Strategic Planning & Research

MONTHLY BULLETIN*

JANUARY 2007

GENERAL OUTLOOK

EU/Turkey: Freezing winter...

The European Council agreed on December 15th on a partial suspension of accession negotiations with Turkey. After intensive discussions, the EU leaders unanimously backed an unprecedented Commission recommendation that proposes to freeze 8 out of 35 chapters or policy areas until Turkey fully complies with the Ankara Protocol. They also agreed that chapters not affected by the suspension should go ahead but not be concluded unless Ankara opens its ports and airports to Greek Cypriot vessels and planes. The decision mandates the Commission to carry on regular annual reviews, in particular in 2007, 2008 and 2009, on the progress made by Turkey in the implementation of Ankara Protocol.

EU ministers also reached a political agreement on the economic development of Turkish Northern Cyprus. They agreed to return to the negotiation table at the Council meeting in January to discuss the trade regulation that has been blocked since July 2004 by Greek Cypriot Administration. When approved, the regulation will facilitate direct trade between the EU and Northern Cyprus. However, the Greek Cypriot government wants to avoid any situation where there is any link made between the implementation of the Ankara protocol and the isolation of Northern Cyprus. The Turkish government made its opening of its ports and airports to Greek Cypriot traffic conditional on the end of northern Cyprus's trade isolation.

When commenting on the EU's decision, Turkish Foreign Minister Abdullah Gul stressed that the decision indicated the bloc's lack of vision. Gul, stated that, a new period had started in relations with EU, which has an internal depression, but they will not deviate from EU membership target and they will continue to adopt reforms.

On the other hand, the permanent representatives of EU member states in Brussels (Coreper) agreed on December 20th to send a letter inviting Turkey to open talks in one new chapter of the accession talks, the enterprise and industry chapter, which fell short of Ankara's expectations. Due to pressure from Greek Cypriot Administration and countries such as France and Austria, Coreper did not opt for a quick opening of talks in more than one chapter. Despite the European Council's decision and the Commission's recommendation, Greek Cypriot Administration blocked the opening of three

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chapters on which all conditions were met and technical preparations were finished. Both Turkey and the Commission were ready to open talks in four chapters. Since October 3rd, 2005, when Turkish accession negotiations started, Ankara has only been able to open and provisionally close one chapter: science and research.

IMF approved the fifth review with Turkey...

The IMF approved its fifth review of Turkey's loan program, which allows the government to draw USD 1.13 billion from its USD 10.05 billion financing agreement. As part of the latest review, the IMF approved Turkey's request for waivers on several performance criteria. Specifically, Turkey didn't meet her September-end targets for government spending, nor did it submit income tax reform legislation to Parliament, the IMF stated. In a statement, IMF First Deputy Managing Director John Lipsky said the country had shown economic resilience amid turbulence in global emerging markets in May and June, with growth remaining robust. However, he also affirmed that Turkey's inflation rate was well above target, the current account deficit was widening and public debt was high. He stated that the Central Bank's tightening bias was appropriate, given the inflation problem, which will help lower it toward government targets over time. He welcomed Turkey's commitment to a 6.5% of GNP primary budget surplus target for 2007 but urged authorities to keep spending under control and to maintain the tax base. He encouraged the authorities to keep up their reform agenda, saying it will help sustain growth, maintain market confidence and reduce economic vulnerabilities.

Turkey postponed social security reform launch to June...

Turkey will implement the social security reform in June, six months behind schedule according to the government. The Constitutional Court blocked parts of the reform, which renovates the social security system by raising the retirement age and creating a single social security institution. The Ministry of Labour declared that the reform, whose initial passage through Parliament was also delayed, would be implemented six months later than planned because of the Constitutional Court's ruling. That ruling followed an appeal from President Ahmet Necdet Sezer, after his own veto of the reform was overruled by a second vote in Parliament. The IMF representative in Turkey, Hugh Bredenkamp, said the Fund was ready to help the government to find a way out of the impasse.

World Bank urges Turkey not to slacken reform in election year...

World Bank Vice President Shigeo Katsu called on Turkey to stick to the path of economic reform without any slackening in 2007 when the country faces two elections. Katsu also called on the government to speed up work to complete the privatization of the public bank Halkbank, enact a long-delayed mortgage law and improve conditions in the labour markets. The government, he added, should also keep up efforts to overhaul the troubled social security system after the Constitutional Court cancelled several provisions in the new social security law, throwing into uncertainty some planned reforms.

EU image improves among Turks according to Eurobarometer poll...

The European Union's image is improving in Turkey, despite heated debates and tension over the Cyprus standoff, a public opinion poll showed. For 55% of Turks, the EU conjures up a positive image said the Eurobarometer poll, published by the European Commission, indicating a 12-percentage points improvement in Turkish public perception of the bloc’s image when compared to the spring 2006 survey. The Eurobarometer poll was carried out between September 6 and October

10, two months before EU leaders unanimously agreed to freeze eight out of the remaining 34 negotiating chapters with Turkey.

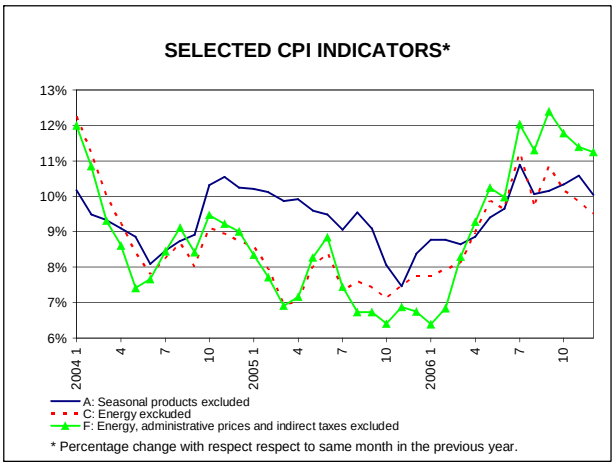
Turkey's economic performance better than some EU members according to the Swiss-based World Economic Forum...

