.

[1] Composed of individuals working for their own account or as employers in agriculture, manufacturing, construction trade and service sectors.

Table I.4.1.1. Household Disposable Income, Indebtedness and Interest Payments (Million YTL)[1,2,3]

	03	04	05	06
Household Interest Payments	3,983	7,245	10,264	12,175
Household Debt	13,442	28,259	49,979	73,656
Household Disposable Income	180,305	218,752	255,640	289,743
Interest Payments / Disposable Income (%)	2.2	3.3	4.0	4.2
Debt / Disposable Income (%)	7.5	12.9	19.6	25.4

Source: BRSA-CBRT, TURKSTAT
(1) Household debt consists of gross consumer credits and credit card balances extended by banks (excluding participation banks for 2003 and 2004) and consumer finance companies.
(2) Household disposable income for 2006 is calculated by using, private sector disposable income for 2005 and private sector disposable income estimation for 2006, under the assumption that the 2005 ratio of household disposable income to private sector disposable income has not changed.
(3) Household Interest Payments include interest and profit-loss sharing contribution paid to banks (excluding Participation Banks in 2003 and 2004) and consumer finance companies.

The household indebtness ratio continued to rise in 2006. Moreover, the ratio of household interest payments to disposable income displayed a limited rise and was realized as 4.2 percent as of year-end 2006 (Table I.4.1.1). The reason for the limited increase in interest payments is mostly due to fixed rate consumer loans.

Box I.4.1.2. Reference Indexes for Mortgage and Variable Interest Rate Housing Credit Agreements

With “Law No: 5582 Amending the Laws Related to Housing Finance”, which was published in the Official Gazette, dated March 6, 2007, the Mortgage system, also known by the public as the “system that will enable the purchase of a house in the same way as renting”, became valid. The main characteristic of this regulation is that it gives longer maturity funding opportunities to banks and other authorized entities by issuing mortgage securities.

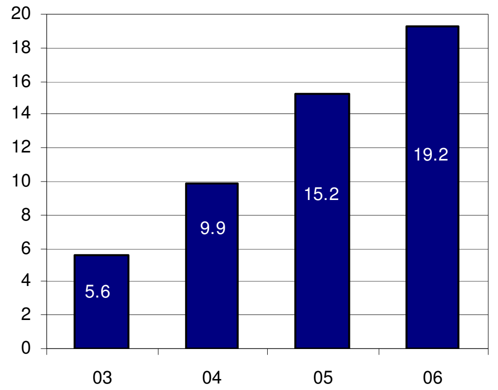
With this law, house financing is defined as “extending credit to consumers with the aim of purchasing houses, renting houses via financial leasing and extending credits secured with real estate”. Unless any application is made to the contrary by June 6, 2007, all housing credits, which were used before the enactment of the law, will be governed by this law. In this framework, credits that are used for refinancing purposes will also be covered by the house financing system. Credit costs were decreased by the exemption of credits covered by this Law from Banking and Insurance Transactions Tax (BITT). Furthermore, fixed rate credit users might be charged a penalty of a maximum of 2 percent in case of early full repayment.

This Law also specifies that variable rate credits along with fixed rate can be extended to consumers and reference interest rates and indexes to be used in variable interest rate housing credit contracts will be determined by the CBRT.

In this framework, the Consumer Price Index (CPI), announced by TURKSTAT, was determined as the reference index for variable interest rate housing credit contracts. This Central Bank Communique was published in the Official Gazette No:26513 dated May 5, 2007 and will become operative from June 1, 2007. According to this Communique, when variable interest rate contracts are initially set or interest rate modifications are made at periods indicated in the contracts, the annual change in the CPI which is published by TURKSTAT two months prior to that, shall be used.

As it is known, the interest rate for fixed rate housing credits does not change during the term and consumers are not influenced by any changes. On the other hand, there could be upward and downward movements in the interest rates of variable rate housing credits during the term due to the movement of the CPI and the installment payments of debtors may change accordingly.

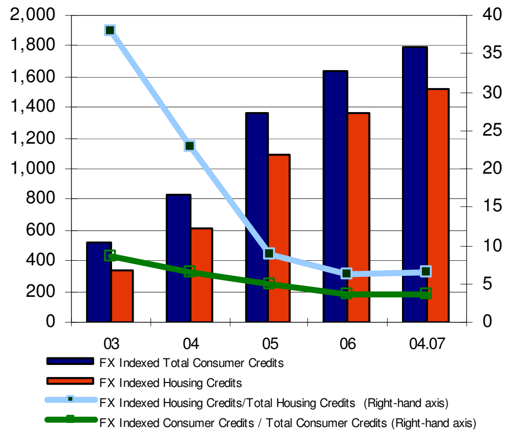
Chart I.4.1.1. Retail Loans to Private Final Consumption Expenditures[1] (%, Share)



Source: CBRT, TURKSTAT

(1) Retail loans are composed of gross consumer credits and credit card balances extended by banks (excluding participation banks for 2003 and 2004) and consumer finance companies to real persons.

