I. MACROECONOMIC DEVELOPMENTS

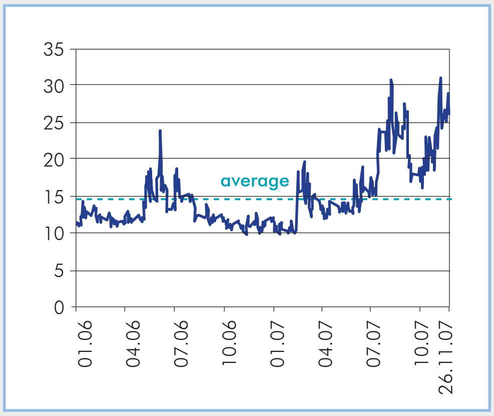
In this chapter, macroeconomic developments will be elaborated, taking into account the importance of such developments for financial stability.

I.1. External Sector

I.1.1. International Developments

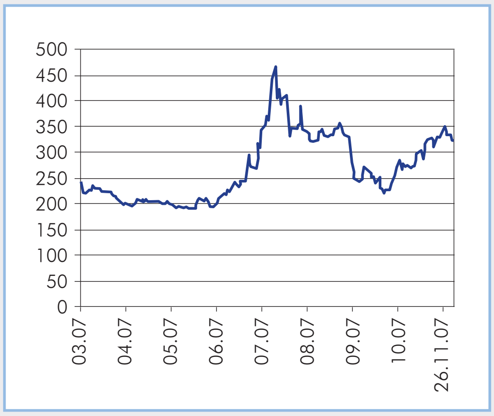
Liquidity conditions induced by the turmoil in international credit markets as well as the changes in the risk appetite of investors remain significant with respect to financial stability. Global liquidity conditions deteriorated in the second half of 2007 due to the US subprime mortgage crisis, thus compelling the FED, ECB, BoJ and BoE to provide liquidity to the market. Moreover, forecasts pointing to a limited slowdown in the US economy coupled with the rapid growth in developing countries have curbed notable changes in investors' risk aversion behavior. Developments in the debt markets of developed countries remain to be of significance with respect to their impact on developing countries like Turkey.

Chart I.1.
VIX Index



Source: Bloomberg

Chart I.2.
iTraxx Europe Crossover Index



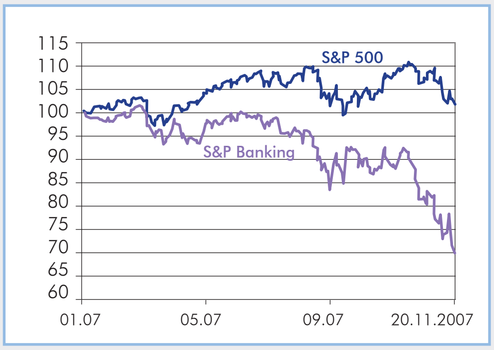
Source: Bloomberg

The rise in default rates, chiefly in US subprime mortgage loans, has led to higher pricing of risks in global credit markets since end-July 2007. This, in turn, caused a contraction in liquidity and a rise in volatility in the markets. As a consequence, the VIX Index, a widely accepted main volatility measure for the US stock market, which depends on real-time option prices and measures the implied volatility in US stock market, has risen (Chart I.1). The persisting high level of the index points to investor expectations of a continuance of current problems in the markets.

The iTraxx Europe Crossover Index, comprising of 50 of the highly traded sub-investment grade corporate bonds, which reflects investors' expectations, rose parallel to the developments in the US subprime mortgage market (Chart I.2). This rise points to an increase in the cost of insuring the bonds of European companies against default and supports opinions that the markets of developed countries have been more severely affected by this fluctuation.

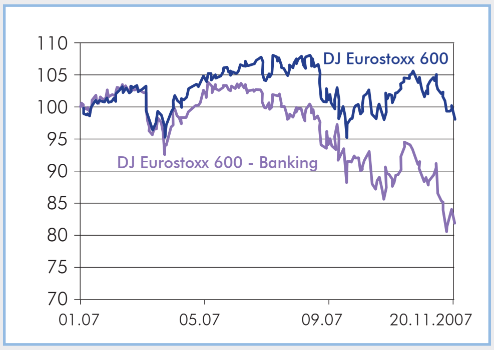
High losses experienced in the US subprime mortgage market and the amount of losses suffered by numerous funds and banks because of liquidity problems are of great importance since they indicate the extent of the cost of such unfavorable developments on developed countries. For instance, Citigroup, Merrill Lynch and UBS announced that they were facing losses of USD 8 – 11 billion, USD 8 billion and USD 3.4 billion, respectively. Meanwhile, a rescue fund of Euro 3.5 billion has been established by some public and private banks led by KfW –one of the main shareholders of IKB, a leading long-term finance company in Germany- to cover IKB's potential losses that might arise from its investments in the subprime mortgage market. Japanese Banks announced that their loss resulting from securities linked to subprime mortgage loans was USD 1 billion.

Chart I.3.
S&P Index
(01.01.2007=100)



Source: Bloomberg

Chart I.4.
DJ EUROSTOXX 600 Index
(01.01.2007=100)



Source: Bloomberg

In line with these developments, there have been sharp downward movements in US and European banks' equity prices (Chart I.3 and Chart I.4).

Box 1.
Recent Fluctuation in the US Subprime Mortgage Market

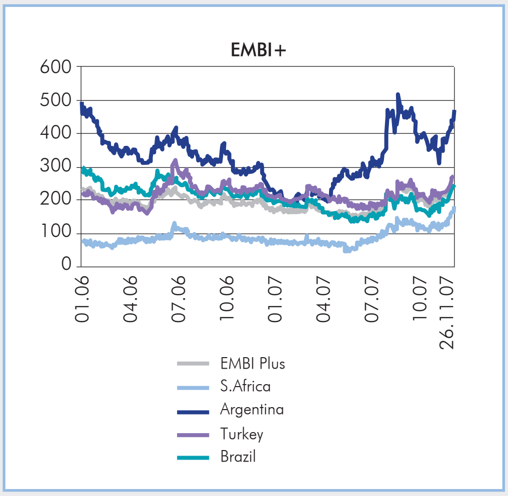
Due to the high demand for housing since the end of 1990s, there was rapid growth in housing loans between 2001-2005 in the USA, which was accompanied by low interest rates and flexible loan terms. While variable rate mortgage loans were 20 percent in 2002, they increased to 50 percent in mid-2005. The share of subprime mortgages in these loans also rose in the same period.

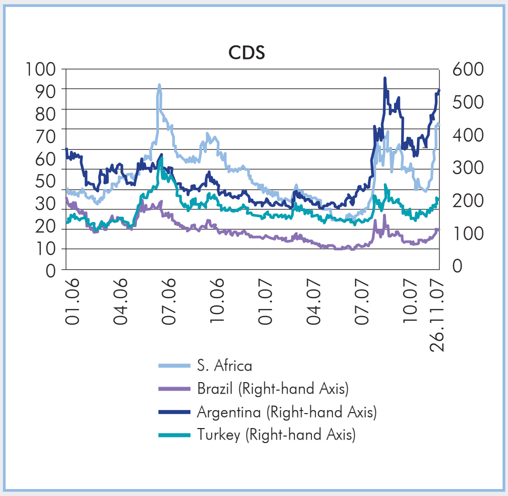
In the USA, the subprime mortgage is the type of mortgage granted to the highest risk group of borrowers. Subprime mortgage loans have a much higher rate of default risk compared to other types of loans. This risk is even higher for those customers with variable-rate subprime mortgage loans that constitute a major part of this type of loans. In order to make subprime mortgage loans with variable rates more attractive, lower interest rates are offered at the beginning of their term and interest rates rise in subsequent years. Any increase in market interest rates leads to a rise in the interest rates of these loans that borrowers already have difficulty in paying, and end up in the bankruptcy of customers.

Interest rates in the USA, which have been rising since mid-2004, led to a rise in the amount of installments that customers of subprime mortgage loans with variable interest rates had to pay. The reversal of the upward trend in house prices during the same period restricted the customers' chance of selling their properties in order to pay off their debt. These developments have led to an upsurge in the number of subprime borrowers in default in the subprime mortgage market since the second half of 2006.

As a consequence, credit rating agencies started to downgrade the credit rating of many securities backed by subprime mortgage loans as of June 2007. Due to the erosion of investor confidence, demand for all commercial papers and asset-backed securities, especially for securities backed by sub-prime mortgage loans, decreased and investors started to edge towards less-risky treasury bonds. Loss of demand triggered liquidity problems in these markets.

Chart I.5.
Risk Premia[1,2] of Selected Countries and Turkey and Development of Credit Default Swap Spreads[3]
(Basis Point)

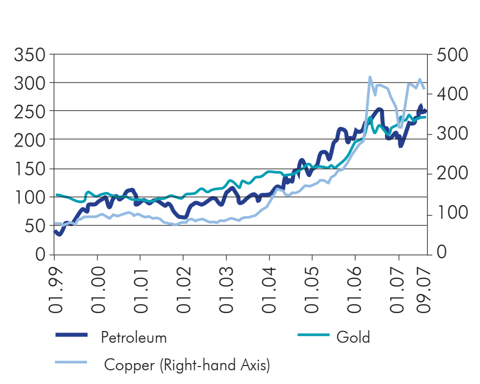




Source: Bloomberg
(1) Country risk premium is the difference between the relevant country's EMBI+ index and returns of US Treasury instruments.
(2) EMBI+ index includes Eurobonds of 18 developing countries, Brady bonds and traded loans. The weight of each country in the index is different. For instance,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

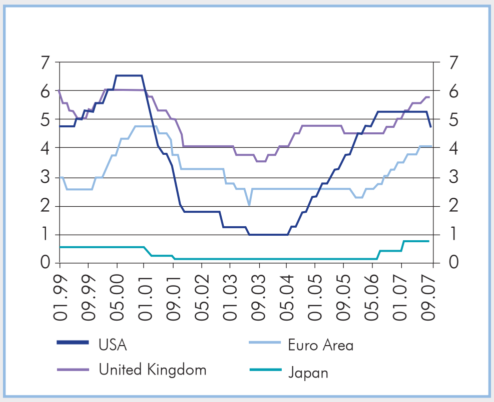
Meanwhile, the effect of the subprime mortgage crisis on developing countries remained quite limited owing to the improvement in economic fundamentals in emerging markets and the non-existence of mature subprime mortgage markets in these countries (Chart I.5).