The Switzerland-based World Economic Forum has praised the Turkish economy, which has shown a better performance than the EU member country Poland and candidate countries Bulgaria and Romania. The 2006 Lisbon Assessment Report, which evaluated the economic performances and the competitive structures of the current EU members, future members and candidates, has placed Turkey above Bulgaria and Romania, which have joined the Union at the start of 2007. The report looked at Turkey's higher productivity and competitive structure to arrive at their conclusion. In its economic assessment, the World Economic Forum designated Croatia's as the country with the highest potential for membership. According to the report, Croatia and Turkey's performances were close to each other. However, the report also said Turkey's performance in agriculture, where about a fourth of its labor power is employed, is remarkably low. Therefore, Turkey needs another set of regulations to be able to meet the EU membership criteria. Moreover, the country is trying to cope with an inflation rate still higher than the EU average. The best performing countries of the EU are Denmark, Finland, Sweden, Netherlands and Germany.

AN OVERVIEW OF ECONOMIC DEVELOPMENTS

In December, both CPI and PPI inflation rates came below market consensus....

Consumer prices (CPI) rose by only 0.23% in December; as a result of which, the annual CPI inflation ended the year at the 9.65% level, well above the 5% target. After the financial turmoil in May-June period, it was almost certain that the year-end target would be missed and this was also acknowledged by the Central Bank (CB). The producer prices, on the other hand, declined by 0.12% in December, leading to an annual inflation of 11.58%. When compared to 2005 year-end, it can be seen that the financial turmoil which occurred in May and June, led the CPI inflation to increase from 7.72% to 9.65% and the PPI inflation from 2.66% to 11.58%, in 2006.



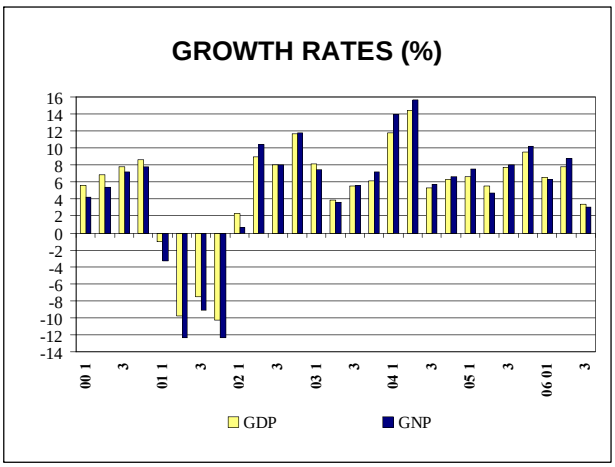
In terms of the consumer prices, it can be observed that the lower than expected. December inflation was mainly the result of the 2% decline in the clothing and footwear prices. Although we have been expecting a decline in this category, the year-end activities combined with the religious holiday seems to have resulted in a more than expected decline. Meanwhile, price declines in the communication sector (-0.14%), as well as other goods and services category (0.12%) helped to reduce the increase in the overall CPI. It is also interesting to note that although the price increase in the housing category (0.71%) in December was high compared to other categories of the CPI, it was the lowest increase registered since June. However, this should not be interpreted as a trend change in housing prices.

Another fact worth to note is that the increase in all the special CPI indicators seem to have come to a halt, as the annual increase in all these indicators declined in December. The annual inflation based on the H indicator, which is closely monitored by the Central Bank and which excludes energy, unprocessed food, alcoholic beverages, tobacco products and gold, declined slightly to 8.9% in December from 9.1% in November. However, the decline in special CPI indicators being very slight, it is too early to conclude that inflation began to head downwards.

Meanwhile, the negative PPI inflation in December was a result of declining agricultural prices (-1.07%), despite the unfavourable seasonality during the winter period. It is worth noting that since 2003 –which is the year the new index begins-, agricultural prices registered high increases from September to December, whereas in 2006, inflation in the agricultural sector has been negative since October. Meanwhile, inflation in the manufacturing industry was almost nil (only 0.06%) in December, with almost half of the sub-sectors registering price declines, which was also effective in reducing inflationary pressures. Finally, the 0.44% monthly price increase in the utilities sector was the only factor increasing the overall PPI.

We expect the CPI inflation to be 6.5% as of 2007 year-end.

Third quarter GDP growth came out below our expectation…

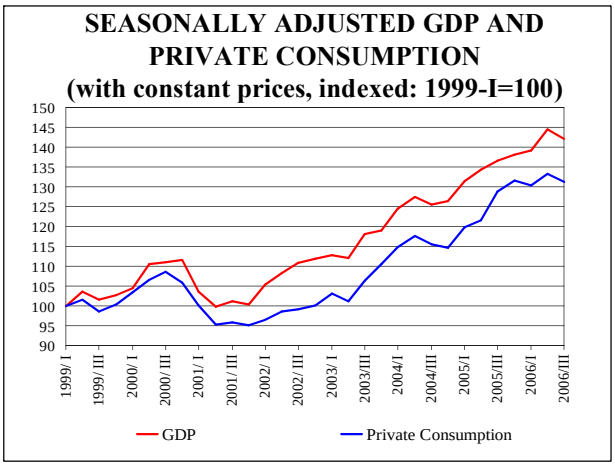


The growth figures for the third quarter of the year, which came out well below consensus forecasts, indicate that the effect of the May-June financial turmoil on the real economy has been more severe than expected. The GDP (Gross Domestic Product) growth, which was 7.2% during the first half of the year, fell to 3.4% during the third quarter. The GNP (Gross National Product), on the other hand, grew by 3% during the July-September period, compared to an increase of 7.7% during the first half of the year.

