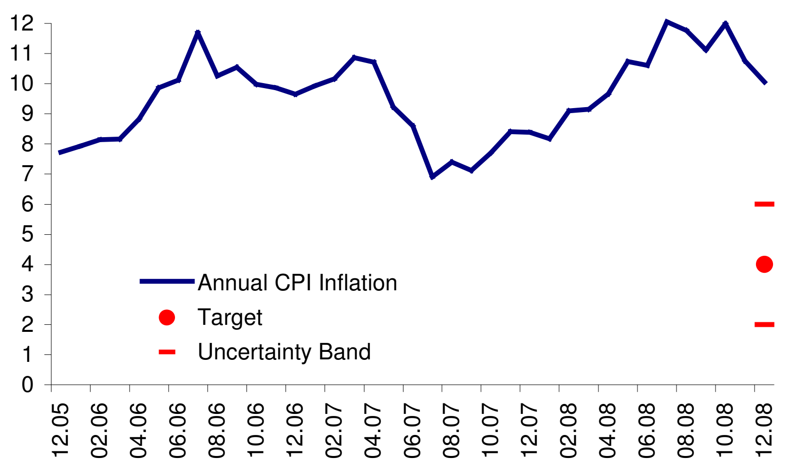
Ankara, January 26, 2009

Mehmet ŞİMŞEK
Minister of State
ANKARA

The Central Bank of Turkey (the CBT) has been implementing an inflation targeting regime since the beginning of 2006. The Central Bank Law, as stipulated in the Article 42, requires the CBT to be accountable for the non-fulfillment of inflation targets. Inflation target for end-year 2008 was jointly set with the Government as 4 percent. To facilitate the accountability principle, our policy statement titled "Monetary and Exchange Rate Policy in 2008" disclosed a quarterly path consistent with the end-year 2008 targets along with an uncertainty band. In this context, any breach of upper or lower limits of the band requires the CBT to write an open letter to the Government, explaining the reasons for the breach and the measures to be taken to ensure that inflation rate will return to levels within pre-established limits.

Inflation outturn as of December 2008 was 10.06 percent, breaching the upper limit of the uncertainty band, which was set at 6 percent for the end-year (Figure 1). Accordingly, this open letter explains the reasons for this breach and presents the strategy adopted by the CBT to bring inflation back to the medium term targets.

Figure 1: Annual CPI Inflation

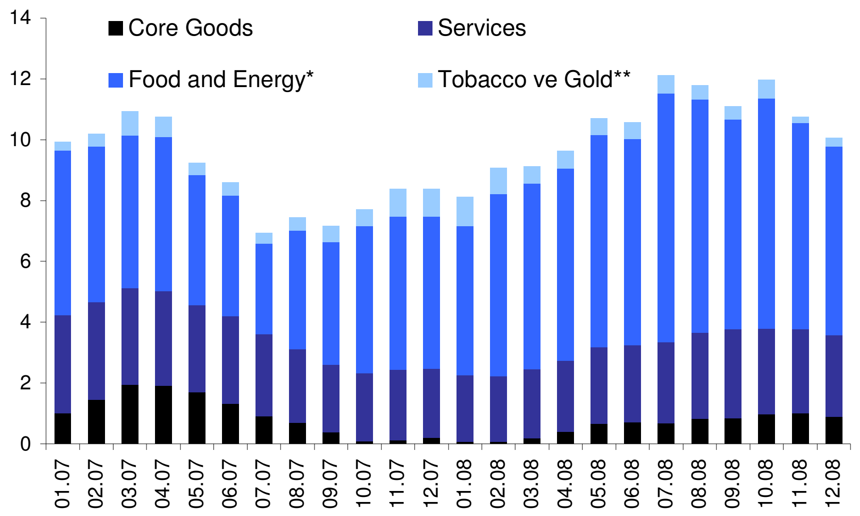


Source: TURKSTAT, CBT.

Reasons For Breaching the Target

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 (Figure 2).

Figure 2: Contribution to Annual CPI Inflation



* Food and Energy: Food, non-alcoholic beverages and energy.

** Tobacco and Gold: Alcoholic beverages, tobacco products and gold.

Source: TURKSTAT, CBT.

