SECTION I

MACROECONOMIC ASPECTS OF FINANCIAL STABILITY

I.1.Intersectoral Developments

In the context of achieving price stability, the primary goal, central banks are responsible for monitoring the financial markets and taking necessary measures in order to ensure financial stability. In this framework, when considering the interaction of all sectors in the economy, it is of paramount importance to analyze public finance, households, the corporate sector, the external sector and the banking sector as a whole in order to monitor financial stability.

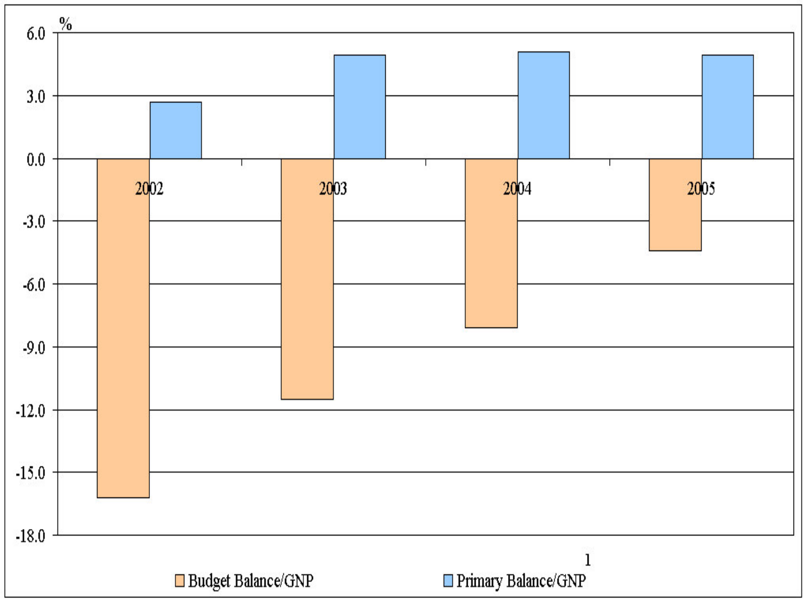
The Turkish economy has improved with the positive contributions made by the strict and fruitful monetary and fiscal policies, as well as the EU process. Single-digit inflation rates, growth rates, which were realized above expectations and decreasing real interest rates are the most distinct indicators of the said improvement.

I.2.Public Finance

In the analysis of the financial system, the primarily important factor in the foreground is the development of public finance. While the risks arising from the interaction between public finance and other sectors are analyzed, public debt to national product, primary budget surplus and the liability structure of public debt are of great importance.

Chart I.2.1
Consolidated Budget Balance

The decrase in the interest rates has positively affected the budget indicators.

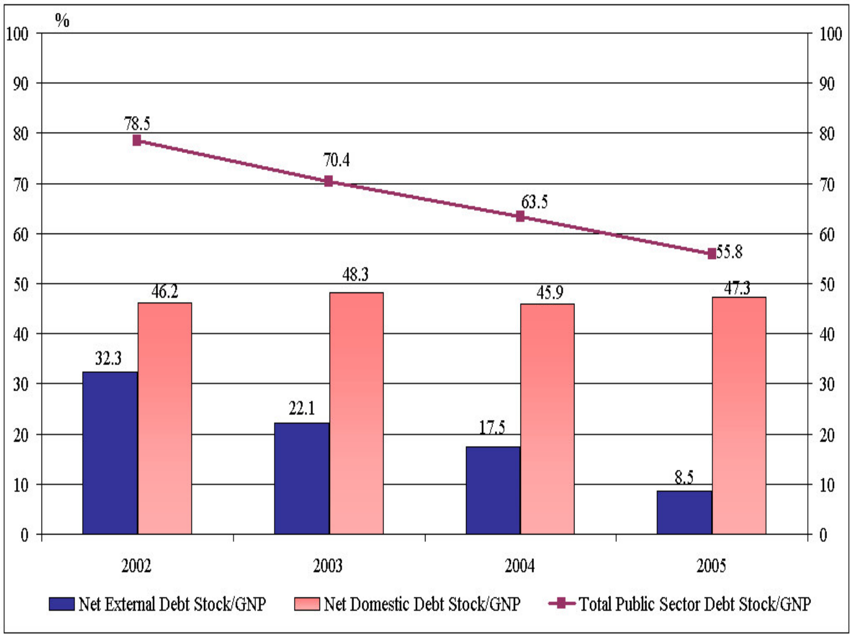


Source: Ministry of Finance and Treasury
[1] It includes only the consolidated budget primary surplus as defined in the IMF program.

Besides the increase in tax and non-tax revenues as a result of economic growth, the decrease in nominal interest rates has positively affected the budget deficit. On account of these improvements, the budget deficit to GNP ratio decreased to 4.4 percent in 2005.

Moreover, the consolidated budget primary surplus to GNP ratio, one of the important indicators of the current economic program, realized as 5 percent as of the end of 2005 (Chart I.2.1). The performance of the primary surplus, one of the most crucial indicators of the current economic program, has also strengthened the positive expectations regarding the budget balance to GNP ratio for the following periods.

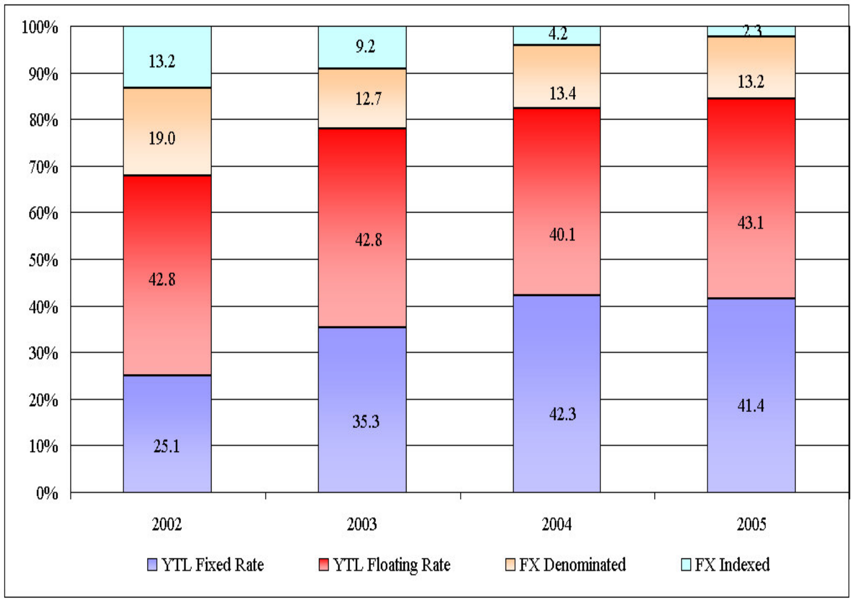
Chart I.2.2
Net Total Public Sector Debt Stock and Its Composition[1]



Source: Treasury
[1] Net public debt stock is calculated by subtracting central bank net assets, public deposits and unemployment insurance fund net assets from public gross debt stock.

The net total public sector debt stock to GNP ratio, which decreased by 7.7 points compared to 2004, was realized as 55.8 percent as of the end of 2005. As a result of high growth rates, the rapid decrease in interest rates and the increase in the Central Bank's net foreign assets, the net total public sector debt stock to GNP ratio declined rapidly (Chart I.2.2).

Chart I.2.3
Composition of Domestic Debt Stock



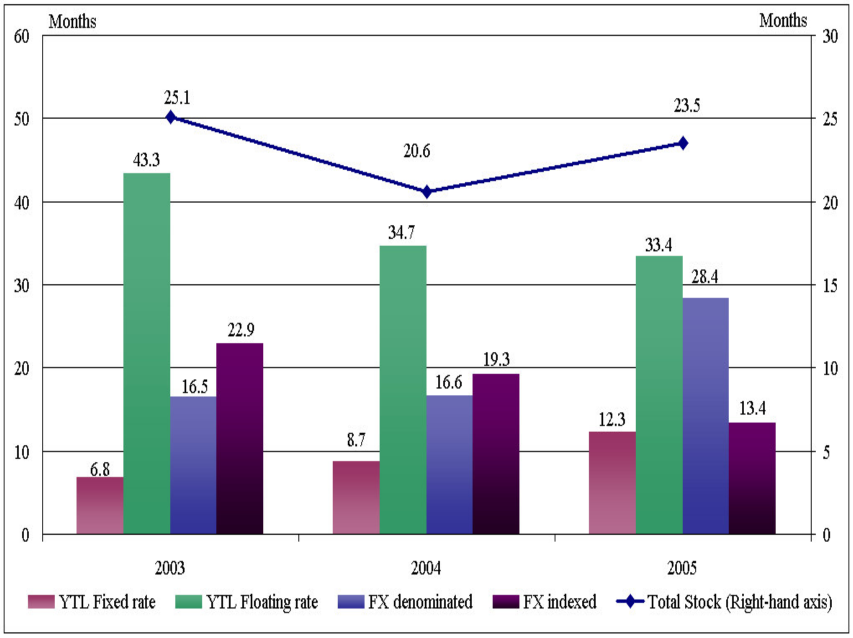
Source: Treasury

The share of FX-indexed instruments in the total domestic debt stock decreased as a result of the Treasury's redemption of the majority of the FX indexed instruments, which were issued on June 2001 with the goal of exchanging the Turkish Lira denominated domestic debt stock instruments. On the other hand, the share of FX-denominated domestic borrowing in the total domestic debt realized as 13.2 percent as of the end of 2005. The share of FX-denominated and FX-indexed instruments in the total domestic debt, which was 17.6 percent as of the end of 2004, fell to 15.5 percent as of the end of 2005 (Chart I.2.3).

While the share of New Turkish Lira denominated fixed rate instruments in the total domestic debt stock decreased by 0.9 percent compared to 2004, the share of New Turkish Lira denominated floating rate instruments in the total domestic debt stock increased.

The trend in the composition of domestic debt stock reveals that the Treasury's sensitivity to exchange rate risk decreased and the sensitivity to interest rate risk increased to some extent in 2005 compared to the previous year.

Chart I.2.4
Maturity Structure of Government Domestic Debt Securities (Month) [1]

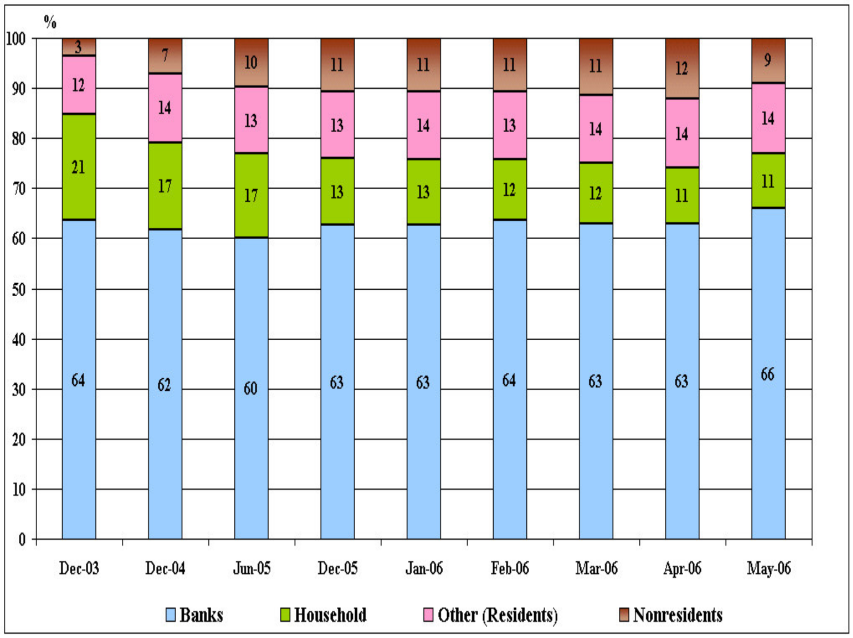


Source: Treasury
[1] Calculation is based on term to maturity.