It is interesting to note that the industrial production remained quite strong (6.4% rise) during this period, while the growth in the construction sector was surprisingly high as well, namely 20%. Hence, the slowdown in the economic activity emanated mainly from the sluggish performance in the services sector (2.8% rise). Meanwhile, the 2% decline in the agricultural output was another factor effective in reducing the overall GDP growth.

An analysis of the national income figures based on expenditures indicate that the decline in the GDP growth was mainly driven by the considerable slowdown in private sector's consumption expenditures, as already suggested by various consumption and domestic demand indicators. In fact, private consumption, which surged by 9.4% during the first half of the year, rose by a mere 1.3% during the third quarter. It is especially worth to mention the drastic decline (8.9%) in expenditures of durable goods during the period under consideration. In contrast, private sector's expenditures on semi and non-durable goods did not cut pace and surged by 20.9% during the third quarter of the year. Meanwhile, it should also be noted that the public sector's consumption

expenditures continued to rise for the eight consecutive quarter, which was previously evidenced by the budget data. However, this has not been causing a problem in terms of budgetary discipline so far, since revenues were increasing strongly as well.

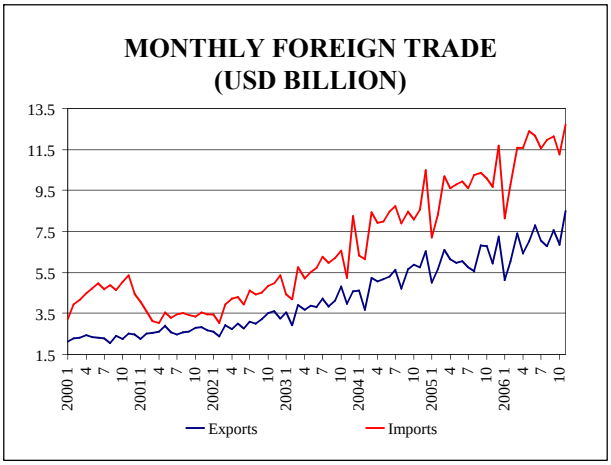


In terms of investments, private sector's investment expenditures continued to increase during the July-September period, however at a slower pace (13%) compared to the past five quarters. Public sectors' investment expenditures, on the other hand, fell by 5.6% during the third quarter of 2006, followed by a 11.4% decline in the previous quarter. It should be noted that investment expenditures of the public sector had increased strongly from the beginning of 2005 until the first quarter of 2006. Finally, despite the widening trade deficit in USD terms, the contribution of net exports on growth, when calculated in YTL terms, has been positive during the third quarter of the year.

We expect the GDP growth for 2006 as 5.2%, while the 2007 GDP growth is projected to be around 5.4%.

SELECTED ITEMS FROM NATIONAL INCOME ACCOUNTS					
	Jan.-Sept. 2005	**2006 QI**	**2006 QII**	**2006 QIII**	**Jan.-Sept. 2006**
By kind of activity					
Agriculture	7.3	5.4	-1.6	-2.0	-1.2
Industry	5.3	4.5	10.8	6.4	7.3
Construction	24.3	27.1	14.7	20.0	20.1
Services	6.2	6.3	6.8	2.8	5.1
GDP	6.7	6.5	7.8	3.4	5.6
GNP	6.8	6.4	8.8	3.0	5.7
By kind of expenditures					
Private consumption	6.4	8.4	10.4	1.3	6.2
Public consumption	3.8	8.1	18.0	15.4	14.2
Private investment	18.9	30.4	15.4	13.0	18.8
Public investment	34.0	34.4	-11.4	-5.6	-2.2
Exports	7.7	2.9	3.4	5.7	4.1
Imports	10.2	8.2	9.5	1.7	6.6
GDP	6.7	6.5	7.8	3.4	5.6

Record high monthly export and import figures…



In November, both the exports and imports hit historically high levels. Exports amounted to USD 8.5 billion and imports surged to USD 12.7 billion. These figures brought the cumulative exports and imports to USD 76.6 billion and USD 125.3 billion, respectively. It is apparent that extraordinary growth in November (42.9% and 31.4% for exports and imports, respectively) completely offset the stagnation observed in foreign trade in October, which was probably due to the delays in Ramadan period and the following holidays. The annual exports as of November reached USD 83.8 billion, while 12-month imports surged to USD 137 billion. According to the Turkish Exporters' Assembly figures, which is announced a month earlier than the official Turkish Statistical Institution (Turkstat) data, exports continued its rapid pace as of December, growing by 19.2% and amounted to USD 8.7 billion. Considering this figure, we might guess that the annual exports in 2006 according to Turkstat is likely to surpass USD 85 billion level, representing a very robust performance in a fifth consecutive year. We may also guess that imports would exceed USD 138 billion at the end of 2006, given the continuing rapid pace of intermediate goods' imports. The significant slowdown in domestic demand in the third quarter has been reflected in imports of consumption goods figures; but this alone did not suffice to affect the overall strong growth in imports in the second half of 2006.