Chart I.6.
Petroleum and Other Primary Commodities' Price Index (2000=100)



Source: IMF IFS

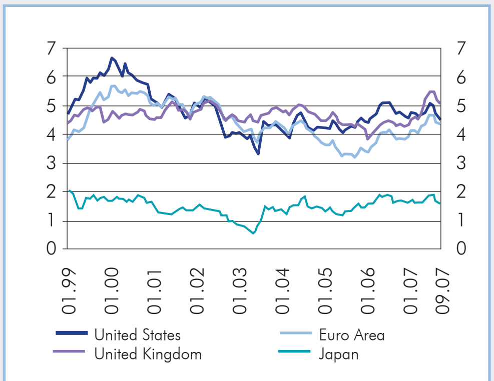
Chart I.7.
Selected Countries' Policy Interest Rates (%)



Source: ECB, Federal Reserve, BoJ, Bank of England

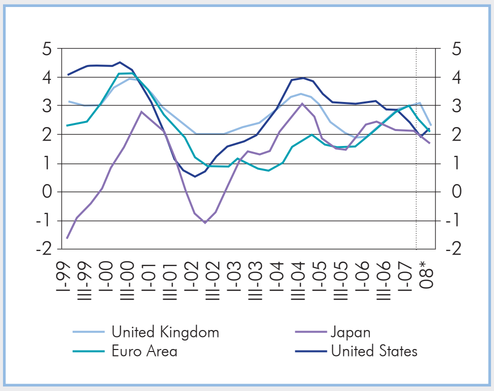
Following the turmoil in the debt markets, there has been a shift in the monetary policy implementations of developed countries. The central banks of these countries, which had tightened their monetary polices due to inflationary pressures driven by the rise in prices of primary commodities, chiefly in oil prices (Chart I.6) in the pre-turmoil period, eased their monetary policies slightly. Despite the sustained rise in the prices of these items, this development was due to the downgrading of growth expectations. The FED cut policy rates by 50 and 25 basis points in September and October, respectively (Chart I.7). Meanwhile, sustained inflationary pressure in the Euro area and inflation persisting above 2 percent are still perceived as risk factors by the ECB.

Chart I.8.
Average Government Bond Yields (10 year) (%)



Source: IMF IFS, ECB

Chart I.9.
Growth Rates of Selected Developed Countries (annualized quarterly, %)



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

An analysis of the public debt markets of developed countries reveals that the liquidity, which is leaving risky debt markets, is heading towards safe haven bond markets, pulling down interest rates (Chart I.8).

Despite concerns about the growth performance of developed countries and the downward trend of their growth forecasts, global growth in 2008 is expected to surpass the averages of previous years[1] due to sustained high growth rates in developing countries (Chart I.9).

Box 2.
Measures Taken by Central Banks

Due to the direct and indirect effects of problems in the US subprime mortgage market, volatility in global markets has increased and liquidity conditions have deteriorated. Financial institutions granting mortgage loans and institutions that have invested in securities backed by mortgage loans have called upon central banks for their liquidity needs. Therefore, with the aim of preventing these developments from growing into a systemic risk, the central banks have supplied markets with liquidity by means of open market operations, and banks in need of liquidity by means of the lender of last resort function.

The FED lowered its benchmark interest rates by 50 basis points to 4.75 percent on September 18, 2007 and to 4.50 percent on October 31, 2007 and provided the necessary liquidity for the market via large-scale open market operations. While the FED used to accept securities only backed by mortgage loans of government-sponsored entities such as Fannie Mae and Freddie Mac as collateral, the FED expanded the list of eligible collaterals on August 24, 2007 and announced that it would start accepting asset-backed securities issued by other commercial enterprises as collateral, including securities backed by subprime mortgage loans. The FED announced that in case of a liquidity squeeze in the future, it would provide liquidity for those financial enterprises in need of liquidity.

With the aim of breaking down the perception that borrowing directly from the FED is a financial weakness, on August 22, 2007, it was announced that four major banks (Citigroup, Bank of America, JP Morgan Chase & Co and Wachovia Corp), which had "substantial liquidity" and the ability to borrow funds at relatively reasonable rates, borrowed a total of USD 2 billion from the Federal Reserve's discount window.

On August 9, 2007, the ECB announced that the tension following the US subprime mortgage crisis has started to hit the money markets in the Euro area. The ECB stressed that the developments were being closely monitored and it would take the necessary measures to calm market conditions. Consequently, the ECB injected liquidity into the market via reverse repo in an amount more than planned.

The BoE continued to carry out its regular open market operations after the turmoil in the credit markets. Meanwhile, taking into account Northern Rock Bank's temporary liquidity problems, the BoE provided emergency liquidity support in an amount of GBP 25 billion for Northern Rock against collateral within the framework of the lender of last resort facility. As this loan was provided within the framework of the lender of last resort facility, it was extended for a 3-month period, maturity longer than those of regular open market operations.

To sum up, the adverse effects of the US subprime mortgage crisis were curbed by central bank interventions and no devastating effects have occurred on the markets of developed and

[1] IMF World Economic Outlook, October 2007.

developing countries. However, the problem has not yet been solved. According to the IMF's Global Financial Stability Report[2] , delinquencies tend to peak 27-30 months after origination. In this framework, some market participants estimate that default rate may rise to 20-25 percent due to new subprime delinquencies on loans extended in 2006. In case these predictions materialize, the pressure on financial stability may also continue throughout 2008 and hence, financial markets both at national and global level may suffer instability.

I.1.2. Balance of Payments

The high current account deficit, driven by the growth in investment rates, increased primary commodity prices and falling private sector savings ratios in recent years, have been mostly financed by long-term credits and foreign direct investments.

Table I.1. Balance of Payments (USD in Billions)

	2004	2005	2006	Jun.07*	Jul.07*	Agu.07*	Sep.07*
CURRENT ACCOUNT BALANCE	-15.6	-22.6	-32.9	-32.6	-33.7	-34.1	-34.4
Foreign Trade Balance	-23.9	-33.5	-41.3	-40.9	-42.3	-43.1	-43.5
Exports (f.o.b) (including gold)	67.0	76.9	91.9	102.2	103.8	105.5	106.6
Imports (f.o.b) (including gold)	-90.9	-110.1	-132.8	-143.1	-146.1	-148.6	-150.1
Rate of imports covered by exports (%)	73.7	69.9	69.2	71.4	71.1	70.9	71.0
Balance of Services	12.8	15.3	13.4	13.5	13.6	13.9	14.2
Balance of Investment Income	-5.6	-5.8	-6.6	-6.8	-6.9	-6.7	-6.9
Current Transfers	1.1	1.5	1.7	1.6	1.9	1.8	1.8
CAPITAL & FINANCIAL ACCOUNT	13.4	20.4	35.1	32.7	35.4	31.9	34.8
Foreign Direct Investments	2.0	8.9	19.0	20.3	21.7	19.0	19.8
Portfolio Investments	8.0	13.4	7.4	14.3	15.1	9.1	8.1
Other Investments	4.2	15.9	14.8	7.0	8.6	15.3	16.0
Reserve Assets	-0.8	-17.8	-6.1	-8.9	-10.1	-11.5	-9.1
NET ERRORS & OMISSIONS	2.2	2.2	-2.3	-0.1	-1.7	2.2	-0.4

Source: CBRT
(*) Cumulative figures for the last 12 months.

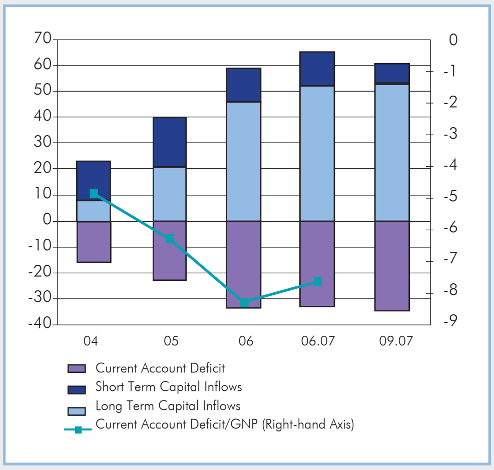
The annualized current account deficit, which had started a downward trend after a record high in November 2006, started to climb as of May 2007, and surpassed USD 33 billion once again in July. The ratio of current account deficit to GNP, which was 8.2 percent at the end of 2006, dropped below 7.6 percent by June 2007 (Table I.1., Chart I.10).

As for the foreign trade balance; exports, which exceeded USD 100 billion in May 2007, reached USD 106.6 billion in September 2007. Meanwhile, the growth in imports goes on due to continued appreciation of the New Turkish Lira, the high share of the imported input components in industrial production, and the persistent rise in energy prices. Because the growth rate of exports exceeded that of imports as of the first quarter of 2007, the ratio of imports covered by exports climbed to 71.4 percent in June and was 71 percent in September (Table I.1).

[2] IMF Global Financial Stability Report, September 2007

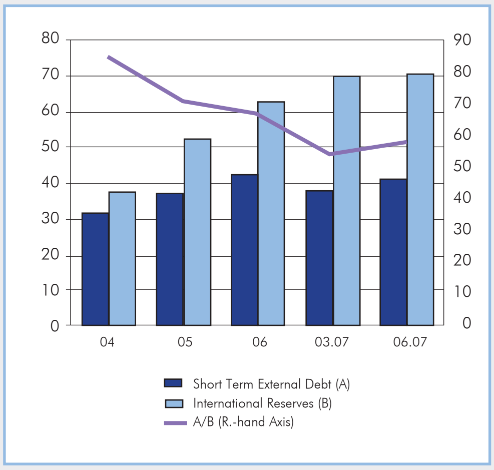
Foreign direct investments, the share of which in total financial accounts has been steadily increasing since 2002, constitutes the most important financing item of the current account deficit. While the share of portfolio investments in financial accounts decreased in August 2007 due to foreign investors' sale of securities as a result of the global turmoil, the share of "other investments" increased with the effect of long-term credits extended to banks and the private sector by banks abroad (Table I.1, Chart I.10).

Chart I.10.
Current Account Deficit and Capital Inflows[1,2] (USD in Billions, %)



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.11.
Short-Term External Debt[1] and International Reserves[2] (USD in Billions, %)



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)

The ratio of short-term debt to international reserves, one of the indicators of external debt service capacity, which was 66.9 percent at the end of 2006, dropped to 58.1 percent by June 2007 owing to the continued rise in the Central Bank's international reserves (Chart I.11).