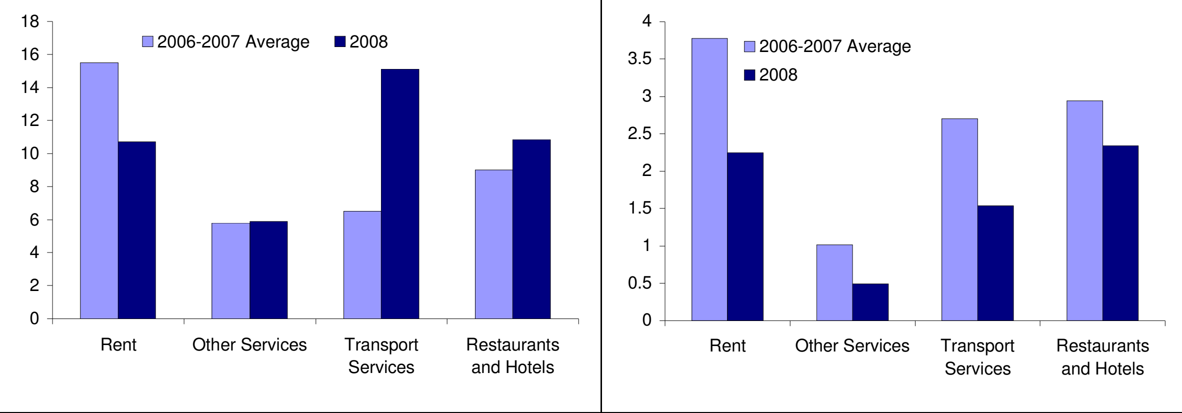
With the collapse in commodity prices, processed food inflation, which is relatively sensitive to import price developments, followed a more favorable course than our expectations in the last quarter of 2008. On the other hand, unprocessed food inflation displayed high volatility throughout the year, showing a marked rise in the last quarter. Overall, although food inflation eased in 2008 compared to the previous year, it was still higher than the headline inflation.

Energy price inflation displayed a significant fall in the last quarter of the year, yet it materialized at around 20 percent by the end of the year. Therefore, given the recent decline in oil prices, we think there is still ample room for fall in energy inflation. Accordingly, we expect the contribution of energy prices to headline inflation to come down considerably throughout 2009.

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 (Figure 3). 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.

Figure 3: Subcomponents of Services Price Index (Cumulative Percentage Change)

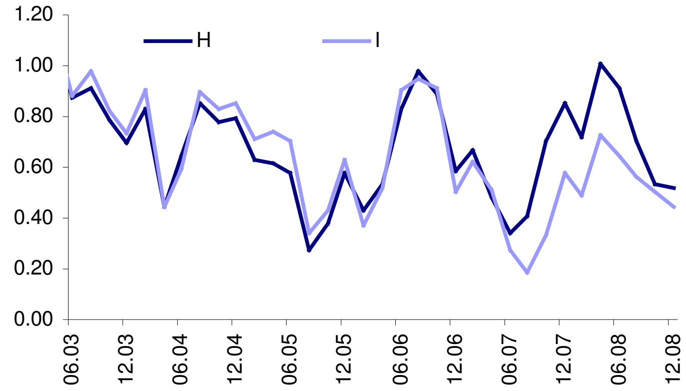
First Three Quarters	Last Quarter



Source: TURKSTAT, CBT.

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 figures suggest that underlying inflation has displayed a downward trend in the last quarter, notwithstanding the significant depreciation in the Turkish lira (Figure 4).

