

Durmuş Yılmaz: Economic outlook for Turkey

Speech by Mr Durmuş Yılmaz, Governor of the Central Bank of the Republic of Turkey, at a meeting organised by the Chamber of Commerce and Industry of Malatya and Dünya daily newspaper, Malatya, 7 September 2006.

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Distinguished industrialists, businessmen, guests and members of the press,

I am very pleased to be in Malatya for this meeting arranged to bring together the Central Bank and the real sector and to create common ground for exchanging views. I would like to extend my most sincere thanks to the Chamber of Commerce and Industry of Malatya and to Dünya daily newspaper for the excellent organization of this meeting.

In today's meeting, I would like to focus on the importance of Central Bank independence and price stability within the framework of our Bank's monetary and exchange rate policies. Following this I will talk about the inflation targeting regime and developments in inflation as well as those in floating exchange rate regime and financial markets and lastly, I will touch upon some of the issues at the top of the agenda, such as growth, employment and the current account deficit.

The amendment made in the Central Bank Law in 2001 was a turning point for monetary policy implementations in Turkey because as per this amendment, the Central Bank of Turkey acquired instrumental independence and the Bank's primary objective was set as achieving and maintaining price stability. Inflation has been declining since 2001, and historic lows that had not been observed in the last 30 years were made possible in this process. Independence enables the Central Bank to shape its policies free from political pressure and daily disputes, and with a medium-term perspective focusing directly on the targets. The point reached in the fight against inflation and the achievements so far confirm the importance of an "independent structure" with respect to both the legal framework and the implementation. Therefore, not merely political circles but all sections of the public are expected to take this into account - not only as an element of discourse but in their actions as a whole. It should be borne in mind that controversy over this concept leads to the questioning of economic policies and the credibility of targets, as these discussions eventually focus on monetary policy. It is obvious that these controversies may be very costly.

There is no doubt that the Central Bank will show no hesitation to continue utilizing instrumental independence in order to achieve targets and will be ready to take any risks and provide the necessary warnings.

It suffices to take a look at the past five years to see why fighting inflation is so important. The high and chronic inflation led to considerable economic and social losses in Turkey in the last 30 years. High and chronic inflation culminated in the adoption of short-term approaches, by adversely affecting expectations, investment and production decisions and deteriorating resource allocation in the economy, which brought along low and volatile rates of growth and employment and aggravated injustice in income and wealth distribution.

We have experienced all the damage of inflation in Turkey, so we expect all sections of the public to support our fight against inflation and defend the achievements we have made so far. It should be borne in mind that striving for price stability means striving for creating an environment where people can make a living, make investments and can look to the future with confidence. With this respect, price stability is a goal that cannot be sacrificed for any other priority or target.

Thanks to the policies implemented by our Bank, great progress was made in the disinflation process: inflation, which was 73.2 percent at the beginning of 2002, was recorded as 10.26 percent in August 2006.

Within the framework of the fight against inflation, the Central Bank of Turkey adopted the formal inflation-targeting regime as the monetary policy strategy at the beginning of 2006.

Now, I would like to mention a few points that I believe are important with respect to the adoption of the inflation targeting regime.

Studies on the inflation targeting regime as a monetary policy strategy were initiated at our Bank in 2000. As of 2002, the "implicit inflation targeting regime" was adopted as a strategy of convergence

with the formal inflation targeting regime and gradually the components of this regime were adopted. In line with these efforts, some changes were made in our Bank's organization and some new departments have been established, our set of data has been expanded and the decision-making processes have been further institutionalized.

By 2005, the monetary policy strategy implemented under the name of the implicit inflation targeting regime had become a regime covering most of the elements of formal inflation targeting and significant achievements had been made in the pre-conditions necessary for a successful transition to the formal inflation targeting regime. In 2006, encouraged by our achievements, the "formal inflation targeting regime" was adopted on time. The new regime necessitated a more institutionalized structure and a higher degree of transparency compared to the previous one.

In order to have a more comprehensive understanding of the course of inflation and the policy decisions of the Central Bank it is essential to have a good grasp of the framework that we have drawn for the inflation targeting regime. Therefore, I would like to take this opportunity to highlight some important elements of the formal inflation targeting regime once more in this meeting today.

