



CENTRAL BANK OF
THE REPUBLIC OF TURKEY

inflation report

2009-I



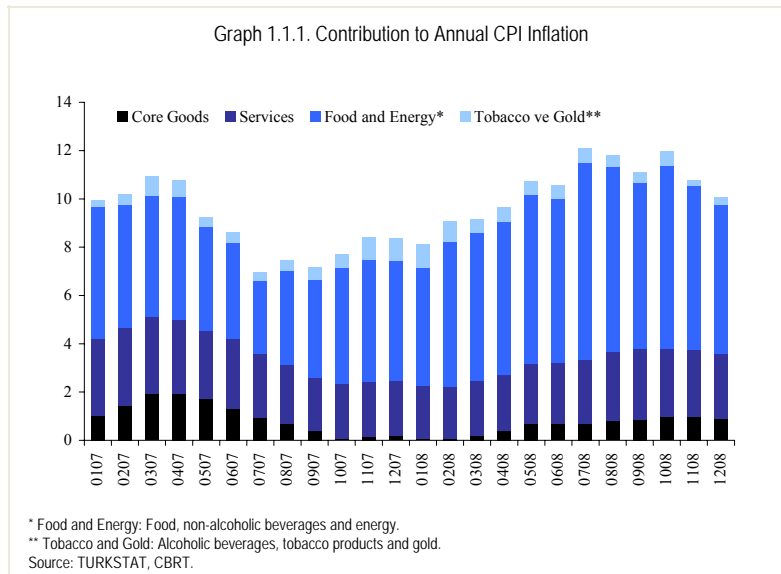
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1. Overview

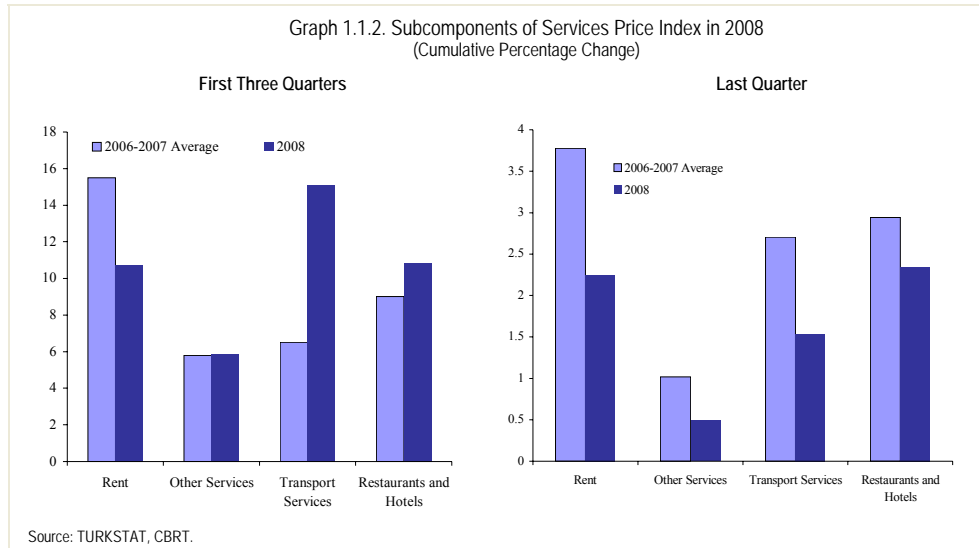
1.1. Inflation Developments

Inflation in 2008 was largely determined by developments in the global economy. After sharp increases in energy and other commodity prices in the first three quarters, there has been a dramatic shift in inflation dynamics in the last quarter. With the intensification of the global financial crisis, commodity prices have displayed a sharp reversal as the global loss of confidence led to a significant slowdown in the world economic activity. Accordingly, there has been a marked fall in domestic energy and processed food inflation in the last quarter. Yet, cumulative past increases in the commodity prices have kept annual inflation at relatively high levels. Around 6.2 percentage points of the 10.1 percent annual CPI inflation in 2008 can be explained by the direct impact of the increases in food and energy prices (Graph 1.1.1).



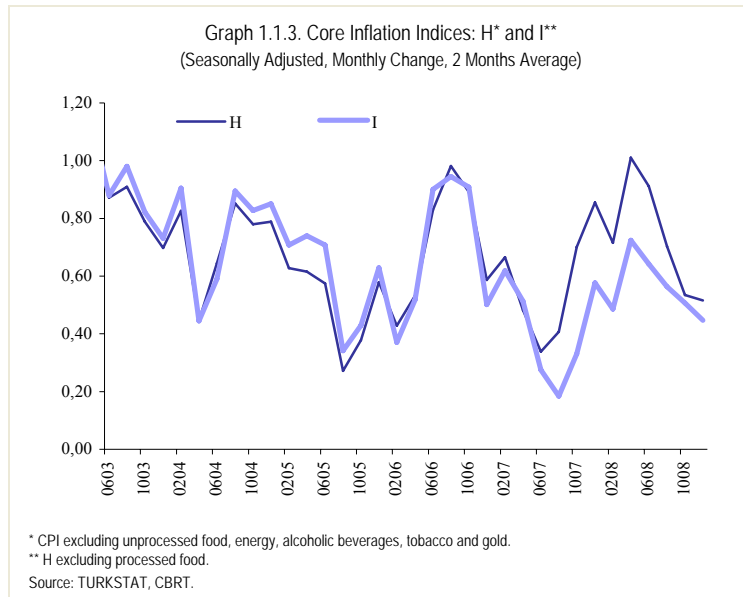
During the first three quarters of the year, inflation in services stayed at high levels due to lagged impacts of food and energy prices, especially in catering and transport services. The upward trend in services inflation reversed in the last quarter with the sharp weakening in economic activity and falling commodity prices (Graph 1.1.2). Rent inflation, on the other hand displayed a steady decline throughout the year. We expect services inflation to continue to

decelerate in 2009, as the accumulated impacts of the supply shocks fade away and the domestic demand remains weak.

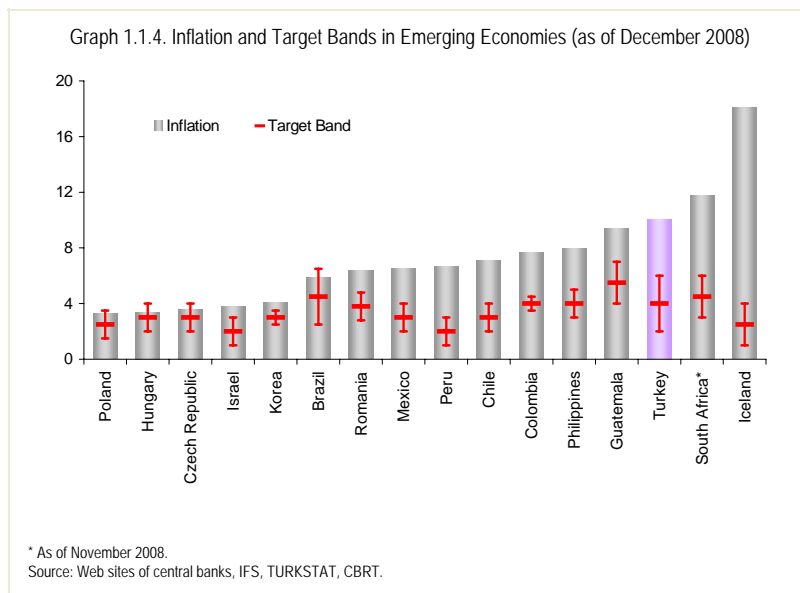


In September and October, high level of uncertainty stemming from the intensification of global financial market turmoil has led to a wave of financial deleveraging, leading to a sharp rise in sovereign credit risk premia and a significant depreciation of currencies in emerging markets, including Turkey. In the October Inflation Report, we indicated that the significant slowdown in domestic demand growth should limit the second round effects of the exchange rate pass-through, and that the pass-through from exchange rates to the domestic inflation should be relatively limited compared to previous episodes. The materialization of the exchange rate pass-through in the last quarter of 2008 turned out to be even below our October estimates, also with the contribution of sharper-than- envisaged declines in import prices.

Annual rate of increase in CPI excluding food, energy, tobacco and gold (I) declined from 7.3 percent to 7 percent in the last quarter. Seasonally adjusted monthly core inflation shown in Graph 1.1.3 suggests that underlying inflation has displayed a downward trend in the last quarter—a notable development given the significant depreciation in the Turkish lira in the final quarter of 2008.



Cross-country figures confirm that inflation has been driven mostly by global factors in the past year. Elevated commodity prices in the first three quarters of 2008 exerted inflationary pressures all over the world, pushing inflation rates above the targets. Along with the easing in global inflationary pressures, inflation displayed a downward trend in emerging market economies. Notwithstanding the downturn in the last quarter, most of the emerging economies under inflation targeting have faced significant breaches in their inflation targets at the end of 2008 (Graph 1.1.4).



1.2. Monetary Policy

Following the intensification of the problems in the global economy, both domestic and external demand slowed down considerably in the last quarter of 2008. Despite the weakening in aggregate demand, uncertainties in the global financial and commodity markets and concerns about the reflections of these factors on the inflation outlook required monetary policy to remain cautious during the peak of the turmoil. Accordingly, the Monetary Policy Committee (MPC) decided to keep policy rates constant in September and October meetings. Incoming information since then has suggested that the significant slowdown in the aggregate demand and falling commodity prices would lead to a sharp fall in inflation, and that inflationary impact of the exchange rate movements would be lower than the levels implied by the historical estimates. Therefore, the MPC cut interest rates by a 50 basis points in November and a further 125 basis points in December.

As the incoming information on inflation and economic activity vindicated the policy rate cuts, inflation expectations reacted favorably, displaying a sharp fall in January. These developments have enhanced the potential effectiveness of monetary policy communication in managing expectations. As a consequence, benchmark bond rates came down significantly, partly driven by the easing tensions in global financial markets.

Recent forecasts suggest that ongoing problems in international credit markets and the global economy may last longer than what had been previously envisaged. Downward revisions in growth forecasts and the sharp fall in oil and other commodity prices have increased the probability of undershooting medium term inflation targets. Accordingly, the MPC decided to cut policy rates by a further 200 basis points in January, moving forward a sizeable part of the monetary accommodation envisaged for the incoming months.

1.3. Inflation Outlook

Factors affecting inflation outlook displayed a sharp downturn in the last quarter with easing commodity prices and the slowdown in economic activity. Both import prices and aggregate demand turned out to be weaker than envisaged in our baseline assumptions appeared in the October Inflation Report. As a consequence, end-year inflation materialized at 10.1 percent—

significantly below our forecast of 11.1 percent. Therefore our starting point for the medium term inflation forecasts has shifted down by 1-percentage points.

Our export performance has become more sensitive to global business cycles in the past years as the share of durables and capital goods has increased in time. In fact, the significant slowdown in our major trading partners and the consequent contraction in exports were among the main drivers of the sharp downturn in aggregate demand.

Not only external demand but also domestic demand have displayed a significant slowdown. Third quarter GDP figures suggest that final domestic demand has contracted three quarters in a row. Readings on the last quarter point to a further contraction in the domestic demand.

Credit conditions tightened considerably and bank loan rates displayed a sharp rise after the intensification of the global financial crisis. The pace of consumer credit growth suggests that financial conditions were restrictive in the last quarter of 2008, as consumer loans fell in nominal terms for the first time in the near history. Recent easing in monetary policy has helped to relieve the tension in domestic credit markets, as there has been a significant fall in consumer loan rates following the policy rate cuts. Yet, business loans rates remain elevated. Heightened risk aversion and the tightening in global credit conditions are expected to continue to restrain domestic credit growth in the forthcoming period.

World economies have become increasingly interdependent since the onset of the global crisis in September 2007. Domestic inflation and monetary policy outlook is likely to remain sensitive to the developments in the global economy, at least in the short-to-medium term. In this respect, assumptions on the future course of global economy are particularly important. The latest Consensus Forecasts survey suggest that major developed economies will continue to contract throughout 2009, before recovering gradually in 2010. Therefore, as a starting point, our baseline forecast is based on the assumption that there will be a gradual recovery in the global economy starting from the first quarter of 2010.

Looking ahead, intensified problems in global economy and the tight credit conditions are likely to restrain domestic demand for an extended period. We envisage some recovery in consumption spending in the second half of

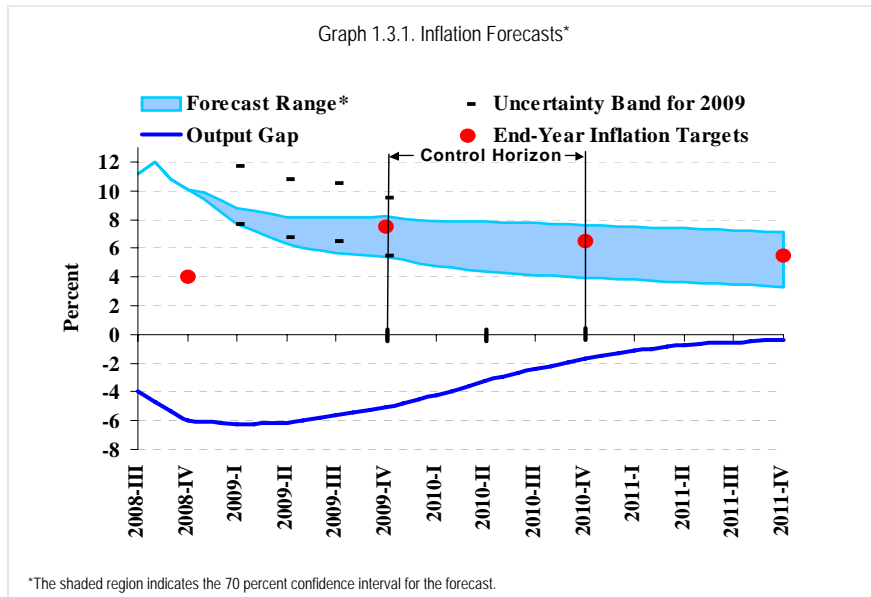
2009, as the monetary accommodation will start feeding through the economy. However, we expect the recovery to be gradual, as it will take time to fully restore consumer confidence in the aftermath of the most serious global crisis in decades.

Overall, we are likely to face a protracted period of weak economic activity in the forthcoming period. Hence, our revised forecasts incorporate a significantly larger contribution from aggregate demand conditions to disinflation, compared to the October Inflation Report. This revision is the major factor driving the recent change in inflation and monetary policy outlook.

The sharp fall in oil prices is another major factor leading to a downward revision in our end-2009 inflation forecasts. Our baseline scenario in the October Inflation Report envisaged a constant path for oil prices around USD 80 per barrel over the forecast horizon. However, oil prices continued to fall in the meantime, averaging around USD 56 in the last quarter of 2008. Taking the average of oil price futures for one to two year maturities as a benchmark, we have revised our baseline scenario for oil prices down to USD 55 per barrel.

Processed food prices followed a sharper downward trend than our expectations, while unprocessed food inflation continued to display a high volatility, materializing at a level higher than predicted for end-2008. Overall, the course of food inflation was close to the path outlined in the baseline scenario of the October Inflation Report. Accordingly, we retained our assumptions for food inflation at 7.5 percent for 2009, and 6 percent for the following years.

Against this background, our medium term forecasts suggest that, assuming a decelerating pace of reductions in policy rates during the earlier part of 2009; with 70 percent probability, inflation will be between 5.4 and 8.2 percent (mid-point 6.8) at the end of 2009, and between 4 percent and 7.6 percent (mid-point 5.8) at the end of 2010. We expect inflation to come down to 5.2 percent by the end of 2011 (Graph 1.3.1).



To sum up, there has been a downward revision in our medium term inflation forecast, owing mainly to the impacts of the favorable energy prices and the weakening aggregate demand. The forecast suggests that the probability of undershooting the end-2009 inflation target has increased, notwithstanding the significant policy easing in the past couple of months.

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions on the future policy rates underlying the inflation forecast should not be perceived as a commitment on behalf of the Central Bank of Turkey (the CBRT).

1.4. Risks

Strains on global money and capital markets have shown signs of easing since the publication of our October Inflation Report. However, the overall confidence loss, wealth destruction and the tightening of credit conditions especially for the business sector, have led to a marked downturn in the global economic activity. In line with latest Consensus Forecasts, our baseline scenario envisages a recovery in global economic activity starting from the first quarter of 2010. Yet, there is still a considerable amount of uncertainty surrounding the global economy. We think developments in the global economy will be the main determinant of the outlook for domestic inflation and monetary policy in the medium term. Hence, in order to enhance the

predictability and transparency of monetary policy, we decided to present two alternative scenarios in the final chapter of the Report, each one based on different timing and speed of the recovery in the global economic activity. The two alternative scenarios are embedded in our forecasts through four main channels: External trade, portfolio flows, commodity prices, and credit channels.

The first alternative scenario is based on a relatively fast recovery in the world economy. In this scenario we assume that the monetary and fiscal measures taken by the major developed economies will be adequate to start pulling the global economy out of the recession in the second half of 2009. Accordingly, a rapid and stronger-than-envisaged recovery in the global economic activity would lead to a rebound in commodity prices, resurgence in capital inflows to emerging economies, pick up in external demand, and relaxation in credit conditions. Under this scenario, meeting medium term inflation targets of 7.5, 6.5 and 5.5 percent in the 2009-2011 period, respectively, could require measured policy rate hikes towards the end of 2009.

The second alternative scenario is based on the assumption of a further deepening in global crisis in the first half of 2009 and an extended period of weakness in global economic activity until the second half of 2010. In this scenario a more protracted and slow recovery would lead to another wave of portfolio shock for emerging markets, weak external demand, tighter credit conditions, and further drops in commodity prices. Our forecasts suggest that, in such a case, medium term inflation targets could be undershot even with a measured sequel of policy rate cuts throughout 2009.

Finally, it is worth to mention that a critical assumption underlying the inflation and monetary policy outlook outlined above is that government fiscal stance will remain neutral in cyclically adjusted terms, and that there will be no changes in indirect taxes or administered price adjustments, except those required by the existing automatic pricing mechanisms. Any significant deviation from this framework may lead to a revision of the outlook for inflation and monetary policy.

1.5. Conclusion

Factors affecting the inflation outlook have undergone significant changes in the last quarter of 2008. With the financial crisis turning into a worldwide recession, there has been a sharp downturn in both domestic and external demand. Moreover, commodity prices collapsed in response to the worsening global economic outlook. Growth forecasts for the global economy have been constantly revised downwards in the last couple of months, and the risks are still seen on the downside. These developments have increased the probability of undershooting our inflation target at the end of year 2009, setting the ground for monetary accommodation. Accordingly, we have cut the policy rates by a total of 375 basis points in the past three months. Moreover, we have taken several measures in order to facilitate the smooth functioning of our financial markets since October. We will continue to take the necessary measures to contain the adverse effects of the global financial turmoil on the domestic economy, provided that they do not conflict with the price stability objective.

Uncertainties regarding the lagged impact of the problems in financial markets on the global economy remain at high levels. Prudent monetary policy is necessary but not sufficient to maintain the resilience of the economy against the global crisis, especially under current conditions. Preserving the fiscal discipline and strengthening the structural reform agenda would help to mitigate the adverse effects of the ongoing shocks on the domestic economy. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be of utmost importance. In particular, advances in structural reforms, which would improve the quality of fiscal discipline and enhance productivity gains, are monitored closely by the CBRT with regard to their implications for macroeconomic and price stability.

2. International Economic Developments

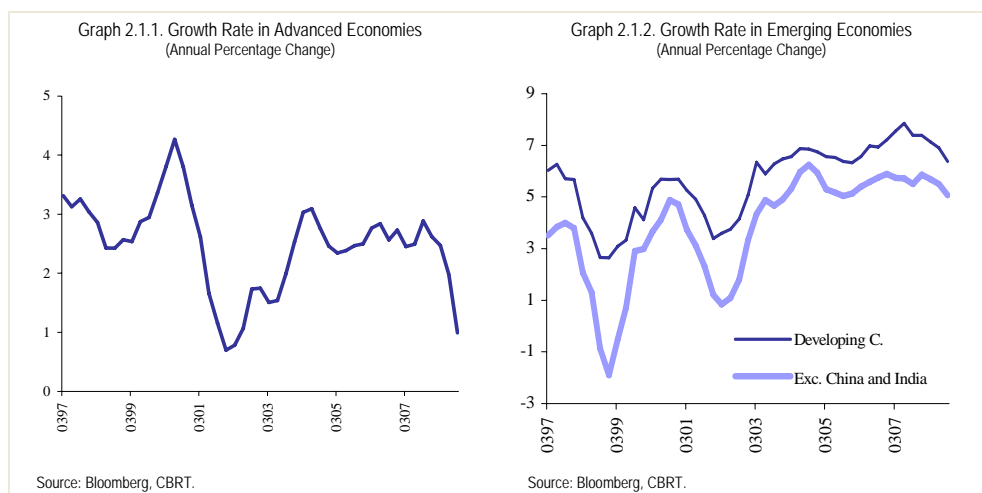
The global financial crisis that emerged in the US subprime mortgage market in August 2007 and deepened following the bankruptcy of several large US financial institutions in September 2008 has recently cooled down, although limitedly, due to the massive coordinated intervention by government authorities and central banks. Central banks in major advanced economies, particularly the US Federal Reserve (Fed), continued to pump liquidity into the financial system and extended the range of distressed assets covered by the assistance program in the fourth quarter. Thanks to Fed's liquidity operations, the monetary base increased by a stunning 105 percent in 2008. However, despite all these measures, the sharp drop in confidence driven by the global financial turmoil has started to dampen the business sector. While the slow-down in global growth became more apparent in the third quarter, indicators related to the fourth quarter suggest that the slow-down accelerated.

With reduced demand from developed economies, commodity and oil prices plunged, leading to a dramatic decline in global inflation. Accordingly, central banks, mostly in industrialized countries, slashed key interest rates. Apart from the measures taken by central banks, governments of advanced economies adopted comprehensive stimulus packages that include tax cuts and government spending, which eased fears of global recession but was not enough to save the world economy from a major downturn.

Central banks in emerging economies had first followed cautious policies to manage exchange rate volatility and maintain financial stability, but as the distress in financial markets faded somewhat and inflation ceased to be an immediate concern, they loosened their brakes in the last months of 2008.

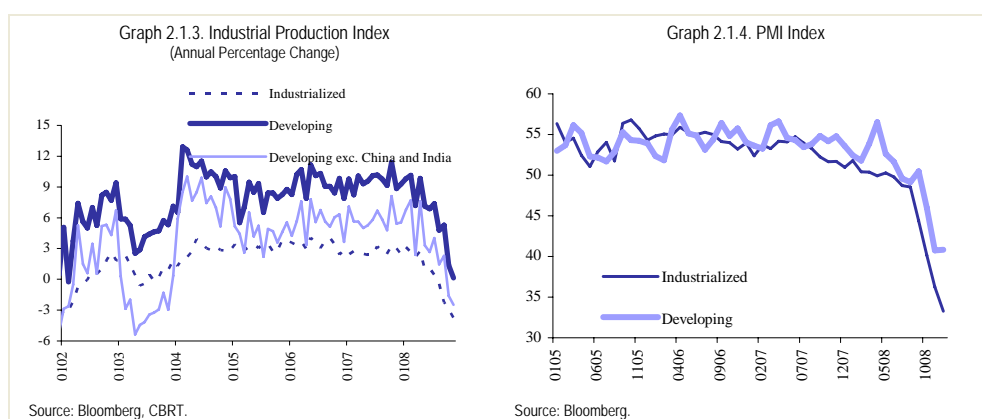
2.1. Global Growth

GDP growth in advanced economies fell from 1.9 percent in the second quarter of 2008 to 1.0 percent in the third quarter. Japan's economy performed the worst, slowing down to -0.3 percent, while the GDP in the US, UK and euro area dropped to 0.7, 0.3 and 1.6 percent, respectively (Graph 2.1.1).



