THE CENTRAL BANK OF
THE REPUBLIC OF TURKEY

inflation report
2007-II

CONTENTS

1.Overview

Annual inflation was 10.86 percent in the first quarter of 2007, remaining within the uncertainty band. The high course of annual inflation partly owes to the elevated unprocessed food prices and the hikes in the prices of tobacco products. Moreover, although the lagged effects of the exchange rate pass-through have moderated, some cumulative impact still remains. The impact of monetary tightening on inflation, on the other hand, remains to be seen. Accordingly, annual inflation stayed at high levels in the first quarter of 2007.

The recent data on economic activity has been in line with the outlook presented in the reports published by the Central Bank of Turkey (CBT) since July 2006. Private consumption demand displayed a noticeable slowdown following the monetary tightening since June 2006. The co-existence of decelerating growth rate of imports; owing mainly to the slowdown in consumption and investment goods imports; and the relatively strong momentum of exports led to a significant contribution of net exports to growth. Hence, the negative impact of the slowdown in domestic demand on growth is largely compensated by the robust external demand. Rising non-interest public expenditures was another factor contributing to economic growth. Notwithstanding the positive stimulus from net foreign demand and public expenditures, growth rate of the economy fell below last five years' average, due to the considerable slowdown in private sector domestic demand.

1.1. Monetary Policy and the Outlook

Monetary Policy Committee (the Committee) decided to keep the tight monetary policy stance during the first quarter of 2007, against risks such as the gap between medium-term inflation expectations and the targets, prevailing uncertainties in the global economy, and the uncertainties regarding the lagged effects of monetary tightening.

We expect the lagged impact of tight monetary policy stance to be effective on domestic demand for a while, suggesting that the demand conditions will continue to contribute to the disinflation process. Recent leading indicators reveal a similar outlook for the first half of 2007. Seasonally adjusted data indicate that private consumption expenditure does not exhibit a noticeable rise in the first quarter of 2007. Private sector demand is expected to remain subdued for the second quarter of the year. Given the robust growth in the Euro Area, the strength of euro, and the ongoing increases in productivity, we anticipate that exports will continue to support the economic growth.

In addition, barring further adverse shocks, a notable base effect stemming from last year's market turbulence and from the adverse supply shocks such as the hikes in energy and unprocessed food prices is expected to ease annual inflation in the coming months.

Although the macroeconomic developments in the last quarter are broadly consistent with the outlook presented in the January Inflation Report, several factors are in place for the inflation outlook to be updated:

- Taking into account the recent revisions in the growth rate figures of 2006, the output gap for the last quarter of 2006 is revised upwards compared to that in January Inflation Report.

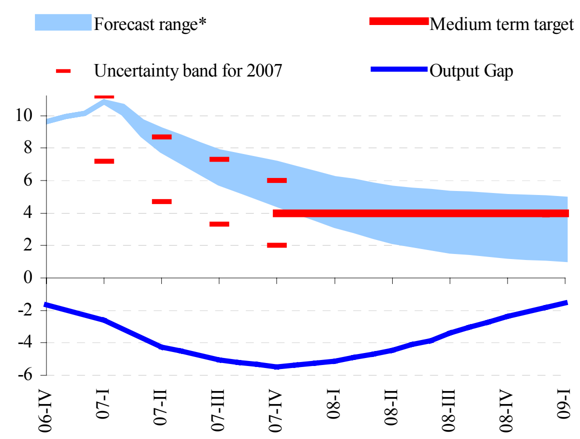
- The short-term inflation forecasts were revised upwards due to several factors: first of all, the anticipated correction in the unprocessed food prices has not materialized. Secondly, there have been some tax driven hikes in the prices of tobacco products. And third, in spite of a partial improvement in services prices, the decline in annual service inflation has been less than anticipated. As a consequence, the annual inflation by the end of March exceeded the median of the forecast path presented in the January Inflation Report.

- The assumption of oil prices is revised up from USD 55 to USD 60 due to the upward movement in oil prices in past quarter.

The "Risks" section of January Inflation Report asserted that, the tight monetary stance can be maintained for an extended period in case inflation shows a stronger-than-expected resistance. Indeed, the upside revisions mentioned above as well as the first quarter data on inflation expectations and services inflation further underpin the need to stay cautious to ensure the consistency of the medium-term outlook with the targets. Within this framework, the forecasts presented in this Report are based on a scenario where the policy rates are constant in the second and third quarter of the year and eased thereafter; however, this easing is envisioned to be more cautious than the one outlined in the January Report. In other words, the Committee —as hinted in March meeting and stated in April meeting— envisions a policy perspective in which the cautious policy stance is enhanced.

The projections consistent with this perspective point out that downward trend in inflation will be more discernible in the second quarter of 2007. It is forecasted with 70 percent probability that annual inflation rate will be within 4.5 – 7.1 range (mid-point 5.8) at the end of 2007 and within 1.3 – 5.0 range (mid-point 3.2) at the end of 2008. These projections imply that meeting the medium-term target of 4 percent requires the maintenance of the tight monetary policy stance.

Graph 1.1.1. Inflation and Output Gap Forecasts



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

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 CBT. Therefore, the policy perspective is subject to change as the economic conditions and the assumptions change.

1.2. Risks

Recent data is broadly consistent with the main outlook presented througout the Inflation Reports since July 2006. The impact of monetary tightening in the second half of 2006 on the demand is visible especially through the slowdown in the expenditures of durable goods and machinery-equipment. Robust performance of exports has been offsetting the contractionary impact of the slowdown in private domestic demand and contributing positively to the economic growth rate. Nevertheless, uncertainties over the monetary transmission mechanism prevail to be a risk for medium-term inflation outlook. While the recent hikes in public expenditures seem to further blur the outlook, the proposed cut-down in certain non-interest public expenditure items have somewhat relieved these concerns. In sum, a lower-than-expected impact of slowdown in domestic demand on inflation still remains as a risk factor. Should such a risk materalize, the CBT may further tighten the policy stance.

Another risk related to the medium-term inflation outlook is the stickiness in inflation expectations and backward looking price setting which would lead to a higher-than-expected inertia in the disinflation process. The improvement in inflation expectations came to a halt in the last three months. Although the expectations should come down gradually as the headline inflation eases, the sticky medium-term inflation expectations remain to be a risk for the inflation outlook through its possible reflections on the price and wage setting behavior. The CBT will keep its cautious stance for an extended period should such risk materialize.

Possible fluctuations in global markets remain as a risk to the inflation outlook. The prevailing uncertainties on the US economy and on global imbalances still have the potential to trigger fluctuations in international markets which may have adverse impact on emerging economies. Moreover, the elevated levels of the oil prices do not help to ease the risks related to global financial markets. On the other hand, the Treasury's strong cash accounts and the recent slowdown in the deterioration of the current account have the potential to mitigate the impact of possible fluctuations in the financial markets. In what so ever, should a shock lead to heigthened perception of uncertainty, the CBT will retain the medium-term perspective and announce the appropriate strategy to bring inflation back to the target.

Price stability is essential for increasing the potential of the economy, achieving a high sustainable growth rate, and enhancing social welfare. Attaining the ultimate goal of price stability will only be possible with prudent monetary policy. Economic agents should be patient in this process in order to reap the long-term benefits of the price stability.

Prudent monetary policy is necessary but not sufficient for achieving long-run price stability. The role of fiscal policy and structural reforms are also critical in this process. Developments in structural reforms that would enhance the quality of fiscal discipline in the medium and long run are closely monitored both in terms of macroeconomic stability and price stability. The European Union accession process and the sustained implementation of the structural reforms envisaged in the economic program also remain to be of concern. Continued determination in implementing the decisive steps taken in these areas in recent years will strengthen the resilience of the economy against possible changes in the global economy.

2. International Economic Developments

2.1 Economic Performance and Monetary Policy Developments

Even though the US economy grew as high as 3.7 percent in the first quarter of 2006, the growth rate dropped to 3.1 percent in the last quarter. This slowdown in the growth rate driven mainly by the slowdown in the housing and mortgage markets may continue in 2007. The future developments in this market will be instrumental in determining whether this deceleration will develop into a recession or not. The moderation in growth produced a favorable effect on inflation and brought core inflation down. Nevertheless, the volatile energy prices and the tight labor market conditions have constituted inflationary pressure. This inflationary pressure is reflected to core inflation through indirect effects. Hence, core inflation is still above desired levels. Federal Reserve (Fed) rates have been kept on hold at 5.25 percent, which suggests that Fed remains vigilant despite the slowdown in growth. Future interest rate decisions will be shaped according to the developments in growth and inflation.

Table 2.1.1. Growth Rates

(Annual Percentage Change)

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

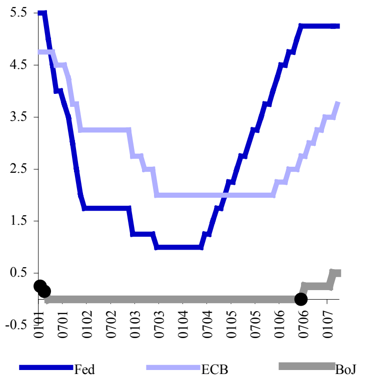
* Forecast.
Source: Consensus Forecasts, Eurostat, World Economic Outlook.

In the last quarter of 2006, unlike the first three quarters, the US current account deficit has demonstrated a downward trend. Both the vigorous growth observed in trading partners of US and the depreciation of the US dollar indicate that the US current account deficit will continue to decline. This development is perceived to be favorable in terms of global economic balance. Moreover, the US economy has recently displayed positive fiscal performance in response to increasing revenues. If supported by social security and health reforms, this positive outlook will reinforce favorable expectations for the future.

In the fourth quarter of 2006, Eurozone grew by 3.3 percent compared to the same period of the previous year and by 2.7 percent for the entire year (Table 2.1.1). In the said period domestic demand was the main determinant of growth. The major component of this domestic demand-driven growth was the increase in profit margins and acceleration in investments owing to credit expansion. Additionally, Germany's hosting World Cup 2006 and rising consumer expenditures in response to advance consumption due to Value Added Tax (VAT) increase scheduled for January 2007 were other factors assisting growth in the Eurozone. In the upcoming period, employment growth and improved labor market conditions are expected to increase real disposable income and consumption expenditures. Moreover, positive financing conditions, higher corporate profits and increase in labor productivity are expected to keep investment brisk. Additionally, with relatively balanced global growth rates, export demand is expected to keep increasing, and support growth in the coming periods. In light of these developments, the Eurozone is expected to grow by 2.8 percent in the first quarter of 2007 and by 2.4 percent throughout 2007. Volatile oil prices stand out as the most critical risk factor against Eurozone GDP growth.

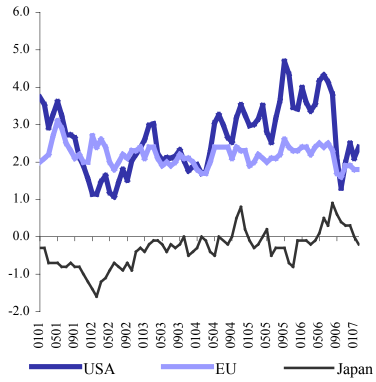
The Eurozone Harmonized Index of Consumer Prices (HICP) inflation fell as of August 2006 due to the decline in crude oil prices (Graph 2.1.2). While the decrease in energy prices exerted downward pressure on inflation, the VAT increase in Germany created upward pressure on inflation. Considering the current oil prices, inflation is expected to remain below 2 percent due to the base effect, with a volatile course throughout 2007. Meanwhile, the unobserved secondary effects of the VAT increase and the possible oil price hikes are considered to be risk factors that are likely to increase inflation in the upcoming period.

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 resulted from the ongoing monetary and credit expansion as a medium and long-term risk to price stability and has maintained its policy of gradual tightening. Within this framework, on March 8, 2007 (Graph 2.1.1), the ECB Governing Council raised interest rates to 3.75 percent by 25 basis points at each of the seven meetings held since December 2005. However, at the last ECB Governing Council meeting of April 12, 2007, interest rates were kept unchanged. Additionally, given the positive outlook of growth, it was emphasized that the ECB will continue to be on the accommodative side.

The Japanese economy grew by 2.2 percent in 2006, mainly driven by private sector investment pulled by corporate profits and export performance (Table 2.1.1). In the upcoming period, public sector investment are expected to downward trend, exports are anticipated to increase parallel to the rise in foreign demand, and domestic private demand will keep its upward trend in line with high corporate profits and moderately rising household incomes. Within this context, the 2007 growth rate is estimated to be 2.2 percent. Due to fall in oil prices, annual rate of increase in consumer prices has been around zero percent in March 2007. Annual rate of increase in consumer prices is expected to be around zero percent in the short term and increase above zero in the long term as long as the output gap continues to be positive (Graph 2.1.2).

At its meeting in March 2006, the Bank of Japan (BoJ) ended its excess liquidity policy that has been implemented for five years, and in the face of developments in the following period, decided to raise its policy rate by 25 basis points up to 0.5 percent at the meetings held on 13-14 July 2006 and on 20-21 February 2007. In the two consecutive meetings following the latest rate hike, BoJ decided to keep policy rates unchanged (Graph 2.1.1). BoJ is expected to raise its policy rates gradually in the upcoming period, in the light of economic growth and price developments.

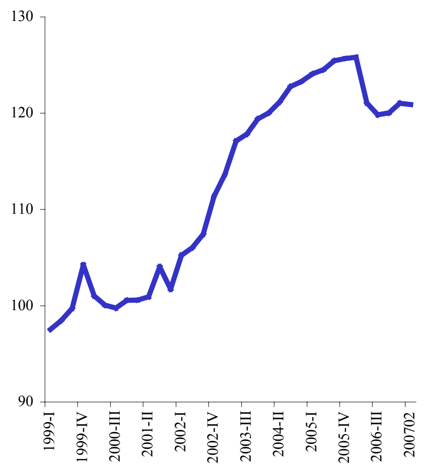
The Chinese economy had a 10.7 percent growth driven mainly by increase in investment and exports, despite the deceleration in fixed capital investment due to tight monetary policy implemented in 2006. As a result of control measures, China's foreign trade surplus showed a tendency to decline in the first quarter of 2007 in comparison to the last two quarters of 2006. Chinese economy is expected to gradually grow at moderate rates in 2007 and 2008 and expectation for 2007 is around 10 percent (Table 2.1.1).

2.2. International Markets

2.2.1. Financial Markets

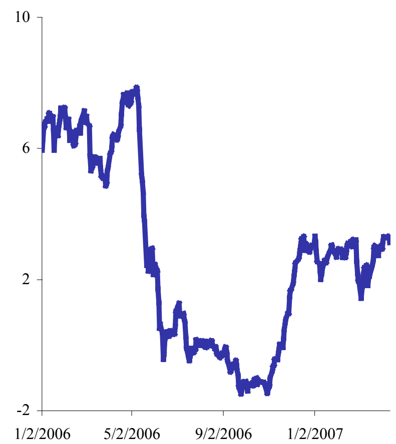
The unfavorable outlook owing to the US economic data released at end-February 2007 and the concerns over US real estate markets coupled with the remarks about a possible hard-landing in the US led to a new wave of sales in international markets. However, the relatively positive outlook of the March data release gave support to soft landing while also limiting the adverse impacts of financial turbulence experienced at end-February. Meanwhile, Eurozone's rapid growth trend and signals of recovery in Japanese economy are expected to ease the effects of a possible slowdown in US economy. In light of these developments, both developed markets and emerging markets have displayed a rapid recovery in the post-February period and caught up with their 2006 end-year performances.

Graph 2.2.1. The Monetary Developments Index for Developed Countries (1999=100)



Source: Central Banks, CBRT and IMF-IFS.

Graph 2.2.2. Credit Suisse Global Risk Appetite Index



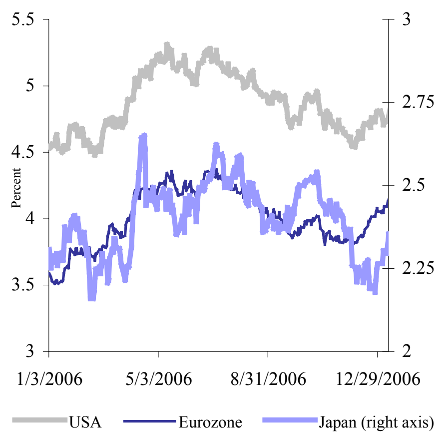
Source: Credit Suisse

The Monetary Developments Index for Developed Countries, calculated by the monetary growth in US economy, Eurozone and Japanese economy with a view to provide insight on the global liquidity conditions, plunged in the second quarter of 2006 in the aftermath of monetary tightening decision by BoJ. In the following period, the Index followed a stable course due to monetary base expansion in the Eurozone, despite the partial tightening of the BoJ and the Fed (Graph 2.2.1).