Under this regime, the Central Bank adopts a medium-term perspective. Accordingly, inflation targets are announced for a period of three years. The targets pertain to consumer inflation and these "point targets" are set jointly with the government.

However, with the aim of setting a rule for the Bank's accountability principle in case inflation deviates from the target or in case a possibility that inflation might deviate from the targets emerges, an uncertainty band has been set as 2 percentage points in both directions.

In case inflation figures go outside the band or there is a possibility of inflation going outside the band, the mechanism pertaining to the accountability principle of the Central Bank would be activated and our Bank would explain the reasons of deviation from the target and provide information on the time needed for converging to the target again in an Open Letter to the Government. Such an Open Letter was written and sent to the Government on July 14, 2006 and was also publicized.

A lot of ground has been covered in the fight against inflation since 2002. However, price stability is yet to be established. It should be borne in mind that this is a long and tough journey. The developments we have observed in the last few months verify this view and make our efforts even more important.

Within this framework, in this part of my speech, I would like to talk about the developments in inflation and the monetary policy responses in the face of these developments since the beginning of 2006 and touch upon the future inflation outlook.

I am sure you have been following very closely the upward trend in inflation observed since the turn of the year. Annual inflation became 10.12 percent in June 2006, exceeding the upper limit of the uncertainty band of the inflation path consistent with the end-year inflation target and this upward trend continued in July with 11.69 percent.

The factors that played a primary role in the upward move in inflation in the first seven months of the year were seasonal factors and external developments.

Prices of unprocessed food products started to increase due to adverse weather conditions by the last few months of 2005 and inflation in this group reached 21.8 percent by July 2006.

Another factor that had an unfavorable impact on inflation was the rise in crude oil and energy prices. Parallel to the rise in crude oil prices that started in international markets in March, energy prices started to climb as of the first quarter also in Turkey and continued due to the rise in exchange rates as of May. The contribution of these increases to July inflation was 0.30 percentage points.

Owing to the fluctuations in international markets and depreciation of the Turkish lira in the May-June period, prices of gold increased by 72.6 percent annually as of July and had a negative impact on consumer prices in the first seven months of year.

Meanwhile, depreciation of the Turkish lira due to excessive volatility observed in international markets in May and June, led to hikes in the prices of petroleum products, consumer durables and the prices of goods that are set in terms of foreign currencies and prices of imported goods. One of the sub-groups that are most severely affected by this situation is the transportation group. Petroleum products prices, which are registered under the transportation group, increased by 5.9 percent and 3.3 percent in June and July, respectively. Meanwhile, automobile prices registered under the same group increased by 10 percent in April-June 2006. Prices of processed food products, which displayed a limited rise in the

first six months of the year, displayed a higher rate of increase in July due to the lagged effects of the fluctuations in exchange rates. The contribution of the depreciation of Turkish lira to consumer inflation in the May-June period reached 1.5 percentage points.

When we analyze inflation under two groups as goods and services, it is observed that inflation in the services group has decreased throughout 2006 compared to the same period last year, however especially due to the high rates of increase in house rents and restaurant-hotel prices, annual inflation in the services group became 11.7 percent annually as of July and maintained its high level. The 20.5-percent rise in house rents is remarkable in this group. Meanwhile, compared to the same period last year, the upward trend in the goods group accelerated due to the rise in unprocessed food products, international oil prices and the rise in exchange rates. Hence, the annual increase in the prices of goods reached 12.1 percent annually as of July 2006, surpassing that of services.

Price increases have been observed in all of the special CPI aggregates due to the impact of exchange rates developments on tradable goods. Within this framework, the annual rate of increase of the special CPI aggregate (D*) excluding energy, unprocessed food products, alcoholic beverages, tobacco products and gold, which is calculated in order to measure the general inflation trend, became 7.19 percent in July.

Inflation followed a track consistent with our projections and decreased by 0.44 percent in July, thus becoming 5.30 percent in cumulative terms in the first eight months and 10.26 percent in annual terms. The 1.21-percent monthly fall in food and non-alcoholic beverages prices and the 6.92-percent monthly fall in clothing and footwear prices as well as the disintegration of the base effect in the prices of alcoholic drinks and tobacco products were important factors in this decline. Especially the 4.43-percent monthly decrease in the prices of unprocessed food products became the primary factor in the decline in the food and non-alcoholic drinks group prices.