FOREIGN TRADE FIGURES						
(USD million)	**Nov. 2005 (I)**	**Nov. 2006 (II)**	**% change (II)/(I)**	**Jan.-Nov. 2005 (III)**	**Jan.-Nov. 2006 (IV)**	**% change (IV)/(III)**
Exports	5 943	8 492	42.9	66 230	76 566	15.6
Imports	9 673	12 711	31.4	105 092	125 298	19.2
Capital goods imports	1 771	2 058	16.2	17 990	19 909	10.7
Intermediate goods imp.	6 634	9 319	40.5	74 183	90 248	21.7
Consumption goods imp.	1 234	1 289	4.5	12 417	14 546	17.1
Foreign Trade Balance	- 3 731	- 4 219	13.1	- 38 861	- 48 732	25.4
Exports/Imports (%)	61	67	-	63	61	-

Examining imports in the October-November period with respect to the same period of the previous year to offset the possible distorting effect of October's stagnation, it is observed that capital goods imports grew by 9.3%, not reflecting a significant slowdown. Imports of intermediate goods in this period, on the other hand, exhibited very strong growth, namely 28%. Imports of consumption goods have been contracting since August and the 4.5% increase in November does not point at a significant recovery. The details of consumption goods imports suggest, however, that it is only the contraction in imports of automobiles that leads to the apparent slowdown. In other major components, such as the durables and semi-durables a change in the robust growth trend has not been observed.

In November, it is worth to note that exports of automobiles and iron and steel products contributed 16 percentage points of the total 42.9% growth. During the whole year, apart from these two sectors, electrical and other machinery and mineral fuels and oils were other strong performers.

Current account deficit has not cut pace as of October…

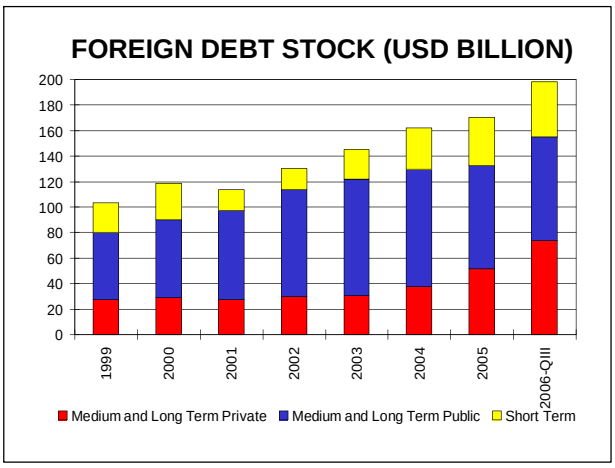
Current account recorded a deficit of USD 2.5 billion in October, in line with market expectations. This brought the cumulative deficit in the first ten months to USD 28 billion. Although moderate domestic demand led to a slowdown in imports of capital and consumption goods in the recent months, robust export activity backed up strong growth in intermediate goods imports. Apart from the expansion in trade deficit, the deterioration in services income is quite marked in the first ten months of 2006, mainly owing to declining tourism revenues. More specifically, income from services declined by 15.2% in the first ten months of the year and the major component of it, the tourism revenues, contracted by 10%.

BALANCE OF PAYMENT DEVELOPMENTS		
(USD MILLION)	**January-October 2005**	**January-October 2006**
Current Account	**-16,767**	**-28,021**
Balance on Goods	-26,615	-35,641
Balance on Services	13,281	11,262
Balance on Investment Income	-4,649	-5,007
Current Transfers	1,216	1,365
Financial Account	**30,608**	**36,580**
Direct Investments	3,339	15,313
Portfolio Investments	8,676	6,902
Other Investments	18,593	14,365
Central Bank	-662	-1,028
General Government	-1,803	-502
Banks	10,525	-2,213
Other Sectors	10,533	18,108
Net Errors and Omissions	**2,632**	**-732**
Reserve Assets*	**-16,473**	**-7,827**
Official Reserves*	-11,546	-3,872
Use of IMF Credit and Loans	-4,927	-3,955
* A negative sign indicates an increase in reserves.		

On the other hand, the financial inflows in the amount of USD 36.6 billion in the ten months more than offset the current deficit. The FDI inflows, with the proceeds from the sale of Denizbank to Dexia Bank in October, reached USD 15.3 billion, constituting 42% of the total capital flows. This is a very strong figure, especially considering the fact that the FDI inflows hardly surpassed USD 1 billion before 2004. Hence, there has been significant improvement in the financing of the current account deficit in 2006. On the other hand, corporate sector's borrowing amounting to USD 17.8 billion in the January-October period, together with the USD 4.4 billion of banking sector's loans constituted 61% of total capital inflows. Net purchases of nonresidents' equity and government bonds in the local markets amounted to USD 5.7 billion in this period, while the public sector's debt repayments led to an outflow through this sector in the amount of USD 0.5 billion.

Consequently, owing to robust capital inflows, reserves increased by USD 7.8 billion in the first ten months. After repayments of loans to the IMF, Central Bank reserves rose by USD 3.9 billion. As of November, the 12-months cumulative deficit in the current account balance amounted to USD 34.4 billion. The current account to GDP ratio is likely to approach 9% at the end of 2006. In 2007, we do not expect a notable improvement in the current account deficit, unless economy slows down significantly.

The foreign debt stock rose to USD 198 billion as of the third quarter of 2006...



Turkey's foreign debt stock surged by around USD 5 billion during the third quarter of 2006, and amounted to USD 198.3 billion as of the end of September. The increase in the foreign debt stock during the first nine months of the year, on the other hand, reached as high as USD 27.7 billion, considering that the stock was standing at USD 170.5 billion at 2005 year-end. However, USD 4.7 billion of this rise stemmed from the changes in the exchange rates.

A large part of the increase in the foreign debt stock registered during the third quarter of 2006, namely USD 3.5 billion, stemmed from the rise in the private sector's debt stock. Meanwhile, the public sector's foreign debt stock increased by USD 1.7 billion during the period under consideration. However, the rise registered during the first nine months of 2006 stemmed solely from the private sector's borrowings. It is worth noting that the foreign debt stock of the private sector reached USD 110.5 billion as of the end of the third quarter of 2006, surpassing by a large margin the foreign debt stock of the public sector, which is USD 67 billion.