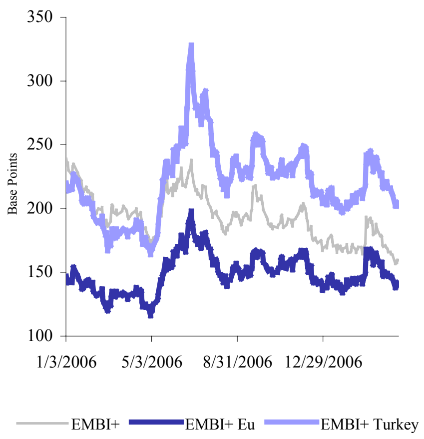
The Credit Suisse Global Risk Appetite Index (CSRA), which reflects the risk perception of global investors, slumped due to fluctuations in May and June, but rebounded in the following period as a result of the positive outlook of data on developed countries. The recovery process in the risk appetite was interrupted by the US-originated fluctuation in late-February; however, as this development has been temporary, the CRSA Index retraced its pre-fluctuation level (Graph 2.2.2).

The analysis of interest rate developments in developed countries demonstrates that Eurozone’s continued monetary expansion and long-term above-potential growth performance, and expectations of new interest rate hikes in response to ECB’s emphasis on inflation pushed yields higher. Despite unchanged policy rates since Fed still perceives inflation as a threat under current circumstances, yields have been on the rise again in the US. Even though the annual inflation rate in Japan turned into negative in February, BoJ's remarks on optimistic expectations for the second half of the year and thus expectations of another rate hike rebounded the yields (Graph 2.2.3).

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



Graph 2.2.4. EMBI+ Developments

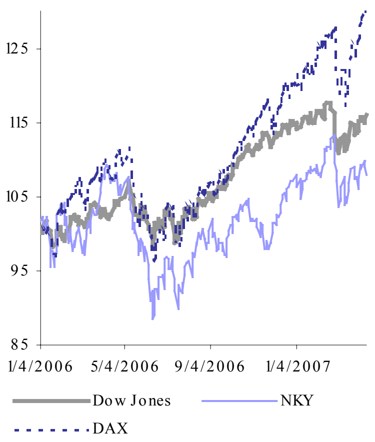


Source: Bloomberg.

Yields of developing countries that had displayed a positive performance after May 2006 gradually converged yields of developed countries as of end-2006. The Emerging Markets Bond Index (EMBI+), Emerging Europe and Turkey sub-indices have increased by end-February in response to the sudden but short-term fluctuations in developed countries. In the successive period, all three indices recovered rapidly along with the added impact of the recovery in the CSRA Index. As of May 2006, the Turkey sub-index recorded higher values above the EMBI+ and as of April 12, 2007, the difference between these two indices has been 43.4 basis points (Graph 2.2.4).

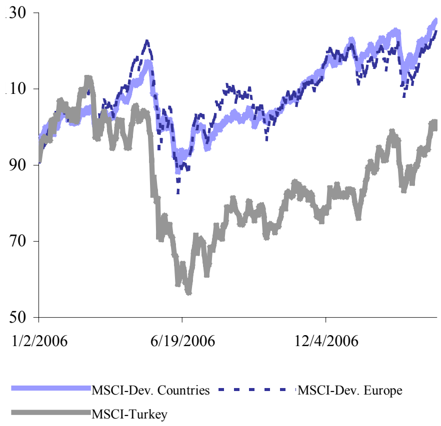
The stock markets of developed countries pursued a remarkably strong course from the second half of 2006 until February 2007. Returns on developed countries' stocks that plunged at end-February, recovered rapidly after February and reached their pre-February levels. The DAX Index displayed a more prominent upsurge, with the exception of late-February, as a result of the high growth performance of the Eurozone and Germany (Graph 2.2.5). As regards developing countries, the Developing Countries and Developing European Countries sub-indices of the Morgan Stanley Capital Index (MSCI) showed a strong upward trend in the last quarter of 2006 and reached pre-turbulence values, while the increase in the Turkey sub-index was rather limited (Graph 2.2.6). Although the fluctuations experienced at end-February caused a decline in these indices, emerging stock markets recovered rapidly.

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



Source: Bloomberg.

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



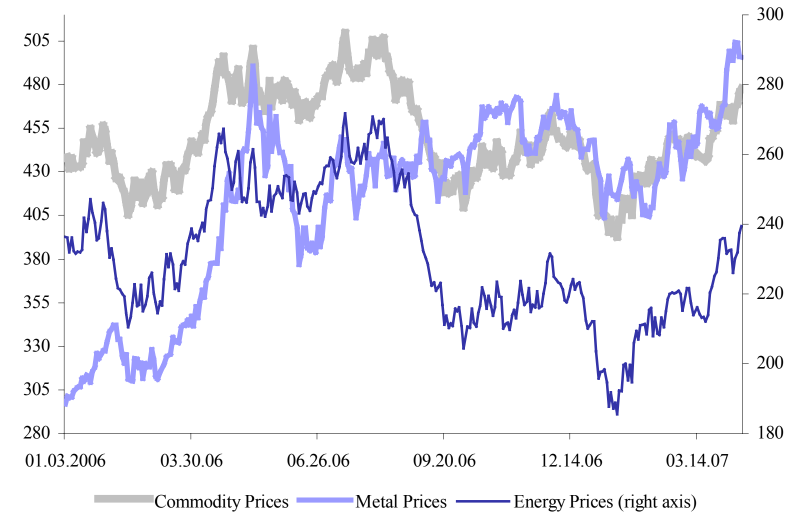
Source: Morgan Stanley.

Uncertainties over inflation and growth in industrialized countries, which led to sharp fluctuations in international relative prices throughout the last quarter of 2006, continue to stand in the forefront as the most significant global economy-related risk factor that will affect developing countries in the coming period. Against this background, a possible increase in developed countries interest rates and a possible slowdown in the US economy may adversely affect the financial assets of emerging market countries. Nevertheless, positive global liquidity conditions and high risk appetite suggest that international conditions will produce a favorable outlook in the second quarter of 2007.

2.2.2. Commodity Markets

In the first quarter of 2007, the Goldman Sachs (GS) Commodity Index remained the same in comparison to the same period of 2006, but dropped by 2.1 percent from the last quarter of 2006. When analyzed in terms of averages, the index re-ascended from mid-January onwards in line with the rise in energy prices, in spite of the decline from the last quarter of 2006. Comparison of the data as of April 12, 2007 with 2006 end-year data, yields an 11.4 percent increase in the main index, an 13.4 percent in the energy sub-index, which has a 70 percent weight in the index, and an 17.0 percent increase in the industrial metals sub-index (Graph 2.2.7).

Graph 2.2.7. Commodity Prices



Source: Goldman-Sachs.

In the first quarter of 2007, the prices of six basic metals traded in the London Metal Exchange (LME) rose by 24.9 percent over the 2006 average and by 6.8 percent over the last quarter of 2006. Recent developments suggest that copper prices, which dropped in the last quarter of 2006, re-accelerated in response to the increasing demand from China and low stock levels. Nickel, with very low stock level, continues to display abrupt price movements. The price of aluminum, which weighs high in the metal sub-index, maintains its stable course (Table 2.2.1).

Crude oil prices, which declined in the last quarter of 2006, resumed its upward trend as of mid-January. This was mainly due to the increasing demand driven by harsh winter conditions. Yet, OPEC countries' production cut in order to comply with the new production quotas effective as of February 1 was another factor boosting price hikes.

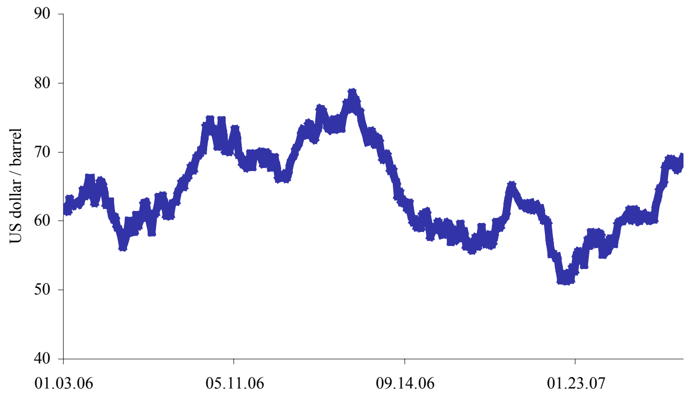
Table 2.2.1. London Metal Exchange Developments

Tons/ USD	**Value**				**(Percentage change)**		
	2006	**2006Q4**	**2007Q1**	**12.Apr**	**07Q1 / 06Q4**	**2007Ç1 / 2006**	**12 April / 2007Q1**
Aluminum	2.595,2	2.676,9	2.747,8	2.835,0	*2,7*	*5,9*	*3,2*
Copper	6.678,8	7.220,5	5.975,1	7.690,0	*-17,2*	*-10,5*	*28,7*
Lead	1.281,8	1.522,8	1.750,7	1.980,0	*15,0*	*36,6*	*13,1*
Nickel	23.223,3	30.778,0	38.809,6	46.400,0	*26,1*	*67,1*	*19,6*
Tin	8.747,4	9.904,9	12.590,0	14.250,0	*27,1*	*43,9*	*13,2*
Zinc	3.248,0	3.956,5	3.441,3	3.510,0	*-13,0*	*6,0*	*2,0*

Source: Bloomberg.

In the subsequent period, the imbalance between US crude oil and petroleum products stocks disturbed the markets, and the political tension in the Middle East led to a sharp upsurge in prices, as high as USD 68 per barrel.

Graph 2.2.8. Oil Prices



Source: Bloomberg.

The new level of crude oil prices and its likelihood to remain unchanged creates concern. At the extraordinary meeting of OPEC on December 14, 2006, reasons for the quota reduction were stated as the expectation of a slowdown in global growth and the positive course of main indicators in oil markets such as stock and idle capacity. Even though, at particular times, imbalances may be observed between crude oil/petroleum products stocks, total stocks keep their high levels, while uncertainties over US economy hinder forecasts for global growth. A continued strong course of global growth might lead to abrupt movements in crude oil prices, especially in the second half of the year, and force OPEC to review their production quotas.

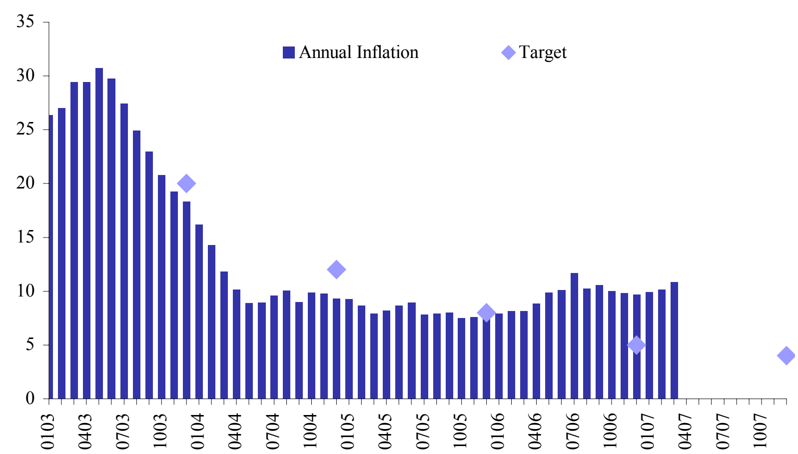
3. Inflation Developments

3.1. Inflation

Annual inflation increased in the first quarter of 2007 to 10.86 percent over the previous quarter (Graph 3.1.1). By the end of the first quarter, however, it has lain inside the uncertainty band around the target path. The first-quarter rise of 2.36 percent in consumer prices is quite high compared to the last three years' figures, which can be attributed to: (i) elevated unprocessed food prices, (ii) tax-driven price hikes in tobacco products (iii) the continued, but slowing, lagged effects of the depreciation of YTL.

The rise observed in annual consumer inflation in the first quarter is believed to be temporary, and given the weakening effect of the exchange rate shock of 2006 on prices, it is projected that inflation will gradually moderate in the upcoming months.

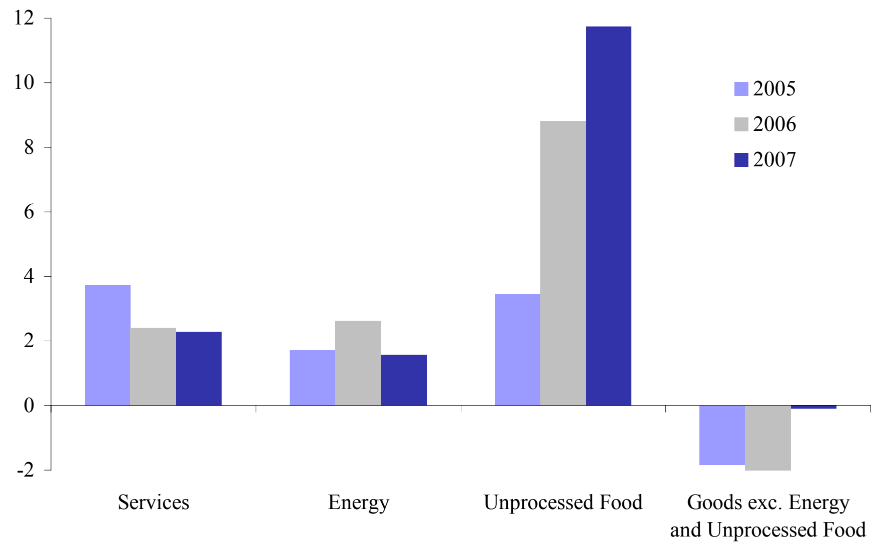
Graph 3.1.1. End-Year Inflation Target and Annual CPI Inflation



Source: TURKSTAT.

The price developments in unprocessed food and in "goods excluding energy and unprocessed food" pushed annual inflation up in the first quarter. Compared to the first quarter of 2006, the rate of increase in services prices improved slightly while the rate of increase in energy prices decelerated (Graph 3.1.2).

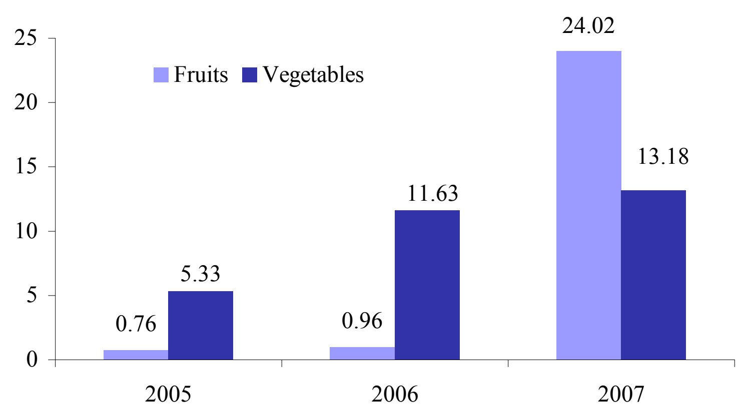
Graph 3.1.2. Consumer Prices
(First Quarter Percentage Change)



Source: TURKSTAT, CBRT.

Unprocessed food prices displayed a significant rise in the first quarter compared to last year. Price developments in this group were among the most influential factors to push up consumer inflation in the first quarter (Graph 3.1.2). Prices of greenhouse vegetables, in particular, increased sharply in January, on the back of an expanded export capacity. Although prices of these vegetables were partially corrected in February and March, both the cumulative effects from January and the rapidly rising fresh fruit prices brought the rise in unprocessed food prices up to 11.74 percent (Table 3.1.1). The fact that fresh fruit prices increased by 24.02 percent in the first quarter, up from 0.76 percent and 0.96 percent in 2005 and 2006, respectively, was the most remarkable development in this group, in the first quarter of 2007 (Graph 3.1.3). Inflation in fruits and vegetables that decelerated in the last quarter of 2006 retraced its earlier run-up, as monthly increases above seasonal rates perceived, which shows that the risks pertaining to unprocessed food prices still prevail.

