CENTRAL BANK OF
THE REPUBLIC OF TURKEY

inflation report
2007-III

CONTENTS

1. Overview

Inflation and other macroeconomic variables have evolved broadly in line with the outlook presented by the Central Bank of the Republic of Turkey (CBRT) since July 2006. The monetary tightening since July 2006 has delivered a considerable slowdown in domestic demand, while the rising contribution of net exports have supported economic growth. Accordingly the demand conditions have increasingly supported the disinflation process. The disinflation process has became discernible in the second quarter of 2007, as the durable goods and services inflation decelerated. Notwithstanding rising oil prices and elevated food prices, annual inflation fell by 2.26 percentage points in the last 3 months to 8.6 percent, staying within the uncertainty band. Although these developments had a favorable impact on inflation expectations, the extent of the improvement was rather limited due to the inertial behavior in expectations.

Demand conditions continued to support disinflation through the first half of 2007. During this period, domestic demand continued to moderate owing to the decline in durable goods and machinery-equipment purchases. The slowdown in the global economy has been somewhat limited, while the Euro area stayed relatively robust. Strong foreign demand, sustained productivity gains, and rising export prices supported exports. Furthermore, the primary government spending continued to expand at a high pace. Despite the rise in external demand and public spending, the growth rate of aggregate demand was modest, owing to the significant slowdown in domestic demand. Consequently, seasonally adjusted quarterly growth rate of Gross Domestic Product (GDP) was 0.4 percent.

Although the domestic demand has shown some signs of recovery in the second quarter, the subcomponents of aggregate demand displayed a similar pattern to the first quarter. In this period, real credit growth has somewhat accelerated but still at a lower pace than in the first half of 2006. Consumption goods imports and domestic sales of white goods declined in quarterly terms. Consumer confidence indices suggested a modest recovery. To sum up, current information set reveals that demand conditions support disinflation as of the second quarter of 2007.

1.1. Monetary Policy and the Outlook

Since these developments were broadly in line with the outlook presented in the April Inflation Report, the Monetary Policy Committee (The Committee) adhered to the policy path envisioned in the April Report and did not change the policy stance in the past quarter. Accordingly, the Committee kept the policy rates on hold in the last three meetings. In the July meeting, the Committee expressed the possibility of a measured easing starting from the last quarter of 2007. The Committee also added that exact timing and extent of the easing may vary depending on the incoming information regarding external demand, public expenditures and other determinants of medium term inflation outlook.

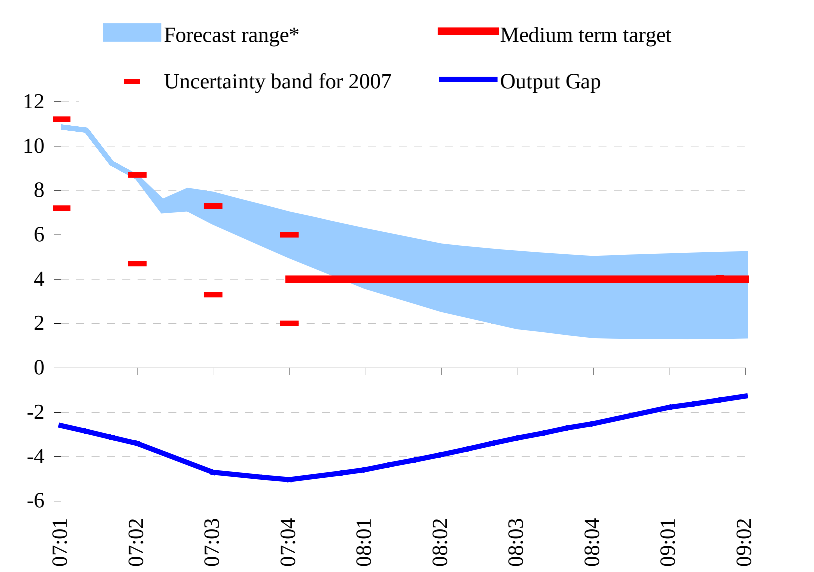
In the second quarter, medium to long term interest rates displayed a downward trend owing to more favorable inflation expectations, and the benign global risk appetite. The decline in interest rates and ongoing capital inflows ease the credit constraints and hence expand the supply of loanable funds. Given the improved credit availability and the fall in relative prices of durables and investment goods, it is likely that the consumption and investment expenditures will rebound in the forthcoming period. However, taking the cautious stance of monetary policy into account, our baseline forecast envisions a rather moderate rise in the domestic demand; that is, aggregate demand conditions continue to support the disinflation process in the short run.

On the other hand, considering the recent developments, our assumption on oil prices was updated to 65 USD per barrel from 60 USD. This revision induced an upward shift in the short term inflation expectations, with no significant impact on the medium term outlook.

To sum up, since the recent developments are broadly in line with our predictions, we keep the main message of the April Inflation Report and hence maintain a similar inflation and monetary policy outlook. In this respect, assuming measured policy rate cuts starting from the beginning of the last quarter, our forecasts indicate that inflation will be between 5.1 and 6.9 (mid-point 6.0) at the end of 2007, and between 1.5 and 4.9 (mid-point 3.2) at the end of 2008 (Graph 1.1.1).

These forecasts do not necessarily imply “a rate cut in October”. The main message of the forecast is that the lagged effects of the past monetary tightening will continue to drive down inflation even under measured rate cuts during the last quarter of 2007. In this respect, possible rate cuts can be considered earlier as well as later depending on the flow of incoming information regarding external demand, public expenditures and other determinants of medium term inflation outlook.

Graph 1.1.1. Inflation and Output Gap Forecasts



*Forecast range corresponds to the 70 percent confidence interval.

It should be stressed that this policy perspective is constructed under the current information set and assumptions, and thus, it should by no means be perceived as a commitment on behalf of the CBRT. There are considerable uncertainties that could necessitate a significant revision in the monetary policy outlook in either direction.

1.2. Risks

Inflation expectations remain sticky, partly owing to the elevated headline inflation figures of the past year. Uncertainties regarding the food and oil prices and the incomes policy in 2007 have also contributed to the stickiness in inflation expectations. The present gap between medium term expectations and targets suggests that the target inflation may have been serving less of an anchor recently. This constitutes a risk for wage setting behavior, and hence, for services inflation. Realization of such a risk would slowdown the pace of disinflation, possibly requiring a tighter-than-envisaged monetary policy.

There are certain services items, of which, inflation inertia is driven by structural factors and thus, cannot simply be explained by backward indexation. Needless to say, these prices can hardly be influenced by monetary policy. For example, annual rent inflation have remained sticky around 20 percent in the past three years, contributing to annual headline inflation by about one percentage points each year. Rent inflation is expected to moderate in the next couple of months, and further stabilize in the medium to long term, as the housing supply keeps rising. Nevertheless, the possibility that rent inflation will continue to exceed the other services inflation is considered as a risk factor against the disinflation process.

The monetary transmission mechanism has proven to be effective during the past year. Although the increase in non-interest government spending and the robust external demand have restrained the disinflation process, monetary tightening has been successful to bring inflation back to a disinflationary path towards the medium term targets. Nevertheless, in order to reach the medium term target of 4 percent, the domestic demand needs to stay under control for a while. However, domestic demand conditions may turn less supportive for disinflation, provided that the uncertainties fade out and the long-term interest rates continue to decline in the second half of the year. Such a situation may lead to a more cautious policy stance than implied by the baseline scenario, as well as the use of policy tools other than short term interest rates, such as required reserves and alike. Nonetheless, this outcome would be less likely, should the cautious monetary policy stance be backed by fiscal discipline.

Possible fluctuations in the global liquidity conditions continue to pose risks to the inflation outlook. The inflation and growth outlooks for the developed economies are still not clear, and thus, international financial markets continue to be sensitive to new data releases. Ongoing uncertainties over the global imbalances stand out as another risk factor that might lead to abrupt changes in portfolio preferences and liquidity conditions. The CBRT will limit the potential inflationary effects of a possible shift in risk perceptions by pursuing an active liquidity management strategy.

In this respect, the Committee, considering the current levels of liquidity, assessed that the Central Bank Liquidity Bills could be used, in addition to the current tools used in open market operations, to enhance the effectiveness of liquidity management when necessary.

Prudent monetary policy is necessary but not sufficient for achieving price stability. The role of fiscal policy and structural reforms are also critical in this process. In this respect, the European Union accession process and the implementation of the structural reforms envisaged in the economic program remain to be important for long-term stability. Particularly, advances in structural reforms that would enhance the quality of fiscal discipline are closely monitored with regard to their effects on both macroeconomic and price stability.

2. International Economic Developments

2.1. Economic Performance and Monetary Policy Developments

The US economy, which grew by 3.3 percent in 2006, had an annual growth rate of 1.9 percent in the first quarter of 2007 due to unfavorable developments in the housing sector (Table 2.1.1). On the other hand, despite the unfavorable conditions in the housing sector, the growth rate is expected to be at a moderate pace both in the first half and over the rest of the year on the basis of favorable domestic demand conditions, a robust manufacturing industry and fixed investments. Federal Reserve (Fed) rates have been kept on hold at 5.25 percent since June 2006. Even though there has been a slowing down tendency in the core inflation recently, the fact that inflationary pressures have not been convincingly moderated leads to differences in the market expectations about the direction of the interest rates. Interest rate decisions over the coming period will depend on the outlook for both inflation and economic growth.

Table 2.1.1. Growth Rates
(Annual Percentage Change)

	2006	**2007***	2006-I	2006-II	2006-III	2006-IV	**2007-I**	**2007-II***
World	5,4	**4,9**	-	-	-	-	-	-
USA	3,3	**2,1**	3,7	3,5	3,0	3,1	**1,9**	**2,0**
UK	2,7	**2,8**	2,5	2,7	2,9	3,0	**2,9**	**2,8**
Asia-Pacific								
Japan	2,2	**2,5**	2,7	2,2	1,5	2,4	**2,7**	**2,1**
China	10,7	**10,4**	10,3	10,9	10,7	10,7	**11,1**	
E. Europe	6,0	**5,5**	-	-	-	-	-	
Latin America	5,5	**4,9**	-	-	-	-	-	
Eurozone	2,7	**2,7**	2,2	2,9	2,8	3,3	**3,1**	**2,7**
Germany	2,5	**2,7**	1,9	2,9	3,2	3,9	**3,6**	**2,9**
France	2,0	**2,1**	1,4	2,7	2,1	2,2	**2,0**	**1,8**
Italy	1,8	**1,9**	1,7	1,6	1,6	2,8	**2,3**	**2,1**

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

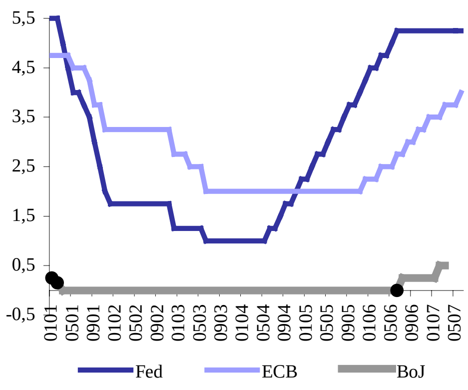
The US current account deficit reached 5.7 percent of the GDP in the first quarter of 2007, displaying an increase over the preceding quarter. The relatively robust global demand conditions coupled with the depreciation of the US dollar signify a declining trend or a limited increase in the current account deficit. This is also perceived as a favorable development in terms of global economic balances.

In the first quarter of 2007, the Eurozone grew by 3.1 percent compared to the same period of 2006 and by 0.7 percent compared to the previous quarter (Table 2.1.1). The said growth was mainly driven by investments and inventory accumulation. Positive financing conditions, both cumulative and ongoing corporate profits, and labor productivity are believed to underpin investment expenditures. On the other hand, private consumption did not contribute to growth as expected because of the Value Added Tax (VAT) increase introduced in Germany in early 2007. In fact, the contribution of the German private consumption to growth was negative in the first quarter. However, the contribution of consumption expenditures to growth is expected to increase in the upcoming period as real disposable income increases on the back of an unemployment rate hitting a 25-year low. Rising consumer confidence and rapid credit and money growth also support these forecasts. In light of these developments, it is projected that the second-quarter Eurozone growth will also be strong. The Eurozone Manufacturing Purchasing Managers Index (PMI), a key indicator of growth, has been rising since May and signals further strong growth in Europe. Moreover, the limited slowdown in global growth suggests that external factors will also support growth in the Eurozone.

High and volatile oil prices are the main risks to slow medium and long term Eurozone growth. Moreover, a rise in protectionist pressures, unfavorable developments resulting from global imbalances and a possible loss of confidence in financial markets are among other risk factors that would threaten economic activity in the Eurozone.

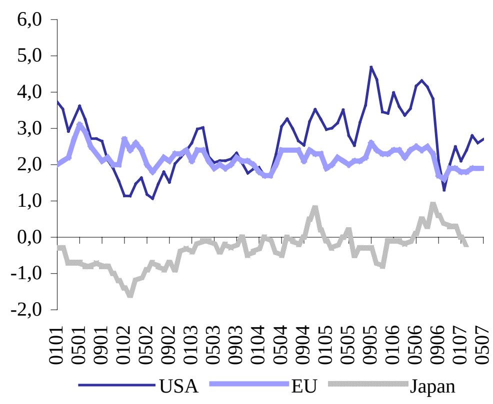
Eurozone Harmonized Index of Consumer Prices (HICP) has been on the rise for the last couple of months (Graph 2.1.2). The Eurozone inflation rate, which is highly susceptible to developments in energy prices, is expected to display a moderate decline in coming months due to the base effect resulting from high oil prices in 2006. However, Eurozone inflation might reaccelerate toward the end of the year due to the current upward tendency of oil prices. Other risks to Eurozone inflation rates are higher-than-expected hikes in administered prices and the probability that the increased capacity utilization may push wages, and hence, prices up.

Graph 2.1.1. Policy Rates
(Percent)



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

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



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

The European Central Bank (ECB) has perceived the excess liquidity that originated from the growing money and credit volume as a medium and long-term risk to price stability and has maintained its policy of gradual tightening. In this framework, the ECB raised interest rates to 4.0 percent by another 25 basis points at its last meeting of June 6, 2007 (Graph 2.1.1). As a consequence of monetary tightening, the M1 growth of the Eurozone has moderated since mid-2006, and both the loans to the private sector and the borrowing by households and non-financial corporations have relatively stabilized. Moreover, short-term rate hikes have slowed house price growth. At the latest ECB Governing Council meeting of July 5, 2007, short-term interest rates were kept unchanged, and given the positive economic outlook , it was emphasized that ECB's monetary policy will continue to be on the accommodative side, despite vigorous economic activity and high M3 growth.

The Japanese economy, which grew by 2.2 percent in 2006, had a growth rate of 2.7 percent in the first quarter of 2007. The falling industrial production growth rate is expected to slow down the second-quarter GDP growth (Table 2.1.1). Exports are likely to continue to grow on the basis of robust foreign demand. Meanwhile, domestic private demand is expected to continue to increase on the background of high corporate profits and the moderate rise in household incomes. Therefore, in light of these increases in both domestic and foreign demand, the growth rate is expected to remain on the rise in 2007.

Japan's consumer prices fell by 0.1 percent in the first and second quarters of 2007. The decline in consumer prices was 0.2 percent in June due to falling food prices. As the unemployment rate hit a ten-year low in the first half of 2007, it is predicted that consumption spending will recover in the upcoming period and possibly push consumer prices up (Graph 2.1.2). Meanwhile, the Bank of Japan (BoJ) decided to keep policy rates unchanged at 0.5 percent considering the favorable developments in financial markets (Graph 2.1.1). However, the fact that economic growth rate in 2007 might exceed the projected rate signals the possibility that the BoJ may gradually raise policy rates in the upcoming period.

The World Bank's forecasts indicate that the Chinese economy grew by 11.1 percent in the first quarter of 2007. Despite the rebound in the foreign trade balance in the first half of 2007, the potential decrease in the second half might stabilize the rapid growth in sales and industrial production, and thus, help Chinese economy slightly slow down during the rest of 2007 and grow at 10.4 percent for the entire year (Table 2.1.1).

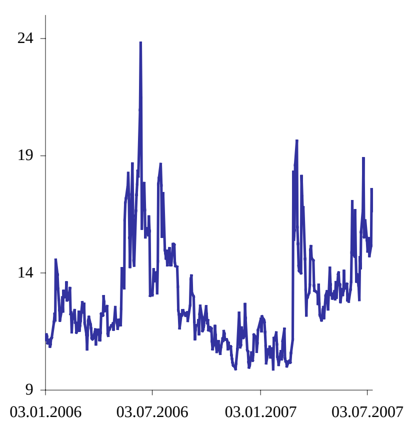
The Chinese government's efforts to move from an export-led growth model to consumption-oriented investments are expected to increase the growth rate of private consumption expenditures to 6.5 percent in 2007 from 6.2 percent in 2006. The 18.1 percent rise in industrial production in the first five months of 2007 compared to a year earlier suggests that the recovery in economic activity will continue. Meanwhile, the rise in retail sales by 15.2 percent has been higher than the rise in the same period of the previous year, mainly on the basis of the increase in urban real wages. Annual inflation reached a 27-month high of 3.4 percent in May. Low rainfall on China's farmlands coupled with strong demand for grains from producers of biodiesel fuel and soaring international grain prices have boosted food prices and have been the key factor behind the rapid rise in inflation.