An analysis of the foregin debt stock according to maturity indicates that the increase in the stock during the third quarter stemmed from the rise in the medium and long term foreign debt, while the stock of short-term debt stock declined slightly. In sum, as of the end of September, 22% of the foreign debt stock (USD 43.3 billion) consisted of short-term foreign debt, whereas the remaining 78% (USD 154.9 billion) was in the form of medium and long-term debt.

The performance of the central administration budget was spectacular during the first eleven months of the year...

The primary balance of the central administration budget registered a spectacular surplus in the amount of YTL 7.1 billion in November. Besides the high tax revenue in November thanks to the temporary corporate tax revenues, which are collected every three months; the YTL 2 billion of revenues from the sale of Turk Telekom was also effective in November's high primary surplus. As a result, the cumulative surplus for the first eleven months of 2006 reached YTL 44.1 billion, surpassing by a large margin the YTL 32.2 billion target set in the 2006 budget. Hence, the Ministry of Finance's revised primary surplus estimation for 2006 announced with the 2007 budget, which is YTL 43.2 billion is very likely to be attained.

Moreover, the primary surplus according to IMF definition, which excludes some revenue items such as privatisation proceeds, cash transfers from Turk Telekom, interest receipts, CB's profit and divident payments of state banks was also considerably high during the period under consideration. In fact, the primary surplus during the first eleven months of 2006 amounted to 35.8 billion, exceeding the target of YTL 30.8 billion for the year as a whole. Even taking into consideeration the fact that the primary balance usually registers deficit in December, the IMF-defined primary surplus is likely to exceed the year-end target in 2006.

Meanwhile, the budget balance registered a surplus of YTL 3.9 billion in November, bringing the cumulative balance to slightly positive; which is a great success considering the large deficits until recently. As a result, the budget balance is expected to end up the year with a slight deficit, probably remaining around 0.5% of the GDP as estimated by the Ministry of Finance.

Although the budget performance seems to be exceptional, it should be noted that expenditures have been increasing in real terms during the first eleven months of the year; and that, the high primary surplus was a result of rising revenues, both tax and non-tax revenues. This picture raises some concerns about the sustainability of the budget performance, considering the fact that 2007 is an election year. Clearly, if the budget revenues are not as strong as this year, the expenditures should be tightened considerably in 2007 in order to sustain low budget deficits and high primary surpluses.

SELECTED ITEMS FROM CENTRAL ADMINISTRATION BUDGET (YTL million)

	Jan.-Nov. 2005	Jan.-Nov. 2006	Real change (%)	2006 budget target	Nov. 2005 / year-end real.	Nov. 2006 / year-end target
Central Administration Revenues	**-**	**157,764**	**-**	**160,326**	**-**	**98.4**
General Budget Revenues	**131,000**	**153,439**	**6.9**	**156,214**	**90.0**	**98.2**
Tax Revenues	108,205	125,952	6.2	132,199	90.5	95.3
Non-Tax Revenues	22,104	24,447	0.9	21,372	94.1	114.4
Other	690	3,040	301.7	2,643	27.3	115.0
Central Administration Expenditures	**138,096**	**157,701**	**4.2**	**174,322**	**0.0**	**90.5**
Non-interest expenditures	**96,664**	**113,633**	**7.3**	**128,062**	**85.2**	**88.7**
I. Personnel exp. & premiums to soc. Sec.	34,615	39,529	4.2	40,995	92.6	96.4
II. Purchases of goods and services	10,776	14,199	20.2	17,721	70.8	80.1
III. Current transfers	41,235	46,121	2.1	49,108	90.4	93.9
Duty losses of SEEs	*477*	*612*	*17.0*	*670*	*91.5*	*91.4*
Transfers to social security institutions	*21,763*	*22,630*	*-5.1*	*23,285*	*93.3*	*97.2*
Agricultural transfers	*3,313*	*4,559*	*25.6*	*4,000*	*89.4*	*114.0*
Other transfers	*15,682*	*18,320*	*6.6*	*21,153*	*86.8*	*86.6*
IV. Capital expenditures	6,858	8,043	*7.0*	12,452	66.8	64.6
V. Other expenditures	3,180	5,741	64.7	7,786	63.4	73.7
Interest expenditures	**41,432**	**44,068**	**-2.9**	**46,260**	**90.7**	**95.3**
Primary Balance *	**34,335**	**44,131**	**17.3**	**32,264**	**106.8**	**136.8**
Budget Balance **	**-7,097**	**64**	**-**	**-13,996**	**52.4**	**-0.5**

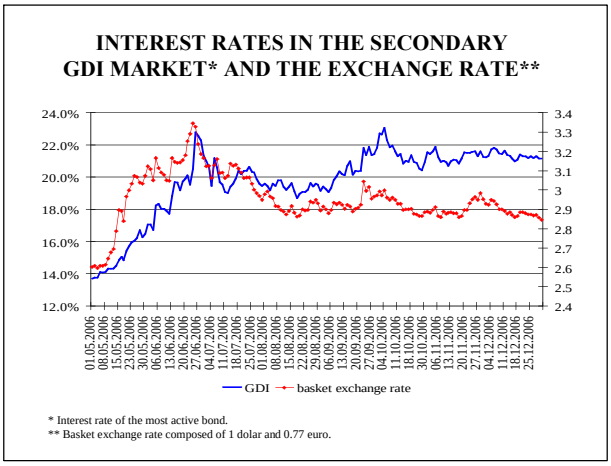
* Primary balance is calculated as "general budget revenues-non-interest expenditures" for 2005 and "central administration revenues-non-interest expenditures" for 2006.
** Budget balance is calculated as "general budget revenues-non-expenditures" for 2005 and "central administration revenues-expenditures" for 2006.