The average maturity of total government debt instruments stock realized as 2 years as of the end of 2005. Whereas the term to maturity of both New Turkish Lira denominated fixed rate instruments and FX denominated instruments increased, the term to maturity of both New Turkish Lira denominated floating rate instruments and FX indexed instruments decreased (Chart I.2.4).

In particular, the fact that the average maturity of fixed rate securities, which comprises the majority of the government domestic debt securities, increased above 1 year and that the average maturity of floating rate securities is approximately 3 years, though their maturity decreased, facilitate the Treasury's domestic debt service.

Chart I.2.5
Distribution of Government Domestic Debt Securities by Holders [1,2,3]



Source: BRSA-CBRT

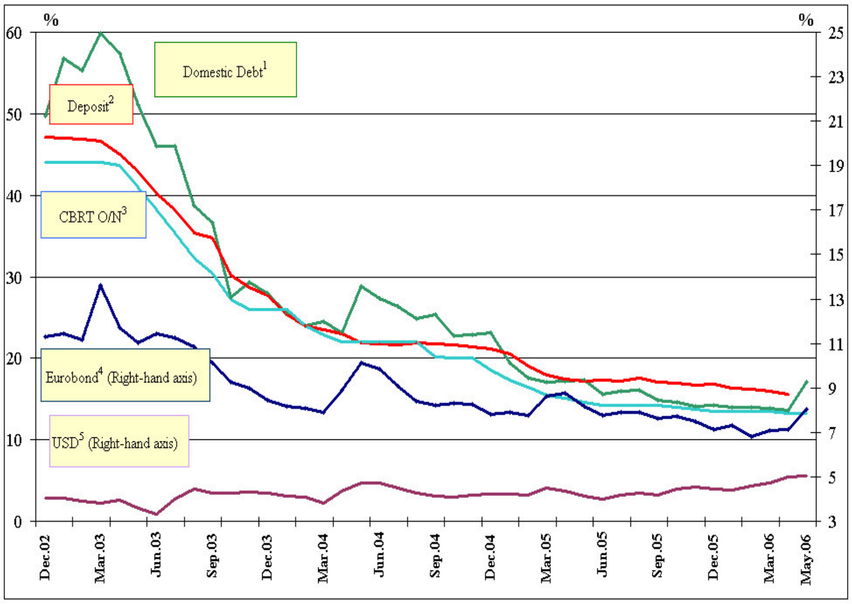
[1] Nominal amounts are used.

[2] "Bank" includes government domestic debt securities owned by banks operating in Turkey.
"Household" contains real persons' government domestic debt securities preserved at domestic banks.
"Other (residents)" covers government domestic debt securities of residents except banks and households preserved at banks.
"Foreign" involves nonresident real and corporate persons' government domestic debt securities held at domestic banks.

[3] Government domestic debt securities owned by the Central Bank and those in the Compulsory Savings Account (CSA) are excluded.

Most government domestic debt securities are owned by the banks operating in Turkey. As a result of the more rapid decrease in the interest rates of government domestic debt securities compared to deposit interest rates (Chart I.2.6), the resident real persons' government domestic debt securities portfolio continues to decline. The other residents' portfolio share, however, increased slightly. The non residents' government domestic debt securities portfolio share decreased by 3 points compared to the previous month to 9 percent due to the fluctuation in international markets in May 2006 (Chart I.2.5).

Chart I.2.6
Interest Rates



Source: Treasury, CBRT

1 Compound interest rate of government domestic debt securities is weighted by net debt amount.

2 3-month weighted deposit interest rate.

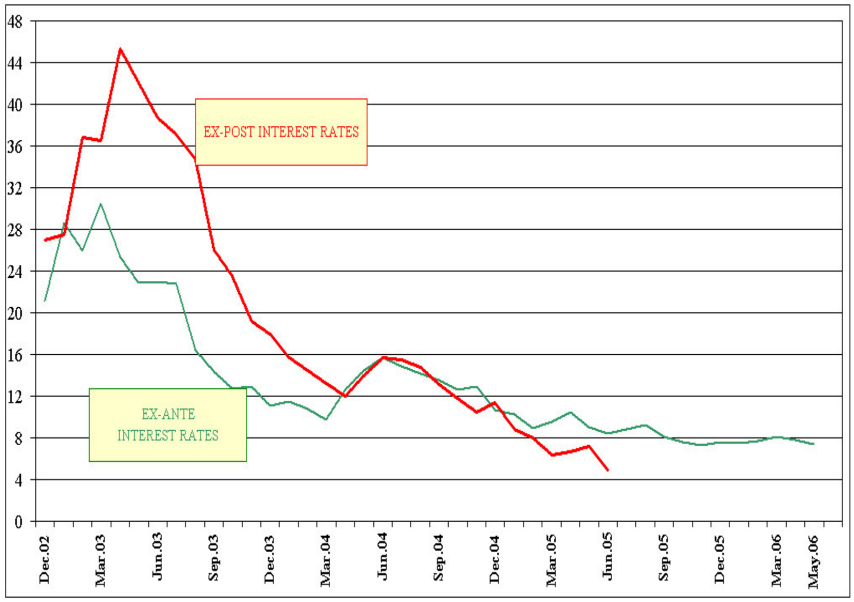
3 Weighted average overnight interest rate.

4 Interest rate of US dollar-denominated Eurobond with maturity date 2030 is taken as a basis.

5 Interest rate of US government bond with 10-year-maturity is taken as a basis.

Positive developments in the economy also affected interest rates. The decrease in interest rates of both government domestic debt securities and Eurobonds influenced the consolidated budget balance and debt stock positively (Chart I.2.6). On the other hand, since the US Federal Reserve increased interest rates from 1 percent to 5 percent on 10 May 2006 and signaled further increases, funding costs are expected to rise in the upcoming periods.

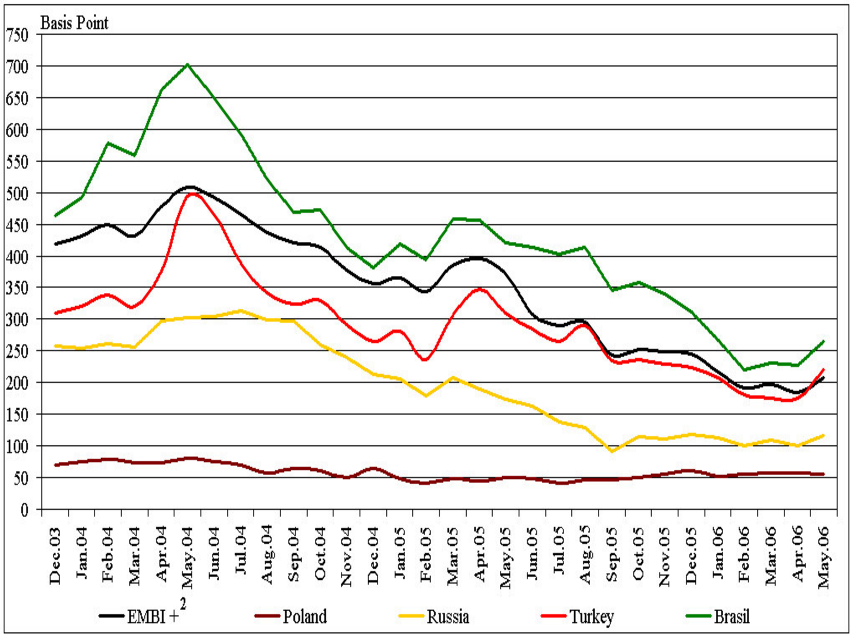
Chart I.2.7
Ex-ante[1] and Ex-post[2] Real Interest Rates of Government Domestic Debt Securities



Source: Calculated by using the data of CBRT, ISE and TURKSTAT.
[1] Ex-ante interest rate =(((1+ nominal interest rate)/(1+ex-ante inflation rate))-1)*100
[2] Ex-post interest rate =(((1+ last year's nominal interest rate)/(1+ex-post inflation rate))-1)*100
As ex-ante inflation rate, yearly ex-ante CPI figures in the monthly Expectation Inquiry published by the Central Bank are used.

Positive developments in interest rates in recent years have been supported by ex-ante interest rates, which are calculated according to inflation expectations. Real ex-ante interest rates, which were about 25 percent in the second half of 2003, have decreased gradually since that time and became 7.4 percent as of May 2006 (Chart I.2.7). On the other hand, because inflation rates have realized above the expectations of the previous year since June 2005, ex-post interest rates stayed below ex-ante interest rates.

Chart I.2.8
Country Risk Premiums in Selected Developing Countries[1]



Source: Bloomberg

[1] Country risk premium is the difference between the relevant country's EMBI+ index and the returns of US Treasury instruments.

[2] EMBI+ index includes eurobonds of 18 developing countries, Brady bonds and traded loans. The weight of each country in the index is different. For instance, Brazil's weight is 23.2, Mexico's weight is 18.8, Russia's weight is 17.3 and Turkey's weight is 9.4 in the EMBI+ index. Also, the EMBI+ index is calculated for each country.

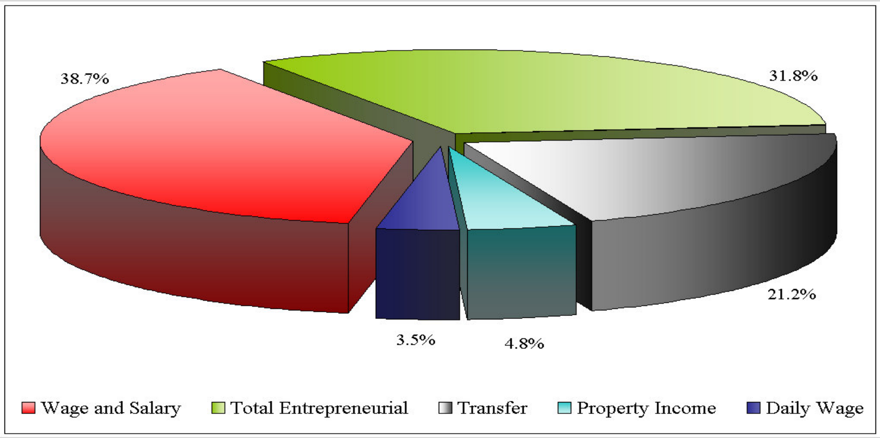
Due to excess liquidity in global markets, the relatively low level of real returns in developed countries and the effective implementation of economic programs in developing countries, there were significant amount of capital flows to developing countries in recent years. With a noteworthy decrease in April 2006, Turkey's country risk realized as 171 base score, which is the lowest level in this period (Chart I.2.8). However, country risk increased to 273 base score in May 2006 parallel to unfavorable developments in international markets.

To conclude, in the face of the increased likelihood of reversal of global liquidity conditions against developing countries, both the maintainance of a determined programme of fiscal discipline and achievement of the primary surplus goals are still of great importance for preserving the stability of the financial system in our country.

I.3.Households

The analysis of households is highly significant both in the evaluations of macroeconomic developments in terms of their role in production and consumption and in the assessments of financial markets as loan borrowers and investors.