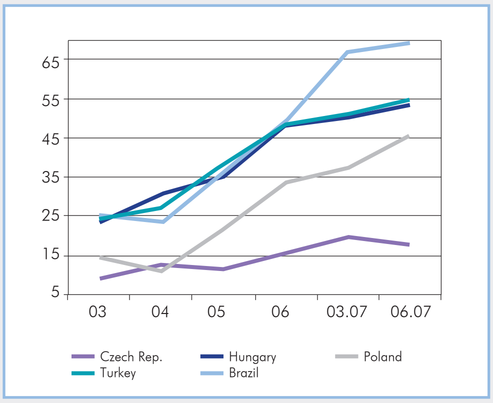
Table I.2. Parties Financing The Current Account Deficit (USD in Billions)[1]

	2004	2005	2006	Jun.07	Jul.07	Aug.07	Sep.07
Current Account Balance	-15.6	-22.6	-32.9	-32.6	-33.7	-34.1	-34.4
Finance Accounts	13.4	20.4	35.1	32.7	35.4	31.9	34.8
General Government (including CBRT and CBRT Reserves)	2.4	-16.5	-2.9	1.7	1.3	-6.6	-6.9
Private Sector (Including Banks)	11.0	36.9	38.0	31.0	34.1	38.5	41.7
Net Errors and Omissions	**2.2**	**2.2**	**-2.3**	**-0.1**	**-1.7**	**2.2**	**-0.4**

Source: CBRT
(1) Annualized data is used

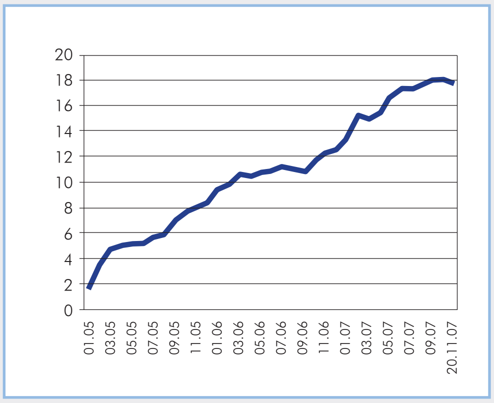
The current account deficit, as is the case in recent years, has been mostly financed by funds obtained by the private sector, including banks (Table I.2).

Chart I.12.
Net Receivables of International Banks from Selected Countries[1] (USD in Billions)



Source: BIS
(1) Figures for June 2007 are provisional.

Chart I.13.
Net YTL-Denominated Bonds Issued by Foreigners (Billion YTL)



Source: CBRT

The rise in funds extended to developing countries by banks reporting to the Bank for International Settlements (BIS), except those of the Czech Republic, has continued and net receivables of international banks from Turkey reached USD 54.9 billion in June 2007 (Chart I.12).

The net volume of YTL denominated bonds issued by foreigners, which was YTL 12.6 billion at the end of 2006, rose to YTL 18 billion by October 2007(Chart I.13). Banks abroad, which hedge against exchange rate risk arising from their YTL denominated investments by means of issuing YTL-denominated bonds for international investors, continued to issue such bonds in October 2007. This indicates that international investors' demand for YTL-denominated borrowing instruments have not been severely affected by the recent turmoil in global markets.

Table I.3. Current Account Balance (CAB) to GDP Ratios and GDP Growth Rates of Selected Economies (%)

	2006		2007*		2008**	
	CAB /GDP	Growth	CAB /GDP	Growth	CAB /GDP	Growth
New EU Members	-6.0	6.4	-7.2	6.1	-7.7	5.2
Bulgaria	-15.8	6.1	-20.3	6.0	-19.0	5.9
Romania	-10.3	7.7	-13.8	6.3	-13.2	6.0
Hungary	-6.5	3.9	-5.6	2.1	-5.1	2.7
Poland	-2.3	6.1	-3.7	6.6	-5.1	5.3
Czech Republic	-3.1	6.4	-3.4	5.6	-3.5	4.6
European Economies						
Advanced	0.5	2.9	0.2	2.7	0.0	2.2
Emerging	0.1	6.6	-1.9	6.3	-2.9	5.7
European Union	-0.7	3.2	-1.0	3.0	-1.2	2.5

Source: IMF, World Economic Outlook (October 2007)
(*) Year-end forecast.
(**) Projection.

Similar to the case in Turkey, it is observed that new EU members also experience rapid growth rates and a high current account deficit simultaneously (Table I.3).

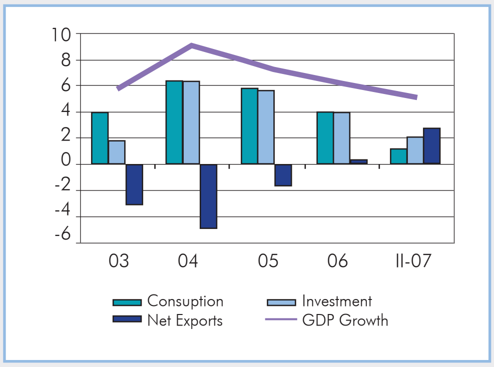
On the other hand, the growing volume of long-term credits and capital inflow to Turkey along with increased foreign direct investments in the last few years are the factors that enhance the quality of the current account deficit financing. In fact, as a favorable outcome of the decline in the share of short-term capital inflows, namely the "hot money" in total financing, concerns over the sustainability of the current account deficit did not display a notable increase during the recent fluctuations in global markets. Nevertheless, as the extent of the impact of the recent global turmoil, especially on developed countries, and the way this will affect global liquidity conditions in the coming months is not yet clear, the current account deficit still constitutes one of the most important risk factors with respect to financial stability.

I.2. Growth and Inflation

I.2.1. Growth

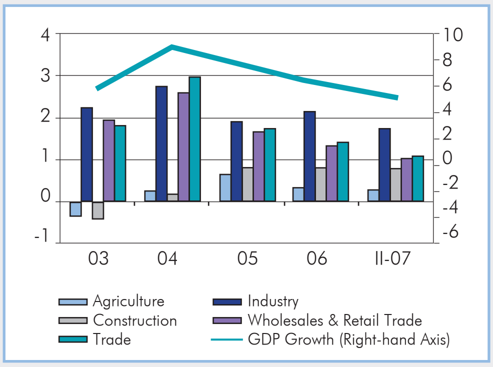
Albeit its sluggish trend in the first half, economic growth in Turkey continued in 2007.

Chart I.14.
Growth Rate and Its Composition[1,2]
(%, Points)



Source: TURKSTAT
(1) Percentage change compared to the same period of the previous year.
(2) Net exports = Exports-İmports

Chart I.15.
Contributions of Sectors to Growth
(%, Points)



Source: TURKSTAT

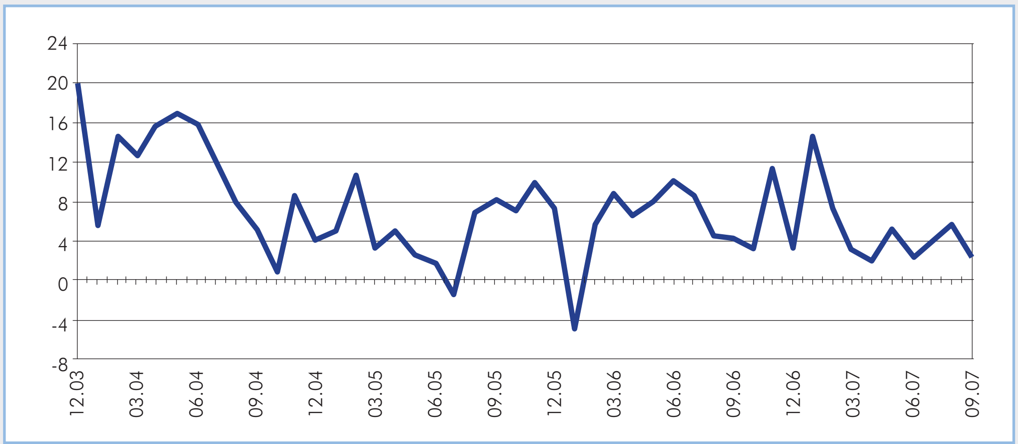
Despite the slowdown in consumption and investment expenditures of the private sector, Gross Domestic Product (GDP) grew by 5.3 percent in the first half of 2007 compared to the same period of 2006 mainly owing to strong foreign demand. While the contribution of consumption and investment expenditures to growth diminished in the first half of 2007; that of net exports increased.

As private consumption expenditures, which is the major component of expenditures in the GDP, increased by a mere 0.8 percent in the first half of 2007 compared to the same period last year, the contribution of consumption to growth has decreased (Chart I.14).

In the first half of 2007, investment expenditures of the private sector rose by 4.9 percent compared to the first half of 2006. Despite the 25.1 percent rise in investment expenditures of the public sector, the contribution of investment expenditures to growth has continued to decrease (Chart I.14).

An analysis of the GDP by sectors with respect to production reveals that the strong contribution of the construction sector to growth continued in the first half of 2007, while that of other sectors diminished (Chart I.15).

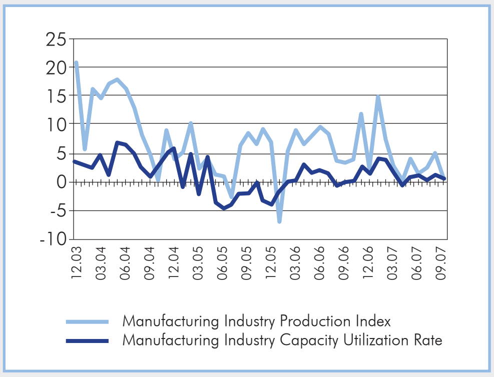
Chart I.16.
Industrial Production Index (%)[1,2]



Source: TURKSTAT
(1) Percentage change compared to the same month of the previous year.
(2) Monthly Industrial Production Index 1997=100

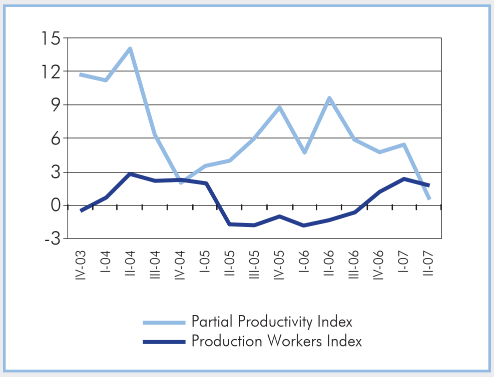
In the first half of 2007, industrial production rose by 5.4 percent compared to the same period of last year. Industrial production data pertaining to the third quarter indicate the continuing moderate growth pace in economic activity. In this period, industrial production increased by 4 percent in annual terms while seasonally adjusted data point to a limited rise of 0.4 percent compared to the previous period.

Chart I.17.
Manufacturing Industry Production and Capacity Utilization Rate[1,2] (%)



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

Chart I.18.
Number of Workers and Partial Productivity per Worker for the Manufacturing Industry [1,2] (%)



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

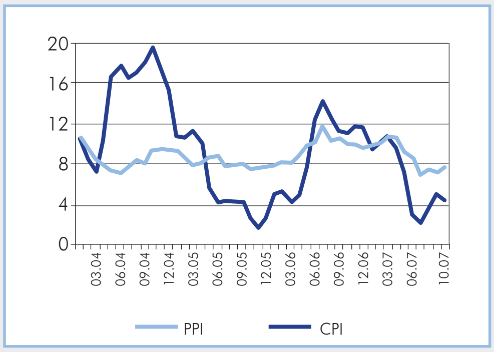
The nine-month average of manufacturing industry production, the share of which is 86.9 percent in the industrial production index, increased by 4.1 percent in 2007 compared to the same period of last year. When the manufacturing industry is analyzed by areas of economic activity in terms of nine-month averages, it is observed that electrical machinery and equipment manufacturing and wood products manufacturing (excluding furniture), made the largest contribution to production in fabricated metal (excluding machinery and equipment) and in the main metal industry.