When prices of goods and services in August are analyzed separately, it is observed that annual inflation in these groups are 10.08 and 11.40 respectively, both below those of the previous month. However, it is observed that the decline in the prices of goods is faster and thus, the services group inflation is once again higher than the goods group inflation.

Moreover, the annual rate of increase in most of the special CPI aggregates declined in August and that verifies our projection that the effect of exchange rate developments on inflation would decrease in August. However, though less intense, the negative lagged effects of the depreciation of the New Turkish lira on the special CPI aggregate excluding energy, unprocessed food products, alcoholic beverages, tobacco products and gold persisted and the annual increase in this CPI aggregate reached 7.8 percent by August 2006.

This improvement in August inflation is very important with respect to attaining single-digits by the end of the year.

The upward movement in inflation in the first seven months of the year and the high rates of increase in inflation exceeding expectations especially in April and May, coupled with excessive fluctuations in international markets and perceptions of uncertainty fuelled by domestic and international developments have been deteriorating medium and long-term inflation expectations until recently. Within this framework, inflation expectations over the next 12 months, increased to 8.07 percent in July from 5.47 percent in April 2006 and expectations over the next 24 months increased to 6.07 percent in July from 4.67 percent in April, that signifies an edging away from inflation expectations.

In response to these developments, with the aim of halting this deterioration both in inflation and inflation expectations and of attaining medium-term targets, the Central Bank of Turkey has effectively used the short-term interest rates that are the main policy instruments of the Bank and has exercised strong monetary tightening, by raising policy rates by 425 basis points to 17.5 percent.

After this strong monetary tightening, the fluctuations in financial markets started to settle and the medium and long-term inflation expectations started to improve. Thus, in August, inflation expectations over the next 12 and 24 months declined to 7.94 and 6.02 respectively.

It should be borne in mind that the impact of interest rate decisions on economic activities and inflation can be observed only with a time lag. It is advisable to take this fact into account while making the analysis and evaluations.

As for the future inflation outlook, we foresee that the negative effect of the depreciation of the New Turkish lira on inflation will gradually diminish as was the case in August.

Although we have achieved rapid recovery and relative stability, the environment created by the fluctuations observed in financial markets in the May-July period are expected to weaken domestic demand in the second half of the year. Meanwhile, analyzing recent data such as those pertaining to investor confidence and to the expectations for domestic sales and orders for the next quarter, it is foreseen that the decline in domestic demand will not be a very sharp one. In other words, the impact of the fluctuations observed in financial markets in May and June on the consumption tendency is likely to be of a temporary nature. Therefore, the said impact is expected to lead only to a limited decline in total demand. Furthermore, it is estimated that the relative depreciation of the New Turkish lira will boost net foreign demand.

Despite the likely positive impact of the demand conditions observed in the second half of the year on inflation, it does not seem possible to attain the 5-percent inflation target set for end-2006. However, as a result of the measures taken by the Central Bank from June onwards, we expect the secondary effects of the developments in exchange rates and commodity prices on inflation to remain limited, the likely pressure on 2007 inflation to diminish along with the recovery observed and the downward trend in inflation to continue.

Parallel to the recovery - albeit limited - observed in inflation expectations in August and the relatively more favorable course of international liquidity conditions observed recently, the Monetary Policy Committee stated at its last meeting that the medium-term inflation outlook was much better compared to previous months and decided to keep short-term interest rates unchanged. However, as the risks against the disinflation process still persist, the cautious stance of monetary policy will be maintained. In this framework, if any development that would deteriorate inflation in the medium term arises, the Central Bank will not hesitate to resort to further monetary tightening.

As I have mentioned earlier, some risks that endanger the continuation of the downward trend of inflation in the medium term do exist.

The first risk is the continuation of the increases in crude oil prices.

Other main risk factors include the rapid changes in global risk perceptions resulting from the monetary policies of developed countries and the fluctuations that might occur in financial markets accordingly. In case such a risk materializes, the Central Bank will act with a medium-term perspective, as it does today: It will not respond to temporary increases in inflation; however, it will closely monitor medium-term inflation expectations.