We think that the revised primary surplus and budget deficit estimations of the Ministry of Finance can be attained as 2006 year-end, namely 7.7% primary surplus to GDP ratio and 0.5% of budget deficit to GDP ratio. Meanwhile, we expect the primary surplus of the central administration budget to amount to 5.7% of GDP and the budget deficit to be around 1.9% of GDP in 2007 year-end.

FINANCIAL MARKETS

The bond and bill rates at 13.8% at the beginning of 2006 ended the year at 21% level …

The May-June financial volatility can be considered as the most important development in 2006, which affected the course of financial markets in Turkey. Until then, the local financial markets were dominated by an optimistic mood. This was due to the abundant inflows of capital to emerging markets, out of which Turkey got her share and this led to a significant decline in interest and foreign exchange rates. In the aftermath of May-June period, however, the optimistic mood in the local financial markets left its place to relative cautiousness and increased risk premiums. Hence, both the interest rates and exchange rates ended the year at quite high levels. The benchmark interest rate in the secondary bond and bill market recorded around 7.5 percentage points increase with respect to the end of 2005, reaching 21.2%, and the basket exchange rate (composed of 1USD and 0.77€) rose by 10.4% in nominal terms.



Examining the year 2006 in more detail, it is observed that until March there was abundant liquidity in the international markets which chased investment opportunities in the emerging markets. It is because of these inflows that the basket exchange rate declined by 2.9% to the lowest 2.503 level at the beginning of March with respect to the 2005-end and the interest rates declined to 13.2% (the lowest of the year) from 13.8% in the same period. Even the direct intervention of the Central Bank (CB) in the FX market and the regular FX buying auctions for reserve accumulation did not prevent the exchange rate from appreciating further. However, it should be noted that the signals of a change in the perceptions in the global economy had started as of March with the increasing inflation rates in the developed economies. For example, the ECB started to increase its interest rates, at the same time with the BOJ changing gradually its long-implemented loose monetary policy. At the US side, additionally, FED's interest rates were also on the rise, given the increasing inflation despite some signs of economic slowdown. Unluckily, this change in the expectations in the global economy coincided with the domestic problems and tensions, most prominent among them being the delays in the appointment of the new Central Bank governor, the worsening inflation expectations and tensions with the IMF due to the VAT reduction in textiles and increase in the public servants' wages. Thus, the benchmark rates could not remain at around 13% level but rose to around 13.8% in March, while the basket exchange rate increased by 4% to around 2.600. It can be said that the governmental authorities were late in observing those changes and were rather overconfident. It is

in this context that the CB reduced its short-term interest rates in April for the first time in 2006 by 25 basis points to 13.25%.

When the global sell-off strenghtened in mid-May, the CB was less willing to intervene in the financial markets but responded limitedly by increasing its short-term rates by 175 basis points at the beginning of June. However, the interest and exchange rates continued to increase, with the benchmark bond's rate hitting 22.8% at the end of June and the basket exchange rate depreciating by 28.7% with respect to the end of April. Since it was clear that the financial turmoil started to harm the economic fundamentals, the CB put into action a series of drastic measures in July to sustain the medium-term disinflation process and to reduce the volatility in the financial markets. The O/N borrowing rate was increased by a further 250 basis points, excess YTL liquidity was withdrawn and foreign exchange selling auctions were started, along with direct FX sales. All of these measures alleviated the tension in the financial markets and stopped the surge in the FX and interest rates.

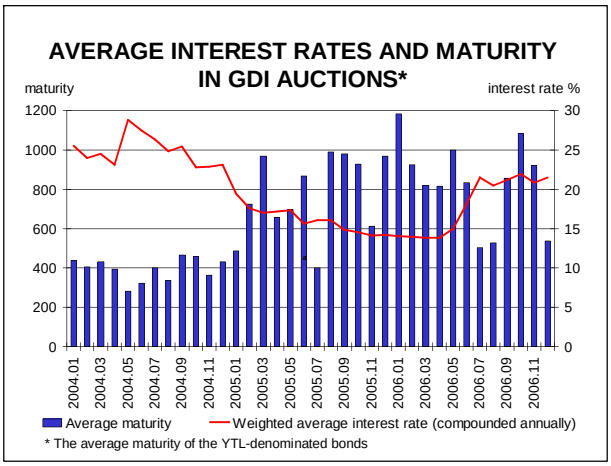
After August, the improvement in the global expectations also aided the easing of tension in the local financial markets. The FED stopped interest rate hikes, emphasizing that the signals of economic slowdown were more apparent than before, despite the continuing inflationary pressures. The capital inflows to emerging markets started again, albeit less aggressive than before. Generally speaking, the investors were more cautious in the second half of 2006 and responded to the changes in the perceptions of global economic environment and local developments more instantly, which led to moderate volatility in the financial markets. Developments in Turkey's EU membership process towards the end of the year also triggered some tension in the financial markets. Nevertheless, this created concerns but did not lead to much volatility in the financial markets. To sum up, in the aftermath of May-June volatility, although the sentiment in the financial markets improved considerably, the interest rates did not decline below 20% level, due both to increased cautious attitude of the investors and the expectations that the CB will continue its tight monetary policy in most of 2007. The decline in the exchange rates was more apparent, however, with the basket rate declining by 14% at the end of 2006 compared to the peak level during the turmoil in June, offsetting much of the bubble of the previous depreciation. At the end of December benchmark bond traded at 21.2% and basket rate was recorded at 2.845. In more detail, in 2006 as a whole, YTL/dollar rate increased by 4.8% in nominal terms to 1.412 and the YTL/euro rate rose by 16.6% to 1.860. The euro-dollar exchange rate, on the other hand, also rose significantly in 2006 by 11.3% to 1.317.

