



MONTHLY ECONOMIC REVIEW

Economic Research Department
September 2007

- ▶ *The possibility that the slowdown in the US housing market could spread to the overall economy raised concerns in the international markets.*
- ▶ *The developments in the mortgage backed securities markets, affected by the problems in the US subprime mortgage credits, led to the freezing of some hedge funds and volatility in the markets.*
- ▶ *During this period, global risk perception increased to the highest level of the recent years and global central banks provided a considerable amount of liquidity to calm the money markets.*
- ▶ *High level of current account deficit and financing requirement make Turkey one of the most vulnerable emerging markets to the volatility in the global financial markets.*
- ▶ *Reestablishment of the budget discipline is critical in order to decrease Turkey's vulnerability to the developments in the international markets.*
- ▶ *In Turkey after the completion of the presidential elections and the announcement of the new cabinet, political uncertainties disappeared. Therefore, we expect that the political risks would be less influential on the economy in the coming period.*

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TURKISH ECONOMY

Concerns about the US housing market...

The possibility that the slowdown in the US housing market could spread to the overall economy raised concerns in the international markets. However, considering that the non-performing housing loans to GDP ratio is quite low in the US and that there has been no deterioration in households' welfare yet, it is expected that the impact of the problems in the credit market on growth would be relatively low. On the other hand, the possible interest rate hikes in credit cards and consumer loans to avoid similar problems, still make the possibility of a crisis in the entire credit market a current issue.

Freezing of some hedge funds led to volatility in the markets.

The developments in the mortgage backed securities markets, affected by the problems in the US subprime mortgage credits, led freezing of some hedge funds and volatility in the markets. In this period, global risk perception increased to the highest level of the recent years and global central banks provided a considerable amount of liquidity to calm the money markets.

High financing requirement increases the fragility of the Turkish economy.

High level of current account deficit and financing requirement make Turkey one of the most vulnerable emerging markets to the volatility in the global financial markets. The revival in the domestic demand and the high level of oil prices point out that the widening in the current account deficit would continue in the coming period. In this context, the continuation of the foreign direct investments backed by privatizations is crucial.

The implementation of the measures on budget expenditures is critical.

Reestablishment of the budget discipline is critical in order to decrease Turkey's vulnerability to the developments in the international markets. Therefore, the measures on budget expenditures should be implemented decisively in the near future.

Political uncertainties disappeared.

On the other hand, after the completion of the presidential elections and the announcement of the new cabinet, political uncertainties disappeared. Therefore, we expect that the political risks would be less influential on the economy in the coming period.

Industrial production increased by 1.8% in June.

In June, industrial production increased by 1.8%, well below the expectations. During this period, the increase in manufacturing industry was realized as 1.1%. The weak performance of industrial production was attributable to the strong base year effect as well as the weak domestic demand before the general elections.

Annual Change (%)	Q1		Q2		H1	
	2006	2007	2006	2007	2006	2007
Industrial Production	3.3	8.0	8.2	3.0	6.0	5.3
Manufacturing	2.8	7.9	8.1	2.0	5.6	4.7

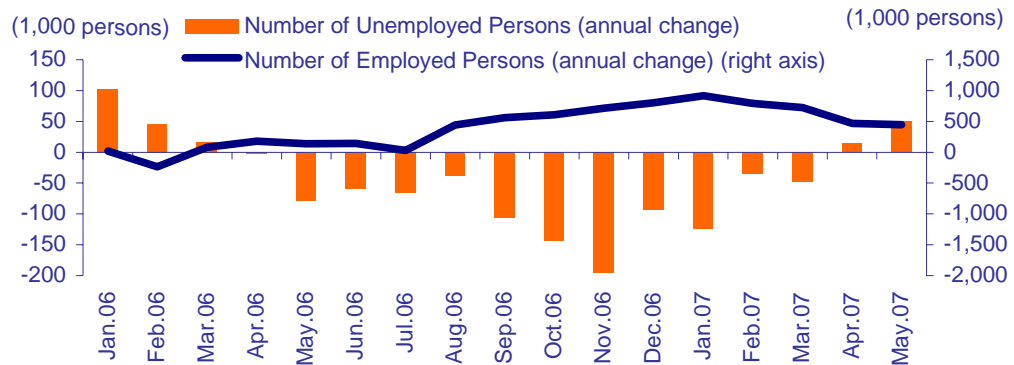
Source: Turkstat, Isbank Economic Research Department

Following the robust 8% growth in the first quarter, industrial production increased by 3% in the second quarter and by 5.3% in the first half of 2007, remaining below the increase of the same period of the previous year. In this context, it is estimated that the contribution of industrial production to the growth, which was 2.4 points in the first quarter, remained limited in the second quarter of 2007. On the other hand, stronger domestic demand due to the diminishing political uncertainties after the elections, is expected to have a positive impact on the industrial production in the second half of 2007. The anticipated fall in interest rates might also support this trend.

Unemployment rate increased.

According to the Household Labor Survey, the unemployment rate increased to 8.9% in May from 8.8% in the same period of the previous year. In this period, the number of unemployed persons increased by 50 thousand persons compared to

the same period of the previous year and reached 2 million 265 thousand persons, while the number of employed persons rose by 449 thousand persons to 23 million 309 thousand persons. The increase in the number of unemployed persons in the last two months and the deceleration in the number of employed persons were noteworthy.