The sharp fall in growth rates in industrialized countries spilled over into emerging economies in the third quarter of 2008. Annual growth rate in emerging economies dropped from 6.9 percent in the second quarter to 6.4 percent in the third quarter, but excluding China and India, it went down from 5.5 to 5.2 percent (Graph 2.1.2). As a major exporter, China's GDP had expanded to 12.6 percent year-on-year in the second quarter of 2007, but almost two years later, it slowed down to single-digit growth, 9.0 percent, mainly due to reduced demand from developed countries.

Fourth-quarter data suggest that industrial production plummeted year-on-year in October and November in both industrialized and developing countries. The industrial production index for advanced and emerging economies dropped by 3.9 and 0.5 percent year-on-year, respectively, in November. Excluding China and India, the annual change for emerging economies was -3.6 percent (Graph 2.1.3). Moreover, the Purchasing Managers Index (PMI) signaled a severe output contraction in industrialized countries in December. The PMI for industrialized countries went down from 36.2 to 33.2 points in December, while that for emerging economies remained virtually unchanged, yet both indicators stood firmly below the neutral mark of 50 points (Graph 2.1.4). The US PMI declined to 32.4 points in December, the lowest reading since June 1980.



According to employment reports released in the final quarter of 2008, unemployment increased, particularly in developed countries. In the United States, unemployment climbed to 6.2 percent in September 2008, from 4.1 percent in October 2006, and hit a disturbing 7.2 percent in December. In euro area, unemployment soared to 7.8 percent in November 2008, from 7.2 percent at end-2007. Developing countries followed the same pattern.

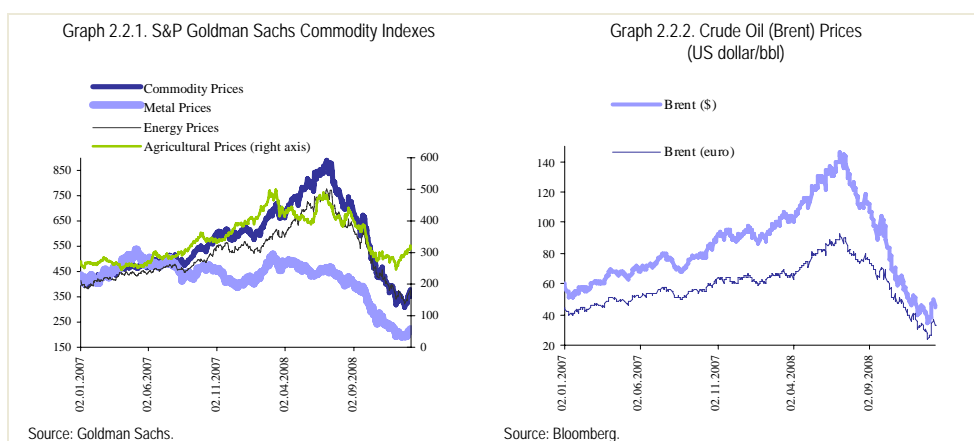
In view of all these developments, many have revised down their global growth forecasts and increasingly believe that the economic recovery will be prolonged. Similarly, the “Consensus Forecast” of January 2009 suggests that advanced economies will only rebound by 2010 (Box 2.1).

The risk of recession is particularly elevated in industrialized countries and therefore the economic contraction is expected to intensify in 2009, which prompt government authorities in those countries to take a series of measures to address problems in the financial sector and to revive the economy. The Fed announced on December 30, 2008 that it would initiate a program to purchase asset-backed securities, including mortgage-backed securities, up to 500 billion US dollars, a measure to bolster the mortgage market that is at the epicenter of the turmoil. Besides, the new US government arranged a financial assistance package of 775 billion US dollars that accounts for over 5 percent of GDP, which is expected to stimulate the economy. Meanwhile, Germany and France launched similar packages worth 50 and 25 billion euros, respectively, and announced that the amount may be raised if necessary. In Japan, the Congress approved a new fiscal stimulus package in December, reaching 58 trillion yen in total.

These packages have generally supported economic growth, but are likely to undermine capital flows into emerging markets, including Turkey, by heightening their need to borrow.

2.2. Commodity Prices

Commodity and energy prices have been on a sharp downward spiral since the final quarter of 2008 as the outlook for global growth has worsened (Graph 2.2.1). The S&P Goldman Sachs (GS) Commodity Index was down 42.8 percent year-on-year and 44 percent quarter-on-quarter in the fourth quarter. Likewise, the GS energy, metals and agriculture indexes dropped by 51.9, 42.2 and 11.9 percent, respectively, from a quarter earlier.



After having rallied and played a major role in boosting global inflation in the summer of 2008, international food prices started to fall markedly with slowing global economy, prospects for a record 2008-2009 wheat production, and higher productivity gains in all grain production. Food prices are expected to slow down further in 2009. In addition, the rise in grain-based biofuel production and the potential demand from emerging markets may put some upward pressure on food prices in the medium term.

The global financial crisis has a depressing effect on economic activity in industrialized countries, leading to a decline in the demand for aluminum, copper and zinc, three backbone commodities in industrial production and construction activities. The decrease in the demand for base metals also owes to the slowdown in the automotive industry. Thus, metal prices have been on a steep decline since the third quarter of 2008. On balance, metal prices are expected to remain low for 2009.

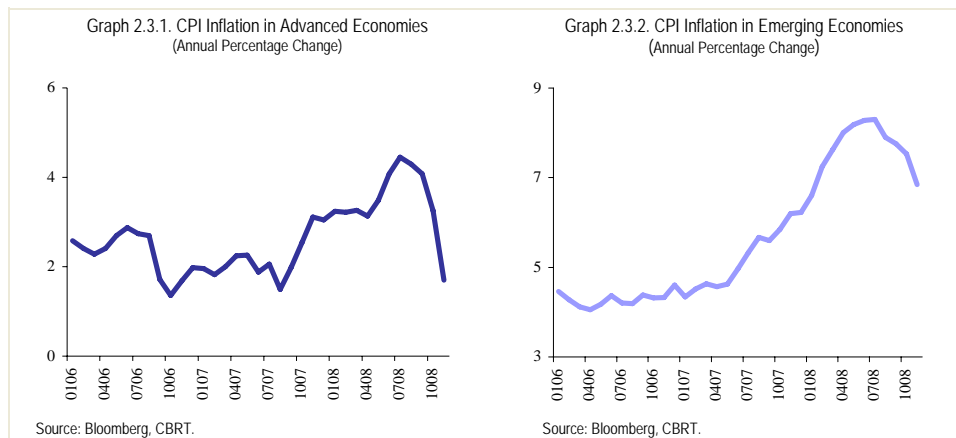
After climbing to a record-high of 145.7 US dollar per barrel in July 2008, international (Brent) crude oil prices began to tumble amid reduced demand from industrialized countries (Graph 2.2.2). The global oil demand fell in 2008 for the first time since 1983 and is expected to remain on the decline in 2009. Despite the softening in oil demand, OPEC expects that non-OPEC oil supply will continue to rise in 2009, boosting crude oil inventories.

Accordingly, crude oil prices slumped to around 34 US dollar per barrel on December 24, 2008, the lowest close since June 2004. In view of plunging oil prices, OPEC decided to reduce production by 1.5 mbb/d in September and by a further 2.2 mbb/d in December. OPEC’s production cuts had only a slight dampening effect, while geopolitical tensions in the Middle East and Nigeria gave a renewed boost to oil prices, which averaged around 45.4 US dollar per barrel in the first three weeks of January 2009, a level down 51.2 percent from a year ago. OPEC’s production cuts and the postponement of new oil production investments in the face of tumbling oil prices, and ongoing geopolitical tensions seem to be the factors that would put upward pressure on crude oil prices in the upcoming periods.

In sum, despite the uncertainty over supply, oil prices are expected to increase only modestly in 2009 due to the reduced global demand.

2.3. Global Inflation

The economic slowdown spreads across the globe and commodity prices fall sharply, causing global inflation to plummet. The downtrend in CPI inflation has recently intensified in both advanced and emerging economies.

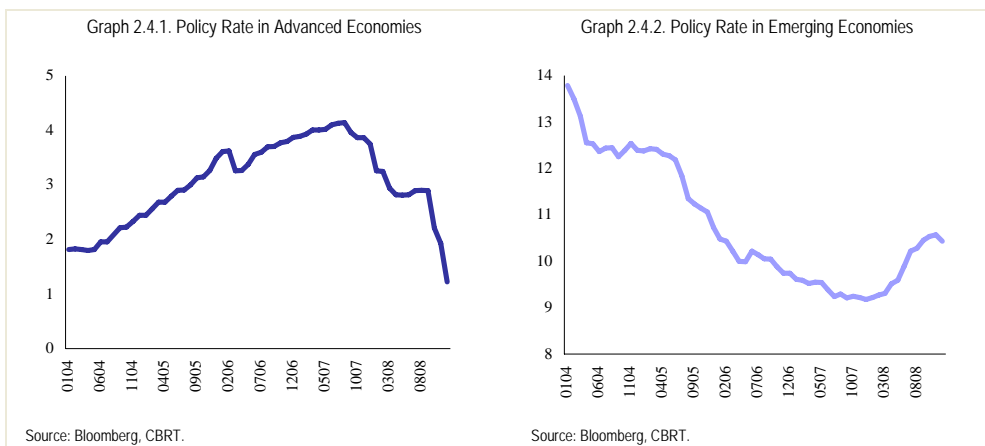


The annual change in CPI inflation in advanced economies dropped to 1.7 percent in November, from 4.4 percent in July 2008. Similarly, the annual change in CPI inflation in emerging economies fell to 6.8 percent from 8.3 percent (Graph 2.3.1 and Graph 2.3.2). By countries, the US inflation dropped to 1 percent in November from 5.5 percent in July, while in Japan, inflation went down to 1 percent from 2.3 percent. Likewise, the euro area Harmonized Index of Consumer Prices (HICP) inflation dropped to 2.1 percent in November from 4 percent in July. In China, a developing country, inflation went down to 2.4 percent in November from 8.7 percent in February 2008.

As a result, falling commodity prices and the sharp economic slowdown not only offer a benign outlook for the dynamics of global inflation, but may also increase the risk of deflation in some industrialized countries.

2.4. Monetary Policy Developments in the World

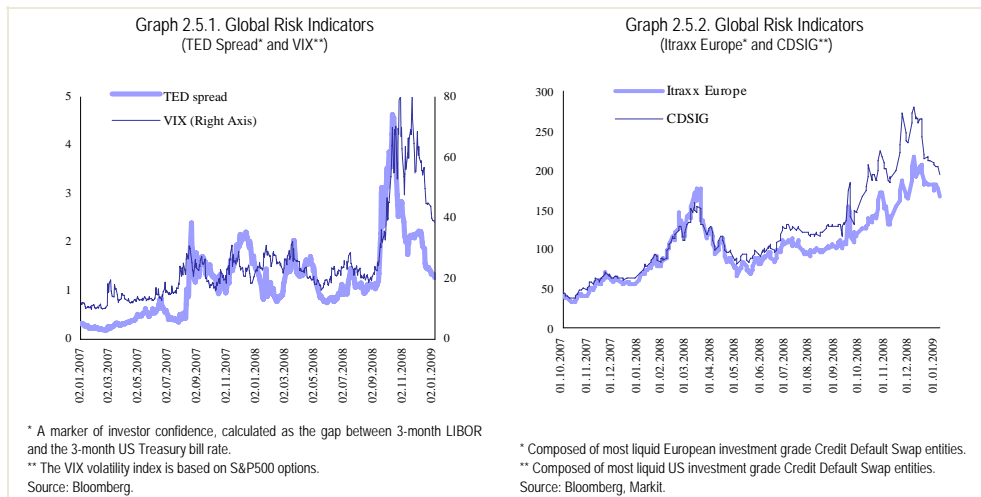
With the sharp contraction in economic activity and the steep decline in commodity prices, inflation rates started to fall substantially in the fourth quarter of 2008, leading to further monetary loosening in advanced economies (Graph 2.4.1). Though a coordinated action by advanced countries, the loosening of monetary policy varies in practice: the Fed pumps liquidity into markets by both cutting its federal funds rate and allowing its monetary base to grow with unsterilized purchases since September, while the European Central Bank (ECB) does not allow for a fast-growing balance sheet. In Japan, the Bank of Japan's (BoJ) monetary base expanded at an outstanding rate in December after a period of stable growth.



On the emerging economies front, monetary policy underwent a major change towards the end of 2008. Due to reduced credit availability, resulting from the global financial turmoil, developing countries had adopted a prudent monetary policy for fear of massive capital outflow and depreciation in local currency, but starting from December, they have been lowering key interest rates rapidly (Graph 2.4.2). Moreover, central banks signal that they will continue with rate cuts in coming months. The fact that inflation appears increasingly likely to fall behind short- and medium-term targets and downside risks to growth have become more pronounced is the main driver behind the policy change in emerging economies.

2.5 Global Risk Indicators

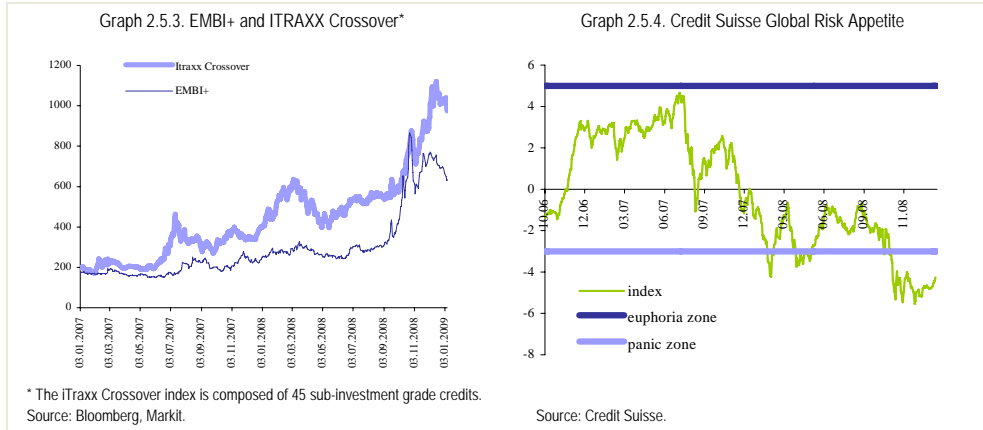
TED spread, a key indicator of liquidity shortage and credit risk in global financial markets, started to fall in November from its peak in October. Similarly, the VIX index, a tool for measuring investors' expectations on future market volatility, has been falling since early December (Graph 2.5.1). On the other hand, the Credit Default Swap (CDS) index remains elevated for advanced economies' companies with higher investment-grade ratings, despite some recent declines (Graph 2.5.2).



Risk indicators for emerging economies suggest that global financial markets are still risk averse. EMBI+ and Itraxx Crossover¹ indices, key measures of investor sentiment towards emerging markets, remain elevated

¹ The Itraxx Crossover index is a key indicator of investor risk sentiment towards emerging markets as the companies involved have similar investment-grade ratings with those from emerging economies, including Turkey.

(Graph 2.5.3). However, the Credit Suisse Global Risk Appetite Index (CSRA) has moved out of the panic zone by September (Graph 2.5.4).



In sum, risk appetite continues to wane on fears of a severe and protracted global downturn and prospects of increased deflationary pressures in advanced economies. In fact, recent risk indicators have improved markedly since September 2008 when the global crisis worsened, but are still running above their historic averages.

BOX 2.1. EXPECTATIONS ABOUT GLOBAL ECONOMY

As suggested by fourth-quarter indicators, the world economy continues to slump at a rapid clip amid sinking confidence and heightened uncertainty. Inflation and monetary policy in Turkey will be highly susceptible to changes in global economy in the medium term. Therefore, assumptions over the time and scale of the global economic rebound are more important than ever for the outlook presented in this Report. This box contains a brief account of 2008 and 2009 global growth forecasts of selected international institutions. These expectations underlie our assumptions about foreign economic activity that are involved in CBRT's medium-term projections.

With the deepening of the global downturn, many international institutions revised their 2008 and 2009 global growth forecasts gradually down in the previous quarter. The December 2008 "Consensus Forecasts" had projected a 0.4 percent global growth for 2009, but the January 2009 release points to a more severe global contraction driven by slowing economic activity in advanced economies, particularly in the US and euro area and suggests that the world economy will grow by -0.2 percent in 2009 (Table 1). Similarly, in its November update to World Economic Outlook (WEO) October 2008 issue, the IMF slashed its 2009 forecast for world growth to 2.2 percent from 3 percent. The WEO Update to be released on January 29 is likely to announce further downward revision. Likewise, in its December 2008 Economic Outlook, the OECD expected the US and euro area to grow by -0.9 and -0.6 percent, respectively, in 2009 (Table 1).

Table 1. Global Growth Forecasts

	2008		2009	
	Previous	Revised	Previous	Revised
IMF				
World	3.9	3.7	3.0	2.2
Advanced economies	1.5	1.4	0.5	-0.3
USA	1.6	1.4	0.1	-0.7
Euro area	1.3	1.2	0.2	-0.5
Emerging Economies	6.9	6.6	6.1	5.1
OECD				
All OECD	1.8	1.4	1.7	-0.4
USA	1.2	1.4	1.1	-0.9
Euro area	1.7	1.0	1.4	-0.6
Consensus Forecasts				
World	2.4	2.3	0.4	-0.2
USA	1.2	1.2	-1.3	-1.8
Euro area	1.0	0.9	-0.9	-1.4

Source: IMF World Economic Outlook, October and IMF World Economic Outlook Update, November.

OECD Economic Outlook, 2008/I, June and OECD Economic Outlook, 2008/II, December.

Consensus Forecasts, December 2008 and Consensus Forecasts, January 2009.

In detail, however, growth forecasts for the US and euro area economy that makes up nearly 55 percent of global GDP suggest a partial rebound by the first quarter of 2010, which coincides with the forecasts of most market analysts, as well as the Fed and the ECB.

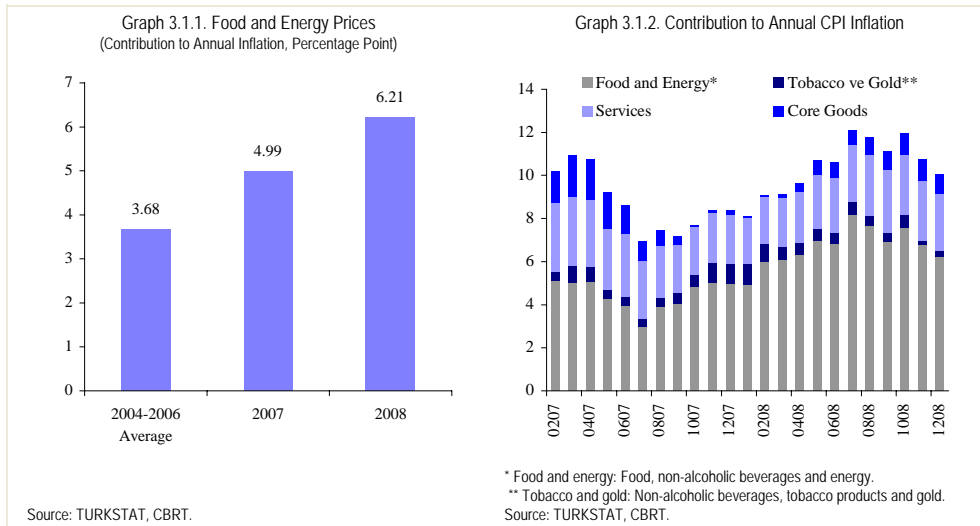
To sum up, global growth forecasts for coming months indicate that advanced economies will continue to slow in 2009 and the world will recover from recession by 2010. Accordingly, we built our forecasts and analyses in this Report on the assumption that a modest recovery will start in early 2010.

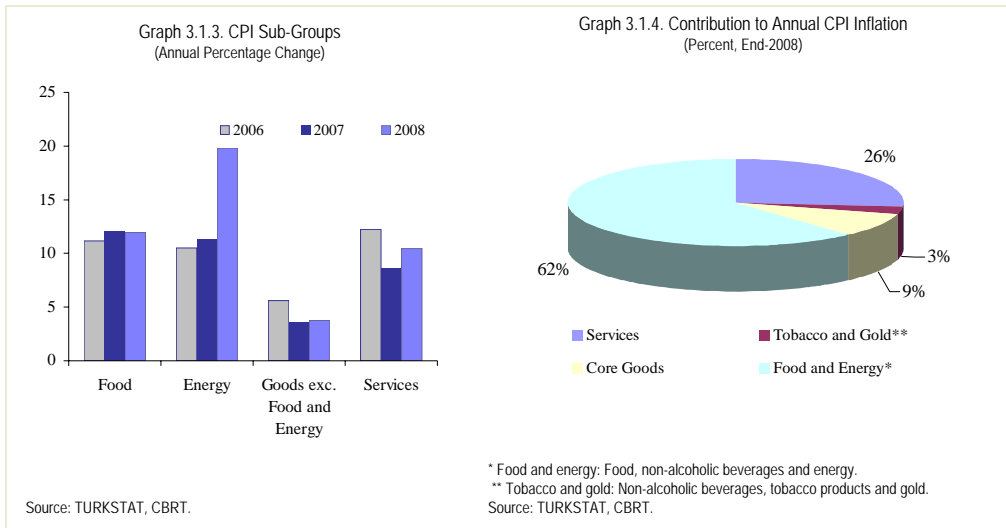
3. Inflation Developments

3.1. Inflation

CPI inflation ended 2008 at 10.06 percent. Consumer prices were up 3.03 percent in the fourth quarter, of which 2.6 percentage points were due to skyrocketing food and energy prices in October. Falling oil and other commodity prices and the softening in demand put significant downward pressure on CPI inflation in the last two months, leading to a historic drop in monthly price changes. In addition, the exchange rate pass-through had a less striking impact on consumer prices in the short run than in previous years thanks to the marked economic slowdown and the decline in import prices.

Despite having decreased gradually in the fourth quarter, the contribution of food and energy to annual inflation remained solid throughout 2008 (Graph 3.1.1). Services prices made a reduced contribution to annual inflation on lower costs and weaker domestic demand, while the contribution from prices of core goods barely changed (Graph 3.1.2).

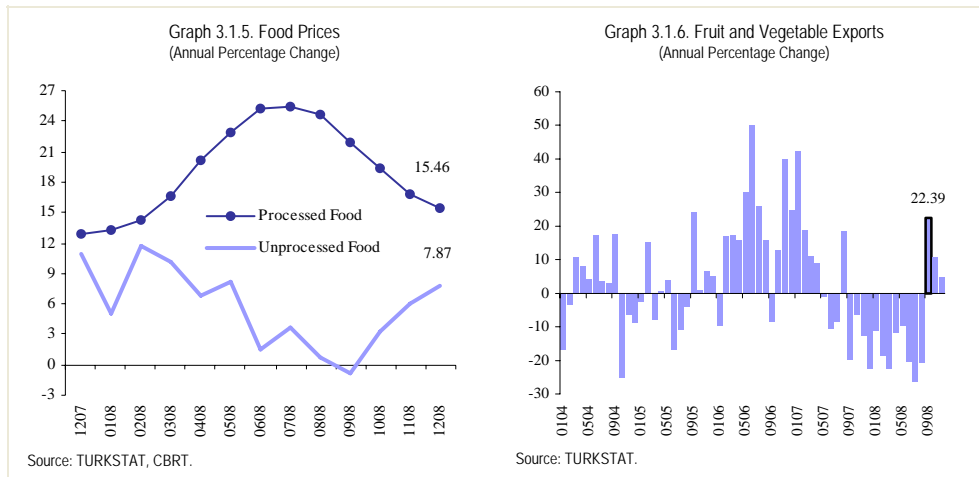




The rate of increase in food prices had accelerated in the first half of 2008 due to lagged effects of supply shortages driven by the drought in 2007, but tapered off in the second half on increased domestic production and lower international prices. However, the uptrend in food prices for the past two years continued in 2008 and became the main driver of inflation (Graph 3.1.3). Meanwhile, energy prices increased at a stronger pace than in recent years on rising fuel and electricity prices. Accordingly, food and energy prices contributed 62 percent to annual CPI inflation which is above the averages. (Graph 3.1.4). Despite the weakening of the Turkish lira, annual inflation in prices of goods excluding food and energy was down from the year-ago average due to the sharp slowdown in economic activity. Moreover, after having advanced at a fast pace between January and September on second-round effects of supply shocks, services inflation decelerated in the fourth quarter amid softening demand conditions, but still made a higher contribution to annual inflation than in 2007.