Compared to the same period of 2006, the capacity utilization rate of the manufacturing industry increased by 0.7 percentage points in September 2007 and reached 83.3 percent (Chart I.17). According to the Manufacturing Sector Tendency Survey results, the main reason for working under-capacity in workplaces in September 2007 was the inadequate domestic demand.

The rate of increase in partial productivity per worker employed in the manufacturing industry continued to slowdown as a result of the deceleration in the rate of increase in the manufacturing industry production index and continuing increase in the number of manufacturing sector workers in the second quarter of 2007 compared to the same period of 2006 (Chart I.18).

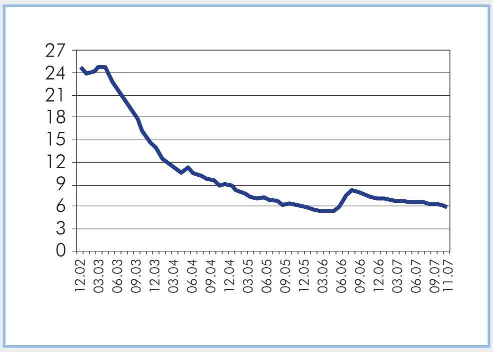
I.2.2. Inflation

Chart I.19.
Annual PPI and CPI Developments
(Annual % Change)



Source: TURKSTAT

Chart I.20.
CPI Expectations for the Next 12 Months
(Annual % Change)



Source: CBRT

Annual CPI inflation, which was 9.7 percent in 2006, dropped to 7.7 percent by October 2007 (Chart I.19). Price hikes in unprocessed food products, price increments in tobacco products and the lagged effects of the depreciation of the New Turkish lira in 2006 triggered a rise in inflation in the first quarter of 2007. However, in the following months, despite the unfavorable developments in unprocessed food and oil prices and the rise in public expenditures, inflation assumed a downward track, with the help of the lagged effects of monetary tightening that started in June 2006 on private consumption demand

The annual Producer Price Index (PPI) inflation, which is an important indicator for evaluating the cost-side effects on consumer inflation, dropped to 4.4 percent by October 2007, from 11.6 percent in 2006 (Chart I.19). While annual inflation in producer prices increased in the first quarter mainly due to the rise in energy prices, it decreased substantially in the second quarter compared to the same period of 2006 with the effect of the high base effect. Meanwhile, there was a limited rise in the prices of manufacturing industry excluding petroleum products. Annual PPI inflation in subsequent months displayed an increase due to the rise in prices of agricultural products, food and petroleum products.

Despite the favorable developments in inflation indicators, short-term inflation expectations have been recently revised upwards due to price increments in energy and food products, and developments beyond the control of monetary policy, such as tax adjustments. Within this framework, it is estimated that inflation would exceed 6 percent, the upper limit of the uncertainty band. Meanwhile, it is observed that the downward trend in medium-term inflation expectations continues owing to the decline in annual inflation (Chart I.20).

I.3. Public Finance

The consolidated government sector primary surplus, which surpassed the program target in 2006, was realized at YTL 9.2 billion below the program target in the first eight months of 2007 because of the increase in public expenditures exceeding the increase in public revenues (Table I.4). In the Annual Programme for 2008, the ratio of consolidated government sector primary surplus to GNP has been projected to be 4.1 percent by the end of 2007.

Table I.4. Consolidated Government Sector Primary Surplus Targets and Realizations (Billion YTL)

	2004	2005	2006	April 2007	August 2007	December 2007
Primary Surplus Target (including SEEs)	26.2	30.4	34.5	12.3	32.3	39.7
Primary Surplus Realization (including SEEs)	27.8	28.3	36.2	9.4	23.1	-
Realization / Target (%)	106	93	105	76	72	-

Source: Treasury

Central government budget revenues increased by 10.9 percent and primary expenditures rose by 19.3 percent as of October 2007. Due to the fact that the rise in total expenditures was realized as 16.6 percent, the ratio of expenditures covered by revenues decreased by 4.7 percentage points in the January-October 2007 period compared to the same period last year (Table I.5).

Table I.5. Central Government Budget Performance (Billion YTL)

	January-October 2006	January-October 2007	Change (%)	2007 Budget Target	Realization / Budget Target (%)
Expenditures	144.3	168.2	16.6	205.0	82.0
Primary Expenditures	103.5	123.5	19.3	152.0	81.3
Revenues	140.5	155.9	10.9	188.2	82.8
The coverage ratio of revenues to expenditures (%)	97.4	92.7	-	91.8	-

Source: Ministry of Finance

The increase in revenues mainly arises from non-tax revenues. The early payment of remaining installments equivalent to YTL 5.8 billion from the privatization of Turk Telecommunications Inc. made during the year and revenue amounting to YTL 1.1 billion from the sale of real estates has had a favorable effect on non-tax revenues. Moreover, the limited increase in the Special Consumption Tax (SCT) and VAT proceeds has limited the rise in tax revenues.

High increases in agricultural transfers, health expenditures and purchase prices of wheat and hazelnuts accompanied by the setting of public workers' wage over the intended rate stood out as factors that exerted pressure on primary surplus budget expenditures.

The 2008 Annual Programme specifies that by the end of 2007 tax revenues would remain below the target, whereas primary budget expenditures would overshoot the target. The Programme also states that central government budget expenditure and revenue targets of

2007 could be achieved owing to positive performance of non-tax revenues and the expected drop in interest expenses.

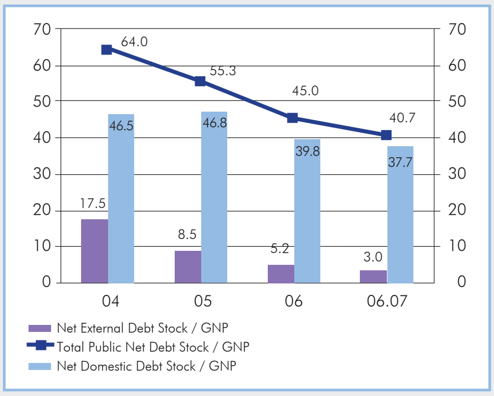
Box 3.
Reduction in the Primary Surplus Target

The ratio of the consolidated public sector primary surplus to GNP, which was set as 6.5 percent for 2007 by the central government draft budget for 2008, was reduced to 5.5 percent for 2008. In 2007, the primary surplus remained below the target due to the increase in public expenditures, inadequacy of tax revenues arising from limited increases in VAT and the SCT and unfavorable developments in the financial position of energy companies. In this framework, the primary surplus is expected to be realized at 4.1 percent by the end of 2007. Given the ratio of the primary surplus to GNP is expected to be 4.1 percent for 2007, a 5.5 percent target for 2008 corresponds to a significant improvement.

In order to attain the target, an adjustment in electricity prices is planned for 2007 and 2008 with the aim of overcoming the cash shortage of the SEEs in the energy sector. An increase by 13.3 percent is targeted in 2008 on the tax revenues side. Within this framework, on November 2, 2007, SCT rates on fuel oil and tobacco products were pushed up.

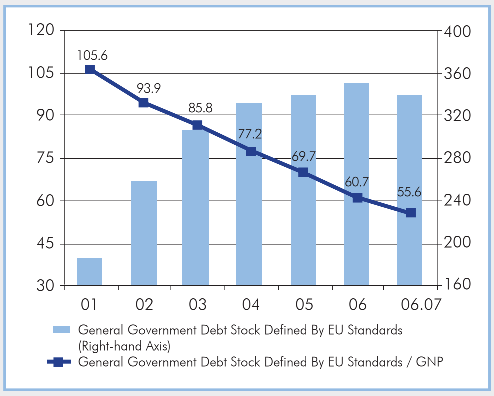
Achieving the primary surplus target is of great importance in terms of reducing the debt stock and improving the country's resilience against possible fragilities by demonstrating the government's intention and capacity to pay its debt. However, the quality of fiscal discipline is also essential for sustainable macroeconomic stability. Therefore, structural reforms in the fields of social security, tax and the labor market are crucial.

Chart I.21.
Composition of Total Public Sector Net Debt Stock [1,2] (%)



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 and June 2007 are provisional.

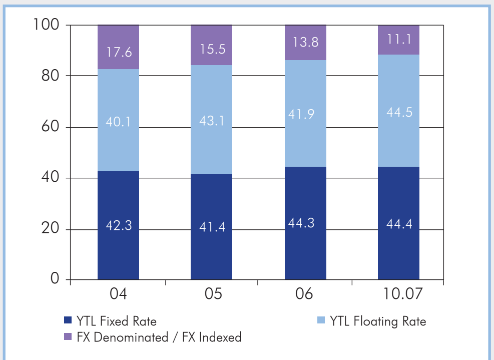
Chart I.22.
General Government Nominal Debt Stock Defined By European Union Standards[1] (%, Billion YTL)



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

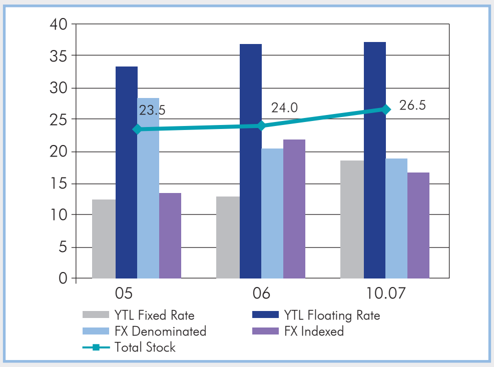
The ratio of public sector net foreign debt stock to GNP continued to decline and was realized as 40.7 percent in the first half of 2007. This decline primarily stemmed from rises in public deposits and unemployment insurance fund net assets and the GNP as well as the decline in the gross debt stock (Chart I.21). The decrease in YTL equivalent of foreign currency debts due to the parity effect was influential in the reduction of public sector gross debt stock. The general government nominal debt stock to GNP ratio, as defined by the EU, continued to decrease (Chart I.22)

Chart I.23.
Composition of Domestic Debt Stock (%)



Source: Treasury

Chart I.24.
Maturity Structure of Government Debt Securities (Month)[1]

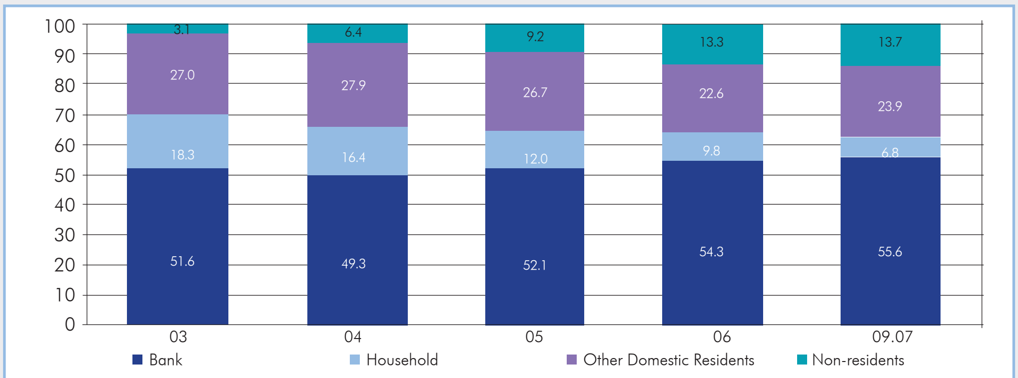


Source: Treasury
(1) Calculation is based on term to maturity.