2.2. International Markets

2.2.1. Financial Markets

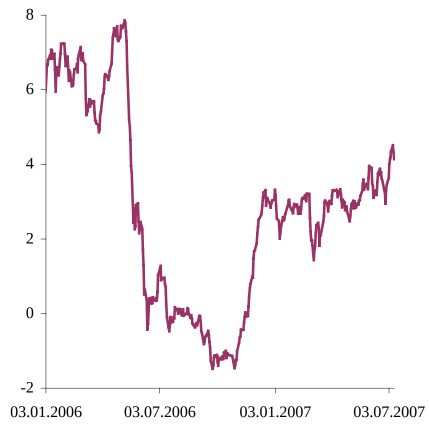
Financial markets have remained largely favorable in the past three months and many indicators hit historic highs. While the strong global growth and the surging risk appetite have supported the current trend, concerns over the sustainability of these levels have become more prominent. The rise in US market rates and the increased volatility, coupled with troubles in the real estate market stand out as major uncertainty factors.

Graph 2.2.1. VIX Index



Source: Bloomberg.

Graph 2.2.2. Credit Suisse Global Risk Appetite Index

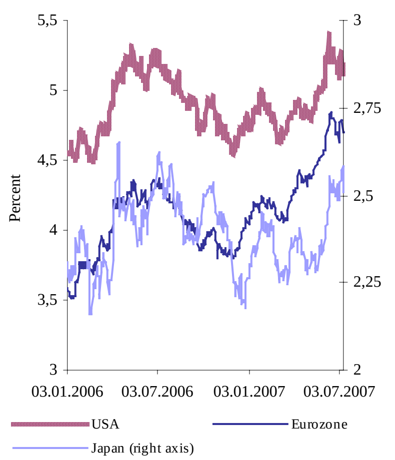


Source: Credit Suisse.

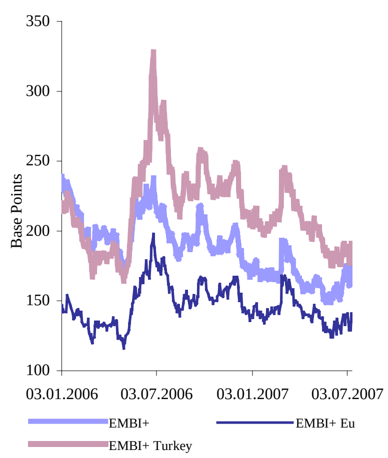
The Credit Suisse Global Risk Appetite Index (CSRA) and the VIX continue to demonstrate high risk appetite. Following the fluctuations in late February, the VIX stabilized at a higher level, but the rise in US market rates and the resulting troubles in the real estate market led the VIX Index to display abrupt shifts. Despite the recent rise, the VIX remains below long-term averages and continues to demonstrate a high level of risk appetite. Similarly, the CSRA also indicates that the risk appetite is high (Graph 2.2.1, Graph 2.2.2).

Among interest rate developments of the industrialized countries, those of the US economy are the most outstanding. The Fed, which was definitely expected to cut rates in 2007, reversed expectations by emphasizing that it still perceived inflation as a threat. This situation affected market interest rates and led to a rapid rise in yields, resulting in a 60 basis point increase in 30-year US bond yields between mid-May and mid-June. The rise in US bond yields triggered increases in yields in other developed countries as well. In Eurozone, the ECB raised interest rates in June, and the prospects for further rate hikes continue to raise the yields. Even if the inflation rate in Japan still remains negative, remarks by the BoJ regarding its expectations for the near future make investors think that the Bank considers this situation temporary, which heightens expectations for new interest rate hikes (Graph 2.2.3).

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



Graph 2.2.4. EMBI+ Developments

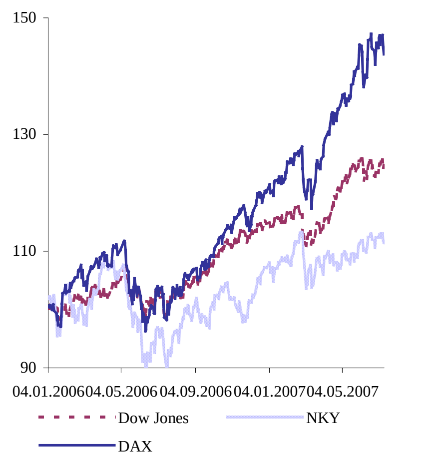


Source: Bloomberg.

While the high risk appetite makes investment instruments of emerging markets more attractive, the rapid rise in US bond yields have further lowered yield spreads, and the Emerging Markets Bond Index (EMBI+) hit a historic low of 149 basis points on June 1, 2007. The EMBI+ sub-index for Turkey had been floating 40 basis points above the main EMBI+ index for a year, but the spread narrowed in the last couple of months, and as of July 6, 2007 it decreased to 16 basis points (Graph 2.2.4).

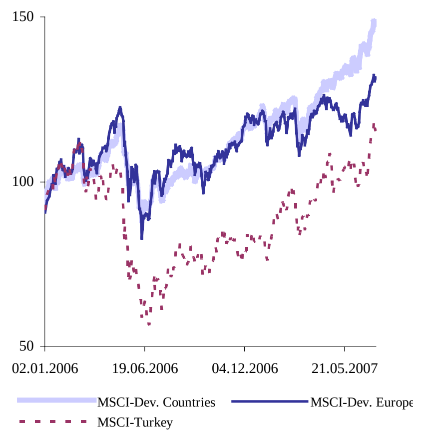
The upsurge observed in the stock markets became even stronger in the second quarter of 2007. Except for the Nikkei index, all indices shown in the graphs recorded all-time highs. Strong global growth and ample liquidity conditions encourage investors to bear risk and invest in high-risk stock markets, while the high returns of instruments fuel this process. An analysis of the markets of developed countries suggests that the rise in the DAX index is more apparent due to the strong growth trend in the Eurozone and Germany (Graph 2.2.5). Developing Countries and Developing European Countries and Turkey sub-indices of the Morgan Stanley Capital Index (MSCI) also displayed a strong upward trend, and the rise in the Turkey sub-index surpassed the developing countries sub-index in this period (Graph 2.2.6).

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



Source: Bloomberg.

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

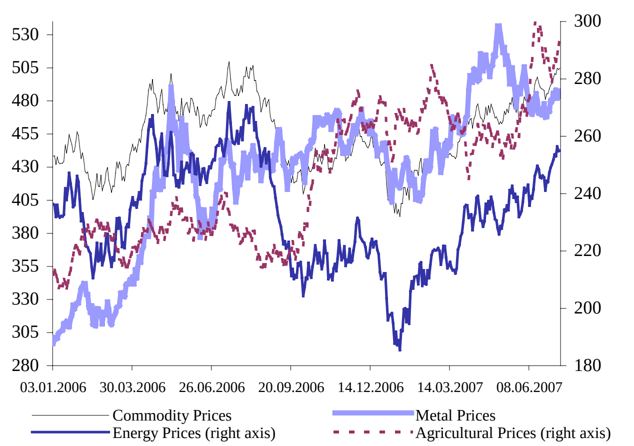


Source: Morgan Stanley.

2.2.2. Commodity Markets

The second-quarter average value of the Goldman Sachs Commodity Index (GS) increased by 1.1 percent over the average value of the first quarter, but pursued a stagnant course compared to the same period of 2006. On a quarterly basis, the Energy and Basic Metals sub-indices predominated, while in annual terms, the rapid increase in prices of Agriculture and Basic Metals was notable (Graph 2.2.7).

Graph 2.2.7. Commodity Prices



Source: Goldman-Sachs.

In the second quarter of 2007, six basic metals traded in the London Metal Exchange (LME) rose by 79.3 percent over the second-quarter average of 2006, and by 16.3 percent over the first quarter average of 2007 (Table 2.2.1). Recent developments suggest that copper prices reaccelerated in response to strong Chinese demand as the effects of the private placement offered by China Strategic Reserves in 2006 started to subside. Prices of nickel, the third major metal in the GS Basic Metal Index, went down by 35.5 percent on July 12 from the price of an all-time high of USD 51.000 per metric ton in early May (Table 2.2.1). LME stock figures also give a clear picture of the tendency of basic metal prices (Table 2.2.2).

Table 2.2.1. London Metal Exchange

Tons/ USD	**Value**				**Percentage (change)**		
	2006*	**2007Q1***	**2007Q2***	**July 12th**	**07Q2 / 07Q1**	**2007Q2 / 2006Q2**	**12th July / 2007Q2**
Aluminum	2.595,2	2.747,8	2.801,9	2.800,0	*2,0*	*8,0*	*-0,1*
Copper	6.678,8	5.975,1	7.578,2	7.825,0	*26,8*	*13,5*	*3,3*
Lead	1.281,8	1.750,7	2.104,6	2.980,0	*20,2*	*64,2*	*41,6*
Nickel	23.223,3	38.809,6	45.701,2	33.200,0	*17,8*	*96,8*	*-27,4*
Tin	8.747,4	12.590,0	13.980,1	14.105,0	*11,0*	*59,8*	*0,9*
Zinc	3.248,0	3.441,3	3.679,4	3.544,0	*6,9*	*13,3*	*-3,7*

* Average value.
Source: Bloomberg.

The surge in international crude oil prices, which started in early 2007, has become more pronounced lately and amounted to USD 78.2 per barrel on July 11, 2007 (Graph 2.2.8). Following OPEC's production cuts, the higher-than-expected demand for oil and the production cuts in Nigeria due to ongoing disturbances caused the rise in crude oil prices to become sharper despite the increase in US crude oil supplies (Table 2.2.2). Moreover, the growing imbalance between crude oil and refined product inventories due to refinery maintenance in the US as well as the tensions in the Middle East have been the key factors pushing up crude oil prices.

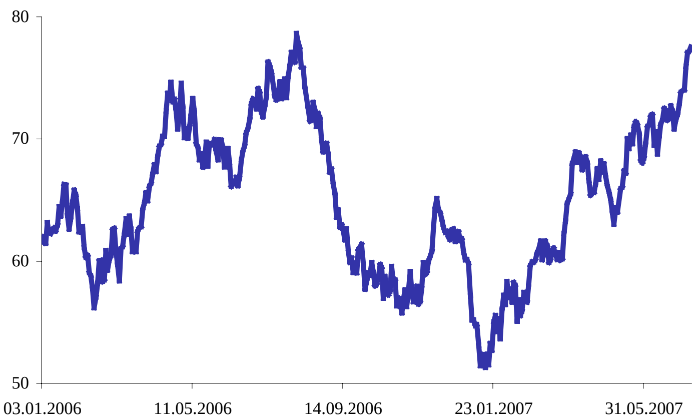
Table 2.2.2. Basic Metals and Crude Oil Stock Values*

	2004-2005	**2006**				**2007**			
	Annual	Monthly Average			Annual	Monthly Average			July**
	Average	Jan.	Nov.	Dec.	Average	Jan.	April	June	
Copper	106.004	100.517	151.014	170.626	118.951	211.825	157.200	114.700	99.350
Aluminum	781.241	672.505	680.381	680.645	723.079	736.875	826.725	824.900	829.750
Nickel	13.477	36.412	7.012	6.560	17.368	3.972	5.016	8.910	10.080
Tin	6.984	16.674	12.411	13.232	13.187	11.400	8.515	12.335	12.050
Zinc	636.348	383.176	93.666	86.967	219.489	97.675	96.375	73.000	69.825
Lead	50.162	50.781	45.630	41.076	76.151	39.050	41.575	45.075	42.925
Crude Oil	1.644,50	1.701,70	1.743,64	1.720,14	1.726,62	1.727,48	1.671,06	1.703,06	1.719,40

* Thousand tons for basic metals from LME, thousand barrels for crude oil from US stock levels.
** Basic metal stock values as of 11 July, crude oil stock values as of 6 July.
Source: Bloomberg.

Since the global economic activity did not slow down as expected by OPEC, which decided on further oil production cuts as of February, crude oil markets have become very susceptible to sudden cuts. In the upcoming period, major risks against oil prices would be an upward revision from OPEC for the expected increase in demand parallel to International Energy Agency's (IEA) estimates and the coming hurricane season. Moreover, OPEC's resistance to revise quotas upward and the continued problems in Nigeria might lead to abrupt price hikes.

Graph 2.2.8. Oil Prices
(US Dollars/ Barrel)



Source: Bloomberg.

The consensus forecasts of investment agencies suggest that average prices for gold and crude oil will follow a steady course, while those of copper and nickel will rise in the last quarter of the year (Table 2.2.3). Forecasts for third-quarter crude oil prices remain well below spot prices, but the 'Consensus Forecasts' of July suggest that they are expected to be around USD 67.1 per barrel in October.

Table 2.2.3. Consensus Forecasts for Main Commodity Prices*

	2007-III			2007-IV			2008-I			2008-II		
	Average	**min**	**max**	**Average**	**min**	**max**	**Average**	**min**	**max**	**Average**	**min**	**max**
Gold	675	600	720	678	600	725	686	615	725	681	650	720
Aluminum	2550	2200	2900	2445	2000	2950	2412	2094	2800	2491	2315	2900
Copper	6604	5500	8000	6173	4500	8150	6928	5750	8100	7215	6746	8000
Nickel	33848	17000	52000	31134	16000	52500	36765	22000	52000	41180	34723	51000
Zinc	3396	2300	4250	3233	1800	4400	3487	3086	4250	3506	2976	4250
Wheat	508	460	550	504	440	544	-	-	-	-	-	-
Corn	372	330	430	378	350	415	-	-	-	-	-	-
Crude Oil	65,33	56,00	74,5	63,01	51,5	72,00	63,06	55,00	72,00	63,5	60,00	68,70

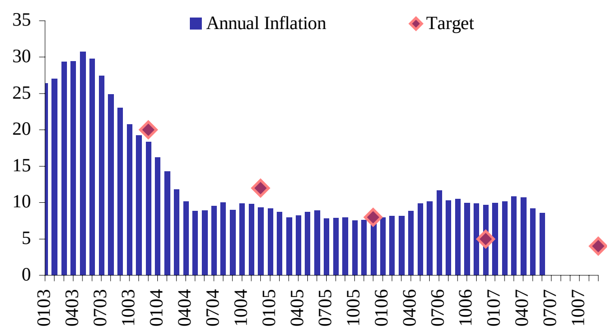
* Basic metal price forecasts are in US dollar/ton, gold prices in US dollar/troy ounce, agricultural raw material prices US dollar/ bushel and crude oil prices US dollar/barrel.
Source: Bloomberg.

3. Inflation Developments

3.1. Inflation

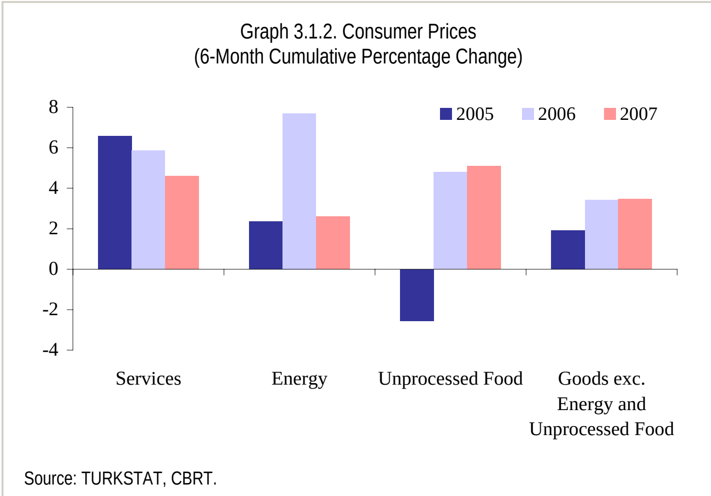
Annual consumer inflation decreased to 8.60 percent in the second quarter of 2007 and remained within the uncertainty band set around the target path (Graph 3.1.1). As highlighted in the April Inflation Report, the first-quarter rise in annual inflation did not persist and was replaced by a decline in the second quarter. Consumer prices increased at a 3-year low of 1.47 percent in the second quarter. The monetary tightening applied since June 2006 affects prices especially via services and consumer durables. The decline in annual inflation became apparent in the second quarter as the base effect from the same period last year weakened.

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

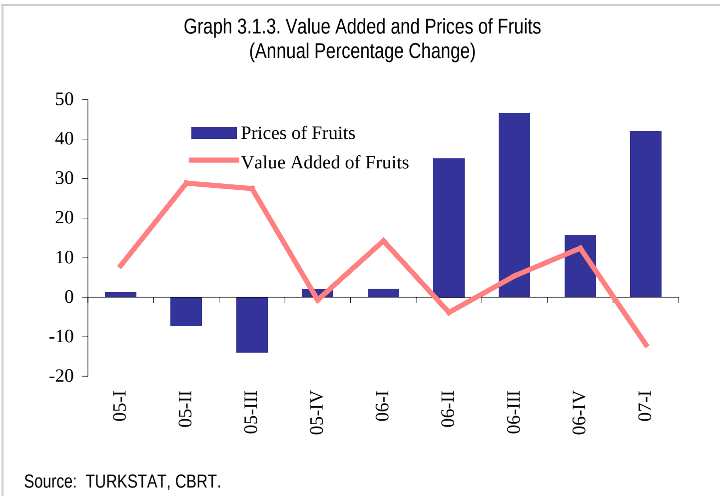


Source: TURKSTAT.

In the first half of 2007, services inflation displayed a noticeable slowdown (Graph 3.1.2). During the same period, the growth rate of energy prices also dropped compared to last year, but unprocessed food prices exhibited an even stronger upsurge over a year earlier. Prices of goods excluding energy and unprocessed food maintained the high level of increase they displayed last year. To sum up, the first-half services inflation displayed a favorable outlook, but non-energy goods prices restrained the decline in inflation.