Another risk factor is that by returning to old habits, variables other than the inflation target are taken as a reference in pricing behaviors. This represents the risk of deterioration in pricing behaviors. In order to prevent such a risk from materializing, the Central Bank will maintain its cautious stance until medium-term inflation expectations converge to the targets.

One of the risk factors, which are important in the disinflation process and are closely monitored, is the price rigidity in the services sector. These sectors require implementations that will increase supply and competition.

Additionally, the Central Bank carefully monitors the political risks that have come to the forefront more and more in the recent period. In this scope, in case it is foreseen that political developments in the country will have a negative effect on inflation, the Central Bank shall take the necessary measures.

It is very important in the fight against inflation and for the attainment of medium-term inflation targets that tight fiscal policy is carried out decisively. It is observed that the primary surplus targets were, to a great extent, achieved, in the last four years. In the first six months of 2006, budget surplus was provided for the first time since 1984 and 78.4 percent of the primary surplus target that was set for 2006 was reached.

It is seen that the resolute attitude towards the continuation of fiscal discipline is still maintained today. In this framework, in the scope of the disinflation process, it is very important for the Central Bank that the policies regarding public revenues and pricing are established consistently with the inflation targets and that any need for any unplanned public price adjustments is precluded by respecting the limits of budgetary expenditures.

In order for inflation to converge to medium-term targets, it is of critical importance that the structural reform process is maintained in a resolute manner and without any compromise. These reforms would enhance the quality of fiscal discipline, improve competition and the investment environment, which, in the long run, would support an increase in productivity, and would therefore contribute to the disinflation process.

Now, I would like to underline a point. In our country, expectations may change and go to extremes very rapidly. Therefore, any kind of implementation, initiative and disclosure that might lead to deterioration in risk perceptions and expectations affect the disinflation process and macroeconomic stability in a rapid, harsh and negative way. In this respect, relations with the IMF and the EU are two important anchors, especially as to medium and long-term expectations. These two factors should remain as anchors in the upcoming periods, as they bear significance for the enhancement of confidence in our country, the uninterrupted implementation of structural reforms as planned and the predictability of our economy in the medium and long-term.

The Central Bank analyzes all kinds of risks in its scenarios designed to foresee inflation and makes its forecasts accordingly. As I have mentioned earlier, on condition that the cautious stance of monetary policy, fiscal discipline and structural reforms continue, the targets set for 2007 and 2008 seem to be attainable. The target we set for 2007 and 2008 is 4 percent and all our policies are directed towards attaining these targets. It is of critical importance that economic agents use these targets as a reference while drawing up their future plans.

The floating exchange rate regime that is implemented today is the sine qua non of the inflation-targeting regime.

The basic principle of formal inflation targeting is to target only inflation itself and to make no commitments other than the inflation targets. Therefore, the Central Bank cannot make any commitments related to the level of exchange rates in an implicit or explicit manner, nor use the exchange rate as a policy instrument. It is out of the question and is impossible.

Under these circumstances, the value of the Turkish lira is determined in the short term by short-term expectations, developments related to foreign exchange supply and demand and the behaviors of market players, while the said value is determined in the medium and long-term by economic fundamentals, the course of structural reforms and the medium and long-term expectations.

However, the fact that exchange rates are determined under market conditions does not imply that the Central Bank will not conduct any transactions in the foreign exchange markets.

The Central Bank basically conducts transactions with two different aims. The first of these transactions comprises foreign exchange purchase auctions that are held with the aim of building up reserves. These transactions are conducted via daily, transparent and exchange rate-dependent mechanisms in the periods where the foreign exchange supply increases in the market and with no intention of affecting the level of exchange rates. As a result of these transactions, Turkey's foreign exchange reserves increased by 181 percent in the last four years and reached USD 57 billion as of 25 August 2006.

Nevertheless, due to the decline in foreign exchange supply, foreign exchange purchase auctions were suspended on 16 May 2006. Foreign exchange purchase auctions would be resumed in line with our strategy to increase reserves moderately when favorable conditions occurred in the foreign exchange market.

The second transaction that is conducted by the Central Bank in foreign exchange markets comprises foreign exchange interventions. They are made in order to prevent any excessive volatility that might occur in exchange rates and depending on the reasons for this volatility and potential developments. In this framework, the Central Bank may intervene directly to curb excessive volatility in either direction and use announcements and warnings.