Food prices increased by 5.14 percent in the fourth quarter, at a faster pace than a year ago. Unprocessed food prices rose sharply, while inflation in processed food prices continued to fall.

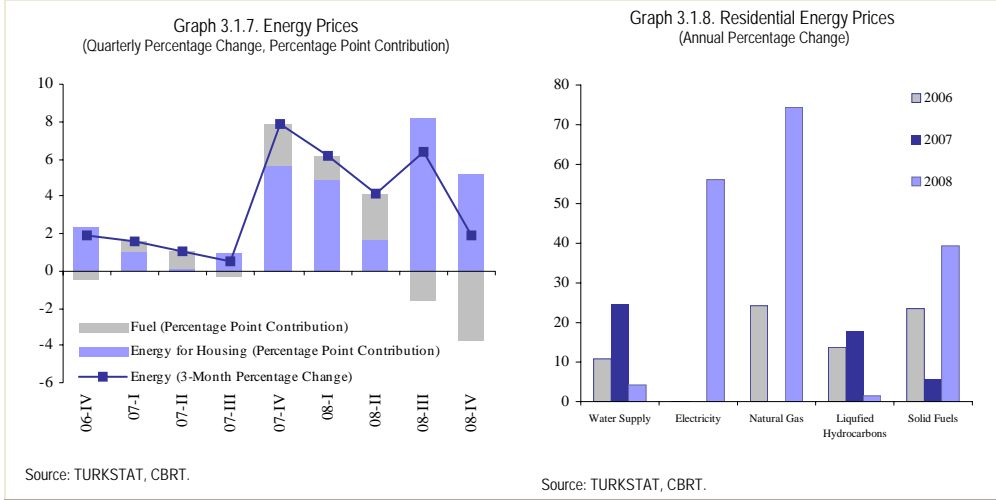
Despite having increased at a relatively modest pace since the fourth quarter of 2007, unprocessed food prices jumped by a stunning 12.45 percent in the final quarter of 2008, at a faster pace than a year ago, mainly on soaring vegetable prices (Table 3.1.2). Thus, food price inflation climbed to 7.87 percent year-on-year (Graph 3.1.5). Supply problems and exports of fruits and vegetables that began to rise year-on-year in the last months after a prolonged downward trend were the main drivers of food price inflation (Graph 3.1.6).



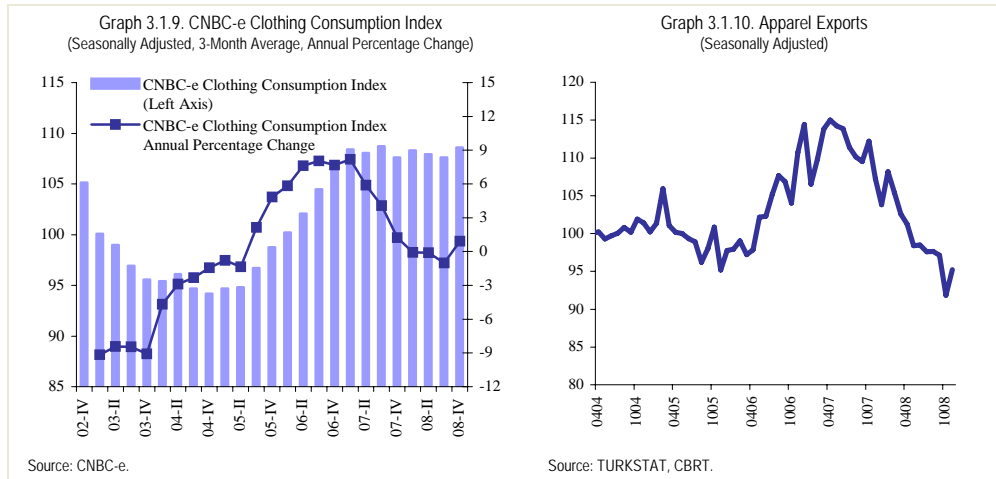
On the processed food prices front, annual inflation climbed to record-highs in the first half but began a steady downward slide in the third quarter thanks to higher production, lower international prices and weaker total demand, which continued firmly into the fourth quarter. Accordingly, processed food prices decreased by 0.20 percent in the fourth quarter, to 15.46 percent year-on-year (Graph 3.1.5). Food import prices continue to fall. Similarly, domestic wheat prices have been on the decline for the past two quarters due to increased output, causing prices for bread and grains to drop by 0.42 percent in the fourth quarter. Annual inflation in processed food prices is expected to decelerate further in the first half of 2009.

Energy price inflation slowed in the fourth quarter, down to 19.81 percent year-on-year. After closing at 115 US dollars in the third quarter, crude oil prices went down to around 55 US dollars in the fourth quarter. The slump in oil prices had an immediate downward effect on domestic fuel prices, while prices for other energy items (electricity and natural gas) continued to soar on lagged effects (Graph 3.1.7). In addition, the third-quarter run-up in prices of solid fuels continued into the fourth quarter (Graph 3.1.8). Given the steep decline in crude oil prices and the cost-based pricing mechanism, annual

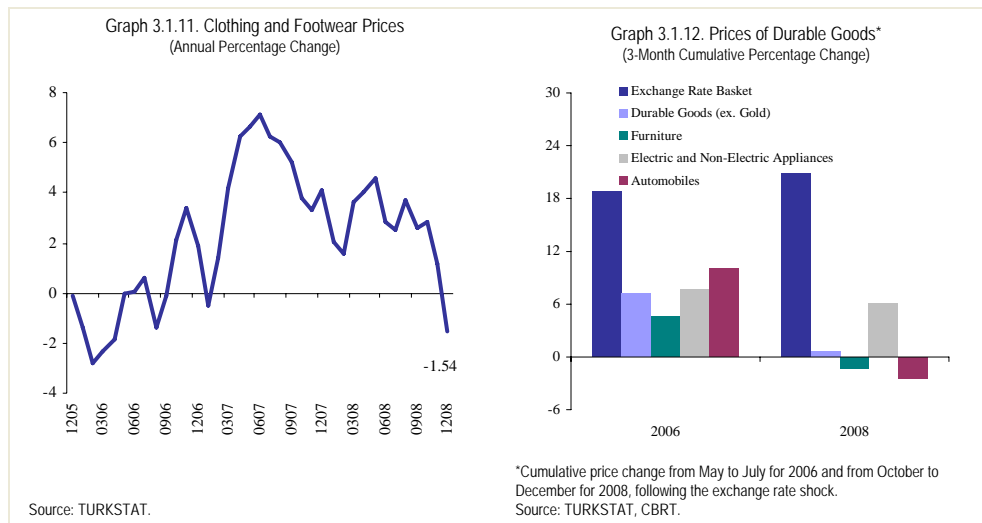
inflation in domestic energy prices is expected to moderate at a sharper rate in coming months.



Annual inflation in prices of goods excluding food and energy was down 0.42 percentage points in the fourth quarter to 3.75 percent. The surge in clothing prices slowed down, while prices of durable goods increased on the weak Turkish lira.



According to the seasonally adjusted CPI, domestic consumer spending on clothing softened from a year earlier (Graph 3.1.9). Similarly, the seasonally adjusted quantity index for apparel exports point to a severe contraction in foreign demand (Graph 3.1.10). The softening in demand conditions prompted the clothing industry to launch discounts earlier than expected, which caused prices to rise at a less marked pace in the fourth quarter than in previous years. Thus, clothing prices sank below their year-ago level (Graph 3.1.11).



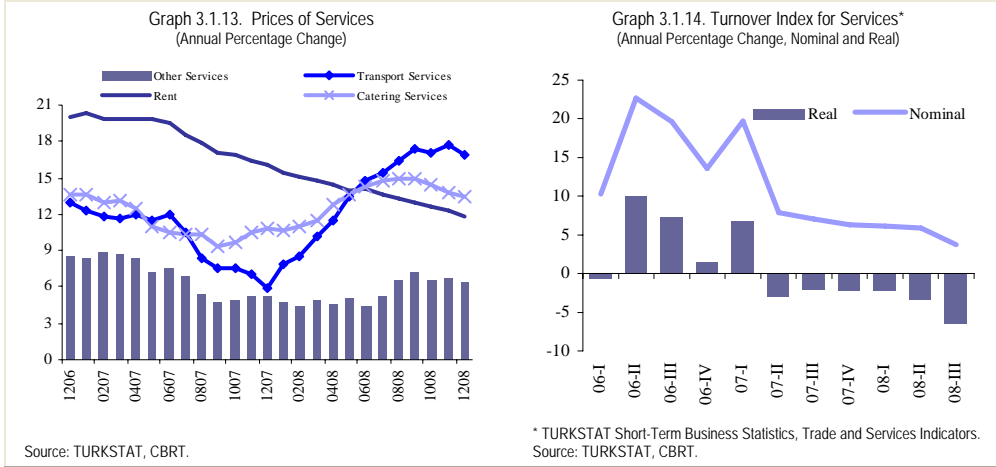
Prices of durable goods (excl. gold) were up 0.61 percent in the fourth quarter, and the group's inflation rose by 3.10 percentage points to 3.19 percent year-on-year (Table 3.1.1), mainly on account of the exchange rate pass-through and the low base from a year ago. Fourth-quarter price developments suggest that the weakening of the Turkish lira had a less dampening effect on prices of durable goods in the short run than in previous years (Graph 3.1.12), which was largely reflected in prices of electric and non-electric appliances. Moreover, the sluggish domestic and foreign demand exerted strong downward pressure on furniture and automobile prices. The downtrend in domestic sales of automobiles since early 2008 intensified in the final quarter, resulting in a 35.8 percent drop in sales from a quarter ago in seasonally adjusted terms (Graph 4.1.9). Accordingly, automobile prices declined by 5.85 percent in six months.

	2007		2008				
	IV	Annual	I	II	III	IV	Annual
Durable Goods (excl. gold)	-2.41	-4.21	1.58	2.81	-1.80	0.61	3.19
Furniture	0.94	-1.80	4.13	7.60	-1.27	-1.31	9.17
Electric and non-electric appliances	-2.35	-8.18	1.16	0.68	0.12	6.04	8.13
Automobiles	-4.42	-3.37	1.04	2.44	-3.63	-2.30	-2.56
Other	0.32	1.71	0.04	0.89	1.02	2.27	4.29

Source: TURKSTAT, CBRT.

Services prices increased by 1.39 percent in the fourth quarter, while the group's annual inflation went down to 10.46 percent (Table 3.1.2). The rate of increase in services prices continues to decelerate on lower costs and weaker domestic demand. After having rallied in the first nine months amid soaring

food prices, catering prices rose only slightly in the fourth quarter thanks to reduced cost pressures and softer domestic demand. Similarly, inflation in transport prices dropped remarkably amid falling fuel prices, which is expected to continue into the first half of 2009 at a stronger pace.



The slowdown in the turnover index for services after the first quarter of 2007 points to a contraction in the demand for services (Graph 3.1.14). In fact, without regard to supply shocks and base effects, services inflation went down gradually in 2008 (Graph 3.1.15). Annual rent inflation dropped by 4.2 percentage points in 2008 and made a significantly reduced contribution to annual services inflation (Graph 3.1.16).

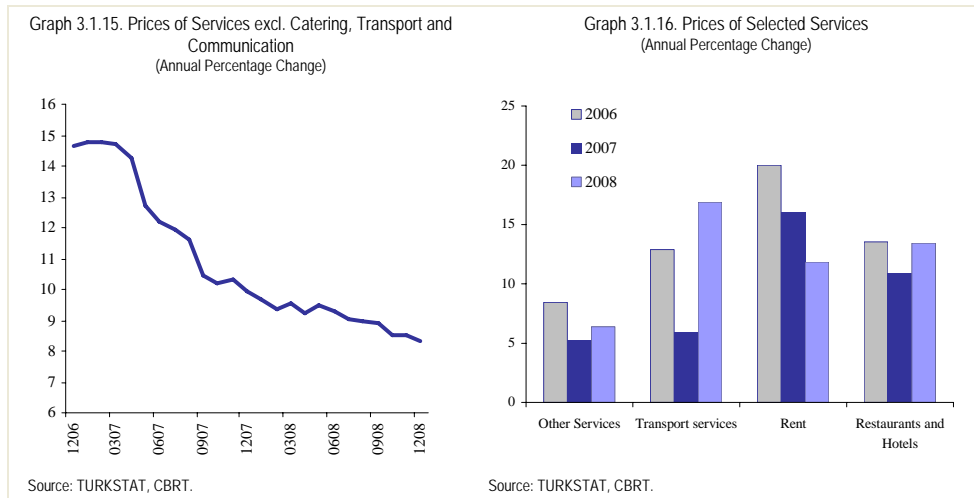
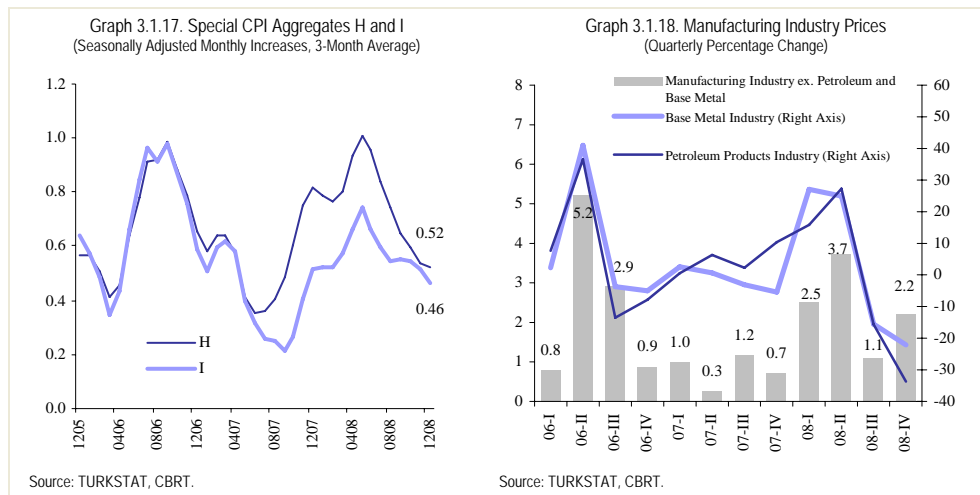


Table 3.1.2. Prices of Goods and Services
(Quarterly and Annual Percentage Change)

	2007		2008				
	IV	Annual	I	II	III	IV	Annual
CPI	4.02	8.39	3.09	2.82	0.78	3.03	10.06
1. Goods	4.65	8.29	3.27	2.69	0.05	3.61	9.93
Energy	7.85	11.25	6.11	4.12	6.41	1.91	19.81
Unprocessed food	3.30	10.99	10.90	-13.25	-0.29	12.45	7.87
Processed food	5.31	12.95	5.61	8.06	1.37	-0.20	15.46
Goods excl. energy and food	3.46	3.56	-2.35	6.87	-3.52	3.04	3.75
Durable goods (excl. gold)	-1.71	-3.34	3.45	1.97	-2.34	2.45	5.54
Semi-durable goods	-2.41	-4.21	1.58	2.81	-1.80	0.61	3.19
Non-durable goods	7.67	7.86	-1.23	9.20	0.01	3.42	11.54
Other	4.21	11.69	6.44	-1.43	0.74	4.07	9.99
2. Services	2.32	8.64	2.55	3.20	2.94	1.39	10.46
Rents	3.30	16.01	2.79	2.74	3.58	2.25	11.85
Restaurants and hotels	3.64	10.87	3.13	4.58	2.77	2.34	13.44
Transport	1.91	5.93	4.10	5.98	4.35	1.54	16.89
Other	1.27	5.29	1.68	1.80	2.29	0.49	6.40

Source: TURKSTAT, CBRT.

The CPI index excluding energy, unprocessed food, alcoholic beverages, tobacco products and gold (SCA-H) fell by 1.66 percentage points year-on-year, while, with a further exclusion of processed food, the index (SCA-I) dropped by 0.37 percentage points year-on-year. The seasonally adjusted monthly rise in both indexes continued to slow at a faster pace in the fourth quarter, suggesting that main trend in inflation is set on a downward path (Graph 3.1.17).



Changes in producer prices have been of great importance as to their cost pressure on CPI inflation. After a skyrocketing first half amid rising international commodity prices, producer prices began to fall in the second half of 2008. Base metal prices slumped by 15.5 and 22.1 percent, respectively, in the third and fourth quarters. In addition, prices for petroleum products sank by 33 percent, whereas manufacturing industry prices excluding oil and base metals climbed. Falling commodity prices reduce the cost pressure on CPI inflation despite the upward pressure from exchange rate changes (Table 3.1.3, Graph 3.1.18).

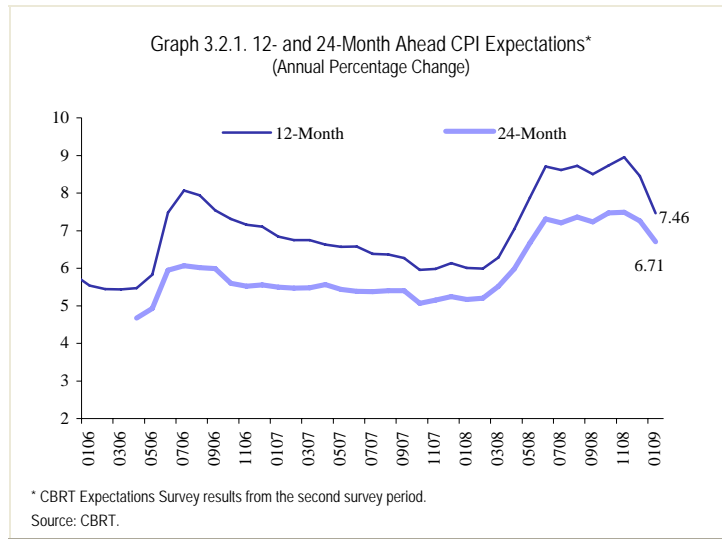
Table 3.1.3. PPI Developments based on MICS Classification
(Quarterly and Annual Percentage Change)

	2007		2008				
	IV	Annual	I	II	III	IV	Annual
Manufacturing industry excl. oil and base metals	0.70	3.15	2.53	3.73	1.11	2.20	9.90
Intermediate goods	-1.25	0.75	7.28	8.84	-2.39	-3.30	10.21
Capital goods	-0.48	-2.31	4.57	6.60	-1.69	5.08	15.15
Durable goods	-3.06	-3.41	1.59	3.05	3.29	3.57	12.00
Non-durable goods	2.88	8.15	1.33	1.76	1.46	1.21	5.89
Energy	2.65	10.02	16.88	16.65	-5.22	-13.14	12.25

Source: TURKSTAT, CBRT.

3.2. Expectations

Medium-term inflation expectations increased markedly in the first half of 2008. The announcement of CBRT's new inflation targets in May saved expectations from further deterioration, but as inflation remained elevated on supply shocks, expectations ran well above medium-term targets for a quite long time. However, with the fall in oil prices since November and softening demand conditions, the inflation outlook has improved, reflecting in lower inflation expectations. Moreover, CBRT's rapid rate cuts regarding the positive outlook in inflation and readings that justified the Bank's move contributed to the reduction in inflation expectations. As of January 2009, 12- and 24-month ahead inflation expectations are at 7.46 and 6.71 percent, respectively, anchored near medium-term targets (Table 3.2.1).



The coefficient variation¹ that measures inflation uncertainty dropped in 12- and 24-month ahead inflation expectations in the latest survey period (Table 3.2.1).

Current Period	Survey Period	Year-end Expectations*	12-Month Ahead		24-Month Ahead	
			Average Expectations*	Coefficient of Variation	Average Expectations *	Coefficient of Variation
Dec-07	2	8.64	6.14	0.13	5.24	0.15
Jan-08	2	6.47	6.01	0.13	5.17	0.14
Feb-08	2	6.54	5.99	0.10	5.20	0.13
Mar-08	2	7.27	6.29	0.15	5.52	0.17
Apr-08	2	8.44	7.04	0.14	5.98	0.16
May-08	2	9.64	7.88	0.14	6.67	0.19
Jun-08	2	10.63	8.71	0.13	7.31	0.16
Jul-08	2	10.76	8.61	0.12	7.21	0.16
Aug-08	2	11.04	8.72	0.09	7.36	0.11
Sep-08	2	10.70	8.50	0.10	7.23	0.14
Oct-08	2	10.45	8.73	0.11	7.47	0.15
Nov-08	2	11.78	8.95	0.13	7.49	0.15
Dec-08	2	11.04	8.45	0.15	7.26	0.16
Jan-09	2	7.55	7.46	0.13	6.71	0.13

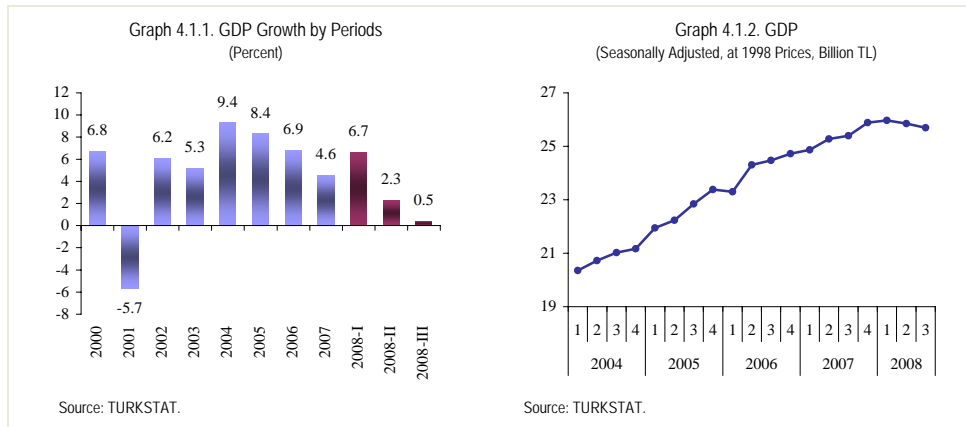
* Average expectation figures presented in the table are appropriate means designated by comparing the arithmetic mean, median, mode, alpha-trimmed mean and extreme value analysis.
Source: CBRT.