Source: Turkstat

Of those who were employed in May 2007; 27.7% was employed in agriculture, 19.1% in industry, 5.9% in construction and 47.3% in services. Compared to the same period of the previous year, the share of agriculture in employment decreased, while the shares of industry and services increased. Non-agricultural unemployment rate remained unchanged at 11.5% compared to the same period of the previous year.

Breakdown of Employment by Sectors					
(1,000 persons)	May 2006	Share (%)	May 2007	Share (%)	Difference
Agriculture	6,488	28.4	6,448	27.7	-40
Non-agriculture	16,372	71.6	16,861	72.3	489
Industry	4,277	18.7	4,451	19.1	174
Construction	1,336	5.8	1,379	5.9	43
Services	10,759	47.1	11,033	47.3	274
TOTAL	22,860	100	23,309	100	449

Source: Turkstat

Note: Total figures may not be exact due to the rounding of the numbers.

In July, the foreign trade deficit was realized above expectations.

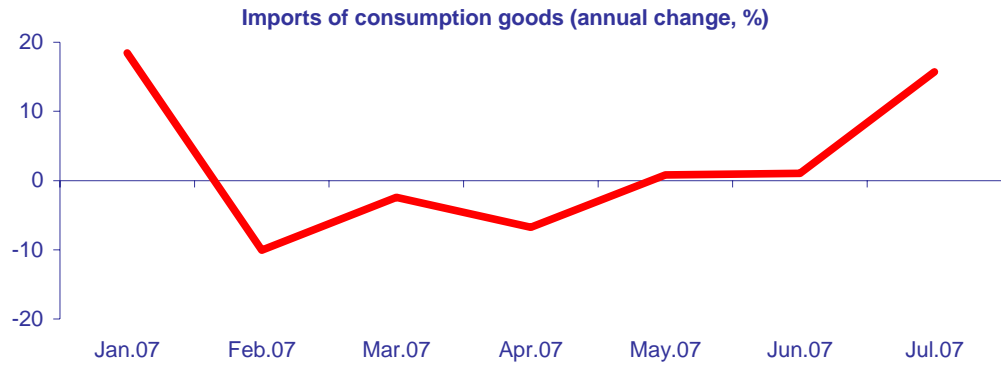
In July, exports increased by 26% to \$8.9 billion and imports rose by 28.5% to \$15 billion compared to the same period of the previous year thus foreign trade deficit was realized as \$6.1 billion. The increase in imports continued to surpass that of exports in July. Therefore, the slowdown in the expansion of the deficit has paused since June. In July foreign trade deficit, widening by 32.1%, was realized well above last year's deficit and import coverage ratio declined below 60%. During January-July period, the increase in exports exceeded that of imports and foreign trade deficit expanded by 9.9% compared to the same period of 2006.

(\$ million)	July		Change	January-July		Change
	2006	2007	(%)	2006	2007	(%)
Exports	7,067	8,907	26.0	46,983	58,413	24.3
Imports	11,709	15,041	28.5	78,003	92,512	18.6
Foreign Trade Balance	-4,642	-6,134	32.1	-31,020	-34,099	9.9
Coverage Ratio (%)	60.4	59.2	-	60.2	63.1	-

Source: Turkstat

Imports of consumption goods increased.

The higher than expected increase in foreign trade deficit in July was attributable to the acceleration in imports. This development stemmed mainly from the high growth rates in imports of capital and consumption goods. Indeed, the imports of consumption goods, which displayed a limited increase in recent months, rose by 15.7% in July. Similarly, capital goods imports gained momentum.



Widening in the foreign trade deficit is likely to continue.

The possibility of the revival in domestic demand in the coming period reinforced the expectations about the continuity of increasing tendency in consumption goods imports. Besides, imports of intermediate and capital goods are likely to accelerate along with the rise in investments. Considering also the high level of oil prices, the widening in the foreign trade deficit would accelerate in the second half of the year. The volatility in financial markets would also have important impacts on foreign trade deficit through FX rates.

According to the data released by the Turkish Exporters' Assembly, exports reached \$8.6 billion in August increasing by 23.4% compared to the same month of the previous year.

In June, current account deficit expanded by 15.7%.

In June, the current account deficit expanded by 15.7% compared to the same month of the previous year and was realized as \$3.3 billion. In the first half of the year, the deficit rose by 0.1% compared to the same period of the previous year and was realized as \$19.6 billion. 12-month cumulative figures indicated that current account deficit, narrowing since February, increased to \$32.8 billion as of June, 2007.

The expansion of the foreign trade deficit and decline in tourism revenues led the current account deficit to widen in June compared to the same month of the previous year. According to the balance of payments data, the foreign trade deficit, which contracted by 3.9% during January-May, expanded by 14.8% in June. On the other hand, although the number of tourists arriving to Turkey increased by 17.1% in June compared to the same period of the previous year, tourism revenues decreased by 2.6%.