Regarding the composition of domestic debt stock, the share of debt stock which is sensitive to the exchange rate movements maintained its downward trend by October 2007, whereas the share of floating-rate government bonds expanded. However, excluding CPI-indexed bonds, which have been issued since February 2007 and are interest rate risk-free though they are included in the floating-rate debt, the relevant share has slightly increased from 41.9 percent to 42.2 percent. This development points that there was no considerable increase in the sensitivity to interest rate risk (Chart I.23).

The average maturity of government securities extended to 26.5 months by October 2007. In the December 2006–October 2007 period, the term to maturity of YTL denominated floating-rate government securities remained unchanged, whereas the term to maturity of YTL denominated fixed rate government securities increased (Chart I.24).

Chart I.25.
Government Debt Securities by Holders[1, 2, 3] (%)



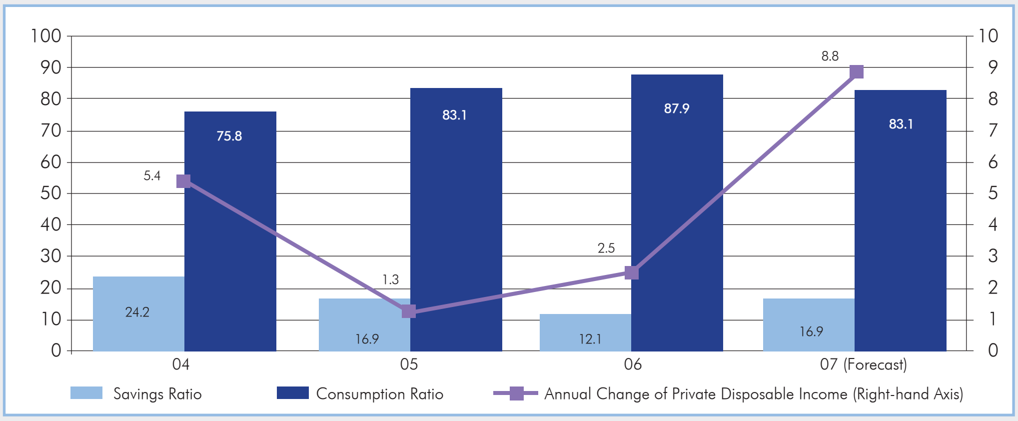
Source: BRSA-CBRT
(1) Based on nominal amounts.
(2) "Bank" includes GDDS owned by banks operating in Turkey; "Household" includes GDDS that belong to real persons kept at domestic banks; "Other domestic residents" includes GDDS of domestic legal persons except banks and households also GDDS of mutual 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 portion of total government bonds is owned by banks, thus comprising a major part of banking sector assets. As of September 2007, the share of banks increased, while the share of households continued declining, whereas that of non-residents did not display a significant change compared to the end of the previous year (Chart I.25).

I.4. Private Sector Developments

The effects of monetary tightening in the second half of 2006 also prevail in 2007.

Chart I.26.
Private Sector 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

In the 2008 Annual Programme, private disposable income is foreseen to grow by 8.8 percent in real terms in 2007, and the savings rate to rise by 4.8 points due to the slowdown in the rate of consumption growth (Chart I.26).

Table I.6. Private Consumption Expenditures (Annual Real Change, %)

	2003	2004	2005	2006	Jan-June 2007
Private Consumption Expenditures	**6.6**	**10.1**	**8.8**	**5.2**	**0.8**
Durable Goods	24.0	29.7	15.0	2.9	-5.2
Services	7.5	9.3	7.8	5.0	2.8
Food and Beverages	4.1	2.8	8.2	3.1	3.9
Semi-Durable and Non-Durable Goods	2.1	18.8	12.9	15.8	-0.6
Ownership of dwelling	1.4	1.8	1.5	2.2	2.4
Energy, transportation, communication	2.2	0.3	-0.1	2.9	4.8

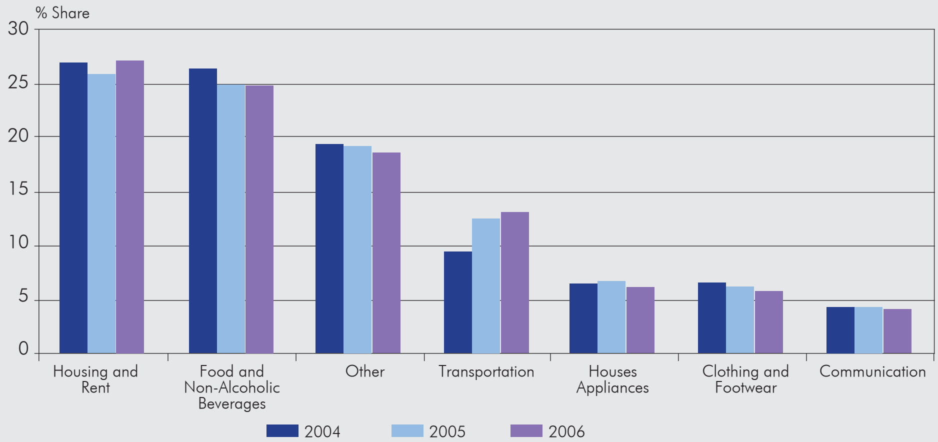
Source: TURKSTAT

The monetary tightening adopted since June 2006 became more pronounced in the second half of 2006 and led to a slowdown in domestic demand. This trend increasingly continued in the first half of 2007 and expenditures on durable goods, semi-durable and non-durable goods showed contraction trends compared to the same period last year. In the meantime, due to food and beverages, ownership of dwelling, energy, transportation and communication expenditures which rose more rapidly compared to the same period of the previous year, increasing services expenditures, albeit at a lower pace, private final consumption expenditures supported the positive course of annual change (Table I.6).

I.4.1. Household

Household liabilities continued to rise in 2007.

Box 4.
Distribution of Household Consumption Expenditures



Source: TURKSTAT, 2006 Household Budget Survey

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

In 2006, the share of expenditures for housing and rent (except for housing purchase investments) in total expenditures was 27.2 percent, while the share of expenditures for food and non-alcoholic beverages was realized as 24.8 percent.

Even though no significant change was observed in the distribution of household expenditures in 2006 compared to the previous year, the share of transportation expenditures in total expenditures continued to expand.

Table I.7.
Household Disposable Income, Indebtedness and Interest Payments[1,2,3] (Million YTL)

	2003	2004	2005	2006	09.07
Household Interest Payments	3,983	7,245	10,264	12,175	14,863
Household Debt	13,442	28,259	49,979	73,654	90,348
Household Disposable Income	180,305	218,752	255,640	292,775	340,786
Interest Payments / Disposable Income (%)	2.2	3.3	4.0	4.2	4.4
Debt / Disposable Income (%)	7.5	12.9	19.6	25.2	26.5

Source: BRSA-CBRT, TURKSTAT
(1) September 2007 household interest payments are calculated on a yearly base.
(2) 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.
(3) Household disposable income for 2006 and 2007 are calculated by using, private sector disposable income for 2005 and private sector disposable income estimation for 2006 and 2007 which are mentioned in 2008 Annual Programme, under the assumption that the 2005 ratio of household disposable income to private sector disposable income has not changed.

As of September 2007, the ratio of household interest payments to disposable income reached 4.4 percent, displaying a slight rise compared to the end of the previous year, while the ratio of total debt to disposable income rose from 25.2 percent to 26.5 percent (Table I.7).

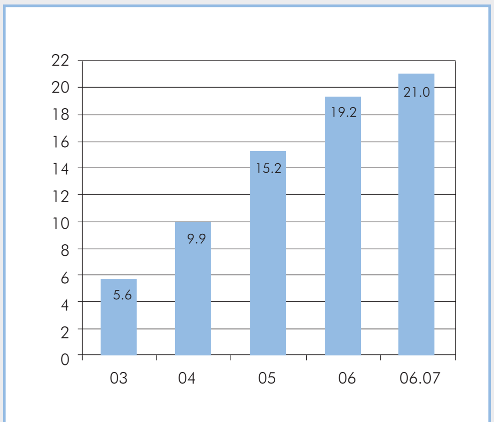
Table I.8. Household Liabilities to GDP in Selected Countries

	Household Liabilities excluding Housing Loans/GDP (%)			Household Liabilities /GDP (%)		
	2004	2005	2006	2004	2005	2006
Lithuania	2.5	4.1	6,7	8,0	13.2	19.3
Czech Republic	3.9	4.7	5.3	4.7	14.3	17.3
Hungary	5.4	6.8	9.2	14.9	16.9	21.1
Latvia	5.3	7.7	9.3	17.1	27.1	38.3
Poland	9.7	9.7	10.7	13.9	15.1	18.2
Italy	12.0	12.3	12.7	25.3	27.6	29.2
Greece	11.0	12.4	14.2	30.5	36.2	41.0
Portugal	13.8	13.9	15.1	63.2	67.3	74.3
Spain	17.5	19.1	20.8	57.5	68.6	76.8
EU-25	17.4	17.6	17.6	56.8	60.4	63.2
Eurozone	15.7	15.9	15.8	49.1	52.3	54.1
Turkey	**5.9**	**7.5**	**8.6**	**6.6**	**10.0**	**12.4**

Source: ECB, CBRT

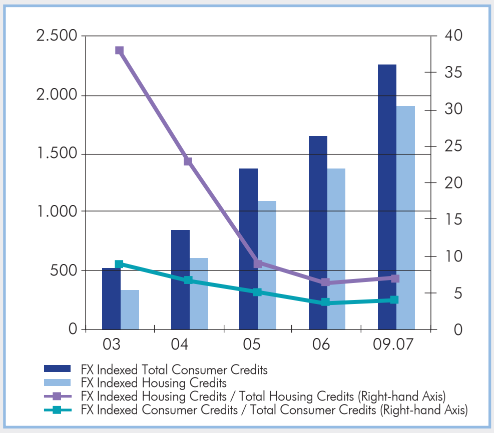
Comparing the ratio of household liability, which increased by 47 percent in 2006, to GDP to selected countries, the ratio in question for Turkey is still lower than that of many other countries. An analysis of this ratio excluding housing loans indicates that Turkey displays a similar pattern especially in line with new member states of the EU. It is expected that household liability in Turkey will rise close to the level of EU countries as a result of the increased utilization of housing loans against a backdrop of sound economic stability, decreased interest rates and a functional mortgage system (Table I.8).

Chart I.27.
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.28.
FX Indexed Total Consumer Credits and FX Indexed Housing Credits (Million YTL, %)



Source: CBRT

The portion of private consumption expenditures financed by retail loans continued to increase in the first half of 2007 as well (Chart I.27).