Chart I.4.1.2. FX Denominated Total Consumer Credits and FX Denominated Housing Credits (Million YTL, %)



Source: CBRT

Ratio of retail loans to private final consumption expenditures kept increasing in 2006 (Chart I.4.1.1).

While FX indexed consumer loans maintain their increase, their share in total consumer loans stands at its lowest level (Chart I.4.1.2).

Table I.4.1.2. Number of Non-Performing Consumer Loans and Credit Card Holders[1]

	2005	03.06	2006	03.07
Non-Performing Credit Card Holders	148,117	82,017	211,565	74,316
Non-Performing Consumer Loans	15,127	6,895	25,806	12,649

Source: CBRT

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

The upsurge in household indebtness caused the number of defaults to increase (Table 1.4.1.2).

Table I.4.1.3. Composition of Household Financial Assets (Billion YTL)[1,2]

	2004	2005	2006	04.07
YTL Deposits	63.5	90.4	113.6	122.1
FX Deposits	61.3	59.8	75.0	81.7
FX Deposits (Billion USD)	45.3	44.5	53.4	60.0
Currency in Circulation	12.4	18.3	24.7	21.9
Domestic Debt+Eurobond	39.1	32.6	28.2	24.8
Stocks	12.3	15.7	15.8	15.0
Repos	1.6	1.5	2.0	2.0
Private Pension Funds	0.3	1.2	2.9	3.3
Total Assets	190.5	219.5	262.3	270.8

Source: CBRT, CMB

(1) YTL and FX deposits include participation funds

(2) Figures for April 2007 are provisional.

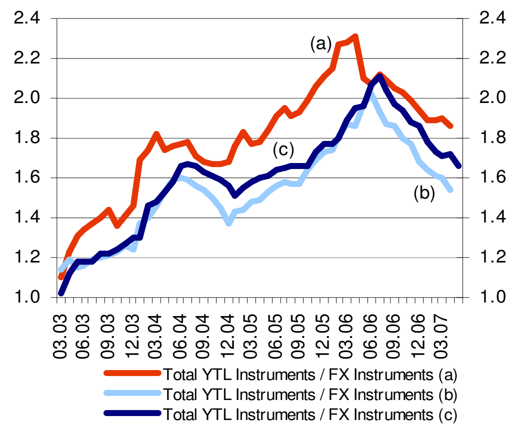
Household financial assets increased by 19.5 percent compared to the previous year-end and was realized as 262.3 billion New Turkish liras by year-end 2006. The aforementioned increase has been maintained in 2007. As of April 2007, 75.3 percent of household financial assets is composed of deposits and 9.2 percent is composed of government domestic debt securities and Eurobonds (Table I.4.1.3).

Household FX deposits, which have displayed a decreasing trend since 2005, tended to increase by the year 2006. This rise in 2006 particularly started in July and it is thought that this tendency is due to savers' changing risk perceptions.

Another important development in household financial assets is the decrease in the GDDS and Eurobond portfolio since 2004. After the financial fluctuations of the May-June period in 2006, the tendency of households to invest in FX deposits rather than investing in GDDS is thought to be effective in the observed decrease.

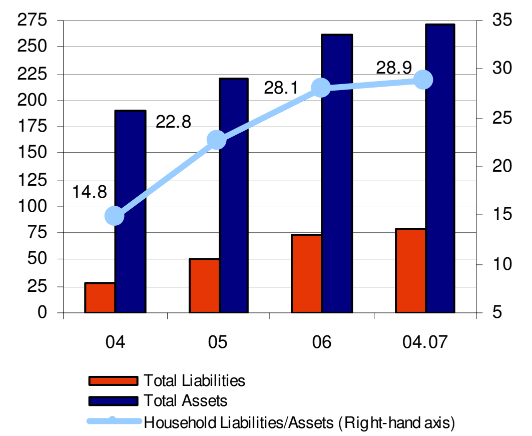
Despite its low level in household financial assets, the most remarkable development is the high increase in pension funds. Total amount of pension funds, which was 1.2 billion New Turkish liras as of 2005, increased by 142 percent and was realized as 2.9 billion New Turkish liras by year-end 2006. This interest in the private pension fund system is expected to create a positive impact on the economy in the long run.