Let me elaborate on a point related to the excessive volatility interventions. As opposed to the auctions held in the framework of our strategy to build up reserves, these interventions do not have a mechanical nature. Each situation is analyzed according to its conditions and the decision for an intervention is made accordingly. Therefore, such interventions do not have a symmetrical nature.

In this framework, in order to prevent excessive volatility, the Central Bank intervened directly in the foreign exchange markets 21 times (15 purchase auctions and 6 sale auctions) under the floating exchange rate regime.

In the framework of both strategies, the Central Bank has made a net purchase of foreign exchange amounting to USD 43.7 billion from the foreign exchange market since 2002.

In the framework of the exchange rate policy that I have mentioned earlier in detail, developments in the foreign exchange market are monitored carefully by the Central Bank as they have a direct impact

on inflation and constitute an important part of financial stability. In this scope, I would like to briefly analyze the fluctuations in financial markets.

In the period between the beginning of May - when fluctuations started - and the end of June, the Turkish lira depreciated by approximately 29 percent.

What triggered the rapid depreciation of the Turkish lira was the change in international liquidity conditions against developing countries. Global risk perceptions changed along with expectations that the central banks of developed countries would tend to increase interest rates, and global liquidity abandoned developing countries and shifted to developed countries. Along with all developing countries, Turkey was significantly affected by the changes in international liquidity conditions, as well. The impact observed in Turkey was stronger compared to other countries because the domestic risk perceptions about inflation, current account deficit and political issues increased in this period.

As a result of these impacts, capital outflow took place over a two-month period. At this point, it should be underlined that a major part of the said outflow was met by the foreign exchange sales of residents.

The process of structural change in the Turkish economy, in other words, the background of the steps taken to strengthen macroeconomic fundamentals and to normalize the economy took only five years.

A 5-year period is very short for the structural achievements made in a country with a 30-year inflationary past to repair the fragility in expectations in a permanent way.

Therefore, in a period where financial fluctuations were observed in all developing countries, the short-term market fluctuations originating from foreigners' exits were perceived to be much more negative in Turkey, although there was not a permanent deterioration in macroeconomic fundamentals.

As seen in the table in the slide, there have been eight fluctuations since the year 2001 when the floating exchange rate regime was put into practice, and exchange rates have even surpassed the top value that was recorded in the recent fluctuation. However, to the extent that the program was implemented decisively and policies were conducted without any interruption, there had always been a return to the main trend where the Turkish lira appreciated. It should be kept in mind that this process is also the process for the Turkish lira to gain credibility. As long as macroeconomic fundamentals are strengthened and structural reforms are achieved, this process is likely to continue.

Table. Rapid changes in exchange rates*

Beginning Date	Ending Date	Duration (days)	Value at the beginning	Top value	% Change	Standard deviation (Daily change%)
15.04.2002	30.07.2002	106	1.2928	1.6966	31.2	1.11
03.12.2002	09.01.2003	37	1.5200	1.6825	10.7	1.00
03.03.2003	25.03.2003	22	1.5962	1.7548	9.9	1.53
24.09.2003	10.11.2003	47	1.3545	1.5048	11.1	0.80
05.04.2004	24.05.2004	49	1.3076	1.5582	19.2	1.18
20.07.2004	21.09.2004	63	1.4293	1.5388	7.7	0.74
08.03.2005	30.03.2005	22	1.2601	1.3905	10.3	1.14
04.05.2006	26.06.2006	53	1.3167	1.7016	29.2	1.61

* CBRT indicative USD selling rate

In this period of fluctuations, in order to ensure the continuation of the downward trend of inflation, the Central Bank used policy interest rates effectively on the one hand, and took the necessary market measures with a view to stopping the fluctuations in the market on the other.

First of all, in order to prevent declining foreign exchange liquidity from increasing volatility in the level of the exchange rate, the Central Bank suspended foreign exchange purchase auctions and intervened directly in the market by selling foreign exchange where deemed necessary.

The Central Bank followed an effective liquidity management strategy and started to hold New Turkish lira deposit purchase auctions with the aim of withdrawing the TL-denominated excess liquidity gradually. At this point, the excess liquidity has been brought down to such an extent that it does not require daily auctions.