Table I.9. Number of Non-Performing Consumer Loan Borrowers and Credit Card Holders[1]

	09.06	09.07
Non-Performing Credit Card Holders	182,076	167,841
Non-Performing Consumer Loan Borrowers	21,660	40,957

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.

In the first nine months of 2007, the number of defaulters increased due to the rise in consumer loan utilization compared to the same period last year. On the other hand, the number of credit card defaulters decreased during the same period due to the enforcement of "Bank Cards and Credit Cards Law" (Table I.9).

The ratio of FX indexed consumer loans to total consumer loans, which was 3.6 percent by the end of 2006, rose to 3.8 percent as of September 2007. This development can primarily be attributed to the increase in FX indexed housing loans. As a matter of fact, the share of FX indexed housing loans, which had increased from YTL 1.3 billion in 2006 to YTL 1.9 billion as of September 2007, in total housing loans rose from 6.1 percent to 6.8 percent in this period (Chart I.28). The said rise in FX indexed consumer loans, albeit with a lower share in retail loans, will lead to increased household indebtedness in case of depreciation of the Turkish currency. Therefore, individuals without foreign exchange income should avoid borrowing in foreign currency.

Table I.10. Composition of Household Financial Assets[1] (Billion YTL)

	2004	2005	2006	09.07
YTL Deposits	63.5	90.4	113.6	134.7
FX Deposits	61.3	59.8	75.0	78.9
FX Deposits (Billion USD)	45.3	44.5	53.4	65.3
Currency in Circulation	12.4	18.3	24.7	24.8
GDDS+Eurobond	39.1	32.6	28.2	20.3
Mutual Fund	-	-	17.5	21.4
Stocks	12.3	15.7	15.8	17.6
Private Pension Funds	0.3	1.2	2.9	4.1
Repos	1.6	1.5	2.0	2.1
Total Assets	**190.5**	**219.5**	**279.7**	**303.9**

Source: BRSA-CBRT, CMB, CRA
(1) YTL and FX deposits includes participation funds

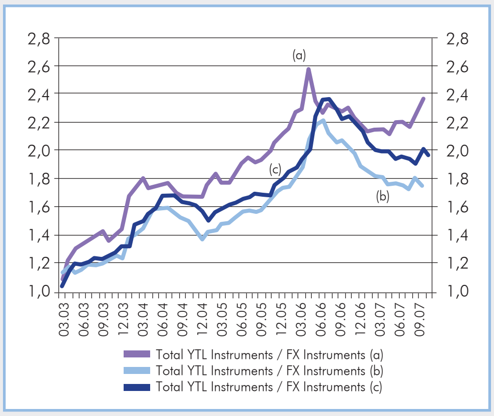
The total household financial assets increased by 8.6 percent as of September 2007 compared to the end of 2006 and reached YTL 303.9 billion (Table I.10).

The share of savings deposits in household assets continues to expand. This is mainly driven by the decline in the share of FX deposits due to the parity effect. As a matter of fact, the share of FX deposits that increased by USD 11.9 billion (22.2 percent) in the first 9 months of 2007, in total deposits dropped from 40 percent to 37 percent, whereas its share in total financial assets declined from 26.8 percent to 26 percent. Recent observations show that households shift to FX denominated assets during periods of appreciation of the Turkish currency, whereas they prefer YTL denominated assets during periods of depreciation of the Turkish currency (Chart I.29).

The 11.4 percent increase in stock portfolio in the first 9 months of 2007 stemmed mainly from price hikes. Moreover, investment funds allowing investment in various capital market instruments such as bonds, bills, stocks and repos at the same time and of which the value increased by 22.3 percent and reached YTL 21.4 billion, progressively assumed more importance in household financial assets. The only investment instruments which exhibited a nominal decline among financial assets within the period concerned were government bonds and Eurobond portfolio (Table I.10).

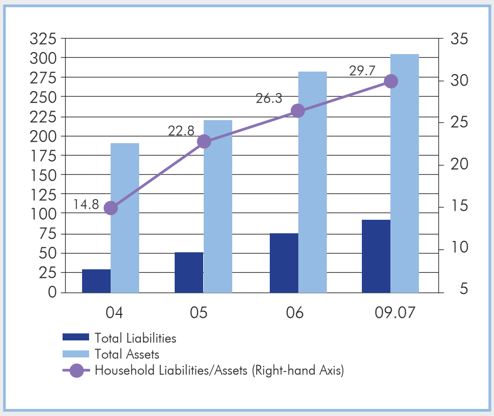
Significant developments have occurred in pension funds, one of the items among household assets, in Turkey since 2004. The share of these funds in total household assets, which was 0.4 percent in 2004, increased to 1.3 percent as of September 2007. Pension funds, which have a significant share in financial assets in developed countries, are regarded as an indicator of financial depth owing to their long-term maturity. Although their share in total household assets is relatively low in Turkey, the rapid developments that pension funds display are considered positive for financial deepening.

Chart I.29.
Ratio of YTL-FX Denominated Investment Instruments[1]



Source: BRSA-CBRT, CMB, CRA
(1) YTL Instruments = Deposits + Repos + Gov. Dom. Debt Sec. + Participation Funds (YTL) + Stocks + Private Pension Funds; + Mutual Funds (starting from April 2006)
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.30.
Households' Financial Assets and Liabilities (Billion YTL, %)[1]



Source: BRSA-CBRT, CMB, CRA
(1) Household Assets= Savings Deposit+FX Deposit+Money in Circulation+ Gov. Dom. Debt Sec. + Eurobond +Repos +Stocks +Pension Funds + Mutual Funds (starting from April 2006)
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.

The ratio of household liabilities to financial assets continues to increase due to increasing retail loans (Chart I.30).

Despite the continuous rise in disposable income as a result of economic growth, the rise in household indebtedness and the increased recovery of consumption expenditures by loans require close monitoring of households by funders with respect to their repayment and expenditure capacity.

Box 5.
Income Distribution

The convergence of the "Gini" coefficient, prominently used measure of income distribution, to zero points to an increase in the equality of income distribution, whereas its convergence to 1 signifies a deterioration in the equality of income distribution. According to TURKSTAT, the Gini coefficient, which was 0.44 in Turkey in 2002, declined in subsequent years and fell to 0.38 in 2005.

Statistics related to income distribution suggest that in 2002, the 20 percent bracket, which had the largest share in income, possessed 50 percent of total income, while this ratio dropped to 44.4 percent in 2005. However, the 20 percent bracket, which had the lowest share in income in 2002, possessed 5.3 percent of total income while this ratio increased to 6.1 percent in 2005.

	Gini Coefficient	Distribution of Household Disposable Income				
		I. 20 %	II. 20 %	III. 20 %	IV. 20 %	V. 20 %
2002	0.44	5.3	9.8	14.0	20.8	50.0
2003	0.42	6.0	10.3	14.5	20.9	48.3
2004	0.40	6.0	10.7	15.2	21.9	46.2
2005	0.38	6.1	11.1	15.8	22.6	44.4

Source: TURKSTAT

Income distribution changing in favor of the group with the smallest share in income will increase involvement in financial markets and thus contribute to financial deepening.

I.4.2. Corporate Sector

I.4.2.1. Financial Analysis of Companies

Table I.11. Financial Ratios (%)

	All Companies			Manufacturing Companies		
	2004	2005	2006	2004	2005	2006
Leverage and Capital Structure Ratios						
Leverage Ratio	47.4	48.6	50.1	45.6	47.1	48.8
Bank Loans/Total Debt	30.6	32.2	36.0	38.0	40.5	42.6
FX Loans in Cash/ Total Loans in Cash	79.7	75.0	70.8	79.6	75.5	71.1
Long Term FX Loans in Cash / Total FX Loans in Cash	56.9	58.5	63.3	48.0	48.8	50.0
Total Debt / Total Equity	90.3	94.5	100.4	84.0	89.9	95.3
Interest Coverage Ratio (times)	3.6	4.3	3.1	3.4	3.6	2.7
FX Short Term Loans / Foreign Sales	13.5	15.2	13.6	13.3	14.9	13.5
Liquidity Ratios						
Current Ratio	138.7	138.5	141.8	160.1	158.7	158.3
Liquidity (Acid Test) Ratio	99.1	100.8	102.6	93.0	96.0	95.6
Cash Ratio	22.9	24.0	26.3	30.7	29.9	27.5
Days' in Inventory	-	48.0	47.4	-	68.9	65.2
Average Accounts Receivable Collection Days	-	64.0	66.4	-	65.2	66.4
Average Accounts Payable Payment Days	-	55.4	55.3	-	54.2	51.0
Profitability Ratios						
Asset Turnover Ratio	1.0	1.0	1.0	1.2	1.2	1.3
Net Profit Margin	4.6	4.0	5.5	4.6	3.3	4.5
Interest Expenses / Net Sales	2.3	1.6	3.1	2.5	1.7	3.3
Net Profit / Assets (ROA)	4.6	4.1	5.7	5.5	4.0	5.7
Net Profit / Equity (ROE)	8.7	7.9	11.5	10.1	7.5	11.0

Source: CBRT Company Accounts (Provisional Data)

When the financial structure ratios of companies are analyzed, the level of indebtedness of these firms is observed to be increasing, mainly in line with their utilization of bank credits. As a result of fluctuations in the financial markets during the period May – June 2006, the interest coverage ratio declined as a result of the increase in interest rates and exchange rates (Table I.11). Although the rise in leverage ratio and the fall in interest coverage ratio are considered to be unfavorable from the credit risk point of view; the total amount of debt being smaller than shareholders' equity and a modest share of interest bearing bank credits in total debt are assessed to ensure a considerable degree of safety for creditors.

Looking at leverage ratios as of the selected sectors, the leverage ratio increased in almost all sectors and the bank credit utilization rate exhibited an upward trend. It is worth noting that leverage ratios in the construction, wholesale and retail trade, machinery and equipment, transportation and textile sectors are above the average of sectors and that the total amount of debt surpasses the shareholders' equity (Table I.12).