Chart I.4.1.3. Ratio of YTL-FX Denominated Investment Instruments of Households[1]



Source: BRSA-CBRT, CMB
(1) YTL Instruments = Deposits + Repos + Gov. Dom. Debt Sec. + Participation Funds (YTL) + Stocks + Private Pension Funds;
FX Instruments = FX Deposits + Gov. Dom. Debt Sec. + Eurobond + Participation Funds (FX),
(a) Current YTL value of FX deposits and Participation Funds (FX).
(b) For FX deposits and Participation Funds (FX), exchange rate prevailing on 31.12.2002 is used.
(c) For FX deposits and Participation Funds (FX), exchange rate prevailing on 31.12.2002 is used and the parity effect is eliminated.

Chart I.4.1.4. Households' Financial Assets and Liabilities (Billion YTL, %)[1,2,3]



Source: BRSA-CBRT, CMB
(1) Household Assets= Savings Deposit+FX Deposit+Money in Circulation+ Gov. Dom. Debt Sec. + Eurobond +Repos +Stocks +Pension Funds
Household's Liabilities consists of gross consumer credits and credit card balances extended by banks (excluding participation banks for 2003 and 2004) and consumer finance companies.
(2) Figures for April 2007 are provisional.
(3) For April 2007, December 2007 data of participation banks is used.

Parallel to the changes in the risk perceptions of savers, YTL and FX distribution of the households' financial instruments recently changed in favor of FX (Chart I.4.1.3).

The ratio of household liabilities to financial assets has increased rapidly in recent years due to the increase in retail loans. This ratio was 22.8 percent at year-end 2005 and although a slowdown took place in the growth rate of retail loans since the second half of 2006, the said ratio increased to 28.1 percent as of 2006 (Chart I.4.1.4).

In conclusion, the repayment and consumption capacity of households should be monitored closely due to the rise in household indebtness and the increasing tendency to finance consumption expenditures with credits. Moreover, while the ratio of the FX indexed household debt to total consumer credits remains steady, it is thought that holding FX debt without FX income causes exchange rate risk and it is necessary for households to avoid it.

Box I.4.1.3. Housing Credits and Income Distribution

Parallel to economic developments in recent years, the increased demand for real estate has caused movement in the housing market and an increase in housing credits. Moreover, with new regulations, banks and other authorised entities are allowed to issue marketable securities in return for housing credits, and thus their funding opportunities are enhanced via the secondary market. However, housing credit demand will be the determining factor here. The household housing credit demand, on the other hand, depends on current disposable income, future income expectations, interest rates on housing credits, interest rate alternatives (variable – fixed rate), the maturity structure of the credit and real estate prices. In this framework, the following analysis was made with the aim of analyzing households' credit borrowing capacity.

Table 1. Housing Credits and Minimum Disposable Income (2006)

Average Amount of Housing Credits	47 Thousand YTL
Average Maturity	70 Months
Interest Rate (Monthly)	1.5 %
Yearly Payment Amount[1]	13 Thousand YTL

Source, CBRT, BRSA
(1) Commision, fees and taxes are not included.

According to recent data, the average maturity of housing credits is six years, the monthly interest rate is 1.5 percent and the average amount is 47 thousand New Turkish liras. The annual payment of these credits amounts to 13 thousand New Turkish liras, excluding commissions, fees and taxes (Table 1). With a prudential approach, based on the assumption that households will spend 30 percent of their annual income on housing credit payments, it is calculated that consumers have to earn an annual income of 43.5 thousand New Turkish liras to utilize such a credit.

Table 2. Household Disposable Income[1] (YTL)

Household Groups (by 10 % groups)	Income Distribution (%)	Disposable Income (Thousand)	Average Disposable Income Per Household	
	2005	2005	2005	2006
1	2.2	5,588,983	3,185	3,518
2	3.9	9,878,838	5,629	6,219
3	5.0	12,729,005	7,253	8,013
4	6.1	15,588,980	8,883	9,813
5	7.3	18,577,358	10,586	11,694
6	8.6	21,901,753	12,480	13,787
7	10.2	26,092,702	14,868	16,425
8	12.4	31,687,149	18,056	19,947
9	15.8	40,352,624	22,994	25,401
10	28.7	73,242,359	41,736	**46,105**
Total 100 %	**100**	**255,639,751**		

Source: TURSTAT, SPO, CBRT, CMB
(1) Household disposable income for 2006 is calculated by using, private sector disposable income for 2005 and private sector disposable income estimation of the 2006 Programme, under the assumption that the 2005 ratio of household disposable income to private sector disposable income has not changed. Moreover, it is assumed that the rise in the speed of increase of the number of households in 2006 will be the same as in 2005 (2.6 percent) and the income distribution of 2005 will remain the same.