Graph 3.1.3. Prices of Fruits and Vegetables
(First Quarter Percentage Change)



Source: TURKSTAT.

Energy prices displayed a relatively favorable trend in the first quarter compared to previous years. The moderate rise in energy prices in January and February was replaced by a 1.1 percent rise in March due to soaring fuel oil prices in line with the developments in the international crude oil prices. Energy for the housing group followed a favorable trend in the first quarter and displayed a lower rise than the same period in 2006 -except for tap water-, the price of which is adjusted by municipalities and displays sharp increases.

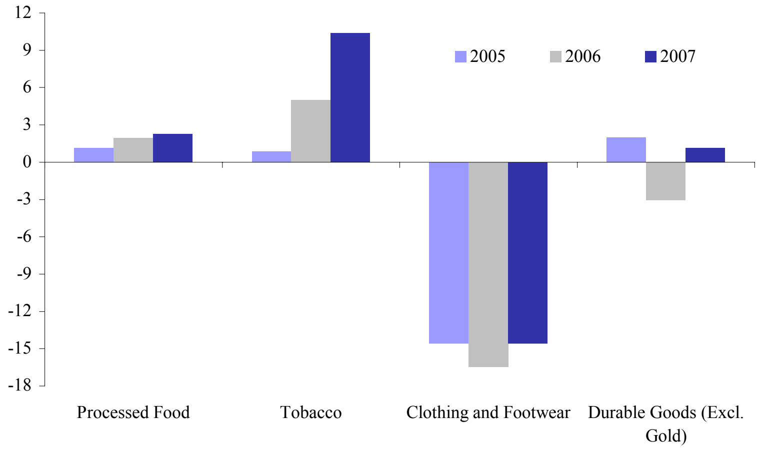
Table 3.1.1. Goods and Services Group Prices
(Quarterly Percentage Change)

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

Source: TURKSTAT, CBRT.

The first-quarter decline in prices of goods excluding energy and unprocessed food remained below that of 2006. Compared to end-2006, the year-on-year inflation in this group rose to 9.01 percent, by increasing 2.1 percentage points, mainly due to developments in tobacco products, consumer durables, clothing and footwear, and processed food prices (Graph 3.1.4). In this sense, it is recommended that the above goods be examined in detail to develop a healthy evaluation of the upward pressure on annual inflation.

Graph 3.1.4. Prices of Selected Goods Excluding Energy and Unprocessed Food (First Quarter Percentage Change)



Source: TURKSTAT, CBRT.

The Special Consumption Tax (SCT) hike on tobacco products affected cigarette prices in the second half of February, resulting in an upsurge of 10.37 percent in prices of tobacco products in the first quarter with a 0.5 percentage point added on annual consumer inflation.

Annual inflation of durable goods (excluding gold) rose by 4.4 percent over end-2006, owing mainly to the low base effect stemming from the significant decrease in durable goods prices in the first quarter of 2006 as a consequence of the long-lasting cumulative appreciation of the New Turkish lira. As regards sub-groups, prices of furniture and electrical/non-electrical appliances fell slightly behind the same period last year while prices of automobiles increased (Table 3.1.2). Among consumer durables, imported automobiles reacted the most to the fluctuations in May 2006. Given the price hikes and the deterioration in automobile loans, domestic automobile sales have been falling down since June 2006.

Another noteworthy development in the sub-items of durable goods is that prices of white goods rose by 8 percent in the first quarter of 2007, up from a relatively moderate increase in 2006. Domestic sales of white goods during January-February 2007 displayed a moderate slowdown compared to the last quarter of 2006 while exports of white goods continued to rise dramatically. Moreover, iron and steel prices, which followed a steep upward trend in the first quarter parallel to the developments in commodity prices in international markets, point to the fact that cost-driven pressures are still in place. In sum, it is believed that both cost pressures and strong external demand elevate white good prices .

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

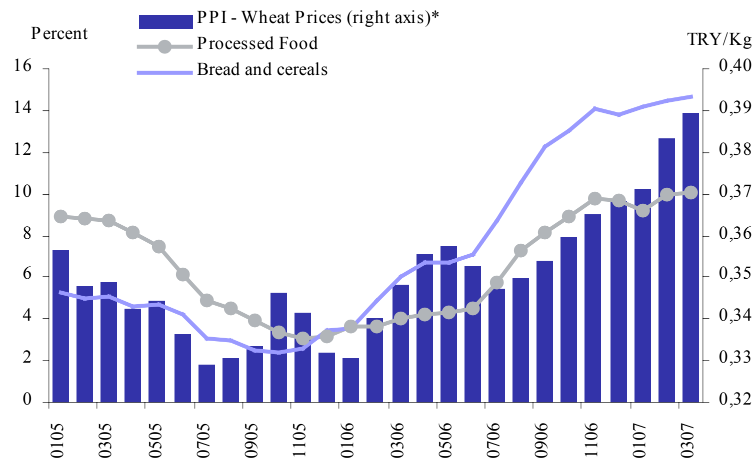
	2006					2007
	I	II	III	IV	Annual	I
Durable Goods (Excluding Gold Prices)	**-3.04**	**5.40**	**2.84**	**-2.20**	**2.78**	**1.13**
Furniture	-7.81	7.45	9.21	-3.17	4.74	-0.60
Electrical and Non-Electrical App.	-5.55	4.51	-0.54	-2.25	-4.03	-0.52
Automobiles	2.93	7.09	2.57	-2.28	10.48	3.22
Other Durable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

Source: TURKSTAT, CBRT.

Occasional irregularities in the seasonal movements of clothing prices lead to volatilities in this group's annual rate of increase. The clothing and footwear prices declined less than the first quarter of 2006 and the group's annual inflation rose to 4.19 percent. Even though this may look at first glance like an unfavorable development, the total discount rate in winter (from December 2006 to March 2007) suggests that this year's rates approached those of the last year. However, the upward trend in apparel manufacturing prices requires close scrutiny of clothing prices.

The annual inflation in processed food prices also increased, albeit at a subdued pace. This rise was mainly driven by price hikes in bread and cereals (coupled with the lagged effects of the post-May depreciation of YTL) (Graph 3.1.5). The upsurge in the annual inflation of bread and cereals prices started in the last quarter of 2005 and became quite marked after the second quarter of 2006, mainly due to the concurrent acceleration observed in wheat prices (Graph 3.1.5). The decreased cereal production in 2006 suggests that the rise in wheat prices was primarily due to supply-side factors. Given the global increase in cereal prices and the expectation of a continued decline in domestic production, it is projected that the supply-driven rise in cereal prices will continue during the remainder of the year.

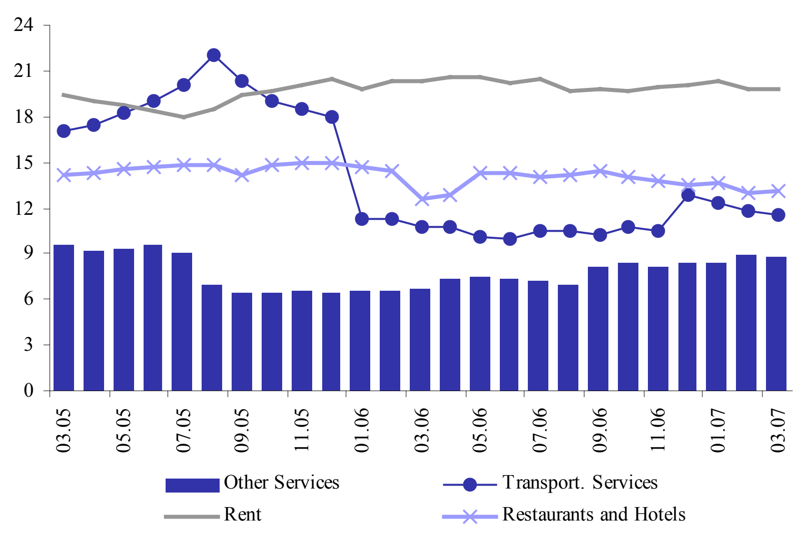
Graph 3.1.5. Processed Food and Bread-Cereals Group Prices
(Annual Percentage Change)



* The level of wheat prices is illustrated on the Graph.
Source: TURKSTAT, CBRT.

With a 2.29 percentage-point rise in the first quarter of 2007, services prices improved slightly over its year-ago level. The first-quarter inflation in rents and hotels-restaurants decelerated to some extent compared to the previous year (Table 3.1.1). Transportation services prices that displayed a moderate increase in response to fuel oil prices, and the average rate of increase in services prices excluding rents, restaurants-hotels and transportation above year-ago levels are the most remarkable developments in this period.

Graph 3.1.6. Services Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

Since the services group is not subject to competition and productivity growth as much as the goods group, services prices are more susceptible to domestic supply and demand developments. Apart from demand-side factors, wages, oil prices and prices of the final products used for services are also important in setting services prices. Moreover, the widespread use of backward indexation is another determinant in the pricing policy for this sector.

Recently, the slowdown in domestic demand continues and oil prices do not present an unfavorable outlook compared to the last quarter in 2006. Nevertheless, the fact that wage increments in overall economy exceed the medium-term inflation target and that annual inflation rates that are widely used as a benchmark for the indexation mechanism pursue a high course cause services inflation to remain high (Graph 3.1.6) (Box 3.1).

While Consumer Prices Index (CPI) inflation increased by 2.36 percent in the first quarter, the special CPI Aggregate-B, excluding unprocessed food products (SCA-B), increased by 0.89 percent (Table 3.1.3). When the effect from tobacco products is also omitted, the rise in CPI inflation falls to 0.34 percent. These figures are evidence that unprocessed food products and tobacco products were the two main factors pushing up consumer inflation in the first quarter.

On the other hand, annual inflation in the SCA-H index (Special CPI Aggregate excluding energy, unprocessed food products, alcoholic beverages, tobacco and gold) and in most of the indices increased due to the low base of the same period last year. As a consequence of the long-lasting cumulative appreciation of the New Turkish lira, prices of durable goods had displayed a remarkable decline in the first quarter of 2006. The lack of a similar movement this year caused the annual increases of the special aggregates to rise. Moreover, the shifts in seasonal pattern of clothing and footwear groups (early launch of new season) have also been pushing these indices upwards.

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

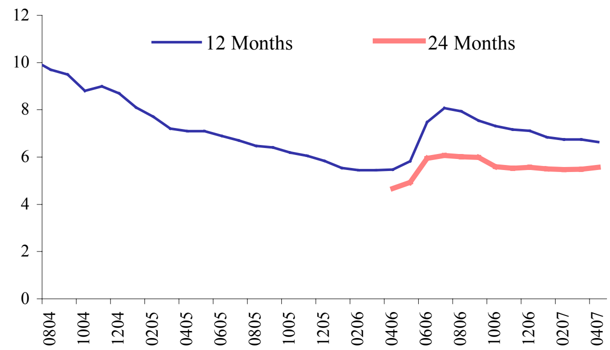
	2006					2007
	I	II	III	IV	Annual	I
CPI	**1.25**	**3.58**	**1.69**	**2.81**	**9.65**	**2.36**
A. CPI Excluding Seasonal Products	2.31	2.79	3.23	1.36	10.04	2.62
B. CPI Excluding Unprocessed Food	0.12	4.79	1.67	2.38	9.21	0.89
C. CPI Excluding Energy	1.01	3.38	1.86	2.96	9.51	2.49
D. CPI Excluding Unprocessed Food and Energy	-0.38	4.77	1.86	2.47	8.95	0.76
E. CPI Excluding Energy, Alcoholic Beverages and Tobacco Products	0.74	3.62	1.98	3.16	9.82	2.03
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
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
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

Source: TURKSTAT.

3.2. Expectations

The improvement in medium-term inflation expectations that had been observed since August 2006 came to a halt in the first quarter, which can be attributed to the rising consumer inflation and the uncertainties generated by short-lived fluctuations in global markets in March (Graph 3.2.1).

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



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

According to the Expectation Survey of the second survey period in April, the expected end-year inflation rate increased by 44 basis points to 7.48 percent compared to the figures mentioned in the previous inflation report. This was partly owing to the higher-than-expected inflation rate in the first quarter. However, the fact that the 12-month ahead inflation expectations decreased by some 20 basis points, and the 24-month ahead expectations displayed no significant change signals that this short-term deterioration is not perceived as a permanent one. Nevertheless, the above-target 12- and 24-month ahead inflation expectations, which are, by April, 6.63 and 5.57 percent, respectively, pose a risk to the pricing behavior in overall economy (Table 3.2.1). Yet, inflation expectations are believed to gradually improve parallel to the decline in annual inflation in the upcoming period.

In sum, as regards the developments in the coefficient of variation, an indicator of the uncertainty over inflation expectations, the uncertainty over the 12-month ahead expectations increased at a subdued rate after the short-lived fluctuations in March while there has been no significant change regarding the uncertainty over the 24-month ahead expectations.[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

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

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

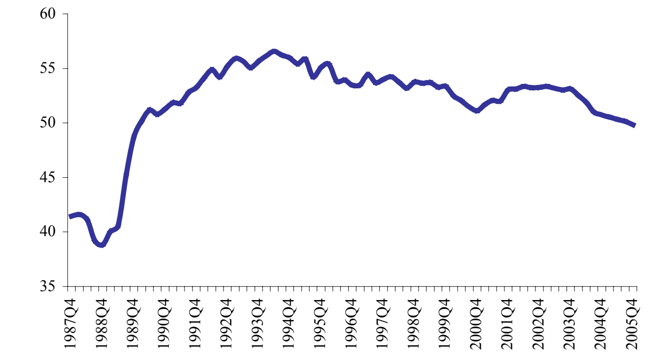
BOX 3.1. WAGES AND SERVICES INFLATION

This Box includes an analysis of how the increases in wages and salaries affect services inflation. The fact that wages and salaries make up a significant part of private disposable income and that private consumption expenditures are very susceptible to private disposable income requires close monitoring of wage and salary developments, primarily in terms of demand. The above-target wage and salary increases can lessen the effectiveness of monetary policy via expectations, especially in sectors where backward-indexation prevails. Moreover, wage and salary increases directly affect inflation via cost increases, particularly in labor-intensive sectors such as services. In this framework, the course of wage and salary increases in the public sector is very important for achieving the inflation target as private sector wages are affected from the incomes policy of the public sector.

Public sector wage and salary increases for 2007 are considerably above the 2007 inflation target of 4 percent. The minimum wage was raised by 6 percent nominally in January, and it is announced that a further 4 percent-increase will be added in July, so the minimum wage will have been raised by 8.1 percent on average in 2007 compared to 2006. As for salary increases, salaries of low-paid civil servants were raised by 6 percent in January, 2 percent of which represents the inflation difference; while salaries of high-paid civil servants were raised by 5 percent, including the same 2 percent contribution. Salary increases for the second half of the year are set as 4 percent for low-paid civil servants and 3 percent for high-paid civil servants. Any inflation difference that might occur in the first half of the year will be added to these rates. Retirement pensions of civil servants, workers and Bağkur members are also raised accordingly.

The fact that public sector labor payments take up almost half of the total labor payments make public sector wage and salary adjustments of great significance with respect to demand-side inflation developments (Box 3.1.Graph 1). According to the data released by SSK, 44 percent of employees get the minimum wage[1], which makes it clear that the public sector has a direct impact on private sector labor payments via minimum wages. Moreover, public wage adjustments also indirectly affect overall wage increases, as they set a precedent for private sector wages excluding the minimum wage.

Box 3.1.Graph 1. Public Sector Labor Payments/Labor Payments
(%, Annualized Data)

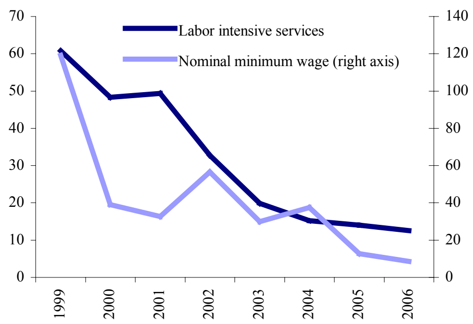


Source: TURKSTAT.

[1] SSK Statistics Almanac for 2005.