	June		Change	Jan.-Jun.		Change
(\$ million)	2006	2007	(%)	2006	2007	(%)
Current Account Balance	-2,868	-3,317	15.7	-19,598	-19,612	0.1
Foreign Trade Balance	-3,670	-4,214	14.8	-21,142	-21,003	-0.7
Services Balance	1,232	1,262	2.4	4,009	4,193	4.6
Tourism Revenues (net)	1,224	1,192	-2.6	4,380	4,315	-1.5
Income Balance	-543	-490	-9.8	-3,120	-3,407	9.2
Current Transfers	113	125	10.6	655	605	-7.6
Capital and Financial Accounts	2,773	4,040	45.7	18,627	16,738	-10.1
Foreign Direct Investments (net)	522	1,049	101.0	9,076	10,296	13.4
Portfolio Investments (net)	-836	-1,024	22.5	-950	6,117	-
Other Investments (net)	1,043	5,811	457.1	14,626	7,215	-50.7
Reserve Assets (net)	2,044	-1,796	-	-4,125	-6,890	67.0
Net Errors and Omissions	95	-723	-	971	2,874	196.0

Source: CBRT

FDI inflows covered 52.5% of the current account deficit.

In the first half of the year, FDI inflows, which amounted to \$10,296 million, covered 52.5% of the current account deficit. Although there was a net outflow of \$1,024 million in June, portfolio investments registered a net inflow of \$6,117 million in the first half of 2007. In the same period of 2006, there had been a net outflow of \$950 million. Non-residents' net purchases of stocks reached \$597

million in June and amounted to \$2.723 million in the first half of 2007 increasing by 170% compared to same period of the previous year.

Credits raised by banks from abroad decreased, while that of other sectors increased in the first half.

Although the other investments account had recorded a net inflow of \$14.6 billion in the January-June 2006 period; such inflows were realized as only \$7.2 billion in the same period of 2007. During this period, the funds raised by the banks from abroad decreased by 26.9% compared to same period of the previous year, while the funds obtained by the other sectors increased by 18.4% and reached \$14.4 billion.

The possible revival of domestic demand after the elections, high level of energy prices and appreciation of TRY point out that the improvement in the current account deficit might lose momentum in the second half of the year. Despite the high level of foreign direct investments, widening current account deficit makes Turkish economy vulnerable to the sudden shifts in global risk perception.

The increase in non-interest budget expenditures restrained the disinflation process.

The Monetary Policy Committee of CBRT decided to keep short-term interest rates unchanged at 17.50% at its meeting on August 14th. After the meeting, it was stated that while private sector investment and consumption demand displayed signs of recovery, the contribution of external demand to growth was moderating and aggregate demand conditions continued to support the disinflation process. However, it was mentioned that non-interest budget expenditures, which increased remarkably in the first half of the year, restrained the disinflation process.

Market fluctuations are not expected to affect the medium term inflation outlook adversely.

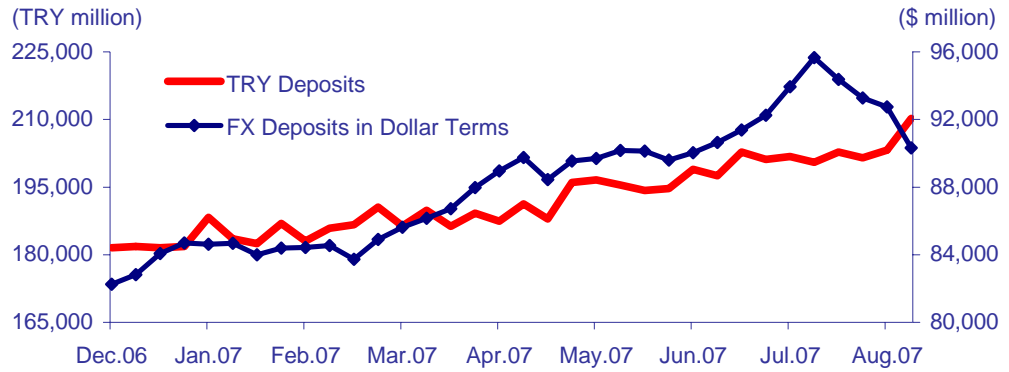
Besides, the Committee considered the volatility in unprocessed food prices and the stickiness in inflation expectations as important risks to the inflation outlook. The Committee mentioned that recent market volatility had the potential to affect inflation adversely through exchange rate channel in the short term although the decline in oil and other commodity prices would ease the cost-push inflationary pressure. On the other hand, the Committee also mentioned that the increase in risk perception would limit the downward trend in the bank lending rates in the domestic markets, and also curb the banks' appetite for extending credit. Accordingly, the likelihood of the materialization of the risk that "domestic demand conditions may turn less supportive for the disinflation process", as quoted at the last meetings, has been reduced. In this context, it was also stated that the volatility in the markets, as of the meeting date, would not adversely affect medium term inflation outlook.

In this respect, the Committee maintained the policy stance envisioning measured easing in short term interest rates starting from the last quarter of 2007. However, the Committee added that the exact timing and the extent of the easing may vary depending on the incoming information regarding global liquidity conditions, external demand, public expenditures and other determinants of medium term inflation outlook.