According to the latest income distribution data, it is seen that only the first 10 percent of households, those which take the biggest share from the income distribution shall be able to use the aforementioned credit (Table 2). According to different maturities and interest rates, yearly payments and the required yearly income for these payments are calculated for a housing credit of 50 thousand New Turkish liras and shown below.

Table 3. Yearly Housing Credit Payments and Minimum Required Disposable Income[1,2] (YTL)

Monthly Interest Rate	0.5%		0.75%		1%		1.5%	
Maturity	Yearly Payment	Yearly Income	Yearly Payment	Yearly Income	Yearly Payment	Yearly Income	Yearly Payment	Yearly Income
10 Years	6,661	22,182	7,601	22,310	8,608	28,665	10,811	36,002
20 Years	4,299	14,314	5,398	17,977	6,607	22,000	9,260	30,835
30 Years	3,597	11,979	4,828	16,076	6,172	20,552	9,043	30,112

(1) Calculated according to a 50.000 YTL housing credit and non-interest costs are not taken into consideration.
(2) It is assumed that households can set aside maximum 30 percent of their income for housing credit payments.

In the table below, those income groups, which can use a 50 thousand New Turkish lira housing credit according to various maturities and interest rates and in line with the current income distribution, are shown with the (√) sign (Table 4).

Table 4. Housing Credit Usage Capacity by Income Deciles[1,2] (YTL)

	Monthly Interest Rate	0.5%	0.75%	1%	1.5%
5th highest 10 %	10 Years				
	20 Years				
	30 Years	√			
4th highest 10 %	10 Years				
	20 Years	√			
	30 Years	√	√		
3rd highest 10 %	10 Years				
	20 Years	√	√		
	30 Years	√	√		
2nd highest 10 %	10 Years	√	√		
	20 Years	√	√	√	
	30 Years	√	√	√	
1st highest 10 %	10 Years	√	√	√	√
	20 Years	√	√	√	√
	30 Years	√	√	√	√

(1) Calculated according to a 50.000 YTL housing credit and non-interest costs are not taken into consideration.
(2) It is assumed that households can set aside maximum 30 percent of their income for housing credit payments.

When the payment capacity of households related to housing credits for various interest rates and maturities is analyzed, the number of households who can use housing credits is 1.8 million, under prevailing conditions as of 2006. If interest rates diminish to 0.5 percent monthly and the maturity extends to 30 years, the figure in question can increase to 9 million (Table 3).

I.4.2. Corporate Sector

In this section, the financial analysis of companies listed on the Istanbul Stock Exchange (ISE) and the foreign exchange positions of non-banking sector are examined.

I.4.2.1. Financial Analysis of Companies

As it is known, the most comprehensive data set concerning the corporate sector is Company Accounts, which is published by the Bank and used in our former reports. However, since this data set is published once a year, it becomes necessary to find an alternative and to update the data set to use in the financial analysis of the corporate sector. Therefore, in this volume of the report, the financial statements of 190[2] companies, which have been continuously traded on the ISE between 2004-2006 and can be consolidated, but which are not financial entities or are not a subsidiary of any financial entity, are analyzed. Of these 190 companies, 148 are manufacturing companies.

However, companies listed on the ISE are large companies, which have high export opportunities and many funding alternatives other than banking credits, such as capital markets and their shareholders equity is relatively stronger. Therefore, it should be taken into consideration that these companies' financial indicators can differ from the indicators of the whole corporate sector. Moreover, when the data of companies listed on the ISE is distributed according to subsectors, it should be noted that some concentrations occur within specific sectors and thus sectoral advantages/disadvantages may be reflected in the ratios.