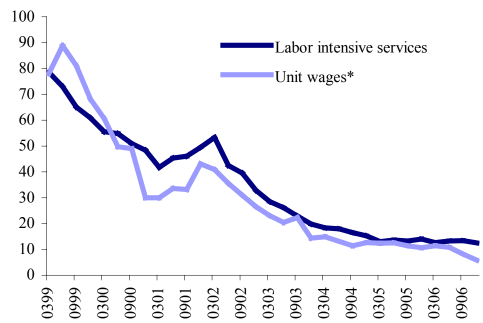
Aside from their effect on demand, wage adjustments are also influential on especially services inflation via costs and expectations.[2] Among services prices, prices of labor-intensive services are particularly sensitive to changes in wages. In this context, wage adjustments that are not consistent with the inflation target impede efforts to reduce the rigidity in services inflation. Accordingly, annual labor-intensive services inflation changes in line with the increases in minimum wage and manufacturing industry unit wages (Box 3.1.Graph 2, Box 3.1.Graph 3 and Box 3.1.Graph 4)

Box 3.1.Graph 2
Labor-Intensive Services Prices and Nominal Minimum Wage
((Annual % Change)



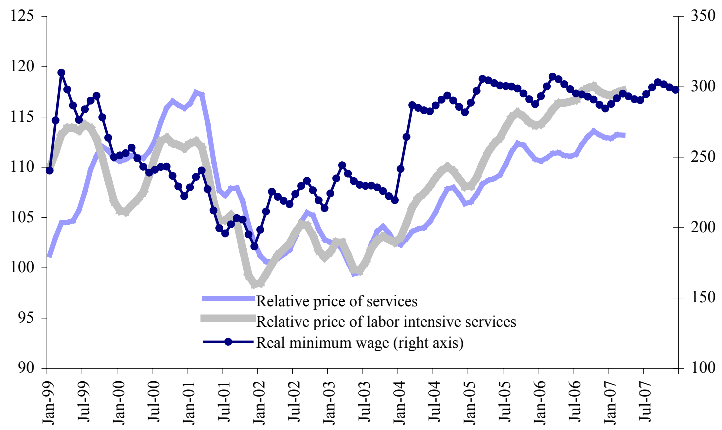
Source: TURKSTAT, *Ministry of Labor*

Box 3.1.Graph 3
Labor-Intensive Services Prices and Unit Wages
(Annual % Change)



Source: TURKSTAT
* Unit Wages in Manufacturing Industry

Box 3.1.Graph 4. Real Minimum Wage Level and Services Sector Relative Price Indices
(Quarterly Moving Average)



Source: TURKSTAT.

Against this background, it is believed that along with the factors that could affect costs, demand and expectations, public sector wage and salary adjustments are critical for the inflation target, especially in connection with the rigidity in services inflation. Public sector wage and salary payments, which took up 12 percent of total consumption expenditures in 2006, increased by 25 percent in annual terms in the first quarter of 2007 according to central government budget figures, which requires careful monitoring in terms of the inflation target.

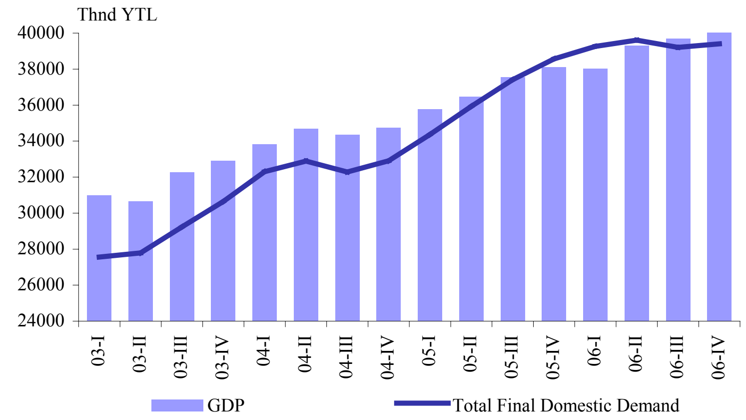
[2] Wage increases are believed to have a stronger impact, particularly via costs, on services inflation. According to the figures of the Input-Output table for 1998, the ratio of wage payments in the services sector to total production is 19.5 percent while that of manufacturing industry is only 8.3 percent.

4. Supply and Demand Developments

4.1. Supply-Demand Balance

In the last quarter of 2006, Gross Domestic Product (GDP) increased by 5.2 percent over the same period of 2005. According to seasonally adjusted figures, the GDP grew by 0.8 percent over the previous quarter. During this period, domestic demand remained below the GDP, as in the third quarter of the year. The GDP that includes the revisions for the first nine months, grew by 6.1 percent for the whole year (Graph 4.1.1).

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



Source: TURKSTAT, CBRT.

Analyzing economic growth in terms of production, the value added of the agricultural sector increased by 9.7 percent in the fourth quarter. Along with the revisions for the first nine months, the sector grew by 2.9 percent throughout 2006. Supported by the strong export performance, the value added of the industry continued to increase in the fourth quarter. Construction sector exhibited a strong growth, albeit at a lower rate compared to overall 2006. The slowdown in domestic demand, and consequently, in imports, limited the increases in the value added of commerce and transportation-communication sectors.

Analyzing in terms of demand components, the rate of increase in private consumption expenditures that realized at very low levels in annual terms became the most important factor restraining growth (Table 4.1.1). According to seasonally adjusted figures, the demand for durable goods, which has partially improved after a sharp decline in the third quarter decreased in annual terms due to the base effect generated by the rapid growth in the last quarter of 2005 and continued to be the most important factor limiting consumption demand. Annual increases in demand for food and semi and non-durable goods continued, albeit at a subdued rate compared to the first nine months of the year. The rate of increase in public consumption expenditures, which recorded high rated in the first nine months of the year, dropped in the last quarter.

As regards the sub-items of private investment expenditures, it is seen that the machinery-equipment investments displayed only a slight increase as expected –, while construction investments continued to grow. As a result of the sluggish increase in public investments, fixed capital investments rose by 4.4 percent in annual terms – a rather low level compared to previous periods. Along with the slowdown in domestic demand, imports lost pace, primarily in consumption and investment goods. However, exports maintained their strong performance. As a result of these developments, net exports made a significant contribution to growth and mainly offset the impact of weak domestic demand on growth.

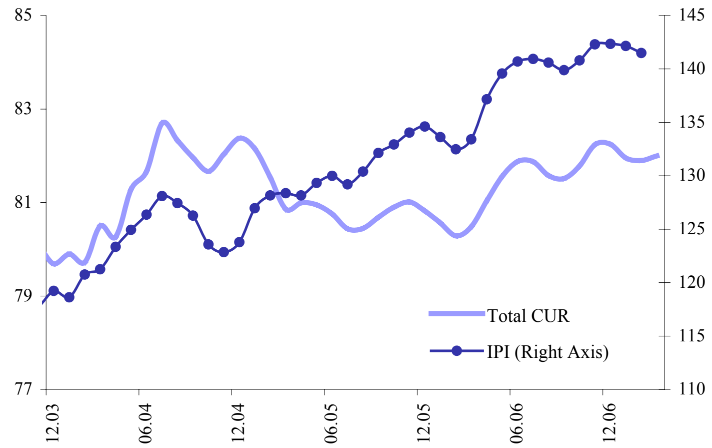
Table 4.1.1. GDP Developments by Expenditures
(Constant Prices, Annual Percentage Change)

	2005					2006				
	I	II	III	IV	Annual	I	II	III	IV	Annual
1-Consumption Expenditures	4.1	3.9	9.8	14.1	8.1	8.3	12.2	3.3	0.2	5.6
Public	4.4	4.0	3.2	0.0	2.4	10.1	18.3	14.8	0.7	9.6
Private	4.1	3.9	10.4	16.7	8.8	8.1	11.5	2.3	0.1	5.2
Durable Goods	3.2	2.9	26.0	31.3	15.0	12.7	15.9	-8.3	-6.3	2.9
Semi-dur and Non-dur. Goods	9.0	3.0	3.7	39.6	12.9	11.8	30.3	19.8	4.2	15.8
Food and Beverages	3.3	8.6	10.8	8.7	8.2	6.6	5.5	1.2	0.2	3.1
2-Fixed Capital Formation	10.3	20.0	30.6	33.0	24.0	32.1	14.0	11.3	4.4	14.0
Public	30.7	30.2	38.2	17.1	25.9	32.8	-11.9	-4.1	1.8	-0.2
Private	8.8	18.4	29.0	41.6	23.6	32.1	18.4	15.0	5.6	17.4
Machinery-Equipment	5.1	15.4	26.8	43.5	21.4	34.9	15.4	7.2	0.3	13.9
Construction	20.8	28.8	33.2	35.9	29.9	24.1	27.9	29.8	21.6	26.4
3- Changes in Stocks	0.6	-0.7	-3.0	-6.3	-2.5	-4.9	-0.9	-3.8	1.3	-2.1
4-Exports of Goods and Services	14.0	6.7	3.9	10.9	8.5	6.8	9.1	11.5	6.2	8.5
5-Imports of Goods and Services	10.6	9.1	11.2	15.3	11.5	10.0	13.7	3.6	1.0	7.1
Net Exports*	0.5	-1.9	-2.7	-2.3	-1.7	-2.2	-3.5	3.4	2.4	0.3
6-Total Domestic Demand	5.6	6.8	10.9	11.6	8.8	8.2	10.6	1.4	2.7	5.6
7-Total Final Domestic Demand	5.5	8.4	14.5	19.1	12.1	14.1	12.7	5.3	1.4	8.0
7-GDP (Expenditure side)	6.6	5.5	7.7	9.5	7.4	6.7	8.3	4.8	5.2	6.1

*Contribution to GDP, percent.
Source: TURKSTAT.

In the January-February 2007 period, the industrial production index increased by 10.8 percent over the same period last year, which can be attributed to the low base effect generated by industrial production that fell in January 2006 due to natural gas cuts and adverse weather conditions. As a matter of fact, seasonally adjusted data do not suggest a briskness in industrial production (Graph 4.1.2). The slowdown in domestic demand restrains industrial production, while strong export performance supports it. Seasonally adjusted data on capacity utilization rates indicate that industrial production continued to increase modestly in March. However, considering the base effect observed in the first quarter of 2006, industrial sector production and its value added are also expected to keep increasing at high rates in annual terms in the first quarter of 2007.

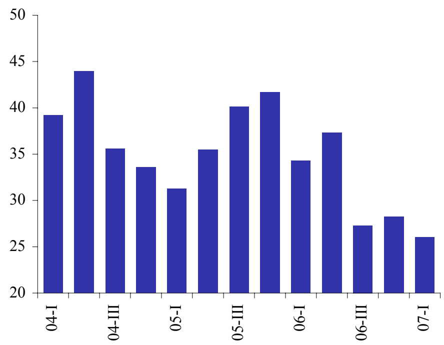
Graph 4.1.2. Industrial Production Index – Capacity Utilization Rate
(Seasonally Adjusted, Quarterly Moving Average)



Source: TURKSTAT, CBRT.

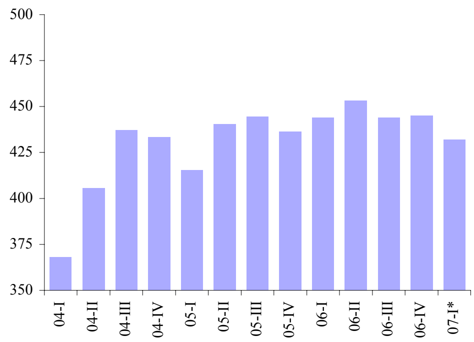
Automobile sales that dropped sharply in the third quarter of the year as a result of the fluctuations in May-June 2006 recovered in the fourth quarter but re-weakened during January-February 2007 (Graph 4.1.3). Sales of white goods reveal a similar outlook (Graph 4.1.4). In this context, the ebbing demand for durable goods continues to limit private consumption expenditures.

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



Source: AMA, CBRT.

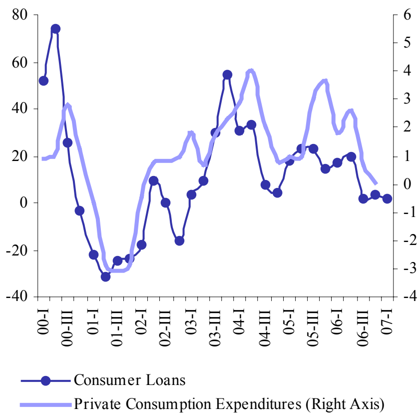
Graph 4.1.4. Domestic Sales of White Goods
(Seasonally Adjusted, Monthly Average, Thousand)



* January-February period is included.
Source: WGSA, CBRT.

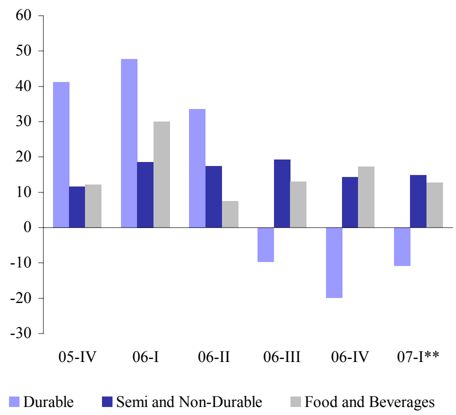
Consumer loans, another indicator of consumption expenditures, continue to display a sluggish trend (Graph 4.1.5). Since first quarter of 2007, vehicle loans have been declining , whereas other sub-items of consumer loans have not accelerated over the second half of 2006. The data on imports of consumption goods also indicate that expenditures on durable goods dropped in annual terms (Graph 4.1.6). Therefore, considering the high base effect observed in the first half of 2006, annual increases in private consumption expenditures are not expected to change significantly in the same period of 2007.

Graph 4.1.5. Consumer Loans and Consumption Expenditures (Quarterly Real Percentage Changes*)



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

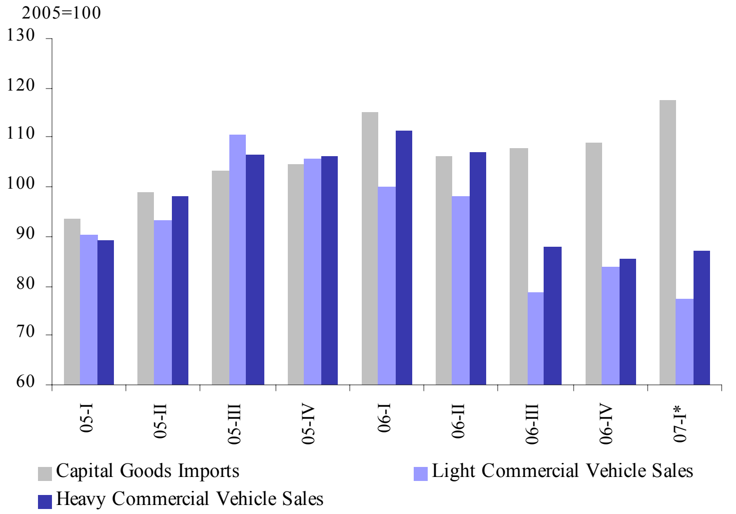
Graph 4.1.6. Imports of Consumption Goods By Items (Annual Percentage Change)



* 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.
**T Latest data cover the January-February period.
Source: TURKSTAT.

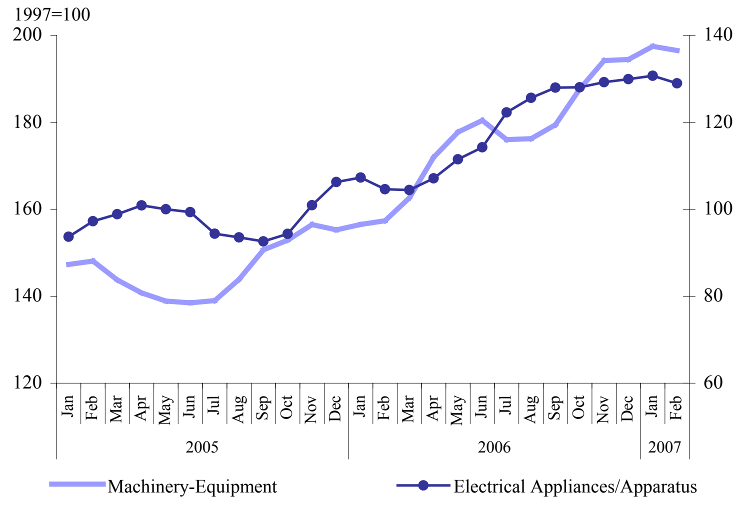
Construction permits issued to the private sector increased by 13 percent in 2006. Accordingly, it is estimated that private construction investments will also continue to grow in 2007, although not as high as it was observed in 2005 and 2006. On the other hand, the slowdown in machinery-equipment investments is expected to persist in the short term. During January-February 2007, imports of capital goods increased over the last quarter of 2006, while sales of light commercial vehicles that declined parallel to automobile sales continued to restrain machinery-equipment investments (Graph 4.1.7). Production in the investment goods producing sectors of machinery-equipment and electrical machinery and electrical appliances/apparatus does not indicate an acceleration in investments either (Graph 4.1.8).