As a result of these measures, the fluctuation in the markets was restrained. From end-June onwards, the Turkish lira appreciated by 16.7 percent while the indicative GS (government securities) interest rates and the average interest rate that is formed in CBRT deposit purchase auctions dropped by 3 points and 3.1 points, respectively. The volatility in both exchange rates and interest rates decreased significantly.

In this regard, I should say that frankly the impacts of such shocks would have been much more severe under a fixed exchange rate regime. At present, the floating exchange rate regime is performing its shock-absorbing function.

This process has shown once more how important it is for economic agents to manage the risks on their balance sheets under the floating exchange rate regime.

As similar volatilities may be observed in the future under the floating exchange rate regime, all economic agents should protect themselves in the framework of modern risk management principles, against interest rate or exchange rate risk on their balance sheets. The Izmir Derivatives Exchange provides an important opportunity in this respect.

After focusing on the monetary and exchange rate policies conducted by the Central Bank and the developments in inflation and financial markets, now I would like to talk about the strong growth performance that has been displayed by the Turkish economy since 2001 and the growth outlook.

As you all know, in the first quarter of 2006, the Turkish economy grew by 6.3 percent in real terms. Hence, cumulative real growth has been 36.9 percent since 2001. The Turkish economy has been growing for the last 17 quarters consecutively.

I would like to draw your attention to the first point that is related to this growth process; the dynamics and actors of growth has changed parallel to the structural changes in the economy.

Today, growing with public resources is no longer the case. The determinant of the growth rates is the consumption and investment of the private sector.

While private sector real investment expenditures increased by 118.2 percent in the period between 2001 and the first quarter of 2006, the said increase in the public sector was realized as 18.6 percent. On the consumption side, expenditures of the private sector and the public sector increased by 32.8 percent and 7.5 percent, respectively, during the same period. Meanwhile, machinery-equipment expenditures of the private sector have increased cumulatively by 217.7 percent since 2001. These figures underline the fact that investment-based growth has also been increasing.

The main contribution of the public sector to growth no longer comes through its expenditures, but through the role it undertakes as a strong supervisory and regulatory agent in the framework of good governance principles and also from its policies focusing on the goal of increasing competitiveness.

The public sector's need for borrowing from financial markets declined due to tight fiscal policies, which provided the private sector the opportunity to find lower-cost and longer term resources.

Another change observed in growth dynamics in line with the structural transformation in the economy is that productivity increases have become the most significant factor in growth. The cumulative productivity increase in the private manufacturing industry for the period between 2001 and the first quarter of 2006 reached 35 percent.

While the said productivity increases support the growth process on the one hand, they improve the quality and contribute to the sustainability of growth on the other.

The last issue I will touch on about growth factors has to do with the increased level of integration of the Turkish economy with the world. In this framework, exports, which rose by 151.5 percent cumulatively from 2001 to July 2006, made a critical contribution to the rapid growth observed for the last four years.

Domestic and foreign competition, which increased due to the increased number of firms that took up export activities and entered international markets as a result of integration with the world, led to a decrease in profit margins in these sectors. In such an environment, productivity increases become the main factor in competition. Sectors with the highest productivity increases became the sectors, which grew most rapidly and increased their exports the most.

Studies to increase productivity and specialization in technology and capital-intensive sectors that create high value added are more critical for the sustainability of increases in exports in the long term, than the advantage of exchange rate movements.

In order to be able to persevere in such a strong competitive environment, medium and long-term strategies – rather than short-term perspectives – are needed. To this end, public and private sectors should act in cooperation and harmony. In this framework, the public sector should try to create an environment for the private sector, in which it can compete with competitors in international markets under market conditions. In the meantime, the public sector should continue to take measures in order to increase its productivity, build robust and transparent balance sheets, turn towards capital markets, attend to risk management principles and try to allocate resources for research and development activities.

When we look at the course of growth in 2006, we see that indicators of consumption and investment expenditures provide signals for a rapid course of growth in the second quarter of the year. Meanwhile, it is anticipated that the environment of uncertainty created by the fluctuations in financial markets in the second quarter will affect domestic demand in a slightly unfavorable manner and hinder the rapid growth process, starting from the third quarter of the year onwards. The declines in the Central Bank Business Tendency Survey indicators and domestic sales of automobiles as well as the fall in the Consumer Confidence Index also support this anticipation. Thus, it seems likely that the rate of growth will decelerate to a certain extent in the second half of 2006 and the first half of 2007.