Table I.4.2.1.1. Financial Ratios of Selected ISE Companies (%)

	All Companies			Manufacturing Industry Companies		
	2004	2005	2006	2004	2005	2006
Selected Financial Structure Ratios						
Leverage Ratio	44.9	46.5	49.0	41.7	44.6	48.2
Equity[1]/Total Assets	52.0	50.6	48.4	55.9	53.2	49.8
Equity[1]/Total Debt	116.0	108.9	98.7	134.1	119.1	103.2
Short -Term Liabilities /Total Assets	29.4	29.9	31.5	29.9	30.8	32.7
Long -Term Liabilities /Total Assets	15.4	16.6	17.5	11.8	13.8	15.5
Financial Debts / Total Liabilities	29.5	33.1	33.0	31.7	34.7	37.9
Profitability Ratios						
Net Income / Equity (ROE)	8.9	10.8	13.9	7.8	9.4	13.5
Net Income / Total Assets (ROA)	4.7	5.5	6.7	4.4	5.0	6.7
Liquidity Ratios						
Current Ratio	148.1	145.2	145.5	158.1	153.7	149.9
Cash Ratio	40.7	35.4	35.7	36.3	27.8	26.3
Short-term Receivables / Total Assets	12.4	14.3	14.8	14.5	17.1	17.7

Source : ISE
(1) "Minority Interests" of the companies which prepare consolidated financial tables according to the full consolidation method are not included in equity.

Similar to the previous year, the share of equity on the balance sheet decreased and debt utilization to finance production increased as of 2006. As a matter of fact, the leverage ratios of all the examined corporations increased at the end of 2005. A similar tendency exists for manufacturing industry companies (Table I.4.2.1.1). On the other hand in 2006, the ratio of equity to total assets is still larger than the leverage ratio, indicating a high repayment capacity.

In 2006, total net income of all the companies examined increased by 44.9 compared to the previous year. On the other hand, while 124 companies, which declared profits in 2005, constituted 84.3 percent of total assets of the companies examined, the number of companies declaring a profit decreased to 119, but they gained 90 percent of the total assets in 2006.

The profitability ratios of those companies examined improved and their return on equity (ROE) increased to 13.9 percent in 2006. A similar tendency exits for manufacturing companies. Moreover, an important increase was observed in the return on assets (ROA) and it was realized as 6.7 percent for both groups in 2006 (Table I.4.2.1.1).

[2] Different from the Section I.4.2.2.2 on FX position of the Companies listed on the ISE, since 3 companies do not have data for 2004, the analysis is made using the data of 190 companies.

As a liquidity indicator, while the current ratio showed a limited increase for all companies analyzed in 2006, it diminished for manufacturing companies. However, the relatively high current ratios of both the “all sectors” and the manufacturing industry sector suggest that liquidity risks are manageable and companies are in a good financial position to meet their short-term obligations even in case of a sudden halt in access to credit. The cash ratio, which shows how efficiently companies use their working capital, decreased to 26.3 percent for manufacturing companies in 2006 due to the fall in the marketable securities of these companies since 2004, in contrast to all companies examined (Table I.4.2.1.1).

I.4.2.2. Foreign Exchange Position of the Corporate Sector

Foreign exchange positions of companies cannot be calculated by using their balance sheets, since financial statements are prepared in terms of Turkish currency, without any distinction regarding currency composition. However, in order to get a general idea of the exchange rate risk of companies, the foreign exchange position of the sector, which excludes households and banks, may be approximately calculated by using data compiled from balance of payments statistics and various statistical reports sent to the CBRT, the database of the Treasury, and “Locational Banking Statistics” published by the Bank for International Settlements (BIS). On the other hand, FX positions of non-financial companies whose stocks are traded on the ISE are calculated by using footnotes of their disclosed financial statements. In that respect, the FX risks of those companies which constitute an important part of the sector and their credit risk for banks stemming from cash loans are examined. Analyses and assessments regarding the FX risk of the corporate sector are based on a macro perspective. For this reason, considering that some companies have a short position while others have a long position, it should be noted that corporate sector vulnerability to exchange rate risk should be evaluated on a company basis.

I.4.2.2.1. Foreign Exchange Position of the Non-Banking Sector

Table I.4.2.2.1.1. FX Assets and Liabilities of the Sector Except Households and Banks (Million USD)