Graph 4.1.7. Imports of Capital Goods and Domestic Sales of Commercial Vehicles
(Seasonally Adjusted, Monthly Average)



* Imports of capital goods include January-February period.
Source: TURKSTAT, AMA and CBRT.

Graph 4.1.8. Machinery-Equipment and Electrical Machinery and Electrical Appliances/Apparatus Production
(Seasonally Adjusted, Quarterly Moving Average)

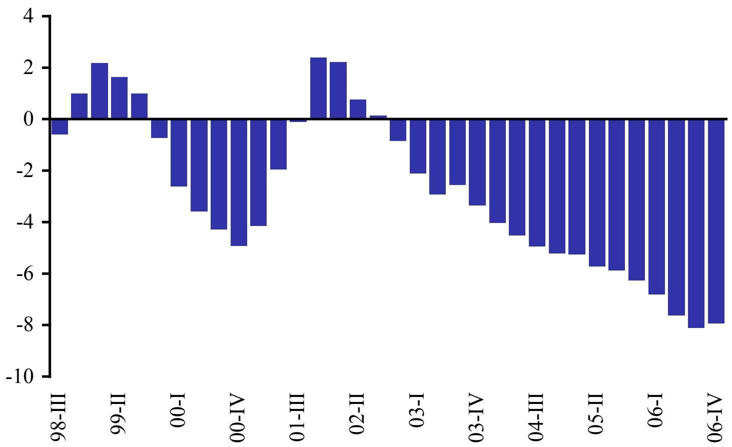


Source: TURKSTAT, CBRT.

4.2. Foreign Demand

In 2006, the current account produced a deficit of USD 31.7 billion as the foreign trade deficit, defined in terms of balance payment methodology, expanded to USD 40.1 billion. Especially by mid-2006, import growth lost momentum, while exports remained robust. According to both real and nominal figures, exports prevailed over imports in this period as a result of the slowdown in domestic demand and falling oil prices. In fact, in the second half of 2006, net exports of goods and services yielded a surplus, as suggested by national income accounting, and contributed to overall growth. Hence, the ratio of current account deficit to Gross National Product (GNP) dropped to 7.9 percent at end-2006, down from 8.1 percent in annualized terms at end-September 2006 (Graph 4.2.1).

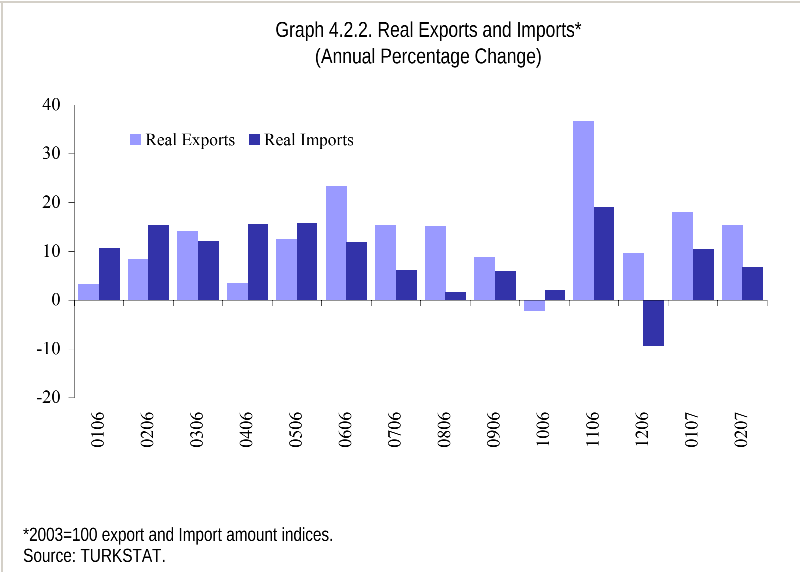
Graph 4.2.1. Current Account Balance/ GNP*
(Percentage)



* Annualized figures.
Source: CBRT.

In the first two months of 2007, foreign trade continued to improve. In addition, tourism revenues which had decreased in 2006,rebounded in the January-February period and helped narrow the current account deficit. As a result, current account deficit decreased to USD 6.3 billion in the said period.

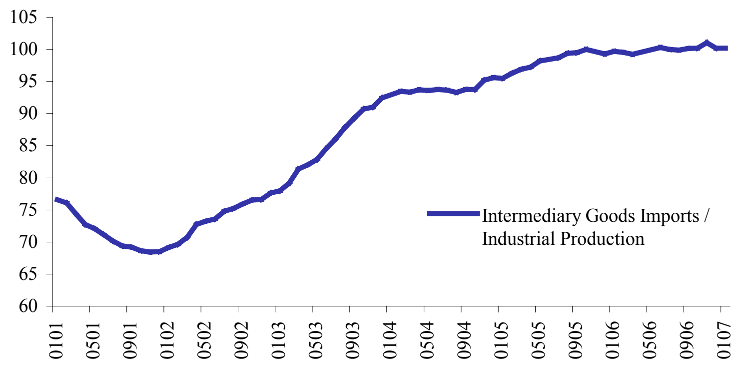
During January-February, exports and imports of goods grew by 26.5 percent and 21.5 percent in annual terms, respectively. As regards quantity indices, exports and imports grew by 16.5 percent and 8.4 percent, respectively (Graph 4.2.2). Leading indicators for March and April also suggest a robust export performance. As emphasized above, against this background, net exports of goods and services is expected to continue to contribute to growth in the first half of 2007.



Among all sectors, motor vehicles, basic metals and machinery-equipment made the largest contribution to export growth since mid-2006. New model launches in the motor vehicles sector and both privatization-led productivity gains and prices hikes in the basic metals sector were influential in this growth. On the other hand, exports of textiles and clothing fell behind total exports, but kept growing. The high quality of textiles and clothing articles and Turkey's proximity to EU, top trade partner, produces comparative advantage in competition against countries with low-cost labor like China.

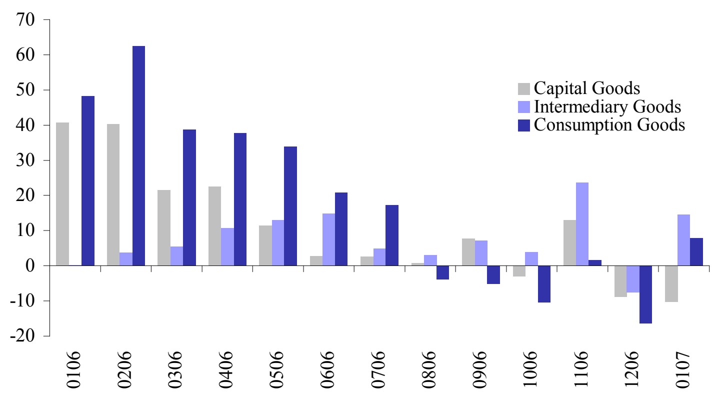
As regards imports, imports of intermediate goods have made the largest contribution to total import growth. Despite falling oil prices, strong industrial production was the most important factor in the import growth of intermediate goods (Graph 4.2.3). For the first half of 2007, it is expected that imports of intermediate goods will increase along with the industrial production growth but the annual rate of increase will be limited by the high base effect observed in the second quarter of 2006. On the other hand, imports of capital goods have entered a sluggish trend from April 2006 onwards (Graph 4.2.4). This slowdown was mainly due to the downfall in imports of industrial transportation vehicles and supplies. Imports of consumption goods continued to decrease in the January-February period. Considering the slowdown in domestic demand and the high base effect, it is expected that imports of consumption goods will continue to decline and imports of capital goods will continue to moderate in the short period ahead.

Graph 4.2.3. Imports of Intermediate Goods and Manufacturing Industry Production *
(12-month Moving Average)



*2006=100 base quantity and production indices.
Source: TURKSTAT.

Graph 4.2.4. Sub-items of Imports
(Quantity Indices, Annual Percentage Change)



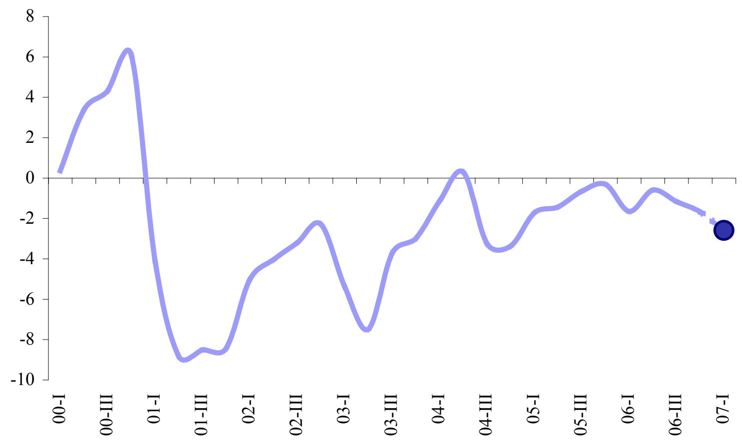
Source: TURKSTAT.

Especially in the first half of 2007, strong foreign demand, productivity gains and the slowdown in domestic demand are expected to continue to help reduce foreign trade deficit. The briskness of economic activities in EU and the strong position of the Euro reinforce this expectation.

In sum, the data available suggest that the growth outlook in the first quarter of 2007 will be similar to that in the second half of 2006. It is estimated that domestic demand will have a limited contribution on growth, while foreign demand will bolster growth considerably. Seasonally adjusted data do not indicate a significant rise in economic activity.

The output gap forecasts produced in the light of these evaluations suggest that the support of demand conditions on disinflation continues (Graph 4.2.5). However, considering the revisions made for the growth rates of 2006, the output gap has been revised upwards for the last quarter of 2006as compared to the January Inflation Report. In other words, demand conditions of 2006 might less contribute to the disinflation process than suggested in the January Inflation Report. As total demand is not expected to grow considerably in the first quarter of 2007, the output gap is estimated to be at a more favorable level with regard to inflation than the previous quarter.

Graph 4.2.5. Output Gap (Percent)



Source: CBRT.

4.3. Unit Labor Costs

According to the statistics of the indices of " Workers, Hours Worked in Production and Partial Productivity in Manufacturing Industry" compiled by TURKSTAT, employment in the manufacturing industry rose by 1.2 percent in the fourth quarter of 2006 over the same period of 2005 (Table 4.3.1). In this period, employment in the public sector decreased, while employment in the private sector increased. Hence, in 2006, employment in the manufacturing industry decreased by 0.7 percent compared to 2005. Real wages per worked hour increased by 2.1 percent in the fourth quarter. Productivity per worked hour increased by 5.3 percent in the fourth quarter and by 6.7 percent in 2006 compared to 2005. Earnings per worker increased by 2.8 percent in the fourth quarter and by 0.9 percent throughout 2006.

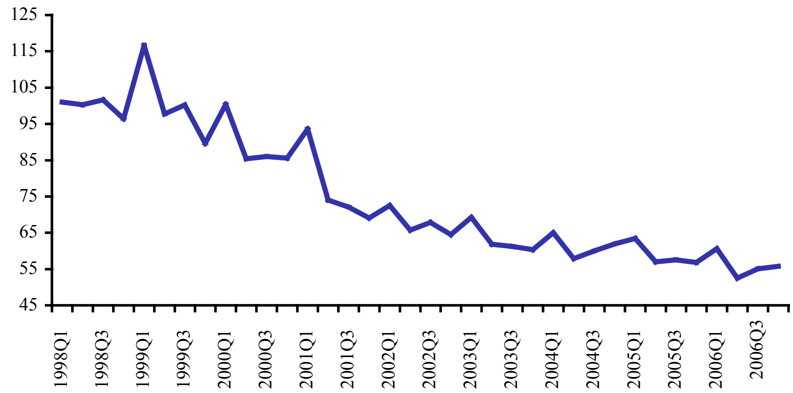
Table 4.3.1. Employment, Real Wage and Productivity Developments in the Manufacturing Industry
(Percentage Change Compared to the Same Period of the Previous Year)

	2005					2006				
	I	II	III	IV	Annual	I	II	III	IV	Annual
Employment[1]	1.9	-1.7	-1.8	-1.1	-0.7	-1.9	-1.4	-0.7	1.2	-0.7
Public	-10.2	-7.1	-8.6	-7.2	-8.1	-3.3	-3.8	-5.7	-2.9	-4.1
Private	3.2	-1.2	-1.1	-0.4	0.1	-1.9	-1.2	-0.2	1.6	-0.4
Wage[2]	3.2	2.1	1.6	0.7	2.0	1.0	0.5	0.0	2.1	0.9
Public	8.7	5.4	9.0	8.4	8.0	-3.9	-2.7	-4.0	-1.4	-3.0
Private	3.5	2.0	1.0	-0.1	1.7	1.8	1.3	1.2	3.1	1.9
Productivity[3]	5.1	4.3	6.1	8.4	6.0	5.0	9.9	6.5	5.3	6.7
Public	7.0	11.8	15.5	9.8	11.0	-3.0	9.6	13.3	8.3	7.0
Private	6.1	3.5	5.2	8.8	5.9	6.6	10.2	5.8	5.1	6.9
Earnings[4]	2.8	2.7	2.5	0.8	1.8	0.4	0.4	0.0	2.8	0.9
Public	10.6	3.5	8.8	3.0	6.1	-3.3	-2.3	-0.4	-0.1	-1.5
Private	2.9	3.2	2.0	1.3	1.9	1.3	1.2	0.7	4.0	1.9

Source: TURKSTAT.
(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 Partial Productivity Per Working Hour as Per Period, 1997=100.
(4) The Index of Real Earning Per Worker as Per Period, 1997=100.

In the fourth quarter, real unit wages in the private manufacturing industry fell by 1.9 percent compared to the same period of the previous year as a result of productivity gains that surpassed the increases in real wages (Graph 4.3.1). In 2006, real unit wages declined by 4.8 percent compared to 2005 and therefore, made a positive contribution to both disinflation and export performance. Along with the continued increase in both industrial production and productivity, it is projected that real unit wages in the manufacturing industry will also continue to restrain unit costs in the upcoming period.

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



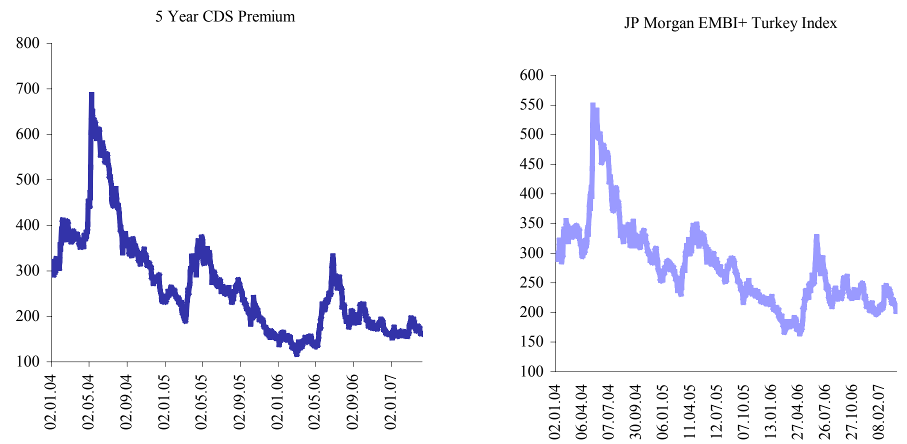
Source: TURKSTAT, CBRT.

5. Financial Markets and Financial Intermediation

5.1. Financial Markets

In the first quarter of 2007, international liquidity conditions and global risk appetite continued to be in favor of developing countries (Graph 2.2.2). The increase in volatility in late February, driven by concerns over a sharper-than-expected slowdown in the US economy and by uncertainties over the Chinese economy, was short-lived and did not affect the inflation outlook. The decline observed in risk premium indicators such as the Credit Default Swap (CDS) and the JP Morgan EMBI+ Index for Turkey was marked by favorable developments in international liquidity conditions (Graph 5.1.1). Nevertheless, international markets are expected to remain sensitive to growth figures and inflation developments of developed countries in the short term.