FOREIGN EXCHANGE RATES

	(1) 30.12.05	(2) 30.11.06	(3) 29.12.06	(3)/(2) % change	(3)/(2) real % change ***	(3)/(1) % change	(3)/(1) real % change ***
YTL / USD*	1.3483	1.4528	1.4124	-2.8	-3.0	4.8	-4.5
YTL / Euro *	1.5952	1.9173	1.8604	-3.0	-3.2	16.6	6.4
FX basket **	2.5766	2.9291	2.8449	-2.9	-3.1	10.4	0.7
Euro/USD rate	1.1831	1.3197	1.3172	-0.2		11.3	

* Central Bank's selling rate; ** 1 USD + 0.77 euro; *** The real change has been calculated using the CPI.

In 2006 Treasury's rollover ratio fell to 77%, significantly lower than previous years...



The decline in interest rates in 2005 and the increase in the maturity led to relatively lower domestic debt redemption in 2006 with respect to previous years. Treasury, who had redeemed over YTL 150 billion of domestic debt in the previous two years, paid YTL 145.4 billion of domestic debt in 2006. The financial turmoil of May and June was managed quite successfully, as the Treasury borrowed significantly less than its redemption during this period, to avoid excess pressure on the financial markets. Moreover, to carry on with the borrowing schedule, FRN auctions with maturities up to 2 years –instead of 5 years- were introduced. In the meantime, the Treasury was well equipped with strong cash reserves that eased the borrowing in this period.

In 2006 as a whole, Treasury borrowed YTL 112.5 billion from domestic markets, which corresponded to 77.4% of the total domestic debt redemption. Compared with the average rollover ratio of around 90% in 2004 and 2005, this represented a significant decline. In terms of cost of borrowing, the impact of the financial volatility was realized as an increase in the average interest rates in the YTL denominated auctions. More specifically, until May the average borrowing rate was recorded as 14.2%, while in the aftermath the interest rate rose to 20.3%. Consequently, compared with the average borrowing rate in 2005, it is observed that the increase in the average borrowing rate was quite limited, from 16.3% in the previous year to 18% in 2006.

Apart from domestic debt borrowing, one of the major sources of financing of the Treasury was an estimated YTL 38.4 billion of primary surplus owing to the strong fiscal performance in 2006. The privatization proceeds which was recorded more than expectations (at YTL 10.6 billion) was another source of financing. The USD 5.9 billion of eurobond issues of the Treasury this year also surpassed the USD 5.5 billion target, improving the financing conditions further.

In the Treasury's financing program, it is announced that YTL-denominated discounted GDIs (government debt instruments) constituted 66% of the net domestic borrowing (on cash basis) in 2006, while 28% was composed of FRN borrowing. The fixed coupon and FX-denominated borrowing's share was 4% and 2%, respectively.

Examining the developments in the domestic debt stock in a few words, it is observed that total stock rose by YTL 8.2 billion to YTL 252.9 billion as of November. The share of bonds increased in this period from 93% to 96%. In terms of instruments, the share of fixed rate GDIs has risen from 41.4% to 44.1%, while there is a slight decline in the share of floating rate notes from 43.1% to 41.7% in the same period. Additionally, the share of FX-indexed bonds also declined from 15.5% to 14.2% in the first eleven months of the year.

TREASURY'S DOMESTIC BORROWING IN DECEMBER 2006							
Date	**Redemption Date**	**Maturity (days)**	**Interest rate (ca, %)**	**Total Bids (Nominal)**	**Borrowing (Nominal) [1]**	**Borrowing (Net) [1]**	**Total Borrowing (Net) [2]**
05.12.06	12.12.07	371	21.02%	YTL 1.4 bn	YTL 0.6 bn	YTL 0.51 bn	YTL 1.39 bn
05.12.06	13.08.08	616	21.69%	YTL 3.1 bn	YTL 2.0 bn	YTL 1.41 bn	YTL 2.93 bn

[1] Sales in the auctions, excluding the sales to public institutions and primary dealers at uncompetitive bids and option sales.
[2] Total sales including the sales to public institutions and primary dealers at uncompetitive bids and option sales.

The first month of the year is quite heavy in terms of redemption …

TREASURY'S DOMESTIC DEBT REDEMPTIONS IN JANUARY 2007 (YTL million)				
Date	**Payments to the market**	**Payments to state enterprises (1)**	**Payments to the CBRT**	**Total**
03.01.2007	1,375	72	0	1,447
09.01.2007	6	0	0	6
10.01.2007	123	3	0	126
12.01.2007	200	0	0	200
15.01.2007	895	0	0	895
17.01.2007	3,907	323	0	4,230
24.01.2007	6,964	2,285	0	9,249
31.01.2007	93	7	0	100
Total	**13,562**	**2,691**	**0**	**16,253**

(1) Sales to the public institutions through uncompetitive bids at the price formed in the auction.

Treasury will redeem YTL 16.3 billion of domestic debt in January, of which YTL 13.6 billion will be paid to the markets. The foreign debt payments amount to YTL 1.8 billion, which brings the total debt payments in January to YTL 18 billion.

TREASURY'S BORROWING REQUIREMENT IN JANUARY 2007 (YTL billion)	
Payments	**18.0**
Domestic Debt Service	**16.3**
Principal	10.5
Interest	5.8
Foreign Debt Service	**1.8**
Principal	0.9
Interest	0.8
Financing	**18.0**
Borrowing from the markets via auctions	**10.3**
Reference T-bill auction (91 day)*	1.6
Reference T-bill auction (91 day)	2.4
Other	6.2
Other financing	**7.7**
Primary surplus	1.0
Privatization	0.0
Sales to public institutions	2.7
Foreign borrowing	0.0
Treasury's cash balance (**)	4.0

(*) Cash receipt of the reference bill auction held on 28.12.2006 will be transferred to Treasury accounts on 04.01.2007.