	12.05	03.06	06.06	09.06	12.06	Change Jun.06-2005 (%)	Change 2005-2006 (%)
ASSETS	49,633	52,977	53,946	57,563	67,101	24.4	35.2
A. Deposits	34,170	37,115	37,598	41,303	49,322	31.2	44.3
-Domestic Banks (1)	15,916	17,929	17,486	18,656	22,626	29.4	42.2
-Foreign Banks	18,254	19,186	20,112	22,647	26,696	32.7	46.2
B. Securities	1,686	1,661	1,536	1,576	1,747	13.7	3.6
- Domestic Issuance	261	268	168	207	225	33.9	-13.8
-Foreign Issuance	1,425	1,393	1,368	1,369	1,522	11.3	6.8
C. Export Receivables	6,721	7,092	7,688	7,454	8,575	11.5	27.6
D. Foreign Direct Invest. To Abroad	7,056	7,109	7,124	7,230	7,457	4.7	5.7
LIABILITIES	77,074	87,405	95,747	98,109	104,125	8.8	35.1
A. Cash Loans	60,794	71,887	78,142	80,936	85,904	9.9	41.3
-Domestic (1,2)	21,581	22,743	25,068	24,766	25,677	2.4	19.0
-Foreign	39,213	49,144	53,074	56,170	60,227	13.5	53.6
Medium and Long-term	38,025	47,912	51,801	54,748	58,831	13.6	54.7
B. Import Payables	10,674	10,951	12,913	12,859	13,028	0.9	22.1
C. Protocolized Receivables of SDIF	5,606	4,567	4,692	4,314	5,193	10.7	-7.4
NET POSITION	-27,441	-34,428	-41,801	-40,546	-37,024	-11.4	34.9

Source: BRSA-CBRT, Treasury, SDIF, BIS
(1) Participation funds and funds-extended by participation banks are included.
(2) FX indexed loans are included.

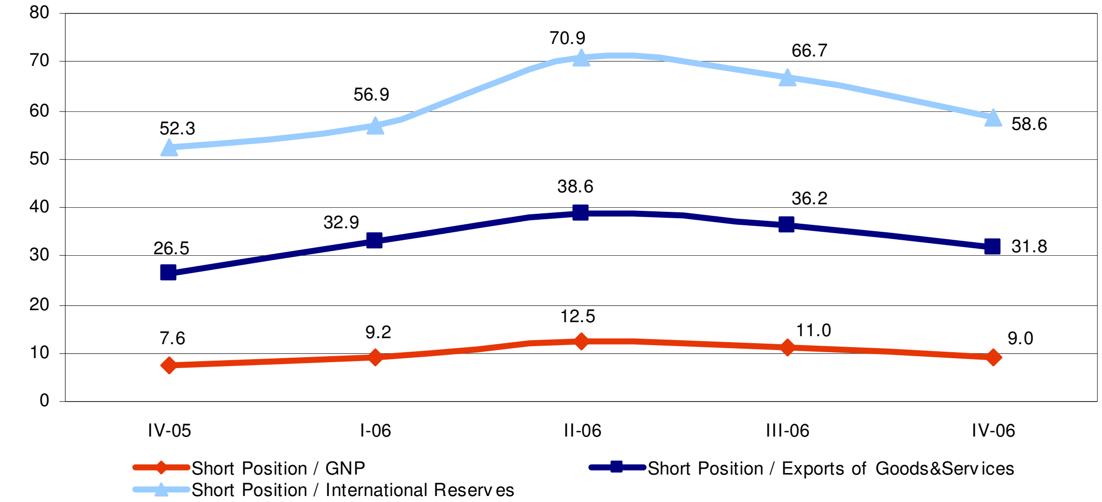
Box I.4.2.2.1.1. Foreign Exchange Position Data of the Non-Banking Sector

Data on the FX Assets and Liabilities of the Non-Banking Sector table is different from the previous report due to the update of data. There may be important changes in the “due from foreign banks” account especially due to the fact that especially the data compiled from the Locational Banking Statistics prepared by the BIS is published with a 6-month lag. In fact, the net short position of September 2006, which was 43 billion USD in the previous report, is calculated as 40.5 billion USD in this volume of the report.

On the other hand, the “due from foreign banks” data is provisional as of December 2006, as the data for the fourth quarter of 2006 was published by the BIS in April 2007 and will be finalized in June 2007.

The net short position of the non-banking sector increased by 35 percent and was realized as 37 billion USD by year-end 2006, compared to year-end 2005. By June, the net short position reached its maximum level for 2006, however following the fluctuations in May, it tended to decrease in the second half of the year due to the higher increase in FX assets (especially deposits) compared to the increase in liabilities (Table I.4.2.2.1.1).