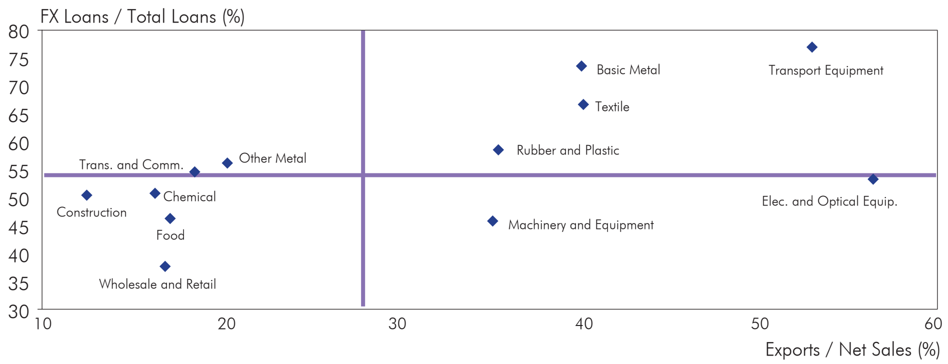
Table I.12. Leverage Ratios for Selected Industries (%)

	Bank Loans / Assets			Debt / Assets		
	2004	2005	2006	2004	2005	2006
Manufacturing	17.3	19.1	20.8	45.6	47.1	48.8
Food	18.5	19.9	22.9	45.9	44.1	45.1
Textile	22.5	24.5	24.7	50.1	51.2	52.1
Chemicals	14.3	16.0	17.0	42.3	41.2	44.4
Other Metals	10.5	13.7	15.1	29.6	35.5	37.8
Basic Metals	18.2	21.1	22.5	40.7	42.9	44.1
Machinery and Equipment	16.8	19.9	23.2	51.0	53.3	56.3
Transport Equipment	18.2	17.1	18.8	49.6	52.0	52.6
Construction	6.7	8.0	7.8	74.5	74.8	74.3
Wholesale and Retail Trade	17.7	19.5	20.2	64.9	67.1	65.5
Transport, Communication	8.4	9.8	18.9	37.8	38.1	48.4
All Companies	14.5	15.6	18.0	47.4	48.6	50.1

Source: CBRT Company Accounts

71 percent of cash loans used by companies in 2006 were FX denominated, while 29 percent were YTL denominated. It is observed that the maturities of FX cash loans were extended. The ratio of short-term FX loans to foreign sales declined due to increased revenues from exports in 2006 (Table I.11). The high level of FX loans, despite the shrinkage in their share, poses a risk for domestic market-oriented manufacturing sectors in this period. Nevertheless, analyzing by sectors, those with a large share of FX loans also have a large share in exports, while the FX loan shares of sectors producing for the domestic market are below the sector average (Chart I.31). However, transportation, communication and other metals sectors take place among the sectors with high FX loan-low exports.

Chart I.31
Exports and FX Loans[1]



Source: CBRT
(1) Areas are defined as of median measures.

The analysis of liquidity ratios, indicators of the capability of firms to repay their short-term debts, points to a recovery in the short-term solvency of firms (Table I.11). Examining the days in inventory and accounts receivables average collection days, which are complementary to liquidity ratios, the length of period products are kept in storage has been shortened, whereas the period for collecting receivables has been extended. The extended receivables collection period increase firms' working capital requirements.

Profitability ratios point to favourable developments for firms. The increase in leverage ratios and return on assets pushed the return on equity up. Despite firms' increased financing expenses, the reduction in cost of goods sold have been instrumental in the rise of the profit margin (Table I.11)

In conclusion, provisional data compiled from the balance sheets of firms sent to the Bank reveal that bank-originated indebtedness ratios of firms rose and that their financing expenses increased due to the effect of financial turbulence experienced in the second half of 2006. Nonetheless, firms' sales to mainly foreign markets continue due to the slowdown in domestic demand and they still maintain their profitability thanks to the reduction in sales costs.

Table I.13. Financial Ratios for Selected ISE Companies

	Jun.06	Sep.06	Dec.06	Mar.07	Jun.07
Asset Turnover Ratio (Times)	0.6	0.9	1.2	0.3	0.6
Net Profit Margin (%)	2.8	5.3	5.5	4.8	6.6
ROA (%)	1.7	4.7	6.4	1.3	3.8
ROE (%)	3.7	10.2	13.5	2.8	8.0
Leverage Ratio (%)	51.6	50.9	50.2	51.2	50.5
Total Debt / Total Equity (%)	112.5	109.1	106.0	110.9	107.3
Equity Multiplier	2.2	2.1	2.1	2.2	2.1

Source: IISE
Minority interest has not been included in equity.

Comparing to the same period last year, firms listed on the ISE[3] maintained their strong profitability level in the first half of 2007 as well (Table I.13). The increase in the return on asset and return on equity stems from the increase in the profit margin. The increase in profit margins

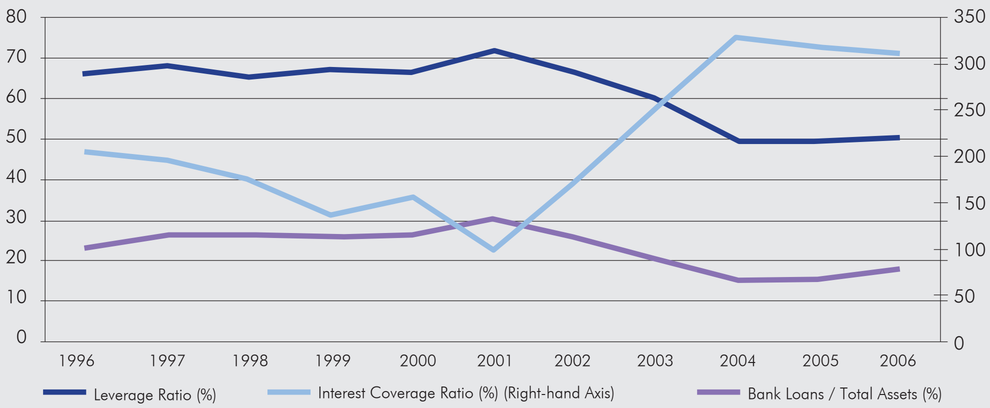
[3] Financial statements of the firms which are publicly traded on the ISE and can be consolidated, however which are not considered as financial institution or a subsidiary thereof, are used.

of firms arises from the exchange rate gains on credit debts caused by the appreciation of the Turkish currency and reflected on net financing expenses. However, it should be noted that the increases in profit margins obtained by non-operating income may not be stable.

Box 6.
Evaluation of Leverage, Interest Coverage, Non-Performing Loan Ratios and Foreign Currency Short Positions of Firms

According to data by the Central Bank, the leverage ratio, which had been fluctuating at around 65-68 percent between the years 1996-2000, reached 71 percent in 2001. This ratio declined during the 2001-2004 period and started to display a moderate increase in 2004. The ratio of bank loans to total assets also followed a similar trend. However, it is noteworthy that both ratios are below their previous levels. The ratio of earnings before interest and tax to financing costs, which is an indicator of interest payment ability, steadily declined during the 1996-2001 period to the extent that it failed to meet financing expenditures in 2001. Following a sharp hike between the years 2002 and 2004, the ratio started to follow a downward trend again, albeit still higher than its previous levels (Chart 1).

Chart 1. Capital Structure Ratios



Source: CBRT

Chart 2. Debt / Equity Ratio and Interest Coverage Ratio

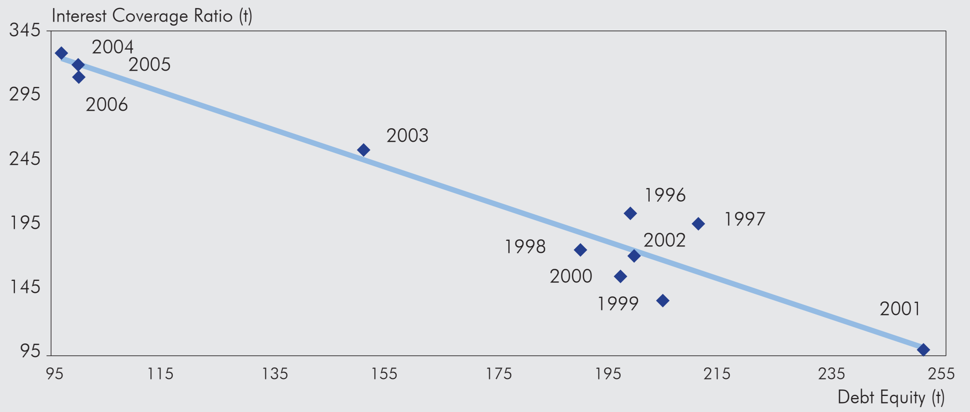
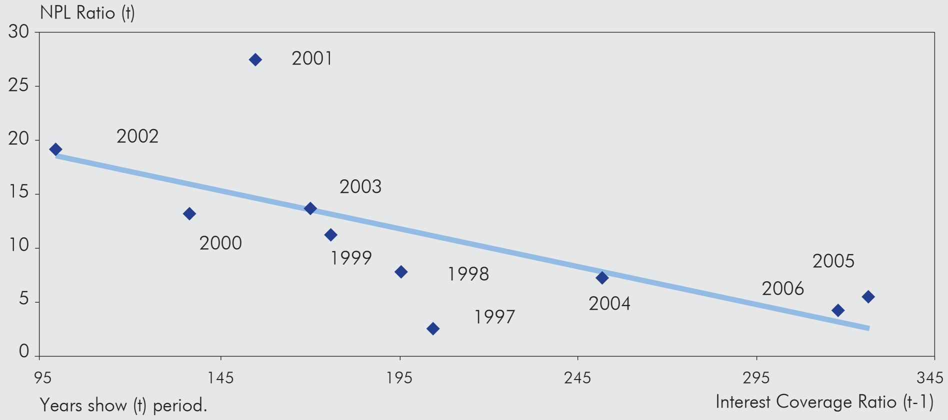


Chart 3. Interest Coverage Ratio and NPL Ratio



An analysis of the relationship between the debt to equity ratio and the interest coverage ratio for the 1996-2006 period indicates that the amount of the funds borrowed by firms increases, the interest coverage ratio decreases, and as the interest coverage ratio falls in the previous period, the NPL ratio of the banking sector rises (Charts 2 and 3). Joint analysis of movements of variables in the said period indicates that interest coverage ratio reduced by 14.3 percentage points on average in line with a 10 percentage point rise in the debt to equity ratio, while the NPL ratio of firms increased by 0.71 percentage point on average parallel to a 10 percentage point decline in the interest coverage ratio in the previous period.

Table 1. Sensitivity Analysis- Change in Foreign Exchange and Interest Coverage Ratio

	Debt / Equity (%)	Interest Coverage Ratio	NPL Ratio[1]	Capital Adequacy Ratio[1]
Current	100.4	309.8	3.7	17.0
10 % Depreciation	109.3	297.1	4.6	16.5
20 % Depreciation	118.7	283.7	5.5	16.0
30 % Depreciation	128.6	269.4	6.5	15.4

Source: CBRT Company Accounts, BRSA, CMB
(1) SDIF Bank, T.Kalkinma Bank, Iller Bank and Eximbank are excluded in the calculation of NPL ratio and capital adequacy ratio.

Depreciation of YTL, *ceteris paribus*, will lead to the erosion of equity by causing foreign exchange losses due to the short foreign currency positions of firms, while, at the same time, will lead to an increase in the debt to equity ratios of firms by raising YTL equivalent of FX denominated debts. As can be seen in the distribution charts, there are strong correlations between the debt to equity ratio and interest coverage ratio on the one hand, and between the interest coverage ratio and the NPL ratios of the banking sector, on the other.