Box I.3.1.Distribution of Household Income Resources (2004)

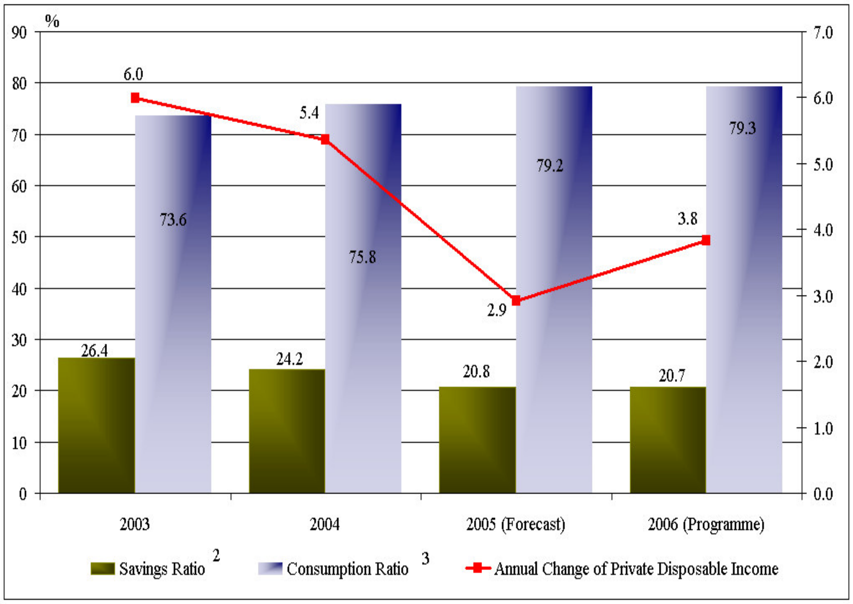


Source: TURKSTAT, 2004 Household Budget Survey

Household income is categorized into two groups as operating and non-operating income. While wage-salary, daily wage and total entrepreneurial income constitute operational income, non-operating income consists of unrequited transfers and property income. Wage-salary and daily wage make up the largest portion with a share of 42.2 percent in household income distribution in 2004. While entrepreneur [1] income is 31.8 percent of household income, the income acquired from the rental of real estate and unrequited and one-sided transfers from the government, private entrepreneurs or from foreign countries constitute 26 percent of household income.

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

Chart I.3.1
Private Sector's Consumption and Savings Ratios and the Real Disposable Income[1]



Source: SPO

[1] Private sector's disposable income and consumption data are converted to real terms by the GNP deflator of the relevant year. For the year 2006, the objective of 6 percent is used for the deflator.

[2] Savings Ratio = Total Private Savings / Total Disposable Income

[3] Consumption Ratio = Total Private Consumption / Total Disposable Income

Since private sector consumption increased faster than disposable income, the consumption ratio increased, however, the savings ratio decreased. In 2004, real disposable income and consumption rose by 5.4 and 8.6 percent in real terms respectively. According to the 2006 Programme of State Planning Organization (SPO), the aforementioned growth rates are expected to be 2.9 and 7.6 percent, respectively in 2005. As for 2006, estimated growth rates for private sector disposable income and private sector consumption are 3.8 and 3.9 percent, respectively (Chart I.3.1).

Table I.3.1
Private Consumption Expenditures

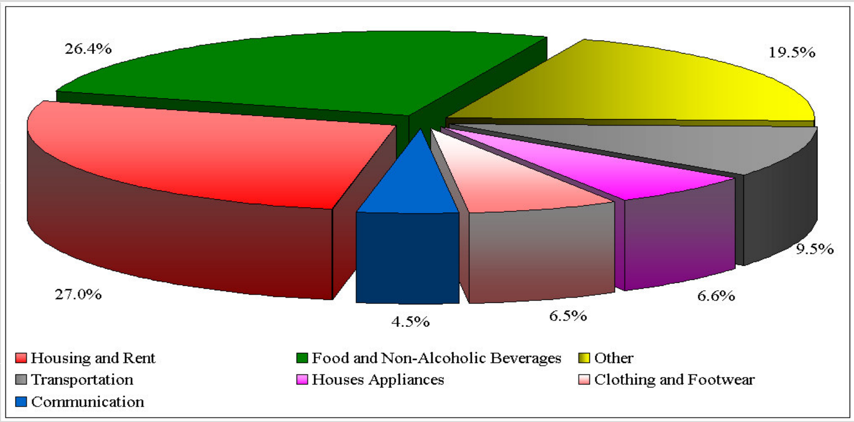
Yearly Change, %	2001	2002	2003	2004	2005
Private Consumption Expenditures	-9.2	2.1	6.6	10.1	8.8
Durable Goods	-30.4	2.1	24.0	29.7	15.0
Services	-9.3	8.5	7.5	9.3	7.8
Food and Beverages	-3.6	1.1	4.1	2.8	8.2
Semi-Durable and Non-Durable Goods	-9.0	3.0	2.1	18.8	12.9

Source: TURKSTAT

In 2005, although the growth rate of the private consumption expenditure slowed down, it was still high.

Private consumption expenditures, of which the growth rate has increased in recent years, slowed down in 2005 since the demand for durable and semidurable consumption goods has been saturated. As a matter of fact, the increase in the growth rate of durable consumption goods expenditures, which was 29.7 percent in 2004, decreased to 15 percent in 2005. On the other hand, food expenditures were the only item in which the growth rate accelerated in 2005 (Table I.3.1).

Box I.3.2.Distribution of Household Expenditures (2004)



Source: TURKSTAT, 2004 Household Budget Survey

Household expenditures include household's monthly purchases, consumption from its own production, consumption from stocks, earnings in kind and consumption in the transfer manner and the monthly average of consumption expenditures for durable consumption goods purchased in the last year. In 2004, expenditures for housing and rent were realized as 27 percent, while expenditures for food and non-alcoholic beverages were 26.4 percent.

Table I.3.2
Household Disposable Income, Indebtedness and Interest Payments

Million YTL	2002	2003	2004	2005
Household Interest Payments	2,485	3,851	6,982	9,747
Household Debt[1]	6,736	13,442	28,259	48,760
Household Disposable Income[2]	143,777	180,305	218,752	237,167
Interest Payments / Disposable Income (%)	1.7	2.1	3.2	4.1
Debt / Disposable Income (%)	4.7	7.5	12.9	20.6

Source: BRSA-CBRT, TURKSTAT

[1] Household debt consists of gross consumer credits and credit card balances extended by banks and consumer finance companies. Consumer finance companies have been included in the accounts since 2003.

[2] Household disposable income for 2005 is calculated by using private sector disposable income estimated in the SPO's 2006 programme, under the assumption that the 2004 ratio of household disposable income to private sector disposable income has not changed.

The ratio of household liability to disposable income, which was 12.9 percent in 2004, increased to 20.6 percent in 2005. Accordingly, the ratio of interest payments to disposable income, which was 3.2 percent in 2004, went up to 4.1 percent in 2005 (Table I.3.2).

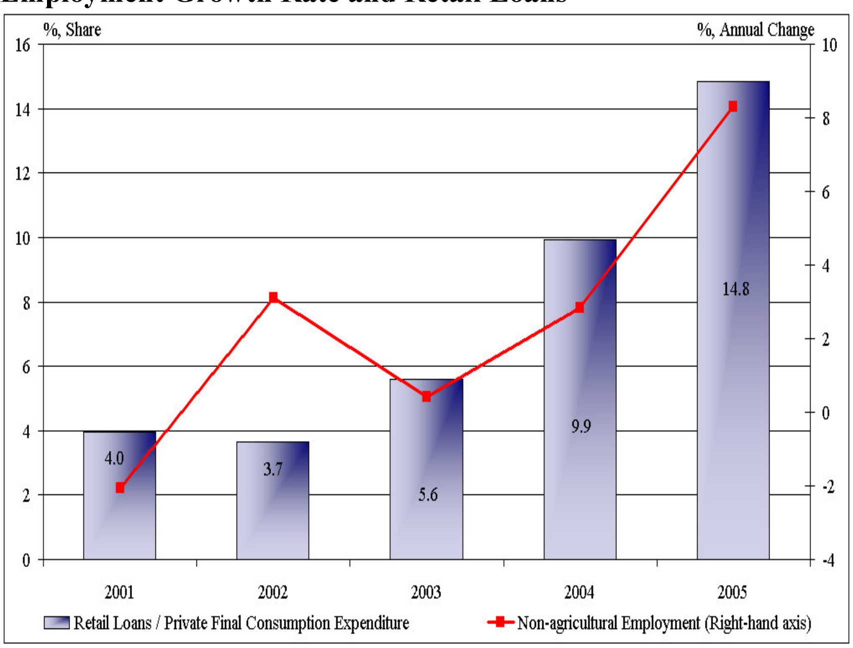
Table I.3.3
Number of Non-Performing Consumer Loans and Credit Card Holders[1]

Number of Person	2002	2003	2004	2005
Non-Performing Credit Card Holders	5,696	4,245	10,082	17,046
Non-Performing Consumer Loans	33,866	32,360	53,173	174,065

Source: CBRT
[1] It indicates the number of credit card and consumer credit debtors in the NPL accounts of banks.

The upsurge in household indebtedness is also reflected on this sector's debt repayments. In 2005, the number of credit card holders who did not pay their credit card debt jumped by 227 percent and reached 174,065, while the number of non-performing consumer loans increased by 69 percent to 17,046 (Table I.3.3).

Chart I.3.2
Employment Growth Rate and Retail Loans[1]



Source: CBRT-TURKSTAT
[1] Retail loans are composed of gross credit card balances and gross consumer credits extended to real persons by banks and by consumer finance companies since 2003.

The increasing part of household consumption expenditure is financed by consumer credits and credit cards. While 5.6 percent of private consumption expenditures were financed by retail loans in 2003, this ratio increased to 14.8 percent in 2005. On the other hand, the rise in non-agricultural employment also has a significant influence on the increase of the share of retail loans in consumption expenditures (Chart I.3.2).

The biggest share in household assets belongs to deposits.

Table I.3.4
Composition of Household Financial Assets

Million YTL	2003	2004	2005
YTL Deposits	44,982	61,753	86,968
FX Deposits	53,034	58,341	56,844
Currency in Circulation	10,129	12,446	18,276
Profit Sharing Fund	3,283	4,632	6,381
Domestic Debt+Eurobond	35,307	39,123	32,613
Stocks	7,972	12,284	15,740
Repos	2,812	1,647	1,473
Private Pension Funds	42	298	1,232
Total Assets	**157,560**	**190,524**	**219,526**

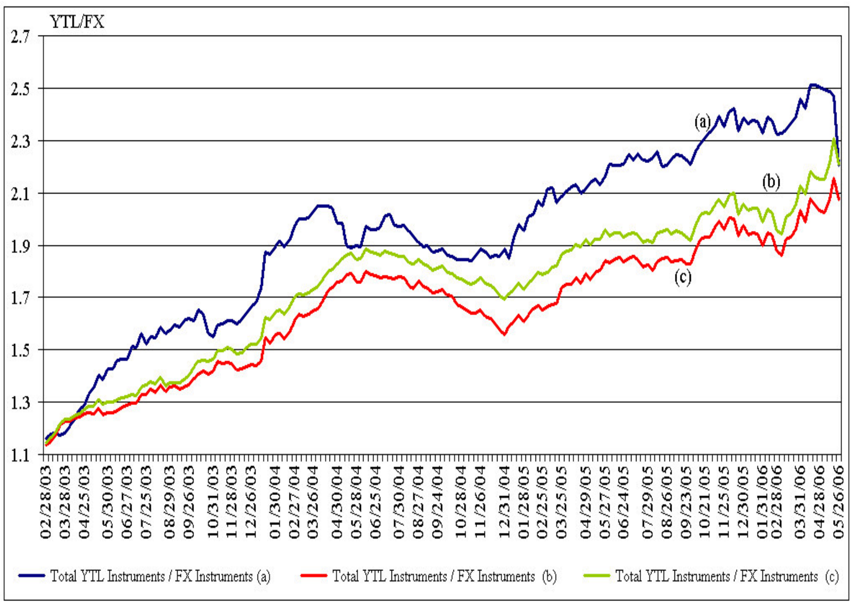
Source: BRSA-CBRT, Treasury

Households' financial assets increased by 15.2 percent at the end of 2005, compared to the previous year, and reached 220 billion New Turkish Liras. In 2005, 66 percent of household financial assets are composed of deposits and 15 percent of government debt securities (Table I.3.4).