Chart I.4.2.2.1.1. Ratios Related to FX Position of the Sector Except Households and Banks (%)[1,2]



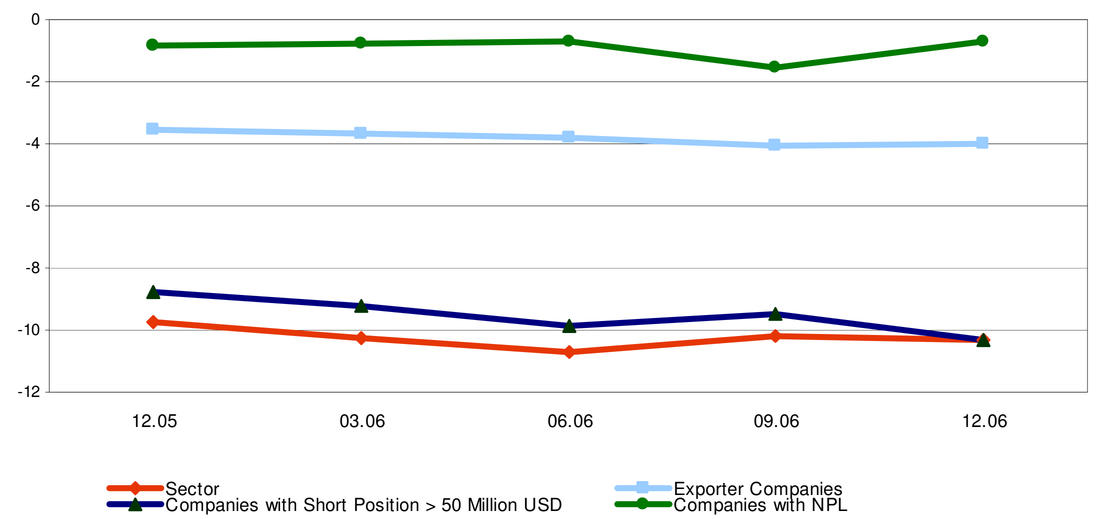
Source: BRSA-CBRT, TURKSTAT, Treasury, SDIF, BIS
(1) GNP and exports of goods & services are computed on a yearly basis. International reserves are outstanding amounts at the end of period.
(2) International reserves are gross foreign exchange reserves of CBRT (including gold).

The rapid increases in the ratios of the non-banking sector's short position to GNP, exports and international reserves in the first half of 2006, started to display a declining trend in the second half of the year in connection with the decline in net short position (Chart I.4.2.2.1.1).

I.4.2.2.2. Foreign Exchange Position of the Companies Listed on the ISE

In this section, the FX positions and bank loans of non-financial companies listed on the ISE are examined. In the analyses, of the companies whose financial statements are published by the ISE as of 2006, 193 companies that disclose their FX positions in footnotes to the balance sheet and that have no financial institutions in their consolidated financial statements are taken into consideration.

Chart I.4.2.2.2.1. FX Position of ISE Companies (Billion USD)[1]



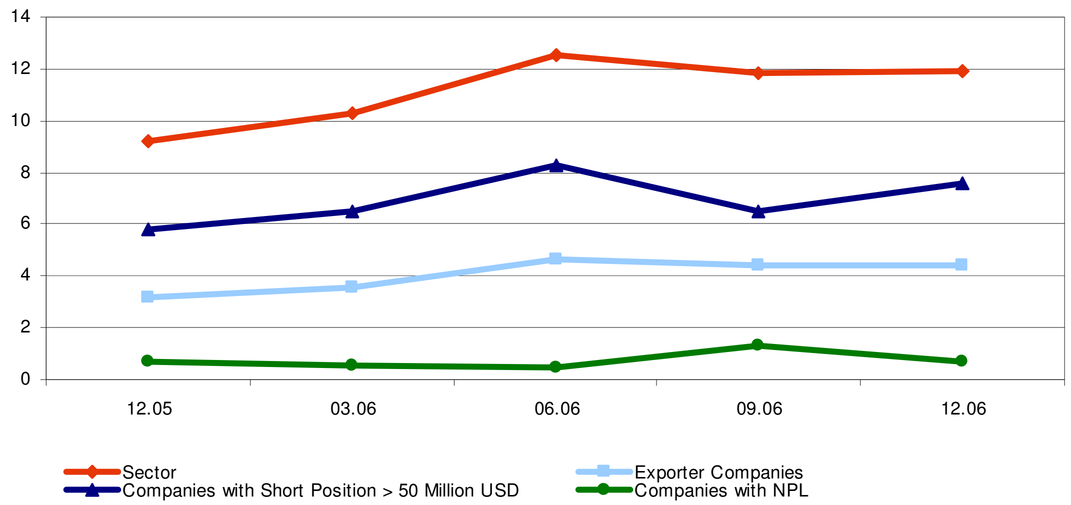
Source: ISE
(1) As of December 2006, companies for which the share of exports in gross sales is equal or greater than 30 percent, are considered exporter companies.