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

4. Supply and Demand Developments

4.1. Gross Domestic Product Developments and Domestic Demand

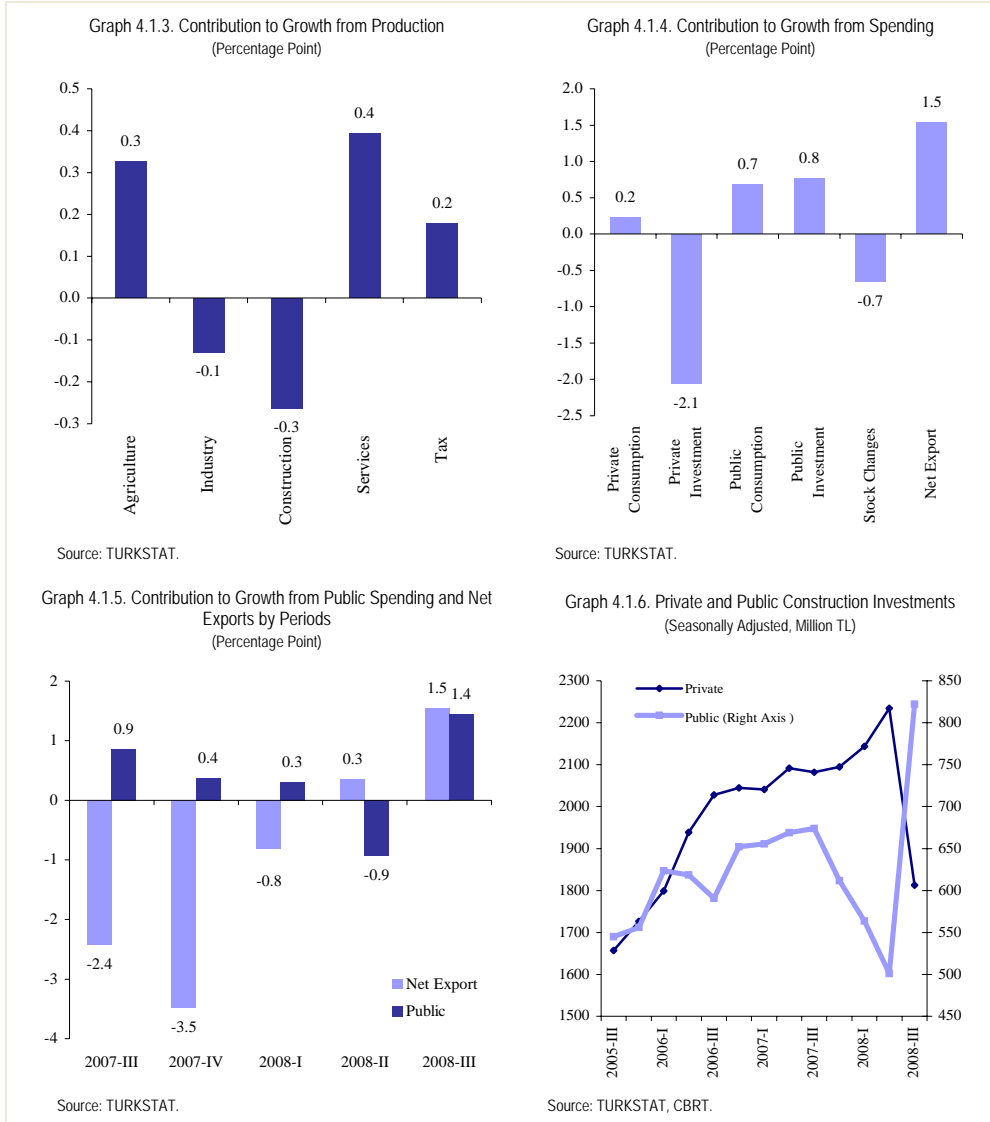
According to the national income data released by the Turkish Statistical Institute (TURKSTAT), GDP rose by 0.5 percent in the third quarter of 2008 from a year earlier (Graph 4.1.1). In that period, annual growth rate of the second quarter was updated from 1.9 percent to 2.3 percent and annual growth rate in the first nine month was recorded as 3.0 percent. In seasonally adjusted terms, the quarterly decline in GDP points to a continued slowdown in economic activity in the third quarter (Graph 4.1.2).



On the production side, agriculture and services added to GDP growth, while industrial production made a negative contribution for the first time since the first quarter of 2002 (Graph 4.1.3). In addition, the value added of construction continued to fall year-on-year in the third quarter.

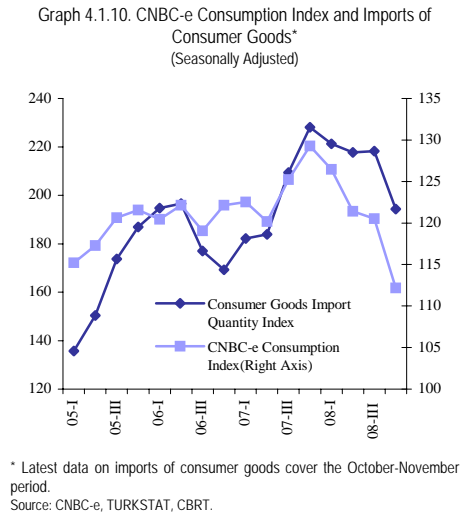
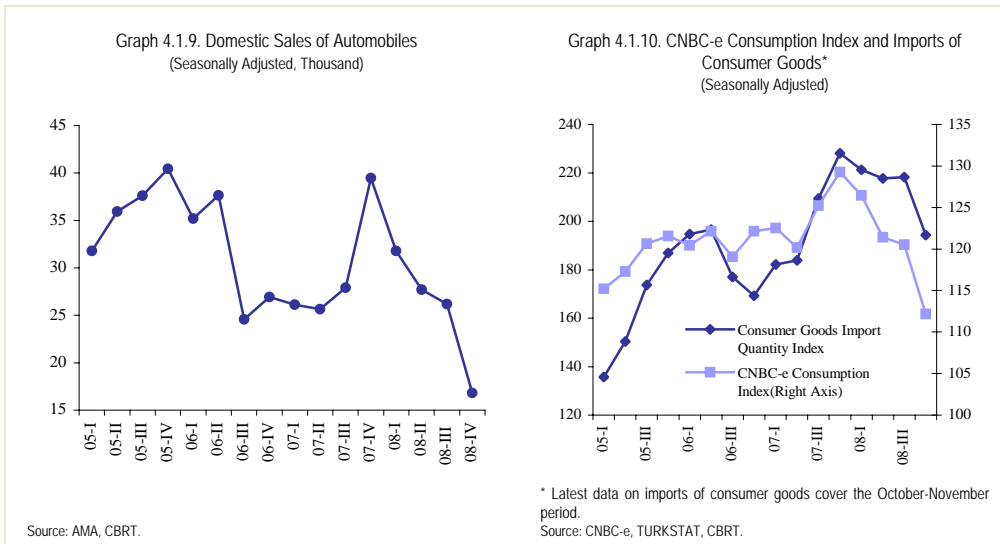
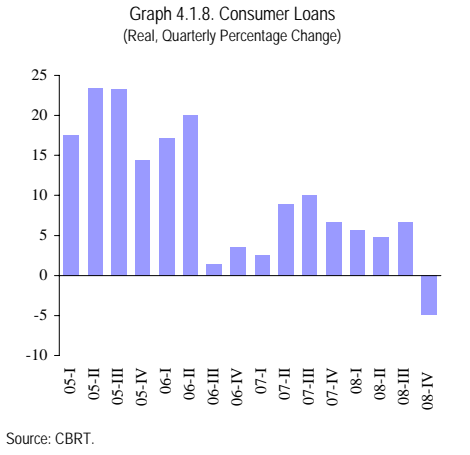
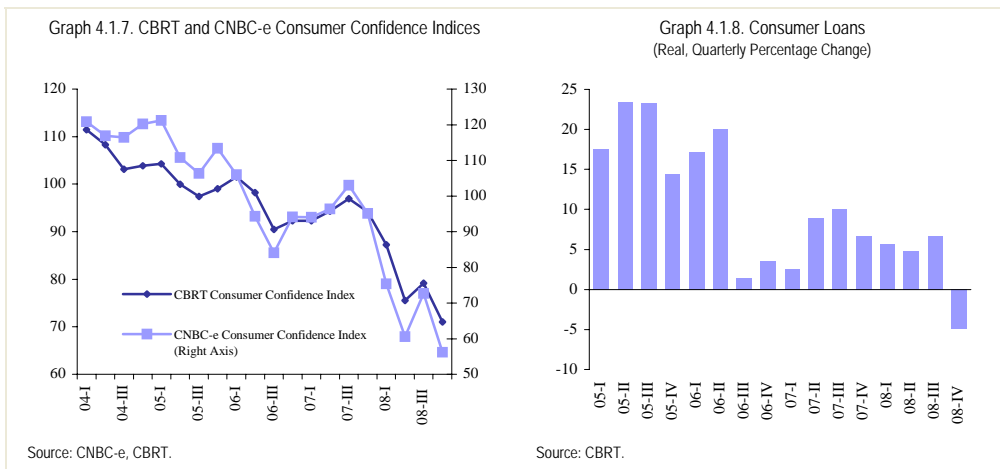
On the spending side, public spending and net exports were the main drivers of GDP growth (Graph 4.1.4 and Graph 4.1.5). Both public spending and public investment gave a boost to growth, while private demand, especially private investment, weakened. In fact, having dropped by 10 percent year-on-year, private investment spending made the largest negative contribution to GDP growth. After having grown constantly in annual terms since the first quarter of 2002, private construction investments contracted by 12.8 percent in the third quarter and posted a sharp quarterly decline in seasonally adjusted terms, which was partially offset by the rapid increase in public spending (Graph 4.1.6). Despite having expanded slightly, net exports added only 1.5

points to GDP growth as imports registered their first annual decrease since the fourth quarter of 2001.



Total final domestic demand decreased by 0.4 percent in the third quarter from a year ago, posting its first annual decline since the first quarter of 2002. Excluding the additional periodic contribution from public spending to GDP growth, in seasonally adjusted terms, continuation of fall in private consumption and investment spending reflects the weakening in domestic demand. Recent readings on private demand suggest that the weakening of domestic demand became more pronounced in the final quarter.

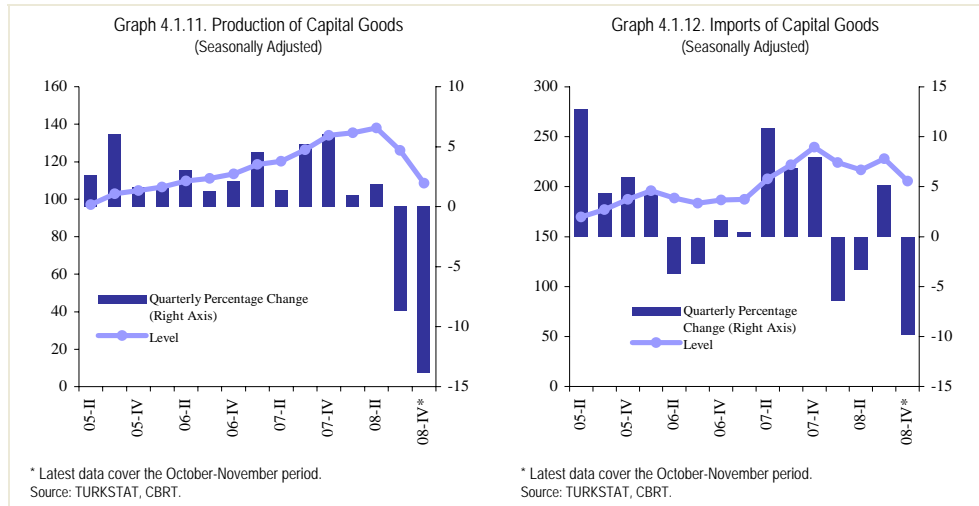
The TURKSTAT-CBRT and CNBC-e consumer confidence indices hit a historic-low in the fourth quarter (Graph 4.1.7). This situation with tighter financial environment put a clamp on borrowing. Accordingly, consumer loans went down both in nominal and real terms, in the fourth quarter compared with the previous quarter (Graph 4.1.8). Other key indicators for consumption portray a similar tendency. In seasonally adjusted terms, domestic sales of automobiles continued to fall at a stronger pace in the fourth quarter, besides, the CNBC-e Consumption Index dipped below its third-quarter average (Graph 4.1.9).



According to industrial production data available from TURKSTAT's Main Industrial Groupings Classification, production of consumer goods slumped during October-November from a quarter ago. In addition, the demand for imported consumer goods followed the same pattern (Graph 4.1.10). In

sum, recent readings suggest that private consumer spending shrank both quarterly and annually in the fourth quarter.

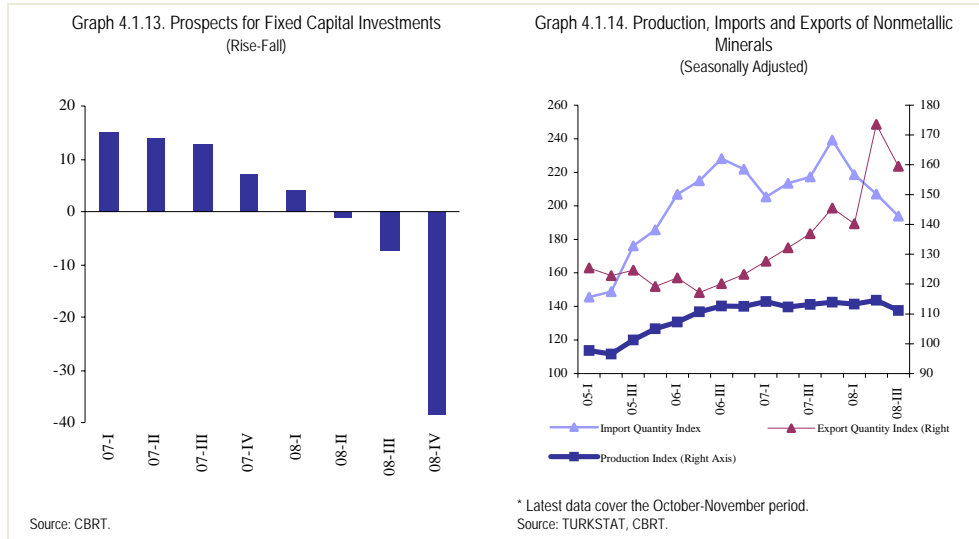
Leading indicators for investment spending, another major component of private demand, continued to slide in the final quarter of 2008. Production and imports of capital goods dropped by 22.4 and 16.5 percent year-on-year, respectively, during October-November, and were quite below their third-quarter average in seasonally adjusted terms (Graph 4.1.11, Graph 4.1.12). Readings on production, imports and exports of investment goods indicate that machinery-equipment investments fell dramatically in annual terms in the fourth quarter.



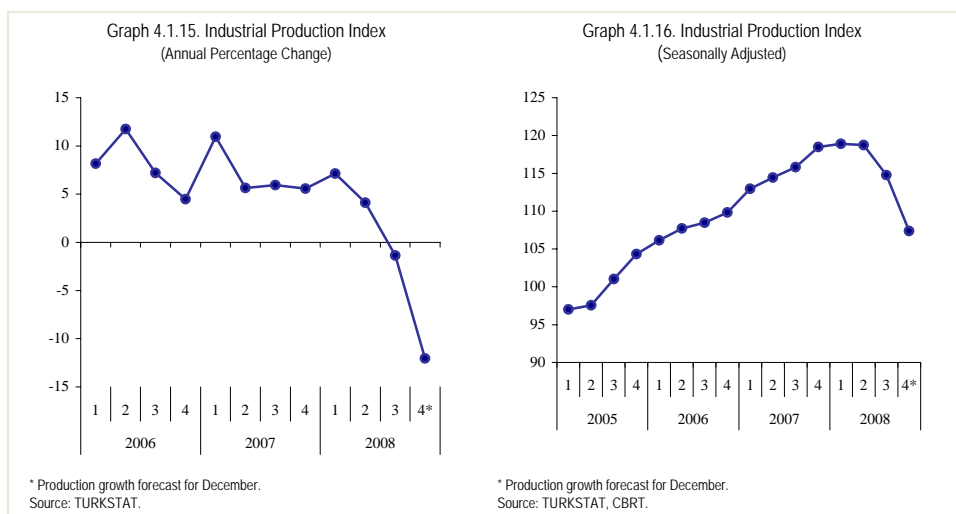
Moreover, according to the CBRT Business Tendency Survey (BTS) results, there are a growing number of firms that consider their production capacity as “more than sufficient” in view of their current order books and demand expectations. Thus, twelve-month ahead investment expectations of firms continued to weaken. The fourth-quarter deterioration in expectations of private fixed capital investment spending, a BTS indicator, confirms this outlook (Graph 4.1.13).

Production of nonmetallic minerals, backbone elements of construction activities, has remained virtually flat since mid-2006. In seasonally adjusted terms, production of nonmetallic minerals sank below its third-quarter average during October-November. Besides, the industry’s import and export performance was also weak in that period (Graph 4.1.14). Accordingly, private

construction investments are expected to fall further, both in quarterly and annual terms, in the fourth quarter.



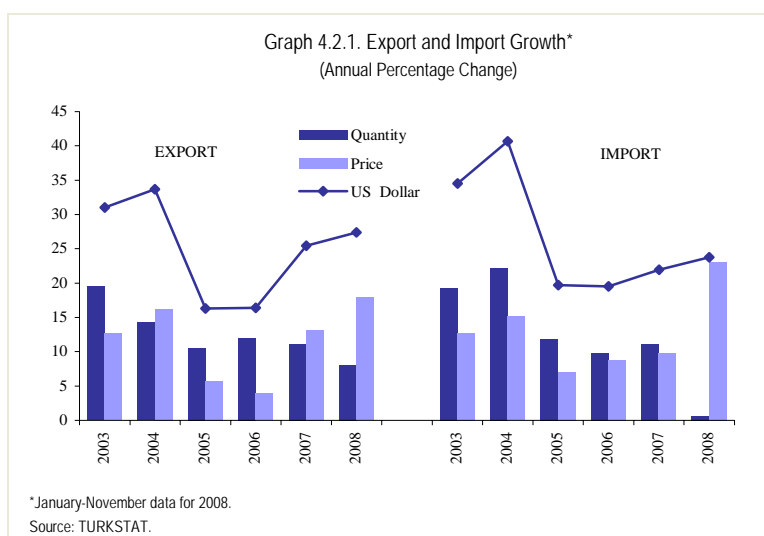
In sum, data on private consumption and investment indicate that both spending items are likely to slow down quarterly and annually in the final quarter. Furthermore, heightened signs of prolonged global recession since October clouded the outlook for foreign demand, leading to a sharp downturn in economic activity in the fourth quarter. Industrial production dropped by 10.7 percent during October-November, and has been falling month-on-month since July in seasonally adjusted terms. Recent readings on capacity utilization also point to a further dramatic decline in annual production in December.



On balance, in view of the changes in industrial production in October and November and the results of the tendency survey in December, industrial production is expected to contract markedly year-on-year in the fourth quarter (Graph 4.1.15). Seasonally adjusted data also suggest a sharper slowdown in industrial production compared to the third quarter (Graph 4.1.16).

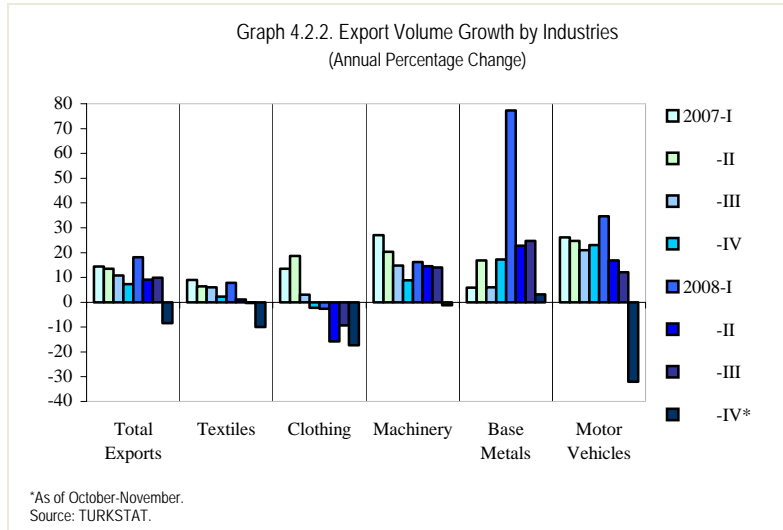
4.2. Foreign Demand

Net exports continued to make an added contribution to growth in the third quarter of 2008. Given the larger decline in real imports than in real exports and the rebound in tourism revenues, net exports added 1.5 points to GDP growth in the third quarter. Foreign trade prices continued to surge in 2008, particularly during the first half, causing exports and imports to grow faster in US dollar terms (Graph 4.2.1). However, foreign trade prices began to plunge by mid-2008 with falling commodity prices amid mounting strains in global financial markets during October-November. Unless there is a rapid turnaround in global demand, developments in the terms of trade will put considerable downward pressure on foreign trade deficit in 2009.

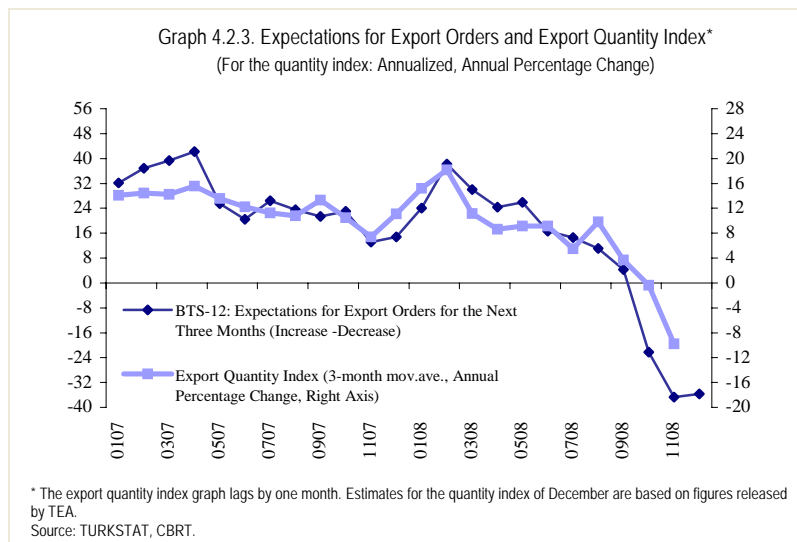


The shift in export composition towards capital-intensive goods in recent years makes exports more vulnerable to fluctuations in the world economy. In fact, the main driver of the recent decline in exports was the slump in the motor vehicles industry, while slowing machinery-equipment exports also had a dampening impact. Besides, exports of clothing and textiles have been declining since mid-2007 and mid-2008, respectively. Due to the recent marked

fall in their export prices, refined petroleum products and base metals had a significantly reduced contribution to export growth (Graph 4.2.2).



Recent information indicates that the decline in exports and imports became more pronounced in December 2008 and January 2009. According to the data released by the Turkish Exporters’ Assembly (TEA), exports contracted by 25 percent in December, while “3-month ahead expectations for export orders” from CBRT’s Business Tendency Survey worsened at a remarkably fast pace (Graph 4.2.3).



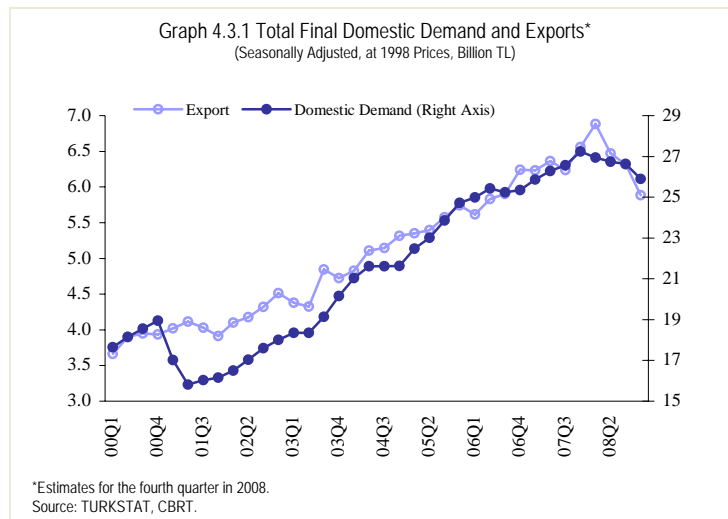
There is still considerable uncertainty about the impact of the global financial crisis on real economy. Forecasts for global growth have been constantly downgraded in recent months. According to Consensus Forecast,

GDP in the euro area, Turkey’s largest export market, is now expected to shrink by 1.4 percent in 2009, worsening compared to estimate of 0.9 percent contraction in December. The possible shift towards the Middle East and Africa to find new market opportunities in coming months is highly favorable, as it may give rise to exports. Yet, the decline in oil prices poses a major threat to Turkey’s exports to oil-exporters that has picked up sharply in recent months. Overall, foreign demand is expected to remain weak in 2009.