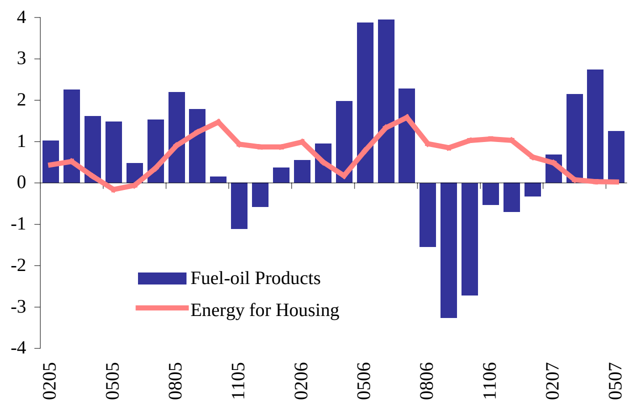


Hikes in unprocessed food prices in the first quarter of 2007, which prevailed over the averages of the past year, slowed down in the second quarter. This can be attributed to the correction in fruit prices that had increased sharply in the first quarter. The notable decline in fruit production in the first quarter indicates that price hikes in this group are mainly supply-oriented (Graph 3.1.3). On the other hand, the "prices of poultry meat", a sub-group under "other unprocessed food products" except fruits and vegetables, rose sharply in the second quarter at around 30 percent, and contributed by 3.9 points to the 13.25 percent annual unprocessed food inflation. This price development was mainly driven by the elevated prices of cereals, which constitute an important input to this group.



Despite soaring oil prices, price hikes in the energy group presented a more favorable outlook in the first half of 2007 compared to last year, mainly on the strong course of the New Turkish lira (YTL) and the positive contribution of the solid fuels item of the housing group (Graph 3.1.4). On the other hand, recent price developments reveal that risks related to petroleum prices persist. In international markets, Brent oil prices surged up to USD 70 per barrel in June and continued to soar in July. As a matter of fact, despite the strong course of YTL over the last four months, prices of fuel oil products rose by 7.93 percent and curbed the pace of disinflation.

Graph 3.1.4. Domestic Energy Prices
(Monthly Percentage Change, Quarterly Moving Average)



Source: TURKSTAT, CBRT.

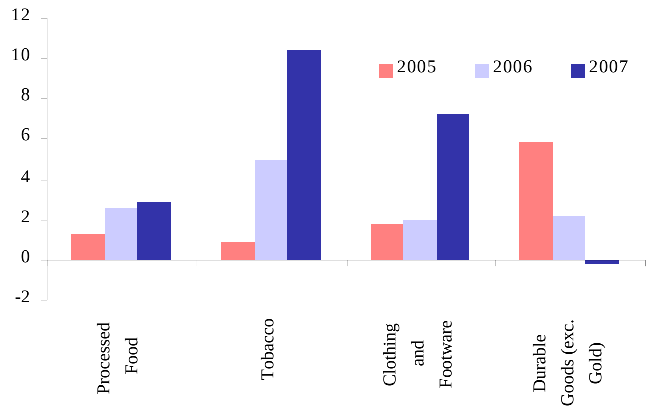
Table 3.1.1. Goods and Services Group Prices
(Quarterly Percentage Change)

	2006					2007	
	I	II	III	IV	Annual	I	II
CPI	**1.25**	**3.58**	**1.69**	**2.81**	**9.65**	**2.36**	**1.47**
1. Goods	**0.80**	**3.67**	**0.88**	**3.10**	**8.69**	**2.39**	**1.18**
Energy	2.63	4.94	0.69	1.92	10.52	1.58	1.00
Unprocessed Food	8.81	-3.67	1.83	5.81	12.94	11.74	-5.93
Goods Excluding Energy and Unprocessed Food	-2.01	5.54	0.67	2.70	6.93	-0.10	3.56
Durable Goods	-1.66	8.69	1.34	-1.58	6.61	1.23	-1.73
Durable Goods (Excl. Gold)	-3.04	5.40	2.84	-2.20	2.78	1.13	-1.36
Semi-durable Goods	-3.65	9.14	-2.14	4.75	7.81	-3.37	7.43
Non-Durable Goods	4.64	-1.12	3.01	3.04	9.82	6.75	-2.07
2. Services	**2.41**	**3.36**	**3.83**	**2.09**	**12.21**	**2.29**	**2.28**
Rent	4.08	3.69	6.67	4.25	20.01	3.94	3.33
Restaurants and Hotels	3.02	4.25	3.40	2.24	13.54	2.60	1.94
Transportation Services	1.27	1.36	6.26	3.50	12.89	0.10	1.70
Other Services	1.80	3.32	2.32	0.76	8.45	2.10	2.19

Source: TURKSTAT, CBRT.

Despite the outlook in the first quarter of 2007, prices of goods excluding energy and unprocessed food increased only at a modest rate in the second quarter, down from a year earlier (Table 3.1.1). This was mainly due to the notably improved prices of durables, contrary to the elevated prices of clothing and footwear. Analyzing the course of prices in the first half of 2007, it is observed that expenditure group prices, excluding durable goods, exhibited a higher rate of increase compared to the same period last year (Graph 3.1.5).

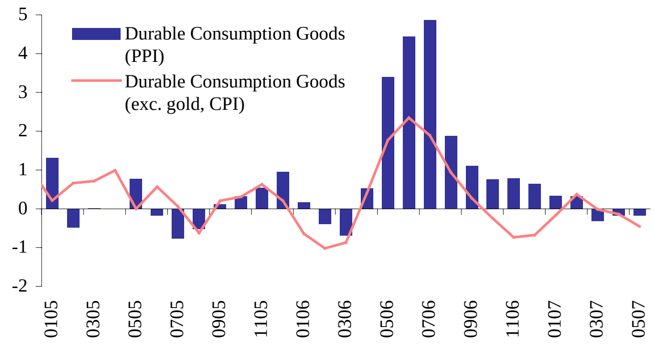
Graph 3.1.5. Prices of Selected Goods Excluding Energy and Unprocessed Food
(6-Month Cumulative Percentage Change)



Source: TURKSTAT, CBRT.

Annual inflation in durable goods (excluding gold) declined to 0.32 percent at the end of the second quarter due to the impact of both the strengthening of YTL and the subdued demand for this group. The rise in producer prices of this group presents a favorable outlook with a slowdown in the recent period (Graph 3.1.6). Prices of electrical and non-electrical appliances and automobiles fell remarkably, while prices of the furniture group increased at a rate below the previous year (Table 3.1.2). Prices of electrical and non-electrical appliances were affected the most by last year’s monetary tightening, and realized even below the level prior to the fluctuation of May 2006. On the other hand, the highest upsurge among durable goods since the fluctuation was seen in the furniture group, where imported input utilization is comparatively low and the indexing behavior is less frequent.

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



Source: TURKSTAT, CBRT.

Table 3.1.2. Prices of Durable Goods
(Quarterly Percentage Change)

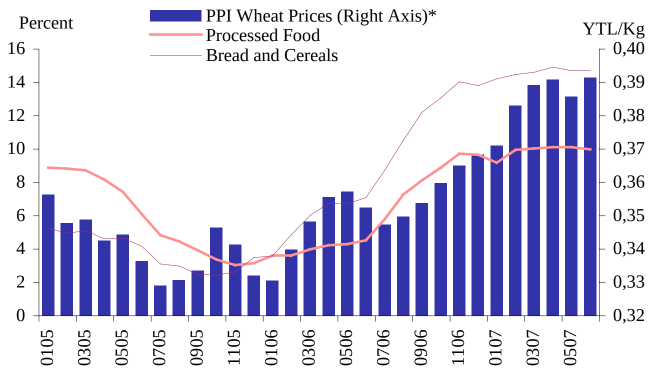
	2006					2007	
	I	II	III	IV	Annual	I	II
Durable Goods (Excluding Gold Prices)	**-3.04**	**5.40**	**2.84**	**-2.20**	**2.78**	**1.13**	**-1.36**
Furniture	-7.81	7.45	9.21	-3.17	4.74	-0.60	4.50
Electrical and Non-Electrical App.	-5.55	4.51	-0.54	-2.25	-4.03	-0.52	-3.75
Automobiles	2.93	7.09	2.57	-2.28	10.48	3.22	-2.74
Other Durable Goods	-1.17	-1.86	1.43	0.91	-0.73	0.82	1.09

Source: TURKSTAT, CBRT.

In the second quarter, clothing and footwear prices increased above seasonal rates, and the group's annual inflation amounted to 7.15 percent as of June. Second-quarter price developments largely confirmed that the positive contribution of the clothing and footwear group to disinflation over the last two years will come to a halt in 2007. The cost-oriented hikes in apparel manufacturing have slowed down in the recent period, but are still high in annual terms. Furthermore, the volume of apparel and textile exports has been growing in annual terms since the last quarter of 2006, with apparel exports reaching a high level. These developments reveal that the rise in the annual inflation of clothing and footwear in 2007 is driven by both cost pressures and strong foreign demand.

The second-quarter price hike in processed food products was not significant in comparison to the same period last year, and, accordingly, the annual inflation in this group preserved its steady course (Graph 3.1.7). The VAT cut in certain processed food products in June produced favorable effects for the entire group. However, the loss in wheat production still poses a risk on processed foods and thus on consumer prices via price developments in the bread and cereals group. As indicated in the previous inflation report, bread and cereals group prices surged up due to the acceleration in wheat prices in 2006, resulting in a significant increase in processed food prices (Graph 3.1.7). In the first half of 2007, processed food prices, excluding the bread and cereals group, increased by 1.13 percent, while price hikes in bread and cereals group amounted to 5.61 percent.

Graph 3.1.7. Processed Food, Wheat and Bread-Cereals Group
(Annual Percentage Change)

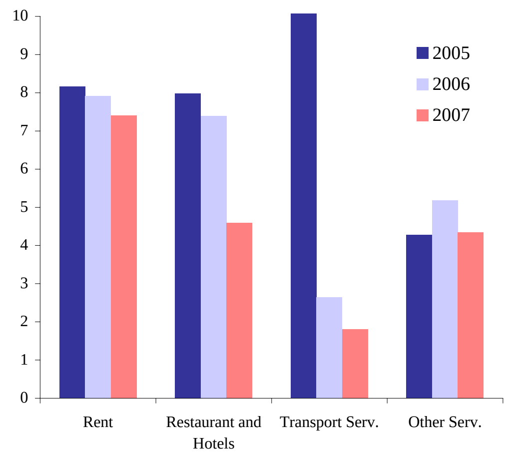


*Wheat prices are presented as level.
Source: TURKSTAT, CBRT.

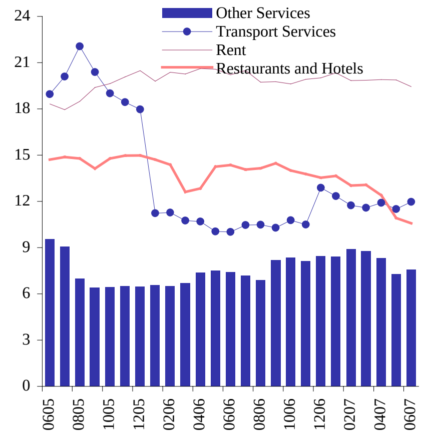
In conclusion, the possibility of low crop yields in certain products – primarily in cereals – owing to temperatures above seasonal norms and lack of rainfall, and the use of some of wheat and corn for bio-fuel production in the world will raise the uncertainties over food prices in the forthcoming period via both processed and unprocessed food products (Box 3.1).

Recent price developments signal a recovery in the services group (Graph 3.1.8). The lagged effects of monetary tightening arose in the first half of 2007 in services prices by an increase of 4.61 percent, the lowest half-term increase in the index for base year 2003. Services prices increased by 2.28 percent in the second quarter, pulling annual inflation in this group down to 10.90 percent (Table 3.1.1). Annual inflation in all services sub-groups except transport declined in the second quarter (Graph 3.1.9).

Graph 3.1.8. Services Group Prices
(6-Month Cumulative Percentage Change)



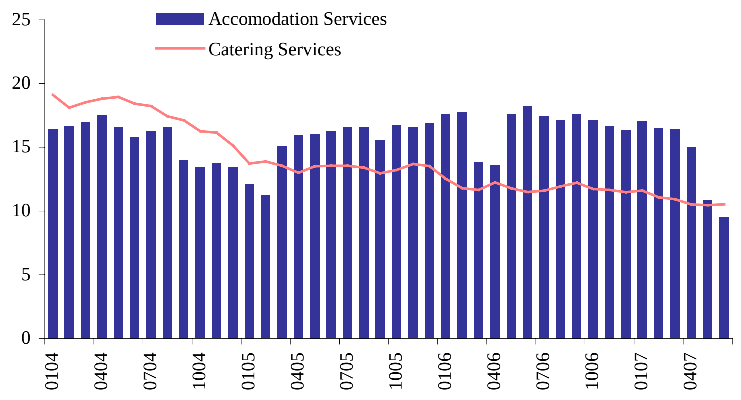
Graph 3.1.9. Services Group Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

The most remarkable slowdown among services price hikes was observed in the restaurants and hotels group. As regards sub-items within this group, inflation in both catering and accommodation services displays a slowdown tendency (Graph 3.1.10). Rent prices, which are highly influential in the rigidity of services group prices, recovered to a limited extent in the first half of the year (Graph 3.1.8).

Graph 3.1.10. Restaurants and Hotels Group Prices
(Annual Percentage Change)



Source: TURKSTAT

Transport services inflation presents a favorable outlook compared to previous years; yet, it increased slightly in the second quarter owing to road transportation prices rising in response to soaring fuel oil prices. On the other hand, annual inflation in services other than restaurants-hotels, rent and transport declined by some 1.2 points in the second quarter to 7.58 percent. Given the ongoing slowdown in domestic demand, the improvement in services prices is projected to continue gradually.

In the second quarter of 2007, annual inflation fell in all special Consumer Prices Index (CPI) aggregates as a result of the favorable developments in durable goods and services prices. Annual inflation in the special CPI aggregate-H excluding energy, unprocessed food, alcoholic beverages, tobacco products and gold fell by 1.32 points compared to the previous quarter. Seasonally adjusted monthly increases of the SCA-H indicator, which rose at a limited rate in the first quarter, displayed a marked slowdown in the second quarter and converged to its pre-May 2006 level. This course of special CPI aggregates implies that the main trend of inflation is mostly downward.

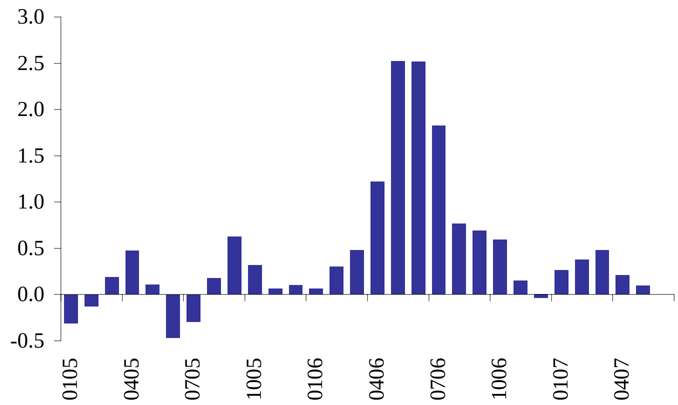
Table 3.1.3. Special CPI Aggregates (2003=100)
(Quarterly Percentage Change)

	2006					2007	
	I	II	III	IV	Annual	I	II
CPI	**1.25**	**3.58**	**1.69**	**2.81**	**9.65**	**2.36**	**1.47**
A. CPI Excluding Seasonal Products	2.31	2.79	3.23	1.36	10.04	2.62	1.00
B. CPI Excluding Unprocessed Food	0.12	4.79	1.67	2.38	9.21	0.89	2.78
C. CPI Excluding Energy	1.01	3.38	1.86	2.96	9.51	2.49	1.54
D. CPI Excluding Unprocessed Food and Energy	-0.38	4.77	1.86	2.47	8.95	0.76	3.11
E. CPI Excluding Energy, Alcoholic Beverages and Tobacco Products	0.74	3.62	1.98	3.16	9.82	2.03	1.64
F. CPI Excluding Energy, Alcoholic Beverages and Tobacco Products, Other Goods with Administered Prices and Indirect Taxes	1.75	3.82	1.86	3.39	11.25	2.24	2.05
G. CPI Excluding Energy, Alcoholic Beverages and Tobacco Products, Other Goods with Administered Prices, Indirect Taxes and Unprocessed Food	0.26	5.59	1.88	2.91	10.99	0.17	4.04
H. CPI Excluding Energy, Alcoholic Beverages and Tobacco Products, Unprocessed Food and Gold	-0.96	4.77	2.18	2.70	8.89	0.03	3.51

Source: TURKSTAT, CBRT

Developments in producer prices are crucial in terms of assessing the cost pressures on consumer inflation. Analyzing the second-quarter developments in producer prices, it is observed that annual inflation in this group fell considerably to 2.89 with the waning high base effect of the previous year. Manufacturing industry prices excluding petroleum products displayed quite a limited rise, by 0.29 percent, in the second quarter. The marked improvement in recent months in prices of the manufacturing industry excluding petroleum products suggests that consumer prices run a favorable course in terms of cost pressures (Graph 3.1.11).