At this stage, I would like to draw your attention to the following point: What Turkey needs is to sustain growth at levels close to its potential. The uninterrupted course of growth in recent years is just the beginning. This process is a dynamic one. Structural reforms are extremely important and should be reinforced with micro measures, and a strategic vision should be adopted in line with changing needs and new structures. The Ninth Development Plan provides significant ground in this regard and should be put into implementation immediately.

I would also like to say a few words about employment, which is another important issue on the agenda of Turkey.

The number of people employed is gradually increasing in line with the high growth performance in our country. In the last one-year period, nine hundred seventeen thousand (917,000) new employment opportunities were created in sectors excluding agriculture. Moreover, in accordance with the structural transformation process in the economy, the sectoral distribution of employment is changing and a rapid shift is observed from the agricultural sector to other sectors. While employment in the agricultural sector decreased by 3.6 percentage points compared to the same period last year, employment in the services sector rose by 2.9 percentage points. In this context, the share of the agricultural sector in total employment fell from 38 percent in 2001 to 28.4 percent, as of May 2006. However, taking into account that this ratio was 3.7 percent for EU-15 countries in 2004, Turkey still has a long way to go. Similarly, when we look at the labor force participation rates, we see a significant discrepancy. The labor force participation rate, which fell by 0.7 percentage points and became 48.6 percent in Turkey in May 2006, compared to the same period last year, was around 65 percent for EU-15 countries by the year 2004.

Meanwhile, a relative improvement is observed in unemployment rates. The unemployed population and the unemployment rate are at their lowest levels since the third quarter of 2001. Compared to the same period last year, the unemployment rate decreased to 8.8 percent from 9.2 percent in May. During the same period, the unemployment rate in sectors excluding agriculture fell by 1 percentage point and became 11.5 percent. Similarly, it can be said that there is a relative improvement in the unemployment rates in urban areas. The unemployment rate, especially among the young population

in urban areas, decreased by 2.3 percentage points and fell to 19.4 percent from 21.7 percent. However, the improvement in the unemployment rate has not yet reached the desired level.

When unemployment rates and the labor market are analyzed in detail, it is observed that unemployment is a structural problem in Turkey.

A continued decline in employment in the agricultural sector due to the structural transformation in the labor market and the participation of this unemployed population in the labor force in urban areas stand as factors that prevent a more significant fall in unemployment rates.

Moreover, although it has lost pace, the rate of the population increase still remains high. In turn, the employable population is rising rapidly and unemployment rates remain at high levels despite the increase in the number of people employed.

Additionally, high employment taxes affect employment figures unfavorably and encourage unregistered employment. The high level of unregistered employment increases the volatility of employment. Although the share of unregistered employment in total employment fell in the recent period, it is still high at 49.4 percent as of May 2006.

Another structural problem in the labor market is that the employment rate of professionally trained people is low. This fact shows that there is a lack of qualified labor force for structural transformation to take place.

The unemployment problem is a critical matter and must by all means be solved. Finding a lasting solution to this problem and sustaining the employment increases are possible only through long-term and supply-oriented policies. Turkey should follow active policies that would create employment opportunities. In this framework, the relationship between the real sector and the financial sector should be reinforced in order to provide the private sector with the financing required for creating employment, the investment environment should be improved, permanent stability should be established in the macroeconomic environment and the capacity of growth to create employment should be enhanced.

Furthermore, training policies should be implemented in order to increase the qualified labor force that would meet the labor demand, employment taxes and other burdens on employment should be reduced gradually in order to register the unregistered employment, and regional markets should be formed for the unqualified labor force created by the contraction in the agricultural sector.

In this scope, the framework drawn up by the Ninth Development Plan in consistence with the European Union Employment Strategy is a road map for what should be done.

In the last part of my speech, I would like to say a few words about the issue of current account deficit, which has frequently been discussed in recent years, and highlight certain points I consider to be significant about Turkey's current account deficit.

As you all follow closely, the current account deficit has widened rapidly in recent years as a consequence of the high growth performance observed since 2001.