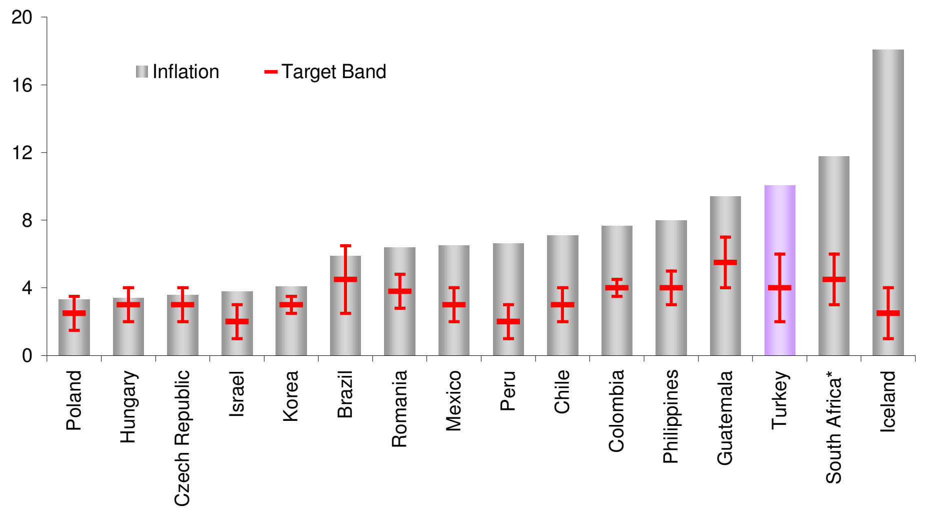
Figure 4: Core Inflation Indices: H* and I**
(Seasonally Adjusted, Monthly Change, 2 Months Average)



* CPI excluding unprocessed food, energy, alcoholic beverages, tobacco and gold.
** H excluding processed food.
Source: TURKSTAT, CBT.

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 (Figure 5).

Figure 5: Inflation and Target Bands in Emerging Economies (as of December 2008)



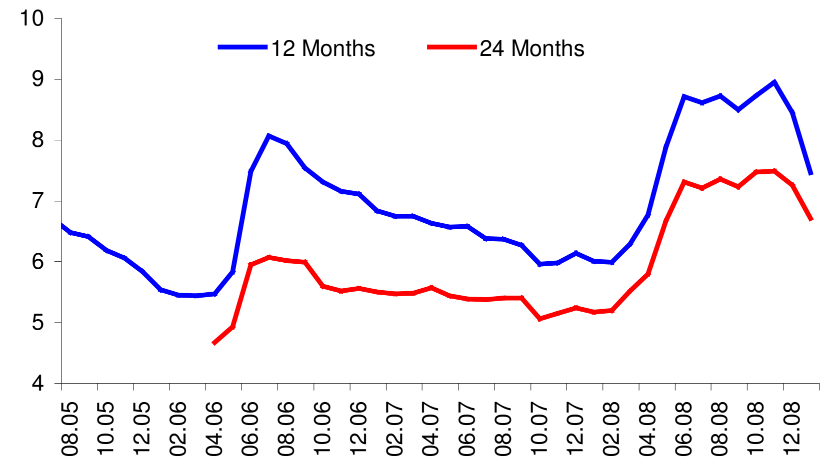
* As of November 2008.

Source: Web sites of central banks, IFS, TURKSTAT, CBT.

Monetary Policy

Inflation dynamics in the first half of 2008 was dominated by the surge in commodity prices, leading to a rise in inflation expectations. In order to contain the deterioration in inflation expectations and to prevent the materialization of the second round effects of these shocks, the Monetary Policy Committee (MPC) implemented a monetary tightening during May-July period, increasing the policy rates by a cumulative of 150 basis points. The tightening in monetary policy, which was implemented jointly with the change in inflation targets, was effective in controlling expectations (Figure 6).

Figure 6: Inflation Expectations*



*24 months expectations is available from May 2006 onwards.
Source: CBT.

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 regarding the global financial and commodity markets and concerns about their reflections on the inflation outlook required monetary policy to remain cautious during the peak of the turmoil. Accordingly, the 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 (Table 1).

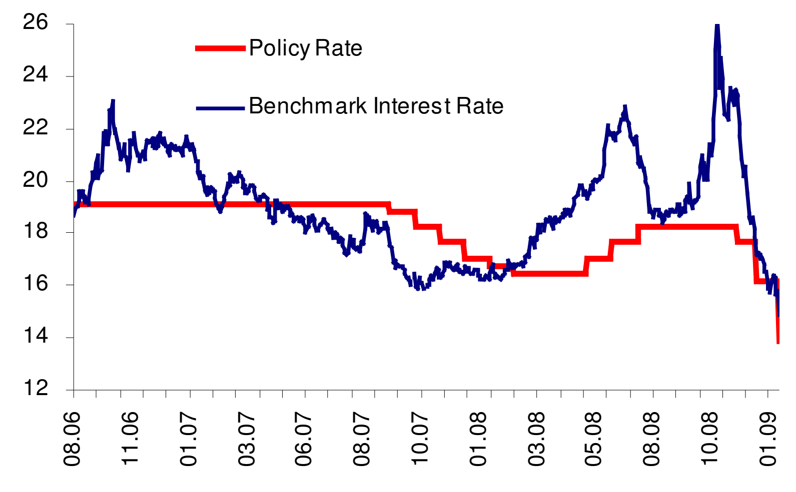
Table 1: Monetary Policy Committee (MPC) Decisions in 2008 and 2009