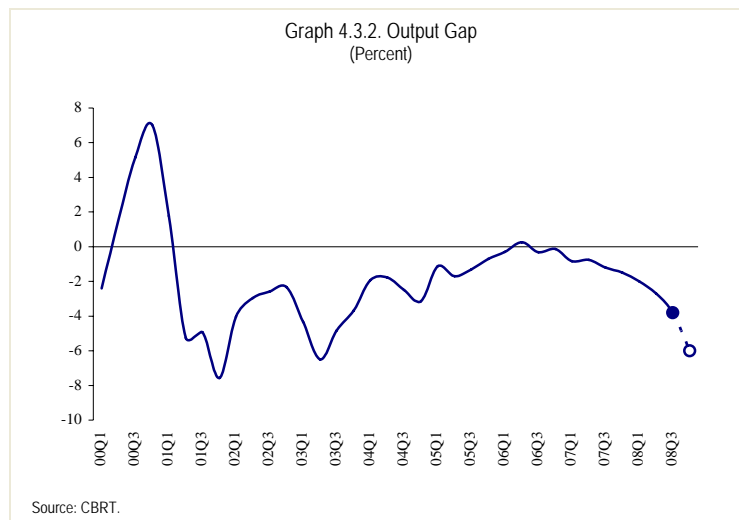
Balance of payments statistics indicate that net exports had an added contribution to GDP growth in the last quarter of 2008, which is expected to continue into the first half of 2009 given the anticipated contraction in global economic activity and the softening of domestic demand. With slower economic activity and plunging oil and other commodity prices, foreign trade and current account deficits will narrow down markedly in 2009.

4.3. Output Gap

The third-quarter national accounts data were largely consistent with projections from the October Inflation Report. Accordingly, domestic demand made a reduced contribution to growth in the third quarter of 2008, whereas net foreign demand provided a boost. Excluding the additional contribution from public spending to GDP, domestic demand was mostly weak. The contribution from domestic demand to GDP growth is expected to lessen further in the fourth quarter, while, despite sluggish exports, net foreign demand will provide a stronger boost thanks to a severe contraction in imports.



Indicators for the fourth quarter point to a gloomier-than-expected outlook for global spillovers and economic slowdown. According to seasonally adjusted quarterly indicators for both consumption and investment spending suggest that private demand continued to weaken at a faster pace in the fourth quarter. Moreover, with the sharpening of global economic slowdown, the outlook for foreign demand has worsened. Although, after a robust third quarter, public spending is likely to make further positive contribution to GDP growth in the fourth quarter, total final domestic demand is expected to decline further from a quarter ago (Graph 4.3.1). In sum, available data indicate that both domestic and foreign demand has softened markedly and the economy will contract at a faster pace in the fourth quarter than a quarter earlier. Therefore, aggregate demand conditions appear to have an added support for disinflation in the final quarter (Graph 4.3.2).¹



4.4. Labor Costs

With the marked expansion in Turkey's foreign trade volume after the financial crisis in 2001, there have been remarkable changes in the supply chain of intermediate goods of manufacturing industry. Large-scale manufacturers have been procuring more inputs from local spare part manufacturers and imports. In addition, firms became increasingly integrated into a global network of buyers and sellers and benefited from better access to credit required by these relations. Therefore, production and productivity in the manufacturing

¹ Output gap forecasts for 2009 and onwards are presented in the last chapter.

industry have become more sensitive to changes in domestic and foreign demand and in credit markets.

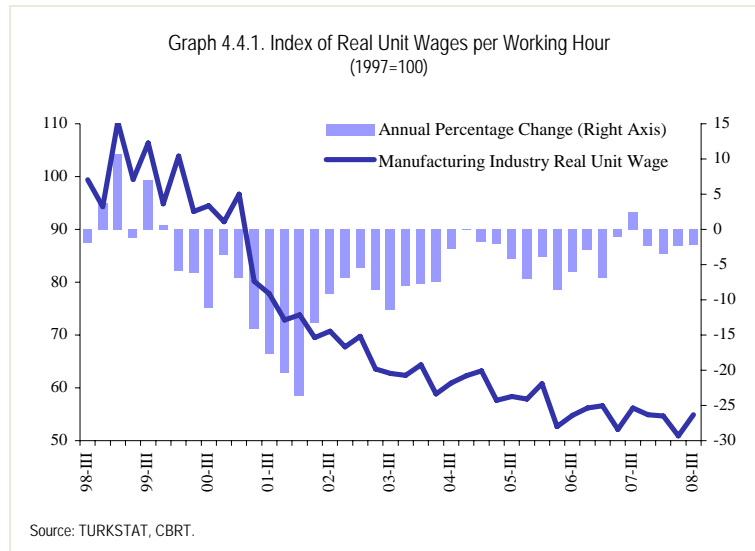
The global financial turmoil has a significant dampening effect on domestic and foreign demand since mid-2008. Accordingly, productivity gains slowed in the third quarter of 2008, and real wage indices declined (Table 4.4.1). As a result, the index of real unit wages fell by 2.2 percent year-on-year (Graph 4.4.1).

Table 4.4.1. Employment, Real Wages and Productivity Developments in Manufacturing Industry
(Annual Percentage Change)

	2006		2007				2008		
	Annual	I	II	III	IV	Annual	I	II	III
Production ⁽¹⁾	5.5	8.5	2.9	3.2	5.1	4.8	6.3	2.6	-2.9
Employment ⁽²⁾	-0.7	2.4	2.0	2.2	1.8	2.1	1.7	0.5	-2.4
Real Wages ⁽³⁾	0.9	-2.1	-0.5	3.5	1.6	0.6	0.0	0.2	-1.8
Earnings ⁽⁴⁾	0.9	-1.3	-0.1	3.7	0.6	0.7	2.1	-0.2	-0.5
Productivity ⁽⁵⁾	6.7	5.1	0.5	1.1	3.9	2.6	3.6	2.6	0.4
Real Unit Wages ⁽⁶⁾	-5.3	-6.9	-1.0	2.5	-2.3	-2.1	-3.4	-2.4	-2.2

(1) Manufacturing Industry Employment Index, 1997=100.
 (2) Index of Workers, 1997=100.
 (3) Index of Real Wages per Working Hour, 1997=100.
 (4) Index of Real Earnings per Worker, 1997=100.
 (5) Index of Partial Productivity per Working Hour, 1997=100.
 (6) Index of Real Unit Wages, 1997=100.

Source: TURKSTAT, CBRT.



Assuming that employment elasticity of output growth is less than 1, productivity per worker may decrease in the upcoming periods with lower levels of production. In fact, manufacturing firms, particularly auto industries, slashed production in the fourth quarter amid falling domestic and foreign demand, while job cuts were gradual. This observation indicates that productivity gains will make a smaller contribution to the decline in unit labor

costs in the fourth quarter. Labor productivity is expected to remain flat in labor-intensive industries, but to continue rising in capital-intensive industries in the medium term.

In the third quarter of 2008, the number of workers continued to grow in private manufacturing industries such as transport vehicles, machinery-equipment, base metals and food, but shrunk in textiles, clothing, chemicals and minerals (Table 4.4.2). Real wages dropped year-on-year across all manufacturing industries (Table 4.4.3). Rising unemployment and falling production are expected to put further downward pressure on real wages in coming months.

Table 4.4.2. Index of Workers in Manufacturing Industry
(Annual Percentage Change)

	2004	2005	2006	2007				2008			
	Annual	Annual	Annual	I	II	III	IV	Annual	I	II	III
Manufacturing Industry	2.0	-0.7	-0.7	2.4	2.0	2.2	1.8	2.1	1.7	0.5	-2.4
Private	3.6	0.1	-0.4	2.7	2.5	2.3	1.9	2.3	1.6	0.2	-2.1
Food	4.6	2.4	2.8	9.4	5.0	3.2	1.2	4.6	0.8	5.5	2.3
Textiles	-3.3	-8.2	-5.9	1.0	2.2	1.3	-2.4	0.6	-4.7	-7.2	-9.7
Clothing	-9.9	-5.4	-11.6	-7.4	-4.3	-1.1	-1.5	-3.6	-2.8	-5.4	-8.6
Chemicals	2.7	0.0	-0.3	-2.6	-1.7	1.0	-1.3	-1.2	2.7	-0.4	-3.3
Nonmetallic Minerals	8.4	8.6	4.3	5.6	4.2	3.2	2.3	3.8	0.0	-2.7	-3.5
Base Metals	10.1	7.3	6.3	7.8	5.6	5.5	5.5	6.1	4.7	4.2	4.3
Machinery-Equipment	15.4	0.9	4.3	6.5	2.5	4.3	4.3	4.4	7.9	7.4	5.6
Transport Vehicles	20.7	10.0	5.1	5.6	8.1	7.7	11.3	8.2	13.4	11.5	6.8

Source: TURKSTAT, CBRT.

Table 4.4.3. Real Wages per Working Hour
(Annual Percentage Change)

	2004	2005	2006	2007				2008			
	Annual	Annual	Annual	I	II	III	IV	Annual	I	II	III
Manufacturing Industry	2.5	2.0	0.9	-2.1	-0.5	3.5	1.6	0.6	0.0	0.2	-1.8
Private	4.8	1.7	1.9	-2.0	0.1	3.5	1.9	0.9	-0.6	-0.4	-1.5
Food	10.3	4.6	3.4	-7.8	-5.1	0.2	-0.4	-3.2	1.8	0.8	-1.7
Textiles	8.5	2.3	-1.3	-4.3	-0.2	2.9	-0.5	-0.5	-2.0	-3.3	-4.1
Clothing	12.3	4.6	-2.7	-3.4	-1.7	5.0	4.2	1.0	1.1	1.7	-0.3
Chemicals	-2.3	1.3	2.1	3.4	4.6	1.7	5.1	3.7	-6.5	-10.3	-7.6
Nonmetallic Minerals	3.7	-0.7	1.1	-2.8	-1.3	0.7	0.7	-0.7	0.1	1.9	1.3
Base Metals	0.1	-0.4	-0.5	0.5	1.4	1.6	-1.0	0.6	0.2	1.3	0.3
Machinery-Equipment	-3.3	3.5	2.3	-1.1	-2.5	7.1	-5.7	-0.7	-1.5	2.0	-5.4
Transport Vehicles	-7.7	-7.4	-0.8	-1.7	0.7	8.6	4.3	3.0	-10.3	-9.7	-13.6

Source: TURKSTAT, CBRT.

So far, TURKSTAT had only released labor cost data for manufacturing industries. In December 2008, TURKSTAT began to release new series of data relating to labor costs for non-manufacturing industries.² In the third quarter of 2008, real turnover per worker fell in all trade-services industries, excluding hotels and restaurants (Table 4.4.4). A joint analysis of indices of real turnover per worker and of employment and gross wages suggests that real unit labor costs continued to rise, albeit at a more moderate pace, across all trade-services industries in the third quarter. On the other hand, real turnover per worker increased in construction industries where real wages declined (Table 4.4.4), which indicates that real unit labor costs continued to fall in construction industries.

Table 4.4.4. Real Turnover per Worker in Trade – Services and Construction Industries
(Annual Percentage Change)

	2006					2007					2008		
	I	II	III	IV	Annual	I	II	III	IV	Annual	I	II	III
Trade – Services	-13.2	0.5	-0.5	-4.7	-4.3	1.9	-6.0	-3.6	-5.6	-3.6	-6.1	-12.7	-7.9
Wholesale and retail trade; maintenance, repair	-15.2	-1.2	-2.6	-4.5	-5.7	0.4	-6.1	-5.0	-5.9	-4.4	-0.1	-8.2	-3.4
Sale, maintenance and repair of transport vehicles	-15.1	-14.1	-22.2	-20.1	-18.1	-9.2	-12.7	2.1	1.1	-4.6	5.7	-6.3	-12.6
Other wholesale trade and commission trade	-14.8	-2.7	-2.1	-1.1	-5.1	3.2	5.2	3.4	3.4	3.8	2.3	-10.4	-5.6
Other retail trade; repair of personal and household goods	-15.9	7.3	6.6	-1.5	-0.7	4.6	-11.5	-15.5	-15.0	-10.3	-4.0	-8.6	3.7
Hotels and restaurants	23.0	-4.5	0.5	-19.6	-1.9	-25.3	-10.8	-3.4	-0.4	-10.1	25.3	23.2	4.0
Transport, storage and communication	-7.6	10.7	3.7	-5.2	0.6	10.4	-8.4	-0.1	0.4	-0.1	-17.6	-16.6	-15.3
Construction	-1.2	1.0	5.1	5.6	3.3	0.1	6.0	-0.3	5.6	3.3	0.8	3.8	9.1
Building	-2.7	9.8	9.9	-1.4	3.3	-3.2	1.5	1.2	15.6	5.7	13.1	15.4	13.9
Non-building	1.3	-11.7	-1.3	18.5	3.2	5.6	14.1	-2.9	-9.7	-0.6	-18.1	-13.8	1.8

Source: TURKSTAT, CBRT.

As there are no production indices in trade-services industries, real unit labor costs are calculated based on real turnover. In this regard, it is assumed that changes in the ratio of wages to turnover approximately reflect changes in real unit labor costs. TURKSTAT's Use Table for 2002 indicates that payments made to workers in trade-services industries accounted for 21 percent of the value added and for about 12 percent of the total turnover. According to results of the duly created index, the ratio of wages to turnover across all trade-services industries has been on a constant climb in recent years. In other words, real unit labor costs based on turnover increased in all trade-services industries (Table 4.4.5).

² Covering short-term business statistics, the new series are based on the year 2005 and involve indices of turnover, working hours, number of workers and gross wages-salaries for trade-services and construction industries, plus production indices for only construction industries. Indices for trade-services industries cover all businesses with more than 50 employees, while a sample survey is conducted for businesses with 0 to 4 employees or 5 to 49 employees. Indices for construction industries, on the other hand, cover all construction businesses with 20 and more employees and surveyed businesses are updated annually.

Table 4.4.5. Ratio of Wages to Turnover in Trade – Services Industries
(Annual Percentage Change)

	2006					2007					2008		
	I	II	III	IV	Annual	I	II	III	IV	Annual	I	II	III
Trade - Services	29.6	7.9	7.0	10.6	12.6	2.5	7.9	10.1	11.4	8.4	10.2	22.2	10.7
Wholesale and retail trade; maintenance, repair	37.0	12.5	13.3	14.2	17.9	7.7	10.7	13.7	11.4	11.4	2.0	18.6	7.2
Sale, maintenance and repair of transport vehicles	27.8	22.8	33.3	28.2	28.3	14.1	18.3	8.6	12.9	13.2	2.5	22.2	20.8
Other wholesale trade and commission trade	36.7	13.3	11.1	8.3	15.9	1.1	-8.7	-0.9	-7.0	-3.8	-3.8	19.4	5.2
Other retail trade; repair of personal and household goods	40.6	6.0	6.8	14.6	15.1	8.0	26.2	32.9	30.4	25.3	7.9	19.4	2.7
Hotels and restaurants	-8.5	10.7	3.1	31.8	9.6	42.4	23.6	12.9	11.7	20.8	-18.6	-13.9	0.5
Transport, storage and communication	15.0	-6.9	-1.7	3.3	1.4	-9.0	6.3	4.7	1.4	1.5	19.9	17.2	12.1
Construction	13.6	17.0	10.4	11.8	-11.4	5.7	-5.9	1.6	-7.7	2.0	4.3	-3.7	-10.4
Building	17.9	10.9	8.7	21.6	-13.7	9.1	-2.1	-1.2	-16.5	5.5	-6.5	-15.7	-18.3
Non-building	6.9	27.5	12.0	-2.8	-7.5	0.7	-11.8	6.7	9.6	-3.7	26.9	21.2	3.5

Source: TURKSTAT, CBRT.

As opposed to trade-services sector, real unit wages have been on the decline since 2007 on slowing construction activities. Real unit wages based on production fell 5.3 percent in the third quarter of 2008 (Table 4.4.6).

Table 4.4.6. Real Unit Wages in Construction Industry
(Annual Percentage Change)

	2006					2007					2008		
	I	II	III	IV	Annual	I	II	III	IV	Annual	I	II	III
Construction	10.3	15.6	13.9	12.8	13.1	0.2	-7.4	-5.0	-4.8	-4.3	0.1	-1.7	-5.3
Building	12.1	19.2	18.5	14.6	16.1	-1.3	-8.5	-6.5	-6.6	-5.7	-4.0	-10.7	-10.7
Non-building	8.9	13.3	9.0	8.3	9.8	5.8	-5.7	-6.5	2.4	-1.5	27.3	38.5	-9.4

Source: TURKSTAT, CBRT.

Moreover, the government announced new minimum wages, a key indicator for labor costs, for 2009. Minimum wages for 16-year-old employees increased by 9.5 percent in the first half of 2009 from a year earlier. Total cost of minimum wage to employer, employer's share of social security premium and unemployment insurance premium plus minimum wage, rose altogether by 9.5 percent. The government decided to raise minimum wage by 8.6 percent year-on-year in the second half of 2009. In this period, minimum wage cost to employer will increase by 8.5 percent (Table 4.4.7).

Table 4.4.7. Minimum Wages by Periods
(Employees Aged 16 and Over)

	2005	2006	2007-I	2007-II	2008-I	2008-II	2009-I	2009-II
Minimum wage (TL)	488.7	531.0	562.5	585.0	608.4	638.0	666.0	693.0
Annual percentage change	12.7	8.7	5.9	10.2	8.2	9.1	9.5	8.6

Source: Ministry of Labor and Social Security.

In summary, the slowdown in economic activity had an adverse effect on indicators such as sales, production, employment and productivity in the

third quarter of 2008. The response to falling sales amid weaker total demand was production cuts first, and then job cuts. As production declined faster than employment, productivity gains slowed in manufacturing industries. The drop in real unit wages was caused largely by falling real wages. Meanwhile, real wages grew at a less marked pace in trade and hotels-restaurants industries, whereas they fell in transport-communication and construction industries. Overall, real unit costs continue to grow, though at a modest pace, across all trade-services industries, while real unit wages decline in construction industries. In recent months, the ratio of wages to turnover has further increased in sub-categories of services, excluding building construction and hotels-restaurants, which suggests that falling turnovers will spur further job cuts in the upcoming period.

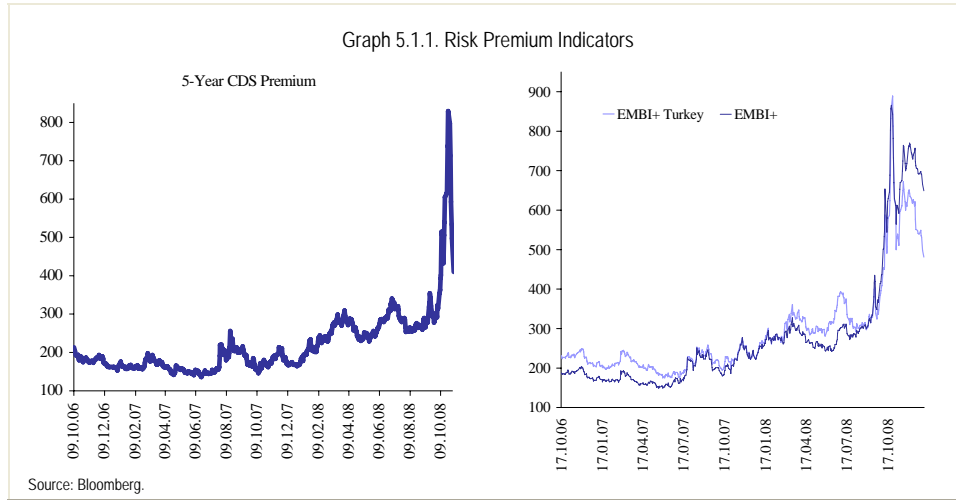
As result, the decline in real unit labor costs will continue to support disinflation in coming months. However, the slowdown in economic activity may lower the rate of capacity utilization and thereby raise costs and reduce total factor productivity in the medium and long term. Therefore, it is of paramount importance for fighting inflation that we continue with structural reforms to drive productivity gains further.

5. Financial Markets and Financial Intermediation

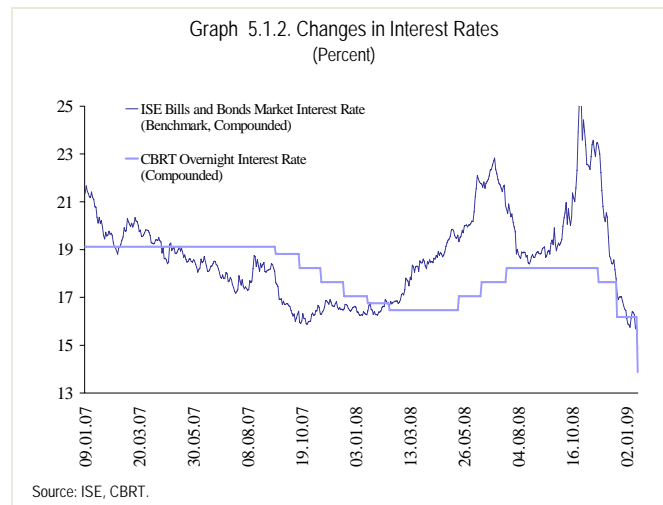
5.1. Financial Markets

Tension in the global money markets continued in the fourth quarter of 2008, albeit at a slower pace than the previous period, whereas concerns about the global economy have mounted. Even though the uncertainty about the financial system has not completely faded, the tight liquidity conditions have been eased and stability in the financial system has been achieved in part as developed country governments and central banks have loosened monetary policy and implemented financial support packages. Yet, the signs of spillover of the crisis from financial markets to the real economy have been evident as the recently announced data indicate a deeper and longer than expected recession.

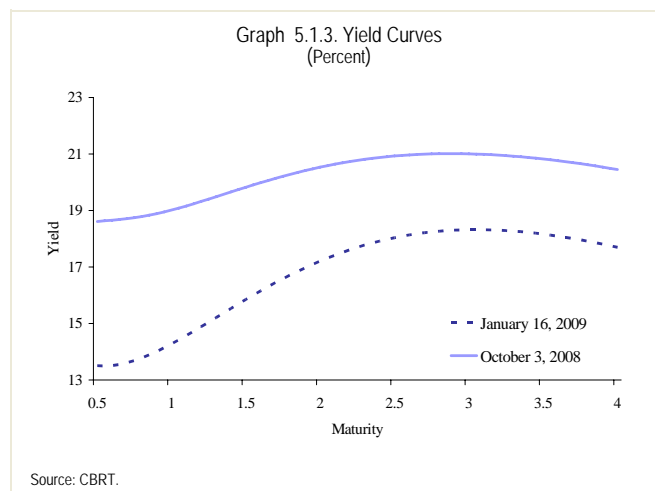
Growing concerns over the soundness of the financial system caused a sharp deterioration in the global risk perception in the fourth quarter. Despite the slight recovery since end-October, risk aversion remained high throughout the fourth quarter (Graph 2.2.3). This situation adversely affected the emerging market economies both from the credit channel and the portfolio flows, hindering access to global capital markets and resulting in risk premiums to remain highly elevated. Furthermore, the fact that the recession in advanced economies has clearly turned into a global economic slowdown by spilling over to the rest of the world, including emerging market economies, contributed to the high risk premium in these economies to persist. Accordingly, high levels were also sustained in Turkey's risk indicators such as 5-year Credit Default Swap (CDS) and the JP Morgan EMBI+Turkey index (Graph 5.1.1). Yet, Turkey's risk premium performed relatively better in the fourth quarter and continued to remain below average of all emerging market economies. Unless the global economic uncertainty disappears, no permanent fall is expected in the volatility of risk premiums and other financial indicators.