Table 1 shows the sensitivity analysis of how the depreciation of the Turkish currency would affect the debt ratios and interest coverage ratio of firms as well as the NPL ratios of the banking sector in the following period. According to the "Analysis of Financial

Structures and Profitability of the Firms Listed on the Istanbul Stock Exchange" published by the Capital Markets Board of Turkey (CMB), the FX denominated debts to total assets ratio of firms listed on ISE was 29.3 percent, while the ratio of their FX assets to total assets was 15.5 percent by the end of 2006. The said ratios have also been used for representing the corporate sector in the Company Accounts of the CBRT. NPL ratio of firms and the capital adequacy ratio of the banking sector are shown as of August 2007.

According to the results of the sensitivity analysis, a 30 percent-depreciation of Turkish currency, ceteris paribus, would increase the debt to equity ratio of firms to 128.6 percent, and bring down the interest coverage ratio to 269.4 percent by triggering a 40.4 percentage points decline. The said 40.4 percentage points decline in the interest coverage ratio of firms would, in return, lead to 2.9 percentage point increase in the NPL ratio of the banking sector and 1.7 percentage point decline in the capital adequacy ratio, under the assumption that full provisions are set aside for all non-performing loans.

When the historical development of financial structure ratios of firms and the results of the sensitivity analysis are analyzed, the indebtedness level of firms is lower compared to that of the past, whereas their interest is higher. Though the interest coverage ratio of firms will weaken in the event of depreciation of YTL due to short positions of firms, it is believed that the interest coverage ratio will remain strong compared to previous years. However, once the interest coverage ratio of firms weakens, the NPL ratio of the banking sector will increase, posing credit risk for the sector. Nevertheless, the high capital adequacy ratio of the sector provides a significant amount of safety against such a risk. However, it should be noted that the capital adequacy ratio in the sensitivity analysis represents the consolidated data of the sector and could vary from bank to bank.

I.4.2.2. Foreign Exchange Position of the Corporate Sector

Foreign exchange positions of the firms operating in Turkey cannot be calculated by referring to their balance sheets since the financial statements of these firms are prepared in terms of the total Turkish currency amount, regardless of the currency composition. However, in order to provide a general idea of the exchange rate risk of firms, the foreign currency position of the non-banking sector can be calculated approximately using data compiled from balance of payments statistics and various statistical reports prepared by banks for the Central Bank, as well as the database of the Treasury and the "Locational Banking Statistics" database of the Bank for International Settlements (BIS). On the other hand, foreign currency positions of non-financial firms on the ISE have been calculated by referring to footnotes in their disclosed financial statements, and the exchange rate risks of these firms, which constitute an important part of the corporate sector, and their cash loan risks for the Turkish banking sector, have been examined. The exchange rate risk of firms in the corporate sector has been analyzed and assessed from a macro perspective. Hence, considering that some firms have short positions while others have long positions, it would be more accurate to evaluate the vulnerability of the corporate sector to exchange rate risk by making individual analyses for each firm.

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

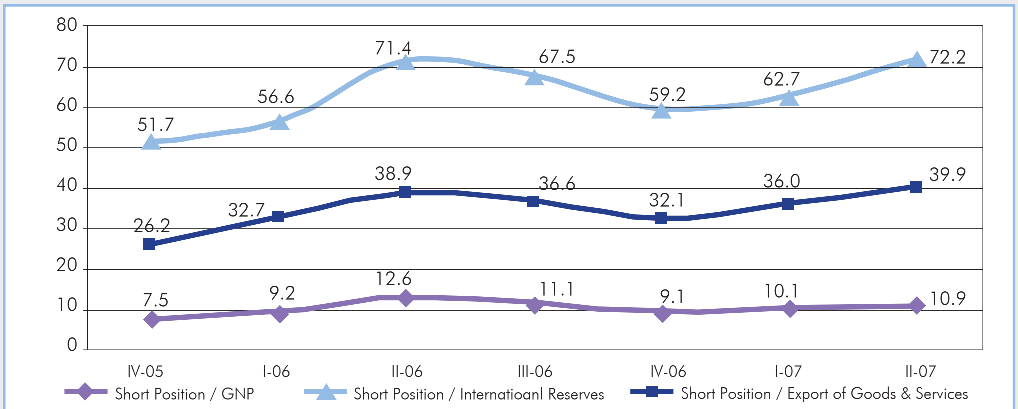
Table I.14. FX Assets and Liabilities of the Sector Except Households and Banks (Million USD)

	12.05	03.06	06.06	09.06	12.06	03.07	06.07	Change 2006-06.07 (%)	Change 06.06-06.07 (%)
ASSETS	49,480	52,820	53,781	57,444	67,108	69,456	72,444	8	35
A. Deposits	34,017	36,958	37,433	41,178	49,334	49,878	52,195	6	39
-Domestic Banks (1)	15,763	17,772	17,321	18,531	22,638	23,053	25,105	11	45
-Foreign Banks (2)	18,254	19,186	20,112	22,647	26,696	26,825	27,090	1	35
B. Securities	1,686	1,661	1,536	1,576	1,745	1,849	1,662	-5	8
-Domestic Issuance	261	268	168	207	225	235	182	-19	8
-Foreign Issuance	1,425	1,393	1,368	1,369	1,520	1,614	1,480	-3	8
C. Export Receivables	6,721	7,092	7,688	7,460	8,572	8,758	9,382	9	22
D. Foreign Direct Invest.									
To Abroad	7,056	7,109	7,124	7,230	7,457	8,971	9,205	23	29
LIABILITIES	76,600	87,039	95,886	98,463	104,520	113,323	123,437	18	29
A. Cash Loans	60,320	71,521	78,247	81,285	86,023	94,786	103,686	21	33
-Domestic (1,3)	21,062	22,317	24,760	24,343	25,096	26,738	28,553	14	15
-Foreign	39,258	49,204	53,487	56,942	60,927	68,048	75,133	23	40
Medium and Long-Term	38,070	47,977	52,216	55,522	59,533	66,730	73,180	23	40
B. Import Payables	10,674	10,951	12,947	12,864	13,304	13,463	14,981	13	16
C. Protocolized Receivables									
of SDIF	5,606	4,567	4,692	4,314	5,193	5,074	4,770	-8	2
NET POSITION	-27,120	-34,219	-42,105	-41,019	-37,412	-43,867	-50,993	36	21

Source: BRSA-CBRT, Treasury, SDIF, BIS
(1) Participation funds and funds-extended by participation banks are included.
(2) It should be taken into consideration that real persons' deposits may be included in "Deposits-Foreign Banks" data received from BIS.
(3) FX indexed loans are included.
Note: Amounts in the table may be different from those published in the preceding issues due to the updates of the data.

The net short position of the non-banking sector, which increased by 21 percent in June 2007 on a year-on-year basis and by 36 percent compared to end-2006, reached USD 51 billion. This increase was mainly driven by loans received from abroad, which rose by 23 percent in the first half of 2007. The short position of the non-banking sector had decreased in the second half of 2006, but started to increase in 2007 (Table I.14).

Chart I.32.
Ratios Related to FX Position of the Sector Except Households and Banks [1,2] (%)



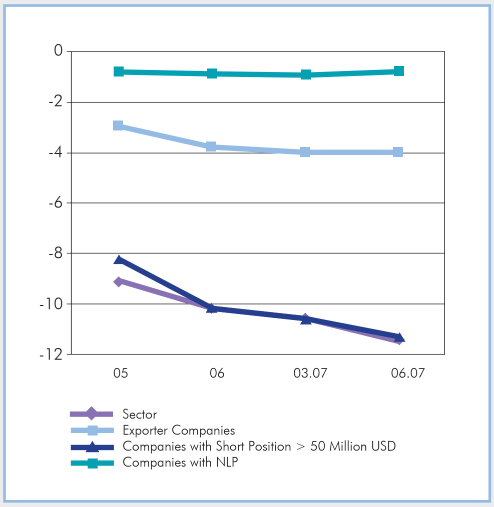
Source: BRSA-CBRT, TURKSTAT, Treasury, SDIF, BIS
(1) GNP and exports of goods & services are computed on a yearly basis. International reserves are outstanding amounts at the end of period.
(2) International reserves are gross foreign exchange reserves of CBRT (including gold).

The ratios of the non-banking sector's short position to GNP, exports and international reserves declined in the second half of 2006. However, the rise in the net short position stimulated an upward movement in the said ratios in the first half of 2007 (Chart I.32).

I.4.2.2.2.Foreign Exchange Position of the Non-Financial Firms Listed on the ISE

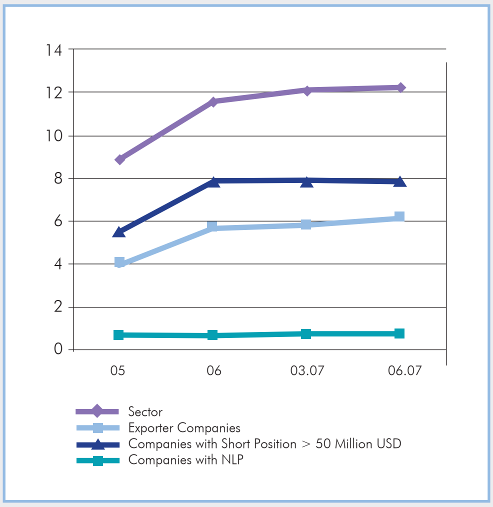
This section examines foreign exchange positions and bank loans of non-financial firms listed on the ISE. The analysis covers 192 firms whose financial statements are published by the ISE, which disclose their foreign exchange positions in their balance-sheet footnotes and do not include any financial institution in their consolidated financial statements.

Chart I.33.
FX Position of ISE Companies[1]
(Billion USD)



Source: ISE
(1) As of year-end periods, companies for which the share of exports in net sales is equal to or greater than 30 percent, are considered exporter companies.

Chart I.34.
Cash Loans Extended to ISE Companies[1]
(Including NPL, Billion YTL)



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.

The short position of firms, which was USD 10.2 billion at end-2006, increased in the first half of 2007 and reached USD 11.4 billion in June. Almost the entire amount of the short position belongs to 42 firms, whose short positions exceed USD 50 million. The short position of 131 non-exporting firms rose to USD 7.4 billion compared to end-2006, making up 65 percent of the total short position (Chart I.33).

Meanwhile, of the 192 firms analyzed, 141 firms have a short position equivalent to USD 12.8 billion and the remaining 51 firms have a long position of USD 1.3 billion, as of June 2007. Compared to end-2006, the number of firms with a short position has increased by nine firms, seven of which are exporting firms.

Total loans of firms, including NPLs, increased by 5.8 percent in the first half of 2007 and reached YTL 12.2 billion. Of these firms, 19 have NPLs (Chart I.34).

The number of non-exporting firms with a short position and the amount of their short positions tend to rise throughout 2007. In addition to the use of derivatives by firms to hedge exchange rate risk and the measures that the authorities may take in the framework of prudential policies, essentially more prudential actions by the banks to avoid the credit risk especially when lending to firms with high short positions and no foreign exchange income would alleviate the potential risks.