Banking Sector

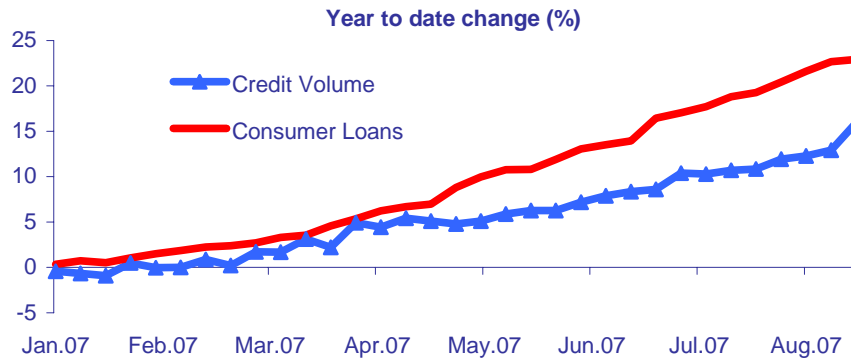
Decreasing trend of FX deposits in Dollar terms...

As of August 17, 2007, the banking sector deposit volume reached TRY332.5 billion increasing by 3.8% compared to the same week of the previous month and by 12% compared to the end of 2006. The increase in TRY deposits supported this development. On the other hand, FX deposits in Dollar terms have decreased since the third week of July.



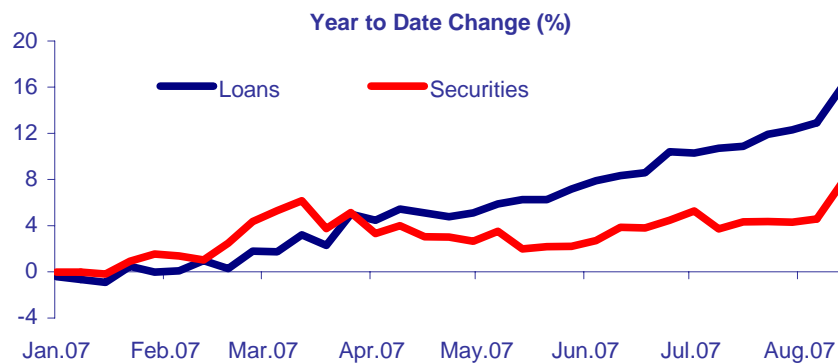
The increase in consumer loans accelerated in the second quarter of the year.

As of August 17, 2007, the banking sector credit volume increased by 4.6% compared to the same week of the previous month and by 16% compared to the end of 2006. The increase in credit volume stemmed mainly from the rise in consumer loans, accelerating especially in the second quarter compared to the first one.



Securities portfolio of the banking sector increased by 7.6% compared to the end of 2006.

As of August 17, 2007, securities portfolio of the banking sector amounted to TRY171 billion, increasing by 3.2% compared to the same week of the previous month and 7.6% compared to the end of 2006. Comparison of the year to date changes indicates that the expansion in securities was lower than that of loans.



Decrease in non-residents' interest towards GDDIs...

As of August 17, 2007, the securities held in custody accounts amounted to TRY108.5 billion decreasing by 0.7% compared to the same week of the previous month while increasing by 2.8% compared to the end of 2006. It was noteworthy that there was a decline in non-residents' interest towards GDDIs.

Banking sector's short position was realized as \$742 million.

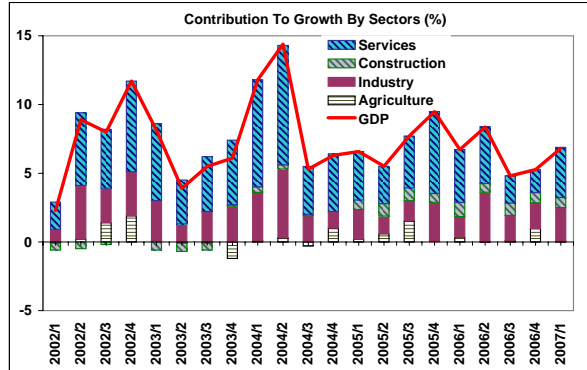
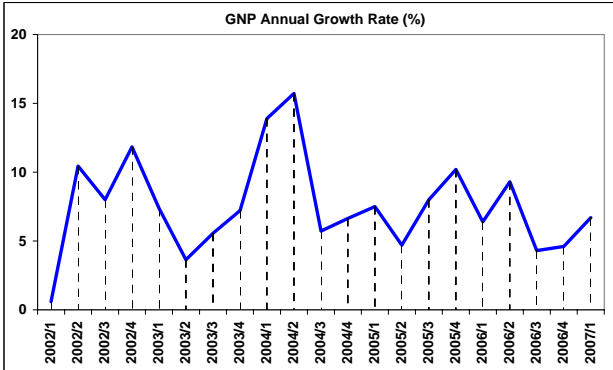
The banking sector's net FX position was realized as -\$742 million as of August 17, 2007. In this period, the short positions of private and foreign banks were \$690 and \$95 million, respectively, while public banks had long position. On-balance sheet FX position was -\$7.4 billion, whereas off-balance sheet FX position was \$6.6 billion.

We expect political uncertainties to diminish and economic activity to enliven after the elections. However, the course of the credit volume depends on the banks' ability to raise long-term funds in an environment with high volatility created by the unfavorable developments in the US mortgage market.