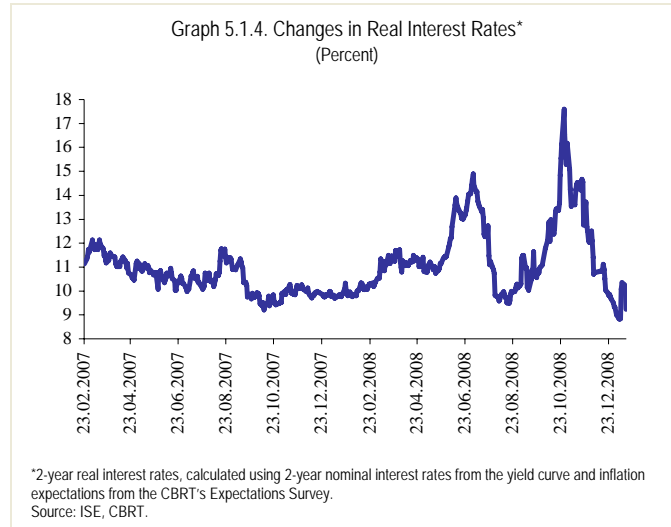
The financial distress that hit the world economy in September and October led to a dramatic upswing in domestic market interest rates. Consequently, with slightly improved risk perceptions, interest rates started to follow a downward trend at the end of October. The main determinant of the downward trend in market interest rates has been CBRT's policy rate cuts. In view of the evident dampening impact of the global financial problems on domestic and foreign demand, the continued tightening in financial conditions and the improving inflation outlook, the CBRT undertook policy rate cuts more aggressively than expected. In this context, the policy rates have been reduced by a total of 375 basis points in the past three months. Subsequent information on economic activity and inflation substantiating CBRT's strategy of rapid rate cuts, gave a major boost to the credibility of the monetary policy. This, and expectations over further rate cuts have reinforced the downward trend in policy rates. Accordingly, the gap between the benchmark government security interest rate and the CBRT's overnight rate has vanished (Graph 5.1.2).



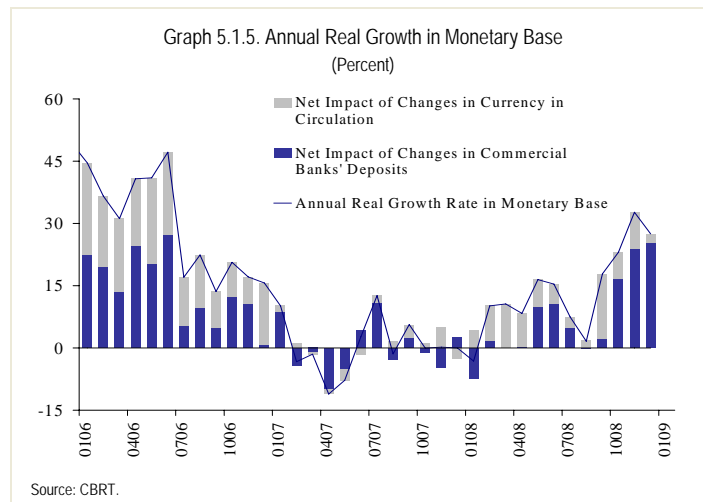
Sharp downward trend in market interest rates has been observed at every maturity. As a matter of fact, yields on January 16, 2009 dipped below those on October 3, 2008 in every maturity range (Graph 5.1.3). On the other hand, the continuing negative slope of the long end of the yield curve indicates that expectations over inflation to maintain its downward trend in the medium term persist.



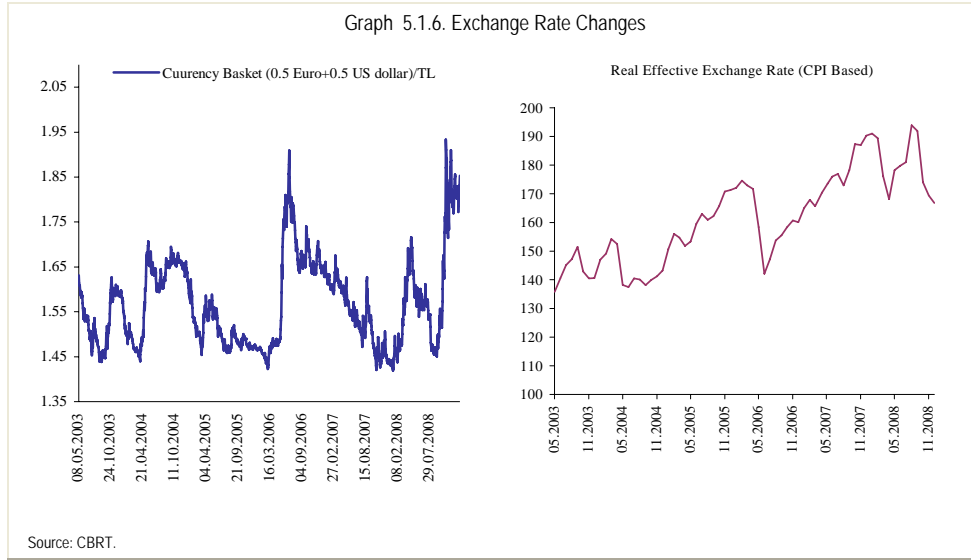
After a sharp increase at the start of the fourth quarter as a result of rising market rates, medium-term real interest rates started to fall back following CBRT's policy rate cuts (Graph 5.1.4). The recent strong downward move has carried real interest rates even below levels observed prior to the globally experienced financial volatility. Yet, given the additional tightening spurred by financing conditions and the downward pressure on both domestic and foreign demand, current monetary conditions are expected to continue to support the downward inflationary trend.



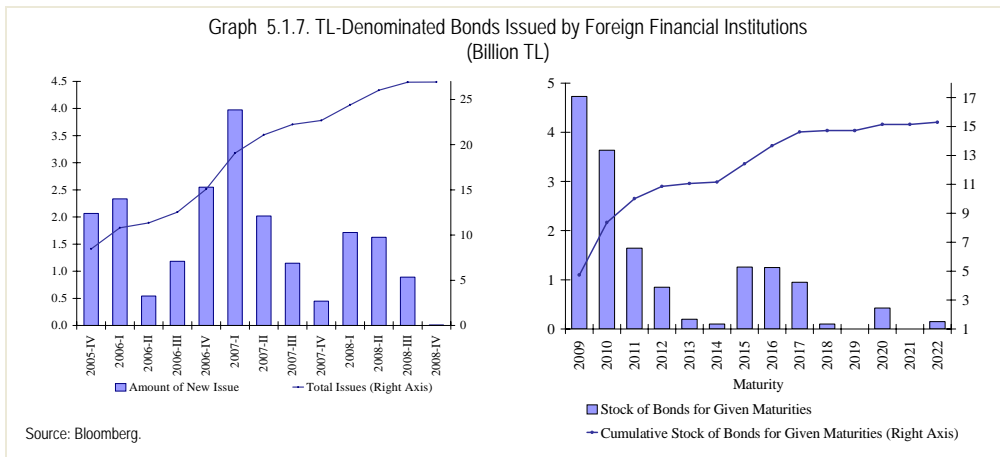
The annual growth rate of the monetary base in real terms has accelerated in the fourth quarter of 2008 mainly owing to the rapidly increasing Turkish lira deposits which are driven by reverse currency substitution (Graph 5.1.5).



As a result of the deterioration in global risk perception in early fourth quarter, Turkish lira as well as currencies of other emerging market economies depreciated against major currencies. The depreciation also brought about more volatility in exchange rates (Graph 5.1.6). The currently high level of risk aversion continues to pose potential pressure on emerging-market exchange rates.

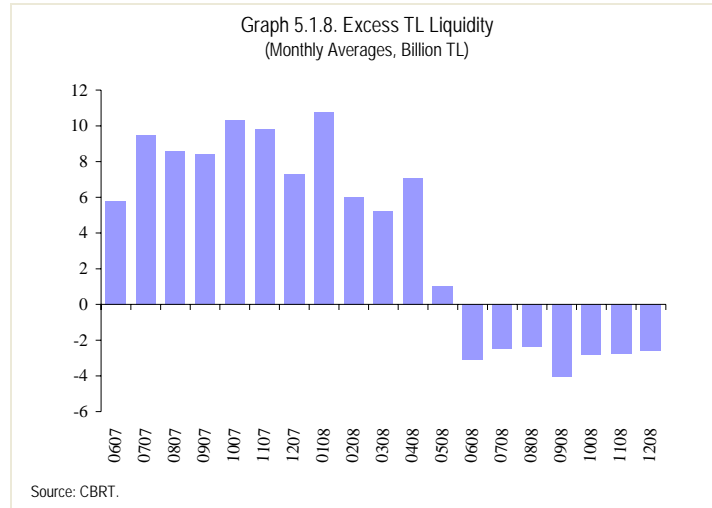


The difficulties in international credit markets and the global risk perception continue to tighten financing conditions. As a result, foreign financial institutions stopped issuing TL-denominated global bonds, an indicator of foreign demand for TL-denominated financial instruments, in the fourth quarter of 2008 (Graph 5.1.7). Accordingly, total bond stock went as low as 15 billion Turkish liras as of January 16, 2009. The demand for these securities is expected to remain weak unless global financing conditions begin to improve.



The liquidity shortage in the overnight market that started in mid-2008 continued in the fourth quarter as well (Graph 5.1.8). In order to provide efficient and stable functioning of the money markets by preventing excessive volatility in the overnight rates, the CBRT provided liquidity through 1-week repo auctions in cases of liquidity shortages. While the amount of liquidity to

be provided was determined by repo auctions, overnight rates were aimed to be set close to CBRT's borrowing rate so that the overnight borrowing rate would continue to function as the reference rate for the monetary policy. Even though critical uncertainties exist about liquidity conditions in 2009, no perpetual liquidity shortage is expected in the first quarter.



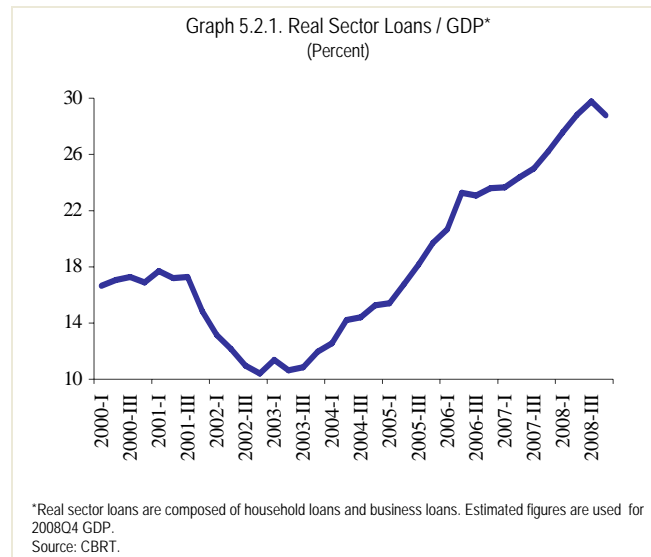
Against concerns of possible negative spillovers from the global financial turmoil, the CBRT, in addition to its main objective of maintaining price stability, has recently followed an active policy and adopted a series of measures to improve the functioning of exchange markets and to boost foreign exchange liquidity. In this context, the Bank resumed its intermediation role in the Interbank FX Deposit Market as of October 9. In the subsequent periods, the transaction limits of banks in the FX Deposit Markets have been increased significantly up to 10.8 billion US dollars. Moreover, the maturity of the FX deposits offered by CBRT to banks have been extended and FX borrowing rates have been reduced. In addition to these measures, FX reserve requirements ratio has been reduced, thereby providing an additional FX liquidity of about 2.5 billion US dollars into the banking system.

In case of deepening of international market problems and emergence of their adverse effects on the domestic financial markets, the CBRT will take further measures. Accordingly, transaction limits in the FX Deposit Market may be raised, maturity of FX deposits offered to banks may be extended and interest rates may be lowered. Additional yet minor cuts in FX reserve requirements ratio may also be considered. During periods of diminishing depth in FX market, FX purchase auctions may be resumed so long as consistency

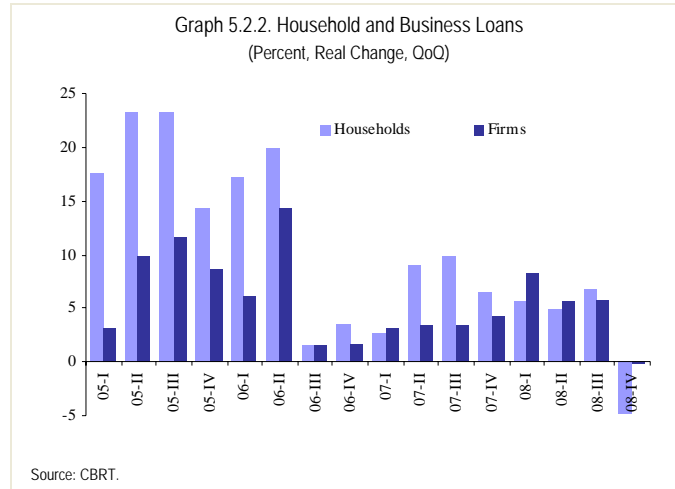
with the floating exchange rate regime is ensured. Furthermore, if non-competitive pricing in FX market is observed due to speculative behavior, direct intervention may take place.

5.2. Financial Intermediation and Loans

In the final quarter of 2008, the mounting uncertainty surrounding the global economy, coupled with the slowdown in the domestic economic activity adversely affected the domestic credit markets. During this period, the sales by foreigners in money and capital markets have aggravated the financial distress, leading to a retreat from long-term contracts. Moreover, weaker domestic demand and uncertainty regarding the disposable income have slowed down the loan demand. Accordingly, the ratio of loans to national income has fallen for the first time since 2002 (Graph 5.2.1).

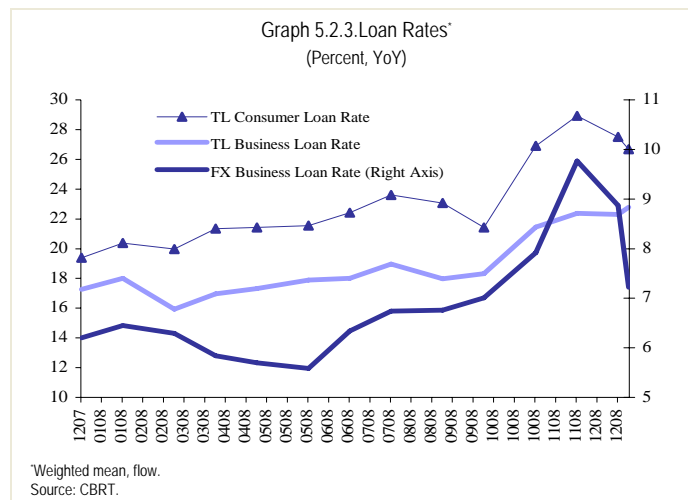


The decline in loans in the fourth quarter was largely driven by weaker supply and demand conditions. Mounting problems in foreign credit markets have reduced access of the real sector to external financing facilities. Domestic financing conditions remain tight as commercial banks stay prudent on lending. Meanwhile, the deterioration in expectations regarding the economic outlook and the decline in consumer confidence have adversely affected the demand for loans. With these constraints in the credit market pertaining to both supply and demand, household and business loans dropped by 4.2 and 0.1 percent in real terms in the last quarter (Graph 5.2.2).



The adverse effects of the weakening in consumption, the tightening in financial conditions and the narrowing in credit supply have been pronounced in all sub-items of the consumer loans. Housing, auto and personal loans fell in the final quarter, while claims from credit cards remained stable.

Having followed an upward trend for a while, interest rates on consumer loans jumped in early October. This was mainly fed by the elevated level and volatility of the market interest rates and the tendency of banks to tighten credit conditions. As the continued tightening in financial conditions and the improving inflation outlook sparked the CBRT to cut policy rates at a more aggressive pace than expected, the upward trend in interest rate for loans came to a halt with the policy rate cut in November, and gave way to a fall following the rate cuts in December and January. Although interest rates on consumer loans declined markedly, business loan rates declined at a more moderate pace, which points to an additional tightening in financing conditions (Graph 5.2.3).



The global economic uncertainty is expected to adversely affect the credit supply and restrict the credit expansion. The heightened uncertainty restricts the credit supply not only by reducing loanable funds by banks but also channeling economic units to liquid portfolio options. The increased perception of credit risk is also expected to cause banks to stay cautious on lending. Particularly, the recent increase in non-performing loan ratio has raised the importance of credit risk (Table 5.2.1).

	Consumer Loans	Housing Loans	Auto Loans	Other	Credit Cards
2007-IV	1.36	0.62	3.80	1.64	6.67
2008-I	1.54	0.71	4.50	1.89	6.59
2008-II	1.66	0.78	4.66	2.06	6.46
2008-III	1.78	0.90	4.60	2.21	6.35
2008-IV	2.25	1.15	5.95	2.82	7.17

Source: CBRT.

Due to the narrowing in global liquidity conditions, the continuity of the smoothness of the domestic financial system and the efficient functioning of the credit markets gained ground. Accordingly, in order to support financial intermediation, the CBRT announced that it would provide the financial system with liquidity effectively by using all instruments at its disposal.

To sum up, ongoing problems in the global economy cause the tight financial conditions to persist. Although recent policy rate cuts have partially compensated the effect of financial tightness, domestic credit expansion is not expected to gain momentum, assuming that access to external finance will be limited. The CBRT will continue to carefully monitor credit developments as they contain information related to the aggregate final domestic demand and the soundness of the financial system.

6. Public Finance

The ongoing financial distress rapidly evolved into a global crisis in the last quarter of 2008, which has tightened foreign and domestic borrowing conditions in the whole world, including Turkey, and caused economic agents, whose expectations turned sharply downward, to spend less. Countries face major cut-backs in production amid slumping total demand, limited access to borrowing and rising costs. Thus, it is essential that countries adopt strong fiscal rules that will reduce the adverse effects of the global financial crisis on production and help maintain sustainable economic growth in the medium term.

In the G-20 summit in November, world leaders agreed to overhaul the supervision of financial markets, strive for a breakthrough in world trade talks, help emerging economies gain access to IMF funds, and take urgent measures conducive to fiscal sustainability. Accordingly, they launched a joint initiative to lower borrowing costs for banks by adopting sound monetary policies that will encourage economic activity in most countries, particularly in developed countries. Similarly, many countries have adopted fiscal measures to strengthen the capital structure of the banking sector, ensure smooth credit flow, and promote domestic demand.

Policies that have been implemented since the 2001 crisis in Turkey helped commercial banks maintain a strong capital position and gain efficiency. However, the weakening domestic and foreign demand plunged into a contraction with the global financial crisis in mid-2008, which reduced the efficiency of the banking sector by having an adverse impact on economic agents' financial position, borrowing costs and access to credit. The current monetary policy framework is flexible enough to pump liquidity into the banking system and lower borrowing costs whenever needed. Although latest policy measures taken by the CBRT have helped allay fears about financial stability, the sharp contraction in total demand, driven by the declining confidence of economic agents, has led to interruptions in credit flow.

Restoring proper functioning of the credit mechanism is vital in minimizing the losses in production capacity and employment. Thus, a fiscal policy framework that clearly sets priorities, heavily focuses on measures to restore confidence and remains conducive to fiscal sustainability in the medium term will be highly accommodative. Therefore, it is essential that the

government builds support mechanisms that will safeguard fiscal discipline and involve the changes in the cyclically adjusted structural budget balance. A successful fiscal policy in a financial crisis requires a strong commitment to maintain fiscal discipline, strengthen corporate governance, and promote transparency in the medium term. Although fiscal measures to address the crisis may cause short-term deviation from the target budget balance, an effective communication strategy that will focus on the cyclically adjusted structural budget balance will boost the credibility of measures to be taken.

6.1. Budget Developments

In 2008, the central government primary budget balance registered a surplus of 33.6 billion Turkish liras, whereas the central government budget balance posted a deficit of 17.1 billion Turkish liras, missing the primary surplus target of 38 billion Turkish liras. Yet, the improved performance of interest expenditures in the first three quarters helped bring the budget deficit slightly below the target. Failure to meet the primary budget balance target was largely due to the sharp reduction in tax revenues driven by the fourth-quarter contraction in domestic demand and the steep increase in budget expenditures. Central government budget expenditures increased by 10.7 percent in 2008 from a year ago, while revenues rose by only 9.7 percent (Table 6.1.1).

With the substantial domestic debt redemption in the fourth quarter of 2008, interest expenditures rose by 55.9 percent from a year earlier, driving central government budget expenditures significantly higher. Despite having decreased by 3.4 percent in January-September 2008 from a year ago, interest expenditures were up 3.9 percent for the entire year on the sharp fourth-quarter rise. Meanwhile, having increased by 12.9 percent for the whole 2008, non-interest budget expenditures rose by 16.0 percent in the fourth quarter, a faster pace than in previous quarters, overshooting the end-2008 target (Table 6.1.1 and Table 6.1.2).

Table 6.1.1. Central Government Budget Aggregates
(Billion TL)

	2007	2008	Rate of increase (%)	Realization/Budget target (%)	2008 Budget target*	2008 Budget target/GDP**
Central Government Expenditures	204.07	225.97	10.7	101.5	222.6	22.9
A) Interest Expenditures	48.75	50.66	3.9	90.5	56.0	5.8
B) Non-Interest Expenditures	155.31	175.31	12.9	105.3	166.6	17.2
I. Personnel expenditures	43.57	48.82	12.1	100.3	48.7	5.0
II. Government premiums to social security agencies	5.80	6.40	10.3	99.9	6.4	0.7
III. Purchase of goods and services	22.26	23.94	7.6	104.5	22.9	2.4
IV. Current transfers	63.29	70.12	10.8	101.3	69.2	7.1
V. Capital expenditures	13.00	18.44	41.8	156.6	11.8	1.2
VI. Capital transfers	3.54	3.17	-10.4	152.2	2.1	0.2
VII. Lending	3.85	4.41	14.7	112.1	3.9	0.4
Central Government Revenues	190.36	208.90	9.7	102.1	204.6	21.1
A) General Budget Revenues	184.80	202.79	9.7	101.7	199.4	20.5
I-Tax revenues	152.84	168.09	10.0	98.2	171.2	17.6
1. Taxes on income and profits	48.20	54.93	14.0	104.4	52.6	5.4
2. Taxes on property	3.65	4.09	12.1	101.5	4.0	0.4
3. Domestic taxes on goods and services	63.59	67.25	5.8	94.2	71.4	7.4
4. Taxes on international trade and transactions	28.97	32.77	13.1	97.8	33.5	3.5
II-Non-tax revenues	31.87	34.30	7.6	121.6	28.2	2.9
B) Revenues of Special-Budget Administrations	3.97	4.37	10.0	127.8	3.4	0.4
C) Revenues of Regulatory and Supervisory Agencies	1.59	1.74	9.7	100.6	1.7	0.2
Budget Balance	-13.71	-17.07	24.5	94.8	-18.0	-1.9
Primary Balance	35.04	33.59	-4.1	88.4	38.0	3.9

* Revised budget targets in MTFB are not entered in the Table.