When the returns of household's investment instruments are analyzed it can be seen that the declining trend in interest rates of both government debt securities and Eurobonds has accelerated since May 2004. The interest rate of government debt securities, which was 23.1 percent at the end of 2004, dropped to 14.2 percent at the end of 2005. Parallel to this development, banks' 3-month weighted deposit interest rates decreased from 21.1 percent to 16.9 percent and realized 15.6 percent as of April 2006 (Chart I.2.6).

As a result of the determined implementation of the stability programme, the positive atmosphere stemming from the EU integration process, and the structural reforms carried out in this process, the reliability on New Turkish Liras increased and accordingly the real effective exchange rate[1] appreciated by 19.6 percent in 2005, compared to the previous year. Parallel to this appreciation in the Turkish Lira, the returns of investment instruments denominated in domestic currency declined, while the returns of investment instruments denominated in foreign currency remained relatively lower. On the other hand, in May 2006, as a result of the turbulences in the international markets, interest rates of government debt securities increased to 17.1 percent, while the New Turkish Lira depreciated by 7 percent in real terms, compared to the end of 2005.

Chart I.3.3
Ratio of YTL-FX Denominated Investment Instruments of Households[1]



Source: CBRT

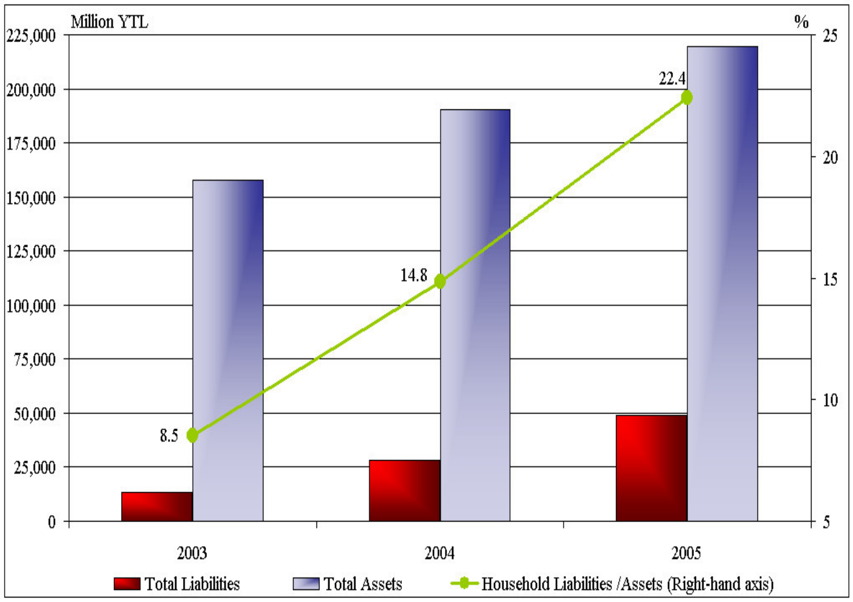
[1] YTL Instruments = Deposits+ Repos +Gov. Dom. Debt Sec. (real person) + Participation Funds (YTL); FX Instruments = FX Deposits+ Gov. Dom. Debt Sec. (real person) + Eurobond (real person) + Participation Funds (FX); (a) current YTL value of FX deposits, (b) for FX deposits, exchange rate prevailing on 31.12.2002 is fixed, (c) for FX deposits, exchange rate prevailing on 31.12.2002 is used and the parity effect is eliminated.

Parallel to the de-dollarization process, households' portfolio preferences between domestic currency investment instruments and foreign currency denominated investment instruments have changed. In fact, the dominant share of domestic currency deposits in total deposits continued with an increasing pace and realized as 60 percent in 2005. As a result of appreciation in the New Turkish Lira, domestic currency

[1] Real Effective Exchange Rate is calculated by using CPI based real effective exchange rate index (1995=100).

denominated instruments became 2.4 times those of foreign currency denominated instruments calculated by the prevailing exchange rates on that date at end–2005. However, in May 2006, along with the depreciation in the New Turkish Lira, the mentioned ratio was realized as 2.2 percent (Chart I.3.3).

Chart I.3.4
Households' Financial Assets and Liabilities[1]



Source: BRSA-CBRT, Treasury

[1] Household Assets = Savings Deposit + FX Deposit + Money in circulation + Participation Funds + Gov. Dom. Debt Sec. + Eurobond + Repos + Stocks+ Pension Funds
Household's liability is composed of gross credit card balances and gross consumer credits extended by both banks and consumer finance companies.

The ratio of household liabilities to financial assets has increased rapidly in recent years. This ratio, which was 14.8 percent in 2004, rose to 22.4 percent at the end of 2005 (Chart I.3.4). Despite this increase, the mentioned ratio was still below the Euro Area average in 2004 (Table I.3.5).

Table I.3.5
The Ratios of Household Liabilities to GDP and to Total Assets in Selected Countries[1]

2004 (%)	Household Liabilities / GDP	Household Liabilities excluding Housing Loans / GDP	Household Liabilities / Assets
Eurozone	50	16	25
New Europe[2]	12	8	23
Bulgaria	12	9	28
Croatia	32	20	46
Czech Republic	14	6	21
Estonia	24	7	83
Hungary	20	10	36
Latvia	19	7	29
Poland	13	9	24
Romania	5	4	31
Slovakia	10	5	22
Turkey	**6**	**6**	**15**
Turkey (2005)	**10**	**7**	**22**

Source: Coricelli F.;Mucci F.;Revoltella D. (2006) "Household Credit in the New Europe: Lending Boom or Sustainable Growth?" Centre For Economic Policy Research, BRSA-CBRT

[1] Figures on financial assets for theEurozone are the Bank of Italy estimates and relate to 2003.

[2] New Europe covers 10 countries on the table.

Household liabilities to GDP ratios for countries (listed) are significantly below the Eurozone, and, except for Croatia, the mentioned ratio varies between 5 percent and 25 percent. Since the share of housing loans in household liabilities for Turkey is much lower than most of the other selected countries, the ratio of household liabilities to GDP in Turkey is also lower than the ratios of others. In fact, when this ratio is recalculated excluding housing loans, the household liabilities to GDP ratios of the selected countries are considerably close to that of Turkey (Table I.3.5).

Box I.3.3.Demographic Structure and Housing Loans

Ongoing immigration to cities along with rapid population growth has raised housing needs. High inflation rates and the crowding-out effect of the public sector have restricted the intermediary function of banks and led housing loans to remain limited until today. However, while the decrease in the inflation rate and interest rates resulting mainly from fiscal discipline has ensured that the credit channel works efficiently, on the demand side, housing loans have increased remarkably due to positive developments in household expectations. In fact, only in 2005, housing loans rose more than 3 times the previous year in real terms (Chart III.1.1.1.11).

Despite the rapid growth in housing loans, the housing loans to GDP ratio in Turkey is still lower than any of the other countries (Table III.1.1.1.2). In our country, housing ownership is common and in total province and county centers, the share of house-owners in the total population is about 60 percent, whereas the share of tenants is about 30 percent. The remaining 10 percent is composed of "hidden tenancy" and the residents of public housing.[1]

Table 1: Total Population and Urban Population

Person (Thousand)	2001	2005 [1]
Total Population	68,529	72,844
Annual Growth of Urban Population	2,100	2,545
Population Growth Rate (%)	1.6	1.4

Table 2: Age Groups

	0-14 age group		15-64 age group	
Share (%)	2000	2005 [1]	2000	2005 [1]
EU15	16.7	15.7	66.9	66.8
Turkey	30.0	28.3	64.4	65.8

Source: TURKSTAT, SPO, Eurostat

(1) Based on the 2000 census and 2003 projections of Turkey Population and Health Research.

Demographic indicators are of great importance in order to understand the current and potential housing need in Turkey. Although the population growth rate slowed down in Turkey, in 2005, it is estimated that the population will be 72.8 million, population density in cities will continue at an increasing pace and in spite of the decrease in the share of young population in 2005, it will be higher than the European countries (Table 1 and Table 2). In fact, the housing need resulting from population growth coupled with renewal and natural disasters is expected to reach 680 thousand in 2005.[2]

Table 3: Number of Housing Licenses[1] and Real Estate Sales and Housing Needs

Thousand	2002	2003	2004	2005
Total Housing Needs in Urban Areas	594	600	634	680
Number of Housing Licenses	166	163	160	240
Number of Real Estate Sales	924	1,018	1,216	1,363
Real Estate Value in Real Terms (Thousand YTL)	1,978	1,971	2,519	3,102

Source: General Directorate of Land Registry, TURKSTAT

1 Corresponds to residential houses.

2 Converted to real terms by using CPI (1994=100).

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(1) Real Estate Secretariat "Turkey Real Estate Ownership Study", February 2003.

(2) SPO, VIII. five-year Development Plan

As well as population growth, urbanization growth and the socio-economic structure, households' investment preferences are influential in housing demand. It is our opinion that the draft mortgage law, rapid decline in credit interest rates and foreign demand for real estate in Turkey are the factors affecting the development in construction sector in recent years. As a result of these developments, the number of housing licenses, which was 160,000 in 2004, increased to 240,000 in 2005, and the number of real estate sales reached 1,363 thousand. Real estate value in real terms increased by 23 percent in 2005 (Table 3).

The households' income level and future income expectations together with interest rate and maturity structure of housing loans determine housing demand. Since the above-mentioned factors turned in favor of households in 2005, housing demand and therefore the value of real estates increased. The fact that supply reacts to demand with a lag also leads to this increase in the real estate prices.