Dates for MPC Meetings	Decision on Interest Rates	Interest Rate
January 17th, 2008	-0.25	15.50
February 14th, 2008	-0.25	15.25
March 19th, 2008	No Change	15.25
April 17th, 2008	No Change	15.25
May 16th, 2008	+0.50	15.75
June 17th, 2008	+0.50	16.25
July 18th, 2008	+0.50	16.75
August 14th, 2008	No Change	16.75
September 18th, 2008	No Change	16.75
October 22nd, 2008	No Change	16.75
November 19th, 2008	-0.50	16.25
December 18th, 2008	-1.25	15.00
January 15th, 2009	-2.00	13.00

Source: CBT.

As the incoming information on inflation and economic activity vindicated the policy rate cuts, inflation expectations reacted favorably, displaying a sharp fall in January (Figure 6). These developments have enhanced the credibility of monetary policy. As a consequence, monetary policy decisions and the associated communication were effective in shaping the yield curve and bringing down longer-term interest rates. Benchmark bond rates came down significantly, partly driven by the easing tensions in global financial markets (Figure 7).

Figure 7: Benchmark Interest Rate and Policy Rate



Source: CBT, ISE.

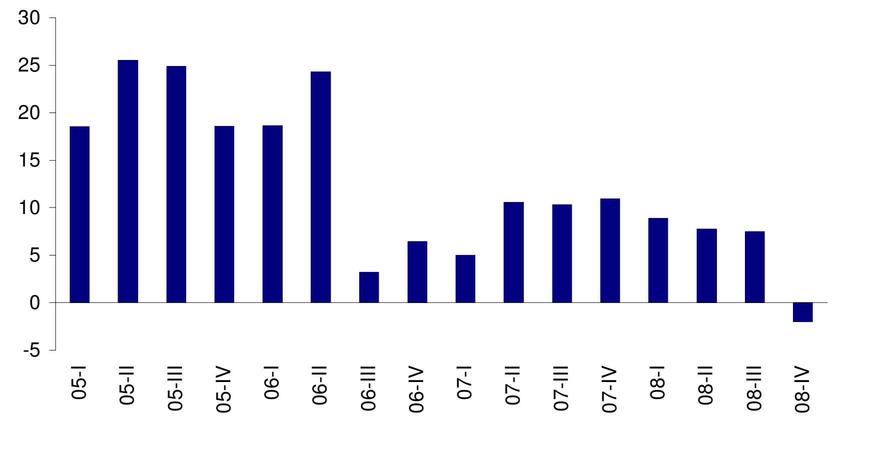
Recent forecasts suggest that ongoing problems in international credit markets and the global economy may last longer than what had been previously envisaged. Downward revisions in growth forecasts and the sharp fall in oil and other commodity prices have increased the probability of undershooting our medium term 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 (Table 1).

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. Moreover, pass-through from exchange rates to domestic inflation was significantly lower than implied by the historical estimates. 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.

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 (Figure 8).