** Nominal GDP is expected to reach 970.4 billion TL in 2008.

Source: Ministry of Finance.

Current transfers, capital expenditures and personnel expenditures contributed by 4.4, 3.7 and 3.4 points, respectively, while capital transfers contributed by -0.2 points to the 12.9 percent rise in non-interest budget expenditures in 2008.

Current transfers, which make up the largest share in non-interest budget expenditures, grew by 10.8 percent in 2008 from a year earlier and rose by a dramatic 12.9 percent in the final quarter (Graph 6.1.1). Shares reserved from revenues, which account for a stunning 28.0 percent in current transfers, grew by 16.5 percent in 2008 on the temporarily increased share of tax revenues for local governments.

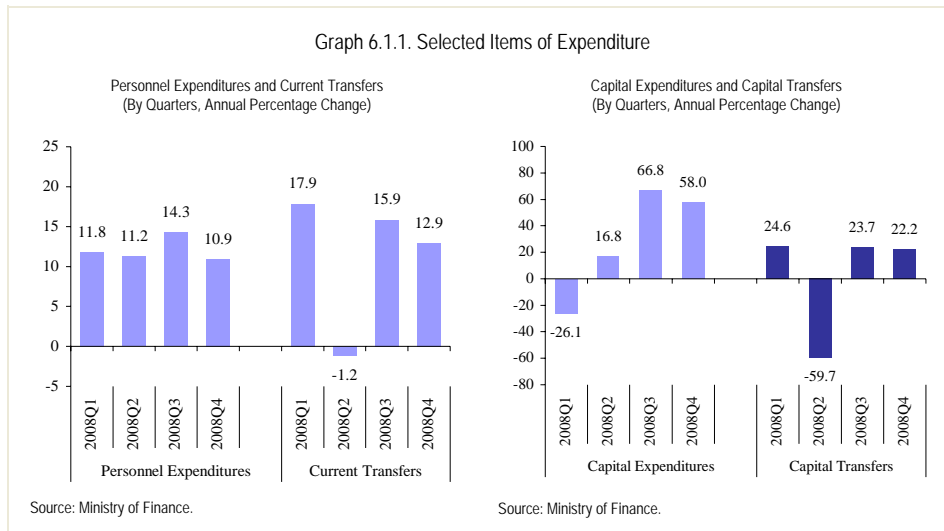
Personnel expenditures increased by 12.1 percent in 2008 from a year earlier on the back of the steep third-quarter rise (Graph 6.1.1). The raised monthly salaries of public employees who do not receive an additional payment from their institutions, as imposed by the new adjustment in August, led to a steep rise in personnel expenditures in the second half of the year. As indicators for government final consumption expenditure, which is classified in the

national accounts, personnel expenditures and purchase of goods and services grew at a slower pace year-on-year in the fourth quarter than a quarter ago.

Table 6.1.2. Central Government Budget Aggregates in Q4
(Billion TL)

	2007 Q4	2008 Q4	Rate of Increase (%)	Realization/ Budget Target (%)	2008 Budget Target *
Central Government Expenditures	50.11	60.49	20.7	27.2	222.6
A) Interest Expenditures	5.98	9.32	55.9	16.6	56.0
B) Non-Interest Expenditures	44.13	51.17	16.0	30.7	166.6
I. Personnel expenditures	10.53	11.68	10.9	24.0	48.7
II. Government premiums to social security agencies	1.71	1.87	9.1	29.2	6.4
III. Purchase of goods and services	8.63	8.87	2.9	38.7	22.9
IV. Current transfers	15.60	17.61	12.9	25.4	69.2
V. Capital expenditures	5.45	8.62	58.0	73.2	11.8
VI. Capital transfers	0.92	1.12	22.2	53.7	2.1
VII. Lending	1.29	1.41	9.0	35.7	3.9
Central Government Revenues	48.57	48.24	-0.7	23.6	204.6
A) General Budget Revenues	46.55	46.43	-0.3	23.3	199.4
I-Tax revenues	41.18	40.81	-0.9	23.8	171.2
1. Taxes on income and profits	13.98	14.56	4.2	27.7	52.6
2. Taxes on property	0.46	0.40	-11.9	10.0	4.0
3. Domestic taxes on goods and services	16.63	16.39	-1.4	23.0	71.4
4. Taxes on international trade and transactions	7.91	7.26	-8.2	21.7	33.5
II-Non-tax revenues	5.27	5.50	4.3	19.5	28.2
B) Revenues of Special-Budget Administrations	1.74	1.51	-13.2	44.1	3.4
C) Revenues of Regulatory and Supervisory Agencies	0.29	0.30	4.2	17.5	1.7
Budget Balance	-1.53	-12.25	698.3	68.1	-18.0
Primary Balance	4.45	-2.93	-165.9	-7.7	38.0

* Revised budget targets in MTFF are not entered in the Table.

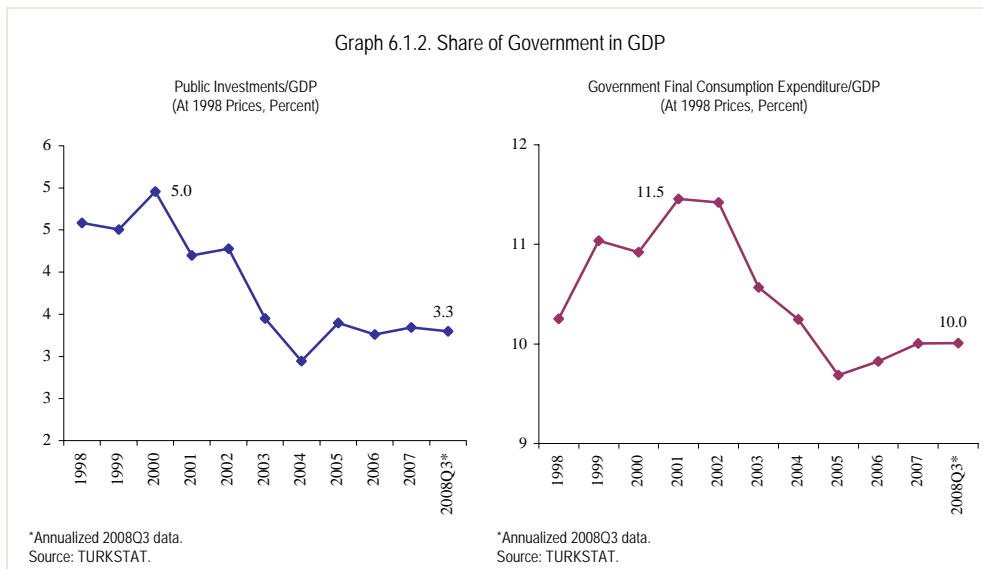


However, capital expenditures rose by a stunning 41.8 percent in 2008 from a year earlier, hitting 156.6 percent of their year-end target. As in the third quarter, capital expenditures grew at a more robust pace in the fourth quarter than in the first two quarters, and went up by a solid 58.0 percent (Graph 6.1.1),

on the back of the substantial rise in investment spending by the General Directorates of Highways and State Hydraulic Works in the second half. Capital expenditures from the budget suggest that the rise in government investment expenditures, which is also classified in the national accounts, will be more robust in the fourth quarter.

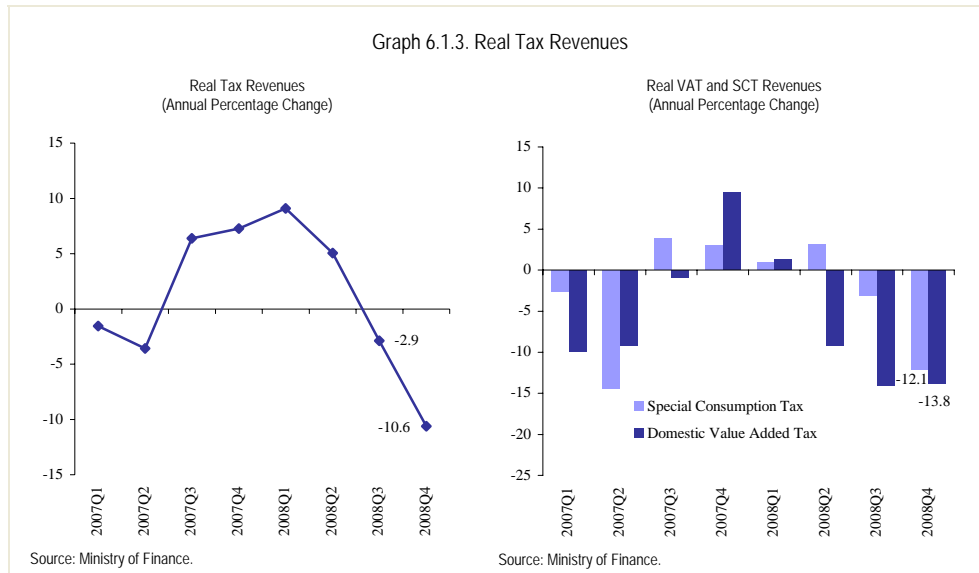
After 3.5 billion Turkish liras in 2007, the amount allocated to capital transfers was only 2.1 billion Turkish liras in 2008. Although capital transfers decreased by 10.4 percent in 2008 from a year ago, they reached 152.2 of the initial appropriation. Capital transfers increased by 22.2 percent in the fourth quarter from a year earlier (Graph 6.1.1).

The increased resource allocation to investments contained in the Southeastern Anatolia Project (SAP) Action Plan and to reduce labor costs caused central government primary budget expenditures to exceed the initial appropriation for 2008. It is well-known that government expenditures stimulate the economy in two ways: by fostering demand in the short run and enhancing economic capacity in the long run. The share of total government investments in GDP trended downward after 2000 on efforts to increase primary surplus, and has remained flat at 3.3 percent in recent years (Graph 6.1.2). Accordingly, the rise in resources allocated to SAP investments in 2008 is expected to raise the share of government investments in GDP and stimulate further employment and economic growth in the short and long run.



Tax and non-tax revenues grew by 10.0 and 7.6 percent, respectively, in 2008. Taxes on wages and profits rose by 14.0 percent, making the largest contribution to the growth in tax revenues. The rise in taxes on wages and profits was mainly driven by strong corporate tax revenues that rose by 22.9 percent. The solid growth in corporate profits in 2007 and in the first half of 2008, particularly in commercial banks, was the main factor behind this positive development. In addition, domestic value-added taxes (VAT) remained unchanged in 2008 from a year ago, while special consumption taxes (SCT) increased by 7.0 percent. Value-added taxes on imports, on the other hand, were up 13.1 percent in 2008 from a year earlier amid growing imports.

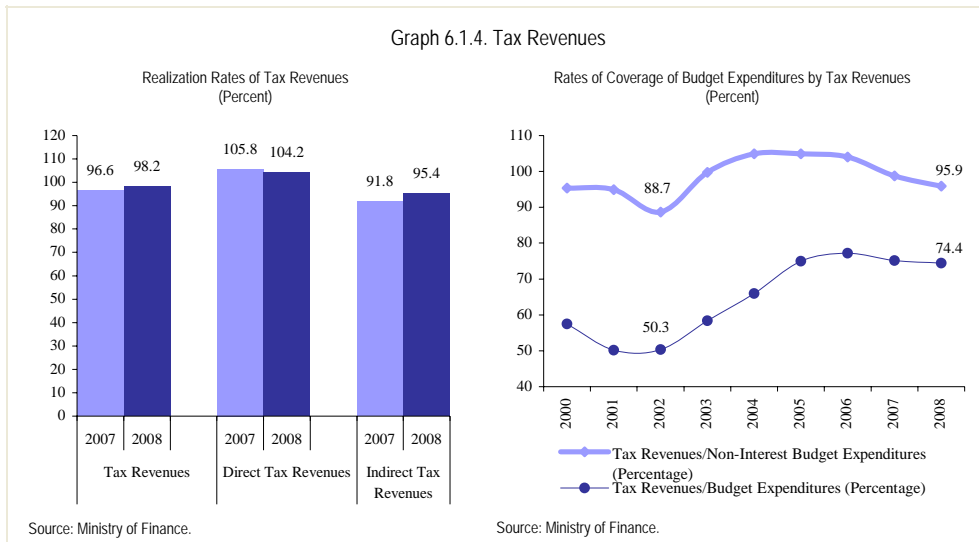
Despite the strong tax performance in the first three quarters, total tax revenues dropped by 0.9 percent in the fourth quarter from a year earlier due to the marked slowdown in economic activity. Meanwhile, domestic VAT and SCT fell by 4.4 and 2.6 percent, respectively. In real terms, tax revenues were down 10.6 percent in the fourth quarter from a year ago, falling at a faster pace than in the third quarter. In addition, domestic VAT and SCT, which are mostly consumption-related taxes, declined by 13.8 and 12.1 percent, respectively, in real terms (Graph 6.1.3), which points to a severe contraction in consumption spending in the fourth quarter.



The rate of coverage of primary budget expenditures by tax revenues was 95.9 percent in 2008. After a realization rate of 96.6 percent in 2007, tax revenues achieved 98.2 percent of their year-end target in 2008 (Graph 6.1.4). Accordingly, after a solid performance in the first three quarters, tax revenues

declined sharply in the fourth quarter on weak domestic demand in 2008 and sunk below their year-end target. Moreover, direct taxes have surpassed initial targets for the past two years, while indirect taxes, which are more vulnerable to changes in domestic demand, have fell below initial targets.

Having declined by 23.8 percent in the first half of 2008, non-tax revenues grew by 7.6 percent in 2008 from a year ago, fueled by the strong performance between July and September. As per Laws No. 4046 and No. 4447, the Treasury received transfers from the Privatization Fund and the Unemployment Fund, amounting to 6.0 and 1.3 billion Turkish liras, respectively, which were recorded as revenue in the central government budget and provided a strong boost to non-tax revenues.



The consolidated public-sector primary surplus had amounted 29.2 billion Turkish liras at end-2007, far below the target of 40.7 billion Turkish liras (Table 6.1.3). Thus, the public-sector primary surplus had failed to meet its end-2007 target, which was 6.5 percent of the national income, and equaled about 3.5 percent, partly due to the renewed national account series. The Medium Term Fiscal Framework now targets a primary surplus of 3.5 percent of GDP for 2008. Although the consolidated public-sector primary balance, excluding SEEs, posted a surplus of 27.0 billion Turkish liras in October 2008, the larger-than-expected growth in government spending and the poor tax performance driven by weaker domestic demand have had an adverse impact on the primary surplus performance of the non-central government sector.

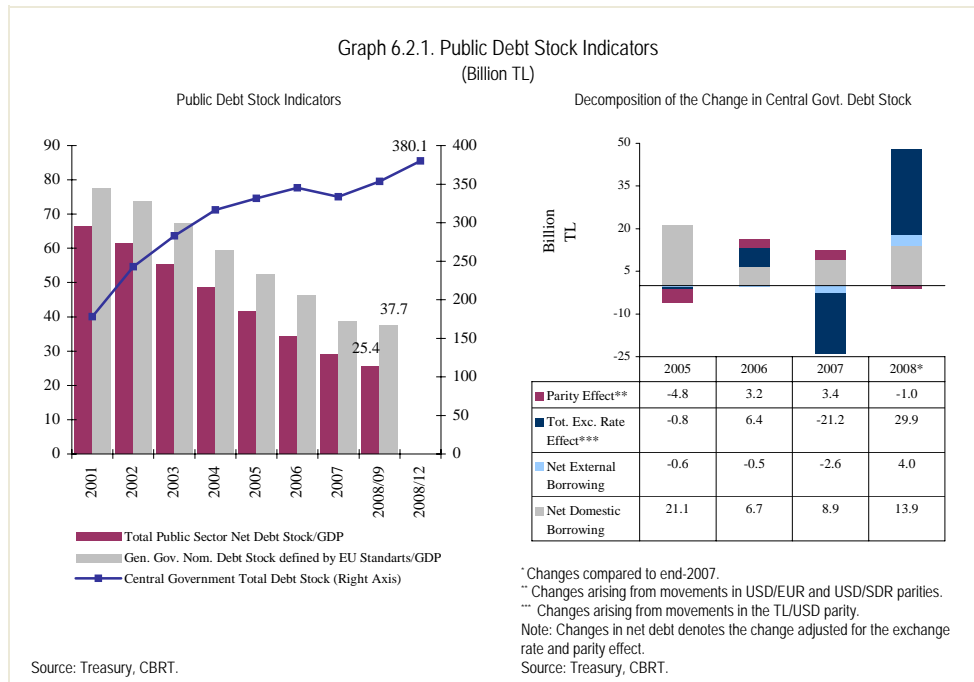
Therefore, the 2008 target for total public-sector primary surplus is not likely to be met.

Table 6.1.3. Program-Defined, Consolidated Public Sector (Cumulative, Billion TL)*					
Realizations					
	2005	2006	2007	September- 2008	October- 2008
Primary Balance	28.3	36.2	29.2	28.1	-
Primary Balance (excl. SEEs)	23.6	34.6	26.7	26.1	27.0
Central govt. budget	24.1	33.5	21.7	22.2	23.9
Overall Balance	-4.2	-1.2	-10.0	-4.7	-
Central govt. budget	-11.5	-6.9	-20.7	-14.2	-14.3
Targets					
Adjusted Program**					
Primary Balance	30.4	34.5	40.7		
Primary Balance (excl. SEEs)	26.7	31.8	38.2		
Overall Balance	-19.7	-6.5	-5.5		

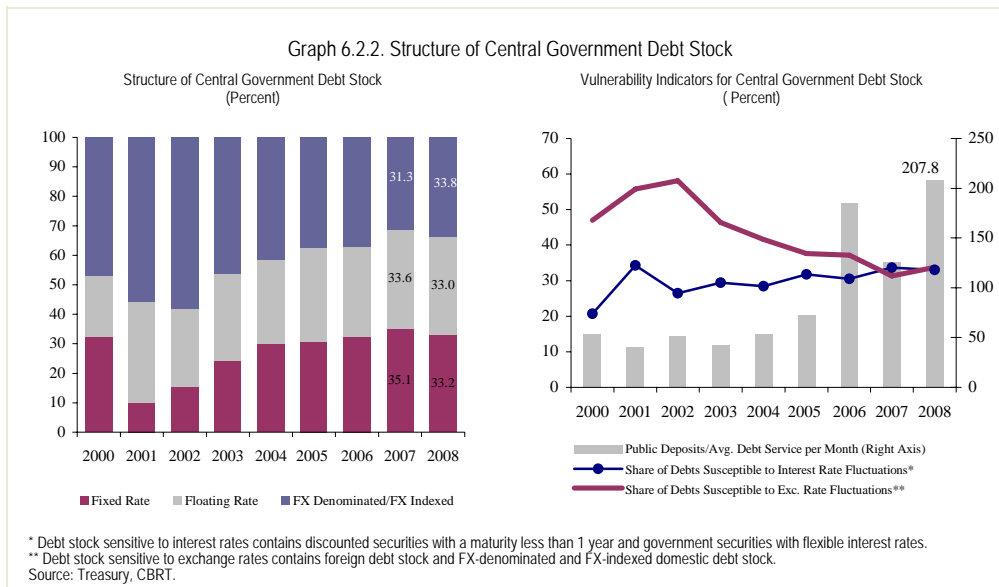
* Figures for 2008 are provisional.
** Budget targets set at the turn of the year are revised by selected adjustment items, which are then defined as adjusted program targets.
Note: Consolidated Public Sector = Central Govt. + 23 SEEs + Extra Budgetary Funds (Defense Industry Support Fund, Privatization Fund and Social Assistance and Solidarity Encouragement Fund) + Social Security Agencies + Unemployment Insurance Fund.
Overall Government = Consolidated Public Sector + Local Administrations + Revolving Funds + Non-CGS SEEs.
Source: Treasury.

6.2. Developments in Debt Stock

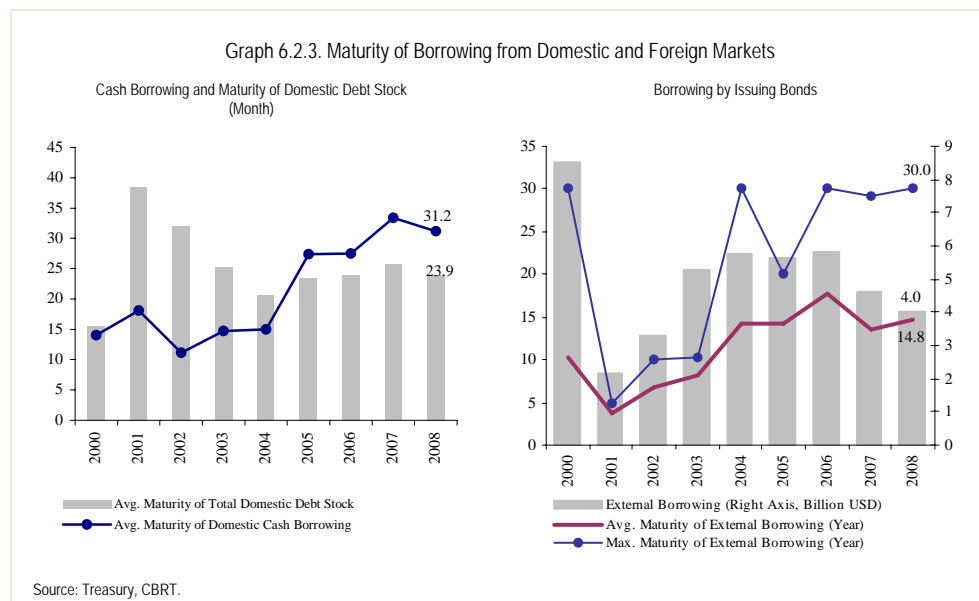
The central government debt stock increased by 14.0 percent to 380.1 billion Turkish liras in 2008 from end-2007. Exchange rate movements, net domestic debt growth and net foreign debt growth accounted for TL 29.9, 13.9 and 4.0 billion, respectively, of the TL 46.7 billion rise in the central government debt stock, whereas changes in parities reduced the debt stock by TL 1.0 billion. Meanwhile, the ratio of net total public debt stock to GDP fell to 25.4 percent in the third quarter of 2008, maintaining the downward trend of the past few years. In addition, the ratio of EU-defined central government nominal debt stock to GDP equaled 37.7 percent (Graph 6.2.1). The improvement in public debt stock ratios within the Medium Term Fiscal Framework is expected to continue into 2012, and the ratio of EU-defined central government nominal debt stock to GDP is expected to drop to 30 percent by 2012 once budget targets are met and projected privatization revenues are collected.



In 2008, the share of fixed and floating-rate instruments in central government debt stock decreased compared with end-2007, while the share of exchange-rate sensitive (FX-denominated and FX-indexed) instruments increased on the weakening of the Turkish lira since October (Graph 6.2.2). With the debt and risk management policies that have been implemented as part of a strategic criteria since 2003 and the macroeconomic stability that has been maintained, the public debt portfolio has become increasingly less sensitive to risks of liquidity, interest rate and exchange rate. In a more stable economic environment, the exchange-rate sensitive debt stock trended substantially down to 30.2 percent in September 2008, but ended 2008 at 33.8 percent. Given the upward shift in exchange rates, the exchange-rate sensitive debt stock is expected to grow in Turkish lira terms. Moreover, the maturity of the current FX-denominated debt stock is relatively lengthened and the Treasury holds a sizeable amount of foreign exchange deposits, which altogether mitigates the risks associated with exchange rate volatility on public sector.