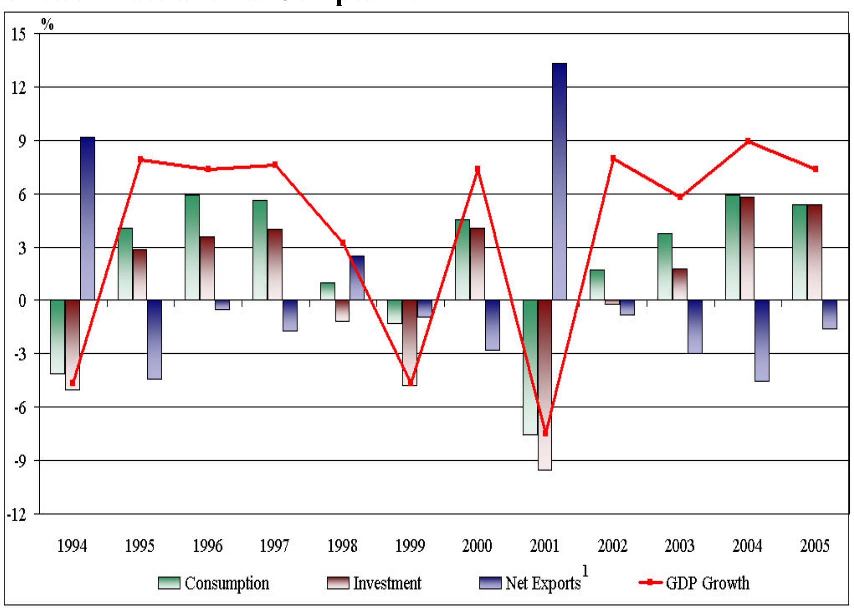
To conclude, with the maintenance of macroeconomic stability in the following periods, in general, household income is expected to develop positively. However, it should be taken into consideration that as seen in some country experiences, there may be "bubbles" in asset prices during the periods of economic expansion, therefore unexpected drops in the value of real estate may reduce the value of guarantees and collaterals held by the financial sector, and lead household wealth to decline.

I.4.Corporate Sector

I.4.1.General Structure

In 2005, the fall in domestic interest rates reduced companies' domestic credit costs and companies had more opportunities to access international funds with better terms and long maturities as a result of rising country credibility and positive international liquidity conditions. These developments played an important role in investment expenditures growth.

Chart I.4.1.1
Growth Rate and Its Composition



Source: TURKSTAT
[1] Net Exports= Exports-Imports

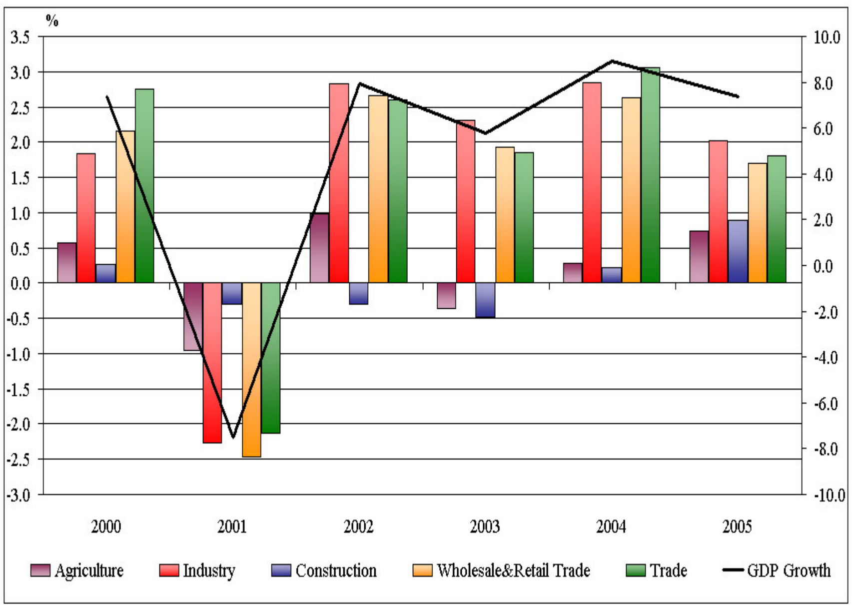
Sustainable growth has been achieved in Turkey in the ongoing low inflation environment of the last four years. GDP growth, which was 8.9 percent in 2004 due to private consumption and investment expenditures, exceeded expectations and was realized as 7.4 percent in 2005, especially as a result of the revival in domestic demand in the second half of the year (Chart I.4.1.1).

Private and public investment expenditures increased in 2005.

In 2005, private consumption expenditures, although low for the first and second quarters, increased by 8.8 percent in real terms compared to the previous year due to the rapid increase in the third and fourth quarters. On the other hand, the annual real increase in public consumption expenditures was 2.4 percent. Public investment expenditures, which fell by 4.7 percent in real terms in 2004 increased by 25.9 percent in 2005, whereas private investment expenditures, which increased by 45.5 percent in real terms in 2004 increased by 23.6 percent in real terms in the year 2005.

Investment expenditures in 2005 supported productivity growth and it is expected that continued investments will increase the potential production level and make it possible to achieve sustainable growth performance without causing any inflationary pressures.

Chart I.4.1.2
Contribution of Sectors to Growth [1]



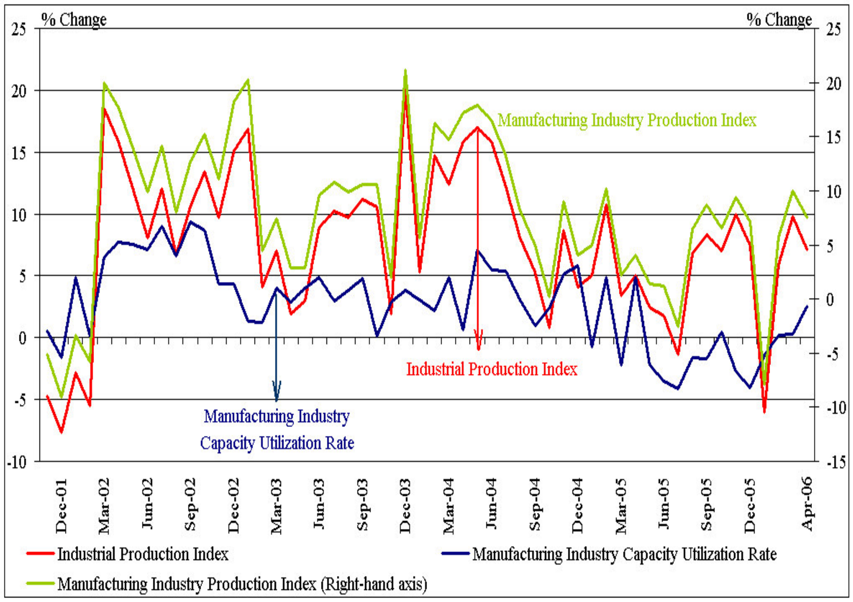
Source: TURKSTAT

[1] The contribution of sectors to growth was calculated by using percentage change in each sector and weighing these figures with the share of each sector in total sectors in the previous period.

Positive developments in the construction sector were influential in growth.

The major contribution to GDP growth in 2005 came from the industry and trade sectors (Chart I.4.1.2). The construction sector, which affected growth negatively in the previous years, started to contribute positively in 2004 and increased its contribution in 2005.

Chart I.4.1.3
Industrial Production and Capacity Utilization Rate [1,2]



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

In 2005, average industrial production growth was 5.4 percent. This growth is mainly attributable to growth in exports as well as the revival of those sectors, which produce inputs for the construction sector. During the same period, manufacturing industry production growth was realized as 4.8 percent on average.

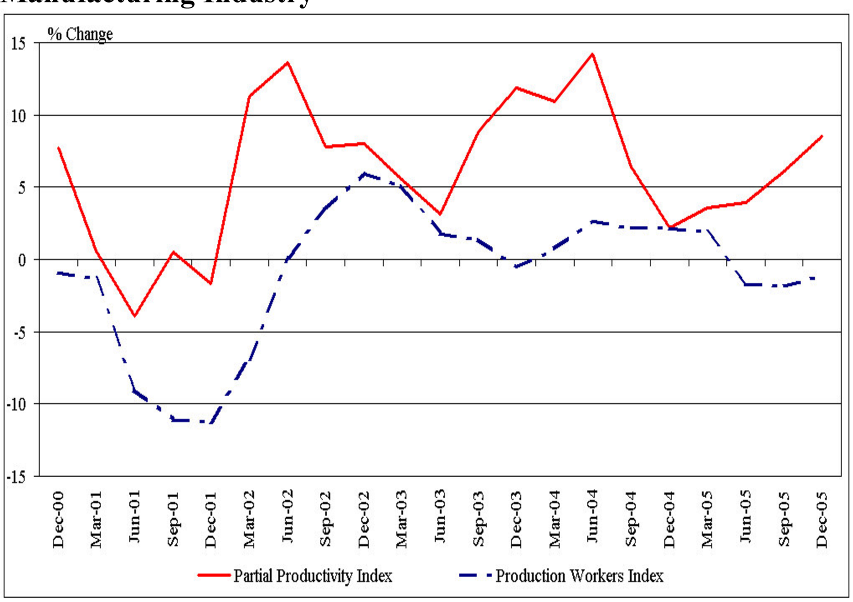
The tendency to increase in industrial production raises the probability of achieving the growth forecasts for 2006.

In January 2006, total industrial production decreased by 6 percent compared to the same month of the previous year as a result of the reduction in economic activity due to unfavorable weather conditions and as a result of reduced workdays due to the religious holiday. However, in the following months industrial production entered an upward trend again and increased by 5.9 percent in February, 9.8 percent in March and 7.1 percent in April 2006. Similarly, the fall in manufacturing industry production by 7.9 percent in January 2006 was followed by 5.7 percent, 10 percent and 7.5 percent increases in February, March and April respectively (Chart I.4.1.3). Consequently, average growth in total industrial production for the first four months of 2006 was 4.4 percent, whereas the same figure for manufacturing industry production was 4.1 percent.

The average growth realized in the manufacturing industry in the first four months of 2006, parallel to the sectors in 2005, is attributable to the manufacture of chemicals and products, machinery and equipment, other transport equipment, other non-metallic mineral products, food products and beverages, motor vehicles, trailers and semi-trailers and fabricated metal products, except machinery and equipment. Nevertheless, despite the reduction in value added tax in order to support the sector, the contraction in the textile products industry and clothing industry that has been going on for the last two years due to the negative effects brought about by the appreciation of New Turkish Lira, as well as competitive pressures from Asian countries such as China and India, restricted growth in manufacturing industry production. Other important manufacturing sectors that contracted are those of coke and refined petroleum products, paper and paper products, rubber and plastic products and radio, TV and communication apparatus.

The capacity utilization rate, which was 80.7 percent by year-end 2005, was realized as 82.3 percent in April 2006.

Chart I.4.1.4
Number of Workers and Partial Productivity per Worker for the Manufacturing Industry[1, 2]



Source: TURKSTAT

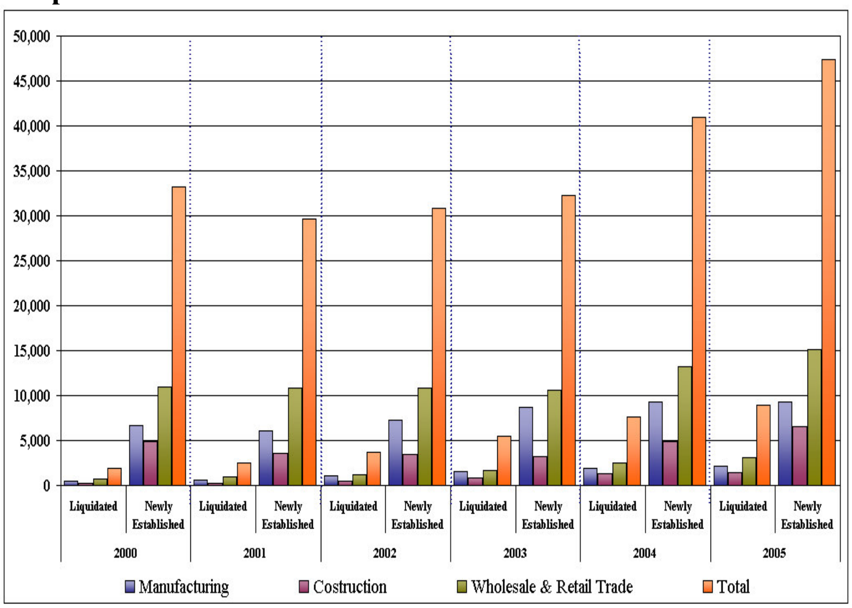
[1] Percentage change as compared to the same month of the previous year.