(**) In case of borrowing from external markets, receipts from privatization revenues or/and cash transfer from Saving Depository Insurance Fund (SDIF) to Treasury, use of cash account is subject to change.

Treasury plans to borrow YTL 10.3 billion from local markets and the remaining YTL 7.7 billion is planned to be raised mainly from the cash balance which is quite strong and sales to the public institutions.

The following is the details of the borrowing program for January:

BORROWING PROGRAM FOR JANUARY 2007				
Maturity	**Instrument type**	**Auction date**	**Value date**	**Maturity date**
6 month (182 days)	YTL, discounted (reference)	16.01.2007	17.01.2007	18.07.2007
4 year (1463 days) (r-o)	YTL, fixed coupon	16.01.2007	17.01.2007	19.01.2011
22 month (672 days)	YTL, discounted	23.01.2007	24.01.2007	26.11.2008
3 year (1092 days)	FX,	23.01.2007	24.01.2007	20.01.2010

(r-o): re-open.

Financial markets will be following the external data and the domestic political news…

The December inflation figures, despite lower than expectations, did not affect the financial markets. The benchmark August 13, 2008 bond's rate traded at around 21.2% in the first days of the new-year and the YTL/dollar rate rose slightly to 1.43 level from 1.412 at the end of 2006. Concerns about the pace of economic slowdown in the US leads to this cautious attitude in the financial markets.

In fact, in January, as in previous months, the market players will be watching the developments in the global economy closely. In addition to the ongoing concerns regarding the inflation and FED policies, the question of whether the slowdown in the US will be smooth or rapid is still an unanswered issue; hence, the global expectations change frequently upon new data, leading to moderate volatility in the financial markets. The positive scenario is that the slowdown in the US economy would be smooth and the FED would begin to reduce interest rates gradually, in which case the capital inflows to emerging markets would continue. In a worse case, the US economy would slow abruptly and its repercussions to the world economy would be very negative, especially on the emerging markets.

Moreover, another issue determining the course of interest and exchange rates is whether the interest rates would be continuing to increase in the developed countries. The strong economic performance in the Eurozone implies further rate hikes, while there are expectations that the BoJ could raise its key policy rate as early as this month. Increasing rates especially in the relatively risk-free countries is a discouraging factor for investment in the emerging markets and limits the capital inflows to those countries.

Consequently, given the concerns in the international economy, we expect that the cautious attitude of investors towards the emerging markets would continue in January, as well. In this respect, the local bond and bill rates are expected to hover around the present levels, with the 20% level being a lower limit at the moment. In case a change in global perceptions takes place, this might alleviate the pressure on the financial markets and lead to a decline in the bond and exchange rates. The declining oil prices also add to the positive mood in the international markets.

Besides, we do not expect a reduction in the CB's short-term rates in January (and at least for a while), given that the 2007's CPI target is 4%. It should be noted that the CPI inflation was

recorded as 9.65% at the end of 2006, significantly exceeding the 5% official target. Given the probable political noise ahead in 2007 due to presidential and general elections and the global liquidity concerns, the CB would be less willing to reduce rates. The local political developments may lead to volatility in the bond and bill rates, as well as exchange rates, in January.

MAIN ECONOMIC INDICATORS (January 5, 2007)

GROWTH:		
GNP	2006 – 3nd Quarter	3.0%
GDP	2006 – 3nd Quarter	3.4%
GNP	2005	7.6%
GDP	2005	7.4%
PRICES:		
Consumer Prices	2006	9.65%
Consumer Prices	December 2006, Monthly	0.23 %
Producer Prices	2006	11.58%
Producer Prices	December 2006, Monthly	-0.12%
EXTERNAL BALANCE:		
Exports (Shuttle trade excluded)	January-November 2006	USD 76.6 billion
Imports	January-November 2006	USD 125.3 billion
Trade Balance	January-November 2006	USD -48.7 billion
Current Account Balance	January-October 2006	USD -28.0 billion
Foreign Debt Stock	January-September 2006	USD 198.3 billion
CENTRAL BANK AND MONETARY AGGREGATES:		
CBRT Foreign Exchange Reserves	22.12.2006	USD 59.2 billion
Total Gross Reserves	8.12.2006	USD 97.3 billion
Total YTL Deposits	30.12.2005 – 15.12.2006, % change	16.4%
Deposit Money Banks Domestic Credit Stock	30.12.2005 – 15.12.2006, % change	38.9%
M1	30.12.2005 – 15.12.2006, % change	1.5%
M2	30.12.2005 – 15.12.2006, % change	18.5%
M2Y	30.12.2005 – 15.12.2006, % change	22.4%
PUBLIC FINANCE:		
Consolidated Budget Balance	January-November 2006	YTL 64 million
Primary Balance	January–November 2006	YTL 44.0 billion
Domestic Debt Stock	January-November 2006	YTL 252.9 billion
FOREIGN EXCHANGE:		
Devaluation Rate (TL/USD)	December 2006 (Monthly)	-2.8%
	2006 (Over year-end)	4.8%
Devaluation Rate (TL/EURO)	December 2006 (Monthly)	-3.0%
	2006 (Over year-end)	16.6%
ISE:		
ISE Composite Index	30.12.2005-29.12.2006, % change	-1.7%

NOTE: This document is prepared by the Strategic Planning and Research Section of Yapi ve Kredi Bankasi A.Ş by using official data. No responsibility is assumed for the accuracy of the information given in the document although utmost care has been taken in their compilation and processing.

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