Following the financing strategy intended for reducing the liquidity risk, the ratio of public deposits to average monthly debt service ended November 2008 at a high 207.8 percent (Graph 6.2.2). The average maturity of domestic cash borrowing equaled 31.2 months at end-2008, down from the 2007 average. Likewise, the average maturity of total domestic debt stock also fell to 23.9 months at end-2008. Moreover, bond issues yielded a USD 4.0 billion worth of long-term foreign debt in 2008 with an average maturity of 14.8 years (Graph 6.2.3).



7. Medium Term Projections

This Chapter summarizes assumptions underlying forecasts, and presents relating medium-term inflation and output gap forecasts and the monetary policy outlook. It is believed that the greatest uncertainty for the upcoming period is the impact of the global financial turmoil on the real economy and the timing of the recovery in the global economy. Thus, the medium-term outlook for inflation and monetary policy will largely depend on developments in the global economy. Therefore, in order to enhance the predictability of monetary policy, we decided to present two alternative scenarios, each including different assumptions on the timing and magnitude of the recovery in the global economic activity. Forecasts in this Report cover the next three years.

7.1. Current Stance, Short-Term Outlook and Assumptions

The assumptions underlying medium-term forecasts are discussed in two groups: assumptions related to domestic economic activity and assumptions related to external factors. These assumptions are revised based on the data released after the October 2008 Inflation Report and compiled from the information, analyses and expertise presented in previous chapters.

In the last quarter, the inflation outlook has changed dramatically amid falling commodity prices and slowing economic activity. Aggregate demand conditions were weaker than anticipated in the October Inflation Report, and the exchange rate pass-through was significantly lower-than-expected due to the contraction in domestic demand and the sharp drop in import prices. Accordingly, inflation ended 2008 at 10.1 percent, and fell 1 point below our forecasts. Therefore our starting point for the medium-term inflation forecasts has shifted down by 1-percentage point.

The forecasts we presented in the October Inflation Report had indicated that domestic economic activity would continue to slow down in the remainder of 2008. Third-quarter GDP figures suggest that domestic demand contracted for the third consecutive quarter. The last quarter figures point to a deepening slowdown in economic activity. Thus, our output gap forecasts for the final quarter of 2008 have been revised down sharply, which is the key driver of the changes in the outlook for inflation and monetary policy.

In our previous forecast, we emphasized that foreign demand would have an added contribution to aggregate demand, which, however, would be largely offset by the economic downturn in Turkey's major trading partners. The fourth quarter figures have confirmed our projections and indicated that foreign demand will make a reduced contribution to aggregate demand, compared to previous quarter forecast, due to a stronger-than-expected contraction in the world economy.

Hence, recent data suggest that problems in international credit markets and in the global economy are likely to extend for a longer span than anticipated previously. Thus, we expect the global economic downturn and the stringency in the credit conditions to curb domestic demand for a longer-than-expected period of time. As suggested by the current short-to-medium-term outlook, aggregate demand will continue to put downward pressure on inflation in 2009.

Developments in consumer credits suggest that financial conditions continue to be restrictive. In the last quarter of 2008, consumer loans fell in nominal terms. Although we believe that the recent easing in monetary policy has helped to relieve the tension in domestic credit markets, heightened risk aversion and the tightening in global credit conditions are expected to continue to restrain domestic credit growth in the forthcoming period. Therefore, our forecasts are based on the assumption that credit conditions are slightly tighter than envisaged in the October Inflation Report.

In September and October, the deepening of the global financial turmoil caused higher risk aversion, resulting in a significant depreciation of currencies in emerging markets, including Turkey. In November, exchange rates stabilized to a some extent. In the October Inflation Report, we indicated that the significant slowdown in domestic demand growth should limit the second-round effects of the exchange rate pass-through, and that the pass-through from exchange rates to the domestic inflation should be relatively limited compared to previous episodes. Accordingly, we predicted that exchange rate changes would add around 1.2 points to 2008 year-end inflation and 1.5 points to 2009 inflation. The materialization of the exchange rate pass-through in the last quarter of 2008 turned out to be even below our October estimates. Moreover, the exchange rate pass-through is expected to remain weak in 2009.

In the previous quarter, processed food prices followed a sharper downward trend than our expectations, while unprocessed food inflation materialized at a level higher than predicted for end-2008. Overall, the course of food inflation was close to the path outlined in the baseline scenario of the October Inflation Report. Accordingly, we have retained our assumptions for food inflation at 7.5 percent for 2009, and 6 percent for the following years.

The sharp fall in oil prices is a major factor leading to a downward revision in our end-2009 inflation forecasts. Our baseline scenario in the October Inflation Report envisaged a constant path for oil prices around USD 80 per barrel over the forecast horizon. However, oil prices continued to fall in the meantime, averaging around 56 USD in the last quarter of 2008. Taking the average of oil price futures for one to two year maturities as a benchmark, we have revised our baseline scenario for oil prices down to USD 55 per barrel.

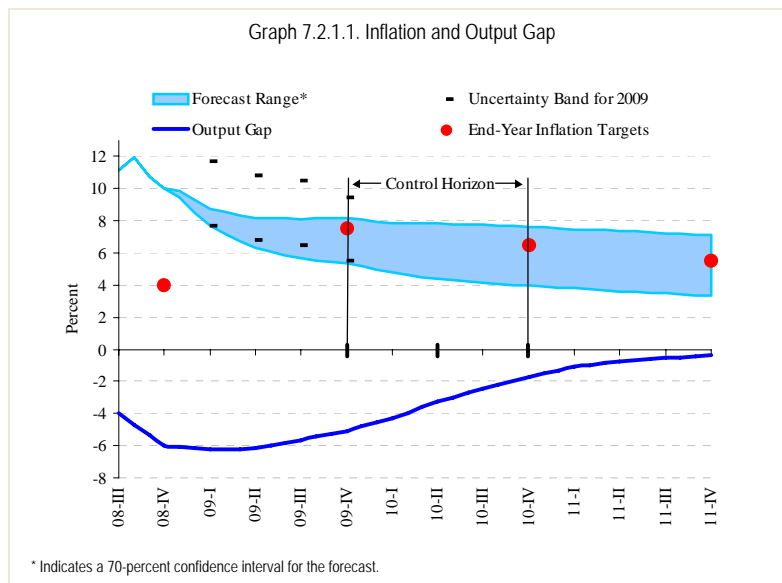
Given the current economic climate, assumptions on foreign economic activity have become increasingly important in building medium-term forecasts. The data available since the October Inflation Report indicate that there is a sharper- and longer-than-expected slowdown in the global economy, resulting in a marked downward revision in global growth forecasts. The January Consensus Forecasts survey suggest that major developed economies will continue to contract throughout 2009, before recovering gradually in 2010. Therefore, as a starting point, our baseline forecast is based on the assumption that there will be a gradual recovery in the global economy starting from the first quarter of 2010. Accordingly, considering the forecasts from the January Consensus Forecast, we assume euro area, Turkey's largest export market, to grow by -1.4 and 0.8 percent and euro area inflation to remain around 1 and 1.7 percent in 2009 and 2010, respectively.

7.2. Medium-Term Outlook

This part, firstly, presents our baseline scenario forecasts that are developed within the framework of the abovementioned assumptions and projections. Furthermore, we propose two alternative scenarios, each including different assumptions on the timing and magnitude of the rebound in global economic activity, and present our resulting inflation and output gap forecasts.

7.2.1. Baseline Scenario

In view of the above projections and assumptions, our medium term forecasts suggest that, assuming a decelerating pace of reductions in policy rates during the earlier part of 2009; with 70 percent probability, inflation will be between 5.4 and 8.2 percent (mid-point 6.8) at the end of 2009, and between 4 percent and 7.6 percent (mid-point 5.8) at the end of 2010. We expect inflation to come down to 5.2 percent by the end of 2011 (Graph 7.2.1.1).



To sum up, there has been a downward revision in our medium term inflation forecast, owing mainly to the impacts of the favorable energy prices and the weakening aggregate demand. The forecast suggests that the probability of undershooting the end-2009 inflation target has increased, notwithstanding the significant policy easing in the past couple of months.

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions on the future policy rates underlying the inflation forecast should not be perceived as a commitment on behalf of the Central Bank of Turkey.

7.2.2. Alternative Scenarios

As it is stated above, developments in the global economy will be the main determinant of the outlook for domestic inflation and monetary policy in

the medium term. Hence, we decided to present two alternative scenarios, each including different assumptions on the timing and magnitude of the recovery in the global economy. We believe that these scenarios will enhance the predictability of monetary policy.

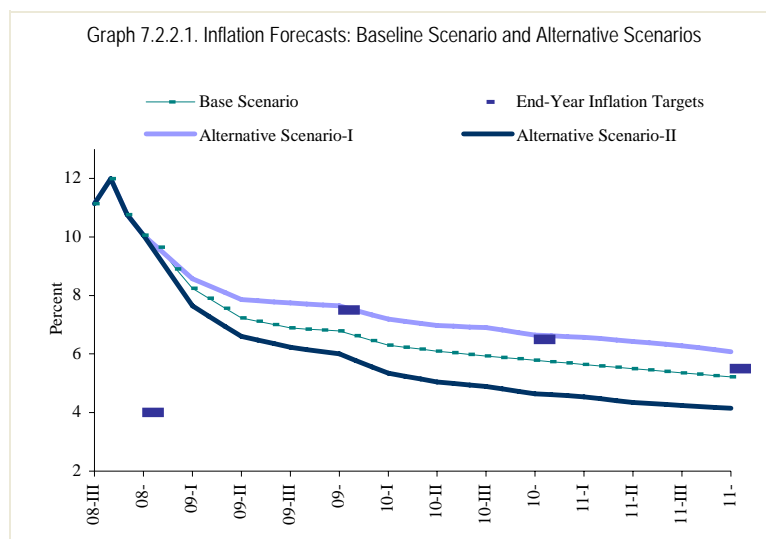
The two alternative scenarios are embedded in our forecasts through four main channels: Commodity prices, portfolio flows, credit and foreign trade. For example, in a scenario, in which the global economy witnesses a prolonged and slower recovery, commodity prices would fall further, emerging markets would experience capital outflows, credit conditions would tighten further and foreign demand would rebound slowly over a longer period of time. In a scenario, in which the global economy recovers sooner and at a faster pace, commodity prices would increase, countries would see capital inflows, credit conditions would become less tight and foreign demand would rebound quickly.

The first alternative scenario assumes that measures taken will help the world economy recover sooner and at a faster pace than in the baseline scenario and start to pick up by mid-2009. Accordingly, it is assumed that commodity prices will begin to rise by mid-2009, and oil prices will climb to USD 75 per barrel by end-2009, staying constant thereafter over the forecast horizon. In this scenario, we assume that credit conditions will be less tight by mid-2009 compared to our baseline scenario. Capital inflows will resurge, while the sooner-than-expected recovery in the global economy will promote an earlier rebound in foreign demand. With the rebound in demand, food inflation will be higher than in the baseline scenario, end-2009 at 9.5 percent and fall to 8.5 percent onwards.

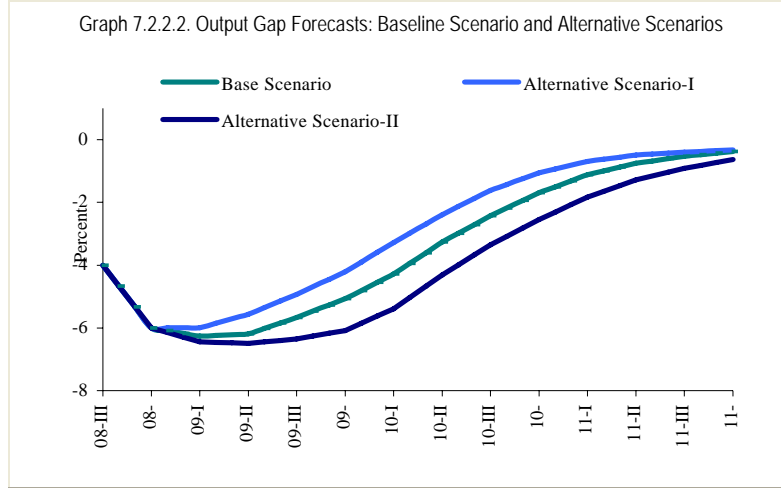
In view of the above scenario, we project that, assuming a measured increase in policy rates towards the end of 2009; with 70 percent probability, inflation will be between 6.2 and 9 percent (mid-point 7.6) at the end of 2009, and between 4.8 percent and 8.4 percent (mid-point 6.6) at the end of 2010. We expect inflation to come down to 6.1 percent by the end of 2011 (Graph 7.2.2.1). In this scenario, as the global economy will recover at a rapid and stronger pace, the course of aggregate demand conditions and commodity prices will cause inflation to be higher than in the baseline scenario. On balance, in case of an earlier and faster recovery in the global economy, meeting inflation targets of 7.5, 6.5 and 5.5 percent for the 2009-2011 period, respectively, may require measured policy rate hikes towards the end of 2009.

The second alternative scenario is based on the assumption of a further deepening in the global crisis in the first half of 2009 and an extended period of weakness in global economic activity until the second half of 2010. Accordingly, given the prolonged and slow recovery in the world economy, it is assumed that commodity prices will fall further, and oil prices will remain around USD 35 per barrel by end-2009, staying constant thereafter over the forecast horizon. In this scenario, we assume that credit conditions will tighten further, markets will experience capital outflows, and foreign demand will remain weak for a longer period of time due to the prolonged recovery in the global economy. Hence, we assume that food inflation will be lower than in the baseline scenario, end 2009 at 5.5 percent and fall to 3.5 percent onwards.

In view of the above assumptions, we project that, assuming measured policy rate cuts throughout 2009; with 70 percent probability, inflation will be between 4.6 and 7.4 percent (mid-point 6) at the end of 2009, and between 2.8 percent and 6.4 percent (mid-point 4.6) at the end of 2010. We expect inflation to come down to 4.1 percent by the end of 2011. In this scenario, as the global economy will recover at a rapid and stronger pace, the course of aggregate demand conditions and commodity prices will cause inflation to rise at a faster pace than in the baseline scenario. On balance, our forecasts suggest that, in case of a longer-than-anticipated global recession, medium term inflation targets could be undershot even with a measured sequel of policy rate cuts throughout 2009 (Graph 7.2.2.1).



Our output gap forecasts under both scenarios are shown in Graph 7.2.2.2. According to the first scenario, the output gap starts to close gradually by the third quarter with the early and rapid global recovery, whereas in our second scenario, the output gap continues to widen and narrows only by early 2010.



7.3. Conclusion

With the financial crisis turning into a worldwide recession, there has been a sharp downturn in both domestic and external demand. Moreover, commodity prices have collapsed in response to the worsening global economic outlook. Growth forecasts for the global economy have been constantly revised downwards in the last couple of months, and the risks are still seen on the downside. These developments have increased the probability of undershooting our inflation target at the end of year 2009, setting the ground for monetary accommodation. Accordingly, we have cut the policy rates by a total of 375 basis points in the past three months. Moreover, we have taken several measures in order to facilitate the smooth functioning of our financial markets since October. We will continue to take the necessary measures to contain the adverse effects of the global financial turmoil on the domestic economy, provided that they do not conflict with the price stability objective.

Uncertainties regarding the lagged impact of the problems in financial markets on the global economy remain at high levels. Prudent monetary policy is necessary but not sufficient to maintain the resilience of the economy against the global crisis, especially under current conditions. Preserving the fiscal discipline and strengthening the structural reform agenda would help to mitigate the adverse effects of the ongoing shocks on the domestic economy. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be of utmost importance. In particular, advances in structural reforms, which would improve the quality of fiscal discipline and enhance productivity gains, are monitored closely by the CBRT with regard to their implications for macroeconomic and price stability.

BOX 7.1. ACCOUNTABILITY MECHANISMS IN INFLATION-TARGETING COUNTRIES

Reporting the conduct and performance of monetary policy in a timely and reliable manner to the public, the government or the parliament is generally accepted as a key element of inflation-targeting regimes. Defined as accountability, this reporting process is complementary to and intimately interlinked with communication policy and transparency. Through effective communication and transparency, accountability provides insulation from political pressure and enhances the independence and credibility of the central bank, and thereby improves the effectiveness of monetary policy.

The conduct of accountability varies across inflation-targeting countries as to its frequency and contents. This Box examines 22 countries that adopted inflation-targeting as a monetary policy framework and lists the most widely used tools of accountability (Table 1):

Reporting to the government, related ministers, the parliament and/or related committees of parliament by delivering written reports or oral presentations: In almost all countries we have examined, central banks are obliged to report on the conduct and results of monetary policy, inflation outlook and future strategies to the legal authority and/or the parliament. This obligation is generally carried out by delivering a written report at regular intervals to related authorities, while in some countries, the governor and senior officers of the central bank make an oral presentation and answer questions (For example: Australia, Sweden, South Africa, Canada, Hungary, Norway, Chile, Turkey). In practice, central banks may deliver presentations at more frequent intervals than the legally required or even if not necessary (For example: Australia, Hungary, Norway)¹.

Periodic release of inflation / monetary policy reports: This report is generally regarded as the main communication instrument of the inflation-targeting regime and the most widely used tool of accountability. In most countries we have examined, central banks prepare and publish reports on inflation developments, monetary policy responses and future inflation expectations at three-month intervals, some of which are submitted to the government and/or the parliament (For example: Indonesia, Canada, Korea, New Zealand).

Release of an annual report: Central banks prepare and publish annual reports to be drawn up on the financial and monetary policy operations and their performance, balance sheet and other financial tables, including auditing reports, over the reporting year. In most countries we have examined, central banks are legally obliged to submit their annual reports to the legal authority and/or the parliament (For example: Australia, Indonesia, Philippines, UK, Israel, Sweden, Canada, Mexico, Norway, Romania).

Release of minutes or summaries of monetary policy meetings: In most countries, central banks announce their policy decisions with a brief, immediate statement following their pre-scheduled monetary policy meetings. Yet, in half of the countries we have examined, central banks also release the minutes of their meetings. These minutes generally serve as the summary of the discussion at meetings and disclose the reasons behind policy decisions and the opinions of decision-makers. Details of voting are rarely disclosed.

Release of extraordinary reports in case of significant deviation from the inflation target: In only 7 of the countries we have examined, central banks are obliged to submit an extraordinary report if inflation deviates significantly from the target (Brazil, Indonesia, Philippines, UK, Iceland, Hungary, Turkey). This report is generally an "open letter" addressed to the government and disclosed to the public that setting out the cause of deviation, the monetary policy response, and present and future measures and the horizon to bring inflation back to target. However, the unavailability of an additional report does not mean that there is no statement on the deviation. Deviations are largely discussed in inflation/monetary policy reports or annual reports.

In Turkey

Article 42 of the CBRT Law stipulates that "the Bank shall submit information to the Government in writing and inform the public disclosing the reasons of incapability to achieve the determined targets in due time published or the occurrence of the possibility of not achieving and the measures to be taken thereof". Under this binding rule, the Central Bank fulfils accountability requirements with due diligence by using all abovementioned communication tools (Table 1).

How the accountability mechanism will operate in case of a deviation from the target is left to the discretion of the Central Bank. Accordingly, the Bank builds an uncertainty band around the target and makes itself available to report if inflation falls outside the confidence interval. In the first three years of inflation targeting, the Bank established a quarterly target-oriented inflation path and an uncertainty band in order to fulfill the conditions of the IMF program, and the cause of any deviation and the related policy action whenever inflation fell outside the uncertainty band were disclosed in open letters to the government and shared with the public.

¹ A presentation is made to the related committee of the Parliament by the Governor and senior officers of Central Banks in Australia and Hungary twice and in Norway once.

As stated in the Central Bank's press release on the "Monetary and Exchange Rate Policy in 2009" of December 16, 2008, the bank has established another quarterly target-oriented inflation path and an uncertainty band for 2009. In case *end-of-quarter* inflation figures breach the uncertainty band, the Bank will disclose the reasons for the deviation in the quarterly Inflation Report, together with the measures to be taken to bring inflation back to target, while, in case *year-end* inflation falls outside the uncertainty band, the Bank will draft an open letter to the Government. Thus, in addition to being the key communication tool under inflation targeting, the Inflation Report has also assumed an important role as the main tool of the accountability mechanism.

Apart from the open letters addressed to the Government and the Inflation Report, biannual presentations made by the Governor to the Council of Ministers and the Planning and Budget Commission of the Grand National Assembly of Turkey – to provide information about Bank operations and monetary policy implementations –; the Annual Report; monthly summaries of Monetary Policy Committee meetings; monthly "Price Developments" reports issued on the next working day following the release of inflation figures; the biannually issued "Financial Stability Report"; and presentations and speeches made by Bank authorities in Turkey and abroad play an important role in informing the public and serve as a tool of accountability.

TABLE 1: ACCOUNTABILITY MECHANISMS

COUNTRIES	Inflation Report / Monetary Policy Report	Reporting to the Government / Parliament	Publishing Minutes of Monetary Policy Decision-Making Meetings	Annual Report	Extraordinary Reporting (in case of a target overshoot)
Australia	4 times a year	Obligated to report	✓	✓	-
Brazil	4 times a year	Obligated to report	✓	✓	Letter to the Ministry of Finance in the following January or February.
Czech Republic	4 times a year	At least twice a year	✓	✓	-
Indonesia	4 times a year	4 times a year	None	✓	An explanatory note to the Government until the following February. Later, the Government and the Bank reports to the Parliament in an open session.
Philippines	4 times a year	4 times a year	✓	✓	Letter to the President in the following January.
South Africa	Twice a year	Once a year	✓	✓	-
UK	4 times a year	Once a year	✓	✓	Open letter to the Chancellor in the relevant month. In case of successive overshoots, a new letter is written after at least 3 months.
Israel	Twice a year	If necessary	✓	✓	-
Sweden	3 times a year ¹	Twice a year	✓	✓	-
Iceland	3 times a year	-	None	✓	Letter to the Government in the relevant month.
Canada	Twice a year ²	Twice a year	None	✓	-
Colombia	4 times a year	Twice a year	✓	-	-
Korea	Twice a year	At least twice a year	None	✓	-
Hungary	Twice a year ²	Once a year	✓	✓	As agreed upon by the Government and the Central Bank, the Bank publishes a note in every February about the inflation performance in the previous year.
Mexico	4 times a year	3 times a year	None	✓	-
Norway	3 times a year	If necessary	None	✓	-
Peru	3 times a year	Obligated to report	None	✓	-
Poland	3 times a year	Once a year	✓	✓	-
Romania	4 times a year	-	None	✓	-
Chile	3 times a year	Obligated to report	✓	✓	-
Thailand	4 times a year	Twice a year	None	✓	-
TURKEY	4 times a year	Twice a year	✓	✓	Open letter to the Government in January, in case of year-end target overshoot.
New Zealand	4 times a year	At least twice a year	None	✓	-

SOURCE: Central bank web sites of selected countries.

1- An update to the Report is published three times a year. 2- An update to the Report is published twice a year.

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ABBREVIATIONS

AMA	Automotive Manufacturers Association
BoJ	Bank of Japan
BTS	Business Tendency Survey
CBRT	Central Bank of the Republic of Turkey
CDS	Credit Default Swap
CPI	Consumer Prices Index
CSRA	Credit Suisse Risk Appetite Index
ECB	European Central Bank
EMBI	Emerging Markets Bonds Index
EU	European Union
Fed	Federal Reserve
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices
GS	Goldman Sachs
IFS	International Financial Statistics
ISE	Istanbul Stock Exchange
LIBOR	London Interbank Offered Rate
MPC	Monetary Policy Committee
OECD	Organization for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers Index
SAP	Southeastern Anatolia Project
SCA	Special CPI Aggregates
SCT	Special Consumption Taxes
TEA	Turkish Exporters' Assembly
TL	Turkish lira
TURKSTAT	Turkish Statistical Institution
USA	United States of America
VAT	Value Added Taxes
WEO	World Economic Outlook