Graph 3.1.11. Manufacturing Industry Excluding Petroleum Products
(Annual Percentage Change, Quarterly Moving Average)

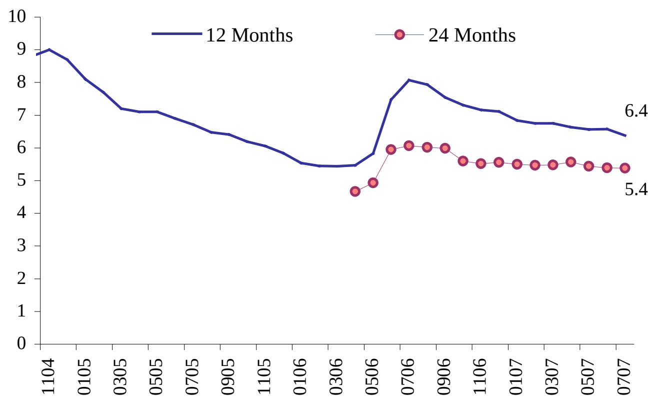


Source: TURKSTAT, CBRT.

3.2. Expectations

The downward trend in annual inflation is also reflected on inflation expectations. Medium-term inflation expectations had followed a horizontal course since early 2007, but have been falling in recent months. Since the previous inflation report, 12 and 24-month-ahead inflation expectations have fallen by 25 and 19 basis points, respectively, thanks to the decline in annual inflation. However, the above-target course of medium-term inflation expectations continues to pose a risk on the wage and price setting behavior (Table 3.2.1).

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



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

An analysis over the coefficients of variation[1], which measure inflation uncertainty, reveals that the July decline in the said coefficient regarding 12-month ahead inflation expectations signals less uncertainty over inflation expectations (Table 3.2.1).

Table 3.2.1. CPI Inflation Expectations

Current Period	Survey Period	End-Year Average Expectation*	Next 12 Months		Next 24 Months	
			Average Expectation*	Coefficient of Variation	Average Expectation*	Coefficient of Variation
January-06	1	5.68	5.49	0.10		
	2	5.67	5.54	0.11		
February-06	1	5.75	5.45	0.10		
	2	5.81	5.45	0.11		
March-06	1	5.8	5.46	0.10		
	2	5.78	5.44	0.09		
April-06	1	5.76	5.41	0.10	4.64	0.11
	2	5.79	5.47	0.10	4.67	0.09
May-06	1	6.27	5.57	0.11	4.79	0.13
	2	6.75	5.83	0.15	4.93	0.16
June-06	1	8.82	6.66	0.15	5.37	0.15
	2	9.78	7.48	0.16	5.95	0.20
July-06	1	10.17	7.89	0.16	6.13	0.19
	2	10.28	8.07	0.16	6.07	0.16
August-06	1	10.59	7.98	0.13	6.06	0.17
	2	10.46	7.94	0.13	6.02	0.15
September-06	1	9.77	7.62	0.13	5.91	0.18
	2	9.63	7.54	0.10	5.99	0.16
October-06	1	9.96	7.38	0.11	5.80	0.17
	2	9.88	7.31	0.11	5.60	0.15
November-06	1	9.84	7.13	0.08	5.55	0.13
	2	9.85	7.16	0.09	5.52	0.14
December-06	1	9.93	7.23	0.11	5.58	0.13
	2	9.96	7.11	0.07	5.56	0.12
January-07	1	6.98	6.84	0.08	5.43	0.14
	2	7.04	6.84	0.07	5.50	0.13
February-07	1	7.16	6.77	0.08	5.43	0.13
	2	7.13	6.75	0.07	5.47	0.13
March-07	1	7.26	6.83	0.13	5.48	0.12
	2	7.28	6.75	0.10	5.48	0.11
April-07	1	7.44	6.64	0.11	5.54	0.15
	2	7.48	6.63	0.11	5.57	0.14
May-07	1	7.78	6.63	0.14	5.52	0.15
	2	7.84	6.57	0.11	5.44	0.12
June-07	1	7.66	6.47	0.11	5.40	0.14
	2	7.67	6.58	0.13	5.39	0.12
July-07	1	7.44	6.25	0.11	5.30	0.13
	2	7.49	6.38	0.09	5.38	0.11

* Average expectation figures presented in the table are specified through the appropriate means designated based on the comparison of arithmetic mean, median, mode, Alfa-and trimmed mean and extreme value analysis.
Source: CBRT.

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

BOX 3.1. RECENT PRICE DEVELOPMENTS IN AGRICULTURAL RAW MATERIALS

Prices of agricultural raw materials increased parallel to soaring crude oil and basic metal prices in recent years, leading to upward pressures on inflation rates in many countries. This box presents a review of price developments in agricultural raw materials and deals with the structural reasons for the said developments.

With the recent rapid growth throughout the world, the increasing involvement of both "hedge fund" and other financial market investors in "futures" and "forward" markets led to high-rated increases in commodity prices.[1] During this period, price hikes in the energy sub-item exceeded that of commodity prices. Due to soaring energy prices coupled with environmental concerns and geopolitical uncertainties, developed countries headed towards renewable energy sources. Production and consumption of bio-fuels grew rapidly chiefly owing to the adoption of the Common Agriculture Policy Reform by the European Parliament in 2003 and the Energy Policy Act by the US Senate in 2005. [2] This tendency is expected to persist in the future, primarily in the USA (Box 3.1.Table 1).

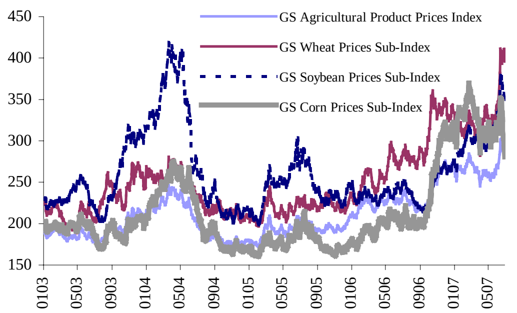
Box 3.1. Table 1. USA Crude Oil and Ethanol Consumption and Production

(Million Barrels per Day)	**2001**	**2002**	**2004**	**2005**	**2010**	**2015**	**2020**
Crude Oil Consumption	19.65	19.76	20.52	21.27	23.21	25.07	26.66
Crude Oil Production	7.67	7.63	7.24	7.29	7.15	7.85	8.07
Ethanol Production	0.1	0.13	0.16	0.26	0.4	1.38	1.98
(Ethanol Consumption)/(Energy Consumption), (Percentage)	0.51	0.66	0.78	1.22	1.72	5.5	7.43

Source: US. Department of Energy, Newsweek issue 8 August (2005), Financial Times, issue 26 August (2005).

Prices of agricultural raw materials have been rising rapidly since mid-2005 in response to the measures to encourage the use and availability of ethanol and bio-diesel (Box 3.1.Graph 1). This tendency is also supported by the fact that the Chinese economy shifts towards land-intensive commodity imports as a result of the structural transformation in production that China has been undergoing following its membership to the World Trade Organization in 2001. Increased temperature due to global warming has also affected agricultural productivity unfavorably. In line with the above-mentioned developments, the US Department of Agriculture largely revised the 2006 figures for corn, grains and wheat stocks downwards.[3] On the other hand, the decline in grain stocks in China by 14-17 percent compared to 1999 as well as the occurrence of a similar tendency in Brazil were other factors that triggered the price hikes in agricultural raw materials.

Box 3.1.Graph 1. GS Price Developments in Agricultural Raw Materials

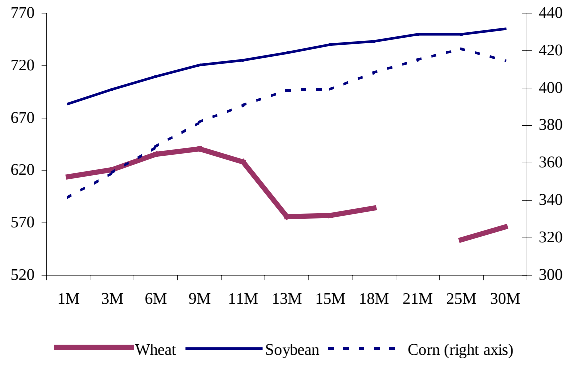


Source: Bloomberg.

The price hikes in international agricultural raw materials that have been observed since mid-2005 have led to an increase in the CPI-Food sub-item in almost all countries, and the inflation of processed and unprocessed food prices in many countries has pursued a course well above the general level of inflation (Box 3.1.Graph 3-6). The rapid growth in consumption arising from the wider use of agricultural raw materials suggests that the upward trend in the prices of agricultural raw materials will continue, which stands out as a major risk factor on worldwide inflation rates. Likewise, investors trading in the 'forward' market expect a rise in the prices of wheat, soybean and corn in the short-run (Box 3.1.Graph 2). Especially the recent rapid growth of ethanol and bio-diesel production and imports resulting from the institutional framework set up in the USA and the Euro Zone is considered the most important reason for the said expectation of an upward trend.

[1] CBRT, (2006), *Inflation Report*, Ankara, October 2006.
[2] Bio-fuels include fuel and many flammable derivative substances as well as various plants with a high rate of alcohol. First out of the two most produced bio-fuels is ethanol, an alcohol fuel distilled from organic products such as corn, wheat, sugar cane and other grains. The second is bio-diesel mainly produced by processing canola seeds.
[3] Julius Bar, (2007), Agricultural Commodity Facts, Private Banking Investment Research, London.

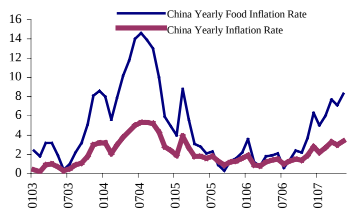
Box 3.1.Graph 2. Wheat, Soybean and Maize Yield Curves (USD/Kilo)



Source: Bloomberg.

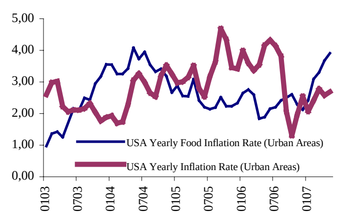
The most significant risk factor among those relating to the course of agricultural raw material prices in the upcoming periods is a possible drought-related sudden price hike. Similarly, the expansion of environmental audits due to increased environmental pressures might lead to further demand for bio-fuels and this may result in a new demand-driven break in prices. On the other hand, China's movement towards land-intensive sectors, primarily ethanol production, might cause a downward uncertainty in future prices. However, given the recent trend of Chinese economy, this seems to be only a little possibility. [4]

Box 3.1.Graph 3. General Inflation and Food Sub-item Inflation Rates in China



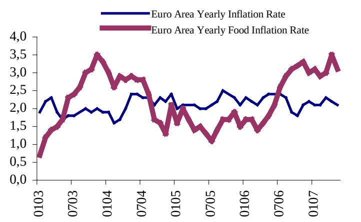
Source: Bloomberg

Box 3.1. Graph 4. General Inflation and Food Sub-item Inflation Rates in the USA



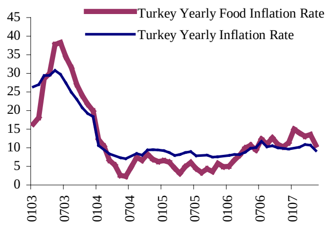
Source: US Department of Labor: Bureau of Labor Statistics

Box 3.1. Graph 5. General Inflation and Food Sub-item Inflation Rates in EU-15 Area



Source: Eurostat.

Box 3.1. Graph 6. General Inflation and Food Sub-item Inflation Rates in Turkey



Source: TURKSTAT.

In conclusion, the increased demand for bio-fuel products leads to upsurges in agricultural raw material prices. Particularly the measures to set up the legal framework for a wider use of ethanol and bio-diesel in developed countries has added to the increase in demand with much higher pace since mid-2005. The ongoing rise in agricultural raw material prices seems to persist in the upcoming period, which stands out as an important risk factor on worldwide inflation.

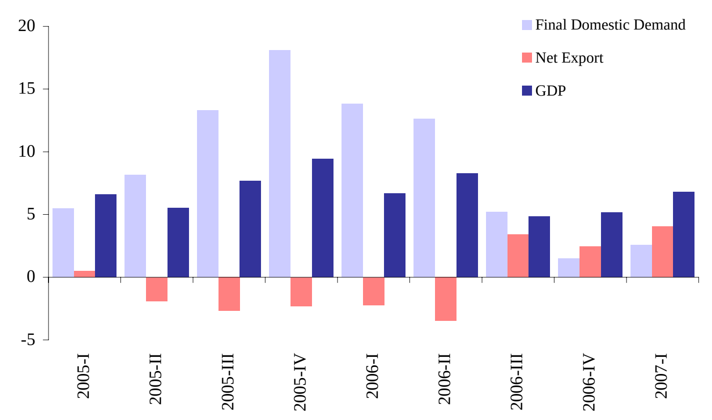
[4] OECD-FAO, (2006), *Agricultural Outlook 2007-2015*, Paris.

4. Supply and Demand Developments

4.1. Supply-Demand Balance

In the first quarter of 2007, the GDP grew by 6.8 percent over the same period of 2006. According to seasonally adjusted figures, the GDP grew by 0.4 percent over the previous quarter. The GDP growth composition of the second half of 2006 persisted in this period. The contribution of domestic demand to growth remained limited, while external demand became the main source of growth (Graph 4.1.1).

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



Source: TURKSTAT, CBRT.

In the first quarter of 2007, the value added of the industrial sector increased by a rate of 7.5 percent due to the base effect created by the low growth rate of the same period of 2006. Seasonally adjusted data did not display a notable change in the value added of the industrial sector compared to the previous quarter. Industrial production was supported by external demand but was restrained by the slowdown in domestic demand. The value added of the agricultural sector grew modestly, whereas that of the services sector increased by 6.5 percent. The value added of the construction sector continued to grow strongly, and the value added of trade and transportation sectors continued to grow in line with the upsurge in the value added of the industrial sector.

The slowdown in private consumption expenditures, which are the largest component of the GDP in terms of demand side, continued in the first quarter of 2007 (Table 4.1.1). According to seasonally adjusted figures, the demand for durable goods, which had displayed a partial recovery in the first quarter, decreased in annual terms due to the high base effect. Demand for semi-durable and non-durable goods and food increased at a low rate. As regards sub-items of private investment expenditures, machinery-equipment investments displayed a decline similar to durable goods and construction investments continued to grow, albeit at a lower rate compared to the last two years. Despite the slowdown in private demand, public consumption and investment expenditures increased at a high rate and bolstered domestic demand. In line with the slowdown in domestic demand, imports grew at a low rate, whereas exports maintained their strong performance. As a result, net exports' contribution to GDP growth ensured the continuance of growth despite the slowdown in domestic demand.

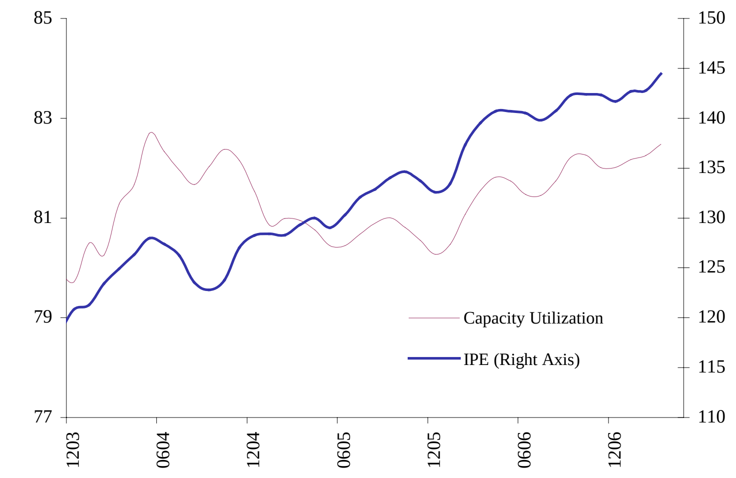
Table 4.1.1. GDP Developments by Expenditures
(Constant Prices, Annual Percentage Change)

	2005	2006					2007
	Annual	I	II	III	IV	Annual	I
1-Consumption Expenditures	8.1	8.3	12.2	3.3	0.2	5.6	2.2
Public	2.4	10.1	18.3	14.8	0.7	9.6	9.0
Private	8.8	8.1	11.5	2.3	0.1	5.2	1.6
Durable Goods.	15.0	12.7	15.9	-8.3	-6.3	2.9	-1.0
Semi-dur and Non-dur. Goods	12.9	11.8	30.3	19.8	4.2	15.8	1.1
Food	8.2	6.6	5.5	1.2	0.2	3.1	1.6
2-Fixed Capital Formation	24.0	32.1	14.0	11.3	4.4	14.0	3.0
Public	25.9	32.8	-11.9	-4.1	1.8	-0.2	9.0
Private	23.6	32.1	18.4	15.0	5.6	17.4	2.5
Machinery-Equipment	21.4	34.9	15.4	7.2	0.3	13.9	-2.6
Construction	29.9	24.1	27.9	29.8	21.6	26.4	17.9
3- Changes in Stocks*	-2.5	-4.9	-0.9	-3.8	1.3	-2.1	0.2
4-Exports of Goods and Services	8.5	6.8	9.1	11.5	6.2	8.5	14.0
5-Imports of Goods and Services	11.5	10.0	13.7	3.6	1.0	7.1	4.2
Net Exports*	-1.7	-2.2	-3.5	3.4	2.4	0.3	4.1
6-Total Domestic Demand	8.8	8.2	10.6	1.4	2.7	5.6	2.5
7-Total Final Domestic Demand	12.1	14.1	12.7	5.3	1.4	8.0	2.4
8-GDP (Expenditure Side)	7.4	6.7	8.3	4.8	5.2	6.1	6.8

*Contribution to GDP, percent.
Source: TURKSTAT.

Leading indicators for the second quarter of 2007 indicate that growth displays a composition similar to that of the first quarter. In the April-May period, the industrial production index rose by 3.6 percent over the same period last year. Although the annual growth rate remained below that of the first quarter, seasonally adjusted data point to an increase in industrial production compared to the previous quarter (Graph 4.1.2). The ongoing strong export performance forms a basis for the industrial production growth.