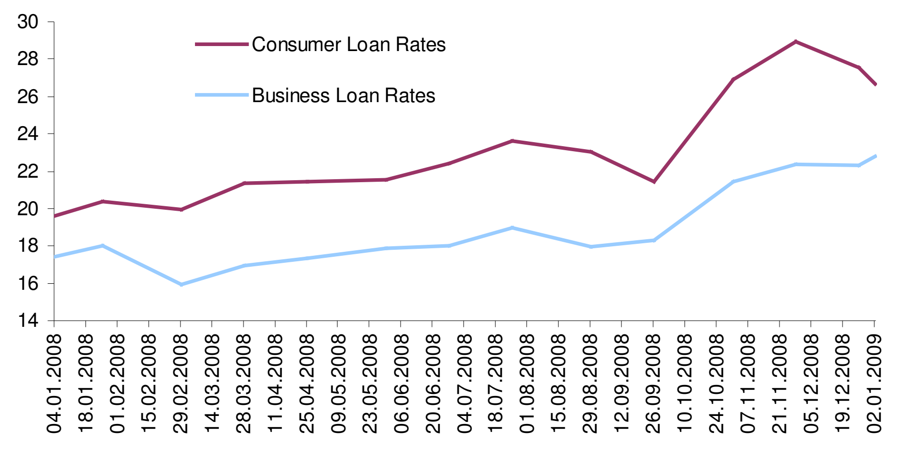
Figure 8: Nominal Consumer Loan Growth Rate (Quarter on Quarter)



Source: TURKSTAT, CBT.

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 (Figure 9). Heightened risk aversion and the tightening in global credit conditions are expected to continue to restrain domestic credit growth in the forthcoming period.

Figure 9: Bank Loan Rates*

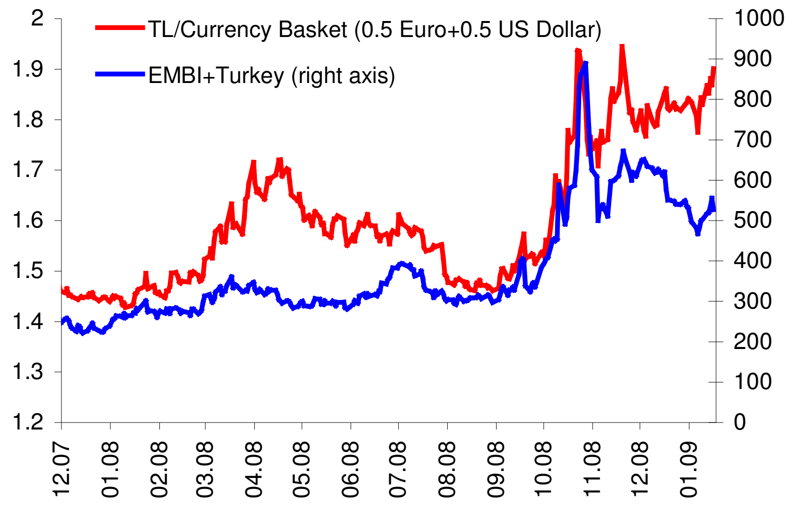


* Weighted average, flow.
Source: CBT, ISE.

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 (Figure 10).

Although exchange rates have remained relatively more stable since November, the potential stress on emerging market currencies has not completely disappeared.

Figure 10: Exchange Rates and Credit Risk

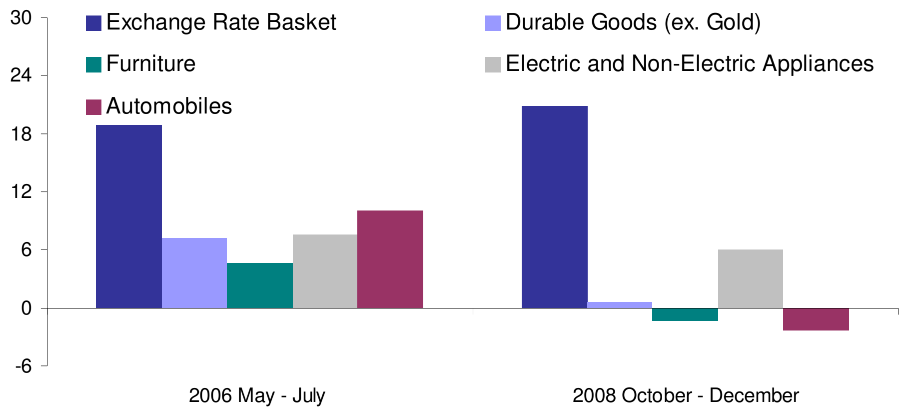


Source: CBT, ISE.