[2] 1997=100 index is used.

Increase in productivity is the underlying factor behind growth.

Despite an average increase of 4.8 percent in 2005, the number of production workers decreased by 0.7 percent in manufacturing industry production. Partial productivity per worker, on the other hand, increased by 5.6 percent. This indicates that the source of growth in 2005, as was the case in 2004, was the increase in productivity per worker. However, the fact that the sources of growth in 2005 were the 8.8 percent increase in private demand for final products and the 24 percent increase in capital accumulation strengthens the expectations that continued growth will have a positive effect on employment.

Chart I.4.1.5
Number of Newly Established and Liquidated Companies and Cooperatives



Source: TURKSTAT

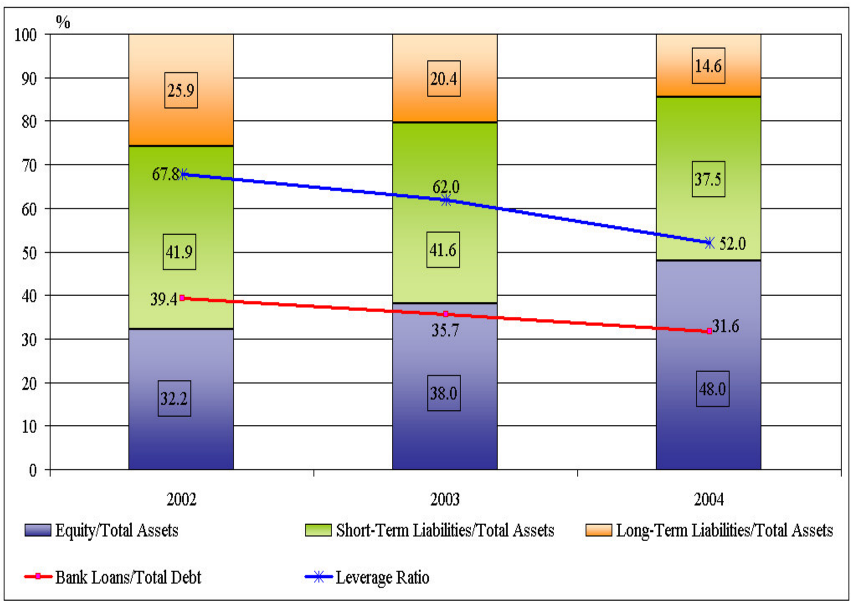
The number of newly established firms, which was 40,925 in 2004, increased to 47,401 in 2005, and the number of liquidated firms, which was 7,660 in 2004, increased to 8,886 in 2005 (Chart I.4.1.5). The number of newly established and liquidated companies during the first four months of 2006 were 19,623 and 3,728 respectively.

I.4.2.Financial Analysis of Companies

Box I.4.2.1.Data Set for Companies

The financial analysis of companies was based on Sector Balance Sheet Statistics published by the Central Bank, which contain the balance sheet and income statement information of 6,618 private sector companies. The most important point that should be taken into consideration in the analyses is that the financial statements for 2004 are adjusted according to inflation, whereas the financial statements for other years are prepared in accordance with historical-cost principles. Therefore, when comparing non-monetary items with previous years this effect should be taken into account.

Chart I.4.2.1
Selected Financial Structure Ratios

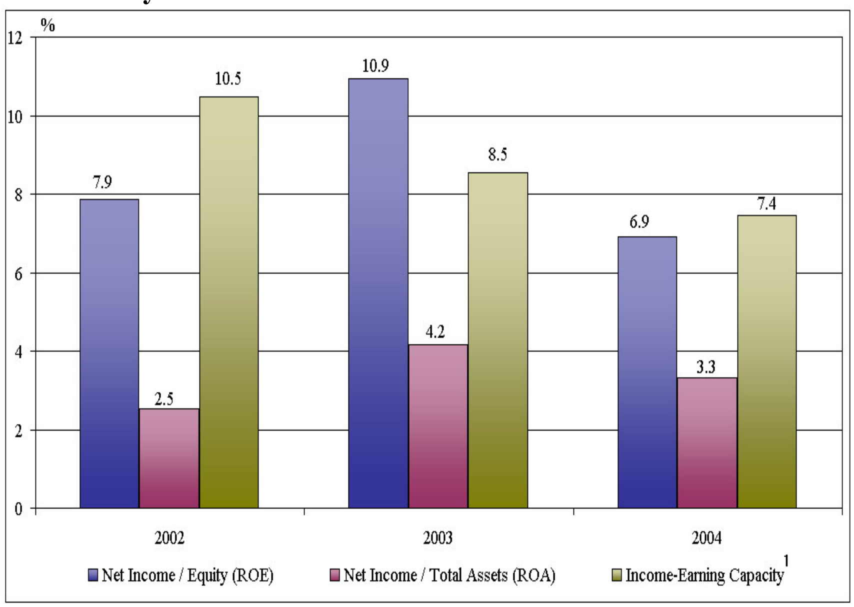


Source: CBRT

As of end-2004, 52 percent of the assets of companies was funded through borrowing and the remaining part was funded by own funds, as a result of the strengthening of firms' own funds due to increasing profitability in the recent years (Chart I.4.2.1). The increase in own funds in 2004 is attributable both to changes in companies' financing preferences and to the re-pricing of capital in the framework of inflation accounting. The rise in own funds financing is regarded as a positive development since it decreases the risk premium for firms and increases the firms' repayment capacity to the banking sector.

Although the financial leverage ratio, which is the ratio of total debt to total assets, dropped to 52 percent in 2004, it can be seen that this figure is still high. The share of bank loans in total debt reveals a declining trend and fell from 39.4 percent to 31.6 percent in 2004 in 2003 (Chart I.4.2.1). In the sub-sectors of the manufacturing industry, 26.6 percent of total bank loans were used by the textile sector, which has a rather high non-performing loans ratio, and whose contribution to manufacturing industry production has been negative since May 2004.

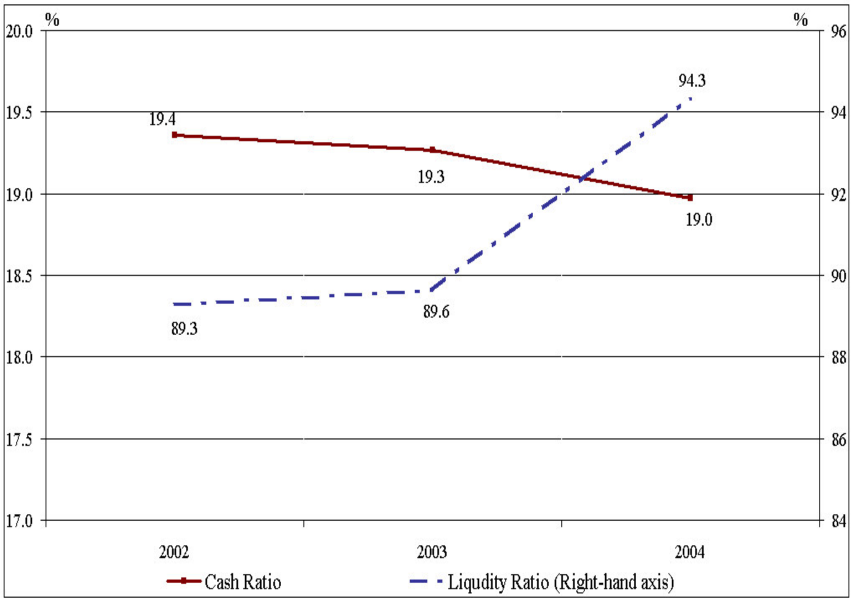
Chart I.4.2.2
Profitability Ratios



Source: CBRT
[1] Income Earning Capacity = Income Before Interest and Tax / Total Liabilities

The ratio of net income to equity, which shows return on firm's equity, decreased to 6.9 percent in 2004 from 10.9 percent in 2003 despite the 20.7 percent rise in net income. This fall is attributable to the increase in equity as a result of the re-pricing of equity in the framework of inflation accounting, although profit margins were affected positively due to the real growth in net sales and the falling share of financing costs in net sales. The ratio of net income to total assets, which shows the return on assets (ROA), decreased from 4.2 percent in 2003 to 3.3 percent in 2004. This fall is again mainly attributable to inflation accounting adjustments since the tangible and intangible fixed assets in the aforementioned ratio are those assets affected by inflation adjustments (Chart I.4.2.2).

Chart I.4.2.3
Liquidity Ratios [1,2]



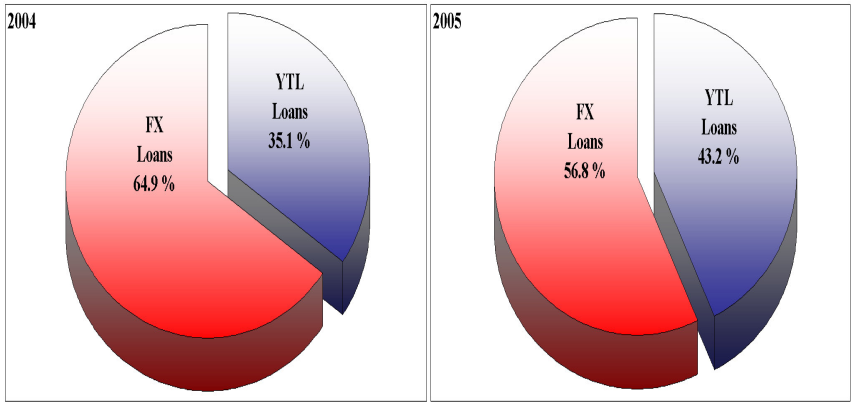
Source: CBRT

[1] Cash Ratio = (Liquid Assets + Marketable Securities) / Short-term Liabilities

[2] Liquidity Ratio (Acid-Test Ratio) = [Current Assets - (Inventories + Prepayments and Accrued Income for the Next Months + Other Current Assets)] / Short-term Liabilities

The liquidity ratio, which shows the ability of firms to cover their short-term liabilities, increased from 89.6 percent in 2003 to 94.3 percent in 2004. The ratio increased since the rise in current assets was more than the rise in short-term liabilities. The cash ratio, which shows how companies place their working capital, is lower compared to the liquidity ratio and was realized as 19 percent in 2004 (Chart I.4.2.3).

Chart I.4.2.4
Cash Loans Extended to Firms[1]



Source: CBRT
[1] Foreign exchange loans include foreign exchange indexed loans.

The share of foreign currency loans including loans indexed to foreign currency in total loans extended to firms decreased to 56.8 percent in 2005 from 64.9 percent in 2004 since domestic currency loans grew faster than foreign currency loans (Chart I.4.2.4).