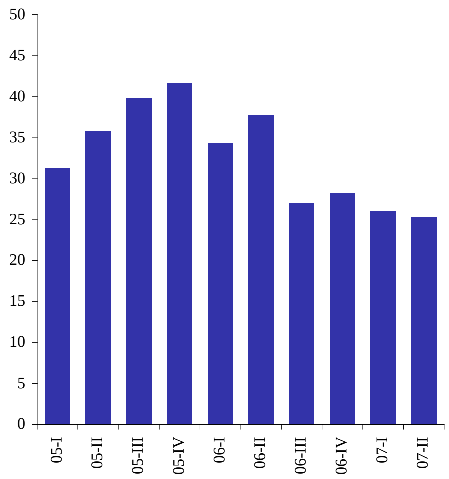
Graph 4.1.2. Industrial Production Index – Capacity Utilization Rate
(Seasonally Adjusted, Quarterly Moving Average)



Source: TURKSTAT, CBRT.

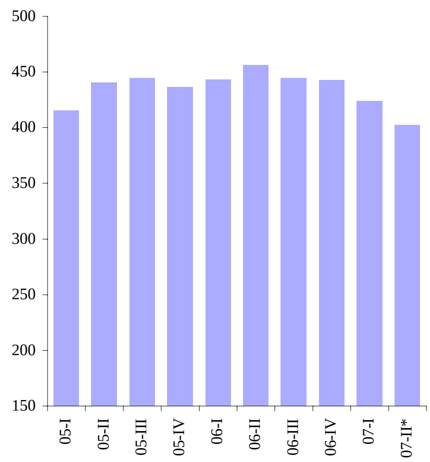
Of the indicators relating to the demand for durable goods, automobile and white goods sales also continued to decline in seasonally adjusted terms in the second quarter (Graph 4.1.3 and 4.1.4). Despite the favorable price effect caused by the strong YTL, the high course of credit interest rates leads to a delay in expenditures for durable goods (Graph 4.1.5). In addition, the uncertainty perceptions caused by the general elections have weakened the demand for these goods.

Graph 4.1.3. Domestic Sales of Automobiles
(Seasonally Adjusted, Monthly Average, Thousand)



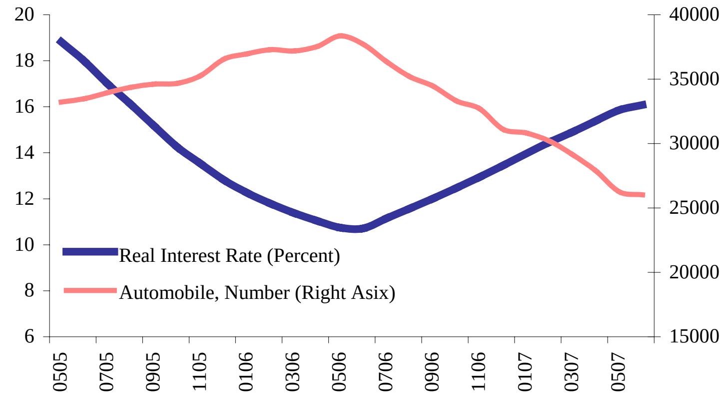
Source: AMA, CBRT.

Graph 4.1.4. Domestic Sales of White Goods
(Seasonally Adjusted, Monthly Average, Thousand)



* April-May period is included.
Source: WGSA,CBRT.

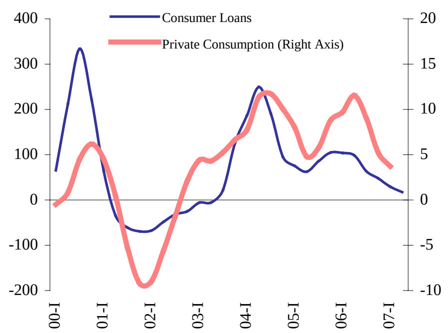
Graph 4.1.5. Domestic Sales of Automobiles and Real Interest Rates of Vehicle Loans*



* Data are annualized. The next 12-month CPI expectations contained in the CBRT Expectations Survey have been employed in the calculation of real interest rates.
Source: TURKSTAT, AMA and CBRT.

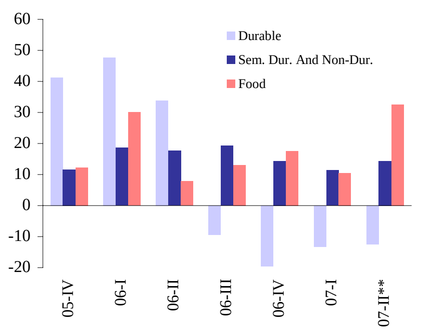
In the second quarter of the year, real consumer loans accelerated over the first quarter, but the quarterly rate of growth was still at a low pace compared to the first half of 2006 (Graph 4.1.6). The seasonally adjusted data on imports of consumption goods, another leading indicator of private consumption, were realized below the previous quarterly average in the April-May period. In terms of annual change, imports of durable goods declined (Graph 4.1.7). In sum, current data signal that the seasonally adjusted private consumption expenditures will increase at a subdued rate in the second quarter over the previous one, which, however, indicates a possible annual decline in private consumption demand given the strong base effect observed in the same period last year.

Graph 4.1.6. Real Consumer Loans and Consumption Expenditures*
(Annual Percentage Change)



* Private consumption expenditures are annualized.
Source: TURKSTAT, CBRT.

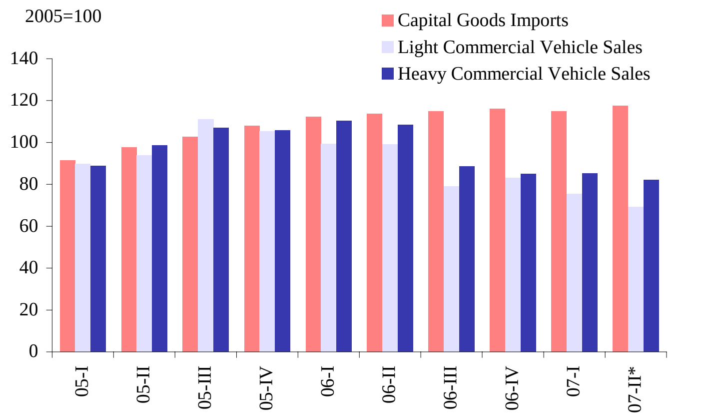
Graph 4.1.7. Imports of Consumption Goods By Items *
(Annual Percentage Change)



* The imports of durable goods data derives from the total imports of automobiles and durable goods covered by BEC (Classification Of Broad Economic Categories). The food imports data derives from the total imports of processed and unprocessed products of food and beverages.
**Latest data cover the April-May period.
Source: TURKSTAT.

Indicators for investment demand point to an ongoing slowdown in machinery-equipment investments. According to seasonally adjusted data, electrical machinery production and imports of capital goods increased in the April-May period, but the decline in the sales of commercial vehicles continued to restrain machinery-equipment investments (Graph 4.1.8). Machinery-equipment production has been running at its steady course since May 2007. Meanwhile, construction investments are expected to maintain their high growth rate throughout 2007, albeit at a lower rate compared to the last two years.

Graph 4.1.8. Imports of Capital Goods and Domestic Sales of Commercial Vehicles
(Seasonally Adjusted, Monthly Average)

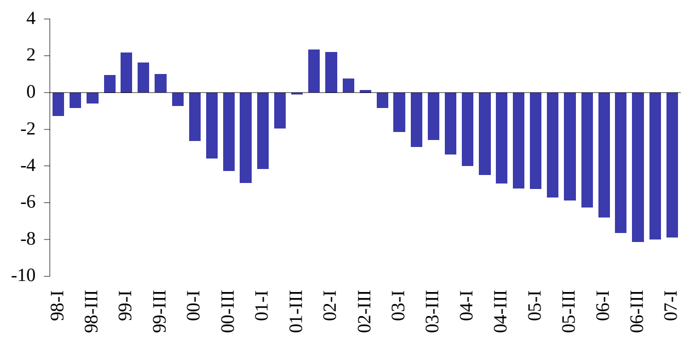


* Imports of capital goods include the April-May period.
Source: TURKSTAT, AMA and CBRT.

4.2. Foreign Demand

The real depreciation of the Turkish lira and the weakening domestic demand, driven by the market volatilities in the first half of 2006, have led to a slowdown in import growth primarily stemmed from capital and consumption goods in the following period. The rapid decline in oil prices from August onwards has also limited import growth in nominal terms during this period. Accompanied by strong foreign demand, these developments provided impetus to export growth. Despite the evident slowdown in domestic demand, the high-rated increase in exports has been the driving force of economic growth, chiefly of industrial production. Hence, net exports of goods and services made a positive contribution to the national income at fixed prices in the second half of 2006. The positive contribution of net exports to national income continued as export growth prevailed over import growth in the first quarter of 2007. As a consequence, the current account deficit over Gross National Product GNP ratio fell to 7.9 percent in the first quarter of 2007, down from 8.1 percent in the third quarter of 2006 (Graph 4.2.1).

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

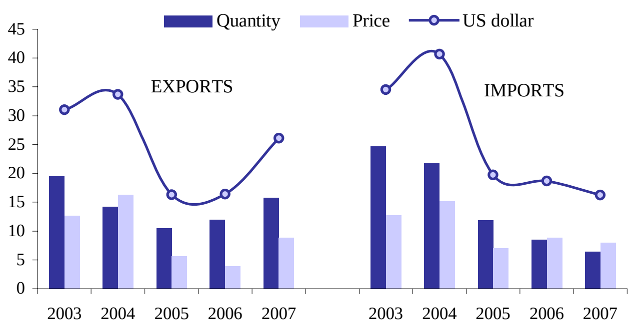


Source: CBRT.

In the April-May 2007 period, foreign trade continued to recover. Moreover, tourism revenues, which had displayed a poor performance in 2006, rebounded in 2007 and surpassed its 2005 level. Hence, the current account deficit continued to improve during April and May. Besides, according to the provisional data announced by the Turkish Exporters' Assembly (TEA), exports continued to grow in June despite a minor slowdown caused by last year's high base effect.

Almost half of the import growth rates that have been realized since 2004 have mainly stemmed from oil-driven increases in import prices, while export growth rates derived mainly from quantity increases (Graph 4.2.2).

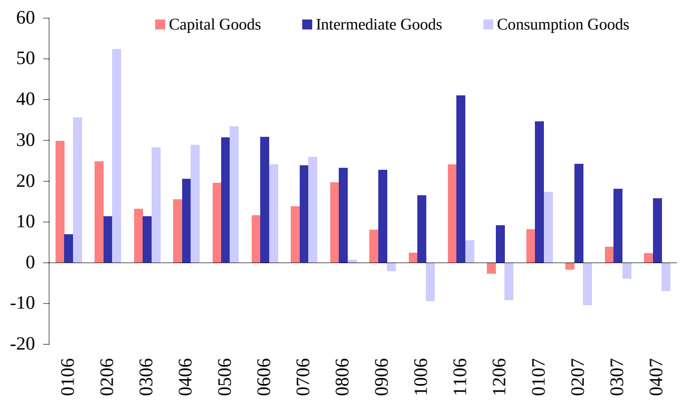
Graph 4.2.2. Export and Import Growth Rates*
(Annual Percentage Change)



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

Although the strong export performance was mainly driven by motor vehicles, basic metals, machinery–equipment, other metal products and electrical appliances, a revival has been observed in textiles and clothing sectors since mid-2006. Moreover, as more than half of exports are done in euro, recent recovery in euro against US dollar has helped exports to grow in terms of US dollar. Export growth rates that remained at low levels particularly in the first four months of 2006 added to the high growth rate of exports in the same period of 2007. Although the New Turkish lira is regaining strength, exports will continue to grow in the second half of the year, albeit at a slower pace, with the upward trend of export prices and the briskness of foreign demand maintained.

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



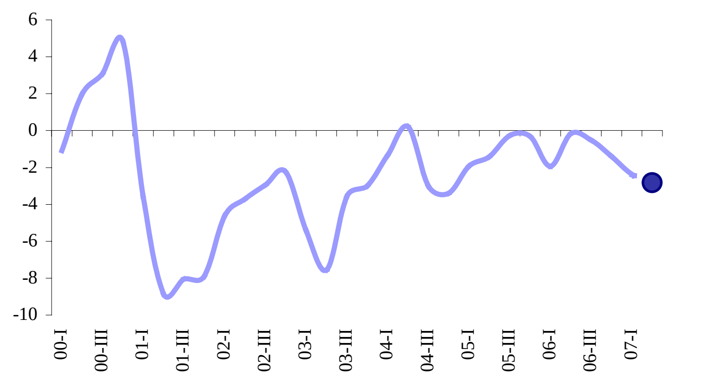
Source: TURKSTAT.

The main source of import growth in the January-May 2007 period was the imports of intermediate goods. During this period, imports of intermediate goods grew by 22.3 percent over the previous year, while imports of capital goods displayed a limited increase of 3.2 percent, and imports of consumption goods fell by 2.1 percent (Graph 4.2.3). Considering the slowdown in domestic demand, it is seen that the increase in imports of intermediate goods in this period mainly stemmed from export-oriented production. In addition to the slowdown in domestic demand, import growth is also restrained by the still-low level of oil prices in the first five months of 2007 compared to the previous year though they are on the rise again. Nevertheless, similar to exports, euro's recovery against the US dollar, raised the US dollar value of imports. Along with a likely revival of the domestic demand in the second half of the year, imports of capital and consumer goods are expected to be in an upward trend, and imports of intermediate goods will possibly continue to grow at a high rate parallel to the soaring exports and oil prices. Accordingly, the current account deficit is likely to re-enter an upward trend in the second half of the year. Nevertheless, it is estimated that in 2007 the ratio of current account deficit to GNP will decline compared to the previous year.

In sum, leading indicators for the second quarter of the year imply that the economy continues to grow at a moderate pace on the back of foreign demand. In this framework, it is forecasted that the contribution of domestic demand to growth will remain limited, while net foreign demand will continue to be the key determinant of growth.

Analyzing the moderate growth in domestic demand with the buoyant foreign demand in light of the current data, it is believed that overall demand conditions will support the disinflation process (Graph 4.2.5). However, in the event that the improvement in borrowing costs continue in the upcoming period, domestic demand that has been delayed for a while may gain momentum. The developments related to this assessment are closely monitored regarding monetary policy which primarily aims to fight inflation with a medium-term perspective.

Graph 4.2.5. Output Gap
(Percent)



Source: CBRT.

4.3.Unit Labor Costs

According to the statistics of the “Indices of Production Workers, Hours Worked in Production in Manufacturing Industry” announced by the Turkish Statistical Institute (TURKSTAT), employment in the manufacturing industry rose by 2.5 percent in the first quarter of 2007 over the same period of 2006

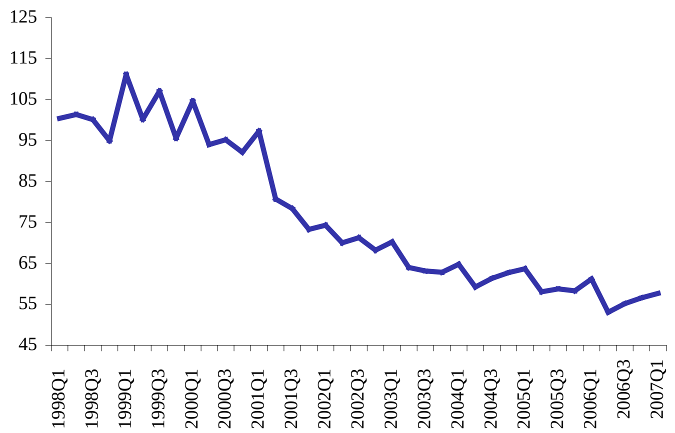
(Table 4.3.1). During this period, employment in the public sector declined, while employment in the private sector increased. In the first quarter of the year, partial productivity rose by 4.3 percent due to the increase in manufacturing industry production surpassing employment growth. Real wages and real earnings in the public sector increased, whereas those in the private sector decreased. In the first quarter of the year, real unit wages in the manufacturing industry fell by 5.8 percent compared to the same period of 2006 as productivity gains exceeded the increases in real wages (Graph 4.3.1). Industrial production is expected to increase at a moderate rate in annual terms in the second quarter of the year. This indicates that the decline in real unit wages may remain more limited in the second quarter of the year.

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

	2005	2006					2007
	Annual	I	II	III	IV	Annual	I
Employment(1)	-0.7	-1.9	-1.4	-0.7	1.2	-0.7	2.5
Public	-8.1	-3.3	-3.8	-5.7	-2.9	-4.1	-2.9
Private	0.1	-1.9	-1.2	-0.2	1.6	-0.4	2.9
Wage(2)	2.0	1.0	0.5	0.0	2.1	0.9	-1.8
Public	8.0	3.9	-2.7	-4.0	-1.5	-3.0	0.5
Private	1.7	1.9	1.3	1.2	3.1	1.9	-1.6
Earnings (3)	1.8	0.3	0.4	0.0	2.8	0.9	-1.0
Public	6.1	-3.3	-2.4	-0.4	0.0	-1.5	0.3
Private	1.9	1.3	1.2	0.7	4.0	1.9	-0.6
Productivity(4)	6.0	5.0	9.9	6.5	5.2	6.7	4.3

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

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



Source: TURKSTAT, CBRT.