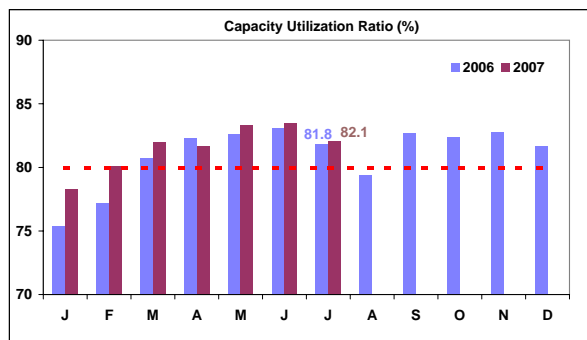
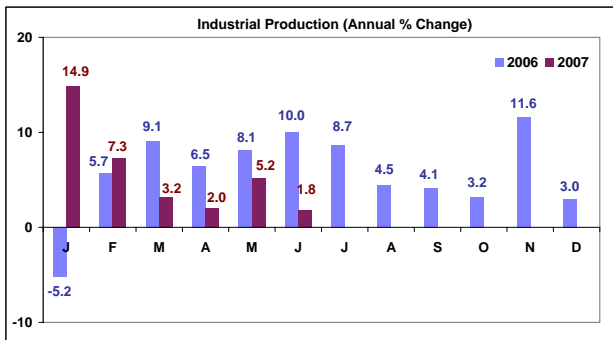
Indeed, the problems in mortgage markets raise the concerns over the liquidity squeeze and adversely affect the global risk perception. Increasing volatility in such an environment has the potential to create problems especially in emerging markets which lead to a flight from risky assets to less risky ones.

TURKISH ECONOMY AT A GLANCE

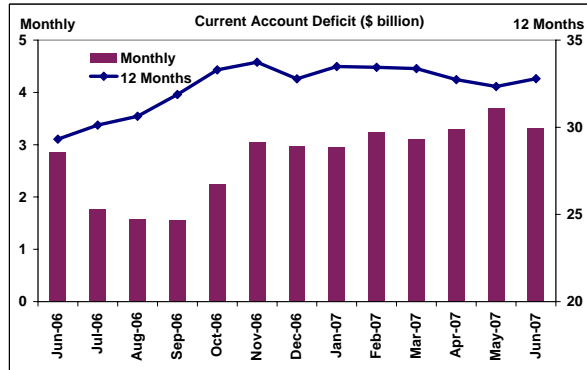
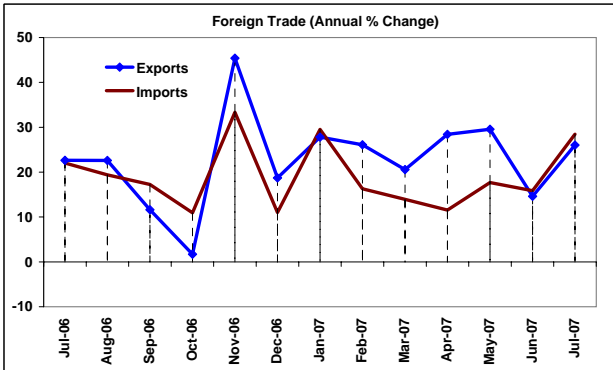
GROWTH



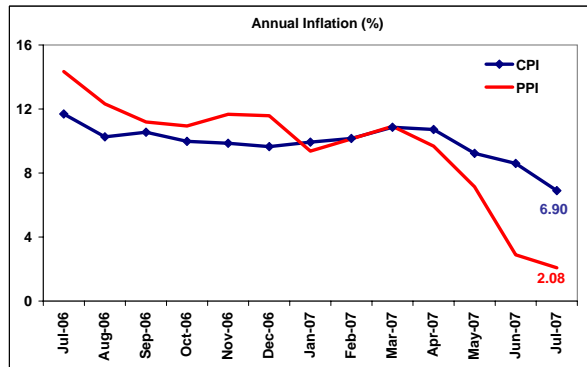
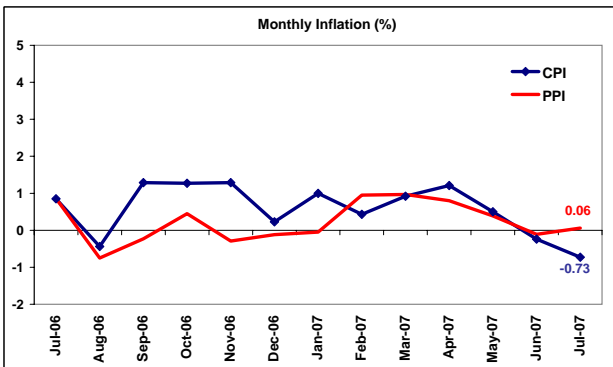
INDUSTRIAL PRODUCTION