The current account deficit, which was USD 23.2 billion in 2005, rose to USD 28.7 billion by June 2006 in annual terms. Analyzed in terms of the ratio to national income, the ratio of the current account deficit was 6.4 percent by the end of 2005. The said ratio rose to 6.9 percent in the first quarter of 2006.

Certainly, high rates of current account deficit are not peculiar to Turkey and can also be observed in other transition economies that grow at similar high rates. For instance, the ratio of current account deficit to gross domestic product is 11.8 percent in Bulgaria, 8.7 percent in Romania, 7.9 percent in Hungary and 7.2 percent in the Slovak Republic, as of 2005¹.

Higher rates of global and financial integration enable countries to sustain higher rates of current account deficit, to the extent that the robustness of their macroeconomic fundamentals allows. Due to the impact of these conditions, a current account deficit on a higher plateau has also been sustained in Turkey in recent years.

¹ IMF, World Economic Outlook, April 2006

The recent high increase observed in the current account deficit in Turkey is not the result of the increase in consumption, but comes from the increase in investments that boosts the production capacity.

Crude oil prices, which have been following a high and volatile course in international markets and maintaining their upward trend in recent years, stand as another factor explaining the widening of the current account deficit. When oil prices are taken as those of the year 2000, it can be said that the ratio of current account deficit to national income is 1.2 percentage points lower as of the first quarter of 2006.

Meanwhile, it is expected that the depreciation of the Turkish currency due to recent fluctuations in financial markets, monetary policy tightening and the relative decline in domestic demand will slow economic activity and imports to a certain extent as of the second half of the year. As for exports, the upward trend is anticipated to gain momentum in line with increased foreign demand. In this framework, it is expected that the ratio of current account deficit to gross national product will fall in 2006 compared to 2005.

The quality of financing is very important for the sustainability of the current account deficit and for preventing the perception that the current account deficit is a risk. The quality of financing in Turkey has improved significantly, especially due to the favorable impact of the structural transformation process and has enhanced the macroeconomic conditions observed in the last five years.

Long-term capital is assuming an increasingly important role in the financing of the current account deficit. By June, 82 percent of the current account deficit has been financed with long-term capital alone. Meanwhile, the ratio of short-term capital to current account deficit stands at 29.4 percent.

In addition, foreign direct investments peaked well beyond historic levels and reached a record-high level of USD 17.3 billion in annual terms in June 2006.

No disruption was observed in foreign direct investment inflow during the fluctuations in financial markets that started in May. This development is a result of the success achieved in macroeconomic stability and also an indicator of confidence in the future. The inflow of foreign direct investment is expected to accelerate further, due to increased privatizations, company mergers and takeovers.

Meanwhile, it is observed that hot money inflows, which lead to frequent discussions about the financing of the current account deficit, have lost pace due to the change in global liquidity conditions. Including net errors and omissions, the ratio of hot money to current account deficit, which was 103 percent on an annual basis by June 2005, decreased to 27.8 percent by June 2006.

We expect that the above mentioned financing structure, which is composed heavily of long-term capital and foreign direct investments, will also continue in the upcoming years in the framework of the structural transformation process in the Turkish economy and the European Union full membership process.

While evaluating the rates of current account deficit, it should be taken into account that the macroeconomic conditions in Turkey are different from those of the past. First of all, the short position of the banking sector is very limited compared to previous years and the financial sector is much more robust. Tight monetary and fiscal policies are decisively implemented. Foreign exchange reserves are high and the floating exchange rate regime is successfully fulfilling its shock-absorbing function.

Lastly, I would like to emphasize that the level of the current account deficit is not so important in terms of ensuring that it does not follow a volatile course and is not perceived as a significant risk factor. However, in an environment where turbulences are observed in the markets and uncertainty perceptions are increasing, it is reasonable to expect a surge in the perceptions of fragility in the current account deficit, as well as the popularity of these perceptions. The current account deficit is a closely followed indicator. We are also aware of the risk potential of the current account deficit and have been carefully monitoring it in coordination with other agents responsible for the economy.

Dear guests,

I was most honored to be here in Malatya and to have the chance to share my views on the Bank's policies and macroeconomic developments with you today.

Thank you.