With the collective labor agreement signed with public workers, it is decided that wages above 1400 YTL shall be raised by 10 percent and those below 1400 YTL shall be raised by 140 YTL for 2007. Furthermore, wages less than 900 YTL shall be raised by an extra 50 YTL. It is also decided that, workers' wages will be raised by 3 percent every 6 months in 2008, and if inflation exceeds 3 percent in a six-month period, an extra payment shall be made to cover the inflation difference. The collective negotiations with civil servants for 2008 will be made in August. Since the wage increases regulated by the collective labor agreement with public workers put into effect as of the beginning of 2007, the decline in real unit wages in the first quarter of the year are considered to be more limited than that mentioned above.

With the revival in investments, the contribution of real unit wages to the disinflation process and the gains in productivity are expected to continue in the medium term. However, as emphasized in the previous Inflation Reports, it is still important that wage adjustments made by the public sector be consistent with the inflation target.

BOX 4.1. STRUCTURAL CHANGE IN THE EXPORT PERFORMANCE OF TURKEY AFTER 2001

In the last six years, Turkey's exports exceeded the historic averages and displayed an ongoing growth. Turkey's average annual export growth, which was 11.2 percent in the 1948-2000 period, reached 20.9 percent in the 2001-2006 period. In this framework, despite the strengthening of the New Turkish lira in recent years, it should be taken into account whether the strong upward trend in the export performance implies a structural change or not. In this respect, Turkey's export performance in the 2001-2006 period is analyzed under five main headings:

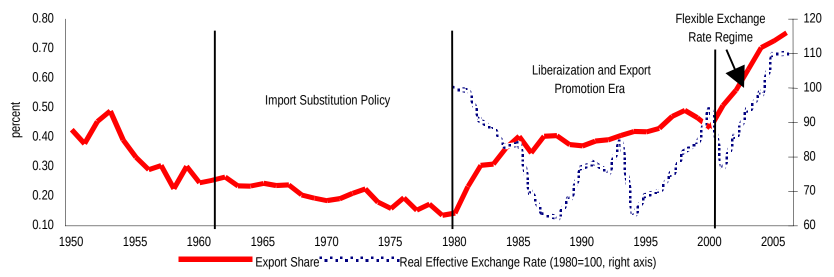
1) Turkey's share in world export markets
2) The product and country composition of exports
3) Transformation in factor intensity
4) Relative export performance of product groups: Comparative analysis of emerging economies
5) Exports' dependency on imports

In the last part, the structural change in the export performance is analyzed by using time-varying parameters (the Kalman Filter technique).

1) Turkey's Share in World Export Markets

There are two remarkable increase in the history of Turkey's share in world export markets: the first half of 1980s and the 2001-2006 period. (Box 4.1.Graph 1). Following the gradual decline in export performance in the import substitution-based industrialization period comprising 1960s and 1970s, the market share of exports increased more than twofold in the 1980s as a result of the economic liberalization process and export promotion policies. While the rate of increase of this share significantly slowed down due to the crises in the 1990s, it re-entered an acceleration trend in the 2001-2006 period. However, the point that should be emphasized here is that the dynamics behind these two periods differ from each other. In the said period, the floating exchange rate regime was adopted unlike the 1980s, and accordingly, there was no intervention in the strengthening of YTL. In this period, export companies avoided the negative impacts of the appreciation of YTL via company-based factors required for global competition, such as technological development, integration with world export markets and emphasis on product quality.

Box 4.1.Graph 1. The Share of Turkey's Exports in Total World Exports (1950-2006)



Source: WTO, TURKSTAT, CBRT.

2) Product and Country Composition of Exports

After 2001, the composition of exports has shifted towards capital and technology-intensive goods. In this period, the most rapid export growth was realized in new product groups rather than Turkey's traditional export products. Accordingly, capital and technology-intensive goods, which are not recognized as traditional export goods, have increased their share in overall trade and total export intensity rate rose after 2001, along with the rapid export growth in these new products. The intra-industrial trade of these products is larger compared to other export products. Nevertheless, parallel to the general tendency in the world, intra-industrial trade is also increased in Turkey. The share of EU countries in Turkish exports increased following the 1996 Customs Union, contributing to the upsurge in export intensity on a country basis.

3) Transformation in Factor Intensity

In the 1980s, the labor force of exports presented a structure that depended on agricultural and raw material-intensive sectors. However, the said export structure has been changing since the beginning of the 2000s. In the 2001-2004 period, the share of high-technology intensive products in Turkey's total exports nearly tripled, compared to the 1990-1996 period. Agricultural and raw material-intensive products, which are considered to be Turkey's traditional export products, declined considerably in the said period (Box 4.1.Table 1).

Box 4.1.Table 1. Exports Classification According to Factor Intensity
(Turkey, Share in Total Exports) (Percentage Share)

	High technology-intensive	Raw material-intensive	Labor-intensive	Capital-intensive	Agricultural products-intensive
1980-1989	6.0	16.9	30.6	9.3	24.2
1990-1996	6.9	5.5	42.7	14.8	17.7
1997-2000	12.0	3.7	44.3	12.8	13.0
2001-2004	18.0	3.9	39.4	16.0	8.8

Source: UNCTAD, CBRT.

The share of high-technology intensive products in Turkey's total exports is below world averages and averages of emerging economies. Turkey ranks the twelfth among 20 emerging economies. However, when the rates of increase between 2001-2004 period and 1997-2000 period are compared, Turkey ranks the first among emerging economies. In other words, the transformation in factor utilization indicates that Turkey's technological competitiveness increasingly integrates with world markets and with the markets of emerging economies.

4) Relative Export Performance of Product Groups: Turkey and Emerging Economies

The export growth rate of each product group is analyzed by comparing the product's export growth rate with the total world export growth rate. Accordingly, in the 2001-2004 period, Turkey had been one of the countries with the best performance among 20 emerging economies compared to the 1990-2000 period, in terms of not only the number of highly-competitive products, but also the share of these products in total exports. Turkey displayed a growth rate above world averages in 164 products among 239 product groups that are classified according to the Standard International Trade Classification Revision 3 codes. The striking point is that these 164 products constitute 88.1 percent of Turkey's total exports. Meanwhile, other emerging economies also displayed a strong performance in the 2001-2004 period. The share of highly-competitive products in total exports was above 50 percent in emerging economies. That is to say, emerging economies displayed better performance compared to the world export market.

When the export performance of each emerging economy is compared with the total exports of emerging economies, Turkey has been one of the countries with the best performance among 20 emerging economies in terms of both the number of highly-competitive products and share of these products in total exports. Turkey displayed a growth rate above the total growth average of emerging economies in 151 products out of 239 products. These products constitute 84.7 percent of Turkey's exports. Turkey's strong performance both in the world market and in emerging economies, and the rise in the share of high-technology products indicates that Turkey is in a process of convergence to emerging economies and world export markets.

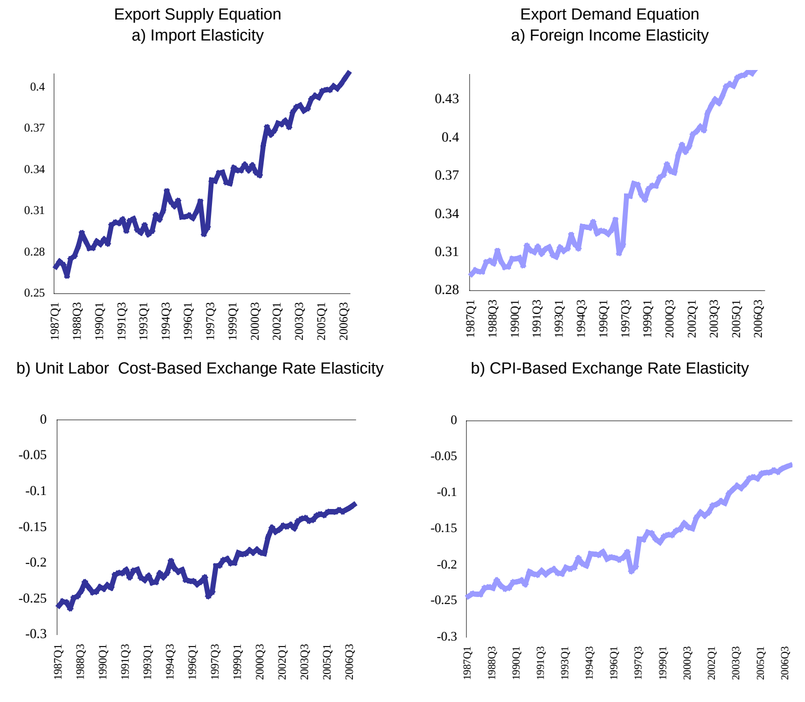
5) Import Dependency

Data pertaining to 1998 onwards suggest that the dependency of Turkey's exports on imports is increasing. This tendency particularly prevails in the manufacturing industry. However, comparing some Eastern European countries that have newly joined the EU with Turkey, it is found that the dependency on imports in these nations has also increased rapidly during this period and that this increase was more striking in the said countries compared to Turkey in general. In this framework, it is believed that the developments in the Turkish economy should not be evaluated irrespective of the developments in the global economy.

<u>Econometric Analysis</u>

Turkey's export function underwent various structural changes in the 1987-2006 period. In order to examine the structural changes, time-varying coefficients of export function are estimated via the Kalman filtering. The Kalman filter method, contrary to other standard econometric methods, allows the coefficients of the model to be estimated as a random variable by using a filtering technique. Considering that supply and demand functions of export are affected by different variables, these equations were estimated separately. In the model, the determining variables of export supply were defined by both the import quantity index and the unit labor-cost-based real effective exchange rate, while the determining variables of export demand were defined by the foreign income (OECD total) and consumer prices-based-real effective exchange rate. The model was estimated with quarterly data for the 1987-2006 period and 3 seasonal dummies were added to deal with seasonality in the data.

Box 4.1.Graph 2. Time-varying Export Supply and Demand Elasticity (1987-2006)



Findings show that coefficients of both export supply and demand equations did not remain constant over time and that while the elasticity of exports to income and to imports increased over time, it became less responsive to exchange rate changes (Box 4.1.Graph 2). These graphs reveal that the Customs Union had an impact on this tendency, albeit partial. Furthermore, it is concluded that the import dependence of Turkey's production and exports increased during the integration process with the EU. Increased import dependence of exports leads to less sensitivity of exports to exchange rate movements, since both costs and revenues of export-oriented sectors are foreign exchange denominated.

Source

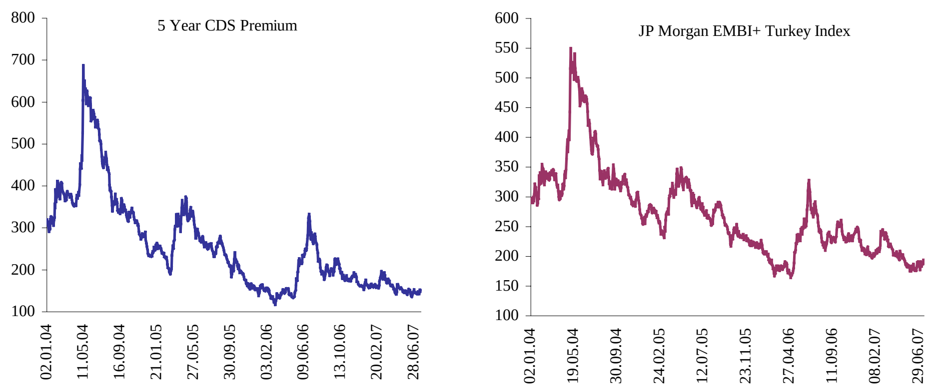
Aydın, F., Saygılı, H. and M., Saygılı (2007): "Analytical Analysis of Structural Change in Turkish Exports: 1980-2006", Central Bank of the Republic of Turkey, unpublished manuscript.

5. Financial Markets and Financial Intermediation

5.1. Financial Markets

In the second quarter of 2007, international liquidity conditions and the global risk appetite continued to be in favor of developing countries despite the upward trend of the US secondary market bond yields in June and concerns over potential losses in US mortgage loans (Graph 2.2.2). This development was mainly driven by the indicators that show US core inflation to be under control and by the ongoing favorable course of growth expectations for the United States and the Eurozone. Rising asset prices, financial deepening and favorable international liquidity conditions altogether supported the downward trend in risk premium indicators such as the Credit Default Swap (CDS) and the JP Morgan EMBI+ Index for Turkey (Graph 5.1.1). Nevertheless, international markets are expected to remain sensitive to growth and inflation figures of developed countries in the short term, and thus, remain data-dependent.

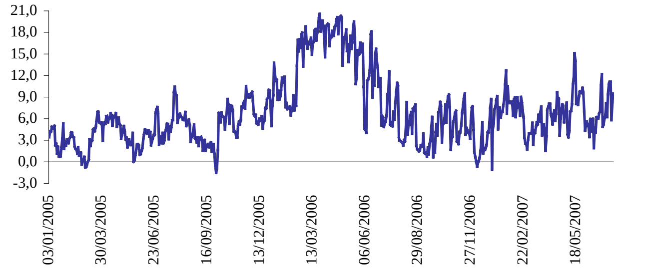
Graph 5.1.1. Risk Premium Indicators



Source: Bloomberg.

Excess liquidity sterilized through the overnight market increased in the second quarter of the year compared to the previous quarter (Graph 5.1.2). Foreign exchange purchase auctions of the CBRT became the determining factor on the mentioned increase, which could not be avoided though it exceeded the roll-over ratio targeted by the Treasury at the start of the year. Considering the levels of liquidity, the Monetary Policy Committee decided at its meeting of 12 July 2007 to use liquidity bills in addition to current tools used in open market operations in order to enhance the effectiveness of liquidity management. In this respect, the first liquidity bill was issued on 19 July 2007 with a maturity of 32 days.

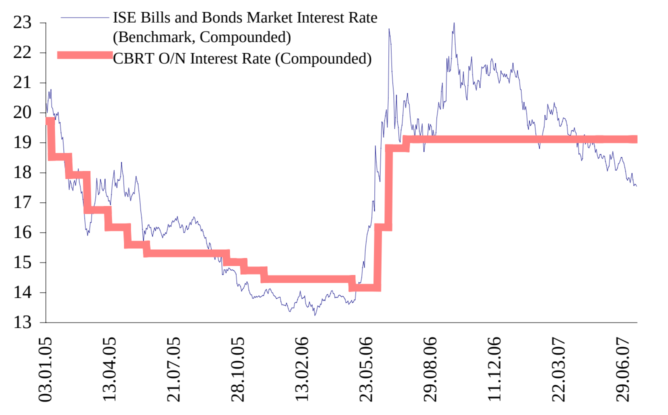
Graph 5.1.2. Excess YTL Liquidity
(Billion YTL)



Source: CBRT.

The downward trend in the benchmark interest rate on government securities in the Bonds and Bills Market of the Istanbul Stock Exchange (ISE) observed since early 2007 became apparent in the second quarter, while benchmark securities interest rates remained below CBRT policy rates and the gap between these two rates further widened (Graph 5.1.3). The fall in interest rates on bonds was mainly due to the falling inflation and the continued demand from non-residents, despite increasing risk perceptions in Turkey.

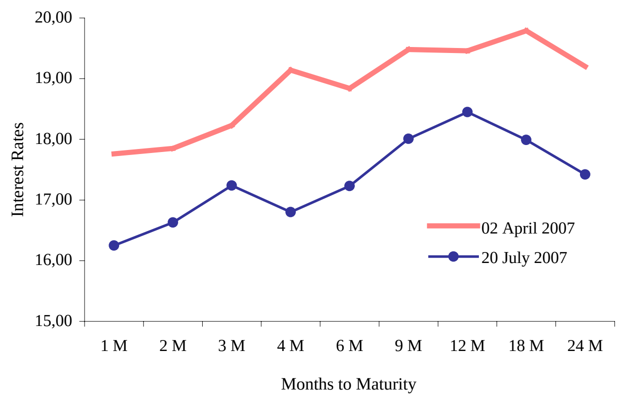
Graph 5.1.3. Interest Rate Developments
(Percent)



Source: ISE, CBRT.

In the second quarter of 2007, the ongoing decisive stance of monetary policy supported the decline in long-term interest rates by curbing inflation expectations and easing the uncertainty over inflation. The yields of 20 July 2007 remained at lower levels for all maturities compared to the yields of the first quarter of 2007, due to the reduced risk premium and the waning inflation expectations (Graph 5.1.4). Moreover, the downward slope of yield curves in maturities longer than 18 months shows that economic agents maintain their expectations for the continuation of the disinflation process in the medium term.

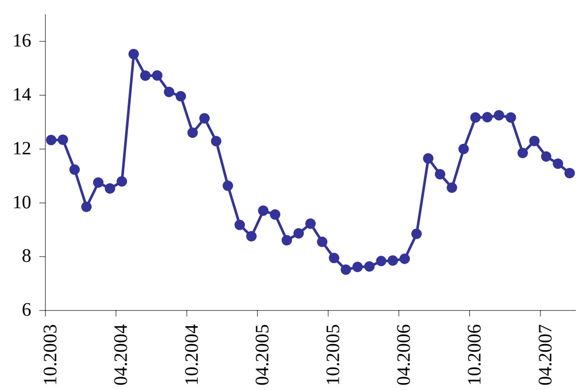
Graph 5.1.4. Yield Curves



Source: ISE.

The decisive stance of monetary policy also paves the way for a decline in medium and long-term real interest rates. Real interest rates, calculated on the basis of benchmark security interest rates and 12-month inflation expectations that derive from CBRT's Expectations Survey, continued their downward trend in the second quarter (Graph 5.1.5).