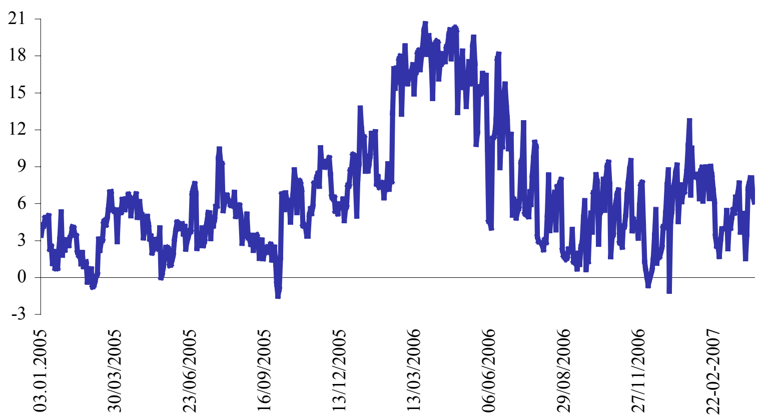
Graph 5.1.1. Risk Premium Indicators



Source: Bloomberg.

Excess liquidity sterilized through overnight market slightly increased in the first quarter of the year compared to the previous quarter (Graph 5.1.2), which can be attributed to CBRT's re-opening of the foreign exchange purchase auctions.

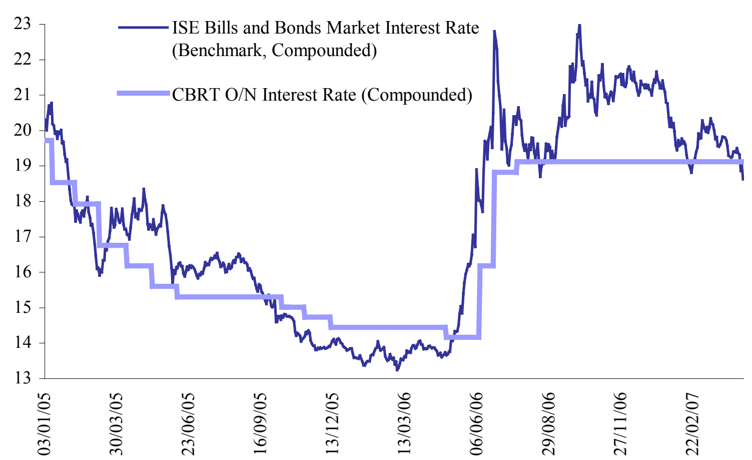
Graph 5.1.2. Excess YTL Liquidity
(Billion YTL)



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 came to a halt at the end of February due to temporarily worsened international liquidity conditions. However, the return on new benchmark securities issued in the third week of April fell below the CBRT policy rate (Graph 5.1.3). The fall in the benchmark interest rate is believed to be an outcome of the reduction in desired risk premium, which was driven by the easing of uncertainty perceptions in the country.

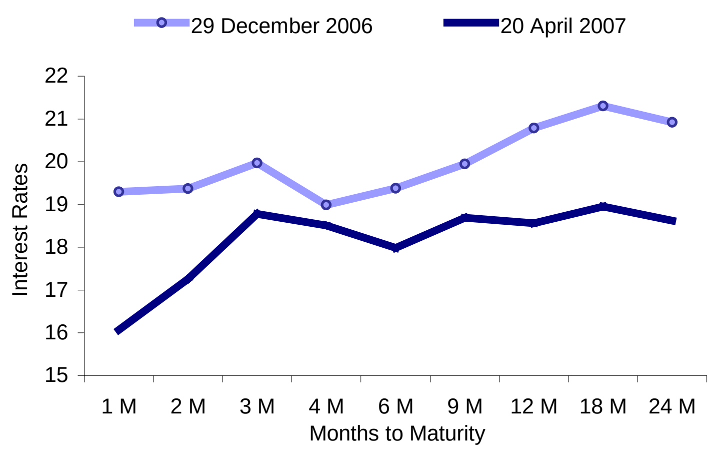
Graph 5.1.3. Interest Rate Developments
(Percent)



Source: ISE, CBRT.

In the first quarter of 2007, the prevailing resolute stance of monetary policy supported the fall in long-term interest rates by easing the uncertainty over inflation. The yields of April 20, 2007 remained at lower levels for all maturities compared to the yields of end-2006, owing to the reduced risk premium and 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.

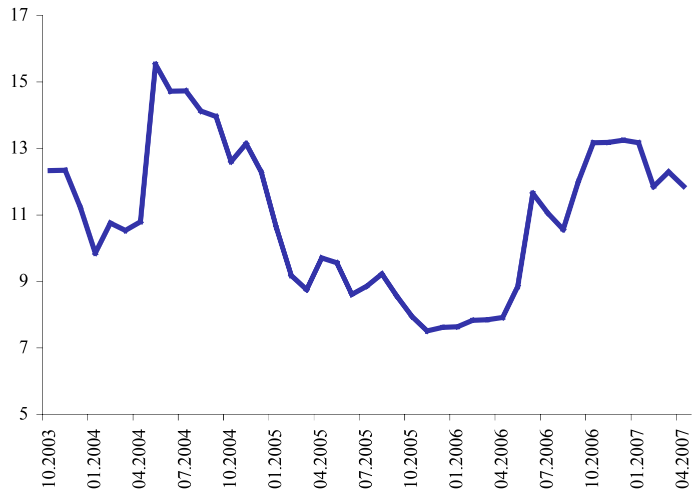
Graph 5.1.4. Yield Curves



Source: ISE.

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, except for a temporary pause in February, due to the fall in nominal interest rates (Graph 5.1.5).

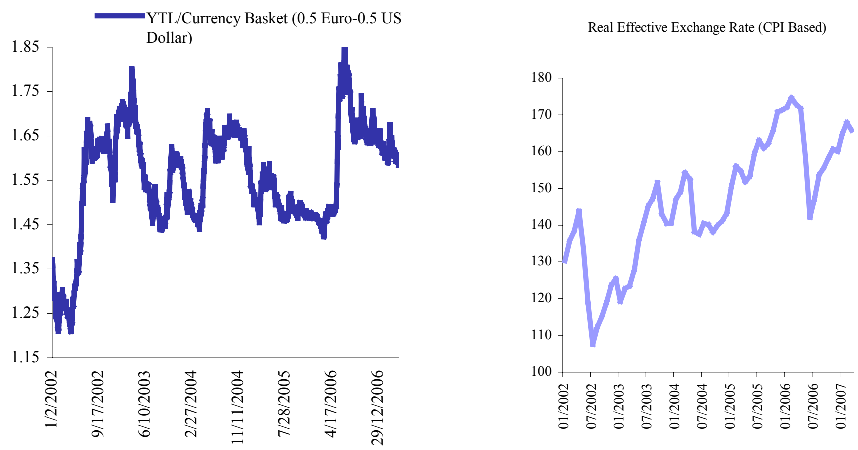
Graph 5.1.5. Real Interest Rates
(According to ISE Benchmark Interest Rate and 12-Month Inflation Expectations)



Source: ISE, CBRT

In the first quarter of the year, the increase in YTL assets of non-resident investors and the appreciation of YTL associated with the high level of foreign direct capital inflows continued (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 April 2007, gross foreign exchange reserves of the CBRT reached USD 65.7 billion.

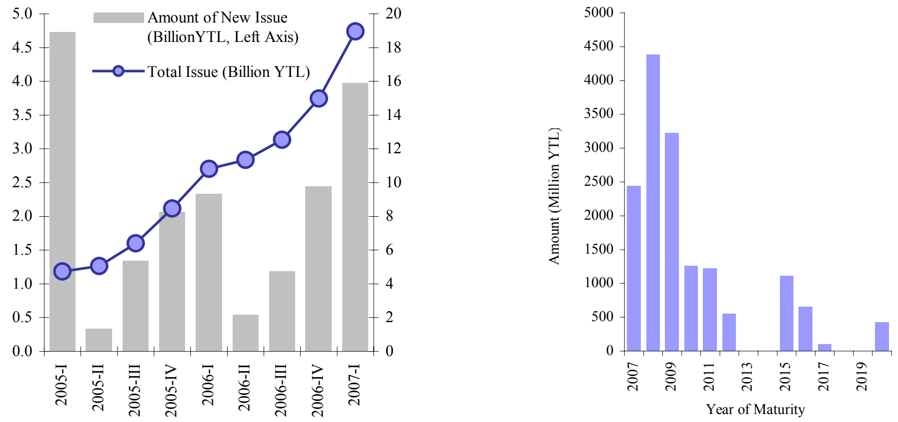
Graph 5.1.6. Developments in Exchange Rates



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, continued to increase (Graph 5.1.7). This is considered to have been due to seasonal effects and the 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

The rate of increase in loans, which slowed down after the CBRT's monetary policy tightening in June 2006, maintained this trend in the first quarter of 2007, while consumer loans continued to increase at a slow pace (Table 5.2.1). The recent increase in consumer loans seems to have resulted from the increase in the "other loans" item, which is mainly composed of short-term consumer loans and excludes housing and automobile loans. Housing loans continued to grow moderately, while automobile loans and credit cards declined in real terms.

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

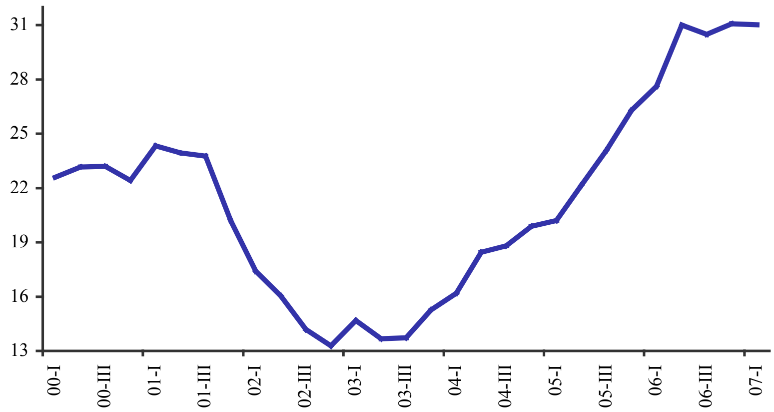
	2005	2006				2007
	I	I	II	II	IV	I
Consumer Loans	14,4	17,2	20,0	1,5	3,3	2,6
Housing Loans	33,3	29,2	22,8	0,9	2,0	2,7
Automobile Loans	6,0	1,9	5,1	-6,4	-5,5	-8,9
Other Loans	1,6	11,7	24,3	6,0	8,7	6,6
Credit Cards	2,3	2,0	6,8	2,1	4,4	-1,6

Source: CBRT.

The slowdown in the growth rate of consumer loans observed since mid-2006 continued in the first quarter of 2007, which indicates that the slowdown is attributable, but not limited, to the fluctuation in May-June 2006 and that the credit channel of the monetary policy transmission mechanism has become operative. However, it should be underlined that the slowdown in loans is also attributable to the prudent stance of banks and consumers in response to temporarily worsening risk perceptions.

In the first quarter of 2007, business loans also continued to increase at a modest rate. Hence, the ratio of consumer and business loans to GNP has not displayed a significant change in the last three quarters.

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



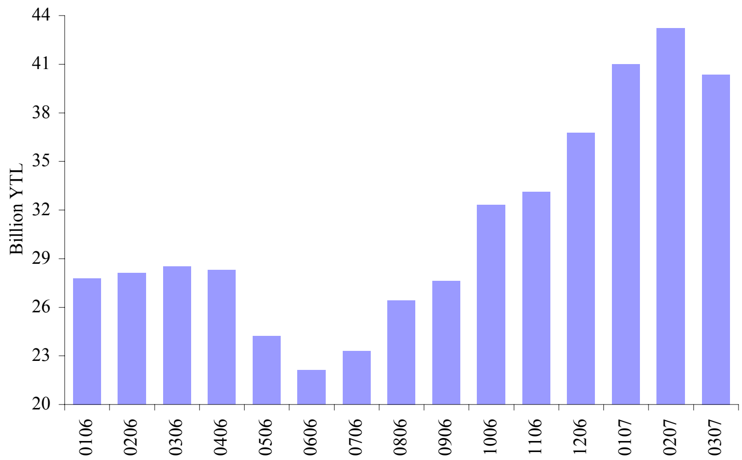
*Real sector loans are composed of consumer loans and business loans. The first quarter GNP of 2007 shows estimated figures.

Source: CBRT

The recently growing amount of liquidity in the domestic market and the favorable course of external borrowing conditions helped improve credit supply conditions. The liquidity volume in the market continues to grow thanks to Treasury's high-level of cash holdings that eased the necessity to keep the roll-over rate high and the CBRT's continued YTL supply via foreign exchange purchase auctions. Moreover, favorable conditions in YTL bond issues of foreign financial institutions played a significant role in improving the facilities for banks to make YTL borrowings from abroad (Graph 5.1.7). Lastly, non-residents continued to raise the portion of government securities in their portfolios in the first quarter (Graph 5.2.2).

An overall evaluation of all these developments indicates that the amount of banks' loanable funds is on the rise.

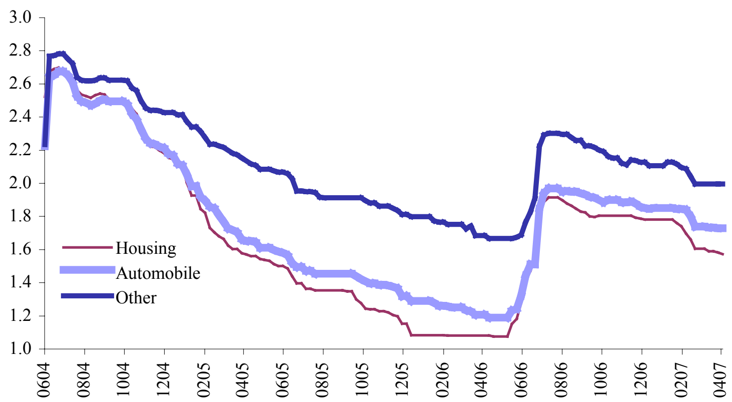
Graph 5.2.2. Government Securities Held by Non-Residents



Source: CBRT.

Despite the relative improvement in credit supply conditions, the high level of credit interest rates continue to restrain the demand for credits. Credit interest rates, which decreased slightly in the first quarter of 2007, are still at high levels compared to the first half of 2006 (Graph 5.2.3). In this framework, consumer loans are not expected to increase in the short term unless interest rates fall further.

Graph 5.2.3. Consumer Loan Rates
(Monthly, Percent)



Source: Web sites of selected banks.

BOX 5.1. INFORMATION CONTAINED IN THE INFLATION-INDEXED BONDS ABOUT INFLATION EXPECTATIONS

Inflation targeting is a monetary policy regime based on the management of inflation expectations. Within this framework, the extent to which medium-term inflation expectations are compatible with the targets is an important credibility criterion for central banks, and the quantitative information on inflation expectations are crucial. The CBRT devised an expectations survey in 2001 to facilitate the correct measurement of inflation expectations and has been regularly publishing the results since then.

However, according to studies in economics and finance, risk is not priced properly in the expectations measured by the help of surveys. Therefore, alternative criteria that can be gathered from market instruments such as inflation-indexed bonds would be beneficial in the information set of central banks. With the auction on February 19, 2007 the Treasury issued CPI-indexed government coupon bonds with five-year maturity and thus created an alternative instrument in Turkey from which information on medium-long term inflation expectations can be derived. Prices of CPI-indexed government bonds might contain significant information regarding inflation expectations and risk premia. Yet, since the information drawn from inflation-indexed bonds is not directly observable as survey data, it needs to be scrutinized from a technical point of view. This box aims to facilitate the correct interpretation of the information obtained from inflation-indexed bonds.

Return Components of Bonds Unindexed to Inflation

In order to obtain sound information on inflation expectations from inflation-indexed bonds, it is useful to have those bonds unindexed to inflation with similar maturities and cash flow. The interest rate difference between YTL denominated government bonds unindexed to inflation with similar maturities and cash flow and inflation-indexed bonds can generate substantial information about the expected inflation.