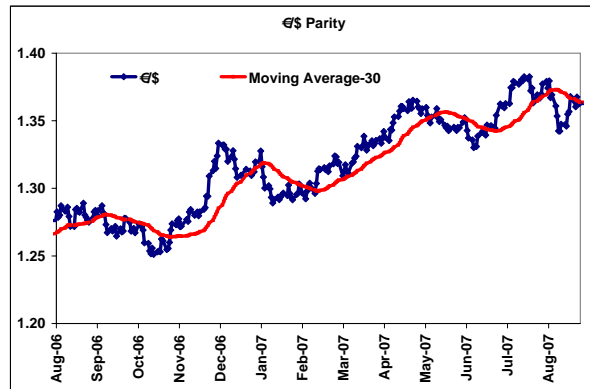
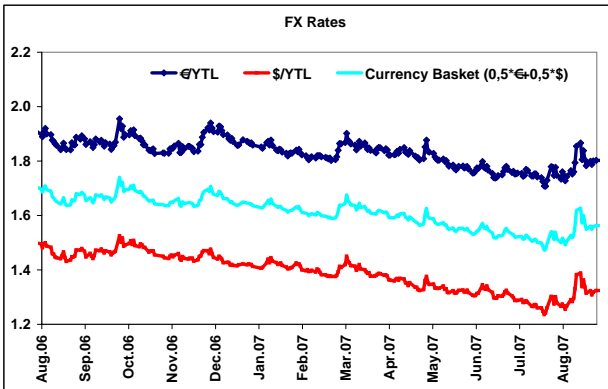
FOREIGN TRADE



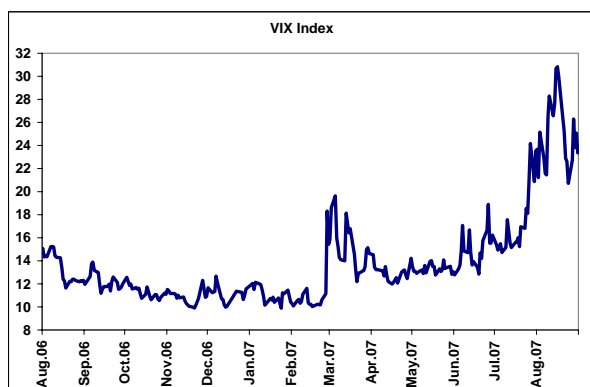
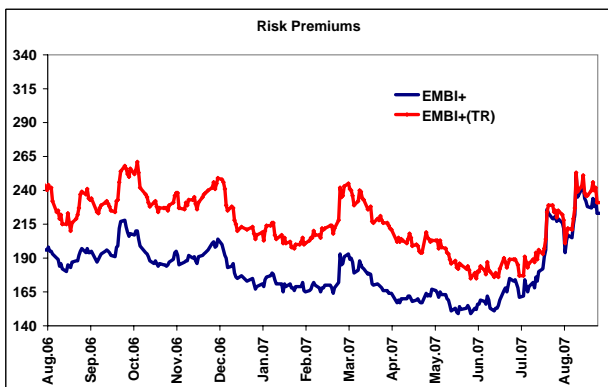
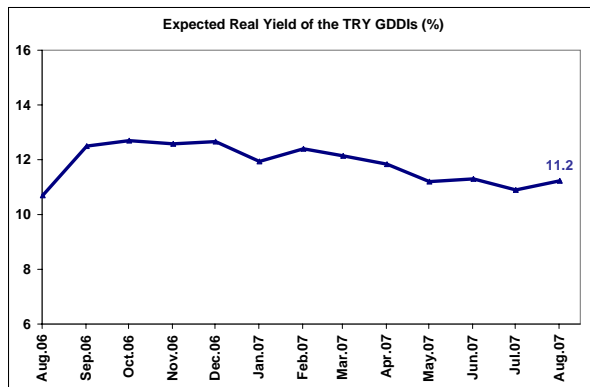
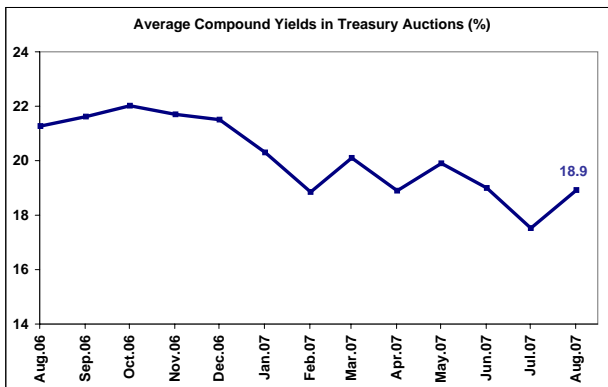
INFLATION