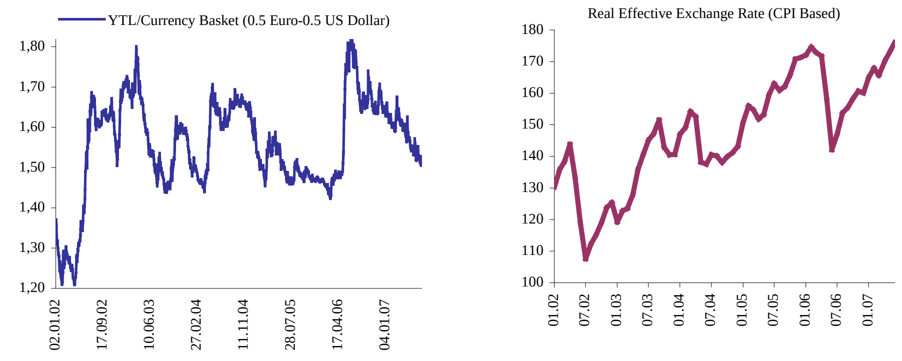
Graph 5.1.5. Real Interest Rates
(According to ISE Benchmark Interest Rate and 12-Month Inflation Expectations)



Source: ISE, CBRT.

In the second quarter of the year, the appreciation of YTL continued due to the increase in YTL-denominated assets of non-resident investors accompanied by the high level of foreign direct capital inflows (Graph 5.1.6). During this period, the net amount of foreign currency purchased by the CBRT via auctions amounted to USD 2 billion. As of 13 July 2007, gross foreign exchange reserves of CBRT reached USD 68.6 billion.

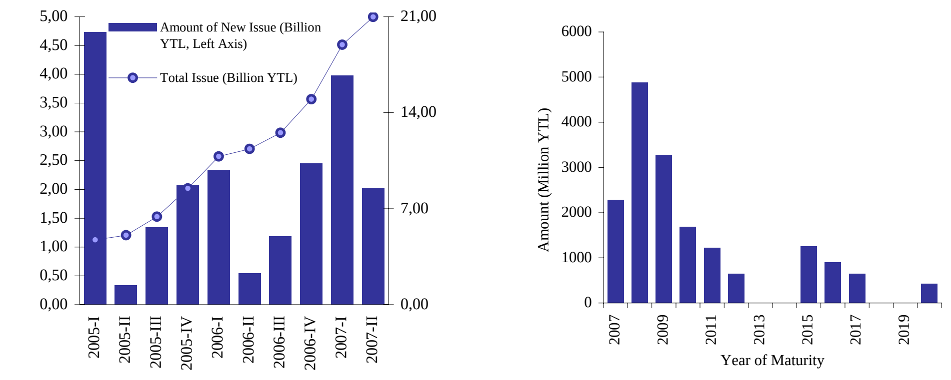
Graph 5.1.6. Developments in Exchange Rates



Source: CBRT.

In the first quarter of 2007, YTL-denominated global bonds issued by foreign banks, an indicator of foreign demand for YTL-denominated financial instruments, slightly decreased compared to the first quarter due to seasonal effects, but registered a significant increase compared to second quarters of past years (Graph 5.1.7). This development points to an improved risk perception of foreign investors.

Graph 5.1.7. YTL-Denominated Bonds Issued by Foreign Financial Institutions

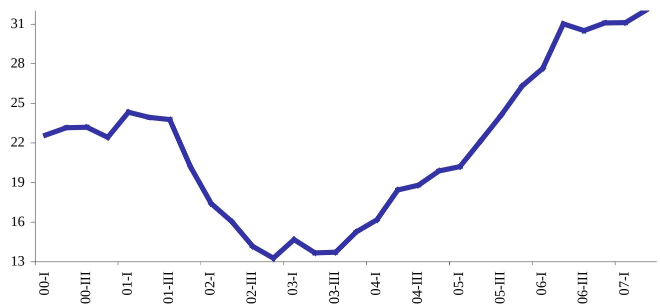


Source: CBRT.

5.2. Financial Intermediation and Loans

In the second quarter of 2007, ongoing capital inflows triggered by favorable global liquidity conditions continued to strengthen the credit supply. The favorable course of YTL-denominated bond issues of foreign financial institutions still persists (Graph 5.1.7). Foreign capital inflows to the banking system via purchase and partnership also continue. Meanwhile, CBRT's continued YTL supply via foreign exchange auctions helped raise the liquidity volume in domestic markets. An overall evaluation of all these developments indicates that the amount of banks' loanable funds is on the rise. These developments both lead to an increase in bank loans and encourage households and firms to use loans.

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



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

The improvement in financing conditions affect credit developments. The share of real sector loans in the national income started to increase in the last quarter, which can be attributed to the partial recovery in the investment tendency as well as to the improved financing conditions. (Graph 5.2.1)

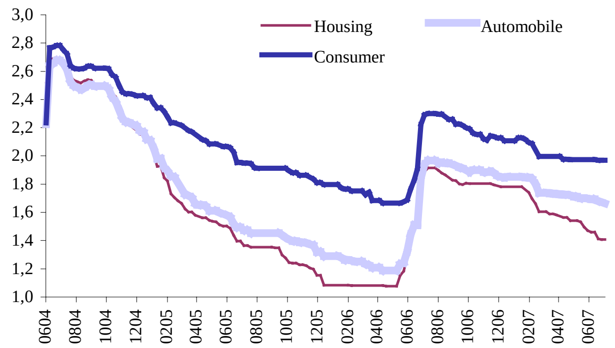
Table 5.2.1. Consumer Loans and Claims from Credit Cards
(Real Quarterly Percentage Change)

	2006				2007	
	I	II	III	IV	I	II
Consumer Loans	17.2	20.0	1.5	3.6	2.6	9.0
Housing Loans	29.2	22.8	0.9	2.2	2.7	7.5
Automobile Loans	1.9	5.1	-6.4	-5.0	-8.9	-3.4
Other Loans	11.7	24.3	6.0	8.9	6.6	14.5
Credit Cards	2.0	6.8	2.1	2.1	-1.6	7.7

Source: CBRT.

Consumer loans increased at an accelerated rate in the second quarter of 2007. Similar to the last one-year period, the increase in consumer loans resulted from the increase in the "other loans" item, which is mainly composed of housing loans and short-term consumer loans with relatively higher interest rates. The recent intensive campaigns of banks had a significant impact on the increase in consumer loans. Housing loans and credit card use continued to grow moderately, while automobile loans declined in real terms (Table 5.2.1).

Graph 5.2.2.Consumer Loan Rates
(Monthly, Percent)



Source: Web sites of selected banks.

Consumer loan rates did not change in the recent period, while housing and automobile loan rates continued to be reduced (Graph 5.2.2). It is expected in the upcoming period that the widespread use of mortgage loans and the increased competition among banks will create an environment where interest rates will further decline. Lower interest rates will possibly boost the demand for consumer loans. The Central Bank closely monitors loan rates in terms of the information they contain about total final domestic demand and the soundness of the financial system.

6. Public Finance

The rate of increase in central government non-interest budget expenditures by the first half of 2007 was higher than the target envisioned for 2007. As of June, the central government budget balance was consistent with targets, mainly due to the advance collection of claims from the sale of Turk Telecom, which was rather like a one-off revenue item. Even though the said collection may ensure the achievement of year-end central government budget targets, it is predicted that attaining the primary surplus target for the program-defined consolidated public sector will only be possible by significantly curbing expenditures for the rest of the year.

It is believed that achieving central government budget targets alone will not be adequate for achieving the 2007 inflation target. In this framework, the necessary adjustment for achieving the primary surplus target should be made through measures, which aim to slow down the rate of increase in public expenditures, rather than increasing indirect taxes. Moreover, in order to sustain the support of fiscal policy in the disinflation process, reforms for a more effective public finance should be uninterruptedly implemented.

In recent years, along with fiscal discipline, public debt management was conducted by adopting an effective borrowing strategy at reasonable risk levels. As a result, concerns over the rolling-over of the debt stock in the short-run and its sustainability in the medium-long term were, to a great extent, eased. Nevertheless, the effective implementation of structural reforms is still of great importance to assure the permanence of gains from tight fiscal policy and to trim down the public debt stock to lower levels. Current structural reforms in the public sector and those planned for the future are vital, not only for securing a sound basis for public finance, but also for ensuring a competitive environment in the economy, and thus, eliminating inflation rigidities in certain sectors.

6.1. Budget Developments

During the January-June 2007 period, the central government primary balance registered a surplus of YTL 21 billion, while the budget balance ran a deficit of YTL 5.9 billion (Table 6.1.1). This deficit equals 35 percent of the year-end target of YTL 16.8 billion.

A detailed analysis over the central government budget figures shows that budget revenues and expenditures increased by 12.8 percent and 23.4 percent, respectively, compared to the same period of 2006. The increase in budget revenues mainly resulted from the 37.9 percent rise in non-tax revenues. Due to the advanced payment of YTL 5.8 billion-claim from the privatization of Turk Telecom in March, non-tax revenues, which declined significantly in the first two months of 2007, stood as the main determinant of the increase in central government budget revenues.

Corporate tax collection fell by 5.2 percent in the first half of 2007, in response to the negative realization of corporate tax collection in January, following the deduction and refund transactions subject to corporate taxpayers. The slowdown in economic activity since the second half of 2006 and the corporate tax rate cut from 30 percent to 20 percent in mid-2006 also stood as other factors that led to a decline in corporate tax collection.

Domestic VAT collection fell slightly by 0.6 percent in the January-June period. The 27.2 percent decline in the VAT collection of the January-February period was believed to be a result of the weakened tendency of the public to get invoices/receipts for their shopping, due to the envisioned application of the minimum living allowance. However, the Revenue Administration Department has announced that the said decline actually originated from the fact that VAT rebates were higher than the previous year and that tax collection shifted to March. Although figures for the following period support this announcement, the VAT rate cut from 18 percent to 8 percent on certain food products as of 1 June implies a careful monitoring of VAT collection for the rest of 2007. Moreover, the slowdown in domestic demand is expected to affect domestic taxes on goods and services performance unfavorably.

While some expenditure items remained consistent with the year-end target, capital transfers, capital expenditures and current transfers increased by 120.3, 47.5 and 31.6 percent, respectively, in the first half of the year.

Table 6.1. 1. Central Government Budget Aggregates
(Billion YTL)

	2006 Jan.-June	2007 Jan.-June	Rate of Increase (Percent)	Realization/ Budget Target (Percent)	2007 Budget Target	2007 Budget Target/GNP*
Central Government Expenditures	**81.60**	**100.68**	**23.38**	**49.1**	**204.99**	**81.60**
A) Interest Expenditures	**22.88**	**26.89**	**17.6**	**50.8**	**52.95**	**22.88**
B) Non-Interest Budget Expenditures	**58.72**	**73.79**	25.65	48.5	152.04	58.72
I. Personnel Expenditures	18.52	21.97	18.62	50.3	43.67	18.52
II. Government Premiums to Social Security Agencies	2.38	2.73	14.29	27.0	10.10	2.38
III. Purchases of Goods and Services	6.79	8.35	23.04	53.6	15.59	6.79
1) Defense-Security	1.77	2.20	24.56	26.9	8.17	1.77
2) Health Expenditures	2.95	3.22	9.36	-	0.17	2.95
a) General Medication	0.41	0.43	5.14	-	0.10	0.41
b) General Treatment and Health Equipment	0.75	0.76	2.00	-	0.07	0.75
c) Green Card Health Services	1.79	2.03	13.39	-	0.00	1.79
3) Other Purchases of Goods and Services	2.03	2.89	42.12	40.4	7.14	2.03
IV. Current Transfers	24.91	32.78	31.56	53.9	60.86	24.91
1) Duty Losses	3.79	0.51	-86.52	43.0	1.19	3.79
2) Government Subventions	11.42	18.03	57.94	52.2	34.54	11.42
a) Financing of Social Security Deficit	9.99	12.77	27.83	100.0	12.78	9.99
3) Subsidies to Households	0.39	0.50	30.56	54.2	0.93	0.39
4) Agricultural Subsidies	2.50	4.83	93.03	92.1	5.25	2.50
5) Shares from Revenues	6.29	8.07	28.28	47.6	16.96	6.29
V. Capital Expenditures	3.03	4.47	47.51	36.9	12.10	3.03
VI. Capital Transfers	0.85	1.88	120.34	51.5	3.65	0.85
VII. Lending	2.23	1.62	-27.57	43.8	3.69	2.23
VIII. Reserve Appropriations	0.00	0.00	-	0.0	2.37	0.00
Central Government Revenues	**84.02**	**94.79**	**12.82**	**50.4**	**188.16**	**84.02**
A) General Budget Revenues	**81.77**	**92.37**	**12.97**	**50.4**	**183.46**	**81.77**
I-Tax Revenues	65.98	70.59	6.99	44.6	158.15	65.98
1. Taxes on Income, Profits and Gains	19.12	21.83	14.14	48.1	45.34	19.12
a) Income Tax	12.66	15.70	23.97	47.0	33.42	12.66
b) Corporate Tax	6.46	6.12	-5.15	51.4	11.92	6.46
2. Taxes on Property	1.52	1.76	15.68	48.3	3.64	1.52
3. Domestic Taxes on Goods and Services	28.98	29.40	1.45	42.7	68.83	28.98
a) Domestic Value Added Tax	8.11	8.06	-0.56	39.9	20.20	8.11
b) Special Consumption Tax	17.69	17.68	-0.03	43.1	41.07	17.69
4. Taxes on International Trade and Transactions	12.89	13.49	4.66	42.1	32.05	12.89
a) VAT on Imports	11.89	12.26	3.07	41.4	29.58	11.89
II-Non-Tax Revenues	15.80	21.78	37.89	83.5	26,09	15.80
1. Enterprise and Property Revenue	4.87	5.70	17.01	72.9	7.82	4.87
2. Interests, Shares and Penalties	10.58	8.75	-17.26	57.5	1.23	10.58
3. Special Revenues, Grants and Aids	0.18	1.38	679.26	286.9	0.48	0.18
4. Capital Revenues	0.17	5.95	3389.41	232.0	2.57	0.17
B) Revenues of Special Budget Administrations	**1.46**	**1.56**	**7.05**	**47.9**	**3.26**	**1.46**
C) Revenues of Regulatory and Supervisory Agencies	**0.79**	**0.86**	**8.54**	**59.8**	**1.44**	**0.79**
Budget Balance	**2.42**	**-5.88**	**-342.89**	**35.0**	**-16.8**	**2.42**
Primary Balance	**25.30**	**21.01**	**-16.96**	**58.2**	**36.1**	**25.30**

Source: Ministry of Finance
*GNP growth rate for 2007 taken from SPO Program of 2007.

As of June, health expenditures have significantly exceeded the initial appropriation amount allocated for 2007. This development has mainly stemmed from the very low amount of allocation for health expenditures under goods and services expenditures in 2007. Since a transition to general health insurance had been envisioned for 2007, the appropriation for health expenditures was included in the "health, retirement and social aid expenditures" item within the current transfers item. However, since the social security law could not be enforced due to the Supreme Court's decision, health expenditures are still registered in the budget accounts as a part of goods and services expenditures.

The whole amount of the initial appropriation allocated for the financing of the social security deficit was used in the first half of the year. Nevertheless, the central government budget for 2007 was drawn up in view of the envisioned implementation of the social security reform and it included a new classification, allocating an appropriation of YTL 13 billion from the budget to government's social security funds and to health insurance premium expenditures of those deprived of social security facilities. However, since the social security reform could not be put into effect, the said appropriation is planned to be used for the financing of the social security deficit.

On the other hand, there are certain factors that may impede the efforts to achieve the central government expenditures target for 2007, which can be listed as providing permanent status for temporarily employed workers in the public sector, resetting the cut-off rates applied on municipalities' shares from budget revenues in return for their public debt, setting corn and hazelnut purchasing prices over the program targets, providing opportunity to all individuals registered with the Social Security Institution to directly benefit from all health care providers with whom the Institution has made contracts, high increases in wages of public sector workers and subventions planned to be given to farmers in 40 cities to offset the effects of drought.

By end-2006, the overall balance and primary balance for the program-defined consolidated public sector exceeded the program target by YTL 5.3 billion and YTL 1.7 billion, respectively (Table 6.1.2). However, although the primary balance provided a surplus of YTL 9.4 billion by April 2007, it still remained YTL 3 billion below the program target. In this respect, the April target, a performance criterion for the consolidated public sector primary surplus, could not be achieved. Because the program-defined central government primary surplus excludes the revenues obtained from the sale of Turk Telecom, dividend revenues of public banks and CBRT's profit transfer, the high increase in non-tax revenues within the central government budget did not have any impact on the program-defined public sector primary surplus. It is evaluated that, depending on the persistence of the above-mentioned trends, the program-defined consolidated public sector primary surplus is likely to remain below the target level by the end of 2007.