For the correct interpretation of the difference between the interest rates of bonds unindexed to inflation and the inflation-indexed bonds, first, the components of the nominal interest rates of the unindexed bond should be clearly understood. When pricing financial assets, the risks associated with the asset need to be taken into consideration as much as the expected return on the asset. Against this background, the nominal interest rate components of YTL denominated government bonds unindexed to inflation are as follows:

Nominal Interest Rate = Average Int. Rate Expectations + Term Premium

= (Real Int. Rate Expectations+ Inflation Expectations) + (Int. Rate Premium+ Other Premia)

Int. Rate Premium:
* Real Int. Rate Risk Premium
* Inflation Risk Premium

Other Premia:
* Default Risk Premium
* FX Rate Risk Premium
* Liquidity Premium

Accordingly, the nominal interest rate reflects not only real interest rates and inflation expectations, but also combinations of various risk premia. A change in nominal interest rates might stem from any one of these components:

- *Real Interest Rate Risk Premium:* the risk premium demanded for any gap between the possibility of ex-post real interest rates differing from the expected real interest rates in case the economic conjuncture falls outside the expectations (such as, productivity increases rising above the expected level or the potential growth rate going up temporarily).
- *Inflation Risk Premium:* the risk premium required for a potential gap between inflation and expectations. In countries with a history of chronic inflation, the level and volatility of this premium is expected to be high.
- *Default Risk Premium:* the risk premium demanded for the possibility of the borrower's inability to pay the interest or principal on their due obligations.
- *Foreign Exchange Rate Risk Premium:* the risk premium an investor, who makes the calculations in terms of foreign currencies, demands in the face of the possible depreciation in the domestic currency to which the security is indexed to.
- *Liquidity Premium:* the risk premium demanded for the possibility of a loss to be borne while cashing where the security is not actively traded in the secondary market.

By all means, these components are not totally independent from each other. Mostly, a change in the term premium in the economy can be caused by variations in several risks at the same time. For example, in a period when FX rate fluctuations increase, both foreign exchange rate risk and inflation risk increase concurrently and it is hard to distinguish between the two components.

Inflation Compensation

Since it provides protection against inflation and inflation risk, the price of (the return on) an inflation-indexed security will be higher (lower) than a security unindexed to inflation with the same maturity. The difference between the interest rates of YTL denominated government bonds not indexed to inflation and inflation-indexed bonds with similar maturities and cash flow is the sum of the *average* inflation expectation and the inflation risk premium generated by the uncertainty over this expectation.[1] The sum of the inflation and inflation risk premium can be defined as the "*inflation compensation*".

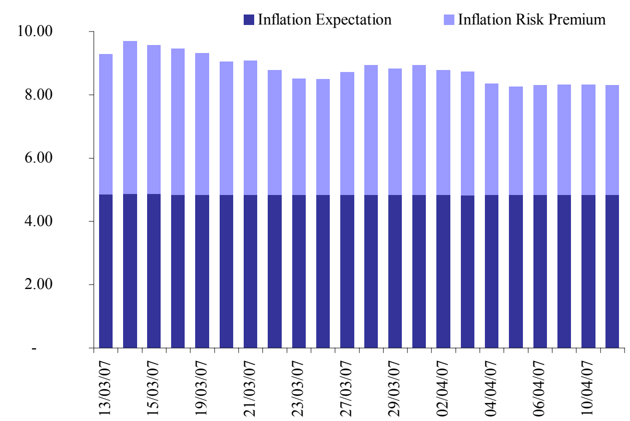
Certainly, the main assumption here is that for both securities all components apart from the inflation risk (default, exchange rate, real interest, and liquidity premiums) stated in the equation above are the same: Both securities are issued by the Treasury, therefore there is no difference in the default risk and foreign exchange rate premia (because they are both YTL denominated). The real interest rate risk premium will not differ either, as the cash flow timetable of the two securities is the same. Moreover, the liquidity premium might be disregarded since the average trade volume of the 5-year fixed coupon government bonds in the secondary market do not differ significantly.

[1] In the markets, it is occasionally overlooked that inflation risk premium is also included in this difference and this difference is erroneously taken as the average inflation expectation.

With the February 19, 2007 auction, the Treasury issued CPI-indexed government coupon bonds with 5-year maturity. A month later, fixed coupon government bonds with 5-year maturity were issued. It is considered that the difference in the returns of these two securities can be used in measuring the 5-year average inflation compensation since they have a similar cash flow timetable and amount.

The graph shows the components of inflation compensation of the two securities - described as the difference in return. The Expectations Survey was used to differentiate between inflation and the inflation risk premium. In order to estimate the 5-year average inflation expectation, which is currently unavailable, 12 and 24 months ahead annual CPI expectations of CBRT's Expectations Survey was used for the first two years, and the inflation target for the remaining three years. Although the information on expectations obtained via surveys might, from time to time, be irrational, currently there is no alternative data that can serve as a reference for the average inflation expectation. The graph presents the 5-year average inflation expectations computed as such and the inflation risk premium is calculated by subtracting these expectations from the inflation compensation.

Box 5.1. Graph 1. Expected Inflation and Inflation Risk Premium



What is remarkable in the graph above is that the inflation risk premium is still very high in Turkey. This level of the inflation risk premium indicates that it is not possible to describe the current state as price stability and calls for a continued fight against inflation. One of the main reasons for the high level of long-term interest rates in Turkey is also the high level of the inflation risk premium. Prudent monetary policy is a precondition to bring the inflation risk premium down. Every step towards price stability will contribute to lowering the inflation risk premium along with long-term nominal and real interest rates. This will lead to a decline in the borrowing costs of the Treasury and will channel savings more towards real economic activities and consequently lead to higher potential and realized growth.

6. Public Finance

The high-rated increase in central government non-interest budget expenditures by the first quarter of 2007 created the need for a savings package of YTL 4.4 billion intended to curb expenditures. Meanwhile, YTL 5.8 billion-worth remaining claim from the sale of Turk Telecommunications was paid to the Treasury, before the official payment date in March, and entered the budget as non-tax revenue. These developments reinforce the expectations that central government budget targets for 2007 will be achieved. However, it is believed that reaching the central government budget targets alone will not be sufficient to provide support from fiscal policy for the 2007 inflation target. Within this framework, the likely increases in revenues should not be channeled to expenditures, and the necessary adjustments for achieving the primary surplus target should not be made through indirect taxes. Moreover, in order to sustain the support of fiscal policy to the disinflation process, reforms for more effective public finance should be implemented without interruption.

In recent years, with the help of fiscal discipline, public debt management was conducted by adopting an effective borrowing strategy at reasonable risk levels, as a result of which, concerns over the manageability and sustainability of debt stock in the short and medium-long term respectively were, to a large extent, eliminated. However, effective implementation of structural reforms is still vital for assuring the permanence of gains from tight fiscal policy and for reducing the public debt stock to lower levels. The structural reforms already implemented 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 January-March 2007, the central government primary balance registered a surplus of YTL 12.6 billion, while the budget balance ran a deficit of YTL 3.3 billion (Table 6.1.1). This deficit equals 19.8 percent of the end-year target of YTL 16.8 billion. The main determinant of this development was the advanced collection of all claims from the privatization of Turk Telecom in March.

A detailed analysis over the central government budget figures shows that budget revenues and expenditures increased by 20.3 percent and 25.6 percent, respectively in the same period of 2006. The increase in budget revenues mainly resulted from the 72.0 percent rise in non-tax revenues. Due to the early 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 9.9 percent since the first quarter of 2007, in response to the negative realization of corporate tax collection in January, following the deduction and refunding transactions subject to corporate taxpayers. As it is known, corporate tax collection rises especially in February, May, August and November, following the submission of companies' balance sheets to tax administration offices, while it remains subdued during the rest of the year. Therefore, comparing the figures of February 2006 with those of February 2007 would provide a more accurate interpretation of corporate tax performance. Corporate tax collection was equivalent to YTL 3.0 billion in February 2007, and YTL 3.1 billion in February 2006. The fact that economic activity slowed down and the corporate tax rate was reduced to 20 percent from 30 percent in mid-2006 explains the limited decline in corporate tax collection.

Domestic VAT collection fell slightly by 0.6 percent in the January-March period. The 27.2 percent-decline in VAT collection of the January-February period was thought to originate from 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 January-March period support this announcement, careful monitoring of VAT collection for the rest of 2007 is considered useful.

The 41.5 percent-increase in interest expenditures played a significant role in the rapid growth of budget expenditures. The increase in non-interest budget expenditures is well consistent with the overall growth target for 2007. Of the YTL 16.0 billion-worth of interest payments made in the January-March 2007 period, YTL 13.4 billion belongs to domestic debt payments, while YTL 2.5 billion belongs to foreign debt payments. The high increase in interest expenditures resulted from the large-scale domestic debt redemptions in January.

Table 6.1.1. Central Government Budget Aggregates (Billion YTL)

	January-March 2006	January-March 2007	Rate of Increase (%)	Realization/ Budget target (%)	2007 Budget Target	2007 Budget Target/GNP[1]
Central Government Expenditures	**39.4**	**49.4**	**25.6**	**24.1**	**205.0**	**32.5**
A) Interest Expenditures	**11.3**	**16.0**	**41.5**	**30.2**	**53.0**	**8.4**
B) Non-Interest Budget Expenditures	**28.1**	**33.5**	**19.2**	**22.0**	**152.0**	**24.1**
I. Personnel Expenditures	8.9	11.2	25.2	25.6	43.7	6.9
II. Government Premiums to Social Security Agencies	1.2	1.4	15.8	13.9	10.1	1.6
III. Purchases of Goods and Services	2.6	3.5	31.2	22.2	15.6	2.5
1) Defense-Security	0.5	0.6	35.4	7.7	8.2	1.3
2) Health Expenditures	1.5	1.7	14.4	-	0.2	0.0
a) General Medication[2]	0.2	0.2	-2.2	-	0.1	0.0
b) General Treatment and Health Equipment	0.3	0.4	11.9	-	0.1	0.0
c) Green Card Health Services	0.9	1.1	18.8	-	0.0	0.0
3) Other Purchases of Goods and Services	0.7	1.1	64.7	16.0	7.1	1.1
IV. Current Transfers	13.1	14.9	13.1	24.4	60.9	9.6
1) Duty Loss	1.7	0.2	-90.7	12.9	1.2	0.2
2) Government Subventions	7.4	9.2	25.3	26.7	34.5	5.5
a) Financing of Social Security Deficit	6.7	6.6	-2.1	51.5	12.8	2.0
3) Subsidies to Households	0.1	0.2	207.6	23.5	0.9	0.1
4) Agricultural Subsidies	1.4	1.1	-20.8	21.3	5.3	0.8
5) Shares from Revenues	2.5	3.8	53.2	22.3	17.0	2.7
V. Capital Expenditures	1.0	1.3	26.0	10.4	12.1	1.9
VI. Capital Transfers	0.3	0.4	37.0	12.0	3.7	0.6
VII. Lending	0.8	0.9	2.4	23.4	3.7	0.6
VIII. Reserve Appropriations	0.0	0.0	-	0.0	2.4	0.4
Central Government Revenues	**38.3**	**46.1**	**20.3**	**24.5**	**188.2**	**29.8**
I-Tax Revenues	31.3	34.0	8.6	21.4	158.3	**25.1**
1. Taxes on Income, Profits and Gains	9.2	10.0	9.4	22.2	45.3	7.2
a) Income Tax	5.8	7.0	20.4	21.0	33.4	5.3
b) Corporate Tax	3.4	3.0	-9.9	25.3	11.9	1.9
2. Taxes on Property	1.2	1.4	13.7	38.1	3.6	0.6
3. Domestic Taxes on Goods and Services	13.4	14.2	6.1	20.7	68.8	10.9
a) Domestic Value Added Tax	3.9	3.9	-0.6	19.0	20.2	3.2
b) Special Consumption Tax	8.0	8.6	7.4	21.0	41.1	6.5
4. Taxes on International Trade and Transactions	5.6	6.3	12.4	19.5	32.1	5.1
a) VAT on Imports	5.2	5.7	10.0	19.2	29.6	4.7
II-Non-Tax Revenues	7.1	12.2	72.0	40.7	29.9	4.7
1. Enterprise and Property Revenue	2.0	2.0	-0.2	17.8	11.2	1.8
2. Interests, Shares and Penalties	4.7	4.1	-14.4	26.2	15.5	2.4
3. Special Revenues, Grants and Aids[2]	0.2	0.2	-3.1	38.3	0.6	0.1
4. Capital Revenues	0.1	5.9	6047.4	225.6	2.6	0.4
Budget Balance	**-1.1**	**-3.3**	**217.5**	**19.8**	**-16.8**	**-2.7**
Primary Balance	**10.2**	**12.6**	**23.5**	**35.0**	**36.1**	**5.7**

[1]GNP growth rate for 2007 taken from SPO Program of 2007.

[2] Annual percentage change is not zero, because values for related items have been rounded off.

Source: Ministry of Finance .

As regards non-interest expenditure items, health and personnel expenditures increased by 14.4 percent and 25.2 percent, respectively. Unlike other expenditure items, the personnel expenditures item does not display notable monthly fluctuations. Therefore, the 25.2 percent-increase observed in the January-March 2007 period might be maintained throughout the year.

By end-2006, the primary balance for the program-defined consolidated public sector (excluding State Economic Enterprises (SEE)) exceeded the program target by YTL 2.8 billion (Table 6.1.2). According to the financial figures of local administrative bodies, which were announced by the Ministry of Finance for the first time, the consolidated local government budget deficit and the primary deficit equaled to YTL 1.36 billion and YTL 0.68 billion in 2006, respectively. It is believed that these deficits will not pose a risk against achieving the budget and primary balance targets for 2006, thanks to the better-than-targeted performance of the central government budget.

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

	2005	March 2006	June 2006	Sept. 2006	Dec. 2006
			Realizations		
Primary Balance	**28.3**	**10.6**	**25.0**	**33.2**	**-**
Primary Balance (Excluding SEEs)	**23.6**	**8.4**	**22.1**	**31.4**	**34.6**
Central Government Budget	24.1	7.6	20.4	30.6	33.5
Overall Balance	**-4.2**	**1.2**	**7.1**	**2.0**	**-**
Central Government Budget	-11.5	-2.4	1.0	-2.8	-6.9
			Targets		
Program					
Primary Balance	30.5	7.6	17.3	29.3	34.1
Primary Balance (Excluding SEEs)	26.7	7.3	16.4	27.6	31.4
Overall Balance	-19.6	-3.7	-4.1	-5.9	-6.9
Adjusted Program					
Primary Balance	30.4	7.8	17.4	29.7	34.5
Primary Balance (Excluding SEEs)	26.7	7.5	16.4	28.1	31.8
Overall Balance	-19.7	-3.4	-3.9	-5.5	-6.5

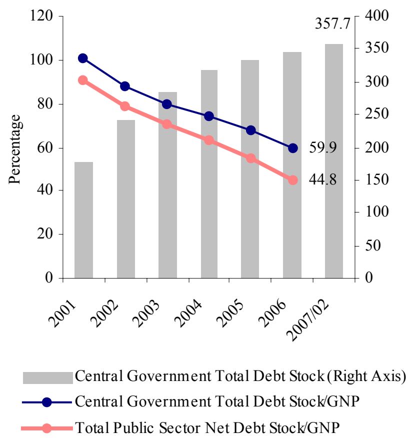
* Figures for 2006 are provisional.
Note: Consolidated Public Sector = Central Government + 23 SEEs + Extra budgetary Funds (Defense Industry Support Fund, Privatization Fund and Social Assistance and Solidarity Encouragement Funds) + Social Security Institutions + Unemployment Insurance Fund.
Overall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

6.2. Developments in Debt Stock

By February 2007, central government debt stock, which constitutes a large share of the total public debt stock, increased by 3.7 percent over 2006 to YTL 357.7 billion. A detailed analysis of the said increase reveals that the increases in net domestic debt and net foreign debt amounted to YTL 11.7 billion and YTL 1.7 billion, respectively. While the overall effect of exchange rate movements reduced central government debt stock by YTL 1.8 billion, the parity effect increased it by YTL 0.1 billion. Meanwhile, by end-2006, the ratio of net total public debt stock to the GNP was 44.8 percent, maintaining its downward course of recent years (Graph 6.2.1).