At the time of the publication of our previous open letter (end-October), the extent of the pass-through from exchange rates to domestic inflation was a major source of uncertainty for the inflation outlook. In the letter, 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. Still, given the sizeable depreciation, we forecasted that the first round effects of the depreciation would add around 1.2 percentage points to 2008 end-year inflation and a further 1.5 percentage 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. Figure 11 compares two different periods of significant currency depreciation, namely October-December 2008 and May-July 2006, in terms of pass-through in durable goods—historically the most sensitive item in the CPI to the exchange rate developments. Prices of most of the durables goods in the CPI basket displayed no significant change (with the exception of electrical appliances, prices of which are largely indexed to the exchange rates) in the post September-October 2008 period, whereas all durable goods had showed sharp increases in the post May-June 2006 period.

Figure 11: Exchange Rate Pass-Through Effect: Durable Goods Prices (3-Month Cumulative Percentage Change)



Source: CBT, TURKSTAT.

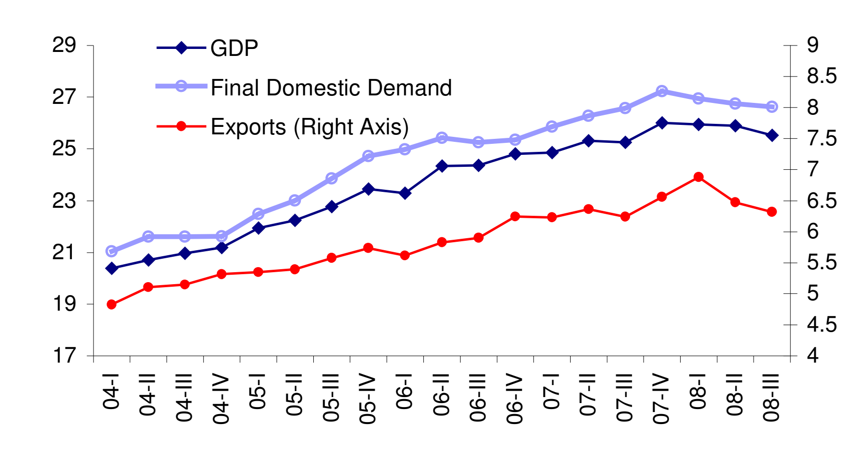
In the October open letter, we predicted that the sharp slowdown in aggregate demand and the depreciation in the Turkish Lira would lead to a higher contribution from net exports to aggregate demand. We also predicted, though, that this effect would be largely offset by the slowdown in external demand due to the sharp economic downturn in our major trading partners. 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. Although export developments in the fourth quarter were qualitatively in line with our expectations, the extent of the slowdown in our major trading partners and thus the contraction in exports were deeper than envisaged in our baseline scenario.

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. 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.

Third quarter GDP figures showed that domestic demand continued to contract for the three consecutive quarters (Figure 12). Our forecasts in October Inflation Report envisaged a moderation in domestic economic activity in the last quarter of 2008. Recent readings on domestic sales, production and confidence indicators suggest that the weakening in domestic economic activity has been deeper than we had envisaged.[1]

[1] Chapter 4 of January Inflation Report provides a detailed exposition of recent trends in the domestic demand.

Figure 12: GDP, Final Domestic Demand, Exports (Seasonally Adjusted, at 1998 prices, Billions, TL)

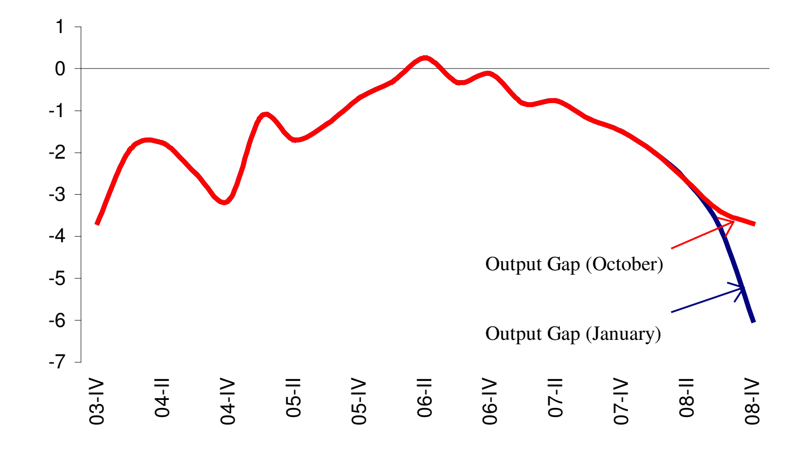


Source: TURKSTAT, CBT.