Table I.4.2.1
Loans Extended to Firms by Sectors [1]

	Total Credits (Million YTL)			FX Credits / Total Credits (%)		
SECTORS	2003	2004	2005	2003	2004	2005
Sources of Electricity, Gas and Water	3,649	3,912	4,272	96.8	95.6	96.0
Hotels And Restaurants (Tourism)	1,284	2,020	3,315	86.7	81.8	77.6
Manufacture Of Transport Equipment	2,382	3,264	3,898	88.2	79.3	76.4
Manufacture of Basic Metals and Fabricated Metal Products	2,602	4,011	5,916	80.8	76.5	73.9
Real Estate, Renting And Business Activities	1,812	2,507	3,502	82.4	78.5	73.6
Manufacture of Textiles and Textile Products	6,950	8,284	9,383	77.9	75.3	70.5
Manufacture of Coke, Refined Petroleum and Nuclear Fuel	1,714	1,819	2,293	84.2	78.4	70.5
Transport, Storage and Communication	4,124	4,133	6,146	90.5	79.5	68.8
Mining and Quarrying of Energy-Producing Materials	581	1,081	1,383	75.9	78.8	68.0
Financial Intermediation [2]	3,480	5,359	7,406	80.3	70.7	66.2
Manufacture of Rubber and Plastic Product	741	1,247	1,672	66.7	67.3	64.5
Manufacture of Machinery and Equipment	1,421	2,435	3,358	70.1	66.6	60.2
Manufacture of Electrical and Optical Equipment	1,112	1,498	1,976	72.4	68.3	59.9
Manufacture of Paper and Paper Products	865	952	1,250	77.7	70.1	59.7
Construction	3,561	4,408	7,005	73.1	65.3	59.5
Manufacture of Chemicals and Chemical Products	1,955	2,623	3,388	66.2	69.0	56.4
Other Manufacturing Industry	599	1,219	1,987	64.9	62.9	53.7
Industry of Tabacco, Beverages and Food	4,359	5,256	7,916	48.4	51.4	47.9
Public Administration and Defense, Compulsory Social Security	495	1,347	2,013	94.9	49.3	45.7
Manufacture of Other Non-Metalic Minerals	1,580	2,366	4,114	72.7	63.1	45.1
Other Community, Social And Personal Services Activities	1,728	2,269	3,917	71.1	63.3	41.1
Wholesale and Retail Trade, Brokerage, Repair of Motor Vehicles	6,122	11,384	20,679	57.1	43.8	38.2
Agriculture, Hunting and Forestry	2,922	3,827	5,093	21.9	22.3	19.5
Other	1,154	2,031	3,222	63.3	53.5	39.3
Total - Average	**57,193**	**79,252**	**115,106**	**72.0**	**65.0**	**57.0**

Source: CBRT
[1] Loan information was gathered utilizing the reports prepared by banks in accordance with Central Bank Law No.1211 Article 44 and includes loans extended by banks (including loans obtained by firms from abroad through the intermediation of banks) to real and legal persons with a credit limit or exposure equal to or above 10 thousand YTL. The figures include interest accruals and discounts, and exclude non-performing loans and non-cash loans. Therefore, these loan figures are different from those used in analyses based on balance sheet information.
[2] Excluding banks.

Table I.4.2.2
Share of Exports by Sectors in Total Exports[1]

SECTORS	Exports (Million USD)			The Share of Sectors in the Total Exports (%)		
	2003	2004	2005	2003	2004	2005
Agriculture, Hunting and Forestry	**2,121**	**2,542**	**3,329**	**4.5**	**4.0**	**4.5**
Fishing	**81**	**103**	**140**	**0.2**	**0.2**	**0.2**
Mining and Quarrying	**469**	**649**	**810**	**1.0**	**1.0**	**1.1**
Manufacturing	**44,378**	**59,579**	**68,809**	**93.9**	**94.3**	**93.7**
Food products and beverages	2,650	3,349	4,272	5.6	5.3	5.8
Tobacco products	90	78	122	0.2	0.1	0.2
Textiles	6,841	7,998	8,743	14.5	12.7	11.9
Wearing apparel	8,154	9,340	9,925	17.3	14.8	13.5
Luggage, saddlery and footwear	286	328	370	0.6	0.5	0.5
Products of wood and cork	146	204	250	0.3	0.3	0.3
Paper and paper products	367	457	559	0.8	0.7	0.8
Printing and publishing	67	82	105	0.1	0.1	0.1
Coke, petroleum products and nuclear fuel	954	1,364	2,519	2.0	2.2	3.4
Chemicals and chemical products	1,926	2,556	2,818	4.1	4.0	3.8
Rubber and plastic products	1,464	1,959	2,485	3.1	3.1	3.4
Other non-metallic minerals	1,800	2,317	2,686	3.8	3.7	3.7
Manufacture of basic metals	3,884	6,816	6,888	8.2	10.8	9.4
Manufacof fabricated metal prod(exc machinery)	1,503	2,200	2,685	3.2	3.5	3.7
Manufacture of machinery and equipment	3,119	3,913	4,864	6.6	6.2	6.6
Office, accounting and computing machinery	41	52	70	0.1	0.1	0.1
Electrical machinery and apparatus	1,221	1,576	1,933	2.6	2.5	2.6
Communication and apparatus	1,948	2,883	3,150	4.1	4.6	4.3
Medical,precision and optical instruments, watches	129	173	197	0.3	0.3	0.3
Motor vehicles and trailers	5,437	8,813	10,226	11.5	14.0	13.9
Other transport	1,037	1,349	1,707	2.2	2.1	2.3
Furniture	1,315	1,771	2,238	2.8	2.8	3.0
Wholesale and retail trade	**183**	**231**	**280**	**0.4**	**0.4**	**0.4**
Other	**21**	**63**	**104**	**0.0**	**0.1**	**0.1**
TOTAL EXPORTS	47,253	63,167	73,472	100	100	100

Source: TURKSTAT
[1] Excluding shuttle trade.

It can be observed that an important portion of those sectors whose foreign currency loans show a tendency to increase consists of exporters or foreign currency earning sectors. Therefore, it is possible to say that those firms, which operate in foreign exchange earning sectors, can better manage foreign exchange risk. For those companies, which cannot earn foreign currency income but use foreign currency loans, open position may be a significant risk (Table I.4.2.1 and I.4.2.2).

Moreover, it is our opinion that Basel II, which is expected to be implemented in Turkey starting from 2008, will have an important impact on funds extended by banks to companies. Accordingly, in the coming periods only those SMEs, which "institutionalize" in line with Basel II requirements, shall have access to loans. In this framework, since company ratings will have a higher influence under Basel II, it will be especially important for SMEs, which constitute an important portion of the corporate sector, to take the necessary precautions in order to benefit effectively from the rating systems. Therefore, as emphasized in the previous stability report, it is necessary to work intensively on transparency, risk management, corporate governance and accounting issues.

I.5. Developments in the External Sector

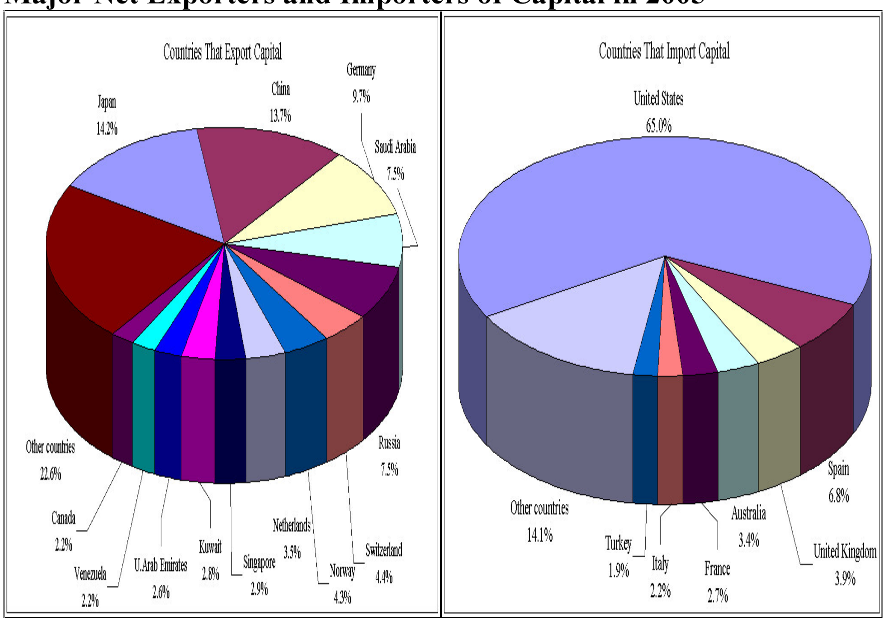
Table I.5.1
Balance of Payments

Million USD	2002	2003	2004	2005	Nis.06[1]
CURRENT ACCOUNT	**-1,524**	**-8,036**	**-15,604**	**-23,031**	**-26,816**
Foreign Trade Balance	-7,283	-14,010	-23,878	-32,722	-36,682
Exports f.o.b.	40,124	51,206	67,047	76,945	78,028
Imports c.i.f.	-51,554	-69,340	-97,540	-116,562	-121,547
Coverage Ratio (%)	77.8	73.8	68.7	66.0	64.2
Balance of Services	7,879	10,504	12,784	13,967	13,886
Balance on Investment Income	-4,556	-5,557	-5,637	-5,744	-5,555
Current Transfers	2,436	1,027	1,127	1,468	1,535
CAPITAL & FINANCIAL ACCOUNT	**1,406**	**3,095**	**13,336**	**20,617**	**24,581**
Direct Investments	962	1,253	1,978	8,603	9,548
Portfolio Investments	-593	2,465	8,023	13,437	12,759
Other Investments	7,190	3,424	4,159	16,424	25,112
Reserve Assets	**-6,153**	**-4,047**	**-824**	**-17,847**	**-22,838**
NET ERRORS & OMISSIONS	**118**	**4,941**	**2,268**	**2,414**	**2,235**

Source: CBRT
[1] Figures for May 2005-April 2006 period.

The foreign trade deficit reached 32.7 billion USD in 2005, and consequently, the current account deficit increased to 23 billion USD. Despite the strong New Turkish Lira, exports grew 14.8 percent as a result of the competitive advantage due to low labor costs and high productivity. Nevertheless, imports increased at a higher rate than exports in 2005, due to the continued strengthening of the New Turkish Lira, the increase in imports of intermediate goods to support the growth in industrial production and the rise in oil prices. Consequently, the ratio of exports to imports, which was 68.7 percent in 2004, decreased to 66 percent in 2005. The aforementioned coverage ratio was realized as 64.2 percent as of April 2006. On the other hand, the ratio of current account deficit to GDP, which was 5.2 percent in 2004, increased to 6.4 percent in 2005. The capital and financial account reveals that the current account deficit was financed by the rise in portfolio investments, loans extended to the private sector and banks, which are among other investments, and direct investments. The significant increase in foreign direct investments as a result of foreign acquisitions, which are related to privatizations in the Turkish economy and merger and acquisitions in the banking sector, and the long term structure of loans extended to the private sector and banks indicate that current account deficit was mostly financed by long term funds (Table I.5.1).

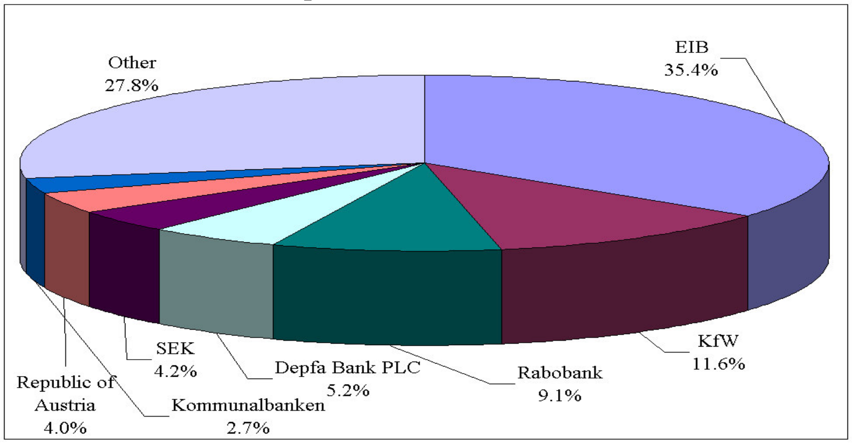
Chart I.5.1
Major Net Exporters and Importers of Capital in 2005



Source: IMF Global Financial Stability Report-2006

Considering the major net exporters and importers of capital in 2005, it can be observed that Turkey received a significant portion, 1.9 percent, of the global capital market (Chart I.5.1).