FX MARKETS

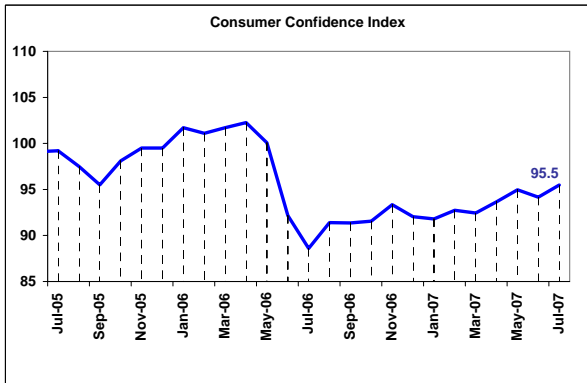
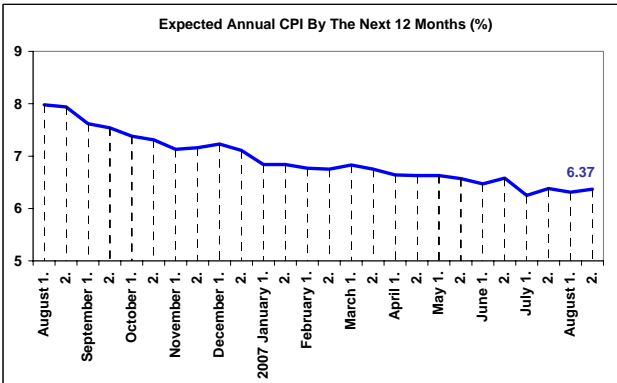
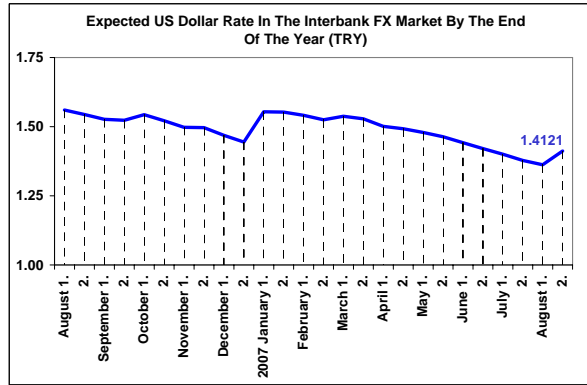
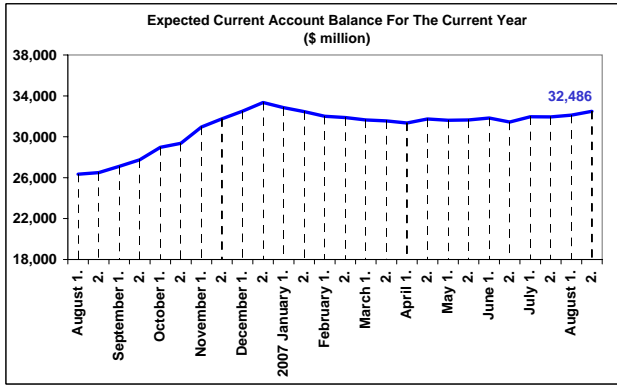
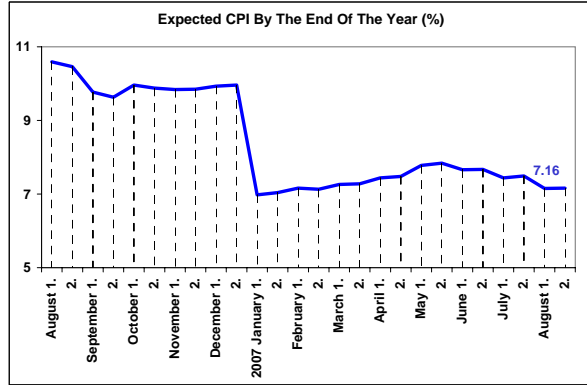
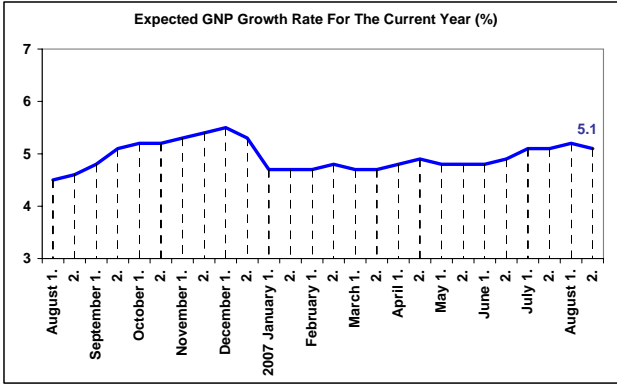


BOND-BILL MARKETS



Source: CBRT, Reuters, State Planning Organization, Istanbul Stock Exchange, JP Morgan, Chicago Board Options Exchange, Isbank Economic Research Department