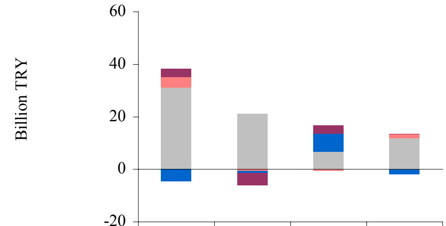
Graph 6.2.1. Public Debt Stock Indicators (Billion YTL)

Public Sector Debt Stock Indicators



Source: Treasury.

Analysis of Change in Central Government Total Debt Stock



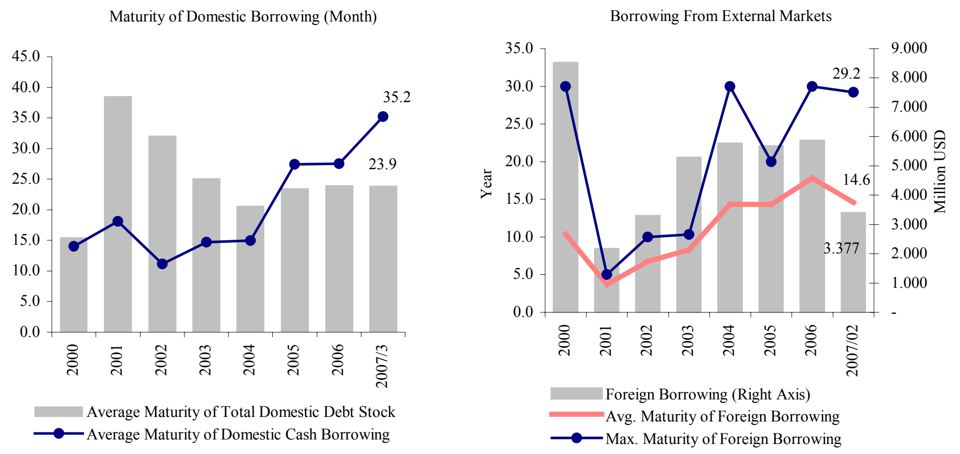
	2004	2005	2006	2007/2*
Parity Effect**	3.0	-4.8	3.1	0.1
Total Exc. Rate Effect***	-4.6	-0.8	6.9	-1.8
Net External Borrowing	4.1	-0.6	-0.4	1.7
Net Domestic Borrowing	31.2	21.1	6.7	11.7

Source: Treasury, CBRT.
* Changes compared to 2006.
** 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 is drawn in line with strategic standard setting[1], the average maturity of cash borrowing, which sets the maturity of debt stock, became significantly shorter in the May-July 2006 period due to financial turbulence. As the issue of both variable and fixed coupon securities with five-year maturity resumed as of September, debt stock maturities extended to 27.5 months in 2006. The average maturity of cash borrowing was extended to 29.2 months by March 2007, due to the impact of long-term bonds issued in February and March. Meanwhile, the average maturity of total domestic debt stock was 23.9 months. By February 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.

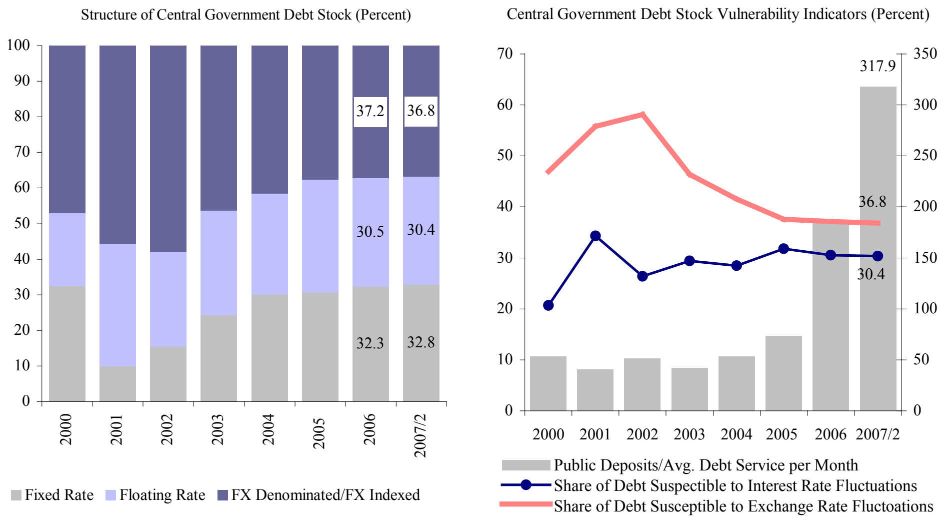
Graph 6.2.2. Maturity of Borrowing from Internal and External Markets



Source: Treasury, CBRT.

In February 2007, the share of fixed- and variable-rate debt instruments in central government debt stock increased, while the share of securities susceptible to exchange rates fell. 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 roll-over ratio to 80 percent, which together 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 as high as 36.8 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 diminishing the liquidity risk, the ratio of public deposits to average monthly debt service reached a very high level by 317.9 percent in February 2007. The high primary surplus and privatization revenues from 2006 played a significant role in this increase (Graph 6.2.3.). Any depreciation of the New Turkish lira or a rise in interest rates is considered a risk to debt stock. However, the large amount of FX- and YTL-denominated deposits held by the Treasury limits this risk.

Graph 6.2.3. Structure of Central Government Debt Stock



(1) Debt stock susceptible to interest rates contain discounted securities with maturity less than 1 year and government securities with flexible interest rates.
(2) 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 that are 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 April 2007 to April 2009.

7.1. Current Stance, Short-term Outlook and Assumptions

Similar to previous Inflation Reports, the assumptions that provide a basis for the medium-term forecasts are divided in two groups: assumptions *pertaining to domestic economic activity* and assumptions *pertaining to external factors*. These assumptions are developed by the data set that has been updated in light of the new data from the last three months following the publication of the January Inflation Report and by compiling the detailed analyses and expert opinions presented throughout this Report.

The analyses regarding the current economic situation and the short-term outlook constitute the starting point of these forecasts. Sub-components of GNP data announced in April are consistent with the forecasts for the last quarter of 2006 given in the January Inflation Report. Thus, as was predicted, net exports limited the slowdown in total demand in this period, by making a significant contribution to growth as import growth moderated and the strong export performance persisted parallel to the slowdown in domestic demand. Data relating to demand conditions for the last quarter of 2006 indicate that domestic demand will contribute to growth at a subdued rate and that growth will be mainly driven by foreign demand in the first quarter of 2007.

In light of these developments and considering the tight stance of monetary policy, the framework of forecasts is based on the assumption that demand conditions will continue to support the disinflation process throughout 2007. However, considering the revisions made in the growth figures of 2006, the output gap has been revised upwards for the last quarter of 2006 compared to the January Inflation Report. In other words, the support given by the lagged effects of demand conditions in 2006 to the disinflation process might be slightly less than that was predicted in the January Inflation Report.

In the January Inflation Report, the assumptions were based on a framework in which real exchange rates contributed to the disinflation process, albeit not as much as they did at the beginning of 2006. Our assumptions for the impact of real exchange rates on the disinflation process are maintained in this Inflation Report. Parallel to the January Inflation Report, this Report also presents an outlook where the current level of real interest rates indicates tight monetary policy and continue to contribute to the disinflation process by restraining demand conditions.

In the first quarter of 2007, the anticipated correction in unprocessed food prices did not materialize. Moreover, in spite of some improvement in services prices, the decline in annual services inflation has been less than anticipated. As a consequence, by the end of March annual inflation exceeded the forecast presented in the January Inflation Report. In this framework, short-term forecasts regarding annual inflation have been revised upwards.

It is estimated that the decline in inflation will be more discernible as of the second quarter of 2007 with the removal of the high base effect created by the supply-side shocks that emerged in 2006 and the weakened impact of the depreciation of exchange rates on prices in the post-May period.

The prevalence of backward-looking pricing behavior in the services sector is one of the main reasons for the rigidity in services inflation. The relatively low productivity increases and the high susceptibility to wage increases are also influential on the high-rated inflation in the services sector. From April 2007 onwards, it is expected that services inflation will decrease to some extent due to the removal of the impact of last year’s depreciation of the YTL on annual inflation and the slowdown in domestic demand. However, under the foresight that the effects of wage increases will continue throughout the year, oil prices will not display a significant decrease and structural factors in the housing sector will prevail; it is estimated that the decline in services inflation will remain limited in 2007.

Besides our projections on domestic economic activity, the assumptions pertaining to external factors are also important inputs forming the basis of our medium-term inflation forecasts. This set of assumptions is comprised of: findings related to macroeconomic variables of the Eurozone such as interest rates, inflation and growth; and projections pertaining to the course of international commodity prices and global liquidity conditions. Assumptions regarding the Eurozone are taken from the April 2007 issue of “Consensus Forecast”. According to these assumptions, growth in the Eurozone, which was between 2.5 percent and 3 percent by the first quarter of 2007, will be around 2 percent by end-2007 and will range between 2 percent and 2.5 percent by end-2008.

The Harmonized Index of Consumer Prices (HICP) inflation is estimated to reach the 2 percent-target by mid-2008 and to remain at this level until the end of 2008. Parallel to the growth performance in the Eurozone, which has continued above its long-term potential and ECB’s emphasis on inflation, this Report presents a framework in which the ECB would tighten its monetary policy by raising interest rates gradually. As the course of international liquidity conditions is also important in the process of making medium-term forecasts, the monetary policy projections of not only Eurozone, our largest trade partner, but also those of developing countries are carefully evaluated.

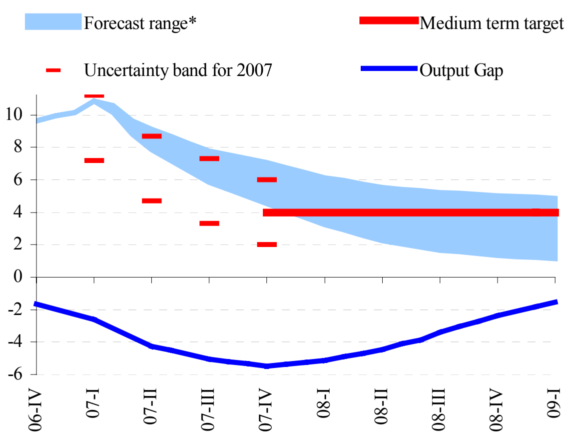
Oil prices have displayed higher increases than expected in the January Inflation Report. The upward trend of oil prices since mid-January mainly stemmed from the upsurge in the demand created by winter conditions. These price increases were also fuelled by OPEC’s production cuts to harmonize with the lowered production quota that took effect on February 1, 2007. Therefore, the international oil price per barrel, which was assumed to be US dollar 55 in the previous Inflation Report has been revised to US dollar 60 per barrel in this Report. Due to the difficulty of making a clear projection regarding the course of oil prices in producing forecasts, it was assumed that crude oil prices would follow a horizontal course at around US dollar 60.

As the change in global liquidity conditions following the financial turbulences in May and June 2006 lasted for a shorter period than expected, in the January Inflation Report it was assumed that there would be no significant change in the risk premium. Our assumptions for the risk premium are maintained in this Inflation Report as there has been no development since January that would lead to a significant change in this assumption.

7.2. Forecasts and Monetary Policy

The "Risks" section of the January Inflation Report asserted that the tight monetary stance can be maintained for an extended period of time in case inflation shows a stronger-than-expected resistance. Indeed, the upside revisions mentioned above as well as the first quarter data on inflation expectations and services inflation further underpin the need to stay more cautious compared to the January Inflation Report to ensure the consistency of the medium-term outlook with the targets. Within this framework, the forecasts presented in this Report are based on a scenario where policy rates remain constant in the second and third quarter of the year and eased thereafter; however, this easing is envisioned to be more cautious than the one outlined in the January Inflation Report. In other words, the Committee -as hinted in the March meeting and stated in the April meeting- envisions a policy perspective in which the cautious policy stance is enhanced in order to achieve medium-term targets.

Graph 7.2.1. Inflation and Output Gap Forecasts



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

The projections consistent with this perspective point out that the downward trend in inflation will be more discernible in the second quarter of 2007. It is forecasted with 70 percent probability that the annual inflation rate will be within 4.5 – 7.1 range (mid-point 5.8) at the end of 2007 and within 1.3 – 5.0 range (mid-point 3.2) at the end of 2008. These projections imply that meeting the medium-term target of 4 percent requires the maintenance of the tight monetary policy stance.

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 underpin the disinflation process throughout 2007. 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 CBT. Therefore, the policy perspective is subject to change as economic conditions and assumptions change.

Consequently, considering the developments of the last quarter, end-2007 inflation forecasts are revised upwards compared to the January Inflation Report and the cautious stance of monetary policy is enhanced in order to achieve medium-term targets.

7.3. Risks

Recent data that have been released within the last 3 quarters are broadly consistent with the forecasts regarding the macroeconomic developments that have been presented in Inflation Reports published since July 2006. The impact of monetary tightening in the second half of 2006 on demand is visible, especially through the slowdown in expenditures of durable goods and machinery-equipment investments. Robust performance of exports has been offsetting the contractionary impact of the slowdown in private domestic demand and contributing positively to the growth rate. Nevertheless, the uncertainties over the monetary transmission mechanism continue to pose a risk for the medium-term inflation outlook. While the recent hikes in non-interest public expenditures seem to further blur the outlook, the proposed cut-down in certain non-interest public expenditure items have somewhat relieved these concerns. In sum, a lower-than-expected impact of slowdown in aggregate demand still remains as a risk factor on inflation. Should such a risk materalize, the CBT may update its policy perspective through further tightening the policy stance.

Another risk related to the medium-term inflation outlook is the stickiness in inflation expectations and backward looking price setting which would lead to a higher-than-expected inertia in the disinflation process. The improvement in inflation expectations came to a halt in the last three months. Although the expectations should come down gradually as the headline inflation eases, the sticky medium-term inflation expectations remain to be a risk for the inflation outlook through its possible reflections on the price and wage setting behavior. The CBT will keep its cautious stance for an extended period should such risk materialize.

Possible fluctuations in global markets remain as a risk to the inflation outlook. The prevailing uncertainties in the US economy and the continued global imbalances still have the potential to trigger fluctuations in international markets, which may have adverse impacts on emerging economies. Moreover, the elevated levels of crude oil prices do not help to ease the risks related to global financial markets. On the other hand, the Treasury's strong cash accounts and the recent slowdown in the deterioration of the current account have the potential to mitigate the impact of possible fluctuations in the financial markets. In what so ever, should a shock lead to heigthened perception of uncertainty, the CBT will retain the medium-term perspective and announce the appropriate strategy to bring inflation back to the target.

Price stability is essential for increasing the potential of the economy, achieving a high and sustainable growth rate, and enhancing public welfare. Attaining the ultimate goal of price stability will only be possible with prudent monetary policy. Economic agents should be patient in this process in order to reap the long-term benefits of the price stability.

Prudent monetary policy is necessary but not sufficient for achieving long-run price stability. The role of fiscal policy and structural reforms are also critical in this process Developments in structural reforms that would enhance the quality of fiscal discipline in the medium and long run are closely monitored in terms of both macroeconomic stability and price stability. The European Union accession process and the sustained implementation of the structural reforms envisaged in the economic program also remain of concern. Continued determination in implementing the decisive steps taken in these areas in recent years will strengthen the resilience of the economy against possible changes in the global conjuncture.

GRAPHS

1. OVERVIEW

2. INTERNATIONAL ECONOMIC DEVELOPMENTS

3. INFLATION DEVELOPMENTS

4. SUPPLY AND DEMAND DEVELOPMENTS

5. FINANCIAL MARKETS AND FINANCIAL INTERMEDIATION

6. PUBLIC FINANCE

7. MEDIUM TERM PROJECTIONS

TABLES

2. INTERNATIONAL ECONOMIC DEVELOPMENTS

3. INFLATION DEVELOPMENTS

4. SUPPLY AND DEMAND DEVELOPMENTS

5. FINANCIAL MARKETS AND FINANCIAL INTERMEDIATION

6. PUBLIC FINANCE

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
IFS	International Financial Statistics
IMF	International Monetary Fund
ISE	Istanbul Stock Exchange
LME	London Metal Exchange
MPC	Monetary Policy Committee
MSCI	Morgan Stanley Capital Index
OPEC	Organization of the Petroleum Exporting Countries
SCA	Special CPI Aggregates
SCT	Special Consumption Tax
SEE	State Economic Enterprises
SPO	State Planning Organization
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