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

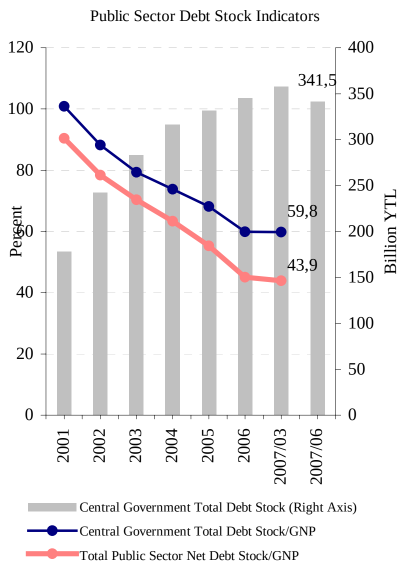
	2005	March-2006	June-2006	Sept.-2006	December-2006	April-2007
Realizations						
Primary Balance	**28.3**	**10.6**	**25.0**	**33.3**	**36.2**	**9.4**
Primary Balance (Excluding SEEs)	**23.6**	**8.4**	**22.1**	**31.4**	**34.6**	**7.3**
Central Government Budget	24.1	7.6	20.4	30.6	33.5	5.7
Overall Balance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

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

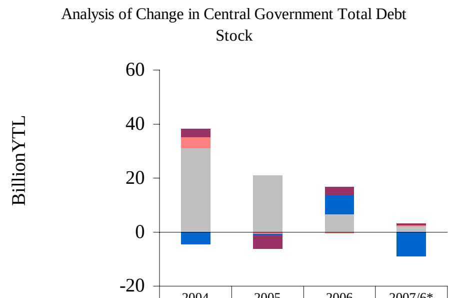
6.2. Developments in Debt Stock

By the first half of 2007, central government debt stock, which constitutes a large share of total public debt stock, decreased by 1 percent to YTL 341.5 billion compared to end-2006 owing to the reimbursement of YTL 4.7 billion-worth Government Domestic Borrowing Securities (GBDS) in the Employees' Savings Promotion Account to the Treasury in June. A detailed analysis of the developments in debt stock reveals that net domestic debt and net foreign debt increased by YTL 2.2 billion and YTL 0.3 billion, respectively. While the overall effect of exchange rate movements reduced central government debt stock by YTL 9 billion, the parity effect pushed it up by 0.7 billion. Meanwhile, by the end of the first quarter of 2007, the ratio of net total public debt stock to GNP was 43.9 percent, maintaining its downward course of recent years (Graph 6.2.1).

Graph 6.2.1. Public Debt Stock Indicators



Source: Treasury.



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

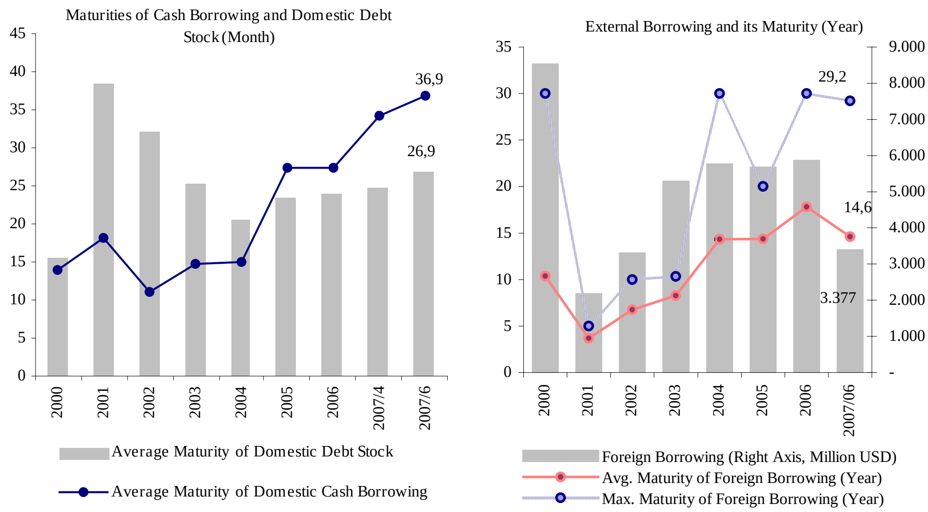
Source: Treasury, CBRT.
* Changes compared to 2005.
** Changes arising from the movements in USD/EURO and USD/SDR parities.
***Changes arising from the movements in YTL/USD parity.

Note: Changes in Net Debt denotes the change adjusted for the exchange rate and parity effect.

Parallel to the financing strategy that has been drawn up in line with strategic standard setting[1], the average maturity of cash borrowing, which sets the maturity of total domestic debt stock, tended to increase significantly in June 2007 to 36.9 months due to resumed issues of both variable and fixed coupon securities with a five-year maturity as of September. The average maturity of total domestic debt stock extended to 26.9 months by June 2007, parallel to the extended average maturity of cash borrowing. Meanwhile, in the first half of 2007, USD 3.4 billion worth of long-term external borrowing was materialized via bond issues, the average maturity of which was 14.6 years (Graph 6.2.2).

[1] In strategic standard setting, the aim is to extend the maturity of domestic borrowing as much as market conditions allow, carry out domestic borrowing generally in terms of fixed income YTL-denominated securities and hold considerable amount of cash reserves in order to reduce the liquidity risk that may arise in cash and debt management.

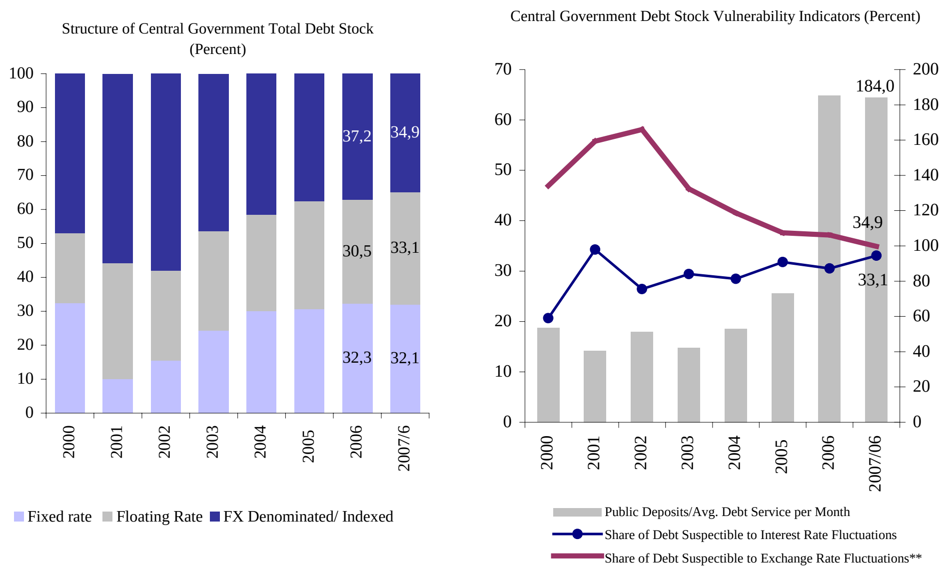
Graph 6.2.2. Maturity of Borrowing from Domestic and External Markets



Source: Treasury, CBRT.

By the first half of 2007, the share of variable-rate debt instruments in central government debt stock increased, while the share of fixed-rate instruments and securities susceptible to exchange rates fell (Graph 6.2.3). As specified in its 2007 Borrowing Program, the Treasury will continue to be a net payer of foreign debt, will not issue any FX-indexed securities and will limit the FX-denominated domestic debt rollover ratio to 80 percent, which altogether are a clear indication that debt stock's vulnerability to FX rates will continue to ease. Although the amount vulnerable to FX rates (FX-denominated and FX-indexed) is still as high as 34.9 percent, risks arising from the volatility in FX rates are restrained in favor of the public sector as the current FX-denominated debt stock is of relatively long-term nature and the Treasury holds a large amount of FX deposits. In February 2007, the Treasury started to issue CPI-indexed government bonds with the aim of extending both the investor base and the borrowing maturity. As a result, the share of variable-rate securities is expected to increase in the upcoming period. Moreover, parallel to the financing strategy intended for reducing the liquidity risk, the ratio of public deposits to average monthly debt service reached as high as 184 percent in June 2007. The high primary surplus and privatization revenues from 2006 played a significant role in this increase.

Graph 6.2.3. Structure of Central Government Debt Stock



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

7. Medium Term Projections

In this chapter, the updated assumptions about fundamental macroeconomic variables will be summarized, and the output gap and inflation forecasts produced according to these assumptions will be presented. In addition, the major potential risks that could lead to a significant downward or upward deviation from the inflation forecasts will be analyzed. Since the forecast horizon is set as two years, these forecasts comprise a period from the third quarter of 2007 to the third quarter of 2009.

7.1. Current Stance, Short-term Outlook and Assumptions

The assumptions that provide a basis for the medium-term forecasts are discussed in two groups: assumptions *pertaining to domestic economic activity* and assumptions *pertaining to external factors*. In forming the assumptions set, the assumptions that have formed the basis for forecasts since the April-2007 Inflation Report have been updated and combined with the data and analyses presented in the previous chapters.

Assumptions pertaining to domestic economic activity are based on analyses regarding the current economic situation and the short-term outlook. The assumption set is the starting point of the forecasts. Moreover, analyses regarding variables of both the demand conditions and the stance of monetary policy are also essential.

GNP data announced for the first quarter of 2007 were broadly in line with the forecasts of the April-2007 Inflation Report. While domestic demand made a limited contribution to growth, the main determinant of growth was the net exports that surged in this period. Leading indicators of the second quarter of 2007 also point to a moderate economic growth stemming from external demand. Thus, considering the tight stance of monetary policy, the forecasts are based on the assumption that demand conditions will continue to support the disinflation process throughout 2007.

In making the forecasts, the earlier assumption that the current level of real interest rates indicate a tight monetary policy and will continue to support the disinflation process by curbing demand conditions was preserved. Besides, it was assumed that real exchange rates continue to support the disinflation process as stated in the April-2007 Inflation Report.

In the second quarter of 2007, CPI inflation displayed a gradual decline consistent with the April-2007 Inflation Report forecasts. Consequently, the decline in annual inflation reached 2.26 points in the last quarter, and following the first quarter, annual inflation remained within the uncertainty band consistent with the target in the second quarter. Considering the strong position of YTL, the lagged effects of monetary tightening and the high base effect of the second half of 2006, it is envisaged that consumer prices will continue to decline gradually in the third quarter of 2007 as well.

In the April-2007 Inflation Report, it was forecasted that the annual growth rate of services prices would lose pace in the remainder of the year in response to the waning domestic demand. As a matter of fact, the slowdown was quite noticeable in the second quarter of 2007. However, this decline is considered to remain limited in light of the forecasts that the effect of wage increases will persist throughout the year, oil prices will continue to be a risk factor, and structural factors in the housing sector will prevail. Therefore, in producing forecasts, the decline in services inflation in 2007 was assumed to be quite modest.

Another significant set of variables that are inputs to medium term inflation forecasts is the data related to external economic activity. This group is comprised of findings pertaining to macroeconomic variables of the Eurozone such as interest rates, inflation and growth; as well as the projections pertaining to the course of international commodity prices and global liquidity conditions. Assumptions pertaining to the Eurozone are taken from the July 2007 issue of “Consensus Forecast” results. According to these assumptions, growth in the Eurozone will be around 2.7 percent in 2007 and become 2.2 percent by end-2008. CPI inflation in the Eurozone is expected to remain at 2 percent until end-2008.

Consistent with the forecasts of the April-2007 Inflation Report, the ECB raised interest rates in June and signaled two more hikes to come by March 2008. Along with the Eurozone, the projections for monetary policies of other developed countries and international liquidity conditions are also scrutinized.

Oil prices run a course above our forecasts given in the April Inflation Report. Recently, following OPEC's quota cuts, the excess demand growth surpassing expectations and production interruptions due to ongoing troubles in Nigeria resulted in a sharp upward trend in crude oil prices. In this respect, the international oil price per barrel, which was assumed to be USD 60 per barrel in the latest Inflation Report, is revised to USD 65 per barrel in this Report.

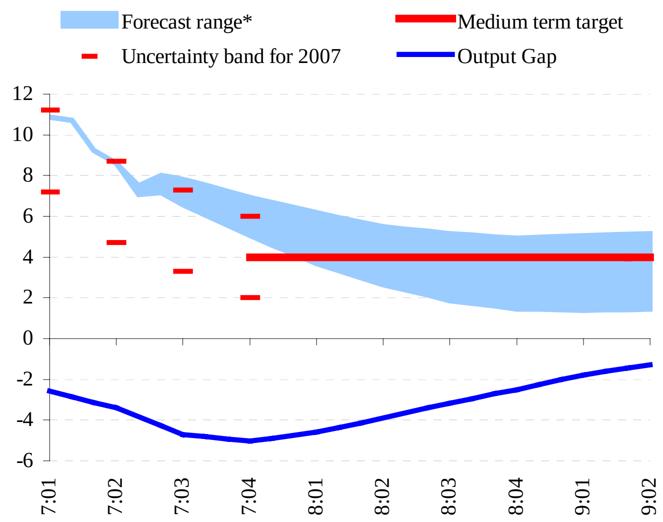
In the reporting period of the April 2007 Inflation Report it was assumed that there would be no significant change in the risk premium. Our assumptions for the risk premium are the same in this Inflation Report as there has been no development since April that would lead to a significant change in this assumption.

7.2. Forecasts and Monetary Policy

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

Inflation forecasts and the monetary policy stance of April 2007 were mainly preserved as the recent developments were to a great extent in line with our forecasts. In this respect, assuming measured policy rate cuts starting from the beginning of the last quarter; our forecasts indicate that, with 70 percent probability, inflation will be between 5.1 – 6.9 range (mid-point 6.0) at the end of 2007, and between 1.5 – 4.9 range (mid-point 3.2) at the end of 2008 (Graph 7.2.1). Given the upward-revised assumptions for oil prices, 2007 end-year forecasts are now slightly higher than those of the previous Report. Nonetheless, owing to the cautious stance of monetary policy, the medium-term inflation outlook will not be affected by this increase.

Graph 7.2.1. Inflation and Output Gap Forecasts



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

Output gap forecasts, which form a basis for the summarized inflation forecasts given above, are also presented in Graph 7.2.1. Under the above-mentioned policy perspective, the demand conditions are expected to continue to support the disinflation process throughout 2007.

These forecasts should not be interpreted as “a rate cut in October”. The main message here is that, in the last quarter of the year, even if there is a measured decline in short-term interest rates, the lagged effects of the tight monetary policy will support the disinflation process for an extended period of time. In this respect, possible interest rate cuts can be considered earlier, as well as later, depending on the flow of incoming information and information regarding external demand, public expenditures and other determinants of the medium term inflation outlook.

It should be stressed that this policy perspective is constructed under the current information set and assumptions, and thus, it should by no means be perceived as a commitment on behalf of the CBRT. There are considerable uncertainties that could necessitate a significant revision of the monetary policy stance in either direction in the upcoming period.

7.3. Risks

Inflation expectations remain sticky, partly owing to the elevated headline inflation figures of the past year. Uncertainties regarding the food and oil prices and the incomes policy in 2007 have also contributed to the stickiness in inflation expectations. The present gap between medium-term inflation expectations and the target suggests that the target inflation may have been serving less of an anchor recently. This constitutes a risk for the wage setting behavior, and hence, for services inflation. Realization of such a risk would slowdown the pace of disinflation, possibly requiring tighter-than-envisaged monetary policy.

There are certain services items, of which, inflation inertia is driven by structural factors and thus, cannot simply be explained by backward indexation. Needless to say, these prices can hardly be influenced by monetary policy. For example, annual rent inflation has remained sticky around 20 percent in the past three years, contributing to annual headline inflation by about one percentage point each year. Rent inflation is expected to moderate in the next couple of months, and further stabilize in the medium to long term, as the housing supply keeps rising. Nevertheless, the possibility that rent inflation will continue to exceed the other services inflation is considered as a risk factor against the disinflation process.

The monetary transmission mechanism has proven to be effective during the past year. Although the increase in non-interest government spending and the robust external demand have restrained the disinflation process, monetary tightening has been successful in bringing inflation back to a disinflationary path towards the medium term targets. Nevertheless, in order to reach the medium term target of 4 percent, the domestic demand needs to stay under control for a while. However, domestic demand conditions may turn less supportive for the disinflation process, provided that the uncertainties fade out and the long-term interest rates continue to decline during the second half of the year. Such a situation may lead to a more cautious stance than implied by the baseline scenario, as well as the use of policy tools other than short-term interest rates, such as required reserves and alike. Nonetheless, this outcome would be less likely should the cautious monetary policy stance be backed by fiscal discipline.

Possible fluctuations in global liquidity conditions continue to pose risks to the inflation outlook. The inflation and growth outlook for developed economies are still not clear, and thus, international financial markets continue to be sensitive to new data releases. Ongoing uncertainties over global imbalances stand out as another risk factor that might lead to abrupt changes in portfolio preferences and liquidity conditions. The CBRT will limit the potential inflationary effects of a possible shift in risk perceptions by pursuing an active liquidity management strategy.

Prudent monetary policy is necessary but not sufficient for achieving price stability. The role of fiscal policy and structural reforms are also critical in this process. In this respect, the European Union accession process and the implementation of the structural reforms envisaged in the economic program remain to be important for long-term stability. Particularly, advances in structural reforms that would enhance the quality of fiscal discipline are monitored closely with regard to their effects on both macroeconomic and price stability.

GRAPHS

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TABLES

ABBREVIATIONS

AMA	Automotive Manufacturers Association
BoJ	Bank of Japan
CBRT	Central Bank of the Republic of Turkey
CDS	Credit Default Swap
CPI	Consumer Prices Index
CSRA	Credit Suisse Risk Appetite Index
ECB	European Central Bank
EMBI	Emerging Markets Bonds Index
EU	European Union
Fed	Federal Reserve Bank of America
GDBS	Government Domestic Borrowing Securities
GDP	Gross Domestic Product
GNP	Gross National Product
GS	Goldman Sachs
HICP	Harmonized Index of Consumer Prices
ISE	Istanbul Stock Exchange
LME	London Metal Exchange
MPC	Monetary Policy Committee
MSCI	Morgan Stanley Capital Index
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers Index
SCA	Special CPI Aggregates
SCT	Special Consumption Tax
SPO	State Planning Organization
TEA	Turkish Exporters' Assembly
TELEKOM	Turk Telecommunications Inc.
TURKSTAT	Turkish Statistical Institution
USA	United States of America
VAT	Value Added Tax
WGMA	White Goods Manufacturers Association
YTL	New Turkish lira