SURVEY OF EXPECTATIONS AND OTHER LEADING INDICATORS



Source: CBRT

ECONOMIC INDICATORS

	2002	2003	2004	2005	2006	2007 ⁽¹⁾			
						May	Jun.	Jul.	Aug.
GROWTH									
GNP (\$ million)	180,888	239,235	299,475	360,876	399,673	91,801 ⁽²⁾			
GNP Growth Rate (%)	7.9	5.9	9.9	7.6	6.0	6.7 ⁽²⁾			
INFLATION (%)									
PPI (annual)	30.8	13.9	15.34	2.66	11.58	7.14	2.89	2.08	
CPI (annual)	29.7	18.4	9.35	7.72	9.65	9.23	8.60	6.90	
FX RATES									
CPI Based Real Effective FX Rate Index	125.4	140.6	143.2	171.4	160.1	173.5	176.0	176.8	
\$/TRY	1.6345	1.3958	1.3421	1.3430	1.4131	1.3253	1.3147	1.3006	1.3242
Euro/TRY	1.7035	1.7451	1.8268	1.5904	1.8586	1.7801	1.7696	1.7777	1.8022
Euro/\$	1.0496	1.2586	1.3558	1.1840	1.3196	1.3451	1.3541	1.3670	1.3628
BALANCE OF PAYMENTS (\$ million)									
Exports	40,124	51,206	67,047	76,949	91,937	43,024	52,488		
Imports	47,407	65,216	90,925	110,479	-133,175	-59,813	-73,491		
Foreign Trade Balance	-7,283	-14,010	-23,878	-33,530	-41,238	-16,789	-21,003		
Current Account Balance	-1,521	-8,036	-15,601	-22,603	-32,774	-16,295	-19,612		
CREDIT UTILIZATION FROM ABROAD (\$ million)									
Banks	-1,028	1,975	5,708	9,248	5,813	3,115	3,958		
Long Term	-297	-40	2,361	6,544	9,765	3,761	4,537		
Short Term	-731	2,015	3,347	2,704	-3,952	-646	-579		
Other Sectors	371	1,022	5,109	10,309	19,106	12,353	14,421		
Long Term	1,099	734	4,768	9,942	18,600	11,974	13,865		
Short Term	-728	288	341	367	506	379	556		
BUDGET (TRY million)⁽³⁾									
Expenditures	119,604	141,248	152,093	159,687	175,304	83,493	100,679		
Interest Expenditures	51,728	58,527	56,491	45,680	45,945	23,665	26,893		
Non-interest Expenditures	67,876	82,721	95,601	114,007	129,359	59,828	73,786		
Revenues	79,420	101,037	122,919	152,784	171,309	80,150	94,795		
Tax Revenues	61,713	84,832	100,342	119,627	137,554	59,224	70,588		
Other Revenues	17,707	16,205	22,577	33,157	33,756	20,926	24,207		
Budget Balance	-40,184	-40,210	-29,173	-6,903	-3,995	-3,344	-5,885		
Primary Balance	11,543	18,317	27,318	38,777	41,951	20,321	21,009		
CENTRAL GOVERNMENT DEBT STOCK (\$ billion)									
Domestic Debt Stock	91.7	139.3	167.3	182.4	178.9	195.4	194.5	196.9	
External Debt Stock	56.8	63.3	68.5	64.7	66.6	67.2	67.2	67.7	
Total Debt Stock	148.5	202.6	235.8	247.1	245.5	262.6	261.7	264.6	

Source: Turkstat, CBRT, Treasury, Reuters

(1) Cumulative figures for foreign trade, current account and budget.

(2) 2007 1st quarter figures.

(3) Data are according to the Central Government Budget.

BANKING SECTOR							Year to Date Change (%) (II/I)
	2004	2005	2006 (I)	Jun.07	Jul. 07	Aug. 17 (II)	
DEPOSITS (excluding interbank deposits)							
Total Deposits (TRY million)	191,360	243,160	296,815	321,539	323,217	332,536	12.0
TRY	106,075	153,995	181,532	202,743	202,809	210,265	15.8
FX	85,285	89,165	115,283	118,796	120,408	122,271	6.1
FX (\$ million)	63,552	66,203	82,257	91,382	94,371	90,324	9.8
FX deposits/Total deposits (%)	44.6	36.7	38.8	36.9	37.3	36.8	-
SECURITIES HELD IN CUSTODY ACCOUNTS (TRY million) (nominal value)							
Total	87,372	90,230	105,505	107,474	110,330	108,460	2.8
Residents	70,912	64,191	65,177	61,270	61,939	63,570	-2.5
Non-Residents	16,460	26,039	40,328	46,204	48,391	44,890	11.3
SECURITIES PORTFOLIO (TRY million) (nominal value)							
Total	123,695	142,853	158,871	165,956	165,800	170,996	7.6
CREDITS (TRY million) (excluding loans to financial institutions)							
Credit Volume	97,329	147,510	207,603	229,191	232,370	240,717	16.0
TRY	62,542	105,945	153,316	170,968	172,887	179,129	16.8
FX	34,787	41,565	54,287	58,222	59,483	61,587	13.4
Retail Loans	34,930	62,348	91,584	106,047	107,855	109,787	19.9
Consumer and Installment Com. Loans	21,010	45,010	69,942	81,927	83,805	85,287	21.9
Consumer Loans	12,731	28,618	45,931	53,766	55,318	56,460	22.9
Housing	2,631	12,405	22,165	25,503	26,301	26,945	21.6
Automobile	4,194	6,146	6,405	5,868	5,819	5,825	-9.1
Consumer and Commercial Credit Cards	13,920	17,338	21,642	24,120	24,050	24,500	13.2
Retail Loans/Total Credits (%)	35.9	42.3	44.1	46.3	46.4	45.6	-
NPL RATIO (%)							
Total Loans	6.0	4.8	3.8	3.6	3.6	3.7	
Retail Loans	2.2	2.5	2.4	2.6	2.6	3.5	
Consumer and Installment Com. Loans	0.7	0.7	0.8	1.2	1.2	1.2	
Consumer Loans	0.7	0.7	0.8	1.1	1.2	1.2	
Consumer and Commercial Credit Cards	4.4	7.1	7.3	7.0	7.0	10.7	
BANKING SECTOR NET FX POSITION (\$ million)							
Total	-71	-97	184	-617	-672	-742	
On-Balance Sheet	-1,390	-1,880	-5,467	-7,722	-8,540	-7,386	
Off-Balance Sheet	1,318	1,784	5,651	7,105	7,868	6,644	

Source: BRSA

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