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 in about two quarters. 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 previous letter. Figure 13 displays the revision in our output gap estimates for the third and fourth quarters of 2008 with respect to the estimates appeared in the October Inflation Report. As depicted in the figure, there has been a marked downward revision for the fourth quarter, which is the major factor for the recent change in inflation and monetary policy outlook.

Figure 13: Output Gap



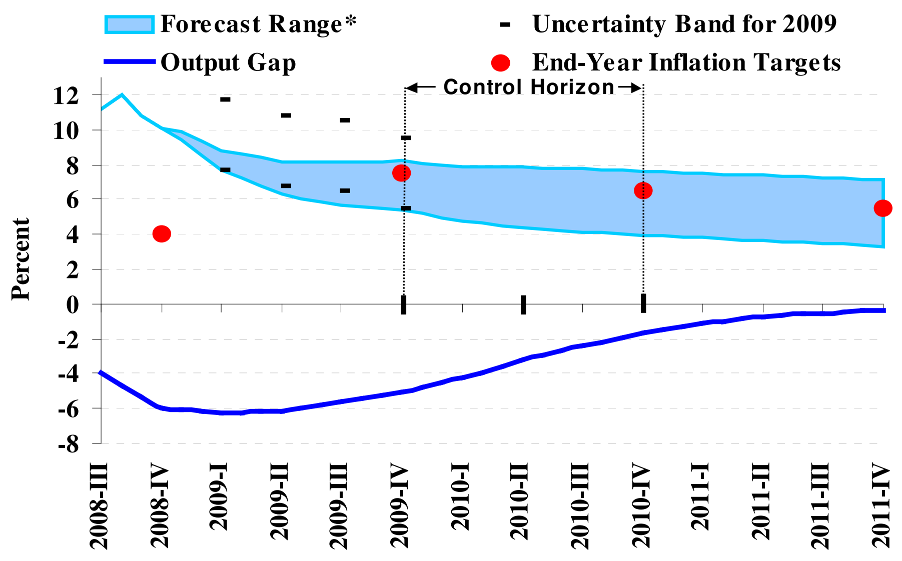
Source: CBT.

The sharp fall in oil prices is another major factor leading to a downward revision in our end-2009 inflation forecasts.[2] 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 years maturity in the first three weeks of January as a benchmark, we have revised our baseline scenario for oil prices down to USD 55 per barrel for the next two years.

The course of food inflation was close to the path outlined in the baseline scenario of the October Inflation Report. Although processed food prices followed a sharper downward trend than expected, unprocessed food inflation continued to display a high volatility, materializing at a level higher than predicted for end-2008. 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 per cent (mid-point 5.8) at the end of 2010. We expect inflation to come down to 5.2 percent by the end of 2011 (Figure 14).

Figure 14: Inflation Forecasts*



Source: CBT.
* The shaded region indicates the 70 percent confidence interval for the forecast.

[2] Research conducted by our staff suggests that a 10 percent fall in oil prices leads to a reduction in annual inflation by around 0.4-0.5 percentage points in one year. October Inflation Report provides more detail on this finding.

To sum up, there has been a downward revision in our medium term inflation forecasts, especially for the end-2009, owing mainly to the impacts of the favorable energy prices and the weakening aggregate demand. The main message of the forecast is 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 our policy stance. Therefore, assumptions on the future policy rates underlying the inflation forecast should not be perceived as a commitment on behalf of the CBT.

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 Inflation 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.

In particular, our 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, resurge 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.

Our 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.

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.

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 CBT with regard to their implications for macroeconomic and price stability.

We have also attached, for your consideration, our latest Inflation Report dated January 26th of 2009, which provides a more comprehensive analysis of the issues presented in this open letter.

Yours Sincerely,

CENTRAL BANK OF TURKEY
Head Office

Durmuş Yılmaz
Governor

Erdem Başçı
Deputy Governor