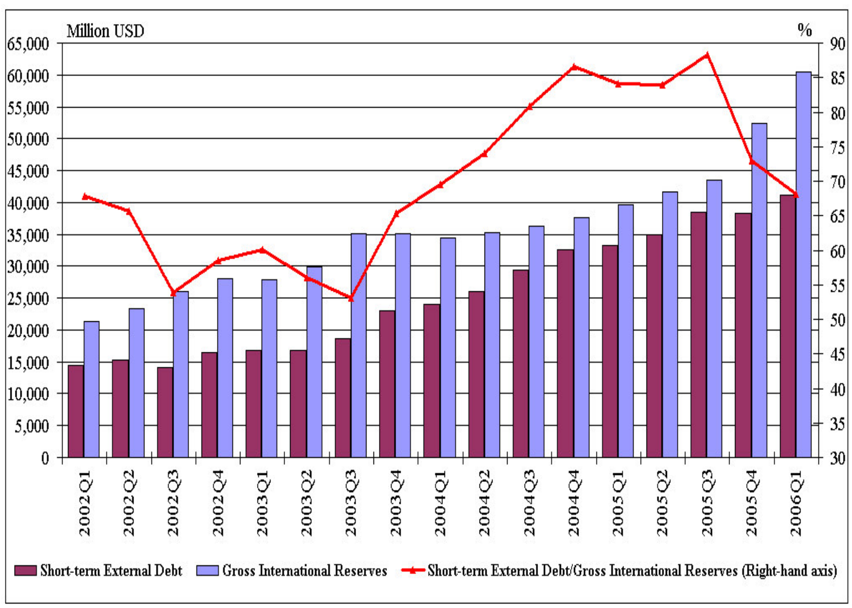
Chart I.5.2
The Composition of New Turkish Lira Bonds Issued By Foreigners in the Period 2005-26 April 2006



Source: CBRT

In line with the positive expectations regarding economic stability in our country, the amount of New Turkish Lira bonds issued by foreigners during the period 2005-26 April 2006 reached 10,050 million New Turkish Lira. In total, 28 institutions issued 86 bonds with various maturities and quantities as of April 26, 2006 and the weighted average maturity of these issues was 4 years (1, 441 days) (Chart I.5.2).

Chart I.5.3
Short-Term External Debt[1] and International Reserves[2]



Source: Treasury, CBRT

[1] Short-Term External Debt = General Government + CBRT + commercial banks + other sectors

[2] International Reserves = CBRT gross foreign exchange reserves (including gold)

As a result of capital inflows in 2005, Central Bank reserves increased by 17.8 billion USD and reached 52.4 billion USD by the end of the year. The ratio of short-term external debt to international reserves, which is one of the indicators of a country's external debt repayment capacity, decreased to 73 percent in 2005 from 87 percent in 2004 due to the increase in reserves.

Table I.5.2
Counterparties Funding the Current Account Deficit

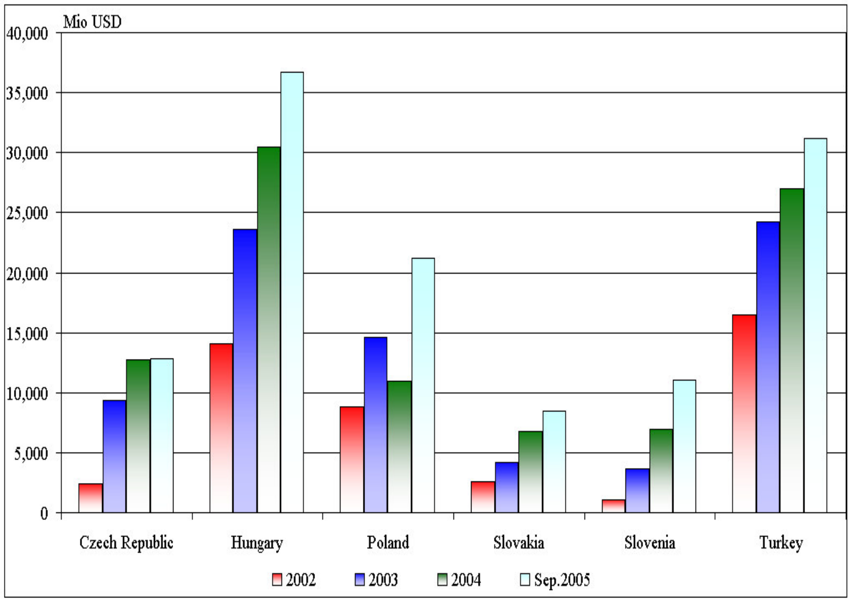
Million USD	2002	2003	2004	2005	Apr.06 [1]
Current Account	**-1,524**	**-8,036**	**-15,604**	**-23,031**	**-26,816**
Financial Account	1,406	3,095	13,336	20,617	24,581
General Government (including CBRT and CBRT reserves)	2,862	-2,624	2,379	-16,524	-22,853
Private Sector (including banks)	-1,456	5,719	10,957	37,141	47,434
Net Errors & Omissions	118	4,941	2,268	2,414	2,235

Source: CBRT
[1] Figures for May 2005-April 2006 period.

In 2005, the current account deficit was financed by funds obtained by the private sector rather than the public sector. The funds obtained by the private sector, including banks, from abroad increased from 11 billion USD in 2004 to 37.1 billion USD in 2005. The aforementioned figure amounts to 47.4 billion USD as of April 2006 (Table I.5.2).

The continuation in 2005 of the upward trend observed in 2004 in the direct funds obtained by the private sector from abroad is important both for the financing of the current account deficit and for contributing to production growth, however it is also crucial that the rising foreign exchange risk is well managed.

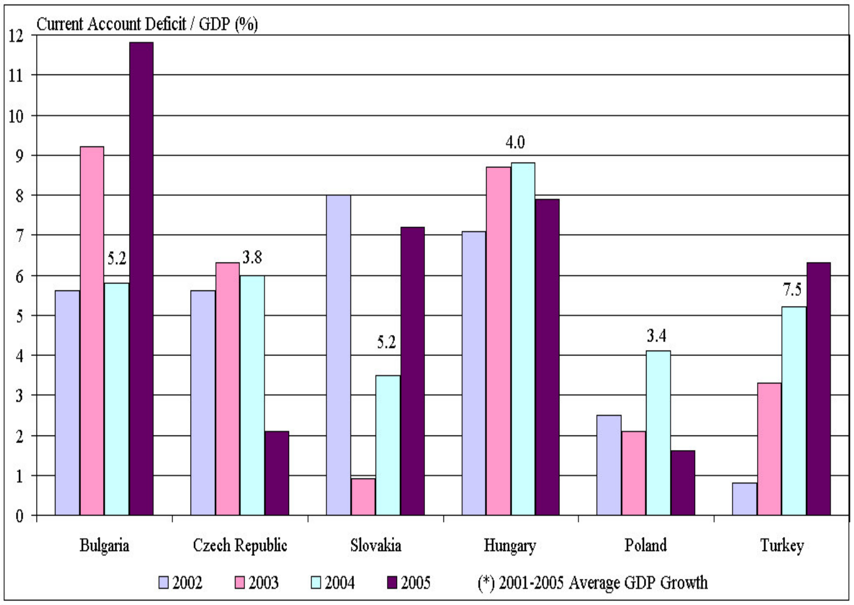
Chart I.5.4
Net Receivables of International Banks from Selected Countries

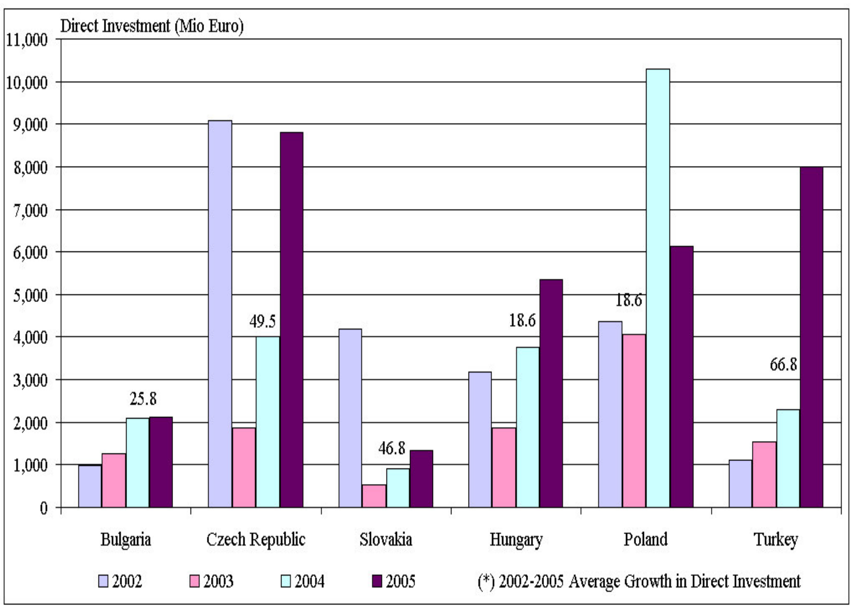


Source: BIS, Eurostat

The upward trend observed in the funds extended by banks of those countries reporting to the Bank for International Settlements (BIS) in 2004 continued in 2005. Consequently, the net receivables of international banks from Turkey increased by 15.4 percent and reached 31.2 billion USD, as of September 2005.

Chart I.5.5
Developments in the Current Account Deficit and Direct Investments of Selected Countries





Source: CBRT, Eurostat, IMF World Economic Outlook - April 2006
* Figures represent average annual change for the period 2002-2005.

Considering the high growth performance achieved, Turkey's current account deficit to GDP ratio, although revealing a tendency to increase during the 2002-2005 period, is not so high compared to other countries with similar economic structures. Moreover, it can be seen that among the selected countries, Turkey realized the highest average growth in direct investments for the 2002-2005 period and attracted the second biggest amount of direct investments in 2005 after the Czech Republic (Chart I.5.5).

In conclusion, the inadequacy of domestic savings to meet investments leads inevitably to a high current account deficit in our country, which is experiencing high growth. The quality of funds obtained, on the other hand, is directly related to the sustainability of the deficit. Within this perspective, it can be observed that the increase in the current account deficit in 2005 was financed by capital inflows through direct investments, portfolio investments and funds obtained from abroad by banks and the private sector and that these capital inflows led to a significant rise in international reserves. The long term structure of the majority of capital inflows, a noticeable rise in foreign direct investments, the decrease in the ratio of short term external debt to international reserves and the implementation of flexible exchange rate regime are regarded positively for the sustainability of the current account deficit. The rising uncertainty concerning global interest rates, triggered by the increase in interest rates by Japan, the USA and the European Central Bank, led to capital outflows from developing countries. However, the negative effects of the outflows are reduced by the shock absorbing function of the flexible exchange rate regime, high quality capital inflows and a solid macroeconomic infrastructure strengthened by the persistent implementation of the current economic programme.