The short position of the companies examined, which was 9.7 billion USD as of 2005, increased in the first half of 2006 and was realized as 10.7 billion USD by June, decreasing to

10.3 billion USD by December. Of this short position, 99 percent is held by 39 companies whose short position is more than 50 million USD. Furthermore, 128 non-exporting companies constitute 61 percent of the total short position and their short position is 6.3 million USD (Chart I.4.2.2.2.1).

On the other hand, of the 193 companies analyzed, 130 have a short position equivalent to 11.7 billion USD and the remaining 63 companies have a long position of 1.4 billion USD as of year-end 2006. The number of companies, which have a short position, decreased by 13 in June 2006 and 10 of these are non-exporting companies.

Chart I.4.2.2.2.2. Cash Loans Extended to ISE Companies (Including NPL, Billion YTL) [1]



Source: CBRT
(1) According to Risk Centre records, the cash loans are the loans which are extended directly by domestic banks or extended by foreign banks with guarantee or through intermediation of domestic banks.

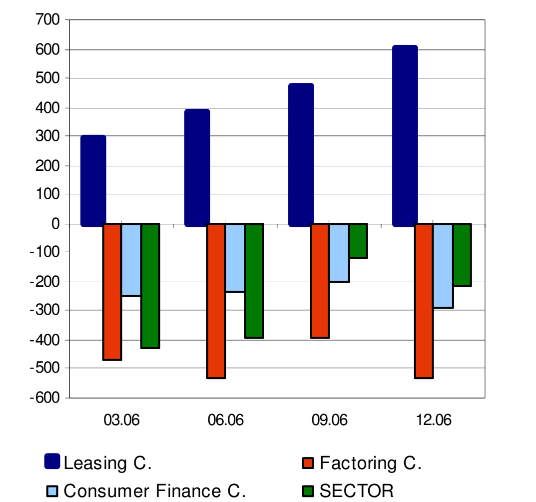
In the analyses, the increase observed in loans in the first half of 2006 was due to the depreciation of the Turkish currency. Total credits of these companies was 11.9 billion New Turkish Liras including NPLs and 17 companies were observed to have NPLs (Chart I.4.2.2.2.2).

Although companies' short positions tended to diminish after June 2006, it is essential for companies to use derivatives in order to hedge the FX risk resulting from sudden exchange rate movements and for banks to avoid credit risk by acting prudently in lending to companies which hold high short positions and do not have FX income.

I.4.2.3. Foreign Exchange Position of the Non-Banking Financial Sector

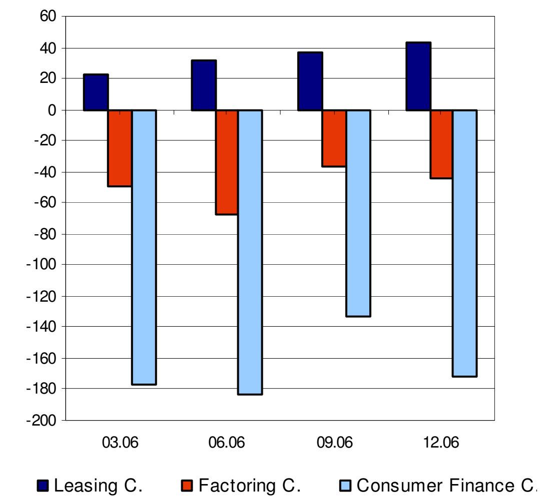
In this section, the FX on-balance sheet positions of leasing, factoring and consumer finance companies, which have a 3.3 percent share in the Turkish finance sector and maintain a close relationship to the corporate sector as well as the banking sector due to the nature of their activities, are examined.

Chart I.4.2.3.1. On-Balance Sheet FX Position of the Non-Banking Financial Sector (Million USD)



Source: BRSA

Chart I.4.2.3.2. On-Balance Sheet FX Position / Equity Ratio of the Non-Banking Financial Sector (%)



Source: BRSA

The FX on balance sheet position of the non-banking financial sector displayed a decreasing trend in 2006 and was realized as 215 million USD in December (Chart I.4.2.3.1).

The high level of FX obligations was a determining factor on the on-balance sheet short position of factoring and consumer finance companies. On the other hand, the on-balance sheet position of leasing companies has a surplus due to the fact that an important part of the leasing receivables is in FX (Chart I.4.2.3.1).

Factoring companies' FX on-balance sheet open position to equity ratio tended to decline because of the fact that the increase in equity was more than that in open position. As a result of intensive funding by debt, the on-balance sheet position to equity ratio of consumer finance companies, which have good borrowing opportunities from abroad, was realized rather high (Chart I.4.2.3.2).